How engaging should DC try to be?

Tim Banks explores the balance between encouraging members to be engaged and accepting that they may never get involved with their pension

It hardly needs repeating that the growing importance of defined contribution (DC) pensions is putting the onus on more and more individuals to save for their own retirement. The problem facing the pensions industry is how to make sure these self-directed savers achieve the best results. In an ideal world they would be sufficiently active, engaged and aware to know how to get the most out of their pension contributions. Unfortunately, the reality is very far removed from the ideal.

Our consumer research among employees of organisations that offer DC pension schemes* found that close to 70% of savers and potential savers are unhappy with their financial situation, yet lack the confidence to do much about it. Many of these people typically have no long-term focus when it comes to investing, even though some may need to think about how to save for a retirement forty or more years away. A good number neither enjoy thinking about financial matters nor are they keen to learn more. Indeed, a large proportion of our sample followed no financial plan at all.

Moreover, the picture is not much more encouraging for the minority of savers who think of themselves as engaged. The way many buyers of equity and property funds – who might be thought of as active investors – tend to buy at market peaks and sell on dips is well documented. It seems that most people make poor chief investment officers, even when their own money is at stake.

We think the evidence is clear: leaving people to their own devices when it comes to saving and investing for retirement is likely to lead to poor results. Not only that, but our research is also pretty clear that trying to encourage people to engage more with the nitty-gritty of investing is doomed to failure. Rather than getting people to make the right active choices, we think a better approach is to embrace the "choice" that most of them make by default. Tailor the default approach to work in their best interests and we believe you solve the issue of engagement at a stroke.

Of course, that begs the question: how can you create such a default? Again, our research over many years tells us that age is the single most important factor in determining the risk and return needs of any given individual. By grouping people of roughly similar ages in a single target date fund (TDF) which will mature around the time they are likely to retire, you can create a savings vehicle with an asset allocation strategy (or "glidepath") that changes with members' needs as they get older.

> **"Tailor the default approach to work in members' best interests"**

The beauty of this single-fund approach is not only that it works in individuals' best interests, but it also fits the psychology of the "natural defaulters": those who typically end up in default funds. We believe that, for many such people, burdening them with too much information and too many decisions can actually work against engagement. It may prompt them to bail out. By contrast, a flexible TDF minimises any such information overload. Because all the asset allocation adjustments (and, indeed, changes of fund managers, administrators etc.), happen within the structure of the fund, the members needn't be troubled by having to agree to them or even be notified in advance.

We believe such an approach offers huge advantages in shaping the conversation with members. Instead of spending time and effort trying to persuade them to make the right investment choices, trustees' and/or employers' resources can be much more fruitfully employed explaining how the scheme works and why it's important members save enough. It also means governance can be much more robust. Rather than monitoring an asset allocation they themselves have set, trustees have more time and independence to oversee the professionals entrusted with that task.

Unfortunately, we see too many DC arrangements which expect too much from members. Few people really know their own risk appetite, yet many schemes demand that people determine it for themselves. A better way, we believe, is for professional managers to work with trustees and/or employers to establish their members' "risk capacity" – the amount of risk they need to take at their stage in life. Of course, this will change over time as members get closer to retirement, but with TDFs this evolution can be built into the process and adjusted as necessary along the journey.

We believe that, with auto enrolment round the corner, it is more important than ever that the industry acts in the best interests of the majority, the natural defaulters. That means accepting the limitations of engagement. Use it to encourage people to save and save enough; don't try to educate them in the minutiae of investment. Above all, choose a default like flexible target date funds that we believe both works in their interests and adapts to change seamlessly. ■

Tim Banks is Head of DC Sales and Client Relations at AllianceBernstein.

* Inside the Minds of UK Participants, Harris Interactive, October 2009

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