

Pensions Committee

2.00pm, Thursday, 23 March 2023

LPF Cost Benchmarking

Item number 6.6

1. Recommendations

The Pensions Audit Sub Committee (Committee) is requested to:

- 1.1 note the report; and
- 1.2 note that the CEM Investment Cost Effectiveness Analysis (to 31 March 2022) and the CEM Pension Administration benchmarking report 2022 have been provided on a confidential basis to the Conveners of the Committee and Audit Sub-Committee and the Independent Professional Observer.

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LPF Cost Benchmarking

2. Background

- 2.1 The purpose of this report is to inform Committee about the annual results from benchmarking of:
- investment costs for the Lothian Pension Fund; and
 - pension administration costs for Lothian Pension Fund and Scottish Homes Pension Fund (and collectively known as **LPF**).
- 2.2 LPF's annual report for 2021/22 identifies £38.0 million of total management expenses, with investment costs (£34.2 million) representing by far the largest proportion of the total, as expected.
- 2.3 Benchmarking is undertaken to help identify areas where improvements can be made to deliver better value for money. The exercise should facilitate:
- comparison between costs and performance;
 - the provision of evidence to support decisions on budget relating to the sustainability and capability of the investment and administrative teams to deliver customer satisfaction;
 - sharing of information and ideas with peers; and
 - and a review of performance trends over time.

3. Main Report

Investment cost benchmarking

- 3.1 Analysis of investment costs was carried out by independent provider CEM Benchmarking Inc. Its 2021/2022 database includes 30 LGPS funds with total assets of £226 billion and a wider global universe of 299 funds with £8.8 trillion of assets.
- 3.2 Lothian Pension Fund's actual investment cost of 0.29% of average assets was below the benchmark cost of 0.50%. The majority of LPF's investment cost relates to external management. The 0.21% difference with the benchmark is equivalent to a saving of approximately £18.9m per year. The main contributing factors to this difference are attributable to:
- LPF managing a high percentage of assets on an internal basis compared to the benchmark peer group; and
 - LPF accessing externally managed private market investments at lower costs than the benchmark peer group.

- 3.3 CEM also highlight that investment costs should be taken in the context of a fund's long-term net returns as well as risk. As part of the benchmarking, CEM provide the median annual return from its LGPS universe.
- 3.4 Lothian's 8-year net return of +9.4% pa was above the LGPS median of +8.8% pa, and in the 82nd percentile of the CEM LGPS fund universe of 30 funds. (100th percentile = highest return)
- 3.5 Lothian's 8-year net return (+9.4% pa) was also delivered with less risk (8.3%), than the median LGPS return (+8.8% pa) which was achieved with a higher level of risk (10.0%).
- 3.6 Further details of the investment cost benchmarking process are provided in Appendix 1.

Pension administration benchmarking

- 3.7 Analysis of pension administration costs was undertaken by the Chartered Institute of Public Finance & Accountancy (**CIPFA**), with data provided for the 2022 exercise. Due to delays in completion of data quality checks by CIPFA, no information is yet available, despite fund officers regularly requesting updates. A verbal update will be provided at the committee meeting in March.
- 3.8 In order to obtain further insight into pension administration cost and benchmarking on quality of service, LPF has also participated in the pension administration benchmarking survey carried out by CEM. Whilst CIPFA is exclusive to the LGPS, CEM also includes UK private sector schemes. Participating funds, both private and public, are of a significantly larger size than LPF. CEM's methodology includes an adjustment to business-as-usual costs to allow for fairer comparison to eliminate the effect of economies of scale. As a result, peer costs are increased by £8.04 per member.
- 3.9 Results from the 2022 CEM benchmarking survey show LPF's pension administration service to be categorised as "low cost; high service standard", with a cost per member of £26.30. The adjusted peer average is £39.94 per member – 52% more expensive.
- 3.10 As with investment costs, cost in isolation is unhelpful, and as agreed in the 2022/23 strategy, the fund strives to provide a quality service which offers value for money rather than being cheap. Again, the CEM benchmarking survey provides positive confirmation of this as LPF's service score is 74 compared to the peer median of 67.
- 3.11 Further details of the pension administration cost benchmarking process are provided in Appendix 2.

4. Financial impact

- 4.1 There are no financial implications arising directly from this report. Out of LPF's total management costs of £38.0 million for 2021/22, investment costs amounted to £34.2 million, administrative costs to £2.0 million and oversight and governance costs to £1.8m. The benchmarking exercise should aid future cost management efforts.

5. Stakeholder/Regulatory Impact

- 5.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.
- 5.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.

6. Background reading/external references

- 6.1 None.

7. Appendices

Appendix 1 – Investment Cost Benchmarking

Appendix 2 – Pension Administration Benchmarking

Investment Cost Benchmarking

Background

LPF has contributed to CEM's database to better understand its investment expense base and how it compares with other pension funds.

The benchmarking analysis undertaken by CEM aims to provide comprehensive, like-for-like comparisons with similar funds, but they are unable to capture all investment costs from all funds. Consequently, the total actual costs reported by CEM differ from those reported in Lothian Pension Fund's annual report. CEM includes private asset performance fees, but investment transaction costs, including property operational costs, are excluded.

In addition, the fund undertakes more detailed cost analysis than CEM for its listed private market funds as these cannot always be directly compared with other funds in the database.

Care should be taken in deriving conclusions from the headline data. CEM itself states that "being high or low cost is neither good nor bad". What matters is whether a pension fund is receiving sufficient value for the costs incurred. This is reflected in the long term returns of pension funds, net of costs.

2022 cost benchmarking

The CEM 2022 global database includes 299 funds with £8.8 trillion in assets, of which 30 are LGPS funds with total assets of £226 billion.

The peer group for calculating LPF's benchmark cost contains 17 funds (including 9 LGPS funds). The peer group funds have been selected on the basis of fund size and holding a broadly similar basket of assets to LPF.

The median fund size within the peer group is £9.6 billion, which compares with Lothian Pension Fund's average assets of £9.1 billion over the year to 31 March 2022. CEM calculates a benchmark cost for Lothian Pension Fund, which reflects the fund's asset class mix, based on the asset class costs of the peer group funds.

LPF's actual cost figure to 31 March 2022 of approximately 0.29% of average assets was below the benchmark cost of 0.50%. The 0.21% difference is equivalent to a saving of approximately £18.9m for the year to 31 March 2022.

CEM concluded that the primary reasons for cost being low compared with the benchmark are due to implementation style, in two areas:

- internal management, where LPF manages a relatively high percentage of assets internally relative to peers. External active management fees are significantly more expensive than internal management and CEM benchmarking also indicates that LPF pays less for internal management relative to peers, and
- private markets, where LPF costs for investing in private markets were significantly less than the costs of the peer group.

CEM analysis also shows that the Lothian Pension Fund cost of 0.29% is significantly lower than the median cost of the 17 funds in the global peer group (0.83%).

Previous CEM cost analyses are shown below (analyses prior to 31 March 2017 were calculated on a calendar year basis):

- 31 March 2021: 0.35% versus the benchmark cost of 0.46%
- 31 March 2020: 0.35% versus the benchmark cost of 0.51%
- 31 March 2019: 0.39% versus the benchmark cost of 0.48%
- 31 March 2018: 0.43% versus the benchmark cost of 0.55%
- 31 March 2017: 0.31% versus the benchmark cost of 0.48%
- 31 December 2015: 0.36% versus the benchmark cost of 0.45%
- 31 December 2014: 0.39% versus the benchmark cost of 0.50%