Competition & Markets Authority

INVESTMENT CONSULTANTS MARKET INVESTIGATION

Summary of hearing with Cardano Risk Management Limited (Cardano) held on 15 November 2017

Introduction and competitive landscape

1. Cardano explained that they provided both investment consultancy (IC) and fiduciary management (FM) services to trustees of pension schemes in the UK. They brought this model from the Netherlands and aimed to bring something different to the UK market. Cardano started offering FM services to UK clients in 2007. At this point the large IC firms in the UK were not offering much FM.

2. In general terms, when starting up, Cardano felt that they needed to have about 25 staff to be able to provide IC and FM services to potential clients. Cardano had some existing relationships with potential clients, but they needed to make considerable investment in manager research to operate as this is resource-intensive. Cardano's research covers a narrower range of providers than the 'big 3' ICs, but they aim to be 'deeper' in the managers they cover. Cardano believed that they had grown due to their industry experience and their reputation.

3. While Cardano's clients were predominantly Defined Benefit (DB) schemes, they had also provided ancillary services to Defined Contribution (DC) schemes. They were also working on a more comprehensive DC solution.

4. In FM, Cardano competed mostly against the 'big 3' ICs, P-Solve and SEI.

5. They found that FM is mostly used by schemes smaller than £1bn. They found that schemes larger than £10bn tend to have in-house investment capabilities, essentially in-house FM.

6. Cardano noted that there are three categories of FM:

   (a) ICs that have entered the FM market;

   (b) Fund managers who provide FM services; and

   (c) Specialists that have established themselves to provide FM services.

Based on this categorisation, each type tended to offer different solutions: consultants tended to implement almost exclusively through third party manager selection; fund managers could implement solutions in-house and through third-party manager selection; specialist FMs typically implemented solutions through a combination of direct investment and third-party manager selection.

7. Cardano designed and implemented LDI portfolios itself and accordingly they purchased gilts, index-linked gilts and swaps directly. Cardano stated that they also hedge currency risks directly using derivative contracts.

8. Cardano also offered clients IC services and FM services together, as well as purely IC mandates. They tended not to move clients from IC to FM but to offer FM at the outset. They tended to work on full FM mandates, rather than partial ones.

Demand side and outcomes

9. Cardano stated that they did not consider that the market for services to DB schemes was working well based on the evidence of poor financial outcomes (funding ratios) of DB pensions schemes over the last twenty years. LDI began to be used by pioneering big schemes (Boots & ICI) around 2000 but since then, the take up by the industry has been surprisingly slow, which has had a detrimental impact on scheme funding. The lack of support from the sponsoring company played a big part in this. Cardano believed this was an example of blurred accountability.

10. Cardano did not agree with other IC's beliefs that advisory work is about process, rather than outcomes. They believed that there was a gap in accountability for scheme outcomes.

11. Cardano believed that a lack of focus on outcomes has contributed to this gap in accountability. In this regard, they indicated that greater transparency in terms of performance would facilitate comparisons and effective monitoring of what pensions schemes are achieving, net of costs, and enable trustees to hold managers, consultancies and fiduciary managers accountable.

12. Around three quarters of their clients now had professional trustees. Cardano stated that professional trustees had made a positive impact on the ability of pension scheme trustees to achieve good outcomes. They noted that they perceived the main benefit to be professional trustee's impartiality, something which is beneficial when there are conflicts between the trustee and the sponsoring employee. However, they don't think that the presence of professional trustees adequately addressed the accountability issue.

13. Cardano stated that negotiating asset manager fees on behalf of clients was important, but that other factors such as capacity and other legal terms are equally important and form part of the overall negotiations with asset managers, alongside fee negotiations.

14. Cardano indicated that its IC clients had performed very differently from their FM clients. They stated that they were clearly accountable for the outcomes that they delivered in a fiduciary relationship. In this regard, they stated that their contract with its FM clients specifies clear objectives relating to assets versus liabilities and is funding-related. They also noted that Cardano frequently agrees performance related fees with their FM clients and is therefore financially aligned and incentivised to achieve the specified outcomes.

15. They thought that low IC switching rates may be due to the lack of clear performance measures and the fact that the service is very relationship-based. This is evidenced by the use of 'key man' clauses in some contracts. Switching was often triggered by a change of personnel at the IC or within the pension trust.

16. Cardano indicated that its FM offering provided trustees with more clarity into the process of their decision-making and better risk-management through the use of LDI techniques, as they were accountable for the performance of assets versus liabilities. While acknowledging that it is the trustee's role to set the investment strategy of the fund, the types of fiduciary contracts that Cardano establishes typically create a higher degree of accountability for outcomes than exists in most advisory relationships, because ICs typically did not have written into the contract an objective that relates to the funding or the performance of the fund.

17. Cardano indicated that most of their clients had appointed independent firms to review Cardano's performance over the course of their client's relationship with them. Cardano believed that the Pension's Regulator's (TPR's) guidance to pension trustees could be clearer with regard to how best to handle FM appointments, monitoring and tendering. They think this could be improved across schemes of all sizes.

18. As most FM mandates in the market were less than two years old, there has not been much switching yet. Cardano have also not yet won a FM mandate from another FM provider.

19. Cardano did not perceive the cost of switching provider to be high and believed that if clients are confident they can get a better outcome, then clients may switch. The transition may take a year to complete. The process

of switching FM provider does involve the cost of moving assets, to the extent that the new FM would change underlying investments. However, trustees would not bear the brunt of the work involved in transferring assets, as the new FM provider would manage the transition and would aim to absorb the associated costs of overseeing the transition over the life of the relationship. They noted that when undertaking a cost/benefit analysis of on-boarding new clients versus front-end transitional costs, Cardano assumed a five-year minimum relationship with the prospective client.

20. Cardano has worked with IC Select on the FM performance framework and supported this. Cardano thought that performance should be reported net of fees and taking risk tolerance into account with a risk-adjusted return. They noted that most FM tenders do not request providers to quote performance data. They noted other IC's objections to having performance measured for the reason that they were not in full control of a scheme's outcome, but they think that, aggregated across all of a firm's clients, a performance measure would still be valid.

21. [✂]. Cardano indicated that it is very much rarer for pension scheme trustees to switch FM than it is for them to switch IC, partly due to the market for the provision of fiduciary management services being nascent. Cardano has never lost a fiduciary management mandate that they had held, nor have they won a FM mandate that had previously been held by a rival. Cardano also reiterated the difficulties in assessing performance, because of an inability to compare providers. Additionally, based on its experience, Cardano stated that it is rare to be asked about its performance track record during the fiduciary tendering process.

22. While Cardano confirmed that a set of industry standard rules to improve the tendering process and make it more transparent would be beneficial, they stated that mandatory tendering should not be introduced, as it could be costly. Instead, they suggested that as trustees are best placed to judge whether or not they should take action, guidance on how trustees might go about selecting and monitoring an IC or FM, as well as encouraging them to develop clear objectives would be beneficial. This guidance could be provided by TPR as an independent party.

23. Cardano supported the potential remedy requiring FMs to report on pension fund returns against agreed benchmarks. While noting that such proposals would involve developing an industry standard benchmark, Cardano advocated a standard based on asset performance, net of all fees and costs, compared to liabilities, as well as a mechanism for calculating a risk adjusted return. The Global Investment Performance Standards (GIPS) method requires that composite returns must be calculated by asset weighting the

individual portfolio of returns, using beginning-of-period values to show a composite return that reflects the overall return of the set of the portfolios included in the composite.

24. Cardano stated that it would be possible to use the same approach for providers of purely advisory services. While acknowledging that there may be some difficulties with interpreting the results of this approach to the provision of advisory services, such as trustees not taking advice, they noted that aggregation across consultancies' client base would be effective, as most advisers should face similar difficulties.

25. Cardano stated that an industry standard of reporting on pension fund returns against agreed benchmarks would require an objective measure of risk based on a realised measure of risk, such as volatility or the draw down. Cardano indicated that the challenge of risk adjusted returns is having a sufficient time horizon that includes periods of financial stress or volatility.

Conflicts of Interest

26. Cardano stated that they had always been clear with clients and potential clients about which services they offered to clients and that Cardano had built their business with a clear philosophy and process around how they believed pension schemes should invest, what the outcomes should be and the importance of risk management.

27. Cardano indicated that they had not moved any of its advisory clients to FM. Cardano indicated that IC is very relationship driven so an incumbent consultant had an advantage when FM is being tendered. Where there is an incumbent IC and the client is considering whether to switch to FM, there should be some parameters around market testing and a comparison of prices and performance. TPR could help by producing guidance about the process of selecting, monitoring and working with third parties.

28. They thought that there is a potential conflict for ICs which do not offer FM and who will not wish to recommend it and that this should be considered as part of the review.

29. Cardano indicated that transparency both in respect of a firm's activities and its other interests and charges should be the starting point to dealing with the areas that have been identified as a potential conflict.

30. Cardano had procedures in place in relation to gifts and hospitality. They indicated that they did not perceive gifts and hospitality as a problem within the industry and noted that MiFID II will introduce strict rules about the

non-monetary benefits that a regulated firm can accept. Recent guidance from the FCA is aligned with the forthcoming MiFID II rules.

31. Cardano believed that it was not clear to pension schemes which investment activities are FCA-regulated and which are not. Cardano treated all their activities as FCA-regulated as they did not provide any stand-alone strategic investment advice. They believed that, if the provision of IC and FM services was brought within the FCA's regulatory perimeter, institutional investors would benefit from having comfort that all firms fall under the same regulatory remit, which would improve confidence in the industry.