Defined Contribution Investment Forum

Trust-based schemes

11•2017

Investment Strategy

A bird's eye view

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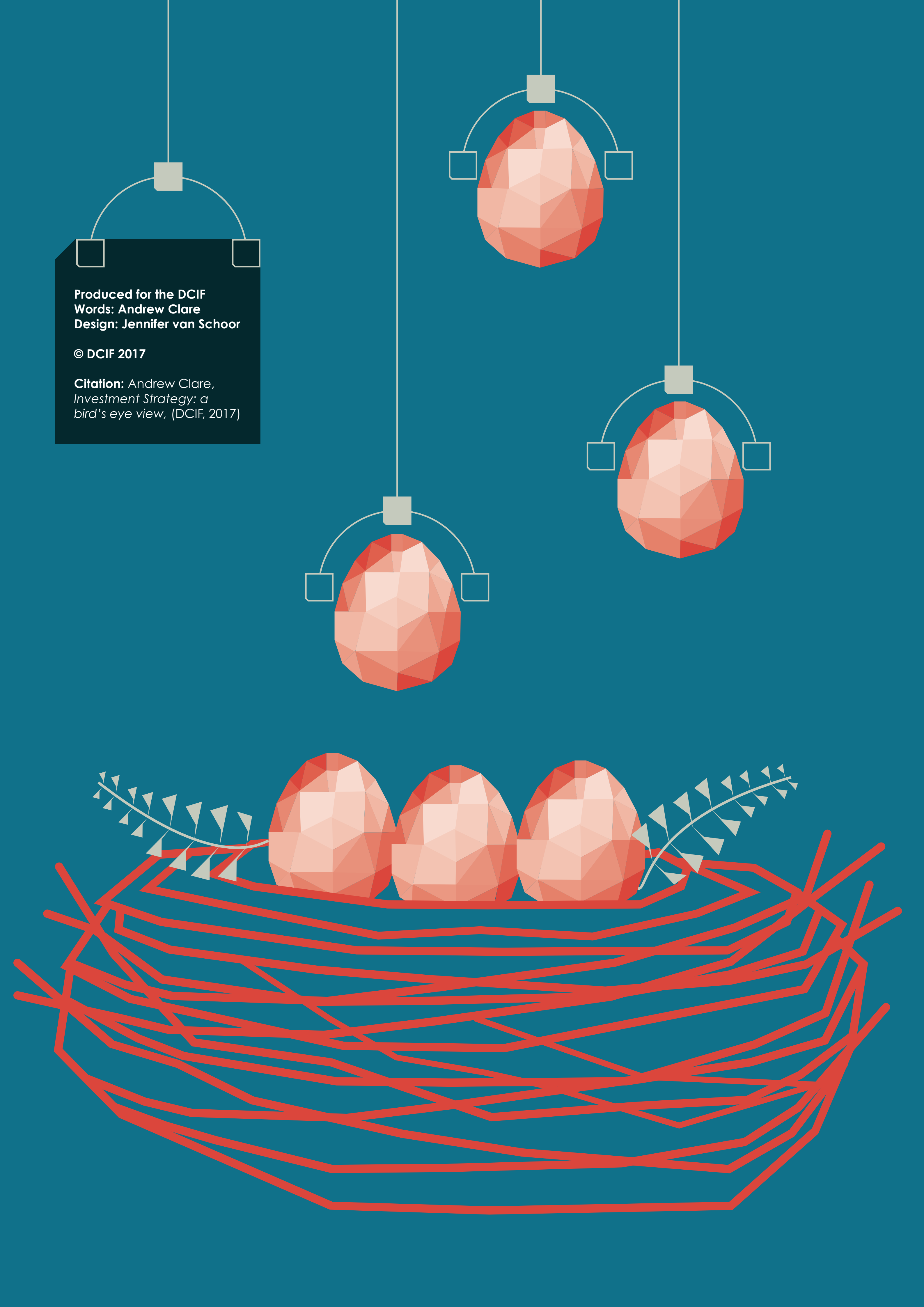

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Contents

Dedicated to promoting investment excellence

The Defined Contribution Investment Forum (DCIF) aims to exchange ideas and develop initiatives to promote investment excellence in Defined Contribution (DC) pensions in the UK. The DCIF consists of investment firms and selected other industry participants who believe that members in DC pension schemes deserve the best possible investment services to help them meet their retirement objectives.

Acknowledgements

The DCIF would like to thank Professor Andrew Clare of Cass Business School for producing this interesting and insightful report.

Our thanks also go to the individuals representing the 20 pension schemes who kindly took the time to be interviewed for this report. We very much appreciate their time and insights.

Thanks also to the industry associations, including the Association of Member-Nominated Trustees and the Investment Association, which generously agreed to be interviewed for this report.

The DCIF's advisory board provided very useful feedback on this report.

Finally, thank you for reading this report. We hope it will inform your thinking and generate some interesting debates.

Chair's foreword

As more and more savers rely on DC to underpin their retirements, the onus is on pension schemes and the industry to meet their needs. That is why the DC Investment Forum (DCIF) decided to take the pulse of a series of influential pension scheme decision-makers in this report. We hope this report sheds light on interviewees' current thought processes, as well as the directions of travel they are contemplating.

On behalf of the DCIF, I would like to thank Professor Andrew Clare of Cass Business School for authoring this snapshot of how pension scheme decision-makers are approaching investment today. It has been our pleasure to sponsor the report and we welcome Professor Clare's very interesting take on the trends he has observed. We would also like to thank the interviewees who kindly participated in this report.

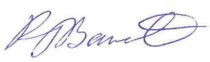
We examined master trusts' investment strategies in our last major research report, which was published in spring 2017. The author of that paper, Nico Aspinall, was able to speak to most of the major master trusts operating in the market today. He found that, in many cases, they were grappling with similar operational and investment challenges, leading to some clearly observable similarities in approach.

By contrast, in this report, we focus on UK trust-based occupational pension schemes. Today's trust-based DC landscape is much more diverse. Schemes' perspectives and decision-making are contingent on an array of factors: scheme size, maturity, population, the degree of paternalism of their sponsor and how they believe freedom and choice will affect their scheme membership, to name just a few variables. This dispersion makes it more difficult to pinpoint widespread trends, which means that this report presents a range of views and ideas.

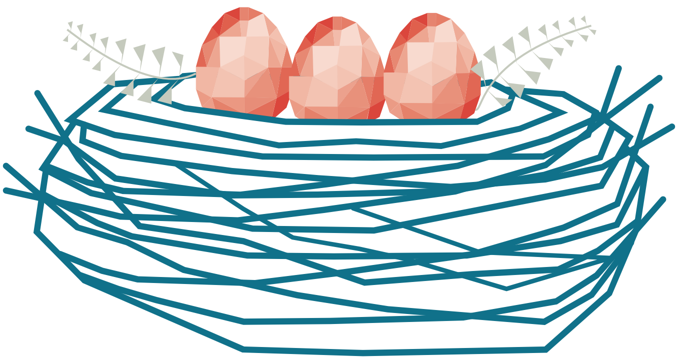
Some clear trends shone through. As Professor Clare writes in the summary, some investment themes were touched on in nearly all his discussions. Happily, the design of the default fund was a major area of focus for interviewees. Additionally, we were also encouraged to see interviewees implementing their asset allocation through both active and passive approaches, balancing costs with a focus on return.

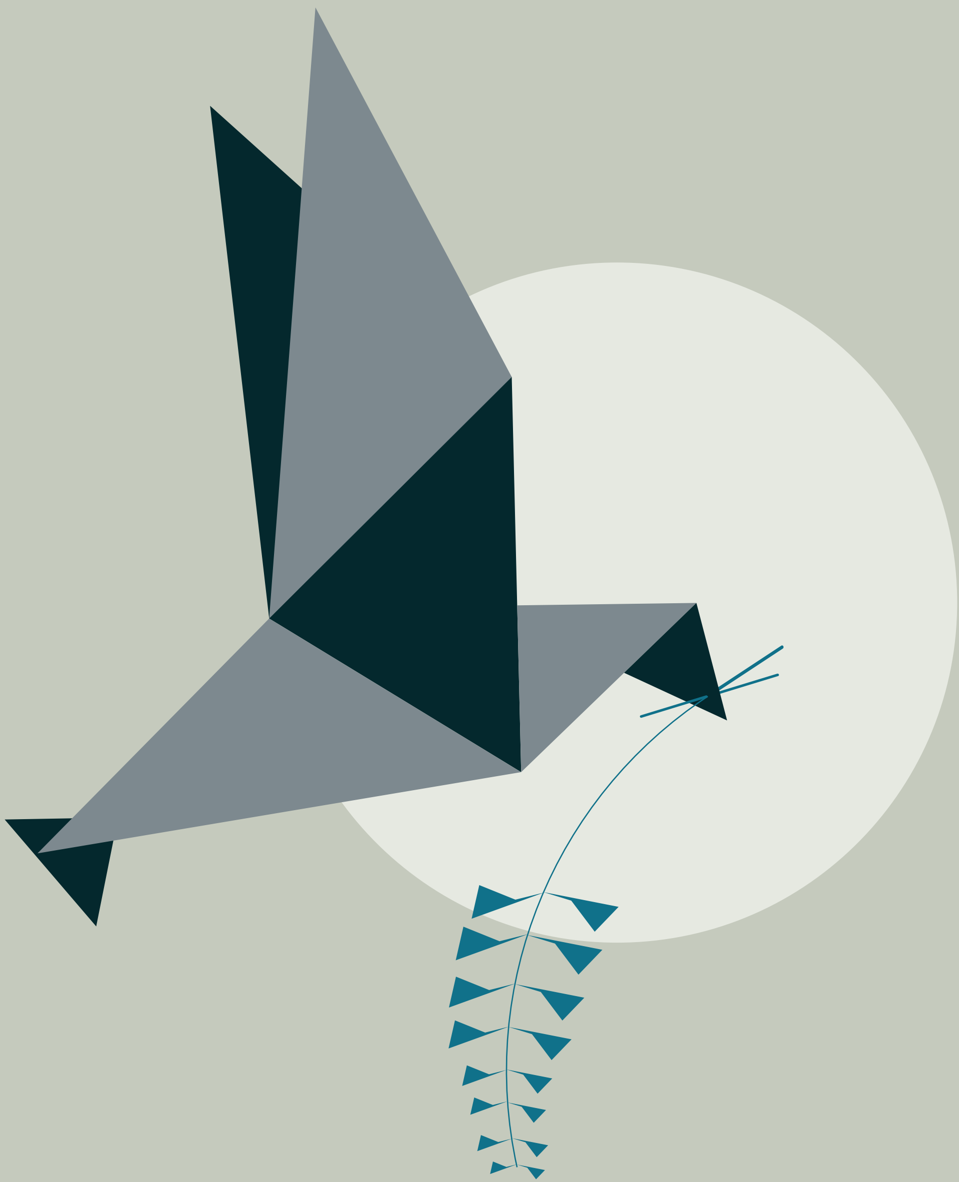
Sadly, we were not surprised by a lack of alternative asset classes in their default funds. This reflects an ongoing industry challenge which we, and others, will continue to focus on in upcoming months. We hope this report encourages greater discussion of this point.

That said, the interviewees demonstrated a clear intention to focus on investment for the future. More and more people are retiring with solely DC savings to rely upon, and this will only grow in the coming years. It is incumbent on the industry to ensure that investment design – and the governance underpinning it – is fit for purpose throughout the journey.



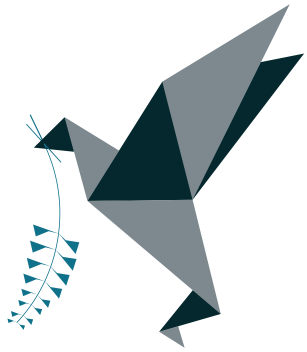
Rob Barrett,
Chair, DC Investment Forum





The study aims to build a picture of the sort of developments in investment strategy that have occurred over the last few years, and that may take place over the next few, in this part of the UK's pension landscape

Executive summary



This report provides a snapshot of the UK trust-based DC landscape in 2017. DC schemes have been faced with large amounts of regulatory change and upheaval in recent years – auto-enrolment, the introduction of the charge cap and Pensions Freedoms – making it hard to prioritise investment. This report focuses on the investment strategy made available to members of trust-based DC schemes and is based upon discussions and interviews with experienced pension scheme trustees, pension scheme administrators, and pension scheme advisors. The findings that we document here are as follows:

Asset classes: The predominant asset class in the early stage of pension accumulation remains developed economy equities, with the preference tending to be for these to be managed on a passive, market capitalisation-weighted basis. However, some schemes now combine an allocation to equities with an allocation to one or more Diversified Growth Funds (DGFs) at this stage of the savings process.

Accumulation investment options: Driven by concerns over early members' investment experiences some schemes have recently introduced more than one option for members at this stage of accumulation to accommodate a range of risk appetites.

Pre-retirement design: Many of the schemes interviewed for this report have developed a more structured approach to asset allocation in the late accumulation stage of pension saving. Here passive equities may be combined with DGFs, and corporate and government bond funds at the outset. These holdings are then gradually de-risked as the member's normal retirement age approaches. These approaches clearly involve more diversity than the traditional approach to life-styling that typically involved a straight-line decline in allocation to equities from 100% to 0% in favour of gilts.

Post-retirement: While some relatively large DC schemes have responded to the new pension freedoms by designing default investment strategies that accommodate a drawdown investment option, smaller schemes are more likely to still offer members only the cash and annuitisation options at retirement.

Drawdown: Where drawdown options are offered, given the immaturity of this market, it is perhaps not surprising that the investment strategy in the drawdown phase of a member's life has received relatively little attention so far. The interviews revealed that a number of questions that will need to be addressed in the future, if schemes decide to offer in-scheme drawdown to members. What strategy should be adopted when drawing from the investment pot? Should a post-retirement life-styling approach to investments be developed and offered to retirees? Should members be reminded about the possible benefits of annuitising at some point post-retirement?

A risky annuity: During discussions about the post-retirement period of members' lives the possible need for asset managers to develop "risky annuities" arose. A risky annuity would be a pooled fund of cash-generative illiquid credit assets of the kind currently favoured by larger DB schemes.

Illiquid asset classes: Although not the view of all interviewees, most felt there should be a role for illiquid asset classes in DC investment options for members, given the long term nature of these assets. A significant number felt the mechanics of DC platforms were one of the key barriers to integrating illiquid asset classes into DC portfolios. Because of this many interviewees felt that for the moment at least, illiquid asset classes were best integrated into member portfolios via DGFs.

Smart beta: Although equities managed on a passive, market capitalisation-weighted basis usually make up a significant proportion of the risky exposure in a default fund and often 100% in the 'growth' phase, the main reason given for the use of passive rather than active funds was cost, rather than any entrenched views about the merits of active versus passive investing. The lower cost of indexed funds allows schemes to integrate DGFs into their strategies, without violating the charge cap. Also, although some schemes have introduced "smart beta" approaches to equity investment, most had not, with some interviewees concerned about the short track record of such approaches.

Cash: With cash rates currently still virtually at zero, a number of interviewees felt that introducing "cash plus" funds to ranges might be attractive, particularly for those members looking to use their savings as the source of their tax fee cash lump sum.

Member engagement: Finally, although this project focused on investment strategy, interviewees generally struggled with a lack of engagement among members. This disengagement means it is difficult to reflect their views and priorities in pension schemes' investment strategies.

1. Introduction

Earlier this year, the DCIF published a paper which focused on the investment design of the UK's new Master Trusts.[1] One of the key findings of this study was that "most Master Trusts [were] opting for a cheap and low governance approach" and that investment strategy was a low priority in the design of these investment vehicles as Master Trust providers focused primarily on their structures, rather than on the investment engine. The DCIF's findings therefore raised the possibility that Master Trust members might be achieving sub-optimal investment returns, and in particular, may be missing out on the potential benefits of active fund management.

The current study is a continuation of this research topic, but with a focus on the investment strategies of occupational trust-based DC schemes. The aim of the study is to build a picture of the sort of developments in investment strategy that have occurred over the last few years, and that may take place over the next few, in this part of the UK's pension landscape.

1.1 The study

To achieve this aim we conducted in depth interviews with experienced trustees and pension professionals, all with significant experience of occupational trust-based DC investment strategies. The findings that we document in this report are based on the comments and thoughts provided by individuals representing 20 schemes.

As **Figure 1** shows the majority of these schemes had more than 5,000 active members. This set of schemes are therefore large – in terms of both active membership and AUM – relative to the average DC trust-based scheme. For example, in 2014 the OFT[2] reported that there were "around 2,900 small and medium size trust-based schemes (with between 12-999 members)".

To develop a wider appreciation of DC investment strategy beyond these relatively large schemes we also interviewed a number of independent, professional trustees and representatives of other relevant organisations, including the Association of Member Nominated Trustees (AMNT) and the Investment Association (IA). The interviews were conducted in confidence between June and October of 2017. We believe that the range of participants and their experience has provided us with a clear picture of the typical approaches to investment adopted trust-based DC schemes in the UK. **Figure 2** provides a summary of the roles undertaken by the interviewees, where some of the interviews performed more than one of these roles.

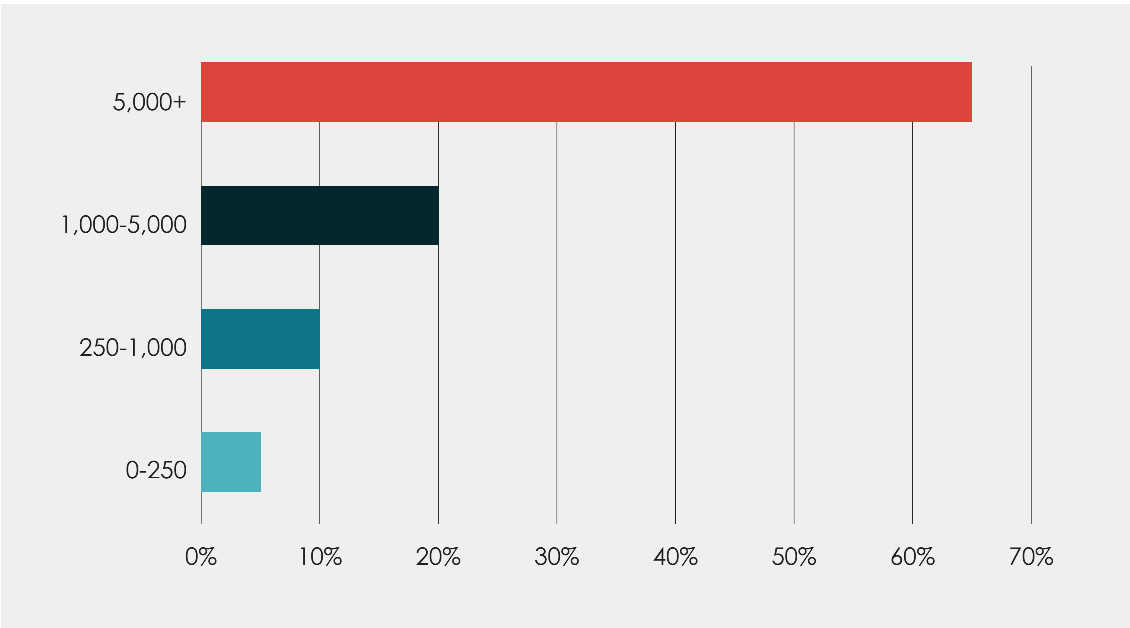
The interview discussions were wide-ranging in their scope, reflecting the different experiences and backgrounds of the interviewees. However, there were a number of investment-related themes that were touched on in nearly all the discussions.

Notes

[1] This paper can be found at: www.dcif.co.uk/wp-content/uploads/2017/06/dcif-master-trustsreport-2017-low-res.pdf

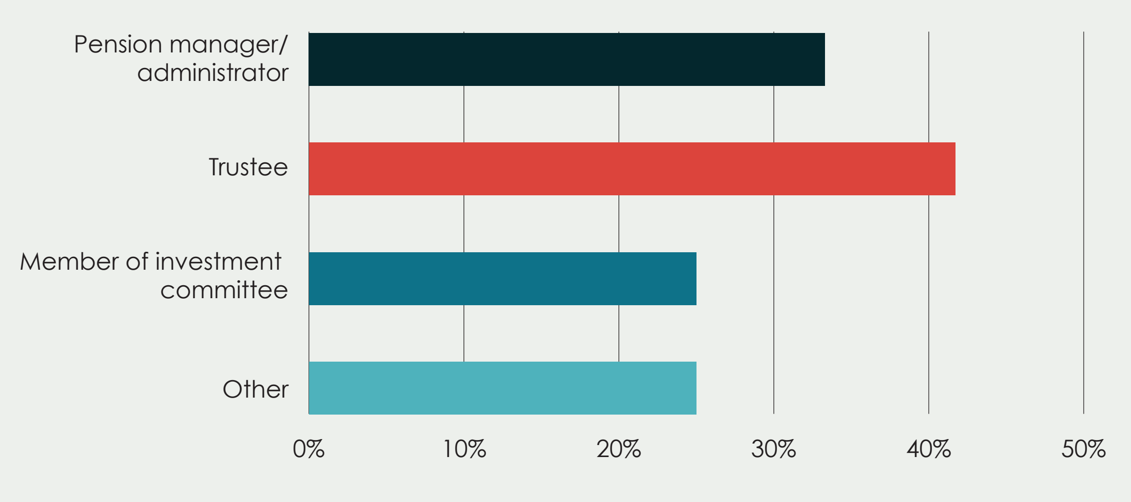
[2] Defined contribution workplace pension market study, OFT, February 2014.

Figure 1. How many members are there in your scheme?



Interviewees reported membership proportions in the default investment option ranging from 75% to 95%

Figure 2. What role do you play in the management of the scheme?



1.2 Default design

The first and most prominent conversation topic was the design of the default fund. It is unsurprising that the investment strategy enshrined in the default fund was the main subject of discussion given that interviewees reported that the vast majority of their members opted (normally passively) for the default fund. In 2013, the NAPF (now the Pensions and Lifetime Savings Association (PLSA)) reported that 80% of DC members were invested in their scheme's default option. The interviewees in this study reported membership proportions in the default investment option ranging from 75% to 95%. With regard to the default fund, the interviewees all gave views and opinions on:

- The impact of Freedom and Choice[3] on design
- Pre- and post-retirement "Life-Styling"
- Passive v active investment approaches
- Alternative asset classes
- Illiquid asset classes

1.3 Self-Select

Although the majority of DC scheme members "chose" the default option(s) made available to them, all of the schemes discussed in the interviews also offered Self-Select options for their members. Here the members are offered the opportunity to shape their own investment strategies, though within the constraints of the funds comprising the Self Select range. During conversations about these Self Select options the range of investment funds available was discussed as well as the attractiveness, or otherwise, of this approach relative to the default option. There is the potential for Self-Select offerings to encompass, new and innovative investment options for members, and discussions often focused on this potential.

1.4 Other factors

The focus of the discussions was investment strategy, as such, the majority of the discussions were about the choices made in the design of the default option(s) and about the fund choices available under the Self-Select options. However, in most cases the interviews also touched on three areas that are not directly related with investment strategy, but which interviewees believed were a factor in investment strategy design and implementation. These themes could be categorised broadly as:

- Member Engagement
- Technology
- Fees and Costs

The interview discussions revealed that as well as being factors that had an impact on investment strategy in their own right, these factors, and the challenges they posed to innovative investment strategy, were often seen as being interrelated by interviewees.

Notes

[3] www.gov.uk/government/consultations/freedom-and-choice-in-pensions

2.The default fund

The default fund has always been the most important component of DC investment architecture. The government's decision to introduce Freedom and Choice was a catalyst for the schemes interviewed in this study to revisit the investment strategy embedded in the default fund.

The additional options afforded to DC scheme members by the new tax rules that made up Freedom and Choice meant that the interview discussions focused on the investment strategy made available over the three distinct periods in a member's life:

1. The early accumulation stage – also referred to as the "growth" stage
2. The late accumulation stage – also referred to as the "pre-retirement" or "switching" stage
3. The in retirement stage

Although all three stages existed prior to the introduction of Freedom and Choice, the introduction of this legislation, giving members the option to keep all of their retirement savings invested with the associated option to draw down regular amounts from these savings, thereby increasing the options in stage 3, also had an impact on investment strategy in stages 1 and 2.

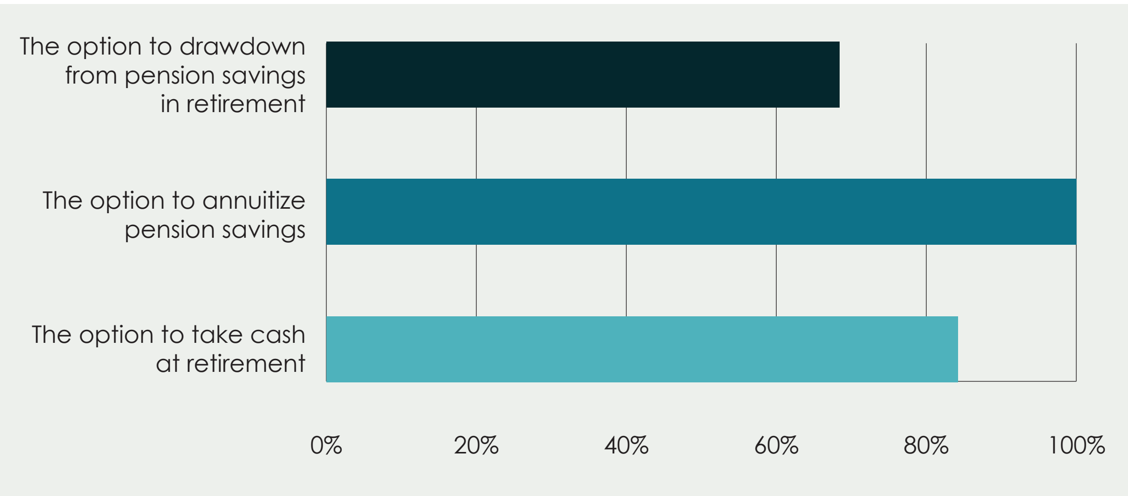
2.1 The early accumulation stage

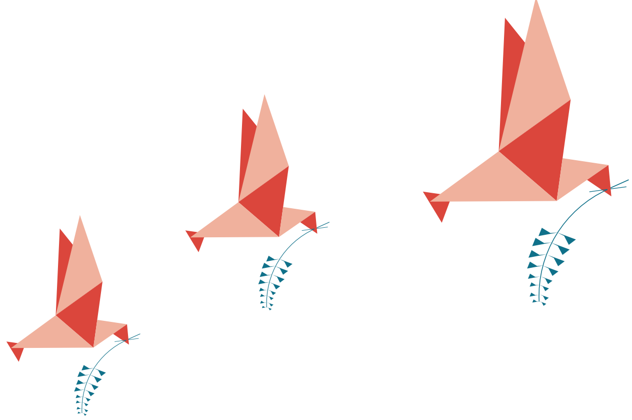
Although Freedom and Choice was clearly a spur for the schemes in our study to review each of the stages of their pension offering, some had already begun to change their investment strategy from the traditional 100% equities allocation in the early accumulation phase, to an approach with more structure. Of the schemes represented by the interviewees in this study, investment strategies in the early accumulation stage (usually ten years before normal retirement age (NRA) ranged from:

i. 100% passive global equities;
ii. 100% mixture of passive and active global equities;
iii. To some proportion invested in a Diversified Growth Fund DGF (or funds), plus (i) or (ii).

Figure 3 presents a summary of the asset classes that comprise the early accumulation investment strategy of the schemes interviewed in our study. Passive, global equities was the dominant asset class and investment approach in this part of the accumulation stage. This asset class, and approach to equity investment, was a fundamental building block for 85% of the schemes. However, as indicated above, where 100% equities is not the main investment strategy, DGFs seem to be the main additional component; 60% of the schemes included DGFs in this growth stage of the pension accumulation process. In some cases member contributions are invested 100% in passive equities, say 30 years from NRA, and then each year this proportion falls with increasing allocations to DGF(s) until around ten years from NRA, meaning that the late accumulation stage begins with a mixture of equities and DGF holdings. Figure 3 also shows that actively managed equities form part of the early accumulation default portfolio, with 35% of schemes incorporating this investment style. In most cases, where active equities were part of the investment strategy, they were combined with passive equities. The minimal use of cash and

Figure 3. What options does your scheme offer members?





bonds is unsurprising given that members in this part of the accumulation phase have, by definition, a significant time until retirement.

The use of DGFs in the early accumulation stage seems to be driven by two considerations. First, a concern that equity returns might be lower in the future than they have been in the past – a common industry concern where the "past" probably means the late 1990s! The second issue relates to volatility. Indeed, the broad consensus among interviewees was that members should be encouraged to contribute more during the early accumulation stage. A large equity market fall might therefore discourage members from contributing sufficient amounts of their pensionable income, ultimately leading to worse pension outcomes for members. By adding DGFs, with their exposures to a wider range of asset classes, it is hoped that members will experience lower volatility via greater diversification, without sacrificing too much (expected) return. The imperative to encourage pension saving was felt to be more important than the investment strategy itself.

In some cases this concern about members' investment experience in the early accumulation stage led schemes to offer more than one early accumulation stage investment option. These options could best be described as "conservative", "balanced" and "growth", with the "growth" option being equivalent to the usual early accumulation investment approach (predominantly equities), the conservative approach representing a lower risk/return strategy, and the balanced approach essentially offering a combination of the other two options. By offering investment strategies with different risk profiles the hope is that members will choose the investment approach that will best suit their risk tolerance.[4]

2.2 The late accumulation stage

Our discussions in the course of this project revealed that it is in the late accumulation stage where most of the changes to investment strategy have been made. Freedom and Choice has certainly been a catalyst in these changes. The new rules essentially mean that there are now more choices at NRA: members can either annuitise their savings; take the savings in the form of cash; leave their savings invested allowing them to drawdown on these investments over time; or choose some combination of each of these options.

Prior to Freedom and Choice this late accumulation stage typically saw members' investment pots transition from a 100% investment in equities to 100% in cash/gilts, usually in a straight line, either five or ten years before NRA. This is commonly known as "lifestyling", and is a typical feature of the default investment option. The purpose of this transition is to reduce, the possible pernicious effects of sequence risk that would remain high if the investment pot comprised 100% equities until the NRA. Sequence risk, relates to the order of investment returns, rather than to their average over time.[5] In other words, an equity market collapse of the kind we saw in October 1987, or of the kind we saw in the lead up to the Global Financial Crisis, could have a dramatic effect on a member's pension savings if it occurred just before a member was due to retire if they were still heavily exposed to equity markets. The closer the event to NRA, the greater the likelihood that equity markets will not have recovered sufficiently.

Our discussions in the course of this project revealed that it is in the late accumulation stage where most of the changes to investment strategy have been made

It is still too early to evaluate the performance of the new asset allocation approaches to the late accumulation stage of pension saving, but in the course of the discussions with interviewees it is possible to identify a number of developments in lifestyling structures that have been driven largely, though not entirely, by the advent of Freedom and Choice.

2.2.1 More diversification

Now that members have more choice at retirement, some schemes have accommodated this by asking their members to indicate to the scheme's administrators whether they aim to build up a pot of cash by NRA, to annuitise at this point, or to remain invested. Depending upon the answer members then default into one of three strategies depending upon their ultimate aim. The annuitise option was the only "option" until recently. However, even though the end point is the same the investment strategy used to fulfil this aim is evolving, as is the strategy employed to achieve a cash pay-out. Instead of the traditional use of equities transitioning into gilts/cash, there is a trend to use DGFs and other asset classes, such as investment grade corporate bonds. **Figure 4** shows the range of asset classes that comprise this late stage of the

Notes

[4] It is interesting to note that many asset management groups, usually via IFAs, allocate retail investor savings (pension and non-pension) to one of up to 10 risk-graded investment strategies. Offering DC members some risk-graded options at this stage of the accumulation process is therefore consistent with practice elsewhere in the finance industry – a practice that has been heavily influenced and encouraged by the FCA in its drive to ensure that investment solutions meet customer needs. However, the lack of engagement with members (see section 6) is perhaps the main reason why offering risk-graded default investment options to DC members is less common.

[5] See Clare, A., Seaton, J., Smith, P. and Thomas, S., Reducing Sequence Risk Using Trend Following and the CAPE Ratio, *Financial Analysts Journal*, Sept 2017, Vol. 73, Number 4.

pension savings process. Passive equities and DGFs appear to play a big role in this period, with 70% of the schemes incorporating passive equities into their asset mix and 65% DGFs. Other asset classes, cash, government and corporate bonds also play a part in this stage. Typically, lifestyling begins with a significant proportion in passive equities and DGFs, and then as the member gets closer to retirement, the portfolio gradually transitions into these lower risk asset classes. Essentially, for many of the schemes interviewed for this project the transitioning process is becoming more diverse, rather than diversifying across one risky asset class – equity – and one lower risk asset class – gilts.

2.2.2 More active management

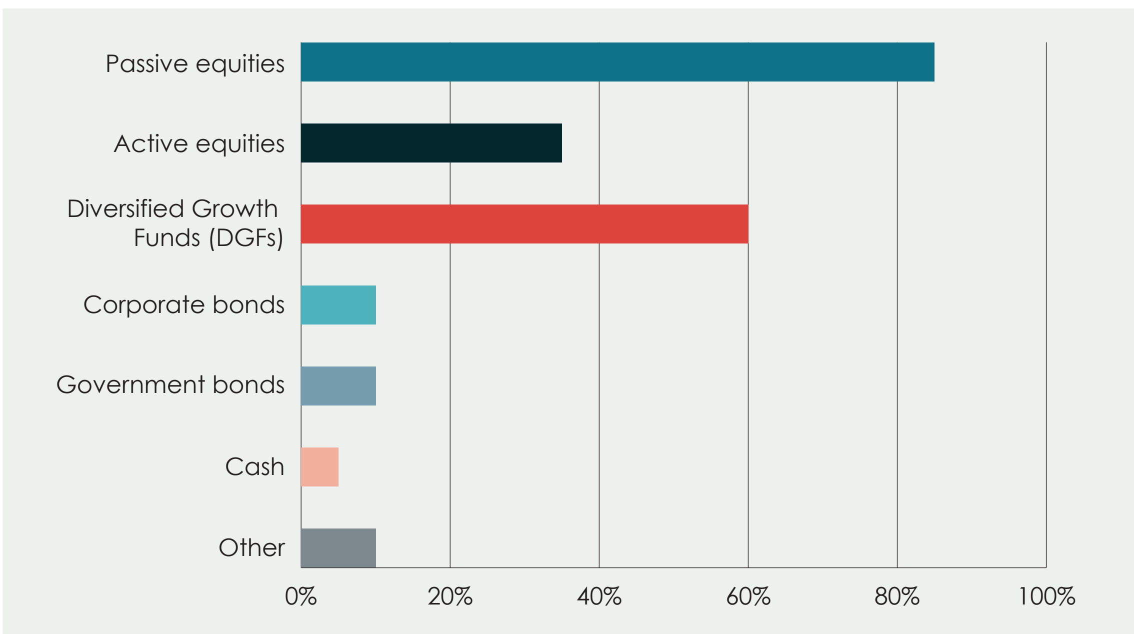
The use of DGFs in this stage of the accumulation process also means that there is the potential to customise the investment return target by choosing different DGF managers with different return targets, tying these targets to inflation. Of course the achievement of these targets will be the task of the DGF manager(s), where this achievement will be down to the skill of the manager, rather than being reliant on the unknown outcome of a mechanical, time varying allocation to equities and government bonds. The bottom line then, is that there appears to be a trend for more multi-asset and active manager exposure in the final stages of accumulation.

2.3 Decision time for drawdown

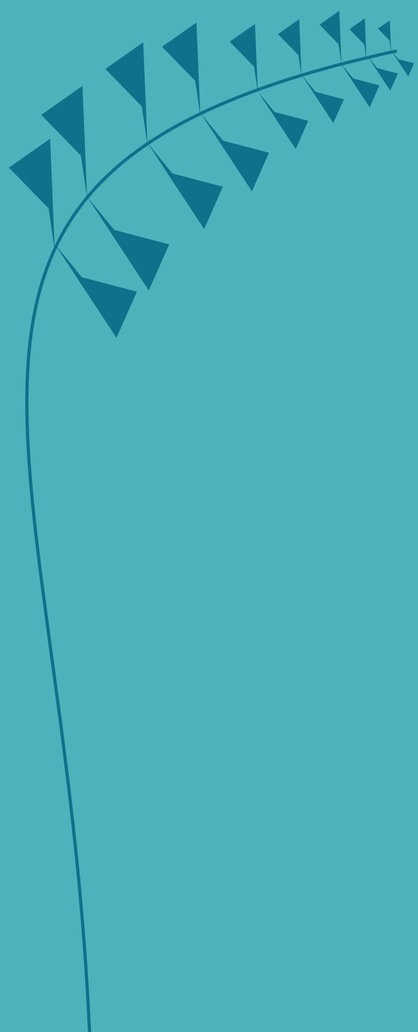
By the admission of most of the interviewees the retirement, or decumulation stage has received less attention than the early and late accumulation stages. The main reason given was that only a relatively small number of members (or at least a small proportion of the total) have reached this point. Of course for those that choose to take a combination of cash and annuities there is no change in the process. But for those that wish to move into drawdown (or who simply wish to delay buying an annuity) new arrangements are clearly required.

Some DC schemes have not felt it necessary to offer their members a drawdown option. Indeed,

Figure 4. What asset classes do you use in the early accumulation phase?



Is there a point at which members should be 'advised' or 'guided' to annuitise their remaining investments, say at 75?



even among the larger schemes interviewed for this project, as **Figure 5** shows, only 35% of the schemes offered this option. Discussions with the independent trustees revealed that some schemes have made the conscious decision to target annuities for their members at NRA, as they did before, because they believe that their role is to generate annuities for members. Elsewhere it is clear that many smaller schemes have not considered this issue yet. Either way, if members do not wish to purchase an annuity when they retire, they can move their pension pot into a drawdown solution provided by a third party, or possibly into a SIPP. Conceptually at least, this third party could be a Master Trust, and in the future members could be offered a kind of open market Master Trust option, in much the same way that they have been offered an open market annuity option for some years now.

For those schemes represented by the interviewees in this study that did offer members a drawdown option at the point of retirement, as **Figure 6** shows, the asset mix at this point was frequently a mix of assets – equities, DGFs, government and corporate bonds. This final mix may have been influenced by choices made in the life-styling accumulation stages. In other instances discussed in the interviews, the mix will simply have been one, default drawdown option in this same stage.

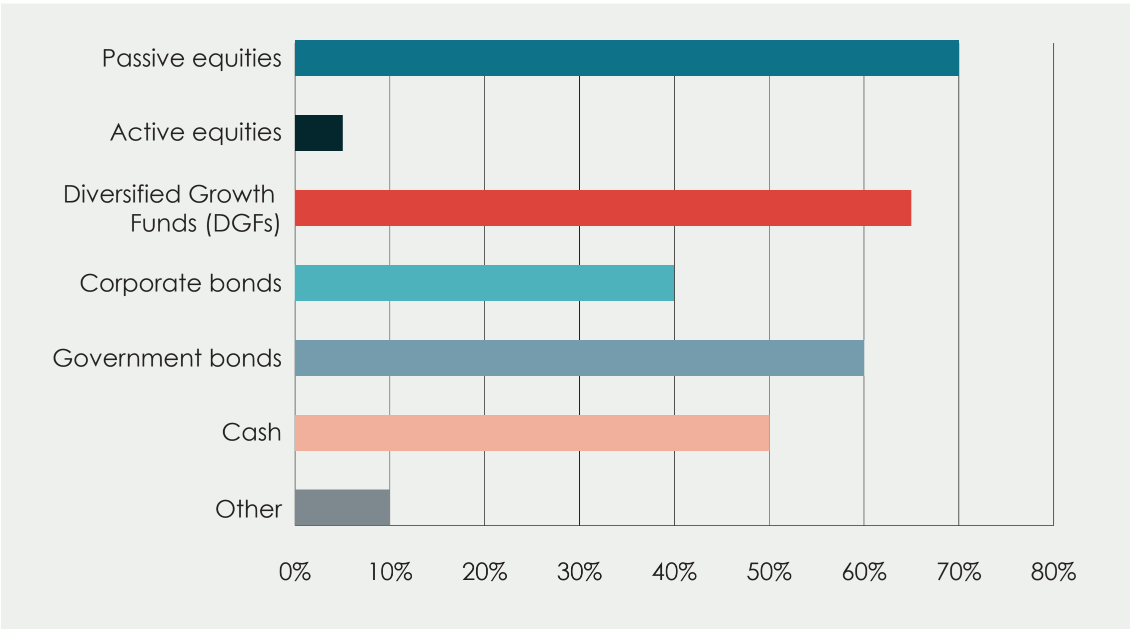
During discussions about the drawdown options, once members have retired, no clear consensus emerged on two points in particular.

First, when a member draws a proportion of their holdings from their pension pot, how should this drawing be funded? On a pro-rata basis, cashing in, say, 5 percent of each asset class/holding? Or by cashing in the required amount from, say, the low risk asset class holdings first? The former approach preserves the structure of the investment strategy until the pot is exhausted. The latter approach has the advantage of allowing the higher risk holdings more time to generate returns. But both approaches have their drawbacks. The pro rata approach essentially ensures that a 65 year old is employing the same investment strategy as a 75 year old. The latter approach has the disadvantage of leaving the investment pot more and more exposed to high risk asset classes, as the member ages and the low risk asset classes are gradually cashed in.

A second issue relates to the member's final drawdown destination. Is there a point at which members should be "advised" or "guided" to annuitise their remaining investments, say at 75? As we grow older many of us will have less capacity to make investment decisions. It may therefore be advisable to embrace the benefits of annuities as that capacity declines.

In the final accumulation phase, some schemes have given a great deal of thought to the reshaping of a members' investment pots in preparation for retirement. Perhaps there should be a life-

Figure 5. What asset classes do you use in the late accumulation phase?



Just over two thirds of respondents selected the following option ‘I want my pension fund to provide a stable income over my lifetime’

styling approach after NRA too? Over time, as more members enter into drawdown, there may be a greater focus on this post-retirement phase. However, for the moment, so far there has not been much thought put in to the "to and through" question.

2.4 A risky annuity?

In the course of interview discussions about the post retirement phase, and in the context of general agreement that a more structured solution should be offered to members in drawdown, one interviewee raised the topic of a "risky annuity", an idea that was raised with subsequent interviewees.

So what is a "risky annuity"?

Traditional annuities have become less popular in recent years for a number of reasons. First, annuity rates have plummeted with gilt yields in the wake of the Global Financial Crisis. Second, standard annuities die with their beneficiary, meaning that pension savings accumulated over a lifetime and invested into annuity cannot be passed on to descendants. But in a 2014 survey of DC members conducted by Cass Business School and Aon Consulting, when asked what they wanted from their retirement savings – just over two thirds of respondents selected the following option "I want my pension fund to provide a stable income over my lifetime." In all but name, they liked the idea of an annuity!

Essentially a "risky annuity" could comprise a mixture of illiquid asset classes (see 3.5 below) with contractual cashflows designed to generate income that could be drawn down by members over time. In the DB world, asset managers have already created funds of this kind that usually target some return in excess of RPI/CPI. Although the value of the funds would rise and fall over time, if based on secured income then they should go a long way to satisfying member demand for "a stable income over my lifetime".[6]

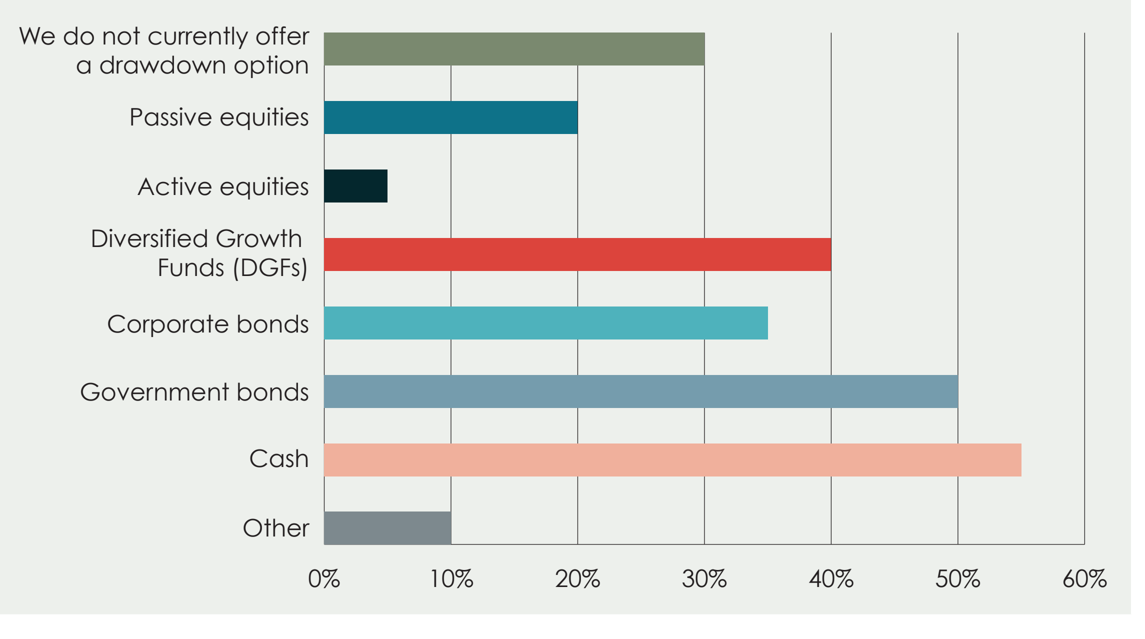
To be clear, such an approach would not be a perfect substitute for an annuity. First, it would carry no insurance company guarantee, and therefore members would have to accept some risk of a fall in the amount that they could withdraw from the fund. Second, although retirees could withdraw from the fund in the future, and bequeath its value, given the nature of the underlying assets, funds would probably not be immediately accessible. Third, given the less than traditional underlying asset classes and the likely illiquidity of the fund it might be desirable (from a regulatory perspective) to limit access to this fund to those that have sought financial advice.

When discussing this idea with interviewees, the phrase "with profits without the guarantee" arose. To some extent this is a fair description of this idea. However, given that funds of this kind are available to DB savers, a number of interviewees felt that it was an idea that should be given further consideration.

Notes

[6] Source: https://retirementandinvestmentblog.aon.com/getattachment/7e83ce27-ecf7-4f0e-aafd-e14dfce5abbd/In-brave-new-Aon-DC-Member-Survey-December-2014-(2).pdf.aspx

Figure 6. What asset classes comprise the drawdown portfolio at retirement?



3. Non-standard asset classes

In the course of discussions with interviewees, the extent to which DC schemes were integrating non-standard, or alternative, asset classes and investment strategies into their investment offerings to members was discussed. Since the turn of this century, and in particular since the Global Financial Crisis, asset managers have made an increasing range of asset classes available for their DB clients, from direct loan funds to insurance-linked funds, and many more.

3.1 Smart Beta Investing

In recent years there has been both increasing interest in and usage of "passive" equity investing and related to this, an interest in alternative ways of indexing equity investments – so called "smart beta" investing.[7] Closely related to this, there has been an increasing interest in "factor-based" equity investing. Essentially the asset management industry now offers both institutional and retail investors a choice between traditional, active equity funds and what could be better described as "rules-based" equity funds, where the latter encompasses "passive", alternative indexing, smart beta, and factor-based equity funds.

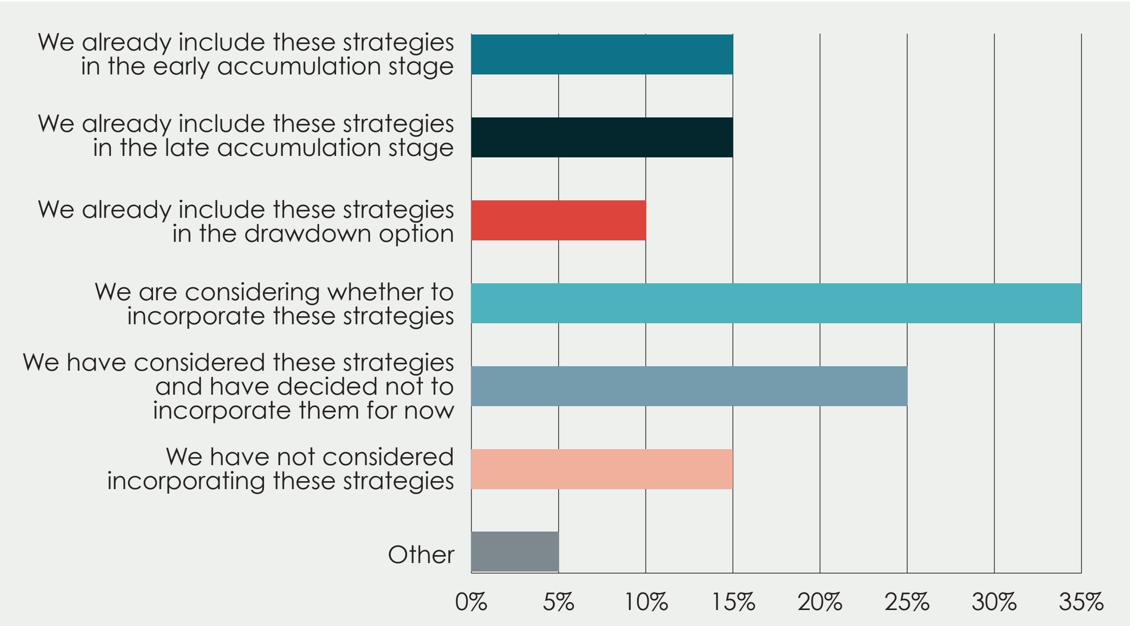
The interviewees for this project revealed that the predominant choice for the equity component of default funds was "passive global equities", that is, portfolios of global equities managed in line with some market cap-weighted global equity index. The main reason given for the choice of this style of equity investing was cost, that is, these funds were cheaper than actively managed equivalents. However, none of the interviewees expressed an evangelical belief in "passive" equity investing, or claimed any special insight that would lead them to believe that passive funds would perform better than actively managed equity funds. Instead, the incorporation of global equities, invested in line with a market cap-weighted index, helps to keep overall all management costs below the fee cap of 0.75%pa, giving schemes room to add more diversity and more actively managed investments such as DGFs.

With regard to Smart Beta and factor-based equity funds, interviewees expressed three views which essentially highlight the nascent nature of such approaches to equity investing; these views are summarised in **Figure 7**. The first being one of scepticism; essentially the view expressed here was that these approaches were unproven and possibly not much more than marketing hype; 25% of the interviewees had considered and rejected these strategies, at least for the time being. 35% of interviewees indicated that their schemes were actively considering the possible benefits of adding rules-based equity strategies. Finally, between 10% and 15% of interviewees reported that their schemes had already integrated smart

Notes

[7] See for example, "An Evaluation of alternative equity indices: Part 1" (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2242028), and "An Evaluation of alternative equity indices: Part 2", (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2242034).

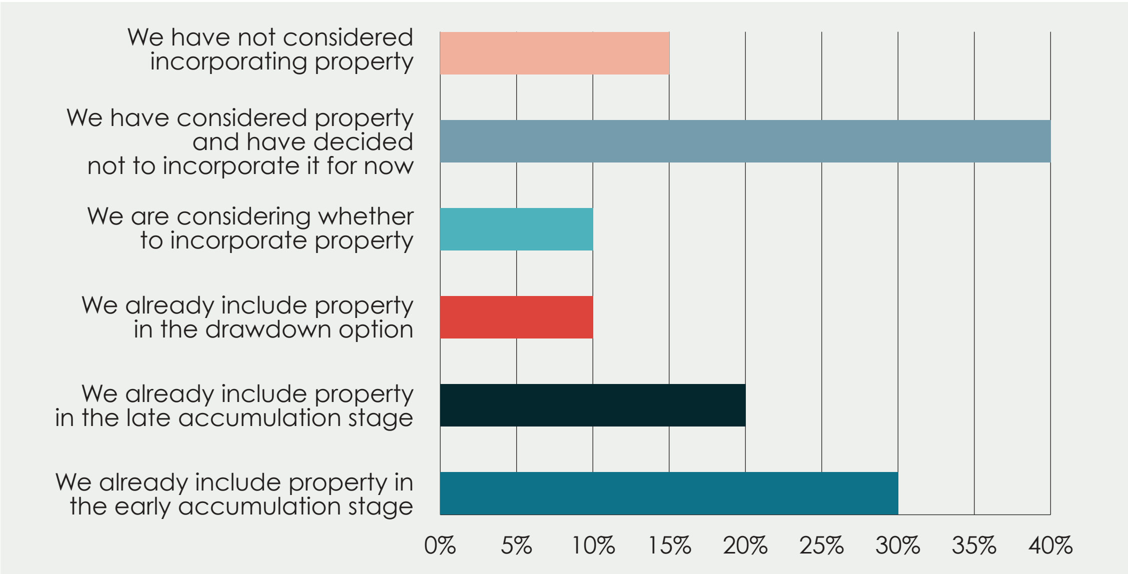
Figure 7. What are you views on "smart beta" investment strategies?



Notes

[8] Although establishing that the size of the illiquidity premium available from a particular asset class is also one of the difficulties involved in allocating to such asset classes. How much compensation is enough?

Figure 8. What are your views on illiquid asset classes?



beta strategies into their default funds, often mixing a value and a low volatility approach with a more traditional market-cap weighted approach, essentially diversifying across a range of rules-based investing.

The trend towards managing equity portfolios according to the rules of alternative equity indices is still at a relatively early stage. However, some schemes have taken matters into their own hands, working with index providers to design indices that meet their specific requirements. These requirements might be investment driven, that is, a belief that a certain style of equity investing would outperform a market cap benchmark over time, or driven by the views of members, perhaps ESG-related views that were not adequately captured in available indices. This bespoke approach to alternative indexing is almost certainly only likely to be pursued by very large DC schemes, nonetheless it does indicate a new and innovative approach to equity investing, furthermore, once the index and fund is established it could be made available to other investors, including other DC schemes.

3.2 Illiquid asset classes

As already indicated above, in the world of DB pensions, illiquid asset classes, with contractually-based cashflows are forming a larger and larger component of asset portfolios as advisors and trustees have gradually come to the view that their long-term liabilities means that they can benefit from the illiquidity premia[8] that other investors, or savings vehicles cannot. For most members of DC schemes, their pension savings represent their main long-term saving commitment. It would be reasonable to conclude that illiquid asset classes could also play a role in securing the retirement incomes of DC scheme members. However, it would be fair to say that the industry has been struggling with the issue of whether DC members could and should have exposure to the returns generated by illiquid asset classes.

Figure 8 summarises interviewees' thoughts on the inclusion of illiquid asset classes in DC portfolios. Only 10% of the interviewees felt that illiquid asset classes were not appropriate for DC investment portfolios; 40% thought that access to illiquidity premia was best achieved via DGFs; while 10% were actively considering incorporating illiquid asset classes into their investment strategies. However, during discussions three particular barriers to investing in illiquid asset classes were identified.

First, some interviewees highlighted the investment platforms and their daily pricing requirement as an obstacle to this ambition; 40% of interviewees saw DC investment platforms as making difficult to incorporate illiquid asset classes into investment strategies. Second, some of the illiquid asset class opportunities that emerge as investment opportunities, are not available in bite-sized bits. Investment in these opportunities often requires scale, preventing many DC schemes from being able to consider them. A small number of the very large schemes interviewed for this study have included explicit allocations to illiquid asset classes in their default fund(s), mainly property. But one of the schemes had an allocation to direct property and infrastructure. These allocations were relatively low – 10% or less – as proportion of the total assets included in any default fund.

The difficulties of gaining exposure to illiquid asset classes highlighted above explain why DGFs were seen by interviewees as the most convenient, and efficient way of gaining that exposure. However, DGFs typically incorporate illiquid asset classes in their listed form, which may be a less than ideal substitute for the direct holdings that DB schemes are able to achieve. 10% of interviewees thought that investing in illiquid asset classes in listed forms was not an appropriate way of accessing the illiquidity premium

The asset management industry has developed pooled vehicles, as well as segregated versions of the same vehicles for bigger clients of illiquid, unlisted asset classes for their DB client base. These funds, understandably, are subject to withdrawal restrictions and also ‘ramp up’ periods. These features clearly pose issues for potential DC investors, but as one interviewee put it: “It shouldn’t be that hard to find a way to incorporate illiquid asset classes into the investment mix.”[9]

There is also a longer term issue that the investment industry may have to face. At some point DB investors will disinvest from these asset classes as they gradually mature. Since DC will at some point be the dominant form of pension saving, unless the pensions industry in collaboration with regulators and the government, finds a way to integrate illiquid asset classes into DC savings perhaps in the form of a “risky annuity” (see above), paradoxically, a large pool of long term savings will be unavailable to corporations seeking long term finance.

3.3 Deferred annuities

There was general agreement among interviewees that the addition of some illiquid asset classes – particularly property (in its many forms) and infrastructure – might be beneficial to scheme members. There seemed to be little interest or “demand” for the inclusion of other less traditional asset classes, such as commodities and foreign exchange. However, there was one asset that was discussed and which could also prove to be useful in member portfolios – deferred annuities.

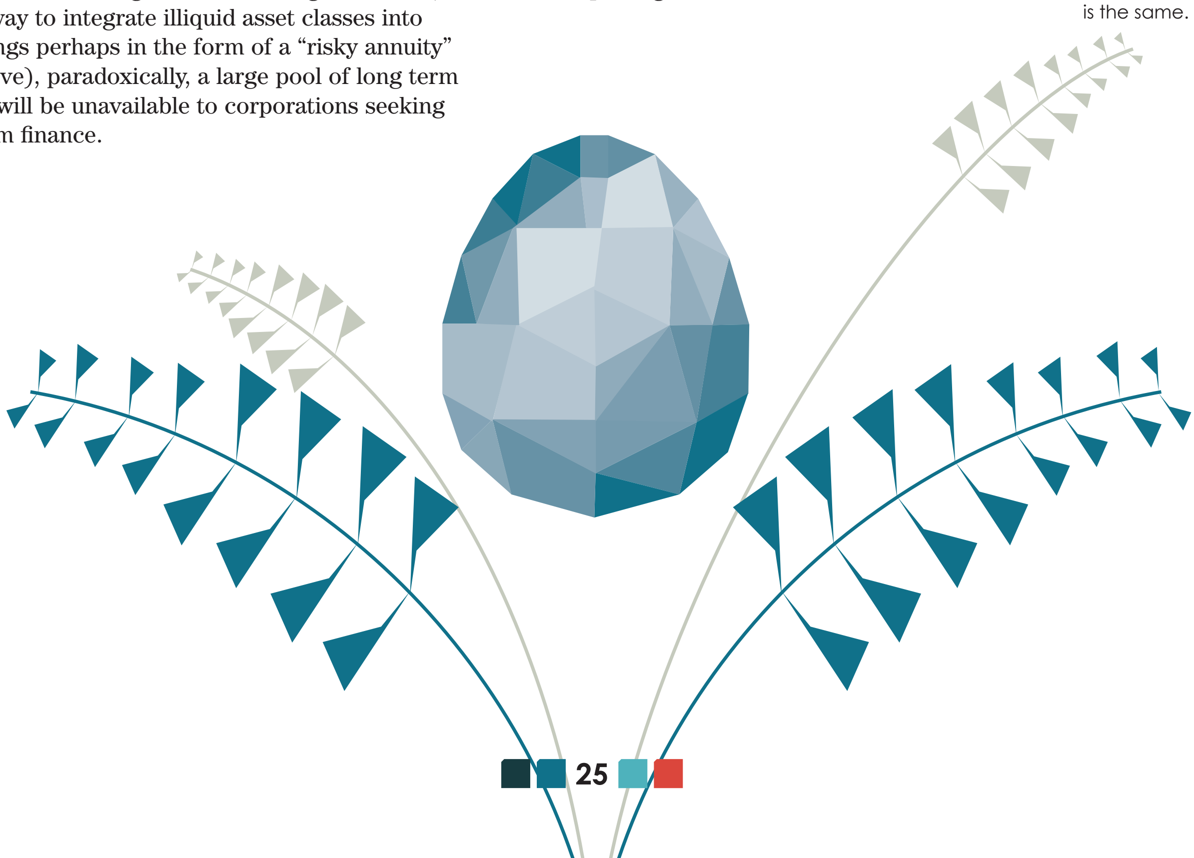
Although traditional annuities are no longer very popular, research by economists has shown that people are more willing to invest in deferred annuities. Sexauer et al[10] show the potential benefits of incorporating these assets/contracts during the early accumulation stage to start at say 75 or 80. They demonstrate that around 20% of the total investment portfolio would need to be dedicated to deferred annuities for a typical pension saver. Their inclusion in the asset mix could help reduce the burden of investment decision making when our ability to make these decisions may be declining. One could argue that investing in index-linked gilts could achieve a similar result, but the income that could be secured from these investments would still be uncertain. The main obstacle to integrating deferred annuities into a default fund solution today is availability. Although these annuities are available in the USA, at present UK insurance companies (to our knowledge) do not offer them.[11] Again, our interviewees felt that this was an investment avenue worth exploring further.

Notes

[9] During the course of the research for this paper, a number of interviewees did mention what they believed to be a fairly innovative fund offering from Partners Group. This fund is comprised of a range of illiquid asset classes – 30% in listed vehicles and 70% in unlisted vehicles. The fund is daily priced.

[10] Sexauer, S., M.W. Peskin, and D. Cassidy. 2012. “Making Retirement Income Last a Lifetime.” *Financial Analysts Journal*, vol. 68, no. 1 (January/February): 74–84.

[11] Although an individual in the UK can choose to defer an annuity on retirement in return for a higher income starting at some point in the future, this is not the same as being able to purchase an annuity in the early accumulation stage deferred until, say, 75 but the principle is the same.



4. Self-Select

While the majority of DC scheme members choose one of the default options, where there may be as many as three of these available to members, based on their intentions at NRA, a small proportion of members chose the "Self-Select" option within their schemes. Here members select from a set funds from a range made available to them by the scheme. Given that the offering does not need to achieve a particular aim, there is the potential to include a wider range of investment options to members. In theory this is possible, but the small number (proportionately) of members interested in using this option often means that this possibility is not exploited by schemes.

4.1 Typical investment offerings in Self-Select

The typical range of funds made available in the Self-Select options discussed with interviewees comprised those funds that represented the building blocks of the default fund offerings, plus a further range of 10 to 20 funds so that a typical offering would cover the following asset classes/ strategies:

i. Active global equity
ii. Passive global equity
iii. DGF
iv. Investment grade corporate bonds
v. Gilts
vi. Fixed income (a combination of iv and v)
vii. Index-linked gilts
viii. Property
ix. ESG
x. Shariah
xi. Cash

With regard to the equity components (i and ii) the range here can be influenced by the geographical location of members. The "Passive" fund options were usually based on market-cap weighted indices rather than on smart beta approaches. The DGF funds were those that typically comprised the default solutions. The fixed income components of the offerings varied in their combinations, but were usually comprised of UK government bonds and sterling investment grade bonds. The only illiquid asset class that was included, and in only some of the schemes discussed with interviewees, was property.

Nearly every scheme discussed included both a Sharia compliant fund and an ESG fund. However, in all cases where these were included, interviewees reported that the amount of member money invested in them was small. It appeared that schemes in the past have felt compelled to include these fund options, but that they have not proved to be very popular with members.

In the course of the interviews it became clear that the majority of funds offered in Self-Select options were relatively conventional. Interviewees felt that their Self-Select ranges were sufficiently diverse to satisfy the needs of the small proportion of their memberships that did not wish to use the scheme's default options. However, all schemes remained open to adding less conventional funds if there was sufficient demand and interest from members.

4.2 Cash funds in Self-Select

Cash, the final asset class on the list would seem like a fairly straightforward fund offering. Cash funds in the Self-Select ranges are typically used by members that intend to take a tax free cash lump sum from the retirement pot. However, in the course of discussions with interviewees the issue of fund fees and likely returns arose. With UK interest rates still at near zero, the fees on typical cash funds mean that realised monthly returns are often negative, and have been for some time. That a cash fund, in the absence of regular contributions, should shrink in value is presumably not what members expected from this investment.

The very low rates of return on traditional cash funds is an issue for other investors. In the DB pension world asset managers have launched "cash plus" funds aimed primarily at those schemes that have built up significant cash exposures from their swap portfolios. A number of interviewees felt that there could be some interest amongst members for such funds. However, interviewees also expressed a concern that any such addition should not use the word "cash" in the name, for example "Cash Plus".

5. Fees and costs

5.1 The Charge Cap

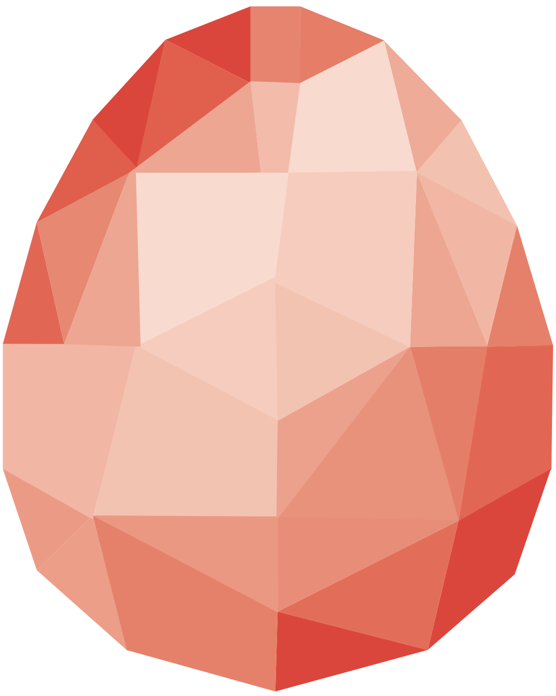
The focus of the interviews for this report was investment strategy. However, during the course of most interviews the issue of fees and costs arose, particularly the subject of the charge cap.[12] The charge cap applies only to occupational pension schemes and is 0.75% of funds under management (essentially a weighted average of individual fund fees) and any administration costs paid by members with any default arrangement. This cap, which came into effect in April 2015, therefore represents a potentially important consideration in the design of any default investment strategy.

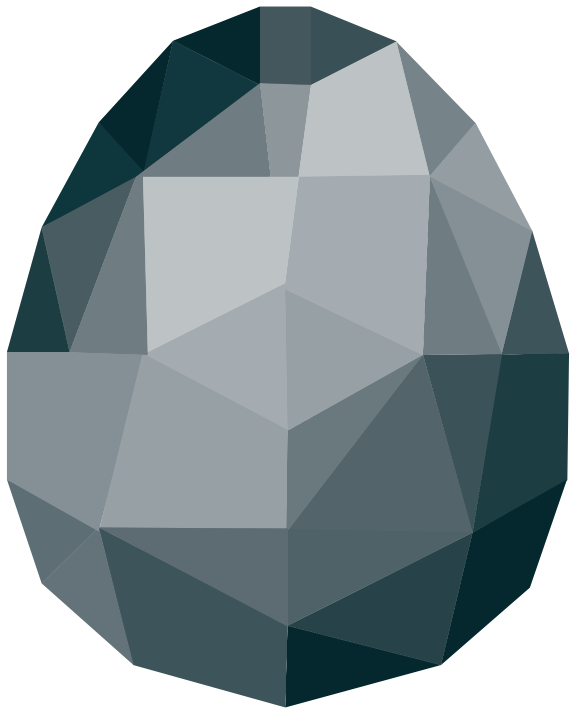
However, perhaps surprisingly, the schemes represented by the interviewees did not find the charge cap to be a significant factor in the design of their default investment strategies. There were two main reasons for this view. First, the use of passive equity funds in the default fund(s) helped to keep the overall cost of the default strategy down. Some interviewees revealed that the cost of passive funds could be as little as 0.10% – well below the charge cap. The use of passive funds therefore went a long way towards keeping overall fund management costs down. Because of this, schemes could then make more use of other funds with higher management fees, in particular DGFs which often incorporate exposure to more expensive to manage illiquid asset class, albeit usually in listed vehicles (see above). To some extent then, the use of passive equity funds as part of the default option allows schemes to offer their members the benefit derived from exposure to a more diversified mix of asset classes, along with the associated active management, that the charge cap might otherwise have limited.

The second reason for the limited impact of the charge cap seems to have been innovation in the fund management industry itself. We have already seen that there appears to have been a tendency to integrate DGFs into all stages of the pension investment process. Interviewees reported that over recent years managers had made an increasing number of DGFs available spanning different investment strategies – some incorporating very active asset allocation, with others offering a more static approach to asset allocation – a range that also meant that there are now DGFs to suit all pockets, with the more active DGFs and those with more illiquid exposures, understandably having the higher fund management charges. The range also allows schemes to mix styles so that they can get the exposure they want, and diversify across managers. In the default options discussed in Section 3, the DGF component of the options often comprised as many as three different DGFs.

Notes

[12] www.gov.uk/government/uploads/system/uploads/attachment_data/file/557888/charge-cap-guidance.pdf





The combination of passive equity funds, with relatively low fund management charges and DGFs with higher fund management fees but which offer greater diversification, together tended not to violate the charge cap. Indeed, some interviews revealed that they had set themselves an internal charge cap of 0.50%.

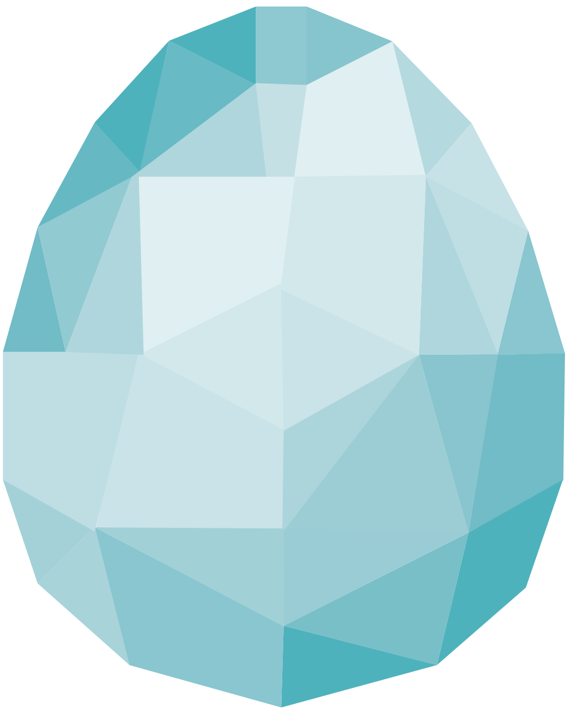
However, the charge cap currently excludes certain costs from the calculation, in particular transaction costs. It has been argued by some that such costs should be included as part of the charge cap and while most interviewees were aware of this trend, none expressed any real opinion on the desirability of the trend one way or another.

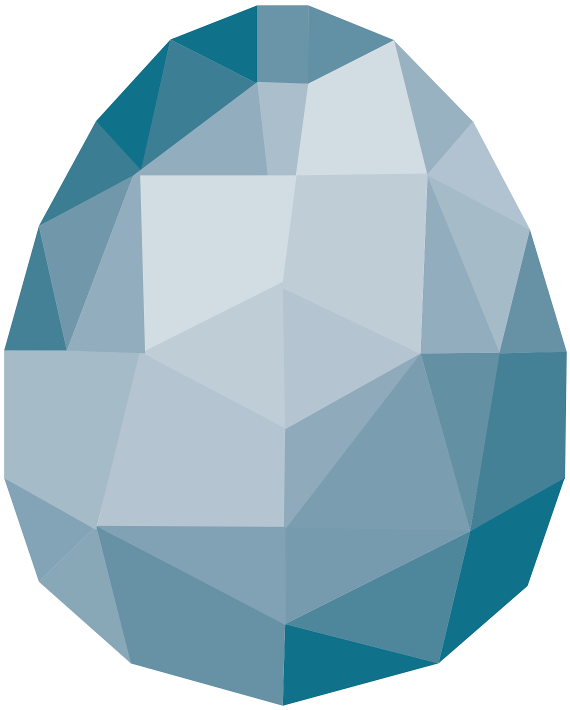
Some of the interviewees mentioned the possible fee benefits for members of remaining invested with the scheme in the drawdown phase. By allowing members to remain invested in the fund, drawing from it over time, members could benefit from the economies of scale that typically allow trustees to negotiate lower fund management fees, lower than a member might incur in other pension arrangements such as a SIPP. The dilemma for schemes will become more pressing as more and more members enter the drawdown phase. Do schemes offer members the option to stay with them into retirement or allow them to follow their own path with potentially more expensive investment options that do not benefit from the scale that comes from institutional investing?

With regard to fee negotiations with asset managers it was clear from the interviewees that two factors in particular could play a part in these negotiations. First, the scale of the DC scheme and second the existence, or otherwise, of a sizeable DB scheme. That is, a fund manager could take advantage of various economies of scale when negotiating with a client with either a great deal of DC assets, or where the manager already had a relationship with the client's DB schemes, allowing the manager to offer more competitively priced fund offerings.

5.2 Platforms

Finally, during discussions about fees and costs and the extent to which these influenced investment strategy some interviewees expressed the view that platform fees are often too high, and that the platforms do not distinguish well, in fee terms, between an "expensive" and "inexpensive" asset class, with fees for cash funds being a particular concern for interviewees (see above). Some interviewees also expressed the view that some platforms were often a barrier to innovation in investment strategy and that switching platforms could be a costly exercise.





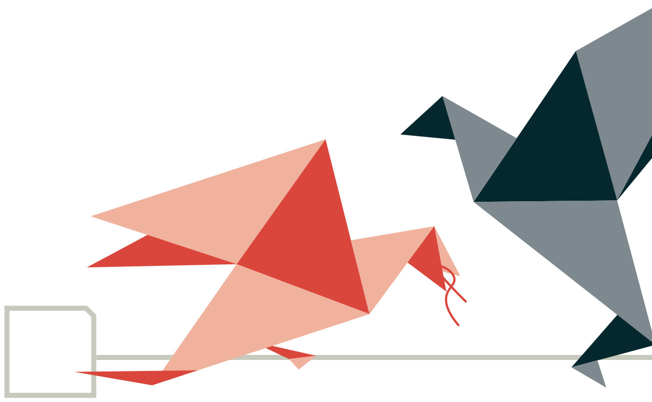
6. Member engagement

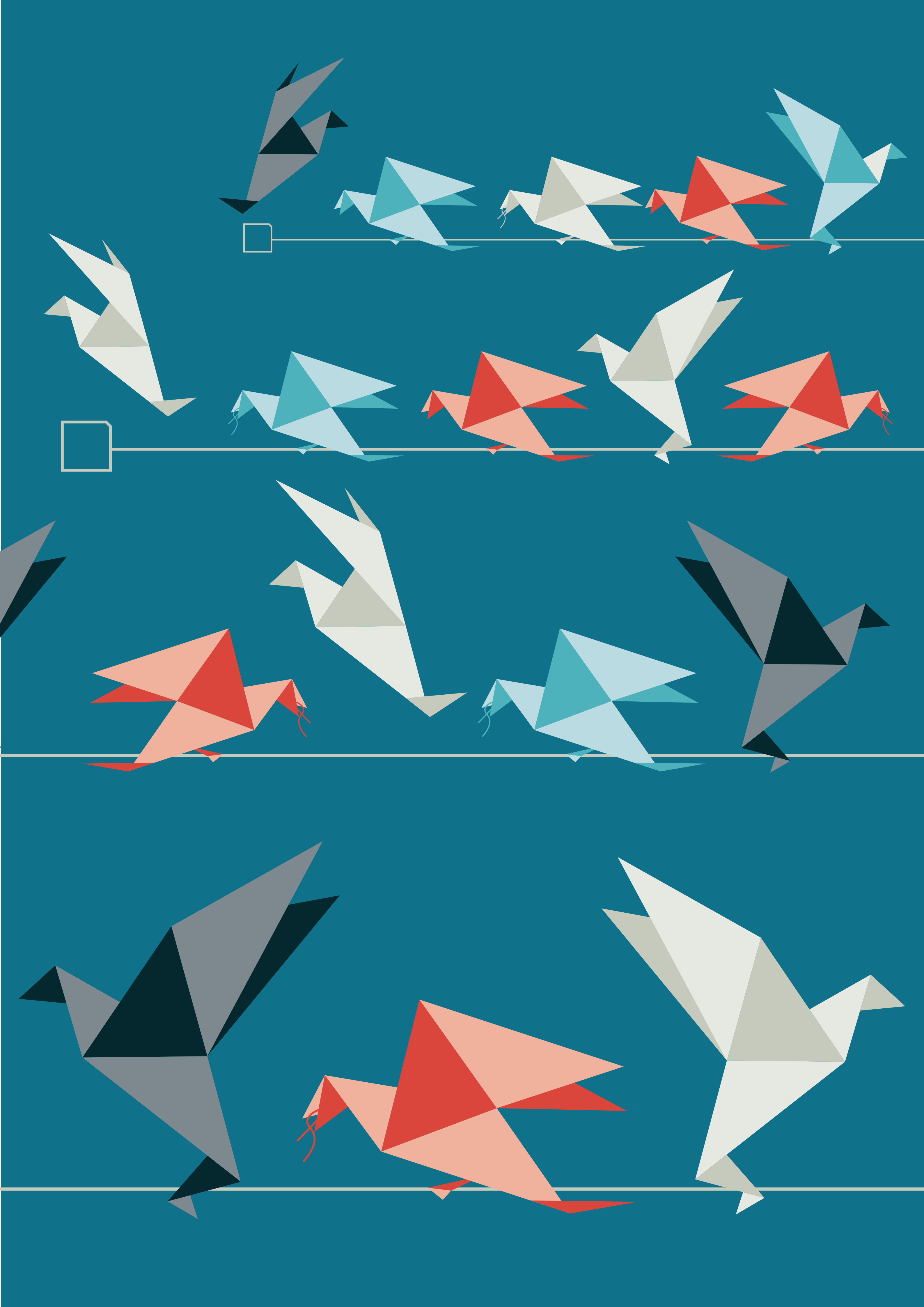
One of the biggest challenges facing all pension fund trustees is member engagement. This challenge has been particularly significant following the Freedom and Choice reforms. The greater options now available means that many more avenues are open to members. Trying to identify what they want under the new freedoms is now a significant issue for schemes. In recent times, advances in technology have offered trustee boards and their administrators new ways to engage their membership in the pension savings challenge. During the interviews, we explored the idea that investment strategy might be affected by member engagement (or the lack of it) and whether new technology might play a role in improving member engagement, possibly leading to a different approach to investment strategy.

A number of interviewees felt that Big Data could be the answer to improving member engagement, in turn leading to more appropriate, more personalised “default” funds.

With regard to the interaction with members and investment innovation, interviewees were broadly split on their views. Some interviewees felt that member engagement would not be a barrier to the inclusion of new investment asset classes into the default mix. These interviewees felt that their membership were too disengaged to be concerned about the asset mix. However, some interviewees felt that including esoteric asset classes might prove problematic with regard to member communications, and that their board would feel uncomfortable including any asset classes or strategy that could not be explained easily to members. Investment in such asset classes would cause particular concern in the event that “things went wrong”.

Overall it is hard to avoid the conclusion that the general absence of effective engagement with members – despite the best efforts of trustee board and their advisors – is a barrier to innovation in investment strategy. Technology and Big Data may improve this situation in the future, but this greater engagement with members using new methods is an aspiration rather than a reality at present.





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