In the driving seat

Target date funds put someone in charge to guide inexperienced DC members in their investment decisions explains Tim Banks, AllianceBernstein

Anyone who remains to be convinced about the importance of default strategies in defined contribution (DC) pensions should look no further than the opt out rates after six months of auto-enrolment. Despite dire predictions that 20% to 30% of workers would choose not to stay in schemes launched to comply with auto-enrolment, the reality has been very different. At Asda, the supermarkets group, for instance, a mere 8% of eligible workers have chosen not to join its new scheme. This is bang in line with reports from consultants that opt out rates are running at between 5 and 10%.

Admittedly, it is early days and only the biggest companies have auto-enrolled so far, but this experience tallies closely with our own. It should also be seen as very good news – for the first time in a while, something may be happening to arrest the long term decline in pension saving. However, the industry cannot rest on its laurels. The next step is for everyone to make sure the experience of these new members is so good that they want to stay and keep saving.

Accidental investors

Yet such goodwill as there is could quickly evaporate. Our research shows very clearly that most savers in DC schemes are "accidental investors". For instance, a survey we did three years ago (but which remains highly relevant) found that more than two thirds were "reluctant" and "unprepared" for what was required of them. Of that total, more than 90% said they would either delegate investment decisions or be guided by others.

We think it is clear. Most people are neither sufficiently engaged nor properly equipped to make sophisticated investment decisions relating to their pensions, yet that is what DC is asking them to do. Auto-enrolment means that many of these disengaged people will end up in default strategies. They need help and, given that a pension should be for life, they need help over an extended period – often decades. We believe that means putting someone in charge, on risk even, who will actively manage the default strategy for the member's benefit now and in the future. It means that "driver" should continue to steer their investments whether they are contributing or not, whether they remain with their original employer, or whether they move to another. This implies a level of fiduciary care which has been alien to the way traditional DC strategies have been run up to now.

Typical of that old approach has been lifestyle. This has been the default strategy of choice for most DC pensions, but we do not think it measures up to the needs of the millions now heading for DC defaults as a result of auto-enrolment. It is true that it de-risks in the crucial period before a saver reaches retirement, typically moving into 75% conventional gilts and 25% cash. Nonetheless, we do not think a fixed formula like that is sufficient to provide the sort of professional active management that most members ought to expect in a default built around their best interests.

Steering the strategy

By contrast, extensive research and experience in DC has confirmed us in our belief that flexible target date funds (TDFs) are ideally suited to meet the needs of default investors. A professional fund manager is given the responsibility of ensuring that the strategy meets the objectives set by the scheme. Not only that, but they are properly equipped for the job, able to use dynamic asset allocation tools to steer the strategy's all important long-term asset allocation through the short term ups and downs of markets, legislation and innovation. In an ever changing world, we think this is vital. Unlike lifestyle, where a predetermined formula changes, if at all, only with the benefit of hindsight, TDFs put someone at the controls who can manage change over the entire savings period.

TDFs are also designed to accommodate the typical behavioural biases of members already apparent from the early days of auto-enrolment in the UK. Savers are effectively telling us they want someone to do it for them. This means that they need to be shepherded into doing what is best. Any default strategy must therefore be built to fit pension savers' risk and return needs, rather than relying on them to take the necessary decisions themselves.

Our research clearly shows that the biggest influence on both these needs is their age. Thus young savers require healthy returns to compound their relatively small savings quickly, but are also well placed to take the necessary investment risks – they have many years of saving ahead of them in which to make up losses. As a result, their portfolios will tend to favour return seeking assets. As they get closer to middle age and on towards retirement, their capacity for taking investment risk accordingly reduces (but then so does their need for returns). So, as they age, the TDF investment "glide path" will progressively increase the amount of diversifiers and risk reducing assets in their portfolios.

However, even at retirement, TDFs will retain a certain proportion of return seeking assets to allow savers to remain flexible about both when a retirement income can be taken and its form. This is essential in a modern world where few people can predict when exactly they will retire. Indeed, research shows that any such predictions are generally accurate less than 20% of the time. Little wonder that, instead of buying an annuity immediately to generate an income in retirement, many people are increasingly finding it attractive to move into some form of drawdown while they decide what to do for the best. This is quite unlike lifestyle, which relies on choosing an exact retirement date many decades in advance of the event and then assuming that the pension saver will buy an annuity immediately. We think this is unnecessarily rigid and out of step with the realities of modern life.

Staying on board

In our view, the TDF approach is a much more sophisticated package than other DC default options currently available. The beauty of it is that it can all be wrapped up in a single fund which the saver can potentially stay aboard throughout their whole lifetime savings journey. Any changes, whether they relate to assets, managers, administrators, legislation or new investment thinking, can be easily and quickly incorporated into this fund. There is no need to be constantly buying and selling individual fund holdings in members' accounts to effect change, nor do members (or indeed sponsors) need to be bothered with the bureaucracy of agreeing every adjustment. So it is simple where it is needed – where it faces the saver – but it is sophisticated where it matters, in ensuring that it is actively managed over time by a professional, with an asset allocation that works in members' best interests.

We also think it provides a much more robust governance model than most DC approaches currently in use. Often, these strategies involve the trustees and/or employer setting the objectives of the scheme, choosing the assets and then also deciding whether the aims are being met.

We believe a more robust approach separates the management of the assets from the monitoring of their performance. With TDFs, the trustees and the employer still set the objectives and oversee whether they are being achieved, but a professional manager is then on the hook for ensuring that the asset allocation does what it needs to do. Not only does this provide better governance and greater independence of oversight, it also allows the trustees and employer to get on with more important things, like ensuring that people join the scheme and save enough while they are there.

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As millions of new savers are auto-enrolled in DC pension schemes, this issue of governance will grow increasingly important, we believe. As we have discussed, most of these new savers will be uninterested and ill equipped for the task of providing themselves with an income in retirement. Many will assume that the default in which they find themselves has been carefully chosen and will be properly managed with their best interests in mind. We do not think that is an unreasonable expectation to have. Unfortunately, we also do not think that most of the defaults on offer today measure up to that expectation.

Now is therefore, in our view, a great time for schemes to look again at their defaults. In doing so, they should also take a long, hard look at flexible TDFs. If they are designed to accommodate people's behavioural biases and with good governance built in, we believe they are currently by far the best way of meeting and exceeding those reasonable expectations of members.

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In a nutshell

- most DC savers are unengaged but will assume the default strategy safeguards their best interests
- current default offerings are unlikely to meet members' reasonable expectations
- we think target date funds will not only meet but exceed those expectations, as they are designed around members' behavioural biases and build in robust governance.