

Fiduciary Manager Appointment Documentation: 10 Critical Issues

In this briefing Adam Rouledge, having reviewed a large number of fiduciary managers' appointment documents, shares his 10 key insights for trustees to consider before they sign on the dotted line.

Like any relationship, it is important that things start off on the right foot. The same is true when appointing a Fiduciary Manager (FM). The appointment documents define the relationship between the trustees and the FM. Relationships are tested in times of crisis. This is where having a well written set of guidelines really comes into its own, in particular taking into account the lessons of the past and trying to anticipate future developments. For example, during the gilts liquidity crisis, we saw a number of examples of FMs and trustees scrambling to change their legal documentation to deal with issues they were facing.

Key highlights

- Fiduciary manager documentation needs to be independently reviewed as it shapes the relationship between trustees and the manager and is of critical importance when something unforeseen happens (e.g. the 2022 gilts crisis).
- Trustees should review the documentation when appointing an FM or when their investment beliefs, market conditions or the funding position change materially.
- Typical documentation covers investment objectives, liability hedge ratios, asset allocation restrictions, de-risking frameworks, trustees' liabilities and fees.

In this article, we give our guidance on what should be covered in these areas.



Fiduciary manager documentation plays a crucial role in defining the relationship between the trustees and the FM. When appointing an FM, trustees should not miss the opportunity to review the documents to shape the relationship with the FM in the way they want it.

Adam Rouledge – Senior Consultant



What is an Investment Management Agreement (IMA)?

Trustees appoint an FM by signing an IMA. IMAs are typically hefty legal documents setting out all aspects of the relationship between the trustees and the FM. Trustees' lawyers often focus on the more legally significant aspects such as the extent of the legal liability each party has to the other, but the investment aspects are also critical.

It's tempting to think of reviewing the IMA as a bit of an inconvenience, having spent a good bit of time selecting a FM and settled on one you think is going to

deliver for your scheme. However, they are important legal documents which will shape how you work with your FM. They become particularly important if something goes wrong (the Autumn 2022 gilts liquidity crisis for example) and it's worth reflecting that you will never have as much influence on the document as you do when the FM knows they have won your business but you have not yet signed on the dotted line. So do not miss this opportunity to shape the relationship in the way you want it.

Why might your existing IMA need to be reviewed?

Where an FM was appointed a number of years ago, you may well not have looked at the IMA since then. However, even if everything is working well, it may be time for a review.

A change in investment beliefs

We think it's critical that a scheme's investment arrangements are consistent with the trustees' investment beliefs – that's why all of our FM selection exercises start with an investment beliefs exercise. A change in beliefs (which could be due to a change in the trustee group or just a change in thinking over time), could be a trigger for a review.

Change in investment market conditions

These would likely have to be very significant to trigger a review. Something like a material increase in the additional yield available on corporate bonds relative to gilts may mean that sufficient investment return could be achieved through investment in corporate bonds, meaning riskier assets like equities could be removed from the portfolio.

A material improvement in the funding position

This could mean significantly less investment risk is then needed.

The rest of the paper sets out a list of 10 areas to consider in an IMA and things to watch out for.

1

Make sure the objectives are right

All of the sample IMAs include a statement of the FM's investment or performance objective – the level of return they are seeking.

Given most pension schemes measure their liabilities relative to gilts, the FMs all sensibly also frame their objectives relative to gilts. However, it is important to consider the treatment of investment fees. Investment performance is uncertain whereas fees are certain. The FM's performance target should clearly state whether the objective is before or after fees as a minimum. Our preference is for an 'after fees' objective i.e. 'net of fees'.

Some of the FMs make no reference at all to their fees in their investment objectives. Given total fees (FM and underlying managers) can be 1% p.a. or more, a clear statement of whether the performance target is net of fees is important in assessing whether an FM has done their job and met their performance target.

Only a few FMs include anything on the target level of risk in their investment objectives. Whilst this was surprising it likely reflects the abstract mathematical nature of most risk measures such as tracking error.

2

Have a clearly defined target liability hedge ratio

Most of the FMs define a target interest rate and inflation hedge ratio.

Some of them give themselves very wide ranges, others less so.

Our preference is to have a well-defined target hedge ratio but with the discretion for the manager to reduce the hedge if needed in extreme market conditions (acknowledging the challenge of defining 'extreme').

3

Ensure there are sufficient liquid assets to support the liability hedge

Some managers include details of the test they use to check whether there are sufficient suitably liquid assets to support the liability hedge.

Given the importance of this and the Pensions Regulator (TPR) guidance in this area, we think this is sensible and allows positive confirmation that the FM is operating in line with TPR guidance.

4

Ensure your hedge ratio is prioritised appropriately

Typically we see relatively few managers specifically include a section in their IMAs on what they would do if there was a repeat of the 2022 gilts liquidity crisis.

As gilt yields increased, leveraged liability hedging funds called for additional cash to reduce their leverage. For some clients this left their FM facing a difficult choice. They could maintain the hedge by selling high returning, liquid assets like equities. But this might reduce expected return below the return target. Or they could accept a lower hedge ratio and risk gilt yields subsequently falling, hurting the scheme's funding position.

One FM's IMA specifically confirms that they will prioritise maintaining the hedge. We think this is useful because, in volatile gilt markets,

meaningfully reducing your hedge can rapidly result in a big deficit arising. In contrast there may or may not be any consequences of a short-term reduction in expected return, depending on market returns. Having the policy understood and documented is helpful in the midst of a crisis.

Some FMs asked for 'emergency' changes to their agreements with clients during the gilts liquidity crisis to give them more flexibility to deal with the crisis. For example being given discretion, without consulting the trustees, to remove hedging altogether. If this applied to your scheme, you should review whether the documents have been subsequently amended to reflect a more stable environment and changes made to LDI funds to make them more robust.

5

Check that asset allocation restrictions are appropriate

All managers include a list of the assets or funds in which they can invest and some limits on the allocations to these assets.

Some managers have much smaller ranges than other managers. There is a balance to be struck between giving managers sufficient freedom to take opportunities / manage arising risks and allocating assets in ways that the trustees aren't comfortable with. Our feeling is that most trustees using FMs don't want to be overly involved with managing the investments, so wide ranges are ok.

However, it is important that there is sufficient trust and communication between the trustees and their manager, together with suitable reporting and oversight arrangements.

Only a couple of managers included reference to restrictions on holding illiquid assets. One of these includes a table setting out the maximum proportion of assets that can be held in different liquidity bands (i.e. realisable within 1 week, 1 month etc). The other referred to maintaining an 'appropriate' level of liquidity, which is so vague as to be almost useless, but at least they have a reference to liquidity unlike the rest!

6

Clear policy on currency hedging

Only a few FMs IMA's specified a target currency hedge ratio.

This is surprising as currency can have a big impact on investment returns. Our 2024 Fiduciary Manager Review showed that four

FMs had more than 40% of their portfolios exposed to currency movements. This had a big impact in 2023 when there was a 7% difference between hedged and unhedged global equity returns for a sterling investor.

7

De-risking triggers should be documented

Some FMs include details of how they will evolve investment strategy over time in response to improvements in the funding level, increases in gilt yields etc.

Whilst we acknowledge that investment strategy can change due to a variety of different factors, we think its sensible to document de-risking arrangements, even if that means more frequent updates to the IMA.

The IMA should identify what de-risking actions will be taken when the funding level (or other de-risking triggers) are hit. It should also specify the process to be followed and the timescale in which the subsequent actions are taken. This is important because de-risking opportunities may be fleeting and there can be material financial consequences of missing opportunities. All parties must be clear on their responsibilities.

8

Pay attention to fees

We would expect all IMAs to clearly define the FM's fees as well as the circumstances and timescales in which the fee can be changed.

We do not favour specifying fees for the underlying investment managers in the IMA because we do not want FMs to have their choice of investment manager impaired by relatively arbitrary fee restrictions. Given fees for the underlying managers ultimately comes out of performance (and performance is the ultimate measure of an FM's success), it is for the FM to determine how much they are willing to pay to the underlying managers.

Ideally the IMA would include details of how the FM fee would evolve over time covering situations where the assets increase or reduce materially from current levels.

This can avoid some awkward conversations in the future. Ideally the fee wording would also cover changes to the FM's fee if the portfolio becomes a lot simpler, perhaps as the scheme moves towards buy-out and de-risks predominately into bonds and LDI.

Given increased allocations to illiquid assets, a key issue when moving to a new FM, is whether the new FM will charge fees on total assets including any legacy external asset holdings they inherit (increasingly common given the rise in the use of illiquids). FMs will often wish to charge a fee on these assets, even though the trustees will still be paying fees to the investment manager and, given the illiquidity of these assets, it may be that the new FM has no ability to sell the assets. In this case the question is, what is the FM actually being paid to do?

9

Make sure notice periods are appropriate

The IMA should specify the notice period that the trustees have to give the FM to end the relationship (and also the notice the FM has to give the trustees if they no longer wish to manage the assets).

The trustees' notice period will ideally be as short as possible. The FM's notice period needs to be sufficiently long to give the trustees time to hold a selection exercise for a new FM. Three months would be the absolute minimum time needed – most selections take longer.

Consider the extent of the trustees' liability

This is an important area for the legal advisor to consider. Trustees will naturally be concerned to see references about having liability beyond the value of the assets invested with the FM.

This is worth considering in more depth. The documentation may specify that the trustees have unlimited liability in circumstances over which they have control. A typical example of this is where the trustees have maladministered the scheme so that it loses its tax-exempt status – this is avoided by the overwhelming majority of pension schemes by trustees diligently meeting their responsibilities, taking advice, following the law / regulation etc.

A scheme losing its tax-exempt status may result in a large tax bill for the funds in which they invest (and hence for the other investors in those funds), so IMAs often contain language to protect other investors. Losing tax exempt status would never happen for a well-run scheme, so agreeing to take on unlimited liability is not much of a concession for a well-run scheme. However, provided all investors have unlimited liability, this gives the trustees protection against other schemes not being so well run. So unlimited liability isn't always bad!

Conclusion

IMAs and guidelines are critical documents, particularly if things go wrong in the future. This briefing has touched on a few of the issues. XPS can review IMAs from an expert investment perspective to make sure that the IMA serves the trustees' interests.

How can we help?

For more information, please get in touch with Adam Rouledge, André Kerr or speak to your usual XPS Investment contact.



Adam Rouledge
Senior Consultant

 adam.rouledge@xpsgroup.com



André Kerr
Partner

 andre.kerr@xpsgroup.com



Important information: Please note the opinions expressed herein do not take into account the circumstances of investors and accordingly may not be suitable for your fund. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investments is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents. This document should not be distributed to any third parties and is not intended to, and must not, be relied upon by them. Unauthorised copying of this document is prohibited.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.

© XPS Investment 2024. XPS Pensions Consulting Limited, Registered No. 2459442. XPS Investment Limited, Registered No. 6242672. XPS Pensions Limited, Registered No. 03842603. XPS Administration Limited, Registered No. 9428346. XPS Pensions (RL) Limited, Registered No. 5817049. XPS Pensions (Trigon) Limited, Registered No. 12085392. Penfida Limited, Registered No. 08020393. All registered at: Phoenix House, 1 Station Hill, Reading RG1 1NB.

XPS Investment Limited is authorised and regulated by the Financial Conduct Authority for investment and general insurance business (FCA Register No. 528774).

This report should not be relied upon for detailed advice. Permission for reproduction of material in this document must be sought in advance of any public domain use.