No investment strategies by default!

Jon Cunliffe highlights the importance of maintaining a default fund that best serves the needs of its members

At The People's Pension, like most pension schemes, the vast majority of members invest in the default. That's why we believe this fund is particularly important and requires a highly focused investment strategy so that savers can receive the retirement outcome they deserve.

Our priority is to optimise risk and return by offering an appropriate default fund that meets the retirement needs of our members in the most cost-effective way. To do this, we invest in several different asset classes offering positive long-term returns but which, over shorter time frames, can perform quite differently. This combination of different assets forms what is known as a 'balanced portfolio', which uses the benefits of diversification and reduces the variance of our members' investment returns.

In the long run, investment returns are overwhelmingly driven by asset allocation in traditional beta, which comprises several sources of return. Equities are the cornerstone, having historically, over the long term, been the best way for investors to benefit from economic growth through corporate earnings.

Within our equity allocation, we make use of risk premia strategies, which use a rules-based approach to benefit from market inefficiencies caused by investors' various cognitive biases. These strategies comprise value, momentum, quality, size, and low volatility, and we incorporate them in a low-cost way within our members' overall asset allocation.

The other so-called 'growth-facing' asset classes we hold are infrastructure and property. These are 'hybrids' in that they have both equity and bond-like characteristics; they can participate in the benefits of economic growth and generate an income stream with lower volatility compared to the broader equity market. These two asset classes help boost the risk-adjusted returns our members receive.

We now need to turn to bonds, historically a key component of a balanced portfolio. However, low yields and high levels of interest rate sensitivity have reduced prospective risk-adjusted returns. While we do accept that future returns will be inevitably lower, we still believe that sovereign bonds do offer valuable diversification benefits in a portfolio of mixed assets.

The scenario of a sustained increase in inflation, prompting investors to force the hand of central banks to push interest rates up too rapidly, needs to be taken seriously. However, high levels of borrowing suggest a limited cycle of rate hikes, with central banks keen to inflate away the debt burden by tolerating above-target inflation, while remaining committed to maintaining interest rates at relatively low levels.

Within our fixed-income allocation, we're heavily weighted towards corporate bonds, which has been a big positive for members' returns. A premature end to the economic cycle would be negative for these assets, but central banks remain committed to supporting the current expansion.

Finally, there is foreign exchange risk. Because we take a rational, global approach to long-term asset allocation, the bulk of our investments are in foreign currency. Since we do not want to hold unrewarded risk for our members, we have analysed what the appropriate amount of exposure to the major foreign currencies we should hedge back to the pound and have determined that 70 per cent is the optimal level.

Let's turn to responsible investing. There is considerable academic evidence suggesting that those companies with higher-than-average environmental, social, and governance (ESG) ratings are rewarded with relatively higher market valuations. A key reason is that these companies are better at managing their non-financial risks, thereby making them relatively more sustainable and less prone to a damaging de-rating by the market.

ESG is important to our members, and the accumulation fund used in our default lifestyle profile is rated 'AA' using Morgan Stanley Capital International methodology, which means that the companies our members hold are, on average, leaders in managing the most significant ESG risks and opportunities.

Furthermore, we have taken the active decision to remove (or choose) investments in companies based upon the nature of their business activities. Given that this approach increasingly informs investor preferences, it should not necessarily entail sacrificing returns and should be able to augment the improved risk-adjusted returns delivered by ESG integration.

As is the case for all major asset owners, we need to continue to evolve our approach, but a lot of good work has already been done to ensure that our members' investment journeys have been positive, and this is something I intend to build upon in the years ahead.

Written by Jon Cunliffe, managing director, investments at B&CE – provider of The People's Pension