Findings of Project POOL

Summary Report

Joint Working Group of Local Authorities

January 2016

Project POOL: Summary Report

Introduction

In the Summer Budget Government asked LGPS funds to put forward proposals to pool investments to reduce costs significantly while maintaining overall performance. In November 2015, the government confirmed the criteria it will apply in the assessment of those pooling proposals: scale, savings, governance and access to infrastructure.

This is a Summary Report on the findings of Project POOL. The full analysis carried out by the project is set out in the Full Report on the project's findings which has been published alongside this report.

The purpose of the report is to provide government with a joined up response from local authorities who run LGPS funds, setting out proposals which are sufficiently ambitious and will achieve government objectives in a way that also meets the needs of those who administer and manage the LGPS on behalf of the 4.6 million scheme members. The government has required that the assets should be formed into up to six pools with a minimum size of £25bn.

The report has been prepared by local authority officers from participating funds who have collaborated under the banner of Project POOL, supported by Hymans Robertson. Project POOL set out with three goals:

1. to produce an evidence based and objective analysis of pooling options
2. to enable LGPS stakeholders to gather round one or a small number of options which satisfy the Government's criteria
3. to form a basis of discussion between the LGPS and Government on the best way forward

We are pleased to say that there is broad consensus on the conclusions drawn from our work and the proposals we set out in this report amongst the diverse group of funds who have committed time and effort to collaborate on this project.

Contributors to the report are set out below. As well as the 24 funds who participated fully as co-authors of the report, another 10-15 funds have given generously of their time and experience on work-streams that have worked intensively to provide the analysis that informed the report.

We are also grateful to others who have supported the work including the fund management community. Eversheds and Northern Trust have provided invaluable assistance on the complex issues of establishing pooling vehicles.

We are grateful for all of this help but above all thanks are due to the LGPS officers who have worked on the various chapters of this summary report and the full report.

While POOL has had significant support from Hymans Robertson, the local authority participants own the report and its conclusions. The project team, guided by a Steering Group consisting of some of the most experienced practitioners in the LGPS, has reached agreement on the recommendations set out in this report and we are happy to speak with one voice.

We believe that the work we have done together has already informed the discussions now taking place between funds as they work to form pools. It is our hope that it will be useful to all local authorities and elected members involved in the LGPS, and to government, in the period between now and the deadlines for pooling proposals in July 2016, and in the implementation phase that will follow.

On behalf of the local authority officers in the Project POOL Joint Working Group

Participants in Joint Working Group

- Bedfordshire
- Cheshire
- Dorset
- East Sussex
- Environment Agency
- Essex
- Gloucestershire
- Greater Manchester
- Hampshire
- Leicestershire
- LGSS
- Lincolnshire
- London Borough of Hackney
- Merseyside
- Norfolk
- Oxfordshire
- Shropshire
- South Yorkshire
- Staffordshire
- Suffolk
- Tyne & Wear
- West Midlands
- West Sussex
- West Yorkshire

Executive Summary

Executive summary and key findings

- **Background:** Currently the Local Government Pension Scheme ("the LGPS") in England and Wales is organised as 89 funds. Most of the assets of the 89 funds are managed by "external" managers in the city but, in some funds, local authority staff manage some of the investments "in-house". Some investments, mainly equities, are managed "passively" (tracking stock-market indices); others are "actively" managed aiming to beat index returns.

- **Why pool?** There is evidence that LGPS funds have procured external investment manager services at competitive fee levels. One way of achieving even greater economies and other benefits of scale, including the potential for performance improvement via a "governance dividend", is to combine assets from more than one fund to form bigger investment pools. Government has asked LGPS funds to put forward proposals to pool investments. Assets of the 89 LGPS funds have to be placed in up to six pools, each with a minimum size of £25bn.

- **Purpose of report:** This report, written by local authorities who run LGPS funds, sets out proposals that will achieve the over-arching aim of costs savings and other scale benefits and meet criteria and parameters specified by government in relation to **scale**, cost **savings**, **governance** and **access to infrastructure**. The report considers options for pooling and the most effective way for those pools to access commonly used asset classes.

- **Recommended approach to pooling**: The objectives are best met by establishing pools which allow for investment into a range of assets (**Multi-asset pools ("MAPs")**) formed by regional and/or like-minded groups of funds. For most assets currently held, namely actively-managed listed equities and bonds, these pools will be of sufficient size to deliver the majority of scale benefits (including cost savings and employing enough managers for diversification but few enough to avoid index returns) while still being of a size that individual funds can participate meaningfully in the pool's governance. Strong governance within the pool should help maintain a focus on the long term and reduce manager turnover.

- **How the MAPs will work**: Individual funds will remain responsible for their own liabilities, for administration of pensions for their members, for setting their employer contribution rates, for their own investment strategy and for asset allocation decisions including use of active or passive investment. Pool responsibilities will include running the legal structure(s) needed, making available asset classes needed by the participating funds, accessing those assets efficiently, monitoring investment costs and performance and making manager hire and fire decisions. Some decisions could be made by the pool or by individual funds; the pool governance committee will agree some of these details. Some pools will use only external managers and others will use a mixture of external and in-house management. Some pools may also have specialist resources in areas like private equities and direct property investment. The asset types available in each pool may differ.

- **LGPS wide investment vehicles available to all pools ("MAPs Plus")**: For a number of asset types, greater benefits may be available by LGPS-wide collaboration. For example, an infrastructure investment platform or a national procurement framework of passive investment managers could be set up alongside the MAPs and be accessible to all of them.

- **Likeminded principles:** It will be important for funds to agree the principles by which their pool will be run. These may include the pool's approach to governance (e.g. one fund one vote, what decisions will be made locally initially and in the long term); attitudes on use of active, passive, external and in-house management; and what the pool will and won't do in the short and long term. In the very short term there needs to be agreement on equitable ways to share the costs of establishing the pool and the cost of transition of assets from the participating funds to the pool.

- **Access to infrastructure**: The infrastructure assets that historically have been most attractive to pension funds like the LGPS are established projects delivering steady income streams that rise with price inflation (since pension payments from the fund increase with inflation). There has also been some demand for some higher risk-return assets, but allocations will likely be lower. Improved access and lower cost is most likely to be achieved through a national platform accessible to all of the Multi-asset Pools (MAPs).

It would have the ability to invest directly in funds and in direct investments and would offer 2-3 types of infrastructure investment (e.g. high, medium and low risk) to meet return expectations of the MAPs, which will in turn represent the collective requirements of the 89 allocating funds, some of which already have successful investment programmes in place. A significant amount of further work is required to determine how the national platform should be established and how it builds on or runs alongside any existing or pooled arrangements. Government can assist the investment in infrastructure by ensuring that there is a pipeline of projects that are suitable for investment by the LGPS.

- **"In-house" management:** Rather than creating a single pool for all "in-house" managed assets, the preferred approach is that a number of MAPs will use both external and "in-house" management. This gives more choice and greater potential to extend use of "in-house" management in future. On day one, funds participating in the pool with "in-house" management must have local choice as to whether or not they use the "in-house" manager but in future (once consistent comparative information is available) pools will decide on the extent to which "in house" and external management are used.
- **Cost savings**: Based on current asset allocations and market values, and allowing for future asset growth in the range 3 to 5% per year, the estimated eventual savings in year 10 values could grow to be in the range £190 to 300m per year.
- The range of potential outcomes is wide. In the first five years, the majority of savings come from fee savings on actively managed listed equities; between five and ten years, changes to how unlisted investments are accessed will have an increasing impact.
- Actual cost savings could be greater due to competition when pools appoint external managers driving fees down, additional savings on less visible layers of fees on alternative assets and greater use of "in-house" management.
- Over the very long term, the costs of transition and establishing and running the pools will be more than recouped by savings and other benefits. However, in the short term the costs of implementing change and transitioning assets are likely to exceed the savings. There will be significant differences between pools in the savings achieved depending on where they start from (asset allocation, prevailing fees, current approach to accessing different types of assets). There will be winners and losers. For example, Funds which currently use a significant element of in-house management are likely to suffer higher costs.
- The eventual cost savings are significant and should be pursued, but this should not be done in a way that puts investment performance at risk. A successful outcome is one which achieves cost savings and potential for enhanced performance through the pool governance arrangements; aggregate outperformance by active equity managers of only 0.25% would add more than £150m of value annually in addition to the fee savings above.
- **Structures**: Approaches to pool structure that should be investigated further include:

  (1) FCA authorised pooling vehicle(s) combined with a joint governance committee:

  - There are a number of pooling vehicles recognised under current legislation, including the Financial Services and Markets Act (FSMA). Such vehicles include, for example, the ACS and exempt unauthorised unit trusts. Through these vehicles there is collective ownership of assets.
  - These pooling vehicles could be accompanied by some form of "joint governance committee" for the pool which could be formed of elected members from each of the funds participating in the pool. That "joint committee" for the pool cannot control the Operator (an FCA regulated business) but may exert a certain amount of influence and express views on the type of funds that the pooling vehicle would need to offer in order to allow the participating funds to implement their investment strategies and which managers the participating funds want to see appointed to manage the assets; the committee would expect the Operator to take those views into account.
  - The Authorised Contractual Scheme ("ACS") in co-ownership form is the favoured structure for some asset types because of its tax transparency (reclaims are made at investor level rather than pool level) and the fact that it is possible to establish a range of sub-funds within a single ACS.
  - Pools may choose to rent or build their own FCA regulated Operator depending on their objectives.

- However, the ACS does not have the flexibility required to accommodate the full range of asset types that LGPS funds currently invest in, including in particular, illiquid assets like private equity and infrastructure. It is likely that each LGPS MAP would need more than one pooling vehicle to accommodate its full range of assets, increasing the costs of running a MAP. A single Operator could however operate all of these structures in a single pool. **Government assistance in making it possible to house assets in one pooling vehicle would be helpful.**
- Another issue is life policies which are commonly used for passive equity investment. These cannot be held in a pool structure and may instead need to be held outside the pool by the beneficial owners (individual funds), potentially accessed via a National Framework for procurement.

(2) "Joint Committee" alone without a pooling vehicle:

- Under this approach, the pool will have a joint governance committee of elected members from each of the funds participating in the pool (as above). Without a pooling vehicle, individual funds in the pool would remain owners of assets but all funds could have identical legal contracts with managers selected by pool's joint committee.
- Matters to be followed up in in the next stage include, for example, demonstrating how a Joint Committee can be equivalent to a pooling vehicle in terms of governance and permanency of commitment and how to mitigate the risk that this arrangement is (1) deemed to be a collective investment scheme under the legal meaning set out in Section 235 in FSMA 2000 and becoming a collective investment scheme, or (2) the governance arrangement becomes involved in providing investment management or investment advisory services, in each case in contravention of FSMA.
- The attractions in this approach are that it could achieve the same or similar outcomes in terms of fee savings and governance benefits but would avoid the complexity and significant higher costs involved in establishing and running a regulated pooling vehicle (potentially several million pounds a year for each pool).

- Further work is needed to investigate fully the various potential approaches to pool structure, including consideration of legal aspects. Different pools might use different vehicles and structures; the optimal mix for each pool will depend on the circumstances of each including the asset types they will hold and how the assets are to be managed (e.g. directly using in-house resource or using external managers).
- **Flexibility to invest outside pools**: Government has already acknowledged that existing directly held property investments can remain outside of pools. There are other investment types where a case can be made for keeping investments outside pools, at least until such times as the pools are better equipped to manage them. These include local investments, investments not available in pools needed for the purpose of employer specific strategies (e.g. buy-ins) and various risk management assets (including currency and interest rate hedges). If and when these assets and risk management instruments are managed within pools, in many cases ear-marking to particular funds will be necessary.
- **ESG and Responsible Investment (RI) considerations:** Government's published criteria and guidance for pooling direct the opportunities for new investment pools to further improve the approach to Responsible Investment (RI) and Environmental, Social and Governance (ESG) in the LGPS. This report contains recommendations on the measures pools should take to achieve this (including a proposal that pools should develop a compliance statement to the UK Stewardship Code).
- **Implementation of change:** Delivering these changes is an enormous undertaking. The effort, costs and risks involved should not be under-estimated, particularly in the context of continuing budgetary pressures and severe internal resource constraints within local authorities. The transition costs will be significant and risks involved in a transition of assets on the scale required are high - **nothing on this scale has ever been done before.** Government could assist by considering ways of mitigating transition costs.
- **Collaboration between pools in implementation phase:** Better outcomes will be achieved by collaboration across pools. A joined up approach will result in synergies and minimise transition costs.
- **Next steps**: Discussions between funds to create MAPs along the lines set out in this report are already in progress. Those discussions are informed by the work of Project POOL between September and December 2015.

There is additional analysis in the detailed work of the Project work-streams that will also be helpful as these plans are taken forward. It is our hope that this summary report and the more detailed report published alongside it will be useful to all local authorities and elected members involved in the LGPS and to government, in the period between now and the deadlines for pooling proposals in July 2016, and in the implementation phase that will follow.

Summary Report

Government requirements

- In the Summer Budget 2015, following earlier consultations with local authority funds on the way forward, Government asked LGPS funds to put forward proposals to pool investments to reduce costs significantly while maintaining overall performance. Government set out its requirements in greater detail in criteria published in November 2015, specifying that assets of the LGPS have to be placed in up to six pools, each with a minimum size of £25bn with the potential to match the infrastructure investment levels of the top global pension funds. We understand that government does not intend to consult further on these requirements and any pooling proposals will be expected to conform fully.

Purpose of this report

- The purpose of this report is to enable local authorities who run LGPS funds to respond to government in a consistent way, setting out proposals that will accomplish the over-arching aim of achieving costs savings and other scale benefits within the constraints of the criteria and parameters specified by government. The report considers options for pooling and the most effective way for those pools to access commonly used asset classes. A range of pooling models has been assessed and a preferred approach identified.

Background

- Currently the Local Government Pension Scheme ("the LGPS") is organised as 89 funds in England and Wales, each with an administering authority responsible for the management of its assets and liabilities and the administration and payment of pensions to its local members. Each separate fund has its own assets invested in equities (stocks and shares), bonds, property and smaller amounts in other asset types such as private equity and infrastructure.

- LGPS funds currently invest around £1 per £100 in infrastructure. By way of comparison, pension funds internationally invest on average about £1 to £2 per £100 of their assets in infrastructure and larger funds around £5 per £100 of assets. The proposed measures will help make appropriate infrastructure investment more accessible to LGPS funds and in the longer term could take levels of investment closer to larger global funds.

- Most of the assets of the 89 funds are managed by "external" managers in the city but, in some funds, local authority staff manage some of the investments "in-house" at lower cost. Some investments, mainly equities, are managed "passively" (they simply track stock market indices); others are "actively" managed with the aim of beating index tracker returns. While most funds have a significant portion of their assets in equities and bonds there is considerable variation between funds in terms of the other assets they hold.

- Investment decisions (e.g. how much to invest in each asset type and which managers to appoint) are made by local governance committees made up mainly of locally elected councillors. They are advised by investment consultants, independent advisers, actuaries and senior finance officers.

  There is good evidence that funds have procured external investment manager services at competitive fee levels (see for example research facilitated by Hymans Robertson in 2013). There remains scope for making further savings through more collaboration between funds to achieve scale benefits including lower external manager fees and greater potential for direct investment to remove some external costs. One way of achieving greater economies and other benefits of scale is to combine assets from more than one fund to form bigger investment pools. This summary report is complemented by a more detailed report published alongside it. We strongly encourage all those affected by the expected changes to read the more detailed report.

Preferred approach to pooling assets

- **Multi-asset pools ("MAPs")** formed by **regional** and/or **like-minded** groups of funds can largely meet Government criteria and the needs of funds but may not be the best solution for all asset classes.
- For the bulk of currently held assets, namely actively-managed listed equities and bonds, these pools will be of sufficient size to deliver the majority of scale benefits while still being of a size that they can satisfy the requirement for meaningful involvement by individual funds in the pool's governance arrangements.
- For a number of asset types, greater benefits may be available by LGPS-wide collaboration. For example, an infrastructure investment platform or a national procurement of passive investment managers could be established alongside the MAPS and be accessible to all of them. We refer to this pooling model as "**MAPS Plus**".
- **Likeminded principles** for any pool may include the pool's approach to governance (e.g. one fund one vote, what decisions will be made locally initially and in the long term); attitudes on use of active, passive, external and in-house management; and what the pool will and won't do in the short and long term. In the very short term there needs to be agreement on the most equitable way to handle the establishment costs of the pool and transition of assets from the participating funds to the pool.
- Each multi-asset pool will offer a range of assets (decided by the pool governance committee) to meet the needs of all of the participating funds where it is economic to do so. There may be differences in the asset choices available in different pools according to the needs of its participants.
- Other pooling models including Single-asset Pools ("SAPs") and pools based on groupings of liabilities were also assessed against government criteria for pooling but were rejected because they are unlikely to meet government criteria as effectively as MAPS formed by regional or like-minded groups of funds.

How the "MAPs Plus" model meets government criteria

- In November 2015, Government confirmed the criteria it will apply in assessing pooling proposals: scale, savings, governance and access to investment in infrastructure.
- **Scale**: It will be possible for individual funds to form up to six groups of funds in MAPS with size of at least £25bn. The scale of the individual pools will permit more effective diversification of manager risk; in other words there can be enough managers included to achieve diversification whilst avoiding having so many that the index (passive) return is achieved in return for paying active manager fees. Any assets of a MAP invested via a national procurement framework or an investment platform would remain assets of that MAP and therefore count towards its total assets under management.
- **Savings**: Based on current asset allocations and market values estimated savings could amount to circa £145-190m per annum but it could take 10 years or more to reach this run-rate. Over the very long term, the costs of transition and establishing and running the pools will be more than recouped by savings and other benefits. However, it is important to appreciate that savings will take time to emerge and in the short term the costs of implementing change are likely to exceed the savings. Funds which currently use a significant element of in-house management are likely to suffer higher costs at least initially.
- **Governance**: Each pool must have a robust structure with effective decision-making and accountability; a formal structure, including for example the establishment of an Authorised Contractual Scheme (ACS) authorised by the FCA and run by an Operator could be put in place. Each individual fund in the MAP could have representation on the governance board of the pool. This should ensure meaningful engagement and pool accountability to individual funds in the pool. Making manager hire and fire decisions the responsibility of suitably experienced people at pool level will help to put the emphasis on a long term approach, **reducing the frequency of manager change that can be damaging to performance**, thereby adding value over and above cost savings.
  The proposed model also **enables individual funds to retain responsibility for investment strategy decisions** that can be executed employing the asset choices that will be available via the pool.
- **Access to infrastructure**: The infrastructure assets that historically have been most attractive to pension funds like the LGPS are established projects delivering steady income streams that rise with price inflation (since pension payments from the fund increase with inflation). There has also been some demand for some higher risk-return assets, but allocations will likely be lower. Improved access and lower cost is most likely to be achieved through a national platform accessible to all of the Multi-asset Pools (MAPs).

It would have the ability to invest directly in funds and in direct investments and would offer 2-3 types of infrastructure investment (e.g. high, medium and low risk) to meet return expectations of the MAPs, which will in turn represent the collective requirements of the 89 allocating funds, some of which already have successful investment programmes in place. A significant amount of further work is required to determine how the national platform should be established and how it builds on or runs alongside any existing arrangements. Government can assist the investment in infrastructure by ensuring that there is a pipeline of projects that are suitable for investment by the LGPS. LGPS funds currently invest around £1 per £100 in infrastructure; pension funds internationally invest on average about £1 to £2 per £100 and larger funds around £5 per £100 of assets. The proposed measures will help make appropriate infrastructure investment more accessible to LGPS funds and in the longer term could take levels of investment closer to that of larger global funds.

- **ESG and Responsible Investment (RI) considerations:** Government's published criteria and guidance for pooling direct the opportunities for new investment pools to further improve the approach to Responsible Investment (RI) and consideration of Environmental, Social and Governance (ESG) value drivers in the LGPS. ESG and RI seek to improve outcomes (such as financial stability under-pinning long-term returns) and the processes by which these may be attained (e.g. improved corporate governance standards in companies). Applying these principles through the governance of LGPS investment pools will assist in delivering strong, stable, long term shareholder returns and contribute to financial stability for the UK economy. It also has the potential to make the LGPS a stronger force in supporting the Government's objectives in delivering the recommendations of Kay Review, assist in rebuilding trust in the Finance sector and enhance the global reputation of the UK businesses and markets. There are practical steps that will help embed ESG and RI approaches in the governance of LGPS investment pools. Guidance for pools is set out detail in the full report. Summary guidance for pools is included later in this report.

Estimated cost savings

- It is difficult to forecast long term cost savings with certainty and the range of potential outcomes is wide. The estimates given here should be treated with caution.
- By year 10 we estimate that potential savings could be running at circa £140-£185m per year based on asset values today. Allowing for investment growth of between 3 and 5% a year for 10 years the estimated eventual savings in year 10 values could grow to be in the range £190-300m per year.
- The table below sets out potential sources of cost savings and the estimated annual amount of savings all based on asset values today.

Asset class	Sources of future savings	Annual savings (£m) (based on current asset values)		
		Year 1	Year 5	Year 10
Active listed equities (externally managed)	• Reduced manager fees (5-10bps)	0	£32-64	£32-64
Passive listed equities (externally managed)	• Reduced manager fees (c4bps)	est £5	£10-12	£10-12
Bonds – active and passive (external mgd)	• Reduced manager fees	0	£5-10	£5 - 10
Property	• Remove multi-managers (FoF) • Migration from indirect to direct • Pooling direct mandates • Total = c28bps	0	£15	£37
Infrastructure	• Remove FoF fees • Move directly invested in-house • Total = c75bps	0	£5	£13.5
Private Equity	• Remove FoF fees • Move directly invested in-house • Fee reductions ext managed	0	c10	35

Other alternatives: Multi-asset Funds (MAFs) & Diversified Growth Funds (DGFs), Hedge, Debt Strategies, Commodities	• MAF: fee reduction 5-10bps • Hedge Fund: reduce base fees on FoF using external advisor • Others: No material saving assumed		2-5m (MAF only – run-off hedge)	7-11m (MAF and hedge)
Total		5	79-121	c140-183

- **The costs of implementing change (establishing new structures and transitioning assets) will exceed savings in the short-term.** Until transition costs are estimated more accurately, it is difficult to estimate how many years it will take to break even. For some asset types (including private equity, hedge funds and infrastructure), it will be necessary to let existing investments run to their natural termination date to avoid the costs of early termination. This means that **the potential annual savings from pooling and new investment platforms will not be fully achieved until year 10 or later.**
- **Actual savings could be higher than current estimates** since:

  a) manager fee reductions in competitive tenders could be greater than currently estimated;

  b) we do not have sufficient data to estimate the potential savings on some of the less visible layers of fees on alternatives (including performance fees); and

  c) extended use of "in-house" management in future would result in greater savings.
- A change in investment strategy to increase the allocation to infrastructure will however most likely lead to higher total costs despite the lower cost per £1 of investment as the increase in exposure would be expected to be funded from equities which carry much lower investment fees. In setting out their expected cost and savings profiles in submissions to government, pools should quantify any increase in costs expected as a result of any intention to increase allocation to infrastructure investment and government should recognise this effect in measuring future costs and savings.
- There will be significant differences between pools in the savings achieved depending on where they start from (asset allocation, prevailing fees, current approach to accessing different types of assets, etc),
- Full details of underlying assumptions are set out in the full report.

A source of further savings - future approach to "in-house" management under pooling arrangements

- While the majority of LGPS assets are managed externally by regulated investment management companies, there are currently 8 LGPS funds in England and Wales which use in-house management for a significant portion of their assets. These funds have combined assets of c £50bn of which just over half are managed by the in-house teams.
- In-house management has significantly lower costs than external management; there is potential for significant further cost savings in the long run if more investment is done by a specialist LGPS resource and less by external managers.
- Two models for accommodating "in-house" management were considered: (1) a single large "in-house" managed pool or (2) **a number of multi-asset pools (MAPs) with choice of external and "in-house" management**.
  The latter approach is preferred by the working group since it introduces more choice for pools and greater potential to extend use of "in-house" management in future.
- This view is conditional upon: (a) on day one funds participating in the pool with "in-house" management will have **local choice** as to whether or not they use the "in-house" manager; and (b) pools in due course (once consistent information is available for proper comparison of in-house and external managers) making the decision on which assets classes and the extent to which "in house" management is used.

Implementation – Pooling Structures

- Approaches to pool structure that should be investigated further include:
  (1) FCA authorised pooling vehicle(s) combined with a joint governance committee; and
  (2) Joint Committees alone without a pooling vehicle
- **Legal structure for Multi-asset Pools (MAPs):** The Authorised Contractual Scheme ("**ACS**") in co-ownership form is the favoured structure for some (liquid) asset types because of its tax transparency (reclaims are made at investor level rather than pool level) and the fact that it is possible to establish a range of sub-funds within a single ACS. However, it may not have the flexibility required to accommodate the full range of asset types that the LGPS currently invest in, including in particular, illiquid assets like private equity and infrastructure. This is because the ACS must be an open-ended fund which means that it must have an element of liquidity whereas investment funds for private equity and infrastructure tend to be closed-ended which means that an investor is not able to redeem their investment until the end of the life of the investment fund (although they can trade their interests on the secondary market). This means LGPS funds that wish to have a sub-fund dedicated to those types of illiquid assets could face challenges to do so in an ACS, consequently, **it is likely that each LGPS MAP will have more than one investment vehicle or structure to accommodate its full range of assets**. Clearly the structures put in place may differ between pools depending on the range of asset types offered and how they are to be accessed (e.g. directly using in-house resource or using external managers).
- **Issues requiring further investigation and clarification**: There are a number of issues that require further investigation and clarification including:
  - **Use of life policies**: Many LGPS funds currently invest via life policies for their passive equity investments which can be a significant proportion of their total assets. Life policies do not fit well in a pool structure because the entity with the insurable risk (the individual fund participating in the pool) must be the beneficiary of the contract. One solution might be for each fund to access passive investment through a life policy that sits outside of the pool (using one of a small number of insurers offering LGPS terms via collaborative procurement).
  - **Vehicles required for illiquid assets (e.g. private equity and infrastructure)**: Current structures commonly used by the LGPS for investments in private equity and infrastructure are closed-ended and so an ACS (the favoured vehicle for other asset types) would not be suitable. There are other fund structures that are available in closed-ended form that could be used for illiquid asset classes (e.g. Limited Partnerships and Unauthorised Unit Trusts) but it might be necessary to have more than one legal structure for each MAP. **It would be very helpful if a means could be found to accommodate illiquid assets under the same fund structure as liquid assets as otherwise it is likely that the costs of establishment and running of the MAPs will increase.**
- **Implementation**: Pools may choose to rent or build their own ACS. The timescale for authorisation of the ACS Operator is six to twelve months. It is estimated that it will take between 4 and 10 months to set up an ACS, with both the Operator and new investment funds requiring FCA approval.
- **Governance**: It is envisaged by the administering authorities of the LGPS funds that the pools that are established will each have a Governance Committee or joint committee ("the Committee") constituted with a representative, most likely one or more Elected Members, from each of the funds forming the pool.
- In an FCA regulated structure, this Committee is separate from the Board of the Operator of any vehicle or vehicles that are set up. The Committee will wish to influence the investment options offered by the pooling vehicles although, strictly speaking, it is the Operator who is responsible for running the vehicle; the Committee cannot direct the way the Operator works and must not give investment advice. The Committee does not have the power to remove the Operator; that power rests with the investors in the ACS (the LGPS funds participating in the pool).

Investors in the ACS would convene a meeting to remove the Operator and a certain percentage of the investors can then require the Depositary to remove the Operator.

- Alternative arrangements, such as a "**Joint Committee**" without a pooling vehicle, require further consideration, including legal aspects. This approach could reduce the complexity and costs and offer an attractive route to those who believe it could deliver governance and accountability as strong as that of an ACS for example.
- **Pooling vehicle establishment and running costs**: As an example, we understand that the costs to date for the establishment of the London CIV have been of the order of £2-2.5m. A limited number of sub-funds have been established so far. Running costs (administration of unit holdings, fund accounting, valuation, unit pricing, manager monitoring, custody, depositary, audit, compliance, legal and tax advice, reporting to investors, etc) for a fund structure hosting £25bn of assets for 15 investor funds across 20 sub-funds are estimated to **be c3bps per annum (£7.5m for a £25bn pool)** – this is not all additional cost since some of these costs are currently incurred at individual fund level and in future will instead be incurred by the pool. It may also be possible for funds to retain a larger proportion of the income generated from stock lending than they do under current arrangements. Transition costs could be significant and are additional to the establishment costs mentioned here.
- **Transition costs**: The transition costs will be significant and risks involved in a transition of assets on the scale required are high. Nothing on this scale has ever been done before. Getting this wrong could wipe out a significant amount of savings. Government could assist by considering ways of mitigating transition costs.
- **Collaborative joint ventures:** LGPS funds are able to establish a joint venture limited company (or other vehicle) with a view to pooling in-house investment teams to provide support for other LGPS funds that do not have an in-house management function. Such vehicles may be used to provide investment advisory and/or management services amongst LGPS funds in a more flexible and less formal manner and also potentially act as manager/operator of any collective investment vehicle in a manner that could potentially reduce external costs (subject to obtaining the suitable FCA permissions). Such vehicles might also provide the flexibility to allow LGPS funds to apply different forms of collaboration, and be deliverable at a lower cost.

Risks associated with the implementation of change

- **Delivering these changes is an enormous undertaking. The effort, costs and risks involved should not be under-estimated, particularly in the context of continuing budgetary pressures and severe internal resource constraints within local authorities.**
- The risks of a transition of assets on the scale required should not be underestimated as **this has never been done previously**. Outstanding project management and the use of the most skilled and experienced transition managers will be critical to managing these risks, but there will inevitably be a significant cost to a transition of this size.
- Government could assist by considering ways of mitigating transition costs.
- In the implementation phase, better outcomes will be achieved with collaboration across pools. Encouragement should be given to efforts to ensure a joined up approach to find synergies and minimise transition costs through the implementation phase and also during the preparation of pool business plans for submission in July.
- Collaboration should ideally extend to the commissioning of legal, tax and structural advice.

Work-stream conclusions

- Project POOL's conclusions on the preferred pooling model were informed by a number of work-streams which carried out in-depth analysis of various asset types and the role of "in-house" management. Their findings are set out below.

Listed Equities (actively managed) (currently c£65bn managed externally)

- There are currently over 170 individual mandates managed by about 40 different managers, half of whom have only one LGPS mandate.
- Including actively managed equities in each of six MAPs formed by regional and/or like-minded groups of funds provides the best compromise between meeting the government's criteria and maintaining local authority accountability and flexibility. Benefits of scale include fee savings and lower manager turnover.
- An LGPS-wide SAP would be less locally accountable and more likely to encounter dis-benefits of scale; we found no evidence that it would leverage greater fee savings than would be achieved by managing listed equities as part of six MAPs each with £10bn or more in actively-managed equities.
- Due to the large number of LGPS active equity mandates and the complexity of setting up new decision making structures, we favour a phased restructure where all mandates are drawn into the MAPs and rationalisation completed over time and with collaboration between the MAPs to minimise transition costs.

Listed Equities (passively managed) (currently c£30bn managed externally)

- The majority of passive equities are currently in life wrapped pooled funds run by 5 managers, one of which manages 40% by value.
- Each of six MAPs would have average passive equity assets of c£5bn and retendering mandates on this scale should capture almost all the saving available for a nationwide SAP while retaining greater accountability. MAPs are therefore the preferred pooling approach.
- A National Framework open to all LGPS funds and all MAPs should be established. This would include 'ceiling pricing' to ensure meaningful average fee savings are achieved. The Framework would be limited to two or three managers, which will be sufficient to maintain pricing tension. This would provide a 'quick win' for LGPS in terms of demonstrable fee savings that could be accessed early, perhaps even prior to formal pooling. The overlay of a National Framework would allow passive providers to look at LGPS in aggregate. This could be of immediate benefit even before pools are established. In fact, a recent joint procurement exercise involving seven funds delivered significant savings. This has shown that a quick win is possible and provides a benchmark for National Framework savings. Providers should be reviewed regularly but not excessively; the norm is for a framework to be re-let every four years although underlying mandates can be contracted for longer.
- It is understood that if MAPs are structured as Authorised Contractual Schemes (ACS) they cannot invest in life wrapped pooled funds. Utilising a different passive fund structure could compromise fee savings, increase ongoing costs and incur UK stamp duty that would 'defer' fee savings for two to three years.

Fixed Income (currently c£31bn)

- Fixed income is likely to be a relatively small (and relatively low-cost) part of LGPS portfolios for some time. We therefore believe that the costs of any solution specific to fixed income would be outweighed by the benefits of following the governance arrangements proposed for equities.
- The pools set up for managing equities should be able to offer passive and active funds for each of gilts, index-linked gilts and investment-grade credit.
- Other funds, for emerging market debt, broader credit markets etc, could be delivered by a national investment vehicle; alternatively, funds could be hosted by one or more MAP. This may prove more resilient to an increased exposure to these assets in the future.

Property (currently c£13bn)

- Existing LGPS Funds with more than £200m in property generally invest in **direct** property whereas smaller allocations tend to be invested **indirectly** through pooled funds, typically overseen by a third party manager. Overseas investment is all indirect. Around 5% of property assets allocated to overseas markets.
- A SAP is not recommended. It is not large enough on its own to meet the Government's target size and, if managed as a single portfolio, this would limit the choice of assets deemed suitable for the pool, introduce significant concentration risk (particularly in London) whilst reducing investment in other UK regions.
- Data provided by IPD demonstrates that larger portfolios (>£2bn) have, over the longer term, demonstrated small levels of outperformance primarily due to their ability to invest in larger lot sizes but greater volatility. Data also suggests that direct portfolios have outperformed indirect portfolios over the longer term. A pool size of £1–3bn would be regarded as a large property portfolio, sufficient to invest directly in most property sectors and is considered to be of an appropriate size for a MAP structure. However, certain market sectors will continue to be better accessed through specialist indirect vehicles.
- Virtual pooling (encouraging managers to take an LGPS wide view of existing holdings even if they remain in the ownership of existing funds for the time being to avoid transition costs) is deemed sensible as a short-term means of placing downward pressure on management fees. This is assisted by the Government's proposal that existing direct portfolios can sit outside pools.
- There are two key **barriers to change**:
    - Property transactions incur significant costs. The round trip cost for sale/purchase typically falls in the range of 6-7% of which 4% is Stamp Duty Land Tax (SDLT). The waiver of SDLT on consolidation transactions would allow for a more efficient process of change.
    - Property markets are illiquid. Whilst the costs of dealing in indirect funds can be (partially) mitigated through secondary market transactions, there is insufficient volume to allow change to take place quickly.
- The implementation of any pooling arrangement must take into account both the costs of change and the underlying illiquidity of the market. Consequently, change will take a number of years to fully implement. Government could potentially accelerate this process by facilitating the efficient movement of assets between structures without triggering SDLT.

Infrastructure (currently less than £2bn)

- The majority of existing holdings are on either a direct fund investing approach (£1.4bn) or via a fund of funds approach (i.e. a manager invests, on behalf of investors, into a series of direct funds, £0.4bn invested). If allocations to infrastructure rise to 5%, total monies invested in infrastructure assets could rise to between £8bn and £13bn.
- Infrastructure assets most attractive to pension funds like the LGPS are established infrastructure projects delivering steady income streams that rise with price inflation (since pension payments from the fund increase with inflation). There may also be demand for some higher risk-return assets, but allocations will likely be lower. Improved access and lower cost is most likely to be achieved through a national platform accessible to all of the Multi-asset Pools (MAPs). It would have the ability to invest directly in funds and in direct investments and would offer 2-3 types of infrastructure investment (e.g. high, medium and low risk). By including three different target return options, the national pool will be able to meet return expectations of the MAPs, which will in turn represent the collective requirements of the 89 allocating funds, some of which already have successful investment programmes in place. Further work is required to determine how the national platform should be established and whether it builds on or runs alongside any existing arrangements. Government can assist the investment in infrastructure by ensuring that there is a pipeline of projects that are suitable for investment by the LGPS.
- The proposed pool structure includes the creation of a 'Clearing House' that will enable a meaningful dialogue with central government, to take place in the period leading up to the formal inception of the small number of pools. The Clearing House would also source, undertake due diligence and aggregate investment opportunities in the interim period.

Private Equity and Other Alternatives

Private Equity (currently c£6bn)

- LGPS schemes currently access private equity not as direct owners of company equity but as limited partners in private equity funds which make the direct equity investments. Investments by LGPS funds are made:
  a) directly, using internal resource to select funds;
  b) directly, using an external advisor to select funds; and
  c) indirectly, as limited partners in funds of funds (FoFs), which in turn invest in a range of funds.
- We recommend all LGPS schemes should **move to a direct investment model**, using a small number of pools.
- Consolidation at a national level via a national SAP would, due to capacity constraints, limit opportunities in small and mid-buyout funds, which are preferred on performance criteria to large buyout funds.
- This and governance considerations support the **MAP option** adopted for other asset classes, although regional concentration (of investment or resource) might result in a smaller number of MAPs hosting investments in private equity from outside the MAP.

Hedge Funds (currently c£2bn)

- More work is required to determine the common ground in current LGPS investment to determine the scope for pooling.

Multi-asset Funds / Diversified Growth Funds (currently c£5bn)

- The relatively small scale of investment suggests that one of the governance solutions proposed elsewhere should be adopted for these funds. Funds could be offered by all MAPs, one multi-purpose SAP or hosted by one or more MAP.

In-house management (currently c£30bn across 9 funds[1])

- LGPS funds with internally managed capabilities have outperformed the average externally managed LGPS funds by over 0.5% per annum after fees over the last 28 years[2]
- Internal management is significantly cheaper than external investment management. According to CEM Benchmarking[3] the bulk of the savings achieved by large pension funds result from in-house management rather than from discounts on external management fees.
- For actively managed quoted equities in the LGPS, the savings from lower fees and transaction costs are estimated to be 0.5% per annum[4], providing a significant starting advantage over external investment management.
- The resources deployed by participating funds are substantial with over 70 investment professionals employed, many highly experienced with over twenty years in investment management. Looking ahead, the resourcing of the internal management capability will need to be flexible enough to cater for the changing needs of the LGPS funds they serve. A multi asset internal management approach is suggested so that resources can be allocated to meet future requirements.
- The most suitable pooling option is likely to be a corporate structure, in which all participating funds are shareholders. The corporate entity will probably have to be FCA regulated.
- The best pooling approach will be the creation of MAPs some of which have the choice of in-house management and externally managed funds.

[1] Includes Lothian Pension Fund
[2]based on performance data 1987-2015 and assumptions made by workstream on lower management costs
[3] East Riding, 2013 "Call for Evidence" submission
[4] Workstream analysis of performance data and transaction information collated as part of the East Riding submission to the 2014 Consultation

This will give greater flexibility in the longer term and the potential for additional savings if use of in-house management is extended since internal management costs are largely fixed compared with ad valorem fee arrangements typically levied by external managers – increasing assets under management managed in-house should not result in any significant cost increase.

A key risk factor facing internally managed teams at LGPS Funds is key person risk. A related one is succession planning. Getting different teams to work effectively together could be a challenge for the future.
Building up capability through pooling arrangements with teams that have compatible objectives, beliefs and values should create greater resilience and so help to address these risks.

Flexibility to invest outside of pools

- Areas where there is a strong case for allowing Funds the flexibility to hold assets outside the pools are:
    - **Local investments** which have twin aims of generating commercial returns and supporting the local economy; investment is frequently through a fund or limited partnership with an appointed manager although some funds with specialist resources are starting to manage such investments directly.
    - **Employer specific investment strategies** which are designed to meet the needs of participating employers with different funding positions, covenants, liability profiles and sensitivities to risk.
    - **Risk management strategies** which are used to reduce exposure to currency, inflation, interest rate and longevity risks.
    - **Cash** which is held for local operational reasons such as paying benefits, covering administration expenses and managing liquidity between investment managers.
- If and when pools have appropriate skilled and experienced resource, new **local investments** should be made through a MAP. In some cases those local investments will be made for all those funds in the pool who are allocating assets to local investments but in some cases certain commercially attractive local investments could be ear-marked by the pool for an individual fund (e.g. where an individual fund demonstrates commercial returns but the investment is not considered suitable by the pool for wider ownership). In the meantime, where appropriate skilled resources remain with individual funds, new local investments may be made outside the MAP where an individual fund can demonstrate commercial return.
- **Bespoke employer investments** should be exempt from pooling in certain circumstances subject to government guidance and supported by financial analysis. In addition a special dispensation should be provided for Passenger Transport Funds. The savings that might be achieved through collective provision of solutions are expected to be small (similar to those on bonds) and unlikely to compensate for the loss of tailoring which permits good risk management for employers. If and when pools have appropriate skilled and experienced resource, pools may be able to procure assets required by individual funds to enable those funds to execute their risk management strategy for specific liabilities. Where those investments are specific to particular liabilities (e.g. a buy-in) the assets would be ear-marked by the pool specifically for the individual fund that requires them.
- **Hedging strategies** should not be viewed as an investment in themselves and they should be permitted to be maintained locally as long as there is “look through” available to the underlying exposures at Fund level. This is consistent with funds maintaining local discretion over strategic allocation and risk management and will allow funds to tailor their risk exposures and will support governance and monitoring requirements. If and when pools have appropriate skilled resource, some of these instruments could be procured by the pool at the request of individual funds who need them to execute their risk strategies. Clearly any such instruments would need to be ear-marked by the pool for the individual fund that requires them.

- Funds should **be allowed to hold sufficient working capital locally** and any strategic cash should be pooled. There should also be some flexibility in the way that this working capital is invested.

Regional Pools

- This work-stream considered the merits of a purely regional approach and how best to implement it.
- Two groupings of funds were considered: 1) exclusively on a regional allocation; and 2) amending the regional groupings to equalise the size of the pools.
- If the groupings are defined along purely regional lines there should be a time-limited opportunity (a '**transfer window'**) when individual funds could request a transfer to another pool. This recognises that some groupings are already establishing themselves and not necessarily along geographic lines.
- Regional pools should work in collaboration where economies of scale suggest optimum sizes of investment within specific asset classes are larger than that run by an individual region. This is effectively the **"MAP Plus" model**.
- The additional savings for a SAP are not considered to be significantly greater than those within MAP, although potential savings vary by region depending on the current starting point for the funds participating in any particular regional pool. Influences on current costs would include fund size (where larger funds have tended to have lower costs), any in-house managed funds joining the pool (where again the costs are lower) and the current use of alternatives (which generally carry higher fees, especially where a Fund-of-Fund arrangement is in place).
- Outside of London which has a structure that can support participation by 32 boroughs through cross-London governance arrangements, the natural limitation of between nine to twelve funds in any one pool should make it possible for each fund to feel that it has a voice in the policy and approach adopted.
- Each grouping of funds should develop and agree a set of **'like-minded' principles** that guide the setting of the cultural and governance arrangements; these principles may vary between groupings and will influence the approach to structure, transition and cost sharing.
- The asset **transitions** that are required will be larger than any transitions completed to date; this brings significant risk and likely costs. There are likely to be opportunities for pools to collaborate to 'cross' assets between them and avoid costs prior to trading in the market. To be successful, this will require careful project management and a willingness to coordinate the timing of the transitions between funds within any pool and between pools.

ESG and Responsible Investment ("RI")

- Each workstream considered ESG and RI in making recommendations in respect of specific asset classes. In addition, the ESG and RI sub-group has made the following over-arching recommendations in respect of the pools themselves. Each pool should:

  a) **Nominate a lead** to co-ordinate the consideration of ESG/RI issues, risks and communications for the pool and support underlying funds in implementation.

  b) **Identify ESG risks and opportunities as part of the wider risk framework** and help ensure that these inform the strategic asset allocation, Investment Principles and Investment Strategy Statements of the individual funds in the pool.

  c) **Share best practice** across LGPS and in the wider UK pension fund industry to achieve time and cost savings and enhanced reputational benefits.

d) Use **National frameworks** and other collaborative initiatives (for example LAPFF) to access services to support cost effective stewardship and consideration of ESG/ RI issues. The use of collaborative initiatives enables more effective collective action.

e) **Develop a compliance statement to the UK Stewardship Code** (or other global codes as appropriate or may supersede) for the pool. Consideration of ESG should also to be consistent with the guidance produced by DWP[6] and TPR.

f) Seek, over time, to apply international best practice, consistent with the application of fiduciary duty as set by the Law Commission. A practical step would be for each pool to become a signatory to the **United Nations Principles of Responsible Investment** by 2020**.**

Conclusion

- The purpose of Project POOL was to identify the most effective way for LGPS funds to form larger investment pools to achieve cost savings and other scale benefits within the constraints set out by government, evidencing our conclusions with objective data and analysis.
- The local authorities participating in the project have come to a strong consensus on the preferred approach – **Multi-asset Pools (MAPs) formed by groups of regional or like-minded funds**. On day one, a number of MAPs may have the option of "in-house" management as well as external investment management while others will only offer external management. These MAPs should be complemented by a small number of additional investment arrangements accessible to all of the pools for asset types where LGPS-wide collaboration may deliver greater benefits (e.g.an infrastructure investment platform or a national procurement of passive investment managers). We refer to this pooling model as "**MAP Plus**".
- Discussions between funds to create MAPs along the lines set out in this report are already in progress. Those discussions are informed by the work of Project POOL between September and December 2015. There is additional analysis in the detailed work of the Project work-streams that will also be helpful as these plans are taken forward.
- It is our hope that this summary report and the more detailed report published alongside it will be useful to all local authorities and elected members involved in the LGPS and to government, in the period between now and the deadlines for pooling proposals in July 2016, and in the implementation phase that will follow.