PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

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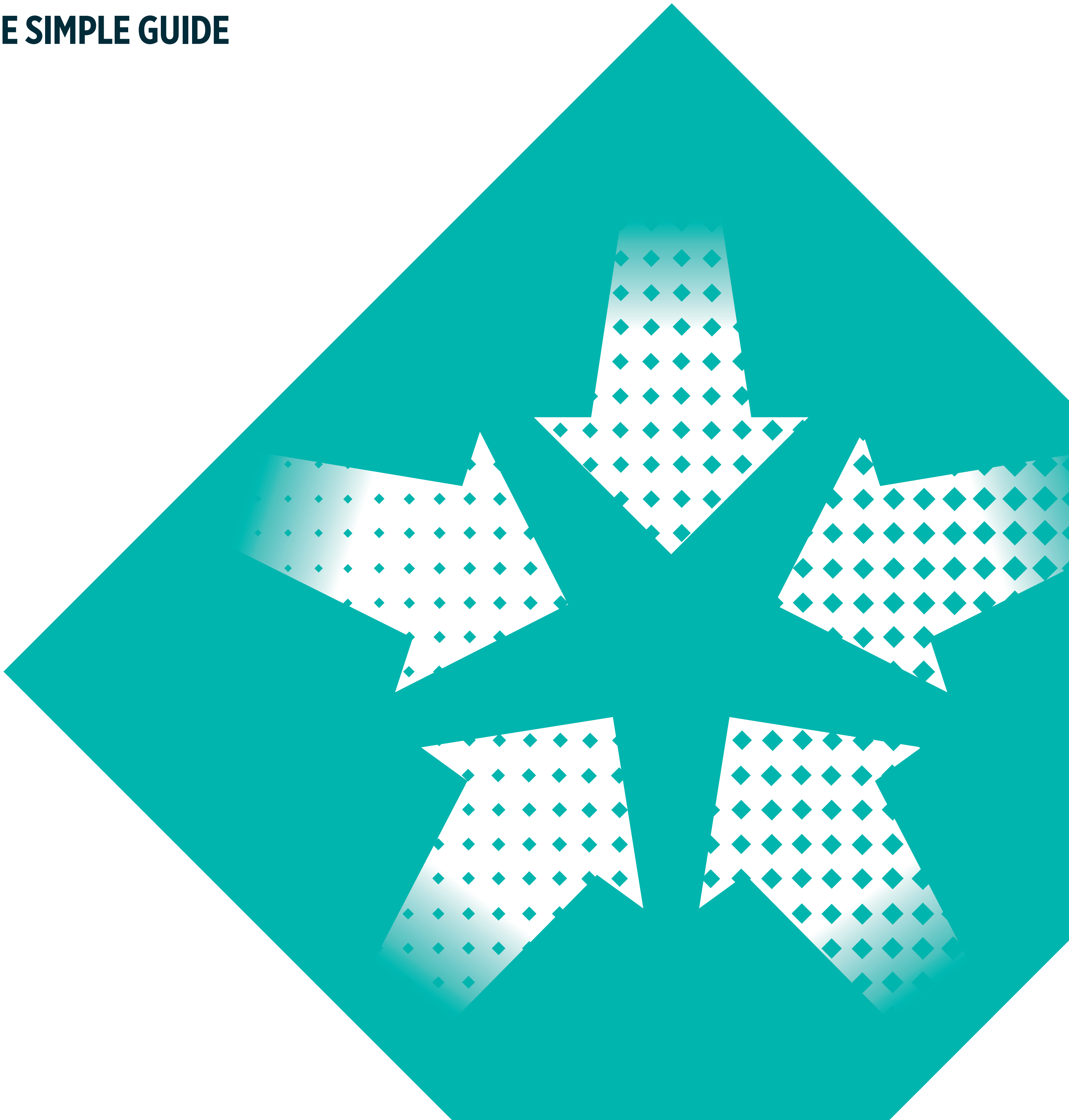
FIDUCIARY MANAGEMENT

MADE SIMPLE GUIDE



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1 INTRODUCTION

THE PAST DECADE HAS SEEN SIGNIFICANT GROWTH IN THE NUMBER OF UK PENSION SCHEMES DECIDING TO ADOPT 'FIDUCIARY MANAGEMENT' ARRANGEMENTS. HOWEVER, THERE STILL EXISTS A LACK OF CLARITY IN THE INDUSTRY AS TO WHAT EXACTLY THIS IS AND THE SCOPE OF THE SERVICES INVOLVED. INDEED, THE DIFFICULTIES START WITH THE NAME: FIDUCIARY MANAGEMENT COMES UNDER A VARIETY OF DIFFERENT GUISES, INCLUDING 'IMPLEMENTED CONSULTING', 'OUTSOURCED-CIO' AND 'DELEGATED CONSULTING'.

Although there is no universally agreed definition for fiduciary management, there are common themes which run through all forms of it.

In its broadest sense, fiduciary management is a governance model which involves the delegation of some, or all, of the day-to-day investment decision-making and implementation for a pension scheme. By delegating certain investment decisions to an expert third-party fiduciary manager, pension scheme trustees are able to focus on high-level strategic issues.

A working definition of fiduciary management:

A GOVERNANCE SOLUTION THROUGH WHICH TRUSTEES DELEGATE THE DAY-TO-DAY IMPLEMENTATION OF THEIR INVESTMENT STRATEGY

This guide aims to help pension scheme trustees understand how fiduciary management can help them overcome the typical difficulties faced by defined benefit (DB) pension schemes in managing investment portfolios. It looks at ways in which fiduciary management can help pension schemes achieve their funding goals, while highlighting certain aspects of the subject which trustees should consider carefully before they adopt such an approach. These include how trustees navigate the fiduciary management market, including a case study that illustrates the steps trustees might take when appointing a fiduciary manager. A glossary is also included.

2
THE FIDUCIARY MANAGEMENT MARKET

THE FIDUCIARY MANAGEMENT MARKET IS A COMPLEX ONE. WITH A VARIETY OF DEFINITIONS, PROVIDERS AND OFFERINGS, TRUSTEES FACE A REAL CHALLENGE IN ASSESSING THE VARIOUS FIDUCIARY SERVICES AVAILABLE.

THE ORIGINS OF FIDUCIARY MANAGEMENT

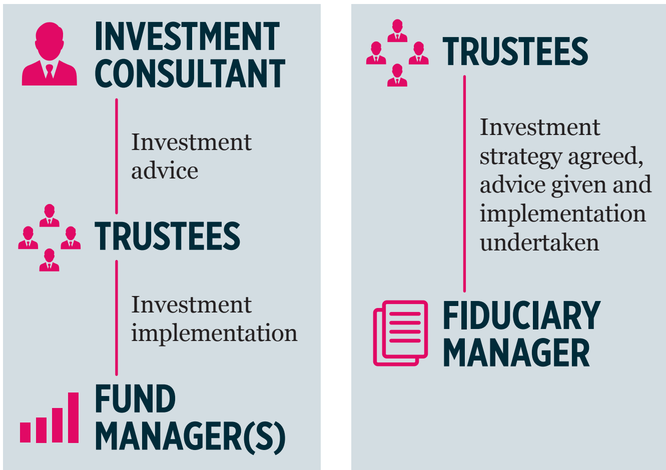
Fiduciary management in its earliest form originated in the Netherlands, which has one of the world's most sophisticated pensions markets. Originally, large pension schemes developed specialist in-house investment teams to whom responsibility for investment decision-making was delegated. This was fiduciary management in its infancy, the start of a new model and way of managing pension scheme assets.

The Dutch market has grown significantly since its origins in the 1990s, with many Dutch pension schemes now under fiduciary management arrangements. But while the fiduciary management market in the Netherlands is nearing full capacity, the market in the UK is a decade younger and growing from a small base. It is however becoming more prevalent in the UK DB pension landscape, with assets under management increasing from around £10 billion in 2007 to more than £120 billion by 2016.[1] The UK has learnt from the experiences of the Dutch market, and as a result now has a remarkably advanced and diverse range of offerings.

HOW DOES FIDUCIARY MANAGEMENT WORK?

Traditionally, a pension scheme has employed an investment consultant to give strategic advice on its long-term asset allocation and manager structure. Asset managers have been appointed, often for individual asset class portfolios, to implement that advice. Trustees must contract with each asset manager in this case, usually under an investment management agreement which will be amended when there are subsequent changes to the strategy (e.g. to investment allocation). Under the fiduciary model, the trustees can subcontract both the strategic advice and its initial and ongoing implementation to a fiduciary manager.

Figure 1: Traditional model vs fiduciary model



Source: Schroders

FULL OR PARTIAL FIDUCIARY APPROACH?

Under trust law, trustees must always retain responsibility for setting the high-level overall investment strategy of the pension scheme (for example the overall split between growth and matching assets)[2]. The scope given to the fiduciary manager can then range from the outsourcing of a specific sleeve of an investment portfolio, for example the alternative assets, to a full strategic partnership where a fiduciary manager is responsible for advising on and implementing the entire investment portfolio. The terms 'partial fiduciary' and 'full fiduciary' respectively are commonly used to express this. The difference between the two lies in the level of delegation over the pension scheme's assets, and the degree to which implementation of the pension scheme's strategy is transferred to the fiduciary manager. In both scenarios, a longstanding relationship is created between the trustees and the fiduciary manager.

1 2016 KPMG UK Fiduciary Management Survey

2 See section 35, Pensions Act 1995 and regulation 2, Occupational Pension Schemes (Investment) Regulations 2005 in relation to the statement of investment principles for occupational pension schemes. The administering authorities of Local Government Pension Scheme funds are responsible for an investment strategy statement, pursuant to regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

Figure 2: Varying levels of delegation

'TRADITIONAL' MODEL

Investment consultant advises on investment strategy and implementation method. Fund managers implement.

'PARTIAL' FIDUCIARY MANAGEMENT

Partial mandates may still receive advice from investment consultants but parts of the investment portfolio are given to a fiduciary manager to manage with greater discretion.

'FULL' FIDUCIARY MANAGEMENT

Fiduciary manager advises on investment strategy and implements across the entire portfolio.

Level of delegation

Source: Schroders

WHO ARE THE PROVIDERS?

There are three main categories of providers: investment consultants, specialists and investment managers.

Figure 3: Providers of fiduciary management

INVESTMENT CONSULTANTS

- Largest share of market
- Expertise in investment strategy advice and external manager selection

SPECIALISTS

- Variety of backgrounds, including in-house investment teams
- Tend to outsource fund management to multiple managers

INVESTMENT MANAGERS

- Typically newest entrants to market
- Expertise in implementation of investment strategy and operational risk management

Source: Schroders

KEY TAKEAWAYS

- Fiduciary management has developed rapidly in the UK
- Fiduciary management is flexible and can be offered on a partial or full basis
- Investment consultants, specialists and investment managers are the main providers

3
THE IMPORTANCE OF GOOD GOVERNANCE

REVIEWING THE GOVERNANCE FRAMEWORK

IT IS IMPORTANT FOR TRUSTEES TO DECIDE AT THE OUTSET WHAT LEVEL OF DECISION-MAKING THEY ARE HAPPY TO DELEGATE TO THE FIDUCIARY MANAGER.

Often trustees will gradually increase the level of delegation over time as they become more comfortable with the fiduciary arrangement, and many providers are flexible enough to offer this change in delegation over time. By creating a transparent and well-structured governance framework, trustees retain control and ultimate responsibility for the operation of the pension scheme. Working through the sort of governance framework we outline below should help to ensure clear accountability and requires that all roles and responsibilities are clearly documented from the outset. In this context, the owner has full responsibility for each decision/activity, and where necessary is supported by an advisor for this action. An overseer takes responsibility, where appropriate, for monitoring the actions of the owner of the decisions.

A blank copy of this framework is provided at the end of the guide for trustees to populate in line with their pension scheme's current arrangements.

Figure 4: Example governance framework

DISCOVER AND TRANSLATE

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Funding objective	Owner	Advisor	
Time horizon	Owner	Advisor	
Risk tolerance (over time)	Owner	Advisor	
Flight path framework	Owner	Advisor	
Liability coverage	Owner	Advisor	

IMPLEMENT

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Managing total portfolio risk	Overseer	Owner	
Setting initial growth portfolio	Overseer	Owner	
Adapting the growth portfolio	Overseer	Owner	
Setting initial matching portfolio	Overseer	Owner	
Adapting the matching portfolio	Overseer	Owner	
Implementation methodology	Overseer	Owner	
Manager selection/deselection	Overseer	Owner	

REVIEW AND ADAPT

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Funding level reporting	Overseer	Owner	Overseer
Review of suitability of flight path	Owner	Advisor	Overseer

Source: Schroders

WHAT IS THE VALUE OF GOOD GOVERNANCE?

Central to fiduciary management is the principle of improving the governance of pension schemes. There has been a great deal of research around whether a 'good governance premium' exists for pension schemes. It is difficult to objectively measure governance quality to assess this premium. Indeed, many studies rely on self-assessment techniques. However, qualitative approaches seek to estimate the following common themes:

- The expertise of the trustee board
- The time and resources available
- The decision-making processes

One such study identified a positive correlation between good governance and investment performance, estimating that pension schemes with good standards of governance added 1-2% per annum in investment performance.[3]

WHO IS FIDUCIARY MANAGEMENT SUITABLE FOR?

Both the number of mandates and the assets under fiduciary management have been growing since 2007. Fiduciary management is particularly popular among smaller pension schemes. Indeed, the majority of pension schemes in the UK which have implemented fiduciary management are under £250 million in size[4]. The low governance aspect of fiduciary solutions is particularly beneficial to this size of pension scheme, as they often have fewer internal resources available to devote to governance. However, it would be wrong to think that fiduciary management is only beneficial for small pension schemes. Fiduciary management has been successfully implemented for DB pension schemes ranging in size from £10 million to more than £1 billion.

KEY TAKEAWAYS

- A governance framework can prove a useful tool to trustees
- Good governance can lead to better performance
- Size is no barrier to fiduciary management

3 Ambachtsheer K, Capelle R, & Lum H (2006), Pension fund governance today: Strengths, weaknesses, and opportunities for improvement
4 2016 KPMG UK Fiduciary Management Survey

4 HOW CAN A FIDUCIARY MANAGEMENT APPROACH HELP?

TRUSTEES' RESPONSIBILITIES ARE WIDESPREAD: THEY INCLUDE ENSURING THEIR PENSION SCHEME IS WELL RUN, PROTECTING MEMBERS' BENEFITS AND FULFILLING THEIR REGULATORY COMMITMENTS. MANAGING THE INVESTMENT STRATEGY FORMS JUST ONE PART OF THESE RESPONSIBILITIES, BUT OFTEN IT'S A TIME-CONSUMING ONE.

A fiduciary management approach can help reduce the burden by delegating day-to-day implementation of the investment strategy to a team of investment experts. This means the fiduciary manager makes decisions on the trustees' behalf, within a clearly defined set of guidelines. This should lead to better decisions and therefore better outcomes by improving focus, expertise, speed and risk management, as we explain below:

1. INCREASED FOCUS ON THE DECISIONS THAT MATTER THE MOST

Trustees have to manage their responsibilities alongside the demands of their normal day job.

By delegating the details of the investment strategy, they gain the benefits of an expert whose sole occupation is to concentrate on investment. By having clearly defined roles and responsibilities, trustees can ensure that they remain in control of the key decisions that affect the future of their pension scheme.

Figure 5: Key focus areas

FOCUS ON WHAT'S MOST IMPORTANT...	...BY DELEGATING THE REST
What are our funding goals?	What asset classes should we invest in?
When do we expect to reach our funding goals?	What implementation route should we use for each asset class?
Is the overall level of risk in the scheme appropriate?	How should we adjust the portfolio for the latest developments in markets?

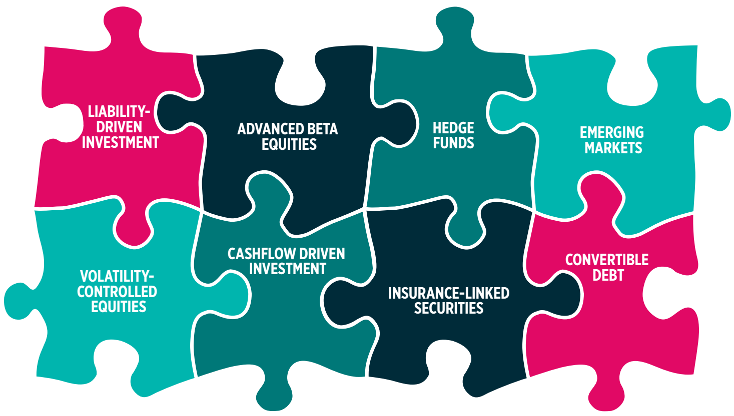
Source: Schroders

2. HIGHER EXPERTISE IN INVESTMENT DECISION-MAKING

Pension scheme investments are becoming ever more complex. For example, strategies that involve derivatives such as liability-driven investment (LDI) and equity downside protection are now commonplace; and developments in technology and new thinking are reshaping how investors consider investment risks. It can be hard to keep up with all of the latest developments.

By using a fiduciary manager, trustees bring specialist investment knowledge onto their board. The fiduciary manager applies their many years of investment experience to the pension scheme's specific circumstances and works with the trustees to develop and implement a strategy to meet the pension scheme's particular needs.

Figure 6: Combining specialist investments



Source: Schroders

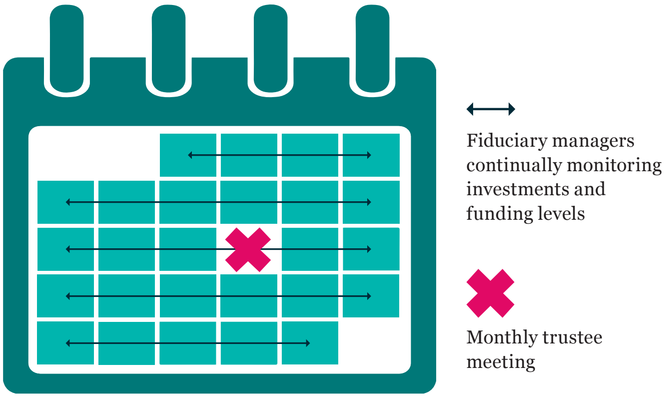
Fiduciary management also enables pension schemes to combine their investments with other similar investors through pooled funds. This can increase the pension scheme's purchasing power, potentially manages costs and enables it to gain easier access to asset classes, such as pooled LDI or alternatives funds.

3. GREATER SPEED OF IMPLEMENTATION

Trustee groups typically meet infrequently, for example on a quarterly basis. While this provides a good framework for longer-term decision-making, shorter-term opportunities may be missed if there are delays in approving and implementing investment decisions. The investment climate can change very quickly and it is important to stay nimble to adapt to changing circumstances, to protect the funding level or to capture market opportunities.

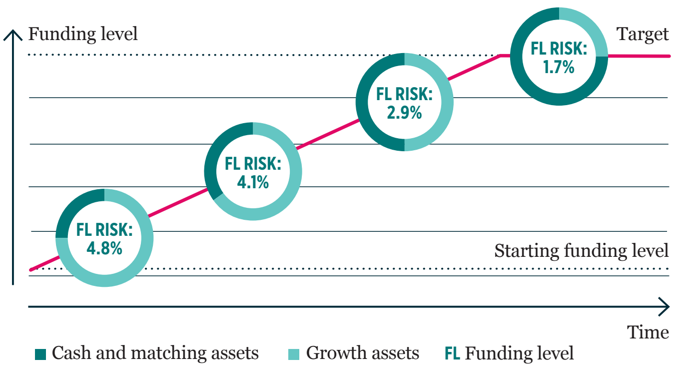
BY DELEGATING THE DETAILS, TRUSTEES GAIN THE BENEFITS OF AN EXPERT WHOSE SOLE OCCUPATION IS TO CONCENTRATE ON INVESTMENT

Figure 7: Speed of implementation



Source: Schroders

Figure 8: Flight path to full funding



Source: Schroders. For illustration only.

Fiduciary management means that trustees have an investment professional who is monitoring their investments and – crucially – is ready to make decisions on their behalf every working day. Once a clear set of guidelines has been established, the fiduciary manager has the authority to act on the trustees' behalf, enabling them to act swiftly to implement changes.

4. BETTER RISK MANAGEMENT AND PLANNING FOR THE FUTURE

Most DB pension schemes are now closed to new members and many are also closed to future accrual. These pension schemes have a finite time period until the last pension is expected to be paid. As a result, trustees and sponsors are increasingly looking to the end-game and are planning towards a lower-risk investment strategy as the pension scheme matures.

Many fiduciary management arrangements include a 'flight path'. This is a long-term plan towards full funding which captures opportunities to de-risk as the pension scheme's funding level improves. Advances in technology mean that fiduciary managers are able to track the pension scheme's funding level on a daily basis. When a funding level trigger is reached, the fiduciary manager immediately moves the pension scheme to a pre-agreed lower-risk strategy. This enables the pension scheme to move quickly to capture opportunities. Having a pre-agreed framework in place means decisions can be taken swiftly by the fiduciary manager, but without increasing the trustees' governance burden.

KEY TAKEAWAYS

- Fiduciary management means that investment professionals focus on pension scheme funding levels every day
- As investment experts, fiduciary managers apply this experience to a pension scheme's individual circumstances
- Under this model, new decisions can be implemented in a short time-frame
- A 'flight path' can allow trustees to plan for the future and manage risk efficiently

5 COMMON MISCONCEPTIONS

THERE ARE SEVERAL COMMON MISCONCEPTIONS SURROUNDING FIDUCIARY MANAGEMENT, TYPICALLY ARISING FROM WORRIES ABOUT COMPLEXITY, COST AND LACK OF CONTROL. THESE THREE AREAS SHOULD CERTAINLY BE WEIGHED UP CAREFULLY WHEN CONSIDERING FIDUCIARY MANAGEMENT, ALTHOUGH IN REALITY THE ARRANGEMENT DOES NOT NEED TO BE COMPLEX, COSTLY OR REQUIRE THE TRUSTEES TO GIVE UP CONTROL.

COMPLEXITY

As the Pensions Regulator has pointed out, the investment industry for pensions continues to develop and innovate[5]. The options open to trustees have multiplied as a result. These include LDI and cashflow driven investment, diversified multi-asset portfolios, illiquid assets, private markets and advanced beta, to name but a few. However, getting the best from them requires significant time and resources. Often, trustees have neither to spare. Fiduciary management provides an investment solution to this issue.

Some trustees may be concerned that the overall investment portfolio could become more complicated in a fiduciary arrangement. In fact, many fiduciary managers adopt a ‘manager of managers’ approach. This means that, while trustees are likely to have an investment strategy with a wider range of underlying mandates than they are used to, the funds are all held on a single platform. As a result, in many cases governance and reporting arrangements are actually simplified.

Even when fiduciary managers do not adopt such an approach, they are likely to invest in a more diverse range of asset classes, and use more sophisticated investment strategies. Although in some respects this can be viewed as adding complexity, it means that trustees are able to benefit from investment strategies that might not otherwise be available to them.

Overall, fiduciary management aims to ease the burden on trustees, particularly where small pension schemes are involved and investment governance budgets may be limited.

Investment training is a crucial part of any trustee-fiduciary manager relationship. Before implementing new investment strategies, fiduciary managers typically give extensive training to trustees to ensure they are comfortable with any changes being made. For example, using derivatives within an investment strategy to protect against equity market downturns may be viewed as additional complexity. However, with the appropriate level of training, actually implementing such strategies using a fiduciary manager can significantly reduce the risk that the pension scheme is running.

COST

There is a common perception that fiduciary management is more expensive than traditional arrangements. In reality, there are many ‘flavours’ of fiduciary management that can be accessed at varying levels of cost.

Although they may not necessarily be more expensive than traditional arrangements, fee structures can be complex. This is particularly the case in ‘manager of managers’ approaches, where layers of fees are sometimes evident. But, taken in the round, such arrangements may mean that pension schemes are able to benefit from economies of scale in a way they could not were they to be acting on their own.

It is therefore vital for trustees to be clear on the fees involved in a fiduciary mandate. The costs involved depend on the particular type of fiduciary management, but typical costs are set out opposite.

5 http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2017.pdf

Figure 9: Typical costs

TYPE OF FEE	WHAT IS THIS FEE?	IS IT CHARGED UNDER THE FIDUCIARY MANAGEMENT MODEL?	IS IT CHARGED UNDER THE 'TRADITIONAL' MODEL?
Investment manager fees	Fee on the underlying funds in the investment strategy	Yes, typically charged on an 'assets under management' basis	Yes, typically charged on an 'assets under management' basis
Fiduciary management fees	Depends on the provider and should clarify at the outset. Typically includes: – Investment advice around strategy – Funding level monitoring and de-risking – Reporting	Yes, typically charged as a bundled fee on an 'assets under management' basis	No, typically investment consultancy costs (which cover similar aspects) are charged on a 'time-cost' or 'fixed fee' project by project basis
Performance fees	A performance fee which is aligned to the funding level outcome	Depends on provider	No
Custody fees	A fee paid to a custodian to take on independent oversight and safekeeping of client assets	Some fiduciary arrangements require clients to appoint a custodian on an individual client by client basis, in which case this fee applies. However, typically the appropriate fee would be paid directly to the custodian.	Some 'traditional' arrangements require clients to appoint a custodian on an individual client by client basis, in which case this fee applies. However, typically the appropriate fee would be paid directly to the custodian.
Exit charges	Some providers have a 'lock-in' period where a scheme will be charged on leaving the arrangement in this period	It depends. Many providers do not have a 'lock-in' period	No

Source: Schroders

One of the easiest ways for trustees to consistently compare costs across different fiduciary managers (or against traditional arrangements) is to consider the 'pounds and pence' total costs. Often different fee components are expressed differently: some are expressed as a percentage of assets (e.g. an equity fund charges 0.45% on assets invested in that fund), others are expressed as a fixed monetary cost for a particular project (e.g. the cost of carrying out a manager selection exercise for a pension scheme is £15,000). Only by summing each of these components in 'pounds and pence' can a consistent comparison be made.

CONTROL

Perhaps the most common misconception about fiduciary management is the fear among trustees that it involves surrendering control of all of their pension scheme's investments. Certainly, by delegating more decisions to the fiduciary manager, it could seem like the trustees' involvement in the pension scheme is lessened. In practice, trustees and their fiduciary manager continue to engage with each other on a regular basis – this is not a 'set and forget' arrangement. Although fiduciary arrangements mean the trustees are not involved in day-to-day investment decision-making, they still retain control over the pension scheme's overall objectives and high-level decision-making. In undertaking these duties, some trustees may choose to be in frequent contact with the fiduciary manager, while others may retain the same quarterly or annual meeting cycle that they adopted under the traditional approach.

It is true that, under the traditional model, a significant amount of time is often spent on decisions relating to which investment manager to appoint for a particular asset class. While this is an important decision, research has shown that manager selection only accounts for around 10% of the risk and return of the portfolio, with high-level asset allocation accounting for the remaining 90%.[6] Under fiduciary arrangements, the largest proportion of a trustee's time and attention can be focused on the 90%, rather than the 10%.

A fiduciary management arrangement works well for many trustees who have full-time jobs, as it releases them to spend the limited time they have available on high-level issues, while knowing that their pension scheme's investments are being monitored daily by an investment professional. It means that trustees are able to 'see the wood for the trees', and can focus their time on the most important matter of ensuring the pension scheme remains in line to meet its long-term funding objectives.

KEY TAKEAWAYS

- Fiduciary management need not increase complexity – trustees may access a broader range of solutions
- Trustees must be clear about what a provider's fiduciary fee covers
- Trustees retain control of the pension scheme's high-level objectives

6 Gary P. Brinson, L. Randolph Hood, Gilbert L. Beebower, 'Determinants of Portfolio Performance'.

6 HOW TO SELECT A FIDUCIARY MANAGER

SELECTING A FIDUCIARY MANAGER IS ONE OF THE MOST IMPORTANT DECISIONS TRUSTEES CAN MAKE, GIVEN THE APPOINTEE'S PIVOTAL ROLE IN SETTING AND IMPLEMENTING A SCHEME'S INVESTMENT STRATEGY.

The decision to change a pension scheme's operating model is a significant one, and therefore requires a substantial upfront investment of time and resource to do the decision justice. However, as a fiduciary management appointment progresses, the reduced governance burden on the trustees acts to offset this initial time investment.

As well as being time-intensive, choosing which fiduciary manager to select can be difficult. There are many fiduciary management styles, and trustees need to decide which decisions to delegate.

Given these issues, there are a number of questions trustees should consider before deciding whether fiduciary management is right for their scheme and embarking on a selection process.

Figure 10: Questions to consider

HOW CAN I FIND A 'STYLE' WHICH SUITS MY SCHEME?

DOES CHANGING THE GOVERNANCE MODEL INTRODUCE POTENTIAL CONFLICTS OF INTEREST?

HOW CAN I COMPARE FIDUCIARY MANAGEMENT TO MY CURRENT GOVERNANCE MODEL?

WHAT REPRESENTS 'VALUE FOR MONEY' IN FIDUCIARY MANAGEMENT?

WHAT DECISIONS WILL THE TRUSTEES STILL MAKE?

Source: Schroders

The table opposite sets out the steps in a typical fiduciary manager selection process, including the essential role of an independent advisor.

KEY TAKEAWAYS

- A thorough selection process is vital when appointing a fiduciary manager
- Before starting the selection process, trustees should ensure they consider their objectives and the extent of delegation they are comfortable with
- The process should include independent advice delivered by a third party
- A range of independent providers have developed resources to help trustees through the selection process

Figure 11: Fiduciary manager selection process

1 **SET UP A WORKING GROUP**	▸ Appointing a fiduciary manager is one of the biggest decisions trustees can make, given the wide-ranging scope of a fiduciary manager. ▸ Many schemes therefore set up a working group to conduct the selection, so that they are able to devote enough time to this decision. ▸ The working group will typically contain representatives from the trustee board and the sponsor, and there may also be involvement from an independent trustee.
2 **APPOINT AN INDEPENDENT OVERSIGHT PROVIDER**	▸ As the fiduciary management industry has matured in the UK, a range of independent providers have started to offer advice on the selection process itself. ▸ Just like in the traditional advisory model, it is important that trustees can access independent advice from a third party that can help them appoint and monitor their fiduciary manager, as they would their investment managers. ▸ Oversight providers are well placed to provide this advice and their presence can only encourage transparency, objectivity and best practice in the industry.
3 **DECIDE ON A LONGLIST**	▸ Comparing different providers' approaches is like comparing apples and oranges. This can make it difficult for trustees to decide on a suitable partner. ▸ However, as experts in the different types of fiduciary management providers, and the different flavours of offerings, oversight providers are able to guide trustees through the options available to them and create a longlist of managers to consider.
4 **SUBMIT AN INITIAL REQUEST FOR INFORMATION**	▸ As with traditional arrangements, submitting an initial request for information can give the trustees an indication of what each fiduciary management provider offers. ▸ Trustees should ask questions on the fiduciary business, and the overall solution the fiduciary manager suggests, including how the assets will be managed.
5 **SHORTLIST PROVIDERS AND SITE VISITS**	▸ Based on the initial request for information, the trustees can narrow their list down and arrange to meet with a shorter list of providers. ▸ Site visits are a crucial way to ensure that trustees are happy with the cultural fit of the fiduciary manager, and they are also a way to probe further on any areas which the trustees are unsure on. ▸ This is also a chance to explore more fully the shape of the strategy and delegation model you wish to implement.
6 **TRUSTEES APPOINT A FIDUCIARY MANAGER**	▸ Trustees decide on a fiduciary manager. ▸ Trustees agree the Investment Management Agreement. ▸ Typically a transitional period then follows, allowing delegation to be phased over a period of time.

Source: Schroders

7 THE IMPORTANCE OF REPORTING

ONE OF THE KEY BENEFITS OF FIDUCIARY MANAGEMENT IS THAT IT GIVES TRUSTEES THE TIME AND RESOURCES TO FOCUS ON HIGH-LEVEL ISSUES, WHICH SHOULD MEAN THEY CAN MAKE MORE INFORMED DECISIONS ABOUT STRATEGY.

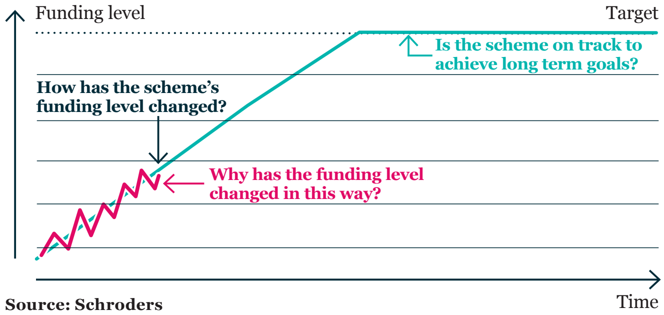
Clear and transparent reporting is essential to support trustees in this process. Moreover, good reporting is also crucial in monitoring the progress of the fiduciary manager against their prescribed objectives.

For all UK DB pension schemes, the fundamental long-term goal is to be able to meet future pension payments. This means that the pension scheme's assets should at least match the liabilities at the point they are to be paid. So two key questions for the fiduciary manager are:

1. How will they design a strategy to meet this long-term funding goal?
2. How will they put it into effect?

Regular reporting should then signal their progress in maintaining or improving the funding level and whether the pension scheme is on track to achieve its goals.

Figure 12: Funding level goals



Source: Schroders

Although the overall objective is clear, measuring the performance of a fiduciary manager is more difficult than, say, that of an active UK equity fund manager. The success of the latter can usually be assessed quite clearly by looking at their performance in relation to a benchmark, such as the FTSE All Share Index. The reasons for this performance might then be explained in terms of their ability (or otherwise) to pick stocks which performed better than the benchmark. In contrast, the reasons for a change in funding level might be more complicated to determine. The following checklist sets out the key questions trustees should ask of their fiduciary manager to assess their performance:

Figure 13: Questions for your fiduciary manager

- ☑ How has the funding level changed?
- ☑ What are the reasons for the change?
- ☑ Have there been any changes to the investment strategy, for example, due to a de-risking trigger being hit?
- ☑ What is the current allocation of the investment portfolio?
- ☑ What is the current level of risk in the investment portfolio, including measures such as 'Value at Risk' and funding level volatility?
- ☑ What is the current attribution of risk in the investment portfolio?
- ☑ How have the underlying funds and/or components performed?
- ☑ Have there been any changes made to the underlying funds and/or components?
- ☑ How have market events affected your pension scheme's investments?
- ☑ What is the sensitivity of your investment portfolio to changes in interest rates and inflation?

KEY TAKEAWAYS

- A fiduciary manager's main goal is to meet the pension scheme's funding level objectives
- Regular reporting against the pension scheme's objectives should be provided
- Trustees should ask lots of questions

8
WHY NOW?

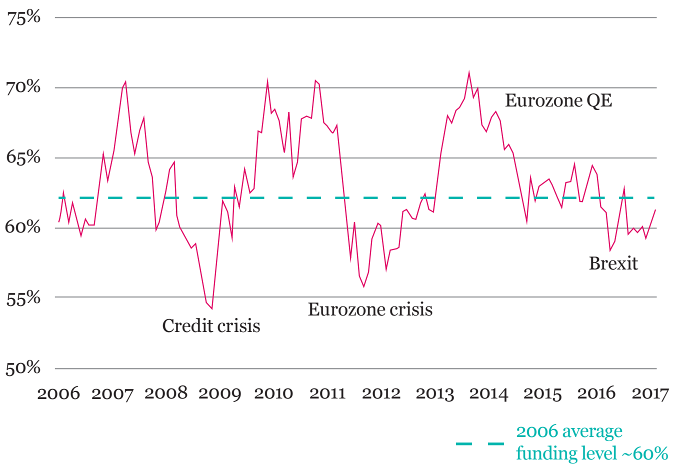
AS MENTIONED AT THE START OF THE GUIDE, IN RECENT YEARS THERE HAS BEEN A SHARP UPTICK IN THE NUMBER OF UK DB PENSION SCHEME TRUSTEES IMPLEMENTING FIDUCIARY ARRANGEMENTS. INDEED, THIS IS NOT A COINCIDENCE GIVEN THE CURRENT INVESTMENT ENVIRONMENT TRUSTEES ARE FACING.

THE 'LOST DECADE'

Over the past 10 years interest rates have fallen significantly: this has resulted in a fall in the discount rate which is used to value pension scheme liabilities, which means that these liabilities have grown. For pension schemes that have not managed their liability risk, asset growth has simply not kept up, resulting in significant pensions deficits appearing on company balance sheets. The chart shown below tracks the funding level of the average UK pension scheme.[7]

While the chart clearly shows that the funding levels have been volatile over the past decade, they have now settled back to roughly where they started. It is what the Pension Protection Fund has rightly called a 'lost decade' for pensions. This comes despite substantial payments from sponsoring employers.

Figure 14: Low-risk funding level of a typical UK Defined Benefit scheme



Source: Schroders

7 Sources for funding level estimates, total asset and liability values (buyout basis) and average asset allocation: Pension Protection Fund as of 31 March each year (to March 2016), http://www.pensionprotectionfund.org.uk/Pages/ThePurpleBook.aspx . Interim asset returns: Barclays, FTSE, MSCI, HFRI and IPD as at 30 June 2017 (all sourced through Bloomberg); gilt yields: Bank of England as at 30 June 2017.

Trustees fundamentally have two main levers when it comes to filling their pensions deficits: sponsor contributions and investment returns. Against this background of continuing uncertainty in markets and increasing demands on pension assets, schemes need to think differently about how to achieve investment returns and fill their deficits. This had led many trustees to reassess their investment governance models, and explore fiduciary management.

KEY TAKEAWAYS

- Many pension schemes have experienced a 'lost decade' with respect to their funding levels
- This challenging environment has led to some trustees exploring new approaches to address the funding gap, including new governance models

9 CONCLUSION

FIDUCIARY MANAGEMENT IS WELL ESTABLISHED AND CONTINUES TO DEVELOP IN THE UK. IT OFFERS A VERY EFFECTIVE AND FLEXIBLE GOVERNANCE MODEL FOR PENSION SCHEMES OF ALL SIZES TO ADDRESS THE PROBLEMS THEY FACE.

With investment professionals monitoring a scheme's investment portfolio and funding level every day, decisions can be made and implemented faster. This should improve outcomes and reduce the governance burden on trustees.

However, there are many types of provider and flavours of fiduciary management. Trustees need to be clear about what level of delegation they want, what fees they will pay and what objectives they expect to achieve. This makes it essential to have a comprehensive selection process, aided by independent advice from a professional oversight provider. Indeed, to do it justice, the initial stages of appointing a fiduciary manager do require trustee resource and time. However, over time this is more than compensated for as the future governance burden for trustees is significantly reduced.

Handled well, fiduciary management should lead to better accountability for funding outcomes and improved governance, resulting – ultimately – in more secure pensions for beneficiaries.

HANDLED WELL, FIDUCIARY MANAGEMENT SHOULD LEAD TO BETTER ACCOUNTABILITY

10 GLOSSARY

Advanced Beta
Advanced beta (or smart beta) approaches aim to outperform traditional passive funds (those aiming to replicate the performance of an index) at lower cost than full-blown active funds. They seek to overcome shortcomings of traditional passive ('indexed') approaches or to gain access to a particular source of return in the market, such as 'value' or 'quality' investment approaches.

Asset allocation
The mix in a portfolio of different asset classes, such as equities, fixed income and alternatives. Strategic asset allocation, in this context, refers to a long-term allocation which aims to achieve the pension scheme's funding objectives. Tactical or dynamic asset allocation refers to shorter-term decisions to shift between assets based on valuations or changes in the market environment.

Cashflow Driven Investment
An investment solution for pension funds which seeks to meet all future liability cashflows. It achieves this by matching the liability payments with the income and redemption proceeds from bonds or bond-like assets.

Deficit
The shortfall between a pension scheme's assets and the present value of its liabilities.

Defined benefit (DB) pension scheme
A pension scheme where the pension paid to members is determined by how long they have worked for the employer and the salary they earned. Today, the vast majority of UK defined benefit pension schemes are no longer accepting new members and increasingly existing members no longer receive future defined benefits ('closed to accrual'). Many defined benefit schemes do not currently hold enough assets to meet their pension promises (known as their 'liabilities').

Delegation
The transfer of responsibility and management from one party to another. Trustees are able to delegate day-to-day investment decisions to a third party, but overall responsibility for securing members' benefits remains with the trustees.

Discount rate
Used by the actuary to place a present value (the value today of a sum of money due or receivable in the future) on a defined benefit pension scheme's liabilities. For example, if a payment of £100 is due in one year's time, then using a discount rate of 5% gives a present value of £100 ÷ (1+5%) = £95.24. The lower the discount rate, the higher the liabilities.

Diversification
Diversification is not simply choosing different asset classes (or securities within the same asset class) for a portfolio. Diversification involves managing risk by looking at how assets typically move in relation to each other (the 'correlation') and choosing those assets whose returns have a low or negative correlation with each other. The idea is that if some parts of the portfolio are underperforming during a particular type of market environment, other parts will be outperforming.

End game
The ultimate goal of a pension scheme. The end game gives the trustees defined objectives to work towards and enables them to align their strategy accordingly.

Fiduciary duty
Trustees of pension schemes have a fiduciary duty to the members of their scheme. This is a legal obligation and entails certain responsibilities to members, including acting in their best interests, acting impartially and acting in line with the trust deed and rules. Although the delegation of certain investment decisions is often referred to as 'fiduciary management', appointing a fiduciary manager does not diminish the trustees' fiduciary duty to members.

Flight path
A plan that involves adjusting the investments and contributions so that a pension scheme can become 'fully funded' or able to be 'bought out' by an insurance company. Investment risk may be reduced over time in response to increases in the funding level or improved market conditions.

Funding level
The value of a pension scheme's assets compared to the present value of its liabilities.

Funding level triggers
Pre-agreed funding levels at which the scheme will de-risk, i.e. reduce the likelihood that funding levels will drop sharply by, for example, switching growth assets into matching assets such as bonds and/or purchasing additional liability coverage via LDI assets (see liability-driven investment).

Liability-driven investment (LDI)
The ultimate objective of pension scheme investing is to ensure that there are sufficient funds to pay the liabilities. LDI puts this objective at the heart of a pension scheme's investment strategy. A key aim of LDI is to manage funding level risk (i.e. the variability of the pension scheme's assets compared to its liabilities). This usually means using a range of assets, such as swaps and bonds, to construct an investment strategy that closely matches the behaviour of the pension liabilities. These assets are often referred to as 'LDI assets' or 'matching assets'.

Operational risk
The risk of financial loss occurring due to an error during the implementation of the investment strategy. Operational risks can occur when assets are moved to a different fund manager, when the fund manager invests the assets or changes the asset allocation, and when assets are moved away from a fund manager. Managing operational risk is a key activity of fiduciary managers, as fiduciary solutions bring together a number of different elements that interact to create the overall strategy.

Value at risk (VaR)
This is a statistical method for estimating the minimum loss (or increase in deficit) that can be expected with a certain level of confidence. Thus a pension scheme could calculate that there is a 95% probability that its deficit will not increase by more than the VaR on any given day. The other side of the coin is, of course, that on five days out of 100 the deficit might increase by more than the VaR. VaR95, which is commonly used, is the smallest amount by which the deficit is expected to increase if a one-in-twenty-year downside event occurs.

11 GOVERNANCE FRAMEWORK FOR TRUSTEES TO COMPLETE

DISCOVER AND TRANSLATE

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Funding objective			
Time horizon			
Risk tolerance (over time)			
Flight path framework			
Liability coverage			

IMPLEMENT

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Managing total portfolio risk			
Setting initial growth portfolio			
Adapting the growth portfolio			
Setting initial matching portfolio			
Adapting the matching portfolio			
Implementation methodology			
Manager selection/deselection			

REVIEW AND ADAPT

DECISION/ACTIVITY	TRUSTEE	FIDUCIARY MANAGER	OTHER THIRD PARTY
Funding level reporting			
Review of suitability of flight path			

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Pensions and Lifetime Savings Association
Cheapside House,
138 Cheapside,
London EC2V 6AE

T: 020 7601 1700
E: plsa@plsa.co.uk

www.plsa.co.uk

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