COMMENT

LGPS asset pooling – does every silver lining have a cloud?

KAREN SHACKLETON OF ALLENBRIDGE DEBATES THE PROS AND CONS OF LGPS ASSET POOLING AND POINTS OUT THAT ALONG WITH THE UNDENIABLE BENEFITS THERE ARE STILL MANY TROUBLING QUESTIONS TO BE ANSWERED

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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair…" This famous quotation from *A Tale of Two Cities* by Charles Dickens is an apt description of the sentiment and divided industry/government opinion over the past two years on the journey towards LGPS asset pooling.

Dancing partners are beginning to step out tentatively onto the dance floor. A number of different pooling solutions are being proposed. Some are regional, multi-asset pools (the London CIV being an example). Some are pooling assets of funds who have similar investment solutions or a shared investment philosophy (e.g. the Lancashire/LPFA partnership). The government is also encouraging schemes to consider a national, single asset, infrastructure fund as a third potential option.

George Osborne, in his speech at the Conservative Party conference in October 2015, announced that pooling "will save hundreds of millions in costs, and crucially they'll invest billions in the infrastructure of their regions." Indeed, Hymans Robertson's original research for the government, in May 2014, pointed to the significant potential cost savings from collaboration, to which George Osborne referred. Yet not everyone agreed with the data, nor with George Osborne's vision.

Gaining benefits

Over the past two years, the advantages of pooling have been promoted, pondered and debated by those in favour and those against, including benefits such as:

- Greater bargaining power when investing
- Lower management fees
- Procurement costs, currently incurred by each local authority, are minimised because the pool takes responsibility for hiring and firing

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managers. Duplication of effort is avoided

- Enhanced returns because the pools will have superior governance resources which will enable improved manager selection/de-selection decisions
- Fewer delays in decision-making due to sensible governance structures unencumbered by the LGPS meeting cycle
- Further savings in management fees due to internal asset management within the pool
- Direct investments in private assets (e.g. infrastructure) becomes a realistic goal even for smaller LGPS investors

And so the list goes on. But is there a cloud to this silver lining? In which areas will local authorities potentially lose out, as the pooling process begins?

Making sacrifices

Manager meetings

At *LAPF Investments'* November Question Time on collaboration, a member of the audience asked whether fund managers would continue to attend LGPS committee meetings. The passive manager who responded confirmed that they were indeed still willing to do this. Other managers have expressed more reluctance, however, arguing that the fee reduction being offered to the pool can only be achieved if they, in turn, are able to reduce their costs. Yet many managers use their face-to-face contact time with LGPS funds to sell other services, to raise more money for their existing mandates, or to ensure the investor stands by them during poor performance periods. With structures such as the one favoured by the London CIV, schemes will still be able to select or de-select individual managers from the roster of firms approved by the CIV, so some of that direct selling may still be desirable.

Nonetheless, it seems likely that meetings with managers will become less frequent, simply because much of the in-depth monitoring and challenge will be delegated to the pool.

Bespoke mandates

When the London CIV approached all the London Boroughs to compile a list of managers and mandates, there was surprisingly less commonality than might have initially been expected. The London CIV had 30 or so schemes to access, increasing the chance of some commonality across mandates. Other pools have far fewer members: the South West group, for example, was formed of just eight member funds when they announced their intentions in October 2015. Commonality across mandates may present a challenge for these pools, at the outset, especially once they look beyond passive or traditional active equities.

Despite this challenge, the London CIV was able to launch with four equity fund managers where there was already some commonality (more on this can be found at *www.lapfinvestments.com*). This initial phase is still expected to generate up to £3 million in fee savings alone. But the fact remains: in order to realise further savings, schemes may need to be prepared to move away from bespoke mandates into a common approach. For some asset classes the impact could be fairly limited; for others it may be a harder pill to swallow.

Accessing boutique managers

With a £30 billion pool of assets, gaining exposure to niche managers is more of a challenge. The new pool may well include a boutique sleeve but the choice of managers will inevitably be more limited, and rules over capacity constraints could impact a scheme's ability to allocate fully to the boutique manager of their choice.

Tailored reporting

Although manager reports generally follow a standard template, some local authorities may be receiving additional, non-standard information from their investment managers. For example, performance may be presented in a bespoke way; perhaps the scheme requested more detailed information on voting, wanted their report ordered differently or requested an early production to meet internal print deadlines.

With a pooled arrangement, the reporting will be to the pool, not to the LGPS client. Some flexibility may need to be given up. LGPS officers will need to liaise with the pool to find out exactly what the reporting format is likely to be, when reports will be sent out and whether this means they will need to modify the management information that they prepare for committee meetings. Some managers may still be persuaded to send across additional data directly but others will not.

Unanswered questions

In addition to these issues, there remain, at this stage, many unanswered questions about how the new pools will operate in practice. For example:

- What happens if the pool performs poorly overall? At present, it is a relatively straightforward process to fire an underperforming manager, but it will be far more serious if a scheme wishes to terminate a relationship with the pool itself. Schemes will need to be confident that the pool's board of directors will challenge their investment committee, heading off problems so that the scheme is not forced to consider leaving the pool completely. This may involve difficult decisions for the board about the pool's investment team.

- If the pool's investment committee decides to terminate a manager, how does this process follow through to the individual scheme? Will new managers be recommended as substitutes? Each scheme will be obliged to incur the transition costs associated with that decision, even if they disagree with it. Who takes the blame if it turns out to be bad timing (and the manager subsequently outperforms)? Performance measurers WM have shown that, historically, the timing of manager hiring/firing has been poor.

- How will capacity constraints be handled? For example, will schemes already investing with a manager in the pool be given "favoured nation status" or will capacity constraints apply to all members of the pool, regardless of whether or not they currently invest with that manager?

- With regard to private funds, will the pools operate a secondary market for schemes who wish/need to exit their private investments? If not, will the scheme be able to exit the investment in the wider secondary market?

- How will Liability Driven Investment (LDI) or liability-aware strategies be implemented?

At this stage there are many more unanswered questions and it seems inevitable that, when solutions are eventually decided upon, they will vary from pool to pool. Schemes are therefore advised to scrutinise the depth of governance resources and the quality of the staff involved, before signing up to a pool. A shared philosophy on key issues is advisable.

A brave new world

The pension committee's role will undoubtedly change, post pooling, with less focus and attention on individual manager monitoring, and more focus on the desired high level outcomes of the scheme. Committee members will spend more time debating how to resolve key priorities, for example eliminating the deficit over 17 years, meeting net cash-flow needs over the next five to ten years, matching liabilities over the next 40 years or dealing with another budget cut resulting in staff losses. This will, in turn, lead to more focus on the strategic asset allocation of the investments: which asset classes and which types of mandates are most likely to deliver to those outcomes successfully? Committees may wish to review their skillset, their strengths and weaknesses and those of their external advisers, and begin to gear more towards those who can demonstrate a capability in formulating investment strategy.

So the conclusion is – probably – yes, every silver lining does have a cloud. In which case, let us hope for a fairly benign summer, with the clouds passing quickly by, to leave clear blue skies ahead.