

# Statement of Investment Principles

October 2006

This Statement of Investment Principles is produced to meet the requirements of the Pensions Act 2004 and to reflect the Government's voluntary code of conduct for Institutional Investment in the UK ("the Myners Principles"). The Board also complies with the requirements to maintain and take advice on the Statement and with the disclosure requirements.

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# 1. Introduction

- 1.1** The Board ('the Board') of the Pension Protection Fund ("the Fund") has prepared this Statement of Investment Principles ("the Statement") in accordance with Section 114 of the Pensions Act 2004 ("the Act") and the Pension Protection Fund (Statement of Investment Principles) Regulations 2005 ("the Regulations")<sup>1</sup>.
- 1.2** This written statement outlines the principles and policies governing determinations about investments made by or on behalf of the Board in the management of the Fund's assets. This Statement also reflects the Myners principles for institutional investment decision-making.
- 1.3** This Statement will be reviewed annually or when there is, or the Board anticipates that there might be, a significant change in relation to any matter contained in this Statement or to any of the matters which this Statement is required to cover by the Regulations.
- 1.4** This Statement is specifically concerned with the investment of the:
- accumulated levy contributions paid into the Fund.
  - assets transferred into the Fund from eligible pension schemes.
- This Statement covers the Fund as defined in Section 114 of the Pensions Act 2004. It does not cover the Fraud Compensation Fund for which the Board is also responsible. A separate Statement of Investment Principles is in place for the Fraud Compensation Fund.
- 1.5** This Statement will be published and made available upon request.

## 2. Governance of the Pension Protection Fund

### **2.1 Investment powers and compliance with the Pensions Act 2004**

- 2.1.1** Section 113 of the Pensions Act 2004 provides that the Board may invest for the purpose of the prudent management of its financial affairs. When exercising its power to invest the Board will consider the interests of current and potential beneficiaries of the Fund and the interests of persons affected by the rate of the levies.

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<sup>1</sup> Statutory Instrument 2005 No 675

**2.1.2** The Board is responsible for the governance and investment of the Fund's assets. The Board is satisfied that it has sufficient expertise, information and resources to carry out its role effectively. The Chairman and three other members of the Board each have over 15 years working experience of the investment industry. The Board also has access to in-house investment expertise within the Financial Risk Management Team. Attached in Annex 2 is a breakdown of the governance structure and the associated responsibilities.

**2.1.3** The Board has considered written advice received from the Fund's investment adviser, Mercer Investment Consulting, who is believed to be suitably qualified and is authorised under the Financial Services and Markets Act 2000. The written advice considers the suitability of the investments, the need for diversification and the principles contained in this Statement. The Board will continue to monitor and review the performance of the Fund's investment adviser at least annually. Actuarial advice relating to the assets and liabilities of the Fund is sought from the Board's Chief Actuary.

## **2.2 Investment Committee**

**2.2.1** The Board has established an Investment Committee to manage, consider and make recommendations on investment issues. The Investment Committee is accountable to the Board.

**2.2.2** The strategic management of the Fund's assets is the responsibility of the Board acting on the recommendation of the Investment Committee. The Investment Committee has delegated authority from the Board to implement and generally ensure adherence to the strategic investment policy.

## **2.3 Day to day fund management**

**2.3.1** The day to day fund management of the assets is performed by professional fund managers, each of whom is authorised and regulated by the Financial Services Authority and appointed in accordance with Section 113(4) of the Act. The Board is satisfied that the appointed fund managers have sufficient expertise and experience to carry out their role.

**2.3.2** The appointment, monitoring and termination of professional fund managers is the responsibility of the Investment Committee.

## 3. Strategic management of the Fund's assets

### 3.1 Objectives

- 3.1.1** The Board's primary objective is to have sufficient funds to pay compensation to the members of eligible defined benefit occupational pension schemes or defined benefit elements of hybrid occupational pension schemes, where these schemes have been transferred into the Fund.
- 3.1.2** In particular, the Board will target the Fund towards reaching an appropriate ongoing funding level, to be achieved by adopting suitable low risk investment strategies, setting a levy on eligible schemes and the prudent management of the Fund's assets.
- 3.1.3** This objective is to be met by the Fund achieving a balance between protecting and securing the compensation payments for actual and potential members of schemes that come into the Fund whilst setting a fair and proportionate levy. Specifically, the investment strategy is designed to match current estimates of the Board's liabilities and provide some outperformance over the estimated liabilities. Any outperformance should contribute to the long-term sustainability of the Fund and therefore reduce the burden on the levy payer.
- 3.1.4** The nature and timing of these actual and potential liabilities are uncertain and will vary as schemes transfer to the Fund. Assets will be set to match current estimates of the Board's liabilities and may be adjusted as the pattern of liabilities evolves over time.

## 4. Risk measurement and management

- 4.1** The Board will assess and consider the following risks on an ongoing basis:
- *"Cashflow risk"* – The risk of a shortfall of liquid assets relative to the immediate liabilities. The Board and its advisers will manage the Fund's cash flows taking into account the timing of future payments, and may borrow over the short term in order to minimise the probability that this occurs.

- *“Financial mismatching risk”* – The risk of a significant difference in the sensitivity of asset and liability values to changes in financial factors, in particular inflation and interest rates. The Board will control these risks by monitoring their key characteristics and setting appropriate tolerances. The Board will also review how these risks might change should pension schemes in assessment transfer into the Fund.
- *“Demographic Risk”* – Demographic factors include the uncertainty surrounding mortality projections such as future improvements in mortality experience. The Board recognises that there is currently no readily-tradable instrument to hedge this type of risk and that this risk may not be fully mitigated. The Board will measure liabilities using mortality assumptions recommended by the Chief Actuary of the Pension Protection Fund.
- *“Manager risk”* – The failure by the fund managers to achieve the rate of investment return assumed by the Board. This issue has been considered by the Board on the initial appointment of the fund managers and thereafter will be considered as part of the investment review procedures the Board has put in place.
- *“Concentration risk”* – The risk that the performance of any single investment that constituted a significant proportion of the assets would disproportionately influence the Board’s ability to meet the objectives. The Board has set diversification guidelines for the fund managers to mitigate this risk.
- *“Systemic risk”* – The possibility of an interlinked failure by a number of companies or organisations that sponsor pension schemes in particular sectors or industries.

This also includes consideration of the overlap of risk between the investment held and the exposure to scheme deficits, as the failure of investments may also coincide with increasing scheme liabilities to the Fund. The Board will seek to mitigate this risk by limiting its exposure to investments with high credit risk. In addition, the asset allocation is set so as to ensure a low level of correlation between the Fund’s assets relative to its liabilities and that of a typical UK defined benefit pension scheme.

- *“Transition risk”* – The risk of incurring inappropriate costs in relation to the transition of assets of pension schemes in assessment to the Fund. The Board will mitigate this risk by using one or more specialist managers to implement transitions of assets with the explicit aim of minimising costs.

- “*Custody risk*” – The risk of misappropriation of assets, delivery that is not in accordance with the instructions, unauthorised use of assets for the benefits of other customers of the custodian, inadequate segregation of customer assets, failure to collect income, recover tax or respond to corporate events and custodian default. The Board will assess and consider the actions by the custodian at outset and on an ongoing basis to mitigate “custody risk”.

All of these risks, which the Board will continue to monitor, are a potential threat to the achievement of the objective to target an appropriate funding level.

## 5. Investment strategy

**5.1** The Board regards the selection of asset classes as the decision which has most influence on its ability to achieve its investment objectives.

### **5.2 Establishing the strategic asset allocation**

**5.2.1** The strategic asset allocation is set by taking into account the nature and timing of both actual and potential future liabilities, which are sensitive to interest rates, inflation, mortality and other financial and demographic factors.

The asset allocation is split into:

- Interest-bearing assets and derivatives that closely match the liability sensitivities to nominal and real interest rates (“matching assets”). A swap overlay is applied to minimise the Fund’s exposure to interest rate or inflation risk. It will also contribute to reduce the level of correlation between the Fund’s assets relative to liabilities to that of a standard UK defined benefit scheme, typically exposed to the risk of a decline in long term interest rates.
- Assets that are expected to generate additional return, avoiding unrewarded risks where possible (“excess return seeking assets”).

**5.2.2** The asset classes and strategies that have been considered to generate additional return are:

- UK and global equities hedged back into sterling;
- Global government bonds hedged back into sterling;
- Property;
- Currency.

It has also been agreed that a protection/hedging strategy will be employed, as appropriate, to mitigate the risk of a substantial fall in equities. Such a strategy lowers the level of correlation between the Fund's assets relative to liabilities to that of a typical UK defined benefit scheme.

**5.2.3** The asset allocation has been set after maximising the expected excess return over the liability subject to the following constraints:

- A risk budget of 4% p.a. at the total fund level. The risk budget is the maximum ex-ante standard deviation of the difference between the asset return and the return on the "liability benchmark". This liability benchmark is the notional portfolio of assets that exactly matches the expected liability cashflows.
- Each asset class is actively managed with tracking error limits and out-performance targets such that the contribution of expected active manager excess returns to total out-performance is a maximum of 25%. Tracking error is the amount of divergence of the performance of the fund against the specified benchmark.
- The correlation between the Fund's assets relative to liabilities and that of a typical UK defined benefit pension scheme will be reduced as far as is consistent with other constraints. This will mitigate the risk of the Fund's assets under-performing its liabilities to the same extent as that of typical UK Pension Funds during times of increasing deficits.

The asset allocation is set out in Annex 1.

**5.2.4** The performance of the Fund is measured against the liability benchmark. This benchmark will change periodically as a result of the Board accepting the legal obligation to pay compensation to eligible pension schemes.

**5.2.5** The Board will, where necessary, use a combination of derivatives (“swap overlay”) to adjust assets to better match the liability profile. This is primarily to mitigate the interest rate and inflation aspects of financial mismatching risk. The regular adjustment of assets to the sensitivities to real and nominal interest rates is undertaken by specialist fund manager(s) using money market instruments, bonds and derivatives.

**5.2.6** The asset allocation strategy is believed to be appropriate to meet the investment objectives set out in 3.1 on page 6, whilst mitigating the investment risks set out in 4 on pages 6, 7 and 8.

**5.2.7** The strategy will be reviewed annually and after each actuarial valuation. An earlier review may be conducted in the inter-valuation period in the event of any significant change in capital markets, the liabilities of the Fund, or governing legislation.

### **5.3 Schemes in Assessment**

The Board will also take note of the asset allocation of pension schemes in assessment and whether and how the investment risks associated with these schemes might be mitigated within the asset strategy of the Fund.

### **5.4 Rebalancing policy and cash flow**

**5.4.1** The Board is satisfied that the spread of assets, the fund managers’ policies on investing in individual securities and the Board’s investment guidelines to fund managers provide adequate diversification of investments. The Board is also satisfied that the mandates awarded to the fund managers mean that the majority of assets held will be readily realisable to provide cash to meet payments by the Fund.

**5.4.2** The Board has the powers to undertake borrowing, with a ceiling of £25m.

**5.4.3** This policy will be reviewed annually and after each actuarial valuation. In addition if there is a significant change in the liabilities or circumstances of the Fund, then an earlier review will be conducted.

## 6. Day to day investment management of the assets

### 6.1 Fund management

**6.1.1** For the management of the portfolios, the Board employs the services of investment experts as its fund managers and has specified investment guidelines to control the level of day to day decision making. The fund managers make their trading decisions independently of the Board. These fund managers are selected by a competitive tender process.

**6.1.2** The fund managers are set a specific benchmark and performance objective by the Board. As a way of monitoring risk in portfolios, the Board agrees tracking error ranges with the fund managers for their portfolios. The portfolios' tracking errors are expected to fall within these ranges and, if not, the fund manager is mandated to explain to the Board why this is so and if any action is required. The Board has also set underperformance floors for the current managers' mandates based on a rolling 2-year period, the breaching of which triggers a review of the mandate by the Board. Performance of the fund managers is measured by an independent performance measurement company on a monthly basis and monitored in detail by the Investment Committee on a quarterly basis. In addition, the managers meet the Investment Committee to report on their performance at least once a year.

### 6.2 Investment performance benchmarks

**6.2.1** The overall Pension Protection Fund benchmark is a notional combination of zero coupon bonds and zero coupon inflation-linked bonds that exactly matches the expected liability cash flows. It has been determined taking into account the liability of the transferred schemes and especially its sensitivity to real and nominal interest rates. This portfolio will change over time with future transfers of the pension schemes.

**6.2.2** The investment performance benchmarks for each asset class are set out in the table below:

Asset class	Allocation	Asset Benchmark
Cash	20%	3-month Libor
Global Bonds	50%	JP Morgan Government Bond Index Global (hedged to sterling)
UK Equities	12.5%	FTSE All-Share Index
Global Equities	7.5%	FTSE All-World Index (hedged to sterling)
Property	7.5%	Investment Property Databank Index
Currency	2.5%	3-month Libor

**6.2.3** The Fund will be rebalanced regularly taking into account the need to minimise both transaction costs and risks associated with deviation from this target asset allocation.

**6.2.4** Given the benchmarks in 6.2.2 and a total risk budget of 4%, the Board expects the return on investments to exceed the return on the liability benchmark by 1.4% p.a. without protection on the equity portfolio.

**6.2.5** Mandates for each fund manager will be agreed prior to their appointment. Strategies relating to the control of transaction costs and soft commission will be specified in these mandates.

### **6.3 Fund manager fees**

**6.3.1** The Board will pay such fees and expenses as are negotiated with fund managers from the Fund in accordance with the Pension Protection Fund (Payment to meet Investment Costs) Regulations 2005<sup>2</sup>.

**6.3.2** The fund managers are currently remunerated by an ad valorem fee based on the level of assets under management. Fee structures of the fund managers yet to be appointed will be set prior to appointment.

<sup>2</sup> Statutory Instrument 2005 No 1610

- 6.3.3** The Board will annually review and if necessary renegotiate the costs of management and transactions.

## 7. Day to day custody of the assets

- 7.1** The Board has appointed State Street Bank Europe Ltd as custodian with regard to the safekeeping of the assets in the Fund.

### **7.2 Performance**

- 7.2.1** The Investment Committee will consider from time to time, and at least annually, the performance of the custodian according to specifically agreed key performance indicators.

### **7.3 Custody fees**

- 7.3.1** The Board will pay such fees and expenses as are negotiated with the custodian from the Fund in accordance with the Pension Protection Fund (Payment to meet Investment Costs) Regulations 2005.

- 7.3.2** The Board will annually review and if necessary renegotiate the costs of management and transactions.

## 8. Transition of assets to the Fund

- 8.1** The Board recognises that the asset allocation of eligible schemes may not reflect the Board's strategic asset allocation but would expect to manage the transition of those assets periodically to be consistent with the investment objectives in 3.1 above. The Board has accordingly appointed State Street Bank to act as a transition manager and may in future consider the appointment of an additional transition manager.

- 8.2** The Board will consider the timing, liquidity and cost of transition of assets of transferring schemes that do not match the asset strategy of the Board. The Board reserves the right to merge the assets into the Fund at the time it deems most appropriate and may hold up to 2.5% of total assets in asset classes not set out in 5.2.1 and 5.2.2. The Board may also retain without limit annuity contracts held by transferring schemes to meet specific liabilities.

## 9. Socially responsible investment and corporate governance

### 9.1 Socially responsible investment

- 9.1.1** The Board's primary concern, in setting investment policy, is to act in the best financial interests of the Fund and its beneficiaries, seeking the best return that is consistent with a prudent and appropriate level of risk.
- 9.1.2** The Board believes that companies and governments with positive social, environmental, ethical and political principles can reasonably be expected to offer strong long term financial performance and stability. It therefore regards a preference for investment in securities issued by such organisations as consistent with the best financial interests of the Fund and its beneficiaries.
- 9.1.3** In its regular review of fund managers' performance, the Board will monitor the way that managers take account of social, ethical, environmental and political considerations in their investment decisions.

### 9.2 Corporate governance

- 9.2.1** The Board's policy on corporate governance is to exercise any rights (including voting rights) attaching to investments in accordance with the guidelines set down in the Institutional Shareholders' Committee statement of principles on the responsibilities of institutional shareholders and agents and for fund managers to comply with these guidelines.
- 9.2.2** The Board has advised the Fund's fund managers that they should normally be expected to exercise any rights attaching to investments (including voting rights) on behalf of the Board.
- 9.2.3** The fund managers have full discretion to act outside these guidelines but would be expected to report to the Board with an explanation of their actions.

## 10. Compliance with this statement

- 10.1** The Investment Committee will monitor compliance with this Statement by the Board annually. In particular it will obtain written confirmation from the fund managers that they have complied with this Statement as supplied to them and the Investment Committee undertakes to advise the fund managers promptly and in writing of any material change to this Statement.
- 10.2** The National Audit Office will audit and monitor compliance as part of its annual review of the Fund's accounts and statement of internal control.

# Annex 1

## Asset allocation and benchmarks

Asset class	Allocation	Asset Benchmark
Cash	20%	3-month Libor
Global Bonds	50%	JP Morgan Government Bond Index Global (hedged to sterling)
UK Equities	12.5%	FTSE All-Share Index
Global Equities	7.5%	FTSE All-World Index (hedged to sterling)
Property	7.5%	Investment Property Databank Index
Currency	2.5%	3-month Libor

**A portfolio of derivatives known as a “swap overlay” is applied to the portfolio above to change its cash flow profile to match that of the “liability benchmark”. This ensures that the sensitivities to real and nominal interest rates of the asset values closely match that of the liabilities.**

# Annex 2

## Governance structure

<b>The Board is responsible for</b>	<ul style="list-style-type: none"><li>• Setting structures and processes for carrying out its role</li><li>• Agreeing investment structures and their implementation</li><li>• Agreeing an investment strategy</li><li>• Reviewing the content of this Statement of Investment Principles in conjunction with the investment adviser, the Fund's actuary and legal adviser and modifying it if deemed appropriate</li><li>• Reviewing the investment policy following the results of each actuarial review and/or asset liability modelling exercise</li><li>• Consulting with relevant bodies when reviewing investment policy issues</li></ul>
<b>The Investment Committee is responsible for</b>	<ul style="list-style-type: none"><li>• Design and review of the investment strategy and manager structure for recommendation to the Board</li><li>• Implementing and ensuring adherence to the strategic investment policy</li><li>• Assessing the quality of the performance and processes of the fund managers by means of regular, but not less than annual, reviews of the investment results and other information by way of meetings with the fund managers and written reports</li><li>• Appointing (and dismissing) the fund managers, liability driven investment manager, custodian(s) and transition manager(s)</li><li>• Monitoring compliance of the investment arrangements with this Statement on an ongoing basis</li></ul>
<b>The investment adviser is responsible for</b>	<ul style="list-style-type: none"><li>• Advising on all aspects of the investment of the Fund assets including implementation of strategy</li><li>• Providing updates as to its view on the fund managers and their likelihood of achieving the performance objectives</li><li>• Advising on this Statement</li><li>• Providing training in investment matters to the Board</li></ul>

**The fund managers are responsible for**

- Discretionary management of the portfolio, including implementation (within guidelines given by the Board) of changes in the asset mix and selecting securities within each asset class
- Providing the Board with quarterly statements of the assets together with a quarterly report on actions and future intentions, and any changes to the processes applied to their portfolio
- Informing the Board of any changes in the internal objectives and guidelines of any pooled funds used by the Fund as soon as practicable
- The safekeeping of the assets within the pooled funds in which the Fund invests
- Investing income paid to the Fund in a timely manner
- Reconciling the manager's record of assets held with those of the Custodian

**The custodian is responsible for**

- The safekeeping of all the directly held assets of the Fund
- Undertaking all appropriate administration relating to the held assets of the Fund
- Processing all income with respect to the Fund in a timely manner
- Processing all tax reclaims in a timely manner
- Investing cash in a suitable low risk manner consistent with the provision set out in the investment management agreements as agreed by the Board
- Reconciling records of assets held with those of the managers

**The transition managers are responsible for**

- Moving assets between fund managers and/or asset types in a cost efficient way whilst minimising risks
- Managing the asset transition process when pension schemes in assessment fall into the Fund

## **Investment adviser**

Mercer Investment Consulting has been selected as the current investment adviser to the Board following a competitive tender exercise. The Board is satisfied that Mercer Investment Consulting has the knowledge and experience required under the Pension Protection Fund (Statement of Investment Principles) Regulations 2005 and that it has arrangements in place to secure that any individuals who provide advice to the Board have sufficient knowledge and experience to provide that advice. Mercer Investment Consulting operates under an agreement to provide a service designed to ensure that the Board is fully briefed both to take the decisions it is equipped to do so after training and advice, and to monitor those decisions that it delegates. Mercer Investment Consulting is paid on a fixed fee basis for work which can be anticipated and a time cost basis for projects or additional work.

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