Gliding down a different path

Chris Newlands explores the need for new approaches to DC default funds' glidepaths

Summary
• DC glidepaths are said to be in need of review.
• Recently, people approaching retirement have been pushed into bonds at the wrong time, in terms of market conditions, as a result of the 'lifestyling'. This is where default funds glide out of typically more 'risky' assets, such as equities, into 'safer' assets such bonds as a person approaches retirement – but without consideration of investment market dynamics at that time.
• There is concern that savers will ultimately run out of money unless current glidepath mechanisms are looked at.

It is no secret that bonds have been a difficult investment over the past few years.

As central banks across the world hiked interest rates, the impact on fixed income assets has been devastating, with 2022 being one of the worst years ever for the asset class. Prices were negatively affected, especially long-dated bonds, and indices lost in the region of 10 per cent during those difficult 12 months.

In such circumstances, investors would presumably want to avoid bonds. For swathes of people getting closer to retirement, however, the way their DC pension pots are constructed meant they were piling in and buying bonds at exactly the wrong time.

This happened because their pension provider's default, or lifestyle, fund was gradually switching them out of shares and into bonds as they got older, which usually takes place between the ages of 55 and 65.

While at one point these glidepaths, as they are called, were judged to be the most effective way of allocating assets, given most people bought an annuity to fund their retirement, they now have their mounting critics.

Not only are people living longer, but the growing use of drawdown, where savers are able to take money from their pension savings while keeping the rest invested, instead of the purchase of an annuity, has cast doubts on the merits and mechanics of glidepaths.

Market timing issues

"Clearly, the products are not fit for purpose," says Chelsea Financial Services managing director, Darius McDermott. "Simplistic products that systematically make changes without any thought or common sense may be prone to mistakes. A good example is how badly bonds have done relative to equities in the past five years."

Any multi-asset manager could tell you what terrible value bonds were, at negative interest rates, he adds. "However, that wouldn't have stopped these products from blindly buying more. They make no account for market timing. Personal circumstances change and this must be taken into account in any portfolio allocation, beyond simply a client's age," he says.

According to data from the Financial Conduct Authority, drawdown has become the most common retirement income route for Brits, with just over 218,000 new drawdown policies entered into between April 2022 and March 2023 – a 6 per cent jump on the previous 12 months. Meanwhile, annuity sales dropped almost 14 per cent over the same period to just over 59,000.

PensionBee director of public affairs, Becky O'Connor, says: "Glidepaths are in need of review, given the very different trajectories to retirement that savers now have and the impact on pension pots of some very unusual market movements in recent months and years, which have seen historically 'safer' investments experiencing high volatility."

The fundamental principle of managing risk towards someone's retirement is sound, she adds, however, the issue with defaults is that, while they may suit the majority, they do not work for a significant minority. "Crucially, these individuals may be unaware that their pension doesn't meet their personal needs and goals," she says.

Longer living

That glidepaths are too prudent, especially with a growing number of studies concluding that babies born today can now expect to live to 100, is a big concern.

McDermott says: "It's a common mistake for younger investors to be overly cautious with their pension allocation when they often have an investment horizon of over 40 years."

He believes most young investors should be 100 per cent in equities because the "compounding impact of missing out on higher returns is enormous".

He says: "Instead of perpetuating existing misconceptions, large workplace pension schemes should do more to empower young investors with the knowledge they need to make informed decisions."

So how can defined contribution glidepaths be improved? That is the million-dollar question, says O'Connor. "There is cause to consider maintaining a higher proportion of assets in equities, given drawdown means a decent chunk of most people's retirement savings will be kept invested until later in retirement. Many providers offer this option, but savers may not be aware of it," she says.

Legal & General Investment Management head of DC investments, Jesal Mistry, agrees: "Over time, it will be vital for glidepaths to align more closely to the member's needs and requirements as they approach retirement and throughout.

"A 'one-size-fits-all' glidepath does not meet this. It will be critical that we work towards achieving greater personalisation of investment strategies in line with the needs of individuals. Over time we will be able to tap into a richer set of data to understand an individual's personal wealth."

The wrong assumptions

One problem in getting this right, according to experts, is that, after the 2015 pension freedoms reforms, most schemes adjusted the target of their DC investment strategies on the assumption people would stay invested in retirement through drawdown, rather than swapping their pension for an annuity.

However, says Redington DC consulting senior vice president, Russell Wright, the latest FCA retirement income market data shows that "57 per cent of people are taking their whole pension out as a lump sum in retirement", which is not in line with what was anticipated.

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He says: "This means their investments won't have been aligned to how they ended up acting. And so, it's hard for decision makers to know how to deal with the fact they don't know how pension scheme members will access their pension. Do they build a strategy based on how they think members should act? Or base it on current actions, i.e. that most take everything out of their pension in one go?"

He adds: "One way to deal with this conundrum is to improve communications leading up to retirement to help members select the right glidepath for them."

Savers must also remember that the choices they made perhaps 15 or 20 years ago regarding their pension can be undone. Nothing is set in stone.

Hargreaves Lansdown head of retirement analysis, Helen Morrissey, reiterates this: "It's important that members know they aren't locked into a lifestyling strategy that doesn't fit their needs and that they can either turn off or delay the transition into lifestyling or else move to a fund that better matches their plans."

Money running out

Ultimately, the danger of glidepaths being wrong is that people will run out of money in retirement – a fear that is ever-present, after government statistics analysed by the Labour Party in April found that nearly one million people aged over 66 in the UK are living in deprivation.

Wright says: "There is a real and frightening risk that the next generation of DC retirees, with all the effort and investment that has gone into automatic enrolment, will have poor outcomes in retirement."

This will not be because people are rushing out and spending their money on fast cars and lavish holidays, he adds, but because people end up taking slightly too much income and not achieving quite enough in investment returns.

"The result could be that they run out of money at the mid-point of their retirement – too late to go back to work, but still with many years of retirement ahead. The industry needs to tackle this risk head-on by driving trust in pensions, improving user experiences, and building retirement propositions fit to deal with the challenges ahead," he says.

Now Pensions director of investments, Martyn James, recognises these issues but is more optimistic in his outlook. He says: "Workplace pension savings are basically a top-up of the state pension. Given the low minimum contribution rates in the UK, there is a risk that many people will retire on less money than they expect and may not be able to live the retirement they pictured. This will be a political and social challenge, but it does not mean that people are at risk of running out of money in retirement."

Written by Chris Newlands, a freelance journalist