Looking after members’ money

NEST’s investment approach
About this guide

This booklet is intended to help you understand what happens to members’ money. It’s one of a series of documents that describe our investment process.

▶ Our Statement of investment principles outlines the policies and principles that guide our decisions when we’re managing our members’ money.

▶ Our Quarterly investment report and Annual report and accounts give more information about how well we’ve delivered against our investment goals.

This investment approach booklet fills in the details. It provides the information you need to understand how our funds are managed, our goals and objectives and the research that led us to set up our investment approach the way we did.
Contents

01 Introduction  
page 4 >>

02 Our investment approach  
page 5 >>

03 Our investment beliefs  
page 8 >>

04 Our ambition for our members  
page 10 >>

05 Our funds in depth  
page 13 >>

06 How we invest members’ money  
page 20 >>

07 Managing money day to day  
page 24 >>

08 What next?  
page 34 >>

Information  
page 25 >>

Decisions  
page 28 >>

Action  
page 30 >>
When we’re looking after our members’ money we have one goal – we want to give them a better income in retirement.

When creating NEST we had the opportunity to build an investment approach from the ground up. We had free rein to create a savings product that focused on what was best for the majority of workers rather than a traditional market of higher earners.

We began with a significant amount of research into our likely membership. We then studied the way other countries had put together mass pensions saving schemes.

We used what we found out as a guide to how we could grow our members’ money while addressing their desire to keep it safe. NEST’s in-house team took existing and well-understood ways of managing money and combined them in a different way to create a new approach to long-term saving for workers in the UK.

We wanted to build a pensions savings vehicle that’s easy for members to use and understand but at the same time gives them access to the latest technology and thinking on portfolio management.

Explaining how we do that is what this booklet is all about.

What is NEST?

NEST is a workplace pension scheme that any employer can use to meet their workplace pension duties. It’s the only auto enrolment scheme in the UK with an obligation to take any employer regardless of the size or value of their business.

NEST is run in the interests of its members by NEST Corporation, which has been appointed as Trustee of NEST. NEST Corporation doesn’t have shareholders and doesn’t distribute a profit.

It’s been designed to be easy to manage online for both employers and members. Our research programme has covered investment, communications and usability with findings in each area directly reflected in the product’s features.
We’ve created an investment product for all investors. The straightforward experience for the member is built on a sophisticated approach to risk management and asset allocation.

**What members see...**
- straightforward enrolment experience
- NEST Retirement Date Funds offering a tailored approach for every member
- clearly labelled fund choices that address the needs of a diverse workforce
- clear communications without overwhelming them with information
- same low charge across all funds.

**What’s driving the member experience...**
- multi-phase investment approach that targets different risk and return objectives
- dynamic risk management designed to succeed in different economic conditions
- delivery system that provides flexibility and efficiency
- high levels of governance and clear alignment of long-term interests between investment managers and members.

We want to make it easy for our members to save. In fact, one of the best things a saver with NEST can do after they’re enrolled is nothing. Doing nothing at this stage means staying enrolled, making contributions and gaining all the advantages of the NEST Retirement Date Fund investment approach.

This is what makes NEST different. We’ve kept things simple and our charges low without sacrificing any of the high-quality management that the most demanding investors expect.
NEST Retirement Date Funds

We’ve focused our efforts on creating a robust default option that’s right for most people. Our research suggests that a significant majority of the people who’ll start saving through auto enrolment don’t want to make decisions about what happens with their money. They just want to know it’s being well looked after and will be waiting for them when they’re ready to use their money for their retirement.

We’ve created our default option – the NEST Retirement Date Funds – for them.

At any time there are up to 50 NEST Retirement Date Funds. Each fund aims to have members’ money ready to convert into retirement benefits in the year they want to take their money out.

If the member wants to take their money out in 2040 their retirement pot will be held in the NEST 2040 Retirement Fund. If they decide they want to save for longer or take their money out earlier they can change their preferred retirement date at any time. Their retirement pot will be automatically switched to the NEST Retirement Date Fund that matches their new retirement date free of charge.

Our other fund choices

We know that some members have faiths or beliefs that mean some types of investment aren’t right for them. We also know that some of our members associate putting their money into the stock markets with a high chance of losing it. Others have the opposite view and have an appetite to take more risk than the NEST Retirement Date Funds typically take.

Without suitable options these people may well opt out of automatic enrolment and have no savings for their future.

To make sure that these savers can take part in NEST we’ve created a range of clearly labelled fund choices. They offer members genuine alternative approaches at the same low charge as our NEST Retirement Date Funds.
NEST Ethical Fund
This fund is designed for members who are concerned about the impact that their investments can have on areas such as human rights, fair labour practices and the environment. Unlike many other ethical funds available, our NEST Ethical Fund choice uses a three-phase investment approach similar to the NEST Retirement Date Funds.

NEST Sharia Fund
This fund is designed for members who want an investment approach based on Islamic law. It invests entirely in global equities judged to meet sharia standards. Because it invests in just one type of asset it carries a higher level of investment risk than our other fund choices.

NEST Higher Risk Fund
This fund is for members who want to take more investment risk to try and make their retirement pot grow more quickly than in a NEST Retirement Date Fund. As members approach their retirement date we’ll move their pot into the appropriate NEST Retirement Date Fund. This will help protect any gains they’ve made and get their retirement pot ready for them to take out of NEST.

NEST Lower Growth Fund
This fund is designed for members who are very cautious about investing. Their retirement pot will be exposed to far less investment risk than a NEST Retirement Date Fund. In the long term however, it will probably grow less than other fund choices and may not keep pace with inflation.

NEST Pre-retirement Fund
This fund is for members who start saving with NEST when they’re near their retirement date and know they want to buy an annuity instead of taking all their pot as cash.
Our investment approach is built around strong ideas about how finance and financial markets work that guide our day-to-day investment decisions. We call these principles our ‘investment beliefs’.

They’re based on investment theory and real-world evidence. They help us make consistent decisions that reflect our views on how economies and markets work and help our members, participating employers and advisers understand what we’re trying to achieve.

Understanding scheme member characteristics, circumstances and attitudes is essential to developing and maintaining an appropriate investment strategy.

Automatic enrolment will bring large numbers of savers to the pensions market who are less able to absorb the high charges that traditional actively managed portfolios attract. However, their collective purchasing power will mean that we can provide equal or better products and services designed exclusively for their lives and aspirations. Our purpose is to deliver the highest quality investment product built just for them.

As long-term investors, incorporating environmental, social and governance (ESG) factors is integral to the investment management process.

We take a holistic approach to risk. We’re particularly aware of how risks change over time – which risks are rewarded and in what time frames. For example environmental risks are relevant for their rewards over the longer term, whereas other risks may have a shorter-term impact. We consider all these different risks when we make investment decisions.

Taking investment risk is usually rewarded in the long term.

The relationship between risk and reward is at the heart of everything we do. In order to consistently deliver returns in line with our investment objectives we need to take investment risk. However, we need to be smart risk takers with an eye on the long term.

Diversification is the key tool for managing risk.

Risks – like rewards – are found in different places and at different times. To deliver sustainable performance we spread risk, reduce volatility and adjust risk allocations over time.
Risk-based asset allocation is the biggest driver of long-term performance.

Achieving our investment objectives depends on a risk/return profile that targets growth but not at any cost. Understanding this drives our asset allocation. Whenever we invest we aim to assess risk and return as efficiently as possible.

Taking account of asset values and asset prices, economic conditions and long-term market developments enhances long-term performance and informs strategic decisions.

We manage risk actively by paying close attention to signals and trends in the markets. We’re committed to long-term investment. We judge our success based on how well we manage our members’ investments across economic cycles, whether economies are experiencing positive growth or severe headwinds.

Indexed management, where available, is often more efficient than active management.

Active management can be expensive and on average, active managers in many asset classes tend to underperform passive benchmarks in the long term. However, all investment styles are open to us. When we want to expose members to a particular type of asset or market we’ll use the approach that provides the best access at the best value.

Good governance, including an appropriately resourced in-house investment function, is in the best interests of NEST members.

NEST considers that its approach – in house active management complemented by the governance processes overseen by the investment committee – is designed in the best interests of its members to achieve ambitious, sustainable returns over the long term.
NEST was established to help its members save for retirement. We want them to understand how they can improve their future lives and we want to make it easy for them to do so.

Investment plays a central role in this. By investing internationally and across asset classes we tap into global growth where and when it’s available. In this way we can give our members a share in the long-term value they bring to the UK economy and in economic growth around the world.

Understanding what our members want and need

Before we could create a good product for our members we needed to better understand their needs and desires. We conducted a significant amount of research into the likely profile of savers who’ll be brought in by automatic enrolment.

We wanted to know what kind of investment will feel right to them. What will feel fair to our members? What are their expectations? What will make them feel that this isn’t an obligation but an opportunity to improve their lives?

Our research shows that while they expect to see growth in their savings they’re uncomfortable with the idea of extreme volatility and concerned about things like stock market crashes. Many people told us that they’d prefer a bit more smoothness in the journey and outcomes that are reasonably predictable. They were less keen on chasing bigger but less likely returns.

We created our NEST Retirement Date Funds for them.

<table>
<thead>
<tr>
<th>What members want</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
</tr>
<tr>
<td>Smooth ride</td>
</tr>
<tr>
<td>Investment decisions made for them</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What members need</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversified portfolio</td>
</tr>
<tr>
<td>Growth-seeking assets</td>
</tr>
<tr>
<td>NEST lifecycle</td>
</tr>
</tbody>
</table>
Why is managed risk important?

It’s impossible to achieve significant returns, such as returns above the risk-free rate, without taking some risk. But risk needs to be taken in a calculated and managed way. Only by doing this can we consistently deliver on our investment objectives.

The goal of our risk management process is to make sure that the risk we take is properly rewarded. We look at the potential return offered by different asset allocations and assess them in relation to the risks they carry. We don’t automatically chase the highest returns for our members and we don’t aim to expose them to the least risk. We look for the investments that offer the best returns in relation to the level of risk.

All of our funds have clear risk targets focused on meeting our return objectives. We constantly monitor where risk comes from, how big it is and whether or not it’s positively rewarded. We aim to take risks that will be favourably rewarded and minimise exposure to unrewarded risks while delivering the risk/return profile as smoothly as possible.

Why inflation?

Our investment objectives are based on delivering above-inflation growth. We’re not interested in delivering market-relative performance. Our members need to grow their money in real terms to build a retirement pot. We want to make sure that our members don’t lose out to either the rising cost of living or sudden investment shocks and that they get back the charges they pay through investment growth. It’s what our members expect and so we’ve put it at the heart of what we do.
Communication

Talking to members

We know from our research into people’s attitudes to savings and pensions that many are concerned about how safe their money will be in a defined contribution pension scheme. We also know that a lot of people across all levels of education and achievement don’t understand what investment is or how it works.

This can stop them from making decisions about their pension out of fear of doing something wrong. But we want our members to have confidence in saving for their retirement. They have a right to know what’s happening to their money and many of them want to know.

If members can understand how we look after their money and their likely outcomes, they’ll be empowered to make informed decisions about their future. This might include making additional contributions or working for longer to get a better income in retirement.

Our ongoing programme of communications research is focused on finding out how we can bring investment issues alive for our members. We want to connect them with their money. In response to this we’ve developed new ways to talk about investment using plain language and real-world examples.

For example, we’ve named our funds to help our members understand their options. We don’t have a ‘higher growth fund’, we have the NEST Higher Risk Fund. This makes savers aware that this fund faces higher volatility than our NEST Retirement Date Funds.

We’re continually fine-tuning our communications in response to what our members tell us and developing innovative new ways to help them understand the opportunities that pension saving offers.

Talking to employers and advisers

We also provide information with a more technical focus for those who want more detail.

We produce a quarterly investment report aimed at advisers. It contains detailed information about asset allocation, risk characteristics and fund performance for each of our fund choices and representative NEST Retirement Date Funds in each of the lifecycle phases.

We also produce documents such as this one to explain our investment strategy and to provide the bigger picture of how our funds work. These include our *Statement of investment principles*, which is available from our website at [nestpensions.org.uk](http://nestpensions.org.uk)
NEST Retirement Date Funds

Each NEST Retirement Date Fund pools the retirement pots of all the members who plan to take their money out of NEST in the same year. So the retirement pots of all our members who plan to take their money out in 2040 are invested in the NEST 2040 Retirement Date Fund. This allows us to efficiently address the common interests of large numbers of savers while still providing a tailored approach for individuals.

We're able to adjust the portfolio of each fund to match our members' place in the saving lifecycle and take account of changing economic and market conditions along the way. This gives our savers a much smoother ride than funds based on a single asset class – such as shares – or those that rely on a mechanical approach that adjusts allocations automatically according to a fixed schedule.

The youngest members who put their money in our NEST Retirement Date Funds will go through three phases. Each phase has a different objective that focuses on the needs of the member at specific times in their savings career.

We have a glide path that sets out the levels of investment risk we expect to take at each stage of the lifecycle. These are designed to balance the member’s need to keep their money growing to at least outperform inflation with their desire to avoid the unpredictable returns that they’ve told us they find alarming.

The glide path is defined by the risk budgets we allow for each phase. We’ve defined these through portfolio volatility levels for the Growth and Foundation phases and derisking to appropriate retirement portfolios for the Consolidation phase. Broadly speaking we’ve set risk budgets in terms of taking sufficient but not excessive risk. However, the way NEST Retirement Date Funds are structured allows us to vary the amount and type of risk taken according to economic and market conditions.

Moving between phases

Our lifecycle isn’t a rigid ‘set and forget’ regime. We dynamically manage the transition between phases to take account of our view of the financial markets, the economic environment and our latest understanding of our members. This helps us judge the best time to begin reducing or increasing the investment risk.

In this way we can take advantage of the good times on our members’ behalf while helping protect them from the bad times.
Growth phase objectives
- Target investment returns greater than inflation plus 3 per cent and cover all scheme charges.
- Target a long-term volatility average of 10-12 per cent.
- Maximise diversification.
- Aim for steady growth in real terms over the life of the fund.
- Maximise retirement incomes by taking sufficient investment risk at appropriate times while reducing the likelihood of extreme investment shocks.

Foundation phase objectives
- Keep pace with inflation while preserving capital.
- Target a long-term volatility average of 7 per cent.
- Significantly reduce the likelihood of extreme investment shocks.
- Take appropriate risk at appropriate times, taking account of current economic and market conditions.

Consolidation phase objectives
- De-risk into cash in the short term.
- From 2021 onwards continue to grow the portfolio in real terms.
- Gradually reduce volatility as the fund gets closer to maturity.

Reference glide path
- **Foundation phase**: CPI+
- **Growth phase**: CPI+3
- **Consolidation phase**: CPI+
The Growth phase is the engine room of the NEST Retirement Date Funds approach where we concentrate on growing the pot quickly. Members could spend up to 30 years in this phase. We’ve set ourselves a benchmark of 3 per cent above inflation after all charges over an economic cycle so that we – and our members – can judge if we’re delivering the growth our members need and expect. In practice, though, we’ll try and outperform our objectives in the good times.

The Foundation phase is focused on getting savers into the savings habit. During our research younger savers told us that they may stop saving if they see falls in the value of their retirement pot. This is true even for a very short-term or one-off loss. For this reason members who join in their 20s will typically spend one to five years in the Foundation phase. In this phase we want to encourage members to keep saving by making sure they see a steady increase in their retirement pot as they make contributions. We still aim to beat inflation to protect the real value of their retirement pot but we don’t expose them to the risks associated with chasing higher growth. Mathematical modelling shows that the impact on final outcomes is negligible for most members, but the impact of stopping saving could be much more harmful.

The Consolidation phase is when we move to lock in any gains that members have made. Investments in this phase are progressively switched out of higher risk assets. We still expect to grow members’ money by more than inflation, but gradually reduce volatility as the fund gets closer to maturity.

NEST Pre-retirement Fund

The Consolidation phase is currently targeting cash. Some savers in this phase will want to buy a retirement income with some or all of their pot, perhaps combining it with retirement pots in other schemes. We’ve created this fund to make that easier for them.
Our other funds

NEST Ethical Fund

- provide a fund choice for members who want to invest in a portfolio that reflects their ethical investment concerns
- aim for steady growth in real terms over a member’s time with NEST
- maximise incomes in retirement by taking sufficient investment risk at appropriate times while reducing the likelihood of investment shocks.

We know from our research that many savers are suspicious of financial services and the financial services industry. Their concerns are not just over the safety of their money – many also worry about the types of business that their money is supporting.

These members may opt out if they can’t be sure that their money isn’t being used by companies involved in products or with policies they feel are unethical. People who were interested in ethical investment told us during our research that their main concerns are global issues such as child labour, exploitation and human rights violations.

We believe that members shouldn’t be penalised for their views. Our NEST Ethical Fund choice has the same low charges as the default. It currently offers members a diversified portfolio including ethical equities, real estate and UK government bonds. As with the NEST Retirement Date Funds we manage the allocation between these asset types to protect members’ retirement pots and take advantage of market growth.
In addition, the NEST Ethical Fund choice follows a similar life cycle to NEST Retirement Date Funds using separate Foundation, Growth and Consolidation funds. This is one of the few ethical pension funds available in the UK that uses a phased investment approach in this way.

At the moment we move members between these phases using a formula based on their NEST retirement date. However, as our membership expands we’ll look at ways we could dynamically manage transitions as we do for the NEST Retirement Date Funds.

Our member and employer research showed there was sufficient interest in investment that’s compatible with Islamic law that some savers would opt out if the option wasn’t provided. Although we expect take-up to be limited it’s important for us to be able to offer funds for as wide a cross-section of the workforce as possible.

The NEST Sharia Fund invests entirely in the HSBC Life Amanah Pension Fund, which tracks the Dow Jones Islamic Titans 100 index. This index is made up of shares in the 100 largest global companies that have been judged compliant with sharia principles by an independent board of Islamic scholars.

This fund’s performance can be volatile because it’s invested entirely in equities. Similarly, we’re currently unable to change the asset mix over a member’s career as we do with NEST Retirement Date Funds as other asset types don’t necessarily meet sharia standards.

We’d like to reduce the volatility of this fund and give members a smoother approach. We’re looking into ways we can do this efficiently using additional sharia-compliant asset classes.

### NEST Sharia Fund

- provide a fund with an investment approach based on Islamic law
- target a long-term volatility expectation of 22 per cent
- grow a member’s pot in real terms over the course of their savings career

Our funds in depth
Our research revealed that some of the savers who’ll be automatically enrolled in schemes like NEST are very unwilling to trust their money to the financial markets. When given no choice about what happens with their money these savers are very likely to opt out rather than put their money into investments they consider unsafe. This fund has been designed for these members.

Members who choose this fund are very unlikely to see a fall in the nominal value of their fund. However, there’s a good chance that at times their retirement pot won’t grow as quickly as the cost of living. Remaining in this fund for very long periods may well not be appropriate but it protects savers against an even bigger risk – not saving at all.

**NEST Lower Growth Fund**

- preserve the nominal value of contributions and grow the fund in line with low-risk money market investments
- achieve an investment return that’s in line with or better than wholesale money market short-term interest rates before charges
- we expect a long-term volatility average of 0.5 per cent
- provide a fund for members who want to take as little investment risk as possible.
Our research into what our members want from a pension scheme showed that a significant minority wanted a more adventurous approach. The NEST Higher Risk Fund is for these people. It has a greater exposure to growth assets than our other funds.

We’re still very conscious of providing a carefully risk-managed portfolio. While the proportion of equities is very high, this fund choice is diversified across the same sorts of assets as the growth phase of NEST Retirement Date Funds.

In addition, members who choose this fund will be moved to an appropriate NEST Retirement Date Fund about 10 years before their NEST retirement date. This will help protect any gains they’ve made in the previous years and get their retirement pot ready to convert into cash or a retirement income when they come to take it out of NEST.

**NEST Higher Risk Fund**

- take more investment risk than the NEST Retirement Date Funds in pursuit of higher returns
- target a long-term volatility average of 17 per cent
- reduce the impact of extreme investment shocks by diversifying across a range of return-seeking asset classes
- gradually de-risk members’ investments as they approach retirement.
NEST uses members’ money to buy units in pooled funds provided by global fund management companies. Each of these funds has a clear investment objective and generally invests in a single asset class. We diversify our members’ money across different types of investment by buying units in each of these funds in varying proportions. These proportions depend on the NEST Retirement Date Fund or the other fund choices our members have selected.

Using third-party pooled funds in this way helps us manage our members’ money efficiently. We’re able to give them exposure to a variety of global markets in a way that meets their needs while keeping our charges low.

**Fund managers**

**UBS Global Asset Management**

**UBS Life Climate Aware World Equity Fund** aims to deliver returns broadly in line with the FTSE Developed Index while overweighting and underweighting companies based on their future contribution to climate change.

**UBS Life World Equity Tracker Fund** provides exposure to global equity markets by tracking the FTSE All World Developed index.

**State Street Global Advisors**

**State Street Global Advisors UK Conventional Gilts All Stocks Index Fund** tracks the performance of the FTSE Actuaries UK Gilts British Government All Stocks index.

**State Street Global Advisors UK Index-Linked Gilts Over 5 Years Index Fund** tracks the performance of the FTSE Actuaries UK Gilts British Government Index-Linked Over 5 Years index.

**BlackRock**

**BlackRock Aquila Connect Cash Fund** is a low-risk fund that aims to maximise current income, consistent with preservation of principal and liquidity through a portfolio of high quality short-term sterling money market instruments.

**BlackRock Institutional Sterling Ultra Short Bond Fund** aims to generate current income and a reasonable degree of liquidity through a portfolio of high quality money market and fixed income instruments including floating rate securities.

**BMO Global Asset Management**

**BMO F&C Responsible Global Equity Fund** seeks to outperform the MSCI World index by investing in global equities that meet certain ethical criteria.

**BMO F&C Responsible Sterling Bond Fund** invests primarily in fixed interest securities of ethically-screened companies, mostly investment-grade corporate bonds. A rigorous management process and widely diversified portfolio seek to control excessive credit risk.
HSBC Global Asset Management

HSBC Global Investment Funds (GIF) Economic Scale Index GEM Equity Fund is an alternative indexation fund with a value style bias. It’s designed to weight companies in proportion to their relative economic footprint as measured by certain fundamentals.

HSBC Life Amanah Pension Fund passively tracks the Dow Jones Islamic Titans 100 index, a global equity index comprised of companies that comply with sharia principles.

Royal London Asset Management

The Royal London Asset Management Sterling Bond Fund is an actively managed fund that aims to outperform the iBoxx Sterling Non-Gilts All Maturities index within a risk-controlled framework. The fund invests mainly in investment-grade sterling credit bonds although it can hold other securities including UK government bonds, UK index-linked securities and money market instruments.

The Royal London Investment Grade Short Dated Credit aims to provide a return from a combination of income and capital growth by investing in a diversified portfolio of investment grade short dated bonds.

Legal & General Investment Management

LGIM Hybrid Property Fund invests in the LGIM Managed Property Fund and the LGIM Global Real Estate Equity Index Tracker Fund on a default position split of 70:30 respectively. This fund provides greater diversity and liquidity, while reducing costs associated with investing directly in property.

LGIM Managed Property Fund (UK) is an actively managed, daily priced, UK real estate fund that invests directly in freehold and leasehold properties.

LGIM Global Real Estate Equity Index Tracker Fund aims to provide global, diversified exposure to listed real estate equity markets around the world by tracking the FTSE EPRA/NAREIT Global Real Estate index.

LGIM single year maturity gilt fund provides a rolling replacement of the fund that matures each year so there will always be ten funds available. For example, when the 2016 fund matures a new 2026 fund will be created.

Northern Trust Asset Management

Northern Trust Emerging Markets Custom ESG Equity Index Fund is managed in the same way as the standard market-cap weighted $225m Northern Trust Emerging Markets Index Fund, but screens out stocks on the basis of certain environmental, social and governance (ESG) criteria. For example, it avoids stocks with involvement in the manufacture of cluster munitions and landmines. It tracks a market capitalisation weighted index.
Amundi Asset Management

Amundi Funds Global Emerging Blended - IE is an actively managed emerging market debt fund that allows us to access the opportunities of emerging markets while managing the risks.

Responsible investment and corporate governance

Responsible investment is focused on the ways that returns for investors can be affected by the environmental and social impact of a company, or the way it’s governed. These are often abbreviated to ‘ESG factors’.

We think that companies with well thought out environmental and social policies and good corporate governance do better in the long run than companies that neglect these issues. It’s in the interests of our members for us to consider how companies behave and how it affects members’ outcomes in the long term.

Our main goal is to manage the risks that ESG factors can bring to investment. Secondary to this is a desire to improve the way markets operate and encourage sustainable performance from the companies we invest in on behalf of members. Finally, we also need to make sure that NEST is seen to be a responsible investor so that the public – be they members, employers or stakeholders in NEST – can have confidence in the scheme.
Our responsible investment objectives

• improve the environmental, social and governance performance of our portfolios if there is evidence doing so can lower the amount of risk we need to take in order to achieve a return

• work individually and collaboratively with other investors to improve the way that the markets we invest in operate and are regulated

• encourage the companies we invest in on our members’ behalf to deliver sustainable and stable performance through longer-term performance horizons rather than a short-term focus

• reduce the possibility of reputational damage affecting the value of a company we hold and having any knock-on effect on the reputation of NEST.

Promoting the benefits of responsible investment

We’ve signed up to two initiatives that promote the benefits of responsible investment.

NEST is a signatory to the United Nations-backed Principles for Responsible Investment (PRI). The PRI are a set of principles that aim to build a framework for global best practice in responsible investment.

We’re also a signatory of the UK Stewardship Code. The code was adopted by the Financial Reporting Council in July 2010. It aims to improve the quality of engagement between investors and companies to help enhance long-term returns to shareholders and improve and strengthen corporate governance.

We’ve published our statement of compliance with the UK Stewardship Code on our website.
We’ve put in place a robust, repeatable process to make sure that our members’ money is managed responsibly. It combines in-house expertise with leading data providers and fund managers and is subject to checks, balances and monitoring to ensure that sound decisions are made on good information and that these decisions are implemented efficiently.

This process is best understood in three main phases.
At the heart of our process is a comprehensive understanding of what’s happening in the economy and the markets. We use this to make appropriate decisions on risk for our members based on how long they have until retirement.

We have two key objectives in mind when managing members’ risk:

- **Achieving our growth objective**
  Our risk management framework helps us to take the right amount of risk required at any given time to achieve our return objectives

- **Avoiding extreme losses for our members**
  Understanding what’s happening to different types of investment in different economic or market regimes helps us reduce exposure to them in periods of crisis and to understand when these assets are undervalued and should be bought.
The risk map

We've created a risk map that tracks a range of vital risk indicators to help us understand the economic environment using rigorous analysis of the latest market data. We rate these as red, amber or green to provide us with an at-a-glance guide to the major threats and opportunities. More red lights increase the degree of caution with which we approach decision making and increases the level of governance any decision is subject to.

<table>
<thead>
<tr>
<th>Our risk map indicators</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economy</td>
<td>growth in developed and emerging global markets</td>
</tr>
<tr>
<td>Inflation</td>
<td>core and headline inflation in developed and emerging markets</td>
</tr>
<tr>
<td>Investor sentiment</td>
<td>measures of investor confidence</td>
</tr>
<tr>
<td>Political risk</td>
<td>focuses on sovereign default risk and government intervention in capital markets</td>
</tr>
<tr>
<td>Default risk</td>
<td>sovereign and corporate credit quality and its impact on the market</td>
</tr>
<tr>
<td>Valuation</td>
<td>valuation of the different asset types we invest in</td>
</tr>
<tr>
<td>Cost of borrowing</td>
<td>how the costs of borrowing and the availability of credit affect individuals and businesses</td>
</tr>
<tr>
<td>Leverage</td>
<td>risks associated with debt levels in business and for individuals</td>
</tr>
<tr>
<td>Concentration</td>
<td>correlation of risks across different asset classes</td>
</tr>
<tr>
<td>Volatility</td>
<td>looks at volatility levels in the broad market and for specific asset types</td>
</tr>
<tr>
<td>Liquidity</td>
<td>assessment of liquidity conditions in the economy and financial markets</td>
</tr>
</tbody>
</table>
Portfolio review

We examine the current portfolio to see where it sits in relation to the risk environment we’ve identified using the risk map.

In particular we look at the portfolio position in terms of value-at-risk, volatility and other dimensions. We also look at portfolio performance and fund manager-specific issues.

Valuations and regime signals

Valuation analysis tells us whether an asset type is fairly priced. This helps us to assess whether the risk characteristics of an asset type are a fair reflection of the potential to increase in value. These give us a positive or negative view of each.

In practice we won’t be buying and selling at every twist of the valuation cycle but these signals will help us manage cash flows. If assets are cheap we’ll act quickly to get members’ money to work. Similarly, if asset classes look overvalued we’ll consider reducing our exposure.

We also examine growth in gross domestic product, inflation and the volatility environment as these factors can affect how different asset types perform at different times. These measures, combined with the asset-specific information we’ve gathered at this and the previous steps, help us to understand how different asset types might perform in the near future.
As a trust we have a responsibility to manage money in our members’ best interests. All the decisions we make are intended to provide our members with a good return.

**In-house investment team**

The investment team manages our members’ money from day to day. They monitor the performance of our fund managers, consider the opportunities available in different asset classes and assess our responsible investment requirements.

We hold an asset allocation meeting every quarter where the investment team reviews all of the information and makes recommendations. This gives us broad weightings for the main asset types we invest in – equities and other growth assets, emerging market debt, corporate and other bonds, property, cash and gilts.
The investment committee
All investment decisions are overseen by the Trustee through the investment committee, a group of Trustee Members that meets quarterly to formally review investment operations and decisions. They decide on the recommendations of the chief investment officer (CIO) on:

- investment objectives
- risk budgets
- strategic asset allocations
- the parameters of dynamic risk management
- approach to active ownership
- evolution of fund choices
- fund manager selection and monitoring
- investment communications for members and employers
- investment costs.

This committee also monitors fund performance and operation to make sure that the Trustee is fulfilling its legal duties.

Members’ Panel and Employers’ Panel
The Trustee also gets the views of members and employers using NEST through the Members’ Panel and Employers’ Panel. These two groups provide member and employer perspectives on investment to the Trustee and have a statutory role in reviewing the Statement of investment principles.

These checks and balances provide NEST with a high level of oversight in its investment operations.
Member's retirement pot held as units in their NEST retirement fund

TCS collects contributions

TCS receives unit prices to value retirement pots

State Street buys units in underlying funds based on NEST’s asset allocation decisions

NEST Retirement Date Funds

Other fund choices

State Street Bank calculates AMC and NEST Retirement Date Fund unit prices

Growth-seeking assets

Income-seeking assets

NEST asset allocation

Amundi
BlackRock
BMO
HSBC
LGIM
RLAM
State Street Global Advisors
UBS
Northern Trust

Underlying funds

Amundi
BlackRock
BMO
HSBC
LGIM
RLAM
State Street Global Advisors
UBS
Northern Trust

Income-seeking

Growth-seeking

TCS

£
Making the decisions happen

Just as important as getting the right information and making the right decisions is enacting those decisions quickly and efficiently. We’re helped in this regard by our scheme administrator Tata Consultancy Services and fund administrator State Street Bank.

Tata Consultancy Services collects contributions for all our members. They pass consolidated trade data on to State Street Bank to invest in NEST funds on behalf of our members.

Our investment operations team is responsible for advising State Street Bank of the changes to the asset allocation and making sure that the changes have been made as directed in a timely way.

NEST Retirement Date Funds structure

We’ve structured our default NEST Retirement Date Funds in a way that allows us to minimise our trading costs. They’re made up of synthetic sub-funds we call ‘tier 2 funds’. Each of these tier 2 funds is a mix of assets designed to focus on growth, income or cash. Tier 2 funds are made up of units in our underlying building block funds provided by our fund managers.
The internal marketplace

NEST Retirement Date Funds
Our default fund structure gives every member an investment profile that matches their planned retirement date.

By creating an internal market between NEST Retirement Date Funds we reduce the drag on performance caused by transactional costs like stamp duty and brokerage fees.

Growth-seeking assets from the NEST 2023 Retirement Fund are passed to the NEST 2052 Retirement Fund without incurring trading costs.

Income-seeking assets held in the income-seeking part of the fund are passed to the NEST 2023 Retirement Fund without incurring trading costs.

Members in the NEST 2052 Retirement Fund are entering the Growth phase
Reducing exposure to income-seeking assets and adding growth-seeking assets

Members in the NEST 2023 Retirement Fund are entering the Consolidation phase
Reducing exposure to growth-seeking assets to get ready for members to take their money out

The internal market
By creating an internal market between NEST Retirement Date Funds we reduce the drag on performance caused by transactional costs like stamp duty and brokerage fees.
Active ownership

It’s important to us to make sure that the companies in which we hold shares on our members’ behalf are well-run.

The voting rights that come with ordinary shares are an important tool for our responsible ownership objectives. Through voting we can engage with companies and influence how they’re run. This helps us make sure they’re acting in the best interests of our members who are the ultimate owners of the shares.

Our voting rights are currently exercised on our behalf by our fund managers. We’ve asked them to make their voting records available to our members. We’ll let them know if we have particular concerns about a company or if we believe they’re voting in a way that’s not in our members’ interests.

As a large investor we’ll be able to make sure the companies held in our funds understand the importance we place on environmental, social and governance factors.

The risks associated with environmental, social and governance factors may not be front of mind for directors. Our influence as active investors can help make sure that the companies held in our funds understand the importance we place on them. We’ll also work with other investors to engage with companies on issues where we have a shared interest. Coordinating our efforts in this way makes it more likely that we can positively influence the companies we invest in.

We expect our fund managers to keep us informed about contact they have with the companies they invest in on our members’ behalf and their efforts to promote high standards.

Keeping track

The investment operations team monitors the activity of our suppliers to make sure they’re providing the level of service we expect. Every day they check that the asset allocations implemented by State Street Bank match our strategy and make sure that unit prices and member accounts are correctly valued. We also monitor the activity of our underlying fund managers to check that they continue to provide the right mix of assets and a high level of service.

We recognise, however, that pricing errors can happen so we have a process to assess and correct them quickly. All pricing errors of more than 10 basis points are recorded, reviewed and reported to our investment reporting and compliance committee. As well as correcting the error they investigate how it happened to make sure there are no problems with our systems or processes.

We’ll pay members compensation where the pricing error has affected the value of their retirement pot by more than 50 basis points, subject to a minimum loss in terms of monetary amounts. We’ll also correct any over-valuations of units so that all our members are treated fairly and in line with industry best practice.
As NEST grows we’ll have many more members making contributions and the amount of money we manage will increase dramatically. This will give us the opportunity to explore other ways of helping our members. Some possible areas of further development include:

- exposure to new asset classes – when we have a larger pool of members we’ll be able to expand the range of building block funds we use
- bringing some outsourced functions in-house – as our member funds under management increase we’ll be able to provide some of the services we currently outsource.