

**HERTFORDSHIRE COUNTY COUNCIL**  
**INVESTMENT COMMITTEE**  
**THURSDAY 5 DECEMBER 2002 AT 10.00 AM**

**Agenda Item No:**

**2**

**PENSION FUND – COST OF INVESTMENT MANAGEMENT**

**Report of the Finance Director**

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**41. Purpose of the Report**

- 1.1 To provide the Committee with a detailed breakdown of all the costs incurred in the investment management of the Pension Fund during 2001/02.
- 1.2 The Myners Review on institutional investment highlighted the need for Pension Funds to challenge their fund managers on the subject of broker commissions. This review of costs enables the Committee to do this.

**2. Summary**

- 2.1 The total investment management fee during 2001/02 was £2.6m; 0.21% of the average value of the fund.
- 2.2 Transaction costs totalled £2.252m during the year with the highest levels being shown by Jupiter.
- 2.3 Rebates totalling £377k were received from the managers in respect of in-house unit trusts.
- 2.4 Other costs incurred by the Fund include HCC Corporate Finance, WM Performance Measurement, PIRC Voting Service fees and Risk Measurement fees.

**3. Conclusion**

- 3.1 Investment management costs in 2001/02 were £4.9m, which is 0.39% of the average Fund value during the year. This is a similar value to the 2000/01 figure of 0.37%.

## 1. Background

- 1.1 A report on the cost of investment management in 1997/98 was presented to the Investment Panel meeting on 20 May 1999, when members requested that this report be a regular feature at Panel meetings. The 2000/01 figures were presented to the Investment Panel meeting on 29 November 2001.
- 1.2 The Myners Review of institutional investment has highlighted the area of broker commissions as one which Pension Funds should review and challenge their managers over. The Panel has been doing this for the last four years through this report.
- 1.3 This report sets out all the costs of investment management incurred in 2001/02 in the same format as previous reports.
- 1.4 The different types of cost associated with investment management are dealt with in turn below. They are:
- Investment Managers Fees,
  - Transaction and holding costs,
  - Unit Trust charges,
  - HCC Corporate Finance costs,
  - WM Performance Measurement Services,
  - PIRC Voting Service Fees,
  - Risk Measurement Fees.
- 1.5 It is important to note that although they are analysed by manager below, transaction and holding costs are not paid to the managers themselves but to third parties i.e. brokers and in the case of custody fees, the custodian ABN Amro Mellon. It is also important to understand that the transaction costs are reflected in the cost of purchases and the proceeds from sales and as a result are directly reflected in the performance of the managers.

## 2. Investment Managers Fees

- 2.1 The fee structure during 2001/02 for portfolio management fees was as follows:

	Fees per annum as % of Funds under Management					
	SIM**	JAM	BG	CAP	ML	JUK*
First £100m	0.25	0.25	0.175	<i>see</i>	0.2	0.35
Next £100m	0.20	0.20	0.175	<i>Below</i>	0.2	0.35
Funds in excess of £200m	0.15	0.15	0.175		0.2	0.35

\*Jupiter UK Equities portfolio – an additional performance fee is payable if the portfolio exceeds the index. This is 0.1% for every 1% outperformance to a maximum of 0.25%

\*\* Schroder fee invoice for December 2001 included a discount for underperformance of £100,628.51

Capital fee structure:

First £17.5m	0.70%
From £17.5m to £35m	0.55%
From 35m to £175m	0.425%

2.2 The higher fees paid to Capital and Jupiter (for the UK Equities portfolio) reflect the specialist nature of these mandates. Specialist mandates attract higher fees to reflect the specialist knowledge, which should result in better performance. A revised fee structure has been negotiated with Schrodgers during 2001/02 which includes a discount for any periods of underperformance.

2.3 The percentage fees are applied quarterly to the market value of the portfolio held by the manager. The application of the fee structure in 2001/02 in 2.1 above resulted in the fees shown in the table below. The average percentage fee for each portfolio is also shown for comparison purposes.

	Fee 2001/02 (£)	Average % Fee
Schrodgers	590,146	0.16%
Jupiter (Balanced)	768,093	0.19%
Baillie Gifford	429,784	0.17%
Capital	479,192	0.52%
Merrill Lynch	118,267	0.25%
Jupiter (UK Equities)	258,657	0.34%
Total	2,644,139	0.21%

### **3. Transaction and Holding Costs (excluding Unit Trusts)**

3.1 Transaction costs include brokers commission, and stamp duty. Holding costs are fees paid to the custodians to safeguard the Fund's assets. Unit Trusts have specific fee structures and therefore will be dealt with separately below.

#### **3.2 Brokers Commission**

3.2.1 This is the commission brokers charge for each deal the investment manager places. In most cases the commission charged is a flat fee, which means that the larger the deal the better value for money it is. It is also directly related to the volume of investment turnover.

3.2.2 The table overleaf shows the total commission charges in 2000/01 and the percentage of the value of transactions the charges equate to. This enables comparison of the level of commission incurred by each of the managers.

	Commission Charged 2001/02 (£)	Percentage of Value of Transactions
Schroders	368,962	0.13%
Jupiter (Balanced)	326,060	0.19%
Baillie Gifford	382,513	0.24%
Capital	119,701	0.22%
Merrill Lynch	0	0.00%
Jupiter (UK Equities)	131,345	0.10%
Total	1,328,581	0.17%

3.2.3 Investment Management houses which have a large value of investments under management are able to command much better rates of commission than smaller houses. This is because they can place deals combining several funds' investments and share the commission costs between the funds. The table below shows the value of UK Pension Funds under management with each manager. It shows that Schroders and Merrill Lynch are much larger operations than Jupiter, Capital and Baillie Gifford and this is reflected in the commission charges.

UK Pension Funds Under Management at 31 March 2002	
Schroders	£41.9bn
Jupiter	£3.1bn
Baillie Gifford	£17.7bn
Capital	£18.3bn
Merrill Lynch	£64.6bn

3.2.4 The other key factor affecting the amount of commission charged is the turnover of the fund. This is the value of purchases and sales as a percentage of the average value of the Fund during the year.

	Value of Transactions 2001/02	Percentage of Average Value of Fund During the Year
Schroders	£277.1m	74.6%
Jupiter (Balanced)	£174.1m	41.2%
Baillie Gifford	£160.6m	63.7%
Capital	£53.3m	59.0%
Merrill Lynch	£2.1m	4.36%
Jupiter (UK Equities)	£125.4m	162.3%

- 3.2.5 Closely linked to turnover is the number of transactions. As flat fees are charged, the number of transactions undertaken by the managers also affects the commission charged.

	Number of Transactions 2001/02
Schroders	1726
Jupiter	653
Baillie Gifford	542
Capital	1,152
Merrill Lynch	9
Jupiter UK Equities	512

### 3.3 Stamp Duty

- 3.3.1 Stamp Duty is levied by the government on the purchase of all UK equities. It is levied at a rate of 0.5% of the value of the purchase. Therefore it varies between managers depending on the value of purchases they make in the UK. The amounts charged in 2000/01 are shown below:

	Stamp Duty charged 2001/02 (£)
Schroders	221,378
Jupiter	249,621
Baillie Gifford	96,965
Capital	0
Merrill Lynch	0
Jupiter UK Equities	250,143
Total	818,107

### 3.5 Custody Fees

- 6.4.1 During 2001/02 custody arrangements changed with custody for all the portfolios now being undertaken by ABN Amro Mellon who were appointed as global custodian to the Fund. The benefits of this arrangement are the independent reporting facilities available whilst costs are partially offset by stock lending.

- 6.4.1 For the completeness of this report the April Custody residual fees for the prior custodian are also included.

	£
Prior Custodian fees – April 2001	40,965
Mellon from 1/5/01 – 31/3/02	151,693
Total	192,628

### **3.6 Soft Commission**

- 3.6.1 Soft Commission is a long standing practice whereby managers receive benefits from brokers in various forms, e.g. provision of a Reuters screen, research and information, which is offset against the commission paid to the brokers on share dealing. Jupiter have soft commission arrangements in place with a number of brokers and provide a summary of what they have paid and received every year.
- 3.6.2 The Myners report was particularly critical of soft commission arrangements, due to their lack of transparency. Myners believes fund managers should pay directly for the services received by them
- 3.6.3 Jupiter apply commission rebates to obtain services such as research, price information and performance measurement. The amount of commission used in this way was £45,772 for the balanced Jupiter portfolio, £1,971 for the Jupiter UK Equities portfolio in 2001.
- 3.6.4 None of the other Fund Managers make use of soft commission.

### **4. Unit Trust Charges**

- 4.1 Unit Trusts are pooled investment vehicles used within the Fund's portfolio to spread investment risk. Units are sold to investors providing all with exposure to a range of holdings. The majority of unit trusts in which the Pension Fund holds investments are run by the managers themselves and are referred to as In-house Unit Trusts. Jupiter and Schroders also had small investments in property unit trusts and these are dealt with separately below.
- 4.2 There are two aspects to the charging arrangements for Unit Trusts. There are initial charges when units are purchased and on-going management fees annually.

### 4.3 In-house Unit Trusts

4.3.1 The Pension fund has investments in a number of In-house Unit Trusts. Below is a summary of the value of in-house unit trust investments and the proportions of the portfolios they represent.

	Market Value of in-house unit trusts at 31/03/02	Percentage of total portfolio at 31/03/02
Schroders	£73.3m	19.8%
Jupiter (Balanced)	£5.7m	1.4%
Baillie Gifford	£36.8m	14.4%
Capital	£2.8m	3.1%
Merrill Lynch	£48.0m	100%
Jupiter (UK Equities)	None	N/A

4.3.2 The treatment of the charges associated with in-house unit trusts varies as does the proportion of the portfolio they represent. The Schroders portfolio was heavily weighted in unit trusts with 19.8%, whereas the balanced Jupiter portfolio has only 1.4% in in-house unit trusts.

4.3.3 Baillie Gifford have changed their charging structure in relation to in-house unit trusts. Their in-house unit trusts were converted into Open Ended Investment Companies (OEICs) during 1999. There are no charges for HCC for investments within OEICs and so no need to calculate rebates when fees are calculated.

4.3.4 Schroders, Capital and Merrill Lynch do not levy any initial charges when units of in-house trusts are purchased for the Fund. The total of all unit trust annual management fees are rebated by reducing the quarterly portfolio management fees discussed in section 2.

6.4.1 When Jupiter purchase units of in-house unit trusts, an initial fee of 1% is paid. This is a reduced rate from the normal fee of 5%. However, it is some time since the last purchase took place and there are no plans for any in the near future. Jupiter's investment in unit trusts require the prior approval of the Finance Director. The annual management fees are subtracted from any income the unit trust generates. Jupiter reduce their portfolio management fee by subtracting the market value of the in-house unit trusts at the end of the period from the overall market value of the portfolio, thereby ensuring the Fund does not pay any overall portfolio management fee for the in-house unit trusts.

- 4.3.6 The rebates from the managers in respect of the in-house unit trusts in 2001/02 are shown in the table below:

	Gross Fees 2001/02 £	Rebate 2001/02 £	Net Fees 2001/02 £
Schroders	590,146	285,817	304,329
Jupiter (Balanced)	768,093	8,339	759,754
Baillie Gifford	429,783	0	429,783
Capital	479,193	53,254	425,939
Merrill Lynch	118,267	30,186	88,081
Jupiter (UK Equities)	258,657	0	258,657
Total	2,644,139	377,596	2,266,543

#### 4.4 Unit Trusts with Management Fees

- 4.4.1 The balanced manager's briefs allowed them to invest in property unit trusts managed by other managers. The initial charges are deducted at the time of purchase of units and the annual management fees are deducted from the dividends received. Both Schroders and Jupiter had property unit trusts within their portfolios during this period.
- 4.4.2 In addition Merrill Lynch deduct fees from income received to their bond portfolio. However they have not had any Broker's Commission charges on the portfolio. The management fees deducted from unit trusts during 2001/02 per manager were as follows:

	<u>Merrill Lynch</u>	<u>Schroders</u>	<b>Jupiter (Balanced)</b>
Unit Trust Charges 2001/02	£8,056	£73,006	£24,807

#### 5. Other Costs

- 5.1 In addition to the costs incurred by the managers, there are various other costs relating to investment management which are not manager specific. These are detailed below:

##### 5.2 HCC Corporate Finance

- 5.2.1 This group, with the Finance Director, is responsible for monitoring the fund managers' performance, reconciling and preparing the pension fund accounts, supporting the Investment Committee, fulfilling a client role regarding pensions benefit administration and maintaining links with employing bodies. The cost of this during 2001/02 was £160,424. This cost reflects different allocations of the time of up to nine full time finance staff.

### **5.3 WM Performance Measurement**

- 5.3.1 The WM Company provide performance figures for the Fund as a whole and broken down by manager on a quarterly basis. They also provide regular information enabling comparison of the Fund with other local authority funds and other private sector pension funds. The cost of this service in 2001/02 was £13,178.

### **5.4 PIRC Voting Service Fees**

- 5.4.1 Pensions Investment Research Consultants Limited (PIRC) provide the Fund with information about Annual General Meetings and Extraordinary General Meetings and guidance on how the managers should vote in order to comply with Corporate Governance principles. This service cost £8,313 in 2001/02.

### **5.5 Risk Measurement Fees**

- 5.5.1 John Morrell Associates have been providing the Fund with risk measurement information since October 1999 and this cost £30,000 during 2001/02.

## **6. Conclusion**

- 6.1 Overleaf is a table which summarises all the costs discussed in this report. They are divided into costs included in WM performance calculations and those not. A grand total of costs is provided per manager. In addition the totals are shown as a percentage of the average fund value in 2001/02.
- 6.2 The charges relative to Fund value incurred by the Jupiter UK and Capital portfolios were highest of the managers. This was mainly due to higher fee levels.
- 6.3 However, the table shows that overall net investment management expenses are £4.9m which is 0.39% of the average Fund value in the year of £1,260m. It is important to note that the WM investment performance figures do not reflect gross investment management fees less rebates and custody fees, but do reflect any transaction costs incurred.
- 6.4 The total cost as a percentage of the value of the fund has increased marginally from 0.37% in 2000/01 to 0.39% in 2001/02. This was a total cost increase of £223,047 or 4.7% from 2001/02.
- 6.5 The main reason for the increase was an increase in the amount of commission paid. Commission is a transaction cost which is reflected in the performance figures reported by the managers. This means there is an incentive for the managers to ensure they get best value for money.

## Summary of Costs

2001/02	Schroders £	Jupiter (Balanced) £	Baillie Gifford £	Capital £	Jupiter UK £	Merrill Lynch £	Total £
<b>Costs not included in performance calculations</b>							
Investment Management	590,146	768,093	429,783	479,193	258,657	118,267	2,644,139
Rebates	285,817	8,339	0	53,254	0	30,186	377,596
Net Inv Mngt Fee	304,329	759,754	429,783	425,939	258,657	88,081	2,266,543
Other Costs							
Custody							192,628
Corporate Finance							160,424
WM Performance							13,178
PIRC Fees							8,313
Risk Measurement							30,000
Sub-Total							2,671,086
<b>Costs included in performance calculations</b>							
Transaction Costs							
Brokers Commission	368,962	326,060	382,513	119,701	131,344	0	1,328,581
Stamp Duty	221,378	249,621	96,965	0	250,143	0	818,107
Unit Trusts	73,006	24,807	0	0	0	8,056	105,869
Sub-Total	663,346	600,488	479,478	119,701	381,487	8,056	2,252,557
Total	967,675	1,360,242	909,261	545,640	640,144	96,137	4,923,643
Total as % of average value of Fund in 2000/01	0.26%	0.32%	0.36%	0.60%	0.83%	0.20%	0.39%

**APPENDIX A**

**COMPARISON OF COSTS IN 2001/02 AND 2000/01**

	<b>Total 2001/02</b>	<b>Total 2000/01</b>
	<b>£</b>	<b>£</b>
<b>Costs not included in performance calculations</b>		
Investment Management	2,644,139	2,923,465
Rebates	377,596	449,095
Net Inv Mngt Fee	2,266,543	2,474,370
Other Costs		
Custody	192,628	124,494
Corporate Finance	160,424	154,627
WM Performance	13,178	15,600
PIRC Fees	8,313	8,107
Risk Measurement	30,000	24,922
Sub-Total	2,671,086	2,802,120
<b>Costs included in performance calculations</b>		
Transaction Costs		
Brokers Commission	1,328,581	936,974
Stamp Duty	818,107	756,544
Unit Trusts	105,869	204,958
Sub-Total	2,252,557	1,898,476
<b>Total</b>	<b>4,923,643</b>	<b>4,700,596</b>
Total as % of average value of Fund in 2000/01	0.39%	0.37%