Three key questions trustees should be asking about their default strategy

In Aon's recent Better DC Decisions Workshop, Investment Principal Chris Inman explored better DC default investments. In this article, Chris shares some of the highlights from that session.

One of the great ongoing debates in defined contribution (DC) pensions is whether members should become more actively involved in their pension's investments or opt for a well-managed default.

Experiences in the Australian DC market show that the majority of members do not have the ability or the willingness to become their own Chief Investment Officer. In the US, there is evidence that members who make their own DC investment decisions have returns that are around 3.3% per annum lower than those in the default[1].

However, if members are to be 'better off' in the default, it is more important than ever that trustees develop and maintain a default strategy which balances risk and return in both the growth and retirement/de-risking phase.

What makes a better growth fund?

When you dig into the detail of many DC default growth phases, there are some imbalances which could be hindering growth. For example, it is not uncommon to see 'global' equity funds that have 30% of their holdings in UK equities. However, the UK only represents 5.7% of the total global equity market, so in these funds, UK holdings are substantially overweight[2]. When you consider that pension savers are already exposed to the UK economy in other ways – through their jobs, property and savings – do we really want to exacerbate that further through their pension investments?

Overexposure to certain industries and individual businesses is another issue in equity funds. In late June 2018, as much as 7.1% of a passive global equity portfolio was invested in the so-called technology 'frightful five' of Amazon, Apple, Alphabet (owner of Google), Facebook and Microsoft[2]. In July 2018, Facebook's shares fell by 20% overnight, illustrating the dangers of such concentrations.

Better diversification of assets in the growth phase is therefore essential. There are three key considerations:

- Geography – make sure funds are truly 'global'. That also includes access to emerging markets, which have different growth patterns, as well as ensuring there is no overexposure to particular industries or markets
- Factors – use rules-based strategies to outperform passive strategies. This opens up further diversification options
- Currency – overseas investment can add unintended risk, so trustees must think about whether, and how much of, their currency exposure to hedge. The significance of currency fluctuations is often underestimated at present

What about default strategy de-risking?

The introduction of freedom and choice, coupled with broader shifts in our working patterns, mean that trustees need to re-think what risk (and by association de-risking) means, as members approach 'retirement'. Retirement could now mean leaving the workforce entirely at the age of 65, or moving gradually to any number of flexible, part time or portfolio working arrangements.

No matter what members' plans, delivering stable returns above inflation and ensuring capital preservation are two key investment objectives for the de-risking phase of a default strategy. However, at present, a typical de-risked profile might comprise 25% cash and 75% UK fixed income. That approach might feel safe and well-tested, but it now risks significant capital losses. In fact, post the Brexit vote UK fixed income fell by between 10 and 15% coupled with heightened volatility. As such, UK fixed income is doing a terrible job of meeting the key criteria of stable returns and capital preservation.

Diversification is the answer again. Multi-asset credit and absolute return bond strategies are expected to outperform UK fixed income and inflation, as well as achieving capital preservation.

How does this improve member outcomes?

Improving diversification in both the growth and retirement phases of a default strategy can drive as much as a 20% higher outcome, according to forward modelling. It gives greater participation in positive growth and reduced fear of downside.

We have seen in the past that losses incurred by members in the growth phase can be crystallised by switching into de-risked strategies too soon. Schemes and their members cannot afford for that to happen again. The introduction of individualised glidepaths, which focus on a member's target savings outcome, allows us to 'bank' accumulated returns while continuing to participate in market growth when required. This means by maintaining growth potential when it is required, individuals can now take advantage of market bounce-backs in helping to achieve their targeted outcome.

It is vital not to de-risk too early. As we have seen, changing models of retirement mean that we need to look again at what a good outcome is and how it is delivered. The right time to de-risk will depend on a number of factors, including the profile of members, what they want to achieve and their contribution levels. Based on those criteria, trustees can use multi-asset 'building blocks' to manage growth and de-risking, and individualised DC investments to help achieve better member outcomes.

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[1]Help in Defined Contribution Plans: 2006 through 2012. Report by Financial Engines and Aon, May 2014
[2]Figures from MSCI as at 29 June 2018

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