pi DC MULTI ASSET roundtable

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DISCUSSION: DC MULTI ASSET

For institutional investors, 2022 was an eventful year. There was volatility, inflation hit double figures and conventional investment theory was challenged.
But how has that changed the way diversified defined contribution (DC) portfolios are being constructed to mitigate longevity risk and further volatility? To find out, *portfolio institutional* sat down with a panel of those with influence on the defined contribution investment chain.

How do you see the new investment environment we are entering following last year's volatility?

Jos North: 2022 was the encapsulation of a new investment environment. When I say that, it often gets conflated to mean that what we experienced last year we are going to experience again and again and again. That's not necessarily the case.

However, some of the themes of last year, and in the wider post-pandemic era, are the big themes we need to think about as DC asset allocators.

For the 40 years to 2020, we had a period of declining interest rates. One of the reasons for that has been low and stable inflation. So we have had low real world volatility and low financial market volatility.

We are now in an era where, on average, we are going to have higher inflation. It probably will not be as high as it is today, but it is going to be higher than 2%.

There will be higher interest rates and higher volatility, so we need to think about the implications for investment strategies.

Natalie Winterfrost: Higher interest rates are an interesting challenge. People didn't want to take annuities because at the rates they were people couldn't afford to retire on an annuity. Hence, we saw the introduction of drawdown and investing through retirement.

We re-designed our default pots to target those. One challenge is: if annuities are priced on higher rates again, are we going to flip back to the idea that the security of an annuity is appealing if it is affordable? This could mean our defaults are targeting the wrong outcome.

More generally, because savings rates are too low, people need to invest in growth assets while they are saving. This can continue through retirement if they take the drawdown option. Hopefully, they are looking at real assets that will keep up with inflation, rather than fixed income markets.

We are also facing the levelling up agenda. The government wants DC money to support growth. Of course, they hoped the defined benefit money might do this but they have realised that it has a short life and so does not have the timescale to start allocating to infrastructure-like assets.

The question is: can that money come from DC? The early stage capital needed is probably a little too high octane for most DC members, but it is an area to consider.

The government wants your DC schemes to invest in infrastructure, Alan. Does that interest you?

Alan Pickering: Hands off! I have been

around long enough to have seen politicians at all points on the spectrum say that pension money is public money, therefore politicians should decide what to do with it.

It is the public's money and the public trust us to try and provide later life security. If one can do good with that money between now and when the member needs to depend on it, so be it. But we should not be the plaything of politicians. Government should stick to governing the country and let us govern pension schemes.

Lydia Fearn: The government are talking about DC schemes committing to a 5% investment in private equity. That will be interesting. The government clearly sees DC money as free wealth to them that will not just level up, but also boost the economy.

That is something we are going to have to work with them on. It is not going away, even if we change government next year.

Jenni, you are a DC investment consultant. If one of your clients said the government wants them to fund new bridges and faster broadband, what would you advise?

Jenni Kirkwood: I would reflect on what my trustees have said to me, which is to approach with a healthy degree of scepticism.

First and foremost, they are making sure they deliver value for members. If what is put forward does that, then of course we are going to be interested. But we are not a nice little piggy bank which is effectively there to be raided to boost the latest political agenda.

There has been hilarity around the table when my trustees meet: "Here they go again." Trustees are savvy, they talk to each other, there are networks, so I get a feeling they will not be bullied into this.

Fearn: But it is being talked about more seriously than I have ever heard it before.

Kirkwood: It is definitely more serious this time. If it is well structured and could deliver then it might be a good opportunity.

Fearn: It is making sure that the people taking the decisions about potentially mandating assets understand the challenges we have been grappling with for years.

Callum Stewart: I picture various potential scenarios here. One is where the government mandates minimum allocations to the UK's levelling up agenda. That would create apathy around the overall view of a wider opportunity set, which could impact negatively on DC savers longer term in that it will constrain thinking around value. But it will be more to do with ticking boxes than thinking about what the member needs.

I would like to see a world where we are not constrained and UK projects could

Government should stick to governing the country and let us govern pension schemes.

Alan Pickering
President
Best Trustees

benefit from that, as part of globally diversified portfolios. But it will be a smaller piece of a bigger pie. The big pie being what is going to drive better outcomes for DC savers in terms of wider investment opportunity, not just illiquids.

Accessing the wider investment opportunity set might attract a higher cost point, but we should be less concerned about whether that is 20 basis points or 70 and be more concerned about whether a particular opportunity is going to improve outcomes longer term net of those costs.

We are not there yet. For me, the solution is to ensure we embed an unconstrained framework in the UK. There are different beliefs across our industry and there is little freedom to deploy them as cost continues to dominate focus. Providers are constrained because we know at the end of the story there is going to be pressure on cost.

Last year, we could have done better as an industry. The average return for an older saver was about -15% across master trusts, for example, reflecting an investment opportunity set constrained by cost. Some negative performance perhaps came from too much duration in bond portfolios, but shorter duration and global diversification would still have likely provided negative returns overall. We should be targeting much better outcomes, but it will require a higher cost point to get there.

Pickering: Where we can help governments is by being responsible investors. It is our role to make sure that whoever is investing and wherever they are investing, the money is appropriately deployed and well stewarded.

It is our job to make sure that what people save is put to good effect and they will get value for money. And in that way, hopefully, we will get growth and government will be able to get back to doing other things rather than trying to prescribe what we do.

Governments killed off defined benefit through over prescription. It would be sad if they were to kill off DC innovation by being similarly prescriptive here.

What lessons did you learn from the markets in 2022 that you will be putting into practice?

North: Diversification. There is a potentially beneficial outcome from the push into less conventional assets, whether it is government mandated or by design. That is, when thinking about the difference between the past 40 years and what we think of going forward, the trend for low interest rates has been a beneficial environment for all assets.

So just owning the market has been fantastic. Being equity heavy in the early phase of the lifecycle and then owning more fixed income later on has been a good solution.

We are probably now in a world where we might have a decade of not much in terms of market returns. In order to deliver the growth Alan was talking about, you will need to look for other assets.

On the growth side, you need other assets to get diversification and other forms of return. And that is addressing the savings rate point that was raised earlier. That is how you build up those savings.

But the real lesson from 2022, from our point of view, is that there is building up your savings and then there is maintaining what you have. When you start to think about retirement, starting to generate an income, starting to think about how big your pot needs to be to cover the rest of your life, suddenly holding on to what you have is important.

The way to do that has been a version of life-styling, so you become more fixed income heavy as you get closer to the mythical endpoint of 65. But that does not work in a world of higher inflation.

Are frameworks helping here?

North: The frameworks with which we have looked at for asset allocation for 20, 30 years need to change.

It sounds like we will be still talking about the impact of 2022 in 15 years' time.

North: No, it could happen again in 2027 and we will be talking about that. Hopefully, our portfolios would have adapted by then so you would not get caught out.

Pickering: When you were describing 2022, you asked how we are going to cope in the new environment. There isn't anything new about 2022.

What goes around comes around. There will be another distortion or bout of volatility. The new environment is that members are now in the driving seat, whether they know it or not.

There is no longer an employer underpin and the new environment is the new working and saving environment. There is nothing magic about 65 anymore. We have to make sure that we have enough money to keep us going until 90 and we are going to have to flex the interaction between work and retirement, pay and pension. It needs to be a process rather than an event.

During the accumulation phase, we have to provide people with access to all of the asset classes DB has had but DC has been denied for all sorts of reasons.

We all want the same thing during the accumulation phase, we then have to bespoke it. In later life when people have to decide if they want to spend their money in Barbados when they are 70 or live in a nice nursing home when they are 85. They need to have an investment strategy that reflects their desired lifestyle.

The money has to keep growing. We can't stop it growing and just protect it at 65 when we have another 30 years ahead of us. That's the new environment, not 2022.

Fearn: We have been working on our soft default for retirement. This is thinking about pushing those growth assets much further out and looking at a potential moment, which is probably around 80ish, to annuitise. It might be some of the pot, it might be all of the pot; it will depend on the scheme.

The actual point of annuitisation is scheme dependent, and members can opt out. But it is this point of how to create a to-and-through investment strategy for members who after so many years suddenly have to make an active choice about their savings.

We are muddling our way through it at the moment because we don't have masses of DC generation yet. But when the DC generation comes through, we want to be prepared for that.

We want to help our members understand the beauty of saving, why it's right and why you need to invest over the longer term, but also how they then manage their assets until they can do whatever they want to do with it.

North: Do they start to take income but still with the aim of annuitising?

Fearn: It's called flex first, fix later. It is like drawdown. You don't have to think about 65, which is the moment schemes theoretically end. It is a long investment strategy that will be higher risk at that point, before moving seamlessly into a drawdown solution which kicks off income. At some point, members have to decide when to annuitise.

It is called a soft default, because at that moment you cannot just put members into a lifestyle default. They have to make a choice about what they want to do with their money.

North: Keep running your growth, start to introduce income but importantly you need to have some downside protection.

Fearn: Exactly. At the early stages, you can take a lot of risk. Later on, you can't.

Diversified growth funds are good for managing some of the risks, along with the other assets you are trying to protect. There is a question around cost and we would like a bit more complexity to manage that downside.

Kirkwood: It would be worth it at that point because it is keeping the money

If you start labelling some self-select options as green, some members are probably going to pick them because it fits with their own stance, rather than because it is an appropriate investment.

Natalie Winterfrost
Director
Law Debenture

safe, but to do that within the charge cap is challenging.

Stewart: We have made progress towards that. We have target-date fund approaches that expand to and beyond retirement. But for me, there are two bits needed to make that happen, which would make a huge difference in terms of value.

One is that most individuals who want to take an income in retirement end up in a situation where they move from an institutional world into a retail one. And there is an upfront advisory cost and ongoing costs of hundreds of basis points a year.

They are not in an institutional world, so maybe there is a debate around the level of governance rigour around the process and the quality of investments available. DC master trusts have the potential to do more for members and will have the benefit of scale going forward.

To me, an obvious value improvement we can make is to default at that point. If an individual does not make an active choice, they would remain invested and can draw on what they have built up.

To me, it does not make much sense to build up assets in one vehicle and then sell them to buy similar assets in another vehicle to then draw on and pay more for the privilege.

Fearn: Or to put it in cash.

Stewart: The other point is that annuitisation in later life, which is going to require an intervention from the individual, becomes tricky. Longer term, I can see a market for deferred annuities.

Fearn: That is what we are working towards, but it is not there yet.

Stewart: Agreed, we don't have the scale yet.

North: Callum, how are you thinking about DC portfolio construction?

Stewart: We need to strive for much better than we currently have. The impact of the environment we operate in today with an emphasis on cost is so constraining in terms of potential outcome.

Most trustees we speak to tend to support the idea that more freedom would be helpful to deploy different beliefs. If you look at the outcome differential we could have through a more unconstrained approach, within the master trust market the difference in retirement outcomes from worst to best is as wide as a 60% range for younger savers. That is within the cost constrained world. Price points sit within a range of 10 basis points difference from lowest to highest, so headline strategy still drives outcomes.

If we were to increase that by 10 basis points, we could improve retirement outcomes by well over 10% for younger individuals. If we could increase the price point by 20 basis points we could increase retirement outcomes by well over 20% for those individuals.

If we can introduce sophistication in the later stages, we could help avoid the issues we had last year where we are reliant on a constrained range of generally cheaper asset classes. We just can't rely on a constrained universe to provide the diversification we need.

So where should it go? I would have less reliance on traditional markets, specifically within bonds. Also, DC schemes generally under deploy to real assets such as infrastructure and real estate. There tend to be small and listed allocations to property and infrastructure rather than access to the physical underlying asset. We can do more there to diversify and offer long-term inflation protection.

But the crucial missing piece of the puzzle, given the completely different economic regime we are moving into – I say different because we don't know what it will look like in five years' time – is that we need to bring relevant expertise closer to the investment decisions. This means we need to carefully select fund managers

Providers are constrained because we know at the end of the story there is going to be pressure on cost.

Callum Stewart
Head of DC investment
Hymans Robertson

A bit more dynamism in investment strategies will be necessary if there is going to be more volatility.

Jos North
Investment director
Ruffer LLP

to help manage risk and deliver better outcomes.

That is important for older savers, where there are going to be some pretty turbulent markets to navigate. I don't think we can have faith that a low-cost world is going to provide adequate levels of protection. To me, paying a little bit more is protection, or insurance as we call it in day-to-day life. It feels right to consider paying a bit more if we can do better than -15% for older members.

Kirkwood: That is where we want to get to, but it needs to be in parallel with the development of investment platforms.

We need to avoid pricing errors. Every time we have a pricing error, it is bad news for our members. At the moment, a lot of platforms are going to struggle to do what you want.

Stewart: We need to put them under the lens and change them.

Kirkwood: There needs to be a seismic shift in the capabilities of a platform.

Fearn: What would drive that change? For master trusts it would be more business. But that is not going to work because if it costs more money, they are not going to win more business.

Stewart: This is where employee benefit consultants have a role to play. If we are evaluating the provider market, one of the aspects we should be evaluating is platform capability. If there is a capability that is inferior to the rest of the market, then that should be reflected in our view.

Fearn: We do that, but there are still employers who just go for the cheapest option. Even if you advise a client that this might be a bit more expensive but it will be worth it, you still get employers going for the cheapest.

There has to be a market shift. We have moved into a different investment environment, and with that comes cost.

If you are going to do ESG then you are going to need to think about more active investments, more active analysis. But it is difficult for a provider to breakaway and win business.

Kirkwood: This is not how it should be. It should be that you are the value player, you are good and everybody should flock to you. But you are just seen as expensive.

Stewart: The pace of change has been quite slow and painful in some areas. If we agree that change needs to happen then we need to drive it.

We need to empower policymakers with the information, knowledge and evidence that they need to change the regulations around this and have a freer framework to operate within.

North: The platform issue is important. If I can talk about it from a portfolio lens, a bit more dynamism in investment strategies will be necessary if there is going to be more volatility.

If you look back to last year, broadly over the whole year, you had a period of high inflation. But actually, in the first nine months, you had bond yields rising, bond prices falling and equities falling but then it switched in October and the dynamics changed.

We were having a conversation with a client yesterday who wanted to implement a new investment strategy and the pipeline was 18 months. We are talking about needing to change investment strategies quickly. You could do it within days by allocating to some active managers, but even at the strategy level, being able to move things around within a month is never going to happen within the existing infrastructure.

We don't know what is going to happen in the next 10 years. But I can say with a high degree of confidence that we are going to need to be much more flexible, much more dynamic in all investment strategies to move quickly once a decision has been made.

Pickering: I'm keen on broadening the asset classes that DC members are exposed to and I'm keen on finding roles for active managers, but I don't want to end up with churn.

Next year we will be investing in a lot of what we invested in this year, but it might need tweaking. We don't want to get so active that we almost become day traders. We are talking about a 50 to 60 year time horizon, so it is more tweaking, nuancing and reviewing. Then having reviewed, it is about implementing decisions quickly, rather than creating an atmosphere that encourages churn.

A lot of members these days want to use their money to make the world greener and fairer. There's a lot to consider when following such strategies, so how is that going?

Winterfrost: There two aspects to this. One, what do your members want to do that's based on their values and morals, but isn't a financial decision? And two, what do we think is the right thing to do as trustees for the bulk of our members?

It is generally accepted that if members have a good reason to invest in a certain way it will encourage them to save more, so offer the options they need. But it comes with a risk. If you start labelling some self-select options as green, some members are probably going to pick them because it fits with their own stance, rather than because it is an appropriate investment. Risk should come first.

There are dangers with fund labelling. But within the defaults, where we are making the decisions, it is about understanding the risks we are managing and what the opportunities are from incorporating ESG. It is widely accepted that there is an impetus behind transitioning to a lower carbon economy and, therefore, one can tilt the portfolio in that way and reasonably expect it to be a return enhancing or risk reducing measure.

Trying to address biodiversity is going to be more of a challenge, but the transition isn't going to be successful unless we deal with the biodiversity question. They are linked. But we are much further behind with biodiversity.

We have measures for carbon, which are universal, are global, whereas the biodiversity metrics being touted are local, making it hard to think of them in the context of a global portfolio.

If you do not appoint a manager that recognises and understands these issues and will engage with investee companies and then make decisions on your behalf, then you may end up invested in a company isn't managing these risks. That is a financial risk and it may become un-investable. As a trustee, we have to delegate quite a lot of this by picking the right partners.

Pickering: At the risk of sounding elitist, I am in the camp of engagement, rather than exclusion. The danger is that if members are in charge of their investment allocation they will go straight to exclusion. They will watch a TV programme tonight and tomorrow they will exclude any of their assets that were badly reflected in that programme.

With engagement you get two bites of the cherry. You might be able to make the world a better place and you might be able to improve outcomes.

Then we have to tell members what we are doing through our engagement strategy. If they want to drive their money to reflect their values, a self-select Isa is the right route rather than the pension scheme.

Pension schemes are capable of being well governed by the people around this table. Members should be told what is going on and that we are doing good stuff, but not have a plebiscite every day as to what should be excluded.

We are not a nice little piggy bank which is effectively there to be raided to boost the latest political agenda.

Jenni Kirkwood
Senior DC investment consultant
Mercer

We have moved into a different investment environment, and with that comes cost.

Lydia Fearn
Partner
Lane Clark & Peacock

Winterfrost: They will exclude all sorts without realising the consequences it will have on their portfolio. For many pension members, this might be their only savings pot and there is a danger that they will be allowed to take poor decisions on the portfolio they are reliant on.

Stewart: Engagement is definitely the preference. Where we start to lose faith is if the engagement is not successful, if there is no reciprocation to it.

There is evidence that engagement can drive change and improve the risk profile of an organisation that you may be investing in. You can add value for members longer term.

To Jos' point, we are moving into regimes where we have to change the way we think going forward. That applies to this piece as well. I struggle with the idea of just investing by taking a slice of the market as it looks today because most people agree that the world will look different in the decades to come.

So, should we be investing towards what we think the world will look like in the future? We can't predict that with certainty, but should we start to align that way at least? I feel that there is a stronger investment thesis behind that.

Expertise is then entrusted to manage that, but it requires a completely different mindset and more freedom in what we can do.

Jos, what is Ruffer's preferred retirement strategy? Could you give us an insight into what you guys are doing?

North: The role we are playing within our DC schemes is predominantly in pre-retirement, where essentially the diversification role that would ordinarily be provided by fixed income can no longer be provided in a world of higher inflation.

It does not matter whether it has a fixed end date, whether that be 65, or a deferred annuity or just needing to run growth, you need to have protection in the portfolio.

Whether it is building up the pot and protecting it for that endpoint, or to protect against sequencing risk, you are trying to make sure that your pot lasts longer than it might otherwise do. It is the ability to provide capital preservation and protection, which we did in 2000, 2008, 2020 and last year, which is pretty invaluable.

What is the investment strategy that you believe will appeal to DC schemes going forward?

North: Avoid static allocations to fixed income. Go from nominal conventional bonds or conventional duration-linked assets to having some real assets or inflation- linked duration. Be more dynamic. Think differently about protection.

Those would be the three main things.

What will be the biggest investment themes of the next 12 months?

Winterfrost: Illiquids, biodiversity and carbon.

Stewart: To add to that, the pre-retirement piece is the crunch point for members. We definitely need to be on that.

I'm supportive of illiquids generally, so I'm happy they are on the table. But we need to think about the crunch point for our members when they can have the opportunity to use their savings and protect them.

Pickering: I would rather think about what is going to happen in the next 10 or 20 years.

One thing I am going to be grappling with is what are the implications of more and more assets being within private markets rather than on public markets. And is that shift away from public to private going to have an impact? Or what will be the impact on our long-term strategy?

Indeed, will the pendulum swing back with public markets becoming popular again, or are we going to have to live long term with more assets being restricted to private markets rather than public ones?