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Innovation and necessity

Innovation and evolution are often driven by necessity. Take penicillin, for example. The need to treat allied troops in the Second World War led to its mass production and distribution. Not only were millions of lives saved back then, but thanks to its constant evolution as an antibiotic, we take it for granted that more and more lives have been saved since.

Innovation has also played a huge role in the development of the investment and pensions industry. One example is the defined contribution (DC) default strategy. This industry development has been propelled by necessity—the provision of default strategies to meet the needs of scheme members, which have evolved as working patterns have changed and longevity has increased.

Of course, innovation has to start somewhere—with an invention. While the pioneering lifestyling strategy ensures that the risk profile of the fund corresponds with the risk of the member depending upon age, de-risking is undertaken at the individual level. The consequence is stark: it is complex to change and laborious to administer.

While we have been critical of lifestyling as a solution for today's DC scheme member, this invention triggered further innovation, the first of these being blending. Here, changes in strategy are made simpler to execute by blending components in the default strategy into a single fund. Again, there are disadvantages, as governance is complex and generally applies only to the growth asset element of portfolios, and not the important de-risking phase.

The next evolution of DC default strategies was the diversified growth fund (DGF). Granted, DGFs enabled asset allocation to be more dynamically managed and sophisticated, but they were expensive. In addition, the fund's objectives were not aligned with members' needs and didn't allow for open architecture. What's more, these funds require the

DGF manager to be a master of all areas of investment.

Lastly, target date funds (TDFs) are a best-of-breed default strategy. TDFs have only recently gained significant traction in the UK, but have been around in the US for some time now. Their acceptance in the UK market was aided when they became the government's strategy of choice for NEST (National Employment Savings Trust). TDFs not only overcome all the weaknesses of their predecessors above, but they combine all the benefits.

They are built using age-appropriate DGFs. They are age-based multi-asset funds designed to dynamically manage investment risk, as members move closer to retirement. Members typically invest in a fund with the two–three year retirement window that is the closest to their approximate retirement age. The fund then uses a mix of sub-funds, using open architecture, to meet its investment objectives.

There are some key underpinning reasons why we think TDFs are the best solution currently available for DC default strategies. Firstly, unlike lifestyle strategies which are managed to a fixed end date, TDFs are actively managed to cope with changing economic conditions. Thus, they provide investors with increased sophistication. TDFs also offer greater flexibility by providing access to open architecture and a much wider investment fund choice. And because TDFs only ask members to choose an estimated two–three year window, it is easy for them to switch to a different fund if circumstances change.

Finally, TDFs are typically more agile. Whereas in a lifestyle strategy it can take months to alter asset allocation because of the permissions required, with TDFs changes can be executed in hours. For example, after our team discussed the impact of the changes following the chancellor's Budget announcement on annuities, we adjusted the allocations of our TDFs and were able to execute the change in a few hours—at no cost to our clients or scheme members.

So, just as antibiotics have needed to constantly develop to remain effective in a changing world, the pensions industry has had to constantly evolve too. We are now at the point at which good TDF providers are able to amend strategies to reflect the new world with both speed and efficiency, and this has led us to what we believe is the best solution to an investors' need for a future-proofed vehicle for pension fund savings.

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