PENSIONS WATCH – ISSUE 10: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments and Senior Visiting Fellow, Finance Faculty, the Business School (formerly Cass), City University, London

With trustee investment governance, in many cases, being tested to the limit, not least in the early stages of the pandemic, in this edition we focus on generating better pension outcomes through improved investment governance and innovative investment thinking.

The investment governance premium

In the mid-noughties, two seminal governance papers estimated that by adopting an advanced level of investment governance and applying this to innovative investment thinking, institutional investors, such as pension funds, could add 1% to 2% per annum to long-run risk-adjusted returns.[1]

Of course, the level of investment governance employed by a decision making body, such as a Trustee Board, Investment Committee or Defined Contribution (DC) Committee, is, by definition, commensurate with its collective capabilities (including its specialist investment knowledge), the efficacy of its time management and how well it organises itself. So, if a Trustee Board or Committee, with strong and diverse collective capabilities,[2] can organise itself to operate in a nimble fashion; focus on impactful strategic imperatives and not the minutiae or that which is beyond its control; and intelligently share and capture the collective knowledge, experience and expertise of all in the room, while encouraging challenge and debate, then more optimal investment and risk management decisions should result. Of course, as no decision – no matter how optimal – is impactful without timely implementation and efficient execution, following a decision through swiftly to its logical conclusion is just as important.

As well as focusing investment governance on traditional asset classes and more mainstream investment strategies, the investment governance premium is increasingly concentrated on and realised through harvesting the illiquidity and complexity premia of heterogeneous illiquid real, private markets and alternative asset classes.[3] However, while much of the leading edge thinking around investment and risk management deriving from best practice investment governance has been successfully applied and developed by many of the UK's larger and better resourced Defined Benefit (DB) and the very largest DC pension schemes,[4] many of the UK's 5,318 DB schemes[5] and the overwhelming majority of the UK's 28,360 DC schemes[6] continue to lag their exemplar brethren by some margin.[7]

[1] Keith Ambachtsheer, Ronald Capelle, and Hubert Lum. Pension fund governance today: strengths, weaknesses and opportunities for improvement. Working paper submitted to the Financial Analysts Journal. October 2006. Gordon L. Clark and Roger Urwin. Best-Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance. September 2007.
[2] Best practice investment governance for all pension schemes starts with considerations of size and diversity. After all, smaller decision making bodies with defined accountabilities perform better than large, while cognitive diversity, deriving from differences in gender, age, ethnicity, socio economic, educational and cultural background and neurology, further optimises decision making.
[3] With their diverse return drivers, long-term cash flows that are often implicitly or explicitly linked to inflation and returns that are often less sensitive than equity or credit returns to the macroeconomic environment, illiquid assets, such as real estate and social and economic infrastructure equity and debt, typically offer a markedly different risk-return profile and pattern of returns to that of public equity and credit markets. See: It's time for investment to do more of the heavy lifting. Chris Wagstaff. Columbia Threadneedle Investments. June 2019. pp.15-17. https://www.columbiathreadneedle.co.uk/uploads/2020/10/ed4862f1e10c34221269b5282dd34337/en_generating_better_dc_outcomes.pdf
[4] The Pensions Regulator (TPR) estimates there are 50 trust-based DC schemes with assets of £250m or more, of which 30 are master trusts, and 140 schemes with 5,000 or more members. These estimates exclude the UK's 1,560 contract-based occupational DC schemes. See: Investment DC Trust Scheme Return Data 2020-2021. The Pensions Regulator. 31 March 2021. Some sponsoring employers of contract-based DC schemes, which are overseen by Independent Governance Committees (IGCs), add another layer of governance by setting up their own DC governance committees, advised by an investment consultant, to yet further enhance the member experience and secure good retirement outcomes. This they do by working with the pension provider, and ultimately the IGC, on matters such as the provision of bespoke DC default strategies and self select funds, member communications and negotiating charges. Additionally, better governed DC schemes are accredited with The Pension Quality Mark (PQM), developed by the PLSA in 2009. This accreditation is designed to increase confidence in pensions by helping employers to independently demonstrate the quality of their DC scheme.
[5] PPF 7800 Index. The Pension Protection Fund. 30 April 2021.
[6] See: The Pensions Regulator (31 March 2021). op.cit.
[7] This shouldn't come as a surprise given that 94% of private sector DB schemes have assets of less than £1bn, while 72% have assets of less than £100m. See: The Purple Book 2020. The Pension Protection Fund. December 2020. Figure 3.12. p.15. Within occupational DC schemes, where 97% of memberships are in schemes being used for auto enrolment, 26,720 DC schemes comprise less than 12 members, while the average assets per member amount to £4,339. See: DC Trust (March 2021) op.cit.

Moreover, with ever greater complexity surrounding investment solutions and regulation, notably around the integration to investment decision making of ESG risk factors and climate change risk management; ongoing challenges to accepted economic and investment paradigms and norms, and often abrupt spikes in market volatility – all compounded by a reluctance by DC savers to materially increase contribution rates[8] and DB sponsors to up their Deficit Reduction Contributions (DRCs) – it's evident that investment governance increasingly needs to do more of the heavy lifting, if good retirement outcomes are to be achieved.

Outsourcing investment governance

Given the extraordinary demands on Trustee investment governance, exemplified in the early stages of the pandemic, it's perhaps unsurprising that UK DC continues to witness consolidation,[9] largely driven by occupational DC schemes transferring to master trusts,[10] while many DB Trustees are starting to more fully appreciate the attractions of Fiduciary Management (FM)[11] as a solution to the, seemingly inexorable, DB investment governance challenge.[12,13] Although FM has principally been the investment governance model of choice for smaller DB schemes,[14,15] anecdotal evidence suggests that even £1bn+ DB schemes are increasingly engaging with this model, with the very largest DB schemes, many with in-house investment teams, beginning to gravitate to the Outsourced Chief Investment Officer (OCIO) model,[16] to address increased regulatory and investment complexity and rising operational costs. The £21.5bn British Airways pension scheme being the most recent example of this embryonic trend.[17]

Not all outsourced investment governance solutions (or providers) are created equal

However, as outsourced investment governance solutions and providers come in all shapes and sizes, schemes looking to outsource their investment governance are increasingly using independent third party search and selection services[18] to, not only determine which governance solution will work best for their scheme, but also which of the many providers will best assist them to meet the scheme's desired journey and end game.

Ultimately though, the validity of outsourced investment governance solutions rests on realised outcomes, principally, risk-adjusted returns. Of course, for FM this must reflect the fact that each DB scheme has a unique journey plan, comprising target investment return, risk tolerance and term to full funding. With this in mind, so as not to compare apples with pears, investment consultant XPS, collected the net of fees returns on the 22 best ideas growth portfolios of 18 FMs. In 2020, as in many other years, XPS found that the difference in net returns between the best and worst FM performers was around 10% (15% if including the outliers).[19] Although all FMs recouped their Q120 losses relatively quickly[20] and generated positive returns for 2020 as a whole, almost all underperformed global equities and a 60/40 equity/bond portfolio, in what proved to be a strong year for equities and fixed income.[21] Crucially, the vast majority of FMs (86%) outperformed the median Diversified Growth Fund (DGF), arguably the most appropriate of the three benchmarks, not least given the multi asset nature of FM portfolios, in both risk-adjusted and non-risk adjusted terms.[22]

Separately, in analysing those 12 FMs who account for around 90% of UK FM assets under management, FM search and selection specialist, Isio, in adopting a similar methodology to XPS, found that during 2020 the difference in cumulative return between the best and worst performer peaked at c.8% at 31 March, narrowing to under 5% by the end of the year.[23]

[8] See: Pensions Watch – editions 6 and 8. https://www.columbiathreadneedle.co.uk/en/inst/insights/
[9] Recognising that scale, and with that, improved investment governance, are key drivers of better retirement outcomes, the DWP has launched a consultation to gather evidence on the barriers and opportunities for greater consolidation of occupational trust-based DC schemes with between £100m and £5bn of assets under management. See: Future of the defined contribution market: the case for greater consolidation. DWP. 21 June 2021.
[10] Master trusts, as multi-employer occupational DC pension schemes, are more of an holistic governance, rather than an investment governance, solution, although the advanced level of investment governance offered by many master trusts remains a key attraction to transferring DC schemes. The UK's 38 authorised DC Master Trusts now manage £52.8bn of assets on behalf of 18.8m members. See: DC Trust (March 2021) op. cit.
[11] Full FM continues to gain traction at a faster rate than partial FM. Full FM means the manager is typically engaged under a fiduciary management agreement (FMA) to manage 100% of scheme assets, whereas under partial delegation, only a portion of the scheme assets or a portion of the Trustees' full fiduciary responsibilities are delegated to the FM. See: UK Fiduciary Management Survey 2020. Isio. November 2020. p.3.
[12] See: Isio (November 2020). op cit.
[13] It should be noted that while transferring the assets *and* members of a DC scheme to a master trust is an *abdication* of Trustee responsibility, transferring a DB scheme's assets (and not its members) to a Fiduciary Manager (FM) or Outsourced CIO (OCIO) is a *delegation* of Trustee duties, with the Trustee ultimately retaining fiduciary responsibility for any decisions made and actions taken by the FM or OCIO. Given this, Trustees are increasingly employing a formal oversight function to oversee and constructively challenge the activities of the FM or OCIO. See: Isio (November 2020). op cit. p.5.
[14] In 2019, 63% of DB schemes delegating to a FM had < £100m of assets, while 22% had between £100m and £250m of assets. See: UK Fiduciary Management Survey 2019. KPMG. October 2019.
[15] Small (largely under £50m) legacy DB schemes are also adopting the sole trustee and/or OCIO/master manager model.
[16] OCIO, sometimes called the master manager model or outsourced investment management, refers to the full or partial outsourcing of a pension scheme's investment function to a third party asset manager or investment consultant. By adopting the partial model, the scheme retains some level of fiduciary responsibility, for example separating control of investment strategy, asset allocation and asset/liability modelling from day-to-day investment and risk management operations and implementation. This separation of responsibilities might result in the OCIO focusing on: manager monitoring and selection; day-to-day liquidity management; implementation of the scheme's RI/ESG/climate change strategy; reporting on manager research findings, asset class positioning, risk metrics and scenario analysis, and ESG and TCFD regulatory reporting.
[17] See: British Airways transfers pension assets worth £21.5bn to BlackRock. Josephine Cumbo. Financial Times. 2 June 2021.
[18] Search and selection services are principally provided by those investment consultants and governance specialists who do not have a master trust, fiduciary management or OCIO offering, as appropriate. 71% of FM searches in 2020 were conducted by an independent third party. See: Isio (November 2020). op.cit.p.5. This percentage is likely to increase in 2021 as schemes who have already appointed a FM without a competitive tender process for more than 20% of scheme assets, are required by the 2019 CMA Order to run a competitive tender process by the later of 5 years from the original appointment or 9 June 2021.
[19] Data to 31 December 2020. Fiduciary Manager Review 2021. XPS. May 2021. p.8. Compared to previous years, the 2020 FM results were characterised by heightened levels of volatility and little correlation between the volatility associated with the resultant returns.
[20] Around one third of FMs eliminated their losses within three months, with almost all doing so within six months. See: XPS (May 2021).op.cit.p.7.
[21] This underperformance was much reduced in risk-adjusted terms.
[22] Very few schemes benchmark themselves against global equities, given that the associated level of volatility of equities can be almost twice that assumed by the median FM portfolio. Although each DB scheme does, of course, have a unique target investment return and risk tolerance, and each FM has its own investment approach, a 60/40 portfolio or the median DGF, is a more appropriate benchmark, the latter especially, given the multi asset nature of FM portfolios and an associated level of volatility which typifies that assumed by the median FM.
[23] A beginners guide to assessing fiduciary management performance. Isio. 27 May 2021.

FM performances in 2020 were, of course, principally determined by the level of equity and credit allocations going into the early stages of the pandemic and the extent to which these were dynamically altered coming out of a highly volatile first quarter. With little, if any, consensus by FMs around strategic asset allocation (SAA) and with significant variations in the level of dynamism attaching their asset allocations (DAA), such a dispersion of returns was perhaps inevitable.[24] Take each FM's average global equity holding and the changes made to this allocation throughout the year. During 2020, one FM's best ideas growth portfolio had over 60% on average invested in equities while another had less than 5%, with every other manager being somewhere in between. Likewise, whereas one manager's best ideas growth portfolio equity allocation was static over the year, another's shifted by almost 25%. However, as one would expect from the risk-controlled nature of fiduciary management, most managers altered their equity allocations by less than 10% over the year and exhibited similar restraint in their asset allocation shifts to corporate bonds. This heterogeneity also played out in the average allocations to LDI assets and cash, which varied from around 3% to 84%, and to illiquid and alternative asset classes, from 2% to around 40%.[25]

Not that this dispersion in approaches to SAA and DAA is anything new. Indeed, over three years – a period characterised by much lower levels of volatility than those experienced in 2020, but with equity weightings again being a significant driver of returns – there was, according to XPS, a c.7% dispersion in annualised FM performance, with almost all managers (86%), once again, outperforming the DGF median return.[26] Separately, Isio, in analysing three years of performance data for its 12 FMs, found that almost all (83%) had significantly outperformed a low investment governance portfolio, and at a lower annualised risk than the benchmark.[27]

So, broadly speaking, fiduciary management, as a mechanism for advancing investment governance for DB schemes, gets a firm tick, noting of course that the critical characteristic any scheme should seek in a FM is one of trusted partner with a willingness to understand the scheme's needs and focus on the journey ahead by setting clear triggers for action.

The heterogeneity of the master trust universe is also evident from the c.6% dispersion of annualised three year master trust growth phase default fund performances to 30 June 2020 (a point at which markets had yet to fully recover from the rigours of Q120). According to investment consultant Hymans Robertson, this dispersion, which was largely driven by relative equity weightings, was accompanied by significant variations in the levels of volatility (10% to 15% p.a.) attaching to each of these performances.[28] Additionally, given this data and the capital market assumptions applied to each of the providers' asset allocations, Hymans Robertson projected the likely (median) fund values to be generated by each provider in 30 years time, along with a projected good (25th percentile), bad (75th percentile) and very bad (95th percentile) outcome. Whereas the dispersion between the good outcomes and the probable was particularly high – the best good outcome was projected to be almost 70% higher than the worst, while the dispersion for the median outcomes was almost 40% – that for the bad and very bad outcomes was, reassuringly, low.[29]

Of course, these results ultimately come down to the SAA and DAA adopted by each of the master trust providers. Moreover, given the positive cash flow and long-term growth focus associated with DC, the case for harvesting the illiquidity and complexity premia of certain illiquid real, private markets and alternative asset classes, is particularly compelling.[30] However, while some providers have fully embraced the long-run attractions of these heterogeneous assets, others appear to be content to limit the number of diverse return drivers in their growth portfolios and simply ride on the coattails of a buoyant equity market. That, for many, remains concerning.[31] For that reason, as an advanced investment governance solution, outsourcing to master trusts receives a tentative tick.

[24] This lack of consensus around SAA is in direct contrast to the blatant herding by the UK's four top institutional fund managers of the 1980s and 1990s around a median asset allocation. These, so-called, balanced managers, who were each entrusted by the vast majority of UK DB schemes to manage a scheme's entire asset portfolio, converged to a consensus asset allocation for fear of underperforming their peers with disastrous results.
[25] XPS (May 2021). op.cit.p.9.
[26] XPS (May 2021). op.cit.p.8.
[27] Of the 12 FMs, one manager had a negative annualised return over the period, while another achieved a lower annualised return than the low governance benchmark. See: Isio (May 2021). op.cit.
[28] Data to 30 June 2020. Master Trust Default Fund Performance Review. Hymans Robertson. November 2020. p.6.
[29] Hymans Robertson (November 2020). op.cit.p.9. However, in the consolidation phase, with values being predicted five years prior to retirement, and the pre-retirement phase, one year from retirement, the dispersion around outcomes within and between providers was even more elevated.
[30] See: Wagstaff (June 2019). op.cit.
[31] See: Master trust default fund performance improves despite pandemic volatility. Duncan Ferris. Pensions Age. 8 June 2021.

Why does this matter?

Against the backdrop of almost static DB sponsor DRCs and DC contribution rates, it is readily apparent that investment governance needs to do more of the heavy lifting if good retirement outcomes are to become the norm. The problem is that few schemes have the requisite governance bandwidth to replicate the advanced investment governance and innovative investment thinking of the UK's leading-edge DB schemes. Indeed, recognising that scale, and with that an advanced level of investment governance, leads to better retirement outcomes, has seen the DWP recently launch a consultation into accelerating consolidation within the fragmented occupational DC market.[32]

However, although, on average, the outsourced investment governance solutions available to DB and DC schemes, which operate in an increasingly price competitive marketplace, have the potential to advance investment governance sufficiently to help secure good retirement outcomes, adopting an outsourced solution shouldn't be seen as an investment governance panacea. Indeed, given the dispersion between providers in terms of investment approach, notably towards strategic and dynamic asset allocation, which ultimately translates into significant variations in risk-adjusted returns, choosing between providers is absolutely crucial if the foundations are to be laid for a retirement to be truly enjoyed.

In short, if the desired journey and end game are to be realised, then there's no substitute for putting in the hard yards to identify which of the many providers best fits the bill. Suffice to say, the chances of doing this successfully are considerably enhanced by enlisting the help of an independent third party search and selection specialist.

[32] DWP (June 2021). op.cit.

To find out more visit columbiathreadneedle.com

Issued 06.21 | Valid to 12.21 | J31624 | 3637926