XPS Investment

XPS FM Watch

Fiduciary Manager Review 2023

Whenever making a journey, we hope for one that is straightforward, smooth and without delay. Trustees of UK DB pension schemes journeying to full funding are no different. However, the increased frequency of what we would consider to be extreme market events in recent years is providing an ever-harder challenge for trustees and their fiduciary managers ('FM') to successfully steer pension schemes to their final destination.

2022 will be remembered as a particularly tough stretch of the road and, for some schemes, large negative returns from traditional asset classes will have put many strategies into reverse gear. With so much focus being placed on how investment strategies coped through the gilts crisis, it would be easy to forget that poor growth asset performance also had a significant impact.

This survey analyses 18 growth portfolios managed by 15 FMs over 2022 (with assets representing more than 90% of the UK fiduciary management market) to assess which fiduciary management solutions have best handled the sharp twists and turns of volatile investment markets.

Key findings

- All FM growth portfolios, excluding just one, provided negative absolute returns in 2022.
- Over 50% of FMs' growth portfolios outperformed the upper quartile of Diversified Growth Fund ('DGF') returns over the year.
- There was a wide range of returns across the UK fiduciary management market over the year with a 13% difference between the highest and lowest returning growth portfolios.
- Larger asset allocations to equities and fixed income were a key determinant for the worst performing growth portfolios. More complex growth portfolios provided better returns.
- Exposures to real assets and hedge funds provided opportunities to protect portfolios from large negative returns however experience varied greatly between FMs.
- There was a strong link between liquidity and performance. FM growth portfolios with higher allocations to illiquid assets were amongst the highest returning portfolios whilst those with the most liquidity had the lowest returns. However illiquidity caused its own problems during the September/October gilts crisis.

With the gilts liquidity crisis being such an intense and significant market event for UK DB pension schemes, it would be easy to forget the large sell off in growth assets, particularly in early 2022.

Guy Plater
Partner and Co-head of Fiduciary Management Oversight

2022 market backdrop

Chart 1: 2022 market performance

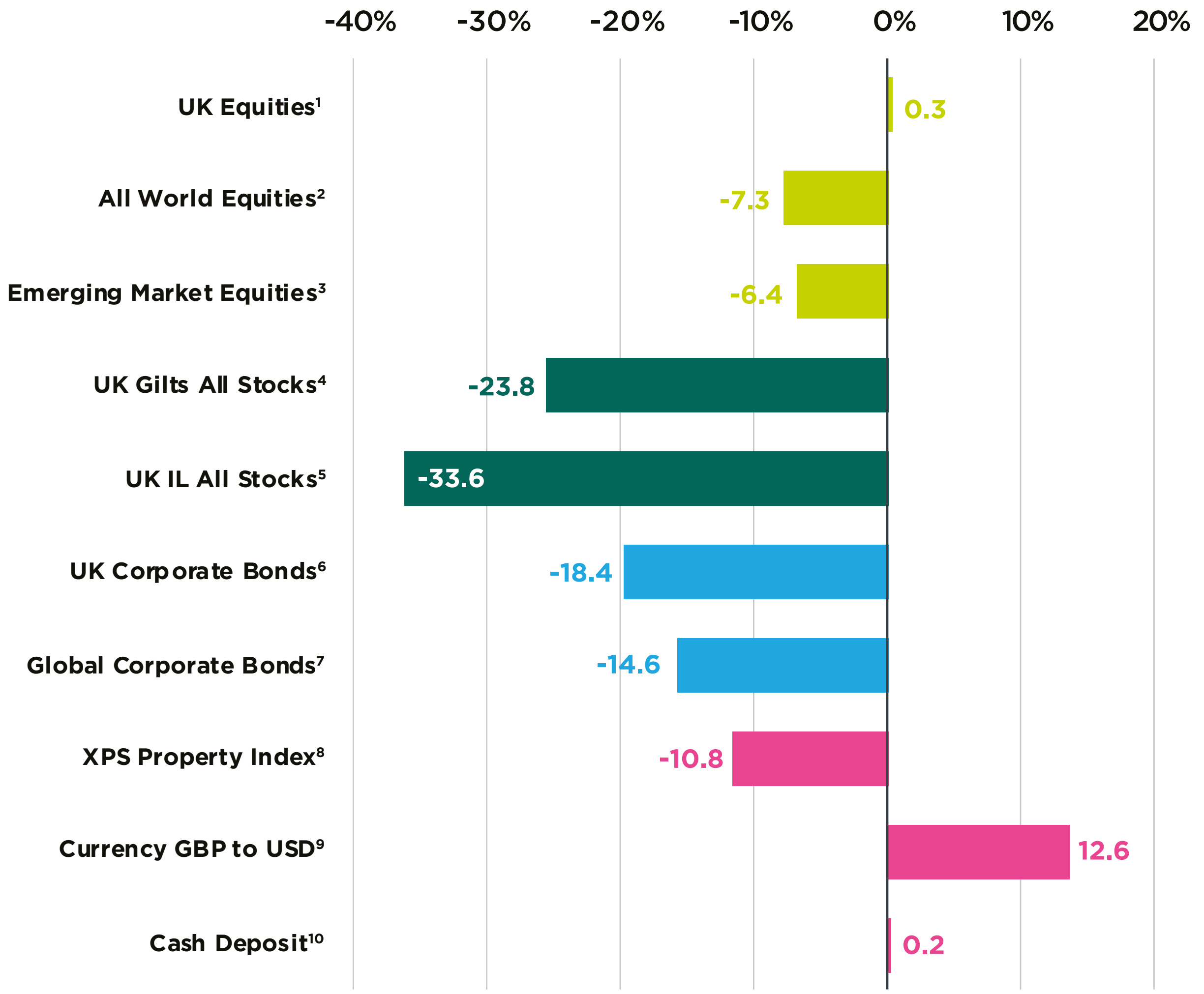


Chart notes:
Source: Refinitiv, XPS Investment

1. FTSE All Share Total Return Index
2. FTSE All World £ Total Return Index
3. FTSE Emerging £ Total Return Index
4. FTSE British Government Fixed All Stocks Total Return Index
5. FTSE British Government Index-Linked All Maturity Total Return Index
6. iBoxx £ Non-Gilts Total Return Index
7. ICE BofA Global Corporate Index – Total Return Index Value
8. XPS Property Index
9. US($) to UK(£) (WMR) exchange rate
10. IBA GBP LIBOR 1 week – Total Return Index

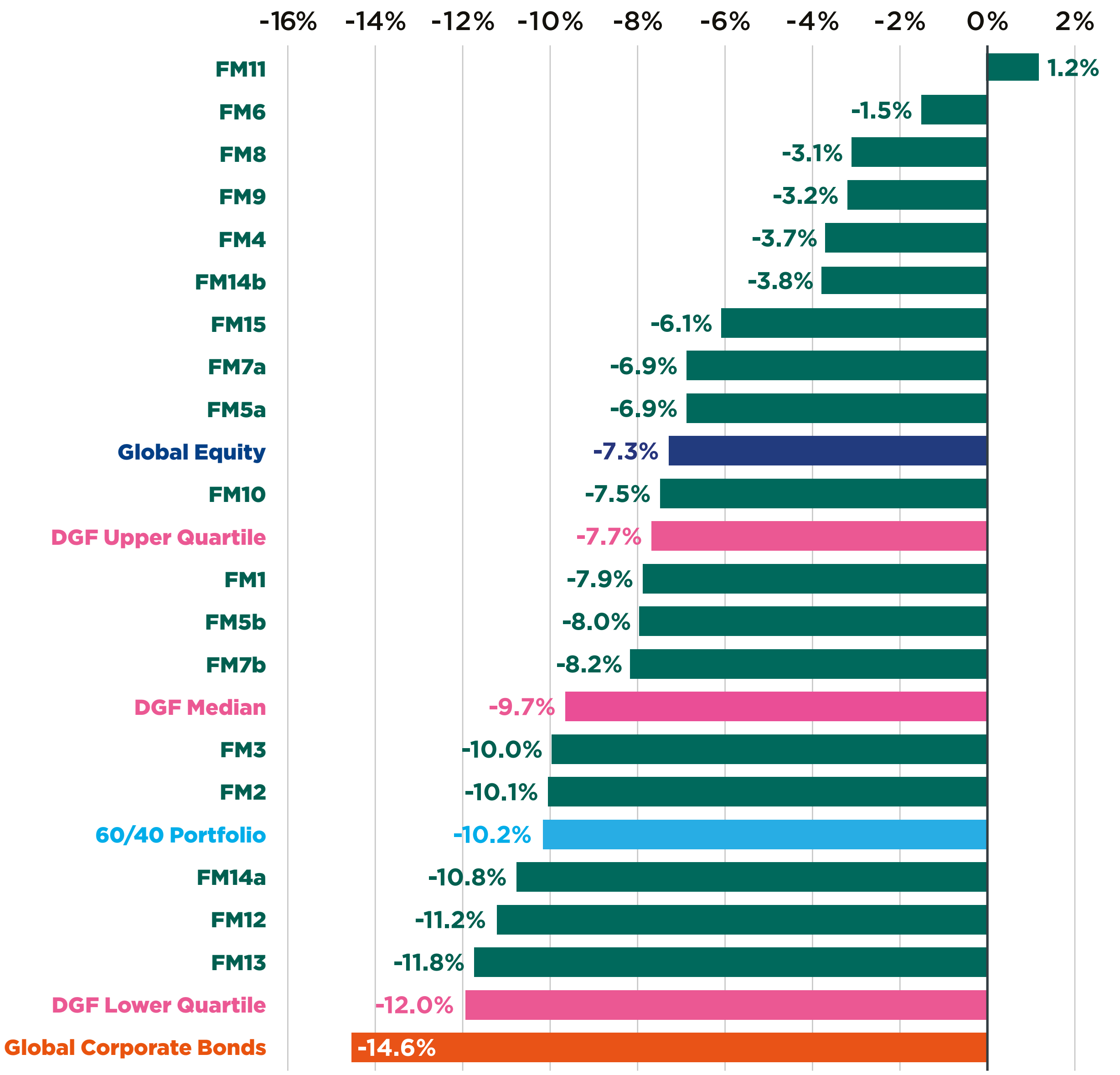
Equities struggled throughout most of the year, heavily impacted by Russia's invasion of Ukraine and rising levels of global inflation and interest rates. Rises in bond yields also led to large negative returns from fixed income. Falls across these markets will have likely resulted in many growth portfolios reducing funding levels over the year.

Fiduciary manager performance comparisons

Those FMs' growth portfolios with higher exposure to equities and fixed income experienced the largest negative returns. Whilst those with more complex growth portfolios incorporating protection strategies along with exposures to real assets and opportunity-seeking hedge funds resulted in some FMs providing better returns, albeit still generally negative. This observation is further supported by the three FMs that provided alternative portfolios, with the FM's more complex portfolios outperforming their simpler, lower cost counterparts.

Chart 2 shows the 2022 absolute performance for a total of 18 growth portfolios, with three FMs providing data for alternative portfolios designed to meet clients' differing objectives. The FMs provided their monthly returns net-of-all-fees, as well as details of the total amount of assets managed and number of clients invested in each of the portfolios.

Chart 2: Fiduciary manager and comparator performance – 2022

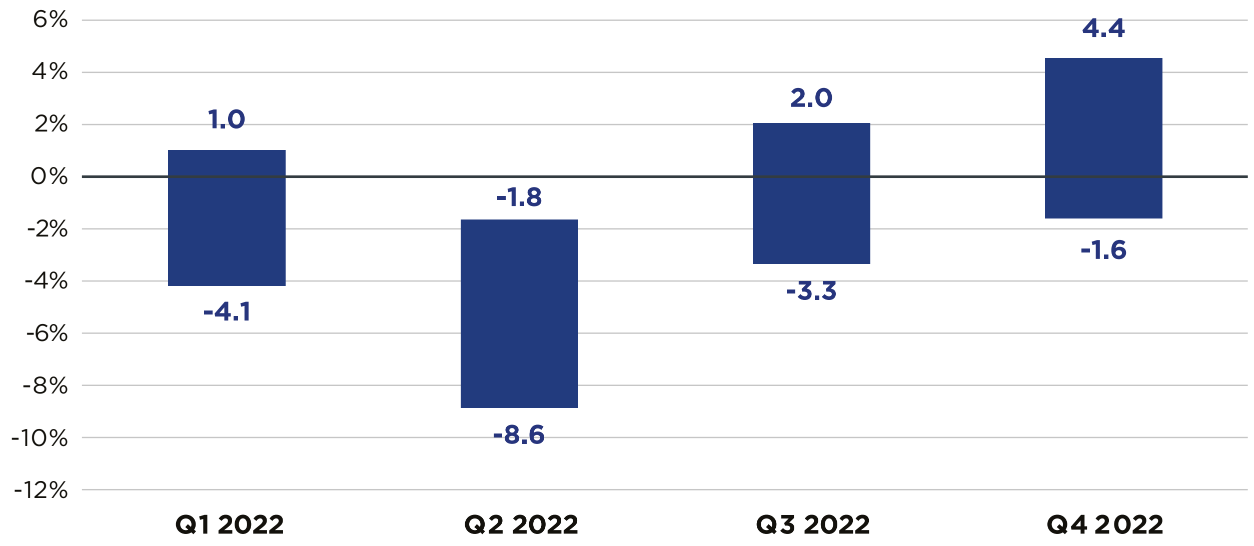


Source: Refinitiv, XPS Investment, fiduciary managers

Despite the large negative returns from both global equity and fixed income markets, a handful of FMs managed to deliver relatively good levels of protection, with one FM even managing to produce a positive absolute return. As we have seen with previous years, the FMs' growth portfolios also performed well relative to DGFs. Over 50% of growth portfolios outperformed the DGF upper quartile return, and all FMs outperformed the DGF lower quartile return. However, in an atypical year where both equities and bonds provided large negative returns, three FM growth portfolios underperformed a low-cost index tracking '60/40' (60% equity/40% bonds) portfolio.

Our previous FM Watch reports have observed that there is always a large range between the highest and lowest returning growth portfolios. In 2022 this was particularly marked, with all four quarters resulting in a wide range of returns. Q2 2022 particularly having a very wide range of 6.8% between the average of the three highest and lowest returning portfolios. All four quarters of 2022 had a wider range than Q1 of 2021 which had the largest range of returns of 2021.

Chart 3: Range of average returns for the three highest and three lowest returning growth portfolios by quarter



Source: Fiduciary managers

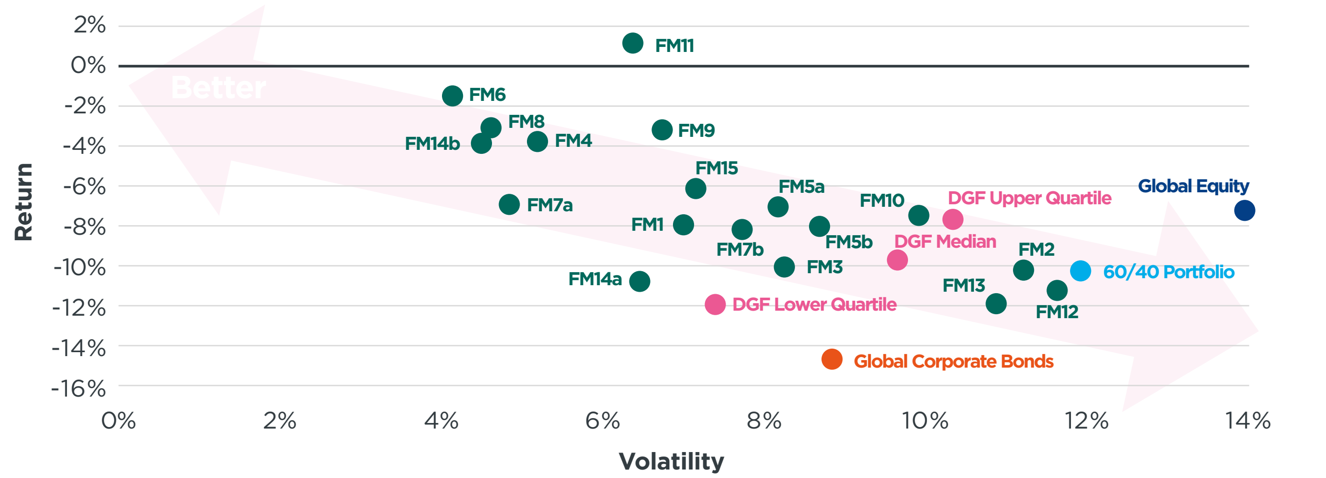
We also observe that the best performing portfolios providing the most protection in negative quarters, were amongst the worst performing portfolios when markets produced better returns in Q4 2022. The opposite was also true – those portfolios which offered little protection in falling markets were able to capture more upside returns when markets improved. This trend perhaps indicates that FM growth portfolios don't change all that dynamically relatively to one another and therefore the type of vehicle chosen for the journey (defensive or more aggressive) very much determines the experience of the ride rather than the dynamic changes to the portfolio on the way.

One conclusion from our previous year's analysis has been that the type of FM growth portfolio employed has a big impact on outcomes – this was even more the case in 2022 with its more extreme market events. Trustees need to be comfortable that the approach taken aligns to the circumstances of their scheme and their risk preferences.

There were a wide range of FM growth portfolio returns in every quarter of 2022.

Volatility-adjusted growth portfolio performance

Chart 4: Return vs Volatility – 1 year to 31 December 2022

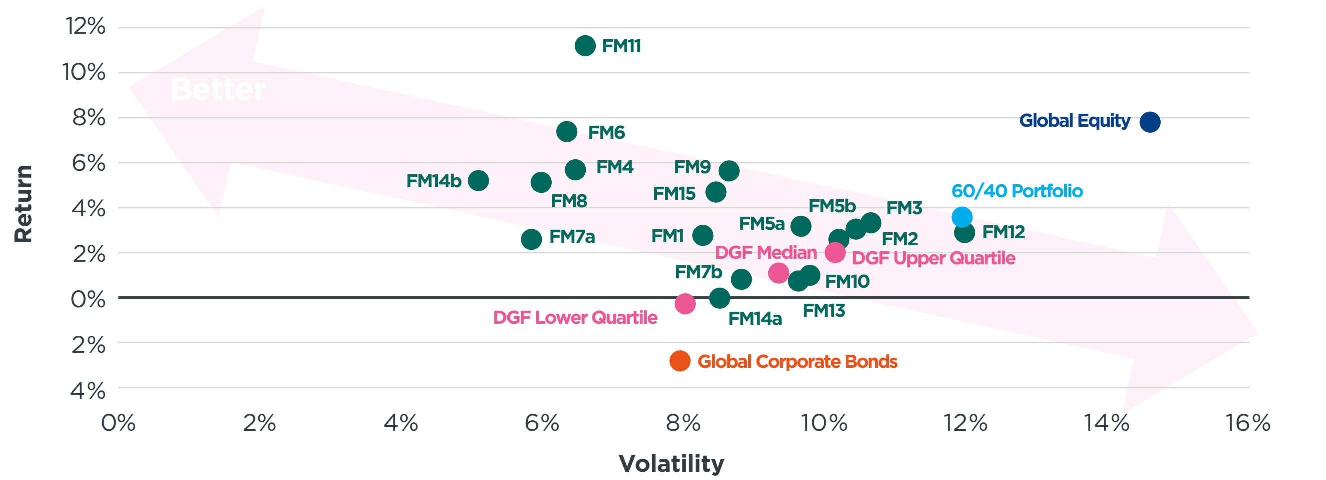


Source: Refinitiv, XPS Investment, fiduciary managers

When reviewing or selecting fiduciary management solutions, trustees should always assess returns generated from the growth portfolio in the context of risk management and the portfolios' return objectives. Chart 4 illustrates the FMs' growth portfolio returns against monthly volatility of returns over 2022, based on calculations by XPS and using monthly return data provided by each FM. In line with the wide range of average returns from the three highest and lowest returning portfolios for each quarter, there was also a very wide range of volatility between the highest and lowest returning growth portfolios for the year - similar to the range of volatility we observed in 2020. Notably, portfolios with some of the highest average asset allocations to both equities and fixed income (FM10, FM12 and FM13) experienced the highest volatility of returns and were hurt by the unusual combination of strong negative returns for both of these asset classes over a sustained period of time.

When assessed on a risk-adjusted basis, the majority of the FMs outperformed a passive 60/40 portfolio, demonstrating that the broad investment tool-kit available to FM solutions adds value for schemes. However there were three FM growth portfolios (FM2, FM12 and FM13) which underperformed the median DGF.

Chart 5: Return vs Volatility – 3 years to 31 December 2022 (p.a.)



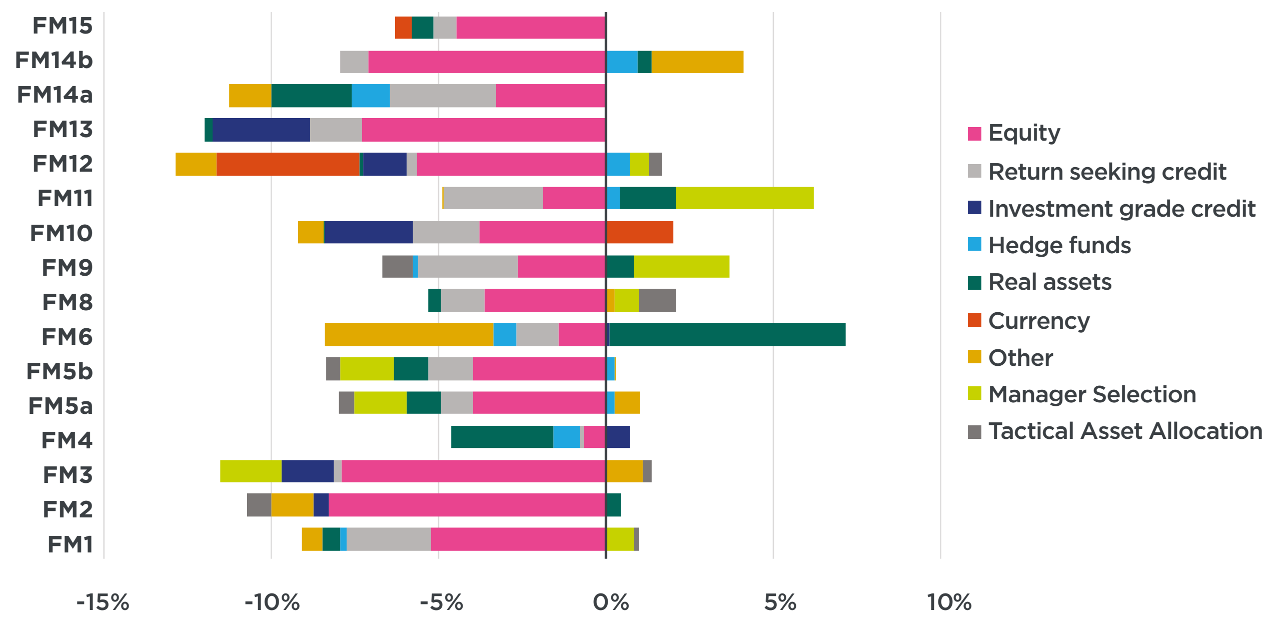
Source: Refinitiv, XPS Investment, fiduciary managers

Chart 5 shows the equivalent data over the three years to 31 December 2022 and still shows a fairly wide range of volatility of returns for the period. This is to be expected, given the period assessed includes 2020, another very volatile period for investment markets. Similar to the one year period, the growth portfolios with higher levels of complexity delivered better returns on a risk-adjusted basis than those with higher allocations to both equities and fixed income.

Investment approach and return contributors

Chart 6 illustrates the contributors of each asset class to the overall returns achieved by each FM in 2022. With the exception of one FM (FM4), both equities and credit contributed to the negative returns for every growth portfolio. Typically we would expect exposures to hedge funds and real assets to provide diversification and some protection from falling equity and credit markets, however there was a very mixed experience as to whether they contributed positively or negatively to returns.

Chart 6: Contribution to returns – 2022



Source: Fiduciary managers

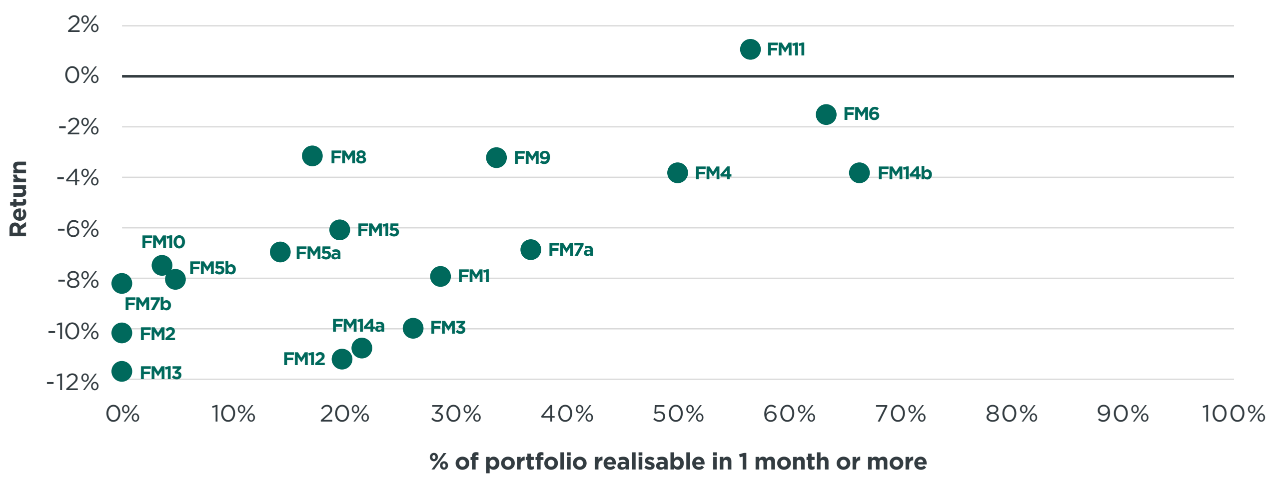
Where provided by FMs, we have included the contributions to returns from manager selection and tactical asset allocation decisions[1]. We view the assessment of value added through this analysis as an important part of fiduciary management oversight given higher fees are often associated with greater use of active management. For 2022, the value added from manager selection varied across all FM growth portfolios and tactical asset allocation either provided marginal gains or losses over the period.

Due to the gilts crisis in September and October last year, 2022 was arguably the biggest test of the liquidity of FM portfolios to date. We define liquidity as the period of time between the instruction to sell and settlement (receipt of the cash proceeds). Chart 7 shows the return for each FM growth portfolio against the proportion of each portfolio that was liquid in one month or longer. The chart shows there is a clear link between the strongest performing portfolios (FM6, FM11 and FM14b) and their relatively lower levels of liquidity compared to the worst returning portfolios and their relatively higher levels of liquidity (FM2, FM13). When assessing the performance of FM growth portfolios during 2022, exposure to more illiquid asset classes was beneficial to returns.

Exposure to hedge funds and real assets can provide good levels of protection from falling negative equity and credit markets, however across FM growth portfolios, there was a mix of either positive of negative contributions to returns.

[1] Where not shown explicitly, the contributions by manager selection and tactical asset allocation are included within the relevant asset class contributions or within 'Other'.

Chart 7: Return vs % of portfolio realisable in 1 month or more



Source: Refinitiv, XPS Investment, fiduciary managers

It is important that trustees understand the liquidity in their portfolios, distinguishing between dealing frequency, which doesn't account for any notice or settlement periods, and the realisation of assets. It is also important to not be distracted by fund naming – whilst a fund labelled as 'liquid growth' might be much more liquid than one labelled 'illiquid growth' it might still take a month or more to receive cash proceeds, rendering less useful to support a leveraged liability hedging portfolio.

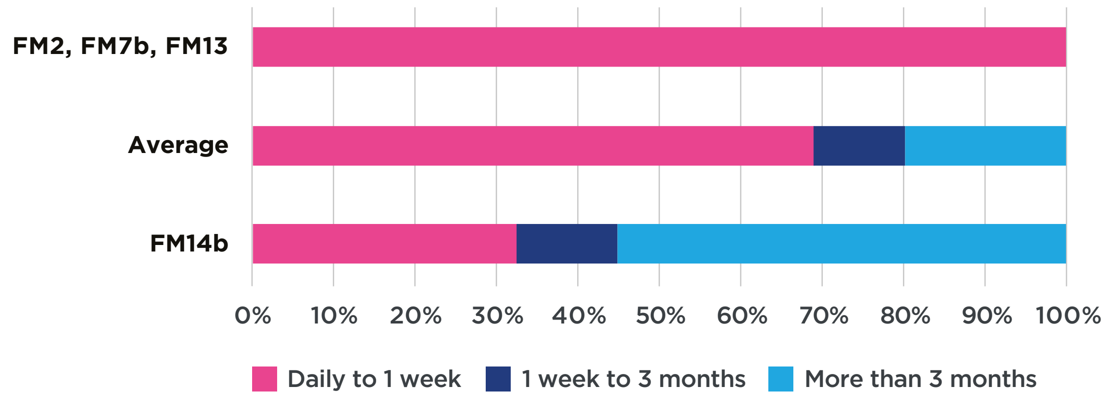
As displayed in Chart 8, there can be a wide range in the liquidity of growth portfolios between FMs. This was particularly important in 2022 during the gilts crisis as a scheme's growth portfolio allocation determined how much capital was available to meet LDI portfolio collateral calls (daily to 1 week liquidity), rebalance the portfolio (1 week to 3 months), or could not be used to support the strategy until well after the crisis. As we have indicated, those growth portfolios with higher levels of illiquid assets tended to have better returns in 2022. It does not, however, provide information to two important questions:

1. Whether it was possible to retain these illiquid assets or if the FM was a forced seller which will have incurred large costs.
2. Whether the allocation to these illiquid assets was appropriate given the requirement for sufficient liquid assets to maintain the target liability hedge.

Due to the gilts liquidity crisis, we have seen many FMs being forced sellers of illiquid assets resulting in large haircuts to the value of these assets.

André Kerr
Partner and Co-head of Fiduciary Management Oversight

Chart 8: % of growth portfolio realisable from point of instruction to settlement – Q2 2022



Source: Fiduciary managers

When assessing a FM, trustees must always assess performance in the context of the whole investment strategy against a scheme's risk and return objectives. We note that whilst our analysis focusses on the FMs' growth portfolios and provides trustees with an indication of how their appointed FM is performing relative to the market, it does not take into account the performance of the FM overall in the context of a scheme's objectives.

For example, and as indicated by our points regarding being forced sellers of illiquid assets and the liquidity of assets to support hedging levels, these aspects can have material impacts on the success of an investment strategy. Applying oversight with frequent assessment of a fiduciary management solution is the approach that trustees can take to know if their appointed FM continues to be right for their scheme.

The significant market events of 2022 highlights that components of FM solutions cannot be assessed in isolation. Detailed and independent oversight allows trustees to get beneath the bonnet and carry out a full engine diagnostic.

Fraser Weir
Investment Consultant

Conclusions

2022 laid out another potential bump in the road for many schemes in their journey to reach their long-term funding targets and FMs had some of the toughest of market conditions to steer through. The vehicles that trustees have selected is resulting in a wide range of experiences not only in terms of growth portfolio returns but in the context of the wider investment strategy. Due to the gilts crisis and through our independent FM oversight service, we have seen first-hand that the structure of growth portfolios, particularly with regards to liquidity, has been hugely important for the success of maintaining schemes' investment strategies. Exposure to illiquid assets may have likely resulted in better growth portfolio performance during 2022, however for some schemes, greater exposure to these assets will have left some desperately needing to re-route their SatNavs.

Key observations

- **FM growth portfolios with higher exposure to equities and fixed income experienced the largest negative returns and greater levels of volatility.**
- **Over 50% of FM growth portfolios outperformed the DGF upper quartile return demonstrating a wider investment tool kit used by FMs adds value.**
- **More complex growth portfolios incorporating protection strategies along with exposure to real assets and opportunity-seeking hedge funds resulted in better returns.**
- **Contribution to returns varied amongst FM growth portfolios with exposure to real assets and hedge funds.**
- **Exposure to illiquid assets was beneficial to returns however trustees must consider this outcome in the wider context of the overall performance for their scheme against the investment objectives.**

Actions for trustees

To get the best assurance against any unexpected and unwanted surprises, either delaying or adding costs to a scheme's journey, trustees should look to apply independent FM oversight to understand:

1. Post gilts liquidity crisis, how the portfolio has changed and whether it continues to be appropriate for your scheme's risk and return objectives.
2. The levels of liquidity and whether this can support the requirements of the matching portfolio and the Regulator's guidance.
3. Whether all parts of the portfolio are providing value as expected.

For further information, please get in touch with **André Kerr, Guy Plater or Fraser Weir.** Alternatively, speak to your usual XPS Pensions contact.

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