Summary
• Investment strategies for DC funds centre around lifestyling. DGFs have historically been used by DB schemes looking for growth but with reduced volatility. However, investment by funds in DGFs has led to some unease regarding customer transparency.
• The gap between DB and DC investment however is narrowing because things like multi-asset credits, which have been popular on the DB side, are now coming across to DC.
• For both DB and DC, periods of growth, consolidation, and potentially decumulation are the aim. In DB, the aim is for a collective pool that reflects the value of the assets, even though there's no money earmarked for individuals. The liabilities are taken into account and a framework is built around that. This provides liquidity and durability targets as well as the return-risk character. This is the same in DC, although it is more about the individuals.

Poles apart

Peter Carvill looks at the different investment needs and considerations of DB and DC funds, their differences and similarities, and whether those are quite so pronounced as the edges between the two are blurring

The Argentinian statesman Mauricio Macri once wrote that there are more things that unify people than divide them. And, yet, the investment strategies for defined benefit (DB) and defined contribution (DC) pension schemes are poles apart.

The reason for this gulf lies in the different make-ups of the funds. Research from the Employee Benefit Research Institute outlines the basic tenets of this. "Under DC plans, it is the employee who bears the investment risk. Favourable investment returns will increase benefits, while unfavourable returns will decrease benefits. [...] DB plan sponsors assume an obligation for paying a stipulated future benefit. Consequently, the employer accepts the investment risk involved in meeting this obligation. If the pension fund earns a lower-than-expected yield, the employer will have to make additional contributions in order to provide the promised benefits," it said.

Difficulties

This leads to what is perhaps the most important difference between the two: the lack of a funding gap in DC schemes. This is because while DB schemes promise a concrete benefit for the pension holder, DC schemes make no such proviso. As *Pension Trends,* a report released by the Office for National Statistics in 2013, explains regarding DC schemes, "the pot of money held by pension holders at the time of their retirement is determined simply by the contributions paid into the scheme and the return, after charges, from investing these contributions in pension funds; so it is not possible for such schemes to have a funding shortfall (deficit)".

PTL managing director Richard Butcher says that DB schemes, in contrast to DC, have a common investment fund from which resources are used. In a DC fund, as pension holders reach retirement age, they and their contributions are removed from the fund, with those contributions being used to purchase annuity or drawdown products.

In contrast, a DB scheme retains its members, paying their benefits out from a central pot. "The fact that that person has retired," Butcher says, "doesn't change the liability structure of the fund because they remain in the scheme, drawing benefits from it."

So, what are the investment strategies? Well, they centre around the needs and aims of schemes, and how those aims are best met.

DC investment

Investment strategies for DC funds often centre around lifestyling. This is where a fund's investment strategy is tied in with the ages of its members. For younger, newer members of the scheme, the fund will look at riskier investments at the beginning, with the aim of finding the greatest returns. As the member ages, the investment strategy will be to shift into looking for lower-risk returns, albeit those still returning growth. This final stage of investment will typically begin around 10 years before that person is due to retire.

Quantum Advisory partner Phil Farre says that traditional investing at the early stages of a pension holder's time within a DC fund has historically centred around equities and corporate bonds, an approach that explains the heightened volatility at this stage. However, he says, recent years have seen a change in thinking and a move away from that approach. "There has been," he adds, "an increased used in multi-asset funds with a whole basket of asset classes. There may be a mix of UK equity, emerging markets, possibly some property, and investment-style corporate bonds. There, you're looking to achieve equity-like returns but with reduced volatility."

DGFs

Farrell says that as clients move through life, there is a move from holding pure equities to having good-quality corporate debt and bonds. One key to managing that transition has been in the use of diversified-growth funds (DGFs), which invest in across a wide variety of asset classes and have become increasingly popular among investors. This is despite controversy in March 2016 when consultancy firm Willis Towers Watson referred to them as being overpriced with 'disappointing returns'.

Barnett Waddingham associate Sonia Kataorais says that DGFs have historically been used by DB schemes looking for growth but with reduced volatility. However, investment by funds in DGFs has led, she says, to some unease regarding customer transparency. "You want to engage with members," she adds, "but they could see their pension pot falling and rising. The problem is that you're paying for volatility reduction control and it's whether that makes sense or provides value for money when members are so far away from retirement. If they only have small pots and are not engaged, is it justifiable to spend that extra money instead of just investing it in passive equities?"

Historically, Kataora says that DC schemes have steered clear of private market investing because the industry requires DC funds to be dealt daily. "DC schemes," she adds, "have missed out on this because of the constraints imposed on them by the collective mindset. I think the gap is narrowing because things like multi-asset credits, which have been popular on the DB side, are now coming across to DC."

DB investment

DB schemes approach investment very differently. For most in this sphere, the highest priority is to close any funding gaps. Currently, 90 per cent of the UK's DB pension schemes are running with such a gap. And there are two solutions to this, neither of which is entirely palatable. Firstly, funds could look to employers for more money. Secondly, the trustees could look to riskier investments to close the risk.

Farrell says that most funds will, in reality, opt for a mixture of the two solutions. The key to this, he says, is the strength of the employer covenant, although there are a number of additional factors that are influential.

"That," he says, "will have an impact on the investment strategy. If you have an employer with a rock-solid covenant, and they are happy with the increased risk, that would influence investment strategy. The foundation of that is the funding position that kickstarts the process."

Commonality

There is a lot going on in investment strategy but the two approaches have a common aim: achieving the best and safest returns possible for pension holders, regardless of whether the funds are DB or DC. And there are broader areas in which the two meet. Butcher says: "You're looking, in both, for periods of growth, consolidation, and potentially decumulation. In DB, you're looking for a collective pool that reflects the value of the assets, even though there's no money earmarked for individuals. You look collectively at the liabilities and build a framework around that that gives you liquidity and durability targets as well as the return/risk character. It's the same in DC, although you're talking about individuals."

Farrell says that the type of investments and their social impacts is an issue that has moved from the fringes of investment thinking into the mainstream. There has been, he says, an increased focus on environmental, social, and governance aspects. "It's about the returns," he says. "Poor policies in these areas can have considerable impact on corporate, which filters through to investors. You are seeing that coming through, and it will impact on schemes, regardless of whether they are DB or DC."

Recent years have seen the lines between DB and DC schemes begin to blur, particularly as DB schemes decline in popularity within straitened times. This has led to more pressure on both DC and DB trustees to show how they are improving the end result for members. Kataora says that the investment strategies utilised by the two approaches are, in fact, moving closer together. She references factor investing, also known as 'smart beta', which she sees fits within both types of schemes. Overall, she concludes, it returns always to the trustees' objectives for the scheme and their fundamental beliefs.

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