

Finding hidden value in your investment governance



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The Pensions Regulator is clear in its guidance – all trustee efforts should be focused on achieving one outcome: “paying pensions to members of the scheme as they fall due and paying them in full”. It sounds straightforward, but then follows numerous further pages of guidance on what good governance means. Three key risks are identified that trustees should be aware of: covenant risk, funding level and investment risk. Each of these risks are in a constant state of flux, and each of the three impacts the other two. To make matters more difficult, trustees tend to meet only 4-6 times a year.

Trustees may be able to fulfil their legal duties to scheme members by operating strict processes or delegating decisions. At LGIM, we know governance is top of mind for many of our clients and so the following paper sets out some practical ways for trustees to not only meet their legal obligations, but also to pay all pensions.

Here we focus on investment governance rather than governance in general (which includes things like administration, managing conflicts of interest, keeping members informed and so on). However some of the principles could also apply more broadly.

PROCESS, PROCESS, PROCESS

Our first point may sound the most obvious, but it is often the one where trustees fall down. Trustees should have a rigorous process for decision making and continue to document the detail, ensuring all relevant advice has been taken (and, if necessary, challenged). From a governance perspective it is the act of taking advice that is the key, and there is usually no requirement to act in accordance with the advice. What's crucial for trustees is thinking critically, and ensuring that scrutiny of advice is hard-wired into the decision making process. In terms of ensuring a rigorous process for decision making, trustees should have a governance checklist to refer back to.

A simple checklist misses that, given finite governance resources, the prioritisation of governance decisions matters. In a changing environment – be that changing market conditions, changing regulations or changing

scheme circumstances – priorities can shift, sometimes quite quickly. If the day-to-day process incorporates “governance triggers” it can generate a review process that allows trustees to react to a changing environment. Take EMIR, for example, and the regulation relating to what constitutes collateral. Just knowing that the regulation exists might be enough to tick the process box. Ensuring your investment manager has provided their advice will probably be enough to ensure the trustees can prove they were informed. However, whilst meeting the legal requirements due to the change in regulations is necessary for good governance, it is unlikely to be sufficient. Some changes to the way assets are managed are probably in the best interests of members. In a recent survey¹, trustees rated their schemes as more effective in achieving compliance than in achieving member-oriented outcomes, such as the scheme’s abilities to meet obligations. It’s important to keep in mind that good compliance and good governance are not the same thing.

A HOLISTIC APPROACH

A crucial problem for many schemes is that they are not viewed holistically. For example, they are often “divided up” into units run by different managers, which means that the pool of gilts that is perfect collateral is sitting somewhere different, usually within an LDI portfolio. There will be many arguments for using a different manager for LDI than for higher return-seeking parts of the portfolio. However, most schemes will not have counted the cost of the new collateral regulations on that manager’s performance or the additional costs of custody accounts, performance management, the trustee’s time governing multiple managers, and so on.

In every portfolio where the investment manager is taking currency (FX) views using derivatives, that investment manager needs to post collateral. Good governance can ensure that these additional collateral requirements are dealt with in the most effective way and, for example, that schemes are not accidentally under-invested in the market that they intend to be exposed to.

READY, STEADY, ACTION

Our experience is that the trustee meeting cycles by themselves may not be sufficient to capture all problems or opportunities that schemes may face. Put simply, most schemes are not able to act quickly enough. Governance triggers can help ensure that changes in circumstances are identified quickly. In addition to triggers, that may identify the need to react, it is important to plan ahead so trustees know how to react if a particular scenario materialises. For example, if rates stay low and transfer values are attractive as we have seen recently, schemes may face a surge in members opting to transfer. In this instance, trustees will find themselves searching for liquidity, and flexible governance would leave the scheme with some room for manoeuvre. In practical terms, the trustees could, for example, generate a set of triggers or guidelines that would allow the LDI manager to raise cash in a pre-determined and efficient way.

In our view the most well-governed schemes have worked closely with their advisors to create flexibility in the governance process, allowing for the scheme to react quickly to potential risks to scheme health, and to respond quickly to market opportunities that may not be available for long.

To summarise part 1:

- Governance is not the same thing as compliance and they should not be confused
- Instigate a process that allows for shifting priorities
- Create flexibility in your governance process to allow for speed of reaction e.g. by incorporating governance triggers

1. Effective Governance – the Art of Balance, Sackers /The Winmark PensionChair Network, May 2017

PRIORITISE AND FOCUS ON THE OUTCOME

It is always more satisfying to spend time doing things that are enjoyable. The downside of this is that we have observed many trustees spending large amounts of time, and therefore large amounts of the governance budget, on relatively small decisions given the only relevant outcome is to pay all pensions as they fall due.

The three key priorities for most pension schemes are to ensure that:

1. A reasonable level of diversification has been achieved
2. There is an LDI programme in place and the main risks to the scheme (rates and inflation) are hedged to an appropriate level given funding constraints
3. The strategic direction has been considered and the trustees are comfortable with the level of risk the scheme is running.

If any of these priorities have not been addressed or reviewed in some time, our advice would be this is a sensible governance focus.

Once they have been addressed, what next?

A recent survey² found that 65% of trustees are spending more time on governance than they were three years ago. However, the majority of boards still spend 20% or less of their time on governance (Figure 1). What this makes clear is the need for these limited governance budgets to be spent as effectively as possible. Our governance budgeting heatmaps (Figure 2) provide a potential way for trustees to think about the “what next” decision, and to get the biggest impact from their limited governance budget.

Figure 1. How much of trustee time is taken up by governance?

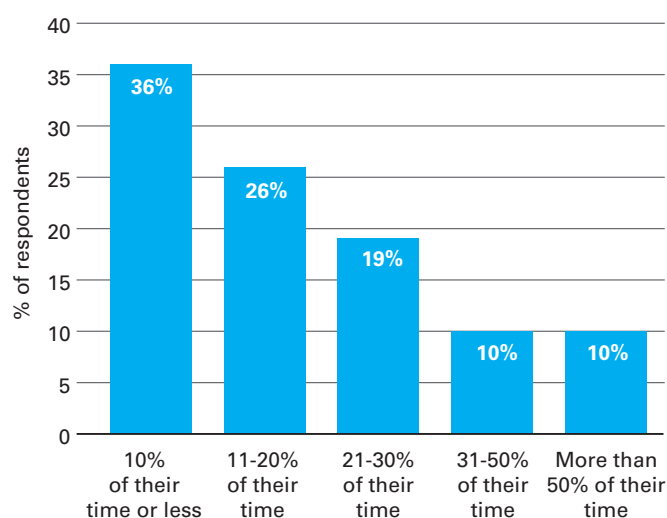
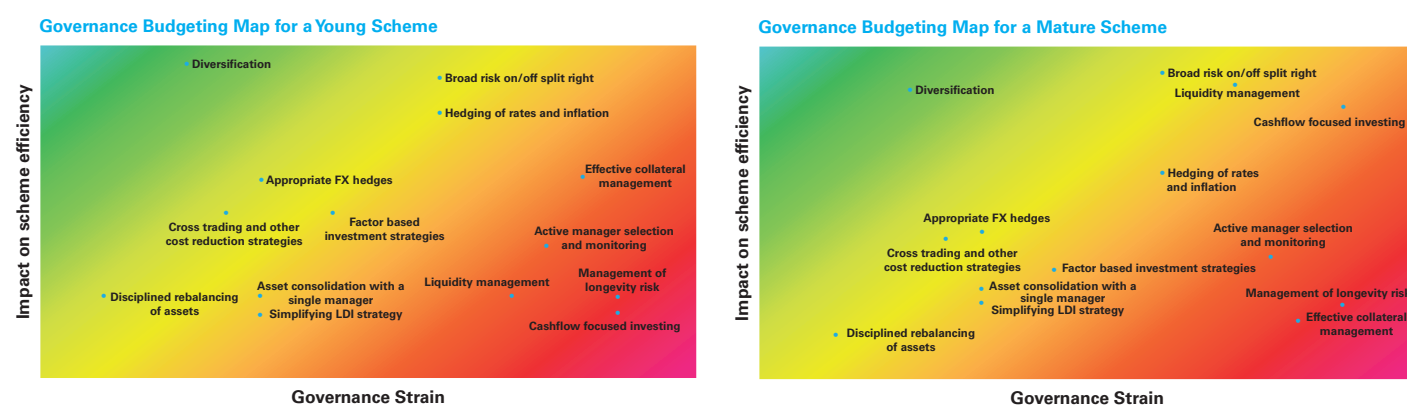


Figure 2. Governance budgeting heatmaps



We plot the impact on scheme efficiency of an action against the governance strain involved in making that action. Items in the top left of the chart deserve to be top of the to-do list – they represent small governance outlay for large efficiency gains. Items in the bottom right will still improve matters but the cost/benefit ratio is far higher. Our observation is that scheme trustees may spend large quantities of their governance budget choosing active managers and then monitoring active managers. When

the additional time spent learning about a new strategy or investment type is factored in, the potential scheme-level return from this activity may not be warranted.

As an asset manager with active capabilities, we at LGIM enjoy our regular updates with our investors. But from a purely outcome-orientated standpoint, schemes may be spending too much time having portfolio update discussions with multiple managers who in some cases

all run the same mandate (i.e. separate managers with responsibility for different parts of the same scheme's credit portfolio). Whilst the relative merits of manager diversification is another issue for another day, the more important question here is that – even if it adds some value - whether this diversification is an efficient use of governance time.

To summarise part 2:

- Governance time is precious. Use your governance budget as effectively as possible and ensure it evolves with the needs of your scheme

MIND THE GAP – SPONSORS ARE NOT INFALLIBLE

While the sponsor covenant is not a neglected piece of trustee governance process, it is rarely integrated into the normal asset and liability modelling work that trustees rely on when evaluating scheme health. In our most recent work in this area we have begun to treat covenant risk as a akin to the default risk of a corporate bond that is modelled in parallel with the scheme's assets and buyout liabilities. The results are very interesting, and are explored in our '[Covenant risk - modelling, managing and mitigating a key risk](#)' piece. With roughly one third of sponsors likely to default over the next 20 years, a number borne out by recent PPF data, a keen interest in the covenant should be high up a trustees governance list.

To summarise part 3:

- Consider using Asset Liability Modelling techniques that incorporate covenant risk to help inform decisions

UNLOCKING HIDDEN VALUE

On the surface we think most trustees are covering governance basics, but few are going the extra mile and looking holistically at the scheme. In our paper on [Liability Aware Investing](#) we highlighted the benefits for the scheme of trustees focusing purely on member outcomes. Holistic risk management is a crucial part of that thesis. As we have spent time looking at governance with trustees and their advisors it has become apparent that some small changes, in the right places, could reap potentially large benefits.

Tweaking current governance processes to include triggers, and creating the flexibility to allow for change, may sound obvious but is not apparent in many schemes.

Governance and governance best practice will constantly evolve. Trustees have a challenging task, but we hope we have at least started a mental check list on whether trustees can still do more, and more efficiently, in the limited governance time available.

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