Summary
- A recent survey found 48 per cent of its respondents using FM felt their investment governance model absolutely provided the necessary support during the LDI liquidity crisis, 52 per cent felt there was room for improvement.
- FMs are currently facing fee pressures, reduced AUM and adapting to pension schemes' changing ESG requirements.
- An increase in FM tenders is expected over the next year.
- Large DB schemes utilising FM services is set to continue, while FMs may also expand their offerings to the sub £100 million market.

One industry, different journeys

Laura Blows looks back on the contrasting experiences within the fiduciary management industry following the 2022 LDI crisis

It was all running along so smoothly for the fiduciary management (FM) market in 2022. Although the more risk-focused FM managers were already assessing their portfolios' liquidity positions as rates started to move up, Secor head of UK distribution, Jason Allan, notes, the market was broadly operating as one.

But then, the mini-Budget and resultant LDI crisis.

"After the crisis, the market diverged, separating out those who could communicate and effect portfolio changes quickly, that is, FMs who have in-house technical expertise and a high staff to client ratio," Allan explains.

The gilts crisis saw a variation in the experience both in how providers implement their strategy and ensure effective communication, Schroders Solutions head of UK client solutions, Ajeet Manjrekar, agrees.

"It demonstrated that with trustees delegating investment decision making, timely and complete communication is crucial to keeping all stakeholders informed," he adds.

Manjrekar highlights how the results of Schroders and PMI's recent survey, *Navigating the key issues facing schemes 2023,* reflect this tale of two halves.

Whilst 48 per cent of the survey's respondents using FM felt their investment governance model absolutely provided the necessary support during the LDI liquidity crisis, 52 per cent felt there was room for improvement.

It is little wonder then that the dust settling from last year's LDI crisis is landing upon a challenging landscape for the fiduciary managers themselves.

Challenges

According to Isio's annual survey, *Latest trends in Fiduciary Management,* published in November 2022, the total number of FM mandates grew 7 per cent compared to 2021.

However, Isio suggested that growth may have peaked as the growth rate remains below pre-2020 levels, while the industry's total assets under management (AUM) fell for the first time since pre-2008 – total AUM decreased 5 per cent to £218 billion in 2022.

"AUM is down for all FMs after last year simply as a result of the impact of hedging strategies and other market movements. That could put some under pressure in terms of profitability but will be a major opportunity for those that can demonstrate their processes and investment styles fared well during the extreme stress test of 2022," Charles Stanley Fiduciary Management senior portfolio manager, Bob Campion, states.

This reduction in AUM may generate potential conflicts of interest, Allan warns.

"The LDI crisis has exposed the

disjointed and fragile operating models of some FM providers. The challenge now will be to appropriately resource risk management, client engagement, and operational capability," he says.

"This is against a backdrop of reduced AUM and many pension schemes now likely one to three years closer to their endgame than before the LDI crisis, albeit with significantly mis-aligned asset allocations and limited portfolio liquidity. Trustees will need to consider how committed their FM provider is to helping them achieve their objectives and reassess potential conflicts of interest."

While the next crisis will no doubt be different to the previous LDI one, ensuring the operational resilience of the FM portfolio will be important, Manjrekar says. Within the pension industry, there is a significant focus on 'true' liquidity at a total portfolio level, particularly where there is a reliance on third-party managers who themselves will demand higher levels of assets to support hedging strategies, he explains.

However, it is not just the LDI crisis creating challenges for the FM market.

For instance, Manjrekar also highlights the importance of FMs adapting to the new regulatory environment, "as clients shift from a focus on return generation to lower returns for longer and meeting pension cashflows", along with integrating ESG and climate risk. "As investors move from a focus on reporting and governance to setting clearer targets, FMs will need to evolve their investment portfolio to better align with their ESG and climate goals of trustees and sponsors," he explains.

According to XPS' report, *Progression of the UK Fiduciary Management Market's Approach to ESG Integration*, published July last year, 83 per cent of FMs now explicitly reference ESG policies in investment policy documents or exclude underlying managers who are assigned the FM's lowest ESG rating.

However, 33 per cent of FMs do not exclude the lowest ESG-rated funds, and 10 per cent of FMs do not have the capability to report their carbon footprint, despite having made commitments as part of the Net Zero Asset Managers Initiative.

A further 17 per cent are also not yet able to provide reporting at a strategy level to support investors specifically with the upcoming Taskforce on Climate-related Financial Disclosures (TCFD) reporting requirements.

Another issue for FMs are fees, which have been compressed over recent years due to factors such as increased competition and the Competition and Markets Authority's (CMA) investment consultancy and fiduciary management market order *[which requires pension trustees to run a tender when selecting a fiduciary manager for more than 20 per cent of their assets]*, Zedra client director, Dan Walsh, notes.

Reviews

As the CMA requires pension schemes to conduct regular reviews of their FMs, and also to do so if there has been a significant change in investment policy, there may be an upcoming surge in FM retenders.

"Post the initial spike tender activity due to the CMA, we expect there to be a much greater level of FM tender activity over the next 12 months as trustees review their governance models," Manjrekar says.

Indeed, the PMI and Schroders' survey results showed that one in 10 respondents will be reviewing their fiduciary manager this year, Manjrekar notes.

Therefore, "we expect a significant uptick in tender activity in the second half of the year", he says, with "the gilts crisis leading to a greater increase in in-depth FM reviews versus general oversight than in recent years".

The PMI/Schroders survey found 28 per cent of respondents were using a third-party evaluator in some way, along with an increase in the number who see value in using a third-party evaluator to oversee a fiduciary manager rising from 27 per cent of respondents in 2022 to 42 per cent in 2023.

"The Schroders/PMI survey results suggested that over 270 UK pension schemes could move from traditional

Fiduciary management and DC schemes

According to Isio's FM survey last year, around 89 per cent of all FM mandates are for DB pension schemes, but as fiduciary managers have diversified their offering in recent years to include defined contribution (DC) schemes, it saw an increase in their presence in this market.

As the DB FM market continues to mature, Goldman Sachs Asset Management managing director of UK fiduciary management business, Ed Francis, is beginning to see the benefits of FM being leveraged in areas beyond DB schemes, including the defined contribution market.

"This is also a phenomenon that is playing out in Dutch pension reform, a four-year complex transition to DC that is leading to pension funds relying on their service providers more," he explains.

According to Schroders Solutions head of UK client solutions, Ajeet Manjrekar, the DC FM market is significantly smaller and whilst the trends are similar [to the DB FM market], there are two key distinctions.

"The shift to DC master trust, particularly from a cost efficiency perspective, has been dominant in recent years and has therefore seen a decrease in trust-based arrangements, whether advisory or fiduciary," he says.

"Where governance of DB schemes and the use of FM continues to be driven by the trustees, the direction of travel for DC is often driven from the corporate perspective coupled with a regulatory focus for consolidation of smaller schemes."

advisory to fiduciary management in 2023," Manjrekar adds.

Campion expects "an increase in FM reviews given the disappointing performance of some managers last year, irrespective of CMA requirements".

Yet on the professional trustee side, Walsh does not expect the number of FM reviews this year to increase compared to 2022.

Clients

One consequence of the reviews, however many there are, could be a different type of pension scheme clientele for FM's services, as changing attitudes are being seen across DB schemes of all sizes.

According to Campion, "very large schemes with in-house teams are reviewing the effectiveness of that approach and considering moves towards an OCIO approach. Smaller schemes are moving towards FM as a result of governance challenges. Mid-sized are caught between the two models but most should be considering either improving their own governance standards or moving towards an FM approach."

In particular, Dalriada Trustees professional trustee, David Fogarty, is seeing more larger schemes outsourcing to fiduciary managers.

"A combination of the increasing competitiveness of the fiduciary management market, the advantage of dealing with a single firm for advice, all of implementation *[being taken care of]* and high-quality reporting are all driving this move. We believe that in order for trustee boards to get the best from fiduciary managers they need significant investment capability and that if that capability is in place, then fiduciary management solutions have the potential to provide better outcomes for schemes at a lower cost point than traditional models," he adds.

Focusing on the large schemes experience, Goldman Sachs Asset Management managing director of UK fiduciary management business, Ed Francis, notes that over the past two years, "we've experienced a once in a generation change in how large pensions schemes are governed. As a result, we are seeing some of the very biggest pension schemes move towards an outsourcing model".

"The LDI crisis has exposed the disjointed and fragile operating models of some FM providers"

He adds that in-house pension investment teams face a number of challenges as the business is structured for the future, including team retention as growth portfolios migrate to liability matching, the day-to-day management and monitoring of the scheme as it moves to being low risk and income focused and the operational risks increase, and the cost of investment in technology for adequate investment and risk analysis.

Walsh gives the examples of Centrica, British Airways and Royal Mail being some of the large schemes that have moved to an OCIO model in recent years and "I would expect that to continue".

However, Isio's report revealed that 18 per cent of all UK DB schemes use some form of FM, and while the number of £1 billion+ pension schemes using FMs has increased, the percentage of the market they represent stayed level.

Most pension schemes are sub £100 million, Walsh notes, *[62 per cent of all mandates by number, versus 54 per cent in 2021, according to Isio's survey]*, if not more so now with recent fall in AUM. Therefore, "a number of FMs are looking to develop or enhance their offerings to this market segment that may have been previously overlooked", he adds.

Trustees at larger schemes tended to have better experiences with their FMs during the LDI crisis, Allan says, although there are "some elements of uneasiness stemming from poor communication and challenges driven by underlying LDI mandates".

According to Allan, trustees are asking questions about the resilience of their governance structure and level of operational due diligence undertaken on their behalf. "It is bringing into sharp focus the difference between a volume/platform-based FM and a tailored solution (generally provided by boutique fiduciaries) where there is greater alignment of interest and a genuine partnership between the trustees and FM," he adds.

Future

Looking ahead, Walsh sees a "few areas that could be interesting" for the FM market over the next 12 months and beyond.

For instance, due to the downward pressures on fees, "will FMs look to change their operating model from a basis point model to a fixed fee, or a combination of both", he queries.

Walsh also questions whether there could be further consolidation in the FM market, "or even some firms exiting the market, noting the competitive and fee constrained environment".

Campion does expect to see "more consolidation and more concentration among the better-performing *[FM]* managers".

Francis is also seeing a continued trend in the consolidation of providers, intermediaries and asset owners.

As he says: "In this environment, scale is king, meaning global firms with true scale are likely to be around for the long term."

Written by Laura Blows