DC investment

Finding the appropriate mix for your members

In conversation:

Richard Skipsey | Richard Butcher |

Paul Black | Robert Booth | Sebastian Cheek

From left to right:

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Richard Butcher, managing director, PTL

Finding the appropriate mix for your members

Chancellor George Osborne's Budget back in March completely turned the world of pensions upside down. From April next year those retiring in defined contribution (DC) schemes will have complete freedom over what they choose to do with their pension pot – reform that has thrown the pensions industry into a spin.

Until now, the default journey for DC members had been predictable in most cases: a member entered the scheme investing in higher risk, return-seeking assets, usually equities and/or diversified growth funds, and then at a set point from their expected retirement date they moved into fixed income and cash to target an annuity. This flight path was played out through traditional lifestyle and more recently target date fund (TDF) strategies.

Now however, the end point of this journey is less obvious. While many people will still choose to buy an annuity when they retire, a growing number will have the opportunity to stay invested throughout retirement or – as feared by some – take the whole lot as cash.

The industry has had to react quickly to the bombshell announcement, from sponsoring employers reviewing their existing default strategies through to industry providers frantically developing new products to allow for this flexibility at retirement – a particularly difficult task given it will be very tricky to know exactly what path each member will take.

What these products look like will become clearer as they develop, but traditional lifestyle defaults will have to adapt in order to keep pace with the changes and a one-size-fits-all solution will no longer be appropriate.

Member engagement in the process remains crucial to ensuring members know at what stage in their DC scheme journey they need to consider certain questions: Am I saving enough? What should I be invested in? What will I do with my pot at retirement?

The introduction of a guidance guarantee will address some of these queries, but there remains a lot more to be done before members are fully engaged and are able to achieve the best outcome possible.

This roundtable brings together a panel of experts from the trustee, provider and consultant side to debate the key issues thrown up by the recent Budget pension reform, including how it will affect investment strategy, the at-retirement stage and member communication.

Sebastian Cheek

deputy editor, *portfolio institutional*


Richard Skipsey

"It's quite dangerous to be making decisions for members without engaging with them. The Budget changes make it very difficult. If you make decisions for members, it could be deemed advice." Richard Skipsey

Today we'll discuss some of the recent changes to DC and their repercussions, but let's start by comparing target-date and lifestyle funds. Can we expect any of them to encourage DC members to save more towards their retirement?

Richard Butcher: As trustees, we're charged with having an appropriate default that delivers the best possible outcome for the members. For 20 years, DC hasn't been run in an optimal way and the last five years have seen it morph towards diversified investment. Pretty much all the input on investment strategy has been focused on the investment characteristics. Passive is good because it's cheap; active is good because it adds value; diversification is good because you get diversification. We're starting to look for investment strategies that are focused on an outcome. This means more granulated investment strategies, even in the master trusts, where you can start to define investment characteristics and start to bracket people and then design defaults that are appropriate for each of the sub-populations.

Paul Black: I'd agree. We need to think about what members want. Typically, members think of pensions as savings, not investments. So you need to start from that perspective and build something which has an appropriate risk-reward profile. Then go on to what the assets are that will give you that rather than think about it the other way around. Granularity is also going to become more important particularly as we look at relatively low-paid members, as you might not want to give them an investment strategy which is the same as highly-paid members – the low-paid members will get a large proportion of their income in retirement from the state.

Robert Booth: The granularity and choice is great, but that default is actually going to have to cope with

Richard Butcher

"A default doesn't have to be a fund, but a strategy where you can dynamically move people. Determine whether a member is likely to take cash, drawdown, etc, and then send them down the appropriate path." Richard Butcher

people who might do it differently. They might choose an annuity; they might choose drawdown or even cash. You may have a strategy that's completely right for one of those decisions and people will still stay in the main default. There has to be one default, even if you have different versions of the default.

Butcher: A default doesn't have to be a fund, but a strategy where you can dynamically move people. So you could get to a point, say 10 years out from retirement, and determine a member is likely to take cash, drawdown, etc and then send someone down the appropriate path.

Richard Skipsey: It's quite dangerous to be making decisions for members without engaging with them. As soon as members have to make a choice, and they're not comfortable engaging, it becomes a lot more dangerous. The flexibility the Budget changes have allowed makes it very difficult. If you make decisions for members, it could be deemed advice.

Black: There is some resistance, as Richard says, to people saying they don't need engagement but will segment members such that they end up with different investment strategies. At the moment, all we do is look at a member's age and assign them an asset strategy. There is a lot more unease that we're starting to segment members in a way we might find difficult to explain to them, despite the logic we might apply.

Skipsey: I'm uncomfortable about what you do with people in the grey areas. With a single default strategy, your trustees are taking professional advice and all the members have that same proposition, and if they want to or choose to do something different, that's their choice.

Butcher: A huge number of them are going to be grey. NEST is a good example with a million members. How many of those are in a grey area where the default strategy isn't optimal for them?

Black: I think we're giving clients insights into what their membership actually looks like. I have one client with 40,000 members and the average pot size is £8,000. What will they do at retirement? They're not going to be drawing down and they're not forced to buy annuities. So we need to design a single default strategy which meets our membership's needs based on the average member, and it will be some time before default strategies can start to take account of other factors as well.

Butcher: So you are designing a default investment strategy which assumes an asset allocation appropriate for an income. But that individual – and the vast majority of individuals – are going to have cash. So how can that be an appropriate default investment strategy?

Skipsey: So the member has to have the ability to do different things.

Butcher: Yes. Let's park member choice for a moment; this is about the default strategy.

Booth: We've got all the evidence that says people make wrong choices, so you're making decisions for them because they'll get it wrong. So there might be nobody who has decided anything apart from on religious grounds. Like others, we're heading towards a de-risking glide path which is geared towards a little bit of cash and buying an annuity. In this environment, is it right to have an annuity-hedging function that gives people choice, when it might protect your exchange rate but won't do wonders for your fund over that time? Maybe an annuity protection fund isn't the right place to be. Those with an appetite for knowledge can engage themselves – I'm not trying to go towards engagement. But those with bigger funds will take an interest – they have the ability to control.

Butcher: A one-size fit-all approach?

Booth: Perhaps, or accept it's appropriate for almost everybody.

Butcher: No, no, no. It's appropriate for an average member.


Paul Black

Skipsey: The point is they've moved the default strategy to the average member so they're de-risking slightly, reducing volatility and adding diversification. The more sophisticated investors who want to take more risk have to make the active decision to do that and I think that is right. If you are more engaged, if you do understand what you are doing, then you have the choice to opt out of the default and do something else.

Black: You want the default to address a member with these sorts of requirements and if it doesn't, you need to do something else and we might make it easy for you by setting up something else. Not other defaults, because you can have only one default.

Butcher: Attitude to risk is one thing; tolerance to risk another. In DC, the tolerance to risk is very significantly lower than DB because an individual can't come up with extra cash and can only defer their retirement for so long. If you compare that to attitude to risk, an individual's tolerance may be much lower than they think according to answering some arbitrary questions. That's where trustees can add value, by steering a sensible course.

What do we mean by member outcomes or outcome-delivered focused investments? Still annuitisation, or something else?

Butcher: Until the Budget, we talked about replacement-income ratios in the knowledge the most significant lever that influences it was one we couldn't control; contribution level.

Black: Not control, but you can influence if you choose to.

Booth: The vast majority of auto-enrolled members will be new to saving. I talk in terms of a savings pot, because they don't like the term 'investment'. If we want to get people to save, we can worry about what they do with it later, but we must get them to start putting money in, get them to start looking and engaging and understanding it will provide the majority of their income.

Black: I don't think it was ever very easy but in DC schemes, we don't have members for their whole lives. They don't start work the day they leave school and retire when they hit state-pension age any more or work for the same employer. We might have them for five years for the average member in most schemes. What are we going to do with our part of their working life to produce what they need in retirement?

Skipsey: Twenty years ago, it was was all about maximising the pot size and not outcomes. Then it moved to outcome-orientated, whereas now, because of the flexibility, we've almost gone full circle. Would the best outcome be to maximise the pot? Then the question is, at what point do you start reducing risk, if you are looking to de-risk at some point in retirement?

Butcher: The point you take the risk off is the boundary between accumulation and consolidation. Traditionally, you would start consolidation perhaps 10 years out. Given that you can take the cash at 55 now, that means that you start consolidating at 45. That could be 35 years before you retire.

Do you think more granularity is achievable with target-date funds versus a traditional lifestyle?

Booth: You need scale. If you've got different outcomes, then already within target-date funds you've got the individual management costs.

Butcher: Scale is important, but only if the governance is implemented much lower down the chain. The danger with scale is you end up with the governance and the members way down and nothing in between. The number of DC schemes has reduced from 45,000 to 35,000 in the space of around 18 months. That's likely to continue, so scale is coming.

Skipsey: History shows the more choice you give a member, the less likely they are to make a choice, so it is about getting the balance right. Do you look at individual member strategies, or concentrate on the average member then give the choice for other members to do something else if they so wish?

Booth: As a trust-based scheme, we can change the glide-path, quite comfortably, then communicate. We don't know what products are going to be around, but target date or a flexible lifestyle approach in the trust area is fine. For contract schemes, you still need a member's signature to change anything. That's ridiculous, so the law has to change or contract schemes are going to really struggle.


Richard Butcher

Rob, are all your members in the same default? Is there flexibility?

Booth: It's preordained as the trustee board is taking responsibility for that member's journey. We didn't ask for DB members to make choices and nobody moaned about it. Even with many AVCs, there wasn't any choice in the contracts.

Black: We've now got a world where people are in pension schemes which might not pay them a reasonable income in retirement as contribution rates are not high enough.

The decision we need members to focus on is how much they're going to contribute, rather than which investment strategy. So, we need to give the right information to allow members to start taking responsibility. To tell them they've got a 2/3 chance of getting an income between X and Y is meaningless to a member.

Butcher: What we can do is transfer our DB experience into DC in terms of helping to model outcomes. We can also get an awful lot better at helping people to make an informed decision about their contribution. We won't always get it right. Perhaps like with endowment mortgages where you used to get the traffic-light letters. Red and there was no way you're going to pay your mortgage off, amber, you've got a reasonable chance and green, you're on track. Can we do that with pensions? Member engagement will have to be light years better than it currently is, but it will get much, much better.

Robert Booth

"Target date or a flexible lifestyle approach in the trust area is fine, but for contract schemes, you still need a member's signature to change anything. That's ridiculous." Robert Booth

Does improved member engagement lead to improved member outcomes? Is it simple as that?

Butcher: If you take engagement as part of a process, there's got to be communication, engagement and education. If you can get to that third stage of education, people will make more informed decisions.

Skipsey: I'm sorry to disagree with you on that, but the most important thing is scheme design. If they aren't engaged, they don't want to engage, but if they are, you can encourage more escalation.

Black: You must communicate, but there's no point telling the 25 year-old about investment strategies. If there's no money in it, it doesn't matter what the investment returns are, but showing them that 50% or 80% of members like them have chosen a higher contribution rate could influence their decisions. With the new flexibilities, we now have to consider members from 45 and up about whether they are likely to buy an annuity or use drawdown.

Skipsey: The tools will improve, but I'm not convinced the will is there for members to get more engaged.

Butcher: It's never going to be as sexy as watching the football or the latest soap opera. Maybe those skills aren't within the pensions industry currently. We can look elsewhere and get better at engagement.

But won't that become more difficult with the Budget changes?

Butcher: Oddly enough, I think it may be easier. There was a survey just after the Budget that found the number of people saying they were prepared to contribute, or to increase the contributions, had gone through the roof as a result of the Budget changes.

Booth: If they can take their fund as cash, it doesn't matter so much about the revenue taking out tax.

Will we see an increase in drawdown or will most people still buy an annuity?

Black: We need mass-market drawdown products to come within the next six months, but I think that's going to be really difficult. What we're hearing from schemes is if members want drawdown, that's fine, but they can go and do it somewhere else. Most schemes do not want the extra administration cost of offering drawdown within the scheme.

Butcher: My instinctive reaction was employers aren't going to want to deal with the payment phase, but the commercial master trusts would want to hold on to money for as long as possible. Fund managers are developing payment-phase investment vehicles.

You've had some thoughts about how that might work, Richard.

Butcher: Just back of the envelope thinking about what could emerge. The distribution of income is U-shaped in retirement – an active phase when you're learning to windsurf and a passive phase when you're at home watching the telly, then the high cost of care. So you have an annuity underpin, which just touches the bottom of the U-shape and you know you're guaranteed that minimum level of income throughout your life. The alternative is drawdown with a deferred purchase annuity that kicks in at that phase. So you drawdown in the interim. You pay a premium perhaps at your 65th birthday knowing this is going to keep you going until you get to 75. Then you drawdown whatever you've got left between now and then.

"Find me a relatively safe income-yielding fund that's going to deliver you 6%. Then don't forget you've got to guarantee that income for life. There is a market still for annuities but it is going to be more flexible." Richard Skipsey


Richard Skipsey and Richard Butcher

Skipsey: You can get guaranteed drawdown products today. But anything with a guarantee costs money. They say annuities aren't great value, but what's the current annuity rate? Around 6%? I'm guessing. Find me a relatively safe income-yielding fund that's going to deliver you 6%.

Then don't forget you've got to guarantee that income for life. There is a market still for annuities but it is going to be more flexible.

Black: We should change the name of annuities. Call them insurance policies that start paying you as soon as you pay out the premium and carry on until you die. Sounds fantastic.

Skipsey: Our research shows 20% of your pot would have to be given up at 65 to have that deferred annuity kick in at 85, about the same if you had taken it before. Is it worth giving up 20% of your pot at the front end to guarantee you a lifetime annuity at the back?

You need some kind of refund if you don't make it to make a product that's attractive. It can be done relatively cheaply, I believe.

That brings us to the guidance guarantee...

Butcher: You need to communicate and educate people all the way through that process. The guidance guarantee is a sticking plaster. It wins votes because it looks good, but in terms of delivering somebody to the right decisions over their lifetime, it's completely irrelevant.

Booth: And you still need to engage with members to let them know the guidance offer is out there. So you've got to get the engagement right before you get to the guidance.

Skipsey: I think it might become an employer requirement to engage with members on an annual basis as part of the annual pay review, for instance. Then it becomes an employer cost, a part of the benefits and engagement package for an employer.

Let's move on to liquidity. Will we ever see the end of daily pricing?

Booth: We don't have daily pricing, as ours is done weekly. If you don't offer fund switching, then there is no issue. What is the problem with weekly pricing? You might get invested on a price a few days later, but it's swings and roundabouts and it's more than made up for in those miniscule reductions on dealing costs by having a weekly bill.

Black: The only people I see pushing to get rid of daily pricing are fund managers of illiquid assets that can see their DB business going out the door. Will it help? At the margin, yes. Compared to other things we can do with DC, is it more important? No. Absolutely not.

Skipsey: One of the issues around holding all these illiquid assets physically is the cost of dealing them. If you are in a position where you can hold on to that asset class for a long period of time, then you'll be able to get the illiquidity premium from it. What's stopping that are the operational requirements of many providers who have no way of suppressing that daily proposition.

Black: Robert, does weekly dealing affect your investment strategy in any way?

Booth: Not at all. But as our assets grow, we will look towards illiquid instruments. At the moment, it would be a pain to look at what would be involved in daily pricing of illiquid assets right now.

Skipsey: DC schemes offer property already on a daily basis, but no property fund values on a daily basis. It just doesn't happen. I don't see why that couldn't be the same for private equity, infrastructure, etc, as DC schemes with a sophisticated enough design can recycle ownership of units within the plan.

Would DC benefit from more of these illiquid assets, such as infrastructure and private equity?

Black: I'm quite cynical about the benefit of illiquid assets and 2008 is probably the best example. Clients were very comfortable invested in illiquid assets until they wanted to sell and couldn't get out.

Skipsey: It's a bit like running an annuity book to a certain extent. As long as you're not forced to sell those illiquid assets, you're fine. So you've got to have an investment approach which will deliver enough cash effectively, enough of a yield to meet the cashflow needs of the portfolio. So you're not a forced seller of stressed assets.

Butcher: I can see the argument for the use of illiquid assets as part of a diversified strategy.

Skipsey: Within a DC scheme structure, you're not going to get a run on a fund. You're not all of sudden going to get 60% of the members of the fund, of the scheme, wanting to take their money out.

Butcher: Yes, but 85% or 90% of the money is being invested by the trustees in their default strategy and trustees should look long term.


Richard Skipsey

As a provider, are you offering those assets in the DC space or are you saying it could work?

Skipsey: You've got to be very careful with FCA regulations around appropriateness and suitability, so typically there are certain funds we will only let trustees use within a blended proposition. We wouldn't allow our commodities fund to be accessed by individuals in case the proverbial Mrs Miggins at the age of 64 decides she wants more of her money in commodities. You've got to have the controls and the governance in place to allow access to these types of vehicles. You can't beat diversification – it's as simple as that. I know we all bang on about it, but it is genuinely the only free lunch that is available out there.

Butcher: Well, a number of funds have had to dump diversification because of the charge cap, so it does depend what you mean by 'diversified'. Diversified growth funds though tend to be quite high-charging.

Booth: From our perspective, with only one strategy, the expression 'default fund' seems wrong. Our members are expecting the fund – that default fund – to be actively managed by someone. The only reason we don't as an industry call it a managed fund is because it's a legacy term. But if you were starting


Paul Black

"The decision we need members to focus on is how much they're going to contribute, rather than which investment strategy. So, we need to give the right information to allow members to start taking responsibility." Paul Black

from scratch now, that default fund should be more managed than anything else, shouldn't it? Maybe you could say to members it is the managed fund, but you would have an alignment between members' expectations and what it does.

Butcher: I would just create one refinement to that as well. We shouldn't refer to it as a fund. It's a strategy – a managed strategy.

Booth: To take Richard's point, that the charge cap is forcing some to revisit how they're run, it goes back to the need for scale in the industry. You can still run a diversified approach in DGF language but you need the scale to be able to do it properly. Maybe we just have too many funds around in the industry at the moment.

Skipsey: Yes, I'd agree and you can do it cheaper. The fund managers have a decision to make. They either use their capacity in the UK market at lower rates if they want to be part of the UK DC market. Or they decide they're not going to play in that market because they don't want to sell their skills at a lower rate. They then use their capacity for sovereign wealth, retail, etc.

So even with the charge cap, it's possible to be diversified?

Butcher: It has caused some tidying up in the market. There are number of very good funds actually that we can't use and some fund managers have cut their costs.

Booth: So if charges have already come down, there's obviously some fat in the margins to play with.

Butcher: There's nothing wrong with making profits. Profit expectations just have to be more realistic.

New DC route-planning: the trustee dilemma

By Emma Douglas, head of DC solutions, Legal & General Investment Management

In the past, the DC journey followed a fairly predictable path: grow some assets, take risk off the table as retirement approaches and then, at retirement, take 25% of the resulting pot as cash and buy a fixed rate annuity.

This may seem an oversimplification but the evidence shows that most DC members did buy a fixed rate annuity at retirement. Indeed, the legislation mandating annuity purchase created a fixed end point that defined the nature of the journey before retirement. And while you didn't have to buy an annuity immediately, income drawdown was not a mainstream option as it generally required a combination of decent pension pot size, some risk appetite and investment expertise that most members simply did not have.

The recent Budget changes mean that there are now several destination points. We think of the DC journey as having three distinct phases – each of these have specific concerns and questions that need to be answered (see figure 1).

Figure 1: Key questions on the DC journey

20s 30s 40s 50s 60s 70s 80s

Accumulation	Pre-Retirement	Retirement
How much do I save? How do I allocate my assets? Should I change my allocation over time?	How much money will I need? When can I stop working? Do I have a plan for my retirement? Will I take it all as cash?	Will I take my whole pot as cash? What should I do with my Pension pot? Should I buy an annuity? If so, when? Should I remain invested and take regular income?

The DC journey we outline starts in the same way as before. Members will still want growth vehicles to help make the most of what they save during the first part of their working life. The pre-retirement phase will still have the same objective – namely to begin adjusting the nature of a member's investments so that these start to reflect the likely needs in retirement. Under our simple '25% cash plus annuity' plan that meant moving some assets into cash and others into assets that would start to mimic moves in annuities, thereby reducing the risk of any adverse moves in prices that would lead to a lower income in retirement.

So the pre-retirement phase has to be influenced by the end goal at retirement. But with auto enrolment vastly increasing the number of people in DC schemes, and the more relaxed rules around retirement, it is fair to say that we will have a far greater number of members looking at a far wider range of options as they move towards and into retirement.

What do those choices look like?

There has been a lot of press attention given to the fact that on retirement, a member can now take their whole pot as cash and blow the lot on fast cars and jet-set holidays. While undoubtedly true, in reality most of us will opt for one of four basic choices:

- Take the whole pot as cash (for smaller pot sizes)
- Take some cash and buy an annuity as has been the case in the past
- Spend some of the pot on an annuity and use the rest to generate income in other ways
- Not buy an annuity at all, but look at other ways to generate income

A quick glance at this list suggests that some form of income drawdown is now a serious consideration for many members – a conclusion backed up by a recent poll[1] that showed nearly 70% of people would select either option three or four. The same poll suggested that a similar proportion were either 'somewhat or very comfortable' in managing their own savings in retirement.

What is a sensible income strategy?

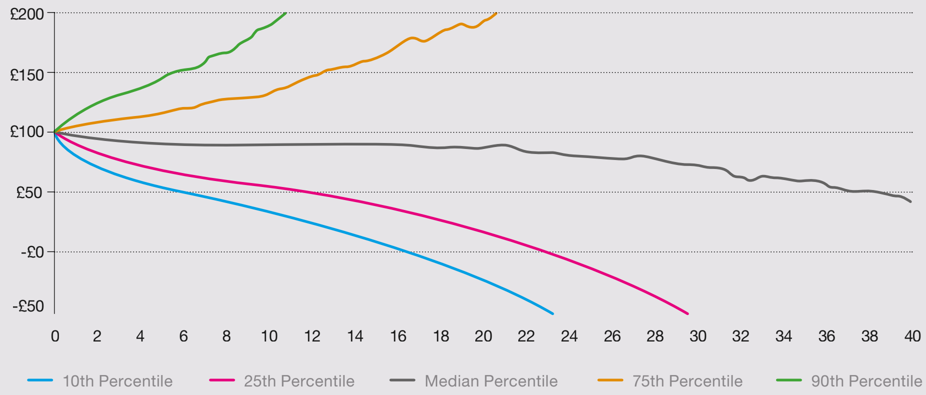
Given that income drawdown strategies are going to become more prevalent, what do these look like? Our modelling – shown in figure 2 – suggests that taking a 100% equity-based approach may not be a great idea: relying on equities can provide a terrific outcome – producing a steady income and plenty of capital growth. Equally, it can leave a pension pot exhausted within 20 years.

One way to try to reduce this negative outcome is through diversification. We therefore expect to see more income-focused multi-asset solutions being launched, with the objective of reducing more extreme risks but maintaining more favourable overall returns.

Figure 2: Good outcomes / bad outcomes

Source: LGIM long-term asset class calculations, assuming monthly drawdown equivalent to £6 p.a. and fees of 0.5% p.a.

£100 invested in 100% UK Equities – 40 years projection



The trustee conundrum

A DC trustee is looking for a default option that will help members negotiate this journey and obtain the best possible outcome for members at retirement. However, the potential for different retirement options complicates this decision, as the right default for someone considering buying an annuity will be different to someone considering a drawdown solution.

Furthermore, a scheme is probably going to need to provide members with more information about making these choices. For example, pot size could be a key determinant of what path to follow, as could risk appetite: generally speaking we believe that the lower the risk appetite, the greater the potential benefit of an annuity given that annuities remove the risk of outliving your pension pot. And in practice, we think that many members may want to consider income drawdown coupled with an annuity to provide a hybrid option, where at least some of the income is guaranteed, so that an individual has more certainty that they can cover their basic living expenses.

This leaves trustees with a dilemma: how can they select a default solution when there is so much uncertainty? To some extent, this is an impossible question to answer, as we cannot see a single solution meeting all requirements and the nature of a 'default' is that there is only one of them. Trustees could look at providing some sort of differentiation, where members follow different 'default paths' based on certain criteria; for example, likely pot size, based on the current pot and salary.

Education education education

Ultimately, trustees may decide that the best approach is to create a number of 'retirement journeys' that take members through the growth phase and the pre-retirement phase towards a defined retirement goal, and get members to elect which path to follow. This would not be easy, as lack of member engagement is often cited as one of the biggest concerns facing DC trustees and employers.

Historically, UK DC members have not really engaged with the pension process. However, if we look to more mature DC markets, such as the US and Australia, member awareness is much greater. We believe this demonstrates that people can and will engage when they either have an incentive to do so or have little choice. Now could be a perfect time to change things in the UK. With auto enrolment bringing more people than ever in contact with a pension, and with the new freedoms provided post-budget, this could be the best opportunity in a generation to get more members considering their financial futures.

Legal & General
INVESTMENT MANAGEMENT

[1]Source: Sunday Times YouGov survey April 2014

The most fundamental change in the way people access their pension in almost a century was announced by the Chancellor in March's budget. By removing the effective requirement to buy an annuity, people will have greater flexibility in taking their pension.

LGIM's dedicated DC team recognises that change will be a constant factor as the DC market becomes broader and more sophisticated. It remains focused on providing the widest range of flexible market-leading 'to and through' retirement solutions to meet these changes. This includes a range of innovative income drawdown funds across the risk spectrum.

When the world changes, do you change with it?

By understanding what matters most to our clients, we aim to deliver the best outcomes for members.

DC SOLUTIONS

As one of the UK's largest DC fund providers, we are uniquely placed to help members at every stage of the pension journey, from growing a pension pot, to de-risking before retirement and post-retirement decisions. We offer an unparalleled range of investment choices and default fund options ranging from index-tracking to active fixed income, as well as active equity, property and multi-asset funds.

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