DC Roundtable Whitepaper

Driving change and choice

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Since our last DC roundtable event we have been encouraged by generally positive changes that have taken place across the DC market. The vast majority of DC plans now favour a more "universal" style of default, designed to be broadly agnostic to how members might actually consider taking their future benefits.

In terms of the growth phase of a typical modern default, we have seen a significant increase in diversification across a wider range of asset classes.

Amongst the larger DC schemes this increased level of diversification and access to alternatives has generally been achieved by blending in one or more Diversified Growth Funds into the model, as opposed to hiring specific managers for each component. This has all been achieved at a relatively low cost to charge cap e.g. at an average blended cost of circa 50 basis points. The actual profile though, will typically be skewed in order to best reflect the perceived risk tolerance of the intended audience.

It is evident that for both the FTSE 250 community and traditional provider model there is far higher weighting towards bond assets, perhaps reflecting a preference for lower average risk. Albeit, our research illustrates wider variances exist across the traditional "bundled" providers, where defaults can include anything from 45% to 85% developed world equities and 14% to 47% invested in bond type assets.

So, since pension freedoms came in there has been wide spread recognition of the need to find a more balanced solution, one that still provides the opportunity to deliver long-term real growth whilst offering a degree of protection against market volatility. There is however, still a great deal of variance in how schemes and providers then choose to de-risk towards the back end of accumulation (transitioning from the "growth phase"), into more cautious portfolios in the period running up to the schemes (or, members') selected retirement age. Here, we see phasing starting anything from 20 years out, down to periods as short as 3 years.

For members this appears to be "good news" as Trustees and Providers grapple with the question as to how best to deliver and protect "value for members". This is however, by no means the end of the journey.

Despite the markets' obvious best endeavours however, individuals are in the main being left in the position of having to reposition their underlying investments when taking full or, partial benefits. This is equally true for both trust and contract based schemes, even where we might reasonably have anticipated that bundled contracts would offer a more seamless route.

CAMRADATA's roundtable discussion focused on what comes next in this evolutionary journey and discussed the opportunities that exist for improving member outcomes still further.

"It is evident that for both the FTSE 250 community and traditional provider model there is far higher weighting towards bond assets, perhaps reflecting a preference for lower average risk."

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Company Profile

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- Global market and investment insights
- Sophisticated risk and portfolio analytics

We work only for our clients, who have entrusted us with managing $5.69 trillion*, earning BlackRock the distinction of being trusted to manage more money than any other investment firm in the world.

*AUM as at 30 June 2017.

Claire Finn
Head of DC, Unit Linked and Platforms

Claire Finn, Managing Director, is Head of DC, Unit Linked and Platforms within BlackRock's UK Business. Claire and her team are responsible for client relationship management and business development with BlackRock's Retail and Defined Contribution distribution partners in the UK as well as UK DC pension scheme managers, consultants, trustees and sponsors.

Claire joined the firm in 2005, initially working as a member of the International Product Development team within Merrill Lynch Investment Managers (MLIM), which merged with BlackRock in 2006. She joined the sales team in 2007 to manage strategic client relationships with large distributors in the UK Retail market. In 2010 following the Barclays Global Investors (BGI) merger, Claire took on an expanded role integrating the BlackRock and BGI teams responsible for these distribution partnerships. In 2012, Claire became Head of Strategic Alliances with responsibility for distribution partnerships across Retail (Direct to Consumer and Adviser-intermediated distributors) and Defined Contribution Pensions Providers. In 2015, the team's remit was enhanced to include relationship management and business development for DC pension scheme managers, consultants, trustees and sponsors.

Prior to joining MLIM, Claire was Associate Director of Product Development at Henderson Global Investors.Claire has a BA (Hons) degree in Spanish and German from the University of Leeds and an MSc in Finance from Birkbeck College, University of London.

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First State Investments
Company Profile

First State Investments ('FSI'), known as Colonial First State Global Asset Management in Australia, is the investment management business of the Commonwealth Bank of Australia. We are a global asset manager with established offices across Europe, the US, Middle East, and Asia Pacific regions.

We are stewards of over £129.6 billion* in assets managed on behalf of institutional investors, pension funds, wholesale distributors, investment platforms, financial advisers and their clients worldwide.

With expertise across a range of asset classes and specialist investment sectors, our approach to investment is driven by a commitment to provide the best possible outcomes over the long term for our investors. To achieve this, we ensure our interests are aligned with our investors and uphold a culture of consistently acting in our clients' best interests.

*Assets under management indicated above includes Realindex Investments which is a wholly owned nvestment management subsidiary of the Colonial First State group of companies. Source: Commonwealth Bank of Australia Financials as at 30 June 2017.

Andrew Harman, CFA
Portfolio Manager, Multi Asset Solutions

Andrew Harman, CFA, joined First State Investments in 2008. He became a Portfolio Manager within the Multi-Asset Solutions team in 2010. In 2015 Andrew launched the flagship Diversified Growth Fund for the UK market which has had strong performance since inception. His responsibilities include research, market analysis and construction of proprietary investment models.

Andrew holds a Bachelor of Business (Banking and Finance) from Queensland University of Technology and a Graduate Certificate in Mathematics from the University of Technology, Sydney.

Participants

Sam Roberts
Head of Investment Consulting

Sam heads the investment consulting team at Cartwright, with overall responsibility for the quality of the investment advice provided by the team, the fund manager research and the smooth implementation of Trustees' investment decisions.

Sam is also the lead investment consultant for his own portfolio of clients, covering all aspects of investment strategy and investment-related consulting.

Sam believes that investment strategies can be relatively sophisticated without being over-complicated or expensive, and that every pension scheme is unique. He enjoys helping clients to prioritise those areas that will have the most beneficial impact, to better understand and manage their investment risks, and to implement practical cost-effective scheme-specific solutions to help to achieve their (and their members') objectives.

Sam is a qualified actuary and worked for over 10 years as a pensions actuary before switching to investment consulting. He believes that this helps him to better understand both sides of a pension schemes' balance sheet (i.e. both the assets and the liabilities). This is particularly important when considering DB liability-related assets such as LDI and bulk annuities, the interaction between the different measures of DB liabilities, and the potential risks faced by DC members when planning for retirement.

Peter Hill-King
Head of Investment Research

Peter is Head of Investment Research at Conduent HR Services, which provides the full range of HR support services including workplace pension planning and investment consulting.

Joining Conduent in June 2017, Peter has 20 years' experience of researching investment strategies for DB and DC investors. Previous roles include P-Solve, F&C, Dean Wetton Advisory and Aon. Advising on equity and a wide range of asset classes, Peter has sought to identify the best investment managers within the context of the client investment strategy, cost and investment horizon.

Peter has a BA in Financial Economics from Coventry University and a MA in Financial Economics from the University of Exeter. He is a member of the CFA Institute

Participants

Helen Stokes
Senior Investment Consultant

Helen works with DC trustees and governance groups to help design DC investment and communication strategies that they can be confident are right for their membership.

Helen leads in implementing changes to investment strategies and has experience in designing a wide variety of DC investment strategies and arrangements. She is also a member of LCP's specialist DC Products Research team focusing on target date fund providers.

In the past, Helen has been seconded to The Pensions Regulator where she helped design the DC content of its Trustee Toolkit.

Alan Emberson
Director Workplace Solutions

Alan joined PS Aspire as Director Workplace Solutions. His focus is on helping employers increase their return on investment, through delivering solutions aimed at improving employee financial awareness and decision making across the range of financial benefits.

During a career spanning over 30 years in financial services Alan held a number of senior business development roles both within the traditional provider market and consultancy firms.

Prior to joining PS Aspire Alan was Corporate Relationship Director with Standard Life, building relationships across the FTSE 350 community. Previous to that he spent many years working within employee benefits consultancies, assisting larger companies in selecting DC suppliers and delivering on large scale communication assignments supporting employees' understanding and ability to plan around their financial benefit choices.

Participants

Niall Alexander
Co-Head of P-Solve DC Solutions

Niall started his career as a trainee pensions Actuary with Willis in his home town of Dublin. He quickly developed to take on a senior role in establishing an investment consulting business for Willis, along with providing investment advice to a range of DB and DC schemes and charities.

In 2011, he moved to P-Solve in London to focus on DC, and currently co-heads the DC Solutions business within P-Solve. He works with a number of UK and International DC clients in developing member-focused objectives and investment strategies, and ensuring quality governance and value for money are present.

Niall is a qualified Actuary and has spent time on the DC Advisory Board, the body responsible for forming and articulating the views of the Actuarial profession. Outside of the office, Niall enjoys marathon running and long distance cycle touring.

Lydia Fearn
Head of DC and Financial Wellbeing

Lydia joined Redington in 2015 as the Head of DC and Financial Wellbeing with the goal of playing a part in helping to secure the financial futures of 100m people. Redington work with a range of clients across the whole DC spectrum, from scheme design, communications and governance, through to investments and bespoke market-leading projects.

Lydia joined from the Barclays CE&S team where she was responsible for creating solutions and leading DC advice to pension scheme trustees and sponsors. Prior to Barclays, Lydia worked at LCP and Aon Hewitt, where she specialised in investment strategy and advice.

Participants

Brendan Maton
Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

Driving change and choice

CAMRADATA held its annual DC roundtable in London in October to discuss how pension scheme provision in the UK was faring. The big theme was how to transform the UK from a nation of savers to a nation of investors. Our mentality needs to change from merely accumulating wealth until pension age to considering when and how it will be deployed across the whole of a lifetime. Various suggestions as to how we make the change were proposed: one is to connect pension scheme members to their investments by reminding them of where they go in the real world, ie getting people to realise that they are financiers and their capital funds society's needs such as new hospitals and roads.

The second suggestion was to focus on an inflation-plus target - or real return. This would give members a more realistic sense of what their assets were delivering as an outcome, in contrast to reporting DC wealth as a lump sum.

The third suggestion was to concentrate on wealth through retirement, reflecting how people now have income from various sources to draw on at different times. The panel proposed that Master Trusts could evolve to offer more holistic financial provision tailored to individual needs. Drawdown also becomes a greater element in whole-of-life investing.

The CAMRADATA DC roundtable began with a consensus that the rate of savings needs to get up to 15% of salary. The current average across all types of DC in the UK – adding members and employers' contributions together - is just 4%[1]. Claire Finn, Head of DC, Unit-Linked and Platforms at BlackRock, noted that 15% was the DWP's recommended contribution rate. BlackRock supports this target and its recent research finds that 70% of respondents would like a mandatory rate of contribution set by government. Exactly five years after auto-enrolment started, however, there is no timetable to escalate the mandatory rate from 8% after next year.

Andrew Harman, DGF portfolio manager at First State Investments, endorsed the notion of contributions rising progressively over time. "Little changes compound over time; start earlier and contribute more," he said.

> "The big theme was how to transform the UK from a nation of savers to a nation of investors"

> "Pension contributions are gaining popularity with younger employees where they form part of an overall package of benefits"

Alan Emberson, PS Aspire's director of workplace solutions, said that young workers should be saving as much as possible as quickly as possible, and in several different forms, not just their pension scheme.

"The salary pot may not be increasing, but we can help people spend their hard-earned income in a more effective, flexible and efficient manner," he said.

Meanwhile, Helen Stokes, senior investment consultant at advisory firm, LCP, warned that those other financial considerations, such as buying a house, meant that twentysomethings simply don't have the capital to put aside substantial amounts of income into pension saving. "I fear a mandatory contribution level of 15% would put young people off," she warned.

Lydia Fearn, head of DC at another consultancy firm, Redington, agreed with Stokes that 15% could be for some people "unattainable". Fearn did note, however, that pension contributions were gaining popularity with younger employees where they formed part of an overall package of benefits.

The singular purpose of pension assets in the UK – they cannot be used to make other purchases such as a house or car or education – was discussed at last year's CAMRADATA DC roundtable.

Harman noted that the Australian DC system, one of the inspirations for auto-enrolment in the UK, also restricts the disbursement of pension assets until retirement, currently 60 in Australia. Harman noted, however, that at age 60, pensioners in the Australian system can take their savings in any form they like, including a substantial percentage as an immediate lump sum.

Harman noted that Australian retirees typically remain invested in financial markets post retirement only making withdrawals at close to the regulated minimum. This lengthens investment horizons through retirement, and with recent investment returns this has meant that pension balances are still rising. This may show a preference for bequeathing wealth to their children rather than using their pension savings to increase their standard of living in retirement.

1 https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/2015

This conservative and selfless trend is in contrast to the advent of Pensions Freedom in the UK two years ago, which has seen many folk clear out their DC pot aged 55 in a trend dubbed “Ferrari freedoms” by critics.

The CAMRADATA panel was quick to point out, however, that this kind of behaviour is often conducted by those with other forms of saving, including Defined Benefit pension. For this golden generation, emptying a minor DC pot aged 55 resembles the use of a DB lump sum at retirement: it affords some luxury – camper van or Ferrari – but can hardly be termed irresponsible. Where the panel was more worried is for the next generation, without the greater DB savings, who might be tempted to take DC wealth earlier and leave themselves destitute as a result. “At the moment DC constitutes relatively small pots. In 20 years’ time, these pots will be people’s mainstay, so we need to consider DC in the context of outcomes. The days of DC being “play money”, so invest in equities and hope for as much growth as possible, are over,” said Niall Alexander, head of DC at consultancy P-Solve.

> “At the moment DC constitutes relatively small pots. In 20 years’ time, these pots will be people’s mainstay, so we need to consider DC in the context of outcomes”

CROSSHEAD: THE TRUST MODEL IS BROKEN

The CAMRADATA panel were worried by the ramifications of Pensions Freedom. Emberson warned that the tradition of a hard switch from accumulation to decumulation, realised previously by an annuity transaction at the point of retirement, has in effect been ruptured. “We need to support a more seamless journey from the point an individual leaves employment and begins to draw funds from their accumulated assets,” he said.

Given the new flexibilities, Emberson said DC provision of the future should come more in the form of an “open-ended” investment structure, not closed off “defaulted” to a predetermined, often fixed-end point. Currently, should a scheme member wish to withdraw their savings under Pensions Freedom, they will typically end up with some kind of insurance policy from a third party. Instead of this, Finn was much keener on adapting a more holistic approach, whereby the individual’s assets are available to meet their needs throughout life. This means giving people access to a mixture of cash, annuity and drawdown. If this sounds complicated, the recent BlackRock survey of DC participants found that far more people are keen on good investment design than simplicity. Fearn suggested a low-risk, multi-asset strategy as one way to achieve the last goal of still building wealth through retirement. Finn mentioned two BlackRock strategies that fit this bill: the BlackRock Dynamic Diversified Growth Fund and the BlackRock Market Advantage Fund. First State’s DGF is specifically aimed at the UK market, with global diversification by geography and asset class but a bias towards UK equities.

> “There is likely to be a consolidation in the Master Trust space and then there is a chance for those left to step up and do something great”

The difficulty with a wealth manager approach is how to supply an equivalent level of financial advice or guidance on tailoring investment flows to personal needs. Clients of wealth managers might be prepared to pay a decent fee for such service but in general the working population demonstrates reluctance to pay for ongoing financial advice.

Peter Hill-King, head of investment research at consultancy, Conduent, said that without good advice, history showed individuals had a strong tendency to buy high and sell low.

Fearn hoped that Master Trusts could evolve to fill this gap. “There is likely to be a consolidation in the Master Trust space and then there is a chance for those left to step up and do something great,” she said.

Sam Roberts, head of investment consulting at Cartwright, expressed concern that this situation could give rise to conflicts of interest if Master Trusts effectively acted as both adviser and provider. Also, Roberts was concerned that annuities should remain an option for members. “If you ask most savers if they want a regular income stream for life, they would still say ‘yes’,” he told the panel.

Emberson said that the “provider” proposition would change. As an example, he suggested the more progressive Master Trusts would provide access to more individually tailored options, supported by guidance and advice, but integrated with the appropriate support members require to make more active decisions.

Emberson said it was staggering that 92% of DC assets are invested via default toward the back end of accumulation, when members have significant assets at risk. To alleviate this, he advocated a shift in focus and spend on education away from the point of crystallisation, to earlier decades throughout people's working lives.

Others defended the persistent importance of default funds. Finn and Fearn believed that if the default fund is effective, then that was the most important thing. The CAMRADATA panel returned to this point later.

CROSSHEAD: TRAPPED LEGACIES

Stokes emphasised the need for greater education. Fearn suggested that technology would be one means to improve member education, and consequently their choices, while keeping a lid on costs. Stokes agreed that using technology to communicate with members about relevant decisions at relevant times could help members engage with their pension savings. Fearn mentioned Wealth Wizards as one example of a corporate pensions adviser that uses technology effectively to try to help employers and employees in a modern way, using algorithms to work out members' best interests and investment preferences but with human advisors on hand as well.

Such firms will haul some extant pots of money into the twenty-first century - but not all of them. This is because the record-keeping in many legacy DC schemes is so bad that no one can get a handle on, let alone refine, UK DC provision in its entirety. Legacy DC schemes, including billions in AVCs that accompanied final-salary arrangements, are decades old. The original provider may have been bought and sold several times, which means scheme records may have been transferred more than once. The original information on members might have been held on paper rather than a computer, and if the latter, certainly not on a current operating system. All this upheaval means that interested third parties, such as those firms represented at the CAMRADATA roundtable, cannot readily access a lot of crucial information on DC schemes – even with the smartest of new technology. Finn said that BlackRock, the world's largest asset manager, struggled to obtain comprehensive data about DC schemes' holdings in BlackRock funds.

PS Aspire has managed to circumvent some of these obstacles by assignment of legacy DC investment contracts and AVCs to a Master Trust structure. PS Aspire also encourages changes in the investment manager line-up in the best interests of members for the longer term. Emberson emphasised that this kind of pragmatic approach had made it easier for Trustees to pass on their quite onerous DC governance responsibilities associated with legacy assets.

> "Record keeping in many legacy DC schemes is so bad that no one can get a handle on, let alone refine, UK DC provision in its entirety"

Moreover, some barriers are for the best of reasons. Client confidentiality and members' control over their assets must be somehow preserved. Nevertheless, legacy DC provision is not something for the UK to be proud of. It even muddies the debate around defaults. It can be nigh on impossible to implement a better strategy because of rules and regulations around extant schemes, such as the need to obtain consent from every individual member prior to altering the default. Stokes noted the expense of sending out a letter to every individual and therefore highlighting how technology could help here.

> "Value for members requirements from The Pensions Regulator unfortunately often get translated as lowest possible cost"

Another complication is that the original default might be running at very low cost. That strategy might look out-of-date in investment terms but Finn noted it is not easy to justify a change of the default investment strategy that incurs greater cost.

A sticking-point here is that no new provider – regardless of how much confidence it has in its investment approach – can guarantee better returns net of fees. Roberts said there is often limited appetite to change a strategy which includes a with-profits policy (particularly legacy AVCs) due to the complexities around potential guaranteed annuity rates and the advisory costs being prohibitive for the relatively small amounts of money involved.

In summary, when decisions can be made, they are often on the restricted basis of cost – and all change, from sending out letters to adding new asset classes, has to be budgeted in accordance with the charge cap of 75 bps on DC schemes. "Value for members requirements from The Pensions Regulator unfortunately often get translated as lowest possible cost," said Finn. "There is unspoken pressure to put money largely into cheap defaults rather than high quality investment solutions." She added that providers are often constrained by old contracts which don't allow them to switch investments for customers. They need the green light from the FCA to be able to improve investment defaults.

Stokes said that there had been movement in the market with some providers taking action to change the objective of investment strategies away from targeting annuity purchase.

CROSSHEAD: DIVERSITY AMONG DEFAULTS

Emberson was surprised at the diverse range of different asset allocation models deployed within the leading DC provider's DC default funds. "One would expect there to be a degree of divergence, reflecting particular in-house expertise and investment styles, but not to the extreme where we see default portfolios with exposure to equities comprising as little as 35% to the highest allocation at 85%," he said. "Similar observations apply to the various Bond holdings that can be as high as 45%."

But other CAMRADATA panellists were less concerned. Alexander noted that the data gathered weren't particularly deep. "You can talk of exposure to global bonds but that is a huge pool to choose from: there are many different kinds of fixed income," he said.

Fearn said that big providers had to cater to a lot of small schemes so it was realistic that the offerings might have to be managed in a cost efficient way. Roberts was equally pragmatic. He said that small/medium schemes usually prefer a more straightforward strategy with three lifestyling choices plus some self-select options. Also, using a couple of simpler DGFs constituted a reasonable way for a small scheme to introduce diversification. "Trustees and sponsors usually won't pay for anything more sophisticated," he said.

Finn said BlackRock was generally keen to see asset management for DC evolve. She repeated the finding from the BlackRock survey that more members are interested in good outcomes than simplicity of design. This is a matter for education and trust; it is also germane to the preponderance of DC savers to end up in the default strategy. BlackRock has priced suitable vehicles competitively well within the 75bps cap. These include Dynamic Allocation Fund priced at 37bps and the BlackRock Market Advantage Fund, priced at 25 basis points, but also an extensive beta range of market cap index and smart beta funds as well as more granular exposures such as an infrastructure index fund.

Apart from these readily accessible alternative betas, Finn mentioned currency hedging as another affordable technique trustees should be thinking of to manage portfolio risk, especially in currently uncertain times.

> "More members are interested in good outcomes than simplicity of design"

PSolve's Alexander was less taken with the recent record of Diversified Growth Funds (DGFs) generally. "Whether the target is cash plus 3%, 4% or 5%, we have seen a lot of "D" but not a lot of "G"," he said. Part of Alexander's dissatisfaction stems from successful DGF managers removing exposure to some of the riskier components of their strategies in the last few years, given their short-term outlook at the time and the various things that could have gone wrong economically and geopolitically around the world. "We are not against the concept of DGFs," Alexander clarified. "But equity indices have had such a good run that many DGFs could have tried a little harder – and seeing some underperform modest targets in such a strong bull run is disappointing. A longer-term view is needed. We are being asked by some clients now to stick more in passive equity now because the historic numbers look so good – but that's not right either in the current environment."

> "DGFs have a place in DC investment strategies"

Hill-King said that the DC charge cap had resulted in a "race to the bottom" led by the adoption of passive global equities mandates. He was not keen on more equity beta exposure in the current environment.

Stokes agreed that DGFs have a place in DC investment strategies but highlighted that different types of diversification could be used at different points of a strategy. She said funds with a focus on capital preservation were particularly key in the later years of a strategy targeting income drawdown at retirement.

In the Australian system, the majority of money is managed by Superannuation Funds (the rest is in self-directed personal plans). Harman explained that Superannuation Funds are able to access sophisticated strategies for better risk-adjusted returns, but members did not know or have to get involved in dynamic risk management. Members are provided with two relatively simple measures to evaluate providers: the estimated return above inflation and the frequency of negative returns based on their investment selection.

As such, DC participants in Australia are not required to have unusually high levels of understanding about where their money goes. But as Fearn noted, they do make the choice of which firm runs their money (and can easily switch). In the UK, it is the employer who chooses on their behalf, which Fearn believes distances individuals from their DC pension.

The investment staff at their chosen Super fund use sophisticated strategies at scale. Annual inflows exceed AUD100bn a year. The First State DGF follows the model of investing in alternative assets such as infrastructure as well as having risk allocations to strategies that are not reliant on bond or equity market returns being positive. The First State DGF also makes active currency allocations to enhance risk-adjusted returns rather than merely hedging. Consequently, the strategy has the potential to access far more sources of return and diversification than an old-fashioned balanced mandate or earlier version DGFs . Hill-King endorsed dynamic over static allocation.

The First State DGF has an inflation-plus target in order to match performance better to savers' eventual needs, ie the purchasing power, as well as focusing on capital preservation. "The typical pension member does not understand what phrases such as 'equity-like returns' mean," explained Harman. "They do understand wealth in terms of what it can buy." Since launch in mid-2015, the First State DGF has met the target of inflation plus 4% Harman also preferred more complete definitions of risk than "volatility". He pointed out that that a single volatility figure did not convey the frequency and magnitude of drawdowns and therefore obscured the differing risk characteristics of various asset classes – especially or objective based funds. First State makes its dynamic allocations in part based on better understanding of when assets' risk-return characters are straying from their long-run fair value.

> "The typical pension member does not understand what phrases such as 'equity-like returns' mean"

CROSSHEAD: WEIGHTING TIME

On risk reporting, Harman added that the best way to manage and communicate on DC wealth is on a time-weighted rather than a money-weighted basis. This appealed to other panellists. Roberts said it was confusing for individuals to see they had £300,000 accrued in pension capital without knowing what pension that gives them over the full course of their retirement, which is a much better measure.

Can such measures be universally adopted? This brought the conversation back to the big challenge of permanently raising workers' interest in the financial services they use and rely on. Fearn said that investor education hitherto had failed in its attempts to enthuse savers. Instead, she proposed something more radical than nudges and apathy. She suggested the links between retirement capital and the world at large had to be demonstrated to illustrate to savers where their money actually goes. "It doesn't just go to big, bad companies. It builds roads and hospitals; vital parts of our country. The kind of stuff that keeps society going. If pension scheme members knew this, they might feel more of an emotional connection with their pension," she said.

In conclusion, the panel agreed that this could be one path to convert the UK from a nation of savers to a nation of investors.

> "Links between retirement capital and the world at large have to be demonstrated to illustrate to savers where there money actually goes"

Don't forget volatility

It never goes away for long

BlackRock®

Diversified growth funds owe their popularity to the most volatile financial events in recent memory – market-moving periods of turbulence like the great financial crisis (2008/9), and the bursting of the dotcom bubble (2000-2002).

For many pension schemes, these events highlighted one thing: how dangerous it can be to rely just on equities to create growth in portfolios. DGFs, containing a range of asset classes in a single investment, were created to help mitigate that.

However, equity volatility has sigificantly decreased over the past few years. Supposedly risky investments have kept on rising, and risk-focused portfolios have lagged – even on a risk-adjusted basis, due to low overall market volatility.

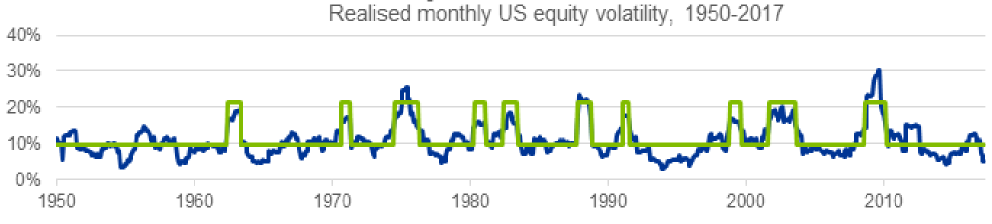
There's just one problem: history suggests that this period of calm will not last. Crises are hard to predict, but the forces that spark sell-offs – excessive borrowing, chasing returns, economic downturns – have not disappeared.

Chart 1 below shows volatility from 1950 in the S&P 500, a globally important index of top US companies. What it shows is that volatility can abruptly return after a period of calm:

> "Diversified growth funds are designed to weather market volatility"

Volatility switch

Realised monthly US equity volatility, 1950-2017



Past performance is not an indicator of future results.

Source: BlackRock Investment Institute, with data from Robert Shiller, June 2017. Notes: Realised volatility is calculated as the annualised standard deviation of monthly changes in US equities over a rolling 12-month period. Using a Markov-Switching regression model, we calculate two volatility regimes: a high-volatility regime (green) and a low-volatility regime (blue). The green and blue lines plot the average level of volatility during each regime based on data from 1872 to 2017.

Written by
Claire Finn
Head of DC
Unit Linked and Platforms

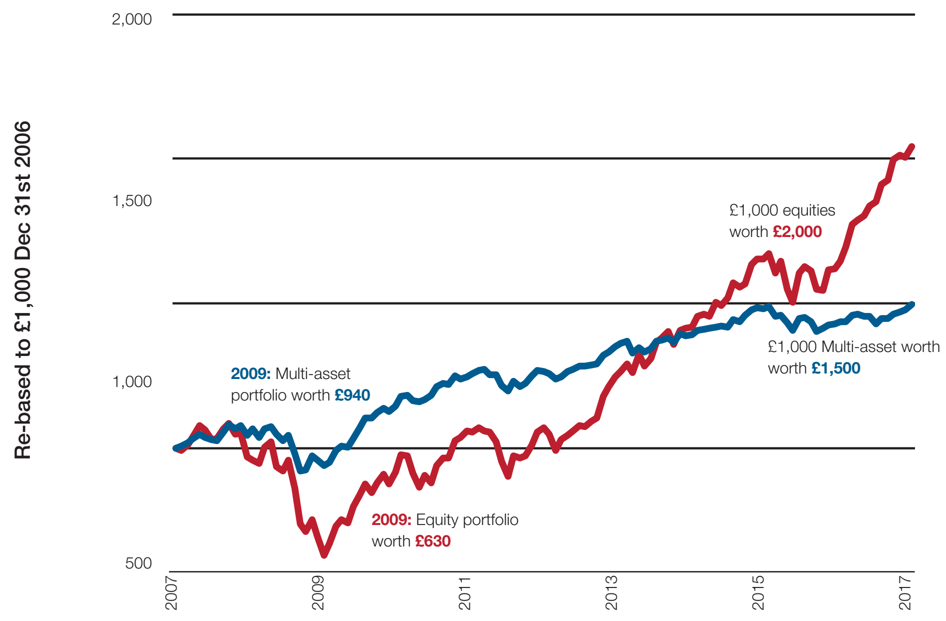
This chart contains an important lesson for investors. Buoyant equity markets, propped up by central bank stimulus, might make it harder to justify allocating to risk-focused DGFs. But cycling into equities or 'equity-heavy' DGFs before a period of heightened volatility, seen in green above, could hurt long term-investment returns, not enhance them.

The power of diversification

It's worth remembering that diversified growth funds are designed to weather market volatility and deliver consistent returns. That's why schemes often put them into the de-risking phase of the glidepath, when a major market event could dramatically affect someone's retirement outcome.

There's a price to pay for this downside risk management.

That price is that a diversified portfolio won't outperform the dominant asset class in any given year. **In Chart 2 below** you can see the performance over the last 10 years of two investments: a pure equity fund, and a blend of DGFs which combines return-seeking investments with defensive ones. The DGF blend shown here has underperformed equities since 2013, but it outperformed them for six years from 2007.



Past performance is not an indicator of future results.
Source: BlackRock/Bloomberg. Data from January 1st 2007 to May 31st 2017. The Multi-Asset portfolio presented above reflects an equally-weighted performance index of four widely available diversified growth funds on a dealing-to-dealing price basis in GBP that are available on a range of platforms. Performance for these funds is shown net of annual management fees. Please note fees charged may vary. Equities are represented by a 50/50 blend of global equities in GBP, and global equities hedged to GBP. They use the MSCI World Total Return Index.

This chart demonstrates the two core truths of DGFs:

1. Steadier investment journey

DGFs are designed to deliver smoother returns – useful for encouraging saving in the growth phase of a glidepath or avoiding large drawdowns as a member approaches retirement. The blue line above shows this in action.

2. Less risk can mean less return

Being diversified means that DGFs are unlikely to outperform the dominant investments during bull markets. You can see this in the outperformance of an equity fund (in green) during the unusual calm since 2013/14. Investors should always assess the relevance of their diversified growth assets, and understand the drivers of return.

At their core, DGFs are well-diversified portfolios watched over by a professional manager with the power to 'dynamically allocate' or rebalance to keep the asset mix at or near long-term targets. That can be a powerful force within pensions saving, and the benefits should not be forgotten even when volatility is low.

> "The benefits [of DGFs] should not be forgotten even when volatility is low"

First State Investments

> “the high proportion of members invested in default options means trustees must find a scalable, appropriate, one-size-fits-all solution”

Written by
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The size of a member’s defined contribution (DC) pension account upon retirement is determined through a combination of the following factors:

1. Age – the earlier a member starts contributing, the better;
2. Contribution Levels – the more, the better; and
3. Investment Returns – the higher, the better.

The holy grail of wealth accumulation can be attained by focusing on these three simple factors. But are they so simple? For the first two, unequivocally yes! Start earlier and contribute as much as you can – the power of compounding is often undervalued. However, in terms of the generation of investment returns, the answer is more complex.

It has been well published that approximately 80% of DC members rely on their Scheme’s default investment strategy to help them build an account balance sufficient to meet their future cash flow needs. The design and performance of a default fund is therefore a key determinant in whether, or not, members are able to enjoy receiving a comfortable income in their retirement.

As such, we believe further inspection of investment returns themselves and the path of these returns is warranted. While the benefits of dollar-cost averaging through regular contributions can be a positive in a volatile market environment, these benefits can be outweighed by members reacting adversely by reducing their contributions in volatile times. In particular, consistently positive investment results have the potential to positively influence action towards the first two factors – age and contribution levels – through the generation of higher member engagement and increased confidence. This then perpetuates a virtuous cycle of a better pension system.

Generating returns above inflation

We believe that the path of returns is of fundamental importance. Being able to generate a more consistent profile of real (i.e. inflation plus) returns helps to better preserve the purchasing power of income in retirement for members.

Having an objective of consistently growing a member’s nest egg at a rate above inflation will allow the magic of compounding to take effect over time. But the key question is, what’s the optimal level of real return over the long-term, and what role does capital preservation have? Too much risk could result in large capital losses in the short to medium term while too little risk will likely end in a short fall. Indeed, this is the investment conundrum.

Solving the investment conundrum?

Over history, equity markets have delivered an excess return over inflation of between 4% and 6%, depending on the time frame and the specific equity market. In essence, investing in equities over the majority of a member’s savings lifetime might by some be viewed as maximising the value of a member’s pot.

However, members’ comfort and risk tolerance has a role to play in whether equity markets are in fact the most appropriate asset class to invest in. Are members able to weather the volatility of equity markets, and indeed should they have to?

History has shown that many investors have a lower risk tolerance then their investments would infer; which results in investors selling equities when prices fall to a deleterious effect. This brings into sharper focus the two key conflicting objectives mentioned above – capital preservation and growth.

First and foremost, capital preservation is key – minimising capital loss in any given year allows for a greater starting point for future growth than for a strategy that suffers greater levels of (downside) volatility. For a sustainable income in retirement, the success (or failure) of an investment strategy is measured in pounds and pence, rather than in percentage terms – ie it is the money weighted investment return that matters rather than the time weighted investment return.

Secondly, it’s well known that delivering consistent, positive returns is the key to increasing the value of an investment over the long term: let the power of compounding do the hard work.

However, the fact that these two objectives are conflicting doesn’t help to provide the optimal investment solution. At the extreme, a portfolio that is fully invested in cash, for example, does provide the desired capital preservation but would fail to deliver the capital growth required to deliver returns above inflation.

The challenge for trustees is, therefore, to seek to achieve the two objectives in a manner whereby members have the greatest chance of success (generating consistent, positive returns) while minimising downside risk (the chance of capital loss) on their behalf.

Is there a simple solution?

Seeking to maximise returns seems ideal for younger members in default options, but at what price? What if chasing those returns increased the chance of capital losses for their fellow members nearing retirement? Whilst not ideal, the high proportion of members invested in default options means trustees must find a scalable, appropriate, one-size-fits-all solution.

This common issue helps explain the rise and rise of Diversified Growth Funds (DGFs) over the past decade, in particular. Most products of this type offer a high level of diversification, both geographically and by asset type and many state their intended return target. This helps to smooth out the large swings in performance that can affect particular investment types at certain times; particularly welcome news for those nearing retirement. The intended smoothing of returns not only provides a degree of peace of mind for trustees, but may also improve member comfort and confidence in the scheme, possibly even helping to lift engagement levels over time.

At the same time, some DGFs aim to add value over time through dynamic asset allocation. Rather than the traditional ‘set and forget’ structure of balanced funds – where asset allocations are often fairly static, with infrequent re-weightings and limited scope to vary allocations from predetermined targets – many DGFs have a less constrained approach to asset allocation. Often they can amend the asset mix more tactically, or dynamically, seeking to take advantage of short-term opportunities as and when they arise.

The flexibility to dynamically rotate in and out of investment types quickly and cost effectively enables skilled investors to increase potential returns and further reduce risk, both of which can have a significant positive influence on long-term performance.

> “the flexibility to dynamically rotate in and out of investment types quickly and cost effectively enables skilled investors to increase potential returns and further reduce risk”

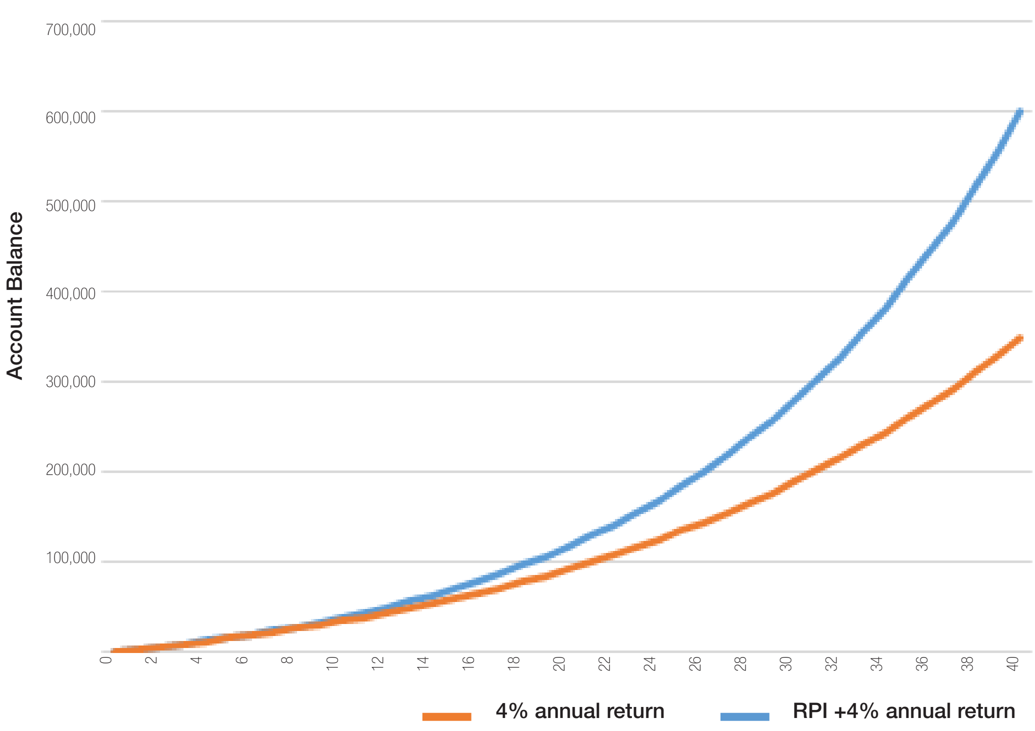
Why a ‘real return’ counts

Maintaining returns above the rate of inflation is another important consideration for trustees. There’s little merit in achieving steady annual returns of 3%, for example, if the long-term average inflation rate is also 3%.

Whilst members’ nominal balances would see steady appreciation, their real wealth would be static. In order to grow their real wealth over the long term and improve their purchasing power in retirement, it’s clear that returns from members’ investments must remain above inflation.

Some DGF managers refer to this concept as 'inflation plus' and establish a particular return target above the official inflation level as a stated objective. Funds targeting "inflation plus 4%", for example, will aim to achieve this return target consistently, regardless of the underlying inflation rate and irrespective of market conditions. If they are able to achieve this outcome consistently, DC scheme members will see the real value of their investments rise steadily, without the unwanted periods of extreme volatility that have been such an unwelcome feature of many pension funds in the past and which can decimate an investment built over a working lifetime.

RPI +4% annual returns will see an accumulated investment perform well



30,000 salary, indexed to inflation at 2.5%, assuming an annual contribution of 8%

This chart illustrates the compounded growth of a theoretical 4% annual return of an investment over 40 years (before commissions, fees and other charges which will reduce the overall growth). It is solely intended to demonstrate the mathematical effect of compounded growth over time. It is in no way intended to indicate the future performance of any investment, which cannot be reliably predicted. It must not be construed as such, or relied upon in any way as the basis for an investment decision.

Even though inflation will erode some of this value-add, we believe that most DC pension fund members would be satisfied with these returns for the more consistent path of returns, thereby helping secure them an adequate and sustainable level of income in retirement. Over time – and with the power of compounding – achieving returns like these would ensure scheme trustees achieve their fiduciary duty to members and, more importantly, enable millions of future retirees to live happily and comfortably in their hard-earned retirement.

Disclaimer

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