Market investigation into investment consultancy services and fiduciary management services
First Actuarial's response to the CMA's Statement of Issues

This response is provided by First Actuarial LLP. We welcome the opportunity to comment on the Competition and Markets Authority's Statement of Issues in relation to the market investigation into the supply and acquisition of investment consultancy and fiduciary management services in the UK.

About First Actuarial

First Actuarial is a consultancy providing pension scheme administration, actuarial and investment consultancy services to a wide range of clients across the UK. Our investment consultancy clients' pension schemes range in size from £0.5 million to just under £200 million in assets and cover a number of sectors including manufacturing, financial services, not for profit organisations and those providing services previously in the public sector.

1 Scope of the investigation

1.1 We consider the proposed scope of the investigation to be reasonable but we are strongly of the opinion that a clear distinction should be drawn between the consultancy markets for large and small pension schemes. Similarly, we think that it will be helpful to consider separately defined benefit and defined contribution pension schemes when carrying out the investigations and judging the effectiveness, unintended consequences and distortions of the various potential remedies.

1.2 First Actuarial predominantly provides investment consulting services to smaller defined benefit pension schemes, and unless otherwise specified, our comments in this response are drawn from that experience and related to such schemes.

1.3 In relation to the size of schemes, the cut-off is difficult to pin-down but certainly pension schemes with assets exceeding £500m have considerable flexibility regarding the investment options available. Smaller schemes, in contrast, face a much narrower range of solutions and will be much more reliant on pooled funds as a method of implementation.

1.4 The differing market by scheme size has an inevitable impact on the structure of the investment consultancy market. Those consultancies (such as First Actuarial) advising smaller schemes do not possess the research resources of the larger consultancies. However, our view is that consultancies advising smaller schemes do not require extensive research resources since the more bespoke investment solutions available to large pension schemes are not practical investments for smaller schemes.

1.5 This distinction introduces a separation of the market. Larger schemes will naturally expect their investment consultants to provide advice on the full range of available assets and will expect their consultants to have experience of all such markets. It is very unlikely that trustees of such a scheme would appoint an investment consultant that specialises in advising at the smaller end of the market. In our view, there is nothing wrong with this position – it simply reflects the relative sizes of firms within the investment consulting industry. Many smaller firms will aspire to become a large firm over time and will gradually attempt to move into advising larger schemes as and when they feel capable of competing in that market. Indeed, we provide actuarial and administration services to some fairly large schemes which retain a larger firm for investment consulting services. So clients are able to pick and choose providers for different services if they so wish, although this becomes more difficult if the client opts for a fiduciary management approach.

1.6 One effect of the increasing level of fiduciary management mandates may be that this migration from advising smaller schemes to larger ones becomes more difficult for firms to achieve.

1.7 One particular barrier we have experienced is where public service schemes explicitly ask for experience in providing advice to such schemes as part of any tender specification for investment consultancy services. This effectively closes that part of the market to new entrants and arguably, as a consequence, restricts innovation.

1.8 A consequence of the different approaches for small and large schemes outlined above is that the investment consultancy market is much more competitive for smaller pension schemes than it is for larger ones.

1.9 We see a fundamental conflict of interest in any arrangement under which an investment consultant recommends funds that are managed by that organisation (or, equivalently externally managed funds from which that organisation receives some remuneration).

1.10 Most of the smaller investment consultancies do not operate fiduciary management models. This conflict of interest is therefore far less prevalent for smaller investment consultancies. However, there is an increasing number of smaller schemes following the fiduciary management route and thereby becoming exposed to this conflict of interest.

1.11 We also see increasing evidence of fund managers seeking to provide strategic advice to the schemes that invest in their funds. We would urge the review of the fiduciary model to encompass fund managers that provide advice, as well as consultancies that have branched into fund management.

2 Effectiveness of the market for smaller schemes

2.1 Some smaller schemes do not appoint an investment consultant at all or will appoint an IFA to advise on the scheme's assets. In our experience, most IFAs fail to appreciate the nature of a scheme's liabilities and will approach the investment strategy in the way that they would for a high net worth individual. Many such advisers will implement retail rather than institutional investment solutions. For such schemes, the appointment of an investment consultant would usually result in lower AMCs, lower investment advisory fees and an investment strategy that is more tailored to reflect the scheme's liabilities.

2.2 We suggest that care should be taken with any attempt to open-up the investment consultancy market to a wider range of participants. Those giving investment advice to pension schemes should have a clear understanding of the actuarial methodology used to value liabilities so that investment advice can be well aligned with the scheme's funding approach – a key concept within the Regulator's Integrated Risk Management framework.

2.3 Focussing on the smaller end of the market where our experience lies, the use of independent trustees is increasingly finding favour. In theory, this should bring greater investment expertise to trustee boards and better equip those boards to understand and evaluate the investment advice received. However, our experience is that some independent trustees do not fully understand charging structures and can tend to simply replicate approaches used in other schemes, thereby reducing the range of investment opportunities utilised. Our experience is that most trustee boards (whether or not an independent trustee is in place) are aware that they are able replace their investment consultant and re-tendering exercises are common.

2.4 We do not believe that the use of independent trustees necessarily helps schemes to assess the performance of their investment consultant, and we would oppose making independent trustees mandatory. Many trustee boards already possess the necessary knowledge to undertake their fiduciary duties effectively and some would not welcome the additional costs that would arise through the appointment of an independent trustee. Furthermore, from our experience, the skills of independent trustees can vary significantly. We work with some very experienced and effective independent trustees who demonstrably add value in their role. However, as with all markets, some participants are less effective and we are sceptical that there are sufficient independent trustees with detailed investment knowledge to make mandatory appointments to all schemes a solution that would work in practice.

2.5 We have seen some examples of clients who are new to us being subject to lock-in penalty clauses in their existing adviser contracts. These clauses introduce an unwelcome barrier to changing investment consultant in a timely manner. Whilst such clauses might be reasonable, for example, in scheme administration contracts (where there are significant data acquisition and system set-up costs), the same cannot be said of investment consulting appointments. One recent case we were involved in had a penalty clause covering actuarial, administration and investment consulting services. The client wished to move for investment consulting services only, but felt unable to do so, because that service was tied in with the other two services, so moving it would have invoked the penalty clause. The existing provider was one of the “Big 3”.

2.6 We therefore believe that the existence of such clauses should be considered as part of the investigation.

3 Innovation

3.1 There needs to be a degree of realism about the extent to which innovation can flourish within smaller defined benefit pension schemes. Most schemes are in similar positions (closed to new entrants and further accrual of benefits, with a funding deficit) and many have the same long-term objectives (ultimately to buy-out liabilities with an insurer, once the scheme is adequately funded). It is therefore not surprising that investment strategies will tend to be similar across a lot of schemes.

3.2 In our experience, investment consultants will work with their trustee or employer clients to develop an investment solution designed to meet that client’s objectives, against the regulatory backdrop for defined benefit pensions schemes. We do not think it is reasonable to level a criticism of lack of innovation specifically at investment consultants.

3.3 If innovation is required within occupational pension schemes then this should be pursued with trustees (and particularly independent trustees) who are the parties with statutory responsibility for determining investment strategies. The regulatory framework would also need to be reviewed. The Pensions Regulator’s repeated emphasis on liabilities being gilts-related and minimising investment risk on this basis creates an environment in which gilts-based investments are generally perceived to be preferable. It is the regulatory framework and an emphasis from the Regulator on ‘de-risking’ that is stifling innovation within the market in our view.

3.4 At First Actuarial, we have, for some years, been challenging this gilts bias (for example by seeking to add balance to the funding debate with the publication of the First Actuarial Best Estimate Index). But it can feel like we are swimming against the tide.

4 Assessing the performance of the investment consultant

4.1 The scope document states "*The FCA found that on average investment consultants are not able to identify managers that offer better returns to investors"* and the issues document suggests that you may extend the FCA's analysis.

4.2 To focus on returns achieved from funds recommended would be to totally misunderstand the role played by investment consultants. In the same way that active fund managers cannot consistently pick the top stocks in advance, it is similarly unreasonable to expect an investment consultant to identify in advance which funds will perform best. To introduce some sort of grading system which rates investment consultants based on the success (luck) of their previous recommendations would be meaningless.

4.3 The most important area of investment consulting work is asset allocation advice. Such advice should reflect the particular circumstances of the individual scheme and its sponsor. Trustee objectives might therefore vary considerably across schemes. For example, two potential objectives might be:

- To target high long-term growth with little concern for short term volatility.
- To closely 'match' the assets to the liabilities to minimise funding volatility and deliver only modest growth.

4.4 Suitable investment solutions for these two schemes would be totally different from one another. The key role of the investment consultant should be to help each set of trustees design a strategic allocation that is appropriate for their objectives.

4.5 The investment consultant should then help the trustees to select fund managers that are well structured, well administered and where the assets are well protected. The consultant should also enable trustees to understand the characteristics, expected return profile and risks associated with different types of funds and, on an ongoing basis, to assess whether fund performance is consistent with the style of management that was expected from that manager.

4.6 The strategic asset allocation and funds used by the two example schemes described above would differ materially. At a later date, to compare the performance of the strategy implemented by one scheme versus the strategy for the other scheme would be meaningless.

4.7 Requiring investment consultants to report performance of their recommendations will inevitably increase costs and we believe the output will be of no value to trustees. Trustees themselves are best placed to assess whether the advice that they are receiving from their investment consultant is helping them to meet their investment objectives. If trustees conclude that their objectives are not being met then it should be easy for them to replace their consultant. At the smaller end of the market, we believe this to be the case but any barriers to such action such as lock-in periods or exit penalties should not be permitted.

4.8 In our experience, the most frequent reason for Trustees being dissatisfied with their investment consultants is due to the time taken for the consultant to deliver advice. If additional requirements are imposed on consultants with a view to enabling trustees to assess performance of their consultant, we would expect that the desired outcome would not be achieved (the additional information would not help trustees) whilst the inevitable consequence of higher fees and slower response time would be unwelcome.

5 Assessing investment consultancy fees

5.1 Our views on this are similar to those we have outlined for assessing investment consultancy performance. The fees incurred by a particular scheme will be driven by the needs of that scheme. Introducing a methodology for comparing fees across schemes is unlikely to produce meaningful information for Trustees.

5.2 With regards to the suggestion that consultants could publish details of fee discounts negotiated with investment managers – there is a danger that this will introduce a barrier to entry within the market. It is unlikely that consultants advising smaller schemes will be able to negotiate with fund managers as effectively as those advising the larger schemes. However, this would not reflect relative negotiating or consulting skills, but rather than relative buying power of the assets under advice.

5.3 We believe strongly that there is a significant lack of transparency in the total expenses arising within investment portfolios. We support the work being done by the Transparency Taskforce in ensuring that these fees can be assessed clearly. If there is a consensus of opinion that investment manager fees are too high, this would be better pursued via pressure on the investment management industry.

6 Demand side issues

6.1 For smaller schemes, the investment consultancy market is competitive and we do not believe dramatic changes are required.

6.2 If trustees were to repeatedly review their investment consultancy appointment, this could have unintended negative consequences, including:

- Investment consultants would spend more time on 'new-business' work rather than consulting which would slow down the provision of investment consultancy advice.

- Investment consultants would spend more time building up familiarity with new schemes – again acting as a drag on delivery of advice.

- Actuarial fees are likely to be increased if they are required to repeatedly provide liability information to a succession of different investment consultants.

- Repeated investment consultant changes are unlikely to help stable trustee boards and more stable Scheme Actuary appointments work together with the investment consultant under the Integrated Risk Management framework envisaged by the Regulator.

6.3 Our expectation is that all of the above consequences would result in an increase in investment consultancy fees.

7 Potential remedies

7.1 Except where referred to elsewhere in this response, we believe it would be premature to provide detailed comments on each of the potential remedy options included in the Statement of Issues - in particular, the various questions in paragraph 94. We do reiterate, however, that some of the remedies appear more suited to investment consultancy services for defined contribution pension schemes.

7.2 We suggest that the list of potential remedies be consulted upon further once the initial investigations into market characteristics and outcomes is completed, and any adverse effects on competition are identified.

First Actuarial LLP

12 October 2017