PENSIONS WATCH – ISSUE 11: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

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Securing value for money, or value for members, particularly from a scheme's asset managers, is central to achieving good retirement outcomes. With this in mind, we consider what constitutes value for money and whether it is being achieved.

What constitutes value for money?

Value for money is one of those terms most people understand but find hard to definitively measure and benchmark. According to the Oxford English Dictionary, value for money is "something that is well worth the money spent on it." In other words, the focus shouldn't only be on cost but also what is received in return – that is, the net value added, or detracted. Never is this truer than in the world of pensions, especially when it comes to a scheme's asset management. After all, low fund management fees and charges, in isolation, do not necessarily imply good value, as factors such as the manager's fund performance, the volatility of these returns, service levels and the quality of communications also impact member outcomes.

What constitutes value for money for pension scheme members?

Since 2015, both the Independent Governance Committees (IGCs) of DC contract-based pension schemes and the Trustees of trust-based DC schemes have been required by the Financial Conduct Authority (FCA) and the Pensions Regulator (TPR) respectively, to assess and annually report on the ongoing value for pension policyholders[1] and Value for Members (VFM).[2] Additionally, TPR, in recognising the significant impact the annual VFM assessment can have on helping to safeguard positive DC and DB member outcomes, also strongly recommends that DB scheme Trustees do similarly.[3]

Of course, these annual regulatory assessments go beyond assessing the value added by a scheme's asset managers. Indeed, as holistic exercises, IGCs and Trustees are required to evaluate and benchmark the quality and cost of all services received from all providers to a scheme, whether pertaining to scheme management and governance, administrative efficiency, investment governance or communications.[4] However, evaluating the ongoing value received from a scheme's asset managers is certainly one of the more impactful aspects of this crucially important exercise, given the extent to which fund performance net of fees and charges ultimately determines member outcomes.

Acknowledging this, since September 2019, the FCA has required asset managers to make rigorous and robust annual Assessments of Value (AoV). Comprising disclosures around seven assessment criteria, principally net fund performance against objectives, fees and charges and quality of service, AoVs are designed to better enable pension schemes, amongst other investors, to make informed value for money comparisons.[5] In order to further facilitate this process, the Pensions and Lifetime Savings Association (PLSA), via its Cost Transparency Initiative,[6] has created a set of templates and tools for pension schemes to receive standardised cost and charges

[1] FCA Handbook COBS 19.5.
[2] Guide to Value for Members. The Pensions Regulator. July 2016. The assessment of member-borne costs and charges must be stated within the annual Chair's statement for scheme members.
[3] See: 21st Century Trusteeship. 10. Value for Members. 2021.
[4] Additionally, the Department of Work and Pensions (DWP) has recently suggested that smaller (typically sub-£100m) DC schemes be required to conduct more in-depth VFM assessments than currently required and, on the basis of this, to more robustly consider the merits of scheme consolidation. See: Consultation outcome of Impact assessment: improving outcomes for members of DC pension schemes. DWP. 21 June 2021.
[5] The FCA's seven assessment criteria comprise: comparable market rates, costs, comparable services, performance, quality of service, economies of scale, share classes. For more detail on each, see: A Review of UK Fund Assessment of Value Reports (2019-20), CFA Society UK. January 2021. See the CTI 2020 Value Assessment Report at: https://www.columbiathreadneedle.co.uk/en/retl/value-assessment-report/
[6] https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative

information from their asset managers. However, after having recently conducted a review of 18 asset managers (a relatively small sample),[7] the FCA found that many of these managers had failed to provide sufficiently informative AoVs, address shortcomings in their reporting and give explanations when value for money wasn't being delivered.[8] Having made recommendations for improvement, the FCA will revisit these managers in 2022 to ensure material progress has been made.

Is value for money being delivered by asset managers?

In short, value for money is being delivered by some asset managers but by no means all. Indeed, this was the conclusion reached by the Financial Times (FT), in a recently published article, which considered a study into the value for money received by UK DB schemes – based on the performance, costs and transparency of 11,500 mandates of varying sizes managed by 420 asset managers across active and passive equities, fixed income and alternative investment strategies.[9] With an average annual fee paid for asset management of 0.65%, these fees ranged from 0.09% to 2.63% per annum, with sub-£100m schemes being subject to the greatest fee dispersion. Given the popularity of global equities mandates amongst DB schemes, another stand out statistic plucked from the study is the 0.36% difference in the fees charged by a first versus a fourth quartile active global equities asset manager, ranked on cost. For the average £109m active global equities mandate analysed, this equates to a fee difference of almost £400,000 per annum.

Of course, as already mentioned, costs considered in isolation tell us very little. What matters is whether the net of fees performance delivered justified the cost. Although only 15 of the 420 asset managers analysed in the study were described as elite, in as far as they delivered top quartile returns at first quartile fees with top notch transparency around each, what really stands out is the dichotomy between the average net fund performance of very small (sub-£100m) and very large (£10bn+) schemes, for broadly equivalent fees. Whereas the average 0.59% fee paid by the latter cohort resulted in average net fund performance of 2.4% per annum, the 0.6% average fee paid by the former was commensurate with a mere 0.1% average net annual performance. Moreover, the dispersion of net returns, both positive and negative, for sub-£100m schemes was considerably greater than for those with assets of £10bn+. Of course, while these results can largely be explained by a combination of the declining fees, the sophistication of investment strategy and the associated step up in investment governance that typically comes with scale,[10] 2.3% per annum compounded, even over only 10 years, represents more than a 25% difference in net value added.

Turning to assessing value for money within DC, two papers, one from Hymans Robertson[11] and the other from Dean Wetton Advisory (DWA)[12] are helpful, albeit they reach slightly different conclusions. By applying a retirement outcomes frame to master trust DC default funds, increasingly the dominant medium within DC, both studies assess the prospective net value added of each provider's principal default strategy by drawing on factors such as recent past returns, the volatility of these returns, the strategic and dynamic asset allocation policy adopted, expected future returns, charges and fees.

Using annualised three year master trust growth phase default fund performances and capital market assumptions applied to each of the providers' asset allocations, Hymans Robertson projects the likely (median) fund values to be generated by each provider's principal default fund in 30 years time, along with a projected good (25th percentile), bad (75th percentile) and very bad (95th percentile) outcome. Whereas the dispersion between the good outcomes and the probable is particularly high – the best good outcome is projected to be almost 70% higher than the worst, while the dispersion for the median outcomes is almost 40% – that for the bad and very bad outcomes is, reassuringly, low. However, in the consolidation phase, with values being predicted five years prior to retirement, and the pre-retirement phase, one year from retirement, the dispersion around outcomes within and between providers is even more elevated.[13] DWA adopts a similar approach using a proprietary tool to calculate the value added or subtracted over a certain period. For example, the study revealed that for "a typical 40-year-old, the top-ranking default [fund] created £4,203 of value in the five years to the end of the first quarter of this year compared to £1,280 for the [lowest ranking] default, a difference of £2,923." The report then goes on to say that, "As the age of the member increases, the difference in investment value created shrinks as the member edges closer to retirement age, with the average gap falling from £2,640 for a 40-year-old to £1,770 for a 60-year-old. This is likely as most pension schemes adopt a more conservative investment approach in the later stages of a member's pathway to retirement".[14]

Perhaps unsurprisingly, given the heterogeneity of the master trust universe, not least in the number of diverse return drivers each captures within their respective default fund portfolios, the differences in net value added can be considerable.

[7] Almost 1,500 FCA-authorised asset managers operate in the UK – the 38 largest representing 74% of UK assets under management. See: Investment management data – Annual Report 2019/20. FCA. 16 September 2020.
[8] See: https://www.fca.org.uk/news/statements/fund-managers-falling-short-assessing-value-their-funds. This review was conducted between July 2020 and May 2021. Separately, the CFA Society UK conducted an independent study of 145 UK investment firms, accounting for funds with £1.3 trillion assets under management, during 2019-2020. See: CFA Society UK. January 2021. op.cit.
[9] See: UK pension schemes waste billions on underperforming asset managers, study finds. Financial Times. Chris Flood. 2 July 2021. Please note that the underlying data supplied by ClearGlass, an independent data services provider, has yet to be published.
[10] See: Pensions Watch – issue 10 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-10/
[11] Master Trust Default Fund Performance Review. Hymans Robertson. November 2020.
[12] Revealed: The disparity in DC default value added. Dean Wetton. Professional Pensions. 7 July 2021.
[13] This study was covered in Pensions Watch – issue 10 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-10/
[14] These outcomes are based on a pensions saver 25 years from retirement, earning £25,000 per annum, with a starting pot of £1,000 and a monthly contribution of 8% of salary.

Why does this matter?

Accepting that investment returns are never guaranteed whereas costs are the one factor that can be controlled, the opportunity costs of solely focusing on charges rather than adopting a more holistic net value added mindset can be considerable. Indeed, prioritising the former over the latter, by not considering the potential value add and risk mitigating nature of more governance-intensive investment opportunities has, to some extent, compromised the economics of portfolio construction and long-run risk-adjusted returns of both DB and DC.

However, changing the prevailing cost minimisation mindset applied to a scheme's asset management to one of maximising the net value added remains a challenge. This is particularly true within the world of charge-capped auto-enrolled DC default funds. Although well intentioned, with the aim of ensuring that members receive value for money, the charge cap has instead seen a race to the bottom with very little spent on investment.[15] *Sadly, the result has, in many cases, been to stifle innovation and creative thinking to the likely detriment of member outcomes.*

That's not to say that genuine cost savings shouldn't be sought. Indeed, achieving genuine cost savings can translate into performance improvements for both DC and DB which can, in turn, take some of the pressure off contribution rates. However, where a value for money assessment reveals poor value to members, it is vitally important that trustees and IGCs identify the validity of the assessment and what steps can be taken to improve matters – for example retendering the mandate, simplifying it or seeking scale-related discounts, depending on the issue identified. Doing so should enhance member outcomes – sometimes considerably so.

[15] The charge cap of 0.75% per annum on the value of funds under management, is net of any administration and communications charges borne directly by DC members and excludes investment trading, or transactions, costs, stamp duty and the costs of maintaining real assets such as infrastructure and real estate.

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