Fundamental question

ANALYSIS: Could the public ever be knowledgeable enough about pensions to be able to choose a fund, rather than settle for default? **asks Charlie Thomas**

FREEDOM OF CHOICE

This month saw the five-year anniversary of New Zealand's KiwiSaver scheme. There are now 1.95 million people in the scheme, and NZ$11.8bn (£6.08bn) is sitting in their retirement savings accounts.

Many in the industry have hailed this uptake as a success, especially as a large amount of the members are young.

According to the New Zealand Herald newspaper, around 55 per cent of the eligible population are now in the scheme, and more than 900,000 of its members are below age 35.

The Ministry of Economic Development is in the process of reviewing the six default providers, and a decision on their future is expected by the end of this year, although their status as providers will remain until June 2014 when their contracts run out.

Speaking to the NZ Herald last week, actuary Jonathan Eriksen raised an interesting discussion point by suggesting that now, after five years in operation, it might be the time to remove the default fund system altogether.

"You don't need any default providers because everybody has heard of at least one bank or provider," he said. "When KiwiSaver first launched, nobody knew how successful it was going to be. Now it [the default system] is redundant."

Eriksen also argues that by removing the default players, the misconception that the government would guarantee the KiwiSaver savings would be removed, and risk to the government (in choosing those six providers) would fall.

He came up against criticism in the article, but it raises an interesting point: could we ever get to the point where members don't need a default fund?

Certainly, aiming for a default fund-free zone in the next five years, in either New Zealand or the UK, would be ambitious, to put it mildly. But what if the government finally introduced financial education in schools?

"Financial education would certainly help, as would making pensions simpler," says Jamie Fiveash, customer solutions director at B&CE. "Look at the popularity of Isas; that's because they're easy to understand. We would be for anything that encourages engagement.

"But our experience is members don't pick their investments and, even where they do engage, more often than not they choose the middle option, as they don't fully understand the choices."

KIWISAVER

The biggest default providers

Provider	Funds under management (NZ$)	Number of default members	Total number of members
AMP	$1.3bn (£0.67bn)	82,325	151,169
ANZ Wealth	$2.8bn (£1.44bn)	80,000	470,000
ASB	$2.5bn (£1.29bn)	84,000	350,000
Axa	$802m (£413.5m)	82,482	105,776
Mercer	$638m (£328.9m)	78,148	87,260
Tower	$777m (£400.7m)	66,236	103,901

Source: New Zealand Herald

Even where they do engage, more often than not they choose the middle option

Paul Macro, head of defined contribution in the retirement business at Mercer, also feels financial education wouldn't be enough to support the removal of a default fund.

"The idea of financial education in schools has been talked about for the past 20 years or more, but it still hasn't happened. It would make a difference, but not to the extent where you could remove the default fund. Consider how many people leave school without any qualifications."

Rather than remove the default, Macro would prefer to see trustees spending more time on getting the default approach correct – but to also recognise that for better overall outcomes, members must understand that contribution levels are as important, if not more so, as investment choices.

Jamie Clark, business development manager at Royal London, argues that even after a decade of auto-enrolment the public won't be ready to make investment decisions on their own.

"Fundamentally changing people's attitudes takes more time. It will take a generation to change the deeply embedded distrust in pensions and the wider financial system. Until that happens, default funds will continue to be necessary."

He also called for a concerted campaign by government and the industry to educate people about pensions, using clear, transparent language.

A provider that stands alone in offering no choice is Now Pensions. It has a single investment option for all members – effectively putting everyone into a default.

Morten Nilsson, chief executive at Now, says initially the team discussed whether to offer high and low-risk versions of its fund, but soon realised they were only considering this to "follow the herd". Nilsson firmly believes offering more choice would not have been in the members' interest.

"The advantages of having just one investment solution are numerous. Not only does it make communication with members simpler, we can also invest more efficiently," he says.

"This had led to some advisers and employers concluding 'this is not for us, we need choice'. However, we are currently seeing a shift, with more employers using this as an opportunity to further engage their employees within the scheme, without distracting people with all the investment choice."

The answer to the question of whether, as a nation, we'll ever be ready to invest without the safety net of a default fund seems to be an emphatic no – which makes getting the default fund, and people's perceptions about what they'll receive in retirement, absolutely imperative to get right.

Tim Banks, head of DC and client relations, AllianceBernstein

Delivering effective diversification

Rising stock market volatility and regulatory pressures are combining to put the focus on diversification in defined contribution pensions. As more savers come into DC schemes, regulators are increasingly keen to see risk management measures.

One obvious way is to diversify members' investments across a number of assets. It is therefore no surprise diversified growth funds have increased in popularity as components of default funds. But what does diversification actually mean in this context?

In many cases it can mean the same investment house provides both the asset allocation and the management of the underlying investments. This can work well, but it runs against the norm in defined benefit schemes. After all, it is hardly likely any single manager will be top-performing in every asset. It would surely be better, in an ideal world, if the asset allocator could choose anywhere in the market to find the best managers in their class.

At the same time, it is increasingly important for any asset allocation to be dynamic. An allocation that charts a course for long-term returns will almost certainly need to make adjustments to manage its way through short-term market dislocations. Without a dynamic element, the diversification provided by the asset allocation can easily be undermined by events.

A better way to deal with these problems is to split management of the underlying investments from the asset allocation, while incorporating a dynamic element in the process.

Such a split is easy to effect with flexible target date funds, as all changes are made within the structure of a single fund in which each member of a given age group owns a stake. The professional managing the assets can then pick virtually any fund from the market to fulfil their asset allocation targets. This is less disruptive for the member, who does not need to agree to every change, and makes it much easier to tailor the investment strategy around the philosophy of the provider and/or trustees.

For instance, it is widely accepted that most value is provided in the asset allocation, so the trustees may decide to devote the majority of their governance budget to that. They may also believe some assets are best managed actively, while for others passive is better. All these requirements can be easily accommodated within a target date approach.

No one is suggesting target date funds are the only way to deal effectively with diversification. More attention needs to be paid to the issue – after all, it has long been a central preoccupation of DB schemes. Yet given the risks, it should probably have an even higher priority in DC. Increasingly, DC will not just need to be thinking about it, but thinking about it differently.

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