The Trustee toolkit downloadable

Investment in a DB scheme

Scenario three

In this scenario you will meet a final time as the investment sub-committee to review the stochastic models Lesley has produced looking at alternative investment strategies before preparing a report and recommendations to take to the full trustee board.

As you work through this scenario you will be tested on your knowledge at decision points. Here you will have the option to work through a related technical tutorial before returning to the scenario or you can skip the tutorial. You can always work through the tutorial separately later if you would prefer. This scenario includes two tutorials:

- Changing the asset allocation strategy
- Reviewing the investment strategy

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

Lesley attends the investment sub-committee meeting

Lesley is back to present the stochastic models produced since the last meeting and her recommendations for changing the investment strategy.

Lesley says: "You'll remember that last time we looked at particular scenarios for your current investment strategy and found that you are carrying quite a bit of interest rate risk, as our liabilities have a long duration and the bonds the scheme holds don't cover all the liabilities and have a shorter duration. You are also very reliant on strong equity market performance on your growth asset portfolio, which isn't as diversified as it could be.

So we've run stochastic models on a number of different changes to your investment strategy. We are recommending that you switch some of your equities in to a diversified growth strategy and that you also look to match your liabilities more closely by switching some of your existing bonds into a liability driven investment (LDI) portfolio.

The stochastic models show that with the recommended changes, your investment strategy would still be consistent with your employer covenant and funding strategy. In the worst case outcomes, the funding level is better following the changes."

Decision point: Changing the asset allocation strategy

The trustees discuss the possible impacts to the scheme of making these changes. Which two of the statements made by the trustees are true?

Charlotte: "Switching from equities to diversified growth may reduce investment risk but we might also lose some potential for growth."

Brian: "Switching from equities to bonds would be simpler and reduce both risks without impacting the expected return."

John: "If we switch to diversified growth from equities we will need to speak to Robert about whether it impacts our assumptions for discount rate."

Answers at the back

Need help with this question? Read the **Tutorial 'Changing the asset allocation strategy'**

Next steps for the sub-committee

The trustees consider Lesley's proposals. John says: "We know that Lesley has worked through this process with Robert but we need to talk to him ourselves about whether these changes would impact the discount rate before making any recommendations to the board."

Charlotte replies: "I'm still concerned about buying an LDI portfolio now whilst interest rates are falling but I know that switching from equities to bonds is not a good option for us, the models Lesley produced showed that quite clearly. Brian, what's your view?"

Brian comments: "In many instances, trustees have wanted to wait until interest rates were higher before investing in an LDI portfolio. Whilst they are low it could have an impact on the contribution rate which you know the employer would struggle to increase just yet. I know that you've talked about LDI from time-to-time but have never felt it's the right time. The scheme was feeling some pain already and now rates are falling further – how much more pain can it withstand with the covenant strength where it is?"

George says: "I think Lesley's report says that it is recommended to start talking to some LDI managers now and perhaps put the infrastructure in place so that when you are ready you can move quickly."

John says: "Okay, I'm comfortable with those as actions, are the rest of you? Good, so the next stage is to talk to Robert and we must take a report back to the full board with these recommendations and next steps as the whole board is responsible for making the decision."

The full trustee board meets

Six weeks have gone by and the investment sub-committee have tabled an agenda item to talk about the outcomes and recommendations for the investment strategy. Charlotte begins: "I'd like to extend the board's thanks to the investment sub-committee members for their work in creating this highly detailed report for us."

John says: "Of course that included yourself Charlotte, and Brian who you've all met before. I have one addition to make since we had to submit papers for today's meeting. I met with Robert earlier this week to talk about the impact to the discount rate assumptions for these changes. He's now confirmed in writing that although the changes will reduce the best estimate for the return on the scheme's assets, as it's not material at this point he's comfortable that the discount rate assumptions can remain unchanged at this time. He will want to review this at the next valuation though."

Alicia says: "I can see from the report that there are some potential drawbacks to switching to an LDI portfolio now – although it would reduce the fall in funding level if interest rates fell, it would also dampen the increase in funding level if interest rates rose. I'd like to know a bit more about how we can mitigate that before we sign up."

Adrian asks: "Do we need to get Edmund's permission to make these changes as the employer?"

Rodney says: "Yes Adrian, I think that would be important, even if we don't need to. Any changes we make here might have a negative impact on those 'green shoots' of recovery the business is seeing."

Decision point: Next steps

The trustees discuss the next steps in more depth. Which three statements are true?

Charlotte: "If we are changing the statement of investment principles (SIP) we will need to consult with the employer, but we don't need his agreement."

Alicia: "We could structure the LDI portfolio to have slightly more gilts to mitigate the dampening effect."

John: "We should set up a risk dashboard so we can monitor the various risks in the strategy and take actions quickly to speak to Robert or Edmund if needed."

Adrian: "If we're not ready to switch to an LDI portfolio at this point, we should set a trigger for when bond yields reach a certain point so that we can act at the right time."

Answers at the back

Need help with this question? Read the **Tutorial 'Reviewing the investment strategy'**

The meeting ends

After a lot of discussion and thoroughly reviewing the report from both the investment consultant and the investment sub-committee, the trustees agree to go ahead with the proposals but set up a trigger for when it is right to make the initial investment in the LDI portfolio.

In the meantime they start to meet with LDI managers to talk about their requirements and to set up the infrastructure needed so they can act when they are ready.

They also talk to diversified growth managers to look at investing in a fund as they do not have the time or expertise to manage a diversified portfolio of growth investments themselves with this size of scheme.

Charlotte and John meet with Edmund to talk about the proposed changes to the SIP and how they might affect the employer if any of the risks materialise. Edmund is comfortable with the changes.

Rounding up

no summary text

Now that you have completed this scenario we would recommend that you begin to work through the 'Check your scheme' worksheet for this module.

Answers

Decision point: Changing the asset allocation strategy

Both Charlotte and John are correct.

A diversified growth strategy is, by its nature, more diversified than equities and so both the potential upside (reward) and downside (risk) are smoothed.

Because of this lower potential for growth, the trustees would be wise to speak to their actuary about the discount rate assumptions as this may change the way the assets and liabilities have been valued.

Brian is incorrect. Switching some equities for bonds would increase the matching of the scheme's assets and liabilities, and would also reduce the scheme's equity market risks. However, it would reduce the expected return, since bonds are expected to return less than equities.

Decision point: Next steps

Charlotte, John and Adrian are correct.

The trustees do need to consult with the employer if they are changing the SIP principles but they do not need his agreement to the changes.

John and Adrian are essentially talking about the same thing, a risk register and triggers for action. The trustees should monitor these and have actions agreed in advance for when triggers are reached such as talking to Robert about the discount rate, or switching assets to the LDI portfolio.

Alicia has the right idea but has chosen the wrong type of asset to mitigate the dampening effect. Structuring the LDI portfolio with more exposure to corporate bonds would work as they have a greater potential for reward than gilts.