Is running a pension scheme becoming more like running a business?

Investment decision-making and governance in UK workplace pension schemes
Pensions Intelligence research report

November 2013

Aberdeen

Foreword

Aberdeen Asset Management's involvement with pension funds spans 30 years and is an important part of our overall business structure. Aberdeen believes in long-term investing, sustainability and the attendant benefits, which is why our Pensions Intelligence initiative, now in its sixth year, continues to offer trustees and pension managers a forum to debate the topics so important to the long term well-being of the pension holders and the wider investment community.

The focus of our latest report is investment decision-making and governance. We have surveyed a mix of trustees, pension managers and experts to provide insights that will be of interest to trustees, industry and policymakers. The message that comes through repeatedly is that running a pension scheme is becoming ever more like running a business as trustees face the challenge of reconciling a long-term commitment to pension scheme members with the demands of a changeable investment and regulatory environment.

On the investment side, the challenge is how to provide adequate investment returns in the face of considerable uncertainty (and sometimes, in the case of DB schemes, a large funding gap). Trustee boards of DB schemes are turning to dedicated investment committees to determine which investments will best match long-term liabilities. This has seen a new emphasis on liability-driven and alternative investments as a potential part of the investment mix. This focus on investment governance is to be welcomed and should be particularly noted by some DC schemes where, according to our survey, investment decision-making is not always given a sufficiently high priority, particularly in relation to the default fund.

It is not just trustee boards that are adopting new approaches to risk management. Scheme sponsors are backing pension funds with assets other than cash. These 'contingent assets' – including property, cheese and whisky – are now in use in one in six schemes surveyed and many more are considering how they can underpin schemes for the long-term with non-cash assets.

The other part of the equation is public policy. After several years of major reform to the pension system, and with auto-enrolment coming into effect now, a stable regulatory environment will help trustees to make long-term decisions with greater confidence. According to our report, stability is particularly important for smaller schemes, where regulatory and administrative tasks can divert boards from investment decision making.

Looking to the future of pension policy, there continues to be support for developing risk-sharing approaches for occupational schemes. However, respondents appear to be unsure about what the government's defined ambition approach will mean in practice. Risk sharing is an important idea and we await further details on defined ambition with interest.

This is a time of considerable change for those entrusted with the stewardship of this important pillar of UK retirement saving. The complexity of the pension landscape and the demands for more robust governance are such that schemes are compelled to attain increasingly high professional standards to keep pace with regulatory requirements and a potentially bewildering array of asset classes and strategies. This report illuminates the ways in which trustees and pension managers are rising to these challenges and are, in the main, successfully managing their schemes in a suitably business-like manner, with an admirable duty of care to their members. A long-term approach from policymakers and the industry will do a great deal to support their efforts.

Martin Gilbert
Chief Executive
Aberdeen Asset Management

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Executive summary

While there is no universal right way to manage a pension scheme because every trustee board, funding position, sponsor covenant and attitude to risk is different, there are certainly 'best practice' examples from which valuable lessons may be learned.

In response to Pensions Intelligence attendees who expressed an interest in exploring the subject of investment decision-making and governance, this report provides such examples, paying particular attention to the issues that research respondents raised as being of concern or special interest to them. It includes insights into the practical steps that trustees and pension managers of defined benefit (DB) and defined contribution (DC) schemes are taking in order to manage and structure their pension schemes under difficult circumstances: a challenging regulatory regime, prolonged low interest rate environment, and potentially bewildering range of investment options and strategies.

Devolved investment sub-committees: good strategic solutions but not the only option

The vast majority of schemes surveyed have devolved sub-committees or working groups to engage in specific aspects of investment decision-making, which effectively compensate for the infrequency and logistical difficulty of convening full trustee board meetings. These enable the business of the trustee board meetings to be transacted efficiently, and allow trustee boards to focus on strategy rather than operational issues. Two thirds of DB schemes in our on-line survey have investment sub-committees and of these, most have a mandate to act swiftly and independently within the parameters set by the trustee board: 60% have a mandate to execute some or most investment decisions without ratification by the board; 40% have no authority to make investment decisions without referring to the trustee board.

While the investment sub-committee structure is a model of good practice it is not the only solution. Not all trustees and pensions managers surveyed regard it as an appropriate or viable structure, especially within smaller schemes. In these cases, independent investment advisers typically play a central, strategic role for the trustee board. The difficulty of getting the right composition of trustee board was an issue raised by respondents of smaller schemes, who mentioned the importance of the diversity of the trustee profile/demographic, and the 'fit' of new trustees to existing members. David Locke, Finance Director, BMS World Mission says, "We do a skills matrix so that when we appoint trustees we will try to get a good mix of skills and backgrounds."

Investment strategy: the risk return balance remains the toughest challenge

The most important decision facing trustees, but one they often find the hardest, is determining the appropriate level of risk and return that should define their investment objectives. We asked survey respondents to select one answer that best described how their investment target was set. Fifty three per cent claimed it was driven by the maximum level of risk they felt it was appropriate to take. A substantial proportion of respondents acknowledge that achieving the balance between LDI and growth, maintaining that balance and staying on course towards meeting their investment objectives is an ongoing challenge.

The search for growth remains a challenge, despite the increasingly wide range of asset classes and strategies available to most schemes.

Schemes vary in terms of their approach and timeframes for de-risking: our survey showed that a minority (19%) have triggers to automatically initiate a re-balance of investments whereas the greater proportion (39%) use triggers as a basis for manual evaluation. Thirty five per cent of schemes decide to make adjustments as and when appropriate rather than considering this in advance. Investment switches are more likely to be generated by a strategic review, typically driven by the valuation or an annual governance cycle, to rebalance their growth/defensive ratio, than any other event. Even so, more than half of our survey respondents consider the possibility, in each case, of switching/moving funds in order to take advantage of opportunistic investments (56%), or as a result of poor performance of an existing fund (51%). In today's environment in particular, the search for growth remains a challenge, despite the increasingly wide range of asset classes and strategies available to most schemes.

Tackling allocations to alternatives

In general, alternatives play a niche role in scheme portfolios. Our research showed that on average, alternatives comprise 11% of investment portfolios within DB schemes. However, most schemes do not choose to retain the decision over how much to allocate to alternatives and what form those alternatives should take, instead typically using a diversified growth fund (DGF). Where schemes do choose to retain the decision on specific allocations to alternatives they often delegate manager selection, typically opting to invest in hedge funds, private equity and infrastructure through a fund of funds approach rather than single funds. Take up of completion funds (which, as opposed to a DGF, aim to invest only in alternatives) is still relatively small, at just 4% of survey respondents. While alternatives allocations appear to feature reasonably highly on the agenda of most DB schemes, they are somewhat of a neglected investment opportunity by most DC schemes. Our survey showed the average proportion of assets allocated to alternatives in DC default funds is only 3% and unsurprisingly, these are typically within a DGF. For three quarters of trustees and pension managers of DC schemes in our survey, alternatives either do not feature, or respondents do not know whether or not they are included in their default fund.

Trustees and investment managers spend much of their time together going through the minutiae of the buy, sell and hold decisions a manager has taken on its stocks. A broader conversation could enhance the value of the relationship.

The place for contingent assets

Contingent assets, including those set up as special purpose vehicles (SPVs), are a new challenge for trustees to grapple with. Our research indicates that while the principle of contingent assets is regarded favourably, the opportunity is not always available. Even so, one in six DB schemes surveyed do currently use contingent assets from their sponsor to improve security for their members. In relying on contingent assets trustees have to consider the double jeopardy risk that their contingent asset loses value when the employer solvency is threatened.

"The use of contingent assets can be seen, perhaps sometimes unfairly, as an investment of last resort by schemes, and clearly places the future of benefits to members around the financial health of the sponsor. This has worked well in couple of cases, but it is clearly by no means a risk-free strategy and could conceivably add significantly to the dynamic tensions that can exist between trustees and the scheme sponsor."

Malcolm Small, Director of Policy, Tax Incentivised Saving Association (TISA)

The role of investment advisers and investment managers

Although independent investment advice is a prerequisite for good scheme governance, it is clear from our research that there is a changing dynamic, which investment advisers need to embrace and respond to: trustees and managers of large schemes believe their role is to challenge advisers and steer reviews in order to ensure that the best possible advice and value is obtained; the highly accomplished pension managers and chief investment officers interviewed for this research reflect an industry trend towards increasingly sophisticated in-house investment and governance teams. Access to top tier advice can be more difficult for smaller schemes, where the tiering of adviser/manager relationships can work against them, which respondents in our research are keen to overcome. Developing closer, direct relationships with investment managers is seen as an integral part of the skills improvement and evaluation process for trustees and pensions managers, who regard regular updates and face-to-face meetings, however informal, as a priority. However, trustees do need to consider how to make best use of the time they spend with their investment managers – many trustees and investment managers spend much of their time together going through the minutiae of the buy, sell and hold decisions a manager has taken on its stocks. A broader conversation could enhance the value of the relationship. The choice of investment provider is not immune from cost considerations, but the majority of respondents (71%) comprehensively fed back that investment performance net of fees is the most important criteria driving their decisions. Only 22% said that investment provider selection is driven by fees.

Investment adviser models and delegated consulting

Independent trustees, who typically have an overview of numerous smaller schemes, see fiduciary management as a growth area, which is most likely to be driven by sponsors rather than trustees. Our survey shows that 22% of schemes delegate at least some of their investment decision-making to a fiduciary manager. However, our research has confirmed that views on fiduciary management remain polarised and respondents recognised that it is difficult to compare offerings on a 'like for like' basis. It is not surprising that large schemes with highly skilled investment committees, which have delegated powers of investment decision-making, are less likely to acknowledge the benefits of fiduciary management than those without such resource.

DC scheme investment decision-making

According to our research, trustees and pension managers are starting to look at opportunities to translate investment decisions from their DB to DC schemes, where appropriate to do so. One in seven has taken an approach towards their DC scheme that is consistent with investment decisions made in their DB scheme. One in three offers a 'white labelled' default fund. Companies have not been afraid to experiment with the number of options made available to members in an attempt to get the offer right – and so the number of funds offered has sometimes see-sawed up and down in the process. Too much choice can potentially do more harm than good, as Lesley Williams, Group Pension Director, Whitbread Group points out, "People told us they were not joining because they were afraid of making an investment choice. We removed choice – we now have a default lifestyle strategy and a single growth fund, a pre-retirement fund and the cash fund."

DC investment decision-making is still lacking an outcome-based focus.

Although there was a call for more innovation in DC investment to deliver better outcomes for members, the great majority (84%) of DC schemes in our survey are not targeting replacement ratios (a targeted proportion of retirement salary) for their members. This indicates that DC decision-making is still lacking an outcome-based focus. However, improving member outcomes is very much a priority for DC scheme managers. When presented with a series of potential considerations which could be described as defined ambition structures, there was a groundswell of positive reaction to schemes which share employer and employee risk to achieve better outcomes. A cash balance scheme, in which employers promise a set pension benefit on retirement rather than the income level, was significantly less attractive to our survey respondents than the other four options: only 33% overall consider this to be attractive.

> "I'm not convinced we need to bring in new types of schemes and have more change. There is a lot of scope for doing DC better: raising contribution rates, increasing member engagement, improving value for money. I would focus on incremental improvement rather than another wholesale change to the system."
>
> **Alistair Byrne, Senior Consultant, Towers Watson**

Is running a pension scheme like running a business?

Investment, governance and business-like challenges facing trustees were highlighted as far back as the 2000 Myners' Review of Institutional Investment, and before. Most trustees and pension managers would argue that running a pension scheme demands the same levels of rigour as a successful company, encompassing management structures, governance, budgetary controls, the need to manage risk – and more. In addition to taking their investment and governance responsibilities very seriously, trustees and pension managers in our survey expressed a profound commitment to long termism and a strong duty of care to members.

Many trustees and managers believe that running a pension scheme is like running a business, but with a far greater requirement for long term thinking and a different approach to the 'end user', or as Bill Whitehead, Director of Pentrus put it, "5,000 pensioners are depending on the trustees to deliver their pension; it is a huge responsibility. I think we have a far greater long term perspective and duty of care to pensioners than some FDs and CEOs have for their company and their staff."

> Is running a pension scheme like running a business?
> "Yes, a business with heart."
>
> **David Locke, Finance Director, BMS World Mission**

Background and market context

The high percentage of pension scheme investment sub-committees is indicative of the increasing complexity of the pension landscape, and yet some industry experts argue that the priority given to investment decision-making is still not high enough.

Low investment yields, inflation and an uncertain economic outlook continue to make the twin demands of safeguarding member pensions while generating the best returns very difficult. Pension managers must think long term while remaining flexible enough to respond quickly to changing conditions. At the same time, growing requirements for more robust governance are placing additional demands on trustees, some of whom struggle to find the time and expertise necessary to keep pace with the complexity of the pension landscape.

For trustee boards that are comfortable to delegate investment decision-making and other aspects of running their scheme, fiduciary management is a potentially attractive option. Our survey shows that 22% of DB schemes delegate at least a proportion of their portfolio to fiduciary managers. The difference in take-up rate could suggest that, numerically, it is the smaller schemes which are most likely to achieve value from fiduciary services but it should be borne in mind that there isn't a clear definition of fiduciary management and this can explain variation in take up reported. Opinion about fiduciary management within the pensions sector remains divided: while some pension schemes recognise the major advantage of accessing expertise in decision-making beyond the skill set of trustee boards, others are concerned about the loss of control that inevitably comes with handing the management of assets over to a third party. There are also concerns about a potential conflict of interest facing the investment consultants entering this arena. What is more, the decision to appoint fiduciary managers may lead to yet another layer of governance, necessary to monitor the decisions of advisers in these circumstances, leading to additional layers of fees.

Low yields and above-target inflation are making it especially difficult for DB schemes, particularly those with flight paths towards fully-funded status, to get the returns they need soon enough. Many such schemes are maturing rapidly, leaving little time for investment approaches that may close the funding gap, to play out. "Pension schemes simply have to work their assets harder to narrow this gap," says John Belgrove, senior partner at Aon Hewitt. "If the value of their assets falls by 20%, there simply isn't enough time to recover."[A]

With this kind of pressure on recovery plans, schemes are looking beyond traditional asset classes for growth and income, which of course adds to the investment decision-making burden. According to Towers Watson's 2013 Global Alternatives Survey, in 1995 pension funds allocated only 5% of their assets to alternatives[B]. This figure has now grown to 19%. Our research indicates that alternatives will continue to play an important role for diversification purposes, but in comparison to traditional asset classes, allocation remains modest.

The 'funding gap' and balancing the weighting to liability-driven investments (LDI)[C] with asset growth are cited by respondents in our research as major challenges. According to KPMG's 2013 LDI Survey, LDI now covers £446 billion of liabilities: an 11% increase over 2012 with 686 UK pension scheme mandates now employing LDI. Thirty five per cent of mandates have de-risking triggers in place, meaning that contingent decisions are in place to increase LDI, so yield reversion should see LDI witness significant growth. However, 80% of LDI managers in the KPMG survey believe that their greatest source of new business will be from pension schemes new to LDI.

One way forward for those schemes with deficits is the use of contingent assets[D]. Nick Griggs, partner at Barnett Waddingham, says, "The use of contingent assets can provide companies and trustees with a viable way of addressing pension scheme deficits without increasing the immediate cash payments. Companies should seriously consider the use of contingent assets, as they can be the extra tool providing enough comfort to the trustees which will allow the company the flexibility it needs in its recovery plan." He also said schemes that put Pension Protection Fund (PPF) compliant contingent assets in place can help to lower PPF levies. "This is a real cash saving, which can help with the management costs of a scheme and allow contributions to focus on tackling past deficits. However, it can be a minefield of detail when trying to put a contingent asset in place, which means legal advice is key and so is acting early."[E]

[A] Financial Times, 16 April 2013
[B] While the definition of an 'alternative' asset class is generally taken to be anything other than investment grade bonds, equities and cash, it is clear that some schemes have specific allocations to, for example, property, private equity, hedge funds, infrastructure or emerging market debt, which they perceive in much the same way as traditional asset classes.
[C] A form of investing in which the main goal is to gain sufficient assets to meet all liabilities, both current and future.
[D] An asset for which the growth potential is determined by future events outside the company's control, and as such are not listed on its balance sheet, but are required to be stated in its financial statements.
[E] Source: www.barnett-waddington.co.uk

Aberdeen's November 2012 Pensions Intelligence funding paper reported on the use of contingent assets to support recovery plans. At that time, parent company guarantees and security on property were the most commonly used structures. Asset-backed contributions were increasing in use but there were concerns about 'double jeopardy' risks in employer-related assets. A growing minority of companies, such as Diageo (using two and a half million barrels of Scotch whisky) and Dairy Crest (using over £60 million worth of cheese maturing in its Nuneaton depot) are backing their pension schemes with assets other than cash, in an effort to improve their financial position at an acceptable cash cost to their business. In this research, one in six respondents said that their scheme uses contingent assets from the sponsor.

Looking specifically at DC schemes, our survey suggests that governance remains a key issue: fewer than half say they have a committee which reviews and recommends the investment strategy of the default fund(s). There are growing concerns that DC schemes are not doing enough to protect their pension funds. The Pension Regulator's 2013 annual survey found that only 54% of DC schemes had reviewed their investment principles over the past three years, despite the fact that doing so is a legal requirement. One in ten of the 454 trust-based schemes contacted between late 2012 and early 2013 said they had never reviewed them.

So, what does good investment governance look like? Experts appear to agree that regular reviews of the size and composition of the board are essential, particularly following a significant change in circumstances. It is likely that boards will get smaller, as schemes recognise that a smaller number of better-qualified trustees may be better placed to react to rapidly-evolving conditions than a larger board with a wide range of skills. Boards would be well advised to have a robust succession plan in place so that they can quickly replace any gaps that appear, and should think carefully about the skill set, experience and 'fit' of new trustees.

Smaller schemes may well struggle to find the right expertise predicts Peter Askins, a director at Independent Trustee Services. "While there will always be vibrant, engaged and knowledgeable trustees willing to serve on the dwindling number of large, well-resourced schemes, the situation facing the rest is increasingly problematic as smaller schemes struggle to find skilled individuals to take on trusted roles,"[F] he says.

While investment decision-making should perhaps be given greater priority, other pressing regulatory and administrative tasks, including auto-enrolment can all too easily divert attention away from such focus.

With smaller schemes in particular struggling to meet increased regulatory requirements, a significant migration to larger employer schemes, master trusts and group schemes, looks likely. Membership of master trusts is expected by some to triple to over six million by 2017/8[G]. The growth of master trusts will, in turn, have implications for governance structures, as responsibility is passed from the traditional trustee board to a commercial enterprise with a trustee board facing new conflicts.

Defined ambition (DA) pension schemes will bring their own governance challenges. However, there is little obvious appetite for such schemes which the government hopes will distribute investment risk between employer and employee. A survey by consultancy Hymans Robertson (June 2013) found that few employers would welcome a model that mimicked DB schemes, while 62% of respondents said they 'would be prepared to put in place a system that would help secure a target retirement income for employees without having to contribute more to the scheme'. This indicates more detail is required over the meaning of defined ambition. In our research, respondents were receptive to the idea of a form of risk sharing where the member and the pension provider share the cost of protection (see page 28 for more details). The wider marketplace appears to back an improved DC system – either a collective DC model or DC-plus – as the most viable direction for the government's DA agenda[H]. Feedback from our research respondents indicates that any new DA approach should avoid new and/or more onerous regulation.

[F] Financial Times, 16 July 2013
[G] Source: Financial Times, 07 June 2013
[H] Source: Aon Hewitt, July 2013 survey

Our research findings

Our research programme comprised two phases: twenty qualitative depth interviews among trustees and pension managers representing schemes of all sizes, from the manager/investor of a small self-invested pension scheme to large-scale schemes, and an online survey which invited trustees, pensions managers, professional trustees and other industry experts, to share their views on key themes that emerged from the interviews. Consultants were invited to participate in a shorter survey. There were 230 survey respondents.

Investment decision-making structure and governance

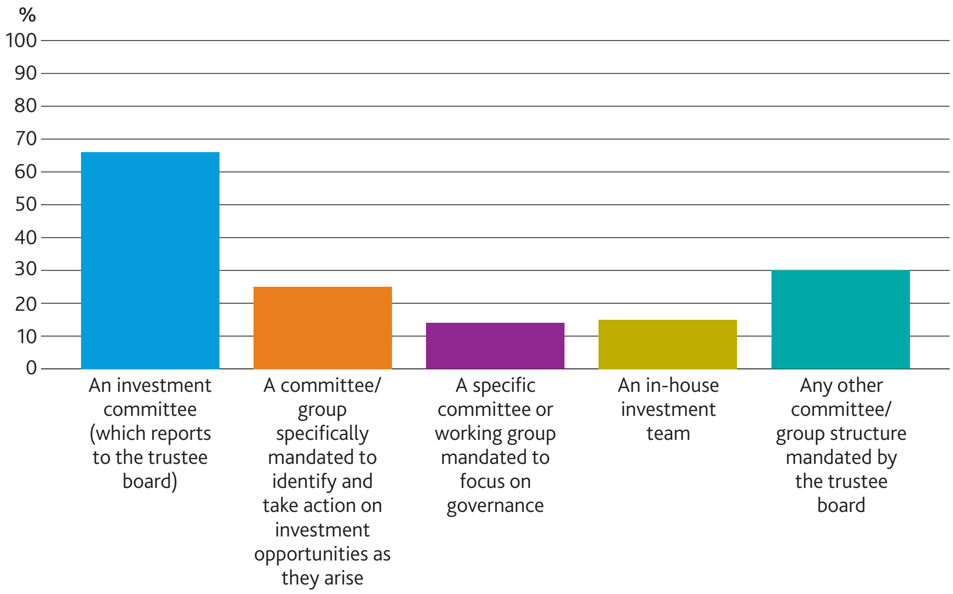
With two exceptions, all respondents interviewed have devolved sub-committees or working groups to engage in specific aspects of investment decision-making. These sub-committees effectively compensate for the infrequency and logistical difficulty of convening full trustee board meetings. The benefits of such sub-committees, particularly for larger schemes, are that they:

- are more agile with respect to investment opportunities, helping to identify, facilitate and potentially speed-up decision-making
- typically have terms of reference which enable them to co-opt expertise and resource, as appropriate
- enable delegation of responsibilities to manage tasks effectively
- sort and streamline information for presentation to, and ratification by, the trustee board
- enable the business of the trustee board meetings to be transacted efficiently, and allow trustee boards to focus on strategy rather than operational issues.

Two thirds of DB schemes in our on-line survey have investment sub-committees and of these, most have a mandate to act swiftly and independently within the parameters set by the trustee board:

- 60% have a mandate to execute some or even most investment decisions without ratification by the board
- 40% have no authority to make investment decisions without referring to the trustee board.

1: Recognising that schemes differ in the way they structure investment decision-making and governance, does your DB scheme have:



"Governance sits within the investment sub-committee: they are the ones who control the statements of investment principles, the monitoring processes, and make sure the trustee board has time to deal with more strategic issues."

Steven Robson, Head of Pensions, United Utilities PLC

Where companies have the challenge of managing a number of legacy schemes, establishing a common investment fund (CIF)[i] creates a central resource for the investment sub-committees and enables the pensions managers to maximise economies of scale, standardise the investment approach and centralise the implementation, monitoring and appointment of fund managers for individual schemes.

While the investment sub-committee structure is a model of good practice it is not the only solution. Not all trustees and pensions managers surveyed regard it as an appropriate or viable structure, especially within smaller schemes, which typically comprise more 'lay' trustees and fewer experienced personnel. In these cases, independent investment advisers typically play a central, strategic role for the trustee board. David Locke, Finance Director for BMS World Mission says, "We have an investment adviser who sits in on meetings with the investment managers; we use them as a mentor and coach at specific times."

In the main, our depth interview participants represented well-structured schemes that clearly operate 'best practice' for their requirements and circumstances. Even so, their trustee boards differ markedly in size and composition; their investment decision-making is geared towards the unique nature of their organisation and membership.
Two of 18 schemes surveyed reported having independent professional trustees on their boards.

The difficulty of getting the right composition of trustee board was an issue raised by respondents of smaller schemes, who mentioned the importance of the diversity of trustee profile/demographic, and the 'fit' of new trustees to existing members. David Locke, Finance Director, BMS World Mission says, "We do a skills matrix so that when we appoint trustees we will try to get a good mix of skills and backgrounds."

Asked how Aberdeen approaches the investment decision-making and governance of its own pension scheme, Alex Barr, Lead Manager Aberdeen Private Equity Fund, and Chairman of Aberdeen's UK DC pension Governance Committee says, "We are an investment company, so as you might expect, there is a high level of focus on getting the right mix of funds into our scheme and monitoring the performance of those funds. We have a Group Personal Pension (GPP) governance committee, with a number of members drawn from our own investment teams. They take that responsibility very seriously because their day job is investing – a lot of effort goes into selecting and monitoring the right funds and fund mix. Because it is a GPP, the level of executive decision-making the governance committee can take is minimal, but we are unusual in as much as an investment sub-committee has been responsible for identifying clusters of funds that our employees can invest in, and individual funds that form those clusters, and we revisit that on a regular basis."

"Our DB investment committee focuses primarily on long term strategy, but they can make themselves available to make quick decisions and have delegated authority from the trustee to put up to 5% of the assets into opportunistic investments should they identify a suitable opportunity."

Carol Young, Head of Pensions, HEINEKEN UK Ltd

"Each individual board has its own investment strategy, but uses the common investment fund as a vehicle in order to implement that strategy; the CIF appoints and monitors the managers and specific fund choices come under their umbrella."

Marion Andrews, Pensions Administration Manager, TUI UK Ltd

[i] Common Investment Funds (CIFs) are collective investment schemes that only charities can invest in and are charitable in law. The Charity Commission has the power to establish CIFs. CIFs are pooled investment vehicles – similar to OEICS –which are tax efficient, administratively simple and cost effective.

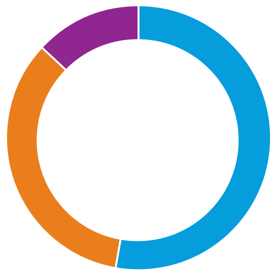
Formulation of investment strategy

The most important decision facing trustees, but one they often find the hardest, is determining the appropriate level of risk and return that should define their investment objectives. Trustees want to seek a certain level of expected return to keep the expected demand on the employer for contributions below a particular level, but are also challenged to determine the maximum level of risk that it is appropriate for them to take given the employer covenant, the current funding level, and other particulars of their scheme. We asked survey respondents to select one answer that best described how their investment target was set. Fifty three per cent claimed it was driven by the maximum level of risk they felt it was appropriate to take.

The complexity of investment objectives will often depend on whether or not the scheme has a target date for fully funded status. Those which do typically set out how the investment strategy will evolve over time, and how that strategy will maintain an appropriate balance between defensive and return-seeking assets, or a consistent flightpath toward increased de-risking.

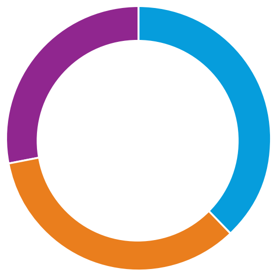
2: How is your investment target arrived at?

The investment return target is driven by the maximum level of risk the scheme feels it is appropriate to take	53%
The target is based on the level of investment returns needed, given the contributions the company can afford	34%
Other rationale	13%



3: Is your investment strategy defined in terms of:

A flightpath toward increased de-risking but with no specific end date	38%
Maintaining a balance between defensive and return-seeking assets	34%
A precise flightpath to achieve fully-funded status by a specific identified date	28%



The path toward de-risking is typically steered by a regular re-balancing of the defensive/ return-seeking ratio. Our survey showed that the average ratio for schemes currently is 48% defensive: 53% return seeking, with an expectation that the average balance will shift to 52% defensive: 48% return seeking over the next few years. One pension manager interviewed said, "We do regular de-risking. We sell equities every quarter and buy liability matching investments."

A substantial proportion of respondents acknowledge that achieving the balance between LDI and growth, maintaining that balance and staying on course towards meeting their investment objectives is an ongoing challenge.

> "The challenge is how to manage your assets so that you make gradual improvement on both a funding and a de-risking basis."
>
> **Philip Gardner, Finance Director, Country Manager UK, Ireland & Sweden, IFF (Great Britain) Ltd.**

"Setting the investment principles is reviewed each year and the trustees look at balancing the investments in relation to that. But any rebalancing is unlikely to be done on an annual basis."

Marion Andrews, Pensions Administration Manager, TUI UK Ltd

Many schemes are forward looking in that they decide in advance under what circumstances they will de-risk further. However, schemes vary in terms of their approach and timeframes for de-risking: our survey showed that a minority (19%) have triggers to automatically initiate a re-balance of investments whereas the greater proportion (39%) use triggers as a basis for manual evaluation. Thirty five per cent of schemes decide to make adjustments as and when appropriate rather than considering this in advance. Carol Young, Head of Pensions for the award-winning HEINEKEN UK pension scheme says, "We run de-risking metrics that are available to us every month. We look at the current situation – in terms of funding, accounting and self-sufficiency – and then we look at the potential impact on these metrics of a number of possible de-risking scenarios including traditional investment de-risking i.e. increasing hedging assets and reducing return seeking assets and "hedge extension" i.e. increasing our exposure to hedging assets through increased leverage, without impacting our expected return. In addition, we consider the potential impact of other ways of de-risking such as longevity swap, buy in/out and liability management exercises."

Con Keating, Head of Research for insurance group BrightonRock, says "The schemes with which I am associated are defined benefit in nature. The return target adopted and estimated likelihood of shortfall considers the potential cost of additional contributions to the sponsor employer and the target is adjusted accordingly. In this we are considering the fund and sponsor jointly, and do this in conjunction with the sponsor's financial management. We adopt a return target and then ask the question: what does the risk of this or that strategy or investment contribute to the likelihood of achieving the desired return? This can be illustrated by our reaction to the post Lehman world when volatility was staggeringly high. To justify investment in markets which were that volatile, a one year expected return of more than 50% would have been required. We instead adopted a policy of writing out of the money put options – none were exercised, and the premiums we received added materially to our cash flows for the year."

As the chart in Figure 2 shows, investment switches are more likely to be generated by a strategic review, typically driven by the valuation or an annual governance cycle, to rebalance their growth/defensive ratio, than any other event. Even so, more than half of our survey respondents consider the possibility, in each case, of switching/moving funds in order to take advantage of opportunistic investments (56%), or as a result of poor performance of an existing fund (51%). In today's environment in particular, the search for growth remains a challenge, despite the increasingly wide range of asset classes and strategies available to most schemes. As Richard Butcher of Pitmans Trustees points out, "There is no standout asset class about which you could say: that is where we think the growth engine is going to be for the next three, four, five years."

As our survey showed, a mechanistic approach to de-risking is not practiced universally. HEINEKEN UK is an example of a scheme that has incorporated an opportunistic approach

"We are constantly looking at what the ideal return-seeking proportion of the fund needs to be and before taking de-risking decisions make an allowance for an ability to recover if there was substantial downside."

Bob Hymas, Secretary to the investment committee, Merchant Navy Officers Pension Fund (MNOPF)

"We adopt a return target and then ask the question: what does the risk of this or that strategy or investment contribute to the likelihood of achieving the desired return?"

Con Keating, Head of Research, BrightonRock Group

"Many pension scheme managers would benefit from working more collaboratively with the company [pension sponsor]. Most trustees and companies ultimately want the same thing."

Steven Robson, Head of Pensions, United Utilities PLC

into its de-risking. This allows them to consider additional de-risking options beyond simply adjusting their defensive/return-seeking weighting. Carol Young, Head of Pensions for HEINEKEN UK says, "Rather than automatically or mechanistically de-risking through our investment policy only, if we find that we are ahead of where we expected to be in our funding plan, we can use the metrics to consider which of these de-risking options is best for us i.e. is there an opportunity to use the fact that we are ahead to tolerate strain in our funding that might otherwise be introduced by, say, longevity or buy-in or a de-risking exercise rather than simply selling growth assets. You might characterise it as a more opportunistic approach to de-risking. The trigger would be that if we found ourselves ahead …it is a lot more fluid than the typical mechanistic flight plan you might see elsewhere."

Other challenges to investment decision-making

Trustee skills and expertise

Finding trustees with the expertise necessary to recognise investment opportunities, challenge advice and feel comfortable exploring investment options, is a challenge for all schemes but particularly difficult for smaller schemes. Skills gaps are typically plugged either by the recruitment of independent professional trustees, or through a close working relationship with investment advisers, but there is a recognition that training is a priority. Our survey largely reinforces this acknowledgement of the importance of trustee training. More than half of pension managers believe that trustee boards need to improve their technical strength (59%) but just over one third of trustee respondents (38%) believe this is required. Of course this might reflect differences in samples rather than a difference of perception – perhaps those trustees that completed the survey were, on the whole, more engaged trustees. Richard Butcher of Pitmans Trustees says, "Most lay trustees don't have any point of reference to decide what good practice is because they are only exposed to their own behaviour."

Maintaining a good level of collaboration between the trustee board and corporate sponsor assists trustees in their understanding of the sponsor covenant and helps to ensure full engagement and co-operation.

Auto-enrolment and administrative burdens

Unsurprisingly, auto-enrolment is cited as a major challenge in relation to DC with the urgency and progress dependent upon the staging dates for individual companies. Coping with auto-enrolment involves consultation processes, administration and process realignment, opening new schemes and member communications, in addition to a significant skill set and governance resource. Marion Andrews, Pensions Administration Manager for TUI UK, has first-hand experience of this demanding environment: "Our staging date was 1st March – it has taken over a year of consultation process and changes to shut down the DC trust arrangement and open up the GPP, deal with member communications and then change it to a new provider."

We asked Helen Roberts, policy lead on investment issues at the NAPF across defined benefit and defined contribution pensions, what can be done to encourage DC schemes to place investment decision-making at the top of their agenda (to secure better outcomes for members). In her experience, Roberts says "From what I see, the current focus is on trying to create a framework for DC; the investment side is important but secondary to trying to get a suitable scheme in place."

The National Employment Savings Trust (NEST) is a good example of a scheme which has established such a framework. Its chief investment officer, Mark Fawcett, has overseen the scheme's investment strategy since it was launched in 2011. The scheme has since attracted high profile companies including the BBC, BT, McDonalds and Travelodge. "The NEST model has three stages", reports Roberts, "Growth, foundation, and consolidation. Each phase has a different objective that focuses on the needs of the member at different times in their savings career. Mark spoke to us at the NAPF about the 2068 fund, 2039 fund, and 2022 fund, and about how he is trying to make sure that the mechanisms NEST uses to allocate assets allow it to deliver a tailored approach to all its members."

Mark said, "The growth phase is the engine room of the NEST Retirement Date Funds, where we concentrate on growing the pot quickly. While we need to take substantial investment risk to generate sufficient investment return, our research suggests that members are intimidated by the idea of extreme investment shocks. For this reason we also manage the volatility of the portfolio throughout the growth phase. The growth phase will typically continue until 10 years before the expected retirement date at which time the fund will move into the consolidation phase. We use the Consumer Price Index measure for inflation.

The foundation phase aims to preserve capital while seeking sufficient return to match inflation and cover all scheme charges. Members who join NEST in their 20s will spend one to five years in the foundation phase. During our research younger savers told us that they may stop saving if they see falls in the value of their retirement pot. This is true even for short-term or one-off losses. For this reason, we focus on steady nominal growth rather than the ambitious targets of the growth phase.

In the consolidation phase, we gradually move the portfolio from the return-seeking assets held in the growth phase to annuity-tracking assets and cash-like investments, to reduce volatility and manage the tracking error to annuity prices. We aim for steady growth in real terms over the life of the fund to maximise retirement incomes by taking sufficient investment risk at appropriate times while reducing the likelihood of extreme investment shocks. This is when we lock in any gains that members have made in the previous years and mitigate the risks that come from converting investment assets into a retirement income and cash. We still expect to grow our members' money by more than inflation but in this phase our primary focus is to secure the member's retirement pot ready for them to take out."

The advantage of a model with three distinct investment objectives is that Fawcett can cost-effectively switch units between the 'pots' to take account of the differing priorities of those retiring from and those entering the NEST arrangement, for example, by trading real estate for more liquid assets. Roberts adds, "Real estate clearly has a part to play in DC investment. Diversification is important; liquidity can be embraced."

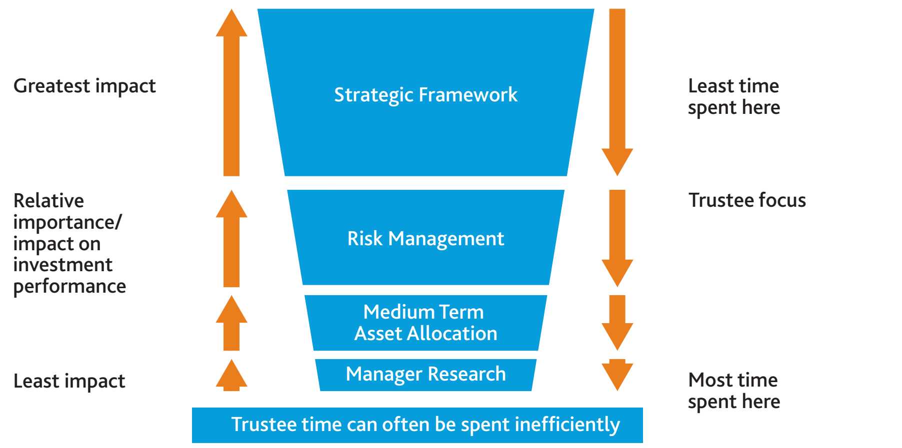
(On overcoming barriers to effective investment decision-making)

> "Know what tools are out there, and while the main focus might be on trying to keep costs down, you should also look at what would suit your members rather than the cheapest solution. Think about your membership for the longer term and what would work best for them."
>
> **Helen Roberts, Investment Policy lead adviser, NAPF**

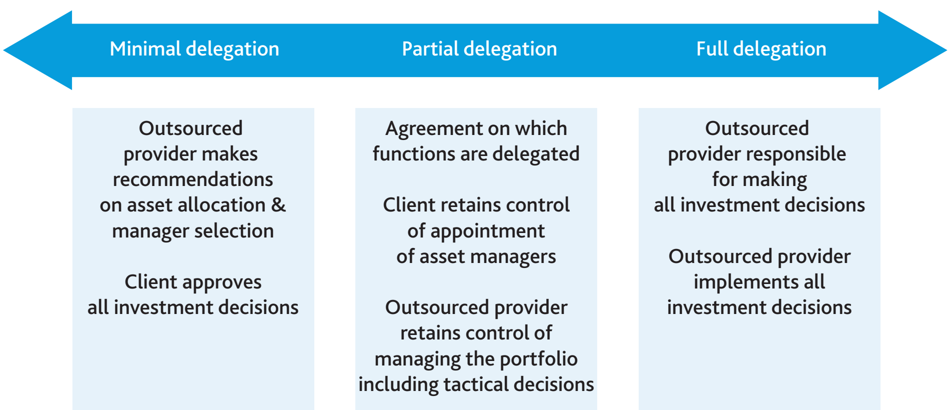
Ensuring the DC default fund is fit for purpose

Pension managers in our research cite two other key challenges in relation to their DC schemes, namely: ensuring that their default fund is 'fit for purpose', and member education and communication. In many cases it is clear that these matters get insufficient attention, but examples of good practice can be found. One pension manager we interviewed said, "The last full review we did was just before auto-enrolment when we reviewed the whole investment range and put a whole new range of funds in the default scheme: that is something that will be revisited annually to make sure that it is still fit for purpose and to see if there is anything new on the market we need to look at."

Does the traditional model have the right focus?



Three delegation possibilities



Source: http://www.fin24.com/Collective-Insight/The-value-chain-in-investment-decision-making/Retirement-funds-evolution-20100319

"On numerous occasions, I have asked fiduciary managers to provide evidential support for their assertions that they can make more timely decisions, which improve pension fund performance. I am still waiting for this."
Con Keating, Head of Research, BrightonRock Group

Investment adviser models and delegated consulting

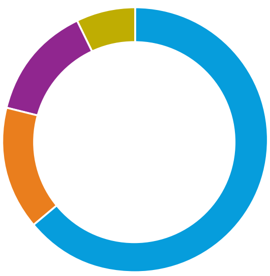
The investment adviser landscape has changed quite materially over the years. Under a traditional balanced approach, typically adopted 20 years ago, trustees took advice on manager selection but largely left strategic and tactical asset allocation to the 'balanced' manager they appointed to select investments. However, the rise of investment consultancy as a specialist area saw and increasing number of trustees recognise and take control of their strategic asset allocation, retaining the decision on the equity versus bond split and perhaps selecting specialist equity and a specialist bond manager. This step change was further encouraged by the introduction of the Minimum Funding Requirement in 1995 which 'matched' pensioners with bonds and actives and deferred members with equity.

Some cynics might perceive the use of diversified growth funds, which delegate asset allocation decisions back to managers, or fiduciary services, as a step back in time, however there should be one big difference. Trustees should recognise the importance of, and focus their time and efforts, on, determining their investment objectives (their risk budget and return target).

We asked respondents to describe the stance of their DB trustee board in relation to fiduciary management, fiduciary management being just one approach available to schemes with respect to investment decision-making and governance. The term fiduciary management has a broad definition and is acknowledged as meaning different things to different people. All would agree that it involves delegation of investment decisions beyond those delegated in a traditional mandate, and most would probably agree that it involves the manager rather more closely in meeting a scheme's overall objectives.

4. Which of the following best describes the stance of your DB trustee board in relation to fiduciary management?

Fiduciary management is not appropriate for our scheme	64%
We have delegated the investment decisions and management of a proportion of our investment portfolio to fiduciary managers (e.g. as a percentage of the fund or our alternative exposure)	15%
We are actively reviewing whether or not to delegate some/all of our investment portfolio to fiduciary managers	14%
We have delegated the investment decisions and management of our complete portfolio to fiduciary managers	7%



Our research has confirmed that views on fiduciary management remain polarised. Our respondents recognised that it is difficult to compare offerings on a 'like for like' basis. Independent trustees, who typically have an overview of numerous smaller schemes, see fiduciary management as a growth area, which is most likely to be driven by sponsors rather than trustees. Our survey shows that 22% of schemes delegate at least some of their investment decision-making to a fiduciary manager.

While one might assume that the key attraction of delegating to a fiduciary manager is to reduce the governance burden, schemes that have taken this approach tend to focus on other benefits:

- engaging the depth of expertise which trustees do not have
- the ability to respond swiftly to investment opportunities
- an expectation of enhanced investment performance
- freeing up time and resource of the trustee board to focus on strategic issues.

Bob Hymas, Secretary to the Investment Committee of the Merchant Navy Officers Pension Fund (MNOPF), which uses a fiduciary manager says, "One way of taking volatility and risk out of the portfolio was through diversification and diversification obviously means a greater number of managers, which actually becomes very impractical for an investment committee or a trustee board to try and operate."

Bill Whitehead, director at Pentrus says, "I can see a lot more schemes being treated almost like a toxic balance sheet item by the company and outsourced as much as possible to fiduciary managers. Fiduciary managers will take the place of some trustee governance. That may or may not mean taking out the traditional role of the investment advisers."

For the pension manager of a (closed) DB scheme and DC scheme, the delegated consulting model offered the scheme access to new opportunities in a timely manner: "We felt fiduciary management enabled the scheme to take advantage of shorter term opportunities because obviously the fiduciary managers are looking at things every day whereas the trustees can't possibly do that. It meant we could take advantage of a whole host of investment ideas that the trustees probably wouldn't be able to take advantage of because of the time and expertise that they needed to understand the whole new set of asset classes, so it also means access to different asset classes."

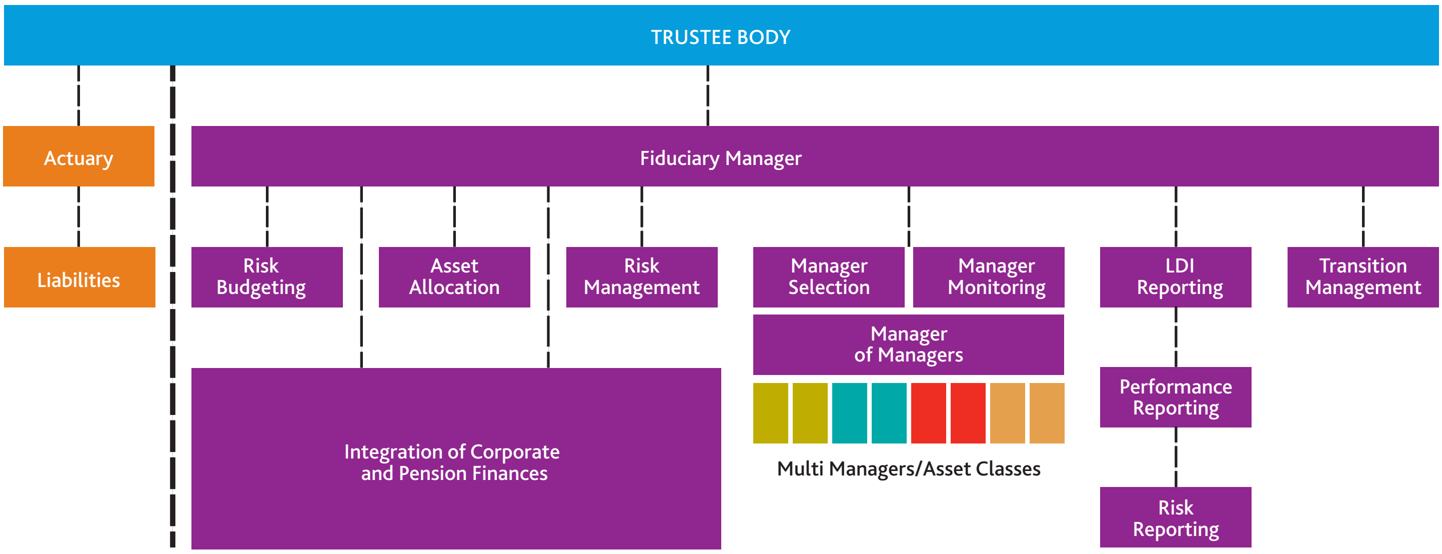
Conversely, Con Keating, Head of Research at BrightonRock Group, says "On numerous occasions, I have asked fiduciary managers to provide evidential support for their assertions that they can make more timely decisions, which improve pension fund performance. I am still waiting for this. The usual caution is act in haste and regret it at leisure, rather than try to outguess markets – that is speculation pure and simple."

It is not surprising that large schemes with highly skilled investment committees that have delegated powers of investment decision-making are less likely to acknowledge the benefits of fiduciary management than those without such resource. The fear of losing control and company culture are also very real concerns for many schemes. For smaller schemes in particular, the additional cost of employing fiduciary managers is a barrier. These barriers are likely to remain in place until fiduciary managers are able to demonstrate strong 'added-value' credentials of enhanced performance.

Lesley Williams, Group Pension Director at Whitbread Group says, "We are pretty close to a delegated consulting model in terms of research and bringing ideas on the DB side. The things I would worry about [with fiduciary management] would be cash flow management; my team is very close to the cash flows that we need to pay pensions, and I think consultants and investment managers sometimes forget that."

Views on fiduciary management are also coloured by who is offering the service. Some of those who took part in our research are emphatic that the service should be delivered by specialist companies rather than investment consultants (for whom they

What a model of fiduciary management might look like



Source: www.step.org/easing-pension-pain

"Private equity and hedge funds tend to be owned at lower weightings in the UK relative to the US."

Alex Barr, Lead Manager Aberdeen Private Equity Fund, and Chairman of Aberdeen's UK DC pension Governance Committee

perceive a potential conflict of interest). Respondents in our research who have appointed fiduciary managers have added an extra layer of governance with oversight from other independent advisers: "The company takes investment advice from a separate firm and the company's investment adviser is always at the investment sub-committee meetings, so although that investment adviser isn't advising the trustees as such, the trustees are getting an alternative view."

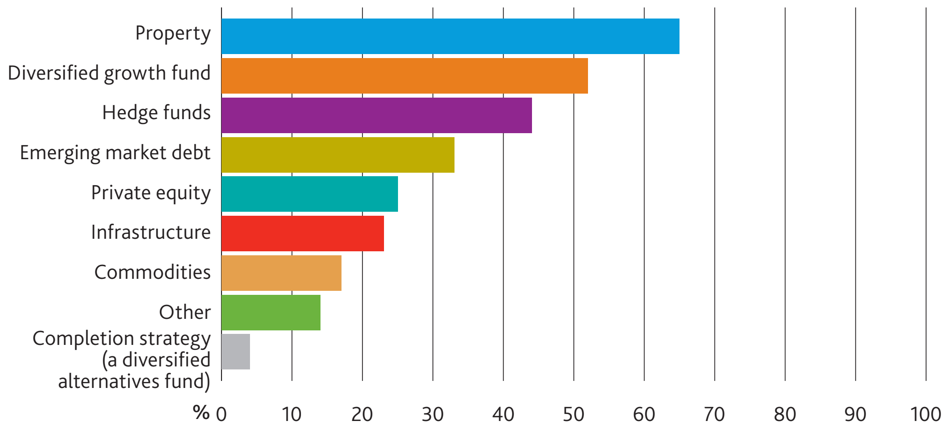
Fiduciary management is not the only choice available for schemes that recognise that they do not have the resource to act nimbly to changing markets but believe that there is value in doing so. Unconstrained mandates targeting specific objectives allow fund managers to select instruments as they see fit, provided they meet the objectives set. Diversified growth funds fall in to this camp and are not generally considered a fiduciary appointment.

Tackling allocations to alternatives

The most important decision for most trustees is the level of risk they should take or return they should target, which in turn drives their allocation between return seeking and risk mitigating or defensive assets. However, once this decision is made they need to consider whether it is appropriate to invest in 'alternative' assets to equity for their return seeking portfolio.

While the definition of an 'alternative' asset class is generally taken to be anything other than investment grade bonds, equities and cash, it is clear that some schemes have specific allocations to, for example, property, private equity, hedge funds, infrastructure or emerging market debt, which they perceive in much the same way as traditional asset classes. As Bill Whitehead of Pentrus sums up:

5: Is your scheme currently invested in any of the following asset classes/strategies?



"The higher risk, higher volatility, potentially higher growth in the medium term, is now what I say is alternative. So, for me, alternative is the more exotic."

In general, alternatives play a niche role in scheme portfolios. Our research showed that on average, alternatives comprise 11% of investment portfolios within DB schemes. However, it is interesting to note that most schemes do not choose to retain the decision over how much to allocate to alternatives and what form those alternatives should take, instead typically using a diversified growth fund (DGF). Where schemes do choose to retain the decision on specific allocations to alternatives they often delegate manager selection, typically opting to invest in hedge funds, private equity and infrastructure through a fund of funds approach rather than single funds.

Take up of completion funds (which, as opposed to a DGF, aim to invest only in alternatives) is still relatively small, at just 4% of survey respondents. This suggests that most schemes are happy to delegate

"As expected, the majority of schemes responding to the survey have exposure to property. Indicating that, firstly, the diversification benefits of investing in property appear to be understood and secondly given a high proportion of property returns are typically derived from contracted income, this provides for a high level of predictability and stability."

Andrew Allen, Director of Global Property Research, Aberdeen Asset Management

Respondents reported that alternatives would continue to be of interest for diversification and that investment in diversified growth funds, property, infrastructure and hedge funds are likely to lead the way. However, the allocation of pension fund assets to alternatives would remain low in comparison to traditional asset classes.

investment of mainstream equity alongside alternatives to a DGF manager rather than seek a specialist for each of equity and alternatives.

'Other' asset classes and strategies cited by respondents included: interest and inflation rate swaps, global tactical asset allocation, emerging market equities, and insurance-linked securities.

While alternatives allocations appear to feature reasonably highly on the agenda of most DB schemes, they are somewhat of a neglected investment opportunity by most DC schemes. Our survey showed the average proportion of assets allocated to alternatives in DC default funds is only 3% and unsurprisingly, these are typically within a diversified growth fund (DGF). For three quarters of trustees and pension managers of DC schemes in our survey, alternatives either do not feature, or respondents do not know whether or not they are included in their default fund. Sadly, this probably reflects the relative lack of attention paid to DC default funds. As Alex Barr, Lead Manager Aberdeen Private Equity Fund, and Chairman of Aberdeen's UK DC pension Governance Committee, points out, "Fund Managers of diversified growth funds are likely to have made some allocation to alternatives in their funds, which may provide smaller pension funds who have included a DGF in their schemes, with look through exposure to alternatives. However at that smaller scheme level trustees are unlikely to introduce direct alternative choices."

Industry experts interviewed for this research believe that trustees and pension managers would benefit from more education on the merits of alternative asset classes for pension scheme investments, for both DB and DC schemes. Alex Barr says "Private equity and hedge funds tend to be owned at lower weightings in the UK relative to the US. To take an extreme example, if you look at the Yale and Harvard endowments, they have very high model allocations to private equity, respectively 35% and 16%. These are long term strategic weightings. Even US public pension plans have high weightings, albeit at lower levels than those endowments, at around 8 to 9%."

In our research, respondents reported that alternatives would continue to be of interest for diversification and that investment in diversified growth funds, property, infrastructure and hedge funds are likely to lead the way. However, the allocation of pension fund assets to alternatives would remain low in comparison to traditional asset classes. From comments made by our respondents, it could be inferred that the reasons for the limit on alternatives holdings is the amount of governance required for each allocation. Diversification of alternatives appears to be the norm and the small investments that result could be onerous in terms of governance for the likely additional return they can generate. For some schemes this means that they are just not worthwhile. Lester Farrant, UK Group Pensions Manager at Total UK, says "I know you need diversification but when you are putting 2% of your fund into one thing and 2% into something else, if only one of them does well then you are actually earning very little return for a huge increase in governance." It is not surprising that this attitude towards alternatives leads to high allocations to DGFs and it would be reasonable to expect a growth in completion strategies.

Most alternatives are considered part of the return-seeking proportion of the portfolio: as portfolios are re-balanced toward defensive assets, the opportunity or appetite for alternatives diminishes. The lack of liquidity in alternatives is also a consideration for schemes that are de-risking.

6: Approximately what proportion of your scheme's assets are held in alternatives?

Response	DB Schemes	DC Schemes
None	16%	46%
1 - 5%	11%	13%
6 -10%	21%	4%
11 -15%	17%	1%
16 - 20%	8%	1%
Over 20%	16%	3%
Don't know	11%	31%

Given that some respondents in our research reported that alternatives play a relatively minor part in their portfolios and felt the amount of governance required is not worth the effort and return, we asked Paul Haines, Chief Investment Officer, Trafalgar House Pensions Administration, for his view on this. He said, "If you are going to accept pretty much everything your consultant advises you should consider formalising the relationship and delegate governance to them by opting for a fiduciary or delegated consulting model. If you want to stay involved in the investment decision-making process, you have to ask yourself what level of governance you can bring to trustee meetings and to day-to-day management of the portfolio, and this is the key issue: you cannot be effective if every time you are presented with an opportunity it demands a disproportionate amount of time to understand and assess."

Haines acknowledges the value of trustee training, but points out the importance of timing in the investment decision-making process, "The more time you spend on training, reading reports and seeing managers, the further away you are likely to be from the optimal investment point. One thing we need to have learned from the past 10 to 15 years is that, as a trustee, you either have to ignore opening prices on the grounds that you are going to be investing for so long that by the time you come to redeem, the opening prices won't have made any difference – there now aren't many pension schemes (outside of the public sector) that can afford this luxury – or you introduce a process that brings timing into the equation. If you are going to invest in alternatives you have got to do the 'leg work' beforehand because such investments will take time to assess and then keep under review – is that the best use of your time? Would it be better to avoid exotic arrangements and focus on bigger issues such as strategy or diversification, for instance?"

The decision to invest in 'alternatives' will almost always be a strategic one, "There is a lot of talk at the moment about property, for example, and property bubbles. 'Bubbles' happen because a lot of people want to invest, and it ratchets up pressure on prices. You can lose sight of what the price actually is. Investments are never simply 'good', they are only ever meaningful for their respective risk – return characteristics. Even if they are going to be around for 100 years you need to look at opening prices. Importantly, are they the right fit?"

"If you are going to invest in alternatives you have got to do the 'leg work' beforehand because such investments will take time to assess and then keep under review – is that the best use of your time? Would it be better to avoid exotic arrangements and focus on bigger issues such as strategy or diversification, for instance?"

Paul Haines, CIO, Trafalgar House Pensions Administration

1 in 6

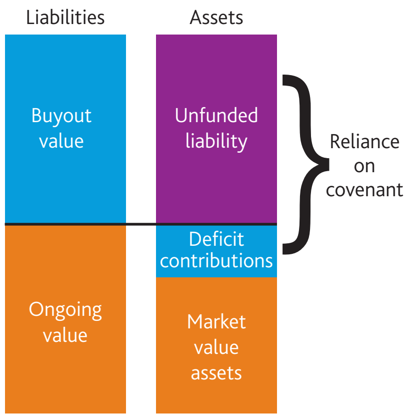
One in six schemes surveyed use contingent assets from the sponsor

"We chose our investment consultant because we didn't want to be a very small minnow in a huge ocean, but our problem is that we get less access to the leading managers."

Philip Gardner (Finance Director, Country Manager UK, Ireland & Sweden, IFF (Great Britain) Ltd

The place for contingent assets

Contingent assets, including those set up as special purpose vehicles (SPVs), are a new challenge for trustees to grapple with. They not only need to consider the strength of the sponsor covenant and its implications for investment and funding strategy, but also what measures they can take to mitigate the exposure they have to this covenant, which often makes up a large part of the asset/liability equation.



Our research indicated that while the principle of contingent assets is regarded favourably, the opportunity is not always available. Even so, one in six DB schemes surveyed do currently use contingent assets from their sponsor as to improve security for their members.

Lesley Williams, Group Pension Director at Whitbread Group reported that their arrangement goes one step further than risk management, "The trustee is a limited partner in a Scottish partnership arrangement that owns a number of Whitbread hotels. The special purpose vehicle could be a contingent asset but it actually provides an income stream, which is LDI linked. I think it is quite a sensible replacement for employer contribution; it is a promised set of cash flows coming from the company."

In relying on contingent assets trustees have to consider the double jeopardy risk that their contingent asset loses value when the employer solvency is threatened. Malcolm Small, Director of Policy at the Tax Incentivised Savings Association (TISA) says, "The use of contingent assets can be seen, perhaps sometimes unfairly, as an investment of last resort by schemes, and clearly places the future of benefits to members around the financial health of the sponsor. This has worked well in couple of cases, but it is clearly by no means a risk-free strategy and could conceivably add significantly to the dynamic tensions that can exist between trustees and the scheme sponsor."

The role of investment advisers and investment managers

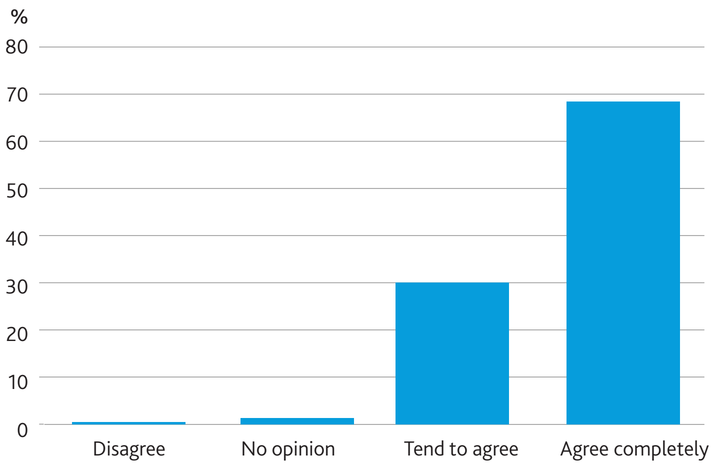
Although independent investment advice is a prerequisite for good scheme governance, it is clear from our research that there is a changing dynamic, which investment advisers need to embrace and respond to: large schemes, typically operated by highly skilled pension managers with the support of in-house investment expertise, believe their role is to challenge advisers and steer reviews in order to ensure that the best possible advice and value is obtained; the highly accomplished pension managers and chief investment officers interviewed for this research reflect an industry trend towards increasingly sophisticated in-house investment and governance teams[J].

Within smaller schemes, there is a growing recognition of, and access to, the expertise and services offered by more sophisticated investment managers beyond those put forward by their existing investment advisers. The tiering of adviser/manager relationships can work against small schemes, which respondents in our research are keen to overcome. Overall, respondents in this research remarked on the importance of advisers working collaboratively with actuaries and investment managers. Philip Gardner (Finance Director, Country Manager UK, Ireland & Sweden, IFF (Great Britain) Ltd) says, "We chose our investment consultant because we didn't want to be a very small minnow in a huge ocean, but our problem is that we get less access to the leading managers. I would like my US sponsor to have heard of some of our managers."

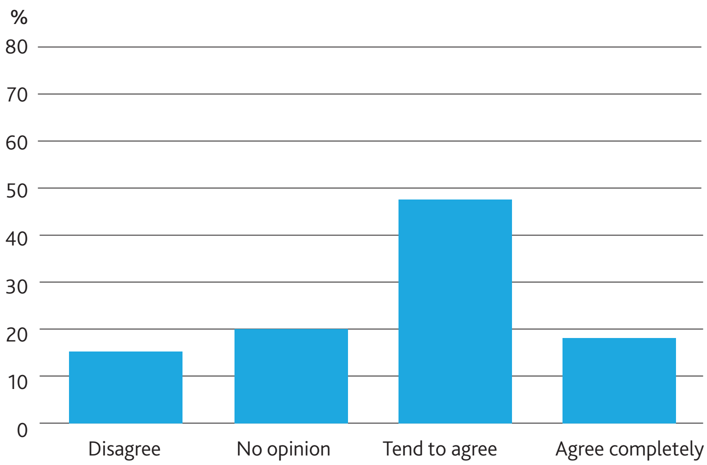
The tiering of adviser/manager relationships can work against small schemes.

7. To what extent do you agree or disagree with these statements by other trustees and pension managers, in relation to the investment management of your scheme?

Ensuring that we receive quality advice from our investment advisers is a priority for us



Our fund managers add value to our relationships by keeping us informed about new opportunities



[J] 'Tesco Pension Fund chose to follow its internal investment team's advice over that of its consultant when choosing an alternative fund, reflecting how large schemes are moving investment governance in-house'. Source: Financial Times, 16/09/13

"A key challenge is to make sure the default fund and lifestyling stay as progressive and competitive as we can make it: we need to keep that on the radar to keep it fresh."
David Locke, Finance Director, BMS World Mission

Almost all respondents agree that the delivery of quality advice from their advisers is a priority. Bill Whitehead, Director of Pentrus says, "As trustees, you need to work out what you expect from your advisers, and are you getting it at the right price? If the answer is yes, keep going. If the answer is no, change it."

Developing closer, direct relationships with investment managers is an integral part of the skills improvement and evaluation process for trustees and pensions managers, who regard regular updates and face-to-face meetings, however informal, as a priority. A mutual understanding of goals is clearly important. However, trustees do need to consider how to make best use of the time they spend with their investment managers – many trustees and investment managers spend much of their time together going through the minutiae of the buy, sell and hold decisions a manager has taken on its stocks. A broader conversation might do much to enhance the value of the relationship. The respondents in our survey agreed that fund managers add value to the relationship by keeping them informed about new opportunities. Lester Farrant, UK Group Pensions Manager at Total UK says, "We speak to other investment managers who we meet at conferences so that we know what is going on, to get a better feel for the marketplace."

Performance, not cost, is the determining factor

The choice of investment provider is not immune from cost considerations, but the majority of respondents (71%) comprehensively fed back that investment performance net of fees is the most important criteria driving their decisions. Only 22% said that investment provider selection is driven by fees.

Do asset managers need to raise the bar?

The recent Kay review of UK equity markets and long term decision making[K] has started a debate about whether asset managers should have a legal fiduciary responsibility to their clients. We asked trustees and pension managers for their views of the Kay review proposal. Their responses indicate that there is some scepticism about the way in which asset managers manage the conflicts they face, and an enhanced duty of care to their clients would be beneficial. Many do believe that a fiduciary responsibility should be placed on fund managers. It is interesting that although the pension managers and trustees were fairly aligned on issues relating to management of conflicts and enhanced duty of care to clients, we found that trustees are more strongly in favour of fund managers having increased fiduciary responsibility than pension managers. This may reflect a better understanding among pension professionals of the potential consequences.

[K] https://www.gov.uk/government/publications/the-kay-review-of-uk-equity-markets-and-long-term-decision-making-final-report

1 in 7

One in seven schemes surveyed has taken an approach towards their DC scheme that is consistent with investment decisions made in their DB scheme.

Commenting on the research findings, Stuart O'Brien, a Partner at Sacker and Partners LLP, says "The fiduciary duties of pension scheme trustees are reasonably clearly understood. Matters become more blurred, however, when such fiduciary concepts are sought to be imposed on the investment managers appointed by trustees. It is perhaps unsurprising, therefore, that there is a range of views on the extent to which fiduciary responsibilities could or should be placed on such managers. In a trust based arrangement the scope of a manager's duties will be set out in the investment management agreement which appoints them and those duties will be owed to the manager's client: the trustees. It may therefore not be appropriate to seek to overlay broad concepts of fiduciary duty on top of those contractual obligations, especially where those obligations arise out of a, potentially very carefully worded, contract. For example, a manager appointed by trustees under a very limited mandate may not in a position to fully investigate the broader investment strategies of the trustees, much less to evaluate the best interests of a scheme's members. In contract based DC arrangements, however, there is a recognised 'governance gap' between a manager and the DC member (with no trustee intermediary responsible for keeping the appointed manager under review). It is perhaps more tempting in this case, therefore, to attempt to ascribe some fiduciary duties to the manager. However, one remains confronted by the same practical difficulty that the manager is unlikely to have sufficient information about the members to be able to act in such a fiduciary capacity."

Robin Ellison, a Partner at Pinsent Masons LLP, and Professor of Pensions Law and Economics, Cass Business School, says "'Fiduciary responsibility' is a US rather than UK concept, and very well explored in US jurisprudence, but virtually unknown here. Introducing it would take thirty years before we really understand how it might operate in practice. Most US court decisions in recent years which have looked at the issue have avoided imposing fiduciary obligations on asset managers, even where the law seems clear. The court's policy reasons seem to be that they are intent on not expanding legal liabilities. The existing contractual, equitable (i.e. trust law), criminal and regulatory obligations on asset managers are more than enough (indeed probably excessive) to protect consumers, and imposing further obligations will simply increase compliance costs (for which the consumer would have ultimately to pay) without adding meaningful added protection."

"There needs to be genuine innovation around DC investment … it is starting to happen but it is very slow and I think the reason it is slow is because the money just isn't there at the moment."

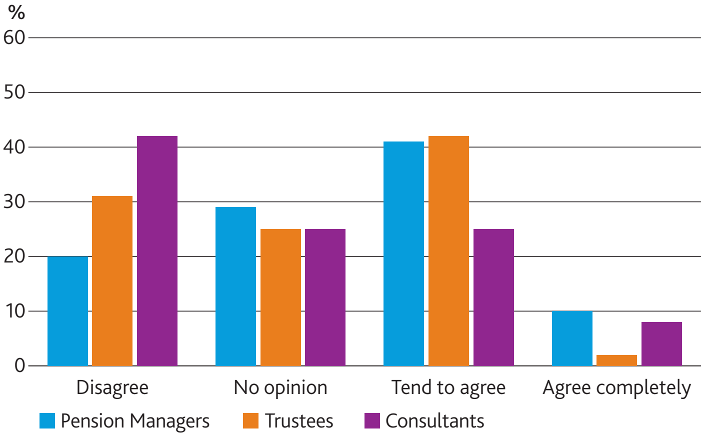
Richard Butcher, Managing Director, Pitmans Trustees Ltd

"Fiduciary responsibility is a US rather than UK concept. Most US court decisions have avoided imposing fiduciary obligations on asset managers, even where the law seems clear… imposing further obligations will simply increase compliance costs (for which the consumer would have ultimately to pay) without adding meaningful added protection."

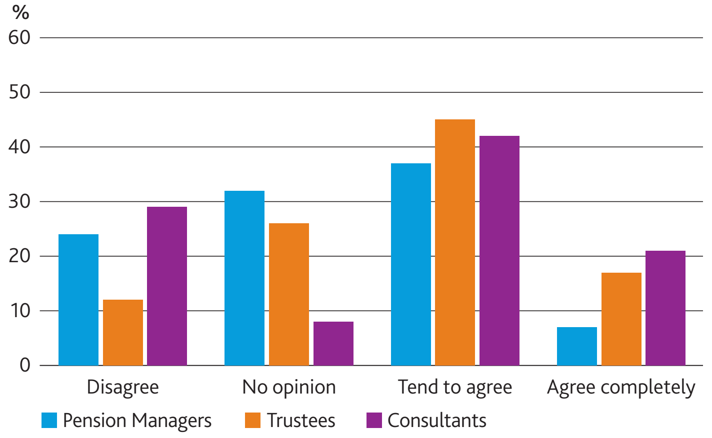
Robin Ellison, Partner at Pinsent Masons LLP, Professor of Pensions Law and Economics, Cass Business School

8: The Kay review suggested that asset managers should have a legal fiduciary responsibility to their clients. To what extent do you agree or disagree with the following:

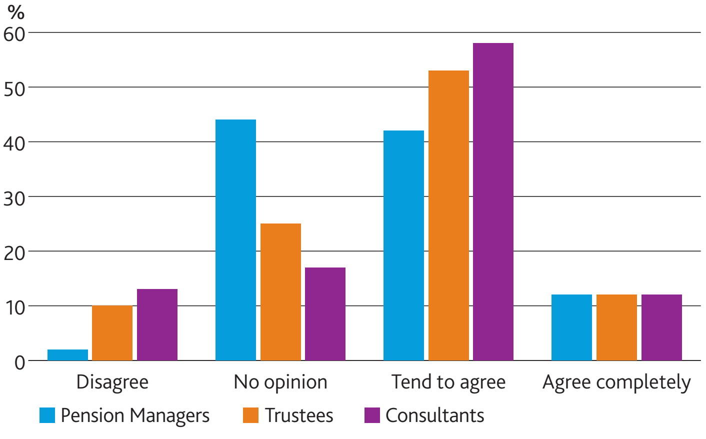
Asset managers appropriately manage the conflicts they face, there is no need for a change in their legal responsibilities



A fiduciary responsibility should be placed on fund managers, even if this requires significant changes to existing asset management models



Fund managers do not always prioritise their clients' interests and some enhanced duty of care would be beneficial



1 in 3

One in three schemes surveyed offers a 'white labelled' default fund.

DC scheme decision-making

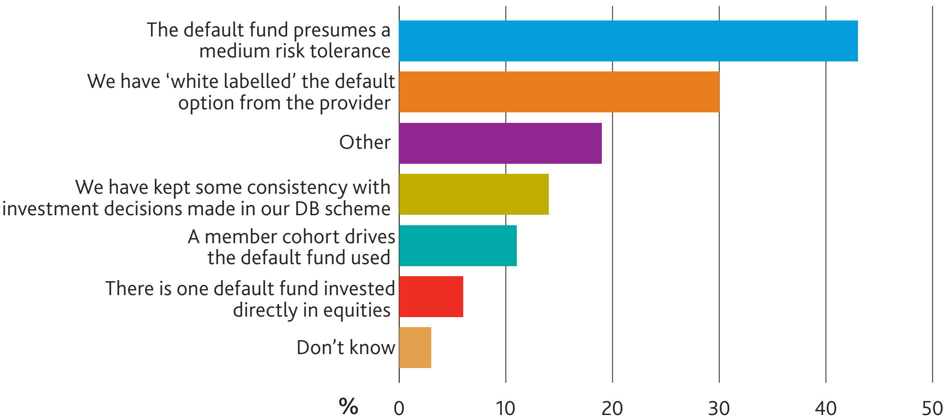
While governance in DC schemes is generally viewed as lagging behind that of DB schemes, relatively few DB schemes feel the need for a separate governance committee but half of all DC schemes in our survey have a governance committee. However, whereas the majority of DB schemes have an investment committee, only about half the DC schemes in our survey had put in place an investment committee. Our data will naturally have a bias towards trust-based DC schemes. The incidence of investment committees would certainly not be so high among contract schemes.

Alongside a recognition that they should be focusing more closely on the governance of their DC scheme, our research found that trustees and pension managers are starting to look at opportunities to translate investment decisions from their DB to DC schemes, where appropriate to do so. One in seven has taken an approach towards their DC scheme that is consistent with investment decisions made in their DB scheme. One in three offers a 'white labelled' default fund.

"I think DC schemes focus on the wrong thing, aiming to get the biggest fund: people are really interested in the income they are going to get."

Steven Robson, Head of Pensions, United Utilities PLC

9: How did you select the funds within your DC default option?



The most frequently mentioned 'Other' responses included target date funds and lifestyle models.

The aspects of DC governance which are considered to be most challenging for trustees and pension managers were reported as the choice of default fund (including monitoring and ensuring it is fit for purpose), scheme administration, member engagement and communications, and auto-enrolment.

Companies have not been afraid to experiment with the number of options made available to members within their DC schemes in an attempt to get the offer right – and so the number of funds offered has sometimes see-sawed up and down in the process. As one pension manager described, "We have moved about quite a lot over the years so at one stage, only a few years ago, we went down to just a couple of choices, but now we have extended it out again; we have got about ten funds available at the moment."

"In DC, we need to find ways of attracting employers and trustees to take interest in default investment options and that means being clearer about what people are buying and clearer about what the options cost. Would you buy a house if you didn't know what it cost and what it looked like?"

Henry H. Tapper, Director, First Actuarial LLP

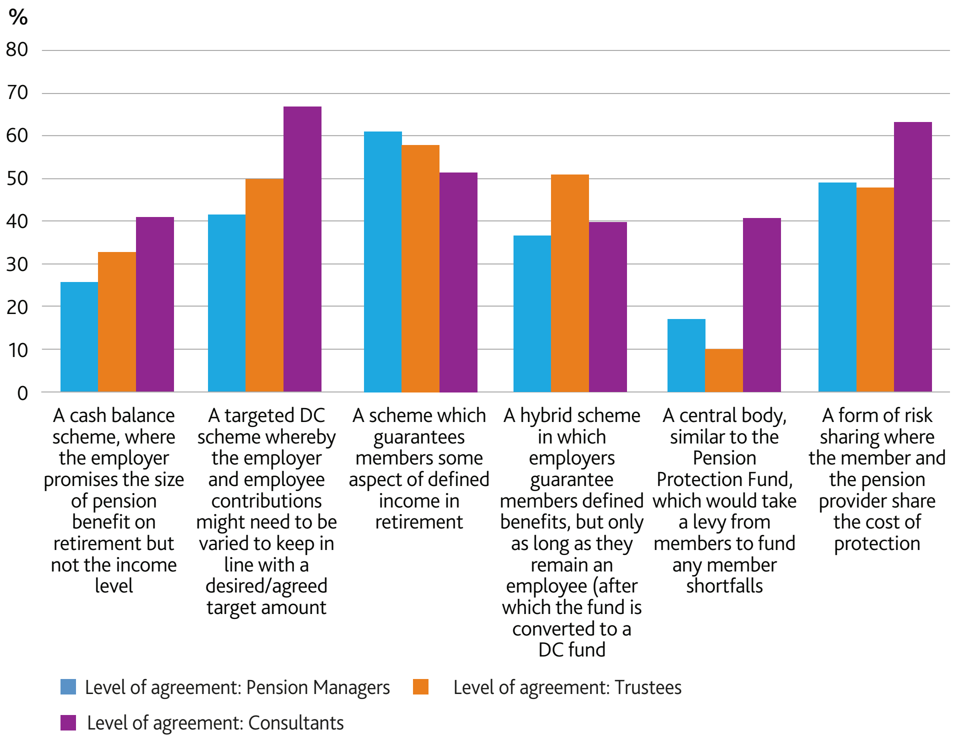
"There is a lot of scope for doing DC better: raising contribution rates, increasing member engagement, improving value for money. I would focus on incremental improvement rather than another wholesale change to the system."

Alistair Byrne, Senior Consultant at Towers Watson

Too much choice can potentially do more harm than good, as Lesley Williams, Group Pension Director, Whitbread Group describes, "When I arrived at Whitbread back in 2007 there were multiple funds available to DC members, so we got rid of lots that people weren't using… then we had three funds, off-the-shelf type adventurous, balanced and cautious. Then I decided that it was time for the trustee to look again, and I think what prompted me was that there started to be more interesting assets becoming available in DC funds. As part of that, we looked at what members were doing. We noticed that people were just going into the first fund that we listed in the booklet and people told us they were not joining because they were afraid of making an investment choice. We removed choice – we now have a default lifestyle strategy and a single growth fund, a pre-retirement fund and the cash fund."

Helen Roberts, Investment Policy lead adviser at the NAPF, says "Of the six case studies we looked at, five out of six DC schemes are using diversified growth funds. I think they are pretty much the norm as investment vehicles for DC schemes. In terms of asset management, there are mixed views – some people are selecting very cheap gilt funds with DGF on the other side; the average cost is somewhere around 50 basis points – they are paying more for the DGF than the equity part of the portfolio. There is obviously a lot of focus on cost, and while profit is a factor, it is important not to forsake value for the sake of cost."

10: Employers might take a number of considerations into account when reviewing benefit structures. How attractive do you consider each of the following options to be



Although there was a call for more innovation in DC investment to deliver better outcomes for members, the great majority (84%) of DC schemes in our survey are not targeting replacement ratios (a targeted proportion of retirement salary) for their members. This indicates that DC decision making is still lacking an outcome-based focus. However, improving member outcomes is very much a priority for DC scheme managers. When presented with a series of potential considerations which could be described as defined ambition structures, there was a groundswell of positive reaction to schemes which share employer and employee risk to achieve better outcomes.

Benefit design

While benefit design is not the responsibility of trustees, it is without doubt an area they are interested in. Many trustees may also wear two hats, having responsibilities in an employer capacity for such decisions.

Interestingly, the cash balance scheme, in which employers promise a set pension benefit on retirement rather than the income level, was significantly less attractive to our survey respondents than the other four options: only 33% overall consider this to be attractive. We asked Alistair Byrne, Senior Consultant at Towers Watson for his views, who said, "There are various ways of creating

Is running a pension scheme like running a business? "Yes, a business with heart."

David Locke, Finance Director, BMS World Mission

hybrid schemes and sharing risks. They can be complex and in some cases either sponsors or members will not be happy with the risks they are left bearing. Overall, though, I'm not convinced we need to bring in new types of schemes and have more change. There is a lot of scope for doing DC better: raising contribution rates, increasing member engagement, improving value for money. I would focus on incremental improvement rather than another wholesale change to the system."

A survey by Hymans Robertson (June 2013), found that few employers would welcome a model that mimicked DB schemes, while 62% of respondents said they "Would be prepared to put in place a system that would help secure a target retirement income for employees without having to contribute more to the scheme."

In our research, respondents appeared receptive to the idea of a form of risk sharing where the member and the pension provider share the cost of protection but, as in the Hymans Robertson research, they did not actually have any appetite for schemes which involved a long term risk commitment on their part. Rona Train, a Senior Consultant at Hymans Robertson who specialises in DC investment and governance, says, "People tend to think that a lot of DB schemes were closed as a cost cutting measure, but for many, the key reason was to control risk and future uncertainty. The idea of risk sharing in DC against that background doesn't bode well for any risk sharing solution. Nonetheless, employers are now starting to take more interest in the outcomes from DC schemes: the abolition of the default retirement age means that this is now an issue for the employer, whereas it was previously only an issue for the employee".

Hymans advocates an approach that focuses on retirement income replacement rates rather than pot size. "Our Guided Outcomes (GO) approach helps members to focus on their target retirement income and gives them support to ensure that they are paying the right level of contributions and investing in the right fund to achieve that. By understanding the link between the contributions they pay now and their retirement income, employees can be prompted to plug any gaps."

Asked about the governance challenges that risk sharing might bring, Train says, "The governance of DC schemes generally, whether trust or contract, has often not been as good as it should be. There are some notable exceptions, where trustees and companies have set clear objectives for the scheme and for the members, to make sure they are on track to achieve the most appropriate member outcome. However, much of the recent guidance uses generic terms such as 'good', 'sufficient', and 'adequate'; but what do these actually mean for individual schemes? It is important for trustees and companies to consider the unique characteristics of their scheme when setting objectives and then map these back to the Regulator's principles, rather than starting with the Regulator's principles and then trying to establish what these mean for their schemes?"

There is very little support for the idea of a central body, similar to the Pension Protection Fund, which would take a levy from members to fund any shortfalls in member outcomes. Most trustees and pensions managers consider this option to be unattractive although it does have more support among consultants and other professional advisers.

Is running a pension scheme like running a business?

The investment, governance and business-like challenges facing were trustees were highlighted as far back as the 2000 Myners' Review of Institutional Investment[L], and before. Most trustees and pension managers would argue that running a pension scheme is the same as running a business, but more difficult. It demands the same levels of rigour as a successful company, encompassing management structures, governance, budgetary controls, the need to manage risk – and more. As Lesley Williams, Group Pension Director at Whitbread Group says, "I juggle a whole world of legal, investment, people, issues. I did an MBA about ten years ago because I thought I needed to have a broader knowledge about running a business in order to run a pension scheme properly. I have needed all those skills."

In addition to their investment and governance responsibilities, trustees and pension managers in our survey expressed a profound commitment to long termism and a strong duty of care to members.

[L] http://www.compliance-exchange.com/governance/library/mynersreview2000.pdf

Best practice examples
Whitbread: a determinedly proactive approach

The trustees of the pension scheme run by hotel and restaurant group Whitbread take a determinedly proactive approach to their investment responsibilities.

When a change of order to the investment options in the scheme information booklet revealed that members of its trust-based defined contribution scheme were simply selecting the first choice on the list and employees were reportedly not joining the scheme because they had to make an investment choice, the trustees decided that giving a choice was not helping people and that they should remove the choice altogether.

"We needed to make sure that what they were investing in was something we really believed in. So, we removed choice. We now have a default lifestyle strategy and a single growth fund, a pre-retirement fund and the cash fund", says Lesley Williams, Group Pension Director, Whitbread Group. Subsequent reviews of the scheme, which take into account member profiles, have resulted in the trustees confirming their original decision.

When considering the funding of its DB arrangements, the company embraced contingent assets early on, announcing in 2010 that a number of its hotels would be used to make a £100 million contribution to its pension scheme. The arrangement, based on a new approach developed by Deloitte, involved setting up a partnership between company and pension trust which allows Whitbread to run the properties while the pension scheme draws income from them. A second, similar arrangement was set up subsequently, contributing another £50 million.

The scheme's investment objectives are set by an investment committee, which is responsible for both Whitbread's defined contribution and closed defined benefit sections. There is a flight plan for the defined benefit scheme but, says Williams, "Whitbread is a very active sponsor so a bit of push and pull goes on and the flight plan results from company/trustee negotiation. The fund has a big sponsor with a very strong covenant, so that is okay."

The Whitbread fund is balanced towards asset growth seeking investments, with 8.6% in special purpose vehicles and 4.6% in property. Almost a quarter (23.2%) is invested in a diversified portfolio which includes hedge funds, emerging market debt, private equity and alternative credit. Williams doesn't define these as 'alternative', but acknowledges that in recent years, the Whitbread fund has seen a shift away from equities towards less traditional asset classes. She identifies her main DB challenge as helping the trustee and company balance risk and return, in order to protect the pension fund.

WHITBREAD

Kingfisher: aiming to be fully funded by 2030

The Kingfisher Pension Scheme began its journey of targeting a fully funded position on a buyout basis back in 2004. The biggest challenge facing the scheme is ensuring that it stays on track and achieves its objective by the agreed target date of 2030. Despite the difficult investment climate in recent years, the scheme remains on course to meet its goal.

Pensions investment manager Matt Fuller says that since 2004 all investment decisions have been made with this goal in mind. "I think that whilst many schemes have a buyout target as their objective, they do not all necessarily have a defined timeframe over which to achieve this," he says. "But the Kingfisher Pension Scheme trustees and the employer have agreed, and are fully committed, to this 2030 target which helps inform and influence the investment decision making process."

The trustees, a ten-strong board which includes the company's human resources director, group property director and an independent trustee, are responsible for setting the scheme's investment objectives. Four of the trustees are member-nominated and include two B&Q store managers. There are four sub-committees: the defined benefit investment committee, which functions as the main investment decision-making body, the defined contribution investment and retirement committee, an audit, accounts and governance committee, and a benefits committee.

In recent years, trustees' concerns that the scheme was too dependent on equities, as a return driver within its return seeking asset portfolio, have led the investment committee to consider alternative asset classes. Currently, the scheme has an allocation of approximately 10% to alternative assets. In May 2013, the trustees gave investment management firm LGT Capital Partners a mandate to invest £100 million of the scheme's assets in a wide range of 'alternative' asset classes, including hedge funds, commodities and insurance-linked securities. The scheme also has allocations to global farmland, property, emerging market debt and emerging market currency.

The scheme also has contingent assets in the form of four B&Q properties that pay rental income into a special purpose vehicle (SPV), which in turn pays an income stream to the pension scheme. The SPV was again structured with the 2030 target at front of mind and the lifespan of the SPV is consistent with that target. The arrangement provides the pension scheme with a greater degree of protection and, in the event of employer insolvency, the properties would pass over to the trustees and become assets of the scheme.

The performance of all the scheme's investments is reviewed on an on-going basis. A full investment strategy review takes place following the triennial actuarial reviews, examining the balance between risk and return in the light of the 2030 target and the scheme's current funding position. Trigger mechanisms have also been established to ensure that prompt action can be taken to switch funds and lock in gains if the opportunity arises. "For instance, we have a trigger mechanism in place at present whereby, if the scheme's funding level reaches a certain point ahead of the projected funding level per the flight path, it would automatically trigger a £100 million switch from return-seeking assets to matching assets, thereby enabling the scheme to lock in the gain" says Fuller.

Agility is important: discussions about where funds should be moved to and from have already taken place, agreed between the trustees and the employer, so that action can be taken within a very short space of time. "The last thing you want to happen is that a funding position is achieved that is significantly ahead of the flight path but you then find it takes weeks or even months for the governance process to be completed in terms of the trustees and the employer agreeing on what basis the assets should be switched, how much should be switched and where the assets should be switched from and to, by which point the opportunity may have passed. It is beneficial for a scheme to have some form of switching mechanism in place but the exact targets, drivers and actions it creates need to be clearly defined and understood" he adds.

Kingfisher

Marks & Spencer: encouraging innovation

The governance structure of the Marks & Spencer defined benefit pension scheme has developed a culture of fresh thinking, fast response to investment opportunities, and willingness to change in order to improve working practices and relationships.

The scheme, which closed to new members in 2002, is run by a corporate Trustee Board comprising nine Trustee Directors, including two independent Trustee Directors. The Board has three key sub-committees: an Investment Committee, a Management and Governance Committee, and a forum for innovative thinking called the Private Equity, Infrastructure and Best Ideas Sub-Committee.

"It is with the Investment Sub-Committee that we have sought to develop particular expertise and to have most of the delegated investment decisions taken", says Lynn Collins, Head of Marks & Spencer's Pension Trust. The focus of the Management and Governance Sub-Committee is "Administration, and making sure that Board level decisions have been made in accordance with the rules". The 'Best Ideas' Committee is "Our way of being able to quickly assess an opportunity, with our rapid response team, if something comes up that needs to be looked at quickly". It also serves as a kind of 'nursery of ideas' for opportunistic ventures that may become more mainstream over time. One such example cited by Collins is "Our reinsurance portfolio, which started off in Best Ideas but we decided to make a bigger commitment and it is now a separate asset class in its own right in the wider investment strategy".

The Trustee Directors' investment strategy is closely linked to a long-term plan which aims to achieve an appropriate level of incremental de-risking commensurate with achieving a number of funding level based triggers: "We are always looking for either de-risking opportunities or opportunities that simply control risk and slightly enhance return," says Collins. "It does mean that we have got quite a lot of different fund managers in our portfolio and some of those will have quite small mandates relative to the size of the overall scheme."

Having a large number of fund managers does yield benefits, she adds, in terms of creating a presence in the market, but monitoring the performance of so many is a challenge. As Collins points out, "We recognise the value of the analysis done by the advisers but we also develop an ongoing relationship with managers, which means that you are monitoring them properly …we like to think that we can get out of things quickly if we think there is a problem coming."

It is also essential, she thinks, that the in-house pensions team remains 'an educated user' of investment advisers. Performance is assessed in a range of ways: advisers are reviewed as part of the annual business plan, usually with a light touch review at three years and a full review at five years that may involve procurement colleagues. Trustee Directors are even invited to assess the performance of Collins' own in-house team. As she points out, "We are always prepared to learn from past mistakes and when you do that you evolve, and you generally get to something that works for everyone".

This results in a balanced approach to the various professionals charged with keeping the fund on track, "We are quite patient and try not to panic over things: we are not particularly slavish to saying, 'Well this fund manager has been appointed for three years, therefore we must review them'," says Collins. "Equally, we are quite happy to take money away when a strategy has achieved what we are seeking or has run its course."

Like many others, she feels that running a pension scheme is like running a business. "I think it is absolutely right that the standards to which you run the scheme should be the same as for any business, which is why we like to think we have got good standards of governance. We also think it is right that you manage your finances appropriately; that you have a proper business plan."

If anything, she argues, the demands of running a pension scheme are greater, "We would like to think that if you came into our Trustee Board room you would find the way in which we run things benchmarks well with PLCs but pension schemes generally have to have a longer term time horizon."

YOUR M&S

Total: a focused, 'hands-on' approach

The oil giant closed its £2.5 billion defined benefit pension fund in 2002 and replaced it with a trust-based defined contribution scheme. A single trustee board is responsible for both schemes.

The engine-house of the pension fund is the investment committee comprising three trustees, with staff from the in-house pensions team and elsewhere in the company acting as 'participating observers'.

UK Group Pensions Manager Lester Farrant is confident that the investment committee provides the best possible structure. "We have given it a lot of thought," he says. "The relationship between the company and the trustees is excellent. It is a very good working relationship."

He is untroubled by the criticism that investment committees can sometimes lack the authority to make time-limited decisions. "If we need to organise a conference call of the investment committee this afternoon, I could almost certainly do so," he says. The trustees pursue a self-confessedly conservative investment strategy, and have no real appetite for alternative investments such as hedge funds or other diversified funds.

"Firstly, the corporate is very conservative," explains Farrant. "Secondly, the trustees are very keen not to go into anything that they don't fully understand. They have this view that if something goes wrong and a member asks them, 'why did you invest in it?' they want to be able to explain why they chose it."

For Farrant there are other disadvantages inherent in spreading investments across a wide range of asset classes: the levels of governance required for overseeing comparatively small investments and the relatively small impact that they are likely to make within the overall portfolio.

Despite Total's reluctance to invest in composite alternatives, the trustees are not averse to looking at different, non-traditional asset classes and strategies: 5% of their fund is in property, and they have also introduced unconstrained mandates into the fund's portfolio, to give their investment managers the ability to take advantage of the potentially higher returns in areas such as emerging markets.

The scheme's flight path aims at self-sufficiency; but as yet no definite target date has been set. However, Farrant reminds us "In theory the oil in the North Sea, which is the main provider of the revenue in the UK, has a life; everybody's estimate today is that life of the North Sea oil is about twenty years". This has to have an impact on investment strategy; and while de-risking is important, with two-thirds invested in defensive assets such as gilts and bonds, the fund is already fairly secure.

Farrant is a staunch believer in transparency between his advisers and investment managers and there is a schedule of regular contact between them: every two years, members of the investment committee visit investment managers at their premises, while Farrant and his team meet regularly with the managers and the fund's advisers.

It is a hands-on approach which empowers his team. "My team's role is to be able to challenge the investment adviser if they have got something that we don't think is suitable for us," he says.

The hands-on management and control exerted by the Total pension scheme trustees rules out the viability of considering fiduciary management. "For us, I don't think it would work," says Farrant. "I can see that for some very small schemes it may be the only way that you can manage your investments properly, but for a larger scheme I would have thought most would have the resources to do it – all I see is just another bunch of fees. I am very cynical about it."

Farrant's advice to other trustees is not to be afraid to challenge advice and to keep control over your investments. "I would counsel people to not buy the product unless you are absolutely sure which direction that it is going in," he says.

He thinks that trustees generally are becoming more and more aware of the need to run a pension scheme like a business. "My team is reporting to a board of directors running a business with assets of £2.5 billion, and we have to make sure those assets generate a return so that we can pay our pensioners," he says. "If that isn't a business, I don't know what is."

TOTAL

International Flavours & Fragrances: a clear-thinking small scheme with big ambition

Top tier investment advice doesn't have to be the preserve of large-scale pension schemes; but whatever advice is proffered, be sure you understand it before taking action.

As finance director and country manager at International Flavours & Fragrances (IFF), Philip Gardner chairs the six-strong trustee board of the £170 million Bush Boake Allen Pension Scheme and is one of seven trustees on the board of IFF's £100 million scheme, so he is particularly aware of the challenges facing smaller pension schemes.

One of his biggest challenges is the ability to access 'top tier' investment managers. "We get a bizarre group of managers put in front of us. It can be people that we wouldn't dream of investing with because they are either too small or too esoteric, which has been a big issue for us recently," says Gardner. He sees this as an inherent fault in the generic tiering which exists in the finance industry. "We suspect that what happens to small schemes like us is we get second tier offerings because those managers are more likely to court our consultant than the big one."

Gardner is frustrated by this, particularly in light of his reporting responsibilities to his US parent company. "I would like my US sponsor to have heard of some of our managers". He also feels that using larger investment houses carries advantages in the form of access to a wider portfolio of products and better training opportunities for his board.

Gardner is proud to have trustees who are considered 'top quartile' in terms of their ability and knowledge; they are also prepared to invest above-average amounts of time in running their schemes. "We are probably quite free-thinking and certainly wouldn't necessarily be led by our investment consultants," he says. He has very clear advice for trustees to have the courage of their convictions and to develop the knowledge to make decisions independently. "You have got to realise that investment consultants are there to advise you; they are not there to tell you. I think it can be quite easy to say, 'I will do what they will tell me to do and if it is wrong I will blame them'. Don't be scared to do your own research on top of that which your investment consultant provides."

This, in turn, creates another challenge: the need to ensure that the board has the right set of skills. And the recruitment of new trustees onto a high-calibre, high performing board requires careful selection and fast-track, applied training to get them up to speed quickly. "If you do get a group of good trustees you have got to think very carefully about how you are going to integrate newcomers; it can be tough," he says. "It is almost like breaking into a gentlemen's club."

Gardner also offers clear advice based on his own experience with a hedge fund "Investing in something that we didn't understand; if you don't understand it, don't put your money in it".

BMS World Mission: a charity scheme that lives by its ethical standards

Being a charity has a significant impact on the way in which BMS World Mission approaches investment strategy and governance.

Finance director David Locke says, "We have a very strict ethical policy. There are some products that we can't invest in because we can't guarantee they are ethically clean. I think diversified growth funds are great, it is just we can't find a good ethical one. So it has restrained us".

The charity's defined benefit scheme (now closed to new members) may be small – approximately £28 million – but this does not stop the trustees from demanding the best support services and investment manager relationships. For Locke, a more systematic tendering policy is at the heart of this.

"Even for a size of scheme like ours, you can get a formula-one team around you as you need the very best tyre fitting, the very best engine, the very best guys on fuel. My experience is that pension scheme trustees can be very loyal and sometimes they need some encouragement to make the tough calls," he says.

The emphasis on ethical criteria follows through to the trustee board structure: new trustees are recruited to ensure that they not only have appropriate backgrounds and complementary skill sets, but also share the charity's values. Ensuring that trustees have the right mix of skills and knowledge, and placing an emphasis on trustee training, is crucial for the charity as all investment decisions are made by the main trustee board. Locke acknowledges that the model has its weaknesses, for example, the board's ability to understand more complex financial instruments and the speed with which investment decisions can be made; but these disadvantages are mitigated by the close relationship and mentoring provided by their very hands-on investment adviser, and the flexible mandates they are happy to give their investment managers to allow them to take appropriate action without referring back to the board. Ultimately, he feels that the board's close, collaborative way of working pays off: the charity's ethical policy has performed well.

"It is almost like baking a cake with just six ingredients instead of the usual ten, while trying to get the same result. We have to slightly alter the blend to get as close as we can to the same risk return characteristics. In fact we have done as well as we would have with those products. The performance has been good and we haven't suffered as a result of being ethical".

With a defined flight plan target less than nine years ahead, this is good news for the scheme's de-risking investment strategy, which is currently on course to full funding. The focus on quality and pastoral care is also reflected in the charity's relatively new defined contribution scheme, which won a Pensions Quality Mark in 2011 for its high level of employer contributions and good communications with members, making BMS World Mission one of the first charities in the country to receive the award. Furthermore, out of the choice of funds offered to members: default, ethical, cautious, adventurous, the ethical fund is performing better than most.

Locke agrees with the idea that running a pension scheme is becoming more like running a business – with the caveat that it is understood as 'a business with a heart'.

"It is not just a profit and loss business; it is about motivating, retaining, promoting and developing your staff" he says.

BMS' recent outsourcing of its pensions administration illustrates how commercial imperatives can run alongside a people-focused culture. "The process involved making a post redundant, but resulted in the best service for pension members, while the choice of partner was determined by the organisation that in addition to good value and quality of service delivered the best cultural fit".

His advice for trustees of similar sized schemes can be summarised in one word: tender. "One of the first things we learnt was if you haven't tendered for, say, six years, think seriously about going out to tender. Tender for all the disciplines: administration, investment advice, legal, actuarial and investment managers. I think it is very important to look around the table at your advisers and ask, 'Have I got the best in the country round my table?' Even with a scheme of £25 - £28 million, when you go to tender, you can still afford the best."

BMS world mission

Conclusion: what does good investment governance look like?

- Trustees and pensions managers need to review regularly how well their investment decision-making and governance models are suited to their current investment objectives, and be prepared to make changes to, for example, advisory arrangements and the delegation of responsibility.
- Schemes with an investment committee should monitor regularly their decision-making powers and terms of reference, ensuring that their investment principles are aligned with the scheme's objectives. Schemes without an investment committee or sub-group, might find that while these may introduce another layer of governance, they could provide an opportunity for more focused investment decision-making, scrutiny of investment advice, and speed of response to investment opportunities, which ultimately benefit the plan.
- Standards and practice of governance remain largely geared towards meeting the requirements of the DB model, which are not easily transferable to DC. Governance for DC must focus on helping members to make their own decisions, which may mean removing choice, in order to make it easier for members to make appropriate investment decisions. Industry experts are calling for better governance and increased scale in the DC schemes of the future; governance might be better if the large number of small DC schemes in the UK were replaced by a small number of large-scale master trusts (as is the case in Australia).
- The default structure must be fit for purpose. Given the growing scale of membership in DC scheme default funds, trustees, pension managers, employers and providers need to collaborate towards better design and governance, in order to deliver good outcomes for members. Industry experts are calling for a move away from top-down regulation towards a more flexible, member/consumer-centric approach, which looks likely to include risk-sharing options.
- Best practice counsel includes: seek the best possible advice from a variety of sources; be imaginative about acquiring information; make time for your own research; commit to training and education; be sensitive to team dynamics within decision-making committees; do not invest in what you do not understand – but be open to new ideas.
- While there is no one-size-fits-all-governance-model to suit all schemes, the overriding message is: set clear objectives, review often and be ready to make changes if necessary.

Summary of best practice counsel from research participants

"In terms of investment decision-making, the really important thing is to understand what you are trying to achieve and how much time, effort, resource and governance budget you have to direct towards that objective. If you think in that context then there isn't a single right solution that fits all pension funds, but if you approach it from that perspective, you optimise your chances of getting the right solution for your plan."

Carol Young, Head of Pensions, HEINEKEN UK

We asked respondents (predominantly trustees and pension managers) what counsel they would give to (other) trustees and pension managers on investment decision-making and governance. In the main, this focussed on empowering and increasing the effectiveness of trustee boards; here is a summary of their suggestions:

1. **Improve skills:** a major theme throughout the research, respondents believe that trustees should commit to increasing their technical knowledge generally, and specifically in order to gain a full understanding of the spectrum of asset classes and strategies available to them.
2. **Set clear mandates, investment principles and benchmarks:** ensure good practice within the trustee board by setting clear terms of reference and objectives; review and monitor these against performance regularly. Respondents emphasised the value of asset liability modelling, creating financial plans, keeping track of decisions made, and being sure to learn lessons from them.
3. **Focus on strategy:** ensure good time management and effectiveness of decision-making by having the board focus on strategy decisions, and delegate day-to-day investment decisions to an internal investment committee or external fiduciary manager. Ensure that the board is able to implement decisions in a timely fashion.
4. **Choose investment advisers wisely:** seek expert advice, but ensure that the trustee board has enough knowledge and confidence to fully understand the actions proposed by advisers, and to challenge advice.
5. **Obtain independent opinions,** if possible, from sources other than your investment advisers or managers.
6. **Do not do anything you do not understand.** In particular, do not be persuaded to invest in seemingly 'fashionable' or opportunistic investments just because they are proposed by your adviser. Ask the question: does this fit within the overarching objectives for the scheme?
7. **Develop direct relationships with your asset/fund managers.** Use them to inform your strategic objectives.
8. **Encourage collaboration** between the trustee board, advisers, actuaries and fund managers.
9. **Stay close to the sponsor,** as a trustee board, and ensure that the investment advisers also work to the principles of the employer covenant.
10. **Communicate clearly to your members.** We still have a long way to go in educating people on the benefits that workplace pensions can offer; it is their choice to make, but be sure to 'speak their language' so as to make the choice a fair one.

Research method

This report is based on a research study comprising 20 qualitative depth interviews undertaken by executives of Gabriel Research & Management Ltd and an online survey that ran between 1 August and 13 September, 2013. During this period there were 230 respondents. For reasons of client confidentiality, some identities are not attributed.

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