Getting the default right

There is growing agreement that a critical element to achieving good member outcomes in a defined contribution (DC) scheme is getting the investment default right. After all, that is where the vast bulk of members' savings is likely to end up.

It is not surprising, therefore, that regulatory and other changes will put pension default funds under the spotlight over the next few years. The advent of auto-enrolment in workplace pensions, the creation of the National Employment Savings Trust (NEST) and the ever-increasing number of pension members reliant on DC savings will combine to make sure of that.

So how can trustees and scheme sponsors ensure that their default is best of breed?

The recently-issued Department for Work and Pensions guidance concerning default funds certainly raises the bar. Meeting the challenge of getting the investment components right without having to engage members is not an easy one when all the evidence suggests the vast majority of members want it done for them.

There has been relatively little innovation in the DC market in the last ten years to assist plan sponsors in meeting this challenge. In fact, what innovation there has been has largely focused on helping members choose where they should invest.

However, new solutions are beginning to appear, such as flexible target date funds (TDFs), that represent an evolution from lifestyle strategies, and help trustees and plan sponsors rise to the challenge.

Advantages of flexible TDFs

Improved diversification

Most defined benefit schemes decided a long time ago that single manager solutions were no longer appropriate. We believe the same to be true in DC. The investment default should use a combination of the best investment ideas available and not be tied to any one manager.

More sophisticated investment strategy

Currently 'lifestyle' strategies work towards a specific date, with an implicit assumption that the member will annuitise the following day. This seems overly prescriptive. Within a flexible TDF, a more robust investment strategy can be designed and implemented - and easily changed when circumstances change. Furthermore, this strategy can be dynamically managed, with the portfolio manager tactically allocating assets based on prevailing market conditions, rather than a 'blind' benchmark.

Improved governance

Flexible TDFs can assist in improving the governance of default funds. Currently, we find that it is usually the trustees or plan sponsor who acts (at least initially) as the fund manager of the DC investment default. We don't believe this represents a strong governance model, given that it entails a dual role of, on the one hand, setting the investment objectives and, on the other, of selecting the investment design and funds. In a flexible TDF, the responsibility (and therefore the risk) for the investment implementation allocation is handed to the portfolio manager.

Future-proof solution

We know very well that nothing ever seems to stay the same in the field of pensions and investments. It is of critical importance to member outcomes not only that the investment default uses the best investment ideas, but that these can be easily changed at any point. Furthermore, as pension regulation and investment markets evolve, it is vital that the default asset allocation strategy can be seamlessly adapted to take account of these changes. We think a flexible TDF answers neatly both these needs.

Summary

We believe that the vast majority of members expect the construction and implementation of the investment default to be handled for them. Put another way, if you had half an hour with a member, you probably wouldn't want to spend it educating them about investment. Rather, you would want to concentrate on how much they are saving and their potential retirement outcomes if they don't save enough.

A flexible TDF allows trustees and plan sponsors to meet members' expectations within a flexible framework that can be easily kept fresh through time.

It will be interesting to see how the market evolves in the next few years. For our part we believe that NEST will have a large bearing on market innovation, and that means that flexible TDFs will have a much greater role to play in DC.

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