

Scale and consolidation

To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?

The (summarised) original objectives of LGPS asset pooling were stated in the November 2015 statutory guidance as follows:

- *Asset pool(s) that achieve the benefits of scale* - at least £25bn of Scheme assets.
- *Strong governance and decision making*
- *Reduced costs and excellent value for money*
- *An improved capacity to invest in infrastructure.* Not specifically UK but there was a clear expectation that the UK economy would benefit from at least some of this investment:

“The Chancellor has announced that the pools should take the form of up to six British Wealth Funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth.” (from paragraph 1.1)

In response, the LGPS successfully created 8 asset pools with differing structures and approaches, all of which will argue they have met the four criteria (with some noted exceptions on scale). This response will focus on our pool - Border to Coast Pensions Partnership Limited.

Participation in Border to Coast has allowed us to meet all four original criteria. By the end of 2024 around two thirds of our Fund’s assets will be invested through the Pool. The remaining third consists of working cash, illiquid investments which cannot easily or cheaply transfer to Pool management, and a small proportion of ‘local’ investments, usually overseen by specialist fund managers. Over the longer term almost all of this remaining third is expected to be invested by the Pool.

Creating the Pool company has been a collective effort of twelve (now eleven following a fund merger) partner Funds and the growing Pool company itself, together committed to the venture’s success. Important elements in ensuring the success of the partnership include:

- Sensible compromise and agreed ground rules (each proposition should attract at least two investors and at least a specific asset value) have been applied to help avoid a proliferation of Pool propositions while ensuring partner Funds can implement their strategies.
- An FCA-regulated arms-length organisation – allowing provision of investment management (including both internally and externally managed propositions), associated tax efficient pooled vehicle operations, and advisory services through a centre of expertise focussed on and delivering for the LGPS. It also enables stability of governance structures for investment decision-making.
- An ability to develop new propositions (such as Climate Opportunities and UK Opportunities) and to bring forward proposition development where required (such as moving forward the development of the alternatives propositions) exemplify the flexible, collaborative approach of the partnership.
- Achieving scale through the Pool has allowed us better access to top quality private markets managers at competitive fee rates. This should benefit the Pool (and our Fund) in the long term, as performance persistence is acknowledged to be more consistent in private markets (compared to public).

Investing in the UK

What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

Our Pool (in common with most/all of the LGPS) already focuses on risk-adjusted net of fees returns when evaluating outcomes.

Increased scale can deliver specific goals, such as more diverse capital allocation across private and public markets, accompanied by the tools necessary for success: notably, strong governance and oversight; investment expertise; and sophisticated procurement methods.

There is a clear link between scale and investment in a wider set of asset classes. Data from CEM highlights that a typical £1bn Fund invests 11% in private markets; a £20bn fund invests 20%; and a £100bn Fund invests 23%. While the cost of this asset class mix increases from 52.9bps for a £1bn fund, to 75.8bps for a £50bn fund, it then falls to 67.6bps for a £100bn fund. The Pension Protection Fund's annual analysis of private sector DB schemes in the UK (the 'Purple Book') shows increased allocations to private markets as scheme AUM increases.

However, although increased investor scale may lead to more private market investment, there is no indication this will necessarily lead to more UK investment.

Our Pool has demonstrated it is possible to use its scale and sophistication to enhance its ability to deliver productive finance in the UK. Our Pool's UK Opportunities strategy is designed to deliver productive finance in the UK. The development of this strategy included workshops with partner Funds and with local economic development offices, Homes England, UKIB and British Business Bank, seeking to build a two-way flow of information and engagement between the Pool, investment managers, and local stakeholders to create opportunities for investment. Larger pools of assets enable greater sophistication, which in turn enables better engagement and influence to make the market, not just be a recipient.

LGPS Funds do not just manage assets, they administer pensions and develop and maintain relationships with scheme members and Fund employers in their area. There is a risk that poorly planned or unnecessary consolidation could have adverse impacts on scheme members and employers.

What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

The LGPS is already a significant investor in the UK. Across our Pool, of the £45bn of investments directly pooled through Border to Coast, over £10bn is currently invested in the UK and this will increase with the imminent launch of the UK Real Estate fund which has the potential to grow to £4bn. Our Fund currently invests around 25% of its assets in the UK (listed equities and private markets including real estate).

The long-term decline in domestic investment in the UK market, particularly in relation to UK-listed equities, has been well-chronicled, factors include:

- Long term historic underperformance – for example, the average annual total return from 1998 to 2023 for the FTSE All Share was 5.15%, and the MSCI World was 7.73%. This performance

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differential is due to a mix of relative valuation multiple contraction but also lower earnings growth

- Structure – FTSE is skewed to old economy sectors (Energy, Materials, Financials (inc. investment trusts) etc.) with less exposure to growth (Tech, Healthcare etc.)
- Lack of dynamism – minimal IPOs, overseas takeovers of growth companies, companies moving listings to higher valued markets
- Complex and expensive listing requirements – ensure listing requirements are consistent with international standards and balance interests of both business owners, operators and equity market investors
- Stamp Duty on share transactions – this currently raises c.0.3% of UK Tax revenue but has a disproportionate negative impact on the economy. Revenues on this duty have remained broadly flat for 25 years. There is a material cost disadvantage vs the US and several major European markets (UK: 0.5%, US and Germany: 0%, France: 0.3%).

Investors have struggled to secure the necessary certainty and appropriate cost of capital in relation to assets in regulated industries. Regulatory reforms need to better reflect the potential impacts on the assumptions underpinning investments made with long-term time horizons and the consequent impact on investor confidence.

There are challenges in the planning system, which have long acted as a disincentive to UK investment. Lack of long-term policy certainty, particularly in the case of infrastructure, has further been a hindrance. Government has a fundamental role to play in supporting a pipeline of investable projects and creating sustainable public-private partnership models. Clear and stable industrial and skills strategies will also be important. Across asset classes, a significant challenge for investing in the UK is the level of volatility in public policy that has been seen in recent years. The LGPS invests with a very long time horizon, and many UK growth assets, such as infrastructure, can only be held for the long-term. This uncertainty makes it challenging for the LGPS to invest in such markets. This offers the new government a great opportunity to build confidence by offering policy stability.

Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?

The LGPS has a fiduciary duty to scheme members and employers and must ensure the sustainable and affordable payment of pensions. Requirements to invest in specific geographies or asset classes risks infringing on that. Given the factors set out above, no credible asset allocation model would result in dramatic short-term increases in UK allocations – particularly for listed markets.

Such requirements may drive unfavourable outcomes including distorting effects as capital is driven into markets that are not ready to receive it, negatively impacting returns, and is withdrawn from other asset classes in a way that incurs potential loss of value and additional administrative costs. Imposing requirements also fails to address whether funds have the required capacity and capabilities.

‘Local’ impact can be hard to deliver in less affluent areas. Our Fund’s experience of attempting truly ‘local’ investment (investing in businesses wholly or mainly based in our Fund’s geographical area) has highlighted the difficulty in sourcing these types of investment. Our largest ‘local’ investment – in a challenger bank - is about to reach profitability after a difficult journey but, unfortunately, has

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only achieved this with the assistance of another investor who has (reasonably) judged that the 'local' headquarters is impractical.

Going forward, using the Pool's expertise to assist in sourcing and evaluating 'local' investment opportunities will be helpful. As will widening our geographical lens. The UK Opportunities approach developed with our Pool, once fully developed, will also allow a clear route for businesses seeking capital to propose investment opportunities.