The Trustee toolkit downloadable

An introduction to investment

Scenario three

In this scenario the training continues in the second part of the trustee meeting where Brian will focus on risk and reward, economic cycles and how assets may be affected by them, active and passive management and diversification.

As you work through this scenario you will be tested on your knowledge at decision points. Here you will have the option to work through a related technical tutorial before returning to the scenario or you can skip the tutorial. You can always work through the tutorial separately later if you would prefer.

This scenario includes four tutorials:

- Capital markets and economic cycles
- Risk and reward
- Active and passive management
- Suitability and diversification

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

Brian’s training continues

In this session Brian focuses on some wider aspects of investing pension scheme assets.

Capital markets

Brian says: “The buying and selling of equities and bonds takes place in capital markets. There are two types of market; primary and secondary.

Primary markets are where newly issued shares (equities) and debts (bonds and gilts) are offered to investors. For example a company may need to raise capital for expansion so they issue new bonds through a primary market.

Secondary markets are where equities, bonds and gilts that have already been issued are then subsequently traded. For example, you may wish to sell some shares you already own to another investor.”

Supply and demand

“The levels of supply and demand are part of what determines the value of an asset.

Here’s a simple example. Let’s say you own shares in a particular company and that company has just announced that it is pulling out of certain markets and has made significant losses in the past year. You may decide to sell these shares as you don’t think they’ll recover.

Chances are that other owners of these shares may decide to sell too, so the supply of these shares increases on the market, however the bad news has possibly put off buyers, so there are less of them too. Increased supply and decreased demand will most likely result in the value of those shares falling.”

Interest rates and inflation

“Changes in interest rates and inflation can also affect supply and demand and have significant impacts on asset values and pension schemes.

In simple terms an interest rate is the amount paid to a saver for saving their money, or the amount paid by a borrower of money. If the Bank of England base rate is reduced, it could be bad news for savers but good news for borrowers – so this type of monetary policy can stimulate spending.

The rate of inflation is the rise in the general level of prices and there are two main measures: Retail Prices Index (RPI) and Consumer Prices Index (CPI). RPI determines the coupon and payment at maturity of index-linked gilts. RPI and CPI are also used for calculating uplifts in certain benefits including the state pensions.”

Economic cycle

"Finally, economic cycles also have an impact on the value of assets. There are four stages of the economic cycle:

- boom
- slow down
- recession
- recovery

At different stages of the economic cycle, assets will rise and fall in value. But that doesn't mean that you can predict what to buy and what to sell just based on the economic cycle… otherwise we'd all be millionaires!"

Decision point: Economic cycles

Brian asks the trustees to consider some descriptions of the four stages of the economic cycle. Which one describes each stage of the cycle?

1. A period of high consumption in the market with companies reporting large profits. The 'feel good factor' encourages spending and both inflation and interest rates can rise.
2. A significant decline in activity across the economy with a period of negative economic growth. Company profits are generally lower causing low business confidence. Investors seek 'safe havens' which can push bond prices up.
3. As interest rates rise, the availability and affordability of borrowing money declines and company profits may be squeezed as spending is reined in. Overall growth of economic output will tend to slow and interest rates can start to fall.
4. Companies begin to become more optimistic about the future and expand production. Interest rates usually remain low but with market expectations of an increase. Bond prices may fall and equity prices increase.

Answers at the back

Need help with this question? Read the **Tutorial 'Capital markets and economic cycles'**

Risk and reward

The trustees have got a good grasp of the basics. There seems to be a huge number of investment options and deciding where, when and for how long to invest seems like a minefield. You're interested to understand how trustees decide what to invest in for the DB scheme and what to offer the members of the DC scheme, so you ask Brian.

Brian says: "That's a good question. You need to look at risk and reward. In general terms the more risk you are willing to take the more chance you have of good asset growth, but with that territory comes the risk that you could lose a lot too. How much risk you are prepared to take is called a 'risk appetite'."

In a DC scheme the members take on the investment risk and so it is their risk appetite that is important. For example, some members may be very near to accessing their benefits and so may have a low appetite for risk. Whereas others may be at the start of their career and so have a relatively high appetite for risk. It's not that simple though and different people will have different needs at different times so it's important to make sure you offer a default arrangement and alternative funds that meet the needs of the membership.

On the other hand, in a DB scheme, you as trustees make the decisions as to how to invest scheme assets, of course with appropriate advice. You need to select and monitor a mix of assets which provide an appropriate degree of risk and potential reward for the scheme assets.

You need to consider the liabilities of the scheme (being able to pay the benefits to the members) taking into account the strength of the employer covenant. What you invest in may depend on how confident you are that the employer will remain in business and be able to continue to support the scheme.

As I said, in the DB scheme you need to make sure you have sufficient assets to pay benefits whenever they fall due. This means that in the short term you may have members coming to retirement and you need to start paying benefits. You will need sufficiently liquid assets to be able to do that.

However, over the long-term if you only invest in low risk investments (with low growth potential) then the contributions that have to be paid, so that members can receive the benefits promised to them, may need to increase. This could put pressure on the employer."

Alicia asks: "If you decide to invest in equities will you win out eventually?"

Brian says: "No, you can never be absolutely sure. Historically, over the very long term, equities have tended to outperform bonds and gilts but even over periods of 10 years or so that is not always the case. When the value of equities drops, it can do so dramatically and suddenly.

So you see, it can be serious for members of a pension scheme if a fall in the stock market coincides with the employer's failure (DB) or needing to access their benefits (DC)."

Rodney asks: "How do you know that your assets will grow enough if you take that risk?"

Brian says: "You don't know, and that is why you need a mix of assets and you monitor their performance very carefully. You need to monitor trends in the markets as well, and you can't rely absolutely on growth."

Adrian asks: "Are there any risks in investing in bonds?"

Brian says: "Yes, there can be. For example, if you lend money to a company by investing in a corporate bond, and the company becomes insolvent, you may not get your money back. That's why you get more interest on corporate bonds than you do on government bonds."

Edmund asks: "How do you know whether a company is likely to become insolvent?"

Brian says: "Companies have credit ratings which are readily available. These give an indication of the financial strength of the company and indicate to banks whether or not they are credit-worthy. It is very unusual for companies with good credit ratings to become insolvent, but it has happened and some have been quite spectacular."

Charlotte asks: "What about the income from shares and bonds?"

Brian says: "You can rely on the income from gilts and corporate bonds, unless the company or government fails. Dividends, on the other hand, vary and sometimes by quite a lot."

Decision point: Risk and reward

Round the table the trustees are discussing conclusions about what they should invest in for the scheme. Which two of these statements are correct? "We should have...

1. ...enough liquid assets to secure the income of current pensioners in the DB scheme."
2. ...more bonds than equities because bonds cannot go down in value."
3. ...more equities than bonds because equities always provide a higher income."
4. ...some corporate bonds because they generally offer a higher income than gilts."
5. ...very high proportion of equities because they are guaranteed to outperform bonds in the long term."

Answers at the back

Need help with this question? Read the **Tutorial 'Risk and reward'**

Active and passive management

Brian moves on to talking about how assets can be managed. He says: "In DB schemes, you may directly invest in the asset types we've talked about but more typically scheme assets will be invested in funds with underlying asset types. DC members don't invest directly but will have access to funds. These will be managed by an investment manager who will buy and sell assets on a day-to-day basis."

Edmund says: "Yes, we do invest in funds for the DB scheme and provide both a default arrangement and alternative funds for the DC members. I know we have a mix of active and passively managed funds."

Brian says: "Yes Edmund, funds will either be actively or passively managed by the investment manager. What the scheme invests in or offers to members will depend on your objectives as trustees, the costs involved and risk appetite."

Decision point: Active and passive management
Each trustee has a strong view about active and passive management. Which two statements are true?

1. Adrian: "Passively managed funds always track the index exactly so there is no risk of losing more than the index does."
2. Alicia: "Passive management tracks an index so there is no opportunity to outperform the market."
3. Edmund: "I think it's important to look at the costs of active and passive management relative to their performance. A balanced approach is what's needed."
4. Rodney: "Active management is generally more expensive than passive management so it's never worth investing in actively managed funds."

Answers at the back

Need help with this question? Read the **Tutorial 'Active and passive management'**

The final part of the training

Before the trustees move on to looking at the quarterly investment report, Brian completes his training session by focusing back on the requirements of the trustees.

Trustees' legal duty

Brian says: "So we've talked about a lot of different subjects today to make sure you all have the same basic level of understanding about the different asset types, risk, reward, management styles etc. But to finish I'd like to remind you all of the legal duty you have as trustees to:

- exercise your 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 so as to avoid accumulations of risk in the portfolio as a whole"

Security

"Scheme assets are in the safe keeping of a custodian or a provider. You need to make sure you understand what would happen in the event of fraud or the failure of a provider."

Liquidity

"We have already discussed the liquidity needed in the DB scheme to pay pension benefits as they fall due, but you also need to consider the DC scheme too. There may be a need to restrict dealing on a particular fund and that may cause problems for members wishing to transfer between options, investing contributions or rebalancing the default arrangement if required."

Diversification

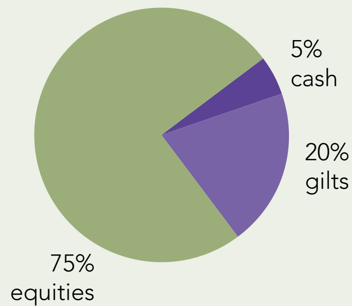
"You also need to give consideration to diversifying the portfolio too. This is important for both the DB scheme and the options offered to DC scheme members.

Diversifying the portfolio or options offered to members is intended to mitigate various risks, and is achieved by investing in a range of different asset types. This process is called 'asset allocation'."

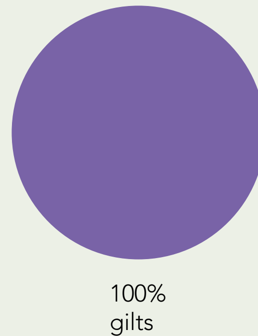
Decision point: Getting the mix right

Brian shows the trustees some pie charts of different asset allocations to discuss. Choose three statements you agree with.

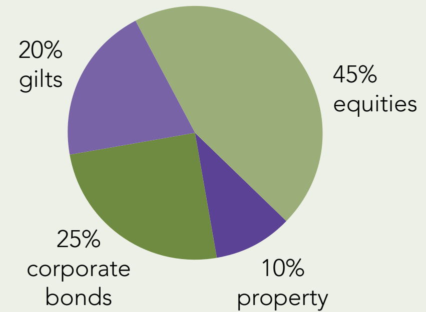
Scheme A



Scheme B



Scheme C



1. A has the greatest potential for growth
2. B is the most risky
3. B would give the most predictable income
4. C will smooth the returns over several economic cycles

Answers at the back

Need help with this question? Read the **Tutorial 'Suitability and diversification'**

Rounding up

Charlotte thanks Brian for the training and moves on to the monitoring performance item on the agenda in the next scenario.

Now that you have completed this scenario we would recommend that you begin to work through the 'Check your scheme' worksheet for this module.

Answers

Decision point: Economic cycles

The correct answers are: 1 = Boom, 2 = Recession, 3 = Slow down and 4 = Recovery

The economic cycle generally moves through ‘boom’, ‘slow down’, ‘recession’, ‘recovery’ and back to ‘boom’ to begin the cycle again.

Decision point: Risk and reward

Statements one and four are correct.

The DB scheme needs to have liquid assets to pay pension benefits as they fall due and would need them now if there are current pensioners.

Statement two is incorrect, bonds can go down in value.

Statements three and five are interesting: equities do not necessarily provide a higher income (there are some years when they don’t provide any income at all). And, while historically there is evidence that they outperform bonds in the long term, there is no guarantee.

Decision point: Active and passive management

Alicia and Edmund are correct. Passively managed funds do not track the index exactly. You would normally expect the return to be close to the index being tracked but, taking into account costs, there will be a difference called ‘tracking error’.

Errors can also be made in the way that the fund replicates the index. This can cause a significant deviation from the index, so it need monitoring.

Active management is more expensive than passive management, but this doesn’t mean that it’s never worth investing in these options. Trustees need to look at the costs involved, and the rewards achieved, to determine a balanced approach.

Actively managed funds do offer the opportunity for outperformance. This is not the purpose of a passive fund.

Decision point: Getting the mix right

Statements one three and four are correct.

A shows the highest proportion of equities, so compared to the other asset allocations this one has the greatest potential for growth. For the same reasons, it would also have the highest risk, not **B** which is invested entirely in government bonds (gilts).

Because it is invested entirely in gilts, **B** does offer the most predictable income compared to **A** and **C**. This is because they both have a high proportion of equities and dividend income is not guaranteed. **C** has a balanced proportion of each asset class so risks are well spread and could smooth returns over several economic cycles.

If you would like to learn more about the legal duties for trustees in the investment of scheme assets including asset allocation, we recommend you start the Tutorial: 'Suitability and diversification'.

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