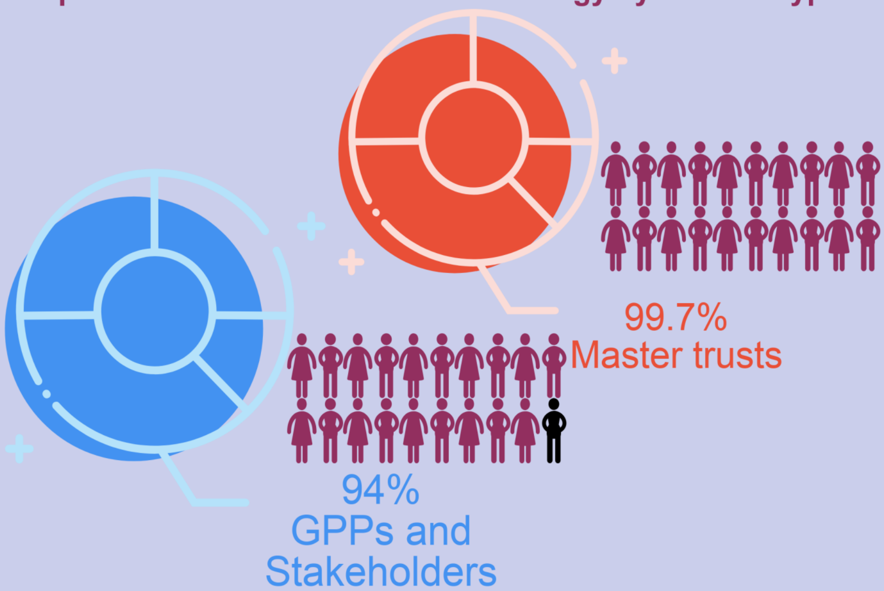
Do default investment strategies align with members' needs?

This is the first of two Briefing Notes looking at default strategies. This Note looks at how well the objectives of pension schemes' default investment strategies meet the needs of their memberships.

Objectives influence how assets are managed and invested and whether default investment strategies are evaluated as delivering value for money. Therefore, a well-structured and transparent approach to the process of setting the default strategy objectives will be a key driver in how Defined Contribution (DC) plans deliver value for members over the long term.

Figure 1: The majority of workplace pension scheme members are in the default strategy

Proportion of members in default strategy by scheme type



Introduction

A pension schemes' default investment strategy is the way in which members automatically have their contributions invested, unless they make an active investment choice from one or more of the other funds offered by the scheme.

The vast majority of pension members generally, either as a result of low engagement or through an active choice, invest in the default strategy (Figure 1). With the advent of automatic enrolment, 9.8 million people have been enrolled into a workplace pension scheme (April 2018).[1] Those automatically enrolled generally have lower incomes, lower engagement with personal finances and less access to individual financial advice than those saving prior to automatic enrolment. Those automatically enrolled are also more likely than those saving prior to automatic enrolment to remain in the default strategy.

Default strategies are often a good option for many members as they generally:

- Cost less,
- Reduce the need for stakeholders to tackle inertia,
- Avoid triggering the behavioural biases that can lead to poor investment decision making when members are left to their own devices.

However, default funds are not always the best option for all members as they are generally designed to meet the needs of the average member, and may not meet the needs of members who have different characteristics from the average.

This Briefing Note is primarily focused on objective setting but will also touch on:

- The use of language around default strategies
- Beliefs and constraints (especially costs),
- How these flow through to default strategy design, and
- How they can help support a quantitative approach to assessing value for money.

The language surrounding default investment strategies is often confusing

The language used by providers, market commentators and regulators when talking about the default investment strategy can be confusing and, at times, contradictory.

This Briefing Note discusses the current use of language about default investment strategies, and defines a few key terms that will be used in the Note going forward.

Default strategy vs. default fund

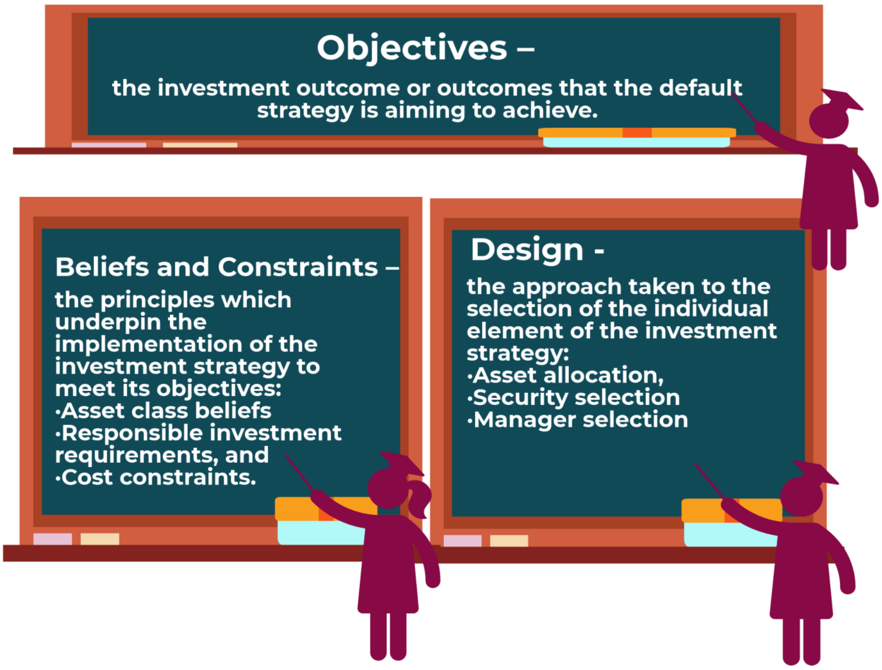
An "investment fund" is a product generally managed by an investment manager which may involve one or several asset classes and is generally designed to deliver a particular return outcome rather than aligning with member needs. A default strategy is an investment strategy designed by or on behalf of the provider to meet the needs of its members. Investment strategies typically involve members moving between two or more "investment funds" except typically in the case of target date funds.

Default objectives vs. default design

Providers are required to set objectives for their default investment strategy. However, some providers report objectives as a statement of how contributions will be invested rather than the underlying objectives; in reality a statement of the "default design".[3]

Default objectives (for example, a risk/and or return objective) are intended to inform the default investment strategy. If the "objectives" merely describe the investment strategy, this implies there are no over-arching member outcome objectives which the investment strategy is intended to satisfy. To have a properly constructed investment strategy, it is necessary to have default objectives which describe the outcome or outcomes that the investment strategy is aiming to achieve.

Figure 2: This Briefing Note uses the following language and definitions



An upfront clarification of language could assist providers (trustees and contract-based providers) in their governance process, particularly when setting objectives and then implementing an investment strategy consistent with them (Figure 2).

Who sets the objectives of the default strategy?

It is the responsibility of the provider to set and regularly review the objectives for the default strategy.

In the case of a trust-based arrangement this will be the trustees.

In the case of a contract-based arrangement this will be the provider (typically an insurer) as overseen by their Independent Governance Committee (IGC).

Ideally, employers selecting a pension arrangement will verify that the provider has adequate processes in place to ensure the default strategy offered to their members is appropriate for them. However, not all employers have the ability or inclination to undertake this assessment.

Legislation requires employers to be consulted when setting the investment objectives for the default strategy for trust-based arrangements, although there are a range of easements for multi-employer schemes.

How are the objectives of the default strategy typically set?

Default strategy objectives are generally set with reference to three main considerations:

- Regulatory requirements and guidance,
- A provider's definition of value for money,
- The needs of the greatest number of members.

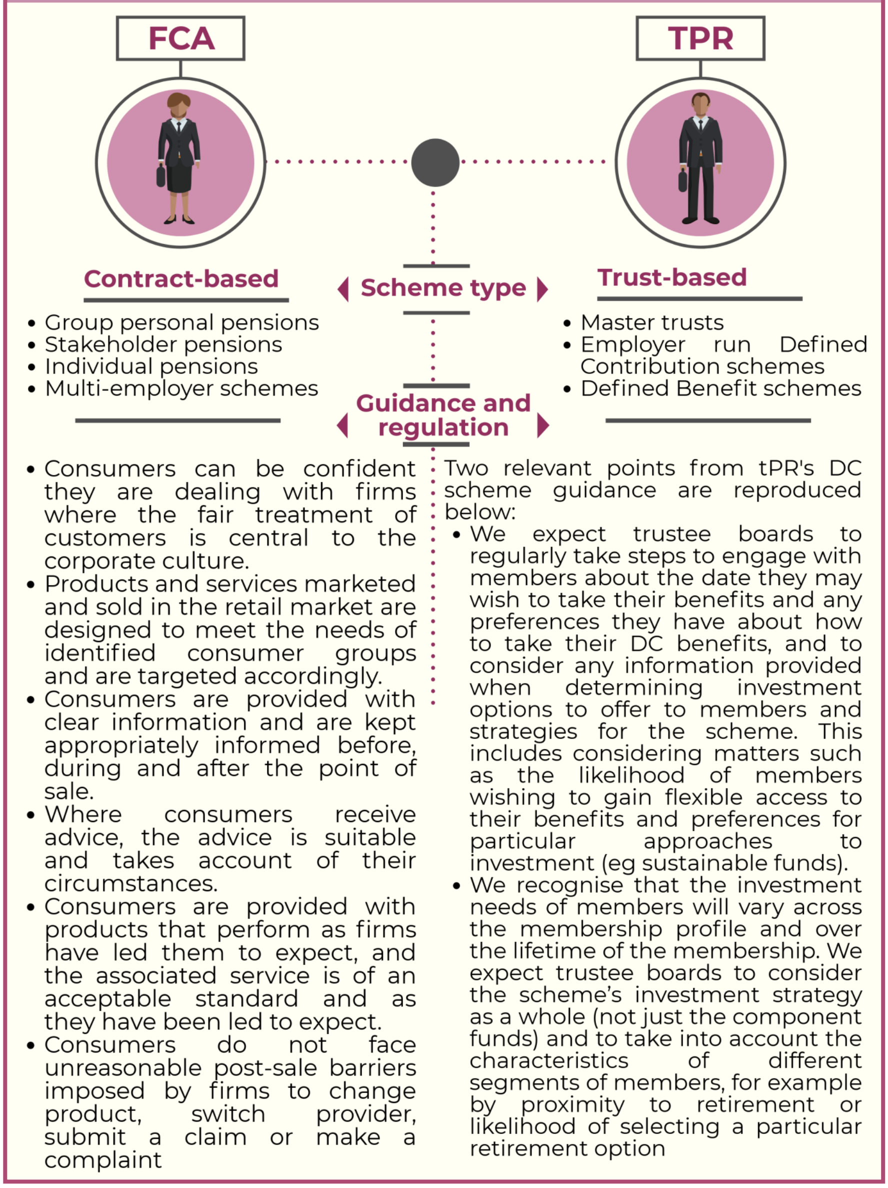
Consideration 1: Default strategy objectives must adhere to regulatory requirements

Defined Contribution (DC) pension schemes are regulated by the Financial Conduct Authority (FCA) (contract-based schemes) or the Pensions Regulator (tPR) (trust-based schemes) and are legally obliged to consider rules and guidance when implementing their default strategy, for example:

- The FCA requires firms to provide products which perform as customers have been led to expect and to provide clear information about products before, during and after the sale.[2]
- TPR and FCA require that *the net returns delivered to members, particularly in the default fund(s) should be assessed in the context of the investment objectives*[4] (Figure 3).
- DWP requires trust-based schemes to publish their default strategy Statement of Investment Principles, including trustees' assessment of the extent to which the return on the default arrangement is consistent with its aims and objectives.

While many aspects of default investment strategies are based on the rules set down in regulation, schemes independently define more detailed aspects of member objectives, for example:

Figure 3: Providers must adhere to regulatory requirements when designing default strategies



- What members should expect from individual product performance,
- Which investment objectives to focus on for a specific membership profile.

Consideration 2: Schemes have differing definitions of value for money

There is no consensus on how best to measure value for money,[5] but most schemes recognise that value for money involves more than just total investment returns after charges. Other scheme aspects also affect outcomes from saving such as:

- Administration/service - for example, how long schemes take to switch members' savings between funds,

- Communications—for example, whether scheme communications are able to help members understand the fluctuating nature of investments or how much they might need to contribute in order to achieve their income targets,
- Investment performance—the level of volatility and returns.

However, providers, trustees and IGCs generally consider two of the most important aspects of value for money to be investment returns and charges of the default strategy. Therefore, many providers set targets for returns and charges.[6]

Many providers set an investment return target

A range of approaches are used to set investment return targets. Some providers set an investment return target of "inflation plus X%", for example CPI + 3%,[7] or just target a return above inflation without setting a percentage.[8] Investment return targets tend to change with the economy and, for some schemes, the target will change frequently as a result of market analysis regarding likely volatility and investment returns. Target returns may be intended as long-term averages, rather than year-to-year goals.[9]

Investment returns do not necessarily always reflect targets, and records of how well schemes meet target returns are not usually readily available. Therefore it may be hard for employers or members to assess how well scheme investments deliver target returns.

Where records do exist, they often do not reflect the stated targets suggesting they may not be actual targets, but rather long-term expectations.

If investments are not being managed to deliver the set return targets, this makes evaluation of value for money and performance more difficult.

Setting a return target on its own will not necessarily meet regulator expectations of setting and reviewing a default investment strategy unless there is also evidence of how well returns meet the targets.

Some alternative approaches to setting return targets are:

- Seek to maximise the return for a given level of risk taken (risk budgeting)
- Compare returns against those achieved by similar schemes offered by other providers, (peer comparison),
- Compare returns against those achieved by other savings and investment products across the market (for example, a combination of simple passive, index, strategies that have a similar short-term risk profile), (market benchmarking).[10]

Some providers use a combination of approaches to setting investment targets

All target approaches have advantages and disadvantage and therefore some providers use a combination of short, medium and long-term targets. For example one approach is to:

- Provide an investible mandate for an independent default investment strategy manager to implement, for example, either an income in retirement or a cash lump sum,
- Monitor whether the long-term performance outcome target is on track by sampling members of different ages,
- Monitor the medium-term performance expectations relative to an inflation + X target which can aid member planning by indicating expected returns and growth,
- Monitor the short-term performance of the default strategy relative to a simple market benchmark (for example, an ISA) with short-term risk capacity.

Clearly set out metrics for monitoring performance make it easier for trustees and IGCs to:

- Provide an independent mandate (goals and aims) for the default investment strategy,
- Monitor the short term investment performance of their default investment strategy manager,
- Communicate the expected investment performance of the default strategy to members and monitor the long-term likelihood that they will achieve it.

Some schemes set short-term maximum charge targets as

part of value for money measures

As with investment returns, scheme charge targets vary. Annual Management Charges (AMC) for default funds in automatic enrolment schemes are currently capped at 0.75%. Master trust scheme members tend mainly to contain automatically enrolled members, 99.7% of whom stay in the default fund.[11]

The way in which the charges specific to the management of the default strategy are set is not always made clear to employers and members. Generally, within employer-run trust-based plans, there is a clearly communicated charge target for the default strategy, with the other costs of managing the scheme covered separately by the employer.

There are issues with the transparency of costs and charges in contract-based and master trust schemes

Contract-based schemes (such as Group Personal Pensions) and master trusts, typically levy an overall charge, a percentage of members' investments, to cover all services provided.

These charges are often paid directly to the investment manager, who then provides a rebate to the provider to cover administration, governance and communications costs. In some cases there is a commercial link between the provider and the underlying service providers to the scheme.

This payment chain makes it harder to provide a clear breakdown of how costs and charges are used to fund specific services, and in most cases this breakdown is not readily available to employers or members.

Some employer-run trust-based schemes also face difficulties with transparency

Some employer-run trust-based schemes also struggle with transparency as a result of using "bundled services" from a single agency who manages all the scheme's administration and investment services. In these cases it is often difficult to obtain a clear breakdown of how the costs and charges are used.

A further potential barrier to transparency in relation to employer-run schemes, is that trustees are often responsible for setting the objectives, but also making the key investment strategy decisions and reviewing them in order to assess value for money. This puts trustees in the difficult position of reviewing their own decisions, rather than having their decisions reviewed by an independent external body.

This low level of transparency makes a granular verification of value for money by members and employers difficult. Therefore, it can be difficult for these bodies to hold providers to account if they are not providing value for money. The FCA is working towards a requirement for asset managers to provide a full cost breakdown (or estimate) to providers.[12]

Transparency would be aided by more clarity on which costs are being paid to whom

One of the problems with complex payment chains and bundled services is that it becomes difficult for an external agency to understand how much is being paid to any particular entity and what services the payments cover. For cost breakdowns to be transparent, a split would need to be provided, not just of what costs cover, but of how much money is paid by members to:

- The provider,
- Organisations which the provider has an underlying commercial relationship,
- Independent third-party organisations (Figure 4).

However, at the moment these breakdowns are not made clear which makes assessment of value for money difficult.

In order to properly assess value for money, default investment strategy costs would need to be fully transparent

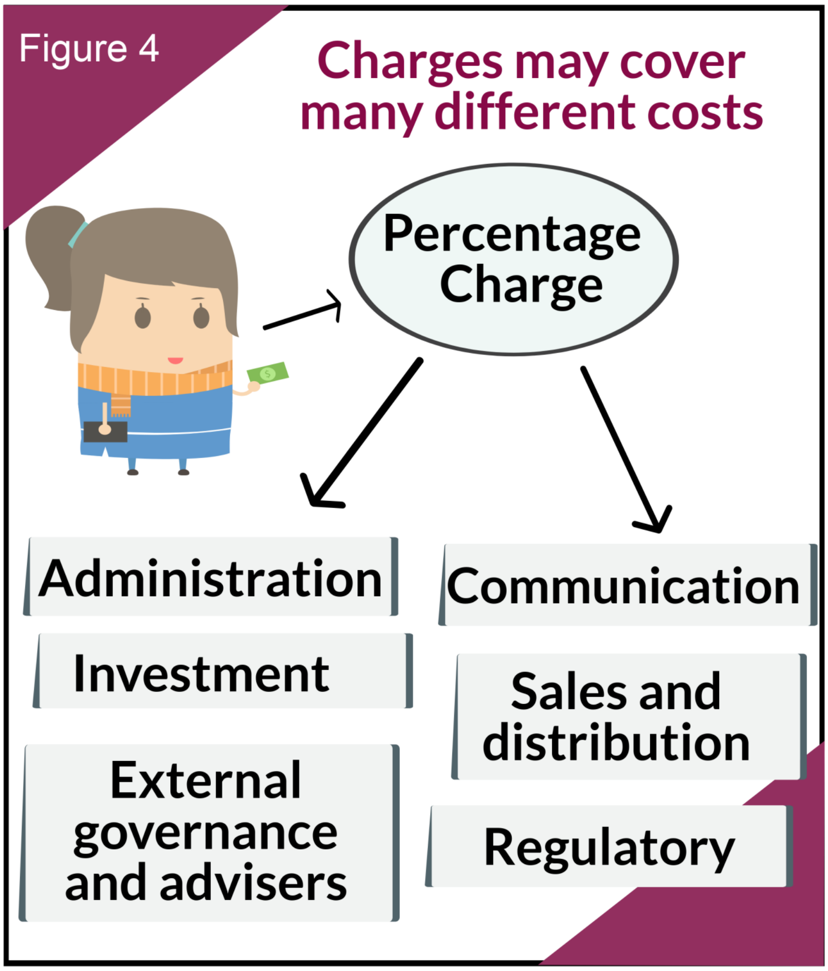
In order for IGCs, trustees, employers and members to be able to assess the value for money of their scheme's default strategies, they will need to know the answers to the following questions:

- How much: What are the current investment costs [of / associated with] the default investment strategy?
- Affordability: What is the maximum budget available to the trustees or insurer to spend ?

- Responsibility: Who has set this budget?
- Best execution: Has the provider implemented this strategy as cost effectively as possible?
- Best net outcome: If members paid more in charges on average, would they achieve a better overall service from their provider and/or return from their investments?

Transparency would also be aided by providers clearly setting out the approach they have taken to setting the objectives for the default strategy and providing an investment mandate implemented them in a way which can be independently assessed over time.

This would require objectives, beliefs and constraints to be available in a form that would enable an independent body monitor performance via verifiable benchmarks.



Many providers do measure value for money internally through a matrix

As well as setting investment return and charge targets, providers and IGCs often use a matrix of benefits and services to judge whether schemes are providing value for money to members, for example:

- Regular reviews,
- Proportionate charges for services received,
- Investment performance.

Each indicator on the matrix is graded with, for example, a number or traffic light system to determine how schemes perform.

These matrices could be extended to provide detail on the quantitative measures underlying each indicator, for example, how fair costs are defined and judged.

Alongside assessing value for money, IGCs oversee scheme's investment management and undertake regular reviews of how managers are performing.

Consideration 3: Default strategy objectives are generally set to meet the needs of the greatest number of members

One of the challenges facing providers is how to set the objectives of the default strategy to fit the needs of a vast majority of members rather than just the average member.

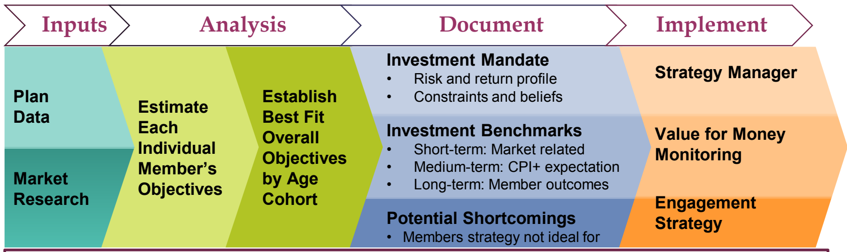
The most typical approach providers take to this challenge is to set the default strategy objectives to suit a person who meets the average, among its membership, of a combination of characteristics:

Known data:

- Current fund value
- Current contribution level/earnings
- Age

Figure 5: Bluesky Pension Scheme

Default Investment Strategy Approach



Trustees with their independent adviser oversee alignment of strategy with member needs and whether it both has and will deliver value for money on their behalf

Their current default strategy manager (responsible for analysis, documentation and management of the default strategy) is AllianceBernstein and independent adviser (responsible for oversight) is Dean Wetton Advisory

- Current post-retirement market products and regulatory environment

Assumptions (or further known data):

- How people might use their savings in retirement
- Behavioural characteristics/ risk tolerance
- Other forms of retirement savings

An alternative approach utilised by some providers is to identify what the long-term objectives (such as a secure income stream or flexible drawdown) for each individual member might be. The long-term objectives are identified by using data on behaviour, risk profile, age and pot size to determine how members are most likely to access savings in retirement.

This approach then utilises this data to construct objectives for the default strategy based on an assessment of the most likely behaviour of members when they come to access their pension savings.

Whilst conceptually this is similar to the first approach, it does have some differences. The analysis of how members might access and use their pension savings helps to position the objectives such that it is designed to be good for a vast majority of members rather than just the specific needs of the average member. It also more precisely identifies the characteristics of members for whom the default is not a good fit, because they are likely to use their pension savings in a different way from the majority of members, and allows exploration of whether a focused engagement plan is needed for these members, or a different default strategy.

Figure 5 shows how one provider goes about setting the default strategy objectives with this approach in mind.

It is difficult to set default strategy objectives which will be appropriate for the entire membership of a scheme

Unfortunately, by their nature, default strategies cannot cater to the diverse needs of the entire membership of a pension scheme.

There will always be members in a scheme who have quite different needs to that which the default strategy objectives are set. One of the challenges facing providers is to identify those who are not catered for by the default strategy and support them to make different investment choices. The majority of those automatically enrolled are relatively passive in regards to financial decision-making and might require intervention in order to make an active investment choice.

Default strategy objective setting would benefit from access to more detailed information

Providers do not generally have access to all the information they would need in order to fully understand their membership. While most providers have access to information on earnings, contributions, age, selected retirement date (although this in itself is often a highly unreliable data item) setting the default strategy objectives would benefit from access to the following member information:

- Job role, education and engagement levels
- Future spending needs
- Other forms of savings and assets

Some providers have developed heuristic (rule of thumb) based assumptions that, averaged across the entire membership, can inform the default strategy objectives. However, when using this approach, care should be taken to ensure that rules of thumb are not over-relied on to predict member behaviour at the individual level.

Default strategy objectives will need to evolve as members' needs change

In order to remain appropriate for both current and future members, and best deliver value for money, default strategy objectives will need to evolve over time as member needs, the retirement market, and regulation evolves.

Evolution within the market generally occurs as a result of regulatory change or consumer demand. However, the market may need to be able to continue adapting without the need for consumer engagement, as a new generation of savers with lower financial capability on average has been brought into pension saving as a result of automatic enrolment.

Some providers are still reviewing their default strategies in response to freedom and choice, despite member needs changing from the 2015 policy implementation, after which many began to access pension savings more flexibly, were less likely to buy an annuity with DC savings and more likely to enter drawdown or take lump sums. These changes affect the risk profiles of members leading up to and in retirement and could necessitate changes to pension investment strategies.

One barrier to faster adaption by providers is the fear of the potential legal ramifications of changing a strategy after people have signed their initial pension contracts. Whilst this should principally be an issue for contract based schemes there are a number of Trust based schemes that operate different default arrangements for different membership cohorts for similar reasons.

Another barrier is that there are administrative and investment-related difficulties associated with transferring a member's savings from one type of default pathway to another.

Conclusions

Providers are required to set objectives for their schemes' default investment strategies. However there are several barriers preventing these objectives always being set in a clear way which provides members and their representatives sufficient information to hold providers to account and assess value for money. Some of these barriers are listed below:

- The language used by providers, market commentators and regulators when talking about the default investment strategy can be confusing and, at times, contradictory.
- Default investment strategy objectives are often unclear, make no reference as to how they align with members needs and are often set out as investment return objectives rather than overall default strategy. This can make it difficult to design an investment strategy as there is no over-arching member outcome objective to follow. A lack of clear objectives also makes it more difficult for external bodies to hold providers to account as there is no clear objective to measure performance against.
- Investment returns do not necessarily always reflect targets, and records of how well schemes meet target returns are not usually readily available. Therefore it may be hard for employers or members to assess how well scheme investments deliver target returns.
- It is often difficult to disaggregate costs and charges from the complex payment chains and bundled services used by providers making it difficult for external agencies to understand how much is being paid to any particular entity and what services the payments cover.
- One of the challenges facing providers is how to set the objectives of the default strategy to fit the needs of the greatest number of members.

- A lack of clear metrics against which the past and future performance of the default strategy should be assessed, and how these align with the overall objectives of the default strategy make value for money assessments either by trustees and IGCs as well as employers and their members very difficult.

Overcoming these barriers would help default investment objectives to be more transparent and potentially better meet the needs of a greater number of members. Some potential ways in which these barriers could be overcome are:

- An upfront clarification of language by providers (trustees and contract-based providers) could assist them in their governance process, particularly when constructing objectives and the designing default investment strategy.
- All approaches to setting an investment return target have advantages and disadvantages. Using a combination of short, medium and long-term targets could help overcome some of the disadvantages.
- For cost breakdowns to be transparent, a split would need to be provided, not just of what costs cover, but of how much money is paid by members to:
  - The provider,
  - Organisations which the provider has an underlying commercial relationship,
  - Independent third-party organisations.
- Transparency would also be aided by providers clearly setting out the approach they have taken to setting the objectives for the default strategy and providing an investment mandate implemented them in a way which can be independently assessed over time. This would require objectives, beliefs and constraints to be available in a form that would enable an independent body to monitor performance via verifiable benchmarks.
- One way of attempting to design default strategy objectives to suit the greatest number of scheme members is to determine what long-term outcomes would be suitable for members and then design around the outcomes which are suitable for the greatest number of members. This approach may also make it easier to identify members not covered by the default strategy and enable exploration of whether an engagement programme would assist or the creation of alternative default strategies.

1 TPR (2018) Monthly declarations of compliance up to April 2018
2FCA (2018) Fair Treatment of Customers www.fca.org.uk/firms/fair-treatment-customers
3 Interviews with providers
4 TPR (2013) Code of practice no: 13 Governance and administration of occupational trust-based schemes providing money purchase benefits
5 PPI (2016) Value for money in DC workplace pension
6 Prudential Independent Governance Committee's Report 2018; National Employment Savings Trust pension scheme annual report and accounts 2016/17
7 IGC reports and interviews with chairs
8 Royal London Independent Governance Committee Annual Report, 2018; The Independent Governance Committee's annual report for the year ending 31 March 2018 for the EasyBuild Stakeholder Pension Scheme
9 Annual Report for Standard Life Workplace Personal Pensions 2017 – 2018; Aviva Independent Governance Committee 2018 annual report
10 Zurich Independent Governance Committee Chair's report 2017/18 April 2018; National Employment Savings Trust (2009) Building personal accounts: designing an investment approach; Building personal accounts: designing an investment approach
11 PPI (2017) The Future Book: unravelling workplace pensions
12 FCA (2017) Asset Management Market Study Final Report

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