Emma Reynolds MP
Minister for Pensions
HM Treasury,
1 Horse Guards Rd,
London,
SW1A 2HQ

25 September 2024

Dear Minister,
CC, Pensions Review Team,

Hymans Robertson LLP is pleased to submit this LGPS focused response to the Pensions Review call for evidence, as part of our ongoing engagement with the Government on this important issue. It forms part of our wider submission, which includes our response to enquiries relating to DC.

Hymans Robertson LLP has a significant legacy in the Local Government Pension Scheme (LGPS), providing independent pensions, investments, benefits and risk consulting services, as well as data and technology solutions, to LGPS stakeholders, employers, trustees and financial services institutions. We've been advising local government on their pensions for over 100 years. We currently advise 75% of LGPS funds and some of the LGPS Pools.

Through our work, we know that:

- Compared to private sector and other public pension arrangements, the LGPS is already highly efficient at providing benefits and value for money for employers and taxpayers. The average employer contribution rate is 21.1% of pay – compared to rates ranging from 23.7% to 38.7% of pay in other public sector pension schemes.
- LGPS employer contributions typically account for around 8-10% of Local Authority budgets. Therefore, maintaining local control of pension costs is an important element of local service provision. A similar concept to the government's devolution drive to empower regional areas.
- The £360bn of assets as at 31 March 2023 is an increase of £180bn (100%) over the prior ten years, primarily due to investment returns. This increase is equivalent to c.7.0% pa, which compares favourably with financial indicators (e.g. UK GDP growth of 1.6% pa) and returns achieved from pension scheme peers (even against the standout 8.0% pa average return of the "Maple-8").

With this in mind and reflecting on where the sector can support the Government's investment aspirations and continue to deliver successful outcomes for pension savers, we have drawn on the breadth and depth of our expertise in collating this response and look forward to discussing this further, as part of the review.

Pensions Investment Review: Call for Evidence – our LGPS response

As an organisation focussed on building better futures for people across the UK, we fully support the government's ambitions for the UK economy and the recognition that increased investment can catalyse growth. As long-term investors, the LGPS can make appropriate investments to support the UK economy, building on what it has achieved already.

This must be done without losing sight of the core purpose of the LGPS of paying members benefits when they fall due. We believe investments in the UK should be driven primarily by

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the quality of the available investment opportunities and suitability. This may require the Government to consider how it can make such opportunities available.

As specialist LGPS investment consultants, we are well placed to work with Funds and Government to articulate to asset managers and private equity firms the design characteristics that would make UK investment opportunities more strategically attractive to LGPS investors. Our investment research teams already proactively search markets and engage with asset managers and private equity firms to develop such opportunities. From our discussions with LGPS funds and asset managers, their main challenge for investing in the UK is volatility in public policy.

We've provided a more detailed response to each of the questions relevant to the LGPS in our formal submission, but the key points of our LGPS response are as follows:

Scale and consolidation

- Significant time and money have been invested in current pooling arrangements, which have delivered meaningful benefits in many areas. The pools have already successfully delivered against the aims they were set up for.
- However, given that the pools have only recently moved into their delivery phase, we do not think there has been sufficient time to fully realise their value. This value is likely to be further delayed by more time-intensive reforms. We do not believe now is an opportune time for significant restructure or enforced changes of pool operating models.
- Greater scale could help the LGPS to invest in larger productive finance projects, however these large-scale projects typically already receive funding, often from large international investors. We believe the LGPS's greatest potential for additive economic growth is leveraging its regional expertise to support smaller, local investment. Increased scale and consolidation may disrupt this potential.

Investing in the UK

- LGPS investment strategies are a function of fiduciary duty – increasing diversification by investing globally, with the widest possible opportunity set, is aligned to improved risk-adjusted returns.
- Despite this, the LGPS has a strong home bias compared with the UK's proportion of the global investment opportunity set (particularly in equity, bond, property and infrastructure portfolios). Without updating fiduciary duty, the LGPS can only favour the UK for the reasons of risk-adjusted returns. Reevaluating LGPS fiduciary duty to consider if money can be deployed for people/community/planet impact as well as paying pensions will help the government achieve greater investment in the UK.
- Incentives and support offered by government that improve risk-adjusted return characteristics of UK investments would support greater investment.
- As part of forming a solution the Government should consider incentives solely for the LGPS to recognise its unique position as a taxpayer-backed public sector scheme, with a focus on projects that grow GDP likely to recoup any upfront incentive costs borne by Government.

In previous reform exercises, the best outcomes have been achieved when government and the LGPS community have worked together to identify solutions and future evolution of the scheme. We are keen to see this come to fruition here.

We would welcome the opportunity to discuss our response and would reiterate our earlier offer of support to Pension Review – through resource, data and insight and/or connection with LGPS stakeholder views. This would build on the previous support we have provided Government in this sphere, including:

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- Public service pension reform – providing secondees directly to the Hutton Review to ensure the policy analysis had deep understanding of the LGPS.
- LGPS asset pooling – we brought together over 40 funds to prepare a report setting out the best, evidence-based options for pooling LGPS assets. This was the blueprint for the initial steps in establishing LGPS investment pools.
- LGPS Good Governance project – the LGPS Scheme Advisory Board appointed Hymans Robertson to identify improvements to LGPS governance arrangements. Our recommendations struck the balance of evolution to deliver better outcomes whilst retaining support and buy-in from LGPS stakeholders (e.g funds, unions, employers).

We look forward to receiving your response and continuing to work closely with you and your team as the review progresses.

Yours sincerely,

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For or on behalf of Hymans Robertson LLP

Encl. “Hymans Robertson LLP - Pensions Investment Review Call for Evidence response (LGPS)”

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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?

Summary: the pools have successfully delivered against the aims they were set up for. There's no clear evidence of particular models being better than others – both the in-house and outsourced models have been successful and have their merits.

The success of pools should be measured against the objectives they were created to address: to achieve benefits of scale; support strong governance and decision-making; reduce costs and achieve excellent value for money; and to improve capacity to invest in infrastructure.

Scale

Measured by scale, we estimate the proportion of partner funds' assets pooled to be around 70%. This means pools have each achieved £10s of billions of scale. However, when we consider by pooling model, there's no observable success of one model by proportion of assets pooled.

Cost

Pooling, across all models, has reduced investment management fees. However, these fee savings could have been achieved through collective procurement, as shown by the Seven Shires passive management procurement.

Pools report their costs and savings each year via an agreed calculation method. However, there is deviation in the inputs/assumptions used in these calculations. We believe more robust information could be achieved through an independent method that is transparent and appropriate for the structure of the pools.

Returns

To expand this into value for money, returns must be considered – there's no benefit to paying lower fees for something that underperforms. The low fee levels paid by the LGPS mean it doesn't require much underperformance to remove the benefits of any savings. Also, the short lives of the pools make it impossible to assess whether they've achieved value for money or improved long-term risk-adjusted returns, as most funds the pools manage have a track record of less than three years.

Supporting governance, decision-making and wider range of asset classes

The pools have taken some decisions out of funds' hands, particularly in terms of manager selection, which links to funds' access to a wider range of asset classes. By leading on fund design and manager selection, the pools have removed work from funds, lowering barriers to entry for new asset classes. However, the benefits are probably stronger for smaller and less well-resourced funds. Pools are facilitating investment into a wider range of asset classes via more niche areas – for example, helping funds to diversify property allocations into residential and global. Again, there's no strong pattern across the pools that points to more successful models.

Similarly, the pools have done great work helping funds integrate responsible investment. This can be complex and time-consuming, and the pools have again lowered barriers here, particularly for less well-resourced funds.

The pools have also taken on some investment monitoring work from funds. This benefits funds that switched from holding multiple managers in a single asset class to investing in multi-manager pool solutions, as funds only need to monitor the performance of the pool's fund. However, this monitoring has often proved challenging, as the pool-

managed funds are more complex. Many funds commented to us that pooling has far increased their workload, but we expect that this won’t be the case once the pools are fully formed.

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?

Summary: the potential for increased scale to facilitate UK investment depends on the government's priorities. Greater scale will help the LGPS to invest in larger infrastructure projects, but there's greater potential for additive economic growth by the LGPS supporting smaller, local investment. Increased scale and consolidation reforms may disrupt this potential.

We don't believe inadequate scale is preventing the LGPS from investing more in the UK. All pools are well positioned to invest efficiently in public markets. The challenge has been finding suitable UK investment opportunities, particularly compared with the global opportunity set. To address this, we believe other changes are required from government.

The potential for increased scale to boost UK investment depends on where the government wants the investment to flow. If the LGPS is to fund the biggest UK infrastructure projects, a solution to create greater scale would be required. However, if the government's intention is for investment in smaller opportunities that often miss funding, including in local areas, then increased scale may harm this.

We'd point out that large-scale projects already receive funding, often from large international investors. Therefore, LGPS money would simply replace that capital, which may become invested in other countries. This wouldn't be additive to the UK economy, so we believe the LGPS should focus on smaller-scale investments.

If combined, larger- and smaller-scale investments would help across the spectrum of the UK economy, boosting the entire financial ecosystem.

Potential solution for larger opportunities

For the LGPS to fund larger-scale UK projects, we believe a single-asset, specialist investment vehicle for all funds and pools would be most effective. This would maximise scale benefits to fund large projects, while achieving diversification. It would prevent funds and pools bidding against each other for opportunities while providing a single point of contact for government. The merits of multi-asset pools, complemented by single-asset-class specialist pools, were considered by Project Pool. This solution is less disruptive and faster paced than full-scale consolidation or restructuring of pools. These may also form part of the National Wealth Fund, or work alongside it.

Potential solution for local opportunities

To help achieve smaller-scale local investment, we believe funds need support in making connections and finding solutions. Creating entities for this around the UK would stimulate investment. This could be done through the pools; however, these aren't all in the same geographic regions. Where pools are based around geographic regions, they can be important for sourcing and scrutinising investment opportunities eg the Welsh pool has helped Welsh LGPS funds to finance growth investments.

Impact on net investment returns

Switching the focus to net of fees returns, instead of outright costs, may help increase LGPS investment in the UK. However, we'd expect it would have a larger impact on the DC market. While many UK growth opportunities will be

through private markets, which typically have higher fees, many LGPS funds already focus on net of fees returns, having significantly increased private markets commitments.

The important things from a costs perspective is that investors are paying competitive fees. The LGPS has done great work in bringing fees down, both through collective procurement and pooling.

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?

Summary: LGPS investment strategies are a function of fiduciary duty – increasing diversification by investing globally, with the widest possible opportunity set, is aligned to improved risk-adjusted returns. Despite this, the LGPS has a strong home bias compared with the global investment opportunity set, particularly in its equity, bond, property and infrastructure portfolios.

For the LGPS, there are two key factors for government to consider:

1. The LGPS has been moving, over decades, from being fully invested in the UK.
2. Many funds still hold strong overweights to the UK compared with the UK's weight in the global opportunity set, typically 25–35% of their assets including equities, infrastructure, property and bonds. In comparison, the 'Maple-8' Canadian funds invest around 27% domestically (with the majority of holdings in domestic bonds ie a small proportion of domestic 'productive assets').

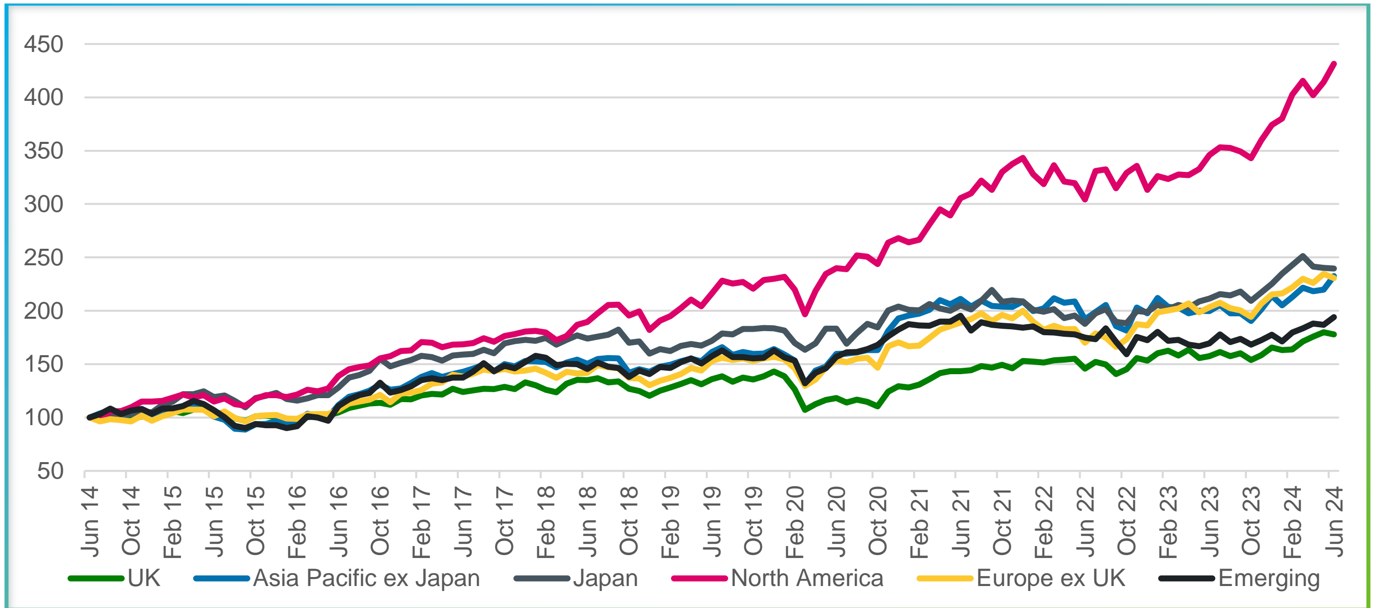
The overwhelming issue for UK investment is the fiduciary duty placed on funds, so that they can pay pensions as they fall due while managing risk for the participating employers. As long as this is the fund's sole purpose, it's also the focus when selecting investments. There's strong evidence of the benefits of diversification and maximising an investment opportunity set for risk-adjusted returns. Therefore, if there are attractive UK opportunities, the fund will invest in them. However, if there are more attractive opportunities overseas, fiduciary duty drives investment elsewhere.

The long-term shift to investing globally is driven by several factors: the pursuit of better risk-adjusted returns from a broader opportunity set as well as the desire to manage climate risk and support the move to a low-carbon economy. These do not preclude investment in the UK, as proven by the home bias in the LGPS. However, fiduciary duty means the UK can only continue to be favoured for the reasons of risk-adjusted returns, not government purposes.

The charts and tables below demonstrate the underperformance of the UK stock market over the last decade. While it can be tempting to conclude that the reduction in UK investments by pension schemes caused this underperformance, the key driver is the makeup of the UK market compared with its global peers. The UK market's lack of exposure to technology stocks is another significant driver.

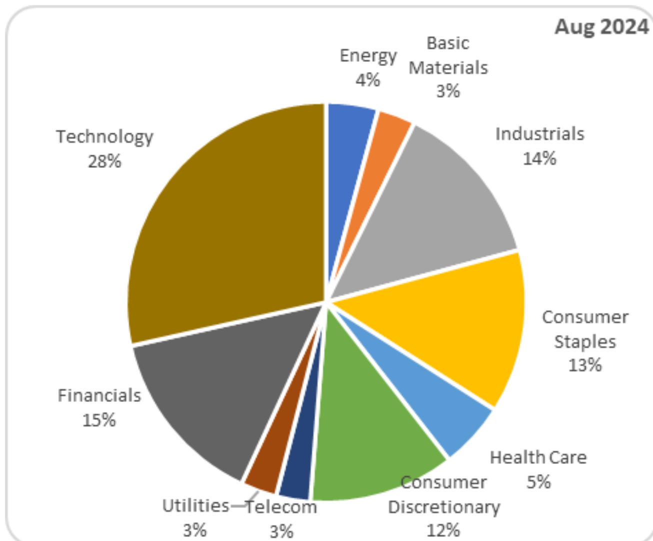
Similarly, the large bias to commodity and energy stocks has led those concerned with the climate transition to reduce their allocation.

Chart 1: Equity market performance 1 July 2014 to 30 June 2024; rebased to 100

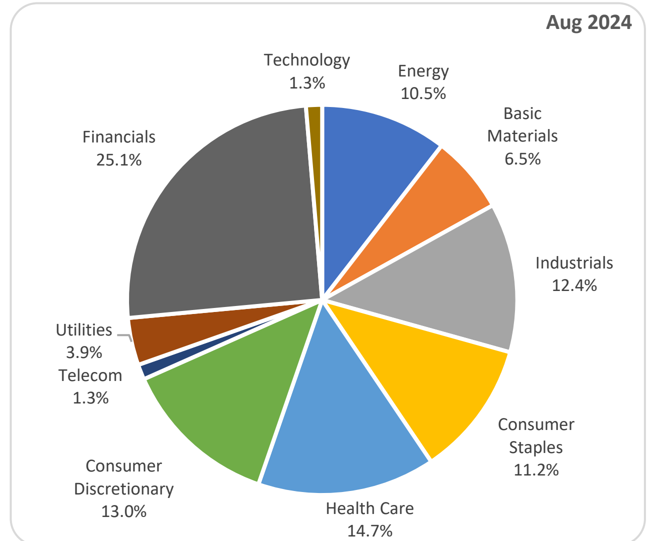


	FTSE ALL SHARE	FTSE W ASIA PACIFIC EX JAPAN £	FTSE JAPAN £	FTSE W NORTH AMERICA £	FTSE W EUROPE EX UK £
Return (p.a.)	5.9%	8.8%	9.1%	15.7%	8.7%
Vol.	12.1%	14.6%	11.7%	12.6%	12.9%

Pie Chart 1: FTSE All World sector allocation



Pie Chart 2: FTSE All Share sector allocation



The UK stock market is only one example demonstrating that less attractive investment prospects lead to lower investment into the UK. From our discussions with LGPS funds and asset managers, their main challenge for investing in the UK is volatility in public policy. The LGPS invests with a very long-time horizon, and many UK growth assets, such as infrastructure, can only be held for the long term. This uncertainty makes it challenging for the LGPS to invest in such markets. Which offers the new government a great opportunity to build confidence by offering policy stability.

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?

Summary: Incentives and support offered by government that improve risk-adjusted return characteristics could stimulate UK investment, while a focus on projects to grow GDP could recoup upfront government spend. The government should consider incentives for the LGPS to recognise its unique position as a taxpayer-backed public-sector scheme. Requirements are likely to come with legal challenge and unintended consequences.

We believe the government could further incentivise investment in UK markets to bolster growth. Given fiduciary duty's effect on driving pension schemes' capital allocation, we believe change is required.

The purpose of the scheme

The LGPS exists to pay pensions while managing risk for employers. So, it's challenging for the stewards of these funds to favour the UK without clear financial reasons to do so. Options include updating the LGPS definition of fiduciary duty or introducing a dual role for the LGPS to pay pensions and invest to support UK growth, similar to the CDPQ in Canada. However, this would need policy change to ensure the investments still offered strong returns.

Otherwise, the options would be making opportunities' risk/return characteristics fit LGPS needs or placing requirements on the LGPS. These could be supported by vehicles to make accessing opportunities easier.

Incentives and policy change

Better diversification and risk-adjusted returns have driven the trend for overseas investment. Incentives that improve returns or reduce risk could counter this trend. Many investors point to the impact that PFI and government subsidies had on the appetite to invest in UK infrastructure.

We acknowledge that incentives may cost money upfront. However, by focusing on projects that are additive to GDP, the government will recoup its investment over time. The government could consider LGPS-specific incentives, given its unique position as a public-sector scheme with taxpayer-held risk. For example:

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

Short-term tax incentives for new UK investments could show the government's commitment to growth policies, leading to higher tax revenues after incentivisation periods.

If a higher UK allocation resulted in poor returns (compared with a more globally diversified portfolio), then LGPS employers would have to make up the funding difference via raising contributions. Therefore, easier access to pension scheme surplus could be a fair trade to compensate for the higher risks associated with increasing investments in the UK. For example, LGPS employers with sufficient funding level could be allowed to access surplus to compensate for the higher risks if their fund met a UK investment allocation threshold.
This would provide a financial incentive for LGPS employers to support an increased UK allocation and offset some risk.

Requirements

Requirements may increase investing in the UK; however, they're unlikely to have an impact quickly. The legal issues would require examination, as would the interaction with fiduciary duty. Similarly, if requirements are made without ensuring adequate investment opportunities, returns are likely to be poor.

Making investment easier

Another challenge to making UK growth investments is the governance burden on funds. As set out earlier, specialist vehicles, as well as greater support for the creation and sourcing of smaller-scale local investments, would help increase UK investment by lowering governance barriers.