Investment guidance
for defined benefit pension schemes
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Using this guidance

This guidance is for trustees of occupational pension schemes providing defined benefits (DB), and will therefore also be of interest to advisers and sponsoring employers.

It is set out in six sections:

1. DB investment governance
2. Investing to fund DB
3. Matching DB assets
4. DB growth assets
5. Implement a DB investment strategy
6. Monitoring DB investments

You can also read a summary of the DB investment guidance at: www.tpr.gov.uk/investment-guidance.

Our Code of Practice 3: Funding defined benefits (the DB funding code) sets out the standards we expect you to meet when complying with the law and this guidance provides information on how you might meet these standards in practice. You should read the code before you read this guide. It can be found at: www.tpr.gov.uk/code3.

This guidance aims to provide you with practical information, examples of approaches you could take and factors to consider when investing scheme assets to fund defined benefits. Often the methods and approaches you choose to adopt will depend on the nature of your scheme.

We have used the phrases ‘you should’ and ‘you need to’ to indicate good practice approaches. This contracts with legislative requirements (which are identified as such), and language such as ‘we would encourage you to’ and ‘you may wish to’, which indicate matters you may find it helpful to consider.

Some of the text in this guidance is highlighted to emphasise key principles and questions for consideration. Examples are used to illustrate concepts and provide practical guidance.

If your scheme has multiple benefit types, eg DB with a defined contribution (DC) additional voluntary contribution section, then you’ll also need to read our guidance on DC investment management.
Using this guidance

Trustees of some schemes, such as those with fewer than 100 members, wholly-insured schemes or small self-administered schemes are subject to different requirements in some respects. If you think that this could apply to your scheme, you should obtain legal advice on the applicable requirements.

What other publications could be useful?

- Code of Practice 9: Internal controls: www.tpr.gov.uk/code9
- Integrated risk management (IRM) guidance: www.tpr.gov.uk/irm
- Assessing and monitoring the employer covenant guidance: www.tpr.gov.uk/covenant-guidance
- Conflicts of interest guidance: www.tpr.gov.uk/conflicts-guidance
- Record-keeping guidance: www.tpr.gov.uk/guidance-record-keeping
- The trustee board guide (this guide has been prepared for schemes with money purchase benefits, however other trustees may find it useful): www.tpr.gov.uk/trustee-board
- Scheme management skills guide (this guide has been prepared for schemes with money purchase benefits, however other trustees may find it useful): www.tpr.gov.uk/skills
- The Law Commission guidance on pension trustees’ duties when setting an investment strategy: tinyurl.com/LawComFid
- Myners Principles for institutional investment decision-making: tinyurl.com/MynersPrin

Links to the Trustee toolkit

Throughout the guidance, we’ve referred to the relevant modules and tutorials of the Trustee toolkit, our free online learning programme at: www.trusteetoolkit.com. You should sign up for a Trustee toolkit account if you do not already have one. Alternatively, if you have a Trustee toolkit account you can log in. You will then have access to all the materials, including downloadable resources, interactive sections, case studies and quizzes. You can also save your progress and download and share a record of your achievements.
Understanding your legal duties

Purpose of investment
The fundamental purpose of trustees’ investment powers is to generate returns in order to enable the scheme to pay promised benefits as they fall due. When exercising investment powers, the law requires you to act in the best financial interests of scheme members and beneficiaries.1

Investment powers
As a trustee, you benefit from a statutory power to make any kind of investment.2 However, this broad power is subject to a number of restrictions.

A scheme’s governing documentation might limit the scope of the trustees’ discretion. For example, a scheme’s trust deed and rules might prohibit investment in certain asset classes. You need to check your scheme’s governing documentation for restrictions. Note that restrictions cannot be placed on trustees by requiring them to obtain the consent of the employer in relation to investment.3

Employer-related investment (ERI) is restricted or prohibited, depending on the form of investment.4 ERI is not covered in this guidance, so you need to ensure you understand the scope of these restrictions and how they might apply to your scheme.

You should not take account of the potential for the Pension Protection Fund (PPF) to provide compensation to members when exercising your investment powers.

Delegation to fund managers
The trustee board has ultimate responsibility for the scheme’s investments. However, in practice, the role played by trustees will generally be constrained by the Financial Services and Markets Act 2000 (FSMA). You need to familiarise yourself with FSMA so you understand what activities the trustee board (or a sub-committee of trustees) can take.5 This guidance should be read with the restrictions of FSMA in mind.

In summary, FSMA requires that ‘regulated activities’ are only carried out by persons who are authorised or exempt. Most day-to-day investment activities carried out on behalf of an occupational pension scheme are regulated activities. In practice, this means these decisions will generally need to be delegated to an investment manager who is appropriately authorised under FSMA.

1 Regulation 4(2) Occupational Pension Schemes (Investment) Regulations 2005 (the ‘Investment Regulations’).
2 Section 34 Pensions Act 1995.
4 Section 40 Pensions Act 1995.
5 The Financial Conduct Authority’s perimeter guidance at: www.handbook.fca.org.uk/handbook/PERG provides guidance on activities in relation to pension schemes at Chapter 10 and the FCA’s Handbook at: www.handbook.fca.org.uk is the principal guide to roles and responsibilities under FSMA and FCA regulation.
Understanding your legal duties

Where activities have been delegated, it is important that you monitor the fund manager’s performance. This is because as a trustee you may be responsible for the actions of the fund manager unless you:

- satisfy yourself that they have the appropriate knowledge and experience for managing the scheme’s investments, and
- monitor them to check they are carrying out their work competently and complying with applicable statutory requirements.

It’s also important that the terms of contractual arrangements and fund documents in place with investment managers and advisers are reviewed (including legal review) and negotiated to ensure this is achieved.

Trustees who are not appropriately authorised or exempt are generally restricted to making strategic decisions. These include decisions about:

- the statement of investment principles (SIP)
- formulating asset allocation policy
- the balance between generating income (eg from interest) and capital growth
- the use of risk mitigations such as liability hedging
- appointing investment managers
- the purchase of units in collective investment vehicles

In this guidance, we’ve indicated some additional circumstances where you may consider it appropriate to seek professional advice to support your decision-making in relation to investment issues. If you are unsure about your duties and the legal requirements in relation to investments, you need to undertake relevant trustee training and/or obtain appropriate legal advice.

Further information on ensuring your trustee board has the right governance, skills and knowledge to work together and with scheme advisers can be found in our conflicts of interest guidance and scheme management skills guide (this guide has been prepared for schemes with money purchase benefits, however other trustees may also find it helpful).

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Your duty to obtain advice

There are two circumstances in which you are required by law to obtain and consider investment advice:

- Before preparing or revising your SIP.
- Before investing in any manner. In most cases, you will not be taking this kind of day-to-day decision due to the requirements of FSMA. However, FSMA does allow unauthorised trustees to take a limited number of day-to-day investment decisions, for example purchasing units in a collective investment scheme. Before doing so, the law requires you to obtain investment advice, and renew that advice periodically.

You need to be satisfied that your advisers are suitably skilled and professionally qualified (and, where relevant, appropriately authorised under FSMA) to provide the advice they’re giving.

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8 Section 36(3) and (4) Pensions Act 1995. This advice is sometimes called ‘Section 36’ advice.
1. DB investment governance

Understanding your trustee duties and setting up an appropriate governance structure for your scheme’s investments

What you need to do

- Understand your responsibilities relating to investments.
- Put effective governance arrangements in place.
- Focus the trustee board on those decisions most likely to make a difference to meeting scheme objectives.
- Consider delegating less significant matters while retaining appropriate oversight.
- Decide when to use advisers and who is appropriate.
- Critically evaluate the advice and information you receive.
- Manage the principal/agent issues within your governance arrangements.
- Seek to develop a mutual understanding of investment and risk issues with the employer.
- Document your governance arrangements in a suitable form.
- Assess the effectiveness of the trustee board.
- Understand the issues relating to appointing and retaining fiduciary managers when assessing how appropriate this governance model may be for your scheme.
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.

It is important to obtain relevant professional advice in relation to the scheme’s investments, but (even if you have delegated day-to-day investment decisions) it is your role to decide how scheme assets should be invested, at least at a strategic level.

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 specifically) which summarises 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 those decisions most likely to make a difference.

If you think the trustee board does not have the skills and expertise necessary to do this, it is important for you to consider your options for addressing these weaknesses, for example by increasing your skills and expertise, delegating, simplifying the investment arrangements, or winding up the scheme. In taking such steps you will also find it is appropriate to document your actions and the reasons they were needed, and the improvement to the situation you aim to achieve.

For a brief summary of your legal duties in relation to investment, go to ‘Understanding your legal duties’. If you’re unsure about these requirements in general, you should undertake relevant trustee training. If you’re unsure whether your scheme’s particular investment governance arrangements are consistent with the law, you should obtain appropriate legal advice.
1. DB investment governance

In this guidance, we’ve indicated some additional circumstances where you may consider it appropriate to seek professional advice to support your decision-making in relation to investment issues.

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 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 (including legal review) and negotiated as appropriate to ensure this is achieved.

Further information on ensuring your trustee board has the right governance, skills and knowledge to work together and with scheme advisers can be found in our conflicts of interest guidance and scheme management skills guide (this guide has been prepared for schemes with money purchase benefits, however other trustees may also find it helpful).
Investment decisions and your statement of investment principles (SIP)

The law requires trustees of a scheme with more than 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 policy⁹. You should take written advice when preparing and reviewing your SIP¹⁰.

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

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 order, from those most likely to impact future outcomes, to those least. That order will depend on your scheme’s particular circumstances, but a suggested broad order is set out below:

- investment governance structure
- investment beliefs (if you have developed these)
- investment objectives
- risk capacity and risk appetite
- long-term journey plan (if you have developed one) and short-term milestones
- risk management approach (structures for de-risking and re-risking)
- strategic liability hedge (eg inflation and interest rate target hedge ratios)
- strategic asset allocation (eg target return and risk levels)
- cash flow and collateral/liquidity management strategy
- monitoring

It is good practice for your SIP to cover these areas (in addition to the items required by legislation¹¹). Other investment decisions with a lower impact that you may wish to include are:

- the design of matching and growth asset portfolios
- investment manager selection
- manager implementation

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⁹ Regulation 2(1) of the Investment Regulations.

¹⁰ Regulation 2(2) of the Investment Regulations.

¹¹ Regulation 2(3) of the Investment Regulations.
Consideration of these aspects will help you determine which decision-making to retain and which to delegate. For example, you may wish to delegate decisions about the selection and implementation of a liability hedging strategy or responsibility for selecting and replacing investment managers to an investment sub-committee. You may also decide to delegate the management of a part (or all) of the scheme assets to a fiduciary manager and retain responsibility for setting the strategic objectives and monitoring that mandate.

**Collaborative working with the employer**

The law requires you to consult with the scheme’s employer when preparing or revising the scheme’s SIP. In this context, 'consultation' involves exchanging views and giving proper consideration to the employer's perspective. The requirement to consult doesn’t mean you need to reach agreement with the employer, as the trustee board retains responsibility for the investment strategy.

However, we anticipate better outcomes will generally be achieved if trustees and employers work together to develop an understanding of the investment and risk issues.

Where possible, a collaborative approach should be followed, with trustees, employers and their respective advisers communicating regularly about notable developments relevant to the scheme's investments. Our DB code provides further detail on how trustees should engage with employers.

**Investment delegation structures**

Your governance structure should strike an appropriate balance between speed of action, and checks and balances to ensure that actions 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 strategic asset allocation and overall risk appetite. 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, are delegated to investment managers.
1. DB investment governance

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 set up, 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:

a. Does your scheme have the resources to cover the cost of a sub-committee? Does the size of the scheme and the number of members justify this?

b. What benefits might it offer? For example, would it enable the trustee board to make better decisions on investment, assess and implement a particular investment or risk management strategy, or broaden the range of investment and risk management techniques considered?

c. Do members of the proposed investment sub-committee understand their legal duties and responsibilities?

d. 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.

e. What are your scheme’s liabilities and the level of maturity of the scheme?

f. How developed is your scheme’s approach to integrated risk management?

If you decide to set up an investment subcommittee, you may wish to consider the balance between independent, employer and member-nominated trustees (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 its ‘fit’ with the skill set needs of the trustee board.
1. DB investment governance

Working with your investment advisers

The ‘Understanding your legal duties’ section sets out when you are required by law to obtain investment advice.

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 the scheme actuary. 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 independent trustees, investment managers, investment service providers and, for larger schemes, in-house investment teams.

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.
1. DB investment governance

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.

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) 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.

Monitoring investment governance
You need to regularly assess the effectiveness of your investment decision-making and investment governance processes, considering the impact on the scheme performance and meeting the scheme objectives of:

- your own performance as a trustee board
- the advice received relating to setting investment strategy and implementing investment decisions
- 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.
1. DB investment governance

**Things to consider: Reviewing your own performance as trustees**

Some examples of issues to consider are:

- Does the investment governance structure of the trustee board enable appropriate oversight and for decisions to be made effectively?
- 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)?
- Are investment decisions made in a timely fashion?
- Are the investment service providers, such as the investment adviser and investment managers, being held to account and agency issues addressed?
Fiduciary management

Fiduciary management is a form of governance model which involves significant delegation of investment powers to the chosen fiduciary manager. Some schemes delegate the management of all their assets to the fiduciary manager; others delegate a part of their portfolio. As with all governance models, under fiduciary management the trustees remain responsible for the stewardship of the scheme, including setting the overall investment strategy.

If you consider this an option for your scheme, you should commit sufficient time and resources to the process of selecting and appointing the fiduciary manager. This includes taking appropriate advice and considering a suitably wide range of potential managers, as for any other investment management appointment. You should also consider the implications of the CMA’s report on its investigation of the investment consultancy market, and take advice on how to comply with the new requirements which will, following that investigation, be imposed (probably with effect from October 2019 and April 2020) in relation to competitive tendering and re-tendering for the appointment of a fiduciary manager where certain conditions are met.

You should carry out enough due diligence to be comfortable that the proposed fiduciary manager has the appropriate experience and skill set for the mandate, bearing in mind the degree of delegation proposed. This is particularly relevant if you propose to appoint your existing investment consultant; the skills required to be a successful consultant are not exactly the same as those required to be a successful investment manager.

There is a potential for conflicts of interest between various parties when appointing a fiduciary manager, for example the existing investment consultant, third party advisers and the fiduciary manager. You should ensure that appropriate measures are in place to identify, mitigate and manage those conflicts.

For more information, see our conflicts of interest guidance and scheme management skills guide. (This guide has been drafted for schemes with money purchase benefits, however other trustees may find it a useful guide to ensuring their trustee board has the right governance and the skills and knowledge to work effectively together, and with advisers.)
If you are considering appointing a fiduciary manager, you may wish to consider appointing an independent consultant or intermediary who has specific expertise in this area. An intermediary should be able to provide specific advice on the structuring of the mandate and the selection of the fiduciary manager. They should also be able to assist with the ongoing monitoring and evaluation of the fiduciary manager’s performance.

Example 2: 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 pension scheme issues.

They conclude that the lack of continuity of the trustee board membership and lack of sufficient knowledge of some more complex asset classes and risk management strategies has been a barrier in implementing investment and risk management decisions.

The trustees are aware that fiduciary management is just one form of governance model and decide to get some independent advice on the most appropriate investment governance structure to adopt for the specific circumstances of their scheme.

They decide to appoint a fiduciary manager to look after part of their portfolio. This reduces the implementation burden on the trustee board and enables them to focus on more strategic issues for the scheme.

Learning points: 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, trustees should consider things like:

- 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 (and liability management) and those implementing the mandate, as well as the impact this has on the extent of independent advice required on the fiduciary mandate and how any potential conflicts are managed
- their interaction with your governance arrangements, their alignment with your objectives, and responsibilities for the management of the scheme
- how performance will be delivered, the cost implications for the scheme, the total costs of the mandate and how you expect the mandate to add value. In this context it will also be useful to understand how past performance has been delivered and, in particular, what contribution to historic returns has come from return-seeking assets and hedging implementation over different times
- potential risks and issues associated with the mandate and governance structures, now and in the future
- establishing appropriate reporting relationships with suitable oversights 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 mandate’s performance and risks on an ongoing basis
- how the assets could be transferred away from the fiduciary manager, in full or in part, and the costs involved in doing this (for example, you may wish to transfer assets for an insurance company buy-in, or to replace the fiduciary manager following a period of underperformance or a change in scheme strategy)
Investment stewardship

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, DB schemes with 100 or more members will be required to include in their SIP details of the trustees’ policy in relation to voting, engaging, and monitoring. In this context, engagement is:

- with ‘relevant persons’ (including an issuer of debt or equity, an investment manager, or another holder 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 ‘relevant persons’ also include any other 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 should 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.
1. DB investment governance – Investment stewardship

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.

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**Things to consider**

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?
- Can they provide voting records?

Your scheme’s SIP is required to include (among other things) statements about your policy (if any) on voting rights and the extent to which you take ESG factors into account in the selection, retention and realisation of investments\(^\text{12}\). You may wish to expand these statements into meaningful policies on long-term sustainability, how you apply the principles of the Stewardship Code, and how you will take non-financial factors into account.

\(^{12}\) Regulation 2(3) Investment Regulations.
1. DB investment governance – Investment stewardship

Useful links

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.

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- ShareAction reports

Trustee toolkit online learning: www.trusteetoolkit.com

Module: 'An introduction to investment'
Tutorial: 'Investment in a pension scheme'

You must log in or sign up to use the Trustee toolkit.
2. Investing to fund DB
Considerations to help you formulate, refine and revise your investment strategy

**What you need to do**

- Decide as a trustee board whether to develop investment beliefs, ensuring your investment strategy then reflects these beliefs.
- Establish your risk capacity and risk appetite.
- Set investment objectives and an investment strategy consistent with your risk appetite.
- Take an integrated approach to investment strategy, which considers the employer covenant and funding level.
- Seek to work collaboratively with the employer to set the investment strategy.
- Understand your scheme’s principal investment risks, balance appropriately the risks you are taking and put in place suitable mitigation strategies including contingency plans.
- Take environmental, social and governance (ESG) factors into account if you believe they’re financially significant.
- Carry out an appropriate level of analysis on investment options and understand the limitations of the analysis.
Investment guidance for defined benefit pension schemes

2. Investing to fund DB

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.

Example 3: Investment 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.

- 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 always 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 usually better value.
- Well governed companies that manage their businesses in a responsible way will produce higher returns over the long-term.
- Climate change is a long-term risk for the scheme and has the potential to impact the scheme’s investment strategy.
- Investing responsibly and engaging as long-term owners reduces risk over time and may positively impact scheme returns.
2. Investing to fund DB

**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 your 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 the scheme 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.
2. Investing to fund DB – Sustainability

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.tcfdhub.org/


Pension scheme investments are 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 the ESG 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 engaging with the companies in which investments are held (either directly or via your investment manager or bundled service provider as appropriate).
Financially material and non-financial factors

Financially material factors

When considering investment decisions/setting investment strategy, you should take into account all ESG and other 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. From October 2019, it will be a legal requirement that your SIP includes your policy on these factors.

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

- You may 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 where the fund viability might be compromised by any meaningful disinvestment (for example a member transferring out).
- Determining what will constitute a financially material consideration will often involve professional judgement.

From 1 October 2019 you will be 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 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 (www.lawcom.gov.uk/project/pension-funds-and-social-investment) 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 matters’ 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. You may consider some of the issues financially material 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 matters reflected in members’ views 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 matters 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 you 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.

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 matters into account is likely to avoid uncertainty or disputes at a later stage.

See the Law Commission for more information.

In the following section, we consider the extent you may choose to canvas the views of members.
**Example 4: Considering financial factors**

The trustees of ABC Scheme set an investment strategy to deliver a required level of return over the long-term. When reviewing the statement of investment principles (SIP), the trustees consider market developments and conclude that climate risk is financially material to the investment strategy.

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 the SIP as follows:

- We expect fund managers to have integrated climate risk into their risk analysis and investment process.
- We will try to ensure that we manage all new and existing investment arrangements in a way that takes account of climate risk.
- In monitoring the performance of our fund managers, we will also regularly consider how they are performing with reference to climate risk issues.

In addition, the trustees decide to report annually to members on how the climate risk policy has been applied.

**Learning points:** 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.
Example 5: Considering non-financial factors

The trustees of ABC Scheme receive a number of 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. The trustees 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 greater than they might have expected when compared to responses they have received relating to other communications they have shared with members. Of the members who responded, the majority were strongly in favour of factoring these ethical considerations into investment decision-making. The remaining respondents 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 members’ ethical concerns. They indicate that investing in a way which would address the ethical concerns expressed would not be expected to materially reduce the scheme’s expected returns (net of fees) nor increase the scheme’s investment risks.

The trustees review their investment beliefs and develop an addition to their policy on non-financial matters in their SIP. They also engage with their investment managers to embed the ethical principle in their existing mandates and all new investment mandates, where that is possible and having given due consideration to transaction costs arising from any fund switching required to achieve this.

NB: Some research methods can be expensive. Alternatives might involve reviewing relevant publicly available data from sources such as YouGov surveys or corporate position statements.
2. Investing to fund DB

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.


We don’t expect you to consult with members on every aspect of how you should be investing scheme assets, but you may wish to consider representations that members do make to you 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.

**Learning points:** There is no legal requirement to do so but you may take non-financial matters into account if you have good reason to consider the membership holds a similar view and you are satisfied that the investment does not present a risk of significant financial detriment – and that the costs involved with making the necessary assessments and adjustments are justified.
2. Investing to fund DB – Members’ views

Members’ views continued...

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 or forums. Although this guide was prepared in relation to defined contribution schemes, it does contain some guidance that can be applied more generally.

See our guide to Communicating and reporting for more information. Also see the Law Commission guidance.

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 risks associated with businesses relying on these products (for example reputational risk, or the risk of future legislation) 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 chose to take to inform your decisions.

- Having up-to-date policies in place will help you respond to members about their investment concerns.
2. Investing to fund DB

**Setting an appropriate investment strategy**

An investment strategy essentially sets out how the scheme’s assets are to be invested. An appropriate investment strategy balances risk and return in light of evolving scheme circumstances and objectives over time. The scheme’s investment strategy is one of the most important drivers of the scheme’s ability to pay promised benefits, and you should ensure you allocate sufficient time and resource to it.

Considering the following will help you set an appropriate strategy:

**Governance**

You need to have appropriate investment governance arrangements in place for your investment strategy. Further details are provided in Section 1: DB investment governance.

**Setting scheme investment objectives**

It’s important to set clear investment objectives for your scheme and to identify how and when they should be achieved. You may wish to set multiple objectives over different time periods. Your investment strategy should support and be consistent with your objectives.

**Iterative process**

The scheme objectives cover the trustees’ duty to pay benefits promised in accordance with their scheme rules as and when they fall due, linked to the statutory funding objective. You also need to have sufficient and appropriate assets to cover your scheme’s technical provisions (TP).

In practice, setting your scheme objectives and your investment strategy is likely to be an iterative process. This is because conclusions on your risk appetite will drive the level of expected return that the investment strategy can deliver. In turn, the level of expected return that can reasonably be targeted within your risk appetite will affect the likelihood of achieving the scheme objectives. You may need to reconsider the objectives in light of this.

**Taking an integrated approach**

Your scheme’s investment strategy is a key part of an integrated risk management (IRM) approach, and should be considered alongside the employer covenant and the funding level.

Our DB code of practice and IRM guidance set out the importance of taking an integrated approach in managing and monitoring the risks faced by your scheme.
2. Investing to fund DB – Setting an appropriate investment strategy

**Working collaboratively with sponsoring employer(s)**

As a trustee, you are responsible for the scheme’s investment arrangements, including determining its investment strategy, but we anticipate that better outcomes will generally be achieved if trustees and employers work together to develop an understanding of investment and risk issues.

**Risk capacity**

Broadly speaking, your scheme’s risk capacity is the maximum level of risk that you could choose to take when setting an appropriate investment strategy.

Risk capacities are not static. You need to regularly monitor and assess whether there have been any material changes to the risk capacity, which will affect the suitability of the current investment strategy.

The strength of the employer covenant will inform the risk capacity. Please see our covenant guidance for further details about assessing the strength of the employer covenant.

**Risk appetite**

Risk appetite is a measure of how much risk you are willing for the scheme to bear, having considered the employer’s views and the upper risk limit set by your scheme’s risk capacity. This risk appetite can help you determine whether the current investment strategy is appropriate or whether you should implement any alternative strategies to achieve the scheme’s objectives.
Things to consider when setting your risk appetite

- your risk capacity
- the employer’s risk appetite
- the scheme’s objectives
- how the factors which influence your assessment of risk capacity might change over time (e.g., the strength of the covenant)
- a greater level of risk requires a higher level of governance
- the scheme’s liability profile, including sensitivities
- the evolution of the scheme’s future cash flow requirements
- the level of expected return given the level of risk, now and as the strategy evolves
- the level of prudence the trustees view as appropriate

Example 6: Setting an appropriate investment strategy – risk capacity and risk appetite

The trustees of ABC Scheme have a long-term objective to be fully funded on a low risk basis within the next eight years. The trustees also have a short-term objective of achieving full funding on their technical provisions (TPs) basis. The existing recovery plan has a six-year recovery period with fixed contributions of £4 million per annum. The sponsoring employer operates in a sector that has high barriers to entry but little scope for future growth.

As part of their triennial actuarial valuation, the trustees receive their employer covenant review from their covenant adviser, which indicates that the scheme’s employer can afford deficit repair contributions (DRCs) of up to a maximum of £10 million per annum before affecting the sustainable growth of the employer.

continued...
Example 6: Setting an appropriate investment strategy – risk capacity and risk appetite continued...

The covenant adviser has also assessed the ability of the covenant to support the:

- TP deficit according to the latest actuarial funding report, which also indicates that the deficit has increased from the previous valuation
- risks within the scheme’s investments, as discussed in the investment adviser’s latest quarterly risk and performance report which shows a range of relevant Value at Risk (VaR) statistics

The covenant adviser believes that the covenant could support the increased deficit and the level of investment risk shown by the VaR statistics, if the trustees are prepared to accept them being made good over a 13-year period if the risk materialises at that level.

The trustees ask their investment adviser to carry out some initial modelling to help them work out investment and funding strategies as part of their triennial actuarial valuation process. The trustees are particularly concerned by the 13-year period over which the covenant would need to make good the TP deficit and scheme investment risk (if it were to materialise). They request analyses on a TP and lower risk basis using two contribution schedules – the existing £4 million per annum and the maximum £10 million per annum, as advised by their covenant adviser. The analysis is carried out on the scheme’s existing investment strategy and on an appropriate alternative lower risk investment strategy.

continued...
On receipt of the analyses, the trustees note that:

- £4 million per annum is no longer sufficient to achieve their short-term or long-term objectives with either investment strategy, on account of the increased deficit.
- Contributions of £10 million per annum should enable the scheme to achieve its short-term and long-term objectives. The likelihood of achieving these objectives is higher under the scheme’s existing investment strategy, but the downside risks are also materially higher.
- The risk in the new investment strategy proposed by their investment adviser (as shown by the corresponding VaR statistics) could be expected to be made good over nine years if it materialised at that level.

The trustees discuss their risk appetite and are concerned with the potential downside risk of the current strategy, especially as the deficit and current investment risk (if a downside event occurred at the level under discussion) could only be expected to be removed over a 13-year period. The trustees decide to adopt the proposed lower risk investment strategy while also requesting contributions of £10 million per annum. The TPs are then set in light of this lower risk investment strategy.

The trustees are more comfortable with this revised approach as it is consistent with their long-term objectives. They also believe that, given that there is little scope for future growth in the sector which the employer operates in, a nine-year period is a more reasonable term over which to expect the covenant to provide support.

**Learning points:** You should assess the extent to which the level of risk you decide to accept in your scheme lies within your risk appetite and can be supported by your scheme’s risk capacity, in the event that those scheme risks materialise.

You need to recognise that as scheme liabilities mature, scheme and employer circumstances will change and the appropriate level of investment risk to accept will evolve. How you expect the scheme risk appetite to evolve should be reflected in how you expect the investment strategy to evolve over time in order to achieve the scheme objectives.
Understanding the asset risks
As well as ensuring the overall level of investment risk is appropriate, it’s important to have a suitable balance of individual asset risks within your investment strategy. You need to identify and understand the key individual risks and mitigate these where appropriate. You should also assess the return you expect for taking investment risk and consider whether this is sufficient for the risk taken.

Understanding the scheme liabilities and how they are valued
The law requires you to invest your scheme assets in a manner appropriate to the nature, timing and duration of the expected future retirement benefits payable under the scheme, considering how they may change over time.

Understanding your liquidity needs
Your strategy should be appropriate for your liquidity needs, for paying benefits and expenses and for any collateral requirements. It should take into account the risks introduced if your scheme is significantly cash flow negative, or is expected to become so in the future.

Understanding other risks
You should also bear in mind the potential for other risks to arise, for example, longevity risk and operational risks related to scheme administration, legislative and regulatory risks.

Contingency planning
As part of setting an investment strategy and taking an integrated approach, you also need to consider setting contingency plans. Where a scheme has a journey plan with specific downside triggers, these can be related to these agreed contingency plans. Please see our guidance on IRM for further information.

Monitoring
Monitoring risks on an ongoing basis is important to ensure the level of risk taken remains appropriate. Monitoring can provide a flag to identify developing risks and investment opportunities. Ongoing monitoring of key scheme risks can be included within your scheme’s regular investment governance updates. Section 6: Monitoring DB investments provides further information on monitoring investment strategy.

Investment guidance for defined benefit pension schemes
Example 7: Assessing whether investment risk can be supported by the employer covenant

The trustees of XYZ Scheme are in the process of their triennial actuarial valuation and receive the employer covenant report from their adviser. The report suggests that the employer can afford DRCs of £2.5 million per annum before it affects the sustainable growth of the employer. It also notes that, while the employer is profitable today, it operates in a declining sector and it would be reasonable for the trustees to assume the covenant will gradually weaken over the next decade. The deficit on the draft TP basis is £20 million.

To assess whether the level of investment risk the trustees are currently taking is supportable by the covenant, the trustees commission their investment adviser to carry out an asset-liability modelling study. This shows that, if £2.5 million per annum is paid the scheme would be expected to achieve full funding on the draft TP basis within six years under the current investment strategy. However, under this investment approach there is a significant risk that in ten years’ time (when the covenant is expected to have weakened) the deficit will be greater than or equal to £12 million, even assuming the £2.5 million per annum continues to be paid after six years.

The trustees are concerned about the future of the employer covenant (as highlighted in their adviser’s report) and the outlook for the sector it operates in. They decide that this level of downside risk is unsupportable and inappropriate to take. The trustees request that the modelling be updated to look at alternative investment strategies including strategies that gradually de-risk over the short to medium-term.

After considering the updated modelling, they decide to maintain the current investment strategy, which is supportable today, but to gradually reduce the risk being run. While this approach lowers their expected return and their discount rate, and extends their recovery plan by two years, it significantly reduces the likelihood of the scheme getting into a position where it cannot be supported by the employer.

continued...
Example 7: Assessing whether investment risk can be supported by the employer covenant continued...

**Learning points:** You should understand how the level of risk in your scheme can be supported by the employer, both initially and in the future. Where the employer covenant is expected to weaken, you should consider what action to take. This may include seeking to de-risk, increasing or accelerating recovery plan contributions and using the flexibilities available in the funding regime (for example, by extending the length of the recovery plan).

Example 8: Collaborating on changes to the investment strategy

The trustees of the QRS Scheme are carrying out a review of the scheme’s investment strategy following a recovery in the employer’s business and its long-term outlook. After a difficult period, the employer has rebuilt the business – improving cash flows, strengthening their balance sheet and diversifying their product lines. As a result, the scheme covenant has improved materially and this has been confirmed by the trustees’ independent covenant adviser.

The trustees determine that, as a result of the increased covenant strength, they could take more risk in the scheme’s investment strategy. They consider with their advisers the advantages and disadvantages of strategically taking more investment risk now and targeting a higher return.

The trustees decide it could be attractive to increase their risk appetite and targeted return, in the expectation they will achieve their scheme funding targets sooner. They discuss this idea with the employer, which confirms that it is comfortable with an increase in investment risk, but the employer wishes to be kept informed of possible changes to the investment strategy to understand how this fits with the employer’s risk appetite.

continued...
2. Investing to fund DB – Setting an appropriate investment strategy

Example 8: Collaborating on changes to the investment strategy continued...
The trustees are advised that the new covenant strength could support an increased allocation from 40% to 75% to growth assets. However, while an allocation of 75% to growth assets is supportable, the trustees and employer have lower appetites for risk and, following discussions, agree that the growth assets allocation should increase to 65%. This is expected to reduce the period over which the funding targets can be achieved by five years, which is attractive to both parties.

When implementing the strategy changes, the trustees, having consulted with the employer, set two further principles to mitigate risks:

- They will maintain the current interest rate and inflation hedging levels by using liability driven investments (LDI), which use leverage rather than physical bonds.
- They will increase the diversification of the growth portfolio, as it will now represent a greater proportion of total assets.

**Learning points:** You need to implement an investment strategy that takes account of the employer’s covenant. You should engage with the scheme employer to understand their risk appetite before making changes to the investment strategy. An open and collaborative approach between trustees and employers can lead to better member outcomes.
Implementation

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

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, 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.

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 asset allocation, can be much more onerous.

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 for your scheme.
2. Investing to fund DB – Impact investment and patient capital

**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 enabling the scheme to pay the promised benefits. There is, however, no barrier to investments that have a social impact as a by-product where that primary purpose is met.

As trustees, you can also choose to actively take account of impact considerations in making an investment decision where you have good reason to think scheme members share their view and there is no risk of significant financial detriment to the fund. You 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 (given the legal requirement for trustees of schemes with more than 100 members to exercise their investment powers with a view to securing this).
2. Investing to fund DB – Impact investment and patient capital

**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.
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.
2. Investing to fund DB

**Journey planning**

When setting your investment strategy, you should not only consider the asset allocation and risk mitigations you’ll use today but also how you expect these to evolve over time. Journey planning can assist you in setting a long-term investment plan. It involves setting out:

- clear long-term objectives for your scheme and interim milestones
- how you propose to meet them
- how you will measure and monitor progress towards them
- what you will do to try and keep progress on track

We encourage trustees to have a journey plan appropriate and proportionate to their scheme’s circumstances. This plan should be realistic and demonstrate the **principles of IRM**.

You should discuss the journey plan with your sponsoring employer as part of a collaborative working approach. Information and idea-sharing between trustees and employers should assist you in formulating and maintaining your journey plan for your scheme, and help the employer to see your investment strategy in context.

Journey plans may help your scheme plan towards being well-funded on a low-risk investment strategy, which places minimal reliance on the employer covenant, in the future. A valuation basis consistent with this low-risk investment strategy is then often used as a secondary funding target alongside the formal scheme funding (ie TP) valuation. Journey milestones can then be set by reference to this secondary target.

**Monitoring your journey plan**

Monitoring progress along your journey plan will enable you to take action where appropriate. It’s important to consider in advance what actions to take if progress is not as expected. This applies whether progress is behind expectations or ahead of it. It’s also good practice to consider how these actions will be implemented so you can put the necessary governance and operational infrastructure in place beforehand.

Monitoring arrangements will depend on your scheme’s circumstances, including the available resource. Triggers are one common monitoring approach, especially ones based on the scheme’s funding level.

As part of developing a journey plan, you need to decide who will carry out the monitoring and how often. Monitoring investments is more beneficial when you consider in advance how you will respond to what the monitoring reveals.
Example 9: Journey planning and monitoring

Following their annual scheme strategy day, the trustees of EFG Scheme decide it would be beneficial to implement a journey plan to help them to assess the progress of their scheme against their long-term objective to be 105% funded on a low risk basis within 10 years. At the previous valuation date, on this basis, the scheme was 76% funded.

The scheme actuary advises the trustees of how the scheme’s funding position is expected to progress over 10 years. The trustees recognise that any journey plan they develop will be most useful if it sets out actions that will be implemented if progress differs materially from expectations, ie if funding is outside certain agreed boundaries.

They agree that if the actual funding progression is more than 4% different from expectations, this will be a flag for action. For example, in two years’ time, they expect the scheme to be 80% funded. However, if the scheme is less than 76% funded (ie below their lower bound) or more than 84% funded (ie above their upper bound) they will take action.

The trustees discuss the potential options available if the funding level is ahead of expectations (ie above their upper bound). In particular, the trustees consider:

- reducing the allocation to growth assets to a level where the objective is still expected to be met with no further contributions over and above those already promised by the employer
- bringing forward the target date to achieve full funding, while maintaining the prevailing asset allocation
- reducing risk by increasing the level of scheme hedging

continued...
Example 9: Journey planning and monitoring continued...
The trustees also discuss the potential options if the funding level is behind expectations (i.e., below their lower bound). They consider asking the employer to provide:

- contingent contributions to take the scheme back up to the lower boundary funding level over the following three years
- a guarantee from the employer or another entity in the employer’s group to cover the funding gap compared to expectations
- a funded escrow account from which contributions to the scheme will only become payable if the funding level is still below the lower bound at the next valuation date
- an agreement to reduce dividends and increase the cash held by the employer until the scheme is back within the boundaries
- re-risking the investment strategy as long as it remains supportable by the covenant

The trustees decide they will review progress against this journey plan at each future quarterly meeting and will revisit the underlying assumptions following each future triennial valuation. They also agree to review the journey plan basis periodically to check it remains appropriate.

**Learning points:** You should consider developing a long-term funding objective for your scheme, for example, to enable the scheme to be run on a lower-risk basis once that objective has been reached. This funding objective should be reflected in a realistic journey plan, which should include actions to be taken if the funding level is above or behind expectations.
Example 10: Hedging triggers

The trustees of the ABC Pension Scheme have recently implemented a liability hedge to reduce their interest rate and inflation risks. The scheme is currently 85% funded on the TP basis. After receiving advice on the risk and reward trade-off, as well as assessing the ability of the employer to support the scheme, the trustees initially decide to hedge 50% of both their interest rate risk and inflation rate risk on the TP basis.

The trustees would like to increase their level of hedging. Following advice, they decide to set some opportunistic triggers where their investment manager will automatically increase the levels of hedging if long-dated yields hit particular levels. The trustees develop a plan and governance framework setting out the following:

- The levels at which triggers will be set: their advisers help them set some realistic triggers based on the levels of interest rates and inflation rates.

- The actions to take when these triggers are hit: the trustees decide to increase their hedging levels by 30%. This is expected to reduce the VaR by a material amount for the scheme.

- Responsibility for monitoring: they decide to formally document the triggers so the investment manager will implement actions automatically if the triggers are hit.

- Timescales for review: they agree to formally review the levels at which the triggers are set at least every 18 months (and more frequently following significant market events) to make sure they remain appropriate in the prevailing market conditions.

The trustees are aware that their scheme liabilities are gradually maturing and are keen to ensure that their level of hedging (and risk reduction) continues to increase – at least until they are hedged at a similar level as the TP funding level. They also agree to set some time-based triggers which will lead to increased hedging as time passes.

continued...
Learning points: Where you set triggers to help hedge the interest and inflation risks of your liabilities, you should develop a formal plan and governance framework. You should ensure you consider a range of trigger bases, for example, related to scheme funding level, time-periods (time-based) or market levels (opportunistic). You should regularly review the frameworks, assess progress and take action where necessary to ensure scheme risks are appropriately managed.

Useful links

Trustee toolkit online learning: www.trusteetoolkit.com
Module: ‘An introduction to investment'
Tutorial: ‘Setting an investment strategy’

You must log in or sign up to use the Trustee toolkit.

Understanding investment risks

When setting your investment strategy you should:

- identify the key risks to your scheme
- understand, quantify and document the materiality of each risk to achieving your objectives
- determine whether the return associated with the risk is appropriate
- develop strategies to mitigate and manage these risks (where appropriate)
- monitor the key risks to your scheme regularly
2. Investing to fund DB – Understanding investment risks

You need to understand the risks associated with your investment strategy and the impact those risks may have on your scheme achieving its objectives. Sharing relevant information with the employer will help them understand their exposure to these pension scheme risks as part of the prudent management of their business.

Your approach should be proportionate to the size and complexity of the risks and you should identify the key risks to focus on. While some investment risks can be quantified, you may need to assess others qualitatively (such as political or regulatory risks, or future climate change).

You need to explore ways of mitigating risks, to address those that merit immediate mitigation, and to identify those that are acceptable today but you may wish to mitigate in the future. This will allow you to make more informed and efficient choices in the future.

### Risk mitigation strategies

Some risk mitigation strategies used by pension schemes are:

- changing the allocation from higher to lower risk investments
- hedging liabilities, eg against interest rate and inflation risks
- diversification – within and across asset classes, by drivers of return (or risk factors), geographies, investment managers and counterparties
- hedging asset exposures, eg equity options and currency hedges
- liquidity and collateral risk management frameworks

Investment products are available that enable smaller schemes to implement types of risk mitigation that were previously only practicable for larger schemes. We’d encourage you to keep abreast of market developments in this area if applicable to your scheme. Your investment adviser should be able to assist with this.

You can mitigate risk by having robust investment governance and monitoring procedures in place for your scheme.

When setting your investment strategy, you need to consider the scheme’s asset, liability valuation and cash flow risks. We explore these below.
2. Investing to fund DB – Understanding investment risks

**Asset risks**

With all assets, there’s a risk that the returns they provide may be lower than was expected when the investment was made. You should understand the expected economic and market drivers of return that underlie your investment strategy and what may cause returns to be different from expected.

In setting the scheme’s asset allocation, we’d encourage you to consider investing in a wide range of asset classes. You should also consider the available implementation routes as these influence the risks and return expectations of the investment. Issues related to implementation are covered further in Section 5: Implement a DB investment strategy.

Asset risk can be mitigated in various ways, including through diversifying asset allocations and through hedging using derivatives.

More information on asset risks is covered in Section 3: Matching DB assets and Section 4: DB growth assets.

**Liability valuation risks**

A pension scheme’s funding level compares a value placed on the scheme’s liabilities with the market value of the scheme’s assets. Both of these values vary with investment market conditions. Schemes are typically exposed to liability valuation risk. This means the values of the liabilities and assets do not usually respond in exactly the same way to changing market conditions. The difference in response can have a material impact on the scheme’s funding position. You therefore need to understand and quantify the liability valuation risks you are running.

You can mitigate liability valuation risks by investing in assets that move in a similar way to the value placed on the liabilities as market conditions change. These asset strategies are known as liability driven investment (LDI) or liability hedging strategies.

The way the liability value varies with market conditions depends on how the valuation assumptions are derived. Typically, long-term interest rates and long-term inflation expectations have a significant influence on the valuation. Therefore, LDI strategies typically involve a portfolio of high quality bonds and other assets and/or derivatives and their collateral whose value responds to changes in market conditions similarly to how the liability value responds.

You need to understand the nature and extent of liability valuation risks your scheme is exposed to and clearly document your rationale and approach to managing these risks. More information on liability valuation risks is covered in Section 3: Matching DB assets.
Sequencing risk
You should understand how your scheme’s assets, liability values and cashflows are expected to develop in the short, medium and long-term when setting your investment strategy. This is because the impact of investment performance on meeting scheme objectives depends on when the performance occurs. For example, investment underperformance when the scheme is relatively large is potentially more significant than underperformance when it is relatively small. This is referred to as sequencing risk.

Put simply, it matters when investment returns occur, as underperformance when the asset base is large will need to be made good in future, all else being equal, either by higher DRCs or through higher investment returns from a smaller asset base.

Sequencing risk is particularly relevant for schemes that are more mature, where the asset base is expected to decline over time due to the net cash flow out of the scheme being greater than the investment return achieved. Schemes in this position can be more vulnerable to investment underperformance.

The materiality of sequencing risk to your scheme will depend on several factors. Schemes where it is most significant are likely to have some of the following characteristics:

- cash flow negative, ie more benefits and expenses are being paid out than income received from contributions and investments
- mature (and hence a short time horizon to make good any reduction in funding level)
- volatile investment strategy (hence the degree of any underperformance is likely to be greater)
- poorly funded (so that the outgo from scheme benefits and expenses is a greater proportion of the asset base than if the scheme were better funded)
- weak covenant (so that the employer will find it difficult to pay additional DRCs to make good any underperformance)

It’s good practice to explore how material this risk is to your scheme, especially if your scheme exhibits some of the above characteristics or is expected to do so in the future. Where this risk is material, having robust risk management and risk mitigation strategies is key.
Scenario projections or asset-liability modelling can be useful tools to assess this risk. For smaller schemes, instead of carrying out a detailed asset liability modelling exercise, a useful insight could be obtained, for example, by applying a shock to the assets and/or to interest rates, and projecting the value of the assets and liabilities over a reasonable future time period.

### Cash flow and liquidity risks

You should understand how your scheme’s benefit and expense payments and contribution income are expected to develop when setting your investment strategy, so your strategy can take into account the scheme’s cash flow and liquidity risks.

If the benefit and expense payments exceed the contribution income, they will need to be met from investment income or asset sales. Meeting them from asset sales introduces the risk that assets cannot be sold quickly enough, or they can only be sold quickly enough at a reduced price. This is known as liquidity risk. Cash can also be needed to make collateral payments if you have certain types of derivative arrangement in place, such as those associated with LDI, or currency hedging arrangements.

Your investment strategy should take account of your scheme’s need for cash, and the associated liquidity risks, and we would encourage you to develop a cash flow management policy. This should address the typical cash flows’ in ‘business as usual’ circumstances, and how you would deal with more exceptional circumstances.

When considering your cash flow management policy, you need to be aware of the liquidity characteristics of all the investments the scheme holds and how they might vary in different market environments. You need to ensure you have sufficient liquidity within the portfolios to meet scheme benefit cash flows and any collateral requirements arising from derivative or currency positions held.

Even where the risks associated with cash flows are not material, we consider it good governance to set a cash flow management policy to help keep the scheme’s actual asset allocation in line with the investment strategy. It can also help you deal with unexpected cash flow requirements promptly and efficiently.
Example 11: Considering the impact of meeting benefits as they fall due

The XYZ Scheme is currently invested 35% in UK equities, 35% in global equities and 30% in gilts. The scheme has TP of £160 million, a deficit of £35 million and a nine-year recovery plan of £4 million per annum. The scheme is mature, with 70% of its liabilities being in respect of pensioner members, and the employer has been rated as ‘tending to weak’.

As part of their investment strategy review, the trustees look at long-term projections of how they expect their assets and liabilities to evolve over time. While the scheme is expected to achieve its TP funding objective in nine years in over 50% of the scenarios, the analysis also shows there are several scenarios where the scheme’s funding level deteriorates over time, sometimes quite rapidly. Their adviser explains that these scenarios are being driven by a combination of the funding position (ie the underfunding), the volatility in the investment strategy and the fact that the scheme is paying out between £7 million to £10 million per annum in benefits over the projection period. Their adviser further explains that:

- in the event of a sustained period of underperformance or a significant downside event, the prevailing (and smaller) asset base would have to perform even better in future years to recover any underperformance
- benefits continue to be paid out in full while the scheme is underfunded. If the investments underperform expectations over a sustained period or a significant downside event occurs, the cumulative effect will lead to deterioration in the funding position of the scheme

continued...
Example 11: considering the impact of meeting benefits as they fall due continued...

In light of this analysis, the trustees recognise they need to take steps today to reduce the risk of significant investment underperformance now and in the future. As a result, the trustees decide to:

- increase the diversification of their return-seeking assets (to help minimise the volatility of their combined asset value)
- identify a more appropriate split between matching and return-seeking assets
- design an IRM trigger based on the minimum level of funding, below which recovery to full funding would not be possible through future investment performance (taking account of the maximum acceptable level of investment risk) and planned future contributions to the scheme
- share the analysis with the scheme employer so that they are aware of the risks in the current strategy

**Learning points:** Trustees need to understand how their scheme cash flows are likely to evolve. In particular, where their scheme is underfunded and the assets held are volatile, the trustees should seek to understand the impact that significant benefit outflows might have on the ability of the remaining assets to deliver enough performance to recover the funding level.

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**Useful links**

**Trustee toolkit online learning:** [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

- Module: 'An introduction to investment'
- Tutorial: 'Capital markets and economic cycles'
- Module: 'Investment in a DB scheme'
- Tutorial: 'Changing asset and liability values'

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2. Investing to fund DB

**Using models to assist in setting your investment strategy**

You or your investment adviser may make use of models to assist in setting your investment strategy. You can use models to help identify and quantify risk as well as to illustrate the likelihood of achieving scheme objectives. Modelling can also be useful when comparing the risk and rewards of different investment strategies.

We expect your use of models to be proportionate to the complexity of the risks concerned. Sophisticated risk assessment tools may not be necessary if the risks facing the scheme are simple and straightforward; the modelling approach should be appropriate to the circumstances. You may wish to seek the help of your investment adviser on whether a detailed risk analysis would be beneficial. As a minimum, we expect you to complete some scenario or sensitivity analysis.

If it is appropriate to carry out comprehensive modelling of your scheme, for example long-term modelling and/or decomposition of the risks into the key components, you will need to review and update this modelling at appropriate intervals as the scheme develops. When undertaking long-term modelling you need to consider the potential impact of the covenant on the payments under the recovery plan and on any contingent assets.

Where the scheme risks are significant in the context of the employer’s business, we would expect you (and the employer) to consider the risk management benefit that might be achieved by undertaking more comprehensive analysis.

**Metrics used to quantify and assess risks**

You may find it useful to develop specific risk metrics for your scheme. Identifying and quantifying risks, as well as considering mitigation strategies, may be carried out using models and metrics such as **stress tests**, **scenario analysis**, asset-liability modelling and/or VaR analysis decomposed into the various contributing risk factors (amongst other models and metrics).

Modelling output can help you identify the most material risks for your scheme, so you can monitor and mitigate them. It may also show you where your scheme is exposed to common risk factors across its investments, the employer’s business and any contingent assets. This process will also help you identify which modelling assumptions you should consider in greater detail when interpreting the results.
While models can be useful tools in setting investment strategies, it's important that you are aware of model limitations and the key assumptions that underlie their outputs. This is important as the output is ultimately a reflection of those assumptions. There are significant differences between models and between modelling approaches; not all models identify the same risks.

For example, a short-term VaR model will not identify the risks to a scheme associated with how its cash flow profile is expected to evolve over the medium or long-term. For schemes where this is a significant risk, long-term modelling, where the asset cash flows are modelled accurately, would be appropriate.

Example 12: Choosing the most suitable modelling

The Trustees of the ABC Pension Scheme are carrying out a review of their investment strategy following the appointment of a new investment adviser. The scheme is mature, cash flow negative and 75% funded on a TPs basis. The trustees have set a secondary funding target to reach full funding on a basis similar to buyout over the next 15 years.

The scheme's investment adviser suggests carrying out some modelling as part of the strategy review. The adviser acknowledges that while modelling will not capture all the risks to a scheme, it can be a useful tool to compare the high level risk and return characteristics of different investment strategies. Historically, the trustees have only looked at the scheme's overall VaR figure as a high-level metric to assess the risks to the scheme, so they are hesitant to incur costs. The adviser suggests the scheme carry out:

- a decomposed VaR assessment (ie a VaR measure broken down into the key component risk parts)
- some long-term projections to assist the trustees in their decision-making

The adviser suggests that the decomposed VaR would be beneficial as it will identify those risks which are the most material to the scheme. He believes that identifying these risks will help the trustees to focus their time appropriately.

continued...
Example 12: choosing the most suitable modelling continued...

The adviser suggests that long-term modelling, such as scenario projections or asset-liability modelling, would be beneficial to help understand whether the current strategy, and how it’s expected to evolve, is appropriate given the scheme objectives. The adviser highlights that looking only at a VaR figure would not illustrate the range of ways in which the funding level of the scheme and the risks associated with the scheme strategy could develop in the future.

The employer, having been informed by the trustees, advises that the long-term projections will assist with their longer term corporate planning and acknowledges that the additional work, even though it would incur costs, will have significant value. The trustees decide to include a decomposed VaR analysis and scenario projections in the scope of their investment strategy review.

**Learning points:** There are different risk measures and different models look at risk from different angles, for example, over different time horizons or to consider individual risks versus overall risks. Trustees and their advisers should consider what analysis would be most appropriate for the scheme and employer’s circumstances.

**Understanding assumptions**

We expect your advisers to clearly identify the key assumptions used in their advice. We encourage you to discuss these assumptions with them to ensure you understand them and assess the degree of confidence the advisers have in them. You need to ensure that they are consistent with your documented investment beliefs and that they are appropriate for how the investment strategy will be implemented in practice.

Given that interest rates are often the primary source of funding volatility, it’s important that you understand whether the central modelling assumptions follow current market expectations or whether they incorporate a different view of how these rates will evolve over time. For example, some models assume interest rates and/or gilt yields will rise to a higher level in the long-term than currently priced into markets.
For some alternative asset strategies, advisers may have limited experience and data from which to develop modelling assumptions. Where you consider it proportionate, you may wish to look at the model output using a different set of assumptions to help you assess how material the assumptions that underlie the model are.

There can be significant differences between theoretically modelling an investment and the real-life implementation of that investment. In practice, asset classes can be accessed through various routes and the asset modelling may not reflect the possible implementation routes and/or investment manager approaches to the assets. This can be a particular issue when modelling and implementing multi-asset investment strategies such as diversified growth funds (DGF).

For more information on modelling and DGFs see Section 4: DB growth assets.

**Considering alternative assumptions**

Key assumptions to consider will depend on your scheme’s unique circumstance, but may include the:

- future path of interest rates and/or gilt yields
- future path of inflation expectations
- expected returns and volatility of asset classes that are material to the scheme
- **risk premium** assumed for each asset class and its stability over time
- correlations between asset classes, particularly between those which are expected to offer significant diversification benefits
Example 13: Understanding models

The trustees of the XYZ Pension Scheme request some asset-liability modelling (ALM) from their adviser as part of their review of the investment strategy. The adviser demonstrates their latest modelling tool to the trustees, to show them the impact in real-time of making investment strategy changes.

At the meeting, the trustees consider various investment strategies and review the ALM output of those strategies. They decide not to make any changes to the strategy as it is expected to achieve their TPs funding target by the end of the recovery plan and they believe the downside risks of the strategy are supportable by the covenant.

A year later, the trustees observe that their investment strategy had performed as expected. However, the scheme funding level is noticeably lower than expected when considered against the ALM projections. They ask their advisers why this might be the case.

Their adviser notes that one of their model’s central assumptions was that interest rates would rise faster than priced into markets. However, in practice, interest rates have not moved significantly over the one-year period. This factor is the primary reason for the difference.

The trustees request their advisers show them the ALM output, on an alternative basis, using a central assumption that interest rates follow what is priced into markets. The ALM output is materially different and the trustees acknowledge that, had they been aware of the differences, they may have made different decisions at last year’s meeting. The adviser explains that this assumption was noted in the appendix to their strategy review.

The trustees agree that they should seek to understand material assumptions and the implications on scheme outcomes of key assumptions not being borne out in practice. The advisers agree they will be more explicit with the trustees on the significance of individual assumptions underlying their models and will explain the rationale of their central assumptions.

continued...
Example 13: Understanding models continued...

**Learning points:** Trustees should understand the key assumptions that underlie any modelling they receive and consider the impact of making alternative assumptions. Advisers should also be transparent with their clients on the key assumptions that influence the model output.

**Examples:** For further examples on modelling, see the appendix of the IRM guidance.

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**Useful links**

**Trustee toolkit online learning:** [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

- **Module:** 'Investment in a DB scheme'
- **Tutorials:** 'Future projections and scenario planning'
  - 'Stochastic modelling'

You must log in or sign up to use the Trustee toolkit.
3. Matching DB assets

Using matching assets to manage investment risk relative to the scheme liabilities

What you need to do

- Understand the purpose of your matching assets, including the risks they are seeking to mitigate, so you can assess how appropriate and effective they are.
- Understand the risks introduced by your matching assets, so you can ensure you have appropriate strategies and appropriate governance arrangements in place to manage these risks.

Using matching assets

You are legally required to invest assets backing DB liabilities in a way that’s appropriate to the nature, timing and duration of the expected future retirement benefits payable under your scheme. To help achieve this, many schemes hold ‘matching assets’ in order to manage investment risk relative to the liabilities.

Different types of matching asset match the liabilities in different ways, with varying degrees of accuracy, and with different levels of expected return. Your scheme’s matching asset portfolio may comprise only physical (ie non-derivative) assets, eg fixed or index-linked gilts, corporate bonds, long-lease property and some forms of infrastructure. However, it is common practice for matching asset portfolios to use derivatives as well, to increase the level of matching achieved. This type of approach is known as liability-driven investment (LDI).

In order to assess your scheme’s matching asset portfolio and how appropriate the assets used are, you need to understand why your scheme invests in matching assets. It may be to:

- reduce the volatility in the funding level by investing in assets which respond to changes in interest rates and/or inflation in the same way as the liability value does
- prepare for a liability transaction, eg a partial buy-in, by reducing the volatility of the assets relative to the transaction price
- generate cash flows that coincide in timing and amount (ie match) with scheme cash outflows, such as the payment of pensioner benefits, in the short to medium term
- seek to match the long-term cash flows of your scheme
3. Matching DB assets

You need to understand, at a high level, the principal characteristics of the liabilities or cash flows you’re trying to match and the main features of your scheme’s matching assets.

**Things to consider: matching assets**

- How sensitive are the matching assets to interest rates?
- Which interest rates are used to measure the sensitivity (eg gilts, swaps, corporate bonds)?
- How sensitive are the matching assets to future inflation?
- To what extent do you want your matching assets to match the change in the value of the liabilities and/or to match scheme cash flows?
- Over what timescale and how closely are you trying to match the liabilities or cash flows?

You can use this information to assess how effectively the matching assets are meeting your objectives for them, and whether any changes would be appropriate. Your investment adviser should be able to assist with this.

**Understanding the risks of your matching assets**

You need to understand the risks introduced by your matching assets. You may wish to consider risks in relation to:

- credit/default
- liquidity
- collateral requirements and management
- derivative counterparties
- foreign exchange
- concentration, eg in relation to specific issuers, sectors or portfolio factors
- reinvestment/roll
- political and regulatory
- investment manager skill
- basis
If your matching assets include derivative instruments, you should consider the additional risks these introduce. A key issue to understand is how the matching asset portfolio will behave in an environment of rising long-term interest rates (and therefore, falling values of liabilities and matching assets) and how this may impact on the collateral being held and potentially on the scheme’s other assets.

The use of derivatives in your matching assets may require you to hold a minimum amount of assets eligible to meet collateral requirements, such as cash or gilts. Your investment manager or investment adviser will be able to explain whether and how this affects your scheme and what processes and plans are appropriate to meet any collateral movements and to address the associated operational risks. For more information see ‘collateral management’ in Section 5: Implement a DB investment strategy.

You might be holding matching assets to prepare for a future liability transfer exercise, e.g. a buy-in or buy-out of your scheme liabilities (or some of them). You should consider with your investment adviser whether the assets you hold for this purpose are likely to be acceptable to an insurer and, if not, the impact that might have on your liability transfer objective. In particular, you would then need to consider how to convert those assets into cash, the costs involved in realisation and any potential restrictions on sale.

**Diversification**

It is a legal requirement for scheme assets to be properly diversified. Diversification means investing in a range of assets to ensure the scheme is not overly reliant on any single investment or portfolio of investments. Not all investments perform the same way under different economic and market conditions. Diversifying your scheme’s assets should therefore provide greater stability of investment returns and reduce risk. You may wish to consider diversification of your matching assets in terms of:

- asset classes
- geography
- bond issuers
- derivative counterparties
- asset managers

13 Regulation 4(7) of the Investment Regulations.
3. Matching DB assets

**Governance**

We expect you to have appropriate investment governance arrangements in place for your scheme’s matching assets so the risks are properly managed. In particular, the use of derivatives can introduce investment and operational risks that require careful oversight.

**Liability-driven investment**

Derivatives, such as interest rate or inflation rate swaps, gilt repurchase arrangements (gilt ‘repo’) etc, can be used to match liability or cash flow characteristics more closely. They can also, through the use of leverage, provide increased exposure to interest and inflation rates and reduce the proportion of the scheme’s assets that need to be held in the matching asset portfolio to achieve a given level of matching. This type of approach is known as LDI.

Investment in derivatives is subject to additional statutory requirements. The law requires that this type of investment is only be made to contribute to a reduction in risks, or to facilitate efficient portfolio management.\(^\text{14}\)

The use of LDI typically enables pension schemes to achieve an improved balance between investment risk and return but it does introduce additional risks, eg around the use of leverage and in relation to operational risks around the management of collateral. Your investment adviser will be able to discuss the merits of an LDI approach to your matching assets with you.

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**Example 14: LDI**

The assets of the XYZ Pension Scheme are invested 60% in global equities, 10% in index-linked gilts, 10% in fixed gilts, 10% in corporate bonds and 10% in property. The bonds are benchmarked against the over-5 years FTSE index-linked gilts index, the over-15 years FTSE gilts index and the all stocks corporate bonds index, respectively. The duration of the assets held, as advised by the scheme’s investment consultant, is around five years.

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\(^{14}\) Regulation 4(8) of the Investment Regulations.
Example 14: LDI continued...
The trustees are in the process of completing their actuarial valuation and the draft actuarial report indicated that:

- the scheme is 80% funded on their technical provisions (TP) basis
- the liabilities are broadly split as 50% fixed, 50% inflation-linked (uncapped)
- the duration is 18 years for the fixed liabilities and 22 years for the inflation linked liabilities

As part of their quarterly update, the scheme’s investment consultant advises that:

- there is a significant mismatch between the duration of the scheme’s assets and liabilities
- a 1% reduction in interest rates would increase the value of the liabilities by around 20% but only increase the value of the assets by around 5%
- as the scheme is only 80% funded, the value of liabilities, compared to the assets, would increase by more than 15%

The trustees are concerned about the level of risk in their scheme assets compared to the liabilities. They instruct the investment adviser to analyse the sensitivity of the assets and liabilities to a range of factors, and to propose changes to the investment arrangements to reduce the degree of interest rate (and inflation) mismatch without initially reducing the expected return on assets.

The investment adviser proposes an incremental approach whereby the trustees would initially allocate 30% of their assets to LDI and gradually increase their allocation afterwards. The adviser proposes that the initial allocation to LDI would be funded from the scheme’s existing bond investments. The adviser also recommends that the LDI portfolio should be constructed using:

- a bespoke bond portfolio, ie a portfolio of bonds that better reflects the profile of the scheme’s liabilities compared to the current bond holdings which are based around common industry benchmarks

continued...
Example 14: LDI continued...

- interest rate and inflation rate swaps, as these derivative instruments would allow the introduction of a limited amount of leverage (on average two times) to enable a greater reduction in liability risk.

The investment adviser also advises that, due to the use of derivatives (swaps) and leverage, collateral would need to be held and managed. The adviser explains the extent of the collateral risks that the scheme would be exposed to and develops a collateral risk and management plan for the trustees, which would be periodically reviewed.

Learning points: Trustees may wish to consider LDI to enable them to better manage the interest and inflation risks within their schemes. However, LDI introduces some additional risks, e.g. around leverage and collateral management, and trustees should understand these and take appropriate steps to manage them.

Useful links

Trustee toolkit online learning: www.trusteetoolkit.com

Module: 'An introduction to investment'
Tutorials: 'Types of asset: Common assets'
        'Types of asset: Alternative assets'
        'Capital markets and economic cycles'

Module: 'Investment in a DB scheme'
Tutorials: 'Changing the asset allocation strategy'

You must log in or sign up to use the Trustee toolkit.
4. DB growth assets
Using growth assets to generate investment returns relative to the scheme liabilities

What you need to do
- Understand the risks your growth assets are taking to seek return, including those in multi-asset funds.
- Put in place appropriate methods, such as diversification and hedging, and appropriate governance arrangements to manage those risks.

Understanding growth assets
Pension schemes hold growth assets, also known as ‘return seeking investments’, because they want a positive return over time to grow the scheme assets.

Investment in growth assets involves taking risks to target the desired return. Many different types of growth asset are available to pension schemes and involve taking different types of risk to seek that return.

You need to understand how your growth assets are expected to generate return and the principal risks involved. Your investment manager(s) or investment adviser should be able to explain this to you and provide relevant training.

You may find it helpful to consider whether the return is essentially:

- contractual (such as bond investment), where a legal agreement gives you the right to a specified level of return but you take the risk that the other party (eg the bond issuer) may default, or
- non-contractual (such as equity investment), where you are entitled to a share in the profits from a venture, but you take the risk that these profits may not be achieved.
You may wish to use a framework that considers the underlying drivers of return of the growth assets and reconcile these with your investment beliefs, if you have developed them, eg:

- credit risks
- equity market risks
- real estate risks
- insurance risks
- interest rate risks
- inflation risks
- currency risks
- liquidity risk
- political risk
- non-macroeconomic/behavioural factors
- investment manager skill
- environmental risks including climate change
- governance and stewardship risks

A framework like this can help you understand how your growth assets may perform across a range of different economic and market environments. It can also help you critically assess proposals to invest in new or different types of growth asset.

As well as the risks from the investments themselves, you need to consider the risks arising from how those investments are accessed, particularly where pooled fund structures are used.

**Diversification**

As described in the matching assets section, it is a legal requirement for scheme assets to be properly diversified. Diversification may provide greater stability of investment returns and reduce risk. For growth assets, you may, for example, wish to consider diversification in terms of:

- asset classes
- geography
- asset managers
- sector risks
- underlying securities
4. DB growth assets - Diversification/Governance/Multi-asset funds

Schemes generally seek diversification by investing across different asset classes. However, the returns from different asset classes may be driven by the same underlying risk factors. Consideration of these underlying factors should enable more effective diversification to be embedded in your scheme’s investment portfolio.

You should also consider how diversified your scheme’s assets are from the scheme’s employer. If the same factors significantly affect the employer covenant and the scheme assets, it increases the overall risk in the scheme.

Even pension schemes with well-diversified investment strategies may experience periods where diversification offers little protection. This happened in the global financial crisis of 2007-2008, when many asset classes performed badly at the same time. You may therefore wish to consider other types of risk mitigation techniques, eg reducing your scheme’s exposure to significant market falls by using suitable tail risk hedging strategies. You can see an example of assessing employer risk in our IRM guidance.

**Governance**

You need to have appropriate investment governance arrangements in place for your scheme’s growth assets so the risks are properly managed. A portfolio of growth assets that is well-diversified across different risk factors can involve different managers and asset classes and may require increased governance and monitoring.

**Multi-asset funds**

Multi-asset funds are a popular way to access a diversified portfolio of return-seeking investments, with the aim of reducing scheme risk while maintaining scheme return. While these funds may offer benefits to schemes in terms of risk and return, they cover a wide range of investment asset classes and investment and risk management strategies. Fund performance over different times and market cycles can vary significantly between funds. You need to check the selected fund is consistent with your investment objectives.

Adopting this approach outsources the selection of assets and governance of that portfolio to the fund provider. If you’re considering investment in a multi-asset fund, 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. Assessing historical fund performance under different market and economic conditions can help with this.
If you decide to invest in a multi-asset fund following an investment modelling exercise, you should satisfy yourself that the chosen fund fits with the modelling assumptions used, revisiting the modelling with more appropriate assumptions if necessary.

**Things to consider: diversified growth funds (DGFs) and other multi-asset funds**

The range of approaches adopted by DGFs and other multi-asset strategies can vary significantly between funds and strategies. Examples of areas to understand are:

- the range of asset classes the fund may invest in
- the degree of investment flexibility within the mandate, eg the equity allocation in a DGF might be able to range between 15% and 85%
- the extent to which derivatives, the ability to short stocks, structured products and other complex instruments are used
- how the manager expects to generate the return objective, including the amount of return generated by active management of the underlying assets (alpha), general market movements (beta), by tactical asset allocation (market timing) and by other components, such as currency, sector and sub-asset class investment decisions
- how past performance (and risk control) has been delivered and the extent to which that was influenced by market conditions
- how volatility within the portfolio will be controlled
- how performance can vary over different time periods – many DGFs are designed to target equity-like returns with less volatility over the long-term, but short-term performance can be materially different from this
- which parameters to use for the fund when doing investment modelling, eg those for expected return, volatility and correlation with other asset classes
4. DB growth assets

Useful links

Trustee toolkit online learning: www.trusteetoolkit.com

Module: 'An introduction to investment'
Tutorials: 'Types of asset: Common assets'
'Alternative assets'
'Capital markets and economic cycles'

Module: 'Investment in a DB scheme'
Tutorials: 'Changing the asset allocation strategy'

You must log in or sign up to use the Trustee toolkit.
5. Implement a DB investment strategy

Implementing your investment strategy, including considering operational risks, the security of scheme assets, asset transitions, liquidity and collateral management.

What you need to do

- Understand the risks associated with implementing an investment strategy, including operational risk, so you can manage these risks and organise appropriate due diligence processes.
- Understand the security of your assets so you can decide if asset security risk levels are appropriate and take action where necessary.
- Ensure that the risks and costs of asset transitions are effectively managed.
- Understand your scheme’s exposure to collateral movements (if any) so you can develop and maintain a collateral management plan.

Implementation considerations

As well as setting the investment strategy for your scheme, it’s important to consider how that strategy can be implemented. This includes consideration of operational risks, security of scheme assets, asset transitions and liquidity and collateral management.

We expect you to understand, and mitigate where appropriate, the principal risks associated with implementing your scheme’s investment arrangements.

Identifying, understanding and mitigating implementation risks can be complex. We recommend you take an approach proportionate to the risks concerned. You may want to consider assistance from your adviser and investment providers.
Operational risk

Operational risks associated with the management of the scheme investments can arise from the operations of the custodian(s), investment manager(s), derivative counterparties and scheme administrator(s).

Our Code of Practice 9: Internal controls sets out how occupational pension schemes should satisfy the legal requirement\(^{16}\) to have adequate internal controls in place, which should manage operational risk within the scheme.

The degree of operational risk associated with managing the scheme’s investments is likely to depend on factors such as the structure and complexity of the scheme investments and counterparties used. For example, the use of derivatives gives rise to greater operational risks.

You should have a prioritised strategy in place to manage and mitigate operational risks proportionate to their significance in the context of your scheme’s overall investment-related risks. It’s good practice to document and regularly review your strategy, including the mitigations in place against the risks identified.

You may wish to consider the need for operational due diligence before appointing any third party involved in managing your scheme’s assets, and as part of your ongoing monitoring of operational risks. This may include due diligence processes by you, your investment manager(s), investment adviser, legal adviser and/or specialist providers.

Operational due diligence

Operational due diligence includes assessments of a third party’s awareness of their own operational risks and what controls they have in place to identify, manage, monitor and report on them. If you do not believe the third party’s operational risk framework is adequate, you’ll need to decide whether to put in place additional mitigations or avoid working with them.

The level of due diligence undertaken should reflect the significance of the risks associated with the third party’s operations. In many instances, such as in relation to regulated investments in mainstream asset classes, it is sufficient to seek input from your investment adviser as part of the third party selection process. The third party is likely to have pre-existing analysis covering operational risks that you and your investment adviser can review to assist with making this assessment.

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\(^{16}\) The legal requirement is set out in Section 249A(1) of the Pensions Act 2004.
Some operational risks are especially prevalent in alternative asset strategies such as hedge funds and private equity investments, which are often subject to less regulation than traditional securities. You may consider it proportionate to seek a greater degree of assurance regarding such investments. Where the risks are particularly significant, you may find it appropriate to use a specialist operational due diligence provider to understand and manage the level of operational risk to an acceptable level.

**Understanding the security of your assets**

As a trustee, you have a duty to ensure your scheme’s investments are held securely. You therefore need to understand the arrangements in place to safeguard your scheme assets.

To do this, you will usually need to know who the custodian(s) of your scheme’s assets are, and their roles and responsibilities. Normally, at least some of the assets are held by a custodian, although only larger schemes with segregated mandates are likely to have appointed a custodian directly. A segregated mandate is a fund run exclusively for the pension scheme where the portfolio is tailored specifically for the needs of the scheme. You can read further guidance on holding scheme assets securely in the ‘Scheme investments’ section of the trustee guidance at: [www.tpr.gov.uk/guidance-trustee](http://www.tpr.gov.uk/guidance-trustee)

Where your custodian participates in securities lending activities, you should ensure the terms of engagement with the scheme permit these activities and consider the financial benefit to the scheme. Example 10 within the guidance accompanying *Code of Practice 9: Internal controls* provides an example of this issue.

The use of pooled funds can bring greater risks to asset security, compared with making the equivalent investment via a segregated portfolio.

For example, many schemes make pooled investments by taking out a managed fund policy with a life assurance company (so-called ‘life funds’). Investors in life funds are exposed to the risk that the company writing the policy may default, in addition to the risks of the underlying investments. Other types of pooled funds may also expose investors to unexpected credit risks.

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17 Regulation 4(3) of the Investment Regulations.
In addition, the use of investor platforms to access funds means the scheme may have contractual agreements with the platform provider, rather than the underlying fund, potentially weakening the scheme's position in a credit default event.

Mechanisms exist to provide investors with protection against these risks. Investors in regulated funds benefit from the requirements of their regulatory authorities. For example, the regulatory framework for life assurance companies seeks to prevent them from defaulting, and some providers of life funds put in place additional protections for their policyholders.

You need to understand the type and level of investor protection applicable to your investments. This is especially the case where investments are made in unregulated funds, where the level of investor protection is generally lower than for regulated funds and the risk of loss higher.

Establishing the level of protection that different scheme assets would have in the event of fraud, malfeasance or other adverse events is not straightforward. 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 there are no definitive criteria for establishing the extent to which an occupational pension scheme is covered. 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 the FSCS, and these will depend on the structure of the scheme’s investments and how they’re held. You may wish to include questions on asset security when tenders for new investments are issued, and seek contractual commitments from the provider to keep that information up to date. It’s likely that you will need to take advice to establish the levels of cover and risk the scheme remains exposed to. You can then decide whether you’re comfortable accepting that level of risk, or if you need to make changes to the scheme’s investments or the contracts governing the investments, in order to reduce the level of risk.
Negotiating additional protections

You may be able to negotiate bespoke terms with your investment manager to better protect your scheme’s investments. These could cover, for example, the manager’s liability for non-investment losses such as operational errors. If you are investing in a pooled fund, the terms may also cover the pooled fund’s investment mandate.

You can document these terms in a formal investment management agreement, or a side letter to the fund documentation. This is particularly relevant to investment in unregulated funds.

Fund documentation

We consider it good practice for trustees to review the 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, eg in times of market stress. You should familiarise yourself with the arrangements and how they can be applied.
Example 15: negotiating additional protections

The trustees of ABC Pension Fund undertake a selection exercise for a UK equity manager. They decide to appoint XYZ Asset Management, and to invest via a pooled fund, having obtained proper advice on how appropriate the investment is. The trustees note that, under the rules of the pooled fund, up to 20% of the portfolio may be invested in non-UK equities. They are fine with this, because the manager has explained the rationale for this during the selection exercise.

Upon further reading, they note that the fund documentation allows the manager to use derivatives for efficient portfolio management (EPM), and for other purposes. They are familiar with the use of derivatives for EPM and risk reduction. However, they wish to know more about potential other uses of derivatives allowed in the portfolio.

The manager tells them this is standard wording and it applies across the manager’s pooled funds, some of which make extensive use of derivatives as a core part of the investment process. However, the manager doesn’t intend to take advantage of this wording for the UK equity fund, which is currently run on a straightforward basis. This does not reassure the trustees, as the manager could change their approach at any time, which the trustees may not be comfortable with.

The trustees ask their lawyer to review the documentation and to discuss matters with the investment manager, who reconfirms that the manager only intends to use derivatives in the UK equity fund for efficient portfolio management purposes. However, the manager agrees to enter into an additional agreement, confirming the manager give the trustees due notice of any change in approach. The trustees will then have the option to accept the change or transfer out of the fund.

Learning points: You need to be aware of what your funds invest in and how they’re managed. This may not always be obvious from the label on the fund, 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, it may be possible to negotiate additional investor protections.
Asset transitions

You need to be aware of the operational and market risks involved during asset transitions, such as those that arise from changes in investment strategy or changes of investment manager. You need to assure yourself that there are appropriate mitigations in place to address the risks of trading. Ordinarily, your investment adviser and/or investment managers can assist in implementing asset transitions. However, for more complex transitions it may be helpful to appoint a specialist transition manager.

The costs involved in transitioning investments can be significant. It’s important to consider these costs and the ways you can mitigate and manage them when making your investment decisions. Often, the explicit (visible) costs in a transition can be far less than the overall costs. You may wish to take advice about the transition options available to you.

Common mitigations against 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
- trading investments in stages to reduce the negative impact that buying or selling at a particular point in time may have if market conditions are unfavourable

You need to assure yourself that there are appropriate reconciliation and reporting arrangements in place, eg between investment managers and administrators. You should also ensure that third parties are transparent about the costs involved, so you know these are appropriate.

Collateral management

The need for collateral management arises from the use of derivative instruments, eg those used in LDI arrangements. Derivatives can require security, in the form of cash or eligible assets, to be transferred from and to the scheme, in order to manage the counterparty credit risk arising from changes in the value of the derivatives. As well as placing liquidity and eligibility requirements on the scheme assets, this gives rise to operational risk.
When a scheme invests in pooled funds the fund manager normally undertakes routine collateral management within the funds without requiring collateral movements between the scheme and the fund. However, in the case of leveraged LDI funds, the manager can request additional collateral from investors, or may pay surplus amounts back to investors, if market conditions have changed.

You should consider, with your advisers, what your scheme’s collateral needs may be in changing market or regulatory conditions and ensure the scheme has suitable assets available to meet them. We would encourage you to consider a number of potential scenarios and assess their implications for the investment strategy.

You need to put in place and maintain an effective operational plan to ensure a smooth experience if assets are needed at short notice for collateral calls, for example if you have segregated or leveraged pooled LDI arrangements. This can include ensuring clear processes and communication channels exist, keeping up-to-date signatory lists and understanding the documentation requirements of the investment providers in advance.

**Useful links**

**Trustee toolkit online learning:** [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

Module: 'An introduction to investment'

Tutorial: 'Suitability and diversification'
6. Monitoring DB investments

Identifying and communicating the information you require to effectively monitor your scheme’s investments and funding level

**What you need to do**

- Focus on the key drivers of funding level change and investment performance, monitor them in a timely manner, and take appropriate action when necessary.

- Identify the key information you require to do this, and ensure that this is presented clearly so that you can make effective well-informed decisions.

- Monitor the investment strategy to help you assess whether investment returns and risk levels are within acceptable ranges and whether your objectives and any triggers remain appropriate.

- Make arrangements to monitor and review your investment managers’ performance.

**Monitoring principles**

Monitoring your scheme investments is a key part of integrated risk management (IRM). You should monitor scheme investments in the context of monitoring the employer covenant and funding level, and consider the results together. Our IRM guidance provides practical help on a proportionate and integrated approach to risk management. Monitoring is most effective when it is prioritised, timely and actionable.

**Prioritised**

Prioritise monitoring those things that matter most to your scheme’s investments and funding level.

You may find it helpful to refer to ‘DB investment governance’ in Section 1: DB investment governance, which suggests a generic order of priority of investment decisions based on their likely impact on future outcomes.

Your scheme’s investment strategy is likely to have a far greater overall impact than the investment managers’ performance relative to their targets.
6. Monitoring DB investments

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

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

Timely

It’s important to monitor your scheme’s investments and funding level regularly and ensure monitoring information is prepared and considered in a timely manner.

How often you monitor will depend on your scheme’s circumstances. More frequent monitoring may be appropriate if your scheme is poorly funded, is close to breaching any triggers or where there is a high-risk investment strategy. Some risks may need more frequent monitoring than others.

Actionable

You need to actively consider whether to take action in response to your review. Some information might require action immediately. Other information may indicate a need for future action, for example at the next actuarial valuation or formal investment strategy review. Some information may form part of a contingency plan or trigger framework where the actions are pre-agreed.

Monitoring information

It’s important to identify what information you require to effectively monitor your scheme’s investments and funding level. Your advisers can help you prioritise the available information. You may also wish to receive help and training on how to interpret the information received, for example from your advisers or investment managers.

Your main sources of monitoring information are likely to be your scheme actuary (for reports on the scheme’s funding) and 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.
6. Monitoring DB investments

**Presenting information**

Monitoring is easier if the information is presented in a digestible, visually appealing form. 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 their intended readership and purpose.

You may find it helpful to put together a dashboard to help your monitoring. This is a short overview of key monitoring statistics. It should help you understand your scheme’s finances at a high level and highlight key potential risks. It can also help you identify areas where you need to review additional data and drill down into particular topics.

You could incorporate key elements of this dashboard into a higher-level IRM monitoring dashboard.

The content to include on your dashboard will depend on your scheme and the dashboard’s intended readership, and is likely to change as circumstances evolve.

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**Monitoring dashboard: examples of areas to consider**

**Scheme funding level**

- funding level and surplus/deficit, change since last report and last valuation
- funding level relative to any triggers for action
- action taken if triggers have been met
- progression of funding level compared with valuation objectives
- breakdown of change into key drivers
- projections of future funding levels
- required future return on scheme assets to meet scheme objectives
- expected future return on scheme assets

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<td>- benefits and expenses paid out</td>
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6. Monitoring DB investments – Presenting information

**Liquidity and collateral**
- allocation to illiquid assets
- leverage ratio in matching asset portfolio
- collateral required and available
- stress tests of the required and available collateral

**Investment manager review**
- performance of investment managers relative to objectives and benchmarks
- any organisational change at the investment manager firm
- investment adviser’s view of managers’ likely future performance
- dates of last and next meetings with the managers

**Charges and fees**
- investment manager/fiduciary manager fees and fee benchmarks
- investment advisory fees and fee benchmarks
- transaction costs and benchmarks

**Responsible investment**
- manager report on approach and actions taken to incorporate environmental, social and governance (ESG) issues into investment analysis and decision-making
- any ESG events/issues and any material changes to the ESG risks and opportunities in the portfolio
- manager report on social impact of investments

**Stewardship**
- voting activity summary
- engagement summary
6. Monitoring DB investments – Presenting information

Useful link

The Cost Transparency Initiative (CTI) is a partnership initiative between the Pensions and Lifetime Savings Association (PLSA), the Investment Association (IA), and the Local Government Pension Scheme (LGPS) Advisory Board.

With an increasing focus on cost transparency across all financial universes, the CTI has produced a suite of voluntary templates and guidance designed to help trustees understand and compare the costs of their investment services by using a standardised reporting format.

These templates can be used to request charges information and are available here: https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative
Monitoring dashboard: management information and indicators

It’s important to keep your dashboard focused. When considering statistics to include, or remove, you might find it helpful to ask the following questions:

► Does this information tell you something useful that the statistics already on the dashboard don’t? Will it be missed if you remove it?

► What are you going to do with the information? If you cannot or will not act on it, is it worth monitoring?

► If this statistic needs to be calculated just for the dashboard, is the cost justified, or can other already-available statistics be used instead?

Example 16: developing a dashboard

The trustees of a small scheme recognise that the monitoring they receive does not help them assess progress against the scheme objectives or help inform their decision-making. At present, each of the scheme’s investment managers send quarterly performance reports to the trustees and they only receive an annual funding update. Furthermore, the trustees only meet their investment adviser once a year, although their scheme actuary attends each quarterly meeting.

The trustees discuss with their advisers how they could improve their monitoring without incurring significant additional costs. While the scheme is running risks supportable by the covenant, the trustees wish to better understand its progression towards the objectives and identify emerging risks that would require action.

Following discussion, the trustees decide to introduce a dashboard to review at each quarterly meeting, setting out the following:

► Overall scheme asset performance over the quarter and since the valuation. This is then monitored against the return anticipated under the scheme’s funding strategy.

continued...
A proxy of how the liabilities have changed since the last valuation/actuarial update. This is calculated approximately based on the difference in market conditions since then.

Estimated funding level based on the proxy liability calculation. This is then assessed against the expected funding level when the recovery plan was put in place.

The quarterly asset allocation (£ value and %) compared to the previous quarter and strategic benchmark.

Individual investment manager performance against their objectives.

Net cash flows over the quarter.

It is proposed that the scheme actuary, with the assistance of the investment adviser, will prepare this document for discussion at each quarterly meeting. It is also agreed that the investment adviser will flag to the trustees any concerns the investment adviser has with any of the appointed managers as soon as their concerns materialise.

To help inform decision-making, the trustees and their advisers also agree to set boundaries around these statistics. They adopt a traffic light system where green indicates performance in line with expectations, amber indicates performance outside of expectations, but not materially so, and red indicates performance materially outside of expectations. An amber warning would identify areas where the trustees need to drill into more detail and a red warning would identify when immediate action may be required.

**Learning points:** Schemes of all sizes should consider whether their monitoring is fit for their purpose and, if not, seek improvements. Monitoring is more useful if consideration is given in advance to the values for the various statistics, which would require further investigation or action.
Monitoring investment strategy

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. If the investment strategy is failing to meet its long-term objectives or if you have investment triggers in place which are persistently not being met, you need to form a view on whether this is likely to persist and decide what action, if any, to take.

If you do have triggers in place you should consider whether the market expectations the triggers are based on remain realistic, and accordingly whether the strategy or the triggers need modifying to meet the long-term objectives. In both cases, you may also wish to review whether these original objectives for the investment strategy remain appropriate.

If developments in investment markets have been significant, you may wish to reconsider any investment beliefs you hold.

Where the investment strategy has delivered significantly above expectations, or triggers have been met more rapidly than expected, we would encourage you to undertake a similar review process. These may be indications that the investment strategy is taking more risk than necessary to meet objectives, or that triggers should be set at different levels.
Example 17: Monitoring and reviewing scheme triggers

The trustees of the EFG Pension Plan implemented a ten-year de-risking strategy five years ago. This included triggers for increasing the hedge ratio, based on bond yields. They wished to increase the hedge ratio from 25% to 75% of funded liabilities over a 10-year period. They set the triggers based on their investment consultant’s view of the long-term fair value level for bond yields, which was higher than prevailing yields at the time.

Over the intervening period, very few of the triggers have been met because interest rates have remained persistently low. The hedge ratio has risen, but only to 35%. The trustees discuss this with their investment adviser, who has been keeping their expectations for future interest rates under review. These expectations are now considerably lower than they were when the plan’s de-risking triggers were established.

After much discussion, the trustees confirm they still wish to achieve 75% hedging by the original target date, ie in five years’ time. The investment adviser advises that the existing triggers are unlikely to be met within this timeframe and recommends new triggers that they believe will be met. The trustees agree to adopt these.

Learning points: If triggers for change – such as interest rate triggers for de-risking – persistently fail to be met, it is important to understand why and consider whether they are still likely to be met. If not, it may be appropriate to adjust them.

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 and you still expect your objectives to be met. Where you have concerns over the short-term performance of your investment strategy, you should ask your investment adviser 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 be recovered.
Example 18: Monitoring investment performance during periods of market volatility

The trustees of the ABC scheme have invested part of the scheme’s assets in non-government bonds. These have been chosen for the cash flows they are expected to produce if they are held to redemption.

The investment manager has assessed the bonds’ credit-worthiness and monitors the portfolio on an ongoing basis. The trustees are comfortable with the portfolio’s performance until a crisis affects financial markets. This causes the capital value of the portfolio to fall, as investors take fright and wish to sell ‘risky’ assets such as non-government bonds for ‘risk-free’ assets such as high quality government bonds.

The trustees are concerned about the loss in capital value and wonder whether the investment approach remains appropriate in these market conditions. The investment manager explains that the portfolio is still delivering against its objectives. Despite the crisis affecting financial markets, the manager believes the bonds will still deliver the anticipated cash flows. She reminds the trustees that the purpose of the portfolio is to deliver cash flows by holding the bonds to redemption.

The trustees understand this and agree to hold their nerve and continue with this investment approach. The financial crisis gradually eases and markets recover. The bonds deliver the anticipated cash flows.

Learning points: It’s important to define clear objectives and understand how your investment strategy is expected to meet them. You shouldn’t be distracted by short-term performance issues if you have concluded there is a good explanation and you still expect your objectives to be met.

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.

As part of your approach to IRM, you should have mechanisms in place to alert you to significant changes to the employer’s covenant or the scheme’s liability profile. Changes in either of these may also prompt changes to the investment strategy.
6. Monitoring DB investments

**Monitoring investment managers**

To monitor the performance of your scheme’s investment managers, you need a clear understanding of their individual objectives, how they plan to meet them, and over what time period.

You may wish to focus on the scheme’s more risky mandates, including more complex or less transparent ones, and the larger ones. In this way, you can pay most attention to managers or funds that represent the greatest risk to scheme performance.

### Things to consider: Reviewing manager performance

- Assess the performance of the manager against their stated performance and risk objectives over the relevant long-term and shorter-term periods.
- Compare investment returns to any relevant market or industry benchmarks.
- Assess the performance against what would be expected in the relevant market conditions, given the manager’s investment approach.
- Understand the level of risk run to deliver the performance and how this compares with the manager’s risk targets.
- Seek confirmation that the risk targets have not been exceeded, especially when the manager has performed significantly outside of expectations.
- Seek confirmation that an appropriate level of risk is being taken to realistically meet the objectives in future.
- Understand the principal reasons for their performance (e.g., 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 manager’s actions regarding ESG factors and shareholder engagement.
- Consider the impact of fees on investment return, as this affects the net return the scheme receives. You should check fee levels for competitiveness against appropriate market comparators for the size and type of mandate.

continued...
6. Monitoring DB investments – Monitoring investment managers

- Monitor levels of portfolio turnover and associated transaction costs, considering whether these are justified in light of investment objectives.
- 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.

**Form of review**

Your review of each manager may take different forms, for example using manager or adviser reports, or meetings with the managers or advisers.

If you are relying solely on reports produced by your investment managers to monitor their own performance including, if used, fiduciary managers, you should consider whether you wish to seek independent advice to help interpret them.

**Useful links**

**Trustee toolkit online learning:** [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

- Module: ‘Investment in a DB scheme'
- Tutorial: ‘Reviewing the investment strategy'
- Module: ‘An introduction to investment'
- Tutorial: ‘Reviewing investments'
Glossary

Agency issues
Conflicts of interest that arise where one party (the agent) is expected to act in another's (the principal's) best interests and where the interests of principal and agent are not fully aligned.

Asset liability modelling
Modelling that involves projections of a pension scheme’s assets and liabilities into the future; typically the projections allow for random variation in outcomes (known as stochastic modelling) and are used to show the potential rewards and risks of different investment strategies.

Basis risk
The risk that an asset used for hedging a liability responds differently to changes in market conditions from the liability that it is hedging. For example, when an asset based on interest rate swaps is used to hedge a gilt-based liability valuation.

'Buy and maintain' strategy
Bonds purchased with a view to holding them to maturity unless the probability of default for a particular bond held rises to unacceptable levels. If this occurs, the bond would be sold and a replacement purchased.

Contributions-at-Risk (CaR)
The additional contributions that would be required in order to achieve the scheme funding objective without changing the time horizon if a significant downside event occurred; often considered together with the corresponding VaR.

Collateral
Assets available to compensate an investor in the event of the other party to an obligation defaulting on their obligation.

Collateral movement
Posting collateral or receiving collateral in respect of an arrangement where collateral is required to manage credit risks; typically found, for example, in connection with LDI arrangements. See ‘Cash flow and liquidity risks’ in Section 2: Investing to fund DB.

Contingency plans
Plans setting out actions that will be undertaken in certain circumstances to limit the impact of risks that materialise or to introduce additional risk capacity. See ‘Contingency plans’ in Section 2: Investing to fund DB.
### Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td><strong>Correlation</strong></td>
<td>The extent to which values of different types of investments tend to move in tandem with one another in response to changing economic and market conditions.</td>
</tr>
<tr>
<td><strong>Covenant</strong></td>
<td>The extent of the employer’s legal obligation and financial ability to support the scheme now and in the future.</td>
</tr>
<tr>
<td><strong>Derivatives</strong></td>
<td>An arrangement or product (such as a future, option, or warrant) with a value derived from and dependent on the value of an underlying asset, such as a commodity, currency, or security.</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>Average discounted term of the liability payments.</td>
</tr>
</tbody>
</table>
| **Efficient portfolio management** | Ways of investing which relate to transferable securities and approved money-market instruments and which fulfil the following criteria:  
  - they are cost effective  
  - they are entered into because of:  
    - reduction of risk  
    - reduction of cost  
    - generation of additional capital or income for the scheme with a risk level consistent with the risk profile of the scheme and the risk diversification rules  |
<p>| <strong>Fiduciary management</strong> | Governance model where a potentially significant amount of decision-making is delegated to a third party. See 'Fiduciary management' in Section 1: DB investment governance. |
| <strong>Insurance risk</strong>  | A driver of return in insurance-linked securities and similar investments where the investor is effectively writing insurance and receiving premiums for this, but is exposed to the risk the insured event may occur. |
| <strong>Investment beliefs</strong> | An agreed, transparent and consistent way of thinking about financial markets in the specific context of a given investor, based on research and experience. See 'Investment beliefs' in Section 2: Investing to fund DB. |
| <strong>Investment governance</strong> | The structures and processes which enable trustees to have sufficient and flexible oversight of the scheme’s investments. See 'Investment governance structures' in Section 1: DB investment governance. |</p>
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<td><strong>Investment management agreement</strong></td>
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<td><strong>Liability-driven investment (LDI)</strong></td>
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<td><strong>Liquidity</strong></td>
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<td><strong>Operational risk</strong></td>
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<td><strong>Pooled funds</strong></td>
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<td><strong>Reinvestment risk</strong></td>
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<td><strong>Roll risk</strong></td>
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<td><strong>Risk appetite</strong></td>
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<td><strong>Risk capacity</strong></td>
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<td><strong>Risk premium</strong></td>
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<tr>
<td><strong>Scenario analysis</strong></td>
<td>Analysing possible events that can take place in the future by estimating the expected value of a portfolio (such as a scheme’s assets and liabilities) after a given period of time, assuming specific changes in the values of variables that may have an impact on the value of the portfolio.</td>
</tr>
<tr>
<td><strong>Scheme objective</strong></td>
<td>The trustees’ objective to pay benefits promised as and when they fall due.</td>
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<tr>
<td><strong>Segregated mandate/portfolio</strong></td>
<td>A fund run exclusively for the pension scheme where the portfolio is tailored specifically for the needs of the scheme.</td>
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<tr>
<td><strong>Short sales</strong></td>
<td>Investment strategy where the investor sells shares of borrowed stock in the open market, hoping to buy them back for a profit after their price has fallen.</td>
</tr>
<tr>
<td><strong>Stewardship</strong></td>
<td>The exercise of ownership rights, including engagement and voting, to protect and enhance the long-term value of investments. See ‘Stewardship’ in Section 1: DB investment governance.</td>
</tr>
<tr>
<td><strong>Stress test</strong></td>
<td>Identifying variables that affect the finances of the scheme or employer, changing the values of those variables, and seeing what effect this has. This helps identify which variables are most important, through their impact on covenant, funding and investment.</td>
</tr>
<tr>
<td><strong>Sustainability/sustainable investment</strong></td>
<td>Meeting present and future needs through the management of long-term risks and opportunities, which involves considering ESG issues and wider societal impacts. See ‘Sustainability’ in Section 2: Investing to fund DB.</td>
</tr>
<tr>
<td><strong>Tail risk hedging strategy</strong></td>
<td>A risk mitigation technique intended to reduce an investor’s exposure to significant market falls, for example using suitable derivative strategies.</td>
</tr>
<tr>
<td><strong>Value-at-Risk (VaR)</strong></td>
<td>A statistical technique used to measure and quantify the level of financial risk within a firm or investment portfolio over a specific time frame and with a given probability.</td>
</tr>
<tr>
<td><strong>Volatility</strong></td>
<td>This is a measure of the variation in the value of a liability, investment, market or parameter. This is commonly used as an indicator of risk.</td>
</tr>
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</table>
Changes since the last version

The latest updates to this guidance reflect a number of regulatory changes introduced in 2018 and 2019, including The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018, and The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019.

The update has involved significant rewriting of various sections throughout the Investment Governance and Investing to Fund DB Schemes portions of the guidance; you may, therefore, find it useful to re-acquaint yourself with the guidance as a whole.

Updated information on investment decisions and your statement of investment principles, stewardship, reporting, sustainability and financial and non-financial factors may be of particular relevance.