Flexible deadline

Tim Banks, AllianceBernstein, argues for target date funds to be the new default for defined contribution schemes

The publication earlier this year of the Department for Work and Pensions' (DWP's) guidance for defaults in auto-enrolment defined contribution (DC) pension schemes has further raised the bar for pension providers and trustees. The principles laid down by the DWP, although not binding, are likely to become a benchmark for the industry. Key questions they raise include whether a DC scheme's default option is "managing risk to achieve the best outcome for members". And whether its investment strategy offers an "appropriate and diversified allocation of assets" which takes into account the retirement profile of members. Meeting these standards will be a crucial hurdle for most DC schemes to overcome as we approach the arrival of the first stage of auto-enrolment in October.

Many providers may simply rely on Nest, the state sponsored scheme also due to launch this year, as their fall-back default option when auto-enrolment arrives. However, we think that flexible target date funds are likely to provide a much superior alternative which not only exceeds the requirements of the DWP standards, but also provides an easy to implement solution for most employers and trustees at comparable cost. In this article, we explain why target date can be so effective as a solution to the issues facing DC providers.

In a nutshell

- DWP guidance sets new standards for default funds in the run up to auto-enrolment
- a suitable default needs to be simple and flexible for members, providers and trustees, yet incorporate sophisticated asset allocation and robust governance
- flexible target date funds are designed to meet all these needs at lower cost and with less risk than alternatives.

Simplicity for members

Like the DWP, we believe most members are likely to be disengaged from the pension process. This is why an effective DC default should be designed to achieve the best outcomes for members, but should also require minimal effort by them. We think flexible target date funds are tailor made for the job.

The only demand they make of the member is that they join or, better still, be automatically enrolled in a single fund with a "target date" that approximates closely to their expected retirement age. That fund, overseen by us, then follows an investment strategy or "glide path" that can be designed to fit closely with the needs and risks of this particular age group as it gets older – and can be easily changed when circumstances change. Furthermore, the fund can be dynamically managed, with assets being allocated according to prevailing market conditions, rather than to a "blind" formula.

These attributes mean the fund is well placed to meet the DWP requirement that the fund should take into account "the likely characteristics and needs of the employees who will be automatically enrolled into it" as well as the number of years to their retirement age. Moreover, because a member never really needs to move away from that fund, the amount of administration in which they are involved is kept to a bare minimum. There is no need for them to approve every change of administrator, custodian or even fund manager.

This keeps those distractions which can be fatal to member engagement – like market volatility or bureaucratic detail – to a minimum. It means that communications can be kept brief and to the point, concentrating on key issues like the member's progress towards hitting their pension target and whether they need to save more.

By contrast, a lifestyle approach typically subjects its members to what can appear wild swings in equity valuations right up until a few years before they retire. And, because the de-risking process involves each member owning multiple separate funds, the administration involved can be time consuming and confusing, not to mention the potential for errors to creep in. We do not think this creates an experience for members that is conducive to keeping them aboard.

Changing priorities

But even if members do stay the full term, we do not think lifestyle approaches serve them well at and after the point at which they start to receive an income. In particular, lifestyle funds typically work towards a specific retirement date, with an implicit assumption that the member will annuitise the following day. This seems overly prescriptive.

As in a lifestyle approach, a flexible target date fund will have reduced investment risks by moving mainly into "safer" bonds by the time the planned retirement date is reached. But it will typically involve a more gradual de-risking process and, crucially, will also continue to take a substantial amount of equity risk to allow the fund to grow into retirement if that is what is desired. The result is a default fund that is much better able to cope with savers' changing priorities. For, in the modern world, people increasingly will not have fixed retirement dates – indeed, many will need to combine semi-retirement with a continuing need to earn an income. Target date funds can offer just the sort of flexibility retirees will require in the future.

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Infinite variety

The apparent simplicity of target date funds belies an investment sophistication that would be very hard to replicate in a lifestyle approach. A range of assets, from emerging market equities to index linked gilts, can be blended and infinitely varied to suit the circumstances of members. This is another way in which the fund can help meet the DWP requirement that risk in the default should be managed to achieve the best outcome for members. And it allows for the creation of a much more appropriate investment strategy than is typically possible in lifestyle strategies.

But the flexibility of target date funds does not end there. Just because members are in a single fund does not mean they have to use a single manager. The investment default should use a combination of the best investment ideas, from whichever manager. This is easy to arrange in a flexible target date fund.

Adaptability

It is vital that the default asset allocation strategy can be seamlessly adapted to take account of regulatory and investment changes, without undue upheaval to administrator, member or manager. We think the built in flexibility of a target date fund answers these needs better than other options available, such as a lifestyle fund.

Improved governance

A key area of the DWP principles covers governance of the default. This emphasises that the ultimate responsibility for the default remains with the pension provider or trustee. But the principles also make clear that, where functions are delegated, the accountability for those functions should be clearly defined.

We actually think this offers the chance to vastly improve the governance of many DC schemes. By lifting the burden of asset allocation from trustees or the plan sponsor, we think their scarce time and resources can be devoted to other parts of their role where it can be more usefully employed, such as ensuring the default continues to meet the needs of members. Indeed, we think that splitting the oversight from the investment management role is essential to minimise conflicts of interest and maximise the available expertise.

Despite that, we often find currently that it is the trustees or plan sponsor who is acting (at least initially) as the fund manager of the DC investment default. We do not believe this represents a strong governance model, given that it involves both setting the investment objectives and selecting the investment design and funds. In a flexible target date fund, the responsibility for the implementation of the asset allocation is handed to the portfolio manager.

Worth a second glance

As trustees and providers face the prospect of the forthcoming changes, now is a good time for them to be thinking about whether their DC pensions are meeting their objectives in the most effective way possible. Given the increasing importance of default funds, this introspection will increasingly need to be focused on whether existing default provision meets the standards suggested by the DWP. We would argue strongly that a lot of this effort can be circumvented by those providers and trustees willing to take a much closer look at flexible target date funds.

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