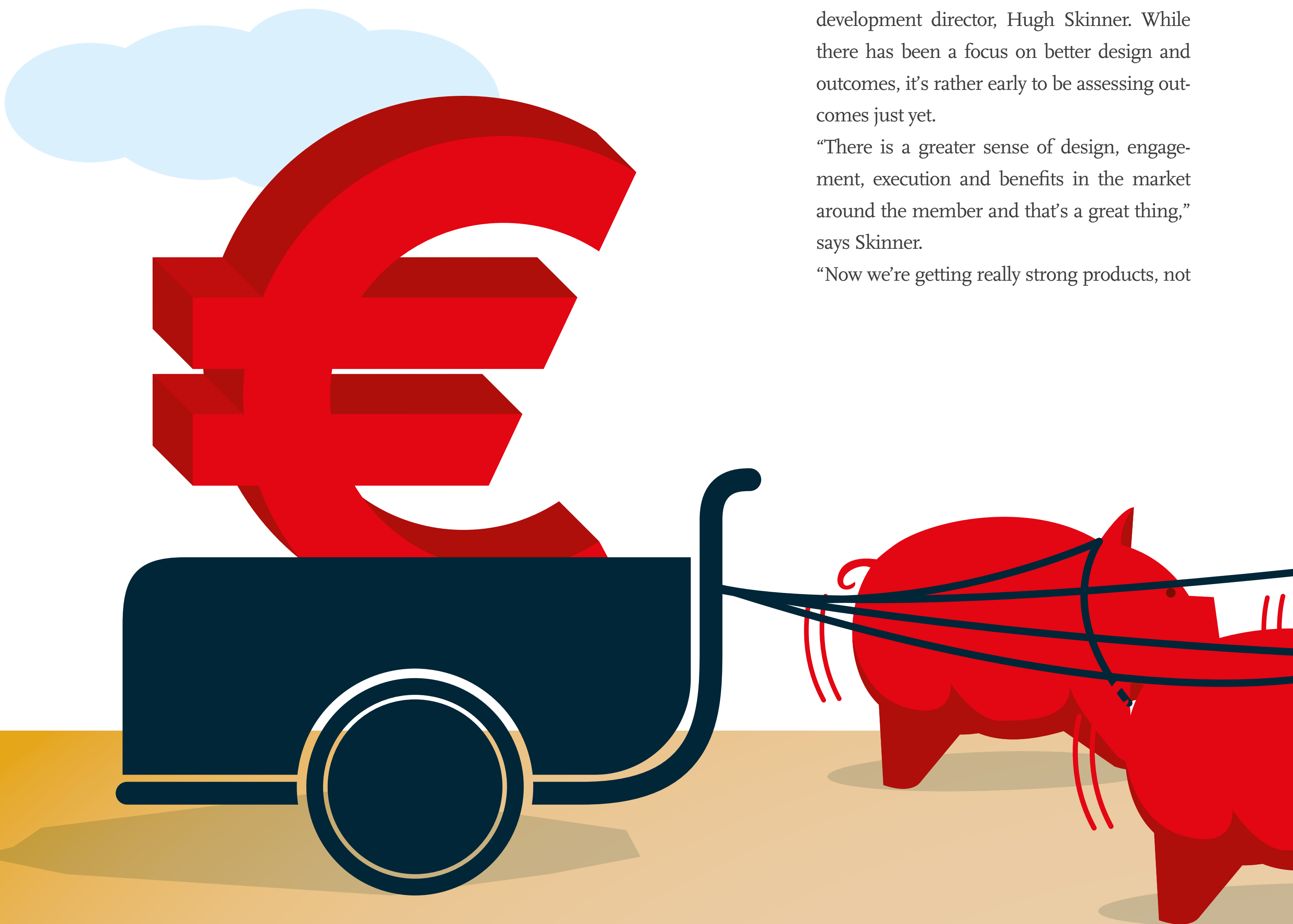
DC: are default strategies delivering?

Default funds have become increasingly sophisticated in recent years, but with cost pressures mounting, are they still up to the job? *Pádraig Floyd* finds out.



Before the coming of auto enrolment (AE), 90% or more of defined contribution (DC) plan members were housed in the default fund.

However, AE is based on inertia and since its arrival the numbers invested in defaults has only increased, so it has to be seen to be delivering for the vast majority of members.

Often, these funds were not fit for purpose, but as those individuals failed to make any choices, that was their look out. Things have changed in recent years, and DC investment strategies have improved.

For years, DC has been a poor cousin says Fidelity International DC business development director, Hugh Skinner. While there has been a focus on better design and outcomes, it's rather early to be assessing outcomes just yet.

"There is a greater sense of design, engagement, execution and benefits in the market around the member and that's a great thing," says Skinner.

"Now we're getting really strong products, not

just in investment, but in other areas such as administration, which is rapidly improving."

Skinner attributes the higher quality DC schemes with smarter use of technology, something the industry used to pay lip service to, but despite all the change the industry has faced in recent years – A-Day, RDR, AE, pension freedoms – is now actively integrating into their offerings.

IT'S GOOD TO TALK, BUT...

Aberdeen Asset Management head of retirement savings, Gregg McClymont says there has been a focus on communications during the this period of upheaval, but that is now "unsustainable", and providers must move back to sorting out investments again.

"Diversification is the only free lunch left, it would appear, but allocations are increasingly simple passive plus blocks of global equity at the margins," says McClymont. "It is time to get it right, but with the risk-free rate of return more or less zero, where will you find reward for taking risk?"

He points out that the Swedish mandatory second pillar has a default that is 100% global equity up to age 55 and then switches 3% each year into fixed income. This has delivered annualised returns of 10% plus between 2010 and 2014. Denmark's ATP meanwhile returned 18% in 2015, driven by a 48% return on Danish equities.

So determining the right thing is very difficult at the moment, says McClymont. "There is so much uncertainty around where returns are coming from will we be forced to look at the illiquidity premium, real assets, and who will take the lead?" he asks. "The regulator would be uncomfortable at encouraging something that is a departure."

NICE TO IGC YOU...

Nevertheless, someone is going to have to take the lead and the likely breeding ground for best practice is going to be among large schemes and in particular, mastertrusts, says Nick Groom, DC strategy consultant and project manager of institutional business at Natixis Global Asset Management.

It is in the independent governance committees (IGCs) that the debate about value for money (VFM) – the latest yardstick DC default funds must measure up against – will be fiercest.

"From our work with IGCs, it is clear that they do not have any real guidance and all reports show different approaches," says Groom.

Many IGCs are trying to combine all aspects of the DC scheme – charges, admin and service, product design, communications, investment choices and returns – into the VFM equation, but while all these are important aspects, it is performance that should receive much deeper analysis in future reports.

Natixis is to launch an analysis service for IGCs so they can get a better idea of whether the portfolios are taking a level of risk that is justified by the performance being achieved. The analysis will also show how portfolios might be improved.

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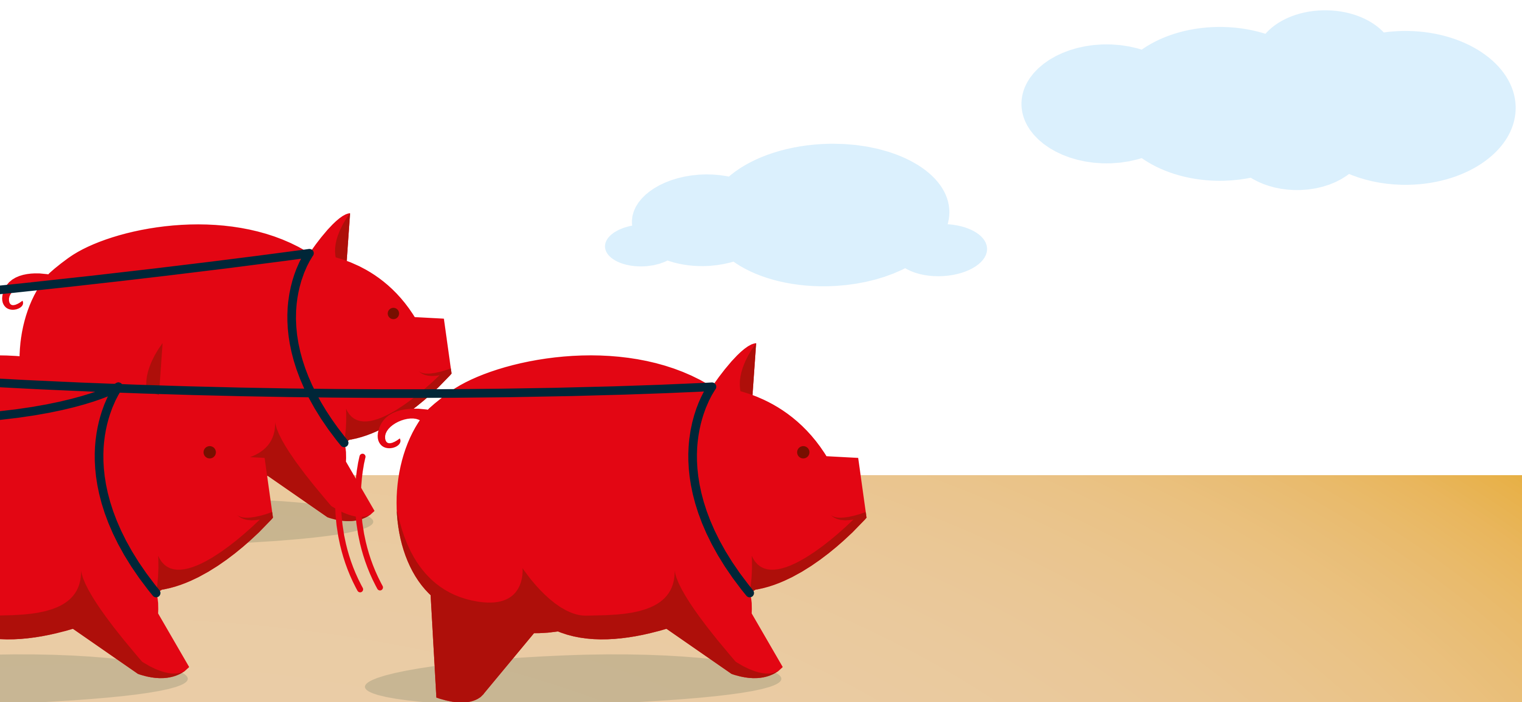

> **"We think schemes should put risk first and make it the main input for asset allocation in order to manage volatility."**
>
> Nick Groom, Natixis Global Asset Management

in order to manage volatility," says Groom.

They should then look to maximise diversification through implementing the broadest range of asset classes and investment strategies. This would include the use of alternatives – some to enhance diversification, others to lower correlations, or temper volatility – but to offer new sources of return.

"We will help them make smarter use of traditional asset classes, to find new, efficient ways of capitalising on the long-term potential of stocks and bonds while maintaining consistency to focus on the big picture and withstand short-term market movements."

IT'S ALL OVER…

The lack of focus on investment is glaringly obvious to Paul Macro, a director of Isinglass Consulting, who says there has been too much focus on retirement. This may have been driven by the recent reforms, but DC defaults should be all about accumulation.

"What you have to do for the first 30 years of a career is achieve consistent above inflation rates of return. That hasn't changed at all," says Macro. "We might know where members are going to go at retirement, but we must deliver a strategy that helps them get there."

For Macro, it is too soon to be overly concerned about the retirement aspect as so many in the next five or more years will only have small pots. Those 20 years away from retirement may experience some short-term change as strategies change, but as demand increases for retirement products, so they will come to market.

IF THE CAP FITS

The charge cap has restricted the ability of DC schemes to have more sophisticated instruments and forced them to load up with passive products. But the effect has not been the same across the board.

Larger schemes who pay for the admin have that bit more to play with for the investment component, while small schemes have benefited from the availability of off-the-shelf products that are more sophisticated, cheaper and yet still better than previous options.

It is the medium-sized schemes that are suffering the most, says Nico Aspinall, head of UK DC investment consulting, Willis Towers Watson, as they charge members for administration but want to do more with their assets.

"They did have DGFs, but if 40 basis points (bps) goes on admin, you must then blend them with passive equities."

If the cap goes down to 50bps, these schemes would become more frustrated he says, as DC would increasingly become the poor relation once again. If the government views the 50bps cap as a way of forcing consolidation, it should give the regulator power to do that, because with economies of scale, the charges could go far lower.

"If you had a £5bn or £10bn-sized scheme, you could do that. But if consolidation is not the goal, there is no point, as you are only robbing Peter to pay Paul."

BIGGER FISH TO FRY

Not everyone is so concerned about the effect of a 50bps cap – Columbia Threadneedle placed this at the heart of its business model.

"We run an active range of funds using internal funds direct investments, with passive strategies where appropriate," says Craig Nowrie, client portfolio manager in multi asset team, Columbia Threadneedle. "We don't use passive to get under the charge cap, but where it is more appropriate for the strategy."

These are in areas that would be operationally difficult. But Nowries' fund does believe in holding real assets as part of the asset mix.

"We have 8% in property, and not as REITs (real estate investment trusts), but bricks and mortar," says Nowrie, but argues its inclusion doesn't make the default 'sophisticated' or 'complex'. "We don't agree with complexity for complexity's sake and would rather stick to what we do within our proven philosophy.

"I would say the fund is easy to understand and look at on a monthly basis. That transparency is key to DC members as they are taking the risks and need to understand how DC fund is invested."

ILLIQUIDITY IS ONLY A SIDE ISSUE

Despite the real estate allocation, private equity and infrastructure don't get a look in as they are simply too inflexible.

But one issue that won't go away is how to create a better asset mix in DC by using real assets.

The government wants pensions to invest in infrastructure, but the daily trading environment won't allow it. Yet, a 22-year-old has at least 33 years – quite probably even more – before they can access their fund.

"I would love to change that," says Aspinall, "but it requires policy from FCA and some joined up thinking with Treasury."

There is one major issue that will shape the future of investment but hasn't even made it on to the radar of DC, and that is climate change.

"I'm surprised that people are surprised about climate change," says Aspinall. He warns investors must be mindful of not only the 2°C threshold, but 1.5°C and suggests the move should be even quicker to reduce this move.

"I see that as a fiduciary duty where there is a huge opportunity to buy into stocks of the future," he adds, "but DC is way behind that and won't be able to buy in with the restriction on daily trading within a 75bps charge cap."

Aspinall – like many in the industry – would like to see lower transaction costs. He favours harmonising when money comes in from payroll and is then invested and hopes the pension commission considers more than the headlines of costs and transaction costs when looking at these matters."

However, the industry is "in limbo" about costs and it has been an easy story to create – financial services is remiss. See some say this is a disgrace and reduces the budget available, while others see it as value for money.

ALL'S WELL THAT ENDS WELL…

The future of regulation weighs heavily on the minds of industry practitioners. Freedom and choice, the introduction of the lifetime ISA and the possible outcomes from a commission makes it very difficult to know the future of regulation, says McClymont.

He fears the regime in future may further disincentivise employers from doing more than the bare minimum, leaving more members reliant on their own as far as finding a way to a decent income in retirement.

He adds: "If there was comfort and stability around continuing incentives, they could do more about the pension in managing their workforce, but stability is a prerequisite."

Ted Jennings, Portfolio Manager, Alternative Income Solutions

TIME FOR PENSION SCHEMES TO SPREAD THEIR WINGS

For pension schemes with long-dated liabilities, sacrificing some liquidity in exchange for the additional yields that assets such as real estate debt and infrastructure offer over conventional credit can be a wise move. For schemes where this is an appropriate solution, Aviva Investors is uniquely positioned to extend our expertise to successfully investing in the more specialist alternative asset classes that form part of this market.

With over £20 billion of alternative income assets under management, we possess substantial trading, deal structuring and project finance expertise required to operate successfully in this very specialist market.

Complementary approach

We utilise a multi-asset approach that harnesses our existing expertise in four main alternative asset classes: infrastructure (equity and debt), commercial real estate debt, structured finance, and private placements. This is because portfolios constructed from these assets benefit from the additional 'illiquidity premium' that accompanies them. Long-term institutional investors who can afford to sacrifice some liquidity can expect superior returns to those available from comparable investment-grade fixed income assets. This makes our approach highly complementary to both long-term income needs and existing fixed income investments.

Original thinking

Our Alternative Income Solutions Team combines a number of our core business strengths as we have well established origination platforms and deal pipelines in the four main alternative income asset classes.

We employ a fundamentally credit-driven approach which combines our rigorous and ongoing analysis of credit risk with the expertise we've amassed as one of the UK's largest providers of liability-driven investments. Our deals are subject to review and challenge at various stages of the deal-making process by an independent credit team. The process is underpinned by a demonstrable track record of excellence in all aspects of due diligence and internal governance.

Utilising illiquidity and complexity

Our aim is to help each of our clients to increase the risk-adjusted return on their portfolios by investing in assets that might otherwise be difficult to access and monitor. By doing so, we can offer clients a diversified range of fixed income opportunities that offer enhanced yields without a meaningful increase in volatility. Thanks to the strong covenants and collateral that tend to be incorporated into such assets, they also have the potential to contain losses in the event of a default more effectively than a conventional bond.

Enhanced appeal

Although complex, alternative income assets have great appeal as, due to their illiquidity, they tend to offer substantially increased yields over traditional corporate bonds but for a very similar level of risk. This makes them especially attractive to longer-term investors such as pension schemes. In essence, these assets are a credit proposition that can either be engineered to complement any traditional fixed income holdings or integrated directly into an existing liability-driven strategy.

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