The Five 'Ws' of FM

With fiduciary management becoming part of the mainstream for pension funds, Hannah Simons, head of fiduciary management at Schroders, covers the five 'Ws' for schemes considering hiring a fiduciary manager

Over the past decade, the number of pension schemes adopting fiduciary management has significantly increased. However, there still exists a lack of clarity in the market as to what exactly the arrangements involve. Here, we look at the 'five Ws' of fiduciary management: What, why, where, who and when?

What?

Fiduciary management is a governance model involving the delegation of some, or all, of the day-to-day investment decision making and implementation for a pension scheme. By delegating certain investment decisions to an investment expert, pension scheme trustees are able to focus on high-level strategic issues.

It is important for trustees to decide at the outset what level of decision making they are happy to delegate to the fiduciary manager. In fact, having a robust process to document all roles and responsibilities is useful for all kinds of governance arrangements, not just fiduciary management.

Working through the framework outlined below helps to ensure clear accountability and requires that all roles and responsibilities are clearly documented from the outset. The framework shown is divided into four key areas of decisions and activities, relating to discovering the trustees' beliefs, translating this into an investment strategy, implementing the strategy and then reviewing its appropriateness over time.

In this context, the owner has full responsibility for each activity/decision and is supported by an adviser for this action where necessary. An overseer takes responsibility, where appropriate, for monitoring the actions of the owner of the decisions. We have populated this for an example framework, but in reality there are a wide range of potential operating models.

Why?

There are many reasons that trustees decide to enter into fiduciary arrangements. Some of the most frequently cited benefits of a fiduciary arrangement include focus, expertise, speed and risk management.

Focus

Many of the trustees we work with see their fiduciary manager as an extension of the trustee board, rather like having their own chief investment officer. In fact, over the past few years some of the largest UK pension schemes have built up considerable in-house resource; their own form of additional management.

By delegating the details of the investment strategy, trustees gain the benefits of an expert whose only task is to concentrate on investment. With clearly defined roles and responsibilities, trustees can ensure that they remain in control of the key decisions that affect the future of their pension scheme, such as the long-term funding objective and the time to full-funding.

Perhaps the most common misconception about fiduciary management is the fear among trustees that it involves surrendering control of their entire pension scheme's investments. In practice, trustees and their fiduciary manager continue to engage with each other on a regular basis – this is not a 'set and forget' arrangement.

Expertise

As the investment industry for pensions develops and innovates, the options open to trustees have multiplied. Getting the best from these new options requires significant time and resources. Often, trustees have neither to spare. Fiduciary management provides an investment solution to this issue. The fiduciary manager applies their many years of investment experience to the pension scheme's specific circumstances and works with the trustees to develop and implement a strategy to meet the pension

Figure: Governance framework

Discover

Decision/Activity	Trustee	Fiduciary Manager	Investment Consultant	Other third party
Funding objective	Owner	Advisor		
Time horizon	Owner	Advisor		
Risk tolerance (over time)	Owner	Advisor		
IRM framework	Owner	Advisor		

Translate

Decision/Activity	Trustee	Fiduciary Manager	Investment Consultant	Other third party
Flight path framework	Owner	Advisor		
Liability coverage	Owner	Advisor		

Implement

Decision/Activity	Trustee	Fiduciary Manager	Investment Consultant	Other third party
Managing total portfolio risk	Overseer	Owner		
Growth portfolio management	Overseer	Owner		
Matching portfolio management	Overseer	Owner		
Implementation methodology	Overseer	Owner		
Manager selection/deselection	Overseer	Owner		

Review and adapt

Decision/Activity	Trustee	Fiduciary Manager	Investment Consultant	Other third party
Funding level reporting	Overseer	Owner		
Review of fiduciary mandate	Owner		Advisor	

Source: Schroders.

scheme's particular needs.

Before implementing new investment strategies, fiduciary managers typically give extensive training to trustees to ensure they are comfortable with any changes being made. For example, using derivatives within an investment strategy to protect against equity market downturns may be viewed as additional complexity. However, with the appropriate level of training, actually implementing such strategies using a fiduciary arrangement can significantly reduce the risk that the pension scheme is running.

Speed

Many defined benefit pension schemes face a significant shortfall between assets and liabilities. This shortfall can be filled either by contributions or by investments returns. If you need to rely on returns, then it is essential to find an investment expert that is close to markets and can be nimble and react quickly as markets change and opportunities arise.

Indeed, trustee groups typically meet infrequently, for example on a quarterly basis. Whilst this provides a good framework for longer-term decision making, shorter-term opportunities may be missed if it leads to delays in approving and implementing investment decisions.

Risk management

Most defined benefit pension schemes are now closed to new members and many are also closed to future accrual. These pension schemes have a defined time period until the last pension is expected to be paid. As a result, trustees and sponsors are increasingly looking to the 'end game' and are planning towards a lower-risk investment strategy as the pension scheme matures.

Many fiduciary management arrangements include a 'flight path'. This is a long-term plan towards full funding, which captures opportunities to de-risk as the pension scheme's funding level improves. Advances in technology mean that fiduciary managers are able to track the pension scheme's funding level on a daily basis. Having a pre-agreed framework in place means decisions can be taken swiftly by the fiduciary manager, but without increasing the trustees' governance burden.

Clear, transparent reporting on progress made against this pre-agreed framework is essential to support trustees in monitoring the progress of the fiduciary manager against their prescribed objectives. Regular reporting should signal progress in maintaining or improving the funding level and whether the pension scheme is on track to achieve its goals.

Where?

Fiduciary management in its earliest form originated in the Netherlands, which has one of the world's most sophisticated pensions markets. Large pension schemes developed specialist in-house investment teams to whom responsibility for investment decision making was delegated. This was fiduciary management in its infancy, the start of a new model for managing pension scheme investments.

The Dutch market has grown significantly since its origins in the 1990s, with many Dutch pension schemes now under fiduciary management arrangements. But while the fiduciary management market in the Netherlands is nearing full capacity, the market in the UK is a decade younger and growing from a smaller base.

The UK has learnt from the experiences of the Dutch market, and as a result, now has a remarkably advanced and diverse range of offerings. Indeed, there is a common perception that fiduciary management is more expensive than traditional arrangements. In reality, there are many 'flavours' of fiduciary management that can be accessed at varying levels of cost.

Who?

The choice of fiduciary manager is one of the most important decisions trustees can make, given the appointee's pivotal role in setting and implementing a scheme's investment strategy.

Figure: Fiduciary manager providers

Investment Consultants
- Largest share of market
- Expertise in investment strategy advice and external manager selection

Specialists
- Variety of backgrounds, including in house investment teams
- Tend to offer "Manager of Manager" approach

Investment Managers
- Typically newest entrants to market
- Expertise in implementation of investment strategy and operational risk management

Source: Schroders.

It can be a difficult decision to make as there are so many different kinds of managers. Often comparing providers' approaches is like comparing apples and oranges. Broadly, providers can be split into three areas: Investment consultants, specialists and investment managers. Trustees should work with an independent oversight organisation who can advise on the selection process, helping them to navigate this important decision.

When?

Pension scheme trustees in today's investment environment find themselves under immense pressure. A demanding macro-economic environment, increasing regulation, uncertainty over future mortality trends and calls from sponsors to de-risk are but a few challenges faced. Designing and managing an investment programme to deal with these multiple challenges can be incredibly time-consuming. With limited time to spend, trustees often don't have the capacity to deal with all the decisions required to ensure long-term success. This has been the impetus for many schemes to turn to fiduciary management in today's climate.

Written by Hannah Simons, head of fiduciary management, Schroders

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Summary
• The Competition and Markets Authority's preliminary report into the UK's pension investment consultancy and fiduciary management market was less radical than some expected – although the call for mandatory tendering raised some hackles.
• The current working definition of fiduciary management focuses on a narrow set of offerings and many believe it needs to be broadened.
• The UK now has 17 fiduciary management firms and the market is growing – often because scheme trustees have to devote more time to areas such as compliance with regulation.

Under the spotlight

A market investigation by the Competitions and Markets Authority has put the industry under the spotlight as more pension schemes employ a fiduciary manager, reports Graham Buck

Were expectations running too high ahead of the Competition and Markets Authority's (CMA) report into the UK's £1.6 trillion pension investment consultancy and fiduciary management market?

Even before publishing its provisional findings in July, the authority ruffled a few feathers; principally those of the investment consultancy market's 'big three' of Mercer, Aon and Willis Towers Watson. The industry was referred to the CMA in September 2017 by the Financial Conduct Authority (FCA), which expressed concerns over a perceived lack of transparency and conflicts of interest.

These are reflected in the CMA's preliminary findings that "around half of pension schemes choose the same provider for fiduciary management that they use for investment consultancy". The CMA review, conducted over nine months, concludes there is an "adverse effect on competition" but does not suggest any major shake up of the industry.

However, Mercer's UK chief executive Fiona Dunsire wrote to the authority post-publication to challenge its data analysis as faulty. "We have several concerns… these include the use of incorrect data, errors in the CMA's analytical code, and reliance on unrepresentative samples," she commented.

Getting off lightly?

Kempen Capital Management senior investment strategist Nikesh Patel regards the provisional report as a "first step", but doesn't expect remedies proposed in the final version to be significantly more radical.

"I suspect the CMA will stay fairly middle-of-the-road," he predicts, although the recent announcement that Marsh & McLennan is acquiring rival Jardine Lloyd Thompson (JLT) promises to further strengthen Mercer's market share.

The statutory deadline for the final report is 13 March 2019, but the CMA has indicated that publication may be brought forward to late 2018.

"The main changes from the CMA will be more open competition for fiduciary mandates and more transparency about the performance of fiduciary managers. Both things are to be welcomed," says State Street Global Advisors head of pensions and retirement strategy EMEA Alistair Byrne.

"There remain strong benefits to the fiduciary approach in supporting trustees with investment expertise and the ability to make more real-time investment decisions as market conditions change."

CMA recommendations include the development of an investment consultant performance standard. However the bone of contention as far as the 'big three' are concerned is with regards to mandatory tendering for schemes' first fiduciary management mandates, and a requirement that those with existing mandates tender again within five years.

Willis Towers Watson's EMEA head of investment, Ed Francis, welcomed most of the CMA recommendations, but questioned "the proportionality and cost to schemes of a mandatory tendering requirement, particularly for smaller pension schemes," a view echoed not only by its two main rivals but by others.

"Many of the changes that the CMA is calling for have actually evolved naturally,

including competitive tendering and greater transparency on both fees and performance," says River and Mercantile Solutions managing director Barbara Saunders.

"While we support the principle of competitive tendering, there needs to be clarity on what fiduciary management is and what it involves and a clear definition is still lacking. Regulation works best with a principles-based approach. A number of schemes have in-house expertise and don't want to have to go through the competitive tendering process again. These would be helped by a 'best practice' basis."

Schroders head of fiduciary management, Hannah Simons, adds: "Competition has moved beyond just the number of fiduciary managers involved in a tender exercise. There are a range of different models for delivering fiduciary management services, and as each scheme has different needs, there's no 'one size fits all'. Trustees should consider a range of provider types, to find the fit that's best for them."

Time constraints

It's generally agreed that more pension schemes have turned to fiduciary management providers in recent years, although Mercer UK head of fiduciary management, Ben Gunnee, stresses the importance of distinguishing between fiduciary management as per the standard definition, and the other services provided by today's fiduciary managers.

"Fiduciary management involves the pension scheme delegating the implementation of the strategic asset allocation," he says. "Trustees are delegating their responsibility for overseeing the entire portfolio, so the fiduciary manager is managing against the scheme's specific liabilities.

"You can separate the various fiduciary management roles and delegate various bits; for example decisions on the private markets or growth portfolios that target a specific return. So we've seen growth in this partial delegation, where trustees seek specific 'pockets' of help.

"A growing number are busy and pick a fiduciary manager to help them with their investment policies. And while many are confident in their investment decisions they still seek to delegate simply because they can't get everything donegiven their limited time and internal resources – for example dealing with increasing levels of regulation. Private markets are quite a complicated area, so it makes sense to have help."

Patel agrees, suggesting that, in addition to the CMA review, two other factors have put the industry under the spotlight. One is a long-term trend towards fiduciary management, which "has grown at a spectacular rate over the past 10 years and now accounts for around 10 per cent of the total UK pensions industry. Even five years ago it was still only niche".

Second is the impact of consolidation. As recently as 2015 there were still more than 6,000 DB pension schemes in the UK, but a steady trend towards fewer, bigger schemes means "fiduciary management can be regarded as a means of consolidating assets. The fiduciary manager is an asset manager, with a larger pot of money available for investment."

"The current working definition of fiduciary management focuses on a narrow set of offerings," adds Simons. "Both a formal fiduciary management proposition and other models such as 'delegated consulting' implemented via a platform can involve a similar level of delegation for the client.

"Yet the former is currently captured by the definition, while the latter isn't. We believe that trustees should be encouraged to conduct a thorough review when considering any type of delegation."

A need for more competition?

So how great is the need for more competition in the industry? "KPMG reported that 70 per cent of schemes don't look further than their investment consultant for a fiduciary manager, but prefer to stay with someone who is familiar," says Patel.

However, Gunnee notes that the UK currently has 17 fiduciary management firms, which the CMA regards as a healthy level of competition. "BlackRock, Legal & General and Schroders are among those to have developed a significant market presence and we hear noises regarding possible new entrants," he states.

Though, he suggests that a major influx is unlikely. "KPMG reports a total of 90 fiduciary mandates were awarded in 2017. If, say, the number of market participants was to increase to over 20 – that allows no more than four or five new wins per firm per year. Unless the number of mandates increases dramatically there's not enough to encourage large numbers of new entrants."

One incentive that might encourage more scheme trustees to consider appointing a fiduciary manager is the dark clouds gathering over the equity markets as fears on Brexit and escalating trade wars deepen. While most pension schemes have produced good levels of investment return in the past five years, conditions have been particularly favourable.

"It's likely that market conditions will become more volatile and some schemes may decide that in order to preserve their funding levels, they need a degree of help with funding decisions," suggests Saunders.

"Fundamentally the problem that schemes face is one of generating investment returns in a risk-controlled manner, which requires investment expertise," adds Simons. "In the tenth year of an equity bull market, and with volatility increasing of late, the ability to be dynamic and adapt to the prevailing environment is absolutely crucial. A fiduciary management approach is one way to make this more achievable for trustees."

Written by Graham Buck, a freelance journalist

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