Trustee toolkit downloadable

Investment in a DC scheme
Tutorial 1 of 5: Setting an investment strategy

Here, you will continue to develop your knowledge of investment, specifically within a DC scheme.

This tutorial is related to the following units in the defined benefit (DB) and defined contribution (DC) scope guidance:

- The role of advisers and suppliers to the scheme (1d)
- Investment of scheme assets (1f)
- The implications of the transfer of risk to members of DC occupational arrangements (7d)
- The implications for the members of the investment strategy adopted by the trustees (8a)
- The importance of member understanding of investment risk (8b)
- The contents of the Statement of Investment Principles (SIP) (11c).

This tutorial is linked to **Scenario 1**.

The Pensions Regulator

Introduction

In the tutorial **Setting an investment strategy** in the module **An introduction to investment**, we covered setting an investment strategy for defined benefit (DB) and DC pension schemes, and the required content for a scheme's statement of investment principles (SIP). Here's a reminder of the issues.

Trustees are required to set the scheme's investment strategy and ensure the long-term suitability of the funds underlying that strategy. The scheme's investment strategy is documented in a SIP.

DC schemes may offer members who do not or do not want to choose their own investments a default option. Where this is a default arrangement under the Occupational Pension Schemes (Investment) Regulations 2005, it is a legal requirement that the trustees or managers prepare a statement of the investment principles governing decisions about investments for that default arrangement. Trustees do not need to produce separate SIPs for different arrangements but they should bear in mind that they must make the most recent SIP relating to any default arrangement available to members as part of the annual chair's statement.

Separate to any default options(s), DC schemes can also offer members alternative investment options for members to choose to invest in. Where members invest in alternative investment options offered, it is the members who set their own investment strategy; the trustees are responsible for ensuring that the funds offered perform in line with the investment manager's stated objectives and remain suitable for the needs of the scheme's membership profile.

Trustees should allow suitable time to design the investment strategy for any default options ensuring that the member data on which the strategy is based is accurate. What is a suitable investment strategy will vary from scheme to scheme depending on a range of factors including the needs, preferences and characteristics of the membership.

You can learn more by reading the guides to investment governance at **www.tpr.gov.uk/invest** and value for members at **www.tpr.gov.uk/value.**

Risks to good member outcomes

In the tutorial **Good member outcomes** in the module **How a DC scheme works (2014)**, we set out how The Pensions Regulator expects DC schemes to be designed and managed to deliver good member outcomes, including appropriate investment decisions.

As part of this, we identified a number of the risks inherent in DC scheme investing including the risk that trustees offer poor or inappropriate investment choices for members.

In order to address and mitigate this risk, trustees should consider the profile of the current scheme membership when choosing which investment options to offer members. This involves looking at member characteristics, such as age, salary and intended retirement date, as well as actively seeking member views on particular issues and considering trends in both scheme data and the industry.

Trustees may take into account both financial and non-financial factors, such as the sustainability of investments or other factors such as members' ethical or religious principles.

Non-financial factors

When designing an investment strategy, trustees may consider non-financial factors as well as financial factors.

Sustainability

Trustees should bear in mind the sustainability of their investments given that most investments are long term and therefore exposed to longer-term financial risks, such as climate change.

Religious and ethical principles

Trustees may wish to offer members funds that select investments according to particular religious or ethical principles, including environmental, social and governance (ESG) factors.

Trustees should only consider these principles if they believe members share their view and there is no risk of significant financial detriment to the fund.

Investment stewardship

For most pension schemes, stewardship activities, including engagement with the companies the scheme invests in, are likely to be carried out by the investment manager on the trustees' behalf. However, it's important that trustees understand their investment manager's stewardship policies and seek to influence them where appropriate. Good stewardship includes the exercising of voting rights attached to shares.

The scheme's SIP must include statements about any policy on voting rights, and the extent to which environmental, social and governance (ESG) factors are taken into account in the selection, retention and realisation of investments.

You can learn more by reading the guide to investment governance at **www.tpr.gov.uk/invest**

Understanding the membership profile

The type and extent of information required will depend on the scheme and membership. In most cases, trustees will need to use their judgement when making decisions relating to member need and preference.

There are a number of different methods that trustees can use to help them understand the needs and preferences of their scheme's membership.

Administrator or provider

The administrator or provider can provide basic information on member characteristics, such as age, salary, intended retirement date and trends in scheme data such as an increase in the proportion of cash being taken as a benefit.

Advisers

Advisers may be able to provide a view on industry trends and also an analysis of membership characteristics for trustees.

Employer

Employers can be another useful source of information, for example in relation to the type of provision they are aiming to provide for their employees as part of the overall reward package (eg basic or market leading).

Members

Member engagement is particularly important for gaining a full understanding of the membership profile. It provides trustees with information such as:

- when members are likely to start accessing benefits
- benefit preferences (eg cash, drawdown, annuity)
- risk appetite
- degree of financial knowledge,
- any preferences for a particular approach to investing (eg use of funds that follow ethical or religious principles)

Segmenting the membership

When trustees have gathered and analysed an appropriate level of information, it can be useful to segment the membership and analyse particular groups of members. Considering this information can help trustees to see whether different investment options might be suitable for different groups, and to set investment objectives and strategies. . Segmenting the membership can also help trustees focus and tailor their communications to members.

The split between active and deferred members: Deferred members can be less engaged than active members.

Membership by age bands: This can help identify young members invested cautiously and older members invested solely in riskier assets.

Membership banded by pot size and salary bands: Members can be more engaged when their pot size grows to become more aligned with their salary.

Typical target pension ages, and when and how people actually choose to access their benefits: This can help in designing investment options to offer as members approach pension age.

Investment options selected outside of the default: This can help identify if members are invested in historic default funds, highlight legacy investment options and indicate whether the scheme offers a selection of alternatives to the default option that remain appropriate for members.

Membership banded by contribution rate: This can help identify if members could be encouraged to contribute more in order maximise employer contributions.

Further groups identified as a result of member engagement: For example, certain members may have a particular interest in funds that follow ethical or religious principles or in funds that cater for a greater tolerance of risk.

You can learn more by reading the guide to communicating and reporting at **www.tpr.gov.uk/communicate**

Changes in membership profile

As time passes, the membership profile will change. It is important to review the membership profile when reviewing the default and alternative fund options. As part of this, trustees should consider how the membership could change.

If the scheme is used for automatic enrolment, trustees may find that the proportion of the membership not engaged with pensions or their investments choices increases. They may experience a high proportion of the membership not making an investment choice and therefore investing in the default option.

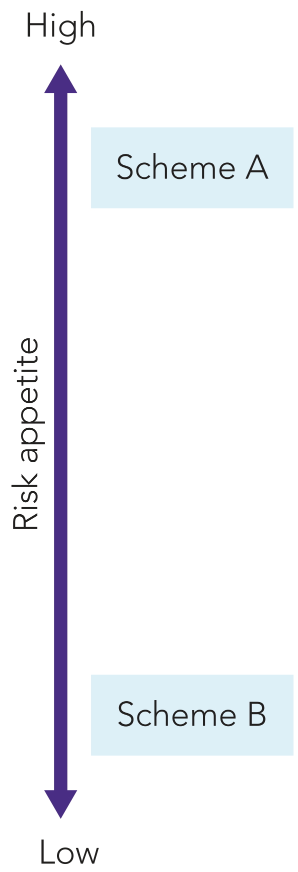
If the parent company's DB scheme closes to future accrual, trustees may find that a number of members join the existing DC scheme with significant historic DB benefits for past service. These members might wish to take more risk with their DC investments as they have already accrued a promise from the employer to pay a specific level of pension benefits at retirement.

As a scheme ages, more of the members will be deferred. Trustees need to consider the interests of both active and deferred members when they make decisions relating to investment options.

Trustees may find that deferred members are not as engaged as active members and are less likely to pick up on changes that are made to the scheme and implications they may have on their investments. Trustees may need to tailor their communications for deferred members.

Risk appetite

Analysing the membership profile can give an indication of the risk appetite of groups of members. This can help trustees set an appropriate default and alternative investment options for members who choose their own investment strategy.



Higher risk appetite

A parent company has worked with the trustees to close scheme A's DB scheme to future accrual.

On closure, a number of employees with significant DB benefits join the company's DC arrangement for future service. These members may wish to invest in a broader range of investment options with higher risk as they already have significant DB benefits for past service. If this is the case, these members can be described as having a higher risk appetite for their DC investments.

Lower risk appetite

The trustees of scheme B have found that all their members are young with smaller pots who haven't saved in a pension before (either in DB or DC). They may be more cautious and risk averse. These members may have a stronger aversion to short-term investment loss than older members. If this is the case, these members can be described as having a lower risk appetite.

Other factors to consider

Before implementing a strategy, there are a number of other factors trustees need to consider. These include:

- whether new funds are being developed that are likely to suit their membership (eg diversified funds that seek to control risk and generate more stable returns)
- whether the costs of funds can add value to member outcomes
- whether the governance required for more complex funds is feasible in the context of available resources
- how to achieve appropriate asset liquidity
- potential changes to investment markets, products and techniques, and think about
- how investment options could be affected by structural changes to the employer or investment service provider (eg through mergers and acquisitions).

Taking advice

As we have seen in the tutorial **Investment in a pension scheme** in the module **An introduction to investment**, before making any investments or revising a statement of investment principles, trustees must obtain and consider 'proper advice'.

This is essentially advice made or confirmed in writing by (in most cases) a person authorised to carry on investment business in the UK (or exempt from authorisation, such as the scheme's investment consultants); or in other cases, from someone who the trustees believe has appropriate knowledge and experience of the management of investments.

You have now reached the end of this tutorial. The next one in the series is **Default investment options**.