

PENSIONS WATCH – ISSUE 13: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS



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According to the 2021 edition of the Pension Policy Institute's (PPI) *The DC Future Book*, more than 95% of members of trust-based Defined Contribution (DC) schemes (including master trusts) are invested in their scheme's default fund.¹ Although many DC default funds and default pathways, which mechanistically de-risk the default fund as the member approaches retirement, are assumed to meet the needs of most of the UK's DC members, a considerable number do not. Therefore, we look at what actions could be implemented if DC savers are not to be set up for failure by poorly designed defaults.

The power of the default

Behavioural science has long recognised the power of the default option in many aspects of daily life. And for good reason. Defaults are often perceived, by the intended audience, as being the recommended option and regularly overcome choice overload, when people are faced with an inordinate number of choices and simply *can't* (for lack of knowledge, information and/or time constraints) or *won't* (because of inertia) make an active decision.² Moreover, the omnipotence of inertia means that take up (and persistence) rates of the default typically increase dramatically when, having been (passively) *opted into* the default,³ people must proactively *opt out* to cease participation.⁴ All of this is, of course, particularly pertinent to the world of Defined Contribution (DC) defaults.

The DC default fund

The default fund is the fund, almost always *passively*, selected by most DC savers (choice overload and inertia at work again), and that which is typically held over the duration of the DC accumulation journey (inertia yet again). Therefore, a DC scheme's default fund, and the associated default de-risking glidepath to retirement, needs to be capable of performing a considerable amount of intelligent heavy lifting if, in the continued absence of a material increase in DC contribution rates and members' changed circumstances over the course of the accumulation period, at least a modest, ideally a comfortable, retirement outcome is to be generated. So what are the key facets of a fit-for purpose default?

DC defaults – the key facets

Firstly, post freedom and choice, with an ever decreasing focus on annuitisation *at* retirement and the continued popularity of income drawdown, as the favoured means by which to access pension savings,⁵ the DC default fund and the associated glidepath should target drawdown, not annuitisation. Most defaults do but some still don't. That's not to say annuities don't have a place *in* retirement – they do – albeit in the later phase of the *in* retirement journey when longevity insurance is provided by the annuity's guaranteed lifetime income and age-related cognitive impediments start to impact decision making.⁶

¹ The DC Future Book: Unravelling Workplace Pensions. 7th edition. September 2021. The Pensions Policy Institute, in association with Columbia Threadneedle Investments. p.41. For master trusts, the average participation rate in the default was 90%. See p.19.

² The power of inertia, or status quo bias – that is, doing nothing or maintaining one's current or previous decision, is well documented. The first empirical study of this bias was published in 1988. See: William Samuelson and Richard Zeckhauser, "Status Quo Bias in Decision Making" *Journal of Risk and Uncertainty*, Volume 1, pp.7-59 (1988).

³ Rather than being required to make an active decision to opt in.

⁴ A textbook example of the power of the default and the prevalence of inertia is the extent to which smartphone users stick with their smartphone's default settings (ringtone aside), despite the ease with which one can change these settings. The *presumed consent model* of opting people into organ donation, unless they proactively opt out, is another example. In a pensions context, the power of inertia is exemplified by the low opt-out rates associated with auto enrolling (opting-in) eligible employees to an occupational pension scheme. These, so-called *nudges*, which typically harness the inertia of the disengaged, are well documented. Nudges are designed to subtly but predictably influence, rather than coerce, people's behaviour so as to make them, and typically society, better off, without harming or disadvantaging them or others in the process. See: Richard H. Thaler and Cass R. Sunstein. *Nudge – The Final Edition*. Allen Lane (2021). pp.3-8.

⁵ PPI (September 2021) op.cit. pp.24-27.

⁶ See: Generating retirement outcomes to be enjoyed and not endured. Chris Wagstaff. Columbia Threadneedle Investments. February 2018. p.42.

Secondly, the typical composition of most DC default funds is one-size-fits-all, positioned to meet the (perceived) needs⁷ of as many of an often broadly-based scheme membership as possible. While, in one sense, this is the default fund's greatest strength, it can also be its greatest weakness in that it fails to distinguish between members' varying risk preferences and, to a degree, investment time horizons. Indeed, although not binary, there are those who have a high tolerance for volatility and an investment horizon long enough to withstand periodic asset market drawdowns and those who don't. The former typically seek to tap into the equity risk premium, via pure global equity or equity-rich portfolios. By contrast, the latter, usually with a shorter investment time horizon, seek a smoother returns experience, increasingly via a dynamically managed multi asset fund mix, which taps into a multitude of diverse return drivers and risk premia, albeit typically with a sizeable equity and fixed income component as the mainstay.⁸ Of course, all risk appetites can be catered for within an appropriately calibrated default glidepath but very few are. In fact, most default funds in the growth phase either assume one or the other fund structure until the default glidepath begins its gradual mechanistic one-size-fits-all derisking from a pre-determined point in the run up to the scheme's normal, or the member's chosen, retirement age.

So what needs fixing?

Three points stem from this. Firstly, an increasing number of DC default funds now adopt a multi asset fund mix, rather than a pure equity focus, a move which has been welcomed given that, for many DC schemes, the former better fits the risk preferences of the majority of members. Moreover, most DC scheme self select fund ranges include one or a number of global equity funds for those members with a tolerance for volatility. However, unless included within a scaled down core fund range, this does, of course, often require the member to overcome choice overload and make an active decision. That said, even if the member gets past these cognitive barriers, most then fail to revisit their fund choice until the end of the accumulation phase (inertia again), by which time their fund choice is likely to have been inappropriate for some time. To address these, long known, shortcomings, some schemes offer dynamically managed adventurous, balanced and cautious defaults in the accumulation phase, each with their own de-risking glidepaths. Others use target date funds.⁹ However, only once a more analytical approach to members' risk tolerances is adopted, will these somewhat approximate approaches to default fund risk budgeting be refined to more closely meet member's individual needs.

Secondly, despite most DC schemes being characterised by positive cash flow and a long investment time horizon, almost all DC default funds still predominantly invest, via insurance platforms, in highly liquid asset classes. As a result, most are missing out on the many longer-term less liquid, or less easily realisable, asset opportunities that populate the asset portfolios and returns of most defined benefit (DB) schemes – many of which have shorter investment time horizons than their DC counterparts. Principal among the diverse risk premia and return drivers that would potentially enhance both the growth and defensive qualities of the multi asset mix is the illiquidity premium associated with those heterogeneous less liquid real, private markets and alternative asset classes, which typically offer a markedly different risk-return profile and pattern of returns to that of public equity and credit markets, upon which many DC default funds overly rely.¹⁰

Moreover, the key impediments to DC schemes investing in illiquid assets, both real and imagined, while manifold, are not insurmountable.¹¹ Indeed, a recently published report by The *Productive Finance Working Group* (TPFWG)¹² encourages DC scheme trustees, trade bodies and consultants to consider how increasing investment in less liquid assets could generate greater long-term value for their members¹³ and to find ways to invest in less liquid assets as part of a diversified portfolio. While the report cites the role that, soon to be launched, Long-Term Asset Funds (LTAFs) should play in this respect,¹⁴ asset managers also have a crucial role in better communicating to DC schemes how the inclusion of illiquid assets in diversified portfolios improve member outcomes. The TPFWG also recognises the risk to schemes of focusing on the cost, rather than the potential value add, of illiquid assets and, unsurprisingly, adds to calls for consolidation in the DC market so that schemes have the necessary scale and investment governance to make a meaningful allocation to these heterogeneous assets.¹⁵ Suffice to say, NEST, the £20bn, government-backed DC master trust, continues to lead the way in allocating to illiquid assets and, in so doing, has facilitated the ease with which others can tread the same path, not least by challenging some of the more punitive illiquid asset charging structures.¹⁶

⁷ Rarely are the needs of a scheme's DC membership regularly surveyed.

⁸ While there are manifold approaches to managing multi-asset fund mixes, whose return objectives are typically expressed as an 'inflation plus X%' or a 'cash plus Y%' absolute return target, only the very best achieve a combination of robust real returns with low levels of return volatility and susceptibility to equity market drawdowns. Crucially, a successful multi-asset approach demands genuinely skilful dynamic asset allocation and truly active management. Of course, making the right asset allocation calls in selecting and dynamically altering the asset mix is by far the biggest determinant of success in adopting a multi-asset approach, with this largely being incumbent on real equity returns and those of other asset classes in the multi-asset mix being positive and greater than cash returns, with the returns of these other asset classes being lowly correlated with equities and relatively volatile to dampen equity volatility. See: Wagstaff (February 2018), op.cit. pp.32-33.

⁹ The underlying asset allocation of target date funds evolves as the target date, which should align with the member's chosen retirement date, approaches.

¹⁰ Failing to diversify across multiple lowly correlated risk assets, with a multitude of diverse return drivers and risk premia, across multiple time periods can leave default funds wide open to investment sequencing risk when markets turn tail.

¹¹ These impediments principally comprise increased due diligence, accommodating higher management and performance fees within the 0.75% charge cap, high minimum investment sizes and the inability of most insurance platforms to offer and administer illiquid assets. For an explanation of each and how they might be overcome, see: It's time for investment to do more of the heavy lifting. Chris Wagstaff. Columbia Threadneedle Investments. June 2019, pp.18-23. Reinforcing these points, the annual IPE infrastructure survey of global institutional investors reveals that the top three reasons for not investing in infrastructure were: illiquidity, sub-scale and inability to undertake due diligence. See: Infrastructure investor survey 2021. Richard Lowe. IPE. September/October 2021 edition.

¹² A roadmap for increasing productive finance investment. The Productive Finance Working Group. September 2021. The TPFWG is co-chaired by the Governor of the Bank of England, the Chief Executive of the FCA, and the Economic Secretary to Treasury. See: <https://www.bankofengland.co.uk/report/2021/a-roadmap-for-increasing-productive-finance-investment>

¹³ Rona Train, DC Partner at consultancy Hymans Robertson, notes in a recent paper that, "All DC fiduciaries should ask themselves: 1. Will the introduction of illiquid assets give me something I can't access in liquid markets? 2. Will they give me better long-term risk-adjusted returns for my members? 3. Can I access them in a way that does not introduce unnecessary risk or complexity to the operation of my overall portfolio? Answering yes to each of these questions is vital before progressing the discussions any further." See: PPI (September 2021), op.cit. Illiquid assets – are they the answer in DC? pp.54-55.

¹⁴ Long-Term Asset Funds (LTAFs), due to be launched in late-2021, with DC schemes in mind, will be open-ended funds, authorised by the Financial Conduct Authority (FCA), that invest in long-term, illiquid assets. While not daily dealt, units in the fund will be able to be sold at set intervals depending on the investment strategy adopted by the investment manager and the availability of cash to meet redemption requests.

¹⁵ The TPFWG also notes that, "As DC schemes consolidate and the industry builds scale, the DWP should:(i) continue to monitor the overall impact of the charge cap; (ii) continue to consider how to reconcile performance remuneration (that may be associated with greater overall value for members) and the charge cap rules." TPFWG (September 2021), op.cit.p.8.

¹⁶ In seeking to allocate more than £1bn into private equity, NEST is confident that it will successfully challenge the traditional private equity management fee plus performance fee model, declaring it won't pay any performance fees or carried interest (the share of any profits that the general partners of private equity funds receive if the fund's returns meet a certain threshold). See: NEST challenges private equity fees. Sarah Rundell. Top1000Funds. 30 September 2021.

Thirdly, default glidepaths fail to recognise that, for many people, retirement is not a one-off event with a defined destination point. Rather, it is a gradual process. Therefore, as was concluded earlier, more detailed member data gathering is required to ensure that members are appropriately invested throughout the accumulation journey, especially as they approach the start of their *at* retirement journey, which will build over time.

Walking the ESG and climate change risk management walk

Finally, and by no means least, there's the question of how DC default funds can most effectively meet the Environmental, Social and Governance (ESG) and climate change risk management (a big part of the E) responsibilities owed to members, who ultimately seek to retire in a world worth living in.¹⁷ However, while there is no one-size-fits-all approach to integrating ESG factors within an investment process, with techniques ranging from negative screening, or exclusion, to more sophisticated engagement and social impact approaches, there is a growing dichotomy between that adopted by actively managed ESG defaults and their increasingly prevalent index-tilted counterparts. Indeed, while the former tend to focus more on engagement to effect positive change, the latter, with their limited exclusions and tilts away from potentially unrewarded ESG and climate risk factors, ultimately fail to move the ESG engagement and ESG risk factor management agenda further forward. Moreover, the challenge for traditional *non-tilted* index funds is having the necessary bandwidth to meaningfully engage on ESG and climate issues with the, often many thousands of, constituent companies within their chosen index. Some do but many don't.

Ultimately, ESG analytics should be an integral part of a DC default fund's risk management, as failure to build sustainability themes into portfolios will inevitably make defaults more susceptible to sudden and potentially sizeable return impacts. This again is where many illiquid assets step in, given the strong ESG credentials of social housing, renewable energy and social infrastructure. In addition, there are increasingly calls from all directions for DC defaults to align with the Paris Agreement, governments' climate targets and for guidance on setting net zero emissions targets.

Why does this matter?

The well publicised reluctance by DC savers to materially increase contribution rates means that if modest to comfortable retirement outcomes are to become the norm, and sub-par outcomes are to be avoided, the composition of, and glidepaths adopted by, DC defaults will become increasingly important. However, as has been identified, there are a number of impediments to be overcome if the necessary change is to make this a reality.

Principal among these impediments are that few DC schemes have the requisite scale and investment governance bandwidth to capture a wider range of long-run rewarded risk premia, by embracing those less liquid asset classes increasingly utilised by DB schemes. This process will, of course, be greatly assisted by, amongst other things, much needed DC scheme consolidation, the launch of LTAFs and changing the prevailing cost minimisation mindset applied by many schemes to investment to one of maximising net value added. The latter, in particular, remains a challenge within the world of charge-capped auto-enrolled DC default funds as, 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. Sadly, the result has, in many cases, been to stifle innovation and creative thinking to the likely detriment of member outcomes. However, if implemented, these measures could collectively not only add as much as one per cent per annum to long-run risk-adjusted returns¹⁸ but also do so more sustainably, given the strong ESG credentials of many illiquid asset classes. Moreover, the very distinct and varied pattern of returns from illiquids could also further improve the defensive qualities of DC defaults when liquid asset markets turn tail.¹⁹ For many people, this could be the difference between retirement bliss and retirement penury.

There also needs to be much closer attention paid to the risk budgeting of defaults over the accumulation journey and a much wider recognition that retirement is, for many people, no longer a one-off event but a phased process. Doing so would greatly enhance outcomes.

¹⁷ See: Pensions Watch – edition 1 (November 2020): <https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-november-2020/> and edition 7 (April 2021): <https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-7/>

¹⁸ Based on Columbia Threadneedle's capital market assumptions and calculated using a multi-factor capital asset pricing model (CAPM). The exposures of each asset to the factors are estimated using a historical data set which covers multiple financial market regimes. See: Planning for the long-term with capital market assumptions. Stuart Jarvis, Joshua Kutin, Lorenzo Garcia and Kavita Tolia. Columbia Threadneedle Investments. March 2021. Please note that returns are not guaranteed, as determining the prospective illiquidity premium is not an exact science, in the same way that calculating those other risk premia which prospectively contribute to an asset's return are typically estimates, albeit calculated using well established financial economics methodologies.

¹⁹ Columbia Threadneedle Investments (June 2019). op.cit. p.6.

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