When self-policing just isn't enough

When investment allocations are only scrutinised by those actually making the decisions, it can lead to a lack of accountability

Who watches the watchmen? It's a question that's been asked since Roman times – and with good reason. If you've appointed people to look after your interests, how do you ensure that they are doing what you intend (and pay) them to do?

This is especially important with regard to defined contribution pension schemes where the vast majority of savers delegate this responsibility to the scheme's trustees or independent governance committee through investment in the default strategy.

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It's not only a matter of ensuring that the component funds, often managed by independent fund managers, are functioning properly; even more important is the balance of those funds – otherwise known as the asset-allocation decisions.

Much academic research suggests that even where the underlying funds are actively managed, as much as 90% of variability in the outcome for savers comes as a result of these asset-allocation decisions.

In the case of passive-only default strategies, virtually the entire investment performance can be attributed to these decisions, with the choice of indices resulting in the asset allocator essentially picking which individual stocks to invest in. Passive default strategies simply don't exist.

This can't be emphasised enough: supposedly passively run schemes end up being – in practice – highly active, with the decision-making element simply coming in at a higher level (strategies or asset classes rather than stocks). And very often, there is no oversight of the decision-making process by third parties.

So savers who take reassurance from the fact that their assets are being run passively are often enjoying a false sense of security: their savings are just as exposed to the frailties of human decision-making as those who use active strategies.

And at least fund managers have their decision-making scrutinised by the trustees or the IGC. When allocations to passive funds are being made by the trustees or the IGC themselves, we have to ask again: who watches the watchmen? Sadly, in this aspect the UK pensions-savings industry faces a governance vacuum.

Typically, the same individuals are not only setting the objectives for the default strategy but are also making all of these key asset-allocation decisions. On top of that, they are then reviewing their own performance on behalf of scheme members and hardly ever publish their performance in a way that they can be held accountable. Or, to put it another way, the only people watching the watchmen are the watchmen themselves.

Our latest member survey suggests strong support from DC members for greater transparency and accountability for the investment performance of the default strategy to which they entrust their savings. There is, however, little evidence that any progress is being made here.

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This is despite undeniable evidence from other markets that transparency and accountability around the performance of a product as a whole drives down costs and improves performance quicker than any other form of governance. The industry needs to go set a watchman.

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