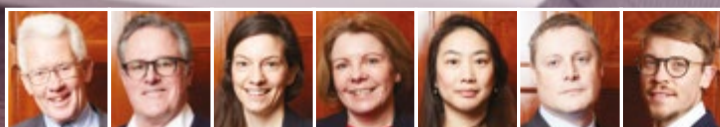


Fiduciary management

Improving oversight of delegated investment



*Alan Pickering | Mike Roberts | Hannah Simons | Alison Bostock |
Celene Lee | Tim Banks | Sebastian Cheek*

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Sebastian Cheek
Editor, *portfolio institutional*



Improving oversight of delegated investment

Fiduciary management (FM) continues to gather steam in the UK, now accounting for £123bn of scheme assets under management across 719 mandates – 459 full and 260 partial.

In the past six months, the pension schemes of McDonald's, electrical engineering firm Sevcon and the University of St Andrews have passed investment decision-making to fiduciary managers, all citing governance reasons for the decision.

FM growth continues apace, but the number of schemes going out to the full market when tendering mandates remains low. In fact, according to KPMG, only 33% of new appointments in 2016 were advised by a third-party, up from just 23% in 2015. The percentage of schemes using an independent provider to monitor their FM mandate was even lower, at just 13%.

Fiduciary management has long struggled to rid itself of the conflicts of interest charges levied against it. It's true that investment consultants are traditionally advisers, not money managers, yet they account for the vast majority of fully-delegated FM mandates in the UK (339 in 2016, compared with 74 run by specialists and 46 by investment managers).

The 'flipping' of a traditional consulting relationship into a fiduciary one is understandable from both parties' perspective. However, it should only really be acceptable if the scheme has undertaken full due diligence when selecting its provider. Ongoing monitoring of the performance of these mandates is a trickier task, given each mandate is bespoke to each scheme's needs. Third-party monitoring is likely to increase as schemes realise they are not adequately equipped to gauge whether their fiduciary manager is delivering the goods. The industry standard currently being put together should help schemes gain a better understanding of performance as well as improve transparency.

This roundtable sees an expert panel of fiduciary managers, advisers, and independent trustees debate the issues around fiduciary management, including why it is appealing, how to compare performance and addressing conflicts of interest.

Contents

P4: Fiduciary management roundtable

Our panel of experts debate the latest issues in delegated investment.

P18: Making fiduciary management work for you

Mercer Global Investments principal, *Tim Banks*, explains how fiduciary management can help plug scheme deficits.

P20: 2017: the year for being nimble

Hannah Simons, fiduciary manager at Schroders, says it pays for schemes to be dynamic when managing portfolio risk in volatile times.

P22: Breaking the stigma: addressing conflicts in fiduciary management

According to surveys, very few schemes are taking independent advice when appointing a fiduciary manager, but does it really matter? *Sebastian Cheek* finds out.



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Hannah Simons

“[Fiduciary management] allows trustees to ensure that somebody on their behalf is making investment decisions every single day.”

Hannah Simons

KPMG has recorded nine consecutive years of growth in fiduciary management. There’s been an increase in smaller mandates and more bespoke mandates, but only a relatively small number were advised by an independent third party. What is the attraction of fiduciary management?

Hannah Simons: It allows trustees to ensure that somebody on their behalf is making investment decisions every single day and making them in a framework based around the funding level.

Tim Banks: Virtually all schemes have a business plan setting out their specific objectives. We take this a stage further in fiduciary management and codify those objectives, risk parameters and restrictions in a legal agreement. It’s very clear that you’re putting someone on risk for managing your assets against your liabilities. Also irrespective of each individual scheme’s size, all benefit from the scale of the fiduciary operation. That gives enormous economies of scale in terms of what and how you’re able to implement. Then in terms of utilising the full investment opportunity set, we often find with trustees it’s a confidence issue, and that a fiduciary relationship can help overcome those fears.

Alison Bostock: It’s the speed of decision making. By the time somebody has brought you the new idea, by the time you’ve educated the trustees, they’ve understood it properly and then started to do it, the opportunity is missed. That’s relevant in all markets but particularly now where it seems so difficult to find return and you need more esoteric and unusual things to find that return.

Mike Roberts: With lay trustee bodies there can definitely be an element of decision making constipation which can prevent them actually making decisions and thinking so hard, they just miss the opportunity.

Alan Pickering: That's an unfair generalisation because there are some trustee boards that are either wholly composed of lay trustees or which have a professional trustee as part of a mix and they can move quite quickly. Where companies have decided they don't want to resource their trustee board to a level that allows them to do lots of stuff then delegation makes sense.

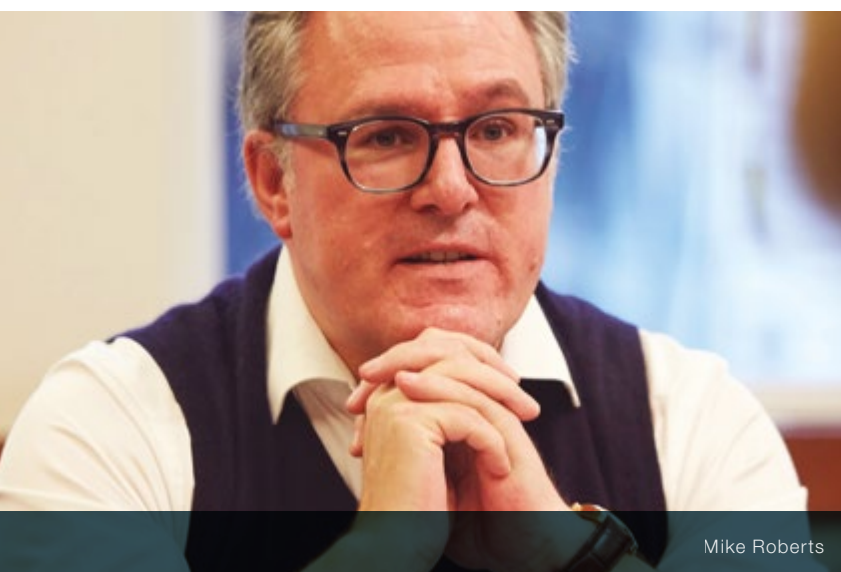
Celene Lee: You often hear trustee bodies saying, "Go into fiduciary management because you have only got 16 hours a year to look after investment matters." But if you haven't got someone who's driving the agenda for the trustee board or enough interest or enough availability to make it happen, you're not going to solve that problem by adopting an FM mandate, because ultimately somebody still has to make the decision. By going into fiduciary management the trustees don't release themselves of the responsibility of the overall management of the pension scheme.

Banks: Fiduciary has grown to a point where the technology, the expertise and the scale all support a level of flexibility that allows trustees to delegate only those decisions to the extent they wish to. This is no longer a cookie cutter, one-size-fits-all service.

If we look at de-risking activity over the past year, we took 85 opportunities to de-risk those clients that are on a de-risking journey plan. Those market-driven opportunities sometimes exist for only one or a handful of days. Often clients don't have the kind of governance structure that allows them to take advantage of those opportunities.

Simons: We have seen larger pension schemes achieve this through effectively building their own fiduciary management operation in-house. In this situation you still have to have a governing executive setting out that long-term journey plan, their aspirations. It's then the delivery of these aspirations that you're effectively delegating.

Pickering: It's really important that the fiduciary managers do understand they might not be wanted forever and we might want to bring the responsibilities back in-house. So a differentiator may well be the willingness and ability of delegated managers to provide you with an easy exit route that doesn't torpedo their business model, but allows you to mix and match externalisation and internal delegation.



Roberts: Do we have examples of exiting from fiduciary and what that looks like? I've not seen that yet.

Lee: There is a risk that clients who have gone into a fiduciary management arrangement, and find they're not getting what they thought they were, could find it hard to exit. At the end of a full fiduciary arrangement means having all the assets with one provider and it is important to bear in mind that you may want to reverse your decision so an exit plan is equally as important. They need to think about how they can effectively insource and outsource over an entire lifetime of a pension scheme and not just five to 10 years.

Pickering: Businesses need to learn from elsewhere within their operations how have

other forms of subcontracting and delegation worked and what sort of escape routes have they negotiated in their non-pension delegation contract.

Bostock: It's going to be quite unlikely that people who've opted for the fiduciary route then undo it. Once you've chosen one and even if it's running beautifully against your liabilities and you're improving your funding level, there's always that nagging question in your mind of wondering if the other lot would have done it better. The answer is you'll never know because you can't get those comparisons because it's all bespoke to your liabilities.

Simons: Perhaps more so if they 'sleep-walked' into a fiduciary manager arrangement. The comfort isn't the same as someone who undertakes a full market review, using an independent organisation to help them select the right fiduciary provider.

Bostock: I've certainly witnessed the consulting advice becoming more and more complex and ever more esoteric. Asset classes are being introduced to the point when the trustees say, "Oh I don't think I can govern this anymore." The consultant says, "That's okay, I can take that for you now and we'll do exactly the same in a fiduciary model." I've seen it happen and, as you say, that's how trustees can slightly sleepwalk into it. You can see exactly how that happens because actually they love their consultant, they've done a great job. They've always taken all the advice straightaway.

How did fiduciary management perform over the Brexit vote period?

Banks: In the run up to Brexit we had a huge amount of meetings and did a huge amount of research. We couldn't call the result of the referendum, but we did take the position that if the UK voted out, a lack of confidence would be expressed in the pound. We took one decision as a business and that was really to take the currency hedge off. Now that was hugely beneficial to clients.

Lee: I don't doubt that compared to some trustee boards who are not able to meet often to make investment decisions, having investment professionals meeting more often and thinking about scheme assets more often is undoubtedly a good thing. But Brexit is a binary event. Not only were we not able to guess with any degree of confidence if it would happen or not, nobody knew what the market outcome would be afterwards. You can always pick out certain events and decisions managers have made and use that as a case to prove fiduciary is a good outcome.

Banks: We saw an asymmetric risk in the pound in the event of a 'leave' vote, which we thought the less likely outcome. We took advantage of that for our clients and as a result clients were around 6% better off the week following Brexit, depending on their portfolios.

Bostock: Fiduciary management forces trustees to focus on the absolute key decisions such as risk-on/risk-off or the proportion of hedging. Rather than spending hours picking an active equity manager or constantly monitoring that active equity manager to frankly not much purpose. Because resources, generally speaking, are limited. So, to me intraday movements on referendum day are almost a bonus. I do have a case where the fiduciary manager did very well on that day by being able to be very nimble in a way that we wouldn't have been able to do otherwise.

How does a scheme know whether or not fiduciary management is right for them?

Pickering: It depends on the appetite of the employer to be involved, the appetite of the trustees to be involved, the availability of people to do it. It's nice to have the option of delegation. It's nice to have the ultimate option of delegating to a fiduciary manager, but it isn't a silver bullet and it can't make up for flaws elsewhere in the pension food chain.

Roberts: A number of funds switched to fiduciary without really thinking about it. We'll see advisory firms help those schemes understand whether it was the right choice. There are so many different flavours of it and there are so many participants that you really do need somebody to help you get the right answer.

Pickering: For one of my clients we got the lawyer to talk to us about the ability of our particular scheme, with its documentation, to delegate further. And the auditor to talk about problems that there had been with fiduciary management or non-fiduciary management elsewhere. As a result, the trustees decided not to go the whole hog to fiduciary management, but decided to delegate more to the investment consultant than they had previously delegated. So no longer do we have beauty parades. They're quite happy to accept recommendations, particularly if the consultant comes and says, "If you want to do £10m LDI, there really is only one show in town and we recommend x, y, z."



Alison Bostock

FIDUCIARY MANAGEMENT

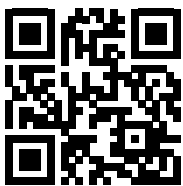
YOUR DESTINATION, OUR NAVIGATION

Current market conditions and the volume of new pension legislation mean that many trustees are facing significant time and governance challenges. Mercer's Fiduciary Management team can assist you with meeting your investment and risk management objectives – your destination, our navigation.

To talk to us about how we are helping more than 100 clients reach their destination please contact:

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Tim Banks

“Virtually every single tender we saw in 2016 was run by a procurement consultant or professional trustee or someone tasked with asking us the right questions.”

Tim Banks

How can we compare the relative performance of different fiduciary management operations?

Lee: In practice different fiduciary managers are able to access a different opportunity set. Some are able to get their operations together and access certain asset classes and create these new products for clients. Whereas others may not have the same level of operational capability. With full delegation it's more difficult for clients to really understand if a manager is performing or not. I don't think we've cracked this nut yet, but I'm sure that the more we talk about it, the better things will become.

Simons: The comparison across providers can be tricky because of the bespoke nature of each client's situation. If we, as providers, work together with the organisations that offer monitoring and oversight services and independent trustees, we can find ways of helping trustees. There is already work underway on building an industry standard for performance measurement.

Banks: It's very difficult, and you can see providers' reluctance to be compared on a very simplistic basis right across the industry. Everything we do for our fiduciary clients is bespoke to that client. They all have different return expectations, constraints, risk appetites and are at different stages of their journey. It's one of those issues where procurement consultants can really add value by teasing out what's important to the client, and working out the best governance model. There are very real differences in providers' capabilities. Then it often comes down to chemistry in beauty parades; who do people want to

Rethinking Fiduciary Management



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It should be as complex as necessary but no more

Do you know all of your costs?

You need value-for-money and no 'nasty' surprises

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Schroders



work with. When trustees are selecting a new fiduciary manager the questions posed by procurement consultants are usually extremely detailed. They are probing in all the right areas. We have a seven-year performance track record, and it's there for people to interrogate. Clearly you're outsourcing based on trust and track record. Virtually every single tender we saw in 2016 was run by a procurement consultant or professional trustee or someone tasked with asking us the right questions.

Lee: Whatever the objective is, there will be times when the fiduciary managers will not meet the target, whatever it is that they're targeting because markets will be what markets will be. We cannot control how the funding level will progress.

That is when your manager will come along to you and say, "I'm sorry for this year, I'm not going to deliver what we were meant to deliver." That's the real test for the trustees to then say, "Well actually what are we going to do about that? How are we going to understand that actually although markets will be markets and we can't control it, is the manager still doing a good job?"

What's a reasonable time period over which to judge a fiduciary mandate?

Lee: We tell clients, apart from performance, you need to step back and think about the reporting, the transparency, the working relationship with the fiduciary manager. So not overly focused on whether they are doing the best and delivering the best performance this year and then switch to someone else. I don't think that's the right answer.

Simons: It is really critical that reporting is focused on what happened to the funding level. How did it perform relative to the expected journey? What were the reasons behind the performance? The performance attribution is really important, because when things don't go as expected it's easy to identify the decisions the manager made and ask if they were good ones.

Bostock: The reason it's so difficult is because generally speaking with fiduciary you've got far more complexity going on under the bonnet. So, for example, it hasn't worked, what are the reasons? Did you not have enough hedging? Did the hedge not work in the way it should have done? Was it that one manager was picked wrongly or underperformed? Was it the actual underlying asset allocation? For one of mine, the page that tries to explain whether the liability hedging is working or not is incredibly complicated, I'm not sure any of the trustees understand it.



“I’m much more concerned about conflict of interest at the point of appointment rather than ongoing monitoring.”

Alan Pickering

Roberts: Does a third-party monitor involved with the fiduciary help you deconstruct that?

Bostock: I’m not sure it does. It really comes back to trust, they tell me the hedge is working. Is it working, yes or no? Then having a whole page of figures to try and explain precisely why it didn’t work to a tiny degree, it’s pretty hard work to be honest.

Lee: To understand the performance of the fiduciary manager you need to go the next level down. How the asset allocation decisions lead to good and bad outcomes. In that sense we probably haven’t really cracked it. Ultimately, it is still pretty hard to say, “Is that manager better than another manager?” because the changes that they can make are so wide.

Do we think that the industry addresses conflicts or is there more to be done in this space?

Pickering: Delegation has been at the heart of trusteeship ever since trusteeship was applied to pension schemes. The challenge for trustees is that when I first became a trustee there was a clear distinction between consultants who sold advice and product providers who sold products. Trustees have now got the challenge weighing up the relative merits of consultants who want to sell products and product providers who want to sell advice. I would always try to improve the relationship with the incumbent consultant before going to a market test, because it may well be that time has elapsed since the trustees appointed their investment consultant. I want to make sure that as a trustee I am not missing out on things that they could do for me just because they haven’t told me.

If as part of that refreshing the relationship they come along and say, “We can now do delegated investment management that we couldn’t do at the outset”, at that stage, I would then find somebody else who knows what they’re talking about

but hasn't got a financial interest in the outcome of that decision. I'm much more concerned about conflict of interest at the point of appointment rather than ongoing monitoring. Ongoing monitoring is important but it's much more painful if you start off in the wrong place.

Simons: What's really critical is that trustees and the delegated provider recognise the potential conflicts and talk about how they're managed. Rather than simply saying "They just don't exist".

Roberts: The one thing you can change is fees. If you hired somebody three years ago at the same mandate now the fees would be less, I'm pretty sure about that. Generally the fiduciary's response is, "Yes, we will look at that for you," and that can only be a good thing. The service does not change at all. It's really just a question that the scale of the business is a lot bigger now, so actually the fees charged don't need to be as large.

Bostock: Conflict of interest is why fiduciary management will never take over the world, because there will be some boards that just cannot get themselves comfortable with the concepts and the conflicts and the management. As you say, the consultants are charging by the hour, it's all set out in the asset management market study. It's a really difficult area.

Banks: At Mercer, we work really hard to manage conflicts of interest. Pretty much every sales process we go through now is a competitive process. It may not have been the case four years ago but it is today.

Lee: The conflicts issue actually, to me, is being addressed as we speak. By the media, by the fact we are talking about it makes trustee boards so much more aware that there is such a conflict. And it's a really welcome move to see that the FCA has written about it and we are seeing it in mainstream newspapers as well. The whole point of getting somebody else involved is to manage that relationship, so it helps you to manage the relationship between the trustee, the company and the fiduciary.

Simons: Trustees need to look at themselves and appreciate whether they can ask the questions that are needed, whether it's a selection exercise or a monitoring situation. If they can't, they should absolutely find someone that can; that could be an independent trustee on their board or it could be an external third party.

Roberts: You don't know what you don't know, this is often the problem. Even as professional trustees you're not going to know the nuances of all 15 fiduciary managers that are out there. So I'm very supportive of independent monitoring and procurement of fiduciaries.

Bostock: Is there some point when you're mostly sitting in gilts and you don't need a fiduciary? Are you then needlessly paying for some level of active management and advice that you don't need? Similarly, if it becomes advantageous to do a pensioner buy-in, who is going to come to me and say, "You don't need those gilts you'll be better off swapping them for a buy-in". Is my fiduciary manager going to do that?

Banks: We're looking at taking our Mercer pensions risk exchange, which provides 'live' pricing from insurers against scheme specific data, with the ability to be able to transact, and use this for clients who are nearing the end of their journey plan.

Pickering: Trust really is important. So that you're going to tell me we've been doing a really, really good job for you but we think that buyout is now appropriate.

Banks: It's a great point because we've taken five clients to the end of their journey and they'll no longer be fiduciary clients of Mercer. So it's having a clear and transparent record that you are doing the right thing on behalf of your client, right the way through to securing the benefits.

Simons: As your investment risk reduces through time, through a de-risking programme, longevity risk becomes a greater proportion of the remaining risk.



Mike Roberts and Tim Banks



Celene Lee

“We have helped [clients] get much better reporting and find if their fiduciary manager is picking the right managers.”

Celene Lee

Bostock: Picking active equity manager is like going on a date, picking a fiduciary manager is like getting married. We’re talking here about a pre-nup, aren’t we?

Simons: Along the way things can change dramatically. The strength of a sponsoring employer can change, so perhaps something they’ve committed to in the past is no longer possible or actually the opposite happens and they’re able to commit more money.

Lee: Don’t forget the trustees themselves, the decision-makers will change for sure over that cycle. Sometimes they have their own preference and they bring with them their own experience and personalities about what they would like to do and not like to do.

Are schemes getting the best out of their third-party monitoring?

Lee: The cases we have seen the most are clients who have gone into a fiduciary management arrangement and then after a few years ask if they should be rethinking it, renegotiating fees and so on.

So clients have said to me, “We didn’t realise that’s how the fees were worked out.” So there was clearly a lack of transparency there. We have helped them get much better reporting and find out if their fiduciary manager is picking the right managers. Part of our job is really to be neutral and educate and help the client to manage the provider relationship with the fiduciary manager, but not to interrupt it or upset it.

Roberts: Is there a beauty parade to hire Conduent versus KPMG versus E&Y?



Alan Pickering

“There is so much uncertainty out there [in DC] that I just wouldn’t know what contract to try and negotiate with a fiduciary manager.”

Alan Pickering

Lee: Yes.

Roberts: How many options are there with regard to procurement and monitoring this?

Banks: We see at least 12 firms on a regular basis.

Pickering: When it comes to projects whether it’s buy-in, buyout or appointing a fiduciary manager, it’s quite nice to test the market by having someone with whom I haven’t got an ongoing relationship to do that piece of project work for me, because it increases my contemporary awareness of the strengths and weaknesses within the market.

Bostock: With fiduciary the reason a lot of people think it’s expensive is because they’re actually buying services they weren’t previously buying. They needed them but they weren’t actually paying for them. If you just have gilts and passive equities, but you never reviewed your manager or performance, then inevitably with fiduciary you’re buying a lot more than you were previously buying.

What innovation can fiduciary managers provide to clients?

Banks: When you manage £110bn on behalf of clients, it gives a fantastic opportunity to leverage the intellectual capital of our business for the benefit of clients. A few months ago we launched a sustainability fund, which is something we’ve been researching for a couple of years. We think there is a premium that we can exploit there on behalf of clients. Right now that fund is already used in a number of clients’ growth portfolios. Another example would be that for some larger schemes we’re providing solely the fund infrastructure, using our platform to take away all of the operational and legal burden, and

harnessing our considerable buying power to the benefit of our clients. This level of flexibility is one of the key innovations that we're seeing in the market. You can only really start to do that once you've invested in technology and the platform you operate has achieved scale.

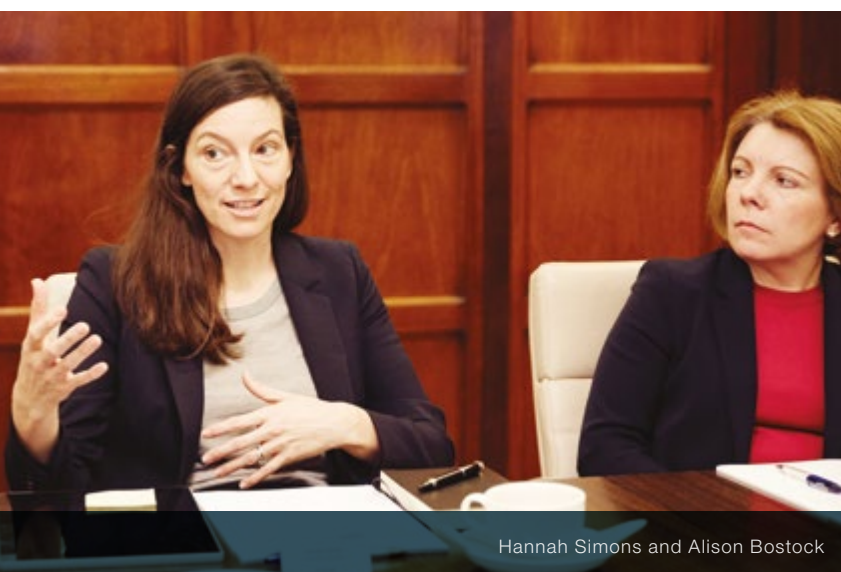
Simons: One of the biggest elements that's helping innovation is the new entrants driving change. Clearly consultant-led solutions were the first wave of fiduciary specialists and asset managers then followed.

The principles of fiduciary cross over so well into the DC world. You could say that every one of us is on our own personal funding level journey to their target retirement date. So looking at how technology can help translate all of that scale and all of those principles of managing asset allocation through time, getting access to the broadest range of investment strategies for DC is really important in making the journey successful.

Would it be a DC trustee board who decides to outsource?

Simons: In many DC arrangements that's actually what happens. The asset allocation through time is a really, really critical piece to making sure you have sufficient funds to meet your retirement needs. So delegating that to an investment professional, using the language we've used earlier, who's making day to day investment decisions on your behalf to deliver the outcome that the individual has specified. Again, instead of trustees saying, "I want to be this amount funded over this period," the individual is essentially saying, "These are my aspirations for my retirement."

Pickering: As a trustee, my answer to this question is not yet, if ever, because the landscape is so cloudy out there in that we're all now coming to terms with the impact of freedom and choice and getting our minds around the jargon of accumulation, consolidation, decumulation. How much engagement is it realistic to expect the individual to have with you during each of those phases? During accumulation, probably not at all because they've got better things to do. Consolidation and decumulation, probably because they know what they've got under their financial belt already and what their employment prospects are.



Hannah Simons and Alison Bostock

We don't know how pensions are going to interact with the LISA, how LISAs are going to interact with employee share ownership plans. There's so much uncertainty out there that I just wouldn't know what contract to try and negotiate with a fiduciary manager, who knows as little as I do about what market products are going to emerge.

Bostock: You've got the problem of the charge cap, you're not going to get that within 0.75%.

Banks: If I look at DC master trusts, quite frankly, they are fiduciary relationships without any shadow of a doubt. Within the cost constraints, we can construct funds using our strategic asset allocation and dynamic asset allocation capabilities. This forms a part of the default strategy in our master trust.

Lee: In order to keep asset management margins up what it potentially means is that products will need to become very standardised, which means over time you're going to have to lose that bespoke approach that you're able to offer under fiduciary management.

Banks: For us, every client is a bespoke client, necessarily so, everybody has different characteristics, they're all on a different journey, they all have different covenants. They each want a different level of risk. What is common is the buying power in terms of the asset management that we bring, and consistently finding the best in class managers to invest in.

Simons: When we get into the investment challenge if we think about our portfolio of best ideas, in some way these best ideas should find a way into each client portfolio. I don't think you have to compromise on that nimbleness and ability to keep developing and building and evolving as market opportunities and new techniques come along.

Making fiduciary management work for you

Tim Banks
Principal
Mercer Global Investments



Mercer's Pensions Risk Survey data shows the accounting deficit of defined benefit (DB) pension schemes for the UK's 350 largest listed companies was an eye-watering £152bn as at 30 September 2016. This highlights the scale of the funding challenge facing DB scheme trustees, deficits near an all-time high, compounded by the time horizons for securing benefits continuing to fall.

Against this backdrop it's hardly surprising that fiduciary management services continue to be in demand, helping trustees to deliver on the pension promises made. Clearly each scheme's circumstances differ dependent on the current funding levels, sponsor covenant and the scheme demographics. Trustees need to carefully consider all of the issues against the backdrop of their own circumstances, and set out their key strategic objectives to meet the liabilities. These will reflect both their investment beliefs and the sponsors' commitment.

It is important to firstly understand the 'end-game' as this will influence the investment strategy implemented. Our fiduciary management business assists trustees in setting out the most efficient journey plan, the optimal investment strategy and short terms targets (for example de-risking triggers).

Having set out a realistic journey plan, with the trustees and employer on the same page, it is then important to understand how the journey plan will be executed and how short term risks can be managed. Trustees need to manage an increasing number of short-terms factors along the journey.

With a sharp fall, and subsequent rebound in bond yields over 2016, market volatility and generous equity valuations, governance models need to be able to cope with the ever faster changing environment. Added to this schemes are increasingly becoming cash-flow negative, bringing with it an increasing focus on funding level volatility. Against this backdrop we helped clients significantly improve their funding levels against the average FTSE 350 pension scheme.

Solving the investment puzzle

A great investment structure is like a jigsaw puzzle, it consists of a number of pieces that need to be joined together in the right order to provide the complete picture. We believe there are six key pieces in building a robust structure:



Using a traditional governance structure trustees have often focused on one piece of the puzzle at a time rather than considering them as a complete picture, and how they interact with each other.

Given decisions on investment strategy, hedging and asset allocation need to be much more dynamically managed than was previously the case, the answer for an increasing number of trustees is to delegate decisions they previously made themselves to a fiduciary manager.

Flexible governance model

Fiduciary Management has evolved a considerable amount since its inception, the way in which the various elements (see below) can be used, and the extent to which decisions can be delegated has changed. As providers achieve scale, new technology and capabilities allow each element of the service to be tailored to the schemes specific circumstances and governance requirements. Rather than a 'loss of control', this is a service to complement and implement the strategic decisions reached by the trustees.

As well as bringing all pieces of the jigsaw together in a more efficient way, fiduciary management can also bring benefits to each individual jigsaw piece as well.

The benefit of fiduciary management is you don't need to buy the whole jigsaw, trustees can just employ the fiduciary manager for the bits that are missing, or need enhancing in their current arrangements. Many schemes now utilise a few of the services,

Jigsaw Piece	Fiduciary Benefit
Investment Strategy	<ul style="list-style-type: none"> Daily oversight of strategy and funding level against target Dynamic de-risking to lower risk as and when affordable
Asset Allocation	<ul style="list-style-type: none"> Access to a greater range of asset classes Implementation of illiquid portfolios to target
Manager Selection	<ul style="list-style-type: none"> Multiple best in class managers per asset class Efficient and timely replacement of investment managers
Hedging Decisions	<ul style="list-style-type: none"> Bespoke liability hedging portfolios Dynamic changes to hedging linked to interest rate movements
Market Awareness	<ul style="list-style-type: none"> Timely implementation of best ideas Portfolio tilts to asset classes with current attractive returns
Risk & Operational Control	<ul style="list-style-type: none"> Holistic risk management and oversight of overall portfolio Daily operational and cash flow management

	Fiduciary Approach	Pre-Fiduciary Approach	Benefit
Asset Growth	114%	69%	+45%
Funding Level	86%	68%	+18%

The chart above shows Mercer's first full fiduciary client in the UK to highlight how their journey has evolved over the last 6 years:

- When the client switched to a fiduciary approach their 60% allocation to growth assets was retained, however their interest rate hedging was significantly increased, thus reducing the overall risk in the portfolio.
- We had agreed funding level triggers with the client. The funding level was monitored daily and when a trigger was reached, assets were switched from the growth portfolio and invested in matching assets to further lower the funding level volatility. Since inception the client has seen growth assets reduce from around 60% down to 20%.
- During their fiduciary journey the scheme has experienced a 75% reduction in risk.
- The client is now working with us to consider buy-out, and finish the journey they started.

configured to their specific needs. Sometimes creating and managing a bespoke growth portfolio, or a de-risking portfolio, sometimes solely using the investment infrastructure to release the legal and operational burden, and access the platforms considerable economies of scale. This flexible approach to managing investment governance has helped increase the use of fiduciary management within the UK.

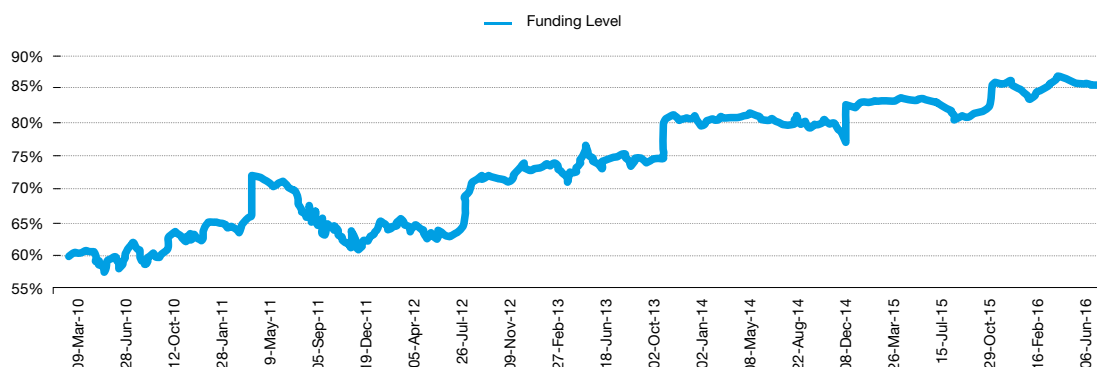
Building a better picture

The early adopters of Fiduciary Management now have meaningful track records of 5 years+ which can provide evidence of whether a fiduciary management approach has made a difference to the outcome for pension schemes.

Final thoughts

The continued time and governance challenges faced by trustees, coupled with the increased uncertainty of future events means fiduciary management is increasingly likely to be considered as a way of helping trustees manage their journey to securing the benefits.

Actual client experience



2017: the year for being nimble

Hannah Simons
Fiduciary manager
Schroders



According to the Pension Protection Fund (PPF)*, the average defined benefit pension scheme has experienced a “lost decade” – 10 years when funding levels have not improved despite significant payments from employers. And the uncertainties look set to continue this year. Whether it is the newly inaugurated Donald Trump as US president or elections in the Netherlands, France, Germany and possibly Italy, few are sanguine about the prospects for political stability in 2017. The result is that market volatility is back and likely to be with us for some time.

But every cloud has a silver lining and volatility also means opportunity. While liabilities may be difficult to pin down in this climate, growth assets can do well at such times. Whether it be managing erratic funding ratios or exploiting investment opportunities, it will be more important than ever for pension schemes to be both prepared and nimble.

Widen the search for matching assets

Schemes can prepare in a number of ways. Many already use liability-driven investment (LDI) approaches which should come into their own in these conditions. By locking in liabilities to matching assets, trustees can sleep that bit easier at night. However, while growth assets remain available for those able to accept the risks, the bigger problem has been finding bonds that are attractively priced for matching purposes. Government bonds (gilts) are particularly problematical right now, given that real yields on most are negative. This means liabilities – and therefore provisions – remain high, increasing the pain for the growing number of schemes whose contributions from the sponsor and members are insufficient to cover the pensions they pay out. In the absence of help from contributions, such schemes need to make their assets work harder.

One possible option for trustees in this situation is to seek an affordable solution by adopting “cashflow-driven investing” (CDI). Instead of a traditional growth portfolio using gilts, CDI uses corporate bonds and other credit assets which can provide both low-risk growth and the ability to match liabilities. Although it can be implemented on its own, CDI can achieve an even closer cashflow match between assets and liabilities if it is combined with a traditional LDI portfolio. The higher expected return of CDI assets relative to a gilt portfolio means a scheme

can achieve a close match with liabilities while maintaining the outperformance assumed in the technical provisions. For those trustees looking to manage their pension scheme on a long-term basis there are also potential cost benefits when compared to buyout pricing. Furthermore, CDI portfolios can often represent a “set and forget” approach, making them low maintenance for trustees.

Outsource the effort

If indeed we do see heightened volatility this year, it will be more important than ever that growth assets are managed flexibly, decisively and speedily. In other words, investors will have to be nimble if they are to climb the ladders and avoid the snakes. Unfortunately, that is inherently difficult for trustees who may meet only once a month or even once a quarter and who do not have the time and resources necessary to run investment portfolios effectively. In these circumstances, it will make increasing sense to sub-contract the management of all the growth assets.

This delegation can take a number of forms, but it need not be radical. A few larger schemes may be able to recruit their own investment experts to do the work. For others it may simply be a question of handing management responsibility to a small sub-committee that combines expertise with expedition. For a much larger number of arrangements, however, it is likely to be more cost-effective to let outside professionals take over the day-to-day management of not just the scheme’s growth assets, but also the liability-matching portfolio as well.

Apart from the gains in flexibility and speed, this should allow greater specialisation and more accountability. Trustees can discuss and agree both their objectives and favoured strategy for achieving them directly with the manager. Suitable financial incentives can be agreed to ensure that both manager and client are pulling in the same direction. That manager can then implement the decisions directly and be directly responsible for the results.

Move to manage risk

Of course, being nimble in volatile markets may not be enough. However good they are, active managers may not be able to

take avoiding action if markets dive. Schemes that want greater protection may need to have at their disposal more systematic approaches. This could involve taking out “loss insurance” in the form of downside risk protection using, say, put options. Such insurance can be expensive, however, it could be combined with – or replaced by – strategies that systematically control equity volatility.

These approaches will be more effective if the same manager also manages the liability-matching portfolio and provides asset allocation advice. In what could be a difficult investment environment, such unity of advice could be invaluable. While the scheme may have a long-term de-risking plan, it is important that it retains the flexibility to deviate from that strategy from time to time. Having a manager on call should allow changes of tactics to be undertaken nimbly as circumstances change.

A single manager totally aligned to the objectives of the trustees with an overarching view of the whole portfolio is much better placed to advise on the scheme’s strategy. A single manager with all-round vision can much more easily decide the tactics to adopt and the risks to avoid. Any such manager should clearly have access to, and knowledge of, a wide range of investment tools and approaches in a selection of investment vehicles to suit different risk tolerances and budgets. Moreover, by having a single manager with access to a rich palette of investment approaches, both the growth and liability portfolios can be better tailored to the needs of the individual scheme. The result should be better and more timely decisions, which should in turn feed through into better results for scheme members.

*Source PPF: December 2016

A calendar pregnant with possible market shocks



January 2017

Greek debt restructuring

January 2017

President Trump inaugurated

Early 2017

UK pensions green paper published

March 2017

UK to trigger article 50

March 2017

Netherlands general election

March 2017

German state election in Saarland



April/May 2017

French presidential election

May 2017

German state elections

June 2017

French general election

September 2017

Planned Catalonia independence referendum

October 2017

German general election

May 2018

Italy general election

Sources: <http://www.zerohedge.com/news/2016-11-08/election-fatigue-we-have-bad-news-you>



Schroders

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Breaking the stigma: addressing conflicts in fiduciary management

Surveys show a low number of pension schemes taking independent advice when selecting a fiduciary manager. But is that really the case? And does it actually matter? *Sebastian Cheek* finds out.



“ We’ve taken five clients to the end of that journey and they’re no longer fiduciary clients of Mercer. ”

Tim Banks, Mercer

Fiduciary management (FM) continues to gather UK pension scheme assets. According to KPMG’s latest survey, the discipline has seen nine consecutive years of growth and now accounts for £123bn of scheme assets under management across 719 mandates – 459 full and 260 partial.

In the past six months the pension schemes of McDonald’s, electrical engineering firm Sevcon and the University of St Andrews have passed investment decision-making to fiduciary managers, all citing governance reasons for the decision.

St Andrews said it wanted to get the best ideas and expertise into the portfolio without the need for the trustees to select, review and monitor multiple managers. For Sevcon, it was about stabilising volatility in its funding level and having the right investment managers in place to do that. McDonald’s meanwhile, said FM would enable the trustee directors to focus their time on decisions that matter most to the outcome for members.

However, despite the uptick in mandates, there remains a lack of schemes going out to the full market when

tendering managers. The KPMG survey found 33% of new appointments in 2016 were advised by a third-party compared to just 23% in 2015. However, the percentage of schemes using an independent provider to monitor their FM mandate was a lot lower at just 13% in 2016.

GREATER DUE DILIGENCE

Despite KPMG’s findings, it appears that schemes’ overall level of due diligence when selecting fiduciary managers has actually jumped up a notch over the past year.

Aon Hewitt’s latest fiduciary management survey found 67% of the 250 DB schemes it quizzed used a beauty parade or site visit when appointing a manager, while 55% used formal RFPs. This was up slightly on the year before when 65% opted for a beauty parade and 35% chose a site visit.

According to Sion Cole, partner and head of European distribution at Aon Hewitt, the results show schemes are beginning to take a thorough approach to selecting a fiduciary provider.

“To put this in context,” he adds, “80% of our new fiduciary mandates over the

past 24 months have been won from a full competitive pitch process.”

This chimes with the experience of Mercer Investments principal Tim Banks who, speaking at PI’s fiduciary management roundtable (see p4), said every sales process Mercer now goes through is an open tender.

“It may not have been the case four years ago, but it is today,” he added.

Anthony Webb, head of fiduciary research, investment advisory at KPMG, believes the percentage of appointments advised by a third-party will creep up from its current low base. Webb believes this is because trustees now have a better idea of their limitations and recognise that they cannot do adequate manager selection and monitoring themselves. He adds the low numbers of third-party advice can be explained by two commonly held perceptions among schemes.

Firstly, some schemes don’t appreciate that moving into a fiduciary mandate is a big change; this is particularly the case with schemes moving into a mandate with their existing supplier.

“We would disagree with that because it does have big implications for how

your scheme is run,” he adds.

Secondly, Webb claims there is a perception among some schemes that bringing another party into the relationship can add complexity and more cost – this is a bigger issue for smaller schemes where the cost is a larger proportion of assets.

CONFLICTS

An increasing level of due diligence is a promising development for the industry, but FM is still struggling to break free from the stigma of conflicts of interest and lack of performance monitoring inherent in the industry.

The Financial Conduct Authority’s (FCA) industry-rocking interim report on asset management, published late last year, highlighted “concerns” over the need for greater and clearer disclosure of fiduciary management fees and performance, especially from investment consultants.

As such, the watchdog is consulting on making a market investigation reference to the CMA on the investment consultancy market.

The report said: “We have concerns about conflicts of interest that arise in fiduciary management, which is increasingly offered by investment consultants and fund managers. These issues are exacerbated because investors cannot assess whether the advice they receive is in their best interests.”

The ‘flipping’ of traditional consulting mandates into fiduciary ones is taking place and there is no doubt investment consultants with FM operations are continuing to eat into asset managers’ territory.

Indeed, KPMG’s report highlights that consultants still own the lion’s share of UK FM mandates. It found with regard to full mandates in 2016, consultants ran 339 of them, 74 were run by specialists and 46 by investment managers.

In addition to conflicts, the bespoke

nature of fiduciary makes it difficult to truly measure success. In terms of monitoring a FM mandate, providers argue it is like comparing apples with pears because each scheme has its own parameters, constraints, risk appetites and is on a different part of its journey.

FM is also a relatively new discipline meaning many mandates have not been running long enough to adequately judge performance.

EXTERNAL MONITORING

One way to judge if a fiduciary manager is performing how it should is to appoint a third-party monitor to oversee a mandate once it is in place. The appointment of such external monitors is on the rise, but that is coming from a very low base (13% of mandates in 2016, according to KPMG’s study).

According to Aon’s survey, performance is the number one quality that schemes consider when selecting the fiduciary provider. But when it comes to how schemes like to measure this performance, the vast majority (87%) of those surveyed prefer to measure performance relative to their scheme’s specific investment objectives, rather than a generic industry standard.

But an industry standard is exactly what IC Select, a specialist oversight and selection firm, is currently putting the finishing touches to. According to the firm, the industry needs a common standard because the current performance information provided by FMs does little to help trustees understand how value will be added to the scheme because each manager presents something different.

IC Select says the aim of the standard therefore, is to agree a standardised methodology for data calculation and presentation of FM performance information. In order to do this, it will form ‘composites’ comprised of similar funds that are grouped together with

performance and risk calculated on an average basis, rather than the performance of just the best fund.

SEVERING THE TIES

But what if a scheme is not happy with the performance of its FM and wants out of the arrangement? For BESTTrustees chairman Alan Pickering it is important FMs understand that trustees might want to bring the responsibilities back in-house at some point.

“A differentiator may well be the willingness and ability of delegated managers to provide you with an easy exit route that doesn’t torpedo their business model, but allows you to mix and match externalisation and internal delegation,” he said at PI’s roundtable.

A scheme could simply decide the strategy is not working and want out, or it could reach a certain point in its de-risking journey, or a point where a buy-in makes sense, and no longer require a FM to steer the ship.

Speaking at the same roundtable, Celene Lee, principal at Conduent HR Services, which acts as a third-party selector and monitor of FM mandates, said clients of hers had gone into fiduciary and then considered exiting it, because they felt that the arrangement was just too complex.

“At the end they decided not to [exit] because once you’ve got all the assets with one manager the cost of exit was actually too high for them to really have the conviction to go elsewhere,” she added.

During the same discussion, PTL client director Alison Bostock queried what happens in a situation where a scheme reaches the point when it is mostly sitting in gilts ahead of a potential buy-in and no longer requires a FM.

“Are you then needlessly paying for some level of active management and advice that you don’t need?” she said.

This begs the question: do fiduciary managers write break clauses into their

contracts? After all, it is not in their commercial interest to terminate a mandate with a client even if it has reached self-sufficiency.

Mercer's Banks says securing a scheme's benefits is the main aim of fiduciary management, even if it means losing that scheme as a client.

"We've taken five clients to the end of that journey and they're no longer fiduciary clients of Mercer," he says.

"So it's having that transparency of record that you are doing the right thing on behalf of your client, right the way through to securing the benefits."

According to KPMG's Webb, it should not be a problem for schemes to easily move from one provider to another, but he warns those looking to switch to be mindful of being inadvertently locked into illiquid assets.

He says: "If you have a private equity mandate you could be stuck with it for more than 10 years, and that might mean being stuck with your fiduciary manager for that period as well."

Trustees should therefore understand exactly what is in the underlying portfolio to avoid a situation where they are constrained, despite the contract saying they can leave.

Schemes should also familiarise themselves with the conflicts of interest inherent in these models, as with all relationships in the investment sphere whether advisory or delegated.

As Pickering observes, this is nothing new as delegation has been at the heart of trusteeship ever since trusteeship was applied to pension schemes.

"The challenge for trustees is that when I first became a trustee there was a clear distinction between consultants who sold advice and product providers who sold products," he adds.

"Trustees have now got the challenge of weighing up the relative merits of consultants who want to sell products and product providers who want to sell advice."

“ Trustees have now got the challenge of weighing up the relative merits of consultants who want to sell products and product providers who want to sell advice. ”

Alan Pickering, BESTrustees



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