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An insight into fiduciary manager performance and actions in Q1 2020

Through the lens of a duathlete

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Lessons learnt from our first duathlon

A duathlon is a multi-sport event, consisting of run-bike-run, whereby participants quickly transition between each sport. Similarly, we saw investment markets enter a significant transition period of their own during Q1 2020. We moved from a prolonged period of assets trending upwards, to that of severe volatility and uncertainty. As the bike leg of the duathlon event begins for fiduciary managers, the road now appears hilly and uncertain. Nobody has been quite sure of the course ahead, but what lessons can be learned so far?

This paper follows our initial observations piece published in April 2020. We have drawn on our client experience, Global Investment Performance Standards (GIPS) data and a questionnaire that we issued to fiduciary managers to provide insight. Looking at performance in Q1 2020, what changes have fiduciary managers made to their portfolios and, importantly, what does this mean for pension schemes using fiduciary management? We report the following key lessons:

"Trustees want confidence and comfort that their scheme is in safe hands and they remain on track to meet their investment objectives."

Faye Mullen, Head of Fiduciary Management Research

1. Focus on the big picture

To do well in a duathlon you need to be a strong runner or cyclist (ideally both!) – a slick transition between the two sports will help, but it won't have a huge impact on the end result.

The most fundamental driver to investment returns continues to be the long-term strategic allocation, highlighting the importance of getting this right. Small tactical changes might add incremental value or offer some degree of protection, but the magnitude of this isn't enough to offset the overall positioning.

2. Collaborate to get the best results

Whilst the turns and climbs of a course might be unknown, you can choose an option that you know will be best supported – to keep you on track, give you a cheer when you need it and even a feed station to make sure you don't go flat.

We see the most successful managers being fully collaborative. In times of stress this means ensuring that the strategy in place continues to be appropriate. It also involves considering the sponsor's position (including any impact of the timing of deficit payments), working with the scheme's Actuary, and, understanding any liquidity needs. Most importantly, Trustees working alongside their fiduciary manager need to ensure that there continues to be an appropriate framework for the scheme to achieve its long-term investment objective.

946	£172bn
Total FM mandates in the UK	Total assets under FM

Data based on our 2019 UK Fiduciary Management Survey

3. Transparency is important

Most duathletes will have a fancy watch so that they know exactly how fast they are going, maybe even how they compare relative to their usual performance.

Whilst Trustees may delegate some of their investment decision making, they still ultimately have responsibility for ensuring that the pension scheme is on track to meet its investment objective. Understanding the position relative to the journey plan, how the fiduciary manager is performing/adding value and options to make changes is important. It shouldn't be the case that Trustees are surprised by the outcome of the scheme.

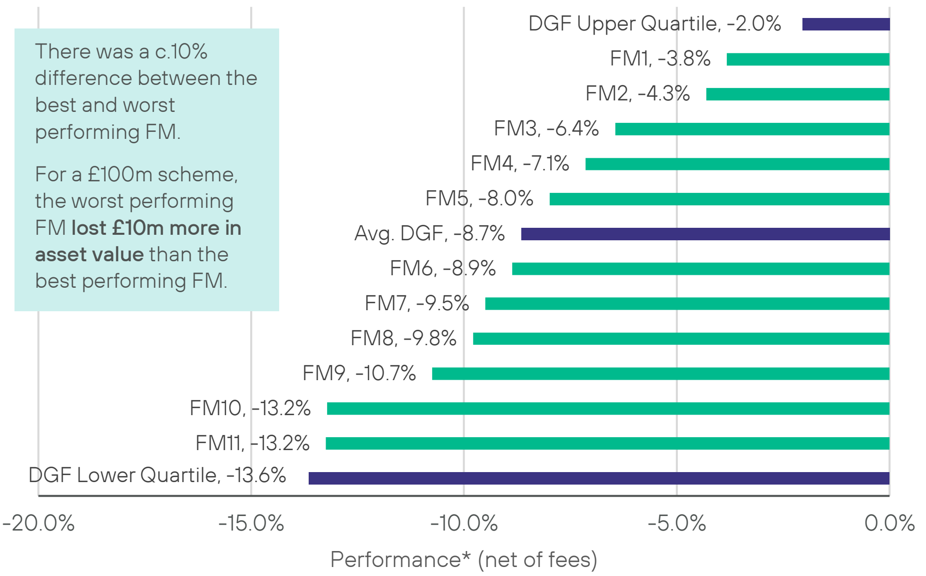
Which fiduciary manager is having a good race?

How did my fiduciary manager perform this year?

In order to assess the performance of fiduciary managers during this pandemic, we have collected data from the fiduciary managers reported under the Global Investment Performance Standards (GIPS) for fiduciary management clients. This data allows us to fairly compare the **actual client performance** of managers rather than representative "best ideas" growth portfolios.

The chart below compares the relative returns achieved by 11 fiduciary managers over and above the liability benchmark, net of all fees, during Q1 2020. These managers collectively manage over 80% of all fiduciary assets under management in the UK. These returns have also been compared to the performance of a selection of Diversified Growth Funds (DGFs) that we monitor on an ongoing basis.

Net relative returns of fiduciary managers - Q1 2020



"Fiduciary management should protect the downside leading to more certain outcomes. If your manager is not delivering this, it may be time to reassess!"

Aqib Merchant, Fiduciary Management research team

What does this mean for my scheme?

Our analysis doesn't suggest standout positive correlation between Q1 and longer-term performance i.e. the top performing manager in our chart isn't top over the three-year period. Ensuring your manager is delivering to your long-term objectives is key, a cumulation of solid short-term performance will keep this on track!

If we do focus on the first quarter of 2020:

Fiduciary managers had less divergence than the universe of DGFs – all fiduciary managers performed within the upper and lower quartile of DGFs' performance. Nevertheless, there is still significant dispersion between fiduciary manager performance, which has meaningful impacts on pension scheme funding levels.

Equity positioning driving recent returns – managers with relatively higher alternatives allocations and less in equity did better in Q1. However, we would expect the managers with high equity positions to have fared well to the end of 2019. It will be interesting to see how managers recover and also whether any impairments follow for those holding less liquid allocations.

Pleasingly we are beginning to see **greater transparency and comparability** of fiduciary manager performance data. Many clients have now been invested in fiduciary management for several years and, therefore, Trustees can assess meaningful scheme specific performance.

** DGF performance is absolute whereas the fiduciary manager performance is relative to a liability benchmark. Whilst not directly like-for-like, we still feel this is a useful comparator to fiduciary manager performance in Q1. This largely offsets the liability hedging decision to focus on growth returns.*

What changes have been made

To understand more about the fiduciary manager's risk management, nimbleness to make changes and outlook, we issued a questionnaire to the fiduciary manager universe. We received responses from 14 fiduciary managers, representing over 95% of all UK fiduciary mandates. We summarise trends in their responses below.

I. Managing growth asset risk

You need to do well in all legs of the race to be successful overall.

Since quarter end we have already seen markets rebound. We asked fiduciary managers what asset allocation they had changed the most over the entire period of Q1 2020 to react – the chart below illustrates the results.

The target equity allocation, regardless of tactical decisions, has been the biggest driver of underperformance and volatility for schemes in Q1 this year.

Contractual returns over equity – the increase in investment grade credit shows a more defensive stance being taken by fiduciary managers. Credit markets also stand out for where the fiduciary managers seem to be seeking opportunities.

A mixed bag for views on equity – while some managers sold equity to protect from further falls, an equal number took the opportunity to increase their allocation given the more attractive entry price points available in the market.

We believe that managers are well placed to identify and implement opportunities to add value looking ahead.

What does this mean for my scheme?

Asset allocation and return drivers could have changed significantly – several managers have made meaningful changes to their respective portfolios since the end of 2019. It could be that your scheme has an increased reliance on equity or credit relative to previously. Do you understand the current positioning?

Tactical opportunities arise – in our independent oversight role we observed a number of managers increasing cash holdings over the period ready to redeploy. Opportunities could arise through a designated fund-of-funds, or via standalone opportunities such as Term Asset-Backed Lending Facilities (TALF). Do you know if your fiduciary manager is acting nimbly to utilise the opportunities available?

Overall, we are looking for consistency as the course and challenges evolve.

**Note – the asset class options above exclude cash.*

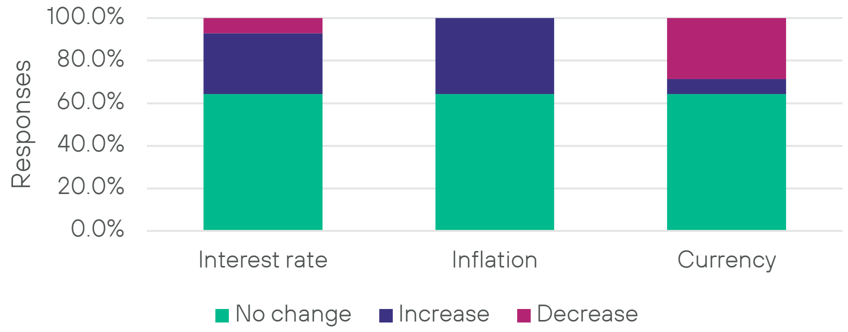
“In recent years schemes that fully hedged liability risks saw the best funding improvements. This decision is as important as getting the growth portfolio right.”

Alex Owen, Fiduciary Management research team

II. Hedging decisions

Before any race a duathlete will check their trainers, their bike, and their other equipment. By mitigating these risks as much as possible, they can focus on the bigger picture: their performance.

We asked fiduciary managers if they had changed their hedging levels for interest rate, inflation, and currency risks during Q1 2020. The results are shown below.



An increase in liability hedging – The majority of managers left their liability hedging targets unchanged, we expect partly because historic hedge targets have been high. If changes were made, this was to further increase hedging targets. This shows a desire to protect strategies further against key sources of volatility.

A decrease in currency hedging – The majority of managers left their currency hedging targets unchanged. However, those who did change decreased hedging over Q1, with some fiduciary managers seeking incremental returns for clients by taking advantage of Sterling depreciation.

What does this mean for my scheme?

It depends... it depends on what level of discretion your fiduciary manager has for each of these levers i.e. interest rate, inflation and currency hedging. We typically see that managers have a little flexibility around the strategic hedging benchmark. The strategic level will have the biggest impact on return as opposed to tactical tilts. We are supportive of managers who are using hedging to reduce the portfolio risk.

We asked fiduciary managers which one asset class they saw as most attractive today. The top answers were as follows:

1. High Yield
2. Alternative Credit
3. Alternatives (e.g. hedge funds, private equity, infrastructure equity)

III. Regret risk and looking ahead

It’s very easy to reach the end of a race and look back to say “I wish I’d...” – have started training sooner or not set-off too quickly. Personally, I would be looking ahead at the next race in the calendar!

Many fiduciary managers admitted they would have reduced risk in hindsight in late 2019, specifically equity risk or at least increased their equity protection strategies. We see a range of asset classes that those fiduciary managers have identified as most attractive looking ahead, with some establishing special “opportunities” funds.

What does this mean for my scheme?

Transparency is critical - we encourage you to speak to your fiduciary manager or oversight provider to understand your position. It can be helpful to understand if risks are being managed effecively and whether decisions taken are adding value.

In our oversight role managers have been forthcoming about changes, which positively demonstrates collaboration. We too believe that credit is more compelling right now. We will be closely monitoring what change managers implement, whilst questioning market liquidity and trading costs.

Recapping the lessons learnt so far in our duathlon

How is your race going? If you had a great first run leg, do you understand how your scheme has transitioned in Q1 and has been performing since? Are you in the lead group of cyclists or have you been dropped?

In this paper we have drawn on our client experience, GIPS performance data and our questionnaire to fiduciary managers to provide insight into the fiduciary market. We identified the following three lessons:

1. **Focus on the big picture** - Are you on track to achieve your investment objective?
2. **Collaborate to get the best results** - Does your strategy continue to be aligned with your funding objective and covenant strength?
3. **Transparency is important** - Do you understand your positioning and return drivers?

What's next?

Q1 2020 was a pivotal quarter for all Trustees regardless of whether they use fiduciary management or not. This environment tested the governance framework that Trustees have in place and how well-equipped schemes are to protect against downside events and volatility. We continue to believe that fiduciary management can be an effective tool for certain schemes to manage their investment strategy.

The fiduciary market is evolving, we think improving. An approach that wasn't right for your scheme yesterday, might be worth considering today.

There is more focus to ensure that fiduciary providers are doing the best job that they can - we fully support this.

Why Isio?

Fiduciary research team of 10 individuals

Independent advice and perspective

Spend over 100 hours every year researching each rated manager

Isio FM Oversight - How is your race going?

We can act as your coach. We are experienced and knowledgeable in this area and we genuinely believe we can help you get the best out of your fiduciary manager, and in turn get the best outcome for your scheme.

There are many big distractions in the world right now. At Isio, we are committed to keeping on top of the fiduciary management market. The table below outlines areas where we have been spending a lot of time talking to our clients about so far in 2020, and why now is an appropriate time for these items to be on the agenda.

What do you need help with?	Service	Why?
1. An independent perspective on performance	Ongoing oversight	We can help you understand your fiduciary mandate, what is driving returns and if you are on track to meet your objectives.
2. Selecting the right provider	Tender exercise Retender exercise	We utilise our manager research and ratings, and, listen to your priorities to take Trustees through an efficient selection process. We have options available to ensure we help you meet the CMA Order requirements in a pragmatic way.
3. To understand all fees and costs paid	Fee review	We can help you understand the fee arrangement that you have in place, how this compares to the wider market, and value for money.

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