XPS Investment

Fiduciary Manager Review 2024

Analysis of 20 UK fiduciary management growth portfolios

April 2024

Contents

Executive summary

Following large changes to the investment landscape for defined benefit pension schemes in recent years, many schemes are hitting the final stretches of their race towards their full funding objectives. Whilst there has been a wholesale shift in the level of fixed income yields fuelling a surge to their finish line, many pension schemes will also have growth portfolios playing a key role within their strategy to help them get to the full funding finishing ribbon in one piece.

Bearing the scars of a tough year in 2022, for which it was likely growth portfolios had experienced significant absolute negative returns, many fiduciary managers ('FM') faced a difficult task jostling to position portfolios in the midst of a high inflation environment and with expectations of a global recession whilst also still adjusting the asset allocations of portfolios post the gilts liquidity crisis.

In 2022 those with higher allocations to illiquid assets and higher complexity provided protection against large negative returns. However, in 2023 there was a very different market backdrop.

Covering more than 90% of the UK fiduciary management market, this survey analyses 20 growth portfolios managed by 17 FMs over 2023 and assesses which fiduciary management solutions delivered the strongest investment performance.

Key findings

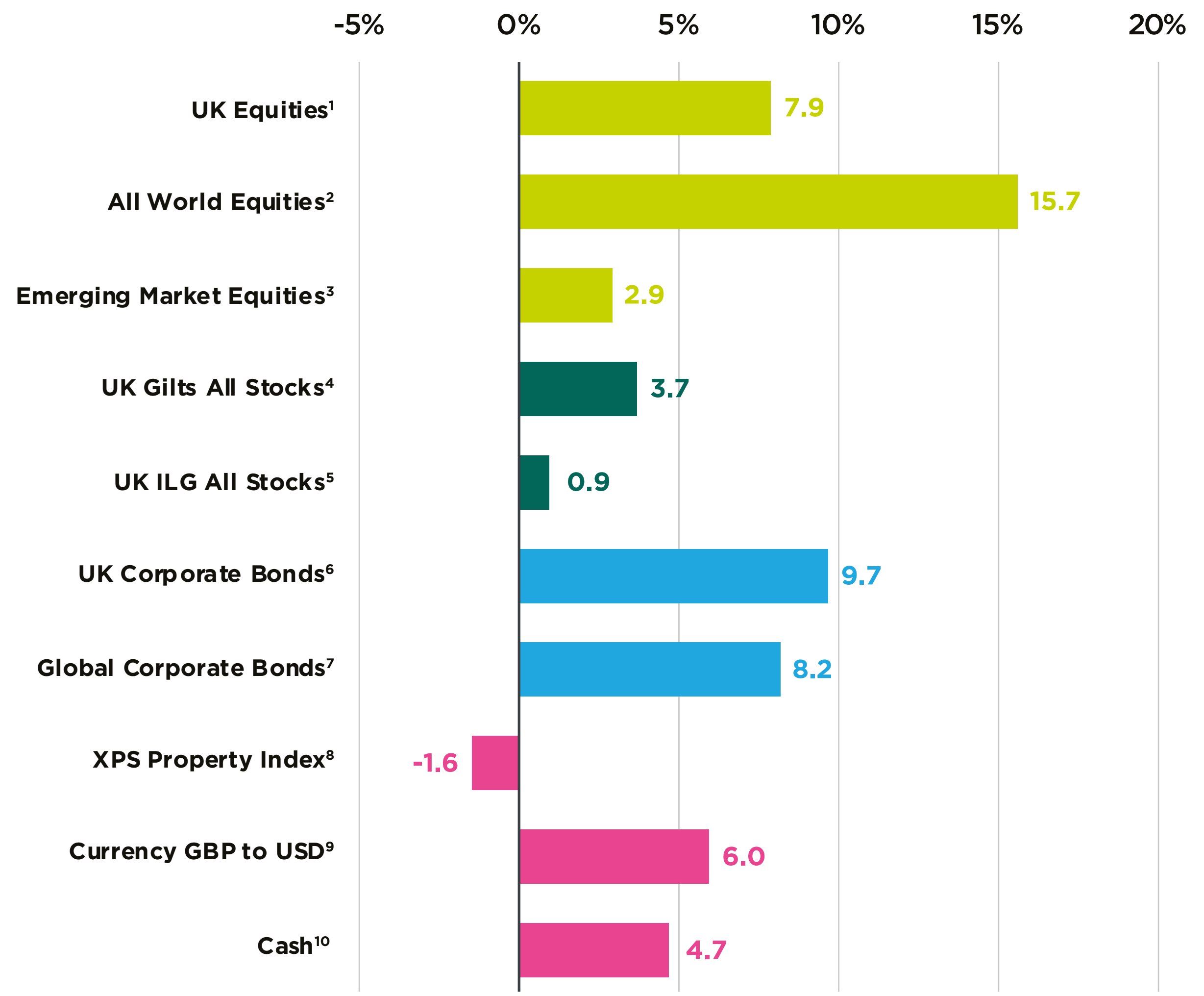
- **All FM growth portfolios provided positive absolute returns in 2023. However, there was a wide range (12.9%) between the highest and lowest portfolio returns.**
- **There was a strong link between relatively high levels of illiquidity and lower absolute returns.**
- **The majority of FM growth portfolios underperformed their stated target returns with some portfolios underperforming by 3% or more.**
- **The majority of FM growth portfolios outperformed diversified growth funds ('DGFs') on a risk-adjusted basis over the 1 and 3 year periods to 31 December 2023.**
- **For higher returning portfolios, exposure to equities and credit made up significant proportions of overall returns. However, some FMs provided significant negative returns due to equity hedging and downside protection strategies.**
- **Five FM growth portfolios underperformed the DGF lower quartile for 2023.**

Many FMs had cautiously positioned growth portfolios entering into 2023 due to fears of macro-economic headwinds. Those who were able to rebalance illiquid positions and/or reduced downside protection strategies were able to capture market returns over the year.

André Kerr
Head of Fiduciary Management Oversight

2023 market backdrop

Chart 1: 2023 market performance



Source: Refinitiv, XPS Investment

Chart notes:

1. FTSE All Share Total Return Index
2. FTSE All World £ Total Return Index
3. FTSE Emerging £ Total Return Index
4. FTSE British Government Fixed All Stocks Total Return Index
5. FTSE British Government Index-Linked Gilts All Maturity Total Return Index
6. iBoxx £ Non-Gilts Total Return Index
7. ICE BofA Global Corporate Index – Total Return Index Value
8. XPS Property Index
9. US ($) to UK (£) (WMR) exchange rate
10. UK SONIA

Following their struggles in the previous year, equity markets bounced back in 2023 with strong returns and major indices reaching all-time highs driven by growth stocks fuelled by artificial intelligence developments. Fixed income markets also generated positive returns as the cycle of interest rate hikes came to an end and inflation slowed. Positive returns across most asset classes will have likely resulted in a positive contribution from growth portfolios to improve funding levels.

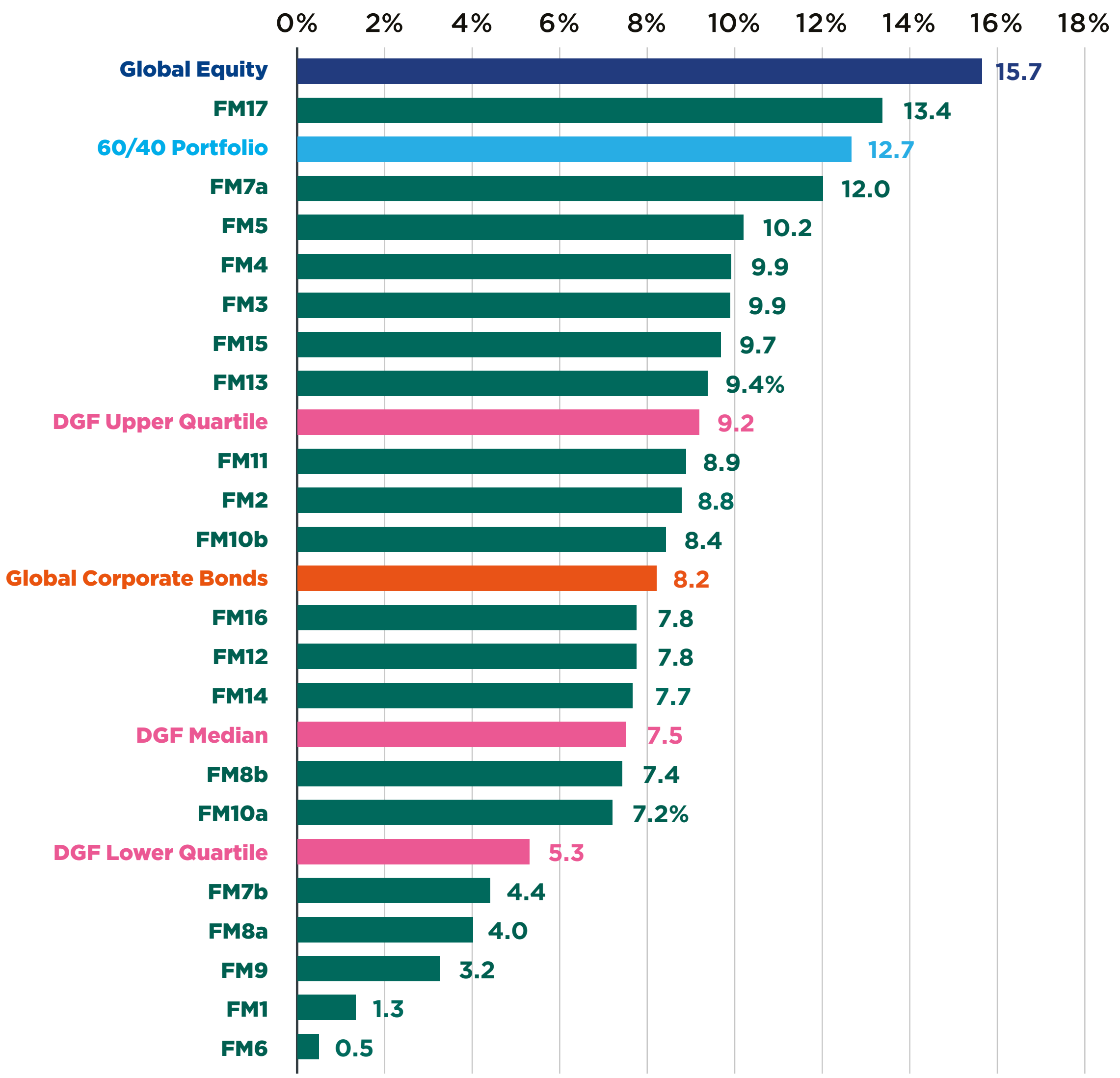
Fiduciary manager performance comparisons

Chart 2 shows absolute performance over 2023 for a total of 20 growth portfolios, with three FMs also providing data for alternative low-cost options designed to meet clients' differing objectives. The FMs provided their monthly returns net-of-all-fees, as well as details of the total amount of assets managed and number of clients invested in each of the portfolios. Our assumption was that there would be a narrower range of returns given strong equity and corporate bond returns but this was not the case.

All FM growth portfolios provided positive absolute returns in 2023 and similarly to previous FM Performance Watch reviews, there was a large range (12.9%) between the highest (13.4%, FM17) and lowest (0.5%, FM6) portfolio returns.

Given the strong year for both equity and global corporate bond returns, just one FM (FM17) outperformed a low-cost index tracking '60/40' (60% equity/40% bonds) portfolio. This is to be expected given simpler portfolios have an inherent exposure to duration, which provided strong positive returns over 2023 (and the opposite in 2022). FM growth portfolios however have the capability to invest in a wide range of asset classes and therefore provide better diversification and lower volatility, often resulting in better returns in negative markets. This was evidenced in 2022, when both equity and global corporate bond returns were both negative, the vast majority of FM growth portfolios (more than 80%) outperformed the 60/40 portfolio, providing protection in falling markets.

Chart 2: Fiduciary manager and comparator performance – 2023



Source: Refinitiv, XPS Investment, fiduciary managers

As per previous years when assessing absolute returns, there were a number of FMs that performed well relative to diversified growth funds with seven FMs outperforming the upper quartile of DGF returns. However, in 2023, there were a handful of FMs that underperformed the DGF lower quartile.

Of these five that underperformed the DGF lower quartile, four (FM1, FM6, FM8a and FM7b) were amongst the FMs with the lowest asset allocations to equities. Their average equity allocations for 2023 ranged from 11% to 29% compared to the average equity asset allocation of 37% across all FM growth portfolios. However, low allocations to equities weren't necessarily the main driver for lower absolute performance which is evident when we assess the contributions to returns later on.

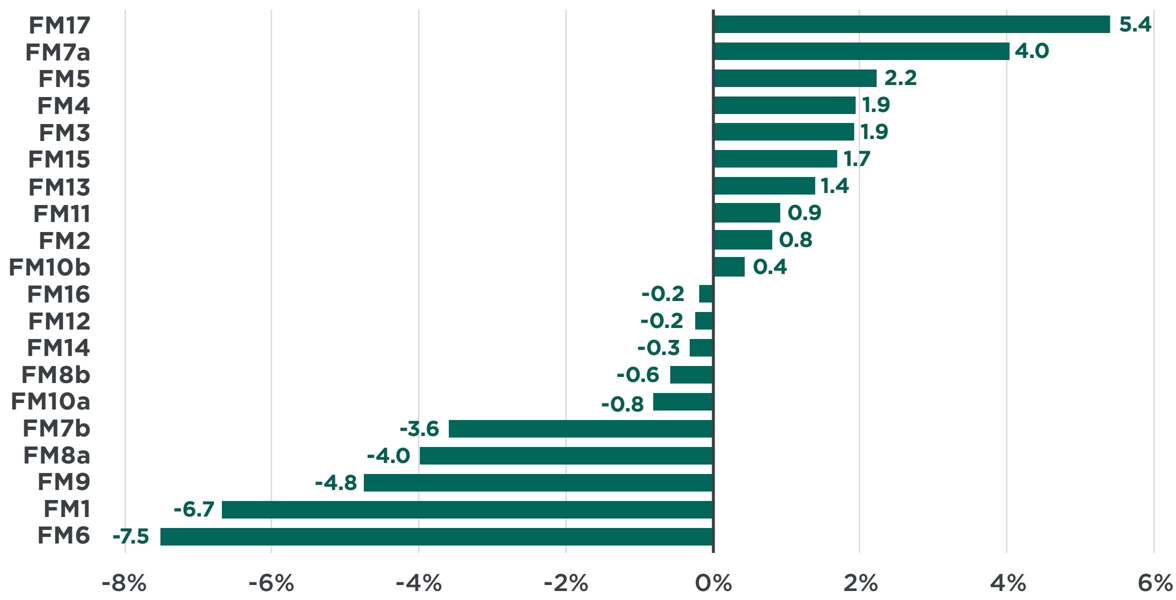
There was also a clear link between illiquid allocations and lower absolute returns as these portfolios (FM1, FM6, FM7b and FM9) had the highest allocations to assets with realisation periods of at least six months. This is in stark contrast to 2022 when illiquid allocations provided significant positive contributions to returns. When considering clients' growth portfolios, 2023 performance could have been significantly reduced due to portfolios being overweight to illiquids and underweight to liquid assets like equities going into 2023 following the gilts liquidity crisis.

Over the longer 3 and 5 year periods, the picture is somewhat mixed. Some FM portfolios performed relatively well against peers over the longer term but had a bad 2023, suggesting 2023 was an isolated bad year. Whereas for some FM growth portfolios, they consistently produce lower returns than their peers over the medium term (3-5 years).

Alongside a wide range of investment returns for FM growth portfolios, there are also a wide range of stated target returns (gilts, cash and CPI) and anywhere between 1% and 5% per annum of outperformance against these.

Performance against these targets was varied and in 2023, 12 FMs underperformed their stated targets with five of those underperforming by at least 3%. In a calendar year which provided good market returns across many asset classes, it may be surprising to see so many growth portfolios underperforming their stated targets.

Chart 3: FM growth portfolio relative return vs. average target return – 2023

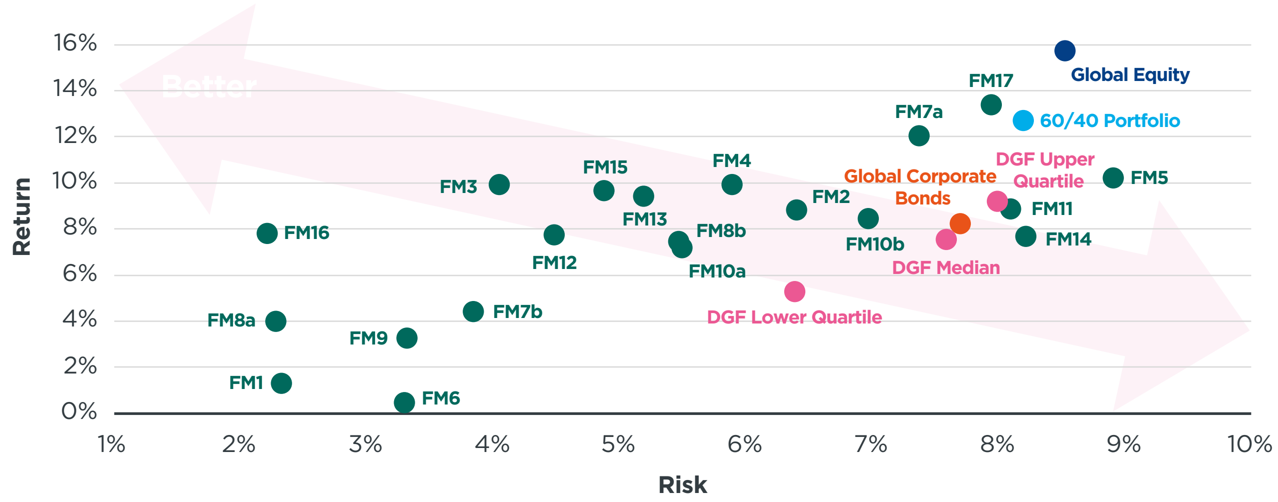


Source: Refinitiv, XPS Investment, Fiduciary Managers
Note: FM growth portfolio average absolute stated target return was 8.0% per annum.

Chart 3, shows returns relative to the growth portfolios' average return target (8% per annum in 2023). A total of ten FM growth portfolios underperformed the average target. Despite increasingly de-risked investment strategies across the DB landscape, growth portfolios still have a role within many strategies and should be assessed accordingly by trustees as to whether they are adding value. Trustees should review whether their FM's performance target is appropriate and seek to change it if not.

Volatility-adjusted growth portfolio performance

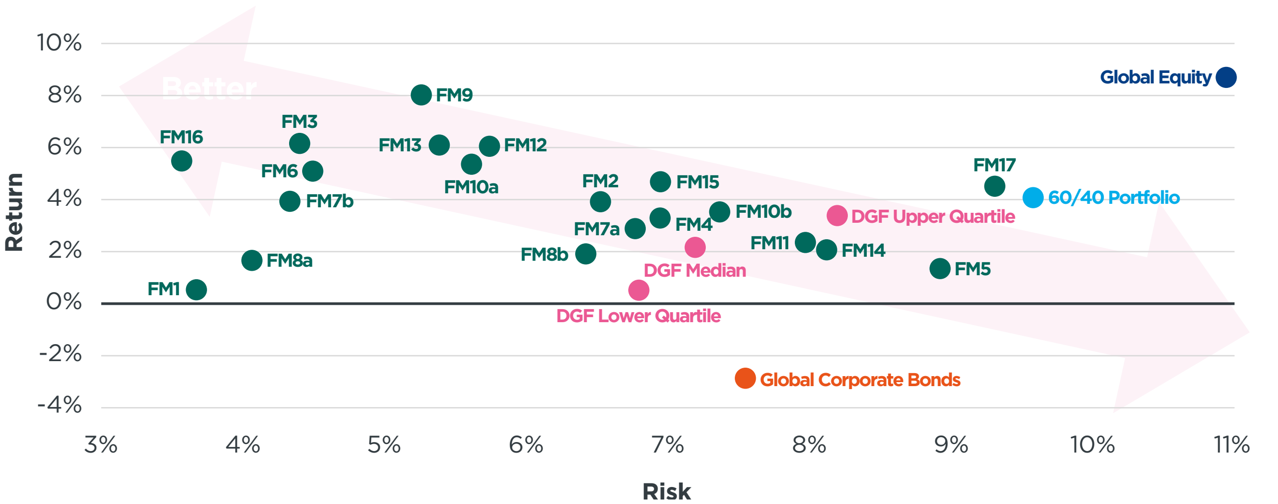
Chart 4: Return vs volatility – 1 year to 31 December 2023



Source: Refinitiv, XPS Investment, fiduciary managers

When reviewing the performance of FM growth portfolios, trustees should always consider returns on a risk-adjusted basis particularly given many pension schemes require a focus on risk management. Chart 4 illustrates the FMs' growth portfolio returns against the monthly volatility of returns over 2023, based on calculations by XPS and using monthly return data provided by each FM. As was the case in the XPS FM Performance Watches for 2020 and 2022, there were a wide range of volatilities between the highest and lowest returning portfolios for the year which highlights the importance of trustees ensuring their fiduciary manager is implementing a growth portfolio that matches their risk requirements. On a risk-adjusted basis, most FM growth portfolios performed better than DGFs providing either higher or similar returns with lower volatility.

Chart 5: Return vs volatility – 3 years to 31 December 2023 (p.a.)



Source: Refinitiv, XPS Investment, fiduciary managers

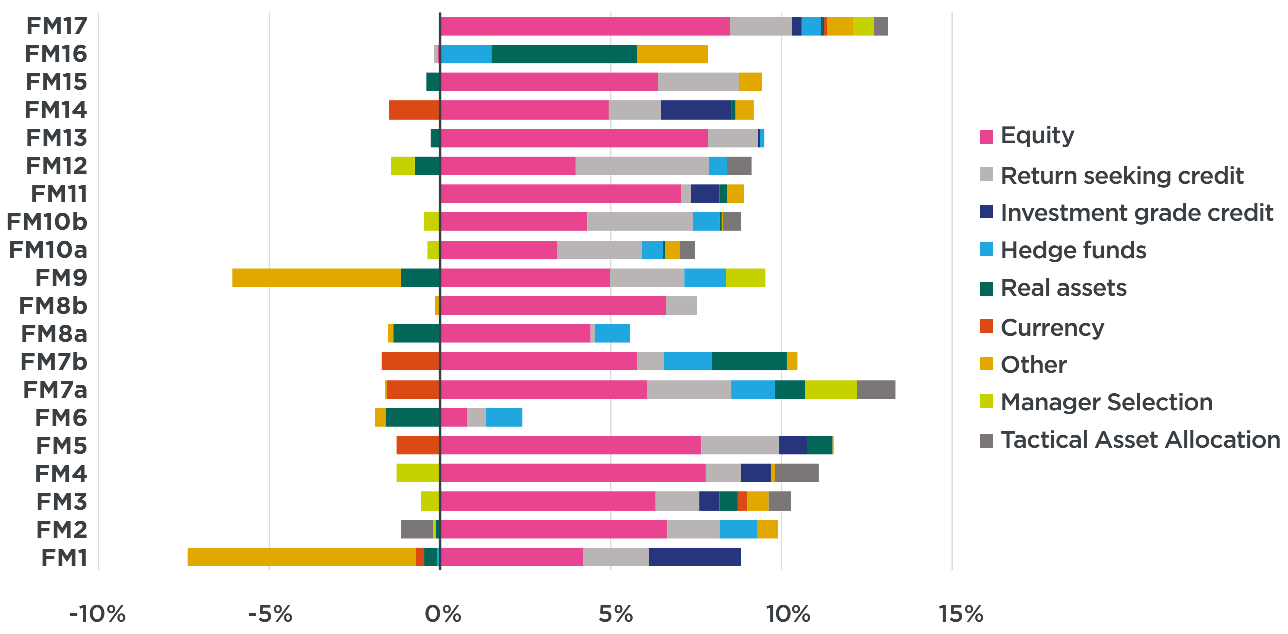
For the 3 year period, the majority of FM growth portfolios performed better than DGFs on a risk-adjusted basis and, given this period covers the large market falls of 2022, it demonstrates that FM portfolios are able to provide added value in various market conditions versus generally cheaper and less complex multi-asset funds.

Contribution to returns

Chart 6 illustrates the contributors of each asset class, as defined by the FMs, to the overall returns achieved by each FM growth portfolio in 2023. For the vast majority of the FM growth portfolios, allocations to equities and credit made up significant proportions of the overall returns. Being exposed to these asset classes, whether through passive or active management, contributed to the total absolute return as demonstrated by the three portfolios with the highest overall returns (FM17, FM7a and FM5) which all had amongst the highest allocations to equities.

However, some FMs were unable to make the most of the strong equity and credit market returns. Within the group of the lowest absolute returning portfolios, FM9 and FM1 had their positive returns from equity exposure 'undone' by equity hedging and downside protection strategies which counteracted the positive returns provided by equities. Notably, FM16 was an outlier and had very little exposure to equities and credit but was able to provide a strong positive return from alternative asset classes.

Chart 6: Contribution to returns – 2023



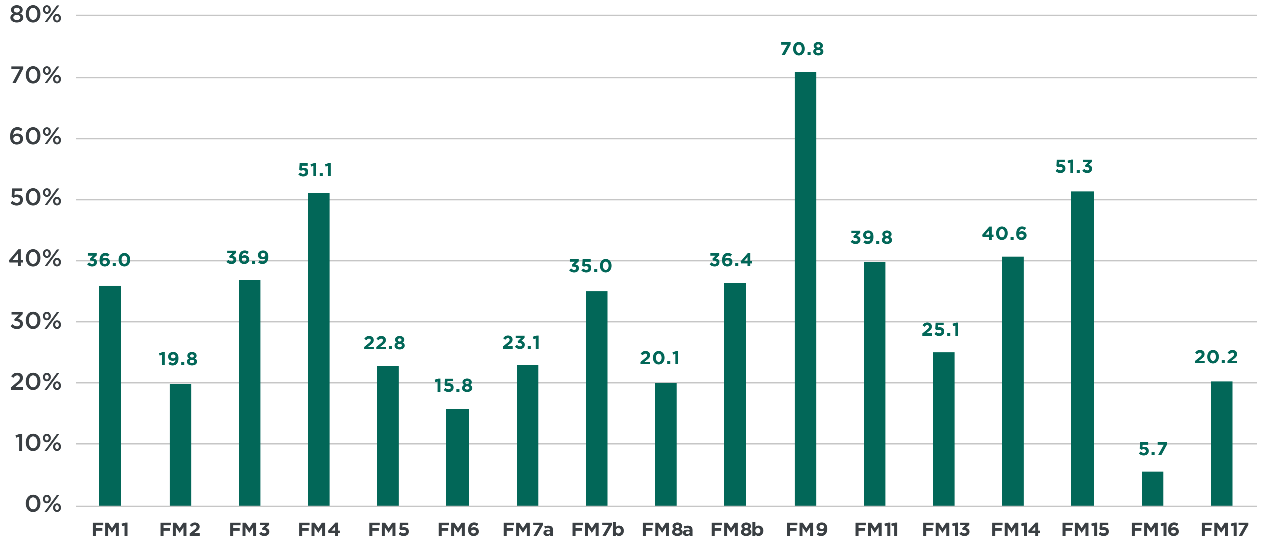
Source: Fiduciary managers

We have also shown the contributions to returns from manager selection and tactical asset allocation decisions[1] where provided by the FMs. As with previous FM Watches, the outcomes are mixed across FM growth portfolios as to whether they added value. Across the market, FMs' solutions vary as to the extent to which active management is used for each asset class. Given higher fees are associated with greater use of active management, trustees should always assess whether the approach is worth the cost.

For trustees, capturing and understanding the key drivers of portfolio returns is essential to understand the performance of their scheme's growth portfolio and whether it is adding value.

[1] Where not shown explicitly, the contributions from manager selection and tactical asset allocation are included within the relevant asset class contributions or within 'Other'.

Chart 7: Unhedged currency exposure – 2023

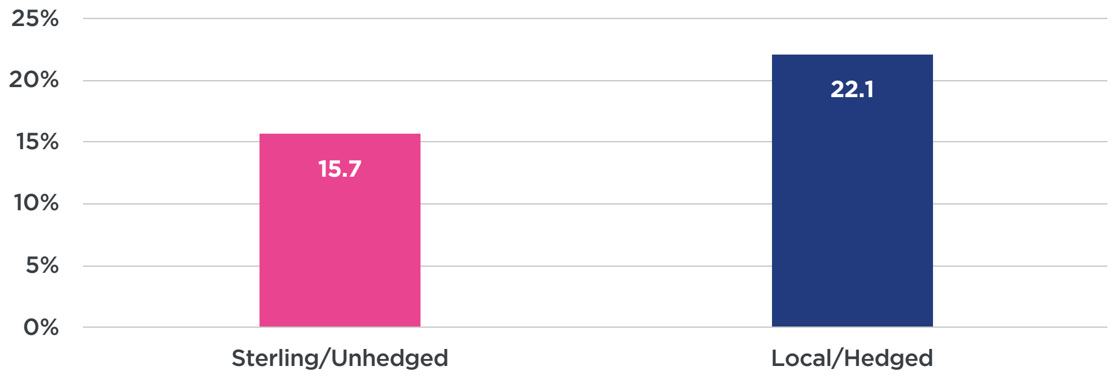


Source: Fiduciary managers

As part of our analysis we also asked the FMs to provide the currency exposures of their growth portfolios. Whilst not all the FMs provided this information, amongst those that did, it revealed there were some significant unhedged overseas currency exposure (four FMs with at least 40%) as shown in chart 7.

Furthermore and as demonstrated in chart 6, not all FMs separate out the contribution to returns from currency exposures, wrapping them within the contribution from 'Other' or within other asset classes shown. Nonetheless, depending on the level of exposure, trustees should be aware of the effect currency exposures are having on growth portfolio returns and assess the impact of this as returns in sterling and local currency terms can differ significantly, as shown in chart 8.

Chart 8: Unhedged vs hedged global equity return 2023



Source: Refinitiv, FTSE All-World Equity Index

Conclusions

Market returns for 2023 were, for most schemes, likely to have been an unexpected and welcome sight given the outlook at the start of the year and 2022 having been one of the worst calendar years for investors. As demonstrated, there were a wide range of returns across growth portfolios with some able to make the most of strong equity and corporate bond market returns, whilst others lagged due to allocations to illiquid assets or through the use of equity hedging and downside protection strategies.

Depending on the asset allocations coming out of 2022, actual client experience will also have varied widely, especially as following the 2022 gilt liquidity crisis, a lot of schemes' growth portfolio allocations would have been materially different from their targets. This will have resulted in a mix of outcomes as to whether growth portfolios were able to rebalance and position themselves to capture upside market returns.

Whilst the allocations to a growth portfolio as a proportion of total assets varies from scheme to scheme, a growth portfolio's performance can have a material impact on progress towards a scheme's objectives. Looking forwards, buying-out with an insurer may still be considered the blue ribbon race by many trustees, however the Government's Mansion House reforms might mean some schemes may carry on for a few more laps of the track yet. All finishing lines are adjustable and are different for different schemes. For trustees, whatever the objective, it is critical to have a growth portfolio that sets the right pace.

Key observations

- In a calendar year with strong market returns, the wide range of FM growth portfolio returns is surprising and we typically observe a narrower range of outcomes between FM growth portfolios.
- Across FM portfolios, there was a mixed outcome as to whether manager selection and tactical asset allocation added value.
- There is a large range of currency exposures across FM growth portfolios. There is a potential for volatile returns for those managers with significant unhedged currency exposures.

The large shift in bond yields in the last couple of years has resulted in many schemes now having better funding levels and lower target return requirements. FM growth portfolios are materially changing to adapt to these circumstances.

Actions for trustees

1	Understand if your FM added value through active management alongside capturing strong market returns from equities and corporate bond markets and the impact this has had on your journey plan.
2	Check the liquidity of your growth portfolio and whether illiquid allocations have now been rebalanced post gilt liquidity crisis in 2022.
3	Assess your FM growth portfolio's return over the longer term against peers in the FM market.
4	Consider the stated outperformance target of the growth portfolio, whether it is right for your scheme and agree with your FM and/or third party evaluator how to assess performance against the target. Our preference is for this to include a risk based measure.
5	Consider your solution's FM management fees and underlying manager costs against the market benchmark and whether higher costs lead to added value.
6	Be aware of currency exposure and understand the impact these are having on your scheme's growth portfolio returns.

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