Response to the Exposure Draft – Guidance Statement on fiduciary management providers to UK Pension Schemes

Background

After several years of operating GIPS for Fiduciary Manager Performance further guidance is required on the construction of composites to ensure the maximum level of comparability between fiduciary managers (FMs). Consequently, I welcome this initiative by the CFA Institute, and I am pleased to provide my feedback in a personal capacity.

The original intention of the performance standard was to create a methodology that as far as possible was able to separate skill from noise. This led to the structure of 'unconstrained' composites, with hedging levels of 100%, with other 'constrained' composites for hedging levels that deviated from this. In deciding on the original structure, I asked FMs what hedging level would be their neutral position if there were no client constraints, a survey IC Select continue to carry out on an annual basis. Every year in response to this the majority of FMs state that they would hedge 100% of interest rate and inflation risk if they were able to do so. Of those that do not specify a 100% hedge, we cannot recall any manager, at any time, suggesting that they would hedge less than 95% of either interest or inflation risk. FMs do not consider that interest rate or inflation risks are risks worth taking (unrewarded risk) and would always, unless client demands dictate otherwise, hedge this away except for small tactical positions.

With hindsight, when we were developing the standard, the use of the word 'unconstrained' to define these portfolios capable of 100% hedge was perhaps ill considered. It might have been better to refer to them as the 'neutral' portfolio that most closely reflect the FMs pure investment thinking. Any deviation from this will only occur because of either client constraints, liquidity constraints or the investment time horizon, all of which are out of the fiduciary manager's control even though they may modify their 'neutral' advice to accommodate them. Therefore, it is essential that any performance standard should seek to separate the performance of the neutral or unconstrained portfolio from those portfolios that significantly modify the neutral portfolio because of constraints.

Fiduciary managers act as both asset manager and investment adviser to a fund. Whilst these roles are closely integrated it needs to be recognised that they are separate, indeed, at many managers they involve separate legal agreements and, for some funds, the role of investment adviser may be outsourced. The advice that the adviser gives has to comply with guidance from the Pension Regulator, particularly now in terms of liquidity management. There is limited scope for a FM to deviate from this guidance and, consequently, advice from FMs and investment advisers on liability hedging will fit into a narrow band with the only significant driver of difference the investment assumptions of a particular firm and the construction of the growth assets.

I agree that the universe of firms that fit into unconstrained composites is disappointingly low, although I believe that if the areas for improvement outlined below are addressed then this can be enhanced. However, if the changes outlined in the exposure draft on liability hedging were implemented then the data in the performance standard would become virtually useless as the noise from interest rate and inflation hedging would overwhelm any signal of skill for a manager. This amount of noise over signal would mean that the standard would not present investment performance based on the principles of fair representation between managers and could lead Trustees to make erroneous decisions, based on the standard, that are detrimental to their duty as Trustees.

For example, in the last year the noise element could represent an increase of 15% (e.g. from 1% to 16%) in relative return as a result of under-hedging, completely swamping the skill information in the data.

Whilst the use of the hedge adjusted performance would to some extent mitigate this effect it would not allow managers that follow a total portfolio approach to fairly represent their performance. These managers will often make small adjustments to the hedging levels to gain tactical exposure to interest rates or inflation instead of investing an element of the growth portfolio in government or corporate bonds. The hedge adjusted approach neutralises these tactical decisions when assessing performance and does not provide a fair representation of total portfolio managers added value.

Areas for improvement

I do not regard the current standard as optimal as there are areas of guidance on composite construction that can benefit from greater clarity. In my view the most significant issues to be addressed to improve the standard are:

a) **The treatment of hedge constraints close to 100%.** How should a client be defined where the IMA specifies a hedge level from 95% to 100% of assets when if the FM would, in a fully unconstrained approach, hedge 100% with a small tactical deviation?

   Where a manager includes a hedging constraint as part of their legal agreement this is to do with the structure of the contracts rather than any view of whether the portfolio is constrained. If the constraint, as shown in the legal documentation, would still allow the manager to hedge 100% of the asset value of the liabilities then this would still allow the manager to invest in the 'neutral' portfolio. However, once the constraint is of a level of magnitude that the 'neutral' portfolio could not be achieved then this has to be treated as a constrained portfolio as the manager is being forced to take investment risk they do not want to take because of constraints.

   Consequently, scenarios 1 -10, as described in in the exposure draft, must be regarded as constrained. To do otherwise would render the data next to useless and would fail to allow fair representation between managers.

b) **The treatment of portfolios without private assets.** If an FM would normally include private assets as part of the growth portfolio but is unable to do so because of either a liquidity constraint on the fund or the timeline to buyout, this should be treated as unconstrained?

   In this circumstance the FM is still proposing a portfolio that they believe can achieve the target investment return even though there may be limits on the amount of private assets that can be used. In other words, there are rewarded risks that the manager proposes to take to achieve the target. Although this may not be the FM's optimal portfolio, it is still a portfolio that the FM believes will achieve the goal within the normal bounds of rewarded risk. It would therefore fall into their set of neutral or unconstrained portfolios.

   Therefore, scenarios 12 to 14 would be a positive addition to the standard and would improve the representation between managers and increase the universe of funds considered as unconstrained.

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