February 2010

Law Debenture has been acting as a professional pension trustee for over 25 years. Our experience, today applied to over 250 pension schemes of all types and sizes, means that we are able to bring a unique perspective to considering investment issues.

How to invest a pension scheme's assets is, with little doubt, the most significant and sustained challenge which Trustees face. It involves mastering inherently difficult subject matter, grappling with the fact that resources are scarce, and reconciling the need to contain risk with the desire to obtain an adequate return. All of this takes place against a fast-changing economic present and an uncertain future.

There are no quick and no easy answers. However, we believe that the multi-faceted challenge can be made manageable by identifying and being precise about the underlying questions and issues.

This, the sixth in our series of *Essentials*, reflects long and painstaking discussion amongst our team of professional trustees, all of whom have significant experience of investment issues and a number of whom have a professional investment management background. We have tried to distil the questions which we believe Trustees should address, but we recognise that not all of the questions will be applicable for every scheme.

We have grouped the issues to be considered into seven broad categories: Investment Objectives; Investment Risk; Investment Strategy; Derivatives & Hedging; Investment Consultants; Investment Managers and Governance & Compliance. At the end is a Glossary defining some of the terms used which might not be familiar to all.

Beneath each question there is a space for comments. Trustees may find that best value will be derived from this document by considering and answering the questions and then discussing issues which have been identified.

Law Debenture welcomes any comments from users of this document as to how it could be developed. These may be addressed to: **bryan.king@lawdeb.com** (tel: 020 7696 5905), or to your usual contact at Law Debenture.

Copies of this document are available to download at **www.lawdeb.com**. Click on **Pension Trusteeship** and then on **Essentials**. Paper copies are available on request.

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February 2010

Pensions
Essentials
Investment

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Investment Objectives

Question	Guidance
A1 Do we have a clear investment objective?	It is important that trustees formulate a clear investment objective. This should be related to the scheme's liabilities, and be set within defined risk parameters. It is important to reconsider the investment objective from time to time.
Comments:	
A2 Are we achieving our targeted returns on the scheme's assets?	Meeting members' benefits in full in the longer term may depend on consistently achieving adequate investment returns. The overall investment performance of the scheme's portfolio against benchmark and target (net of fees) should be regularly reviewed.
Comments:	
A3 In formulating our investment objective, should we consider our investment beliefs?	Some trustees find it helpful to formalise their beliefs in order to help frame their discussions. Factors to consider here include the extent to which there is an equity risk premium; the respective merits of active and passive investment management; the significance of credit risk and the importance of a liquidity premium. Beliefs should also be tested in the light of market experience.
Comments:	
A4 What are the employer's thoughts about investment strategy?	It is helpful to have shared objectives. This may facilitate agreement on funding strategy and enable the planning of de-risking opportunities. The reaching of shared objectives may be assisted by the use of the same approach to analysing risk as that of the company.
Comments:	

Investment Risk

B1 How should we measure and monitor investment risk?	Value at Risk (VaR) and other volatility statistics are widely used measures of risk in an investment portfolio. However, like any model, their usefulness depends crucially upon the validity of the underlying assumptions. This concerns both the distribution of returns and the sensitivity to small changes in the future level of those returns. It is important to measure risk at the overall portfolio level, as well as that of individual managers. Particular care should be taken when using any framework which assumes that returns are normally distributed. Experience, including the credit crunch, suggests that returns often have “fat tails”, i.e. extreme events happen more frequently than is implied. It can be useful to conduct scenario analysis, and also to carry out back testing.

Comments:

B2 How do we determine an acceptable level of investment risk?	The main factors to consider are the strength of the employer’s covenant (by which is meant its ability and willingness to pay), and the structure of the liability profile. It is probable that the employer’s appetite for risk will set an upper limit to the level of risk to be adopted by the trustees.

Comments:

B3 Do we attach sufficient importance to understanding and managing risk?	The trustees’ risk tolerance should be agreed prior to deciding investment strategy. This should be reviewed periodically and should always be revisited alongside the valuation.

Comments:

B4 Have we given appropriate consideration to the amount of investment loss which the company would reasonably be expected to make good?	It would be useful to determine what the maximum loss is that the company would be expected to make good over an appropriate timescale. Trustees should consider any correlation between a loss in investment assets and a reduction in the employer’s ability to make it good.

Comments:

Question	Guidance
B5 Are we sufficiently well prepared and protected in the event that the strength of the employer's covenant weakens or is threatened, or if there are significant changes in economic or financial conditions?	Changes often happen quickly and trustee boards are, without forward planning, unlikely to be able to assess the position and react in good time. Trustees should actively plan for potential changes; know what their impact on the scheme is likely to be, and what the options are for the scheme. Trustees should ensure that the employer understands in advance what the trustees' response is likely to be to material adverse changes. The trustees and employer may wish to review the potential for additional security or contributions to be provided.

Comments:

Question	Guidance
B6 What are the key investment risks?	The key risks are those that result from investments (such as equities) that do not provide a good match for the liabilities. The measurement of the liabilities is based on future expectations for interest and inflation rates. The pricing of assets such as equities is not directly dependent on those expectations. Other investment risks include: counterparty, credit (downgrades and defaults), currency, liquidity, longevity, manager, market, and, when derivatives are used, basis risk.

Comments:

Question	Guidance
B7 To what extent should inflation risk be hedged?	The potential impact of inflation should be quantified. Clearly, the greater the inflation linkage of the liabilities, the greater the impact of a change in inflation will be. Trustees should monitor the costs of hedging as these can vary over time.

Comments:

Question	Guidance
B8 To what extent should interest rate risk be hedged?	As with inflation risk, a decision to hedge should only be taken after a careful review of the impact of interest rate changes on the liabilities and an analysis of the costs of hedging.

Comments:

Question	Guidance
B9 Are there other risks which are not sufficiently well rewarded to be worth taking?	Trustees should, in general, seek to limit exposure to unrewarded risks. An example might be currency exposure.

Comments:

Investment Strategy

Question	Guidance
C1 How do trustees allocate the risk budget?	The first step is to determine the division between return seeking assets and those assets intended to match liabilities. Within each category, the next step is to establish the range of assets to be used. It is important for the trustees to consider the robustness of the statistics on which recommended asset allocations are based. Some models generate radically different results when only a small change occurs in the time period over which the analysis is carried out.

Comments:

Question	Guidance
C2 In which asset classes are we prepared to invest?	Some schemes confine their investments to the “traditional” asset classes of cash, bonds, equities and, perhaps, property. While this could be appropriate in some circumstances, such schemes might be missing out on the diversification and/or return benefits from other asset classes. This is not to suggest that other asset classes are necessarily beneficial. However, trustees should be prepared to consider new asset classes, and other asset classes should be excluded only after proper consideration. Key factors in determining the usefulness of other asset classes include the scheme size, the proportion invested in return seeking assets, governance resources, liquidity requirements and the overall return objective.

Comments:

Question	Guidance
C3 Do we attach sufficient importance to asset allocation?	This is of prime importance as investment returns from mainstream markets are likely to be much more dependent upon the choice of asset class, rather than the selection of the portfolio manager. Trustees should beware of devoting too much time to the selection and monitoring of individual portfolio managers at the expense of asset allocation. However, when alternative investments such as hedge funds are considered, the choice of manager assumes far greater significance.

Comments:

Question	Guidance
C4 How are the views on asset allocation generated?	Having determined the range of eligible asset classes, the trustees, working closely with advisers, need a structured process to set and change overall asset allocation. This may entail drawing on asset liability modelling, actuarially-based projections, scenario planning, and economic and financial forecasts. Asset allocation should be reviewed periodically, after full actuarial valuations, after periods of substantial market volatility, and after the performance of key asset classes has diverged radically (in either direction) from projected returns.

Comments:

Question	Discussion
C5 What is the optimal level of diversification?	Diversification of assets between asset classes and within asset classes themselves is a fundamental way to reduce investment risk. Factors to be taken into account should include: the level of risk and return required; the level of complexity that can be undertaken; and such matters as country specific risk. A variety of methods including statistical modelling and optimisation can then be employed.
Comments:	

Question	Discussion
C6 Should we emphasise UK equities over global equities?	UK equities represent about 10% of the global equity market. UK funds generally have a greater exposure on the grounds that their liabilities are sterling denominated. A significant proportion of large UK companies derives the majority of their earnings from overseas. However, the UK equity market is very concentrated and a small number of sectors and stocks comprise a very high proportion of total dividends. The UK market, as represented by the major indices, has become less representative of the UK economy. Given that equities are return seeking rather than matching assets, is there a justification for overweighting the UK market?
Comments:	

Question	Discussion
C7 To what extent should investments be liquid?	Account needs to be taken of our ability to meet near term demands. These include pensions in payment and calls on existing investment commitments. It is also worthwhile to be mindful of the cost of disposal of illiquid assets should there be a change in strategy, including a buy-in. At times of stress in financial markets, there is a danger that seemingly liquid assets can become illiquid. Some vehicles, for example some property funds and hedge funds, chose to lock in investors during the credit crunch, rather than sell their assets at distressed prices.
Comments:	

Question	Discussion
C8 How should our asset allocation respond to changes in market levels?	Is it wise to attempt to take advantage of shorter term market opportunities? In order to do so, it is usually necessary to be able to implement changes relatively quickly. If there has been a significant change in markets, trustees should check whether their perception of the strength of the employer's covenant is impacted. Where trustees have a gradual long-term strategy of increasing exposure to one or more asset classes, it is possible to construct rules to accelerate the process when the assets to be sold have performed well or when the assets to be purchased have performed poorly. This is likely to be relevant when a long-term de-risking strategy is being considered, for example.
Comments:	

Question	Guidance
C9 Should we have a re-balancing strategy?	Trustees may decide to let the actual asset allocation vary in response to relative market changes within broad ranges, or to limit fluctuations through a set re-balancing framework. This may be symmetrical around given target central allocations or alternatively one-sided in order to facilitate a longer-term trend re-allocation (generally towards defensive assets). The frequency of rebalancing will depend on how closely trustees wish to maintain their central asset allocations, and the transaction costs involved.
Comments:	
C10 Do we believe in "alpha"? If so, in which markets is it likely to be found?	Alpha is the outperformance generated by a skilful active manager. Some belief in alpha is required to justify investment in a number of asset classes, with hedge funds being the most obvious example. Alpha is more elusive in well researched markets such as major developed equity markets, where a passive approach might be more appropriate. A passive approach may, however, be almost impossible to use elsewhere. We should carefully evaluate the returns (net of fees) likely to be achieved by active as opposed to passive management.
Comments:	
C11 Are the additional returns from active managers sufficiently attractive?	If skilful managers can be identified and accessed on reasonable terms, then a spread of managers may be required for the trustees to be reasonably confident of capturing any "skill premium".
Comments:	
C12 Have we considered the pros and cons of investing through pooled vehicles rather than directly?	The advantages of investing through pooled vehicles might include cost, governance, and diversification. As far as cost is concerned, certain pooled vehicles will be accessible at a lower annual management charge than is available by investing directly. This is especially true for smaller schemes. The burden of governance is likely to be lower both initially and for ongoing monitoring of investments. Pooled vehicles offer schemes diversification benefits by enabling them to gain exposure to specialist markets. Disadvantages exist in that trustees will have less control over the operation of a pooled vehicle than of a segregated fund.
Comments:	

C13 Has sufficient consideration been given to the structure of the pooled investment?

Issues may include restrictions on the ability to redeem investments. For example, dealing may be permitted only on a few specified days.

Additionally, the fund manager may have the power to restrict the total size of redemptions in a given period ("gating"). There may also be other liquidity issues impacting on redemption. In certain circumstances, these could lead to redemptions being made "in specie", that is to say by a transfer of a share of the underlying assets.

Comments:

C14 Do we consider the relative merits of new investment opportunities and techniques? Do we understand these sufficiently?

New investment opportunities may have characteristics not available elsewhere and increase the scope for diversification. The trustees need to understand issues such as sustainability of returns, and correlations with other investments.

Comments:

C15 Where is our investment strategy documented?

It will appear in the Statement of Investment Principles.

Some trustees may prefer that the SIP concentrates upon high level principles, with more detail about specific policies contained in an accompanying document or appendix.

It is useful for trustees to think of the arrival of a new trustee, and to ensure that there is one place where a new trustee can quickly gather an understanding of the existing investment strategy.

Comments:

Derivatives and Hedging

D1 Have we considered using assets to match specific sections of our liabilities?

The risk of mismatching assets and liabilities is highlighted in asset-liability modelling. Periods of extreme market volatility (e.g. 2007-2009) may crystallise funding mismatches. Dedicated matching strategies should help to limit this exposure.

Comments:

D2 Have we considered the full range of risk reduction approaches?

These include LDI strategies and insurance policies. Insurance policies may be held as an asset of the scheme (buy-in) or may be assigned to the members concerned if the scheme rules allow this (buy-out).

Comments:

Question	Guidance
D3 Is a key objective to insulate the fund from changes in inflation or from changes in interest rates, or both? Is longevity exposure at manageable levels?	In general, schemes should consider hedging both interest rate and inflation exposures. The pace of implementation may be affected by current yield and implied inflation levels. There may also be an element of market timing involved. It is good practice to set trigger levels at which hedging should occur. In addition, trustees may wish to consider hedging longevity exposure through the mortality swaps market, or all three exposures through a buy-in or buy-out of part of the liabilities with an insurance company.
Comments:	
D4 Have we considered using derivatives in our investment or hedging strategy?	Derivatives offer scope to obtain exposure to markets with greater flexibility and lower transaction costs than with cash investment in the underlying securities. Derivatives should only be employed if their usage contributes to risk reduction or for the purposes of efficient portfolio management. Swaps are becoming more mainstream pension fund investment instruments and are especially useful to cover longer-dated exposures, and when free cash resources are limited. Swaps are particularly useful where there is a dearth of very long-dated bonds.
Comments:	
D5 What proportion of our liabilities should we hedge?	Schemes should consider the impact on prospective risk and return of hedging increasing proportions of their liabilities. This will have implications for the required return needed to achieve their funding objectives, and hence the split between investment performance and additional company contributions required to cover any deficit.
Comments:	
D6 If we have an LDI programme, does it extend beyond fixed income assets to encompass overlays on return seeking assets?	This may be advantageous, especially where overall fixed income exposure is moderate relative to total liabilities. Its effectiveness will depend partly on the correlation between the scheme's return seeking assets and the (bond-type) liabilities. Clearly, the greater the correlation the less value there is to extending the LDI overlay.
Comments:	
D7 Have the trustees considered using option strategies?	For schemes that have sizeable equity exposures, it may be advantageous to modify part of the risk-return exposure to limit downside risk, while still retaining a reasonable exposure to market upside. This can be achieved by an equity "cap and collar" arrangement.
Comments:	

D8 If using derivative strategies, are the trustees confident that they have in place a robust policy to manage counterparty risk?	Schemes need to model collateral requirements to ensure that there is adequate cover for extreme movements in underlying cash markets. Counterparty exposure should be well-diversified, with daily collateralisation ideally.

Comments:

D9 Should longevity swaps or buy-ins be used in conjunction with an LDI programme?	For schemes faced with substantial longevity exposure it may be advantageous to consider combining an LDI programme with a longevity swap on part of the liabilities. This will create a "synthetic buy-in" covering actuarial exposures.

Comments:

Investment Consultants

E1 How effective is the consultant in helping us establish our investment strategy?	Factors to consider include the degree of pro-activity, responsiveness, and focus of the advice.

Comments:

E2 Do we know the key elements of our consultant's approach to investment?	For instance, it is important to know their thoughts on active versus passive investment management, alternatives, and their approach to LDI. It is vital to establish whether the consultant's approach to investment matters is consistent with that of the trustees.

Comments:

E3 What proportion of the fund management universe is covered by the consultant's research?	Is the consultant able adequately to cover the smaller investment managers, specialist managers and those located outside the UK? Trustees should consider the size, experience, and breadth of the consultant's research team. It is beneficial if detailed research on short-listed managers is made available to trustees, as part of a selection process.

Comments:

E4 Does the consultant's research capability extend to operational issues?	Does it embrace: counterparty risk (e.g. the standing of swap counterparties); back office capability (including the importance of the prime broker role for hedge funds); or in-house vehicles (e.g. composition of cash funds)?

Comments:

E5 Does the consultant demonstrate consistent ability to shortlist good managers?	We should be aware of the consultant's record in identifying managers who subsequently perform well. Are we reasonably confident of its repeatability?

Comments:

E6 Does the consultant provide a helpful framework for discussions with investment managers?	An effective consultant works with the trustees to set an appropriate agenda, highlighting the key areas for discussion, and suggesting important questions which may be posed to the investment managers.

Comments:

E7 Are investment transitions implemented effectively?	Consultants may be asked to help with implementing changes in asset allocation and investment managers. Trustees will expect this to be done in a timely and cost effective manner. Is adequate advice provided as to whether a transition manager should be appointed? Does the consultant provide a comprehensive analysis of the outcome?

Comments:

E8 How pro-active is the consultant in keeping abreast of new developments?	Developments include new asset classes (such as catastrophe insurance), new investment techniques and instruments, business or staff changes at investment managers, together with market and regulatory developments.

Comments:

E9 What is the preferred fee basis for remunerating our investment consultants?	There is often a combination of base fee, project fee, and an additional hourly rate. However, thought should be given to including a performance-related element in order to align more closely the consultant's interest with those of the trustees.

Comments:

Investment Managers

Question	Guidance
F1 Do we have sufficient understanding of each proposed manager's style and investment process?	It is essential to understand the investment process and any style bias. In addition to explaining when they will perform well, each manager should be able to state under which market conditions they are unlikely to perform well.

Comments:

Question	Guidance
F2 How should we assess and monitor our investment managers?	Each investment manager's performance and risk should be compared with the agreed benchmark and target. Formal assessments are best undertaken over a long time period, say, rolling 3 years. Performance measurement should, ideally, use data that is net of fees. Even where performance is satisfactory, the trustees should monitor significant changes in style, process, or personnel. Performance reports should be provided by an independent source, which could be the custodian.

Comments:

Question	Guidance
F3 How should we approach managing underperformance and terminating mandates?	An important consideration here is the appropriate length of time an underperforming manager should be given to demonstrate improvement. Has the investment manager's process changed, and is it still relevant? Termination is often not the ideal solution. Trustees should consider the costs of changing manager and the danger that a manager is fired just at the time his performance begins to improve.

Comments:

Question	Guidance
F4 How well does the manager explain its approach to risk management?	The manager should report on risk levels in a clear, consistent, and comprehensive way.

Comments:

F5 Does the manager take appropriate risk given its agreed investment targets?	Managers should take the appropriate level of risk to achieve their performance targets. The trustees need to have confidence in the ability of their manager to turn risk into return. The greater the performance target, the greater the associated risk. The investment manager should ensure that the scheme's level of risk does not rise unacceptably when market conditions change, unless explicitly authorised by the trustees.
Comments:	

F6 How clearly does the manager explain underperformance?	The attribution analysis will normally encompass asset allocation, stock and sector selection, and currency exposure.
Comments:	

F7 How clearly does the manager explain exceptionally good performance?	This is often overlooked. It is important to establish that exceptionally good performance is not a result of running inappropriate risks.
Comments:	

F8 Does the manager keep trustees informed of personnel and organisational changes?	At some managers, performance is dependent on certain individuals (key person risk). At others, the team as a whole is more important. Particular attention should be paid to this area at times of corporate activity and/or significant changes in the level of assets under management. Trustees should ensure that they are kept appraised of major changes in responsibilities or remuneration structure.
Comments:	

F9 Are our investment management fee arrangements appropriate?	Structures include: ■ A flat fee. ■ A fee expressed as a tapered percentage of total assets under management. ■ A fee which depends solely on performance which can be absolute, or relative to a benchmark. ■ Some combination of the above. Consider how experienced and comfortable the manager is with the fee scale in question. Is there an incentive to manage the portfolio in an inappropriate way because of the fee? If a performance fee is proposed, does it embody a high watermark? If not, only a very small amount of the outperformance might be left for the scheme's benefit. Consider having a period of 3 years before performance fees can be fully earned.
Comments:	

F10 In the case of passive management, do the trustees have sufficient understanding of the index replication technique being used?	A variety of approaches are used by fund managers. These vary from full replication to stratified sampling. The trustees should consider how accurately the index is matched.

Comments:

F11 Have the trustees considered allowing their investment manager to use derivatives to help achieve their investment objectives?	Derivatives add to the flexibility of investment portfolios and may enable managers to implement strategies more rapidly and at lower cost than through using cash markets. Schemes need to be satisfied that managers have adequate risk management routines in place to monitor a derivatives programme, including robust collateral arrangements.

Comments:

F12 Does the investment management agreement permit stock lending?	If it does, are the trustees satisfied with the collateral arrangements? Consideration should be given to the risks associated with the assets to be used as collateral.

Comments:

F13 Should passive managers have any scope to enhance performance?	Often passive managers attempt to take advantage of technical changes in the market due to revisions in index components. Trustees need to be satisfied that any deviation in performance from a passive manager is within reasonable bounds.

Comments:

F14 Should Trustees appoint a transition manager when significant changes to the portfolio are planned?	Transition managers can assist with the movement of funds between asset categories by seeking to minimise out-of-market exposures, and using their access to significant flows of funds to contain costs by crossing transactions and limiting the market impact of significant portfolio movements.

Comments:

Governance and Compliance

Question	Guidance
G1 Is our governance structure proportionate to the scale and sophistication of our investment management programme?	Important factors here include the structure of committees, the existence of suitable, qualified and dedicated executive personnel, and the extent of trustee knowledge and understanding.

Comments:

Question	Guidance
G2 How should the responsibilities be divided between the board of trustees and the investment committee?	The investment committee may have decision-making powers or be limited to an advisory role. Typically, responsibility for asset allocation lies with the trustees. The investment committee may be responsible for manager selection and de-selection, fee negotiations, discretionary re-balancing of overall asset allocation, implementing a tactical asset allocation overlay and the extent to which derivatives and currency hedging are used. Custodianship matters and the review of investment manager contract details may also be delegated to the investment committee.

Comments:

Question	Guidance
G3 Do we have sufficient skills and knowledge to challenge our investment consultant effectively?	Trustees should ensure that they have sufficient investment knowledge to be able to challenge the advice they receive. Otherwise, the investment consultant may dominate.

Comments:

Question	Guidance
G4 Is the completeness, accuracy and timeliness of reporting adequate for proper governance?	The board of trustees should receive sufficient information to understand the work of the investment committee and act upon it where appropriate. Effective governance requires the prompt reporting of information and should include data on asset allocation, performance and risk, together with comment on attribution. Consideration should be given to a separate rolling three-year business plan for an investment committee.

Comments:

Question	Guidance
G5 Do we have the appropriate structure to respond in a timely fashion to opportunities?	If not, there is a danger that attractive opportunities will be missed.

Comments:

Question	Guidance
G6 Should we consider utilising investment expertise from outside the trustee body?	Investment expertise may be available in the company, or it may be appropriate to appoint specialists to sit on the investment committee from outside the trustee board. The company's treasury department may be utilised, for instance in connection with LDI programmes.
Comments:	
G7 Do we comply with the six revised Myners Principles?	These cover effective decision-making, clear objectives, risk and liabilities, performance assessment, responsible ownership, and transparency and reporting. Trustees are expected to adhere to the Principles on a "comply or explain" basis. The Pensions Regulator's website contains helpful tools to assist trustees in meeting these principles.
Comments:	
G8 Do we ensure that our investment managers adopt the Institutional Shareholders' Committee Code on the Responsibilities of Institutional Investors?	This Code, drawn up in 2009, sets out best practice for institutional investors that choose to engage with the companies in which they invest. It applies on a comply-or-explain basis. Its seven principles cover: the public disclosure of policy for discharging stewardship responsibilities; managing conflicts of interest; monitoring of investee companies; guidelines on when and how to escalate activities from monitoring to intervention; willingness to act collectively with other investors; a clear policy on voting and disclosure of voting activity; and periodic reporting of stewardship and voting activities. Trustees should ascertain whether any proposed new UK equity manager adheres to the Code. Some of those that do will be able to provide an independent audit opinion to that effect. Institutional investors that do not wish to engage are asked to state publicly that the Code is not relevant to them and to explain why.
Comments:	
G9 Do the trustees regularly review their SRI policy?	Trustees should be aware of the arguments for the impact of SRI considerations on shareholder value. Trustees should consider the extent to which they wish to delegate this responsibility to their investment managers or to a specialist. Trustees should be aware of each investment manager's policy and practice in this area and should monitor them.
Comments:	
G10 Have we considered alternative governance approaches (e.g. delegation to a "fiduciary" manager, sometimes referred to as implemented consulting)?	Fiduciary management provides a combination of investment consulting, portfolio construction, manager selection, monitoring, and reporting. Some schemes, for example those with a limited governance budget, may find this attractive.
Comments:	

Question	Guidance
G11 How would we specify and measure investment performance of a "fiduciary" manager?	An appropriate benchmark would need to be set which might be based on asset class indices, or be a liability-based "gilts plus a margin" measure. Trustees should decide how best to select and appraise periodically the performance of their fiduciary manager. Trustees should also consider the advice which they will need in order to select and monitor a fiduciary manager.
Comments:	
G12 What does our adviser think about our governance?	The investment consultant will be able to draw on their experience of other schemes so as to offer a relative judgement.
Comments:	
G13 Do we have adequate compliance routines in place?	Important items include: ■ proper consultation with the sponsor on changes to the Statement of Investment Principles; ■ obtaining from each investment manager an annual certificate of compliance with the investment management agreement; ■ adequate diversification of investments and compliance with any limitations to the permissible range of investments; ■ no breaches of self investment limits; ■ use of derivatives restricted within permitted ranges; ■ no day-to-day investment decisions by trustees or short term trading by investment managers (either of which could breach tax registered status); ■ member communications on investment issues are reviewed by an authorised adviser and avoid giving investment advice; ■ periodic review of AVCs; and ■ review of AAF 01/06 manager reports on internal controls including confirmation of appropriate action in the event of qualifications in such reports. An investment risk assessment register and Investment sub-committee business plan might usefully record compliance routines.
Comments:	
G14 Do we review money purchase AVCs periodically?	Obtain annual written advice on the adequacy of the range of investment options and fund performance and communicate with members accordingly.
Comments:	

Glossary

Asset Liability Modelling (ALM)	A statistical technique measuring movements in assets and liabilities of the scheme under a variety of macroeconomic scenarios and asset allocation strategies.
Basis risk	This risk arises when the Scheme uses an imperfect hedge. An example would be using a FTSE 100 future to hedge a FTSE All-Share UK equity portfolio.
Collateralisation	Collateral is an asset pledged by a borrower to a lender in respect of an obligation. In the event that the borrower defaults on the obligation, the lender has the right to seize and sell the collateral. A common feature of derivatives.
Credit risk	The possibility that a bond will default and the borrower fails to repay principal and/or interest on schedule.
Derivative	A financial instrument such as a future, an option, or a swap, whose value is dependent on the value of an underlying asset or payment stream.
Equity risk premium	The extra return expected from investing in equities over and above that available from a risk free asset to provide compensation for the additional volatility of equities.
High watermark	An important factor in performance-related fees. It means that an investment manager will not receive performance fees until such time as the portfolio value is greater than the high watermark value when performance fees were previously earned, and will earn fees only on the new outperformance.
Liability Driven Investment (LDI)	An investment strategy which is specifically related to the liabilities of the Scheme, rather than only to the maximisation of returns. The objective is that movements which occur in the value of liabilities will be matched by similar changes in the value of the assets.
Liquidity premium	The additional return an investor requires in order to be compensated for holding an asset with liquidity lower than cash.
Swap	The type of derivative where two entities agree to exchange cash flows over an agreed period. Swaps can be based on interest rates or inflation or currency or other cash flows. For example a variable interest rate cash flow may be exchanged for a fixed interest rate cash flow.
Value at Risk (VaR)	The expected loss when there is an extreme outcome, usually set as the 1 in 20 year worst case, expressed as VaR95.

Notes

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