PENSION SCHEME
INVESTMENT POLICIES

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A report of research carried out by the
Department of Applied Economics on
behalf of the Department of Social Security
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Our thanks go to the staff of the Department of Social Security particularly Richenda Ward and Andrea Garman who managed the study. Dr Richard Butler of the Judge Institute of Management Studies helped us with the interviews and commented on the draft report. At the Department of Applied Economics, Anne Mason and Suzanne Fletcher provided excellent secretarial support for the study and Diana Day and Ann Newton suggested improvements to the draft report.
This study examined trustees' decisions about pension scheme investment prior to the implementation of the reforms introduced by the Pensions Act 1995. The Department of Applied Economics (DAE) was commissioned by the Department of Social Security (DSS) in September 1996 to conduct the research.

The three aims of the research were to:

- examine how the trustees responsible for pension scheme investment reach their decisions, the reasons why they make particular decisions concerning investments, and what do they take into account and why;
- explore trustees' relationships with the other parties involved - the sponsoring employer, pension fund managers, advisers and consultants (internal or external) - who do trustees consult, when do they consult, and why;
- investigate whether trustees' investment decisions had changed, or whether trustees think they will change in future, and if so, why and in what ways. Conversely, if trustees do not plan to make any changes, either now or in the future, the research should obtain their reasons for this view.

The study involved in-depth interviews with 48 trustees of pension schemes. The sample included a range of pension schemes, 42 defined benefit schemes and six defined contribution schemes. Of the defined benefit schemes, 22 were less mature, 17 were mature and three were frozen schemes. The size of the schemes measured by the total value of their assets ranged from less than £2m to more than £1bn, and the sponsoring employers for the sample schemes operated in a wide range of manufacturing and service sector industries. The interviews were carried out between the beginning of November 1996 and the end of February 1997.

Most of schemes included in the study were soundly financed with a surplus of assets over estimated liabilities. Generally, the surpluses of assets over liabilities indicated by the Minimum Funding Requirement (MFR) calculations were greater than those based on actuarial calculations.

The investment background to the enquiry was that the actual returns on investments obtained by most pension schemes have exceeded prior actuarial expectations over the period since 1980 because of the buoyant performance of equities in nominal and, more important, in real terms.

1 The maturity of schemes reflects the balance between the contributions paid in for active members and the payments of pensions to pensioner members. In brief, the higher the proportion of pensioner members in the total membership the greater the maturity of a scheme. Schemes were defined as 'less mature' if the number of active members exceeded the number of pensioner and deferred members with each deferred member given an imputed weight of 0.2 and each pensioner a weight of one. Schemes were defined as 'mature' if the number of active members was less than the number of pensioner and deferred members.
The objectives of the investment policies of trustees were to:

- achieve a good return on the assets of the schemes to provide attractive pensions and to limit the costs of the schemes to the sponsoring employers;
- avoid risking a significant reduction in the value of schemes’ assets and income.

Trustees reported that they seek to resolve the conflicting objectives of achieving a high return and putting assets at risk by:

- appointing expert advisers;
- appointing fund managers with a reputation for, and record of, successful investment and then monitoring their performance;
- adopting what they perceive as cautious investment policies;
- limiting and constraining the investment policies of the fund managers and providing them with guidelines and benchmarks to ensure the assets of the schemes are invested in a range of different classes of assets and that investments in equities are distributed over a wide range of companies.

Generally, the largest schemes with assets of £100m or more had investment sub-committees of the boards of trustees. The extent to which decision taking was delegated to these sub-committees varied, but, where they existed, most investment sub-committees had a good deal of delegated authority for deciding investment policy. The trustees of smaller schemes with less than £20m of assets tended to function without formal investment sub-committees.

The trustees reported that they had been able to reach consensus on matters relating to investment strategy by discussion and that there had been few sources of major conflicts or disagreements between trustees.

There were two main elements of investment decision making by trustees:

- the appointment of advisers and the fund managers; and
- deciding the allocation of assets between asset classes.

Generally, trustees were not involved in stock selection, which was left to fund managers.

All of the sample schemes had access to actuarial advice, either from firms of consulting actuaries or from firms of administrators. Generally, the advisers to the trustees were appointed by the trustees. At some larger schemes with assets of £20m or more, the actuaries who provided investment advice attended all the meetings of trustees at which investment matters were considered. The advice of actuaries was important for informing trustees whether their policies conformed to laws, rules and the practice of other pension schemes. The valuations and papers from actuaries, administrators and other advisers were important sources of information for trustees considering investment policy.
The majority of the schemes had appointed external fund managers. The minority of schemes used internal fund managers. Fund managers were usually appointed after a 'beauty parade' at which presentations were made to trustees or a sub-committee of trustees. Final decisions on the appointment of fund managers were usually taken by the boards of trustees of schemes. There was a considerable turnover of fund managers, half of the defined benefit schemes had appointed or changed managers within the past five years.

Trustees of most of the largest schemes with assets of £100m or more set strategic benchmarks for asset allocation and bands around these benchmarks within which fund managers could vary asset allocation. The reports received from fund managers were the principal focus of discussions at most trustee board meetings concerned with investments. Fund managers attended meetings of trustees at least once a year.

Most of the larger schemes with assets of £20m or more set targets for their fund managers, usually these targets were related to the Combined Actuarial Performance Services (CAPS) or World Markets (WM) averages. Typically, the targets were to beat the CAPS or WM median by one per cent a year over rolling three year periods and not to fall below the median by more than two per cent in any 12 month period. Apart from setting a performance target for fund managers, the targets signalled to the fund managers the degree of risk they should take. The implication was that the higher the target, the greater was the expected divergence from the average asset allocation by pension funds. A majority of the smaller schemes with assets of less than £20m did not set targets for their fund managers. The main explanation for the smaller schemes not setting targets was that they used pooled funds.

Trustees reported that the principal channel through which the sponsoring employers were involved in, or influenced, the policies of pension schemes, was the inclusion of directors of the sponsoring employers on the boards of trustees. Trustees reported that conflicts of interest between trustees and sponsoring employers concerning investment policies had not occurred.

The main features of the actual allocation of assets between asset classes by the sample of defined benefit schemes were:

- uniformly high allocation to equities;
- the holding of a diversity of assets;
- large variations between schemes in the holdings of each of the classes of assets, apart from equities, as percentages of total assets.

Pension schemes, on average, invested about 70 per cent of their equity portfolios in UK equities and 30 per cent in the shares of companies based overseas. The principal explanation for this allocation, given by trustees, was the possible effects of a currency mismatch with investment overseas and liabilities for pensions set in sterling if sterling appreciated. There was a sharp divergence of policy on investment in property. The majority of the largest schemes with assets of £100m or more invested in property. A significant minority of the largest schemes and most of the smaller schemes with assets
of less than £20m did not invest in property. There was a general movement to reduce the proportion of assets allocated to property.

The five main influences on asset allocation which were identified by trustees were:

- that equities have provided the highest investment returns in the past and were expected to do so in the future. This was the main influence explaining the dominant position of equities in the portfolios of pension funds;
- the allocation of assets by other schemes as evidenced by the averages published by CAPS and WM. Most schemes had not strayed very far from the average allocation;
- the financial state of schemes. The existence of widespread and substantial surpluses permitted greater freedom to allocate funds to the class of assets expected to provide the highest returns and traditionally perceived to be the asset class exposed to most risk, equities;
- the maturity of schemes. Less mature schemes could take a longer term perspective and hold a higher proportion of their assets in equities, other things being equal. However, maturity was not a dominating consideration because for many schemes their surpluses removed most constraints, apart from those dictated by prudence, on investment allocation;
- the decisions of fund managers who determine asset allocation usually within ranges set by trustees.

Pooled investment funds were used by many, but not all, of the smaller schemes with assets of less than £20m. The larger schemes with assets of £20m or more made some use of specialised pooled funds for certain types of investments including venture capital and investment in emerging markets. A significant minority of the sample of defined benefit schemes used tracker funds.

Whether a scheme was contracted out of SERPS (State Earnings Related Pension Scheme), or not, was not a factor which trustees consciously considered when deciding the investment policies of schemes.

Most trustees did not obtain risk statistics\(^2\). Nevertheless, trustees showed that they were aware of risks and took steps to limit their exposure to risks. They limited investment in any one company to three or five per cent of the equity portfolio and they limited the use of derivatives; many schemes, particularly the smaller schemes with assets of less than £20m made no use of derivatives. We were told by trustees that the schemes did not use derivatives to gear up their investments, that is, to increase schemes’ investments in risky assets by, in effect, borrowing money to buy more risky assets.

Investments in emerging markets, venture capital and the business of the sponsoring employer were very limited. When asked about the effects of a crash or collapse of equity prices, the response of most trustees was that: ‘. . . if markets fall they will recover’, as they always have in the past.

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\(^2\) Risk statistics summarise the probability distribution of the possible performance of funds and are based on analyses of the historical financial performance of assets.
Changes to investment strategies

The two most common changes to investment strategies made by trustees during the past five years were to change, or appoint additional, fund managers and to reduce investment in property. Most trustees did not expect to make any major changes to their investment strategy over the next three years. The main reason given by trustees for not expecting to make any major changes was that they were satisfied with the current arrangement and performance of their schemes.

Informing members

The principal channel of communication for informing members about the performance of larger pension schemes with assets of £20m or more was a newsletter usually distributed once a year. Newsletters were distributed to active members and to pensioners but many schemes did not distribute them to deferred members, often because they did not have the up-to-date addresses for many of these members.

Smaller schemes with assets of less than £20m tended to circulate copies of the annual report and accounts to members. Employee trustees of smaller schemes were another channel for informing members about matters concerning the pension schemes.
1 INTRODUCTION

1.1 The aims of the study

In September 1996 the Department of Applied Economics (DAE) was commissioned by the Department of Social Security (DSS) to carry out a study of trustees' decisions about pension scheme investment prior to the implementation of the reforms introduced by the Pensions Act 1995.

The three aims of the research were to:

• examine how the trustees responsible for pension scheme investment reach their decisions, the reasons why they make particular decisions concerning investments, and what do they take into account and why;

• explore trustees' relationships with the other parties involved - the sponsoring employer, pension fund managers, advisers and consultants (internal or external) - who do trustees consult, when do they consult, and why;

• investigate whether trustees' investment decisions had changed, or whether trustees think they will change in future, and if so, why and in what ways. Conversely, if trustees do not plan to make any changes, either now or in the future, the research should obtain their reasons for this view.

1.2 The Pensions Act 1995

The Pensions Act 1995 sets out certain requirements concerning investment which could result in trustees altering their investment decisions to bring them in line with these requirements. The Pensions Act was designed to place responsibility for decision making and running pension schemes firmly with the trustees. The three key requirements for fund management and investment which trustees must comply with are described below.

1.2.1 The minimum funding requirement (MFR)

The MFR applies to most private sector defined benefit schemes. Trustees must ensure that contributions due to the scheme are adequate to meet a minimum funding level so that the scheme is funded to meet its liabilities at all times. The MFR is designed to take effect from schemes' first valuation on or after 6 April 1997, although there will be a transitional period of five years from April 1997 before it takes full effect. Schemes are expected to have a full 100 per cent funding level by 2007. The aim of the MFR is to ensure that defined benefit schemes are backed by funds to provide security for the pension promises which the employers have made (to pay pensions based on length of service and salary).

Trustees must ensure an MFR valuation is carried out by the scheme actuary at least once every three years. To meet the MFR, trustees must maintain a schedule of contributions which show the rates of contribution to be paid by the sponsoring employer and scheme members and the dates by which these contributions are to be received over the next five years. The schedule must be certified annually by the actuary to confirm that the contribution rates will:
keep the funding at least at the level of the MFR over the period covered by the schedule; or

- if the scheme is below the MFR at the valuation, reach the MFR by the end of the period covered by the schedule. If the valuation shows the funding level to be below 90 per cent, special rules will apply. Usually the employer will be required to restore the funding level to 90 per cent within 12 months as well as agreeing sufficient contribution rates to achieve the 100 per cent level within five years.

1.2.2 The statement of investment principles

Trustees of both defined benefit and defined contribution schemes must explain in a written statement the principles which govern their investment decisions. In preparing or revising the statement, trustees must obtain and consider the written advice of a suitably qualified investment adviser. They must also consult the sponsoring employer. They must publicise the existence of the statement of investment principles and provide a copy to scheme members who wish to see it.

1.2.3 Self investment

The Pensions Act has removed restrictions on what assets trustees can invest their pension fund resources in; however, it has tightened up the restrictions on, and introduced penalties for investing in, the sponsoring employer's business. The requirement that trustees must not invest more than five per cent of a scheme's assets in the business of the sponsoring employer or any connected companies came into effect in March 1992 and is not a provision of the Pensions Act.

1.3 Methodology

The study involved interviews with trustees of 48 self-administered occupational pension schemes. In order to understand the strategy used by trustees for pension fund investment and to find out how they made decisions about investment, qualitative research was used to explore these complex processes.

Prior to the interviews with trustees, we carried out seven developmental interviews with managers of three investment organisations which manage pension funds, three firms of actuaries and the National Association of Pension Funds (NAPF). The purpose of the development interviews was to obtain the views of knowledgeable people about the investment policies of pension funds to help with the design of the topic guide which was used for the interviews with trustees and which is copied as Appendix II of the report.

The sample of pension schemes for the research was selected to ensure that a range of views were represented and was obtained from two sources. Most of the sample schemes with assets of more than £20 million were drawn from the publication: 'Pension Funds and their Advisers' (Philipp, 1996) Sample schemes with assets of less than £20 million were drawn from a list of schemes provided by the DSS from the Pension Scheme Registry. The Registry was established as a tracing service for people who have lost touch with their pension schemes. It contains details of all tax approved occupational pension schemes with two or more members.

3 The relevant legislation was in the Occupational Pension Schemes (Investment of Scheme Resources) Regulation, 1992.
A letter was sent by the Social Research Branch of the Department of Social Security to the administrators of all the schemes selected, explaining the nature of the research and requesting that the schemes take part in the study, but offering them the chance to opt out of the research. The administrators of the schemes which did not opt out were contacted, by telephone, by the Department of Applied Economics and were asked to answer a brief questionnaire. A copy of this questionnaire is included as Appendix I of this report. The information requested included the value of the assets and liabilities of schemes, the rates of contributions from employers and employees to the schemes, the numbers of members, the types of schemes, the categories of employees who could join the schemes and some details about the trustees of the schemes. If the characteristics of a scheme brought it within one of the sample size/maturity/type of scheme categories for which interviews were required, arrangements for an interview were discussed with the administrator.

1.3.1 Sample composition

Type of scheme

All of the schemes included in the sample were self-administered schemes; insured schemes were excluded, as, in these types of schemes, investment decisions are made by fund managers within the insurance company. The composition of the sample of schemes for which interviews were arranged is summarised in Tables 1.1 and 1.2. The interviews were concentrated on defined benefit schemes as most self-administered schemes are defined benefit schemes. However, six self-administered defined contribution schemes were included in the sample so that comparisons could be made between defined benefit and defined contribution schemes.

Maturity

The definition of maturity of defined benefit schemes used for the study was based on the relationship between the numbers in each category of membership - active contributing members, pensioner members and deferred pensioners. The numbers of active, pensioner and deferred members were obtained from the administrators of the schemes. In order to make comparisons to assess the maturity of the schemes, a weighting system was required, because the potential pension liabilities in respect of each deferred member were usually much less than for each pensioner member. Schemes were defined as less mature if the number of active members exceeded the number of pensioner and deferred members, with each active and pensioner member given a weight of one and each deferred member given a weight of 0.2. The weighting for deferred pensioner members was based on the median ratio of the actuarially estimated average liability for deferred pensioners' pensions to the average liability for pensioner members for the 20 deferred benefit schemes for which this information was obtained from the administrators of schemes. 'Mature schemes' were defined as schemes for which the number of active members was less than the number of pensioner members, including the weighted number of deferred pensioners. The method of assessing maturity

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4 Deferred pensioners are employees who have left the employer or the scheme but their pension rights are retained in the scheme.
was relatively crude and there was a wide spread of maturity within the two categories, less mature and mature.  

Trustees were asked whether their schemes were regarded as less mature or mature and how they assessed maturity. For many schemes maturity was clear cut as the schemes had few, or many, pensioners relative to active members. It was, therefore, not surprising that most trustees classified their schemes in the same way as we had classified them. Trustees of two very large schemes with total assets of more than £1bn which we classified as less mature viewed their schemes as mature, although in one case ‘not desperately so’. Two trustees of large schemes with assets of between £100m and £1bn, which we classified as less mature, reported that their schemes were ‘maturing’ and ‘not very mature’. A trustee of a small scheme classified the scheme as mature because it had been in existence a long time and many of the active members were elderly; on our classification the scheme was less mature. The main criteria the trustees used for classifying their schemes were comparisons of numbers of active members and pensioners and comparisons of the valuations of liabilities for active members and for pensioners. The use of cash flow, the excess of contributions and investment income over pension payments was mentioned by several trustees; the implication was that these trustees would view a scheme as mature when its expenditure on pensions exceeded its income.

**Size of scheme**

The sample covered a wide range of schemes of different sizes. Size was measured in terms of the size of the schemes’ assets. The schemes were divided between five bands, according to the size of their assets (see Table 1.2). For convenience, we labelled these bands ‘Very large’ (schemes with £1bn or more of assets), ‘Large’ (schemes with £100m but less than £1bn of assets) and so on. This table shows the distribution of the schemes by type of scheme (defined benefit or defined contribution) and maturity.

Many of the sponsoring employers of very large and large schemes and some of the sponsoring employers of smaller schemes operated more than one scheme. In some cases there was a separate scheme for certain employees, for example, for directors or for staff, or, where a business (or businesses) had been acquired, the pension arrangements for the employees of the acquired business were continued as a separate scheme. (In many cases the pension arrangements of acquired companies were consolidated into the main company scheme.) Several sponsoring employers had closed their defined benefits scheme to new members and new employees could join a defined contribution scheme. In most, but not all, of the cases, where a number of schemes were in operation, the scheme studied was the largest defined benefit scheme.

Eight of the sponsoring employers of the defined benefit schemes and two of the employers of the defined contribution schemes were subsidiaries of companies based overseas.

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5 The problems of assessing maturity accurately can be illustrated for one of the sample schemes which according to our definitions was mature. One division of the company employed predominantly young graduate women, while the other division had contracted, closing warehouses and reducing its labour force, and it had a high turnover of staff. Consequently, pensions for most of the active members would not be payable for many years and 70 per cent of the pensions in payment were for less than £1,000 a year, so the scheme was less mature than our measure indicated.
Table 1.1 Characteristics of the sample schemes

(1) **Type of Scheme**

<table>
<thead>
<tr>
<th></th>
<th>Number of Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Benefit</td>
<td>42</td>
</tr>
<tr>
<td>Defined Contribution</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>48</strong></td>
</tr>
</tbody>
</table>

(2) **Maturity of the Defined Benefit Schemes**

<table>
<thead>
<tr>
<th></th>
<th>Number of Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Mature</td>
<td>22</td>
</tr>
<tr>
<td>Mature (excluding frozen schemes)</td>
<td>17</td>
</tr>
<tr>
<td>Frozen schemes</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>42</strong></td>
</tr>
</tbody>
</table>

(3) **Industrial Classification of the Sample Schemes**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining and Manufacturing</td>
<td>17</td>
</tr>
<tr>
<td>Utilities and Construction</td>
<td>3</td>
</tr>
<tr>
<td>Services of which:</td>
<td></td>
</tr>
<tr>
<td>Retailing</td>
<td>7</td>
</tr>
<tr>
<td>Wholesaling</td>
<td>4</td>
</tr>
<tr>
<td>Financial services</td>
<td>5</td>
</tr>
<tr>
<td>Other sub-sectors</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>48</strong></td>
</tr>
</tbody>
</table>

(4) **Size of Trustee Boards**

<table>
<thead>
<tr>
<th>Number of trustees</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Schemes</td>
<td></td>
</tr>
<tr>
<td>Two</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Three</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Four or five</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td>Six to nine</td>
<td>22</td>
<td>3</td>
</tr>
<tr>
<td>Ten or more</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>42</strong></td>
<td><strong>6</strong></td>
</tr>
</tbody>
</table>

*Industrial sector* Section 3 of Table 1.1 summarises the industrial classification of the sample schemes and shows that the schemes included in the sample were drawn from a wide range of industries.

Generally, the industry in which a sponsoring employer operates does not affect a pension scheme. One exception is the financial sector, where the trustees and many of the members of schemes might be expected to have a greater understanding of pensions and investment.
Table 1.2 Number of interviews by size of scheme assets

<table>
<thead>
<tr>
<th>Size of Scheme</th>
<th>Defined Benefit Schemes</th>
<th>Defined Contribution Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Interviews</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less mature</td>
<td>Mature</td>
</tr>
<tr>
<td>£1bn or more</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Very large schemes</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>£100m to less than £1bn</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>£20m to less than £100m</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>£2m to less than £20m</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>less than £2m</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Totals</td>
<td>22</td>
<td>20</td>
</tr>
</tbody>
</table>

(1) All defined contribution schemes were less mature
(2) Including two frozen schemes
(3) Including one frozen scheme

1.4. Structure of the report

The results of the study are described in six chapters. Chapter 2 provides some background information about trustees and the operation of pension schemes. Chapter 3 describes the roles the trustees, their advisers and fund managers take in determining and managing investment policies. Chapter 4 assesses the influences on the allocation of schemes' assets between classes of assets - equities, fixed interest bonds, etc. The final three chapters describe: the methods adopted by trustees to control risks; the changes to investment strategies made by trustees; and the methods used by trustees to inform members of pension schemes about the conduct and performance of their schemes and about the investment strategies adopted by trustees. Appendix III describes some details, including the size and type, of the schemes included in the sample. The descriptions are necessarily brief to preserve the anonymity of the schemes.

The Glossary, which can be found after Chapter 7, provides definitions of the technical terms used in this report.
1.4.1 Definitions and abbreviations used in this report

The following definitions were used for describing the size of schemes:

**Asset size**

- **Very large**: £1bn or more
- **Large**: £100m to less than £1bn
- **Medium**: £20m to less than £100m
- **Small**: £2m to less than £20m
- **Very small**: Less than £2m

For some purposes it was useful to group size categories together because schemes in two or more size groups have particular characteristics, or to preserve the anonymity of particular schemes. These size categories were defined as follows:

- **Largest**: schemes with assets of £100m or more
- **Larger**: schemes with assets of £20m or more
- **Smaller**: schemes with assets of less than £20m

The term ‘Large/Very large’ has been used for attributing quotations from trustees who were in the two largest size categories, to preserve the anonymity of these trustees.

The following abbreviations have been used in this report to describe schemes when attributing quotations:

- **DB**: Defined benefit scheme
- **DC**: Defined contribution scheme
- **CO**: Contracted out of the State Earnings Related Pension Scheme (SERPS)
- **NCO**: Not contracted out of SERPS
2.1 The trustees

In this section we describe some characteristics of boards of trustees of the sample of pension schemes.

2.1.1 Meetings of trustees

The number of members of the boards of trustees of the schemes is shown in Section 4 of Table 1.1. The number of trustees ranged from two for one small scheme to 24 for one very large scheme and even more for an industry-wide scheme. Most often boards of trustees met quarterly to consider investment matters, but practice varied. The trustees of two very large schemes met each month, while the trustees of one small scheme only met once a year and, until recently, the trustees of a very large scheme met twice a year. Trustees have other matters besides investment policy to deal with, so trustees who meet each month do not necessarily consider investment policy and performance at every meeting, though they have the option to do so. Influences determining the frequency of meetings of the full board of trustees included the degree of delegation to sub-committees and the size of schemes. Trustees of one very large scheme which did not have an investment sub-committee met each month. The difficulty of arranging meetings of trustees who were eminent professional people not in the employment of the sponsoring employer was the explanation for the trustees of the small scheme, referred to earlier in the paragraph, meeting only once a year.

2.1.2 Training for trustees

We asked the trustees who were interviewed: 'What steps, if any, do trustees take to train for their role as trustees, particularly in relation to making investment decisions?' The answers indicated a very widespread use of short courses, particularly by new trustees. The courses were provided by NAPF, firms of consulting actuaries, firms of administrators, firms of solicitors or were provided in-house. It was mainly the larger schemes which provided in house courses, often in addition to external courses. Some schemes had arranged special courses dealing with the changes brought about by the Pensions Act 1995. The Act affects training in two ways: trustees need additional training to obtain knowledge of the provisions of the Act; and the Act identifies a need for training. At most schemes training had been provided for some time; it was not a new innovation in response to the Pensions Act 1995. However, without being able to quantify the change, we obtained an impression from trustees that there had been an increase in the provision of training courses. Two large schemes were exceptional, they had provided little or no training*. A trustee of a medium-sized scheme reported that:

'Training has been a bit spasmodic; part of the new set-up is going to be a more formal training programme'.

(Medium-sized, less mature, DC, CO)

* No new trustees had been appointed at one of these schemes for four years. Special arrangements for training new trustees were made by many schemes.
2.2 The current financial state of schemes

Many trustees provided estimates of the financial state of their schemes which had been made by the schemes' actuaries. The financial state of pension schemes was assessed by comparing their total assets to estimates of their total liabilities; schemes were taken to be soundly financed if they had an excess of assets over liabilities. Comparisons of the financial status of schemes were clouded by variations in the assumptions made by actuaries to value assets and liabilities, the differing dates the valuations were made and the multiplicity of bases for calculating the state of schemes' finances, including the definitions used by actuaries, Inland Revenue guidelines, guidelines used for purposes of preparing financial accounts and the MFR. The assumptions used by actuaries about future returns on equities relative to inflation, the extent of inflation-proofing of pensions and future contributions and contribution holidays seemed to vary in part with the wishes or directions of clients. One trustee commented:

'Two actuaries can sit in a room and [one] determine that a scheme is in surplus and the [other to argue that the] same scheme is in deficit'.

(Very small, frozen, DB, CO).

For most schemes total assets exceeded the estimated total liabilities and the schemes were considered by the trustees to be soundly or very soundly financed. For a minority of schemes included in the sample their assets barely covered the liabilities and two schemes had deficits which were attributed in part to the poor performance of fund managers who no longer managed the assets of the funds.

MFR calculations had been made for three quarters of the defined benefit schemes and, for more than half of these schemes, trustees provided quantitative estimates of assets as a percentage of the liabilities of the schemes. For a majority of the schemes for which estimates were available, the schemes had substantial surpluses, the assets were 130 per cent or more of the liabilities. The MFR calculations often showed a larger surplus than the actuarial calculations of liabilities.7

2.3 Investment background

The investment background to the study, described to us by actuaries in the development interviews and by trustees, was that the actual returns on investments obtained by most pension schemes exceeded prior actuarial expectations over the period since 1980 because of the buoyant performance of equities in nominal and, more important, in real terms. As a trustee of a large scheme put it, the rate of return on equities since 1980 has been 'remarkably good'. The total return over the 10 years to the end of 1995 for the CAPS median pension fund averaged 13.3 per cent a year, compared to the average increase in the retail price index of 4.6 per cent a year and of the earnings index of 6.6 per cent a year. The median return on investments in UK equities by pension funds averaged 15 per cent a year over the 10 year period (CAPS, 1995) Typically, actuaries assume the return on UK equities will exceed the increase in the index of earnings by two per cent a year. As

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7 For one large scheme, while the actuarial estimate showed a bare excess of assets over liabilities, the MFR calculation showed a ratio of assets to liabilities of 1.3 to 1.0. The actuarial calculation was based on an assumption that pensions were fully inflation-proofed, though the scheme was not legally committed to this.
a result of the favourable investment returns, as already noted, most of the pension schemes we studied were soundly or very soundly financed with a surplus of assets over liabilities. However, it is important in assessing the findings of this study to recognise that the interviews were undertaken at a time when the stock market had been remarkably buoyant. It is outside the scope of the report to assess how the findings of such a study would be affected by a sustained fall in stock market prices.

Since 1980 there have been widespread redundancies or downsizing among many large UK and overseas companies and pension fund surpluses have been a factor enabling companies to provide more generous redundancy terms. We were told by actuaries at the development interviews and by trustees that, generally, redundancy schemes and the sale of subsidiaries enhance the per capita surpluses of pension schemes. If a scheme has a surplus, redundancies which crystallise liabilities usually increase the surplus relative to the liabilities in respect of the pensioners and the remaining employees, and when companies sell or hive off subsidiaries, the financial transfers to the new pension schemes, generally, do not include a fully proportionate share of the surplus. However, in at least one case, the sale of part of the business and redundancies had increased the scheme’s deficit. We were not able to quantify the relative contribution of redundancies to pension fund surpluses.

2.4 The objectives of pension scheme investment policies

The future returns on investments are uncertain. Statistical analyses and modelling used to forecast the future movement of asset prices are based on assumptions that some aspects of past experience will be replicated in the future, though the extent to which they will, in the event, be replicated is uncertain. Investment strategies of pension funds have to be formulated to deal with uncertainty.

In brief, the objectives of pension scheme investment policies as described by the trustees were twofold:

- to achieve a good return on the assets of the schemes to provide attractive pensions and to limit the costs of the schemes to the sponsoring employers;
- to avoid risking a significant reduction in the value of schemes’ assets and income.

If the investments perform well, the sponsoring employer and employees may be able to take a full or partial contributions holiday and in some cases the sponsoring employer receives a transfer (refund) of assets from the scheme. If the investments perform badly the sponsoring employer will have to make good any deficit. Information about contributions provided by the administrators of schemes indicated that a contributions holiday could represent a reduction in costs equivalent to as much as 10 per cent of the payroll of a company – a potential source of significant competitive advantage.
There is, of course, a trade off between achieving a high return and putting
assets at risk - the higher the expected return, the greater the expected risk.
Pension scheme investment policies are designed to achieve a balance between
the objectives. Trustees reported that they seek to resolve the conflicting
objectives, to achieve satisfactory returns without taking undue risks, in four
ways, by:

• appointing expert advisers;
• appointing fund managers with a reputation for, and record of, successful
  investment and then monitoring their performance;
• adopting what they perceive as cautious investment policies;
• limiting and constraining the investment policies of the fund managers
  and providing them with guidelines and benchmarks to ensure the assets
  of the schemes are invested in a range of different classes of assets and that
  investments in equities are distributed over a wide range of companies.
3 HOW TRUSTEES DETERMINE AND MANAGE INVESTMENT POLICIES

3.1 Investment decision making by trustees

3.1.1 The expertise of trustees

The financial expertise of the trustees interviewed ranged from those with very little previous experience of investment when they were appointed as trustees to Chartered Accountants with a life time of experience of monitoring and advising on financial decisions. We collected information about the qualifications of the trustees interviewed but not for other members of the boards of trustees. Most of the trustees interviewed had at least one advanced educational or professional qualification, while a minority had no formal qualifications. Accountancy qualifications were the most common. Membership of the Institute of Pensions Management or actuarial qualifications were the next most common forms of qualification. Trustees with other qualifications included MBAs, a solicitor, a barrister, a doctor of science and a chartered secretary. The minority of trustees without formal qualification tended to be 'employee' trustees.

3.1.2 Investment sub-committees

Practice on delegation of investment decision making to an investment sub-committee differed. A significant minority of all schemes had investment sub-committees and these tended to be the largest schemes. The extent to which investment policy making was delegated to the investment sub-committee, where it existed, also varied. The range of the delegation of responsibility is illustrated by two examples. At one extreme, the four trustee members of the investment sub-committee of a very large scheme 'broke ground for the trustees' (had preliminary discussions), while for another very large scheme the investment sub-committee, which in the past had included only two trustees, together with eight employees of the sponsoring employer, 'took the decisions' and the board of trustees had met only twice a year. These arrangements had been changed recently to increase the number of trustees on the investment sub-committee and to increase the number of meetings of trustees to four a year in response to the Pensions Act 1995.

Where they existed, most investment sub-committees had a good deal of delegated authority - the case where the investment sub-committee merely had preliminary discussions was exceptional. A scheme with 12 trustees had an investment sub-committee and both the sub-committee and the board of trustees met quarterly.

'The sub-committee would not take a major decision, for example, appointing or removing a fund manager, without consulting the trustee board, but it had delegated powers to agree the terms of an investment management agreement with a fund manager'.

(Large/Very large, mature, DB, CO)
For some schemes the role of the investment sub-committee was reported by trustees to be decisive. For a large scheme for which the sponsoring employer was a firm of accountants, an investment strategy sub-committee in effect decided the asset allocation which involved all of the assets of the fund being invested in UK and overseas equities. The committee’s proposed asset allocation was put to the trustees for their formal agreement. At another large scheme, trustees’ consideration of investment strategy consisted primarily of taking decisions on the benchmarks for the allocation of assets but, in practice, they were said to ‘rubber stamp’ the proposals put forward by the investment sub-committee to which most matters concerning investment strategy were delegated. The trustees of a large scheme had delegated investment strategy to an ‘investment trustee’ and did not consider investment strategy at all in trustee board meetings. The investment sub-committee of one scheme was separate from the board of trustees and there was limited overlap of membership. This committee had

‘...a powerful say in deciding to initiate a fund manager beauty parade and for determining investment strategy’.

(Large/Very large, mature, DB, CO)

In general, trustees of schemes without investment sub-committees reported that all the trustees took decisions relating to investment policy. In some cases where it was reported that all trustees took decisions, one or more trustees carried out some preparatory work, for example, drawing up a list of fund managers for a beauty parade.

3.1.3 Consensus among trustees

The trustees interviewed were asked: ‘How do trustees seek to reach a consensus on matters concerning investment strategy?’ From the responses it seemed that trustees were able to reach a consensus by discussing issues and there appeared to have been few sources of major conflicts or disagreements among trustees.

A trustee of a small scheme reported that: ‘Issues are discussed but never taken to a vote’. A trustee of another small scheme commented that the trustees had an ‘unvoiced understanding’ to avoid isolating one trustee. The four trustees of this scheme had worked together as trustees for many years. One trustee of a very large scheme reported that the board of trustees would not over-ride the opposition of a single trustee. Although some trustees reported that a single trustee could not exercise a veto in this way, in practice, a single trustee can sometimes do so. For example, a trustee of a very large scheme operated by a financial institution objected to a proposal that the scheme should lend stock. The other trustees did not over-ride this opposition, perhaps, in part, because the trustee was a senior official of the institution. Our discussions with trustees suggested that whether the views of a single trustee were over-ridden depended on the issue and the trustee. For example, a decision whether to invest in venture capital would not be seen as of vital importance and so opposition by a single trustee could stop such investment. However, if the finance director of the sponsoring employer was a trustee, and opposed increasing investment in equities, that could sway the other trustees because the sponsoring employer was ultimately responsible for the financing of pensions.
3.2 Investment strategies

We asked trustees: ‘What are the principal elements of investment decision-making which trustees consider?’ and: ‘What is the present investment strategy of the trustees?’ Some trustees could not readily answer these questions. For some trustees the difficulties related to the fact that their boards of trustees handed over investment strategies to their fund managers. A trustee of a scheme replied:

‘The strategy of the trustees is the strategy of the fund manager which is bearish, high in cash and low in UK equities’.

(Large/Very large, less mature, DB, CO).

The answers most trustees provided identified two main elements of investment decision making:

• the appointment and monitoring of advisers and the fund manager(s);
• deciding the allocation of assets between asset classes.

In addition to making appointments, trustees reported that they reviewed existing appointments - removal of an adviser or fund manager was always an option for trustees. If a scheme’s investments were performing well, which was usually assessed by comparing the performance of the scheme’s investments with that of averages for other schemes, reappointments were often a formality, but this was not always the case. For example, the board of trustees of one large scheme wished to change investment policy to invest more in Asia and decided to appoint a manager with special expertise in that region. Another important element of investment decision making is the selection of stocks and shares within categories of assets. However, trustees reported that this task was usually delegated to external or internal fund managers.

Some trustees interpreted the question about investment strategies by describing the objectives their boards of trustees had formulated; for example, ‘to beat the index’, ‘to obtain a return of four per cent over the RPI’, ‘to achieve above average [pension fund] performance’, ‘to keep within the top quartile of pension schemes’, ‘to minimise risks’, ‘to maximise current return and minimise costs to the company’, ‘currently the fund is growth orientated, though also somewhat conservative and unwilling to take risks’, to ‘look for the best return’, and to ‘achieve the best return with limited risks’.

Some trustees did outline a strategy. An asset liability study had shown that there were few constraints on the investment strategy of a very large scheme and it had opted for a high exposure to property compared to the average for pension funds. For another scheme the strategy was:

‘To use an efficient frontier model8 to allocate assets to achieve the highest return compatible with the risk the sponsoring employer was willing to take’.

(Large/Very large, less mature, DB, CO)

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8 An efficient frontier model purports to quantify the trade-off between future performance in terms of return on assets and the degree of risk inherent in alternative allocations of assets. The estimates are based on analyses of historical data.
The strategy of the trustees of a very large scheme was to consider the potential returns available from different asset classes and the risks attached to them, in conjunction with the liabilities of the scheme, and to ensure that the scheme's portfolio was well diversified by setting ranges for investment in asset classes. A small scheme had a strategy of high investment in equities which had evolved over a period of 10 years.

As the implications of some of the 'strategies' described by trustees were vague or, as one trustee put it, 'hollow', it was difficult to assess the extent to which they were implemented and to trace their evolution. However, if strategy is interpreted as involving the appointment and reappointment of advisers and fund managers and making changes to asset allocation, then many schemes had made changes to their investment strategies. The three most frequent changes were:

- the appointment of a new or additional fund managers (as described later in this chapter);
- reductions in property investments as a percentage of total assets (discussed in Chapter 4);
- increases, or reductions, in holdings of equities; in many cases the latter were brought about because of the investment policy of a fund manager (described in Chapter 4).

In law, the trustees are clearly responsible for the investment decisions taken for schemes but, as some of the trustees claimed, they are entitled to rely on the expertise of advisers and fund managers they appoint in good faith and after due diligence in enquiring about their reputation and performance. If the actuary and the fund manager of a scheme have been appointed by many other schemes and are thus shown to be widely respected, the trustees can consider they have fulfilled their responsibilities in appointing them - if things turn out badly, they have an answer: that they had good reasons for making the appointments as evidenced by other boards of trustees having made the same appointments. Most trustees took the view that there was no point in paying actuaries and fund managers and then ignoring their advice. The trustees monitored the performance of their schemes and, if a fund performed relatively badly and/or the advice of the actuaries or fund managers proved to be unsound, the remedy was to replace the actuaries and/or the fund managers.

In practice, trustees do delegate much of the detailed decision taking. The extent to which trustees delegated decision taking to investment sub-committees has been described earlier in this chapter. The other main dimension of delegation is to fund managers.

The trustees of many of the largest schemes distinguished between strategic asset allocation which they decided and tactical asset allocation which they left to their fund managers to determine. The strategic asset allocation was set by the trustees based on advice, including asset liability studies they obtained from their actuaries, other advisers, the fund manager and the employer. Trustees set a percentage breakdown for investments between asset classes or they based the target allocation on the average asset allocation by pension.
schemes as calculated by CAPS or WM. Usually they set a range for each asset class, and sometimes also a 'mid-point' or 'benchmark'; for example, investments in UK equities were to be targeted at 60 per cent over the longer term, and were at all times to be between 50 per cent and 70 per cent of a scheme's total assets. The ranges were set to give fund managers scope to add value to schemes by varying asset allocation through time within limits that ensured the schemes at all times held a diversity of investments.

The scheme outlined in Example 1 illustrates this kind of approach.

Example 1 Large/Very large scheme

The trustees, who met at least three times a year, were responsible for appointing and dismissing advisers and fund managers and they set the financial objectives and strategy for the scheme, after consulting with the sponsoring employer. The trustees distinguished between strategic asset allocation, 'the long term neutral position for the Fund reflecting the Fund's financial characteristics', and tactical asset allocation, deviations from the strategic asset allocation made by fund managers 'to take advantage of short term market opportunities'. The strategic asset allocation benchmarks at the time of the interview were:

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK equities</td>
<td>60</td>
</tr>
<tr>
<td>Overseas equities</td>
<td>25</td>
</tr>
<tr>
<td>Fixed interest and cash</td>
<td>7½</td>
</tr>
<tr>
<td>Index-linked gilts</td>
<td>7½</td>
</tr>
<tr>
<td>Property</td>
<td>0</td>
</tr>
</tbody>
</table>

The trustees had set the strategic asset allocation benchmarks after commissioning an asset liability study. The ranges were set after consultations with the leading fund manager.

For some schemes the fund manager was more influential in deciding the allocation of assets. Example 2 illustrates arrangements of this sort.

Example 2 Large/Very large scheme

The trustee interviewed reported that the main element of decision taking by trustees was the allocation of assets and that this was substantially made on the recommendation of the fund manager. The other approach would be for the trustees to decide the allocation and use specialist managers, but the trustee considered it would be very difficult for a body of trustees to decide asset allocation.

'The trustees are told what the state of the market is by the fund manager. People like myself can have a fairly erudite conversation about it ... If the manager wants to be underweight in the US market, it would be an unusual position for trustees to direct the manager to double his stake in the US ... The reality is that most trustees listen to what the fund manager has to say and nod'.

(Large/Very large, less mature, DB, CO)
For some large and most very large schemes the trustees appointed more than one fund manager. We were told by trustees that in some cases they appointed two or more fund managers to provide an element of competition and/or to reduce risks. Another objective was to make use of the perceived distinctive expertise of a number of fund managers; some fund managers have a high reputation for investment in a particular class of assets such as fixed interest securities, or in companies based in emerging markets. Some schemes invested some of their assets in tracker funds; again, certain fund managers have acquired a reputation for operating tracker funds successfully. Schemes which had property investments usually employed a specialist manager or adviser for these assets. Trustees of schemes which employed specialist managers affected allocation when they decided the allocation of assets to the specialist managers but the specialist fund managers had some control over asset allocation as they usually had discretion whether to invest all of the funds allocated to them or to hold some cash.

An arrangement adopted by several schemes was to appoint a tactical asset manager who by the use of derivatives could vary the allocation of assets, thus over-riding the effects of the allocation between specialist fund managers. Example 3 illustrates this kind of arrangement.

Example 3 Large/Very large scheme

The trustees met monthly as a board or as an investment sub-committee: all the trustees were members of the sub-committee. The trustees considered the strategic asset allocation at intervals of three years when they received an actuarial valuation. They were provided with papers prepared by the scheme’s strategic asset allocation consultant and the scheme’s secretariat as a basis for their discussions. Before a final decision on asset allocation was reached, the employer, who took a view on the balance of risk and return the scheme should aim for, was consulted. The scheme had eight fund managers; two managers invested in UK equities, four in North American equities, two in European equities, two in Japan, two in the Pacific Basin, excluding Japan, and one in emerging markets. (Some managers invested in more than one region.) A tactical asset manager could vary the allocation of assets, for example, varying the exposure to UK equities between 40 and 60 per cent of the total assets, without reference back to the trustees. The trustees considered each manager’s performance twice a year and so they had two reports to deal with at most meetings. The trustee interviewed reported that the trustees certainly did not automatically rubber stamp the recommendations put to them by the secretariat and consultants.
Example 4 is for a scheme where the assets were invested in pooled funds.9

Example 4 A small scheme

All of the assets of the scheme were invested in balanced, pooled funds and the trustees met once a year. (Balanced funds are funds which include investments in a range of asset classes, such as equities and gilts. The fund manager can change the allocation of the fund to asset classes.) Until recently all the assets were invested in a single pooled fund operated by an insurance company. The trustees had decided to add a second fund operated by a leading London fund manager in a move which was seen to reduce risks - the effect of one manager performing badly would be reduced.

3.3.1 Stock selection

Although most trustees delegate stock selection, the selections made by fund managers were perused by trustees to check that they held a wide selection of equities and that, for example, the fund managers were not investing a large part of the portfolio in speculative shares such as small oil or mineral exploration companies. We were told that managers' selections were discussed by many boards of trustees at meetings, usually at meetings attended by fund managers, but that this was more with a view to the trustees being able to understand the reasons for the selections, particularly of the larger holdings, and being able to question the manager at subsequent meetings, than interfering with the selections. Indeed, many trustees told us that they were reluctant to interfere with the freedom of managers to select stocks as this could provide the managers with a defence if they performed poorly.

Nevertheless, trustees may influence, and do place limits on, stock selection. We were told by actuaries during the development interviews and trustees that many fund managers have a house style; for example, they have a preference for 'value investing' - investing in undervalued companies - or 'growth investing' - investing in companies perceived to have good prospects of achieving rapid growth. Alternatively, they have developed a reputation for cautious or aggressive investment strategies. Many trustees were clearly aware of the differences in the house styles of fund managers and that by selecting a particular fund manager or combination of managers they could exert an influence on stock selection. Also, trustees can, and usually do, limit the amount fund managers can invest in any one stock. Finally, trustees can, in effect, eliminate stock selection by opting to appoint a manager who uses a tracker fund approach.

There were two exceptions to the rule that trustees did not select stocks. Two very small schemes had a history of trustees making stock selections, but both had appointed local branches of regional stockbrokers as fund managers because of new Investment Management Regulatory Organisation (IMRO) rules. In both cases, the trustees claimed to have retained considerable input into stock selection. In one case, the trustees had had a successful investment record and one of the considerations in appointing the regional broker as fund manager was an understanding that the trustees could continue to influence the choice of investments, though the manager had the option of vetoing their suggestions.

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9 The use of pooled funds by schemes is described in Chapter 4.6.
Trustees of a small scheme, for which the sponsoring employer was a charity, placed ethical constraints on the investments the fund manager could buy but this case was exceptional. None of the schemes currently placed constraints concerning environmental or political considerations on their fund managers.  

3.3.2 Voting rights

Another aspect of the involvement of trustees is the extent to which they exercise or supervise the use of voting rights for the shares owned by the fund. Trustees were asked: 'What policy stances do trustees have, and how do they implement policies to influence directors of companies in which their scheme invests to conform to recent proposals or guidelines for corporate governance?' Trustees of some of the very large schemes took the exercise of voting rights very seriously indeed and the exercise of all votes by these schemes were reported to trustees. In one case a very large scheme exercised votes regularly on the terms of reappointing directors despite this practice having been a cause of concern among certain of its own customers. Generally trustees left the exercise of voting rights to their fund managers. In the event of particularly controversial or high profile takeover bids, fund managers did consult with scheme managers and trustees before accepting or rejecting an offer.

3.4 The roles of the advisers to the trustees and fund managers

The managers of larger schemes and the persons performing similar roles at smaller schemes, who were usually appointed by the employer, assisted the trustees. Trustees appointed actuaries, other investment advisers and fund managers as described below. In addition, trustees appointed bankers, auditors, legal advisers and custodians for securities, but generally these agents and advisers did not advise on, and were not involved in setting, the investment strategies of pension schemes and they are not considered further in this report.

3.4.1 Pension scheme managers and the administrators

The management and administration of pension schemes involves many tasks, including:

- the secretarial tasks of arranging meetings of trustees;
- providing trustees with relevant information;
- maintaining records and paying pensions;
- checking that the fund manager is operating within the terms of his appointment.

The secretarial and other administrative arrangements of schemes varied – at one extreme, very large pension schemes had pension departments which carried out the full range of tasks, while at the other end of the spectrum, acting as secretary to the board of trustees and dealing with pension scheme matters were among the many tasks carried out by the finance director of a small company and his staff. Outside firms administered the payment of pensions for many schemes. Usually, for the smaller schemes the finance director or one of his staff arranged and prepared papers for meetings of trustees, while for larger schemes a separate member of the staff managed

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10 The trustee of a very small scheme reported that all the members had views about ethical constraints on investments, but that it was difficult to apply constraints because the scheme used pooled funds and views differed about what restrictions to impose.
matters relating to the scheme. In some cases a firm of administrators prepared
the papers for meetings of trustees. For one scheme the administrator made
presentations at each of the meetings of the board of trustees (two meetings
a year) and prepared agendas, minutes and any papers required. At another
scheme a firm of administrators had for many years been the sole trustee of
the scheme. This arrangement was in the process of being changed by the
appointment of five trustees to meet the requirements of the Pensions Act
1995.

Examples of the title of the senior pension scheme officials of the largest
schemes were manager/director/chief executive/secretary. Three of the
'managers' of the largest schemes were qualified actuaries. The manager of a
scheme who may, or may not, be a trustee could be influential in shaping its
investment policies. He/she could not take final decisions about appointing
or dismissing fund managers and asset allocation, but could have an important
role in initiating debate about changes. The managers also acted as a link
between the adviser(s), the fund manager(s) and the trustees. Generally, trustees
met quarterly and received reports from the fund manager. If between
meetings a fund manager decided to make significant changes in asset allocation
or to make use of derivatives in a way they had not been used previously, the
fund manager had an obligation to contact the manager of the scheme, who,
if he/she thought fit, would then consult the trustees. For many of the larger
schemes we were told that there was active liaison of this sort.

3.4.2 Actuaries and other
investment advisers

All the schemes had access to actuarial expertise and most schemes, particularly
the larger schemes, had appointed leading firms of consulting actuaries who:
• carried out triennial valuations of the schemes' assets and liabilities;
• advised trustees of many schemes on investment policy;
• monitored the performance of the fund managers;
• advised on the need for the appointment of new fund managers and
  suggested possible candidates;
• prepared asset liability studies and other valuations in addition to the triennial
  valuations as required by schemes.

The leading firms of consulting actuaries can provide administrative services
for schemes. Some of the schemes, particularly smaller schemes, did not
appoint a separate firm of consulting actuaries as actuaries to the scheme, but
used firms of administrators who also provided actuarial services.

Leading firms of consulting actuaries have separate departments for making
valuations and for advising on investment policy. Among the largest schemes,
some boards of trustees obtained investment policy advice from their actuaries,
while others used a separate firm of consulting actuaries or another source of
advice about investment policies, in addition to, or in place of, advice from
the actuaries.
The actuaries and other advisers were reported to be appointed by the trustees. Exceptionally trustees reported that the advisers were appointed by the employer or a company committee. In one case, a trustee of a very small scheme commented:

'I made the appointment [of a firm of administrators] and I am both a trustee and finance director of the company. I do not know which hat I was wearing'.

(Very small, less mature, DC, CO)

This appointment of administrators was one of a series of measures taken to reduce the costs of the pension scheme to the company. In some other cases, the actuaries had been appointed many years ago and the responsibility for the original appointment was obscure. In some cases, the actuary also reported to and/or was paid by the employer. (Employers require actuarial advice about, for example, the level of contributions.)

Some trustees reported that the appointments of actuaries and other advisers had been terminated and new appointments had been made. The trustees of a small scheme changed actuaries because the leading firm of actuaries they had used 'was not good value as regards the timeliness and the quality of information they provided and their bills were excessive'. A trustee of another small scheme considered it was about time the scheme went out and tested the market (for actuaries). Nevertheless, changes of actuaries were less frequent than changes of fund managers.

The actuaries or other advisers attended meetings of trustees as requested. At some larger schemes such advisers attended all trustee meetings at which investment policy was considered. The practice of the smaller schemes was to invite the actuary less often, perhaps once a year, though more often recently because the implications of the Pensions Act 1995 needed to be considered. (Actuaries charge some small schemes for each visit or consultation. For some larger schemes they charge an inclusive fee.) At schemes which had appointed an administrator and had not appointed a separate firm of actuaries, a member of the staff of the firm of administrators attended at least some, if not all, of the meetings of the board of trustees.

Trustees reported that they received papers from their schemes' actuaries, administrators and other advisers. Important roles of the actuary were to:

- keep the trustees on the right side of any laws or rules;
- alert the trustees if they were diverging from the practice of other pension schemes;
- provide trustees with an evaluation of the effects of proposals and decisions.

The sample schemes with substantial surpluses were not greatly constrained by the advice about asset allocation provided by actuaries. Some trustees reported that their schemes' surpluses meant that the actuaries did not tie down the allocation of assets, though they did in some cases recommend an allocation or propose alternative allocations and provide estimates of the
3.4.3 Choice of fund managers

The trustees of most schemes had appointed external fund managers. As noted earlier, many of the very large schemes and some of the large schemes used more than one external fund manager simultaneously - one scheme used nine fund managers. Five large and very large schemes used internal managers. In two of the five cases, the sponsoring employers were financial institutions which had internal expertise in fund management and, in one of the other cases, the scheme, which was operated by a UK subsidiary of an overseas parent company, used the internal fund management organisation of the parent company which was located overseas.

A feature of the study was the extent to which schemes changed their fund managers. 21 of the 39 defined benefit schemes, including 12 of the 27 larger schemes, had changed or appointed fund managers within the past five years. The reason for many of the changes was dissatisfaction with the existing fund managers and the changes were made with a view to improving the investment performance of the schemes. Trustees described how managers who had a disappointing record were replaced, or partially replaced, by managers who had a record of outperforming averages. In some cases the record of outperformance by the new managers did not continue after their appointment. The schemes which made changes included schemes which had appointed additional fund managers and had not replaced the existing managers, one scheme whose former fund manager had withdrawn from the business of managing pension fund investments; two schemes which had switched from using internal to external fund managers (in one of these cases, the internal fund managers had set up as an independent fund management organisation and been appointed by the scheme); and the two very small schemes which had appointed fund managers to comply with IMRO rules.

Trustees reported that fund managers were usually appointed following some form of ‘beauty parade’ and that in many cases firms of consulting actuaries were influential in deciding which fund managers were included in the beauty parades. Selection of a fund manager usually started with the scheme’s actuary being asked to prepare, or assist with, the preparation of a description of the appointment and to provide a list of fund managers who were deemed to meet the requirements of the scheme. We were told by actuaries at the development interviews, and by trustees, that firms of actuaries monitor the effects of the alternative allocations. (We take up these important points again in Chapter 4.) Trustees are more reliant on the advice of actuaries when a scheme is in deficit or frozen. A trustee of a very small frozen scheme commented:

‘The trustees are always responsible and make the decisions, but they are guided very much by the actuary’s view as to how they should meet the scheme’s liabilities’.

(Very small, frozen, DB, CO)

11 The 39 defined benefit schemes exclude the three frozen schemes.
performance of the leading fund managers and collect information about the performance of particular individuals employed by fund managers, the investment philosophy of the fund management houses and whether they are gaining or losing business. Trustees reported that there are a substantial number of fund managers, more than 20, from which to select for short lists. The trustees, or a sub-committee of trustees, usually obtained written submissions from all or some of the listed managers. Next, a short list of fund managers was prepared to make presentations to the trustees or to a sub-committee. The final decisions of the trustees were based on the presentations, the responses to questions, the written submissions, the records of the fund management houses and individual managers, the investment strategies proposed and, in some cases, assessments made by existing customers of the houses which were obtained by the trustees.

Trustees, at least formally, and in most cases effectively, took decisions to appoint fund managers. There were two exceptional schemes. At one very small scheme the owner of the sponsoring employer, who was one of three trustees, appointed the fund manager, and the other two trustees accepted the appointment. At a large scheme operated by a subsidiary of an overseas company the trustees were 'heavily influenced' by the overseas company when appointing the fund manager.

The experience of operating a 'beauty parade' by a large scheme is used to illustrate the steps in the process. With the help of the actuary, the manager of the scheme prepared an investment questionnaire which was sent to 13 fund managers. On the basis of the answers, the manager, again with the help of the actuary, selected six fund managers. These were each interviewed at their offices by a sub-committee of trustees, knowledgeable employees of the sponsoring employers and the actuary. The short list of six was then reduced to four and the manager of the scheme reported to the board of trustees how they had arrived at this short list. The full board of trustees then interviewed the four fund managers. Later the trustees selected two fund managers, each of whom was allocated half the assets of the scheme. At a very large scheme three fund managers were interviewed and more emphasis was placed on their records and strategy than their presentations.

For smaller schemes, the 'beauty parade' tended to be less elaborate, with all the trustees considering fewer fund managers for the appointment and placing more reliance on their advisers. The actuary of a small scheme advised the three trustees of the scheme to consider five insurance companies. A trustee and the finance director of the sponsoring employer of another small scheme interviewed four fund managers. It was a difficult choice; the different strategies proposed by the managers, their records and their personalities influenced the final decision.

The fund managers attended meetings of trustees at least once a year. At some large and very large schemes which employed more than one fund manager, each manager attended different monthly or quarterly meetings, but all were interviewed at least once a year. At small and very small schemes,
the fund managers generally attended meetings of trustees less often, but the
fund managers did meet the trustees once a year.

Most of the schemes did not relate the fund manager's fee to the performance
of the fund. However, the fund manager's fee was usually related to the size
of the fund and so the manager did benefit from good performance. Also,
where a scheme has more than one fund manager, it is standard practice to
reduce the size of funds managed by a manager if there is any doubt about
the performance of that manager and this reduces the fees the manager earns.
A few of the schemes which did relate a manager's fee to his performance
did so for only one of their managers.

3.4.4 Targets for fund managers

Where targets were set they usually related to the CAPS or WM medians.
Nearly all of the larger defined benefit schemes set targets for their fund
managers. There were only two exceptions among the larger schemes where
targets were not set; one scheme had an internal fund manager and the
trustee of the other scheme reported that, though there was no formal target,
'the manager knew he had to perform'. The most common target was to set
multi-asset fund managers with discretion to vary the asset allocation, a target
to beat the WM or CAPS median performance by one per cent a year over
three years and not to fall below it by more than two per cent in any period
doing so for only one of their managers.

...he is not going to be sacked if he fails to get two per cent. In fact we would
all be highly delighted if he achieved one per cent every year'.

(Large/Very large, less mature, DB, CO)

For specialist gilts funds the target was reported by trustees to be lower; for
example, the appropriate gilts index plus one quarter per cent a year. A few
schemes set targets of two per cent above the appropriate index for investments
in overseas markets because there was considered to be more scope for
outperformance in these markets. Trustees of one very large scheme set
targets of three per cent over the indices for specialist managers investing in
Europe and in the Far East.

In addition to signalling to the fund managers what was expected in terms of
performance, some trustees intended the targets to indicate to fund managers
the degree of risk they should take. The trustee of a scheme which set its
manager a target of beating the WM average commented:

'It follows from this target that the manager is expected to take modest risks and
to keep the asset allocation near to the pension fund average'.

(Large/Very large, mature, DB, CO)
The implication was that the higher the target, the greater was the expected divergence of the scheme's allocation from the average asset allocation by pension funds and the greater the risks. A target of two per cent above the median for the CAPS or WM populations of pension funds would have indicated to the manager that he could take more risks.

A majority of the smaller schemes did not set targets for their fund managers but a minority did so. The main explanation for the smaller schemes not setting targets was that they used pooled funds.

3.5 The role of the employer

Trustees reported that the sponsoring employer was involved, or influenced, their decision making in several ways:

- directors of the companies which sponsored the schemes were trustees;
- discussions between trustees, including trustees who were directors, and other directors;
- trustees obtaining the views of the sponsoring employers about the investment strategies to be adopted by schemes.

For all except one scheme, 50 per cent or more of the trustees were nominated by the sponsoring employer and, in many cases, the finance director was a member of the board of trustees. Personnel directors, other executive and non-executive directors were also on some boards of trustees. Sponsoring employers clearly had channels through which they could, if they were so minded, attempt to influence the policies of trustee boards. Also, the inclusion of directors of the employer companies among the trustees ensured that the sponsoring employer was kept informed about the policies adopted by the trustees of the pension scheme. An example of the liaison between trustees and an employer was provided by a trustee:

‘Keeping the employer informed is an easy process because both the chairman and finance director of the sponsoring employer are trustees, though not members of the investment sub-committee.’

(Large/Very large, mature, DB, CO)

Trustees of some schemes described how the Chairmen or Chief Executives of the companies were kept informed about decisions trustees were taking concerning appointments of advisers and fund managers and the allocation of assets.

Clearly the trustee directors wore two hats: they were trustees of the pension funds and were often, but not always, active members of the schemes, and they were directors of the companies. The trustees interviewed, including some finance directors, reported that, in practice, conflicts of interest involving investment policies had not occurred and that many employers had been satisfied with the performance of their pension funds. Where there was dissatisfaction it related to the underperformance of fund managers not to the decisions of trustees. However, the absence of conflicts could reflect the surpluses many schemes have accumulated after a period of buoyant equity prices, and might not apply in the absence of these conditions.
'We do not have any pressure from the sponsoring employer because the employer has been on a contributions holiday for a number of years, but there will come a time when the company takes an active interest in the investment policy of the scheme.'

(Large/Very large, mature, DB, CO)

3.6 How trustees check performance and the role of comparators

Nearly all the trustee boards had access to comparisons of their schemes' investment performance with the performance of other pension funds. The largest schemes subscribed to WM or CAPS. Most of these schemes subscribed to WM to obtain a comprehensive overall comparison, and a comparison for sectors. The comprehensive annual comparisons were for calendar years but WM also provided summary comparisons on a quarterly basis. The largest schemes in the sample made comparisons with WM averages for the top 50 funds. CAPS comparisons were in some cases presented to trustees by the actuaries to the schemes. Schemes also compared their manager's performance against stock market indices.

'We obtain comparisons from ... [a performance measuring service] but by the time they are received they are out of date, so we calculate the performance of our managers against stock market indices ourselves. We prefer comparisons with the appropriate index'.

(Large/Very large, mature, DB, CO)

Trustee boards of the smaller schemes relied upon their advisers or fund manager to provide performance comparisons rather than WM or CAPS. The trustees of one scheme which had relied on comparisons made by the fund manager had recently commissioned a one-off study by WM to assess the fund manager's performance, to provide a check on the comparisons the fund manager had provided. Three other smaller schemes did subscribe to a performance measuring service and one scheme had subscribed to a performance measuring service but had withdrawn its subscription. The latter, small, scheme had not found the comparisons useful and it now relied upon the performance comparisons provided by its fund manager. A trustee of a small scheme said that the trustees were concerned that the valuation of assets at the successive actuarial valuations should be enough to enable the scheme to increase benefits. This had been achieved and, according to the actuary, the benefits provided by the scheme were now on a par with those provided by the best schemes.
4 ASSET ALLOCATION

4.1 Classes of assets

The allocation of assets between the main asset classes is a principal component of the investment strategies of pension schemes. The main asset classes are listed in Table 4.1.

<table>
<thead>
<tr>
<th>Equities:</th>
<th>Inflation-proofing</th>
<th>Historical Return</th>
<th>Riskiness</th>
<th>Liquidity</th>
</tr>
</thead>
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<tr>
<td>UK Overseas</td>
<td>Loosely</td>
<td>Highest average returns</td>
<td>Traditionally viewed as risky - are subject to short-term volatility</td>
<td>High</td>
</tr>
<tr>
<td>Gilts (traditional bonds)</td>
<td>None</td>
<td>Low real returns especially during the 1970s</td>
<td>Traditionally viewed as safe but exposed to inflation risk</td>
<td>Very high</td>
</tr>
<tr>
<td>Index-linked bonds</td>
<td>Almost completely</td>
<td>Low real return</td>
<td>Risk free</td>
<td>Very high</td>
</tr>
<tr>
<td>Property</td>
<td>Loosely</td>
<td>High average real return</td>
<td>Subject to short term volatility</td>
<td>Relatively illiquid</td>
</tr>
<tr>
<td>Cash and deposits</td>
<td>None</td>
<td>Low real return</td>
<td>Minimal but exposed to inflation risk</td>
<td>Maximum liquidity</td>
</tr>
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</table>

Table 4.1 The asset classes

(a) The table is based on the authors' general knowledge of investment markets.

4.2 Asset allocation by defined benefit schemes

The points to note from Table 4.2, which shows the asset allocation of the defined benefit schemes and the WM and CAPS averages, are:

- the uniformly high allocation to equities: only three schemes had less than 60 per cent of their assets invested in equities;
- that, apart from one scheme which had all of its assets invested in equities, schemes held a diversity of assets. (The risk reducing advantages of holding a range of classes of assets for which changes in values are not highly correlated are obvious; the downside of investing in asset classes apart from equities has been the lower returns);
- the relatively large variation in allocations to each of the classes of assets apart from equities.

The asset allocation for all the defined benefit schemes included in the sample, apart from the three frozen defined benefit schemes and one scheme for which the information was not obtained, is shown in the table.
Table 4.2 Asset allocation by defined benefit schemes

<table>
<thead>
<tr>
<th>Size of Schemes and Maturity</th>
<th>Scheme Number</th>
<th>Contracted Out</th>
<th>UK Equities</th>
<th>Overseas Equities</th>
<th>Total Equities</th>
<th>Fixed Interest Bonds UK</th>
<th>Fixed Interest Bonds Overseas</th>
<th>Index-linked Bonds</th>
<th>Total Bonds UK</th>
<th>Total Bonds Overseas</th>
<th>Property</th>
<th>Cash</th>
<th>Other</th>
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<th>Overseas Equities</th>
<th>Total Equities</th>
<th>Fixed Interest Bonds UK</th>
<th>Overseas</th>
<th>Index-linked Bonds</th>
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<td>0</td>
<td>21</td>
<td>0</td>
<td>0</td>
<td>3</td>
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</tr>
<tr>
<td>£2m to £20m Mature</td>
<td>32.</td>
<td>Not</td>
<td>57</td>
<td>24</td>
<td>81</td>
<td>4</td>
<td>0</td>
<td>5</td>
<td>9</td>
<td>4</td>
<td>0</td>
<td>2</td>
<td>4</td>
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<tr>
<td></td>
<td>33.</td>
<td>Yes</td>
<td>55</td>
<td>26</td>
<td>81</td>
<td>5</td>
<td>3</td>
<td>0</td>
<td>8</td>
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<td>0</td>
<td>6</td>
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<tr>
<td></td>
<td>34.</td>
<td>Yes</td>
<td>55</td>
<td>23</td>
<td>78</td>
<td>2</td>
<td>10</td>
<td>2</td>
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<td>2</td>
<td>0</td>
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<tr>
<td></td>
<td>35.</td>
<td>Yes</td>
<td>29</td>
<td>12</td>
<td>41</td>
<td>0</td>
<td>41</td>
<td>0</td>
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</tr>
<tr>
<td>Less than £2m Less Mature</td>
<td>37.</td>
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<td>53</td>
<td>30</td>
<td>83</td>
<td>7</td>
<td>5</td>
<td>0</td>
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<tr>
<td>Less than £2m Mature</td>
<td>39.</td>
<td>Yes</td>
<td>66</td>
<td>12</td>
<td>78</td>
<td>18</td>
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<td></td>
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<tr>
<td>Average end 1995&lt;sup&gt;(2)&lt;/sup&gt;</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>CAPS Weighted</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average end/1995&lt;sup&gt;(3)&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

<sup>(1)</sup> Part contracted out, part not contracted out.

<sup>(2)</sup> Source: Table provided by the WM Company, Edinburgh.

<sup>(3)</sup> Source: CAPS (1996) p. 21, weighted average.
4.2.1. Inflation-proofing

Nowadays, the bulk of pension scheme assets is invested in equities, the asset class which since 1950 has provided the highest average returns. The pension entitlements of active members of defined benefit schemes are, in effect, inflation-proofed as they are usually related to future wages of the members, and the pensions of most deferred members and pensioners are at least partially inflation-proofed. Among asset classes, index-linked bonds provide guaranteed inflation-proofing but investment in this asset class was limited. In a rough and ready way, real assets, equities and property were expected by actuaries and trustees to be inflation-proofed in the long term and were therefore seen to provide a good match for inflation-proofed pension liabilities. As described below, the principal explanation given by the trustees for the dominance of equities, rather than index-linked gilts or property, in pension scheme portfolios was the expectation of trustees that equities would provide the highest returns.

4.2.2. Overseas equities

In terms of market capitalisation the UK market is a small percentage of the world market - about five per cent. A risk-averse investor might therefore be expected to invest a large part of his funds in overseas markets. In practice, pension schemes on average invest about 70 per cent of their equity portfolios in UK equities and 30 per cent in the shares of companies based overseas (see the WM average at the bottom of Table 4.2). The explanations for this stance given by trustees were:

- the currency mismatch between pension liabilities fixed in sterling and overseas equity assets;
- pension funds have exposure to overseas economic activity through the overseas operations of companies based in the UK in which they invest;
- dividend taxes could be more readily reclaimed from UK companies.

(From July 1997 UK pension funds cannot reclaim taxes deducted from dividends by UK companies.)

Firstly, the liabilities of pension funds are fixed in sterling while exchange rates fluctuate and are difficult to predict, so there is a danger of a mismatch if sterling rises; in the absence of other changes, the value of overseas equities will fall relative to the pension liabilities. Some trustees considered overseas equities to be the most risky class of assets in which they invested because of the currency mismatch. Secondly, many UK based companies have overseas subsidiaries which account for a substantial fraction of their profits and, therefore, provide exposure to overseas trading for their investors and reduce the need for pension schemes to invest in companies based overseas.

Three of the smaller schemes held no overseas equities; for one small scheme it was a policy prescribed by the overseas owner of the sponsoring employer. Trustees of a second small scheme took the decision on the advice of investment advisers to the overseas parent of the sponsoring employer and its UK advisers. The trustee commented that, in terms of currency, UK equities match the scheme’s liabilities and ‘big (UK) companies are exposed to international trading conditions’. Trustees of the third scheme which was very small had found from experience that the transaction costs for buying and holding overseas equities were high and were a barrier to this category of investment.
4.2.3. Bonds

The proportion of assets invested in bonds by the 38 schemes averaged 17 per cent. For very large schemes the percentage varied between 11 and 15 per cent - a relatively narrow margin. Of the four schemes with the highest exposure to bonds (59, 42, 39 and 33 per cent, respectively), three were operated by the UK subsidiaries of companies based overseas. In two of these cases equity holdings had been reduced and bonds increased quite recently; the allocations were not the result of long-standing policies. The division between UK bonds, overseas bonds and index-linked bonds varied widely. The trustee of a very large scheme with 12 per cent of its assets invested in index-linked bonds reported that this relatively high allocation reflected the index-linking of pensions. The scheme had approximately equal numbers of active, deferred members and pensioners.

4.2.4. Property

There were sharp divergences of policy on investment in property. The majority of the largest schemes invested in property, while the others held no property. A minority of the smaller schemes invested in property, in most cases through pooled investment funds. In addition, the fund managers of some of the schemes may have held shares in property companies as a part of their equity holdings. Trustees confirmed that smaller schemes would be unable to acquire a diversified commercial property portfolio if they invested directly in property and that this constrained their investment in property.

It was clear that there had been a general movement to reduce the proportion of funds allocated to property. We were told by trustees that the reduction in property investments was attributable to the recent and expected future low returns on commercial property, the perception that the growth of out-of-town shopping could damage rents for shops in town centres and the increasing costs of renovating and refurbishing office property to contemporary standards. Trustees reported that it was difficult to get in and out of property and that the depressed state of the property market had made some property illiquid and difficult to value - another justification for reducing investment in property. However, a trustee of a very large scheme said this was not a consideration in the decision to reduce investment in property because the scheme had plenty of assets which could be realised quickly and it had a large surplus. Declines in the value of some commercial property during the early 1990s combined with increases in equity prices had automatically reduced the weighting of property in portfolios.

4.3 Asset allocation by defined contribution schemes

Two of the six defined contribution schemes allowed members to choose investments, one scheme from a menu of four pooled investment vehicles, varying ‘from a very low risk building society deposit up to a fund invested in equities’, managed by financial institutions, and the other scheme from a very wide range of assets. The latter scheme was a top-up scheme which employees could use for a part of their bonuses - up to the tax relief limit for contributions to pension schemes. Three of the schemes had between 80 and 95 per cent of their assets invested in equities and two others used pooled vehicles. The asset allocation of these schemes does not suggest that the allocation of assets by defined contribution schemes results in lower exposure to equities, but the number of schemes in this sample is small.
4.4 Influences on asset allocation

Seven influences on decisions concerning asset allocation by defined benefit and defined contribution schemes were given by trustees. The first six influences are listed in order of their importance, though such an ordering can only be approximate. The ordering was made by the authors of the report based on the frequency with which the influences were mentioned by trustees and the importance they attached to the influences in their comments. Of the six influences, the fifth and sixth were clearly less important to trustees than the first four.

4.4.1 Past returns on classes of assets

Past returns on classes of assets, which are outlined in Table 4.1, are clearly influential and in the long term the main influence determining asset allocation and, in particular, the allocation of three quarters of assets to equities. The ‘investment philosophy’ of one scheme was based on a perception that:

‘Over the long term equities ... have achieved higher returns than alternative investments’.

(Large/Very large, less mature, DB, CO)

An employee trustee commented:

‘The fund has a high exposure to equities. History has shown that equities are a good area in the long term. I cannot foresee that other investments will be as good’.

(Large/Very large, less mature, DB, CO).

An overseas trustee of a large scheme with 84 per cent of its assets invested in equities would have liked more of the fund (40 per cent) to be invested in fixed interest bonds, but the actuary’s view and the consensus among the trustees was that if the scheme were to go more heavily into bonds,

‘...ultimately the overall return would be likely to be lower, increasing the cost of the scheme to the employer’.

(Large/Very large, less mature, DC, CO).

References by trustees to the past performance of equities were common. In contrast, trustees did not attempt to justify their allocation to equities by describing why equities should continue to achieve high returns, though one interpretation of their references to history is that they expect the forces which led to high returns in the past to continue into the future. Similarly, an important influence on the reduction of investments in property was the low/negative returns experienced during the early 1990s. Very few trustees obtained or made estimates of future returns on different classes of assets. Some trustees reported that their fund managers provided such forecasts and others mentioned assumptions about future returns made by actuaries. This absence of explicit forecasts is compatible with reliance by trustees on past relative returns on different classes of assets being replicated in the future, at least in the long term.
4.4.2 Allocation by other schemes

The allocation of assets by other pension schemes is very influential on the decisions of trustees, advisers and fund managers for three reasons:

- the effects of decisions on asset allocation are uncertain. The views of other fund managers, advisers and trustees encapsulated in the average allocation, as calculated by CAPS and WM, is an important source of information;
- if the trustees and fund managers match the average allocation they have a justification for their decision if, in the event, it turns out to have been misguided. 'Everyone else will be in a mess as well'. This view is encouraged by players in the 'investment industry' who assess risk as relative error or tracking error - relative to averages;
- sponsoring employers and employees will expect their schemes to match or exceed the average performance and whether a scheme does that is primarily determined by the allocation of its assets. If a scheme underperforms relative to the average, the continued employment of the fund manager, administrator and advisers and reputation of the trustees nominated by the sponsoring employer are at risk.

The study showed that most trustees are very aware of the relative investment performance of their schemes and are ready to replace fund managers if they underperform the pension scheme average, even where the fund manager has achieved a substantial positive real return on the assets. As reported in Chapter 3, many boards of trustees set targets for their fund managers which were related to the CAPS and WM averages and hence signalled to their fund managers to stick closely to the average asset allocations made by other pension funds.

4.4.3 The financial state of schemes

Trustees of schemes which have a substantial surplus have greater freedom to invest a high proportion of assets in equities which are perceived by advisers and trustees to be the asset class which will provide the highest return but which perhaps involve greatest risks. The existence of widespread and substantial surpluses was reported in Chapter 2 and our discussions with trustees indicated that these surpluses were an important influence on asset allocation. Some trustees of schemes with large surpluses reported that they could take greater risks. (Alternatively, the surpluses could lead employers to instruct schemes to take fewer risks to safeguard the surpluses, but none of the trustees suggested that this happened.)

4.4.4 Maturity

An inverse relationship would be expected between the maturity of a scheme and its allocation of assets to equities. A less mature scheme can take a longer-term perspective. Although there have been short-term setbacks for equity prices and even 'crashes', in the long term real returns on equities have always outperformed bonds and cash. A less mature scheme is likely to be able to wait longer for a recovery than a mature scheme and can therefore invest a higher proportion of its assets in equities. Certainly maturity was mentioned by trustees as an influence on decisions, but, though it was occasionally an important influence, our conclusion from the comments of trustees was that it was not a dominating consideration for most schemes.
Maturity does not change much from quarter to quarter in the absence of a take over or sale of a business by the sponsoring employer or a redundancy programme, so trustees do not consider it regularly at every meeting. It tends to be considered when the trustees receive the triennial actuarial valuations, the results of asset liability studies which are commissioned on a one-off basis, and MFR calculations. Many of the trustees we interviewed looked to their actuaries for guidance as to the implications of scheme maturity for the allocation of investments.

Why is the degree of maturity of schemes not a clearer determinant of investment strategy? The main explanation is that most of the sample schemes which are mature had a surplus, in many cases a substantial surplus. For example, for one very large scheme with a substantial surplus, an asset liability study showed that there were few constraints on its asset allocation policy. A trustee of another very large scheme reported that there had been ‘no need’ to have an asset liability study made, or for it to hold bonds, in spite of its being a mature scheme because of its large surplus.

Table 4.3 shows a ‘broad brush’ comparison of the actuarial liabilities and assets of a large scheme. The first column of the table shows the estimated liabilities of the scheme by categories, as percentages of the total liabilities, in order of maturity, starting with mature liabilities for pensioners. The second column shows the percentages of total assets which the categories of liabilities represent, and the third column matches the assets in terms of riskiness to the categories of liabilities, with the least risky assets first, set against the most mature liabilities. Cash, index-linked bonds and traditional bonds are seen as the least risky or most liquid assets and are set against the liabilities to retired members. However, these assets are not sufficient to cover the liabilities in respect of retired and deferred members, so a part of the next least risky asset class, UK equities, is set against these liabilities. All of the fund’s liabilities were covered by 84 per cent of the fund’s assets, and what was perceived as the most risky class of assets, overseas equities, was matched, in large part, to the scheme’s surplus.

Many schemes had larger surpluses, so maturity imposed few restrictions on asset allocation by these schemes, if they had an allocation not far from the median for pension funds. For MFR calculations and the matching of assets to liabilities, schemes with surpluses could allocate assets which were perceived to be risky or illiquid, such as venture capital, against the surpluses. For a very large scheme with twice as many pensioners as active members and 86 per cent of its assets invested in equities and property, the explanation given for the high exposure to real assets was that it was for the employer to choose the allocation and hence the risk of having to pay high contributions in the future. The assets of the scheme were valued at 110 per cent of the scheme’s liabilities, a surplus of 10 per cent. A trustee of a scheme with nine per cent of its assets in index-linked bonds reported that this allocation was ‘due to the maturing nature of the fund’. An exercise had been carried out by the actuary and the external investment adviser a couple of years earlier to assess how much ought to be invested in index-linked bonds.
The figure they came in with was much higher ... but there is a limit to how far the company is willing to be over the top in index-linked when you can get a better performance from equities'.

(Large/Very large, mature, DB, CO)

For a few funds maturity was important. For example, one of the small schemes which had been closed had a deficit and had only 41 per cent of its assets invested in equities and 59 per cent in bonds.13 At the instigation of its overseas parent, another small scheme had increased the mid-point of its benchmark for gilts from 30 to 42 per cent of total assets when a subsidiary had been sold which had had the effect of increasing maturity. This change was made without commissioning a full asset liability study, but the actuaries had made a brief review.

Table 4.3. Asset/Liability comparison for a large scheme

<table>
<thead>
<tr>
<th>Actuarial Liabilities for:</th>
<th>As % of total liabilities</th>
<th>Fully covered by % of assets</th>
<th>As % of total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retired members</td>
<td>47</td>
<td>39</td>
<td>10</td>
</tr>
<tr>
<td>Deferred members</td>
<td>8</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>'Mature' liabilities</td>
<td>55</td>
<td>46</td>
<td>46</td>
</tr>
<tr>
<td>Active/employed members</td>
<td>45</td>
<td>38</td>
<td>38</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>100</td>
<td>84</td>
<td>84</td>
</tr>
<tr>
<td>Surplus</td>
<td>21</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Funding</td>
<td>121</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>UK liabilities</td>
<td>100</td>
<td>84</td>
<td>73</td>
</tr>
<tr>
<td>Surplus</td>
<td>21</td>
<td>16</td>
<td>27</td>
</tr>
<tr>
<td>Funding</td>
<td>121</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>100</td>
<td>84</td>
<td>73</td>
</tr>
<tr>
<td>UK assets</td>
<td>100</td>
<td>84</td>
<td>73</td>
</tr>
<tr>
<td>Overseas assets</td>
<td>21</td>
<td>16</td>
<td>27</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asset Classes</th>
<th>(in order of risk)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK cash</td>
<td></td>
</tr>
<tr>
<td>UK index-linked bonds</td>
<td></td>
</tr>
<tr>
<td>UK bonds</td>
<td></td>
</tr>
<tr>
<td>UK equities</td>
<td></td>
</tr>
<tr>
<td>UK equities/property</td>
<td></td>
</tr>
<tr>
<td>Overseas bonds</td>
<td></td>
</tr>
<tr>
<td>Overseas equities</td>
<td></td>
</tr>
</tbody>
</table>

Pensions schemes involve risks for sponsoring employers. If the investments of defined benefit schemes perform badly, the sponsoring employer has to make good any deficit and some schemes were in a position to take greater risks than others. Certain schemes where the sponsoring employers were highly profitable were able to take greater risks because of this, and the risk-reward relationship of pension schemes for sponsoring employers was also

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4.4.5 The profitability of employer organisations and the size of schemes

13 The scheme had 30 active members and 358 current and deferred pensioners.
affected by the size of the schemes. Where a defined benefit scheme was small relative to the size of the company sponsoring the scheme, the scale of the risks was reduced. For some schemes, the pension scheme assets were relatively small compared to the assets of the company. For example, employees could only join one scheme at the age of 35 and many of them were under this age limit; another scheme was open to managers and office staff but not to the majority of employees, and the UK employees of a third scheme were a small percentage of the global employment of the UK based company - employees in other countries were members of defined contribution schemes. The profitability of schemes and the relative size of schemes were cited by certain trustees as an influence on decisions about the allocation of assets. At the other end of the spectrum of ability to take risks, trustees of closed schemes where the sponsoring employer was in receivership had no recourse to the employer to make good any future losses on investments.

4.4.6 Attitudes towards risk taking

The attitudes towards risk taking of boards of trustees and sponsoring employers were an influence on asset allocation. A trustee of a very large scheme reported that trustees as a group were ‘extremely conservative’ with their investment policy and later in the interview he attributed the absence of investments in venture capital funds to this ‘very conservative policy’. A trustee of a large scheme commented: ‘the policy of the trustees is to avoid surprises’; 20 per cent of the scheme’s assets were invested in bonds, a relatively high percentage for large schemes. A trustee who was reputed to be influential for investment decisions commented:

‘The scheme does not invest in emerging markets. I would not invest my own money in those markets.’

(Small scheme, less mature, DB, CO)

Several trustees said the policy of the trustees was to avoid risks or to be cautious. A few trustees based overseas were reported by the trustees we interviewed to have taken a more cautious view and favoured less exposure to equities.

4.4.7 Fund managers

As noted earlier in the chapter, most boards of trustees allow their fund managers some discretion to vary asset allocation, so the decisions of the fund managers are a factor determining asset allocation. An interesting perspective on the role of trustees and fund managers in determining asset allocation was provided by one leading fund manager. This fund manager had taken a cautious view of the prospects for the UK and particularly the US equity market from about the end of 1995; the argument was that in terms of past valuations equities had become over-valued. The manager had increased liquidity and reduced exposure to equities. All of the eight funds which employed the manager on a discretionary basis had been affected, even a less mature fund which had already allocated a substantial proportion of its assets to gilts. The extent of the effect was influenced by the proportion of assets managed by the manager, which varied; the manager was one of nine for one scheme, managed 40 to 50 per cent of the assets of five schemes and was the only manager for two schemes. At the time of the interviews the
decision of the fund manager had proved to have been mistimed, as equity markets had risen through 1996 and in 1997. Recently, measured on an annual basis, this manager was an underperformer relative to the median pension scheme. The important point was that none of the boards of trustees had stopped the fund manager increasing liquidity and none had dismissed the manager; indeed, in at least two cases, the trustees seemed to have welcomed the cautious move when it was made. A trustee of a large scheme commented:

'I have a lot of sympathy with [the fund manager's] view that the market is over cooked'.

(Large/Very large, less mature, DB, CO)

Trustees reported that two other leading fund managers had reduced equity holdings of some pension schemes whose assets they managed on a discretionary basis.

4.5 Conclusions on asset allocation

We have described the asset allocation by the sample of pension schemes. The WM and CAPS averages shown at the foot of Table 4.2 indicate that the average allocations by the sample are close to the averages for UK pension funds. In line with this, the pension schemes studied had allocated a high proportion of their assets to equities. This allocation reflected the high returns obtained on equities in the past and the expectation that they would continue to provide the highest returns. The policy of concentrating investments on equities had been very successful and as a result most schemes had substantial surpluses which enabled them to allocate their funds to asset classes without constraints, except those dictated by prudence. There is no universally agreed basis for scientifically specifying what allocation is prudent, though attempts are made by actuaries to illustrate the possible distribution of outcomes for employers' future contributions of alternative allocations of assets. In practice, the fallback guide to prudent allocation is the allocation of other pension schemes. Most schemes had not strayed very far from the average allocation and we were told by trustees that actuaries advised them to move towards the consensus allocation - in particular, trustees of schemes with relatively high investments in property were given this advice.

4.6 The use of pooled investment funds

Pooled funds vary in structure from 'balanced' funds which hold investments in UK equities, overseas equities and bonds to very specialised funds which invest in a single overseas country or region. Another important category of pooled funds is tracker funds. Many, though not all, of the smaller schemes used pooled funds for investing all their assets. Three very small schemes operated separate segregated funds, but the trustees of one of these were considering switching to the use of pooled funds. At all three schemes, trustees had in the past controlled or influenced the selection of shares. Medium-sized schemes made use of pooled funds for investment in overseas equities and particularly for investment in emerging markets. Certain medium-sized schemes used specialised pooled funds for overseas fixed interest stocks and/or for investments in companies based in Europe, Asia, etc. The largest schemes limited their use of pooled funds to funds investing in special categories of equities such as venture capital and shares of small companies, investments in some overseas markets and tracker funds.
4.7 The use of tracker funds

Tracker funds were used by more than half the very large schemes but the extent of use of tracker funds varied from 15 to 70 per cent of their assets. The use of the tracker approach by smaller defined benefit schemes was much less common. Two of the six defined contribution schemes used tracker funds. The main advantage of tracker funds given by trustees of the largest schemes was that it was easier to use tracker funds than to operate a discretionary active management policy successfully. To have a significant impact on performance and to stand a chance of beating the average which tracker funds should match, a scheme would have to take large stakes (bets) on individual companies and its purchases and sales would move market prices to the scheme's disadvantage. Other advantages of tracker funds mentioned by trustees were that they had in the past outperformed funds operated by many active managers and that the management charges were lower.

4.8 Contracting out

The eight defined benefit schemes which were not contracted out are distinguished in column 2 of Table 4.2. Whether a scheme was contracted out, or not, was not a factor which consciously affected trustees when deciding the investment strategies of the schemes.

4.9 Frozen schemes

Three of the sample schemes were frozen. Additional information about other frozen schemes was obtained from three professional trustees who had experience of administering many frozen schemes not included in the sample, in addition to the schemes in the sample of which they were trustees. Trustees of frozen schemes reported that the usual practice was that shortly before or after the decision was taken to freeze a scheme, equity and property assets were converted to gilts, cash or guaranteed bonds. The term of the bonds acquired was affected by the maturity of the scheme, essentially the term structure of the bonds chosen was selected to match the liabilities.14

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14 In one case the trustees had retained a property investment which had development potential and which was difficult to value.
5 CONTROL OF RISKS

5.1 Methods of assessing risks

We asked trustees how they evaluated risks and how they would like to evaluate risks. Most trustees had not obtained any risk statistics\textsuperscript{15} for their funds. Trustees of some larger funds referred to risk statistics which appeared in the reports of fund managers and actuaries, but our impression was that provision of these statistics was not widespread and, where trustees had access to them, they did not make much use of them. Nevertheless, trustees were clearly aware of risks and the possibility of, and effects of, a crash in equity prices was discussed with the trustees.

Trustees take a number of steps to limit risks. The appointment of expert actuaries and fund managers, and investment in a range of asset classes to damp down risks have already been noted. One explanation for employing more than one fund manager given by several trustees was to spread risks to avoid the poor performance of a single manager resulting in a fund having an overall poor performance. Also, selecting fund managers with different strategies was seen by some trustees as a risk-spreading strategy.

5.2 Measures taken to limit risks

In nearly all cases, the fund manager's terms of reference limited, usually to three or five per cent, the percentage of the scheme's assets which could be invested in any one company. The percentage of any company's equity which the fund could hold was also limited, generally to three per cent. (If a scheme holds a large percentage of a company's shares, the holding tends to be illiquid.) One small scheme was exceptional: it had about eight per cent of its assets invested in the shares of a leading bank and a similar percentage in a much smaller quoted company. At the time of the interview, both investments had performed well. Generally, apart from tracker fund managers, fund managers were not subject to restriction on the amount they could invest in any one sector of the market or industry, though they were expected to hold a wide range of investments.

5.3 Control of the use of derivatives

Pension schemes, if they use derivatives at all, use them for reallocating assets at low cost or hedging foreign exchange exposure. Certainly, the use, if any, of investment derivatives was reported by trustees to be limited in this way. Some schemes, particularly the smaller ones, made no use of derivatives at all. As noted earlier, a few schemes employed tactical asset managers to vary the allocation of assets and exposure to currencies through the use of derivatives, but the extent of the exposure was limited by guidelines. A few large schemes allowed the fund manager to use derivatives to hedge currencies and/or to use futures contracts to redeploy assets from one national or regional market to another. The textbook advantage of derivatives for such moves is the greater speed, the reduction in market impact and lower cost at which the change can be carried out. Apart from the use of derivatives by tactical asset managers, all of the uses of derivatives were reported by trustees to be

\textsuperscript{15} Risk statistics summarise the probability distribution of the possible performance of portfolios of assets and are based on analyses of historical data.
defensive rather than aggressive, and in no case were the effects of the use of derivatives to gear-up investments, to increase schemes’ investments in risky assets by, in effect, borrowing money to buy more risky assets.

5.4 Other measures to limit risks

Investments in emerging markets and venture capital which might be viewed as particularly risky made up very small percentages of total investments, and neither were more than five per cent of total assets for any scheme. Most of the largest schemes had some investments in emerging markets and for most of these schemes, investments in emerging markets exceeded investment in venture capital. Smaller schemes were less likely to invest in emerging markets or venture capital and again, where they existed, investments in emerging markets were more common than investments in venture capital.

The explanations given by trustees of larger schemes for slight or no venture capital investments included:

- poor returns on past venture capital investments;
- the conservative, risk averse, policy of trustees;
- difficulty in finding sufficient attractive venture capital investments;
- individual venture capital investments were too big to undertake.

In a couple of cases the explanation for having no venture capital exposure was experience of poor returns on this type of investment in the past. As noted earlier, a trustee of one very large scheme attributed the scheme’s very low investment in venture capital to its conservative approach: the scheme had high exposure to equities and the trustees did not want to be exposed to the risky end of equities as well. At another very large scheme with one per cent of its assets in venture capital, the explanation for not having invested more was said to be the difficulty of finding attractive venture capital investments. For a large scheme the problem described by the trustee was that the scheme was not large enough to invest amounts of, say, £20m in individual venture capital projects.

Investment in the sponsoring employer involves special risks for the active members of pension schemes because their pensions as well as their jobs are at stake if the employer fails. Also, pensioner and deferred members risk losing the fallback protection of the employer making up a scheme deficiency. Three-quarters of the defined benefit and defined contribution schemes did not invest in the sponsoring employer organisation, at all. For all the sample schemes which did invest in their sponsoring employer such investments represented less than the five per cent of total assets. The schemes which invested in their sponsoring employers’ companies were:

- four very large schemes which invested in shares of the sponsoring employer which formed a significant component of the FT-SE index as part of a tracker approach;
- one per cent of the assets of a large scheme were invested in the shares of sponsoring employer – a hangover from a larger, long-standing holding, and one defined contribution scheme allowed members to select shares in the parent company for inclusion in their scheme investments;
5.5 Responses to a fall in equity prices

- five schemes owned some property which was let to the sponsoring employer. There had been moves to reduce such property holdings, but, for very large schemes which own blocks of property, exclusion of any letting to the sponsoring employer would, according to the trustees interviewed, be inconvenient for both the pension scheme and the company;

- one medium size scheme loaned four per cent of its total assets to the sponsoring employer.

Many boards of trustees allowed their fund managers to change asset allocation and to increase liquidity at times, as opposed to remaining fully invested in equities at all times, and this was seen as a means of reducing risks. Also, the use of appropriate buy or sell disciplines by fund managers was seen as a risk reducing policy. The idea was that if the price of a particular share fell by, say, 10 per cent, the holding would be sold to limit the loss.

Although trustees were not asked whether their schemes borrowed to gear-up investments, from the information we obtained about asset allocation, it appeared that none of the schemes did borrow.

The possibility of a crash and/or sustained fall in equity prices was a focus of some of our discussions with trustees about risks. The main response of trustees was to refer to the history of recovery and further growth of equity prices after past crashes and set-backs. The trustee of a very large scheme commented: 'We are not greatly concerned - if markets fall, they will recover'. Another trustee commented:

'We do not see risks as academics do, in terms of volatility, the trustees lived through the 1974 collapse and the 1987 crash. We would be concerned about the whole thing going up in smoke, but the scheme has a wide spread of assets, it has chosen fund managers who hold a wide spread of investments and it has not set onerous targets'.

(Large/Very large, mature, DB, CO)

Other trustees commented:

'If the bottom fell out of the equity market we would wait for recovery. If the market did not recover the policy to adopt would be decided by the company, they would have to foot the bill'.

(Medium-sized, less mature, DB, CO)

'If the equity market fell and the scheme's surplus disappeared, the trustees would have to switch from equities to gilts. However, they would not expect a short term fall to cause such a switch - the scheme should be able to ride it out'.

(Medium-sized, mature, DB, NCO)

An experienced trustee of a large defined benefit scheme stressed the importance of future income streams, in the short term capital values were not important if the future income stream was not affected. Nevertheless, changes in relative asset prices do, however crudely, reflect changes in expected future income flows.
6 CHANGES TO INVESTMENT STRATEGIES

6.1 Changes to investment strategies made during the past five years

As noted earlier in the report, most schemes which we studied have performed well because of the unexpectedly high returns on investments, particularly on equities. In these circumstances dramatic changes of investment strategy would not be expected. Nevertheless, trustees are always looking for ways to improve the performance of their schemes and change policies with a view to doing this.

The most common change affecting half the defined benefit schemes was the replacement of existing fund managers or the appointment of additional fund managers or the initial appointment of fund managers. These changes were described in Chapter 3.

The second most common change of policy was to reduce investment in property as a proportion of total assets. (The number of schemes for which investment in property was reduced could miss out some schemes where the trustee interviewed was not aware of a change because he had only recently become a trustee.) The reasons for reducing investment in property, including the recent and expected relatively low returns on property, have been described in Chapter 4.

There had been a diversity of changes to asset allocation. These included both increases and reductions in the percentage of assets invested in equities, reductions in the allocation of funds to fixed interest and index-linked bonds. Other examples of changes were increased investment:

• in Pacific Rim countries (very large scheme);

• overseas to avoid political risk in UK. (The interviews took place prior to the May 1997 election and the political risk foreseen by the trustees was the election of a Labour Government which would adopt policies which would reduce the real value of UK assets) (very large scheme).

The Pensions Act 1995 was not cited as the reason for many changes in investment policies. The Act was not reported to have contributed to any of the decisions to appoint or change fund managers or to reduce property investments. The debates about self investment which preceded the Pensions Act 1995 were an influence on several schemes to reduce, or eliminate altogether, their investments in properties which were let to the sponsoring employers. A trustee of a large scheme attributed an increased allocation to gilts (fixed interest government bonds) from equities, reducing equity holdings from 90 per cent to 80 per cent of the scheme’s assets, which was made by the trustees in 1994, to anticipating ‘the way things were going’ with the Pensions Act 1995. The new allocation was based on a study of the scheme’s liabilities by the scheme’s actuary ‘that would help us meet the MFR when it came in’. This was an isolated example of the Pensions Act 1995 and its antecedents having caused a substantial reallocation of assets from equities to gilts.
6.2 Expected changes to investment strategies over the next three years

Trustees were asked what, if any, changes in the investment strategy of their scheme they expected during the next three years. The most common response was the negative one: that most trustees could not identify any change they expected to make. Several trustees referred to the effects of the increasing maturity of their schemes at some time in the future, but usually the effects were not expected to have an impact on investment policy over the next three years. Also, there were some indications of a move to reduce holdings of equities and increase investment in gilts in response to the Pensions Act 1995. Examples of changes affecting asset allocation towards greater investment in bonds and less in equities which were contemplated by trustees were:

- the adoption of a more cautious policy at least in part because of uncertainty about the effects of the Pensions Act (large scheme);
- a possible reduction in investment in equities and increased investment in gilts as a result of an asset liability study which the scheme had commissioned. (The need for a formal statement of investment principles introduced by the Pensions Act 1995 may have brought forward the commissioning of the study but there were other influences on the timing of the decision including new accounting standards) (large scheme);
- 'over time the [provisions for the MFR in the] Pensions Act may lead to a larger allocation to gilts and less to overseas investments' (medium-sized scheme);
- two separate schemes with a single sponsoring employer operated a combined investment fund with one board of trustees. As a result of the Pensions Act 1995, the schemes would have to operate separate investment funds and this would affect asset allocation, increasing investment in gilts (large scheme);
- a firm of pension administrators which provided actuarial services for a scheme were currently assessing its MFR position and were expected to inform the trustees that they should reduce the scheme's holdings of equities and increase the fixed interest component by 20 per cent of the total assets. The trustee interviewed regretted the scheme would have to make such a transfer because of the lower average return on gilts relative to equities (medium-sized scheme).

Other examples of changes in asset allocation contemplated by trustees were:

- to reinvest in equities if the market fell (medium-sized scheme);
- to go back into index-linked bonds if inflation takes off (medium-sized scheme).

Trustees were also considering changes to their arrangements for managing their funds. Examples of the changes affecting fund management were:

- the use of a tracker fund for overseas equity investments (large scheme);
- the use of specialist fund manager (large scheme);
the trustees were considering abandoning a segregated fund and using pooled vehicles. (The actuary to the scheme was pressing for the change arguing that the fund was too small to actively buy and sell, and needed to work its assets harder. Also, the actuary pointed to the fund being under-invested in overseas equities. The need to recruit a new generation of trustees and the Pensions Act were additional pressures for this change.)

small scheme;

the scheme may, together with the pension schemes of other subsidiaries of the international group, use common investment funds to reduce costs (large scheme).

6.3 Reasons for not changing investment strategies

The overwhelming reason given by trustees for not expecting to change their investment strategies was that they were satisfied with the arrangements and performance of their schemes. Several trustees also referred to the large surpluses as a reason for not being under pressure to make changes. This might be expected to lead trustees to increase the equity content of their portfolios, but, in practice, the strong rise in equity prices had led to caution about at least the short term prospects for equities and, as reported in Chapter 4, had led one leading fund manager to reduce the exposure of the funds he managed on a discretionary basis to equities. Another reason why trustees could not foresee changes they would make was that where changes were considered necessary, they had been made. Some trustees expected their scheme would make changes in response to events, but they could not foresee what these events would be.
7 INFORMING MEMBERS ABOUT INVESTMENT DECISIONS AND STRATEGY

7.1 Newsletters

For many of the employees of the companies which operated the sample schemes, their pension rights were a very valuable part of their remuneration packages, so it was not surprising that employers took steps to inform employees about their pension schemes. There were a number of channels of communication for providing members with information about the schemes. For most of the larger schemes the principal channel was a newsletter (booklet, review) usually distributed once a year to members. Typically the newsletters contained information about:

- the trustees with some curriculum vitae details, including age, professional qualifications, date of joining the company, position in the company, year of joining the board of trustees;
- the number of members;
- an outline of the actuaries' report on the scheme;
- allocation of the fund to asset classes with comparative figures for the previous year;
- a list of the largest investments;
- the names of the fund managers and advisers to the scheme;
- a summary of the income and expenditure of the scheme;
- details of changes in benefits.

Generally, newsletters did not discuss, or made limited reference to, investment strategies or investment policy issues, but there were exceptions. One newsletter described the political and economic background to investment and gave a brief description of the investment activity of the scheme and the reasons for the policy changes which had been made.

A few large employers had company newspapers in which they included columns discussing pension fund matters.

7.2 The annual report and accounts

For all the sample schemes a report and accounts were prepared each year and copies were made available to members; for example, one company distributed two copies of the report to each of its 1,300 operating sites in the UK. Members were reported to show little interest in the reports or obtaining copies. Smaller schemes which did not distribute newsletters tended to circulate copies of the report and accounts to members. In some cases the report and accounts included an investment report which described the investment policies of the trustees, the changes in investment policies during the year and the reasons for the changes.
7.3 Distribution

Companies which distributed pension scheme newsletters and/or copies of the report and accounts for their schemes invariably sent them to active members and usually sent them to pensioners. Practice on sending copies to deferred members varied. Of the trustees who did know whether or not copies were sent to deferred members, the majority reported copies were not sent. Schemes which sent copies to deferred members could, of course, only send to those whose current addresses they held. There appeared to be some variation in the effort which schemes put into maintaining an up-to-date record of these addresses. A minority of smaller schemes did not circulate members with information about their schemes. Trustees of two of these schemes made a reference to 'before the Pensions Act'.

7.4 Other channels of communication

Other channels of communication included committees and contact between trustees and members. It was not possible to obtain information about these channels of communication for many of the schemes. However, an employee trustee of a medium-sized scheme reported that there was a committee of employee representatives from all the employer's factories to which the employee trustees reported. When asked whether this committee discussed investment strategy, the trustee replied: 'We [the trustees] tell them everything'. At a recent meeting there had been a lively debate about the performance and retention of the fund manager. Some other schemes had similar committees; for example, one large scheme had a Pensions Consultative Committee made up of 24 people from the company's sites. The purpose of the committee was for the trustees and manager of the scheme to pass on information about the scheme and for employees to give their views. The manager of a large scheme visited all the company's sites in the UK to inform members about the pension scheme. At a firm with fifty employees, the employee trustee clearly kept other employees aware of matters concerning the pension scheme and his concerns about the scheme.
## GLOSSARY

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
<th>Further Reference</th>
<th>See also:</th>
<th>Additional Notes</th>
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</thead>
<tbody>
<tr>
<td>Active Management</td>
<td>Active portfolio management is the managing of a portfolio of assets with the aim of outperforming an index or benchmark. This may be done via two types of activity: <strong>Asset Allocation</strong>, which requires forecasts of broad-based (asset class) market movements, and security (stock) selection, which involves selection of those securities which are perceived to be underpriced in the market. The intention of Active Management is to outperform a <strong>Passive Management</strong> strategy.</td>
<td>Kane (1992) p 13</td>
<td>Asset Allocation, Passive Management.</td>
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<tr>
<td>Asset Allocation</td>
<td>Asset Allocation is the split of funds in a portfolio between asset classes, as part of an <strong>Active Management</strong> strategy. At a basic level the allocation is between 'risky' long term assets such as equities, and 'safe' short term assets such as fixed-income securities.</td>
<td>Kane (1992) (1) p 13</td>
<td>Active Management.</td>
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<td>Asset Liability Modelling/</td>
<td>Asset liability modelling is a technique used to determine the most appropriate way of managing a pension scheme's funds (or a business's funds). This takes into account assets, liabilities, capital, risk, liquidity and cash flow, and selecting the strategy appropriate for the maturity and other characteristics of a particular pension scheme.</td>
<td>Lewis (1992) p 70</td>
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<td>Studies</td>
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<td>Benchmark</td>
<td>A (scheme specific) benchmark gives a rule or set of rules as to the general allocation of funds for a particular pension scheme. For example, a benchmark may stipulate that x per cent of the funds be invested in equities and y per cent in bonds.</td>
<td>CAPS (1996) p 50</td>
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<td>CAPS</td>
<td>Combined Actuarial Performance Services Limited (CAPS) is an independent investment performance measurement service for the UK, covering over 1800 pension funds. CAPS was set up as a joint venture of firms of consulting actuaries.</td>
<td>NAPF Yearbook (1997) p 285</td>
<td>Performance Evaluation.</td>
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<td>Closed Schemes</td>
<td>A closed pension scheme is one which does not admit new members, but contributions may still be made by existing members and/or the employer. Members continue to accrue new pension rights.</td>
<td>Goode (1993) p 600</td>
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<tr>
<td>Term</td>
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<td>Contributions Holiday</td>
<td>A contributions holiday is a period during which employers’ and/or employees’ contributions to the fund are temporarily suspended, either in full or in part, generally when the fund is in surplus.</td>
<td>Goode (1993) p 602.</td>
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<td>Defined Benefit (Salary Related)</td>
<td>In a defined benefit scheme the employer undertakes to pay members a pension based on the length of service and salary.</td>
<td>Davis (1992) p 129.</td>
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<td>Defined Contribution (Money Purchase)</td>
<td>Money purchase benefits are benefits paid to a member of a pension scheme, the rates or amounts of which are calculated by reference to the value of the fund which has accumulated in respect of contributions paid by or on behalf of the member and not according to salary considerations. A money purchase scheme or defined contribution scheme means a pension scheme under which all benefits which may be provided are money purchase benefits. In a money purchase scheme contributions are fixed and benefits vary with market returns.</td>
<td>Pension Schemes Act 1993 (s. 181(1)).</td>
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<td>Derivative</td>
<td>Derivative is a generic term for futures, options and swaps - financial instruments of trade which are derived from conventional direct dealing in securities, currencies and commodities. They are often used as a safeguard against exchange rate changes and fluctuations in security prices.</td>
<td>Bannock and Manser (1995) p 80.</td>
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<td>Diversification</td>
<td>Diversification is the spreading of a fund between asset classes so as to reduce the overall risk element of the portfolio of assets.</td>
<td>Elton and Gruber (1991) p 31.</td>
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<td>Frozen Scheme</td>
<td>A frozen pension scheme is one where no further contributions are payable and no further benefits accrue but members are entitled to preserved benefits.</td>
<td>Goode (1993) p 604.</td>
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<td>Fundamental Analysis</td>
<td>Fundamental analysis involves the study of financial accounts and other information about companies in order to form expectations about future share price movements.</td>
<td>Bannock and Manser (1995) p 396.</td>
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</table>
Minimum Funding Requirement
Defined benefit occupational pension schemes are subject to a requirement that the value of the assets of the scheme are not less than the amount of the liabilities in the scheme. This is designed to provide protection for members if the scheme winds up or the sponsoring employer becomes insolvent. The MFR applies from the first valuation on or after 6 April 1997. Under the MFR, pensioner liabilities are calculated by reference to the long term rate of return on investment in gilts, and liabilities in respect of non pensioners by reference to the long term rate of return on investment in equities. The calculation of liabilities is compared with the market value of the assets.


Passive Management
A passive portfolio management strategy allocates funds to a small number of asset classes and varies this allocation only when the specific circumstances of the pension fund and members change. A passive management strategy, therefore has very low management costs.

See also: Active Management.


Performance Evaluation
This is a set of techniques in finance used to determine whether the portfolio of a fund manager earns suitable returns, after adjusting for risk. These techniques compare the portfolio's performance against a Performance Benchmark, for example a share index or alternative measure. A fund manager may have a Performance Target - a level of returns which he or she is required to attain. For example this may be the average performance of all funds. Large pension schemes generally subscribe to a performance measurement company such as CAPS or WM.

See also: CAPS, WM.


Pooled Funds
A pooled fund (Pooled Investment Vehicle) is a fund which combines its resources with those of others. The pooling may be via investment in a unit trust, or in a fund managed by an insurance company. In pooled investment funds the assets of each participating fund are amalgamated and each investor (fund) owns units in the total pool. Generally speaking, pooling is more likely for small schemes, allowing them to hold a greater range of assets than they would be able to hold directly.


Returns
Return (on investment) shows the interest or dividend, plus the capital appreciation or less the capital loss, as a percentage of the value of the relevant assets.


Segregated Fund
A segregated fund has its investments managed by an external investment manager independently of any other funds under the manager's control.

Strategic Asset Allocation

The Strategic Asset Allocation is the long term allocation of assets which is suitable for the financial characteristics of a particular pension fund.

See also: Asset Allocation, Tactical Asset Allocation.


Tactical Asset Allocation

Tactical asset allocations (also called market timing) change a portfolio over time to take advantage of present and expected future relative performance in the bond and stock markets.

See also: Asset Allocation, Strategic Asset Allocation.


Tracker Fund

A tracker fund is a portfolio which is constructed so as to move in line with a specific index, such as the FT-SE 100. The more closely the tracker fund is required to follow the index, the more transactions need to be made for the fund to keep in line, and thus the heavier the transactions costs. Therefore, there is a trade-off between transactions costs and tracking error.


WM

The WM (World Markets) company is a world-wide independent investment information services company which provides, amongst other services, performance measurement services to pension funds and other investing institutions.

See also: Performance Evaluation.

BIBLIOGRAPHY


'The Pensions Act (1995)', HMSO.

APPENDIX I  THE QUESTIONNAIRE FOR ADMINISTRATORS

Pension Scheme Investment Strategies

The Scheme

Name of Scheme .................................................................

Market value of the scheme’s assets: £ .............

date of valuation Month ............. Year .............

The scheme’s liabilities: Total £ .............

of which for:
  active members £ .............
  deferred members £ .............
  pensioners £ .............

date of valuation Month ............. Year .............

Contributions from:

  the employer\(^1\) (as percentage of payroll costs) ............. %
  employees (as percentage of pensionable pay) ............. %

Numbers of members of the scheme:

  active members\(^2\) .............
  deferred pensioners/members\(^2\) .............
  current pensioners\(^2\) .............

Is the scheme based on:

  a. defined benefits/salary related benefits? □
  b. defined contributions/money purchase? □
  c. benefits which are calculated using both methods? □

\(^1\) If the employer or employees are having a contributions holiday please state the normal contribution rates. If the contributions vary for employees, please provide an estimate of the average percentage.

\(^2\) Active members refers to current employees who are members.

Deferred pensioners or members are people who were members of the scheme but have left it, usually because they have joined a new employer. Contributions are no longer being made into the scheme either by the member or the employer. The rights are frozen or retained in the scheme until they are drawn as a pension or transferred to a different pension scheme.

Current pensioners are people who are currently receiving a pension. Please note that these will include survivors (e.g. widow(er)s and/or dependants) who receive pensions.
Is the scheme:

a. open to new members?

b. closed?

c. frozen?

Is the scheme:

contracted out of SERPS?

part contracted out/part contracted in?

c. contracted in?

When was the scheme set up?

Is the administration of the scheme carried out:

in-house

out-sourced

The Employer

The name of the sponsoring employer: .................................................................

Total number of full-time employees: .............................................................

Total number of part-time employees: ...........................................................

What is the nature of the main business carried out by the organisation? ..

.................................................................................................................................

Please state the year (or approximately the year) your organisation commenced its operations in Britain? .........................

Membership of the Scheme

What type of employees can join the scheme?

all employees in organisation

senior management only (including directors)

white collar/staff employees only

blue collar/works employees only

all employees in a particular subsidiary or the organisation

only those invited to join

some other group (Please specify)

.................................................................................................................................

5 Closed schemes are schemes where no new members are allowed to join but contributions may still be made by existing members and/or their employer. Frozen schemes are schemes which no new members are allowed to join and no contributions are being paid or will ever be made by members and/or the employer.

4 If the organisation commenced as a result of a take over or merger, please state the date the original business was set up.
### Board of Trustees (or Directors) of the Scheme

<table>
<thead>
<tr>
<th>Number of trustees (or directors)</th>
<th>........</th>
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<tr>
<td>of which:</td>
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<tr>
<td>trustees nominated by the</td>
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<tr>
<td>sponsoring employer</td>
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<tr>
<td>nominated by members</td>
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<tr>
<td>members of the scheme</td>
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<td>corporate trustees</td>
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<tr>
<td>professional trustees</td>
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<tr>
<td>independent trustees</td>
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</table>

How were member nominated trustees selected/elected? ..................
APPENDIX II  THE TOPIC GUIDE FOR TRUSTEES

I. Information about the Scheme and its Investments

1. What is the current financial state of the scheme? (The most recent valuation of assets relative to the latest valuation of liabilities, to indicate whether the scheme is in surplus or underfunded).

   Has the scheme’s viability in relation to the MFR been estimated?
   If yes, what was the result?

2. Is your scheme regarded as mature or less mature?
   How do you assess its maturity?

3. How are the scheme’s assets currently allocated between the main asset classes, (distinguishing UK and overseas investments, and traditional and index-linked bonds)?
   a. Does the scheme use pooled investment units/funds?
   b. Are any of the equities invested in tracker funds?
   c. How significant are investments in:
      (i) emerging markets?
      (ii) venture capital funds?
   d. Does the scheme invest in the sponsoring employer’s business?
      What proportion of the scheme’s assets are invested in this way?

II. The Decision Making Process

1. What are the principal elements of investment decision making which the trustees consider?

2. What is the present investment strategy of the trustees?
   How have you arrived at/decided upon the current investment strategy and allocation of assets?

3. How involved are the trustees in determining investment strategy?
   a. Do all the trustees make decisions or are decisions delegated to a sub-committee?
      Where some decisions are delegated, which decisions are delegated, and how are trustees informed about decisions taken on their behalf?
   b. How do trustees seek to reach a consensus on matters concerning investment strategy?
   c. Who do trustees involve in the decision making process/from whom do they seek advice?
      How are the advisers appointed?
      What are their terms of reference?
      How do they interact with the trustees, fund managers, and the sponsoring employer?
      How, and to whom, do they report?
d. How are the interests of the sponsoring employer brought to bear on decisions concerning investment strategy?

   Does the sponsoring employer have a committee which reviews matters relating to the investment strategy of the pension scheme?

   If so, how does this committee interact with the trustees?

   Is there any overlap in the membership of this committee, the directors of the company, and the trustees?

e. What sorts of information do trustees use to help with investment decision making?

   How useful are these?

f. What steps, if any, do trustees take to train for their role as trustees, particularly in relation to making investment decisions?

4. What factors do trustees currently take into consideration when making decisions about investment strategy?

   a. the state of the markets.
   b. the level of contributions.
   c. the maturity of the scheme.
   d. the value of the assets relative to liabilities.
   e. forecasts/assessments of future returns on different classes of assets.

      if yes,

      what are the bases for the forecasts?
      what are the current forecasts?
      do the forecasts incorporate forecasts of future exchange rates?

   f. comparisons with other schemes/the industry standard.
   g. the duties and responsibilities set out in the Trustee Act 1925 and the Trustee Investment Act 1961 covering delegation and investment (in terms of what trustees can invest and how much of the funds of the pension scheme they can invest in, for example, gilts, equities, property, etc).

5. Do the trustees adopt an aggressive or passive approach to investment strategy?

   What factors would determine whether the trustees adopt a more aggressive/passive approach to investment?

III. Fund Manager(s) 1. If a fund manager (or managers) has been appointed for the scheme:

   a. When did you appoint your present fund manager?
   b. Who was involved in the process of selecting the fund manager?

      Were all the trustees involved in all stages of the process?
      What part did the sponsoring employer play in making the decisions leading up to the appointment?
      If the trustees did not appoint the fund manager, who did and why?
c. How was the manager selected?
d. How do you measure and assess his performance?
e. Does the scheme subscribe to a performance measuring/comparing service?
   If yes, which service?
   If no, why not?
f. Is the manager’s fee related to the performance of the fund?
g. How has the scheme performed under this manager?
   How does this compare with the performance of his/her predecessor?
h. Do you set targets for the fund manager?
   If yes, why, and what are they?
   If the trustees do not set targets, why not?
   How are the targets changed, if at all?
i. What reporting mechanisms exist between the fund managers and the trustees?
j. Do the trustees agree future strategy at meetings with the fund manager?
   To what extent do these agreements limit the manager’s scope for making changes between meetings?

2. a. How does the scheme control and monitor investments made on its behalf?
b. How do the trustees control and monitor:
   i. investment in derivatives?
   ii. investment in unquoted shares?
   iii. investment in partly paid shares?
   iv. underwriting new issues?
   v. investment in any one industry/company?
   vi. investment in businesses related to the employer organisation?
   vii. the rebalancing of investments in response to market movements?

IV. Risks and other Investment Policies

1. In what context and to what extent do trustees consider the scheme is exposed to risks?
   How do trustees evaluate risk?
   How would they like to evaluate risk?
   What risk statistics are reported to trustees by the fund managers?
   What steps do you take to limit the risks?
2. What policy stances do trustees have, and how do they implement policies to:
   a. influence directors of companies in which their scheme invests to conform to recent proposals/guidelines for corporate governance?
   b. place constraints relating to ethical, environmental, or political considerations on the investments made for the scheme?

V. Changes in Strategy

1. Have the trustees changed their investment strategy or instructions, in non-trivial ways, to fund managers in the last five years?
   a. What were these changes?
   b. Why were the changes made?
   c. Have changes in the maturity of the scheme caused changes in strategy?
   d. Have changes in the extent of the surplus/deficit of the scheme influenced changes in strategy?
   e. Have the changes affected or been affected by:
      (i) management costs?
      (ii) contribution rates?
   f. Have any changes in the employment practices of the sponsoring employer affected the scheme’s investment strategy?
      In particular, has any shift towards employing more employees on fixed term or short term contracts, or more part-time employees, affected investment strategy?
      Might such changes have effects in the future?
   g. Have changes in expectations about the future rate of inflation affected the scheme’s investment strategy?
      If yes, how?

2. Do you foresee that there will be any changes in the investment strategy of the scheme during the next three years?
   a. What are these changes?
   b. Why are these changes being made?
   c. Do you expect changes in the maturity of the scheme to cause changes in investment strategy?
   d. Will the changes affect
      (i) management costs?
      (ii) contribution rates?

3. If the trustees do not intend to make any changes to their investment strategy, either now or in the future, why is this?
VI. Information Provision

1. What information do the trustees currently provide about their investment decisions and strategy?
2. To whom do they provide the information?
3. How do they make it available?

VII Trustees

Please provide the following information for the trustee(s) interviewed.

Name of trustee .................................................................
Professional qualifications ...................................................

Is the trustee:

nominated by the sponsoring employer? YES/NO
nominated by members? YES/NO
an independent/corporate/professional trustee YES/NO

If the trustee was nominated by members, how was he selected?

------------------------------------------------------------------
Note: The main allocation of assets for all of the pension schemes is shown in Table 4.2 and is not repeated in the following case studies.

Case Number 1

Size £1bn or more
Maturity Less mature
Type of scheme Defined benefit
Status Contracted out

The scheme was started in the 1920s. The results of an MFR calculation showed a surplus.

There were eight trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There was one internal fund manager.

The scheme had less than two per cent of its assets invested in emerging markets and none in venture capital.

Case Number 2

Size £1bn or more
Maturity Less mature
Type of scheme Defined benefit
Status Contracted out

The scheme was started before 1950. An MFR calculation showed a surplus.

There were nine trustees on the board of trustees, six of these were nominated by the sponsoring employer.

There was one internal fund manager.

Investments in emerging markets represented 2.3 per cent of the scheme’s assets and investments in venture capital a further two per cent.

Case Number 3

Size £1bn or more
Maturity Less mature
Type of scheme Defined benefit
Status Contracted out

The scheme started in the 1920s. The scheme was in surplus at the time of the interview. The results of the MFR calculation were not known.

There were nine trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There were three stock market managers: one using a tracker approach with 15 per cent of the fund and two active managers. There was also a property adviser.

Approximately three per cent of the scheme’s assets were invested in emerging markets. Investments in venture capital were negligible.
Case Number 4

Size: £1bn or more
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was set up in 1972 but the company had pension arrangements before 1972. The results of an MFR calculation showed a surplus.

There were nine trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There was one external stock market and one property manager.

Investments in emerging markets represented 2.4 per cent of the scheme's assets. Investments in venture capital were negligible.

Case Number 5

Size: £1bn or more
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was started in 1971. An MFR calculation showed a surplus.

There were nine trustees on the board of trustees, four of whom were nominated by the sponsoring employer.

There were eight fund managers, including a tactical asset manager using derivatives.

Investments in emerging markets represented three per cent of the scheme's assets. One per cent of the scheme's assets were invested in venture capital.

Case Number 6

Size: £1bn or more
Maturity: Mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was set up in 1950. An MFR calculation showed a surplus.

There were 13 trustees on the board of trustees, seven of these were nominated by the sponsoring employer.

There were nine fund managers with half of the fund invested with tracker fund managers.

The scheme had three per cent of its assets invested in emerging markets. The scheme had not invested in venture capital.
Case Number 7  
Size  £1bn or more  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme started in 1983. The results of an MFR calculation showed a surplus.  
There was one fund manager.  
The scheme had five per cent of its assets invested in emerging markets. A very small amount had been invested in venture capital.

Case Number 8  
Size  £1bn or more  
Maturity  Mature  
Type of scheme  Hybrid defined benefit and defined contribution  
Status  Contracted out  
The scheme was started in 1971. The results of an MFR calculation showed a surplus.  
There were 12 trustees on the board of trustees, six of these were nominated by the sponsoring employer.  
There were eight fund managers: one of which investing 15 per cent of the fund on a tracker basis.  
The scheme had less than five per cent of its assets invested in emerging markets. The scheme had no investments in venture capital.

Case Number 9  
Size  £1bn or more  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was started in 1972. An MFR calculation showed a surplus.  
There were 24 trustees on the board of trustees, 12 of these were nominated by the sponsoring employer.  
There were three external stock market managers with discretionary mandates and one internal property manager.  
A small percentage of the scheme’s assets were invested in emerging markets but the exact percentage was not known. Investments in venture capital represented three per cent of the scheme’s assets.
<table>
<thead>
<tr>
<th>Case Number 10</th>
<th>Size</th>
<th>£100m - £1bn</th>
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</thead>
<tbody>
<tr>
<td>Maturity</td>
<td>Less mature</td>
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<tr>
<td>Type of scheme</td>
<td>Defined benefit</td>
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<tr>
<td>Status</td>
<td>Contracted out</td>
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</tbody>
</table>

The scheme was started in 1985. The results of an MFR calculation showed a surplus.

There were seven trustees on the board of trustees, four of these were nominated by the sponsoring employer.

There were two fund managers with discretionary mandates and a property manager.

Less than three per cent of the scheme’s total assets were investments in emerging markets. The scheme had no venture capital investments.

<table>
<thead>
<tr>
<th>Case Number 11</th>
<th>Size</th>
<th>£100m - £1bn</th>
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</thead>
<tbody>
<tr>
<td>Maturity</td>
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</tr>
<tr>
<td>Type of scheme</td>
<td>Defined benefit</td>
<td></td>
</tr>
<tr>
<td>Status</td>
<td>Contracted out</td>
<td></td>
</tr>
</tbody>
</table>

The scheme was set up in 1976. The results of an MFR calculation showed a surplus.

There were eight trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There was one stockmarket manager and one property manager.

The scheme’s investments in emerging markets and venture capital represented between five and seven per cent of its total assets.

<table>
<thead>
<tr>
<th>Case Number 12</th>
<th>Size</th>
<th>£100m - £1bn</th>
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<tbody>
<tr>
<td>Maturity</td>
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</tr>
<tr>
<td>Type of scheme</td>
<td>Defined benefit</td>
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</tr>
<tr>
<td>Status</td>
<td>Not contracted out</td>
<td></td>
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</tbody>
</table>

It was not known when the scheme was set up. The actuarial valuation showed assets equal to liabilities. An MFR calculation showed a surplus.

There were nine trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There were six stock market managers, including a tactical asset manager, and a property manager. Two-thirds of the fund was managed by tracker fund managers.

Investments in emerging markets represented 1.5 per cent of the total assets of the scheme and investments in venture capital were insignificant.
Case Number 13

Size: £100m - £1bn
Maturity: Less mature
Type of scheme: Defined benefit
Status: Not contracted out

The scheme started in 1892. The results of an MFR calculation showed a surplus.

There were 11 trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There was one internal fund manager.

The scheme had 2.3 per cent of its assets invested in emerging markets. Less than one per cent was invested in venture capital.

Case Number 14

Size: £100m - £1bn
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was started in 1959. The results of the MFR calculation showed a surplus.

There were 10 trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one internal fund manager.

The scheme had very little of its assets invested in emerging markets or venture capital.

Case Number 15

Size: £100m - £1bn
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was set up 1943. The scheme had a surplus at the time of the interview. An MFR calculation had not been made.

There were six trustees on the board of trustees, three of these were nominated by the sponsoring employer.

There were two fund managers, a tracker fund manager for UK equities and an active manager for overseas equities.

Information about any investments in emerging markets and venture capital was not available.
<table>
<thead>
<tr>
<th>Case Number</th>
<th>Size</th>
<th>Maturity</th>
<th>Type of scheme</th>
<th>Status</th>
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</thead>
<tbody>
<tr>
<td>16</td>
<td>£100m - £1bn</td>
<td>Mature</td>
<td>Defined benefit</td>
<td>Contracted out</td>
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<tr>
<td>17</td>
<td>£100m - £1bn</td>
<td>Mature</td>
<td>Defined benefit</td>
<td>Not contracted out</td>
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<tr>
<td>18</td>
<td>£100m - £1bn</td>
<td>Mature</td>
<td>Defined benefit</td>
<td>Not contracted out</td>
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The scheme was set up in 1961. The scheme had a surplus at the time of the interview. The results of the MFR calculation indicated that the scheme had 'no problems'.

There were 18 trustees on the board of trustees, nine of these were nominated by the sponsoring employers.

There were two managers of stock market securities and one property manager.

Less than five per cent of the scheme’s assets were invested in emerging markets and there were no investments in venture capital.

The scheme was set up in 1961. The scheme had a surplus at the time of the interview. An MFR calculation had not been made.

There were six trustees on the board of trustees, four of these were nominated by the sponsoring employer.

There were three balanced fund managers, one managed more than 70 per cent of total portfolio.

Investments in emerging markets and venture capital were insignificant.

The scheme was set up in the 1920s. An MFR calculation showed a surplus.

There were seven trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one internal fund manager.

The scheme had 4.9 per cent of its assets invested in emerging markets. It held no investments in venture capital.
Case Number 19

Size: £100m - £1bn
Maturity: Mature
Type of scheme: Defined benefit
Status: Contracted out

It was not known when the scheme started. The results of an MFR calculation showed a surplus.

There were seven trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There were three fund managers; one which invested half the scheme’s assets operated on a tracker basis.

An insignificant amount was invested in emerging markets and even less in venture capital.

Case Number 20

Size: £100m - £1bn
Maturity: Mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme started in 1977. An MFR calculation showed a surplus.

There were 14 trustees on the board of trustees, seven of these were nominated by the sponsoring employer.

There were two fund managers.

There were some investments in emerging markets and venture capital but these were ‘a small percentage of the total assets of the scheme’.

Case Number 21

Size: £20m-100m
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was set up in 1978. A 1994 valuation showed the scheme was slightly underfunded. The results of an MFR calculation which had been made were not available.

There were six trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one fund manager.

Less than two per cent of the scheme’s assets were invested in emerging markets. No investments had been made in venture capital.
Case Number 22  
Size  £20m - £100m  
Maturity  Less mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was set up in 1995. The results of an MFR calculation showed the scheme was 'fully funded'.  
There were six trustees on the board of trustees, three of these were nominated by the sponsoring employer.  
There was one fund manager.  
Decisions whether to invest in emerging markets or venture capital were left to the fund manager. Any investments in either emerging markets or venture capital were said to be a very small percentage of the total assets of the fund.

Case Number 23  
Size  £20m - £100m  
Maturity  Less mature  
Type of scheme  Defined benefit  
Status  Contracted out  
It was not known when the scheme started. The results of the MFR calculation showed a surplus.  
There were 11 trustees on the board of trustees, seven of these were nominated by the sponsoring employer.  
There was one fund manager.  
There were some investments in emerging markets. An insignificant amount of the scheme’s assets were invested in venture capital.

Case Number 24  
Size  £20m - £100m  
Maturity  Less mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was set up in 1994. An MFR calculation showed the scheme was 'very adequately' funded.  
There were seven trustees on the board of trustees, four of these were nominated by the sponsoring employer.  
There were two fund managers.  
Investments in emerging markets represented 4.8 per cent of the assets of the scheme. Investments in venture capital were insignificant.
Case Number 25  
Size  £20m - £100m  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme started in 1984. The results of the MFR calculation showed a surplus.

There were seven trustees on the board of trustees, four of these were nominated by the sponsoring employer.

There was one fund manager.

There had been a small amount of investment in emerging markets. Less than two per cent of the scheme’s assets were invested in venture capital.

Case Number 26  
Size  £20m - £100m  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme started in 1973. The scheme was in surplus at the time of the interview. An MFR calculation had not been made.

There were seven trustees on the board of trustees, four of these were nominated by the sponsoring employer.

There were three fund managers.

There had been some limited investment in emerging markets. An insignificant amount had been invested in venture capital.

Case Number 27  
Size  £20m - £100m  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Not contracted out  
The scheme was very old. Calculations indicated that on an MFR basis the scheme was in surplus.

There were seven trustees on the board of trustees, four of these were nominated by the sponsoring employer.

There were two fund managers.

Investments in emerging markets represented between two and three per cent of the scheme’s total assets and investments in venture capital less than two per cent.
Case Number 28  
Size £2m - £20m  
Maturity Less mature  
Type of scheme Defined benefit  
Status Not contracted out  
The scheme was set up in 1974. The MFR calculation showed a surplus.  
There were three trustees on the board of trustees, all of these were nominated by the sponsoring employer.  
There was one fund manager.  
The scheme invested in a pooled investment fund. It was not known what, if any, investments had been made by the manager of the pooled fund in emerging markets or venture capital.

Case Number 29  
Size £2m - £20m  
Maturity Less mature  
Type of scheme Hybrid defined benefit and defined contribution  
Status Contracted out  
The scheme was set up in 1966. The results of the MFR calculation showed a surplus.  
There were six trustees on the board of trustees, all of these were nominated by the sponsoring employer.  
There was one manager who operated tracker funds.  
The scheme had not invested in emerging markets or venture capital.

Case Number 30  
Size £2m - £20m  
Maturity Less mature  
Type of scheme Defined benefit  
Status Contracted out  
The scheme was set up in 1965. An MFR calculation showed that the scheme was in surplus.  
There were five trustees on the board of trustees (until recently a firm of administrators had been the sole trustee of the scheme), all of these were nominated by the sponsoring employer.  
There was one fund manager.  
The scheme had not invested in emerging markets or venture capital.
Case Number 31
Size £2m - £20m
Maturity Less mature
Type of scheme Defined benefit
Status Not contracted out

The scheme was 'very old'. The scheme was 'soundly financed' at the time of the interview. An MFR calculation had not been made.

There were nine trustees on the board of trustees, five of these were nominated by the sponsoring employer.

There was one fund manager.

The fund manager 'had just started to move into' emerging markets but so far these investments were a small percentage of total assets. No investment had been made in venture capital.

Case Number 32
Size £2m - £20m
Maturity Mature
Type of scheme Defined benefit
Status Not contracted out

The scheme was set up in 1930. The MFR calculation showed a surplus.

There were 12 trustees on the board of trustees, six of these were nominated by the sponsoring employer.

There was one fund manager.

Less than five per cent of the assets were invested in emerging markets. No investments had been made in venture capital.

Case Number 33
Size £2m - £20m
Maturity Mature
Type of scheme Defined benefit
Status Contracted out

The scheme was started in 1983. The scheme showed a 'slight' surplus at the time of the interview. An MFR calculation had not been made.

There were six trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There were two fund managers.

It was not known if the pooled funds in which the scheme invested held investments in emerging markets or venture capital.
Case Number 34  Size  £2m - £20m  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was set up in 1968. The scheme showed a small deficit at the time of the interview. The MFR had not been calculated. 
There were seven trustees on the board of trustees, all of them had been nominated by the sponsoring employer. 
There was one fund manager. 
The scheme had made no investments in emerging markets or venture capital.

Case Number 35  Size  £2m - £20m  
Maturity  Mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was set up in 1978. The scheme had a substantial though declining deficit. The MFR had not been calculated. 
There were four trustees on the board of trustees, two of these were nominated by the sponsoring employer. 
There was one fund manager. 
Decisions about investments in emerging markets were left to the fund manager and it was not known how much if anything was invested in these markets. There were no investments in venture capital.

Case Number 36  Size  Less than £2m  
Maturity  Less mature  
Type of scheme  Defined benefit  
Status  Contracted out  
The scheme was started in 1974. The scheme was in surplus at the time of the interview. The MFR had not been calculated. 
There were three trustees on the board of trustees, two of these were nominated by the sponsoring employer. 
There was one fund manager. 
Information about any investments in emerging markets and venture capital was not available.
Case Number 37

Size: Less than £2m
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was started in 1984. The scheme showed a 'small' surplus at the time of the interview. An MFR calculation had not been made.

There were two trustees on the board of trustees, both of these were nominated by the sponsoring employer.

There was one fund manager.

Information about investment in emerging markets and venture capital was not available.

Case Number 38

Size: Less than £2m
Maturity: Less mature
Type of scheme: Defined benefit
Status: Part contracted out, part not contracted out.

The age of the scheme was not known. The financial state of the scheme was reported to be 'sound' at the time of the interview and the actuaries to the scheme had reported that the MFR would create 'no problems'.

There were 12 trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one fund manager.

The scheme may not hold any investments in emerging markets or venture capital. In any case such investments are a negligible percentage of the total assets.

Case Number 39

Size: Less than £2m
Maturity: Less mature
Type of scheme: Defined benefit
Status: Contracted out

The scheme was started in 1960. The scheme was in surplus at the time of the interview. An MFR calculation had been made and according to the actuaries the scheme would 'not be troubled by it'.

There were four trustees on the board of trustees, three of these were nominated by the sponsoring employer.

There was one fund manager.

There were no investments in emerging markets or venture capital.
Case Number 40

Size: £100m-£1bn
Maturity: Less mature
Type of scheme: Defined contribution
Status: Contracted out

The scheme started in 1988.

There were nine trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There were two fund managers, including one for bonds.

Less than five per cent of the assets were invested in emerging markets. An insignificant amount had been invested in venture capital.

Case Number 41

Size: £2m - £20m
Maturity: Less mature
Type of scheme: Defined contribution
Status: Not contracted out

The scheme had been set up in 1995.

There were six trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one fund manager appointed but members could choose from a wide range of pooled funds and investments.

An insignificant amount was invested in emerging markets and venture capital.

Case Number 42

Size: Less than £2m
Maturity: Less mature
Type of scheme: Defined contribution
Status: Not contracted out

The scheme started in 1984.

There were six trustees on the board of trustees, four of these were nominated by the sponsoring employer.

An administrator invested the scheme’s assets in pooled investment funds.

It was not known if the pooled funds invested in emerging markets or venture capital.
Case Number 43
Size Less than £2m
Maturity Less mature
Type of scheme Defined contribution
Status Not contracted out

The scheme was set up in 1963. The scheme was in surplus at the time of the interview.

There were four trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There was one fund manager.

An insignificant amount had been invested in emerging markets and venture capital.

Case Number 44
Size Less than £2m
Maturity Less mature
Type of scheme Defined contribution
Status Part contracted out, part not contracted out.

The scheme started in 1995.

There were three trustees on the board of trustees, two of these were nominated by the sponsoring employer.

There was one fund manager.

Information about asset allocation was not available.

Case Number 45
Size Less than £2m
Maturity Less mature
Type of scheme Defined contribution
Status Contracted out

The scheme was started in 1994.

There were five trustees on the board of trustees, all of these were nominated by the sponsoring employer.

There were four fund managers.

Information about investment in emerging markets and venture capital was not available.
Case Number 46

Size: £2m–£20m
Maturity: Mature (frozen)
Type of scheme: Defined benefit
Status: Contracted out

It was not known when the scheme started. The scheme had a surplus at the time of the interview.

There were three trustees on the board of trustees, two of these were nominated by the sponsoring employer.

There was one fund manager.

There were no investments in emerging markets or in venture capital.

Case Number 47

Size: £2m–£20m
Maturity: Mature (frozen)
Type of scheme: Defined benefit
Status: Contracted out

The scheme was started in 1988. The scheme was in surplus at the time of the interview.

There were four trustees on the board of trustees, two of these were nominated by the sponsoring employer.

There was one fund manager.

There were no investments in emerging markets or venture capital.

Case Number 48

Size: Less than £2m
Maturity: Mature (frozen)
Type of scheme: Defined benefit
Status: Contracted out

The scheme was set up in 1990. The scheme was in surplus at the time of the interview.

There were four on the board of trustees, all of these were nominated by the sponsoring employer.

There was one fund manager.

There were no investments in emerging markets or venture capital.
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