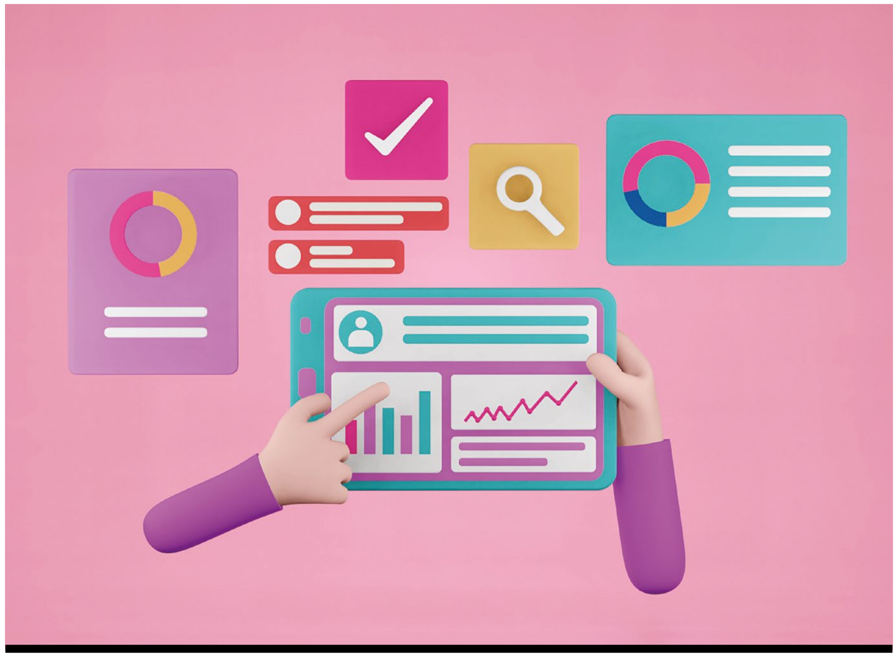

Designing defaults

Joanna Sharples explains how default investment strategies must evolve to meet members' needs

Almost all defined contribution (DC) scheme members rely on the performance of the default investment strategy to grow their retirement savings and provide them with the money they need to enjoy their expected standard of living in retirement.

Most members recognise that short-term market shocks will affect the immediate value of their savings, but over the long term they need certainty that their default strategy will deliver the returns they need to retire.

Default fund investment strategies need to evolve and innovate to meet members' expectations. Good, ongoing investment governance is crucial to helping members build sufficient savings, manage investment risk and be confident that their pension is invested responsibly.

Help me build the right size of pension pot

One of the biggest challenges for members is understanding how much they need to save to achieve an adequate standard of living in retirement, and whether they are on track to achieve it.

The PLSA's Retirement Living Standards are rule-of thumb figures showing how much members need for a minimum, moderate or comfortable standard of living. These are being adopted by an increasing number of DC pension schemes, including Aon's DC default solutions where we target the moderate standard of living from the PLSA's figures.

We use these standards, combined with an understanding of roughly how much an average member is likely to contribute regularly and how long they might work for, as the basis for our investment strategy design.

In our default strategy, we target an overall long-term return of inflation-plus 4 per cent per annum, gradually reducing to inflation-plus 2 per cent at retirement. If members continue to make adequate contributions to their pension savings over time, we believe these returns should provide them with a moderate standard of living.

But as the last year has shown all too clearly, investment returns can fluctuate over the course of a member's working life. While younger workers have time for their savings to recover from difficult market conditions, those approaching retirement have less flexibility – but still need to be confident their pension will deliver the returns they need.

With inflation increasing sharply as market returns have fallen, our long-term targets have been challenging to achieve this year. However, because we are aiming to achieve our inflation-plus targets over the whole of a member's savings lifetime, we can take a dynamic approach and consider our funds on a backward-looking basis and explore whether historically our funds have outperformed those targets. Using this information, we can then consider reducing investment risk in the portfolio earlier than expected and still be confident of delivering the overall returns needed to meet members' needs.

We were able to do that last year and earlier this year for a number of our funds. Our five-year annualised returns to 30 September 2022 for the passive investment default fund, for a member in the growth phase, continued to deliver the inflation-plus 4 per cent per annum target, even though the one-year performance has been affected by market volatility.

Manage my investments for me

There are many reasons why members do not take a hands-on approach to pensions investment, from lack of time or confidence in money management, through to trust in the expertise of their pension providers.

We also know that members rarely monitor the performance of their pension pots, even when markets are volatile. For example, our 2021 DC member survey, *Keeping on Track in Challenging Times,* found that only 7 per cent of DC members checked the performance of their pension savings during the first quarter of 2020, when Covid-19 disrupted life and markets. A similar proportion said they were likely to check them over the following 12 months.

That means schemes must create good value default investment strategies that will grow members' savings and manage risk effectively on their behalf. It also means that good investment governance such as monitoring market conditions and adjusting strategies accordingly is crucial. Taking a set-and-forget approach could mean missing out on important opportunities to improve member outcomes over time and leave them exposed to unnecessary risks.

Aon reviews its default fund asset allocations regularly to make sure we have the right asset mix to achieve our inflation-plus targets. For example, we have adjusted the balance between growth equities and bonds, as well as thinking carefully about the types of gilts that we hold, to make sure we keep on track over time.

Until this year, gilt yields were exceptionally low which made it increasingly difficult to meet our inflation-plus returns target, particularly for members at retirement. In response, we increased our allocation to equities and corporate bonds and removed long-dated index-linked gilts which were expensive and expected to deliver returns below inflation. Instead, we decided to focus on short duration gilts. This has been an important decision for members approaching retirement, given recent market movements.

Being able to make these types of asset allocation changes is only possible because of our governance structure. Regular reviews of the default fund investment strategy enable us to identify risks and poor value for money, and take advantage of emerging opportunities.

That will continue to be the case in the future. For example, inflation is currently high and may rise further, but we expect it will peak at some point and start to fall again. To combat rising inflation, the Bank of England has already raised interest rates and seems likely to carry out further increases. This feeds through to the gilt market, leading to higher yields and lower prices. For our members approaching retirement this reduces the cost of buying gilts and possibly even creates a buying opportunity which could further help members close to retirement.

Invest responsibly on my behalf, but still deliver growth

As well as providing sufficient funds for their retirement, scheme members want their pension savings to be invested responsibly. Climate-aware investing and wider environmental, social and governance (ESG) factors, such as good employment practices, have become higher profile through public campaigns such as Make My Money Matter. That means ESG considerations now need to be at the heart of a well-managed default fund strategy.

However, this has been a tough year for ESG fund returns and the robustness of schemes' responsible investing beliefs. The war in Ukraine and rising energy prices has had a marked effect on controversial sectors in ESG investment, such as defence and energy stocks. Both have soared in value, leading some schemes and investors to question whether ESG-focused funds can deliver long-term growth on a par with more conventional investments.

There are many different approaches to ESG, including exclusion (i.e., omitting whole sectors such as weapons); low-carbon factor-based investing (i.e., a low-carbon tilt on a mainstream index) and more bespoke funds, such as Aon's Climate Transition Fund (CTF). The CTF focuses on those companies that will benefit from the energy transition and, rather than taking an exclusionary approach, invests more in stocks that focus on ongoing carbon reduction over the long term, green energy such as renewable energy and green technology, as well as companies that are having a positive societal impact.

There is a big difference in the way these different types of funds have performed over the course of 2022. It is becoming clear that simplistic approaches, such as excluding entire sectors, are not the most effective way to achieve ESG-related performance. By comparison, the CTF has performed well to date against market cap (all sectors), which is a good early indicator that its more sophisticated approach will deliver strong returns over time.

ESG investment does not have to mean constraining your opportunity set. It is possible to be focused on delivering growth as well as positive impact. It is also proof that, with the right governance structure, an ESG-driven default strategy can combine growth that DC members need, with a wider environmental and social impact increasingly valued by members.

The objective of a default investment strategy has to be to help members achieve an adequate retirement living standard, assuming they are making appropriate contributions over time. That requires robust investment governance and innovation from pension providers, with careful management of risks and opportunities. This is at the heart of Aon's approach to DC investment.

Written by Aon partner, Joanna Sharples

In association with AON

*2021 DC member survey, Keeping on Track in Challenging Times: https://aon.io/3V73FfG