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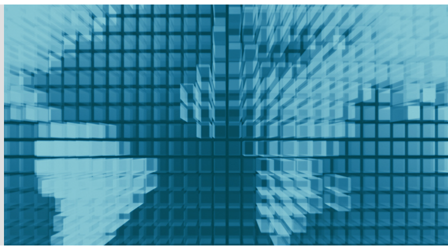

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Time to re-invent the default wheel?

Nick Groom reveals how a combination of member profiling and applying a risk-first investment approach improves member outcomes

Key Takeaways

- The DC market of multi-asset default funds needs a considerable review and overhaul, given that they represent 95% of all assets and in many cases one size and type of default does not now fit all of the needs of a mobile workforce.
- The establishment therefore of different member cohorts by member profiling and member segmentation is of paramount importance.
- A combination of member profiling and applying a risk-first investment approach to a multi-asset solutions should lead to better member outcomes in both investment experience on the journey and return.

Auto-enrolment is the most successful pension scheme mechanism to drive up participation rates since we were hoodwinked into our company's final salary scheme. Just enrol members at the highest contribution rate and add auto-escalation and we can really celebrate!

And do you remember your first DB scheme, enrolled by stealth, stuck with this undecipherable benefit until death us do part? It was hidden towards the end of your contract of employment: "You will be automatically placed in the company's final salary pension scheme; this scheme will give you 1/60th of your final pensionable pay for every year that you work until you reach your 65th birthday. Some of your benefit may be taken as tax-free cash; this will be commuted using the following calculation: 3n/80ths. Please refer to your scheme booklet for a full description of your benefits". It all sounded like gobbledygook!

I remember my first DB scheme. I was just 24 years old in the '80s in my first financial services job, but that didn't mean I understood my pension! The language was difficult for most people to understand, so they were not unlike the DC joiners of today – pretty disengaged by the language and complicated calculations we often use, but without the safety net that we had back then.

Nick Groom
Head of UK DC Strategy and Sales

Natixis Investment Managers

Wow, and what a benefit a DB scheme was (still is for some), with so many people not even knowing they had this gold-plated reward until they came up to retirement. Normally they twigged it when the company held a retirement seminar with a local IFA or benefit consultant. But then if you recall, annuity rates were so good that they headed off into the sunset with plenty of regular cash, none the wiser as to how they did it, keeping quiet just in case it was a magnificent ruse, no investment decisions to make, apart from perhaps a few who got duped into some weird and wonderful offshore investment scheme for their tax-free cash that admittedly was burning a hole in their pocket. This is in stark contrast to now, with all of the risk transferred to the hapless employee, who is being asked to dip hard into his pocket to augment the employers' contribution, which is a small fraction of what the employer had been paying with DB – something the employer is extremely glad about! I am going to skip a generation of early DC pioneers and arrive in my pensions Tardis at pension freedoms, now allowing greater flexibility and better death benefits than final salary schemes. Many are now heading towards taking their pension as cash to spend on things they wouldn't ordinarily have, or for the lucky ones with enough of a pot, they can consider drawing an income from it. As a result of these changes, the DC market of default funds needs a considerable review and overhaul, given that in many cases one size does not now fit all of the needs of a workforce where circa 95 per cent invest in the default. Also, a high proportion of defaults may still be heading towards a 75/25 mix of bonds and cash, and that just won't cut it. So as the pensions market migrates from DB to DC, and the investment risk shifts from the corporate provider to the member, there are enormous investment implications. And the DB adage of buy-and-hold may not be appropriate in the new DC world where member engagement is increasing and member investment experience is gaining in importance.

At Natixis, we believe that member profiling and member segmentation, which is the establishment of different member cohorts, are of paramount importance. One size rarely fits all of the population within a scheme and although age-based cohorts are a good start, members may more likely be as interested in cohorts built around their attitude to risk, ethical stance, domestic bias etc. And even within age-segmented cohorts there is argument that the younger cohorts may not want to invest in a buy-and-hold strategy at the highest risk level because limiting the risk of loss of capital is very important to them.

We could consider default cohorts based around the generation game; for instance centennials who are going to live forever, millennials the most knowledgeable generation. Also, there are baby boomers, all set pretty fair with DB and property, while Gen X perhaps need careful consideration as they could have either been very lucky, or very unlucky as they may have neither had a DB scheme or took advantage of early undeveloped DC. So as you can see, there are lots and lots to think about.

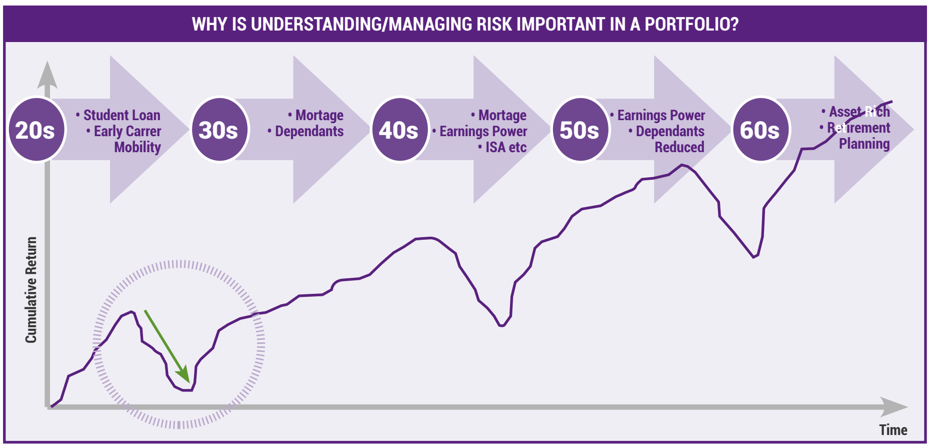
The younger age groups are complicated as they tend to be more mobile and with this mobility, they may be consolidating pension pools and potentially crystallizing or at least seeing the effects of volatility at the wrong time. In some cases a fund might have a third of its value wiped away by a risk event. They may also be more ethically and socially aware than older cohorts. Furthermore, the non-pension investment plans such as LISAs are going to take 'market share' from pension contributions if this cohort isn't correctly engaged and satisfied with their pension investment. In short, we believe that a combination of member profiling and applying a risk-first investment approach to our multi-asset solutions will lead to better member outcomes in both investment experience and return. And why are we suggesting that we turn investment philosophy on its head and put risk first?

Risk is a far more stable indicator of markets. In this instance, we consider the rolling annualised volatility of markets over five- or ten-year periods. When comparing this to the annualised return counterpart, we note that volatility tends to be more stable over time. Applying this logic to specific cohorts we can better manage the risks associated for that group. In particular, we can be better placed to manage future corrections in a way that is more acceptable from a risk perspective for that group. We truly believe that it's not the members that need to be thrown a choice of cautious, moderate and aggressive risk profiles for them to choose, but for the scheme governors to do that choosing for them.

In the chart below, we show how the early years of a member's investment can experience considerable volatility. If this was the start point for a young person starting out on his/her career, entering with piled up student debt and looking for a deposit on a house, they could be easily put off pensions at a critical time because a high-risk strategy was wrongly chosen for this younger cohort. But it could be any cohort.
So we are advocating the use of risk parameters as the main input for asset allocation to manage volatility. For the last decade, the risk profiles of some indexes have been relatively stable – while their returns varied dramatically. Our investment methodology targets a consistent range of risk, rather than a potential range of returns. The result is added predictability and, ultimately, durability in the portfolio. Return, and performance, analysis is important but secondary to risk. Furthermore, the global investor community has migrated from longer term investment horizon to shorter term horizons that tend to have greater emphasis on investment experience, where risk of loss is becoming more prevalent in investment processes.

We believe those responsible for governing employers' schemes have the appropriate knowledge of the schemes' membership (and are better placed) to build an optimum number of risk-first multi-asset default solutions based around specific cohorts that cater better for the needs of a diverse and more demanding workforce. Let's reinvent the wheel!

Written the 18th November 2017



Source: Natixis Portfolio Clarity[SM]

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