HYMANS ROBERTSON

Improving DC member outcomes through smarter default investing

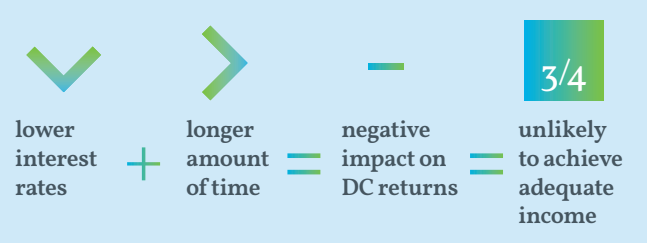
Following the EU referendum and the US election result last year, we have seen sizeable swings in markets over the course of 2016. Yields on government debt in particular have often resembled the trajectory of a roller coaster ride over the past year.

We are now in a world where traditional "low risk" asset classes are exhibiting significant month to month volatility, and where traditional "risky" asset classes have relentlessly climbed higher and higher defying most expectations.

What's clear is that returns on most asset classes remain as volatile as ever. Market uncertainty combined with increasing longevity and poor member engagement means a treacherous landscape for defined contribution (DC) members.

But expected member returns could be improved by making DC investments work harder to offset the implications of lower yields and lower growth environment.

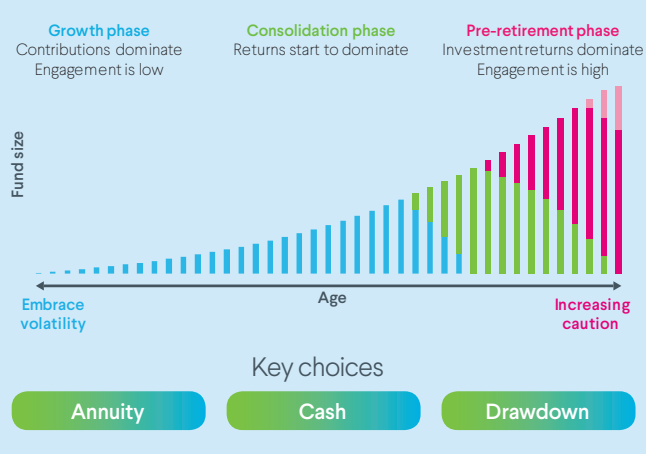
Low yield, low growth reality: as we have moved to a lower for longer environment, the proportion of DC members unlikely to achieve an adequate income in retirement has steadily risen to three-quarters.



Some savers will now need to contribute up to 20% of earnings to their pension over their working life to be able to retire on an adequate income. For many this is just not realistic. Fortunately there is scope to make investment strategies work harder to close the gap.

Rethinking the growth phase

There are three distinct phases when investing in DC pensions: Growth, Consolidation and Pre-retirement. We believe more can be done in the growth phase to maximise gains for scheme members.



Many default strategies in the market place are too focussed on short term volatility management in the growth phase, often with large allocations to Diversified Growth Funds (DGFs). In, our view, this emphasis on short term risk management is detrimental to long term returns for members. During the growth phase, when contributions dominate, members should prioritise seeking returns. This could lead to higher short-term volatility, but that is relatively unimportant in the context of a member's final pot size. Moreover, there is no evidence that market volatility leads to increased member opt outs.

"Paying high charges to minimise short term volatility when you're 30 or 40 years out from retirement does not seem value for money. By reducing the focus on controlling short term volatility at this stage of investing and implementing a low cost, high expected return solution, we can significantly improve member's final fund size.

The common approach of 50% DGF and 50% traditional passive equity is an expensive way of ultimately delivering lower fund sizes at retirement. We need to try a different approach in the growth phase which boosts fund size rather than restricts room to grow."

Anthony Ellis
Partner and Head of DC investment

A DC strategy for a low return environment

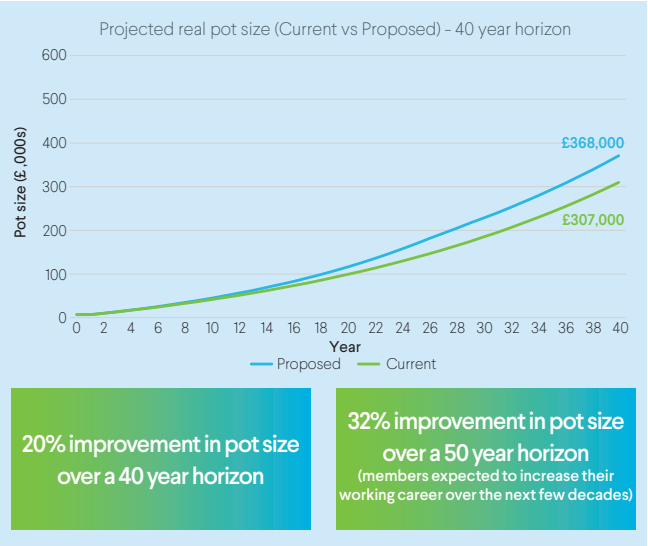
As 'Lower for longer' interest rates appear to be the new normal, we need to make pension savings work as hard as possible at the right time in the savings journey. By embracing volatility in the growth phase we can get more people hitting retirement savings targets and rebalance the negative impact of a low growth environment.

How to improve DC investment outcomes

As the scale of assets in DC has grown so too has the range of alternative asset classes and alternative approaches to investment that can be utilised in DC. Our own research has identified factor based investing (an alternative approach to traditional passive investing) as an area where added value can be achieved.

A factor based approach (or "smart beta" approach) is one where indices are constructed and weighted using "factors" such as value, volatility or size rather than the traditional approach of using market capitalisation of companies. This factor based approach aims to remove some of the inbuilt disadvantages of market capitalisation indices such as continually overweighting stocks that have risen in price.

Our research has found that if a 100% factor based equity allocation is used in the growth phase this could deliver a considerably higher pot after 25 years compared to the typical 50% equity/50% DGF allocation.



"If we focus on embedding the right investment characteristics at the right time for members, with less focus on managing volatility in the growth phase and more focus on maximising total long term returns, pension savings can work much harder in the new 'lower for longer' climate, markedly improving outcomes for DC members."

More information

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