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Ms Victoria Edwards
Department for Communities and Local Government
Eland House
Bressenden Place
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11th July 2014

Dear Ms Edwards,

Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

The CFA Society of the United Kingdom (CFA UK) is pleased to share its views, ideas and observations about the Department for Communities and Local Government (DCLG) consultation 'Local Government Pension Scheme (LGPS): Opportunities for collaboration, cost savings and efficiencies'. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC).

The PSMPC identifies and monitors key regulatory and best practice developments likely to affect CFA UK members. CFA UK members abide by a Code of Ethics and Professional Standards that focuses on placing client interests first; there is summary of the Code and Standards in the Appendix.

Overview – the interests of the member/beneficiary should have priority

"In contrast to the duties on private sector occupational pension schemes, there is no specific requirement in the LGPS Investment Regulations to invest scheme assets in the best interests of scheme members."
(Law Commission: Fiduciary Duties of Investment Intermediaries, July 2014)[1]

CFA UK previously responded to the call for evidence[2] on this extremely important topic and set out its views as to how to identify areas for LGPS reform. We were hoping that these suggestions would have been given consideration and formed part of any evidence base that was developed. Sadly, we conclude that DCLG has proposed a one size fits all approach that, we believe, is not supported by the evidence commissioned and neglects the potential impact on the scheme member and beneficiary.

The Law Commission states that the LGPS *"is not technically a trust, though at a practical level the duties of those managing the scheme's assets will be similar."* However, it appears that in contrast to the duties on private sector occupational pension schemes, there is no specific requirement in the LGPS Investment Regulations to invest scheme assets in the best interests of scheme members. We note the Law Commission's observation:

"article 18(1) of the IORP Directive imposes a "best interests" duty. Member States must require that "institutions for occupational retirement provision" in their territories invest in accordance with the "prudent person" rule. In particular, the following rule must be complied with:
The assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries. This

[1] Fiduciary Duties of Investment Intermediaries, July 2014, Law Commission
http://lawcommission.justice.gov.uk/publications/fiduciary_duties.htm

[2] CFA UK response to the Department for Communities and Local Government (DCLG) call for evidence on the future structure of the Local Government Pension Scheme
https://secure.cfauk.org/assets/1302/CFA_UK_response_LGPS__SENT__2_.pdf

provision has only been transposed into UK law for private sector occupational pension schemes."

While we accept that the administering authority and local taxpayers interests also need to be taken into account, the priority should be about how the LGPS reforms serve the interests of each fund's members/beneficiaries. Ideally, we would hope that the funds are administered and managed as if they were trusts and so exercise fiduciary duty. It would be a tragedy if any of the intended LGPS reforms resulted in significant detriment to the members and beneficiaries of these schemes. It is not clear the consultation recognises this.

CFA UK would have been able to be more supportive of the consultation if it had commissioned and drawn conclusions based on comprehensive fund by fund research that permitted like for like comparisons within the Scheme, rather than research that focuses solely on costs.

Having a focussed fund oriented strategy for reform could prove more efficient and cost effective than any proposal based on a 'one size fits all' approach based on aggregated data. Such an approach would have empowered the DCLG to assess which funds might benefit from assistance. Those funds that can demonstrate they are delivering value for money should be encouraged to share best practice. [3]

Economies of scale [4]

"*Differences in investment policy do indeed have a significant impact in explaining differences in fund returns. Thus, raw fund returns are too noisy to be subjected to comparative measurement. Factors such as fund size, management mode, and type of sponsor do not explain differences in policy-adjusted returns in a significant, consistent manner"*

(Keith P. Ambachtsheer, 1994)

Based on Hymans' research, the consultation concludes that having large common investment vehicles (CIVs) for investing passively and accessing alternative investments will provide cost

[3] The Economics of Pension Fund Management, Keith P. Ambachtsheer
Financial Analysts Journal, November/December 1994, Vol. 50, No. 6:21-31.

[4] Why We Need a Pension Revolution, Keith Ambachtsheer
Financial Analysts Journal, January/February 2007, Vol. 63, No. 1:21-25.

savings. However, the consultation admits that the actual costs the proposals could save are unknown. Based on the official data published with the call for evidence, the costs related to the assets of the LGPS are 0.3% of the assets (with total assets of £180 billion this equates to some £536 million). Hymans's report estimates that the total asset management costs are as high as £790 million or 0.4% of total assets (paragraph 2.5 of the consultation). This is still dwarfed by fund deficits which are estimated at £99.3Bln[5].

Distribution of LGPS

The research did not convey the distribution of the assets, liabilities, costs and income of the funds in the LGPS. We have formulated Table 1, below, based on our analysis of the available data. It sets out the median, average, maximum and minimum data for the total expenditure, income, fund management costs as a percentage of expenditure and the pension fund assets. It shows that the median fund management costs as a percentage of the pension fund for the 89 LGPS in England and Wales is 0.3%. 50% of the funds have a cost ratio of between 0% and 0.3% and the remainder a cost ratio of 0.3% to 0.8%.

Table 1 – Distribution of LGPS data

	Expenditure (£000)	Income (£000)	Difference Income less expenditure (£000)	Fund management costs as a % of pension fund	Fund Value 1 Apr 2012 (£000)
Median	71,820	93,916	18,509	0.3%	1,199,000
Average	102,043	133,399	31,357	0.3%	1,767,474
Maximum	530,008	675,021	202,008	0.8%	11,142,716
Minimum	10,679	8,954	-60,439	0.0%	174,410

Source: Local Government Pension Funds 2012/13

The Office for National Statistics (ONS) shows that LGPS expenditure has increased markedly between 2008/09 (when it was £6,502 million) and 2012/13 (by which time it has risen to £ 8,490 million). However, in proportion to the size of the funds the increase in costs is less marked (a decline from 6.6% to 5.1%) and within this the costs of managing the funds in the scheme, as a percentage of total expenditure, have only marginally increased from 5.8% in 2008/09 to 6.0% in 2012/13. The costs of managing the funds fell as a percentage of assets (0.37% in 2008/09 compared to 0.29% in 2012/2013) despite a trend towards increasingly

[5] Whole Government Accounts 2012-13. Note 27 page 118.

complex investment arrangements, extensive revisions of pensions contributions, benefits and auto enrolment.

Given the lack of evidence at fund level we are sceptical about the ability to generate the savings figure given. We have no evidence that these 'savings' will benefit the member/ beneficiary or administering authority, both of whose interests are best served by optimising the risk adjusted net return. The research commissioned from Hymans was too narrow in its focus. We cite a more robust way of developing the evidence base to look at the potential efficiencies available across LGPS funds, based on the work of Keith Ambachsteer's (a prominent and renowned pensions specialist).

Pension fund management involves creating one of the two following relationships over time:

Policy return = f(Policy risk-cost), or

Policy return+ Additional return= f(Policy risk-cost, Additional risk-cost).

Ambachsteer states that the following approaches need to factored in when assessing pension fund management operations.

1. Total fund returns must be decomposed into policy- and implementation-related components before any peer-relative comparative analyses are performed. Funds may have different investment policies because of differences in such factors as liability structure and risk tolerance, so policy-related return components across different funds contain no information about management skill.

2. To understand the sources of implementation- related fund return, it is useful to decompose it into within-asset class and across-asset-class (mix) segments. Ideally, return (and risk) decomposition continues down to the level of individual portfolio management mandates within the fund.

3. When peer comparisons of fund returns are made, only implementation- related fund return (and risk) components calculated with identical decomposition procedures are comparable.

4. Total fund operating costs must be de-composed into minimum-required and incremental components before any comparative analyses are performed. Because funds have different asset values and different investment policies, minimum-required operating costs across different funds will differ and will contain no information about management skill.

5. To understand the sources of incremental operating costs, it is useful to further decompose them into those directly related to investment management and those related to governance and administration. Ideally, the costs directly related to investment management should be further decomposed down to the level of individual portfolio management mandates within the fund.

6. When peer comparisons of fund operating costs are made, only incremental operating cost components calculated with identical decomposition procedures are comparable.

7. When peer comparisons of fund re-turn-operating cost combinations are made, only implementation-related fund return and incremental operating cost combinations calculated with identical decomposition procedures are comparable

Table 2 demonstrates the approach using empirical evidence for the years 1991-1993. The table shows that high value added schemes can be both high cost and low cost; cost is not a determining factor of value add. Ambachsteer also found that high value added funds are those of a larger size or $333 Mln -$380 Mln (c£200Mln). This fund size criteria implies that all the funds in the LGPS are 'large'. The average fund size (see Table 1) is £1.7 billion while the smallest fund size is £174 million.

Following the above approach one can derive a benchmark for operating costs of the funds and assess how each fund compares to a peer benchmark. However, while this approach considers operational costs it does not focus on the key metric, which is risk adjusted return. For example while a fund may have higher costs than its benchmark, if this is because it generates higher risk-adjusted benefits then the fund should be allowed to continue with its approach. Similarly a fund that has costs lower than its benchmark but can improve its risk-adjusted position by paying higher fees should be allowed to do so.

The evidence that tries to link cost savings and size is not proven; yet the DCLG proposals rae based on this unfounded assumption.

Table 2: Average Fund Characteristics Based on Cost-Effectiveness Experience

	Hi-VA		Lo-VA	
Characteristic	Lo-Cost	Hi-Cost	Lo-Cost	Hi-Cost
Implementation returns	1.2%	1.7%	−1.0%	−0.7%
In asset class	0.9	1.6	−0.9	−0.6
Mix	0.3	0.2	−0.1	−0.2
Incremental costs (basis points)	−6	+7	−8	+9
Average dollar size (billions)	$15.7	$4.7	$2.0	$8.8
Median size (billions)	4.5	1.1	0.5	1.1
Percent internal passive	14%	2%	2%	1%
Percent internal active	28	4	25	19
Percent external passive	14	14	8	5
Percent external active	44	81	65	75
Number of external managers[a]	12	15	4	8
Average dollar mandate (millions)	$380	$333	$121	$159
Percent performance fees[b]	5%	8%	2%	4%
Total funds	26	26	18	6
U.S. funds	15	16	3	1
Canadian funds	11	10	15	5
Corporate funds	14	23	8	5
Public funds	10	3	9	1
Other	2	0	1	0

[a] External managers with stock, bond, or TAA mandates.
[b] Percent of total assets covered by performance-based fees; funds having zero percent are included.

Since costs are not the determining factor in value added, we must look to the skills and expertise available to manage fund assets, aligning asset risk to liability profile. Perhaps the use of large CIVs may help attract suitably qualified candidates for implementation, but as we noted in our response to the call for evidence, the commercial realities may make this difficult. Part of any reform should be directed at improving the skills and expertise of those running LGPS funds.

One size does not fit all

"To get out of the pension crisis hole, the first step involves creating a liability index customized to client needs. No two liabilities are ever alike—they all have different schedules and shapes—and because of that variability, they will have different growth rates. Given the wrong benchmark, the client receives the wrong risk–reward."
(Ronald J. Ryan, CFA, President Ryan Labs, Incorporated)[6]

[6] Pension Fund Management: Addressing the Problem of Asset/Liability Mismatch; Ronald J. Ryan, CFA CFA Institute Conference Proceedings, August 2004, Vol. 2004, No. 6:33-42.
http://www.cfapubs.org/doi/pdf/10.2469/cp.v2004.n6.3439

Table 3: Asset allocation of some other funded public sector schemes

Pension Fund	Equities %	Bonds %	Property %	Alternatives %	Value (£m)
BR (Railways Pension Scheme)	57	33	9	2	18,226
British Coal Staff Superannuation Scheme	68	17	7	7	9,105
Mineworkers Pension Scheme	66	19	10	5	10,960
The BT Pension Scheme	23	46	11	20	38,783
The Audit Commission Pension Scheme	0	14	0	86	662
Bank of England Pension Fund	0	100	0	0	3,122
The British Museum Company Ltd Ret Bens Plan	8	15	15	62	10
British Tourist Board Staff Pension Life Assurance Scheme	41	27	9	23	197
British Transport Police Railway Pension Scheme	53	17	9	21	76
British Waterways Pension Fund	57	43	0	0	308
Combined Nuclear Pension Plan (all sections)	40	35	10	15	678
Combined Nuclear Pension Plan (Closed section)	70	30	0	0	72
GPS Pension scheme (at 31/3/2012 before transferring to CNPP) in WEC/UAM/SLC	38	34	9	19	539
Nirex Pension Scheme (part of CNPP)	50	50	0	0	26
Environment Agency Active Fund	78	19	3	0	2,122
Environment Agency Closed Pension Fund	0	100	0	0	167
Financial Services Authority	48	45	6	0	484
Highlands and Islands Airports	58	42	0	0	71
Highlands and Islands Enterprise	61	39	0	0	64
Legal Services Commission No.4 Pension Scheme	45	52	0	3	352
OFCOM Staff Pension Scheme	16	22	0	62	249
PCPF	69	21	10	0	493
Student Loans	40	30	10	20	57
WEIGHTED AVERAGE/TOTAL	**41**	**38**	**9**	**12**	**86,824**

Source: Hyman Robertson LGPS Structure Analysis[7]; Environment Agency funds are also part of LGPS.

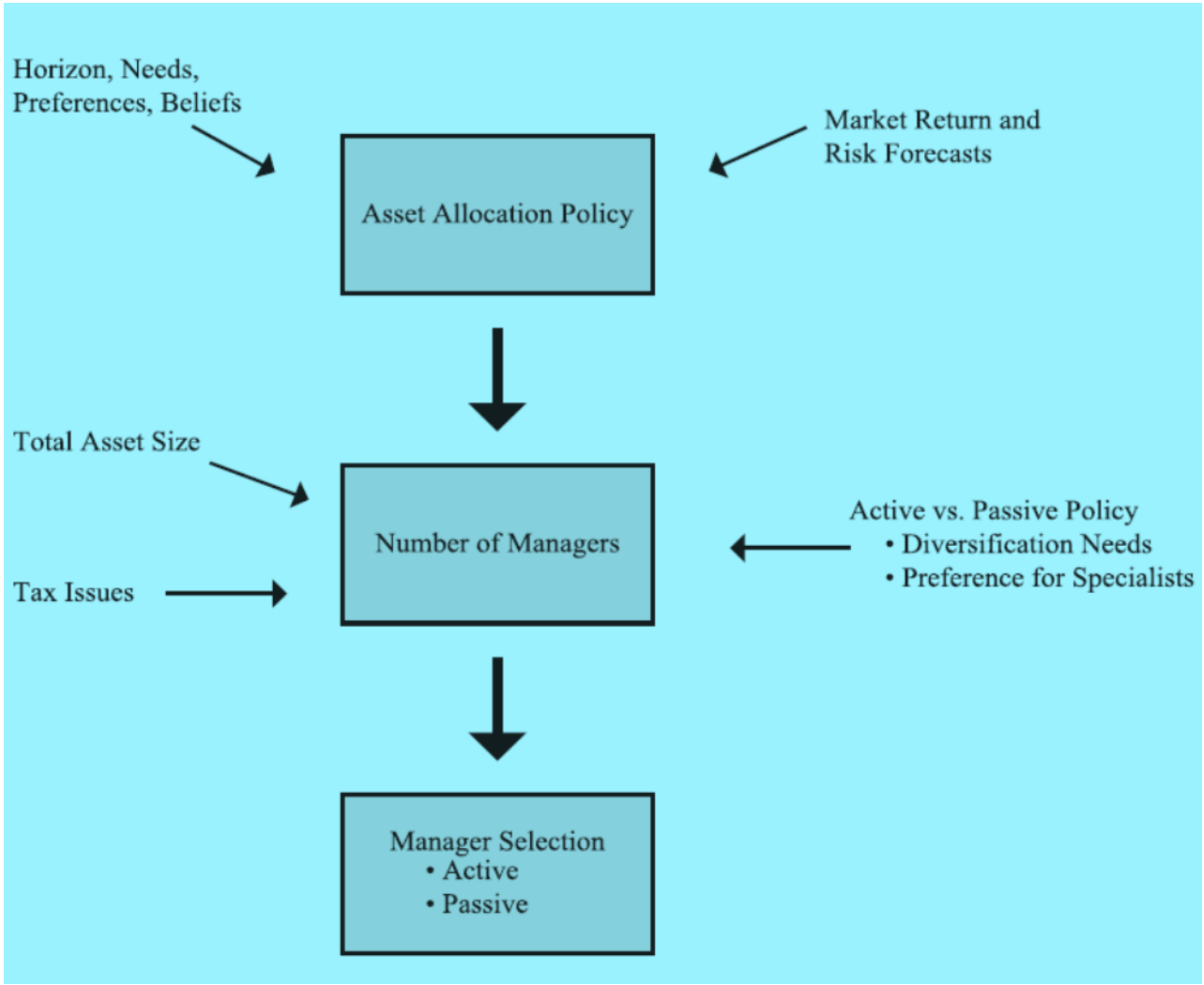
The suggestion within the consultation that only a small number of CIFs might be a plausible solution, gives the impression that the Government believes that all funds in the LGPS may have similar needs and therefore implies that the they have the same liability profile and administering authority risk profile. We would have liked to see research commissioned that –

[7] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

- Recognised the differing liability profiles of each fund
- Recognised the particular nature of assets that could hedge this liability profile cost effectively, taking into account both their risk characteristics and their return prospects
- Identified which funds could benefit from cost savings.

How each fund should best meet its liabilities will differ and this is not obviously recognised by the Hymans Robertson research. Table 3 (19) from the Hymans Robertson research shows the diversity in asset allocation between pension funds, which demonstrates that funds structure their portfolios very differently.

Figure 1: Implementation process –Liability profile will the main driver



The Statement of Investment Principles (SIP) should be a robust governance tool to ensure that a fund's portfolio remains aligned with its goals and preferences. It is our view that all aspects of the SIP should remain under the control of local authorities. Figure 1 sets out the decisions that need to be made by a fund to meet its objectives. The key driver for portfolio construction for each fund will be the liability profile. Decisions include asset allocation, asset/passive mix, use of alternatives etc and when constructing any portfolio the aim should be to maximise risk-adjusted returns.

Active vs Passive

When constructing any portfolio to meet an objective, the aim should be to use the most appropriate combination of investments that can maximise the chance of meeting the required risk-adjusted return net of costs. There are a variety of approaches that can be used ranging from all passive funds to all active funds or a combination of both. Regardless of whether the fund is passively or actively managed there must be a rationale for its inclusion in the portfolio. Conversely, the same rationale should apply when removing an investment from a portfolio.

CFA UK is agnostic about whether assets should be managed actively or passively. What is important from our perspective is that most appropriate portfolio is constructed so that it reflects the requirements and preferences of the ultimate beneficiary. Therefore, it is essential that DCLG allow funds to consider the key factors related to active, passive and alternative asset management. Cost alone should not be the main driver for selecting investments.

Active management

The wealth of empirical evidence into the active vs passive debate is based on the theoretical view that markets are efficient. The only way to 'beat the market' is by taking on additional risk. The active vs passive debate has long been a discussion focussed on cost and performance. The third dimension missing from this discussion is risk. Asset management is as much about risk management as it is about performance generation. Risk-adjusted returns are what matter. Even if all schemes adopted a passive approach they would still be exposed to market risk and should achieve performance net of fees that was below the market return.

Table 4 provides further insight as to why risk-adjusted returns matter and compares two hypothetical funds that invest in UK equities. Both the passive and active funds generate gross returns of 20%. However in our example, after costs, the active fund underperforms the passive fund; the immediate response might be to choose the passive fund. This would most

likely be the wrong decision because the active fund in our example has managed the risk better than the passive alternative, which is reflected in the risk-adjusted return – the active fund has a 14% higher risk-adjusted return than the passive fund. So while the passive fund appears to be cost effective and delivers higher net returns than the active fund, the active fund is the better choice. Switching from an efficient active fund to an inefficient passive would worsen the risk/reward ratio of the portfolio; thereby increasing the risk of deficits.

Table 4 – Illustration of risk-adjusted returns

UK equities	Active	Passive
Return	20.0%	20.0%
Total costs	1.0%	0.5%
Net return	19.0%	19.5%
Volatility	17.0%	20.0%
Risk-adjusted return	**1.12**	**0.98**

According to the CFA Institute's Research Foundation monograph 'Manager Selection'[8]

"Although the whole population of managers cannot be winners, some managers will beat the market or earn a positive alpha (that is, beat the relevant benchmark after an appropriate adjustment for risk)."

Among the research cited in the monograph is that undertaken by Eugene Fama[9] and Kenneth French (2010), who reviewed the distribution of active manager performance and compared it with a random distribution of zero-mean alphas to determine statistically whether over- and underperforming managers deliver results from the application of skill or simply based on luck. Their tests suggest that more managers generate high levels of statistically significant risk-adjusted performance than randomness alone would suggest and, similarly, that more managers generate statistically low levels of alpha than would be expected from luck.

Table 5 summarises their statistical analyses, listing t-statistics of alphas computed over a 22-year period for groups of managers, sorted by computed t-statistics and compared with a distribution of t-statistics from a randomised world with variable but zero alphas. The alphas

[8] Manager Selection , Research Foundation Publications December 2013, Vol. 2013, No. 4 by Scott D. Stewart, CFA http://www.cfapubs.org/toc/rf/2013/2013/4

[9] Eugene Fama recently shared the Noble Prize for Economics awarded in 2013

are listed in the form of t-statistics, rather than raw alphas, to standardize for variability through time. A positive number in the third column of Table 5 indicates that a group outperformed the simulated results; the top 10% and top 5% of the sample have positive numbers in this column, which provides evidence that those groups added value. To summarise, the top and bottom 10% of mutual fund managers have generated gross alphas higher and lower, respectively, than simple randomness in a population would give you. The test results indicate that there is skill in the tail deciles, gross of expenses. While there is little evidence to indicate there is sufficient statistically significant alpha to cover expenses; active may still be providing risk-adjusted returns that may be ahead of the equivalent benchmark.

Table 5 t-Statistics of Alphas for Percentile Ranges of Actual vs. Simulated Zero-Alpha Managers, 1984–2006

Performance Percentile for Fund	*t* -Statistic for Actual	*t* -Statistic for Simulation	Difference
Bottom 5%	–2.1	–1.7	–0.4
Bottom 10%	–1.6	–1.3	–0.3
Bottom 40%	–0.3	–0.3	0.0
Top 40%	0.3	0.3	0.0
Top 10%	1.6	1.3	0.3
Top 5%	2.1	1.7	0.4

Note: *t*-Statistics are based on monthly time series of regression-estimated, four-factor, gross-of-expenses alphas for US equity mutual funds.
Source: Fama and French (2010).

Barras, Scaillet, and Wermers (2010) also sought to separate skill from luck when studying manager alphas in US mutual fund data and tested ways to capture future positive alpha. For the period 1979–2006, they reported a declining percentage of skillful managers as the number of total funds grew dramatically. They demonstrated a technique that included estimating both the number of skillful managers through time and a measure of luck for each manager. They then applied both estimates to annual manager rankings. This selection technique has been shown to be superior to ranking managers solely by historical returns, alphas, or t-statistics.

While in aggregate active management may not deliver value, research indicates that there are active managers that do deliver superior risk-adjusted returns. Admittedly such managers

are few in number, but if funds currently have access to such managers then forcing them to switch to passive mandates undermines the integrity of their portfolios, perhaps compromising their fiduciary duty. Furthermore, altering the funds opportunity set in this way could also reduce their expected risk-adjusted and thus increase the shortfall risk.

Funds that do have access to high quality active managers should determine an appropriate division of the expected excess return between the asset manager and the fund. There may be scope for a fee code to be developed which we would support as the subject of a future consultation.

Alternatives

Table 6 Characteristics of Traditional and Alternative Investment Portfolios

	Publicly Traded Securities	Non-Publicly Traded Securities
Instruments	Equities, fixed income, commodity futures, REITs, high yield	Private equity, direct real estate, direct commodities, distressed
Portfolio construction	Diversified	Concentrated
Portfolio transparency	High	Low
Liquidity	High	Low
Funding	Quick implementation	Commitment implemented over time
Information sources	Much, publicly available	Much, privately collected
Fund accessibility	Commonly open	Commonly limited
Asset accessibility	Open	Limited
Asset ownership	Passive	Active
Leverage	Uncommon	Financial leverage common
Fees	Lower	Higher, performance based

Source: Manager Selection

Alternatives include private equity, hedge funds, commodities, loans etc. For some property is considered an alternative but for others it is a mainstream asset. However all of these assets are usually less liquid than traditional asset classes. In some cases the investor has to wait ten or more years before exiting a Private Equity Limited partnership. Investors in limited partnerships do not typically have an easy option to terminate their managers, making the manager selection process critical. Table 6 presents the characteristics of traditional and alternative assets. For the purpose of the consultation it is useful to consider what asset classes fall under the definition of listed versus unlisted. Public equities and corporate bonds are listed while most alternatives are unlisted.

Alternatives bring their own challenges. Timing can be more difficult to implement - an investor may think that private equity valuations are low, but the process of identifying and funding a private equity manager could take years. Portfolios of alternatives may be riskier than portfolios of publicly traded securities as they commonly include financial leverage however they can also be a risk mitigating asset for funds (e.g. secondary infrastructure offering an index linked payment stream not dissimilar to fund liabilities).

Table 7: Evidence of Alternative Investment Alphas Based on Results from Four Research Studies

	US Equity Mutual Funds	Fund-of-Funds Hedge Funds	Venture Capital	Private Equity	Real Estate
Evidence of positive average net alpha	Zero	Marginal	Mixed	Mixed	Marginal
Evidence of superior managers	Limited	Yes	Yes	Yes	Limited
Evidence of alpha persistence	Limited	Yes	Yes	Yes	Limited
Evidence of flows to positive-alpha managers	Yes	Yes	Yes	Yes	Yes

Notes: "Marginal" means there is some evidence of positive alpha but net alpha is not statistically significant at a high confidence level. "Mixed" means some evidence suggests positive net alpha but other evidence suggests only marginal alpha. "Limited" means there is evidence for a subset of the universe but that it is not necessarily sufficient for supporting profitable trading strategies.
Sources: The hedge funds study is Fung, Hsieh, Naik, and Ramadorai (2008). The venture capital and private equity study is Kaplan and Schoar (2005). The real estate studies are Lin and Young (2004) and Bond and Mitchell (2010).

As with standard asset assets, superior alternative asset managers do exist and like their contemporaries face challenges when it comes to capacity. Successful alternative strategies often get crowded out, so large CIVs may find securing investments at an attractive price will be a challenge.

Management fees charged by alternative investment managers are much higher than those charged by managers of liquid portfolios. Despite the challenges involved in selecting and investing with alternative managers, hedge funds, private equity, real estate, and commodities remain popular with investors, as illustrated in Table 7.

Passive – why is alternative beta not considered ?

As set out in 'Manager Selection' passive management is not without problems, something not reflected in the Hymans Robertson research. The goal of an index fund manager is to track a pre-specified index as closely as possible. The measure for replication success is called "tracking error" and the acceptable level depends on both the relevant security market and the size, liquidity, and stability of the index. Index construction and maintenance rules also affect the ability of an index manager to succeed.

Sources of tracking error include –

- imperfect security weightings (for example, those attributable to delayed adjustment to constituent changes);
- cash build up (when the portfolio is not 100% invested because of income, corporate actions, contributions, or withdrawals);
- transaction costs (trading to handle constituent changes and cash flows);
- sampling error; and
- model error (because statistical models for building index portfolios that do not own every index constituent do not provide perfect forecasts).

Tracking equity indices with liquid constituents, like MSCI world, is easier than those with many constituent companies, illiquid securities, or fixed-income securities (because bonds typically do not trade in small lots and many issues that are not current may not trade at all). The latter may require "sampling" techniques because not all constituents can be purchased. Effective sampling techniques go beyond random selection and instead require the use of statistical models that measure risk exposures and help managers build portfolios that are forecast to exhibit low tracking.

In Table 4 we highlighted the importance of risk-adjusted returns. This also has to apply to assessing passive investment vehicles. However, this is not as straightforward as it appears. Traditionally a passive portfolio consisted of securities weighted by their market value. However, evidence demonstrates that this approach is not efficient and so this has resulted in finding alternatives ways, such as fundamental factors, to weight the constituents of an index-tracking portfolio, but as soon as one moved away from markets weights an index cannot be tracked passively as regular rebalancing is required.

The developments in indices has resulted in what is commonly known as alternative 'smart beta'[10]. In the paper by Chow et al they show how different approaches to weighting portfolios can bring about different outcomes. Alternative weights are used to construct the portfolio for example equal weights, risk weighted and using accounting metrics to weight the portfolio using business related factors e.g sales. In doing it has been shown that these alternative approaches to beta (or market return) can result in better risk-adjusted returns than their traditional passive counterparts.

Table 8: Return Characteristics of Annually Rebalanced Global Strategies for 1,000 Stocks, 1987–2009

Strategy	Total Return	Volatility	Sharpe Ratio	Excess Return over Benchmark	Tracking Error	Information Ratio	One-Way Turnover
MSCI World Index[a]	7.58%	15.65%	0.22	—	—	—	8.36%
Heuristic-based weighting							
Equal weighting	8.64%	15.94%	0.28	1.05%	3.02%	0.35	21.78%
RCEW (*k* clusters)	10.78	16.57	0.40	3.20	6.18	0.52	32.33
Diversity weighting ($p = 0.76$)	7.75	15.80	0.22	0.16	1.60	0.10	10.39
Fundamental weighting	11.13	15.30	0.45	3.54	4.77	0.74	14.93
Optimization-based weighting							
Minimum-variance	8.59%	11.19%	0.39	1.01%	8.66%	0.12	51.95%
Maximum diversification	7.77	13.16	0.27	0.18	7.41	0.02	59.72
Risk-efficient ($\lambda = 2$)	8.94	14.90	0.32	1.35	3.58	0.38	36.40

[a]For the MSCI World Index, we report the turnover of a simulated global developed cap-weighted index of the top 1,000 stocks rebalanced annually on 31 December.

Tables 8 and 9 set out these different approaches for global equities and U.S securities and compares these with the standard passive index. On a risk-adjusted basis most of the alternative approaches do outperform the traditional passive index and produce higher risk-adjusted returns – the key metric that matters.

[10]A Survey of Alternative Equity Index Strategies; Tzee-man Chow, Jason Hsu, Vitali Kalesnik, and Bryce Little Financial Analysts Journal, September/October 2011, Vol. 67, No. 5:37-57.
http://www.cfapubs.org/doi/pdf/10.2469/faj.v67.n5.5

Table 9: Return Characteristics of Annually Rebalanced U.S. Strategies for 1,000 Stocks, 1964–2009

Strategy	Total Return	Volatility	Sharpe Ratio	Excess Return over Benchmark	Tracking Error	Information Ratio	One-Way Turnover
S&P 500[a]	9.46%	15.13%	0.26	—	—	—	6.69%
Heuristic-based weighting							
Equal weighting	11.78%	17.47%	0.36	2.31%	6.37%	0.36	22.64%
RCEW (*k* clusters)	10.91	14.84	0.36	1.45	4.98	0.29	25.43
Diversity weighting ($p = 0.76$)	10.27	15.77	0.30	0.81	2.63	0.31	8.91
Fundamental weighting	11.60	15.38	0.39	2.14	4.50	0.47	13.60
Optimization-based weighting							
Minimum-variance	11.40%	11.87%	0.49	1.94%	8.08%	0.24	48.45%
Maximum diversification	11.99	14.11	0.45	2.52	7.06	0.36	56.02
Risk-efficient ($\lambda = 2$)	12.46	16.54	0.42	3.00	6.29	0.48	34.19

[a]For the S&P 500, we report the turnover of a simulated U.S. cap-weighted index of the top 500 stocks rebalanced annually on 31 December. Actual S&P 500 turnover is generally lower owing to committee-based stock selection rules.

The authors then carried out a transaction cost analysis for a $100 million mandate and applied it to each type of portfolio. The summary of these results are set out in Table 10. Note that the trading cost estimates are naturally lowest for the market capitalisation portfolio and are economically higher for the other strategies. From the authors' estimations, however, it can been seen that the transaction costs for most strategies generally do not erode the entire return in excess of the benchmark. Based on this evidence we would encourage DCLG to acknowledge that there are alternatives to traditional passive approaches that can deliver better risk-adjusted returns and hence better outcomes for funds and their beneficiaries.

Table 10 Transaction Cost Analysis

	Global (1987–2009)						U.S. (1964–2009)					
Strategy	Excess Return over Benchmark	One-Way Turnover	Market Cap (US$ billions)	Avg. Bid–Ask Spread	Adj. Daily Volume (US$ millions)	Trading Costs[a,b,c]	Excess Return over Benchmark	One-Way Turnover	Market Cap (US$ billions)	Avg. Bid–Ask Spread	Adj. Daily Volume (US$ millions)	Trading Costs[a,c]
Cap-weighted benchmark		8.4%[d]	66.34	0.11%	464.91	0.10%[d]		6.69%[e]	80.80	0.03%	735.40	0.03%[e]
Heuristic-based weighting												
Equal weighting	1.05%	21.8%	23.90	0.16%	174.96	0.31%	2.31%	22.6%	11.48	0.06%	132.49	0.22%
RCEW (*k* clusters)	3.20	32.3	37.47	0.17	189.12	0.69	1.45	25.4	37.14	0.04	312.04	0.12
Diversity weighting ($p = 0.76$)	0.16	10.4	52.37	0.12	368.16	0.13	0.81	8.9	50.53	0.04	477.87	0.06
Fundamental weighting	3.54	14.9	59.14	0.14	397.81	0.28	2.14	13.6	66.26	0.05	617.47	0.13
Optimization-based weighting												
Minimum-variance	1.01%	52.0%	23.97	0.35%	128.43	0.49%	1.94%	48.4%	19.63	0.05%	136.37	0.43%
Maximum diversification	0.18	59.7	20.08	0.45	122.50	0.57	2.52	56.0	14.77	0.06	124.08	0.53
Risk-efficient ($\lambda = 2$)	1.35	36.4	26.90	0.15	193.53	0.33	3.00	34.2	12.06	0.06	140.07	0.25

Note: Market capitalization, bid–ask spread, and adjusted daily volume are estimated for rebalancing at the end of 2009.

[a]Trading costs are estimated with the model proposed by Keim and Madhavan (1997), which accounts for (1) different exchanges, (2) size of trade, (3) market capitalization, (4) price per share, and (5) style of investment. Portfolio size is fixed at US$100 million; style of investment is set as indexed.
[b]We modified the Keim–Madhavan model to reflect additional costs for trading on the London Stock Exchange (50 bps for selling) and the Hong Kong Stock Exchange (10 bps for buying and selling).
[c]Trading costs include portfolio rebalancing only, not the costs of entering and exiting the strategies.
[d]Turnover and trading costs are based on a simulated cap-weighted index of the top 1,000 stocks in the global developed market.
[e]Turnover and trading costs are based on a simulated cap-weighted index of the top 500 stocks in the U.S. market.

Responses to questions

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

Based on the evidence we have cited in this response the use of CIVs may provide superficial efficiencies. Investment requires a three dimensional approach; the DCLG has favoured a one dimensional approach focusing purely on costs and ignored what really matters which is risk-adjusted returns net of costs. For funds it should be about aligning their portfolios with their liability profiles in the most effective way possible. We believe the DCLG consultation ignores the most important party – the member/beneficiary.

The evidence presented by DCLG does not take into account how a cost only focussed approach will affect each fund's ability to manage its liability profile. Some funds may have access to limited capacity managers on attractive terms and may be worse off if forced in to a CIV. If put in place a CIV structure cannot be a one size fits all – for example administering authorities for some funds may feel that access to certain alternative investments, regardless of their return potential, do not align with meeting the liability profile of that fund.

The consultation does not take into account the practicalities and potential diseconomies of scale from having CIVs access alternative investments. As we state above the quality managers will always face capacity constraints and just because the demand for good alternative opportunities exist does not mean that the supply will be there to satisfy that demand. While there may be a desire for investment into local infrastructure projects, these projects have to be viable on economic grounds.

If quality managers limit the capital that could be deployed, this may mean that funds in the alternatives CIVs would remain uninvested. In addition, there could be temptation to find opportunities of a lesser quality and so affect the risk/return trade-off for funds that have invested in this way. Having funds allocate capital at fund level rather than the allocation being made at scheme level reduces capacity constraint problems and perhaps enables the funds to negotiate better terms then the CIV approach.

Use of CIVs would clearly be appropriate if every scheme had the same portfolio composition to meet similar liability profiles. However as we have demonstrated one size does not fit all.

We would encourage the DCLG to undertake a more meaningful course of action in providing the appropriate evidence that is fund based rather than aggregated data. Any use of CIVs must remain voluntary.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

Until the DCLG can provide evidence to the contrary at fund level, decisions about asset allocation should be kept with the local fund authorities. This is in keeping with the stated aim of empowering local authorities to manage their finances. The use of CIVs should be at best voluntary or the Government is taking a clear step back towards centralising finance.

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

This question starts with the assumption that CIVs are the most relevant approach to take. Based on our previous answers and content of this submission the proposal to have CIVs should be delayed until more robust evidence is provided about how well each fund is aligning the portfolio with its liability profile. If DCLG is determined to have CIVs, however unsupported this course of action may be, funds should be given the choice of whether or not to participate.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

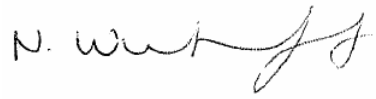
At present the DCLG has not supported its view that a CIV is an appropriate approach. We would offer an alternative solution and that is to undertake evidence gathering at fund level and identify which funds have scope to improve and which schemes are proving effective in managing their liability profile.

Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

The evidence on using aggregate performance is questionable for the reasons outlined in this response, as is any conclusion drawn from this evidence and so neither option offers the best value for taxpayers, Scheme members and employers. Unless the DCLG undertake evidence gathering at fund level it will remain unsighted as to the actual benefits available for all stakeholders, most notably the scheme members and beneficiaries. We urge the DCLG not to be tempted by headline savings that are not substantiated by the evidence and could potentially create diseconomies of scale, which in turn may harm the interests of LGPS members and beneficiaries.

We trust that these comments are useful and would be pleased to discuss them in person.

Yours,



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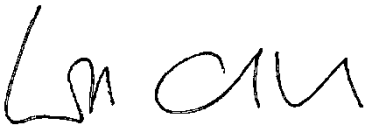

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CFA Institute

CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity of and uphold the rules governing capital markets.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:
   - **a.** Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   - **b.** Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   - **c.** Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients. Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Members and Candidates in the CFA Program. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

About CFA UK and CFA Institute

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 11,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.