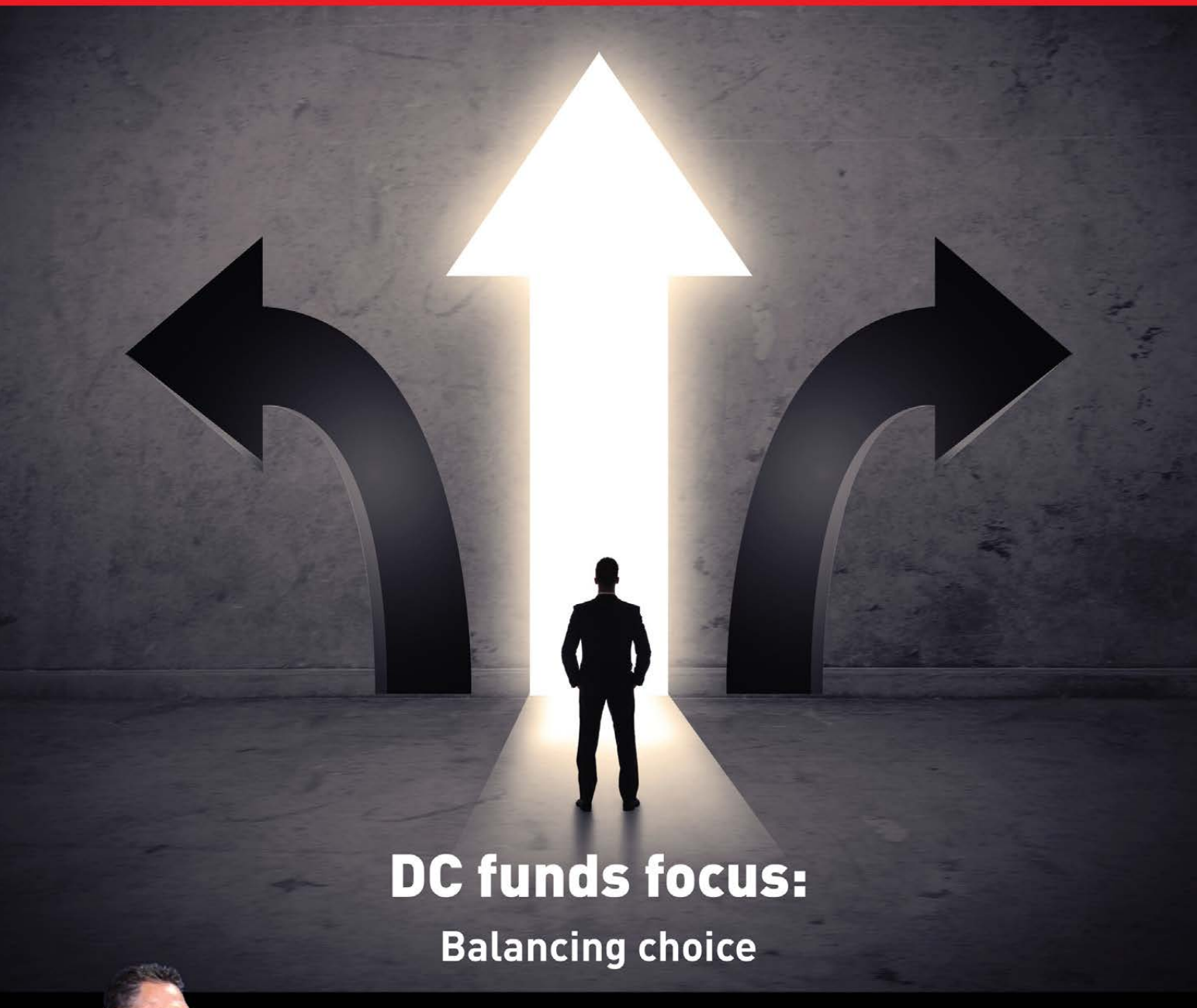




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## DC funds focus: Balancing choice



◀ **Mark Fawcett, CIO, NEST**



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# Investment matters

► **Laura Blows talks to NEST CIO Mark Fawcett about managing market conditions and compiling the best fund choices for DC members**

► **Could you provide me with an overview of current market conditions?**

It is pretty challenging at the moment, although the global economy seems to be growing pretty well. A lot of asset classes are looking fairly fully valued, and there are a number of risks on the horizon. In the short to medium term we are seeing political risks. In Europe they have tended to subside a bit, but clearly we have the issue of what's going on between the United States and North Korea that is creating a lot of tension.

Longer term, we are concerned about the amount of leverage in China. So the amount of private debt in China as a percentage of GDP probably exceeds that of Japan at the peak of the bubble, so that is a ongoing concern.

And then finally, in the very long term, we are very aware of climate change risks and we are looking to manage those in the portfolio.

► **That's quite a few risks, both short term and long term, for pension**

**schemes to manage. How do you recommend they handle changes in market conditions?**

For NEST, one of the key ways we manage risk is through diversification. We invest in a range of asset classes, trying to take the opportunities that are available. So recently for example we added emerging-market debt and high-yield debt in addition to the equities and property that we are investing in.

Then we need to be proactive and innovative when it comes to longer term risks. So I talked about climate change being a key risk for us and we have started investing in a climate aware equity fund, which looks to overweight the beneficiaries of climate change, such as renewables, and underweight companies that are heavily exposed, such as companies with large carbon reserves or high carbon emitters.



And we dynamically manage shorter-term risks, so for example we've looked to hedge some of the political risk in Europe during the 2017 election cycle, through an equities derivatives overlay strategy.

**➤ While managing changing market conditions, how do you ensure you still maintain your own scheme's investment priorities? What are they for NEST?**

We have very clear objectives for our membership. For us, understanding our members and meeting their needs is absolutely top of our list. So we have a number of investment beliefs that support that. For example, we believe taking investment risk is rewarded in the long term and that diversification is a key tool for managing risk. Our beliefs also

guide our approach to passive and active investing. There's this myth that NEST is just passive because we are low charge, but we have a number of active managers in both credit and property. And then managing the long-term risks is really important, so that we can deliver a smooth journey and grow the members' pots over the long term.

**➤ I believe NEST has its own in house investment team. Is that an advantage in terms of ensuring that you always stick to your aims and objectives of meeting members' needs?**

Yes, we as a house do a lot of research on our members to understand their needs and wants. Meeting the members' objectives is important and having the in house team means I can align their incentives with meeting those objectives.

The other key thing is academic

evidence shows asset allocation decisions drive investment returns and therefore we make sure that we do the asset allocation in house and then we allocate to best in class managers for each of the individual asset classes.

**➤ So you provide a wide range of fund choice I assume?**

Most of our members, and most of the members in DC schemes generally, are in the default fund. Typically something like 90 per cent of the members in DC schemes are in default. Ours is actually higher than that, it's over 99 per cent, so we put a lot of effort into designing the default fund and we have a series of 47 target date funds that are tailored depending on the age of the members.

But, default funds are not right for everyone, therefore it is really important to make alternatives available and provide clear choices. So we have five other fund choices, and they are very clearly differentiated in terms of the objectives, to the default fund. And because there's a carefully selected range, it's easy for the members to choose. So an example would be the ethical fund. The ethical fund is similarly diversified as the default fund, it has the same investment objectives, but it screens out companies that some people don't want to invest in, for ethical reasons, like tobacco.

**➤ How important would you say fund choice is to employers looking to select a pension scheme for their staff?**

I think it's very important and employers need to know that their employees have a suitable range of investments. At the same time the behavioural research shows that if you give people too much choice, or if you give them the individual building blocks of different asset classes, equities, bonds etc, it's very hard for them to make investment decisions.

Employers don't want their employees coming and saying 'well there are 200 funds to choose from, which do I go into?' So keeping the fund choice relevant, differentiated and focused I think is vital.

**➤ As you mentioned, the vast majority of people will never move away from the default fund. So, for employers looking to select a pension scheme, a good quality default fund must be key. What are the characteristics of a good quality default fund?**

The first thing is to have clear objectives, and objectives that are aligned with what the members need. For NEST, the first thing we did was do that research to understand what our members' risk appetite was likely to be, and understand what their end objectives were going to be.

Then it's really important to build in flexibility. We have flexible target date funds that allow us to adjust asset allocation. So when market conditions change, the economy changes, we are able to adjust. A good example is when freedom and choice was announced, and compulsory annuitisation was abolished, we were able very quickly to change the glidepath so that we were no longer targeting annuitisation but targeting the sort of strategy and portfolio that would suit members as they took their money out of the scheme at retirement. So having clear objectives, meeting member needs and having flexibility is important.

I think also, longer term, we clearly have a lot of scale. We have five million members, over 400,000 employers, and currently £2 billion of assets growing very rapidly. That's going to allow us to access a range of asset classes that aren't usually associated with DC, such as private markets, infrastructure etc. So I think employers probably want to look at the ability to get the benefits of that scale at low cost and have a truly multi-asset, diversified default fund.

**To watch this video interview, please visit [pensionsage.com](https://pensionsage.com)**

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### Summary

- Despite customers expressing a willingness to engage, actual engagement is pretty low.
- Giving too many options for customers is a bad idea – most schemes should only offer eight to ten funds, and make any more than that harder to access.
- Since most customers stick within a default fund, that remains the most important part of any scheme.

# The needs of the many

**How much choice should DC members be given with fund selection? Too much choice can leave members overwhelmed and disengaged. But no choice could put people off engaging with their pension savings. But why should schemes even offer choice if most do not engage? Peter Carvill examines these conundrums**

It is a truth self-evident within the industry that our end customers, the pension holders themselves, do not engage with the product. And yet they should; slight differences today will make a huge difference tomorrow.

### Engagement

The statistics are fairly stark. In *Damage by Default: The Flaw in Pensions Auto Enrolment*, a recent survey by Decision Technology, it discovered the depth and breadth of the ignorance of pension holders towards their assets: just under a third did not know who their pension provider was, four-fifths had no idea how much was in their pension pot, and more than nine out of ten did not know which funds their pension was invested in.

Other research, *Workplace Pensions: The Members' Perspective* by Price Bailey, indicates that two-fifths did not know whether they were part of a DC or DB scheme; around half did not understand the fees charged, their purpose of those fees; and despite 40 per cent saying that they actively wanted to avoid investing unethically companies regardless of investment performance,

the majority did not understand in what companies or sectors their funds were invested in.

But the benefits of being engaged are obvious, no? After all, as Decision Technology writes in *Damage by Default*: "If people were to engage with their pension and choose a better fund to invest their money in, each employee could increase the value of their pension pot by an average of around £180,000."

Despite this bleak picture, there is no real dearth of pension holders looking to engage in thinking about their futures. Price Bailey also noted: "Over half of pension scheme members in England profess an active, regular interest in their pension savings and retirement planning."

But still, the authors add, "[...] half do not feel confident that they have the knowledge they need to make informed decisions about their retirement and – particularly among women – a lack of understanding is seen as the main barrier to being more engaged in pensions."

### Choice

As a consequence, most find themselves within a fund's default option at the beginning, and then stay there.



According to NEST, 99 per cent of pension holders within a fund go down this route. Other organisations, such as Fidelity, place this figure lower – 80 per cent of its members remain in the scheme's default, with only 45 per cent taking up the open market option.

So little engagement begs the question of why should funds work to offer a range of investment choices. PTL managing director Richard Butcher says that regardless of actual engagement, it is still best practice to offer a choice. "I'm not sure the two things go together," he says. "But the fact that they choose not to engage doesn't mean we shouldn't offer a range of funds. But when we set up the fund, there's still a default strategy that's designed around the needs of the average member."

In fact, says Butcher, the lack of engagement from pension holders may be of benefit to a pension trustee. "It may not be such a huge problem when it comes to actually investing," he explains, "as most of them tend not to make good decisions in this area. A lack of engagement means that we can put







them in a well-designed and managed default fund. Overall, that's probably a better outcome than them trying to do it themselves. The only thing we don't get enough engagement of is in their contribution decision. That's the significant leverage that they have and if we can engage with them more on that, the better."

Butcher points to what he calls the split between freestylers in a typical scheme. He says that you will often get a 25 year old with investments in cash or a 63 year old with their money in emerging markets or equities. Those choices, he says, may have been made for their own reasons but are not likely to be sound investment decisions.

For those that do engage, there is a risk of too few funds or too many. Give them a too-limited choice and a pension holder may become resentful, feeling somewhat powerless or as if they are being treated like a child. But at the opposite end of the spectrum from the illusion of choice is having far too many options. In that case, those non-professionals may find themselves

overwhelmed and consequently become frozen like deer in headlights.

"Choice confuses people," says Butcher. "On the funds we work on, we usually limit the choice to about eight. So you'd have things like cash, property, diversified funds, etc..."

At this point, NEST and PTL diverge in how they approach the issue of too much choice. The difference between the two is small in principle, but important.

NEST CIO Mark Fawcett says: "While offering a small range of choices is better than offering a vast range, the choices need to be clearly differentiated and sufficiently different from each other so members know what they're getting. One of the main problems of too much choice is that all the fund options are pretty much the same as each other, so how can members possibly choose between them?"

In contrast, Butcher posits that an approach that gradually gives access to a great range of pension funds, but with progressively-tougher access. "If you don't like the default, here are eight other funds. After those eight, there's a further 20 but only accessible through a website. After that, there's another 100 but through a website with a login. If they don't like those, there's more—but they have to phone up the company. So if someone wants to look at 1,000 funds, they can. But they've got to be committed in order to gain access."

The present also brings challenges because many pension holders will have reservations about the type of investments that are being made, as it were, in their name. Price Bailey's figures show that over half (53 per cent) of respondents said it was important to them for their pensions to be invested ethically, in companies with good human rights records and high standards of socially-responsible behaviour. At the forefront of this was an aversion to investing in 'payday' lenders, which were held up to being particularly 'not acceptable'.

Fawcett, however, is keen to point out that SRI and ethical investing are two separate and distinct things. NEST, he says, applies a 'responsible approach' to all its funds. This is because, he adds, "[this] delivers better risk-adjusted returns. Some people want to invest according to moral or ethical convictions. That's a completely different issue."

### Default

Questioning the number of funds, though, may be sleight of hand for the real topic: the strength of the default fund. Since so many never stray from this, a trustees' priority in this regard must be its strength; it is, after all, is set up to best serve the interests of the average member. On a Bell Curve of priorities, very few will deviate from this and, even then, probably not by much.

"Most needs are very similar," says Butcher. "So our members, by and large, are happy with the default. In fact, they're almost nearly always better off that way."

The ideal default, says Fawcett, will look and be constructed a certain way. It needs to be designed for the membership, to be flexible in order to enable dynamic risk management but also respond to change. Cost, he says, is also important, especially when choosing appropriate strategies for different asset classes and the delivery model. And it needs to have clear objectives that are tied into members' needs.

The key to good governance, then, is not to give members a huge number of choices but to give them the right options that are best suited to them. For most, that will be to remain in the default. As it should be.

Written by Peter Carvill, a freelance journalist

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