The Trustee toolkit downloadable

An introduction to investment

Tutorial eight: Suitability and diversification

By the end of this tutorial you will better understand:

- the importance of the security, liquidity and diversification of the scheme's investment portfolio
- the principle of asset allocation

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

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

Introduction

As we saw in the tutorial 'Investment in a pension scheme', trustees have a legal duty to:

- exercise their powers of investment in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole
- ensure that scheme assets are properly diversified to avoid excessive reliance on any particular asset, issuer or group of undertakings, and so as to avoid accumulations of risk in the portfolio as a whole
- for DB schemes, invest assets held to cover the scheme's technical provisions (ie liabilities) in a manner appropriate to the nature and duration of the expected future benefits payable under the scheme

The investment regulations cover a range of issues together. This tutorial focuses on the issues of security, liquidity and diversification of the scheme's portfolio as a whole.

Security of assets

Trustees must give due consideration to asset protection and understand what would happen in the event of a problem. In this context, trustees should consider what recourse, if any, they have in the event of fraud or the failure of a provider, a custodian for example.

Trustees should understand the protection relating to assets held overseas directly or through an investment fund. It may not always be possible to obtain an appropriate and enforceable financial guarantee, particularly in the context of pooled mandates.

If no guarantee is available, trustees should consider the extent to which (if any) compensation arrangements and other methods of recourse are available to them if an investment provider/manager defaults and scheme assets are lost or dissipated (other than through exposure to market risk in accordance with set investment mandates).

Liquidity

Trustees should consider the liquidity of assets held in the funds underpinning the investment strategy, or in the case of DC schemes, the funds underpinning the default strategy and other funds offered to members.

DB schemes

In a DB scheme, 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.

DC schemes

In a DC scheme, when a fund holds illiquid assets, it may be necessary for the fund to restrict dealing frequency. This needs to be taken into account as it may result in delays in investing contributions or rebalancing the default strategy.

The out of market risk (ie the risk that the member faces of not having market exposure for a period of time) and the risk of being imbalanced to target as a result of such delays needs to be balanced carefully with the potential investment return premium to be gained from holding illiquid assets.

You will find more information on this topic in the Module: 'Investment in a DC scheme'.

Diversification and asset allocation

Diversification

Diversification is generally achieved by investing in different asset classes (more commonly referred to as asset allocation).

For DC schemes all risk is borne by the members, so trustees must consider the range of risks likely to be relevant to members (for example negative real returns, annuity conversion risk) and design a combination or range of asset choices which will be suitable to mitigate these risks. Trustees will need to take advice from their own investment advisers on the question of whether their scheme assets are appropriately diversified.

Asset allocation

The process of investing in different asset classes is referred to as asset allocation. Asset allocation is based on the principle that different assets do not perform in the same way in different market and economic conditions.

It should therefore be possible to secure greater stability by investing a proportion of the assets in lower risk asset classes, such as cash and bonds whilst taking advantage of the potential for growth in higher risk asset classes, such as property and equities.

This strategy is, for example, used for managed funds and other mixed asset class portfolios. An investment manager will decide on the percentage mix of the various asset classes, depending on their expectations of market movements and trends in the economy.

This 'mix' will be subject to regular review but it will generally not be subject to constant change to take advantage of long term growth.