

THE TRUSTEE MAGAZINE

ENGAGED INVESTOR

JULY/AUGUST 2010



The fiduciary flight path

CONTENTS

- The fiduciary flight path – 38
- Myths and truths – 40
- Fiduciary management Q&A – 41
- Trustees' questions answered – 42
- Delegated consultancy in detail – 43
- Delegation with confidence – 44

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The fiduciary flight path

Fiduciary management has been labelled as the future for pension schemes, but trustees should be aware of what they want to achieve, says **Ceri Jones**

Among the many lessons learned by trustees as a result of the financial crisis, none have been more important than the need to regularly review funding, looking at the relationship between assets and liabilities, and holding to account under-performing managers.

Many schemes – such as Barclay's UK Pension Fund – have responded to these pressures by taking investment management expertise back in-house and in some cases, appointing their own chief investment officers to help bridge the gap. Others, such as Habitat (see below right), are looking at moving in the opposite direction and considering options such as fiduciary management. Fiduciary management aims to cut away the complexity of trustees needing to monitor several asset managers by contracting out investment management to just one provider, which takes on the responsibility of constructing portfolios to manage

the investment strategy agreed by the trustees, and of appointing asset managers to run the different aspects of the portfolio.

A fiduciary manager is able to take a total overview on the assets and liabilities of the pension scheme, while being able to concentrate solely on monitoring investment performance and acting on the results of that monitoring. Through that the fiduciary manager can help to guide the scheme to whichever end point trustees have chosen, such as full funding or a buyout. This should free up trustees to concentrate on more important concerns, such as setting the overall strategy of the scheme.

TAKE OFF

The concept of fiduciary management came to the UK a few years ago from the Netherlands, where it has proven highly popular. Indeed, fiduciary management is already so entrenched in the

Netherlands that only one quarter of Dutch schemes do not use it.

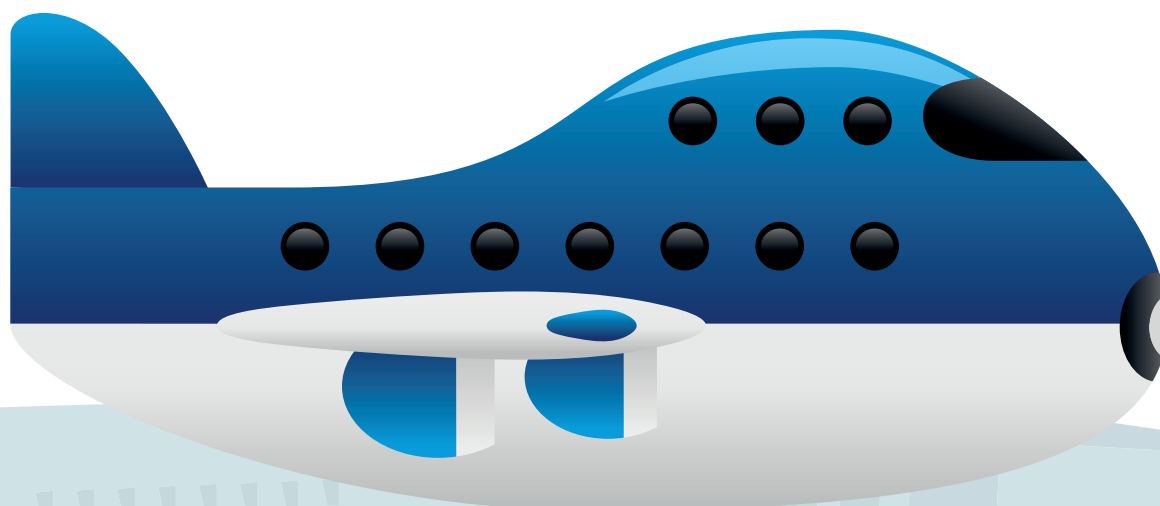
Take-up in the UK has been far slower. Reasons cited include the difficulty in building momentum – the argument being that until a few big deals are done, other schemes will be loathe to commit to the approach – and the substantial change in trustee attitudes to scheme management that fiduciary management requires. However there are signs the market is gradually coming to life.

Although only a few fiduciary mandates have been awarded to date in the UK, notably retailer Habitat, there is a huge amount of activity behind the scenes. Asset manager SEI, which offers fiduciary management to pension schemes, says it has met with over 100 funds in the last year, solely to talk about the service. Specialist advisers such as KPMG and Capita Hartshead are helping trustees to evaluate the market.

Traditional consultancies are also having some success in converting existing clients with whom they already have a relationship, into clients of fiduciary management-type services, sometimes referred to as 'implemented consultancy'.

Mercer, for example, has taken on 87 fiduciary clients across Europe since 2006, with assets under management of over \$4.5bn at the end of May. "We have huge demand from clients in the UK who want to delegate for reasons of governance, focus, efficiency and cost," says Michael Kinney, director of implemented consulting at Mercer.

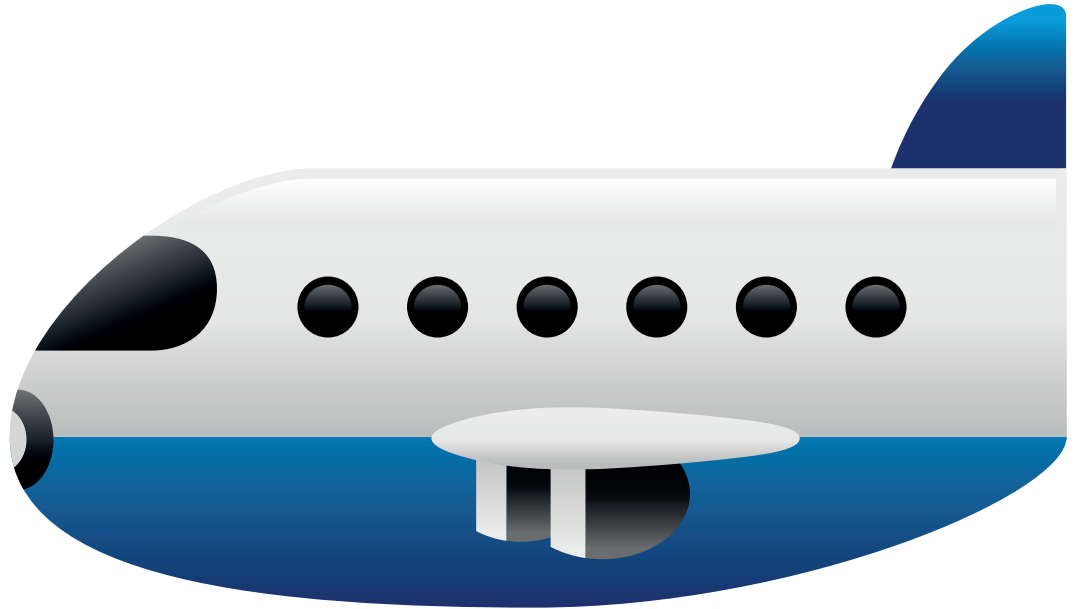
But just as fiduciary management is taking off here, the reverse seems to be happening in its homeland of the Netherlands – many pension funds are now re-examining their managers, and in extreme cases terminating them on the grounds of poor investment performance and the risks involved in delegating the entire strategic advice, risk control



KEY POINTS

- Fiduciary management allows trustees to outsource investment decision-making, but responsibility for the scheme's funding still remains with the trustee board
- A good fiduciary manager will look at assets in conjunction with the scheme's liabilities
- There are a variety of different models of fiduciary management and investment outsourcing – trustees will need to decide what will work best for their scheme

“Fiduciary managers claim they are able to lower costs by as much as 20-30% in some cases”



and asset management piece to a single third party.

RESOLVING TURBULENCE

Most criticism centres on two main concerns. Firstly, many managers are felt to be selling nothing more than a rebranded multi-manager solution – essentially selecting and packaging up various investment funds – with little regard to the liability side of the balance sheet.

Secondly, providers that come from an asset management background have been accused of investing the majority of their fiduciary business in their own in-house funds, then defending such decisions on the basis of reduced fees and better visibility.

“A fiduciary manager needs to be able to act like a trustee in manager selection and some providers are conflicted in picking funds,” says Ashish Kapur, European head of institutional solutions at SEI.

“They may argue it is cheaper but cost is not an indication of quality. You can see how pressure could be applied internally to choose a certain in-house fund, or how on termination the in-house fund manager may apply pressure to allow them to be given the benefit of the doubt.”

Tony Broccardo, chief investment officer of the £16bn Barclay’s UK Retirement Fund, agrees with the

need to draw on a wide range of investments. He says “even medium performance” is not enough.

“You need to target exceptional performance, which will mean third party skill across equities, credit, hedge funds, private equity and other above average sources of return. Therefore, having the widest range of funds to select from is important.”

COST AND RISK

Despite these concerns, one big attraction of fiduciary management is cost. Fiduciary managers claim they are able to lower costs by as much as 20-30% in some cases, and costs are also more predictable. This may be partly because a scheme has decided that it can operate with fewer advisers such as investment consultants if it is using a fiduciary manager, or that it needs reduced involvement from consultants. Much of the rest of the savings are from negotiation between the fiduciary manager and asset managers to drive down fees through economies of scale, providing small pension funds with better deals than they could achieve alone.

A good fiduciary manager will also bring substantial benefit in selecting appropriate assets to fit the amount of risk the scheme is prepared to take on. “The most important need

is for the fiduciary manager to recognise both sides of a scheme’s balance sheet – to get to grips with the nature of the pensions liabilities (ie the amount of money the fund must pay out in pension promises), the funding ratio (the relationship between the scheme’s assets and its liabilities) and the cash flows,” says Andrew Slater, UK managing director at governance specialist

Ortec Finance. “The integration of the asset and liability side should help drive a proper asset liability approach. Sometimes there is not a great conversation between them.”

Lodewijk van Pol, head of fiduciary management at Lombard Odier in Amsterdam, says: “A good fiduciary manager will be looking at where it is rewarding to pursue alpha (i.e. returns above the

CASE STUDY: HABITAT

UK furniture retailer Habitat outsourced the management of its £24m pension scheme to the fund manager SEI in 2009. The trustees wanted to be able to focus more fully on strategic issues, whilst outsourcing the day to day pensions management to an expert partner. The fund has also been able to make cost savings.

“We decided appointing a fiduciary manager was the right route for us because, as a trustee body, we found it difficult to select and monitor fund managers,” says Malcolm Curzon, chairman of the trustees at Habitat UK Pension Fund. “We found the process time consuming, costly and complex and did not feel that our investment consultant was providing value for money. We wanted to improve our governance and find a service which would be aligned with our goals and would allow us to focus on the strategic issues, rather than the day to day minutiae of running the scheme investments.

“Although it is still early days, we have already experienced several advantages. The way SEI looks at assets, liabilities and company cash flows has assisted in discussions with our sponsor and the manager of managers implementation has ensured we are much more diversified. We have also been able to save on costs and we are now paying 30% less than we did previously. Importantly, we are also moving in the right direction in terms of addressing our funding objectives.”

EXPERT VIEW

Myths and truths

Ashish Kapur dispels some of the myths around fiduciary management

With fiduciary management becoming more popular in the UK and many trustees exploring the service it is important to address some of the myths that have arisen:

MYTH: Trustees have to delegate everything to the fiduciary manager

Fiduciary management is not about delegating responsibility rather it is about partnering with trustees to provide an enhanced governance framework. This can lead to improved decision making and a better chance of meeting funding goals. The fiduciary manager acts as a strategic partner assisting and supporting the trustees in setting objectives and making informed decisions about long term strategy whilst at the same time being more proactive in making short term decisions which are not reliant on a quarterly meeting schedule. The approach puts trustees more in control by ensuring that their time is spent on the strategic decisions rather than the minutia of running the scheme.

MYTH: Fiduciary management costs more

A fiduciary management approach can often lead to significant savings rather than costing more. In most fiduciary management models, fees are expressed as an asset management fee (a percentage of the assets). This fee incorporates all services including advice, risk management and asset management. This bundled fee is very different to the fee structure that trustees may be used to, where they will pay separate fees to each individual asset manager and to their consultant who may charge by the hour. It is important that when trustees are considering fiduciary management they are aware that they are paying one bundled transparent fee for everything.

MYTH: There is a conflict of interest in the fiduciary manager providing advice and implementation

Many fiduciary managers use their own fund management arm(s) to

implement investment decisions which may raise concerns over conflicts of interest. Implementing fiduciary management via a manager of managers approach using independent managers, on the other hand, may help address these concerns because the manager of managers process ensures there are no qualms in firing any underlying manager if there are any concerns about their investment process or performance. A manager of managers approach using pooled funds also ensures that all clients regardless of size are treated the same so when a manager change or replacement decision is made, it can be implemented quickly and at exactly the same time for every client.

MYTH: It is very difficult to measure and monitor a fiduciary manager

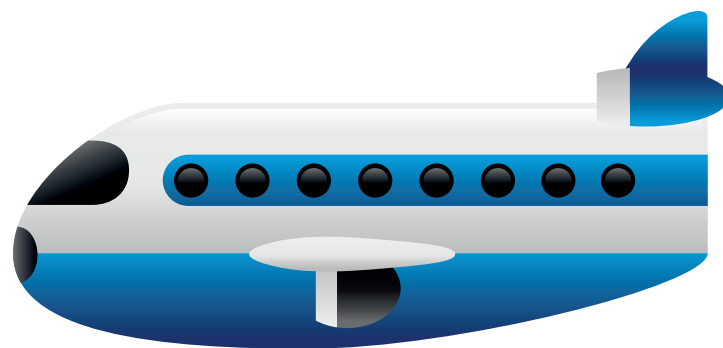
In reality the monitoring and measurement of a fiduciary manager is easier than in most pension fund models. This is because reporting is tailored to the individual client's goals. It will be clear to the trustees whether the fiduciary manager is doing what was asked of them because the trustees can see their progress on the journey to reach their funding goal. In addition, if the trustees feel they need additional oversight they could appoint a professional trustee to provide assistance in both monitoring and reviewing the fiduciary manager's advice. ■

For more information about SEI's Fiduciary Management offering please visit www.seic.com

This information is for educational purposes only and not intended as investment advice.



Ashish Kapur, European head of institutional solutions at SEI



performance of an index such as the FTSE 100), and will make a clear distinction between the liability-matching portfolio and the return portfolio."

He says the crisis has also made it clear that some trustees did not understand the make-up of their investments, where their assets were allocated and what was held in certain mandates, resulting in poor investment decisions. "A fiduciary manager will implement a relatively simple set up, look at how the mandates have been put together and how it works, then explain policy and structure to the trustees."

In terms of investment decision-making, many trustees feel unable to move quickly to take advantage of opportunities in the market or move out of positions which could be damaging. A recent survey by fiduciary management provider Russell Investments revealed 40% of trustees were not confident in their ability "to respond quickly to new situations". This could be for a variety of reasons, such as training needs, the structure of the trustee board's decision-making process or concerns over the extra costs involved in changing asset allocation.

Whatever the reason, in the rapidly changing market environment that we have seen over the last few years, the ability to move quickly to 'lock in' the benefits from funding gains when the investments hits certain trigger points can be important. By focussing purely on investment, fiduciary managers are well positioned to do this.

Lloyd Raynor, a senior consultant

at Russell Investments, says: "If a fund is ahead of its journey plan, the trustees may look to lock in returns on their return-seeking assets and this requires real-time expertise."

While a fiduciary manager's ability to look at a portfolio holistically has advantages, trustees must still be aware of how this is being implemented, says Barclay's UK Retirement Fund's Broccardo.

"Fiduciary management is climbing a wall of worry," he says. "Is the mandate appropriate in terms of risk and return? Are the performance targets sufficient and appropriate? And there is the issue of agency risk – if all the underlying management and investment is dealt with by one party, there will be a lack of flexibility for trustees who wish to change manager in the future or in the event of corporate restructure."

Deciding whether fiduciary management is right for their scheme requires trustees to consider how it will fit with their existing advisory structure (or what changes they will need to make to ensure that it fits) and whether the cost benefits will be realised for their scheme. However, increasing numbers of schemes are at least beginning to ask themselves those questions. ■

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 Visit our website to find out more about fiduciary management

- > TKU Unit 9: Fund management for schemes
- > Delegation of duty: an introduction to fiduciary management



Fiduciary management: Q&A

The time has come for trustees to embrace fiduciary management, says **Colin English**

Why are pension schemes interested in fiduciary management now?

Current UK governance structures for pension schemes have put desperate pressure on trustees. There is too much to do, and very little time to do it in. Identifying the key areas of focus for trustee's limited resources is vital.

Traditionally trustees have been encouraged to spend their time on manager selection and other operational issues, but these activities have a small impact on the overall returns that are achievable for their scheme. Strategic and tactical issues need trustees' time more urgently – but many are unable to give this the focus that it needs. Fiduciary management, or other governance structures of a similar vein, can help trustees focus on strategic and tactical issues, while routine matters, such as manager monitoring, can be left to a third party.

Mn Services has been surprised by the appetite of trustees in the UK to explore whether fiduciary management is right for their scheme. The pace of engagement has been much quicker than we expected, particularly in relation to the speed with which many trustee boards have started to explore the options presented by fiduciary management to support and enhance their investment strategy and governance.

From that initial interest, we've also been delighted with the swiftness with which trustees have moved to a formal selection process. Much of that rapid response has come from larger funds, who have some, but limited resources. They may have trustees or advisers in-house who know the market and can recognise opportunities, but are not able to actually act on those opportunities due to limited time. Such schemes have recognised the benefits that external resources like fiduciary management can achieve through improving the setting, implementation and monitoring of an investment strategy.

Overall, there has to be an improvement in the investment governance of pension schemes. As awareness of fiduciary management increases and more schemes decide to choose this method of governance that will in turn encourage more trustee boards to investigate this approach.

Is the same approach to fiduciary management suitable for all schemes?

In Mn Services' model we emphasise that performance of assets is not the only thing that matters. Investment returns have to be put into the context of the scheme's liabilities and risk tolerances. Any two schemes, even with the same assets under management, will have different underlying risk profiles that will depend on factors such as the strength of the employer covenant, the benefits offered and contribution rates. Therefore they will need to structure their investments differently. Our

“ Fiduciary management is not getting rid of investment issues; it is about challenging those issues and seeking improved, rapid and more timely solutions them ”

model therefore says that each scheme working with us will have a personalised investment solution.

However, no matter what a scheme's risk profile is, fiduciary management enables implementation of a more efficient, dynamic, and diversified investment strategy, resulting in higher expected returns per unit of risk for trustees and the funds they are responsible for.

The way in which we work with trustee boards will also differ from scheme to scheme. One thing remains constant – and that is that trustee boards remain responsible for their overall investment strategy. But within that, the approach we take can vary. For example, schemes may have an in-house investment adviser who might wish to retain the lead on setting strategy, and Mn Services will support that governance structure with suggestions to improve investment strategy as well as implementing and monitoring it. In other scenarios, we will lead the agreed strategy and report back to the board on how it is performing

across the whole portfolio. The reporting we provide is not just at manager level, but also at asset class, asset portfolio and balance sheet level, giving a complete and fully transparent picture.

Ongoing monitoring must be provided to trustee boards, but we have found that boards who have engaged with us regularly have benefitted more from changes in the market than those who have retained a traditional three-month structure for reporting and decision-making. It's important to remember that fiduciary management is not getting rid of investment issues; it is about challenging those issues and seeking improved, rapid and more timely solutions to them.

Is the UK alone in its interest in fiduciary management?

Mn Services' background is in fiduciary management in the Netherlands. We set up as an independent company in 2001 and by the end of 2009, we became the market-leading provider of fiduciary management in the Netherlands. Most of our clients in the Netherlands are large schemes, including a number of industry wide structures, and we generally work with schemes of £100m or more in assets with our largest scheme having £30 billion in assets.

Strategically Mn Services believes that the fiduciary management trend will continue to build across Europe – although at different speeds in different countries.



Colin English
Head of Business Development UK
Mn Services



Trustees' questions answered

Many Trustees are showing increasing interest in fiduciary management (FM) as a robust governance solution to help address the challenges faced by pension funds. **Shamindra Perera**, Russell Investments, answers some Trustees' questions on this topic.

The theory is that expert investors used by fiduciary management schemes will be more nimble, more knowledgeable, and provide a higher return than the current route using inexperienced Trustees who meet only quarterly. The logic sounds good, but is there hard evidence to support it overall (i.e. when looking across all FM performers, not just 'cherry picking' the best FM performances)?

The scepticism implied in the question is justified as there is a vast gulf between investment advice and implementation. One of the advantages of fiduciary management is that it involves making day-to-day investment decisions. However, not all the providers have actual experience of investment management. The resources, infrastructure, systems of investment management may be acquired or built, but scale and efficiency are more difficult to acquire overnight. Most importantly though, a culture of investment decision making, which dare I say it, involves making the inevitable mistakes and learning from them, takes years to develop. Trustees should therefore select providers with a proven expertise and experience of both design and implementation of pension strategies - an actual track record of investment management rather than advice.

In addition, the suggestion in the question is that fiduciary management is meant to compensate for the lack of expertise of Trustees. On the contrary, a fiduciary manager cannot take on the responsibilities of Trustees; it merely provides Trustees with the tools and resources to fulfil their obligations.

How do you determine whether a FM firm is favouring investments in its own funds, rather than objectively choosing the best ones in the market for the client?

Choosing a fiduciary manager with an open architecture multi-manager structure (i.e. using specialist managers that are independent of the provider) avoids this conflict. Ultimately, you need to consider whether your investment strategy is unnecessarily constrained because of limitations of your provider, which is the broader issue implicit in this question. Single versus multi-manager is only one such constraint. The breadth and depth of resources and scale of a fiduciary management provider are key considerations in this regard. A provider which lacks scale, depth and breadth of resources and

expertise, track record and investment DNA may impose significant constraints in terms of the investment solution regardless of whether it is a single or multi-manager approach.

Are there any learning points from other countries where FM is more common (e.g. The Netherlands)?

One of the key lessons to learn is that appointing a fiduciary manager doesn't absolve the Trustees from the responsibility for the fund's objectives and ownership of the fund's investment strategy. It is the execution of the investment strategy that is being delegated. Trustees need to understand the risks in the fund and determine whether the level and types of risk are appropriate for the fund. The fiduciary manager needs to provide Trustees with the transparency and necessary tools to perform these functions. Trustees should avoid black-box solutions where they have no understanding, visibility or control over their investment strategy.

“Appointing a fiduciary manager doesn't absolve the Trustees from the responsibility for the fund's objectives and ownership of the fund's investment strategy. It is the execution of the investment strategy that is being delegated.”

If the FM firm turns out to underperform badly, are the Trustees at increased personal risk for having taken the decision to put 'all eggs in one basket' (albeit a diverse basket)?

In Russell Investments' fiduciary management mandates the assets are managed by multiple specialist investment managers – typically a greater number of managers than the funds would otherwise have – more rather than less baskets. However, the active management risk that has been spread between multiple managers is typically a fraction of the overall fund risk. Even if a fund had spread its active manager risk by appointing multiple managers under the traditional governance structure, it would still have significant risk relative to liabilities at the

aggregate fund level – and importantly – none of these active managers would be monitoring or managing this risk. It is these unmanaged risks that have caused the dramatic fluctuations in funding levels pension funds have experienced, including the decline in funding levels in 2008.

Trustees are ultimately responsible for these risks and take on a significant level of personal risk as a consequence. Having a fiduciary manager ensures that these risks are managed in real time within guidelines set by the Trustees, with de-risking and the resultant downside protection being implemented opportunistically for instance. Appointing a fiduciary manager implies that Trustees have taken pro-active steps to identify, monitor and manage the key aggregate risks of the fund.

It is important to stress however that if total control over asset allocation and risk budgeting is delegated to the fiduciary manager, Trustees will effectively be putting all their eggs in one basket. We do not believe this is prudent. Trustees need to retain responsibility for investment strategy, which should specify the levels and types of risks to be taken. It is only the implementation of this strategy that is being delegated to a fiduciary manager, within carefully drafted guidelines and using multiple specialist investment managers. Trustees who transfer total asset allocation discretion to a fiduciary manager are more likely to take on a level of risk which is significantly greater than they realise, or is appropriate.

To sum up, if used appropriately, a good fiduciary manager enables Trustees to plan and actively manage the diverse range of overall plan level risk effectively, thus increasing Trustees' control over their pension plan. Appointing individual investment managers to manage sleeves of plan assets doesn't enable Trustees to achieve this objective, and only provides an illusion of control. Improved governance should reduce personal liability and enable more effective implementation, such as real-time decision making. ■



Shamindra Perera,
managing director and head
of fiduciary management at
Russell Investments



Delegated consulting in detail

Zuhair Mohammed explains everything you wanted to know about Delegated Consulting Services Operational Risk (but were afraid to ask!)

Investment management for pension schemes is fast evolving and in the words of Ferris Bueller¹ "if you don't stop and take a look around once in a while, you could miss it!" There is an increasing number of firms launching "delegated consulting" services for defined benefit (DB) schemes and increasing numbers of DB scheme trustees who are already reaping the benefits. Also known as implemented consulting or fiduciary management and brought to the market in varying forms, delegated management allows trustees to use external investment specialists to do more than offer advice. While the ultimate responsibility is still with the trustees and requires trustees to define investment objectives and limits, monitor regular performance reports etc, this approach takes full advantage of the range of expertise in a firm providing this service for day to day management of a scheme. For schemes with trustees who meet infrequently, who may not have in-depth investment knowledge and with constraints that prevent decisions being swiftly implemented, delegation may be a good solution.

Of course, performance is important when evaluating an investment offering, but, what about the nuts and bolts? How can trustees be confident that there is an operationally robust infrastructure or that there are adequate risk systems and controls in place? Where should their broad areas of focus be?

As a starting point, a delegated consulting team should work within a wider organisation which has a strong network of applicable expertise. This should include a well-established manager research department covering all asset classes, so that diversification can truly be achieved. It is well worth a trustee arranging to meet with the head of manager research, to gain an understanding of how the manager selection process works at a particular firm, as this will largely determine the choice of managers that will be employed by the delegated investment platform. Trustees seeking delegated consulting services including management of liabilities should also pay close attention to their advisers' asset liability matching and risk teams. Is their work innovative and up to date with market developments? What have they achieved for



other clients? More generally, the wider firm should demonstrate appropriate support in general business areas. For example, as the delegated consulting team will more than likely be approved and regulated by the FSA (for some of the investment activities undertaken) it is good practice for the team to have a dedicated compliance resource.

Ideally, a delegated consulting services team will have been carefully assembled by someone with experience in building a delegated investment services business, and as this activity requires effective management of investment assets, the team will include investment management professionals who can demonstrate independence from the underlying investment managers.

For the trustee, it is advisable to scrutinise the delegated team's risk framework. A well-designed approach should come from a very thorough risk assessment in which all operational risks facing the business are identified and a catalogue of risk controls put in place. Ideally, an external auditing firm will be commissioned for the risk assessment, as this draws on independent expertise. If you want to see a risk framework in action, ask to see a copy of a firm's operational procedures manual or similar. This will give you a good idea of where they place emphasis on risk and the focus of their key operational controls. In order to make the risk framework robust, there also has to be a way to ensure that the controls are being adhered to. So it is good practice to employ

internal monitoring personnel and for the trustees to review this annually.

Drilling down further into the day to day work of a provider, a trustee should gain a detailed understanding of its operational due diligence work on the managers used. You should expect their process to demonstrate that they "go the extra mile" in terms of investment manager selection and contingency management to replace managers etc to ensure that the investment management is effective. The due diligence work should ensure that all their managers have adequate operational systems and controls, that they have appropriate corporate governance and are examined for operational "red-

flags". The importance of this function should not be under-estimated and if you are engaging with a potential delegated provider, rigorously explore their activities in this area. A strong procedure should include a thorough written interrogation in the form of an operations and risk focused questionnaire, an on-site visit to meet key management, as well as various due diligence tasks such as verifying third party relationships (such as auditors and custodians) and reviewing the managers' financial position etc.

Finally, it is vital to appreciate that as part of the consideration of finding an appropriate delegated provider, trustees should use their position as a prospective client to scrutinise the operational robustness of a delegated consulting services firm. A delegated team of real substance will welcome this scrutiny and use the opportunity to demonstrate their operational strengths. ■

¹ Ferris Bueller's Day Off, Paramount Pictures (1986)

