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DEFINED CONTRIBUTION: IT'S TIME FOR INVESTMENT TO DO MORE OF THE HEAVY LIFTING

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Generating better DC outcomes through improved investment governance and innovative investment thinking – a summary

"Adding one per cent per annum to long-run risk-adjusted returns really is the difference between retirement bliss and retirement penury."

The illiquid opportunity

Unlike defined benefit (DB), with its increasingly negative cash flow and de-risking focus, defined contribution (DC) has positive cash flow and a growth focus. However, most DC schemes, DC default funds in particular, still predominantly invest, via insurance platforms, in highly liquid asset classes. As a result, most are missing out on the many longer-term illiquid asset opportunities and the associated illiquidity and complexity risk premia that populate the asset portfolios and returns of most DB schemes. This could amount to forgoing a one per cent per annum increase in long-run risk-adjusted returns.

Illiquid real and alternative assets, such as real estate and social and economic infrastructure, are a heterogeneous group of assets that typically offer a markedly different risk-return profile and pattern of returns to that of public equity and credit markets, upon which many DC schemes overly rely. Real estate and infrastructure, in particular, offer diverse return drivers, long-term cash flows that are often implicitly or explicitly linked to inflation, and returns that are typically less sensitive than equity or credit returns to the macroeconomic environment, albeit sometimes with an element of political and regulatory risk.

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Overcoming impediments to investing in illiquids

The key impediments to DC schemes investing in illiquid assets are manifold but not insurmountable. This is certainly true for larger DC schemes, particularly master trusts, most of which have scope to consider an allocation to illiquid strategies of 5%-15% of assets.

These impediments will be overcome by regulatory change and guidance, not least to remove the real and perceived regulatory barriers to illiquid investment, to accelerate DC consolidation and to accommodate the increased charges and performance fees associated with illiquid assets within the charge cap. Changing the prevailing cost minimisation mindset applied to investment to one of maximising the net value added, and insurance platforms, through which most DC schemes invest, undertaking the necessary investment to cater for illiquid assets, are also prerequisites.

Better investment governance is the key to better returns

The 10/30/60 retirement rule suggests that better DC outcomes principally derive from enhancing long-run risk-adjusted returns. These, in turn, flow from improved investment governance and innovative thinking, rather than by placing undue reliance on raising DC contribution levels to punitive levels.

By advancing DC investment governance and innovative investment thinking to leading-edge DB standards, DC schemes would be better positioned to embrace those asset classes and investment techniques, including integrating Environmental, Social and Governance (ESG) factors into investment decision making, increasingly utilised by DB schemes. As suggested earlier, doing so could add as much as one per cent per annum to long-run risk-adjusted returns.

Of course, getting the asset mix and its ongoing dynamic management right really is the big investment decision and key to constructing a fit-for-purpose DC default fund. However, most DC default funds fail to diversify across multiple lowly correlated risky assets across multiple time periods. This typically leaves DC members wide open to periods of exceptional price and returns volatility and also periodically large capital draw downs.

Other considerations

DC consolidation

While larger DC schemes are likely to proliferate and reach critical mass, principally as a result of the larger master trusts taking an ever increasing slice of the UK DC market and through natural attrition, DC decision makers should be required to regularly consider whether or not scheme members’ interests would be best served by transferring them to another DC scheme, or tPR-authorised master trust.

Sustainability

Given that climate change poses significant risks to both the global economy and global financial stability, sudden sizeable return impacts are likely to dominate those portfolios that fail to build in sustainability themes. By tilting away from fossil fuel stocks towards higher weightings of companies active in energy efficiency, DC schemes can significantly reduce their exposure to energy transition risks without prospectively sacrificing financial returns. Indeed, emerging evidence suggests that the valuation premium paid for companies with strong sustainability performance has increased over time.

DC savings rates

There is scope to increase DC savings rates, especially by using simple behavioural interventions to address the behavioural impediments to long-term saving, just not to the extent that many suggest.

Conclusion

As DB benefits disappear and the state pension is paid ever later in life, so people will become increasingly dependent on their DC pension pots to secure their desired standard of living in retirement. Failing to move the DC investment governance and innovative investment dial sufficiently far forward, especially in the absence of a material increase in contributions, will risk a combination of enforced longer working lives and retirements that are increasingly endured and not enjoyed. Adding one per cent per annum to long-run risk-adjusted returns really is the difference between retirement bliss and retirement penury.

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