Aberdeen Standard Investments

January 2018

Rethinking DC Default Design

Part 2: budgeting for behaviour

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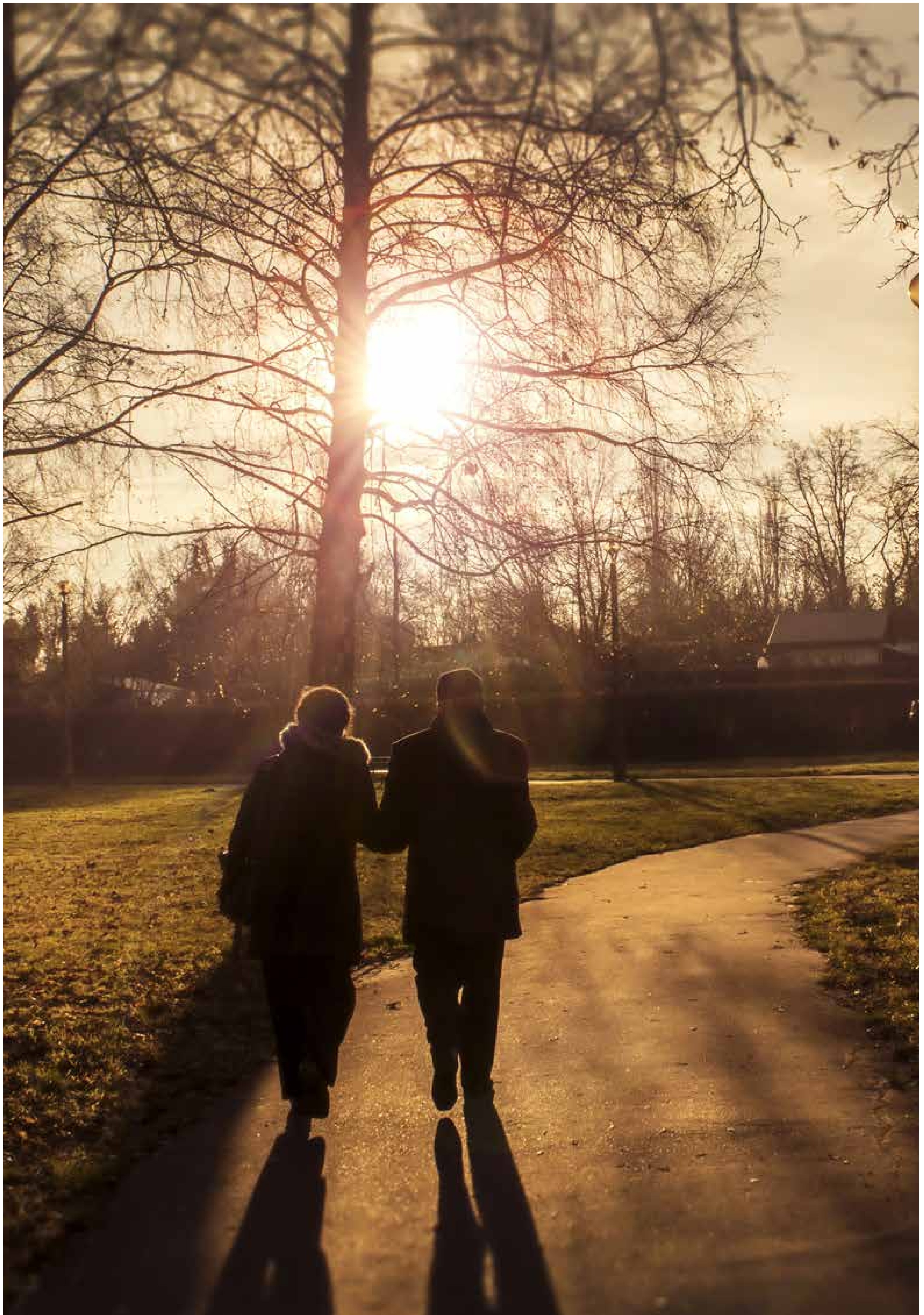
Introduction

Following the introduction of pension freedoms in the UK in 2015, we explore defined contribution (DC) default design and consider some principal challenges for DC pension providers. In particular, we ask whose needs should be foremost in default design, identifying those members most likely to rely heavily on the DC plan to sustain their standard of living through retirement. We consider how we can best meet the needs of that group and find there is a clear case for reviewing the role that tax-free cash has played in defining lifestyle profiles.



Executive summary

The UK's Pension Schemes Act 2015 presents multiple challenges for both DC members and scheme providers. While the ultimate aims of the reforms are clearly stated – including 'value for money' and 'good retirement outcomes' for DC members – there is scant guidance for providers as to what these objectives actually mean, let alone how they might be achieved.

In designing the default investment strategy, scheme providers need to budget for members' behaviour. Theory would indicate that portfolios can be aggressively managed in the early stages of pension saving. In practice, the investment results in very early years have limited impact on the final retirement outcome but can significantly influence members' faith in the value of long-term saving and investment. For novice investors, this can permanently blunt their appetite for risk or, worse, cause complete disengagement. For members to remain engaged, the default investment strategy offered by the plan must not only deliver good, consistent outcomes but also match the risk expectations of members.

Whose needs are paramount in default investment strategy design? We believe no single solution can truly meet the needs of all members. It is also a mistake, in our view, to design the default around the needs of an 'average' member. The wealthiest have means and access to independent advice and so will remain in the default only if it happens to be aligned with their needs. Those who make little or no commitment to the scheme in terms of contributions cannot reasonably expect to rely heavily on the outcome. The needs of these two groups should not therefore be paramount in the design of the default investment strategy.

The default is the engine of growth that is vital in delivering a good outcome for those who are truly dependent on the scheme to sustain their living standards through retirement.

We conclude that default design should prioritise the needs of committed savers, the 'squeezed middle' who are most dependent on a favourable outcome but have limited resources. With this in mind, we focus on changes to the 'lifestyle' approach used in many default investment strategies that could materially improve the results.

The traditional lifestyle approach is geared towards tax-free cash and annuity purchase. The design of lifestyle default strategies today should reflect the reality of continued investment activity into retirement, that much is clear. However, equally anachronistic is the cash pot that is typically built up in the later years leading to retirement in order to provide tax-free cash. For the squeezed middle, for whom the pension they receive from the scheme is critical and likely to be only just adequate, these assets are unlikely to be spent rashly.

We conclude there is little logic in the current default design practice of building up a large and unproductive cash tranche in the lead-up to retirement. More productive use of these assets before and after retirement could make a substantial difference to the outcome.

Budgeting for behaviour

In earlier work, we showed that the best DC results come from early and material commitment to appropriate levels of pension contribution (https://uk.standardlifeinvestments.com/WP_Investment_Challenges_Of_Decumulation_17.pdf). Securing member trust and engagement from an early stage should therefore be a priority. In reality, however, younger employees face what reasonably appear to be more pressing calls on limited disposable income, and saving for retirement is a low priority. Engagement is little better for those in mid-career, sandwiched between servicing debt and caring for children, elders or both. By the time these pressures abate, there remain limited working years and a large savings challenge. Even more imperative, then, that we get the default right for committed savers and ensure it encourages early and continuous engagement.

Historically, default design has tried to cater for the average risk appetite, with 'lifestyling' used to compensate for variations in risk capacity through time. Younger members are assumed to have greater risk capacity, since they are long-term investors and have relatively small financial assets at stake. Conversely, older members have more at stake and less time before retirement. The tendency is for their assets to be progressively de-risked approaching retirement, despite their now potentially having another 20-40 years of investment post-retirement, thanks to the pension freedoms.

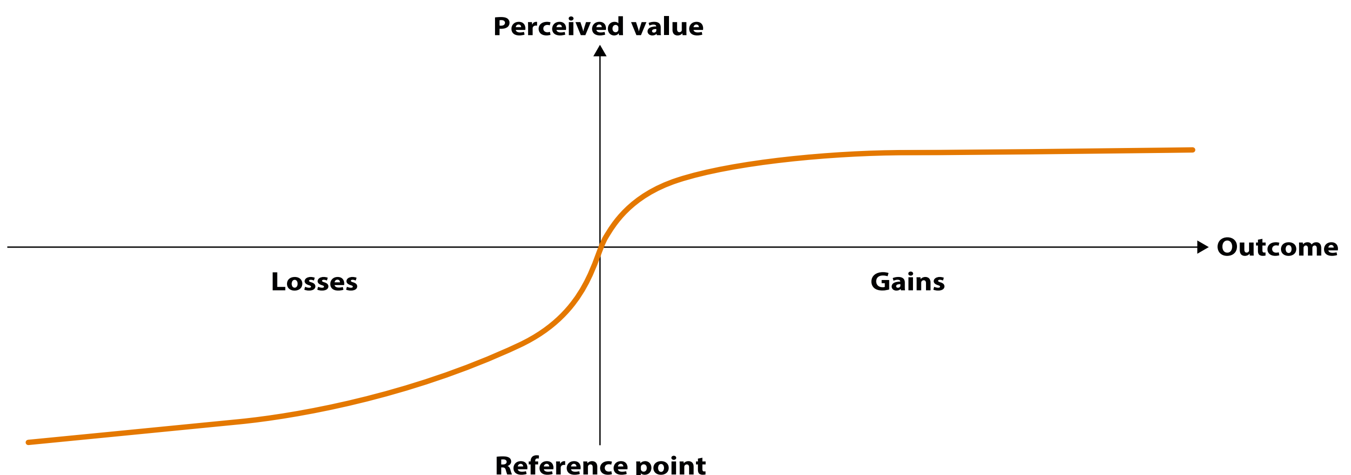
Behavioural finance research tells us that individuals are not always rational and their behaviour is likely to be affected by cognitive biases. For example, 'prospect theory', developed by Kahneman and Tversky in 1979, finds that individuals tend to place more weight on losses than they do on gains of equivalent size (see Chart 1).

This is borne out by various studies of attitudes to investment risk, both qualitative and quantitative. The results showed that the majority of participants were not just risk averse, but also preferred an investment that provided consistency, even after being told higher risk investments would be more likely to result in higher accumulated values. Moreover, they expected their pension savings to behave in this way, delivering stable, low-risk returns.

In one such study conducted by the Department of Work and Pensions (DWP), 68% of participants agreed it was better to play safe with your savings, even if taking more risk could make you more money (DWP Attitudes to Pensions 2009).

This is aligned with the experience of Standard Life (now part of our parent company Standard Life Aberdeen). Of customers who complete a risk appetite assessment (with or without an adviser), only 7% select a high-risk investment from a range of risk-based fund options, while over three-quarters choose medium or low-risk options. This insight is important, and goes beyond the pension regulator's requirement that the default design takes account of members' risk appetite. It tells us that an investment solution that does not behave in the expected and desired way could potentially mean a loss of trust and member confidence.

Figure 1: Losses matter to investors more than gains



Source: Kahneman and Tversky - Prospect Theory: An Analysis of Decision Under Risk, 1979

In a world where DC schemes are the main source of retirement income, contribution levels are the largest single factor influencing outcomes. Therefore, it is vital to maintain engagement throughout the savings period. Poor experiences, particularly in the early stages, may well discourage further engagement.

However, greater engagement makes it more likely that members will be aware of fluctuations in the value of their savings. If there is volatility, this in turn increases the risk that they lose confidence and composure during their savings journey. That could mean contribution rates never get close to levels necessary for a comfortable retirement.

Research conducted by the UK government's workplace pension scheme NEST in 2014 revealed that the most commonly stated response to loss was to stop contributing or to switch to a lower-risk fund.

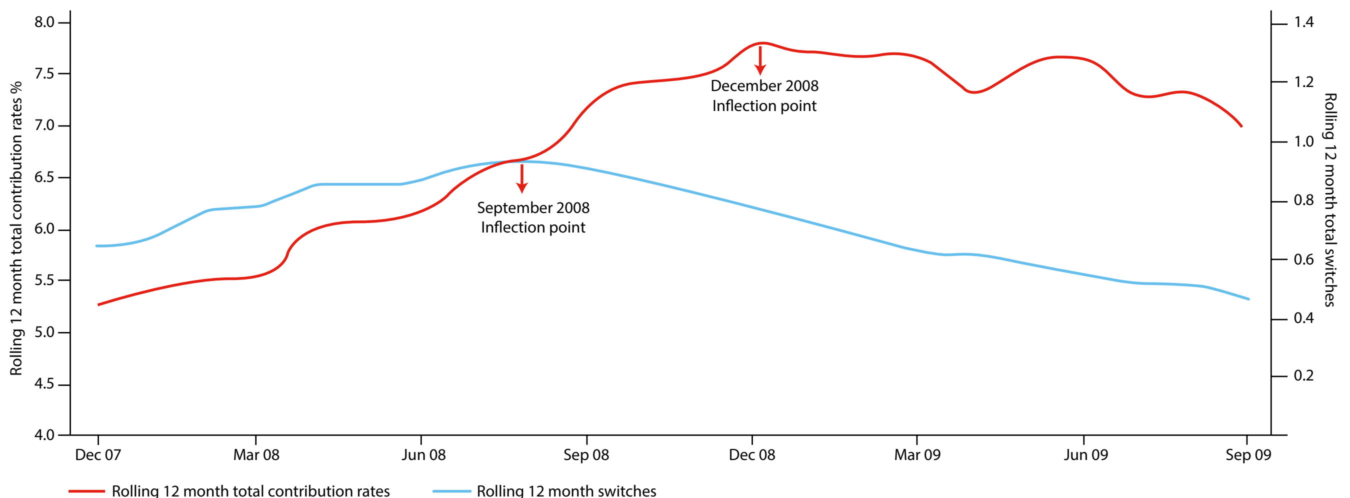
NEST also looked at the actual contributions and switching behaviour of 25,000 UK DC pension savers in December 2007 and September 2009 (i.e. immediately before and after the financial crisis). They found that contribution rates, which had been trending upwards during preceding years, fell in the immediate aftermath of market lows, as shown in Chart 2 (NEST: Improving Consumer Confidence in Saving for Retirement 2014). Clearly, we can only expect members using the default investment strategy to remain engaged if they are confident it will not only deliver good and consistent retirement outcomes, but will also match their risk expectations.

However, as we saw in Part 1 (https://uk.standardlife investments.com/WP_Investment_Challenges_Of_Decumulation_17.pdf), the level of potential return also plays a highly significant role. Only members with very high contribution rates can expect to take little investment risk and still retire comfortably. Good default design is a compromise that maximises return potential within the level of risk members are willing to tolerate at the various stages of the pension savings journey.

In this context, however, we cannot infer that 'attitude to risk' corresponds directly to investment 'risk appetite'. As we saw, the latter has important implications for the required level of contribution and/or the scale of the likely outcome. Risk should more accurately be thought of as the likelihood of failing to achieve an acceptable pension outcome.

For example, for a member who cannot afford to increase their contribution, reduced investment risk can simply increase the likelihood of a failed outcome. This is much more subtle than the traditional age-related profile commonly seen in default lifestyle funds.

Figure 2: Fund activity of actual DC savers before and after the 2008 credit crunch



Source: NEST

Whose needs are paramount?

No wonder, then, that it is impossible to construct a single DC default solution that will meet the needs of all members. This being the case, it makes sense to direct efforts towards meeting the needs of those members who are most reliant on the success of the default investment strategy. Who, then, is most critically reliant on the default? And if we focus on their interests, are others materially disadvantaged?

Consider a typical DC plan membership profile, shown in Chart 3. We identify three distinct groups of member and consider some broad characteristics that might reasonably be inferred.

Group 1 (blue) - the wealthiest 5%
Wealthy individuals tend to be most engaged and more commonly recognise the value of seeking investment advice. Insofar as they do, these members will only remain in the default investment strategy if it happens to be relevant and suited to their individual needs. If not, then their wealth is likely to cushion against any adverse long-term consequences. Consequently, orienting default design around the needs of this group is arguably less critical to their retirement outcome despite the scale of their assets (42% of the scheme assets in the profile in Chart 3).

Group 2 (green) – the disengaged 'tail'
Despite the prominence of pension issues today, there are many for whom saving for a pension remains an unaffordable luxury or otherwise low on a long list of priorities. Minimal contribution rates and low salaries mean that many members will rely primarily on state benefits to provide their retirement income. Any savings they do accumulate in DC pensions will likely make little overall difference to their long-term retirement lifestyle.

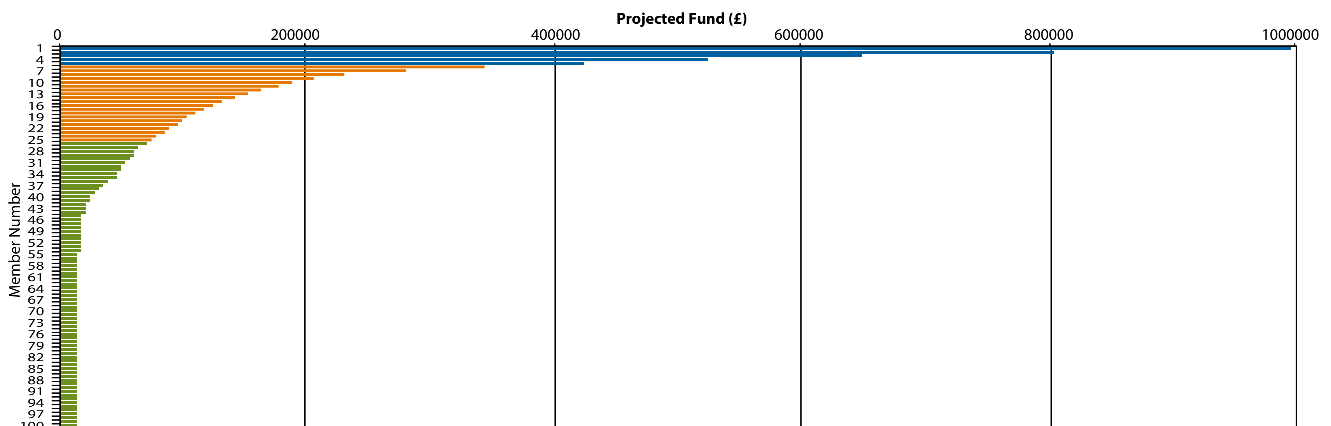
This group is typically not engaged, is unable or unwilling to contribute much above that offered by the employer and accumulates too small a pension pot to reasonably expect to rely solely on the DC scheme in retirement. Many in this group are likely to take their entire pension pot at retirement, to spend or reduce debt, not to invest.

Arguably a lifestyle glide path that de-risks completely would suit these members, but what of the consequences for others? While there may be many members in this group, their collective assets will represent only a small proportion of the plan (20% in the profile in Chart 3). Among them will also be some late-starters who are committed contributors with meaningful benefits in other plans. Their needs are different again.

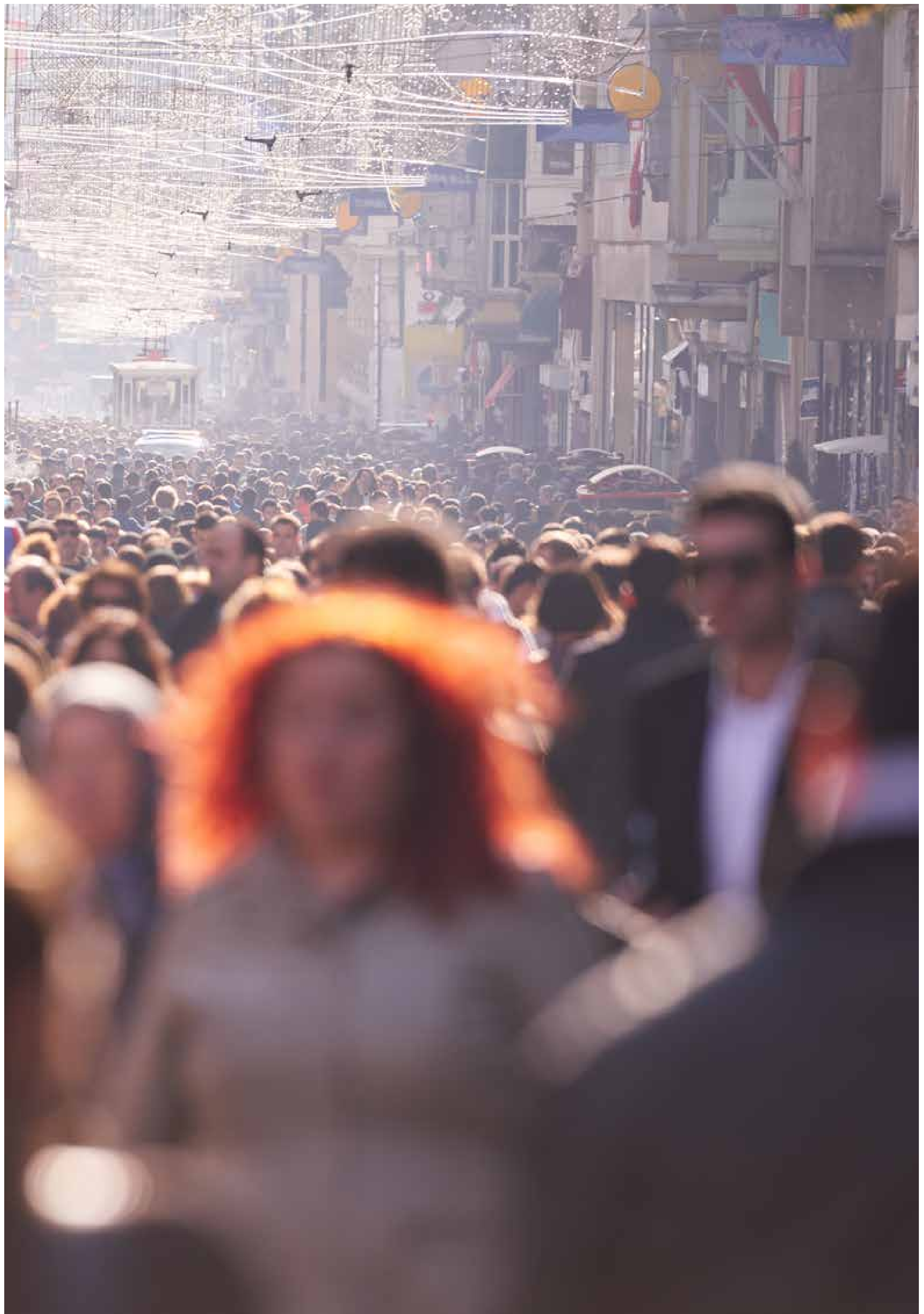
Group 3 (orange) – the 'squeezed middle'
Between the other two groups is a group of people who do contribute personally, foregoing consumption today to secure a retirement not solely reliant on the state. For this group, the expense of bespoke advice is unappealing and the ability to make informed personal investment decisions rare. Critically reliant on the quality of the default investment strategy and personally invested to the tune of 40% of plan assets (in the profile in Chart 3), it is these members who form the majority of engaged default investors. We suggest it is they who should be foremost in the minds of those devising the default investment solution.

What common characteristics of this group might inform the design process? Few, if any, will have saved so much that a risk-free investment will suffice in delivering an acceptable retirement outcome. Given that higher returns are needed, we highlighted in Part 1 the importance of advanced multi-asset solutions in improving risk-adjusted returns. But what of the lifestyle profile/glide-path that has historically altered the risk of the default investment strategy as retirement approaches?

Figure 3: Typical DC scheme membership profile



Source: Standard Life/Aberdeen Standard Investments



The lifestyle profile: tax-free cash or better pensions?

In the days of compulsory annuity purchase on retirement, the option to take up to 25% of the pension pot as tax-free cash provided an appealing once-in-a-lifetime lump sum. Often used to pay off a mortgage, buy a new car or take a vacation, it was considered a start-of-retirement perk and an incentive to accumulate pension savings in the first place.

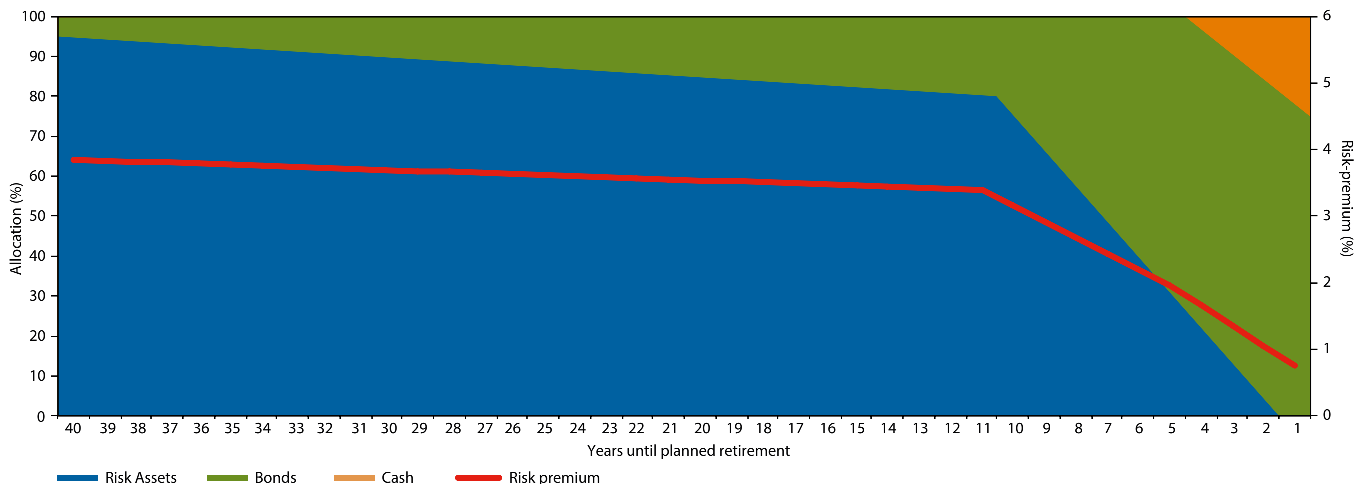
With members now having full access to their pension assets and a broad array of post-retirement investment choices, we suggest lifestyle glide-paths require a complete overhaul. For the growing numbers opting for drawdown, it is vital their assets can generate sufficient growth to provide a sustainable income throughout retirement. This is incompatible with a pension pot consisting largely of cash and bonds at retirement. In addition, the focus on providing tax-free cash is potentially costly and at odds with the interests of the squeezed middle identified earlier.

Consider a typical DC glide-path aimed at buying an annuity at the point of retirement (see Chart 4). The red line running through the middle represents our forecast of the potential excess return of the portfolio. Notice how it dips markedly at the right-hand end in the years leading up to retirement.

At retirement, this glide-path leads to an asset mix of 25% cash and 75% bonds. In other words, after the tax-free cash has been taken, the portfolio consists entirely of bonds. This is not the optimal investment strategy for the majority of DC members who today choose drawdown. It lacks diversification, offers a low yield and has limited long-term return potential that could be vital in sustaining income over potentially 20-40 years of retirement.

It is clear the landing site for lifestyle glide-paths needs to be redesigned towards a portfolio more appropriate for drawdown investors. We also need to consider the needs of our squeezed middle. Is their priority a new car or a holiday or is it sufficient assets to sustain a comfortable standard of living through retirement?

Figure 4: Return potential of a typical DC lifestyle strategy



Source: Aberdeen Standard Investments

'Tax-free assets'

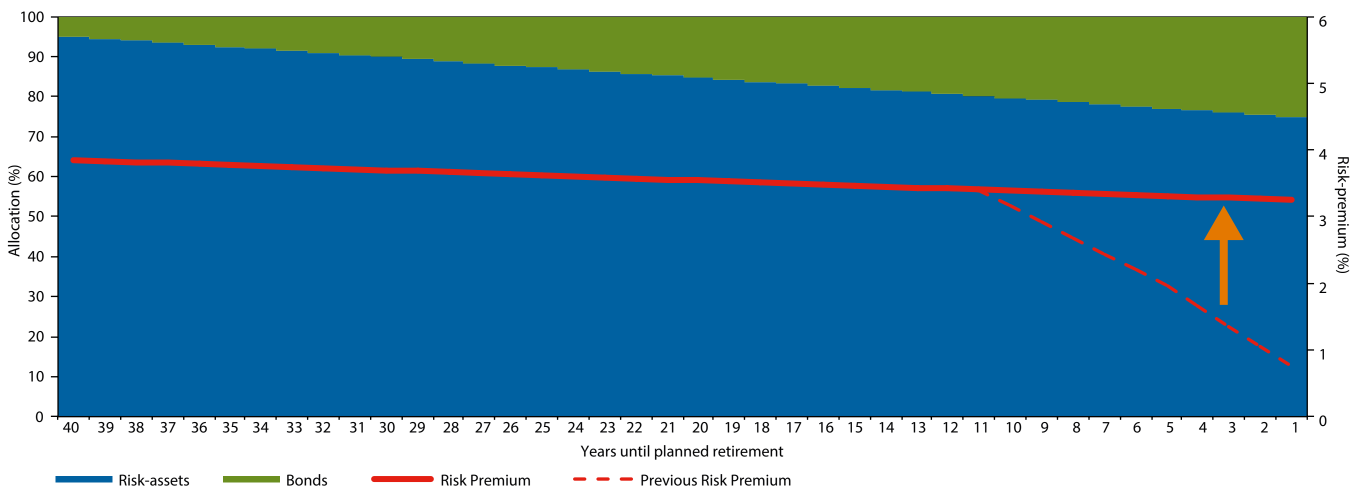
Our quest for a glide-path better-suited to the needs of the squeezed middle led us to explore the concept of 'tax-free assets' in place of tax-free cash. Given their modest contribution rates, many of these members face a fall in their standard of living post-retirement. What they have saved will make a great difference compared with relying on state benefits alone. Therefore, spending one quarter of their pension pot will also have a huge impact. They are unlikely to do so without very careful consideration and forward planning. Indeed, given the personal nature of this choice coupled with the extent of the retirement freedoms, there is no need for the default glide-path to design in this choice, especially given the scale of the consequences.

We modelled a revised glide-path that removes the build-up of the cash pot prior to retirement and also targets a portfolio more consistent with the post-retirement needs of drawdown investors (see Chart 5). So, instead of 25% cash and 75% bonds, the pension pot retains a substantial proportion of growth-generative risk assets (75%) with a material but smaller allocation to bonds (25%). The member can still choose to remove assets as they please. A portion, at least 25%, remains tax-free. These assets can be invested or spent but, if the latter is their objective, then it is their responsibility to plan appropriately. Is it really the responsibility of the pension plan to fund holidays and new cars for some, at the expense of better pensions for others?

We find that, compared with the traditional lifestyle model in Chart 4, this tax-free asset approach generated a pension pot that was on average over 17% higher at retirement. In the context of the squeezed middle struggling to sustain their lifestyle, this is a highly significant improvement.

Moreover, for the majority of members choosing drawdown and continuing to invest after retirement, the exposure to growth assets and bonds is better-suited to generating income throughout retirement. Additionally, it avoids the need to 're-risk' an inappropriately bond-oriented portfolio, removing the associated market-timing risks.

Figure 5: Return potential of modified glide-path strategy, replacing tax-free cash with 'tax-free assets'



Source: Aberdeen Standard Investments

Conclusion

Behavioural studies tell us that good default investment strategy design is a compromise that maximises return potential within the level of risk members are prepared to tolerate at various stages of the pension savings journey. Members will remain engaged only if they are confident that the default will not only deliver good and consistent retirement outcomes but will also meet their risk expectations.

Given the impossibility of creating a single default to suit all members, we argue the default and its associated lifestyle glide-path should be designed around the needs of the squeezed middle that is likely to be most heavily dependent on it for a comfortable retirement. With this group in mind, and with continued investment now the preferred retirement option for most members, the redesign of the lifestyle glide-path has a critical role to play. Building up a large and unproductive cash allocation is inappropriate when members can in any event access their entire pot should they wish. The prize offered by a more holistic through-retirement default investment strategy design is a material boost to the size of expected pensions.

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