Brunel Pension Partnership

Response to Treasury: Pensions Review 2024: September Call for Evidence.
Brunel Pension Partnership

BACKGROUND:
Brunel was formed in 2017 to pool the assets of 10 LGPS administering authorities: the pension funds of Avon, Buckinghamshire, Cornwall, Devon, Dorset, the Environment Agency, Gloucestershire, Oxfordshire, Somerset and Wiltshire.

Our clients have transitioned over 85% of their assets into the pool, meaning we make the investment management decisions for c.£37bn in AUM. This has enabled Brunel's significant track record in UK and local investment, while also offering our clients the breadth of investment choice they need. As a regulated pool, we are always seeking to innovate and extend our services to deliver good outcomes for our clients and their pension fund members.

As administering authorities of an open-ended DB scheme, our LGPS clients are long-term investors who take into account a wide range of risk factors that could impact their investments, including a strong emphasis on Responsible Investment (RI) as the best means to achieve appropriate risk-adjusted returns over the long term.

Brunel is the only pension pool in the UK to have focused significantly on RI for the past seven years. That extended focus makes us unique amongst our peers for investing across the breadth of the ESG agenda (including local impact), and we are known as a leader on investing for Net Zero. We are thus very well-placed to deliver sustainable investment into the UK.

The Brunel pool has made significant progress in implementing the purpose and spirit of LGPS pooling. Brunel and its clients consider that a fundamental redesign of the Brunel pool or the Local Government Pension Schemes (LGPS) at this time would likely delay continued sustainable investment in the UK, without offering major improvements on cost savings, centralised investment expertise, or access to private markets.

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1-5: To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term, risk-adjusted returns and capacity to invest in a wider range of asset classes?

Brunel's pooling has achieved its core aims: targeted cost savings (early); diversified investment choices for clients (via pool investment depth, skills and knowledge).

Pre-pooling, our clients had multiple managers and multiple strategies. With small private markets allocations mostly in property funds, clients felt pooling could enable new infrastructure, private equity, private debt (as size/pension officer expertise had been constraining). Brunel today has c.£10bn committed to private markets, including multiple commitments to UK investments.

Pooling successes:

1. Portfolio range: Brunel designed c.20 listed and multiple private markets portfolios (including local impact). These meet client specifications but are sufficiently standardised to enable aggregation and attractive terms.
2. Net Zero alignment (current government objective):
    a. Adoption: Pre-pooling, one client had committed to a low-carbon economy – today, 9/10 have NZ targets.
    b. Passive: Lack of aligned products led Brunel/FTSE Russell to co-design new Paris-aligned benchmarks, enabling access to passive fees while investing for NZ – indices since adopted by others.
    c. Recognised climate leader: Co-design of Net Zero Investment Framework, and a Brunel Chair of IIGCC – providing industry expertise/influence on RI, especially climate change.
    d. Rapid progress towards 2030 50%-NZ target (ahead of trajectory): all managers invest client funds in line with Climate Change Policy and clients' Paris alignment ambitions:
        i. Net Zero alignment across 90% of equity investment
        ii. 33% carbon intensity decline (equity investments since inception)
3. UK investment impact:
    a. We selected Schroders Greencoat to manage a substantial investment in renewable income assets (via **GRI**), including a large-scale greenhouse project (East Anglia), using heat from a recycled water plant (emissions -75%; created 137 permanent local jobs).

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   b. Cornwall Pension Fund award-winning local impact portfolio: significant investment in affordable housing in Cornwall, plus commitment to Cornish renewable energy assets.
   c. Schroders Greencoat's 2023 collaboration enabled six Brunel clients to invest in acquisition of the largest UK operational solar PV portfolio ever traded which will deliver reliable returns, supports government priorities/NZ strategy, and improves UK energy security.
   d. A new Natural Capital portfolio in the pipeline, which could have significant UK allocation (supply of investments allowing).
4. Scale impact: Initial £25bn rationalisation into coherent strategies (across 10 clients) – 2024: c.£37bn of transitioned assets. We are repositioning our £2bn UK Equity portfolio away from FTSE All-Share to focus small/mid-cap UK investments, which better support UK growth (as per government objectives).
5. Cost savings: At inception, the partnership set a target of c.£43m p.a. by 2025 (far surpassed since). 2022-23: cost savings reached £41m p.a.
6. Regulation, governance, outsourcing:
   a. The use of an FCA-regulated entity as investment manager assures clients of FCA supervision; right systems/controls; required capital for strong, stable financial position.
   b. Shareholders' agreement and governance framework strike balance between pool delivery capacity and client shareholder oversight.
   c. Operating model uses outsourcing extensively, enabling Brunel to be agile, scaleable, and deliver cost-saving objectives. Manager quality and range – from BlackRock to boutiques delivering bespoke products. The pool's size, scale and reputation mean managers are flexible, as keen to work with us.

2-2: Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

Yes, we believe there is a case for intervention and that, for the LGPS, the most immediate step is to complete the transition of assets into their pools and to ensure those pools are set up effectively to deliver the full benefits of pooling. Investing smaller amounts of capital can mean that the best investment opportunities are not available, or at least not at an acceptable cost. This makes it harder to achieve higher returns. Well-run pools can assist with this.

Larger-scale projects that might generate strong and reliable returns, such as infrastructure, also require large-scale investors (who can make meaningful investments), which puts such projects out of reach for pension schemes with smaller investment budgets. It is also harder to develop sufficient expertise for those investment decisions within smaller pension schemes, potentially resulting in increased cost to the fund to ensure that the investment risk is well-managed. Since some LGPS funds have thus sought to avoid increased costs over time, risk has not always been appropriately diversified.

The scale and sophistication of the Brunel pool makes higher-risk projects more viable, due to sub-sector-by-sub-sector expertise internally, and allows for specialisation, and collaboration and partnerships between pools. Understanding the risks presented by an investment opportunity is key, which entails detailed due diligence and comparison with other opportunities in the market.

Maximising the opportunity to invest in larger infrastructure projects in the UK like rail and ports can only be done if investments can be made at the right scale, with an ability to diversify risk. This will require pension schemes to pool their investments or collaborate in some other way, if they are to access such opportunities.

Whilst the LGPS has made progress, the best way to enable it to support such investments would be to complete the transition of assets into pools, allowing the pools and their investors to collaborate on larger projects. We consider that, for the LGPS, completing the transition of its assets into the pools is the most immediate need.

There are benefits to a consistent model across a sector, making it easier for participants to collaborate, and for suppliers to deliver cost-effective solutions, while managing the risks to the public money being invested. In the case of the LGPS, we believe that now is the time for the pool model to be standardised. The government should make it clear that the pools must be well-governed by an experienced Board, regulated by the FCA, permitted to make investment decisions for the good of the whole pool to get the full benefit from scale – and benefit from sufficient budget to deliver on all the above.

A focus solely on cost and control will not produce good investment outcomes. This has been one of our key lessons of the past 7 years. Ensuring these outcomes will enable increased exposure both to higher returns and to those impacts (e.g. environmental, social) available from private markets asset classes, as Brunel has demonstrated.

3-1: What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

The health of the UK's capital markets is a key driver for UK growth. For that growth to thrive, listed equities require a long-term view, responsible oversight (through good stewardship), and a favourable tax regime. The government needs to be clear what it means by investing in UK asset classes and the likely consequences for UK growth of different types of investments. Investing into UK-listed equities, particularly those in the FTSE 100, does not necessarily result in investment into the UK; for example, c.80% of the revenues of the constituents of the FTSE 100 are derived from outside the UK.

However, if the question is which asset classes could most benefit the UK (via increased investment), then we would emphasise private markets as where we see the strongest impact opportunities in the UK, plus private market sectors help to drive strong net investment returns.

Historically, some LGPS pension funds found UK infrastructure harder to access as an asset class. Pooling assets provides the scale needed for access and the additional incentive of investing in the UK, since it is harder to hedge an overseas infrastructure portfolio.

As an example of the potential, the Brunel pool has approximately 14% of its £37bn AUM currently invested into the UK, across listed and private markets. We are well-placed as a pool to invest further into the UK, particularly via private markets, and have a strong track record in this area, examples of which include:

1. Europe's largest greenhouses project (East Anglia) to produce 10% of UK tomato crop, powered via wastewater heat runoff
2. Affordable housing in Camborne, Cornwall (Cornwall Local Impact portfolio)
3. Repurposing of landfill site to build a new solar farm (Essex)
4. Investment in decarbonisation of UK transport (buses and EV charging infrastructure)
5. Green hydrogen production assets in UK
6. Largest pathology unit in UK (London)

For those LGPS administering authorities that have not yet pooled effectively, there could be substantially improved access to UK private markets opportunities through transitioning assets into a pool that is already well-placed to access these asset classes.

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3.2: What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK listed equities) such as past and predicted asset price performance and cost factors?

Globalisation is a 30-year-old structural trend, meaning the UK now represents an increasingly small portion of the global investment universe. In turn, leading pension fund investors reduce their exposure to UK asset classes, driven by the need to be prudent, diversify, take advice and act in the best interests of their beneficiaries.

In particular, three main factors have driven the change:

- Supply: The increasing sophistication of the institutional investment and consulting market, which is providing a more globally consistent and diversified range of products and advice. Portfolio construction has also been significantly impacted by improvements in technology such as asset-liability modelling, index construction and benchmarking.
- Demand: A desire for better risk diversification has been catalysed by events and trends which brought home investment risks: for example, the Global Financial Crisis; BP Deepwater Horizon tragedy; price bubbles bursting such as Japan or dotcom; Brexit; climate change.
- Regulation: Uncertainty of regulation has adversely impacted the relative attractiveness of UK investments and/or made it more difficult for pension schemes to grow assets under management. Examples include taxation of surplus, changes to accounting standards and requirements to de-risk portfolios, changes to the tax treatment of UK dividends, changes to the tax treatment of pensions.

Looking forward, we believe that RI considerations may lead investors towards a renewed interest in investing in the UK. In Brunel's case, a growing ESG impact demand from our clients over the past seven years has prompted us to pivot more towards investing into the UK – and we are well-positioned to do more. Furthermore, the supply of appropriate and cost-effective investments will be a key issue. Public policy focused on ensuring that supply, demand and regulation act in concert can also help to expand the accessible opportunity set.

3-3: Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?

We note the recent Wilson Report's recommendations to create incentives for institutional investment in UK companies and to remove barriers to institutional investment (pp.17-18).

Brunel is already investing into the UK but further incentives in emerging, transition areas (where risk might swamp return) could catalyse further investment. Examples include lower fees; lower costs; first loss acceptance; risk sharing; and using the government's contractual buying power to secure the revenue stream (as done with roads, schools, hospitals).

We would encourage the government to look at reversing the negative dividend tax impact on pension funds introduced in 1997.

However, we do support the removal of Stamp Duty Reserve Tax as an antiquated tax that taxes purchases, rather than the making of gains, thereby creating friction in the marketplace that is out of step with other jurisdictions. This tax also impedes the creation of new collective investment vehicles that might otherwise be used for collaborative investment in the UK.

Subsidies can be used to selectively incentivise correctly, especially for illiquid/private assets. However, policy consistency over the longer term – across multiple parliamentary terms – is imperative to provide investors with the confidence to make long-term decisions. Changes to the electric vehicles market by the last government provide a good example of government undermining investor confidence through short-term decisions. We would encourage the government to seek cross-party agreement on policy, in order to deliver long-term confidence for investors, aligning investor interests with key national missions such as boosting economic growth; creating globally consequential British technology, space and life sciences companies; and decarbonising our economy.

The key principles are to ensure the right risk-return profile and to ensure that investors have sufficient scale for fee negotiations, long-term investment perspectives, expertise and risk budgets. In this respect, the National Wealth Fund's focus on supply reflects its catalytic purpose: opening up hard-to-access sectors via capital from the Treasury. This Treasury

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capital can have a higher risk budget, in order to then crowd in private capital (e.g. in National Wealth Fund targets like green hydrogen, "renewable-ready" ports).