MERCER

MAKE TOMORROW, TODAY

ALL WALES COLLABORATION

JULY 2015

MARSH & McLENNAN COMPANIES

CONTENTS

1

Executive Summary

This paper provides an overview of the work completed 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 the key benefits which 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 assets 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 assets.
- 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).
- 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 active equity as the immediate mandate to commence under the new collaborative framework. The analysis conducted highlights that these mandates offer the greatest potential for cost savings and improved net of fees returns.

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

We begin at the point at which the eight LGPS Funds in Wales have decided there is merit in exploring whether investing their assets together is (tangibly) worthwhile.

There are a range of options for investing collectively and for each option we have considered;

- The costs of set up
- The financial benefits
- Implementation issues
- The governance implications
- The legal implications

We have made recommendations in terms of the options we feel should be taken forward and as such have provided details of next steps for implementation.

Proven Benefits?

At the outset of the project, Officers of the eight Funds were clear that a discussion was needed on the benefits of collaborative investing and the extent to which these were proven; the rationale being that this may help form the guiding principles or aims of any collaboration project.

In order for collaboration to be "proven", we arguably need to obtain improved investment returns after fees.

Reductions in fees are of course tangible, but arriving at improved investment returns can be a result of a number of inter-related factors, and so the singular impact of collaboration may be difficult to definitively prove.

Nonetheless, there are a range of factors, be they direct or indirect, that collaboration will bring to the table, which we believe will have a measurable benefit;

- Increased scale would **reduce costs** but also allow for more **diversified, but focused** portfolios

Care would need to be taken not to "over-diversify"; however, a weight of collective assets would allow for more focused or specialised portfolios, perhaps covering opportunities that would not be possible on an individual Fund basis. We also believe there is a real opportunity to take a long term approach in illiquid, alternative assets that may not exist at an individual Fund level presently. A carefully considered collective vehicle, tailored for the needs of the LGPS, would have distinct merits – managed by the LGPS for the LGPS.

There needs to be an awareness of **diseconomies of scale** however (for example, smaller boutique managers may not be able to facilitate large pools of assets).

- Improvements in governance

By delegating manager decisions to a joint Welsh body, individual Funds will have more time to spend on strategic issues such as funding and investment strategy. Structured correctly, a joint body operating outside the usual Committee cycle will increase the speed of decision making and be able to be more “market aware”. There is of course also the point that “eight heads may be better than one” in terms of diversity of ideas.

- Increasing operational efficiencies

Currently eight Funds are independently diverting internal resources and paying fees to external providers. Where there is commonality in services required, whether it be 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.

3

Governance

Governance is Key

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 Welsh entity; although clearly the direction of travel post Budget is that meaningful steps are likely to be required by all Funds in England and Wales. However, 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 with respect to 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
    - 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?

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. Second, the governance structure of the collective entity itself is of utmost importance in 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;

- It may be worth considering having an elected official from each local 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.

4

Avoiding Complexity

What can be done within the current arrangements for each Fund?

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 reviewed the following areas:

- Aggregate fees – how do fees of the eight Funds in aggregate compare to other large mandates?
- Potential for savings within passive mandates
- Commonalities within active 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, due to the lack of comparable data, our Fee Survey does not provide information on mandates of the scale possible across the eight Welsh funds collectively.
Potential for savings within passive mandates	Fees are relatively good value compared to other passive mandates globally. However, this is an area of increasing focus for joint procurements, so it may be an area worthy of investigation. We believe there is potential for fee savings in Wales as a collective seeking to negotiate with the leading passive managers. Based on recent experience, 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 due consideration in addition to headline manager fees.
Commonalities within active UK and global equity strategies	There is limited commonality between the Funds' manager line-up. Even where there are consistencies at a manager level, due to Fund specific requirements in the majority of cases there is little scope to enable Funds

	to leverage any economies of scale under the current structure. However, there is consistency of strategy and allocation across the Funds and so equity mandates may actually offer the greatest scope for initial collaboration.
Initial thoughts on alternative assets	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 that aggregates Funds' assets – but the "model" will need to be in place first.
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 with mandates in their current formats. 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 and by looking to procure a single custodian across Wales 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 at present 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 are 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 any wider collective investment model considered.

5

Asset Pooling

Should Assets be Pooled?

In order to achieve lasting scale, we believe that there needs to be some form of asset pooling across Funds. This need not be wholescale; we would suggest that careful consideration is given to the type of assets or mandates that would provide either the greatest efficiencies, or the greatest opportunity for creating excellence in investment.

Joint procurements would provide an initial level of cost savings, but there still needs to be some sort of structure in place to enable the project to "have legs" and with that in mind, joint procurements probably have more mileage for less complex mandates such as passive.

The advantage of pooling is that it provides some sort of physical structure on which a joint entity can be based.

As part of this exercise, Officers considered in detail various methods of asset pooling and the types of structure that exist. The conclusion was reached that from a risk management 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 provide longevity of approach.

Whilst at first glance, an unregulated structure like a Common Investment Fund may feel like a more simple solution it doesn't solve any governance issues for the 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.

6

A Joint Structure

How to achieve a joint, regulated structure

In order to establish a Welsh fund / vehicle, a Management Company will be required and there are two options; either "build" a Welsh Management Company, or "rent" the structure from a provider.

In practice, the two options become three;

1. Establish a Welsh Management Company ("build");
2. Use the Management Company of a third party custodian ("rent");
3. Access the Management Company of third party provider to tailor a Welsh solution ("rent").

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

Costs and Timescales

Officers have considered in detail the requirements, timelines, costs and ongoing obligations associated with the establishment of a management company and related regulated fund structure.

As a guide, we estimate that the minimum timeframe involved to establish a fund and related entities is **12-18 months**. 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.

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 £3.1m, 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 for providers, which we believe in practice is unlikely.

Under the appropriate regulation, 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.

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 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.

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

There are of course a range of governance considerations related to this option and Officers will consider these in detail before and as part of any potential procurement exercise.

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.

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. **These services would need to be contracted separately under Option 2**.

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 or internal team or delegated to external consultants.

Specifically, Option 2 would also not allow for any potential manager fee reductions above and beyond the scale of the Welsh assets (no access to global buying power, which may be important if take up amongst the Welsh Funds is low to begin with).

Because the set up costs of option 3 are likely to be 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

Officers have considered in detail the indicative costs associated with the existing approach compared with either of the two rental options.

As a starting point, and for simplicity, we looked at the eight Funds' **active UK and global equity** allocation and assessed the potential costs of a collaborative approach according to various levels of take up.

There were 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 believe 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;

- 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.

The potential estimated cost savings for options 2 and 3 are outlined below:

Cost saving (p.a.)	100% take up	50% take up	25% take up
Option 2	£1.6m	-£0.3m	-£0.5m
Option 3	£2.7m	£1.0m	£0.1m

The calculations above relate only to the tangible expected cost savings relating to investing UK and global equities collaboratively. Further savings would be achieved as more assets (in particular alternative assets) were introduced to the structure. In addition, the performance impact of an improved governance structure has not been incorporated.

There are several notes to the estimated and these can be found in the appendix.

Recommendation

We would discount the build option (option 1) on the grounds of initial cost, 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.

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.

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£3-4million 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 UK and 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 £0.5m p.a. to a reduction of fees of £2.7m p.a.). **The savings would increase as more asset classes are incorporated; significantly in the case of alternatives**. 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. **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.

7

Legal Issues

Advice has been sought from Sacker and Partners who looked at the following principal questions:

- do the Councils have power to implement the Proposals being considered;
- 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?

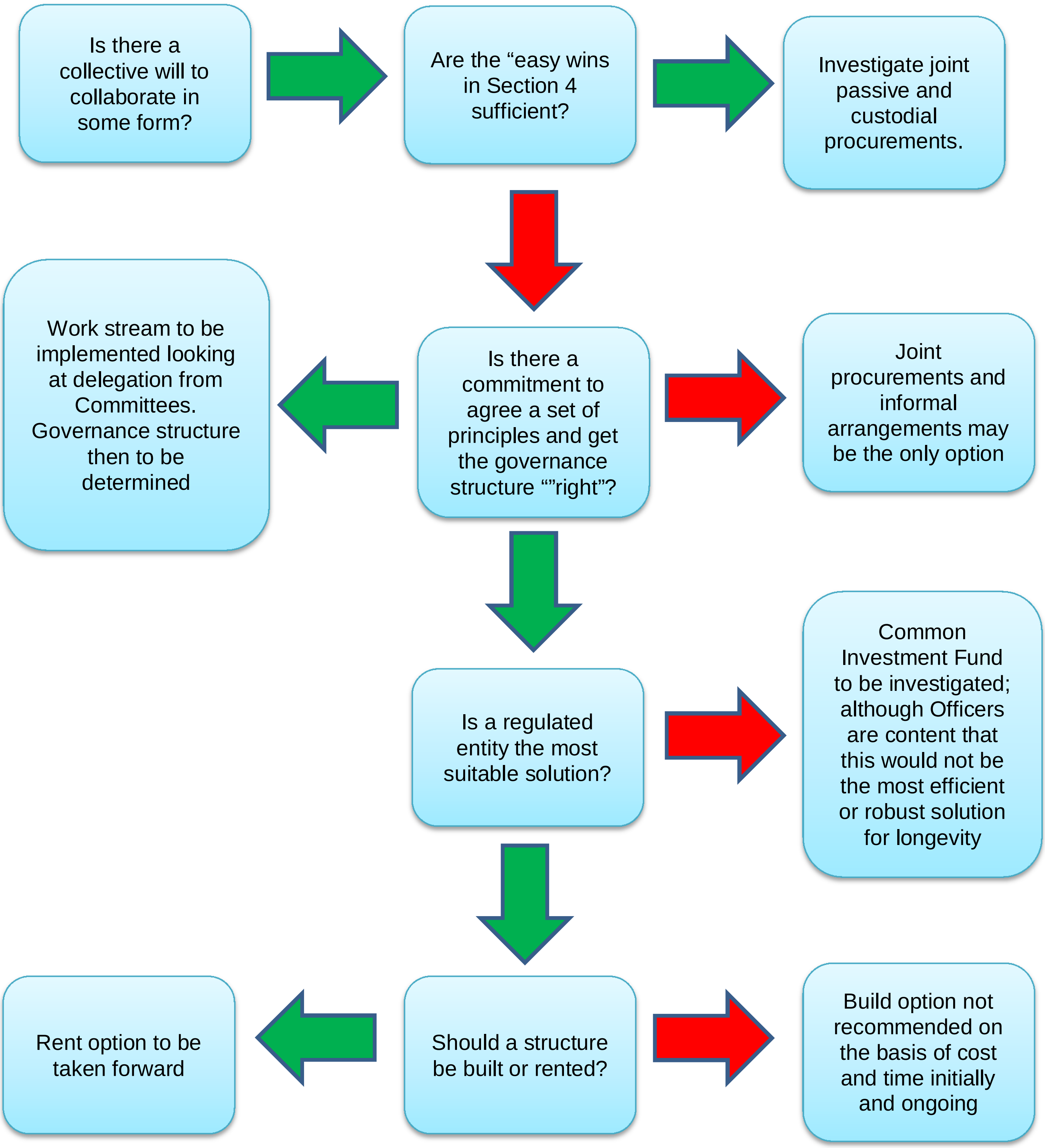
Sackers have not identified any legal show stoppers which would prevent the Councils proceeding. However, they do identify a number of points in relation to governance, delegation and procurement that Officers will take into account as the project progresses.

8

Decision Making – An Overview

The project undertaken by Officers has been all encompassing, and a summary has been provided within this report.

By way of a summary, the following diagram may help the reader work through the decisions that Officers are minded to make:



9

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 equity as a starting point will offer tangible savings. 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.

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 should not, in their view, be subject to any limits under 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.

- 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.

- 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.

Next steps

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

Stage	**Time scale**
Development of guiding principles	Summer 2015
Training for Key Stakeholders on principles and options	Summer 2015
Workshop / training for Officers on the operational aspects of the "rent" option.	Summer 2015
Draft of specification for providers	Q3 2015
Draft Terms of Reference for All Wales Investment Committee	Q3 2015
Each Fund to work through constitutional issues in terms of delegation to All Wales Investment Committee	Q3 2015
Initial due diligence meetings with providers	Q4 2015
OJEU Process to begin (if required)	Q4 2015

10

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualized investment advice.

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For the most recent approved ratings of an investment strategy, and a fuller explanation of their meanings, contact your Mercer representative.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.

Jo Holden
Mercer
July 2015

APPENDIX

Notes to cost savings calculations

The savings quoted are in relation to manager fees only and for one asset class (UK and global equity) only. It should also be noted that recent fees for UK equity have been higher than has historically been the case due to strong performance and the addition of performance related fees. Therefore, rather than use more recent fees, we have taken a longer term historic average.

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.

Implementation fee

Options 2 and 3 may have an "implementation fee", be that implicit or direct.

All services will be included within Option 3 and the provider may well waive the fee.

Option 2 however will require the Welsh Funds to undertake, or outsource, the following tasks and therefore there will be a set up or implementation cost:

- 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 should manager appointments be made as a collective the costs could reduce 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.

MERCER
MAKE TOMORROW, TODAY

1 Tower Place West,
Tower Place,
London
EC3R 5BU.