Aon Investment Research 2020

Covid, climate and compliance– are you ready for the new investment challenges?

Focus on costs and transparency

Empower Results®

Contents

Foreword

2020 has been a year of significant change for UK pension schemes' investment strategies — even before we take the effects of the Covid-19 pandemic into account. Governance has come under ever-greater scrutiny from The Pensions Regulator, responsible investment is rising rapidly up the trustee agenda, and pension schemes are demanding ever greater cost transparency from their providers.

Over the summer, we set out to listen and to understand how investment decision-makers were responding to all these changes and accompanying challenges. Through a series of in-depth interviews, we were able to gain real-world insights into key trends, common approaches — and differences — to paint a picture of current thinking in pensions investment.

Inevitably, the pandemic was a common thread running through all the discussions. And, while it's still too early to understand its longer-term effect on schemes and markets, the crisis has already started to reshape investment strategy decisions and the way these are made.

Now, more than ever, investors need support to continue to protect the retirement income for their members and to manage the increased pressure and demands on their investment governance and operational strategies. We have specialist teams and deep expertise to help you to rise to all these challenges — from governance, responsible investment and investing for the endgame to costs and transparency and the DB funding code of practice.

We look forward to continuing the discussion with you.

Emily McGuire
Partner, Aon

About the research

In July and August 2020, Maggie Williams, an experienced pensions commentator, writer and editor, carried out in-depth interviews with 20 pension scheme decision-makers on behalf of Aon. Interviewees were drawn from a wide range of disciplines — professional, independent and member-nominated trustees, third party evaluators and pensions managers — representing both defined benefit (DB) and defined contribution (DC) schemes. DB scheme sizes ranged from a £10 million to over £10 billion.

The interviews focused on five key areas:

- Investment governance
- Responsible investment
- Investing for the DB endgame
- Costs and transparency
- Investment implications of the DB funding code of practice

Our thanks go to everyone who took the time, during very difficult and challenging circumstances, to participate in this research and to provide valuable insights.

Read all reports

Aon insight
Costs and transparency

We are still at the start of the journey to improving investors' awareness and focus on charges. It's a journey that has been started several times before but never completed. This time it feels, and is, different. There is now a real impetus (and regulation) behind improving transparency of asset manager costs.

Over the summer of 2020, we surveyed over 100 pension scheme trustees and almost all agreed that cost monitoring should be an integral part of a trustee's investment manager monitoring toolkit. As a minimum, they all expected to require full transparency from their asset managers in future.

The FCA's desire for a standardised and consistent template for the disclosure of charges has culminated in the release of the Cost Transparency Initiative (CTI) templates. However, the templates should not be seen as an immediate panacea to the ills of opaque and inconsistent disclosure practices.

Our team has been at the forefront of the initiative and has worked with almost one thousand 'completed' templates from managers. There is still a lot of work to do: the quality of submissions needs to improve markedly before trustees can start to use the data with some degree of comfort around its veracity. For example, in one exercise, we analysed 150 cost submissions from managers and only around a quarter contained data which was usable without further recourse or resubmissions from the asset managers.

There are concerns that giving investors access to more information about charges may lead to unintended, and potentially negative, consequences for pension schemes. For example, there are fears that the provision of data on transaction costs (which can account for up to 50% of a pension scheme's total investment charges) may lead to less efficient portfolio structures in the pursuit of lower costs. We think these fears may be unfounded. Virtually all the trustees we surveyed recognised that transaction costs are necessary to produce investment returns and that 'large' costs are not necessarily a bad thing, provided these are fully understood by trustees. At Aon we believe the important thing is to understand the costs, monitor the trends over time and ask managers to explain if, and when, divergences begin to emerge.

In time, we expect the quality and quantity of data to improve and, with it, the ability to benchmark your pension scheme's charges and performance against the rest of the industry. This will drive even more value for scheme members. Aon will continue to be at the forefront of these initiatives for our clients, and the wider industry, with the aim of increased costs transparency in the near future.

Neil Smith
Head of Costs & Transparency, Aon

Cost is whose problem?

Institutional investors, and particularly trustees, say they have a responsibility to drive greater transparency around costs. "At the end of the day, the more money trustees are paying in fees, the less they are delivering to members," said a professional trustee of a DB and DC scheme. "You need to be able to challenge the providers for the fees they are charging and the basis of them and determine if they are reasonable or not."

A professional trustee, working with both DC and DB schemes, concluded that both regulators and investors need to drive greater transparency. "It has to be a combination of institutional investors and regulation. Finally, we are getting some traction on the regulation side and that's making quite a difference. Institutional investors could do more – and could stick together more."

> "Some managers claiming to be active are really index-hugging, and yet charging an active fee. That is unreasonable and must be challenged. Trustees do have a responsibility to improve transparency, but at the same time, the fund managers must be reasonable."
>
> Trustee, medium-sized DB scheme

This view was echoed by a third party evaluator: "Clearly, trustees are in a position of influence, but only if they act collectively. The question, then, is how do you enable that to happen? I'm not sure I have the answer, but asset pooling is one example, and I would like to think that fiduciary managers who look after vast sums of aggregate pension scheme assets have the ability to drive change." Very large schemes could also be able to apply pressure in isolation, but the same respondent concluded that "for a regular small or medium-sized scheme, there is very little they can do by themselves. But it is beneficial for everyone if change can happen."

> "Just how effective regulations will be [at improving transparency] is interesting, because you still hear stories of different providers finding clever ways to report costs differently within new rules. Other providers complain then that [trustees] can still not compare like for like."
>
> Third party evaluator, DB schemes

Transparency around charges is integral to building trust between asset managers, consultants and trustees. "A lot of trust is built through the scheme and consultant relationship," said a third party evaluator. "Part of that is being transparent and ensuring that trustees do understand what they're paying for. I think that's best practice." The same respondent felt that progress had been made recently to improve levels of trust: "I think over the last year or two, transparency has got better. Having independent oversight helps with that, and fiduciary managers have got better too." However, there is still work for some trustee boards to do: "There are probably still some schemes out there who could understand a bit better what they're paying, in terms of different layers of fees."

The relationship between cost and value

Even with greater transparency, respondents said that cost information alone would not drive their investment strategy or asset class selection. Rather, it would be used as the basis of discussions with asset managers about future cost management. "It's all enabling the end user to take a view of value for money. It doesn't mean you pay the cheapest," said one professional trustee.

"It is always a difficult conversation for schemes, because fees are certain, and returns are not," added another respondent. "It would be wrong to choose investments based only on the lowest possible fees because you would put all your money in passive equities, which is probably not appropriate for most schemes."

> On one hand, it's the net performance that is important to me. But we should also be saying, 'You should be transparent about what you are charging us.'
>
> Professional trustee, DB and DC schemes

"My philosophy is that you have to pay good money to get good advice. You must give people leeway to express themselves, and you must pay for that. I don't think it's any coincidence that the schemes following this mentality are the ones which have got to the best place."

The exercise of exploring costs in depth can drive wider governance changes in the portfolio. One DB trustee gave the example of how an exercise to examine costs had led to consolidation of passive mandates across several schemes with a single manager. The trustee estimated that the scheme had roughly halved the cost of its passive management in doing so.

When costs are carefully monitored, they can help to drive decision-making at asset class level as well. A trustee of a large DB scheme, with a DC section, running its own in-house investment team said "[Cost monitoring] provokes conversations about why we own a particular strategy and whether it is a good deal or not from a cost benefit perspective. On occasions it has led to some interesting conversations about why we are taking on something that is so expensive when it is not obvious we are getting the returns."

All respondents felt that reducing costs would not hinder creativity either for schemes or asset managers. They felt that asset managers would still have sufficient capacity to innovate and would need to do so to attract volumes of assets in the future.

> "Asset managers are always going to need to look for differentiators to be attractive. They can just about differentiate with cost, but I don't think that's enough. I think there will be more innovation, not less, if the schemes demand it because they want the business."
>
> Professional trustee, DB and DC schemes

The Cost Transparency Initiative and standardised reporting

Cost transparency is complicated by inconsistent formats and reporting, but there is action from within the pensions industry to address this. All respondents were aware of the industry-driven Cost Transparency Initiative (CTI), which aims to introduce a set of standards and common templates for asset managers to use with pension schemes. However, only around half have explored its potential for their own scheme. Three respondents had been directly involved in helping to shape the CTI standards.

Respondents saw CTI as a positive move that will be beneficial but is still at an early stage. Yet more work and wider adoption is needed. “At the moment, [CTI] is something of a struggle because the data that comes out is still not particularly transparent,” said a professional trustee who also chairs boards. “You have to take the information with a fairly large pinch of salt. But the initiative and the direction are incredibly helpful.”

> "We're already starting to talk to the individual managers to say, ‘Well that just looks off the mark'. If they refuse to do anything about it, we're then starting to question whether that is a trigger to make a change. Or, if we like the asset class, to identify a replacement manager who will manage it in a more transparent way."
>
> Investment manager, DC scheme

The same respondent gave an example of a scheme that estimated its annual investment costs were between £7m and £8m before using the CTI approach. “The far more accurate and detailed assessment of the costs truly staggered the board and were closer to £15m.”

Some participants said that they are using their own in-house processes or other industry templates, such as the DC Workplace Pensions Template (DCPT), to collect cost information. With no regulatory guidance, schemes and their managers select what they feel to be the best approach for their needs. “We get our transaction cost data from our platform provider,” said one DC scheme trustee. “We can ask them to report either way (using CTI or DCPT). They have opted for DCPT and unless there is a strong steer from a regulator, or otherwise, I don’t see us changing.”

> "I don't think [CTI] will change our approach a lot in the UK [as we have already explored costs in detail]. The challenge for us will be how we comply with any future reporting requirements in the most cost-effective way. But we might surprise ourselves. We might find something where there is a cost saving but I suspect it won't be massive in our case."
>
> Trustee, DB scheme

Without regulation to mandate an approach, most respondents felt that inconsistent data will continue to be the norm, and make it difficult to compare like with like, even within an asset class. Inconsistency in cost reporting is not just an issue for schemes that want to better understand their investment costs. It is also causing issues for decision-making. “There is no uniformity in how managers are reporting,” said the investment manager of a large DC scheme. “You end up comparing apples and oranges which doesn’t serve anyone’s benefit.”

Some respondents questioned if the amount of time and money involved in improving transparency justified the benefit they would achieve. However, others have already seen sizeable savings from improved cost transparency. Participants felt that as an aggregate across the DB pensions industry, there will be savings – but the benefit will vary from individual scheme to scheme. “Do the benefits outweigh the costs [of carrying out transparency exercise]?” asked one DB trustee. “Maybe on an industry level the answer is yes, but not for all schemes.”

> "My observation on transparency would be there's a cost to working out, writing down and publishing what your costs are. So, if we're going to be asked to spend more money to prove that we're saving money, we have to ask, where is the balance?"
>
> Trustee, large DB scheme

What to do with cost data?

Once schemes have more transparent information about their costs and charges, how will that affect decision-making, both in terms of selecting providers and making decisions on asset classes? “Up to now, many decisions have been cost-driven, but those haven’t always reflected the true cost,” said a professional trustee. “Having a complete picture is always going to help you make the right decisions.”

A professional trustee questioned whether all boards have the governance capacity and skills required to analyse data about costs collected using CTI and other templates: “If we were drilling into this in any detail, I would engage a third party with the requisite skills to advise me. I’m a professional trustee, but I’m not an investment expert. I would still need a third party to help me decide whether the fees are fair.”

The blend between active and passive management is one area where cost and value are hotly debated. “I think there are areas where active management is absolutely required. You need to be able to see what the actual difference in cost is and whether that provides good value. On DC, cost information is critical because there’s no way individual members are going to be able to see what they’re being charged,” said a professional trustee with responsibility for both DB and DC schemes.

Costs and charges – the DC Chair's Statement

DC scheme trustees are already engaged to some extent with cost transparency, as well as the relationship between charges and value for money. With a charge cap in place on the default fund, plus TPR requirements to show costs and charges borne by members during the scheme year – and over time in the Chair's Statement – it is a part of running a compliant scheme.

However, several respondents felt that the information required for the Chair's Statement offers little benefit, either to the scheme or to its members. In fact, one felt that the information reported in the statement might have a negative effect on investment innovation: "It's been quite unhelpful for investment. You are having to input the cost and charges illustrations into your Chair's Statement and report on the level of transaction costs. It's making actively managed funds look much more expensive, with much, much higher transaction costs. All the other benefits of active management – the volatility dampeners, the controls, the ability to shift, make practical calls, strategic calls – are not really factored into the limited capacity that's asked for in the statement. Arguably, it is pushing trustees towards more passive mandates."

"As an end user, we should expect transparency. It never ceases to amaze me that when we first had to disclose costs on a chair's statement, that asset managers said, 'We don't know how to get the transaction costs accurately.' You just think, 'Don't you remunerate your staff with bonuses based on all transactions?' To drive change, we should demand it."

Professional trustee of DB and DC schemes

As there is a direct relationship between charges and DC members' savings, communicating information on costs and value in a meaningful way is another important consideration.

However, respondents felt that the Chair's Statement requirements do not fulfil this brief either. "For the average member, [Chair's Statements] are very difficult to understand. I think there is good information in there, but there is an education piece for members to help them understand it," said the investment manager of a large DC scheme. "I think it can be improved. That impetus should come from The Pensions Regulator in terms of clear language initiatives to make this better."

"It's really important to understand the nuances of transaction costs, and the tweaks that asset managers make. We need standardisation and transparency in DC – you could end up spending so much time on this."

Pension committee chair, DC scheme

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Aon Investment Research 2020

This report forms part of a body of research into current thinking in pension investment.

Access all the reports in the series to discover key trends and common approaches among pension scheme decision-makers as they rise to the challenges presented by covid, climate and compliance.

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