Summary
- The FCA's proposed red/amber/green 'traffic light' rating system for rating the value for money (VFM) for DC default funds has led to concerns that this may result in default funds 'herding' together into similar investment strategies.
- Herding concerns include asset allocation capacity constraints and dampening innovation.
- There already is a degree of herding within DC default strategies.

VFM: Herding into harm's way?

Laura Blows considers whether the FCA's proposed value-for- money (VFM) rules – specifically its 'traffic light system' – run the risk of DC schemes' default investment strategies herding together

Farming and the UK pensions industry aren't known for their similarities, but they do currently have one thing in common: Managing herding concerns.

But while farmers grapple with the best approaches to herding, the UK DC pensions sector is increasingly worried about herding generally occurring within its default investment arrangements.

But why the concern now? It begins in August 2024. This is when the Financial Conduct Authority (FCA) launched a consultation on its proposed rules and guidance for the value-for-money (VFM) framework for contract-based pension schemes.

This included a suggested red/amber/green (RAG) 'traffic light' rating system within the public VFM disclosure of workplace DC schemes' default investment strategies.

A 'red' assessment will signify poor value and a scheme in danger of wind-up, 'amber' will mean there's room for improvement, and green will signify that the scheme provides VFM.

"Schemes not scoring green could face severe consequences; amber-rated schemes must improve by a deadline and close to new employers, while red-rated schemes must transfer members to better arrangements. Pension schemes will want to do all they can to score green and avoid these serious consequences," AJ Bell head of public policy, Rachel Vahey, warns.

Following the flock

"It has been suggested that the new VFM framework could increase the likelihood of herding. This is because the VFM framework will lead to every default arrangement being assessed, including its investment performance, against three other default funds – two of which must be from large organisations," Aegon UK managing director, investment proposition, Lorna Blyth, explains.

"If there is material underperformance over a period of time still to be clarified, the arrangement could be forced to close to new employers or, if no improvement, wind up and consolidate. This increases the risks of taking an investment strategy that is significantly different from your peers, which could create a stronger herding instinct."

While VFM involves showing that scheme charges are low, service quality is high, and investment performance is consistently good, "a key component is workplace schemes must measure themselves against their peers, other workplace schemes", Vahey says.

"There's a risk schemes will avoid doing things differently, in case they stand out from the crowd and jeopardise their green rating. Instead, schemes are more likely to herd towards uniform offerings lacking distinction," she explains.

While supportive of robust VFM systems, Hymans Robertson head of DC investment services, Alison Leslie, warns that herding may occur in this market if the framework to assess schemes inadvertently promotes some behaviours more than others.

"For example, if the VFM framework is unduly penal to schemes who invest differently and the returns from that investment take time to be achieved. For example, private market investments are, by their very nature, long-term investments and therefore short-term comparisons against private markets may not be appropriate. It doesn't mean one scheme is doing the right thing and one the wrong, the timeframes and investment opportunities are different, therefore the comparisons should not be the same. Care has to be taken when designing frameworks that compare apples with oranges," she explains.

This potential herding may occur in various ways. According to Quantum Advisory investment consultant, Joe Condy, herding may occur through investors replicating the investment strategy of other investors, "out of the fear of making the wrong decision themselves, which may lead to irrational decisions", or by focusing solely on fees and 'herd' to the cheapest available fund options on the market, or to the best performing fund over recent years, "without considering other important factors".

Within DC pensions, 'herding' might involve investors implementing investment strategies that look similar to the competition in their peer group, Broadstone senior consultant, Richard Sweetman, says.

"This might be in terms of the 'design' of the default investment approach, for example the length of the lifestyle glidepath or the type of retirement income being targeted, and also in terms of the asset allocation of the funds being used in terms of the percentage allocated to equities, bonds, private markets etc," he explains.

In a practical sense, herding may occur into asset classes that are perceived as safe or popular, such as government bonds, large-cap stocks, or real estate, the Investment Association senior policy adviser, pensions and institutional market, Imran Razvi, says.

"There's a risk schemes will avoid doing things differently, in case they stand out from the crowd and jeopardise their green rating"

As the Australian 'super' pensions market has been considered an indicator of the direction of travel for the UK DC sector, it is interesting to see that its "small number of very large super funds have, over time, started to converge in terms of asset allocation and investment", Leslie says.

While Australia is "often cited as the international example of where herding takes place", this is "generally at the smaller end of the market where smaller superfunds have tended to align with the industry benchmarks to minimise risk of failure", Standard Life head of investment proposition distribution, Callum Stewart, says.

"From our recent on-the-ground research, we found that larger (i.e. scaled) superfunds were predominately operating in pursuit of best long-term net outcomes," he adds.

Whilst not proposing a mirror framework, the VFM consultation did make reference to the Australian system, LifeSight at WTW head of investment, Andrew Doyle, notes.

However, there are mixed lessons to be learned from that market, he states.

"While increasing scale and rooting out underperformers can help improve member outcomes, this approach has also made Australian providers highly peer-aware, changed behaviours, and arguably stifled innovation to the potential detriment of member outcomes in other ways," Doyle explains.

Razvi also notes that research of other countries, such as the Netherlands and Chile, has found evidence supporting herding behaviour in the asset allocation of pension funds.

Examples can also be found closer to home, with corporate DB schemes, "where the regulatory framework has encouraged de-risking, the use of LDI and ultimately a concentration of DB holdings in parts of the gilt market", he says.

And within DC, "with most workplace default funds currently taking largely passive approaches, there is already a degree of commonality across workplace defaults", Blyth states.

Also, "many providers that have underperformed the peer group in recent years are currently redesigning and re-launching their default funds, with most moving to designs and asset allocations that are closer to those of the top performing providers," Sweetman says.

Condy highlights that "there is such thing as intentional herding i.e. 'follow the leader, leader…'. But spurious, i.e. unintentional herding is also possible, where investors do critically consider their decisions, but end up with the same conclusion".

"One example of the latter is the rise of passive investing in DC pension schemes, particularly equity allocations. Some may call this herding. Some may say that the decision makers recognised that the stock market is highly efficient and beating benchmarks is a very difficult game, with very little success overall. And ultimately, over the past 10 years, this has resulted in good outcomes for members overall. The vast majority of active equity managers have indeed underperformed their benchmarks."

So, as it is already occurring in some form across UK pension strategies and beyond, does the proposed VFM framework potentially increasing investment herding really matter?

Herd mentality

It does, according to Leslie, as systemic risk could inadvertently be created.

"If schemes are invested in one geographical area or in one asset class and the money follows towards that, on any failing in that area, it affects all schemes and all members. You can also create capacity crunches, particularly in private markets, where supply does not meet demand," she warns.

"Herding is a cause for concern because it can lead to market inefficiencies and financial instability. It can result in a concentration of investments in certain asset classes, which has the potential to create market bubbles or crashes due to rapid and unpredictable price movements," Razvi says.

He gives the example of the 2022 gilt market shock, "where the concentration of DB pension funds in the long-dated and index-linked gilt markets resulted in a negative price spiral as many investors sought to exit their positions at once, without there being sufficient demand on the other side to absorb these sales".

"Even if herding leads to investments in 'good' high-quality assets, it can still create systemic risks due to the concentration of funds in a few asset classes. For DC pension funds, herding can result in a lack of diversification, increasing the risk of adverse outcomes during market crises," he adds.

Blyth agrees that herding could drive up valuations, "causing asset bubbles, which could result in widespread impact on returns if these assets face a downturn".

"However, this needs to be seen in the context of global markets, where UK pension fund money is invested alongside other global institutions. It is unlikely that UK DC pension fund money on its own, which the Office for National Statistics estimates at £830 billon, will drive systemic financial risks," she adds.

Even if the worst market impacts of any herding are avoided, "it still implies a reduced degree of investment innovation amongst pension schemes. This is because the incentive to herd, which for example in the UK might be caused by efforts to avoid a red or amber rating, outweighs any benefit to innovating in investment strategies", Razvi says.

"If all pension providers choose the same investment approaches, then all members will achieve the same returns and outcomes – this is fine if returns are good but could be a risk if returns are bad"

The fear of standing out does tend "to result in managers unwilling to back their ideas. It leads to small risk positions and overall leads to average performance for everyone. While this may sound good, the result is that it drives out active decisions and most of the productive finance that the government is driving for investment into needs active management", HS Trustees managing director, Bobby Riddaway, says.

As Sweetman notes, "if all pension providers choose the same investment approaches, then all members will achieve the same returns and outcomes – this is fine if returns are good but could be a risk if returns are bad".

Condy agrees that trustees/providers might fear going out on a limb and seeking value for clients (net of fees) at the risk of looking more expensive in comparison to peers and underperforming cheaper options. "This has the risk of stifling innovation, but on the other hand simple investment strategies that members understand is not necessarily a bad thing," he says.

Riddaway mentions another risk, that if the RAG boundaries are set so that schemes only take on risk or innovation within those boundaries and "they may tone down risk to stay within the boundaries, thus artificially constraining innovation".

How the traffic light system is implemented is therefore likely to be a key factor for whether, and to what degree, investment herding is to occur. Blyth highlights that "if the rules are too draconian, focus too much on short-term performance, and/or have little tolerance for temporary underperformance, the temptation to follow the pack will be higher".

"This could mean greater focus is placed on returns over the short term, with schemes being afraid to innovate. This could result in members receiving the 'average' return, rather than benefiting from an investment strategy which seeks to maximise returns over the long term.

"On the other hand, if the rules are more pragmatic and allow for some departure (underperformance) without any cliff-edge consequences, or if those ultimately deciding on a RAG rating can consider contextual factors such as investing in different asset classes, then the likelihood of herding is reduced," she says.

Reaching new ground

The space for nuance within the rules is required, as schemes' different membership demographics, beliefs and preferences are an important factor when deciding an investment strategy, Condy says.

"If trustees/providers adopt similar strategies, without giving due

regard to these factors, this may cause suitability issues. To mitigate the risk, the framework for assessing VFM should incentivise and reward long-term thinking and differentiated investment strategies that are bespoke to the membership demographic, rather than focusing on cost-efficiency and short-term performance.

"If some element of acknowledging the risk/return features of the design/asset allocation and the provider's objectives for the strategy can be reflected in the traffic light scoring then that would go some way to overcoming the natural tendency to look at headline performance only," he adds.

Particularly as devising an investment strategy is tricky, as Vahey acknowledges.

"Trustees and providers need to walk a fine line between avoiding excessive risk associated with unproven assets, while also making sure they don't take too little risk either. The FCA and DWP need to look again at the proposals to avoid unintended consequences. Adopting a wider range of scores, instead of just three [RAG ratings], would remove the cliff-edge between making the grade and falling by the wayside," she says.

"A more balanced approach, recognising schemes won't score perfectly each year, will encourage them to adopt braver and more innovative investment strategies, as well as different service and support solutions, without the Sword of Damacles hanging over their heads," Vahey adds.

Razvi highlights that "since performance is measured on a relative basis, herding resulting in an outcome where all schemes are rated green would not be helpful to customers in selecting a scheme. That's why we have proposed that schemes should be judged against whether they are delivering on their own stated investment objective, rather than how they compare against other schemes in the market".

While NatWest Cushon director of policy and research, Steve Watson, is very supportive of the government's VFM framework, he would like to see forward-looking returns incorporated into the VFM framework and traffic light system.

"If a VFM framework incorporated future returns, schemes would have more latitude to be creative with their investment strategies. This would drive differentiation: They can be ambitious and more adventurous, particularly with the likes of private market assets," he explains.

The hints so far are that the FCA is carefully listening to industry concerns as to how to implement the VFM framework.

When asked at the PLSA Annual Conference in October if there was scope to evolve the traffic light system, particularly given industry concerns around the stark step between amber and green ratings, the FCA head of asset management and pensions policy, Nike Trost, agreed that there was.

A framework that will drive action is required, she said, adding that "it should be a simple framework, but does it have to be red/amber/green? Not necessarily".

Whatever form the VFM framework may take, "provided the overarching aim and requirements to provide value for members from the investment approach equates to maximising net long-term returns, we believe it will be challenging for schemes to herd around overly cautious approaches," Stewart says.

"This, in our view, could support better focus on net return drivers and collective learning, and this shouldn't be a cause for concern, if the overall aims and outcomes are improved across the industry, and if the regulatory framework supports, rather than stifles, innovation.

"In principle, this may support a positive form of herding over the longer term rather than short term. i.e. in the short term we may expect more innovation, and in the long term we may expect more 'positive' herding as the industry develops consensus views from experience."

Mitigating the negative risks of herding, while maximising value for members? That'll do.

Written by Laura Blows