UK fiduciary management outlook for 2021 and beyond: a changing landscape for UK pension funds

The pension scheme landscape in the UK – and the role of pension fund trustees – is changing dramatically, but this isn't just a theme for 2021: it will run for much longer. We believe this will drive further demand for fiduciary management services. In this outlook, we talk about what's likely to happen over the next few years, provide some forecasts for 2021, and discuss some of Kempen's plans for the year ahead.

PENSION FUNDS ARE MATURING, SO A NEW INVESTMENT MINDSET IS NEEDED

Defined Benefit pension funds in particular are facing a major medium-term challenge: their memberships are maturing very quickly. In the past, these schemes had large net cash inflows, but they are now paying out an increasing amount of cash as more and more members retire and contributions dry up. This means they're turning cashflow-negative – paying out more cash than they receive. This requires a huge change in their investment mindset.

An additional concern is that the likelihood of receiving the cash that has been promised by sponsors is falling as companies struggle in an uncertain economic environment. This has been exacerbated by coronavirus: recovery contributions need to be paid by sponsors, but if the company goes bankrupt there's no way they can make those payments. A lot of pension schemes are now in a position in which their sponsors are struggling to make the cash payments they have committed to. Regulatory guidance at the beginning of 2020 encouraged sponsors and trustees to agree shorter deficit plans, but the financial impact of the pandemic means that these are more likely to be pushed further out.

These changes mean pension funds need to adopt a very different investment mindset from the one that has dominated over the past decade, when they have invested in return-seeking assets on one hand and hedging assets on the other. Now that pension schemes are having to pay out more cash, building a diverse set of cash-generating, income-producing assets in their portfolio has become more important than ever.

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Fiduciary management tender deadline

In 2019, in response to concerns about a lack of competition in the fiduciary management market, the UK Competition and Markets Authority (CMA) ruled that pension trustees are legally required to run a tender when selecting a fiduciary manager to look after more than 20% of their assets, and that any schemes that had appointed a fiduciary manager without such a process would have to run a competitive tender within five years of the original appointment or by 9 June 2021, if later. This was just one of six recommendations to the Financial Conduct Authority, but stole far and away the most headlines.

We expect this deadline to drive further activity in the fiduciary market up until June and beyond, as some schemes will have a longer deadline to review. In other words, there will be a long tail of activity.

The CMA review has broadly achieved what it aimed to do – it's made a lot of trustees more aware of how their fiduciary manager really compares to the competition, and in some cases they've decided to change fiduciary managers. They've become more informed buyers, which is in our eyes a big positive.

A SHIFT AWAY FROM EQUITIES

This means we're going to see a continued move away from equities into more secure investments that provide predictable cashflows like corporate bonds, inflation-linked debt of various flavours, and potentially more niche markets, like lifetime mortgages. Around 20 years ago the average UK pension fund invested more than 60% of its assets in the stock markets. As of the middle of 2020, this figure had dropped below 20%, and it's likely to fall to 10% or even lower over the next decade for all but a handful of open schemes. The biggest beneficiaries of this trend over the past ten years included diversified growth funds and the broad church that is 'alternatives'. Now, investors are pulling out of multi-asset funds because they've lost trust in them given their lacklustre performance. This is actually one of the biggest drivers of the shift towards fiduciary managers, which have been able to achieve better results with respect to schemes' specific objectives and better diversification by exploiting a greater opportunity set, and at a lower cost.

MORE AGGRESSIVE IN THEIR INVESTMENTS

Against a backdrop of a huge impending need for cashflow and return, pension schemes don't want to allocate much more to the usual set of alternatives, and they need to reduce their equity allocation and invest more in bonds and bond-like assets. If they don't update their thinking, then over the coming years they're going to have to be more aggressive with their equity, bond and existing alternative investments to achieve the returns that they need. This search for return is going to cost pension funds considerably more in terms of risk than it has over the past 15 years.

FIDUCIARY MANAGERS CAN HELP

Running more risk at a time when their sponsors are in trouble will have big implications from an integrated risk management perspective. A fiduciary manager can manage the balance between sponsor risk, investment risk and changing markets, as well as shifting to a more income-focused mindset. Trustees could

do it themselves, but there's a strong argument that a fiduciary manager could do it better and more efficiently.

What's more, investments are becoming more complex and time-consuming, and more expertise is required, at a time when trustees are faced with an increasing regulatory burden in a number of fields away from the pure investments arena. Trustees have to ask themselves if they want to carry on with their current governance model, where they decide and take advice, or delegate some of the decisions and the execution to an external expert.

Pension funds seem to be realising the benefits of a fiduciary manager: at the end of last year the amount in fiduciary assets was around GBP 172 billion; by the end of 2020 we expect it to be close to GBP 200 billion, and we expect a similar – if not larger – increase next year.

Short-term return issues

The immediate return issues that pension schemes are faced with are well known: with global yields so low, the search for returns is becoming increasingly difficult and increasingly risky. That's because they need to go into riskier markets to achieve the same return that five years ago they could have earned from bonds. Indeed, today's modest return needs could have been met entirely by bonds prior to the Global Financial Crisis!

Compounding this problem is the ongoing global uncertainty affecting all investors. Events that could have huge impacts on the markets include possible further waves of coronavirus, the US elections, and various geopolitical matters, including the US-China trade conflict, the Middle East, the continued existence of the eurozone, and Brexit (which we are confident will not be resolved – whatever the politicians may be saying by the time this is printed).

We expect many pension schemes to respond to the return challenge not by investing more in equities, but by increasing the level of risk of their equity allocations. For example, they might use more leverage, or allocate more to emerging markets, small caps or more aggressive active managers in a bid to achieve similar returns to previous years. It's likely to be a similar story in bonds and alternatives.

ONGOING CONSOLIDATION

We expect a significant number of pension schemes to undertake some form of consolidation over the next 4–5 years, and this will have implications for fiduciary managers, asset managers and the insurance industry. A good fiduciary manager can help trustees keep on top of all the options available to them, including the potential for a consolidated exit versus an insured exit.

WHAT TRUSTEES NEED TO DO IN 2021 AND BEYOND

Over the past three years we've seen a big increase in what's on trustees' agendas. They've always been keen to be involved with investment discussions, but we're now seeing a recalibration of the level at which these discussions take place.

What trustees really bring to the table is their link to their members and sponsors – they can't delegate that because they have knowledge no one else does in this regard. They need to make sure sponsors are in agreement with what's being done, supportive, and deploying capital as a business where they need to most. Hopefully, that's not topping up poorly performing pension schemes.

Trustees often have to deal with short-term issues, which prevents them from focusing on bigger-picture issues like the end of their pension scheme – can it get to buy-out, buy-in or consolidate; can they secure their scheme's covenants; can they get more money from the sponsor? These are really important questions that we think they should be spending more time on than considering, say, which manager did well over the past three months or which style or factor might be in vogue next.

In 2020 the vast majority of trustee boards have been able to adapt to the new environment and deal with the issues facing them, but in 2021 trustees need to understand and recognise their strengths to address the bigger picture. The fiduciary management model provides trustees with the space to achieve just that.

ESG to grow in importance

It almost goes without saying that we expect a continued uptick in pension funds' focus on responsible investment and ESG. As we come out of the coronavirus crisis we believe pension funds will be keen to do more than just what is required of them by regulation. This will be a result of pressure from their stakeholders, reputational risk, and the growing realisation that investors need to be doing more with their assets than purely seeking returns.

KEMPEN'S PLANS FOR 2021

At Kempen we're planning to concentrate on a number of areas for our fiduciary management clients in 2021.

A MORE TARGETED APPROACH TO FIDUCIARY MANAGEMENT

We're going to focus more than ever before on risk transfer – looking at buy-ins and buy-outs on behalf of our clients. We're also going to be focusing on DC even more, as we expect DC to play a more prominent role in the pension services we provide in 2021.

In the past, clients appointed fiduciary managers based on the expectation that they would help them improve their funding levels, but we're starting to see clients appoint managers to help them achieve other priorities, like improving governance and solving operational issues around implementation, with the goal of enhancing performance linked to these broader improvements. We expect to be helping our clients achieve such aims next year too.

INVESTMENT THEMES

We believe one of the highest-potential return areas of the markets in 2021 will be distressed debt. There's going to be a withdrawal of monetary support after the coronavirus crisis and we'll see many companies default or go into administration. That means there will be an opportunity for investors willing to accept short-term illiquidity to buy the debt of firms that are at or past default, help them restructure, and then return them to the public markets at a substantial profit. But of course it's important to find the right partner and build a portfolio carefully, because if you buy the wrong distressed company you might never see your money again. It's a high-risk segment, but if you do it right it should be the standout asset class for returns in 2021 and through to 2023.

We'll also be helping our clients adopt a smarter approach to the equity markets. For example, rather than allocating to the so-called 'smart betas' and the usual styles such as value and growth, we prefer to invest thematically in global megatrends that are going to shape the world around us over the next decade. We think such themes can be rationalised better than financially engineered concepts such as value and growth, have stronger return potential, and are better aligned to the greater focus on ESG of pension schemes and their members. We'll also be looking closely at Chinese equities as well as shaping our equity exposures using derivatives – essentially modernising the approach to equity investment.

SOLUTIONS FOR SMALLER PENSION SCHEMES

We're going to be creating scalable solutions for smaller clients. It's easy to build something bespoke for large pension funds, but it's harder for smaller schemes as there's a limit to how small you can make certain good ideas. We're going to be looking at how to overcome these limits and make things smaller so that every scheme can benefit. For example, a scheme would normally have to invest at least GBP 10 million to access asset classes such as private debt, direct lending, farmland or agriculture directly, effectively taking them off the menu for smaller schemes (or forcing them to use multi-asset funds). Reducing the minimum investment to GBP 1 million would open up these asset classes to a vast number of smaller- and medium-sized schemes.

CHOOSE YOUR FIDUCIARY MANAGER CAREFULLY

There's been a lot of analysis on how different fiduciary managers have performed during the coronavirus crisis. It is evident that fiduciary managers are not all equal and not doing the same job. In particular, some are running lots more risk than others. Pension funds need to think carefully about which party they want to work with in 2021 and whether they did what they said they would during 2020. It's not just about risk-adjusted out or underperformance, it's about how close the fiduciary manager gets to the target that they were set. Any fiduciary manager who hasn't been able to navigate the recent crisis may not be well placed to navigate the next one.

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