Summary

- High management fees have been squashed as a result of the 0.75 per cent charge cap, but so has performance, meaning members may struggle to reach their retirement goals.
- There are concerns of a race to the bottom of the investment pile among cost-conscious trustees due to confusion about the term 'value for money'.
- The charge cap has been accused of stifling innovation in investment products.
- Since the cap, DC schemes have been avoiding illiquid alternatives and active strategies, with DC schemes being offered 'DGF-light' funds compared to the DGF offerings for DB. However, alternative indexation products have grown in popularity.

A cap on innovation?

Lynn Strongin Dodds asks whether the DC charge cap is restricting product choice for pension scheme investors

As with many regulations, the government's 0.75 per cent charge cap for DC schemes has had the inevitable unintended consequences. High management fees have been squashed as promised, but so too has performance, which means that auto-enrolled members may struggle to reach their retirement goals.

Growing gap

The trend was evident before the cap, which covers administration, communications and governance as well as investment, was introduced two years ago. Figures from the Organisation for Economic Co-operation and Development show that at 38 per cent, the UK's net replacement rate for the average earner trails the OECD average of 63 per cent. This translates into the average earner only garnering just over a third of their net pre-retirement income in retirement.

However, the gap has continued to widen since the regulation. This is because instead of selecting multi-asset funds that can smooth the bumps and produce the requisite returns for a comfortable post work life, there is an apparent race to the bottom of the investment pile among cost-conscious trustees.

"At the moment, members could retire with around 25 per cent of their salary and not the 40-45 per cent of the defined benefit salary that they may have come to expect," says Natixis Global Asset Management head of UK & Ireland Institutional Business Euan MacLaren. "However, even within the 0.75 cap, default funds can be built with a passive core alongside true, proper active management that represents value for money. The issue with the fee cap is where passive cores include closet index trackers that have large number of holdings and are charging active fees to mirror a benchmark."

One problem is the confusion triggered by the 'value of money' concept enshrined in The Pensions Regulator's edict. Although the TPR states that trustees can chose the pricier option if it "can be justified by improved benefits", there is no statutory definition or common framework as to determine how that can actually be measured and monitored.

'Strangling' innovation?

The result is that "in light of a lack of a definition, schemes have instead focused on low-cost products and this has stifled innovation," says J.P. Morgan Asset Management client adviser for UK defined contribution Annabel Tonry. "The problem is that cost is only one part of the overall decision-making process and should not be the main driver. However, this message has not been taken on board."

Schroders DC solutions manager Tim Horne also notes that quantifying value for money on the complex and complicated products is even more difficult. In addition, in this current fee-focused environment trustees are often taken to task if they pay extra for a new and more expensive strategy.

"This has strangled innovation and caused a move away from certain asset classes such as illiquid alternatives, as well as more active strategies that potentially have a higher fee, but can provide a better risk/return profile than traditional equity strategies over the long term," he explains.

The same is true with diversified growth funds, which are the mainstay of the majority of default funds. Many have been re-engineered to be top heavy in equities but lightweight in non-mainstream holdings such as property. The difference in the composition of these funds also helps explain why there can be a price differential between DB and DC offerings from the same fund manager.

"The funds that are offered under the DC cap are what I refer to as DGF light – cheaper but much more static and less diversified than what you would get with DB," says AllianceBernstein senior vice president and head of multi-asset pension strategies David Hutchins. "It is a challenge because moving forward DC schemes will need to increase their active budget as equities and bonds will not perform as well as in the past and they are becoming more correlated. We are in danger of building a strategy in the rear-view mirror."

Taking its toll

Research from JPAM shows that a sluggish growth scenario, coupled with a less accommodative central bank policy, will take their toll on markets in the future. For example, European bonds, which averaged an annualised 6 per cent total return in the 30 years leading up to 2017, are now projected to generate a mere 0.5 per cent. European equities will fare better but are still expected to also see a drop to less than 5 per cent in the future, compared to their 7.5 per cent annual output over the past 20 years.

The members that will suffer the most are those who are near, or a decade away, from retirement. Their pots are close to brimming over and an overreliance on equities could potentially erode their future income stream. In contrast, the younger generation have the luxury of time. They have not accumulated a significant nest egg and can wait for a correction, improving performance as well as recovering capital values.

As Mercer partner and DC and financial wellness leader Brian Henderson puts it: "One of the challenges we are finding, especially for smaller schemes, is that a large slug of the 0.75 per cent charge cap is being gobbled up by administrative fees. That impacts the amount of money they have to spend on the investment component. Even if it is 40bp they are less likely invest in traditional active management because it will be too expensive."

Different approaches

The flexibility to expand investment horizons is not just down to the cap but also the size and structure of the scheme. For example, members tend to shoulder more of the burden when a company contracts a DC scheme provision to a group pension provider or a master trust, whereas the employer tends to foot the bill if the scheme outsources the administration to a third-party provider.

Not surprisingly, in general, the larger schemes with the more generous sponsors will enjoy the most leeway. Their DC plans can more easily absorb the administration costs than those at the smaller end of the spectrum. Equally as important, they can exercise greater clout and influence at the asset management negotiating table, enabling them to move away from the conventional passive trackers and funds.

Within this realm, one of the most popular additions has been alternative indexation products, which deliver broader return profiles because they are not based on assets that are focused on market capitalisation, for example, but instead utilise different non-correlated factors.

"Smart beta or factor-based investing can improve efficiency and generate a better risk return profile at an additional but not that much higher cost – only a handful of basis points, says Aon Hewitt investment consultant Jo Sharples. "They are not widespread but we are seeing fund managers increasingly use them for DC schemes that do not have an appetite for fully active strategies but are willing to pay more to add value."

Sharples also notes a move towards multi-asset funds that focus on asset allocation structures using futures and exchange-traded funds, as well as investing in alternatives such as real estate through listed real estate investment trusts.

Although different investment solutions and a more educated member base are required for a more developed industry, the catalyst of change is likely to be when the first generation of DC retirees hit the streets.

"This is a personal view, I do not think we will see any major changes from the current focus on low-cost products until people start to see their parents and grandparents struggle to retire," says Tonry. "It is important to remember though that the market is nascent and there are still a lot of people retiring on defined benefits but that will change over time."

Written by Lynn Strongin Dodds, a freelance journalist