The active versus passive debate continues

This month panellists looked at the issues surrounding active and passive funds and what improvements need to be made

At the Defined Contribution Investment Forum (DCIF) it was argued there is a "structural imbalance" towards passive funds in the UK that can lead to "unintended risk imbalances". Do you agree that this is the case?

Tim Banks: While passive fund components are significantly more prevalent in UK DC default funds than in the US, we do not necessarily see this as a structural imbalance. We do however agree that a large number of DC default fund strategies are outdated. Cost has often played a disproportionate role in the investment design process.

Of course, there is no such thing as a passively managed DC default strategy, given that 80% to 90% of risk and return is driven by asset allocation. So getting the 'glidepath' asset allocation right is the most important element in determining outcomes.

Having determined the appropriate asset allocation through time, the glidepath should use the desired fund manager components from the best investment ideas available. Whether these are managed on an active or passive basis should reflect fiduciaries' views, but is clearly a value call for each asset class considered.

> **"Trustees should also keep in mind the longer-term aspects of the fund and not make changes as a result of short-term market moves"**

Finally, the strategy should be put together in a

way in which any element (the glidepath and the fund components) can be changed as circumstances change, without disruption to members.

Andrew Benton: Echoing the findings of the DCIF, we certainly think this is true. While the drivers behind this are well-intended, the outcome is that passive management dominated UK DC landscape. The fundamental issue is defining where 'active' can play a part for the DC member. We would argue that active asset allocation has a key role in generating returns and preserving capital for DC members. This is widely accepted in the DB landscape, where active and passive approaches are used in conjunction to deliver a targeted outcome.

Hamish Brown: Most UK DC plans will currently have a default with 80% or more invested in equities and this does create a risk imbalance for members. However if there is a structural imbalance it is to an over reliance on equities than passive funds per se. An active and passive global equity fund will represent similar risk for members in terms of long-term outcome relative to the plan objective. However the active fund will represent greater risk in terms of outcome relative to the underlying markets.

A key issue when considering active or passive is the appropriateness of the approach to the overall objectives, one is not better than the other. The overall asset allocation of the default will be the key determinant in outcomes for members rather than whether active or passive funds are used. That should be the primary focus for trustees.

Do you think we will see a shift towards increased use of active funds in DC defaults during 2012? What are the issues trustees need to consider when looking at active funds?

Tim Banks: Yes, the investment environment of the last decade has taught us that we need to incorporate both greater diversification and dynamic asset allocation techniques into the design of DC default funds. For these reasons we have seen a move to use diversified growth funds (DGFs) as components of DC investment defaults.

We expect this shift to see more use of the emerging default of choice, flexible target date funds. Flexible target date funds address the single manager risk issue, as well as the cost issue, and can be thought of as age-appropriate DGFs. By using open architecture, flexible target date funds permit the use of combinations of active and passive components, together with the ability to change these components or the strategy at any point.

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This agenda will continue to be driven by the need to find better solutions, increased governance requirements and market innovation.

Andrew Benton: Yes. We see more and more clients incorporating active management of asset allocation in their default offering. The key issues for trustees when considering managers in this space are not surprising. Has the manager generated real returns (after active fees) across benign and challenging economic cycles? Is their philosophy and process clear, have they applied it consistently? And can it be communicated to both trustees and members?

Hamish Brown: Default funds are likely to incorporate greater use of DGFs over 2012 and beyond. The fund may be used in its own right or in conjunction with a conventional equity fund which may be active or passive. Consideration may also be given to volatility controlled funds which will likely incorporate an element of active management. The reason for this is that greater consideration will be taken of volatility than has happened in the past. There is unlikely to be a marked increase in the numbers of actively managed funds that are not diversified growth or controlled volatility types.

Trustees need to consider the active manager's track record, costs, fund objectives and risk taken to achieve the objective. They should also consider issues such as liquidity of the assets held and how the relevant fund may perform during adverse market circumstances.

What steps can trustees take to ensure their default fund is fit for purpose?

Tim Banks: We believe that there are a number of principles that are critical in demonstrating to members that the DC investment default is a well-run option.

- A clear investment objective
- Clearly assigned roles and responsibilities
- Independent oversight of investment performance
- An age-appropriate investment management approach
- Ability to seamlessly change the default as required (strategy and fund components)

- Value for money
- Simple for members to understand

Many of these dovetail with the guidance published by the Department for Work and Pensions in May 2011. In reality, we find that many DC investment default objectives merely describe the default mechanism, rather than stating what the plan sponsor is trying to achieve on behalf of the member. In considering roles and responsibilities, we think it is important to assess the competency of the organisation tasked with performing any given role and the fall-back position should anything untoward happen. Finally, the practical implementation issues should not be an obstacle to good decision-making on behalf of members, while a default fund should be flexible enough to meet changing needs.

Most schemes use lifestyle mechanisms which would struggle to meet the challenges set out above. In contrast, our flexible target date funds have been designed to incorporate these important features.

Andrew Benton: They should take the time to see what constitutes best practice in terms of the default strategies developed by their peers. Over-simplifying the debate into active versus passive is misleading – this often turns into a fee debate, which misses the point. A good default strategy should aim to meet the expectations of members in terms of generating growth, managing volatility and preserving capital in times of extreme stress. Active and passive approaches both have a role in building a default that will met these expectations.

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Tim Banks, director – sales and client relations, UK & Ireland, AllianceBernstein
Tim Banks is responsible for sales and marketing of AllianceBernstein's DC product solutions for pension schemes, plan sponsors and intermediaries in the UK and Ireland. Prior to joining AllianceBernstein in 2010, he held senior positions at Fidelity, Standard Life and Towers Watson, where he specialised in employee benefits and investments, performing several roles in sales, consultancy and business leadership. He is an associate member of the Pensions Management Institute and is Investment Management Certificate (IMC) qualified.

Andrew Benton, head of international sales and business development, Barings Asset Management
Andrew Benton joined Barings in June 2010 to lead all UK, European and Middle Eastern institutional sales activities. Before joining Barings, Andrew spent five years as head of UK institutional sales at Schroders, developing their DB and DC offerings to institutional clients and platforms. Prior to Schroders, he held senior consultant/client roles at RCM Ltd UK, Royal London Asset Management and SLC Asset Management.

Hamish Brown, head of investment sales at AEGON
Hamish Brown has almost 25 years industry experience, all gained at AEGON in a variety of roles. Hamish is ACII and IMC qualified and is a member of the Investment Advisory and Platform Investment Committees. His role includes involvement in new business pitches to corporate clients as well as attendance at ongoing employer and trustee meetings for AEGON schemes.

Hamish Brown: Trustees should take professional advice with regard to the structure of the default fund. They should ensure that the performance and structure of the fund are reviewed regularly (typically at least every three years). Trustees should also keep in mind the longer-term aspects of the fund and not make changes as a result of short-term market moves. Taking account of the Investment Governance Group principles for DC will also help Trustees ensure that the default is fit for purpose.