The Trustee toolkit downloadable

An introduction to investment

Tutorial two: Setting an investment strategy

By the end of this tutorial you will better understand:

- what should be considered when setting a scheme investment strategy (DB and/or DC)
- what might trigger a review of the scheme investment strategy
- statutory restrictions on investment in a pension scheme

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

Glossary

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

The Pensions Regulator

Investment in a pension scheme

The tutorials in this module provide an introduction to investment which will help you to fulfil your role as a trustee. In this tutorial, you will find out about the importance of having a sound investment strategy.

It summarises the responsibilities and requirements in relation to investment which apply to the majority of trustees. However the trustees of some schemes, such as those with fewer than 100 members, wholly insured schemes or small self-administered schemes (SSAS) are subject to different requirements in some respects. If you think that this could apply to the scheme which you are a trustee of, you should obtain legal advice on the applicable requirements.

There are later modules which focus in more detail on the knowledge that you will need as either a defined benefit (DB) or defined contribution (DC) trustee.

Setting a scheme investment strategy

Trustee responsibilities in setting an investment strategy are different depending on whether you are a trustee of a DB or DC scheme.

DB schemes

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

You will find more information on this topic in the Modules: 'Funding your DB scheme' and 'Investment in a DB scheme'

Trustees will need to consider and respond to changes in the strength of the employer covenant and the level of investment return expected in the scheme's recovery plan (if it has a deficit on the statutory funding basis).

DC schemes

Trustees are required to set the scheme's investment strategy and ensure the long-term suitability of the funds underlying that strategy. The scheme's overall investment strategy is documented in a Statement of Investment Principles (SIP).

DC schemes may offer a default option to members who do not or do not want to choose their own investments. Where this is a default arrangement under the Occupational Pension Schemes (Investment) Regulations 2005, it is a legal requirement that the trustees or managers prepare a SIP governing decisions about investments for that default arrangement. Trustees do not need to produce separate SIPs for different arrangements but they should bear in mind that they must make the most recent SIP relating to any default arrangement available to members as part of the annual chair's statement.

> You can learn more about the requirement to draw up, maintain and review a SIP under the Pensions Act 1995 in the Tutorial: 'Investment in a pension scheme'.

Separate to any default options(s), DC schemes can also offer members alternative investment options for members to choose to invest in. Where members invest in alternative investment options offered, it is the members who set their own investment strategy; the trustees are responsible for ensuring that the funds offered perform in line with the investment manager's stated objectives and remain suitable for the needs of the scheme's membership profile.

Trustees should allow suitable time to design the investment strategy for any default options ensuring that the member data on which the strategy is based is accurate. What is a suitable investment strategy will vary from scheme to scheme depending on a range of factors including the needs, preferences and characteristics of the membership.

> You will find more information in the Module: 'Investment in a DC scheme'.

Restrictions: Exercising trustee powers

There are a number of statutory restrictions on how trustees may exercise their power of investment.

Invest in the best interest of members and beneficiaries

The investment regulations require scheme assets to be invested in the best (or sole) interests of members and beneficiaries.

Ensuring security, quality, liquidity and profitability

Trustees' powers of investment must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

> You will find more information in the Tutorial: 'Suitability and diversification'.

DB schemes

Assets to cover the scheme's technical provisions (ie its liabilities) must be invested in a manner appropriate to the nature and duration of the expected future pension benefits payable under the scheme.

This is relevant for DB schemes only and broadly means that trustees must take account of the liquidity needs of the scheme to provide benefits to current pensioners as well as the need to secure the investment returns necessary to continue providing benefits in the long term.

> You will find more information in the Module: 'Funding your DB scheme'.

Restrictions: Portfolio construction

Trustees will need to consider how the funds forming their investment strategy (or in the case of a DC scheme the underlying funds of the default arrangement and alternative funds offered to members who choose their own investment strategy) fit together. In particular:

- assets of the scheme must consist predominantly of assets traded on regulated markets
- investment in assets which are not admitted to trading on regulated markets must be kept to a prudent level
- assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular assets, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole

These restrictions are explored in more detail in later modules.

Restrictions: Using derivatives

Trustees will need to consider the restrictions in the investment regulations around investment in derivatives. Investment in derivative instruments may only be made insofar as they:

- contribute to a reduction of risks
- facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk)

Any investment in derivatives must be made and managed to avoid excessive risk exposure to a single counterparty and to other derivative operations. The investment regulations do not prevent trustees from entering into derivative transactions with a single counterparty, provided they are satisfied that this does not involve excessive risk.

Investment regulations do not provide any guidance on what level of risk is unacceptable or excessive. However, we would normally expect trustees only to invest in derivatives to the extent that a prudent investment manager would accept the relevant exposure.

> You will find more information in the Tutorial: 'Types of asset: Alternative assets'.

These requirements only apply where trustees invest directly in derivatives and not where the trustees invest in pooled funds which themselves invest in derivatives.

Restrictions: Employer-related investments

The Pensions Act 1995 restricts the extent to which pension schemes can invest in employer related investments. This means investments related to the statutory employer or any person which is connected with, or an associate of, the employer.

What are employer-related investments?

They include:

- stocks and other securities issued by the employer
- loans to the employer
- property used by the employer
- transactions at an undervalue

What are the restrictions?

Loans are prohibited. 'Loans' include any amounts owed by the employer to the scheme but not paid. All other employer-related investments are limited to a maximum of 5% of scheme assets.

What are the possible implications for trustees for exceeding these restrictions?

If trustees decide to invest in breach of these restrictions they are liable to criminal prosecution. However, where the restrictions are otherwise breached (for example because market movements mean a shareholding increases beyond 5%), trustees have a statutory obligation to take reasonable steps to bring it back within the restrictions.

Are there any exemptions?

The restrictions apply to all investments other than in very limited circumstances where certain tests are met (for example, in relation to unpaid contributions).

Trustees should obtain legal advice if they have any concerns in relation to employer related investment. All other employer related investments are limited to a maximum of 5%.

Monitoring and reviewing the strategy

DB and DC scheme trustees must review their scheme's SIP at least every three years or without delay when there is a significant change in the scheme's investment policy. Certain events may also trigger a review. These include:

- a merger with another organisation which results in the change in demographics of the scheme membership
- a significant change in membership profile for DC schemes
- an increasing maturity of a DB scheme
- a change in the strength of the sponsoring employer's covenant in a DB scheme
- sustained changes in market conditions
- a change in ownership or personnel of investment managers
- changes in pensions law and regulatory requirements
- innovations in investment markets and products

Any review should take into account the needs of both active and deferred members. In addition it should take into account members of DC schemes who are accessing their benefits directly from the scheme and pensioner members in the case of DB schemes.

Where a DC scheme is used to comply with employer duties under automatic enrolment legislation, trustees have additional obligations.

Selecting investment funds

Trustees of DB schemes must select funds and managers in accordance with the scheme's investment strategy. Trustees of DC schemes need to select pooled funds for the default arrangement strategy and, if appropriate for the scheme membership, further fund options for members who wish to set their own strategy.

Trustees should devote sufficient time and resources to understand the objective of each fund. In particular, trustees should understand:

- the asset classes being invested in, for example, equities and bonds
- the level of risk both in the strategy for each fund and in the underlying investments, for example, levels of volatility for each asset class

- the objective and investment style of the investment manager, for example to replicate or outperform an index
- the net of expenses target return, for example to match a cash or inflation benchmark

Monitoring and reviewing fund performance

DB schemes

For DB schemes, this means that trustees should regularly monitor and review the performance of their investment funds against the objectives set out in the scheme's investment strategy.

DC schemes

For DC schemes, this means that trustees should regularly monitor and review investment performance net of expenses both for any default arrangements and other investment options available to members. Trustees must monitor and review that:

- the strategy for each default arrangement continues to be suitable for scheme members, particularly those who don't want to choose their own investments
- other investment options continue to be appropriate for members who want to set their own strategy
- the performance of each investment option, including any default arrangements, meets the investment objectives

Frequency of review

The frequency of review should depend on factors such as:

- type of investment
- the risks of the investment
- size and value of the investment
- when certain events occur, for example a significant change in the market, the strength of the employer covenant in DB schemes or the scheme itself
- in the case of DC schemes, the types of investment selected by members
- requirements set out in law

Where the performance of an investment fails to meet the scheme's investment objectives, trustees should consider whether to make changes.