The science behind defined contribution redesign

Seismic changes to the DC landscape mean providers must redesign products for savers unsure of what they want

Tom Dines

The introduction of freedom and choice and the charge cap this year marked two profound changes to the defined contribution marketplace, affecting both what DC investment products will be expected to deliver and the limits within which they have to deliver them.

The changes mean scheme members now have hugely increased flexibility as to how they access their cash at retirement, doing away with the effective requirement to buy an annuity for all but the most wealthy.

Product design in uncertain times

Designing products for the DC market is now more complex. Members will not necessarily opt for an annuity and a lump sum in the same volumes they did previously, while the growth in drawdown and other strategies ends the previous view of retirement as a fixed date in time, as people gradually withdraw bits of their pension pot over many years.

Annabel Duncan, associate at JPMorgan Asset Management, says: "The single biggest thing at the moment is freedom and choice and what that means for investment design.

"We see clients and consultants thinking about glidepaths, what they should look like, whether you should have multiple glidepaths."

Simon Chinnery, head of UK DC at the asset manager, says this has meant "a lot of conversations are moving from derisking to to-and-through [products], and where should people land in retirement".

Perhaps unsurprisingly, this means members are in many cases unsure about what they will want to do when they retire.

This is forcing providers to focus on flexibility while the changes bed in and members become accustomed to their choices, while at the same time collecting data on member choices to inform developing products.

Brian McCauley, client director at fiduciary manager SEI, says: "We're getting a lot more detail to do the member analysis, then [clients] ask us to look at those members within 10 years of retirement."

However, Alastair Byrne, senior DC strategist at investment adviser State Street Global Advisers, says members find it very hard to pick a retirement date or course of action in advance.

He says: "If you speak to people in their fifties and ask how they plan to take and use their assets they aren't sure because there are so many unknowns... People want to keep their options open."

The gradual shift from defined benefit to DC means many of those accessing their pension pots today have relatively small amounts of money and are opting to take it out as cash.

Recent data from the Financial Conduct Authority showed uncrystallised funds pension lump sums, otherwise known by the clunky initialism UFPLS, have been the most common choice among savers since the introduction of the freedoms.

Emma Douglas, head of DC solutions at provider Legal & General Investment Management, says it is a very "vibrant" time for the industry. "We're getting a lot more attention than we used to around what is the right strategy and how do you ensure value for money," she says.

Douglas adds that the focus is starting to move away from cost. She says: "The real challenge is to justify where you have active management. Do you blend it with passive or is it a strategy specifically designed for DC?"

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Charge cap challenges

Despite this, many in the industry mention the challenges presented by the inevitable focus on cost that the 0.75 per cent charge cap brings, especially when it came to products incorporating active management of investments.

Hugh Skinner, head of UK DC investment at provider Fidelity Worldwide Investment, says the cap created particular difficulty for diversified growth funds, which were beginning to emerge as a favourite asset class for the growth phase.

He says: "Where these fund products have begun to face challenges is by the nature of the underlying design... they have the ability to invest in a range of products, but what they come with is a relatively high total expense ratio."

Skinner adds: "Once you've designed these products it's very difficult to go back in and remove expensive assets.

"You run the risk your product won't deliver what you've been explaining to the market."

There is a lot of speculation that in time the charge cap will come down further, increasing the strain on active management.

McCauley says this risks damaging outcomes for the member, as a cap that is too low becomes, "at a certain level, detrimental to the member".

Jo Sharples, investment principal at consultancy Aon Hewitt, says a further drop would hit small schemes especially hard.

"It's okay for the big schemes but for little schemes often you'll pay that much just for your administration," she says. "All schemes deserve the right to be able to use different investment strategies."

Pro active management

Some experts say the market volatility brought about by recent events in China could serve as a chance for active managers to demonstrate their worth, as a relatively benign investment environment has hampered returns in recent years.

McCauley says: "That volatility should be good for active managers. Our early results for August have been good."

Despite this, Chinnery says: "There is an argument that risk in terms of equity volatility, especially for younger [members] is low."

However, he says he welcomes anything that tilts the argument around investment away from "[charge] cap equals passive equals job done". P

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DC Investment

Tim Banks

Flexibility is key

Given the pension industry's journey of seemingly continuous change, a future-proof default strategy might seem like a distant hope.

Many traditional schemes are too unwieldy to adapt to change and providers have tended to try to tinker with the engine with each development rather than taking a step back to consider what's really needed in order to design a modern investment vehicle for the long-term.

With compulsory annuity purchase a thing of the past and with the new freedoms in place, the most obvious answer would seem to be a default strategy that's robust enough to withstand change in its many forms.

The ideal solution would be one that's flexible enough to adapt and respond to both the uncertainties in the markets as well as the unpredictability of members' savings journeys.

Future-proof investment vehicles do exist. One example is the flexible target date fund. These multi-asset default investment strategies are designed to be adaptable to members' changing needs and can respond swiftly to the shifting regulatory and investment landscape.

TDFs are easy to change from a fund management perspective. Investors are buying the top-level fund, so the manager has the authority to make changes when required within the agreed parameters — unlike in many lifestyle strategies where permission must be sought from the trustee board and/or end investors — something that can take months.

And because the underlying funds are constantly managed on a daily basis they can be changed quickly and easily.

TDFs are easy to change from a fund management perspective

The speed to react simply can't be matched by many lifestyle strategies that employ a formulaic approach to asset allocation.

Being highly adaptable has other benefits too. Bespoke or customised strategies can be created to the exact requirements and objectives of the trustees.

The speed and ease with which changes can be made to TDFs means costs, as well as time-consuming communications, are kept to a minimum.

Lifestyle strategies can be expensive and complicated, as change often involves not just communication with investors, but also the involvement of record-keepers and lawyers.

An accelerated pace of change may well be an ever-present part of life going forward, and successful DC pension schemes must have greater future-proofing built in.

Flexible TDFs offer a robust model that provides trustees with the peace of mind that they will still be relevant after 40 years and won't leave scheme members disappointed with the result.

Tim Banks is managing director, pension strategies group, at AllianceBernstein