<u>Wales Pension Partnership (WPP) Call for Evidence response</u>

Scale and Consolidation

We understand that questions 1 - 4 are specific to DC markets (not LGPS nor Additional Voluntary Contributions related), therefore no answers have been provided.

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?

Investment pooling has been a success for the LGPS funds in Wales and across England and is achieving government's objectives including delivering scale benefits. WPP has: **- pooled 74% of assets** **- achieved total savings to 31 March 2024 of £56.67M** **- enabled access to a full range of private market assets classes** **- centralised and delegated investment manager selection** **- facilitated increased local investment and advances in responsible investment** **Different models of pooling have been shown to be effective, including the WPP outsourced model. WPP uses an independent third-party fund operator with responsibility for investment manager appointments. This reduces conflicts, enables best in class operator and investment manager appointments and obtains the scale benefits of the operator and its investment advisor.**

WPP pooling model

Pools have different operating models aligned to their circumstances and needs. Each has its merits and are effective in delivering the benefits of investment pooling.

WPP uses an out-sourced model. At the outset of pooling, the Wales LGPS Funds commissioned an independent report that considered various pooling models and concluded the outsourced model as most appropriate for Wales.

The design of this model allows the pre-existing excellent working relationship between the Administering Authorities to continue. The key features are:

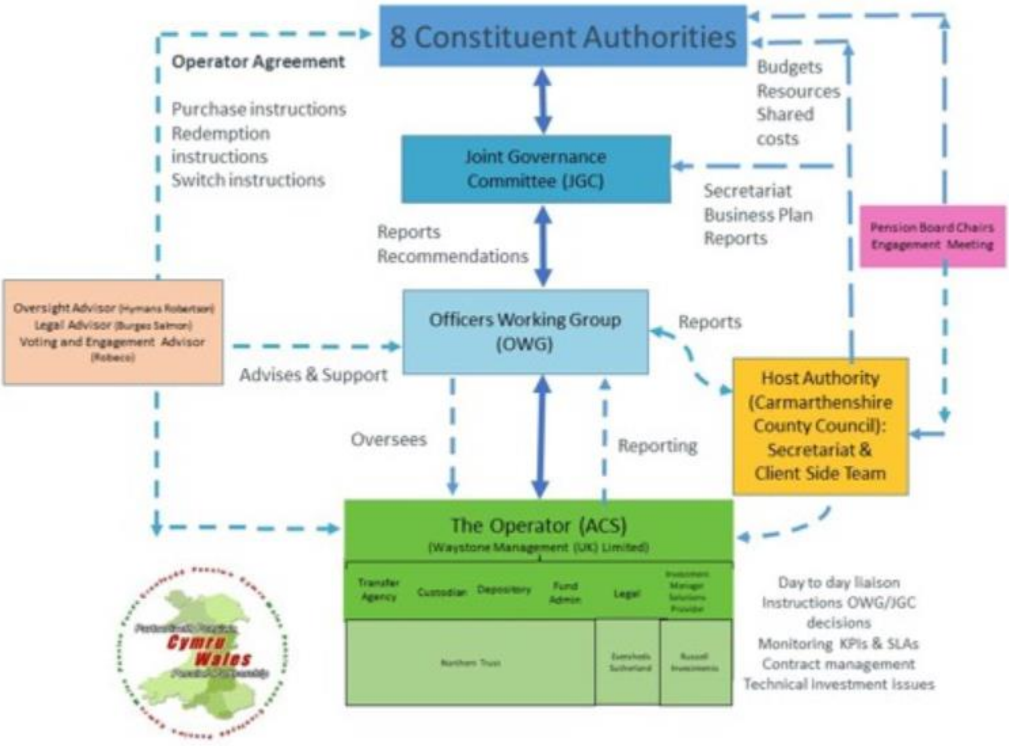
1) an FCA regulated entity (a UK regulated Authorised Contractual Scheme (ACS) or "fund operator") operates a pool investment vehicle for all liquid asset classes (a UK Authorised Contractual Scheme) - the fund operator (Waystone) is appointed by WPP as fund sponsors using transparent public procurement;
2) it appoints an "Investment Management Solutions Provider" (Russell Investments) who designs multi-manager sub-funds aligned to the locally decided investment strategy objectives of investors (LGPS funds in WPP), selects investment managers and negotiates fees;
3) the operator provides the platform, governance, regulatory compliance, risk management and independent investment oversight for the active equity and fixed income sub funds
4) the operator has regulatory responsibility for hiring and firing fund managers;
5) the operator contracts with investment managers and other service providers;
6) a similar model is used in private markets – an "investment allocator" is appointed for the different private markets investments and is responsible for designing mandates to meet WPP fund objectives and selecting investment managers;
7) passive investments are outsourced via joint procurement; and

8) governance and oversight by Joint Governance Committee (JGC) comprised of the 8 underlying funds enshrined in a Legally binding Inter Authority Agreement

Each model has different merits. Benefits of the WPP model include:

1) use of an independent third-party fund operator removes conflicts inherent in other models – the WPP authorities don't own the fund operator or in-house investment management functions;
2) in addition to the normal risk reduction benefits of FCA oversight of regulated pool entities (including FCA monitoring and reporting, risk capital requirements, SMF functions, etc) the WPP funds also benefit from additional legal protections under commercial contracts including liability and cyber insurance requirements;
3) all parties delivering pool services can be replaced by transparent public procurement;
4) WPP had minimal set-up costs compared to other pool models due to its structure and benefits from the scale of its third-party service providers since they spread their costs over multiple clients and their size enables them to achieve reduced fee rates (e.g. Russell's global negotiating power);
5) WPP's outsourced "investment allocator" model delivers similar benefits for private markets;
6) The equitable governance structure ensures the Pool prioritises investors' investment requirements and not its own agenda; and
7) The current governance and pooling structure allows the constituent authorities to comply with local (unique to Wales) regulatory requirements e.g.
    - Welsh language Act
    - Future Generations of Wales Act
    - Separate Accounts and external audit regulation

The WPP's model, including the governance structure as shown below:


8 Constituent Authorities
Operator Agreement
Purchase instructions
Redemption instructions
Switch instructions
Budgets
Resources
Shared costs
Joint Governance Committee (JGC)
Secretariat
Business Plan
Reports
Pension Board Chairs Engagement Meeting
Reports
Recommendations
Oversight Advisor (Hymans Robertson)
Legal Advisor (Burges Salmon)
Voting and Engagement Advisor (Robeco)
Advises & Support
Officers Working Group (OWG)
Reports
Host Authority (Carmarthenshire County Council): Secretariat & Client Side Team
Oversees
Reporting
The Operator (ACS)
(Waystone Management (UK) Limited)
Transfer Agency
Custodian
Depository
Fund Admin
Legal
Investment Manager Solutions Provider
Northern Trust
Eversheds Sutherland
Russell Investments
Day to day liaison
Instructions OWG/JGC decisions
Monitoring KPIs & SLAs
Contract management
Technical investment issues
Cymru
Wales

Pooling success

Achievements to date include:

1) scale: as of 31 March 2024, 74% of WPP assets are pooled/under pool management;
2) costs: total cost savings to 31 March 2024 are £56.67m;
3) net performance enhanced by cost savings and is expected to be less volatile from the pool due to use of multi-manager sub-funds;
4) governance: a number of functions and decision-making responsibilities are centralised and delegated to the pool, including investment manager search and selection (delegated to the operator's investment advisor Russell) and performance reporting; and
5) pooling has delivered other benefits that would have been difficult to deliver without pooling. These include the provision of wide range of asset classes, including private markets (allowing smaller access to these opportunities), leading to the facilitation of significant UK and local investments, with associated community benefits and significant advances in responsible investment.

Costs 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?

Although government incentives to make investment in the UK more attractive would be helpful (see later), we do not believe that government intervention to "encourage" an increase in investment budgets is the only or primary factor in seeking higher returns from a wider range of asset classes.

Other considerations include locally decided investment strategy appropriate to each fund's liabilities, greater risk to employer sponsors from high return investments and fiduciary duties of local councils.

The government should note that investment "budgets" or costs have increased (despite lower fee levels achieved by pools) due to a significant increase in allocations to private market investments, some of which is supporting UK growth. This is because investment management costs on these asset classes are greater.

Higher investment returns can increase risk to employers who fund the LGPS. A sustained fall in value of higher risk assets could cause an increase in employer contributions.

Considerations in seeking higher returns from broader range of assets include:

1) locally decided investment strategy appropriate to the liabilities of each individual LGPS fund (extent of surpluses, maturity of liabilities, cashflow positive or negative, appropriate diversification to reduce risk, etc);
2) level of risk acceptable to employers who fund the LGPS and agreed in locally decided funding strategies; and
3) fiduciary duty to pay pensions when due (which in turn leads to seeking appropriate risk-adjusted returns net of costs).

Funds have increased allocations to a wider range of asset classes in order to diversify. Investment in property, infrastructure, private equity and private credit has increased significantly – partly due to greater accessibility made possible by pools. Investment in infrastructure increased ten-fold between 2016 and 2023 (from 0.6% to 6.2% of LGPS assets) and in private equity there was a three-fold increase (from 2.1% to 6.2%). A proportion of this is supporting UK growth.

Not all private markets asset classes or types of investment within an asset class offer higher returns. For example, some types of infrastructure investment offer lower, more stable, inflation linked returns.

Private market asset classes have higher investment management costs than liquid asset classes (even where accessed cost effectively via LGPS pools). This, along with significant growth in asset value, have contributed to an increase in total investment costs that has been observed by government (despite lower fee rates obtained by pooling). This was anticipated when pools were being established. Some other asset classes have the potential for high returns with very low investment budgets / costs (e.g. passive equity investment). All are an important part of the overall mix.

We do not believe Government intervention to encourage an increase in investment budgets would necessarily result in LGPS funds and pools seeking higher returns for a wider range of asset classes (factors other than investment budgets drive decisions on asset allocation) but incentives to make certain UK assets more attractive might.

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?

Consolidating LGPS pools will not deliver the government's objective of greater net investment in the UK. Currently the limiting factors are availability and attractiveness of UK investments and fiduciary duty.

In fact, consolidation of pools could reduce investment in opportunities that support economic growth in Wales. Similar considerations apply elsewhere in the UK where local impact investment could be reduced by consolidating pools. This kind of investment can increase net investment in the UK whereas investment by LGPS funds in large UK infrastructure projects for example might simply replace investment in the same UK assets by other investors resulting in no net increase.

The government goal is better achieved by increasing availability and attractiveness of UK investments or by changes to fiduciary duty.

WPP currently invests c. 20% in both pooled UK assets and those under pool management. This includes investments in passive UK mandates, actively managed mandates, fixed income mandates, allocations to UK in global mandates for infrastructure and private equity and local investment in Wales (please see case study below).

This will increase as assets move into the private markets pooled solutions over the next 6 months.

We do not believe that the size of pools is hindering the LGPS from investing more in the UK. The limiting factors are:

1) availability and attractiveness of suitable UK investments relative to global investment options; and
2) fiduciary duty which requires LGPS funds to seek the most attractive risk-adjusted returns globally in each asset class it decides to invest in as part of its investment strategy.

As well as UK specific equity mandates, Wales has global mandates in listed and unlisted equities and in infrastructure that can invest in the UK. In those global mandates, allocations to the UK are reflective of investment manager views on the attractiveness of UK investment opportunities. Private market allocators also have a significant role to play in influencing greater UK Investment. WPP has built strong strategic relationships with the allocators and the views of WPP are taken into account when making asset allocation decisions.

Investment by LGPS pools in smaller scale, local opportunities is important. These are potentially additive to UK growth (whereas investment by the LGPS in large-scale infrastructure for example could simply displace investment by international investors who will instead invest in other countries so that there is not a net increase in UK assets). We believe that consolidation and absorption of the WPP into a larger pool would likely make it more difficult to invest locally in infrastructure in Wales.

Case study – WPP local investment

WPP have committed £68m into the greenfield development of onshore wind Energy Parks in Wales. This will deliver ethical investments and clean green energy to the people of Wales and beyond.

Once operational, the Energy Parks are expected to deliver approximately £800m of Community Benefit Funding to the communities living closest to the projects.

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?

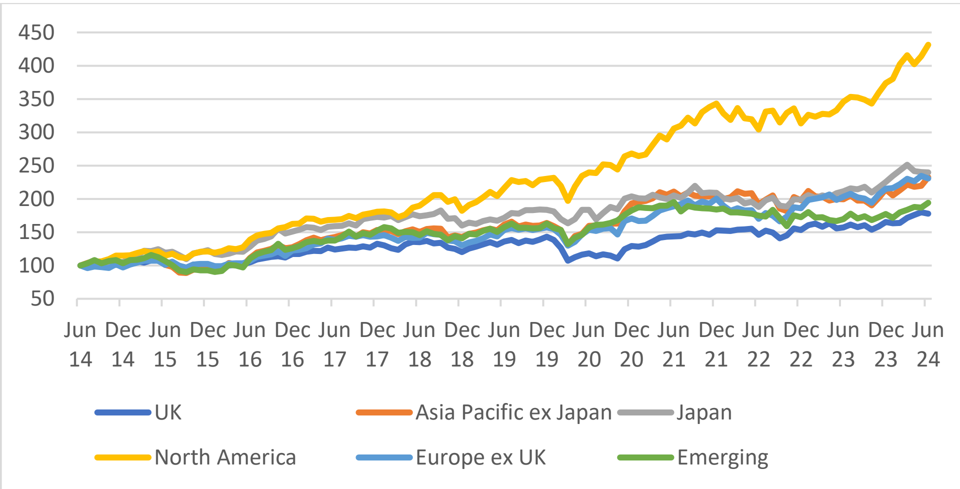
LGPS and UK private sector pensions used to invest more heavily in UK assets. LGPS funds now invest globally in pursuit of diversification and attractive risk-adjusted returns. At the same time, UK allocations remain relatively high across equities, fixed income, real estate and infrastructure.
This shift is consistent with the fiduciary duty of LGPS funds – the pursuit of more attractive risk-adjusted returns and risk reduction (reducing concentration in UK markets).

Return, not cost, is the primary consideration. The UK has underperformed other markets for a number of reasons including sector composition (e.g. US markets have more technology stocks). Another factor in investment allocation decisions is responsible investment goals - the FTSE 100 has a high weighting of carbon intensive industries.

The primary driver of the shift away from UK investment is fiduciary duty – seeking attractive risk-adjusted returns in each asset class. This has led to greater diversification by geography across all asset classes and pursuit of the most attractive risk-adjusted returns from the global opportunity set.

Over the last 10 years, the FTSE 100 investment return was 6.5% per annum (vol. 3.5%) compared with more than 9% per annum (with similar vol) in Europe (excluding UK), Asia (excluding Japan) and Japan. US markets (currently c28% tech stocks, 10 x the UK weighting to tech stocks) has performed even better (c15.5% per annum with similar vol to UK).

The cumulative effect is shown in the chart below:



Responsible investment and climate risk are also an important factor. Global investment provides greater opportunity to invest in a low carbon economy since the UK has a high weighting to carbon intensive industries (e.g. commodities and energy stocks).

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?

Yes. Although WPP and other pools already have a significant allocation to the UK, there is a case for establishing additional incentives to encourage higher allocations to UK assets generally. Incentives could increase the relative attractiveness of investment in the UK and make it possible to invest more in the UK within existing fiduciary responsibilities.

If the government wishes to impose "requirements" (e.g. specific allocations to UK assets in aggregate or for specific asset classes) then it will be necessary to investigate the legal issues around the interaction of such requirements with fiduciary duties.

Incentivising local investment and thereby increasing its attractiveness could further increase allocations within the current constraints of fiduciary duty and provide additive investment in UK growth.

There are various ways in which the government could incentivise increased investment in UK markets and support UK growth within the constraints of existing fiduciary duty requirement.

Incentives could take the form of reduced tax and duties on UK investments or providing guarantees or underpins to reduce risk. An example of this being effective is the impact that PFI and government subsidies had on the appetite to invest in UK infrastructure.

Specific examples include:

- land donation, planning guarantees or end-product contracts to speed up and reduce the risk of UK projects;
- incentives for the LGPS when making investments through initiatives closely linked with government like the National Wealth Fund;
- investment underpins guaranteeing a minimum return on local investments such as housing, transport, water, schools, etc; and
- tax breaks, such as removal of stamp duty increases returns reduce the cost of investing in the UK and push up returns.

Incentives carry a cost to government in the short term but would likely be recouped in the longer term.

Mandation of requirements to invest in certain UK assets may help to increase investing in the UK but will take time and may result in lower returns for LGPS funds with knock on effects for employer contributions. This approach may create legal issues which require examination, in particular, the interaction with fiduciary duty.