The Trustee toolkit downloadable

Investment in a DC scheme

Tutorial two: Default investment options

By the end of this tutorial you will better understand:

- the risks to members and trustees in the selection and governance of a default arrangement
- the legal requirement to provide a default arrangement if the scheme is being used for automatic enrolment
- types of default arrangement including lifestyle strategy
- the typical assets types used as a member approaches retirement in a lifestyle strategy

This tutorial is part of Scenario one.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

Introduction

In the Module: 'How a DC scheme works (2014)', the Tutorial: 'Good member outcomes' discussed some of the risks for both trustees and members inherent in a DC scheme, including:

- trustees offering poor or inappropriate investment choices to members
- lack of member understanding or engagement in pensions

In this tutorial we focus on these two key risks which are particularly relevant to selecting and monitoring a scheme's investment strategy including the investment strategy for the scheme's default arrangement (where the scheme is used for automatic enrolment). These two risks combined pose a significant threat to good member outcomes, as you'll see in the following example.

Meet John

Meet 40 year old John, a new employee of Pasties and Pies, a UK distributor of baked goods to cafes. John's never had much of a head for financial matters and has never saved for a pension before with any of his previous employers.

The Pasties and Pies scheme

Pasties and Pies are using their existing trust-based DC scheme for automatic enrolment and John has just joined.

John's investment

He does not make an active decision about investment so is automatically put into the scheme's default arrangement designed by the trustees.

20 years later...

John doesn't look at this again until six months before he retires, when a financial adviser friend is helping him decide what to do. He is astounded to find that his pension is worth less than he imagined. The adviser looks into it and finds that the:

- fund is an actively managed global equity fund and his entire retirement account is still invested there
- fund has not only underperformed the market consistently over the past 20 years, but has crashed in value in the last six months
- charges, although within the charge cap, were also very high for what was being delivered and in comparison to other similar funds

John is worried. He doesn't understand pensions and thought the trustees would have provided something better than this, or at least kept an eye on it over the years.

Why is governance so important?

As you can see from John's example, the design and governance of any default arrangement by the trustees, and its performance is vital. Typically, many DC scheme members are invested in default arrangements. The members that invest in the default arrangement will typically:

- cover a wide range of ages, salaries and contributions rates
- be less engaged with pensions
- stay in the default arrangement throughout their career, which could be a relatively short period of time or for over 40 years

In an automatic enrolment scheme, a member's contributions will be automatically invested in the default arrangement unless the member chooses to set their own strategy.

So by its very nature, members invested in the default arrangement will have not made an active decision to invest there. They are unlikely to be engaged with the investment of their pension contributions and so are also unlikely to be monitoring its performance and making decisions to change strategy.

As the number of employees that are required to be automatically enrolled increases, it's expected that large proportions of members will be enrolled into a scheme's default arrangement.

The trustee's role

The design, governance and communication of the investment strategy for any default arrangement plays a crucial role in helping to ensure good outcomes for many of a scheme's members.

The trustee's responsibility

Trustees of a DC scheme are responsible for setting the investment strategy for any default arrangements which are used for members who do not wish or feel able to make a decision of where to invest (this is a legal requirement for all automatic enrolment schemes), and for ensuring the long-term suitability of the funds underlying it.

It is the trustees' responsibility to ensure that the investment strategy for any default arrangement is intended to ensure that assets are invested in the best interests of the relevant members and relevant beneficiaries.

Designing the default arrangement investment strategy

Trustees of a DC scheme will need to design default arrangement investment strategies that cater for all members invested in it with a wide range of needs.

The Department for Work and Pensions (DWP) has issued guidance on offering a default arrangement. This can be followed to help govern the scheme and is intended to support existing legislation.

View the DWP's default arrangement guidance at http://www.gov.uk.

The guide to investment governance can be found at www.tpr.gov.uk/invest.

Trustee considerations

Trustees should consider the principles governing the investment strategy of a default arrangement and where responsibilities lie. These include:

- deciding the objective of a default arrangement
- ensuring the suitability of a default arrangement for the relevant membership
- designing the investment strategy for any default arrangements
- monitoring the performance of any default arrangement at least every three years and without delay when certain events occur
- communicating information about the investment strategy for any default arrangement to members
- reviewing and/or changing the investment strategy for any default arrangement

Designing the default arrangement investment strategy

Trustees of DC schemes should allow suitable time to design the investment strategy for any default arrangement and ensure that the member data for the default arrangement is accurate.

What a suitable investment strategy for a default arrangement is will vary from scheme to scheme depending on a number of factors which include:

- the membership profile
- the trustees' objectives
- the risks to members
- costs

We will now look at each of these factors in turn.

1. Membership profile

By analysing the membership, trustees can identify possible characteristics to include in the investment strategy for a default arrangement. This will include consideration of the benefits members are likely to access at pension age, for example how likely members are to use their pot to purchase an annuity or use it for flexi-access drawdown.

Trustees should also consider the membership's risk appetite by analysing the member characteristics, such as age and salary, and seeking member views in relation to financial awareness and need.

For example, member engagement might reveal that the majority of members consider their DC pension pot to be their main source of income at pension age and through retirement. In this situation, trustees may consider designing a less risky default arrangement.

> You will find more information on this topic in the Tutorial: 'Setting an investment strategy' earlier in this module.

2. Trustees' objectives

When setting the investment objectives, trustees should consider the data from any relevant membership analysis and use their judgement.

For example, trustees of DC schemes have the discretion to use actively managed funds or passively managed funds or a combination of both depending on the asset class.

Trustees should consider if simplicity is a key objective for the scheme. This may influence the funds included in a default arrangement and how these are explained to members.

Once trustees have considered the membership profile and used their judgement, they can set an overall objective for the investment strategy of a default arrangement.

For example it could be to provide good member outcomes by providing positive, real returns over the members' careers, or it could be to protect purchasing power to buy an annuity where members have indicated this is their preferred way to access their benefits.

> You will find more information on this topic in the Tutorial: 'Active and passive investment management' in the Module: 'An introduction to investment'.

3. Risks to members

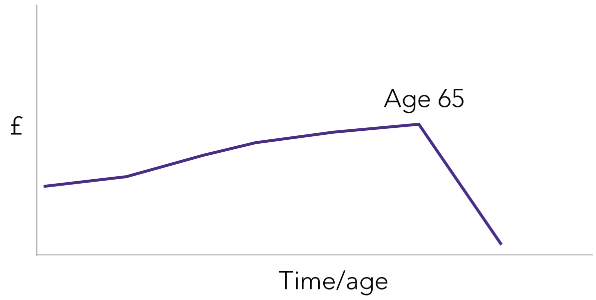
There are a number of member-borne risks that members face over the course of their careers that trustees should consider as part of setting the investment strategy for a default arrangement, as well as the range of alternative options to offer.

Capital risk

There is a risk that the capital value of a member's investments falls.

This risk is most relevant typically in the run-up to retirement for that portion (normally 25%) of a member's accumulated fund earmarked for tax free cash.

This is also known as investment risk, and is the risk that people typically associate with making investments – the risk that they will lose money on them.

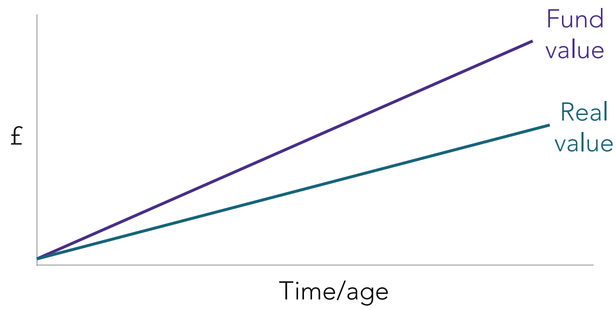


Inflation risk

There is a risk that over the long term inflation can erode the real value of the pension pot the member builds.

This can be mitigated by investing in real assets such as equities and index-linked gilts.

This risk is most relevant typically in the early and mid-stage of a member's career.



Pension conversion risk

At retirement, historically, the majority of members will use the assets they have built up to buy an annuity. However the level of the annuity could be less than the member expects. This can be mitigated by investing in a manner that reflects annuity pricing (eg fixed and inflation linked bonds).

There is a further risk that scheme investments have not taken account of alternative options open to members for accessing their benefits, such as flexi-access drawdown. This can be mitigated by engaging with members about how and when they plan to access their benefits throughout their membership.

4. Costs

Trustees should take care to understand and monitor the member-borne costs of the investment options offered and in particular the default investment strategy. Member-borne costs should be reasonable and fair in relation to the work carried out and represent good value for members.

Charges should reflect the balance between likely risk and return. The law imposes a cap of 0.75% pa on charges borne by members for a default arrangement in schemes used by employers to comply with their duties under automatic enrolment legislation. The total expense ratio (TER) and administration charges (unless they are paid by the employer) should come within the 0.75% pa cap. Some costs are excluded from the cap, such transaction costs which are incurred as a result of buying, selling, letting or borrowing investments.

The law also allows only two charging structures for default arrangements, so it is important that trustees understand the charges in their default arrangement.

You will find more information on this topic in the Tutorial: 'Charges' later in this module, and also in the Module: 'How a DC scheme works (2014)', the Tutorial: 'Value for members and charges'.

Exercise: Check your scheme

Before we look at different types of default investment strategy, take this opportunity to answer these questions about your own scheme.

- What is your default investment strategy?
- What proportion of your membership is invested in the default investment strategy?
- What is the objective of your default investment strategy?
- How often is it reviewed?
- Does your default investment strategy include actively managed funds?
- What are the charges for your default investment strategy?

Typical types of default arrangement investment strategies

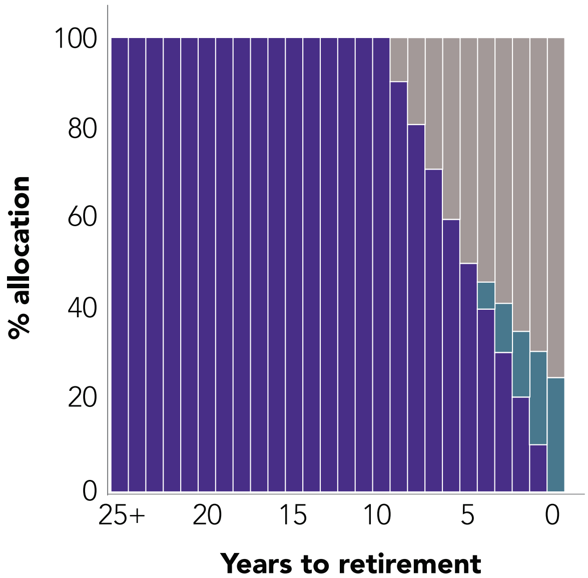
Default arrangement(s) will vary from scheme to scheme.

- Single fund: Some schemes may set a single fund with a static underlying asset allocation as the investment strategy for the default arrangement. However the range of investment risks borne by the members of a DC scheme may not be mitigated by one asset class or one fund.
- Blend of funds: In some cases trustees may wish to diversify the investment strategy for the default arrangement by blending two funds together to mitigate member-borne investment risks. Blending, as the name suggests, simply means that two or more funds are brought together to form a single fund with a single price.
- Lifestyle strategy: To help mitigate the changing investment risks as they occur to a member, trustees of DC schemes can use a 'lifestyle strategy' as the default arrangement's investment strategy. This type of strategy typically invests in underlying funds and changes its allocation to them over time.

We will now look at lifestyle strategies in more detail.

Lifestyle strategy

Lifestyle strategies aim to address the changing investment risks members face over the course of their careers by changing the asset allocation of a member's investment automatically over time. The following example shows a lifestyle strategy for a scheme where members typically aim to buy an annuity at retirement.



This example shows the allocation from 25 years to retirement. As you can see, in this example a proportion of the growth assets are replaced by bonds from 10 years to retirement. From five years to retirement onwards, growth assets are replaced by both bonds and cash until the member is completely invested in these typically lower risk assets by the time they retire.

How the asset allocation changes from growth to bond like assets is often referred to as the decumulation phase. Different assets may be designed for a scheme where members typically target to take cash at retirement.

Remember John, the DC scheme member we introduced you to at the start of this tutorial? He was still invested 100% in the global equity fund as he neared retirement and as a result was very exposed to the higher volatility in this type of fund. The value of his pot fell drastically in the last six months as the value of global equities crashed.

If he had been invested in the lifestyle strategy in this example, his growth assets (the global equities) would have been slowly replaced by bonds and cash in the last 10 years, reducing his exposure to sudden movements in the market at retirement. We will return to John's story in later tutorials in this module. Note that John's story is for illustration purposes only and you should not view this as a recommendation for this type of default arrangement investment strategy.

Approaching retirement: Typical assets

Lifestyle strategies tend to include allocations to assets shown below towards the end of a member's career.

Index-linked gilts

Holding these can provide some protection against the risk that inflation in the years before retirement could reduce the real value of members' expected benefits (or annuity). It can also provide a partial pricing match should members choose to purchase an inflation linked annuity.

Fixed interest gilts

Research has shown that pension scheme members have historically tended to take fixed pensions. An allocation to fixed interest bonds can provide a partial pricing match against the cost of purchasing this type of annuity.

Corporate bonds

Some schemes may have an allocation to corporate bonds as well as fixed interest gilts for two reasons. Corporate bonds are sometimes held by insurance companies (who sell annuities) and therefore annuity prices are to some extent driven by corporate bond yields. Corporate bonds generally offer higher expected returns than those on equivalent gilts.

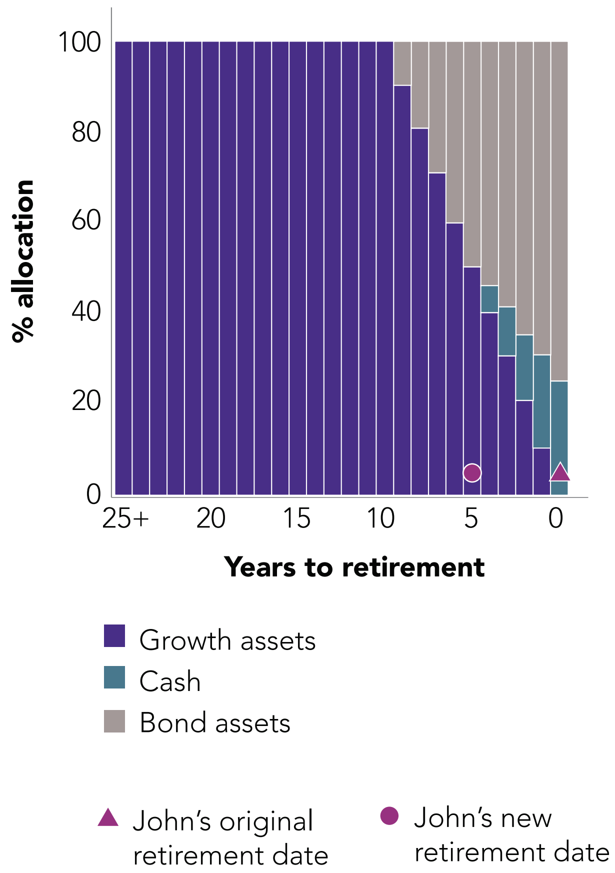
Cash

An allocation to cash can help to protect the value of the member's pot against losses. Many members can also target a holding of 25% of their pot in cash, if they plan to take a tax free lump sum.

Early retirement in a lifestyle strategy

If a member invested in a lifestyle strategy wants to retire earlier than the target pension age they have selected they may find that the mix of assets they are invested in does not suit their plan of how they want to access their benefits. Let's take a look at John's story again.

Let's say John was invested in the lifestyle strategy we showed you earlier and originally planned to retire at age 65 but has decided to retire early when he is 60. He plans to take 25% of his benefit as a tax free lump sum and use the remainder to buy an annuity. With his current lifestyle strategy in place this would leave 50% of the value of John's pension pot exposed to more volatile markets at retirement.



It is important for trustees to try and engage members with their pension planning as much as possible. It is good practice to notify the affected members that their fund is about to start switching into lower risk investments. This allows members to consider whether this is appropriate for them, and to consider whether their target pension age is still appropriate.

In John's case he may have been able to inform the trustees of his plan to retire early if he was contacted at age 55 when the lifestyle strategy was about to start. The switch to bonds and cash could have been accelerated to protect his pension pot to age 60.

Early stages of a member’s career

We have already looked at reducing exposure to volatility as the member approaches retirement, but what about diversifying the growth assets in the early stages of a member's career?

Diversifying growth assets

In the early stages of a member’s career, a member’s investment will generally aim to deliver long-term investment growth by investing in equities and other growth assets for example. Some trustees may diversify the growth assets to reduce investment risk and improve the expected risk/reward profile.

You will find more information on this topic in the Tutorials: ‘Diversification’ and ‘Risk and reward’ in the Module: ‘An introduction to investment’.

Example allocations

Lifestyle strategies can incorporate allocations to the following investments in the early stages of a member’s career.

Equities

Holding these can help achieve long-term growth within a member’s pot. They can also provide some protection against the risk that, over the long term, inflation can erode the real value of the pot the member builds.

Many schemes use passively managed equity funds for equity exposure in the early years of a member’s career.

Diversified growth

Holding this can also help achieve long-term growth and protect against inflation. As diversified growth funds aim to control volatility and can aim to focus on preserving capital they are often most effective when they are actively managed.

Approaching pension age

Trustees do not know, and members themselves rarely know, how members will choose to access their benefits. It is therefore difficult for trustees to design the perfect decumulation phase.

An 'annuity' (an income for retirement) is just one way that a member might choose to take their benefits. For members targeting to buy an annuity, lifestyle strategies typically switch from growth asset into bond-like assets at least five years before a member's chosen retirement date.

Members have many other options available to them, and they may choose one or more of them at retirement, or at different times during their retirement. These options are:

- taking a flexible income (flexi-access drawdown)
- taking their whole pot in one go
- taking their pot in a number of lump sums

If you haven't already you can learn more about the different retirement options available to members and, where relevant, the likely tax consequences for the member in the Module: 'How a DC scheme works (2014)' in the Tutorial: 'Decisions at retirement'.

As we saw from John's story, the switch to more stable and less volatile investments as a member approaches retirement is to reduce the impact a market shock may have on a member's pot, but depending on the options offered by your scheme, and the profile of your members, there may be different considerations.

Other considerations

Finally, here are some further considerations when developing a default arrangement investment strategy.

Can an investment manager do this for us?

Trustees may delegate some investment decisions in relation to the default arrangement's investment strategy to an investment manager. For example, in a 'target maturity fund' or 'target date fund', a manager may be given discretion over the timing of changes in the mix of underlying assets within the fund in order to mitigate member-borne risks as they approach pension age.

When a member invests in a target date fund, they select a target date for retirement. If a member does not select a target date this will typically be presumed to be the current state pension age.

Where they have delegated certain investment decisions, trustees still need to be confident that decisions are made in the best interests of members and beneficiaries in mind and by people with the right expertise. Trustees should clearly document the objectives, roles, responsibilities and reporting relationships of all parties involved in making investment decisions.

How often should we monitor and review the default arrangement and investment strategy?

Trustees should regularly monitor and must review the default arrangement investment strategy and the performance of the default arrangement at least every three years and without delay after any significant change in investment policy or the demographic profile of relevant members.

You will find more information on this topic in the Tutorial: 'Managing performance' later in this module.

When carrying out this review trustees must consider the extent to which the investment return net of fees is consistent with the trustee's objectives for the default arrangement.

What information should be made available to members?

It is good practice for pension schemes to provide information on the default arrangement investment strategy to the members. At a minimum, this should include:

- a description of the default arrangement
- a statement of the overall objective of the default arrangement's investment strategy with an indication of the risk profile
- a disclosure of the charging structure
- clear signposting on how to request further information

Given that members who are invested in the default arrangement are likely to be less interested in communications about pensions, trustees should pay particular attention to ensuring that communications are:

- accurate
- clear and in plain English
- relevant

What is meant by investment mapping?

This is where trustees have changed the investment available to members and the members' assets are 'mapped' to the new investments. This could mean that members are investing in a fund that they have not chosen to invest in even though they chose to invest in the original fund. This might result in the new fund falling within the definition of a default arrangement and being subject to the rules relating to those arrangements.

You will find more information on this topic in the Tutorial: 'Member communications' in the Module: 'How a DC scheme works (2014)'.