Accepting the limitations of engagement

Tim Banks
Head of DC Sales
and Client Relations
AllianceBernstein

Defined contribution (DC) pensions have not had a good industry press this year. Charges have been attacked, while annuities have been criticised for the way they are sold to disengaged consumers. Many would argue that the real problem lies with peoples' lack of engagement with pensions. This issue was highlighted by consumer research* from the Association of British Insurers earlier this year which found that, for numerous reasons, "awareness and understanding of how defined contribution pensions work, and engagement with decisions that will need to be made at retirement, were very low".

None of this is news to us. Our own consumer research among employees of organisations that offer DC pension schemes** concluded that close to 70% of savers and potential savers are unhappy with their financial situation, yet lack the confidence to do much about it. 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.

We think the evidence is clear: leaving most 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 suggests 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 default strategy and make it as good as it can possibly be. Tailor the default to work in their best interests and we believe you solve the issue of engagement at a stroke.

In creating such a default, our research over many years tells us that age is the single most important factor. By grouping people of roughly similar age 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 glide path) that changes with members' risk and return needs as they get older.

Few people really know their own risk appetite. Far better, we believe, is to take the TDF approach: leave it to professional managers, who work with trustees and/or employers to establish members' risk capacity for their stage in life. This will, of course, change over time as members get closer to retirement, but with TDFs such an evolution can be built into the fund's glide path. Crucially, this can be adjusted as necessary along the journey.
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 burdening such people 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. Instead of spending time and effort trying to persuade members 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 people save enough. It also makes governance 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.

We believe that, with automatic 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 that works in their interests, offers value for money and adapts to change seamlessly. We believe flexible TDFs fit the bill perfectly.

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* ABI Research Paper No. 31, 2012, *Shopping Around for Retirement Income: Unrequested Annuity Illustrations*, report from TNS-BMRB by Ben Toombs and Vicky Campbell-Hall

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

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