Pensions Management Institute
Knowledge

In association with

RIVER AND MERCANTILE

# Navigating the key issues facing schemes in 2021

**Welcome to the first issue of the Annual UK Fiduciary Management Survey from the PMI in conjunction with River and Mercantile.**

# Foreword

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Whilst collaborating with the PMI as their Fiduciary Management Partner during the tumultuous backdrop of 2020, discussions would often focus on the burden being placed on trustee boards. During the year, changes to working practices, combined with a fast-changing investment and regulatory environment, added to an already evolving and growing list of priorities for Trustees. We therefore saw a need to provide some guidance to Trustees on what were likely to be key themes for 2021.

By carrying out this research, we are able to share some valuable knowledge around the issues facing Fiduciary Management and Trustees. This will not only help market participants to plan and prioritise, but also help us to work with them to develop solutions and services that match their evolving needs.

As part of this initiative we are forming a Fiduciary Management Strategic Forum made up of leading industry practitioners. This Forum will meet quarterly to continue to discuss and develop themes affecting the markets, as well as pinpointing new ones as they arise throughout 2021. The debate and conversation that this brings will also inform us around the questions to cover for next year's Survey.

**I hope you enjoy reading the findings.**

Anyone who has been watching the latest Netflix hit, 'The Queen's Gambit,' will know the importance of the 'endgame' in chess. And from the responses to our survey, the pension scheme endgame is clearly at the forefront of Trustees' minds at present. With almost 100 respondents to our Survey, we have some very robust data and interesting findings.

**A snapshot of the key findings is as follows:**

# Introduction

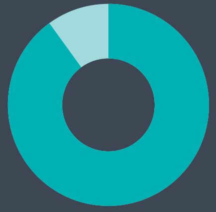
- Over **90%** of respondents indicated that they were looking to review their investment strategy in order to be sure of achieving their desired outcome, whether that be self-sufficiency or buy out.
- Related to the point above, over **90%** of respondents also indicated that accessing the 'full toolkit', e.g. new ways of protecting against downward market moves was very relevant, and **80%** of them considered it a priority.
- Nearly **80%** of respondents believed that the regular quarterly meeting cycle had lost its relevance as a result of Covid changes and a similar amount felt that they needed better access to accurate and timely investment information, which would be provided by technology.
- **70%** of respondents had either already appointed a fiduciary manager or considered it a relevant option (nearly **50%** are already using the services of one).



"It is important that all pension schemes set a long-term funding goal that takes them past the technical provisions basis. But this is only the first step, it is vital that trustees monitor the progress to this long-term funding goal and periodically assess if it remains appropriate."

**André Kerr**
Partner, Head of Fiduciary Management Oversight, XPS Pensions Group

# Long-term funding... where do we go from here?



**90%**

of those surveyed stressed the importance of setting a long-term funding goal, and re-aligning their investment strategy in order to achieve it

As Trustees and Sponsors emerge from a challenging 2020, the Pensions Regulator's spotlight is on long- term funding – making it clear that it is important to **"start with the end in mind"**. Irrespective of the scheme journey so far, Sponsors are going to be in a very different position over the next few years. Therefore, it is critical the investment strategy today is **targeting the right level of return to drive long-term funding success**. In doing so, Trustees need to keep a keener **eye on what risks may blow the journey off course** and how they manage them from here.

The endgame will differ depending on the Trustee and Sponsor's risk appetite. It may go from a low-dependency position (for additional contributions) through to a complete buy-out with a third-party insurer. That said, the common thread is that 2020 has seen many schemes take a step back from funding progress of prior years. **Indeed, some might call it a lost year for defined benefit funding**. This is particularly important as schemes are getting more mature and paying out increasing amounts in pension payments.

So, where do Trustees go from here? The starting point from our survey acknowledged the need to look beyond Technical Provisions reflecting tPR guidance. This means setting a long-term funding goal, and over **90% of those surveyed stressed the importance of re-aligning their investment strategy** in order to achieve that goal.

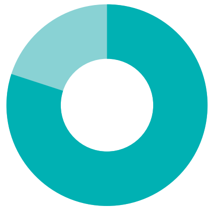


When reviewing investment strategy, the starting point for many Trustees and Sponsors is to re-assess the target investment return from the assets as well as the key risks that lie ahead. Is the current journey plan and de-risking framework fit for purpose? **In fact, 4 out of 5 respondents noted that this was a key priority for 2021 given recent market movements.**

This process needs to take into account a review of covenant strength and support from the Sponsor today and into the future. For many sectors, this is resulting in the need to re-examine what is truly affordable as companies look to position themselves beyond lockdown.

From a Trustee perspective, they want the Sponsor to remain a going concern for as long as possible, as this provides an effective financial support to improve scheme funding. Respondents expect there to be a shift in the format of deficit contributions, potentially with lower contributions for longer as a compromise.

In turn, this will have a direct impact on investment strategy design, particularly to meet pension cashflows. Previously, this had been largely met from deficit contributions, whereas Trustees may now be forced into selling growth assets at an inopportune time. **Our survey noted that over 60% of respondents were expecting to focus on better cashflow management and the use of income-generating assets next year.**



**4/5**

respondents noted that a fit for purpose de-risking framework was a key priority for 2021

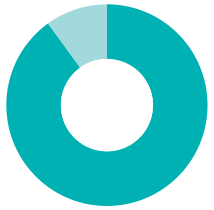
**60%**

of respondents expect to focus on better cashflow management and the use of income generating assets next year

"There are lots of different fiduciary managers out there who do operate differently and have different return drivers. It's important Trustees understand the approach of their fiduciary manager so they don't get any surprises."

**Faye Mullen, CFA**
Head of Fiduciary Management Research, Isio

# The full toolkit... does your scheme have access?



## 90%

of respondents see keeping abreast of the latest market developments as a key objective given current economic challenges

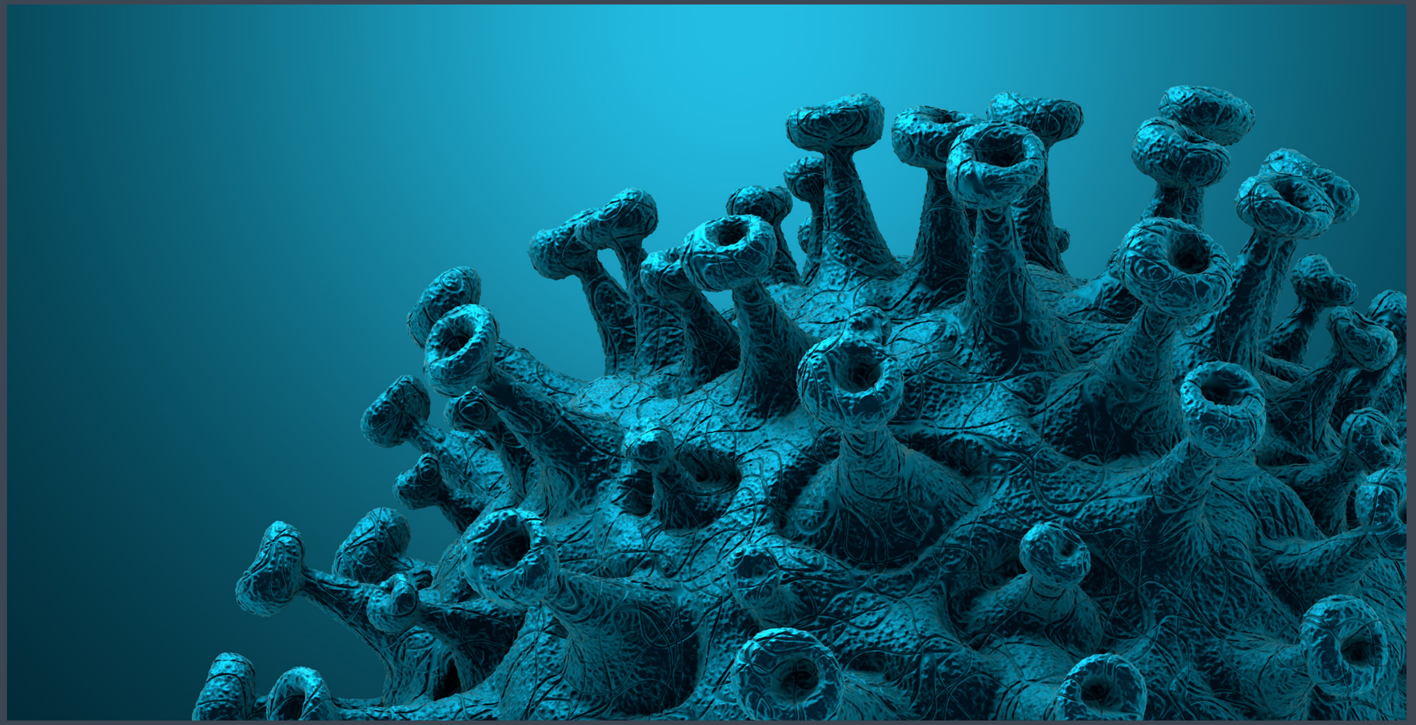
Scheme size has often been heralded as an impediment for Trustees getting access to the best thinking and the latest innovation. Indeed, the growing interest in consolidators and superfunds may well provide a future mechanism from which small to medium schemes can benefit.

As we look forward, where does fiduciary management sit on this spectrum? In principle, established fiduciary managers are often heralded as using their economies of scale to deliver material cost savings to their clients. This can make a difference, accessing the best equity, credit or passive manager at lower fees than as a standalone scheme.

However, there is a wider question – **are their clients getting access to the best and latest ideas, typically being used by the largest institutional investors?** Surely that is where fiduciary management can make a real difference? Fiduciary management should be much more than a series of multi-manager products. After all, there have been numerous surveys on the contribution of asset allocation vs manager selection to overall returns, no matter how cheaply we can source the manager.

In doing so, we asked our survey respondents to probe this area in more detail, as this places the onus on looking under the hood to understand what providers are doing to generate consistent risk-controlled returns on behalf of their clients.





## 8/10

schemes see protection strategies as a priority to address in 2021

## 2/3

schemes highlighted a lack of resources compared to bigger institutions as a governance problem

With the recent spate in market volatility, we asked whether schemes were able to weather the storms of market losses through using explicit downside protection. These strategies have been available to defined benefit schemes for over 15 years, particularly larger investors. Indeed, this should be a common part of the investment toolkit (like LDI has become), **yet 8 out of 10 schemes saw protection strategies as a priority to address in 2021.**

A similar theme can be seen in more niche opportunities such as the illiquid credit strategies that became more attractively priced in the second quarter of 2020. Nimble, large investors alongside some fiduciary managers were able to access these opportunities quickly in order to generate attractive returns on behalf of their clients. However, our survey observed that **2 out of 3 schemes highlighted this as a governance problem for them**, with a lack of resources available compared to bigger institutions.

Finally, as Trustees look to position their investment strategies to deliver strong funding progress from here, there is an expectation that Trustees keep abreast of the latest developments and newer tools becoming available. Given the challenging economic backdrop as we emerge from Covid, **almost 90% of respondents saw this as a key objective to address.**

"Virtual meetings and technological advances have improved the efficient flow of information to trustees. Going forward a flexible meeting structure may be the optimal solution; where regular oversight meetings are supplemented by short, focused sessions to discuss and take important or urgent decisions."

**Anne-Marie Gillon, CFA**
Director, IC Select Ltd

# The demise of the quarterly meeting... Continuous Governance from here

**80%**

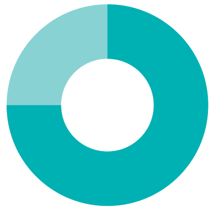
of respondents feel the quarterly meeting cycle has lost its relevance

Wild swings in asset and liability valuations for most of 2020 have laid waste to the best made journey plan for many DB schemes. This makes it ever more challenging for trustees to govern their funding and investment arrangements without information readily available at their fingertips.

With the majority of meetings conducted on video conference, this has seen a rapid and very welcome growth in Trustees using technology solutions with their advisors. This is much more than clicking through a PowerPoint presentation or report. In particular, where the meeting is taking place many weeks after quarter end, the contents of the report may now be completely irrelevant.

So, does this mean the end of the quarterly meeting cycle in favour of more ad-hoc short on-line meetings? **In fact, 80% of those surveys said it did, and felt the historic format had lost its relevance**. Furthermore, with just 25% seeing this as a priority for next year, the trustee framework **may have shifted permanently to continuous governance already**, especially when we consider that **7 out 10 schemes are making full use today of technological advances to provide them with more accurate and timely information about investment performance.**





**75%**

of respondents feel that they need better access to information

As we look forward from here, continuous governance doesn't just mean dissecting historic investment performance on a more frequent basis. From our survey, respondents acknowledged the importance of looking forward. To do so, there needs to be a great usage of interactive tools that are clear and straightforward to understand and support informed decision making.

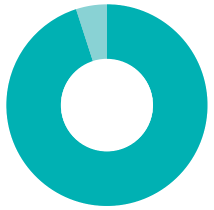
The survey found that **75% of respondents felt that they needed better access to information**, and over half believed that this would be relevant to their strategic and governance needs in the coming year.

So, in practice, we should expect to see shorter, more regular trustee meetings to achieve continuous governance. Despite the efficiencies of electronic document packs, these meetings may see a progressive reduction in lengthy documentation. Instead, the latest scheme information will be shown as an interactive dashboard. This will enable trustees to look backwards and forwards, facilitating better decision making and full transparency for all stakeholders.

"Looking forward, the move toward investing in more sustainable portfolios will be a key trend. For any scheme investing in growth assets over the next say 5-10 years and beyond, we consider the move to a lower carbon world, and the risks and opportunities that this will bring, to be a material factor to address in portfolio construction."

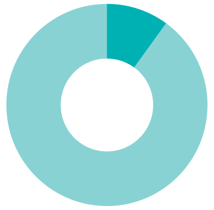
**Peter Daniels**
Head of Fiduciary Management Evaluation, Barnett Waddingham

# What's next on your ESG agenda?



**95%**

of respondents feel that understanding the ESG approach investment managers are taking during portfolio construction and stock selection will be key



**10%**

of schemes did not see ESG as a pressing concern

Environmental, Social and Governance ("ESG") has been the investment hot topic of 2020, and doubtless will remain so for some time to come. Despite the events surrounding the COVID-19 pandemic rightly taking up a lot of our thoughts, ESG integration is still very relevant to trustees with **98% of survey participants citing it is a pressing priority for the year ahead.**

However, as Trustees look forward from here, there is an inherent call to demonstrate action alongside addressing their other priorities today, such as Sponsor covenant strength and deficit funding.

With these competing priorities, the survey examined what steps Trustees can start to take today. With the advent of implementation statements and greater need for disclosure, **10% of respondents regarded setting ESG objectives as not very relevant, it could be that these schemes have already documented their ESG objectives. Interestingly, 95% of respondents felt that understanding the ESG approach that investment managers are taking during portfolio construction and stock selection will be key.**

To do this, we should expect to see a progressive improvement in transparent reporting with supporting narrative to explain or justify the decisions taken from an ESG perspective and the impact on performance. This will not only improve the level of trustee governance, but it will also arm trustees with better tools to engage and ensure alignment with their providers.



"Our experience is consistent with your results. We are observing a greater emphasis being placed on ESG risk management by fiduciary managers too. Just a few years ago it would be the exception for good quality ESG reporting to be provided to Trustees, whereas now it is much more the norm.."

**Jonathan Craddock, CFA**
FM Research Lead, EY LLP

Similarly, with the requirements under the Task Force on Climate-related Financial Disclosures ("TCFD") set to become a mainstay for pension scheme governance, it is important that Trustees start thinking about the impact of climate-risk on their investment portfolio. A starting point for many schemes is to consider carbon footprinting and greenhouse gas metrics based on the portfolio today.

That said, our survey also identified the importance of managing the funding and investment journey from here. What are the risks that may blow a scheme off course and impact on member security? In the next few years, we expect to see more and more tools become available to quantify this risk and drive a call to action.

Crucially this should not just be an investment risk question, but it should also take into account covenant risk. Covenant strength is front of mind for many Trustees today, however we will emerge from 2020 and attention and timeframes will start to expand. As they do, Trustee attention should turn to the durability of the covenant (whether directly or the underlying sector) and the extent that climate risk management has been incorporated into the Sponsor's long-term plan and therefore ability to support the pension scheme.

# Thanks to all research group participants

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**Tim Middleton** - Director of Policy and External Affairs, The Pensions Management Institute (Group Secretary)
**Lyn Ellis** - Professional Trustee, Trafalgar House Pension Trust
**Faye Mullen, CFA** - Head of Fiduciary Management Research, Isio
**Jonathan Craddock, CFA** - FM Research Lead, EY LLP
**Peter Daniels** - Head of Fiduciary Management Evaluation, Barnett Waddingham
**André Kerr** - Partner, Head of Fiduciary Management Oversight, XPS Pensions Group
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