Original Article

Outsourcing investment policy

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ABSTRACT This article focuses on the development of outsourcing arrangements by pension trustees, evolving from different types of providers into what is commonly known today as fiduciary management. This evolution is put into a historical context, with its beginnings in the United States, progression in the Netherlands and its expansion in the United Kingdom. Trustee attitudes over the past decade are examined, with an observation that there is almost begrudging acceptance in 2011 that the approach may have some relevance in the management of today's UK corporate pension schemes. The pros and cons of this solution are explored, including the difficulties associated with appointing a fiduciary manager, and the importance of good governance, monitoring and challenge. Finally, the reader is asked to ponder on the changing business model of the investment consultant and to reflect on the importance of an emerging role for the non-conflicted, independent investment adviser.

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INTRODUCTION

The outsourcing of investment responsibilities has been part of the trustee decision-making process for a number of decades. Delegating tasks such as portfolio management, custody and administration to third-party experts has been commonplace, with only the largest schemes setting up in-house facilities to provide these services. More recently, however, the decision to delegate an increasing proportion of fiduciary responsibilities has gained traction both in Continental Europe and the United Kingdom. The 30 or so different service providers have, somewhat unhelpfully, put their own labels on this approach, with a welter of names that can puzzle and confuse trustees. 'Fiduciary management', 'delegated consulting', 'implemented consulting' and 'solvency management' are all used to describe a broadly similar service, with the nuances of each provider's approach requiring more detailed knowledge and understanding. They can, however, be broadly split into two groups of providers: investment consultants and fund managers.

THE CONSULTANT APPROACH

To understand the subtle differences between the two types of approach, it is important to recognise that the investment consultancy offering has grown out of the advisory business model. Consequently, many consultants prefer more of the decision-making to remain with the trustees. While the implementation of that decision-making is delegated, such as the fund manager

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beauty parade or choosing between different possible strategic asset allocations, the trustees still give the final sign-off and retain the power of veto.

THE FUND MANAGER APPROACH

In contrast, fund managers have, for many years, been comfortable operating with full discretionary power to invest assets as they feel appropriate, subject to the guidelines set out in their investment manager agreements. Their existing business model means that their outsourcing approach tends to involve taking over more of the implementation process, with manager selection, monitoring, hiring/firing and portfolio implementation all being delegated to the fiduciary manager. In this structure, the manager works within pre-agreed guidelines set out by the trustee body. The trustees' fiduciary responsibility is limited to the discussion and ultimate specification (and periodic review) of those guidelines.

MOVING ALONG THE DELEGATED SPECTRUM

Most providers work with trustees to move towards a fully delegated approach in a gradual manner. The list below shows the most common, fully outsourced, decisions at the top, with those least likely to be outsourced at the bottom (that is, at the end of the delegated spectrum).

- custody of securities;
- investment/fund management;
- monitoring performance;
- manager research: identifying potential investment managers for each asset class;
- setting the managers' benchmarks and performance targets;
- actuarial advice on the management of the liabilities;
- hiring (and firing) managers as required;
- monitoring and implementing tactical opportunities to de-risk (or re-risk) the portfolio;
- deciding which asset classes to include in the strategic benchmark;
- setting the strategic benchmark (the long-term asset allocation) and the levels that will trigger further risk reduction;
- agreeing which risk mitigation strategies to consider (for example, asset-liability modelling);
- choosing an appropriate target level of risk for the investment portfolio;
- agreeing the risks affecting the pension scheme in the current climate.

It is easy to see the attraction of the one-stop shop solution. As investment strategies have become more complex, new asset classes more esoteric and markets more volatile, it is little wonder that fiduciary management has generated quite so much interest among trustees.

HISTORY

Although the concept of fiduciary management originated in the United States, it is in the Netherlands where the approach initially took hold, in 2002. Since then, an estimated 89 per cent of pension assets have turned to fiduciary management[1] in the Netherlands, propelled in 2007 by the Dutch Pension Act and the new supervisory framework, the Financial Assessment Framework (FTK). This forced Dutch pension funds to focus more on their liabilities, resulting in a desire to act more speedily in terms of asset allocation, and to place more emphasis on diversification by investing in alternative assets such as hedge funds, private equity and property.

In contrast, it is estimated that only 6 per cent of UK funds are currently using a fully outsourced investment approach.[1] Paul Myners' report in 2001 discussed the importance of proper advice and separation of interests. He expressed concern over the governance of pension funds and recommended a code of best practice for investment decision-making by pension fund trustees. It was around this time that fiduciary management first began being debated in the United Kingdom, alongside more general discussions about governance. Yet even as recently as five years ago, there was still a resounding vote of 'no confidence' when the concept of outsourcing fiduciary responsibilities was debated with UK pension funds. The sentiment then was that the members of a pension scheme would most certainly look to the *trustees* to accept responsibility, not to a third-party provider. This made it extremely

difficult for the trustees to consider outsourcing their fiduciary responsibilities, although there was a degree of open-mindedness towards the concept of outsourcing more *tasks*, such as manager selection. It is interesting to note that, at this time, Investment Sub-Committees were growing in popularity, partly as a response to Myners' report but also in recognition of the increasing complexity of the issues surrounding liability-driven investment, following the closure of many DB schemes and the need for a flight-path towards the final end-game.

The UK outsourcing debate was fuelled by the credit crunch in 2007. Concerns were expressed over whether trustee bodies could act speedily enough in the face of such a crisis. Yet, at the same time, reservations remained over whether trustees could legally discharge their responsibilities under the Pensions Act of 1995. There was still considerable resistance among UK pension fund trustees towards the approach although by this stage the larger fiduciary providers were selling the concept quite aggressively and marketing was gathering pace (helped by the scaremongering in the press throughout the credit crisis). By the turn of the decade, there was a noticeable change in the attitudes of UK pension funds (albeit still with considerable confusion over the meaning of fiduciary management). There was now a grudging acceptance that outsourcing more of the decision-making may have its place. Interestingly, though, the larger schemes seemed to think it was more suited to smaller schemes, whereas the smaller schemes thought the opposite.

This 'not for me' attitude has changed in 2011 and there is finally an acceptance that outsourcing the implementation of investment policy may be the right approach, especially now that experiences of fiduciary management can be shared. With pension funds such as GKN, MNOPF, Habitat and Asda having taken the plunge, trustees are now much more prepared to debate whether this approach is suitable for their own scheme.

BENEFITS OF FIDUCIARY MANAGEMENT

Although the providers of outsourcing solutions will bombard trustees with the benefits of fiduciary management, this article focuses on the benefits as described by the *pension funds* themselves, and not the provider. This raises an interesting point about conflicted advice and one to which I will come back later. Pension funds rely heavily on their third-party advisers when considering a strategic change in their governance arrangements. Yet genuinely impartial advice from a consultant who is also a provider of the very governance arrangements being considered is simply not going to be viable. Trustees need to consider this when undertaking a review of their existing arrangements.

- *Cost*: The fiduciary manager can charge the pension fund a single fee, which covers custody, investment advice, portfolio management, strategic reviews, manager selection and other tasks. Not only is this simpler to account for, but it gives trustees more bargaining power in terms of negotiating a discount on existing elements (the fee for the total service ought to be considerably less than the sum of the parts).
- *Speed of decision-making*: The committee process for the hiring/firing of managers can be lengthy, time-consuming and expensive in terms of manpower. Concerns over a fund manager or a decision to switch into new asset classes, for example, will be raised by the consultant then debated by the Committee. An agreement is then made to undertake a tender process. A 'Request for Proposal' (RFP) is drawn up, submissions assessed and a shortlist presented to the Committee. The manager interviews will be conducted and from that a manager appointed. All this can take up to six months, taking into account the quarterly Committee cycle. The process is considerably easier if a fiduciary manager has delegated powers to implement this on the trustees' behalf. The drain on the company's in-house pension staff's time is also considerably reduced. Regulatory issues sometimes make this level of delegation difficult: for example, UK local authority pension schemes are obliged to abide by the European Directive on public tendering which states that tendering can only be implemented through a process

advertised by the administering authority, that is the trustees, as the public body.

- *Reporting*: The pension fund receives a combined, total fund report rather than a series of individual reports with the fund manager's own customised format and presentational style. Over the many years that I have undertaken market research in this industry, one of the most common complaints from pension funds is the lack of clarity and presentational format of reporting. Investment managers' reporting is designed to be as efficient and time-saving as possible, as far as the investment manager is concerned. It can be difficult and costly for trustees to request bespoke reporting on their investments. The advantages of a fiduciary manager's combined report include consistency of style (across investment managers), a strategic view on the whole portfolio and online access.
- *A more strategic view*: Because the trustees spend less time on manager selection and asset allocation decisions, this approach allows them to take a more holistic approach, without the need to respond emotionally to market movements. The roadmap, or flight-path, then becomes much clearer. The benefits of being able to do this should not be underestimated.

DISADVANTAGES OF FIDUCIARY MANAGEMENT

- *Cost*: While there is a discount on the underlying component parts, as described under 'Benefits of Fiduciary Management', the additional layer of fees that the outsourced manager charges for absorbing more of the fiduciary responsibilities is not inconsequential.
- *Assessing value for money*: Because the fiduciary manager charges a single fee, it is difficult to assess whether individual component parts are offering good value for money or not. A pension fund may be very happy with the performance of the underlying managers, for example, but less happy with the strategic asset allocation or the de-risking decisions. It is far easier to assess contract performance against fees when the component parts are made up individually.
- *All the 'eggs in one basket'*. This approach can mean that the fund is exposed to one provider rather than many. While this is not a problem if the fiduciary manager performs well, poor performance can necessitate a major upheaval for the total fund.

APPOINTMENT ISSUES

As alluded to earlier, a key issue is the consultant's conflict of interest when advising a client as to whether or not they should move to a fiduciary management arrangement, and who they should appoint to do that job. Take the following real-life example which was relayed to me recently by one unhappy fiduciary manager. A consultant advised their client to move to an outsourced manager and drew up a short-list of three providers. The first provider went in to make their presentation. On the way out they passed the second provider and, with some surprise, realised that the second candidate was the very consultant who had drawn up the short-list. It came as little surprise to the first provider when the client appointed the second candidate!

There are two key issues to consider here:

- When seeking advice on whether or not to outsource more, or all, of their decision-making, trustees should seek input from expert independent advisers who have *no involvement whatsoever* in the fiduciary management space. Impartial and objective advice should be just that. Good governance can only be adhered to when trustees make decisions, based on input from expert advisers, the outcome of which neither benefits nor disadvantages that adviser.
- Trustees should spend time assessing the relative merits of the different providers' approaches, and should undertake sound and thorough due diligence on any short-list. Independent firms can provide help with this: due diligence should not be undertaken by any consultant who offers this approach themselves, even if they are not on the short-list being considered. While there are many honourable consultants in the industry (and I should stress that I have considerable respect for many individual advisers at these firms), trustees

must recognise that a potential conflict of interest exists. For example, it may benefit the consultant to recommend firm X over firm Y, especially if firm Y is a major competitor.

THE IMPORTANCE OF MONITORING AND CHALLENGE

Once the exhausting process of choosing a fiduciary manager has been undertaken, one of the main concerns for a trustee body then becomes how to monitor effectiveness and how to challenge with rigour and expertise. Just because a trustee body has outsourced some, or most, of its decision-making does not mean they can absolve themselves of any responsibility over the performance of that provider. The bewildering selection of asset classes, the esoteric instruments used in LDI strategies, the perplexing graphs mapping the path of the deficit using Monte Carlo simulations, all this can leave trustees nodding wisely during presentations from their outsourced manager without really understanding how to challenge this expert knowledge. Bear in mind that the fiduciary manager has to provide evidence that the trustees made a wise decision to outsource. The danger is that they evidence that with unnecessary complexity.

By appointing an independent adviser, trustees can rely on impartial but expert insights into the fiduciary manager's ability. An independent adviser can, for example, unpack the complex graphs, explain how the esoteric instruments work and challenge the manager on why a new asset class has been introduced.

Acting as an interface between provider and supplier, an independent adviser is able to ask questions such as:

- Does the strategy still reflect the trustees' de-risking objectives?
- Has any rebalancing programme been activated, and if so, has it been effective?
- Has the communication from the fiduciary manager been clear and concise?
- Is advice being given with conviction? Is it genuinely tailored to the scheme, or is it a house view?
- Are ESG and SRI issues being reflected in the strategy, according to the Scheme's wishes?
- Is training being delivered effectively, especially for new asset classes or instruments?
- Is the administrative support satisfactory? How might weaknesses be improved?
- Has the speed of decision-making increased, and has this helped performance?
- Is the fiduciary manager giving good value for money?

Knowledge of the wider industry gives the independent adviser the ability to compare one outsourcing provider with another. This allows the trustees to benchmark their own supplier against the industry standard, something they would otherwise be unable to do effectively.

A CHANGING BUSINESS MODEL

Regardless of whether or not a pension fund chooses to outsource decision-making, it is important to recognise that the model for pension fund investment is changing. The demarcation lines between fund manager and consultant are becoming blurred. Fund managers are now less comfortable than ever about sharing information openly with a consultant, who may next week be pitching for the same piece of business as them. The pastry has been re-rolled and the pie is being cut up again. There are compelling reasons why this had to happen but trustees need to recognise that the brave, new world has brought with it potential conflicts of interest for their consultant.

So, what about the independent adviser: offering expert investment advice, but without all these extra trimmings? Into my head comes the phrase 'The King is Dead, Long Live the King'. Pension fund trustees will still need to receive independent, expert views in order to fulfil their duties as a trustee, even in this brave, new, outsourced world. The pieces may be moving around the chessboard but the rules of the game remain the same.

NOTE

1 According to market research by Spence Johnson.

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