Investment proposition
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Introduction

There is a lot that goes into the running of a pension scheme, but the biggest factors which will determine what our members will receive when they come to retire fall under three main headings:

- **Time to retirement**
- **Contributions paid**
- **Investment returns**

At NOW: Pensions, we don’t have much control over the first two, but we do have a responsibility to make sure that the investment engine is working effectively to get the best return on the contributions that we hold on behalf of our members.

This booklet explains how we do that.

The NOW: Pensions investment proposition represents simplicity and sophistication

In keeping with our overriding objectives of simplicity, sustainability and affordability, we offer one investment solution and do not think it’s appropriate to burden our members with the responsibility of making a choice on where they should invest their contributions.

The sophistication comes in the design and ongoing management of the investment funds throughout the lifetime of an employee’s membership of the scheme.

With an uninterrupted focus on a single investment solution, we can ensure a strong approach to investment governance, allowing members to concentrate on the things they can influence – fundamentally when they plan to retire, what they plan to do when they do retire, and how much they should be saving to turn their dreams into a reality.

‘Not following the herd’
Our goal is simple...

To provide an investment solution that represents good value and secures good outcomes for our members over the longer term. We break down our investment goal into our beliefs and how we can make sure that we stay true to those beliefs.

### Investment beliefs:

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<tr>
<th>Belief</th>
<th>Description</th>
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<tr>
<td>Horizon</td>
<td>Long-term investment strategies tend to offer superior risk-adjusted returns compared with short-term investment strategies</td>
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<tr>
<td>Risk Premia</td>
<td>Risk premia, the expected additional return for holding riskier assets, should compensate for the greater risks being taken. Individual risk premia vary over time. Holding a diversified portfolio of risk premia strategies is more efficient than trying to time individual risk premia</td>
</tr>
<tr>
<td>Diversification</td>
<td>Diversification of risk factors and sources of return provides a more stable portfolio return over the longer term. However, in the short term, correlations may become unsettled and the benefits of diversification may temporarily diminish</td>
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<tr>
<td>Markets</td>
<td>Market inefficiencies and irrational investor behaviour can cause prices to deviate from their fundamental values. Such deviations can give rise to opportunities for alternative risk premia strategies and tactical trades</td>
</tr>
<tr>
<td>Behaviour</td>
<td>We have limited predictive power. We focus on superior management of areas where we can make a difference, such as efficient diversification and cost of implementation</td>
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To achieve our goal, we invest all members’ contributions into one fund for most of their working life. We then gradually move those contributions into a safer environment, as the member begins their approach to retirement. We do this to reduce the impact of any sudden market surprises that might jeopardise any retirement plans.

The glidepath into retirement

\[ \text{Growth phase} \quad \text{Countdown Phase} \]

\[ \text{Asset allocation} \]

\[ 100\% \quad 90\% \quad 80\% \quad 70\% \quad 60\% \quad 50\% \quad 40\% \quad 30\% \quad 20\% \quad 10\% \quad 0\% \]

\[ \text{Saving into a pension} \quad \text{Time to go until retirement...} \]

\[ \text{Joined scheme} \rightarrow \text{10 years} \quad \text{8 years} \quad \text{6 years} \quad \text{4 years} \quad \text{2 years} \quad \text{Retired!} \]

- **Diversified Growth Fund**
  - Return Target: Cash + 3%

- **Retirement Countdown Fund**
  - Return Target: Cash
Funds used during the phases:

**Growth phase**

**Diversified Growth Fund (DGF)**

The DGF provides the engine which powers the journey towards a better retirement for our members. The fund uses a diversified investment strategy, balancing the risk of the different investments held by the fund. We believe this is the right approach if we are to deliver strong and stable returns over the long term.

The DGF adopts a modern approach to investment where we take steps to avoid being overly exposed to the performance of any particular asset class by constructing a more diverse and more risk balanced portfolio. We focus on a risk allocation, rather than asset allocation. This is different to more traditional investment approaches that focus on asset allocation and tend to have a much higher proportion of their overall risk exposed to stock markets.

By focusing principally on the investment risk characteristics of each investment, we are able to construct a balanced portfolio without subjecting our members to inappropriate risk.

We have spent a number of years understanding the risk characteristics of investments. That means being able to identify and understand the risk factors at play behind our investments and other investments available in the marketplace.

When we consider any new investments, we can measure and analyse how they will interact with what we already hold in the portfolio.

We separate all investments within the DGF into what we call risk factors. We have four risk factors:

- Equity Factor
- Interest Rate Factor
- Inflation Factor
- Diversifying Strategies

The risk and return characteristics within each investment are separated into these four risk factors depending on the types of risk to which the investment is exposed. The graphic below shows this in practice.
A balanced diet of pension investments

To put that into an everyday scenario, these risk factors can be likened to the nutritional value in food. All foods contain various combinations of the basic building blocks (proteins, carbohydrates, fat, etc.), but a well-balanced diet can only be achieved by balancing the nutrients within the different things we eat. Similarly, the DGF consists of a number of building blocks (risk factors) which can combine to create a portfolio with an appropriate balance of risk.

We have created our core strategy on the principle that over the long term, a balanced risk based portfolio provides higher risk adjusted returns. The factor based investment approach increases flexibility by allowing detailed analysis and comparison of investments without reference to asset type. The expected return from an investment can be determined based on a comparison with other investments with similar underlying risk characteristics.
The **Equity Factor** predominantly contains exposure to global equity risk, but can also include corporate bonds. That's because those bonds display characteristics which are closely aligned to equity risk. The exposure is achieved by investing in equities and equity derivatives as well as corporate bonds and credit derivatives which contain a credit risk, and funds containing similar investments. Investments within the Equity Factor are likely to produce returns that generally reflect expectations for economic growth.

The **Interest Rate factor** typically invests in government bonds with low credit risk, as well as other bonds with low credit risk. Investments will normally focus on the UK, Europe and the US and we introduce further diversification by investing in bonds with a variety of different maturity dates. Returns within the Factor will be largely driven by changes in interest rate expectations.

The **Inflation Factor** largely contains exposure to commodities and global inflation. Global inflation normally focuses on the UK, Europe, and the US. Investments are made in index-linked government bonds and other bonds with low credit risk. We will normally strip out nominal returns and focus on break-even inflation; that is to say the difference between the yield on a fixed rate-bond and that on an inflation-linked bond. The Inflation Factor can also contain commodities such as energy and precious metals.

**Diversifying Strategies** are systematic rule-based strategies which are specifically targeted to introduce additional diversification to the DGF. These strategies will typically have a low correlation to the other risk factors which are essentially long-only exposures. An example of this approach might be taking positions on a variety of currencies against the US dollar. Other strategies used within this factor could include trend strategies where we will invest more in assets with strong recent performance; or a “betting-against-beta” strategy, where we buy more shares with lower risk and fewer shares with higher risk.
Countdown Phase

As members approach retirement, we gradually switch their funds from the Diversified Growth Fund into the Retirement Countdown Fund (RCF).

The RCF is designed to generate returns similar to those available from cash holdings, by investing predominantly in cash deposits and money market funds.

The effect of switching members’ investments into this safer environment is that the nearer each member gets to their retirement, the lower the impact of any sudden market movements will be on the value of their money invested with NOW: Pensions.

We cannot predict how and when our members will draw their pension fund, and we do not believe that many members are in a good position to do so until they are very close to their retirement. Our glidepath strategy addresses this need for flexibility.

For those who wish take the full fund as cash

The glidepath gradually moves members’ funds towards cash, reducing volatility risk as well as creating an element of protection on the ultimate value.

For those who wish to purchase an annuity

Some members may wish to purchase an annuity with their retirement fund. Of course they may amalgamate funds from other pension arrangements to buy their annuity. With so many choices at retirement, we do not believe it’s appropriate for the investment strategy to focus on annuity purchase.

For those who wish to take Flexible Income Drawdown

Some members with larger retirement funds may consider transferring their pension fund to an income drawdown product. Our regular communications with members reminds them of the possibility of extending their retirement age to delay or even stop the glidepath process.
Some of our Investment risks and what we do to mitigate those risks:

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<tr>
<th>Risk</th>
<th>Description</th>
<th>Mitigation</th>
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<tr>
<td><strong>Currency risk</strong></td>
<td>The additional risk that the value of any overseas investments may rise or fall because of movements in currency exchange rates.</td>
<td>The target is 100% hedge +/- 5% of all non-GBP holdings.</td>
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<tr>
<td><strong>Counterparty risk</strong></td>
<td>Counterparty risk is related to assets held in credit institutions and to derivative exposures, to the extent that the other party to an agreement will default.</td>
<td>The risks are mitigated by following a thorough counterparty selection and monitoring process, and spreading the exposures between several counterparties. We also make sure that any derivative exposures are fully covered.</td>
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<tr>
<td><strong>Concentration risk</strong></td>
<td>The risk of having too much exposure to a particular instrument, or a particular issuer.</td>
<td>Concentration risk is mitigated by diversifying the investments across asset classes and investment products. As an example, equities issued by a specific company may not exceed 10% of the total issuance by that specific issuer or 5% of the total fund size.</td>
</tr>
<tr>
<td><strong>Asset liquidity risk</strong></td>
<td>This primarily relates to the ability to reduce or increase risk in all asset classes when we need to, and meeting any requirements for cash from our investments.</td>
<td>We make sure that the investments held by the fund are in liquid instruments to mitigate these risks.</td>
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<tr>
<td><strong>Operational risk</strong></td>
<td>The risk that internal operating procedures fail.</td>
<td>We have a number of safeguards and controls in place to mitigate operational risks:</td>
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<td></td>
<td></td>
<td>• Separation of Management and Board – Management executes; Board supervises (and holds Management to account)</td>
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<td></td>
<td></td>
<td>• Independent risk management and compliance functions provide additional oversight</td>
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<td></td>
<td></td>
<td>• Straight through processing ensures compliance with guidelines and minimises human error</td>
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<td></td>
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<td>• Post trade controls – conducted on a 'four eyes' principle</td>
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<td></td>
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<td>• Business continuity contingency plans in place</td>
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Why one investment strategy is the right approach

The Defined Contribution pensions market in the UK has traditionally offered members choice of investment. We believe this choice is more often than not inappropriate, dangerous, and passes an unwelcome responsibility across to scheme members. However, perhaps the industry has maintained that approach in a belief that it will achieve greater awareness and engagement among pension scheme members.

It’s true that the number of funds being offered has reduced over recent years, as the challenges and flaws associated with too much choice have been identified and well documented. However, only a few progressive schemes such as NOW: Pensions believe that providing one unified investment strategy, tailored to the planned retirement date of each member, is far more beneficial to the long-term wellbeing of members than offering a wider choice of funds.

Our view is that the vast majority of people saving for retirement are more comfortable in the knowledge that someone else is managing their investments on their behalf and that person is taking responsibility for their long-term savings needs. That is the responsibility of the NOW: Pensions Trustee Board.

There is strong evidence to support the view that investment choice often results in lower member outcomes.

Members who self-select are normally guided by the risk classifications of the funds available. However, regardless of the tools at their disposal, members continue to struggle to determine their own attitude to risk.

Their investment decisions are also influenced by market conditions at the time they make those decisions. If, at the time of joining the scheme, markets are bullish, members often have a lower perception of risk and higher expectations of return and will therefore be more likely to select adventurous funds. The converse is also true. Whichever scenario may apply, the results can have dangerous consequences, because although these emotional influences may be short-lived, those investment decisions may be long-term.
Few members ever change their investment decision. Research has shown that around 80% of members who make their own investment selections change those selections less than once every five years. More than half of them never review their initial investment selection.

While perceived attitude to risk may alter during the lifetime of a scheme member, this inertia means that the chances of a member changing his/her initial decision are low.

To make matters worse, we know that the few members who do switch their investment funds will very often find themselves chasing the market. The buy-high / sell-low behaviour of even the most experienced investors is well documented and pension scheme members who do make active investment decisions, however seldom, often fall into this trap.

At the time an employee joins the pension scheme, the more decisions they are asked to make, the more confusing pensions become, when actually we should all be making an effort to demystify the whole concept of saving for retirement. Attitudes to risk; fund descriptions; fund fact sheets; risk warnings; and investment choices take time to interpret and digest and that leaves less time to consider the important issues such as:

- **When do I want to retire?**
- **What do I want to do when I do retire?**
- **How much should I be paying into my pension scheme?**

If we focus on the automatic enrolment market for a second, we know from our peer group that when presented with investment choice, more than 99% of members have remained in the default fund offered. Investment choice is just not supported.
Additional information

Charges and pricing

The annual management charge of 0.3% is applicable throughout the Growth and Protection phases. A separate monthly administration charge of £1.50 is also applied. These charges apply to both active and deferred members. Units allocated to members’ funds represent their share of the funds and are single-priced. That is to say, on any given trading date, we only use one price for both the purchase and the sale of units.
‘Simplicity is the ultimate sophistication’

Leonardo Da Vinci