

# The Trustee toolkit downloadable

## Investment in a DC scheme

### Tutorial five: Managing performance

By the end of this tutorial you will better understand:

- ▶ factors to consider when reviewing the investment strategy and investment performance
- ▶ steps trustees may be able to take to withdraw or replace an investment option including communicating to members
- ▶ what 'out of market' risk is and ways of mitigating it

This tutorial is part of Scenario two.

#### Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

# Introduction

Trustees of a defined contribution (DC) scheme are responsible for setting the scheme's investment strategy. This is documented in the scheme's statement of investment principles (SIP).

You will find more information in the Tutorial: 'Setting an investment strategy'.

For qualifying schemes used by employers to comply with their duties under automatic enrolment legislation, trustees are also responsible for the investment strategy of that scheme's default arrangement. These legal requirements are aimed at ensuring the long-term suitability of the funds underlying the scheme.

It is important, and for some schemes it is a legal requirement, to monitor and review a DC scheme's investment strategy for its default arrangement(s) as well as any alternative investment options trustees have made available for members who wish to set their own investment strategy.

This comprises elements such as:

- ▶ reviewing the appropriateness of the relevant investment strategy
- ▶ reviewing the performance of the arrangements and funds underlying the strategy
- ▶ considering other events that could trigger a review

This tutorial covers these three elements as well as dealing with the results of reviews and making changes to the investment options available as a consequence.

You will find more information in the guide to investment governance at [www.tpr.gov.uk/invest](http://www.tpr.gov.uk/invest)

## Reviewing the appropriateness of the relevant investment strategy

It is a legal requirement that trustees formally review the SIP at least every three years or without delay after any significant change in investment policy.

If your scheme is required by law to have a default arrangement, the investment strategy for, and the performance of that default arrangement must also be reviewed at least every three years and without delay after any significant change in the investment policy or significant change to the demographic profile of relevant members.

You will find more information in the Tutorial: 'Setting an investment strategy'.

## Typical questions

The review will typically consider the questions below, covering the time period since the last review.

### Has there been a significant change of employer structure or member demographic?

For example:

- ▶ a bulk transfer (following an acquisition or a merger) which changes the profile of the membership
- ▶ a significant increase in the average contribution paid by members
- ▶ a particular group of members

These examples could lead to a change in the risk appetite of the membership and therefore the suitability of the investment strategy or funds offered.

### Is the range of options offered appropriate?

Trustees should consider the take up of the alternative investment options. If members are not investing in them, trustees should look at why this is and consider the extent to which it is appropriate to offer a different range of funds. Trustees should also consider introducing additional funds that the membership may request or that its profile may warrant, for example, the addition of a Sharia-compliant fund.

### What is a Sharia-compliant fund?

A Sharia-compliant investment fund invests in accordance with Islamic law. It excludes investments in companies involved in producing alcohol or pork-related products, financial services and gambling.

### Is the lifestyle strategy still appropriate?

Trustees should consider how and when members are choosing to access their benefits and whether the lifestyle strategy meets their needs. For example, a lifestyle strategy may target annuity prices towards the end of a member's career but the majority of members might in reality take an income at retirement via flexi-access drawdown. In this situation, the trustees are likely to want to consider altering the decumulation (or retirement) phase of the lifestyle strategy.

### Is the lifestyle strategy meeting its long-term objective?

For some lifestyle strategies, trustees may set a long-term investment objective for the growth phase and a separate one for the decumulation (or retirement) phase. For example trustees may set an investment objective of outperforming inflation by 3% pa in the growth phase and to match annuity prices in the decumulation phase. Trustees should assess whether their objectives have been met.

## Are the investment fees appropriate?

Trustees should review the costs associated with the investment options offered to members and consider if they remain appropriate, offer value for members and comply with restrictions to charges that may apply.

## Other considerations

Trustees should also consider if there have been significant innovations in the DC investment market and if there have been major changes in the financial markets, economy or the tax treatment of pensions or investments.

### Reviewing performance: John's story

If you have already worked through the Tutorials: 'Default investment options' and 'Alternative investment options' you will have met John.

At 40, John was a new employee of Pasties and Pies, a UK distributor of baked goods to cafes. John didn't have much of a head for financial matters and had never saved for a pension until he joined the Pasties and Pies scheme through automatic enrolment. He didn't make an active decision about investment so was automatically put into the default arrangement selected by the trustees.

Six months before he retired he showed his pension statements to a financial adviser friend to help him decide what to do next with his pot. He was astounded to find that his pension was worth less than he imagined. The adviser looked into it and found that the fund is an actively managed global equity fund and his entire pot was still invested there, even six months before his expected retirement date.

The fund had not only underperformed the market consistently over the past 20 years, but had crashed in value in the last six months. The charges were also very high for what has been delivered and in comparison to other similar funds.

In John's case the default arrangement has underperformed the market consistently over the past 20 years. But, what was the objective of the investment strategy for the default arrangement? Were the trustees reviewing this regularly? And if so, why did they not consider changing it? What if John had been invested in an alternative fund which had seen the same performance? Would the trustees have reviewed or changed that too?

# Reviewing performance

Trustees should regularly review the performance of each investment option offered to members and of each fund underlying any default arrangement against their stated investment objectives and industry benchmarks. The way in which trustees review the options made available to members will vary from scheme to scheme.

## Understanding when to review

Typically, trustees will want to monitor performance (net of fees) against investment aims and objectives on a quarterly basis. However, as a general rule, trustees should consider the long term nature of pension scheme investments and should not take decisions based on short term performance. They need to consider performance in the context of the strategy they have set. Some trustees may set different review periods for different investment options.

For default arrangements of schemes being used by employers to comply with their duties under automatic enrolment legislation, the strategy and the performance of any default arrangement must be reviewed:

- ▶ at least every three years
- ▶ without delay after a significant change in investment policy or a demographic profile of relevant members

It must include reviewing the extent to which the return on investments relating to the default arrangement (net of fees) is consistent with the relevant aims and objectives, as set out in the SIP. Trustees should also review the performance of any other investment funds they make available for members who set their own strategy.

## Understanding the investment process

For actively managed funds trustees may consider the investment process of the funds offered to members when reviewing the performance. For example:

- ▶ depending on the asset class, an active investment manager may not expect to outperform in all market conditions
- ▶ a defensive investment manager would not expect to outperform in strong rising markets

You will find more information in the Tutorial: 'Types of asset: Common asset' in the Module: 'An introduction to investment'.

## Understanding the markets

Trustees should consider the market environment over the period under review. Trustees should understand the equity, bond and other relevant markets as context for the main drivers of returns in their funds.

## Understanding if performance is consistent

Trustees should consider the performance achieved by an investment manager and if it has performed in line with their expectations given their investment process and the market environment. This could involve comparing investment returns to industry benchmarks.

Trustees should consider if an investment option is performing in a different way from the agreed objective or benchmark. Although it may be performing better than its objective, trustees should understand the reasons for outperformance and what had driven returns and consider if they are comfortable with the investment manager's strategy.

If trustees identify issues of performance with any of the options available to members then they should assess whether they are able to make changes to the available options. Issues could include underperformance or concerns about the investment manager's strategy.

You will find more information in the Tutorial: 'Managing advisers and service providers' in the Module: 'How a DC scheme works (2014)'.

## Other events that could trigger a review

Certain events may trigger a review of the investments made available to members out of the three year review cycle. These events include:

- ▶ significant and relevant legislative changes
- ▶ significant changes in the demographic of the membership
- ▶ changes in ownership or to key members of the team managing a fund at an investment manager
- ▶ or, less commonly, concerns about the financial security, liquidity and safe custody of scheme assets

## Case study

In the Tutorial: 'Charges' earlier in this module we looked at some example investment options and their performance, net of fees. In that tutorial we focused on value for members and, although Fund A had the highest fees of all three funds, it offered the best value due to the good performance it had. We will now look at the same example, some years later, but focus on the performance, net of fees, in relation to the objective set.

	Type of fund	Benchmark	Performance objective	Performance over 3 years per annum (after fees)
A	Active global equity fund	FTSE All World Total Return Index (GBP)	Outperform benchmark by 2% pa over 3 year period after fees	2.0% pa
B	Active global equity fund	FTSE All World Total Return Index (GBP)	Outperform benchmark by 1% pa over 3 year period after fees	7.4% pa
C	Passive global equity fund	FTSE All World Total Return Index (GBP)	Perform in line with benchmark after fees	6.9% pa

### The performance

Over the three year period, the benchmark, FTSE All World Total Return Index (GBP), returned 7% pa. Over this time period, Fund A has now underperformed the benchmark significantly, returning 2% pa. This has underperformed the benchmark return by 5% pa and its objective return by 7% pa. Fund B has returned 7.4% pa which outperformed the benchmark, but underperformed against the objective by 0.6% pa. Fund C returned 6.9% pa. Its objective was to perform in line with the benchmark of 7% pa.

A member may incur additional costs (such as platform charges) to the annual management charge (AMC) but for simplicity we have excluded them in this example.

### The trustees' next step

As part of the ongoing quarterly monitoring of the investment performance of the options made available to members, the trustees of the scheme have identified that Fund A is no longer the best value and its performance has been disappointing. They agree to more closely monitor the performance of Fund A from now on.

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### The result of further monitoring

The trustees of the scheme have been monitoring the appropriateness of Fund A in more detail over recent quarters and as it has not improved, they have decided to look at the extent to which they are able to take action. As Fund A is not meeting its stated objective, the trustees are considering:

- ▶ closing the fund to new contributions, to transfers-in and switches into the fund (leaving the existing investments in the fund)
- ▶ in addition to closing the fund, switch the existing investments to a new fund

Both options are significant actions. Trustees need to take investment and legal advice on the extent to which they are able to make the changes.

## Deciding to change a scheme's investments

Before redirecting contributions or existing investments, a new fund will need to be selected for the contributions and/or the existing investments. An existing investment option offered to members might be used if, for example, a large scheme offered two relatively similar global equity funds with different investment managers. If a new investment option is required, the trustees will need to carry out an appropriate selection process to select one.

### Closing a fund to new contributions

Trustees may be able to choose to close an existing investment option to new contributions leaving the existing investments there to minimise the complexity of the transfer. Trustees may choose to write to the members who have chosen that option to alert them to their decision to close the fund and to draw members' attention to the recent performance of the funds in question.

### Switching existing investments to a new fund

Trustees may be able to decide to switch members' current investments to another investment option and remove the existing one. This will usually take place by means of a 'bulk transfer' (ie all monies moved at the same time) rather than as a set of individual transactions. A project like this will require, as a minimum:

- ▶ advice on the extent to which this is possible
- ▶ careful planning
- ▶ clear communication with members
- ▶ close attention to the accuracy of records to ensure that they reflect the investment switches that occur at a member level
- ▶ careful attention to the management of costs

## Master trusts

Trustees of authorised master trusts are expected to notify us of significant changes to the SIP as a 'Significant Event'. Further information can be found in our Code of Practice 15: Authorisation and supervision of master trusts' at <http://www.tpr.gov.uk/docs/code-15-authorisation-and-supervision-of-master-trusts.pdf>.

## Communicating changes to members

Trustees will usually explain to members why they are making changes before they go ahead.

## Black-out period

Most transitions will also result in a period when members will be unable to view or alter their accounts and this should be communicated to members. This is known as a black-out period.

## Planned actions

The trustees may look to replace this manager with an alternative investment manager or fund. In order to do this, the trustees will usually need to notify the members already invested ahead of the planned change.

Should a member not want to invest in the chosen replacement active manager, this allows members time to decide to move their money to another fund before or after the switch takes place. Depending on the scheme rules, the trustees may or may not need consent from the members to replace the investment manager.

Normally, communicating with members is very important. However, on occasions, it may be necessary to transfer investments urgently to protect members, without communication with them beforehand. This might happen, for example, if there was a risk of provider insolvency. In instances like these, where it has not been possible to communicate with members about the transfer beforehand, communication should happen as soon as possible afterwards.

## Costs

Trustees will normally provide members with an estimate of the transaction costs involved in making the changes and inform members of who will bear these costs.

## Guarantees and promises

Some restrictions on charges do not apply to arrangements which contain third party promises, or guarantees about the level of benefits members will receive.

Trustees should assess whether any guarantees or other favourable treatment might be lost on switching and whether penalties will be triggered.

## Minimising cost and risk

If trustees decide to transition out of one investment and into another, this usually involves selling all of the existing units and then, with the proceeds, purchasing units in a new investment option. This transaction can normally be completed relatively quickly, but it can result in significant costs and risks to members.

Out of market risk is key for scheme members. It is the short-term risk of missing out on the return on a market because of not being invested in that market.

Here's a simple example: Trustees are transferring investments between Fund A and Fund B, both invested in UK equities. During the transfer the funds are held in cash for a few days while settlement proceeds are awaited from Fund A. During these few days the UK equity market grows, meaning that the members have lost out on this growth whilst the monies were held in cash. An out of market loss has been incurred. At times of high volatility, an out of market period of a few days can lead to the risk of unexpected losses or gains.

## Managing out of market risk

This risk can be managed in a number of ways and include those below.

### In-specie

The underlying assets are transferred from one investment to another in the form of actual securities (eg company shares) rather than cash. The underlying assets are transferred rather than traded. This avoids the costs of selling assets with one manager and buying the same assets with another manager.

### Re-registration

This is typical for a scheme that changes its investment provider. For example a scheme may offer the Coleman Asset Management UK Equity Fund via Platform A and decide to appoint Platform B as the new investment platform provider.

Platform B also offers the Coleman Asset Management UK Equity Fund. Instead of disinvesting or transferring asset in-specie, the trustees can arrange for the units in the Coleman Asset Management UK Equity Fund to be re-registered to Platform B.

Re-registering will typically involve the underlying investment manager and the relevant platform providers.

### Pre-funding or pre-investment

As units are sold in the old investment, units in the new investment are purchased before the cash is realised from the old one. This minimises, or in some cases removes, out of market risk. In some cases, the new investment manager will provide a pre-funding facility at a cost.

## Phased selling

This involves spreading the sale of units over a number of days or weeks, which can help reduce the risk of adverse market conditions on a given trading day. However, this can increase the length of the black-out period.

Following the transition, the trustees and their advisers will need to fully reconcile the transfer of investments and cash between the parties involved to ensure that individual member assets have been treated fairly and as the trustees expected and instructed.