XPS Investment

XPS FM Watch

2018 saw Fiduciary Managers struggle to deliver their performance targets in testing markets

2018 was the worst year for financial markets since 2011 making it a real test for Fiduciary Managers' (FMs') growth portfolios and for many FMs the first real test. In the first **XPS FM Watch** report, we have compared their growth portfolio performance to each other and Diversified Growth Funds (DGFs) to assess how well they're doing.

Whilst FMs really struggled in 2018, this is to be expected in this sort of market environment. It is also consistent with our view that growth portfolios should be constructed such that performance is driven by market exposures rather than manager skill.

Background

The number of UK pension schemes using Fiduciary Management is growing. According to the CMA Investment Consulting Market Investigation final report (December 2018) there are around 1,000 schemes using some form of Fiduciary Management representing assets of over £160bn. So the performance of FMs is important.

FMs are typically trying to achieve a target level of returns in a risk-controlled way for their clients. In order to assess whether they're doing a good job, we need to consider their performance and the associated level of risk (and other factors as well). The focus of this initial report is on performance, and in particular the performance of the FMs' growth portfolios, although we also touch upon risk.

> The fiduciary managers have generally done a good job of hedging liability risk and delivering good growth portfolio performance over the longer-term, with most achieving their targets and outperforming most DGFs.
>
> However, the performance of their growth portfolios has disappointed in 2018, which was a really testing year. This is to be expected if market exposures rather than manager skill are driving returns, which is something we prefer to see.
>
> **Sophie Tennison**
> Investment Consultant

2018 Market backdrop

To give a feel for the challenging market environment faced by investors during 2018, we show a summary of key market returns in Chart 1.

Chart 1: 2018 market performance

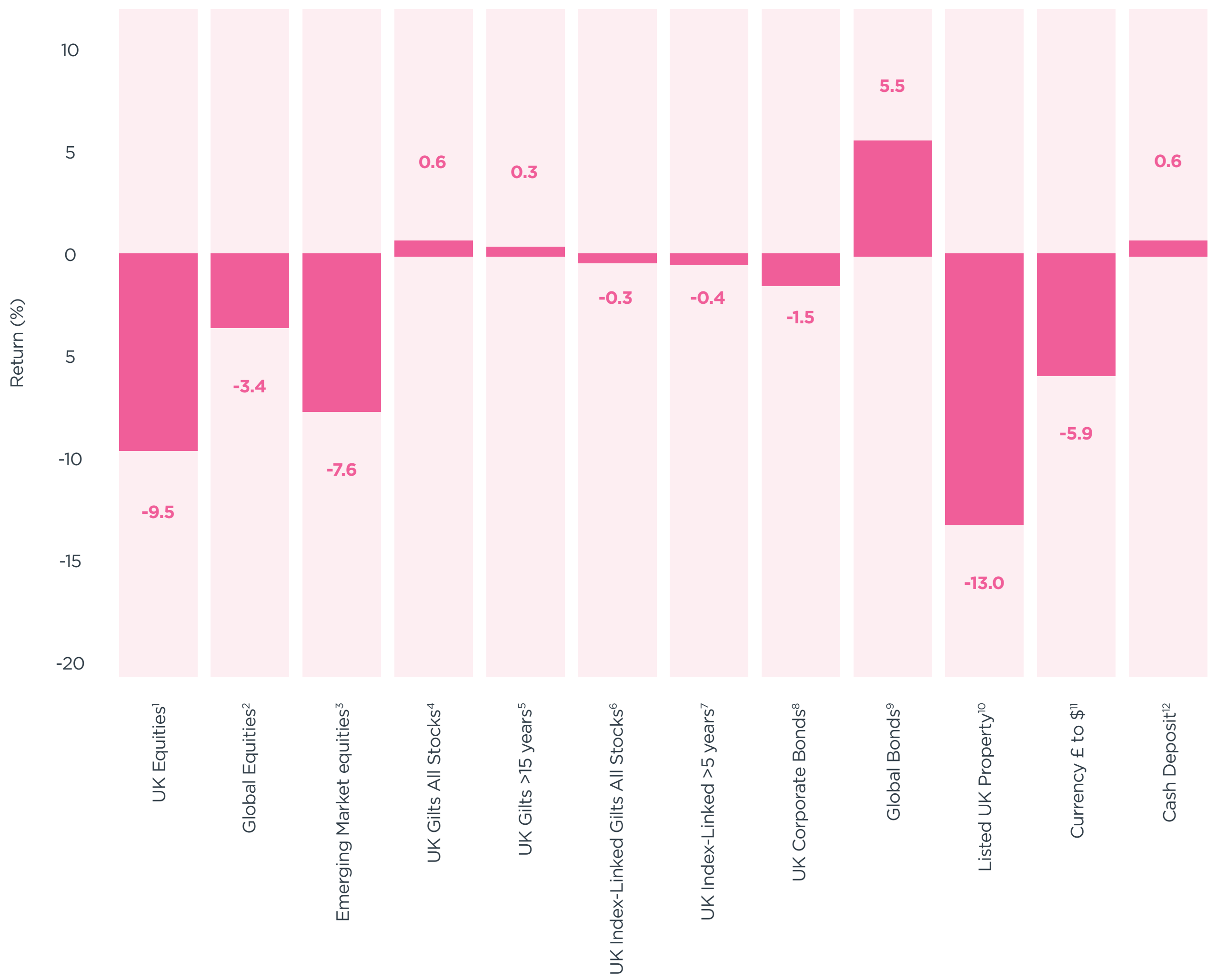

Chart notes:
Source: Datastream, XPS Investment

1. FTSE All Share Total Return Index
2. FTSE All World £ Total Return Index
3. FTSE Emerging £ Total Return Index
4. FTSE British Government Fixed All Stocks Total Return Index
5. FTSE British Government Fixed >15 Year Total Return Index
6. FTSE British Government Index-Linked All Maturity Total Return Index
7. FTSE British Government Index-Linked >5 Year Total Return Index
8. iBoxx £ Non-Gilts Total Return Index
9. JPM GBI Global All Traded Index
10. FTSE EPRA Nareit UK Total Return Index
11. US($) to UK(£) (WMR) exchange rate
12. IBA £ Interbank LIBOR 1 Week Delayed Total Return Index

Equities and property struggled, sterling denominated assets were weak in comparison to other major currencies and UK bonds were flat. In this environment it was very difficult to deliver positive returns from a growth portfolio.

Growth portfolio performance

FMs have tended to implement high levels of liability hedging, benefiting their clients, but how have their growth portfolios performed? 2018 was the second worst year for financial markets since the 2008 global financial crisis, the worst being 2011. So 2018 was the most significant test of their growth portfolios in seven years.

We've analysed a snapshot of the performance of FMs' growth portfolios (net of fees) covering over 90% of the market based on data we've obtained from the FMs. The FMs' growth portfolio performance data is from the main pooled funds they offer to their clients.

We've looked at their performance alongside XPS' recommended DGFs to see how well they did. We've compared their performance to DGFs (net of fees) as they're trying to do a similar job, both aiming for a target of around cash plus 4% pa (net of fees) by investing in diversified assets and strategies. The analysis for 2018 is summarised in Chart 2.

Chart 2: FM Growth Portfolio Returns – 2018

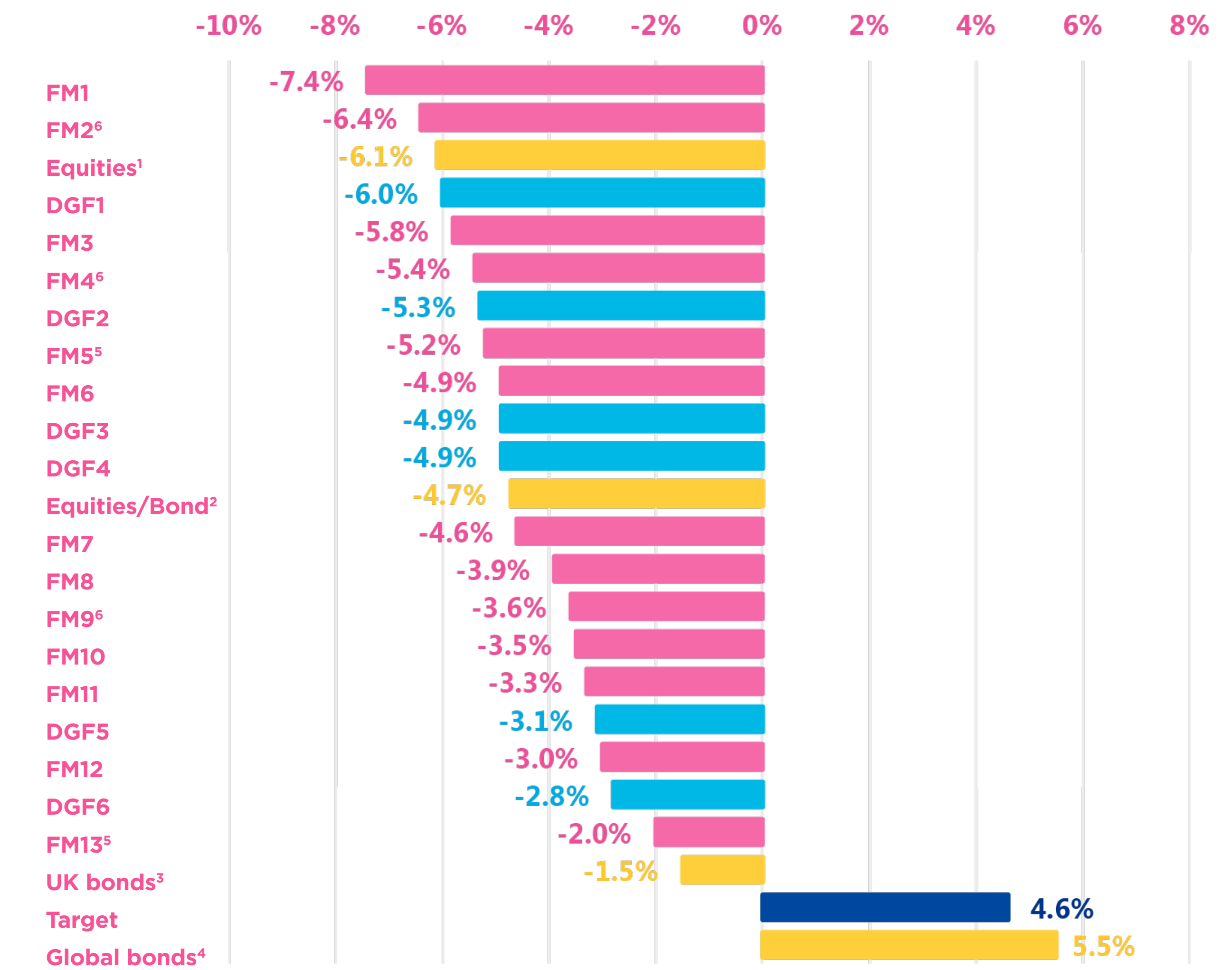

Chart notes:
Source: Datastream, XPS Investment, FM various

1. FTSE All World Total Return Index
2. 70% global equities (50% currency hedged), 30% UK corporate credit
3. iBoxx £ Non-Gilts Total Return Index
4. JPM GBI Global All Traded Index
5. Unconstrained option
6. Low cost solution

These **FMs' growth portfolios delivered a wide range of outcomes for schemes in 2018, but all significantly underperformed their target**, from 6% to over 11%. In monetary terms **the performance ranged from a £4m loss down to an eye-watering £8m loss for a £100m scheme** with a 70% exposure to growth assets.

The average performance of the FMs' growth portfolios was very similar to the universe of DGFs shown, in both cases -4.5%. In 2018 a scheme would have achieved similar overall results with a FM or a DGF combined with a 100% LDI hedge.

However, we can't draw meaningful conclusions from one year's performance so we've also shown five-year performance for those FMs and DGFs that have been around long enough in Chart 3.

Chart 3: FM Growth Portfolio Returns – 5 years (annualised)

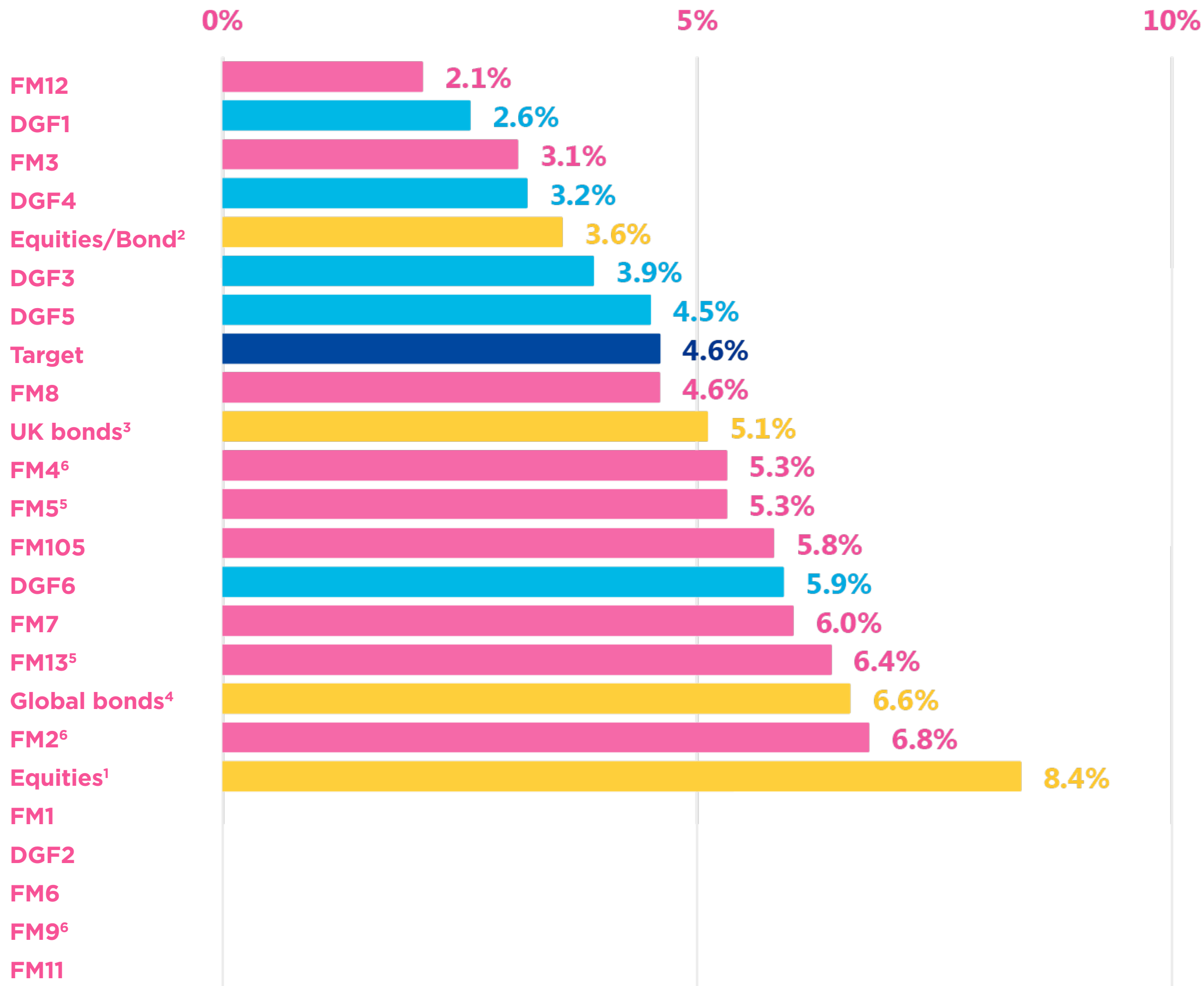

Chart notes:
Source: Datastream, XPS Investment, FM various

1. FTSE All World Total Return Index (50% currency hedged)
2. 70% global equities (50% currency hedged), 30% UK corporate credit
3. iBoxx £ Non-Gilts Total Return Index
4. JPM GBI Global All Traded Index
5. Unconstrained option
6. Low cost solution

FMs' longer term performance is much stronger, but they again delivered a wide range of outcomes. The performance difference between the best and worst FM equates to 28% over the five-year period. All except two of the FMs achieved the target and they outperformed the DGFs by 1.0% pa on average equating to £3.5m for our example scheme. We'd expect the FMs to outperform the DGFs as they typically have a bigger investment opportunity set and more ability to take on illiquidity within their portfolios.

> The performance difference between the best and worst FM equates to 28% over the five-year period.

Considering performance and volatility together

We have also looked at the volatility of returns that their growth portfolios have delivered over the longer term. The FMs are typically trying to deliver returns from their growth portfolios with lower volatility than equities. Chart 4 below shows the five-year average return and volatility metrics for the FMs in comparison to the average for the DGFs and equities. We also show the point representing the FMs target return (cash + 4% pa) with half equity risk being a reasonable proxy for their volatility target.

On average the FMs have delivered much lower volatility than equities (broadly around half) with most also achieving or exceeding their performance target. The FMs have also, on average, delivered stronger performance than the DGFs with similar levels of volatility. So FMs have been successful over the longer-term in an absolute sense and relative to DGFs.

Chart 4: Return versus volatility – 5 years (annualised)

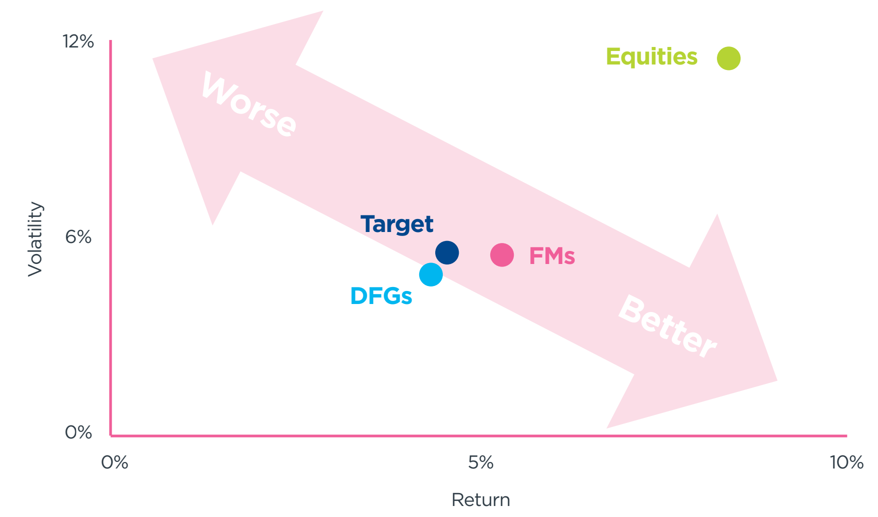

Chart notes:
Source: Datastream, XPS Investment, FM various

[1] FTSE All World Total Return Index (50% currency hedged)

FMs have been successful over the longer-term in an absolute sense and relative to DGFs.

> Different fiduciary managers have delivered very different outcomes for their clients. Over 5 years the difference between best and worst growth portfolios is 28%. Portfolio volatility varies quite a lot as well. The data confirms that the FM a scheme chooses is a really impactful and hence important decision.

André Kerr
Head of Fiduciary Management Oversight,
XPS Investment

Conclusions

Overall, FMs have performed well over the longer-term, but struggled in 2018 when growth markets wobbled. Their 2018 performance is to be expected in testing markets. It is consistent with market exposures driving returns – one of our portfolio construction preferences.

There is clearly quite a wide range of performance outcomes from the FMs. It would be easy to suggest that schemes should avoid the worst performers, but unfortunately life isn't that simple. It's impossible to predict in advance which FMs will deliver the strongest performance.

However, there are some common themes across the stronger performing FMs that can be identified:

- Higher exposure to contractual cashflow assets;
- Higher exposure to illiquid assets; and
- Higher exposure to the USD.

We are strong supporters of using contractual cashflow and illiquid assets within our clients' portfolio construction. In our view, looking for an FM that incorporates these themes into portfolio construction is likely to lead to better outcomes in testing growth markets. Higher exposure to overseas currencies as an intentional driver of returns is not something we support strategically as it has a binary outcome.

We believe schemes should not rely heavily on past performance when appointing a FM as it is a poor indicator of future performance. The themes driving portfolio construction should be a key factor, however. They should be understood alongside the views held by the FM for the future and how those views drive portfolio construction. Trustees can then select the FM whose views and approach they understand and feel most aligns to their own beliefs and aims. An independent oversight provider can really help with this.

Looking for an FM that incorporates contractual cashflow and illiquid assets into portfolio construction is likely to lead to better outcomes in testing growth markets.

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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