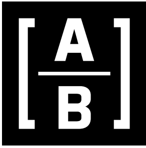

AllianceBernstein

Lessons Learnt: Designing Whole of Life DC TDFs Based on Drawdown Fund Experience

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Introduction

UK defined contribution (DC) savings have reached an important milestone. Data from the Office for National Statistics' (ONS) Census 2021 showed that, for the first time, savers were more likely to pay only into a defined contribution pension (26%) than a defined benefit (DB) pension (23%).

This pivotal moment calls for a timely review of how UK DC default investment solutions serve pension savers' needs, both as they save for retirement and as they transition into retirement. At AB, we think that the default fund journey of the future should seamlessly extend from accumulation into the decumulation phase. We also believe that Target Date Funds (TDFs) are a highly efficient default investment structure for that whole of life journey.

Robust default fund design based on practical experience is essential if DC savers are to achieve their retirement goals. At AB, we have 14 years' experience designing and managing TDFs for UK DC pension plan members' accumulation savings. We also have eight years' experience in managing their decumulation savings through our Retirement Bridge income drawdown fund range.

Retirement Bridge complements our accumulation TDFs and has paved the way for our new Whole of Life TDF range, which provides UK DC pension plan members with a seamless transition from accumulation to decumulation using an institutionally governed and priced income drawdown strategy. Retirement Bridge has also provided valuable lessons for our Whole of Life design in three key areas: *Investment Design*, *Payout Management and Communication*, and *Product Strategy*.

Introducing Retirement Bridge

AB's current UK DC retirement income strategy, Retirement Bridge, comprises a range of dynamically managed multi-asset funds. These funds pay a regular sustainable income (reviewed annually) to DC retirees and target an age of 75—when retirees may wish to secure an income via an annuity, or choose a different income strategy (for instance, AB's Evergreen Income fund, which focuses on capital preservation). This fund range was launched in 2015, after a five-year research programme.

Just as DC members can invest in a TDF anchored to their expected retirement age, investors in our Retirement Bridge strategy can invest in one of a series of Retirement Bridge Funds according to their year of birth (for example the "Retirement Bridge Fund 1959"). And just as in AB's regular TDF ranges, DC members' Retirement Bridge savings are actively managed across a mix of equities, bonds, commodities and other diversifying investments. The funds have a defined end date and a specific objective: maintaining a high and sustainable income while minimizing the chance that retirees will suffer a fall in income when they eventually use their retirement savings to annuitize.

Investment Design

Discouraging Double-Dipping

Drawdown strategies have historically faced a chronic risk budgeting problem. Retirees have tended to "double-dip" their retirement savings: that is, draw their monthly retirement income and make regular drawdowns too, by selling units. This makes it very difficult for the investment managers to estimate likely withdrawal rates over time and forces them to adopt overly conservative risk budgets—which tend to curtail potential investment returns.

With Retirement Bridge, we've actually seen limited unit redemptions, indicating that double-dipping has not been a major problem, so far. That's probably down to two reasons. Firstly, most Retirement Bridge savers were previously invested in our DC TDF default funds, where all the investment decisions were managed for them, encouraging member inertia. Secondly, Retirement Bridge has a simple, straightforward design, aiming to provide a sustainable income over a defined horizon (up to age 75) from a given capital value (and number of fund units). That makes it easier for savers to understand that double-dipping will likely impair their future retirement income levels.

Naturally, these are issues that we continue to monitor carefully as we launch our whole of life TDF range—especially since members will be able to enter this arrangement on a default basis without making an active product choice.

Balancing Relative Versus Absolute Risk

Retirement Bridge has an explicit objective of providing income through to the age of 75. After that, we expect retirees will either annuitize or continue to invest their pension savings using a different income fund for end of life and/or legacy planning. Hence, we need to keep Retirement Bridge investors' options open, managing their savings to help guard against increases in annuity prices (relative risk) while also seeking to avoid significant capital losses (absolute risk). Balancing relative and absolute risk in this way can be challenging and complicates risk budgeting for our Funds.

Adopting a whole of life default TDF approach simplifies our risk budgeting. Since annuitization is no longer an explicit priority in the new product design (although it does remain an option), we can focus more on absolute risk management. In our view, this should result in better long-term outcomes for the majority of DC savers who prefer not to annuitize.

The value of an investment can go down as well as up and investors may not get back the full amount invested. Capital is at risk.

Payout Management and Communication

Managing Payout Expectations

Our Retirement Bridge approach emphasizes keeping income levels sustainable—that is, we seek to minimize the probability of having to reduce income payouts. We recognize that reductions are painful for retirees and the rationale for any cut in payouts following an annual review must be clear.

Since Retirement Bridge launched there has been only one such reduction, following the 31 March 2020 annual review. This took place as the market declined sharply during the uncertainty caused by the outbreak of the COVID-19 pandemic. In this instance, the reasons for the market falls leading to the income reduction were so momentous—and companies' dividend cuts/suspensions attracted so much media attention—that we received limited queries or complaints from our clients on behalf of their retirees. We are prepared for members to be more vocal in future emergencies. Even so, given our prudent approach to setting income payout levels, we think future payout cuts will only be necessary in severely adverse macroeconomic environments and that retirees will acknowledge these environments are extreme.

We recognize that some savers in our new Whole of Life range may be less sophisticated than our early-mover Retirement Bridge investors. Consequently, we plan to have very thorough communications strategies in place should further cuts to payouts be necessary in the future.

Making Payouts More Predictable

After we launched Retirement Bridge, our initial annual income review was an unfamiliar exercise and determining the appropriate payout levels was necessarily a fundamentally-driven discretionary process. Through time, and after multiple reviews, with the benefit of experience we have developed and formalized our current quantitative-based, transparent and repeatable process, with a fundamental overlay.

Improving the decision-making process in this way is very important, given our commitment to clear, transparent and detailed reporting for our TDFs and our other retirement savings products.

We've learnt that simplicity and stability are paramount for retirees, and we will continue to build these member-friendly features into our new Whole of Life solutions.

Keeping Payouts Stable

Retirement Bridge has a clear payout philosophy: investors' monthly income must be completely stable throughout any distribution year. This approach mirrors both investors' experience with salary and wages during their working careers and the payments they would receive from a Defined Benefit (DB) plan.

Consequently, Retirement Bridge pays a fixed pound-and-pence amount per unit held—as opposed to a fixed percentage of the unit price, which would be affected by market moves. And to avoid eroding monthly income from fees, administration fees are taken directly from the NAV of each Fund, rather than by unit deduction.

We think that simplicity and stability are paramount for retirees, and we will continue to build these member-friendly features into our new Whole of Life solutions.

Product Strategy

Helping Members Who Don't Engage

Lack of member engagement is characteristic of the UK DC pensions industry. It's most problematic when members approach retirement and need to make active, informed choices based on the options available under their pension arrangements.

Many members are unaware of—or ignore—drawdown options like Retirement Bridge, for two reasons.

Firstly, we see a lack of member understanding and/or engagement with in-plan drawdown options. Secondly, members are increasingly choosing to access their retirement savings in ways that are easy but suboptimal via the high street.

Members with smaller pots typically cash out in full or withdraw in a series of payments over a short time horizon. Some remain invested in their default fund briefly before cashing out. But in either case, we think members would likely benefit from transitioning to a default income strategy, even if they subsequently decide it does not fully meet their income needs and they have to cash out.

Members with medium- and larger-sized pots are most suited to income drawdown solutions and should have the benefit of institutional-standard governance/oversight and fees, in our view. But in practice we are seeing many of these members transfer out to retail or advised drawdown solutions, which typically come with higher management and advisory fees and charges. High fees detract from investment returns and higher-fee investment products will on average result in lower standards of living in retirement for DC plan members.

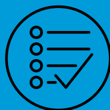
The time is right for the occupational pensions industry to address these problems. Default decumulation products, like our whole-of-life TDF fund range, are innovative solutions that can help members at retirement—without needing to rely on engagement strategies

Living Without Annuities

Our research shows that, even before the 2015 Freedom and Choice pension reforms, annuities were unpopular with members—and have remained so. The main negatives are the relatively low income payouts from annuities prevailing since the global financial crisis, and annuities' inflexibility to adapt to members' changing retirement needs.

This experience has directly informed the design for our Whole of Life TDF range. Although an annuity pathway is available as an option as part of the product design, the Whole of Life TDFs offer a default income pathway for members and enable them to draw an income through to age 95.

Investors in the new TDFs retain control of their savings at all times—so they always have the option of reconsidering and switching into an annuity product to remove all risk of outliving their savings.



Designing and managing Retirement Bridge has involved asking many questions, generated a lot of practical experience and led to clear conclusions regarding next steps. Some watchpoints remain, and we aim to be mindful of these as we manage our new Whole of Life range. But there's one standout lesson—in an environment where many providers are developing drawdown offerings for the first time, experience is the best teacher. We aim to continue putting our pension investing experience at the service of DC savers, for the whole of their lives.

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Some of the principal risks of investing in Target Date Funds include:

Market Risk: The market values of the Fund's holdings rise and fall from day to day, so investments may lose value. **Interest Rate Risk:** Bonds may lose value if interest rates rise or fall—long-duration bonds tend to rise and fall more than short-duration bonds. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or capital—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. A**llocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign Risk:** Investing in non-UK assets may be more volatile because of political, regulatory, market and economic uncertainties associated with them. These risks are magnified in assets of emerging or developing markets. **Currency Risk:** If a non-UK asset's trading currency weakens versus sterling, its value may be negatively affected when translated back into sterling terms. **Reinsurance Risk:** The underlying fund(s) is accessed via another insurance provider, also known as a reinsurance arrangement; creating a direct counterparty exposure. In the event of default by an insurance provider, the value of the assets will likely fall, which will be reflected in the value of our Fund price.

Target Date Retirement Funds (TDFs) are designed for a typical pension fund saver intending to retire in or around the years stated in the name of the Fund. As the Funds are intended to be default pension saving vehicles which seek to meet the requirements of a broad range of persons, they do not take into account an individual's personal circumstances and may not be suitable for a particular individual or group of individuals with complex financial or personal circumstances.

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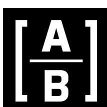

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