The Changing Landscape of Fiduciary Management

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A frequently heard criticism of the pension industry is that change, if it happens at all, takes place at a glacial pace. While this might be fair sometimes, it certainly can't be said of the changes currently taking place in the fiduciary management and investment landscape in the UK.

The FCA Asset Management Market Study, launched in November 2015, and the subsequent referral of the Investment Consulting and Fiduciary Management market to the Competitions and Market Authority, thrust the fiduciary management investment approach into the spotlight.

At the same time, we've witnessed significant changes to pension scheme investment requirements. The closure of pension schemes to new membership and accruals as well as the ongoing changes of scheme demographics, have dramatically changed the investment requirements. Open schemes with long-term investment requirements have historically been able to set static portfolio asset allocations and accept the volatility in investment returns, with time diversification smoothing the bumps. This is no longer the case for most schemes whose liabilities resemble a closed annuity book.

After a period of sustained challenges for pension schemes from rising deficits, some respite has been witnessed with changes to mortality assumptions and strong investment returns.

But while the sustained bull run in most asset classes has provided windfall gains for pension schemes, it leaves them with the unenviable task of trying to replicate these returns in the future.

The changing needs of pension schemes

We've been through a long period where managing scheme funding positions has been a continual battle. Falling interest rates have pushed up liability values, improving longevity estimates have further driven up liability values and investment returns have failed to keep pace. Those schemes that took early decisions to hedge liability valuation risks have been well rewarded. For others, the higher balance sheet risk has been evident on the evolution of the funding level. More recently, the tide has turned somewhat. Continued strong investment returns have been supported by changes in liability valuations. A slowdown in the expected longevity improvements has fed through to reducing liability valuations and long-dated yields are up from their lows of mid-2016.

However, scheme closures to new members and future accrual have changed the demographic profile of DB pension liabilities dramatically. The majority of schemes are now cashflow negative, with benefit payments exceeding contributions. Managing cashflows has become a key objective for many trustees, with the regulator taking an increasing interest. Alongside the structural change created by demographic changes, many schemes are experiencing significant transfers as members take advantage of the 'freedom and choice' rule introduced in 2015. The natural evolution to a cashflow negative position is being compounded by near term liquidity needs.

The long-term set and forget investment approach that was a feature of pension schemes historically is no longer valid. Schemes have much shorter investment time horizons, real-time risk measurement and management and immediate liquidity needs. By necessity, schemes are having to more frequently review and adjust their investment portfolios.

> "...greater transparency and competition will serve consumers well going forward"

The investment environment

After almost a decade of strong returns across most asset classes, the outlook for the future is less certain. On a structural basis, forecasts for long-term market returns are lower today than they have been historically, reflecting the higher starting valuations. With low starting yields, bond markets – government or corporate – cannot continue to produce the returns that we have seen of late. Similarly, in equity markets with high earnings multiples, it would take significant and sustained earnings growth to continue to see high returns over the long term.

The US economy is currently running with above trend growth and although this may be sustainable for the near future, it seems likely that the policy response of the US Federal Reserve will serve to cool this growth rate and there is an elevated risk of recession in late 2019 or 2020. Global trade wars and the uncertainty of the Brexit process could rapidly destabilise investment markets.

This outlook highlights the challenge facing pension schemes. It's not necessarily a doom and gloom scenario, but it does feel like it's going to be hard to generate the kind of returns that schemes need to achieve their funding objectives.

The impact of the FCA and CMA Reviews

The consecutive reviews of the industry by the FCA and then the CMA have provided a ready source of material for journalists. Beyond that, they have shone a light on the complex industry structure through which pension scheme investments are managed. MiFID II, regulatory change and a number of voluntary initiatives have worked in parallel with these reviews to increase transparency and enable pension schemes to make informed choices.

It feels like the publication of the CMA's provisional report in July will soon bring the period of introspection to an end and will result in changes that produce better outcomes for trustees and the members that they represent.

The proposed remedies for the fiduciary management sector seek to redress the 'incumbency advantage' that exists for the big three investment consultants. This advantage has been successfully exploited over recent years and the sheer volume of mandates that have been awarded without competitive tender is a sad indictment of this and has been highlighted by the CMA. What's done is done but greater transparency and competition will serve consumers well going forward. A levelling of the playing field will benefit trustees, particularly where they are supported by The Pensions regulator in running tenders.

Unsurprisingly, the big three consultants are already resisting the idea of mandatory tendering, citing the additional cost and burden on smaller schemes. However, there is no reason why a procurement exercise should be unduly time consuming or expensive.

The CMA review has highlighted the complexity of an industry where there are few common definitions of

the various services provided. Fiduciary Management, Implemented Consulting, Delegated Consulting and outsourced CIO are all terms used to represent a similar set of services. As a result, we've been in a weird world where some providers of fiduciary management services have been in the full scope of the FCA and European regulatory environment. Other providers of similar services, by dint of their business model or organisational history, have fallen outside the FCA jurisdiction. The CMA's recommendation to extend the FCA's regulatory perimeter to include the main activities of investment consultancy and fiduciary management providers will ensure a consistent application of the regulatory protections that benefit trustees and members.

The broken consulting model

The investment consulting model served trustees of defined benefit pension schemes well for many years, driving innovation in asset allocation and risk management. However, its efficacy has been called into question on a number of occasions recently and consultants have been challenged to demonstrate their added value. Once again, reviews of the performance of consultant 'buy-rated' products highlight an ineffective process. Consultants themselves recognise the weaknesses in their process. Chris Ford of Willis Towers Watson described the consulting services they provide to clients as "a very weak process" and that "they don't think it is the best way to do it" (FTfm 18 October 2015).

In its assessment of the investment consulting market, the CMA finds "there is a low level of engagement by some customers in choosing and monitoring their provider. It is difficult for them to access and assess the information needed to evaluate the quality...." The proposed remedies of common reporting standards, and clearer objectives should increase engagement and enable trustees to more effectively evaluate their provider.

The challenge with the consulting model may be deeper rooted, however. The traditional consulting model requires trustees to make decisions on the basis of imperfect information and in an environment where outcomes exhibit a degree of randomness. The result of asset allocation or manager selection decisions is uncertain. The traditional consulting model relied on the fact that pension scheme investment horizons were sufficiently long to reduce the impact of variability in returns. However, in the current environment, scheme objectives and market conditions call for dynamic portfolio management.

SEVEN QUESTIONS FOR TRUSTEES TO ASK ABOUT THEIR EXISTING FIDUCIARY MANAGEMENT ARRANGEMENTS

As fiduciary management has become a mainstream mechanism for managing pension assets, trustees are being called to review their existing arrangements.

1. Is the fiduciary management solution aligned with the investment objectives of the scheme?
2. Is the solution flexible to meet the changing needs of the scheme?
3. Was there a clear process for selecting the provider?
4. Is performance against the scheme objectives presented regularly, clearly and in a consistent format?
5. Is there a clear investment process that gives confidence in the repeatability of outcomes?
6. Is there a clear mechanism for assessing value for money, including consideration of performance fees?
7. Is there independent scrutiny of the investment arrangements by a professional trustee or independent consultant?

ASSESSING THE PERFORMANCE OF INVESTMENT CONSULTANTS

As a fiduciary manager, we provide clear performance reporting on a monthly and quarterly basis. This tracks the performance of the solution relative to the investment objectives of the scheme. The reporting is presented in a consistent format and highlights the key drivers of the outcome and the key investment risks being taken by the scheme.

The impact of liability hedging, asset allocation and portfolio construction on the investment outcome are all presented in a transparent fashion to trustees.
There is no reason why traditional investment consultants should not present their results in a similar way.

Trustees may supplement their assessment with some softer factors, but the quantitative impact of consultant recommendations should be made available and serve as the backbone of any performance reporting by consultants.

How can fiduciary management help?

An alignment of the investment solution with the scheme objectives

The scheme specific investment objectives form the starting point of any fiduciary management solution. Objectives should be defined in terms of a target return in excess of the liabilities and level of risk (defined by the proportion of liability valuation risk hedged). These are documented in advance in an investment management agreement. The investment solution is tailored to meet these objectives.

A fiduciary management solution allows trustees to retain control over the decisions that are critical to them. These include the return objective and risk tolerance but may also include other factors, for example, the approach to responsible investing and ESG issues.

Flexibility to meet change scheme circumstances

Scheme circumstances and objectives change. For example, the attitude of the corporate sponsor or changes to the covenant risk may impact the investment objectives. Similarly, changes to the liability demographics or actuarial assumptions can have a meaningful impact on the investment requirements. A good fiduciary management solution can evolve with these changing needs.

A dynamic investment approach

The traditional model of pension fund investing with a static asset allocation and a traditional consulting model is not fit for purpose in the current investment environment. Open DB pension funds could rely on time to recover the impact of any investment losses and diversification was the only tool required.

Today, with shorter investment horizons, negative cashflows, and frequent mark to market valuations, pension funds can no longer rely on diversification alone. There is not the time horizon to allow investment losses to be recovered.

Diversification needs to be supplemented with a dynamic approach to managing the assets. This allows emerging portfolio and market risks to be identified early and managed. In a world where it is hard to generate investment returns, dynamic management of the portfolio is a necessity to augment asset allocation.

A robust investment process

With the need for a dynamic investment process comes the requirement for a robust investment process. A fiduciary management solution provides a robust framework for making and reviewing investment decisions. Sophisticated tools can be employed to assess risks and to model the portfolio against potential scenarios.

Reporting

The clear definition of the investment objective allows for clear reporting of the outcome and makes it easier for trustees to assess the effectiveness of the fiduciary management solution. With the development of industry standard reporting frameworks, trustees will be in a stronger position to make comparisons across providers.

Value for money

Fiduciary management solutions often result in an overall reduction in the cost of running the scheme as economies of scale can accrue to the pension funds. An improvement in fees, combined with a more controlled risk management framework and access to a broader range of investment strategies results in better value for money for scheme trustees.

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