The Trustee toolkit downloadable

An introduction to investment

Tutorial nine: Reviewing investments

By the end of this tutorial you will better understand:

- why regular reviews of the suitability of investment funds are important
- how investment fund performance can be measured
- potential 'triggers' for taking action regarding investment fund performance
- what benchmarks are

This tutorial is part of **Scenario four**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Why are regular reviews important?

Investment products and investment funds change over time. The economy and the investment market alter and some assets and funds become less or more attractive. It's important to keep under review the suitability of:

- investment funds underlying the scheme's investment strategy (DB) or default arrangement (DC)
- other investment funds trustees make available for members who set their own investment strategy (DC)

This is to ensure that:

- the investments are still suitable and appropriate for meeting the scheme's investment strategy (DB) or the investment strategy for the default arrangement (DC)
- fund performance and investment volatility is tracked and compared to an appropriate benchmark

Trustees should also ensure that there are no matters to address in relation to:

- those responsible for managing the investments, eg the investment manager, being investigated by the Financial Conduct Authority (FCA) or involved in some malpractice
- significant changes which could alter the original objectives of the investment fund, such as a change in fund manager or strategy

This could have a significant impact on the fund's performance, risk exposure or continued appropriateness of the investment.

This tutorial is a basic introduction to reviewing investments as this principle applies to both DB and DC schemes. Reviewing the investment strategy/default arrangement and making changes to underlying assets or funds (and in the case of DC, alternative funds to be made available to members) will be looked at in more detail in later modules.

Measuring fund performance

Understanding how the investments are performing enables trustees to identify whether things are progressing as intended. If they are going wrong, trustees can then take remedial action if necessary. Take a look at the simple statements from two schemes below. What do you think of their performance?

DB scheme: 'Our scheme's assets have exceeded the performance of similarly sized schemes by 2% in the last year.'

DC scheme: 'Our scheme's investment funds underlying the default arrangement have increased in value by 2.5% in the past year.'

1. This is good performance, both schemes are doing well
2. This is terrible performance, I would expect more for these schemes
3. I can't decide whether this is good or bad performance on this information alone

Answers are at the back

How is performance measured?

Trustees should build flexibility into the review and assessment of fund performance. In order to measure fund performance, trustees should consider:

1. what performance measures they are going to use
2. over what time period the performance should be assessed
3. fund performance review triggers
4. what benchmarks they are going to use

1. What performance measures to use

Some investment managers set objectives to outperform a benchmark by a given percentage. This could for example be the FTSE index plus 2% and is called a performance 'target'.

Margins between the benchmark and target normally vary between asset classes and are likely to be smaller for bond funds. This reflects the lower average returns and lower volatility, which in turn present fewer opportunities for outperformance.

The greater the margin the greater the risks the investment manager might have to take to meet or exceed it. This may increase the chance of underperformance so trustees need to bear in mind appetite for risk and membership profile when setting targets.

2. Time periods for assessment

Investment performance is measured over specific periods of time, for example, quarterly, one yearly and three yearly. This can produce different results. This provides the trustees some indication of how the investment has performed in the short term, as well as over longer periods of time. Other performance periods such as one month and five years can also be used.

The performance is generally compared to the percentage return of the benchmarks of the investments. This provides trustees with information of how the investments are performing in comparison to investments of similar composition (eg same asset class) over the same time period. Investment managers would generally have a standard format of illustrating investment performance when providing this information to trustees, sorted into a performance table under headings indicating the time periods. This ensures consistency in the presentation of the data and enables trustees to track the performance and compare this to the rest of the market.

3. Triggers for action

As a general rule, trustees should set triggers which are appropriate to the long term nature of pension scheme investments and should not take decisions based on short term performance. They need to consider performance in the context of the strategy they have set.

A short term view

In this example, the quarterly performance figure revealed a sudden drop in the return of the investment of -7.5%. The trustees may take the view that the investment is on a dangerous decline in value and that they need to intervene, for example by switching the investment. This is known as a 'stop loss' action.

However, in a situation where the value of an investment is switched or in another way 'capitalised' during a market downturn, which is followed by a recovery in the market, the losses are effectively locked into the value of the investment. But a market decline may not necessarily be followed by a recovery so very careful consideration needs to be given to decide when a 'stop loss' action may be necessary.

A long term view

Taking the longer term view the trustees may take the view that the drop in the return of the investment is part of the economic cycle where short term peaks and troughs in the market are evened out by a long term performance that meets the objectives of the investment.

It may benefit trustees to set up triggers to alert them that the investment performance requires a review and which circumstances may require the trustees' immediate attention. There is no right or wrong answer, but the use of triggers, mechanistic or otherwise, can be a useful mechanism for trustees to use to bring order to their review of managers.

Performance triggers

These triggers can be set up to work mechanically, so for example when the performance of the investment drops below the benchmark being used, by a certain level, the investment is taken up for review.

These triggers need to be appropriate for the type of fund and its objective. For example, an index tracking fund may merit triggers which are configured tightly around the index return. However an actively managed fund holding volatile assets may merit triggers configured more loosely around its long term performance objective.

Other triggers

Fund performance should not be the only factor which may trigger action by the trustees. This will vary from scheme to scheme.

The size and value of each investment fund should be a factor in considering the nature and frequency of review.

Changes to the risk rating and volatility of the investment as well as the appointment of a new investment manager are also triggers for when an investment may require a review.

Triggers for DC schemes

In DC schemes, the types of investment funds selected by members may also trigger a review. For example, trustees may decide to select a higher risk investment fund to review on the basis that it is more volatile, regardless of the fact that it is likely to represent a smaller element of members' portfolios.

4. What benchmarks to use

Benchmarking is a way of measuring the performance of various classes of assets by comparing them with similar types of investments elsewhere in the market, often with reference to a published index.

Indices

There are many different indices, which relate to various types of investments, and which may be specific to particular investment products, geographies, economic groupings, and/or company sizes. For example, the benchmark for the scheme's UK equities could be the FTSE All-Share Index, whilst bond funds may be measured against an iBoxx index (bond market indices for professional use).

It may be difficult to find a relevant index to compare with, if for example pension equity assets span both UK and international equities, so two different indices may have to be used or combined. It may also be difficult to select an appropriate benchmark for pooled investment funds. Such funds are generally compared to composite indices.

Volatility and rankings

A more rounded view of performance may be obtained if measures such as the volatility of the fund and quartile rankings are used. The volatility of the investment provides an indication of how 'stable' the investment is, so that if an investment changes by showing increased volatility, it is an indication of higher risk than previously. Volatility ratings therefore serve to help with the comparison of risk, against the return that has been achieved.

The quartile ranking is another measure of how well the investment has performed in comparison to others of a similar composition. If for example the performance places the investment in the first quartile, this means that the investment is ranked in the top 25% of all investments in the group.

Choosing appropriate benchmarks

Trustees are likely to decide on the most appropriate benchmark (or benchmarks) at the point of choosing their investment strategy/default strategy and range of funds.

Trustees will normally seek input from their investment advisers as to the most appropriate benchmark to be used. The benchmark should be incorporated in the scheme's Statement of Investment Principles (SIP).

Answers and feedback

Measuring fund performance

The last option is correct. It may be tempting for DB schemes to compare their performance with other schemes, and DC schemes to look at whether the funds underlying the default arrangement have simply increased or decreased in value. However, what if the DB scheme is being compared to another with completely different assets? What if that scheme is performing poorly?

What if the market had risen 4% in the past year compared to the 2.5% performance of the growth fund in the DC scheme's default strategy? What if other similar growth funds had risen in value by more than 2.5%? What if the target for this fund was actually 3%?

Whilst it is important to measure the extent to which the value of an investment has increased (or decreased) in absolute terms, performance cannot be measured on this information alone. What is likely to be of particular significance to trustees is how good the investment performance has been when compared to the performance of other similar investments and the targets set. In other words, is their investment manager 'doing a good job'?

This analysis is not always straightforward because trustees must balance their findings against the legislative requirements of suitability and diversification.