Quarterly investment briefing
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First Actuarial LLP

Discussion topic – manager research

In this quarter's investment briefing Dominic West, the latest graduate to join the investment team, speaks to Rob Skelton and Tiksha Kaul about the latest areas of interest in fund management.

Dom: I hear you had 80 meetings with fund managers last year. Apart from all those long lunches, what did you get out of it?

Rob: Ha! I think you're referring to the "good old days". Nowadays, things are much more professional.

Tiksha: To be frank, I'm glad. I can think of much more fun things to do with my lunch break than speak to fund managers. New regulations (MiFID II) make it even easier to turn them down.

Dom: OK, sounds less glamorous now. So, what exactly do you talk about when you meet with a fund manager?

Rob: It depends on the purpose of the meeting. Some of the meetings are about seeing the whites of the eyes of the individuals making the investment decisions. These meetings tend to come at the end of a detailed manager selection process when we're down to just a handful of candidates.

Tiksha: We also use those meetings to clarify all the details of the funds. Our rating committee won't approve the funds if we haven't done this due diligence.

Dom: You say you get down to just a handful of candidates. How many do you start with?

Tiksha: As many as possible! For the last search we did, we wrote to around 40 fund management firms. We have a database that lists the asset classes fund management firms have expertise in. For each search, we ask the fund management firms with the required expertise to put forward a product. We then screen the list down based on the information they provide and responses to our questions.

Dom: What other purposes do your meetings with fund managers have?

Rob: Other meetings are more of a general catch up on market trends and product development. These meetings are very useful as they allow us to think ahead about the type of products our clients may benefit from accessing in the future.

Tiksha: And don't forget - discussions around what's going on in the fund managers' business. We saw quite a few corporate restructures last year along with key fund managers retiring or changing firms. These changes can be very disruptive, so we try to thoroughly understand what's going on before advising clients about it.

Dom: So what insight into market trends and product development do you have?

Rob: The FCA's referral of the industry to the Competition and Markets Authority has been a big driver for change. Especially for those firms operating both consultancy and fiduciary management businesses; the likes of Aon Hewitt, Mercer and Willis Towers Watson. These firms now make it clear that the fiduciary management part of their business should be treated like any other fund manager. These firms are also starting to behave like any other fund manager by looking to distribute their products more widely.

Dom: Do these fund managers have any products of interest to our clients?

Tiksha: Rightly or wrongly, they had a captive audience and that has allowed them to herd investors into products that might otherwise have been difficult to get going. Some of their illiquid market funds access asset classes such as infrastructure, renewables and long lease property. We think these are of interest.

Rob: That's not to say that illiquid markets can only be accessed through fiduciary fund managers. Many traditional fund managers have responded by launching similar products. There are private market specialists who offer diversified funds in this area.

Dom: What about fund manager fees? I hear you talking about that a lot.

Tiksha: I think there has been increasing scepticism about the value fund managers can add through active management. This has put downward pressure on their fees. We've seen some fee reductions on active products along with mergers of fund managers designed to cut costs. Hopefully, fee reductions will continue.

Rob: In a similar vein, "buy and hold" corporate bond products are gaining more traction. Such products sit somewhere between active and passive in terms of fees.

Dom: What do you mean by "buy and hold"?

Rob: The managers of these funds actively select the bonds they buy based on the yield and the potential risk of default. However, once they've bought these bonds, they try to hold them to maturity rather than actively trade them.

Tiksha: In practice, there will be some trading of bonds in a buy and hold fund. If bonds perform particularly strongly and there's not much potential return left, they'll be sold. Similarly, if the manager is concerned about default, they'll sell. "Buy and Maintain" is probably a more accurate description.

Dom: I get it. Anything else?

Rob: Cashflow matching is a subject that fund managers are talking to us about more often. The aim is to avoid being forced to sell assets to pay benefits. Doing so would avoid trading costs being incurred and the potential to crystallise a loss by selling an asset at a depressed price. However, predicting benefit outflow more than a few years ahead is very difficult so trying to deliver income that matches it accurately may not be worthwhile.

Tiksha: There's also the threat of climate change and the risk this poses to asset values and future returns. Funds designed to avoid or reduce exposure to fossil fuels may help mitigate the downside. Additionally, funds designed specifically to do well in a transition to a low carbon economy may help hedge some of the risk within other funds.

Dom: Of these new developments, which ones do you think pension schemes should consider as a priority?

Rob: A lot of pension schemes can liquidate all their assets within a few days. There is generally no need for schemes to be able to do that, so illiquid assets are something to consider. Especially now, there are plenty of options available to access these markets.

Tiksha: The impact of climate change risks may not be that far off also. Recently, it was reported that the New York City pension fund will divest all its $5bn invested in fossil fuels companies within the next five years. If other major investors follow suit, it could have a major impact on markets.

Rob: Last on the list are buy and maintain corporate bond funds simply because yields are so low. However, if yields were to rise dramatically, it might be a no-brainer to lock in by buying bonds and holding them to maturity.

Small print

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