The Trustee toolkit downloadable

An introduction to investment

Tutorial three: Types of asset – Common assets

By the end of this tutorial you will better understand:

- what the common asset types are
- the key characteristics of the major asset types

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

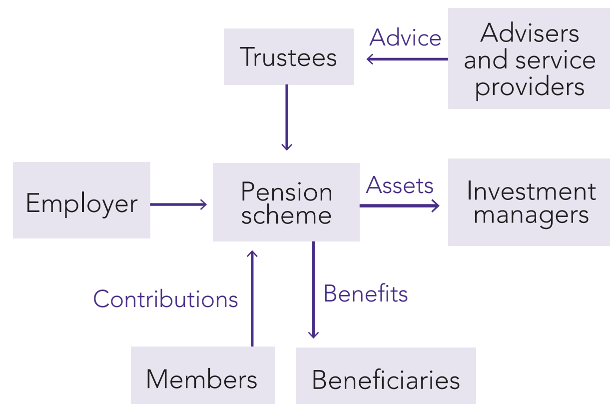
Glossary

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

The Pensions Regulator

How are assets held?

As we will cover in this and the next tutorials, pension schemes can invest in a number of asset types. Before we look at them in detail, it is useful to understand how the asset types can be held.



Directly

Assets can be held directly by the scheme. For example the scheme can hold 25,000 shares in Vodafone or 10,000 15-year bonds, issued by the British Government. We will look at these asset types in more detail later in this tutorial.

The investment may be known as a 'segregated' portfolio, which means that a scheme's investments are held separately from those of other investors. This approach offers greater flexibility. For example, the trustees can stipulate the precise investment objective to be followed and can dictate which assets can or cannot be held. Trustees can also customise their ethical policy and choose to eliminate shares they view as unethical from the portfolio.

In investment funds

More typically, pension schemes invest in assets held as part of an investment fund where there is more than one investor. This is commonly known as a 'pooled fund' or a 'collective investment'. In these types of investments, an investor's money is aggregated (or pooled together) with that of other investors to purchase assets. Investors are allotted a share of those assets in proportion to their contribution. Ownership is represented by the number of 'units' allocated. For example, if the asset pool is worth £1m and there are 1m units then each unit is worth £1.

Pooled funds offer smaller investors an easy way to gain exposure to a wide range of investments, both within markets (for example by buying units in a UK equity fund) as well as across markets (for example by buying units in both a UK equity fund and a UK corporate bond fund). Pooled investments have some drawbacks in comparison to direct investing. For example, any individual investor is unlikely to be able to influence the management of the pooled fund.

Types of asset

Pension schemes can invest in many different financial products and markets which are made up of one or more assets. This tutorial provides an introduction to four traditional asset types: equities, bonds, gilts and cash, plus different investment approaches.

Equities

Equities are shares in a company. Owning shares makes the shareholder a part owner of the company and can therefore share in its profits.

Bonds

A bond is a security issued to investors by governments, companies and other organisations. If you buy bonds, you lend money to a government or a company.

Gilts

A government that wishes to raise money may do so by issuing bonds. Bonds issued by the British Government are known as gilts because the bond certificates issued by the Government used to have a gold border, ie they were gilt edged.

Cash

Trustees can invest in cash funds which in turn are likely to be invested in a range of liquid financial products.

Growth and income

In this tutorial we will look at how each asset type achieves investment growth, as some may increase in value, some may produce an income and some may do both.

This can be compared to someone buying an investment property which they put to let. As an investor, you hope that the property will increase in value over the years as well as providing a regular rental income.

Risk and reward

We will also focus on the risk associated with each investment as different asset types have different risk exposure as well as the potential for reward. It is helpful to get to know the different categories and grading for different asset types so that you understand the relevance of the various types of investments in your pension scheme.

You will find more information on this topic in the Tutorial: 'Risk and reward' later in this module.

Equities: The basics

Equities are shares in a company. Owning shares makes the shareholder a part owner of the company and can therefore share in its profits.

How do equities change in value?

If a company does well and its shares are popular, the value of the shares will usually rise. If an investor sells their shares at this higher price, they will have made a profit on the investment. The investor is said to have 'long position' in this equity. A long position is made when an investor expects to benefit from the share price rising. For example, an investor will buy the share for a price in anticipation of it increasing and making a profit when they sell it at a higher price. If the company does badly and lots of shareholders want to sell their shares, the value of the shares will usually fall.

Share prices, particularly in larger companies, may go up and down together in response to various factors such as economic conditions. However, particular circumstances will affect the share price of individual companies and market sectors.

How do equities produce an income?

Some companies, particularly larger, more stable businesses, pay out a share of their profits as dividends to their shareholders. Shares in these companies can provide investors with a steady income through the payment of dividends, as well as the prospect of some growth through an increase in the value of the shares. This income can be useful for trustees of DB schemes to meet benefit payments as they fall due. Other companies, particularly smaller businesses, may not pay out dividends as they reinvest their profits to grow their business more quickly.

Risk and reward for equities

Equities are considered to be the most volatile of the traditional asset types. This means that the value of the shares can vary widely from day to day and even within the day, so shares carry considerable short-term risk. Although they tend to carry a higher risk than the other asset types, they can offer a higher reward, ie the value of equities can increase or decrease dramatically. Most equities that are traded on stock exchanges can be bought and sold quickly and easily.

Overseas equities investments will be made in foreign currencies (for example US dollar, euro and yen). Investors in overseas equities will be exposed to movements in exchange rates between these currencies and Sterling, as well as movements in the share price. This is known as currency risk. Investors often have the option to choose whether to manage this risk by 'hedging' the currency exposure.

Hedging

Hedging is an attempt to manage the risk of the fall in the value of one asset type, 'A', by purchasing another offsetting asset type, 'B'. The aim is for the value of B to respond in an equal and opposite manner to A to a given set of factors.

For example, you could try to hedge the risk of wet weather if you own shares in an ice cream company by buying shares in an umbrella company.

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

Investment managers typically hedge currency risk by using derivatives.

What are 'listed' equities?

Equities can be 'listed' or 'unlisted'. Listed equities are bought and sold on a stock exchange such as London, New York or Tokyo. Most countries have their own stock exchange, which will usually deal primarily in the shares of their own country, but they may also trade shares of other countries.

The performance of stock markets is measured by indices. Each stock exchange may have one or more stock market indices. For example, the FTSE 100 lists the 100 largest companies traded on the London Stock Exchange whilst the FTSE All Share lists all companies traded on the London Stock Exchange.

How are equities classified?

Equities can be classified using a number of different characteristics including:

- geographical area: UK, Europe, North America, Japan, Far East
- economic position: Developed markets, emerging markets
- market capitalisation (cap): The market value of a company's issued share capital, ie the number of shares multiplied by the current price of those shares on the stock market. These are then split into groups: large cap, medium cap, small cap
- sector: mining, technology or healthcare

Funds are available that only invest in specific groupings of equities for example, the UK Small Cap Fund or the Emerging Market Fund.

How do DB schemes access this type of asset?

DB schemes can invest in individual shares via segregated portfolios or in pooled funds that hold a number of different shares.

How do DC schemes access this type of asset?

A DC scheme member can invest in a pooled equity fund to achieve long-term growth whilst they are still some way from accessing their benefits.

Equities: Approaches to managing assets

There are two main approaches to investment management: active and passive.

Active

The investment manager is actively involved with decisions on choosing investments and buying and selling investments. There are many different approaches to active equity management which we will look at next.

You will find more information in the Tutorial: 'Active and passive investment management'.

Passive

The investment manager constructs a portfolio with the aim of replicating the performance of a benchmark index.

Equities: Approaches to active equity management

Equity funds can be described as income, thematic, unconstrained, or quantitative funds. There are also equity funds which have a particular investment 'style' bias, which are known as value, growth, top-down or bottom-up approaches.

Income

An income fund focuses on investing in stocks which pay a significant dividend and may have had a history of above average dividends increases.

Thematic

A broad term that is widely used, but its meaning can differ depending on the audience. In general, it is considered to mean an investment manager choosing particular themes that they believe are important drivers of future share prices, such as technology change, or an aspect of the environment such as water shortages, and then populating the theme with companies they can invest in.

For example, if one of the themes was the ageing population an investment manager might then believe there will be a rise in pet ownership as older people are typically more likely to have a pet. The investment manager will then invest in this theme by purchasing shares in a chain of pet superstores.

Unconstrained

Also known as 'best ideas' funds, where an investment manager has much less constraint placed on their investment discretion than normal. The investment manager will often only hold a share within their portfolio if they rate it highly and this places a higher emphasis on manager skill.

For example, a Global Equity investment manager may invest with an active approach, but broadly in line with a global equity index. The allocations will be constrained in proportion to that index. In comparison, an unconstrained Global Equity investment manager could choose to ignore the allocation of the index.

Quantitative

An investment manager bases investment decisions primarily on a mathematical analysis of the stocks within a particular market. It is often referred to as 'quant'.

Value

An investment manager seeks shares of companies that they believe the market has undervalued. They believe the market overreacts to good and bad news, resulting in stock price movements that do not correspond with the company's long-term fundamentals. The result is an opportunity for value investors to profit by buying when the price is deflated.

Growth

An investment manager seeks shares of companies that have substantial potential for growth in the foreseeable future. These companies may currently be growing at a faster rate than the overall market, and are often in areas such as technology, alternative energy and biotechnology.

Top-down

An investment management approach that focuses primarily on broader sector or country characteristics rather than individual companies. There is a focus on broader, macroeconomic themes that a fund manager can use to identify strong companies. Investments are driven by macroeconomic factors, for example unemployment, consumption and international trade.

Bottom-up

An investment management approach in which a portfolio is constructed by focusing initially and primarily on the features of individual companies, rather than macro-economic factors.

Defensive

An investment management approach where the investment manager looks to preserve capital whilst markets are falling by investing in less cyclical shares. Cyclical shares tend to rise and fall with the economy as consumers increase and reduce their discretionary spending. Less cyclical shares, such as big brands, tend to react less when markets are volatile.

ESG investment

'ESG investment' means taking a range of 'Environmental, Social and Governance' factors into account when making investment decisions. ESG investing is an approach to investment which involves taking ESG factors systematically into account in investment decisions, throughout the investment process, from the initial analysis to the buy/sell/hold decision and through ownership.

You must set out in your SIP your policies in relation to ESG considerations, such as climate change, where these are financially material over the appropriate time horizon of the investments. This includes setting out how those considerations are taken into account in the selection, retention and realisation of investments.

Environmental factors

These are factors that relate to hoe a business or investment impacts on the environment; examples include:

- climate change
- biodiversity loss
- resource depletion

Example risks you might need to consider, arising from such environmental factors, could include:

- the risk of carbon-generating assets you have invested in decreasing in value due to policy changes and market changes as economies seek to transition to lower carbon in response to climate change
- the reputational risk to investee companies where their operations have a negative impact on the environment and biodiversity, which could result in a reduction in share value
- the risk that, due to depletion of resources and natural capital, companies supply chains and operations may be disrupted, for example through regulatory change or social pressure and their financial performance may be impacted by higher production expenses, liability costs or business interruption.

Social factors

These are factors that relate to the impact that businesses have on their employees and wider society; examples include:

- diversity
- slavery
- health and safety

Example risks you might need to consider, arising due to social factors, could include:

- reputational risk, for example the risk that bad publicity arising from the use of "sweat shops'" could lead to lower demand for certain brands, adversely impacting their value
- the potential for business's profits to be adversely impacted by regulatory intervention - for example, requiring health and safety breaches to be remedied - or legal action for example, from employees claiming the right to equal pay
- the potential for poor productivity making a business less attractive as an investment, for example, due to ongoing industrial relations issues

Governance factors

These are factors that relate to how companies are governed; examples include:

- bribery and corruption
- executive remuneration
- board structure and conflicts

Example risks due to governance factors could include:

- the potential for a business's profits or reputation to suffer as a result of regulatory intervention or legal action seeking to address corrupt practices

- the risk that the business will suffer, and become less attractive as an investment, as a result of poor decision-making for example, if members of the board have conflicts of interest, and favour their personal interests over those of the company
- the risk of reputational damage, and potential loss of business, customers, and share value, if poor internal controls lead to breaches of legislation, for example, failures to properly protect customer's personal data

Additional requirements for certain schemes

In addition, some larger schemes (and all authorised master trusts and collective money purchase schemes), must by law ensure proper governance of climate related risks and opportunities under the Occupational Pension schemes (Climate Change Governance and Reporting) Regulations 2021. This involves ensuring that climate-related risks and opportunities are identified, assessed and properly managed, including considering how they impact investment and funding through scenario analysis, and calculating at least three climate change metrics and setting a target for one of those metrics.

ESG continued

Companies and investment that have good ESG credentials and are not exposed to material ESG risks may offer an improved opportunity for long-term value for investors to be delivered. ESG opportunities as well as risks may be financially material over the appropriate time horizon of the investments.

Interest in ESG investment in recent years has increased significantly due to regulatory developments driving improved disclosures and growing investor interest in more sustainable investments. Climate change, given its potential to cause systemic risks, has also been a key focus for both policy makers and investors. These developments have improved the range of ESG investment opportunities beyond core asset classes.

How do DB schemes access this type of asset?

For DB schemes there is a range of pooled funds that apply specific ESG policies. The availability of ESG investment opportunities in some asset classes, for example, some private market asset classes, is currently limited. Some scheme trustees may with to be more specific in their ESG criteria in which case they may wish to set up a separate, scheme-specific portfolio.

How do DC schemes access this type of asset?

Trustees of some DC schemes may choose to set up a default fund that is invested in pooled funds that apply specific ESG policies. Another option they may choose is to offer self-select funds to members that meet specific ESG criteria, for example, in relation to climate or sustainability.

Trustees can also take member views, including their views on ESG and other ethical matters, into account when making investment decisions - and need to report in the SIP the extent to which they do so. However, they need to balance this carefully against their fiduciary duties to fulfil the purpose of the trust, and act in member's best financial interest.

Useful link

The Law Commission's report on "Fiduciary duties of investment intermediaries"
https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries

Bonds: The basics

A bond is a security issued to investors by governments, companies and other organisations. If you buy bonds, you lend money to a government or a company.

How do they work?

In exchange for an upfront payment, an investor normally expects to receive:

- a series of regular interest payments (known as the coupon)
- at the agreed end date where the loan will be paid back, called the maturity date, a final lump sum payment

This lump sum will typically equal the amount invested originally, or this amount will have increased by reference to some index. This 'coupon' can be a fixed amount of interest or an amount varying in time by an index.

The most important examples of those with varying interest are index-linked gilts, whose coupon and maturity payments are linked to the UK Retail Prices Index (RPI), ie inflation. The term fixed income tends to be used to cover both types of bonds.

What is the difference between gilts and corporate bonds?

Government bonds

A government that wishes to raise money may do so by issuing bonds. Bonds issued by the British Government are known as gilts because the bond certificates issued by the Government used to have a gold border, ie they were gilt edged.

Corporate bonds

Investors can lend money to companies by buying bonds. Corporate bonds are therefore issued by companies.

How do bonds change in value?

Because bonds are debts, investors do not share in the potential increases and decreases in the value of a company as they would if they invested in shares. However, there is usually a market in bonds, so once you own a bond you are normally free to sell it to a third party at the market rate.

The price of a bond is affected by interest rates, and supply and demand.

For example, if you invested in a bond that was issued when interest rates were high, then the bond is likely to offer a high fixed interest rate (the coupon). When interest rates fall, this bond will become more valuable because buyers will be willing to pay more in order to receive the high fixed rate of interest that the bond provides.

Similarly, if you invested in a bond that was issued when interest rates were low, it is likely to offer a low fixed interest rate. When interest rates rise, this bond will become less valuable because buyers will be able to get a higher fixed rate of interest from more recent bonds.

How do bonds produce an income?

If you own bonds, you are paid interest (the coupon) on the money you've lent at a rate specified at the start (ie when the bond was issued).

Risk and reward for bonds

In the event that there is a problem and the issuer of a bond fails, holders of bonds will rank ahead of shareholders in the company for a distribution of a company's assets. Therefore they carry less risk than holders of equity shares.

As with equities, the investment carries an element of currency risk. This can be mitigated by allowing the investment manager to invest in currency derivatives which 'hedges' the currency exposure.

Government bonds (Gilts)

These are as secure as the economy backing that government. Bonds issued by the most stable economies do not generally give very high returns. Bonds issued by less stable economies may offer a high coupon but are likely to carry a higher risk of default on the interest payments and/or the capital repayment at maturity.

The income of a government bond can be an agreed fixed interest rate or can be linked to some index. The most important examples are index-linked gilts, whose coupon and maturity payments are linked to the UK RPI (inflation).

Corporate bonds

The rate of interest is primarily dependent on the strength of the company. The stronger the company, the lower risk of insolvency and therefore the cheaper it is for them to borrow money. A stronger company will offer a lower interest rate coupon. Corporate bonds are not normally index-linked.

Credit rating agencies

Assessing the risk of bonds can be difficult. There are specialist agencies which provide a service in assessing the risk. They are called credit rating agencies, for example Standard & Poor's, Moody's and Fitch. The highest rating offered by these agencies is AAA (or Aaa in the case of Moody's).

Their assessment of the risk can have an impact on bond prices. The agency awards governments and companies a rating depending on how likely they are to be able to repay debts they owe.

It is more expensive for governments and companies with a poor credit rating to borrow money. They need to offer a high rate of interest to attract investors to buy their bonds, due to the higher likelihood that they will default on the payments due. Bonds with the poorest credit ratings are known as 'junk bonds'.

How do DB schemes access this type of asset?

DB schemes can invest in individual bonds or in funds that hold a number of different bonds. As with equities, DC schemes almost always invest in funds.

A bond investment can be considered as a series of cash flows expected to be paid to a DB scheme. The benefits a DB scheme expects to pay to its membership (its 'liabilities') can be considered in a similar way, a series of cashflows.

Trustees of DB schemes typically hold bonds to help match changes to the scheme's technical provisions caused by changes in interest rates and inflation.

How do DC schemes access this type of asset?

For DC scheme members, bonds are typically used to help match the changes in annuity prices from changes in interest rates and inflation. Members tend to invest in bond assets in the period approaching when they want to access their benefits.

Cash: The basics

Trustees can invest in cash funds which in turn are likely to be invested in a range of liquid financial products.

Risk and reward for cash funds

These are not the same as cash deposits, like you may have in a bank or building society. Their value can sometimes fall. In the long term, cash funds are not generally expected to produce the same level of return as equities or bonds.

How do DB schemes access this type of asset?

For DB schemes, cash funds can be used for cash flow purposes when there is a preference to invest surplus cash and disinvest it as and when required.

Note that pension schemes also need a temporary home for contributions when they come in and for monies that have been disinvested. Bank accounts/cash deposits are useful for these purposes.

The rates offered on bank accounts are generally much lower than those offered by cash funds.

How do DC schemes access this type of asset?

It is common for members to hold an increasing proportion of their pot in cash as they approach the time they want to access their benefits. Typically around 25% is held in cash at this time, which is then available to fund a member's 25% tax free lump sum (which is generally a maximum of 25% of the value of the pension pot).

Note that pension schemes also need a temporary home for contributions when they come in and for monies that have been disinvested. Bank accounts/cash deposits are useful for these purposes.

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