Summary
- Pension freedoms have left default funds with an uncertain target.
- TDFs are slowly replacing the lifestyle approach.
- Default funds are set to start investing in illiquid assets and apply ESG criteria.

It's nobody's default

Almost four years on from the introduction of the pension freedoms, Alastair O'Dell looks at how DC default funds are adapting to increasingly diverse retirement choices

Structuring defined contribution (DC) default funds appears to be a simple task, given their universal aim and strict control on costs, with a universal solution. But while they all share a growth stage followed by a de-risking stage, there are a huge variety of approaches and outcomes.

Freedom and choice has left default funds chasing an uncertain target and rival approaches have emerged. Since 2015/16 members can take lump sums, drawdown and/or the traditional annuity, with access from 55. As it is too early to determine the 'new normal', default funds need to accommodate all likely member choices.

The underlying assumptions have a big impact. Fidelity International, head of UK DC investment, Hugh Skinner, says: "Providers work out a non-standardised model for each client. Each has its views about capital markets, the investable period and universe, inflation, contribution growth and likely retirement dates. Little variations mean they will not deliver the same experience."

As the vast majority of members will enter a default fund – for instance, in excess of 99 per cent of Nest's members are in its default target-date funds (TDFs) – so it is essential to concentrate efforts on its selection or construction.

Abandoning annuities

The aim of de-risking is to end up with a pre-retirement portfolio that mirrors the post-retirement strategy as closely as possible. The high price of annuities, due to low gilt yields and increased longevity, has left the traditional solution as the least popular choice.

"Providers are no longer targeting annuities – less than 20 per cent of our clients still have annuity purchase as their default," says Hymans Robertson, head of DC investment, Raj Shah. This has a big implication for the investment strategy: "Long-dated bonds can be volatile and you would not want to see a big swing your pot size just before you cash out."

Nest's at-retirement TDF portfolios maturing 2021 and beyond will have a CPI+ target. Nest, head of private markets and investment proposition, Stephen O'Neill, says: "We knew evidence would not be in about how people are decumulating, but it at least keeps pace with inflation. It's kept in constant review."

PLSA policy lead: investment and stewardship Caroline Escott says: "Schemes are looking at default pathways but the market is continuing to evolve and will do so more rapidly once the *Retirement Outcomes Review* follows through."

Scheme membership analysis can be used to shape the strategy. Small pots are usually taken as cash while larger ones are more likely to enter drawdown, where a proportion can remain return-seeking for longer.

Barnett Waddingham head of DC investment Sophia Kataora says: "There is no industry standard – it very much depends on the membership. If DC members also have big defined benefit (DB) benefits we can be relatively sure they will take a tax-free lump sum. That shapes the derisking profile."

Skinner adds: "It's difficult at this point. People are electing to do things with their DC pots that are not necessarily reflective of what DC retirees will do in the future. We can't say in any way that we have the blueprint."

Fidelity offers a strategy that aims to preserve the option to annuitise, cash out or drawdown within one lifestyle solution. "We could offer three options, but then one of them would be the actual default. The natural tendency would be to go for that, for a significant majority.

"An individual needs to have elected a glidepath many years before retirement, as it has an impact on investment for the preceding period. People are not engaging at that early point."

Trending to target-date funds

Lifestyle and TDF approaches both effectively aim for the same outcome but via different structures. PLSA found in 2017 (it plans a survey for 2019) that 80 per cent of main default funds were lifestyle. Only 14 per cent were TDFs, although this was rapidly increasing and "it's fair to say that trend has continued", Escott says.

As TDFs are less expensive and easier to administer, at scale, some are surprised they have not been adopted more rapidly, as has been witnessed in the US.

TDFs allow members to take full advantage of the freedoms; one could take a lump sum at 60, work part time with a small drawdown to 65, then retire completely and enter full drawdown, before purchasing an annuity at 75. While this would require an uncommon degree of foresight the market may well mature in this direction.

"The beauty of TDFs is you can invest in different funds that target different outcomes at different points," Kataora says. "It's very difficult to do that through a traditional lifestyle strategy with its administration constraints."

In lifestyle funds, each member has their own fund and the administrator trades according to a matrix-based strategy, an intensive process with the potential for error. In TDFs, members are pooled so the fund manager trades within a single fund.

Nest was an early adopter of TDFs, benefitting from being able to start with a blank-sheet design and anticipating sufficient scale to run its own TDFs. A standalone pension fund may have to choose off-the-shelf products, albeit from a wide range of automated or tactically allocating products.

JLT Employee Benefits, DC investment consulting, Maria Nazarova-Doyle, says: "You must have confidence the TDF manager can deliver for all asset classes and de-risk appropriately. You must really understand the product and know it fits your membership. In lifestyle you can pick all the components and managers, so there is a lot more input from trustees.

"TDFs are less expensive, but I do not yet see a trend. Trustees are used to being in control. But as the market consolidates into bigger master trusts or DC super funds it will potentially all go towards TDFs."

The change cannot happen very quickly, according to Skinner. "There are regulatory challenges around construction and delivery using a TDF structure that need to be thought through properly."

Diversity in default

DC funds have followed DB funds into ever more esoteric asset classes in pursuit of diversification and returns. "Since 2015 there has been access to an increasing range of asset classes in the DC market," Shah says.

One major focus is on illiquid asset classes, such as infrastructure and corporate loans, which exchange a long-term commitment for premium returns. O'Neill says private markets are the "natural evolution" for Nest and notes this is the route taken by similar US funds.

The major problem is illiquid assets are intrinsically unsuitable for the daily-priced, unitised DC world. However, the Treasury's *Patient Capital Review* is shedding light on how DC capital can be invested.

Nest is working with the British Business Bank on accessing growth stage private equity and venture capital. "It's challenging to say the least but there is a lot of political investment in the programme and the early signals suggest the market is innovating," O'Neill says.

Despite booming institutional demand there seems to be sufficient supply. Shah says: "In the next few years the global need for infrastructure will go up. There is a massive deficit and trillions are needed. It's the same for patient capital – supply will keep on coming. At the moment limited supply may be driving up pricing – but this is a long-term thing."

Skinner says illiquid assets "certainly have a role to play" but cost is an issue with the ongoing charges figure (OCF) capped at 0.75 per cent. "True illiquid assets – not securitised ones – would undoubtedly bring additional charges that would probably have to be offset elsewhere."

He also notes an operational hurdle. Money needs to shift between asset classes – but the illiquid manager cannot guarantee timely entry or exit. "Everyone wants this done fluidly, transparently and with great control and automation. Automation and scalability are the key factors in driving down costs and making sure you can run broad market solutions."

Another major trend is for environmental, social and governance (ESG) investing. "I see this really changing this year," Escott says. "A lot of schemes are looking at ESG investment regulations and the duties being placed on them. Schemes are aware of the benefits that ESG can bring to investment strategies, including default funds."

Trustees have become a lot more conscious of non-financial factors, according to Shah. "There is a lot of product development, such as for multi-factor investing with an ESG tilt."

Skinner says the industry is evaluating how ESG can be incorporated: "What is appropriate for the membership? How should it be deployed and assessed? How do you achieve the right balance with fees? What is the most appropriate timeline?"

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