

# Guidelines for setting investment strategy for defined benefit schemes

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## 1. Introduction

The objective of these guidelines is to set out the Pensions Authority's (the Authority) view of good practice in the process of setting the investment strategy of a defined benefit (DB) scheme. These guidelines deal only with the process of setting a strategy and do not consider the specific investment alternatives available to a scheme.

## 2. General principles

Every DB scheme needs to have an investment strategy, which sets out the basis on which the trustees will decide how to invest the assets of the scheme in order to pay the benefits to members as they fall due. Once the trustees have decided their strategy, they can use it to set the strategic asset allocation, which sets out the minimum and maximum amounts that will be invested in each asset class.

The following points should be borne in mind by trustees when considering their investment strategy:

- The investment strategy decision should follow a structured process.
- The investment strategy is one of the most important responsibilities of trustees. Trustees should ensure they allow enough time for this work and should follow a structured process in doing so. These guidelines can be the basis for this.
- Almost all trustees will need professional advice when deciding their strategy, but the decision is theirs alone.
- It is important to distinguish clearly between the role of the trustees, which is to make the decisions, and the role of the advisers, which is to provide the trustees with the information they need to understand the choices they face and the factors affecting their decisions.
- The trust deed may require that the trustees consult the sponsoring employer when deciding on the scheme's investments. Even if the trustees are not required to do so, they may wish to consult the sponsoring employer as a matter of good practice; however, investment decisions will ultimately be the responsibility of the trustees.
- Because the objective of the investment strategy is to decide what investments will and will not be made, it must be specific and clear.

For example, if one of the objectives of the investment strategy is defined as being to achieve a 'reasonable' rate of investment return, this will mean different things to different people, and it will make interpreting and implementing the strategy a subjective matter. On the other hand, if the trustees set a target of, say, a specific margin above the liabilities or the yield on a specified benchmark bond portfolio, everyone will be clear about what has been decided, and can afterwards judge whether the objective has been met.

- Although the investment horizon of the scheme is likely to be long term, the investment strategy should be reviewed at least every three years.

### **3. Setting the investment strategy**

The ultimate objective of the investment is to pay the benefits of the scheme. In order to do this efficiently, the trustees will want to achieve as high a rate of return as possible, but only if risks are kept to an acceptable level. On the other hand, the lower the target rate of return, the higher the contribution required will be. The fundamental challenge of setting the investment strategy will be balancing the need for adequate returns with the ability of the scheme to tolerate risk. The contribution rate and the strength of the employer covenant will be fundamental considerations.

#### **Setting investment objectives**

Setting the investment objectives is an important step in developing the investment strategy. The trustees' investment objectives will be closely linked to the funding strategy and therefore actuarial advice will generally be required in setting the objectives. Conflicts may arise where there is more than one investment objective and therefore the trustees must be clear on the relative importance of each objective for their particular scheme in order to achieve an appropriate balance.

#### **Contribution rate and target rate of return**

In many cases, the investment strategy will be reviewed when the contribution rate is being considered, whether as part of a triennial review, in connection with a funding proposal or for some other reason. In other cases, the investment strategy will be reviewed after the contribution rate has been agreed between the trustees and the sponsoring employer.

The contribution rate and the target rate of investment return are interdependent: either the contribution rate is a function of the target rate of return that has been agreed by the trustees in consultation with their advisers, or the required rate of return can be

derived by the advisers from the contribution rate that has been negotiated.

## **Risk tolerance**

The trustees will need to consider the scheme's risk tolerance. When setting the risk tolerance of the scheme, the trustees should take account of the ability of the scheme to absorb losses and to recover from adverse events. This will depend on a number of factors, including whether or not the scheme is in surplus relative to its benefit obligations and, if so, by how much; the possibility of increased contributions in the event of losses; and the average duration of the scheme's liabilities. The risk tolerance assessment will involve consideration of the employer covenant and the level of volatility of contributions the employer can tolerate.

The ability of the employer to support the scheme may be assessed by examining the company's financial strength and future trading prospects. The willingness of the employer to support the scheme may be more difficult to assess in practice; however, the trustees could try to assess the employer's position through meetings with senior management or through monitoring the policies and actions of associated companies. The discussions and negotiations that resulted in the contribution rate may also provide an insight as to the strength of the employer covenant.

In order to set out the maximum risk a scheme can bear, it is necessary to define how risk will be measured. There is no single definitive system for measuring investment risk, but the trustees should adopt one that is in reasonably common use. External professional advice will be needed to decide this. In the Authority's view, a quantitative risk measurement model is needed in order to check the consistency of investment strategy with risk tolerance. The risk tolerance objectives can be expressed in many ways. Examples of how trustees can express their risk tolerance include the following:

- The chance of failing to satisfy the funding standard and the funding standard reserve after X years should be no more than Y%.
- There should be no more than a one in Z chance that employer/member contributions will need to be increased over the next X years.

## **Consistency**

Once the trustees know the level of contributions, know their target rate of return and have decided their risk tolerance, they need to judge whether these three elements are compatible. This is a task for the professional advisers, who will use models that incorporate assumptions about the expected risk and return characteristics of different asset classes, having regard to the nature of the scheme's liabilities. The trustees are not expected to have an in-depth understanding of the investment risk models

employed by their advisors. However, the trustees should seek from their advisers a broad understanding of the limitations of those models and the underlying assumptions used, in terms that trustees can understand.

If these three elements of the investment strategy are not compatible, the process must be revisited to see if consistency can be achieved. If it cannot, this means that the available contributions are not enough to provide the benefits within an acceptable level of risk. This raises the question of the sustainability of the scheme, and the trustees should address this as a matter of urgency.

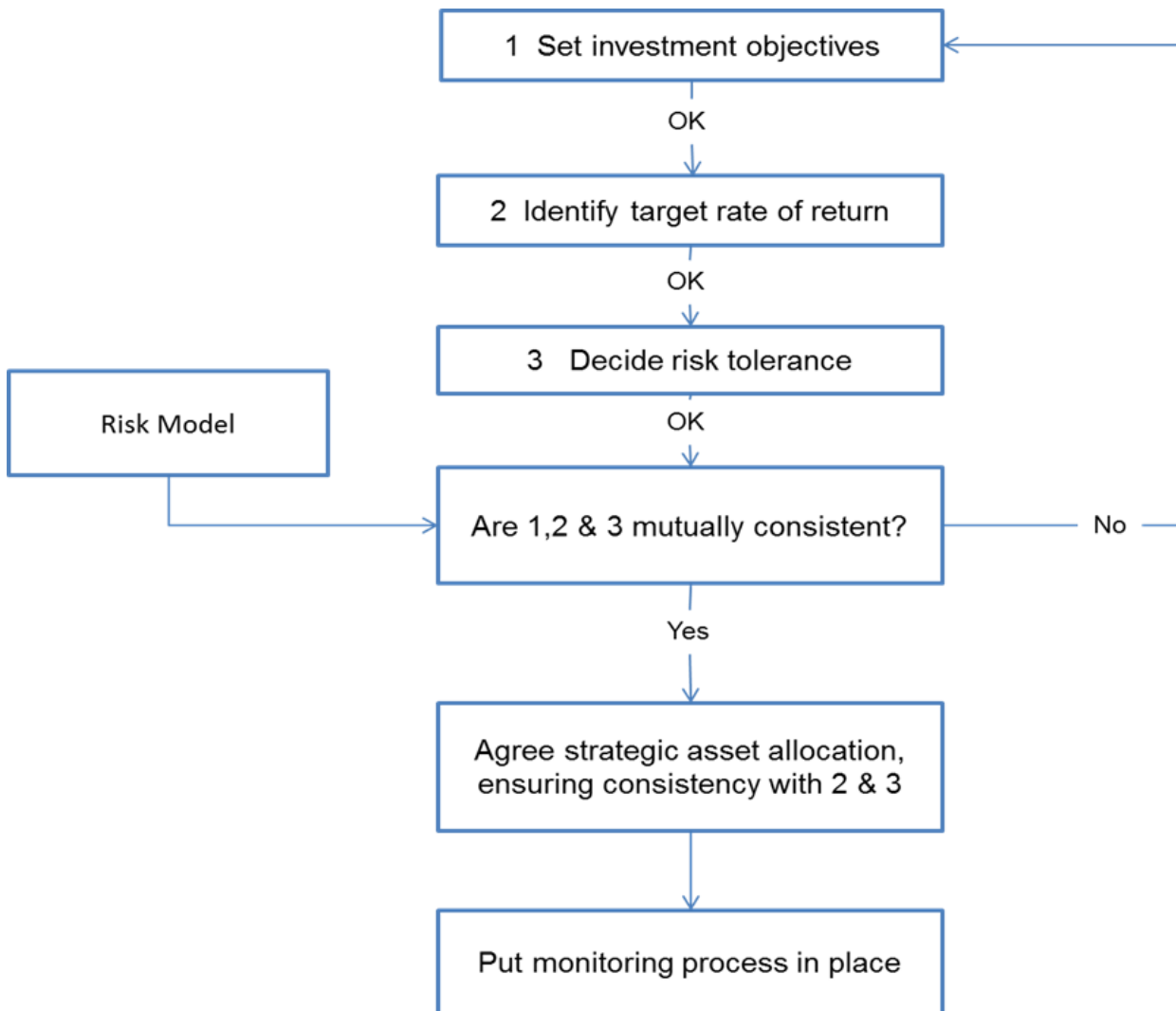
## **Strategic asset allocation**

Once the contribution rate, target rate of return and risk tolerance have been agreed and reconciled, the trustees should ask their advisers to develop proposals for the scheme's strategic asset allocation setting out the target allocations for the various asset classes. Once agreed, this will be used as a basis for the instructions given to the investment managers.

Section 59AB(2)(c) of the Pensions Act, 1990, as amended (the Act) , imposes an obligation on trustees to invest the assets of the scheme 'in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole'. The investment rules set out in the Act must be complied with when setting the investment mandate. The trustees may also have policies covering environmental, social and governance issues, which should also be taken into account when designing the investment mandates.

## 4. Overview

While no one approach to setting an investment strategy will be appropriate for all schemes, the diagram below illustrates an approach which, in the Authority's view, would be suitable for many DB schemes.



This may well be a time consuming, iterative task. While this is not a prescribed process, the above or a similar model would enable a rigorous defensible evidence-based investment strategy to be produced that can be explained to members.