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Chapter 1
The trustee's role

In the last decade, the role of managing a workplace pension as a trustee has become more tightly defined and more complex. A series of regulatory changes has unambiguously placed responsibility on them for making strategic investment decisions on behalf of their members. At the same time, the cosy assumptions on which asset allocation once depended are being broken. It is no longer enough to settle for annual returns benchmarked against everyone else.

To meet future liabilities and achieve higher returns, trustees are routinely having to consider alternative assets, notably private equity and hedge funds, which demand a new way of thinking about investment returns. At the same time, they are having to explore how they can use derivatives to match their assets and liabilities more efficiently without exposing themselves to a total loss of their capital.

Although trustees are non-executives, relying on professional advice and delegating day-to-day investment decisions, they now have to be sure that they are in a position to ask some searching questions about the basis on which their funds are being invested. Should they abandon bonds altogether in the search for higher returns in privately held assets? Or should they tie the future flow of payments to their members to a predictable stream of income? How trustees respond will have far-reaching implications for the future benefits of their members.

Trust and regulation

Most workplace pensions in the UK have traditionally been set up as trusts to separate the interests of the sponsoring company and the people who benefit. As a trustee, your job is to act on behalf of the beneficiaries.

Your actions are governed by a deed, which gives you a series of powers. The strength of these varies from scheme to scheme, but will include the right and obligation to set the investment strategy for funds contributed to the scheme.

Until the late 1990s, despite what the law actually said, pension funds in the UK were largely unrestricted in making their investments. In the 1920s, Parliament had placed severe limits on trustees. Only the safest investments were allowed. But it was a fall-back position. In practice, trustees were nearly always granted wide extra powers under their deeds.

The Pensions Act of 1995 addressed this anomaly. The power of trustees to invest was enshrined in law. You can now buy anything, as long as you take proper advice and act as if you are looking after money for other people.

In return for bringing the law up to date, however, all trusts now fall under the supervision of a Pensions Regulator, who has responsibility for monitoring the level of risk in all schemes.

Knowledge and understanding

The main consequence for trustees of this new regulatory regime is that you are now formally expected to have 'knowledge and understanding' of the law relating to pensions and trusts, as well as the principles relating to the funding of

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occupational schemes and to the investment of assets. Within six months, you must know enough to be able to perform your role in a way that satisfies the regulator.

Behind this requirement lies the objective of freeing trustees from the herd mentality in financial markets by putting them in a position to make informed, independent and active decisions about setting an investment strategy designed specifically around the needs of their scheme.

As a trustee that means that you are going to have to complete three particular tasks: develop a clear view of how your scheme is going to meet its future liabilities, work out your investment principles and decide how to allocate your assets.

What impacts our investment decisions?

Invesco Perpetual looks at the impact psychological factors have on our investment decisions

'Behavioural finance' applies findings from psychological research to finance to enable us to better understand and explain why we make certain financial decisions.

Academics studying behavioural finance have found that individuals do not always make rational investment decisions and they have identified a number of areas where psychology has tended to lead investors to make irrational decisions.

Look to the long-term

One of behavioural finance's key findings is that investors place a far higher significance on losses than gains. Research shows that individuals put a worth on losses that is two and a half times the worth they ascribe to gains*. This finding has been used to explain the equity risk premium – one of the basic justifications of equity investing – which basically says that over the long-term equities have on average outperformed bonds.

According to the Barclays Capital Equity Gilt Study 2006, over the past 106 years to 31 December 2005, equities have outperformed gilts by 4% a year. Yet, in the short term, the greater volatility of equities compared to bonds means there is a greater chance of making short-term losses. The aversion to investment losses, together with a tendency for short-term investing, means investors are often guilty of not giving equities valuations as high as they otherwise might have.

Behavioural finance research indicates that we should have the mindset of long-term investors and be willing to invest with at least five to ten-year time horizons in mind, or even longer, if possible.

Take a holistic approach

A further finding of behavioural finance is that the framing of financial questions has a bearing on the answers reached. In practical terms, the most common implication of this is that financial decisions are often viewed in isolation when they should be viewed together.

For example, people tend to consider their current accounts, deposit accounts, investment funds, credit cards and mortgages separately. Generally speaking, however, it would be far better financially to think of them together. For example, it is generally better to pay off debt with a credit balance than to pay out a certain rate of interest on the debt and collect a rather smaller one on the credit.

By taking a holistic approach to financial arrangements, people would be able to evaluate all their assets and liabilities together and avoid an unnecessary segregation of accounts.

Don’t get sucked into momentum-driven rallies

A final important observation of behavioural finance is that investors often under or over-react to stockmarket information. The most notable recent example of this was the ‘dot com’ bubble, when stock prices greatly exceeded reasonable valuations.

Investors often use a limited set of information, which they regard as representative, when reaching decisions. For example, companies may be regarded as ‘winners’ or ‘losers’ depending on recent stock market performance. This tag may give a stock price momentum in one direction or another for long after this is justified, which could have a similar effect on the whole stock market.

In conclusion

Overall behavioural finance opposes what is often referred to as ‘rational finance’, which sees financial decisions being made in the context of a rational appraisal of risk and return. In particular, it further stresses the importance of investing for the long-term and having a tolerance for short-term losses. Research into investor psychology identifies observable and systematic errors in the decisions which are made by investors and the recognition of these may help in making better financial decisions.

Further information

For further information on key investment topics, visit Invesco Perpetual’s website dedicated to pension scheme trustees at:
www.trusteetraining.co.uk

Invesco Perpetual UK Institutional team
Tel: 0207 065 3489
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Chapter 2

Scheme funding

As a trustee, your main concern is to ensure that your members' benefits are going to be properly funded and protected. As far as possible, you want to be sure that pensions are going to be paid now and into the future.

Since 2005, this obligation has been encapsulated by the Pension Regulator as the 'statutory funding objective'. Essentially, you are going to have to demonstrate that you have sufficient assets to meet any 'technical provisions'. Or, in other words, are you actually going to be able to fulfil your ongoing commitment to pay benefits to current and future pensioners?

Predicting your liabilities so far into the future with any certainty is a hazardous business, particularly as people are living longer and you do not know by how much rates of pay are going to change in the next 5, 10 or 20 years.

In consultation with an actuary (a specialist who advises you on your long-term liabilities), you are responsible for drawing up a valuation of the scheme as the basis for judging whether the current level of funding is going to be sufficient.

You will then have to agree your conclusions with your sponsoring employer. Such discussions are bound to be sensitive. Employers naturally want to keep their contributions down and are prone to taking a rosy view of the potential upside on any investments. You will tend to be more cautious and prefer to keep contributions up.

But when a shortfall is identified in funding members' benefits, negotiations on how to cover the deficit can become difficult, particularly as the Pensions Regulator is encouraging trustees to think like bankers in such situations. The line is that any deficit should be treated like a default on a loan.

Given that the collective deficit on UK pensions was at one time estimated to have reached as much as £700bn, most trustees now find themselves with a demanding extra dimension to their role. Where there is a deficit, you are responsible for drawing up a recovery plan under the supervision of the Pensions Regulator, which necessitates taking a more aggressive stance in pressing employers for extra contributions.

In the worst case, depending on your powers under the deed, you might even have to ask for the scheme to be wound up and for the employer to settle all current and future liabilities now.

The valuation

Long before any such drastic action may be necessary, trustees are expected to conduct a regular valuation to check whether their statutory funding objective is being met or not. Under your direction, an actuary will undertake the technical work and advise you on what assumptions to make in deciding on your valuation.

On likely investment returns, you want to see a range of outcomes and are expected by the Pensions Regulator to take a 'prudent view'. You should check too whether the

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rate for calculating your liabilities is linked to UK government securities or is set at a higher level by the actuary. The effect on the extent of your liabilities can be dramatic.

You also need to consider carefully assumptions about mortality and how longer life expectancy actually applies to your members. Where in the country are they based? What type of work have they undertaken? Any variations should be checked, as they can be significant.

The sponsoring employer

The valuation can no longer be made without taking account of the position of the sponsoring employer. As a trustee, you are expected to examine closely its financial position and ask whether it can continue to fund the scheme if the current investment strategy falls short of expectations.

Employers are now obliged to supply you with any information you might reasonably require about how its business is performing and in the event of any transaction, such as an acquisition, disposal or restructuring, you can expect to be closely involved.

The recovery plan

If the pension fund is showing a deficit, then trustees are expected by the Pensions Regulator to find ways of eliminating it as swiftly as the employer can reasonably afford. In practice that means conducting any negotiations on extra funding while taking into account an employer's business plan, planned investments and patterns of expenditure. You can then take a view on whether to ask for:

- a one-off payment to balance the books

- an increase in the level of monthly contributions
- an adjustment in the retirement age

The approach that you take will be coloured by the age profile of your members. If many have already retired, then a one-off payment is likely to be preferable. If, instead, most are going to be working for years to come, then contributions can be pushed up over a longer period.

In your back pocket, it is worth knowing your chances of pursuing an employer to make good any deficiency in the event of winding up a scheme.

If you fail to reach agreement with your employer on contributions, then you can ask the Pensions Regulator for guidance.

Schedule of contributions

Trustees can now fulfil one of their most important responsibilities: making sure the right money is paid into the scheme at the right time. In 'a schedule of contributions', which has to be approved by your actuary to take effect, you should specify what employers and employees are going to pay into the scheme and when.

You should make clear in the document exactly what rates apply, rather than referring to any other paperwork, and employers have to pay in employees' contributions 19 days from the end of the month of their pay being deducted.

Trustees are charged to make sure the contributions are right and on time. If late payments start to threaten the security of members' benefits, then the Pension Regulator should be notified.

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Funding statements

Fifteen months after conducting a valuation, as a trustee you have to agree 'a statement of funding principles' with your sponsoring employer, in which all the assumptions used in calculating the balance of liabilities and assets are explained. You should also spell out the basis on which any deficit is going to be covered.

However, within three months of a valuation, 'a summary funding statement' should be sent to members of the scheme, in which you explain any changes to the funding position of the scheme.