CFA Institute®
Global Investment
Performance Standards

EXPOSURE DRAFT

GUIDANCE STATEMENT ON COMPOSITES FOR FIDUCIARY MANAGEMENT PROVIDERS TO UK PENSION SCHEMES

Effective Date: TBD

Public Comment Period: 20 July 2023 – 20 September 2023

CFA Institute

© 2023 CFA Institute. All rights reserved.
www.cfainstitute.org

GIPS® is a registered trademark owned by CFA Institute.

© 2023 CFA Institute. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the copyright holder.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is distributed with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

INVITATION TO COMMENT

Exposure Draft of the Guidance Statement on Composites for Fiduciary Management Providers to UK Pension Schemes

CFA Institute established the GIPS Standards Fiduciary Management Provider Technical Committee (FMP TC) as the governing body for the Global Investment Performance Standards (GIPS®) for Fiduciary Management Providers to UK Pension Schemes. The FMP TC, which is responsible for the technical oversight of the GIPS standards for FMPs to UK Pension Schemes, seeks comment on the proposal set forth herein regarding the Guidance Statement on Composites for Fiduciary Management Providers to UK Pension Schemes.

Questions are positioned throughout the document to elicit feedback on specific issues. In addition to responding to specific questions, please provide feedback on the entire document, including items you support. All comment letters will be considered carefully and are greatly appreciated.

Comments must be received no later than 20 September 2023. Please submit your comments as early as possible to facilitate the review process. Unless otherwise requested, all comments and replies will be made public on the GIPS standards website (www.gipsstandards.org). Comments may be submitted by email to standards@cfainstitute.org.

Introduction

The GIPS standards for Fiduciary Management Providers to UK Pension Schemes ("GIPS standards for FMPs") are ethical standards for calculating and presenting investment performance based on the principles of fair representation and full disclosure.

The GIPS standards for FMPs require Fiduciary Managers (FMs) to include discretionary schemes in composites following a required composite structure. Schemes are generally classified as either unconstrained or having hedge restrictions and are further classified by return objectives. We understand that there is some ambiguity on how some Provisions in the GIPS standards for FMPs should be interpreted. For example, how should a scheme be classified when the FM advises on a hedge target versus when it does not, or should a scheme be included in a hedge restriction composite if the FM sets the hedge target?

This exposure draft of the Guidance Statement on Composites for the GIPS standards for FMPs seeks to provide clarity on some of the issues that have been brought before the FMP Technical Committee.

Composite Assignment

Many scenarios could arise where it might be unclear as to how a Fiduciary Manager (FM) should classify schemes for composite assignment purposes. To assist FMs in this endeavor, we provide some broad guidance as well as some specific scenarios. Generally, the objective of the GIPS standards for FMPs is to include as many schemes as possible in unconstrained composites (i.e., to consider schemes as unconstrained except where the client imposes an asset restriction or specifies a hedge target that is materially different from what the FM would choose to implement, given the discretion to do so). This approach will allow more comparability between FMs. Where the FM has accepted a scheme with a hedge target that is in the hedge range that the FM would consider to be appropriate, whether implicitly or explicitly, the scheme should be classified as unconstrained.

Some guiding principles that apply across all composites include:

- Where the client has selected a hedge target (e.g., 75%) or hedge range (e.g., between 70% and 80%) that is not materially different from the hedge target or hedge range that the FM would choose to implement, the scheme should be considered unconstrained.
- Where the FM has recommended a hedge target or hedge range that the client has agreed to, the scheme should be considered unconstrained.
- A scheme should not be considered hedge restricted solely because the hedge target or hedge range is specified in the investment management agreement (IMA).
- At times there may be changes in laws or regulations that will require the FM to change the return objective for a scheme, but the scheme is still considered unconstrained. When there are changes in laws or regulations that restrict an FM's ability to meet the return objective for a scheme (e.g., there is a reduction in leverage allowed by regulation), the FM should discuss the return objective with the client and document any agreed-upon changes. The agreed-upon changes may necessitate moving a scheme to a different composite. As an example, assume a scheme has a target return of liabilities +2%, but due to the decrease in allowed leverage, the new target return is liabilities +1%. In this case, the scheme should be moved from the unconstrained liabilities + 1.5% < x ≤ 2.5% composite to the unconstrained liabilities + 0.5% < x ≤ 1.5% composite.
- Decisions on composite assignment must be made on an ex-ante basis. Schemes should not be assigned to composites with the benefit of hindsight or based on how the scheme performed.

The following scenarios and guidance are intended to help FMs better understand how certain situations should be handled.

1. Scenario: The FM has recommended a hedge target (e.g., 75%), and the hedge target is specified in the IMA. Because the hedge target is specifically listed in the IMA, should this scheme be considered hedge restricted?

   Guidance: Where the FM has recommended a hedge target, and the hedge target that is specified in the IMA is the same as the hedge target that is recommended by the FM, the scheme should be considered unconstrained.

2. Scenario: The FM has recommended a hedge target of 80%. However, the client specifies a hedge target of 60%, which is materially different from the hedge target recommended by the FM. How should this scheme be classified?

   Guidance: Where the FM has recommended a hedge target and the client insists on a hedge target that is materially different, the FM should consider this scheme to be hedge restricted.

3. Scenario: The FM has recommended a hedge target of 85%. However, the client selects a hedge range that does not include the hedge target (e.g., a range of 75-80%). How should this scheme be classified?

   Guidance: Where the FM has recommended a hedge target or a hedge range that is different from the hedge range specified by the client, the FM should consider whether the difference between what the FM recommended and what the client specified is material. If the FM determines that the difference is immaterial, the FM should consider the scheme to be unconstrained. If the FM determines that the difference is material, the FM should consider the scheme to be hedge restricted.

4. Scenario: The FM has advised on the hedge target for a mandate with a high return target and liquidity constraints and has full discretion over the investment mandate. Given that higher return mandates and mandates with liquidity constraints often limit the amount of hedging that may be possible, how should this scheme be classified?

   Guidance: Where the FM has advised on the hedge target given the client's higher return mandate and liquidity constraints, and has full discretion to implement the mandate, the FM should consider the scheme as unconstrained.

5. Scenario: A scheme is currently classified as hedge restricted because the FM's hedge target recommendation was materially different from the hedge target specified by the client. Over time, the FM's hedge target recommendation has changed and now it is consistent with the client's specified hedge target. How should the scheme be classified?

   Guidance: If the FM has changed its recommended hedge target over time and its recommendation is now consistent with the client's specified hedge target, then the FM should consider the scheme unconstrained as of the date for which the FM's recommendation and the client's hedge target are consistent. The scheme should be moved from the hedge-restricted composite to an unconstrained composite on a prospective basis. The historical performance of the scheme must remain with the hedge-restricted composite.

6. Scenario: The FM acquired a new scheme, and the hedge target was determined by the prior FM. The hedge target is within the hedge target range that the FM would have recommended. How should this scheme be classified?

   Guidance: Where the FM has acquired a scheme that has a pre-established hedge target that falls within the hedge range that the FM would have recommended, the FM should consider the scheme as unconstrained.

7. Scenario: The FM does not recommend a specific hedge target but recommends a hedge range. The scheme adopts a hedge target that falls within the recommended hedge range. How should this scheme be classified?

   Guidance: When the FM recommends a hedge range and the scheme adopts a hedge target that falls within the recommended hedge range, the scheme should be classified as unconstrained.

8. Scenario: The client allows for a hedge between 50% and 100%. The FM has recommended a hedge target of 60%. How should this scheme be classified?

   Guidance: Where the FM has recommended a hedge target that is within the hedge range allowed by the client, the scheme should be considered unconstrained.

9. Scenario: The client allows for a hedge range between 50% and 100%. The FM has recommended a hedge target of 70%, which is within the allowed hedge range, and the FM considers the scheme to be unconstrained. Due to market conditions, the FM makes tactical changes that cause the scheme's hedge % to move away from the 70% hedge target. How should tactical changes be treated?

   Guidance: Schemes should not be moved between composites due to tactical decisions. See the discussion for Provision 33.A.8 in the GIPS Standards Handbook for FMPs.

10. Scenario: The client imposes a hedge range between 70% and 90%, which is outside the range recommended by the FM. The FM considers the scheme to be hedge restricted. Because the hedge target spans two hedge-restricted composites, should the scheme be included in the hedge restriction 60% ≤ x < 80% composite or the hedge restriction 80% ≤ x ≤ 100% composite?

    Guidance: Occasionally a scheme that is considered to be hedge restricted will have a hedge range that spans more than one hedge-restricted composite. In such cases, if the scheme also has a specific hedge target, the FM should include the scheme in the hedge-restricted composite based on the specific hedge target. If the scheme does not have a specific hedge target, the FM will have to use its judgment to determine which hedge-restricted composite is

the most appropriate. The FM should document its reasoning for why it believes the selected composite is the best fit.

11. Scenario: The client's guidelines in the IMA limit the position in an issuer to 5% of net assets. How should the FM classify schemes with these types of restrictions?

    Guidance: A client's investment policy statement (IPS) may include a number of restrictions or asset class limitations (e.g., a limit on holding more than 5% in one issuer, a limit on the percentage of foreign investments, a limit on the percentage of bonds rated below investment grade, a limit on the percentage of illiquids the scheme may hold, or a limit on the strategic allocation to property), which the FM must consider when taking on a client. The FM must determine if such restrictions and limitations will impact its ability to manage the scheme to the intended mandate. If the FM can reasonably manage around these restrictions and limitations, the scheme should be considered unconstrained. If the FM determines that the restrictions and limitations have a material impact on its management of the scheme, the FM may classify the scheme as asset restricted.

12. Scenario: The FM tendered and won a strategy for a scheme that is targeting a buyout in 5 years. The FM and the client agreed on a target return using only liquid assets. Should the FM classify the scheme as asset restricted?

    Guidance: The scheme is being managed within the specifications of the mandate, which reflect the planned buyout in 5 years and is not a specific client restraint per se. If the FM is able to manage to the target return using only liquid investments, the FM should consider the scheme to be unconstrained.

13. Scenario: The FM acquired legacy private equity assets. Should the FM classify the scheme as asset restricted?

    Guidance: There will be times when an FM acquires assets from another FM that cannot be liquidated for a period of time, or even on a longer-term basis. The high cost of disposing of some legacy assets may also cause the FM to keep assets it would otherwise wish to sell. FMs should consider whether the legacy assets represent a material amount of assets and whether the FM can manage around these assets. FMs are encouraged to classify such schemes as unconstrained unless the amount of legacy assets is so large that it has a material effect on the FM's ability to manage the scheme to its intended strategy.

14. Scenario: A client wished to review and approve strategic asset allocations falling outside the range of asset allocation parameters delegated to the FM provider. How should the FM treat this situation?

    Guidance: There is no clear answer here. The FM should consider whether such a client request results in the scheme being considered non-discretionary. If the FM determines that the client request materially impacts its investment discretion and therefore considers the scheme to be non-discretionary, the FM should document its decision and the reasons for considering the scheme to be non-discretionary.

Question: Do you agree with the guidance above? Are there any scenarios that you do not agree with or that you think require additional guidance? Are there any scenarios that should be added? Please provide comments on any specific scenarios.

Broadly, we agree with the guidance set out above but have suggested some additional aspects to consider in some scenarios. Even with the guidance there still exists scope for subjectivity and outcomes which may not reflect a reasonable representation of FM skill. We comment on each scenario further below.

We welcome both the initial setting up of the composites and the additional guidance provided here. At a high level, the CMA's report set out that for prospective fiduciary clients 'it is difficult to compare the performance 'track record' of competing providers' and that the 'methodologies used … vary considerably' making it 'extremely difficult to draw like for like comparisons'. The large number of scenarios highlighted here and the degree of subjectivity that still exists within the related guidance for each scenario will still make it difficult for prospective clients to draw reasonable comparisons.

We would like to see additional guidance / information provided for the users of the data contained in the composites in terms of interpreting it.

Fiduciary management presents a challenge in that performance is assessed against a liability benchmark (which itself is open to interpretation and variability). Relative performance is therefore driven by the performance of a) growth assets and b) the amount of hedging undertaken. Historically, hedging has been the dominant driver of relative performance. However, as these scenarios suggest, often the amount of hedging taken is not a pure investment decision by the FM i.e. the client can specify it or it can be a function of high investment objective/ lower leverage post the gilt market turbulence. Furthermore, where it is a pure investment decision, the value added is not a reasonable measure of FM skill given the binary and extreme nature of the outcome.

Given this it would seem preferable from a prospective client's point of view to focus on the performance of the growth assets relative to cash. This is a better measure of FM skill and avoids the issue of who decides the hedge ratio and which measure of liabilities to measure against. However, accepting that some FMs do target and generate relative returns from hedging decisions then it is

reasonable that the standards focus on top level performance. Currently though the standards present the user with an average return (and risk) number with no context around how this number was generated and whether it was largely driven by FM skill or luck (the latter of which, as highlighted in the previous paragraph, is conceivable). We believe there is more information that could be provided to help meet the initial aim of drawing 'like for like comparisons'. For example,

- Showing performance of unconstrained composites additionally versus the hedge-ratio adjusted benchmark rather than just full liability benchmark;
- The FM stating the level of discretion they are allowed to take on active LDI decisions;
- Attribution of performance attributable to LDI decisions;
- Attribution of performance attributable to growth portfolio decisions.

Scenarios that should be added

1) A client hedges a % of liabilities that attempts to equate to 100% of assets. The FM has advised a benchmark hedge ratio of 100% of assets.

We believe this client should not be included in the unconstrained composite. There will be inevitable funding level drift between their benchmark and the liability benchmark. This drift will impact the relative level of performance and is not a result of an active LDI view by the FM and as such not a reasonable reflection of their skill.

2) A client has a hedge ratio of 100% of assets with credit default swaps (CDS) embedded within the benchmark. The FM has recommended a hedge ratio of 100% of assets and is not assessed against the CDS performance (as it is embedded in the benchmark).

We believe this client should not be included in the unconstrained composite. When performance is compared against the liability benchmark (as defined in this guidance) then the performance of the CDS will be shown as a value add for the FM. However, this is not a reasonable reflection of the FM's skill as the decision to invest in CDS is in most cases not one that is made by them.

In both cases above, compelling assessment against the hedge ratio adjusted benchmark (in addition to the liability benchmark) will alleviate the issues.

Comments on each Scenario

Scenario 1 – currently the unconstrained composites only prescribe performance versus the liability benchmark. In this scenario the scheme is 25% underhedged on interest rates versus the liability benchmark which will materially impact performance and has a (potentially large) binary outcome. Performance versus the hedge-ratio adjusted benchmark should also be prescribed and, ideally, performance attribution splitting out the contribution to return from LDI and growth assets.

Scenario 2 – we agree with the guidance. We note that different FMs will have different levels of what is deemed material.

Scenario 3 – this combines scenarios 1 and 2 and as such the same challenges. Additionally, if an FM deems the difference to be immaterial there is an added complexity in like for like comparisons with the unconstrained composite. Performance is compared versus the liability benchmark and so has the same challenge as Scenario 1. Added to this under this scenario is the difference in hedge ratio which is driven by the client decision. This is not a reflection of FM skill and currently there is no way for a prospective client to discern this. Prescribing performance versus hedge-ratio adjusted benchmark and performance attribution will help in this respect.

Scenario 4 – classifying this as unconstrained presents the same challenges as we set out for Scenario 1

Scenario 5 – we agree with the guidance but note that where the FM's recommended hedge target is < 100% then the challenges of scenario 1 (and 3) we set out above will apply.

Scenario 6 - we agree with the guidance but note that where the FM's recommended hedge target is < 100% then the challenges of scenario 1 (and 3) we set out above will apply.

Scenario 7 – we agree with the guidance but note that where the FM's recommended hedge target is < 100% then the challenges of scenario 1 we set out above will apply.

Scenario 8 - we agree with the guidance but note that where the FM's recommended hedge target is < 100% then the challenges of scenario 1 we set out above will apply.
Scenario 9 – we agree with the guidance

Scenario 10 – we agree with the guidance

Scenario 11 – we agree with the guidance

Scenario 12 – at a high level we agree with the guidance but variations of this theme do introduce some potential unintended consequences. For example, a particular composite may consist solely of a small number of schemes all with liquid portfolios. However, the portfolio for the prospect may contain a material amount of illiquid assets and hence the composite numbers are not representative of the mandate for the prospect.

Scenario 13 – we agree with the guidance, if the FM is willing to take on legacy assets then they should always be placed in the unconstrained composite (assuming the hedge ratio target is in line). Like our comments on Scenario 13 this could lead to unintended consequences if, for example, this client is the sole client in the composite it is subsequently placed – the performance shown will not necessarily be representative of what other prospective clients in this composite might expect.

Both scenarios above highlight issues with composites with a small number of mandates in general and trying to draw meaningful comparisons from them. This extends beyond the make up of the portfolio but also, for example, the investment objective return. At an extreme, two FMs may only have one client each in a particular composite but the target returns may be up to 1% different with no way for the prospect to identify this.

Scenario 14 – we agree with this guidance

Liability Benchmark

We understand that further clarification may be needed regarding the definition of liability benchmark.

15. Scenario: A scheme has a hedge target of 80%. The liability benchmark included within the IMA reflects the liabilities scaled by the hedge target (80% of full liabilities). How should we determine the liability benchmark in this situation?

    Guidance: The FM must present performance relative to the liability benchmark. A liability benchmark may be:

    - 100% of full liability cash flows;
    - a liability proxy benchmark constructed from gilts or swaps to represent the cash flow liabilities; or
    - a gilt of similar duration to the liabilities if neither the full liability cash flows nor a liability proxy benchmark constructed from gilts or swaps exists.

    This is true whether the scheme is included in an unconstrained or hedge-restricted composite. The hedge target or ratio is not a factor when calculating the liability benchmark.

    If the scheme is included in a hedge-constrained composite, then the FM must also calculate a hedge ratio–adjusted benchmark and present performance relative to both the liability benchmark and the hedge ratio–adjusted benchmark.

Question: Does the guidance on liability benchmark clarify what is meant by liability benchmark? If not, please let us know where further guidance is needed.

Following the discussion on the call on 29 August we think there needs to be clarification that the liability benchmark return is the return on the liabilities which is equivalent to a benchmark of 100% of assets.

If the benchmark is 100% of the liabilities scaled to the value of the assets, then the benchmark return will exactly equal the return on liabilities. This is akin to if the benchmark was 100% of MSCI scaled to the value of the assets then the benchmark would exactly equal the MSCI return.

If instead the benchmark is 100% of the liabilities (i.e. not scaled to the value of the assets), then the benchmark value would be 100% of liabilities +/- a cash amount, where the cash amount is such that the

value of the benchmark equals the value of the assets. The benchmark return would then be part liabilities and part cash, and therefore not equal to the return on full liabilities.

We suggest that the FM must also present performance against the hedge-ratio adjusted benchmark for an unconstrained composite as well as a hedge constrained composite. Without this, material differences between FM returns will be highlighted which don't represent their skill. The scenarios set out in this document highlight that the hedge ratios for unconstrained composite clients might also differ materially from the liability benchmark (and that this may or may not be by the design of the FM).

By only showing unconstrained performance versus the liability benchmark the scope exists for the relative performance of FMs with hedge ratios not equal to 100% of assets to vary significantly. This could be either positive or negative but it is a) not necessarily an investment decision made by the FM b) the outcome is not a reasonable measure of FM skill given the binary nature of the outcome and c) there is no way for the prospective client to attribute the relative performance between hedging and growth asset decisions.

In the absence of adding attribution as part of the composite output, compelling FMs to show performance of an unconstrained composite versus a hedge adjusted benchmark would lead to more meaningful comparisons. We believe this should be a relatively easy adaptation for FMs to make as they are already calculating hedge adjusted benchmarks.

Effective Date and Application of Guidance Statement

The FMP Technical Committee recognizes that any proposed guidance that is adopted would likely result in FMs needing to make changes to composite membership. We propose requiring FMs to implement any changes required by this Guidance Statement no later than six months from the effective date of the final guidance statement. FMs may apply the changes on a prospective basis or retroactively if they choose. Any changes that affect composite assignment, whether prospective or retrospective, would require disclosure of the change in the GIPS Composite Report (e.g., effective 1 January 2024, some schemes that were previously included in a hedge-restricted composite were reclassified to the unconstrained composite on a prospective basis).

Question: Do you agree that FMs should be required to make changes only on a prospective basis, or do you think FMs should be required to make any changes retroactively? If you agree with requiring changes on a prospective basis only, should FMs be allowed to make changes retroactively, provided they disclose that the changes were made retroactively?

FMs should be required to make these changes retroactively. We welcome the guidance here, which in addition with further input from all FMs, will help meet the aims of more meaningful comparisons for prospective clients. This guidance may result in material changes for some FMs. Applying them prospectively only, would leave composites with different definitions at different points in time. The historic definitions are known to be 'incorrect' and possibly materially so. This will mean that longer term performance comparisons continue to lack meaning and the aim of providing this guidance will not be met.

Requiring changes to be required retroactively does provide scope for FMs to game the situation but we believe the requirement for clear composite definition and documentation for rationales undertaken counters this.

If calculating the attribution historically is overly problematic for FMs then the history could be reduced to, say, the last 5 years and the composites begin from that point in time.

Other

Question: Given the changes in the liability-driven investing (LDI) market and collateral requirements, are there any additional situations that we should address?

The clear direction of travel from the guidance is for as many clients to be defined as unconstrained as possible. The guidance indicates that this may include clients with hedge ratios significantly below 100% and that this may be a result of the target rate of return being too high to allow a 100% hedge. As unconstrained composites are currently compared versus the liability benchmark only, this could encourage FMs to use as much leverage as possible to maximise the hedging. This seems contrary to public policy and we suggest the views of the Bank of England are sought on this proposal.