

DC default and other investment options

European Pension Fund Congress

Sabine Mahnert

20 November 2012

Default funds

“The fact that the majority of DC plan members may well end up in the default fund means that the choice and design of the default will be a crucial determinant of members’ subsequent retirement income.”

(International Organisation of Pension Supervisors)

Investment Governance Group (IGG) Principles

Stage I: Governance structure

- Principle 1: Clear Roles and Responsibilities
- Principle 2: Effective Decision Making

Stage II: Investment choices and monitoring

- Principle 3: Appropriate Investment Options
- Principle 4: Appropriate Default Strategy
- Principle 5: Effective Performance Assessment

Stage III: Communications

- Principle 6: Clear and Relevant Communications

Auto-enrolment is driving up number of schemes with default options

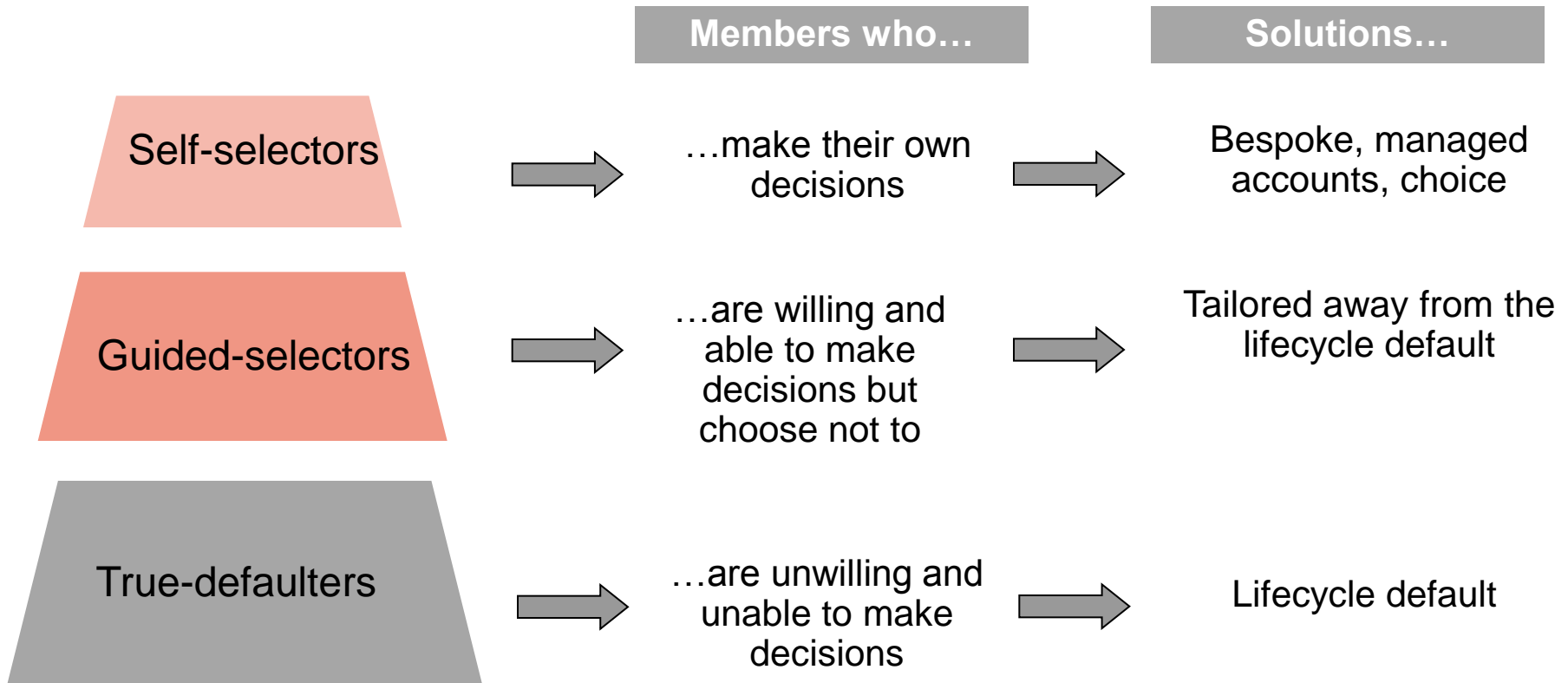
- According to 2012 Towers Watson research*:
 - 92% of FTSE 100 companies offer a default investment strategy (up 10% from previous year)
 - Over 50% of FTSE 100 DC schemes have more than 90% of members invested in the default investment option
 - 70 of the FTSE 100 offer Diversified Growth Funds (DGFs) as part of the fund range in their DC schemes, up from 43 the previous year

* The Towers Watson FTSE 100 Defined Contribution Pension Scheme 2012 Survey

Lifecycle is a simple solution to a complicated problem

- The purpose of a DC plan is to turn today's savings into tomorrow's retirement income
- Members, however, are generally unwilling/unable to make investment decisions and investment risk lies with those least able to manage it
- A simple auto strategy that seeks to provide an appropriate risk/reward trade-off to investors can assist members in their DC journey
- Lifecycle design is a simple solution to this problem
 - An investment strategy which automatically adjusts the allocation of a member's investments, moving from growth investments to safer assets (bonds and cash) as the member approaches a particular target date (usually retirement)
 - It is easy to understand
 - It can be modified to take account of individual preferences and circumstances

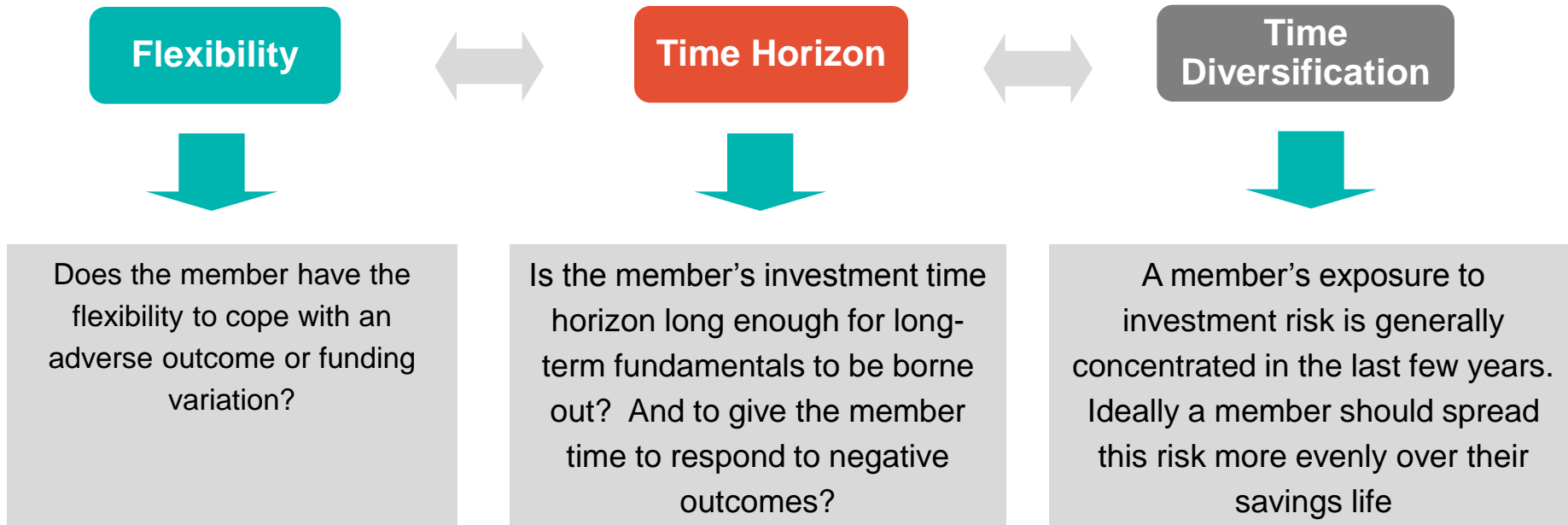
There are three types of member in a DC plan



Lifecycle default structure considers the profile of the typical member

Should DC members take investment risk?

- The answer lies in a combination of 3 factors:



We believe there are good reasons for a DC member to invest in growth assets at some stage along their journey – so long as they have the flexibility to cope with adverse outcomes

Factors influencing the ability to take on risk

Traditional Lifecycle

- Younger members have high human capital and the luxury of a long investment horizon to correct problematic investments, flex consumption and spending habits, adjust goals
 - Primary aim is to **maximise returns**
- Older members have low and falling human capital with a shortening investment horizon, with less flexible consumption and spending habits, firmer goals
 - More risk-averse portfolio with the need to **minimise the volatility** of prospective pension nearer to retirement

Refined Lifecycle

- More factors besides time to retirement are taken into account. Examples include wealth, health, dependents, strength of human capital, etc
- Better defaults achieved when sponsors have knowledge of their typical member and can construct the default or range of defaults with this segmentation in mind
- Additional factors are used to suggest 'nudges' away from the default structure towards a structure more suited to a member's needs and circumstances
- Success depends on strong engagement and communication

The desired level of contributions and the ability / willingness to take on risk are interconnected

Understanding the needs of the membership

- Understanding of the membership is important in designing the range of options and the default strategy.

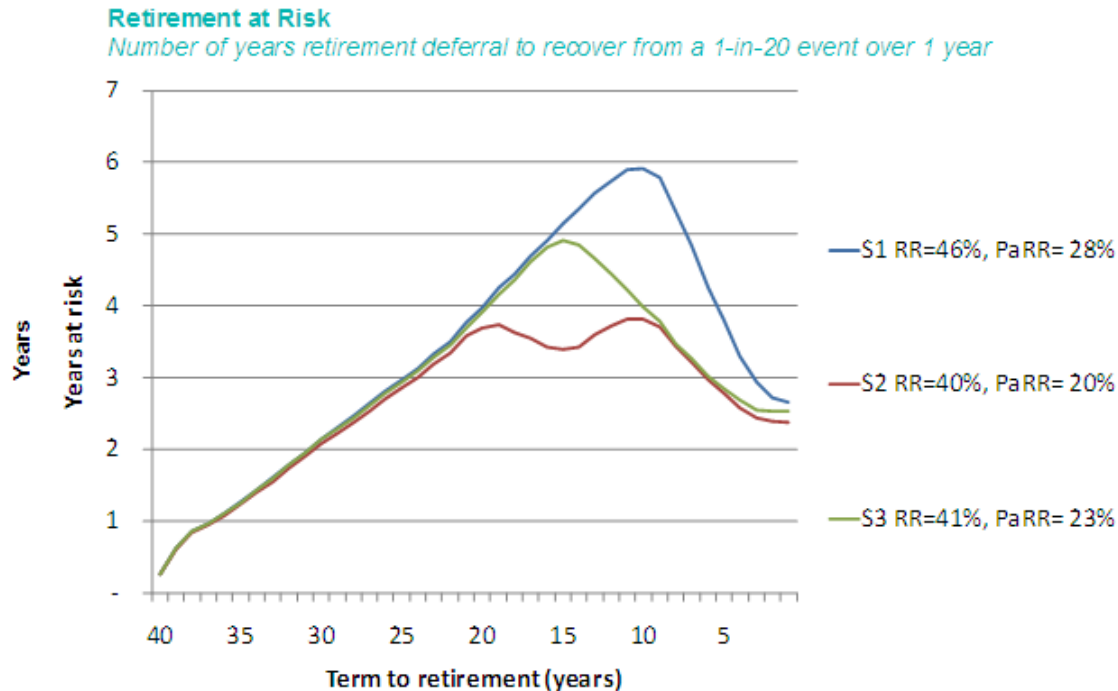
Overall risk tolerance by age group



Designing the default strategy

- The default strategy should target a specific outcome and be evaluated against this target.

**It's not just about the size of the risk....
.... it's also about when you take it**



Asset structure

Protection and growth assets

DC Pot

Protection assets

Index-linked bonds
Long term bonds
Cash
Variable annuities
Deferred annuities

Attributes

- Proxy to the “matching asset”
- Lower volatility
- Focus towards income generation

Growth assets

Equities
Alternatives
Real estate
High yield
Diversified growth

Attributes

- Exploits risk premium
- Higher return in exchange for more volatility
- Focus towards capital growth
- Benefits from diversification

Proportion in each depends on individual circumstances (other assets, liabilities; risk preferences; strength of human capital; flexibility of consumption)

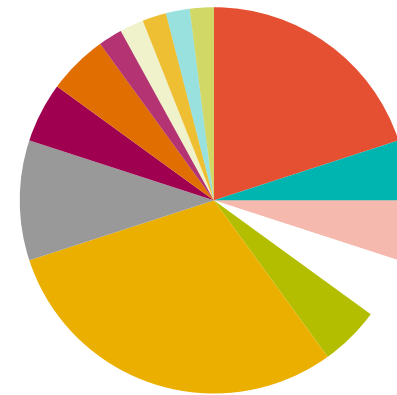
Evolution of multi asset products

Traditional Balanced Fund



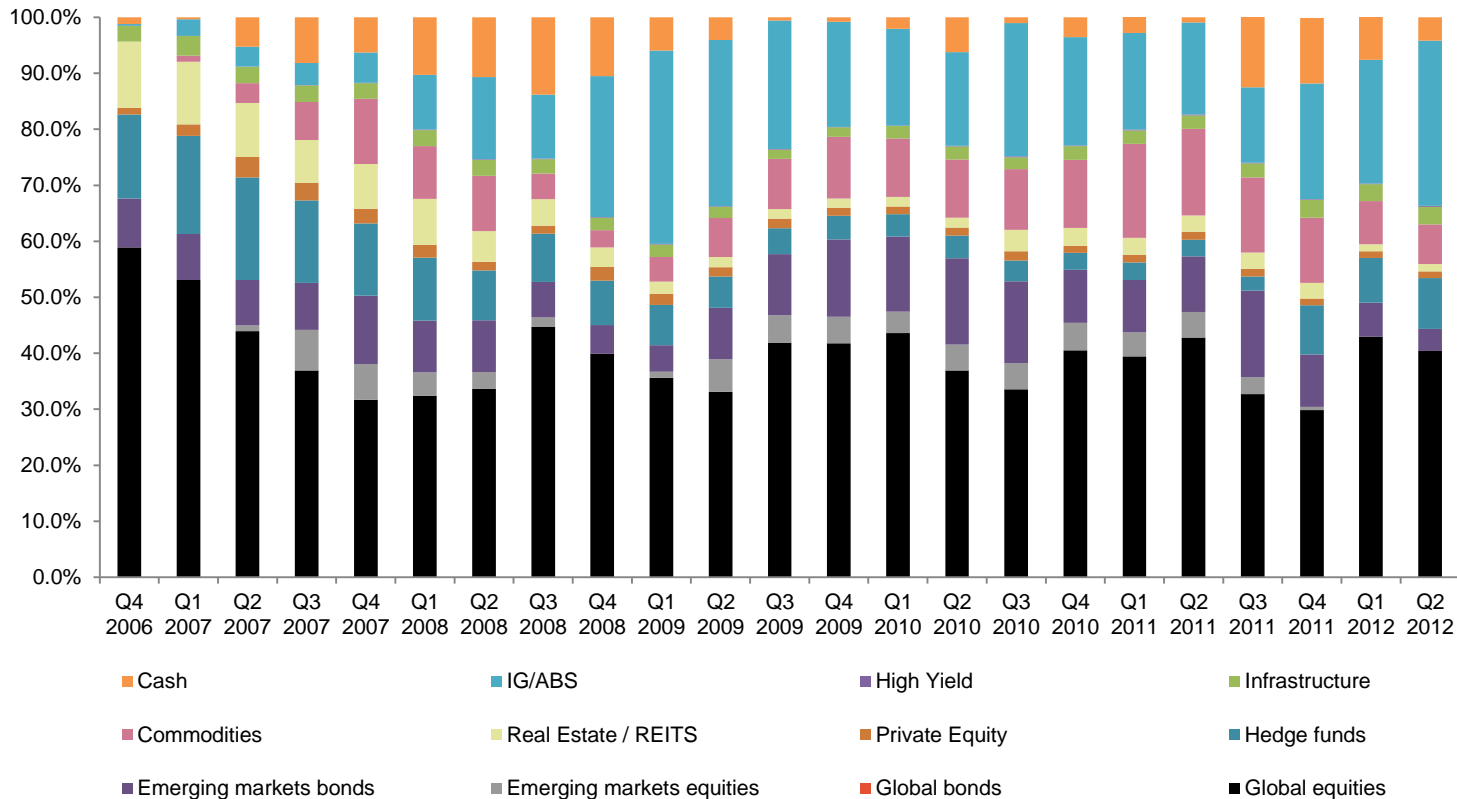
- Domestic/Global Bonds
- Domestic/Global Equities

Typical Multi Asset Fund



- Domestic/Global Bonds
- Emerging Market Bonds
- High Yield Bonds
- Emerging Market Equities
- Buy-Write
- Real Estate
- Infrastructure
- Inflation Linked Bonds
- Investment Grade Corporate Bonds
- Domestic/Global Equities
- Domestic/Global Equity Sectors
- Commodities (inc Gold)
- Private Equity
- Hedge Fund Beta

Typical DGF...?



- Asset allocation is likely to be the key driver of excess returns. Managers vary in terms of how dynamically they asset allocate. Products are typically active in terms of asset allocation and manager selection. Many strategies permit the use of external funds ('open architecture').
- The approach to manager selection tends to be focussed on finding an appropriate solution to fit with the broad asset allocation of the product, as opposed to covering the entire universe of possible managers. However, there are some managers that are more focused on this.
- Management fees are 50 - 100bps. Total Expense Ratios are 75 - 200bps.

Multi Asset Solutions

Advantages

- In theory these products exploit the widest universe possible and give investors the most freedom
- They can offer a cost effective way to achieve diversification which may be otherwise unattainable for some clients
- Funds can differentiate themselves in a variety of ways: better manager research capability, differentiated asset allocation and macro outlook, more efficient implementation

Other considerations

- Correlation to equity markets
- Fees and general expenses can be high
- Convergence to most successful model of constructing and running a multi asset fund can erode competitive advantage
- Funds used not always “best in class”
- Short track record for the universe as a whole
- Benchmarking and heterogeneity of universe
- Capacity

Glide-path design

- In the early part of a person's working life the ability to take on investment risk is generally high, suggesting a (close to) 100% allocation to growth assets
 - Arguably the effective allocation could be greater than 100%
 - The allocation is dependent on other circumstances, such as mortgage
- Assuming most members annuitise at retirement, the member portfolio should be (close to) 100% protection assets at the time of retirement
- This suggests a glide-path design which steadily reduces exposure to growth assets through a DC journey, possibly at an accelerating rate towards the end of the journey
- Development of a journey plan suggests two-way rebalancing through most of the journey. As the journey end approaches, however, one-way switching may be considered given the costs involved

Glide-path example

Reduction in the exposure to growth assets starts 25 years before retirement, with the annual shift to protection assets increasing every five years

- 2% p.a. for the first five years, then 3%p.a. for the next five etc until 6%p.a. in the last five years before retirement

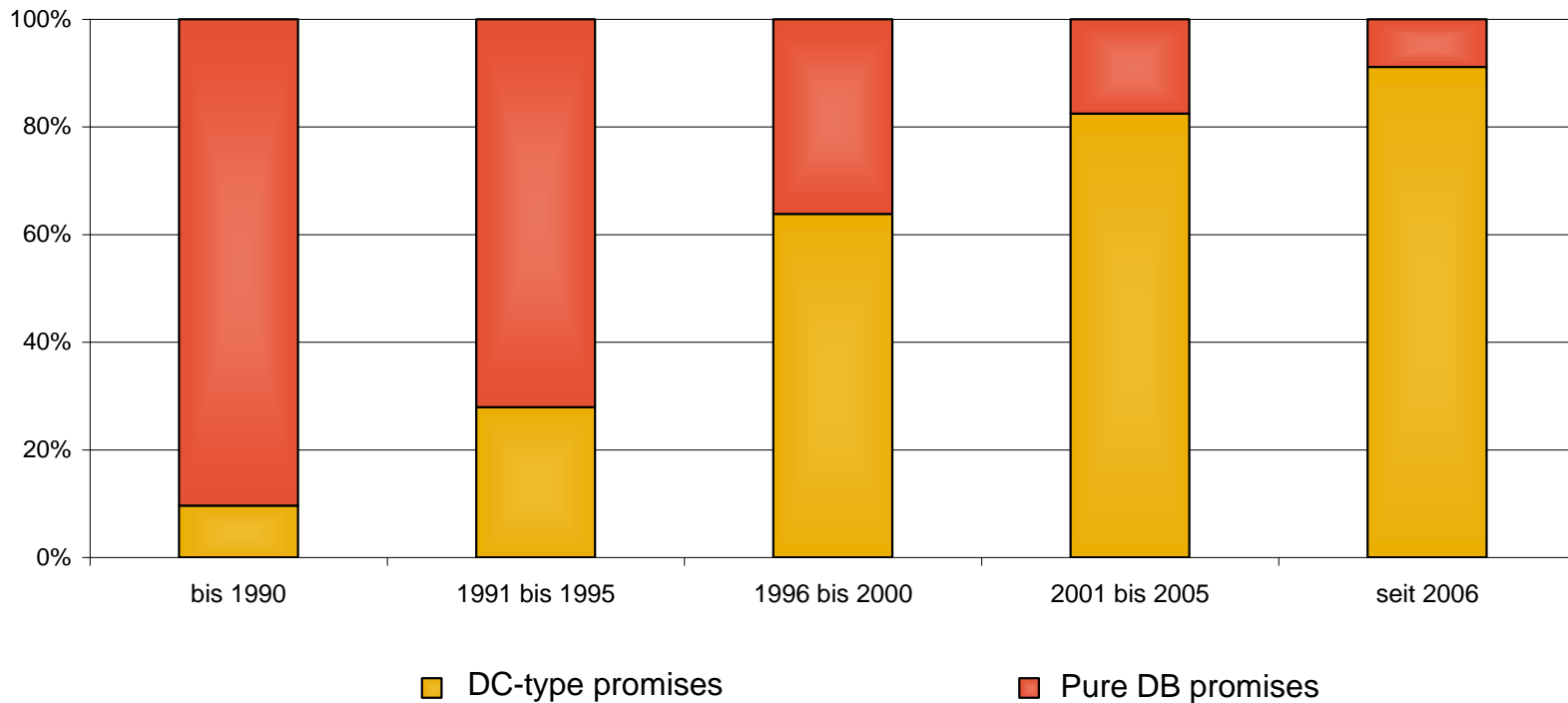
Protection strategies

- The purpose of lifecycle is to offer downside protection by gradually switching into protection assets / annuity matching funds
- Downside protection could, in principle, be purchased explicitly by a member while maintaining a high exposure to growth assets, for example through option strategies
- Protection strategies are more likely to be implemented as an overlay by a member, rather than incorporated within a default lifecycle strategy
- In practice costs may be an issue
- Note, however, that protection strategies tend to focus on capital protection rather than retirement income protection

DC in Germany

Continuing trend towards defined contribution promises

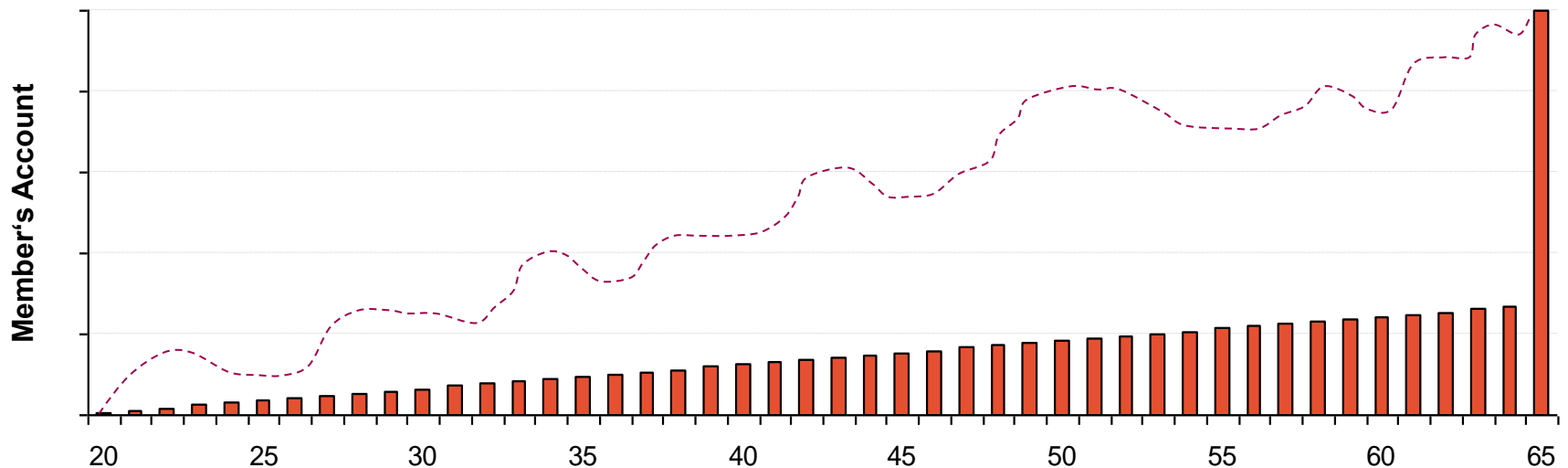
- Approx 90% of all plans introduced after 2006 are defined contribution type promises.



Source: Towers Watson Benchmarkstudie 2009

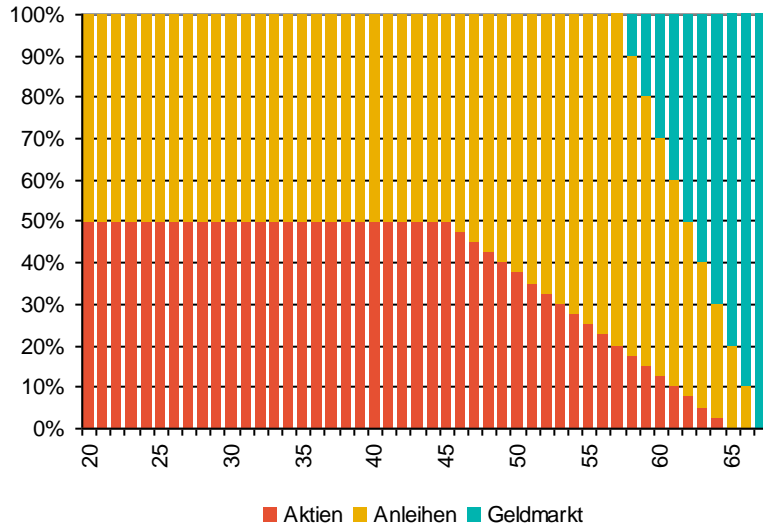
German DC plan with minimum guarantee

- The member is promised the value of a certain reference fund or combination of reference funds with a guaranteed underpin.
- The minimum guarantee can either be underwritten by the employer or charged as a cost to members' accounts.
- The guaranteed underpin could cover nominal contributions or also include an interest guarantee.
- The member typically has no investment choice.

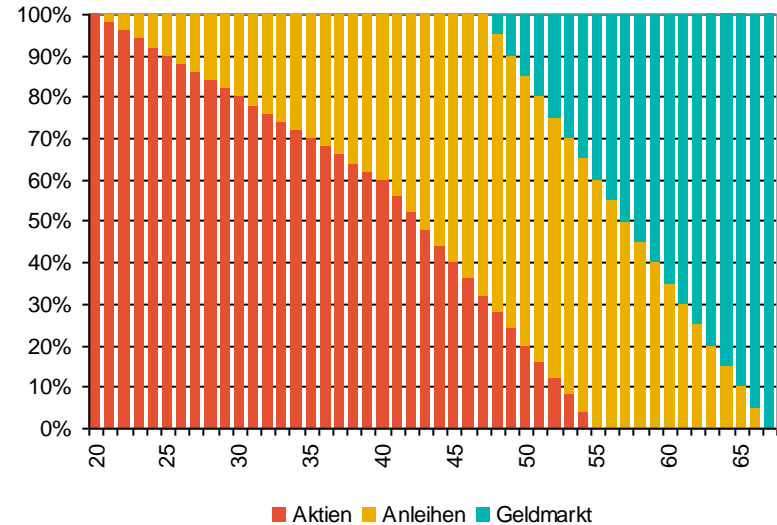


Lifecycle Model

- There are several investment „pots“ which could represent individual asset classes or be a mixture of asset classes or funds.
- This example is based on the asset classes equities, bonds and cash.



Model for new entrants and tranfers from DB scheme



Model for new entrants only

- Lifecycle model is regularly monitored using risk modelling techniques.

Contact

TOWERS WATSON



Sabine Mahnert
Senior Consultant

Eschersheimer Landstr. 50
60322 Frankfurt
Deutschland

T +49 69 1505-5240
F +49 69 1505-5250

Sabine.Mahnert@towerwatson.com