July 2024

Fiduciary Manager Trends for 2023/24

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Introduction

We are pleased to share our first annual edition of Isio's Fiduciary Manager Trends.

This paper aims to provide insights to any group or individual who uses either fiduciary management or OCIO services for their pension schemes. This includes trustees and company sponsors.

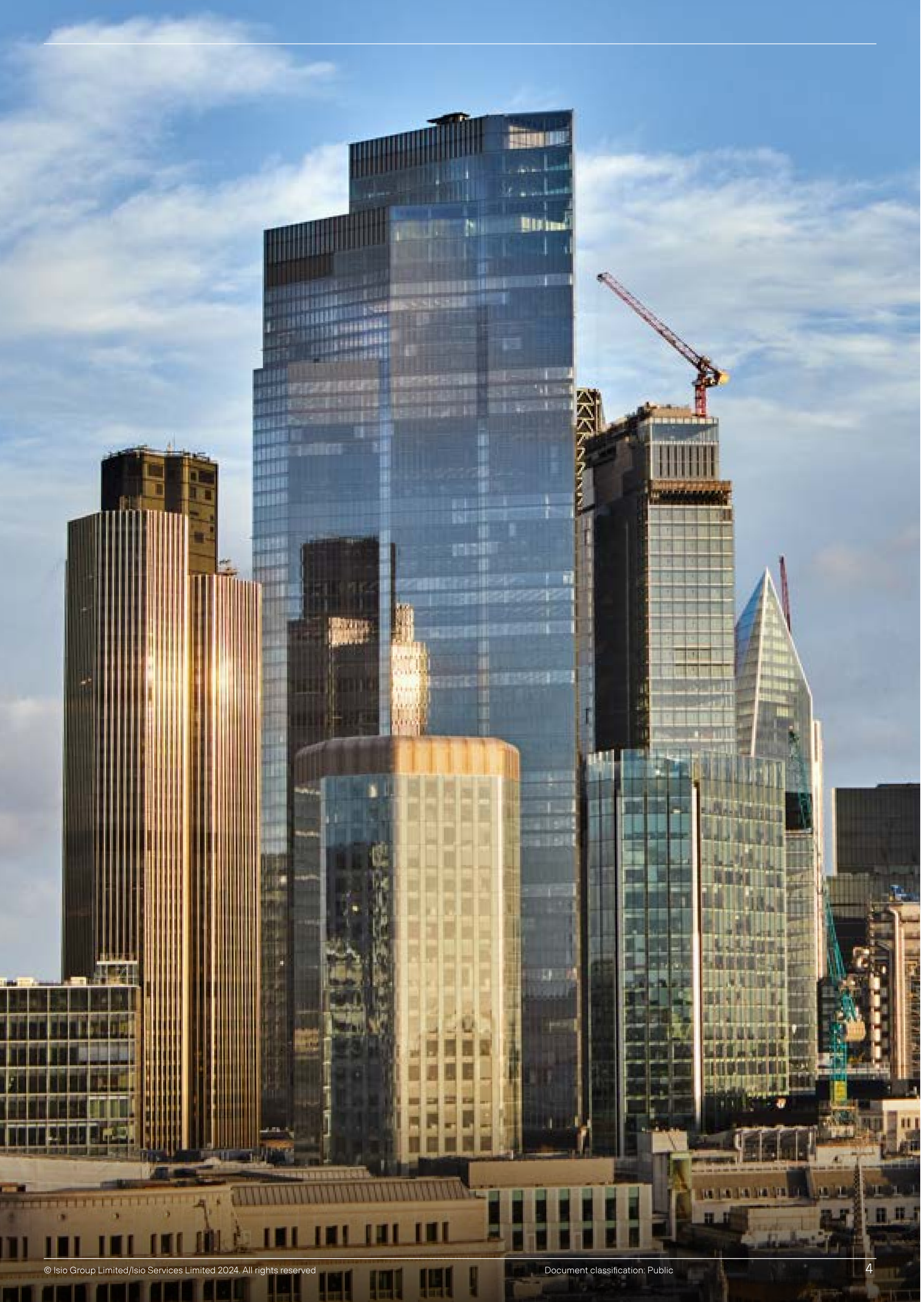
Every year Isio conducts extensive due diligence on 11 fiduciary managers, which represent the vast majority of fiduciary mandates in the UK. Isio then assigns a formal research rating and gives managers feedback on what they are doing well, what could improve, and how they compare to the wider fiduciary market.

The depth of our research means we are at the forefront of the fiduciary market in the UK. This allows us to answer the following questions: Where are managers focusing their efforts? What new developments are coming? Where could fiduciary managers do better? These are just a few areas this paper captures for 2024 and the year ahead.

While Isio works with many fiduciary managers to assess and share these trends, we won't be discussing specific managers by name in this update.

If you are interested in hearing our views on specific managers and how they compare to each other, please contact a member of the team (contact details are on the back page).

What's in this paper?



Summary & overview

Rebuilding for a new era

2023 was truly a dramatic year for schemes using fiduciary management. Trustees and Sponsors who use fiduciary management had previously bought into the idea that it could improve their governance of investment issues, and as such the gilts crisis of 2022 represented a real test of their abilities. Could fiduciary managers really be reactive and nimble in the fast changing market conditions that followed the gilt crisis? Did they support with strategic discussions during and after the crisis?

From our perspective the fiduciary model generally weathered this test well. In many cases we heard how managers acted quickly to preserve hedging, managed market risks, and communicated well with trustees and their sponsors. It has also been fascinating to watch how those managers responded over 2023 as the dust settled. The key trends we've observed are below.

High liability hedge levels were preserved (for most but not all clients) – The consensus of the industry remained focussed on keeping schemes' liability hedges as high as possible. We view this as sensible risk management to protect investment strategies – except where maintaining a high hedge ratio would expose the scheme to other bigger risks.

Improving liquidity was a focus for all - Every manager addressed liquidity risks in some way. This wasn't without considerable challenges presented by illiquid holdings and, in some cases, investor outflows impacting certain funds.

Performance differences became more dramatic – The difference between the best and worst performing fiduciary managers widened. This has a meaningful impact on outcomes for schemes depending on which managers were used.

Insurance solutions step into the foreground – Fiduciary manager capabilities and experience in this area have become increasingly important and, in our view, highlight considerable differences in the market. This seismic shift is why Isio now has formal research ratings for Insurance & Endgame capabilities for all 11 fiduciary managers that we rate (more information on this is provided on page 7).

Some managers proposed fee increases, but not all – We observed 4 out of 11 of our rated managers proposing fee increases for the average client. Managers gave us reasons such as rising cost inflation, and the impact of falling asset values (following rising gilt yields). We do however still see a range of different pricing points in the market and, with the majority of managers not changing their fiduciary fees, the differences between highest and lowest cost managers appears to be increasing.

Isio fiduciary manager ratings – We assign formal research ratings to 11 fiduciary managers in the market. This year saw us make the largest number of changes to ratings on record, with 5 downgrades and 2 upgrades to report. Many of the changes we made came as a direct consequence of how managers responded after the gilts crisis, both positively and in some cases, with room for improvement. Our ratings continue to uphold high standards for clients across the industry (more information on this provided on page 6).

1. Isio's fiduciary manager ratings

Isio's fiduciary manager ratings reflect which fiduciary managers we believe are best placed to help trustees navigate the constantly changing challenges their schemes face. Our rating changes this year reflect that we believe some fiduciary managers are better placed than others in the new era for pension schemes.

Did we change any of our 11 FM ratings this year?

This year saw us make the largest number of changes to ratings on record, with 5 downgrades and 2 upgrades to report.

Isio's fiduciary manager ratings descriptions	Isio ratings in 2024
Meets criteria These managers have the **strongest fiduciary propositions** and are most credible when compared to others available.	5
Partially meets criteria There are **areas of weakness** in the manager's proposition compared to others available.	6
Fails to meet criteria We have **significant concerns** with this manager and do not have confidence putting the manager forward to clients.	0

Why we changed ratings this year

- Business ownership and team
- Transparency in performance and how investment ideas add value
- Operational deftness and liquidity management

Environmental, Social and Governance ("ESG") ratings update

We maintain an ESG rating for all our 11 rated managers. This rating evaluates managers on a range of important ESG responsibilities, from how ESG is integrated in investment strategies, to how they engage and report metrics.

This year we upgraded 2 fiduciary managers to our "best practice" rating. This rating aims to identify managers that go beyond just meeting reasonable ESG criteria, by demonstrating climate, social, and impact factors in their fiduciary decisions. There were no ESG downgrades to report.

We are pleased with the positive direction of travel from managers, who are continuously developing tools and consulting with clients on all aspects of ESG. We are however mindful that ESG is a fast evolving area, and aim for our ratings to also evolve to maintain the high industry standards from managers that we expect.

Insurance capability ratings - a new addition from 2024

Fiduciary managers can offer insurance related services to help trustees and sponsors through a transaction, such as a buy-in or buy-out.

To reflect the rising importance of insurance capabilities for fiduciary managers, Isio now has insurance ratings for our 11 rated managers.

We are not assessing whether managers are experts at broking an insurance transaction. Rather, we are looking at how they integrate capabilities into their investment services. For example: journey planning, liability hedging, asset transitions, and how they monitor market pricing.

Insurance capability ratings for our 11 rated managers

3 **Market Lagging**	5 **Market Neutral**	3 **Market Leading**
These managers lack differentiators and experience compared to peers.	These managers have some capabilities and experience, but lack differentiators.	These managers have strong capabilities and experience compared to peers.

2. New investment ideas

Sustainability is a key theme influencing new ideas being introduced by fiduciary managers over the past year. This is a reflection that fiduciary managers are treating their stewardship responsibilities seriously and taking action to improve long-term risk management.

1. Sustainable global infrastructure – Real assets that represent facilities and services used by the public.

We observed 3 managers introducing flavours of infrastructure over the past 12 months. Managers see many positives for DB schemes, focussing on inflation-linked returns, generating cashflow, and positive ESG credentials.

Interestingly we saw a mix of both listed and unlisted infrastructure being introduced. We therefore encourage trustees and sponsors to be aware of how much equity linkage there is in the proposed allocation, and whether any illiquidity aligns with your scheme's objectives.

2. Insurance-linked securities – An alternative asset that enables investors to receive a share of insurance premiums for insurable events, and a drop in value should those events occur.

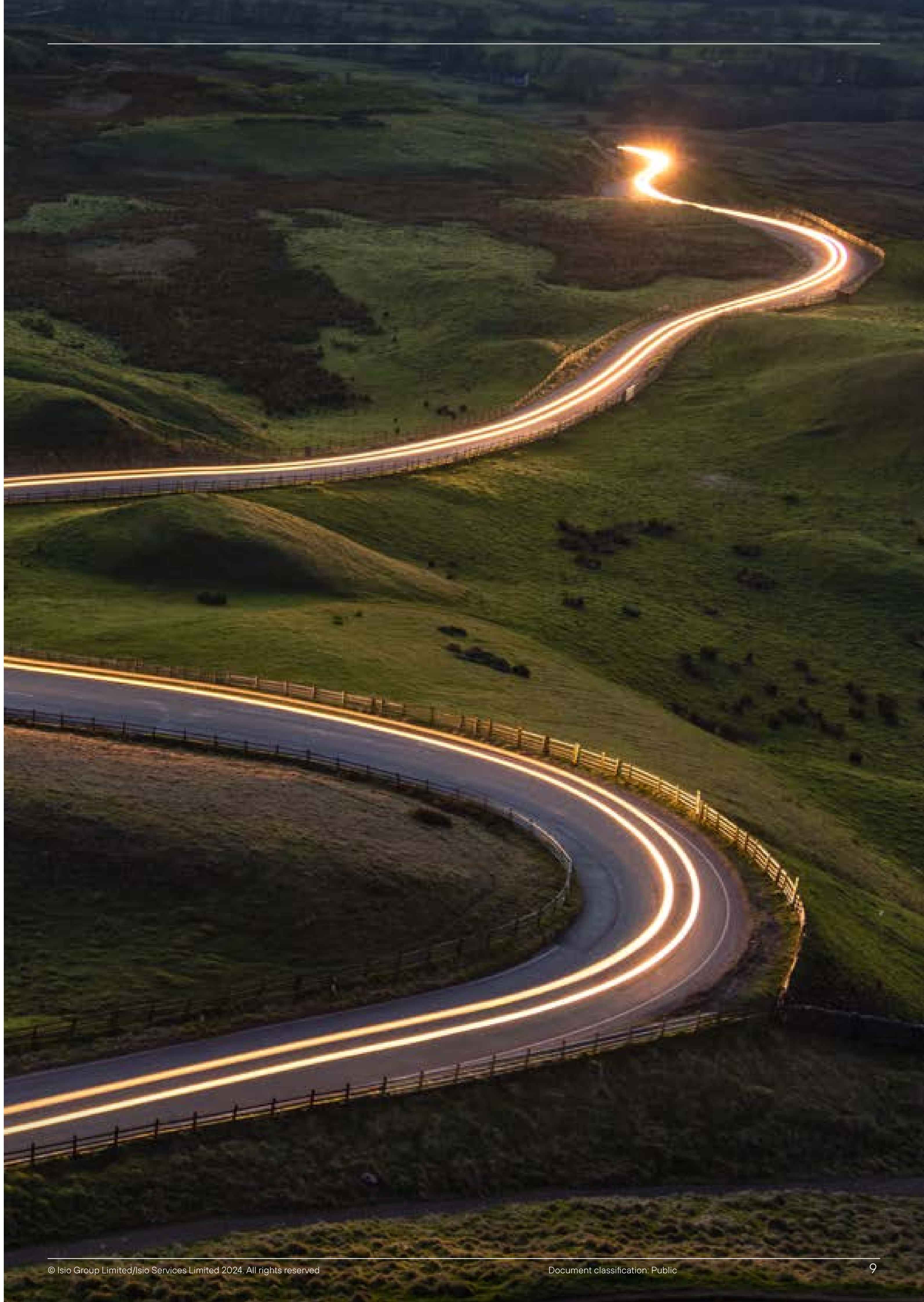
Managers have liked this idea in the past as the investment returns are often uncorrelated to traditional markets like equity and bonds. In this case, 5 managers are looking to add this to portfolios, as insurance premiums appear attractive.

Diversity through alternative assets like this can help managers deliver more stable returns over time. We do however recommend checking the liquidity terms and the size of the allocation with your manager, as the idea is still relatively niche.

3. Equity with downside protection – Options contracts that give managers the right to sell equity at a specified price, which can provide protection should equity markets fall.

A further 3 managers introduced this idea over the past year. The idea itself isn't new, but the timing of its introduction to portfolios can signal that managers are worried about declines in equity values.

Fiduciary client portfolios often use equity as a key driver of delivering returns, and this strategy can provide helpful protection if implemented and sized sensibly. We think it is worth checking with your manager about the intended timeframe though, as there is often a financial cost to buying this protection. This can lead to underperformance when equity market values are rallying.



3. 2024 manager trends

Liability hedging – keeping those hedges high!

For many years most managers had a consensus that liability risks, interest rates and inflation, should be hedged as far as possible. This often meant targeting hedging levels of 100% of Scheme assets (or close to this level).

Isio find it particularly interesting that managers have not changed their stance following the gilts crisis. In general they perceive there to be a real risk to pension schemes looking to achieve their long-term journeys. No managers are taking a bet on the direction of interest rates from here. For our 11 rated fiduciary managers, all of them made a clear statement – hedge liability risks as far as possible. We support this sentiment.

There were some managers who had to reduce client hedges during the gilts crisis, other LDI managers were arguably running too much leverage, often due to liquidity constraints that arose from holding illiquid assets. In most of these cases, Isio observed managers restoring hedges as soon as liquidity was freed up. We support this action, which in our view has helped clients avoid future uncertainty.

Observed liability hedging trends

All 11 fiduciary managers who we rate have made some form of change to their Liability-Driven Investment approaches and/or the collateral that supports it.

Below we show the proportion of our 11 rated managers who have made certain changes to their liability hedging and collateral arrangements in the past 12 months.

100%
Managers who increased collateral requirements

27%
Managers who switched one or more of their LDI fund managers

18%
Managers who changed from using pooled funds to using segregated (bespoke) LDI

"The changes that managers made are a reflection (or perhaps an admission) that management of the gilts crisis was not a perfect experience. Liability hedging continues to be a critical part of fiduciary manager responsibilities. We see it as a positive reflection by managers to address imperfections, reflect new regulatory guidance, and ensure hedges remain fit for purpose."

Heightened liquidity risks – flexibility is king (for now)

Before the gilts crisis, some managers took stronger views on the use of the "illiquidity premium" for pension schemes; essentially, helping schemes to make the most out of their long-time horizons by locking up invested assets to earn additional returns.

In some cases Isio saw schemes allocate 30% of total assets to illiquid assets. While this appears high in retrospect, it was felt to be reasonable strategy for clients with long-time horizons that were adequately meeting cashflow needs of their members.

That stance has changed dramatically in the year that followed the gilts crisis. No longer is it viable to achieve high returns, high hedge levels, and high allocation to illiquid assets. The flexibility that liquidity of assets provides has drastically been revalued over the last year, and every manager that we rate made changes to improve it in 2023.

Observed liquidity trends

55%
Managers who reduced their target illiquid allocations where applicable to new clients

20%
Managers who changed specific fund terms to improve liquidity

60%
Managers who improved client reporting to show liquidity and collateral

Fund termination – the liquidity dilemma

Often fiduciary managers will create their own funds for clients. These funds can help clients get access to investments that the manager likes, and do so in a cost-controlled way. Since the gilts crisis we have seen some of these funds experience challenges as demand for illiquid assets falls. In some cases managers have even terminated their funds.

So what's been the reason for the fund terminations? Many redemptions were needed by schemes to maintain their hedges levels during and after the gilts crisis. Those redemptions came from a range of assets, including those that were illiquid like hedge funds, property, and alternatives. As investment strategies were reviewed by managers and clients, those target allocations to illiquid assets were also often reduced.

We think this issue hasn't gone away. Any fund where the underlying assets are less liquid than the terms of the fund will be potentially vulnerable.

Where funds are being invested in under fiduciary arrangements, we recommend speaking to your manager about what protections are in place against fund terminations. We think this is a real risk and is something that we will continue to monitor. In some cases we recommend thinking ahead now to what you would do if a manager were to unexpectedly wind up a fund that your scheme invests in.

"In general all the managers we work with made positive changes to improve liquidity, and we still see a place for private markets for some schemes where their journey plans permit. How these are positioned within portfolios and how the type and mix of assets change, will be one to watch."

Performance divergence – the pack widens

Isio's analysis of fiduciary manager performance saw an increased divergence following the gilts crisis. The difference between the best and worst managers in one composite was as much as 10% in funding level terms. To put this in perspective, for a £100m scheme this suggests the best performing manager is £10m better funded than the worst, which is a material difference.

Below are some of the trends we are observing:

The financial impact of liability hedge changes – For the typical client, 50% of fiduciary managers experienced falls in funding level as a direct result of lost hedges during the gilts crisis. A further 30% of managers saw cuts to hedging targets, driven by the level of illiquidity in their portfolios. Volatility in markets following the gilt crisis meant that the timing of when these changes occurred in late 2022/ early 2023 also had an impact. In our opinion this explains a considerable part of differences in performance between managers.

Bulls vs. bears – Philosophical differences in manager approaches in 2023 meant that some positioned themselves to capture greater returns for clients, and others took a more cautious stance. With 2023 overall turning out to be a volatile but upward trending market for growth assets, those with a bullish approach found they outperformed others, due to greater allocations to public equity and higher yielding credit. Those managers who use dynamic asset allocation as a key source of delivering returns also performed relatively better. By contrast, more defensive managers held less equity and purchased downside protection that proved to be a drag on returns.

Equity diversification proved costly - Those managers who implemented strong ESG tilts saw underperformance last year vs. broad market indices. Managers who also tried to diversify away from the large mega cap stocks that dominated US and European equity indices also tended to underperform. Both decisions were taken with long-term risk management in mind, but nevertheless explained how some managers underperformed others.

There is no right approach that will consistently work for every time period and return target. We do however think that client objectives should be delivered in a risk-controlled manner. Over the longer term we question how managers can deliver outperformance of gilts (or cash) when interest rates are high – and thus the hurdle to meet outperformance is higher. By contrast, an approach that is too defensive may do more harm than good if client objectives aren't delivered. We expect managers to use their risk budgets wisely.

"While Isio support the aims of ESG strategies over the longer term, the underperformance of these funds will be tricky for managers to navigate if it is sustained. We therefore recommend trustees and sponsors review allocations to these ESG funds and explore sources of underperformance."

Insurance capabilities - is your manager equipped?

While it has always been part of fiduciary manager services to offer credible support in delivering endgame objectives for clients, the significance of these services has increased in recent years.

To support this, our 2023 Fiduciary Management Survey estimates that c.18% of all schemes using fiduciary management will go through an insurance transaction in the next 3 years – a significant number.

Through our new process of evaluating manager insurance services we uncovered the following trends:

Experience gap – Some managers have helped many schemes undertake an insurance transaction, and by contrast some managers have little or no experience. A lack of experience itself is not necessarily a problem, and can often be explained by managers being relatively new entrants to the fiduciary market and who their clients are. That being said, experience does demonstrate how a manager puts their services into practice and gives credibility to helping with a transaction.

Differentiators exist – Some managers told us about insurance services that are specific to their business and that their fiduciary clients can benefit from. Whether its sources of insurance data, tools to improve pricing for clients, or tools to reduce cost, our review identified a range of unique offerings.

In-house vs. external, is there a clear winner? – We tested to see whether managers with an in-house insurance team could show how this was integrated into the fiduciary offering. By contrast, those managers without an in-house team highlighted their ability to work with a range of advisers on a transaction. So what was our conclusion? We don't consider either approach to be "best", and it comes down to the individual manager having a clear process for advising clients at the right time (regardless of where the data is coming from).

"Fiduciary arrangements are long-term in nature, and post-gilts crisis many schemes found their journey plans shortened. Understanding how your manager can support in your long-term goals is critical, to give you confidence in how this will be achieved. We recommend keeping an eye on the fiduciary costs you are paying as your scheme de-risks on approach to an endgame objective, to ensure your scheme and members still receive value from fiduciary management."

4. Isio manager predictions for 2024

1.

Competition will be driven by large fiduciary mandates - We have seen an increasing trend of schemes moving to a fiduciary, partial fiduciary, or OCIO governance approach. This is particularly the case for larger schemes where assets are over £2bn. Sometimes this comes with a move of staff from an in-house pensions team (e.g. schemes such as British Airways and BAE Systems) to a fiduciary manager to continue working on those schemes. Often it can simply involve the appointment of a fiduciary manager who is willing to dedicate a bespoke service to a large client, with input and advice from a strategic adviser. We expect this trend to continue and drive competition between fiduciary managers this year.

Isio thoughts – How do these large schemes impact fiduciary manager resources for all other clients?

2.

Private markets will see a gradual reintroduction in client portfolios - With UK interest rates at the highest level for 16 years, we think this puts pressure on fiduciary managers to deliver their outperformance objectives. High interest rates present a high hurdle for managers aiming to outperform the base rate. We think client portfolios have changed since the gilts crisis, with liability hedges supported by larger buffers of cash collateral, so the natural focus is on how managers can deliver sustainable returns. Given the liquidity lessons learnt by some fiduciary managers over the gilts crisis, we think managers will display caution over reintroducing lots of private market assets for schemes. We do however think we'll see a more gradual reintroduction, as managers seek opportunities where these are both affordable and in line with clients' journey plans.

Isio thoughts – What private markets does your scheme allocate to?

3.

Manager consolidation will continue - In our FM conference last year we predicted that consolidation between managers will continue. This has since been proved right with Mercer announcing their intention to acquire Cardano in June 2024 (please note at the time of writing this deal is still subject to regulatory approval). We believe we will continue to see consolidation in the market. The competition between managers is also ever present with an invigoration from OCIO, and a steady stream of new DB schemes moving to fiduciary management. It is therefore our prediction that we will see consolidation continue between managers in some form.

Isio thought – What protections are in place if my fiduciary manager goes through a merger or acquisition?

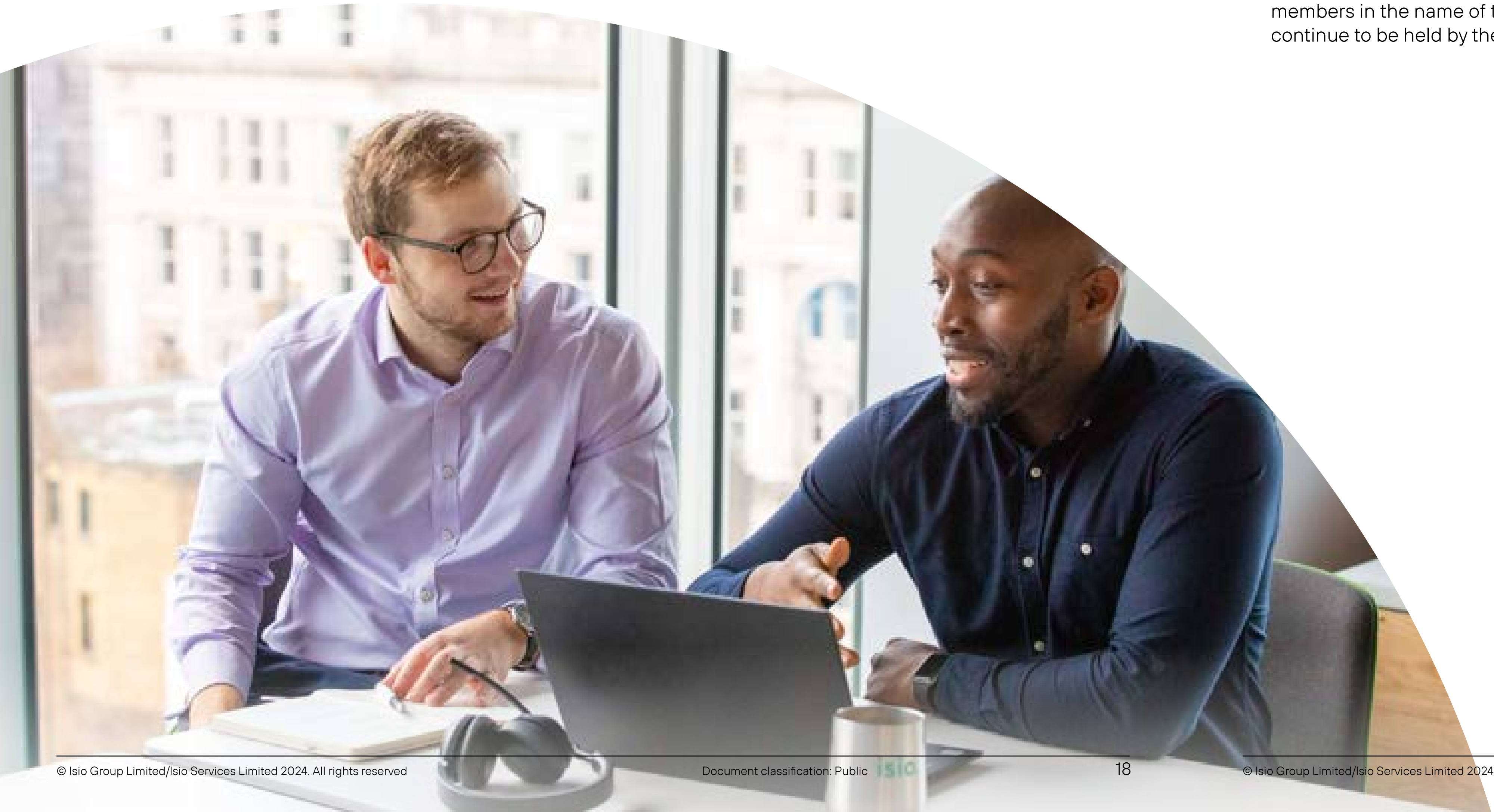
Would you like to know our rating of your fiduciary manager?

If you would like to talk about how this paper applies to your pension scheme or any particular fiduciary manager, please do reach out to us at Isio.

We provide fiduciary management advice but don't provide any fiduciary management services, so we give an independent view.

We provide the following fiduciary oversight services:

- FM Governance Review
- Selecting / Retendering a Fiduciary Manager
- Onboarding and Transitions Review
- Ongoing FM Oversight
- Fiduciary Performance Review
- FM and Buy-out / Self-Sufficiency
- Fee review



Definitions

- **Investment governance** – How investors make investment decisions, who is responsible, and what decisions are retained or delegated.
- **Fiduciary management** – An investment governance structure commonly used by trustees of UK DB pension schemes. It involves delegation of investment responsibilities to a third party. This includes both investment strategy advice and portfolio management.
- **Outsourced Chief Investment Officer ("OCIO")** – This can have a number of meanings and there is no "one size fits all" definition. An example of which is a type of investment governance model that delegates responsibilities to two independent third parties. This typically sees one party responsible for strategic advice, one party responsible for implementation, and both parties working collaboratively with each other.
- **Buy-in** – The purchase of annuities for some, or all, members in the name of the scheme. The annuities continue to be held by the scheme as an asset.
- **Buy-out** – The purchase of immediate annuities for all pensioners and deferred annuities for non-pensioners, in the names of the members of the scheme. This involves the transfer of pension assets and liabilities to an insurer.
- **Pooled LDI** – Pooled funds work similar to mutual funds, grouping the capital of multiple investors to deliver a standardised hedge solution.
- **Segregated LDI** – Segregated funds deliver a bespoke hedging by purchasing gilt and credit instruments directly.
- **Environmental, Social and Governance ("ESG")** – ESG is investing with an awareness of wider risks associated with the impact of investments on society as a whole.
  - **Environmental** – How an investee company performs as a steward of the natural environment.
  - **Social** – How a company manages relationships with its employees, suppliers, customers and the communities in which it operates.
  - **Governance** – Looking at a company's leadership, executive pay, internal controls, external audits, and shareholder rights.

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