pi DEFINED CONTRIBUTION roundtable

Invesco

NEWTON Investment Management

Mary Cahani | Paul Brain | Andrew Hope
Martyn James | James Lawrence
Emma Matthews | Roger Mattingly

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DISCUSSION: DEFINED CONTRIBUTION

Auto-enrolment has revolutionised the British pensions landscape. More than a decade after it became mandatory for workers to save into a defined contribution scheme, one master trust has to put around £400m worth of contributions to work in the markets every month.
This highlights how important defined contribution has become. It is also maturing as a retirement solution, given how schemes are applying issues such as sustainability to their strategies.
To find out how defined contribution schemes are investing their capital and managing their assets, we assembled a panel of insiders from across the investment chain to sit down and discuss the issues impacting the industry.

What are defined contribution schemes investing in?

James Lawrence: We are looking at a few areas within private markets. Green infrastructure, venture capital and natural capital are the biggest asset classes for us right now, but it's probably a 12-to-18-month project to get those off the ground.

Emma Matthews: We are going through our triannual strategic investment review, so we are looking at the assets we are managing and how best to allocate over the long term. For example, private markets are topical with the Mansion House reforms, so we are potentially going to make some commitments there.

Roger Mattingly: The Cushon Master Trust seeded Schroders' Long-Term Asset Fund (LTAF) in March, which was the first to be approved by the Financial Conduct Authority. Up to 15% of the assets will be invested in private equity, infrastructure and natural capital.

The other 75% of the scheme is invested through Macquarie in a customised index. This is about reducing our Scope 1 and 2 emissions. The intention is to include Scope 3 emissions as soon as practicable.

Paul, where are the schemes you work with looking for value?

Paul Brain: Last year was a watershed in that we are now in a different environment. We are going to be sitting with higher inflation, which means higher cash rates. The risk-free rate bar has been raised and a lot of investors are judging their assets against a higher cost of capital.

There have also been significant problems with liquidity. This suggests that you need a liquid complement as you move towards higher returning assets, which tends to push you towards private assets.

It is adjusting to the new regime. It is recognising that a 60/40 approach now needs to be a balance of liquidity, of alpha generators and perhaps exposure to some less correlated assets.

Mary, what are investors looking for in this new regime?

Mary Cahani: Part of my job is speaking to key stakeholders in the DC space to understand their challenges. One of those is investing in the asset classes that provide diversification and extra return, be that at higher costs.

Additionally, many stakeholders are asking if the 60/40 split is still valid and questioning the passive approach to asset allocation. Are there other ways to enhance return and can they get that

exposure with ESG integration in a more cost-effective manner?

How has what DC trustees want from their default strategies changed?

Martyn James: Trustees have been looking at their portfolios in the wake of 2022, where performance was hit in pretty much all asset classes. DC investors are long-term investors, so generally clients are not making knee-jerk reactions. They are looking at the glide path and how much risk they should take for younger members and the asset allocation as members approach retirement. For example, some plans have a proportion of defensive assets in the 'growth phase' which didn't perform well, so it is deciding if that is still the right philosophy going forward. For some it will be, others may prefer a different approach.

Andrew, what are schemes asking for when building a bespoke strategy?

Andrew Hope: In terms of bespoke versus off-the-shelf, it is an interesting time. Trustees are becoming more interested in accessing things like private markets. But there are some fairly large operational hurdles for integrating these assets within a bespoke solution, so we are not there yet.

We are looking at what we can leverage without losing sight of trustees needing something specific for their membership.

Trustees can take more risk at certain times and have tended to have a pure equity growth phase, whereas some of the off-the-shelf designs tend to have a take more modest risk through multi-asset approach. When taking higher risk to seek higher returns, it's looking at what that equity bucket looks like that's important.

Performance has been driven by a small number of stocks, so what does that concentration risk look like? And even if we are accessing more traditional asset classes, are they providing diversification? These are interesting times.

Lawrence: We are having a similar debate internally. Every product we build has the same concentration risk because we look at assets that are low carbon. I would be interested in a way around that without being too active in our stock selection.

Hope: We have trustee boards, which are effectively capping their largest stocks and distributing that allocation across the market. That has been one approach.

To the point of what impact ESG has on allocations: again, it tends to exacerbate that concentration risk. That is definitely something to be mindful of.

Members have been used to low fees, but that is reflected in their outcomes.

Mary Cahani
Director, UK Institutional
Invesco EMEA

Cahani: In the conversations we are having, most trustees are concerned about concentration risk. The Mansion House reforms allude to a lot more concentration if you focus on the UK alone when allocating to Illiquids and not necessarily the best value-add propositions for members.

There is a lot to be said for having a semi-active approach to the already passive equity exposure that DC schemes have. For example, passive enhanced strategies can operate under similar fee structures as existing standard passive solutions whilst delivering a client an investment experience akin to active management in terms of sustainability. This could be a sweet spot for many schemes, looking to manage costs but at the same time having an active approach when it comes to sustainability goals.

James: There is a heavy weighting to equities, so you are going to have a concentration issue. But to get diversification with illiquids, there is the issue that fees will increase.

Currently, our master trust and some of our clients consider allocations to REITs and other listed real assets. They are not perfect, and potentially we would rather get that exposure from elsewhere, but meaningful allocations to those assets do help with the diversification issue.

Matthews: It is interesting because we are coming into a period which, even for government bonds, is far more attractive than we have seen in a long time. We saw in 2022 how painful those assets can be, especially if they are being held for members approaching retirement. But we have gone from interest rates being 0.1% to where they are now, which is far, far higher.

Lawrence: There's going to be a lot of forced defined benefit sellers in the next few years. There will be a big opportunity for DC, not just in gilts, but also in private equity and other illiquids.

Brain: I'm glad you mentioned that because in 2022 there was a significant move in interest rates, which led to all the correlation changes. But let's not just judge all portfolios on that one year because that happens every now and then. Once it has happened, the new reinvestment rate – whether it is cash, gilts or corporate bonds – has a much more attractive risk/reward.

Two years ago, there was no income and we had to chase illiquids. Now, there is plenty of income in the liquid market. And it may be an income that is more attractive with less volatility going forward.

We are not out of the woods. Regime change means that we are still going to see inflation. It will bounce around a bit, but it is not going to be at 2%. Interest rates will stay high, which means that income levels will stay high.

Cahani: Fixed income is passive in most default portfolios. In defined benefit, fixed income exposure can be both global and actively managed for the contractual-cashflow matching approach. Should there be a similar approach to DC fixed income investing, without the cashflow matching component?

Lawrence: All of our default fixed income is active, but it depends on the master trust. It has traditionally been that those who can find more fee budget, tend to use it on fixed income because it is a good place to be active.

Brain: A large chunk of defined benefit assets are stuck in government bonds, which is the bit that is likely to shrink. A lot of people have moved to a multi-asset credit approach because it adds diversification.

Mattingly: A reduction in interest rate sensitivities has been on the agenda for the last 12 months or so. What hit everybody last year was the compulsory purchasing of annuities ending, because post freedom and choice there was no longer the direct correlation between the price of bonds and the payment of benefits, unless an annuity is purchased.

Bonds plummeting as people were about to take their benefit wasn't a problem until that relationship was broken in 2015 when freedom of choice came in, and all for good reasons in terms of flexibility, versatility and customisation of income stream.

James: There is certainly an argument to be invested in bonds for individuals taking an annuity when they retire, but a lot of members will potentially still be investing in retirement for another 20 to 30 years. And it is debatable whether they should have a significant amount of bonds in the pre-retirement phase.

Mattingly: You are assuming the pot sizes are sufficiently large to drawdown on, whereas the average minimum auto-enrolment pot is £5,000 to £6,000. They are not going to drawdown from that, so they will almost certainly take it as cash and will have been realising those bond value reductions.

Hope: Coming back to off-the-shelf designs, most have to be appropriate for a range of people. How do we do this, while still ensuring the design is supporting good outcomes for all?

Matthews: It is challenging. At Now Pensions, we have a broad membership. We do a lot of work with gig economy workers, who might not be consistent in their savings journey. And you have to be mindful of members who are in their 20s and have only been contributing for a couple of years.

The picture we typically build is that our members generally take a cash lump sum at retirement. Having that debt duration in the portfolio simply does not make sense for a person who then takes cash.

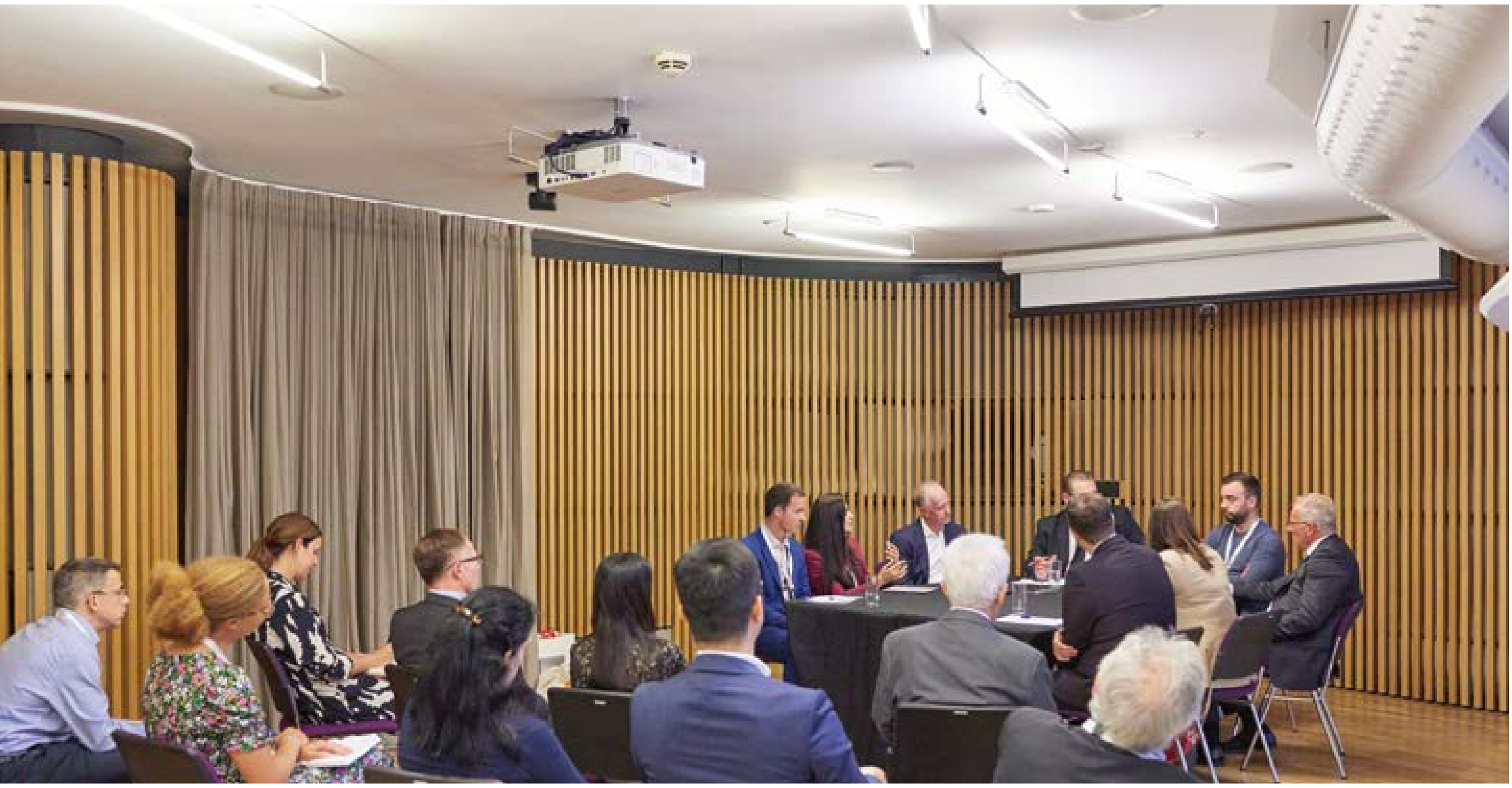
Cahani: Decumulation is one of the hardest problems people are grappling with. How much work is being done for members who have £50,000 to get a proposition that will keep their lights on?

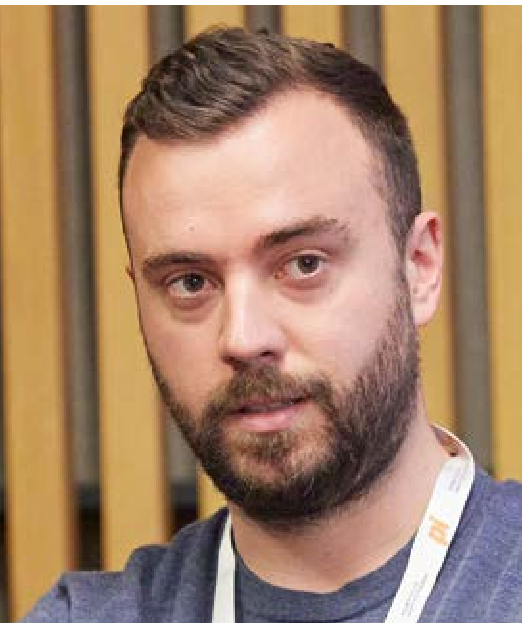
We are doing a lot of work in this space to understand further the needs and wants of the members. The outcome of most conversations comes to them needing longevity protection through the annuity piece but at the same time they would like to sweat their assets a bit more during their early retirement, eluding to a need for a combination of annuities and some growth as a post-retirement solution.

The government wants DC schemes to fund the upgrade and repair of Britain's infrastructure. Are they putting assets in front of you to invest in?

Brain: No. It is something that is going to come, because it has to. The direction by the government towards pensions to shoulder the investment burden in the economy is something that is going to come through, whether it is infrastructure or something else.

We have seen it before, but it was half-hearted. There are economies in Europe where there is greater emphasis on that, but it is not happening at a significant scale in the UK yet.





We are not going to be the government's coffers.

James Lawrence
Head of investment proposition
Smart Pension

What I'm alluding to is that the UK government doesn't have sufficient money. There have been too many incentives aimed towards achieving net zero. It needs to switch to the 'stick' rather than the 'carrot' approach: decarbonisation has to be taxed.

Are asset owners interested in infrastructure?

Lawrence: Yes, very much so. We are mainly looking at renewables. It is probably going to be global; we are not going to be the government's coffers.

There are lots of opportunities across Europe in the green infrastructure space. We are interested in Spain and looking at batteries, solar and wind.

Matthews: Cost is a consideration for master trusts. How do you overcome that challenge?

Lawrence: We have to be innovative. There are some managers who are willing to play in this space at good fee levels. There is not much capacity in those managers, so there's probably some good deals to be had quickly.

Roger talked about Macquarie's index; that is probably going to be the way forward for many DC schemes along with the structured equity piece. You go from paying low single-digit basis points for equity to zero or negative fees. That is going to open up.

Hope: We are at a crossroads in terms of absolute charges versus value. Within our *2023 DC Pensions and Savings* survey, we found that the appetite for trustees and sponsors to pay more to access some of these asset classes is low.

There is going to have to be a shift, and some regulatory pressures in terms of value for members to help drive this shift. But we need to fundamentally move towards a perception of value rather than absolute cost.

The margins which master trusts look at are fairly small and to make some of these allocations meaningful, we have to accept the increase in charges; we can't just focus on cheap passive assets. There needs to be repositioning from that.

Lawrence: The problem is we have been saying that for about five years.

James: Do you not feel there has been a bit of a sea change?

Lawrence: Not significantly. We are not increasing our prices, which is what we need to do, but we are not decreasing them as rapidly as we have done.

James: Fees are a big issue when a company considers a master trust for their employees and we are seeing a lot of competitive pressure on fees. When considering infrastructure and other illiquid investments, our master trust is considering how to get illiquid investments into the master trust at an appropriate fee level. There needs to be a sea change with third-party evaluators and then the clients buying master trusts with respect to fees if we are to see more in illiquids.

With the value for money consultation and the Mansion House Compact, I do potentially see things changing. How quickly behaviours will change, I'm not sure. But there is a change in the air and hopefully from 2024, there might be an acceptance for higher fees in master trusts to pay for illiquid investments. Clients might be buying those who venture first into this space, but it remains to be seen.

Hope: I share your optimism. One of the big fundamental shifts in value for members is around the disclosure of net performance, rather than just explicit charges. If we are focusing on net performance around adding value to members' pots, the charges get pushed to one side if the net performance is better.

I take your point. We have been talking about this for a while, but we are reaching a critical point where I'm not sure the charges can be squeezed any further. Ultimately, it feels like we are going to see

something changing over the next couple of years. It might take a while, but we are getting there.

Matthews: Fees are, of course, important but as a typical master trust accumulates assets, there comes a tipping point of being able to start allocating to get that diversification. When you are going into illiquid assets, that is incredibly important.

Cahani: There are ways around the charge cap. Members have been used to low fees, but that is reflected in their outcomes. Surveys show that members want to find a cost-effective way as diversification is important to them.

Speaking from where we are with markets, private equity supposedly is not the most effective way of deploying assets at the moment. In private debt, due to interest rate movements, you could effectively make the same return for a lower cost.

For Invesco, as an asset manager, there has been a lot of listening and we are working on designing active, customisable investment solutions.

Lawrence: It depends where you invest. There are big opportunities in VC.

Cahani: Yes, but it is better to be a lender right now than an investor.

Brain: There is a note of caution to be sounded here. Are they tested through a proper economic cycle? One of the consequences of higher interest rates is that you get more economic volatility, more ‘boom and bust’, as well as more inflation.

Liquidity is one thing, but default is another story. Your capital can evaporate fairly rapidly if we go through a period of significant economic stress, which is coming. So you will need to balance your private assets with liquid assets.

The other issue is that a passive investment is a way of delivering a solution at a cheaper price, but it is a beta play. Active investment costs more and the challenge for us is to deliver active investment at a competitive price. One that gives the clients access to that regime change backdrop while delivering more than just the beta.

> **We are coming into a period which, even for government bonds, is far more attractive than we have seen in a long time.**
>
> Emma Matthews
> Head of investment
> Now Pensions

On the subject of fees, has regulation been a help or a hindrance?

Mattingly: Performance-related fees are an issue. We were going to involve a particular sustainable energy company in the illiquid exposure of the Cushion Master Trust but there was an insistence on performance-related fees, which excluded them from that strategy.

From a regulatory perspective, the pressure should be put on the private market providers to create a charging structure that is more palatable to master trusts.

In DC there is a massive scramble for assets. Over the next 10 years, 10, maybe 15, master trusts could possibility have £1trn between them. So the prize for private market providers is huge.

Rather than putting the changes to regulation on the side of schemes fitting in with the private market charging structure, it should have been done the other way around: the challenge should have been to private markets saying that this market is going to be absolutely huge and there is a desire to have uncorrelated and diversified assets, to have significantly higher attributions to private markets, so can you make your charges more palatable? And that may be to recognise the complexity and the specifics of some products.

Performance-related fees are an issue. It is causing a problem.

> **Pressure should be put on the private market providers to create a charging structure that is more palatable to master trusts.**
>
> Roger Mattingly
> Trustee director
> Independent Governance Group

Matthews: I will second that. I get the benefit of performance fees elsewhere in the market, but with DC, when its member assets, when you are pricing regularly, the mechanism for implementation is difficult to justify and make sure you are treating all of your members fairly.

Cahani: One of the main fiduciary duties trustees have is making sure that if you are paying fees, you are getting the return. If young members are part of that, and people in their 50s are doing the same, they are not going to have the same investment power.

Mattingly: It causes a fiduciary problem.

James: Can I play devil's advocate? We look at Australia as the future and they invest in illiquid assets and are willing to pay higher fees looking for stronger net of fees performance.

Lawrence: It is a journey. There are enough operational issues with getting these assets in without performance-based fees being another. There are managers out there that understand the issues and are willing to go with lower fees, or maybe without performance-based fees, just to get into the market early.

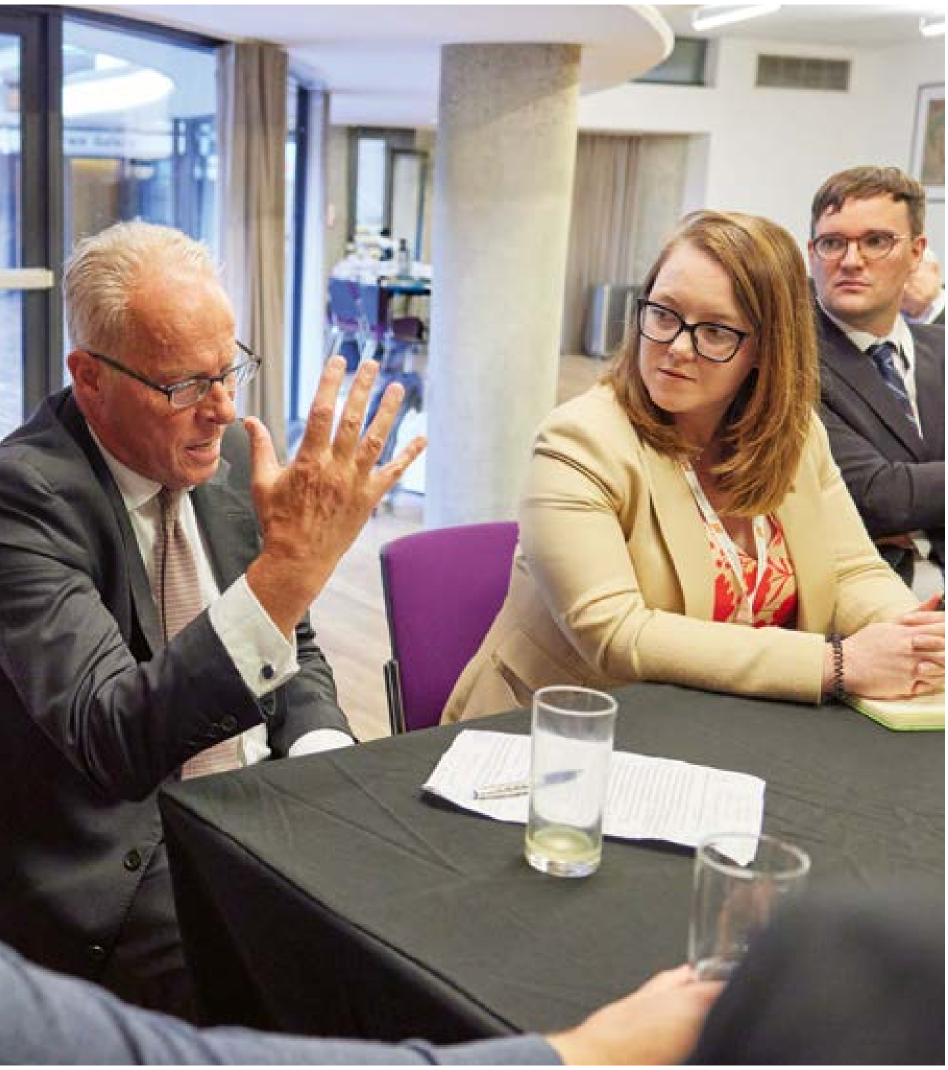
Things may change over time, but it is an issue. Performance-based fees would be another headache, which wouldn't be overcome by most master trusts or DC plans right now. Perhaps, as things mature, they could come back if demand is there.

Cahani: Conversations are happening in this space. Master trusts and pension schemes are asking us to show them what a mandate would look like with and without performance fees.

We are grappling with this when it comes to the value proposition for the client and implementation challenges.

Lawrence: Presumably, when you build something without a performance fee to co-invest in secondaries, there are pros and cons to that.

Cahani: Or if you include alternatives that don't charge performance fees. A number of schemes are looking to have liquidity built within an LTAF structure based on the platforms they use. In these cases, you are looking at a weighted-average fee of the LTAF, which leaves some room for movement.



What are the big barriers to making DC portfolios more sustainable?

Matthews: It's a challenge. It is about finding the right balance between allocation and engagements. It is something that has evolved materially over the last few years. That has expanded our equity exposures, which are tilted towards lower emissions, but also recognising that the transition and allocation alone are not going to solve the problem.

If you disinvest from something that has terrible carbon emissions, they are still going to be emitting. We are trying to find that balance, engaging and looking at how we can leverage our investment managers on the equity side as well as what we can do with bond issuers to further that journey.

Lawrence: We discuss it at every trustee meeting in significant depth. The governance required to do this properly is difficult, especially as we have biodiversity in our default fund and TNFD is coming up, which is going to be another layer of scrutiny and intensity on master trusts.

We have just implemented trustee-directed voting. We are probably not going to give our members 1,000 votes a year, but we will give them a voice on the biggest votes, Shell and BP, etc. Where stewardship sits is a big discussion.

Hope: The regulations are putting more onus on trustees. We are finding that trustees are feeling a little bit helpless in the sense that there are a number of layers to get through. A lot of them are invested in pooled passive funds and then through to the managers involved. Trustees want, and in some cases due to scale must, delegate a lot to the investment managers.

The real problem is the work investment managers, particularly passive managers, need to be doing is through meaningful engagement with the underlying hold-

> **There will be a greater focus on the natural costs of sustainability going forward.**
>
> Paul Brain
> Deputy CIO of multi-asset
> Newton Investment Management

ings across the board. There needs to be an exponential growth in these engagements from stewardship teams. Trustees appreciate that it is an issue but are feeling a little caught in the middle.

Matthews: It is also prioritisation. There are a million and one things that we could do, but it comes back to: how do we fight the right fight.

What are the big sustainability issues that we are talking about here?

Matthews: For us, we have gone back to looking at what is important. We are balancing the environmental side as well as the social side. I mentioned gig economy workers, so when we engage, we are not just looking at climate change and biodiversity, but also at gender equality and living wages and how do we fight those fights for our members, while still acting within our fiduciary duty.

Brain: We spent a lot of time making sure that on the fixed-income side we have a voice in the stewardship engagement. And because we invest in investment grade and high yield, we have more access to companies than some of our equity investors. It is surprising how many times we engage with companies.

If we don't like what we see, if they don't have the right diversity mix on the board, for example, we can tell them why we are not going to invest in their bonds. We get a lot of changes through that way. We don't have a vote, but you would have to be quite a big equity investor to change the direction of the company.

If you can work with them to coerce them in the right direction, then you have used that capital in a sustainable way.

Cahani: When it comes to sustainability, you have to consider an adaptive approach over the long term.

For example, we are looking at how an active illiquid approach to fixed income can adapt the portfolio over time to be net zero, or a certain targeted sustainability goal that they have. It's an adaptation over the long run.

Brain: To add to that, we have so many different tools because we invest in different levels of the capital structure. We are not just buying listed equities. We can buy sustainability-linked bonds or green bonds and we can engage with the company and get them to change their standard issues as well.

James: Taking a slightly different tact, I have been told that from our RITE survey, 60% of our DC clients have an ESG fund in their default, which is positive. It is likely to be a passive global equity index, but it's a good step.

We talked about barriers. Fees are higher for active funds looking for a positive impact in companies looking at climate change, etc, and therefore are generally only available as self-select funds.

As well as making the world a better place, asset managers have to make money for their clients. How are investment managers helping schemes to earn value from the energy transition?

Cahani: On the equities side, we know that a number of DC schemes, sponsor and master trust led, are targeting net zero by 2035 and 2050. This is a moving target and you are not expected to meet this through a passive approach to investing.

A lot of the conversations we have are about adding that active layer to the existing application, basically an active tilt to a passive portfolio for performance enhancement or ESG goals.

Some interesting trends have emerged around commodity ETFs. Instead of as an inflation hedge, they are being used as an asset-transitioning tool. If your assets are in transit, or you are waiting to deploy a bulk of assets over time, a custom-made allocation to such a proposition can target certain ESG goals.

When you think commodities, you think carbon, but you can include a reduced carbon approach to that allocation. That is a trend we have seen emerge in that space.

Matthews: We historically had oil exposure, but we removed it a while ago to look at commodities and how different commodities can support the green transition and the journey to net zero.

Cahani: It is interesting how many positive trends have emerged in this space. We did a session on this last week, and I was surprised at how you can positively tilt an energy allocation in terms of returns.

Matthews: When we get to 2050, we will need to build new homes and we will still need electricity. We have to be mindful on how we incorporate that into the journey.

Mattingly: The great thing about large master trusts is they can have an almost infinite time horizon. So liquidity is pretty illusory and should not be a barrier to the world of private markets and sustainable energy.

This requires incredible discipline on the operational side. It is okay if you have many millions of pounds coming in every month but there is a lock in period of three years which needs to be navigated, and you need a lot of stress testing in terms of market changes to make sure you always have enough money to pay benefits.

With the DC population, there will be an inflection point when it becomes a mature population. At the moment, it's not. Across the board, it is a pretty immature population in terms of membership across master trusts.

Trustees have to check it against financial materiality. That is difficult when you have the Ukraine and Russia situation almost artificially inflating market prices of certain fossil fuel energy companies. You have to continue with the belief that those companies that take the transition physical risks of climate change seriously and risk manage those that they will outperform in the medium to long term.

Hope: On the financial materiality point, the difficulty with these funds is that they have short historical performances. It is one thing me talking to them about empirical evidence, but how is this playing out?

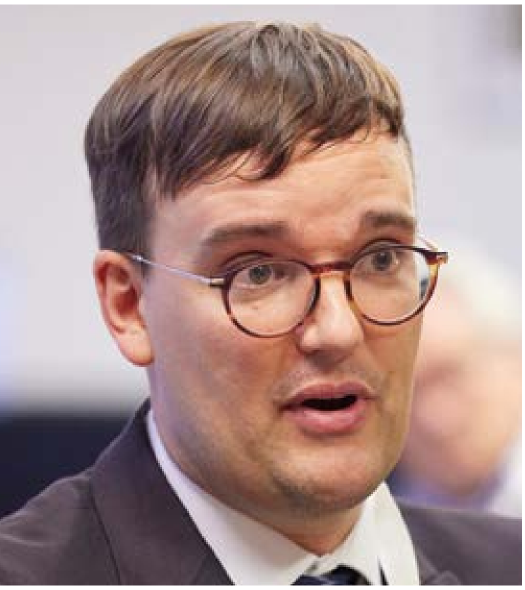
We had an unusual 2022, but surveying the membership gave trustees comfort. The member responses are probably the one area where I have been enthused by the level of engagement, with up to 60% to 70% of the membership responding. We even asked if they would pay more or retire later if you were to invest in a sustainable way.

We had some positive responses, but the responses tend to be quite heavily correlated by age. As people get closer to retirement, their willingness to pay more or retire later diminishes.

I started this discussion by asking each of the asset owners around the table what they want to invest in. All three said natural capital. Why is it so popular?

Lawrence: Inflation protection is a big piece of that. Biodiversity credits are going to be big as well, so we are getting ahead of that journey. It is also a great member engagement story. It is a pretty under-invested market, so there is an opportunity.

Mattingly: It is horribly complex. There are the carbon markets and sequestration, and then there is deforestation. The irony is that making wind turbines, until fairly recently, decimated forests in Columbia in the process. The more you delve and the more you get to grips with this, the more you realise that you are not getting to grips with it. It is a three-dimensional simultaneous equation.



We need to fundamentally move towards a perception of value rather than absolute cost.

Andrew Hope
Director
Willis Towers Watson

There is a lot of consolidation in the DC market. Is that helping?

Brain: In the investment management industry, consolidation is a natural consequence of the fee pressure. Active managers have to deliver products at ever lower costs to the investor, and naturally, that leads to consolidation.

That will only go so far, because you don't want to lose the ability to generate alpha. Unfortunately, if you squeeze it too much you end up with supermarkets which don't deliver alpha. We may be getting

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Martyn James
Partner, DC and DB investment specialist
Mercer

close to that point, but we probably have a couple more years of consolidation to get through.

Cahani: Schemes, be that master trust or sponsor-led, are grappling with the same issues: sustainability, fee compression and consolidation. They will impact the propositions that come to market and how we handle conversations with clients.

The biggest shift that is going to come through consolidation is we are going to see more of a partnership approach. You will see DC schemes and master trusts working closely with asset managers and platforms to create more holistic propositions.

What will be the next big development in DC?

Brain: A realisation about sustainability and its costs. The transition comes at a cost in many ways. In every large investment cycle, there has been an awful lot of wastage of previous capital, and then there is a lot of wastage of natural resources to come up with new capital. We need to judge that more clearly. Unfortunately, the regulation we were coping with does not necessarily help us do that.

What we as investors need to do is lift the lid a little more on electric vehicles. The batteries are great, but how are we creating them? What damage does it do to the environment? Is there a better way?

There will be a greater focus on the natural costs of sustainability going forward.

What are the big investment challenges for DC going forward?

Hope: One area where there is going to be some focus is post-retirement and what those designs look like in this pensions freedom world.

How people access their funds and what they are going to do about long-term care will decide what the investment designs will look like through to retirement. That is definitely going to be an area of focus for master trusts and trustees.

Matthews: Post-retirement development is essential. We cater from the day someone becomes a member all the way to retirement. It surprised me when learning about master trusts for the first time, that we didn't cater for it all the way through. We should be developing something to do that.

Cahani: I came here from a meeting on the same topic. We are going to see access enablers that can bring together propositions for schemes and master trusts to enable access to asset managers in a simplified method.

A few are already doing that, but we will see more of them emerge.

Matthews: Do you need a platform? Could you just build it yourself and remove that cost?

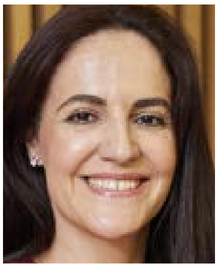
Cahani: Master trusts and pension schemes can do it, but it is about enabling access because members may not want to stay with their master trust upon retirement.

Providing that flexibility to choose the proposition. Here are the tools, here is the platform you can design on your wants and needs, they can do a glide path with drawdown protection, as well as keep the lights on with annuities. Bringing those propositions through to members via a platform is quite powerful because it gives them choice but also some guidance.

Sometimes it is a fine line between advice and guidance. The best way trustees can facilitate this is through giving them guidance towards the right enablers for this.

James: There are other issues post-retirement. There is potential for Collective Defined Contribution [CDC], for example. Also, as another example, we have a solution which provides digital and regulated advice to all individuals regardless of pot size, not just at retirement, but in retirement as well.

This means their investment allocation is looked after right the way through retirement, so there definitely are some interesting innovations in this area and there are some exciting new areas to look at.



Mary Cahani is Invesco's UK institutional director focused on DC clients

NAVIGATING TROUBLED WATERS: THE POWER OF A PARTNERSHIP APPROACH TO SOLVING DC SCHEME CHALLENGES

The unique and various challenges faced by defined contribution (DC) schemes – from member engagement to decumulation – are made only more complex as a backdrop of market uncertainty persists. Requirements for capital protection, diversification, inflation protection, income stability and sustainability demand careful balance; a balance that we believe is best struck by consolidating knowledge of needs across key decision makers.

Each DC scheme and member has its own distinct characteristics; therefore, a customised approach is needed to solve their unique challenges. Invesco's global footprint, rich expertise and investment capabilities, coupled with our partnership approach when engaging with DC schemes (master trust or sponsor-led) can provide the help needed to navigate challenges faced across the spectrum: whether that's looking to enhance passive exposure, integrating alternatives as part of the portfolio, or solving for decumulation.

Harnessing alternative thinking

Alternative asset classes, including private credit, private equity, infrastructure and real estate, are already well known for their potential to help DC schemes increase income stability for their members. However, implementing alternatives in DC comes with its challenges, with access and operational complexities, as well as intricate fee structures limiting all but the largest institutions from accessing these markets and reaping their potential benefits. Expert knowledge when it comes to operational pitfalls and access requirements for DC schemes is essential.

A collaborative, partnership approach can help DC clients navigate these complexities with confidence, and Invesco's global alternatives platform provides just that. We've been managing alternative solutions for almost 40 years, with assets under management totalling $186bn (£153bn). And with 481 dedicated private markets professionals around the world to support them, our DC clients are well positioned to benefit from the potential for enhanced income, diversification and inflation-hedging these ever-growing asset classes can provide, be that via a multi-alternative solution or single asset class such as private credit or real estate.

The transition to sustainable investments

Pensions Minister Guy Opperman said in 2020: "If you are in the pensions and savings business, you start with the fundamental principle that you believe saving should be done for the longer term. If you aren't addressing climate change, there is no longer term. It is the defining issue of the 21st century."

Sustainability has long been the elephant in the room for DC schemes striving to find the balance between financial objectives and sustainability objectives. And while concerns that investment performance can be impeded by a focus on sustainability are rightfully fading, many schemes turn to the abundance of passive sustainability indices to meet their needs in a low cost, low governance way.

The skillset required to get the most out these two objectives simultaneously in a passive portfolio, however, remains specialised and can be difficult to achieve in a fully-passive solution. Invesco's access to a broad range of passive products enables customisable solutions to be packaged in-house, allowing for dynamic active alignment towards your sustainability objectives. Utilising Invesco's portfolio construction capabilities, our DC clients can be better positioned towards more active management implementation, including superior sustainability metrics and greater control over tracking error.

The growing challenge of decumulation

Decumulation. A concern that Nobel Prize winning economist William F. Sharpe called one of the "nastiest, hardest problems in finance".

With today's DC schemes continuing to mature and seeing more people opting to take out cash once retirement is reached, we are faced with the huge challenge of low member engagement limiting access to the decumulation solutions which can help optimise their income in retirement and provide the inflation and longevity protection members need.

While the government has shown a willingness to allow for innovation in this area and the DWP works to establish frameworks to support and inform members, a solution in this space requires a carefully-balanced mix of net cash moving away from a strict annuity doctrine.

Our scale and partners enable us to work towards a cost-effective, innovative proposition that is easily accessible to DC members and can help effectively meet their needs for the retirement journey.

A true partner for DC schemes across the spectrum

Invesco's global footprint, wide range of capability set and our customised approach to solutions provides us with the perfect toolkit to tackle a number of challenges faced by DC schemes and its members.

We strongly believe in the power of collaboration and knowledge sharing when designing fit-for-purpose solutions for DC schemes across asset classes. By better understanding the needs of each scheme and its members, we will be able to positively contribute towards improved member outcomes during the growth and decumulation stage. We Listen, learn, share and action!

Invesco

Chris Nichols is head of client solutions at Newton Investment Management

THE MULTI-POT MODEL FOR RETIREMENT INVESTMENT DECISION MAKING

The introduction of pensions freedoms in 2015 has meant that defined contribution (DC) retirees face a plethora of decisions to be made, and with this comes potential risks.

Whether guided or advised, one of the common approaches to settling upon an appropriate retirement investment portfolio is the use of a multi-pot model. By separating pots of assets according to different underlying purposes – for example, a 'wallet' for day-to-day spending, a 'rainy-day fund' for unexpected expenses, and a long-term pot to generate returns – retirees implicitly commit to using those assets for a particular purpose.

Evaluating the multi-pot retirement investment strategy

The value that the multi-pot model creates has been demonstrated to be connected to the mechanism used for rebalancing across the pots as markets move and income is drawn. The demonstrable weakness of many multi-pot drawdown portfolios is the fact they are automatically rebalanced across the pots.

This means that spending from the 'wallet' is effectively just spending across all the pots. There is no discretion applied to the timing of sales of higher-risk assets to refill the spending bucket, nor is there ongoing re-evaluation of the mix between growth and later-life (perhaps annuity purchase) pots.

Even those pensioners benefitting from personalised advice from an independent financial adviser may find that discretionary rebalancing is not a service that is offered. Advisers are typically specialists in personal finance and tax planning rather than investment markets. Making discretionary portfolio changes puts the adviser at risk of being criticised for mistiming the asset switches.

Even when a discretionary portfolio management service is employed, the push for efficiency means that standardised model portfolios are often used and, as a result, the asset allocation is not client-specific so cannot take account of any particular level of income being drawn down.

What can be done?

Clearly there are some discretionary advisers who, for a suitable fee, will use their own research to make the timing call for their clients. For those that do not want to pay such fees, and

for institutional DC plans offering decumulation in-plan using robo advice to guide members, other options are available.
If the multi-pot model is deemed unnecessary, a risk-appropriate multi-asset investment could be used given that, within the portfolio, the asset manager may make asset-allocation calls as part of the overall active investment process. While this may lack calibration to individual drawdown levels, both risk capacity and market path dependency can be actively and expertly managed.

The potential benefits of an income focus

For those that want to retain the personalisation, cognitive comfort and ease of understanding that the multi-pot model offers, there may be another option – the use of income-focused equity and multi-asset portfolios in the mid and long-term pots.
By using their income share classes, the dividends can be directed straight into the 'wallet'. This effectively devolves the timing of moving assets to the individuals closest to the economic activity that actually underpins the returns as a whole – the organisations that are using pensioners' capital. They are arguably in the best position to determine when they can pay sustainable dividends – they pay dividends when they feel this is the smartest way they can add value for their shareholders.
The fact that the pensioners' portfolios contain a diverse array of dividend-paying securities means the timing of 'rebalancing' is smoothed by the separate decisions of the firms, each one making the optimal timing choice for its business.
Naturally, one may ask, in this arrangement, what if the income flowing into the short-term/cash pot is not enough (or is too much) compared to the pensioners' actual spending needs?
In such a case, a pensioner's additional demand could serve as a first indicator (to them) that their spending may be too high to be sustainable over the long term without capital erosion.
Alternatively, if the short-term/cash pot is growing steadily, it could indicate that their investments are doing well enough to support additional spending. In either case, this would lead to a need to engage with the drawdown platform, along with its built-in guidance tools. In the process, the pensioner should actively reconsider their situation, rebalancing their pots if necessary, and become cognisant that they shoulder responsibility for any decision to decumulate faster (or slower) than is naturally supportable.
The pensions freedoms come tied up with a complex set of personal responsibilities, and for those who find the burden is too great and are not prepared to seek expert advice, the annuity option is always available.