XPS Investment

End-game Planning

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How do fiduciary managers de-risk as schemes approach their long-term funding targets?

Fiduciary managers (FMs) have a reputation for providing solutions for clients during the growth stage of a scheme's funding journey, where assets are typically required to deliver high levels of return to reduce a funding deficit.

Often portfolios are constructed with a degree of complexity and may utilise illiquidity to target high levels of return, often at a higher cost. However, as the Pensions Regulator places more emphasis on the importance of long-term funding targets, we look ahead to consider what tools FMs utilise to de-risk strategies towards an end goal and what trustees should also consider.

In this report we explore:

- **The long-term targets currently being adopted by FM clients;**
- **Three key approaches to de-risking;**
- **A summary of the advantages and disadvantages; and**
- **FM approaches to preparing for buyout.**

Key Findings

1. Many FMs are largely untested when it comes to de-risking strategies and helping clients achieve their long-term objectives. Trustees should hold FMs accountable to the agreed long-term target. Independent FM oversight can assist with this.
2. The approach taken by FMs to de-risking varies greatly and is impacted by size of scheme, flexibilities in the FMs' approaches and opportunity set.
3. When appointing or reviewing an FM, trustees should consider their approach to de-risking and consider how they plan to achieve their scheme's long-term funding objective. This is important to consider when appointing an FM – even if not an immediate concern – due to high barriers and costs of exit.

> Given the importance for trustees to set long-term targets, it is imperative that FMs understand these objectives as soon as possible and are measured and monitored against them.

André Kerr
Head of Fiduciary Management Oversight, XPS Investment

Long-term targets

Having a clear long-term target is an important starting point for an FM in establishing a suitable de-risking journey plan for a scheme. We asked the FMs in the UK market to comment on their exposure to schemes targeting buyout and schemes targeting low dependency as long-term targets. Over 90% of the market responded based on market share.

Chart 1, below, shows that about half of the FMs who responded had a similar proportion of clients aiming for buyout as those aiming for low dependency, whilst the other half was split between those mainly targeting buyout and those mainly targeting low dependency.

The results show a considerable variation in the different end game targets. The FMs have clear influence over what objective schemes are targeting and we would typically expect a more even mix across each FM. This is likely to evolve as more clients set their long-term funding targets.

Chart 1: Long-term targets

Source: XPS Pensions Group, Fiduciary Managers

With such a split in scheme objectives, it should be no surprise that FMs' approaches to de-risking vary greatly and it is important for trustees to consider how these approaches sit alongside individual investment beliefs and preferences.

As more and more pension schemes approach the end of their journey plans and consider de-risking their investment strategies, it is important that trustees understand the different approaches taken by FMs and which ones could be suitable for their scheme.

Having a clear long-term target is an important starting point for an FM in establishing a suitable de-risking journey plan for a scheme. When appointing or reviewing an FM it is important to understand the tools they will use to help meet the ultimate aim of the scheme and ensure it is aligned with trustee beliefs and preferences.

Sophie Tennison
Head of Investment, Bristol

Three key approaches to de-risking

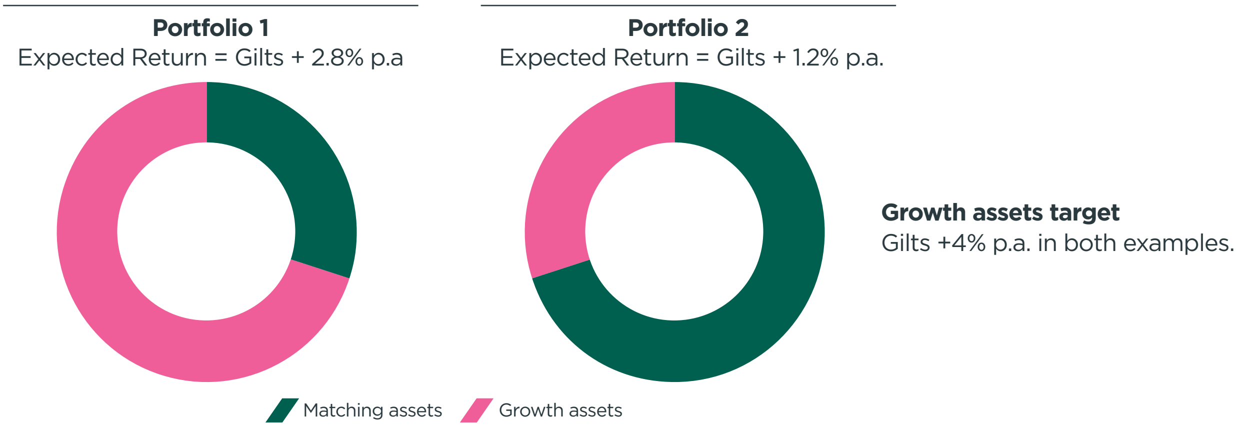
Below, we have summarised the three main approaches used by FMs as part of the de-risking toolkit for end-game investing.

1 Barbell approach

Under this approach, whilst the asset allocation typically moves from growth to matching assets, the asset allocation within the growth portfolio remains broadly the same. For example, the growth portfolio of an FM may have a typical target return of cash + 4% p.a. To generate this return the growth portfolio will be working hard, with good levels of diversification to reduce risk. As illustrated in Chart 2, below, as the target return of the portfolio reduces, it is only the split between growth and matching assets that changes, not how the assets are invested. This can result in the emergence of a mismatch between the efficiency of the growth and matching portfolios.

Typically, this approach is used by FMs that offer a one-size-fits-all approach for their smaller clients, and as such there can be instances of a lack of lower returning options that can be incorporated into portfolios. This approach therefore tends not to suit clients with lower return requirements, say in the later stages of their journey plan, as well as other approaches.

Chart 2: Example de-risking strategy using the Barbell approach



Source: XPS Pensions Group

2 Lower risk growth portfolio

Under this approach, as the target return of the portfolio is reduced, the growth assets are typically invested in lower returning, lower risk assets, such as credit or high-quality secure income assets. The strategy may still hold growth assets, but they will be a smaller proportion and reducing over time. This type of portfolio is appropriate for schemes targeting self-sufficiency or buyout.

3 Cashflow driven investing (CDI)

We consider the primary benefit of CDI is to invest in contractual income generating assets to lock in returns for the longer term. However there are a range of interpretations and some managers may also seek to match near term cashflows to pay benefits. Therefore, the approach taken by an FM varies considerably depending on how they define CDI.

The portfolio will often have exposure to contractual income streams, a mixture of high-quality credit and secure income assets with varying durations. As the strategy invests in assets with a known yield (assuming no defaults), there is also the possibility to align the funding basis to reflect the assets that are held, reducing overall volatility.

One issue we have observed with cashflow driven investment approaches is that many FMs are only starting to develop their propositions to be able to build low risk credit and secure income asset-focused portfolios for a range of client sizes. Therefore, for some schemes – particularly those of a smaller size – these approaches may not yet be an option.

In Table 1, overleaf, we summarise some of the broad characteristics of each approach.

The advantages and disadvantages of the approaches to de-risking

Table 1

	Barbell approach	Lower risk growth portfolio	Cashflow driven investing
Advantages	• Simple approach. • Growth assets still diversified across a range of asset classes.	• Efficient portfolio across both growth and matching assets. • Reduction in exposure to economically sensitive assets. • Potential to still have exposure to traditional return seeking assets such as equities. • Can invest in cashflow generative assets. • Increased exposure to credit-based assets which is beneficial as these assets are contractual in nature rather than being economically sensitive.	• Little or no exposure to economically sensitive asset classes. • Invested assets will generate the cashflows required by the scheme. • Potential to align the funding basis to reflect the invested assets, reducing funding level volatility. • Increased exposure to credit-based assets.
Disadvantages	• Still retains exposure to economically sensitive asset classes. • Lack of flexibility. • Mismatch in the efficiency of the growth and matching portfolios. • Tends to hold too much in very low risk assets and too little in moderate risk assets.	• Not all FMs will be able to offer this approach for all clients, especially the clients with smaller amounts of assets.	• Not all FMs will be able to offer this approach for all clients, especially the clients with smaller amounts of assets. • May be an increased reliance on illiquid assets. • Typically requires a level of bespoke analysis and tailoring that may not necessarily sit with the FM operating model.
Within FM toolkit?	• Typically, this approach can be used by all FMs and is an approach that can be used across clients of all sizes.	• Where FMs use a one-size-fits-all approach to an investment portfolio, there may be limited ability to adopt this type of low risk portfolio. This is most likely to impact pension schemes with assets less than £100m.	• The use of cashflow driven investment portfolios by FMs has been more limited, with many FMs currently not having the breadth of a solution to offer this for clients of all sizes. • However, there are some credible solutions for clients available.
Suitability of approach	• Suitable for smaller schemes that prefer a simplified approach. There could be more efficient ways of de-risking the portfolio. • Not particularly suited to schemes close to buyout or low dependency targets.	• Suitable for schemes ultimately targeting relatively swift progress towards buyout but less suited to latter stages of risk reduction than CDI.	• Suitable for schemes ultimately targeting low dependency but could be used for buyout as additional risk control becomes more important.

The choice of the most suitable de-risking method should be driven by trustees' investment beliefs and preferences. However, scheme size and the opportunity set of the FM is likely to dictate the de-risking approach used.

Other considerations for de-risking approach

Aside from the approaches above, it is also important for trustees to consider the following:

- **The potential allocation** to illiquid assets in the portfolio;
- **Additional hedging benefits** from non-LDI assets;
- **Reducing mismatching risk** between LDI assets and liabilities; and
- **Fees payable to both** the FM and the underlying managers.

FM approaches to preparing for buyout

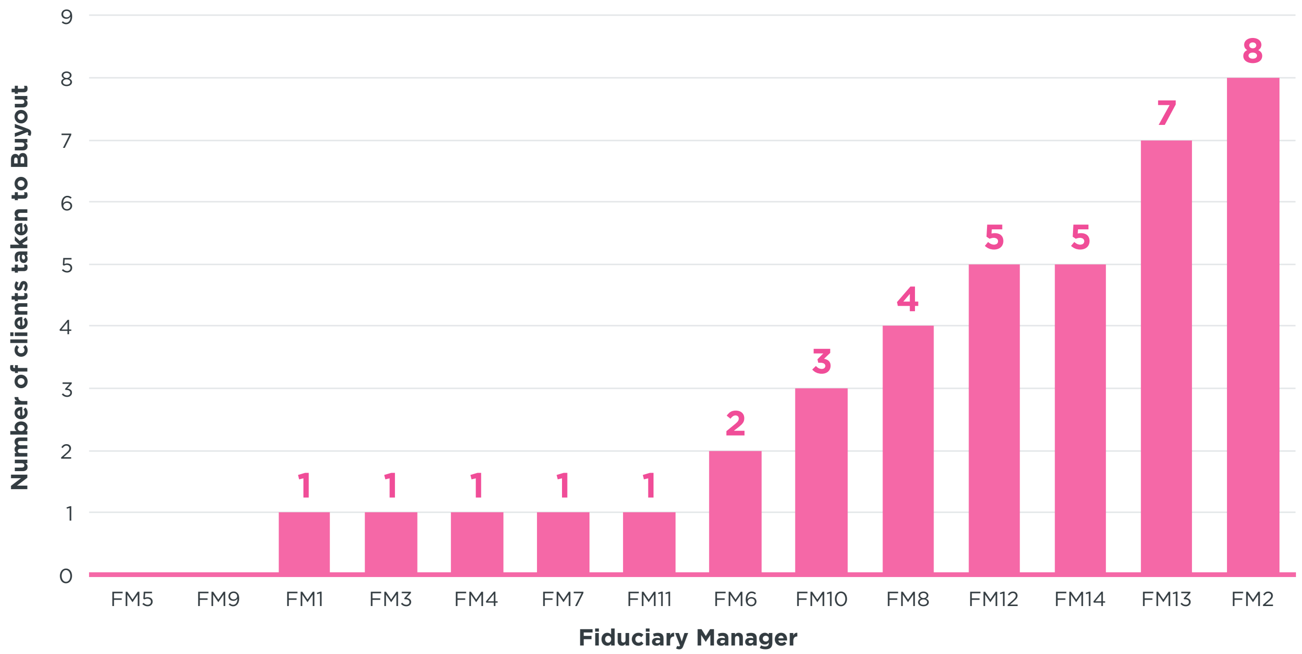
For schemes ultimately targeting buyout, the approaches used by an FM within the de-risking phase will be important – particularly when buyout remains a few years away – but consideration should also be given to other ways in which the FM will support schemes in their transition to ultimately transacting with an insurer.

One example of this is where FMs use live tracking for buyout pricing to take advantage of favourable market buyout pricing. This approach contrasts with those FMs that set their own proxy buyout bases, where there can be a spread of up to 0.5% p.a. between the most optimistic and most prudent discount rate assumptions and hence a potential mismatch relative to the price at which the scheme can transact.

FMs that originated as traditional consultancies tend to have established, in-house processes and utilise the tools within the wider business to support schemes in these sorts of areas. For other FMs, such as certain asset managers and specialist firms, end-game investing is relatively new. However, to be able to support clients, some have linked up with various third-party firms to ensure FMs can provide clients with a credible end-to-end solution. In many cases, these third-party agents will be solely focused on insurer dealings and are very experienced in this field.

However, whilst trustees should be exploring an FM's capabilities in supporting a move to buyout where that is their end-game, it is also important to understand the level of experience FMs have in using these tools. Of those FMs that responded to our information request, many had very little experience in getting clients to buyout and some declined to respond as a result. The fourteen FMs that did respond to our survey represent over 90% of the fiduciary management market based on market share. Chart 3, below, illustrates their range of experience in taking schemes through to ultimate buyout.

Chart 3: FM experience in taking schemes to buyout (as at 2020)



Source: XPS Pensions Group, Fiduciary Managers

Although this partially reflects where schemes tend to be along their journey plans, it also shows that several UK FMs have not yet assisted their FM clients through this process. You would expect them to have greater experience beyond what is shown in this chart when assisting other clients through to buyout.

Trustees should consider how an FM would approach achieving their long-term target, considering strategy and practicalities of approaching the buyout market, when selecting or reviewing their adviser.

Conclusion

No matter where schemes are on their journey plans, trustees using or considering an FM arrangement should be seeking to understand how an FM can provide support throughout all phases of those plans, rather than focusing solely on the strategy that has relevance today. This is true even for schemes with a reasonable time horizon remaining. It may be valuable for Trustees to seek independent advice for the most suitable solution and how that will evolve over time.

Whether it be low dependency, long-term targets or those aiming for ultimate buyout, many fiduciary managers have been somewhat untested so far when it comes to getting a meaningful amount of clients to their end goals. Trustees should therefore look at several factors when considering how an FM will assist them in the latter stages of their scheme's journey plans. These include de-risking tools available, additional expertise in transitioning to buyout and ultimate experience in taking schemes through to the different types of end-game targets. For some FMs, these factors will be more aligned to trustees' beliefs and preferences than others.

How an FM manages the latter parts of a journey has the potential to have a significant impact on the outcome for a scheme. With high barriers to exit – which become even less economically viable as a scheme approaches ultimate buyout – these considerations should be placed on trustees' agendas early on in their assessments of an FM, rather than waiting until the end-game appears to be close.

Whether it be low dependency long-term targets or those aiming for ultimate buyout, many fiduciary managers have been somewhat untested so far when it comes to getting significant numbers of clients to their end goals. But it is important to think about their approach for when you reach your target.

For further information, please get in touch with **André Kerr** or **Sophie Tennison** or speak to your usual XPS Pensions contact.

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