Essentials

Investment

February 2018

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Cover image: Cheek by jowl - David Barry
Entrant to the Law Debenture Lens competition

Law Debenture has been acting as a professional pension trustee for over 35 years. The range and depth of our pensions work gives us unparalleled understanding of the market enabling us to have an immediate and lasting impact on the boards we join and allowing us to bring a unique perspective to considering investment issues

We act as trustee for over 200 pension schemes. Our clients come from right across business and industry sectors and include defined benefit, defined contribution and hybrid schemes. We also act as sole trustee for a growing number of schemes that have decided to simplify their governance and substantially reduce the level of internal resources required .

How to invest a pension scheme's assets is, with little doubt, the most significant and sustained challenge which trustees face. It involves mastering inherently difficult subject matter whilst grappling with the fact that resources are scarce. Specifically it requires reconciling the need to contain risk with the desire to obtain an adequate return and the requirement to meet pension payments as they fall due. All of this takes place against a fast-changing economic environment, an uncertain future and an evolving regulatory regime.

There are no quick and no easy answers. However, we believe that the multi-faceted challenge can be made manageable by identifying and being precise about the underlying questions and issues.

This Essentials document is primarily aimed at Defined Benefit schemes and reflects extensive discussion amongst our team of professional trustees, all of whom have significant experience of investment issues and a number of whom have a professional investment management background. We have tried to distil the questions which we believe trustees should address, but we recognise that not all of the questions will be applicable for every scheme.

We have grouped the issues to be considered into seven broad categories: Investment Objectives; Investment Strategy; Investment Risk; Derivatives & Hedging; Investment Consultants and Investment Managers. Governance & Compliance is the subject of a separate guide. At the end is a Glossary defining some of the terms used which might not be familiar to all.

Trustees will find that best value will be derived from this document by considering and answering the questions and then discussing issues which have been identified. It is therefore very helpful to have as many comments included in the responses as possible.

Mark Ashworth
Chairman, LawDeb Pension Trustees

February 2018

How to use this document

There are 55 questions divided into the following categories:

- Investment Objectives
- Investment Strategy
- Investment Risk
- Derivatives and Hedging
- Investment Consultants
- Investment Managers

Best value will be derived from this document by considering the questions and then examining the collective comments and views of fellow trustees. The exercise will help trustees to record and demonstrate good practice and highlight areas for improved investment knowledge and processes.

Please note this document is not intended to constitute advice, nor to replace the need to take appropriate professional advice in the relevant areas.

Law Debenture welcomes any comments from users of this document as to how it could be improved. These may be sent to us at: pensions@lawdeb.com or to your usual contact at LawDeb Pension Trustees.

Copies of this document are available to download at www.lawdebenture.com

Investment objectives

A1. Do we have a clear investment objective

It is important that trustees formulate a clear investment objective. The investment objective should be in relation to the scheme's liabilities and the timeframe set to achieving fully funded status and self-sufficiency or buy-in/buy-out.

When defining the investment objective trustees need to take into account:
- funding position
- liquidity requirements and liquidity sourcing strategy
- risk appetite and risk aversion
- investment time horizon
- current contribution plan
- pensions in payment and potential cashflow negativity
- restrictions on security selection and asset classes
- sponsoring employer covenant
- views of the sponsoring employer

Having set out a clear investment objective it is important to capture this information in the Statement of Investment principles (SIP), more information of which can be found in section B15.

It is important to reconsider the investment objective when:
- there are changes in the sponsor's ability to pay contributions or indeed other changes to the covenant
- there is an unexpected increase or decrease in the deficit of the pension fund
- the time horizon to achieve full funding changes
- fundamental changes have occurred in, for example, the assumptions underlying the existing objective, the economic environment market conditions or the regulatory regime
- liquidity requirements have changed (for example if increased transfer activity is occurring or expected)

Comments:

Investment objectives continued

A2. In formulating our investment objective, should we consider our investment beliefs?

Some trustees find it helpful to formalise their beliefs in order to help frame their discussions around where to seek the returns needed to achieve their investment objectives.

Trustees should understand and consider the different risk characteristics of each asset class and also the asset classes' individual contribution to overall risk. Trustees should also consider whether there is an adequate reward for the risk associated with the asset class.

The respective merits of active and passive investment management should be examined for each asset class. Furthermore there are hybrid approaches such as buy and maintain which seek to target the appropriate return, income and risk characteristics for the scheme's circumstances and liabilities, whilst at the same time minimising cost and reducing turnover.

Beliefs should also be tested in the light of the current economic climate and wider forecasts.

Comments:

A3. What are the employer's thoughts about investment strategy?

It is helpful to have shared objectives with the employer. This may facilitate agreement on the funding strategy and encourage agreement on the level and composition of investment risk that is needed to achieve the investment objectives.

The reaching of shared objectives with the employer could also result in a collaborative approach to analysing and managing risk.

Comments:

Investment strategy

B1. How do trustees allocate the risk budget?

Once Trustees have decided how much overall risk needs to be taken to achieve the investment objectives, it is then necessary to consider how this risk is to be distributed through a process known as risk budgeting. This process should also ensure that the risk budget is spent efficiently in a diversified manner and not overly concentrated.

A common first step is to determine the division between return seeking assets and those assets intended to match liabilities. Interest rate risk, inflation risk and longevity risk are typically referred to as unrewarded risks. This means that there is no return (or premium) expected to be earned by simply taking these risks. So, market conditions and cost factors permitting, these risks should typically be avoided (or hedged using matching assets). In contrast return seeking assets bring exposure to those risks for which we do expect to earn a premium (such as equity, credit, illiquidity etc). For these assets an appropriately diversified mix is typically held to generate the required return. For completeness it should also be recognised that some assets have both liability matching and return seeking attributes. For example infrastructure debt or real estate debt both offer liability matching characteristics through their long dated cashflows (either directly or indirectly linked to inflation) as well as offering return seeking characteristics via the additional return expected through taking illiquidity and credit risk. It is therefore important to be able to capture and attribute risk in a clear and transparent manner such that its source and contribution to overall risk can be easily understood.

The next step is to establish the range of assets to be used. Here it is important for the trustees to consider the robustness of the statistics on which recommended asset allocations (or mixes of assets) and forecast returns are based. Some mathematical models generate radically different results when only a small change occurs in the time period over which the analysis is carried out, or when other underlying assumptions are changed.

Trustees would normally expect their Investment Consultant to lead them through this discussion but it is important that Trustees understand the underlying information and the process that has been followed.

Comments:

Investment strategy continued

B2. In which asset classes are we prepared to invest?

Some schemes confine their investments to the “traditional” asset classes of cash, bonds, equities and, perhaps, property. While this may be appropriate in some circumstances, such schemes might be missing out on the diversification and/or return benefits from other asset classes. This is not to suggest that other asset classes are necessarily beneficial by default. However, trustees should be prepared to examine new asset classes, and these should be excluded only after proper consideration.

Key factors in determining the usefulness of other asset classes include the scheme size; the proportion invested in return seeking assets, governance resources, liquidity requirements and the overall return objective. Increased diversity of investments is often only achieved with a higher cost in terms of governance and fees.

A list of typical, but not exhaustive, asset classes that pension schemes invest in is included in the Glossary.

Comments:

B3. Are we achieving our targeted returns on the scheme’s assets?

Meeting members’ benefits in full in the longer term may depend on consistently achieving adequate investment returns. It is important to understand how certain, or otherwise, is the target return.

Comments:

Investment strategy continued

B4. Do we attach sufficient importance to asset allocation?

This is of prime importance as investment returns from mainstream markets are likely to be much more dependent upon the choice of asset class, rather than the selection of the asset manager. Trustees should beware of devoting too much time to the selection and monitoring of individual asset managers at the expense of asset allocation.

However, when alternative investments such as hedge funds or illiquid credit are considered the choice of manager assumes far greater significance, since performance is more related to the strategy and skill of the manager.

Trustees would normally expect their Investment Consultant to lead them through this discussion but it is important that Trustees understand the underlying information and the process that has been followed.

Comments:

B5. How are the views on asset allocation generated?

Having determined the range of eligible asset classes, the trustees, working closely with advisers, need a structured process to set and change overall asset allocation. This may entail drawing on asset liability modelling, actuarially-based projections, scenario planning, and economic and financial forecasts.

Asset allocation should be reviewed periodically, after full actuarial valuations, after periods of substantial market volatility, and after the performance of key asset classes has diverged radically (in either direction) from projected returns.

Comments:

B6. What is the optimal level of diversification?

Diversification of assets between asset classes and within asset classes themselves is a fundamental way to reduce investment risk.

Factors to be taken into account should include the level of correlation of the returns between the different asset classes: the level of risk and return required; the level of complexity that can be undertaken.

A variety of methods including statistical modelling and optimisation can be employed. Again the Trustees would normally expect their Investment Consultant to lead them through this discussion but it is important that Trustees understand the underlying information and the process that has been followed.

Comments:

B7. Should we emphasise UK equities over global equities?

UK equities represent about 10% of the global equity market. UK funds have typically maintained an exposure greater than 10%, though this has fallen in recent years.

A significant proportion of large UK companies derive the majority of their earnings from overseas. However, the UK equity market is very concentrated and a small number of sectors and stocks comprise a very high proportion of total dividends. The UK market, as represented by the major equity indices, has become less representative of the UK economy.

As with any overseas investment trustees should ask what level of currency exposure and foreign exchange hedging is appropriate when considering global equities. Further given that equities are return seeking assets, is there a justification for overweighting the UK market and having such a concentrated risk exposure?

Comments:

B8. To what extent should investments be liquid?

Long term investment opportunities should be a good match to the long term liabilities of pension funds. However, these long term investments may lock you in for a set timeframe. It is worthwhile to be mindful of the cost of disposal of these illiquid assets should there be a change in strategy, including a buy-in or a buy-out. There is an illiquidity premium (or additional expected return) associated with these types of illiquid asset, but as with any investment the additional expected return to be gained must compensate for the associated risk. This type of premium is particularly important in a low return environment or a low yielding environment (for example when interest rates are low).

At times of stress in financial markets, there is also a danger that seemingly liquid assets can become illiquid. Some vehicles, for example some property funds, infrastructure and hedge funds, chose to lock in investors during the credit crunch, rather than sell their assets at distressed prices.

Account needs to be taken when choosing assets and considering their liquidity and their ability to meet near term demands. These include pensions in payment and calls on existing investment commitments. It is important to have a plan in place that highlights the order in which assets should be sold to source required liquidity, recognising also that flexibility may be required in stressed market conditions.

Comments:

B9. How should our asset allocation respond to changes in market levels?

Is it wise to attempt to take advantage of shorter term market opportunities? To take advantage of market opportunities trustees need to be able to review and act in a timely fashion. Consideration should be given to delegate the implementation to a third party with a clear mandate.

Where trustees have a gradual long-term strategy of increasing exposure to one or more asset classes, it is possible to construct rules to accelerate the process when the assets to be sold have performed well or when the assets to be purchased have performed poorly. This is likely to be relevant when a long-term de-risking strategy is being considered, for example.

Where there has been a significant change in markets, trustees should also check whether the strength of the employer's covenant has been impacted with due consideration to the integrated risk management framework.

Comments:

B10. Should we have a re-balancing strategy?

Trustees may decide to let the actual asset allocation vary in response to relative market changes within broad ranges, or alternatively limit fluctuations through a set re-balancing framework. This may be symmetrical around given target central allocations or alternatively one-sided in order to facilitate a longer-term trend re-allocation (generally towards defensive or more liability-like assets as funding level improves).

The frequency of rebalancing will depend on how closely trustees wish to maintain their central asset allocations, and the transaction costs involved.

Comments:

B11. Do we believe in "alpha"? If so, in which markets is it likely to be found?

Alpha is the outperformance versus benchmark that is generated by a skilful active manager. Some belief in alpha is required to justify investment in a number of asset classes, with hedge funds being the most obvious example.

Alpha is more elusive in well-researched markets such as major developed equity markets, where a passive approach might be more appropriate and cost effective.

A passive approach may, however, be almost impossible to use elsewhere. Trustees should carefully evaluate the returns (net of fees) likely to be achieved by active as opposed to passive management.

Comments:

B12. Can trustees continually appoint successful active managers?

If skilful managers can be identified and accessed on reasonable terms, then a spread of managers may be required for the trustees to be reasonably confident of capturing any 'skill premium'. One of the services provided by investment consultants is the identification, via detailed research, of managers who they believe capable of capturing the skill premium in different asset classes.

Comments:

B13. Have we considered the pros and cons of investing through pooled vehicles rather than directly?

Pooled vehicles offer schemes diversification benefits by enabling them to gain exposure to multiple asset classes and managers that, due to the size of the investment, cannot be accessed via a segregated mandate. The advantages of investing through pooled vehicles might include reduced cost, simplified governance, and increased diversification.

As far as cost is concerned, certain pooled vehicles will be accessible at a lower annual management charge than is available by investing directly. This is especially interesting for smaller schemes. The burden of governance is likely to be lower both initially and also for the ongoing monitoring of investments.

Disadvantages exist in that trustees will have less control over the operation of a pooled vehicle than of a segregated fund.

Comments:

B14. Has sufficient consideration been given to the structure of the pooled investment?

Issues may include restrictions on the ability to redeem investments. For example, dealing may be permitted only on a few specified days.

Additionally, the fund manager may have the power to restrict the total size of redemptions in a given period ('gating'). There may also be other liquidity issues impacting on redemption. In certain circumstances, these could lead to redemptions being made "in specie", that is to say by a transfer of a share of the underlying assets.

Comments:

B15. Do trustees consider the relative merits of new investment opportunities and techniques? Do we understand these sufficiently?

New investment opportunities may have characteristics not available elsewhere and thus increase the scope for diversification. The trustees need to understand issues such as sustainability of returns, correlations with other investments and exact nature of the risk associated with these opportunities.

Comments:

B16. Where is the Investment Strategy documented?

It will appear in the Statement of Investment Principles (SIP).

The SIP (and supporting documentation) must include the policy on:

- choosing investments;
- the kinds of investments to be held, and the balance between different kinds of investment;
- risk, including how risk is to be measured and managed, and the expected return on investments;
- realising investments;
- the extent to which the trustees take account of social, environmental or ethical considerations when taking investment decisions; and
- using the rights (including voting rights) attached to investments if the trustees have them.

Some trustees may prefer that the SIP concentrates upon high level principles, with more detail about specific policies contained in accompanying or supporting documentation such as an Investment Policy Implementation Document ("IPID").

It is useful for trustees to think of the arrival of a new trustee, and to ensure that there is one place where a new trustee can quickly gather an understanding of the existing investment strategy.

Comments:

Investment risk

C1. How should we measure and monitor investment risk?

Volatility is a measure of the variation of the return of an investment over time. Historic volatility is derived from time series of historic market returns. Volatility is therefore used as one risk measure for an investment.

Value at Risk (VaR) is a widely used measure of risk in an investment portfolio. It is used as an estimate of the probability of portfolio losses based on a statistical analysis of historical trends and volatilities and can be expressed as either a percentage of asset value or as a capital amount. For example a VaR(95%) risk of 3% implies that 95% of the time losses are not expected to exceed 3% of asset value. Alternatively it is expected that 5% of the time losses may be greater than 3%.

Tracking Error is another widely used measure. It is used as an estimate of the probability of deviation of return from either a liability or market benchmark. It is also based on a statistical analysis of historical trends and volatilities and can be expressed as either a percentage of asset value or as a capital amount. For example an investment portfolio with a tracking error of 5% versus liabilities is expected to be within plus or minus 5% of the liability return 66% of the time. Like all models, their usefulness depends upon the validity of the underlying assumptions.

It is important to measure risk at the overall portfolio level, as well as that of individual managers or asset types. The risk of the overall portfolio is likely to be less than the sum of the individual investments since it will incorporate diversification effects.

Particular care should be taken when using any framework which assumes that returns are normally distributed. Experience suggests that returns often have “fat tails”, i.e. extreme events happen more frequently than implied by a normal distribution and in these extreme events (like global financial crisis or Brexit) lies the real risk. It can be useful to conduct scenario analysis to see what will happen to investments in certain extreme events.

Comments:

C2. How do we determine an acceptable level of investment risk?

The trustees' risk tolerance should be agreed prior to deciding on an investment strategy. This should be reviewed periodically and should always be revisited alongside the valuation. It is often the case that the employer's appetite for risk will set an upper limit to the level of risk to be adopted by the trustees.

The trustees should consider the strength of the employer's covenant (by which is meant its ability and willingness to pay), and the structure of the liability profile.

Further it would be useful to determine what the maximum loss that the employer would be expected to cover over an appropriate timescale and any correlation between a loss in investments and a reduction in the employer's covenant.

The use of an Integrated Risk Management framework helps trustees identify and manage the factors that affect the prospects of meeting the scheme objectives.

Comments:

C3. Are we sufficiently well prepared and protected in the event that the employer's covenant weakens or is threatened, or if there are significant changes in economic or financial conditions?

Changes often happen quickly and trustee boards are, without forward planning, unlikely to be able to assess the position and react in good time.

Trustees should actively plan for potential changes; know what their impact on the scheme is likely to be, and what options they have in these circumstances.

Trustees should ensure that the employer understands in advance what the trustees' response is likely going to be to material adverse changes. This could be in relation to disappointing investment returns and/or a weakening of the covenant.

The trustees and employer may wish to review the potential for additional security or contributions to be provided.

Comments:

Investment risk continued

C4. What are the key investment risks?

The key risks are those that result from a mismatch of the investments and the liabilities. The value of the liabilities is based on future expectations for interest and inflation rates. The pricing of assets such as equities is not directly dependent on those expectations.

Other risks to consider include: longevity, counterparty, credit (downgrades and defaults), currency, liquidity, manager, market, and, when derivatives are used to replicate physical assets, basis risk.

Comments:

C5. To what extent should interest rate risk and inflation risk be hedged?

The impact of interest rate changes on the funding of pension schemes has had significant impacts on those schemes without the appropriate level of hedging. It is important to understand the impact of interest rate risk.

However although interest rate risk is unrewarded risk, any decision to hedge interest rates should only be taken after a careful review of the impact of interest rate changes on the value of the liabilities (and hence the funding level) and an analysis of the costs of hedging and existing market conditions.

Similarly although inflation risk is unrewarded risk, any decision to hedge inflation risk should only be taken after a careful review of the impact of inflation on the future liabilities and an analysis of the costs of hedging and existing market conditions.

The cost of hedging interest rate risk can vary over time due to changes in interest rates and liquidity in the markets. As with interest rate risk the cost of hedging inflation risk can vary over time.

It should also be noted that the level of interest rate and the level of inflation hedging should be co-ordinated so as to avoid unintentionally increasing risk.

Comments:

C6. Are there other risks which are not sufficiently well rewarded to be worth taking?

Trustees should, in general, seek to limit exposure to unwanted and unrewarded risks with due consideration being given to the cost of removing these risks. An example might be currency exposure.

Comments:

Derivatives and Hedging

D1. Have we considered using assets to match specific sections of our liabilities?

The risk of mismatching assets and liabilities is highlighted in asset-liability modelling. Periods of extreme market volatility may crystallise funding mis-matches. Also, changes in the valuation of the liabilities caused by changes in gilts or swap discount rates can have a major effect on the overall funding level. Dedicated matching strategies should help to limit this exposure. For shorter maturity liabilities there are a multitude of assets than can be used to match liabilities, for example corporate bonds, asset-backed securities, loans, and high yield bonds as well as gilts and swaps. For longer maturity liabilities the range of assets is somewhat more limited, for example infrastructure debt, long-lease real estate, gilts and swaps.

Comments:

D2. Have we considered the full range of risk reduction approaches?

These include LDI (Liability Driven Investments) strategies and insurance policies. Insurance policies may be held as an asset of the scheme (buy-in) or may be assigned to the members concerned if the scheme rules allow this (buy-out).

Comments:

Derivatives and Hedging continued

D3. Is a key objective to insulate the fund from changes in inflation or from changes in interest rates, or both? Is longevity exposure at manageable levels?

In general (see also C5), schemes should consider hedging both interest rate and inflation exposures. The price of hedging and the pace of implementation will be affected by current interest rates and implied inflation levels. There may also be an element of market timing involved. It is good practice to set trigger levels at which hedging should occur. Common triggers are based on market levels (less common in modern hedging strategies), scheme funding level or are time-based. It should be noted most

In addition, trustees may wish to consider hedging longevity exposure through the mortality swaps market.

Trustees can also decide to hedge all three exposures, interest risk, inflation risk and longevity risk through a buy-in or buy-out of part of the liabilities with an insurance company. As noted previously, the level of interest rate and the level of inflation hedging should be co-ordinated so as to avoid unintentionally increasing risk.

Comments:

D4. Have we considered using derivatives in our investment or hedging strategy?

Derivatives offer scope to obtain a synthetic exposure to markets with greater flexibility and lower transaction costs than with cash investment in the underlying securities. Derivatives should only be employed if their usage contributes to risk reduction or for the purposes of efficient portfolio management.

Swaps and repurchase agreements (or repo) have become more mainstream pension fund investment instruments and are especially useful to hedge longer term liabilities.

An alternative approach is to use pooled LDI funds for those schemes that do not wish to invest directly in derivatives.

Comments:

Derivatives and Hedging continued

D5. What proportion of our liabilities should we hedge?

Schemes should consider the impact on prospective risk and return of hedging increasing proportions of their liabilities. Hedging results in the removal of unrewarded interest rate and inflation risk and reduces the volatility in the overall funding level of the scheme.

However changes in the overall investment return due to increased hedging of liabilities could result in the need for additional employer contributions to cover any deficit. Any decision on the level of hedging should be made with due consideration to the integrated risk management framework.

Transfer activity and changes to longevity (through published mortality tables) can have a significant impact on liabilities and so it is important, particularly as hedge ratios increase towards 100%, to carefully monitor the impact of such factors on the overall hedge ratio.

Comments:

D6. Have the trustees considered using option strategies?

For schemes that have sizeable equity exposures, it may be advantageous to modify part of the risk-return exposure to limit downside risk, while still retaining a reasonable exposure to market upside. This can be achieved by the use of equity options. With these types of strategies careful consideration needs to be given to the cost of and the timeframe over which the downside protection is to be purchased. These types of strategies also require enhanced governance structures given their additional complexity.

Comments:

Derivatives and Hedging continued

D7. If using derivative strategies, are the trustees confident that they have in place a robust policy to manage the risks, including operational risk, collateral adequacy and counterparty risk?

Schemes need to ensure that the risk of derivates is managed well and reported to the trustees. Counterparty risk is managed by posting of collateral, usually in the form of cash or financial securities. The collateral requirements, called the 'posting of margin', change with the change in market value of the underlying derivatives. Therefore, trustees need to ensure there is adequate cover for extreme movements.

Alternatively Trustees could use pooled LDI funds as this delivers a simpler structure to manage risk.

Comments:

D8. Should longevity swaps or buy-ins be used in conjunction with an LDI programme?

For schemes faced with substantial longevity exposure it may be advantageous to consider combining an LDI programme with a longevity swap for part of the liabilities.

Comments:

Derivatives and Hedging continued

D9. Have we selected the right party to execute and manage the derivatives?

The execution and implementation of derivatives will need expert advice and a secure and a sophisticated infrastructure to manage the positions and to report on the risks involved. Trustees need to ensure they selected the right party who can prove they are competent and experienced in counterparty selection, derivatives execution and managing counterparty risk to ensure a cost-efficient implementation of derivatives strategies.

This is of increasing importance due to regulations requiring over the counter (OTC) derivative contracts to be centrally cleared.

Comments:

Investment Consultants

E1. How effective is the consultant in helping us establish our investment strategy?

Factors to consider include the degree of pro-activity, responsiveness, and focus of the advice as well as how clearly and concisely are all important aspect of investment strategy articulated to the trustee.

The consultant will need to have a thorough knowledge on the universe of investments and solutions in relation to the management (and improvement) of the funding level.

Comments:

E2. Do we know the key elements of our consultant's approach to investment?

The consultant should assist trustees in risk/reward decisions that will most affect the funding position. Therefore it is important to know their views on different asset classes, on active versus passive investment management, alternatives, derivatives, and their approach to LDI.

It is vital to establish whether the consultant's approach to investment matters is consistent with that of the trustees.

Comments:

Investment Consultants

E3. What proportion of the fund management universe is covered by the consultant's research?

The consultant should be able to adequately cover each asset class across a range of investment managers, specialist managers and also those located outside the UK.

Trustees should consider the size, experience, and breadth of the consultant's research team. It is beneficial if detailed research on short-listed managers is made available to trustees, as part of a selection process.

Comments:

E4. Does the consultant's research capability extend to operational issues?

Trustees also should insist on operational and legal due diligence on fund managers.

The operational due diligence should focus on the management of a fund, the procedures of investing, the decision making framework and the infrastructure of the fund and the back office capabilities.

The legal due diligence should deal with liabilities and warranties, who are the owners of the fund (the shareholders), what are redemption clauses and potential gates.

It also should embrace: the management of counterparty risk, i.e. collateral management (for derivatives positions); back office capability; and in-house vehicles (e.g. composition of cash funds)?

Comments:

Investment Consultants continued

E5. Does the consultant demonstrate consistent ability to shortlist good managers?

The trustees should be aware of the consultant's record in identifying managers who subsequently perform well or deliver as required. Trustees should also be reasonably confident of its repeatability.

Following the selection of new investment managers, consultants should have procedures to review all existing fund managers periodically. They should be able to identify changes in the management of a fund, changes in performance and track record, redemptions levels as well as changes in the assets under management.

Comments:

E6. Does the consultant provide a helpful framework for discussions with investment managers?

An effective consultant works with the trustees to set an appropriate agenda, highlighting the key areas for discussion, agree appropriate benchmarks with managers, and suggesting important questions which may be posed to the investment managers.

Comments:

Investment Consultants continued

E6. Does the consultant provide a helpful framework for discussions with investment managers?

An effective consultant works with the trustees to set an appropriate agenda, highlighting the key areas for discussion, agree appropriate benchmarks with managers, and suggesting important questions which may be posed to the investment managers.

Comments:

E7. Are investment transitions implemented effectively?

Consultants may be asked to help with implementing changes in asset allocation and investment managers. Trustees will expect this to be done in a timely and cost effective manner.

Adequate advice should be provided as to whether a transition manager is required. For each asset class the trustees may need different specialist transition managers and so the selection procedures the consultant has must be appropriate. The consultant should also provide a comprehensive analysis of expected versus realised cost of the transition.

Comments:

E8. How pro-active is the consultant in keeping abreast of new developments?

Developments include new asset classes (such as less liquid credit), new investment techniques and instruments, business or staff changes at investment managers, together with market and regulatory developments.

Investment Consultants continued

E9. What is the preferred fee basis for remunerating our investment consultants?

There is often a combination of base fee, project fee, and an additional hourly rate. However, thought should be given to including a performance-related element in order to align more closely the consultant's interests with those of the trustees.

Comments:

E10. How are conflicts of interest managed?

As the market has evolved investment consultants (and also investment managers) necessarily need to have appropriate processes in place to manage the conflicts of interest that have arisen as business models have adapted to new opportunities and new challenges.

Comments:

Investment Managers

F1. Do we have sufficient understanding of each proposed manager's investment policy, the style and investment process?

It is essential to understand the investment policy of a manager, the process and any style bias. In addition to explaining when they will perform well, each manager should be able to state under which market conditions they are unlikely to perform well. It is important a manager can provide a clear and concise articulation of their investment process, if in doubt ask questions and demand clear answers.

Comments:

F2. How should we assess and monitor our investment managers?

Each investment manager's performance and risk should be compared with the agreed benchmark and target.

Formal assessments are best undertaken over a long time period, say, rolling 3 years. Performance measurement should, ideally, use data that is net of fees. Providing there is no change to the fund, with regards to management or assets under management.

Even where performance is satisfactory, the trustees should monitor significant changes in style, process, management, key personnel and redemptions.

Performance reports should be provided by an independent source, which could be the custodian.

Comments:

Investment Managers continued

F3. How should we approach managing underperformance and terminating mandates?

An important consideration here is the appropriate length of time an underperforming manager should be given to demonstrate improvement. The investment consultant will have also have views on this as detailed due diligence is a key part of their manager selection process.

If the investment manager's investment policy and process has changed, it is important to re-assess whether it is still appropriate for the trustees investment objectives.

Termination is often not the ideal solution. Trustees should consider the costs of changing manager and the danger that a manager is fired just at the time his performance begins to improve.

Comments:

F4. How well does the manager explain its approach to risk management?

The manager should report on risk in the fund in a clear, consistent, and comprehensive way. They should also be able to explain what would happen to the returns in different economic scenarios.

Comments:

F5. Does the manager take appropriate risk given its agreed investment targets?

Managers should take the appropriate level of risk to achieve their performance targets. The trustees need to have confidence in the ability of their manager to turn risk into return. In general, the greater the performance target, the greater the associated risk.

The investment manager should ensure that the scheme's level of risk does not rise unacceptably when market conditions change, unless explicitly authorised by the trustees.

Comments:

F6. How clearly does the manager explain underperformance?

The manager must be able to clearly articulate what the portfolio positions have been, what the strategy was and what has happened in the markets that was not in line with their expectations.

The attribution analysis will normally encompass asset allocation, individual stock/security and sector selection, and currency exposure.

Comments:

F7. How clearly does the manager explain exceptionally good performance?

This is often overlooked. It is important to establish that exceptionally good performance is not a result of running inappropriate risks.

Comments:

F8. Does the manager keep trustees informed of personnel and organisational changes?

At some managers, performance is dependent on certain individuals (key person risk). While, at others, the team as a whole is more important.

Particular attention should be paid to this area at times of corporate activity and/or significant changes in the level of assets under management.

Trustees should ensure that they are kept appraised of major changes in responsibilities or remuneration structure.

Comments:

Investment Managers continued

F9. Are our investment management fee arrangements appropriate?

Structures include:

- a flat fee
- a fee expressed as a tapered percentage of total assets under management
- a fee which depends solely on performance which can be absolute, or relative to a benchmark
- some combination of the above

Investment consultants will assist in this process, proving the relevant market context and a benchmarking of fees versus other asset managers who provide similar investment strategies. There should not be any incentive to manage the portfolio in an inappropriate way because of the fee.

If a performance fee is proposed it should embody a high watermark. If not, only a very small amount of the outperformance may be left for the scheme's benefit. Consider having a period of 3 years before performance fees can be fully earned.

Comments:

F10. In the case of passive management, do the trustees have sufficient understanding of the index replication technique being used?

A variety of approaches is used by fund managers. These vary from full replication to stratified sampling. The trustees should consider how accurately the index is matched and how much potential for underperformance is introduced.

Often passive managers attempt to take advantage of technical changes in the market due to revisions in index components.

Trustees need to be satisfied that any deviation in performance from a passive manager is within reasonable bounds.

Comments:

F11. Have the trustees considered allowing their investment manager to use derivatives to help achieve their investment objectives?

Derivatives add to the flexibility of investment portfolios and may enable managers to implement strategies more rapidly and at lower cost than through using cash markets since by using derivatives transaction costs may be greatly reduced.

Schemes need to be satisfied that managers have adequate risk management routines in place to monitor a derivatives programme, including robust collateral arrangements.

Comments:

F12. Does the investment management agreement permit stock (or securities) lending?

If it does, the trustees need to be satisfied with the collateral arrangements. Consideration should be given to the risks associated with the assets to be used as collateral. The borrower of the security pays also a fee to the lender so the trustees need to be satisfied the reward for the securities lending is adequate given the additional risks.

Comments:

Glossary

Alpha, ά	Represents the additional or excess return, relative to the market return (Beta), which is derived from a portfolio selected by a skilled active investment manager.
Asset Class	Although not an exhaustive list, typical asset classes include equities, bonds, commodities, currencies, property and other real assets.
Asset Liability Modelling (ALM)	A statistical technique comparing movements in assets and liabilities of the scheme under a variety of macroeconomic scenarios and asset allocation strategies.
Basis risk	The risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position. An example would be using a FTSE 100 future to hedge a FTSE All-Share UK equity portfolio.
Beta, β	Represents the market return, which is the total return from investing in a market index or an index-tracking (or passive) fund.
Collateralisation	Collateral is an asset pledged by a borrower to a lender in respect of an obligation. In the event that the borrower defaults on the obligation, the lender has the right to seize and sell the collateral. A common feature of derivatives.
Credit risk	The possibility that a bond will default and the borrower fails to repay principal and/or interest on schedule.
Derivative	A financial instrument such as a future, an option, or a swap, whose value is dependent on the value of an underlying asset or payment stream.
Equity risk premium	The extra return expected from investing in equities over and above that available from a risk free asset to provide compensation for the additional volatility of equities.
Gate Provision	A restriction placed on a pooled fund limiting the amount of withdrawals from the fund during a redemption period. The implementation of a gate is up to the fund manager, the purpose is to prevent a run on the fund, which could cripple its operations, as a large number of withdrawals from the fund would force the manager to sell off a large number of positions, potentially in illiquid or otherwise challenging market conditions.

Glossary

Index Replication	The goal of passive funds is to track, or replicate, the performance of an index. Fund managers have two ways they can do this: Full Replication: Buying all of the securities that make up the index in identical weighting to the index. Sampling: Buying the securities in an index that provide the most representative sample of the index based on correlations, exposure and risk. This may or may not involve some form of optimisation.
High watermark	An important factor in performance-related fees. It means that an investment manager will not receive performance fees until such time as the portfolio value is greater than the high watermark value when performance fees were previously earned.
Liability Driven Investment (LDI)	An investment strategy which is specifically related to the liabilities of the Scheme, rather than only to the maximisation of returns. The objective is that movements which occur in the value of liabilities will be matched by similar changes in the value of the assets.
Liquidity premium	The additional return an investor requires in order to be compensated for holding an asset with liquidity lower than cash.
Option	A derivative instrument that gives the right, but not the obligation, to buy or sell an underlying financial asset at a pre-agreed price over a specified time horizon.
Pooled Funds	Funds from many different investors that are aggregated for the purposes of investment. Investors in pooled fund investments benefit from economies of scale, which allow for lower trading costs per pound of investment, diversification and professional money management.
Redemption	The sale of units in a fund or the return of an investor's principle in a fixed income security, such as a preferred stock or bond. Redemptions occur with funds, at the choice of the investor, however, limitations by the asset manager may exist, such as minimum holding periods.
Segregated Funds	Where the assets of a client are held/registered in the name of the client and separated from the other client funds and, in many cases, held by a separate custodian. The investment manager may manage many segregated funds using a similar model.
Stock/Securities Lending	The beneficial owner (lender) temporarily transfers title of the security and associated rights and privileges to a borrower which is required to return the security either on demand (an open loan) or at an agreed date in the future (a term loan). In return for lending the security, the lender receives a fee and collateral from the borrower, generally either cash or liquid securities.

Glossary

Swap	The type of derivative where two entities agree to exchange cash flows over an agreed period. Swaps can be based on interest rates or inflation or currency or other cash flows. For example, a variable interest rate cash flow may be exchanged for a fixed interest rate cash flow.
Tracking Error	The expected deviation of return of a portfolio from a benchmark (or liability profile).
Value at Risk (VaR)	Value at Risk is a technique used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities. It measures expected portfolio losses over a given time period and at a certain confidence level.

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