An ideal pension scheme investment model?

Taking a fresh look at the UK DB pension scheme investment model

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Overview

Imagine we had a clean slate and could start from scratch when it comes to the UK defined benefit (DB) pension scheme investment model. How would we set up the running of a pension scheme’s investments?

In this latest paper we look at some of the key characteristics that we believe might form the ideal pension scheme structure and governance model. We also propose some actions you can take to assess your current investment decision-making model and ways to make improvements.

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An ideal pension scheme investment model?

There are six elements of a pension scheme model that must be considered when it comes to the ‘ideal’ approach for investments.

1. Scheme structure (and decision-making)  
2. Expertise  
3. Access to a wide support network  
4. Nimbleness within a risk framework  
5. Fees and reporting  
6. Time

In this paper we look at each of these in turn and what the ideal approach or structure might look like.

1. Scheme structure (and decision-making)

Let’s start at the beginning and look at the structure or make-up of the decision makers for a pension scheme.

It might make sense that the starting point would be to appoint a group of investment professionals (the ‘group’) with different backgrounds as the pension scheme decision makers. Then give them the sole task of improving and stabilising funding levels. This group of individuals should represent the views of the sponsor company and the scheme members. This will make sure that decisions take into account both perspectives while focusing on member needs. This will also help maintain the careful balance between contributions and risk/return targets that can often be a point of contention with the current framework.

Secondly, it is essential that scheme knowledge does not transfer out when one of these investment professionals leaves or the sponsoring company changes (through takeover or merger, for example). Retaining knowledge of the scheme, its history and understanding of the decisions made is important to enable the scheme to evolve and improve the portfolio as conditions / needs change. This could be achieved by consistency in some form within that group; whether through carefully controlled rotation of representatives or consistent external representation, and through detailed minutes with rationale for decisions.

Finally, it is important that the scheme’s benchmark should be designed around its specific liabilities. The risk and return targets around this benchmark should then reflect the collective views of the group from both the sponsor and member perspective. A key part of this is challenging views and decisions to avoid any behavioural biases creeping in.

Now, you may well be thinking that everything we have just outlined is exactly what the current model looks like. Schemes already have all of this. So what’s the difference? Running the pension scheme investments and the governance around that is not straightforward. It is more than just one element running smoothly. This is akin to cooking a soufflé. Not only does every ingredient need to be just right, but it needs to be combined in the right way and in the right order. And the smallest mistake or weakness could make it collapse. The ideal model, and best chance of success, is when all six elements are optimal and combined in the best way. Any weakness or cracks means it will not work. And that is why the current model does not seem to be working for most schemes.
2. Expertise

The second element is expertise.

In an ideal world, the scheme’s investment professionals, discussed in the first element, need to have wide-ranging expertise across the whole investment universe. This will enable them to distinguish between the different options available, then debate and discuss what would work best for their specific scheme.

To achieve this, the group also needs to access a range of comprehensive systems. This would allow them to easily model and monitor a wide range of potential investment strategies. This means decisions are well-informed and can take into account detailed analysis and scenario testing.

Decisions could then be made based on their unique circumstances, taking into account the broader picture, without taking undue risks and while focusing on their long term strategy.

Most schemes currently have some investment expertise, either through a paid professional trustee with an investment background, or through a trustee who has worked in financial markets. However, most individuals do not have expertise across every asset class and every investment approach – particularly as new solutions or strategies are regularly becoming available.

Clearly it is not going to be easy for every pension scheme to have this level of access to systems and have detailed investment expertise across all areas, including risk management, to be able to do this fully themselves. Achieving this would take time, resources and incur costs. Typically, in the current pensions world, only the £5bn+ schemes with in-house investment teams and CIOs would have anything like this.

As mentioned above, while those involved in the daily running of the scheme should have a robust understanding in these areas, we understand that the investment universe is incredibly vast. No single person can have sufficient expertise across all areas. This is something even the largest pension schemes with in-house teams do not find easy.

Access to professional researchers in areas such as equities, fixed income, hedge funds, property, private equity and infrastructure is therefore important to give more in-depth analysis. These specialists should have the knowledge to be able to look through all the potential products and investment solutions available. They then need to be able to carefully assess these and choose what they believe are the best in class. This will help ensure that only the very best the market has to offer is considered for inclusion in the scheme’s portfolio. Clearly this will help increase the chances of success – that is, meeting the end-goals of the scheme in the set timeframe.

Furthermore, macroeconomic outlooks from dedicated market economists with decades of experience in understanding the complexities surrounding the workings of the world’s markets should also be fed into the decision-making process. This, combined with the professional research expertise, will help ensure that as new products develop, they are researched and managers identified in order to exploit opportunities as they arise.

Schemes, say, under £1bn typically draw upon the services of their investment consultant to support them in achieving this level of coverage and insights in the market. Even the larger schemes who may undertake some of this in-house may rely on an external third party to help support in some areas where there is perhaps less knowledge. So, as long as the support network being used has the right expertise, this is a strength of the existing model and a good way to ‘plug any gaps’.

3. Access to a wide support network

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4. **Nimbleness within a risk framework**

What about the day-to-day running of the scheme itself? In the current environment it is more important than ever to ensure the scheme has as much agility (or nimbleness) as possible, alongside robust risk management. By this first point we mean being able to react to markets or capture opportunities as they arise. Linked to the above, this could mean investing quickly into new ideas or strategies as they are researched and then capturing that opportunity efficiently.

Linked to the third element, risk management is integral to any investment decision and the ongoing monitoring of the pension scheme’s portfolio. Tools that provide daily details on funding levels, asset holdings, risk management and general portfolio oversight will help ensure the scheme’s portfolio is being carefully monitored and managed.

Daily monitoring of funding level and any appropriate triggers needs to be combined with the ability to take action when needed, quickly and efficiently. This will allow the scheme to take effective action within a very short space of time and switch between asset classes, strategies and managers where necessary to capture opportunities as they present themselves.

Systems and tools are also important to ensure that all possible risk/return trajectories are considered. This includes undertaking shock testing, scenario analysis and complementary manager analysis in order to assess the wide range of risks contained at an individual stock level, asset class level and overall portfolio level.

How does this compare to the current investment and decision making model? Well, this is an area which truly differs from scheme to scheme. Many trustees meet four times each year to discuss not just investment matters but a wide array of issues around the running of the pension scheme. This clearly impacts how nimble they can be when it comes to investing in new ideas or disinvesting and re-investing quickly and efficiently.

Those schemes that meet more frequently or have investment sub committees can clearly do things more quickly. However the optimal solution would be having even more frequent attention and daily monitoring of the entire investment portfolio. Something that is not easy to achieve without extensive external support (or a very large in-house team and CIO!).

5. **Achieving more: fees and reporting**

It is stating the obvious to say that the lower the fees can be pushed for any given service the better. This applies to our day-to-day lives as well as running a pension scheme.

So within this idealistic pension scheme investments environment we are looking at, how would this work? The concept would be that the group of scheme professionals would be able to combine with other schemes to collectively drive down the fees of underlying managers and improve the terms under which they invest. Smaller, individual schemes just could not get this type of bargaining power alone.

Schemes would then no longer be treated as a single investor but would work together. They would all be treated as collective investors with a common outlook and aim; achieving economies of scale and value for money. The outcome of this is ultimately the potential for better net of fees returns for the scheme.
Clear, concise and easy to understand reporting would also be readily available in the ideal world we are describing. It would be focused on the key metrics, as outlined by the scheme, and be tailored to the individual stakeholders within the group.

This is something the local authority pension schemes have begun to look at with pooling of assets to create more bargaining power. This has not yet happened with corporate pension schemes but could be something to consider. The other way to achieve economies is for an external provider to help bring together assets to help with negotiating with managers.

This already happens to a small degree but the assets are not officially pooled. For example, when your investment consultant, is negotiating with an equity manager and saying they have five clients with AuM of around £250m to invest, what’s the best fee they can do... This is clearly going to be stronger than clients separately speaking to a manager with smaller amounts of money being discussed.

6. Time

The sixth and final element is something we have not yet mentioned but is critical to all of the previous elements; time.

Running a pension scheme takes time. Making decisions that are well informed, draw upon expertise or advice, within a risk framework, can take significant investment of time.

Aon Hewitt’s Fiduciary Management Survey 2016 showed that 68% of trustees spend five hours or less each quarter on investment matters. That is a maximum total of 20 hours each year. Clearly this is not enough to undertake all that we have outlined above with the ideal model.

So what would the ideal time commitment be if you were to effectively implement all the elements? If the trustees would do this all themselves, and not delegate any aspect to an external third party, this could be around 5 hours per month or more (depending on the objectives and investment strategy). This would equate to a minimum of 60 hours each year. Of course this is required from each of the trustees and thus totals an overall commitment of 360 hours to the pension scheme (assuming an average of six trustees / representatives running the pension scheme’s investments).

You might be thinking this does not leave much time for all the other aspects of running a pension scheme like reviewing benefits, the actuarial valuation and assumptions, legal advice and so on...
Theory or reality?
Is now the time for change?

Legislation has evolved. The investable universe has expanded and become increasingly complex. Schemes are closing, which means a finite timeframe to reach the end-goal. There has been a lot of change over the past decade (some positive and some more challenging).

However, what we would probably all acknowledge is that the pension scheme model has not evolved to the same extent or pace. The structures, decision making and overall set-up for DB pension schemes has not materially changed during this time.

So, if we had our time again, and could start from scratch, would you set up the investment aspects of a pension scheme as we have just described? With every single element working well and combined to perfection. Clearly there are challenges to a lot of the suggestions and without investment of time, commitment, effort and resources a lot of these ‘ideals’ would be impossible to implement. In fact, those barriers are the main reason why the current model does not look like as we have described.

What we can say though, is that even small changes to some or all of the six elements can make a big difference. So here are some actions everyone can consider to help move toward this ideal model:

• Assess your current framework and approach in each of the six areas we’ve discussed in this paper
• Identify areas of strength or weakness and thus where improvements could (and should) be made
• Work with your investment consultant or strategic partner to look at the best ways to implement these changes
• If you agree with any of the proposals in this paper, it is also worth considering whether there are any elements, or parts of the six elements, that you might want to outsource to help achieve this. For example, asking your investment adviser to be more directive (help speed up decision making and save time), or asking a provider to implement the investment strategy set by the trustees
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To talk to us about any of the points we have raised in this paper or to find out more information about our delegated offering, please do not hesitate to contact your Aon Hewitt Consultant or Sion Cole, Senior Partner and Head of European Distribution, Delegated Consulting Services, on +44 (0)20 7086 9432 or at sion.cole.2@aonhewitt.com.

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