HERTFORDSHIRE COUNTY COUNCIL PENSION FUND (“THE FUND”)

OPTIONS FOR POOLING

Background

It has been mandated that the 89 LGPS Funds in England and Wales must aggregate their assets to form six distinct asset pools. An initial deadline of 19 February 2016 was set down for each LGPS Fund to state its commitment to pooling, and the Government will be assessing the resultant pools according to the following criteria:

Size (at least £25bn in assets under management)
Governance
Reduced fees and “value for money”
An increased capacity for investing in infrastructure

Once the Government has given the green light to the chosen pools (and at the time of writing the number of pools was 7-8), the next stage will be for detailed submissions on pool structure to be finalised in July.

Options for the Fund

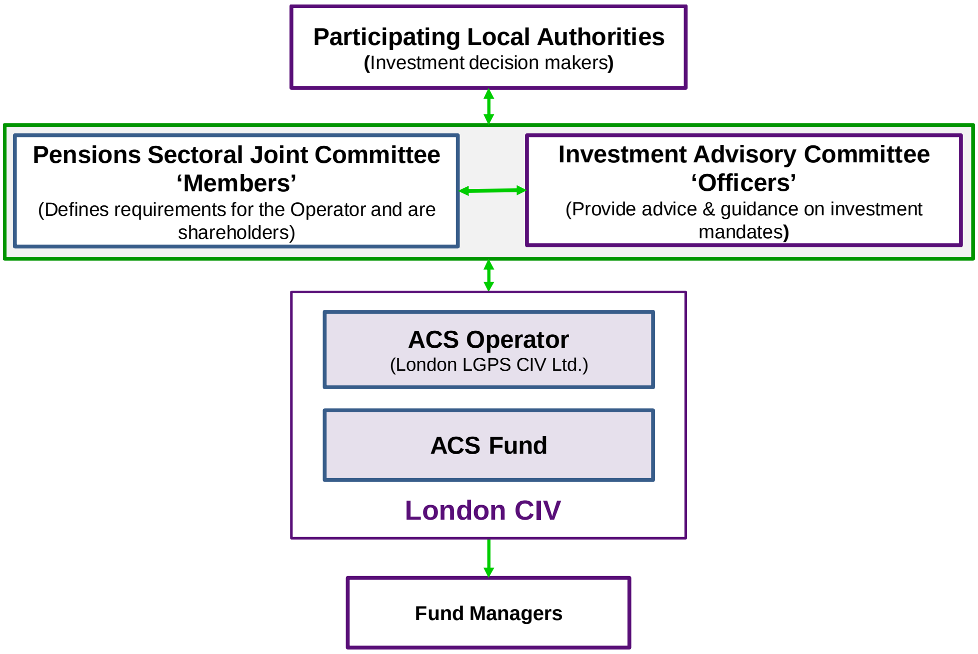
This report considers the three options for asset pooling that have been put to the Fund and makes a recommendation as to which one should be pursued. It should be noted that we make our assessment on the basis of information provided by each pool and with reference to our knowledge of the governance structure and day to day operations of the Fund; we have not conducted detailed due diligence in relation to the operational structure or offerings of each pool (in part because in certain cases, details have not been finalised or published by each pool).

The three options under consideration are:

1. To join the London Collective Investment Vehicle (“the London CIV”)
2. To join the Lancashire LPFA pool; the London Lancashire Pensions Partnership
3. To join ACCESS (A Collaboration of Central, Eastern and Southern Shires)

The London CIV

The London CIV is the asset pool for the 32 London Boroughs and the City of London Corporation. It was first established in 2014 by London Councils and involved “building” an investment management company, which has recently been authorised by the Financial Conduct Authority. Its structure is illustrated in the following graphic (diagram provided by the London CIV):



An “ACS” as noted in the diagram above is an Authorised Contractual Scheme, which is essentially a tax-transparent UK based fund, authorised by the FCA in its role as regulator of the UK’s financial markets.

The London CIV is offering a range of funds run by individual managers; the first five funds being global equity via Baillie Gifford and Allianz (both are currently managers for the Fund), passive via Legal & General (also a manager for the Fund) and BlackRock and diversified growth via Baillie Gifford. In short, those managers with a large number of mandates across the London Boroughs have been the first to be transitioned onto the structure, after negotiating terms and conditions. A programme of work is currently underway to decide which asset classes to prioritise in terms of populating a manager line up.

The intention of the London CIV is that LGPS Funds will retain the right to choose which managers they want to use; i.e. there will not be a “London Global Equity Fund” consisting of a number of managers blended together. This raises potential questions in relation to the fee savings that will be achieved; namely whether having a larger number of managers, some of which may only have limited investment by London Boroughs, can be as efficient as a joint decision to invest in a smaller number of managers. It is worth noting that the London CIV was established prior to the Government’s mandatory pooling agenda and this may go some way to explaining the approach being taken.

Every London Borough Fund that has signed up to the CIV is an equal shareholder, and has contributed £125,000 to the regulatory capital of the management company. In addition, each Fund has paid initial costs of £75,000.

An overview of the characteristics of the London CIV, and our comments thereon is provided below:

	London CIV
Description	An FCA regulated management company with a platform of individual manager offerings under an ACS (pooled fund) wrapper.
Principles	One fund, one vote. External management in the first instance. Fee savings expected via economies of scale. Control stays at local level in terms of manager choice.
Participants and degree of “like-mindedness”	London Borough LGPS Funds, managed by London Councils. London Boroughs often not comparable to County Councils in terms of size, governance, and often politics. Difficult to quantify likeminded-ness. The CIV was arguably set up as a defence against merger; 30+ Funds are unlikely to have the same mindset as each other in unison.
Size	30+ London Boroughs with total assets under management in excess of £24bn.
Internal or external management?	External – may explore internal if there is demand later.
Governance	Each Fund is a shareholder. Each Fund has a (Councillor) seat on the Joint Committee. An Officer group advises the Committee. The CIV “Company” makes final manager decisions for regulatory reasons.
Initial Costs	£75,000 per Fund. £150,000 contribution to regulatory capital per Fund.
Ongoing Costs	£25,000 p.a. per Fund (currently).
Synergies - managers	Allianz Global Equity and L&G passive are available via the CIV. Baillie Gifford is currently the Fund’s UK Equity manager; their global strategy

	would be available.
Synergies - governance	Arguably limited. Hertfordshire would be one voice amongst a minimum of 30 other Funds, some of which have very different governance structures and political make-up. Hertfordshire would be the largest Fund by some margin.
Synergies - advisors	The London CIV have to date eschewed the use of investment advisors; although an Investment Consultant Framework is under consideration.
Transition Issues	Indications are that in specie transfers of assets where Fund's existing managers are on the CIV platform may not be possible, so transition costs could result regardless.
Progress to date	FCA authorisation obtained. Chairman, CEO and Investment Oversight Director appointed. 2 global equity managers, 2 passive managers and one diversified growth fund in situ, but significant assets yet to transition across from Funds.
Headline Advantages	Regulatory work and governance structure completed; furthest advanced of the pools. As the first LGPS CIV, "teething problems" have been encountered ahead of the game. Initial costs are known.
Headline Disadvantages	No control over direction of travel; structure already determined. One vote amongst 30+ Funds, which **may** have different priorities. No guarantees that the Fund's future investment strategy could be accommodated.
Cost savings	Given that manager choice from those on the CIV rests with each Fund, is the potential for fee savings as high as a pool that chooses a small number of managers collectively?
Comments	The CIV has been an easy target for critics, but managing the expectations of 30+ Funds is a significant challenge. It ticks many of the boxes in terms of the Government's criteria for pooling. If the Hertfordshire Fund was to join the London CIV, it would be at the mercy of a large Committee and its existing project plan / timelines in terms of new mandates, although the Fund's Allianz and Legal & General mandates could be immediately accessed at a lower fee. If the Fund wanted to join an established structure that gave immediate fee savings for two of its existing managers and greater certainty of set up costs and there was no desire to be involved in the structure / set up of the pool, then this could be a low maintenance option. However due diligence would be needed, initially via the CIV's prospectus, in relation to operational issues, transition procedures and costs, but also in terms of ongoing costs and future plans.

The London Lancashire Pensions Partnership ("LLPP")

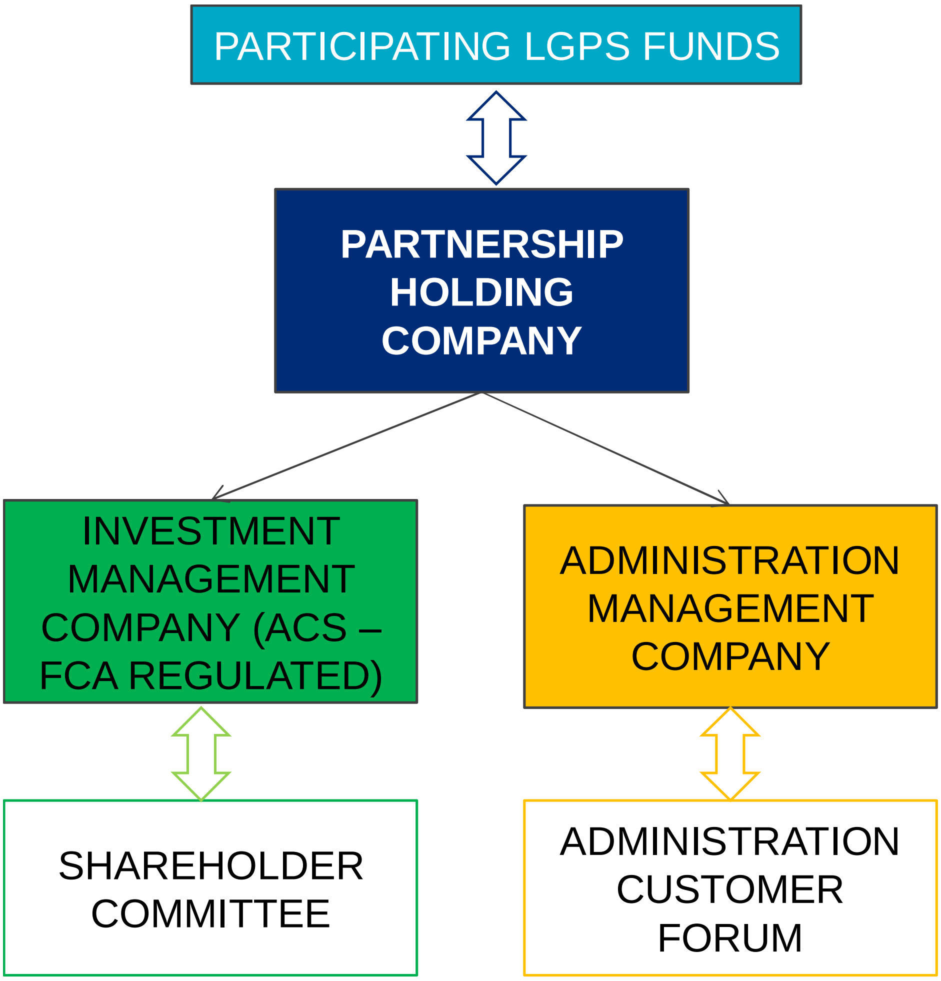
The LLPP was established in 2014 as a joint enterprise between the Lancashire Pension Fund and the London Pension Fund Authority. The venture was termed an "asset liability partnership" and was all about collaborative investment and liability management.

Similarly to the London CIV, the LLPP have been working towards building an investment management company that would invest via an ACS and have FCA authorisation. An independent Chairman has been appointed and other independent Non-Executive Directors ('NED') will also be recruited. In addition, each shareholder Fund will have a representative NED.

Participating Funds essentially have two options; join as a shareholder and have a say in the direction of the partnership, or delegate asset and liability management to the LLPP via a fiduciary management option. The LLPP is not looking for participating Funds to contribute to the set up costs or the regulatory capital; both of which have already been funded.

Both Funds currently use external investment management (although the LPFA has an internally managed buy and hold equity mandate) for traditional asset classes and have in house teams building portfolios of alternative investments (via external funds and also direct investments). We understand that the intention would be to further build out the internal management but little detail has been provided as yet.

The structure of the LLPP (using information provided) is as follows:



STOP PRESS – An announcement was made on Friday 19 February, that the LLPP was in early stage talks with Northern Powerhouse pool, comprising of the Greater Manchester, Merseyside, West Yorkshire Pension funds (c£30bn), following acknowledgement of the fact that they alone do not meet the Government's size criteria.

A great deal of time and resource has been invested in the setting up of the LLPP and it may be the case that a possible joint entity of LLPP and Northern Powerhouse uses this structure. In the absence however of any further detail at this stage, we proceed with an assessment of the LLPP structure below:

	LLPP
Description	An “asset liability partnership”, offering shareholder or non-shareholder participation (the latter being akin to fiduciary management). Investment services include “real time liability management capability”. Option to add additional services such as pensions administration for shareholders. Awaiting FCA authorisation and will utilise an ACS structure.
Principles	Offers the choice of one fund, one vote or fiduciary management. Intended bias to internal management. Liability management sits alongside asset management.
Participants and degree of “likeminded-ness”	Two large Funds with a preference for internal management and a stated intention for liability management to be at the heart of the pool.
Size	Lancashire and LPFA with assets of c.£11bn. Also in discussions with the Berkshire Pension Fund (£1.7bn). Noting recent announcement that discussions are being held with Northern Powerhouse pool (c. £30bn).
Internal or external management?	Internal predominantly with access to a “rationalised” list of external funds.
Governance	Two models available: shareholder or non-shareholder. Shareholders operate under one fund one non-executive director vote, although independent directors also have voting rights.
Initial Costs	Nil – already covered by Lancashire and the LPFA who are not looking to recover costs from joining Funds.
Ongoing Costs	Not yet known.
Synergies – managers	Little across traditional asset classes.
Synergies - governance	Hertfordshire could either be a shareholder and be one voice amongst several, or delegate investment management entirely to the partnership. The founder Funds have different governance structures to Hertfordshire, with more delegation to Officers and the use of independent advisors.
Synergies - advisors	Neither Fund has a retained consultant; rather independent advisors and internal investment teams dominate.
Transition Issues	No information to date, other than a statement that in-specie transfers will be considered.
Progress to date	Awaiting FCA authorisation of the joint entity. At £11bn, the LLPP falls some way short of the £25bn criterion.
Headline Advantages	Regulatory work and governance structure progressing with FCA authorisation expected in March 2016. Existing relationship for the Fund via pensions administration; indeed the LPFA does have experience of collaborative working and service provision. Independent Chairman with relevant background.

Headline Disadvantages	Unlikely to meet the Government's size criteria for pooling of £25bn; although talks in progress with Northern Powerhouse. Although the Fund would have an equal vote if joining as a shareholder, the structure and principles have already been determined. (Independent Board members have also been appointed by the two founder Funds). No evidence has been presented to make the case for why this pool will achieve "better" returns or offer the flexibility that the Fund may require depending on its future investment strategy.
Cost savings	Internal management is often heralded as being lower cost, but transparency is sometimes lacking. External managers are utilised, in alternatives for example, and no evidence has been presented suggesting that the LLPF could achieve lower fees than other pools.
Comments	There is a great deal of uncertainty surrounding this pool. As a standalone entity, it appears to be at an advanced stage in terms of structuring the investment management company, but it is unclear how this would fit with the Northern Powerhouse pool. The Hertfordshire Fund would need to be placing a high weighting towards its current relationship with the LPFA and the progress made on the structure for this option to have a realistic chance of consideration.

ACCESS

ACCESS is in the very early stages of development, but is essentially an agreement between 10 County LGPS Funds with assets under management of £30bn to establish a collective asset pool; run by the LGPS for the LGPS. The Fund has been involved in discussions with ACCESS from the outset and if it chose to join would bring the number of funds to 11.

To date, little work has been completed on potential structures; an ACS will likely be required (following feedback from the Government), but whether ACCESS will build its own investment management company, or "rent" the structure from an external provider is yet to be decided. A project plan has been finalised by Hymans Robertson that is intended to get ACCESS to the point of the July submission to Government on structures; this will involve a great deal of work from Officers and will also require external advice on issues such as tax and legal requirements.

Governance is seen as being key, and a set of shared principles has been developed covering:

- collaboration
- risk management
- evidence-based decision-making
- equitable cost sharing
- equitable voice in governance
- professionalism
- evolution and innovation
- value for money
- no unnecessary complexity

An overview of the characteristics of ACCESS, and our comments thereon is provided below:

	ACCESS
Description	An early stage collaboration between 10 LGPS Funds (largely regionally based). No decisions on structure have yet been made, but work has been completed on principles and a memorandum of understanding has been produced.
Principles	Based around collaborative, collective decision-making.
Participants and degree of "likeminded-ness"	10 County LGPS Funds: • Cambridgeshire • East Sussex • Essex • Hampshire • Isle of Wight • Kent • Norfolk

	• Northamptonshire • Suffolk • West Sussex Significant work done on determining a collective mindset.
Size	£30bn
Internal or external management?	External; no stated intention to develop an internal management function (partly for reasons of proximity to London and the associated issues of recruitment / retention / remuneration).
Governance	A governance work stream has been initiated.
Initial Costs	Each Fund will commit an equal share of the costs to get to the July submission date. Set up costs for the structure as yet unknown.
Ongoing Costs	Unknown at present.
Synergies – managers	ACCESS have 75% of collective assets across 12 managers.
Synergies - governance	All County Funds, run with very similar Committee structures and Officer teams.
Synergies - advisors	Most Funds have a retained investment consultant; Mercer and Hymans Robertson dominate.
Transition Issues	Not yet known – to be determined collectively.
Progress to date	Principles have been established and a memorandum of understanding agreed. A work plan has been determined and structures will be investigated Feb to July. Work on establishing the chosen structure will begin once Government approval is obtained post July.
Headline Advantages	This option gives the Fund the opportunity to be a founding partner, working with "like-minded" funds with similar governance structures, with arguably much more control over its own destiny than the other options considered.
Headline Disadvantages	There are so many decisions still to be made, that this option arguably represents a leap of faith; structures and costs are unknown and significant Officer time will be required between now and July to get to the point of making the next submission to Government.
Cost savings	Not yet known.
Comments	Although ACCESS represents an early stage pool and is a long way behind the more established London CIV and LLPP, it is not an outlier relative to the other emerging pools. The choice is reasonably stark; join a more established pool that has clear pros and cons or be part of establishing a pool with (arguably) more like-minded partners which in turn could lead to a more favourable balance of pros and cons from a Hertfordshire perspective

Should the Fund consider other pools?

This of course is an option; the other pools being Central (comprising of LGPS funds from the Midlands), Border to Coast (a collection of mostly Northern / Eastern funds plus Warwickshire and Surrey), Brunel (the South West plus Buckinghamshire and Oxfordshire) or Wales. There is also the Northern Powerhouse pool which is in discussion with LLPP.

There is no real reason why discussions shouldn't be held with these pools, but the reasons for so doing are probably no more compelling than the arguments for ACCESS. Most of the pools are at a similar stage (although one or two are more advanced in terms of draft governance arrangements and have carried out a good amount of work on possible pool structure).

Our recommendation

ACCESS is at an early stage, but on the grounds that a strong governance structure will be key for any well-functioning asset pool, the degree of like-mindedness across the participating funds should not be underestimated as a strength. There are many unknowns, but the underlying principles developed by ACCESS are a strong foundation for developing a solution to pooling that will work for the group and it would be our preferred option.

There are several positive arguments for both the London CIV and the LLPP; however there are significant disadvantages too. The London CIV is run by LGPS funds with a very different structure to the Fund (in terms of governance, size, objectives) and there are questions about whether its intention to continue to offer a range of manager options is optimal. The London CIV offers one fund, one vote, but the Fund would be one of 30+ funds and so the power to influence its own destiny amongst many other (sometimes very different) partners could be a frustration.

The LLPP is not a viable option at its current size, and the potential merger with the Northern Powerhouse pool increases the number of unknowns for the Fund.

Next Steps

There is a considerable amount of work to be done between now and July in order that ACCESS has a viable submission to put to Government in relation to the structure of its pool.

A project plan has been devised by Hymans Robertson and the founder funds, and it is expected that external advice will also be required given the complexities of what will essentially be the set-up of an investment management company.

We would strongly recommend that ACCESS considers the appointment of an independent chair or advisor at the outset; ideally someone with operational experience in relation to investment management. There are many options that could be considered and the right independent chair could help steer a path through a complex area, helping ACCESS focus on prioritising the more valuable actions.

We look forward to discussing this report with the Committee and Officers.

Jo Holden
Mercer
February 2016

Important Notices