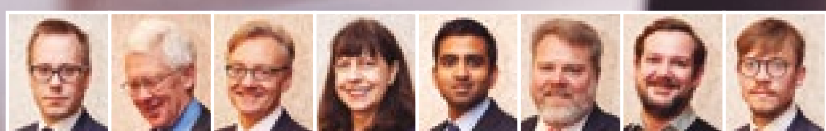
DC investment

New thinking on the future of retirement



*Matthew Bullock | Alan Pickering | Neil Latham | Emma Douglas |
Jinesh Patel | Dean Wetton | Ben Piggott | Sebastian Cheek*

FEBRUARY 2017 | PORTFOLIO INSTITUTIONAL ROUNDTABLE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New thinking on the future of retirement

Defined contribution (DC) scheme trustees have had plenty to think about over the last couple of years. The introduction of freedom and choice has meant having to adapt to an increasing number of scheme members wanting to either take their entire pot as cash or remain invested into and throughtout retirement, all against a backdrop of increasing longevity and heightened volatility.

Despite the changes brought about by the freedoms, innovation from product providers has been slow to appear. There have been some interesting moves from certain areas of the market towards incorporating drawdown into DC investment strategies, as well as ways to include more illiquid private market assets in default funds, but overall progress has been more leisurely than many would have hoped.

But getting the investment piece right, while hugely important, is only half the battle. People could be in the best investment strategy in the world, but if they are not saving enough in the first place then they risk facing an extremely underwhelming retirement. Auto-enrolment has been a success in taking the important first step of getting people to save in a pension, but current contribution levels are far below what they should be and that needs to change.

There also needs to be more emphasis on educating people about what to do with their pot when they retire. What people want is advice, not guidance, from professionals they trust to steer them in the right direction. Incorporating this into DC provision is a tricky, but important and necessary, part of the future.

Another crucial factor is the administration that sits behind schemes. With more savers expected to enter drawdown-type structures, the ability for schemes to be able to efficiently pay income directly to members will become integral, but this is not something many admin firms can facilitate at the moment. Quality administration is underrated by many, but it can help members to save more. Initiatives such as micro investing and auto-escalation are simple but effective ways to help people put away more for their retirement. There is no question that in a rapidly changing DC landscape the industry must place greater emphasis on good quality administration in order to lubricate the investment process and help members save more.

This roundtable sees a panel of asset managers, consultants and asset owners debate the issues around DC investment, including opening up schemes to illiquidity, the different approaches to default fund design, and some of the administration initiatives that will help shape the future of DC.

Sebastian Cheek

editor, *portfolio institutional*

Much illiquidity, but no premium

International best practice shows that DC funds with illiquid assets outperform in general. Daily pricing means UK funds do not benefit as much, but the industry has several initiatives to fix this. *David Rowley* reports.

In Australia, once a quarter, a Melbourne-based organisation called Industry Super Australia puts out a crowing press statement telling how industry superannuation funds have outperformed their peers.

This September, the difference in returns between industry funds and bank-owned retail funds was 2.2% over 10 years, 2% over seven years, 1.8% over five years, 2.2% over three years, and 2.67% over one year.

It's a crushing victory and one of the biggest reasons is allocations to illiquid assets of between 20-30%. Having a captive audience of employers who default their members into a fund relative to their trade or industry gives a stable membership, allowing industry funds to take the risk of owning more illiquid assets.

If that membership is predominantly young, then the allocations can go even higher. This is true of Hostplus, the AU$20bn industry super fund that accumulates retirement savings for Australians who work in hospitality, tourism, recreation and sport. Its default fund has 60% in equities, 15% in property, 10% in infrastructure, 5% in private equity with the remaining 10% in a mixture of cash, fixed interest and alternatives. Unlike the average UK defined contribution (DC) fund, most of its property and infrastructure is directly owned in co-investments with other large institutional investors. It also has an in-house private equity specialist who monitors the allocations and relationships with fund managers. To the end of June 2016, Hostplus delivered returns of 9.23% over five years.

There is a similar picture coming from the US too. In February 2016, Cambridge Associates published a survey of 453 university, college and foundation endowments in the US. The report stated: "Endowment portfolios with more than 15% allocated to private investments have outperformed their peers consistently, and for decades."

UK INITIATIVES

These tales from overseas are inspiring a host of new initiatives to raise the proportion of illiquid assets invested by UK DC funds.

There is an Investment Association report which will be produced by a working group of prominent fund managers in the first quarter of 2017. There is also a working party at the Institute and Faculty of Actuaries looking into it.

The problem is that most UK DC funds access illiquid assets through a life insurance platform which needs to be 'life wrapped' to create a mirror unit-linked policy. This means adhering to an automated trading system and daily trading which does not favour allocations to illiquids.

So, typically illiquid assets are accessed through daily-priced investment trusts within diversified growth funds (DGFs). To what extent these access the full illiquidity premium enjoyed by funds in Australia and the US is a moot point.

Catherine Doyle, head of defined contribution at Newton Investment Management, says DGFs are good for diver-

> **"In an ideal world, you would not be forced into that straitjacket of daily liquidity."**
>
> Catherine Doyle, Newton Investment Management

sification of returns, but not for accessing the full illiquidity premium. "There is a realisation that it is not necessarily the best way of capturing the premium of these asset classes as you do not have the full economic exposure. In an ideal world, you would not be forced into that straitjacket of daily liquidity."

The benefits of direct ownership of illiquids are extolled by one of the world's most progressive owners of infrastructure. Annabel Wiscarson, executive director, UK/Europe at IFM Investors, says: "Private investment allows managers to have governance over the assets, and make strategic decisions to enhance the long-term value of the assets. Adding a liquid component requires different team skills; an acceptance of volatility; and limited governance over key strategic decisions."

DGF managers would disagree with some of these comments.

Mike Brooks, head of diversified multi-asset strategies at Aberdeen Asset Management, says that his purchase of illiquid assets through closed end investment trusts can give the same returns, if not better than directly owned assets.

He cites Greenco's renewable energy fund. "That could have been a listed closed end fund or it could be a fund that Australian investors bought directly into," he says. "It is the same cash flow stream."

He adds that as such funds can trade at a premium or a discount to their net asset value then a DGF has great flexibility to trade at attractive prices. He points out that renewable energy funds were trading at a discount at the start of the year but rose to a premium by October.

The Henderson Diversified Alternatives fund, which is used by the Royal Bank of Scotland DC scheme, believes it can be a shrewd purchaser of unlisted assets too. From experience, it has learnt that many private equity closed end vehicles trade consistently at a discount to net asset value, while infrastructure closed end vehicles tend to trade at a premium to NAV.

ARBITRAGE PROBLEM

Another approach is to use a fund such as the Legal & General Hybrid Property fund, which invests approximately two-thirds in direct UK property and one-third in a global REIT. The REIT ensures all contributions can be invested as soon as they are received until such a time they can purchase UK property directly.

The National Employment Savings Trust (NEST) has used the fund for 20% of its growth phase for the past three years. Mark Fawcett, the fund's chief investment officer, says he is pleased with the returns, the way in which the fund has worked and is now interested in replicating the model for infrastructure assets too.

For the future, he envisages a time when NEST will have the scale to enter into co-investments with large overseas investors, to own assets outright or to participate in a UK equivalent of IFM, where DC investors band together to create their own specialist infrastructure fund manager.

Until that time, the industry will need to come up with working solutions for daily pricing of directly owned illiquid assets.

Fawcett says: "We need daily dealing more than other funds as we get contributions in from employers pretty much every day. It is done to ensure members are being treated fairly and there is no opportunity to arbitrage."

He points out that arbitrage has occurred between superannuation members in Australia in late 2008 when the pricing of infrastructure funds was not updated daily, but those of equities were. This meant those that sold out of their default and moved into cash before an update in the price of the infrastructure assets, were gaining an unfair advantage over remaining members.

Fawcett believes like many others that the key is to find acceptable methods for achieving a synthetic, but fair

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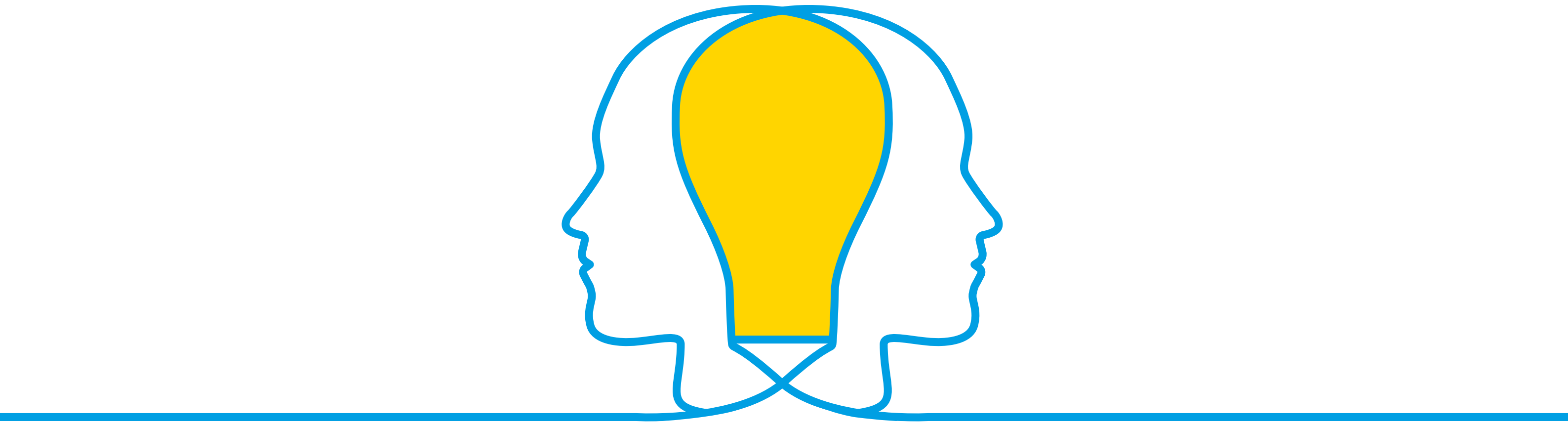

We think that the most effective client relationships aren't just based on mutual interest, they're based on a genuinely shared agenda.

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daily price for illiquid assets.

IFM's Wiscarson explains how the setting of fair daily prices is done by superannuation funds in Australia. "The Australian Prudential Regulatory Authority does not provide rules on liquidity, but rather they provide guidelines due to the unique nature of every fund," she says. "Scheme trustees are responsible for setting the appropriate liquidity policy for members, rather than the underlying managers."

Unlike in Australia, the initiative in the UK is currently being led by fund managers. In a development that has generated excitement across all the consultants spoken to for this article, the private equity specialist Partners Group has launched the Generations fund for the UK DC market.

An open-ended fund, it is daily priced and invests in private equity, private debt, infrastructure and real estate through both listed and direct investments.

Partners Group has been running such funds with monthly liquidity and pricing since 2001 and its experience and scale have led it to gain the operational expertise to be able to create daily pricing based on fair value estimates based on pricing in listed illiquid assets.

Consultants say the fund will be too expensive for DC funds seeking to keep annual management charges low, but the manager says it already has a strong pipeline of potential investors and expects to see inflows in Q1 2017. In addition to this, high net worth manager St James's Place has launched an income drawdown product, the full details of which are not yet pubic, which has high levels of private debt and private equity in it.

HOW SOON IS NOW?

Newton's Doyle says that despite the clamour for change, market demand is still very much for daily dealing and daily liquidity.

"There is a certain amount of nervousness at a move away from members not being able to change their asset allocation model, even though in practice we know they do not tend to trade their investments." She adds illiquids are less transparent and harder to understand.

Equally, Laura Myers, partner at LCP, says there is the extra issue of cost, which will put illiquid assets out of the reach of many schemes that are heavily focused on a low annual management charge within the charge cap.

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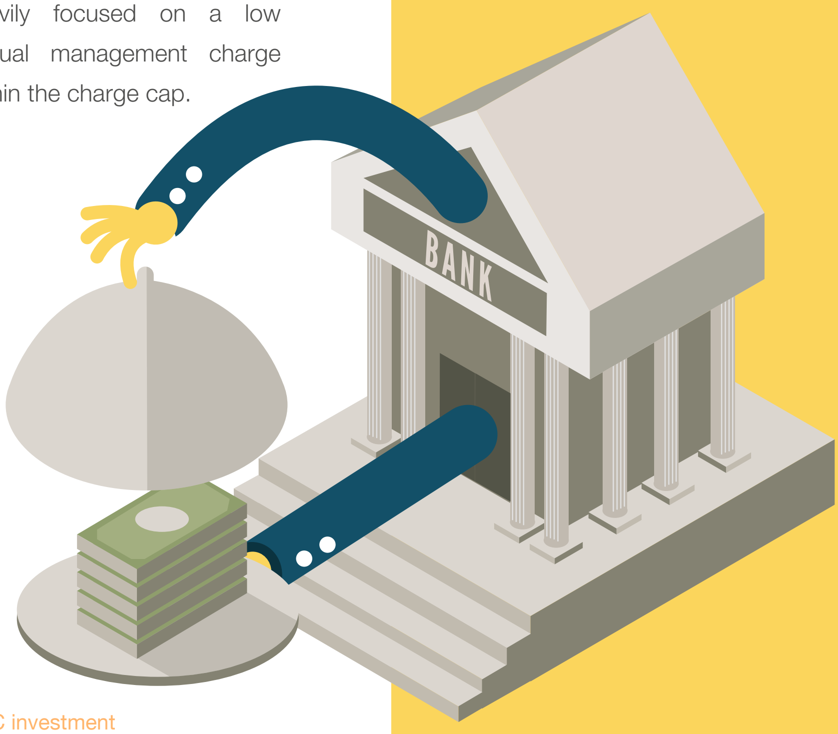
>
> Mark Fawcett, NEST



Jinesh Patel
vice president,
Redington DC team

Dean Wetton
lead adviser and founder,
Dean Wetton Advisory

Ben Piggott
DC plan secretary,
Royal Mail

Alan Pickering
chairman,
BESTrustees

Emma Douglas
head of DC,
Legal and General
Investment Management

Neil Latham
principal,
Aon Hewitt

Matthew Bullock
investment director,
Wellington Management

Sebastian Cheek
editor,
portfolio institutional


Neil Latham

"If you don't deliver a reasonable return above a risk-free rate, then people will not continue to save."

Neil Latham

What challenges does the 'lower for longer' environment present both DC members approaching retirement and the wider asset management industry?

Matthew Bullock: A client's return expectation can be too high, because I know we get asked questions all the time about trying to create a strategy that delivers 8%, 9%, 10% return with very low volatility, and that's not going to happen. There's not enough return out there.

Emma Douglas: It's the contribution problem. If you had more money going in, that would make a much bigger impact on solving the DC crisis. Investment is important, but it's a second-order problem.

Neil Latham: People aren't saving enough. They join schemes paying contribution levels that are too low, and they mistakenly think that once they've joined it's all going to be okay, and it probably isn't.

How far should contributions rise?

Douglas: Certainly 12% was what the adequacy report from the PLSA [Pensions and Lifetime Savings Association] recommended as a minimum. We all know 8% isn't enough.

Dean Wetton: It's even harder because what you're saying to members is, "Every pound that you want to spend in retirement is pretty much every pound you're going to save now, because there's no growth."

Latham: If you don't deliver a reasonable return above a risk-free rate, then people will not continue to save – they're conscious of the charges, and everyone's telling them that charges are too high. They're also conscious that this money is locked away and they can't touch it until later. So, the negatives of long-term saving can start to appear to overwhelm the positives.

Alan Pickering: As a trustee, my current concern is the exit strategy rather than the input challenge. People in their 50s and 60s might even lose nominal value on a cash account. What do you do for people who are facing the challenge of freedom and choice in a completely different environment?

Had it been 8%, 9%, 10% return environment, it would be a lot easier to help them through that transition. With negative returns, it's a double-whammy.

Ben Piggott: What you'll find is that there won't be a cliff-edge retirement date anymore. There's just going to be a great transition into people working longer than they expected, and employers probably having to facilitate that with part-time working and flexible working hours.

Wetton: The challenge for the wider asset management industry is, in a higher return environment, it's easy to have relatively high fees. But in a low risk-free rate with low returns, those fees, at the same rate, become a much bigger proportion. And you're effectively then competing with sticking the money in the bank, which is essentially free.

Piggott: Yes, and for the DC member, it's a double whammy. So, although we're looking at the investment side and the growth side, the other part of your balance sheet, your student loan, your mortgage- they're not going to erode away as quickly by inflation.

So, it's going to take you twice as long to save, twice as much effort to save, and twice as much effort to pay down that debt.

Pickering: It just adds to that negative mood music. "I'm not going to save, because those folk down in London say I'm being ripped off." And then I've got to say, "No, no. You're in a master trust, we're keeping the costs down. It's really, really good." But I've lost it if the newspapers say, "Pensions are a rip-off."

Douglas: That's what worries me. We can get ourselves worried about how awful this message is, and then we've got to communicate that to people who aren't used to dealing with these kinds of things anyway.

And it's really difficult to be honest but reassuring in such a way that people don't just think, "Oh, well, I'm just going to give up, then. That's hopeless. So, I've got to save £10,000 to have £10,000 in retirement, and you're telling me that that's going to buy me an income of £300 per year?"

Alan Pickering

Bullock: In the shorter term the focus on fees is a good thing. However, the question isn't so much how much you're paying. It's the value for money that you're getting with that.

The biggest risk of the focus on fees is to create poorer products to make sure we meet that criteria, which may not be the better thing in the longer term. At some point, when we do see a resurgence in market volatility, we want to make sure people are positioned well for that, and haven't just gone into the cheapest product.

Latham: Is that real? Or is that the spin the investment management industry would put on things; to say, "Oh, you're constraining our cost-cap. That means we're going to give you worse value."

Douglas: It's the asset classes you can't invest in that worries me, in terms of constraining the fees. For a standard developed equity market fund, you shouldn't have to charge that much.

But surely, we should be looking to add in other sources of return, particularly in this very low interest rate environment.

Why should a DC trustee, whether it's master trust or trust, not have access to the full investment set, whereas a DB trustee does? What innovation are we seeing in DC?

Douglas: We have to react as an industry with some new ideas for those pots, as they get bigger. One idea I really like, because it's so simple, is when you have a big enough pot you just split it in half. Half of it goes to buy an annuity. The other bit, you dip into as and when you need. Potentially, that can help you with U-shaped retirement spending.

Wetton: Certainly when the charge cap came out we were not big fans of it. But having grown used to it, and realising that it's a regulatory constraint, actually, it's quite liberating, in that you're trying to do the best you can with that budget. L&G is a good case in point of being able to squeeze as much as you can out of a very small investment budget.

Jinesh Patel: What people need is a more personalised journey. A personalised glide path – so actually, why should you de-risk at a certain age?

Latham: So, we provide members with a suite of tools, and now that everybody's a digital native, we assume they will be able to access these and create their own personalised journey, is that the idea?

Patel: For Redington's scheme everyone has their own personalised default. You've got the option of going into seven different risk-rated strategies, taking into account your personal needs and your income requirements, etc.

Wetton: The issue is, how does that interface with the member? It's the administration that needs the investment. How do you agglomerate it, whether it's in a master trust environment? At the moment, we only know of two or three administrators that are able to pay out natural income from a fund directly through to members. It's that innovation which is missing.

Pickering: That's critical. If you were to ask me, "What are the three most important aspects of a DC scheme?" I would say, "administration, administration, administration." Because that's where, again, you lose the trust of the individual member.

Jinesh Patel

Bullock: In Australia, certain superannuation savers will soon be able to elect to round up purchases in places like supermarkets to the nearest dollar, and it goes into their retirement pot. Now, that, to me, is innovation. If it was rounding constantly, every time you went to the supermarket, you wouldn't notice. That is the sort of path that we should look at.

But it's wrong for us to be too innovative when it comes to actually creating investment strategies. Because that can create things that are too complex, things that, at some point, will not work in the way the investor expects.

Douglas: There is an administrative cost of doing that. The providers who are going to succeed in a DC market are going to have to make that big leap, put the money in, and know this is a long-term investment. That will be the next step-change, and it is bringing the administration systems up to the level we need.

Latham: For personalised journeys the innovation is robo-advice.

Piggott: Well, we have innovated in that space, in terms of the at-retirement, wake-up process. So, if you've got more than £10,000, (i.e. "small pot" cash withdrawals), the company will pay the £X for a whole of wealth adviser. So, it's not face-to-face, but it's over the telephone. So, the adviser would give you written advice on your retirement decision on whole of wealth, annuity-broke for you, and with the drawdown part, they will take it from your trust and put it into a new separate trust.

Emma Douglas

"The providers who are going to succeed in a DC market are going to have to make that big leap, put the money in, and know this is a long-term investment."
Emma Douglas

Latham: Members don't want guidance. They want advice, and no matter how far they go down the do-it-yourself route, they eventually want someone else to say, "That looks all right", as the expert.

Piggott: Yes. There's a huge gap there. It's a whole untapped market and I don't think robo-advice will fill it.

Douglas: One of the things we've been looking at is what we're calling 'micro-advice journeys'. So, it is advice, but it's answering a specific question. Should I put my money into a lifetime ISA or a pension? What should I do with my £25,000 DC pension pot? And then you limit it, so it's not a 100% full fact-find, but it is advice.

What is best practice on designing the ideal default fund?

Bullock: What we're seeing with the investment products is this split beginning to form between funds that are predominately passive and those that are active high alpha. But the bulk of funds still sit in that middle piece, which is active but largely market-type returns and those funds are the ones that will be under the most pressure and will most likely disappear. I would buy passive and some real sort of alpha-generating strategies. That gets me into a much better place than, say, buying 90 or 100 basis points for something that delivers largely what markets do themselves.

Pickering: I wouldn't get too hot under the collar worrying about volatility because people probably

won't read their annual benefit statements anyway, and hopefully, the contributions have compensated for volatility anyway. All the tools used in the DB world should also be used in the DC world. It's when you get to the consolidation and the decumulation phase, when we really have to get our person-specific or group-specific thinking caps on.

Latham: We believe people need to take more risk when they are younger, keep it passive, to keep the costs down and under control, but definitely accept investment risk when they are accumulating.

Pickering: My communications budget, I've spent 98% of it on the over-55s. For the under-55s, it's a case of trying to use inertia and nudging them to pay in enough money. It's when they get to 55-plus when you can start saying to people, "What does your working life and family life look like from here-on in?" But that's where I think we need to do the really innovative member-focused, member-engagement stuff, rather than at the accumulation phase.

Piggott: We have a life-cycle set up. It is a bit of a silver bullet. It's trying to achieve a lot. So, I'm quite

"There's a huge gap [for member advice]. It's a whole untapped market and I don't think robo-advice will fill it."

Ben Piggott

interested to know what you guys think, and where we think the industry will go to, in terms of the investment structure. Are target date funds better than a lifecycle?

Douglas: Are target date funds a communication strategy, more than anything else? Before we had freedom and choice, I was interested in the idea of target date funds that could be very precise in their targeting of an exact retirement year. We nearly launched those at Legal and General, then I was so pleased we didn't when the legislation changed. And now the ones we've got are five-year 'buckets'.

Matthew Bullock

"We've seen a growing number of S&P 500 companies reporting on ESG factors. There is so much momentum there, that it would be wrong not to participate."
Matthew Bullock

What I like about the target date fund structure is that it does provide the member with an ongoing default after retirement, as well.

Wetton: Target date funds are better for communication. They're slightly better for administration. They're easier, from that point of view. It's a lot easier to do in the future, so future-proofing is the benefit of the target data fund.

What role can smart beta and factor investing play in a default?

Bullock: All of those things are important. Smart beta has its place, factor investing has its place.

Wetton: It's an enhanced index isn't it?

Bullock: Yes, and there is a risk of it being mis-sold as something that it's not. It is not the solution to all problems. It is a building block. In our multi-asset portfolios, we use active, we use passive. We're an active manager overall, but we use all the building blocks, as well. We use factors. But we look at factors and say, "It's just a different style of risk. It's not going to be our complete portfolio overall."

Wetton: When you talk about multi-asset, are they those outcome-based mandates? In which case, yes, there's some good thinking going on. But if it's simply scooping up a number of passive things and lumping them in a pot, and not really thinking much about what that asset allocation is – a good example is that conservative multi-asset funds will have done well because bonds have done well.

Bullock: But that's where the potential split that I'm seeing between people who are looking at passive and people who are looking at the more of the active, more alpha-generating, strategies will probably put more pressure on to actually do that sort of work. So, when we are out there talking about a pure alpha strategy, in that case, it is all about the skill of the manager. The upside to that is, the investor can clearly see if we got it right. If we don't, again it's very clear and very obvious that we've underperformed in our objective. So, it's clearer, whereas when you're in that middle space, which is where a large part of the industry has been, managers have been able to rely on beta to say, "We've done a really good job. We've generated some good performance." That's usually because equities are up though – that's not skill.

Latham: As a consultant, we talk to our clients about the objective, which is more growth. We use passive funds in developed markets, because it's cheap, it works, and it's effective. We need active funds in the right places, where we can't use passive, or it's dangerous to do so, perhaps in some of the emerging markets, or bond markets. And we'd also like to have some infrastructure funds.

Patel: Yes, whatever helps you meet the endgame of what you're trying to achieve. Like you say, there are building blocks required at certain places in time. Whether that's active, whether that's passive. As long as it meets the end-objective, what you're trying to do, everything's got a role.

Bullock: You're still running beta in those factors, you're isolating the names that you've got in that passive exposure to being more growth-related-type strategies, and momentum-driven strategies.

Douglas: Yes, so it's really just the tilted index. You're still going to get broadly index performance, but with tilts applied to it. And actually, one of the discussions we've been having recently is with a large UK pension scheme and its use of the Future World Fund. So, that's a factor-based index fund, but with a climate tilt, as well.

Dean Wetton and Neil Latham

Do you canvass members to see if they want that type of fund?

Patel: HSBC [which uses the Future World Fund] did do some member pilot questionnaires, but that was more of a secondary thing. But their focus is to help younger members in particular – I think 60% of their workforce is under 40. They were looking at a long-term investment, and by making this change to the relevant tilt, isn't that a better investment strategy in the long term, versus other options?

Bullock: It's a positive conversation to have, because there is increasing evidence some of these companies that have a big impact on society actually may be the growth companies in the future. It's just a better way of trying to identify them at a very early stage. It's almost like a liquid private equity-type approach, to try to find these companies out there that are going to have a positive impact on society. We've already seen a growing number of S&P 500 companies reporting on ESG factors. There is so much momentum behind there, that it would be wrong not to participate in.

Latham: I would argue that if companies are taking ESG seriously, then their house is likely to be in order in other areas, and they're likely to be well-run, well-governed businesses with strong due diligence. I'm not sure that trustees would necessarily say, "Our objective is to improve climate change." The objective of a trustee is to invest the scheme assets safely, for the benefit of their members, and produce realistic returns. If the membership, though, are saying, "We must do more," then that's a legitimate consideration for a trustee.

Wetton: Yes, but how often do members seriously say that?

Pickering: You'd be skewed by the activist.

Douglas: You can have people campaigning around the building to request some form of ethical fund, and then hardly anyone invests in it, because it tends to be a very small number of members who actually choose this type of fund, so what's bold about this fund is that it is being used as a default. And that's the really interesting decision to take, to replace a more standard global equity fund with a factor-based, climate tilted version of a global equity fund.

Latham: It does put the pressure on, doesn't it? If it underperforms, people will criticise.

Douglas: They will, and so it's very much out there in the public domain, and everyone will probably be watching its progress with a lot of interest.

Wetton: But then you need to be clear that it is an active decision, and it does chew up some governance budget.

Douglas: It will do that.

Patel: It boils down to what risks you think are worthy, and worth spending time on.

Should DC schemes invest in illiquid assets like infrastructure?

Pickering: I wouldn't want to deny access to any stage of the project, from design, to shovel-ready, to build, to ongoing management, so long as there is transparency about what you're signing up for, and more importantly, how you can get out of it if what the fund is delivering no longer meets your requirements. It might be a perfectly good fund, but my scheme might have evolved to a point where it doesn't really benefit from that asset class.

Wetton: We're in the process of putting that in place for a master trust within a target date fund structure, and it's all about getting the governance right, and who's accountable for which bits, who's going to live with the illiquidity mismatch – and whether you have the governance tolerance for it. But it is feasible, and it is worthwhile, because of the low-yield environment.


Matthew Bullock

Douglas: We're looking to add a daily priced private equity and private debt fund to be part of a blended default for one of our clients. There are some gating issues, in terms of getting the money out of it. Then, our group CEO, Nigel Wilson, talks very passionately about urban regeneration, the need to invest in our cities. And that's through building accommodation, for people who are last-time buyers, as well as first-time buyers, or student accommodation. And he's really keen on the idea of a regional fund, so you might launch, say, the Manchester fund, which means that you can invest in a fund that invests in your local area.

Wetton: In the DC environment, you don't necessarily have those chunks to be able to allocate, and you need to deal with contribution flows of £50 per month. And that starts to become the real challenge.

Patel: You can definitely see the master trust with scale being the place. As more assets go in there, they are going to get more of the premiums, and they're the ones that can develop more and have illiquid strategies as part of their default.

Latham: These are bond-like investments. They're perfectly suited to some of the cashflows that come out of DC. Our 2016 survey with YouGov asked members what they wanted to do with their money at

Ben Piggott

"Private debt is the market we really need to exploit and fill the gap from the banks retrenching."

Ben Piggott

retirement. A small number wanted cash, but two thirds wanted an income. These feel like assets that you can hold within the final phase of target date funds and probably never have to liquidate. People understand that some assets, like property, are not quickly encashed, so gate the infrastructure fund, tell members, "If you commit to this, you can't get your money out very easily." Be very clear with people about what the constraints are.

Douglas: There are a lot of ways that you can manage temporary illiquidity.

Wetton: But what you need to be critical on, or be very clear on, is who is wearing that liquidity risk. Is it the member, or provider, or asset manager? That has to be laid out.

Piggott: In managing some of those constraints, so the cashflows, or liquidity, transfers out, etc., and managing those asset allocations, is there a danger that we end up eating into the premium that we're trying to find in the first place? So, to help liquidity, you might hold some cash. Or to actively manage the asset allocation, and then you pay VAT on the management bit, which again, is eating into the premium you are seeking.

Wetton: So, exactly how it gets done is critical. What we've found, for the liquidity buffer, for example, is using a passive small cap fund that we can trade cheaply.

Douglas: Yes, so hopefully, you wouldn't have to hold cash. To me, freedom and choice makes this more viable because there isn't that cliff-edge moment. You know, "I need to get my tax-free cash. Therefore, I


Dean Wetton and Neil Latham

“[Illiquid assets in DC] is feasible and it is worthwhile because of the low yield environment.”

Dean Wetton

must annuitise. Therefore, I need all of my pot now, thank you very much.” We haven’t got that anymore, and that’s why I quite like the idea of this within a multi-asset blend because then, if someone does need to take some money out, they can still take some of their money. There’s so much more reason to do this now, in DC, than there was before. There are the constraints of daily liquidity, but you can manage those within your multi-asset portfolio.

Latham: The difficulty is, finding the infrastructure assets out there to buy.

Wetton: We agree that market is oversold. Certainly, that’s why what we’re doing on the DB side is finding infrastructure projects in Africa, mobile phone towers in West Africa, or gas pipelines in South America.

Latham: Infrastructure is a long-term investment that brings other issues, such as the covenant, surrounding it, into play.

Piggott: I’m not sure all of the alternative investment classes are suitable for DC. For example, I don’t think infrastructure is suitable for post-retirement DC investors.

Wetton: Yes, but private equity is good for growth.

Piggott: Yes, certainly in the growth part, and the target date fund, you know you’ve got that cohort of 20, 25, 30 years of illiquidity, give or take cashflows, transfers out and staff turnover ratios. But the question of, “Are there enough assets?” Private debt, I think, is the market where we really need to exploit and fill the gap from the banks retrenching. Structurally, there’s a gap there, and if pension schemes aren’t going to come in and fill that gap for the prop trading desks and the banks' balance sheet regulatory requirements, then somebody else probably will and the opportunity is gone.

Wetton: Arguably, the cause of the financial crisis was that you had people wrapping debt and then selling it on to someone else. So, the buyers of the debt weren't necessarily well-versed, or understood clearly, the debt that they were buying, the credit risk they were buying. So there was a conflict of interest.

Bullock: I was in Australia before the financial crisis, and I was doing DC over there at the time. And at that point, many market participants were trying to get people into infrastructure, and the people weren't comfortable with the illiquid nature. So, all these vehicles were set up, which provided fantastic daily liquidity, which worked brilliantly until the day it didn't. It kind of feels like we're nudging full-circle. Because we're in a low-growth environment, we're trying to find growth and income anywhere possible, and we're taking illiquids into a liquid state, into a market that doesn't understand the differences between daily pricing and an illiquid asset. And that makes me slightly nervous.

Douglas: You have to think carefully about what you're going to do with the monies that you receive when you can't invest it in a closed property fund. But it's manageable, and so we should not shy away from that. I do share your concerns. Is this the right time to be doing this? But I still think it is, long term, the right thing to do.

Wetton: We deal quite a lot with private equity, and one of the strategies that we invest in is 'secondaries'. So, we monitor the liquidity in the illiquid market for bulk transactions. And it trades sometimes at a premium. The longer-term average is about 10% to 20%. So the irony is, when you really need liquidity, you can probably get it. The only caveat was, during the financial crisis, prices went down about 70%, but it was a spike rather than a prolonged period of write-offs. So, you can liquidate your entire illiquid portfolio pretty quickly if necessary, at a reasonable discount; 10%, 20% is not great, but it's not horrendous.


Emma Douglas

Target Date Funds - Under the Bonnet

By Neil Latham, principal, Aon Hewitt

Target Date Funds (TDFs) are one area where the recent shake-up of defined contribution (DC) pension provision has sparked renewed interest, in particular from product providers. As well as new fund launches, we have seen a number of managers revamping existing funds to reflect the new pension flexibilities now available. But what effect has this had? Aon's DC Survey identified that 12% of respondents are using TDFs, but there was also a startling knowledge gap – two out of five respondents were not familiar with TDFs.

You could certainly be forgiven for being in the 'don't know' camp. The pace of change in DC has been staggering, and is certainly proving a challenge for many trustees. TDFs are not new. Pioneered in the US back in the early 1990s, US TDF assets are now more than $750 billion according to Morningstar research, and growth is set to continue. The best known UK use of TDFs is by NEST (the National Employment Savings Trust) which uses TDFs as its default strategy. The fact that TDFs control the asset shift within the fund has a number of important implications.

Advantages of TDFs, compared to lifestyling

- Professional management
- An easier concept to communicate to members; pick a planned retirement date and stay invested until fund maturity of glidepath asset allocation and underlying fund components
- Tactical views to adapt to changing market conditions
- Ease of making changes at the fund level
- Simpler administration, by removing the need for asset allocation switches
- Custom fund design is sometimes possible, although requires sufficient scheme size

Disadvantages of TDFs, compared to lifestyling

- Lack of tailoring to match target year of retirement; often span three to five-year periods
- Not always best in class funds; typically comprise funds from a single provider or manager, regardless of skill across different asset classes
- Member retirement plans may change which may mean having to disinvest and reinvest in another vintage
- Potentially more expensive: fees are payable for both TDF management and design of the glidepath
- Less transparent in the eyes of some commentators, but could be overcome by thoughtful communication

A question of governance

Both TDFs and lifestyling are geared towards the same objective; providing an investment strategy which maintains an appropriate balance between risk and reward over the working lifetime of the members. Both approaches can follow a similar glidepath, investing in higher risk assets during the early part of a member's career and progressively moving into lower risk assets as a member approaches retirement.

But do not be lulled into thinking this is purely an investment decision. The key question is one of delegation, and how much of the decision-making you are comfortable delegating to one fund manager or provider. By using TDFs, you are delegating not only the design of the glidepath but also the choice of underlying asset class structure and manager.

This means that understanding how a TDF strategy works is critical, as well as picking a provider with the necessary skills to deliver the best possible outcomes for your members. One pitfall investors need to avoid is failing to examine the detail of the underlying components. Remember to look under the bonnet, and consider the pros and cons in the context of your individual scheme circumstances.

About Aon Delegated DC Services

Aon Delegated DC Services brings together the best of Aon's DC and investment expertise, to position trust-based schemes for investment success and to drive better member outcomes by: providing schemes with greater access to investment expertise than trustees normally have time to provide, strong governance structures and a broader range of investment options for members.

Trustees work with Aon's DC investment experts to develop their investment strategy, set their scheme objectives, as well as determine a glide path. Aon then implements this strategy on behalf of trustees, working with Aon's experienced delegated investment teams to deliver that strategy efficiently.

We provide:

- DC fund design and construction, including: Default fund strategy, alternative lifestyle strategies, and Aon-designed target date funds; as well as a range of white-labelled self-select funds
- Asset allocation decision within those strategies
- Fund manager selection, transition and monitoring
- Comprehensive investment reporting and fund factsheets for members
- Governance review and documentation

All delivered with, transparent, charge cap compliant investment fees and market-competitive charges for the services. To learn more, contact Joanna.sharples@aonhewitt.com.

Jargon Buster

Target Date Fund

A multi-asset fund with a built-in glidepath strategy. The fund manager controls the asset allocation and de-risks the strategy as the target date approaches. Providers typically offer TDFs at intervals of three to five years (e.g. 2040 Fund, or 2045 Fund) and members should select the fund which broadly matches their planned retirement date.

Lifestyling

A strategy where the member makes a single choice to select the lifestyle option, and their savings are moved from higher risk/return funds to lower risk/return funds at predefined periods before their selected retirement age. The strategy is designed by the scheme, and the administrator implements the required movements between funds.

The new passive? – Tracking the rise of factor-based investing

By Aniket Das, investment strategist, Index & Smart Beta, Legal & General Investment Management

Not only does index investment still have a crucial role to play in portfolios, but the rise of factor-based investing, or 'smart beta', means that investors now have a single route to accessing the potential benefits of both active and passive investing. Factor-based investing, which seeks to identify the underlying characteristics that drive performance, has grown rapidly since the global financial crisis. This is because investors are looking to go beyond asset class labels and understand the true drivers of risk and return in their portfolios. Investors are using factor-based investing across equity, fixed income and multi-asset strategies, seeking a cost-effective route to enhanced returns, lower risk, or higher levels of income.

What are factors?

Market factors can be defined as any broad driver of the performance of an asset class. Examples include growth, inflation and interest rate sensitivity. All three of these factors are typical drivers of corporate bond prices, for instance. Shocks to growth can hurt company profits and a bond's safety, while changes in interest rates and inflation levels can affect the discount rate investors use to price the bond.

While broad asset class returns can be explained by market factors, we have to look at individual securities to explain the performance of a portfolio holding active, or off-benchmark positions. We can then see that certain characteristics, or factors, drive the performance of one security relative to another, and that these characteristics are distinct from market factors.

In the case of equities, factors are labelled under groups such as value, size, momentum, low risk and quality. These groups of characteristics, alongside market factors, better help to explain the different drivers of overall portfolio performance.

Fig 1. Describing different factors

Value	The value factor considers how 'cheap' a stock is relative to others based on comparing a stock's price to company financial data such as earnings, cashflows, sales or book value.
Low risk	The low risk factor in academic literature is defined variously as low stock price volatility, low market beta or low idiosyncratic volatility, though all the definitions rest on a similar behavioural concept of low risk investing.
Quality	Quality companies are those that produce strong, sustainable returns for shareholders; this factor is usually defined by a combination of measures including high profitability, low investment and/or low leverage.
Small (size)	The size factor refers to the market capitalisation of a company, with mid and small-cap having more exposure to this factor than large-cap companies.
Momentum	Momentum is typically characterised by a stock's return over the past 12 months, with strong momentum indicative of high historical returns.

Choose your factors carefully

While factors may drive risk and return, they do not necessarily produce a positive long-term return. Investors must therefore be careful to understand which factors are likely to be rewarded when choosing where to invest. We would suggest investors consider the following three questions:

- Is there an economic reason, a behavioural trait or a structural anomaly as to why the factor should be rewarded?
- Is there a body of academic research supporting the existence of a positive return premium in the factor?
- Is there evidence of the factor working in multiple regions, time periods and possibly asset classes?

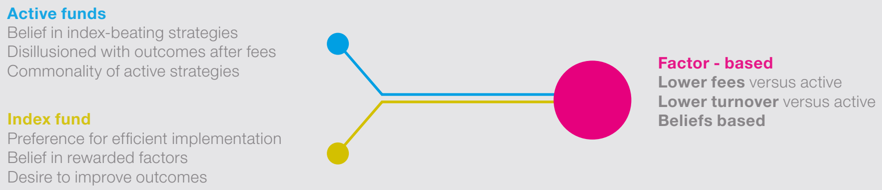
Answering these questions is fundamental before plotting a course towards factor-based investing if investors are to gain the type of outcome they desire.

How can factor-based investing help investors?

We believe investors are increasingly looking to factor-based investing, or 'smart beta', for three key reasons:

Active management – Many investors currently holding exposure to 'traditional' market-cap weighted indices believe in index-beating strategies and are looking to generate better outcomes.
At a lower cost – Investors wish to access some of the benefits of active management but at a much lower cost.
With improved diversification – By providing a different potential source of return to more traditional investment strategies, factor-based investing can have attractions for investors looking for increased portfolio diversification.

Fig 2. Why are investors looking to factor-based investing?



With a large number of investors already having exposure to single-factor smart beta strategies, many are now taking this a step further by moving to a 'multi-factor' approach. As individual factors have their own cycles of performance, diversifying across a number of factors can help to smooth returns over time, leading to the potential for improved risk-adjusted performance.
It stands to reason that equities exposed to different factors can perform differently. For example, based on comparisons against a market capitalisation weighted global equity index, since September 2003 smaller companies, or the 'size' factor, have produced higher returns than the market-cap index, but with greater volatility.
'Momentum', 'low risk' and 'quality' have also outperformed the market cap index, although 'value' has underperformed over this time period. Crucially, however, combining the five factors in equal weights has produced higher returns than the market-cap weighted index, but with lower volatility than many of the individual factors.
A further application for smart beta could be to use factors while limiting the exposure to market risk, e.g. through an appropriate short position in equity futures. This leads to the creation of pure factor portfolios which generally have a generally low, sometimes negative, correlation to market returns, and may therefore be suitable for investors seeking additional diversification from traditional equity and credit market exposure.

The new passive?

The use of factor-based investing is growing, with investors understandably attracted to the benefits of transparent, rules-based strategies with strong links to academic research. Investors are also increasingly using the approach to try to gain a better understanding of risk and return, increase diversification, enhance return, reduce risk or generate income – all in a cost-effective manner.
To date, our experience with investors shows that this new innovative route to 'passive' investment is proving popular, and helping investors to achieve their desired outcomes.

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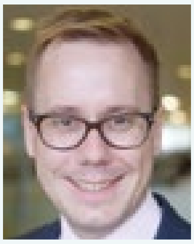
INVESTMENT MANAGEMENT

Alternative strategies:
The new default for diversifying risk

By Matthew J. Bullock, investment director, Global Multi-Asset Strategies, Wellington Management



Diversified growth funds (DGFs) are a fast-expanding segment of the UK market, with assets under management expected to top £200 billion by 2019. Much of their recent growth has been driven by an attractive sales pitch offering consistent returns and lowered risk through diversification. Performance has been good too, although that has in many cases been driven by rallies in equities and bonds.

The sector has come under scrutiny after many funds lost money in volatile markets – failing to perform in the stressed conditions they were supposedly designed to protect against. Moreover, most of the funds were launched after 2008 and haven't yet been through a prolonged period of stress.

At Wellington Management, we've been researching the DGF sector for some years. We divide funds into "traditional" (predominantly long-only) and "alternative" (deploying a wider range of strategies[1]) categories. This mirrors how consultants often view the market and reflects the very different characteristics and performance of the sub-sectors.

Our research has found that traditional DGFs are highly correlated to market movements, and have clearly benefited from the strong equity and bond returns of recent years. Over 72% of volatility can be explained by equities and bonds, compared with 37% for alternative DGFs[2]. This lack of diversification suggests most traditional DGFs risk substantial drawdowns in volatile markets, particularly in equity sell-offs. Worryingly for investors, third-party studies suggest over 70% of DGFs are traditional in nature.

Our analysis suggests that investors in many traditional DGFs would be better off investing in simple balanced funds, especially when one considers value for money. Indeed, we found that many supposed defined contribution (DC) "solutions" are not suitable for the investors they target. Certain strategies that reduced fees to be eligible for DC consideration have simply been stripped of differentiating return drivers to get costs down. Watering down such portfolios in this way compromises both their diversification and ability to generate returns across market environments. At a time when DC investors are struggling to reach return targets, this is a particular concern.

There is no perfect benchmark for DGFs, although we believe that a simple index of 60% global equities and 40% gilts provides a good starting point. Compared against this benchmark over the period January 2008 – November 2016, our analysis showed that traditional DGFs displayed a similar risk profile (volatility) to the 60/40 index but delivered a meaningfully lower annualised return.

We found further that the drawdowns experienced by traditional DGFs have been comparable to, and often exceeded, those of the index. This is bad news for DC savers, who have taken on the risks to their pension plans but lack the resources to plug any funding gap in retirement. Risk management strategies of traditional DGFs have reduced volatility but not, in our view, enough to justify the cost and adverse impact on funds' ability to capture upside.

Thus, many traditional DGFs aren't very diversified and rely on equity market rallies for much of their performance. They have underperformed the simple benchmark and have demonstrated limited ability to cap volatility. These findings question whether traditional DGFs offer value for money and, given their lack of true diversification, whether investors might not be better off simply investing in an index and saving management fees.

[1] While we use the term "alternative" to describe strategies that were once considered on the fringe (e.g., relative value and momentum), we're entering a world where investors should regard these approaches as the new default.

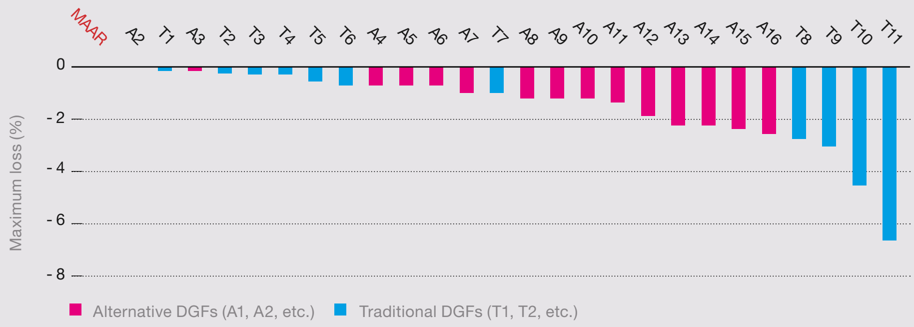
[2] Sources: Bloomberg, Wellington Management, April 2008 - August 2016; based on 27 funds available in the UK offering a sterling share class, excluding balanced and multi-manager funds.

However, investing in an alternative DGF makes sense for many investors and would often complement an existing portfolio. Over the period January 2008 – November 2016, alternative funds delivered a higher return than the 60/40 benchmark with significantly lower volatility. Crucially, they also suffered far shallower drawdowns — which is, after all, the whole reason for the existence of the DGF sector.

The turmoil that engulfed markets following the Brexit referendum provided an opportunity to test whether DGFs can provide the diversification necessary to protect against a market sell-off. A review of the sector's performance shows that nearly all DGFs suffered declines immediately following the Brexit vote. Of the 27 funds available to UK investors, 25 experienced drawdowns — more than 6% in the worst case — in the five days following the referendum (see chart below).

Many DGFs failed the Brexit test

Sources: Bloomberg, Wellington Management



Furthermore, the speed with which most DGFs recovered their losses as the market rebounded was fortuitous, but underlines how many funds simply mimic equities and bonds. This serves as a warning that DGFs are likely to be tested even more severely in a prolonged period of volatility. As we appear to be entering an environment of low market returns and heightened volatility, we would expect many DGFs to underperform their benchmarks and potentially suffer significant capital drawdowns.

We believe that true diversification can protect investors against losses in falling markets. We set about designing a solution that would meet investors' retirement objectives, seek downside protection through true and transparent diversification, and offer value for money. In 2012 we launched the Wellington Multi-Asset Absolute Return Fund (MAAR), which now manages over US$150 million (as at 30 November 2016).

In our view, the proven approach to asset allocation we use to structure the fund helps provide true diversification across market environments, which mitigates volatility-driven drawdowns. Specifically, instead of considering portfolio allocation in terms of traditional asset classes, such as equities, bonds, commodities, and currencies, we allocate across three broad and independent categories:

- **Market Exposures** allocation looks to capture market movements
- **Manager Alpha** allocation seeks to isolate the manager's skill in outperforming the market, with no market risk (beta)
- **Alternative Strategies** allocation looks to capture inefficiencies in markets, for example, arising from relative value or momentum.

This diversification strategy not only successfully protected against downturns in the aftermath of the Brexit vote, but produced positive returns over the period in which most of the sector lost value. We believe that MAAR, with its diversified sources of return, low correlation to traditional market betas and strong downside protection, offers people saving for retirement a meaningful alternative to traditional DGFs.

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Editor: Sebastian Cheek
Contributing editor: David Rowley

Contact:
Sidra Sammi
Phone: +44 (0)20 7822 8522
E-mail: s.sammi@portfolio-verlag.com

Printer: Buxton Press
Pictures: Richie Hopson
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Contact us to find out more:
Sidra Sammi
Phone: +44 (0) 20 7822 8522
E-mail: s.sammi@portfolio-verlag.com

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