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Latest trends in Fiduciary Management

2023 Isio UK Survey

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fm. Fiduciary Management Survey 2023

Snapshot of the Fiduciary Management ("FM") market 2023

The year of the gilts crisis

In our last fiduciary management survey, we talked about how market conditions had tested fiduciary manager portfolios and risk controls. This year the consequences of the gilts crisis has presented even greater challenges for fiduciary managers and the wider pensions industry. The "gilts crisis", as we now call it, occurred during September and October 2022 as gilt yields increased at an extraordinary pace following the UK government's mini-budget announcement. This caused the value of liability driven investment ("LDI") portfolios to fall dramatically, alongside the fall in value of UK defined benefit scheme liabilities. Fiduciary managers were required to source capital for LDI portfolios to maintain liability hedging targets, but faced the challenge of liquidity, meaning they weren't always successful.

This unprecedented event had a large-scale impact on the industry, arguably changing the industry forever. As all UK pension schemes faced investment challenges from this backdrop, how fiduciary management both helped and hindered has been a key theme of the year.

A dramatic decrease in assets under management for fiduciary management clients as rising gilt yields have continued to put downward pressure on asset values.

Growth in the number of fully delegated mandates has stalled – for the first time since our survey began in 2008, we observed fewer new schemes moving from investment consulting to fiduciary management.

A notable shift in target portfolios towards liquid assets, and in particular equities, to drive returns. However, in reality many schemes are "stuck" in illiquid assets and LDI.

Lower fees or revenue for fiduciary managers given the fall in assets values. Managers consider a variety of fee structures to soften the blow.

Lower risk schemes: liabilities + 0.5-1.5% is now the most common return target for FM schemes for the first time.

An increase in the use of third party evaluators to review fiduciary managers.

Click on each icon to read more

Market update

Gilts crisis dominates market

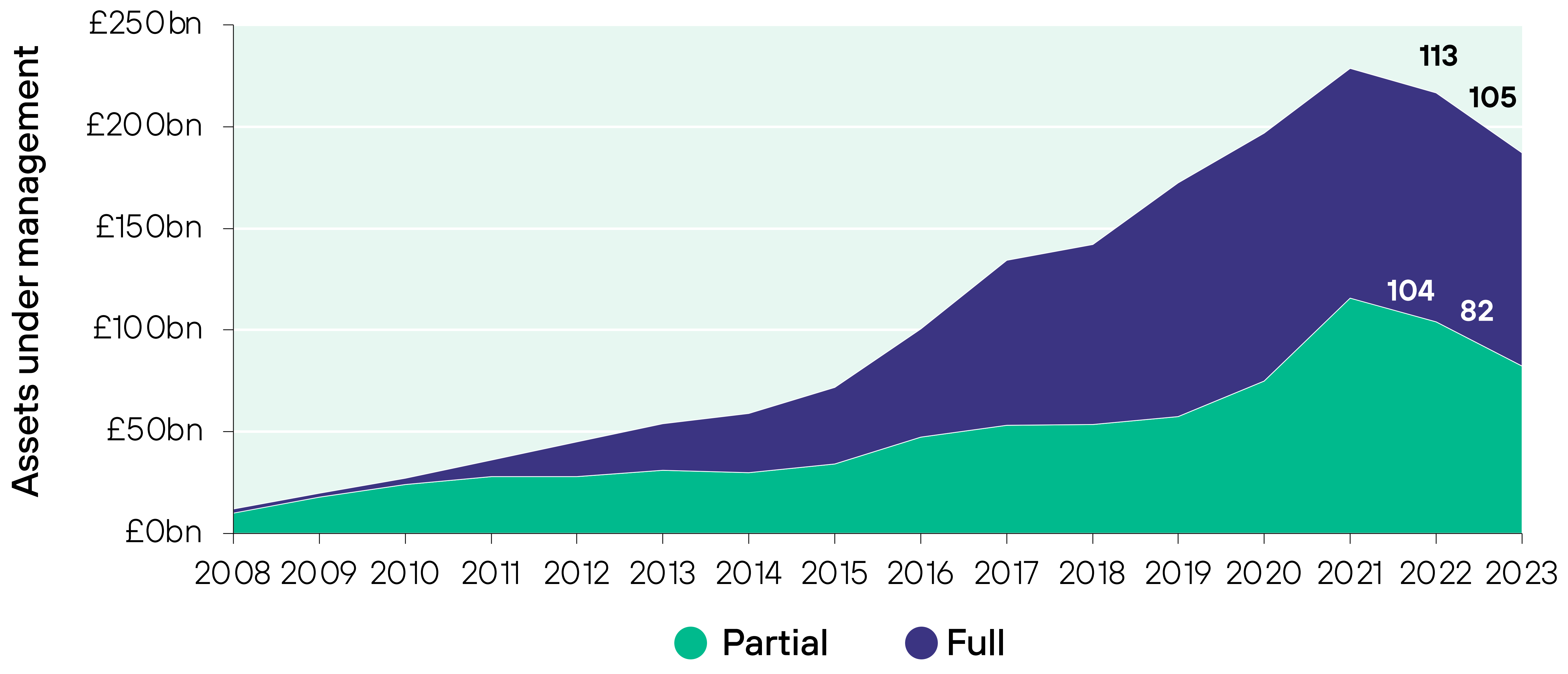
Assets under management

The gilts crisis had a significant impact on all pension schemes and those using FM were not immune. One key outcome was the fall in schemes' asset sizes which resulted in a substantial decrease in assets under management ("AUM") for the FM market.

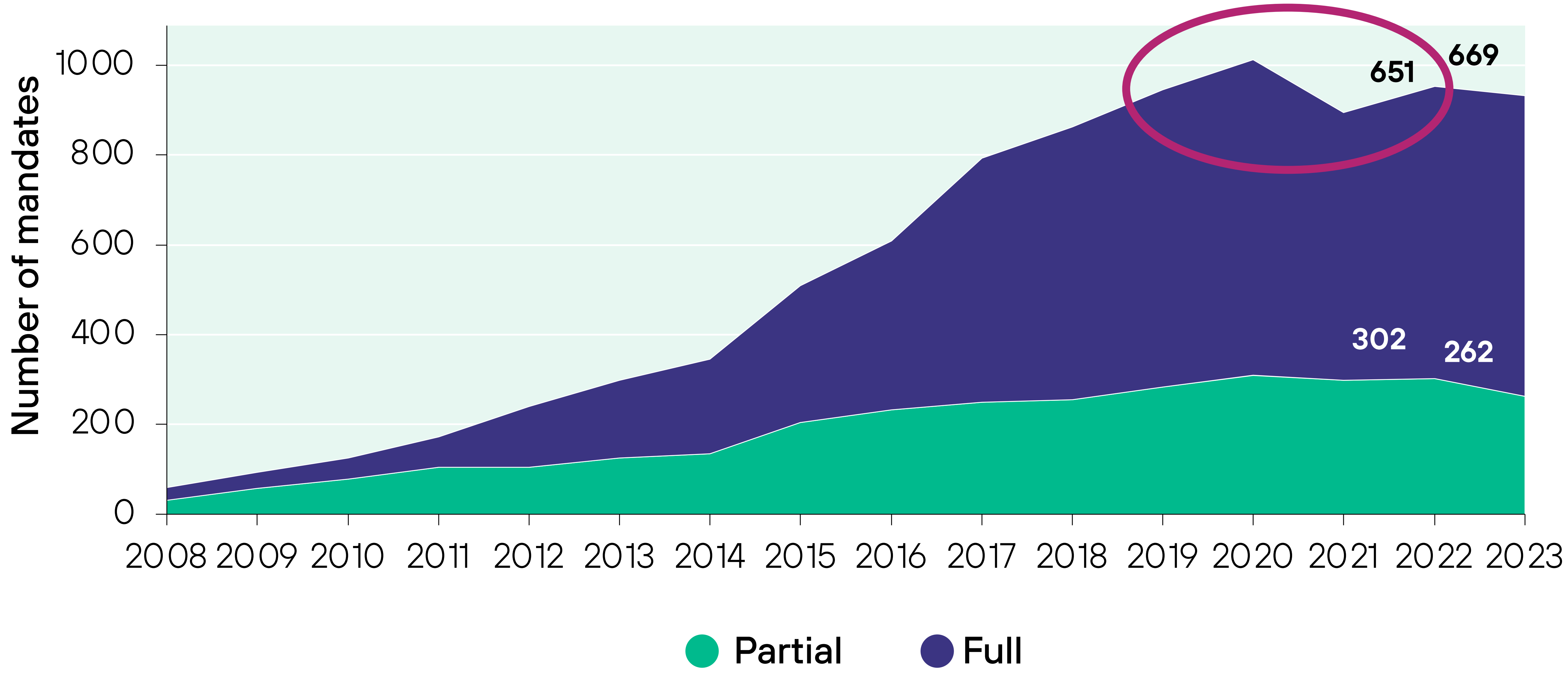
This was a result of fiduciary managers holding liability hedging assets to manage their liability risks, with those assets falling in value alongside scheme liabilities. We find this fall unsurprising given the low level of growth in new mandates and in the context of the market backdrop. The further implications of this are seen across all areas of our survey.

The impact of the gilt yield rises was prominent in 2022 and 2023, with falling AUM in both years.

Growth in Assets under Management



Growth in the Number of Mandates



Number of mandates

For the first time since our survey began in 2008, the number of schemes using FM (including full and partial FM mandates) has declined[1].

Full FM mandates **increased** by c.3%

Partial FM mandates **decreased** c.13%

[1] Other than due to reclassification impact from JLT in 2021

*This is based on our findings for the total number of UK DB schemes using full and partial fiduciary management as at 30 June 2023 compared to the number of schemes in the PPF Purple Book 2022, which is listed as 5,131 eligible UK DB schemes.

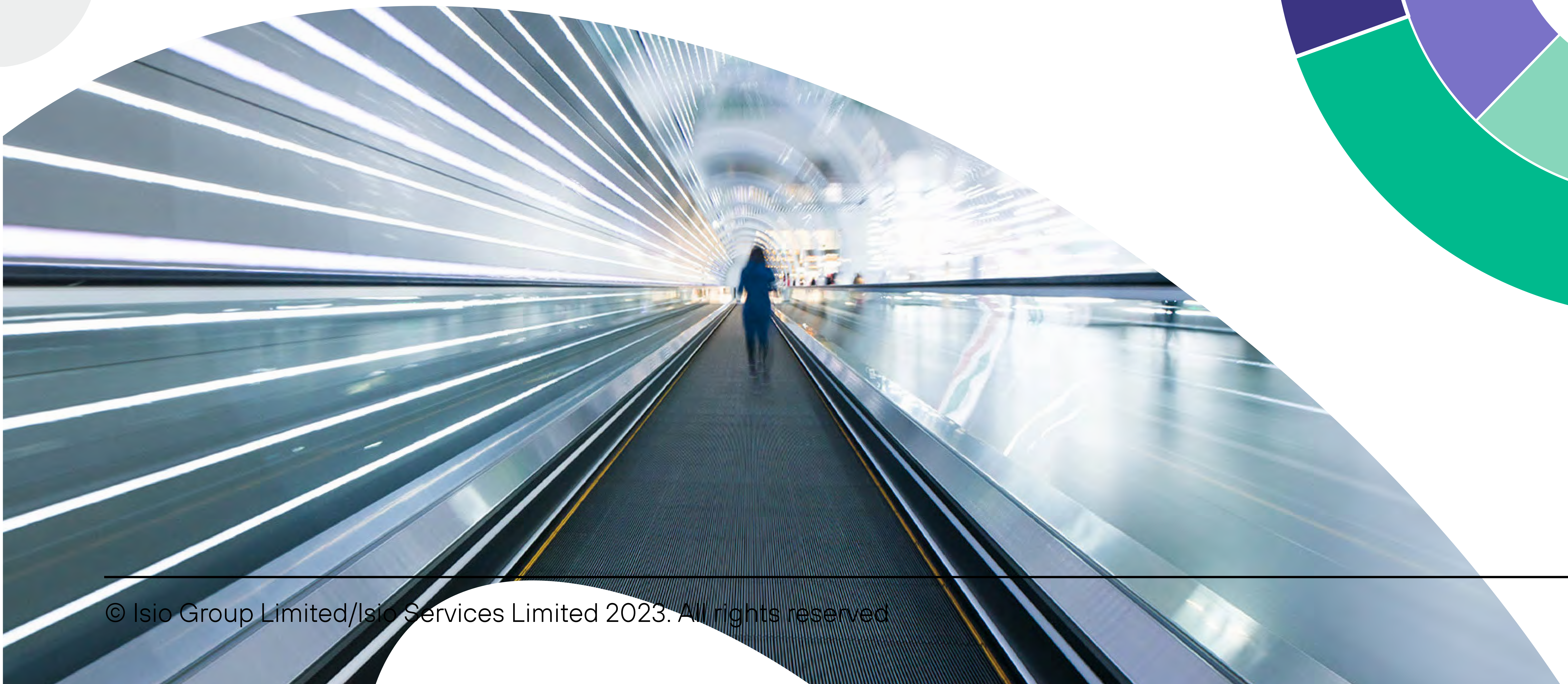
Partial mandates can take multiple forms - it may be that only a portion of the scheme assets are delegated to the fiduciary manager or only certain responsibilities. With many different reasons for schemes using this approach, it can be hard to determine the exact reason for the decrease in number of mandates. We suspect that this is due to forced strategy changes over the year, driven by a need to support hedging (particularly as partial mandates are commonly used to manage growth portfolios).

***The percentage of the UK Defined Benefit schemes using some form of fiduciary management is unchanged at 18%.**

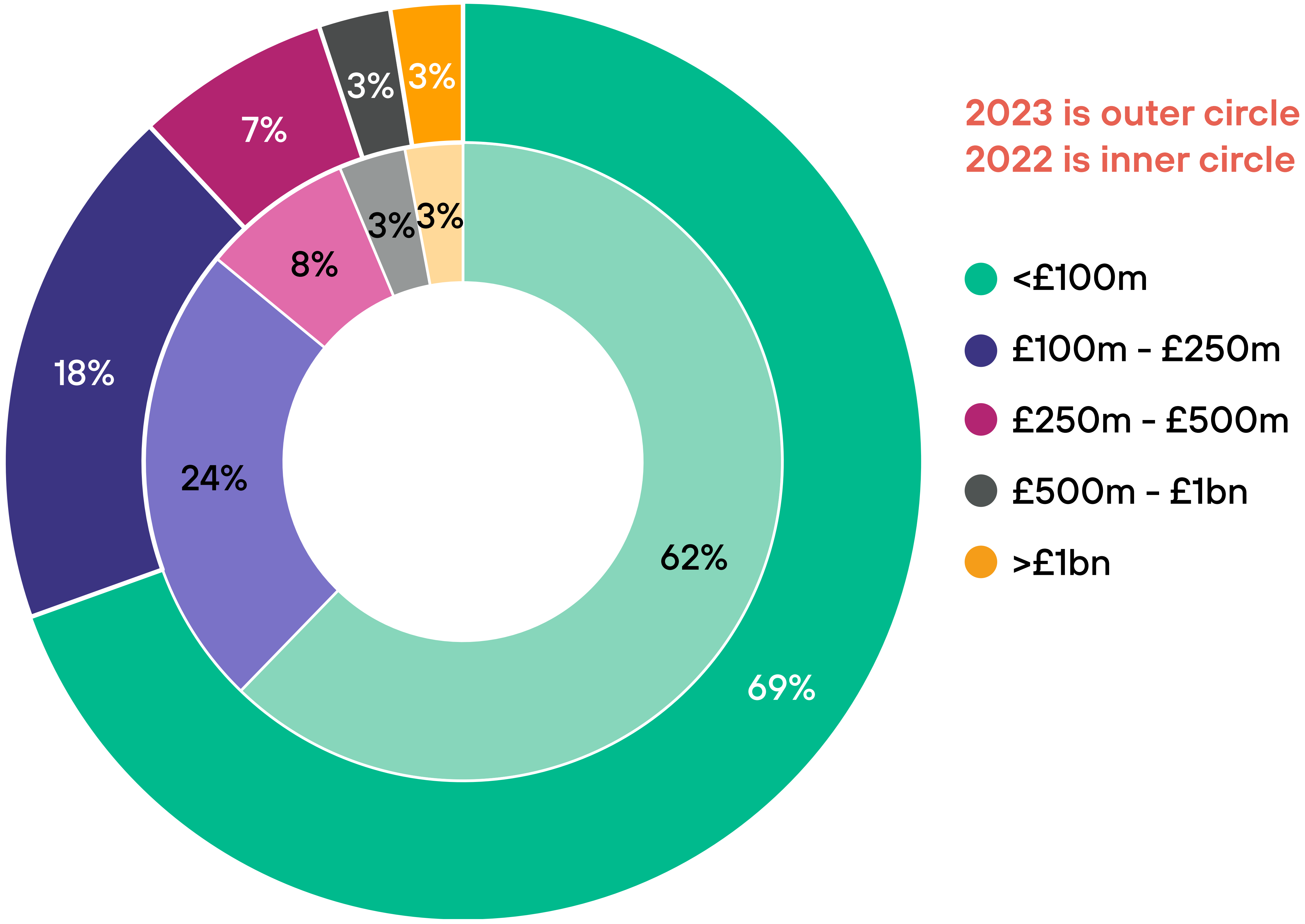
Last year we asked – has growth peaked? 2023 trends suggest it has stalled at least temporarily, however the requirements from LDI portfolios during the gilts crisis led to an enormous governance burden on trustees, which we believe highlighted some of the governance benefits from FM. We predict we may continue to see a gradual uptick in new schemes entering the FM market to reduce their governance burden - however, as schemes move to transact with insurers, we would expect, over the longer term, the number of DB pension schemes using FM to fall away.

Future of FM

2023 showed a noticeable shift in the makeup of the market, this is mostly explained by the decrease in assets under management. More clients are now in the lower assets under management buckets, with a significant increase in those below £100m. However, there has also been a shift in focus over recent years with smaller clients entering the market as fiduciary managers have expanded their propositions to appeal to them through competitive fees or simpler portfolios.



Proportion of Mandates by Size



The market is dominated by smaller schemes - over recent years we have seen an uptick in this trend as smaller schemes take advantage of the benefits of FM.

Full FM insurance transactions:

Over the year the market saw a marginal increase in buyout transactions, however we understand that a number of buyout transactions were paused during the gilts crisis.

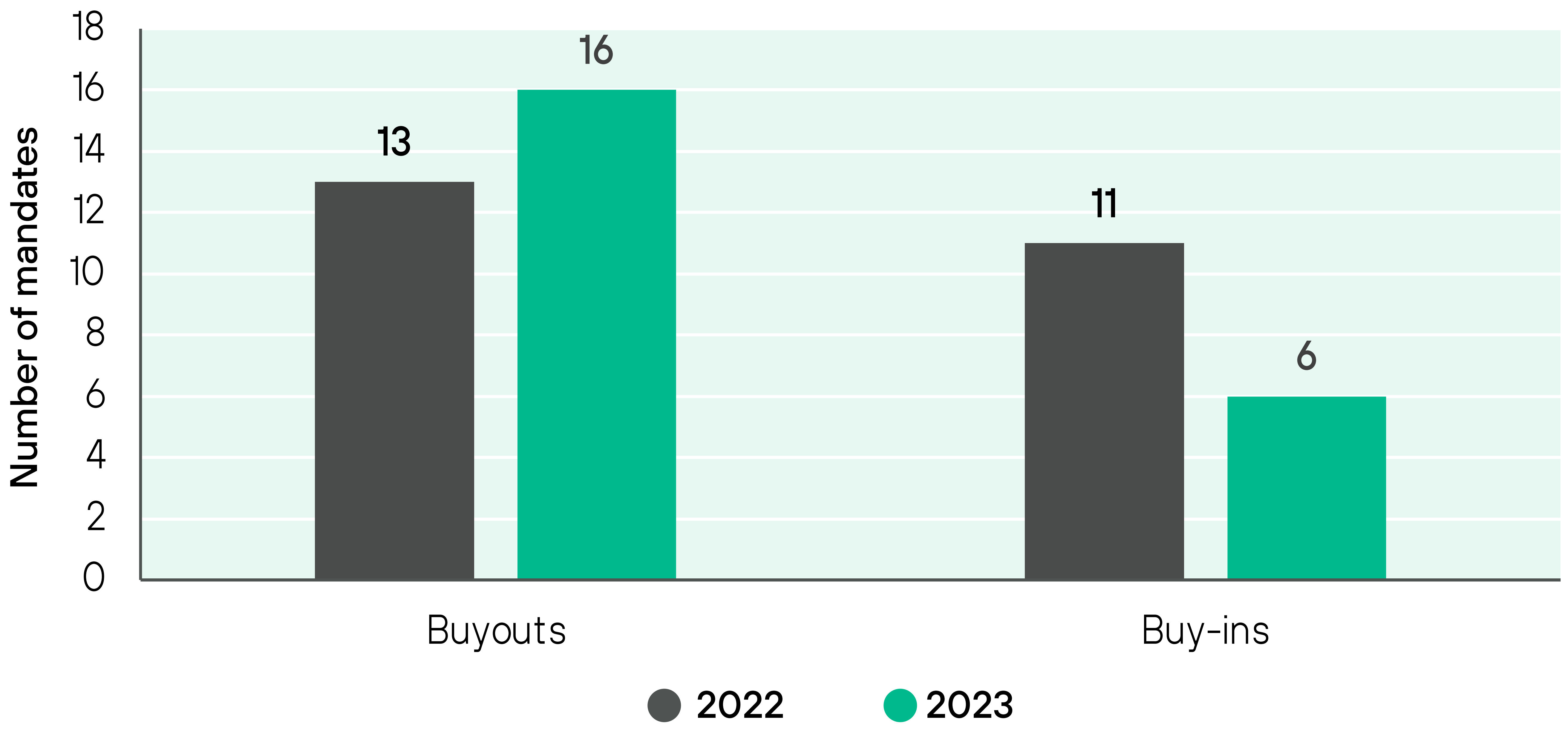
We might have expected the number going to buyout, or being less than three years away, to be higher as a large portion of schemes saw their journey to buyout expedited due to the gilts crisis. However, independent of the funding level, the practicalities around insurance transactions require a significant amount of preparation, including from actuarial and admin viewpoints. As more schemes move closer to their end game objectives, we expect to see a rise in insurance transactions coming through in the next 5 years. However, insurer capacity will be a key factor in determining the extent of this.

Conversely, the number of partial buy-ins reduced over the year as schemes changed their focus to retain more liquidity within portfolios to support their liability hedge. Partial buy-ins were a less favourable decision for pension schemes, which we expect to be a function of the liquidity challenges schemes have faced this year.

14% of schemes were 3 years from buyout in 2022, 18% of schemes are now 3 years from buyout[1].

Buyouts - we expect these trends to continue as more schemes get closer to their end game. The capacity of the insurance market, however, will have a significant impact here.

Full FM - Insurance transactions completed over the survey period



[1] 10 managers answered this question

Environment, Social and Governance factors

ESG integration comes in different shapes and sizes

We continue to see fiduciary managers and schemes working to demonstrate 'best practice' in ESG matters, but what is clear from our results is that there continues to be large disparity in the market for ESG integration. This means certain fiduciary managers will be doing more in this space than others.

This year we asked fiduciary managers what percentage of their fully delegated schemes have specific ESG targets. Interestingly only 30% have a net zero carbon emissions target in place, and only 35% have a carbon emissions reduction target. Fewer than 10% of managers have an implied temperature rise target for their schemes.

While it is not a requirement for trustees and fiduciary managers to have such targets, climate related risks pose a real long-term risk to schemes achieving their objectives. How managers demonstrate they are mitigating against these risks without targets for their schemes is in our view a real issue.

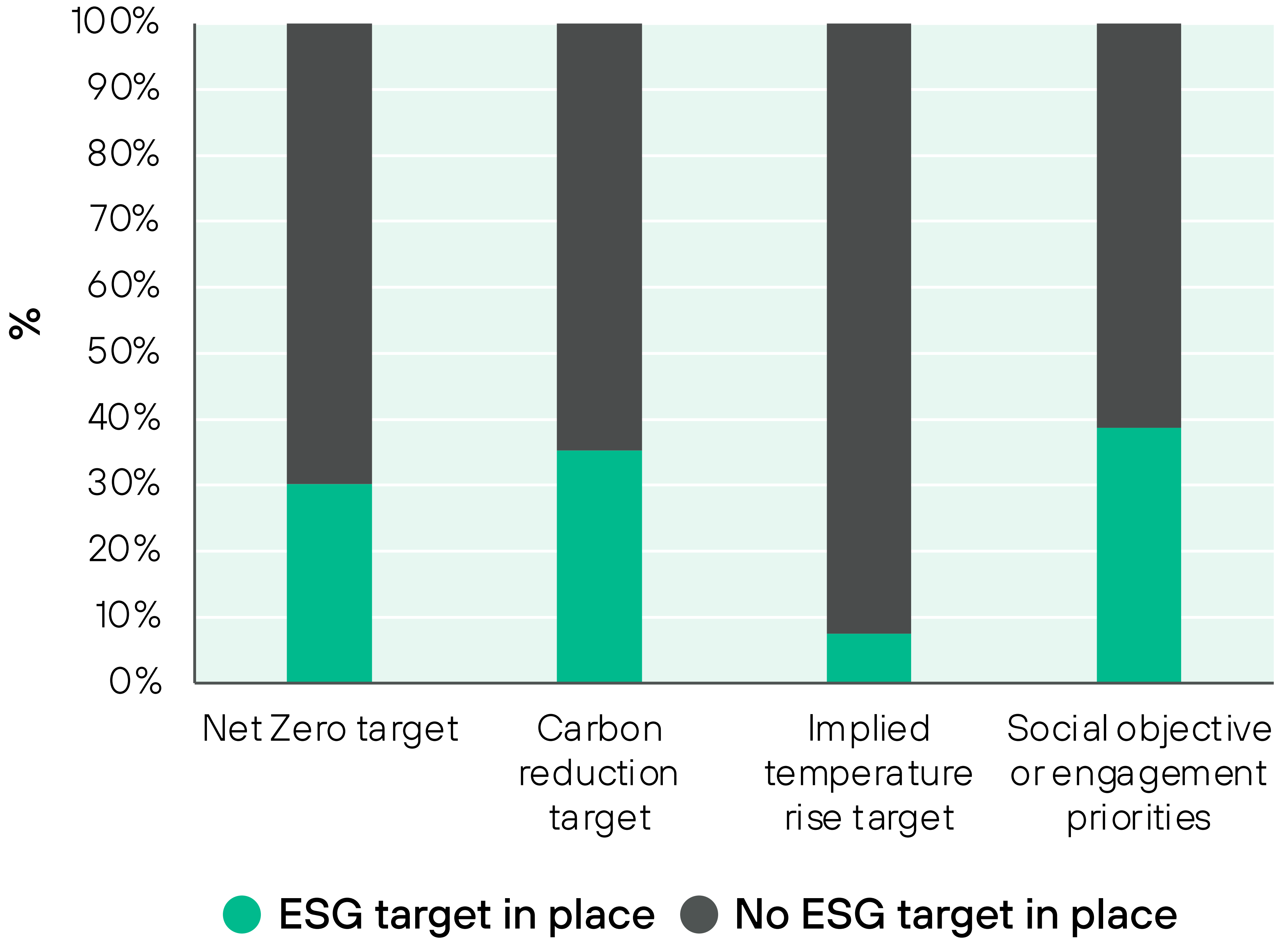
In addition, less than 40% of schemes have introduced social objectives or engagement priorities, for example, engaging with companies or fund managers on specific social issues.

While the data here can be can be alarming, in our experience managers are often setting and engaging on these targets selectively within their strategies – for example, within certain funds.

We do however challenge the fiduciary industry to improve and consider where these targets can apply to pension schemes' overall investment strategies. With more schemes being captured by TCFD reporting requirements, Isio hope this will drive an increase in those setting targets for their schemes.

As at 30 June 2023, only 3% of full fiduciary mandates were £1bn+, so likely to be covered by TCFD regulation.

% of full fiduciary mandates with the following ESG targets in place



Asset Allocation

A flight back to equity

Fiduciary managers revert back to more “traditional” growth assets

We asked fiduciary managers to tell us how they would invest the assets of a £500m scheme, targeting a return of Gilts + 2% per annum. We compared the average response for a ‘best ideas’ portfolio to our 2022 results, and found that the main changes were:

Increased liability hedging assets

With new regulatory guidance around minimum collateral requirements within LDI, this has meant more capital is required to support the same liability hedging target. This is an unsurprising result.

Increased liquidity

A notable move from illiquid alternatives and credit to liquid alternatives and equity. The gilts crisis highlighted the importance of having access to liquidity when using leveraged LDI (which is the case with most UK defined benefit schemes).

A move back to equities

Last year we reported how we have seen fiduciary managers diversify away from equities for return. This year we have seen a reversal in this trend, with fiduciary managers substituting credit assets back for equities, in particular passive equities. We suspect that the efficiency of equities to deliver return, without sacrificing liquidity, is the key rationale.

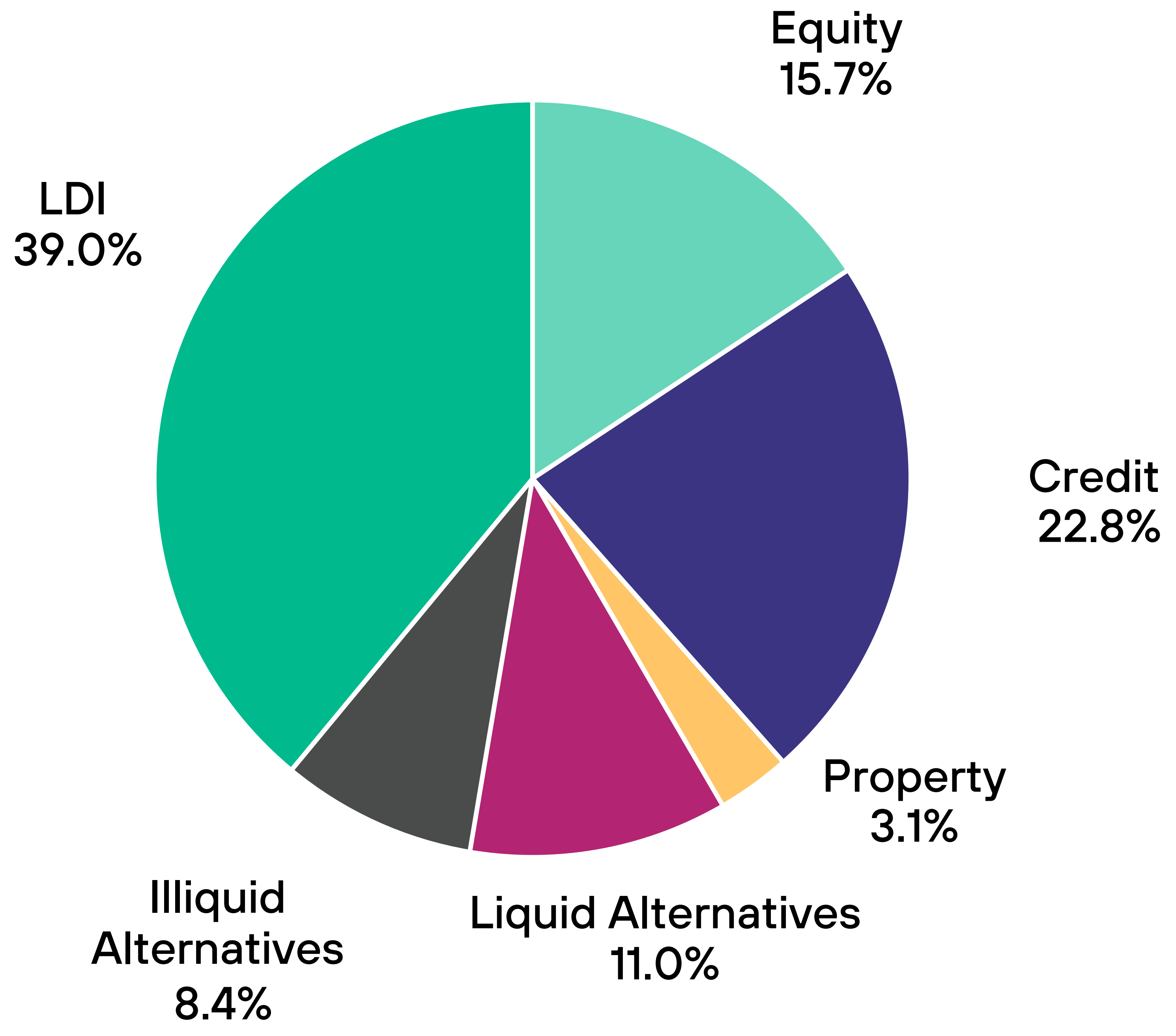
Proposed Investment Portfolios

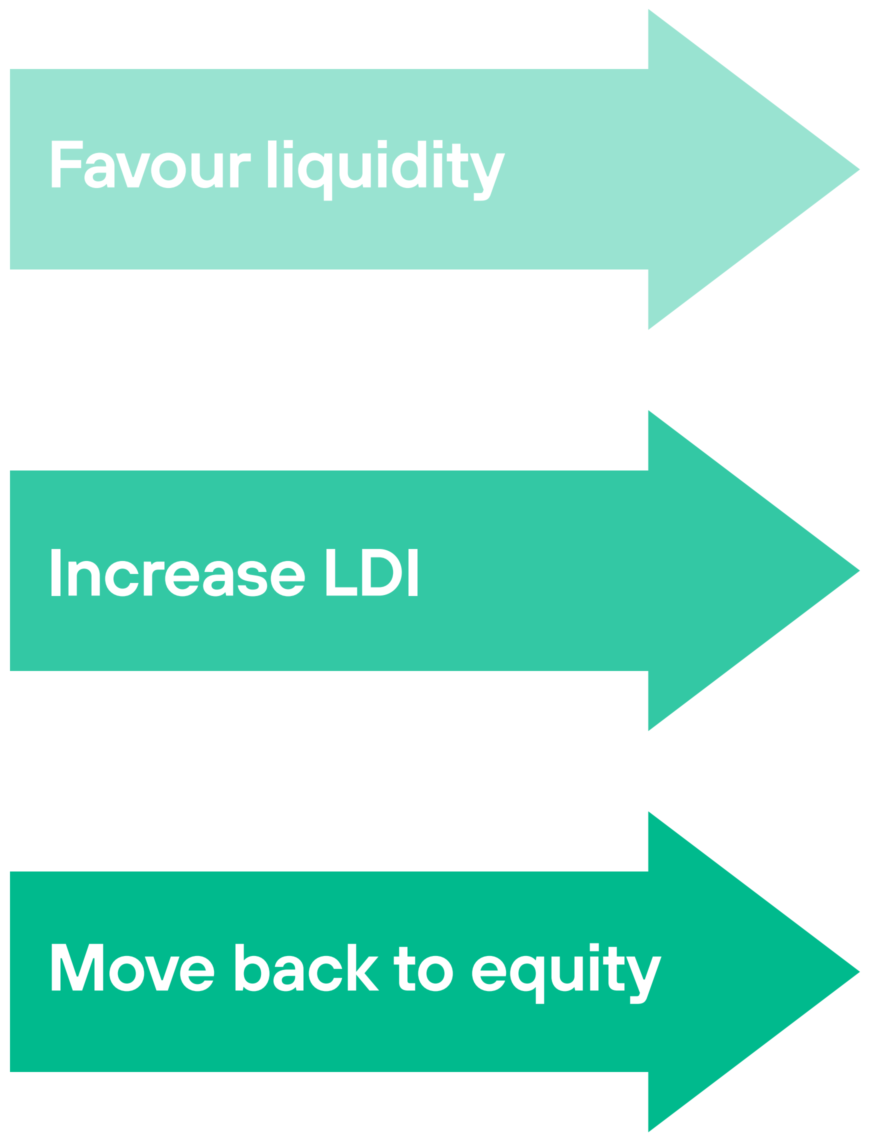
The portfolio responses from fiduciary managers represent their "best ideas", but in our experience what client portfolios currently look like can be very different.

As asset values have fallen and growth assets have been sold towards the end of 2022 and 2023 to support liability hedging, illiquid allocations have increased as a proportion of scheme assets and have presented challenges for schemes looking to increase liquidity.

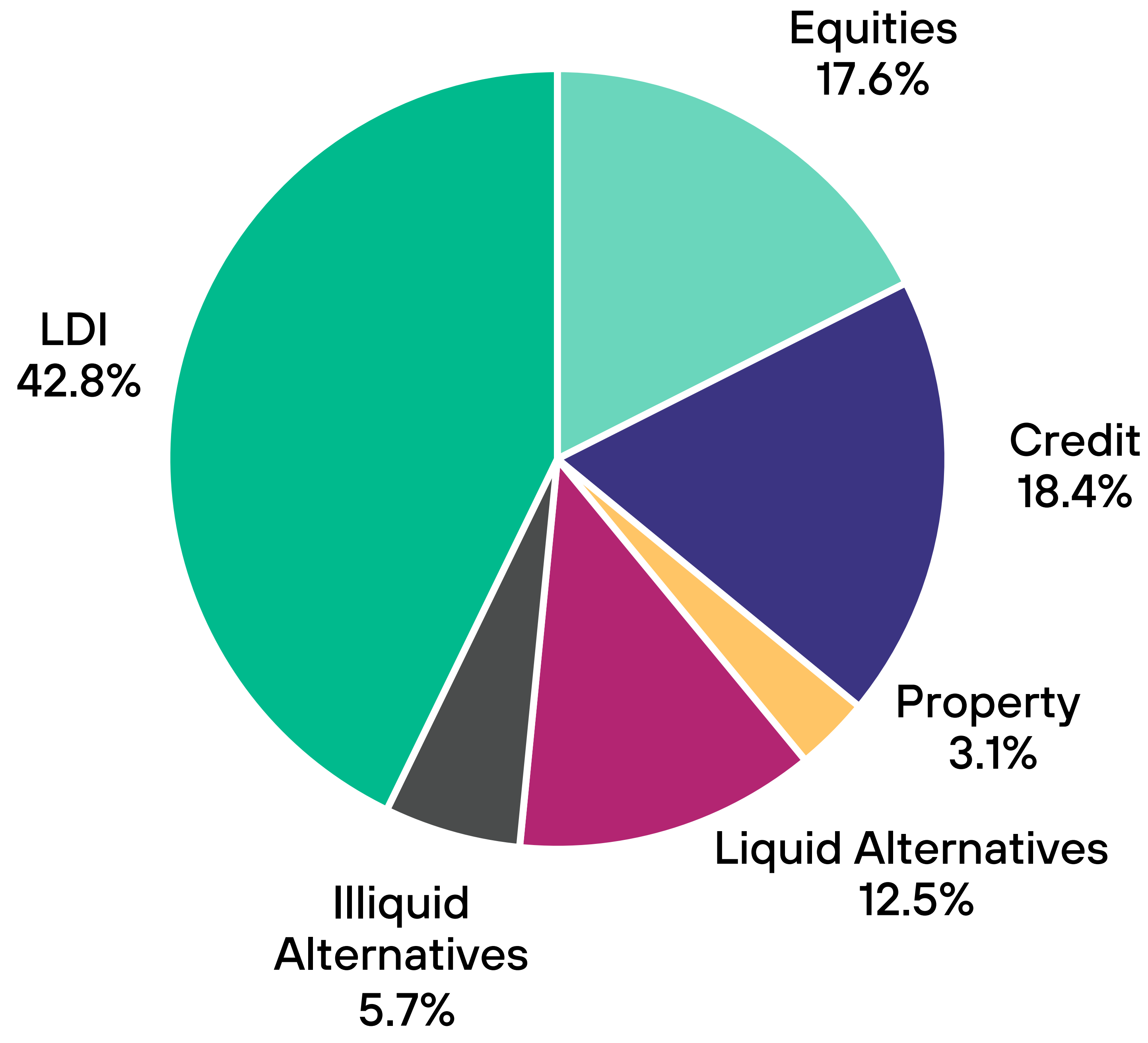
Best Ideas Growth Portfolio

2022





2023



Fees

Is a change occurring in the structure of fees?

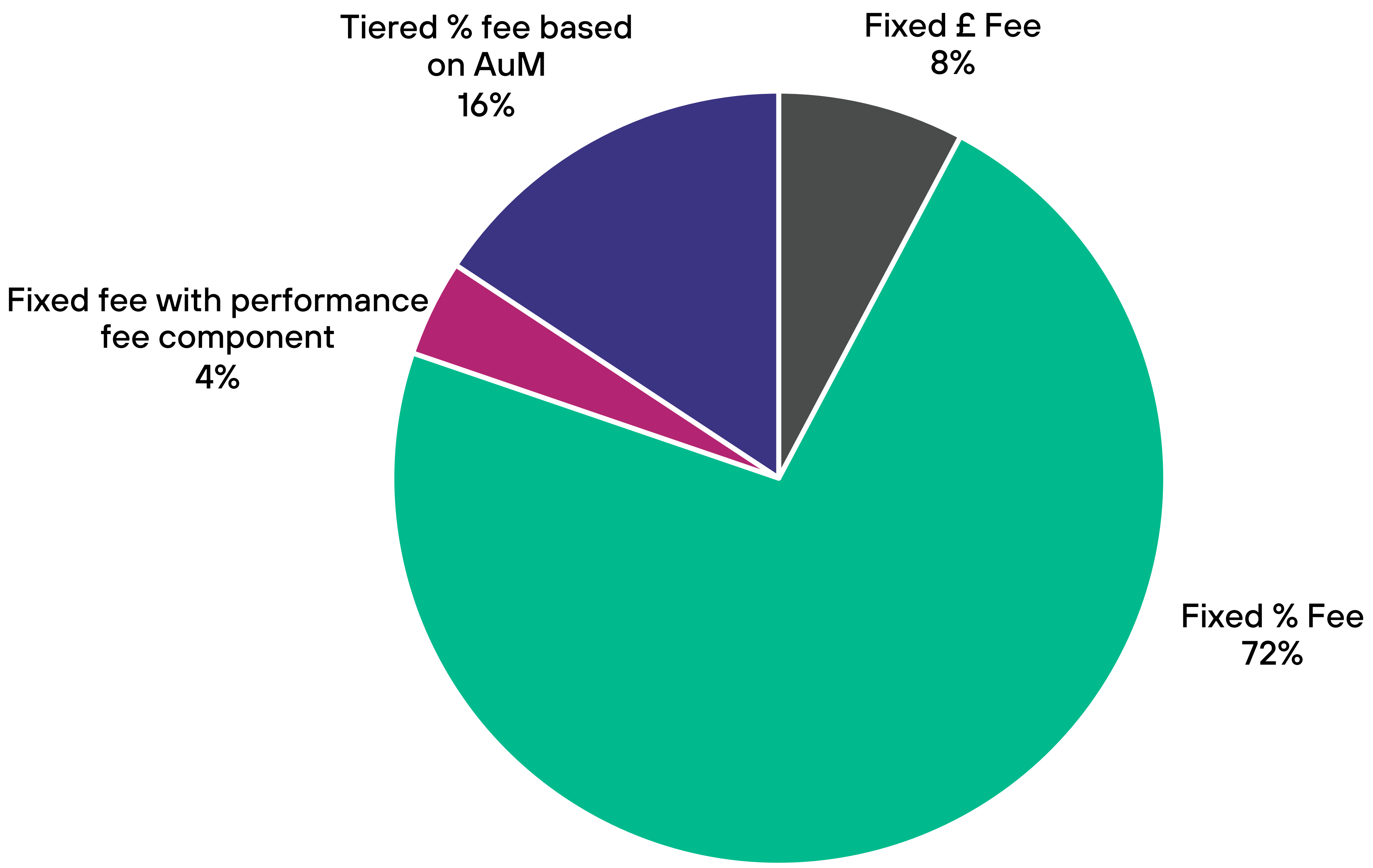
The conversation around FM fees has been an interesting one over the past year. This is because FM fees have historically been priced as a % based on assets under management. With assets under management having fallen markedly across schemes over the past year, FM fees have significantly reduced in monetary terms. Alongside rising cost inflation for fiduciary management businesses, these changes have prompted some fiduciary managers to reassess their pricing models.

In 2023, the majority of FM schemes used fee structures linked to % of assets under management (88%). However, the market has seen a significant increase in usage of the following fee structures over the past year amongst certain fiduciary managers:

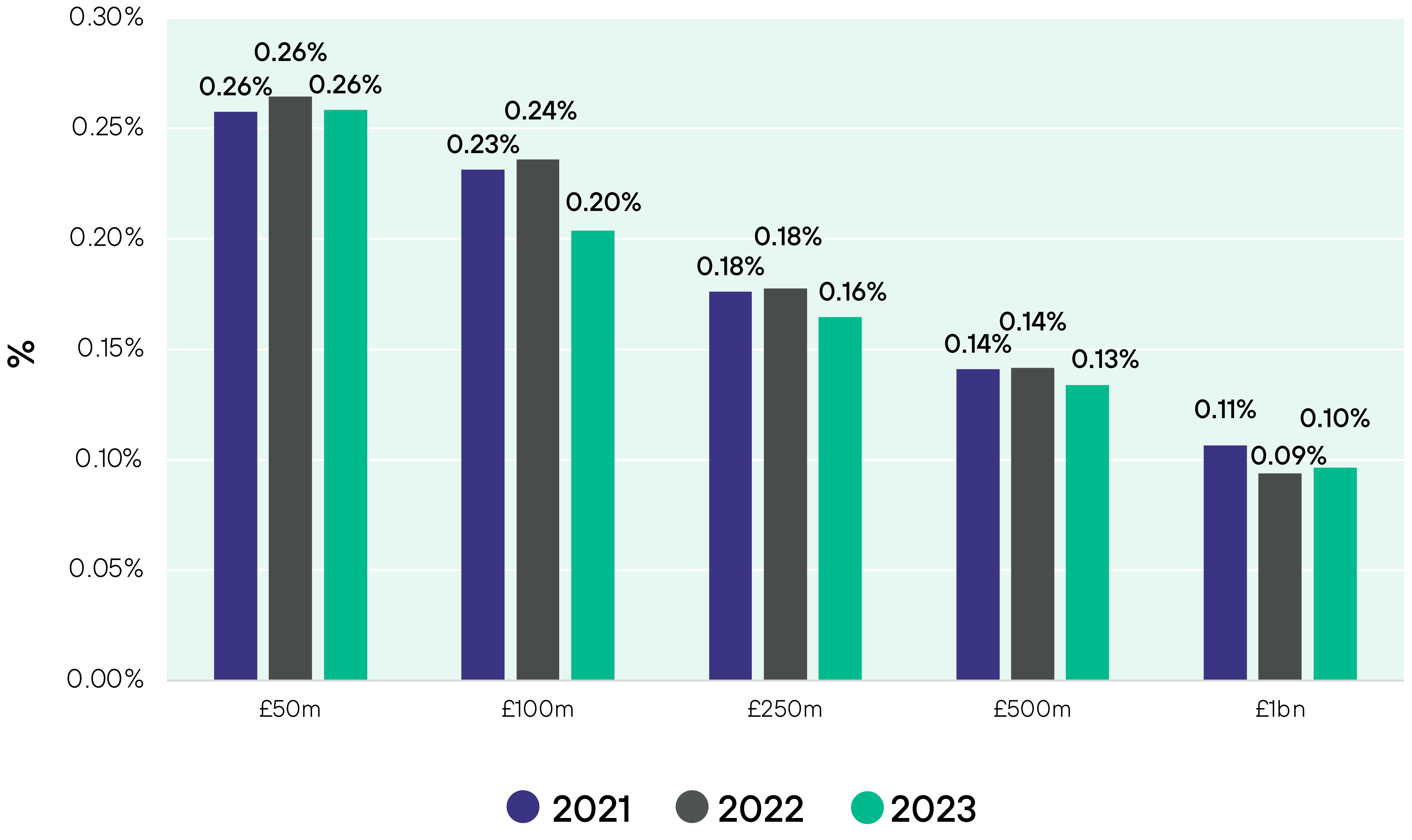
- Tiered fee – which means fees change with asset size
- Fixed fee with performance fee element

Fee increases may lead to a greater use of different fee structures.

Proportion of mandates using each fee structure



Average FM Fee by AUM (Best Ideas %)



We have calculated previous year numbers using linear interpolation to be consistent with this year's numbers

Average FM Fee by AUM

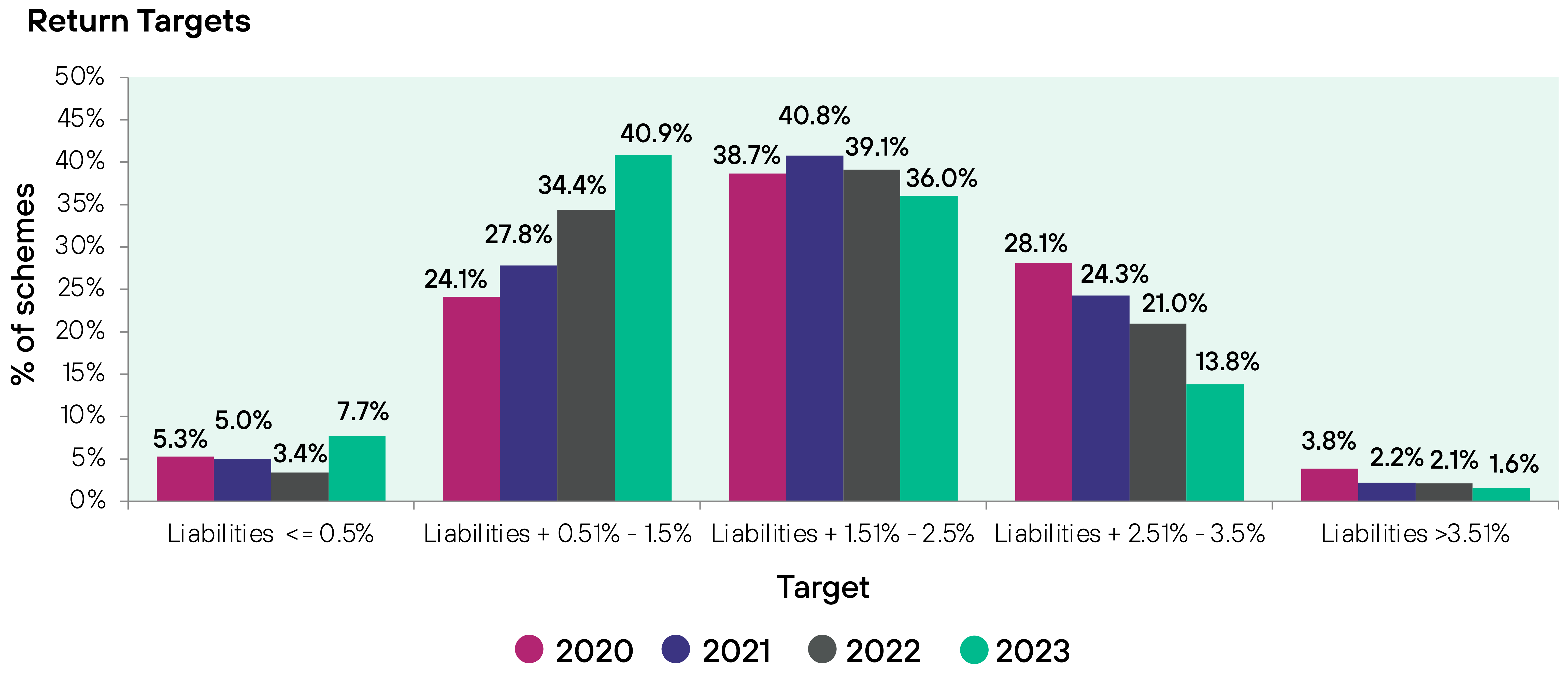
Each year we ask fiduciary managers what their FM fee would be for a scheme targeting a return of Gilts + 2% per annum dependent on the asset size of the mandate. Retender activity prompted by the CMA review has resulted in a downward trend in these fees for several years. This movement was slightly more muted during 2022. However, this year we have seen proposed fees reduce again across most asset buckets. We suspect this could be reflecting a slightly more competitive market for new clients. However, it is worth noting that recently we have seen some fiduciary managers reviewing their fee arrangements for existing clients as an attempt to recoup some of the fees lost due to a fall in AUM across the market. It will be interesting to see if this is reflected within our results over the coming years.

What is a fair fee? This is a key question if fiduciary managers negotiate higher percentage fees today and asset values rise again in the future. Tiered fees have been recognised as a potential solution to this problem. Views from fiduciary managers on whether the use of tiered fees will increase are mixed meaning there is currently huge disparity in fees across the market.

Schemes might have to create their own competitive tension to get the best fee.

Long Term Objectives

Change of focus of the FM market



Liabilities + 0.5%-1.5% is the most common return target for the first time. Domination of a low, rather than a high growth based, return target means that the focus for the fiduciary market is shifting, with increased importance on insurance capabilities and end game planning. We see some fiduciary managers with stronger capabilities in these areas. How others adapt to stay competitive in this area will become increasingly evident over the coming years.

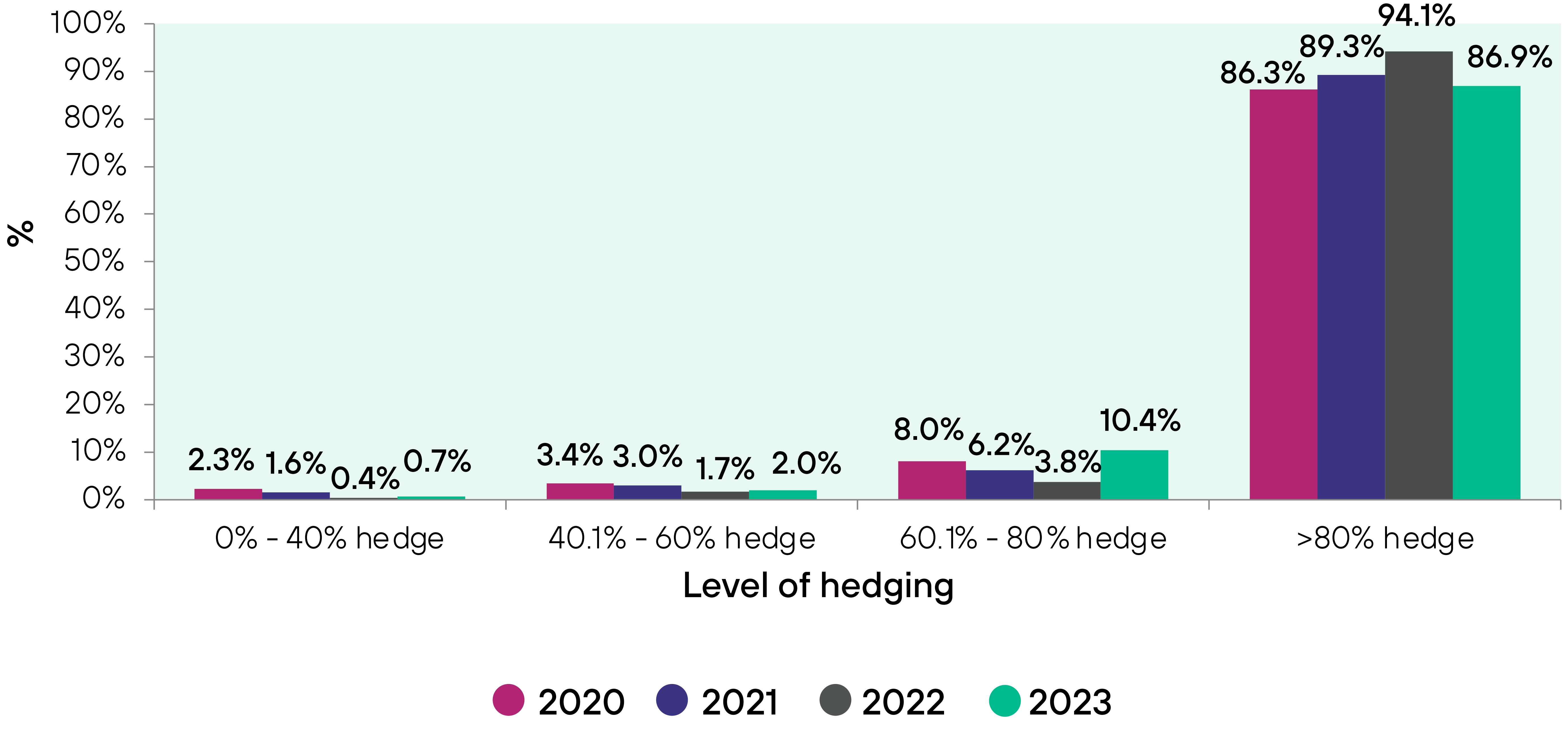
Liability Hedging

Average hedging level targets decreased slightly after years of positive trajectory as greater capital is now required in LDI to maintain hedging levels. Differences in hedging levels were driven more by the balance of liquidity and return, rather than the fiduciary managers expressing strong market views.

Going forward we predict the conversation will change for schemes with shorter journey plans to focus on hedging on a buyout basis.

In reality we saw significant decreases in hedging levels during the gilt crisis, over the first half of 2023 there has been movement to reinstate hedges as close to initial targets as possible. This movement won't have been captured within the data.

Level of hedging



Reviewing your arrangement

This chart doesn't include any one-off projects such as LDI and FM reviews, we have seen a significant uptake of these in the market prompted by the gilts crisis!

71% of schemes with FM carried out strategy reviews over the year.

Pooled vs Segregated LDI:

Historically, aside from schemes with assets of £1bn+, the majority of FM clients have used pooled funds for LDI. As LDI arrangements now require more assets and more collateral to support them, there has been lots of exploration on the use of bespoke arrangements like segregated LDI for FM clients. In terms of implementation, the result is massively dependant on individual fiduciary managers' views regarding cost effectiveness of segregated LDI portfolios.

5% of schemes moved from pooled to segregated LDI over the year, we expect this number to rise further as a number of fiduciary managers are in the process of changing their entire client base to segregated LDI arrangements.

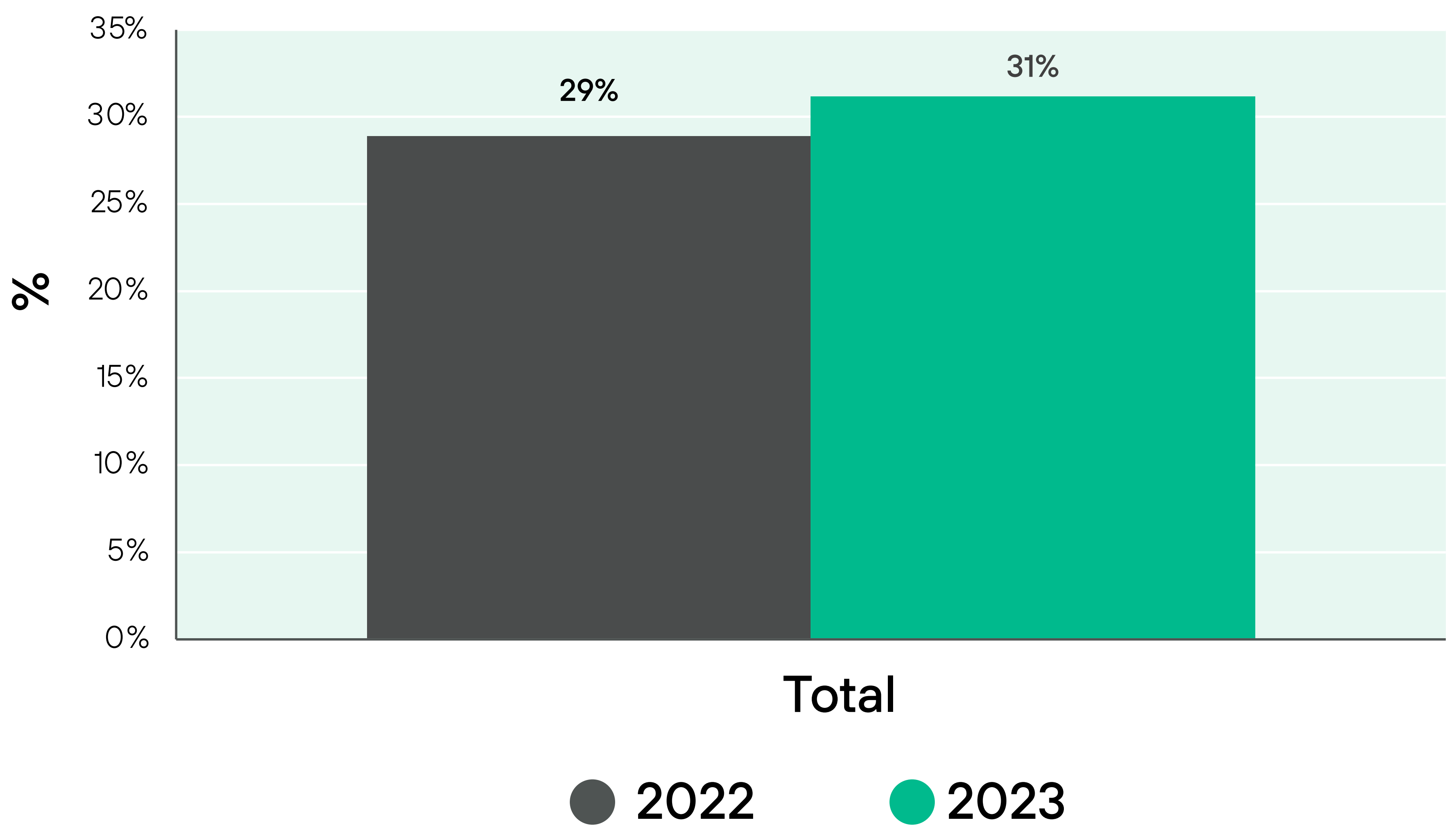
Third-Party Evaluators:

There has been increased usage of third party evaluators ("TPEs") for ongoing monitoring.

Another piece of work we are more regularly helping clients with is reviewing whether the FM arrangement is still appropriate for schemes with a low return target and how it can be tailored to fit the new priorities (or whether an FM approach is indeed appropriate!). This review includes the perspectives of governance, strategy, journey planning and fees.

80% of FM mandate wins over 2023 used a TPE for the selection exercise.

Use of TPEs in ongoing oversight (% of total full FM market)



Isio and Fiduciary Management advice

Fiduciary management expertise

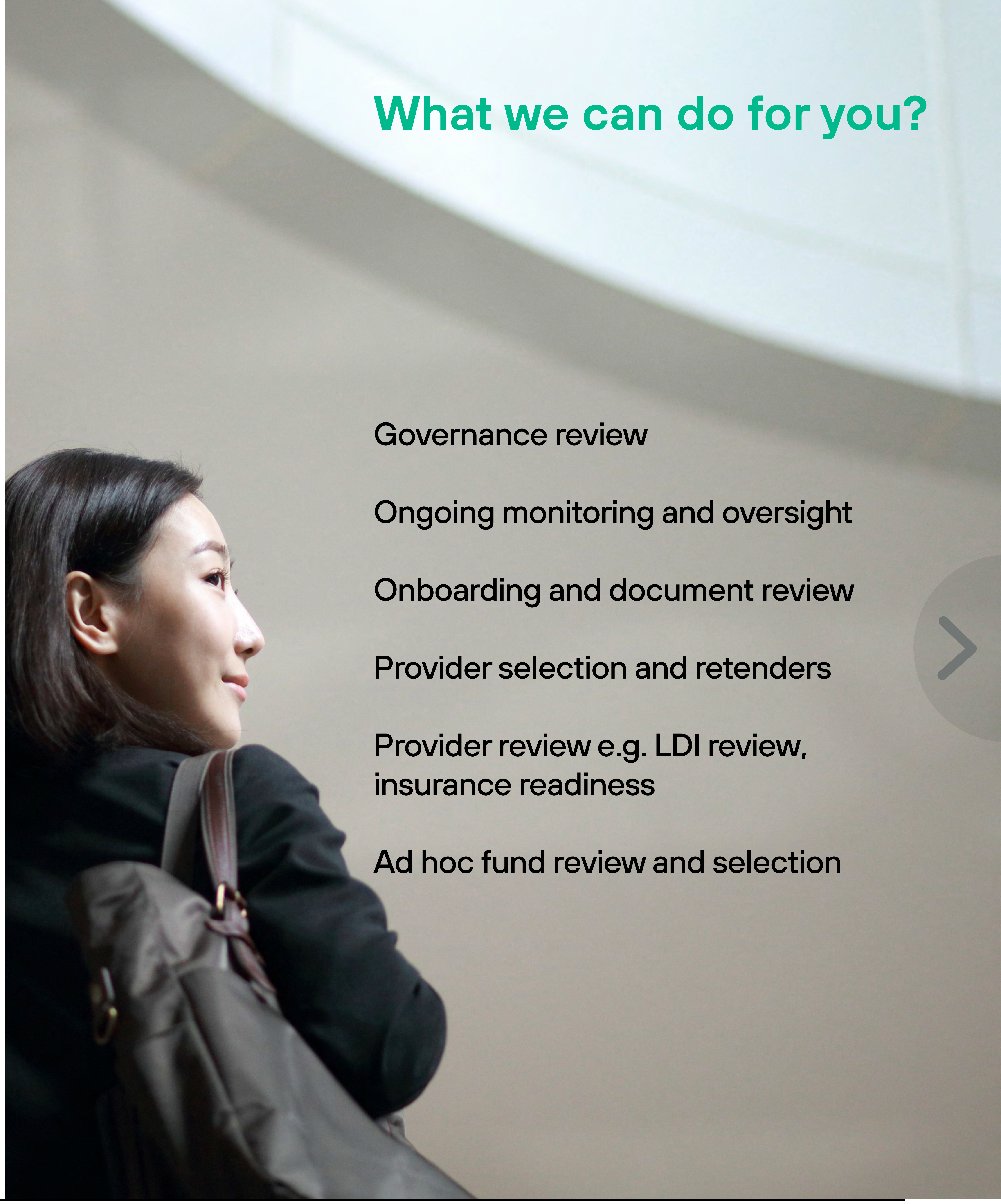
We provide ongoing independent fiduciary oversight to clients ranging from less than £20 million in size to over £4 billion.

Investment advisory expertise

Our traditional investment advisory practice advises the trustees and corporates of UK DB pension schemes and others, with assets under advice of over £120 billion.

Wider pensions resources

We can bring you experts in trustee board governance, insurance and risk transfer solutions, Defined Benefit and Defined Contribution services, or any other areas required in advising on how best to meet your scheme objectives.



What we can do for you?

Governance review

Ongoing monitoring and oversight

Onboarding and document review

Provider selection and retenders

Provider review e.g. LDI review, insurance readiness

Ad hoc fund review and selection

Who took part in our survey?

The survey results presented are based on the responses received from the following fiduciary managers operating in the UK Defined Benefit pensions market with data as at 30 June 2023.

We thank each provider for their input in this exercise. We have relied on the information provided to us by the fiduciary managers as being correct.

- Aon
- BlackRock
- Cambridge Associates
- Cardano
- Charles Stanley Asset Management
- Columbia Threadneedle
- Goldman Sachs Asset Management
- Van Lanschot Kempen
- Legal & General
- Mercer
- Russell Investments
- Schroders
- SECOR Asset Management
- SEI
- State Street Global Advisors
- WTW

Definitions used in this survey

Full delegation
The fiduciary manager provides the full delegated service and is engaged under a formal agreement to manage 100% of scheme assets. Service provision will typically include all, or most of: journey plan design, strategic and tactical asset allocation, growth and matching portfolio structuring, setting a target liability hedge ratio, investment manager selection, implementation and administration. The mandate objective is typically to meet a funding level/liability target within a prescribed timeframe. It must be a complete service with no additional investment advice required from a third party.

Partial delegation
Trustees delegate only a subset of investment management to the provider. It may be that only a portion of the scheme assets are delegated to the fiduciary manager or only certain responsibilities. For example: growth portfolio management, tactical asset allocation or manager selection. Mandates where the liability hedging target is not set by the fiduciary manager are defined as partial delegation. The partial delegation assets under management reflect only the assets delegated. In order to qualify as partial FM the service must be a subset of an alternative full FM service provided by the same firm.

Environmental, Social and Governance ("ESG"):

Environmental, Social and Governance ("ESG") is investing with an awareness of the wider risks associated with the impact of their investments on society as a whole.

ESG can be defined within the headings:

- **Environmental:** How an investee company performs as a steward of the natural environment.
- **Social:** How a company manages relationships with its employees, suppliers, customers and the communities in which it operates.
- **Governance:** Looking at a company's leadership, executive pay, internal controls, external audits and shareholder rights.

Engagement is defined as the inclusion of an ESG item on a trustee or investment committee agenda which you have discussed in the year to 30 June 2023.

Coverage is defined as the proportion of funds invested in that will provide ICSWG and TCFD metric data.

More guidance on metrics data can be found here:

ICSWG Metrics TCFD Metrics

Buy-in

The purchase of annuities for some, or all, members in the name of the scheme. The annuities are held by the scheme as an asset.

Buyout

The purchase of immediate annuities for pensioners and deferred annuities for non-pensioners, in the names of the members of the scheme.

Fees

External manager fees: Fees paid to any externally managed funds, including any performance-related fees.

In-house manager fees: Fees paid to the Fiduciary manager for any in-house managed funds, including any performance-related fees.

Other fees & expenses: Includes custody, audit and any other operational/ancillary fees. Excludes any initial and ongoing transaction costs.

Pooled LDI

Pooled funds work similar to mutual funds, grouping the capital of multiple investors to deliver a standardised hedge solution.

Segregated LDI

Segregated funds deliver a bespoke hedging by purchasing credit instruments, which mature at the same time as future cashflows are due to be paid to members.

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