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Local Government Pension Scheme (England and Wales): Fit for the future

We, the Association of Real Estate Funds[1] (AREF), have read with interest the Pensions Investment Review Interim Report and the consultation on Local Government Pension Scheme (England and Wales): Fit for the future. We have responded to some of the questions regarding LGPS pooling in the consultation paper. We have made some key points relating to investment by pension schemes in real estate as an asset class that we believe should be taken into consideration by the Government as part of this review.

LGPS Pooling

Question 1: Do you agree that all pools should be required to meet the minimum standards of pooling set out above?

Please see our answers to Questions 2-6.

Proposal 1: Requirement on AAs to fully delegate the implementation of their investment strategy to their pool.

Question 2: Do you agree that the investment strategy set by the administering authority should include high-level investment objectives, and optionally, a high-level strategic asset allocation, with all implementation activity delegated to the pool?

The one exception we would like to see to the pools implementing the investment strategy is when there are legacy assets. It may be more cost effective for the AA to continue to manage the legacy assets. Please see our response to Question 8.

Question 4: What are your views on the proposed template for strategic asset allocation in the investment strategy statement?

We are pleased to see that that the template for strategic asset allocation includes "property/real estate" and "infrastructure".

We appreciate that the template is for the AAs to record their strategic asset allocation at a high level. We assume that the AAs would not expect that investment in "property/real estate" and "infrastructure" to only be through direct investment. The pools could use fund structures such as the Reserved Investment Fund (RIF) and Long-Term Asset Fund (LTAF) to obtain exposure to real estate and "infrastructure. The RIF will

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has around 50 member funds with a collective net asset value of more than £50 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

complement and enhance the UK's existing funds regime with lower costs and more flexibility than the existing Authorised Contractual Scheme (ACS) and will be open to professional and institutional investors such as LGPSs. Please see our response to Question 6.

Proposal 2: Requirement on AAs to take their principal investment advice from the pool.

Question 5: Do you agree that the pool should provide principal investment advice on the investment strategies of its partner AAs? Do you see that further advice or input would be necessary to be able to consider advice provided by the pool - if so, what form do you envisage this taking?

We agree with the AAs taking advice from their pool on investment strategy but as we have mentioned in our response to Question 6, it should not be frowned upon if the AAs or their pool need to seek external expertise.

We would envisage this advice or input being obtained by the pool employing specialist managers on separate account mandates, or through investment in fund structures such as LTAFs or RIFs.

Whilst these methods are already employed by AAs operating real estate investment strategies themselves, the pools will be able to use separate account mandates to access more specialist strategies than AAs would directly thereby reserving greater control over the management of assets. When investing in specialist fund vehicles the pools will be better able to achieve costs savings by investing at greater scale than individual AAs.

Proposal 3: Requirement for pools to be established as investment management companies authorised and regulated by the FCA, with the expertise and capacity to implement investment strategies.

Question 6: Do you agree that all pools should be established as investment management companies authorised by the FCA, and authorised to provide relevant advice?

We understand the benefits of Proposal 3, however, we have concerns with the following statements in the consultation:

> "*20. The government's view is that pools with outsourced models, or pooling of some private markets assets only, have delivered significant savings and diversification to date but are not well placed to deliver for the future while retaining their current model. They lack the substantial in-house expertise, capacity and resilience provided on a non-profit basis by the LGPS pool companies. In addition, the pool companies that have - or are in a position to develop - in-house investment management capabilities should benefit from significantly lower costs compared to the use of external private sector investment managers, given existing experience within the LGPS.*"

We are concerned that there will be the expectation that pools will only use in-house experts to implement their investment strategies and it will be considered bad practice to pay for external expertise. This will depend on the nature of the underlying investments – some may require a high degree of very specialist expertise that may not be available in the pool. Real estate is a very granular asset class. At the moment there is strong interest in investment in residential (of different types), life sciences and data centres, all of which require very specialist management. The most traditional types of real estate, offices and retail, are undergoing a unique level of change. In many cases, these assets also need specialist management. Recognising this will not only protect the pension outcomes of the policy holders but will also facilitate investment in areas key to the government's broader industrial, regeneration and housing strategies.

In addition to the specific management services, the LGPS will require experts in a wide range of fields, for example, legal, financial, planning, sustainability and also experts with detailed local knowledge. External expertise will be required where the in-house knowledge is not available, or it is too expensive to employ experts in house.

An additional challenge with some of the new investment opportunities, in particular data centres, is the size of the individual assets. To achieve a diversified spread of investments, even the largest global investors are investing through third-party managed funds.

Proposal 4: Requirement for administering authorities (AAs) to transfer legacy assets to the management of their pool.

Question 8: Do you agree that administering authorities should be required to transfer legacy illiquid investments to the management of the pool?

We agree that the transfer of all assets to the management of the pool must be the ultimate objective. However, in the context of illiquid assets such as real estate we are pleased to see that it is acknowledged in paragraph 49 of the consultation:

> "…*the government recognises that transferring legacy assets into pooled vehicles may incur unnecessary costs in the short term, including for termination of long-term contracts.*"

For this and other reasons, as mentioned in paragraph 50 of the consultation, some pools manage legacy assets but keep them under the ownership of the AAs. We would warn against the absolute desire that all legacy assets are managed at pool level. Where it is not an easy exercise to move management of a legacy asset from the AA to the pool additional costs could occur that could be avoided by leaving the management of the asset with the AA. From both a pension investment and a broader government strategy perspective, it would seem more sensible to focus resources on making new investments rather than focussing on moving legacy ones which may in any case be sold in the short to medium term.

We would note that to benefit from seeding relief when transferring illiquid assets, LGPS will be required to use either the ACS or RIF structure. The regulations applying to the ACS structure can make it expensive and resource-intensive which could be a significant constraint on the transfer of legacy assets to the pools. Whereas, the RIF, an unauthorised fund for UK regulatory purposes, should be a more efficient structure to operate.

Question 9: What capacity and expertise would the pools need to develop to take on management of legacy assets of the partner funds?

Similar to our response to Question 6, for managing certain types of assets, the pools may need to use external expertise. It may not be cost effective for them to have in-house expertise for every type of legacy asset they may be required to manage.

Collaboration and specialisation

Question 11: What scope is there to increase collaboration between pools, including the sharing of specialisms or specific local expertise? Are there any barriers to such collaboration?

We fully support collaboration between the pools, However, as we have mentioned in our response to Question 6, there must be the capacity for pools to obtain external advice when appropriate. We have concerns with the following statement in paragraph 61 of the consultation:

> "Areas where specialisation or collaboration (between pools) may be particularly attractive include alternative investments including private equity, private debt and venture capital, as well as infrastructure and investment in specific local or regional investments"

We are concerned that there will be the expectation that pools will <u>only</u> collaborate with other pools when investing in real estate and other "alternative investments" and it will be looked down upon if they pay for any external expertise. This could lead to pools not being able to invest in niche investments and move into new innovative investment strategies where they don't have this expertise. For example, data centres are currently a type of long-term asset that LGPS may wish to invest in. It is very unlikely any of the pools will have experts in investing in data centres as this is a very new type of real estate asset. The pools would need to obtain external investment advice otherwise they could miss out on this and other new investment opportunities.

We think that there are also huge benefits in pools collaborating with other types of investor. For example, a pool investing through a fund or joint venture might allow other investors, such as overseas institutions to invest alongside, unlocking valuable investment into areas of strategic importance to the government's broader strategy.

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Local Investment

Definition of 'local investment'

Question 13: What are your views on the appropriate definition of 'local investment' for reporting purposes?

We welcome the clear definition of local investment which has to date been interpreted differently across the LGPS.

Proposal 7: Requirement for the pools to develop the capability to carry out due diligence on local investment opportunities.

Question 16: Do you agree that pools should be required to develop the capability to carry out due diligence on local investment opportunities and to manage such investments?

The pools may face challenges in fairly allocating capital to local investment projects across the regions governed by their member AAs. Governance structures for selecting local investment projects need to be very robust to ensure decisions are made on investment risk and return grounds without political influences being brought to bear by the shareholders of the pools. Independent third-party input to the due diligence process in underwriting and managing local investments will be necessary in our view.

Proposal 8: Requirement on AAs to include in their annual report a report on the extent and impact of their local investments.

Question 17: Do you agree that administering authorities should report on their local investments and their impact in their annual reports? What should be included in this reporting?

We agree with the principle of AAs reporting on their local investments and their impact. We would comment that in the real estate sector, a consistent framework for reporting on the environmental and social impact of local investments needs to be developed.

If you would like to discuss any aspect of our response, please contact Jacqui Bungay (jbungay@aref.org.uk), Head of Policy at AREF. Also, as our members invest in real estate and other real assets for various types of open-ended and closed-ended funds, we are always willing to assist the Government by sharing this wealth of knowledge and experience.

Yours sincerely

Paul Richards

CEO, The Association of Real Estate Funds