Fiduciary management focus: Monitoring performance

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Pieter Steyn, head of delegated investment services UK, Willis Towers Watson

Fiduciary providers: Separating fact from fiction

Pieter Steyn asks whether your fiduciary manager really is as good as they say they are

Humans are subject to any number of behavioural biases affecting how they invest. They suffer from regret, or loss aversion, which leads them to hang on to poor investments because to sell them would confirm they had made a poor decision. Investors also frequently prioritise allocations to familiar investments, ignoring the advantages from diversifying their portfolio through less familiar assets. They chase trends in the mistaken belief that historical returns predict future returns. They are sometimes over-confident and over-estimate their skill and ability to make predictions.

All of these biases, and more besides, can be addressed through better governance. It is not surprising, then, that many pension schemes have started to ask themselves searching questions about the governance they put around their investment decisions. They have come to the realisation that most long-term value creation is derived from sustained organisational excellence, rather than from fund manager or stock selection processes.

Although some schemes have already developed strong governance structures, for others the process is in its formative stages or yet to be formally addressed. The typical structure for many schemes still involves delegating part of the investment process to a sub-committee of their board and then seeking help from advisers. Accountability is not always particularly clear under this arrangement and, almost certainly, the frequency with which decisions are taken is a function of when meetings can be shoe-horned into busy diaries.

Research[1] has shown that best practice investment governance includes, among other things, a competent investment executive function with delegated authority and clear accountability. Pension schemes with sufficient scale have the resource to develop in-house executive functions. However, for most institutional investors best practice is probably more feasibly achieved by embracing the outsourced CIO (OCIO), also known as the fiduciary management model.

Growing recognition of fiduciary management services

The evidence shows that institutional investors are gravitating towards fiduciary management as a means of improving investment governance and investment outcomes. Willis Towers Watson is approaching $90 billion in its services, mainly for pension schemes in the UK, the US, Canada and Germany. Other regions are starting to take note too.

The rapid uptick in adoption worldwide reflects the fact that most pension schemes, primarily due to lack of time and resources, are not structured optimally to maximise investment returns and manage risk appropriately. Opportunities are missed in both these areas and value slips away amid protracted decision-making processes. Allied to this, the commercial pressures that most company sponsors now face has led to a desire to better manage costs and obtain the most from scarce resources.

OCIO or fiduciary management services address the gap that exists between the investment strategies available to the largest schemes with sizeable internal management resources and the governance capabilities of more typical schemes. For example, Willis Towers Watson has clients with assets below £200 million, but their portfolios and manager fees are akin to schemes with tens of billions. This is the advantage of scale and scope. Fiduciary management enables pension schemes to do more, employing diversified investment strategies that are more appropriate for today's complex and volatile markets. This leaves trustees free to concentrate on the strategic

aspects of managing their pension schemes.

Governance challenges

But is the answer as simple as that? Do you just appoint a fiduciary manager and wait for wonderful outcomes to emerge? Regrettably it is not quite that simple.

A few governance challenges remain and these feature in a fresh research paper[2] looking into the OCIO model. The first challenge is to ensure that the roles, delegations, accountabilities and goals are in sync. The fiduciary manager does not operate in a silo. It is merely the outsourced version of what would typically happen in-house if you had the scale and necessary resource.

The in-house team would ideally understand where it fits into the decision-making structure of the fund and each party would be clear about its roles and accountabilities. This includes the trustee board, committees, in-house team and underlying asset managers. The same therefore applies to the fiduciary manager that acts as an extension of the internal governance.

The fiduciary manager should complement the decision-making of the trustee board or investment committee, especially where accountabilities intersect. This is why we feel that good fiduciary management is more than just asset management. The fiduciary manager needs real governance acumen to understand how best to complement a trustee board. Equally, the trustee board must work hard to get most from this model.

The second challenge stems from the fact that fiduciary management is a form of outsourcing. A materially-delegated structure creates what is called a concentrated principal-agent problem. Or perhaps, in plain English, the 'all your eggs in one basket' problem.

The trustee board of the pension fund becomes heavily reliant on the fiduciary manager. It is also reliant on the fiduciary manager's (the agent) ability to keep its own interest secondary to that of the trustee board (principal). This is probably at its most difficult when the fiduciary manager mostly uses in-house asset management products.

The way schemes address this governance challenge is by professionalising the investment committee. An experienced professional committee would be highly alert to the agency issues and will be able to put metrics in place to protect the principal's interest.

Smaller schemes may have trouble building a professional investment committee, and the growing intermediary market is offering the opportunity to appoint a strategic adviser to the trustee to manage this risk. The intermediary 'oversees' the work of the fiduciary on behalf of the trustee. It ensures the right metrics are being reported and it gives the trustee someone to turn to in case of concern.

Deeds, not words

The main ingredients of an excellent OCIO offering, we think, are timely and insightful strategic advice, allied to outstanding execution.

The trouble is, investors find it hard to work out if providers excel in these two key areas and to distinguish between differing OCIO offerings. Providers of delegated or OCIO solutions tend to present similar pitches to prospective clients, which can confuse schemes, particularly since they generally have little prior experience in selecting an OCIO provider. Most providers will cite their dynamic process, their focus on investment diversity and risk management, while some will also talk about their ability to secure sizeable manager fee discounts.

However, not all providers are able to match these words with deeds, and prospective clients cannot be sure which providers have superior capabilities, if they possess the capabilities at all. In short, it can be a real struggle to make an informed judgement.

Evidence

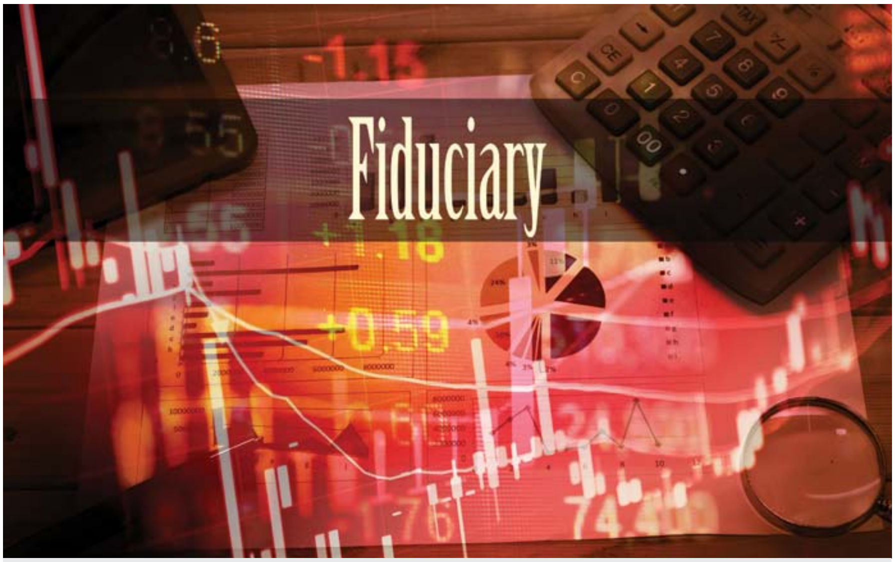
Investment suffers from spectacularly noisy outcomes. This means it is very close to impossible to discern over the short term whether outcomes were created by skill or luck. We suggest trustees ask for as much evidence as possible from the 'pretender to the throne' fiduciary manager during the selection process. When they explain a supposed differentiating factor, trustees should seek to understand how that will create an advantage over other professional fiduciary managers. Remember, hope is not a strategy. Do they really match their words with deeds? And trustees should also seek to understand the extent to which these differentiating factors are used in the portfolio. There is no point assigning much weight to it if it is hardly used.

In conclusion

As with many other professional services selections, the devil is in the detail. Providers work hard at composing an overall appealing message. But look at the evidence and ask yourself or your intermediary, is it also credible? And is it also differentiated? Only then will you be able to believe that it can produce advantage for you.

Written by Pieter Steyn, Head of delegated investment services UK, Willis Towers Watson

1. Best Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance - Gordon L. Clark and Roger Urwin 2007
2. The Outsourced Chief Investment Officer Model of Management and the Principal Agent Problem – Gordon L. Clark and Roger Urwin 2017



Summary
- Fiduciary management has seen considerable growth over the past five years.
- The use of fiduciary management among schemes had increased to 46 per cent in 2015 – up from 18 per cent in 2011 and 37 per cent in 2014.
- The past couple of years have seen considerable growth of third-party providers that help schemes to select and appoint a fiduciary manager.
- Trustees must be absolutely clear on the scope of the contract with the fiduciary manager, any benchmarks to be used and the objectives of the scheme if they are to hope to be able to measure the performance of their fiduciary manager.

The measure of success

As the fiduciary management market grows, so does the responsibility for pension schemes to ensure their fiduciary managers are doing a good job. But whose duty is it to oversee the work being done, and how should schemes measure performance? Lauren Weymouth explores

Over the past decade, the fiduciary management market has grown consistently. In 2016 alone, the market had increased by some 50 per cent, with take-up rates surging to 45 per cent among pension schemes in the UK. The demand is rising, as trustees face the increasingly-complex job of successfully running a scheme and ensuring members are granted the outcome they expect and deserve.

As well as helping to eliminate the increased pressures placed on trustees to deliver better member outcomes, fiduciary management is also proving popular for reducing the overall costs of running a pension scheme. According to the LCP *Fiduciary Management Survey*, which collated responses from more than 100 UK trustees, pension professionals and finance directors, 65 per cent said they believe overall costs are much lower under fiduciary management.

A change in demand

But there are reasons for such an increase in appetite that stem from deeper roots than cost. Willis Towers Watson head of delegated investment services, Pieter Steyn, claims for many, the appetite has come from "disappointing funding levels, coupled with low-growth expectations from mainstream markets".

"Fiduciary managers give clients a scale benefit, but also the scope to seek out opportunities that would otherwise be too challenging to implement," he adds. "Others find the improved governance structure appealing. The trustee sets strategy, a professional fiduciary manager executes the strategy, which leaves the trustee free to oversee the execution. The accountabilities in this structure is clear."

With growing deficits and lengthening recovery plans, the expectation to deliver high investment returns has never been greater. But this expectation has also brought with it the need to challenge the traditional, slow-moving approach to scheme investment.

Oversight

But, while the demand for fiduciary managers is surging, so is the need for oversight and a better measurement of success. In order for fiduciary management to be worthwhile and beneficial for all parties, there needs to be clear evidence that their input is enhancing the scheme's performance.

This issue surrounding a lack of oversight was evident in LCP's survey, which found only 20 per cent of pension professionals received advice on monitoring the continued performance of their scheme's fiduciary manager.

In 2015, the FCA launched a review into the asset management industry and said it would be looking to increase transparency among fiduciary managers due to a lack of "publicly available, comparable performance information", which makes it hard for investors to assess value for money.

But while there have been many issues surrounding oversight, many industry figures would argue that trustees are already working to overcome this themselves.

Aware of the fact that better regulation is needed to ensure maximum results, trustees are commonly looking to appoint third-party intermediaries to help out. PTL director Keith Lewis says it is a "developing trend" for trustees to be supported by an independent third-party to oversee the fiduciary manager."This may include an annual review of whether the fiduciary manager remains "fit for purpose" and continues to demonstrate the key attributes that won them the appointment in the first place," he explains.

However, Steyn says the extent of the oversight varies from situation to situation. "For some smaller schemes, it involves annual meeting attendance and review of performance and service, whereas the more intensive ones involve multiple interactions per quarter as well as all meeting attendance. Our experience is that trustees generally find the work of overseers valuable."

BlackRock managing director in the institutional client business, Graham Jung, agrees that the appointment of an independent overseer is both valuable and increasingly common. He notes how almost all of the selection exercises he's seen have been run by an external, independent evaluator, rather than the trustees themselves or the incumbent adviser.

The appointment of a little help doesn't mean the trustees responsibility stops there, though. Whilst delegating the day-to-day investment management, trustees still remain responsible for investment strategy and for investment performance. This means they also continue to retain an oversight role of the fiduciary manager, including the responsibility to review the appropriateness of the fiduciary manager alongside the scheme's other advisers.

Measuring success

So how exactly can success be measured? Steyn argues that investment outcomes are "spectacularly noisy", which means it is almost impossible to infer over the short term whether returns came from skill or luck. But, there are of course methods, and methods that help determine just how valuable the role of the fiduciary manager is.

In most cases, fiduciary managers are set a benchmark, which is usually liability driven. Quite simply, the target will be to achieve a return in excess of the liability. If they can beat this, then they have done their job. However, this isn't always the most accurate representation of the work done.

Lewis argues that in practice, "it is more complex than that and it is probably appropriate to consider a number of measures, including performance broken down into the key drivers – the level of risk taken should also be considered".

There are currently several efforts across the industry, such as the FCA's review into the asset management industry, to create industry-standard performance reporting, which would allow for a more concise breakdown of the areas in which fiduciaries have exceeded and fallen short. This would be widespread and every fiduciary manager would be aiming to meet the same benchmarks.

But, Jung argues, while this is the case and industry-standard performance is important, most fiduciary management appointments are bespoke mandates created for each trustee's own circumstances. As such, he claims the best measure of success for schemes to monitor is the progress of the funding level towards the "agreed objective, supported by a clear attribution of the decisions that were taken".

A tailored approach

Transparency has been highlighted as one of the biggest areas for improvement within the fiduciary management market for years, and it is something that is actively being worked on, with the help of industry figures. But this is just a minor room for improvement in an industry that is consistently booming.

In 2016, Aon Hewitt's *Fiduciary Management Survey* found a staggering 98 per cent of those using the service rated their experience as excellent, good or satisfactory.

But perhaps most interestingly, against fierce action from regulators for greater transparency and oversight within the fiduciary management market, the research found that when looking at performance of a provider, 87 per cent of schemes noted they prefer to take an individual approach, where they measure the performance of the fiduciary provider relative to their scheme's specific requirements rather than a general approach.

Trustees are already showing signs of seeking independent bodies to help with the oversight of their fiduciary managers, and in the meantime, as Aon Hewitt partner Sion Cole concludes: "No two pension schemes are the same. Therefore, it is important when implementing a fiduciary solution, that trustees make sure that their provider creates a bespoke benchmark that accurately reflects their precise objectives and their unique liability profile.

"It is key that performance is shown clearly versus this benchmark and that trustees have a full breakdown of what is behind that performance."

Written by Lauren Weymouth, a freelance journalist

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