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CRACKING THE DC CODE: VALUE FOR MONEY

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Cracking the DC Code: Value for Money

Rickard Mills

Council Member, IAPF

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CRACKING THE DC CODE: VALUE FOR MONEY

Section 1

Cracking the DC Code - Value for Money

Ciarán Long

Former Company Secretary, Permanent TSB

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Cracking the DC Code - Value for Money

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4 Key Messages on Value for Money (VFM)

- Trustees have the Responsibility
- VFM is both Quantitative and Qualitative
- Costs and Charges are Complex
- Good Governance is needed for Trustee protection

What are the DC Codes

Set out the standards trustees will be expected to adopt to demonstrate their commitment to serving the best interests of members and beneficiaries.

- Set out expected standards of conduct and practice
- Practical guidance
- Useful benchmark
- Supplement to Trustee Handbook

11 Codes
But No. 11 impacted by activities in previous 10

1. Governance plan of action
2. Trustee Meetings
3. Managing Conflicts of Interest
4. Collection and Remittance of Contributions
5. Investing Scheme Assets
6. Paying Benefits
7. Keeping Records
8. Data Protection
9. Risk Management
10. Member Communication
11. Value for Money

What is “Value for Money” (VFM)

“A buyer's perception of the goods or services that they receive”. ***Wikipedia***

“..where the costs and charges …. provide good value compared to the benefits and services provided when compared to other available options”. ***DC Code 11***

“It does not necessarily mean low cost, provided higher costs can be justified by improved benefits”. ***UK Pensions Regulator (TPR)***

- ***Was the ticket price for “the match” good value for money ?***

  (Depends on whether you are a Dub or a Culchie!!)

- ***Could have watched it on TV and “surfed” channels (to see Man U v Everton).***

VFM is a personal concept **-** how is it applied to the world of DC pensions

The Search for VFM

Most members of DC schemes rely on others to make the important decisions about their fund and to deliver and assess value for them.

Trustees have fiduciary duty to act in best financial interests of all members.

- Understand costs
- Expand their cost focus
- Develop a VFM policy

In summary, members expect a high level of accountability from Trustees on delivering VFM from their Pension Scheme

Complexity of Costs & Charges

What Costs/Charges actually impact on VFM

- Ongoing administration, communication, record-keeping and reporting
- Fund Management fees embedded in unit price as annual % of fund
- Bid offer spreads and allocation rates on initial and ongoing contributions
- Charges for encashing, cancelling or switching units
- Optional/ad-hoc services
- Time based fees

Note:

- Not all costs are invoiced or readily transparent
- Sponsors may meet some costs

Providers always say:

- "We operate in a Transparent and Competitive Marketplace"

  and

- "Performance and Fees is what matters".

Provider Risks and VFM

How safe are your Service Providers

- Back-up systems/Off-Site storage/Disaster Recovery/Business Continuity
- Data encryption/Fraud prevention/unauthorized access
- Misuse or damage to software, communications and data
- Service Delivery and Quality controls

Are there Conflicts of interest

- Are there fees/commission/revenue sharing arrangements in place with other parties
- Do economic benefits accrue to others

Collateral Risks

- Corporate Stability and Resilience
- Reputational Damage

Trusteeship is Complex

…….hence the need for Good Governance

Good Governance is:

- Not just about Compliance

- More about demonstrating good <u>Behaviours</u> and <u>Practices</u> to ensure good member outcomes.

Trustees as Supervisors

Trustees legally responsible for the sound operation of the Pension plan.

- Many (if not all) operations delegated, but responsibilities retained
- Trustees act as supervisors to ensure delivery.

This involves:

- Scrutinising the performance of Providers in meeting agreed objectives
- Monitoring the reporting of performance
- Satisfying themselves on the integrity of financial information
- Ensuring that financial controls and systems of risk management are robust and defensible.

In summary:

– **Trustees need to have a Governance Framework in place.**

Regulatory Review of Bank Governance

Governance Framework

- Documented Roles, Responsibilities and Processes
- Procedures Manual and Terms of Reference
- Adherence to the specified framework and evidencing of required governance

Oversight and Interaction :

- Quality of Board and Board Committee Minutes
- Evidence of adequate discussion and challenge on key items and decisions
- Evidence of oversight of CEO performance and CEOs review of direct reports
- Adequacy of reporting to the Board and escalation of key issues to the Board
- Need for regular Board Review / Evaluation

Risk Culture

- Corporate values that underpin the Code of Ethics
- Management of Conflicts of Interest
- Whistleblowing and internal alert mechanisms
- Follow-up on Internal Audit findings

If it is not documented, it didn't happen

Developing a Governance Framework

Trustees must (per Pensions Authority)

- Know their Scheme
- Know the Financial, Legal and Regulatory Environment in which they operate
- Know who their Stakeholders are

and

Translate into a Plan of Action

Governance Focus for Pension Plans

- Collection of Contributions
- Record Keeping
- Investment of the Scheme Assets
- Communication of Information
- Payment of Benefits
- Compliance

Developing a Plan of action

- Ascertain Charges
- Determine Criteria
- Evaluate Costs & Benefits
- Establish Risk Register
- Discuss and Review
- Take Action

Procurement

- Ask the right questions when engaging a supplier (otherwise the supplier dictates)
- If you simply ask for bids, you will gravitate to the people you like, based on the submission.
- You end up with the “smoothest” operator - not one based on objective assessment

(“John is nice – I think I can work with him”.
Remember John has his own pressures that can impact on delivery – has he back-up?).

Preparation is key

- Spend time on the questions you want answered – know what you want and set down the questions to ask
- Decide on an objective set of criteria on which you will assess each answer
- Get your contract to specify the delivery of the criteria you have decided

Contract is Crucial

- You hope you never have to refer to it but you need it if something happens.
- Does Mgt. Fee cover everything or is it simply a retainer
- Ignore the things that seem nice but don't appear on your list of key requirements
- Put the effort in upfront - get an independent 3rd party (not in the bidding process) to help you understand what you want/need.

Regular Review

- Convert your original criteria into KPIs
- Get legal team to put the KPIs in the contract
- Review KPIs quarterly

Good Governance is more than being compliant
– ultimately it is a system of decision making and oversight to invest assets and achieve desired outcomes for scheme members.

Delivering Value for Money

- Low cost vs High cost
- Different people value different services
- Understand member characteristics (Demographics / Salary /Expectations)
- What represents value for money for your members (Quality & Scope)
- Member feedback
- Compare with market

There is no uniform approach

4 Key Messages on Value for Money (VFM)

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Thank You!

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Section 2

Value for Money

Brian Delaney, CFA

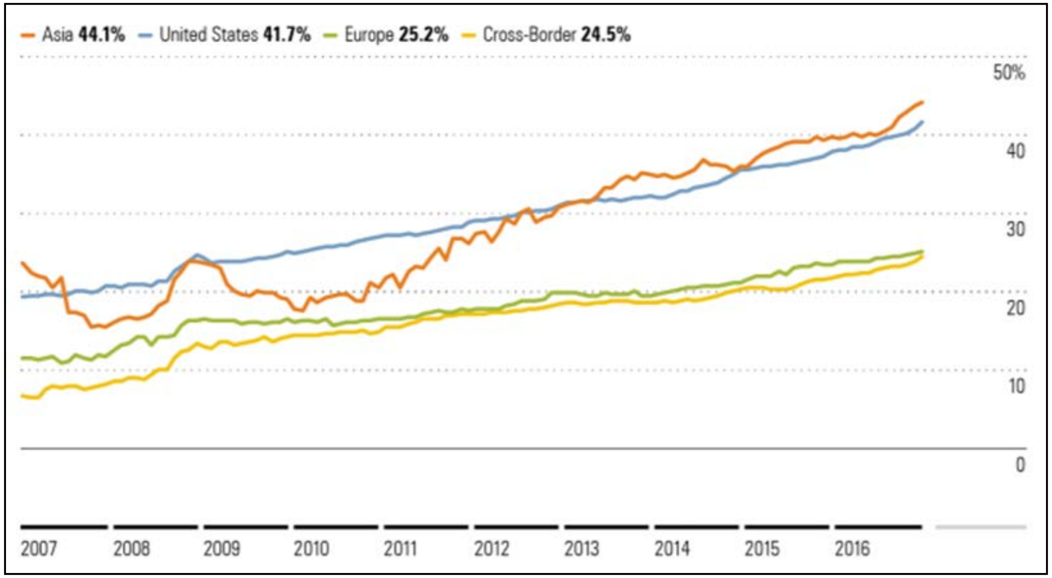
Senior Investment Consultant, Aon Hewitt

The trend towards passive investing is accelerating…

- Morningstar published a report in March 2017, which highlighted that the trend towards passive or indexed investing, particularly with equities, had accelerated sharply to become a dominant theme across the world

- **In Asia, 44% of assets are now invested in passive equity funds, double what was invested just five years ago. The trend, at 42%, is similar in the United States**

Percentage of Assets Invested by Region in Passive Equity Funds

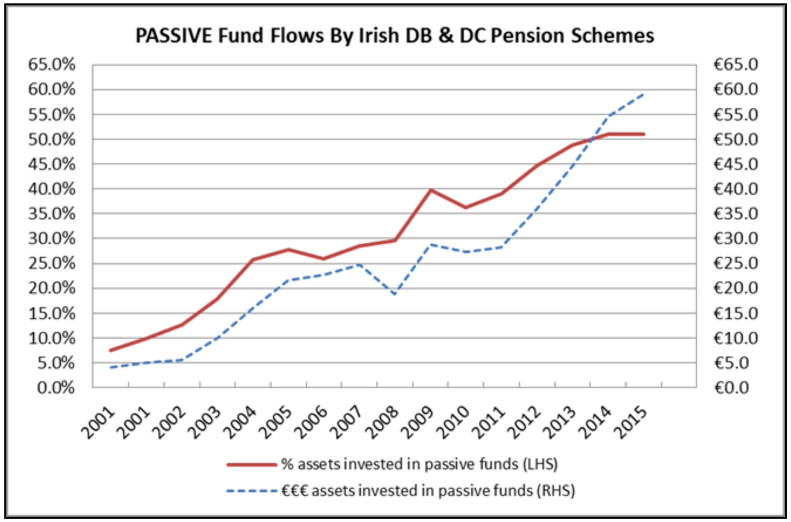


Source: Morningstar Report, March 2017

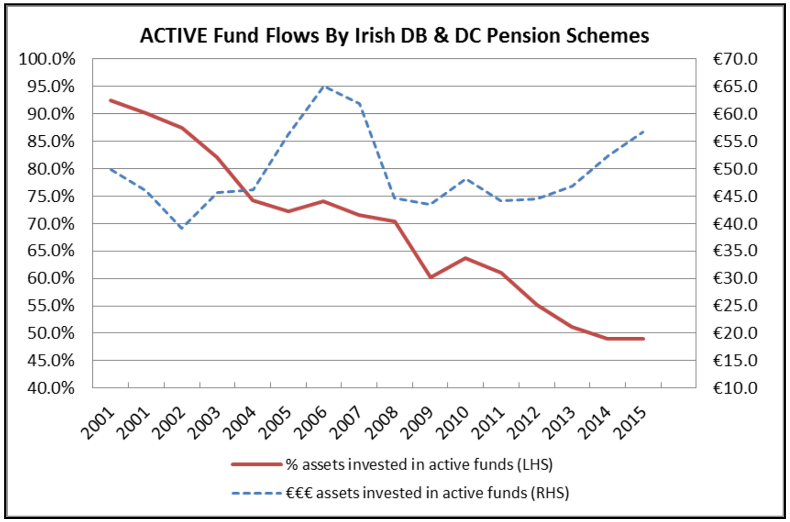
This trend is even more pronounced in Ireland…

- The Irish Association of Pension Funds' (IAPF) annual investment survey states
  - Allocation to **passive** investment strategies increased from 7.5% of DB and DC pension scheme assets in 2001 (€4bn out of €54bn total) to 51% of pension scheme assets in 2015 (€59bn out of €116bn total)
  - Allocation to **active** investment strategies has fallen from 92.5% of DB and DC pension scheme assets in 2001 (€50bn out of €54bn total) to 49% of pension scheme assets in 2015 (€57bn out of €116bn total)

Passive Fund Flows By Irish DB & DC Pension Schemes



Active Fund Flows By Irish DB & DC Pension Schemes



Source: Irish Association of Pension Funds annual investment survey

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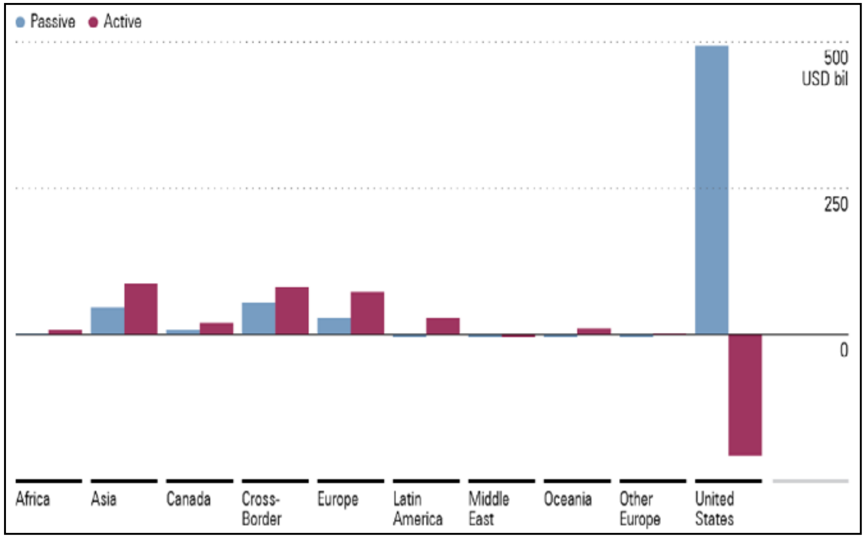
The gap between active and passive fund flows reached $700bn in 2016

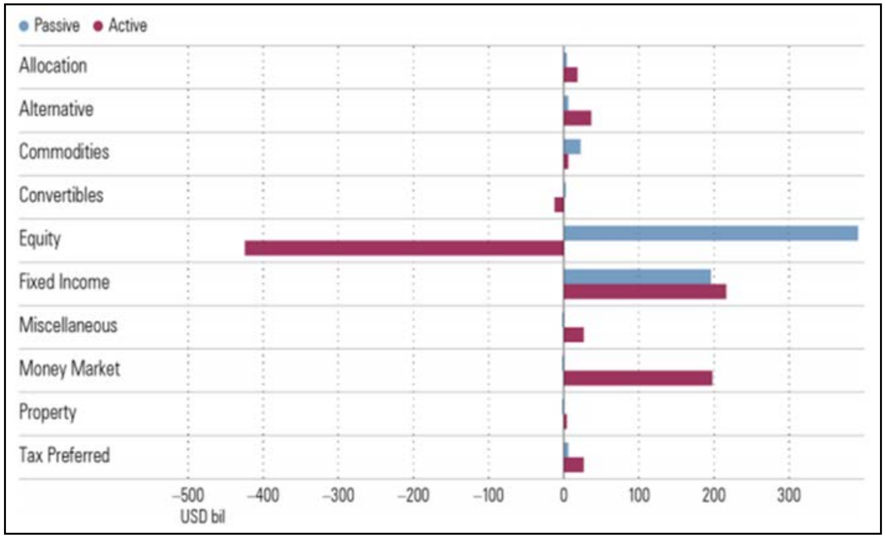
- The gap between active and passive fund flows in the U.S has never been wider. In 2016, US index funds received $492 billion, while US active funds saw $204 billion in outflows. In Asia and Europe, active fund flows outpaced passive flows in 2016

- The active/passive divide was most pronounced in equities. US passive equity fund **inflows** were $390 billion or 79% of total passive fund inflows, while US active equity fund **outflows** were $423 billion in 2016

Passive & Active Fund Flows in the United States in 2016 By Region



Passive & Active Fund Flows in the United States in 2016 By Asset Class

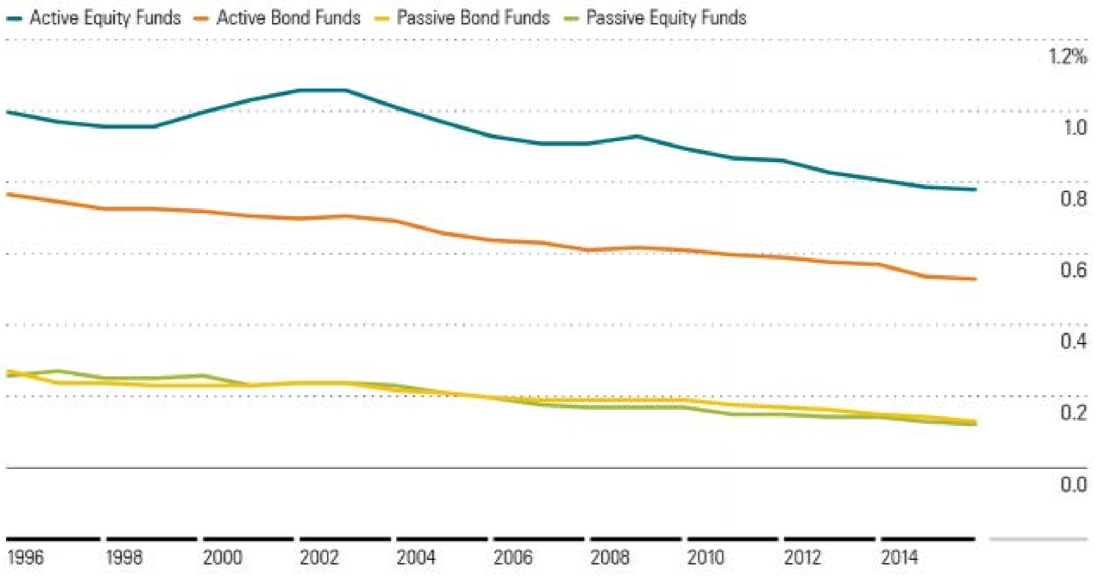


Source: Morningstar report, March 2017

Investment management fees are driving the decision-making process

- Fees for active and passive funds have been trending lower for 20 years but there's still a 65 basis point difference between active and passive fund expense ratios for equity management
- When compounded over 20 years, this cost differential amounts to 14%, a key driver for the structural shift towards passive investing as trustees focus on getting value for money for their membership

Average Asset-Weighted Expense Ratio for US Funds



Source: Morningstar report, March 2017

What are the consequences of this trend towards passive investing?

US concentration

The weighting of the US in global equity benchmarks has grown by approximately 25% since 1990. This has led to investors in passive global equity funds to have a concentration in US stocks.

Risks

This opens up investors' portfolios to a number of risks, including sector, stock and currency concentrations as well as US-specific risks.

Benefits

Investors have benefitted significantly from strong performance of US stocks, with the technology sector in particular (which is largely based in the US) performing strongly.

Mitigate

There are a number of ways investors can mitigate these risks, including currency hedging, making a strategic allocation to emerging market equities, and taking a short-term tactical underweight position to the US.

Is indexed investing a win-win for investors and trustees?

- Not quite. While active managers focus on stock valuations when making investments, passive managers do not. Passive fund inflows - $492bn in 2016 (Morningstar) - are allocated to indices in line with the weightings of each index, with absolutely no regard to individual company valuations
- The majority of equity indices are market-capitalisation weighted, so the larger the company, the larger their allocation in the index. Examples include the FTSE All-World Index, the S&P 500 and the Nasdaq 100
- Apple, Google, Microsoft, Amazon and Facebook together account for 6% of the FTSE All World Index, 11% of the S&P 500 Index and 43% of the Nasdaq 100 Index today

Stock	AAPL	GOOG	MSFT	AMZN	FB
Price	$159.27	$921.28	$72.69	$952.45	$167.74
Shares	5.23	0.70	7.81	0.48	2.95
Market Cap	**$833.6**	**$648.1**	**$567.6**	**$461.0**	**$495.0**
Revenues	$215.64	$90.27	$89.95	$135.99	$27.64
Net Income	$45.69	$19.48	$21.20	$2.37	$10.22
EPS	$8.73	$27.69	$2.72	$4.90	$3.46
PE	**18.2**	**33.3**	**26.8**	**194.4**	**48.4**

Focus should be on delivering value for money for clients!

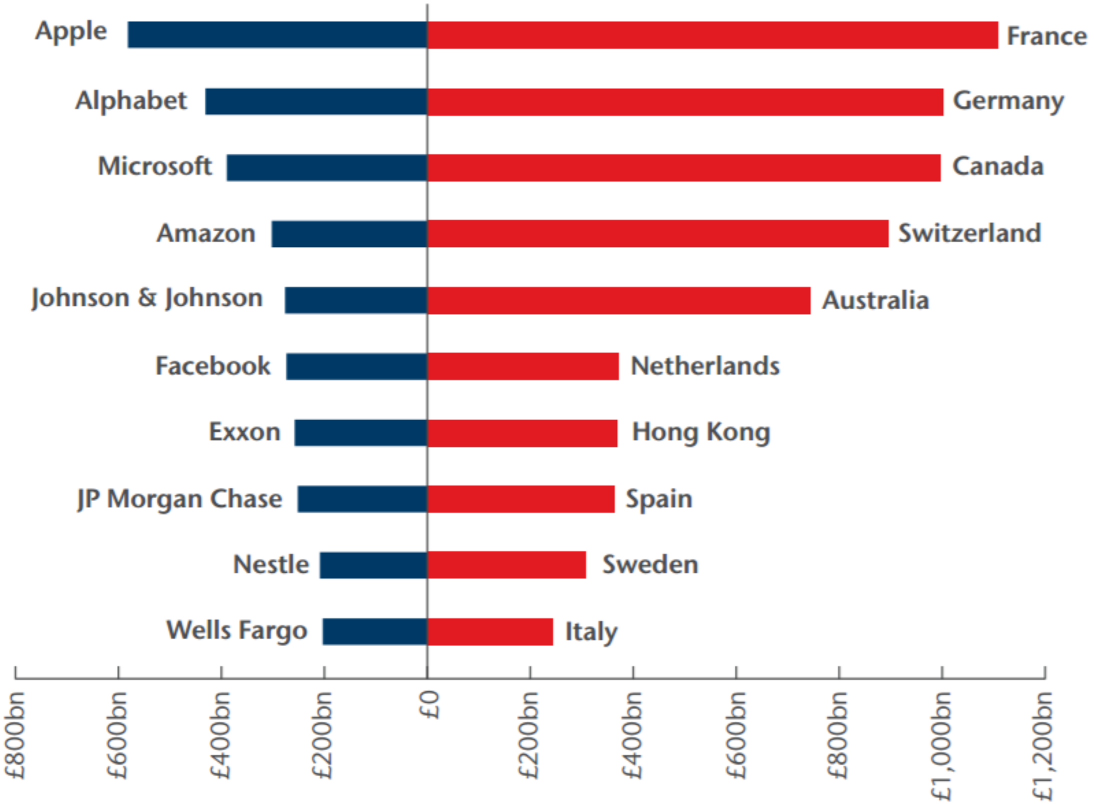
- Those five stocks trade at an average P/E multiple of 64 times earnings!
- Valuations matter…. Eventually!

The top 5 tech stocks are dominating the benchmark

The largest stocks in the MSCI World index are comparable in size to the largest countries in the index, by market capitalisation

The graph to the right shows how comparable the market capitalisations of the ten largest stocks are with the ten largest nations in the MSCI World index excluding US, Japan and UK.

- The top 5 tech stocks now have a larger allocation in the MSCI World Index than the UK.
- Facebook has a larger market capitalisation than India.
- Cisco is a similar size to Mexico.
- IBM is a similar size to Russia.
- Apple and Amazon combined are a similar size to China.



Source: MSCI

Are there any better alternatives?

- Indexed equity funds, by their very nature, deliver market returns before fees and deliver good member outcomes during rising markets. However, during declining markets, passive fund investors suffer the full brunt of equity market declines

- Unfortunately, active equity funds haven't done much better. Only 4 of the 20 active global equity managers included in our Aon InVision survey have delivered an annual return net of fees in excess of their benchmark over the last 10 years

- A new approach to active equity management, factor based investing, is making waves in the industry and has become increasingly popular in recent years. Factor based investing offers an element of active management for passive fees

- We believe this new style of active investing should deliver better outcomes for members over time than a traditional passive investment approach

Section 3

Factor Investing

Factor investing: the basics

What is factor investing?

Factor investing strategies use rules-based, transparent investment processes which isolate factors that have been shown to outperform market-cap-weighted indexes over time

Passive

- Index
- Low cost
- Low turnover

Factor Investing

- Diversifier
- Alpha
- Cost-effective

Active

- Alpha
- Customised
- High cost

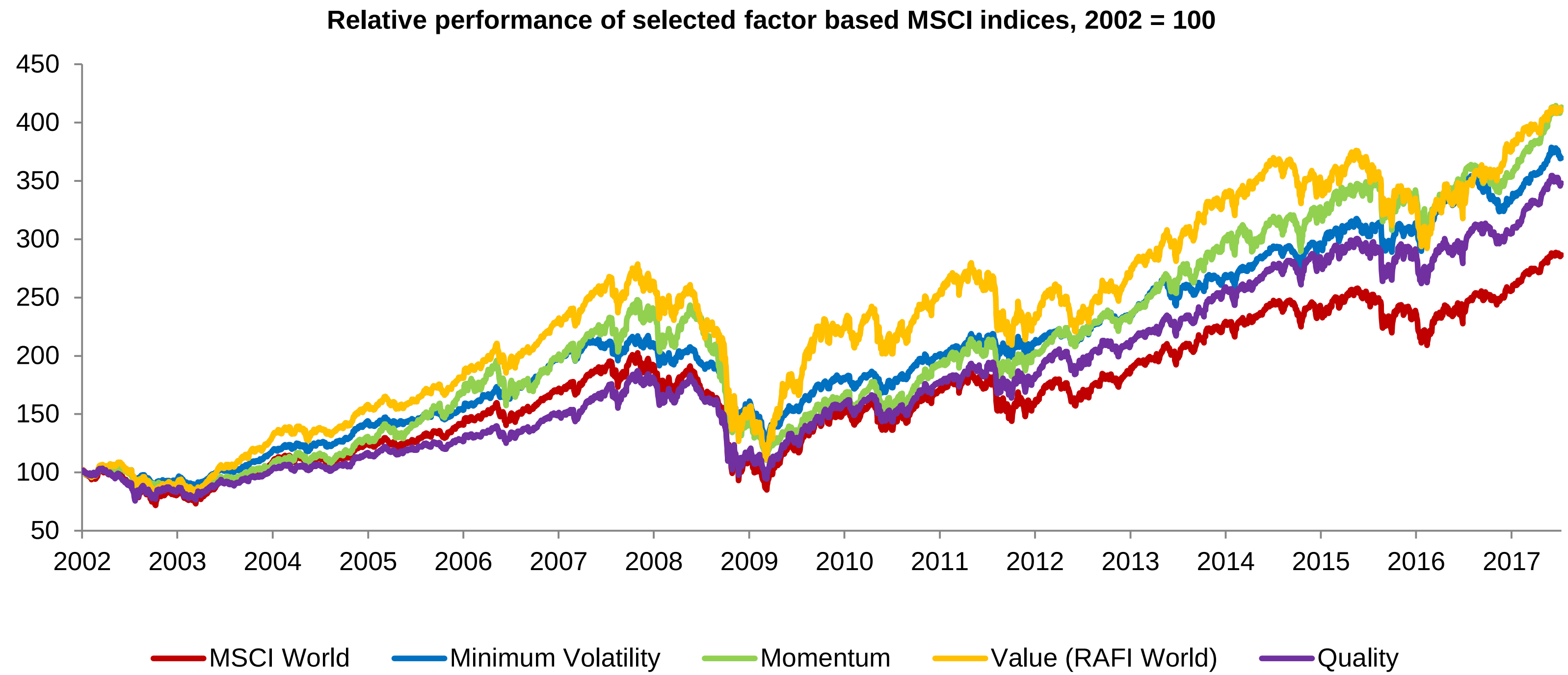
The five main factors

Value	Size	Minimum Volatility	Momentum	Quality
Stocks discounted relative to their fundamentals	Smaller, high-growth companies	Stable, lower-risk stocks	Stocks with upward price trends	Financially healthy companies

Multi-factor strategies

- Combine exposures to multiple return drivers to build diversification
- Help mitigate drawdowns and increase predictability of performance
- Help navigate a variety of economic environments

Factor based strategies have performed better over the long term



Source: Thomson Reuters Datastream

- Shorter term performance depends on the market environment
- Your choice of the combination in portfolio construction is important

Diversifying your factor exposure helps

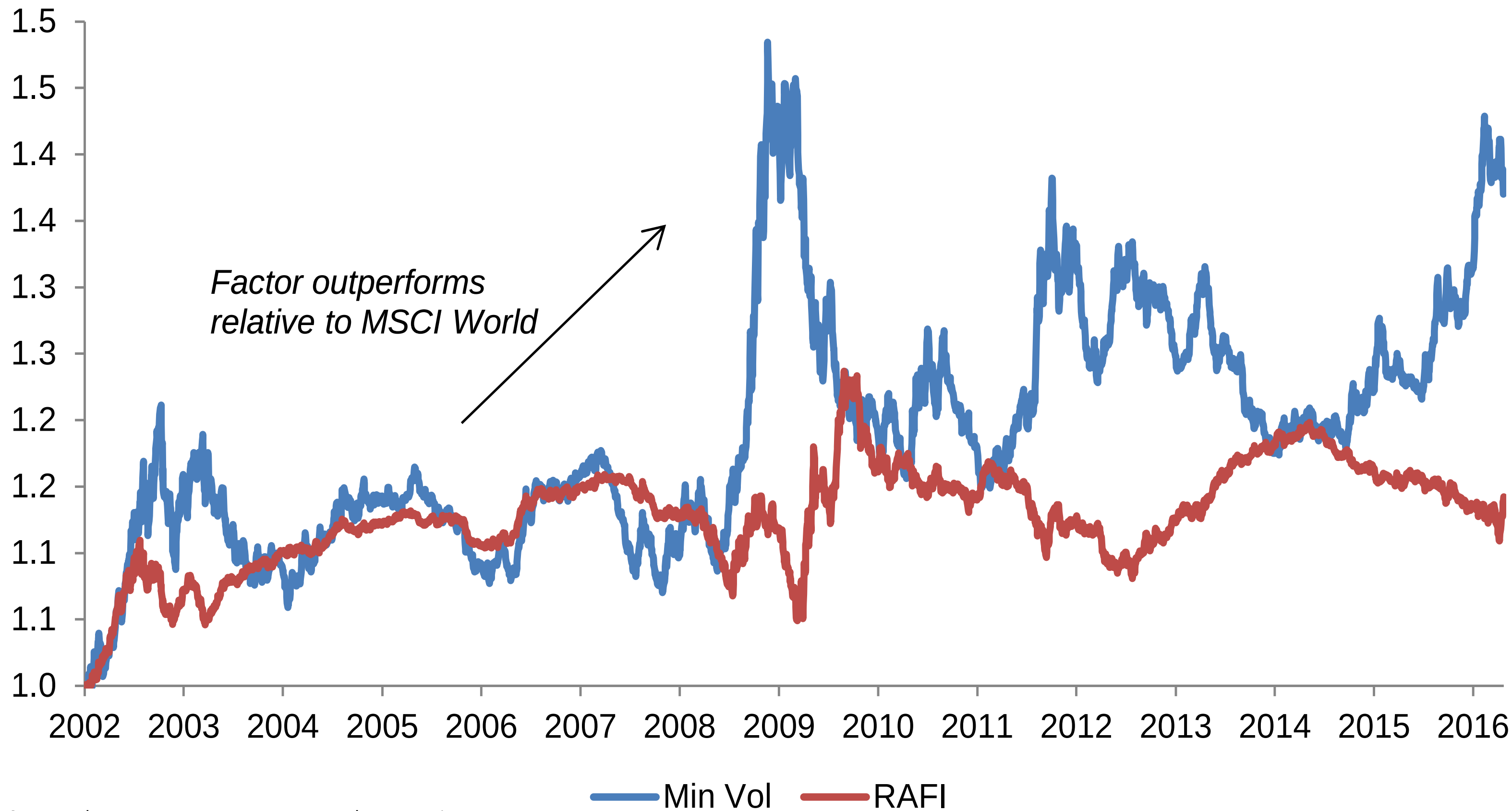
Performance relative to market	Low Volatility	Momentum	Quality	Small Cap	Value	Combined portfolio
Post TMT boom*	0.8%	3.5%	-4.5%	7.3%	2.8%	3.0%
Financial crisis*	10.8%	3.3%	13.2%	-5.0%	-4.8%	1.4%
Post crisis rally*	-10.2%	-4.0%	-2.6%	23.5%	0.0%	3.0%
Greek debt crisis*	13.4%	6.6%	7.1%	-4.6%	-0.5%	2.8%
H2 2016 rotation*	-10.2%	-6.8%	-3.1%	3.2%	3.7%	-1.7%

* Annualised performance shown, periods less than 12 months not annualised. Post TMT boom is period 1 Jan 2002 to 31 Dec 2006. Financial Crisis is period 1 June 2007 to 31 March 2009. Post-crisis rally is period 1 April 2009 to 30 June 2011. Greek debt crisis is period 1 July 2011 to 30 September 2011. H2 2016 rotation is period 1 July 2016 to 30 December 2016.

Source: Aon Hewitt, MSCI.
NB Combined portfolio is a hypothetical portfolio combining the styles in the following weights: Low Volatility (12.5%), Momentum (25%), Value (25%), Small Cap (25%), Quality (12.5%).

Better risk-adjusted returns by combining factors

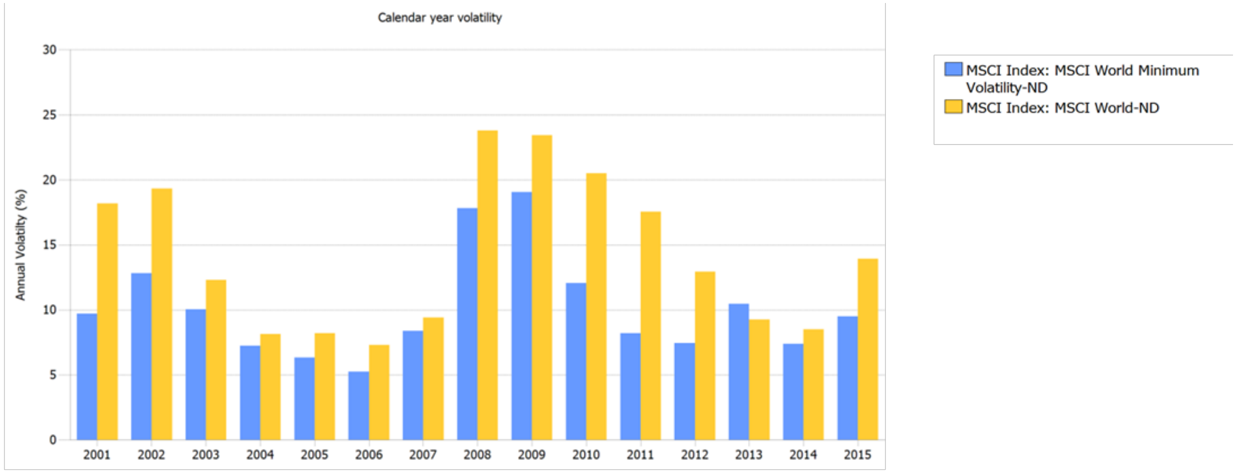
The performance cycles of Min Vol and RAFI are negatively correlated
Cumulative performance relative to MSCI World



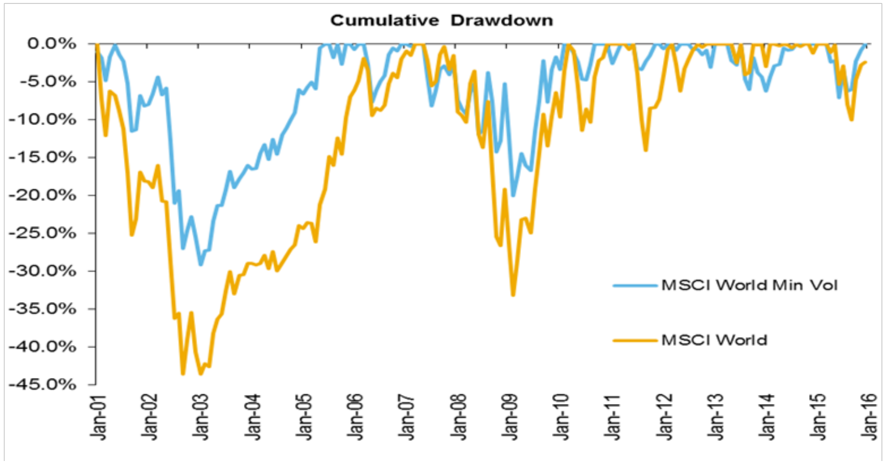
Source: Thomson Reuters Datastream and Aon Hewitt

Minimum Volatility versus Market Capitalisation

A Minimum volatility approach can significantly reduce volatility relative to the traditional approach



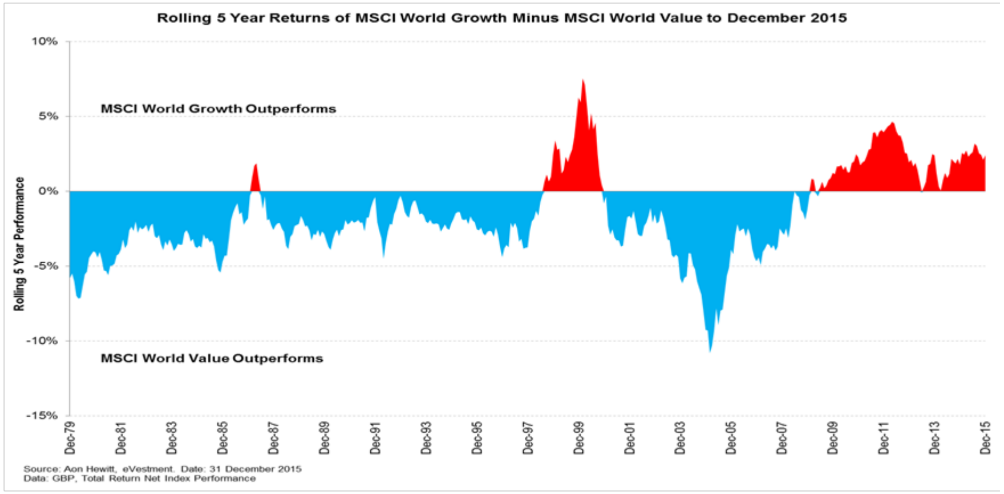
It also has the potential to protect during equity market downturns. The fall in value (drawdown) is lower than that of a market capitalisation index



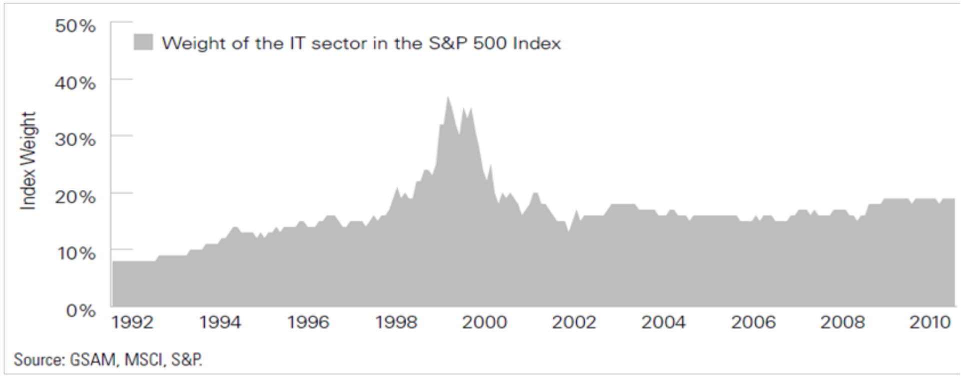
Source: Thomson Reuters Datastream and Aon Hewitt

Fundamental Value versus Market Capitalisation

- Fundamental based approaches may generate better risk adjusted returns than market capitalisation indices in most cases BUT this may not occur for long periods
- The chart shows growth out-performing value over the last 6 years but longer term value has out-performed



- The market capitalisation approach invests a larger proportion of the index to stocks which have been driven up to levels which may not reflect their intrinsic value (the chart shows the example of the 'Dotcom' bubble)
- Although investors will benefit from the price increase, these are potentially the holdings which may suffer the greatest losses when market bubbles burst



Source: Thomson Reuters Datastream and Aon Hewitt

Factor investing – value for money

Let's look at some different scenarios.

If we take a client with £100 million this is what they can achieve across different strategies:

Strategy	Performance (net alpha)	Fees
Active	125bps	65bps
Factor-based	60bps	15bps
Passive	0bps	10bps

For illustrative purposes only, based on industry data.
Source: Performance estimates – Aon Hewitt, fee data – BlackRock.

Benefits of factor investing

Improve risk-adjusted returns

Multi-factor strategies can help achieve above-market returns

Manage risk

Some factors can reduce volatility of portfolio such as quality and low volatility

Enhance diversification

Allocating to multiple factors enables greater portfolio diversification

Cost-effective

Essentially an active strategy at a passive cost

Key takeaways

- Consider factors when constructing your low cost equity portfolio
- Make sure you diversify your factor exposure and are prepared to be patient
- Make sure you implement carefully

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PANEL DISCUSSION

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UPCOMING EVENTS

03 Oct: Trustee Training Refresher Course

12 Oct: Benefits Conference (Free for Trustees)

28 Oct: Breakfast Briefing (Free for Trustees)

7 Nov: Trustee Network Event (Free for Trustees)

14 Nov: Breakfast Briefing

29 Nov: Governance Conference (Free for Trustees)

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