Target date funds start to deliver

Final salary closures have put defined contribution pension schemes in the spotlight, emphasising the need for a high-quality default fund, writes **David Hutchins**

The recent closure of the last FTSE 100 defined benefit pension scheme (at Shell) and the introduction of auto-enrolment later this year means the focus in 2012 is now well and truly on defined contribution (DC) pension provision.

The debate over what good DC provision should look like will almost certainly cover issues such as the adequacy of contribution rates and how the accumulated DC fund can be turned into a retirement income. However, for DC providers the more immediate issue will be ensuring that their default investment fund is fit for purpose.

Three years ago we proposed that flexible target date funds were the best approach to default fund provision, addressing the governance, risk-management, value-for-money and member communication challenges faced by traditional lifestyle funds. Clearly NEST agrees with us, having adopted this methodology for their default fund offering.

But, given that the concept is no longer new and there is now live experience of such strategies built for the UK market, how did they perform in 2011? Well, judging by the performance of our own range of dynamically managed target dates funds, we think they did a good job for members in a challenging market. Here's the 2011 report card for three of our funds (part of our Retirement Strategies range, where all the underlying stock selection is done passively) for members in three distinct stages of their lives.

For a young saver invested in the Retirement Strategies 2056-2058 Fund, we emphasised the need for future growth, whilst ensuring losses could be managed.

Most of the fund for this saver is allocated to well-diversified equity-like investments (including a significant proportion of emerging market equities). The aim here is to seek the best possible risk-adjusted returns for the saver whose likely future contributions vastly outweigh the value of their accumulated funds.

Over 2011, our risk management approach saw us reducing the equity content as the crisis in the euro area intensified, thus reducing losses, and then increasing the allocation again as the expected returns from equities increased. For a member who started saving £250 per month at the beginning of the year, their total fund value by the end of December would have been £2,840, for a loss of £160 (after fees) on their £3,000 total annual contribution. Not a great result, but not disastrous either in a year in which global developed market equities fell by more than 6% and emerging market equities by nearly 20%.

For a mid-life saver invested in the Retirement Strategies 2020-2022 Fund, we balanced the need for future growth with protection for their accumulated savings.

For this saver our fund has a more balanced approach to investing, aimed at a saver whose ability to make good losses from future contributions or market mean reversion is more limited. As with the younger saver, we reduced the equity content as the euro crisis grew, and hence reduced losses, before raising the allocation again as the expected returns associated with equities increased.

So a member planning to retire in 10 years' time, who started the year with £20,000 and continued to save £250 per month, would have ended the year with a fund of £23,620, net of fees. This member would have been nearly 3% better off than if they had simply put the money under the mattress – a good outcome given the market background.

For a saver approaching retirement invested in the Retirement Strategies 2011-2013 Fund, we provided growth, whilst closely matching the cost of retirement income provision.

For this saver, our funds have a cautious approach to investing given that their ability to make good losses is likely to be very limited. The key issue here is to manage the money against the saver's need to secure an income in retirement. Unlike some traditional strategies, we continue to invest in equities for this group and actually added to our holdings over the year as we perceived the biggest risk for these people was not from equities but a loss of real income due to low returns on government gilts and high inflation.

For a member planning to retire at the end of 2011 and who started the year with £30,000 and continued to save £250 per month, their retirement fund at the end of the year would have been £36,900 net of fees. Indeed, in a year in which annuity prices rose by 10% and cash yielded less than 0.5%, we gave a return of close to 12%, whilst continuing to hold equities in the fund to ensure we could grow the member's savings should they decide to take their retirement fund later.

Whilst we can't talk for other providers, our feeling is that, overall, 2011 provided a positive demonstration of what target date funds can deliver. We will continue to develop our target date funds' investment approach as both the market environment and legislation unfold in 2012. Meanwhile, our customised service means that we can shape the level of risk and return to the requirements of trustees' own specific membership and their choice of underlying fund managers. ■

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