

Innovating within the charge cap

Volatility in the stock market and value for money pressures all add up to considerable challenges for today's investment managers – but those with innovative approaches are well placed to meet savers' needs

As we all know, past performance is no guide to future returns. That well-worn warning is particularly pertinent today. Emerging-market equities and commodities aside, most asset classes have delivered strong positive returns in recent years. Now the good times seem to be coming to an end. Concerns are growing about the economic slowdown in China, the slump in commodity prices and the divergence in monetary policy in the developed world. So far this year, asset markets have been volatile.

This suggests that the substantial market returns that many investors have enjoyed over the past few years are unlikely to continue. Many analysts expect most asset classes to produce below-average returns in the next few years – a scenario that poses considerable challenges for defined contribution (DC) schemes.

The investment managers employed by DC schemes will have to innovate to deliver attractive returns. But they will also need to keep to a tight budget. The regulations that came into place last April impose a charge cap of 0.75% of assets under management. And the value for money regulations that come into force in June will add pressure on trustees.

For trustees, then, the overriding imperative is to achieve demonstrable value for the scheme's members. There are two considerations. First, could a given outcome be achieved at a lower cost to members? And, second, could a better outcome be achieved for members for a higher cost?

At AB, we take both of these

considerations into account. We are focusing on adapting our asset allocation to include alternative sources of returns that we can access in a cost-efficient manner.

We aim to do this by bridging the gap between traditional, low-cost passive components and more expensive, concentrated active components, which can offer superior outcomes. We are looking to achieve this balance in three key areas.

First, we are targeting specific risk factors in equities. We are doing this by moving away from a conventional market-cap-weighted approach and embracing a dynamic, factor-based approach. A passive market-cap approach involves weighting a portfolio's equity holdings by the size of their market capitalisation. This compels the portfolio to hold more of companies that have performed well and are thus less likely to offer attractive value.

In contrast, a focus on specific factors, such as value or quality, enables the portfolio to focus on those stocks that are poised to perform well in future, rather than those that have done well in the past.

Second, we are seeking intelligent ways of accessing broader fixed-income strategies. For example, we are looking at the ways in which we might include emerging-market debt and high-yield bonds in our portfolios.

These are asset classes that look attractive on a valuation basis. We are well aware, however, of the need to be highly selective in these asset classes, given the risks that they entail.

Third, we are exploring alternative asset classes such as private equity.

The key here is liquidity – we have to be able to move in and out of these assets to meet members' requirements and as market conditions dictate. Private equity, however, is necessarily illiquid – at least for those who invest in it directly. We are therefore looking at liquid investment vehicles that can provide our portfolios with access to private equity.

By combining these innovative approaches, we believe that we can offer DC scheme trustees an attractive investment proposition.

The charge cap has brought a renewed focus on the value that investment managers offer to DC scheme members. Innovative investment managers should welcome this. Rather than resting on past performance, they can offer dynamic approaches focused on the future.

“The overriding imperative is to achieve demonstrable value for the scheme's members”

Karen Watkin
Portfolio Manager,
Multi-Asset
Solutions

