LGPS CENTRAL LIMITED

Pensions Investment Review

Call For Evidence

LGPS Central Limited ("LGPSC") is pleased to respond to the government's Call for Evidence (CfE) *The Pensions Investment Review: Call for Evidence.*

LGPSC is the full service FCA-regulated asset manager for eight local authority pension funds (our Partner Funds) across Central England. Our Partner Funds, who are both our shareholders and clients, are: the Cheshire Pension Fund, Derbyshire Pension Fund, Leicestershire Pension Fund, Nottinghamshire Pension Fund, Shropshire Pension Fund, Staffordshire Pension Fund, the West Midlands Pension Fund and the Worcestershire Pension Fund. We are jointly owned in equal shares by those Partner Funds. We are one of eight Local Government Pension Scheme (LGPS) asset pools in England and Wales.

As at September 2024 we are responsible for managing over £30bn of their assets across public and private markets. A third of our assets are managed internally and over a sixth are invested in the UK.

We have restricted our comments to those questions pertaining to the LGPS and pooling.

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'Scale & Consolidation' - Q5

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?

LGPS Central Limited (LGPSC) works in close partnership and collaboration with its Partner Funds. We believe that by taking this approach, pooling has been successful and has delivered significant benefits in terms of investment opportunity and efficiency:

- To date, LGPSC has delivered £89.0m of gross cost savings for our Partner Funds and we are projected to deliver £339.1m of gross savings by 2033/34, consistent with the government's wish to drive further efficiency and value for money in the LGPS.
- Through pooling we have increased the range of investment opportunities available to our Partner Funds. Our £5bn private markets programme provides value through fee reductions, low-cost direct investment and exposure to top tier external managers which is only possible with scale. A quarter of our Private Market investments are in the UK. This includes our recently launched residential property fund which is focused on affordable housing. We have made thirteen direct co-investments in Private Equity (PE) each generating savings in excess of 2% a year in management and performance fees.
- Increased scale through pooling has allowed us to invest in internal investment resources, with related cost savings and greater alignment of interests. LGPSC Partner Funds have access to internal capabilities that they would not have without pooling. In the case of LGPSC this includes equity and fixed income trading, currency hedging, transition management, risk management and Responsible Investment services. LGPSC is unique amongst LGPS asset pool entities in providing internally managed passive equity and gilts capabilities, in-house derivative trading and directly managed private equity co-investments. Together these services deliver cost savings and operational efficiencies by avoiding outsourcing to third party providers.

These benefits have only been achievable through pooling.

LGPS pooling has only been in existence for six years. It is therefore very early to judge the investment performance of long-term asset managers seeking to generate returns to support long-term liabilities, and too early to judge performance across all products. Nevertheless, our multi-manager Global Equity Fund is a top-quartile performer versus its industry-wide peer group over five years. Our Private Equity co-investments have delivered outstanding returns. For example our Private Equity Co-Investment Partnership 2018 has delivered an IRR in excess of 30%.

We believe a particular success factor has been our model of pooling. We are an FCA regulated company in which we are also the authorised ACS provider. This

service has not been outsourced to a third party, which has delivered the dual benefits of integrated in-house regulatory governance and avoiding cost leakage. This approach strengthens investment governance and provides our Partner Funds with assurance.

Our ownership and governance structure helps to retain democratic accountability. The fact that we are based amongst our Partner Funds in the Midlands retains strong regional connections and has continued to benefit the region through the development of local investment expertise.

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'Cost vs Value' – Q2

Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

This question is relevant to the LGPS insofar as there is an inconsistent approach between LGPS member funds in navigating the trade-offs between cost and value.

It has not always been helpful that one of the key measures of success for LGPS pooling has been the delivery of *cost savings* rather than being framed as improved returns net of fees – i.e. *value for money*. We therefore welcome any change in policy to focus on delivery of value. We recognise that it is difficult to define this, not least because even long-term returns realised net of fees do not easily reveal the differential levels of risk that might have been taken to deliver them and are not therefore easily comparable.

Overall, however, we believe that increased budgets for investment management fees can deliver value – especially in the case of increased tolerance for performance fees.

In the case of the LGPS, improvements in portfolio performance will not lead to better retirement outcomes for beneficiaries, as benefits are defined. However, higher performance *could* potentially lead to a more sustainable LGPS over time, leading to reduced contribution rates from employers and/or members.

A focus on value rather than costs, coupled with the increased in-house expertise, of the kind already being provided by LGPS Central Limited (LGPSC), could lead to increased allocations to more complex and higher cost strategies which are typically seen in areas such as Venture Capital, Private Equity, 'Greenfield' Infrastructure, and property development and construction.

We note that such investments would not have to be in the UK. The more important question for any investor, and in particular pension fund investors is, rather than its location, whether the investments have the right characteristics of risk and return to satisfy their fiduciary responsibilities.

So the question the government must address is how to make such opportunities in the UK attractive to investors. We believe there is a critical role for government in helping to ensure there is the right supply of assets, structured in the right way for UK pension funds, to invest in and thus help drive UK growth. The issue is not a shortage of capital but rather a shortage of the right kind of investable assets.

We believe this is where government intervention should be focused. To this end, the creation of the National Wealth Fund, together with institutions such as GB Power, and the UK Infrastructure Bank will be helpful and these institutions must work closely with UK pension funds.

This should be the focus of government activity rather than any specific interventions, such as setting targets or aspirations for private markets investments, that could run counter to funds' fiduciary duties.

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'Investing in the UK' – Q1

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?

The scale achieved through effective pooling already delivers significant benefits (see answer to question above). These include the ability to access sophisticated asset classes through an expert in-house team, larger pools of capital available to deploy into the right opportunities when they arise, and cost savings deriving from both scale and in-house capability.

LGPS Central Limited (LGPSC) already has 25% of its current private market investments in the UK – an overweight allocation when measured against global GDP. Our investments include, for example, £30m in local NHS facilities.

With more scale there is the *potential* for further investment. However, there is a false equivalency between the ability to undertake a professional assessment of an investment which would be granted by sufficient scale, and the desirability of such assets. As an FCA regulated manager of assets on behalf of our Partner Funds, we need to consider the suitability and relative risk and rewards of any investment we make.

We would urge caution, therefore, in simply suggesting that consolidation of LGPS asset pools – still in their infancy – is the answer to driving higher levels of investment in productive capital that can drive UK growth.

Each pool – even the five FCA authorised pool companies – is slightly different from each other, reflecting their own establishing Partner Funds' needs. Moreover, enforced mergers would consume a considerable amount of time and resource and could divert pools' attention away from investing in private markets and increasing allocations to the UK.

It could also dilute a pool's local presence, diluting in turn the impetus for local investment. We believe that any direction provided by government should focus on the transfer of assets from member funds to their existing pool. To this end, we believe clear guidance is needed about the respective responsibilities of funds and their pool entities together with clear expectations and a clear requirement for funds to delegate implementation decisions to their pool entity.

We note also that collaboration, and leveraging assets and scale, can take many forms. Encouragement should be given to pools to work together, for example on co-investments and to seek out together investment opportunities in the UK, mindful of their respective Partner Funds' needs and their fiduciary duties.

Coupled with an increased supply of high-quality investable assets, the conditions could prove positive for increasing UK pension fund investment in UK assets.

To support pension funds to invest in the UK, the government should be clear about how it is defining UK investment. For a well-diversified pension fund, this extends beyond private markets investment and will include gilts (which are lending money to HM government and the UK economy) and publicly listed markets. So we believe 'UK investment' should be broadly defined focusing on the economic benefits to the country/regions.

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'Investing in the UK' – Q2

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?

There are several factors behind the changing patterns of UK investment by UK pension funds:

1. Declining DB provision

   Provisions put in place to protect pensioners, accounting rules and the consequent decline of the corporate Defined Benefit pension system, have led to a focus on investment into lower-risk assets which are attractive to regulated insurance companies, and the divestment of riskier assets (which in the case of UK pension schemes used to have a significant allocation to the UK stock market) in favour of fixed income.

   The subsequent shift towards DC schemes has seen lower overall levels of contributions and has also led to a shift towards international investment and global investment strategies, with default fund settings including lower proportions of UK equities than was historically the case.

2. Performance

   The performance of the UK economy and the relative lack of depth of liquidity in, and flows into, its stock market has made it increasingly difficult for investors to make the case to invest here.

   In contrast, the US economy has performed strongly and a higher degree of personal savings flow into the stock market, meaning that US indices have outperformed and show every likelihood of continuing to do so, making the investment case easier.

   In numbers, UK equities have underperformed their US peers over the 1,3,5 and 10 year timeframes to the end of Q2 2024. The annualised lag in returns (between the FTSE 100 and S&P 500 broad indices) over a 10 year period is 10.4% per year.

3. The regulatory environment

   Long term investors – especially those interested in investing in illiquid markets – need clarity, stability and certainty. The lack of policy and regulatory consistency through the decisions of successive UK governments has inhibited commitments to infrastructure or indeed any long-term investment.

   Examples include changes to subsidies for renewable energy, inconsistency of strategy relating to the HS2 rail project, changes in the financing models for

nuclear power projects and the approach to the rollout of the next generation of cellular and fibre broadband.

This inconsistency must be addressed if the UK is to be an attractive option for pension fund investment.

While there is a significant role for politics in setting strategy, investors, including LGPS investors, need a regulatory framework that provides stability over the longer-term to avoid the short-termism that inevitably comes with political cycles.

4. A smaller universe of stocks

In liquid markets, there is some lack of dynamism and diversity in the sectors represented in the UK stock market. Many UK listed stocks are not strong on environmental credentials (oil and mineral extraction sectors for example), making them less attractive to certain investors, including the LGPS.

The current trend is also concerning as relatively low valuations have led to acquisitions and subsequent de-listing of companies from the UK stock exchange, leaving an even smaller selection of attractive investment opportunities from which investors can choose.

To reverse this trend, there need to be incentives for dynamic companies to have their headquarters and list in the UK.

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'Investing in the UK' – Q3

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?

Incentivisation of, or requirements on, UK pension schemes, particularly the LGPS, to invest in the UK would need to be implemented thoughtfully.

Most importantly, these would need to be considered against the fiduciary responsibilities of pension fund trustees and Pensions Committees (in the case of the LGPS). This requires fiduciaries to act in the best interests of members and beneficiaries so that pensions can be paid as they fall due, to secure good member outcomes, stability of contributions and value for money. This principle is at the heart of UK pension provision and any requirement or expectation to invest in a specific way could cut across this fiduciary responsibility.

It is not that LGPS Central Limited (LGPSC) and our Partner Funds do not believe there is an important role for such investments – we do; and our private markets programme is evidence of that. However, we also believe that any investment decision should be consistent with fiduciary considerations.

Any compulsion would risk undermining the benefits of professional portfolio construction and investment management, contrary to the long-term interests of investors. This would not be consistent with the priorities of the review.

We believe that government should avoid enforcing explicit requirements to allocate to any specific geography or asset class.

Nonetheless, we believe that there is a case for targeted incentives which adjust the risk/reward balance of UK investments in favour of the investor, but any incentive system needs to avoid driving misallocation of capital and/or the creation of unbalanced portfolios.

One widely discussed suggestion would be the introduction of guarantees or 'first loss' investments from the government on specific UK investment projects. There is a good case for this in terms of managing risk for investors and it may therefore be effective, but a balance needs to be carefully struck.

If the remaining investment, which benefits from the guarantee or risk reduction, does not continue to deliver sufficient return, it may cease to be attractive. Long-term investors like the LGPS need a good return for an acceptable level of risk, rather than a totally de-risked investment which delivers poor returns.

Investments in local communities do not always have an obvious, predictable or reliable income streams. The same is true for investments in renewable energy and many other infrastructure projects. There is a strong case for the government to incentivise investment through guarantees of minimum income yields, giving investors confidence in long term returns. This is likely to be effective if investors have visibility on the return of their invested capital such that downside is protected whilst upside remains to reward them for their investment.

Another option would be to make grants available to qualifying investment opportunities, reducing the cost of entry for investors and therefore reducing levels of risk and enhancing the expected return on investment. This may be even more effective than guarantees or first-loss investments insofar as grants may not so significantly reduce expected investment returns. Grants could be recoverable once investors have generated sufficient return on their capital.

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