Summary

- Prior to Chancellor George Osborne's Budget announcement in 2014, glidepaths mainly involved switching away from equities towards less risky assets at the end of the growth phase.
- According to PLSA's 2015 annual survey of pension schemes, nine out of 10 active DC members use a default fund and 92 per cent of the schemes surveyed use some form of lifestyle strategy.
- Pension freedoms have resulted in a shift away from the use of fixed-interest assets during the at-retirement phase of the glidepath.
- There is a fear that decisions around the default fund are being based on short-term member behaviour.
- Advisers have stressed the importance of effective member communication when altering the default strategy. The other significant challenge when changing the default may be effective cost management.
- There are fears that Osborne's 2016 Budget could affect the pensions market, particularly concerning tax treatment, which would make the development of effective yet adaptable strategies for default funds even more important.

Defining the default

David Adams analyses the morphing landscape of default funds and how more innovation may yet be around the corner

When most people bought an annuity at the point of retirement, plotting glidepaths for managing the default funds to which many savers entrusted their pension pots was straightforward. You simply switched away from equities towards less risky assets at the end of what was usually an easily defined growth phase.

Following George Osborne's shock announcement of the pensions freedoms in 2014, most commentators assumed this would have to change because many more savers would be taking their pots as cash or considering some kind of drawdown product, and some would be accessing at least some of their money before retirement.

But, as PTL managing director Richard Butcher notes, in 2014 no one really knew how the pension freedoms would affect saver behaviour – and in 2016 we still don't know to what extent the saver behaviour seen since they came into force in 2015 will continue in the longer term.

Assessing behaviour

Research conducted by the Pensions and Lifetime Savings Alliance (PLSA) in 2015 for its *Understanding Retirement* report suggests that of the 2.8 million individuals with DC pension pots not yet in payment, many more (63 per cent – 1.75 million people) have begun actively considering how they will take their pension than the numbers who have either taken no action (23 per cent), or have already accessed their pots (14 per cent).

Nine out of 10 active DC members use a default fund, according to PLSA's 2015 annual survey of pension schemes; and 92 per cent of the schemes surveyed use some form of lifestyle strategy – the sort of glidepath described above, for those default funds. But the survey also revealed a shift away from use of fixed-interest assets during the 'at retirement' phase of the glidepath, presumably as a consequence of the introduction of the pension freedoms.

Mercer UK DC leader Brian Henderson says his company's client base have split three ways. "About a third changed their defaults, about a third are looking at changing them soon; and about a third have left them alone," he explains. "Of those that have chosen to leave them alone, they've looked at it and thought that what they've got is fine. Some clients are saying 'Let's give it a year or two and see what the members prefer, then revisit it further down the line.'"

Hymans Robertson partner and senior consultant Rona Train says that about 80 per cent of the schemes her company works with have changed or plan to change default strategies. Often their actions have been based to some degree on average member pot size. If the average is between £10,000 and £15,000, for example, there has been a general assumption that most savers will take their benefits in cash.

"For those schemes we've been suggesting a strategy that goes to 100 per cent cash or something cash-like, like absolute return bonds, to protect against inflation," Train explains. "Where pots have been larger we've been looking at strategies for drawdown. That would mean retaining some kind of growth assets, in many cases through using a combination of absolute return funds or diversified growth funds. They would retain that to retirement then introduce cash in the last three years.

"A lot of clients have introduced three lifestyle strategies: cash, annuity

purchasing or drawdown, then decided which of those three is right for that particular member," she continues, noting that this makes effective member communication absolutely vital during the de-risking phase.

This is also the approach Mercer is recommending to clients, says Henderson. "There's a lot of variety out there – and for justifiable reasons," he says. "If you're a huge scheme, with people who have pretty chunky pots, you have to think differently to those running schemes with younger members, where there's nobody, or very few, going through the retirement process. So in our master trust, for example, the default is drawdown."

In the longer term, he believes drawdown, in some form, will be a useful tool for most members. That will mean there is a need for a 'to and through' retirement strategy.

There is likely to be a lot more product development in this area, agrees Train, particularly as so few trust-based schemes currently offer members drawdown options. "At the moment people still get to retirement and have to sell assets and then buy a post-retirement product," she notes. "That, I think, will change."

Barnett Waddingham head of DC Mark Futcher says his company's approach has been to advise schemes not to make any radical changes too quickly. "There is a danger you'll take decisions based on short-term member behaviour," he says.

He recalls one employer that had looked at moving the default strategy straight over to cash. "We challenged that. There were very specific reasons why people were moving towards cash in the short term – and if you looked at when people were taking cash it was at most ages apart from at 65, so the investment strategy would not have been doing what it was supposed to do."

Advisers stress the importance of effective member communication when altering default strategy. The other significant challenge may be effective cost management. "New strategies may be more expensive: a diversified portfolio at the point of retirement is going to be more expensive than managing gilts," says Train. "For trustees it's about weighing up the additional costs to members against benefits they get."

The newer master trusts are in a different position from the average workplace scheme, with their scale and (in some cases) the nature of their membership allows them to use defaults in different ways. "We didn't have any employers or members before auto-enrolment, so when the freedoms were announced our average fund size was very small," says NOW: Pensions director of investment and product development Rob Booth.

"Our initial analysis was that the vast majority of members would take cash at retirement. We changed our glidepaths to a cash fund. We wrote to everybody with a reasonable fund size to tell them what we were doing and give them a chance to change their retirement age – but nobody did. As funds grow we will decide whether to build a post-retirement drawdown arrangement in, and how many options we give members in terms of the glidepath."

Nest also altered glidepaths for its Retirement Date Funds – target funds into which members are placed according to their assumed retirement years – following introduction of the pensions freedoms. "The primary objective of the consolidation phase for funds maturing after 2020 is to outperform CPI after all charges, while aiming to progressively dampen volatility as a member's fund approaches maturity," says Nest CIO Mark Fawcett.

For members likely to retire before 2020, the strategy assumes members will take cash. "They've only been saving with us for a short time, so have very small pots, which we expect they'll take as cash," says Fawcett. "So far this is happening. Nest's target date fund structure allows us to be dynamic and respond to changing circumstances."

Trouble looming?

But two years on from Osborne's 2014 Budget bombshell, the pensions industry is waiting to see if the 2016 Budget will contain another significant announcement around tax treatment of pensions – which would mean this question would need to be examined all over again.

Futcher fears that whatever Osborne announces is likely to have some negative effects on some scheme members. "If senior managers are upset and have a negative view of pensions that filters down through the organisation," he warns. "You've also got young people coming into jobs with high levels of debt who want to try to get on the housing ladder. Pensions are not a priority for them. I think pensions are going to fall down the list of benefits companies use to attract employees."

That's a gloomy thought for anyone who believes in the importance of a strong pensions system in society. But it would also make development of effective yet adaptable strategies for default funds even more important. This is an area where innovation, careful and sophisticated management and excellent member communications will be needed for years to come.

Written by David Adams, a freelance journalist