What is 'value for money'?

New regulation will mean trustees and IGCS must demonstrate they provide 'value for money'. **David Hutchins** of AB (formerly AllianceBernstein) explains how this can be assessed

This year sees the introduction of new regulations that require trustees and investment governance committees (IGCs) to give 'value for money' statements on their defined contribution (DC) schemes.

Of course, trustees have always had the duty to act in the best interest of members but these new regulations bring extra clarity.

In terms of investment, the default pension scheme – covering in the region of 80% of scheme members in the UK – is the key focus of 'value for money'. Within this, there are a couple of central issues for trustees to deal with.

One challenge is for trustees to quantify the correct things. Costs are significant in the 'value for money' calculation, and fund managers have to disclose these consistently as part of MIFID 2 rules. But detailing the cost of managing the fund components in a scheme is the easy part. For lifestyle strategies, costs do not just boil down to fund management alone as they are also incurred by the fund-switching mechanism, notably at the de-risking stage. MIFID 2 rules do not address this, even though it is an important cost incurred by members. To publish true 'value for money' statements, the cost of switching needs to be measured. Taking the example of a passive, low-cost managed lifestyle strategy, the transaction switching costs could be more significant for members than the annual management charge for the funds.

However, for target date funds (TDFs) all the transition costs (both between asset classes and between managers) are covered by the fund. Therefore, members are clearer about value for money.

The other challenge facing trustees is a follow on from the measuring of transaction costs – accurate performance measurement. It is important for traditional lifestyle strategies to show a fair performance comparison by including the transaction costs for switching between components. Fund administrators – as opposed to fund managers – need to measure these costs (and this is not normally the case). In addition, because switching costs are different for each member in a lifestyle strategy, the overall bearing on fund-level performance is a challenge to measure.

Do cost and value equate?

How should value for money for members be assessed by trustees and IGCs? Partly, this analysis comes down to cost – that is the price paid for the bundle of services in a member's scheme. But there are other important considerations as it is the financial return delivered by the investments chosen by the fund manager that has the biggest influence on a member's outcome. Therefore, being able to maximise the manager's investment budget is crucial to the provision of value for money.

At the heart of things, both trustees and IGCs have to understand whether enough is being spent on the investments and if that spend is producing the desired results. We think that most pension trustees are not allocating enough to their investment budget, and are thus not producing enough diversification or risk management. We find it an interesting anomaly that there is a higher amount spent on investment budgets per member in defined benefit schemes than in DC schemes.

Trustees should consider the following issues:

- What proportion of the budget is for investment and how is this then divided?
- Are members getting a good return on their pension investments?
- How do costs compare on a like-for-like basis?
- How often should they search the market for better (value for money) alternatives?
- Should their focus be keeping risk to a minimum or getting the best possible outcome for members?

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Cheapest outcome versus best outcome

If the trustees' task is to produce 'cost' statements, then they need to focus on finding the cheapest solution for members. However, when producing a statement on 'value for money', they have to be looking at achieving better solutions.

Finally, if statements are made more transparent and more understandable, we think members should be able to judge for themselves if they are getting value for money from their scheme. And that this would be a better outcome.

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