Protecting Scheme Assets

"small errors can result in significant refunds"

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Background

Previous articles have highlighted the importance of monitoring investment managers' performance and carrying out a review of fees to ensure that they represent value for money. However other checks, such as ensuring the correct investment management fees have been invoiced, or that a change in investment strategy has been implemented correctly could be overlooked. Due to the size of pension scheme assets, even small errors can result in significant refunds being due if an error is identified.

Calculating Fees

The fees charged by an investment manager are not always straightforward. There may be a fixed fee element, together with a variable component. This is usually expressed as a percentage of the Assets Under Management (AUM). Complexity starts to creep in as these percentages vary depending on the circumstances. For example, by total level of AUM, types of investment held, services provided, level of investment performance and whether in-house or external funds are used. As well as increasing the complexity of calculation, it also increases the risk that an error in the fee calculation slips through unnoticed.

Common errors

There are a number of different ways in which fee errors could occur, such as:

- increasing asset values
- changes in asset allocation
- application of fee discounts

What can Trustees do?

A good starting point is to consider scheme governance arrangements. Do trustees carry out an annual review of fees invoiced, which would help identify any issues? We have carried out several recent fee reviews which resulted in schemes receiving refunds totalling around £50,000 for a single quarter. What is perhaps of most concern is that some errors had gone unnoticed for some considerable time and spanned more than 10 years.

New Fee Term Eligibility

The assets of many pension schemes are likely to have grown considerably since the initial fee terms were agreed, perhaps many years ago. If the investment manager applies a tiered rate fee structure the scheme's assets may have passed these thresholds unnoticed. Missing out on the lower fee rates, as asset values increase, means that schemes are potentially paying more fees than they should be for each future year until the error is spotted.

Special deals

It is fairly common for a small scheme to negotiate the same favourable fee structure deal where it has a link with a larger scheme within the same group. Anything that is a "non-standard" arrangement increases the risk of an error occurring. This could arise due to a failure of internal communication somewhere along the line. A similar situation may arise if new clients are being offered improved introductory terms relative to existing clients. In addition, where new clients are being offered better terms than existing clients, it may be advantageous for existing clients to update their fee agreements to benefit from lower fees.

There are other areas where schemes might inadvertently suffer a financial loss. These are most likely to occur when something is changing, such a restructuring of the portfolio.

Investment Transactions

When trustees wish to switch to a new investment strategy an investment manager is instructed to make the change on a specified date. The late, inaccurate or even missed application of instructions can result in the scheme being invested in the wrong assets for a period. This could adversely affect the investment performance. Trustees can minimise this risk by checking that the transactions were carried out correctly. Where any shortcomings are discovered, investment managers must rectify the situation by correcting the asset allocation and making good any shortfall in the asset value. Spotting these errors early is important in reducing the level of risk to which the scheme is exposed.

Out-of-Market Risk

Trustees should also be aware of the risks associated with transferring funds between investment managers. Often this involves selling the assets held by one manager and reinvesting them with another. This introduces a period where the assets are held in cash (out-of-market). The risk is that there is a significant market movement during this period and a scheme misses out on potential investment gains. The risk can be reduced by using in specie transfers and/or using pre-investment (a loan facility offered by some investment managers). This enables investment in the target assets on the same day that existing holdings are liquidated.

Conclusions

Undetected errors in fee calculations and unnecessary out-of-market risk could potentially result in a significant financial loss to a scheme. However, it is a relatively simple and inexpensive process to put in place measures to safeguard a scheme's assets and strengthen its governance arrangements.

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