XPS Investment

Investment Briefing

October 2022

How well did your fiduciary manager weather the storm in the gilts market?

Fiduciary managers are often perceived as the safest of houses – solid foundations, the thickest walls and a new roof. Under a fiduciary management (FM) model, the day-to-day management of investments is outsourced to a third-party expert, we might therefore expect them to weather the storm better than a traditional investment arrangement giving the significant immediate governance demands.

In this briefing, we consider the different foundations in place for fiduciary managers, what worked well and what didn't during the recent gilts crisis and importantly we look ahead to explore how greater resilience can be built. We also provide a short set of questions you can ask yourself in relation to your fiduciary manager if you need help understanding the state of your portfolio – e.g. is it still resilient and can it be expected to deliver to your short, medium and long term objectives?

Key highlights

The impact of the 'mini-budget' put a huge strain on the UK pension scheme market, and fiduciary managers have by no means been exempt from this.

We have seen that some portfolios are built stronger than others, some have got themselves back in order more quickly and some might need greater time to repair the damage.

In many FM arrangements:

- Hedging is being reduced
- Investment guidelines are being altered
- Restoring the liquidity of portfolio could take several months
- Any tactical view on the level of liability hedging is now likely to be a significantly larger risk

With trustees relinquishing a degree of control to their fiduciary managers, how can you be sure that appropriate decisions are being taken on your behalf?

In line with the CMA Order, it is important to assess if objectives set for your FM are being met. With our investment experience, we are well placed to challenge your FM and support you in understanding their current position.

1. Surveying the foundations

Fiduciary managers employ a variety of different approaches to constructing a portfolio. Importantly these differences can lead to varying cost, complexity, liquidity and flexibility. The recent liquidity crisis in Liability Driven Investments (LDI) shone a light not only on portfolio construction in this part of the portfolio, but also the wider portfolio that needed calling upon to help source cash.

Below we outline four example structural decisions in relation portfolio construction.

Liquid vs illiquid assets

How long it takes to buy or sell a specific asset defines its liquidity. Less liquid assets are termed illiquid and assets may be 'tied-up' for longer.

Pooled or segregated arrangements

With pooled arrangements you invest alongside others in a fund, whereas with segregated you are the only investor and have more control.

Internal vs externally managed funds

Whether an FM manages a fund in-house or employs a separate third party investment manager to manage assets on their behalf.

Fund vs fund of funds (FoF) approach

FoF is an investment strategy to invest in several funds in a single solution rather than a single fund.

XPS View

The exact combination of these four approaches will have had a significant impact on a scheme's experience during the gilt crisis. As trustees are further removed from decision making within an FM arrangement compared to a traditional advisory approach, there is more scope for them to be less familiar with these factors.

2. What helped to keep out the rain?

We explore how some of the aspects of portfolio construction helped during the gilt crisis.

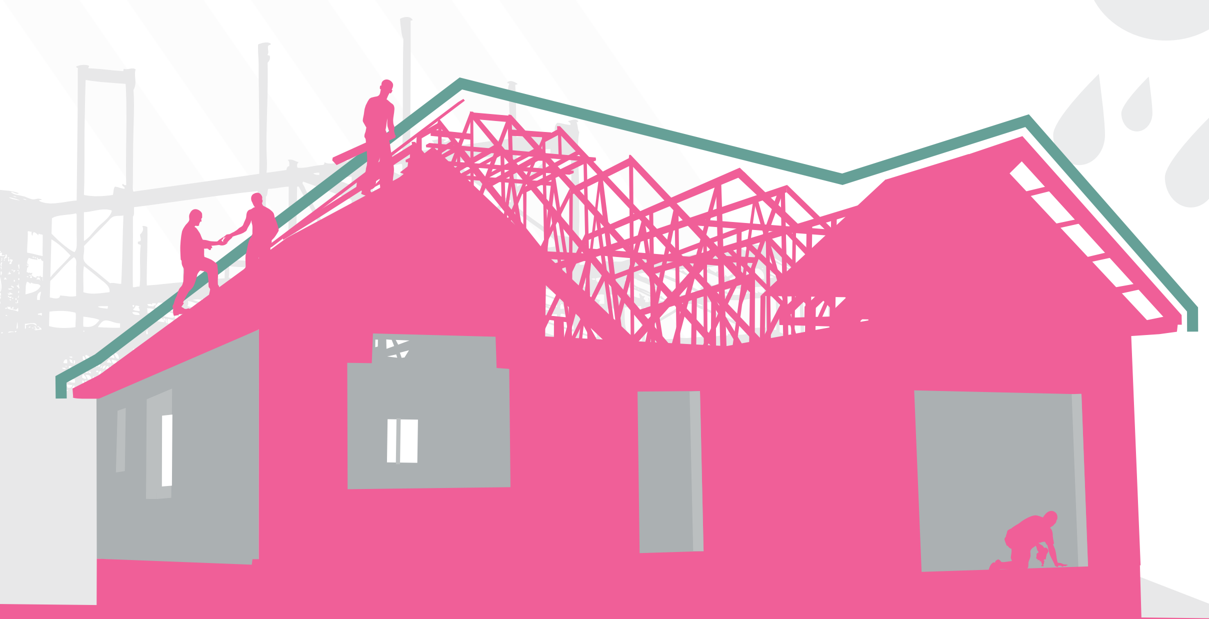
- **Liquidity** – greater liquidity allowed collateral calls to be met efficiently, ensuring hedging levels and risk exposure could be maintained for clients. It also facilitated scope for greater diversification of the residual assets.
- **Choice of LDI manager** – some LDI managers have dealt with the recent crisis better than others in terms of coordinating client calls, accuracy of information shared and communication. Some FMs have one preferred LDI manager whilst others use several.
- **Proportion of assets managed internally** – this can offer greater visibility to help FMs make investment decisions.
- **Communication** – although not an aspect of portfolio construction, we have seen a huge disparity with how FMs have communicated with clients during this period. With the strongest taking trustees on the journey with them, even if only to keep them informed of actions being taken on their behalf.

In most cases, FMs have prioritised addressing immediate issues during the past few weeks, where action was required. However, as we now begin to look more holistically at the medium term, it is important that your FM doesn't have tunnel vision but can step back and consider if others should be involved in the conversation, such as the trustees, sponsor or actuary. This is important given funding positions may be materially different (in many cases improved) and the portfolios expected return may be substantially different to its target.

XPS View

The most important thing is to ensure the risks faced by the scheme are appropriately managed at all times. A joined-up approach should lead to better outcomes for all.

It is also helpful to reflect with your fiduciary manager to understand what went well and what didn't.



3. Action plan for the coming months

Recent events have fundamentally changed the way in which LDI portfolios can be managed, which means your portfolio will likely need to change.

Your portfolio will never look quite the same as it did before. This is primarily driven by the greater capital requirement of all LDI portfolios, meaning there is less capital to be held in non-LDI assets. In the short to medium term you may also be holding more illiquid assets than is optimal, as your liquid assets have recently been depleted (both at fund and/or underlying fund levels).

The most prevalent changes observed so far:

100%

For some FMs, investment guidelines are changing for 100% of their clients

20-30%

Typically we are seeing 20-30% of clients having their hedge reduced

- Many FMs have significantly **reduced the hedging** in place for their clients, but for different reasons (we explore rationale in the next section).
- **Investment guidelines –** whilst most fiduciary managers have been capable of making investment decisions within existing guidelines to date, several are seeking more flexibility looking ahead. Schemes' investment strategy and journey plans will also need revisiting. We understand that this is something on the agenda with FM's, to lock-in any potential gains or get back on track, we encourage this to be looked at as soon as possible.

Gilt yields are significantly more volatile than they were prior to September with significant intra-day movements observed. Changes are being made to the level of hedging in place but also widening the discretion to permit further changes. Greater market volatility combined with reduced hedging levels have introduced schemes to greater risks. Discussing the new conditions with scheme sponsors is also an important action.

XPS View

We consider interest rate and inflation to be unrewarded risks – in that we do not expect them to be a source of expected return over the long term. Where possible we believe that schemes should aim to maintain their hedging in portfolios, exploring all options.

Where levels of liability hedging have been reduced it is important to understand why and the implications.

4. Asking the right questions

Decisions in the past few weeks have needed to be made quickly. Now the urgency has passed we think it is necessary to revisit your current financial position, how your portfolio is constructed and ensure that you get the best out of your FM looking ahead. We hope that the questions outlined below can assist with this.

Potential questions a trustee board can ask itself

Has your FM made changes to the way they manage your assets and the portfolio regarding the following:

1. Hedging

a. **If your hedging level has been reduced, it is important to understand why, and what options you have.**
   - i. Is this due to necessity, driven by investment returns required under the journey plan? Could the target return be temporarily lowered until the volatility in markets subsides?
   - ii. Is this due to a tactical view on the level of hedging and the direction of yields?
   - iii. Is there sufficient liquidity to retain the current level of liability hedging?

b. **Matching portfolio**
   - i. Are you still comfortable that your FM is well equipped to build and manage a robust liability hedge?

2. Growth portfolio

a. **Is the portfolio out of balance due to the need to meet collateral calls?**

b. **How long will it take to get the portfolio back to its target weights and what risk exposure do you have in the meantime?**

c. **Has the approach to portfolio construction been impacted by meeting collateral calls – does the current approach remain appropriate?**

d. **Do you have enough liquidity to meet future collateral calls?**

3. Guidelines

a. **Have these been changed?**

b. **If they have been loosened thereby giving the FM more freedom does this expose the scheme to more risk?**
   - i. Why does the FM need more latitude and flexibility?
   - ii. How long should these guidelines be loosened for?

4. Communication

a. **Have the changes and rationale been communicated effectively by your FM?**

XPS View

We expect answers to these questions to depend on:

a) the approach to how your portfolio is constructed;
b) your scheme's specific circumstances; and
c) ultimately the decisions that your FM has been making on your behalf.

How XPS can help

The nature of these conversations is amongst the most technical when it comes to UK pension schemes and responsibilities of trustees. We believe having an independent advisor with a strong investment background is paramount in being able to question and engage with your fiduciary manager with you or on your behalf, and ultimately help to get better outcomes for your members.

LDI health check – an independent survey of your scheme

We have developed an **LDI health check** to assist trustees who are unsure how they have been impacted by the recent LDI liquidity crisis. The aim is to aid trustees' understanding, and ensure risk is being managed appropriately looking ahead. This covers answers to the questions set out on the previous page, liquidity analysis of your portfolio and a summary of suggested key areas that trustees should engage with their FM. **Please get in touch if this would be helpful for your scheme.**

About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 994,000 members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £113bn of assets under advice.

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