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ALL WALES COLLABORATION

FINAL REPORT

MAY 2015

MARSH & McLENNAN COMPANIES

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1

Executive Summary

This paper outlines the background and relevant details to support the eight Welsh LGPS Funds ("the Welsh Funds") in their considerations in establishing a collaborative governance and investment framework. The paper recommends that the Welsh Funds:

- Spend time to develop a shared set of principles for collaboration.

- Pursue a more collaborative approach in order to avail of key benefits that include economies of scale and lower costs, increased consistencies, enhanced governance and operational management across the Welsh Funds.

- Select a single passive provider for passive global equities to obtain immediate cost savings. A pooling structure would not be required to achieve these gains.

- Establish a pooling framework to extend on collaboration beyond passive global equities

- Adopt a regulated (pooling) vehicle along with a model that supports leveraging the infrastructure of a third party provider (rather than building such infrastructure internally). In addition, the paper suggests that the Welsh Funds should look to appoint a provider with appropriate experience who can provide an optimal level of governance and operational support, reducing both the risk and cost of developing internal resources and capabilities to operate the new framework.

- Consider framing the new collaborative framework as optional for each Welsh Fund but target mandates that are common to all to ensure strong uptake and an engaged and simple approach.

- Consider both active global equity and UK equity as the two immediate mandates to commence with the new collaborative framework. The analysis outlined in the paper highlights that these two mandates are consistent across the vast majority of funds and offer the greatest potential for cost savings.

- Agree a set of next steps to take forward the project, including a workshop / training session and development of a project plan, including the potential tender process to assess suitable partners/providers to support the new collaborative framework.

2

Background and aims of this report

Background

We begin at the point at which the eight LGPS Funds in Wales have decided that there is merit in exploring whether investing collectively is worthwhile and how it might be achieved.

The previous report on this issue, compiled by PwC, suggested that there would likely be savings (or improvements in net return) if assets were pooled. We agree with this concept, although clearly there are many variables here; not least of which is the issue of the degree of take up within any collective arrangement.

The previous report suggested that savings of between £1.6m and £4.4m could potentially be made (depending upon the investment model adopted). The obvious starting point therefore is to consider whether any quantum of those savings could be made by keeping things simple and leveraging existing arrangements. We do this in Section 5.

We have not looked to repeat any of the work carried out previously (although we do provide an analysis of the current situation in Section 5 for context). It is a matter of fact that the majority of investment managers will levy lower fees if dealing with a single large pool of assets relative to a larger number of smaller mandates.

Investing collectively will also likely allow the Welsh Funds to access asset classes and build strategies (cost effectively) that can make more sense with scale. Alternative assets are the obvious example.

Nonetheless, we are also cognisant of the fact that numbers showing cost savings can be open to interpretation and are heavily assumption dependent. It has to be accepted that there are also qualitative arguments that come into play too. For example, we would argue that a more focused, nimble / market aware approach could be taken under a collective, professionalised structure that would not be possible under a single Fund approach operating under a typical "Four Committee meetings per year" arrangement.

Investing collectively can take many forms, and we have assumed that a regulated entity of some description is the most sensible route; however this is discussed further in Section 7.

With a regulated entity however comes a plethora of operational and compliance related issues, which leads to the question of whether to "build" that entity or to "rent" the associated infrastructure. Regardless of either building the capabilities to manage an investment vehicle in-house or appointing a partner with existing infrastructure, it is critical that the Welsh Funds establish an appropriate governance and investment framework to support the decision-making process (both taking and implementing decisions) to ensure that the collaborative framework operates efficiently.

This report

This report develops a business case for the **establishment of a governance structure and investment framework** that will allow the eight Welsh LGPS funds to invest collaboratively. We have approached this project on the assumption that participation will be optional and that asset

allocation will remain a local decision; in short we have looked at options that are flexible enough to cope with the many or the few.

The vision, as we see it, is to create a vehicle, which forms part of a collaborative investment framework across the Welsh Funds, whereby efficiencies are maximised (both in investment fees, investment returns and operational efficiency) by having participants' investment needs optimised through such a vehicle. Creating a flexible vehicle will, we believe, maximise participation.

The business case will:

- set out governance requirements in establishing a collaborative investment framework;
- highlight possible options for the structure of a collective investment vehicle, within the new framework;
- identify how in practice such a vehicle can be implemented and managed on an ongoing basis;
- consider financial savings and costs that could be anticipated;
- identify any practical difficulties which would need to be overcome;
- set out next steps and project plan to set up the new framework.

In addition we will:

- consider any legislative implications;
- identify a clear Governance model.

Integral to this whole project is the issue of "building" versus "renting" the chosen structure and both will be considered. However, no degree of asset pooling can occur without first considering governance structures and so we consider this early in the report.

3

Are the benefits of collaboration proven?

In order for collaboration to be proven to be effective, the overall ‘result’ needs to lead to improved investment returns net of fees.

Fee savings are tangible, but arriving at improved investment returns may require a different approach to decision making and a long term outlook, and the impact of these factors are less simple to calculate, particularly over short term periods.

In short, we suggest that by delegating the implementation of investment manager decisions to a collective vehicle (in which each Fund will have representation and control across decision-making), individual Committees will be free to spend more time on the issues that really impact the bottom line; namely investment and funding policies. Of course the impact here is virtually impossible to quantify except over the long term, but various academic research suggests that if governance is improved (often by focusing on the big picture items) then there is a significant return premium to be earned. (This is discussed further in Section 4).

LGPS funds are long term investors and we do believe there is a premium therein. We have carried out analysis that supports the theme of investing for the long term through engaged ownership and its financial benefits are well supported. Putting in place a structure which looks to deal with leakages arising from a short term outlook can increase asset values by as much as 25% over a 20 year accumulation period (Ambachtsheer, 2013). We would argue that a collective vehicle funded by a number of committed, long term investors could have the potential to reap the rewards if the right principles are established at outset.

The opportunity to collaborate has the potential to allow the Funds (in aggregate) to achieve things that perhaps weren’t possible in isolation and in turn provide greater flexibility and choice. Let’s take Alternatives and specifically “Real Assets” as an example. This is an increasing area of focus for LGPS funds with their inflation linked liabilities, but one that can present difficulties for individual funds to properly access the best of the market without the appropriate scale. A carefully considered collective vehicle, tailored for the needs of the LGPS, would have distinct merits – managed by the LGPS for the LGPS.

Collaboration also allows operational efficiencies to be realised. Currently eight Funds are independently diverting internal resources and paying fees to external providers. Where there is commonality in services required, whether it investment related (e.g. a manager selection requirement for a particular asset class) or operational (e.g. use of a custodian) collaboration can drive operational efficiencies of a significant magnitude.

There will always be a tipping point in terms of economies of scale becoming diseconomies, but unfortunately there is no definitive evidence that quantifies a particular level. For example, significant scale may mean that smaller boutique managers do not have capacity to come on board. At current asset levels, we would not envisage this to be an issue for the Welsh Funds, but it will be one to watch over time.

In practical terms, there are an increasing number of pension schemes both exploring and adopting collaborative governance and investment frameworks. A number of our clients, with similar challenges to the Welsh Funds have implemented such solutions and are achieving the benefits of

collaboration (economies of scale and lower costs, enhanced governance and increased speed of decision making, efficient implementation and improved performance) on an ongoing basis.

Summary:

- The key benefits to collaboration are:
    - Increased scale to reduce cost and improve diversification potential;
    - Improve consistent and simplification of investment arrangements;
    - Co-ordinated governance to improve operational management of Welsh Funds, including speed and implementation of decision-making.

4

Governance issues and a shared vision?

Key to any potential collaborative project is whether each individual Fund is on board and willing to commit to a shared set of principles. With this in place, a sensible governance structure will be easier to achieve.

It is worth noting that we are not recommending any degree of compulsion for any individual Welsh Fund to invest in a collaborative entity. However, regardless of whether a structure is built or rented, each Fund (and its associated Committees), if deciding to use the structure, will need to be on board with the concept of delegation to a collective entity of some description in terms of manager selection, monitoring and implementation. With this in mind, we would suggest that it is crucial that a joint vision or set of principles is established at outset that local Committees can buy into and reference at future points.

We would strongly recommend that after consideration of this report, the eight Funds prioritise the establishment of a shared set of principles. Issues to resolve will include:

- What is the primary aim of collaboration?
  - Cost savings
  - Pursuit of excellence – governance and investments
  - Defence against merger
  - Implementation of a long term investment philosophy
- How will success be measured?
- Will decisions require a majority or full consent?
- Will all Funds approach engagement with Committees collectively or individually (at outset and on an ongoing basis)?
- How will operational issues such as procurement be dealt with?
- How often and where will the group meet, and with the difficulties presented by geography and travel, will sub groups for potentially separate work streams be established?
- What asset classes / mandates to include in the initial collaboration framework?

Governance

Good governance is crucial.

There is academic research that suggests the existence of a good governance premium; ranging from 0.05% p.a. (Clarke, 2007) to 1-3% p.a. (Ambachtsheer 2007, Watson Wyatt 2006)

“Pension Fund Governance can make a positive difference to financial performance, cost efficiency, and the trust of stakeholders in the institution” (Clark, 2007)

There are several reasons as to the relevance of a governance premium in this case. In the first instance, by delegating investment manager issues to a collective entity, the more important considerations of funding and investment policies can be given more time by Committees (locally) at each Welsh Fund. Of course this assumes that all Funds do use the collective entity to a significant degree. Second, the governance structure of the collective entity itself is of utmost importance in terms of the role it plays in efficient decision making and implementation.

Any collective entity will have an Investment Committee of some description that will need a Terms of Reference to determine its precise make up and roles / responsibilities and this will become more tangible once a collective model is established. In the meantime, we would make the following initial suggestions:

- All Funds participating will require representation, but on the grounds that it is our opinion (and experience) that smaller groups tend to operate more efficiently, we would recommend that each Fund has just one representative;

- Depending on the structure chosen, it may be that an independent chair and a secretary are considered. Otherwise, it may be worth considering having a rotating chair with perhaps each Fund's representative serving as chair for six months;

- To maximise the professionalism of decision making, we would suggest that the Fund representatives are Officers with investment experience / expertise rather than elected officials;

- It may be worth considering having an elected official from each local Pensions Committee form a Consultative Committee that could receive periodic reports from the Investment Committee.

Summary:

- Key to any potential collaborative project is whether each individual Fund is on board and willing to commit to a shared set of principles.

- We would suggest that these principles are formalised at outset and are focused around:

    - Aims of collaboration
    - Measures of success
    - Decision making process
    - Engagement at a local level
    - Operational considerations

- In putting in place an appropriate governance structure, a balance needs to be struck between retention of issues at a local level (where appropriate); but the need to delegate aspects where it "makes sense" to do so.

5

Increasing efficiency within the existing arrangements

It would seem sensible before embarking on a project requiring change, to consider whether there are efficiencies that can be easily exploited within the existing arrangements.

We have considered the following areas:

- Investment manager fees (based on commonalities across current assets / manager structure);
- Other expenses (e.g. custodian and consulting costs).

Investment manager fees

An obvious place to start is to review the aggregate investment manager fees currently in place across the eight Funds. We set out below a summary of asset allocation and the manager fees paid at an aggregate level.

	Assets (£bn)	% of assets	Total fee (£m)	Average fee
UK Equity	**2.5**	**20.7**	**11.7**	**0.47%**
Active	1.3	10.8	10.9	0.82%
Passive	1.2	9.9	0.6	0.05%
Global Equity	**4.4**	**36.0**	**15.6**	**0.35%**
Active	3.3	27.3	14.6	0.44%
Passive	1.1	8.8	1.0	0.09%
Emerging Market Equity	**0.4**	**3.2**	**1.9**	**0.47%**
Active	0.2	2.0	1.7	0.69%
Passive	0.2	1.2	0.2	0.13%
Property	**0.8**	**6.5**	**3.8**	**0.35%**
Diversified Growth / Balanced funds	**0.7**	**5.6**	**1.6**	**0.24%**
Alternatives	**1.2**	**10.0**	**11.1**	**0.91%**[1]
Bonds	**2.2**	**17.9**	**4.0**	**0.18%**
Corporate bonds	1.6	13.0	3.5	0.22%
Government bonds	0.6	4.9	0.6	0.10%
Total	**12.2**	**100.0**	**49.7**	**0.40%**

Source: All Wales. May not sum due to rounding. Based on data as at 30 September 2014.

[1] Approximate – based upon the data provided. Where fees were not provided an estimate has been made. Underlying manager fees have been excluded unless explicitly provided.

In establishing any potential cost efficiencies within the existing asset structure we reviewed the following areas:

- Aggregate fees – how do fees of the eight Funds in aggregate compare to other large mandates?
- Commonalities within active UK and global equity strategies
- Potential for savings within passive mandates
- Initial thoughts on alternatives
- Implications for bond portfolio

A summary of our findings is below. Further detail on each aspect is outlined in the appendix.

	Comment
Aggregate fees	Current fees are generally competitive across the board compared to our Global Fee Survey (used to benchmark fees relative to the industry). However, the Fee Survey does not provide information on mandates of the scale possible across the eight Welsh funds collectively.
Commonalities within active UK and global equity strategies	There is limited commonality between the Funds' manager line-up, and even where there are consistencies at a manager level, due to the client specific requirements in the majority of cases there is little scope to enable Funds to leverage any economies of scale under the current structure. Given the allocations and consistency of UK and global equity across the schemes, these mandates offer the greatest scope for initial collaboration.
Potential for savings within passive mandates	Fees are relatively good value compared to other passive mandates globally. However, specific to the LGPS we are aware of the leading passive managers becoming increasingly commercial to win (or retain business). We believe there is potential for fee savings in Wales as a collective seeking to negotiate with the leading passive managers. Based on halving the existing fees (based on our experience this would not be unsurprising), this could lead to savings of £800,000 p.a. We would caution however that other factors (such as profits on stock lending and costs of trading) would also need consideration.
Initial thoughts on alternatives	It is very difficult to quantify any potential for immediate cost savings through leveraging any commonalities due to complex structures in place. There is also little point in attempting to renegotiate fees with private markets managers given the Funds are "locked in" to these investments. There is potential for significant savings should Funds collaborate on alternatives under a revised model – but the "model" will need to be in place first.

	Comment
Implications for bond portfolios	The make-up of the individual Funds' bond portfolios are wide ranging, and can broadly be categorised into UK Government, UK Corporate and Global bonds. There is little commonality between mandates and so little scope to harvest significant fee savings. We do however note that from a strategic perspective the case for holding bonds in the current environment is changing. Therefore to the extent to which these mandates are up for review there may be more potential for collaboration going forward.
Other expenses	The Funds incur other expenses of c£1.6m p.a., with the largest expenses relating to custodian and consulting costs. We would view custody as an area where fee savings could be made. From the data provided, there are at least 3 named custodians (HSBC, BNY Mellon and Northern Trust) and by looking to procure a single custodian we would expect significant savings to be made as a result of incredibly aggressive pricing in the market. We would suggest any wins here are considered as part of the wider collective investment model for Wales as opposed to a stand-alone custodian decision being made.

Summary:

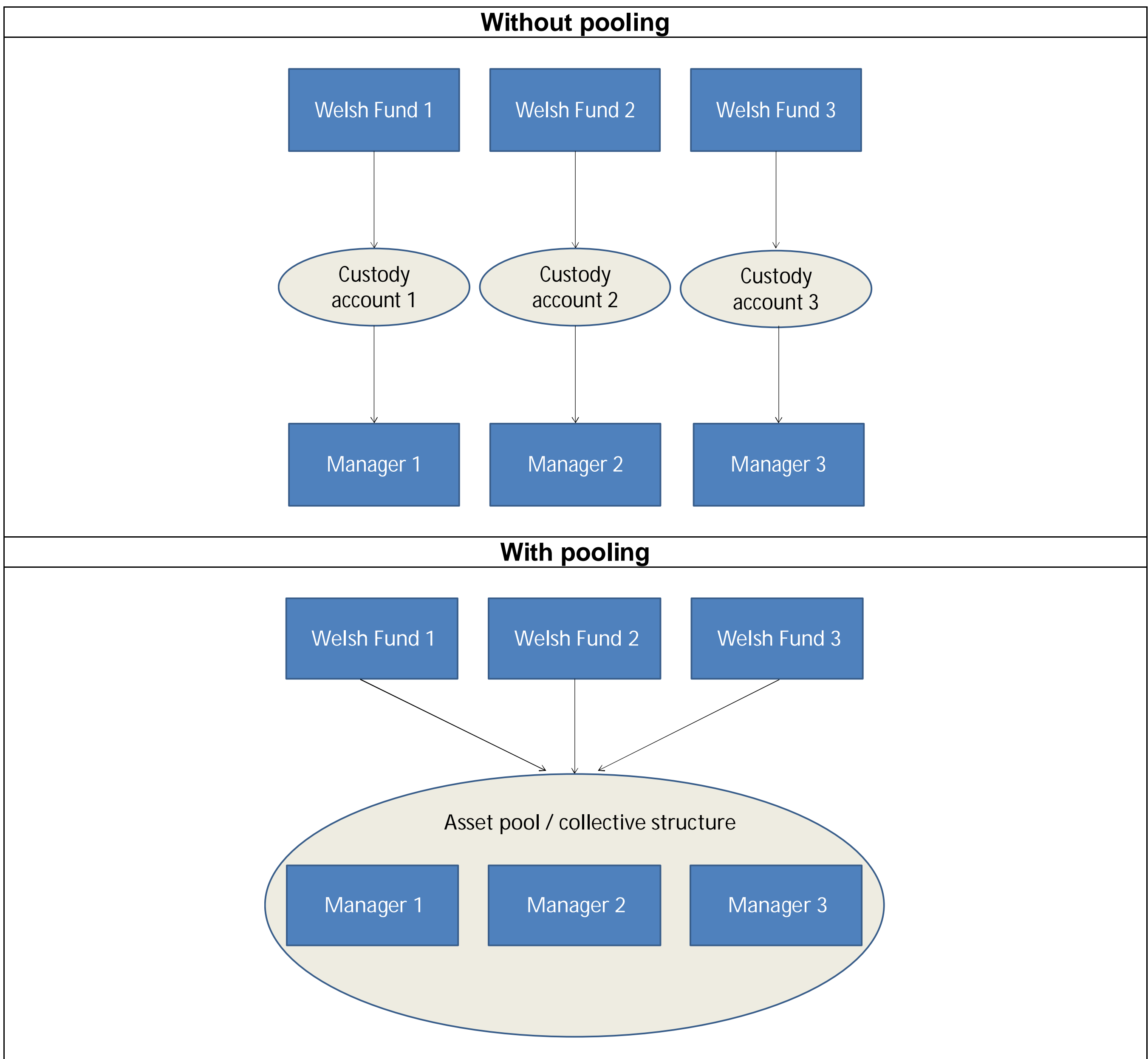
- We have investigated the potential for cost efficiencies in respect of investment manager fees and other expenses under the existing arrangements. Given the allocations and consistency of UK and global equity across the funds, these mandates offer the greatest scope for initial collaboration.
- The diversity across mandates suggests that there are limited initial savings to be made without aggregating assets in some way. The exception would be the passively managed funds, which could achieve savings of c£800,000 p.a. should the funds appoint a common manager.
- There is also potential fee savings to be made in respect of appointing a common custodian. We would however suggest that this is considered as part of the wider collective investment model being considered for Wales under the buy or rent structure.

6

Asset Pooling

In technical terms, asset pooling is the commingling of assets from multiple investors into one vehicle. Investment managers and pension schemes tend use the following five structures to commingled assets:

- Corporations
- Trusts
- Insurance companies
- Partnerships
- Contractual arrangements



Main Challenges in Asset Pooling

A significant challenge in successfully pooling assets is achieving scale to cover set-up costs, ongoing operating expenses and governance costs. Scale is also required to make the structures efficient and have a reasonable expense ratio on an ongoing basis. Another large challenge is collaborating with local fiduciaries and internal stakeholders to obtain approvals and support for the asset solution. A smaller challenge is to align the investments and asset classes to the right vehicle to ensure smooth operations and quality accounting; however, if scale cannot be achieved running multiple funds and structures become expensive.

Potential Benefits in Asset Pooling

In our experience, schemes pool assets to realise the following benefits:

- Ability to leverage larger plan scale to smaller plans reducing fees and operating costs
- Better diversifications and investment opportunity set for smaller plans
- Investment decisions taken by people with experience and expertise
- Greater control over investment decisions
- Better risk management over investments and liabilities
- Faster investment decision-making and greater ability to respond to dynamic markets across all investor plans in a short time frame
- Improved transparency and governance
- Reduced governance resource demands at a local level
- Reduced administrative, legal and transition costs associated with changing managers or portfolio construction

It is important to highlight that achieving the benefits above depends on the operational management and implementation efficiency of the new structure.

7

Available structures

In establishing a collaborative investment framework, the assets of the plan will be required to be "pooled" in some form. This pooling aspect can be achieved through an unregulated or regulated structure.

Unregulated Structures

An unregulated structure is not subject to the same level of oversight and governance as the regulated vehicle. Options include:

- Increase efficiency of existing arrangements i.e. selecting common managers and negotiating lower fees (as discussed in section 5) ;
- Common Investment Funds.

At first glance, a common investment fund may feel like a more simple solution. However, it doesn't solve any governance issues for the eight Welsh Funds. There would need to be a lead authority or a joint body of some description that would take responsibility for manager selections, reporting and monitoring, transitions, and unitisation.

From a risk perspective, a regulated structure with proper operational controls and expertise will provide a more robust solution and establish a professional framework that would stand up to best practice and ensure the Welsh Funds are meeting appropriate standards.

Regulated Structures

Some of the key factors / drivers to be considered in determining the most suitable regulatory regime include:

- Investor type – retail or institutional
- The investment strategy to be adopted within the Fund i.e. asset classes and investment approach
- Required degree of flexibility and control
- Future proofing

Options available include:

- UCITS, or;
- Qualifying Investor Alternative Investment Fund ("QIAIF") (replacing the Non-UCITS QIF effective 22 July 2013)

UCITS

UCITS (Undertakings for Collective Investment in Transferable Securities) are defined under a European Union directive which covers the coordination of national laws, regulations and administrative provisions in relation to collective investment in securities.

In general, UCITs operate on the basis of their availability to the "man in the street" and their investment & borrowing powers are not negotiable. However, they are also used by institutional investors for whom the drawbacks noted below are not significant.

- Restrictions on the investment and borrowing powers of the UCITS and on the use by the UCITS of leverage and financial instruments.
- Where financial derivative instruments are utilised by a UCITS, the UCITS must establish an extensive risk management process ("RMP") which must be approved by the Regulator.
- Higher cost of legal & regulatory compliance e.g. RMP, UCITS IV Business Plan and the production of Key Investor Information Document (KIID).
- UCITs can be sold without any material restriction to any retail investors in the EU. This is subject to compliance with local regulatory rules.

A UCITS fund may be established through any one of the following vehicles:

- An investment company;
- A unit trust; and
- A tax transparent fund.

QIAIF ("Non-UCITS")

Non-UCITS are generally intended for institutional investors and have few investment restrictions.

The Welsh Funds could self-impose any investment restrictions through the fund's investment guidelines rather than having to adhere to strict regulatory imposed guidelines. Non-UCITS offer:

- Greater flexibility with respect to investment styles and restrictions;
- Extensive risk management process not required;
- Quicker upfront and ongoing change approval process with Central Bank;
- Compliance with domestic legislation.

It is likely that the QIAIF is the most suitable regulatory regime to meet the Welsh Funds' requirements.

Recommendation

The decision as to which fund vehicle, regulatory framework or structure is most appropriate for the Welsh Funds will be dependent upon a variety of considerations including:

- Investment Strategy (now and in the future);
- Foreign Tax Considerations;

- Whether the fund would be offered to new investors over time;
- Speed of Authorisation.

The key factor for the Welsh Funds is investment strategy; and in particular the likelihood of investment in alternative asset classes. The non-UCITS regulatory structure would provide necessary advantages of investment flexibility and future-proofing.

However, the decision to choose an appropriate vehicle will depend on the “build” v “rent question. If the Welsh Funds choose the “rent” model i.e. to leverage the existing infrastructure of a third party, then the vehicle chosen would be made in conjunction with, and the input and support of, the appointed partner.

Vehicle Domicile

Within Europe, the leading (and proven) fund domiciles are Ireland and Luxembourg; although we note the recently available option of a UK Authorised Contractual Scheme. The choice of vehicle between Ireland and Luxembourg is finely balanced and we would suggest that this issue is investigated further as and when the Welsh Funds move towards asset pooling.

Summary:

The main decisions in respect of a chosen collaboration structure are as follows:

- ***Regulated or unregulated:*** We would suggest that a regulated structure with proper operational controls and expertise will provide a more robust solution.
- ***Type of regulated vehicle:*** If a regulated vehicle is agreed upon, the options relate to whether a UCITS or QIAIF (“non-UCITS”) structure is adopted. We would recommend a QIAIF as this provides fewer investment restrictions and provides the Welsh Funds with flexibility to self-impose their own investment restrictions as opposed to having to adhere to regulatory imposed guidelines.
- ***Vehicle Domicile***: We would suggest that this issue is investigated further as and when the Welsh Funds move towards asset pooling – but the leading fund domiciles are currently Ireland and Luxembourg based.

8

Build or rent?

Management Company and Governance

In order to establish a Welsh fund / vehicle, a Management Company will be required.

The Management Company is responsible for the running of the fund but generally delegates its main day-to-day functions (fund management, custody and fund administration). The Management Company has a fiduciary responsibility for the fund and must exercise oversight and appoint all delegates. The Regulator needs to be satisfied as to the suitability of the management company, its directors, shareholders and share capital.

The main duties of the Management Company are to:

- Issue the Prospectus (which contains details of the underlying investments and certain required disclosures). This is approved by the Regulator and must be kept up to date;
- Appoint appropriate advisors;
- Monitor investment performance
- Administer the subscriptions and redemption of units;*
- Value the assets, calculate the net asset value per unit and keep books of account;*
- Prepare the annual report and accounts;*
- Make necessary filings and ensure compliance with applicable regulatory and legal requirements.

In practice, the items marked with an asterisk (*) are often delegated to an Administrator.

The options for the Management Company are:

1. Establish your own Management Company;
2. Use the Management Company of a third party custodian;
3. Access the Management Company of third party provider to tailor a Welsh solution.

Option 1 – Establish a Management Company (the “build” option)

We outline here the requirements, timelines, costs and ongoing obligations associated with the establishment of a management company and related regulated fund structure (the “**Fund**”). The management company could be located in any of the main jurisdictions for fund domiciles (Ireland, Luxembourg, for example and most recently the UK). The principles, cost and timelines are broadly similar regardless of the choice of fund domicile.

In summary, the following practical elements should be considered when deciding whether to establish a fund:

1. Initial set–up of a regulated Fund, to include the Management Company being authorised in accordance with AIFMD (Alternative Investment Fund Managers Directive).

The essential elements of the authorisation process which would need to be undertaken are outlined below:

1. Choose an appropriate legal structure for the Fund
2. Choose regulatory framework for the Fund
3. Establish Management Company
4. Put in place required governance structure
5. Appoint Directors
6. Alternative Investment Fund Manager entity selection and authorisation * *for prudence we have assumed AIFM license is applicable*
7. Appoint all 3rd Party Service Providers
    a. Investment Manager appointment and authorisation
    b. Administrator / TA
    c. Depository
    d. External Legal Counsel
    e. External Tax advisors
    f. External Auditor
8. Appoint External Directors
9. Fund Approval (Regulatory)
10. Fund Set up and launch (Operational)

Timing

As a guide, we estimate that the minimum timeframe involved to establish a fund and related entities is **12-18 months**. This timeframe, however, would be prolonged considerably if the appointment of any external service provider, such as the investment manager or administrator to the Fund, were to trigger the OJEU Process (and it is more than likely that this would be the case). The timeframe is also contingent on a dedicated team of internal and external resources working on this project on a full-time basis and all aspects of the project going to plan.

The timing will be dependent on the level of complexity. Whilst the regulatory authorisation timeframes are not extensive, the level of preparation in terms of making key decisions, drafting and negotiating contractual documentation, and establishing all of the required structures in place requires the majority of resources, in terms of time, cost and key personnel.

Costs

In addition to the external tax and legal costs that we expect will be incurred (estimated to be in the region of £0.5m to £0.8m) considerable resources, both internal and external (in the form of consultants) in terms of time and costs need to be considered.

We estimate total resource related costs (internal and external) to be in the region of £2.7 to £3.1 m bringing the total initial cost estimate to between £3.2m and £3.9m.

This estimate is based on Mercer's own experience and cannot be relied upon as a definitive figure and is also contingent on no OJEU processes being triggered.

Capital Requirements

Under AIFMD, the initial capital requirement for the Management Company is estimated to be between £3 - £6 million. This amount is subject to regulatory change and ongoing monitoring by the Welsh Funds.

2. On-going considerations

Having established a Management Company and related Fund, the Welsh Funds have ultimate fiduciary responsibility.

While certain functions may be outsourced, there is a requirement that the Fund is not a "letter box" entity. The Management Company will need to satisfy the Regulator on an ongoing basis that it has adequate management resources to conduct its activities effectively and employs personnel with the skills, knowledge necessary for the discharge of the responsibilities allocated to them.

There are considerable ongoing governance, oversight and reporting requirements to be undertaken by the Welsh Funds as a result of the establishment of regulated entities and funds. Examples include:

- Board representation and quarterly Board meetings
- Required governance structure and committees, internal policies and procedures to mitigate risk
- Oversight of all service providers
- Regulatory reporting and filings

The Welsh Funds will be subject to the Regulator's supervision, which is carried out as follows:

- Analysis of returns submitted to the Regulator
- Risk-rating of companies
- Themed and general inspections
- Review meetings
- Regular correspondence and engagement with companies under Central Bank supervision

The Welsh Funds will need to ensure sufficient ongoing internal resources are available to accommodate all of the ongoing requirements.

The Regulator has the power to impose sanctions on regulated entities for breaches of regulatory requirements ranging from substantial fines to, ultimately, the loss of authorisation. It is therefore crucial that any regulated entity has access to an adequately resourced and experienced team of compliance professionals. As is common with regulators around the world, the Central Bank is increasingly focused on supervision and enforcement.

We have provided an overview of the steps and costs only. If more detail is required we would be happy to provide additional information.

Option 2 – Access the Management Company of a third party provider (the "rent" option)

The second option would be to use the standalone, pre-existing Management Company of a Custodian or an Investment Manager (for example).

As the Management Company is legally responsible for appointing the custodian, administrator and investment managers, it would be important to ensure that a suitable governance framework was established which would ensure that the Welsh Funds' preferences for investment managers could be satisfactorily accommodated without compromising the Management Companies' legal obligations. In addition, there is the potential for conflict as the Management Company would effectively be overseeing themselves in the role of custodian and fund administrator.

This approach would provide the benefits of avoiding to "build" an internal management company and therefore avoid the associated cost and complexity outlined in Option 1.

However, it should also be noted, that while a Custodian and/or Investment Manager may be able to provide a Management Company and infrastructure, the needs to support a collaboration framework are typically wider. The Welsh Funds would still require internal resources to support the governance and operations layer outside the Management Company to cover project management, manager appointments and implementation and asset transition.

A custodian would not typically have the internal investment expertise or capabilities to provide this wider support. In addition, the appointment of an investment manager in this role may create challenges with other investment managers managing the assets of the Welsh Funds in that they would need to provide their stock holdings and undertake fee negotiations (typically confidential information) with a competitor.

Notwithstanding this, Option 2 would be a viable option where the Welsh Funds would like to establish an internal team (significantly less than would be required under Option 1) to co-ordinate their investment arrangements.

The costs of Option 2, along with those of Option 3 for comparison are covered below, and we have also provided a comparison of included "services" between the two options.

Option 3 – Access the Management Company of third party provider to tailor a Welsh solution (a further "rent" option)

The third option is for a third party provider to tailor a solution for Wales using their existing infrastructure and in addition, to support the operational co-ordination of the new framework on a day to day basis. Ideally a provider would be found who has experience of this role with other UK pension schemes and has established a number of different umbrella fund structures. This means that the Welsh Funds would not need to go through the full legal process of establishing a fund - the provider could simply launch a bespoke fund via an umbrella structure.

In addition, Option 3 would not require the development of internal Wales' resources as the appointed provider would provide the expertise, project management and operational governance to set up and operate the new arrangement on behalf of the Welsh Fund.

Some thoughts on the differences between Options 2 and 3

The difference between Option 2 and Option 3 is that the latter allows for an integrated investment advisory support to the Welsh Investment Committee decision-making process, along with implementation in terms of set up, execution of manager appointments / replacements, transitions and rebalancing etc. Depending on the specification requirements of the provider, it would also allow for operational due diligence of the underlying investment managers and real time risk / portfolio reporting of manager's portfolios. Depending on the chosen provider, Option 3 would also allow for additional scale in terms of securing lower manager fees.

Specifically, Option 2 would **not** allow for the following:

- manager fee reductions (no access to global buying power)
- manager selection and implementation
- portfolio construction, analysis, (manager allocations, manager styles)
- expertise to connect holistically with each Fund's liabilities
- the support of decision-making that needs to be integrated with implementation

It is also unlikely that Option 2 would provide support in terms of co-ordinating and execution between managers, transition managers, custodians, pension advisors, legal advisors. It is therefore likely to require specialist / specific Officer support; perhaps in the form of a dedicated project manager.

We suggest a more framework based approach with a single provider that can support the full remit to the Welsh Funds to ensure all of these parties are co-ordinated and ensure an efficient set up and **effective ongoing investment governance around the collaborative framework.**

Further, we believe there to be a number of advantages to Option 3:

1. It is arguably the most efficient option in terms of timing and cost;
2. The provider will have a dedicated team of professionals across investments, operations, legal, compliance and risk management;
3. Specialist transition management services;
4. Independent oversight of the Administrator/Custodian;
5. Because the Management Company and fund are not public bodies, we understand (and have taken advice to the effect) that there would be no requirement to procure third party providers via the OJEU process;
6. Depending on the provider chosen and the investment managers that are ultimately used, there is the potential for even greater fee savings than the collective Welsh assets would bring. (For example, the Welsh Funds would likely also leverage the provider's scale of assets under management with many managers);
7. Lower operating, administrative, legal and governance costs at inception and on-going;
8. No set-up costs for the Welsh Funds to cover;
9. Lower internal resource requirements to manage and monitor the vehicles and underlying managers;
10. Limited operational risk;
11. Limited regulatory risk;
12. Flexibility – there will be minimum asset sizes required to make this option viable (and also attractive to providers) but it may mean that individual Funds do not need to sign up at outset.

Under this option, the Welsh Funds should have flexibility to determine the make-up and the Terms of Reference of the Investment Committee of the Management Company. There will be some stipulations / parameters from the provider on the basis of the regulatory requirements of the structure itself. The key point here however is that the Welsh Funds would have majority

representation on the Investment Committee and would therefore be predominantly responsible for investment manager appointments and portfolio structure (for example the asset allocation within an equity fund).

Because the set up costs of this option are absorbed by the provider (and probably recouped by way of a minimum ongoing fee once assets are invested) there are no cost implications for Funds who decide not to participate from the outset. This does however assume that a minimum scale is achieved via those Funds who do invest.

It is also worth raising the issue of ongoing advice in terms of manager selection and implementation, and monitoring. Under Option 3, all these items are covered and there would be no requirement for individual Funds who are committed to engage these services at a Fund level. Of course, it may be the case that existing Fund consultants and advisors are engaged to provide advice on the recommendations of the Investment Committee to the collective structure, but that would be an individual Fund choice.

Nonetheless, we understand that, in order to fully assess the differences between Options 2 and 3, the Welsh Funds may wish to seek proposals from interested parties along with associated cost estimates.

Costs of rental (Options 2 and 3) versus current approach

We outline below the indicative costs associated with the existing approach compared with either of the two rental options.

As a starting point, and for simplicity, we have taken the eight Funds' **active global equity** allocation and assessed the potential costs of a collaborative approach according to various levels of take up. (We consider equities in totality later in the report).

There are several reasons for starting with one asset class only:

- It is more tangible in the sense that the simpler we make it, the fewer assumptions that are needed;
- We think that by starting with one asset class and getting a structure in place, it is more likely that any collaboration project will actually get off the ground;
- Global equity is arguably far less controversial (and easier for a collective to agree on) than a wider ranging project such as "alternatives";
- Once a robust governance structure is in place, more complex decisions such as the structure of an alternatives portfolio have a proper forum for discussion.

Take up by Welsh Funds	100%		50%		25%	
Current Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.44%	14.6	0.44%	7.3	0.44%	3.7

Option 2 - Custodian Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.37%	12.5	0.41%	6.8	0.42%	3.5
Structural Fee	0.04%	1.4	0.06%	1.0	0.10%	0.8
Implementation Fee	Not included as part of the service and potentially difficult to quantify. Items for inclusion include investment advice (for manager selection), transition fees, advice on terms of reference for Committees, monitoring of custodian / third party provider. For illustrative purposes 0.01% = £0.33m which may be useful when considering the associated advisory and procurement services still required under this model.					
Total		13.8		7.8		4.4
Potential saving per annum		**0.8**		**-0.5**		**-0.7**

Option 3 – Tailored Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.31%	10.4	0.31%	5.2	0.31%	2.6
Structural Fee	0.08%	2.7	0.12%	2.0	0.15%	1.3
Implementation Fee	Nil	-	Nil	-	Nil	-
Total		13.1		7.2		3.9
Potential saving per annum		**1.5**		**0.1**		**-0.2**

Numbers may not sum due to rounding

To note:

Additional savings / benefits

The savings quoted are in relation to manager fees only and for one asset class only.

Alternative assets are the area where anecdotally the largest savings could be made but this would be a longer term project first in terms of running off existing commitments and second building a long term collective strategy.

Over time, for a Fund committing a significant proportion of assets, there would be associated reductions in fees for:

- Custody
- Reporting
- Procurement / manager selections

Based on each Fund committing to the collective arrangement, we estimate an additional £0.1m of savings per annum per Fund (or £0.8m collectively).

In addition, the additional premia discussed earlier in terms of ***long term investment philosophy*** and the ***governance premium*** should also be considered.

Additional costs

There would also be transaction costs in migrating to the new arrangement. However, in practice, we would expect the fund to be built around existing high quality managers where appropriate.

There would also be the costs of procurement and internal resource to be incorporated.

The implementation fee

Options 2 and 3 have an “implementation fee” row within the above table. Option 3 includes all associated services in relation to the final product i.e. in this case a global equity fund for Wales.

Option 2 would need the Welsh Funds to undertake, or outsource, the following tasks:

- Advice in relation to manager selection and portfolio construction
- Procurement of managers
- Transition services

Assumptions

The key assumptions outlined in the analysis are as follows:

- Current approach:

  We have assumed the current manager fees (including performance fees) represent the cost of the typical manager fees under the existing arrangements. Where take up is reduced, we have assumed the basis points fee remains the same.

- Option 2 – Custodian approach:

  We have assumed that, based on the size of assets in place (£3.3bn), should manager appointments be made as a collective the costs could reduce, in basis point terms to 0.37% p.a. should all global equities be moved into this structure. The fees secured under the 50% and 25% take up options are higher to reflect the discounts being secured with managers reducing.

  The structural fee in adopting this approach with a custodian increases (in basis point terms) as take up rates fall.

- Option 3 – Tailored approach:

  We have assumed that using a third party provider, the fees secured with managers would be the same regardless of the take up. This is owing to the buying power already being in place from a global organisation with extensive assets under management

  In line with Option 2, the structural fee in adopting this approach with a custodian increases (in basis point terms) as take up rates fall.

The numbers outlined here are indicative and would be dependent upon the managers and structural platform used.

Clearly the above relates solely to actual monetary cost savings and does not allow for any potential for improved decision making and the extent to which this translates to improved investment returns.

In order to provide clarification of the potential savings that could be made across ***all*** active equities, we set out below similar analysis which includes UK and emerging markets actively managed equity strategies, in addition to solely considering the global equity analysis provided in the draft report.

Take up by Welsh Funds	100%		50%		25%	
Current Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.47	22.9	0.47	11.5	0.47	5.7

Option 2 - Custodian Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.41	20.0	0.44	10.7	0.45	5.5
Structural Fee	0.03	1.3	0.04	1.0	0.06	0.8
Implementation Fee	Not included as part of the service and potentially difficult to quantify. Items for inclusion include investment advice (for manager selection), transition fees, advice on terms of reference for Committees, monitoring of custodian / third party provider. For illustrative purposes 0.01% = £0.49m which may be useful when considering the associated advisory and procurement services still required under this model.					
Total	0.43	21.3	0.48	11.7	0.51	6.3
Potential saving per annum	-	**1.6**	-	**-0.3**	-	**-0.5**

Option 3 – Tailored Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.35	17.0	0.35	8.5	0.35	4.3
Structural Fee	0.06	3.2	0.08	2.0	0.11	1.3
Implementation Fee	Nil	-	Nil	-	Nil	-
Total	0.41	20.2	0.43	10.5	0.46	5.6
Potential saving per annum	-	**2.7**	-	**1.0**	-	**0.1**

Numbers may not sum due to rounding

* Note that the actual UK manager fees for the Welsh Funds over recent history is 0.82% p.a. inclusive of performance fees. We recognise that this fee is higher than would be expected over the longer term and have assumed 0.5% p.a. would be a more appropriate figure. This provides a degree of prudence in the above cost savings.

Recommendation

In short we would discount the build option on the grounds of timings and resource constraints and would recommend that consideration is given to Option 2 or 3. The differences between Option 2 and 3 relate to the desire for the Welsh Funds to establish an internal team to co-ordinate and manage day to day the various components of the new collaborative arrangements. This is the key question that should be considered (along with the cost) between Option 2 and 3.

Given our knowledge of the Welsh Funds, we would see Option 3 as the best fit with the existing and desired governance arrangements of the Funds. From our experience and the growing trend across the market place, this would be optimal to support the key objective of cost efficiency, consistency and ongoing governance and operational efficiencies in both setting up and operating the new framework.

We would **further recommend** that the Welsh Funds consider the following question:

Is there a need for a "big bang" solution (i.e. having a collaborative approach that covers all asset classes from day 1) or should a solution be phased or incremental?

We would strongly recommend that consideration is given to the latter, on the following grounds:

- Although the costs savings associated with a single asset class are clearly lower than the entire asset allocation, starting singularly means that a platform and governance structure can be built that will allow more complex decisions to be given proper consideration.

- We would predict that by starting with an asset class such as equity and allowing others to follow, the project will have a much shorter timescale to fruition.

The above two bullet points also reflect the view that Option 3 would support the best fit for the Welsh Funds at this time.

Summary:

- In order to establish a Welsh fund / vehicle, a Management Company will be required – this can be **"built"** or the structure could be **"rented"** from an existing provider.

- The estimated costs of build would be c£4million and it would take at least 12-18 months to establish, plus any procurement time in addition. The internal resource required to build would also be significant. On this basis, **we have discounted "build" as a viable option for Wales.**

- There are two main ways in which the Funds could "rent" a Management Company – either solely purchasing the infrastructure (option 2) or by using a tailored third party approach, which would also incorporate governance and operational oversight (option 3). **The upfront costs, internal team requirements, and timescales are significantly reduced under the rental option and is therefore our favoured approach.**

- There are **expected to be cost savings associated with collaboration** and we have provided information using active global equities as a starting point. The costs do however vary depending upon take up and the solution sought (from an increase in fees of £0.7m p.a. to a reduction of fees of £1.5m p.a.). The savings would increase as more asset classes are incorporated. In addition, the additional benefits in terms of long term investment philosophy and the governance premium should also be considered.

- The **key question to decide between Options 2 and 3 relates to the desire to develop internal resources and priority for cost-efficiency** across the Welsh Funds. Both internal resourcing and cost would be higher under Option 2. Given our understanding of the key objectives of the Welsh Funds we would view Option 3 as the best fit at this time. This would also align with market trends and best practice.

- **Costs savings are expected to be increased further if other asset classes are adopted over time** – most notably from alternatives, albeit noting that this is likely to be a longer term project first in terms of running off existing commitments and second building a long term collective strategy.

- In setting up an appropriate course of action, we would **strongly advocate a phased / incremental approach to collaboration** (e.g. using global equities as a starting point); as opposed to a "big bang" solution (which might cover all asset classes from day 1). This would reduce the timescales for implementation and the level of complexity in the shorter term.

- We would suggest that the **next step for the Welsh Funds would be to invite non-binding proposals from potential "rental" providers** in order that a comparison of services and costs can be made.

9

Legal issues

The advice in this section of the report has been provided by Sackers

Advice from Sackers

Background and summary

The purpose of this section is to identify the high level legal considerations raised by the proposals outlined in the rest of this paper (for the purpose of this section, the "Proposals"). In particular, the Proposals include the possibility of establishing a bespoke Welsh investment vehicle (the "Welsh Fund") and either creating or appointing a management company to manage that vehicle.

The principal questions are:

- do the Councils have power to implement the Proposals;
- how do the proposals interact with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("Investment Regulations"); and
- what procurement obligations apply?

In summary, we have not identified any legal show stoppers which would prevent the Councils proceeding. However, we do identify a number of points which we should draw to the Councils' attention. These points do not affect our overall conclusions, but do raise some issues which will need to be addressed should the Councils decide to continue.

Power to implement proposals

Outline of proposals

From the legal perspective, the Councils must each be satisfied that they have the necessary statutory powers to proceed with the Proposals.

The Proposals could involve:

- the establishment of a Welsh Fund;
- appointing a third party management company and potentially "building" that company under one of the options;
- active engagement in the governance of the Welsh Fund and/or the management company, most likely via a joint committee operating through a formal delegation; and
- the investment of all or part of the pension fund assets into the newly created Welsh Fund.

Exercise of powers and proper delegations

Subject to our comments relating to the Investment Regulations, we are satisfied that the Councils have power to take each of the steps outlined above provided they are satisfied that the proposals are in the best interests of each sections' members and their respective rate payers.

Care should, however, be taken to ensure that the appropriate decision maker within each Council is engaged and that proper delegations are put in place. These activities (particularly the establishment of a Welsh Fund and/or management company) go well beyond ordinary investment decision making.

Each Council will need to consult its own constitution and delegation arrangements to ensure that a decision to engage with these proposals is made at the appropriate level (i.e. we imagine this would be a full Council decision rather than an investment sub-committee decision unless very clear delegations have already been put in place).

Governance arrangements will need further thought depending on the preferred structure. However the Councils may ultimately need to establish a joint committee to discharge their duties in relation to the Welsh Fund and management company. This delegation will need to follow the relevant statutory and Council procedures.

Strategic management and ongoing monitoring

The Councils cannot, in our view, divest themselves of ongoing responsibility for:

- strategic management; and
- on-going monitoring.

The proposals do not envisage either scenario, but the Councils will want to ensure that they can demonstrate their ongoing governance role in both respects and structure any ongoing (joint) investment committee documentation with these high-level principles in mind.

LGPS investment limits

The Proposals could involve the use of a Welsh Fund and each Council's commitment to that vehicle would, in our view, be treated as an investment. The Investment Regulations limit the amount that any one LGPS section may invest by reference to the legal structure of the underlying investment. For example, investment in any single partnership is limited to 2% or 5% of the section's assets.

The Welsh Fund will need to be structured through a vehicle which gives the participating Councils as much flexibility as possible in the context of the Investment Regulations. In theory, we envisage that the Councils will want the option of investing up to 100% of their scheme assets through the Welsh Fund. The Investment Regulations do not contemplate a joint investment structure and there is therefore no specific exception or easement designed to assist Councils who wish to collaborate in this way.

There are a limited number of options for achieving the desired outcome. One such option involves structuring the Welsh Fund as a contractual vehicle such as an English authorised contractual fund or an Irish or Luxembourg common contractual fund (as distinct from shares in a company, units in a unit trust or a limited partnership interest).

The Investment Regulations state that the Schedule 1 limits "shall have effect for the purpose of limiting the making of investments of the types described in the table"[1]. The Investment Regulations do not refer in any way to contractual schemes which are therefore not investments "of the type described in the table". The effect of this appears to be that there is no applicable limit to the amount an administering authority can invest in this type of vehicle, provided the authority is satisfied that the investment is otherwise reasonable for the scheme.

While we are not aware of any alternative reading of these provisions, our interpretation does have the effect of apparently circumventing the intended limits set out in the Investment Regulations. It is therefore possible that the legislation could be amended to address this or that, if the investment were challenged in court, a judge might be disposed to favour another interpretation of the Investment Regulations.

As the Councils are no doubt aware, prior to the recent election DCLG, confirmed their intention to review the Investment Regulations. We do not yet know if they will make any changes or what those changes might be.

The Councils will also want to be mindful of potential reputational risks though, in this instance, there has been considerable public/political pressure on Councils to work collaboratively.

Management Company

A key consideration for the Councils will be establishing the parameters of their control over the management company of any new investment vehicle. Much of the work around the London Council's proposed common investment fund has focused on this aspect.

The Proposals suggest:

> **Option 1 – the "build" option**. This is the option being pursued by the London Councils, who will be shareholders to the management company of the common contractual vehicle. In addition to the employment, contractual and operational issues which would flow from establishing the company, the new management company would need to go through the (onerous) process of becoming FCA authorised.
>
> **Option 2 and 3 – the "rent options".** Both options involve establishing a joint governance structure to supervise the activities of a third party manager with control of the investment company. The management company will be appointed by the Welsh Fund. We envisage that this relationship would need to be supplemented by an investment management agreement between the management company and the Councils (either individually or through a properly constituted joint committee).
>
> The Councils should appreciate that their relationship with the management company will be different depending on whether the management company is a company established and owned by the Councils (as with option 1) or whether they have selected a third party provider and contractually agreed the services to be provided by a third party, as with options 2 or 3. Option 1 is likely to be more onerous in terms of establishment and (possibly) ongoing operation, but it will potentially allow much greater control of the manager from the legal perspective. The Councils should form a clear view of how actively they wish to be involved in the running of the management company, or whether they would prefer to accept a greater degree of reliance on a third party.

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[1] Regulation 14(1) of the Investment Regulations.

As noted above, in either scenario, the Councils will want to be very clear that they are retaining ultimately responsibility of the management company's activities and will need to retain strategic control over the activities of the management company.

Procurement

Procurement considerations for the Councils

The Councils will also wish to take into account is obligations under the Public Contracts Regulations 2015 (the "**Procurement Regulations**"). Again, the obligations under the Procurement Regulations will flow from the plans ultimately adopted by the Councils and we deal with different possibilities below.

Activity	Comments	OJEU applies?
Establishment of the Welsh Fund	To the extent that the establishment of the Welsh Fund is carried on in-house, there no actual outsourcing and therefore no procurement obligation. In practice, the Council is likely to engage the assistance of its professional advisors. To the extent to which this involves additional/extended appointments, the usual procurement rules will apply.	✗ ✓
Creating and/or appointing a third party management company.	The establishment of a management company should be regarded the same way as establishing the Welsh Fund (see above). The appointment of a management company by the Councils may depend on how the management company is established. It is possible that the management company may fall within the *Teckel* exception if it is created by the Councils (and assuming the Welsh Fund is not offered to other investors). The alternative option is that the appointment is under the exception in Regulation 10(e) which excludes*: "financial services in connection with the issue, purchase, sale or a transfer of securities or other instruments in particular transactions by the contracting authorities to raise money or capital".*	✗ ✗

The investment of (potentially all of) the pension fund assets into the newly created regulated or unregulated structure.	In our opinion, it is not necessary to follow a statutory procurement process. There are two possible arguments to support this conclusion: It could be argued that an investment decision should not be characterised as a contract for the supply of services or goods and therefore falls completely outside the scope of the Regulations; or If the Regulations do apply, then an investment decision of this sort also falls into the exemption for "financial services in connection with the issue, purchase, sale or transfer of securities" under Regulation 10(e).	×

We are aware that other local authorities choose to go through procurement processes in relation to their investment decisions even where there may be no strict legal obligation to do so under the Regulations. They do this either for reputational reasons or because they regard doing so as consistent with their broader duties to ratepayers. Given the likely profile of this decision, the Councils may wish to procure some aspects of the services for these reasons even in the absence of a legal obligation to do so.

Procurement considerations for the Welsh Fund and management company

A further consideration is that the management company and the Welsh Fund are each likely to outsource some of their service (e.g. custody) and make further investments in third party products. This may require further consideration, particularly if the "build" option is pursued. The procurement Regulations cover *"bodies governed by public law"*, which has a broader definition than might be expected in that it includes:

> *"bodies that have all of the following characteristics: (a) they are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) they have legal personality; and (c) they have any of the following characteristics: (i) they are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law; (ii) they are subject to management supervision by those authorities or bodies; or (iii) they have an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law".*

The Councils will want to keep these requirements in mind in establishing the structure of the Welsh Fund and management company and it may be appropriate to seek counsel's opinion depending on the likely impact of this point.

Statement of Investment Principles

Each Council's statement of investment principles would need to be amended to reflect these proposals.

Pensions Boards

The Councils will be aware of the new Local Pensions Board roles and may wish to take steps to establish the boards' buy-in and parameters for their involvement in any joint structure. Local Pensions Boards can now be established jointly between a number of administering authorities. If the Councils are considering a joint investment structure, it might make sense to also establish a joint Local Pensions Board.

Tax

Please note that we are not providing tax advice as to the efficiency of the proposed Welsh Fund. The Councils will want to ensure that the proposed Welsh Fund is appropriate from this perspective.

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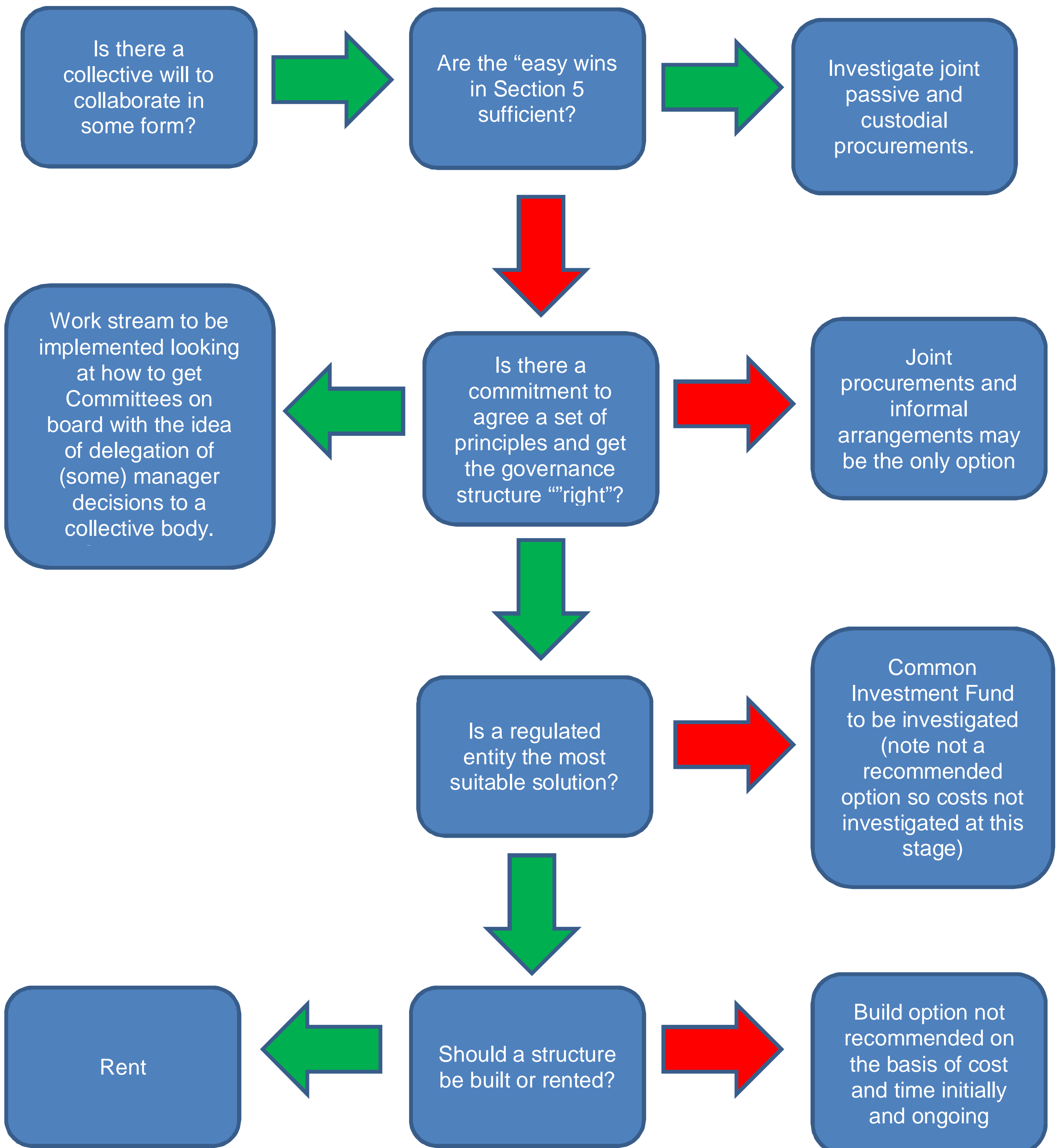
Where to start?

We would suggest the following series of questions are worked through as a starting point:



For the purposes of this report, we have assumed that the “rent” option is preferred and in which case, the first step will be to define a set of principles and to consider how the governance structure would work. This was covered in Section 4.

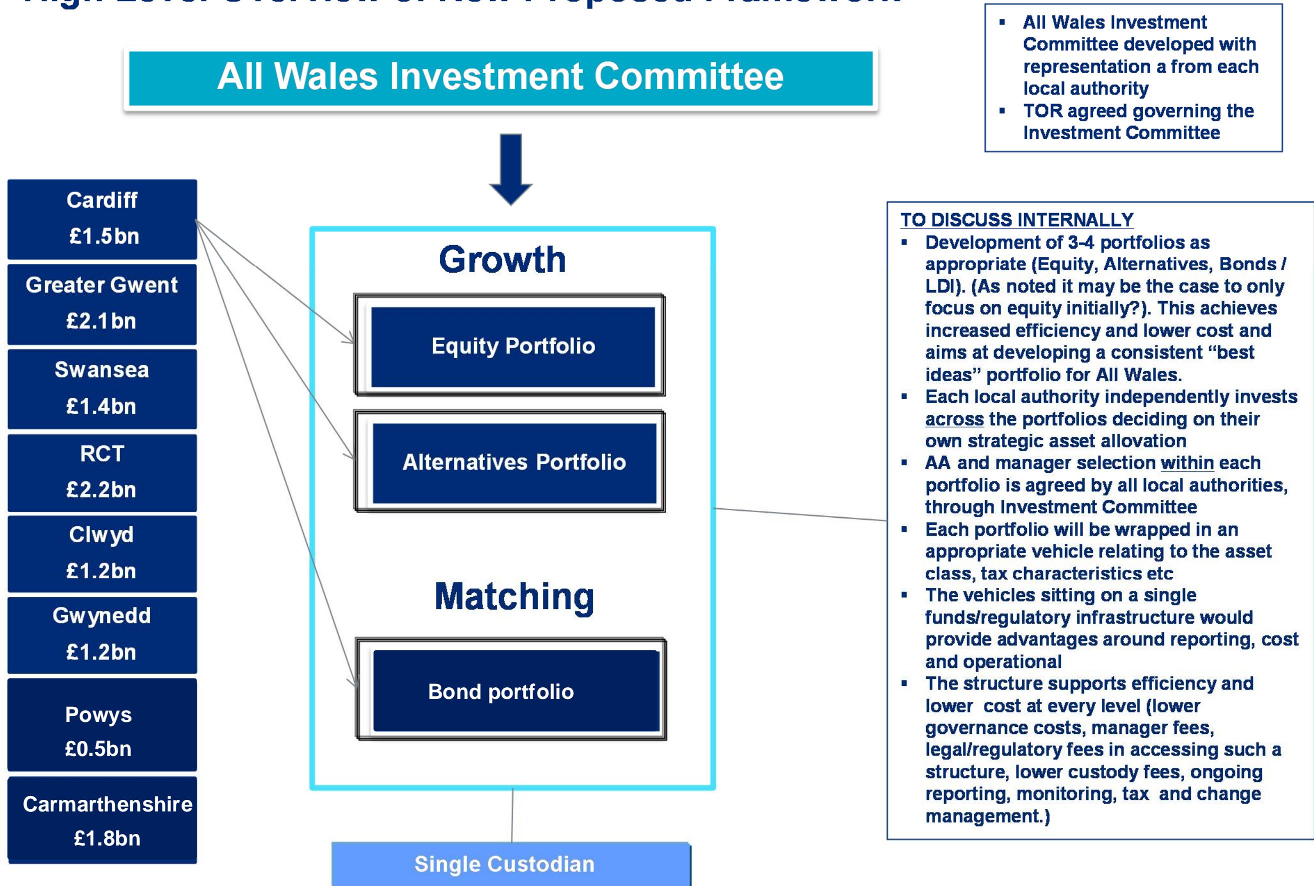
The next consideration is whether there are any legal barriers to implementation (Covered in Section 9).

Next is whether the structure be Option 2 or 3 (as detailed in Section 8).

Once this decision is made, we would suggest that proposed specifications and costings are sought from potential providers. We would expect that an OJEU process will be required to ultimately appoint a provider; although this will of course take time so it is crucial that the general specification of services required is clear at outset to avoid unnecessary analysis of unsuitable tenders.

In order to do this however, thought would need to be given as to the asset classes that would be available through the collective structure and the level of participation that would be likely. However, initially, it may be worthwhile considering the selection of a singular asset class (one that has scale and would have an impact on cost) such as global equity to get the project up and running. Once a platform is established, then more asset classes can be added.

The graphic below illustrates the resultant structure.



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Summary and Recommendations

There are significant savings to be made; both direct and indirect, some more quantifiable than others, through pooling assets and investing collectively.

Governance and delegation

For the Welsh Funds to use a collective structure there must be a shared vision and we would suggest that a set of principles are established at outset.

We believe that there is a premium to be achieved through good governance and sufficient time should be spent in establishing the correct construct of an investment committee of a collective investment structure.

We further believe that there is a real opportunity here to establish a collective with long term principles of investment at its heart; a philosophy that in itself has been show to add real value.

Steps that could be taken without the need for a collective structure

In the particular circumstances that the Welsh Funds find themselves (most notably little cross-over of existing mandates), we conclude that there are few “easy wins” in terms of leveraging existing mandates. We do however recommend that a joint procurement is effected for passive management and possibly custodial arrangements (once decisions have been made on a collective structure).

We would suggest that a single passive manager for Wales would not need to operate under a collective structure and that savings of around £800,000 p.a. could be made if all Funds participated at current levels of assets under passive management. It is likely that this would need to be procured under OJEU due to the additional services deployed by passive managers, such as swing management / rebalancing roles. We have not allowed for transition costs in this instance, on the grounds that passive mandates ought to be transferred between managers on an in-specie basis.

In addition, we note that a joint custodian procurement, presumably utilising the National LGPS Custodian Framework, could harvest further savings. ***However, this is not a step we would suggest considering until decisions are made on collective investing***.

A collective structure

We have recommended, for reasons of future proofing and efficiency, that ***a regulated vehicle is the optimal solution*** for any collective vehicle.

We would further recommend that ***a structure is “rented”*** (i.e. leveraging the existing infrastructure of a third party) ***as opposed to “built”*** (on the grounds of cost, resource and time). An increasing number of sophisticated institutional investors across Europe are moving in this direction.

The attraction of a rental model lies in its ***flexibility***; there will be minimum asset sizes that need to be committed in order to make it a viable proposition for the provider, but by no means do all eight Funds need to commit all of their assets to make it work. We suggest that a rental model using active global equity as a starting point will offer tangible savings; more so if UK equity is included.

This feels like an “easy win”; a starting point to try out a collective arrangement whilst a longer term plan on more complex assets is determined.

There are reduced or no set up costs to be incurred under Options 2 and 3, other than procuring the provider, by the Funds. These are bourne by the provider who will likely charge a minimum ongoing fee for an initial period in order to cover this; just an ongoing operating cost, which means that Funds need only commit (and pay) when they are ready to invest. Of course the cost savings would be greater the more Funds that invest, but we would suggest that the idea of a platform being available to rent / use when needed may be more attractive than compulsion to use a model that has been expensive to build independently.

Under the right model / provider, there would be no “give up” in innovation; the Funds would be free to consider a range of options and perhaps these are more plentiful in the alternative assets space. Indeed, there is the future option here of the Welsh funds running solutions for LGPS funds e.g. an LGPS real assets fund may have real appeal to funds outside of Wales. However, we would contend that Option 3 lends itself more readily to this idea on the grounds that providers in this mould will have relevant experience in creating bespoke strategies for similar clients (whereas Option 2 providers will simply provide the operational infrastructure once All Wales have developed ideas, taken advice, chosen managers etc).

The next step will be to assess the options that are available from the various providers under this model and we can help formulate a template for discussion if required.

Critical Mass

Under the rental model, critical mass will be determined by the minimum fee set down by the chosen provider, but it will also depend on the time period over which savings need to be demonstrated.

For example, if half of the Funds (by asset value) commit to looking at global equities first under a rental model, then the immediate fee savings may be net neutral and a commitment would be needed towards a longer term aim of adding additional asset classes.

Legal Issues

Sackers’ high level advice confirms that the use of a contractual vehicle (such as a CCF or UK ACS) should not, in their view, be subject to any limits under Schedule 1 of the LGPS Investment Regulations. They have not identified any show-stopper legal issues with the use of a manager, either rented or built.

Sackers have also confirmed their view that there is no legal obligation to go through a formal Procurement Regulations 2015 (or “OJEU”) procedure in respect of the initial investment into a bespoke pooled vehicle or in respect of the appointment of a “rented” manager. However, they note that some Councils choose to go through a procurement obligation for policy and/or reputational reasons even where the Regulations do not require this.

Recommendations

- To consider the appointment of a single passive manager across the eight Welsh Funds (regardless of any decision to proceed with a collective structure; although noting that this could just as easily fall under the collective structure for ease).

For actively managed assets:

- To avoid compulsion; a collection of the willing with a shared set of principles is likely to result in a more robust, focused arrangement;
- To be clear on guiding principles;
- To consider the governance structure;
- To consider the set-up of a regulated vehicle;
- To consider leveraging the infrastructure of a third party provider to tailor a Welsh solution. Given our knowledge of the Welsh Funds we would suggest Option 3 provides the most suitable fit to meet existing needs.
- To start with a single asset class, with a view to adding more complex propositions once the structure and its governance arrangements are up and running. Given our analysis, both UK and global equity would offer a strong starting point to fit into the new collaborative framework given the allocation and consistency of these mandates across the schemes and the potential to leverage material cost savings.
- We would suggest a training workshop to discuss the details and workings of the new framework to be set up for the summer period. A separate session would be required for Officers and key Committee members. (Mercer would be able to provide these workshops under the terms of the contract i.e. there would be no additional fee).
- After the workshops, the next step for the Welsh Funds would be to invite non-binding proposals from potential providers in order that a comparison of services and costs can be made. Appendix B contains suggested areas for questioning.

Next steps

We would see the next steps of the project being as follows:

Stage	Time scale
Development of guiding principles	Q2 2015
Training for Key Councillors of each Fund's Committee on principles and options (Mercer would be able to provide this at no additional fee)	Summer 2015
Workshop / training for Officers on the operational aspects of the "rent" option. (Mercer would be able to provide this at no additional fee)	Summer 2015
Draft of specification for providers (Suggestions found in Appendix B)	Q2 2015
Draft Terms of Reference for All Wales Investment Committee	Q2 / Q3 2015
Each Fund to work through constitutional issues in terms of delegation to All Wales Investment Committee	Q2 / Q3 2015
Initial due diligence meetings with providers	Q3 2015
OJEU Process to begin (if required)	Q3 2015

Jo Holden
May 2015

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Important Notices

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Appendix A

Increasing efficiency within the existing arrangements

As summarised in section 5, we set out below further detail on the current arrangements in place.

Aggregate fees

Putting aside any differences in manager line up between Funds, and any implications of regional equity structures (compared to global mandates), we outline below a broad comparison of the aggregated Funds' assets and fees compared to what we might typically expect based on our Global Fee Survey in 2014, which benchmarked our experience of clients fees' globally.

The intention of the comparison is to stop any "glaring" disparities or areas to explore further. There will likely be a number of differences in the specifics of the Welsh Funds mandates relative to those included in the survey and the analysis is intended as a guide, but it may point out whether there are any obvious issues relative to peers.

Note we have excluded alternatives (including property) due to the wide variation in mandates which make it difficult to do a like for like comparison. We have however included performance fees in order to compare like with like.

	Assets (£bn)	ALL WALES Total fee (£m)	ALL WALES Average fee	MERCER FEE SURVEY Total fee (£m)	MERCER FEE SURVEY Average fee
UK Equity	**2.5**	**11.7**	**0.47%**	**-**	**-**
Active	1.3	10.9	0.82%	6.1	0.45%
Passive	1.2	0.6	0.05%	1.2	0.10%
Global Equity	**4.4**	**15.6**	**0.35%**	**-**	**-**
Active	3.3	14.6	0.44%	18.6	0.56%
Passive	1.1	1.0	0.09%	1.4	0.13%
Emerging Market Equity	**0.4**	**1.9**	**0.47%**	**-**	**-**
Active	0.2	1.7	0.69%	1.9	0.77%
Passive	0.2	0.2	0.13%	0.2	0.16%
Bonds	**2.2**	**4.0**	**0.18%**	**-**	**-**
Corporate bonds	1.6	3.5	0.22%	3.6	0.23%
Government bonds	0.6	0.6	0.10%	0.9	0.15%

Key: Green – Paying less than expected fees, Red – Paying more than expected fees

The key findings from this comparison are as follows:

- Fees are generally competitive across the board compared to the fee survey; although UK equities do look high (albeit there is a large performance related element). This is not unsurprising given our experience of fee negotiations with managers within the LGPS.

- Please note we have included performance related fees which impact both the UK and Global equity strategies shown. Clearly, the nature of performance fees can be volatile and therefore a meaningful comparison may differ from year to year.

- Whilst not captured within the Mercer fee survey itself we are aware of developments within passive managers over recent years in providing significant reductions to LGPS clients (both before and following the London CIV discussions). We cover this later in this section.

- Whilst fees are generally competitive, it is worth noting that the fee survey generally stops at asset sizes of £250m. It supports the argument that there would be further savings to make with large enough mandate; although we recognise that this may be seen as an anecdotal argument.

Active UK and global equity strategies

We do believe that consolidation of mandates across the eight Funds could reduce fees. Further, where there are already similar mandates in place with a particular investment manager this *could* (manager permitting) lead to some fee savings without having to change the structure. The area where this has the most potential is actively managed equity strategies.

Based on the data provided, c40% of the eight Funds' assets are managed in active UK, global or regional equity funds. However, whilst a significant proportion of the assets across all Funds held in actively managed equities, there is a limited commonality in their underlying structures.

The table below highlights the detail of the underlying structures in order to demonstrate the commonality between Funds. This shows that there are limited similarities in manager line-up, and even when there are consistencies at a manager level, due to client specific requirements in the majority of cases there is little commonality to enable Funds to leverage any economies of scale.

	Total number of mandates	Total number of managers	Difference
UK active equity strategies	8	7	1 common manager
Regional (ex UK) active equity strategies	US: 1 European: 3 Asia-Pac: 2 Japan: 3 Emerging markets*: 7	US: 1 European: 2 Asia-Pac: 2 Japan: 3 Emerging markets*: 3	US: 0 European: 1 Asia-Pac: 0 Japan: 0 Emerging markets*: 4 common managers
Global active equity strategies	13	10	2 common managers (one manager used within 3 Funds)

** includes Frontier markets*

- In the event that Funds are invested in the same asset class with a common manager, there is potential for fee savings should Funds join together to request fee reductions. To the extent that there are common mandates (in a pooled fund) there could be potential savings if a manager has a tiered fee scale and is willing to view common mandates as one (e.g. for reporting purposes).

However, as outlined above, there is limited commonality at a mandate level. When "looking through" the underlying structures, even where there is some commonality by manager, due to the use of segregated accounts with specific Fund objectives, there is likely to be little to no efficiencies in reporting as each account will be treated separately. We therefore believe it is unlikely to harvest any meaningful saving in approaching managers in this way.

- Should Funds be willing to lose some flexibility, either by moving away from segregated accounts to a pooled fund structure (where there is already existing commonality at a manager level); or by reviewing their manager appointment in place (perhaps by looking to run a joint procurement process), this has the potential for fee savings. However, there would be transition costs associated with any change in mandate; and the upfront costs of running any procurement exercise. Practically, this approach is not "future proofed" as it may store up problems for later as and when individual Funds wish to make local decisions – for example, if one Fund looks to terminate a manager whilst another wishes to retain an appointment.

Overall, we believe there are limited savings to be made under the existing structure for actively managed equity mandates under the current individual Fund structure. We have spoken to managers where there is a high degree of commonality with mixed results. Aberdeen would be unlikely to reduce fees for a joint entity as their fees are already well below their standard fee scales. BlackRock would look at fees if reporting to a single entity. Baillie Gifford's tiered fee structure would result in reduced fees should there be efficiencies in reporting.

As noted earlier, fees at a local level are already relatively competitive based on each individual Fund size and there is limited commonality to improve fees further without making additional structural change.

Passive mandates

Around 20% of the Fund's assets (predominately equities) are passively managed. Unlike actively managed strategies, passive mandates can arguably be viewed more as a "commodity" and we would therefore expect local Funds to be more comfortable in moving away from an existing provider if this led to meaningful cost efficiencies.

When reviewing the Fund's assets compared to other passive mandates globally (as outlined earlier), fees appear to offer relatively good value.

However, specific to the LGPS, we are aware of the leading passive managers becoming increasingly commercial to win (or retain) business. We therefore believe there is potential for fee savings in Wales as a collective seeking to negotiate with the leading passive managers in aggregate.

Where managers are willing to view the eight Funds as an informal collective, this would likely lead to extremely competitive pricing (even further than those already well negotiated fees).

For example, should the existing fees be halved (based on our experience of a selection of similar sized mandates this would not be unsurprising), this would lead to savings of £800,000 p.a. As this would not require a huge amount of resource to investigate, this may be something which the Funds are willing to pursue further.

It should however be noted that investment manager fees are not the only costs associated with passive management. There are other factors to consider in reviewing any appointments – including:

- Profits on stock lending – to what extent does the manager take a proportion of these?

- Bid/offer spreads – as the passive mandates are the most common 'holding ground' for mandates during any asset allocation re-structure, ensuring any move in and out of passive assets is carried out with minimal transaction costs should also be considered.

We would suggest that a cost benchmarking exercise is carried out as part of any next steps resulting from this report before any procurement is undertaken.

Initial thoughts on alternatives

The collective Funds' alternative asset portfolios was the area that was most difficult to quantity any potential for cost savings through leveraging any commonalities.

In particular, there were extreme disparities within the structures in place, fee structures are complex (owing to underlying manager fees which are not always typically accounted for) and the approach to alternatives was inconsistent, which is not entirely unexpected. However, from experience, there is little point in attempting to renegotiate fee arrangements with the private asset managers given the Funds are "locked in" to these investments.

Whilst we would not expect much merit from pursuing fee reductions based on the current structure, there is a potential for reviewing how Funds can collaborate on alternatives under a revised model. This is considered later within the report.

The majority of the Funds' property allocation are UK based, but there is little commonality at a manager level to pursue fee negotiations. Property is also too illiquid to be a first port of call for any immediate change in structure – particularly given the majority of the mandates in place are pooled arrangements where the individual Fund has little to no control. DGFs are yet to form a significant allocation (c1% of total assets) with already competitive fees; and the balanced funds (c5% of total assets) relate to two long standing mandates which would unlikely be a starting point for any further collaboration activity.

Active bond strategies

The make-up of individual Funds' bond portfolios are wide ranging. Broadly, we can categorise the eight Funds' aggregate allocation as follows:

UK Government Bonds:	27% (including Liability Driven Investment – LDI) 3 mandates.
UK Corporate Bonds:	49% (including absolute return mandates) 6 mandates.
Global Bonds:	24% (two global bonds and a Multi-Asset Credit mandate).
Total:	*100%*

UK Government bonds consist of a mix of 2 government bond mandates with one provider, but very different objectives (one is passive index linked gilts, the other an actively managed Core Plus strategy). The remaining LDI mandate is not an area we would collaboration to be best utilised - as portfolios are driven by a Fund's own liability profile; of which there will be different challenges at a local level.

The UK corporate bond holdings relate to 6 mandates with 3 managers. There is however no commonality at the underlying fund level to leverage any efficiencies in their current form. We do note that from a strategic perspective the case for holding UK corporate bonds is changing. Therefore to the extent to which these mandates are up for review may provide potential for collaboration – for example, within a joint procurement, if this was to be considered an appropriate approach.

There are no consistencies to leverage within global bonds.

Other expenses

Investment manager fees aren't the only way to levy cost efficiencies under the current arrangements. Over £1.6m of other expenses were disclosed across the eight funds over the last year and a summary of these are outlined below.

Custody (£000)	Reporting (£000)	Consulting advice (£000)	Audit and legal (£000)	Other expenses (£000)	Total (£000)
647	99	648	105	115	1614

The remainder of this section provides comment on any potential cost efficiencies that we believe could realistically be achieved.

Custody

An area where the LGPS is already benefiting from improved collaboration is in respect of custodian services.

A summary of the custodian fees currently incurred are outlined below:

	Fund A (£000)	Fund B (£000)	Fund C (£000)	Fund D (£000)	Fund E (£000)	Fund F (£000)	Fund G (£000)	Fund H (£000)	Total (£000)
Custody Fees	51	N/A – pooled funds only	50	None disclosed	157	134	138	117	647

From the data provided, there are at least 3 named custodians (HSBC, BNY Mellon and Northern Trust) between the Funds who disclosed custodian fee information.

By looking to procure a single custodian we would expect there to be significant fee savings to be made, and are aware of incredibly aggressive pricing in recent custodian reviews.

To give an idea of the order of magnitude; when Norfolk, Hackney and Suffolk went through a joint process under the National Custodian Services Framework; the three funds, with combined assets of £5.2bn, disclosed that they are expecting to save a total of £1.25m over the lifetime of the contracts. A reported £250,000 was also saved in procurement costs by using the framework.

There are clearly fee savings to be achieved here; but should a decision be made to build or rent a collective model for Wales we would suggest this forms part of those considerations as opposed to being considered as a standalone decision.

Other expenses

Other significant expenses relate to consulting, reporting and audit and legal costs.

However, the nature of the costs being incurred are specific to work carried out at a particular Fund level, and we have therefore not considered the cost savings any further.

Appendix B

Outline questionnaire for providers

At this stage we have simply provided headline suggestions of areas for initial questioning. If required, we would be pleased to forward a draft RFP.

Background

The eight Welsh LGSP Funds have assets under management of £X and collectively have Y investment manager mandates.

The Welsh Funds are keen to explore collaborative solutions for investing and have the following goals:

- Improved governance
- Best in class investments
- Cost reduction and transparency
- Robust risk management

Specifically, in the first instance we are looking for a provider who can aggregate our equity assets under a single structure, whilst fulfilling our 4 stated goals set out above.

Current Mandates

[To add a description of mandates at the time of tender]

Requirements

The investment services provider must be able to document experience in the management of the above or similar solutions.

(IF THE WELSH FUNDS DECIDE TO OPT FOR OPTION 3, WE WOULD SUGGEST THE FOLLOWING IS ADDED)

The provider must be able to meet the following minimum criteria at the time of submission:

- Independent Investment Research – Global investment manager research team which advises clients of a similar size to Client
- No in-house management of individual securities
- Independent Operational Research Team – A dedicated global operational research team which advises client of a similar size to Client
- On-line access to investment manager research and operational risk reviews
- Global operational infrastructure with portfolios that have been implemented
- Demonstrable experience in implementing multi-manager multi asset portfolios
- UK presence with a minimum of two investment relationships with institutional

investors

- Currently running a fully integrated solution including manager research, advice, operational risk review, portfolio risk management (based on security level data), implementation and oversight of all third parties and integration with in-house risk systems
- Proven success in reducing explicit costs from third service provider (including but not limited to asset managers, custodians etc)

Further information can be obtained from: [TO INSERT}

SUGGESTED HEADINGS FOR QUESTIONS

- BACKGROUND INFORMATION ON YOUR ORGANISATION
- MANAGER RESEARCH AND ADVICE
- RISK MANAGEMENT SERVICES
- IMPLEMENTATION AND TRANSITION SERVICES
- OPERATIONAL AND COMPLIANCE DUE DILIGENCE
- THIRD PARTY RELATIONSHIPS
- COMPLIANCE & CONFLICTS OF INTEREST
- COSTS, FEES & COMPENSATION
- ADDITIONAL INFORMATION

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