The Trustee toolkit downloadable

Investment in a DB scheme

Tutorial one: Understanding investment strategy

By the end of this tutorial you will better understand:

- the purpose of an investment strategy in the context of a DB scheme
- how the investment strategy is linked to the funding strategy and the employer's covenant
- the importance of trustees engaging with the employer when setting or reviewing the investment strategy
- the main broad groups of assets used in the setting investment strategy
- the difference between matching and growth assets

This tutorial is part of **Scenario one**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Introduction

In the Module: 'An introduction to investment' you learned about the basics of investing scheme assets including the requirement for the trustees to draw up a Statement of Investment Principles (SIP), trustee powers and restrictions.

If you are new to the role of trustee and have not yet completed that module, we would recommend you do so as this module requires a basic level of understanding. So that you have an understanding of scheme funding we would also recommend that you have completed the following modules.

- How a DB scheme works.
- Funding your DB scheme.
- DB recovery plans, contributions and funding principles.

Setting an investment strategy

As a reminder, trustees of DB schemes have a duty to set the scheme's investment strategy and to select and monitor underlying funds and managers. When setting the scheme's investment strategy, trustees of DB schemes need to consider how the assets are best invested to help the scheme to pay benefits when they are due, whether these are due in the short or in the long term.

Reminder: SIP

With limited exceptions, schemes must draw up a written SIP, which sets out the trustees' investment objectives for the scheme and the principles governing how decisions about investments must be made.

The SIP must be reviewed regularly (at least once every three years) and trustees must take investment advice when preparing or revising a SIP.

If you haven't already, you can learn more in the Tutorial: 'Investment in a pension scheme' in the Module: 'An introduction to investment'.

Exceptions

The exceptions to the requirement to have a SIP are:

- schemes not established under trust (eg contract-based)
- schemes with fewer than 100 members
- statutory schemes which are guaranteed by public authority

Reminder: Integrated risk management framework

Setting the investment strategy is ideally done as part of an integrated risk management framework, where the key risks around covenant, investment and funding are managed in a joined-up way. For example, the ability of the employer to make good any investment losses is a key factor in setting the level of investment risk.

Given the potential impact of downside investment scenarios on future calls on the employer's cash, it is important that trustees engage openly with the employer when setting and implementing their investment strategy so that both parties understand the risks being taken.

What does 'investment strategy' mean?

A DB pension scheme's 'investment strategy' is essentially a statement of how the scheme's assets are to be invested across different types of investment. The choice of investments determines the risk and return of the assets relative to the scheme's liabilities.

As you know, trustees are required (with limited exceptions) to draw up a SIP for their scheme. If you take a look at your scheme's SIP you are likely to find a table setting out the scheme's investment strategy. It will show a set of 'target weights' for the proportion of the scheme's assets that is to be held in each asset class, expressed as percentages of the scheme's total assets. The table shows a simplified example that we will follow throughout the module.

If you haven't already, you can learn more in the Module: 'An introduction to investment' in the Tutorials: 'Types of asset: Common assets' and 'Types of asset: Alternative assets'.

In this example, the scheme wishes to hold 'target weights' of 20% of its assets in global equities, 20% in diversified growth and 60% in sterling-denominated bonds. Your scheme's SIP is likely to include a wider range of asset classes.

Asset allocation strategy

Because the investment strategy is concerned with the allocation of scheme assets across the different asset classes, it is often referred to as the 'asset allocation strategy'. It is also called the 'asset allocation benchmark' because it serves as a reference point against which the actual asset allocation can be compared.

Different asset classes perform differently over time. Therefore, the actual asset allocation will tend to move away from the target weights, unless action is taken to correct this. Schemes normally have processes in place to keep the actual allocation within agreed tolerance limits of the target weights.

This is because the strategy will have been chosen to give a particular balance of investment risk and return to be able to pay promised benefits as they fall due. If the actual allocation becomes too different from the strategy, then it will no longer have the desired characteristics.

If you look at your scheme's latest investment performance report, you will likely see an asset allocation table. This will compare the actual proportion of the scheme's assets held in each asset class at the reporting date, with the target weights. This is used to monitor the scheme's actual asset allocation against the investment strategy so that any corrective action necessary can be agreed and implemented.

Main asset types

Earlier in this tutorial we mentioned that your scheme will likely invest in a wider range of asset classes than the three used in our example asset allocation strategy. Some schemes, with the resources in place to keep track of them all, invest in many. Fundamentally however, assets fall into two broad groups: matching and growth assets. Some schemes also put in place downside protection and flight/glide path arrangements.

Matching assets

These are held principally to reduce risk relative to the scheme's liabilities. Examples include:

- fixed interest gilts
- index-linked gilts
- investment grade corporate bonds

These asset types all share a common characteristic, ie providing predictable income streams similar to scheme benefit payments. You will learn in a later tutorial that, as market conditions change, their value tends to move up and down in line with the value placed on scheme liabilities. For these reasons they are often referred to as 'matching' scheme liabilities.

Other types of matching asset include so-called 'liability driven investment (LDI) funds' (or LDI portfolios), that are put together to provide a particularly close match for liabilities. They are typically made up of cash, bonds, and various types of fixed interest derivative instruments.

If your scheme invests in these, then you will need to understand what they are and how they work, including their risks and how trustees and fund managers address these. This tutorial only covers them at a high level.

Growth assets

These are held to seek an investment return that will grow the assets over time and meet the scheme's funding targets. This is why they are commonly referred to as 'growth assets' or 'return-seeking assets'. Examples include:

- equities
- property
- diversified growth strategies
- a wide variety of 'alternative asset types' such as hedge funds, sub-investment grade or 'high yield' bonds, target absolute return funds

Growth assets are expected to produce a higher rate of return than matching assets but they have greater risk attaching to them. This includes the risk that they may produce a lower return than matching assets. Schemes invest in growth assets (rather than wholly in matching assets) because they need the higher return in order to meet funding targets, and are willing to take the risks in the context of their integrated risk management framework.

Downside protection arrangements

As well as matching and growth assets, schemes may also have arrangements in place to protect the scheme's assets from adverse changes in market conditions. They might be designed to limit the effect of falls in equity markets for example.

Downside protection strategies are intended to offer protection in extreme market conditions, rather than just 'averagely bad' conditions. In concept, they are similar to taking out an insurance policy. They typically involve investment in assets or derivative strategies that are expected to deliver a large positive return in extremely bad market conditions, but small negative returns in more normal conditions.

If you would like to understand more about these we would recommend you read the Case example: 'Downside protection arrangements'.

There are many variations on downside protection arrangements. If your scheme has one, then you will need to understand what it is and how it works.

What is a flight/glide path?

Your scheme may have a plan in place for future changes to the benchmark, eg as the scheme's funding level improves or investment market conditions make it attractive to do so. These are often referred to as 'flight path' or 'glide path' arrangements.

They are normally intended to reduce investment risk in a scheme when circumstances are appropriate for this. These are a development of the basic asset allocation strategy approach.

Summary

The split between growth and matching assets is often used as a 'rule of thumb' for assessing the riskiness of a scheme's investment strategy. However it can be misleading, especially if the matching assets are a particularly good (or bad) match for the liabilities. You will learn more about this later in this module.

> If you haven't already, you can learn more in the Module: 'An introduction to investment' in the Tutorials: 'Types of asset: Common assets' and 'Types of asset: Alternative assets'.

Exercise: Check your scheme

Take a look at your scheme's SIP and the asset allocation strategy. You should find that most of the investments fall into either matching or growth assets. You may have found that it is not always clear-cut, especially with corporate bond portfolios or property portfolios.

Corporate bonds

Investment grade corporate bond portfolios provide a predictable income stream, and so they are generally considered to be matching assets. However, they are riskier than gilts (UK government bonds) in that the companies issuing them are more likely to default on their bond payments than the government. They therefore offer a higher yield to compensate. On account of that higher yield, and the higher risk, they also have some of the characteristics of growth assets.

High yield (ie sub-investment grade) bond portfolios provide a much less predictable income stream than investment grade bonds. The organisations that issue them are considered much more likely to default on their obligations, and they offer notably higher yields to compensate. Investors in high yield bonds therefore typically regard them as growth assets.

However, the payment stream from high yield bonds is a contractual obligation of the issuer, unlike equity dividends, and can be predicted to a certain extent. On account of this, they have some of the characteristics of matching assets.

Property

Historically, pension funds invested in property as a growth asset, anticipating a rise in capital values over time as well as rental income payments from the tenants of the property.

More recently, interest has grown in properties that offer secure long-term streams of rental income. An example would be offices let to a government tenant for 25 years where future rental increases linked to inflation are set in advance for the entire term of the lease and the tenant does not have the option to break the lease early. Their secure stream of income payments is a characteristic of matching assets.

It is important to understand the role of each asset in your scheme's investment strategy. You may find it helpful to discuss these with your fellow trustees or the scheme's investment consultant.

Integrated risk management framework

At a high level, setting or reviewing the scheme's investment strategy involves making an appropriate balance between growth and matching assets to ensure that the investment strategy is in the best interests of members.

This balance, and the choice of which growth and matching assets the scheme should invest in, will determine the expected return and overall riskiness of the scheme's investments. Therefore, setting the investment strategy is often said to be about setting an appropriate level of investment risk for the scheme.

It is important that you understand the broad principles of setting an investment strategy in an integrated risk management framework.

An integrated risk management framework means taking a joined-up approach to assessing, monitoring and managing pension scheme risks, in particular employer covenant, investment risk and funding risk.

Useful links
Read the 'Funding defined benefits' code of practice at www.tpr.gov.uk/code3.

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How employer covenant affects the investment strategy

The employer covenant should be strong enough to support the riskiness of the investment strategy, that is to say the employer should be able to generate sufficient cash, now and in the future, to fund downside scenarios.

For example, if the investment strategy is set to achieve high levels of return and these are not met, the employer may need to pay additional contributions. If the covenant deteriorates, then the investment strategy may need to be de-risked unless measures are taken to strengthen the covenant. This in turn will affect the funding strategy and contribution requirements.

How investment strategy affects funding strategy and contributions

Your scheme will already have a funding strategy in place. It will be based on an assumed level of future return from the scheme's investments, ie the current investment strategy.

If the investment strategy is changed and as a result the expected return is reduced (because, for example, the trustees wish to reduce investment risk) then the funding strategy will need to be reassessed. This may apply both to the technical provisions and the recovery plans.

If there is an increase in the deficit as a result, trustees may have to seek increased contributions, reconsider the length and structure of the recovery plan and/or seek additional security from the employer.

Further information

The scheme actuary assumes a certain rate of return from the scheme's investments when advising on the funding strategy. This reflects the expected return on the investments, less a margin for prudence. If the expected rate of return from the assets is reduced, then the scheme actuary will wish to review the valuation assumption and may recommend it be reduced.

Reducing the valuation assumption will increase the value placed on the schemes past liabilities, which may lead to additional deficit recovery contributions being required. The value of any benefits still being earned will also increase, leading to an increased contribution rate for these too. An increase in contributions may impact on the employer's sustainable growth plans. This would need to be discussed with them.

> If you haven't already, you can learn more in the Module: 'Funding your DB scheme'.

Engaging with the employer

It's important the trustees understand the degree of reliance of the scheme on the employer covenant, both on an ongoing basis and in the case of adverse experiences and whether the employer can afford to support the scheme when needed.

It's equally important for the trustees to engage with the employer when setting their investment strategy to understand their views on risk. Investment risks hitting the scheme could have a significant impact on their future business and employers may prefer to pay higher deficit repair contributions in order to allow less investment risk to be taken.

If you haven't already you can learn more in the Module: 'How a DB scheme works' in the Tutorials: 'Employer covenant' and 'Risks to employer covenant'.

Conclusion

As we have shown, the employer covenant, investment strategy and funding strategy are closely linked. That is why we refer to managing covenant, investment and funding risks within an integrated risk management framework, ie in a joined-up way.

Changes to any one will potentially have impacts on the others, and achieving an appropriate balance between them is not always easy.

If you haven't already you can learn more in the Modules: 'How a DB scheme works', 'Funding your DB scheme' and 'DB recovery plans, contributions and funding principles'.

Over the course of the next four tutorials, we will cover what is involved in an investment strategy review, and the types of analysis and modelling typically involved.

In the last tutorial, we bring these elements together and describe the part an investment strategy review plays in achieving this balance.