Time for a change

Alex Janiaud considers whether the DC lifestyling investment pathway is still fit for purpose

Summary
- 'Lifestyling' is the default defined contribution investment pathway in the UK.
- Some experts believe that lifestyling is leading to poor outcomes for savers.
- Target-date funds can offer greater flexibility but have not been universally embraced.

There is more than one way to build a defined contribution (DC) investment strategy. Yet the most conventional DC investment pathways are under scrutiny over their ability to deliver good retirement outcomes at a time when trustees are also being pressured to invest in UK plc.

'Lifestyling' involves gradually de-risking DC pension pots as savers age, with pots typically holding a higher allocation to bonds as retirement nears. This change in asset allocation may occur as early as between five and 15 years before retirement, according to The Pensions Regulator (TPR). Average equity allocations are slashed from approximately 75 per cent to 25 per cent, according to *Corporate Adviser* data cited by Columbia Threadneedle.

Therefore, some providers are instead looking to 'target-date funds', which are single funds that are usually managed by investment professionals according to an expected retirement window, when a member is likely to access their savings. Proponents of target-date funds argue that they are more flexible than lifestyle funds, arguing that the latter are unable to respond to market conditions, owing to their automatic de-risking process.

And as providers try to figure out the optimal investment pathway for their members, they face relentless demands to consolidate and invest in UK assets.

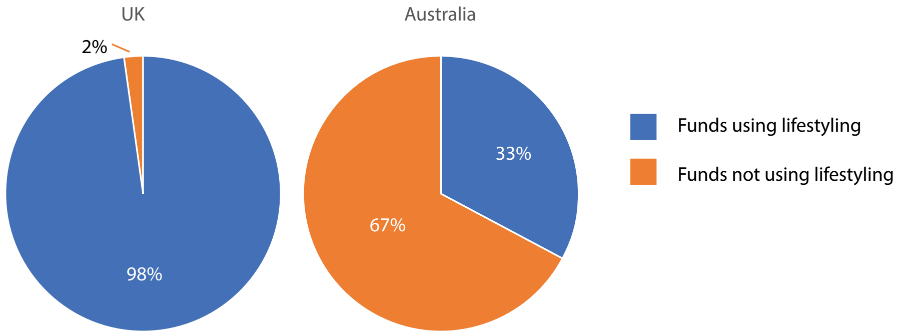
'Excessive de-risking' in lifestyling

Lifestyling is the dominant DC investment strategy in the UK, where it is used by 98 per cent of schemes, according to the Policy Exchange.

"Fundamentally, lifestyling is still a sensible way of offering a default strategy," says Broadstone head of DC workplace savings, Damon Hopkins. But lifestyling "doesn't offer the same flexibility or ease with which different cohorts of members can be accommodated, in the way, for example, target date funds can – which can enhance returns", he admits to *Pensions Age.*

"Often employers or trustees are somewhat hamstrung by the way a provider's default strategy is set up," Hopkins observes, noting that many providers do not offer a choice on how their default investment strategies are structured.

A November 2024 report authored by Columbia Threadneedle Investments head of dynamic real return, Christopher Mahon, is more damning. Observing that other DC pensions systems such as that of Australia do not de-risk as retirement nears, the report claims that



Source: Policy Exchange *Growing Pension Capital: Lessons from Australia*, 2024

the UK is "something of an outlier", estimating the annual cost of "excessive de-risking" to savers at 2.3 per cent, which is approximately equivalent to cost of £12,000 to a conventional £100,000 pre-retirement pot.

The report also argues that "tackling excessive de-risking" could create a £10-25 billion boost to UK capital markets and investment.

A 2024 report authored by Mahon and the Policy Exchange head of political economy, James Vitali, recommends that TPR should "review and reverse the regulatory preference for de-risking strategies and lifestyling", arguing that "this has led to poor outcomes, particularly for older savers closer to retirement". The report suggests that regulators should instead look to incentivise innovation in the annuity market.

But Quantum Advisory investment consultant, Joe Condy, argues that the risk reduction usually seen in lifestyling "doesn't necessarily mean no risk", noting that "some risk may be maintained to generate returns post-retirement where income is being drawn".

Target-date funds offer greater flexibility

UK providers, including Vanguard and Nest, have adopted target-date funds. In a 2023 newsletter, the Rolls-Royce Retirement Savings Trust announced that it was closing its lifestyle investment programme from June 2023 to members who are more than three years from their retirement dates, also closing its other lifestyle programmes, replacing its lifestyle arrangements with a target-date fund that invests in BlackRock funds.

The trust said that the change would deliver over £500,000 of annual fee savings, as well as help to provide "a more sustainable investment proposal" to its members.

"Larger master trusts, because of their size and scale, have the ability to create their own, tailored, target-date funds," says Condy.

"As a result, they have the opportunity to introduce alternative and illiquid asset classes, which could potentially benefit members over the long term", he continues, suggesting that the adoption of target-date funds could increase in the event of more consolidation in the market.

A target-date fund "gives you a lot more flexibility, and you can change things under the bonnet much more easily in a target-date fund structure than you quite often can in a lifestyle structure," says Hymans Robertson head of DC investment, Alison Leslie.

However, the Defined Contribution Investment Forum chair, Mark Austin, observes that "target-date funds haven't really taken off in this country" and that changing schemes from long-standing default arrangements would be "quite difficult", in part due to the need to engage extensively with members.

Target-date funds can also prove too complicated for smaller providers, according to Aon senior DC consultant, Steve Leigh. Of the single trust schemes that Leigh has observed, "very few are using target-date funds just because of the complexity", other than schemes that have delegated investment management to consultancies like Aon.

These schemes are still in the minority, Leigh believes, suggesting that these schemes tend to want to manage their own investments but lack the necessary infrastructure for target-date funds.

Innovation and Mansion House

The UK's DC investment landscape looks ripe for innovation led both by industry and the government.

"How DC funds invest will likely be drastically altered by the government's growth agenda"

"More innovation is required," says Hopkins. "While many providers offer different investment solutions or pathways, these tend to target a single retirement outcome or decision such as purchasing an annuity or drawdown."

"In reality, most members, particularly those retiring in years to come who have much larger DC pots than those currently retiring and potentially more complex retirement income needs, are likely to want a combination of options," he continues. "This may be, for example, drawdown for a period and then purchasing an annuity for a period/portion of their savings."

How DC funds invest will likely be drastically altered by the government's growth agenda, which in Chancellor of the Exchequer Rachel Reeves' Mansion House address in November reiterated Labour's desire to see DC pensions invested in UK assets.

Observing that there will be £800 billion in workplace DC schemes by the end of the decade, Reeves said that for "too long, pensions capital has not been used to support the development of British start-ups, scale-ups or to meet our infrastructure needs". She pledged to consolidate the DC market.

The reforms "will result in more focus on the composition of defaults and inclusion of a wider range of asset classes, especially private markets," says Zedra client director, Sam Burden.

Law Debenture director, Elizabeth Hartress, believes that the reforms "will be a catalyst for change, although the direction of travel in the past few years has already been for bigger funds and new ideas".

"Both the impact of auto-enrolment, which is pushing DC funds towards large aggregate numbers, as well as the consolidation already happening in the master trust arena post-authorisation, mean that the current players are having to find innovative strategies," she adds.

"Innovation doesn't need to come from the obvious, largest, or incumbent players: we are keen to see enough flexibility in the eventual plans to allow disruptive, brilliant, member-focused solutions to break through and challenge the prevailing approach.

"At the same time, we remain concerned about pensions adequacy, and hope the industry doesn't get distracted from the fundamental challenge of helping people save enough for the retirement they want and need."

Written by Alex Janiaud, a freelance journalist