PENSIONS POLICY INSTITUTE

PPI

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

Executive Summary

The Pensions Policy Institute (PPI)

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The PPI, established in 2001, is a not-for-profit educational research organisation, with no shareholders to satisfy – so our efforts are focussed on quality output rather than profit margins. **We are devoted to improving retirement outcomes.** We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. The PPI gives you the power to influence the cutting-edge of policy making. Each research report combines experience with independence to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **Independence** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

Our Vision:

Better informed policies and decisions that improve later life outcomes

We believe that better information and understanding will help lead to a better policy framework and a better provision of retirement income for all.

Our Mission:

To promote informed, evidence-based policies and decisions for financial provision in later life through independent research and analysis

We aim to be the authoritative voice on policy on pensions and the financial and economic provision in later life.

By supporting the PPI, you are aligning yourself with our vision to **drive better-informed policies and decisions that improve later life outcomes** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

For further information on supporting the PPI please visit our website:

www.pensionspolicyinstitute.org.uk

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The future is ever changing,
but the PPI remains a constant
"Voice of Reason"
in the ongoing debate on the
future of retirement in the UK.

Pensions Policy Institute
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EST. 2001

This report has been authored by:

Bob Collie – Research Associate

Bob Collie has led consulting practices and research teams in the US and the UK at some of the world's leading investment consulting firms. An Actuary by training, he has specialised in investment for almost thirty years, in roles that have included asset allocation specialist, general investment consultant, business leadership and strategic research. He is currently Principal at Collie ESG Ltd, which advises investment organisations on best practice in ESG and sustainable investing.

Bob has made notable contributions in ESG, in liability-driven investing and in defined contribution design, including, with Don Ezra and Matthew X. Smith, the 2009 book *The Retirement Plan Solution: The Reinvention of Defined Contribution* (John Wiley & Sons). He has a first-class degree in Mathematics from the University of Oxford. He has also conducted work for the Pensions Policy institute, and was the lead author on the 2021 PPI report: *How do UK pension schemes approach investment into overseas assets?*

Chetan Jethwa – Policy Modeller

Chetan Jethwa joined the PPI modelling team in April 2018 as a Policy Modeller. He is responsible for maintaining and developing PPI models as well as producing modelling results and undertaking analysis to feed into the PPI's research.

Chetan has a BSc in Actuarial Science from the London School of Economics.

Daniela Silcock – Head of Policy Research

Daniela is Head of Policy Research at the Pensions Policy Institute (PPI) and leads the Policy Research team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of state and private pensions policy, writing articles for journals and national press, and presenting to a variety of domestic and international audiences, including radio and television appearances.

Daniela originally joined the PPI in 2008 and took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee.

Prior to working in research and policy Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics.

Tim Pike – Head of Modelling

Tim is the Head of Modelling of the PPI responsible for delivering the models and modelling to support the PPI's current research program. He joined the PPI in July 2015 and since then has analysed the projected implication of pension policies upon many significant groups. These have included the self-employed, women, younger generations, and the Exchequer.

Tim has worked alongside academics and other researchers on collaborative projects including WHeRL and CASPeR. These projects bring multidisciplinary research to widen the research scope to give a more complete view of the implications of interacting areas of policy.

Prior to joining the PPI Tim worked for Legal and General where he spent nearly ten years contributing to a wide variety of actuarial modelling projects, from financial reporting to annuity pricing.

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A Pensions Policy Institute report

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Executive Summary

This report explores the extent to which the investment of Defined Contribution (DC) pension scheme assets in the default investment strategy 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. This summary covers the main points of the report and acts as the conclusion.

Default investment strategy: The investment strategy (collection of funds) in which members will automatically have their contributions invested if they do not make a choice.

- DC scheme members' contributions are invested through a default investment strategy unless members make an active choice
- People with particular characteristics may benefit from an increased focus on enhanced returns or reduced volatility than found in standard DC default investment strategies, though it is not possible to quantify the proportion of people who fit into these categories
- There are several policy options for ensuring that DC default investment strategies meet the needs of a wider range of members
- Increasing asset allocation to alternatives could enhance returns while also increasing diversification, potentially benefiting all members
- However, there are cost and resource issues involved with tailoring investment strategies to different members and a lack of member data can also make identification difficult
- Default investment strategies also carry behavioural benefits, such as not requiring people to make active choices, which could be lost in more tailored strategies

This report does not highlight the proportions of members who would fit into each characteristic, as many members will benefit from staying in the default investment strategy and some members will fit into several categories. Instead, the examples illustrate the types of characteristics which may be associated with members who might benefit from having their contributions invested in a strategy which seeks higher returns or lower volatility than the average found in default investment strategies.

As more people are now saving into DC schemes, the default investment strategy design will affect the future retirement incomes of more people

Membership of DC default investment strategies has increased as automatic enrolment has brought an additional 10 million people into pension savings, most of whom have remained in their schemes' default investment strategy; 90% of those enrolled in master trust/multi-employer schemes are in the default investment strategy.[1]

Within Defined Benefit (DB) schemes, members contribute into a single fund, designed to support scheme liabilities towards current and future pensioners. Within DC schemes, members have individual pots and it is they (rather than the plan sponsor or company) who bear the investment risk. As a result of this difference, default investment strategies within DC schemes are designed with the principle of best meeting the needs of individual members, rather than focusing on the combined cash flow needs of the scheme as a whole.

The majority of DC pension scheme members do not select an investment strategy for themselves, but rather depend on the scheme's default investment strategy.

Default investment strategies are generally selected based on the needs and circumstances of representative, or typical, scheme members

The default investment strategy design is the responsibility of the scheme's trustee board or investment manager, based on expert advice. The default investment strategy determines the extent of the market risk that is taken on and, hence, of the potential for enhanced investment returns in the long run.

> **Market risk:** the collection of investment-based risk which those invested in pension savings may face, including currency risk, inflation risk, insolvency risk, and investment risk.[2]

The design of a default investment strategy is generally based on the modelling of projected risk and return outcomes under various alternative investment approaches.

In selecting an investment strategy that best meets the needs of the scheme membership as a whole, trustee boards and investment managers must weigh various factors. Some of these factors relate to the nature of the available investments: the potential for strong returns, the volatility of the asset values, the potential for significant losses in value and practical considerations such as cost, liquidity and ease of access.

The assumptions about members relate to their circumstances (such as income level or period of contributing), assumed objectives (such as desired method of access to pension savings) and preferences (such as how much investment risk is tolerable).

Investment strategy design involves trying to find the right balance between risk and return

Finding the appropriate balance between these two contrasting goals, higher returns and lower risk, is a key challenge when setting the high-level asset allocation strategy. Since a default investment strategy applies to a wide cross-section of scheme members, it cannot be tailored to each member's individual circumstances and preferences. Rather, the best possible fit must be found to a diverse range of needs.

This means that, for members who do not fit the typical or representative profile on which the default investment strategy is based, better solutions may exist. And, in broad terms, those solutions will involve either (a) more focus on the maximisation of return or (b) more focus on the management of risk, either in the default investment strategy, or in alternative, self-select or other pre-packaged strategies which could be offered alongside main default asset allocation strategies.

1 Wilkinson *et. al.* (PPI) (2020)

2 See glossary for definitions of individual market risks

Previous PPI research has also explored the way that improving governance and increasing asset allocation to illiquid and alternative or Environmental, Social and Governance (ESG)-compliant assets could increase member pot sizes at State Pension age (Spa).[3]

Some people with particular characteristics may benefit from an increased focus on enhanced returns or reduced volatility than found in standard DC default investment strategies

Those particularly likely to benefit from a focus on enhanced returns include:

- **People who work for longer (past SPa) and higher earners –** who have a higher level of income and savings, and can withstand greater volatility, because losses are unlikely to impact overall retirement income less significantly than for those dependent on a smaller amount of DC savings.
- **Those who accumulate marginal amounts of savings -** whose pot is unlikely to represent a significant increase in retirement income; there is less need to ensure that the capital is preserved, and therefore less requirement to focus on reduced volatility.
- **Those with patchy work and contribution patterns -** because the majority of the retirement provision for these individuals comes from other sources, mainly State Pension provision and benefits, which puts a floor beneath the potential impact of poor investment returns.
- **Those with DB savings in addition to DC savings –** those savers whose DC arrangement is additional to a DB pension and can, therefore, afford to have less regard to risk, since the DB benefit acts as an underpin to the State Pension.

Those particularly likely to benefit from a focus on reduced volatility include:

- **People who stop contributing at younger ages (before SPa) -** because they are more dependent on their DC income to support them up until SPa, and volatility could lead to a lower income both before and after SPa.
- **People who use uncrystallised funds pension lump sums (UFPLS) or purchase an annuity –** as their need to take an income from their pot, or apply it to the purchase of an annuity, without re-investing it in a return-seeking product (such as drawdown) means that they are likely to be more sensitive to increases in volatility which will affect either the amount available to withdraw (UFPLS) or the annuity rate.
- **Those without supplementary savings –** those with no other supplementary savings, but sufficient DC savings to make a difference to their retirement income, will be more sensitive to, and potentially negatively affected by, volatility in their investments, which affect the overall pot size at retirement and as a corollary retirement income levels.

There are several policy options for ensuring that DC default investment strategies meet the needs of a wider range of members

1. Increasing asset allocation to alternatives could enhance returns while also increasing diversification, potentially benefiting 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

Alternatives could enhance returns while also increasing diversification

Expanding the range of assets used in a default investment strategy may be done either with the goal of enhancing returns, or reducing risk, though many alternatives offer both increased diversification and potentially higher returns - potentially allowing for both.

Part of the reason many DC default investment strategies have a limited range of asset exposure is the increased costs associated with this, which could translate into higher member charges. Higher charges may result in a loss for some members, particularly for members of smaller DC

3 Silcock *et al* (2019)

schemes which may not have the scale to reduce administrative costs as a way of freeing up extra investment budget.

In considering the effect of expanding the range of assets used in default investment strategies, it is important to look at the portfolio-level impact, rather than the characteristics of the alternative asset class in isolation. Assets which, considered in isolation, offer volatile return patterns may nonetheless serve to reduce a portfolio's overall volatility, provided they diversify existing exposures.

Previous PPI work found that, net of fees, a median earner contributing throughout their working life into a pension with 10% to 15% of funds in illiquids could have a pension pot at retirement around 2% to 3% higher than if their pension was not invested in any illiquids.[4]

Using existing data on members, such as pot size, in order to provide prompts about using non-default (self-select) investment strategies, or choosing between a number of pre-packaged strategies

At present, lifestyling means that most default investment strategies vary with the age of the member. Where more information is available (e.g., account balance data is available to the scheme) those additional data points could be used to achieve greater customisation even without direct member engagement. As technology advances, such greater customisation is likely to become more feasible in practice.

For example, those with a high account balance might be regarded as having more to gain from more customised investment approach, be able to afford higher member charges, and bear more risk, so that group might receive targeted communications about their options. Though some of those with high account balances may still be highly dependent on their DC income or have a low risk-appetite, so any communications will need to be carefully designed. Schemes or employers informing members about appropriate investment strategy could also be seen as giving advice, which is a regulated service. Therefore, some form of protection for the provider of the prompt would need to be built into the system.

Gathering more data on members in order to make DC default investment strategies more tailored or to provide prompts about non-default (self-select) investment strategies

Scheme data is currently constrained by the data that employers gather on their employees before enrolling them. Alongside this, some schemes or employers may conduct surveys or data gathering exercises, but these are not consistent between schemes. In order to better understand the profiles of scheme members, additional data could be gathered covering income level, gender, ethnicity, ability, caring responsibilities, other savings and assets, and attitudes to risk. Gathering additional data could make customising the default investment strategy simpler, as well as making it easier for schemes to identify members who may not be best served by remaining in the default investment strategy. However, there would be additional costs and privacy issues involved in a data gathering exercise of this kind. In order to be rolled out, it would require the investment and support of both the Government and industry in order to ensure policies are clear and straightforward, and that cost and privacy concerns are dealt with in a way which does not pose a threat to members, employers or schemes.

Alternative asset class exposures can potentially enhance returns

The primary driver of returns within most default investment strategies is the listed equity market. In order to enhance returns without increasing the concentration in this asset class (and the attendant risk), higher returns might be sought elsewhere. For example:

- **Private markets –** assets not publicly listed
- **Real estate –** property and property development
- **Other alternative assets –** for example, commodities, infrastructure and hedge funds
- **Selected parts of the fixed income market –** privately listed debt and credit

4 Silcock *et al* (PPI) (2019)

These assets are typically more volatile and/or less liquid than listed equities or listed fixed income (such as bonds and gilts), and generally cost more to invest in - while also requiring higher levels of due diligence and ongoing monitoring.

Alternative asset class exposures can increase diversification, reducing volatility

The power of diversification means that expanding the range of asset class exposures can lead to potentially better portfolios, not only in a context of seeking higher returns, but also to reduce risk. Most default investment strategies are heavily dependent on global equity market performance as the primary driver of investment returns; to the extent that other sources of return can be brought in to sit alongside and supplement this exposure, so the concentration of risk can be reduced.

Practical considerations take on greater importance for alternative assets

Although investment strategy is generally based on industry modelling of projected outcomes, this cannot, however, incorporate every relevant consideration, such as income levels and the way that needs and resources might change throughout working life and retirement. Practical implementation issues can arise, so that an approach appearing attractive on paper is less appealing in reality. For example:

- Projection risk is greater for alternative assets
- Not all schemes have equal access to investment opportunities
- Poor timing can be a drag on performance
- Liquidity needs may constrain exposure to alternative asset

The role of fees and other investor costs is particularly important, and trustees and investment managers tend to place considerable weight on fees as a decision factor.[5] Fees are an easy way to justify decisions and to divert potential criticism. This can lead to fees being dominant in decision-making, with less weight being placed on other factors that are more opaque or difficult to interpret, even where this does not lead to the best outcomes for scheme members.

An over-emphasis on cost, rather than value, may be a particular hindrance to the consideration of alternative asset classes.

Default investment strategies also carry behavioural benefits which could be lost in more tailored strategies

Default investment strategies carry behavioural benefits, such as not requiring people to make active choices or engage when they do not have the support or financial capability to make informed decisions. Default investment strategies can also be designed in a way which targets people with specific behavioural characteristics, such as the NEST default strategy which reduces volatility in the first few years of saving in order to encourage those with low risk appetites to remain contributing. Thought will need to be given to how to avoid losing the advantages of these benefits if more tailored strategies are pursued.

5 PPI (2021)