XPS Investment

XPS FM Watch

Fiduciary Manager Review 2021

Stating that 2020 was a unique year for financial markets is an understatement, and, in many ways, could be viewed as being represented by the letter V: virus, volatility, v-shaped recovery and virtual. The market environment has been the biggest test for many since the global financial crisis and fiduciary managers' growth portfolios have had some tough questions asked of them.

This paper presents a holistic analysis of 22 growth portfolios across 18 fiduciary managers (FMs) over 2020 to assess where and how FMs have added value within full discretionary portfolios.

Key findings

- FMs produced positive but variable returns over 2020. The rapid recovery after the market chaos of Q1 was remarkable.
- Arguably the rapid recovery, driven by strong underlying market returns, masked the differing approaches and risk levels adopted by the FMs.
- The level of dynamism shown through the Covid crisis varied, with some FMs looking to take advantage of attractive valuations later in the year and others choosing to 'stick to their guns' in terms of asset allocation.

We review how their growth portfolios protected in times of market stress, where opportunities were captured and showcase the wide range of approaches different FMs used during the year and the subsequent outcomes.

2020 has been the first opportunity for many trustees to see how their FM's portfolio fared in a market crisis compared to the calmer waters of the last few years.

Guy Plater
Partner and Co-head of Fiduciary Management Oversight

2020 market backdrop

Chart 1 shows both the scale of the initial impact on financial markets of the Covid pandemic and the subsequent rebound.

Chart 1: Q1 2020 and 2020 market performance

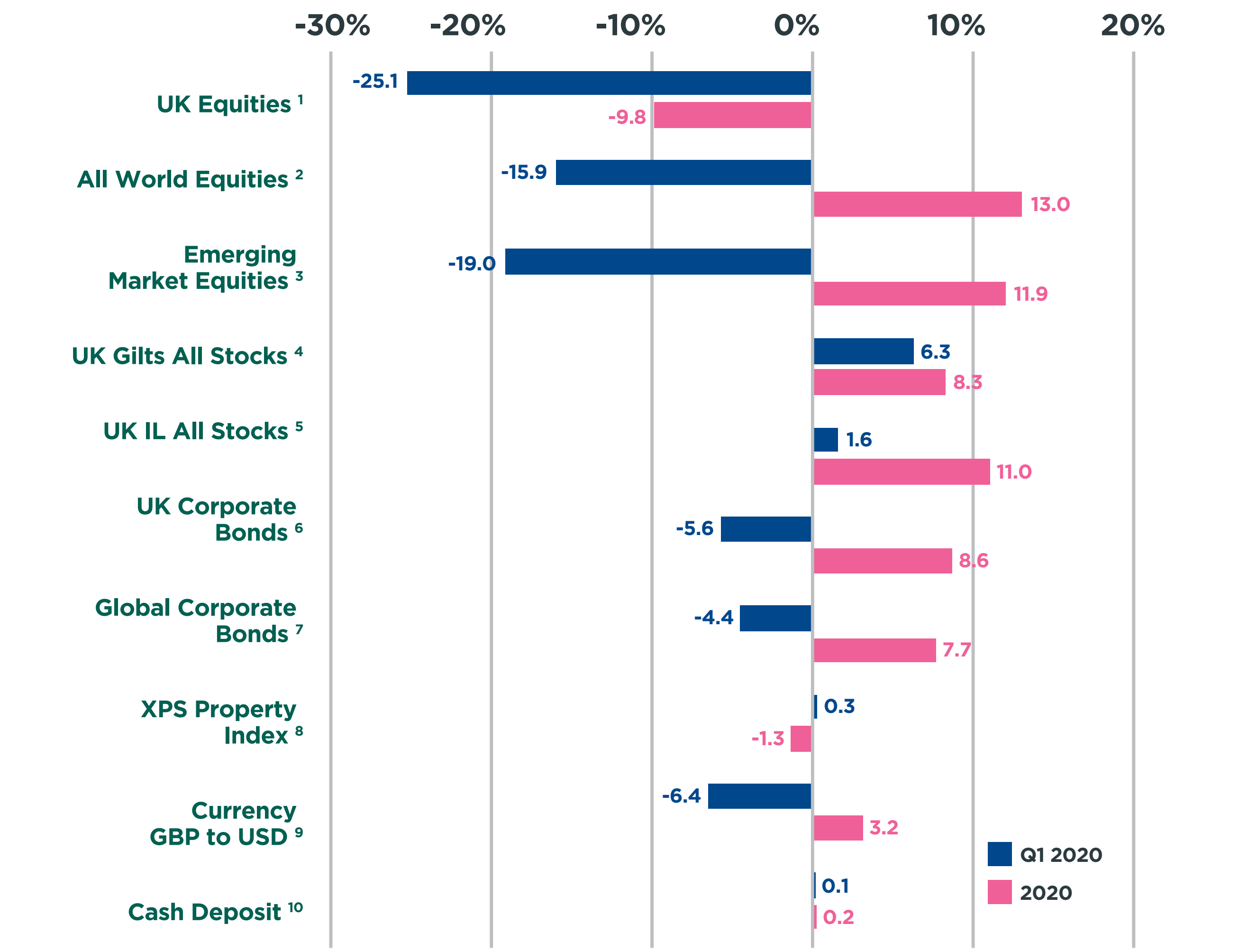


Chart notes:

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

The rebound was fuelled by huge stimulus from central banks and governments and came despite international trade tensions and worries over the US presidential election. UK equities did not fare as well as global equities, weighed down by concerns over Brexit and with a higher proportion of companies in those sectors impacted most by the pandemic. The stimulus pushed gilt yields to record lows, driving strong returns in gilt markets (but increasing pension scheme liabilities) and gains for corporate bonds. UK property struggled in the wake of the pandemic as trade headed on-line and shops, pubs and restaurants were forced to close.

Despite significant market falls in Q1, 2020 as a whole saw global equity markets once again posting double-digit returns (in sterling terms).

Growth portfolio performance

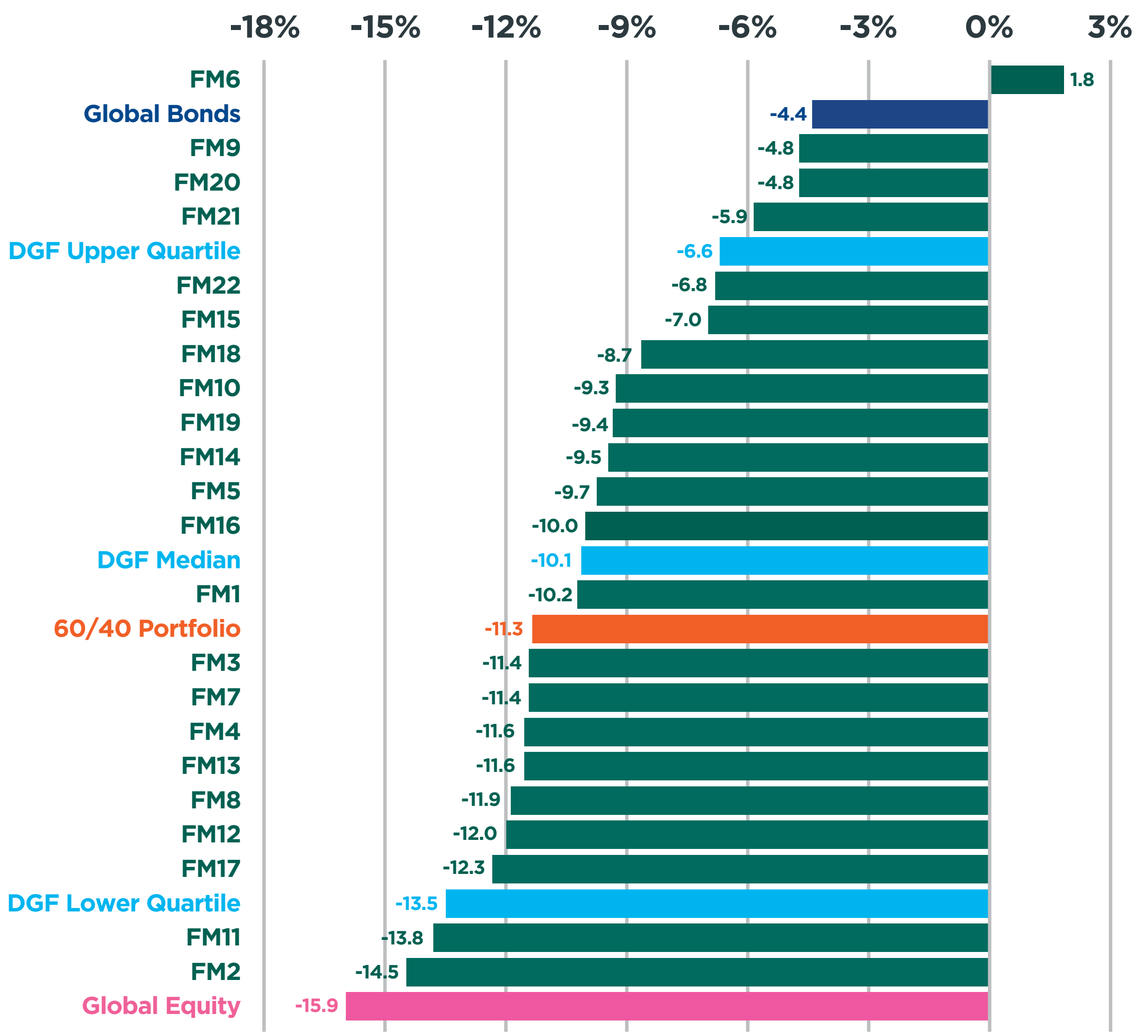
The fall in gilts yields experienced during the first half of 2020 would have negatively impacted the funding level of pension schemes that did not have high levels of liability hedging in place. However, as FMs tend to remove as much interest rate and inflation expectation risk as possible, their pension scheme clients would generally have been well-hedged against these yield movements and we have therefore focused on the performance of their growth portfolios.

On the face of it, Chart 1 shows that the FMs could draw on very strong market returns in 2020 to drive their performance. However, this disguises the huge market falls in Q1, including a point of genuine crisis when even UK gilt markets seized up. 2020 posed the differing challenges of how much downside protection to have in Q1; how and when to re-risk as market falls left some assets (corporate bonds for instance) looking attractive; and whether to take profits towards the end of 2020. Q1 2020 will have been the first opportunity for many trustees to see how their FM's portfolio fared in a market crisis compared to the calmer waters of the last few years.

Fiduciary manager performance comparisons

We have collected returns on 'best ideas' growth portfolios from 18 FMs. This captures 99% of UK fiduciary clients. Some FMs now offer different versions of their best ideas portfolios, with alternatives catering for clients seeking lower risk or lower fees compared to the flag-ship portfolios. For the first time, we have shown these different portfolios for certain managers (giving a total of 22 portfolios across the 18 FMs). Note the data represents actual portfolio returns and therefore reflects real client data and experience. For long-term returns a limited number of FMs have supplemented actual client returns with model portfolio returns.

Chart 2: Fiduciary manager and comparator performance – Q1 2020



Sources: Refinitiv, XPS Investment, Fiduciary Managers

Fiduciary manager performance comparisons (Continued)

Chart 2 illustrates the performance of the 18 FMs' best ideas growth portfolios, net of fees, during Q1 2020. All but one managers' growth portfolios produced negative returns over Q1. FM6's performance represents a single client, with a specialised mandate and so may not be representative. In general, managers with the best returns over 2019 were hardest hit in Q1 2020. This is due to the managers with higher equity and market exposures faring better during 2019 than the FMs that have either more complexity or diversification within their portfolios. However, FMs with higher equity and market exposures, will tend to experience higher volatility and more exposure to significant downturns.

All managers provided some protection against falls in global equity markets although some only marginally added value compared to a simple, low-cost equity index-tracker. As we have observed in previous periods, Q1 2020 again saw significant differences in performance levels across the FMs' growth portfolios. In this case, even if we exclude FM6 (which might be considered an outlier), we observed a difference of 9.7% between the best performance (from FM9) and worst performance (from FM2) – representing nearly £10m in a £100m allocation to growth assets.

Another interesting observation from Chart 2 is that only slightly more than half of the FMs outperformed the median diversified growth fund (DGF). This is somewhat surprising given the wider opportunity set used by FMs – the ability to invest in private markets and high quality illiquid assets being a particular advantage in Q1 2020. That said, the market sell off in Q1 was very broad based with many of the diversifying assets employed by FMs selling off almost as much as equity markets. Set against that background, we believe the majority of the FMs performed reasonably well.

The difference between the highest and lowest returning portfolio was around 10%; in monetary terms, a £100m investment with FM9 at the start of the year would now be £10m more valuable than if invested with FM2, all else being equal.

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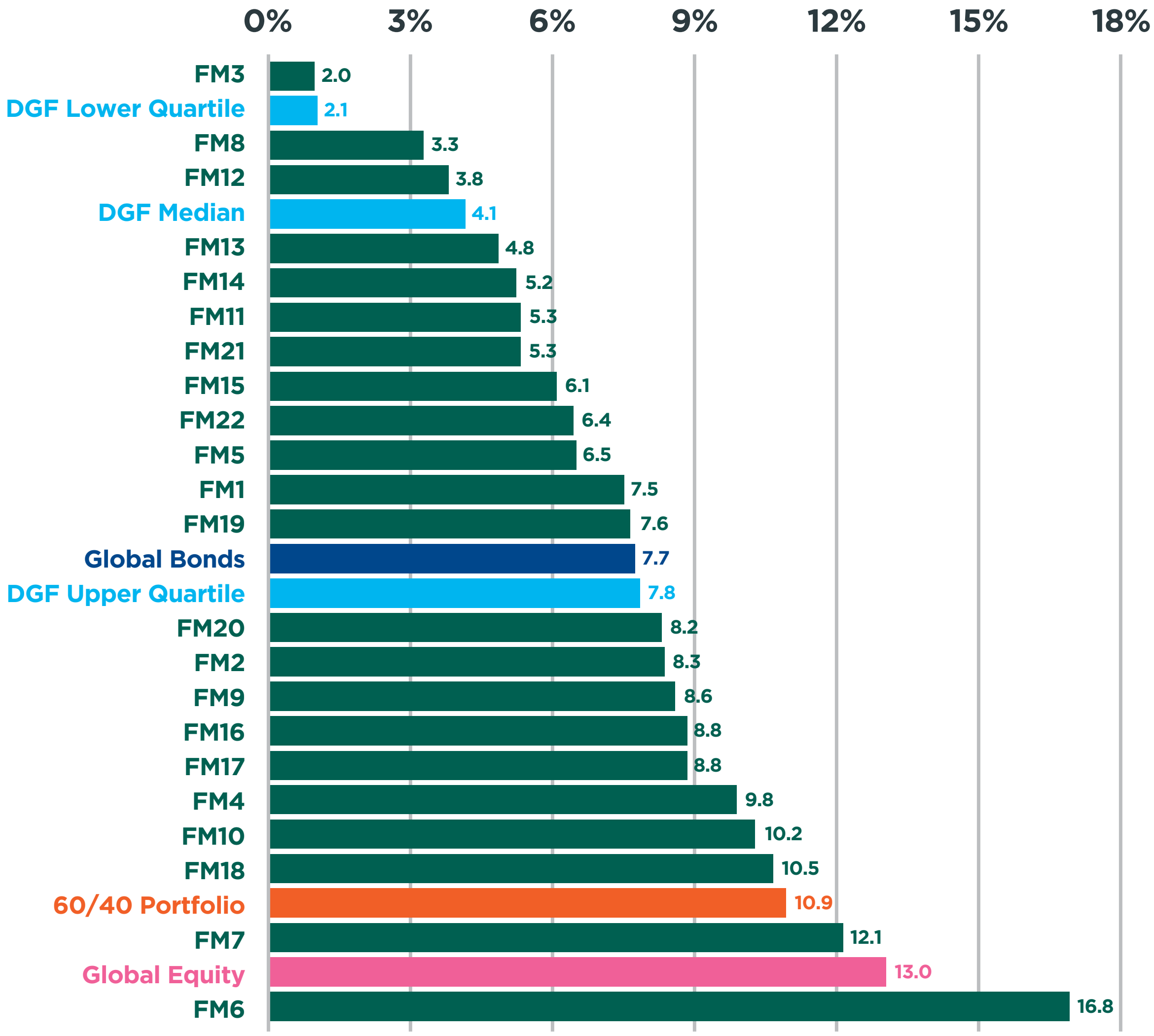
2020 full year performance

Chart 3: Fiduciary manager and comparator performance – 2020



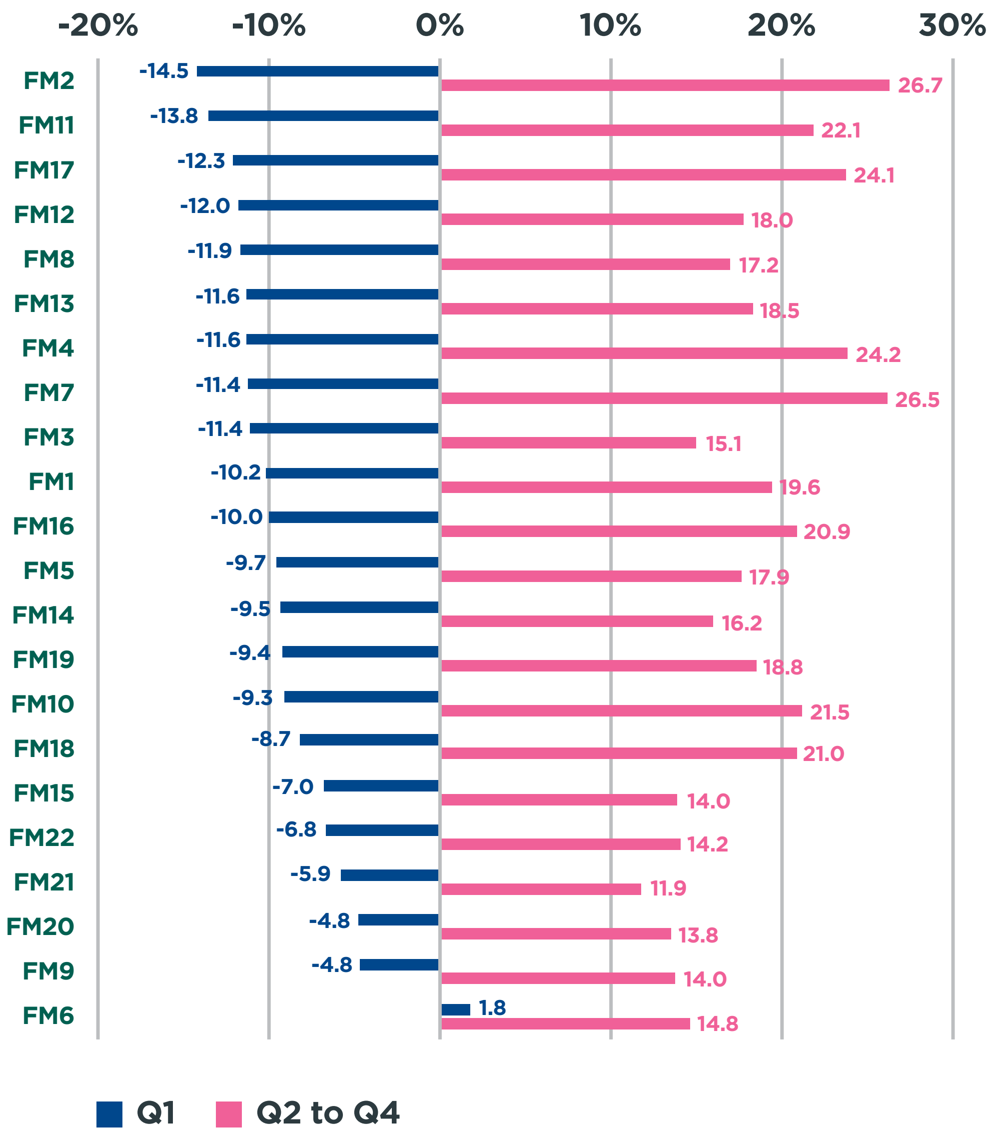
Sources: Refinitiv, XPS Investment, Fiduciary Managers

Chart 3 shows the FMs' returns over 2020. This shows that the managers made good their losses over Q1 with all managers generating positive returns over the remainder of 2020. The majority comfortably outperformed the median DGF return over the full year. As would be expected in a year of (overall) strong equity returns, the majority of FMs underperformed global equities. Again, there was a significant difference of around 10% (excluding FM6) between the best and worst performers, demonstrating the impact that FM selection has on outcomes.

2020 performance by quarter

Chart 4 delves a little deeper into the FMs' returns and splits their 2020 returns between Q1 2020 and Q2 to Q4. We have sorted the FMs by their Q1 performance (worst to best).

Chart 4: Breakdown of 2020 Performance



Sources: Fiduciary Managers

This shows a general trend that those managers who performed worst over Q1 had the strongest recovery over the rest of the year. This suggests that managers generally 'stuck to their guns' through the Covid shock in terms of the overall level of risk taken.

Most FMs produced strong returns over 2020. However, some managers delivered more consistent returns through the year, while others were more volatile.

Managing risk

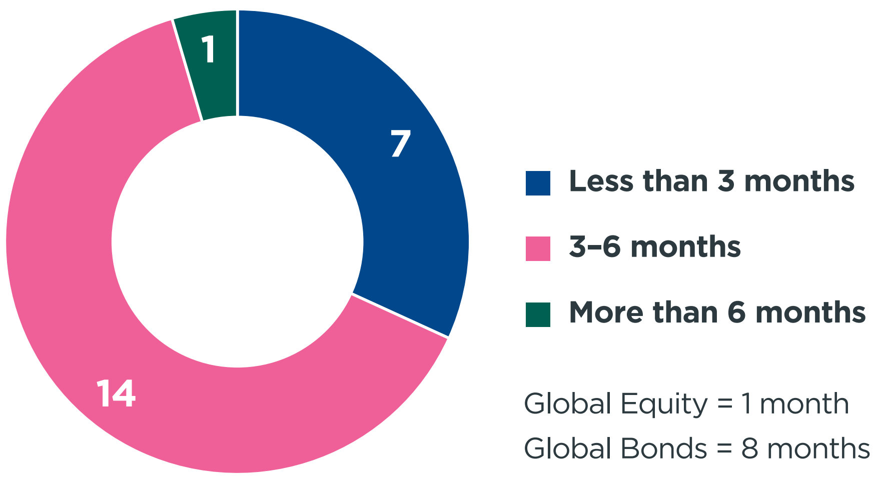
Those managers who went into 2020 running the most investment risk were generally hardest hit in Q1. Retaining investment risk through the market crisis paid dividends for the rest of the year. Conversely, managers who were more cautiously positioned as the pandemic struck and who lost less initially, generally underperformed afterwards, suggesting that they did not aggressively add risk to capture opportunities in the latter part of the year (with a few notable exceptions). We would have had concerns if we had seen radical shifts in target levels of investment return (and hence risk).

Clients generally like to understand the level of risk their FMs are taking – this might be a key reason for an FM's appointment. Radical changes in risk – perhaps by reducing risk in the face of losses or aggressively increasing risk in search of higher returns – may have meant FMs not meeting clients' expectations.

Those managers who went into 2020 running the most investment risk were generally hardest hit in Q1. Retaining that investment risk through the market crisis then paid dividends for the rest of the year.

Chart 5: Time to recovery from maximum drawdown

Number of managers



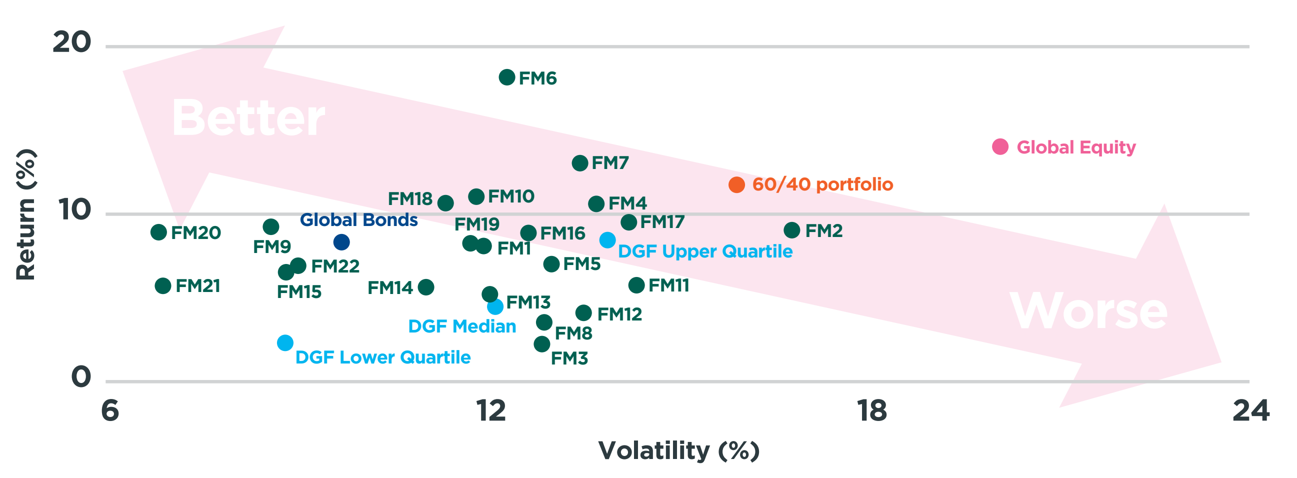
Sources: Fiduciary Managers

Chart 5 shows how long it took each of the managers to make good their losses. All but one of the portfolios took 6 months or less. This illustrates that whilst Q1 was a shock, it was a short-lived one. Equity markets recovered to deliver another year of strong returns in 2020. Global equities have now on average returned double digits over the last ten years. Sterner tests in the form of a more prolonged equity bear market are likely to come at some point and trustees may wish to test their FM's preparedness before it does.

Volatility-adjusted growth portfolio performance

In addition to assessing portfolio returns over 2020, we have also analysed the monthly volatility of returns, and we show this information in Chart 6. A comparison with the same chart from our 2019 report shows that the managers' returns were significantly more volatile in 2020 as might be expected given the extreme market volatility. In 2019, the managers who produced the highest returns also took the most investment risk. This pattern was still present but was less marked in 2020, as careful risk control paid off in Q1 for some managers.

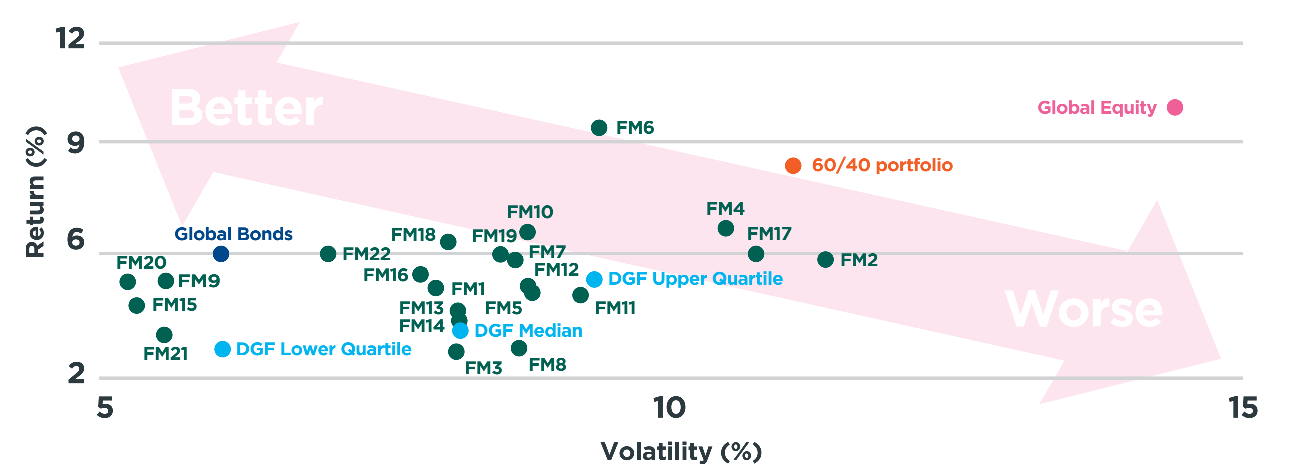
Chart 6: Return vs Volatility – 1 year to 31 December 2020



Sources: Refinitiv, XPS Investment, Fiduciary Managers

Chart 7, which looks at the longer term, shows a clearer relationship between volatility and return and it's interesting to note that FMs 2, 4 and 17 took most investment risk over both the one and three year periods to 31 December 2020, and were generally rewarded through strong returns. Conversely FMs 15, 20 and 21 took the lowest amount of risk over both periods (despite not explicitly targeting 'low risk' strategies) and their returns were lower as a result. As we have commented before, there is a wide range of approaches FMs take, which results in different levels of return (and different levels of volatility).

Chart 7: Return vs Volatility – 3 Years to 31 December 2020 (pa)

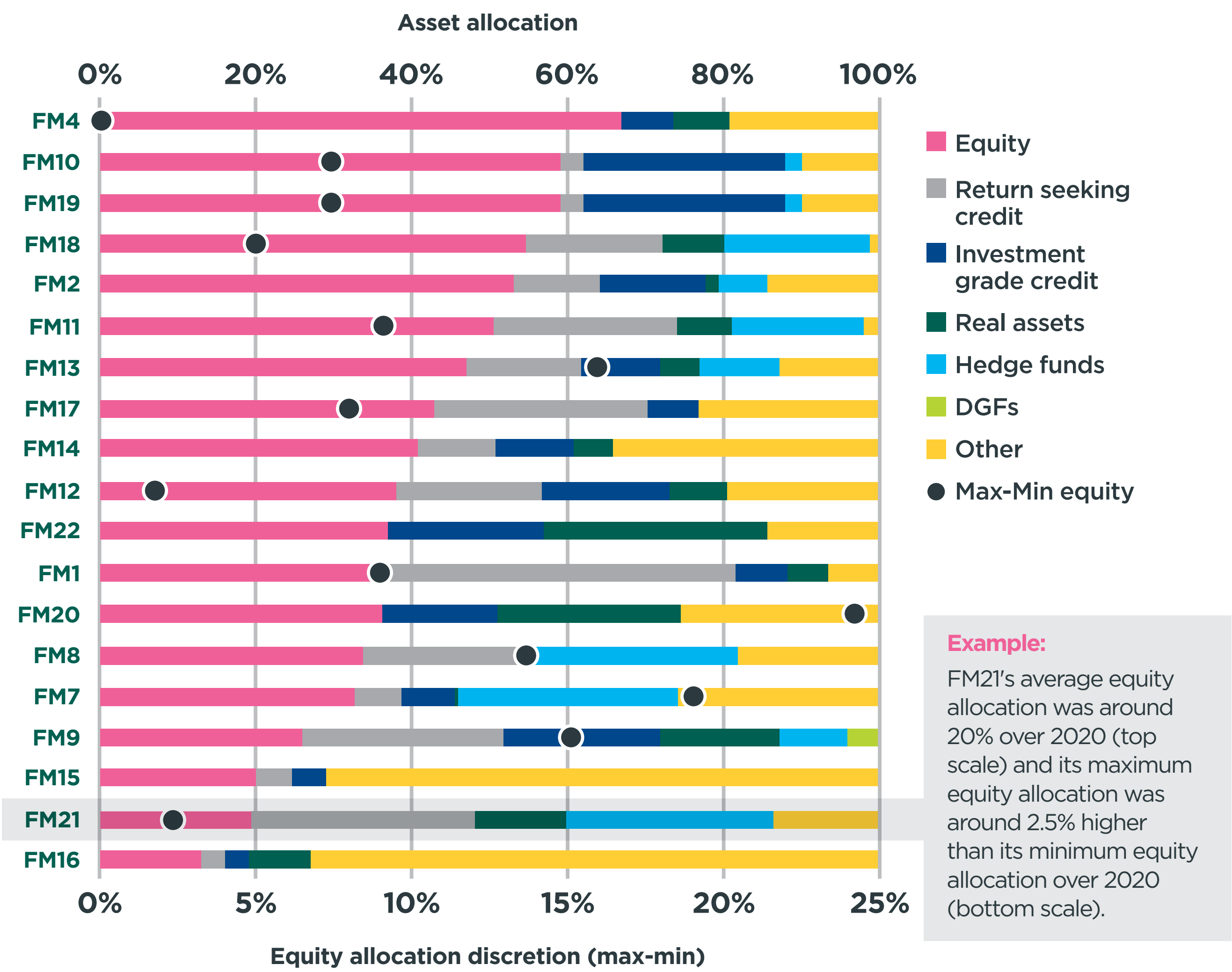


Sources: Refinitiv, XPS Investment, Fiduciary Managers

Investment approach and return contributions

The bars (top scale) in Chart 8 show the managers' average asset allocations between the major asset classes over 2020. The markers (bottom scale) show the difference between the managers' maximum and minimum equity allocations over 2020. Absence of a marker indicates that the manager did not provide this data.

Chart 8: Average Asset Allocation – 2020



Sources: Fiduciary Managers

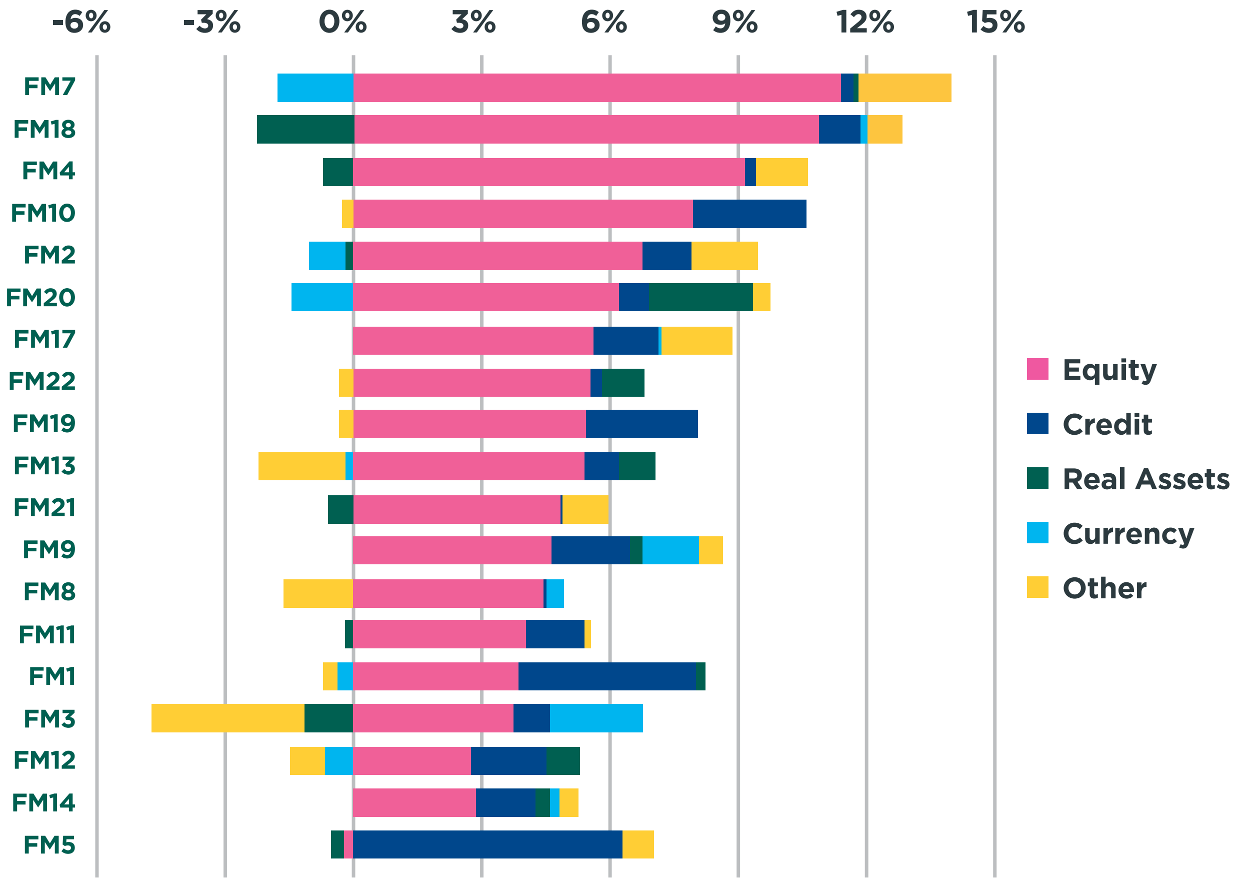
There is little evidence of a 'consensus' asset allocation emerging with the FMs just yet. This was a criticism of balanced funds in the 1980s and 1990s, where frequent comparisons of managers' performance with the median return led to a 'herd-like' mentality amongst managers with them not straying far from the median asset allocation for fear of underperforming.

There is plenty of variation between the managers over the level of dynamism in their asset allocations over 2020. A number of managers kept a static asset allocation. A minority of FMs made significant changes to their equity allocations during the year, with only 5 managers altering their equity allocations by 10% or more over 2020.

Many managers also increased their credit allocations over the year, feeling that credit valuations looked attractive in late March, with the reassurance of government loans to businesses and central banks buying corporate bonds. Timing was key with this trade, with corporate bond prices recovering rapidly once the scale of government and central bank action become apparent; those slower to move missed the best returns. However, overall changes in credit allocations look to be less marked than for equities. This is an interesting area trustees may wish to explore. Would it have been possible for trustees to have been as dynamic with the asset allocation of their schemes' investments without employing an FM? Did trustees see their FM making changes to their asset allocations and, if so, why? Will they do anything differently next time?

Chart 9 illustrates the contributors to the overall returns achieved by each manager in 2020.

Chart 9: Contribution by Asset Class – 2020



Sources: Fiduciary Managers

The chart shows that market movements were the key driver of total returns for most managers, with equity returns being the most significant contributor to overall performance. It also shows that 'Other' factors were responsible for either adding to, or detracting from, returns for a number of FMs. These factors include instances where performance has been driven by returns from the stock selection and asset class allocation decisions taken by an FM's underlying managers, as well as an FM's own tactical asset allocation decisions (and some other miscellaneous items).

It is important for trustees to understand the extent to which their FM is trying to add value in these areas and evaluate whether they have the skills necessary for success in these demanding disciplines.

FMs' returns were largely driven by equities over 2020, benefiting significantly from the speed in which equity markets bounced back.

André Kerr
Partner and Co-head of Fiduciary Management Oversight

Conclusions

2020 saw the first major market crisis that many FMs have faced and brought about the first opportunity for trustees to observe the difference a fiduciary management approach can make during such times. In general, FMs delivered strong performance during the year. Whilst they did not keep pace with global equity market returns, they added value compared to a number of DGFs, albeit in many cases this came with more volatility.

We once again saw a significant dispersion of returns from FMs over the year, reflecting their different investment approaches generally, and in some cases, their attempts at responding to the crisis as it unfolded.

Equity allocations were a drag on returns in Q1, before becoming the key driver of strong performance for the rest of the year, where managers were able to make back all of their losses and more. Those managers who had the strongest performance in 2019 were often the hardest hit in Q1 2020, with some only modestly outperforming tumbling equity markets.

With the benefit of hindsight, there were significant opportunities to re-risk in the wake of Q1's market crash. A number of FMs employed their tactical asset allocation skills to benefit from increased equity and credit allocations, with those implementing most quickly reaping the greatest benefits.

However, generally FMs did not make fundamental changes to their portfolios and the expected levels of return and risk. Whilst trustees might expect FMs to be dynamic at times of market stress and opportunity, the level of dynamism used by FMs is often constrained by the investment guidelines set by trustees.

Whilst the experience of 2020 has been illuminating, the short-lived impact of Covid-19 on equity markets has arguably smoothed out the relative performance figures of many of the FMs in the market. Our analysis shows the wide variety of approaches taken by FMs both before and during a period of significant market turmoil. At some point in the future, equities are likely to experience a more prolonged bear market which will present different challenges. Trustees may therefore reflect on recent experience to gauge whether their FM is likely to be prepared for such an eventuality.

FMs delivered positive performance over 2020, albeit with a wide range of returns. The Covid crisis did not result in major changes in the FMs' approaches.

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