20 September 2023

Guidance statement on composites for Fiduciary Management Providers to UK pension schemes

Cardano's response

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Dear Members of the Fiduciary Management Provider Technical Committee,

Response to the CFA Institute's Fiduciary Management Provider Technical Committee's consultation on composites for Fiduciary Management Providers to UK Pension Schemes

Thank you for the opportunity to comment on the Global Investment Performance Standards (GIPS®) for Fiduciary Management Providers (FMPs) to UK Pension Schemes.

This response is provided on behalf of Cardano Risk Management Limited ("Cardano") which provides specialist fiduciary management services to UK pension schemes.

Our response is divided into two parts:

- Firstly, we have used this consultation as an opportunity to share our perspectives on the standards more generally, as well as how composites are being used and applied in the FM market.
- Secondly, we have commented on each scenario and accompanying guidance. We have indicated clearly where we support the guidance and, where our views differ, sought to explain why.

We would welcome the opportunity to discuss or elaborate on any aspect of our response with you.

Yours faithfully,

Richard Dowell
Partner and Co-Head of Clients

Andrew Stewart
Head of Client Solutions

Overall perspectives on the consultation

We believe the consultation and the guidance therein is helpful to the industry to clarify how different situations should be approached.

However, there are three broad areas where we either disagree with the conclusions (or direction of the guidance) or where we believe more clarification is required. We have commented as such in response to the relevant scenarios/guidance (see subsequent section) but for additional clarity we also provide an overview of this thinking below.

Association of specified investment targets with an unconstrained mandate

There are two scenarios in the consultation (1 and 4) which discuss specific investment parameters which have been agreed following advice. However, the provision of the advice, and the agreement of the parameter, should not be confused with exercising investment discretion.

This is because the recommendations may often represent a compromise between the preferred position of the FM (e.g., house views or best ideas) and the client's constraints, preferences and beliefs or that of other stakeholders. The ultimate decision can have a large impact on the level of hedging and/or choice of investments. As such, clients may agree parameters which lead to a markedly different portfolio to an FM's best ideas portfolio and it is not appropriately automatically to treat them as unconstrained. That distinction should come down to how material the portfolio differences are (see subsequent points).

Encouraging a greater number of schemes to be treated as unconstrained

A running theme throughout the guidance is to set higher thresholds for FMs to allocate their clients to composites that are restricted e.g., by hedge ratio or asset class. If adopted, this will inevitably lead to most schemes being classified within FMs' unconstrained composites.

We have an alternative view. Unconstrained (and constrained) portfolios vary amongst FMs. That's a good thing for trustees as it promotes healthy competition and choice. Reporting performance in a way that fairly illuminates these differences should be encouraged and emphasised to support better decision-making and client outcomes.

In our view, the proposal to treat most schemes as "unconstrained" will obfuscate, rather than highlight, differences between FMs' approaches. That is because the reported results will converge to the FM's "average" composite portfolio (which doesn't exist in practice), even when that is not representative of their best ideas approach. This would be the case where an FM runs a meaningful portion of mandates which place material limitations on the investment toolkit (due to views on costs and liquidity for example). We expect this is the case at most FM firms.

We would instead advocate the use of composites that are delineated by asset class restrictions (see comments below) as these would provide a much better representation of the solutions that trustees are asked to compare and choose between in selection processes. We consider this to be the best way to ensure that the composite reports provided to prospective clients reflect the performance of the FM's clients who follow the same strategy to the one that is under consideration.

We don't think this is new news. In fact, Third Party Evaluators (TPEs) have been "plugging" this gap for some time. Whilst approaches amongst TPEs vary, a consistent theme is the provision of performance information in procurement exercises which takes a different form to the GIPS® standards for FMs in order to assist with like-for-like comparisons between FMs.[1]

[1] Most commonly, the performance of the proposed growth portfolio over several time periods.

Differentiating between constrained and unconstrained approaches

We believe there is significant value in differentiating between investment approaches to provide the end user with useful and representative information to take decisions on.

Where the differentiation is based on the hedge ratio, we believe the scenarios and guidance in the consultation generally provide sufficient clarification of how to handle different cases (subject to our first point above about not necessarily associating a specified investment parameter with an unconstrained mandate and to our last point below about clarifying what counts as a material deviation from the FM's preferred position).

But, where the differentiation is based on asset restrictions within the non-LDI assets, we believe further guidance is required. First, to confirm that this is appropriate and beneficial for the purposes of FMPS. Second, to clarify how asset restrictions should be handled in practice. We recognise that this needs to be simple and suggest the following type of distinctions would be appropriate:

- Unconstrained including use of illiquids
- Unconstrained but illiquids restriction

Illiquids have a meaningful impact on realised risk when measured by volatility because they re-value infrequently

- Cost constrained
- Cashflow-oriented

These composites should then be delineated by hedge ratio, creating results that are much more likely to be reflective of the proposed portfolios than not.

Many clients will have portfolios which do not fit neatly into the above categories, for example they might follow an unconstrained approach aside from an allocation to inherited illiquids (as per scenario 13). Hence case-by-case judgements will have to be made around the appropriate classification. Although this cannot be fully prescribed, some guidance on how to do this is necessary. Otherwise different FMs will treat the same situation differently, leading to less comparable results and undermining the overall purpose of FMPS.

Composite assignment

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.

For each scenario, we have indicated where we agree with the accompanying guidance. Where our views differ, we have sought to explain why and what changes or clarifications we would make to the guidance.

Scenario 1

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 1

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.

Comments:

Disagree.

The Trustees decide the parameters specified in the IMA, after taking after appropriate investment advice. In some cases, the parameter is a compromise between the preferred position of the FM (e.g., house views or best ideas) and the client's constraints, preferences and beliefs.

Hence, the existence of a hedge target in the IMA does not imply that the scheme is unconstrained. Rather, it is unconstrained only when the IMA hedge target is consistent (not materially different) to the FM's preferred position. In this scenario, the performance of the portfolio could differ significantly from other portfolios and would not represent the "value add" of the fiduciary manager.

Scenario 2

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 2

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.

Comments:

Agree.

Scenario 3

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 3

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.

Comments:

Agree.

However, different providers may take different views on what counts as material. Hence, guidance on this is required to ensure consistent approaches. See our opening comments.

Scenario 4

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 4

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.

Comments:

Partially agree.

As per Scenario 1, the Trustees decide the objective of the mandate, after taking after appropriate investment advice. In some cases, these are a compromise between the preferred position of the FM (e.g., house views or best ideas) and the client's constraints, preferences and beliefs.

Hence, the existence of a hedge target does not imply that the scheme is unconstrained. Rather, it is unconstrained only when the hedge target is consistent (not materially different) to the FM's preferred position. Some judgement should be applied by the FM when prospectively classifying this client for inclusion in the most relevant composite.

Scenario 5

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 5

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.

Comments:

Agree.

Scenario 6

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 6

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.

Comments:

Agree.

Scenario 7

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 7

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.

Comments:

Agree.

Scenario 8
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 8
Where the FM has recommended a hedge target that is within the hedge range allowed by the client, the scheme should be considered unconstrained.

Comments:

Agree.

Scenario 9
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 9
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.

Comments:

Agree.

Scenario 10
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 10
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.

Comments:

Agree.

Scenario 11

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 11

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.**

Comments:

Disagree with blue highlighted text.

We find it hard to believe that there are any active FM mandates where an FM has signed up to a set of restrictions that the FM is unable to reasonably manage around (i.e., invest appropriately consistent with the restrictions set) to meet the client's stated long-term objective(s).

However, being able to manage around restrictions is not unconstrained discretion. Restrictions, by definition, place controls or constraints on the investment decision-making process. It's true that some restrictions have a much more significant bearing on risk and return outcomes than others (e.g., 5% issuer limits will have less impact on realised risk and return than excluding illiquid investments). But this does not mean that most restrictions should be ignored in composite construction.

Agree with black highlighted text (i.e., we'd agree with the guidance if the blue text was removed).

Scenario 12

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 12

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.

Comments:

Disagree.

Liquidity is a client constraint as much as cost, time horizon, risk tolerance, etc.

There are fundamental differences in how FMs would approach asset allocation and hedging decisions when a client is targeting a buy-out or run-off objective. Comparing the performance of an FM's composite comprised largely of clients targeting buy-out is unlikely to be useful for a scheme pursuing run-off (and vice versa). In particular, the use of illiquid assets should be expected to have a meaningful impact on realised risk when measured by volatility because these investments re-value infrequently.

As we explained earlier, liquidity constraints (or any other asset constraint) can have a significant bearing on realised and prospective performance so we believe that delineating client classifications by a narrower list of asset restrictions can 1) help to improve comparability across providers and 2) promote creating composite results that are much more likely to be reflective of FMs' proposed portfolios for a scheme's specific circumstances.

Scenario 13

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

Guidance 13

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.

Comments:

Disagree.

See our comments on Scenario 12.

The previous FM used its discretion to size the private equity assets relative to other investments in the portfolio. That decision should be viewed as unconstrained, irrespective of whether changes in market conditions have subsequently led to a substantially different portfolio.

The new FM is responsible for working around these assets using its discretion. The fact that a work around is necessary, by definition, limits discretion. The extent to which this discretion is limited should be judged on a case-by-case basis. For example, if the inherited position is consistent with how the FM would have implemented its preferred portfolio, then the client should be considered unconstrained. Otherwise, it should be asset constrained.

Scenario 14

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 14

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.

Comments:

Agree.

Liability benchmark

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

Yes.

We'd also make it mandatory to disclose performance relative to hedge-adjusted liabilities.

Effective date and application of Guidance Statement

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 that they disclose that the changes were made retroactively?

Generally, FMs should be required to make changes on a prospective basis. We do not believe that FMs should be given the option to retrospectively change composites to reflect changes in composite methodologies. If it is decided that changes need to be made, it should be a requirement.

An option to restate composite reports will likely lead to mixed implementation across FMs whereby the incentive to restate a track record (or not) is inextricably linked to whether such restatement would result in an improvement in an FM's track record.

Other

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

No.

As you explained, changes in law or regulation may restrict the FM's ability to meet a particular scheme's stated investment objective(s). In this scenario, it is reasonable to expect that the FM would need to consult with the client to agree changes to their investment objective(s) and document any agreed change(s) to those objective(s).

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