XPS Investment

XPS FM Watch

Fiduciary Managers under the spotlight

Whilst financial market performance during the first quarter of 2020 was overawed by the global economic impact of COVID-19, markets over 2019 were buoyant, with equity indices hitting record highs and gilt yields falling to record lows.

In this paper we present a holistic analysis of 16 Fiduciary Managers (FMs) growth portfolios over 2019, identifying who capitalised on the favourable market conditions, but more importantly how they went about it.

In this report we:

- Review the market backdrop;
- Compare the performance of 16 FM growth portfolios to a selection of high profile Diversified Growth Funds (DGFs);
- Introduce a measure of risk into the portfolio performance assessment; and
- Illustrate the different investment approaches FMs used to deliver returns over the year.

XPS's FM Watch is clear, helpful, comprehensive (without being excessively detailed or complex) and interesting. It allows market participants to compare fiduciary managers to each other and the broader Diversified Growth Fund market. The comparison of fiduciary managers is a difficult balance between providing enough information and too much complexity. XPS's FM Watch focuses on performance in a very clear, easy to understand way but with reference to all these other factors such that the context for the past performance can be understood. FM Watch has been welcomed by the market and has evidently filled a gap in useful publicly available information. **UK Fiduciary Manager**

Exhibiting positive returns in a bull market is only the prologue; quantifying the amount of risk taken and evaluating the types of investments used tells the full story. Our analysis demonstrates the myriad approaches to delivering investment returns for clients. We can help trustees find the manager whose approach suits their circumstances best.

Charlie Stewart
Senior Investment Associate

2019 market backdrop

To provide a sense of the buoyant market environment faced by investors in 2019, we illustrate a summary of key market returns in Chart 1.

Chart 1: 2019 market performance

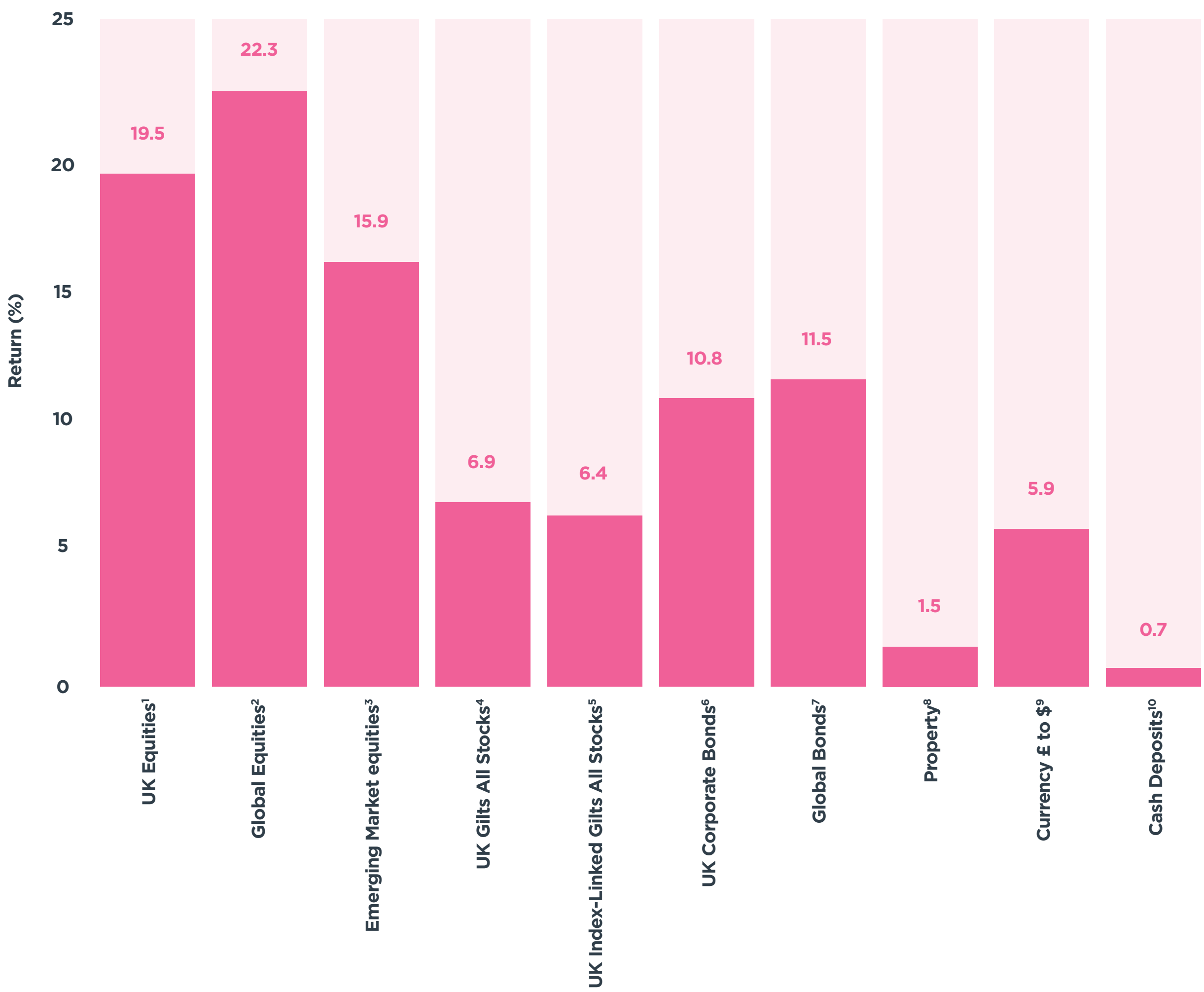


Chart notes:

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. ICE BofA British Pound 1-Month Deposit Offered Rate Constant Maturity In - Total Return Index Value

Global equity markets delivered double digit appreciation across all regions with developed markets outperforming emerging markets. Gilt performance was also positive for investors as yields fell to, what were then, record lows. Strong equity markets, falling government bond yields and further monetary stimulus created a favourable market environment for global credit assets. UK pension schemes will also have benefited from an appreciation of Sterling against most major currencies.

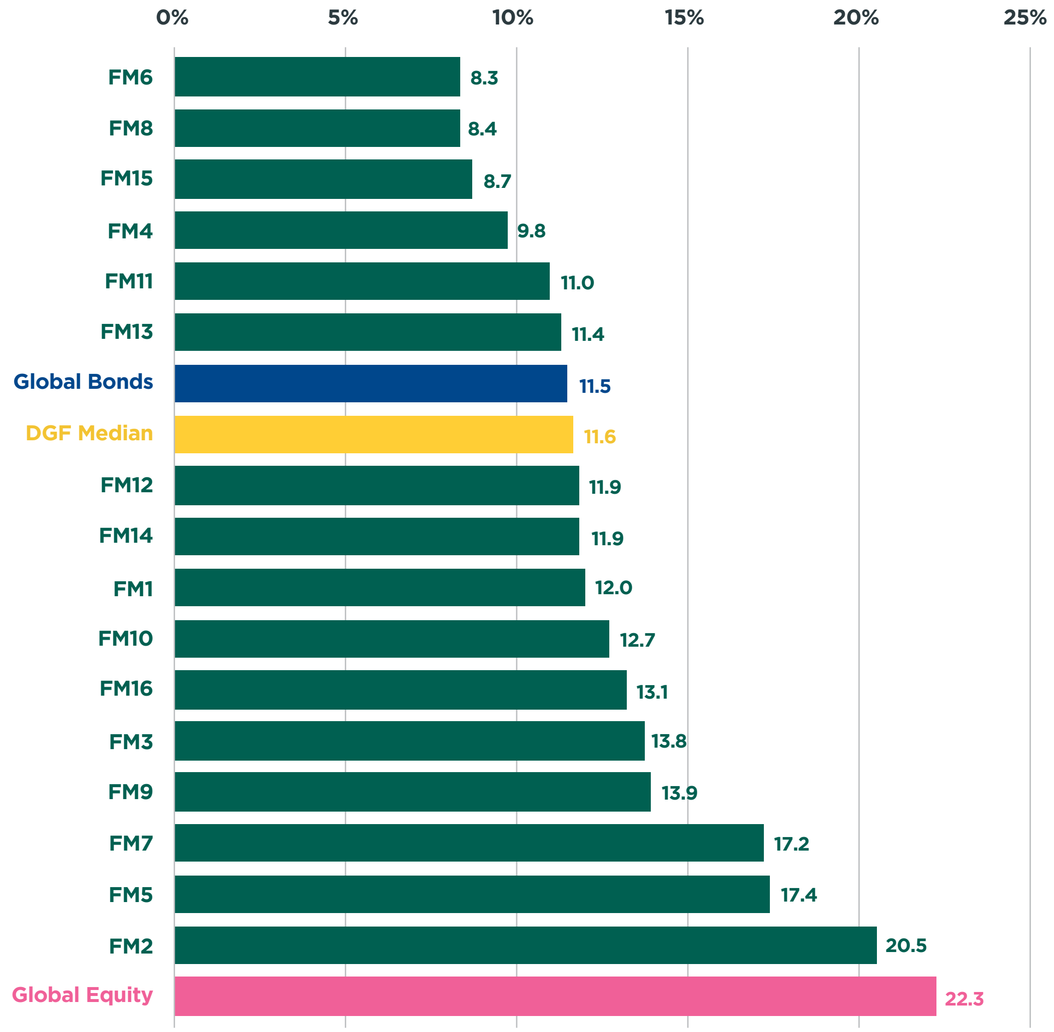
Growth portfolio performance

FMs have been strong advocates of the use of Liability Driven Investment which, when implemented effectively, provides a capital efficient method of protecting the funding position against movements in interest rates and changes in inflation expectations. This allows the remainder of the portfolio to focus on delivering growth in order to improve the funding level. Excluding the gilt indices, Chart 1 provides a sense of the strength of returns the FMs could draw on to deliver their portfolio performance over 2019. Chart 2 (overleaf) illustrates the performance of 16 FMs 'best-ideas' growth portfolios, net of fees, during 2019. This captures 99% of UK fiduciary clients.

Performance comparisons

1-year performance

Chart 2: Performance – 2019



Sources: Refinitiv, XPS Investment, Fiduciary Managers

All FMs captured the positive market returns but there was a broad range of outcomes. The difference between the highest and lowest returning portfolio was 12%; in monetary terms, a £100m investment with FM2 at the start of the year would now be £12m better off than if invested with FM6. This may have enabled clients to hit a de-risking trigger they otherwise wouldn't have (an important factor given the market downturn in the first quarter of 2020).

Compared to a selection of over 20 high-profile DGFs, the majority of FMs have delivered returns broadly in line with, or above, the median DGF return. We would typically expect FM portfolios to outperform DGFs as they have a broader opportunity set available to them.

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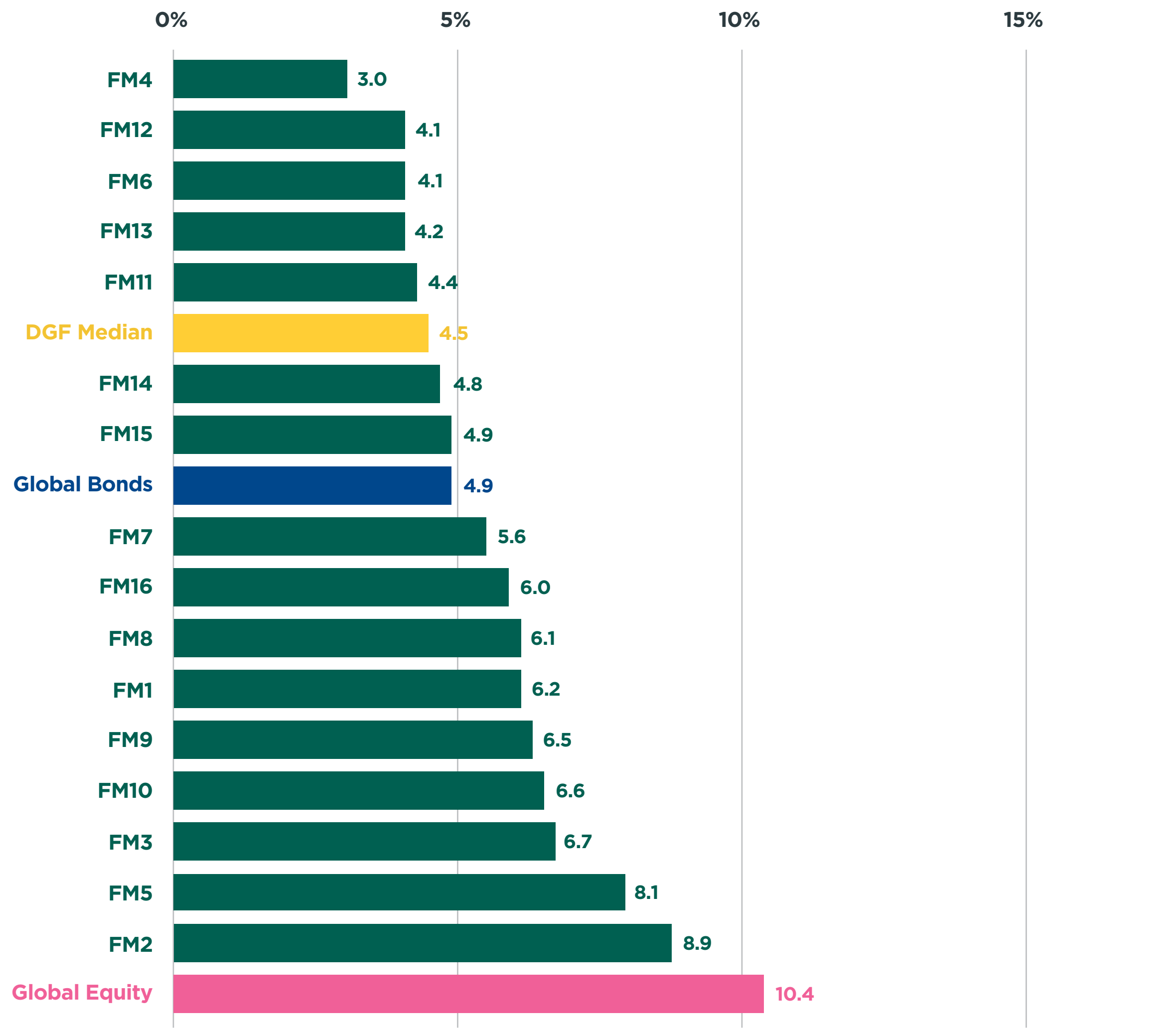
3-year performance

Like DGFs, most FMs will determine their effectiveness using a long-term performance target, therefore we have illustrated three year returns in Chart 3 to give a better indication of the ability of each FM to deliver performance over a longer timeframe.

Chart 3: Performance – 3 Year (pa)



Sources: Refinitiv, XPS Investment, Fiduciary Managers

Over three years, the majority of FMs have delivered stronger performance, however there is a wide range of outcomes. The cumulative difference between the FM with the best and worst return equates to a 20% over the three-year period.

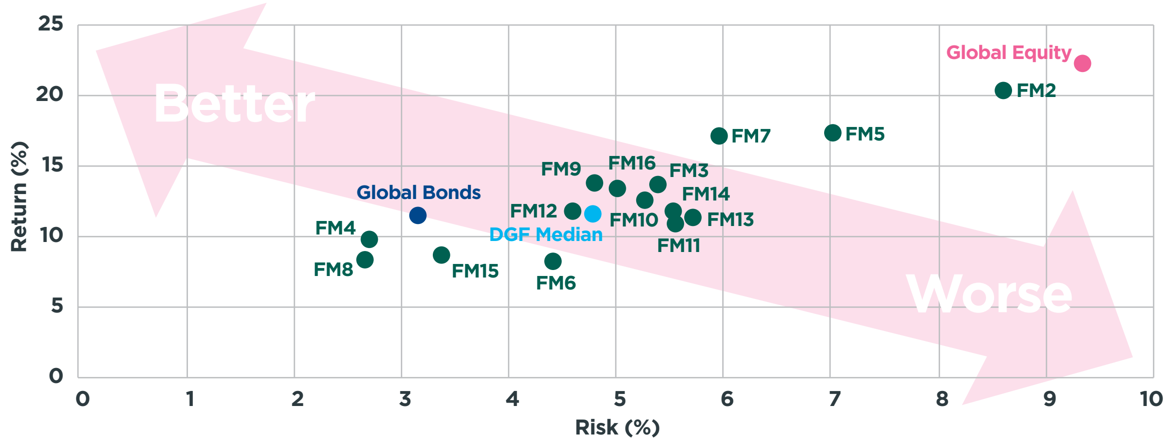
Although absolute returns are an important metric, the amount of risk taken to achieve that level of return should be considered in equal measure.

The return difference between the FM with the best and worst return equates to a 20% cumulative difference over the three-year period considered.

Risk-adjusted growth portfolio performance

In addition to assessing portfolio returns over 2019, we have also analysed the monthly volatility of returns, and combined this information in Chart 4. The spread of risk taken by the FMs is wide, which demonstrates the variety of approaches taken by the FMs. Whilst FM2 had the highest 1-year return, the level of risk taken is noticeably above the peer group.

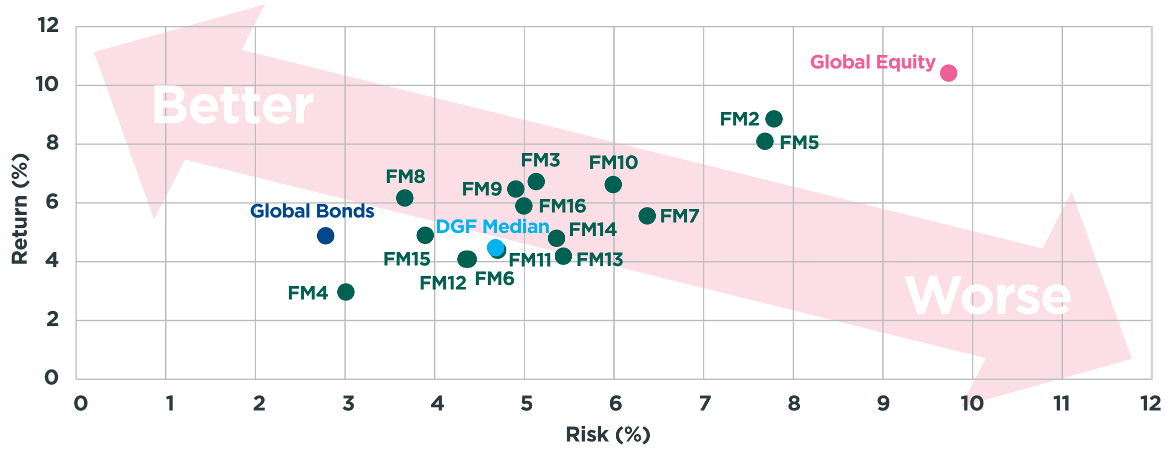
Chart 4: Return/Risk Plot – 2019



Sources: Refinitiv, XPS Investment, Fiduciary Managers. Data not provided by FM1

One-year data does not always show the full picture. We have also provided three year analysis in Chart 5.

Chart 5: Return/Risk Plot – 3-year analysis



Sources: Refinitiv, XPS Investment, Fiduciary Managers. Data not provided by FM1

Charts 4 and 5 indicate that FM2 and FM5 are being rewarded with a higher return for accepting a greater level of risk within their growth portfolios. In contrast, FM8 was able to deliver relatively strong returns with a lower level of volatility.

The investment approach taken by FMs to achieve respective targets is a vital consideration when explaining the significant variance in volatility shown above.

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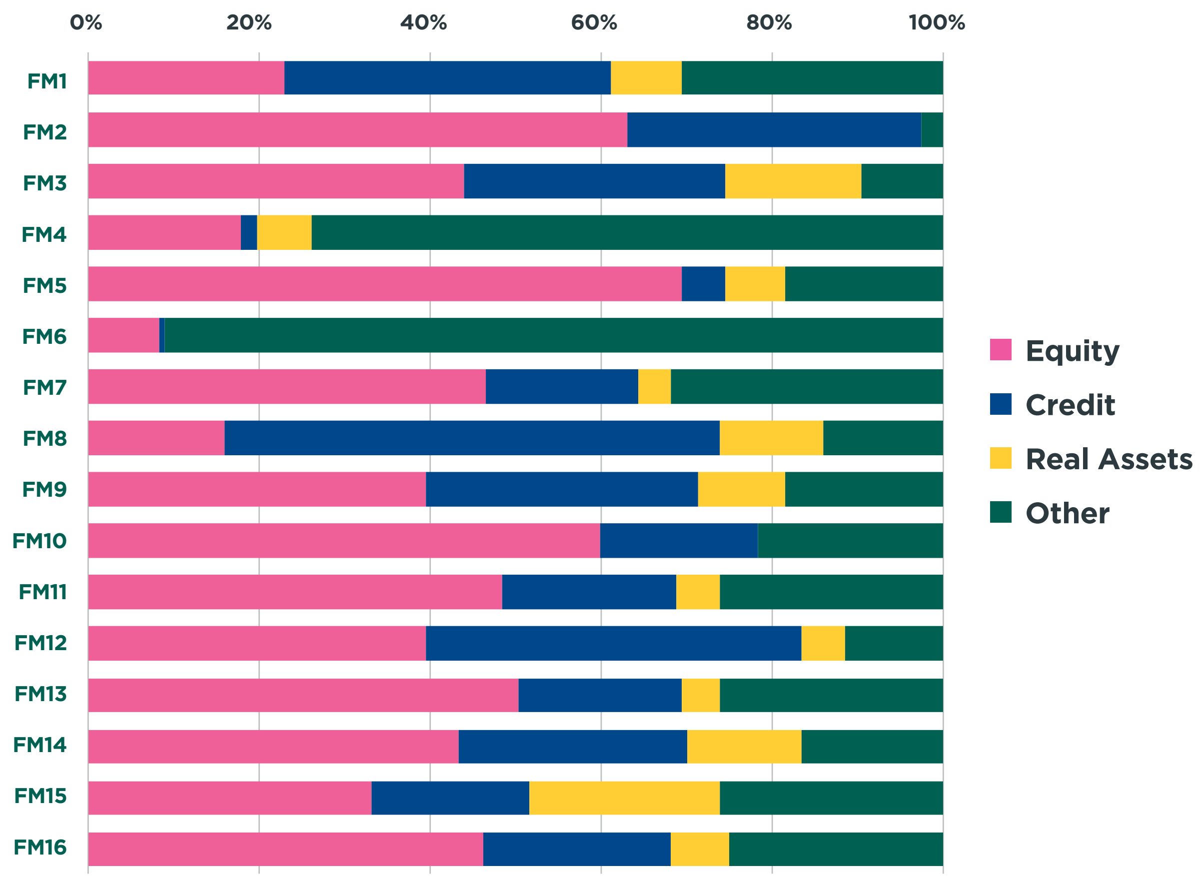
Investment approach and return contributions

In this section we look at the asset allocation within the growth portfolios of each FM and how this has contributed to performance in 2019.

Chart 6: Average asset allocation – 2019



Sources: Refinitiv, XPS Investment, Fiduciary Managers

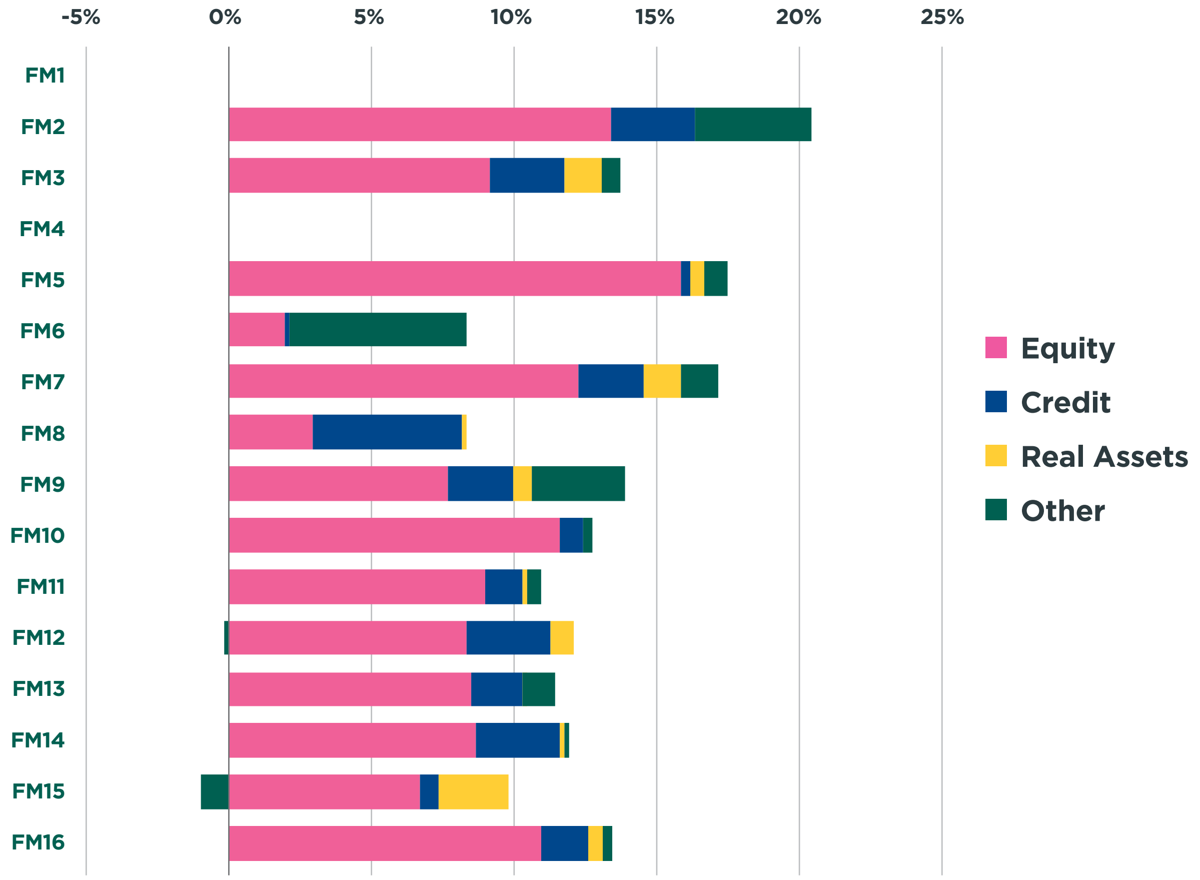
The allocation to equities within FM5 is greater than that of a number of other FMs which provides some explanation to the higher volatility of returns in 2019.

FM8 had the highest allocation to credit over 2019 whilst FM6, conversely, relies predominantly on investments in non-traditional asset classes to deliver returns. Over 2019, FM6 had a higher allocation to non traditional asset classes (captured by the 'Other' category), which encompasses hedge funds, currency, volatility strategies, private equity, commodities and more.

Whilst the investment objectives of the growth funds is similar, the asset allocations are significantly different, with varying levels of market beta, active management and complexity.

Chart 7 illustrates the contribution of each asset class to the overall returns achieved by each manager in 2019. Whilst the asset allocations of each FM provide an indication as to the source of risk and returns, we can go one step further to analyse the actual contribution of each asset class to performance, which includes any additional returns generated from active management.

Chart 7: Contribution by asset class – 2019



Sources: Refinitiv, XPS Investment, Fiduciary Managers, Data not provided by FM1 and FM4

Chart 7 highlights the important role that equities play in generating returns in almost all of the FMs portfolios. Trustees should understand how that equity return is delivered, whether it be through passive management or a more active stock-picking approach. It also suggests that the asset classes featuring most prominently in the growth portfolios of FM5, FM8 and FM6 (equity, credit and 'other' investments respectively), have been the source of the majority of the returns achieved by those managers.

One important point to bear in mind though, is that the mix of asset classes shown in Chart 6 will not be a function of expected returns alone – there are other roles they can play in the growth strategy. Developing an understanding of the role each component part of the portfolio plays in the strategy will help clients determine a complete perspective of the performance of their FM.

> At XPS we believe it is really important to understand where your FM is getting it right and where it could, and should be, doing better.

André Kerr
Head of Fiduciary Management Oversight,
XPS Investment

Conclusions

Over 2019, FMs have generally delivered strong positive performance and either performed broadly in line with, or outperformed DGFs. This is also the case over the longer-term and on a risk-adjusted basis. We would expect FMs to have a better return per unit of risk than DGFs over the long-term as they have a greater ability to utilise illiquid real assets and alternatives; asset classes which can target growth and help to dampen volatility.

Each FM takes a different approach to asset allocation which, in turn, leads to differences in the level and volatility of returns. The range of risk levels taken by managers is broad, with the highest being almost three times greater than the lowest. The FMs who achieved the greatest returns over 1 and 3 years did so with a higher allocation to equity markets, thereby also experiencing the greatest volatility of returns.

Clearly there is no single right way of investing, however trustees should recognise the importance of ensuring they understand which approach their manager takes, that it is in line with their investment beliefs, and most importantly that it is consistent with their scheme's objectives and circumstances. An independent FM oversight provider can truly help develop this understanding and add value in the selection of the most appropriate FM for each individual scheme.

We will shortly be looking at the impact of COVID-19 on the actions and performance of FMs during the first quarter of 2020 and we expect there to be a wide spectrum of results.

Each FM takes a different approach to asset allocation which, in turn, leads to differences in the level and volatility of returns.

For further information, please get in touch with André Kerr or Charlie Stewart or speak to your usual XPS Pensions contact.

t 0113 284 8054

e andre.kerr@xpsgroup.com

t 0113 284 8057

e charlie.stewart@xpsgroup.com

@xpsgroup

company/xpsgroup

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