Objectives of funds

1. Introduction

1.1. Chapter overview

Institutional investors make up the vast majority of the investors in the financial market. Of these pension funds are the largest institutional investors, followed by insurance companies, collective investment schemes (such as unit trusts) and then investment trust companies.

The factors affecting by these funds when considering asset allocation are much the same as the factors affecting individuals: primarily the fund objectives – their expectations on risk and return – and the constraints put upon them by time horizon, liability structures, liquidity requirements, tax obligations and legal requirements.

This chapter does not investigate the structure of the institutions themselves, but instead focuses on the likely objectives and constraints on these funds. It also considers how this is likely to have an impact on the asset allocation within the portfolios under management.

The greatest emphasis in the exam, as you will see, is on the pension funds.

1.2. Learning outcomes

On completion of this module you will:

Major funds in the UK

- 5.7.3 - Explain the return objectives of the major fund types
- 5.7.4 - Classify funds by their income / capital growth requirements
- 5.7.5 - Explain the effect of each of the following on a fund's asset allocation: time horizons, liability structure, liquidity requirements
- 5.7.7 - Explain the effect that taxation legislation may have on the stock selection and asset allocation of a fund

Objectives and constraints of pension funds in the UK

- 5.7.1 - Explain the features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC))
- 3.2.11 - Explain the significance of the Pensions Act 2004: scheme specific funding requirement, the Pensions Regulator, the Pension Protection Fund
- 3.2.12 - Explain the purpose of a Statement of Investment Principles
- 5.7.8 - Identify other types of legal requirements that affect pension funds

Objectives and constraints of insurance companies in the UK

- 5.7.1 - Explain the features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC)), life assurance, general insurance

- 5.7.8 - Identify other types of legal requirements that affect insurance funds

General comments

- 5.7.2 - Distinguish among the typical asset allocations for DB and DC pension funds, life assurance and general insurance funds

2. Major funds in the UK

2.1. The return objectives of major funds types

Like individual investors, funds will have set objectives that they wish to achieve. These will be set down in the constitutional documents for that particular institution, for example the trust deed for a unit trust or a statement of investment principle for an occupational pension scheme.

These objectives can be divided into two broad categories:

- Maximising returns
- Matching liabilities

If we consider the major fund types in the UK (pension funds, insurance companies, collective investment schemes and investment trusts), we can make the following groupings.

Table 5.

Maximising returns	Meeting liabilities
Defined contribution pension scheme	Defined benefit pension scheme
Collective investment scheme	Life assurance company
Investment trust company	General insurance company

Liability driven investment

Those funds that need to meet liabilities are said to engage in liability driven investment or asset and liability matching strategies. Institutions will try to ensure that the returns generated by any investment will meet the liabilities due on their due date.

Many liability driven investment strategies make use of fixed income securities, such as government bonds. These give predictable cash flows that can be matched with the timings of liabilities; a process called dedication or cash flow matching.

It is also important to identify what types of liabilities the fund faces. Again, these can be broadly divided into two categories: real liabilities and nominal liabilities.

Real liabilities are those that are affected by inflation. For example, if we consider a defined benefit pension scheme linked to an employee's final salary. The employee is not due to retire for 20 years. In this scenario the liability that the pension fund needs to meet is exposed to the impact of salary inflation – one would imagine that over the next 20 years, the employee's salary will increase. Clearly, this will not always be a long-term liability, and, in 15 years, the liability becomes more imminent. Most long-term liability driven funds will adjust their asset allocation accordingly when the liabilities draw near.

In these situations, cash flow matching may not be appropriate, as the investor would need to anticipate inflation over a long period of time. Often investors facing real liabilities to match will use real assets – those that typically increase with inflation – such as equities and index-linked instruments.

2.2. Influences on fund asset allocation

As mentioned in the chapter on client objectives, asset allocation is considered to have the greatest impact on the returns of a portfolio. This is as true for institutions as it is for individuals. Elements that could impact on a fund's allocation include:

Time horizons

The length of time a fund is able to commit its resources to investments is key to asset allocation. The longer term the investment horizon, the more short-term risk a fund will be willing to take. In addition, a longer investment horizon will have an impact on the funds attitude to liquidity and, possibly, inflation.

For example, consider a whole-of-life assurance policy for a healthy person in their thirties. Probability would suggest that the liability faced by the insurance company on this particular policy is a long way in the future. This would allow the company to take an increased level of short-term risk without too much concern about liquidity, possibly opting for equity and property within the portfolio.

Compare this with a general insurance company offering car insurance. Car accidents occur all the time, and the general insurance companies will pay out immediately. These immediate and uncertain liabilities would lead the company to take a short-term view of investments, possibly choosing cash deposits or money market instruments.

Tax

The tax status that a fund is subject to has a major impact on the assets used for investment. Insurance companies are liable for tax on their investments, so consideration needs to made.

Mutual funds in the UK, such as unit trusts and investment trust companies, also pay tax, but typically only on interest income from bonds and deposits or property income, if relevant.

Some funds, such as pension funds and charities, pay no tax on investment returns (income or gains). However, there will be tax implication. Where investments are received net of tax, the manager will need to factor in the time to reclaim the tax. In addition, these funds are likely to avoid tax-free investments. Investments, typically, are tax free for a reason, and that is typically an additional risk to capital.

Legal and regulatory restrictions

Many funds have restrictions placed upon them by laws and regulations.

Authorised collective investment schemes in the UK must adhere to the FCA collective investment scheme sourcebook, which restricts the asset classes and the concentration of those assets within a fund.

General insurers are required to keep solvency margins, expressed as a percentage of net assets to net premiums.

All funds will be governed by their constitutional documents, which once filed, become binding on the fund.

Other considerations

Many funds restrict the allocation of assets in other ways. Socially responsible investment funds will place restriction on investing in unethical firms, eliminating investment issued by, among others, arms companies, tobacco companies or countries with questionable human rights records.

3. Objectives and constraints of pension funds in the UK

3.1. Features of pension funds

A pension fund is an investment scheme where the contributors are saving for retirement.

Provided the pension scheme is approved by the HMRC Pensions Schemes Office, it will enjoy certain tax benefits:

- Contributions to an approved pension fund are free of tax
- Whilst investments are in the fund, any capital gains or income are not subject to tax
- However, when the pension fund begins to pay out a pension, the recipient will be subject to income tax on their pension income

In the UK, National Insurance payments contribute towards a state pension scheme.

There are also pension schemes provided by companies (‘sponsoring’ companies) for their employees - these are known as **occupational pension schemes** (OPSs).

Alternatively, an individual may take out a **personal pension plan** from a private pension provider.

3.2. Stakeholder pensions

Stakeholder pensions were introduced on 6 April 2001. They allow a low cost pension alternative to the self-employed and to middle-income employees.

Employers are generally obliged to offer stakeholder pensions to their staff unless they already offer adequate pension arrangements or have less than five employees. Alternatively, the pensions can be bought directly from pension providers.

3.3. Occupational pension schemes

Types of occupational pension scheme (OPS)

There are two types of OPS: **defined contribution** schemes and **defined benefit** schemes.

Defined contribution schemes

These are schemes where the sponsoring company contributes a set amount to the fund on the employee's behalf.

These contributions are invested and grow over time.

The returns from the investments determine the pensions paid.

Defined benefit schemes

These are schemes that guarantee to pay a pension of a certain size once the employee retires, i.e. a fixed percentage of the employee's final salary.

The returns from the investments in defined benefit schemes are known as 'actuarial' returns.

In the US and the UK, there has been a noticeable shift towards defined contribution and away from defined benefit schemes by employers. Personal pensions are usually of the defined contribution type.

Many defined benefit schemes, have switched away from equities towards bonds. A number of schemes have adopted liability-driven investment (LDI) strategies that involve not just a switch to bonds, but the use of swaps and other derivatives to more accurately match assets to liabilities. The sponsoring company must first appoint a trustee.

Approval of an OPS

The schemes are approved by the HMRC Pensions Scheme's Office.

Approved pension schemes enjoy tax benefits, e.g. no income or capital gains tax liabilities.

The trustee

The trustee will be appointed by the sponsoring company to oversee the running of the fund and take legal ownership of the scheme's assets. They are responsible for the creation of the statement of investment principle, setting out the nature of the fund. The trustee also has the final say over decisions regarding the scheme and essentially is the representative of the beneficiaries of the scheme.

Although we will see later that the trustee can delegate some of his roles to others, the trustee retains overall responsibility.

The trustee will consult with the sponsoring company to draw up a **statement of investment principles** (SIP).

The investment manager

The trustee appoints the investment manager.

The trustee must take every care in selecting and supervising the investment manager, as it will be the trustees who will be held ultimately responsible for any losses or criminal acts that are perpetrated by the investment manager.

The trustee must ensure that the investment manager adheres to the regulations and objectives of the fund.

However, the investment manager maintains responsibility for the investment strategy i.e. achieving the objectives set by the trustee.

Investment strategy

The age of the fund's members is an important consideration regarding the investment strategy of the fund.

If the members of the pension fund are, on balance, older, then the investment manager might consider moving into bonds and fixed interest securities. This increases the reliability of payments to the fund and hence its ability to meet imminent liabilities.

Equities also have their place in pension portfolios. For instance, a higher tolerance of risk from the trustees would result in the portfolio moving towards equities. UK pension funds, typically, are more heavily weighted towards equity than their European counterparts.

The fund may wish to invest in the shares of the sponsoring company. Although this is permitted, it is limited to a maximum investment of 5% of the sponsoring company's share capital.

3.4. The statement of investment principles

When creating an occupational pension scheme, the sponsoring company must first appoint a trustee.

The trustees of most schemes must draw up a written statement of investment principles (SIP). The SIP sets out the principles governing how decisions about investments must be made.

What the SIP must include

The SIP must include the trustee's policy on:

- Choosing investments
- The kinds of investments to be held and the balance between different kinds of investment
- Risk, including how risk is to be measured and managed, and the expected return on investments
- Realising investments
- The extent, if at all, taken into account of social, environmental or ethical considerations when taking investment decisions
- Using the rights (including voting rights) attached to investments if they are available

Reviewing and revising the SIP

A trustee will need to review the SIP regularly - at least every three years and whenever there has been a significant change in investment policy.

Legal requirements when choosing investments

Regulations set out how trustees or fund managers must exercise their investment powers. This includes exercising those powers to ensure:

- Security, quality, liquidity and profitability of the fund
- Due consideration towards the nature and duration of the expected future retirement benefits of the scheme
- Diversification in the choice of investments for the scheme
- The scheme assets are invested mainly in regulated markets

When choosing investments, the trustee (or the fund manager acting on his behalf) must exercise his investment powers in line with the scheme's statement of investment principles (SIP).

Holding scheme assets securely

The trustee has a duty to make sure that the scheme's investments are held securely.

If the services of a custodian are not used, a trustee should check that the arrangements in place for holding the scheme's assets are satisfactory.

Trustees must be able to clearly identify scheme funds. They must keep scheme money received in a suitable account with a bank or building society separate from the employer's account.

Appointing a custodian

If a custodian is appointed to hold the scheme's assets, the trustee should ensure they have adequate insurance arrangements and that, if the custodian uses sub-custodians, sufficient guarantees are in place.

The trustee should also check the arrangements in place between the custodian and the fund manager for making sure the assets the custodian holds are the same as those reported by the fund manager.

3.5. The Pensions Regulator

The Pensions Regulator was established by the Pensions Act 2004.

Objectives of the Pensions Regulator

The objectives of the Pensions Regulator are to:

- Protect the benefits of members of work based schemes
- Reduce risk of situations requiring compensation from the Pension Protection Fund
- Promote good administration and improve understanding of the schemes it regulates
- Maximise employer compliance with employer duties

Powers of the Pensions Regulator

The Pensions Regulator's principal aim is to prevent problems from developing. Where possible, they will provide support and advice to trustees, administrators, employers and others where potential problems are identified.

The Pensions Act 2004 provides the Regulator with a range of powers - as well as those it inherited from its predecessor OPRA - to enable it to meet its objectives.

The powers fall into three broad categories:

- Investigating schemes: gather information to help identify and monitor risks
- Putting things right where problems have been identified
- Acting against avoidance: ensure that employers do not sidestep their pension obligations

Investigating schemes

The Pensions Regulator collects data through the scheme return. It also expects to receive reports of significant breaches of the law from 'whistleblowers', and reports of notifiable events from trustees and employers.

Trustees or scheme managers are also responsible for notifying the Regulator promptly of changes to information such as the scheme's address, details of trustees, or the types of benefit provided by the scheme.

Protecting the benefits of scheme members

Where the Pensions Regulator believe that a scheme is deliberately avoiding their obligations, they have the power to issue:

- **Contribution notices** - where there is a deliberate attempt to avoid a statutory debt, those involved must pay an amount up to the full statutory debt, either to the scheme or to the Board of the Pension Protection Fund.
- **Financial support directions** - these require financial support to be put in place for an under-funded scheme.
- **Restoration orders** - if there has been a transaction that under-valued the scheme's assets, the Regulator can take action to have the assets (or their equivalent value) restored to the scheme.

Scheme funding

The Regulator also expects to receive reports where a scheme is unable to comply fully with the new scheme funding framework. If a scheme has a shortfall, the Regulator expects to receive scheme funding information.

Scheme specific funding requirement

The Pensions Act 2004 also requires that the trustees prepare a **statement of funding principles** specific to each scheme explaining how the statutory funding objective will be met. The statutory funding means that the fund has sufficient resources to meet an amount required for the fund to meet its obligations. This amount is based on actuarial calculations.

The scheme specific funding requirement must include details on:

- Regular actuarial valuations and reports: how they will be made and how often
- Preparing a schedule of contributors, showing the rates of contributions payable to the scheme and the dates on which they are to be paid
- Putting in place a recovery plan for when the statutory funding objective is not met. This must set out the steps to be taken to meet the funding objective and the period within which this will be done
- This must be reviewed every three years

3.6. Pension Protection Fund (PPF)

The Pension Protection Fund's main function is to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation.

The Pension Protection Fund is a statutory fund run by the Board of the Pension Protection Fund, a statutory corporation established under the provisions of the Pensions Act 2004.

To help fund the Pension Protection Fund, compulsory annual levies are charged on all eligible schemes.

The Pension Protection Fund is also responsible for the Fraud Compensation Fund - a fund that will provide compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty.

Compensation

In summary, if an employer is insolvent and the pension scheme cannot meet its liabilities then the PPF will provide compensation of:

- Up to 100% of benefits to existing pensioners

- Up to 90% of benefits to those who have not yet retired

Existing pensioners

For individuals that have reached their scheme's normal pension age or, irrespective of age, are either already in receipt of survivors' pension or a pension on the grounds of ill health, the Pension Protection Fund will generally pay 100% level of compensation. This means a starting level of compensation that equates to 100% of the pension. This can even be index-linked: increasing each year in line with the retail price index, capped at 2.5%.

For those yet to retire

For the majority of people below their scheme's normal pension age, the Pension Protection Fund will generally pay 90% level of compensation. This means 90% of the pension an individual had accrued can be paid out. This compensation is subject to an overall annual cap, which, as at April 2010, equates to £29,748.68 at age 65 after the 90% has been applied, but is again index-linked.

The Pension Protection Fund has the ability to alter the levy to meet its liabilities. However, in extreme circumstances, compensation could be reduced.

Levels of compensation could also be reduced by the Secretary of State on the recommendation of the Pension Protection Fund.

The Pension Protection Fund is funded by a levy on all defined benefit pension schemes.

4. Objectives and constraints of insurance companies in the UK

4.1. Life insurance

A **term insurance policy** covers the life of an individual over a specific period (usually ten years or more). In the event that the insured person survives the period, no payment is made.

A **whole of life policy** will insure the life of an individual and pay a capital sum on the policyholder's death, whenever the death should occur.

An **endowment policy** combines a savings element with a life insurance element. In return for regular premiums, an endowment policy will pay a fixed sum of money (the basic sum assured) in the event of the policyholder's death, or at least the same fixed sum if the holder survives for a pre-specified period. Endowments policies were popular in the 1980s and 1990s, often taken out as insurance cover for mortgages where the sum assured is equal to the outstanding value of the mortgage. If the holder dies during the life of the mortgage, the mortgage provider receives the sum assured, thus paying off the mortgage. Alternatively, if the holder survives the period of the mortgage, the value of the endowment is designed to be equal to the value of the mortgage when the mortgage is due to be redeemed.

With-profits endowment policies give the opportunity for a surplus to be accrued over and above the basic sum assured. The rate of bonus passed on to investors is not directly related to the performance of the underlying managed fund. The objective of with-profits funds is to deliver a smoothed return by means of bonuses rather than returns directly linked to the markets, which may be volatile. This will mean putting funds into reserves during periods of strongly positive investment returns and drawing on reserves during periods of poorer performance. It is clear to see that if a life office continued to pay bonuses in excess of actual returns, it would deplete its reserves, and this could jeopardise the sustainability of future bonuses.

4.2. General insurance

Most of the element s on general insurance have been covered in previous sections of this chapter. In summary:

- Includes insurance cover for cars, homes, contents of homes, pets, etc.
- Typically short-term investment horizon
- Low tolerance of risk
- Highly liquid assets
- Solvency requirements

5. General Comments

5.1. Summary of typical asset allocations

Table 6.

	Young DB pension fund	Mature DB pension fund	Life assurance company	General insurance company
Investment horizon	Long-term	Short-term	Long-term	Very short-term
Attitude To short-term risk	Positive	Negative	Positive	Very negative
Liquidity	Low	High	Low	Very high
Liabilities	Real	Real/Nominal	Nominal	Nominal
Asset choice	Equities; Property; Index-linked gilts	Bonds	Equities; Property; Bonds	Cash; Money market instruments

6. Summary

6.1. Key concepts

Major funds in the UK

- 5.7.3 - Explain the return objectives of the major fund types
- 5.7.4 - Classify funds by their income / capital growth requirements
- 5.7.5 - Explain the effect of each of the following on a fund's asset allocation: time horizons, liability structure, liquidity requirements
- 5.7.7 - Explain the effect that taxation legislation may have on the stock selection and asset allocation of a fund

Objectives and constraints of pension funds in the UK

- 5.7.1 - The features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC))
- 3.2.11 - The significance of the Pensions Act 2004: scheme specific funding requirement, the Pensions Regulator, the Pension Protection Fund
- 3.2.13 - The purpose of a Statement of Investment Principles
- 5.7.8 - Other types of legal requirements that affect pension funds

Objectives and constraints of insurance companies in the UK

- 5.7.1 - The features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC)), life assurance, general insurance
- 5.7.8 - Other types of legal requirements that affect insurance funds

General comments

- 5.7.3 - The typical asset allocations for DB and DC pension funds, life assurance and general insurance funds

Now you have finished this chapter you should attempt the chapter questions.