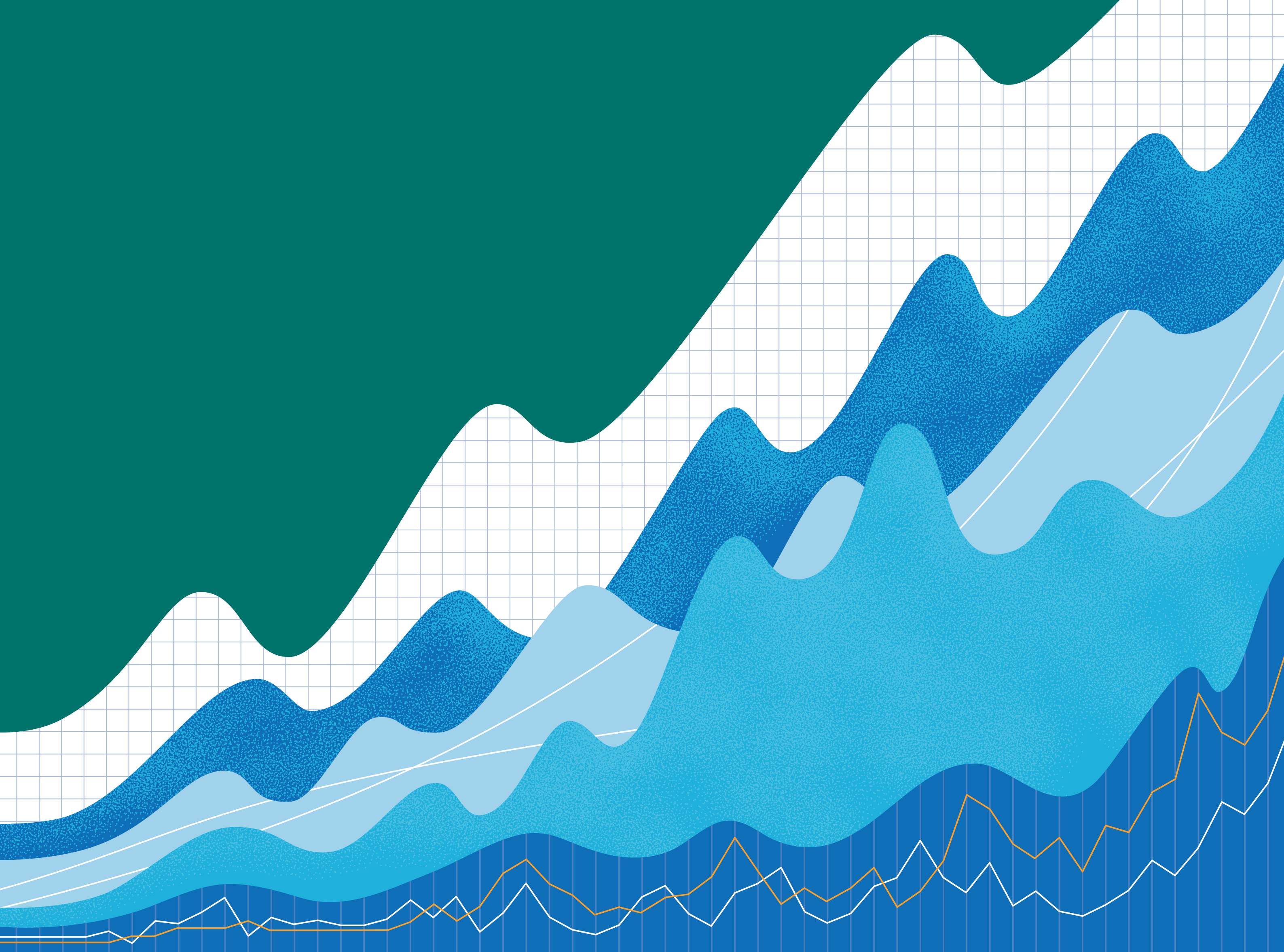
Pensions Management Institute
Knowledge

In association with

Schroders solutions

Navigating the key issues facing schemes in 2022



Welcome to the second issue of the Annual UK Fiduciary Management Survey from the Pensions Management Institute ("PMI") in conjunction with Schroders Solutions.

Introduction

Ronan O'Riordan
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Head of UK Client Solutions, Schroders Solutions

Gareth Tancred
Chief Executive Officer, Pensions Management Institute

As we issued our first survey last year, we created the Fiduciary Management Forum in partnership with the PMI. This group represented many of the third party evaluation firms involved in the Fiduciary Management market, along with senior independent trustees. The forum is mandated to continue the discussions on the key areas affecting pension schemes across all sizes.

Many of the issues we researched last year were topical again throughout the year, in particular ESG and long-term funding. In fact, legislation affected both these areas, pushing schemes to take action. It was also the year that the Fiduciary Management market reached its deadline for the CMA review process, which was a reason for much debate and discussion within our Forum.

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

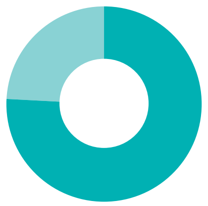
We hope you enjoy reading the findings.

Is there light at the end of the tunnel?

The regulator and many pension schemes certainly seem to think so. As we move into end game territory for many schemes, their needs will shift. This report is examining what is exactly shifting and what perhaps just needs to stay the same?

This year, we had over 100 responses from a wide range of respondents, which has led to some very interesting findings.

Foreward

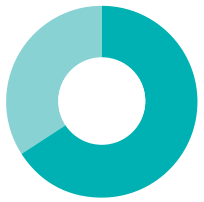


76%

of respondents thought it was necessary to revisit their journey planning now that the endgame is in sight.

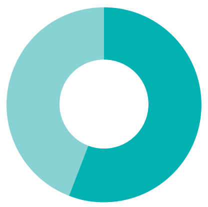
27%

of participants believe that trustees would benefit from better third party oversight



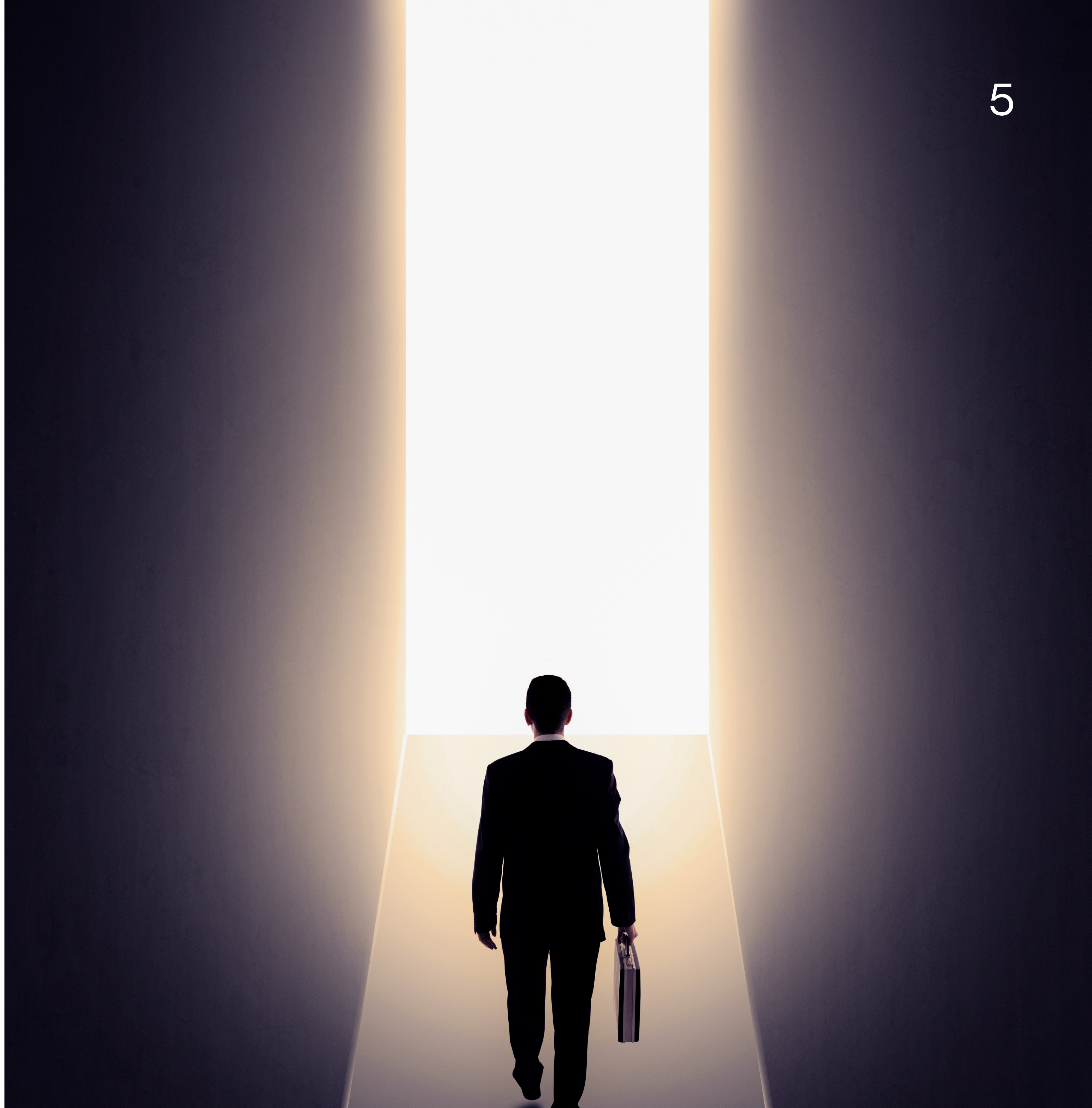
2/3rds

of participants favoured having ESG milestones highlighting the importance of this topic for trustee boards.



56%

of participants favour using illiquid assets as they hone in on their endgame



"Fiduciary management enhances a scheme's governance by improving risk management. The need for strong governance is essential, especially as schemes approach their end-game. Our research finds that FMs help to evolve end-game solutions, and do so at pace, which increases pension schemes' likelihoods of meeting their objectives. A key element to this is introducing lower cost options and reviewing risk more holistically, through multiple different lenses."

Jonathan Craddock, CFA
FM Research Lead, Ernest & Young LLP

"Good fiduciary managers are demonstrating their worth in the current environment, guiding schemes towards an approaching endgame while balancing the risks and opportunities of increasingly volatile asset markets. Pragmatic portfolio construction, well-timed moves into 'forever assets' and collaborative governance will be key to their success."

Graham Jung
Trustee Director, Ross Trustees

Long-term funding - is your destination now in sight?

Since the lows of March 2020, pension scheme funding has re-bounded meaningfully, buoyed by strong growth markets and falls in liability values. As an example, the PPF7800 Index saw funding levels improve by 13% through this period to the end of 2021.

Long-term funding targets continue to be a focal area for the Pension's Regulator. Whilst the new DB Funding Code may not be with us just yet, many trustees are keeping the Code's underlying principles in mind when setting their actuarial valuation assumptions.

Given recent strong funding progress, this led us to question participants on their approach to journey planning. Namely, is it time to re-think their existing plan? Three quarters of participants agreed. Many schemes are now much closer to their endgame than they may have previously thought.

Trustees need to re-think their journey plan in light of recent strong funding progress

Neither support nor oppose - 35%
Strongly support - 10%
Support - 37%
Strongly agree - 9%
Oppose - 9%

"As funding positions have improved focus has shifted to attainable long term targets and Trustees and sponsors are thinking more specifically about what the long term risk objective is. The result is not always to pay a premium to go to buy-out, particularly as other options are presenting themselves."

Melanie Cusack
Client Director, PTL

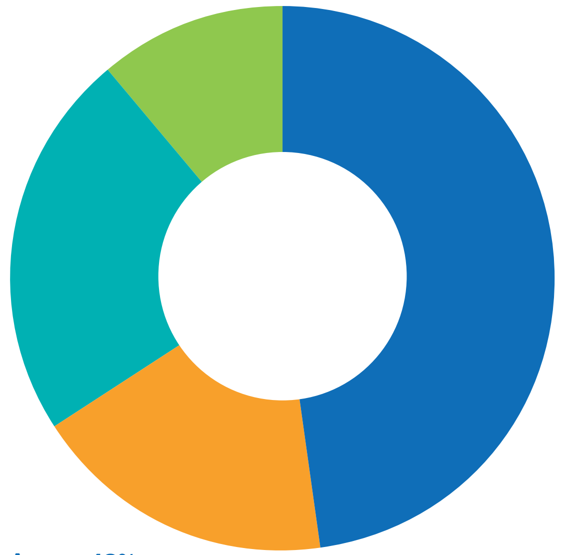
Self-sufficiency is no longer the only 'endgame' in town

The recent regulatory authorisation of pensions superfund, Clara-Pensions, throws a spotlight on the increasing plethora of endgame options available, with more coming to market in the coming years. Whilst historically the notion of "self-sufficiency" or a low dependence on the sponsoring employer was the primary game in town, this may no longer be the case. Many risk transfer specialists are predicting record-breaking activity levels in 2022, driven by factors such as pent-up demand, better affordability, and significant improvements to funding levels last year.

Despite buyout becoming more affordable and expectations of a record year for transactions, two -thirds of participants said they will need to consider options other than buyout as their long-term funding goal. Improvements in transparency could reveal that buyout is a more feasible target than participants thought.

Buyout/solvency assumptions become quickly outdated as a scheme matures and as market conditions and insurers' appetite shifts. Schemes need better access to live buyout pricing, which reflects their maturity to ensure they are equipped with more accurate information and are less likely to miss an opportunity to transact.

Schemes will need to consider other options, e.g. self-sufficiency rather than buy-out as their long-term funding goal



Agree - 48%
Stongly Agree - 18%
Neither Agree nor Disagree - 23%
Disagree - 11%

Increasing focus on liquidity

The wrong investment strategy could mean you're running too much risk, and we expect pension scheme liquidity to be an increasing area of focus as schemes get themselves better prepared for the future. Illiquid assets have been a growing part of pension scheme investment strategies as trustees seek assets which provide a smoother funding journey and help meet increasing cashflow demands. The majority of participants favour using illiquid assets as they hone in on their endgame. For schemes targeting low dependency, illiquid assets can form a long-term key strategic component.

But for schemes targeting any kind of risk transfer, trustees will need a plan to ensure they have sufficient liquidity coming up to the point of transaction. Added to this, from a practical perspective, there are operational issues to consider. Schemes will need to get their liabilities in shape–cleaning up member records, establishing benefit specifications etc. will put schemes in a better place as they close in on their destination.

There is much to do.

Schemes have a greater tolerance of illiquid assets, despite their focus on getting to their end-game

Strongly support - 10%
Support - 37%
Strongly agree - 9%
Neither support nor oppose - 35%
Oppose - 9%

"It's not surprising most people agree models should be re-assessed. Just because something worked yesterday, doesn't mean it works today. Or tomorrow. Innovation in the market is at an all-time high and other models are emerging."

Keira-Marie Ramnath
Head of Fiduciary Management Oversight and Selection, PwC

Time to reassess the engagement model

Participants felt that as they get closer to their endgame, they should reassess their engagement model, i.e. Advisory or Fiduciary Management. This is a call-to-action to Investment Consultants and Fiduciary Managers alike to ensure their endgame strategies, solutions, and service meet the needs of pension schemes for the final leg of their journey.

These include flexible cost-effective investment strategies, risk management solutions, access to real-time information, and a clear path to your final destination.

How does your provider measure up?

Trustees should re-assess their engagement model (Advisory or Fiduciary Management) as they get closer to the end-game

Strongly support - 20%
Support - 39%
Strongly agree - 11%
Neither support nor oppose - 23%
Oppose - 6%
Strongly oppose - 1%

"Climate risk is an absolutely crucial area for trustees to consider and, as with many aspects of investment, the only way to do that is to have the right data. As the economy shifts to reduce dependence on carbon, understanding the impact of a pension schemes investments and how that is changing is essential for success, but remains a real challenge."

Alan Baker
Director, Law Debenture

Climate Risk –
Schemes can't COP out anymore

In the last few years, ESG and Climate Risk have risen to prominence on the trustee agenda. This is supported by a raft of regulatory disclosure requirements for trustees, both qualitative and quantitative. Whilst onerous, disclosure can be effective in setting a baseline to measure where schemes are today and engaging wider stakeholders. Indeed, sponsoring employers are facing similar requirements as part of a collective global drive to improve transparency.

Divestment versus engagement

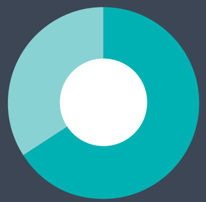
We wanted to understand how trustees were adapting to these requirements and responsibilities.

This led us to question participants on divestment—this is a hot topic today, as many large asset owners have considered excluding certain industry sectors or companies. But how are trustees reacting? Are they divesting from managers with low ESG or Climate Scores? The majority of participants were in favour of divestment. Until recent history, divestment has been the only practical approach available for most trustees.

However, is divestment simply greenwashing the portfolio today based on backward-looking information? Where does engagement sit? As an engaged investor, there is actual power and influence to enact positive change. Trustees need to consider the balance between engaging with managers to drive improvement versus a swift exit in favour of more positively aligned strategies. This will be a debate that will accelerate as improved transparency and better forward-looking analysis give trustees a more informed view.

Schemes should divest from managers with low ESG and Climate scores

Strongly agree - 11%
Agree - 38%
Neither agree nor disagree - 25%
Oppose- 23%
Strong disagree - 3%



2/3rds

of participants were in favour of climate milestones

"'Collaboration between asset owners and fiduciary managers is crucial to the integration of ESG values and beliefs into investment portfolios. Setting milestones is one method for trustees to express clear expectations on their managers, ensuring a mutual understanding of the Scheme's ESG and climate goals."

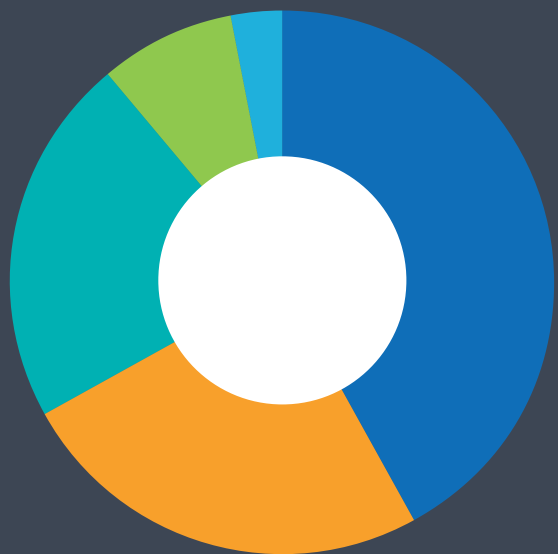
Anne-Marie Gillon
Director, IC-Select

An evolving approach to ESG

Whilst it is important for trustees to understand where they are today, we also wanted to understand how schemes are looking forward. Should trustees be setting "climate milestones"? How might investment strategy need to evolve? Two-thirds of participants were in favour of climate milestones, which highlights not only the fiduciary importance of this topic but a desire to act now.

There is a collective recognition that trustees can't make a wholesale change overnight. Mapping the funding journey has been the mainstay for trustees for the last decade. The spotlight now needs to examine the climate journey more closely. Whilst this is a mandated priority for only the largest schemes in 2022, all trustees should educate themselves on the issues at hand, and on how they might address them in the future.

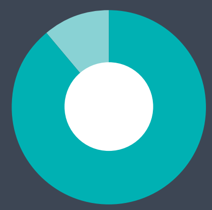
Trustees should be setting "climate milestones" to frame how their investment strategy is expected to evolve with the implementation of strategies that achieve ESG goals



Stongly Agree - 25%
Agree - 42%
Neither Agree nor Disagree - 22%
Oppose - 8%
Strong Disagree - 3%

Continuous governance is here to stay

Last year's survey highlighted the demise of the quarterly meeting cycle. The pandemic threw trustees into a virtual environment, bringing on a move to more frequent and concise engagement. Trustees wanted better access to real time data and tools to help review their investment progress and evolve their investment strategy to meet its long-term objectives.



89%

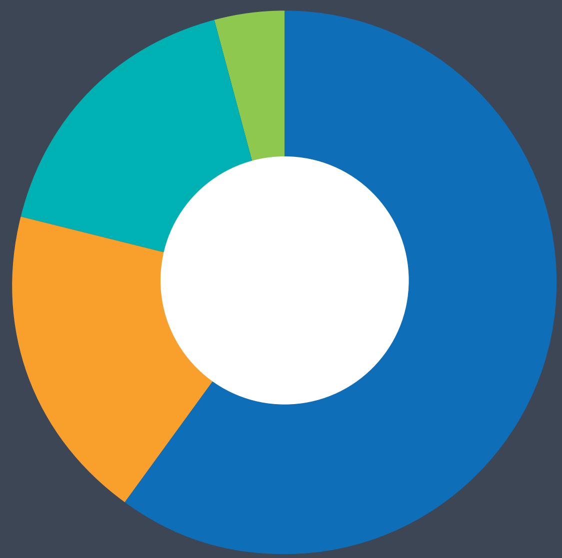
of participants favoured greater use of risk dashboards to help quantify investment and non-investment risks

Information – please, Sir, can we have some more?

In the last year, as working environments have opened back up, we wanted to understand the implications for participants. Has their appetite for receiving relevant and timely information been satiated? The resounding feedback from participants was a quest for more - 78% wanted more transparency with greater use of interactive tools to govern their investment arrangements.

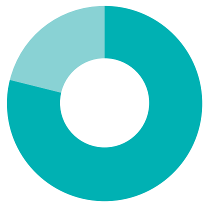
Real-time funding information is now market standard, enabling trustees to understand the journey so far with more detailed attribution. But backward-looking data isn't sufficient. Being able to look forward is of vital importance to understand progress against key objectives and identify calls to action.

Schemes have better transparency through the use of interactive tools to govern their investment arrangements today



Strongly agree - 19%
Agree - 60%
Neither agree nor disagree - 17%
Oppose - 4%

Supporting this aspect, 89% of participants favoured greater use of risk dashboards to better quantify the investment and non-investment risks they face. This needs to go beyond the three pillars of integrated risk management (funding, covenant and investment) but also inform decision making on other aspects that may affect the desired outcome, such as ESG and climate risk.

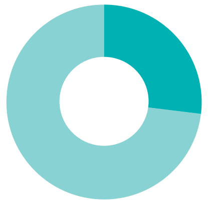


79%

have better transparency through the use of interactive tools to govern their investment arrangements today.

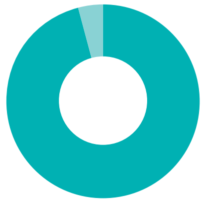
Schemes should make more use of risk dashboards to better quantify the investment and non-investment risks they face

Strongly support - 26%
Support - 47%
Strongly agree - 16%
Neither support nor oppose - 9%
Oppose - 1%
Strongly oppose - 1%



27%

of participants believe that trustees would benefit from better third party oversight



96%

support the defining of key performance indicators to measure the success of their investment strategies

"The role of oversight of a fiduciary manger should be forward looking, and help trustees understand if their chosen FM will help them achieve their long-term goals and needs. However, in doing this it is helpful to understand the drivers behind their past performance."

André Kerr
Partner, XPS Pensions Group

Who watches the watchmen?

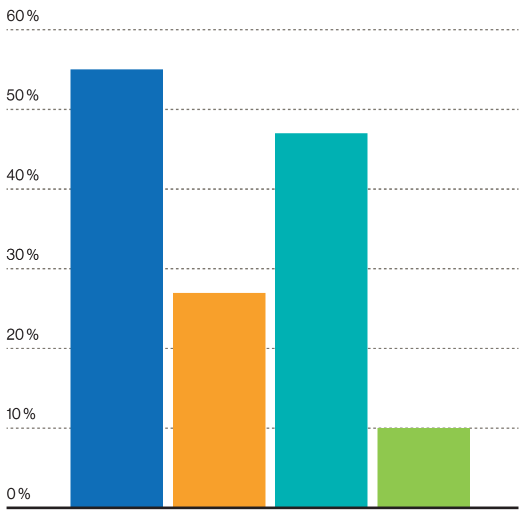
Since the CMA Investment Consultancy and Fiduciary Management Market Investigation Order in 2019, there has been a significant improvement in pension scheme governance of investment consultancy services and fiduciary management.

Using Third-Party Evaluators ("TPEs") was an area of the market that experienced material change because of the CMA Order. The proportion of schemes who used a TPE in Fiduciary Management selections and retenders increased, indicating trustees saw value in appointing specialist independent advice. Schemes using a TPE to monitor their Fiduciary Management mandate also increased, particularly for schemes with assets under £100m'.

When asked whether trustees would benefit from better third party oversight of their current arrangements, 27% of participants were in favour. For the remaining 73% of participants, this begs the question of whether they feel existing trustee governance standards are sufficient, or whether the potential benefits of oversight aren't well understood. For example, participants were firmly on the fence when asked whether oversight should focus more on forward looking metrics such as journey planning and climate risk.

'Source: isio Fiduciary Management Survey 2021

Do you agree with the following statements?



Schemes should separate costs for advice and implementation to better understand value for money - 55%

Trustees would benefit from better third party oversight of their current arrangements - 27%

Oversight needs to focus more on forward looking metrics such as journey planning and climate risk - 47%

None of the above - 10%

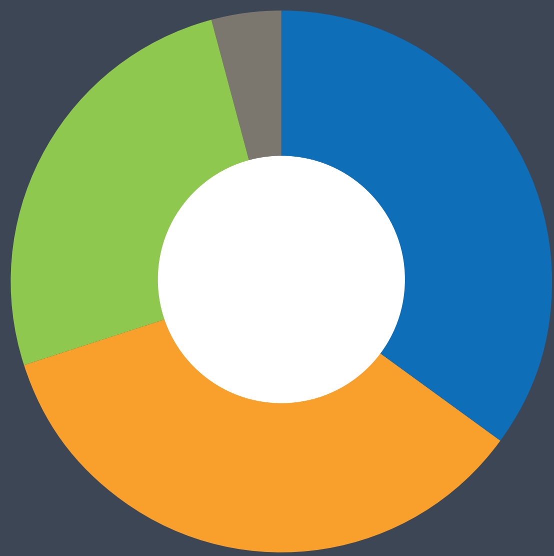
Our data suggests a desire for better governance standards, with 96% of participants supportive of defining key performance indicators to measure the quality of their investment strategy in meeting its objectives and 67% of participants supporting industry-wide benchmarking. Participants also felt there was scope to separate the costs for advice and implementation to better understand whether schemes were getting value for money.

Trustees should consider whether they have sufficient access to information and resources to govern their fiduciary manager effectively.

"'Performance against strategic objectives is of fundamental importance, but best practice oversight also includes understanding how your fiduciary manager is performing against their competitors and where they are adding value. Comparable fiduciary manager performance data is more accessible than ever and can be a powerful tool, as long as it is used in the right way."

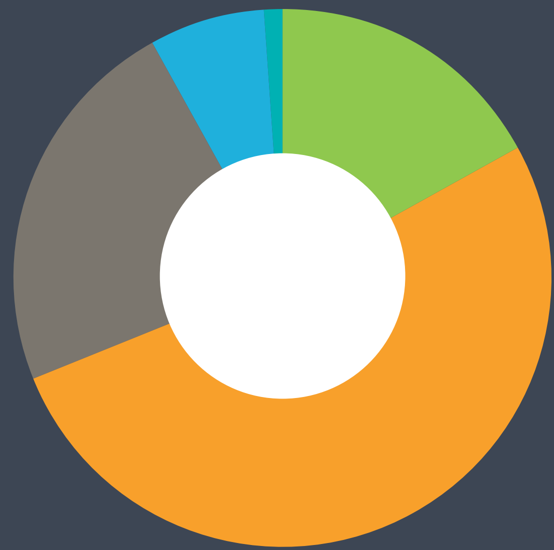
Peter Daniels
Head of Fiduciary Management Evaluation, Barnett Waddingham

Trustees should define key performance indicators to measure the quality of their investment strategy in meeting its objectives



Strongly agree - 26%
Strongly support - 35%
Support - 35%
Neither agree nor disagree - 4%

Schemes should actively participate in industry-wide benchmarking to understand where they stand



Strongly agree - 17%
Agree - 52%
Neither agree nor disagree - 23%
Oppose - 7%
Strong disagree - 1%

Thanks to all research group participants

PMI & Schroders Solutions UK Fiduciary Management Strategic Research Forum includes:

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Ajeet Manjrekar - Head of UK Client Solutions, Schroders Solutions
Gareth Tancred -Chief Executive Officer, The Pensions Management Institute
Lyn Ellis - Professional Trustee, Trafalgar House Pension Trust
Anthony Webb, FIA - Head of Fiduciary Clients, Isio
Jonathan Craddock, CFA - FM Research Lead, Ernest & Young LLP
Peter Daniels - Head of Fiduciary Management Evaluation, Barnett Waddingham
André Kerr - Partner, Head of Fiduciary Management Oversight, XPS Pensions Group
Sue Hall - Professional Trustee, Capital Cranfield
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Chris Roberts - Director, Dalriada Trustees
Melanie Cusack - Client Director, PTL Governance Ltd
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