# The age of default funds

## This month panellists looked at how member engagement can be increased

**As increasing emphasis is placed on defining the right default scheme are we in danger of overlooking those who wish to make active investment decisions?**

**Stephen Bowles:** If we are overlooking anything it's the damage that can be done to the level of retirement income through well meaning, but often catastrophic active member decision making. We treat the achievement of such member engagement as though it is the Promised Land, a solution to all the ills of DC provision. However be it around the area of investments, contribution levels or annuity/income provision I suspect that the track record of the average active member decision is far removed from the panacea that many would have us believe.

Unless members are actively taking individual financial advice then I believe they should all be encouraged to take the more generic 'financial guidance' that's being offered, often for free, through their pension scheme. Be that around the default investment fund or guidance on the type of annuity, members would often be well advised to stick with the crowd rather than going it alone.

**David Hutchins:** We think the vast majority of savers will actually be better off in default strategies. These tend to reduce costs (benefiting from scale buying power) and overcome the inertia and behavioural biases that have done so much damage to savers' wealth in the past.

Take, for example, the billions of pounds left in zombie funds by savers who seem to be engaged initially, but whose investment strategies are then never updated to cope with changing best thinking, pricing and legislation. Even those who remain engaged often struggle to avoid the natural temptation – a behavioural bias in most human beings – to buy high and sell low, as demonstrated by the data provided by the Investment Management Association on retail investment funds. Indeed we are concerned about sending inexperienced

investors down the "do it yourself" or "help me do it" routes, both of which have been shown historically to worsen average outcomes.

Where work is needed, we believe, is to make sure that those who do wish to take active decisions are provided with the appropriate skills and education, and that their engagement is not just fleeting, often focused on the point where they start saving, but is maintained for the rest of their lives. Based on the evidence to date, these are high hurdles for the pensions industry to tackle.

**Saq Hussain:** We generally see three key types of members in DC schemes – those who will make decisions for themselves and are financially aware, those who are engaged and willing to make decisions, and those who are unwilling or unable to take decisions for themselves.

While the former group are happy to select from a large list of funds accessible through their providers' platform provided sufficient information is available, and the latter need helping by means of a default fund, we agree that there is a risk of those members that fall in the middle group being left in the cold.

Fortunately, this can be readily resolved through ensuring that schemes offer a core range of funds which are well explained and is not dauntingly large, together with access to a much broader range of risk-rated funds with appropriate fund information should they wish to go further.

**Laith Khalaf:** This is definitely the case in some quarters of the industry who are obsessed with creating one size fits all investment solutions and imposing them from above on as many people as possible. Or to put it in a less favourable light: 'we know better than you so leave it to us and don't worry your pretty little head about it.' This is nonsense. Individuals are in the best position to assess their own attitude to risk and personal circumstances.

As an example take lifestyling, which de-risks investors' pensions as they approach a retirement date which they marked on a form twenty years ago, taking no account of whether that date has changed. Nor indeed whether they intend to draw their pension in some way other than a level annuity, in which case lifestyling is almost certainly unsuitable for them.

Automatic defaults are important and we should make sure that they are as good as they can be. However we should be investing as much if not more time educating members to put them in a position where they can make informed decisions themselves, even if that decision is ultimately to stay in the default option.

**Hamish Wood:** It will probably take many years before we move away from the situation where the default caters for the majority of individuals in a pension scheme. For that reason, focusing on the default approach is appropriate. Our experience of those making active investment decisions is that they want a broad fund range, tools to help analyse funds and an understanding of what risk may be appropriate. They are well catered for in that respect.

Perhaps a more important decision than selecting funds is how the individual will take an income at retirement. While it will be important to consider what needs to be done to better support those that want to make active investment decisions, the full retirement planning journey should be considered and appropriate support provided.

**What can be done to increase member engagement with investment decisions?**

**Stephen Bowles:** The well worn phrase putting the cart before the horse is never more apt than in DC, in fact often we take it a step further and put the horse in the cart and try and pull it ourselves!

The most important element of pension provision is not increasing investment decision making, it's not even investments generally, it's getting people saving and we are finally moving, albeit at a glacial pace, in the right direction with auto enrolment.

This will undoubtedly have a second order effect of increasing the number of DC investors in the default; something I believe in general should be wholeheartedly welcomed.

If we are to truly look to increase member investment decision making then the only way this can be beneficially rolled out is in conjunction with free individual financial advice and the only source of funding I can see is the less than wealthy UK tax payer.

**David Hutchins:** We think most engagement efforts should be concentrated on issues where they can have most effect, namely how much people should save and what the outcome might be. Successful engagement with these two interlinked issues is far more effective than trying to increase engagement with investment decisions.

The priority for investment education should be to avoid significantly handicapping the strategy unnecessarily by focusing on savers' emotional, and often highly unreliable, "risk tolerance". Instead, we should aim to educate savers about their more objective "risk capacity", something which is largely determined by their investment horizon and hence their age.

**Saq Hussain:** Communication and education is key. Members need to know, in straightforward terms, what the funds they can choose from offer in terms of risk and expected returns, without overwhelming them with too much technical detail.

Two paths to achieving this are making better use of white-labelled funds to better explain what individual funds' aims and risks are, and making sure that funds have a clear risk rating and identify what risks members are exposed to by investing in them.

It's also important to keep members engaged through regular, meaningful reporting of fund performance and more importantly what their investments might be expected to produce at retirement.

**Laith Khalaf:** In two words: good communication. Seminars and one to one meetings are in our experience key to getting pension savers engaged in their pension. This has to be done in simple terms that they understand; the pension industry has a tendency to overcomplicate matters with jargon.

Communications need to be targeted, simple and clear. They need to lead savers through the things

they need to consider and give them concrete investment suggestions at the end of it. Risk profiling tools come up short in this respect. They ask pension members lots of questions and then tell them whether they are an adventurous, balanced or cautious investor; they probably already knew that bit! What they want to know is what to invest in if they are cautious, balanced or adventurous, that's where we can add value.

**Hamish Wood:** Increased member engagement will happen when individuals are more knowledgeable about investment issues and have confidence in making decisions. Increased knowledge results in better understanding which leads to greater confidence in making active decisions. Individuals also have to want to become more actively involved in making investment decisions.

Providing meaningful and jargon free literature covering the basics of investment and the key considerations should be the foundation of helping improve understanding. Web tools also need to be easy to use, easy to understand and model scenarios that are meaningful to the member. And, support from the employer in terms of allowing time for presentations or helping promote the pension arrangement will be important.

It is also important to start increasing knowledge from an early age. Broader financial planning, and what individuals need to do to secure a comfortable retirement should be covered from school age to ensure the basics of saving and investment are understood before a career is started.

**How often should scheme investments be reviewed to ensure they remain appropriate?**

**Stephen Bowles:** Robust governance structures are essential, but such governance needs to be about so much more than the typical quarterly performance evaluation. For example, specialist committees should be established, consisting of trustees with suitable knowledge and experience of DC schemes.

There can be no doubt members' interests are important and time needs to be taken to identify the most suitable investment solutions and products for members, rather than just implementing the 'easy' ones. The default fund should also be a 'safe harbour' for both members and scheme governors, as it stands DC governors remain severely reluctant to take decisions on behalf of members. This presents a material obstacle to progressing investment solutions in DC. Finally we need to move to a position where the governance of derisking assets as well as growth assets is seen as equally important: Governance is required across all stages of the flight path, including the pre-retirement phase.

The other key area that needs to be mentioned is implementation – so many good investment ideas lay unimplemented or only partially

**Stephen Bowles**
**Head of defined contribution, Schroders**
A specialist in the creation of defined contribution solutions for pension scheme clients and consultants, Stephen joined Schroders in 2008 to take responsibility for its defined contribution proposition. Prior to joining Schroders Stephen worked at Prudential with responsibility for the institutional investment only platform, Hewitt Associates as a pensions and investment consultant and held roles at both Fidelity and Friends Provident. Stephen is an Associate of the Chartered Insurance Institute and has the Investment Management Certificate (IMC).

**Saq Hussain**
**Head of DC consulting – North**
**PwC**
Hussain leads the PwC DC team across the North and is involved with helping clients design, implement and govern their pension arrangements, and in particular their investment options.

**David Hutchins**
**Head of DC Investments, AllianceBernstein**
David Hutchins is responsible for defined contribution research and investment design for pension schemes in the UK and Ireland, researching and delivering effective default asset-allocation strategies and retirement income guarantees. He joined AllianceBernstein in 2008 after spending two years at UBS Investment Bank and, prior to that, 13 years at Mercer.

**Laith Khalaf**
**Pension investment manager, Hargreaves Lansdown**
Laith Khalaf has worked for Hargreaves Lansdown since 2001 when he graduated from Cambridge University. As pension investment manager his research skills and knowledge of the UK pension system have made him one of the foremost pension commentators in the country. He is frequently interviewed on television and radio and his comments are regularly reported in the national press.

**Hamish Wood**
**Head of investment sales, AEGON**
Hamish Wood 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.

implemented due to other issues. A classic example is the new default fund which has only been implemented for future contributions due to legal or operational concerns. When I buy a new car I don't leave my existing children in the old one!

**David Hutchins:** Our clients typically review their default fund at least twice a year to check it is performing as they expected, with a more formal review of its objectives and manager(s) at least every three years.

Our experience in this area is that the reasonable expectations of a saver in the default strategy are far greater than most such strategies offer. Savers would expect that the default is subject to continuous oversight by a professional manager, appointed to be independent of those setting its objectives.

Not only would this manager be independently accountable for making the asset allocation decisions necessary to meet the strategy's objectives, but also responsible for amending these decisions in a timely fashion to account for changes in market conditions, best thinking and legislation. An active investor should set themselves no lower benchmark for managing their own money.

In our view flexible target date funds are currently the most credible approach to meeting savers' expectations for a professionally-managed default strategy in the UK market today. Indeed evidence shows that many active investors, once they realise the difficulties of doing it themselves, actively choose a professionally-managed default.

**Saq Hussain:** This should be part of the scheme's ongoing governance processes, and so should be visited regularly – what's important is having a solid governance process in place to ensure that trustees or sponsors have a process for reviewing default options and core funds, how these funds will be monitored for appropriateness (based on returns, risks and appropriateness for members).

It's also important to ensure that schemes are reviewing the right thing – has the population of the scheme changed since the last time the investments were looked at, and are previous assumptions about members' circumstances and attitude to risk still valid?

This is particularly relevant given auto-enrolment, where a scheme's membership might change dramatically in a short space of time with the influx of new members who could have very different expected contributions and risk tolerances to existing members – it may well be that the existing "one-size-fits-all" approach to setting a default lifestyle option is no longer relevant if there are clear groups with different characteristics within the population.

**Laith Khalaf:** Investments should be formally reviewed by the investment adviser every six months and probably once a year by the employer's pension committee.

While regular reviews are appropriate, it is important to avoid short term thinking. An actively managed fund can easily underperform for a couple of years and still be an excellent fund choice.

Look at Neil Woodford who runs the Invesco Perpetual Income fund; he had no exposure to banks coming into the financial crisis and he still doesn't.

This saw him do very badly compared to his peers in 2009 and 2010 as QE prompted a huge and indiscriminate market rally, the so-called 'dash to trash'.

Some people called into question his skill as a manager during this period, but he has been proved right since a dose of realism has hit the markets and a series of scandals have hit the banking industry. Despite a couple of years of underperformance,

Woodford has turned £10,000 invested in at the beginning of 2000 into £31,000 today. Not bad in a 'lost decade' for stockmarkets.

**Hamish Wood:** There is a balance to be struck between ensuring that scheme investments remain appropriate and not reacting to short term issues or performance. For GPPs, most providers will regularly review the funds that are made available to individuals and ensure that the range remains appropriate. The ongoing governance in many cases will also ensure that

action is taken to address performance or other issues when required.

For Trust DC or GPPs where a narrow range is offered, the funds available should probably be reviewed every three years to ensure the options meet current thinking. The default approach should be reviewed every three to five years with the DWP guidance for auto-enrolment defaults a helpful benchmark for the key considerations. Any review should also take account of whether any changes can be made without member consent.

Trustees can control where members invest, and the default. However, under a GPP, while changes can be made to the default, other changes cannot be made without consent unless there is a specific agreement between the adviser and the individual.

Performance should be monitored at annual governance meetings. It is important to take into account performance, relative to the funds' objective and the reasons for any adverse performance before making any changes.