T +44 203 637 6341
+44 7876 350650
E william@linchpin.uk.com
W linchpin.uk.com
A Riverside House, River Lawn Road, Tonbridge, Kent TN9 1EP

31st January 2019

Response to MCHLG consultation on proposed asset pooling guidance

Linchpin Advisory acts as Independent Advisor to three LGPS Funds - Teesside, Nottinghamshire and East Sussex - and William Bourne acts in a personal capacity as Independent Chair to two Local Pension Boards, Lancashire and LPFA. From these various roles we have insights to a greater or lesser extent into four of the eight pools - LPP, ACCESS, LGPS Central and Borders to Coast. In the case of the first three we have watched their creation and development from the very beginning, and we have been active in advising and commenting on governance issues in particular.

We concur with the rationale for creating the Pools and believe that there will be significant wins from their establishment, not just in terms of cost savings but also greater resources to apply to areas such as responsible investment and infrastructure. That said, in law the Pool Members still retain overall responsibility for investment. For this reason it is essential that effective governance measures are put in place to hold the Pools to account in order for 101 Committees and Pension Boards to discharge their legal duties.

This is made more difficult by a number of factors: the additional complexity of the 'pooling' model; the blurred relationships resulting from Pool Members being, in most cases, owners as well as clients of the Pools; and the not-for-profit nature of the latter. The ultimate sanction of terminating the relationship, which would be a normal response to poor performance in the private sector, is not readily available to Pool Members.

It is therefore our strong view that effective governance over the Pools is the single most important determinant in their long term success and this lies behind most of our comments on individual sections in this response. References are as per the Consultation document.

Structure and Scale

3.6 In our view the wording should make reference to the <u>risk-adjusted</u> performance net of costs. We argue this because passive investments tend, by the nature of their construction, to exhibit greater volatility than active funds. This is because efficient diversification is one of the basic tenets of active portfolio construction but indices, and by implication passive portfolios, are diversification unaware. For example the MSCI Global index has around 60% of its weight in in the United States and there is no fundamental factor to correct this level of concentration. In contrast, active managers have a strong incentive to diversify.

Active equity managers will always exhibit some deviation relative to the benchmark index given the latter is, by definition, the reference point. Our argument is that when comparing passive to active strategies on an absolute performance basis, passive strategies will in most cases show higher volatility. Hence we advise the insertion of the word '*risk-adjusted*' before '*performance*'.

Governance

4.4 We understand the intention behind this paragraph but we cannot see how benefits 'across the scheme as a whole', or even the Pool, can be equated with being in the interests of a Pool participant's members, employers or local taxpayers. 101 Committee members have Trustee-like responsibility to their membership, as this guidance makes clear, and in our view this needs to be paramount. If the Pools are indeed going to provide genuine long-term benefits, as we believe they will, 101 Committee members should balance any short-term costs against these and be able to take decisions in the interest of their own members on that basis. We advise removing the words '*take account of the benefits across the pool and across the scheme as a whole, in the interests of scheme members, employers and local taxpayers, and should*' from the last sentence.

4.5 We enthusiastically agree with the sentiment and intention behind this paragraph. Some Pension Boards have found it difficult to obtain relevant data from Pools to allow them to fulfil their duties. Pools have on occasion used data confidentiality (on the basis that they are a separate legal entity) as a reason to withhold or redact relevant data and reports going to Pension Boards or even Pension Committees. We would like to see some wording in this paragraph to make it clear that Pools are obliged to behave with complete transparency to all governance bodies of the Pool Members.

4.6 We can see the merit of increased transparency (see comment on 4.5) by allowing Pension Board members as observers on Pool governance bodies. However, we are concerned that such observers might find themselves with a conflict of interest. Pension Boards are there to assist Pension Committees and should not find themselves with any duties or accountability to Pools. It may be worth adding wording in this paragraph to make that clear.

Transition of Assets

5.3 Again we understand the intention behind this paragraph but we believe it will be difficult, if not impossible, to implement in practice. We say this because calculating transition costs is a necessary input into any inter-authority payment calculation and that is an imprecise science. Some elements are fixed, but others such as the market impact and the opportunity cost are difficult to estimate on a precise basis.

Making New Investments Outside the Pool

6.1 From our knowledge of the four Pools we are involved with, the majority of Pools will not be in a position to offer all asset classes to Pool Members by April 2020. Setting up new sub-funds is time and resource-intensive, and should not be subject to any time guillotine. Not only does it require genuine consent in detail from Pool Members but also careful and considered procurement where external managers are concerned.

Hurrying this process will result in sub-funds which do not meet Pool Member requirements and are therefore shunned.

We view the proposed timetable as unrealistic and suggest that substantially more flexibility is built into the wording. We would suggest in particular the last sentence is worded as '*From 2020, or when new investment strategies are in place, pool members ~~should~~ are encouraged to make new investments ~~outside~~ into the pool as their default option on a comply or explain basis~~only in very limited circumstances~~*. (added wording is underlined).

6.3 We strongly encourage wording which allows Pool Members to use vehicles in other Pools. In our view this provides the most effective sanction available if a Pool is failing to perform adequately. It is closer to the proven private sector model where well-run asset managers flourish and poorer ones die. We would argue that this would be the surest safeguard to ensure the long term success of the pooling model, and therefore benefits to Pool Members' own members and employers.

We would consequently suggest that this paragraph is widened to allow Pool Members the freedom to move assets to different Pools under any circumstance and is not just limited to cross pool collaboration or specialisation.

Infrastructure

7.2 We would caution against any assumption that there is a 'correct' level of infrastructure investment on the basis of what other investors are doing. Each investor's circumstances are different and this paragraph risks leading Pension Fund Committees to follow an inappropriate investment strategies simply on the basis of what other investors are doing. We would recommend deleting the last sentence of this paragraph.