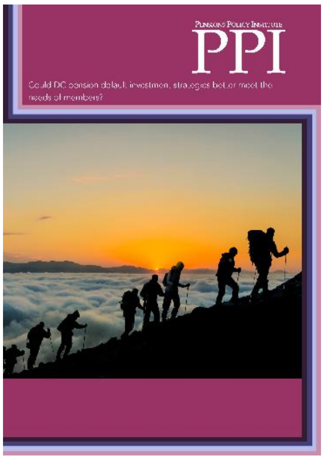
Pensions Policy Institute
PPI

Could DC pension default investment strategies meet the needs of members? Launch summary



The Pensions Policy Institute (PPI) held a policy seminar on 2nd February to launch its report *Could DC pension default investment strategies better meet the needs of members?* This report, sponsored by The Association of Investment Companies (AIC), explores the extent to which the default investment strategies of Defined Contribution (DC) pension scheme assets could be redesigned to better meet the needs of certain groups of scheme members who do not fall into the typical member profile, and possible responses.

The event was run as an online seminar, with around 50 attendees representing a broad range of interests within Government, the investment industry and the pensions industry.

Mel Duffield (Pensions Strategy Executive, Universities Superannuation Scheme, and PPI Governor) chaired the event. **Richard Stone** (Chief Executive Officer, AIC) provided a welcome from the report's sponsor.

Bob Collie (Research Associate, PPI) presented an overview of the report's key findings. Default strategies are at the centre of DC investment today, but this has not always been the case. In the past, individual members had greater responsibility for making decisions about investment but this became less appropriate as DC coverage expanded through automatic enrolment with many automatically enrolled individuals poorly equipped for making these complex financial decisions. Automatic enrolment has shifted the responsibility of decision-making away from individual savers, with investment decisions made on their behalf by the scheme in most cases. However, this raises questions about whether there is a trade-off involved with this shift towards widespread use of default investment strategies. When considering the benefits of diversification into alternative assets, there are also questions about whether one size fits all, how much variation can be seen between members in terms of attitudes towards risk and return, and whether insights on characteristics of different attitudes could help to customise investment strategy based on more than just age and distance from retirement.

What are the characteristics of those who could benefit from changes in investment strategies?

- Those who might benefit from enhanced return focus: People who work for longer (past State Pension age (SPa)) and high earners; those who accumulate marginal amounts of savings; those with patchy work and contribution patterns; those with DB savings in addition to DC savings.
- Those who might benefit from a focus on reduced volatility: People who stop contributing at younger ages (before SPa); people who use UFPLS or purchase an annuity; those without supplementary savings.

What are the potential options for meeting a wider range of member needs?

1. Increasing asset allocation to alternatives could enhance returns while also increasing diversification, potentially benefitting all members.
2. Using existing data on members, such as pot size, in order to provide prompts about using non-default (self-select) investment strategies.
3. Gathering more data on members in order a) to make DC default investment strategies more tailored or b) to provide prompts about non-default (self-select) investment strategies.

Conclusions:

Most DC savers are in default funds, designed around the needs of the typical member. There are benefits to a one size fits all strategy, but people with certain characteristics may benefit from increased returns through diversification or reduced volatility. Increased diversification and better member data could help to better tailor investment strategies. However, there are cost and practical challenges to be aware of.

Guy Rainbird (Public Affairs Director, AIC) presented the sponsor's response to the research. Greater allocation to alternative assets can increase pot sizes and lower volatility, but trustees are still cautious. Market infrastructure and current practice reinforces the investment status quo, while policy has driven focus on cost – although there is now an increasing focus on value for money. Schemes with different needs require different approaches. Investment companies with mature portfolios and tested strategies can help schemes to build and adjust exposure to alternatives over time. In order to capture the illiquidity premium associated with some alternative assets, the investment must involve a sufficiently long investment horizon, which these investment companies are well-placed to provide. Trustees must also consider operational factors such as how to disinvest. Many investment companies in this area can offer no lock-ins, daily trading etc., which allows dynamic management of exposure. Trustees are rightly focused on the needs of members, so investment in alternatives through experienced investment companies may be the best way forward, particularly for smaller schemes or those testing the waters.

Panel discussion

Mel Duffield chaired the panel discussion and Q&A session, introducing panellists who had not yet spoken to give some opening remarks in response to the report:

- **Fiona Tait** (Technical Director, Intelligent Pensions & PPI Governor): Automatic enrolment has increased pension coverage but engagement is extremely low. It would be interesting to see if increased allocation to alternatives could increase engagement with investment. Most savers are not well-equipped to make investment decisions alone but schemes could offer defined options to tailor investment to individual characteristics and preferences. ESG could be an important part of this engagement.
- **Des Healy** (Policy Manager, DWP): This is a really timely report from a DWP perspective, as focus increasingly shifts from cost to value for money. The report raises a number of challenges to be considered. Automatic enrolment has been a success in increasing coverage but we now need to ensure that it delivers positive outcomes and better meets the needs of members. Strategy should be regularly reviewed to ensure that it reflects the needs of members and focus on member outcomes is essential. However, there are questions around how to increase member engagement and the right

touchpoints for engagement, as well as the challenge of ensuring that members fully understand risks associated with investment.

Bob Collie and Guy Rainbird also joined the panel.

Q&A session

The following points were raised during the Q&A discussion. The remainder of the seminar was held under the Chatham House Rule and the views expressed do not necessarily reflect the views of the PPI or panellists.

- **Complexity of communication:** Automatic customisation of investment strategy, in terms of risk and return, based on member characteristics, could increase the challenges associated with member communications. If one member receives a communication from the scheme that they are aiming to deliver a 3% return, for example, while another is aiming for 4% return, members may not understand why this is the case, leading to an increase in complaints and potentially legal action further down the line. However, it was noted that the members most likely to be aware of and complain about this disparity are already much more likely to be engaged with pensions and investments. Auto-customisation will be most beneficial for those who are not currently engaged at all. This challenge emphasises the importance of keeping a record of the process and why different strategies have been applied to ensure the scheme is protected in future. However, there are still likely to be concerns among trustees about the potential for future legal action, even if differential strategies were applied in members' best interests.
- **Shifting focus from cost to value for money:** It is easy to focus on cost as it's the one thing that is fixed and can be predicted going forward. It will be easier to demonstrate value for money on a return dimension than on a volatility/risk dimension. As long as increased return outweighs increased cost, there is a clear argument. In terms of the argument for diversification/risk reduction, illustration is more challenging. It was also suggested that it is easier to justify higher costs at the higher end of the spectrum of pot sizes, but at the lower end of the market it might be slower to move away from focus on cost.
- **The risk of exacerbating existing inequalities in the pension system:** There was a question around whether customisation based on member characteristics, such as gender and risk aversion, could exacerbate existing differences. Using gender as a single measure could lead to problems but depends whether the scheme is determining automatic customisations based on data or if members are self-selecting customisation. While both could lead to the same outcomes, there would be a different liability associated for the scheme.
- **The role of technology:** The report suggests that without further data gathering it might be harder to meet the needs of a wider range of members. Challenges around data gathering can be a constraint on customisation but the possibilities are expanding with technology. Even without getting direct input from members, schemes can gather a certain level of data and use that to inform investment strategy. In terms of governance costs associated with this sort of analysis and customisation, advances in technology will help to make this much more workable for smaller schemes, although consolidation will also help in this area.

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