Information for trustees

A quick guide to

defined benefit investment

About this guide

An overview of what to consider when you look at the investment strategy and governance for a pension scheme offering defined benefits.

Investment governance

As a trustee, you're responsible for your scheme's investment governance arrangements, including determining its investment strategy. The law requires you to ensure you're familiar with the basic legal principles of pension scheme investment, as well as the investment provisions of your scheme's governing documents.

We encourage you to work collaboratively with the scheme's employer and anticipate that better outcomes will generally be achieved if trustees and employers work together to develop an understanding of the investment and risk issues.

We expect you to have suitably documented investment governance arrangements that are appropriate for your scheme's circumstances, including their level of complexity. They should enable effective and timely decision-making, focused on those decisions most likely to make a difference. If you think the trustee board does not have the skills and expertise necessary to do this, you need to increase your skills and expertise, delegate, or simplify the investment arrangements, documenting your reasons why.

A good investment governance framework is likely to involve the full trustee board taking the highest level strategic decisions and, where appropriate, delegating their implementation and execution to sub-committees or third parties such as advisers and investment managers, including fiduciary managers.

The framework will involve advice from your investment adviser(s) and may include input from other professionals such as your investment manager(s). You should consider carefully what advice and other input you need in order to govern the scheme's investments effectively. Obtaining the minimum level of advice necessary for legal compliance may not meet this aim. You need to critically evaluate the main points of advice and understand the key underlying assumptions, so you can satisfy yourself that the scheme's strategy and management is in line with the best interests of the scheme's beneficiaries.

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You should be aware of any conflicts of interest (eg agency issues) that you, your advisers or your delegates may have regarding the scheme's investment arrangements. You should ensure that appropriate measures are in place to mitigate and manage those conflicts.

You should also put in place effective oversight arrangements for your delegates. These include agreements that define what is expected of them, how they will be remunerated and how their performance will be monitored against those expectations. You need to monitor your own effectiveness as a trustee board and the effectiveness of sub-committees undertaking investment governance activities.

Governance of your investments also includes stewardship activities. For many pension schemes, these activities are delegated to the investment manager. Where you have not developed and implemented your own policies, we encourage you to be familiar with your managers' policies and, where appropriate, seek to influence them.

Setting your investment strategy

Your investment strategy, setting out how the assets are to be invested, is one of the most important drivers of your scheme's ability to meet the fundamental objective of paying the promised benefits as they fall due.

You need to take an appropriate amount of investment risk to seek the return needed to meet this fundamental objective, to understand the overall level of investment risk in your scheme and to manage that risk effectively. This means taking enough risk to meet this objective, but not more risk than is necessary. It also means having realistic contingency plans in place in case the risk-taking does not pay off.

You may find it helpful to develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. Investment beliefs, supported by research and experience, can help focus your investment decision-making and make it more effective. If you do this, your investment strategy should then reflect those beliefs.

Most investments in pension schemes are exposed to long-term financial risks, which may include risks around long-term sustainability. These can relate to factors such as climate change, responsible business practices and corporate governance. We expect you to assess the financial materiality of these factors and to allow for them accordingly in the development and implementation of your investment strategy.

It's important to set clear investment objectives for your scheme and to identify how and when they should be achieved. You may wish to set multiple objectives over different time periods. Your investment strategy should support and be consistent with your objectives.

Your scheme's investment strategy should be set in the context of your integrated risk management (IRM) framework.

The overall level of investment risk taken to meet your objectives should be consistent with your risk appetite. Your risk appetite should be set having considered the employer's views and the upper limit set by your scheme's risk capacity. The risk capacity should be informed by the strength of the employer covenant.

Setting your investment objectives and investment strategy is likely to be an iterative process, with adjustments being made to your risk appetite and/or investment objectives until an investment strategy can be found that satisfies both.

As well as understanding the overall level of investment risk, you should seek to understand the relative size of different types of investment risk in your scheme. This will enable you, in conjunction with your investment adviser, to develop an investment strategy that balances the different risks faced by your scheme appropriately. The type and depth of this analysis should be proportionate to the complexity of the risks concerned.

You should seek to understand how the value placed on the scheme's liabilities will vary as market conditions change, which depends on how the valuation assumptions have been derived. How the assumptions relate to the investments held by the scheme, both now and as the investments change, will significantly influence the volatility of the scheme's reported funding level.

We'd encourage you to consider the long-term evolution of your scheme when setting your investment strategy to help you plan for future changes, eg as the funding level improves or the scheme matures. Long-term journey plans are likely to work best when clear end goals are set, progress towards them is monitored and remedial action taken on the way if necessary.

To summarise, a good investment strategy is likely to:

- involve effective governance, delegation and monitoring
- form part of an IRM process
- be consistent with the scheme's objectives and any long-term journey plans
- have an overall amount of risk consistent with your risk appetite
- involve risk-taking that is understood and balanced, and
- allow for the scheme's future cash flow and liquidity requirements

Your investment portfolio is likely to include matching assets to offset liability risks. You need to understand how they are intended to do this, eg by reducing volatility in the funding level or matching scheme cash flows, and the particular risks they may introduce, such as leverage.

You need to understand the cash flow requirements and liquidity needs of your scheme, especially as the liability profile matures, and to take these into account when setting your investment strategy. You should pay particular attention to when your scheme is expected (if at all) to become cash flow negative.

Using investment models to analyse investment options can help you compare the risk and rewards of different strategies and the likelihood of achieving scheme objectives. When doing this, you need to understand the key modelling assumptions as they can materially change model output.

You need to be aware of the need for diversification when choosing investments for your scheme. Diversifying your scheme's assets across genuinely different underlying risk factors should provide greater stability of investment returns and reduce risk. You should also consider how diversified your scheme's assets are from the scheme's employer. Even pension schemes with well-diversified investment strategies may experience periods where diversification offers little protection. You may therefore wish to consider other types of risk mitigation techniques, eg reducing your scheme's exposure to significant market falls by using suitable tail risk hedging or other derivative strategies.

Implementing the investment strategy

As well as setting the investment strategy for your scheme, it's important to consider how that strategy is to be implemented. This includes consideration of operational risks, security of scheme assets, asset transitions and liquidity and collateral management.

We expect you to understand, and mitigate where appropriate, the principal risks associated with implementing your scheme's investment arrangements.

Identifying, understanding and mitigating implementation risks can be complex. We recommend you take a prioritised approach proportionate to the risks concerned. This may, for example, include undertaking due diligence prior to appointing third party providers, and refreshing it periodically thereafter.

You should pay particular attention to the risks involved in investment transitions such as those that arise from changes in investment strategy or changes of investment manager.

You need to make sure you understand your scheme's exposure, if any, to collateral movements and develop and maintain a collateral management plan which allows for the cash flow requirements of your scheme and reflects the liquidity profile of your scheme's investments.

You should also consider seeking appropriate protections to mitigate operational and security risks in your legal contracts with third parties such as your advisers, investment managers (including fiduciary managers) and custodians.

Monitoring investments

Monitoring is an essential part of your investment governance. It should be prioritised, timely, and lead to actions.

You should focus on, and monitor most frequently, those factors that will make the most difference to meeting the scheme's objectives. Typically, we would expect these to be the investment strategy and related market risk factors.

You may find it helpful to put together an investment monitoring dashboard, ie a one or two page overview of key monitoring statistics. A well-designed dashboard should enable you to quickly understand the up-to-date financial position of your scheme and progression against objectives, and should highlight key potential risks and developing issues. Furthermore, the dashboard should empower action by helping you make effective decisions in response to the information shown.

As part of your monitoring, we expect you to understand the costs involved with the management of your scheme assets, with a view to ensuring that these represent good value.