Gauging true value for money

Karen Watkin of AllianceBernstein (AB) explains how trustees can measure the effectiveness of their default strategy

What does good performance look like? When the trustees of a defined-contribution (DC) scheme assess the performance of their default strategy over the past year, how should they judge it? And how should they look to assess its performance in future?

Longer-term benchmarks are easy to establish. Typically, a default strategy has an objective such as beating cash or inflation by a specified number of percentage points. But while that can be fairly measured over five, 10 or 20 years, appropriate short-term benchmarks are much harder to set.

Similarly, it's easy to assess the performance of the individual components of a strategy, by measuring each asset class against a suitable market benchmark. But the aggregation of those benchmarks will fail to reflect one of the most important aspects of the overall strategy: the efficacy of its investment design.

While the strategy's asset allocation can be measured against a composite benchmark, this fails to hold to account the decisions that led to that asset allocation in the first place – and the trustees, consultants and the investment managers who took those decisions. If the benchmark mirrors the asset allocation, then the investment design is simply being marked against itself – a pointless exercise.

At AB, we believe that the glidepath design and strategic asset allocation of our target-date funds (TDFs) is a vital part of the value we add. And we think it should be measured as such. To do this, we think the best practice is to construct a simplified market benchmark. This should consist of a mix of equities and bonds, providing a neutral asset allocation consistent with the default strategy. We do not think this simplified benchmark should mirror the underlying asset allocation, as that will not reflect the risk profile of the strategy.

Our method of constructing a simplified benchmark aims to reflect a given strategy's risk profile. This allows the scheme's trustees to measure the impact of the investment design and therefore how much value has been added through strategic asset allocation. That is, it gives a fair reading of how successful the decision-making behind the construction and management of the investments has been. It also allows an assessment of the impact of other trading or security-selection decisions.

Judging value

So, if we adopt a benchmark that allows us to assess the efficacy of the investment design, how then do we judge whether it's delivering value for money? The first step is to evaluate the scope and quality of each investment service against its cost. Are there justifications for any cost differences from similar investment options? To decide this, we think trustees should ask two simple questions. First, could the same outcome be achieved at a lower cost to members? And, second, could a better outcome be achieved by spending more?

This approach helps trustees to determine the quality of the scheme's investment services. But it can still be hard to judge the scope and quality versus investment costs in the context of what else is available in the market. That's because there is still a lack of transparency when it comes to schemes publicly disclosing the performance of their default strategies. This is especially true of figures that take all costs into account.

Could a better outcome be achieved by spending more? To answer this, trustees need to measure and compare investment performance and outcomes for members of the different options available

Our recent review of the markets suggested that very few master trusts make a full public disclosure of their default strategy's investment performance, net of all costs. Some only disclose their strategic allocation and the performance of its components. Some others don't even appear to disclose anything.

Much of the recent debate about value for money has centred on costs. But that's only half the picture. Remember our second question? Could a better outcome be achieved by spending more? To answer this, trustees need to measure and compare the corresponding investment performance and outcomes for members of the different options available.

In assessing the scope and quality of investment services, trustees should also consider the total costs paid by members for other services – and the impact these have on their outcomes. We still come across many default strategies in which the platform or administration charges account for a much higher proportion of members' total costs than the investment services themselves. Yet it is the investment performance (net of fees) that will ultimately deliver members' outcomes in retirement.

In part, this is a legacy market practice. Buying decisions for DC schemes are still often led by the administrative platform, which means investment decisions are restricted to what is available on that platform. But this can lead to sub-optimal investment strategies being selected. It can also mean asset managers who do not offer bundled services are unfairly penalised and forced to focus on cost rather than value in order to compete. Those asset managers will also be unfairly blamed when retirees' pension pots prove insufficient.

Ultimately, we should see investment design as the heart of a default strategy. Measuring its effectiveness and true value allows trustees to monitor the performance of their schemes and challenge the decisions that they, their consultants and their investment managers have made on behalf of their members.

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