The Trustee toolkit downloadable

Investment in a DB scheme

Scenario one

In this scenario you will discuss the DB scheme's investment strategy at the fourth quarterly review in light of a report provided by Lesley, the scheme's investment consultant.

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 two tutorials:

- Understanding investment strategy
- Changing asset and liability values

Glossary

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

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The meeting

After completing all the standing items, the trustees move on to the main agenda item, reviewing the employer covenant, funding strategy and investment strategy.

Charlotte says: "So on to the next item, our fourth quarterly review of the funding and investment strategies we have in place for the scheme and the employer covenant. The reports sent out with the papers make interesting reading. We carried on monitoring the covenant strength regularly since things started to deteriorate nearly two years ago now. There are some signs that business is recovering, with a small profit made in the last financial year and they've signed contracts with two major new customers in the last six months.

But there's nothing strong enough here to hang our hats on just yet. The newco is still repaying the loan they took from the business, and, as the years pass, the back-end loading of deficit repair contributions will start to kick in. We'll need to keep monitoring the covenant, but there are signs of some 'green shoots'."

Market conditions

Charlotte hands over to George to present the market conditions report from the investment consultant. George says: "The market conditions report shows that the equity markets have improved over the past 12 months. This is in comparison to the previous 12 months where despite contributions going in to the scheme, the asset values remained fairly flat due to poor equity performance."

Rodney comments: "Well that sounds like very good news. When we last looked at the investment strategy we were comfortable that it supported the funding strategy and employer covenant. It looks like we made the right decision to leave things as they were."

George replies: "Yes, the scheme has benefited from rising equity markets, however, bond markets have remained static as interest rates have stayed the same. The forward look they've provided says that they believe interest rates will start to fall over the short to medium term."

Adrian asks: "So how does that impact the scheme? Is it worth us looking at the strategy again and where the scheme assets are invested so we can make sense of this?"

Decision point: Types of assets

The trustees take a look at their current investment strategy and see that assets are broken down at a high level into three categories: growth assets, matching assets and downside protection arrangements. Which of the definitions match these categories?

Options: Downside protection, growth assets, matching assets

1. Assets held principally to reduce risk relative to the scheme's liabilities
2. Assets held to seek an investment return over time and meet the scheme's funding targets
3. Assets held to protect the scheme's assets from adverse changes in market conditions

Answers at the back

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

Impact to assets and liabilities

Charlotte continues the conversation about the changing market conditions and how this has impacted the scheme. Charlotte says: "Although equity markets have risen, bond values have remained static so this has resulted in only a modest increase in asset values."

Alicia says: "That sounds like the scheme's funding position will have improved though?"

George says: "Well, certainly the asset value is slightly higher. But with interest rates low and potentially falling further, this could impact both the asset and liability values."

Rodney says: "I see in this report there are some figures for interest rate duration. I seem to remember that this is useful for understanding how the scheme's asset and liability values might change if interest rates change – is that right?"

Adrian says: "What about inflation? The report says that although this has been over target for the last 12 months, the view is that this will fall over the coming 12 months. How will that impact the scheme?"

Alicia says: "Our discount rate is based on gilt yields plus an addition. Should we be looking at our assumptions for the discount rate if interest rates are going to fall?"

Decision point: Changing asset and liability values

The trustees are discussing the investment report and how the scheme might be impacted. Which two statements are true?

Rodney: "If interest rates fall, the present value of the liabilities will increase but the value of bond assets would also increase."

Alicia: "The present value of our liabilities would increase if our assumptions for discount rate also increase."

Adrian: "If we change the assumption for inflation to a lower rate this will increase the liabilities in future years."

Charlotte: "Interest rate duration and inflation duration can affect both asset and liability values depending on what types of assets the scheme holds."

Answers at the back

Need help with this question? Read the Tutorial 'Changing asset and liability values'

Impact to the scheme

The trustees begin to realise that there is more risk in the current investment strategy than they are comfortable with.

Charlotte says: "Looking at the conclusions in Lesley's report, we are more reliant on equity performance than I would like when bond markets have remained static."

Alicia says: "I agree Charlotte, with interest rates likely to fall, although our bond assets will increase in value, our liabilities will also increase."

Rodney says: "If there was to be another fall in equity markets we would be very exposed with the employer covenant still weakened from the management buy-out in this scenario."

Adrian says: "I think I'd like to see some more scenarios on our existing investment strategy so we can understand just how much risk we are carrying. After all, the investment report's forward look hasn't always been right."

Charlotte replies: "I agree Adrian and I think this is a next step for the investment sub-committee and also for Lesley. I would recommend that Lesley provides some scenario analysis and stress testing to the sub-committee for review based on our existing investment strategy. She can attend the next investment sub-committee meeting to present her findings."

Rounding up

The trustees all agree with the proposals and George arranges this with Lesley, making sure she is in touch with Robert, the scheme actuary, to include an assessment of the scheme's funding strategy.

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: Types of assets

The correct answers are 1. Matching assets, 2. Growth assets, 3. Downside protection.

Growth assets such as equities are held to seek an investment return over time to meet the scheme's funding targets. Matching assets such as bonds are held to principally reduce risk relative to the scheme's liabilities.

Downside protection arrangements aim to protect the scheme's assets from adverse changes in market conditions. They typically involve investment in assets or derivative strategies that are expected to deliver a large positive return in extremely bad market conditions.

Decision point: Changing asset and liability values

Only Rodney and Charlotte are correct. If interest rates fall this would directly increase the value of the scheme's bond assets. However, because the discount rate is based on gilt yields, the discount rate would fall, increasing the value of the scheme's liabilities. So Alicia is incorrect because if the discount rate increased, the present value of the liabilities would fall, not rise.

Both interest rate and inflation duration can affect the value of the scheme's liabilities. Inflation affects the estimated cash flows and present value of the liabilities; interest rates affect the assumption for discount rate. Both can also affect asset values if the scheme holds bond assets that are index-linked.

Finally, Adrian is incorrect. Changing the inflation assumption for a lower rate would mean that inflation linked liabilities would also reduce, in turn reducing the present value.