Summary
- Many DB trustees are unable to identify all the costs they pay around investment, particularly those in smaller schemes.
- Trustees are encouraged to talk directly with managers about what they are being charged.
- Passive and simple investment strategies can help keep costs down.
- Smaller schemes can band together to achieve scale and reduce the cost per member of running the scheme.
- Trustees should not focus on cost alone, bearing in mind value and quality of service.

Cost control

Defined contribution charges have been the subject of much debate recently, but running costs can be just as big of an issue in the defined benefit space. Nick Martindale asks how trustees can better monitor fees, and keep the cost of running their schemes down

The issue of charges for defined contribution schemes has generated much attention over the past year, but less scrutiny has been levelled at defined benefit arrangements. Yet research by The Pensions Regulator suggests this should perhaps be more of an issue.

According to the survey, nearly a quarter of schemes are unable to identify all the costs and charges they pay around investments, which rises to over a third among trustees of small schemes. The findings should be of most concern to trustees of those smaller DB schemes, which pay up to four times as much per member in running costs compared to larger ones.

This is clearly a confusing area, and one that the asset management industry has done little to make any less murky over the past few years. But knowing what charges they are paying for and why is an important part of a trustee's position; all the more so if it transpires the costs schemes are paying are out of line with the rest of the industry.

"Trustees need to ensure they are achieving value for money for the beneficiaries and the sponsor," says 20-20 Trustees director and chief executive Antony Miller. "It goes without saying that this should include what you are spending in expenses and what you get back in return in terms of performance, allowing for risk. Arguably in the past some trustees have fallen short of the ideal in this respect, and have accepted high fees or mediocre performance without necessarily understanding or questioning it."

Communication

Understanding what the various costs are is a good starting point in ensuring the charges a scheme faces are fair and in line with both the level of service and performance that is required. KPMG pensions partner and head of investment advisory Patrick McCoy says there are essentially two types of charge: investment manager fees, which can range from 1 per cent to 2 per cent of the value of assets under management, and the cost of making investments.

"The investment management fee should be relatively easy to compile," he says. "Each investment manager should be able to provide the charges that they have levied to the scheme, either directly or indirectly, even if the fees are deducted from units within a pooled fund. The other costs are associated with the underlying investment, which may include factors such as bid or offer spreads and stamp duty, can be more difficult to compile. The key for trustees is to ensure their investment managers are reporting their charges and to record all expenses incurred against the budget."

"For trustees wanting to get to grips with their fees, the first port of call should be to talk to investment managers themselves"

Investment management fees can become more complicated, however, in cases where there is an element of performance-related fees. "These tend to be very complex because trustees are looking for sustained performance and do not want to reward an active manager for riding on the back of a generally rising market," says Stephenson Harwood pensions partner Fraser Sparks. But these can also throw up odd and unintended results, he adds, which can lead to disputes between the parties involved.

For trustees wanting to get to grips with their fees, the first port of call should be to talk to investment managers themselves. "Ideally trustees will ask each investment manager for a reconciliation at the end of each year, showing exactly what investment fees have been deducted from scheme assets and how that correlates to the amounts under management," says chair of The Pensions Trust's trustee board Sarah Smart. "Managers are reluctant to provide this information as it is extra effort and cost for them, but if all trustees ask for it then they will have no choice."

If trustees feel they may not be getting the best value for money – or that what they are paying for is no longer right for their needs – they may want to conduct a market review, usually with the help of an investment consultant, says Spence & Partners head of trustee advisory services Marian Elliott. "It is important to isolate the sources of cost and examine other products and services available in the market to check whether the solution adopted reflects good value, and whether the same or better component of the service received could be obtained at a lower price elsewhere," she says. "As part of this review exercise, trustees should also check that they aren't paying for things they don't need or haven't asked for."

But this, in itself, can incur extra costs, points out State Street head of asset owner solutions UK Ian Hamilton. He believes having and maintaining an effective relationship with service providers should ensure costs are regularly reviewed and remain fit for purpose. "As the scheme evolves, requirements develop and market characteristics change over time, both parties should work together to ensure that the service and the associated costs are in line with the market," he says.

Investment

For those committed to bringing down investment costs, adopting a

simpler investment approach is one option. "Choosing to use a passive rather than active approach to investment management will result in significantly lower management fees and monitoring costs than are incurred with active management," says Barnett Waddingham partner Jonathan Daykin. "Costs can also be kept down by restricting asset allocation to the most basic asset classes, such as gilts and equities. The main disadvantage of this approach is that the strategy adopted may be materially worse in terms of expected risk and return than the strategy that might otherwise have been adopted."

PTL client director Colin Richardson suggests steering clear of categories that carry higher charges, such as emerging markets and property. He, too, though, warns that this will come at the expense of less diversification, which could impact on returns. "The main area of risk is the allocation between asset categories rather than the investment manager risk," he points out.

Another option, particularly for smaller schemes – the research found the average cost per member of running a small scheme is £1,054 a year compared to £281 for a large scheme and £182 for a very large one – is to join forces with other schemes to increase buying power and reduce administrative charges. "This may be by looking to join with other schemes of the same or an associated employer in some form of common investment fund, or to consider a segregated DB master trust arrangement where costs can be reduced significantly," says Premier senior consultant John Reeve.

This already happens across certain industries, and can lead to shared administration costs and economies of scale around investments, adds Miller. Such an approach isn't just for smaller schemes, either. "Even at the very largest end there are potential further economies available by growing or merging schemes," he says.

Russell Investments' head of pensions solutions group Shamindra Perera, believes the root cause of the current confusion around charges is the governance system deployed by most organisations around DB schemes, and advocates the use of internal or external fiduciary managers to better manage the allocation of funds and charging arrangements. "Trustees can't be expected to be aware of and manage all the fees," he says. "If the management is delegated to someone who is accountable for the overall outcome then straight away the costs of managing arrangements are very much part and parcel of delivering the overall outcome. This is where there is a void in the governance model of UK pension funds."

Yet trustees should not get too worked up over cost at the expense of value and performance, argues Elliott. "Trustees need to optimise the equation with cost on one side and quality of service, performance or advice on the other," she says. "They should identify their objectives, be clear about what they are trying to achieve and then select a product or service which delivers against the particular circumstances of their scheme at a proportionate cost."

Written by Nick Martindale, a freelance journalist