For professional clients only. Capital at risk

Growing the retirement orchard – making sense of CDC

Massi Delle Donne explains how collective DC could bear greater fruit for pension savers

Collective defined contribution (CDC) is a hot topic in our industry with many enthusiastic supporters, including the Minister for Pensions, Torsten Bell, extolling the potential superior member outcomes. However, there are sceptics, and those with more conspiratorial views argue that CDC is just "actuarial voodoo" (which is terrifying as I now cannot dispel the picture of a cackling, top hatted actuary with a necklace of tiny financial calculators and mystical stochastic symbols). I therefore aim to describe CDC's benefits intuitively, without the use of my beloved Excel.

The solo gardener: Imagine you are a gardener who plants a single fruit tree. You water it regularly, and after many years, it grows and starts to produce fruit – your reward for all that effort. This tree represents your pension savings. You invest steadily over time (watering the tree), and when you retire, you start to live off the income it produces (eating the fruit).

But being reliant on just one tree comes with risks. If the tree does not grow well or suffers from disease, there may be too little fruit. You might be hesitant to use a powerful fertiliser if there's even a small risk it could kill the tree. And, perhaps most worryingly, the tree might stop producing fruit while you still need it – leaving you with nothing in your later years.

This is a useful way to think about the challenges of a typical DC pension. Individuals are responsible for their own investment decisions. They bear the investment risk, must decide how ambitious or cautious to be, particularly near or in retirement, and manage the risk of outliving their savings. It can be an uncertain path.

Joining the orchard club: Alternatively, imagine you join a gardening club. When you join, a sapling is planted, but instead of having your own tree, you get a share of the entire orchard. Everyone contributes by watering the trees, and in return, the club aims to give you a steady supply of fruit from a set date for the rest of your life. While the amount of fruit is not guaranteed, it's designed to be more predictable and sustainable over time.

There are clear advantages to the orchard approach. You are not dependent on a single tree – if one tree has a bad year, others in the orchard can make up for it. As new members join, planting more saplings, the orchard continues to grow and replenish itself over time. Thus, the orchard can take more risks overall, including using that powerful fertiliser, without putting the whole orchard at risk. Critically, the amount of fruit distributed to each member is based on how long the average member is expected to live. But, as some will live shorter-than-average lives and others longer, retired members know they can keep getting fruit for life.

However, there are trade-offs too. If the tree you planted produces a bumper crop, you need to share the windfall across the group. And if you pass away before the tree, you cannot leave behind a tree that your family can inherit.

The orchard metaphor highlights the differing features of a CDC. There is only one shared investment fund, so

risk is shared across members and spread over time. This means that a CDC can take on more risk than a typical DC, but any windfall return is shared by all. CDC schemes share longevity risk which ensures an income for life, but in the event of an early death, the residual capital is not passed to your estate.

CDC does not eliminate risk, but it does redistribute it. Think of it less like 'voodoo' and more like joining a cooperative. It is not magic, and it is not perfect, but for many, it could be a better way to manage the uncertainties of retirement.

Written by BlackRock institutional client specialist head, Massi Delle Donne

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