XPS Investment

XPS FM Watch

How well have fiduciary managers tackled the COVID-19 crisis?

The impact of COVID-19 on global financial markets will be forever referenced in stock market history alongside the Wall Street Crash of 1929, Black Monday, the Dot-com Bubble, and the 2008 Financial Crisis.

Fiduciary Manager (FM) appointments were few and far between before the 2008 financial crisis and it is only recently that a number of fiduciary managers have faced their first real challenges. Since 2008, fiduciary managers have operated in one of the longest bull runs. We examine how FMs have coped during the volatile quarter and whether FMs have managed to deliver the promises they made to pension schemes.

In this paper we:

- Outline the market movements during the quarter;
- Compare the Q1 performance of 16 FM growth portfolios to a selection of high profile Diversified Growth Funds (DGFs); and
- Highlight the different actions taken by the FMs over this period.

> For pension scheme trustees, determining if your Fiduciary Manager has timed the market should be a secondary consideration; the benefits of such actions may only become apparent in 2021 and beyond. The primary question is to determine if your Fiduciary Manager was evolving the strategy as your funding position progressed over a buoyant 2019. All scheme's looking for asset growth need to be exposed to some element of this risk – those taking more risk than necessary will be the ones who will be worst impacted.

André Kerr
Head of Fiduciary Management Oversight

Q1 2020 market backdrop

To provide a sense of the challenging market environment faced by investors in Q1 2020, we illustrate a summary of key market returns in Chart 1.

Chart 1: Q1 market performance

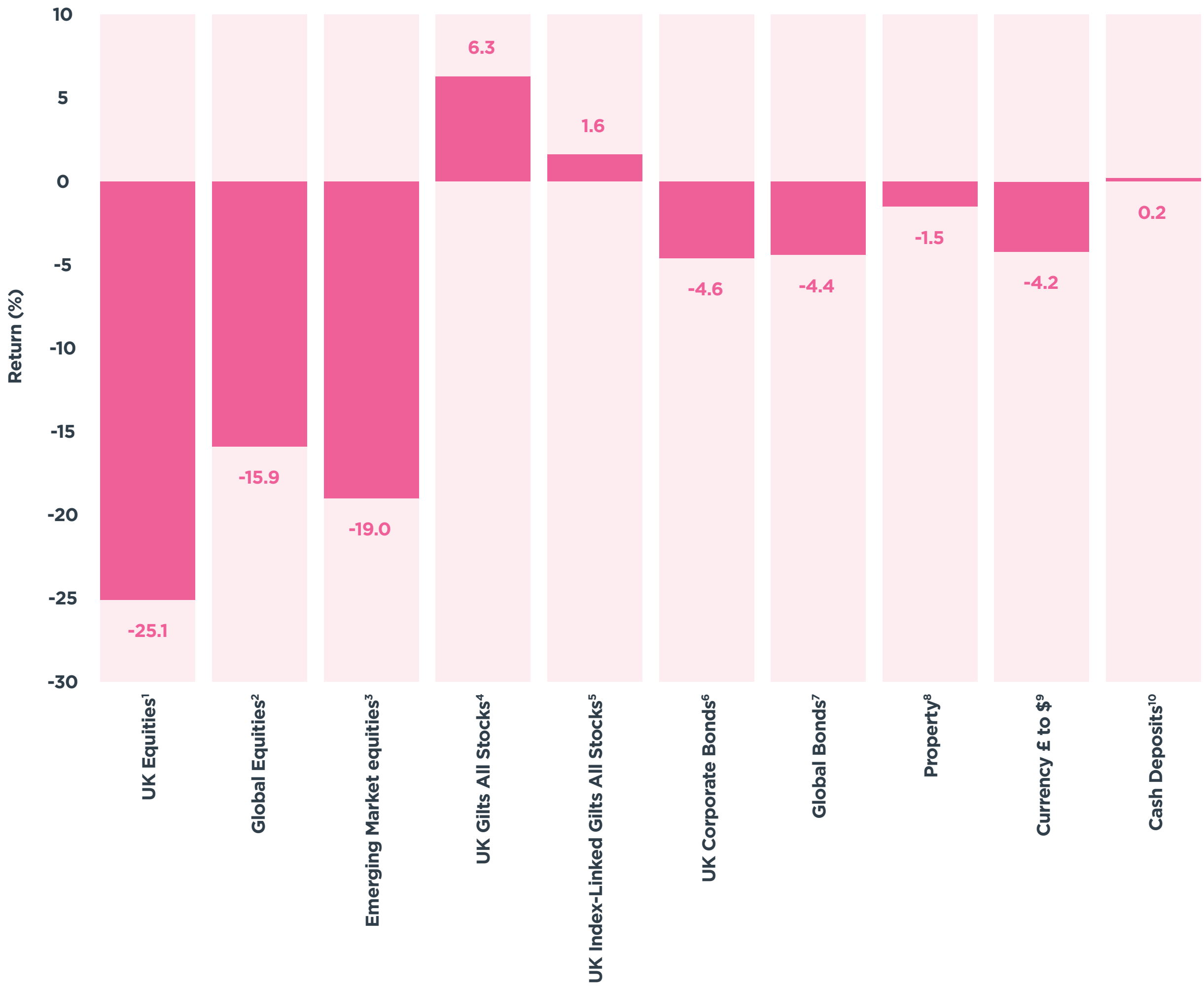

Chart notes:

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

As the true extent of the virus unfolded, with global lockdowns constraining labour and supply chains, businesses around the world have been impacted. Despite a brief rally at the end of March, global equity markets were down by around 16% over the quarter, with regions such as the UK being hit harder still. As company valuations tumbled, credit spreads spiked and the price of corporate bonds fell. Property markets were severely impacted with many independent valuers unable to accurately value properties. Investors typically looked to 'safe haven' assets such as government bonds and US Dollar exposure.

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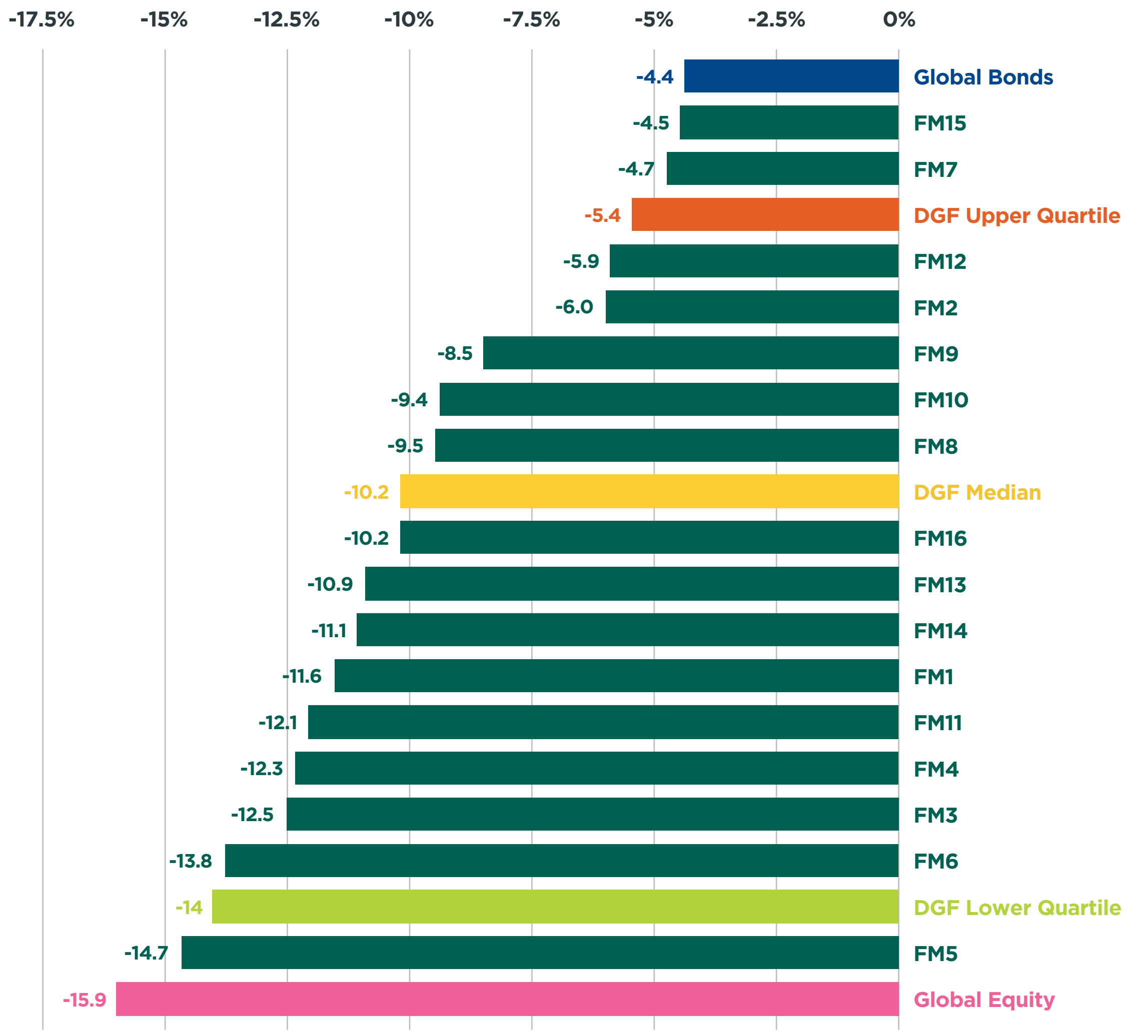
Growth portfolio performance

Chart 2 illustrates the reported performance of 16 FMs' 'best-ideas' growth portfolios, net of fees, over Q1 2020. This captures 99% of UK fiduciary clients. It should be noted that most FM portfolios will have some investment in illiquid or esoteric asset classes, many of which are difficult to price, particularly in the current market environment, such as property funds. Therefore the ultimately confirmed performance numbers over Q1 may differ slightly from those in Chart 2, which is based on currently available information.

Chart 2: Performance – Q1 2020



Sources: Refinitiv, XPS Investment, Fiduciary Managers

All FMs delivered negative market returns over the three months but there was a wide range of outcomes. The difference between the highest and lowest returning portfolio was around 10%; in monetary terms, a £100m investment with FM15 at the start of the year would now be £10m better off than if invested with FM5, all else being equal.

Compared to a selection of over 20 high-profile DGFs, approximately half of the FMs have delivered returns below the median DGF return, despite the broader opportunity set available to them.

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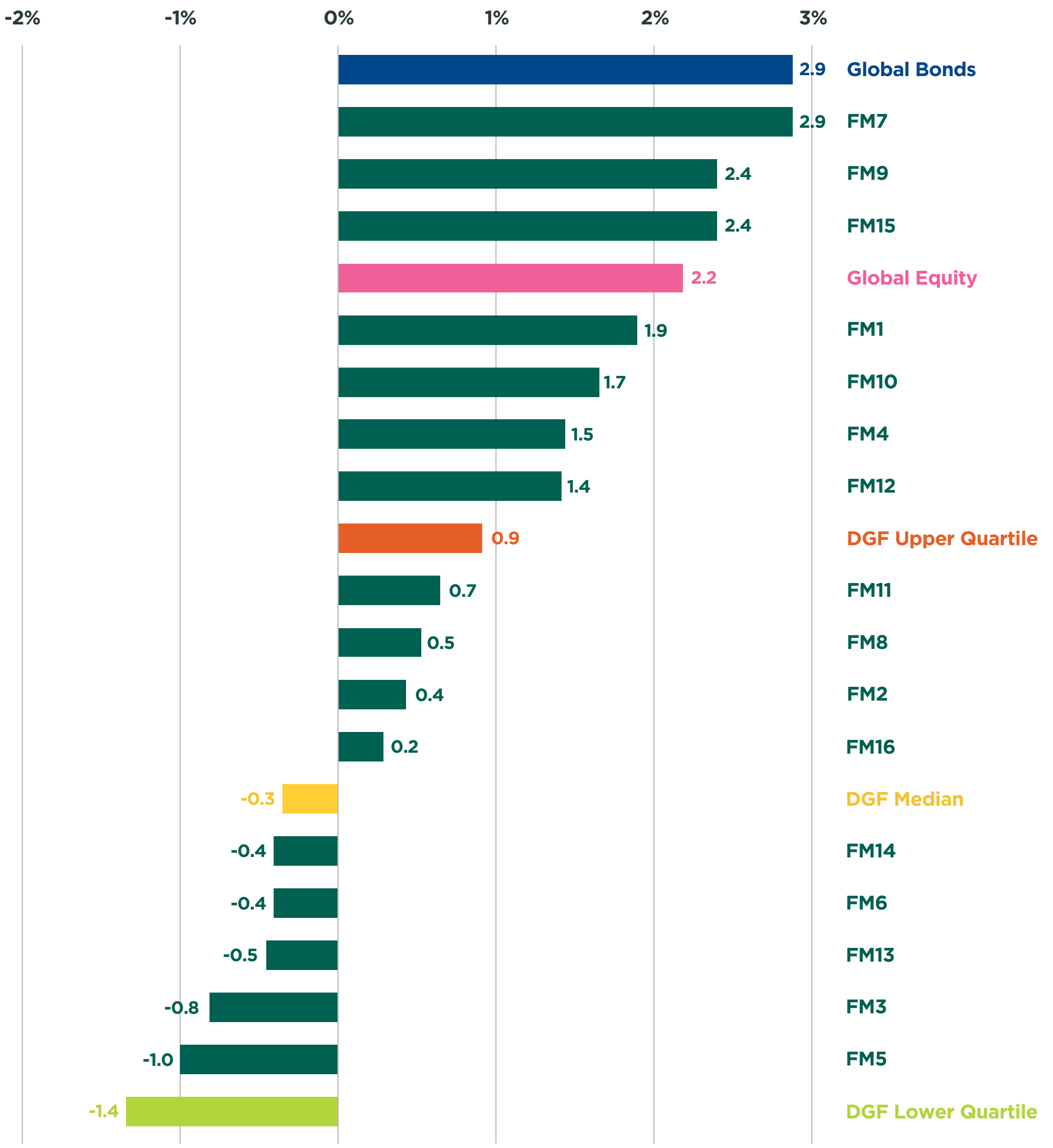
Chart 3: Performance – 3 Year (pa) to 31 March 2020



Sources: Refinitiv, XPS Investment, Fiduciary Managers

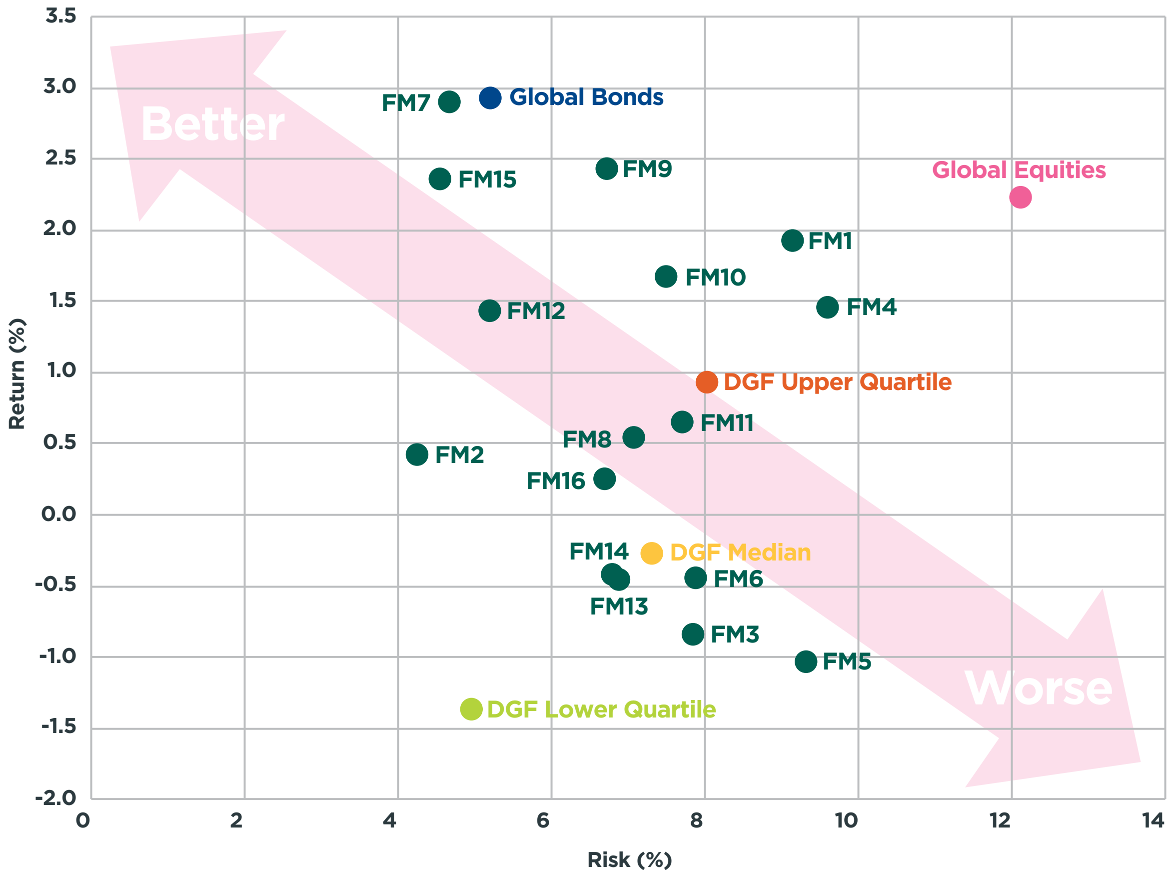
Chart 3 illustrates the returns over the 3 years to 31 March 2020. This period also covers another notable market drawdown in Q4 2018, and further reveals which FMs have best withstood the sharp declines in the markets. The range of returns is still significant, with the difference between the best and worst performing growth portfolios of 4% per annum (equal to 12% cumulative).

Over a 3 year period the majority of FMs produced better returns than the median DGF. This is to be expected given the increased investment opportunity set available to them.

The range of returns is still significant, with a difference between the best and worst performing growth portfolios of 4% per annum (equal to 12% cumulative).

Risk-adjusted growth portfolio performance

Chart 4: Return/Risk Plot – 3-year (pa) to 31 March 2020



Sources: Refinitiv, XPS Investment, Fiduciary Managers.

As with our previous FM Watch paper, in addition to analysing portfolio returns, it is also important to consider the level of risk that the FM is taking in order to achieve that return. Chart 4 provides a comparison of the returns and monthly volatility of returns over the 3 years to 31 March 2020. A number of FMs, such as FM9, have been able to produce a similar return to that of global equities, whilst reducing the level of volatility to that experienced from bonds, despite the pronounced market drawdowns.

Chart 4 illustrates the wide range of outcomes, in terms of both risk and return, with broadly 50% of FMs delivering good risk adjusted returns over the 3 year period to 31 March 2020.

> Over the three years to 31 March 2020, we have seen a huge divergence in performance from FMs. It is important that trustees understand what is driving this and how the FM portfolio aligns with their investment beliefs.

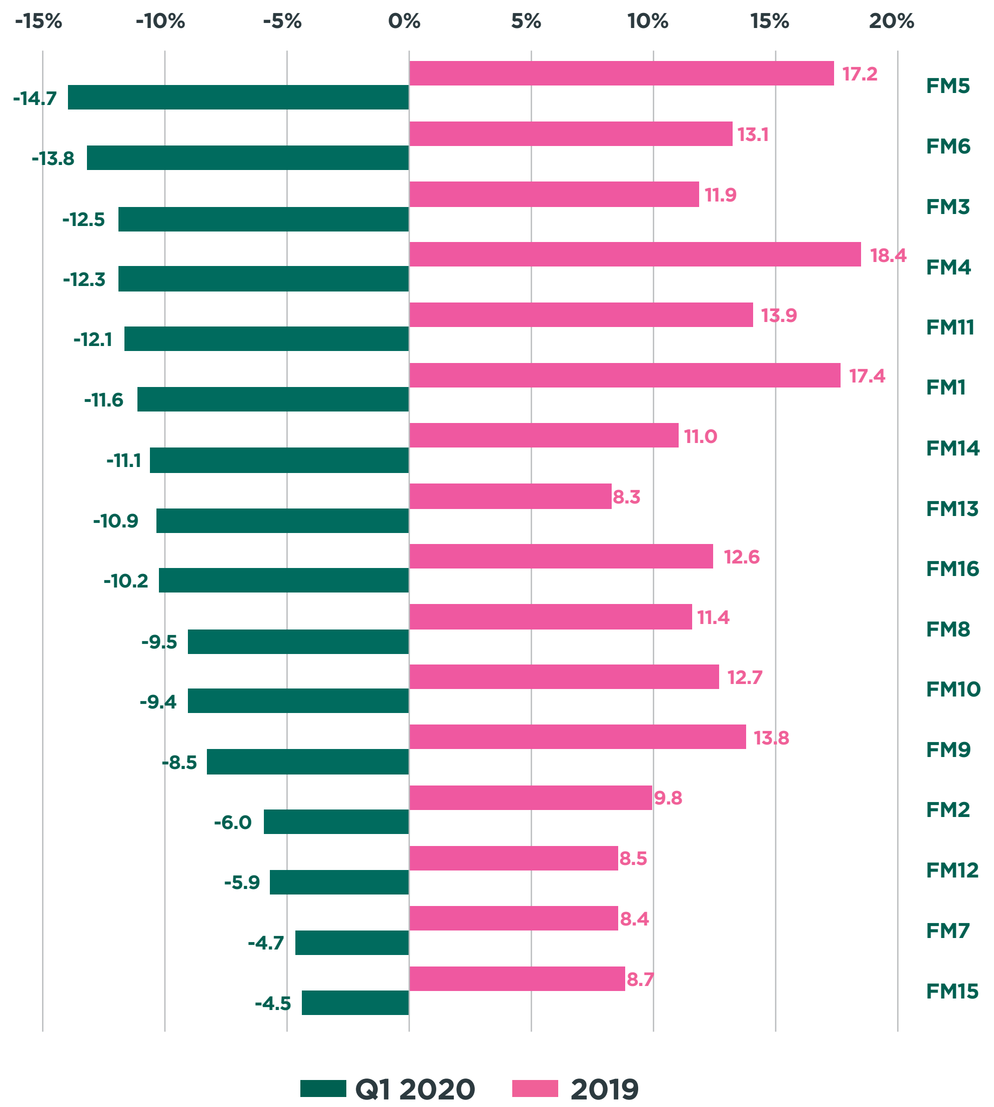
Charlie Stewart
Senior Investment Associate

Positioning prior to 2020

In our previous FM Watch paper we looked at the average asset allocation within the growth portfolios of each FM and how this contributed to performance in 2019. Our conclusion was that those managers with a higher allocation to equities, such as FM5, generally had a better return in 2019, but at a higher level of risk.

Chart 5 highlights that managers such as FM5, who had a higher level of return in 2019, also suffered the greatest losses in Q1 2020, whereas managers who had lower levels of return in 2019, typically had portfolios that were better prepared to withstand the market falls in Q1 2020.

Chart 5: Performance – Q1 2020 & 2019



Sources: Refinitiv, XPS Investment, Fiduciary Managers

However, it is possible that those FMs with a stronger return in 2019 will have helped pension schemes reach the next funding level trigger point, enabling them to crystallise the gains achieved in 2019 by de-risking the investment strategy. Trustees should be aware of de-risking steps taken by their FM and whether these have improved outcomes for the pension scheme.

Managers who had a higher level of return in 2019, also suffered the greatest losses in Q1 2020, whereas managers who had lower levels of return in 2019, were better prepared to withstand the market falls in Q1 2020.

Changes during Q1 2020

In Q1 we saw a heightened level of activity from FMs, with 75% of the participating managers indicating that they had made short-term 'tactical' asset allocation decisions during the quarter, either to take advantage of opportunities in the market, or protect assets from further depreciation. Examples included strategic asset allocation changes such as reducing equity exposure and increasing cash holdings, to more nuanced changes such as tilting the strategy to have a greater exposure to developed markets. A common theme across the majority of managers was the purchase of investment grade credit at the end of the quarter, capitalising on favourable yields following credit rating downgrades. Figure 1 illustrates some examples of the actions taken by FMs, before and during the quarter.

Figure 1: Example FM Portfolio Actions

Portfolio 1

- **2019**: No significant movements within growth portfolio
- **February 2020**: Disinvested 10% from equity allocation Proceeds held as cash; Switched 5% from high yield to investment grade credit
- **March 2020**: Further reduction of equity and return-seeking credit; Increased allocation to gilts; Held 25% as cash at the end of the quarter

Portfolio 2

- **2019**: Reduced one third of equity risk in October
- **February 2020**: No significant movements within growth portfolio
- **March 2020**: Increase gold exposure and allocation to gilts; Started to increase equity allocation

Portfolio 3

- **2019**: Purchased three, 3-month equity put options
- **February 2020**: Introduced market neutral strategies
- **March 2020**: Added market neutral fund with focus on environmental, social and governance factors

Sources: Refinitiv, XPS Investment, Fiduciary Managers

Figure 1 highlights just some of the range of approaches taken by FMs over this short period. At the end of 2019 and early 2020, some FMs, such as in Portfolios 2 and 3, looked to crystallise the gains made in 2019 by materially reducing equity exposure or purchasing downside protection. In contrast FMs such as in Portfolio 1, made little or no de-risking changes, and these managers may have suffered greater losses at the outset of the market downturn.

In late February and March, we saw some FMs, such as in Portfolio 1, make active decisions to revise their strategic asset allocation and allocate more of the growth portfolios to cash and high quality credit. Other FMs which look to utilise relative value trades, such as in Portfolio 3, moved to more market neutral strategies. In contrast FMs, such as in Portfolio 2, looked to either rebalance portfolios back to the strategic asset allocation, or avoid trading during heightened market volatility.

Towards the end of March and early April, we saw a divergence of views on the economic outlook as some managers, such as in Portfolio 2, look to re-risk portfolios by increasing exposure to equities for example. However other FMs, such as in Portfolio 1 and 3, positioned themselves more defensively by holding a greater allocation to government bonds or cash, or by moving to additional market neutral strategies, and these managers may have missed out on some of the gains as markets rebounded at the beginning of Q2.

Conclusions

The market downturn experienced in Q1 was the first big challenge for a number of FMs. All managers suffered losses, to varying degrees, subject to the repricing of some illiquid asset classes. Those managers who took more risk in 2019 generally suffered the greatest losses in Q1, although some of these managers may have de-risked at the turn of the year as funding level triggers were reached.

During Q1 we saw a number of FMs make significant changes to their portfolios, with some choosing to reduce risk at the beginning of the pandemic, and others deciding to avoid trading where necessary for fear of unfavourable terms. The variations in outlook has seen FMs positioned very differently at the end of Q1, which will have had a material impact on returns in Q2 and thereafter. The changes over this period not only highlight the divergence in views, but also the contrasting approaches to short-term tactical changes.

Clearly the full impact of the pandemic, and the bearing this has on the long-term performance of FMs, will not be known until much further in the future. However trustees should be aware of the steps that their FM has taken over this period, the reasons for doing so and whether this is ultimately in the best interests of the members of the scheme. Independent third party oversight can help trustees understand these decisions and whether they are consistent with the long term objectives of the scheme.

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

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