Adopting a Belt and Braces Approach to Defined Benefit Scheme Investment Governance

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Successfully managing a defined benefit (DB) pension scheme is a complex integrated risk management exercise with myriad moving parts. In fact, for many schemes, it has long been the investment decision making and associated risk management which has stretched trustee governance budgets - especially in the period that preceded the Autumn 2022 mini-budget which necessitated increasingly governance-intensive investment and hedging strategies. Of course, the dramatic improvement of DB funding levels since, has led to an equally dramatic revision of many DB schemes' end-game strategies and timelines and with it a concerted move to lower-risk, less governance-intensive portfolios, albeit still with a degree of sophistication.

But here's the thing. Against the backdrop of heightened geopolitical tensions and increased systemic and macro risks, building and maintaining resilience through diversification, active asset allocation and robust risk management, remains a necessary imperative. As does having the ability to nimbly move into attractive and impactful but often fleeting investment opportunities. Yet, over 80% of DB schemes continue to adopt the advisory model for investment advice and implementation, rather than delegating the more arduous, governance-intensive aspects of building and managing resilient investment and hedging portfolios and cashflow management to fiduciary managers (FMs). Not that fiduciary management, with its typically nimble decision making, is a panacea. Indeed, there were significant differences in the actions and performances of FMs in responding to the challenges of both the global pandemic in 1H20 and the fallout from the disastrous mini-Budget of September 2022. Relatively speaking, some had a good crisis, in one or both cases, others not so good. Not that this should surprise anyone, given that the fiduciary management universe comprises a healthy mix of investment consultants, asset managers and dedicated specialists, each with their distinct set of capabilities and own way of doing things.

As pension scheme management evolves, so the FM model adapts

Back to 2024 and just as the dynamic world of pension scheme management is evolving, so the world of fiduciary management is adapting to these changes and putting its best foot forward in a number of areas.

Firstly, FMs are putting an ever-increasing emphasis on managing scheme Environmental, Social and Governance (ESG) risk factors, notably in setting net zero targets for client schemes and including scheme-specific climate metrics in their ESG reporting. Given that 97% of fully delegated fiduciary management mandates are for schemes with assets of less than £1bn,[1] i.e. those not subject to mandatory TCFD reporting, this means a principal source of systemic risk is being flagged and managed in a way that it probably wouldn't otherwise be.

[1] Multi-billion pound mandates increasingly separate advice from implementation via the Outsourced Chief Investment Officer (OCIO) model. These partially delegated mandates typically delegate implementation to the FM and advice to a third-party investment advisor.

Secondly, as better funded schemes move towards lower return targets, increasingly mature schemes to cash flow generating strategies, and buyout becomes viable for many within a relatively tight timeframe (though around one third of fiduciary mandates are targeting run-on), so FMs are expanding their capabilities to ensure client schemes achieve their evolving objectives. However, once again, each is refreshing its proposition, in its own way, in terms of capabilities, idea generation and asset class coverage.

So how do we know if our fiduciary manager is doing a good job?

Although fiduciary management is multifaceted in that relationship management, client engagement and the quality and transparency of reporting are all integral components, ultimately the validity of any outsourced investment governance arrangement rests on realised outcomes. That is, determining whether the FM has efficiently and effectively managed the mandate to an agreed return target and journey plan within an agreed risk budget, over a sensible timeframe, and having done so at a competitive fee that represents value for money (VFM).

Measuring performance over a sensible timeframe is key. After all, a FM isn't employed to shoot the lights out quarter after quarter and, in the short-term, a good process and genuine skill can be overwhelmed by bad luck and visa versa. However, in the medium-term, as luck evens out, the quality, or not, of the FM's process and skill should be evident.

Of course, good medium- to long-term performance is contingent on robust risk management. That is, assuming the right risks, i.e. those long-run rewarded risks, at the right size, at the right price and within agreed parameters, while hedging those long-term unrewarded risks, again at the right price and size. Necessarily this is underpinned by regularly conducting scenario analyses and stress tests of the known, knowns and known, unknowns, while horizon scanning for the next black swan. Astutely managing myriad and impactful ESG risks, many of which, as noted earlier, are systemic, is likewise integral to robust risk management.

But how do we fully ascertain all of this?

Remarkably, given the complexity of many of the decisions made by FMs, the cost implications of this decision making, the multiplicity of processes and risk management systems, and the potential conflicts which arise, with most mandates providing both advice and implementation and managers using their own fund of funds within client portfolios, only around one third of FM schemes use a third party evaluator (TPE) to oversee and scrutinise the FM's activities, principally on a quarterly or annual basis. This contrasts with around 60% of schemes employing a TPE in FM search and selection.

Okay, bigger schemes are much more prevalent than small in employing TPEs for FM oversight and professional trustees now sit on more than half of all trustee boards. But, as noted earlier, successfully managing a pension scheme is a complex integrated risk management exercise with myriad moving parts. Therefore, getting into the weeds of FM attribution is no easy task. Yes, professional trustees, in constructively challenging the FM, can complement the work of TPEs, but, in all but a small minority of cases, cannot replicate the sheer breadth and depth of TPE oversight.

For instance, we all know the adage “what gets measured gets managed”. But what if something is incorrectly measured, or the wrong item is measured, or questionable assumptions have been used to define and measure a particular metric? Have the key risks assumed within the portfolio been dealt with optimally? Is the hedging performing in line with expectations? How impactful has the FM’s advice, idea and theme generation been? Has an active asset and strategy allocation been adequately rewarded and were the associated transaction fees and dilution levies incurred reasonable? What fees are being incurred along the value chain? Has the FM fully embedded stewardship and ESG considerations into its implementation? Is active management delivering to expectations? And how about any conflicts and undesirable biases - are these being kept in check? These are but a sample of the many questions that aren’t immediate apparent from, or which often go unanswered in, some FM reporting, all of which a TPE will interrogate.

Crucially, TPEs also have the ability to determine the robustness of a FM’s risk management systems – specifically whether weaknesses exist in one or pervade several interconnected defensive layers. Expounded by the, aptly-named, Swiss Cheese Model, with weaknesses represented as holes within each layer, an undetected alignment of holes in each of these risk management layers can spell disaster. Indeed, having a TPE on board during 2020 and 2022 was particularly valuable in formally assessing how well, or not, each FM dealt with the crises in those two instances – not least in understanding how robustly risk management processes withstood each crisis, what lessons were learnt and how these processes were adapted to potentially counter the inevitable next crisis.

In conclusion

In summary, fiduciary management is a valuable nimble investment governance solution to what is a complex integrated risk management exercise that necessitates the need to build and maintain resilience. In so doing, it enables schemes to adopt a keener focus on those, often underexplored, strategic imperatives outside of investment. Moreover, in contrast to common misconceptions, fiduciary management isn’t an abdication of fiduciary duty, or results in a loss of trustee control. Rather, it’s a delegation to a trusted partner, who understands the scheme’s needs and is typically fully aligned with the trustees’ investment beliefs and policies.

While not a panacea, and principally for that reason, the governance-enhancing merits of fiduciary management can be yet further elevated by employing a TPE. Some see this latter step as governance overkill, cynically framing it as guarding the guards. But it really isn’t. Anyone who fully appreciates the value of good governance can vouch for the importance of adopting a belt and braces approach to pension scheme governance, which is exactly what this is.