

Local Authority Pension Fund Costs

Dr Chris Sier



SUMMARY

- The Total Cost of Ownership (TCO)
- Looking at some real data – Local Authority Funds
 - Administration cost
 - Investment Management Expense (the total of invoices Mgt and Performance fees)
 - Custody Fees
- Implications of the data
- London Funds
- Equity Trading
- Other costs
- What do Custodians actually do?
- Some interesting data – Fund Performance vs Fees
- Conclusion
- Afterthought

What is the Total Cost of Ownership (TCO) of a Pension for a Consumer/Scheme Member?

- This is hard to establish for a number of reasons:
 - Overt costs (Investment Management Expenses (= AMC) and Administration Expenses) can be found in annual reports but there is no benchmark
 - Covert costs (the so-called 'hidden' costs) are difficult to establish...but, significantly, not impossible
- A better measure than the oft-stated AMC and TER would be to consider the TCO from the point of view of a scheme member (the 'consumer')
 - This would include ALL costs, both overt and covert, as well as opportunity costs
 - Figures vary but it is likely that the TCO for Retail Funds is often as high as 4%

How high is the TCO for a Pension Fund and how might it be calculated?

A Simplified model for a Pension Fund Value Chain

		Overt Costs			Covert Costs											
TCO	=	Admin Exp	+	IM Exp	+	Custody Fee	+	Equity Trading <i>Commission (& Spread?)</i>	+	FI Trading <i>Spread only</i>	+	Alternatives <i>Commission & Spread?</i>	+	Stamp Duty & Taxes	+	FX Costs <i>Commission & Spread?</i>
Data obtainable?		YES		YES		YES		Commission YES Spread NO		Allegedly NO		Allegedly NO		Perhaps		Allegedly NO
Sources		- Annual Reports (AR)		-ARs		-ARs <i>sometimes</i> -Obtainable on request from Custodian		-Commission in IMA Disclosure Tables -Spread not reported or collected - Both obtainable from IM		-Never reported -Obtainable from IM		-Never reported -Obtainable from IM		ARs rarely		-Never reported -Obtainable from Custodian

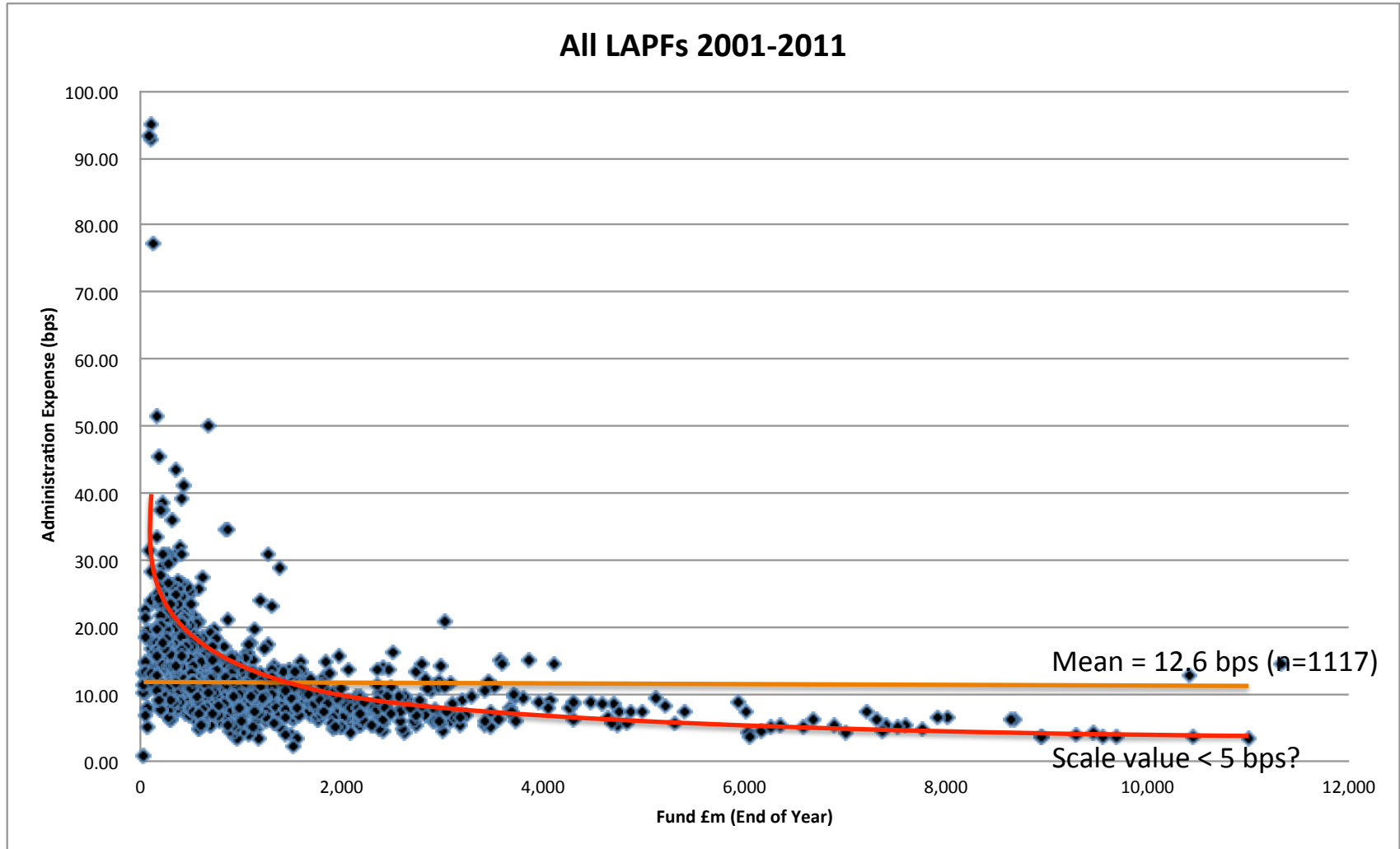
There are two additional 'Opportunity Costs', but more on these later

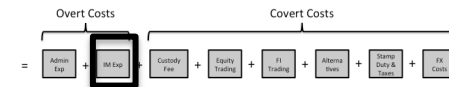
I have been trying to fill in the blanks in the TCO equation

- I have looked at:
 - Over 1000 annual reports across multiple years (2001+) across all Local Authority Pension Funds (LAPFs)
 - I have coupled this data with Equity Commission and Turnover data for some of these LAPFs for the similar time periods obtained via Freedom of Information Act (FOIA) requests for IMA Disclosure Tables by University of Oxford
- The analysis demonstrates the extent to which the value chain is NOT transparent
- Costs and performance are two sides of the same coin - reducing costs has a positive and material impact on Pension Fund performance

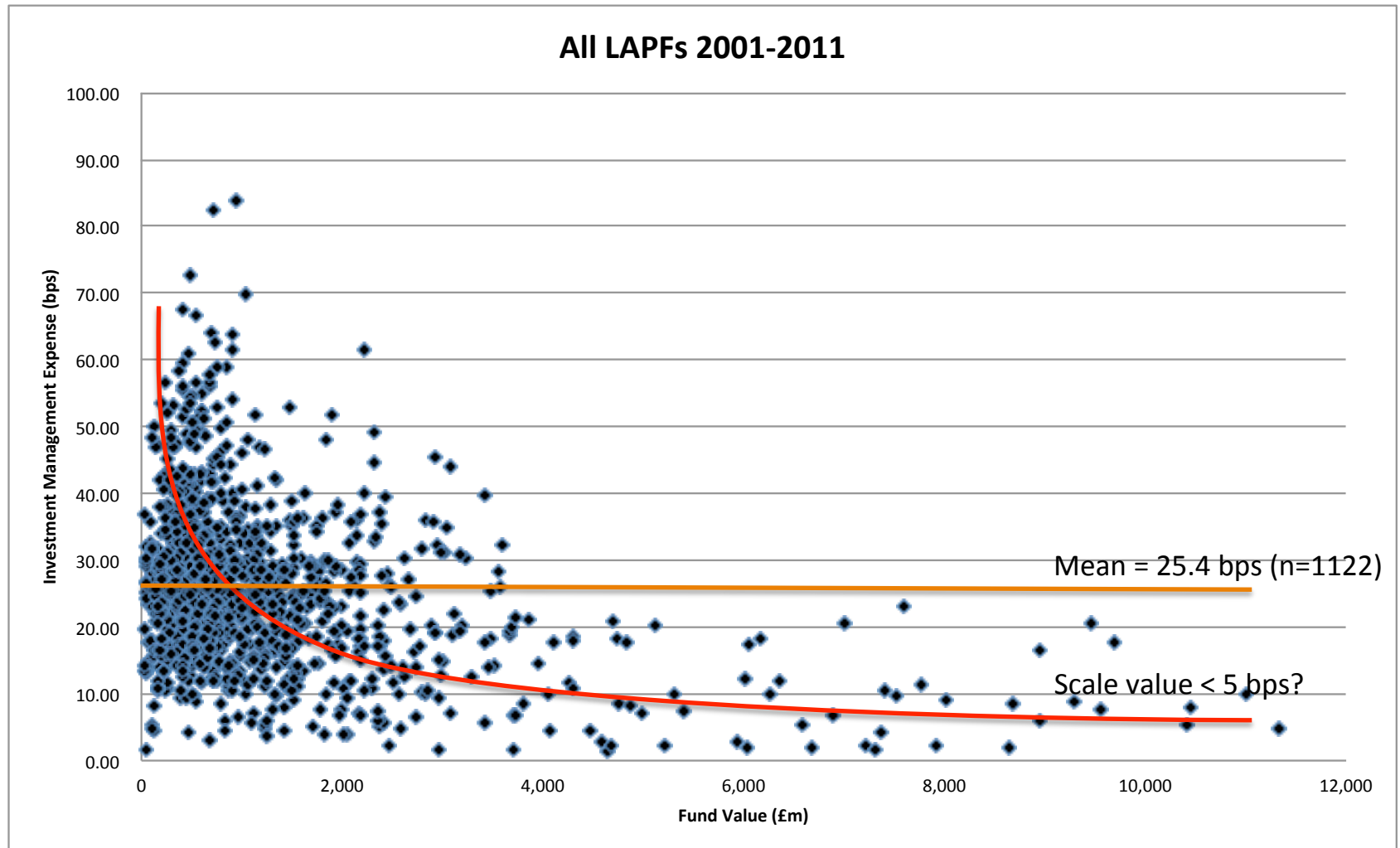
My Aim: To create a not-for-profit 'social' business to provide cost analysis

Administration Expenses





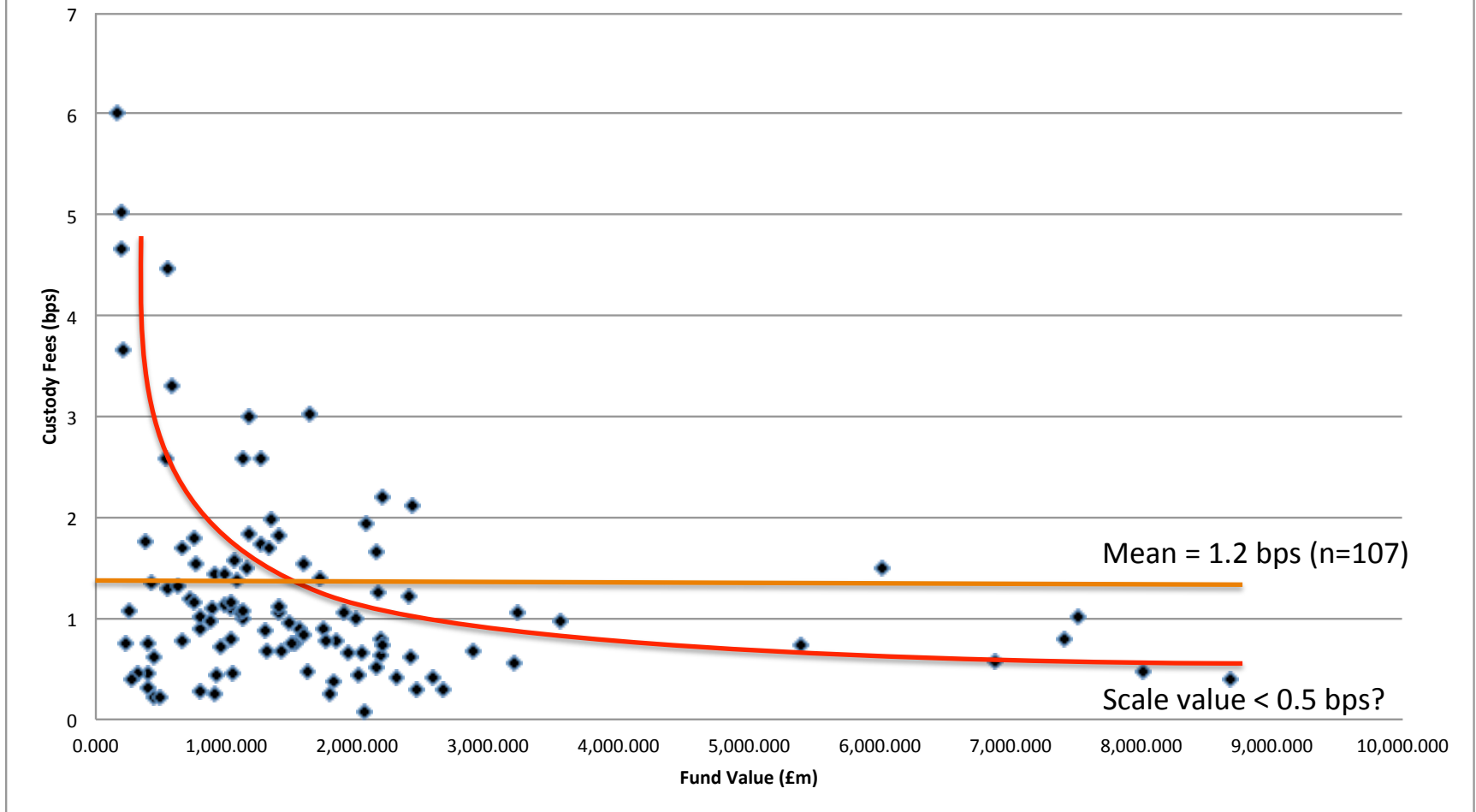
Investment Management Expenses





Custody Fees

'All' LAPFs (where data available) 2001-2011



What can we do with these numbers?

- Estimate possible savings to Pension Funds by one of three means:
 - METHOD 1: Compare current fund costs to the mean value
 - (METHOD 2: Compare current fund costs to scale value for each fund – benchmarking!
 - METHOD 3: Combine the funds and compare current costs to costs at scale

METHOD 1 – Individual Funds	Admin	IM Exp	Custody	TOTAL
Mean value	12.6bps	25.4bps	1.2bps	-
% of funds above mean	33%	52%	33%	-
Potential saving at mean	£17.3mn	£44.3mn	c£3-5mn	c£65mn pa

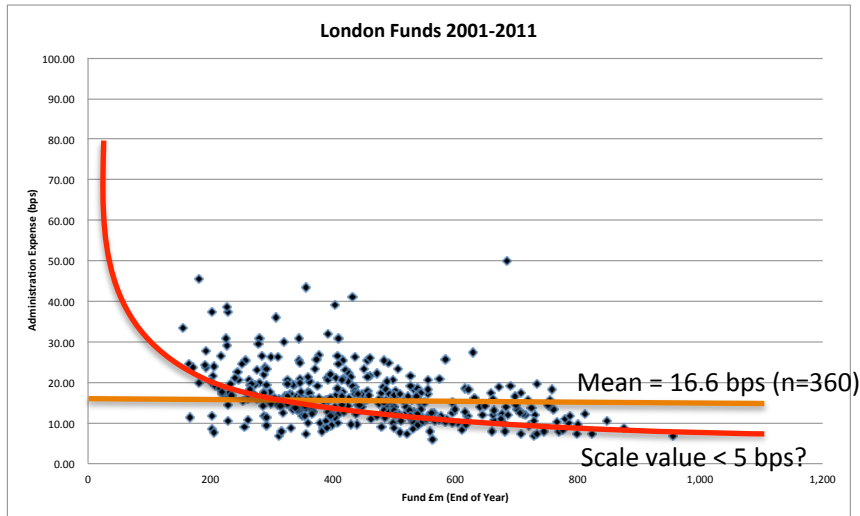
METHOD 3 – One £170bn Fund	Admin	IM Exp	Custody	TOTAL
Scale value	c5bps	c5bps	c0.5bps	-
Potential saving at Scale	c£130mn	c£350mn	c£12mn	c£500mn pa

- REMEMBER: A cost saving is a performance gain

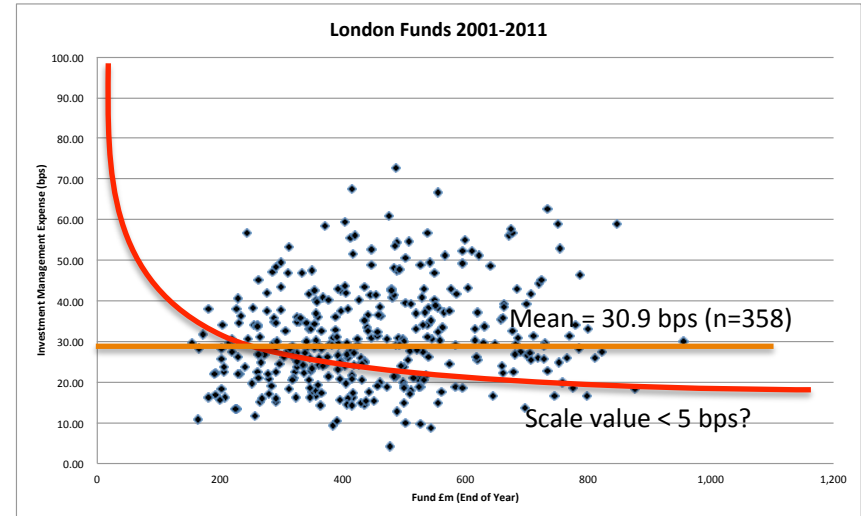
A funding shortfall of 20% (£35bn) could be made up in <8yrs

Similar Analysis is available for London Funds

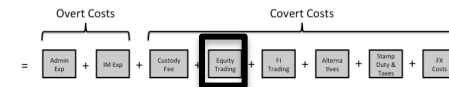
Administration



IM Expense

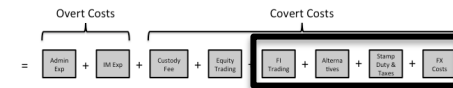


METHOD 3 – One £19bn Fund	Admin	IM Exp	Custody	TOTAL
Scale value	c5bps	c5bps	-	-
Potential saving at Scale	c£14.5mn	C£38.9mn	-	c£55mn pa



Equity Trading Costs

- The cost of trading is one of the so-called 'hidden costs' of fund management that are allegedly difficult to establish
- However, since the Myners Report (2007) the Investment Management (IM) industry has adopted a voluntary code of practice to collect commission data on equity trades from Brokers and publish these to their Pension Fund clients
- I looked at equity brokerage commission data obtained by the University of Oxford by FOIA requests for IMA disclosure tables from LAPFs
- There were some challenges:
 - Data was inconsistently submitted to, and/or collated by, Pensions Funds from their IMs
 - IM and Broker names were redacted by the IM prior to responding to the FOIA requests
- Good commission data was therefore available for only 60 Pension Funds across 4+ years
- **With some extreme outliers removed, average commission as % of Equity AUM was 10.3bps (range 0.3 – 121.4bps)**
- **Fund churn data was equally diverse with mean churn being 130% (range 3% - 3800%), again with extreme outliers removed. This has a significant impact on Stamp Duty**



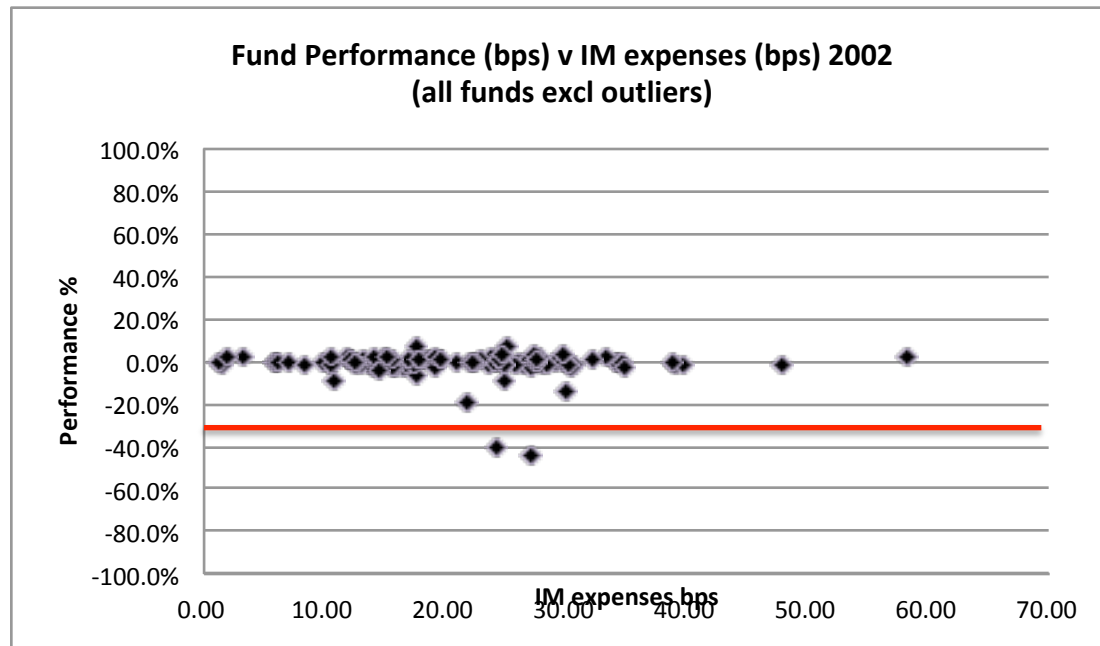
Other 'Covert' Costs

- Although commission on equity trades is an obtainable (though difficult) cost, it may be that some costs are hidden in spreads on equity trades.
- For Fixed income ALL cost is buried in spread
- The costs of using alternatives (e.g. Property, PE, derivatives...) may be buried in both commission and spread
- In any case NONE of these costs have been obtained or benchmarked
- Yet all of these costs are material, likely to be large and OBTAINABLE on demand
- Stamp duty is also material, obtainable and/or calculable if equity turnover data is available (it is – see IMA Disclosure Tables)

KEY QUESTION: How can custodians deliver custody so cheaply?

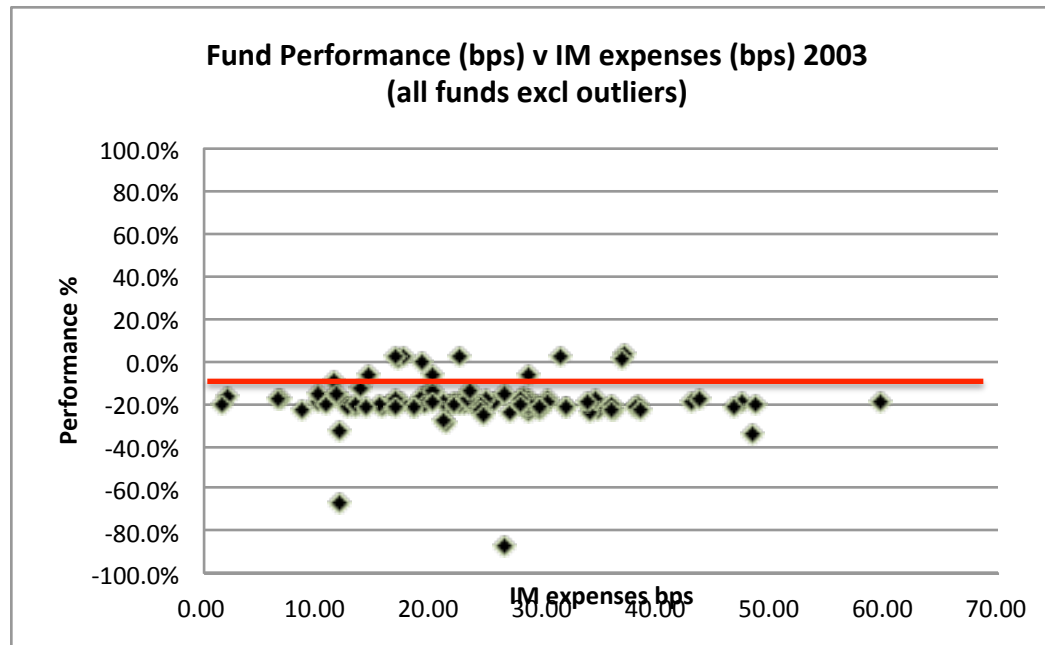
- Mean Custody fee is 1bp. This is equivalent to £100k on £1bn asset base
- So what is Custody?
 - Protection (Insurance) of your assets against loss. This is usual by operational capability (segregated accounts) or capital on balance sheet
 - Corporate action processing (e.g. Dividends, other revenue events, stockplits...etc
 - All of these cost money. A LOT of money. But more than £100k per £1bn of assets?
- The answer is that custody is a loss leader for Custodian Banks
 - Average compensation of an employee in a custody bank is approx £120k
 - Fully-loaded cost is approx 2-3 times this figure, i.e. £220-360k. Your £100k custody fee therefore pays for less than HALF of one employee.
 - Yet Custody Banks are profitable
- So where are Custody Banks making the rest of their money?
 - Stocklending: Do you understand the risks and are you sharing in the reward?
 - Interest Income: Are you receiving your share? Custody Banks make 1-2% spread
 - F/X: A grey area, a dark art, and subject to intense scrutiny in the US currently

Something interesting - Fund Performance vs. IM Expense 2002



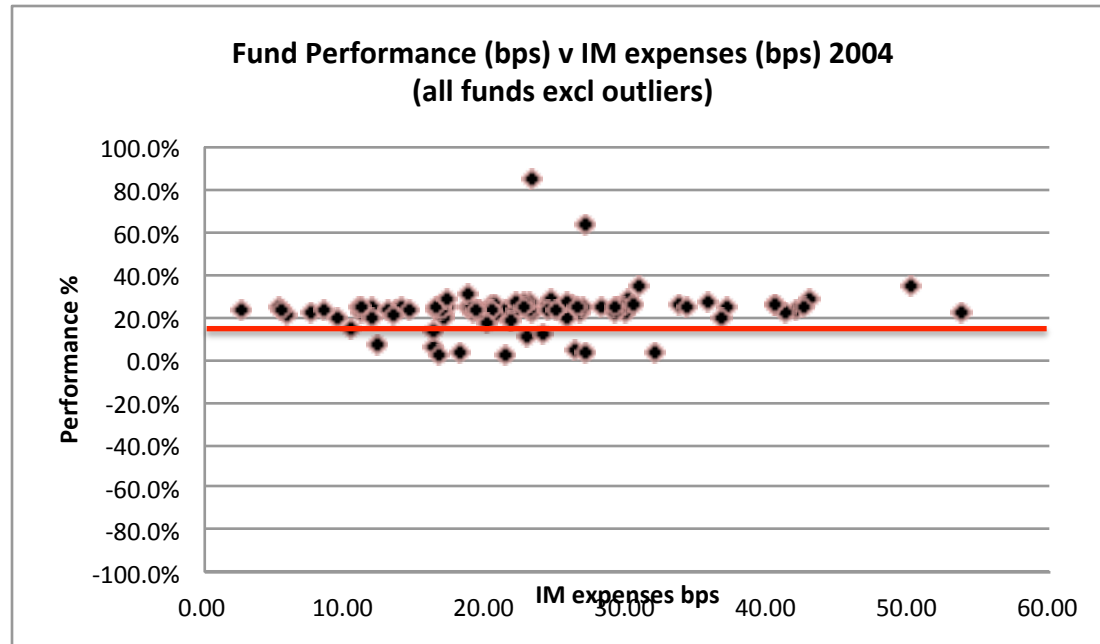
— FTSE Performance

Fund Performance vs. IM Expense 2003



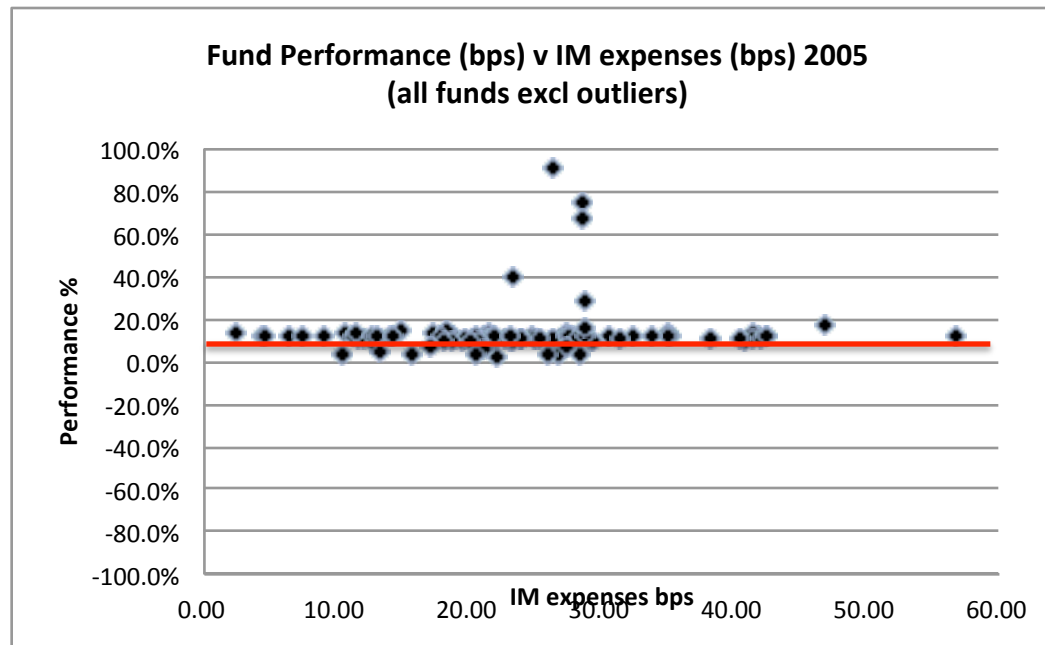
— FTSE Performance

Fund Performance vs. IM Expense 2004



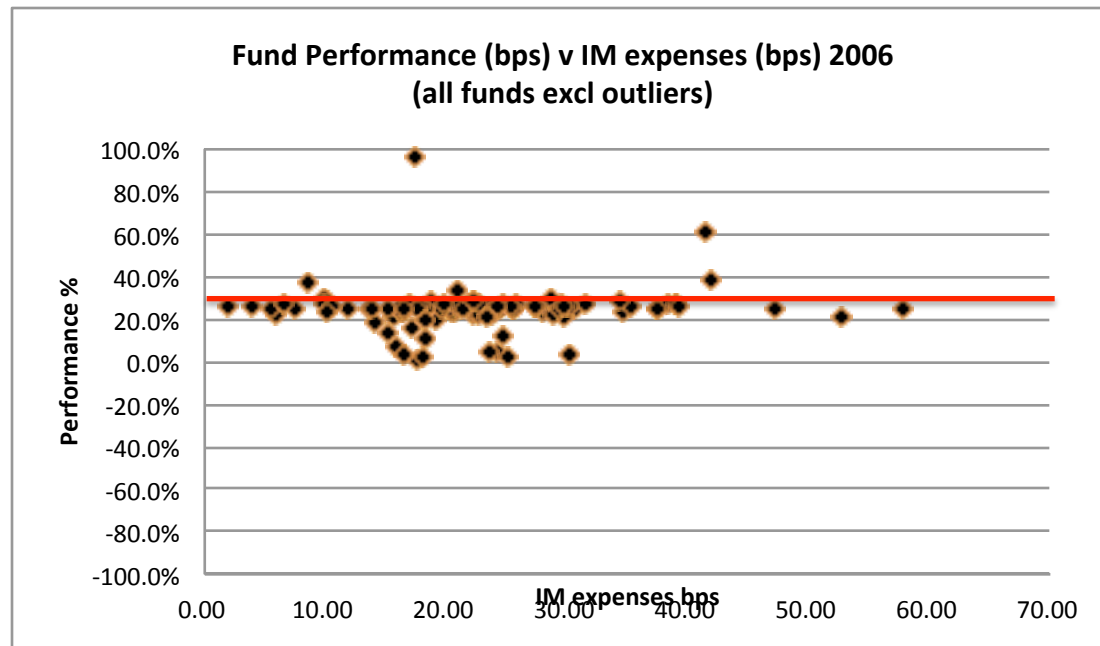
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Fund Performance vs. IM Expense 2005



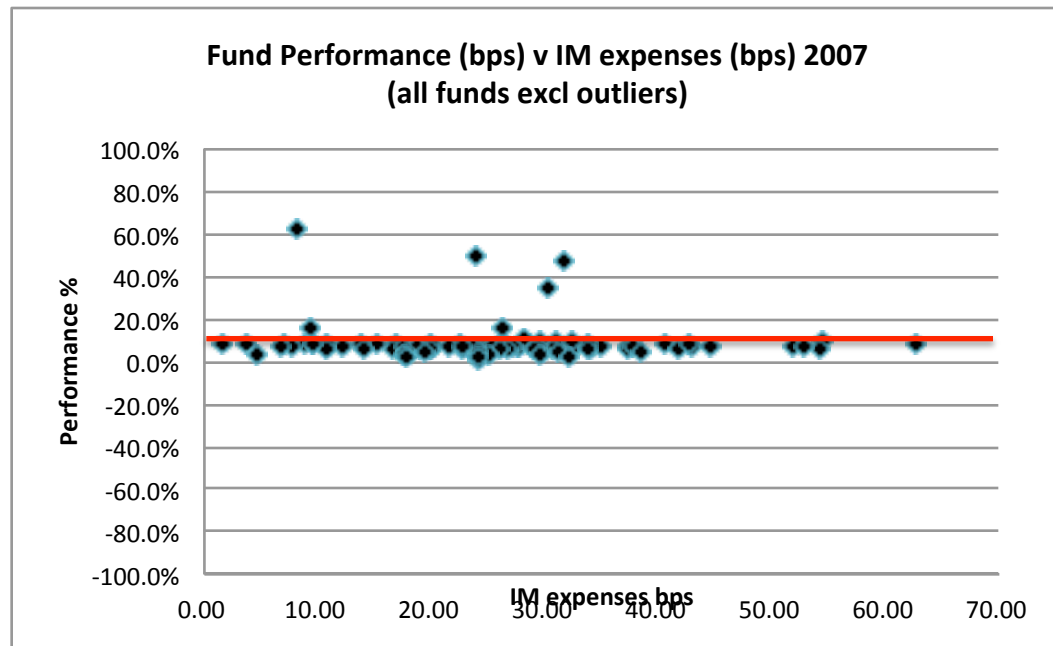
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Fund Performance vs. IM Expense 2006



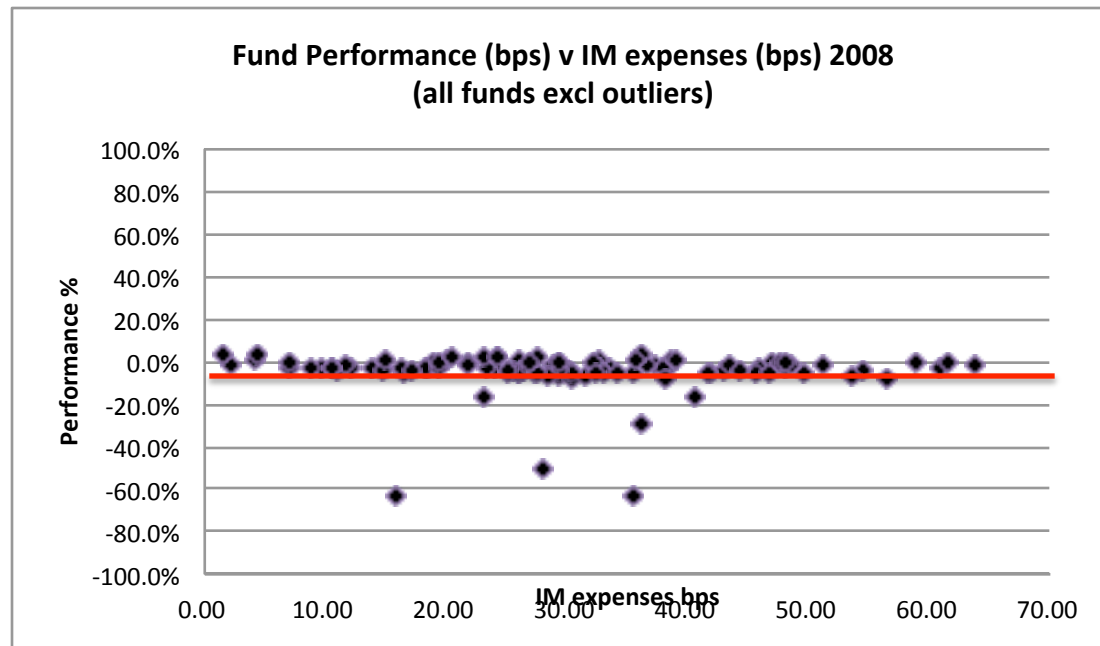
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Fund Performance vs. IM Expense 2007



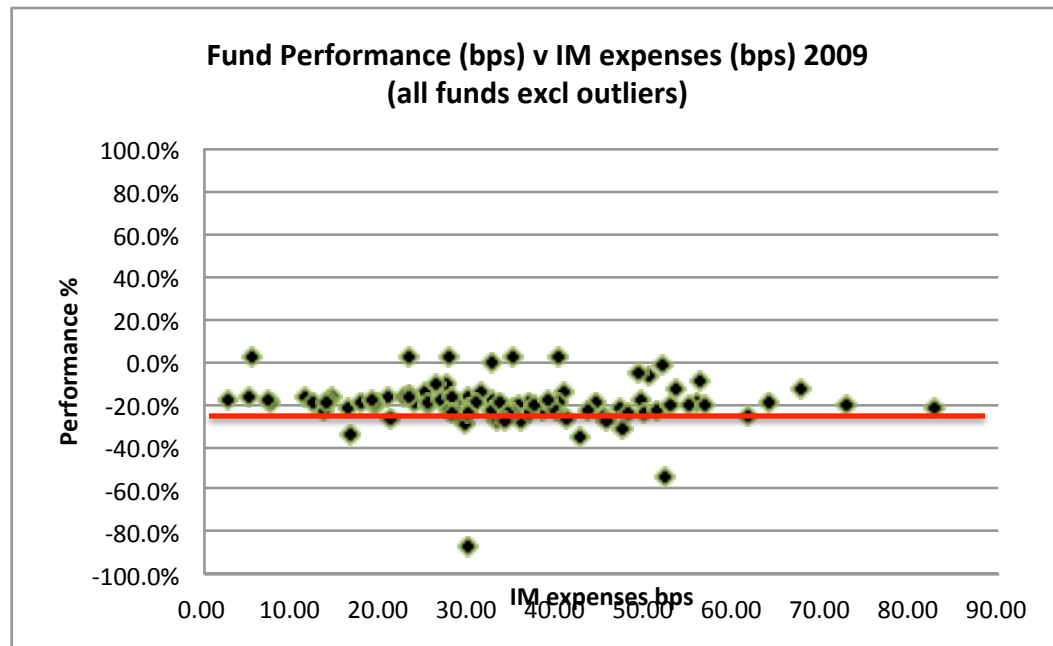
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Fund Performance vs. IM Expense 2008



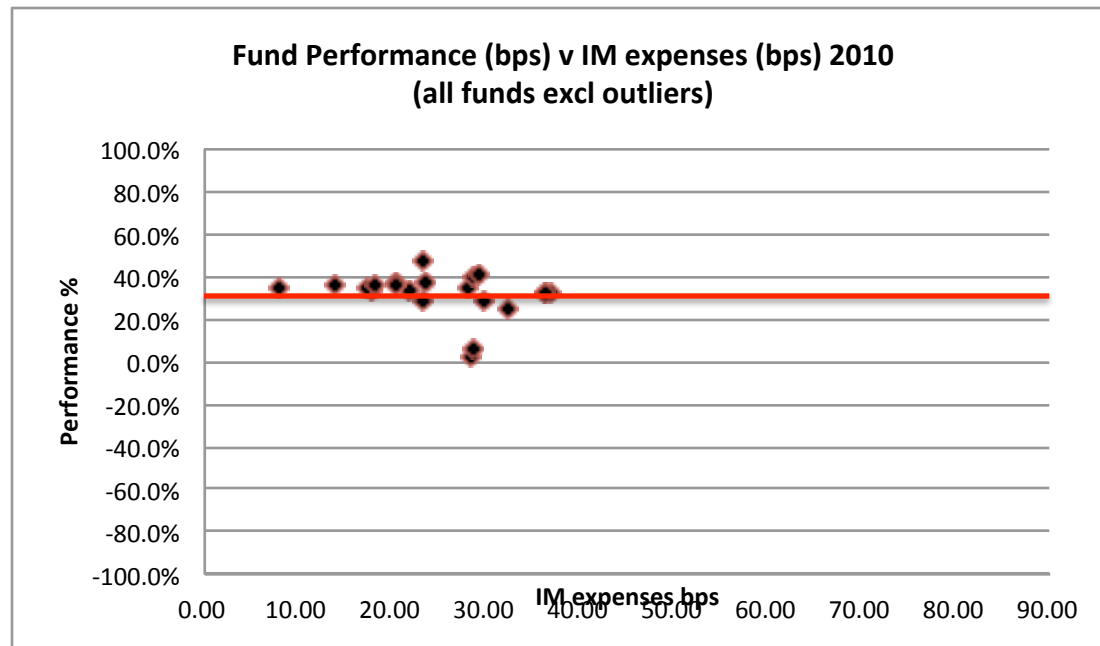
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Fund Performance vs. IM Expense 2009



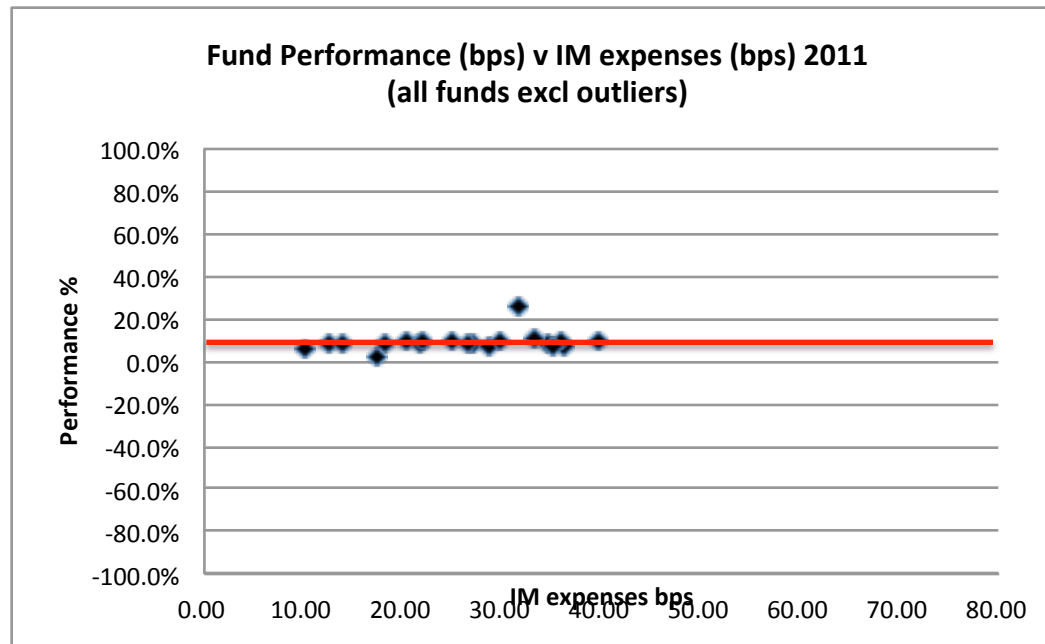
— FTSE Performance

Fund Performance vs. IM Expense 2010



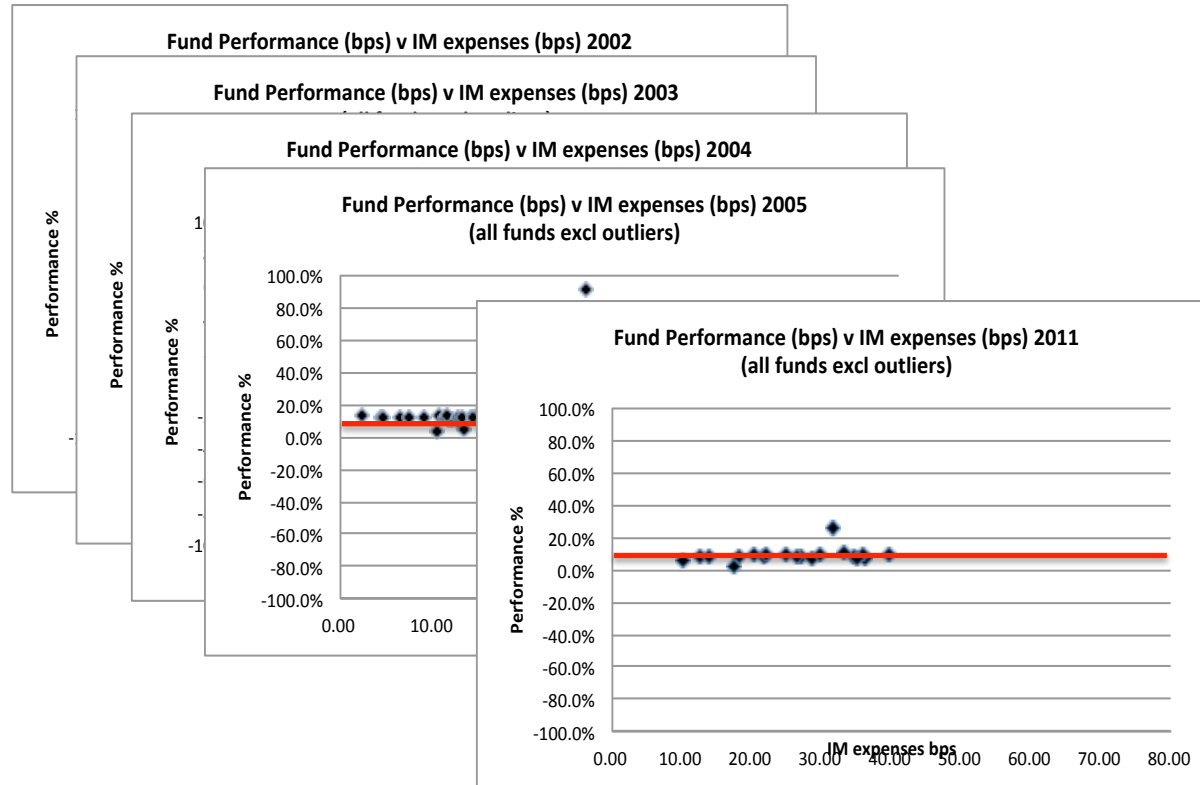
— FTSE Performance

Fund Performance vs. IM Expense 2011



— FTSE Performance

Not sure what to say really...



- ...But put it like this: If you had the lowest IM Expense you would have saved 80bps of cost each year. Or, to put it another way, gained up to 80bps of performance each year, compounded over 10 years.

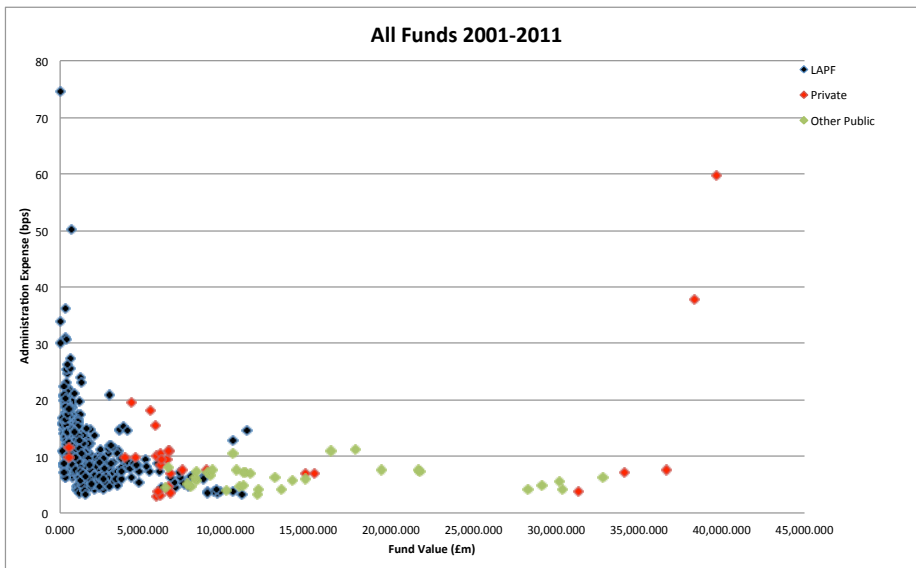
CONCLUSION

- You can request any data from your Investment Manager and Custodian
- This might include:
 - Equity Commission data (IM Disclosure Tables) – from Investment Manager
 - Fixed Income spreads and timing of transactions to compare to spot prices – Investment Manager
 - Other transaction data (commission and spread) of other asset classes – Investment Manager
 - Timing of FX transactions, spot prices and spreads on FX trades – Custodian
 - Interest Income on cash – Custodian
 - Stocklending data – Custodian and Investment Manager
- All of these can be used to build benchmarks to allow for better fee negotiation to reduce cost
- Reducing cost is material as cost and performance are equivalent:
 - Reducing costs by 1% on a £1bn fund will add £10mn to the value of the portfolio, compounded each year.
 - In a market where fund performance is otherwise flat, this equates to increasing portfolio value by 33%, or £335mn, in 30 years

My Aim: To create a not-for-profit 'social' business to provide cost analysis

ADTERTHOUGHT: Just to prove it works for larger funds...

Administration



IM Expense

