Equity Investment Within the LGPS

Over the year to end March 2018 the average Local Authority pension fund, as represented by the PIRC Local Authority Universe*, returned 4.5%.

In a year where returns were quite tightly grouped strategic asset allocation decisions had less of an impact than usual. The key differentiator in the latest year was the performance of active equity managers. Funds that did well tended to have seen strong outperformance by their global equity managers. As a group these managers outperformed their benchmarks by 2% over the year but, as ever, there was a wide range of results.

The longer term results however are less stellar. Over the last three years the active global equity manager outperformed their benchmarks by 0.5% p.a. after fees. Across the LGPS universe, much of this outperformance was due to one manager – Baillie Gifford. When this manager is removed from the results the remaining portfolios saw, on average, no added value after fees from their managers. The results are slightly better over the last five years, however over this period there will be some survivor bias as the result of mandates terminated (often as a result of disappointing performance).

Despite increased research, analysis and coverage it still appears that active equity managers are appointed largely on the back of strong recent performance. Many funds are still feeling the costly impact of such a decision – when they appointed AllianceBernstein after a period of extremely good results – dragging upon their medium term results. More recently a number of funds have had a similar experience with GMO; appointing after strong performance and subsequently seeing that performance fall away.

Over both the three and five years the number of portfolios outperforming by 2% p.a. was small. Funds who set their manager this ‘high alpha’ target had only a slim chance of achieving it. The probability of finding more than one manager that achieved such an outperformance would have been extremely small.

The results for UK mandates demonstrated similar difficulties.

Expensive Indexation?

It is worth noting that in some of the emerging pooling structures a number of active managers may be put together in a multi manager arrangement. The rationale behind such a structure is that the managers will have different strategies that will be lowly correlated and therefore volatility will reduce whilst active value can be added across all managers through skilful selection.

Whilst such an arrangement will almost certainly have a lower level of volatility than using a single manager, unless those selecting active managers demonstrate considerably more skill than has been shown before, the risk is that active manager added value is diluted.

Funds could get broadly index returns whilst paying active manager levels of fees. Fund should ensure that they are comfortable that manager selection skill can be evidenced otherwise low cost index tracking would seem to be the more measured decision.

Not Quite Passive?

Interestingly, even with the less than stellar results from active equity managers, the move towards passive investment that has been progressing slowly for over a decade, paused in the latest year. There has been an increase however in 'alternative indexation' or 'smart beta' strategies whereby assets are managed against a benchmark designed for a specific purpose rather than to reflect an overall market. There is much interest currently in 'low volatility' index strategies where funds seek to reduce some of the risk of investing in equities by investing in a subset of stocks that have more stable performance than their peers. The rationale for the investment is that this basket of stocks will deliver market return at lower than market volatility. Whilst managed on a passive basis, it could be argued that these reflect active stock selection decisions (insofar as the decisions are made around the stocks that are chosen within the index benchmark) and that the overall investment should be measured against the market index, as well as its own basket of securities. It will be interesting to see how these investments fare over the coming years.

*at end March 2018 the PIRC universe comprised 62 funds with a value of GBP 177bn

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