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Where next after ‘peak complexity’?

Outsourcing and risk management considerations for defined benefit pensions

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In this paper we explore the outsourcing approaches available to pension fund trustees and consider where outsourcing can manage complexity risk, as opposed to merely delegating it.

Over the last 30+ years, pension trustees have added significantly to their investment portfolios:

- introducing additional sources of return by asset type, geography, and investment vehicle, and
- using a wider toolset to manage and control risk

Overall, the results have been positive, but at the price of greater complexity. It has stretched governance resources and operational processes and has increased costs substantially.

One of the key issues arising from these changes has been the increase in the number of parties involved in the overall management of the portfolio.

This approach has been based on a belief that a best-in-class line up of fund managers can deliver consistent alpha over and above a diversified set of betas.

The cost of this model in terms of higher fees has always been a point of debate, with many schemes opting for passive management in more ‘efficient’ markets. This has helped drive down asset management fees in those areas significantly over the years.

But the cost of complexity in terms of the additional governance, liquidity and operational risks have not always been well examined.

The turmoil in gilt markets in September–October 2022 was a stark reminder that complexity introduces risks that can more than offset the performance benefit of a best-in-class strategy. This has profound implications for pension schemes, investment managers, investment consultants and other service providers, as it highlights that de-risking is about more than reducing investment volatility.

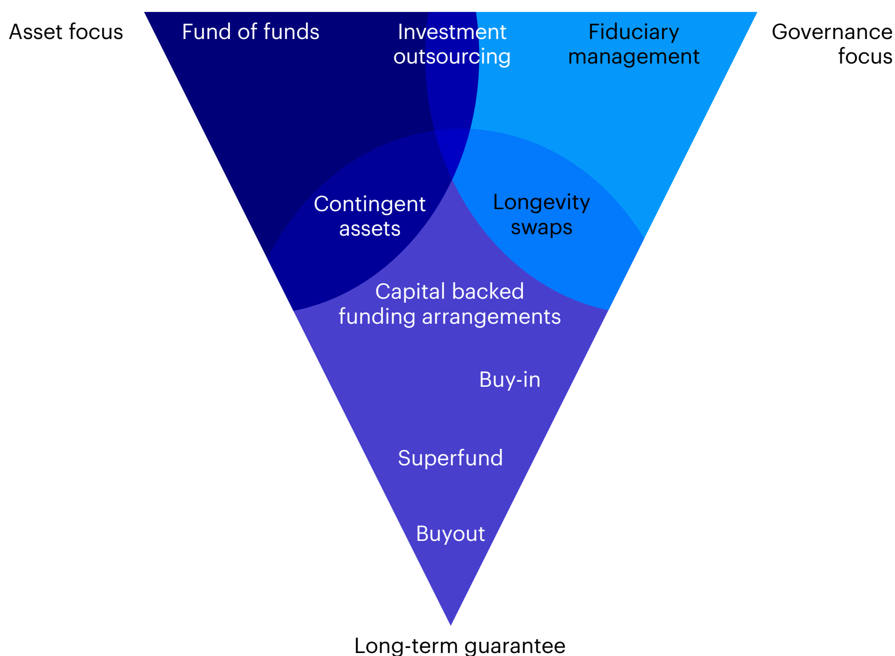
1. Outsourced investment approaches: A full menu

An array of approaches has been developed in recent years, which is perhaps evidence of the appetite for outsourcing in some form.

Indeed, industry feedback to the Pensions Regulator's revised funding code has been reflected in the final consultation material. The consultation adds emphasis of the flexibility available to trustees, and explicit reference to the visibility, reliability and longevity of the employer covenant as relevant factors in determining the scheme's investment strategy.

The three ultimate requirements to manage assets, govern the scheme and ultimately guarantee to pay pensions are variously in focus across the available approaches:

The outsourcing landscape



Source: Invesco as of 31 December 2022. For illustrative purposes only.

- A **fund of funds** takes responsibility for manager selection within a particular asset class.
- **Investment outsourcing** involves varying levels of outsourced investment responsibility bespoke to each scheme, may be provided by an in-house investment team, asset manager or fiduciary manager. May be referred to as Outsourced Chief Investment Officer (OCIO) (full or partial), or delegated investment services.
- **Fiduciary management** takes responsibility for a broader range of investment decisions, such as asset allocation and providing investment suitability advice. For smaller schemes this may be provided within a DB mastertrust, alongside other services such as pensions administration, actuarial advice and employer covenant monitoring.
- **Capital backed investment arrangements** allow a higher level of return to be targeted, backed by external capital. Capital provision may be bundled with the asset management, or provided separately (such as through employer-related contingent funding).
- **Contingent assets** in other forms may be used to focus on enhancing the covenant or pledging assets in case of insolvency.
- **Longevity swaps** can be used alongside an Liability Driven Investing (LDI) strategy either as a form of self-sufficient management or as a staging post to buyout.
- Investment contracts which pay a total return linked to a group of scheme members **(Buy-in)** can also be used as means of staggering full risk transfer over time.
- Finally, solutions which break the link with the sponsoring employer are available for schemes which either have sufficient resources to transfer all risks to an insurer **(buyout)**, or have sufficient resources to be managed on a self-sufficiency basis **(superfund)** where agreed with the relevant supervisory authorities.

2. The need for resilience: Risk reduced or simply outsourced?

Integrated Risk Management (pictured opposite), a key pillar of the Pensions Regulator's scheme funding guidance, highlights the importance of considering risk in the round.

However, the three pillars are not intended to be exhaustive: The risk of the investment strategy is greater than simply the 'investment risk' of the strategy.

In times of crisis, pension funds' investment strategies are put to the test. And this year has hardly been short of crises. Resurgent inflation, rising interest rates and Russia's invasion of Ukraine had already led to dramatic volatility in bond and equity markets before an abrupt shift in UK fiscal policy caught investors by surprise and made matters worse. Trustees need to assess the operational capabilities of their advisers and managers, the quality of communication, the performance achieved through these volatile markets and their confidence in the investment strategy. Are improvements required so the fund will be sufficiently resilient when the next crisis strikes? But care needs to be taken that, in solving one problem, another is not created.

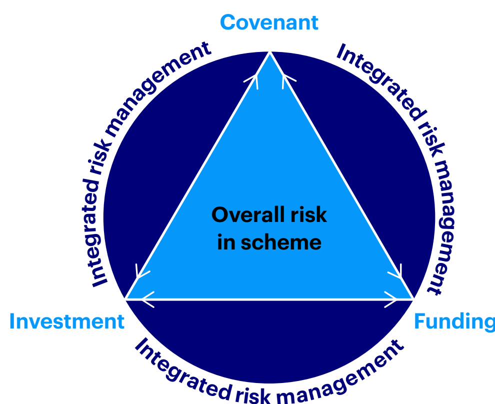
Anne-Marie Gillon
Head of Research at IC Select

We see that where investment risk management is outsourced, target return, value at risk, hedge ratio and illiquidity are the norm for key performance indicators. But what about risks that are harder to measure? For example:

- liquidity of the fund vehicles used
- the reliability of that in stressed market conditions
- pinch points in staffing (within or beyond the outsourced provider)
- handoffs between stakeholders

We believe these issues are particularly acute where a provider is operating "at scale", where a similar strategy is implemented across a large number of clients. All processes have points of operational weakness, within or between investment managers, downstream to outsourced service providers, or upstream to external decision-makers. The more stakeholders are involved, the greater the holistic operational due diligence needs to be to assess where the weakest points in the process lie, their potential impact and whether the scheme will be compensated if they fail. Such due diligence is often undertaken on each manager in isolation but rarely on the overall process.

The Integrated Risk Management Framework



Source: The Pensions Regulator.

When considering outsourcing, then, it is important to be aware what risks are being managed and how – out of sight is only out of mind until the skeletons fall out of the cupboard.

Strong fiduciary management offerings will assess the "return on complexity", reducing the number of handoffs required between stakeholders and adopt a higher governance approach only where it is justified by the superior risk management achieved. This may, for example, involve accepting a higher value on some risk measures, in order to better manage risks that don't show up in this measure.

Even an insurance buyout, rightly hailed for the strong protection afforded by private capital and the Financial Services Compensation Scheme, is not "risk free" – widespread corporate downgrades not anticipated in the "matching adjustment" regime may still cause havoc at some point in the future.

Outsourcing substantially to one agent, then, might not necessarily reduce risk.

The cost of complexity: A cautionary tale
The merits of holding an LDI strategy that consistently outperforms its benchmark by 0.2% every year for a decade (for example), would be wiped out in an event where the hedge ratio is reduced by 10% and interest rates subsequently fall 1%. For comparison, yields fell 1.2% in the fortnight following the LDI crisis.

In this instance, trustees are understandably looking for ways to reduce complexity as it relates to leveraged funds. However, there is always a danger of learning too specifically. Rather than simply add more assets into the LDI portfolio, we can at least ask the question if the extent of LDI exposure is still needed. For example, a switch from equities and gilts to long-dated credit may provide additional duration with no loss of return, a switch from growth assets to private credit may deliver similar benefit. Even where the LDI allocation is to remain unchanged, what is required is to have a keen eye on available 1, 5, 30-day liquidity and to act on it when required.

3. Considerations for best practice

We believe a wider view of risk can help. We offer some suggestions for harder-to-quantify risk management:

Three ‘signatures of success’ that stand out over the last few months are: schemes where sponsors and trustees had an established ‘joint working’ forum fared well – they could make decisions when it counted; simpler, well-understood investment strategies often fared better than complex ones; and trustee boards that were able to access a diverse range of viewpoints, both on the board and from advisors, tended to stay on course.

John Dunn
Head of pensions funding and transformation at PwC

Challenging advice
There is therefore no such thing as “impartial” advice in its purest sense. What is needed is access to sufficient advice, together with the ability, time and culture to appropriately consider, challenge and discuss that advice, to reach good decisions in the interests of those we represent.

Manager risk
Can diversification ever be too much of a good thing? In some cases, the reduction in value-at-risk from a strategy with a large number of managers can be more than offset by the adverse impacts of its complexity. This might be addressed, for example, by allocating schemes across a representative sample of best-in-class managers, without every client needing to be invested with every manager. In some cases, fee structures may need to be addressed where they incentivise complexity.

Liquidity risk
There are risks from having too much liquidity as well as having too little. The ability to realise cash from assets quickly is understandably a current focus. But this discussion should be focussed on where it matters – pension liabilities remain a long-dated and illiquid liability. There is a risk that larger cash buffers alongside leveraged LDI portfolios take schemes further from a low-dependency position that a mature mix of cashflow-matching credit and gilts might provide.

Industry concentration risk
Diversification by client type is often overlooked. It is common to ask of a potential fund manager what proportion the scheme’s assets would constitute, but with schemes’ asset allocation increasingly driven by the same drivers this is not enough: Each scheme might constitute less than 5% of a fund, but if 60% is UK DB clients, this is still a concentration risk. This concentration is particularly acute in UK property funds and some consultant-developed funds and led to several property funds suspending redemptions in October 2022 as multiple schemes sought to sell at the same time. Funds whose mix of client type and home country should offer more resilience against this (all else equal). This risk becomes particularly acute as the industry consolidates and exits certain asset classes in the coming years.

Cost risk
Improving value for money is not the same as driving fees down. When I take my car to be serviced I am attracted by garages with a lower service fee, but if the car breaks down later in the year I may regret my choice! So too with investment management fees – operational due diligence is a key part of overall fee discussions and while this is generally covered at inception, wearing down of fees over time might come at the expense of a hollowing out of operational resilience. For a manager, the desire to build scale is helpful if it improves efficiency, but will there be sufficient expert resource still available in a time of crisis? This will become an even more important consideration as the industry consolidates, if we are to get the right balance between quality and price and so avoid the “winner’s curse”.

Barbells are a heavy lift

Investment efficiency arguably took a leap forward when leveraged LDI portfolios enabled liability hedging while also closing the deficit using growth assets. This has resulted in a barbell "growth + matching" strategy for many schemes.

That barbell became more extreme in October 2022 as many schemes were forced to sell liquid "middle ground" assets (such as corporate bonds) to meet capital calls.

Barbell strategies are difficult to manage, as when one underperforms there is pressure to double down on its objective – as we saw in the "search for yield", when falling yields 2011–2021 led to greater demand for "high yield" assets, reducing their yield further (spreads move inversely to prices).

Global high yield spread to swaps (%)

Source: Bloomberg as at 16 December 2022.

An LDI-plus-growth portfolio is essentially the opposite of a matched portfolio of bonds that an insurance "matching" portfolio would hold. A 50-year gilt for example scores well on duration but extremely poorly on income and yield, whereas a diversified portfolio of reasonably long duration bonds (public and private, corporate and government) could deliver duration, income *and* yield.

While LDI may have been needed by DB schemes for hedging purposes when it was originally purchased, at the end of October 45% of corporate DB schemes were at least 90% funded on a buyout basis.[2] These schemes are in the enviable position that they can now afford this diversified bond portfolio without needing leveraged LDI at all.

Heading into 2023, the need for larger LDI capital buffers could further exacerbate the barbell rather than mitigating it.

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Derek Steeden
Portfolio Manager,
Invesco Investment Solutions

4. The case for partial outsourcing

2022 has been a wake-up call for many and we feel we may have reached (or exceeded) their appetite for complexity.

Stronger funding levels and a breadth of outsourcing options mean that many schemes could:

- reduce the need for leverage
- simplify the strategy
- spend costs well

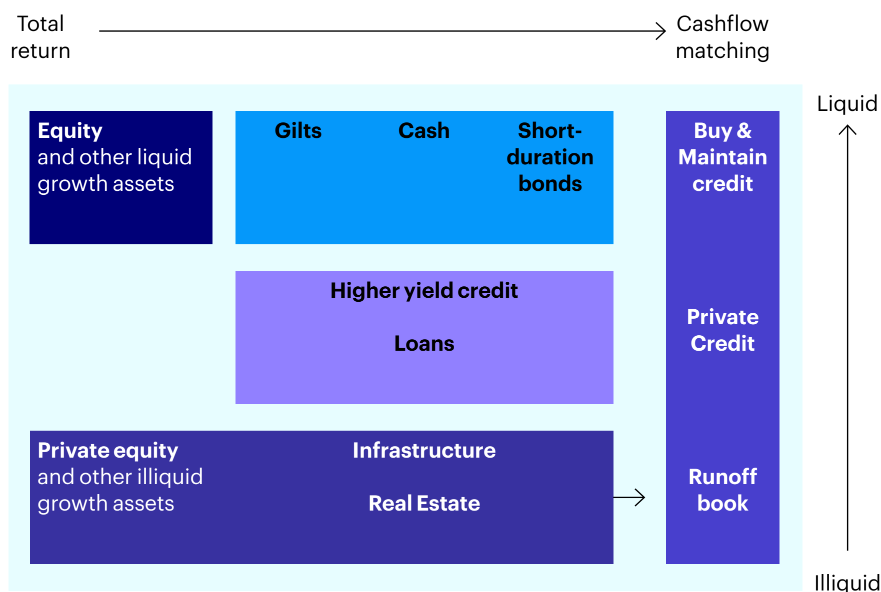
Fortunately, the menu of available options means an all-or-nothing decision on outsourcing is not required, or necessarily appropriate. It can be helpful to talk of partial outsourcing. That is, to ask:

- what is the minimum necessary complexity to achieve the scheme's objectives?
- to whom should these responsibilities be delegated? and
- how should they interact with each other?

Managing consolidation and runoff is quite a different skill set to managing for growth, as income timing, turnover and transaction costs all require careful consideration. Care needs to be taken to ensure the right focus on the "offboarding", when unlike "onboarding", the investment managers and manager selection consultant may be less incentivised to support. outsourcing can help address this, as one manager takes responsibility for the investment programme in a given area.

A scheme could, for example, decide to appoint one manager to deliver income and another to manage duration, together with an appropriate liquidity buffer. The former might manage cashflow-matching credit, private credit and running off legacy assets, while the latter focusses on LDI and cash. We illustrate this below. There are many potential groupings and the appropriate solution will necessarily be scheme-specific.

Liquidity can be managed by more than one provider



Source: Invesco as at 31 December 2022.

Such "multi-mandate" appointments can enable a genuine partnership between trustee and manager, allowing the portfolio to deliver on trustees' actual objectives, which can be hard to quantify fully in static investment guidelines.

They can also reduce turnover – while having a roster of managers with regular hire/fire decisions can harness manager outperformance, this can easily be eaten away by the transaction costs, advice costs and the harder-to-measure costs of complexity outlined above.

Finally, partnering with a few multi-mandate managers can also help a scheme build a scheme-specific runoff portfolio while having at least one eye to prepare for buyout should circumstances change.

Such partnerships may help us get ahead of future regret risk.

5. Future-proofing is essential, be that under full or partial outsourcing

We are seeing the desire for significant consolidation in the number of investment managers appointed by each scheme, but a concern that transferring all assets to one manager only could be unnecessarily limiting. Therefore, for many schemes, particularly the large schemes, there is an expectation/desire to consolidate asset management into a smaller number of sleeves, potentially with one manager responsible for their oversight and integration.

Every scheme is unique, therefore, it's critical that the outsourcing providers focus on the decisions that really matter to future-proof the scheme for its endgame objective. If the governance approach is to outsource, it is crucial to partner with a provider that truly dedicates time to understand the scheme's specific needs. A provider needs to have the tools, systems and people in place for holistic management of a scheme journey plan, to allow trustees to focus on decisions that are critical to achieving success.

Invesco manages £1.2 trillion[3] in assets globally across major asset classes and investment styles. Our strategic partnership approach and our outsourced investment management capability enables us to work with clients under a number of governance models. We are well placed to work with pension schemes under full outsourcing (all scheme assets) or partial outsourcing (e.g. sleeves of particular assets), but always with a view to future-proofing the scheme as it progresses on its journey to buyout or self-sufficiency.

Invesco Investment Solutions
Learn more

References

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2. LCP report on future demand and supply in the buy-in and buy-out market, October 2022.
3. Invesco as at 30 November 2022.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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