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POLICY BRIEFING NOTE:

Overseeing your pool

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The live government consultation on the LGPS (Fit For The Future) is putting forward some monumental changes to how funds invest in very short timescales. Most notably, the proposals represent an immense level of delegation of investment decisions to pools. This shift would require significant oversight by funds of their pools, but there appears to be little thought given to this in consultation proposals. Here, we look at what appropriate oversight takes.

The government's proposals

In the consultation launched alongside the Chancellor's Mansion House speech on 14 November, the government set out a broad set of reforms to LGPS investments. Gaining the most attention are proposals that the pools will not only advise funds on the setting of investment strategy, but also will have full discretion over the implementation of that strategy. While these ideas have received considerable challenge, another area also being questioned is: if these proposals are put in place, how would the government like the approach to oversight to work? Without strong, independent oversight, it wouldn't be possible to properly manage the significant conflicts of interest of a model where the entity that's managing the assets is also setting their own objectives. And it would be hard for the individual authorities to assess performance and value for money. The consultation clearly sets out that this should be performed by independent advisers, individuals with pensions and investment experience, who either work with, or sit on, the pensions committees of funds. Investment consultants are only to be used by funds in "exceptional circumstances".

There are some very talented, experienced and knowledgeable investment advisers within the LGPS. However, proper oversight and challenge of an investment manager the size of the pool, which both gives investment advice and implements it, takes significant resources that an individual cannot provide.

At Hymans Robertson, we provide oversight services to private sector pension schemes that use fiduciary managers to advise and implement their investment strategy. The trustees of these schemes employ this service (ie not the fiduciary managers themselves) to ensure this advice and implementation has been of high quality. When they hand over their keys to a fiduciary manager, they want to make sure oversight is robust.

There are strong comparisons to the role the pool will now play for LGPS funds, so we share below just what it takes to properly oversee a fiduciary manager.

Why is oversight of the pools this important?

The government's proposals are a vast expansion of the role of pools. It has taken almost a decade to reach this point, and there are now only 16 months for the pools to develop the services of a fiduciary manager, on top of taking in a substantial quantum of assets, at pace, and providing local investment due diligence. This alone needs oversight, so that your pools are able to continue the day job while building out such significant services so quickly.

However, once that is done, LGPS funds will find themselves with control over only their high-level investment strategy. They'll still need to ensure their pool has both provided them with strong advice to set that strategy and is then implementing that strategy well. While investment strategy is the most impactful decision for long-term returns, the implementation can still have a large effect. This is made more important by investment beliefs, particularly on responsible investment issues. Given that the pools have never performed this role before, it will take a very close eye to make sure your assets are being looked after.

Exacerbating this issue is the fact that funds are "trapped" customers of the pools. While changing fiduciary managers in the private sector is no mean (or cheap) feat, it's an option open to pension schemes if theirs is underperforming. This is sometimes the best option for a scheme to remedy significant concerns with their fiduciary manager – it's far faster and less burdensome than working with the manager to fix the issues. It also has the benefit of keeping the fiduciary managers competitive, in their fees, solutions and client service.

LGPS funds will not have this option. They will need to work through any issues at their pool, a time-consuming undertaking. That makes strict oversight essential to spotting any potential issues early, or ideally ahead of time. This will help to prevent major issues developing, avoiding the damage to returns and significant work to remedy them.

It's therefore imperative that proper oversight of the pools is undertaken by adequately qualified, experienced and resourced providers. This is also needed on an ongoing basis, not just under exceptional circumstances when the problems have already occurred. There are strong reasons why the Competition and Markets Authority stepped in to the fiduciary market to ensure managers are properly overseen and regularly retendered.

What should effective oversight do?

Before we get into the details on what oversight involves, why do we need it? The three key objectives of oversight are:

1. Provide an independent perspective on goal-setting

This answers key questions such as "Is your strategy appropriate and in your best interests?" and "Have you been given good advice?"

Given the importance and impact high-level investment strategy has on your fund, it's vital that this advice is robust. It will therefore be incredibly helpful to have an expert second opinion on the advice when it's given. Similarly, reviews of the strength of that advice over time are also critical. If mistakes were made, it's imperative that they're identified, and that the adviser learns from this and improves their processes. This is of particular relevance to the pools, who will be providing advice for the first time.

2. To assess performance

This is to answer questions such as “Has performance been in line with expectations?” and “Has your strategy been implemented well?”

If you are to delegate all the implementation of your strategy to your pool, – which will, again, be the first time they’ are performing this role – it’s extremely important that you’re able to review whether they have done this well. Decisions such as the design of each of your asset class portfolios will have a strong impact on your risk and returns. For example, within your equity portfolio, how it’s allocated between active and passive funds, styles of investment approach, different regions and sectors, manager selection, stock selection, currency decisions, as well as the shorter-term tactical management of these, will all be drivers of returns. Picking through this level of decision-making to understand whether they’ve added to returns – to the degree that would be expected for the level of risk – is a significant task, involving vast amounts of analysis. Again, this is especially important for the pools, who haven’t undertaken this work before.

3. To assess value for money

Answering key questions like “Are the charges you’re paying reasonable and competitive?”

These include the fee you pay to your fiduciary manager, or pool; the fees they have negotiated where they’re investing in external managers; and the level of costs incurred in the implementation, such as transaction costs. Fees can be a significant drain on returns, so it’s important they are as low as possible.

Here, it’s extremely valuable to be able to compare to other pools and fiduciary managers as a way of assessing value for money. Where you find that costs appear high, you can then challenge your pool on the causes for this, and whether any savings can be made.

What does it take to oversee a fiduciary manager?

The first thing we’ve learnt is that to provide effective oversight, it’s important to have real-world experience. Without running countless investment strategy reviews, asset class searches and investment transitions, you can’t know all the potential pitfalls and difficulties of doing the work. Knowing about the common problems means you know the important questions to ask and what a good answer looks like. Investment consultancies have large teams of highly qualified and experienced people, who’ve undertaken the same work that we’re monitoring, giving a large pool of knowledge and experience to draw on.

Assessing performance is very resource intensive. Firstly, you need to research and monitor a range of similar providers to build up a peer group to benchmark against. This allows you to see the bigger picture and understand how your provider is performing relative to others. To research the UK market of around 15 fiduciary managers last year alone, we held 42 research meetings and spent 335 hours of time on research. This was split across our team of 19 people.

Within the LGPS, we’ve also begun to work with funds to assist in overseeing their pools. This has covered whether the pool is building and operating in an appropriate way, as well as providing deep-dive reviews of specific investment funds’ performance. Again, this requires a team of people, as well as knowledge and experience of what the other pools are doing – something we at Hymans possess from working with so many LGPS funds across England and Wales.

Research on this scale, across the required number of peers, is impossible for independent advisers to conduct.

Proper oversight also requires the fiduciary manager to build trust with the person or firm providing this service. The ability to provide oversight relies on the fiduciary manager sharing information and analysis that can be sensitive in nature. Therefore, having proper risk controls, IT security and governance processes in place is key to evidencing that the oversight is being carried out appropriately and focused on delivering on the fund’s needs. This is something that Hymans has worked hard to build through the development of its fiduciary oversight services.

Having the right tools is also important. The tools of the trade are data feeds and modelling resources, but access to these is expensive and only achievable at scale. Annual subscriptions to data feeds and services run into the tens of thousands of pounds. And if you want the ability to financially model scenarios and assess performance in depth, you need to have the people and knowledge to do this.

In essence, investment consultants have spent years achieving the ability to set investment strategies, research asset classes and monitor performance at scale. These are all the tools needed for effective oversight of LGPS funds’ assets. It would be the opposite of consolidation if this oversight were to be taken up by a dispersed market of independent LGPS advisers.

The consultation lacks any detail on the vital component of pool oversight (only 3 mentions across nearly 15,000 words).

We believe that transparent and expansive oversight of the pools will be central to ensuring informed decision-making, robust audit trials and good outcomes. We would highlight that with public sector governance requirements mean the oversight bar is raised even higher compared to private sector arrangements. There is significant work to be done to meet even a minimum standard.

We would argue that established and tested oversight to the satisfaction of funds and regulators must be in place before further control is delegated to pools.

Measured against a range of metrics, LGPS investment consultancies are overwhelmingly best placed to provide pool oversight and complementary support to funds.

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