Unlocking the Efficiencies of an Investment Platform

How £1bn+ DB schemes can benefit from operational infrastructures

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Overview

The logistics and operational demands UK DB pension schemes have to cope with when investing are high. Pension scheme investing is more than just setting the right strategy and picking the right managers. It takes time and resources to get it right; undertaking operational due diligence, review of legal documentation, negotiating fees and terms with each manager and so on.

As well as being time consuming, it can feel like an inefficient use of time and be costly (time cost and fees). Ultimately, it can prevent a scheme actually investing in new ideas or certain strategies. How can large schemes overcome these challenges?

Investment platforms already exist in more basic formats in the DC world. But is there a similar solution that DB pension schemes can take advantage of? An investment platform for large DB schemes needs to be more than a ‘fund supermarket’. When working closely with a provider, it is more like a fully tailorable operational infrastructure. This offers schemes a practical and highly efficient way to achieve time and cost savings.

In this paper we look at what an investment platform looks like, the efficiencies and cost savings that you could achieve using this approach, and how you can decide if this approach is right for your scheme.

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Unlocking the efficiencies of an investment platform

Investment logistics are important

In our daily lives we are used to sophisticated logistical networks delivering our online orders the same day at the touch of a button.

While the pensions industry has evolved significantly in recent decades, it is still trying to catch up in some respects. The defined benefit (DB) investment world has barely been touched by the logistics revolution that surrounds us (unlike the world of defined contribution (DC) which has).

Logistics is important for everyone from multi-billion pension schemes to small schemes with a handful of members. An investment platform (or perhaps a better term would be an ‘operational infrastructure’) is one way to improve pension investment logistics for large DB pension schemes. In the rest of this paper we explore why this is important, the cost savings that can be achieved and what it might look like.

What is an investment platform?

An investment platform can be thought of as a portal to a set of investment funds. Much like a self-select ISA, investors can access a wide range of funds/investments easily and in a regulated way. No further documentation is required and you can have peace of mind that the funds offered have been through rigorous checks and due diligence.

The existing investment platforms available in the DC or retail investor world are not suitable for DB pension schemes. This is due to tax inefficiencies, different pricing for institutional and retail funds, and the fund structures that have been set up.

So what does an investment platform in the DB world look like? It is more than just a ‘fund supermarket’. Working with a provider that has an investment platform means large schemes can choose which parts of the platform they use. This means it should be seen more as a fully tailorable operational infrastructure than ‘just’ an investment platform.
Getting the logistics wrong could mean losing money

Operational Due Diligence (ODD) is essential in the modern investment world but it is time consuming and expensive for individual pension schemes to each carry out their own due diligence reviews.

Trustees therefore have an impossible choice to make. They can choose to do nothing and take comfort that the rest of the herd is taking the same risks. Or they can pay/undertake regular ODD reviews which will more-often than not show that there are no problems.

Smaller schemes (say under £1bn) typically use the services of an investment consultant (leveraging their manager research team and wider resources) to help with this. Although it is worth noting that this is not necessarily a foolproof solution as other investment and governance challenges remain in terms of their ability to make timely decisions and quick, efficient implementation.

Larger schemes, say £1bn+, tend to have an in-house pensions and investment team or CIO. ODD would fall under their remit however even with a dedicated team this can be challenging.

So is there another option for these large schemes? Our view is that there is, and it could in fact be a better way.

Investment platforms make ODD more efficient

ODD is not limited to oversight of asset managers and funds/investments. The role of custodians and depositaries is often overlooked even though they have a crucial function in protecting clients’ money. A recent example highlights the seriousness of this whereby a large investment manager was fined £8m by the FCA for inadequate oversight of its custodian. Pension schemes therefore need to take the operational aspects of pension scheme investing seriously.

Full ODD exercises should take days; from the prep work, pre-questionnaires and data-gathering through to a site visit, and then onto the detailed post-meeting analysis and conclusions. For large schemes, an investment platform makes this type of detailed ODD more efficient and affordable. This is because the significant scale created by combining multiple large schemes allows costs to be spread, and of course it relieves the in-house team of the time and resource costs.

Case study: ODD in action

As part of an ODD exercise, in 2013 we were digging into the operations of a high profile hedge fund. After careful research and probing, we discovered the directors of the fund vehicle had links to Madoff. This had been missed by the trustees already invested. We highlighted the links to the investment manager who replaced the directors in question.
Examples of cost savings:

- Review of legal documents and negotiation of terms: Individual schemes must either accept terms without negotiation (which favours investment managers), or pay legal fees for individual negotiation of contracts to get the right terms. Both approaches are inefficient – it would be better for schemes to consolidate and use their collective purchasing power to negotiate terms.

- Rebalancing: Pension schemes typically have rebalancing policies which result in trading assets (e.g., moving assets from growth to matching back to the strategic target split). Trading always costs money so it needs to be scrutinised carefully. The FCA Competition review highlighted the practice of “Box profits” where asset managers take risk-free profits by trading at different bid and offer prices, even though they can net the trades and don’t actually incur the bid-offer spread. Best practice would be that trades are ‘crossed’ with other investors to minimise the net trade, but to do this requires the kind of dedicated oversight that many pension schemes simply don’t have.

- Investment due diligence: Individually researching a manager’s investment capabilities is expensive. As mentioned previously, this is why many schemes use an investment consultant and their manager research capability to deliver a cost-effective service. For large schemes that have their own in-house team or CIO this is something they would look to undertake themselves. However, this remains time-consuming and expensive. Even greater scale than this is needed to deliver quality, value-for-money investment. We think there is a way to do this through an investment platform.

Doing investment logistics yourself could be career limiting!

We have yet to come across a trustee, scheme secretary, pension manager or Chief Investment Officer that wants more paperwork to review and complete. That's important because it means that the level of administrative burden can limit the choice of investments. A good strategy can add £millions of extra return and materially reduce risk. So it makes sense to make sure any obstacles to achieving the very best strategy possible are overcome and thus benefit from that potential boost of returns. In short, getting the right strategy is career enhancing (no matter your role on the pension scheme), taking on more paperwork is not.

So how do we reduce the amount of paperwork? First, much of this is essentially the same paperwork duplicated across different investors so, as an industry, we are inefficient. Second, as much as many readers may dislike it, completing most investment documentation is a skilled task needing particular expertise. It also takes a lot of time to complete all the paperwork. An investment platform allows trustees to streamline appointing a new manager.
Bringing DB pension schemes into the 21st century

Many of us are familiar with investment platforms in retail pensions and investments (e.g., Self-Select pension plans and self-select ISAs). A DB investment platform is similar but, importantly, it is much better value for money and not just a ‘fund supermarket’. It should be viewed as an operational infrastructure offering large schemes flexibility on which bits they use and which they want to retain responsibility for themselves.

The diagram below illustrates how an investment platform works. Trustees retain the big decisions such as setting the overall strategy, choosing the managers, deciding the rebalancing policy and any dynamic de-risking programme. What is different under this approach is that the implementation of the trustees’ decisions is passed to the investment platform.

Trustees still get to choose from a range of independently buy-rated managers, the difference is speed of execution and actual investment. For example, if an active equity manager needs to be changed, it can be replaced almost instantly by another. An investment platform is effectively a subs-bench full of pre-negotiated buy-rated managers, ready to step in at a moment’s notice.

Importantly, the trustees can decide which bits of the operational infrastructure they use and which bits they do not. This means it is fully tailorable to each scheme’s unique needs, preferences, resources and expertise.
Saving you money!

An investment platform can (and will) save large pension schemes money in a number of ways, including;

- **Consolidation**: Legal, operational, administrative experts in one place serving many investors
- **Amalgamation**: Removing duplication of similar activities across schemes (e.g., contract negotiation)
- **Negotiation**: Using consolidated scale and bulk buying power to negotiate better fee and investment terms

At the moment, Local Authorities are leading the charge as they work to set up ‘superfunds’ of £25bn or so in order to reduce costs for their pension schemes. It seems to us that the time is right for private sector DB pension funds to explore this approach too. Indeed both the FCA and the PLSA have called for greater consolidation and an investment platform is an excellent route to help achieve this goal.

Logistical nightmare? Or logistical dream?

In a few years’ time, we may look back on pension scheme logistics in the way that we look at creating ‘mix tapes’ 20 years ago; with a degree of nostalgia but we wonder how we ever had the time to sit and manually record each song from one tape to another to create the ultimate mix of your favourite songs! (When nowadays you just create a playlist and ‘shuffle’ it on your iphone / ipod.) In much the same way we might see that an investment platform is more nimble, more efficient and a better experience for the end-user and wonder how we ever did things differently.

As with any change though, the emergence of investment platforms ought to be scrutinised carefully. We have set out in the box some common questions that we are asked when discussing this with our clients, and the answers we give. These may be something trustees ask all providers to ensure they are comfortable with the approach and how the operational infrastructure will work.

### Common questions

**Q. Will I see fee savings with this approach?**
A. Yes. In many cases, savings will more than offset the platform costs.

**Q. Can it widen my investment options?**
A. Yes. You get access to a wide range of funds on the platform and you can still invest off-platform and costs are no higher.

**Q. Do I have greater control?**
A. Yes. By releasing trustees from operational burdens more time can be spent on sophisticated portfolios. You therefore increase control because you can afford activities such as ODD, and these are carried out regularly. You can also choose which elements of the platform you use so there is great flexibility on what the solution will look like for your scheme.
How do you know if using an investment platform is right for your scheme?

You might be thinking, how do you decide whether to use an investment platform or not? How do you know if the traditional approach is better or worse for your unique situation compared to an investment platform?

The first step is determining the suitability of this approach. We’ve listed below a number of features of your pension scheme from size, governance framework, investment strategy and expertise perspectives.

- You have £1bn+ in DB pension scheme assets (either in a single scheme or totalling across multiple schemes with the same sponsor)
- You have your own full time, in-house investment expertise
- Your investment strategy includes investing across multiple asset classes and utilises liability management tools or solutions
- You feel resource constrained and/or overcome by the paperwork needed to achieve your desired investment strategy
- Investment ideas are being rejected because they would take too long to implement or due to operational challenges
- You are willing / keen to delegate the more administrative and operational tasks of pension scheme investing

If your scheme fits most of these (ie you agree or can say yes to the majority including the £1bn+ criteria), then an investment platform approach would be suitable for your scheme. The next step would be to consider the pros and cons of each, or undertake a SWOT or similar analysis. An example of what this might look like is shown for illustrative purposes.

<table>
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<tr>
<th>Choice of managers</th>
<th>DB platform</th>
<th>Traditional</th>
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<td>✓ Based on advice</td>
<td>✓ Based on advice</td>
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| Reduced manager fees due to scale and discounts negotiated by provider | ✓ | × Less scope for negotiations |
| Savings on legal fees | ✓ Cost spread over all clients | × Cost borne by individual clients |
| Governance reduction | ✓ | × E.g. paperwork, rebalancing, transition |
| Ease of implementation for single board schemes | ✓ Easy way to utilise investments | × Accept higher costs or use CIF structure |
| Regular operational due dilligence | ✓ Included | × May be ommited |
| Combined reporting | ✓ Included | × Additional costs |
It’s also important to ask yourself a few key questions. Are the operational risks covered - when were the last ODD reviews for your managers and providers? Do you feel you (your trustees and stakeholders) are spending time where you want it to be spent? Finally, ask when you last negotiated fees with your managers – is it an ongoing process or only at the start of the relationship?

The answer to if an investment platform is right (and helpful) for your scheme is often found in the answers to these questions.

Conclusion

The operational and logistical demands UK DB pension schemes have to cope with when investing are significant. Operational due diligence, legal documentation, negotiation with managers and actually changing managers, can be time consuming and costly. Further, it can prevent a scheme investing in new ideas and accomplishing the strategy they are trying to achieve.

An investment platform is one solution to these challenges as it offers cost savings and greater efficiencies. However, it is important to think of it as more than just a ‘fund supermarket’. When £1bn+ DB schemes work with a provider that has a platform which allows them to choose which bits they take advantage of, it becomes more of a fully tailorable operational infrastructure. This offers value for money and cost savings through consolidation, amalgamation and negotiation.

The future of DB investing has never been a certain one. Even the largest schemes look externally for support or advice. With operational infrastructures now a very real option with very real benefits, we strongly believe they are worth consideration.
Working in partnership with our clients

At Aon Hewitt we believe in working closely with our clients from the very outset to understand the challenges they face and their individual needs. Working in partnership with the trustees and sponsor, we create a bespoke solution to help address these issues and help them to meet their long term goals. No two clients of ours are the same and each have their own bespoke liability benchmarks, reflecting our truly tailored delegated offering.

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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