Addressing the needs of the deferred pensioner in DC

AllianceBernstein

Tim Banks of Alliance Bernstein discusses how to help deferred pensioners get the best from their savings

Deferred pensioners are the Cinderellas of the workplace savings industry. Members who leave the company that originally provided their pension arrangement have rarely been top priority for either defined benefit (DB) or defined contribution (DC) schemes. Yet figures* from The Pensions Regulator suggest that well over half of members in DC and hybrid DC-DB occupational pension schemes are deferred members. For this army of people, numbering around 1.3 million, the way in which the pot of money they leave behind is invested will be crucial in determining their eventual income in retirement.

Of course, some of these members may have made a conscious decision to remain with their old scheme. They may have weighed up the options and decided to sit still rather than transfer their pension savings to any new arrangement that is available to them. However, our research into the attitudes and behaviour of people when confronted with pension choices is that inertia usually overrules any other influence.

Deserving better

In practical terms, this means that most members tend to end up in the default arrangements offered by their scheme. Unfortunately, though, the strategy they find themselves in may have been designed some years earlier and never updated. We believe deferred members deserve better. Indeed, we think that the overwhelming inertia shown by pension members can actually be turned to their advantage.

The key is to ensure that the default fund is managed with their expectations in mind.

So let's start by looking at what those expectations might be. We believe that members have a number of clear, if unspoken, expectations.

We think members would expect that the default strategy is being professionally managed, on a daily basis, towards an objective they can understand; that someone is "on the hook" for the decisions that are made; and that the strategy adapts through time, taking account of the changing investment environment, the best new ideas and any evolving retirement patterns.

Finally, the member might reasonably expect that there is some independent oversight built into the model.

Responsibilities

So who is responsible for ensuring that these expectations continue to be met once the member leaves the employer providing the scheme? In a trust-based arrangement it's quite clear that it's the trustees' responsibility. And, in our experience, trustees do take this responsibility seriously, so that when a trust-based scheme decides to change its default offering, deferred members are offered the choice of switching. Unfortunately, we also find that, because they're not engaged, hardly any of the members make the move. In a contract-based scheme the issues are more complex. Very often, the employer and their adviser have moved the scheme to a different provider, leaving the deferred members still using yesterday's solution. So this presents a dilemma.

The issues are compounded by the typical default design, a lifestyle approach, which is an administrative formula that moves the member's pension savings into less risky assets as they get closer to retirement. That is the theory, although we would contend that the asset allocation needs to be managed actively for these members.

After all, last year saw "less risky" long-dated UK government bonds return more than 20% – what if they had gone in the opposite direction? Given the volatility of markets, we think members may be left exposed if there is no-one actively managing their asset allocation.

Lifestyling issues

The problem is that lifestyle ignores prevailing market conditions and is usually only reviewed with hindsight. Moreover, given the expensive and time-consuming way in which the various fund components used in a lifestyle approach are changed, we would argue that the mechanism is a real impediment to good governance. Against such a background, who will lead that change on behalf of the member?

So is there another way to ensure that investment defaults remain current and fresh for deferred members? We believe that flexible target date funds, professionally managed at the total strategy level, can provide an answer.

Crucially, the fund manager is mandated to keep the default up to date at all times using the latest investment ideas, with the assets suitably diversified and dynamically managed within an open-architecture framework. It then becomes irrelevant whether or not the original plan sponsor or adviser are still involved – and it becomes much more possible to meet those unspoken member expectations, irrespective of whether the member is active or deferred.

Tim Banks is the head of sales and client relations at Alliance Bernstein

*DC trust: a presentation of scheme return data, The Pensions Regulator, October 2010