The Evolution of Pension Scheme Investing

Looking Beyond DGFs to Fiduciary Management

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The UK pensions landscape and the challenges facing pension scheme trustees and sponsors have changed significantly over the last 30 years. How pension schemes invest and the solutions available have also evolved in reaction to this.

In this paper we look at the evolution of pension scheme investing from the ‘equity only’ days through to diversified growth funds (DGFs) and to the more recent development of fiduciary management solutions. Each of the approaches we discuss has ticked a number of items on the ‘investment shopping list’ but is this enough?

Fiduciary management is one solution to the challenges currently facing UK pension schemes. Not only can it ‘tick all the boxes’ but, perhaps most importantly, it offers a tailored solution focused on funding levels and on closing pension scheme deficits.

We believe trustees should look at their individual scheme needs and requirements, decide what their unique investment shopping list looks like and then assess if fiduciary management is the right solution for them.

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UK pensions landscape: a ticking time bomb

The UK pensions landscape has evolved significantly over the last 30 years and so has the way pension schemes invest.

Many pension schemes are now faced with large deficits and volatile funding levels. According to the Pension Protection Fund, 60% of schemes are currently in deficit, with the aggregate of those deficits totalling over £100bn (as at 31 December 2013). Over 80% of schemes are now closed to new members and / or future accruals. This means that the endgame has now started, giving trustees a shorter and finite timeframe to recover those deficits.

The combination of challenges and pressures facing pension scheme trustees and sponsors has never been so great and this has created what could be likened to a ticking time bomb.

The range of investment options available to help meet these challenges has also evolved over the last 30 years. However, many of these require greater investment of trustee time, the ability to react quickly and the need for more detailed knowledge. This places additional burdens on existing governance frameworks.

This raises a number of questions. Is there a solution to these challenges? What do pension schemes need? What are pension schemes looking for in an ideal world?

The 'investment shopping list'

Every pension scheme is unique and as such has different requirements. This could be deemed an ‘investment shopping list’ whereby schemes identify what they need to help them reach their long-term objectives and what they would ideally like to have. When reviewing potential solutions available in the marketplace, schemes then look to tick this off their shopping list to help them make a decision.

What is diversification?

Different asset classes tend to move differently through market cycles. At any one time, it is likely that some asset classes will be rising, even if others are falling.

As we have seen over the past decade, in times of market crisis, all growth asset classes tend to fall in value, but some fall by less than others. Diversification involves investing in a range of asset classes to provide protection, reduce risk and with the aim of smoother returns, i.e. not putting all your eggs in one basket.
Diversification: a key part to addressing challenges

Given the challenges faced, achieving better pensions stability is now a key focus for many schemes and sponsors. Diversification is a key part of any solution.

Diversification can give smoother returns than investing in a single asset class, without reducing the expected level of returns. Hence, it can improve the risk and return profile of a portfolio over an economic cycle, giving investors a theoretical ‘free lunch’.

Definitions

- **Active management**: A type of portfolio management where the fund manager deliberately invests their portfolio out of line with their benchmark in the expectation / aim of generating a higher return.

- **Dynamic asset allocation**: The tactical tilting of portfolios to reflect market views / economic conditions in order to capture opportunities and help ensure clients meet their objectives. Often used interchangeably with tactical asset allocation.

- **Best of breed managers**: Not all asset managers have strengths across all asset classes and strategies. Best of breed refers to those funds which are top tier in their particular asset class / strategy.

The evolution of how pension schemes invest

The evolution of how pension schemes invest has been driven by the need for diversification and ultimately the need for pensions stability — so the ability to tick off as many items on the ‘investment shopping list’ as possible is key.

In the rest of this paper we look at how pension scheme investing has evolved, and how each of the approaches fares against the list.

Equities only

In the 1970s and early 1980s many schemes only held equities. Initially this was just UK equities but subsequently there were moves by schemes to include overseas equities as well. Pension schemes were focused on generating growth / returns and equities were seen as their ‘growth engine’.

Few other asset classes were held, nor was it thought necessary to expand this any further. This solution worked well at this time as things were relatively straightforward for trustees and sponsors with the majority of schemes open and well funded (unlike today). Equities were delivering strong, consistent returns and deficits were pretty much unheard of; member benefits were secure.

However, as the landscape evolved such an approach became less appropriate for the challenges faced. Equity returns became more volatile, trustees recognised scheme maturity was rising and legislation was introduced that forced schemes to reduce surpluses and increase member benefits. This drove trustees to look at reassessing their investment approach and consider other alternatives to just equities alone.

Balanced funds

Balanced funds emerged in the 1980s with the aim of better diversification of returns (and to provide some protection) through including a wider range of asset classes, not just equities.

The benchmark for these funds was the median value of similar balanced funds and hence the asset allocation typically reflected the average of those rather than a scheme’s requirements. Trustees effectively delegated the asset allocation, and choice of underlying holdings within asset classes, to their balanced manager. This was a relatively cost effective solution as it was a ‘bundled’ package.

Balanced funds emerged in the 1980s with the aim of better diversification of returns.
The 1990s saw the introduction of further pensions legislation (Pensions Act and Minimum Funding Requirement) which forced schemes to put in place recovery plans to reduce deficits and think more carefully about their investment strategy.

In response to this, and acknowledging some of the pitfalls of the balanced approach, and that one size no longer fits all, “do it yourself diversification” emerged with scheme specific benchmarks. This meant that schemes were able to tailor their portfolios to their specific needs and invest in best in class managers for each asset class.

The portfolio was largely made up of equities and bonds but, importantly, assets were invested with some consideration to scheme funding and covenant, which helped stabilise funding levels. In order to get the levels of diversification needed and the full benefits of this approach, trustees would need to actively review their asset allocation and the underlying investment managers. However, this significantly increased governance requirements — in terms of pressures on trustee time and the wider range of investment to understand and monitor.

Not all schemes had the time and governance framework to be able to do this fully, or large enough in asset size to access all the asset classes required to give a good level of diversification. Depending on the scheme size this can also be an expensive approach.

By splitting up the investment strategy by asset class, as part of this DIY approach, schemes lost the ability to move quickly (as trustees were typically limited to making decisions at their quarterly meetings with inactivity in between). Delegation was also constrained to each manager making stock selection decisions within their asset class.

The sentiment of this approach was the right one (diversification, tailored solutions etc), however the governance pressures, scheme size and cost issues that were evident is what led to the creation of DGFs around 2005.

DGFs are a single fund that includes a number of growth asset classes which aim to produce long-term absolute returns above an inflation or cash benchmark with less volatility than equities. DGFs are similar to traditional balanced funds, although they tend to invest in a larger range of assets and take a more active approach to choosing how much to invest in different asset classes.

With this approach, trustees delegate the management of these assets to the manager; so the manager is responsible for taking asset allocation and stock selection decisions as well as the discretion to use derivatives. The underlying funds may be internally or externally managed and the manager can choose between active and passive funds. Utilising manager expertise to deliver intelligent implementation is a key attraction.

DGFs tried to deliver the benefits of the DIY approach but in a way which was cost effective and which was accessible by schemes of all sizes. It was also seen as a good way to overcome the governance burden that the DIY approach had re-introduced - so there was a rapid take-up of these funds.

Definitions

• **Equities**: An equity is a share of ownership of a company, also known as a stock. The objective of an equity is to generate long term growth through capital gains and dividends.

• **Balanced funds**: Pooled funds investing in equities and bonds. The split between the two asset classes remains fairly static and ‘balanced’, usually around 60% in equities and 40% in bonds. However some have a significantly higher allocation to equities.

• **Diversified growth funds**: A pooled fund that invests in a range of asset classes. They typically aim to achieve equity-like returns but with 2/3rds the volatility. The manager has been given total freedom on how to achieve the end-goal / target, in terms of underlying investments, asset allocation etc.

While DGFs give schemes greater access to diversification and the ability to tilt portfolios to the current environment, they could also be described as ‘new age balanced’. This is because they have reintroduced some of the issues of the balanced approach seen years ago — a pooled fund, with access to a wider opportunity set, but with no ability to tailor and use of in-house funds in most cases (so losing the best in class managers for...
each asset class). As an off the shelf product, the lack of tailoring means the portfolio cannot be adjusted to any specific requirements your scheme has.

DGFs tried to deliver the benefits of the DIY approach but in a way which was cost effective way and which was accessible by schemes of all sizes. As with all the approaches up until this point, DGFs failed to look at anything but the growth engine, meaning funding level volatility was still high as liabilities moved in disconnect. The current pensions landscape, as briefly outlined at the start of this paper, has become so challenging that trustees and sponsors are searching for a solution that brings together the benefits of all these approaches in a cost efficient manner with a simple governance framework – something that ticks all the boxes. This is how fiduciary management emerged around 2008 onwards.

Fiduciary management solutions

Fiduciary management is the most recent solution to become available to UK pension schemes and is very much an evolution of the previous approaches. It looks to draw out the best of the balanced, DIY and DGF approaches but in a more simple governance framework and with none of the sacrifices.

Exactly the same as with a DGF approach, trustees delegate the management of their assets to a fiduciary provider (including asset allocation, stock selection and, where appropriate, the use of derivatives). Importantly, trustees retain all the strategic investment decisions and setting of the investment objective. The fiduciary manager is able to provide daily attention to the scheme and react quickly to changes in the market. This means opportunities can be captured as they arise and funding level improvements can be locked-in by dynamically de-risking (usually as part of an agreed flight plan). Importantly and unlike the other approaches, this daily attention is not just about the scheme’s assets but looking at the assets relative to the liabilities, and so in the context of the overall funding level. This is all within a clear framework and parameters set by the trustees at the outset.

Fiduciary management is very much an evolution of the previous approaches.

One of the key differentiators that fiduciary management offers pension schemes, which the other approaches do not, is a bespoke solution that is tailored to each scheme’s unique circumstances. This is combined with the ability to offer access to an extensive range of asset classes, with active management, dynamic asset allocation and all within a cost effective framework. Many fiduciary managers, particularly those with a consultancy heritage, will also only invest in their buy-rated managers, ensuring best-in-class managers are included.

Fiduciary management therefore fulfils all of the elements on the ‘investment shopping list’. But are there more elements to consider above and beyond the list? Every investment strategy needs to be right not just for today, but to also be able to evolve and ensure the pension scheme is best placed for the future.

One of the key differentiators that fiduciary management offers pension schemes, which the other approaches do not, is a bespoke solution that is tailored to each scheme’s unique circumstances.

‘Investment shopping list’

<table>
<thead>
<tr>
<th></th>
<th>Equities only</th>
<th>Balanced funds</th>
<th>Do it yourself diversification</th>
<th>Diversified growth fund</th>
<th>Fiduciary management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wide range of asset classes</td>
<td>✗</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Active management</td>
<td>?</td>
<td>?</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Best of breed managers</td>
<td>?</td>
<td>✗</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
</tr>
<tr>
<td>Tailored to individual circumstances</td>
<td>✗</td>
<td>✗</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
</tr>
<tr>
<td>Cost efficient</td>
<td>?</td>
<td>✔</td>
<td>?</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Dynamic asset allocation</td>
<td>✗</td>
<td>?</td>
<td>✗</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ability to lock-in gains</td>
<td>✗</td>
<td>✗</td>
<td>?</td>
<td>✗</td>
<td>✔</td>
</tr>
</tbody>
</table>
Ticking off these boxes alone is not enough

In today’s pensions landscape the focus for pension schemes is no longer just about returns and improving the diversification of your growth engine to smooth those returns. With the introduction of the minimum funding requirement and then scheme specific funding in 2005, there is now legislation in place that requires schemes to have investment strategies in place that are relevant to their unique circumstances and focused on meeting their funding level goals.

What all of the first four approaches failed to do was to look at assets (growth engine) in unison with the unique liabilities of the scheme. So while the ‘investment shopping list’ is important, it should not just be focused on from the perspective of the growth assets alone. The focus of any solution has to be around improving funding levels and reaching your long-term objectives.

The complete solution therefore has to tick all the boxes from both the growth and liability perspectives. It also needs to take into account the governance framework (and governance budget) of the scheme. Is there a complete solution that does all of this but without increasing the governance burden on trustees?

The focus of any solution has to be around improving funding levels and reaching your long-term objectives.

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**What do we mean by governance framework and budget?**

Governance framework is the rules and practices under which the trustees carry out their responsibilities for the scheme. In a traditional investment context this will include setting the Strategic Asset Allocation, making Tactical Asset Allocation decisions, hiring and firing investment managers, managing transitions between asset classes and managers and ensuring compliance with regulatory requirements.

A governance ‘budget’ broadly defines the amount of time and resource the trustees have available to carry out these tasks.

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**Fiduciary management: ticks all the boxes and more**

As previously mentioned, fiduciary management is very much focused on improving scheme funding levels and helping trustees and sponsors meet their objectives, ultimately securing member benefits and providing pensions stability. It offers a complete and comprehensive solution. Not only does it tick all the boxes in the growth engine and diversification department (ticking more boxes than a DGF) but it also takes into account each schemes’ unique liabilities. Importantly, it does all of this without needing a complex governance framework (discussed further under the ‘potential benefits’ section shortly).

The chart (below) shows each of the approaches discussed in this paper, and the level of diversification versus the level of governance budget / input required.

<table>
<thead>
<tr>
<th>Diversification</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Fiduciary</td>
<td>DGFs</td>
</tr>
<tr>
<td>Balanced</td>
<td>Equities</td>
</tr>
<tr>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

**Potential benefits of a fiduciary management approach**

Under pure fiduciary, every solution should be totally bespoke and so no two solutions will look the same. This means that schemes can tailor any element of their solution and include any requirements or restrictions within the set guidelines and parameters the fiduciary provider must work within. For example, schemes may stipulate a preference to exclude property from their portfolio due to a shorter time frame to reach their end-goal. Fiduciary management allows trustees to specify any unique requirements.
The primary aim of fiduciary management is to achieve a scheme’s long-term goal in a risk-controlled and cost effective manner.

Fiduciary solutions provide a high level of diversification of the growth assets and, typically, improved liability matching (protecting the scheme against interest rate and inflation risks). This helps to reduce the risks faced, smooth returns and provides greater certainty around reaching your end-goals.

Fiduciary solutions can incorporate a flight plan and dynamic derisking programme. This is where assets are shifted from growth to matching when pre-agreed funding level trigger points are reached. This ensures opportunities to de-risk are captured, locking-in gains as funding levels improve. The frequency of monitoring and speed of implementation varies between providers.

With all of the different elements and services that fiduciary management provides, it may sound as though there are additional burdens placed on trustees. However this is not usually the case. In the vast majority of cases, the overall governance budget is reduced by such an approach. A fiduciary management solution enables trustees to step back and focus on the strategic decisions of the scheme while the day-to-day management and monitoring of the portfolio and investment are monitored by experts. Most fiduciary managers have investment professionals looking at their clients’ portfolios daily and making any changes quickly and efficiently (this varies from same day implementation to a week or two; all of which are significantly quicker than would usually be seen by the average UK pension scheme).

Conclusion

The pensions landscape and individual pension scheme circumstances are continually changing. The solutions available to sponsors and trustees are also evolving and expanding alongside this. What was available and most appropriate in the past may no longer be suitable now.

It is therefore important that schemes take a fresh look at what is the best available solution for their specific scheme. This should be viewed alongside your investment shopping list, and long-term objectives, and reviewed regularly to ensure the solution you have in place is the best one for you.

Fiduciary management is the more recent solution that has become available to pension schemes, however, it is not the only option. What fiduciary management does offer - which makes it attractive - is the best of balanced, DIY and a DGF but without the sacrifices of those approaches. The key differentiator is that fiduciary management looks to offer a complete solution, viewing assets and liabilities in unison, focusing on improving funding levels and pensions stability with the ability to tailor the solution to a scheme’s unique needs.

All pension schemes are unique and therefore there is no one solution that fits all.
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