Summary

- With around 88 per cent of members in default funds, it is the responsibility of the industry to make sure these funds work well.
- Recent data has shown a vast difference in asset allocations, leading to return variations of over 3 per cent for a three-year period.
- Experts warn that some funds need to take more risk in the early years.
- Projections for long-term returns show a gap of 40 per cent between the worst and the best performing default funds.

The luck of the default

With around 88 per cent of defined contribution members in their scheme's default fund, it is imperative that the industry creates the best funds it can for members. Natalie Tuck looks at the impact of return variations on a member's prospective pension pot

The industry has perfected to a fine tune a chorus of experts telling members to contribute more to their pensions.

Indeed, the amount of money a member pays into their pot is crucial to having an adequate sum of money to support them in retirement. KPMG head of DC Anne Swift says that the ultimate value of your pot is much more dependent on how much you pay in rather than the investment return, and for most members, that is what they can control.

"If I was member, the thing I would feel most in control of is how much I'm paying into the scheme, but I probably wouldn't want to be so in control of my own investment decisions. Unless you really get that engagement and that education right, there is a real risk that people will make the wrong decisions," she says.

Swift is right; the majority of defined contribution savers leave it entirely up to their provider to choose where their pension is invested. The Pensions and Lifetime Savings Association's 2017 annual survey reveals that 88 per cent of defined contribution savers are in a default fund.

Industry responsibility

As Swift notes, it is therefore "incumbent on us an industry" to make sure that things will work out for members when they get to retirement. "There are always things we can do to create better solutions and we really need to be on top of it."

The defined contribution system in the UK was built around the employer choosing the provider, rather than the member. This adds further responsibility on the employers and providers to create a default fund that gets the best possible outcome for the member.

Recent default fund performance, however, has shown a wide gap in the returns generated. According to Punter Southall Aspire's *DC Default Survey 2018*, over a three-year period, the gap between the best and worst performing leading funds was 3.75 per cent; Zurich gained 7.29 per cent, whilst Standard Life lagged behind with 3.54 per cent.

Standard Life, which includes an active management element within its default fund, defends its poor performance. It says the fund is built with customers in mind, which balances their need for returns in the long term, their capacity to take risk and their attitude towards risk.

"It seeks to do this by adopting a much more diversified approach to asset allocation than many alternatives and, as a result, over the shorter time periods, it is much less likely to experience either extreme highs (when markets race ahead) or extreme lows (when markets fall) but in the longer term will generate enough return to meet investment objectives," a spokesperson says.

Diverse asset allocation across default funds is the reason for such vast return variations. Although the average allocation to equities is around 66 per cent, according to PS Aspire, there was a gap of 40 per cent between the highest and lowest. Default options also hold a significant portion of fixed income, allocating 27 per cent on average to this asset class, but a look at the portfolios reveals a gap of 10 per cent between the highest and lowest exposures.

What is the right amount of risk? Punter Southall Aspire

DC investment consultant Christos Bakas notes that as the growth phase is the longest period, having a bad year of performance, particularly in the early years, is not going to affect a saver that much.

He also thinks the cost of the fund can serve to hinder poor performance even more: "Standard Life has performed so badly over the past few years, and because they have active funds it's an expensive strategy. If we incorporate the bad performance and the cost, in the end, the projected fund value is going to be much lower than a fund that's had a better performance and is cheaper," he explains.

A long-term look

The industry's leading association, the PLSA, says default fund performance is a "critical matter" for trustees, and it expects them, along with their advisers, to devote sufficient time to default funds at meetings of the trustee board and investment committee.

However, PLSA policy lead for DC Tim Gosling notes that it is important to not put too much emphasis on short-term performances. "Returns for defined contribution default funds since the beginning of automatic enrolment are important early indicators of performance, but we need to judge returns over a much longer time period of time. For younger investors, what happens over the next 30 years will be much more important than what has happened over the past five."

Analysis by KPMG on the long-term expected returns of 15 leading defined contribution providers reveals a startling difference, with a gap of 40 per cent between the best and the worst performing defined contribution funds.

The report explains that a 25 year-old today who puts 10 per cent of their £30,000 pensionable salary away every year, and retires at 65, could have a pot

Do return variations matter for DB?

Recent data from IC Select revealed a "colossal" spread in asset allocations by fiduciary managers of defined benefit pension schemes, which will surely result in a wide range of return variations.

The amount fiduciary managers are allocating to equities ranges from 9 per cent to 34 per cent, while illiquid allocations range between 9 and 32 per cent. IC Select director Roger Brown says that fiduciary managers are "making huge bets and they will either win or lose in the next 10 years".

But when schemes select fiduciary managers, are returns the most important thing on their mind? According to the Competition and Markets Authority (CMA), following its investigation into the investment consultant and fiduciary management market, there are a number of reasons for selecting a fiduciary manager, such as reducing risk, as well as managing funding levels.

Given that the CMA found that asset allocation advice is highly scheme specific, with advice tailored based on a number of factors, it is no surprise that returns vary. It does however, point out that returns should be compared to an appropriate benchmark, and the benchmark should be clearly stated.

However, PTL director Richard Butcher notes that when choosing a fiduciary manager it's "nothing to do with returns". Instead it's about structure, and choosing a fiduciary manager that meets the scheme's objectives. He adds that once you apply filters based on your objectives, then the population of fiduciary managers available is severely restricted down to two or three.

"Relative performance for each of them is relatively unimportant, how they approach achieving your funding objective is more important. I would far rather, if I set my funding objective at 2 per cent above Libor, that they consistently delivered 2 per cent above Libor, rather than three or one; I don't want them to underperform, I don't want them to outperform, I want them to perform exactly as I expect them to do," he explains.

The CMA's report on the fiduciary management market brought to light the opinion of many in the industry, that comparing managers is notoriously difficult. CEM Benchmarking principal John Simmonds explains that the difficulty for any fiduciary management firm when it comes to providing performance updates is that if you take any universe, within that universe there are going to be winners and losers.

"That story may change over time, but it is very challenging for any fiduciary manager to want to offer up to its clients a report that does not paint it in a positive way, and that's the fundamental problem in actually getting fiduciaries to self-regulate around this. Unless they are compelled to do it, they are not going to do."

He said of the firms that he has seen, there is no consistency of performance, there are some schemes where over a period of time, costs and have been low and returns have done well, but the same fiduciary manager for a different client, over the same time, has had higher costs and poorer performance.

With this in mind, it is no surprise that the CMA's proposals to increase competition in the investment consultants and fiduciary management market were welcomed. Schemes will have to run a competitive tender when selecting their first fiduciary manager, and the managers will have to provide clearer information on fees.

The CMA is also making recommendations for new guidance from The Pensions Regulator, which would provide trustees with more advice on how to choose and scrutinise providers. In fiduciary management, it would seem that return variations are to be expected, but there is a strong desire for greater clarity across the market.

£100,000 smaller than it might have been, based on a range of expected outcomes from provider defaults.

This too comes back to risk, with KMPG finding that the default funds with the lowest expected outcome have relatively cautious investment allocations in the early years. The report states that the funds fail to take on too much risk in the early years when members are young, with some strategies holding as little as 40 per cent in equities.

There will be some members that feel confident to opt out of the default fund, but this comes with its own risks. For those in master trusts the alternative options are usually presented much more clearly than contract-based schemes, where members are often presented with a long list of funds and little help.

For those that want to remain in the default, Bakas hits the note perfectly, stating they should have a "solid savings plan".

Written by Natalie Tuck