Deep Contemplations #2

DC Pensions in Wonderland

July 2017

"Would you tell me, please, which way
I ought to go from here?"

"That depends a good deal on where you
want to get to," said the Cat.

"I don't much care where –" said Alice.

"Then it doesn't matter which way you go,"
said the Cat.

"– so long as I get SOMEWHERE," Alice
added as an explanation.

"Oh, you're sure to do that," said the Cat,
"if you only walk long enough."

Alice's Adventures in Wonderland, Chapter 6

Summary

This paper reviews the default strategy of 29 of the larger Defined Contribution pension propositions currently available in the UK. Our aim is to try to understand whether buyers of these defaults, or those enrolled in them, are given enough information to make an informed choice.

To make this assessment, we have used the four questions previously identified in Deep Contemplations #1:

1. What will I get out?
2. How much needs to be put in?
3. How much will be charged in fees?
4. Am I on track?

Our key findings are:

- Communication of objectives and risks is inconsistent across propositions despite regulators providing guidance about the information that should be set out. Ambiguous objectives make it difficult to see what buyers might get out of a particular proposition at retirement in most cases.

- There is a worrying disconnect between the stated objective of the proposition and the end benefits aimed for. There is also no link made between what is paid in and what is projected to be paid out at retirement.

- Benchmarks for measuring and comparing performance rarely align with objectives and few propositions offer clear risk controls. This makes it difficult for savers to know whether they're on course for the retirement they're aiming for.

- Overall, we see the opportunity for improved communication and better-structured explanations of the propositions used for savers' retirement provision. These improvements would help employers to manage their workforce and employees to approach their future after full-time work with greater confidence.

- If the current situation continues, savers will need to carry on wandering, and working, much longer than anticipated to get where they want to be financially.

Introduction

Retirement is a destination. But without clear directions and planning, it's difficult to tell whether you're getting any closer. Saving for retirement through a Defined Contribution (DC) pension is a good starting point. However, many savers are actually wandering like Alice in Wonderland – hoping they'll eventually find their way, wherever they're going.

We want to help more savers and employers get to their desired financial destinations in good time. By asking the right questions today, we believe we can help people providing or paying into a DC pension scheme to identify the right proposition to help them reach the retirement they want.

The purpose of this paper:

In Deep Contemplations #1 we asked: what does good look like in DC?

This question arose from trying to work out, based on third-party research, what savers and employers want from DC.

We established four questions, representing these wants, by which to evaluate both existing DC pension provision and products/services that might be used for future provision:

1. What will I get out?
2. How much needs to be put in?
3. How much will be charged in fees?
4. Am I on track?

In this edition, we want to assess the default options of the main Qualifying Workplace Pension Schemes (QWPSs) in the UK using the information publicly available about them.

Ultimately, we are trying to understand whether buyers of these defaults, or those enrolled in them, are being provided with enough information to make an informed choice.

Which propositions are we looking at?

We have looked at the larger Qualifying Workplace Pension Scheme propositions, and related defaults, using information that is publicly available about them. These consist of 19 master trusts (multi-employer arrangements with a shared provider) and 11 contract-based arrangements (typically a policy by an insurance company). We have also included five investment-only propositions.

This group of 35 propositions includes six cases where the provider offers both a master trust and a contract-based arrangement (i.e. a total of 12 propositions). We have counted these six cases only once each – giving a total sample size of 29 propositions. (See the Appendix for our full list of propositions analysed.)

What do providers need to tell you?

Regulatory guidance exists for the information that should be provided around default options. Separate, but consistent, standards exist for trust-based and contract-based arrangements.

Trust-based arrangements

The Department for Work & Pensions sets out the way in which the default's features should be communicated as follows:

‘The default option should have a high-level objective, which explains in broad terms what the default option aims to do and the strategy it will use to achieve this aim; this should be reflected by its name.’

‘The overall objective should cover a simple description of how the investment strategy will manage risk, including what it aims to achieve for member outcomes.’

Source: Department for Work & Pensions – ‘Guidance on offering a default option for defined contribution automatic enrolment pension schemes’ (May 2011)

Contract-based arrangements

The Financial Conduct Authority's view on all products, not just the default option, is that 'clear product descriptions are necessary for investors to understand which strategies funds follow, how fund managers will invest on their behalf, and what risks are involved when investing. Firms need to provide customers with enough detail about a fund in a clear and concise manner that they can understand. Not providing enough information, or using jargon, can limit customers' ability to make informed investment decisions.'

Source: Financial Conduct Authority – 'Meeting investors' expectations' [TR16/3] (April 2016)

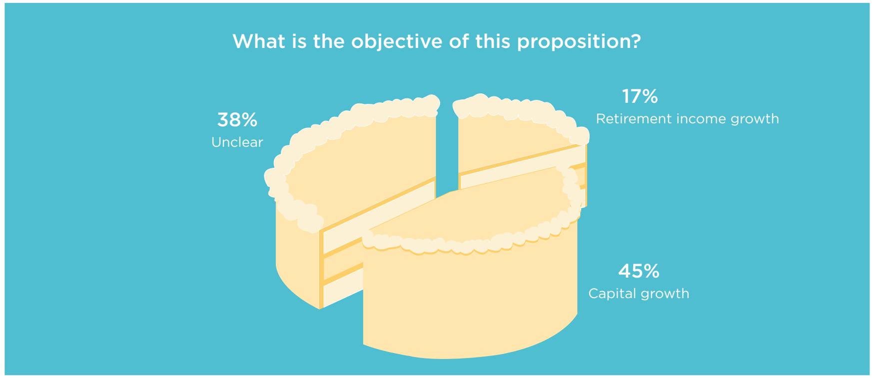
The FCA's Asset Management Market Study (June 2017) flagged 'concerns about how asset managers communicate their objectives to clients.'

So what?

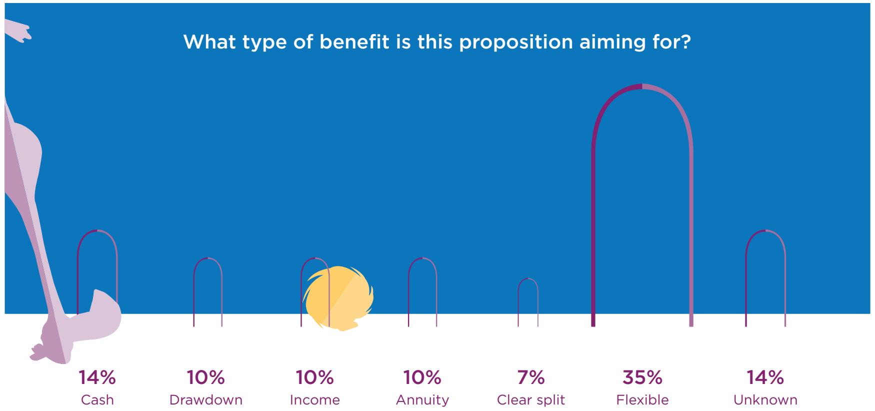
- There is consistent regulatory guidance to make the objective of a proposition and the risks it faces clear. However, this guidance is not being followed, not making it any easier for clients to understand the proposition.

How do the propositions' default strategies stack up against our four questions?

1. What will I get out?



- The **most popular** objective by far is growth of the capital value of savings.
- **Around 17%** of propositions focus on retirement income.
- **38%** of propositions do not make it clear what the objective is, despite the regulatory guidance for this to be unambiguous.
- Several propositions use the same (third-party) investment offering but state **different objectives** (as well as benchmarks, risk metrics and risk budgets).



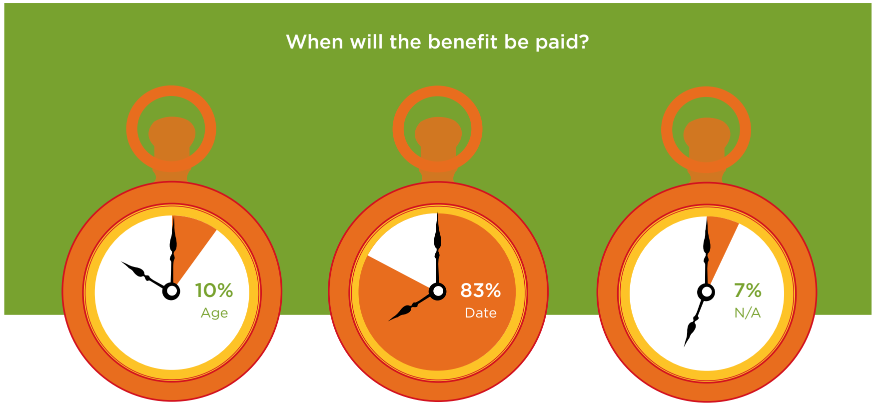
- **The most common benefit being aimed for is a flexible outcome** that allows the saver to choose between cash or a retirement income – either drawdown or an annuity. Covering around **one-third of the propositions**, this reflects the impact of the 'freedom and choice' policy introduced as part of the 2014 Budget.

- A variation of the flexible approach, where the outcome aimed for is **split across the various options**, accounts for a further 7% of cases. Freedom and choice has led to a single savings account having multiple aims in around 40% of all cases.

- **30% aim to deliver a retirement income** of some sort, but 10% don't specify whether this income is in the form of drawdown or an annuity. This 30% figure is far higher than the previous question found, where **only 17%** stated a retirement income as their objective.

- **14%** aim for a cash lump sum. However, nearly half of the objectives stated relate to capital growth which would mean aiming to grow the cash value of the savings. **Only 3%** have both a capital growth objective and aim for cash benefit.

- **14%** do not state what benefit is being aimed for at all.



- The **majority of propositions** are based on the time until retirement rather than a specific retirement age.

- Only **10%** are linked to an explicit retirement age.

- **7%** do not state an explicit retirement age or date – meaning the underlying investment strategy will not change as retirement approaches.

So what?

- **Inconsistent communication** makes it difficult to understand what buyers might get out of most of the propositions.

- Objectives are often not aligned with the target outcomes – nearly 40% have **no clear objective** but still claim to aim for some sort of benefit.

- **Around 30%** claim to target retirement income while **only 17%** state a retirement income objective.

- A single proposition that aims for multiple outcomes presents challenges in **communication, investment and risk management**.

- Propositions based on the same underlying investment products but with **different stated objectives could confuse buyers**.

2. How much needs to be put in?

- **None of the propositions provide an explicit link between** contributions and the expected benefits at retirement.

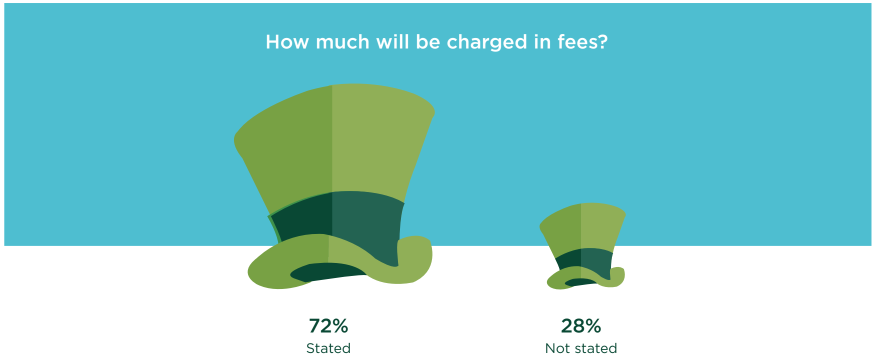
- **Several propositions provide modelling tools** on their websites to help savers work out what they need to put in. However, differences in their structure and underlying assumptions **make comparison difficult**. What's more, these assumptions often do not bear any connection to forward-looking market conditions.

So what?

- It is **difficult to understand what retirement benefits are likely** for a specified level of contributions.

- If a level of retirement benefits is being targeted, it will be challenging to set the related level of contributions.

3. How much will be charged in fees?

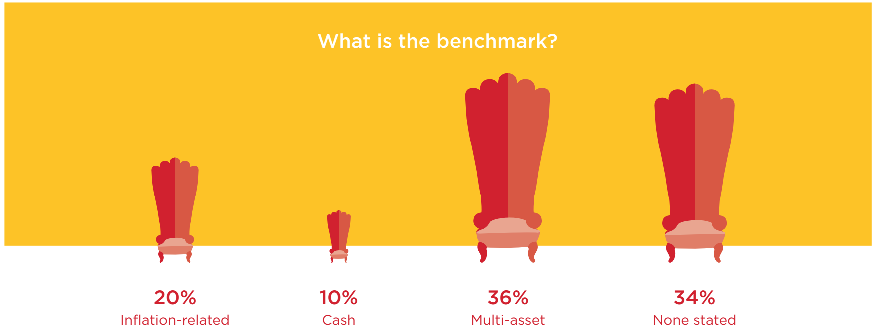


- **Most propositions** set out their charges as part of their upfront communication.
- 28% set charges on **a client-specific basis**, which means having to ask for a quotation before knowing the operational cost of pension provision.

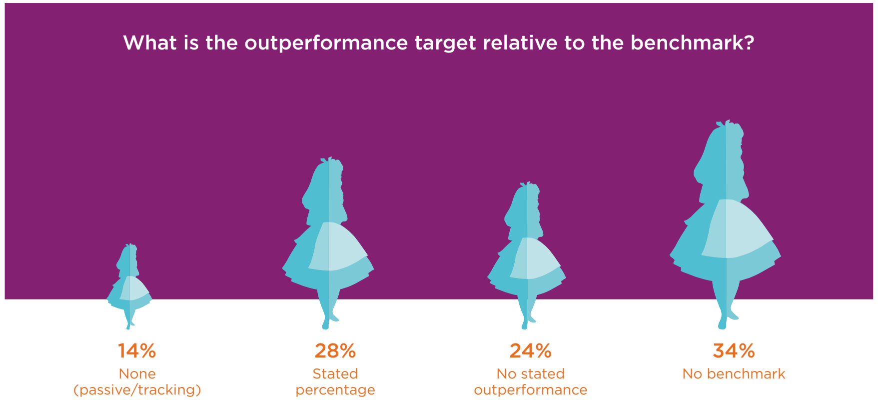
So what?

- It is not always clear what the headline costs of provision are from publicly available information.
- Ongoing industry-wide reviews into costs and charges, by bodies like the Financial Conduct Authority, **will reveal how closely the headline charges reflect the full costs of provision**.

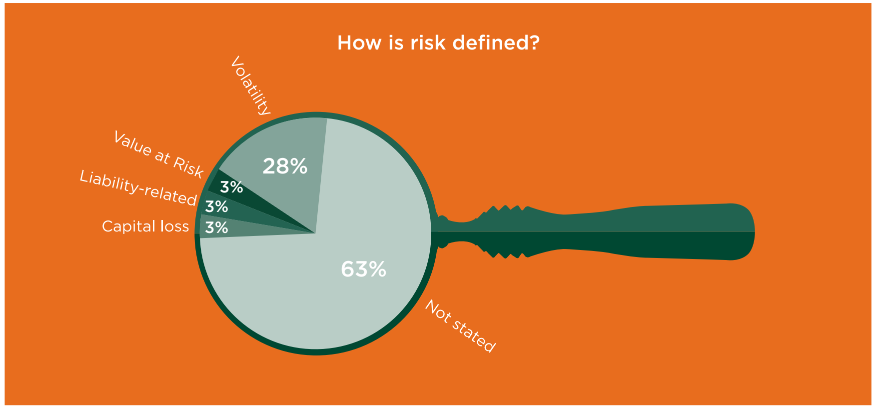
4. Am I on track?



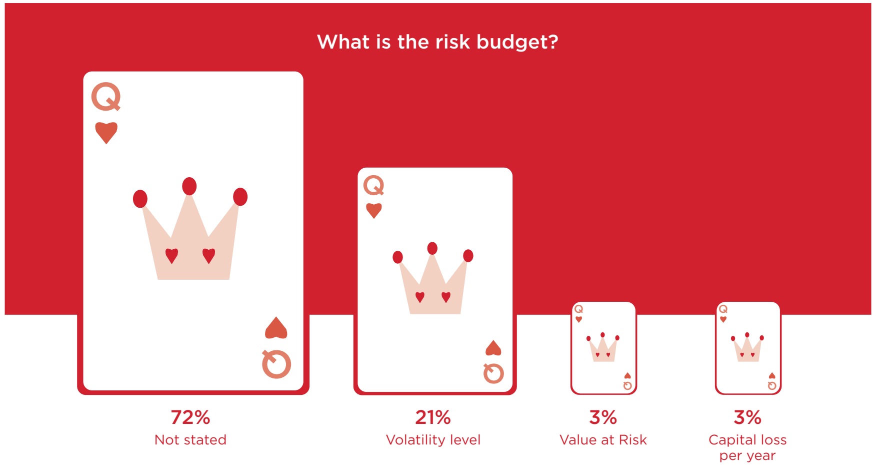
- Around one-third of the propositions **do not have a stated benchmark**.
- A further one-third use benchmarks based on **combinations of multiple asset classes**.
- Around one-fifth **use inflation as the benchmark** – the Consumer Price Index (CPI) in every case but one.
- One-tenth of propositions are **benchmarked against cash** but none of these strategies have an objective of capital growth.



- **24%** of propositions have a clear benchmark but **do not state an outperformance target** relative to this benchmark.
- When you add these cases without outperformance targets to the instances of no benchmark then **58% have no clear performance objective**.
- **28%** of propositions explicitly state the target outperformance relative to the benchmark (e.g. cash +3% p.a.).
- **14%** of propositions are clear that they intend to take a passive approach, tracking the benchmark as closely as possible.



- Nearly two-thirds of propositions **do not define what is meant by risk**.
- **Over a quarter** define risk in asset volatility terms. These are based on current savings and **do not take future outcomes (capital or income) into account**.



- The majority of propositions **do not have a stated risk budget**.
- Almost 30% have a volatility-based risk metric but **only 21% quantify this metric**.

So what?

- We found it **difficult to work out whether a proposition is on track** to deliver on its objectives (in the cases where such an objective exists). There is limited consistency between what many propositions claim to aim to deliver and the related benchmark.
- **Less than a quarter** have benchmarks that align with their stated objectives.
- Over half **do not have an explicit performance target**, making it difficult to work out whether performance is keeping up with expectations.
- Most propositions **do not help buyers understand risk as a concept**, the risk that a particular proposition is exposed to or how this relates to its objective.
- Qualitative terms like ‘medium risk’, ‘balanced’ or ‘cautious’ versus ‘adventurous’ make it **difficult for buyers to make like for like comparisons** – especially as the benchmark and related investment risk differs widely across the same descriptors.

Conclusions

Following these questions, we have arrived at several key conclusions. It's worth considering these conclusions before venturing any further down the rabbit hole into the world of DC pensions.

Beware the information gap

Based on the information that's publicly available, we found it difficult to answer our four headline questions when reviewing the 29 propositions. With this lack of clarity, we expect it to be extremely challenging for buyers to know what they're getting.

Destination unknown

We found that the objective of the various propositions to often be unclear. What's more, there is a lack of alignment between the objectives and the end benefits aimed for. There is also no link made between contribution levels and the retirement benefits projected to be paid. Benchmarks rarely align with objectives and few propositions offer clear risk controls. This makes it difficult for savers to know whether they're on course or even where they're heading.

The need for alignment

The lack of alignment between objectives, target benefits and benchmarks means that achieving the expected outcome on retirement is more likely to be through luck than planning. Disappointment is more likely, which could have consequences for workforce management, labour relations and wider society.

A start, a middle and an end

Buyers need to know where they want to be financially at retirement to stand a chance of getting there. If they don't know, then the proposition should make it clear where they're likely to get to and by when.

In either case, a proposition should help savers achieve the expected outcome by having:

- A clearly stated objective
- A clear link between the objective and savings rate
- Fees that do not make the objective impossible
- A way to monitor progress and check whether you're on track to reach the goal

Without this information, the buyer might enjoy a false sense of security about their future retirement and fail to reach the goal they were hoping for. These savers will need to carry on wandering, and working, much longer than anticipated to get where they want to be financially.

Appendix

Methodology

We have evaluated the default arrangements of the larger Qualifying Workplace Pension Schemes (QWPSs), both master trusts as well as contract-based arrangements, and the more popular investment-only ranges (where these are not offered by an affiliate of the fund manager within a QWPS) by seeking to answer the four stated questions.

We based the responses on publicly available information, e.g. websites and printed materials, as well as follow-ups with the providers where we had further queries or required clarification.

We worked with Jonathan Parker Consulting to gather the underlying information. The base information was collected in May and June 2016 and subsequently refreshed in 2017. We have sought to base our conclusions on data as at 31 March 2017.

The views and analysis expressed are those of Cardano alone. Jonathan Parker Consulting has not had input into the views and analysis.

We have listed the propositions analysed in this paper on the next page.

List of propositions included

Key: CB: Contract-based | IO: Investment only | TB: Trust-based

Provider	Proposition	Default	Type
Aegon	Group Personal Pension Plan	Default Equity & Bond Lifestyle	CB
AllianceBernstein	Retirement Strategies		IO
Atlas (Capita)	Atlas Master Trust	The Passenger	TB
Aviva	Company Pension	Future Focus 2 Drawdown	CB
B&CE	The People's Pensions Scheme	Balanced Investment Profile	TB
BlackRock	BlackRock Group Personal Pension/Master Trust	BlackRock LifePath Flexi	CB or TB
BlueSky	The BlueSky Pension Scheme	Target Date Funds	TB
Cheviot	The Cheviot Trust	The Cheviot Lifeplan	TB
Ensign	Ensign Retirement Plan	BlackRock LifePath Flexi	TB
Fidelity	Fidelity Group Personal Pension Plan/Master Trust	FutureWise	CB or TB
Friends Life	New Generation Personal Pension/Master Trust	My Future	CB or TB
JPMorgan Asset Management	SmartRetirement		IO
LGIM	L&G Pathway Funds	Journey Plan 2	IO
Legal and General	WorkSave Pension Plan/Pension Master Trust	L&G (PMC) Multi-Asset Fund 3	CB or TB
NEST	NEST	Retirement Date Funds	TB
NOW: Pensions	NOW: Pensions		TB
Pensions Trust	Flexible Retirement Plan	Target Date Funds	TB
Prudential	Group Personal Pension	Dynamic Growth Lifestyle - targeting Retirement Options	CB
Railway Pensions Scheme	Railways Pension Scheme Industry Wide DC Section	Long Term Growth Lifestyle Strategy	TB
Royal London	Royal London Group Personal Pension	RLP Balanced Lifestyle Strategy (Annuity)	CB
Salvus	Salvus Master Trust	Cautious Strategy (Goddard Perry Governed Portfolio)	TB
Scottish Widows	Group Personal Pension Plan	Balanced (Targeting Flexible Access) Pension Investment Approach	CB
Smart	Smart Pension	Lifestyle Default	TB
Standard Life	Group Flexible Retirement Plan/ Standard Life DC Master Trust	Active Plus III Universal Strategic Lifestyle Profile	CB or TB
SSgA	Timewise Target Retirement Funds		IO
Vanguard	Vanguard Target Retirement Funds		IO
Welplan	Welplan Pensions	Cash Lifestyle	CB
Xafinity	National Pension Trust	Balanced Growth Strategy	TB
Zurich	Retirement Saver/Zurich Master Trust	Dynamic Interim Lifestyle	CB or TB