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Has your fiduciary manager got holes in their cheese?

Investment risk in fiduciary management, applying the Swiss Cheese Model

isio.

Introduction

Who, or what is to blame? This is often the first question that comes to mind when a mistake or failure occurs. However, complex problems rarely have a simplistic and singular root cause – it is more likely to be the alignment of a number of smaller errors, occurring in parallel, that has led to the accident.

This theory of accident causation is the basis for the “Swiss Cheese Model”, a principle which illustrates how accidents can occur from various weaknesses in a defensive system lining up.

Fiduciary managers set up several layers of defence to protect client portfolios from errors occurring. In this paper we consider how the Swiss Cheese Model can be applied to the Fiduciary Management (“FM”) proposition and used as a framework to evaluate risks. We discuss the various tools which trustees can use to apply this analysis and identify any areas of weakness within their fiduciary arrangement.

Who is this paper for?

This paper is aimed at trustees or sponsors of UK pension schemes who use or are thinking of using a fiduciary manager.

Our aim is to give you a framework to question your fiduciary manager – and to give you an insight into how we approach investment risk when providing fiduciary management advice at Isio.

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Our thoughts in a nutshell

It is not just the quality of the fiduciary managers teams that are important, how they interact with each other can have a massive impact on how vulnerable they are to things going wrong.

By applying the Swiss Cheese Model – originally developed to investigate and prevent crashes in the airline industry – to fiduciary management, we can get a more reliable understanding of the robustness of a fiduciary manager, how likely your scheme is to experience a crash.

How Isio can help

Different schemes following different investment strategies will need to concentrate on different areas of fiduciary manager risk control. If you would like us to review your scheme's fiduciary management mandate, please do get in touch **paula.champion@isio.com**

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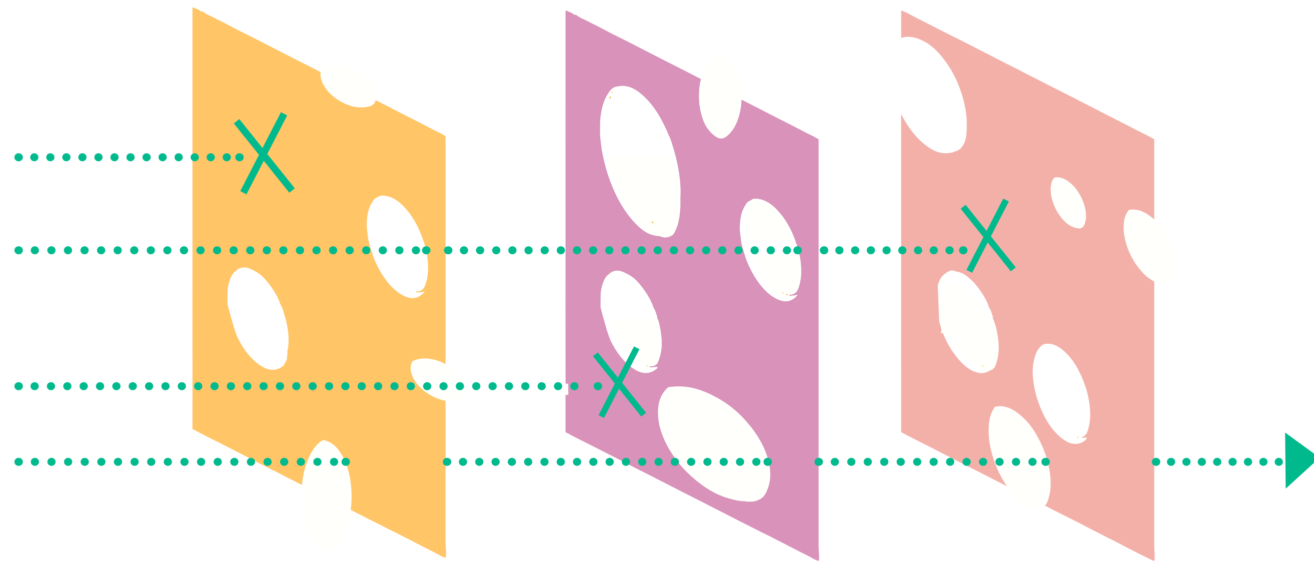
What is the Swiss Cheese Model?



The Swiss Cheese Model is a method for visualising weaknesses within complex human systems. It describes a system as a combination of defensive layers, with weaknesses represented as holes within each layer, similar to Swiss cheese.

This model was developed to identify the causes of accidents in the airline industry. Here we are applying the same framework to fiduciary management.

It is important to note that simply because a particular layer has a weakness does not mean that a system failure will take place, because the hole in one layer could be covered by the strength of another. It is only when there is an alignment of these holes that a crisis occurs. However, just because the hole in one layer of defence may not cause an overall catastrophic failure, it does not mean that it cannot have a negative impact to the system and should not be fixed. Therefore, the model can not only be used to identify the sources of potential errors, but to identify exposures to risk.

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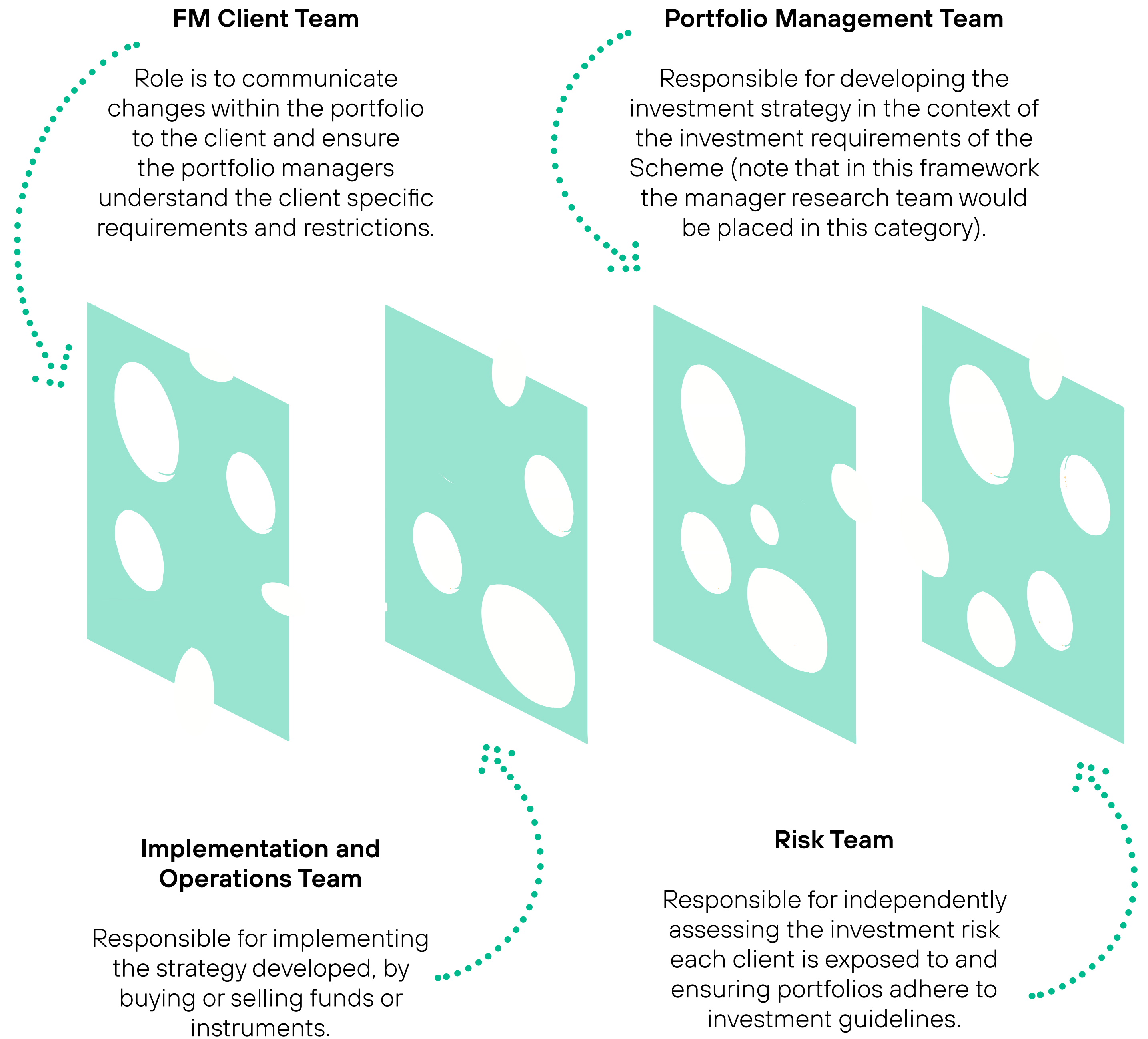
For the purposes of this paper we will be keeping our focus on the fiduciary manager, taking a high-level, team orientated, view. With this in mind, our slices will be the following:



An error could be very significant if holes align through all of these layers. But an error could still be material if it goes through some but not all layers. In this paper we will consider both scenarios.

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Does your fiduciary management have a hole in their cheese?

1.

Are the layers high quality?

For example: who is making the portfolio management decisions? Do they have enough expertise and experience? What will happen if they leave the business? How frequently does the manager review their portfolios? What do they look for? Each fiduciary manager layer needs to be well resourced and with effective processes. This is the layer that is traditionally the focus of fiduciary manager research. But we should also be looking at:

2.

Are the layers independent?

If the layers are independent, a mistake in one layer can be spotted and corrected by another layer but if two or more layers merge together, this reduces resilience. For example, if the Risk Team is the same as the Portfolio Management Team, then any bias or blind spot is much less likely to be scrutinised and challenged.

3.

Is there good communication between the layers?

While independence is critical, it is also equally important that the layers talk to each other. For example: when moving money between funds the Implementation Team needs to be totally clear on their instructions, and if any supporting trades are needed, for example on currency hedging or LDI exposure.

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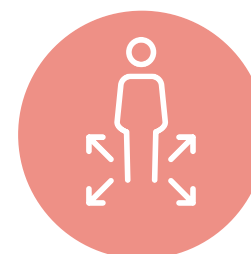
How do you make this assessment?

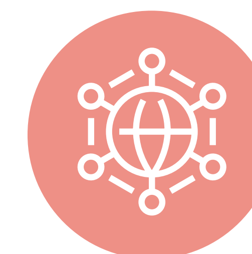
Looking forwards

To make an assessment you need to have a good understanding of the make-up of the fiduciary manager's teams. You also need to understand the processes that the teams follow: the decision-making flow and frequency, and the implementation procedure. In short, your research of the fiduciary manager needs to be thorough and up to date.

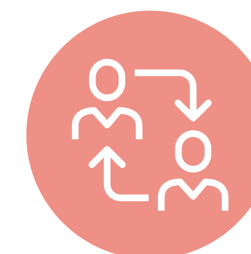
In addition to scrutiny and review of processes, some reliance needs to be placed on:



Good quality people at the fiduciary manager, who are properly incentivised to control risk appropriately (and organised into mutually reinforcing layers as set out opposite).



The materiality of the process. For example, changes to your asset allocation are likely to be very material and need to be understood thoroughly. Changes to the investment reporting process are likely to be less material. In practice you won't be able to review every fiduciary manager process in granular detail – and each individual client will also have different objectives and priorities which can influence this materiality question.



Third parties, for example Internal Controls assurance reports. These reports may highlight internal process that may not be working effectively, and crucially: how the fiduciary manager is responding to this. While you cannot place complete reliance on these third-party reports – and they are by no means exhaustive in their scope – they can provide very helpful supplementary insight.

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Looking backwards

If an error has occurred, applying the Swiss Cheese model framework can be very useful in identifying whether or not the error was preventable and the actions needed to reduce the change of a similar error happening again. We have set out some case studies in this paper which discuss errors that we have seen and use the Swiss Cheese Model to analyse them.

Investment risk needs to be deliberate

It is important to remember that there is always risk present in all systems. For example, there is always the possibility of human error, such as incorrectly typing out a trading instruction. As such, one of the goals of the model is to emphasise the need to structure your layers as defensively as possible, so that the weakness of one unit is combated by the strengths of the others. A simplified example of this is making sure your asset transitions process involves checks from the portfolio management and client teams. However, even if such a process is implemented, the risk of error will never be zero.

And of course, when making an investment, risk is inherent in generating a return. Even government bonds can be very risky investments as many pension scheme investors discovered in September and October 2022. Therefore, in this paper we are assessing how fiduciary managers can avoid unnecessary, unrewarded or outsized risks, not eliminating the (always present) possibility that an investor can lose money.

Finally, this model is also dynamic, as holes can change – new holes can emerge and existing holes can get bigger and smaller. As problems occur, your fiduciary manager will learn and adapt, shrinking and sometimes removing all-together the holes in their defences. A good fiduciary manager is not necessarily absent of holes, but they should have the ability to continuously develop and enhance their risk management procedures to protect against error and loss.

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Case Study 1
Hedge reduction error

During the LDI crisis in 2022, a fiduciary manager made a trading error on a LDI hedge that cost their client over a million pounds – the client was subsequently compensated for this loss. We were called in to help review what went wrong.

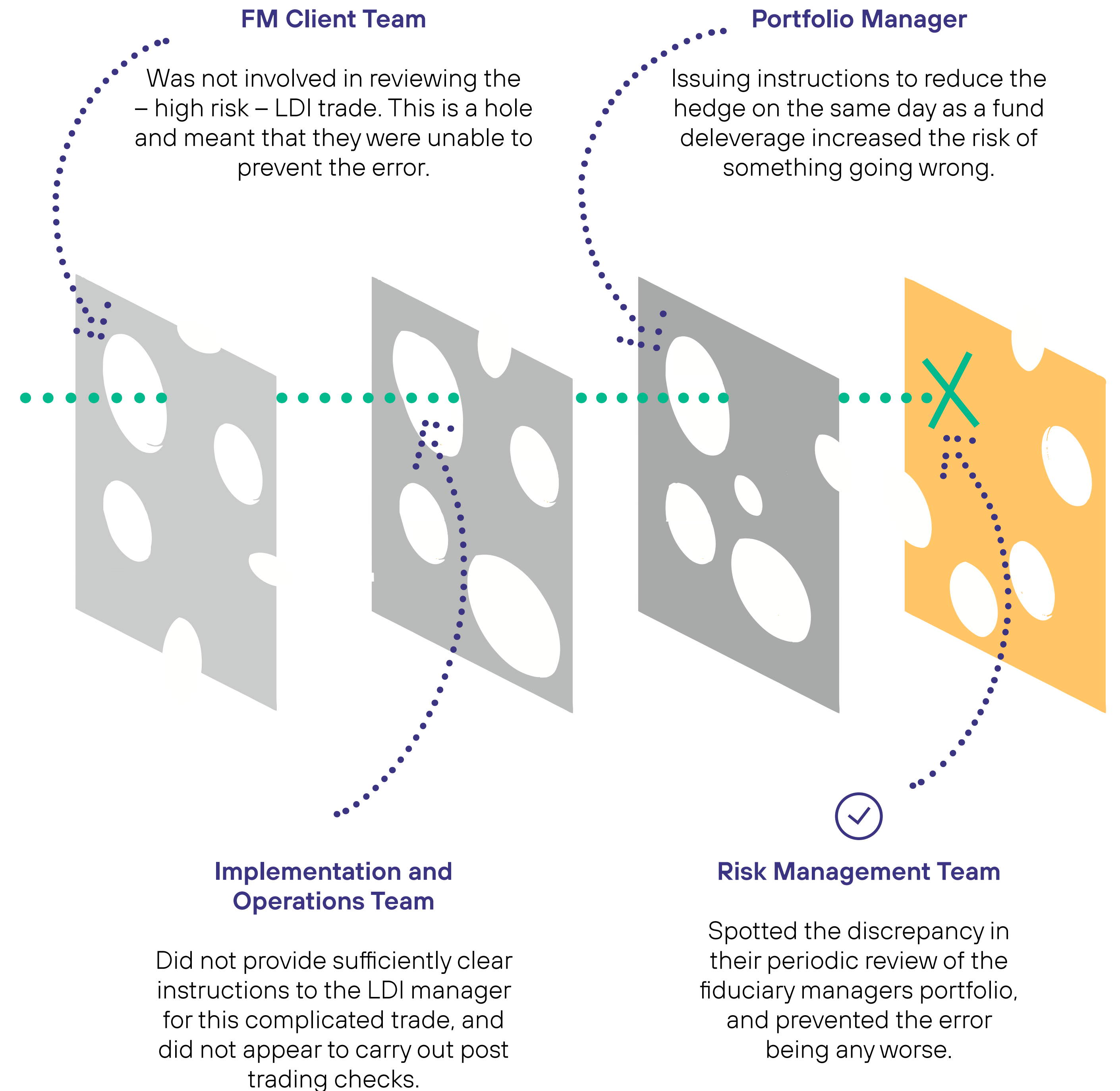
What happened?

1. The LDI manager requested additional cash from the Scheme to maintain the same level of hedging. The Scheme could not liquidate assets in time, so the fiduciary manager decided to accept the reduced level of hedging.

2. This was not in itself a problem, but on the same day the fiduciary manager decided to reduce the LDI hedge to a level that they felt could be sustained by their client. They issued a "reduce the hedge" instruction to the LDI manager.

3. The problem was that the LDI manager did both - the hedge was reduced because the capital call was not met and then reduced further by the amount instructed by the fiduciary manager. The hedge level fell by 65%.

4. A week and a half later the fiduciary manager Risk Management team spotted that the client had the wrong number of LDI fund units and corrected the error, increasing the hedge.



It was the final layer of defence, the Risk Management team, that stopped this event from going unnoticed and resulting in significant further losses.

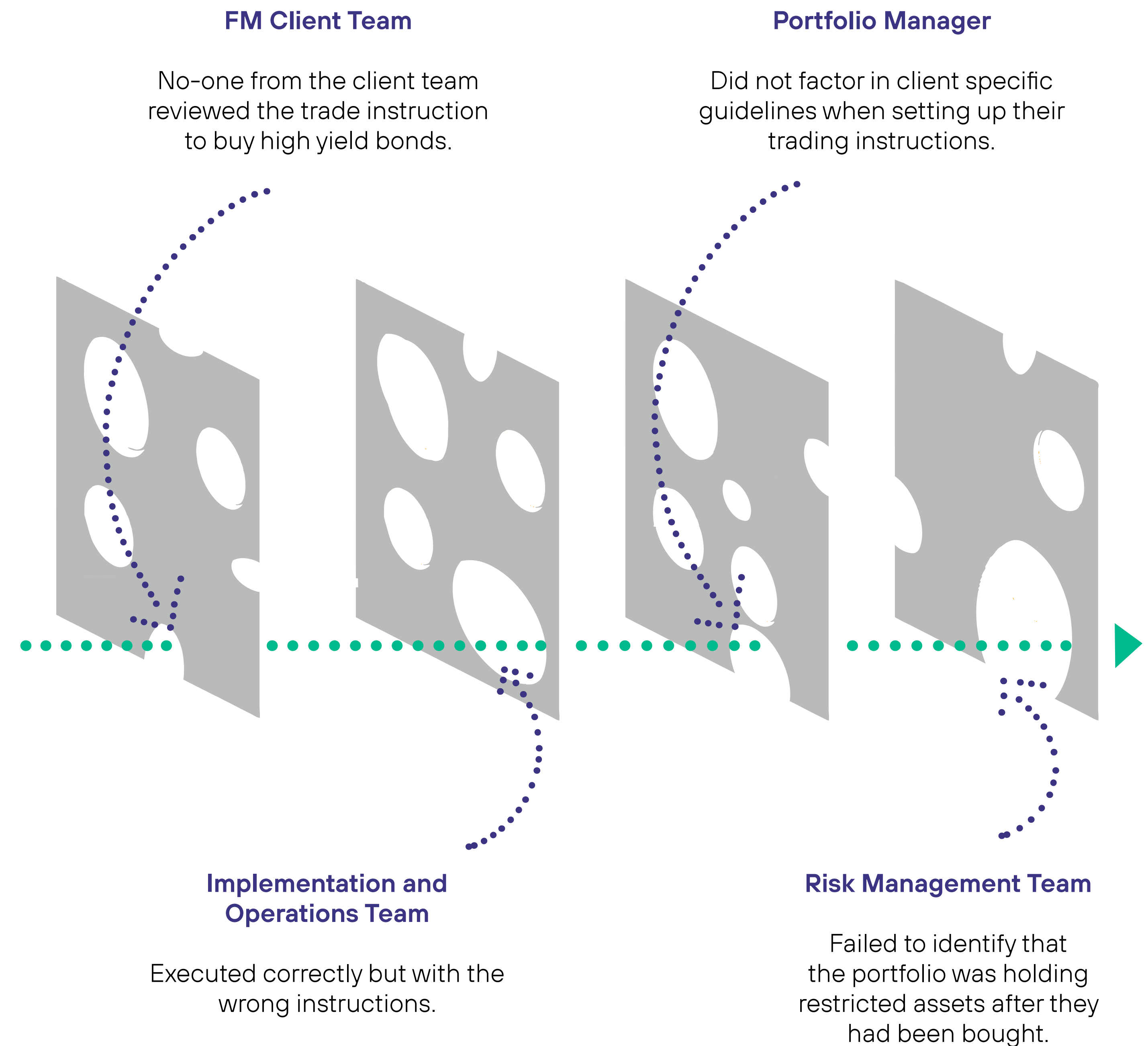
What we did

With each layer operating independently there was no-one to check it "made sense". Our key recommendation was that in future there should be an individual on the FM Client Team responsible overseeing the other layers during a high-risk activity such as this one. We believe this will significantly reduce the chance of future similar errors.

Case Study 2
Buying the wrong assets

What happened?

1. When our client appointed their fiduciary manager, they instructed them not to include high yield bonds in their portfolio.
2. Two years later, the fiduciary manager did just that – the allocation to high yield bonds was increased in their model portfolio and this change in allocation was mistakenly applied to our client's portfolio too.
3. We spotted this mistake when conducting our quarterly fiduciary oversight review and alerted the fiduciary manager.
4. As soon as they realised what had happened the fiduciary manager sold the bonds. Luckily the fiduciary manager did not experience a loss from holding these bonds.



What we did

Our recommendations were:

- All portfolio changes for the client should be reviewed by a member of the FM client team (who will know the client's specific circumstances)
- Improve the communication between the FM Client Team layer and Portfolio Manager layer – in this case with codification of client restrictions on the Portfolio Manager's trading system.

Since these changes have been made we have not seen similar errors from this fiduciary manager.

Conclusion

The Swiss Cheese Model illustrates the importance of appointing a fiduciary manager with strong defensive layers at the outset, and monitoring for holes occurring within the layers over time. As a recap the three elements to look for are:

Are the layers high quality?

Are there any areas of weakness and how critical are they to your situation?

Are the layers independent?

If not, are there any other safeguards in place?

Is there good communication between the layers?

Can anything be done to improve this?

If you are selecting a fiduciary manager, the overall strength of these elements should be a key part of your decision.

But it is important to keep your fiduciary manager under review: if you are looking at your current fiduciary manager and a weakness is uncovered, you will need to decide how material they are to your particular investment strategy, whether improvements can be put in place, and ultimately whether to accept the risk or whether to move to an alternative, more robust, fiduciary manager.

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An independent assessment of your fiduciary manager

As an independent advisor who specialises in the fiduciary market, at Isio we can be the final level of cheese and a key layer of defence in keeping your investments on track to meet your objectives!

If you would like to talk about how this paper applies to your pension scheme or any particular fiduciary manager, please do reach out to us at Isio. We provide fiduciary management advice but don't provide any fiduciary management services, so we give an independent view.

A full list of our fiduciary oversight services is:

- FM Governance Review
- Selecting / Retendering a Fiduciary Manager
- Onboarding and Transitions Review
- Ongoing FM Oversight
- Fiduciary Performance Review
- FM and Buyout / Self-Sufficiency

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Contact

Paula Champion
Head of Fiduciary Management Oversight
paula.champion@isio.com
+44 (0)117 3746 477

Anthony Webb FIA
Head of Fiduciary Clients
anthony.webb@isio.com
+44 (0)207 123 6004

Aimee Buchanan
Investment Consultant
aimee.buchanan@isio.com
+44 (0)131 202 3913

Nathaniel Lock
Investment Consultant
nathaniel.lock@isio.com
+44 (0)141 726 0723

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