Summary
- Research has shown that younger people tend to have a low risk appetite when it comes to saving for retirement.
- This lack of risk appetite can have serious long-term effects on their lifestyle in retirement, especially since the introduction of pension freedoms.
- Understanding why young people may be risk averse can help the industry find solutions.
- Most agree that financial education is key to helping people make the most of pension-building opportunities when they are young.

Fortune favours the brave

Jack Gray investigates why young people may have a lower risk appetite than previous generations and what the industry can do to improve their understanding of the risk/reward balance

In most aspects of life, this generation of youngsters are generally more cautious than the generations that preceded them. Studies have shown that young people drink less, go out less and are more risk averse with their money than their parents. This extends to pensions, with recent research by Interactive Investor finding that around four million workers under the age of 40 could be missing out on investment returns due to being in low-risk pension arrangements.

The study notes that around 19 per cent of people under 40 are in a high-risk scheme, while 54 per cent believe that a medium-risk pension would deliver the strongest returns, despite evidence that higher-risk portfolios with a greater exposure to equities are more likely to produce higher growth over the long term. Just 16 per cent of respondents describe their risk appetite as high.

"Research over the past decade suggests that young people have become more risk averse than those in previous generations," says LCP senior consultant, George Currie. "This has manifested itself in several areas of life, including in their financial choices."

Currie notes, however, that it is hard to conclude definitively that younger pension savers are more risk averse than those in other age groups, as other factors, such as auto-enrolment and limited financial education, are likely to be contributing to the perceived lack of risk appetite.

"However, for those younger members who are engaged with their pension, their higher level of risk awareness could be contributing to them remaining in the default, as it's viewed as a safe choice and, perhaps, a lower-risk choice than self-selecting an investment strategy," he adds.

Hit the ground running

In pension saving, having a high risk appetite is likely to be most beneficial when an individual is young. Due to the long-term nature of saving for retirement, building up funds when you have the time to do so and when you are not in imminent need of using those savings can, ironically, be the least risky long-term strategy. Savers can hit the ground running when they are young and take less risks as they near retirement. Unfortunately, young people are likely to have less confidence in planning their finances than when they are more experienced later in life.

"Selecting a higher-risk pension plan may seem daunting for young savers - especially if they are just starting out in their pension saving journey," comments PensionBee CEO, Romi Savova. "However, while higher-risk investments can see sharper increases and decreases in their value, they're likely to provide a higher rate of growth than lower-risk investments over the long term.

"As pensions are a long-term investment, it's crucial for young savers to remember that short-term fluctuations are unlikely to cause any lasting damage, especially for those who are at least 30 years from retirement. Low-risk plans tend to usually only be considered for savers who are withdrawing their entire pension imminently. So, if a saver maintains a risk-averse attitude in their earlier years, over time they may end up with a much lower retirement income than expected."

Currie adds that, as they will most likely be dependent on defined contribution pension savings, alongside their state pension, the investment performance of their savings will be one of the key determinants governing when they will be able to retire and what kind of lifestyle they will have in later life.

"Taking more risk at an earlier age could help them to achieve their goals more easily," he continues. "It could also help members to smooth their income more effectively over their lifetimes by reducing the burden on contributions to deliver the outcome they desire."

Young people having a high risk appetite for their pension saving can also be less risky than in other financial spaces due to the risk controls put in place by trustees. The industry itself is, by nature, averse to risk due to the long-term and critical nature of the overall objective – funding retirement. Currie explains: "It's rare that we see young members (or any members for that matter) taking too much risk inside the pension wrapper. Trustees play a critical role in selecting, reviewing, and refining the investment range available to members, and the due diligence they exercise helps to protect members from investing in assets that they deem to be too risky."

Why the low risk?

It is important to understand why young people may lack risk appetite, as the research suggests, to help provide them with a better standard of living in retirement. A lack of financial education and experience are key factors as to why there may be a lack of confidence in taking risk among the under-40s, as Interactive Investor head of pensions and savings, Rebecca O'Connor, explains: "Its could be down to a lack of experience with investing and the very correct sense that a pension is an important pot of money, therefore why would you put it at 'risk'?

"It's very understandable that younger workers, who might not fully appreciate that more risk can and usually does lead to higher growth, particularly over long time periods, cleave to the safety of low risk at first. The problem is this may be a one-off decision that they do not revisit again or at least not for several years. By the time they do develop a better understanding of risk, they may already have missed out on thousands of pounds worth of investment growth."

Furthermore, young people have grown up in a world with more than one global financial crisis. This experience of seeing how quickly money can seem to disappear, plus the perceived need to have emergency funds in place in case of times of financial hardship, could also have contributed to the lack of risk appetite amongst young people.

A lack of understanding and interest

Although some assert that young people are more risk averse with their pensions, others think that the larger trend is a lack of understanding and interest with pensions among the under-40s.

"I would question the assumption that younger people have lower risk appetites," says Cushon CEO, Ben Pollard.

"Outside of pensions, it seems that this is not necessarily the case with younger people investing in high-risk products such as cryptocurrency – research from the Financial Conduct Authority suggests that they are attracted by the 'thrill' and the 'novelty' factor rather than saving for the future."

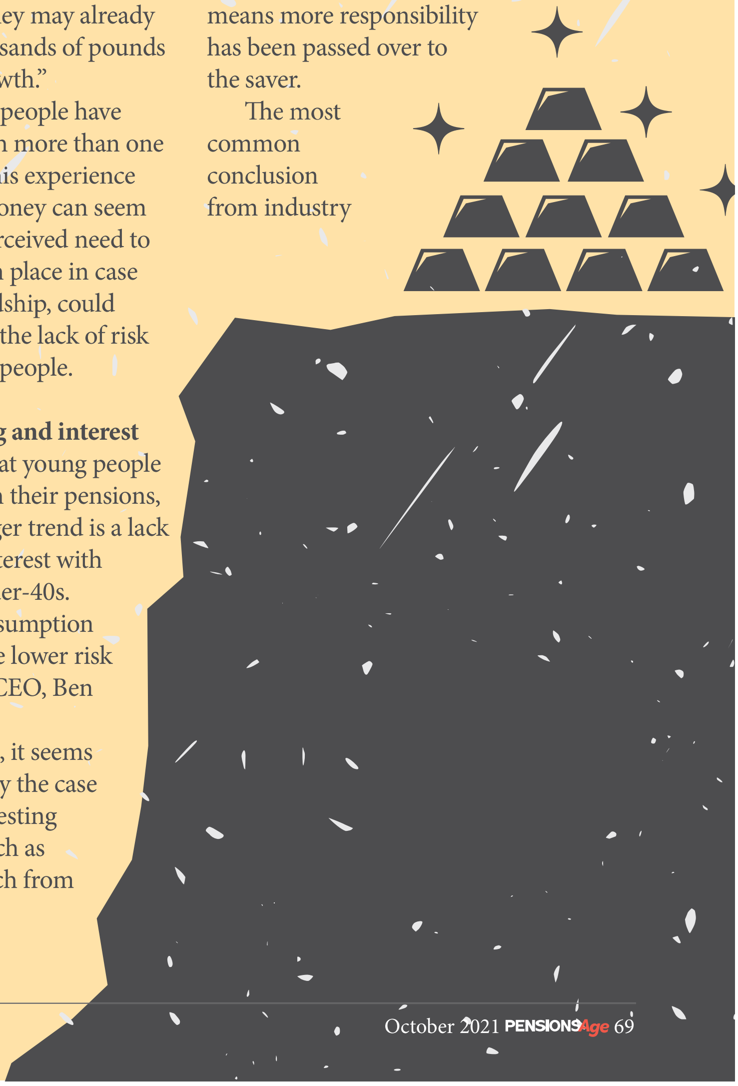
Pollard argues that, for pensions, the issue is that younger people are not connected. Unlike high-risk products that offer excitement and an element of instant gratification, the timeline for pensions is much longer and so it's more difficult to get them engaged, he notes.

"Hence they stay in the default fund that by its very nature is lower risk – in other words they are not driven by their attitude to risk but rather inertia," Pollard adds.

Addressing the issue

Whatever the reason for young people's lack of appetite for or interest in high-risk pensions, it is a problem that needs to be addressed, especially since the introduction of pension freedoms means more responsibility has been passed over to the saver.

The most common conclusion from industry



experts is that more needs to be done to educate younger generations about the potential benefits of having a high risk appetite towards the beginning of their retirement journey. Many believe that if there was a greater understanding around pensions, younger people would be more confident.

"If we are to see the younger generation fulfil their retirement ambitions, the pensions industry needs to work together to combat young savers' lack of risk appetite," says Savova.

"The world has never been more uncertain for prospective retirees, so a wider awareness of the differing investment strategies throughout someone's lifetime is essential."

O'Connor adds that there is not necessarily a need for young people to have higher risk appetites, as it is not a negative thing to be a cautious person, but what does need to improve is young people's understanding.

"A cautious young person can, once it is explained to them, still appreciate that they might need to step out of their comfort zone a little to seek long-term returns and end up with a bigger pension," O'Connor continues. "In my experience, this is rarely explained to people clearly when they start a new job. If risk and return is explained, it is rarely understood that this can have a huge impact on what you eventually end up with. Better illustrations of retirement scenarios might inspire people to look more closely at what they can do, including possibly moving from a low to a high-risk portfolio."

She adds that there is an issue around the word 'risk', as it has negative connotations, and it "almost always" needs to be supplemented with 'growth'.

"It really should have very little to do with appetite or character and a lot more to do with time horizon," O'Connor continues. "You don't want to push people to the point of anxiety, but there are ways of making people more comfortable with a higher risk/growth option."

Currie also asserts that it not a job for the industry to increase savers' risk appetites, as a pension scheme can never have a full understanding of an individual's financial circumstances, but rather to help members understand the choices they face and the potential consequences of taking more risk.

"Engagement is key to this," he explains. "Finding issues that resonate with younger people, such as the responsible investing agenda, can help to improve engagement levels and enable schemes to deliver guidance on the key decisions they should be taking regarding their pension.

"Equally, ensuring that schemes use engaging technology, such as retirement income modellers and app-based tools, can help to make the retirement journey more immediate to members and get them to consider whether their risk appetite will deliver the outcomes they want."

Pollard echoes the sentiment about connecting young people with their pension and investments by educating members about how pensions can be used to help tackle environmental and social issues.

"In the lead up to the launch of our net-zero pension, we conducted research which tells us that 62 per cent of employees would engage more with their pension if they knew it was having a positive impact on climate change – it's not just about attitude to risk it's about higher purpose," he states. "It's this higher purpose that can get them connected and more engaged which will lead to better decision making and ultimately better retirement outcomes."

Written by Jack Gray