Fundamental question

ANALYSIS: Choice is not a good thing when it comes to DC funds, **says Bob Campion.** Are pension savers capable of making sensible investment decisions?

TOO MUCH FREEDOM?

Should active decision-making be encouraged, or should everyone simply be funnelled down the same preordained route? In recent years the debate has swung in favour of the latter approach, championed by the new breed of large scale auto-enrolment defined contribution schemes.

The National Savings Employment Trust and NOW: Pensions favour target date default funds, which lead savers down a path determined only by their likely retirement age. At the most extreme is NOW, which offers no choice at all, while Nest offers a small range of specialist finds, mostly to accommodate diverse ethical views rather than investment views.

Educational disadvantage

But having dismissed the DC pensions member as unable to choose for themselves, have we unfairly disempowered the consumer? The great British public is generally considered a savvy consumer of retail goods. When it comes to buying anything from shirts to groceries, price competition and the availability of information is high. Even for esoteric or infrequent technical products such as car insurance, the plethora of comparison websites ensures it is relatively quick and easy for consumers to swat up and make an informed choice, even though they are not expert buyers.

Consider the purchase of a new laptop. You may know little about memory specs, graphics cards and hard drive space, but that does not stop sellers competing fiercely on these points and retailers providing detailed leagues tables to aid the infrequent, novice buyer. So why is the same not true for investment funds? Advocates of financial education point to the lack of practical training at school age – covering basics such as compound interest and inflation – and the poor quality of information provided to investors which is frequently dull and technical.

Both points are difficult to disagree with, but it is also worth noting that in America, where the average consumer has much more direct investment buying experience, incumbent providers of DC pensions have largely adopted the default fund ethos. The most recent research shows that in the US, 53 per cent of Americans own shares, either directly or though mutual funds, although that figure was 65 per cent in 2007. By contrast, in the UK the proportion is much lower, with one survey by Aviva this year reporting that only 16 per cent of UK families have equity investments.

And yet the headline conclusion of an OECD report into DC pensions, which focused on the US in 2010 was that: "The design of default investment options in DC pension plans is of critical policy relevance, as many members of DC plans are incapable or unwilling to choose investment strategies among the great variety offered."

The problem, as the Department for Work and Pensions discovered in its own early research into auto-enrolment, is consumers do not accept the basic premise that if you risk losing money in the

Irrationally but understandably, consumers are more willing to risk small short-term savings than large long-term ones

short term you stand to benefit in the long term. Irrationally but understandably, consumers are more willing to risk small short-term savings than large long-term ones. And that is due to degrees of scale and importance. The risk of £1,000 losing some of its value in an equity ISA should not be a life-changing disaster. The same is not true of your life savings or pension.

Risk versus reward

DWP research into personal accounts in 2006 implied if members were presented with the full facts and warnings, they would largely end up in cash or extremely low-risk investments entirely inappropriate for a long-term commitment. As a result, the choice of diversified growth funds as the engine of most mass market auto-enrolment default funds is an attempt to accommodate the paradoxical requirement for significant growth without substantial risk of short-term loss.

The analogy does not extend to pension investments because the tension between price and quality that normally guides the consumer's hand does not provide sufficient help. Price can be difficult to identify and quality even harder to determine in investment funds. Crucially, investors do not know what they want, and there may be an inverse relationship between what you need (to take risk) and what you want (not to lose money). This fact is unlikely to change even with a substantial increase in basic financial education. The gulf between the logical choice and the emotional choice is too wide to be bridged in the classroom or on TV; sometimes we just need to be told what to do.

The pensions industry used to view inertia as their enemy. With auto-enrolment it becomes their friend. Workers who do nothing end up in a target date fund managed for them until they retire. They may even be better off than if they made an active decision, as the chief mistake self-directed investors make is they do not review their strategy over time.

The one useful instinct consumers can bring to bear is price sensitivity; competition has certainly heated up this year, with costs coming down across the board on DC funds, driven by anxious employers and an ongoing media campaign.

But the industry should be mindful that by abdicating responsibility for their pension savings, the British public now has someone else to blame if it all goes wrong. Clever really, as if that had been the plan all along.

Bob Campion is a freelance journalist

David Hutchins

Can defaults accommodate active investors?

There is a danger the recent focus on default funds in defined contribution schemes will obscure the need to cater for the few members likely to be actively interested and engaged in the pension process.

The evidence shows many of these active investors, once they realise the difficulties of doing it themselves, will actively choose a professionally-managed default. Flexible target date funds offer the most credible approach to meeting their expectations, but to be effective they must form a core part of an intelligent engagement programme.

A good default is the starting point for such a programme. We suspect few would argue with the view these strategies tend not only to reduce costs (benefiting from scale buying power), but more importantly for active investors, they can also 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 thinking, pricing and legislation. Even those who remain engaged often struggle to avoid the natural human bias to buy high and sell low, as demonstrated regularly by Investment Management Association data on retail investment fund sales.

This is one of the reasons we are concerned about sending inexperienced investors down the do-it-yourself route. If investors who want to take active decisions are to be properly equipped for the task, they must be provided with the appropriate skills and education, and they must stay engaged throughout their lives. Savers' engagement is often fleeting and focused on the point where they start saving. Based on the evidence to date, these are issues the pensions industry has yet to tackle effectively. Engagement efforts should instead concentrate on areas where they can have most effect, namely how much people should save and what the outcome might be. This will be far more effective than trying to increase engagement with investment decisions.

But such an engagement programme needs to go hand-in-hand with the provision of a default that meets the reasonable expectations of active as well as disengaged savers. Both would expect a default subject to continuous oversight by an independent professional manager. Flexible target date funds, whose asset allocation is subject to the constant oversight of an accountable manager, is best placed to meet these requirements. The result should be a default that can indeed accommodate the active investor.

David Hutchins is head of DC investments at AllianceBernstein

AB
AllianceBernstein