A sensible choice

Glenn Dobson explains why default funds are the simple and sensible choice for most

Default fund is an unfortunate label. A word with negative connotations, the dictionary definition of 'default' describes something that exists or happens if you don't change it intentionally by performing an action.

In fact, I'd argue that default funds are the next success story after auto-enrolment – a well-governed default is the simplest path to achieving good returns. They address challenges of human behaviour – that people lead busy lives, get overwhelmed by too much choice and complexity, and if left to their own devices may make poor decisions.

The beauty of the well-governed default is that it's simple for members. They don't need to actively do anything to benefit from the default but, behind the scenes, there's a huge amount of activity by experts in the complex world of investments.

And with 99.7 per cent of savers remaining in the default (according to the Pensions Policy Institute), it's a part of the system I believe we should celebrate as an industry.

For most people, taking matters into their own hands poses risks. We already have useful lessons from the Australian Productivity Commission which looked at the efficiency of the Australian defined contribution pensions system. It found that – taken as a whole – 'choice options', where individuals self-selected funds, produced lower returns and had higher charges than simple, single investment option default funds.

A recent report by The People's Pension and State Street Global Advisors found that DIY investors risk losing out on thousands of pounds by taking their own investment decisions rather than staying in the default. Workplace Defaults: Better Member Outcomes explains that we're all influenced by behavioural biases that affect our decisions. We use mental short-cuts to simplify decisions and we're influenced by the way things are presented or framed – neither of which may lead to the best outcomes.

The research also shows we can be guided towards choices that are in our best interests – auto-enrolment is a great example of this as it's easy to stay in, whereas you actually have to do something to opt out.

The report models potential outcomes from the most common mistakes DIY investors make with their pension savings and compares them with a typical default fund. Over 40 years the default investor amasses a pot of nearly £430,000. The DIY investors risk missing out on as much as £247,000 by switching out of the default.

Mistake 1 is chasing past performance – 'Performance chasing Patricia' buys high into a strong performing fund expecting it to continue to do well but sells when it falls, and she loses faith.

Mistake 2 is putting all your eggs in one basket – 'Eggs in one basket Elliot' fails to diversify his portfolio and invests in only UK funds.

Mistake 3 is not taking enough risk – 'Cautious Connor' doesn't like taking risk so invests in a cash fund.

And finally mistake 4 is forgetting to take account of changing circumstances – 'Forgetful Fiona' is initially an active investor but as time goes by, she forgets to review her investments.

These examples highlight the fact that investment decisions are complex, and most pension savers can't give them the time and attention they deserve. In contrast, investing in the default strategy is a sensible choice for the majority and means putting their future finances into a well-governed and efficiently scaled fund managed by experienced professionals.

I've spent my working life trying to demystify pensions, and I know that savers and employers alike crave things to be as simple as possible. It's true there may still be a lot of complicated technical detail within the inner workings of pension schemes, investment funds and regulatory input. But that's the point with a default fund. Dedicated experts whose job day in day out is to be specialists in this stuff take the necessary action to ensure a scheme is well run and investments are managed with great scrutiny, so that members don't have to. A default isn't a last resort. In well-governed master trusts, they represent a solution which is in the best interests of the vast majority.

Add to that the tight regulation and governance assigned to master trust defaults, in particular, and it's clear they are far more than just a back-up position for those who don't engage with investment decisions.

We should celebrate a system which offers better outcomes for most members in a simple way without them having to make any difficult decisions. In a world where we're so often faced with an overwhelming array of choices, it's hugely reassuring.

Read the report, Workplace Defaults: Better Member Outcomes www.thepeoplespension.co.uk/member-outcomes-PA2 or to speak to us, call 0333 230 1310

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