EXPERT OPINION

Trustee Behaviour and Investment

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Do we know how effective Trustee boards are in making decisions on behalf of members?
Against a background where there is little formal research on the effectiveness of pension fund trustees, Aon recently undertook a research partnership with Leeds University Business School (LUBS) to look at the trustee landscape in the UK, to help further understand trustee decision-making.

In the largest survey of its kind, LUBS surveyed 197 trustees, looking at different aspects of trustee governance including decision-making, financial literacy, attitudes to risk, and socio-demographics

While the focus of the research is on trustees of defined benefit schemes in the UK, the findings are also applicable to **trustees of defined benefit and defined contribution schemes in Ireland.**

The research covered both large and smaller schemes with asset sizes ranging from £5bn to less than £15m, with the median scheme in the £100m to £500m range.

What does the typical trustee board look like?
The Trustees boards were found to be strongly homogeneous.

- The average trustee is a 54 year-old male, with over 70 per cent of trustees aged 50 and above.
- Fewer than 1 in 5 trustees in the survey is a woman.

- Trustees surveyed ranked highly on education and experience.

- The average trustee has been a trustee for 10 years

Trustees tend to have a university degree, moreover, 27 per cent have a Master's Degree and 5 per cent have PhDs. They have an especially high concentration of financial qualifications. While this is strongly positive, behavioural science indicates that a diverse set of subject knowledge may be more valuable to a board.

Why does all this matter?
The lack of diversity in trustee boards creates two potential issues:

- There is little diversity of opinion across gender as only one in five trustees are female. Several research studies [1]) have shown that the presence of women on corporate boards is beneficial for monitoring and board process and that female board members have a greater impact where governance is weaker. Gender diversity on trustee boards is thus an important issue to consider going forward as it may improve board effectiveness.

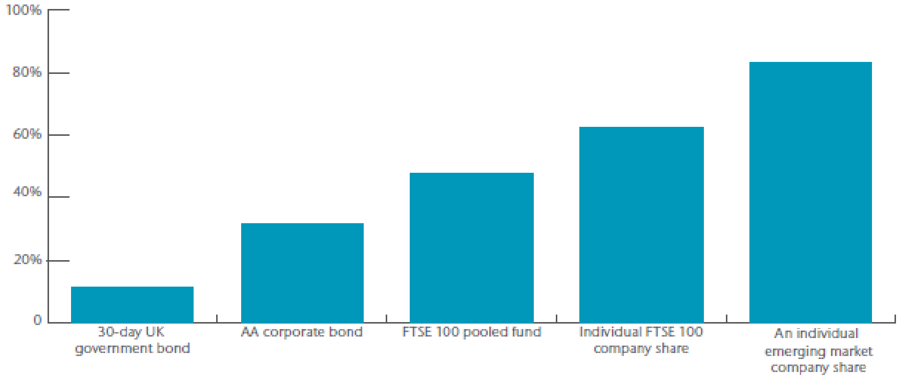
- There is a risk that trustee boards are not exposed to new ways of thinking or at least the diversity of approaches that a more age-diverse board would otherwise have. This is not to say that all decisions reached would be different, however, there may be instances when a broader perspective would be advantageous and improve decision-making. A common age profile of trustees can create an environment with the potential for groupthink to emerge.

Being aware of these behavioural biases is a big step towards controlling them. Skills audits can be really useful to identify strengths and weaknesses and consider gaps when choosing new trustees. Using frameworks to consider multiple viewpoints and scenarios builds a more robust picture of the challenges we face.

Trustees' Approach to Investment
Our research also focused on the attitude of trustees to investment matters.

Importance
Just over 50% of a full trustee board's time is spent on investment matters and most trustees feel this is about right. Additionally, just under two-thirds of trustee boards have an investment sub-committee which, in over 75% of cases, meets quarterly

How would you rate the risk of each investment below (average scores presented)?



and in a significant minority of cases (14%) meets monthly.

Financial Literacy and Risk

It is not surprising given the profile of the trustees surveyed that the research also indicates good financial literacy. As you will see in the chart below, based on responses to a number of key questions on asset classes, investment choice and risk, Trustees exhibited a high level of financial awareness, understood diversification and on average ranked the risk of different asset classes correctly.

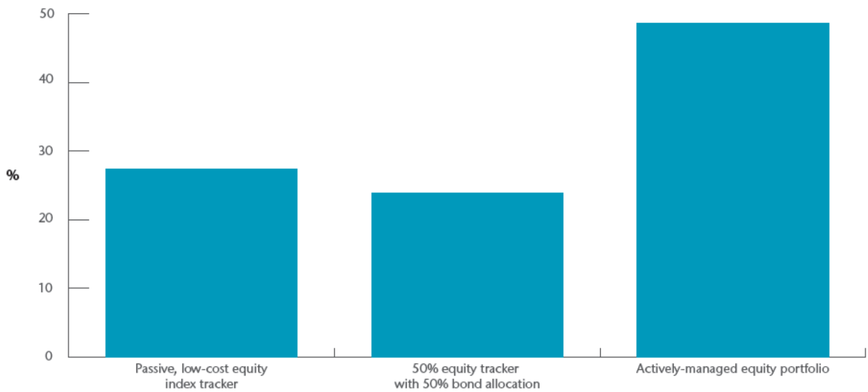
This is in contrast to earlier UK studies [2]) which found that trustees lacked a minimal understanding of investment strategy and probably reflects an increased focus on qualifications and training for trustees following the Myners Report (2001) and the subsequent UK Pension Act (2004).

The Irish Pensions Authority is now also placing a strong emphasis on the capabilities and understanding of trustee boards and one can expect this to form a core part of policy and regulatory development going forward.

Choosing Investments

The research asked trustees to choose between:

- A passive, low cost equity index tracker,
- A balanced fund with a 50% equity index tracker/50% bond allocation
- An actively managed equity portfolio



As the chart above shows, almost half of trustees choose active over passive investment and prefer equity investment to balanced funds. The significant preference for active investment is interesting in the context of general industry movement towards indexation and alternative indexation strategies given evidence of the difficulty for active managers overall to deliver excess returns net of fees.

Attitude to Costs and Fees

The responses on fees and costs were interesting in a context of increasing media and industry attention to asset management costs and fees charged to investors.

The responses showing a preference for active funds (where fees are generally higher) might lead one to conclude that trustees have a relatively low awareness or understanding of fees. However, the research findings indicate that trustees are generally good at understanding explicit net of fees analysis (although there was evidence that this was stronger amongst trustees of larger schemes and trustees of smaller schemes had a lower level of understanding).

Explicit fees are the annual management charges (AMC) charged by the fund manager. With the advent of MiFID II [3]), trustees will need to place significantly greater focus on fees to ensure value for money for scheme members.

They will need to be aware not only of the explicit fees but also implicit fees and charges which can have an impact on overall asset returns. Examples of implicit fees are dealing costs, bank charges, taxes, custodian fees. These and other costs may be added to the AMC to make up the Total Expense Ratio (TER) or Ongoing Charges Figure (OCF) which is the true cost which must be recovered before an investor begins to make any gain.

When Trustees were asked their level of familiarity with these implicit costs and fees there was a significant difference in the responses between trustees of large and smaller schemes. Clearly there is an education process to be undertaken with many trustee groups to improve understanding in this area.

Conclusion - Managing the Trusteeship Challenge

Strong Trustee board governance is critical to managing the issues we have identified, such as behavioural bias and lack of investment knowledge.

Fortunately, there are a number of options to address these challenges. Alternative governance methods such as Master Trusts, professional trusteeship or delegation of investment via fiduciary management can each help in steering the right path and producing better outcomes for members and sponsors.

At Aon we have also created a suite of FREE tools and checklists to help with the efficiency of scheme management and to help reduce bias in decision making.

For your free copy of these checklists and guides, please email: Betty O'Reilly: **betty.oreilly@aon.com** or speak with your usual Aon representative.

Notes

1) Adams & Ferria, 2010; Gul et al, 2011

2) Clark et al, 2006

3) Market in Financial Instruments Directive (Directive 2004/39/EC).

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