

A guide to

# Investment governance

To be read alongside our DC code of practice no. 13



Also in this series:

1. The trustee board
2. Scheme management skills
3. Administration
5. Value for members
6. Communicating and reporting

## About this guide

This is one of six guides to support trustee boards in meeting the standards set out in our Code of practice 13: Governance and administration of occupational trust based schemes providing money purchase benefits ('the DC code').

- ▶ The trustee board
- ▶ Scheme management skills
- ▶ Administration
- ▶ Investment governance
- ▶ Value for members
- ▶ Communicating and reporting

While the DC code sets out the standards we expect you to meet when complying with the law, the guides provide information on how you might meet those standards in practice. You should read the DC code before you read this guide.

The guides aim to provide you with practical information and examples of approaches you could take, and factors to consider. The guides are not intended to be prescriptive, though in some instances we state what we consider to be best practice (ie an approach that should be followed in most circumstances). Often, the methods you choose to adopt will depend on the nature of your scheme and its membership.

In the case of AVCs, where legal obligations apply you should consider the risks to members in the context of the significance of the value of AVCs relative to members' overall benefits in the scheme, and apply a proportionate approach to meeting the relevant standards in our DC code.



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## The trustee board's role in investment governance

As a trustee board, you retain ultimate responsibility for a scheme's investments, but this doesn't mean that you have to (and you may not be permitted to) do everything yourself and you may find professional advice is required to understand where delegation is appropriate.

Certain tasks and decisions can be delegated, but you should take reasonable steps to satisfy yourself that whoever is undertaking the task has the appropriate knowledge and experience and is performing their role competently in accordance with section 36 of the Pensions Act 1995.



See **section 36 of the Pensions Act 1995** for more information.

Where investment powers are not delegated, it is important to obtain relevant professional advice in relation to the scheme's investments (and in some cases you must do so), but it is your role to decide how scheme assets should be invested.

Your scheme's investment governance arrangements need to be consistent with your legal powers and responsibilities regarding investment. The Law Commission has prepared an overview (see chapters 3 and 4), summarising the interaction between relevant parts of the law including trust law, pensions law, financial services legislation and the scheme's trust deed and rules.

We expect you to have suitably documented investment governance arrangements that are appropriate for your scheme's circumstances, including their level of complexity. These arrangements should enable effective and timely decision-making, focused on the decisions most likely to make a difference.

If you think the trustee board does not have the skills and expertise necessary to do this, you should consider your options for addressing these weaknesses, such as increasing your skills and expertise, delegating, simplifying the investment arrangements, or winding up the scheme. In taking such steps, it would demonstrate good practice to document your actions, the reasons they were needed and the improvements you expect to see.

If you're unsure whether your scheme's particular investment governance arrangements are consistent with the law, you should obtain appropriate legal advice.

Where you outsource or delegate any part of the investment governance structure, you will need to be confident that those functions are still carried out in accordance with legal obligations, with the best interests of beneficiaries in mind, and by people with the right expertise.

It is important that the terms of contractual arrangements and fund documents in place with investment managers and advisers are reviewed and negotiated as appropriate to ensure this is achieved.

If your scheme is a wholly insured bundled arrangement incorporating investment services, consideration will be appropriate of your level of awareness and understanding of the investment governance arrangements the provider has in place and be satisfied that they are in line with the beneficiaries' best interests.

## **Working with your investment advisers**

We expect you to consider what advice and other input you need to govern the scheme's investments effectively (including consideration of what advice may be needed beyond just complying with legal requirements). It's your responsibility to decide when to use advisers for the specific circumstances of your scheme, taking into account the investment knowledge and experience at the board's disposal and the relevant legal requirements.

The role of the person giving the investment advice can vary depending on the nature of the advice, scheme size and complexity, and the governance structures used. When we refer to 'investment adviser' in this guidance, we're not being prescriptive about their precise role. For example, they may be in-house for the largest schemes, an external investment consultant or an actuary performing some of the roles of an investment consultant. You may find it appropriate to seek advice from different sources on different investment matters.

As well as appropriate use of investment advisers, we would encourage you to make use of the other sources of investment knowledge available to you, which may include professional trustees, investment managers, investment service providers and, for larger schemes, in-house investment teams.

Different advisers will have different views on the relative importance of different aspects of investment, which will vary with your scheme circumstances. However, you may find it useful to consider your various investment decisions in an order that will depend on your scheme's particular circumstances. A suggested broad order is set out below:

- ▶ Investment governance structure.
- ▶ Investment beliefs (if you have developed these).
- ▶ Investment objectives and member preferences where identified.
- ▶ Risk capacity and risk appetite of the trustees and the members.
- ▶ Risk management approach.
- ▶ The design of the default investment strategy.
- ▶ Investment manager selection and implementation.
- ▶ Ongoing monitoring of the investment proposition.



It is good practice for your SIP to cover these areas (in addition to the items required by legislation). See the section on **Investment decisions and your statement of investment principles (SIP)**.

Other investment decisions which, depending on the circumstances, may have a lower impact and you may wish to include are:

- ▶ the range of self-select funds offered to the membership
- ▶ investment operational and fund platform provider selection and ongoing monitoring
- ▶ existence of plans to support the membership at retirement when they wish to manage the drawdown of their accumulated fund.

Consideration of these aspects will help trustees determine which decision-making to retain and which to delegate. For example, you may wish to delegate decisions about the design of the default investment strategy or responsibility for selecting and replacing investment managers to an investment sub-committee.

You need to be able to critically evaluate the main points of the information you receive and understand the key underlying assumptions. This would include consideration of any likely biases (certainly in relation to potential legal or commercial conflicts of interest) and any interest the person giving the input may have in the decisions to be made.

It is also important to consider value for money in relation to the nature of any costs and charges applicable to any advice you seek and/or investment transactions that may result (and this will form part of the value for members assessment that many DC scheme trustees are required to carry out and report on in their annual chair's statement).

The FCA's Institutional Disclosure Working Group (IDWG, now Cost Transparency Initiative (CTI)) has developed investment costs and charges templates (<https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative>) that you might choose to require your investment fund managers to complete to provide you with this information. If you lack the skills and expertise to make sense of the data provided through the templates, you could seek advice, for example from your investment consultant, to help you interpret this information.

Consider your members' best interests in this regard. You may decide this is served by greater returns from a higher cost product/service or you may decide that one with lower fees will leave greater returns for members (lower volatility may be another factor to assess).

It is good practice for you to give your scheme members sufficient information on your decision-making processes regarding value for money of investment costs and charges on advice and investment transactions. If you are required to prepare a chair's statement, this may be considered as part of the preparation of that statement.

## Investment delegation structures

Your governance structure should strike an appropriate balance between speed of action and checks and balances to ensure that any actions you take are appropriate. A simple investment structure might involve four parties - the trustee board, the investment consultant, the legal adviser and the investment manager.

Under this structure, the trustee board determines the overall investment objectives and makes the strategic investment decisions, eg the risk/return profile appropriate to the membership and the design of the default investment strategy. Suitable advisers, such as the investment consultant and legal adviser, will advise the trustee board in relation to what they need to consider as part of their decision-making process. The day-to-day investment decisions, eg which individual investments to hold, and which are delegated to investment managers.

This structure can work well, provided that the trustee board is able to devote enough time and skill to the scheme investments and is able to convene quickly to make decisions if required.

You may be able to improve the investment governance by setting up an investment sub-committee. Depending on the terms under which the committee is constituted, it may be able to take some of the investment workload from the whole trustee board. When deciding whether you need an investment sub-committee, consider questions like:

- ▶ How diverse is the membership? Do you have a variety of members with different characteristics for whom investment objectives are likely to vary – and what is your understanding of the specific needs and spending patterns of individual members at retirement?
- ▶ What is the size of your scheme membership?
- ▶ Does your scheme have the resources to cover the cost of a sub-committee?
- ▶ Does the complexity of the investments held by your scheme require you to spend more time on investment issues outside of regular trustee board meetings? You may wish to consider the implications of the CMA's investigation of the Investment Consultancy Market, and whether you really need such complex expensive investment solutions and in whose interests such products have been designed and sold.



See the **CMA's investigation of the Investment Consultancy Market** for more information.

If you decide to set up an investment sub-committee, you may wish to consider the balance between independent, employer and member-nominated trustee (and perhaps non-trustee, eg investment consultant) members of the committee. It is worth considering whether the trustee appointments are based primarily on the individual skill set and 'fit' with the skill set needs of the trustee board.

## Clear roles and responsibilities

Regardless of the investment governance structure in place, all the involved parties need to be clear on where responsibility and accountability sits in relation to the provision of oversight, advice and decision-making. Clear terms of reference are important for any sub-committees, as are documented service level agreements with providers.



See also the guide on **Scheme management skills** for more information.

It may be helpful to prepare a matrix or table of accountabilities, showing the delegation and control structure within your scheme. An example table you can adapt for your scheme can be found in **Appendix 2**.

You may wish to prepare a high-level summary of the governance arrangements, explaining in a few key points what they are and why they have been chosen. This could form part of the scheme's statement of investment principles (SIP) (see the following section and our guide on **Communicating and reporting** for more information on SIPs), or be part of a larger, overall governance plan. You could make this summary available to members, eg by publishing on the scheme's website or the employer's intranet.

The document may help when you review the investment governance arrangements, as it will record the outcome of the previous review and the rationale behind it.



See our guide on **Communicating and reporting** for more information on SIPs.

## Investment decisions and your statement of investment principles (SIP)

The purpose of a SIP is to set out your investment strategy, including the investment objectives and investment policies you adopt.

The law requires trustees of a trust-based occupational pension scheme with at least 100 members to prepare a SIP and ensure it is reviewed at least every three years and without delay after any significant change in investment policy<sup>1</sup>. It is a legal requirement that you take written advice when preparing and revising your SIP<sup>2</sup>.

From 1 October 2019, such trustees must also specify:

- ▶ their policies in relation to financially material considerations (including those relating to environmental, social and governance (ESG) considerations, such as climate change), over the appropriate time horizon of the investments including how those considerations are taken into account in the selection, retention and realisation of investments
- ▶ their policy in relation to:
  - the exercise of the rights (including voting rights) attaching to the investments, and
  - undertaking engagement activities in respect of the investments (including the methods by which, and the circumstances under which, trustees would monitor and engage)
  - And by 1 October 2020, their policy in relation to trustees' arrangement with any asset manager explaining; how it incentivises the asset manager to align its investment strategy and decisions with the trustees' policies, how it incentivises the asset manager to make decisions based on assessments about medium to long-term financial and non-financial performance of an issuer of debt or equity and to engage with such issuers in order to improve their performance in the medium to long-term, how the method (and time horizon) of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the trustees' policies, how the trustees monitor portfolio turnover costs incurred by the asset manager, and how they define and monitor targeted portfolio turnover or turnover range, and the duration of the arrangement with the asset manager.

1 Regulation 2(1) of the Investment Regulations.

2 Regulation 2(2) of the Investment Regulations.

- ▶ the extent (if at all) to which members' views on non-financial matters (including ethical views, views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme) are taken into account in the selection, retention and realisation of investments.

Trustees of schemes of at least 100 members offering money purchase benefits are also required to make their SIP publicly available free of charge on a website, unless exempt, for example where the only benefits are those attributable to additional voluntary contributions.

## Sustainability

You must consider financially material risks relating to your investments over an 'appropriate time horizon' of the investments. 'Appropriate time horizon' means the length of time you consider is needed for the funding of future benefits by the investments of the scheme. This requires you to consider risks in the context of a scheme's own profile and maturity. The length of time refers to benefits payable by the scheme and not the duration of individual investments, so for example, trustees of schemes approaching buy-out or wind-up are likely to need to consider financially material short-term risks. By contrast, for many ongoing schemes the appropriate time horizon looks towards the longer-term in a way that reflects the demographics of members and beneficiaries.

Consideration of ESG factors allows you to evaluate the short and long-term financial risks and opportunities of your investments by looking at the current practices of the firms in which you invest. Environmental considerations might include carbon emissions and water management, social considerations might include employee or local community relations, and governance considerations might include board diversity and remuneration.

In seeking to apply your policy in relation to ESG issues in your investments, you should carefully consider the demographics of your scheme and the nature of potential ESG issues that may affect the risk adjusted return that members may receive. Where a pooled fund is chosen, your ESG approach may be constrained by the fund options available. Care is then required to understand the ESG approach of the available funds, including in the selection criteria for new funds, and monitoring how managers take account of ESG factors in practice.

It is important to understand the implications of the systemic risk of climate change on investment decisions in the context of your scheme when developing your SIP. In doing so, you should consider talking to your advisers and asset managers (unless you have the relevant in-house expertise and capacity) about how climate change risk (including both long term risk presented by raising global temperatures and potential short-term risks associated with transitioning toward a low carbon economy) is currently built into their recommendations and what, if any, measures are taken to reflect it within portfolios. As climate change is a systemic, macro-economic risk, you should also consider how engagement could be used to mitigate these risks by engaging with investee companies, policymakers and collaborative industry initiatives.

You should consider the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD), which have been endorsed by the UK government, these recommendations provide a global framework for identifying, assessing, and managing climate-related risks. You can find asset owner guidance to help engage with fund managers on climate-related risks and opportunities at <https://www.tcfhub.org/>

The PLSA's climate risk 'guide for trustees' gives an overarching practical framework for schemes on how to consider climate risk for trustees: <https://www.plsa.co.uk/Policy-and-Research-Document-library-More-light-less-heat>

Many members of DC schemes will be invested for a long time and will be exposed to longer-term financial risks. These potentially include risks relating to factors you will probably have encountered while preparing your policy around ESG factors, and could be financially significant, both over the short and longer term. When setting investment strategies, we expect trustee boards to take account of risks affecting the long-term financial sustainability of the investments.

You will want to assess the financial materiality of these factors and to allow for them accordingly in the development and implementation of your investment strategy. You should ask your investment manager(s) and investment adviser for help with this if you do not have the necessary expertise in-house.

Once you have considered the longer-term sustainability of your scheme's investments, you may need to take action to ensure that your policies are being applied; possibly including active public policy engagement, collaborative initiatives and advocacy. This might include making changes to the investments included in the default arrangement or those offered to members to select, or engaging with the companies in which investments are held (either directly or via your investment manager or bundled service provider as appropriate).

## Financial and non-financial factors

### Financial factors

When considering investment decisions/setting investment strategy, you should take into account all factors that are financially material to the performance of an investment and you may require professional legal advice to help clarify your understanding of them. It is a legal requirement that your SIP includes your policy on these factors.

The following considerations may help you identify and assess whether the financial factors of your investment plan are material or not:

- ▶ A relatively minor negative financial factor for the default fund or default arrangement may have an impact on a very high proportion of the scheme membership and may be of a material concern to you. On the other hand, a material negative financial factor for an additional self-select fund, in which only a handful of members are invested, will still be a significant issue to members impacted by it, and therefore will also be a material concern to you.
- ▶ You may also need to consider the proportion of a fund that is owned by your scheme, particularly where you have been involved in its specific design. For instance, careful consideration may be needed in relation to the early days where the fund viability might be compromised by any meaningful disinvestment (for example a member transferring out), exposing remaining members to excessive costs or a sub-optimal investment strategy (possibly over weight in the more illiquid elements of the portfolio).
- ▶ Determining what will constitute a financially material consideration will often involve professional judgement.
- ▶ Many members will be invested in the same fund for many years if not decades into the future. The ultimate benefits received by a member will largely depend on the performance of the fund. You are required to consider your policy on financially material considerations over the appropriate time horizon for your members.

You should satisfy yourself and be able to demonstrate that you, or your chosen advisers, have considered, understood and adequately addressed issues of financial materiality relating to your scheme's investments - in line with your SIP. Consider expertise on these issues when appointing advisers and fund managers.

## Non-financial factors

Non-financial factors are factors that are not motivated by 'financial' concerns of balancing rewards against risk in certain circumstances. You may find it a useful exercise as a trustee board to challenge yourselves about what you believe to not be financially material.

While non-financial factors are subordinate to the main purpose of providing a pension, the Law Commission concluded that trustees may take account of non-financial factors:

- ▶ if they have good reason to think that scheme members share a particular view, and
- ▶ their decision does not risk significant financial detriment to the fund.



See the **Law Commission** for more information.

From 1 October 2019, trustees preparing a SIP are legally required to include the extent, if at all, to which non-financial matters will be taken into account in the selection, retention and realisation of investments. Here, 'non-financial factors' means the views of members and beneficiaries, including in relation to ethical matters and their views on social and environmental impact and present and future quality of life of the members and beneficiaries. While these are given as examples of non-financial factors, you may instead consider these financial factors due to the way you view their impact on investment returns and treat them accordingly.

In determining the investment principles for your scheme, you may in certain circumstances choose to consider factors which are not financially material to your scheme. These could include offering funds that select investments according to particular religious principles or are based on environmental or social impact.

Decisions based on non-financial factors should be taken considering all factors and considering evidence on both questions the Law Commission identified as a test, ie do you have good reason to believe that members share the concern and are they satisfied that the risk would not involve material detriment to members relative to a scenario where those factors were disregarded? If the issue is not controversial, and there is good evidence of agreement from some people, the Law Commission has said that you may act on these views even if many people fail to engage.

Where there is a disagreement among members around a controversial non-financial investment proposal, the Law Commission comments that the courts are likely to expect you to focus on financial factors.



See the **Law Commission** for more information.

You as trustees have primacy in investment decisions. While you should not necessarily rule out the option to take account of members' views, you are never obliged to do so. Having a carefully considered policy in place on how you will take non-financial factors into account is likely to avoid uncertainty or disputes at a later stage. In the following section, we consider the extent you may choose to canvas the views of members.

### Example: Considering financial factors

The trustees first review their training and knowledge, and the reports received from the fund manager on stewardship activities, scenario analysis and impact on asset allocation. Then, when reviewing the SIP, the trustees, consider market developments and conclude that climate risk is financially material to the investment strategy and therefore the return their members may receive. They set out the following investment belief:

'As long-term investors, we believe climate risk has the potential to significantly affect the value of our investments.'

They develop this belief in their SIP as follows:

- ▶ We expect fund managers to have integrated climate risk into their risk analysis and investment process and, where appropriate and practical, we will take it into account when managing new and existing investment arrangements. When monitoring the performance of our fund managers, we will also regularly consider how they are performing with reference to climate risk issues. Given the systemic nature of climate change, we will also seek to discharge our duties by robust engagement with investee companies to encourage alignment with a low carbon economy and with policy-makers and governments to advocate for the same.

This is worked into a policy in the SIP, setting out how they will consider climate risks and opportunities when appointing, monitoring, engaging with and replacing investment managers.

The trustees decide to report annually in their SIP implementation report on how the climate risk policy has been applied. (From 1 October 2020 there will be an obligation on DC schemes with at least 100 members (unless exempt eg AVC only) to report in an implementation report, on, among other things, on how the principles set out in the SIP have been followed. This forms part of the annual report and must be made publicly available, free of charge, on a website. See **page 30** for more information.

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Example: Considering financial factors continued...

**Learning point:** Many factors can impact investments over the long-term. Where you consider these to be financially material, you are required by law to factor them into your investment decision-making.

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**Example: Considering non-financial factors**

The trustees of ABC Scheme receive communications from members setting out ethical concerns about some individual investments held within the scheme's investment portfolio.

The trustees don't have a position on the relevant ethical issues. They conduct a survey of members and beneficiaries to ascertain whether the ethical concerns are reflected within the scheme's membership.

The trustees receive a high number of responses as a proportion of the total membership, and a greater number compared to responses relating to other member communications. The majority were strongly in favour of factoring ethical considerations into investment decision-making. The remainder were not strongly opposed to doing so, provided the returns for the scheme were not expected to be materially less as a result.

The trustees seek advice from their investment adviser, who performs a comparison of products with investment characteristics suitable for inclusion in the scheme's portfolio, including the existing investments in question, and alternative market products, including those which address the majority of members' ethical concerns. They indicate that investing in a way that addresses the ethical concerns expressed would not materially reduce the scheme's expected returns (net of fees) or increase the scheme's investment risks.

The trustees review their investment beliefs and develop an addition to their policy on non-financial factors in their SIP. They also engage with their investment managers to embed the ethical principle in their existing mandates and all new investment mandates. They need to consider any transaction costs arising from fund switching required to achieve this.

Some research methods can be expensive. Alternatives might involve reviewing relevant publicly available data from sources such as YouGov surveys or corporate position statements.

**Learning point:** There is no legal requirement to do so but you may take non-financial factors into account if you have good reason to consider the members hold a similar view, you are satisfied that the new investment does not present a risk of significant financial detriment - and the costs involved with making the necessary assessments and adjustments are justified.

## Members' views

Low levels of member engagement, as noted in The Law Commission's report, **Pension Funds and Social Investment**, can make it hard to understand how your members want to see their scheme's assets invested.



See **The Law Commission's report, Pension Funds and Social Investment** for more information.

We don't expect you to consult with members on every aspect of their investment preferences, but you may wish to consider representations that members do make to them about their preferences.

If you believe there is a chance the wider membership would support a proposed ethical investment position, you might conduct a member survey before adopting or rejecting the proposal.

When you consider that the suggested proposal will not present an additional risk of significant financial detriment to members, you can adopt it as part of your investment principles. This should align with the policy set out in your SIP. If it does not, we expect that you consider whether you need to revise your SIP.

The Law Commission has made clear that it is not always necessary for trustees to survey scheme members to understand their concerns. It should be possible to make assumptions based on the information you already know about the membership of the scheme or the population as a whole.

Aside from surveys, you could use other methods of gaining members' views as set out in our **Communicating and reporting** guide, such as setting up a member panel (for larger schemes) or running focus groups of forums.



See our guide to **Communicating and reporting** for more information.

You should bear in mind that members' views on an issue might change over time.

### **Example: Considering members' views**

It would be reasonable to assume that, in the UK, the overwhelming majority of people would be opposed to controversial business practices, investments in warfare or single-use plastics, even if they offer significant returns or are legal under UK jurisdiction.

The trustees might form a view that the reputational risks associated with businesses relying on these products elevates them into the category of material financial risks.

#### **Learning points:**

- ▶ Where you determine that members are likely to hold a particular view on a matter and you therefore are unlikely to need to consult with them to confirm their position, your policy (if you have one) on taking account of non-financial factors and the circumstances you would account for in consulting members, will make clear what actions you may or may not choose to take to inform your decisions.
- ▶ Having up-to-date policies in place will help you respond to members about their investment requests.

## Monitoring investment governance

We expect that you regularly assess how effective your investment decision-making and governance processes are, considering the impact on the scheme performance and meeting the following in relation to your scheme's objectives:

- ▶ Your own performance as a trustee board.
- ▶ The implementation of the investment strategy, including, where applicable, the performance of your fiduciary manager - trustees need to regularly review and assess the performance of their investment consultants as suggested by the CMA Consultants Market Investigation.



See the **CMA Consultants Market Investigation** for more information.

- ▶ The advice you have taken relating to setting investment strategy and implementing investment decisions.
- ▶ Your understanding of the costs of delivering investment services.

The level of attention you pay to these areas should reflect their potential contribution to your scheme's objectives. Your review should focus on value and not just cost.

## Reviewing your own performance as trustees

Some issues to consider are:

- ▶ Does the investment governance structure of the trustee board enable appropriate oversight and for decisions to be made effectively and in a timely fashion? See the FCA Asset Management Market Study insights on behavioural biases with trustee decision-making which might also be taken into consideration. See: <https://www.fca.org.uk/publication/research/tilba-baddeley-liao.pdf>
- ▶ Is sufficient investment advice and knowledge available to enable decisions to be made in a considered manner?
- ▶ Could the same level of investment performance be delivered more efficiently at a lower cost (eg by replacing some active management with passive management)?
- ▶ Have the potential benefits of consolidation been considered, such as access to a wider set of investments, economies of scale and lower costs?
- ▶ Does the investment proposition remain suitable for the evolving profile of the scheme membership?

- ▶ Are the investment service providers (such as the investment adviser), investment platform, investment operations and investment managers being held to account and are agency issues addressed?

## Investment beliefs

You may find it helpful to develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. Investment beliefs, supported by research and experience, can help focus your investment decision-making and make it more effective. If you do this, your investment strategy should then reflect those beliefs.

Some example beliefs in the areas of risk, active management and responsible investment are set out below, to show how they can be set out as simple, short statements. They also show that different investors can hold different beliefs. Note these are examples by way of illustration only.

### Examples: Investment beliefs

- ▶ Risk is necessary to achieve return, but not all risks are rewarded.
- ▶ Risks that are not sufficiently rewarded should generally be avoided, hedged or diversified.
- ▶ Markets are not necessarily efficient and there are opportunities for good active managers to add value.
- ▶ Finding investment managers who can consistently spot and exploit market opportunities is generally difficult; passive management is therefore an appropriate option.
- ▶ Investing responsibly, taking account of ESG factors and engaging as long-term owners reduces risk over time and can positively impact scheme returns.
- ▶ The ability of the financial system to deliver attractive risk-adjusted investment returns over the long-term depends on the sustainability of the underlying economic, social and environmental systems. Therefore, we should invest in a way that supports the long-term sustainability of these systems.

## Stewardship

Stewardship is the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society.

Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities. It is up to the trustees to exercise stewardship and ensure, as far as they are able, that this is done through the whole length of the investment chain. This is particularly relevant for the management of macro-economic, systemic risks such as climate change, which cannot be sufficiently hedged through portfolio construction and asset allocation alone.

For many pension schemes, stewardship activities, including engagement, are likely to be undertaken by the investment manager on the trustee board's behalf. This especially applies where investments are made via pooled funds.

We would encourage you to become familiar with your managers' stewardship policies. Where you consider it appropriate, seek to influence them, and use stewardship as a criterion when shortlisting and selecting managers. For wholly insured schemes, it is unlikely to be possible to engage directly with your provider's fund managers, but you should ask your provider for information about the fund manager's stewardship policies.

From 1 October 2019, DC schemes with 100 or more members are required to include in their SIP and their default SIP a stewardship policy to encompass the trustees' policy in relation to voting, engaging, and monitoring. In this context, engagement is:

- ▶ with 'relevant persons' (including the investee or debtor entity, investment managers or other holders of debt or equity) - explicitly acknowledging that stewardship can include direct engagement with an investee or debtor company, indirect engagement via an investment manager and 'peer-to-peer' engagement with fellow shareholders of an investee company. By 1 October 2020, such policies must be updated so that a relevant persons also include stakeholders as well.
- ▶ on 'relevant matters' - including matters concerning the investee or debtor entity, including performance, strategy, risks, social and environmental impact and corporate governance. By 1 October 2020, policies must be updated so that a relevant matter will also include capital structure and management of actual or potential conflicts of interest.

The practices by occupational pension scheme trustees of voting, of giving investment managers voting instructions, expressing an interest or engagement with asset managers' voting behaviour, would not generally constitute the regulated activity of managing investments. You would therefore not usually need to apply for FCA authorisation for these activities.

While there is no requirement for schemes with fewer than 100 members to have a policy on stewardship, and smaller schemes will have more limited influence over firms in whom they invest, you may be mindful of your duties to act in the best interests of beneficiaries. While trustees of smaller schemes may not have the resources to carry out stewardship activities on the same scale as larger schemes, they can act collectively with other investors to ensure that the interests of beneficiaries are protected. A stewardship policy for a smaller scheme might set out its policy for the appointment, monitoring and where necessary switching of investment managers, and how the trustees will monitor and publicise how their scheme's investment policies, eg in relation to ESG and climate change, and member preferences are reflected in the voting behaviour of their investment managers.

Stewardship includes the exercising of rights attaching to investments, such as the voting rights attached to shares (although considering stewardship in relation to other asset classes, eg corporate bonds, is also relevant). Where practicable, you may wish to agree specific voting criteria with your investment managers or consider potential managers' willingness to abide by your preferred voting criteria when selecting investment managers. Services are available that provide analysis and voting recommendations and can help you set criteria.

Where you don't agree specific voting criteria with your investment managers, you might still wish to ask them questions like:

- ▶ Who is their proxy voting adviser?
- ▶ How often have they disagreed with their adviser's recommendations and are there any particular issues on which they consistently disagreed?
- ▶ Are there any instances where they did not cast votes at all – for example in specific markets – and why?

Information on quality engagement between institutional investors (which includes pension schemes) and the companies they invest in is available from the Financial Reporting Council's (FRC) pages on the UK Stewardship Code.



Read the **UK Stewardship Code** for more information.

This code outlines best practice on stewardship, and trustees are encouraged to sign up. We would like trustees to adhere to the code in their stewardship activities with a view to improving long-term returns and reducing the risk of poor outcomes due to poor strategic decisions. The FRC is to be replaced in due course by the Audit, Reporting and Governance Authority (ARGA).

The Association of Member Nominated Trustees (AMNT) has developed the **Red Line Voting** initiative to enable pension schemes to take a more active asset ownership role.

Further information on the quality of engagement and reporting by asset managers may also be found at:



**UN Principles for Responsible Investment transparency reports**



**ShareAction reports**



**The PLSA's Stewardship Disclosure Framework reports**

You may wish to expand these statements into meaningful policies on longer-term sustainability, how you apply the principles of the Stewardship Code, and how you will take non-financial factors into account.



See our guide on **Communicating and reporting** for further information about the SIP and general guidance on communicating with members.

## Setting objectives and strategies

When setting investment objectives, you need to consider how the needs of your members might vary in the period before they begin to access their benefits (the accumulation phase) and when they are accessing their benefits (the decumulation phase).

You may find it helpful to develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. Investment beliefs, supported by research and experience, can help focus your investment decision-making and make it more effective. If you do this, your investment strategy should then reflect those beliefs.

## Implementing the objective

The next step is to select an investment structure that can deliver the strategy and enable the objective to be met. There can be significant differences between investment structures, eg in terms of risk, costs, investment flexibilities, services included and investment transition efficiencies. You might consider these factors as part of your selection process.

## Accumulation phase

The age of members within a scheme will vary. While some may be very close to retirement, others may have just started a career and will have many years until they retire. These members may have very different expectations around how they would like their funds invested.

For example, older members may wish to hold more stable investments that expose their accumulated capital to less volatility, whereas younger members may wish to hold higher risk investments that are expected to deliver higher returns over the longer term.

## Decumulation phase

How a member's fund is invested in the years leading up to the benefits being taken will be influenced by how they may be accessed.

Depending on the scheme rules, individual members may take their benefits as cash, income drawdown, pension annuity or a combination of these. When setting objectives, you need to consider the form of benefits members are likely to take and the age at which they intend to take them.

# Designing investment arrangements (including default arrangements)

## Understanding your membership

You need to understand the needs of your membership, and how these might change in the future, so you can define your objectives and set an appropriate strategy. You can gather information from a number of potential sources. Some examples of these are set out in the table below.

Source	Information
Administrator/provider/ platform provider	<ul style="list-style-type: none"> <li>▶ Basic information on membership, age, intended retirement date etc</li> <li>▶ Trends in scheme data, for example, increase in proportion of cash being taken as benefit</li> <li>▶ Trends in industry (based on their data), for example changes in member retirement dates</li> </ul>
 <p>See 'Know your members and seeking their views' in our guide on <b>Communicating and reporting</b>.</p>	<ul style="list-style-type: none"> <li>▶ Benefit preferences, eg cash/pension drawdown/pension annuity</li> <li>▶ Risk appetite, eg low/medium/high</li> <li>▶ Preferences regarding non-financial factors and preferences regarding socially responsible investment</li> <li>▶ Degree of financial knowledge, eg low/medium/high and preference for more complex investment options</li> <li>▶ Other pension benefits</li> </ul>
Advisers	<ul style="list-style-type: none"> <li>▶ Analysis of scheme membership</li> <li>▶ Industry trends, eg structure of benefits required</li> </ul>
Employer	<ul style="list-style-type: none"> <li>▶ Employer strategic objectives for scheme, as part of their reward package, eg basic provision or market leading provision</li> <li>▶ Prospects for employer, eg future recruitment etc</li> </ul>
TPR's website	<ul style="list-style-type: none"> <li>▶ Trends in industry, for example, changes in retirement dates, benefit preferences, etc</li> </ul>
Relevant research reports	<ul style="list-style-type: none"> <li>▶ General research on pension scheme member views and preferences</li> </ul>

When assessing your membership characteristics, you may use regular reports from your administrator or provider. Where these do not include enough detail, you may need to ask for bespoke reports.

While there is currently not a great deal of widely available data to help you predict the retirement choices members might tend towards, in light of the pension flexibilities the volume of data is increasing.



See the interim and final reports of the **FCA Retirement Outcomes Review**<sup>3</sup> for more information.

As more members use the flexibilities now available to them, the structure of the benefits they take may change. You may choose to take the trends in members' choices into account by analysing their behaviour through the scheme data and the ways they choose to access their benefits. You may also supplement your views with those of your administrators and providers, and look at wider market trends for similar organisations.

<sup>3</sup> <https://www.fca.org.uk/publications/market-studies/retirement-outcomes-review>

## Interpreting the data

When analysing the information, you have gathered, you should be proportionate and consider the governance requirements involved.

You may find it useful to identify groups of members with common characteristics, for example a similar attitude to risk or a preference for a similar type of benefit and use that to help you decide whether to provide one or a number of default arrangement options for different groups of members.

You can use your analysis to form high-level objectives for your scheme's investments. As an example, for a default arrangement you might use the following:

'We want members to be invested in a fund which:

- ▶ up to the age of 55 will seek to grow the members' assets with a medium level of risk
- ▶ from the age of 55 will seek to reduce the volatility to the members' benefits and will progressively switch the members' assets equally between three funds, although may members may be offered the choice to increase the allocation to one or more of the funds:
  - **A cash fund:** to preserve capital and to meet the members' need for cash at retirement.
  - **A bond-based fund:** to invest in assets which are broadly expected to match those which an annuity would be based on.
  - **A lower-risk growth fund:** to achieve a level of growth up until and potentially through retirement which will be used to fund the members' plans for income drawdown.'

## Available market options

For some schemes, particularly those where available resources for administration support, investment advice and governance time available are limited, you may wish to consider a range of 'off-the-shelf' options (eg target date funds), which are available in the market. Some possible sources of information are outlined below.

Source	Information
Insurer/product provider	<ul style="list-style-type: none"> <li>▶ The range of available 'bundled' services where investment, administration and other services are included</li> </ul>
Investment manager	<ul style="list-style-type: none"> <li>▶ Investment management options</li> <li>▶ Dedicated funds which de-risk the members' investments and align them towards their chosen benefit structure as they approach retirement</li> </ul>
Administrator/ fund platform	<ul style="list-style-type: none"> <li>▶ The range of administration and other services where in-house support is unavailable, or an unbundled approach is used</li> </ul>
Investment consultant	<ul style="list-style-type: none"> <li>▶ Advice on range of market options and on costs (including assessing the incoming information generated by the use of FCA's IDWG (now CTI) templates on investment costs and charges), benefits and risks etc associated with different approaches</li> <li>▶ How investments can be blended to form a strategy</li> <li>▶ Information about platforms, which can give access to multiple fund managers</li> </ul>
Legal adviser	<ul style="list-style-type: none"> <li>▶ Advice on the benefits and risks of different structures (eg investing directly in pooled funds versus investing via a platform)</li> <li>▶ Advice on the rules and regulations that apply to certain options</li> <li>▶ Checking the terms of contracts and fund documents, and assisting in negotiations</li> </ul>
Other sources	<ul style="list-style-type: none"> <li>▶ TPR/PLSA for information and guidance on what you should consider</li> </ul>

When thinking about how you might implement a strategy and achieve your objectives for the scheme, consider also taking account of the following:

### **Unregulated investments**

'Unregulated' investments purporting to offer more 'exciting' investment returns than conventional assets can understandably appear attractive. While such investments cannot be promoted to the general public, they may be promoted to trustees of workplace pension schemes.

While some unregulated investments may be legitimate and suitable for you to consider, we expect that you should understand an unregulated investment is not subject to the same controls and restrictions in relation to their investment powers and how they are operated. In the absence of regulatory oversight, there is no ongoing scrutiny of their operations and therefore investors will not be protected by regulators, ombudsmen or official compensation schemes.

Consequently, it is critically important that you ensure you fully understand the nature of such an investment and seek the advice you need. This includes a thorough understanding of the underlying investment proposition, the inherent risks that exist within it and an ability to clearly explain the charges that apply. You and your advisers must be able to demonstrate a thorough understanding of the components and assumptions behind the investment return being promoted to effectively verify it.

### **Implementation costs**

Designing and implementing a new investment strategy involves costs and imposes demands on your time and your governance budget. Consideration may help to determine whether these are costs that can:

- ▶ add value to member outcomes, for example where the benefits of moving to a new product or fund strategy which offers better risk adjusted outcomes or a more appropriate level of risk outweigh the costs, or
- ▶ diminish member outcomes, for example where the costs to move between different funds outweigh the benefits, or through applying excessive fund charges.

## Implementation governance

Consider the immediate and ongoing governance and cost requirements of different implementation options. Some strategies can be more difficult to implement and the ongoing requirements for monitoring and investment/administration input, eg in relation to switching funds to rebalance members' funds, can be much more onerous.

## Implementation report

Schemes, unless exempt, will be legally required to set out in a report made publicly available free of charge on a website, how they have followed and acted upon their stated investment policies in their SIP, as well as details of any review of the SIP during the year and subsequent changes made, and the date of the last SIP review. The requirement to produce this report comes into force from 1 October 2020.

The purpose of the report is to help ensure that 'action follows intent' as far as possible. The process of having to consider the content of the report will help to focus trustees' minds on how well their investment policies and stewardship arrangements are delivering against their scheme's agreed investment principles.

This report should detail where decisions have diverted from the policy and also should explain how the policy has been followed and the extent to which its objective has been achieved. Where this has not been successful, the report should set out what actions you will take to rectify the situation.

By 1 October 2021, the report is also required to include a description of the voting behaviour by, and on behalf of, trustees (including the most significant votes cast by trustees or on their behalf) during the year and state any use of the services of a proxy voter during that year.

The implementation report might include detail on the following:

- ▶ How you developed your policies on voting and engagement, including the relevance of investment beliefs underpinning those policies and their investment time horizons.
- ▶ The time and resource you dedicated to the process, including details of any relevant sub-committees and advice taken.
- ▶ How those policies have been implemented in practice, for example:
  - actions taken with investor coalitions (for example, on climate change, the Institutional Investors' Group on Climate Change, or the CA100+), including leadership roles as part of any such coalitions
  - a review of investment manager mandates, perhaps resulting in a decision to replace an existing manager with one whose engagement policies were in line with those of the scheme
  - how the shares owned by the scheme have been voted on, including in relation to significant votes and use of proxy advisers
  - engagements undertaken, together with their purpose, objectives, and planned escalation strategies where relevant.
- ▶ Public policy work undertaken.
- ▶ Lessons learned in engaging with specific assets on specific issues.
- ▶ The relative effectiveness of these actions in achieving their aims.

It is important that you include the relevant useful information and do not simply produce a 'tick box' report, so members can be confident their expectations are being met.

### **Asset liquidity and dealing frequency**

Most members will not have a need for immediate liquidity of their investments, and it may not always be beneficial for dealing to be carried out daily. You should think about the level of liquidity that your members need, eg in relation to likely transfers from the scheme, and in that context consider the liquidity constraints on certain fund structures. You should seek to balance the liquidity of assets against the investment objectives. Holding too high a proportion of liquid assets may impact the level of investment return, and limit opportunity for diversifying your portfolio of assets.

## Allowing for the future

We would expect you to think about how the arrangement implemented could cope with future changes, such as the following:

- ▶ **Membership:** If the number of members changes significantly, will the arrangement still be appropriate, and can it be altered relatively easily?
- ▶ **Investment:** Markets change, new financial risks emerge, and investment products and techniques evolve. Consider the ability of the scheme to access new products or fund structures using different techniques, for example through your chosen platform.
- ▶ **Organisational:** Employers and providers can change dramatically. Consider what would happen if the employer were to grow, stagnate, be taken over or decline. What would happen to the arrangement in the event of the employer failing? How would your scheme cope if providers undergo change, for example if a provider decides to withdraw from a particular market?

## Bespoke arrangements

If your scheme seeks a bespoke investment arrangement to meet specific requirements for the membership, you will need to take more advice on these types of products. In each case, you should document a clear explanation of your strategy and objectives and how you expect them to be achieved by implementing a bespoke arrangement.

## Additional fund options

For many schemes, a single default arrangement or limited series of default arrangements will be enough for their membership. However, you may decide to make an additional range of funds available from which members can select. The number of fund choices you offer to members may be influenced by the following:

- ▶ The views of the employer, for example the desire to offer a market leading pension product as part of their recruitment policy or the need to offer investments that align with its own corporate responsibility policy.
- ▶ The governance budget, in terms of time, expense and resource of the trustee board. For example, the more limited this is, the less time you will have to monitor and review additional funds options in addition to the default arrangement.

- ▶ The needs of the membership. For example:
  - investment options tailored to particular religious beliefs
  - ethically focused investment
  - the wish to take their benefits in a different form and at a different date to that targeted by the default arrangements
  - a desire, by those with more financial knowledge, to manage their own pension portfolio, and/or
  - tolerance to risk, for example members with substantial other assets or pension savings may have a much higher tolerance of risk than that included in the default arrangement.

## Fund selection

When selecting individual funds, you should devote enough time and resources to the following:

- ▶ Understanding the objective of each investment fund. In particular:
  - the level of risk in the strategy and in the underlying investments and the ways in which those risks are measured and managed, and
  - the investment objective and net expected return of the investment manager and the way in which the manager seeks to achieve that, eg by active or passive management.
- ▶ Understanding the basis upon which the total level of costs and charges is calculated and levied on each individual fund. You should consider:
  - how ongoing costs, charges and transaction costs can erode the value of member accounts (see our guide on **Value for members** for information about charge controls and transaction costs), and
  - the need, if applicable, to report on charges and transaction costs in the chair's annual governance statement.



See our guide on **Communicating and reporting** for information about the chair's statement.

- ▶ Completing enough due diligence in selecting platforms and providers. You should make sure that any adviser you use to assist you with this task has appropriate experience in this area.
- ▶ Ensuring that the number and risk profile of investment funds offered as an alternative to the default arrangement(s) reflects members' needs.
- ▶ Making provision for investment fund options to appropriately de-risk as members near retirement, where you believe there is a risk of members not continuing to engage on an ongoing basis with their initial fund selection.

See **Appendix 1** for information about investment mapping and the definition of a default arrangement.

## Strategy, performance monitoring and review

Our DC Code of Practice describes the legal requirement to review your SIP, default strategy and performance of the default arrangement.



You can also see our accompanying guide on **Communicating and reporting** for further practical information.

One of the circumstances when you are required to change your default arrangement SIP is where there are significant changes to the demographic of the membership.

What you decide is significant will be relative to the size and existing demographic of each scheme, but examples of significant demographic changes might be:

- ▶ a bulk transfer (eg following a merger or acquisition) to or from the scheme which significantly changes the average age of the scheme membership or a particular group of members
- ▶ a significant increase in the proportion of members tending towards or away from a particular method of accessing their benefits (eg there is a significant reduction in the number of members wishing to access their benefits as cash)
- ▶ a significant increase in the average contribution paid by the members or a particular group of members, where this was not already factored in to setting the strategy, and/or
- ▶ a trend towards consolidating previous pots within the scheme which increases the average pot size of members or a particular cohort of members.

Unless your scheme's membership is very diverse and changes frequently or rapidly, you are unlikely to need frequent and in-depth analysis to assess whether the scheme demographic remains consistent with the investment strategy initially set.

However, you should keep an eye on changes in membership (for example through your administration reports) and aim to carry out a full analysis at least every three years or after any significant change in the demographic profile of the relevant members.

## Monitoring

Monitoring is most effective when it is prioritised, done regularly and identifies issues where you might need to act.

### Prioritised

You should monitor the issues that matter most to your members' investments. As an example, you may conclude that your scheme's default arrangement has a greater overall impact on members than the additional self-select fund options.

Additionally, a relatively small issue could be amplified if it affects a significant proportion of members, rather than a material performance issue in an additional fund which impacts a very small number of people.

You should bear this in mind when allocating time and resources between the investment strategy and your investment managers. In this guidance, we have accordingly placed greater emphasis on monitoring the investment strategy.

When deciding how closely to monitor specific risks you need to consider how likely they are to occur, and potential impact, so you can focus on more likely risks with significant impacts.

### Timely

We expect that you regularly monitor your scheme's investments and performance (as well as the performance of your investment advisers) against your stated investment principles and ensure monitoring information is prepared and considered in a timely manner.

### Actionable

You need to consider whether to act in response to issues you identify. Some issues might require immediate action to protect or maximise returns to members, while others may indicate a potential need for future action. Some information may be compiled as part of a contingency plan or trigger framework where the actions are pre-agreed.

## Monitoring information

Will include identifying the information you require to effectively monitor your scheme's investments.

Your main sources of monitoring information are likely to be your investment adviser and investment managers (for reports on the scheme's investments). Their reports need to contain enough data and commentary for you to understand developments since the previous report and over the long-term, as well as the reasons for this, any views expressed regarding future developments and any significant assumptions underlying the report. If any report is not clear enough, we encourage you to discuss this with the report provider and seek improvements.

Your advisers and investment managers can help you prioritise the available information and can also provide help and training on how to interpret it.

## Documentation

Document the information appropriately so you can use it to assess whether the fund performance is in line with the objectives and continues to remain suitable for members.

## Presenting information

Monitoring is easier if the information is presented in a digestible way. For example, graphs can be easier to understand than tables of numbers. 'Traffic light' graphics can quickly highlight when monitoring statistics are outside tolerances. The balance between summary and detail in monitoring reports should be appropriate for the intended readership and purpose.

You may find it helpful to put together a 'dashboard' of key statistics to facilitate monitoring. It should help you focus on key potential risks and identify areas where you need to review additional data and drill down into particular topics.

The content to include on your dashboard will depend on the nature of your investment proposition and is likely to change as circumstances evolve.

## Fund and strategy performance

We expect that you to regularly review the longer-term performance of individual funds against the fund benchmarks and the net outperformance targets.

It is important to consider how the fund performance impacts different members or groups of members. For example, the fund performance may be on target for members within 10 years of their expected retirement date, but for members with 20 or more years until their expected retirement date, the performance may be below target. There are commercially available index providers, whose indices you might consider to help you monitor your scheme's investment performance. More bespoke performance monitoring services are also available. Your consultant should also be able to provide industry-produced peer group benchmarks. The limitations of benchmarks will be worth bearing in mind, eg good performance against a benchmark may disguise poor overall performance because of risk factors that may negatively affect the whole economy (such as climate risk).

To monitor the investment strategy effectively, you need to have a clear understanding of the objectives it is seeking to deliver. You also need to understand the expected long-term performance, the timescale over which this is being measured, and the likely range of short-term performance in different market conditions.

## Long-term performance

We encourage you to focus on the long-term when monitoring investment strategy performance. If the investment strategy is failing to meet its long-term objectives you need to form a view on whether this is likely to persist and decide what action, if any, to take.

If developments in investment markets or the financial materiality of risk factors (such as climate change) have been significant, you may wish to reconsider any investment beliefs you hold.

## Short-term performance

We encourage you not to be unduly distracted by short-term performance issues if you have concluded there is a good explanation. Where you have concerns over the short-term performance of your investment strategy, you should ask your investment adviser or investment manager to explain how it compares to the expected range of short-term performance, the reasons for it and whether, when and how they expect performance to recover.

Where the investment strategy significantly out-performs in the short-term, we would encourage you to undertake a similar review to check that risk levels are appropriate.

## Monitoring investment managers

To monitor the performance of your scheme's investment managers, you need a clear understanding of the individual objectives of each of the funds they are managing on your members' behalf, how they plan to meet them, and over what time period.

If appropriate for your scheme, you may wish to focus on the scheme's default strategy (or default strategies) where the vast majority of the membership is likely to be invested, and any specialist mandates exhibiting poor relative performance so you can pay most attention to managers or funds that represent the greatest risk to your members' performance.

Further information relating to the importance of establishing an appropriate performance monitoring framework for your fiduciary manager is discussed in the section on fiduciary management starting on page 43.

## Reviewing fund performance

You may review your fund performance by using manager or adviser reports, or having meetings with the managers or advisers. If you are relying solely on reports produced by your investment managers, you may wish to seek independent advice to help interpret them.

When reviewing and monitoring fund performance, we suggest that you do the following:

- ▶ Assess the net performance of each investment fund against stated performance objectives over the relevant long-term and shorter term periods.
- ▶ Compare net investment returns to any relevant market or industry benchmarks.
- ▶ Understand the level of risk run to deliver the performance and how this compares with the investment manager's risk targets.
- ▶ Seek confirmation that the risk targets have not been exceeded, especially when the manager has performed significantly outside of expectations.
- ▶ Understand the principal reasons for their performance (eg market returns or manager actions), form a view on whether the performance is likely to persist and decide what actions to take, if any.
- ▶ Evaluate the investment manager's actions regarding ESG factors and shareholder engagement.
- ▶ Consider the impact of fees on the investment return, as this affects the net return members receive. You should check the level of fees against appropriate market comparators to ensure they remain competitive.



See also our guide on **Value for members**.

- ▶ Monitor the levels of portfolio turnover and the associated transaction costs, and consider whether these are justified in light of net returns and investment objectives and whether the level of costs suggests the transfers have been efficiently carried out.
- ▶ Ensure that controls (including those related to the security, liquidity and safe custody of scheme assets) are in place to alert you to potential risks.
- ▶ Regularly assess the effectiveness of your investment decision making and governance processes, make improvements to the processes as appropriate and report to interested parties (including members).

## Fund documentation

It is good practice for trustees to review the investment managers' fund documentation, obtain appropriate legal and investment advice, and explore negotiating investor protections with the managers in light of that advice.

A review of the documentation should ensure you are aware of the main features of the fund's investment mandate, so you can understand the principal risks inherent in the portfolio. It should show which investments are allowed and which investments the fund will typically be invested in. These may not always be obvious from the fund's title.

The documentation may also set out the liquidity arrangements for investing in the fund. The fund may deal weekly, monthly, quarterly or even less frequently. In addition, the fund documentation may permit the investment manager to impose additional liquidity constraints, for example in times of market stress. You should familiarise yourself with the arrangements and how they can be applied.

Trustees of DC schemes unless exempt (for example AVC only schemes) that are invested in any pooled funds (also known as collective investment schemes), are required, if requested to do so, to provide members or recognised trade unions with the name and ISIN of the top level of the funds for which public information is available and in which that member is invested. This information must not be more than six months out of date, so you may find it useful to update pooled fund information on a six-month cycle.



See also our guide on **Communicating and reporting**.

## Fund scale

You are likely to find it helpful to build flexibility into the investment review and assessment of arrangements. You may pay more frequent attention to investment funds holding a significant proportion of scheme members' assets, including the investment funds underpinning the default arrangement(s). Other considerations include whether a significant increase in asset scale could enable fee scale discounts to be achieved.

## Self-select options

Periodically review the range of self-select investment funds available to members to ensure the funds remain relevant to the members' objectives. You should also regularly review the performance of the self-select funds used by members against their performance objectives and against industry benchmarks where available. Again, it is important to consider the impact of the fund performance on different members or groups of members.

## Changing investment funds

It can be expensive moving investments to a different investment fund or manager, so you should consider these costs (and the ways you can mitigate and manage them) when making your investment decisions. In particular, you should bear in mind that the explicit (visible) costs in a transition can be far less than overall costs. You should seek to understand the transition options available and take appropriate advice. Common mitigations against out-of-market risk and other transition costs include:

- ▶ in specie transfers where the assets are simply reregistered rather than traded
- ▶ pre-funding which reduces the time investments spend out of the market, and
- ▶ undertaking phased selling to reduce the adverse impact that selling may have on price and average out the market conditions over which it occurs.

You should make sure there are appropriate reconciliation and reporting arrangements in place, for example between investment managers, fund platforms and scheme administrators. You should also ensure that third parties are transparent about the costs involved, so you know they are appropriate.

## Member notice

It is generally good practice to inform members in good time before any fund transfer so they can switch to a different fund if they do not want their investments to be automatically moved to the new fund.

See **Appendix 1** for information on investment mapping.

Most transitions will also result in a black-out period when members will be unable to view or alter their accounts and we encourage you to communicate this to members. However, member communications should not delay a transfer that needs to happen urgently to protect member investments, for example due to a risk of provider insolvency. In those circumstances, you can send communications as soon as practicable after the transition.

## Market developments

You and your advisers are likely to be aware of market developments that may help you meet your scheme investment objectives or manage your members' investment risks in a more efficient and cost effective way.

The costs involved in changing funds can be significant. It is important to consider the long-term nature of pension scheme investments and not take decisions based solely upon short-term performance.

## Fiduciary management

Fiduciary management is a term used by industry and generally refers to a large degree of delegation of investment powers to a third party, the chosen fiduciary manager, although the exact structure may vary.

Until recently, fiduciary management was a concept largely associated with the defined benefit (DB) market. It is now emerging in the DC marketplace to describe a model where the design and implementation of a scheme's investment strategy relating to its default fund(s) or default arrangement(s), including manager selection, has been outsourced to a suitably qualified external third party.

The terms of such an outsource arrangement could extend to include responsibility for the whole investment proposition of the arrangement including self-select fund options.

The Competition and Markets Authority order coming into force in December 2019 requires trustees to run a competitive tender process for any fiduciary management arrangements (within the meaning of the new requirements) that result in a total of 20% or more of the scheme's assets being subject to such an arrangement. This requirement will apply whether those arrangements pre-date or post-date the order coming into force.

If you consider this as an option for your scheme, you will want to think about whether you have done the following:

- ▶ Committed sufficient time and resources to the process of selecting and appointing the fiduciary manager. This not only includes competitive tendering, but also taking appropriate advice and considering approaches to a suitably wide range of potential fiduciary managers, as for any other investment management appointment.
- ▶ Carried out enough due diligence as part of, and separately to, the competitive tender process, to be comfortable that the proposed fiduciary manager has the appropriate experience and skills to manage the investment proposition.
- ▶ Considered the proposed degree of delegation and the experience and skill-set of the chosen adviser. This is particularly relevant if you propose to appoint your existing investment consultant. The skills required to be a successful investment consultant are not the same as those needed to be a successful investment manager.
- ▶ Ensured that appropriate measures are in place to identify and manage conflicts of interest between various parties when appointing a fiduciary manager.



See our guide on **Scheme management skills** for more information about managing conflicts of interest

- ▶ Established appropriate reporting relationships and put suitable oversight in place so you can effectively monitor the performance of the fiduciary manager and the underlying funds they are responsible for.
- ▶ To help inform your appointment decisions, considered appointing an adviser who has specific expertise in the structuring of the mandate and the selection of the fiduciary manager in the context of a DC scheme. They should also be able to assist with the ongoing monitoring and evaluation of the fiduciary manager's performance.

You should note that fiduciary management does not necessarily relieve trustee boards of their investment duties and trustees should take advice on their duties and obligations.

### **Example: Appointing a fiduciary manager**

The trustees have just completed their annual review of the performance of the trustee board and have identified their future training needs as part of that exercise. They realise that, due to retirements and leavers, the trustee board membership has changed significantly recently. Many of the trustees feel that, due to work commitments, they are unable to spend enough time on default investment strategy design.

From an investment perspective, they conclude that the lack of continuity of the trustee board membership and lack of sufficient knowledge of some more complex investment issues and related risk management strategies has been a barrier in implementing investment and risk management decisions.

The trustees are aware that fiduciary management is one form of governance model and decide to get some independent advice on appropriate investment governance structures to inform their assessment of the specific circumstances of their DC scheme.

They decide to appoint a fiduciary manager to take responsibility for the design and management of their default fund and range of self-select investment options to reduce the burden on the trustee board and to enhance the investment expertise focused upon this element of the scheme.

**Learning point:** Trustees should periodically review how their investment governance structure is functioning and consider whether any changes, including greater delegation of responsibilities, should be made to improve future scheme outcomes.

## Things to consider

When delegating to a fiduciary manager, key considerations include the following:

- ▶ The objectives for appointing a fiduciary manager.
- ▶ The range of fiduciary models available and the benefits, risks, costs and value that different approaches can offer.
- ▶ The potential for conflicts of interest (for example, agency issues) and how to avoid, mitigate or manage them.
- ▶ The extent of separation between those providing strategic investment advice to the trustees, those monitoring the outcomes of the strategy and the extent to which those responsible for its design and implementation have accountability for its performance. This is particularly important where advisers, strategist and fund manager all come from the same firm. Trustees must be alert to this and ensure they can independently monitor the performance of these entities.
- ▶ How performance will be delivered, the cost implications for the scheme, the total costs of the investment fund proposition and how you expect the fiduciary manager to add value.
- ▶ The potential risks and issues associated with the appointment of a fiduciary manager and the governance structures that are in place, now and in the future.
- ▶ Establishing appropriate reporting relationships with suitable oversight in place to effectively monitor the performance of the fiduciary manager and the underlying mandates.
- ▶ How to ensure that you and your advisers have sufficient access to information to understand the fiduciary managers' performance and risks on an ongoing basis.

It is critical that trustees are aware of the costs involved in transitioning assets to or from a fiduciary manager, which will require an understanding of how these are affected by the operational framework applicable to the scheme.

## Impact investment and patient capital

As markets develop and new instruments and analysis become more readily available to investors and product designers, new investment concepts and strategies emerge. These may create more choice (and complexity) but also potentially enable trustees to offer access to a wider range of investment themes and concepts than it was possible to do previously.

Two concepts that are currently gaining profile in the market - impact investing and patient capital - are described below.

**These are provided for information only and should not be taken to be any representation as to the suitability for your scheme.**

It is very important that you formally consider the suitability of such new strategies very carefully and always seek advice on how appropriate they are to include in a multi-asset default investment arrangement or default fund and/or as an option within a menu of self-select investment options available to members.

### Impact investment

Impact investment (sometimes referred to as social and/or environmental impact investment) aims to deliver tangible positive impacts on society and the environment alongside generating investment returns.

Typically, the positive impacts address basic societal and environmental problems such as food production, the provision of clean drinking water and healthcare. Impact investors expect companies and enterprises to measure and report their wider impact on society and hold themselves accountable for delivering and increasing positive impact.

Impact investments have a range of objectives, strategies and approaches to investment, governance, impact measurement, monitoring and reporting. Assets range from large-scale infrastructure projects, to social housing, to companies with a specific social aim.

Investment structures can be anything from listed equities and bonds, to private equity allocations, to bonds with a specific purpose.

Some less liquid investments, which may include investments referred to as patient capital, can form part of an impact investment approach. You may consider such an allocation for diversification, positive risk adjusted returns and higher-yielding, long-duration, inflation-linked income streams.

The impact of investment decisions is a lesser concern to the primary purpose of pension investing, which is delivering an appropriate return. There is, however, no barrier to investments that have a social impact as a by-product where that primary purpose is met.

Trustees can also choose to actively take account of impact considerations in making an investment decision where they have good reason to think scheme members share their view and there is no risk of significant financial detriment to the fund. They should not choose impact investments where there is a risk of significant financial detriment to the fund.

Risks can include liquidity and a lack of common standards. Your investment adviser should be able to assist you in considering these areas and any proposed allocations to impact investments and how the investments would affect the security, quality, liquidity and profitability of the portfolio as a whole.

### **Patient capital**

Patient capital investment involves the provision of long-term finance to firms that have potential for growth over the long-term, to help them realise that potential.

Patient capital investment is typically directed towards start-ups which are looking to up-scale or innovate, but it might also be needed by more established businesses looking to achieve next-level growth. In practice, many of these investments are likely to be targeted towards capital intensive research and development companies, businesses with long product development cycles, or businesses with innovative technologies or significant intellectual property which need access to growth funding.

These investments are typically illiquid, so are likely to represent only a small proportion of a pension fund's overall asset allocation. Patient finance investments offer the potential to benefit from longer term outperformance through:

- ▶ investing in an inefficient market which is (currently) fragmented and underdeveloped
- ▶ enabling businesses to up-scale and achieve transformational development, and
- ▶ eliminating short-term financing constraints and enabling management to focus on business development, optimisation of value creation and improving any future business disposal strategy.

If you are considering patient capital investment, you need to complete sufficient due diligence before investing to ensure you properly understand the main drivers of the expected return and how risks are managed and mitigated. You also need to consider the suitability of the scale, expected time horizon and illiquidity of the investment in the context of your scheme's objectives and member profile.

## Security of assets

Establishing the level of protection that different scheme assets would have in the event of fraud, malfeasance or other adverse events is not a straightforward task. You may not always be able to definitively establish the extent to which your scheme's assets are covered.

The Financial Services Compensation Scheme (FSCS) may provide some protection, but it is a 'last resort' arrangement and the FSCS confirms coverage on a case by case basis.

There are mechanisms that may cover some or all of a scheme's assets outside of the FSCS, and this will depend on the structure of the scheme's investments and how they are held. You may wish to include questions on asset security when you issue tenders for new investments, and seek contractual commitments from the provider to keep that information up-to-date. It is likely that you will need to take advice to establish the levels of cover, and you may also need to take professional advice on the overall extent of coverage the scheme has, and the level of risk that the scheme potentially remains exposed to.

Security of assets continued...

You can then decide whether you are comfortable accepting that level of risk, or whether you need to make changes to the scheme's investments or the contracts governing the investments in order to reduce the level of risk. We consider it best practice for you to communicate your conclusions about the residual level of risk and any planned actions to members.

There are a range of ways that you can communicate this to members, for example in the annual benefit statement or other regular member communications, or in the annual report and accounts. You may choose to describe the range of protections that are applicable to the scheme's assets and outline any advice you have received to inform your conclusion.

The Security of Assets Working Group has produced a **guide for trustees** to help you understand the risks your scheme's assets may be exposed to, and questions you can ask your providers and advisers to help you establish the level of protection and therefore the level of residual risk.



See the Security of Assets Working Group **guide for trustees** for more information

## Negotiating additional protections

You may seek to negotiate bespoke terms with your scheme administrator, investment manager or investment platform provider to better protect your scheme's investments. These could cover, for example, the administrator's liability for non-investment losses such as operational errors. If you are investing in a pooled fund, the terms may also protect members from a fund investing outside its agreed guidelines.

You can document these terms in any formal contractual terms agreed with your suppliers.

### Example: Negotiating additional protections

The trustees of ABC Pension Fund wish to add a pooled diversified growth fund to their range of fund options available to members of the scheme. The trustees undertake a selection exercise and decide in principle to appoint XYZ Asset Management. The trustees' detailed assessment of the investment guidelines reveals that the investment manager is permitted to use derivative instruments for **efficient portfolio management (EPM)**, with some discretion to extend their use.

The trustees wish to know more about potential other uses of derivatives allowed in the portfolio. The manager tells them this is standard fund provision which applies across the manager's pooled fund range, clarifying the scope of likely uses of derivatives in the future.

This does not reassure the trustees, as they believe that too much scope to increase derivative usage exists. Given that the manager is not prepared to amend the terms of its pooled fund guidelines for one client, the trustees decide not to invest in this particular fund. Instead, they proceed with an alternative fund where derivative usage is more clearly defined and controlled.

**Learning points:** You need to be aware of what your funds invest in and how they're managed. This may not always be obvious and it may require research and input from your advisers to understand this. If you're not happy with the freedoms a fund's documentation gives the investment manager, if the manager is designing a fund for your exclusive use it may be possible to negotiate alternative investment guidelines. It is equally important to clearly understand the roles and responsibilities of the various parties in relation to the implementation of the investment process.

## Appendix 1: Default arrangements

There are different definitions of 'default arrangement' used in legislation, which vary for different legal requirements. In this guide, the term means arrangements into which members' contributions are invested if they do not choose their own investments. Schemes being used for automatic enrolment must have at least one default arrangement. If your scheme has a diverse membership you might decide that more than one default arrangement is appropriate.

### Definition

Broadly speaking, where the term default arrangement is used in legislation, the difference between the two definitions is that for the charge cap, it relates only to arrangements in schemes being used for automatic enrolment. For governance standards the definition also includes schemes which are not being used for automatic enrolment. Some exceptions and exemptions apply, and you may need to take advice to establish which arrangements in your scheme meet the different definitions.

You should read the **DWP's guidance on the charge controls** in relation to the restrictions on charges as this includes a section on identifying default arrangements.

When reading the guidance, trustees should note that whether the scheme is used for automatic enrolment purposes is not relevant in the context of requirements to comply with the governance standards, including the requirement to produce a SIP relating to default arrangements.



See the guide on **Communicating and reporting** for more information about SIPs.

## Investment mapping

Some schemes have arrangements in place where mapping exercises take place, or have taken place in the past. This is where the trustee board has changed the investments available to the member and the members' assets are 'mapped' to the new investments. This may be because the investments in which members' funds were held are no longer offered, or the trustee board no longer considers them appropriate.

The result of such exercises is that a member may now be investing in a fund that they have not chosen to invest in, even though they made a choice to invest in the original fund, which has now been mapped to a different fund. A similar situation could also arise due to 'white-labelling', where members choose a type of fund or investment they want their contributions to go to, but the trustee or investment manager decides which particular investment to use.

This may mean that the arrangement falls into the definition of a default arrangement which is subject to charge controls.



See the guide on **Value for members** for information about the charge controls.

The DWP has published further guidance on fund mapping (see paragraphs 52-58 of Bulk transfers without consent: money purchase benefits without guarantees – guidance for trustees. See: <https://www.gov.uk/government/publications/occupational-pensions-bulk-transfers-without-consent-of-money-purchase-benefits-without-guarantees> and has clarified that the receiving arrangement is always a default.

The only circumstances in which the member does not enter is a default is where the member remains invested in the same overarching arrangement. To establish whether this is the case, you will usually need to refer to information supplied to the member at the point they originally chose to invest, and any subsequent relevant information, to establish whether the member had signed up to a particular investment approach or to a particular fund.

Examples of things you may wish to consider are:

- ▶ whether the communications disclosed the possibility that the arrangements underlying the choice of investment may be subject to change
- ▶ whether at the point of joining it was made clear that the member was signing up to a strategy or an asset allocation rather than a specific named fund

This will assist in forming a view as to whether the member chose to invest in the new arrangement. Where it appears that the member did not choose to invest in the new arrangement, it should be treated as a default arrangement.

## Appendix 2: Example table of accountabilities

This table is for illustration only of possible accountabilities and is not intended to be representative of the actual or desired accountabilities for any particular scheme.

	Investment governance decision (or process)	Decision-maker for trust-based schemes
Governance structure	Appointment of trustees	Employer*
	Consider establishing an investment sub-committee	Trustees*
Objective and strategy setting and design of arrangement	Selecting the provider/adviser and agreeing investment governance process	Trustees**
	Scheme design: investment principles etc	Trustees**
	Selecting the fund range, including the default option	Trustees**
Monitoring, review and change	Compliance with, and ongoing monitoring of, legal and regulatory requirements	Trustees plus investment advisers, lawyers and auditors
	Monitoring and reviewing investment performance and the performance of the investment advisors of the funds	Trustees**
	Reviewing (and changing) provider/adviser and fund range	Trustees**
Communications to members	Communication to members on investment choices, performance, retirement options etc	Trustees**
	Review communications to members	Trustees**

\* With input from professional advisers and providers as appropriate.

\*\* With input from employer, advisers and providers as appropriate.

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[www.trusteetoolkit.com](http://www.trusteetoolkit.com)

Free online learning for trustees

To be read alongside our DC code of practice no. 13

### **A guide to Investment governance**

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