UK Defined Contribution Pension Survey 2020

How do you measure up?

For professional clients only

Aon
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SECTION 4

Made to measure

An ever-changing investment landscape

DC investments and charges

We are now nearly five years on from the Pensions Freedom changes which led many DC schemes to rethink their default investment approach.

> Our biggest challenges are making sure our employees are being charged fair fees (no hidden fees), have a good return on investment and are prepared for Brexit.

Generally, since the 2008 financial crisis, we have experienced a sustained period of positive returns across most asset classes. How do schemes plan to address new challenges, such as finding returns for their members with the expectation of a lower-growth future, and the emerging demand for a greater focus on responsible investment, including new regulatory requirements? How can your DC plan stay on its ‘A’ game?

Investment to-do list:

- Check your default aligns with your members’ needs.
- Streamline your selection of self-select funds to increase engagement.
- Consider the integration of responsible investing into your default fund option and use it as a tool for engagement with members by explaining the connection between their pension savings and the impact on the wider world.
- Review your investment charges on a regular basis to ensure your members benefit from any reductions.

1 in 5

investment defaults still target annuity purchase

Just 8%

of default funds invest in ESG funds

Investment default charges are falling, but underlying fund charges less so

Default investment options

A DC scheme is required to provide a default investment option if it is to be used to comply with auto-enrolment legislation. Most members will remain in this default option rather than making their own investment choices.

Typically, schemes offer a lifestyle or target-date default investment option. This is where a member's DC pension savings are initially invested to target higher growth and gradually switched as the member approaches retirement into assets designed to be appropriate for the method by which they wish to access their savings.

Only

11%

of individuals purchased annuities with their DC funds in 2018/2019

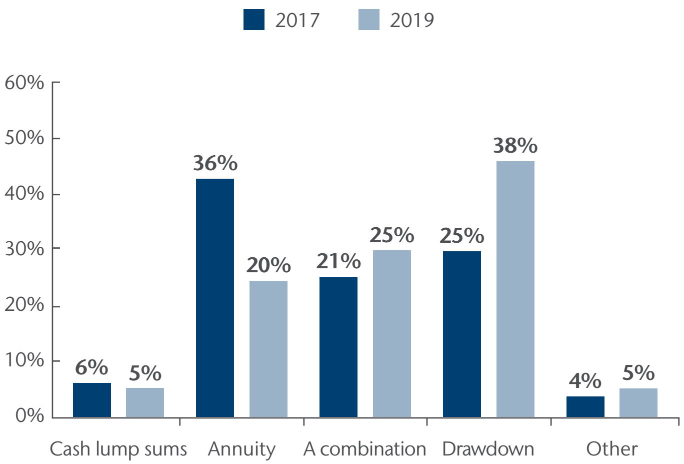
Following the Pensions Freedoms introduced in 2015, there has been a major change in how DC members access their savings. Prior to this, nearly all DC members who could not take their funds under trivial commutation rules used their DC funds to buy an annuity at retirement. By 2018/19, the Association of British Insurers reported that the percentage of individuals purchasing annuities with their DC funds was just 11% of the total.*

The new FCA retirement pathways requirement for contract-based schemes will soon also require a default investment path in retirement. It is likely that trust-based schemes will follow over the next few years.

* Source: FCA website

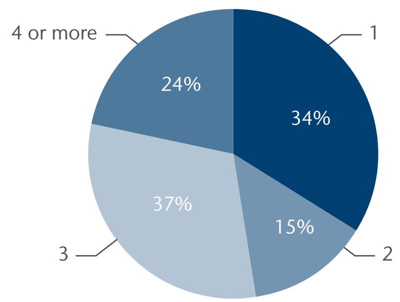
Our survey found that DC schemes have been adapting to these changes in member behaviours. Flexible drawdown is now the most popular target for a default investment. A 'keeping your options open' approach is the next most popular, with one in four DC schemes offering a mixed target approach for their default investment. It could be argued that these two approaches are very similar in that they both result in a multi-asset investment mix that aims to maintain above-inflation growth potential.

While annuity purchase at retirement has become less common over the last two years, our research discovered that a surprisingly high one in five schemes still offer an annuity target as their default investment option. Is this an active decision or a lack of a review?



Our research found that the most common approach is three lifestyle or target date options. Around a quarter of schemes only offer one, and around the same number offer four or more options to members, with contract-based pensions having the highest proportion of schemes in this category. Master trusts are the least likely to offer four or more.

How many lifestyle or target date funds do you offer to members?



While drawdown is the most popular choice, some members choose to access their DC funds in other ways. Schemes are generally looking to accommodate this by offering alternative lifestyle or target funds, aiming to target different options at retirement.

Choices, choices, choices

In society today, we are bombarded with choice. Whether in fashion brands, mobile phone models, or eating out, we are surrounded by a sometimes unfathomable list of options.

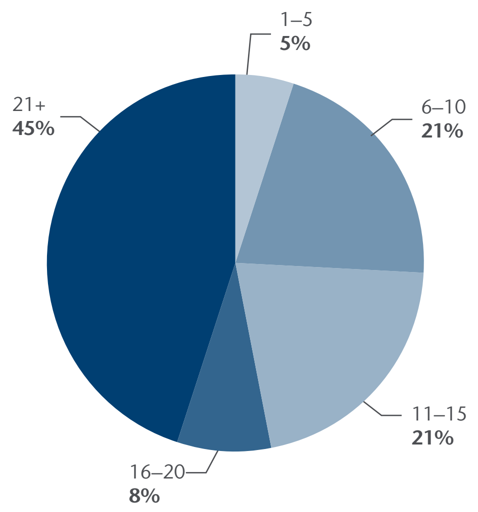
The same can often be said for pension members. Being able to offer an extensive range of individual self-select funds to members was once viewed by some as an important aspect of DC schemes. It gave members flexibility and choices to determine their own future. However, it has become more widely accepted that for most DC members, a large number of investment choices can be a negative.

Too many investment options can make a pension seem overly complex; members are ill-equipped to make investment decisions about their pension savings which can reduce engagement. In addition, offering a high number of self-select funds will increase the complexity of the scheme governance, potentially impacting the trustees' or governance committee's ability to monitor their members' investments adequately.

Aon's DC Solutions

The investment approach taken by Aon's own delegated DC Solutions offers a simple and concise investment menu. It accommodates members under three behavioural characteristics: 'Do it for me' (target date options), 'Help me do it' (objective based funds) or 'Give me full control' (choice of asset classes and specialist funds).

How many self-select investment options do you offer to members?



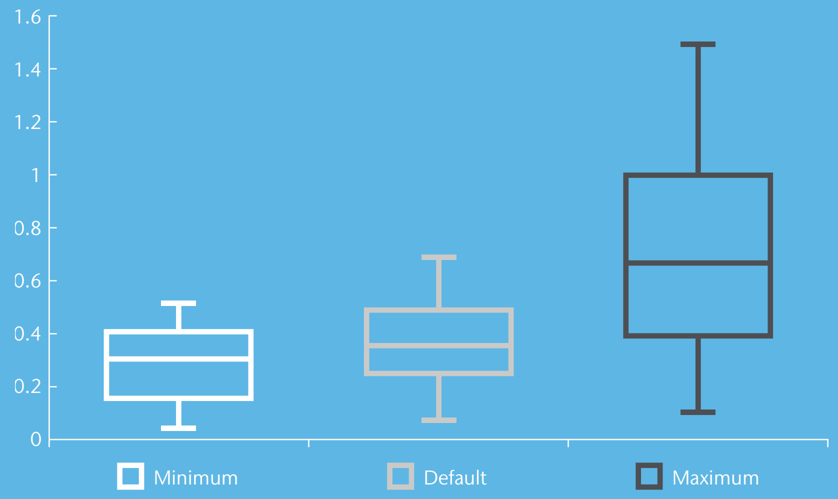
At Aon, we believe in making pensions easy for members. Our DC consultants work with schemes to agree an appropriate range of member investment choices. We help schemes to understand the appropriate level of ongoing monitoring and whether they have adequate governance in place, need to make changes, or should consider delegating this aspect of running their DC scheme. See Section 2 – Weigh up your options, for more on how DC schemes delegate different aspects of their operation.

Charges

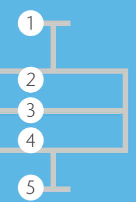
Our analysis found that average charges for default investments have fallen over the last two years, but underlying fund charges have been broadly unchanged.

The fall in default charges may be due to the increase in scale as DC fund values have grown since 2017. However, a much smaller reduction in the typical minimum fund charge (such as a passive fixed-interest investment option) suggests that there are other considerations at play. It is likely that many schemes are taking a more passive investment approach in their default option, perhaps being driven by a focus on cost. While this may seem appropriate in a period of sustained growth, there may be more risk to members in the event of a prolonged market downturn when paying a higher charge for diversification may be invaluable for savers. When considering the investments offered to members, we believe the focus should be on value and potential outcomes, rather than cost in isolation.

Q. What charges do members pay?



Reading the box plot charts



The centre line (3) in each box represents the median average result, while the top and bottom of the 'box' represent the second (4) and third (2) quartiles (ie, the middle 50% of answers).

The end of the whiskers represent the bottom (5) and top (1) deciles, so any results outside these lines are either in the bottom 10% or top 10% of scores.

Responsible Investing

Those running DC schemes are being compelled to consider Responsible Investing – and not just by societal pressure. The Pensions Regulator now requires trustees of DC schemes to state their policy on financial and non-financial matters in relation to ESG.

Historically, the view was that Responsible Investing would very much fall into the non-financial category, ie, it was a matter of ethics and therefore most trustees and employers took the view that it was up to individual members to choose whether they wanted to invest in this way. However, this view is changing.

We are seeing increasing pressure on governments to curb carbon emissions and reduce nations' impact on local ecology (eg, Brazil and the Amazon rainforest). People are becoming more aware of issues relating to how goods are produced, such as concerns about slave labour, fair pay or cruelty to animals.

Companies linked to environmental damage or social issues are under increased scrutiny in the public eye.

Many companies developing environmentally friendly technology or a reputation for being socially aware have gained a strong footing in their respective fields. As a result, investing in funds aligned with these factors can be increasingly profitable and is seen as a sustainable way to generate financial growth.

Jargon buster

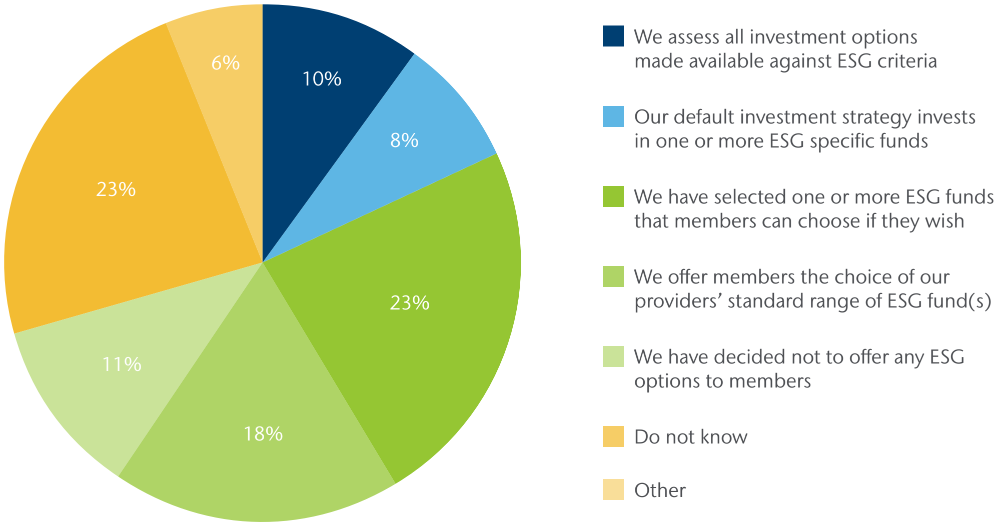
ESG stands for Environmental, Social and Governance.

ESG investing aims to take positive environmental, social and governance factors into account in investment decisions.

The most popular approach, taken by around two in five schemes, is to offer one or more self-select ESG investment options to their members, either through design or based on their provider's standard offering as shown in the pie chart. Only half as many actively incorporate ESG principles on behalf of members, either through investment as part of the default option or by assessing all funds offered against ESG criteria (the blue segments).

Our 2019 Responsible Investment Survey found that over 85% of UK investors consider Responsible Investing to be at least 'somewhat important'.

Approach to Responsible/ESG Investment



57%

of members would be more engaged with their pensions as a result of Responsible Investing

Some schemes are also using Responsible Investment as a way to engage with members. According to the Defined Contribution Investment Forum in Q4 2018, a survey focused on ESG investments found that Responsible Investing would make 57% of members more engaged with their pensions. Schemes that can share 'good news' with their members about how their pension savings are working to make the world a better place, as well as being invested to grow, will be able to engender pride and raise engagement with members.

Alternative asset classes

Despite the increasing prevalence of investing alternative assets in DB plans and consultations about extending this type of option to DC, just 6% of DC schemes say that they would like to extend the range of investment opportunities but are unable to offer the investment types they would like to provide.

This is perhaps surprising, particularly given the focus on exploring ways in which DC members can benefit from the **illiquidity premium** associated with infrastructure or private market investments. There may be various reasons for this: the addition of alternative asset classes can seem extremely challenging, or schemes may feel that their current governance structures or knowledge levels are not suited to effective monitoring of these types of investments. There may also be concerns about potential delays in accessing illiquid investments when schemes need to pay benefits. This can be solved by receiving further training from your investment consultant or delegating investment responsibilities, as covered earlier in this report in Section 2 – Weigh up your options.

Jargon buster

The **illiquidity premium** is the idea that investors should expect to receive a premium, or higher return, on investments which require funds to be committed for a longer period of time in return for the risk of not being able to easily access them.

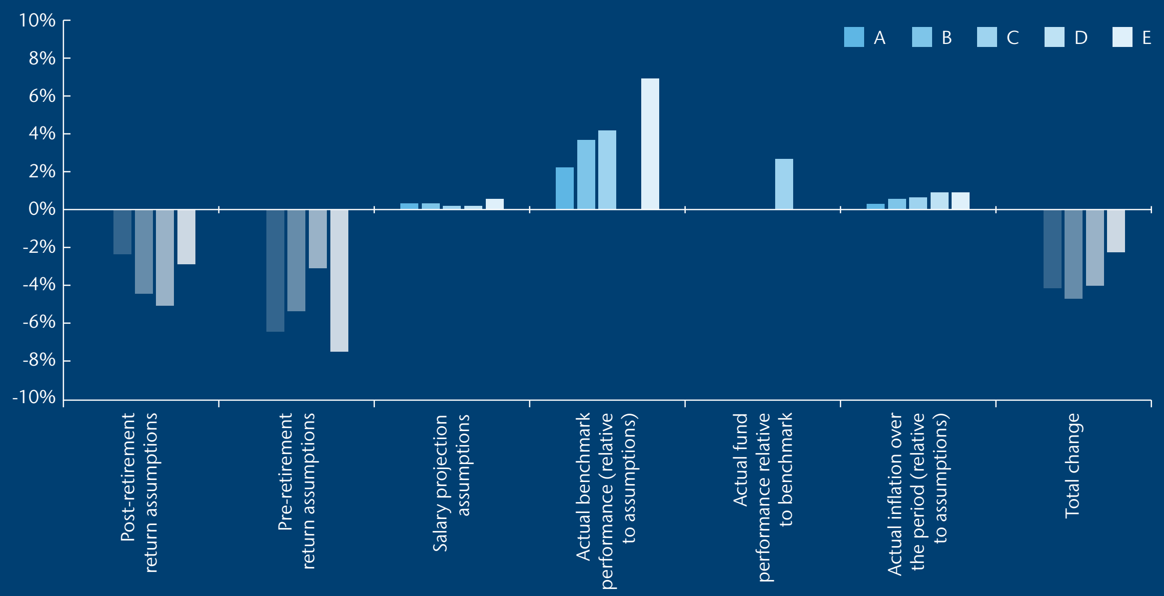
Quick win

Ask your adviser or provider to deliver a training session on alternative investments and different methods of accessing them for a DC scheme. Then you can balance the potential benefits with any challenges to decide whether you think they could improve outcomes for your members.

How Aon can help

Aon consultants can provide analysis of the range of outcomes from your scheme's investment strategy, by using stochastic modelling of projected outcomes of different asset allocation models for your representative members. This approach informs trustees and scheme managers, allowing them to understand the expected range of returns and downside risks that their default investment strategy and alternatives could have for their members. Trustees and companies should consider whether the current investment strategy remains appropriate or whether a delegated approach might help deliver better outcomes for members.

Example member retirement outcomes analysis



Aon point of view

It is important that investment defaults are aligned with member needs, not just in terms of how DC benefits will be taken at retirement, but also in terms of appropriate target levels of investment risk and return at different stages.

Scrutiny of pension schemes' approaches to Responsible Investment is on the rise and, increasingly, members will want to know where their savings are being invested.

The expected lower growth future environment may mean that DC default funds need to adapt to achieve appropriate levels of growth. Those running schemes should seek to understand new types of DC investment opportunities and whether they are appropriate for their members.

Effective measures

Most DC schemes measure the performance of their underlying investment funds against benchmarks, but this may not give them the full picture. It can be useful to measure the aggregate performance of the building blocks at different stages of a lifestyle. These can be measured against objectives such as a specific return target in the case of the growth stages, or volatility or maximum downside targets in the later stages as members approach retirement. Some schemes are now measuring changes to projected member outcomes. These look not only at historical inflation and fund performance data, but also consider changes to forward-looking assumptions to understand how the projected retirement savings of typical scheme members are changing over time.

Contacts

Tony Pugh
Head of DC solutions EMEA
+44 (0)20 7086 1009
tony.pugh@aon.com

Steven Leigh
Senior consultant
+44 (0)113 394 3424
steven.leigh@aon.com

Karina Klimaszewski
Senior consultant
+44 (0)20 7086 9165
karina.klimaszewski.2@aon.com

About Aon

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