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Fiduciary management focus:

Marching on together

Russell Investments head of strategic client solutions David Rae

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We've come a long, long way together

David Rae looks back on the journey of fiduciary management and how it is adapting to meet the needs of pension funds today and for the future

Fiduciary management has gained something of a Marmite status as an investment management approach. Many advocates cheer the simplified governance approach to an investment solution, while others bemoan the apparent one-size-fits-all nature of it. As the fiduciary management industry has matured and attracted greater scrutiny the true merits and differentiators across providers have and will become increasingly apparent.

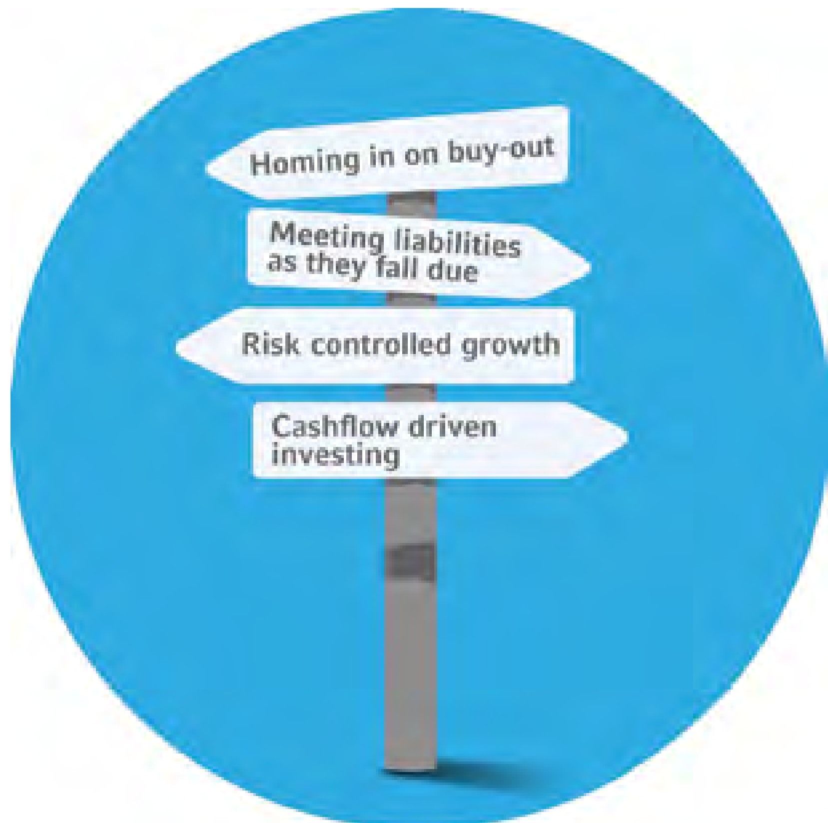
It's hard to determine the exact origins of fiduciary management. If this fact stands for anything, there has been a Wikipedia entry since 31 March 2009. Our own experience of acting as a fully outsourced fiduciary manager in Europe definitely predates that, stretching back more than a decade.

Without doubt, since that time, markets have provided both the hard times and the good. Coming out of the financial crisis, equity markets and risk assets have generally been good. The FTSE 100 index is today flirting with a level of 7300 (as at 16 February 2018) – 86 per cent higher than its level at the end of March 2009 and that doesn't include dividends.

While this level of return is quite unprecedented, trustees and sponsors are acutely aware that the mark to market value of the liabilities have increased significantly as a result of the falls in long-term interest rate – a key component of almost all valuation methodologies.

Fiduciary management has served as a powerful force to increase the level of liability hedging, particularly amongst smaller and mid-sized pension schemes. Early fiduciary management solutions usually revolved around three core elements: the use of derivatives to hedge the key liability valuation risks, interest rates and inflation; more diversified and sophisticated growth portfolios that reduced the reliance on equities to generate returns; and de-risking strategies to create an evolutionary path towards a lower risk sustainable strategy. We may not know the counterfactual but fiduciary management solutions have clearly improved the funding position for the large number of pension schemes that have adopted this approach.

Defined benefit pension funds are continuing on a journey. The destination for all is to ensure that the retirement promises made to members are met as they fall due. The route to this destination can be different for different funds and we continue to witness increased variety in the long and short-term objectives of pension funds. Some are looking to immunise and lock down risk, accepting a higher funding cost to do so. Others are looking to longer-term return generation,



accepting this may lead to more volatile short-term outcomes. With greater input from corporate sponsors, regulators and other stakeholders, the range of potential investment solutions that meet everyone's needs is growing.

We're seeing a lot of evolution in the fiduciary management solutions to ensure that this approach keeps pace with the specific needs of each pension fund client. As pension funds continue to mature and demand for fiduciary management grows, we're building an array of fiduciary management solutions.

Striving for growth in a risk-controlled way

This was the starting point for many fiduciary management solutions. Generating strong investment returns to appease the costs of the pension promise in a risk-controlled fashion.

Fiduciary management provides an ideal platform to build a portfolio that achieves the required level of returns while managing risk relative to fund specific requirements. The combination of a well-diversified multi-asset portfolio coupled with fund specific liability valuation hedging has served our clients well over the last decade. By effectively managing the key liability valuation risks, our clients have been able to take advantage of the strong investment returns, progressively improving the funding position and de-risking.

Homing in on buyout

For many, the ideal end game is to transfer the pension liabilities to an insurance company at an acceptable cost or premium level. That will benefit the trustee and the sponsoring employer. Removing the reliance on the sponsor's covenant to serve as the backstop has benefits to trustees and employers alike. As funding positions have improved and insurance pricing has cheapened, we've been able to help clients execute both buy-in and buyout transactions.

Once again, the fiduciary management approach can play a critical role in delivering these outcomes.

Cashflow-driven investing

A big theme for pension funds over recent months has been the focus on cashflows. As cash outflows have increased for funds they have been increasingly prominent in trustees' thinking. The traditional investment industry has responded in time-honoured fashion, by pushing product.

My view is that cashflow-driven investing (CDI) is about so much more than this. It is about redefining the risk management framework to focus on the actual cashflows, rather than just the value of the liabilities. For me, CDI is a risk management approach, not a product.

Fiduciary management offers a robust means to build this risk management framework, to ensure that the appropriate risk measures are being monitored and managed towards. In time, portfolios can be reoriented towards greater cashflow generation as required. For some pension funds, this will include increased use of illiquid debt instruments. For others, particularly those looking to near-term buyout, liquid, Solvency II-friendly assets will continue to dominate.

Where next for fiduciary management?

Fiduciary management has never been about a one-size-fits-all solution for pension funds. As pension fund requirements have evolved over the past decade, we have seen our own solutions develop and evolve alongside our clients. Investment strategies have become more sophisticated in response to market conditions. Equity returns have been very strong but current valuation levels suggest it will be harder to generate similar levels of return going forward. The investment portfolios within our fiduciary management solutions have become more sophisticated, seeking out sustainable and repeatable sources of returns.

There has always been a strong focus on managing liability valuation risks within fiduciary management. This remains at the fore-front of fiduciary management and the evolution of risk management towards cashflows and insurance transactions will continue to develop.

Investors are taking their responsibilities seriously. The integration of ESG and sustainable development into fiduciary management solutions is critical to the future. As a signatory to the UNPRI since 2009, we're committed to evolving our investment solutions to integrating its six principles into our fiduciary management solutions.

Having proved itself adaptable to the changing needs of pension funds, the next 10 years will prove that not all fiduciary management solutions are built the same. It is now the time to objectively compare across providers, identify the best fit and switch if necessary.

Written by Russell Investments head of strategic client solutions David Rae

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Summary
• A recent KPMG survey found that the number of DB schemes in the UK using a fiduciary manager has steadily grown over the past decade to 14 per cent. Further growth is widely expected, but projections vary as to whether it will reach 50 per cent by the end of the decade, or no more than 20 per cent.
• Governance, cost-effectiveness, performance and speedier decision making have all been among the drivers of growth to date.
• The Netherlands has been the pioneer of schemes using a fiduciary manager. The UK and the US (which prefers the term outsourced chief investment officer) are moving down the same path.

Sky's the limit?

The number of pension schemes using a fiduciary manager is on the rise, helped by the option of partial mandates. Further growth seems assured, although opinion divides on how far and how fast the market will expand

More defined benefit pension schemes are turning to fiduciary management. The latest industry survey by KPMG, released in November 2017, found that the UK market has steadily grown over the past decade and that a total of 805 DB schemes, around 14 per cent of the total, use fiduciary managers. Of these, 546 schemes delegated full control of their assets – and day-to-day management of the scheme – while the remaining 259 used a partial mandate.

There have been bullish – and fairly recent – forecasts that the impetus for more schemes to go down the fiduciary management road is accelerating. Bullish projections suggested the percentage could reach as much as 50 per cent by the start of the next decade. That forecast has begun to look overly optimistic – 20 per cent is now cited as a rather more realistic figure – with many keen to see what the Competition and Markets Authority's (CMA) ongoing investment consultants market investigation contains.

The Financial Conduct Authority (FCA) announced last September that it had asked the antitrust body to undertake a review of the entire investment consultancy and fiduciary management sector because of "serious concerns" about the industry – although these relate to issues such as transparency and value for money and not the validity of fiduciary management.

Among past concerns has been a tendency for smaller schemes to move from a consultant relationship to a fiduciary management relationship with the same provider, without involving any competitive tendering process involved. However, KPMG's survey found that 60 per cent of schemes appointing a fiduciary manager over the past year had received independent written advice on the selection and appointment process, against only 33 per cent in the 2016 survey.

The CMA's probe is scheduled to take a further 12 months and will deliver its assessment in March 2019.

Drivers of growth

The fiduciary management pioneer has been the Netherlands, where up to 90 per cent of scheme assets are managed –the figure admittedly helped by giant standalone pension funds such as ABP for government and education employees that regards itself as a fiduciary manager.

Across the Atlantic, US schemes of various sizes are also moving to fiduciary managers – although the preferred term is outsourced chief investment officer (OCIO) or outsourced CIO, which some believe more accurately summaries the role.

"The use of fiduciary managers by pension schemes is now fairly well established in the UK," says Russell Investments head of client strategy and research David Rae.

"Our industry has gone through the process of identifying cost-effective structures for managing funds and the two main options of either doing it yourself or outsourcing the task. If the latter, it needs to be cost-effective and offer the scheme value for money.

"It's a complicated decision and the FCA/CMA review has noted the morphing of traditional consulting assignments into fiduciary management assignments. The differences need to be clear for trustees on basics, such as the respective services and costs."

A major driver behind the increasing use of fiduciary managers is the issue of governance, says Kempen Capital Management UK head of investment strategy Nikesh Patel – in particular the amount of time that scheme trustees must devote to investment issues, including funding arrangements. "Governance is quite stretched when it has to consider investment," he adds.

"More recently, cost control has also become a major driver. Using a fiduciary manager gives a scheme access to greater

buying power. At the same time fees have typically reduced by 30-40 per cent over the past decade, which has made using a fiduciary manager more attractive."

For Cardano chief executive of investment consultant Kerrin Rosenberg, performance is the top consideration. "Over the past decade, the average pension fund has earned returns on its assets that have been 20-30 per cent below the increase in their liabilities," he notes.

"This underperformance has caused the large deficits we now see in the industry. It has forced those companies that can afford it to inject huge sums into their pension funds and left trustees vulnerable to sponsors who cannot afford large deficit repair contributions.

"Not only has the investment experience been disappointing, it's been incredibly volatile. As pension funds mature and they enter the decumulation phase, this volatility is increasingly hard to live with. We think fiduciary management offers trustees a more reliable improvement in their funding ratio – better returns but, crucially, better risk management as well."

Schroders head of fiduciary management Hannah Simons reports that many of their clients cite the speed of decision making as the main attraction of fiduciary management.

"Many scheme trustees met on a quarterly basis to decide the funding level they wish to target and over what time horizon," she says.

"However, this means that some opportunities may be missed. February's market correction underlined the need to be nimble and make adjustments. Many trustees have realised that quarterly meetings aren't conducive to changing behaviour and reacting swiftly, which supports the case for using a fiduciary manager."

Add to these drivers the fact that more DB schemes will mature over the coming years, says Simons. "Trustees are looking ahead to the end game, which in many cases will involve an insurance solution. Using a fiduciary manager along the pathway to an eventual buyout means that more decision making is delegated at an earlier stage, which is also likely to assist growth over the next five to 10 years."

Upcoming challenges

Alongside the traditional fiduciary management arrangement, under which the scheme trustees delegate control of the fund's assets, the past two to three years has seen a growing number opt for partial mandates, in which the fiduciary manager takes responsibility for only a portion of the assets. Patel says that the latter option is proving popular among larger schemes, with at least £1 billion in assets.

UK pension schemes collectively have an estimated £1.6 trillion in assets and the fiduciary management market has now reached around £150-160 billion. Patel believes that a number of very large schemes, collectively representing around £250 billion in assets, are unlikely to go down the fiduciary management route.

"At the other end of the scale, while outsourcing fiduciary management makes sense for smaller schemes, the fees are probably too high so that probably rules out a further £100 billion." That leaves just over £1 trillion, of which schemes making up around half the figure could ultimately give a full or partial mandate to a fiduciary manager, he suggests.

Stamford Associates head of fiduciary Carl Hitchman is optimistic on the outlook. "Trustees will have a greater range of options and individuals will become more comfortable with the concept of fiduciary management," he predicts. "The future performance of fiduciary managers will become more visible – and provided it is good, more schemes will be attracted.

"Investment returns over the next few years are likely to be more muted than previously, although this will be offset by the fact that the absolute returns needed by many schemes are likely to be less than before.

"As we've been reminded, the markets are susceptible to sharp corrections. If expectations aren't met, valuations are likely to come under threat. In particular, the staged withdrawal of quantitative easing (QE) could result in increased corporate insolvencies. Active fiduciary managers will need to start proving their worth in picking the best-performing companies and we'll start seeing a noticeable difference in returns."

Patel adds that the low to zero interest rate environment of recent years have already presented fiduciary managers with a challenge but also provided an opportunity to prove themselves. "Fiduciary managers were more focused on risk diversification and hedged far more against interest rates – meaning that they either suffered fewer losses or were able to make gains from the introduction of QE," he notes.

Having correctly deduced that interest rates would stay low for rather longer than many anticipated back in 2008-09, the industry's next challenge could lie in correctly determining when the next recession begins.

So are trustees seeking consulting or asset management skills when they appoint a fiduciary manager? Rosenberg believes that it's both. "At its heart, fiduciary management is a form of asset management, and trustees clearly need to be comfortable with the asset management capability of their preferred fiduciary manager," he explains.

"However, fiduciary management is more than a product, it's a solution. Trustees expect the fiduciary manager to understand and advise on their liabilities, journey plan and actuarial valuation, free from conflicts of interest and a desire to sell more 'product'."

Written by Graham Buck, a freelance journalist

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