DC fiduciary management focus: Creating new paths

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Niall Alexander, director, P-Solve

Keeping investment on the agenda

Niall Alexander explores how fiduciary management for DC can keep the focus on investments to deliver the best outcome for members

Between the 2,600 or so pages of legislation, guidance, best practice and all the other documents produced since 2011, there's a lot for DC trustees to think about: administration, communications, investment governance, trustee knowledge, board governance, accounting requirements, value for members, chair's statement – it's a long list.

At the heart of it all, we need to improve member outcomes. So what does that mean? Better communications? Sure. Quality administration? Definitely. Value for members is present? Absolutely.

But as important as these areas are (and they are important), the purpose of a pension scheme is to provide members with an income in retirement. A good outcome for an individual scheme member means having as large a pension pot as possible at retirement.

Contributions need to count

There are two ways to get a large pot: higher contributions and better investment returns.

There has been a lot of focus on DC in recent years. Auto-enrolment will mark a historical turning point in the DC industry, and has rightfully been lauded by the media as a success – due both to its vast improvement on the previous landscape and to its low opt-out rates.

However, contribution rates under auto-enrolment are low. The headline rate of 8 per cent on qualifying earnings translates into rates of between 3.3 per cent and 7 per cent of salary. In order to meet members' needs, this leaves a heavy reliance on investment returns that, in these challenging markets, are widely considered unrealistic.

Whether auto-enrolled or not, the reality is that people don't save enough. If we can make the investments work a bit harder, then members will be better off. An extra 0.5 per cent per annum from age 50 to 62, for example, when pot sizes are approaching their largest, could add £8,000 to a low-earning auto-enrolee's pot at 65. Lower risk investment strategies allow return to be targeted for longer.

Investment performance matters

Under the Code of Practice and the guidance surrounding value for members, trustees can be compliant if the scheme's default strategy is invested in a passive equity fund that falls 30 per cent, so long as it has tracked its benchmark all the way down, the trustees have watched the fall closely enough and members are told about it in the right way. Communications can be glossy and engaging, but if investments fall like this, members will not be happy.

And rightly so. It is hard to argue that a 30 per cent fall represents a good outcome, especially for, say, a member aged 55 who, due to a change in life circumstance, finds benefits are needed early.

Risk management is key

For DC members, it's not just target investment return. The journey is important too: a large loss feels worse than a large gain feels good, and can lead to members reducing contributions or withdrawing altogether. So we should ensure the journey towards retirement is as smooth as possible.

DC members could have very different outcomes depending on their entry and exit points into/out of the pension scheme, and on investment markets. The difference becomes more pronounced the more volatile the investment journey – so more true for equities than, say, cash.

Our experience as a multi-asset fiduciary manager has shown us that intelligent diversification, a more active approach to asset allocation and knowing when to pay more for active management can all significantly improve risk management to deliver a smoother investment journey.

What is fiduciary management for DC?

Interpreted literally, fiduciary management means outsourcing investment to a third party. Most schemes do that. But the distinction is who you outsource to – fund manager or consultant.

A consultant will provide more than just fund management – it provides a full investment strategy meeting the specific needs of your members, and one all-in fee covering advice, fund management, help with changing regulation and everything else required so the investment strategy works within governance requirements. Consultants can also help communicate the value for members.

How (consultant-led) fiduciary management can help

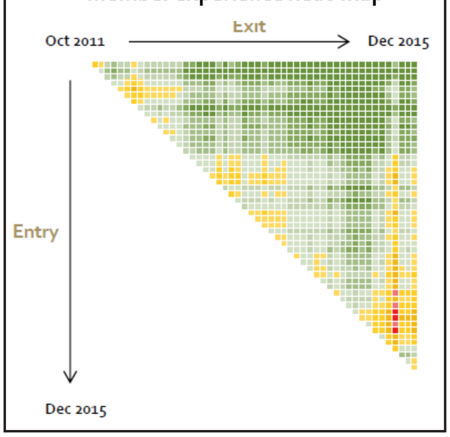
Our version of DC fiduciary management consists of white-labelled blended funds, each comprised of up to around 30 underlying instruments: mostly funds, with some exchange traded funds (ETFs) or direct holdings. Trustees delegate day-to-day investment decisions – we do asset allocation (within agreed ranges) and manager selection, while each blended fund has its own risk and return targets (linked to inflation). With the advice of the fiduciary manager, trustees construct a default strategy out of these blended funds.

Fiduciary management for DC in this way can help trustees manage growing DC responsibilities. By delegating day-to-day responsibility for DC-related investment decisions, trustees can spend more time considering strategic issues, such as governance, administration, regulation and communication.

Investment governance is also very important. While many managers report on performance over discrete time periods (which is useful), this lacks the context of DC members entering/exiting schemes and contributing monthly.

The chart below, for example, shows the combination of entry points (vertical) and exit points (horizontal) in which fund objectives were met. A smoother journey will result in much more green outcomes for the members, regardless of their entry and exit points into the investment strategy.

Member experience heat-map



Costs can be contained

In fiduciary management for DC we are very cognisant of cost. We do not pay for active management unless we believe it is absolutely necessary. A lot of value can be added by being dynamic with passive investments. Our actions the morning of the Brexit referendum result are a good example:

Ahead of the vote we modelled potential trades on various scenarios so we could execute our decisions quickly. When equity markets opened and fell sharply, we quickly took advantage by buying equities. Speed was essential – for example, the FTSE-100 index was below 6,000 for 40 minutes that morning, hitting a low at 8:08am and then climbing. We bought it at 5,850 (using ETFs). It finished the day at 6,139.

While we don't normally try to time market movements, knowing DC members really need every penny of return, we saw the morning of the result as an important buying opportunity and were willing to buy more equity for the right price. When the price isn't right, lower risk assets or cash are useful until we believe perceived risks have passed.

Putting investment back in the spotlight

Recently we have seen a fee cap (absolutely necessary, because there were too many legacy arrangements stuck on retail fees of 1.5 per cent that were no longer fit for purpose), a DC Code of Practice (twice) and a requirement for the chair of trustees to certify (among other things) that value for members is present. While these are great steps forward for DC, ensuring schemes are affordable and well run; they have taken the focus away from investments. Less attention is being dedicated to ensuring the investments are helping to deliver the best outcome for members.

Fiduciary management for DC provides a complete investment service with defined objectives tailored to your members. This is provided for an all-in fee to ensure compliance with the (ever-evolving) DC Code of Practice, assistance with investment communications and a strategy that can adapt to the changing regulatory framework without extra cost. And by delegating investment decisions within this framework the trustees can make sure that investment is kept on the agenda, even when it's not on the agenda.

Written by Niall Alexander, co-head of DC solutions, P-Solve

Summary

- Fiduciary management use within DC schemes allows trustees to have an input into the design of their default fund to suit their members, rather than having to choose an off-the-shelf lifestyle fund.
- Fiduciary management will not be an option for most UK DC schemes as they are contract based. Therefore it may the largest trust-based DC schemes that adopt this approach.
- The additional layer of monitoring generated by fiduciary management will add to costs. This could mean that DC fiduciary management is only available to those trustees who have a budget to pay for services that cannot be provided within the charge cap.
- Through fiduciary management, DC schemes may be able to adapt its investment strategy quickly in response to change. This could be beneficial for DC schemes, given the much greater choice members now have as to when and how they take their benefits.

Following DB's lead

Following the growth of fiduciary management use within DB schemes, Sally Ling examines why fiduciary management is now being implemented for DC investment management

The introduction of automatic enrolment and the closure of many DB schemes has resulted in a massive increase in DC pension arrangements. It is no surprise, therefore, that advisers and providers are looking at ways to apply investment solutions developed to address DB funding issues to DC schemes. One such approach is fiduciary management, under which trustees delegate most aspects of their scheme's investment, including asset allocation, manager selection and governance, to a single organisation. Proponents of fiduciary management say that it can improve the retirement outcomes of the majority of members who invest in their DC scheme's default fund. But how does it differ from traditional lifestyling and why might trustees consider making the leap?

How it works

With the increase in DC there has been a great deal of regulatory focus on member engagement, communications and charge caps, but little on investment management. The fiduciary management proposition appears to offer a solution to this by focusing on investment performance, governance and member outcomes. Ernst and Young partner Iain Brown explains that: "A lot of fiduciary managers are applying DB-style asset liability modelling techniques to DC. They look at the probability of certain retirement outcomes if an individual adopts a certain approach, to come up with a range of options. Some individuals will be happy with a wide range of possible outcomes, others will want more certainty."

One potential selling point of the fiduciary management approach is that trustees can have an input into the design of their default fund to suit their members rather than having to choose an off-the-shelf lifestyle fund. P-Solve, which has been offering DC fiduciary management for around five years, has set up a series of 'blended' funds. Each of which has an 'inflation plus' return target and a risk target. Under P-Solve's guidance, trustees use these funds to construct a lifestyle fund that might have an income replacement target or a return target, to suit their members' needs.

Specialist fiduciary managers SEI moved into DC around 10 years ago, which it delivers via its master trust arrangement. The firm also offers scheme-specific default funds. SEI director of institutional group solutions Ash Kapur explains: "We will know what the typical member looks like based on the scheme's contribution rates and average salaries, so we design a default that meets a target income for the least level of risk." This target income becomes the benchmark against which the default fund can be measured, a feature which Kapur says most DC schemes don't have.

Who is it suitable for?

While the term fiduciary management has become increasingly familiar in recent years, it can mean different things to different people and covers a wide range of delegated management. BESTrustees chair Alan Pickering points out that trustees have always needed to delegate some executive functions to

'hired hands', so it is important that those who advocate the extension of fiduciary management to DC are clear about what they mean by it.

However it is interpreted, fiduciary management will not be suitable for, or available to, everyone. In fact, as Brown observes, it will not be an option for most UK DC schemes as they are contract based, that is, run by insurance companies; he suspects that it will mainly be the largest trust-based schemes that adopt this approach.

Alexander says that P-Solve has a mix of clients across the size range but admits that the approach probably wouldn't work for very small schemes. He says they are seeing different schemes with different reasons for adopting this approach. Some already use fiduciary management for their DB schemes and are happy with it; others choose it because the trustees do not like making investment decisions. A lot depends on the culture of the people on the board, what they want to achieve and why they think fiduciary management is a fit.

Choosing a provider

Pickering recommends that trustees considering going down this route identify what the problems are with their current governance model and how these can be mitigated. He adds that trustees need to ask themselves: "What do we want fiduciary management to do on our behalf?"

Brown says that there are quite a lot of different solutions available with a wide spectrum of fees and charges so it can be hard to grasp exactly what you are buying. He adds that it is important to look into the provider's ability to support their solution with infrastructure and whether they have the necessary controls, checks and balances in place.

According to Pickering, DB schemes' experience of fiduciary management has not been wholly positive and he hopes that the same lessons do not have to be re-learned for DC.

One particular area of concern is that some trustees who had a very good relationship with their consultant believed that their consultant would be good at fiduciary management and sleepwalked into a fiduciary management relationship.

Now trustees are encouraged to shop around and get someone impartial to help them appoint the right provider, set the parameters and then monitor that provider to see if they are delivering. This additional layer of monitoring will add to cost and could mean that DC fiduciary management is only available to those trustees who have a budget to pay for services that cannot be provided within the charge cap.

Freedom and choice

One often-cited advantage of fiduciary management is that the provider has sufficient decision-making authority to allow it to adapt the investment strategy, quickly if necessary, in response to change. This could prove to be a bonus for DC schemes, given the much greater choice members now have as to when and how they take their benefits.

Brown says that this new flexibility means that: "The old lifestyle model whereby assets are switched as members approach retirement has become outdated – people are no longer deciding 10 or 15 years out how they are going to take their benefits or even when." Brown feels that something more sophisticated is needed and that's where a fiduciary management approach could help members to plan. Alexander adds: "The offering needs to be flexible enough for trustees to pick an approach that will suit how members want to take their benefits."

Even though the pension freedoms have been in place for nearly two years, the financial services industry has been slow to respond with new retirement income products. Pickering observes: "At the moment we don't know what products the industry will bring to bear to deal with freedom and choice and who those products will be targeted at – the rich, the poor or those in the middle."

Kapur says that in the past two years, SEI has evolved its approach so it does not just target an income at retirement age, but can be adapted to be suitable for drawdown. He adds, though, that at the moment very few people are taking full advantage of flexibility, with most either taking all cash or deferring taking their money until much later. However, as auto-enrolment contribution rates increase people will be retiring with bigger pots and the expectation is that more people will opt for drawdown.

Pension investment is a very long-term affair and only time will tell if fiduciary management can deliver good members outcomes for the majority of members who invest in their scheme's default fund. But on paper DC fiduciary management offers a lot – a measurable, outcomes-based approach to default fund investment that can adapt to changing members' needs and all within the charge cap.

Written by Sally Ling, a freelance journalist