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Macquarie Portfolio Solutions
LGPS Pooling:
Challenges and Opportunities in Transition Management

CIPFA Pooling Implementation Seminars

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- Transition costs
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- Practical considerations - where transition modelling can help

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Introduction – LGPS pooling

Presentation objectives

- Provide insight into the issues and solutions available
- Every transition is different and all your pooling events are particularly diverse
- However, your pooling Transition is an opportunity to realise significant savings by co-operation

Spectrum of pooling approaches

“Insource”

- Setting up of FCA authorised asset manager, owned by pooling partners:
  - Manages the collective assets of the underlying funds, usually through an ACS for listed assets
  - Allows the pooling of unlisted and alternative investments through bespoke private arrangements

“Outsource”

- Establishment of a fund platform with a rationalized fund line up for each asset class, via a CIV
- A more flexible arrangement for the LGPS

Transition management

What is transition management (TM)?

Transition management is the risk controlled, cost effective process for managing changes in mangers or asset allocation. TM is heavily focused on project management and co-ordination; identifying and managing risks; estimating and minimising costs.

What role does transition management have to play in the pooling process?

A transition manager can:

- provide an estimate of the costs involved in transition at the fund and aggregate level
- provide analysis of the different costs for various possible manager allocations
- provide advice on potential difficulties and risks
- develop a well defined implementation plan
- identify the most cost effective and risk controlled route to effect the pooling
- provide comprehensive project management and co-ordination

Opportunities and challenges

Opportunities

- to achieve economies of scale through size
- to work collaboratively to reduce costs in implementation

Challenges

- to ensure an ‘equitable’ distribution of costs for each legal entity
- to be able to demonstrate ‘value for money’
- to asses the impact of increased scale on investment strategies

Risk management

The most important element of any restructure

Holistic risk management plan essential to the smooth, successful and cost effective implementation of portfolio changes

Not just market risk

An effective risk management plan identifies all potential issues, including:

- Operational risk, settlement issues, custody account operation, emerging market issues, reporting requirements etc.
- Opportunity cost / tracking risk
- Liquidity risk
- Cash flow risk
- Sector / country risk
- Information risk (keeping the details confidential to avoid costs associated with information leakage)

The risk management plan

- Identify all potential issues
- Measure the amount of risk, decide whether acceptable or material.
- Hedging and mitigation (control what you can with a hedge, have a back up plan for everything else)

Risk management in practice

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Market risk – exposure management

- Being out of the market or over exposed (leveraged), even intraday, can be expensive and / or lead to governance issues
- Management required where there are differences in regional asset allocation or liquidity profile of target and legacy
- Regional differences (e.g. selling Asia, buying US equities) can be controlled by Futures overlay or trade scheduling
- Liquidity differences (e.g. a liquid target portfolio and illiquid legacy portfolio) can be controlled through matched trade scheduling, usually requiring a longer implementation period appropriate for the least liquid portfolio

All the above needs modelling at the fund and aggregate level.

Market risk – opportunity cost / tracking error

- Intricately related to how different legacy and target portfolios are - country, sector and individual stock differences
- Much of the sector / stock risk can be managed through the diversifying characteristics of the legacy and target portfolios
- Country risk can often be managed through Futures hedges or where appropriate, ETF's or Swaps

All the above needs modelling at the fund and aggregate level.

Operational risk

Operational risk often best managed through detailed checklists, including details such as:

- Are custody accounts for the manager operated funds fully set up and operational?
- Are restricted market approvals (Foreign investor ID's) in place for all markets and portfolios?
- Do the pooling vehicles have all regulatory and governance sign offs in place?
- What are the potential road blocks?
- Are managers contracted and have a clear mandate?
- What effect do settlement cycles have on cash flow (eg large sell in USA (T+3) reallocated to Europe (T+2)?
- Are processes in place for the clear and effective communication between all stakeholders?

+ Numerous other considerations relevant to the specific project

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Understanding the costs involved

Explicit costs

These are direct costs with actual currency changing hands explicitly, and are known in advance.

- Transition fee if applicable
- Trading commission
- Taxes and fees

Implicit costs

Indirect costs - often referred to as "Slippage" - in aggregate represent the value of the difference between benchmark and actual traded prices.

- Bid-offer spread
- Market impact
- Opportunity cost

Minimising costs

- Employ a trading strategy that minimises total implicit costs – the trade off between market impact and opportunity cost
- Managing the pace of trading is key to finding the optimal trade off
- Using an appropriate amount of crossing, whether on or off exchange can help minimise spread costs (spread costs are relatively small and increasing risk by delaying execution to enable a cross may not be optimal)

Key considerations:

- Are all costs equally important to control?
- Is £1 of market impact cost of equal value to a potential +/- £1 of opportunity cost?

Simultaneous or separate transitions

An opportunity to save costs through collaboration

Schemes and pools must determine whether to implement the transition scheme by scheme or collaboratively. By working collaboratively and executing the restructure together, schemes maximize the probability of crossing investment holdings between schemes, and eliminating the associated market trading costs in the process.

On the flip side, with identical target portfolios (and in some cases, common legacy managers), these savings can be counteracted to some extent by an increase in expected market impact costs resulting from the larger scale required from trading simultaneously.

However, where schemes are less sensitive to opportunity costs (or moving instantly to the new portfolio), market impact costs can be reduced by slowing the pace of trading and maximising the use of block crossing.

Ensuring equitable outcomes

Where the legacy assets remain in the name of the scheme during transition into the pooling vehicle, the transition manager has a duty to each of the schemes involved. In most pools this is around 10 schemes.

This means ensuring that the costs and savings from working collaboratively are distributed ‘fairly’ or ‘equitably’. Each fund should share in the benefits of the collaboration.

Detailed analysis is required to compare the expected costs for each fund on a separate or simultaneous trading basis to demonstrate that this duty has been met.

The transition manger will have a responsibility to each pension fund individually, not simply a duty to reduce total cost and risk at an aggregate level.

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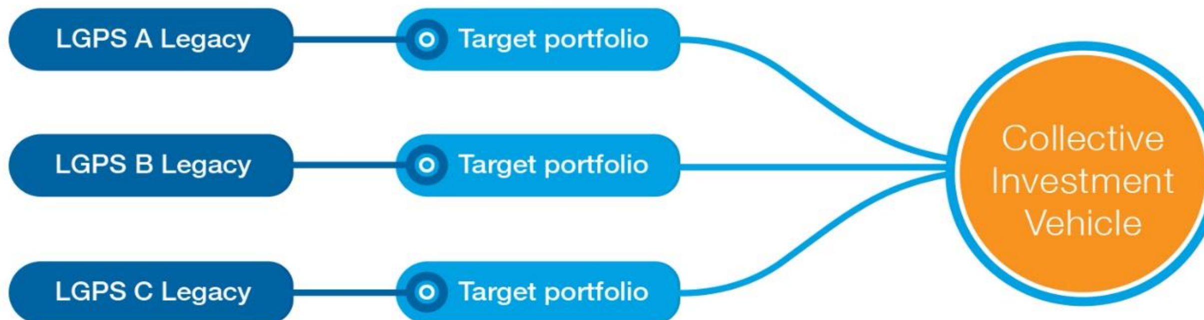
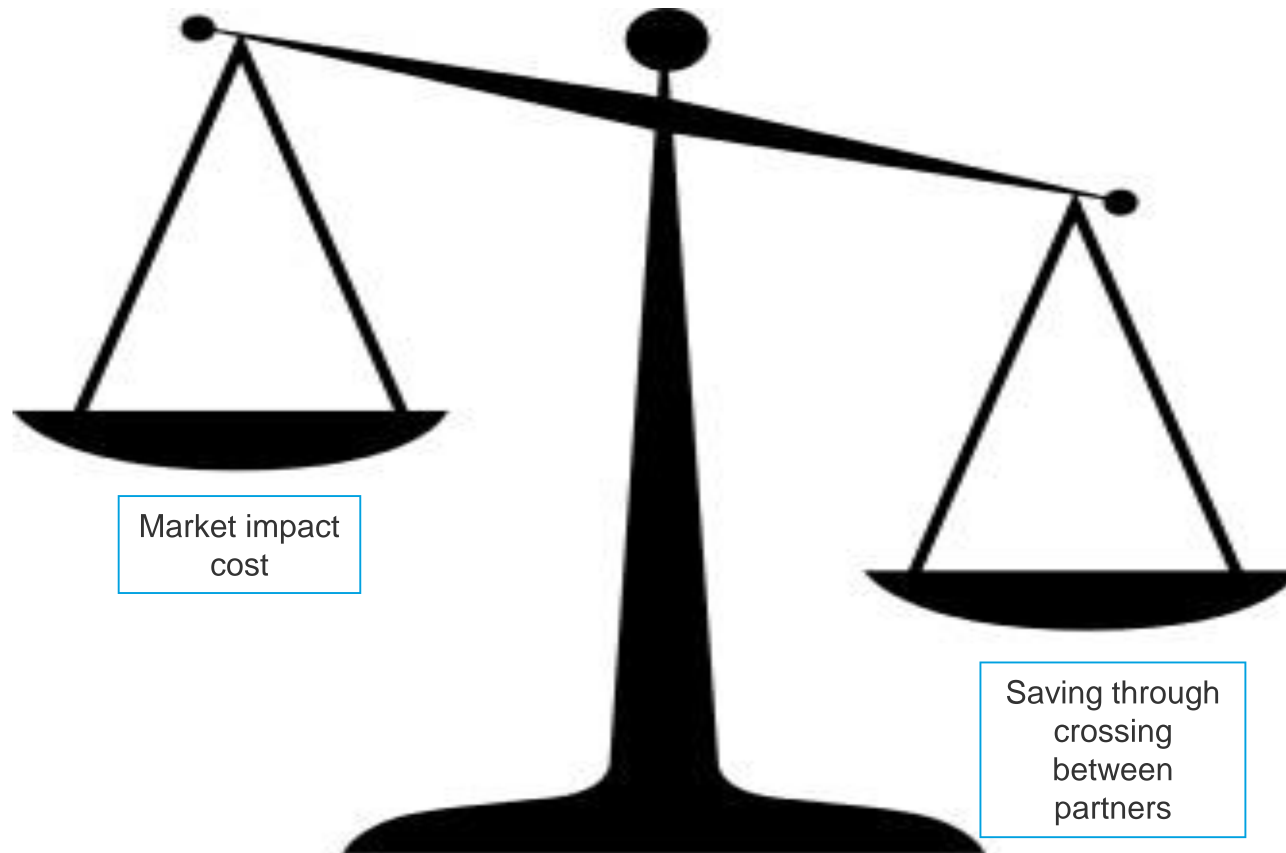
Simultaneous or separate transitions

Strategy A – Independent trading: discrete transitions prior to pooling of assets



Strategy B – Combined trading: simultaneous transition

Simultaneous or separate transitions?



Other potential savings by co-operation

Risk reduction

The Risk profile for a simultaneous transition of several pension funds will be very different to the risk of several separate transitions. As with cost, any risk reduction benefits need to be experienced by each pension fund. It would be insufficient to demonstrate that risk is reduced in the aggregate. It is theoretically possible that the transition risk of one pension fund being higher if executed as part of the simultaneous event.

Unitised funds

Receiving underlying securities, rather than cash redemption, offers more opportunity to cross between funds. Open Ended Investment Company (OEIC) creation requires careful execution ordering to alleviate multiple stamp tax on the same equity holdings.

Stamp tax

The TM can work with the funds' tax and legal advisers to where possible, ensure that stamp tax on the same equity is not paid multiple times during the transition. Consideration should be given to adjustment of the target portfolio at an individual pension fund level, to retain equity required by another fund in the pool.

Practical considerations
Where transition modelling can help

Timing and scheduling

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The scale of the challenge

- The pooling of LGPS investments is a massive undertaking for all of the LGPS involved
- Wholesale changes to both internal and external management of assets is expected, across the spectrum of asset classes

A staged approach

Given the operational resources required and the sheer complexity of the project, it would recommend considering a sequential transition strategy. These transitions are complex and lessons learned at each stage can then be integrated into the subsequent iterations, improving efficiency.

Do the "easy" ones first

Given the learning involved, there is an argument that it is prudent to do the easy transitions first, and apply the lessons learnt to subsequent, more difficult transitions.

For example, a suggested order might be:

- Indexed equity and fixed income portfolios
- Active large cap developed equity
- Small cap or specialist equity
- Active credit portfolios
- Emerging market equity and fixed income
- Multi asset portfolios
- Private markets / illiquid alternatives

Manager selection: Taking into account trading costs

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A range of potential costs

- Whilst the legacy investments are in place and largely fixed, there are many possible combinations for the target portfolio.
- The expected return profile for some of the different possible combinations may be quite similar, but the costs of moving to these portfolios could be very different, resulting in divergent returns net of transition costs.

Assistance from your transition manager

- Transition managers typically have sophisticated analytical tools to estimate the cost of implementing any portfolio change, and should be able to provide detailed cost estimates for the range of possible manager combinations.
- Where these differ significantly, it may help to distinguish between the alternatives based on the impact to the portfolio. Additionally, this analysis may help identify situations where the preliminary cost estimates differ significantly, and the reasons.

Manager selection: Eliminating bias and allocating costs

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Cost sharing principles

Each of the pools has stated in its submission to DCLG the agreed cost sharing principles for both the transition and the ongoing collective management of the investments.

Typically, for the transition phase, these have been variants on two themes, both options presents challenges that will need to be addressed in designing the transition plan:

- Each fund bears its own costs to get to the pooled portfolio, but use collaboration to minimise these costs.

or

- Each fund shares in the total costs of transition, in proportion to its size within the pooled vehicle

Eliminating legacy manager bias

Where each fund pays its own costs of transition, the least cost route to pooling for each fund individually would be to keep its current manager line up: no changes = no cost of change. This could introduce a bias for each fund towards its current managers.

Allocating cost equally across schemes

In order to distribute the costs of the entire transition equally across schemes by AUM in each portfolio could require the whole transition to take place within the pooling vehicle. Depending on the structure of the pooling vehicle, this may not be the optimal process, due to costs, especially taxes and fees, of moving the legacy investments into the pool.

Additional Considerations: Effect of pooling on the chosen strategies

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Effect of scale

- Many funds have good performing “niche” fund managers
- Specialist investment strategies or concentrated portfolios, with small scale, for possibly one of the partner funds in the Pool.
- If this performance leads to manager being selected for whole pool, need to understand the effect of scale on the strategy.

Capacity

- Does the investment strategy have the spare capacity to provide the whole pool the same level of alpha?
- Are the opportunities to add value still there at the larger scale?
- Do the trading costs at the larger scale impact on nimbleness of the manager or net alpha retention?

Transition costs

- What are the expected costs of moving to the required scale? Do these outweigh the expected outperformance?
- Should the pools terminate the mandate, what are the exit costs? Is the portfolio liquid enough to sell at short notice?

Your transition manager can help with analysing these issues and providing quantitative estimates to assist decision making.

Additional considerations: Best practice in transition management

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What can you expect from your TM?

- Rigorous analysis of costs on industry standardized basis (T-Charter)
- Detailed transition implementation strategy, and risk management plan
- Comprehensive project management expertise and effective communication across multiple stakeholders
- Demonstrable cost savings for the selected strategy across all schemes
- Comprehensive performance reporting, using industry standards

The Importance of transparency

- LGPS' strive not only secure 'value for money,' but to be able to demonstrate 'best value'. Given the complexity of the transition process, effective transparency and communication are essential
- The transition manager needs to provide the reporting and data to ensure that the 'value for money' generated by the transition manager is effectively communicated to each scheme

The aggregate and fund responsibilities of the TM

- Working in partnership with other schemes in the pool will generally reduce cost and risk
- Need transparency at both the aggregate and scheme level
- The TM has an equal responsibility to all scheme members of the pool

Conclusion

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Transition management

- Transition management has the potential to significantly reduce the costs and risks of changing investments, as suggested by the Financial Conduct Authority in its thematic review in 2014.

- 'Without the [transition management] industry, changes between asset class, geography or manager would take longer, be more complex and could result in more risks and higher costs'.

I would recommend reading the FCA Thematic Review to any transition client considering a transition.

Engage a TM at the earliest possible opportunity

To provide analysis, experience and support when making key decisions throughout the process

Insist on a bespoke plan, with full transparency

- Your transition with multiple funds, multiple pools and sheer scale will be unique and complex
- Detailed analysis is required to ensure all funds incur the lowest costs and risks
- Best practice in TM requires absolute transparency at all levels throughout the process

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Macquarie Portfolio Solutions

Contact details;

London;

Mark Dwyer; mark.dwyer@macquarie.com; +44 20 3037 1981

Graham Cook; graham.c.cook@macquarie.com; +44 20 3037 2229

Sydney;

Mick Larkin; mick.larkin@macquarie.com; +61 2 8232 0639

David Goodman; david.goodman@macquarie.com; +61 2 8232 5245

Elliot Graham; Elliot.graham@macquarie.com ; +612 8237 4704

Scott Macaulay; scott.macaulay@macquarie.com; +61 2 8232 4782

New York;

Fred Fogg; fred.fogg@macquarie.com; +1 212 231 1194

Matthew Rossignol; matthew.rossignol@macquarie.com; +1 212 231 1297

Peter Pascali; peter.pascali@macquarie.com; +1 212 231 2464

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