In-house professionalism can assist with new and innovative investment in DC schemes

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Future pensioners will receive the majority of private pension income from Defined Contribution (DC) savings and this has led to an increased focus on DC scheme investment.

From the introduction of the first Defined Benefit (DB) scheme in the 1600s (the Chatham Chest which provided pensions for injured naval seamen), DB schemes have been the main source of private pension income in the UK. It is only during the last couple of decades that there has been a dramatic decline in the provision of DB schemes in the private sector and the growth in DC provision.

Automatic Enrolment was introduced in 2012 into a market in which DC schemes were the most common form of workplace pension on offer. As a result, the number of active savers in DC schemes grew from £4.3 million in 2011 to £13.1 million in 2018. In 2018 there were around 7 million active savers in DB schemes, including those in the public sector (PPI aggregate model).

This increase in DC savers, and reduction in DB savers, means that future pensioners will receive the majority of private pension income from DC savings. The DWP estimates that by 2060, DC pensions will provide around 28% of average income from state and private pensions and DB will provide around 13%, with the remainder from the State (DWP, income projections).

As a result of the growing importance of DC savings there has been increasing focus on the transparency, charging structures and value for money of DC schemes. There have also been innovations in thinking regarding the way that DC scheme assets should be invested and, in particular, discussion about whether they are currently being invested in a way which will lead to future pensioners experiencing the best possible retirement outcomes. The three main investment focusses at the moment are:

- **What the most appropriate default investment strategy for those saving in DC schemes is**
- **Whether greater use of illiquids should be encouraged and how to do so**
- **How to ensure that the financial implications of economic, social and governance factors are taken into account when making investment decisions.**

There is no widely recognised 'appropriate default strategy' for DC members

One investment practice which has been called into question is the use of traditional 'lifestyle' funds for DC pensions. From April 2015, people are no longer required to purchase a secure retirement income product in order to access their DC savings. A lifestyle strategy, which de-risks assets in the approach to retirement on the assumption that members will use their savings to purchase an annuity, may be unsuitable for people who wish to continue investing their savings. However, many DC schemes continue to employ lifestyling for their default strategies. This is partly because there is no widely recognised 'appropriate default strategy' for DC members, as lifestyling used to be.

DC schemes could potentially achieve greater long-term returns through increased investment in illiquid and alternative assets

There are a range of assets available for DC pension schemes to invest in. However, 76% of DC assets are currently invested in bonds and equities. Greater DC scheme investment in illiquids and alternative assets could potentially yield benefits to pension scheme members. Illiquid and alternative assets have the potential to deliver a higher return, net of charges, over time than liquid assets; are not generally subject to the same market forces as public equities; may deliver inflation-linked returns over the long term, better suited to pension investments; widen the range of potential investments; and could increase the value of assets that the UK puts into positive social impact investment.

However, illiquid and alternative assets are complex to research, evaluate, monitor and manage and, as a result, cost more and require more resources to manage than bond and equity investments.

There is growing pressure on pension schemes to consider the financial implications of environmental, social and governance factors when making investment decisions

The potential economic consequences of global trends such as climate change, social movements, and increased regulation are becoming clearer to many investors. The Government has laid regulations which strengthen the obligation on trust-based pension scheme trustees to consider environmental, social and governance (ESG) factors in investment decisions. The FCA currently plan to consult on corresponding requirements for contract-based pension schemes in the first quarter of 2019. Pension schemes which do not start to integrate ESG consideration into their investment strategy could face legal difficulties as a result of not complying with regulations, higher admin and legal costs, and potentially reduced returns in the future as a result of not taking financially material risks into account.

However, as with illiquid and alternative assets, assessing the ESG credentials of companies and determining how to integrate ESG assessments into an investment strategy is complex and resource intensive.

Smaller schemes may struggle to make complex decisions about their investment strategies

Smaller DC schemes tend not to have the resources to bring their investment team in-house and as a result, lack the professional knowledge and ability to design detailed investment strategies. Smaller schemes tend to base investment decision on the advice of third party investment consultants and advisers. Most small schemes use investment platforms to access funds for their scheme investments and therefore have their investment options limited to the funds that are offered on platforms.

This outsourcing of finance professionalism means that smaller schemes are struggling to redesign their default investment strategies and have less access to illiquid assets or funds that include ESG consideration. Complex funds which contain illiquids and/or consideration of ESG factors are absent from the majority of investment platforms and many consultants do not advise trustees and providers to consider more complex options because of the costs and resources involved.

Meanwhile, many larger schemes are making headway in designing default strategies better suited to people who may choose from a variety of options for accessing DC savings, and in integrating the use of illiquids and ESG factor consideration into their investment strategies. Very large schemes have the resources to bring professional investment management in-house and negotiate more competitive deals with external managers.

Some smaller schemes could increase access to in-house professionalism through consolidation or fund pooling

There are many small DC schemes: in 2017 there were around 35,000 DC schemes in the UK, of which around 90% were 'micro schemes' with fewer than 12 members. Only 130 schemes had memberships of more than 5,000. This means that the vast majority of schemes are unlikely to be able to bring professional investment management in-house and their members may not benefit from advancement in thinking around the best ways to invest DC members' contributions to achieve optimal retirement outcomes.

There are some potential ways around the 'small scheme' conundrum. The Government is moving to make DC scheme consolidation easier and to introduce more pooled funds which DC schemes can access. Consolidated schemes could join resources to bring investment expertise in-house and schemes in pooled funds will have more collective buying power to buy in resources and expertise. However, not all small schemes will pursue these options.

Though some small schemes may eventually close down, there is likely to continue to be a dichotomy between the in-house professionalism of large schemes and the dependence on external advisers and managers by small schemes. Members of small schemes may not benefit from advances in investment thinking, therefore, until these practices become standard among larger schemes and start to affect the behaviour of the external professionals used by small schemes.