



Active governance at NEST

NEST is a new defined contribution (DC) scheme that's open to all employers. It aims to provide an additional retirement income to the millions of people who will start saving under automatic enrolment, many of whom will have little, if any experience with occupational pension arrangements before being enrolled in NEST.

Having been automatically enrolled by their employer, we expect that most of these savers won't want to make difficult investment decisions. They'll expect investment and pension professionals to look after their interests. So do we. That's why NEST's Trustee and executive team have set themselves the goal of establishing high standards of investment governance.

We carried out an extensive consultation exercise before designing NEST's investment approach. When we reviewed the UK DC landscape we identified several areas where improvements could be made, like communication and engagement with members, transparency, value for money and investment design to name a few.

Overall there was a sense that the industry had made much less effort for DC propositions than it had for DB. There was significant room for improvement to the level of attention given to the governance of existing DC provision.

Risk management is one of the main areas of governance that NEST's Trustee, and its investment committee in particular, decided to focus on.

In 2011, NEST conducted an extensive search for a service provider that could help us achieve our strategic objective for active governance. For us, active governance means a continuous focus on effective governance, making sure we put in place the appropriate means and resources specific to address each issue faced by the scheme.

In the field of risk management we needed a provider that could appreciate the DC revolution taking place in the UK, and NEST's role in it. We were also seeking a strong organisation that would devote research to support the need for innovation at NEST and provide comprehensive and scalable technology solutions.

After a thorough procurement process, NEST appointed MSCI as its provider for a risk management system. The choice of BarraOne as the risk management platform was driven by the quality of the model analytics and research provided by Barra and their solid client focus and commitment.

Below we share some early fruits of the NEST-MSCI relationship. In summary, in less than a year we have been able to fully integrate MSCI as a strategic component of our investment research platform, design, implement, and monitor a dynamic risk budgeting approach and establish strategic reporting supported by risk-adjusted performance indicators.

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Section 1 - NEST risk budgets

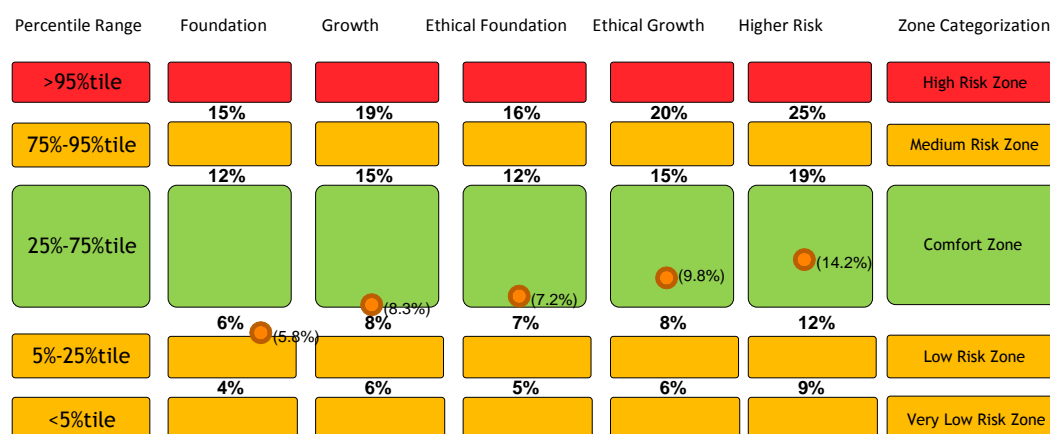
NEST has established a volatility risk budget for each fund. This includes each of our fund choices and the three separate lifecycle phases - Foundation, Growth, Consolidation - of the unique single-year target dates fund that are our default approach.

The volatility risk budget is used as an indicator for appropriate risk taking. Long-term market data and forward-looking capital market assumptions allow us to define what level of risk is appropriate to achieve a particular risk-return profile. This is what the table below describes as a 'comfort zone'.

Below the comfort zone, it would be unlikely that there's enough 'juice' in the strategy to provide the return objective, or there is a sense that risk taking will not be rewarded.

Above the comfort zone, the 'medium zone' generally indicates that return targets can still be achieved but with more uncertainty.

Further up the scale, the high-risk zone would indicate that markets are in such state that achieving long-term return target is seriously threatened.



Source: BarraOne as at June 2012

Obviously investment is not a perfect science - many wouldn't even classify it as a science. These parameters should be considered as supporting indicators, and need to be combined with other indicators to drive a definitive investment decision.

Nonetheless they can serve as effective decision-making tools.

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Section 2 - Monitoring risk budgets

Section 1 showed how we set the volatility risk budget for our funds. This section shows how we monitor these budgets.

Using BarraOne we can look at a monthly estimate of volatility for the coming month and the previous month's figure.

We also look at the realised volatility since launch so that we know if we're currently carrying more or less volatility than we have in the past. We can also check where the current levels sit vis-a-vis the risk budget, and the long-term volatility target.

Using BarraOne, we can also determine a value-at-risk (VaR) estimate for each portfolio and the sensitivity to interest rates.

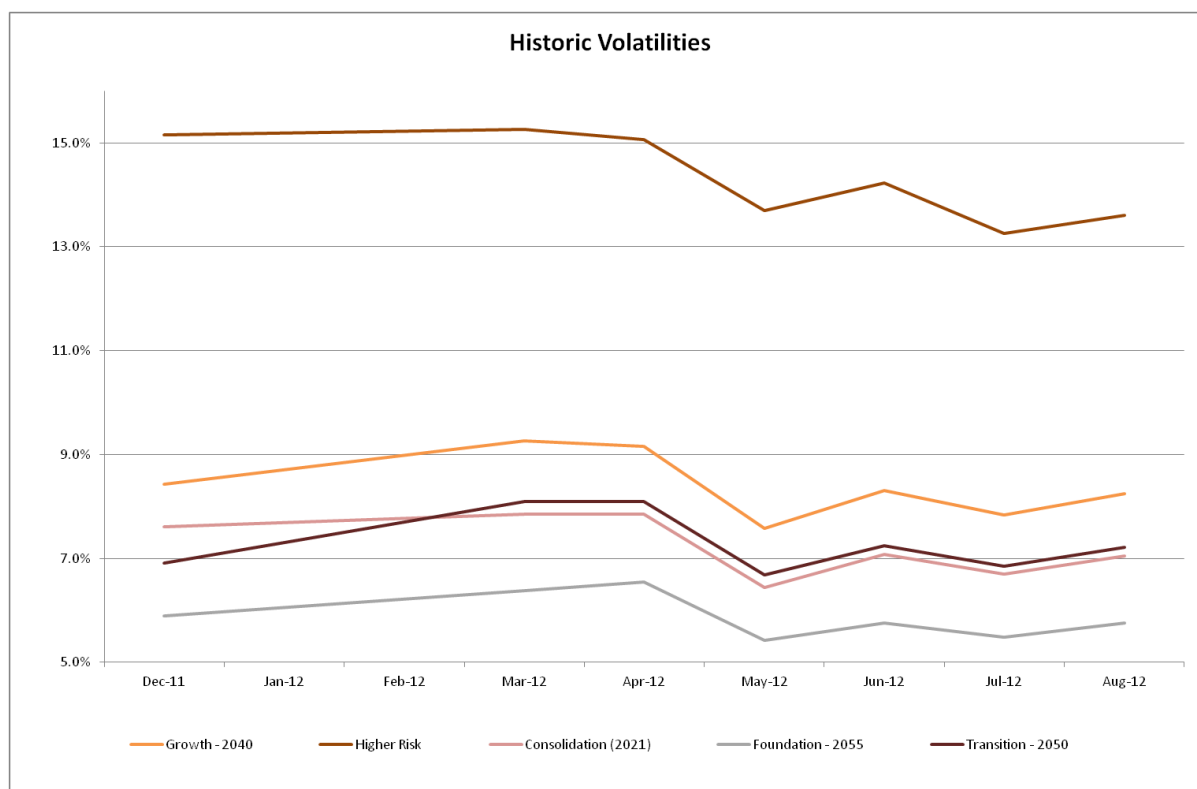
FUND		TOTAL RISK (VOLATILITY)					VaR		Mod Dur'n (Fixed Inc Portion)	
		Risk Budget Zones		Previous (Barra July 12)	Current (Barra)	Realised (Incept to June)	Previous (Barra July 12)	Current (Barra)	Previous (Barra July 12)	Current (Barra)
Target		(Comfort)								
TOTAL SCHEME										
TDFs										
Consolidation (late)	2013	N/A		0.5%	0.5%	0.6%	0.8%	0.8%	0.4	0.4
Consolidation (early)	2021	N/A		6.7%	7.1%	5.7%	11.0%	11.6%	6.5	7.2
Growth	2040	11%	8% to 15%	7.8%	8.3%	6.7%	12.9%	13.6%	6.3	7.2
Transition	2050	N/A		6.9%	7.2%	5.3%	11.3%	11.9%	6.8	7.5
Foundation	2055	7%	6% to 12%	5.5%	5.8%	4.2%	9.0%	9.5%	7.4	7.8
FUND CHOICES										
Higher Risk		17%	12% to 19%	13.3%	13.6%	12.1%	21.8%	22.4%	4.2	5.7
BUILDING BLOCK FUNDS										
BIRk Div. Beta				4.1%	5.4%	4.6%	6.7%	8.9%	4.5	6.1

This analysis is particularly helpful in the context of dynamic risk management. We always know how much of the allocated risk budget is used. In this way we can identify how much room is available/necessary to adjust exposures subject to the likely evolution of markets.

Our goal is to ensure that any rebalancing decision is made with reference to a long-term strategic framework. In broad terms, when certain risk factors are more likely to be positively rewarded, we aim to use the top end of our risk budget. When the opposite (as currently the case), we aim to use the bottom end of our risk budget.

The following graph shows the evolution of these indicators for the past nine months.

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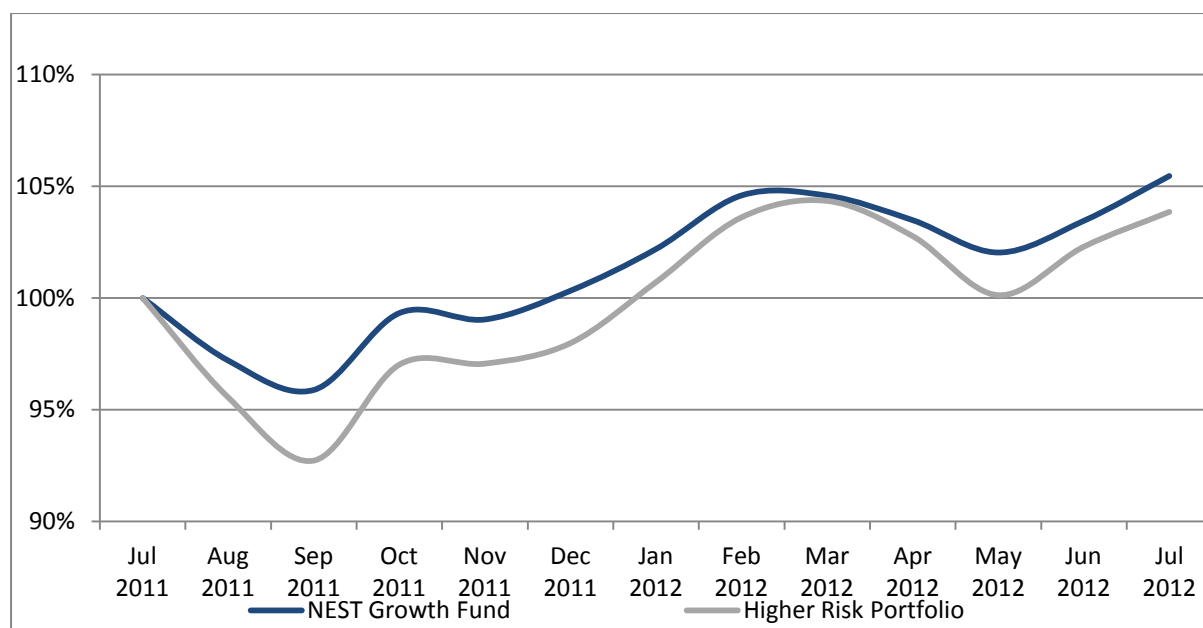
Section 3- How do our members benefit?

In the previous section we discussed how we monitor our risk budgets, and introduced the concept of risk-adjusted performance (RAP). A RAP framework means that we look for rewarded risk factors, and limit exposure to less rewarded ones. In the context of risk budget management, we therefore have to ask ourselves the question: is there a better way to use the risk budget?

We looked at the period July 2011 to July 2012. As section 2 showed, for the most part we used the bottom end of our risk budget during that period. How would our funds have performed if we'd decided to use the top end in the same period, using exactly the same process?

The chart below shows the live performance of NEST's growth fund, as well as that of a hypothetical higher risk budget fund.

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By definition the higher- risk fund carries more volatility, but over this period it also delivered poorer performance. This is a strong result to support our investment process. Indeed we would not expect this result to always be the case. The recent period is somewhat special as a consequence of the recent financial crisis. Yet our processes, and our support systems, have helped us arrive at a better result from a risk-adjusted perspective, which is exactly what they have been designed for.

As our processes have built-in adaptive mechanisms, we expect them to manoeuvre through transitioning markets when the recovery takes place. At that point we don't anticipate perfect market timing but a progressive identification of positive and consistent market signals.

This is the framework that NEST has chosen to deliver the smoother, more consistent long-term returns that reflect the expectations of our members. It also closes the gap between defined benefit and defined contributions governance and outcomes.

We've made risk management a strategic objective that will contribute to our long-term mandate. We expect to work with firms such as MSCI that can help us meet our objectives and commitments. We believe that automatic enrolment imposes a fiduciary duty on our partners as well as ourselves to deliver well-designed sophisticated solutions, a simple transaction mechanism and easy communication, at an affordable price for all.