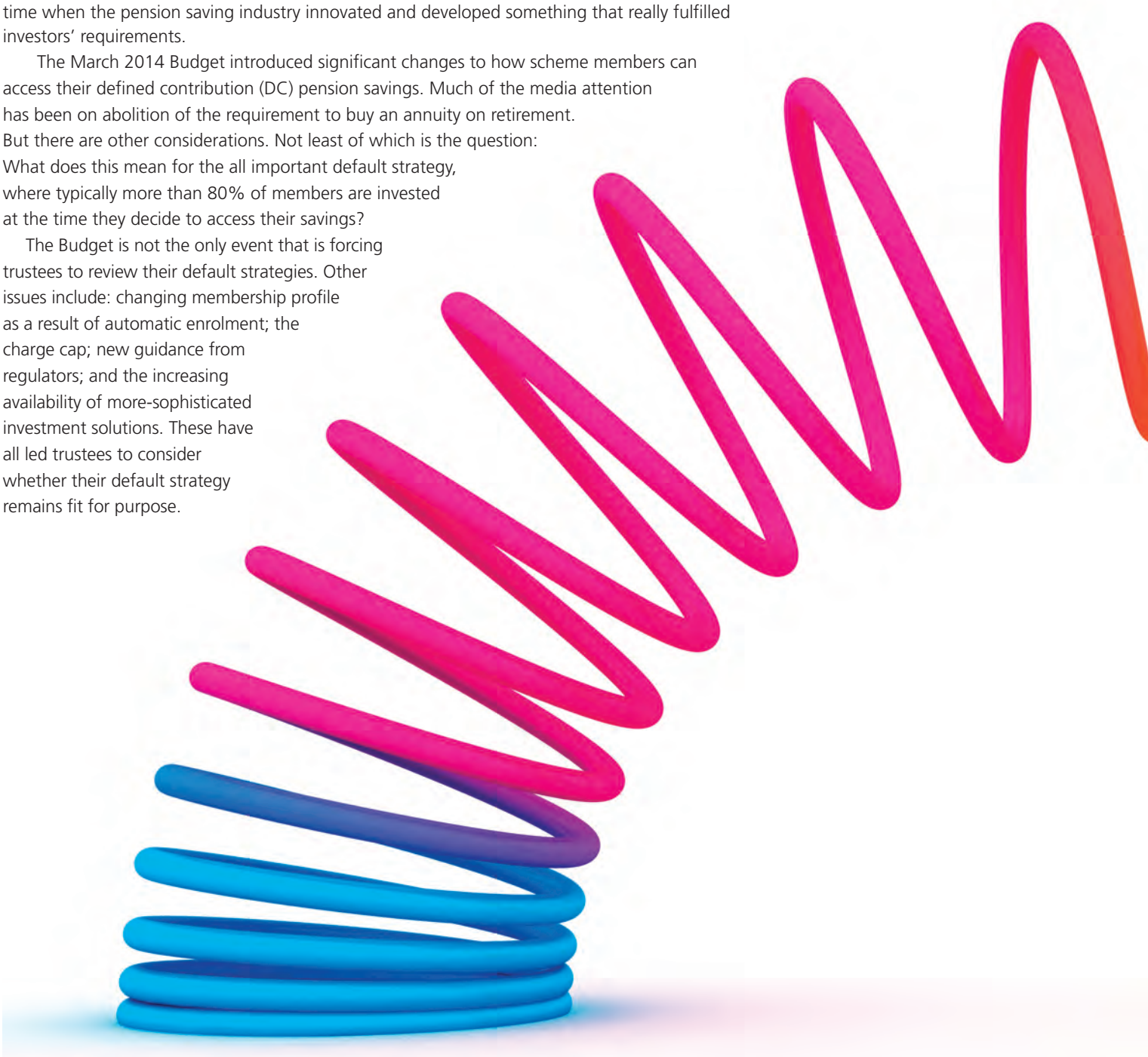
What does the new default look like?

Some of the concepts used in futuristic books and movies seem beyond the realms of possibility when they were launched. Think back to Star Trek and William Shatner's character James T Kirk using his 'communicator' to talk to his mothership – a device that was yet to be invented but that bears many of the characteristics of a modern-day smartphone. Perhaps when investors of the 2030s and 2040s look back at our era, they'll think of it as a time when the pension saving industry innovated and developed something that really fulfilled investors' requirements.

The March 2014 Budget introduced significant changes to how scheme members can access their defined contribution (DC) pension savings. Much of the media attention has been on abolition of the requirement to buy an annuity on retirement. But there are other considerations. Not least of which is the question: What does this mean for the all important default strategy, where typically more than 80% of members are invested at the time they decide to access their savings?

The Budget is not the only event that is forcing trustees to review their default strategies. Other issues include: changing membership profile as a result of automatic enrolment; the charge cap; new guidance from regulators; and the increasing availability of more-sophisticated investment solutions. These have all led trustees to consider whether their default strategy remains fit for purpose.



Driving the default strategy

Fundamentally, two themes are tending to dominate the discussion of how a future default strategy should be provided. The first is how it is governed in a manner aligned with the member's best long-term interests. This is vital as members are not involved; it is critical that those making investment decisions on their behalf are overseen by an independent and competent body. The second is how the default is delivered to ensure it is kept up-to-date in-line with evolving regulation, markets and member behaviours in a timely and efficient manner.

Ultimately if these two features are present in a default strategy then the ultimate goal of delivering good members outcomes and value for money should be achieved.

Fund of the future

We believe that flexible target date funds (TDFs) have demonstrated conclusively that they are able to deliver the default strategy of the future. TDFs are age-based multi-asset funds, where the investment objectives and strategies are decided by expertly advised trustees, and the investment decisions made by an independent fund manager.

How do TDFs achieve their objectives? They create a clear differentiation between the trustees, who set the investment objectives and their advisers, and investment managers, who make the investment decisions.

Indeed flexible TDFs are, in our view, the ultimate combination of all the best market thinking in a simple, easy to use and low-cost package: including lifestyling, multi-asset investing, dynamic risk management, open architecture, fiduciary management and white-labelling.

So if the future is flexible TDFs, what should their investment objectives be? And what investment strategy should they pursue? ▸

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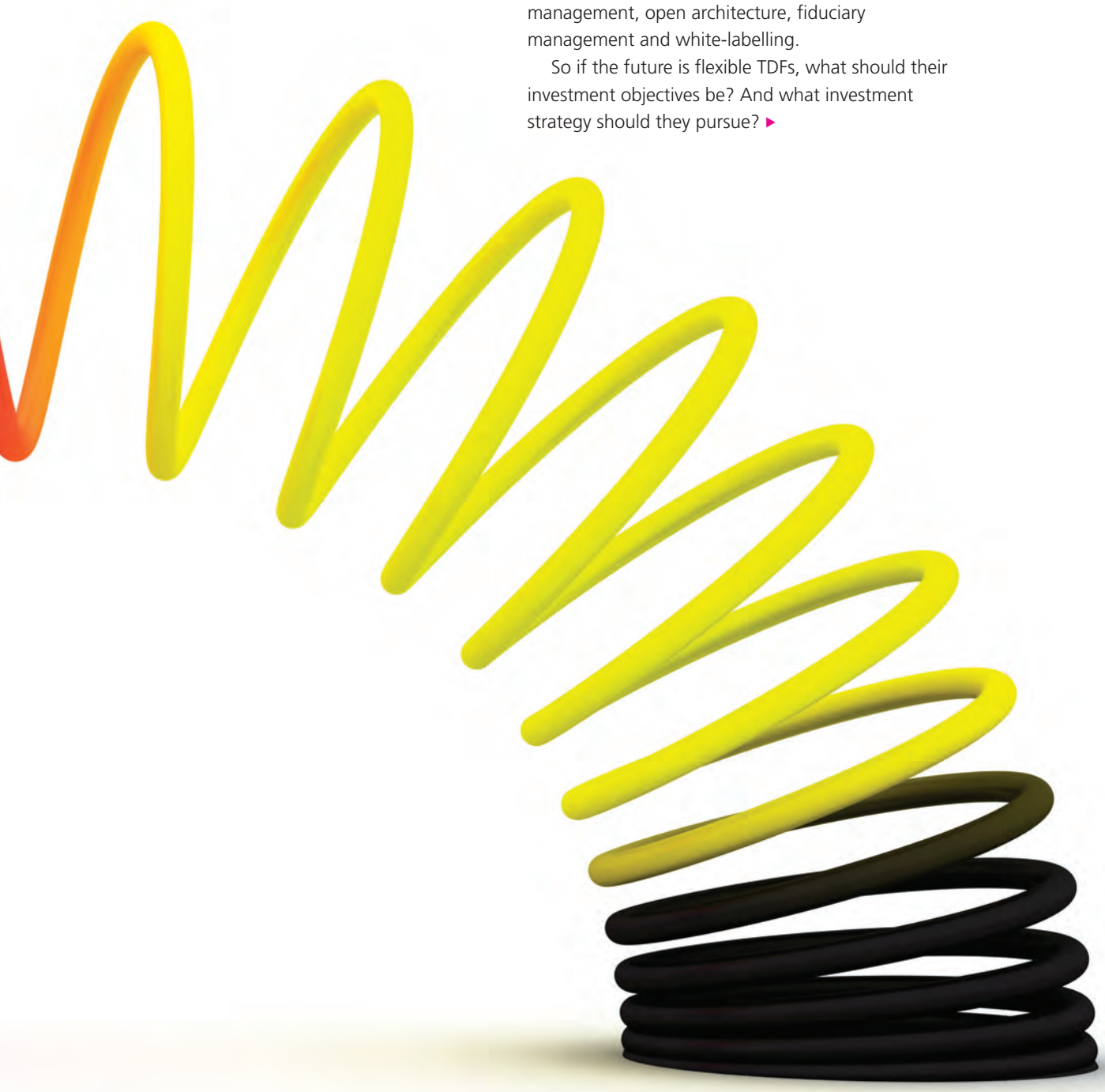

Don't aim high – aim straight

In respect of investment objectives, it is important to work closely with each scheme's trustees and their advisers to ensure that an appropriate objective is set for their membership. For example, in some cases the DC scheme is set up to be a top-up to an existing defined benefit scheme; therefore, a different objective is necessary. In another example, the employees may have a strong ethical belief and so this is reflected in the scheme's investment objective. Despite this, there are many similarities between schemes.

Our latest research with individuals from across a broad spectrum is that, as a group, they expect that the default strategy will be managed to a flexible outcome, both about when and how they come to access their savings. Indeed, what they do not want is to be sent down a precise route to cash or annuity or income drawdown at a definite age. Therefore, agreeing objectives for a client's default strategy, which can be typically captured in terms of an age-based risk-capacity glidepath and target outcome objective, need to reflect this.

Against this background, it is important to ensure that de-risking is gradual over time: in the years that members are able to start accessing their savings, portfolio managers must manage the fund appropriately to allow for the range of options available to members. There is little demand from either members or trustees for default strategies targeting very precise outcomes at a precise age. Neither do members or trustees want to use heroic assumptions based on member data that provides a far-from-full view of the individuals' circumstances: they don't want to aim too high, but instead want realistic and achievable objectives.

Balancing freedom and oversight is the key to investment success

As far as investments are concerned, it is critical that the manager of the default strategy, as opposed to the trustees who provide the objective setting and independent oversight remote from the manager, has enough freedom to achieve the best possible outcomes for members. This will include having access to a broad range of asset classes to not only seek effective diversification, but to achieve sufficient growth in what is likely to be a low growth global economy.

But beyond this, with periods of market turbulence likely to increasingly dominate the market environment, dynamic risk management is critical to ensure the objectives of the default strategy are met. With systematic approaches likely to be found out by the market, any such management will need to have careful fundamental oversight to avoid the potential disasters awaiting purely formulaic approaches.

Finally, we believe that members will increasingly want to access similar strategies not only for their pension savings but also for their personal savings – both before and after retirement, and most probably within an ISA. We think the default strategy of the future will be governed and implemented in a way that provides a level of transparency that such markets demand and that traditional default approaches cannot meet. Alongside this, there will be a level of investment sophistication and transparency that ensure value for money becomes the ultimate defining feature of a default strategy, and not just cost.