Changing tracks

Default funds don't often get good press, whether that be for varying levels of returns across the industry, or the lack of diversification of assets within them. Natalie Tuck examines the problems with default funds and how they can be improved

Summary

- DC default funds have received some bad press for the wide gulf in returns and structure.
- Experts are split on whether there is an industry-wide problem with default funds but are clear that past returns aren't a good measure of performance.
- They are also split on whether introducing a system where the member chooses their provider, as is the case in Australia, or introducing performance league tables, would work in the UK.
- Instead, default funds should focus on the member, and look at assets such as private equity, large infrastructure projects, and ESG.

Earlier this year, The Pensions Regulator (TPR) turned its attention to default fund governance. The legislation was already in place, but a new pilot was launched to increase awareness of trustee duties and ascertain how many trustees are doing a good job.

The law states that a pension scheme's default strategy and the performance of its default arrangement must be reviewed every three years, or when there is a significant change in a scheme's investment policy or demographic of its membership. Trustees are required to check the default arrangement is performing as expected and that the default strategy ensures investments are made in savers' best interests.

TPR's focus, explains its executive director of regulatory policy, analysis and advice, David Fairs, is on good outcomes for savers in their retirement. With more than 95 per cent, according to TPR, of trust-based DC members saving in default funds, it is imperative that they're fit for purpose.

The measure of performance

Hymans Robertson's *Master trust default fund performance review*, published in September 2018, found a large difference (6 per cent, per annum) between the best and worst performer over a three-year period.

To put that into perspective, the report stated: "This can mean a difference of 10 per cent in the value of a member's DC pot in just three years (based on an individual with a salary of £24,000 a year, receiving an 8 per cent contribution (£160 per month) and with a starting value of £1,000, not taking into account any changes to salary)."

In addition, a recent report by Punter Southall Aspire, entitled *Who's performing well?*, looked at the nine leading providers in the DC market for group personal pensions (GPP) at 31 March 2019.

It found that in the growth and consolidation phases, funds varied in design and construction, investment risk and volatility, asset allocation strategy, return benchmarks, management and critically, performance. A broad range of investment strategies ultimately leads to a broad range of results. Over the past three years Zurich was the best performer (11.3 per cent), whilst Standard Life was the worst performer (5.2 per cent).

Fit for purpose?

SEI UK Institutional managing director of defined contribution, EMEA and Asia, Steve Charlton, believes that there "is an industry-wide problem" with default funds, but he does not mean the issue that has been generating the recent bad press, which has been a focus on short-term investment performance.

"The real problem with default funds is that, for the most part, they are built to be the 'least worst' option for the many members they serve. By this I mean that providers will design a single default or select a generic target date fund and squeeze every member into it, without considering the needs, objectives or means of the member," he explains.

However, the view of The People's Pension director of policy, Gregg McClymont, is that one or two poorly-performing funds have received some attention, but many other default funds are performing well.

"More widely, default funds fare well in comparison to more expensive retail

Australia since 1992.

Savers in Australia also benefit from a 9.5 per cent minimum employee contribution, and since 2005, have been able to choose their own pension provider. But would allowing members to choose their provider work in the UK?

Trainor says that the UK has approached pension saving in a different way with auto-enrolment, and the system's low opt-out rates points to its success. "Rather than seeing any further dramatic change in approach, the focus should be on building on the success to date, with increasing engagement and proxy contribution levels that go beyond the current minimums."

The policy of member choice was introduced in Australia over a decade after compulsory pension saving was introduced; SEI's Charlton believes doing that in the UK would be hard to achieve due to the levels of public apathy towards retirement saving in the UK.

Indeed, despite having the choice, many Australians don't exercise this right. Australia's Productivity Commission estimates that two-thirds of people become default members on entering the workforce or changing jobs, and half of all accounts are in the default product (MySuper).

products. The average cost of a default fund across the occupational pensions sector is c.42bps. It costs nearly 45 bps just to sit on some self-invested personal pension (Sipp) platforms, before investment costs are added. Costs matter so much in long-term investment returns."

McClymont's point raises the question of what factors make for a good default fund. Returns are of course important, but there are several other categories to consider.

As Standard Life head of investment solutions, Gareth Trainor, notes: "There are a variety of beliefs of what makes a good default, and innovations in previous years often create variations in performance, especially over the short term.

"For instance, some defaults take significant investment risk, while others do not as they would consider this would not be aligned with the risk appetite or capacity of a large proportion of the members who are asked to bear this risk."

As Nest chief investment officer Mark Fawcett notes: "There are always going to be differences across how default funds are managed, but this does not mean they are inherently unfit for purpose."

Tips from a land down under

Brits can be forgiven for envying many things about Australia, whether that be the beautiful beaches, weather, or maybe even, the pension system. Compulsory pension saving has been in place in

The Association of Superannuation Funds Australia (ASFA) says that, on an ongoing basis, around 5 per cent of fund members in a year switch their fund. Some of these have switched jobs, but even in these circumstances this suggests the member is choosing to consolidate in the new fund rather than this just being a default outcome, ASFA notes.

Aside from the difficulties of implementation and potential lack of uptake, the PLSA's policy lead for investment and stewardship Caroline Escott highlights that the UK would also lose the advantages of the current workplace pension system if it were to change. "Many workplace schemes compete on having a much more generous pension than the automatic enrolment minimum to recruit and retain staff and having an engaged employer can also help promote improved retirement outcomes by supporting employee understanding of pension saving."

Some in the industry, however, do support the idea. Smart Pension director of policy and communications, Darren Philp, notes: "It makes perfect sense for employees to choose where their employer contributions are directed. This would not only help with engagement, but it would also make it easier for people to consolidate their pensions and keep track of their pension saving. Employers would still have to choose a default scheme for those that don't want to choose, but for those that do want to choose we should facilitate choice rather than putting up arbitrary barriers."

Furthermore, Trafalgar House client director, Daniel Taylor, believes that an Australian system would "remedy the UK's burgeoning issue of members having multiple small pots".

"The biggest technical barrier to implementing the Australian model was always the creaking technology infrastructures that sat behind payroll systems. But, with auto-enrolment now introduced and many employers embracing digital engagement platforms, dramatic improvements in payroll technology has taken place that could now support providing payments to multiple self-selected pension providers."

A league of their own

Another idea to increase the competitiveness and performance of default funds in the UK is the introduction of an official performance league table. Escott says that it's important for scheme members to have access to clear, comparable information about their pension scheme to ensure they understand and engage with their retirement savings. However, the PLSA does not think that league tables would achieve this.

"We think that the usefulness to members of investment performance league tables – given the current market, low levels of saver engagement and the fact that members cannot swap from one scheme's default strategy to another scheme's default strategy – would be relatively limited."

Despite this, she does think that league tables might be a helpful additional tool for trustees and scheme decision-makers when considering and designing their investment strategies, though she stresses that trustees would need to ensure they focus on long-term performance.

Furthermore, Charlton is concerned a league table approach could "stifle innovation" and lead to a "consensus approach to default design". As McClymont notes, the main difficulty with introducing a league table would be making sure that you are comparing apples with apples. And with the wide variety of defined contribution schemes, this could be hard to achieve.

The member in mind

Experts agree, however, that creating a good default fund starts with having the members in mind. As Trainor states, rather than having a homogenised 'one-size-fits-all' approach, a solution that can be tailored to an individual's situation would likely lead to better outcomes.

"These multiple 'defaults' merging seamlessly into the next generation of pathway 'defaults' would likely be the next logical step. Gone would be the days of a 'single path' into retirement for all, instead a multi-phase choice architecture taking different variables into account which lead to a more personal approach and increased engagement," he explains.

Escott adds that schemes can help themselves by "collecting more and better data about their members so they can align the default as much as possible with the needs of their unique member demographics and objectives". She explains: "This is just as important for schemes with more members approaching retirement as it is for those with more younger entrants to the workforce."

Incorporating new assets

Provides are also looking to incorporate new assets to improve their default funds. For example, Fawcett says that Nest is looking to add private credit to the stable of asset classes it invests in on behalf of members.

"Private markets offer opportunities for higher returns than publicly-listed markets and we see long-term potential in private credit. Some of our members will be saving with us for more than 50 years. We can be patient with their capital and allow them to benefit from the illiquidity premium to be had from private loans and other illiquid asset classes," he explains.

McClymont too adds that many defaults are not yet invested in unquoted assets: "The fees these asset classes attract are higher than traditional asset classes, and the liquidity and valuations are not provided daily, so the master trust sector needs to see how these challenges can be overcome prior to investing."

Escott is also in agreement, noting that pension schemes are "uniquely well-placed to benefit the illiquidity premium offered by investments, such as private equity and debt, as well as large infrastructure assets and property.

"The PLSA is also supportive of recent regulatory developments on ESG – it is vital that schemes get to grips with financially material ESG issues, as they would with any other long-term risk or opportunity that could have an impact on risk-adjusted returns."

Charlton adds that an increasing trend in default funds is a shift towards a responsible investment approach. As well as the societal and environment benefits, he says it has a secondary benefit of helping to engage members.

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