Building a better NEST egg

Panellists analyse the preparations that are being made by National Employment Savings Trust (NEST), such as its commitment to ethical investment

Earlier this year NEST unveiled its investment strategy. What lessons do you think DC scheme managers will take from the NEST approach?

Tim Banks: As providers of flexible target date funds we can very easily understand the rationale for the NEST investment construct. NEST has recognised the very considerable advantages of the flexible target date fund approach.

Flexible target date funds used as a default are an evolution from today's lifestyle strategies. They allow for greater investment sophistication, blending specialist fund managers from the whole of the market to construct age based funds. In using an open architecture framework they allow for greater fund manager diversification, removing any single manager risk that may exist.

Critically, flexible target date funds allow the flexibility to seamlessly change the 'glide path' design or change fund managers without disruption to members. Additionally, this can all be implemented at a cost-effective price, in a range of age based funds that are simple for members to understand.
We believe that the NEST range of funds is likely to become an industry benchmark, and we are aware of some trustees that are looking at them closely.

Andrew Benton: The roll-out of NEST is a positive start and an encouraging development in terms of putting in place foundations and building blocks for pension provision for many of the country's workers. NEST's investment strategy, which in many respects follows a target date structure through its Retirement Date Funds, is similar to some of the investment strategies being followed by a number of occupational DC schemes. For example, many DC schemes have adopted target return mandates as part of their investment strategies so there is some commonality in approach already in place.

Tim Horne: NEST has brought into focus the need for DC scheme managers to understand the profile of their membership when considering the design of the default investment strategy. NEST has also provided a clear statement that relying solely on equities within the growth phase is not the optimal solution and that the risk/return profile of the strategy should be consistent with its overall default objective. NEST has also been very clear about the fees that members will pay; this should result in greater transparency around fees. Scheme managers and members should focus on value for money from their pension providers. Although this does not necessarily mean the cheapest investment option, but rather high quality strategies that have an appropriate risk/return profile for the membership and that are available at a reasonable cost.

Rob Pearce: If you ever wanted a case study to exemplify best practice in DC investment governance, then NEST would be the one. Its whole approach of researching the target membership, designing the default and supplementary fund options and communicating its investment approach and principles, has been inspiring.

Research to ascertain its investors' concerns, objectives and risk profiles, and then use this to design the default strategy, is a lesson that can be learnt by all DC schemes, particularly with the run-up to auto-enrolment. Annually maturing target date funds are unlikely to be available for the majority of DC schemes. However, all schemes can learn from NEST's approach by greater diversification and dynamic asset allocation within their default fund, especially given recent market volatility.
Governance is also about communicating effectively with key stakeholders. NEST's Statement of Investment Principles is informative, comprehensive yet concise, and it is clear that all member communications will be written in simple but effective plain English.

Are there any aspects of NEST's investment approach that you think need to be changed?

Tim Banks: Given the challenge that NEST faces, the strategy looks a very sensible choice and we would endorse the advantages of the target date fund approach. The inherent flexibility of the model, together with the ability to make changes without member engagement is important in getting members the best possible outcome.
NEST undoubtedly will have a unique population of investors, with a high proportion of assets likely to be invested in the default fund. The risk tolerances of the average NEST investor have been a matter of considerable debate, leading to the lower risk start at outset.

There are only a limited amount of managers in the default target date fund series at commencement, and we would expect that, as the assets under management grow, the managers and strategy will change over time. Potentially a number of specialist managers may be sought in each of the asset classes, and alternative asset classes added over time. This change can be easily implemented – an inherent advantage of flexible target date funds.

Andrew Benton: There are many positive characteristics within NEST's investment approach and strategy which should develop over time. However if we do have any concerns it would be around the use of passive management for the bulk of investments certainly at the foundation stage (first five years). While we recognise passive management serves the needs of some investors certainly as a low-cost solution in the early stages, this may not provide the growth that members will need to deliver a meaningful pension over the long term. Here we would like to see NEST consider an element of active management particularly around asset allocation within their higher risk fund solution.

Tim Horne: NEST has conducted a significant amount of research into DC member behaviour, which identified the psychological impact of people losing money, particularly when they are young, on their desire to save. This research has formed the basis of the default investment strategy design, with a foundation stage investing in lower risk assets, and a middle growth phase only targeting a fairly modest level of return. Although the idea is potentially merited from a behavioural standpoint it is not necessarily consistent with the idea

that the longer the investment horizon the greater the level of risk an individual can bear. Therefore we believe that when members are young they should be taking an appropriate level of investment risk via a well-diversified strategy; enabling members to utilise their long-term savings horizon to maximise their potential retirement income.

The key to taking risk in the early years is that the chosen strategy is focused on delivering real returns in a very risk focused way; this should not be considered as a reckless gamble. If a member does not take sufficient investment risk throughout their working career, this could result in them having a poor level of income in retirement. Also by following an all passive investment strategy NEST members are potentially giving up additional returns that can be generated via high quality active management. We feel that passive investments are appropriate as a core part of the investment strategy, but believe that there are opportunities for well diversified active strategies to play an important role in helping members achieve their retirement income objectives.

Rob Pearce: NEST's low-risk default strategy has been criticised for potentially leading to smaller fund values at retirement. They've justified this based on their risk adverse membership profile. Volatility in markets and the publicity that surrounds this inhibits inexperienced investors from saving, so a cautious approach is particularly ideal in the early years. This strategy works well for younger members within the foundation stage, but for older members joining in the growth stage the premise falls down. Could some form of downside protection have been considered? Target date funds may also not be suitable for the demands of the future workforce, who may need to extend their working lives simply because they can't afford to retire. After all, the removal of the default retirement age was for this very reason.

With the potential growth in emerging economies over the next few decades, exposure to these markets could have been included within the range of investment options.

Despite the shortfalls of NEST's investment approach, it will inevitably form the benchmark for DC schemes in the future.

NEST announced it would be including an ethical investment option – are you seeing increased demand for this kind of investment among DC members?

Tim Banks: An ethical fund option has been a feature of most DC plans for some time. Given the regulatory landscape it is a no brainer for trustees and plan sponsors to include an ethical investment option for their members.

While a vast majority of plans have included an ethical option, we have seen little widespread usage of these options and asset levels remain relatively small.
It may be that, with the adoption of flexible target date funds, more meaningful allocations to ethical funds within the default option could be made.

Andrew Benton: We are not seeing increased demand for ethical investment options as such, but we are seeing increased interest in corporate engagement, and how we maintain a dialogue with companies over time on strategy, performance and the management of risk. As long-term investors, corporate engagement is at the heart of what we do.

Tim Horne: We have seen an increasing trend of trustees offering ethical options on a self-select basis. Although the actual take up of these options still appears very limited.

Rob Pearce: There is interest in these funds, but it is low and slow. Increased media coverage and concern about human rights, the arms trade and climate change, leads to direct action such as boycotting and Government lobbying, but this doesn't seem to extend to investing. Awareness and access to these funds could be an issue and the media, providers and pension schemes could do more to raise the profile of these funds.

Members also need to realise that investing in ethical funds doesn't necessarily mean compromising on performance. After all, some of the latest forms of green technology can provide lucrative returns. However, for the discerning and experienced ethical investor, there will always be a reason not to invest in a particular fund. For the governance committee, there could always be the potential embarrassment of an individual stock held under the fund turning out not to be as 'green' after all.

What issues should employers bear in mind before deciding whether to include an ethical option within their scheme?

Tim Banks: The difficulty in selecting an ethical fund option for your plan is that no two ethical funds are the same. What represents 'ethical' to a DC investor is a deeply personal issue. Finding a fund option that will satisfy the requirements of all your specific members is a difficult task. Whichever type of ethical fund is offered, trustees and plan sponsors need to be very clear with members as to the fund objectives and the mandate of the fund manager.

Andrew Benton: In our experience, the two main things to consider in a DC context are, first, whether a fund managed to one particular set of ethical beliefs will be appropriate for a diverse workforce and, secondly, the effect that an ethical investment policy might have on the way the portfolio is positioned and the ability of the fund to deliver the long-term growth needed for retirement.

Tim Horne: Employers should consider ensuring that they offer investment options that allow their members to invest in a way that is appropriate for their own personal beliefs with the governance requirement that comes with offering additional investment funds. However when auto-enrolment starts it will be important that members are not excluded because a DC scheme does not offer investment options that fit their religious or ethical beliefs.

Rob Pearce: Many schemes won't want to be seen to be 'inferior' to NEST, so will look to offer at least a similar fund range. Consequently we are likely to see an inclusion of ethical (and belief funds) within DC schemes, but will they be avidly promoted? As most ethical funds are actively managed, it leads to higher charges and therefore the funds are unlikely to be part of the main offering made up of largely passive, lower-charging funds.

There are many different types of ethical funds available: 'dark', 'soft' green, climate change – with different ethical policies and ways of researching and evaluating holdings. The issue of who is responsible for governance including monitoring performance, objectives and holdings is a key consideration. For trust-based DC this could fall on the schemes' advisers, but for contact based, it is likely to fall on the provider. The answer is not black or white – or even green – but likely to be grey. ■

The panel

Tim Banks, director – sales and client relations, UK & Ireland, AllianceBernstein
Tim 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. 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 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. Prior to Schroders, he held senior consultant/client roles at RCM Ltd UK, Royal London Asset Management and SLC Asset Management.

Tim Horne, DC investment solutions manager, Schroders
Tim Horne joined Schroder in July 2011 prior to this, he worked at Towers Watson, where he provided investment advice to a wide range of corporate DC pension schemes; he was also a member of the multi-asset manager research team. Other previous experience includes working in the DC investment team at Fidelity. Tim is a CFA charter holder.

Rob Pearce, head of workplace retirement services at HSBC
Rob Pearce joined HSBC in January 2008. He has over 30 years' experience in the group pensions market having previously worked at Zurich Financial Services, Eagle Star, Allied Dunbar and AXA UK. Rob is now responsible for the strategic direction and delivery of the business plan for Workplace Retirement Services.