The Trustee toolkit downloadable

Investment in a DC scheme

Scenario one

In this scenario the investment sub-committee meet to discuss the DC scheme investment strategy and review the investment strategy for the default and alternative investment options provided to members.

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 three tutorials:

- Setting the investment strategy
- Default investment options
- Alternative investment options

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

The agenda

You've been sent the agenda and papers for the next meeting of the investment sub-committee.

1. Apologies.
2. Conflicts.
3. New members.
4. Elect a chair.
5. DC investment strategy.
   - Default arrangement and investment strategy review.
   - Alternative options review.
6. Any other business.

Papers attached to the agenda include a copy of the statement of investment principles (SIP) and lots of performance charts related to the various investment options.

The meeting starts

As Edmund is no longer a trustee, Charlotte welcomes John to the investment sub-committee. They also welcome back Brian who has been co-opted to the committee to provide additional investment expertise.

Charlotte says: "Welcome to the investment sub-committee John and Brian. We are very pleased that John agreed to join in Edmund's stead, and that the employer has agreed to pay for Brian to join us as an adviser."

Brian replies: "Thank you Charlotte, I hope I can live up to expectations."

Charlotte responds: "I'm sure you will. The first matter to attend to is to elect a new chair now that Edmund has left. As I am chair of the full board, I would prefer to move aside for the sub-committee. So as you all know I spoke to the whole board individually and John said he would be very happy to become chair. I am pleased to say that the full board has voted in favour."

John says: "Thank you Charlotte. I'm looking forward to focusing on the investment strategies for both the DB and DC scheme. Today we will focus on the DC scheme and our review of its investment strategy. In particular we had some concerns at an earlier meeting about the performance of the default arrangement and there were a few of the alternative investment options which also seemed to be suffering. We will need to look more closely at these issues and make recommendations for next steps to the full board."

George comments: "I've also prepared some information about the membership to help us with this discussion which was attached to your papers."

Decision point: The investment strategy

Which three statements are true in regard to reviewing the investment strategy for the DC scheme?

1. Decisions regarding the default arrangement and any alternative investment options for members should be set out in the SIP
2. It is a legal requirement for trustees of all DC schemes to provide a default arrangement for members who do not wish to set their own strategy
3. Trustees are responsible for ensuring that any alternative options perform in line with the investment manager's objectives and remain suitable for the membership
4. Trustees are responsible for ensuring the long-term suitability of the funds underlying the default arrangement

Answers at the back

Need help with this question? Read the Tutorial 'Setting the investment strategy'

Reviewing the default arrangement investment strategy

The sub-committee begins to review the default arrangement investment strategy first.

John says: "Looking at the performance of the default arrangement, it is certainly underperforming the objective, but Charlotte, your initial concern that it wasn't even matching the benchmark was unfounded. It has actually delivered in line with the benchmark. Let's start by looking at what the default arrangement is and whether that is still suitable for the membership. Brian, could you explain the strategy?"

Brian replies: "Well, you have a lifestyle strategy for your default arrangement. Whilst your members are far from accessing their benefits they are invested in an underlying actively managed diversified growth fund. At five years before their expected pension age, growth assets for members are replaced each year by typically lower risk assets such as bonds, gilts and cash. The objective the manager has set is to produce returns of 1% in excess of the benchmark after fees, which is not being met."

Charlotte says: "Looking at the membership information you have provided George, it seems that this single option may not be suitable for all the members. We have a legal duty to make sure that the default arrangement is designed and assets are invested in the best interests of the relevant members and relevant beneficiaries."

George responds: "Over 70% of the members are invested in the default arrangement and of those who have now retired, on average they did so two years before their expected pension age. The split between active and deferred members is roughly 50/50. There is also a large number of members with quite small funds, particularly those active members with contributions lower than the maximum the employer matches."

Decision point: What could the trustees consider?

The trustees need to review whether the default arrangement remains appropriate for the relevant members and, if necessary, make recommendations for change to the full board. Which two suggestions would be sensible in this case?

1. As some members have small pots we should change the underlying fund to one investing in gilts, bonds and cash to protect members from investment risk
2. If members are accessing their benefits earlier we could consider offering different lifestyle options
3. If the default arrangement is underperforming, we should look at this more closely and if necessary consider changing the fund
4. The underlying fund should never be actively managed as the potential returns will never outweigh the higher costs involved

Answers at the back

Need help with this question? Read the Tutorial 'Default investment options'

Next steps and reviewing the alternative options

The sub-committee agree to recommend that they more closely monitor the performance of the default arrangement and look at alternative options to only offering a five year lifestyling strategy as the investment strategy for the default arrangement. They move on to discussing the alternative options for members.

John says: "We also need to review the alternative options we provide to members, and we do have a several funds that are also underperforming against their objectives."

George comments: "The data I've collated shows that of the three actively managed funds which are underperforming, one of them has the highest level of investment amongst the members who are setting their own strategy. Interestingly the actively managed funds with the lowest charges have the least amount invested by members but they are all achieving the objectives set by the investment managers.

The two passively managed funds are the next two most popular choices amongst the members. These have the lowest charges of the options offered, though neither have enough members invested in them to be classed as a default arrangement for the purposes of the legislative charge controls."

Charlotte says: "It certainly does seem that costs are high in the members' minds when choosing their own investment strategy. But I see that we've also had some feedback from the membership that you've included in the papers George. Some of the members have asked whether the scheme provides any ethically managed options, which it doesn't currently."

Brian answers: "That's an important point actually, Charlotte. This range of alternative investments was chosen when the DC scheme was started many years ago and there may have been innovations in the market which are worth considering.

For example, you offer a diversified growth fund as an underlying investment in the default arrangement, but I don't see that as an option in the alternative range. You might also want to consider whether there is a demand for a Sharia compliant fund or whether white-labelling some of the more popular funds might be a good idea."

Decision point: Reviewing the options

The sub-committee continue to discuss the member feedback alongside the profile information George as provided and Brian's ideas. Which three suggested next steps might be sensible in this case?

1. We don't need to review the passively managed funds as although there is a high level of investment in these funds they will always match the benchmark
2. We might need to review how the funds are described to members as although lower cost funds seem to be popular, the lower cost actively managed funds have virtually no investment
3. We should consider whether adding some new options to the range might be appropriate to meet the needs of the membership
4. We should look more closely at all the funds which are underperforming their objectives and if necessary remove or replace them

Answers at the back

Need help with this question? Read the Tutorial 'Alternative investment options'

Decisions

The sub-committee agree to report back to the full board with their decisions and John summarises the five recommendations.

John says: "In the case of the default arrangement we want to monitor the performance more closely over the next quarter, and look at our options regarding the five year lifestyle strategy in light of the scheme's experience with members wishing to retire early.

We also want to monitor the underperforming alternative options over the next quarter and suggest a review of the way in which the funds are described to members. We also want to explore adding new options to the range in light of member feedback.

If we need to, we will consider replacing or removing underperforming funds at a later meeting once we completed the further monitoring. When all investigations are complete we will make further recommendations to the board as to whether we need to update the investment strategy."

Rounding up

This meeting of the investment sub-committee has finished and George will write up a report for review before the next meeting of the full board.

> 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: The investment strategy

The correct answers are one, three and four.

DC trustees are responsible for setting the strategy for the default arrangement and for ensuring the long-term suitability of the funds underlying it, but this is only a legal requirement for automatic enrolment schemes.

The trustees are responsible for ensuring that any alternative options offered perform in line with the objectives set by the investment manager and that the options remain suitable for the needs of the membership.

Decisions about the default arrangement and any alternative options should be set out in the scheme's SIP and the SIP in respect of the default arrangement.

Decision point: What could the trustees consider?

Options two and three are correct in this case. The trustees are right to consider the membership profile and the fact that some members are retiring earlier than predicted. The five year lifestyle strategy may be exposing some members to excessive investment risk just before they access their benefits. Considering alternatives is sensible. Switching all members invested in the default arrangement to a fund only investing in gilts, bonds and cash would not necessarily be suitable for members who have longer to go until accessing their benefits or have larger pots. It may expose members to inflation risk.

Actively managed funds can be part of a default arrangement. The trustees will need to consider whether the balance of likely costs and return is right for the needs of the membership and is in their best interests and, where relevant, the costs borne by members should come within the 0.75% charge cap. It is sensible for the trustees to monitor the performance of the fund more closely as it is underperforming the objective and consider changing the fund if the balance is no longer appropriate.

Decision point: Reviewing the options

The correct options in this case are answers two, three and four.

It would be sensible to look more closely at all of the underperforming funds and if necessary consider removing or replacing them if necessary. As the membership has requested additional options it would also be sensible to look at adding new funds so that the range remains suitable for them.

It may also be worth reviewing the way in which the funds are described to members as the lower cost actively managed funds are so unpopular despite the membership seemingly favouring low charges. If the objectives, charges and/or description of the fund is unclear this might need to be changed.