Aon
Retirement and Investment

Putting DC Members Front and Centre

Refocusing DC Investment

Empower Results®

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Introduction

In our paper titled *DC Investment – Making it Pay*, we discussed the need for the design and communication of investment strategies to be refocused on members, their unique and evolving objectives as well as the risks that they are exposed to through their savings journey. Through our experience working in partnership with DC schemes we have constructed a tailored approach to help attain this goal and implement in a practical way:

1. **Discover** – it is important to consider your strategic DC goals and beliefs before trying to answer the question about what types of solutions are right for your members.
2. **Develop** – by understanding your beliefs and membership profile (through the Discover phase) we can design bespoke investment strategies that are tailored to the unique needs and objectives of you and your members; and
3. **Deliver** – better member outcomes within a governance structure suited to your scheme.

This paper will build on the above concepts with a particular focus on the Develop phase. That is, we will put a spotlight on the current use of equities, particularly the ways to improve, as they form a significant proportion of most default glidepaths (and even within a diversified growth fund). The paper will also serve as the first in a series of three that will cover the main asset classes and investment strategies currently used in DC within the UK.

1. Equities (this paper)
2. Diversified growth funds/multi-asset investing
3. Fixed income investing

Through focusing on these distinct areas it is our intention to document the common approaches to investing in each for DC savers, the potential enhancements available to help improve member outcomes as well as how to efficiently implement these strategies within a more risk focused framework.

Discover the member focus

In order to refocus our minds on DC savers we need to take the discussion back to first principles and ask the simple, but difficult to answer, question of "what are we trying to achieve?" The regulatory response of "good member outcomes" is a nice starting point and difficult to disagree with but surely a "good" outcome differs between investment strategies, DC schemes and members. This is why a true 'member focus' is not a one-size fits all scenario. Investment strategies need to be tailored to the unique, and evolving, membership profile of each DC scheme. But how do we achieve this? The table below provides a starting framework to identify the pertinent risks and objectives at each stage of the savings journey for DC members. It also identifies potential themes to help align investment strategies with the desired performance profile and mitigate the pertinent risks.

	Early-career	Mid-career	Nearly there...
Member focus	• Longer investment horizon • Lower savings	• Moderate DC savings • Decreased investment horizon	• Accessing savings
Key risks / consideration	• Not enough return • Capital losses aren't fatal	• Insufficient return • Significant falls in savings not being regained	• Significant losses! • Insufficient returns • Inflation eroding purchasing power • Outliving retirement savings
Financial goal	• Significant growth above inflation	• Positive real returns • Reduce risk of significant loss	• Modest real returns • Minimise risk of loss
Investment themes	• Access equity risk premium in cost efficient manner • Diversify across: – Investment styles; – Return drivers; – Currency; and – Geographies	• Reduce equity correlation • Increase diversification across assets and return drivers • Further focus on capital risk • More considered DGF usage	• **Flexible:** retain growth and capital focus whilst increasing inflation linkage • **Annuity:** mimic annuity price changes with fixed income • **Cash/Immediate Withdrawal:** capital protection, some real growth

While a number of the behavioural elements detailed above will not be new to some, the linking of these to more considered and tailored investment strategies hasn't generally occurred to date. That said, there has been general recognition across the industry of the importance of matching investment strategies to the evolving risk profile of members. This can be seen through the fairly standard implementation of lifestyle strategies that broadly consist of three phases (e.g. early career, mid-career and pre-retirement phases) but if we look under the bonnet, what do the underlying investments consist of?

- Relatively undiversified equities in terms of geography (e.g. overweight to UK), style (e.g. no alternative indexation) and return driver (e.g. no emerging markets);
- Diversified Growth Funds (DGF) that can be relatively expensive but heavily reliant on equity market outcomes (i.e. can suffer significant capital losses); and
- Heavy reliance in the latter years on local fixed income markets, this is particularly problematic when they are viewed as "safe" assets and used to "de-risk" members.

Each of these elements may be appropriate for a certain type of investor but when a member focused lens is applied we find that there a number of shortcomings to such an approach.

With this as our investment framework we will focus on mitigating a risk that, while being most prevalent early in a member's savings journey, is an important factor right up to, and in fact through, retirement. That is the risk of not generating enough investment return which results in an insufficient level of retirement savings. What can also be tricky is the fact that the amount of investment risk that members are willing and able to take in order to generate these returns generally decreases with age. This means that we have to take a more considered and evolving approach to generating these returns for DC savers. Historically, relatively undiversified equity investments have been used primarily as a return generator early in a member's career, but should we be reconsidering this?

Develop your equity investments to help achieve better member outcomes

The "growth phase" (encompassing early and mid-career) of a lifestyle strategy is the most common place that you will find an investment in equities. It is placed there with the expectation that, over the long term, significant positive returns will be generated without too much thought being given to whether there is a more efficient way of accessing these desired returns. In the fee conscious and cost constrained world of DC investing the relatively low cost of a market capitalisation (or cap-weighted)[1] passive investment is tempting but we believe that there are simple aspects that could be considered to enhance your members' savings. The initial question for a trustee to ask in order to begin this process is: *do my passive equity investments have:*

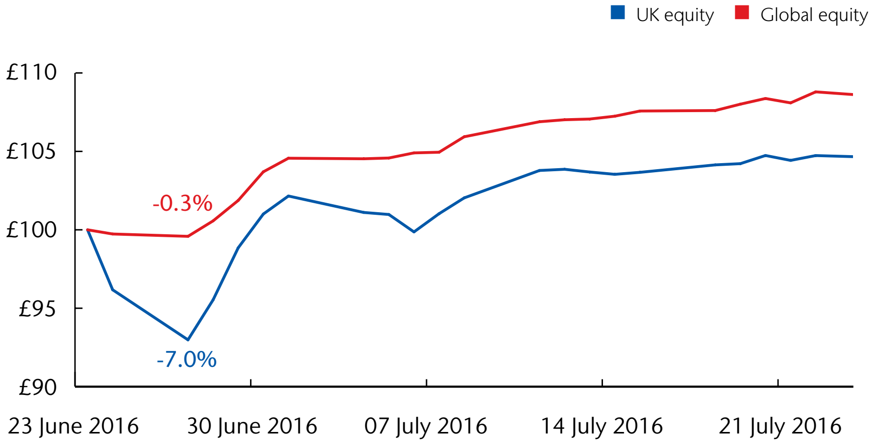
- A significant (above 10%) weighting to UK companies? Leads to a 'home bias'
- Fixed country/region allocations? Leads to an implicit bet that certain markets will perform better than others
- No emerging market exposure? Missing exposure to an important driver of global growth

If the answer is "yes" to any of the above then the first area for consideration is whether these are intended or indeed rewarded deviations from a broad cap-weighted index. Such an index is generally used as a reference for equity investors as it reflects the "average return" earned by global investors. The passive replication of such an index results in a simple, low cost, liquid and generally diversified means of attaining equity returns. To further consider the above questions that we've posed, if your equity investment has a significant allocation to the UK is there an investment rationale or belief behind this.

[1] The critical variables in a cap-weighted index are a company's share price and the number of shares issued. Therefore, the exposure to each company is roughly equal to the value of the shares available to investors.

A "home bias" is an implicit bet that companies listed in the UK will outperform those listed in other regions. The market reaction to the EU Referendum and recent General Election result in the UK was a reminder of how local politics and economic factors can have a significant impact on local markets regardless of where an individual company generates its revenues. Moreover, it can be argued that UK workers have more than enough exposure to the local market through their employment prospects, the value of their homes, etc and so may not need further exposure within their pension savings.

Brexit impact



Source: Aon, Datastream

While we have identified some simple steps that we believe will result in a more diversified equity investment through a move to a global cap-weighted index, there are still a number of potential shortcomings to such an approach. The main problem can occur as the price-driven methodology applies a higher weighting to stocks with higher prices and a lower weight to those with lower prices which can reinforce market "bubbles[2]". Moreover, the index may develop biased exposures by becoming increasingly concentrated in certain stocks, sectors and even countries.

Now we've highlighted the risks, what is a potential solution for DC investors? This is where factor investing (aka smart beta, alternative indexation) can help, by weighting stocks by factors other than their price in an attempt to improve risk-adjusted returns. This is done in a clear, transparent and in most cases a cost efficient manner.

Taking our discussion back to members, we highlight below the four investment strategies which we detailed in *The Rise of Factor Investing: Investing for DC Savers* that we believe are best able to help mitigate some of the risk that DC savers are faced with.

	Quality	Low volatility	Fundamental / value	Momentum
Investment rationale	Stocks of higher quality companies tend to outperform the market	Less risky stocks tend to have better risk-adjusted returns than the market	Stocks with a lower price relative to fundamental measures of value tend to outperform the market	Price trends of a stock tend to persist
Historical volatility	Lower than market	Lower than market	Comparable to market	Comparable to market
Historical correlation	Low with momentum and value	Low with momentum and value	Low with momentum and quality	Low with value and quality
Historical cycle	Defensive	Defensive	Pro-cyclical	Pro-cyclical

Due to the benefits of diversification and the uncorrelated nature of these strategies their combination with a cap-weighted investment can produce a superior performance profile. Moreover, to achieve a more member focused outcome their respective weightings will depend not only on your investment beliefs but the risk and return objectives we are targeting.

[2] The "dot-com bubble" is an example of a period (1995-2001) where the stock price of internet companies were significantly inflated by investor speculation of future growth that wasn't underpinned by fundamentals.

Don't forget currency!

A question that may not have been visited for a while but as a result of Brexit has been brought back into focus is that of currency hedging your equity investments. The good news is that some of this will be automatically applied by DGF and active equity managers but may not be present in your passive equity mandates. As a result of the Sterling's recent depreciation (and therefore boost to unhedged investment returns) it is an opportune time to review your arrangements.

The most appropriate level of currency hedging to put in place will differ based on a number of factors which are covered in detail within *Does Currency Hedging Matter in DC*. These should be discussed with your Aon consultant before any decision is made.

Where to from here?

We challenge you to take your DC process back to first principles and ask "what are we actually trying to achieve for our members?" This is where utilising the Discover phase of our process helps facilitate discussion between all key stakeholders which results, amongst other benefits, in a clearly defined set of beliefs and objectives. This deep understanding of what matters to your members can then be used to develop bespoke investment strategies that are tailored to their unique needs and objectives.

In this paper we have put forth ways in which we can enhance the relatively undiversified equities that are a common occurrence in DC portfolios by:

- **Geography** – reducing the current home bias;
- **Style** – incorporating multi-factor investments to deliver better risk-adjusted returns;
- **Return driver** – including an important global growth engine represented by emerging markets to increase return potential; and
- **Currency** – careful consideration of expected returns and risk reduction to agree an explicit level of hedging.

A final important point is that improving the value of membership in your scheme doesn't necessarily mean using the cheapest investment strategies. We should focus on spending the 'fee budget' where it will truly lead to successful member outcomes.

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