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# ASSET POOLING AND THE LGPS

**The issue**

The Budget in July included an announcement in relation to asset pooling within the LGPS. The Government's aim is to reduce costs significantly while maintaining overall investment performance.

A consultation is expected later in the year that will invite authorities to come forward with their own proposals but will also set out backstop legislation to cover those that do not come forward with "sufficiently ambitious" solutions.

**Background**

The report produced by Hymans Robertson included as part of the last consultation on cost savings suggested that £660m of savings could be made across the LGPS in England and Wales. This covered investment manager fees (£230m), exiting from fund of funds arrangements for alternatives (£240m) and transaction costs (£190m).

It is important to note that Hymans' numbers on investment manager fees and transaction costs assumed that all equities and bonds were moved to passive management. It appears that Government thinking has moved on here and that asset pooling is being seen as an alternative means to reducing fees by taking advantage of economies of scale (although whether backstop legislation suggests a passive approach remains to be seen).

Transaction costs, it was suggested in the report, could be reduced by moving to passive management; but of course this may (depending on the performance of active managers) be at odds with Government's stated aim of maintaining overall investment performance.

It is also perhaps worth noting that transaction costs are not an explicit cost paid by the LGPS (or any investor for that matter) in the way that investment manager fees are. They are accounted for within reported performance numbers (i.e. returns are measured after transaction costs).

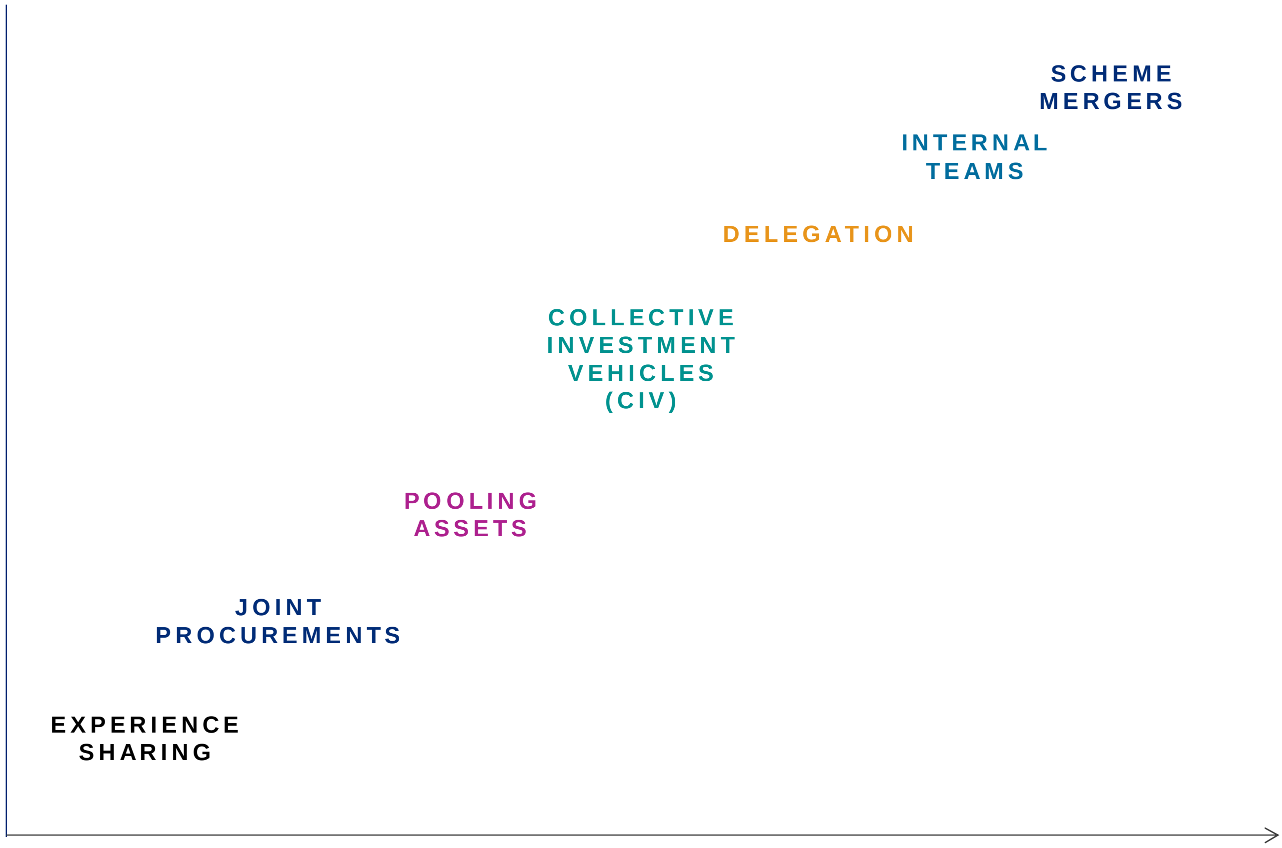
Nonetheless, the key message here is that the benchmark for cost savings seems to have been set at £660m which is the equivalent of the LGPS moving all its equities and bonds into passive management plus the unwinding of fund of fund arrangements for alternative investments.

This is a particularly high benchmark given that it is well know that the LGPS (on the whole) already commands competitive fee arrangements across equities and bonds in particular.

**The Options**

It seems likely that the consultation will ask authorities for very specific and quantifiable proposals on achieving (significant) cost savings.  Failure to come forward with sufficiently ambitious plans will result in "backstop" legislation.

The graphic below indicates the range of options that could be considered.




The areas that are receiving most attention seem to be joint procurements, asset pooling and collective investment vehicles.

Joint procurements are becoming more frequent and can yield a degree of savings.  The passive management market in particular is increasingly competitive, driven by the fact that there are a small number of players and that there are clear economies of scale within passive management. Joint procurements here might drive fees down by several basis points.  (To provide some context, one basis point for an average LGPS fund of £2.5billion equates to £250,000 and is unlikely to be significant enough to satisfy the Government's request for "ambitious" plans).

Pooling assets in its loosest form is essentially one step removed from joint procurements and would mean agreements amongst Funds to appoint the same managers and to unitise each Fund's holding. However, although there is some commonality of mandates across the LGPS, it is unlikely to be enough to simply pool assets in their current form.    Fee discounts would likely result but they may well be minimal, particularly in traditional asset classes; partly because many LGPS funds wield large mandates already and are often at the top of tiered fee scales but also because high quality managers with limited capacity will be unlikely to reduce fees. Asset pooling does not of itself provide a formal structure to ensure that this is a long standing agreement between Funds, so it does not feel like a long term solution.

Collective investment vehicles are a more formal version of asset pooling and may represent a longer term solution. They are housed within a (FCA) regulated structure that may either be "built" by the Funds or "rented" from a third party provider. There are a range of models available but the collective vehicle would have an investment committee (that could well be made up of representatives from each contributing Fund) that determines manager selection decisions. Depending on the model chosen, the economies of scale come from the collective assets of the Funds involved, but may well also leverage the scale of assets of the third party provider of the "rented structure".

One of the key issues is that if assets are to be pooled, then the governance arrangements around manager selection and monitoring will likely change. This will be important to get right in order to fulfil the Government's aim of maintaining investment performance. Regardless of the options chosen, one body will be responsible for manager issues for Funds who invest collectively together. Strategic (asset allocation) and funding issues are the ones that have most impact at a Fund level and these will remain at a local level.

**Next steps**

The date, format and the length of the proposed consultation are unknown; although it is expected before the end of the year. It appears that specific proposals will be required and so authorities, in our view, need to explore their options as soon as possible if they intend to avoid backstop legislation.

**Jo Holden, Head of UK Public Sector**

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