PMI
Floor 20, Tower 42
25 Old Broad Street
London EC2N 1HQ
T: 020 7247 1452
F: 020 7375 0603
W: www.pensions-pmi.org.uk

Core Unit 4 – Financing and Investing for Retirement Provision

Assignment 5 Notes

(Part 5 Investment Strategy and Governance and Part 6 – Investment Management)

Recommended Time: 1 hour

1. **Explain how "white labelling" can assist trustees in communicating the range of investment options in a defined contribution scheme.**

10 marks

The objective of **white labelling** is to help members choose funds that are most appropriate for their circumstances. It involves using fund names that accurately describe the nature of the funds, making them easier to understand. In addition, the trustees will make periodic changes to the underlying investments (mix of asset classes or change in managers, depending on the type of fund) without the need to consult the members, which makes it easier to operate from a trustee perspective while allowing members to focus on the nature of the funds.

The range of funds offered needs to address individual member's varying circumstances and preferences and can be broken down into the following broad categories:

- Growth funds, which aim to provide good long-term performance, such as equities
- Defensive funds, which aim to preserve capital or purchasing power, such as cash and bonds
- Balanced funds, which include a mixture of growth and defensive assets.

In describing the funds, schemes will indicate the characteristics in terms of their target investment returns and level of risk (typically in terms of volatility). This **risk profiling** aims to assist members in matching their requirements to the available funds. Asset allocation within broad asset classes (equities, bonds etc.) is only one aspect of risk profiling. The selection of investments within an asset class is also of significance, e.g. Government bonds are less risky than emerging market bond funds; UK equities (for a UK investor) are less risky than Korean equities.

In **one form of white labelling**, the members are offered funds of specific type, such as a global equity fund. The underlying composition of the fund may change from time to time (in terms of managers and allocation between markets), based on investment advice, but the member will not be involved in that process and will merely need to be aware of the general characteristics of the fund.

Another form of white labelling is where the funds offered have names that indicate their risk profile, for example there could be 'high-risk', 'medium risk' and 'low-risk' funds, or funds might be described with such labels as 'growth', 'adventurous' or 'cautious'. These funds will be combinations of different asset classes (e.g. equities and bonds), and the composition may change in time based on investment advice. The aim is to allow member to focus on the level of risk they are prepared to take and leave the detailed asset allocation decisions to others.

(The relevant section of the Study Manual is Part 5, Chapter 1.2.1)

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2. **Explain the purpose of a secondary funding target for a defined benefit scheme and briefly outline how strategies are devised for reaching this target.**

10 marks

With most defined benefit schemes now closed to future accrual, an increasing number of employers are actively exploring ways in which to wind-up the schemes, or allow them to continue with minimal risk of having to make further contributions (so-called self-sufficiency). This introduces the concept of a **secondary target** for the assets, to equal the value of the liabilities calculated on a buy-out or self-sufficiency basis, and is referred to as a secondary target, or '**end game'**. If the assets are sufficient to cover the secondary target, the scheme can be either wound-up or continued on a low risk basis.

The plan to fully fund the scheme up to the level of the secondary target is commonly referred to as a '**flight path'**. For most schemes, reaching the secondary target is not realistic in the short-term for reasons of affordability, but is an increasingly common medium- to long-term objective. The key features of a flight path are described below.

The scheme has a recovery plan in place agreed at the last actuarial valuation, for making good the funding shortfall

There will be a series of agreed '**trigger points'** when the investment strategy will be adjusted by a pre-agreed amount to a lower risk profile. A trigger point will usually be defined as achieving a specified funding level by a certain date. The idea is that if the funding level is reached earlier than expected, this will be as a result of better than expected investment returns, and de-risking helps to 'lock-in' these additional investment returns before they are potentially reversed by adverse investment experience

The higher than expected asset value resulting from good investment performance could be reflected at the next actuarial valuation by a reduction in funding contributions (ignoring any other factors). However, the scheme would then need to rely more heavily on future investment returns in order to eventually reach the secondary funding target

Alternatively, the funding target could be increased to reflect the lower risk investment strategy and its implied lower expected future investment returns, and contributions maintained at the same level. Naturally trustees will normally favour this option, whereas the employer may prefer the above alternative

At successive actuarial valuations the funding target can be gradually increased, until eventually it equals the secondary target and the scheme is fully funded on that basis

If the employer wished to reach the secondary funding target more quickly, it could increase its regular contributions (and/or make a one off additional contribution) assuming that was affordable, and the trigger points could be revisited accordingly.

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Implementing a flight path requires careful planning, to ensure that appropriate 'trigger points' are agreed, and that when a trigger point is reached there are arrangements in place to ensure that de-risking happens very rapidly, or else the markets could move in reverse and the opportunity would be lost.

A flight path strategy requires close co-operation between the trustees and the employer, but this is normally readily achieved as there is a common interest in securing the benefits of the scheme and removing risk.

(The relevant section of the Study Manual is Part 5, Chapter 2.2.3)

3. **Explain the purpose of a Statement of Investment Principles and outline the main matters covered within this document.**

10 marks

The Statement of Investment Principles (SIP) is the document which describes the trustees' approach to investments. A SIP is required for most defined benefit and defined contribution schemes, exceptions being schemes with less than 100 members and some public sector schemes, while fully insured schemes are subject to different requirements.

Before the SIP is drawn up or revised, the trustees must:

- Obtain and consider the **written advice** of a person who they reasonably believe to have the appropriate knowledge and experience of financial matters and investment management
- **Consult with the employer**. This means considering the employer's views carefully but does not require the employer's explicit agreement.

The SIP must be **regularly reviewed** by the trustees and must be made available to members on request.

The SIP must set out the trustees **investment objectives**:

- In **a defined benefit** scheme this will need to take into account attitude to risk, determined after close consultation with the sponsoring employer, and will specify key objectives which may be expressed in terms of funding targets or levels of contribution.
- In a **defined contribution** scheme, investment objectives will be expressed in terms of offering a range of funds which meets the needs of the membership, satisfies the automatic enrolment requirements (where relevant) and providing good value for money. It will also cover provision of lifestyle/lifecycle strategies and a default fund.

The SIP will describe the trustees' approach to **risk management**, showing the way in which risks are measured and managed.

The SIP will also cover **investment strategy.** This will explain how the strategy relates to the investment objectives in terms of how investment are chosen, having regard for their diversification and suitability, and attitude for risk.

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For a defined benefit scheme, the investment strategy will detail the **strategic asset allocation**, showing the allocation of assets by asset class, at a broad level (growth and defensive) as well as a more detailed level (e.g. the types of growth assets and their relative proportions).

For a defined contribution scheme, investment strategy will detail the types of funds being offered, again grouped at a broad level as well as at a detailed level.

The SIP will specify the **expected investment return** on the scheme's investments. For a defined benefit scheme this will be at an overall scheme level, whereas in a defined contribution scheme it will be broken down by asset class.

The SIP must also specify the trustees' policy on **realisation of investments**, especially relevant in a mature defined benefit scheme where investments need to be regularly sold in order to pay for scheme benefits.

The detail of how the investment strategy is implemented is sometimes set out in the Appendix to the SIP, or in a separate **Investment Policy Implementation Document (IPID)**. There is no regulatory requirement for an IPID, but it simplifies the management if the SIP, which then does not require changing whenever there is a change in the investment management arrangements. The IPID will cover the day-to-day management of the investments, and in particular it will specify which managers have been appointed, their mandates and their fees.

Finally the SIP must provide statements on the trustees' policy regarding:

- **Socially responsible investment**: The extent, if any, to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments
- **Corporate governance**: the exercise of the rights (including voting rights) attaching to the scheme's investments

(The relevant section of the Study Manual is Part 5, Chapter 3.1)

4. **Briefly outline the principles behind active and passive investment management.**

5 marks

Active management stems from the belief that markets are not entirely efficient. Fund managers seek to exploit certain market irregularities or inefficiencies to achieve potentially higher returns. This is closely related to the investment term 'generating alpha'. Alpha is the additional return generated by manager skill as opposed to general market movements.

Active management aims to outperform a particular market index or benchmark through manager skill.
Within the active approach, fund managers take an active role by deciding on which assets to buy and sell. They will take into account various factors affecting financial markets, such as economic and political issues, market and sector trends and company-specific features. Fund managers use various strategies in order to generate excess returns, including stock selection and market timing (or tactical asset allocation).

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Passive management stems from the belief that markets are efficient or that it is difficult to beat the market. It may also be a preferred management strategy for those unwilling to take on the risks of active management. Passive management aims to match the returns of a particular market index or benchmark (also called **index-tracking** or indexing).

Active management is more expensive than passive management, because it involves manager skill as opposed to being process driven. The higher costs are justified by the anticipated additional investment return the manager expects to generate compared with the passive manager, though the use of their skill, although this is not guaranteed.

(The relevant section of the Study Manual is Part 6, Chapter 1.1)

5. **What are the benefits of utilising multi-manager funds as part of the overall investment management of a scheme?**

10 marks

Trustees' responsibility for diversification and to act in the best interests of beneficiaries implies that trustees should use the 'best of class' managers in each area and mix them appropriately to increase outperformance opportunities. This has led to the increased use of **multi manager funds**.

There are two distinct approaches to multi manager funds.

Manager of managers (MoM): Refers to the appointment of a few select managers, who are then given specific mandates to manage the investment in a single fund. The role of the MoM is to select the specialist managers, monitor their performance and to alter the composition of the management team to adapt to market conditions or fund performance.

Fund of funds (FoF): Describes the process whereby a manager builds up a portfolio that invests in funds that are run by a number of other managers. The fund of funds itself is generally structured as an ICVC or as an investment trust.

The key attraction of multi manager funds is the **expertise** that they bring to manager selection. For a fund of funds, the multi manager selection process uses a number of analytical tools to narrow down the fund universe to a more manageable level. The multi manager is likely to conduct a rigorous interview process with each of the fund managers that fit the investment criteria and these meetings will often reveal a good deal more than quantitative analysis.

Importantly, this is also an ongoing process, as many factors can change in the management of a mutual fund, of which a direct investor may not be aware. Meanwhile, some fund managers perform well in certain investment backdrops but not others leading to periods of underperformance. The fund of funds manager can position himself for changing market dynamics by altering his portfolio accordingly.

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Investors in a multi manager fund also benefit from increased **diversification**. Traditional unit trusts provide an extra layer of diversification compared to investing directly in a few individual stocks. Multi manager takes this process a step further by creating blends of best of breed fund managers. A selection of managers with different investment approaches can reduce the risk in a portfolio without eroding the alpha they provide. Alpha is the standard measure of a fund manager's ability to add value.

The diversification aspect of a multi manager strategy and the manager's ability to tilt the fund toward certain investment styles is of even greater importance in multi region and/or multi asset class portfolios. Here the manager can reduce exposure to assets classes or regions of the world that have poor prospects and skew the fund towards areas with better fundamentals.

Another attraction of the multi manager approach is that it allows even small pension schemes **access** to certain funds and investment expertise that would not normally be available. This is due to the minimum amounts of investment required by some investment vehicles or simply because they are not widely known in the wider market.

The main criticism levelled at multi manager funds is that they have **higher charges**. Single manager mutual funds charge fees to investors and so do multi managers' funds. Therefore, it would follow that investing in a multi manager fund results in two layers of charges. This is largely true but, given that one of the benefits of investing in a multi manager fund is economies of scale, such funds are able to negotiate very attractive rates, leading some to have TERs (total expense ratios) similar to standard pooled funds.

(The relevant section of the Study Manual is Part 6, Chapter 1.3.1)

6. **Trustees can measure a manager's investment performance by peer group comparisons or against an index. How do these two approaches differ and supplement each other?**

5 marks

Peer group comparisons involve the collation of performance details for the 'universe' of all eligible pension schemes, both overall and broken down by asset category. This allows each pension scheme to see how it has performed compared to other schemes. Two numbers are normally considered: **percentile ranking**, and the difference between fund performance and **median** performance.

Performance of a pension fund can also be measured against a relevant market **index**. Indices have the advantage of being available on a timely basis, their construction is transparent, and their performance is unambiguous. Nevertheless, care has to be taken when selecting an index as benchmark for a manager.

The two approaches supplement each other in that they measure performance in a different way. One measures performance relative to other comparable funds and is therefore useful in showing how well the manager has performed relative to its peers. The other shows how well a manager has performed relative to an index, which is consistent with the way the manager will be measured and thereby enables the trustees to judge if the manager is performing according to expectations.

(The relevant sections of the Study Manual are Part 6, Chapter 3.3 & 3.4)

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