What is value for money?

Pension schemes face up to new challenge

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Key takeaways:

- Value for money (VFM), key issue in the pensions world, is not clearly defined by either the regulator or the pensions industry. A Natixis Global Asset Management workshop attempted to come up with some useful definitions and potential practice areas.
- Investment performance is regarded as the most important VFM issue, with communication and engagement close behind. However "Investment proposition" is a better description of what schemes should focus on than "investment performance". Investment proposition should include quantitative metrics, while qualitative metrics include the product range, retirement choices and ease of use.
- Incorporating risk alongside performance is a key part of the VFM consideration. The reassurance that assets are not exposed to excessive market risk and can compound year after year is uppermost in the minds of most rational scheme members.

Value for money is emerging as a key issue in the pensions world. This is particularly true in the UK where the Financial Conduct Authority (FCA) has made clear it will scrutinise schemes for value for money (VFM) and, potentially, take action where it finds schemes are deficient. However, the FCA has not defined VFM and has, for the moment, left it to pension schemes to establish their own definitions.

Amid this backdrop, Natixis Global Asset Management held a Value for Money Workshop at its London offices in July 2016.

The attendees, who included portfolio managers, general counsels and pensions specialists, considered what pension schemes should be doing to meet the VFM challenge head on.

Why focus on VFM? Why now?

The context for the workshop is the increasingly challenging environment for DC pension providers:

- DC schemes and members are proliferating, and scheme administrators and trustees are adjusting to ever-growing volumes of savings
- Demands are increasing for member-specific investment strategies.
- Volatile markets and central bank action mean there is little visibility over returns – even over the long term.
- Schemes face a rising regulatory challenge, through the imposition of fee caps and increasing demands for schemes and their fund managers to deliver VFM.

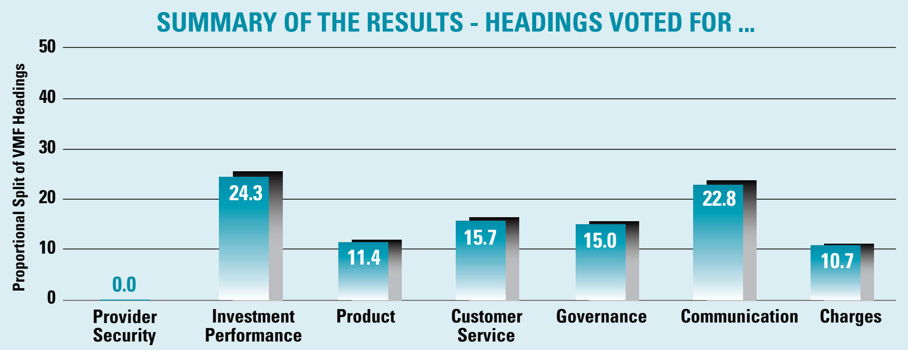
With these demands already on pension schemes, few have had the time or resources to devote to VFM issues. The workshop attempted to frame the VFM debate and come up with some useful definitions and potential practice areas.

Let's try to define VFM

From a pension scheme member's perspective there is no true way of knowing whether you are getting value for money until you start receiving scheme benefits. This makes a defined contribution (DC) provider's job challenging. In the absence of regulatory prescription, providers are tasked with defining what VFM may mean for their membership as a whole and for individual members throughout the pension lifecycle.
The seven industry participants at the workshop were invited to offer definitions of VFM. These definitions were filtered into categories, and participants then scored each category.
The results are summarised below. As can be seen, investment performance is regarded as most important, with communication and engagement close behind.

It was suggested that "investment proposition" is a better description of what schemes should focus on than "investment performance". Investment proposition could include quantitative metrics such as performance, while qualitative metrics could include the product range, the investment process, retirement choices and ease of use.

Communication and engagement.
Perhaps the most valuable activity a DC provider can carry out is improving engagement and getting scheme members a) to invest at all, and b) to think about what they are investing in. Engagement is also poor in the run-up to retirement, with the average member typically only thinking about their options a year or so before taking benefits.



Source: Natixis Global Asset Management, Portfolio Research & Consulting, August 2016

It was agreed that the categories and the scores accorded to each needed further exploration:

Investment performance.
Performance can mean different things to different constituencies. While pension schemes may benchmark performance against other schemes or against a market benchmark, scheme members are not interested in benchmarks. They simply want their annual statements to show consistent and stable (non-volatile) fund growth.

This is possibly because pots are currently small and most members choose to withdraw cash. As larger pots reach maturity, schemes will need to improve communication around the transition period. This is a key VFM issue, even though it is separate from investment performance and charges (which the UK regulator probably has in mind).

Charges.
Partly because of media focus on charges, scheme members are now more aware of the issue and are asking questions of their providers. However, the issue is not solely the quantum of charges, but about systems of charging and whether they are equitable and address conflicts of interest between fund managers, schemes and members.
While the charge cap is important in terms of its constraints on asset allocation, to some extent it is a red herring because it does not address fee alignment and the question of VFM.
The regulator may at some stage look at bundled charging, as it did in the Retail Distribution Review (RDR), which came into force in 2013. Providers should probably think about issues of transparency in advance of any regulatory move. For example, should scheme members be footing the bill for research costs?

Product.
VFM as it relates to product is likely to mean:

- A fund range which is suitable for the particular membership profile.
- Sufficient, relative choices at retirement.
- Regular reviews of investment options
- A fit for purpose default.
- No barriers to additional contributions.

Governance.
Scheme members have effectively delegated someone else to look after their pension and their future. They expect providers to have effective governance – this is a key trust issue and a major VFM proposition.

In search of relevant VFM benchmarks

For members and DC providers alike, a level of consistency and standardisation is required to create benchmarks. Without benchmarks, VFM cannot be assessed.

Benchmark aspirations include:

- Benchmarks of peer groups.
- Benchmarks of performance vs risk (the type of risk measure could have differing interpretations).
- Peer groups vs the market.
- Independent Governance Committee (IGC) vs master trust.

Portfolio management VFM

In a session presented by Andrew Kinsey-Quick, a consultant in Natixis Global Asset Management's Portfolio Research and Consulting Group (PRCG), the focus was on the investment proposition and particularly on the desire of scheme members to access stable returns. The goal of the session was to emphasize the importance of incorporating risk alongside performance as a key part of the VFM consideration.

Kinsey-Quick demonstrated, below, the difficulty portfolios experience when trying to recover from drawdowns caused by extreme market events. As can be seen, it took index-tracking investors more than three years to recover losses from the 2000-02 downturn in the FTSE All World Index, and more than four years to recover losses suffered during the financial crisis.

Portfolios that are apparently diversified can be shown to be more correlated than schemes believe. The grid, below, shows for example that correlations are high across much of the equity portion of a typical "balanced" portfolio (which contains a wide range of traditional and alternative assets across geographies, sectors and asset classes). The darker areas indicate the highest levels of correlation.

markets, could suffer significant losses. As part of the process to create a more diversified portfolio, investors should consider the five principles of **Durable Portfolio Construction** (DPC), as defined by Natixis. This process starts with risk. Assessing portfolio risk can mitigate the risk of significant loss from which a pension scheme's portfolio cannot organically recover.

IS THE PORTFOLIO DIVERSIFIED?

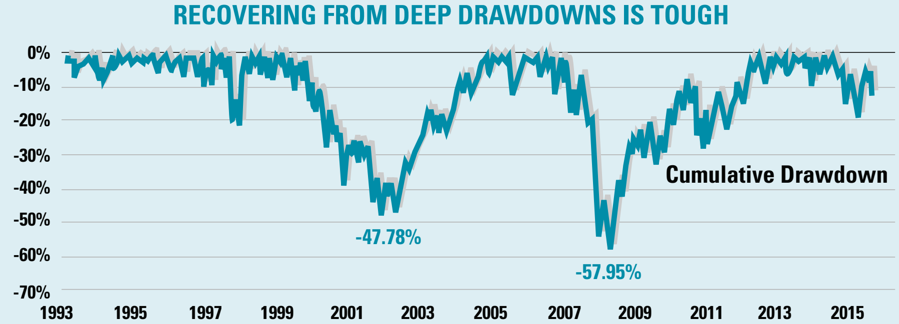
	Existing Allocations	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31
1	**VFM**	**1.00**	**0.82**	**0.88**	**0.88**	**0.88**	**0.91**	**0.83**	**0.71**	**0.89**	**0.90**	**0.93**	**0.85**	**0.89**	**0.59**	**0.63**	**0.58**	**0.78**	**0.76**	**0.57**	**0.70**	**0.62**	**0.63**	**0.64**	**0.47**	**0.68**	**0.44**	**0.43**	**0.79**	**0.47**	**0.01**	**0.06**
2	Equity US Index	0.82	1.00	0.85	0.83	0.79	0.76	0.76	0.58	0.65	0.62	0.69	0.60	0.61	0.44	0.51	0.50	0.57	0.57	0.46	0.46	0.49	0.51	0.53	0.53	0.41	0.39	0.32	0.60	0.19	-0.05	0.17
3	Equity North American	0.88	0.85	1.00	0.99	0.77	0.79	0.63	0.50	0.74	0.76	0.78	0.67	0.76	0.47	0.65	0.60	0.62	0.61	0.35	0.40	0.39	0.39	0.43	0.38	0.52	0.28	0.23	0.71	0.32	-0.01	0.05
4	Equity American Unconstrained	0.88	0.83	0.99	1.00	0.76	0.78	0.62	0.51	0.76	0.75	0.78	0.68	0.76	0.48	0.66	0.59	0.60	0.59	0.37	0.41	0.43	0.43	0.46	0.36	0.50	0.30	0.23	0.68	0.31	-0.04	0.08
5	Equity European Income	0.88	0.79	0.77	0.76	1.00	0.95	0.92	0.76	0.74	0.75	0.80	0.70	0.73	0.49	0.54	0.54	0.66	0.64	0.49	0.59	0.56	0.58	0.51	0.55	0.50	0.41	0.31	0.62	0.36	-0.04	0.07
6	Equity European Growth	0.91	0.76	0.79	0.78	0.95	1.00	0.86	0.76	0.81	0.83	0.85	0.80	0.83	0.57	0.58	0.56	0.67	0.64	0.44	0.58	0.49	0.51	0.50	0.44	0.59	0.33	0.28	0.67	0.41	-0.03	-0.02
7	Equity Continental European	0.83	0.76	0.63	0.62	0.92	0.86	1.00	0.81	0.73	0.69	0.77	0.67	0.66	0.50	0.43	0.40	0.64	0.63	0.59	0.71	0.63	0.64	0.58	0.53	0.50	0.49	0.41	0.58	0.35	-0.07	0.15
8	Equity European Smaller Companies	0.71	0.58	0.50	0.51	0.76	0.76	0.81	1.00	0.78	0.70	0.73	0.76	0.69	0.80	0.28	0.22	0.48	0.45	0.40	0.55	0.44	0.44	0.39	0.30	0.50	0.30	0.28	0.36	0.19	-0.17	0.13
9	Equity UK Income Unconstrained	0.89	0.65	0.74	0.76	0.74	0.81	0.73	0.78	1.00	0.95	0.96	0.95	0.94	0.76	0.47	0.36	0.57	0.55	0.39	0.60	0.44	0.45	0.46	0.18	0.60	0.19	0.22	0.68	0.43	-0.11	-0.05
10	Equity UK Growth	0.90	0.62	0.76	0.75	0.75	0.83	0.69	0.70	0.95	1.00	0.97	0.92	0.96	0.68	0.54	0.41	0.67	0.64	0.37	0.58	0.39	0.41	0.46	0.24	0.71	0.19	0.25	0.72	0.46	-0.10	-0.09
11	Equity UK High Income	0.93	0.69	0.78	0.78	0.80	0.85	0.77	0.73	0.96	0.97	1.00	0.90	0.93	0.69	0.51	0.44	0.68	0.67	0.44	0.61	0.47	0.49	0.49	0.31	0.65	0.26	0.30	0.76	0.49	-0.05	-0.03
12	Equity UK Unconstrained	0.85	0.60	0.67	0.68	0.70	0.80	0.67	0.76	0.95	0.92	0.90	1.00	0.94	0.71	0.45	0.32	0.61	0.57	0.34	0.59	0.40	0.40	0.44	0.18	0.67	0.16	0.22	0.60	0.36	-0.07	-0.08
13	Equity UK High Alpha	0.89	0.61	0.76	0.76	0.73	0.83	0.66	0.69	0.94	0.96	0.93	0.94	1.00	0.65	0.54	0.39	0.68	0.65	0.38	0.59	0.39	0.39	0.48	0.25	0.72	0.16	0.23	0.64	0.42	-0.06	-0.06
14	Equity UK Smaller Companies	0.59	0.44	0.47	0.48	0.49	0.57	0.50	0.80	0.76	0.68	0.69	0.71	0.65	1.00	0.24	0.23	0.27	0.23	0.15	0.32	0.19	0.18	0.13	-0.11	0.38	-0.03	0.00	0.44	0.32	-0.20	0.13
15	Equity Japanese Growth	0.63	0.51	0.65	0.66	0.54	0.58	0.43	0.28	0.47	0.54	0.51	0.45	0.54	0.24	1.00	0.88	0.54	0.52	0.16	0.26	0.25	0.22	0.33	0.23	0.36	0.10	0.00	0.53	0.20	0.09	0.01
16	Equity Japanese	0.58	0.50	0.60	0.59	0.54	0.56	0.40	0.22	0.36	0.41	0.44	0.32	0.39	0.23	0.88	1.00	0.52	0.48	0.08	0.18	0.23	0.20	0.23	0.32	0.30	0.10	-0.02	0.55	0.32	0.12	0.03
17	Equity Global Emerging Market	0.78	0.57	0.62	0.60	0.66	0.67	0.64	0.48	0.57	0.67	0.68	0.61	0.68	0.27	0.54	0.52	1.00	0.99	0.49	0.62	0.55	0.53	0.56	0.68	0.76	0.45	0.57	0.51	0.36	0.11	0.16
18	Equity Global Emerging Market Income	0.76	0.57	0.61	0.59	0.64	0.64	0.63	0.45	0.55	0.64	0.67	0.57	0.65	0.23	0.52	0.48	0.99	1.00	0.51	0.60	0.54	0.53	0.56	0.71	0.72	0.48	0.59	0.50	0.32	0.15	0.17
19	Bond UK Short-Term Investment Grade	0.57	0.46	0.35	0.37	0.49	0.44	0.59	0.40	0.39	0.37	0.44	0.34	0.38	0.15	0.16	0.08	0.49	0.51	1.00	0.79	0.86	0.87	0.89	0.46	0.34	0.81	0.79	0.46	0.32	-0.03	0.38
20	Bond UK Short Duration Credit	0.70	0.46	0.40	0.41	0.59	0.58	0.71	0.55	0.60	0.58	0.61	0.59	0.59	0.32	0.26	0.18	0.62	0.60	0.79	1.00	0.83	0.81	0.80	0.36	0.63	0.61	0.66	0.57	0.52	-0.04	0.15
21	Bond UK Corporate Bond	0.62	0.49	0.39	0.43	0.56	0.49	0.63	0.44	0.44	0.39	0.47	0.40	0.39	0.19	0.25	0.23	0.55	0.54	0.86	0.83	1.00	0.98	0.88	0.50	0.37	0.84	0.73	0.48	0.38	-0.05	0.28
22	Bond UK Investment Grade Corporate	0.63	0.51	0.39	0.43	0.58	0.51	0.64	0.44	0.45	0.41	0.49	0.40	0.39	0.18	0.22	0.20	0.53	0.53	0.87	0.81	0.98	1.00	0.87	0.51	0.33	0.86	0.74	0.50	0.39	-0.09	0.24
23	Bond UK Sterling Credit Short Duration	0.64	0.53	0.43	0.46	0.51	0.50	0.58	0.39	0.46	0.46	0.49	0.44	0.48	0.13	0.33	0.23	0.56	0.56	0.89	0.80	0.88	0.87	1.00	0.51	0.48	0.76	0.73	0.48	0.32	-0.03	0.24
24	Bond Emerging Markets Local Currency	0.47	0.53	0.38	0.36	0.55	0.44	0.53	0.30	0.18	0.24	0.31	0.18	0.25	-0.11	0.23	0.32	0.68	0.71	0.46	0.36	0.50	0.51	0.51	1.00	0.34	0.60	0.60	0.14	0.08	0.24	0.19
25	Bond Global High Yield	0.68	0.41	0.52	0.50	0.50	0.59	0.50	0.50	0.60	0.71	0.65	0.67	0.72	0.38	0.36	0.30	0.76	0.72	0.34	0.63	0.37	0.33	0.48	0.34	1.00	0.25	0.43	0.44	0.39	-0.06	-0.06
26	Bond Global Index Linked	0.44	0.39	0.28	0.30	0.41	0.33	0.49	0.30	0.19	0.19	0.26	0.16	0.16	-0.03	0.10	0.10	0.45	0.48	0.81	0.61	0.84	0.86	0.76	0.60	0.25	1.00	0.89	0.34	0.14	-0.09	0.28
27	Bond Short Duration Global Index-Linked	0.43	0.32	0.23	0.23	0.31	0.28	0.41	0.28	0.22	0.25	0.30	0.22	0.23	0.00	0.00	-0.02	0.57	0.59	0.79	0.66	0.73	0.74	0.73	0.60	0.43	0.89	1.00	0.30	0.16	-0.03	0.27
28	Global Absolute Return Mixed Assets	0.79	0.60	0.71	0.68	0.62	0.67	0.58	0.36	0.68	0.72	0.76	0.60	0.64	0.44	0.53	0.55	0.51	0.50	0.46	0.57	0.48	0.50	0.48	0.14	0.44	0.34	0.30	1.00	0.65	-0.10	0.00
29	Global Absolute Return Bond	0.47	0.19	0.32	0.31	0.36	0.41	0.35	0.19	0.43	0.46	0.49	0.36	0.42	0.32	0.20	0.32	0.36	0.32	0.32	0.52	0.38	0.39	0.32	0.08	0.39	0.14	0.16	0.65	1.00	-0.10	0.10
30	UK Real Estate	0.01	-0.05	-0.01	-0.04	-0.04	-0.03	-0.07	-0.17	-0.11	-0.10	-0.05	-0.07	-0.06	-0.20	0.09	0.12	0.11	0.15	-0.03	-0.04	-0.05	-0.09	-0.03	0.24	-0.06	-0.09	-0.03	-0.10	-0.10	1.00	-0.26
31	Cash	0.06	0.17	0.05	0.08	0.07	-0.02	0.15	0.13	-0.05	-0.09	-0.03	-0.08	-0.06	0.13	0.01	0.03	0.16	0.17	0.38	0.15	0.28	0.24	0.24	0.19	-0.06	0.28	0.27	0.00	0.10	-0.26	1.00

Source: Natixis Global Asset Management, Portfolio Research & Consulting, August 2016

It is clear that despite the wide range of asset types, the portfolio is not sufficiently diversified and, in down

In mitigating the risk of significant loss, the portfolio return can focus on compounding returns, whereas significant loss leads to schemes having to recover these losses before being able to compound returns again.

RECOVERING FROM DEEP DRAWDOWNS IS TOUGH



It took 91.50% over 798 trading days (just over 3 years) to recover from the -47.78% drawdown
It took 138.15% over 1,066 trading days (just over 4 years) to recover from the -57.95% drawdown
Cumulative drawdown of the FTSE All World TR USD Index daily through June 2016
Source: Bloomberg

A durable approach

Natixis Global Asset Management's investment approach (DPC) is designed to reduce the impact of volatility and help build more resilient portfolios. Through conversations with DC schemes, sponsors and scheme members, Natixis' approach helps define and achieve better risk adjusted outcomes.

To help clients build durable portfolios, in 2010 Natixis created the Portfolio Research and Consulting Group (PRCG). Working with thousands of clients across many regions, the group offers a free, bespoke service using advanced analytical capabilities to help improve the way portfolios are created and managed.

For scheme consultants, PRCG is a second pair of eyes to complement their own client activities, while for scheme trustees it can provide a sense-check to ensure the investment strategy is on track. For independent governance committees (IGCs), it can check the relevance, suitability and value for money of the funds they are tasked to govern.

Conclusion – the path to VFM clarity

Value for money is not currently clearly defined by either the regulator or the industry. But common sense and experience can provide considerable clarity even at this early stage. The categories defined by Natixis' panel and the explanation of them surely represent a good starting place for many schemes.

In terms of investment performance – the key VFM issue for scheme members approaching or reaching retirement – a robust, risk-based approach to selecting and combining assets is critical. The reassurance that assets are not exposed to excessive market risk and can compound year after year is uppermost in the minds of most rational scheme members.

Written on August 17, 2016

Additional Notes

Past performance is no guarantee of future results.

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