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Redefining Defined Contribution

The defined contributions environment is evolving rapidly. How can pension providers keep up?

So much is happening and so fast in Defined Contribution (DC) pensions, it is little wonder that some scheme providers are turning in circles wondering what it all means for them.

First there is a structural challenge: DC schemes and members are proliferating as Defined Benefit (DB) is phased out worldwide. As a result, scheme administrators and trustees are adjusting to ever-growing volumes of savings, combined with increasing demands for member-specific investment strategies.

Then there is the market challenge: volatile markets and central bank action mean holders of traditional assets, such as long-only equities and bonds, have little visibility over returns – even over the long term.

Finally, schemes face a rising regulatory challenge, through the imposition of fee caps and increasing demands for schemes and their fund managers to deliver value for money.

Key takeaways:

- The DC industry faces substantial challenges as inflows and member demands increase, bond yields stay low, markets remain volatile and more regulation impacts schemes.
- The first part of the solution is to go back to first principles. This requires independent thinking, and a relationship between fund manager and scheme which is consultative, objective and based on trust.
- The second part of the solution is to implement robust strategies that are designed to perform consistently and shield members from excessive volatility. Such strategies should not only perform well, but meet regulators' value-for-money criteria.

Market regulation on the move

While the structural and market challenges represent slow-burn change, the regulatory landscape has shifted at short notice.

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The DC market has been relatively lightly regulated until recently. Now demands on DC schemes are rising with governance, transparency and charging caps high on the regulatory agenda in many countries. In the UK, in particular, a focus on value for money has been formalised through the creation of Independent Governance Committees (IGCs). Those committees are designed to underpin improvements in the governance of in particular legacy contract based workplace pensions and represent the interests of scheme members in assessing value for money.

These governance measures came into force last year but in response to the new workplace pensions charge controls" on DC schemes, limiting them to 0.75% a year on each member's funds. Suddenly old legacy schemes looked overpriced for the quality of the product, given the new shiny AE products gracing our market. The Financial Conduct Authority (FCA) set about identifying these through an

Independent Project Board (IPB) that has set out how providers' should approach legacy schemes with high associated charging structures that IGCs will monitor their progress in bringing them into line.

This charge cap includes payments to professional services providers, member communication services, such as pension statements and printing and posting scheme documentation and ongoing costs for line items like IT, office, staff and record-keeping. So there is not always a lot left over for investment management fees. This represents a huge challenge for both DC scheme providers and the fund managers which serve them. And if that wasn't enough the FCA has set up a 2017 review to debate whether the current charge cap should be reduced even further. The Investment Association (IA) is campaigning to hold the cap at current levels, as any further reductions may remove the opportunity to use active management to enhance growth and diversification, especially though the use of alternative asset classes.

Taking stock of the challenge

The equation for the pensions industry is simple to express, but not easy to solve: schemes must deliver member benefits, but at reduced cost.

This equation cannot be solved by tweaking the product set or by implementing other marginal improvements to the scheme. The DC industry needs to stand back and work out what members need and how investment solutions can meet with the approval of regulators while providing the desired level of return.

The DC generation is confronted by numerous variables, including how long they might live, the future cost of living and their future spending plans, and these variables require thought to address and skill to solve. Throw the market and regulatory issues into the mix, and it is clear that a targeted and viable strategy is at a premium.

Back to first principles

So the first part of the solution for pension funds is to take a step back and go back to first principles. This requires independent thinking, and a relationship between fund manager and scheme which is consultative, objective and based on trust.

NGAM's Portfolio Research and Consulting Group (PRCG), for instance, provides a fresh, analytical look at portfolios, which is independent of its asset management services and does not make investment recommendations. For scheme consultants, it is a second pair of eyes to complement their own client activities. For scheme trustees, it is a sense check to ensure the investment strategy is on track. For IGCs, it helps ensure the relevance, suitability and value for money of the funds they are tasked to govern.

The PRCG has the scale and skills to analyse funds and underlying securities, apply stress tests and rank performance contributors. It can help schemes create more durable portfolios by prioritising risk management and improving diversification.

Targeting value for money

The second part of the solution is to implement robust strategies that are designed to perform consistently and shield members from excessive volatility. Such strategies should not only perform well, but meet regulators' value-for-money criteria.
For some schemes, this means a growing reliance on low-cost passive investments. Investments which track indices may well be part of the answer, but probably not all of it. After all, index-trackers have produced scant returns for investors in recent times: an investment of £1,000 made in 2000 in the FTSE 100 index would still be worth £1,000 today[1]. That is a huge opportunity cost and not helpful for members' retirement outcomes. And anyone investing in the Eurostoxx 50 over the same period would be sitting on losses of more than 40%.

While index funds may have their place, funds with high active share will provide more alpha and, usually, higher long-term returns. Recent studies on the concept of "patient capital" suggest that asset managers with the highest active share and the longest fund duration tend to outperform.[2]

Alternative strategies can also reduce volatility and drawdown: the addition of alternatives to a portfolio can reduce the extent and duration of the impact of pronounced market falls. For example, infrastructure debt tends to move in the opposite direction to the typical institutional portfolio when the latter drops rapidly in value. Similarly, commercial real estate debt has a consistently low correlation with traditional institutional portfolios. Even an allocation to ESG and green bonds can considerably reduce portfolio volatility over the long term.

Structuring DC portfolios

So how can DC schemes go about putting together portfolios of assets that will both perform to expectations and meet the requirements of modern DC pension platforms?

DC members need investment strategies that are designed for the duration of their working lives – from early career to retirement, and beyond. This means the DC offering must offer members the ability to move along the scale from the accumulation phase, when they are building their pensions savings and require growth solutions, to the decumulation phase, during which DC members' focus switches to post-retirement risks such as generating adequate income, dealing with longevity and inflation, and managing drawdown strategies.

NGAM's multi-affiliate model gives schemes access to more than 20 specialised active investment managers in the Americas, UK, Europe and Asia, and to more than 100 innovative investment strategies. The strategies include traditional and alternative investments, international and domestic securities, traditional and multi-sector fixed income, real estate and liquid alternatives.

NGAM's funds are designed to be integrated as active components in diversified growth funds, glidepath, target date and lifestyle strategies or as standalone options.

Conclusion – long-term thinking and partnerships

It is fair to say, the DC industry is in flux.

Some schemes are finding they are out of tune with their members, who seek more diversified investment solutions and options that match more closely their individual needs. In particular, they seek robust investments, which are better able to withstand volatility and also deliver alpha alongside their passive and smart beta allocations.

This is not easily done. It requires thought, new strategies and, in many cases, new solutions.

Schemes and their managers must reject transaction-oriented, short-term thinking and instead invest in resources that build long-term sustainable value especially as they begin to find the scale that will allow them to diversify the portfolios they govern.

The path to achieving this is likely to involve enhanced dialogue between asset managers, consultants and the scheme providers, with ideas flowing in all directions and a partnership approach to navigating the way through the evolving DC landscape.

[1] At July 11 2016

[2] Martijn Cremers & Ankur Pareek "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." September 2014

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