



# Pension Scheme Lifecycle and the Role of a Fiduciary Manager





## What is "Fiduciary Management"?

Fiduciary management (or "FM") is a way of managing assets that includes both advice on how to invest, and the implementation of that advice. This is an increasingly common way to manage assets for UK pension trustees in particular.

Under a traditional consulting model, this advice comes from their investment consultant; whilst under an FM model, a number of the investment decisions are delegated to the fiduciary manager. Importantly, under both approaches, the Trustees will retain responsibility for setting, monitoring and meeting the investment objectives.

## Introduction

An important consideration for all pension scheme trustees, primarily for defined benefit schemes, is setting an appropriate long-term objective and outlining how they are going to get there, commonly referred to as journey planning.

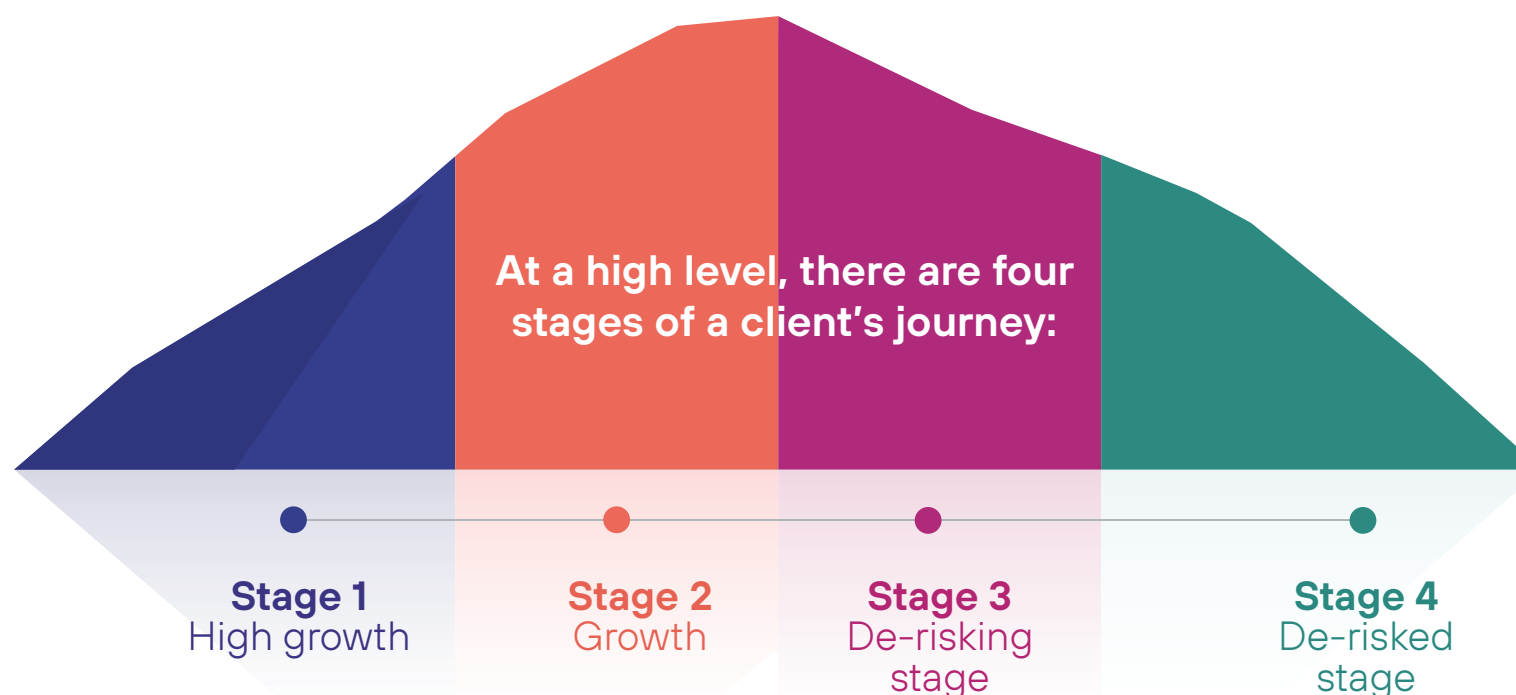
As part of their role, fiduciary managers will support pension scheme trustees in developing and implementing the scheme's journey plan. The 'journey' of the pension scheme to its agreed end position is what we refer to as the 'pension scheme lifecycle'.

Isio believe that at different stages of the lifecycle fiduciary managers should be offering a different service to pension schemes, reflective of the evolving requirements of the scheme's investment strategy in terms of return, risk, liquidity, income and so on.



We would describe the pension scheme lifecycle in four key stages: high growth, growth, de-risking and de-risked.

The investment journey through the stages can be likened to climbing a mountain. First you are in a stage of high growth, as your investments have a lot of work to do to get to your final objective. As you get closer to the peak, you can afford to remove some growth as you become more certain that you will reach your end-goal. When you reach the peak, different skill sets are required to get you where you need to be, so you de-risk and take a steady decline to a de-risked state, eventually reaching your end objective.



## What will I get out of this paper?

Based on market data from our 2021 FM survey, there are still a significant number of Schemes at each stage of the pension scheme lifecycle. However, what has been evident in recent years is a transition towards the latter stages, with defined benefit schemes maturing, setting long term objectives and journey plans to achieve this.

Whilst we acknowledge that the scheme's investment strategy is not the only input into a scheme's journey plan, it is a key factor. In this paper we will explore, in our view, how a scheme's investment strategy and a fiduciary manager's role should evolve. We suggest what should be the key focus for trustees at each of the different stages.

After all, no matter the stage you are at in your journey, it is critical that your investment strategy is relevant - and you have an investment service (and fee) from your fiduciary manager that is appropriate for the job they need to do.



# Stage 1 – High growth

2% of Schemes in the 'high growth' stage in 2021<sup>1</sup>

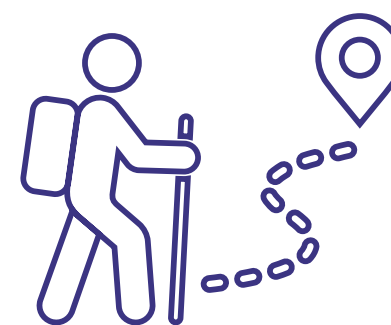
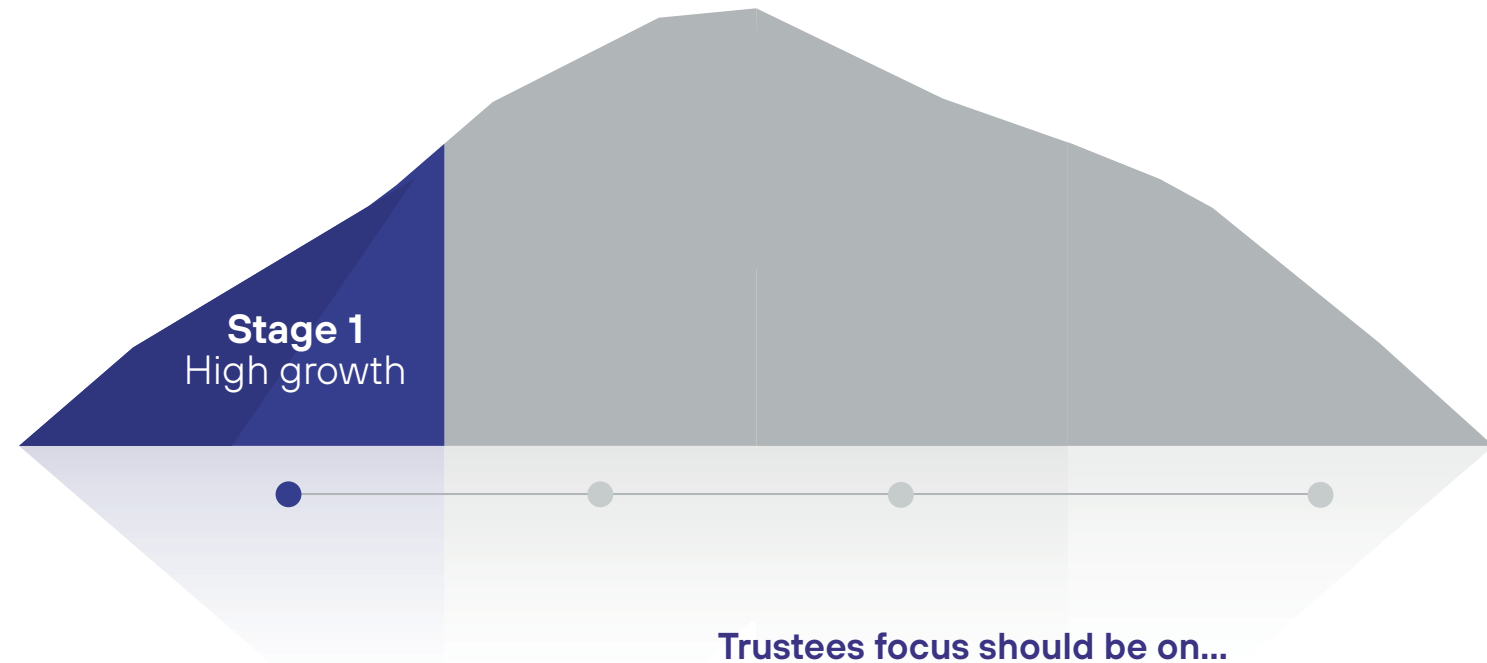
## What does the 'high growth' stage mean for schemes in terms of their portfolio and requirements?

A scheme in the high growth stage will be targeting a high investment return (for example, above Gilts + 3.5% p.a.) with a long-time horizon until the end of the scheme's journey. Given the long-time horizon, the scheme will have a relatively high tolerance for risk, (assuming the sponsor covenant can support it) relying on a substantial allocation (c.50%) to high returning growth assets to drive return. They will be able to invest in illiquid assets given that liquidity requirements are limited over the short to medium term.



## What aspects of the fiduciary manager's tool kit will be utilised at this stage?

- **Dynamic asset allocation** – Potentially make more dynamic changes to asset allocation within the portfolio to take advantage of attractive market opportunities.
- **Active management will be utilised** – To generate high returns, either by selecting external active managers or using active management within their own funds.
- **Portfolio construction** – Use expertise to manage and implement complex portfolios, with allocations to more 'niche' asset classes.
- **Illiquid investments** – Utilise illiquid investments to gain an illiquidity premium.
- **Liability-Driven Investment ("LDI")** – Ability to implement LDI effectively, reducing the impact of changes in interest rates and inflation between the assets and the liabilities, given their visibility over the scheme's entire portfolio. Higher leverage may be used at this stage given allocations to LDI may be smaller. FM portfolios tend to have high hedging targets (maximising the protection of any impact from fluctuations in interest rate and inflation) regardless of the stage of the journey plan.
- **Quick execution and implementation** – This can influence their ability to take advantage of attractive market opportunities (if they pick the right ones!) or to protect the portfolio.



## Trustees focus should be on...

- ✓ **Fees** – Responsibilities of a fiduciary manager during the high growth stage tend to be more complex and higher risk in nature. Therefore, fiduciary managers may charge relatively high fees at this stage. Underlying manager costs are also higher where active management is used, and performance fees will increase when high returns are achieved.
- ✓ **Risk** – Trustees need to be comfortable with the level of risk the scheme is running to generate the high level of return.
- ✓ **Volatility** – Higher risk growth assets are more volatile which, coupled with potentially lower exposure to LDI to manage liability movements, creates greater volatility for the scheme's funding level.
- ✓ **Communication** – With funding level volatility at its highest, it is particularly important that the fiduciary manager keeps trustees well informed.
- ✓ **Assessment** – There is greater reliance at this stage on strategic asset allocation and manager selection to add value. Are trustees sure that their fiduciary manager is making successful decisions for the scheme?

1. Source: Isio's 2021 Fiduciary Management Survey



## Stage 2 - Growth

24% of Schemes in the 'growth' stage in 2021<sup>1</sup>

### What does the 'growth' stage mean for schemes in terms of their portfolio and requirements?

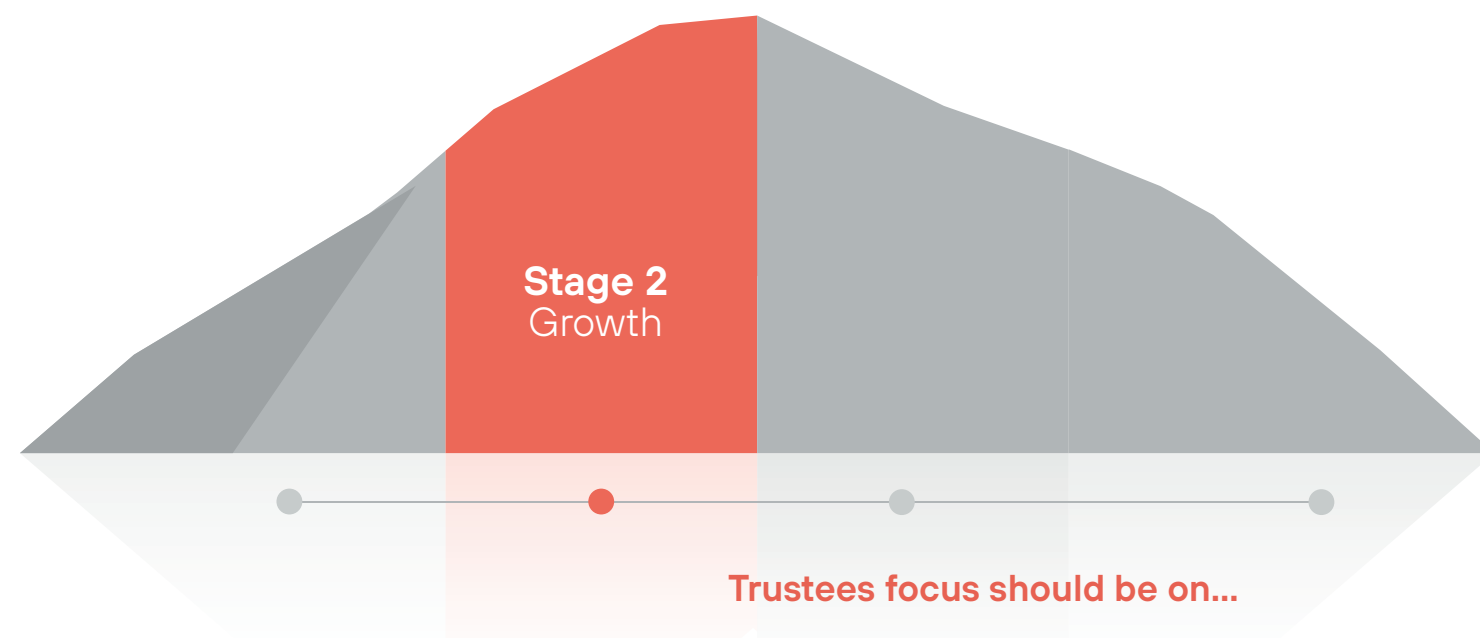
As a scheme's funding level improves, the scheme will gradually begin to remove risk. Schemes will typically move from a period of 'high growth' to a stage of 'growth' as an intermediate step.

The return requirement within the 'growth' stage is high, but reduced (for example, Gilts + 2.5% - 3.5% p.a.) having similar implications for the risk tolerance. Portfolios with this return requirement will typically have a high exposure to growth assets, but with less reliance on higher risk growth assets. As time progresses, illiquid allocations will gradually begin to unwind, distributing income and capital. The Scheme may be minded to increase the allocation to liquid credit assets as a result of lower allocations to high risk growth. With less pressure on the scheme's return target, the scheme may increase liability hedging if affordable.



### What aspects of the fiduciary manager's tool kit will be utilised at this stage?

- **Diversification** – Implement complex, diversified portfolios. Increased diversification within the growth portfolio can be used to reduce risk.
- **Journey planning knowledge and expertise** – Guide the scheme in implementing a de-risking framework, setting triggers for future de-risking as the funding level continues to improve.
- **LDI** – Allocation to LDI may be increased as capacity frees up from growth assets.
- **Quick execution and implementation** – This will allow fiduciary managers to take advantage of de-risking opportunities quickly, as well as attractive market opportunities to maintain the required level of return.



### Trustees focus should be on...

- ✓ **Risk** – The risk that the scheme is running, and if it remains appropriate, or if further de-risking should take place. Fiduciary managers should be revisiting high risk growth assets and considering their future as part of the portfolio. The level of risk taken, and therefore the investment strategy, should be rigorously anchored to the scheme's objectives.
- ✓ **LDI** – Where the fiduciary manager has discretion, they should be implementing higher hedging levels for the scheme.
- ✓ **Fees** – Fees are likely to remain at a similar level. However, trustees may want to begin reviewing their fees with their fiduciary manager as complexity is removed from the strategy (perhaps even negotiating a declining fee schedule as the scheme de-risks).
- ✓ **Communication** – Expect their fiduciary managers to be talking about whether they are on track to meet their long-term funding objectives and setting a clear plan to reach these objectives.
- ✓ **Assessment** – Continually assessing their fiduciary manager to check they are making good progress along their journey.



1. Source: Isio's 2021 Fiduciary Management Survey

# Stage 3 - De-risking

41% of Schemes in the 'de-risking' stage in 2021<sup>1</sup>

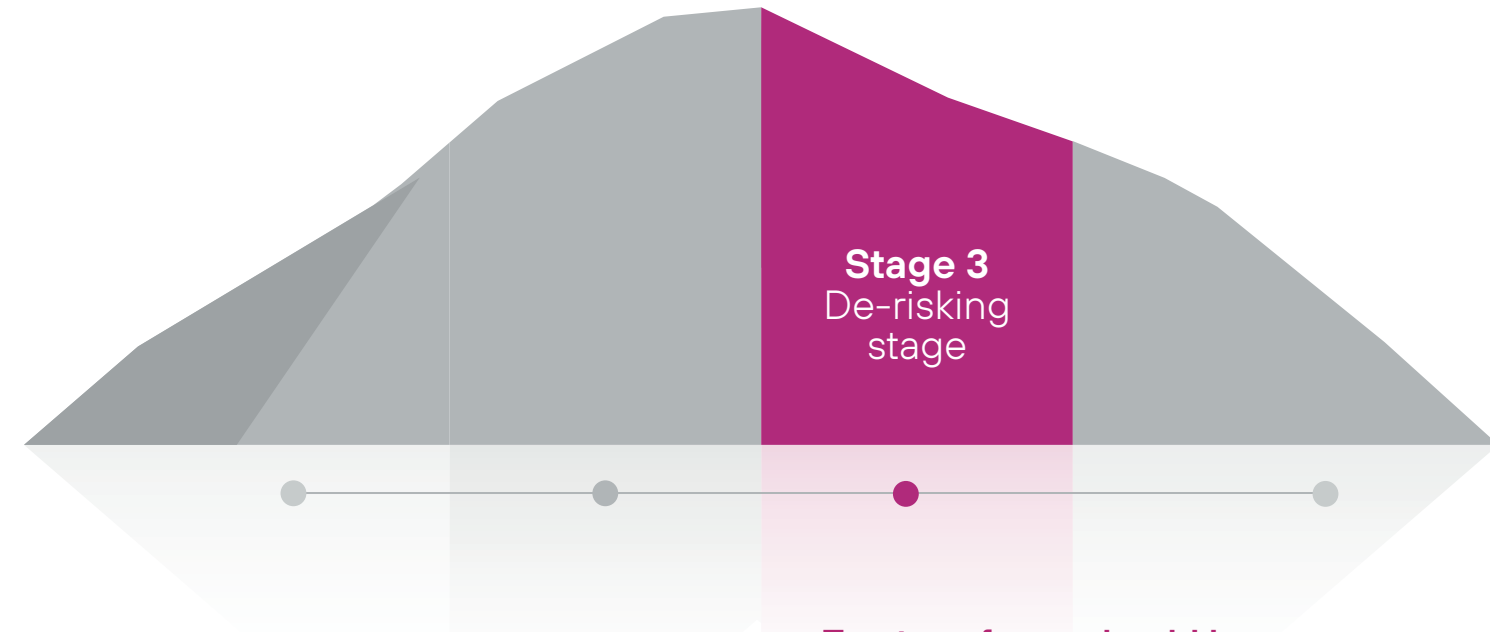
## What does the 'de-risking' stage mean for schemes in terms of their portfolio and requirements?

When the scheme becomes sufficiently close to its funding objective it will enter the 'de-risking' stage. During this stage the requirements for return (Gilts 1.5 – 2.5% p.a., for example) and risk are lower. A key focus will be to increase liquidity in the portfolio. There will also be a large reduction in growth assets within the portfolio, likely materially reducing high risk growth assets such as equities. Liability hedging should be a key component of the portfolio now, with a 100% hedging target to protect against interest rate and inflation risk. The scheme may also start looking into cashflow matching strategies or insurance options, such as a partial buy-in.

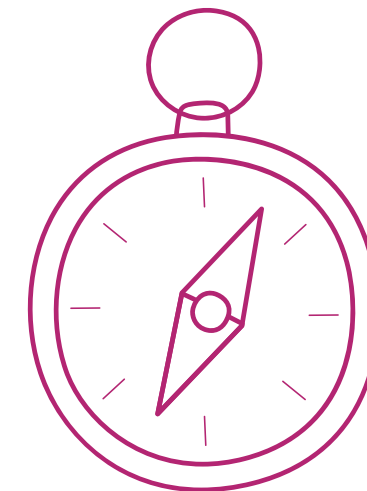


## What aspects of the fiduciary manager's tool kit will be utilised at this stage?

- **Funding triggers for de-risking** – Monitor funding levels closely and reduce risk when it is appropriate to do so. Some may implement de-risking triggers, where they reduce risk within the portfolio when the scheme reaches a predetermined point, for example, at a certain level of funding.
- **Quick execution and implementation** – Allows fiduciary managers to de-risk quickly and efficiently.
- **Portfolio construction** – Typically have good experience in building insurance friendly portfolios. They can also build portfolios to match scheme cashflows with income generated by scheme assets.
- **End-game capabilities** – Begin pitching their end-game capabilities (for example, their expertise in helping schemes move to buy-out) with the trustees. Our research has shown that some fiduciary managers have in-house teams who can assist with insurance transactions, but not all. It may be worth considering other steps to plan for end-game such as data cleansing.
- **LDI** – LDI allocation is likely to be optimised as a risk management tool. Fiduciary managers can implement effectively.



## Trustees focus should be on...



- ✓ **Fees** – We would expect fiduciary management fees to reduce as the scheme reaches the later stages of its journey, given that the nature of the fiduciary manager's role is typically less onerous. However, this will depend on the individual circumstances of the scheme. Manager fees should fall as the scheme will be moving away from asset classes with a high level of manager skill.
- ✓ **Risk** – If they still have high allocations to riskier growth assets and if there is a plan in place to remove these.
- ✓ **Communication** – Fiduciary managers should have communicated a plan to the trustees for achieving the scheme's long-term funding objectives.
- ✓ **Return** – Be wary that the scheme is still hitting its return targets with risk being removed from the portfolio.

1. Source: Isio's 2021 Fiduciary Management Survey



# Stage 4 - De-risked

33% of Schemes in the 'de-risked' stage in 2021<sup>1</sup>

## What does the 'de-risked' stage mean for schemes in terms of their portfolio and requirements?

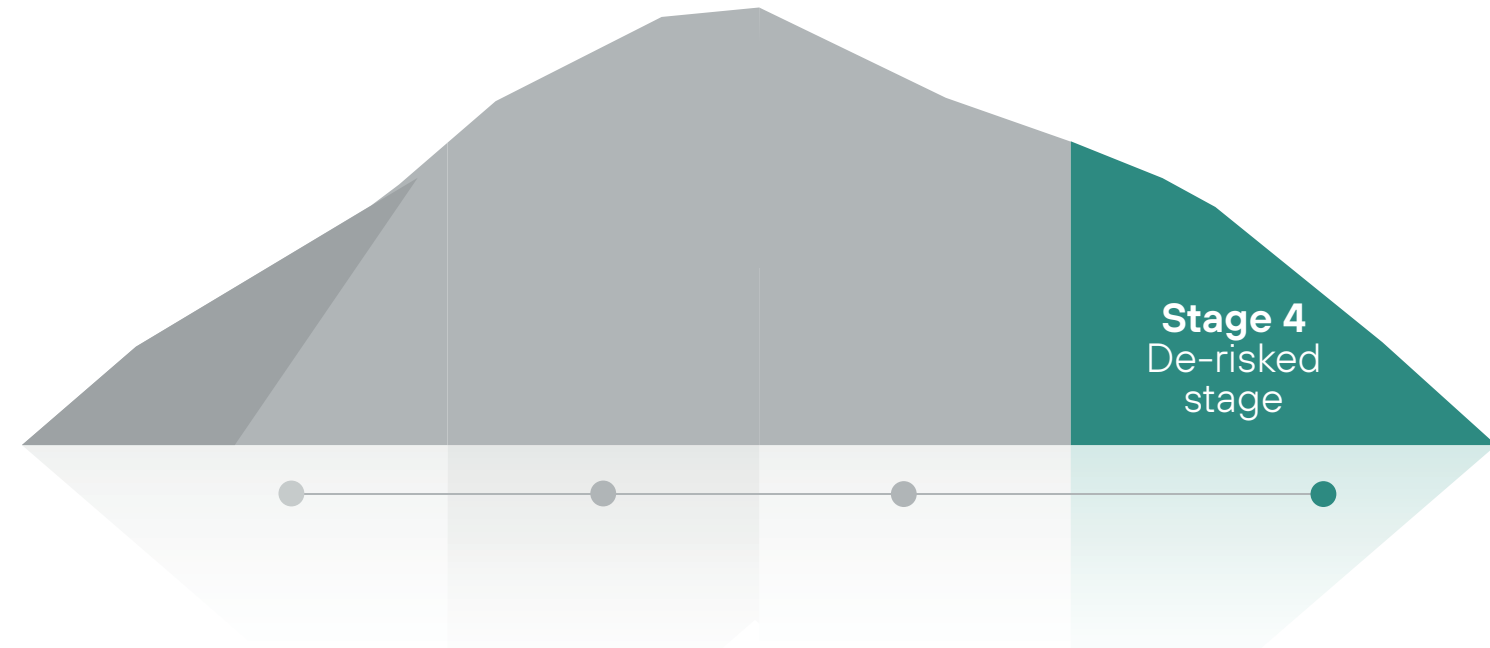
A scheme which has 'de-risked' will typically have a return target of below Gilts + 1.5% p.a., having achieved or being close to achieve their long-term objective, with the possibility of insurance transactions. Such a portfolio will have a very low risk tolerance with limited growth assets, consisting mainly of insurance friendly credit assets (assuming buyout) or alternatively, low risk credit assets. The portfolio should be highly liquid (no illiquid assets remaining in the portfolio) and should be fully hedging interest rate and inflation risk on an appropriate basis.

The scheme may require or have an insurance advisor appointed to support with the transfer of assets.



## What aspects of the fiduciary manager's tool kit will be utilised at this stage?

- **End-game capabilities** – Different fiduciary managers will have varying levels of knowledge and experience of taking clients to their chosen end-game. They may be able to provide insurance advice services in-house if required or the trustees may engage the services of another provider to assist in preparation towards an insurance transaction.
- **Portfolio construction** – Have the knowledge and expertise to construct insurance friendly portfolios.
- **Funding level oversight** – Given the fiduciary manager's role they will have close oversight on funding levels, which will help them to identify opportunities to de-risk and begin looking at insurance options.



## Trustees focus should be on...

- ✓ **Risk** – Credit default risk will become increasingly relevant to the scheme and the trustees should ensure they are happy with this risk.
- ✓ **LDI** – Expect their fiduciary manager to be using lower levels of leverage in the LDI portfolio.
- ✓ **Fees** – Consider if current fees are reflective of the service being provided. There may be additional fees to consider for insurance services.
- ✓ **Active management** – Consider if the current use of active management is still appropriate.

1. Source: Isio's 2021 Fiduciary Management Survey



# Conclusion

In this paper we have explored how a scheme's investment strategy and a fiduciary manager's role should evolve. We have suggested the key focus at each stage throughout the pension scheme lifecycle. Some further questions that trustees might consider are:



- Is your investment strategy misaligned to where you are in your journey?
- Has the funding level improved, but your asset allocation has remained the same?
- Do you increasingly need more income to pay pensioners?
- Is the prospect of buy-out a potential option for the sponsor in the next 5 years?
- Has your fiduciary fee remained stagnant despite de-risking significantly?

If you answer yes to any of the above questions, you should review your approach. Our starting point is always to improve your portfolio with your current fiduciary manager but there may be circumstances where changing is appropriate.

The table on the right provides a recap of the points made in this paper and is to help you consider if your fiduciary manager has the right tools and portfolio for you.

	High growth	Growth	De-risking	De-risked
Return target	Gilts + 3.5% p.a. and above	Gilts + 2.5% - 3.5% p.a.	Gilts + 1.5% - 2.5% p.a.	Gilts + 1.5% p.a. and below
Snapshot of Fiduciary Manager's toolkit				
Importance of dynamic asset allocation				
Reliance on active management				
Importance of portfolio construction				
Illiquid investment allocation				
Benefit of quick implementation and execution				
Funding level monitoring				



While we have provided one perspective of a pension scheme lifecycle it is important to note this may look different for pension schemes based on their specific circumstances. The progression throughout the lifecycle is also not necessarily 'one-way' – a scheme's return requirements may need to increase and the scheme 're-risk'. Whatever the lifecycle looks like for your scheme, this paper provides useful points for consideration and examples of what can be done to identify a scheme's stages, the triggers for a potential move to the next stage and support for schemes as they progress through their journey.



# Best Practice To-Do List

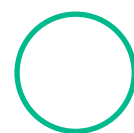
As a trustee, there are key points to consider at each stage of the scheme's journey plan. After reviewing this paper, if you feel that your fiduciary manager is not focusing on the key aspects required at each stage, we have outlined some considerations below to support your role.



## Considerations

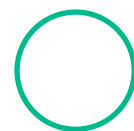
### Review your fiduciary manager at regular intervals

Moving to a different stage of the scheme's journey provides an opportunity to do this, given that the scheme's requirements change.



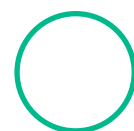
### Review the fees being paid to ensure they reflect the fiduciary manager's service

The service your fiduciary manager provides evolves along your journey and therefore your fee should be revisited at different stages. We have completed fee reviews for our clients and have found that many are paying a fee which is not reflective of the service they are receiving.



### Consider the appropriateness of the investment strategy

It is important to review your investment strategy periodically to ensure it remains appropriate and aligned to where you are in your journey. In this paper we have discussed how a scheme's requirements typically evolve and the high-level characteristics we would expect from a scheme's investment strategy.



## You might want to consider appointing a fiduciary oversight provider to help:

- Periodically review your fiduciary manager to ensure you are getting the best outcomes for your scheme while achieving value for money.
- Provide an independent view on your journey plan and how well your fiduciary manager is preparing you to get to your destination.
- Discuss with your incumbent any potential refinement to the portfolio, level of service and commercial terms.





## Contact

If you would like further information on how Isio can provide support to you throughout your scheme's journey, please contact a member of the FM oversight team.

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