Summary
• The UK's DC pensions industry relies on inertia on the accumulation side through auto-enrolment, and then values engagement once a member approaches retirement.
• Questions are starting to emerge as to whether members should have complete and freedom and choice at retirement, or if guided pathways should be offered.
• Those leaving the default fund at the accumulation stage are able to tailor their investments to their needs, such as taking on more or less risk.
• Engaged and knowledgeable members, especially those that take guidance/advice, can outperform their scheme's default fund, but research into self-selection generally shows poorer outcomes compared to the default.

Lessons from the other side

Following industry debates as to whether there should be some kind of 'drawdown default' or if complete freedom and choice should be maintained at decumulation, Laura Blows looks at the experience of those implementing their freedom and choice to opt out of the default and self-select funds at the accumulation stage

Ideological turmoil faces the UK DC pensions industry. On the one side is the philosophy of inertia, being implemented to great effect at the accumulation stage through auto-enrolment. In contrast, since the 2015 pension freedoms, decumulation has adopted the mantra of individual choice and engagement.

However, having only had a few years to bed in, questions are starting to emerge about whether those at-retirement should have complete freedom and choice at retirement, or whether they still require some guidance from 'above'. As Nest director of investment development and delivery Paul Todd notes, "with freedom and choice, we're seeing a largely unengaged population go from having almost no contact with their pension to having to manage quite complicated and difficult decisions".

Even though the accumulation stage of saving is characterised by a lack of engagement, it does still provide people with the option to connect with their pension saving. So are there any lessons from its experience of offering both choice and inertia that could be tailored to the decumulation stage?

Defaults

The main thing to note is that the vast majority of people saving into a DC scheme do so via the default fund.

The Pensions and Lifetime Savings Association's *43rd Annual Survey,* released in December 2017, found that 88 per cent of DC members remain in their default fund. In JLT Employee Benefits head of DC investment consulting Maria Nazarova-Doyle's experience, up to 99 per cent of scheme members are in default funds.

Despite the high majority of members remaining in a default fund, the PLSA's survey found the number of funds available remains high, with the average being 14. However, the number does vary between trust- and contract-based schemes, with trust-based schemes offering on average 12 different funds compared to 55 in contract-based schemes.

"Accepted behavioural science tells us too much choice means individuals struggle to make a choice, pointing to no more than 20 funds as the ideal figure," Smart Pension's chief investment officer Darren Agombar says.

"People do value the existence of investment choice, even if most don't engage with it," SSGA head of European DC investment strategy Alistair Byrne notes. "We favour a small, carefully chosen range of options – meeting the most obvious needs – rather than dozens or even hundreds of funds that will just cause confusion."

Those that do engage and opt out do so for differing reasons.

Self-selectors

Todd notes that of the small proportion of people making a fund choice or switching their funds, most are actually switching within Nest's default strategy, for instance by changing their retirement age and therefore moving into a different target date fund. The higher risk fund, followed by the ethical fund, are the most popular for those actively choosing an alternative fund.

According to Agombar, Smart Pension will be offering a self-select ESG pathway later this year "because it is important that individuals should be able to reflect their own values in their investments".

However, if members are self-selecting based on cultural or ethical views then they should be able to see a clear comparison of performance and make that choice fully informed of the potential implications on their long-term saving journey, he adds.

For Nazarova-Doyle, those that self-select tend to choose cash or low risk funds, as "they get scared of the scheme's definition of risk".

Therefore, "one of the most obvious dangers is that consumers may take on too much, or not enough risk, leaving them with an inadequate pot in retirement," Zurich head of retail platform strategy Alistair Wilson says.

Yet those that self select are not necessarily concerned with matching or beating their scheme's default fund's returns.

Newton head of defined contribution UK, Catherine Doyle, finds that self-selection is used to complement an individual's additional investments, outside of their pension pot.

According to Hargreaves Lansdown senior pensions analyst Nathan Long, 23 per cent of its workplace pension members choose their own investments, mainly through Hargeaves' 'best buys' fund list. Those self-selecting tend to have larger pension pots and have been paying into them for a long time, "as it takes time to build confidence and want to influence your own retirement", Long says.

Selection results

The company's research found this approach has paid off, as its analysis of 80,000 savers found that self-selectors beat the average default fund by 4.9 per cent per annum over five years.

Yet evidence of self-selection from other countries does not look so successful.

For instance, Sweden's premium pension system is around 20 years old; it allows participants to form their own portfolios by selecting up to five funds from an approved list of hundreds of funds.

According to Henrik Cronqvist and Richard Thaler's *Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience*, people were encouraged via an advertising campaign to make a choice away from AP7, the default fund – and 66.9 per cent did so. However, the funds selected had a higher equity exposure, more active management, much more local concentration, and higher fees. Meanwhile AP7 outperforms the self-selections. For instance, as of May 2015, it provided an annual risk-adjusted return of 30 per cent over the past three years.

A similar story occurs in Taiwan. Research paper, *Just How Much Do Individual Investors Lose by Trading?*, states that individual investor trading results in systematic and economically large losses. It finds that the aggregate portfolio of individuals suffers an annual performance penalty of 3.8 percentage points.

"Individual investor losses are equivalent to 2.2 per cent of Taiwan's

gross domestic product or 2.8 per cent of the total personal income. In contrast, institutions enjoy an annual performance boost of 1.5 percentage points," it reports.

Todd notes the same experience in Australia, where default funds across the 'super' industry outperform alternative fund choices. "That's because where default funds can achieve significant scale and have long term investment horizons, they can adopt more sophisticated investment strategies that maximise returns while keeping costs down," he explains.

Tailoring to needs

However, "there is an argument that self-selection could boost people's engagement and investment experience, which might lead to better outcomes in the decumulation stage", Wilson states.

Self-selecting can also enable people to tailor their retirement savings' investment strategies more towards their needs.

According to PLSA's survey, just over a third of default funds' investment strategy is a passive tracker, followed by multi-asset funds at 26 per cent, diversified growth funds at 25 per cent and bespoke solutions at 21 per cent.

Aon's *Defined Contribution Scheme Survey 2017* from March 2018 expressed concern that 40 per cent of default funds are still targeting annuities by moving members close to retirement into UK fixed income funds, which could be leaving members exposed to "unintended investment risks".

It recommended that members find out from their schemes what sort of strategies their money is invested in as they get nearer to retirement. They can then decide whether UK fixed income is an appropriate investment for them, based on their retirement intentions.

But this should not be a one-time action.

Nazarova-Doyle finds that even those that do engage may make an investment selection, but then do not return to it for many years, or if they leave the company, they forget about that pension completely. "Default funds are tailored to change over time; people who self-select may not do the same," she says.

It is for this reason that Byrne advocates a system used by some schemes in the USA, where members are put back into the default target date fund unless they expressly reaffirm their fund choice.

So if the experience of those engaging at the accumulation stage and moving away from the default fund is at best mixed, what insight does this offer to how the still-emerging, post-freedom and choice decumulation market should be structured? Is a default-style system required here to help people, as it does at the accumulation stage?

Decumulation defaults

In April, the Work and Pensions Committee's *Pensions freedoms* report supported the Financial Conduct Authority's recommendation that every pension provider offering drawdown should be required to offer a default decumulation pathway, suitable for its core customer group.

According to the committee, it hopes to protect savers who do not – or cannot – engage with their pension choices, and empower more consumers to make active decisions.

The pensions industry's reaction to this proposal has been mixed. Smart Pension and L&G announced it is launching the first decumulation default pathway in 2019, and Nest's desire to provide this service has been met with scrutiny.

Royal London director of policy Steve Webb is against decumulation defaults, as "the idea of a standard default makes sense when people are building up pension saving, but not in the diverse circumstances of later life".

"In particular, people may have built up several different pension arrangements with different providers and schemes. It would be impossible for an individual pension provider or scheme to know what the best option for a saver was when they know nothing about these other pensions," he says.

In contrast, the Pensions and Lifetime Savings Association's deputy director DC Nigel Peaple strongly agrees with proposals to introduce default pathways.

"One of the hardest problems we face is connecting DC pension savers with suitable retirement income products," he says.

"The report shows how it is possible to preserve retirees' freedom to choose whilst applying lessons from automatic enrolment to connect savers directly with retirement income products," Peaple adds.

Byrne finds the idea of default pathways helpful as he does not consider there to be much difference between accumulation and decumulation. "Members may differ in how they want to access their assets but they are still unlikely to have strong investment preferences," he says.

"Once a member has indicated broadly how they want to take an income, better that there is a default investment strategy for that objective rather than they been encouraged to choose. Things have changed since the old version of drawdown for wealthy investors with financial advisers. The post-pension freedom version is much more about defaults and simple choices."

Doyle believes that so much effort has been put into accumulation defaults that "some of this good work will be relevant in post-retirement design". However, she does not think we will see such high take up decumulation default s compared to the accumulation ones, as people's income needs at retirement will differ greatly.

Lack of advice

Some guidance would be beneficial, be it as with a pathway or not, as recent Zurich research finds that 32 per cent of retirees selecting drawdown are first-time investors, and 41 per cent of these did not receive either financial advice or guidance.

The report states that 47 per cent of new investors who had not received advice thought drawdown would be simple. A further 29 per cent notes that they were confident in their investment decisions, regardless of the fact that they had no prior experience of active investment.

These findings complement that of the FCA, which reports that 37 per cent of all drawdown products are sold on a non-advised basis.

It warns that customers have often not thought about the investment choices of drawdown. This is particularly the case when their main aim is to access their pension commencement lump sum (PCLS) only, without taking any immediate income.

"As a result, we have seen some customers remain in low-risk assets after following lifestyling strategies. We have seen others stay in cash funds because they have had to enter into a new contract to access drawdown. Both these options increase the risk of customers running out of money in retirement, or having less money than they were expecting," the report says.

The lack of advice or guidance can also put people at risk of scams, Webb warns.

But even those people trying to do the right thing by obtaining guidance or advice can end up going to the wrong sources and falling foul of bad investments. This risk affects not just DC, but those transferring their DB pension into a DC scheme in order to access the benefits of freedom and choice at retirement.

Work and Pensions Committee chair Frank Field recently warned of a "huge misselling scandal", following the number of scammers targeting the troubled British Steel Pension Scheme, encouraging them to transfer out of the DB scheme into risky savings products.

According to data obtained by *The Times* from the Financial Services Compensation Scheme (FSCS) in May, £318 million has been paid in compensation over the past five years to 10,900 people that transferred their pensions into high-risk schemes that subsequently failed, as the financial advice firms that advised them went bust.

Gradual engagement

Whether or not default decumulation pathways are considered necessary to help counter these risks, both sides of the debate agree that the aim is not to try and make people become investment experts – be it at the accumulation or decumulation stage. As Webb says, "People have other things to think about. Do we really want people to be checking their stock everyday?"

Todd agrees that "most people don't want to have to spend time and effort managing their investments". He recommends raising people's awareness of what saving into a pension means and how to achieve the outcomes they desire, as better ways of engaging members.

To assist with this, and to help smooth the sharp contrast between the inertia of accumulation and engagement of decumulation, providing individuals with a mid-life financial 'MOT' has been recommended at around age 50. At this age a reasonably significant pension pot should have been built up and retirement would be close enough to encourage engagement, but with still enough years prior for any changes decided upon to make an impact, Webb notes.

If the freedom and choice reforms are requiring people to become more engaged with pensions many years before retirement, may this result in people taking an interest and moving away from an inertia attitude at even earlier stages of the pensions saving process? May younger savers be inspired by seeing people actively making decisions in preparation of their retirement and move away from the default – or at least review and actively decide to stay in it, instead of being placed into it without acknowledgement on their part?

After all, as Doyle says, the UK's collective savings mentality needs to move on from a paternalistic, DB mindset, to one of individual responsibility with DC.

So the trickling down of decumulation's need for engagement into the accumulation stage may occur at the margins, Webb says, but he warns that "inertia is still a powerful thing".

Nazarova-Doyle thinks for this to occur, a generation or two of people disappointed with their DC-only pension pots will have to occur for the next generation to notice older people's retirement struggles and engage with pension saving. The industry is trying to avoid these lessons being learnt the hard way, she says, "but it would have to get worse before it gets better to change the psyche of the country".

To avoid this worst-case scenario, it is important that any effective strategies to help savers, whether they are typically implemented at the accumulation or decumulation stages, be utilised throughout the process. After all, the lines between the different stages of retirement saving are blurring, as are the boundaries between pensions and other forms of investments. Instead of partisan differences, we are all uniting under the one 'true' belief of the importance that people save.

Written by Laura Blows