The turning of tides

Summary
- While the objective of a default fund remains unchanged, the journey has changed since the introduction of pension freedoms.
- Evolving retirement patterns have resulted in schemes having to rethink their default strategies.
- Improved financial education is key to ensuring members are able to make the best decisions with their DC savings.

The road to retirement for many in the UK has changed since the reforms of 2015. But what has the impact of those reforms been on the default strategies used by DC funds?

It would be no understatement to state that the UK pensions landscape has been transformed by the introductions of automatic enrolment from 2012 and freedom of choice from 2015. In fact, 'transformed' was the word used by the government on one of its websites last year in describing the impact of the former.

The 2015 changes guaranteed freedom of choice to pension holders. From April that year, the reforms meant that pension holders could access as much of their savings from their DC scheme as they wanted through various options.

Any shift in the pensions landscape has the potential to move and change the investment strategy of schemes. For defined contribution (DC) funds, the default investment strategy has traditionally been tailored to the lifecycle of the eventual pension holder, with funds invested in riskier assets when that person is young, eventually moving into safer assets as they approach retirement.

"It's meant," says PLSA head of DC, master trusts and lifetime savings, Alyshia Harrington-Clark, "that managers, schemes, and funds will choose to replace riskier, higher-return assets such as equities with lower-return but steadier income delivering assets like bonds. It's about reducing risk over time towards a target date."

The general feeling amongst commentators is that while auto-enrolment did little to shift the workings of a default strategy, it was the reforms of 2015 that have forced changes.

"The DC market," says Mercer senior investment consultant and principal Adam Hayes, "was anchored around preparing members to eventually purchase an annuity. That meant a de-risking into bonds and cash. The bonds were there to match movements with equity prices but since freedom of choice, the industry data shows that fewer members are purchasing annuities. This

means that a large number of strategies that target an annuity purchase are no longer appropriate for a few schemes."

How did the 2015 reforms change the default?

Some contend that there has been no change in the overall objective of the default strategy. The destination, it seems, has remained while the route has been replanned.

"The defaults before the pension freedoms," says WTW senior director in the investment team, Anne Swift, "were predominantly structured to mitigate against annuity conversion risk. The investments would broadly move in line with changing annuity prices, meaning that you were going to be invested in long-dated bonds. It didn't come overnight, but 2015 changed that. The numbers buying annuities went down significantly while those going for cash went up. The reason was that those people were retiring with relatively little in their DC pots, but many still had a defined benefit (DB) scheme."

Now, the destination has changed, claims Aviva head of investment strategy and proposition, Maiyuresh Rajah.

"The landing point has changed," he says, "so most default funds don't have the same glide path of three-quarters bonds to one-quarter cash. It's now either going into something that looks to optimise the portfolio or into investments where the assumption is that the client will go into drawdown. A lot of people are doing that."

The changing shape and form of retirement is also conspiring against default strategies. Recent figures by the Office for National Statistics indicate that two-thirds of those over the age of 65 in the UK are working part time. Many of these will continue in these roles even after their pensions begin to pay out.

"The cliff-edge retirement," says Harrington-Clark, referring to being in employment on one day and retired the next, "is disappearing rapidly. It's becoming a journey rather than a destination. You may see someone decrease their working hours over several years or move to a shift pattern such as working in a supermarket. It's not retirement in the sense that we've been used to. That's had an impact on how investment defaults are designed in that there's no longer a final date to design a solution for, but multiple dates where someone may take one pension but not another."

The gilts crisis

There was a great number of comments about the gilts crisis of 2022, which ultimately forced a change of government in the UK, with then-Prime Minister, Liz Truss, being shunted out of power after only 42 days.

"One of the issues with no longer having a cliff-edge retirement," says Harrington-Clark, "is that the crisis became a double-edged sword for DC savers. Some of them had been de-risked into gilts that suddenly became risky and volatile. It was highly problematic in terms of someone accessing their pension pots that week or the week after. You would have gotten a terrible price that week. A black swan-event such as that now needs to be a factor in how a default strategy is operated."

Swift alluded to the same event. She says that schemes need to think about investments after drawdown. "One of the risks that members face during drawdown," she says, "is that they flip into an income drawdown arrangement, and then they invest in a very different way to how they've been invested during the scheme. There's a sequencing risk where they could transfer out on a day when the equity markets have tanked. It means that they'll have lost out simply because they've retired on the wrong day."

The road forwards

The most pressing concern for now appears to be educating pension holders about not only what their options are, but where the implications of those options may lie. Financial knowledge is often lacking amongst the general public and freedom of choice also gives leeway to make poor decisions.

"We need lots of education and awareness," says Harrington-Clark. "We need something to show that the industry is better equipped to deliver something that is not harmful to the average person. We still feel that there's a lot of people that take their money and put it into a cash ISA. They think it's about having access to their funds, and it's not a bad choice for some, but it's a bit of a nonsense when the framework for giving people a retirement income is not being used."

She continues: "What happens with freedom of choice is that if someone chooses to do nothing, or is unable to choose what to do, their money sits in a pot and also does nothing. That's a shame. I think there's an industry consensus that something needs to be done to decumulation so that if the saver does not make an active choice, their scheme or fund can still provide them with something that will offer them choice at a later date."

And little attention has been paid to what is going on in the world outside of pensions. A cost-of-living crisis has been taking place across the UK and the rest of Europe for over a year, with core inflation reaching at some points 6.5 per cent.

"It's one of the things that's gone under the radar," says SPP DC Contribution Committee vice-chair, Martin Willis. "People are often needing to take more out of their pensions due to high inflation and there's statistics that drawdown rates have increased significantly. That gives us two problems. One, the money will be used quicker. And, two, if your money's in a pot that's liable to fluctuations, there's a chance that withdrawing it when the market is down only speeds up that depletion. That's a huge pressure."

Written by Pete Carvill, a freelance journalist