Defined Contribution default funds and investment governance

Introduction

Defined Contribution (DC) pension schemes are rapidly growing in importance for the UK population. As a result of the introduction of automatic enrolment, the number of people in the UK saving in a DC pension is projected to increase from just over 4 million in 2012 to almost 14 million by the 2020s.[1]

Since automatic enrolment (AE) — mainly into DC pension schemes — was first introduced in 2012 there has been an increasing focus on the investment governance of DC pension schemes, and in particular of the default funds that the majority of DC savers will be invested in. This Briefing Note looks at some of the issues surrounding the investment governance of DC pension schemes and, in particular considers how new tools — such as DC strategy benchmarks — might be used to improve standards of governance.

The content covered in this Briefing Note was discussed at a Round Table event, hosted by FTSE and Elston Consulting, on 9 January 2015.

Freedom and Choice also has implications for default funds

Other major pensions policy changes are also relevant to the default funds of DC pension schemes. The Budget 2014 changes to the rules surrounding how people can use DC pensions increases the choices for individuals retiring after April 2015. Under the new flexibilities, it is expected that a much smaller proportion of DC savers will use their savings to purchase an annuity.[2] As a result, 66% of DC professionals (including trustees) reported themselves as likely to change their default strategy within the next 18 months, while 52% were planning to implement new retirement solutions following the removal of compulsory annuitisation.[3]

Chart 1: Life style strategies versus target date funds

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Sources sometimes refer interchangeably to lifestyle strategy and target date funds. However, there are the following similarities and differences between these funds:

Similarities

- Both place funds in higher-risk assets when individuals are younger and move these into less risky assets as they approach retirement.
- Both types are managed with a retirement date or retirement window in mind.
- Both types have assumed, at least until recently, that individuals will withdraw a 25% tax-free lump sum and purchase a level annuity.

Differences

- Target date funds are overseen by professional fund managers who can make changes to both the strategic, and for some managers, also the tactical asset allocation in the event of changes to the markets or regulatory framework. In contrast, lifestyle strategy funds are generally pre-programmed to place funds in lower-risk assets as individuals approach retirement, which is a constraint on flexibility.
- Target date funds operate to a broad retirement window (e.g. a 2026-30 fund) in contrast to lifestyle strategies that target an individual's plan anniversary.
- Target date funds can continue to pro-actively manage members' assets beyond their retirement date in contrast to lifestyle strategies that tend to 'set and forget' the assumed conversion to an annuity at expected retirement date.

Role of DC Defaults

The importance of DC default funds should not be underestimated. By 2030 there could be around £480bn (in todays earnings terms) invested in DC schemes, with up to 14 million active members[4]. In the mid-2020s around 90% of members could be invested in the default fund. Of these default funds, just over 60% of the assets are likely to be held in lifestyle strategies compared to just over 20% held in target date funds[5]. Although the terms lifestyle and target date funds are often used interchangeably as strategies that involve the de-risking of the investment fund approaching a specific time period, they are different approaches (Chart 1).

The importance of the default is unsurprising, considering the low levels of member engagement in investment issues. There is a lack of interest in pensions and a lack of certainty around retirement plans. Participants' responses to research suggest a lack of interest in their pension arrangements, despite the fact that they recognize that pensions are important. In particular, awareness of default funds and how these work is very low.[6]

There are two main sources of guidance relating to investment strategy and fund performance for trust based schemes. Firstly, the Department for Work and Pensions (DWP) Guidance for auto-enrolment default funds (Chart 2)[7] states that "the review of the default option should look at:

- Ongoing suitability of the default option, including the governance arrangements and objectives;
- Ongoing suitability of the charge level;
- The investment strategy of the option;
- The performance of individual fund components; and
- Whether the performance of individual components is consistent with the overall objective of the default option."

Secondly, The Pensions Regulator (TPR)[8] puts "good member outcomes" and "value for money" at the heart of scheme quality. With these in mind, TPR has clearly articulated what investment governance should look like. Steps include, amongst other things, clear guidelines for the selection and removal of investment managers, benchmarks for investment options, due consideration of risk and return, net of fees, in the design of the default strategy, assessments of the performance of each investment option and the ability to remove under-performing investment options if appropriate. All of which should be reviewed regularly and at least every three years.

Lastly, DWP has announced intention to legislate a responsibility on trustees to ensure that the strategy remains appropriate for the members of the scheme, and that the net performance of the underlying investment funds meets the aims of the strategy[9].

The Financial Conduct Authority (FCA) has worked with the DWP and TPR to design measures that will help ensure contract based workplace pension schemes are high quality and offer value for money[10]. These measures include new governance standards, a charge cap on default funds, the banning of certain charging practices, and measures to improve the disclosure of costs and charges.

Trustees have a clear fiduciary responsibility to deliver good governance for trust-based schemes. For contract-based schemes, IGCs have been proposed by the Office of Fair Trading (OFT) study into workplace pensions and are intended to have similar responsibilities.

Although the responsibility for good governance is clear, how to deliver that governance is not yet established.

There are a number of areas of the guidance that may prove difficult

Chart 2: Investment Governance in DC default funds

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DWP guidance for AE default funds (May 2011)

"The review of the default option should look at the:

- Ongoing suitability of the default option, including the governance arrangements and objectives;
- Ongoing suitability of the charge level;
- The investment strategy of the option;
- The performance of individual fund components;
- Whether the performance of individual components is consistent with the overall objective of the default option."

TPR Guidance for reviewing investment strategy and fund performance

When reviewing and monitoring a fund's performance, you should:

- Assess performance against objectives;
- Compare returns to industry benchmarks;
- Check that fees are competitive

for trustees and Independent Governance Committees (IGCs) to implement. For example, the interpretation of "good value" or "value for money" across both trust and contract based arrangements is a challenge as there is no clear definition of what these terms mean.

Similarly, there is concern around trustees' capacity to challenge investment performance, particularly for smaller pension schemes and employers. Providers are rarely changed as a result of poor investment performance, more likely as a result of poor service or administration standards.

DC investment performance has not been a strength of all trustee boards. TPR research shows that only 30% of trustees have reviewed their statement of investment principles in the last three years (Chart 3).

While forward looking scenario modelling is commonplace, and subject to its own modelling constraints, there has been no way of evaluating historic performance of different default strategies as experienced by different cohorts of savers. To date performance evaluation has tended to focus on the performance of funds inside a default strategy rather than the strategy or "glide-path" as a whole.

Despite — or perhaps because of — low levels of consumer engagement, DC investment strategies and objectives are becoming more sophisticated. There is a trend for DC funds in the UK to shift away from the more simple and mechanistic approaches with a mix of equities, bonds and cash. There is also a stronger focus on alternative asset classes to diversify and more explicit risk / volatility management such as Diversified Growth Funds. Funds are increasingly focused on outcomes (in terms of target retirement incomes) rather than on a capital pot, which is more closely aligned with the ultimate aim of a desirable outcome for members.

Although processes and responsibilities for good governance are clear, if not always adhered to, and investment strategies are developing over time, there may be scope for further analytical tools to be developed to help inform and improve investment governance. One such measure would be a tool to enable those governing the funds to compare the performance of their own strategy – rather than the individual components within the funds – with scheme and industry benchmarks.

Approaches vary overseas
In different overseas DC markets, alternative approaches are taken.

In the US, many schemes use target date funds, which were originally difficult to evaluate, but in recent years a number of target date fund specific benchmarks and comparison tools have emerged: for example a funds peer group, and specific target date benchmarks developed by S&P, MorningStar and Dow Jones. In the US , benchmark design often relies upon peer group averages of manager glide-paths or other subjective glide-path design techniques. More traditional approaches, such as benchmarking performance of component funds and assessing fees did not focus sufficiently on retirement outcomes and the objective of the fund which might not be solely return focused (for example, an important objective might be volatility management over time).

By relying on comparison with peers, however, there is a concern that "herd-like" behaviour may be rewarded; if you follow the same strategy as your peers you will all achieve the benchmark.

Australia has another approach. The Australian Prudential Regulation Authority (APRA) annually publishes "whole of fund rates of return" from the 200 largest pension funds. This focuses on the relative performance of generating long term returns.

Chart 3: DC investment performance has not been a strength of all trustee board

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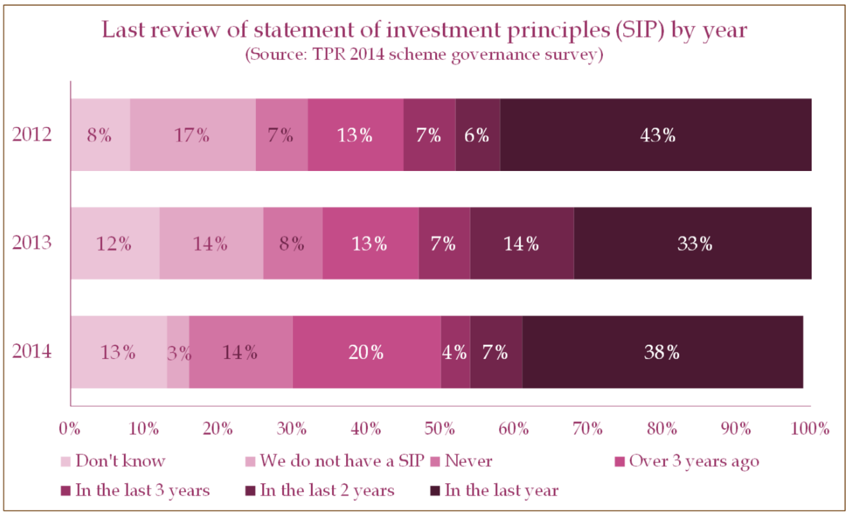

The resulting outputs, however, can be difficult to scrutinize, in particular for specific cohorts (for example those approaching pension age) as Australian funds are much less likely to be target date.

Recent developments in the UK
A different approach is behind recent developments in the UK market. In October 2014, FTSE launched a new UK DC Benchmark series that can be used to compare against default funds. The benchmarks are designed to enable "baseline" reference comparisons, aiming to meet the need for a series of independent benchmarks for evaluating investment strategies.

The index series represents the performance of major asset classes and the glide-path as a whole for discrete time horizons, based on different cohorts of savers' with an expected target (retirement) date. The focus is on the whole glide-path rather than underlying funds that make up the glide-path—this is designed to capture the impact of asset allocation as a key driver of long-term investment returns within the strategy, alongside performance of the component funds.

Benchmarks could improve investment governance….
The benchmarks are designed to provide a consistently calculated reference benchmark for DC default strategies, developed by providers, asset managers or consultants. This enables trustees and independent governance committees to create an independent evaluation framework to assess investment strategy and implementation.

A number of different benchmarks have been developed, with varying levels of equity investment (100%, 80%, 60%), covering target dates in 5 year cohorts from 2015 to 2060, and based on a 20 year de-risking profile.

Those responsible for the investment governance of DC pension funds would need to identify a relevant benchmark based on which of the benchmarks most closely resembles their own strategy. Where there is no comparable benchmark, it is possible to customise a benchmark to match a scheme's glidepath.

Benchmarks could be helpful for employers selecting AE schemes allowing them to make reasonable "like for like" comparisons. It should also be relatively easy to communicate for trustees/ IGCs, as they are independently constructed and calculated by FTSE.

..if they are used appropriately
There are, however, some potential down-sides to the use of benchmarks. For some strategies they may be relatively simplistic, and so not a suitable direct comparison.

Benchmarks should also be considered in the context of the wider objectives and investment principles of the DC strategy. Trustees and IGCs may include broader factors or different approaches to investment principles than those underlying the benchmarks. Where strategies are more diversified, sophisticated or targeting different objectives, benchmarks can only provide one part of a broader evaluation process, and would need to be customised and interpreted accordingly.

A further danger might be, as in the US a tendency for schemes migrating towards replicating the benchmark, as opposed to maintaining their own investment strategy. This could potentially be seen as neglect of fiduciary responsibility—especially as the benchmarks are not designed to be an appropriate strategy for any specific scheme, rather a fixed point of comparison against all other strategies.

It may also be possible for some to game the system by choosing the least challenging benchmarks. Perhaps more importantly, there is the possibility that there could be an inconsistency between the benchmark and other investment governance tools used, such as Statutory Money Purchase Illustrations. The consequent misalignment may be confusing.

Future Challenges
With the increased options and flexibility offered in the Budget 2014 some DC funds may start to offer "through" as well as "to" default strategies, adding a further layer of complexity. This may also lead to some debate of what a "target date" is, if investment is likely to continue for some well beyond the traditional "retirement" date.

There could also be an extension of the debate on charges into investment performance, and it is possible that there could be greater political appetite for ranking of fund performance in post-AE landscape (for example as happens in Australia).

Conclusions
There is widespread support for the development of tools to improve transparency and allow better monitoring of performance. A strategy level benchmark as opposed to a fund component benchmark could provide greater understanding of the glide-path and real member experience.

The use of benchmarks is one way to help improve the governance of DC pension funds, and especially default funds, an area where there is increasing focus. It is important, however, that the benchmarks are seen as a supplement to good investment principles and objectives rather than a replacement. It is important for schemes not to simply herd to, or "hug" the benchmark, which could potentially be seen as a neglect of fiduciary duty. For some schemes benchmarks will be less relevant than others.

Careful monitoring of the use of benchmarks is required to prevent possible misuse, (such as an over focus on short term performance, or pressure on schemes which minimize volatility to change their investment strategies at times of apparent underperformance), or misinterpretation.

1. PPI (2014) *Automatic Enrolment: How will automatic enrolment affect pension saving?*
2. PPI (2014) *Briefing Note 66 – Freedom and Choice in Pensions: comparing international retirement systems and the role of annuitisation;* May 2014
3. www.seic.com/enUK/about/14530.htm
4. PPI (2014) *Automatic Enrolment: How will automatic enrolment affect pension saving?*
5. Spence Johnson (2014) *Market Intelligence 2014 UK Defined Contribution: The year of the master trust*
6. PPI (2015) *Supporting DC members with defaults and choices up to, into, and through retirement*
7. DWP (2011) *Guidance for offering a default option for defined contribution automatic enrolment pension schemes*
8. www.thepensionsregulator.gov.uk
9. DWP (2014) Putting Savers' Interests First, October 2014
10. www.fca.org.uk

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