



**Barnett
Waddingham**
a true partnership approach

Successful investment strategy for pension schemes

A THREE-STEP APPROACH

Successful investment strategy for pension schemes: a three-step approach

Pension fund investment is undoubtedly one of the most challenging elements of a trustee's role.

YOUR AIM IS SIMPLE

A fully-funded scheme with enough money to pay pensioners' benefits when they fall due.

OUR AIM IS SIMPLE TOO

To help you meet this target in the right way for you.

But what fully-funded means for each scheme, and the timescale in which to achieve it, varies greatly, which means that investment strategies need to vary too.

A robust investment strategy for a pension fund does not happen overnight. It requires careful planning within a structured process. But trustees needn't worry about doing that alone. Our clients enjoy a relationship based upon a unique partnership approach. We work alongside the trustee board or investment committee, sharing views and helping trustees make informed decisions. Our services are tailored to your scheme's unique requirements, big or small.

In developing investment strategy, we break the process down into three key stages: planning, asset allocation and implementation.





1. Start with a plan

Planning is essential to understand your Aims, Beliefs and Constraints. Or, as we call it, ‘knowing your ABCs’:

A AIMS

In aiming to provide sufficient funds to ensure pensioners are paid their benefits, there are only two possible scenarios if the trustees run a solvent pension scheme:

- 1 Insuring the pension liabilities and winding-up the scheme
- 2 Running on the scheme until the last member dies.

Many trustees aspire to winding-up but in reality few schemes are in a position to do so. Buy-out is often far away in terms of affordability and, with many pension funds still in deficit, should be considered more as a longer-term aspiration. Most schemes will therefore find themselves somewhere between the two outcomes.

Understanding your short- and long-term objectives is therefore an important first stage in setting an investment strategy.

- What levels of returns are needed in the short term to meet the funding objective?
- And what levels are needed to achieve any further objectives – such as de-risking into bonds more quickly than implied by the valuation, or targeting a buy-out by a certain date?

By analysing both, trustees can better understand the returns – and therefore the risks – needed to achieve certain objectives, and make an informed choice as to whether they are realistic.

B BELIEFS

With objectives in place, the next step is to consider any beliefs or principles held by the scheme or individual trustees that might influence the strategy. Some examples of investment beliefs are:

Active management

Active management offers the opportunity for outperformance relative to an index whereas passive investing is sometimes favoured as a solid long-term option. Increasing numbers are opting for a selective approach. Does your trustee board embrace active mandates and would you be happy to apply them across the investment portfolio?

Innovation

Some trustees welcome new investment concepts, while others see little advantage in being an 'early adopter'. Consider how comfortable you are investing in more innovative strategies?

Diversification

Investors can reduce the expected volatility of future returns by spreading assets across multiple asset classes. While diversification is often desirable, adding asset classes may also increase complexity, so it is important that trustees retain a firm grasp on the overlying strategy. At the same time, the potential limitations of very simple strategies should also be understood.

Risk measurement

Some pension schemes (and sponsors) focus on short-term risk controls and controlling funding and contribution volatility. Others are prepared to accept volatility if it delivers longer-term objectives. Such attitudes may dictate how much of the scheme's assets and governance should be focused on liability-matching assets.

C CONSTRAINTS

Aims and beliefs help shape the strategy but you will also need to be aware of potential constraints, as some are more apparent than others.

A mature pension scheme with a significant cash outflow must consider how to satisfy those short-term cashflow needs as part of its long-term strategy. Likewise a £10m scheme will have a very different range of accessible investment options to a £10bn fund.

New ideas may bring a fresh perspective to a strategy, but complexity could grow. In reality, new ideas will regularly present themselves as opportunities, eating into the governance budget as additional training, monitoring and management are required.

A more complex strategy may require additional investment management and advisory costs. Trustees will need to match their ambition with resource and focus on areas where most value can be added.

Another potential constraint on asset strategy is whether a scheme considers its holdings as long or short-term. A scheme with a longer investment horizon might make allocations to illiquid or potentially volatile assets compared to one investing over a shorter timeframe.

By contrast, a scheme with a weak sponsor covenant may reduce exposure to volatile assets to reduce the likelihood of calling upon sponsor support in the medium term. Together, these 'ABC' aims, beliefs and constraints should serve as a framework for all future investment decisions.



Increasing numbers of schemes are using improved diversification and liability matching to reduce the volatility of their funding level while retaining allocations to growth assets

2. Set the strategy

Building on this foundation, you are now ready to decide how the returns will be generated. This will rest on how the portfolio is split between growth assets such as equities, designed to generate positive net returns, and protection assets such as bonds, whose performance should match the level of liabilities within the fund. And it's just as important to consider how that balance might evolve over time.

For growth assets, there is a choice between holding asset classes such as equities and property directly, or investing indirectly via a fund. In recent years, multi asset investments, particularly diversified growth funds, have become more popular. These seek to reduce volatility by investing across a broad range of assets.

Equally important are the protection assets. The most common approach here is to use government and corporate bonds to balance the duration and inflation sensitivity of the scheme's liabilities and return requirements. However, increasing numbers of schemes are using derivatives to more closely match the nature of their liabilities and reduce volatility.

This process involves many important decisions so expert partnership is invaluable. Whether you are responsible for a large or small scheme, we help you to determine what is required and then help you to put it in place.

3. Put it into action

Once the asset allocation has been agreed, the next stage is to select the investment managers to look after the fund, deciding which elements of the strategy, if any, will be actively managed.

Manager selection can be an interesting process for trustees but you should bear in mind that it is the strategic asset allocation that has a greater impact on long-term returns.

Our total independence means we are not restricted in our recommendations, so can offer a truly objective view of the managers available.

Changing managers is a material undertaking. Where possible, we work in partnership with existing managers to develop portfolios to meet the specific requirements of our clients.

MONITORING PERFORMANCE

The selection of managers is not the end of the process. If anything, it is just the beginning. Schemes must agree how they will monitor the performance not only of the individual managers, but also of the overall investment strategy.


Our strategy review process places the emphasis firmly on long-term objectives and beliefs. It is against this framework that we will monitor the performance and keep you informed.

Regular reports include a full range of management information for trustees but, with limited time, we highlight the most important issues for that period and make key recommendations based on your scheme's specific requirements. We also use alert flags to draw attention to potential threats and opportunities.


By working in partnership with our clients, we deliver a clear, long-term, bespoke and integrated investment service that allows you to make decisions in an informed and timely manner.

What next?

To discuss your investment strategy options contact Marcus Whitehead, Partner and Head of Investment Consulting:

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