Schroders solutions

20 September 2023

CFA Institute
Global Investment Performance Standards

Dear Sir or Madam

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

Schroders is a global asset management business headquartered in London and a FT-SE 100 company. We manage over £735bn of assets on behalf of institutional and personal investors, offering innovative products and solutions. We invest actively and sustainably in a wide range of assets classes, both public and private, and diverse geographies to help clients meet their financial goals as they change over time.

Schroders took on its first UK pension fund mandate in 1947. We remain one of the leading providers of asset management services to UK pension schemes – managing £91bn.

Schroders Solutions is a division of Schroders Group, formed in February 2022 through the acquisition of the UK Solutions business of fiduciary management specialists River and Mercantile. The River and Mercantile solution and team is the longest standing in the UK fiduciary management market, with an 18 year track record of performance and service to UK pension schemes. We provide fiduciary management services to 114 UK pension schemes with a combined £13bn of assets.

Schroders Solutions aims to be the fiduciary provider of choice for pension schemes seeking a true 'end-to-end' solution, to be recognised as a market leader in sustainability and climate integration, and to be thought leaders in the pension scheme space.

As we understand it, the main effect of the Exposure Draft will be to increase the number of pension scheme clients included in "unconstrained" composites, and decrease the number in "constrained" ones. We have no objection to this per se – with a qualification on the question of "what constitutes materiality" (see below) we broadly agree with the guidance in the 14 scenarios, and we feel clear on what is meant by liability benchmark.

However, we feel it is imperative that, for "unconstrained" composites, disclosure of performance relative to hedge ratio-adjusted benchmarks be made compulsory. If this is not done, we believe the "unconstrained" composites will be meaningless and misleading – exactly the opposite of what we all want to achieve.

Schroders Solutions
1 London Wall Place, London EC2Y 5AU
**T** +44 (0) 7658 8677
**www.schroders.co.uk**

On the following pages we elaborate on this crucial point. We also express our hope that more guidance could be given on materiality, and our view that FMs should be required to make any changes retroactively.

Should you have any questions, please feel free to contact me.

Yours faithfully,

*William*

William Hutchings
Solutions strategist
Schroders Solutions

## 1. Compulsory disclosure of hedge ratio-adjusted benchmarks for "unconstrained" composites

We think it should be made compulsory to show a hedge ratio-adjusted benchmark (and present performance relative to it) for "unconstrained" benchmarks.

If this is not made compulsory, the "unconstrained composites" will effectively become meaningless.

a) The dispersion within any one FM's composite will be at least as wide as the variation in funding level of the clients in that composite.
b) It will not be possible to make meaningful comparisons between different FMs' unconstrained composites.
c) Even if an FM precisely and consistently meets all its performance objectives, i.e., performs exactly how its clients have asked it to, the only relative performance that's disclosed for its "unconstrained" composites will fluctuate from period to period – sometimes looking positive, sometimes looking negative – purely as rates rise or fall.

We elaborate on the reasons for this below.

**An appropriate liability hedge for a pension scheme is likely to be different from 100% of TP**

Scaling the liability hedge to 100% of the value of a scheme's TP will protect the scheme's £ deficit or surplus (assets minus liabilities) with respect to its TP. But protecting the scheme's TP deficit or surplus is not what every scheme needs. For example, it would not be suitable or appropriate in the following cases.

1. The scheme may need to protect its £ surplus or deficit on a more prudent liability basis (e.g., low dependency or buy-out). To do so, it will be necessary to scale the hedge to the size of the liability as measured on that more prudent basis. This will be <u>more than 100% of TP</u>.
2. If a scheme has contributions and is less than fully-funded in relation to its target liability (typically this would be its Technical Provisions), the thing it will need to protect is its required return. To achieve this, the hedge must be scaled to the size of the assets plus the present value of those contributions. This will be <u>less than 100% of TP, but more than 100% of the value of its assets</u>. (Note that, if contributions are zero, the required return is determined solely by the funding level, so this case will be like case 3, below.)
3. If a scheme has no contributions, but is less than fully-funded in relation to its long-term liability target (this would typically be its low dependency or its buy-out liability), the thing it will need to protect from changes in expected interest rates and inflation is its % funding level (assets divided by liabilities). To protect a pension scheme's % funding level, the hedge must be scaled to <u>exactly 100% of the value of its assets</u>.
    - We think scaling the hedge to 100% of the value of the assets is the most common approach among pension schemes that use liability hedging.
4. Credit assets carry interest rate risk. If a scheme has significant holdings in credit assets with medium- to long-duration then it may be appropriate to make allowance for them by reducing the liability hedge. This may result in the hedge being scaled to <u>less than 100% of the value of its assets</u>.
5. To make sure the pension scheme is appropriately resilient and meets regulatory guidelines on collateral adequacy, i.e., that the liability hedge can be maintained in the face of expected interest rates rising by five percentage points in five business days, it may be necessary to restrict scale of the liability hedge to <u>less than 100% of the value of its assets</u>.

Note that an FM's view on the direction of rates has had nothing to do with the strategic rationale in any of these five cases.

Accordingly – and especially given the variety of funding levels different pension schemes have – an FM's client list is quite likely to contain pension schemes whose liability hedges are scaled to values very different from their TPs. A range of between 60% and 120% of TPs, or wider, is conceivable. If these schemes are targeting similar returns, and are following the strategy their FM has recommended, then under the proposed guidance they would all fall into the same, "unconstrained" composite.

**Impact on composite performance and dispersion**

If expected rates change materially, there will be an extreme divergence of "performance relative to the liability benchmark", both within this composite and between this composite and those of other FMs. That's because, with respect to their TPs, some schemes will be over-hedged, others underhedged, and the average may be over- or under-hedged – even though, relative to the hedge ratio that is actually appropriate to it, each scheme is perfectly hedged.

Moreover, the composite's "performance relative to the liability benchmark" would be misleading.

Let's take, for instance, a composite where the average scheme is under-hedged relative to its TP, and assume that, in one year, rates fall materially. This composite's "performance relative to the liability benchmark" will indicate that the FM underperformed that year. This will be the case, even if the FM has met all its investment objectives perfectly, i.e., the asset allocation was exactly in line with strategy and the FM generated exactly its target returns from the liability hedge, from return-seeking assets and from any other assets – a situation with which clients would generally be content.

Now assume that, the following year, rates rise materially. Now the composite's "performance relative to the liability benchmark" will indicate that the FM outperformed, even though, again, the FM has met all its investment objectives perfectly – not outperformed them.

The picture of apparent underperformance in year 1 and outperformance in year 2 is misleading: it does not reflect how the FM has performed. In contrast, in both years, the composite's "performance relative to the hedge ratio-adjusted benchmark" would be the same, i.e., the same as the target return – and this would be an accurate, fair and meaningful reflection of the FM's performance over those two years, and how its clients would generally view it.

**Compulsory disclosure**

The only way to reflect the true picture of an FM's performance is to show its performance relative to the hedge ratio-adjusted benchmark.

If disclosure of the performance against this benchmark is not made compulsory, then one or more FMs may choose not to show it. And then the only information that could be compared across all FMs' composites would be the "performance relative to the liability benchmark" (which, as we've explained, would be misleading).

The effect of not making this disclosure compulsory would, in our opinion, render the "unconstrained" composites meaningless and misleading.

## <u>2. Guidelines on materiality</u>

With particular reference to questions 3, 11 and 13, we note that the absence of any indication on what constitutes "material" renders the guidance more subjective than it might be and, hence, more open to gaming.

We accept there will always be a certain amount of subjectivity, and that materiality can be a difficult concept to pin down with much precision. That said, we would hope that at least some indications, or examples, of how or at which thresholds it should be set.

**3. Changes should be made retroactively**

While we acknowledge that this would mean a large amount of work, we feel it would be cleanest, and most useful for those who make use of the composites, if FMs were required to make the changes retroactively.