Fundamental question

ANALYSIS: Is there an alternative to the default fund derisking glide path that moves members' equity investments into gilts? **asks David Rowley**

Reinventing the glide path

The fund management industry is used to finding answers for difficult questions, but the current run of historically low gilt yields has left most holding their hands up in despair.

Most believe it cannot last, but few expect a big correction anytime soon. In the meantime pension funds on glide paths to purchase gilts are having to take the pain.

For default funds this is new territory and it is sparking alternative thinking on strategies used in the past five to 15 years of employment, as members move from riskier assets to cash and gilts.

Though, before one looks at the alternatives, the argument against change should be stated.

Savers do not derisk in one day. Any individual derisking over the past five years will have seen the yields fall on the gilts they have purchased but the capital value of those gilts will also have risen and they will be broadly tracking annuity prices.

Also shifting from the safe linear models of glide paths to suddenly taking asset allocation decisions is risky business for individuals, trustees and pension providers.

Legal & General Investment Management (LGIM) follows the instructions of many consultants and administrators as to how it switches defined contribution funds from equities to gilts and cash. Richard Skipsey, head of platform distribution for LGIM, says: "These strategies are pre-determined and if you step out of that you are in a grey area around advice. If you get it wrong you are putting your neck on the block.

"Many of those default funds at the larger end of the market are being reviewed but I have come across little experience of active asset allocation in the derisking period because it is a very grey area around advice. So the trustees will usually implement that strategy and say if the member wants to do something different they will have to do it outside of that.

"The only people I am aware who are making asset allocation decisions are those that are running target date funds."

Indeed, target date fund providers make a virtue of not following linear glide paths. David Hutchins, UK head of DC Investments at AllianceBernstein, says: "Current markets highlight the need for DC defaults not to rely on blind formulas and to be more dynamic in their management of risk."

Hutchins is of the belief that derisking into a diversified portfolio of gilts and other bonds should take place over a far longer time period than traditional lifestyle strategies, whose formulaic transfers over 10 years or less represent a gamble on asset prices.

He says: "In current markets how you react to low gilts yields will vary depending on the overall portfolio. For example younger members, who traditionally hold little or no gilts, will in the short term benefit significantly from the diversifying properties of gilts in a portfolio that mainly consists of risky growth-oriented assets.

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"Conversely older members holding a significant amount of low-yielding gilts already should be diversifying more also by selling some of their gilts and buying more growth-orientated assets.

"Put simply, at the current time, putting all your eggs in one basket does not seem particularly prudent."

A target date fund approach is not the only innovation taking place in the lifestyling of DC funds.

Skipsey reports a number of trends from clients. Perhaps the most predominant being the shortening of the glide path as more schemes move away from 100% equities to diversified growth funds, which are already partly derisked.

Another is for schemes to write to members giving them the choice to make other investment options, a trend that started back in 2008 when there was concern over members crystallising 40% equity falls in the glide path stage.

Some of the alternatives being offered are longer duration government bonds, instead of an all stock portfolio of government bonds, while others are being offered corporate bonds in the earlier years of the derisking phase, often on a 50% credit and 50% long-dated gilts basis.

Further afield there is talk of funds looking at property funds targeting interest rate revenue streams and infrastructure too. There is also talk of derivatives to hedge interest rate and inflation exposure without committing 100% of the assets.

Though, Skipsey adds: "I am not convinced the FSA [Financial Services Authority] is ready for that type of product yet, as while the solution might be created by a board of trustees the underlying investor is a retail one."

Another alternative approach to glide paths is to place greater focus on the type of annuity that will be purchased by the member. Lifestyle strategies tend to target fixed-rate annuities, but some trustees are now offering index-linked gilt strategies for members that want inflation-linked annuities as a tailored option.

Skipsey also predicts as the average size of retirement pots under DC increase in size then the industry will respond with greater sophistication and more efficient models.

He says: "Should derisking strategies be more forward-looking and say we are not buying an annuity today but in five years' time so therefore could the profile of the derisking component be better?

"In essence should we as part of the derisking path be buying into credit or longer-dated gilts?"

Tim Banks, head of DC and client relations, AllianceBernstein

Unpicking TDF myths

It's not hard to see why target date funds (TDFs) are rapidly moving up the agenda for most defined contribution providers.

As auto-enrolment draws nearer, they answer most of the needs of pension members, providers and regulators. However, as a concept that is relatively new to the UK market, there are still plenty of misconceptions about TDFs. Therefore, it's well worth rehearsing how they work and why few of the criticisms stand up to scrutiny.

In essence, TDFs seek to offer all that lifestyle funds can provide, but with more operational and investment sophistication. Like lifestyle, they aim to ratchet down the investment risk in the years before retirement. There, though, the similarities end and the myths begin.

It is suggested, for instance, that TDFs are end-point sensitive. People often say: "TDFs don't make sense because you don't know when you are going to retire." They then go on to endorse a lifestyle strategy that runs to a specific date, which we would argue members don't understand (and therefore don't engage with). TDFs are much less dependent than lifestyle on a fixed retirement date, offering a wide retirement window.

Another myth is that TDFs are an inflexible packaged solution, a sort of one-size-fits-all approach. In fact we would argue it is lifestyle that is managed to a rigid formula, which only allows changes to be made retrospectively. Both the strategic and the tactical asset allocation need to be managed. That's why the latest generation of flexible TDFs puts a professional in charge of the asset allocation, who can make adjustments to take account of current market conditions and the latest and best investment ideas.

Not only that, but they are accountable for the decisions they make, which offers huge governance benefits to employers and trustees. Moreover, by adopting an open-architecture approach, the new flexible TDFs allow virtually any manager or investment style to be used.

It is also argued that, with so many moving parts, TDFs are expensive for the user. Yet, here again, we would beg to differ. We can offer ours at institutional rates, comparable to the National Employment Savings Trust, in packaged solutions that can be white-labelled.

Implementation is vitally important to the experience of all those involved in DC. With lifestyle, implementing change typically involves the saver buying and selling individual funds, with all the administrative and cost implications that involves. By contrast, TDFs simply require the saver to buy one fund linked to their likely retirement window. All changes are then confined within this fund and can be made with minimal or no involvement by the fund holder.

With all these advantages, we don't think the faith being placed in target date funds by those in the industry is misplaced. Indeed, we would argue TDFs will increasingly become the benchmark for DC.

AB AllianceBernstein