DC defaults: will they work for you?

AllianceBernstein

Tim Banks, head of sales and client relations at AllianceBernstein, assesses the benefits of professionally managed flexible target date funds

Is your defined contribution (DC) pension default fund going to meet your retirement expectations? It's a question millions more people need to be asking themselves as auto-enrolment finally kicks in.

Unfortunately, both our research and our experience tell us the vast majority of these new savers won't be asking it – they're what we might call "accidental investors".

As a result, we believe the only way to avoid widespread disappointment and disillusionment with pensions is to ensure the default strategies they end up in adapt with today's fluid employment market. That means they must be professionally managed, simple to operate and able to change with shifting retirement patterns. In our view, only flexible target date funds (TDFs) meet all these criteria.

You may not think of yourself as an "accidental investor" – after all, by reading this article, you have already singled yourself out as being more engaged than the vast majority of pension savers. Unfortunately, even the most engaged individual cannot and may not want to devote the time and resources necessary to ensure their pension savings are managed to best effect. How much more will this be true of the six to eight million workers who will ultimately be auto-enrolled?

Essentially, most of us want someone else to take the difficult decisions on our behalf. Yet, if these default strategies don't match our (usually unspoken) expectations, many of us are likely to be turned off pensions for good. We would argue that the best way to meet savers' expectations is to ensure that someone takes responsibility for actively managing their money, tasked with looking out for their best interests. That also seems increasingly to be the view of regulators.

> **A TDF approach works by directing the saver towards a fund which has objectives that are aligned with their age group**

The Department for Work and Pensions has set out the government's stall clearly in its *Guidance for offering a default option for defined contribution automatic enrolment pension schemes*, published in May last year. The theme that runs right through this paper is the importance of keeping in mind the needs, risks and objectives of the individual savers. We would entirely agree with these aims, but would question whether many existing default strategies currently match those aspirations or indeed have the practical capability of doing so.

The default strategy of choice in DC continues to be a lifestyle strategy, where the investment risk is automatically reduced a few years ahead of a fixed retirement date by moving to a mostly gilts portfolio. Once the set retirement date is reached, the assumption is that the accumulated "pot" of savings is used to buy an annuity to provide the newly retired saver with an income. Lifestyle represented a major advance when it appeared nearly two decades ago but, with the dawn of auto-enrolment, we believe that change is now overdue.

The problem from our perspective is that this inflexible lifestyle default strategy is unable to cope with the fluidity of investing for retirement today. Lifestyle uses a series of individual funds, each owned separately by the saver and changed according to a pre-determined formula on the premise that they will retire on precisely the day determined for them.

This makes it difficult to cope with fast-changing investment environments, evolving investment ideas, changing regulations and the evolving needs of savers. Changing the strategy or its managers involves time, effort and cost, while being confusing for savers. Much better to have a framework that allows changes to be made seamlessly, with a professional manager on the hook for implementing those changes.

We believe the weakness of the lifestyle approach is highlighted by the recent performance of UK government bonds or gilts, which are traditionally regarded as less risky investments. Long-dated gilts are often a major component of the lifestyle portfolios of savers approaching retirement and last year they rose by more than 25 per cent. The Barclays Capital UK Gilt 10Ü Year Index rose by 25.4 per cent in 2011, including reinvested interest.

However welcome that might have been – although, according to William Burrows, annuity rates over the same period only increased by close to 10 per cent – it could have been disastrous for those about to rely on income from a DC pension had gilt returns gone in the other direction.

Furthermore, we believe lifestyle formulas rely too much on a fixed retirement date, a single point in time that may be wrong many more times than it may be right. The temptation to be overly precise in a DC world ignores the fact that we are dealing with individual benefit outcomes. Much better to aim at a retirement window and be open to the different ways in which people will access their money.

Both our research and our experience tells us that professionally managed flexible target date funds can meet these objectives, offering simplicity for the employee, employer and trustee, while delivering investment sophistication and accountability "under the bonnet". The aim, as in a well-engineered car, is to offer apparently effortless performance, while smoothing out any bumps on the journey without troubling the owner with onerous engagement with the (savings) vehicle.

This approach works by directing the saver towards a fund which has objectives that are aligned with their age group. Each fund links savers of a similar age, allowing its investments and management to be much more closely aligned with their needs and risks, while avoiding the spurious accuracy of lifestyling.

Crucially, the asset allocation can be monitored on a day-to-day basis, which means short-term volatility can be dealt with much more effectively than in a lifestyle strategy, where formulaic management inevitably has to be based on a backward-looking view. As to those assets, flexible target date funds are agnostic, allowing any fund type, manager or asset class to be slotted into the structure equally easily and without disrupting the membership.

Moreover, we believe similar age-based funds can be used as an income-paying "retirement bridge" between stopping work and buying an annuity. This would smooth the transition into retirement by giving people more choice, flexibility and growth potential than an annuity and at a more affordable price than fee-heavy income drawdown.

We don't think it's a coincidence that NEST, the state-backed workplace scheme, has adopted flexible target date funds for its default strategy. Indeed, we believe they will become the benchmark for the industry, leaving "lifestyle" as a term used only for fitness clubs. In our view, flexible target date funds will in the future offer a far better way to meet the expectations of all of us who represent the new generation of employees saving for a pension.