Trustee toolkit downloadable

Investment in a DC scheme

Tutorial 3 of 5: Alternative investment options

Here you will learn about offering alternative investment options for members.

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

- 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).

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

The Pensions Regulator

Introduction

Defined contribution (DC) pension schemes vary greatly, both by assets under management and by number of members. As a result, there are many different examples of investment option ranges for a DC pension scheme. Trustees of DC schemes are responsible for deciding the investment objectives of the default strategy of the scheme and its underlying funds, as well as for the range of funds to offer to members who want to choose their own investment strategy.

What if members don't make a choice of where to invest?

For trustees of a DC pension scheme that is or will be used as a company's automatic enrolment vehicle, it is a legal requirement that the scheme has a default strategy. A member's contributions will be automatically invested in the default strategy unless they make an active decision to choose their own strategy and select from one or more of the alternative select funds the trustees offer.

It is the responsibility of the trustees of a DC pension scheme to ensure that the default strategy remains appropriate.

You will find more information on this topic in the tutorial **Default investment options**.

What if members want to set their own investment strategy?

Trustees can offer further investment options to enable members to choose their own investment strategy. Some of these investment options may also be used as an underlying element of the scheme's default investment strategy.

As with the funds underlying the default strategy, it is the responsibility of the trustees to ensure that all alternative options offered to members who choose their own investment strategy remain suitable for the scheme's membership.

You will find more information on this topic in the tutorial **Setting an investment strategy**.

Considering a scheme's membership profile, including member characteristics, needs and preferences, can help identify which alternative investment options, if any, the trustees should offer.

Alternative options: Risks to members

In setting the range of funds to offer to members to set their own investment strategy, trustees should consider the following risks as a starting point:

- Members being affected by investment risk
- Members being affected by market volatility
- Members making inappropriate investment choices.

You will find more information on this topic in the tutorial **Good member outcomes** in the module **How a DC scheme works (2014)**.

Investment risk and market volatility

In a DC scheme, the investment risk is carried by the member, not the employer, and good investment performance is one of the contributing factors to the value of the member's pot. Take a look at the risks below to find out more.

Risk type	**Explanation of risk**	**Mitigation approach**
Journey risk	Volatility of fund value on the path to pension age	Trustees can offer wide range of asset classes to aid diversification for members
Inflation risk	Investments fail to maintain value in real terms	Trustees can offer some funds that invest in 'real' assets to provide inflation protection
Pension conversion risk	The income for life, or annuity, a member can buy is adversely affected by changes in annuity rates. Alternatively, the member chooses to leave their pot invested in the scheme and draw an income instead of taking an annuity or cash but the investment strategy has assumed the member will take an annuity.	Trustees can offer funds whose value moves in line with price of annuities (eg government bonds). Trustees can educate members about retirement options and engage with them about how and when they want to access their benefits throughout their membership.
Capital risk	The amount of tax free cash available at pension age is adversely affected by a fall in the value of investments	Trustees can offer a fund which maintains its capital value (eg cash)
Default option risk	Default option may be inappropriate if accepted without consideration by the member	Trustees can encourage members to make an active decision over whether default option is appropriate for them

Inappropriate investment choices

If members do not fully understand the characteristics of the different asset classes and the concept of risk and reward, they might select asset classes that are not appropriate for them. This is particularly important in schemes which are not required to offer a default investment strategy and choose not to do so.

The trustees should typically provide the following information for each investment option the scheme offers to members who select their own investment strategy so that they are able to make informed choices about their investment fund options and monitor performance:

- The broad underlying asset classes of each investment option
- The level of risk in the strategy for the fund being offered and in its underlying investments (eg does it include an asset class which is likely to be very volatile?). All funds offered by a scheme should be given a risk rating which enables the member to compare the options
- The objective and investment style of the investment manager for the fund. This could be to replicate or outperform an index or could be a net of fees target return, such as matching a cash or inflation benchmark
- How the costs and charges are calculated and levied on the fund, eg the annual management charge (AMC) and other ongoing charges.

This information must also be clearly documented so that trustees can use it to monitor the performance of funds against their objectives and consider whether they remain suitable options for the membership.

Accurate labelling of fund options is important as some members of DC schemes may focus on the name of the fund.

Alternative options: Risks for trustees

Trustees could offer investment options which are not appropriate for the membership of the scheme, leading to poor outcomes for members. This risk can be broken down into a number of different points:

- The number of funds offered is too many
- The number of funds offered is too few
- The funds offered are inappropriate for members
- The funds offered do not meet their objectives
- The funds offered have high associated costs
- The funds offered are not adequately secure.

Analysing the scheme membership profile, following industry-wide good practices and seeking professional advice will help to minimise the chances of offering inappropriate investment options.

Exercise: check your scheme

Before we cover these trustee risks in detail, think about what your scheme offers to members who wish to set their investment strategy.

- How many investment options does your scheme offer for members who do not wish to be invested in the default strategy?
- What investment options does your scheme offer for members who wish to choose their own investment strategy?
- Does your scheme offer any ethical or religious options?
- Does your scheme offer a with-profits option?

How many investment options to offer?

The number, range and type of fund choices should strike a balance between, offering enough choice to meet members' reasonable growth and protection requirements and offering a range of risk/return profiles within the growth and protection funds whilst avoiding too much complexity.

Consider the membership

The number of funds to offer may also depend on the size of the scheme (number of members and value of assets under management). Trustees should also consider the membership profile to justify a wider or narrower range of funds to offer.

You will find more information on this topic in the tutorial **Setting an investment strategy**.

Too much choice?

There is evidence to suggest that too much choice can be offputting for people. For example a behavioural science study* in America showed that when a supermarket offered 24 jam choices on its display, only 3% of customers actually made a purchase. However, when customers were presented with only six different types of jam, 30% of customers bought a jar of the jam. In the same way that studies have shown that a shopper in a supermarket can be overwhelmed, so can a scheme member if given too many variations on the same product.

Selecting options

Trustees should consider the characteristics of investment funds available and select funds that will meet their objectives. We have covered many of the investment characteristics set out in this section in the module **An introduction to investment**. This section discusses them with a focus on DC investing.

A range of options

Trustees should consider offering a range of asset classes with a range of risk ratings to members who wish to set their own investment strategy. Trustees will need to consider whether the asset classes offered should be managed on an active or passive basis.

*
Reference: Iyengar, Sheena S. and Mark Lepper. 2000. **When choice is demotivating: Can one desire too much of a good thing?** Journal of Personality and Social Psychology 76: 995-1006.

Active and/or passive

Fund options offered to DC members can be managed actively or passively although active management can be more appropriate for some asset classes than for others. For some asset classes, for example property, active management may be the only option.

Some trustees of DC schemes will only offer passive funds, however some may offer a mixture of active and passive or active only.

You will find more information on this topic in the tutorial **Active and passive management** in the module **An introduction to investment**.

Ethical and religious investments

Ethical funds come in a variety of forms. Some integrate the consideration of Environmental, Social and Governance (or ESG) issues into the investment process, while others simply screen (either positively or negatively) a given investment universe (eg the UK equity market) against certain ethical factors, such as whether the firm is involved in the tobacco or defence industry.

It is becoming more common to offer ethical or religious fund options to DC scheme members, for example, Sharia-compliant funds. These funds invest in accordance with Islamic law and exclude investments that conflict with Muslim values, for example in companies involved in producing alcohol or pork-related products; or financial services that operate on interest payments.

You will find more information on this topic in the tutorial **Types of assets: Common assets** in the module **An introduction to investment**.

Trustees should consider if there is likely to be demand from members for these types of funds. It is important to note that where funds have a restricted investment policy, this can sometimes result in performance which differs from the wider market indices.

With-profits

Very few DC schemes now offer with-profits investments to their members although many schemes may have legacy investments.

You will find more information on this topic in the tutorial **Types of assets: Alternative assets** in the module **An introduction to investment**.

How are specific options chosen?

Some schemes will determine their overall investment approach for members who set their own strategy and will then choose the options which best meet their investment objectives.

For example, trustees may decide to offer a diversified growth fund before they identify a specific fund managed by a specific investment manager. They may consider a number of diversified growth fund investment managers before selecting a specific one to offer to members.

What is white labelling?

White labelling is the practice of assigning a simple name to a fund so that the name describes the funds objective and is not associated with a particular investment manager. For instance, rather than, say, refer to the 'XYZ Investment Management Dynamic Multi Asset Fund', it could instead simply be called the 'Medium risk growth fund'.

The benefit of this is that, should a particular investment manager need to be replaced in the future, this can usually be done behind the white label 'screen'. The change might be communicated to members, but there is typically no need to delay the change until member consent is obtained. This allows for faster implementation, means that members are not left in funds no longer deemed appropriate and avoids the proliferation of funds due to 'legacy' issues. It can also be much simpler for the members to understand what this fund is. Some providers will charge an additional cost for white labelling funds.

Trustees should be aware that white labelling can result in a fund falling within the definition of a default arrangement and becoming subject to certain rules. Trustees should seek advice on this point if they are considering the use of white labelling.

You will find more information on this topic in the tutorial **Default investment options.**

What impact do high costs have?

Trustees will typically offer a range of passive funds which have lower costs and charges to members. Some schemes will also offer active funds with higher associated costs and charges. Trustees can offer higher cost investment options when it is believed they provide value for money. Value for money arises when the benefits provided (ie excess investment return) outweighs the costs to the members.

If the costs and charges deducted from members' pots or contributions are higher than you would expect given the benefits including the quality and scope of services provided to members then the scheme may not be providing good value for members. 'Good value' does not necessarily mean low cost. Trustees should be able to understand how higher cost services can add value for members.

You will find more information on this topic in the tutorial **Charges**; and the tutorial **Value for members and charges** in the module **How a DC scheme works (2014).**

Are a DC scheme's investments secure?

Trustees must give due consideration to asset protection and understand what would happen in the event of a problem. In this context, trustees should consider what recourse, if any, they have in the event of fraud or the failure of a provider, for example a custodian or manager.

It is rare for DC schemes to invest in non-regulated markets, but less rare to invest in regulated markets outside the UK, which may benefit from similar protections to the UK.

Although compensation arrangements on failure are as important, it is even more of a priority to prevent a failure in the first instance. For example, trustees should consider asking questions on asset protection when tenders for new investments are issued, and seek contractual commitments from the provider to keep that information up to date. A further line of protection for members can be provided by the depository/custodian arrangement.

Protecting assets

We will now look at available protections in more detail.

Depository/custodian arrangement

Investment managers typically appoint a depositary who is responsible for the safekeeping of the assets. The depositary will normally appoint a custodian to act on their behalf. One of the custodian's primary functions is the safekeeping of securities and cash in deposit accounts, held in the name of the depositary. This has the effect of segregating the funds from the investment manager's own monies and seeks to protect the member's investments should the investment manager become insolvent.

The treatment of an investment in the event of an investment manager defaulting is a complex legal area, depending on the nature of investment vehicle (for example 'life policy wrapped') and which is largely untested in practice. For further clarification, you should seek legal advice.

The Financial Conduct Authority (FCA)

The FCA regulates UK financial firms providing services to consumers and aims to maintain the integrity of the UK's financial markets. The FCA has significant powers, including the power to regulate conduct related to the marketing of financial products. It is able to specify minimum standards and to place requirements on products. One of its roles is to set the regulations for the Financial Services Compensation Scheme (FSCS).

The Financial Services Compensation Scheme (FSCS)

The FSCS is an independent body, established under the Financial Services and Markets Act 2000 as the UK's statutory fund of last resort for customers of financial services firms authorised by the FCA. The FSCS can pay compensation if a firm is unable, or likely to be unable, to pay claims against it. However, it should be noted that there are no definitive criteria for establishing the extent to which an occupational pension scheme is covered – the FSCS confirms coverage on a case by case basis.

Understanding the protection offered

It is important for trustees to understand the level of financial protection their investments hold and the level of compensation members can expect in the event of fraud or the failure of a provider. This will help them to determine the level of risk that the scheme and members are exposed to. Trustees are expected to communicate their overall conclusion on the level of risk, and any planned actions, to members. The availability of protection through investment contracts and, as a last resort FSCS cover, will depend on the structure of the DC scheme and the investment arrangements in place, shown below.

Investing directly with an investment manager

Firstly, to guard against an investment manager acting dishonestly, fraudulently or negligently, financial organisations operate a range of internal checks and balances such as independent internal audits, compliance and risk functions. These will typically involve senior management personnel. There is also external oversight of managers through the operation of the FCA's Conduct of Investment Business Code and visits from the FCA.

A second line of protection for members is provided by the depository/custodian arrangement.

Thirdly, should there be insufficient assets in the investment manager's 'life policy wrapped' funds to meet members' fund value claims (for example if misappropriation of assets taken place), members could potentially be eligible for compensation by the FSCS.

The FSCS may pay compensation if a firm is unable, or likely to be unable, to pay claims against it.

Investing via a platform provider

In general, where a platform provider offers access to an external fund, it is the platform provider which buys and holds the investment in the platform name.

There can be advantages to the investment platform approach, the primary one being that the provider is likely to secure better terms than the trustees. However, trustees should consider the extent to which FSCS compensation may be available via a platform and if not, what other alternative protections exist. FSCS protection available via a platform is likely to differ compared to a direct investment with an investment manager.

Other forms of financial protection

Trustees should consider the extent to which (if any) compensation arrangements and other methods of recourse are available to them if an investment provider/manager defaults and scheme assets are lost or dissipated (other than through exposure to market risk in accordance with set investment mandates). If you are in any doubt, your scheme advisers should be able to help you.

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Exercise: check your scheme

- What form do you hold your investments in? For example do you have direct holdings in life policies? If not, what is the structure of your holding?
- Have you looked at the issues of FSCS protection for your scheme funds and how it might apply? What advice have you taken from your scheme advisers on this issue?
- If you think that FSCS protection may not apply, have you looked at other forms of security for members?

You have now reached the end of this tutorial. The next one in the series is Charges.