

Improving Member Outcomes- Making DC Investment Work

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How do we improve outcomes for DC members?

- 1. DC Schemes must get more care and attention**
- 2. Employees must start saving early**
- 3. Employees and some employers must save more**
- 4. Devising appropriate investment strategies – and monitoring them**
- 5. Ensuring Lifestyle strategies are fit for purpose**

DC investment – getting the attention it deserves?

Existing standards of governance:

- 54% reviewed SIP in last three years (33% never) ⁱ
- 48% schemes review strategy every 3 years ⁱ
- 68% review performance at least once every 3 years ⁱ

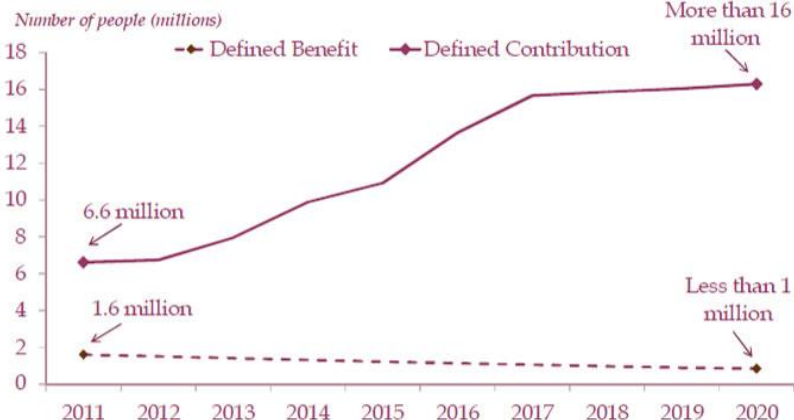
Investment design:

- 18% only offer one fund ⁱ
- 65% small schemes have a default lifestyle ⁱ

The number of savers in private sector Defined Contribution pensions could increase in the future

PENSIONS POLICY INSTITUTE
PPI

Number of people saving in private sector DB and DC pension schemes in the UK



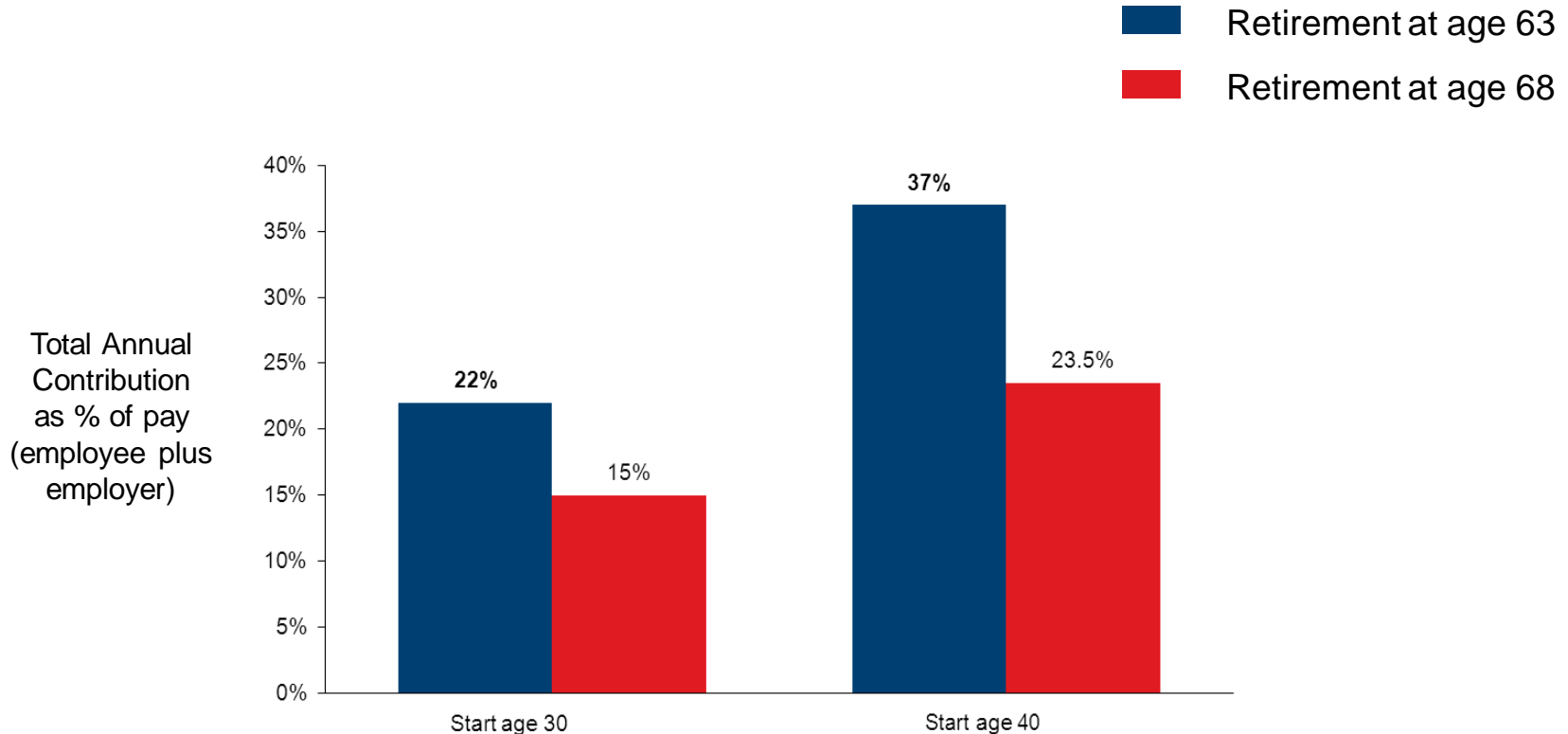
DC default funds expected to grow by a factor of 3.5 over 10 years*

Source: ⁱ Pensions Regulator's 7th annual governance survey 2013 / *NAPF

Savings Rate Targets

How much might need to be saved in order to accumulate an adequate pot?

- Targeting a pension of 50% of pay

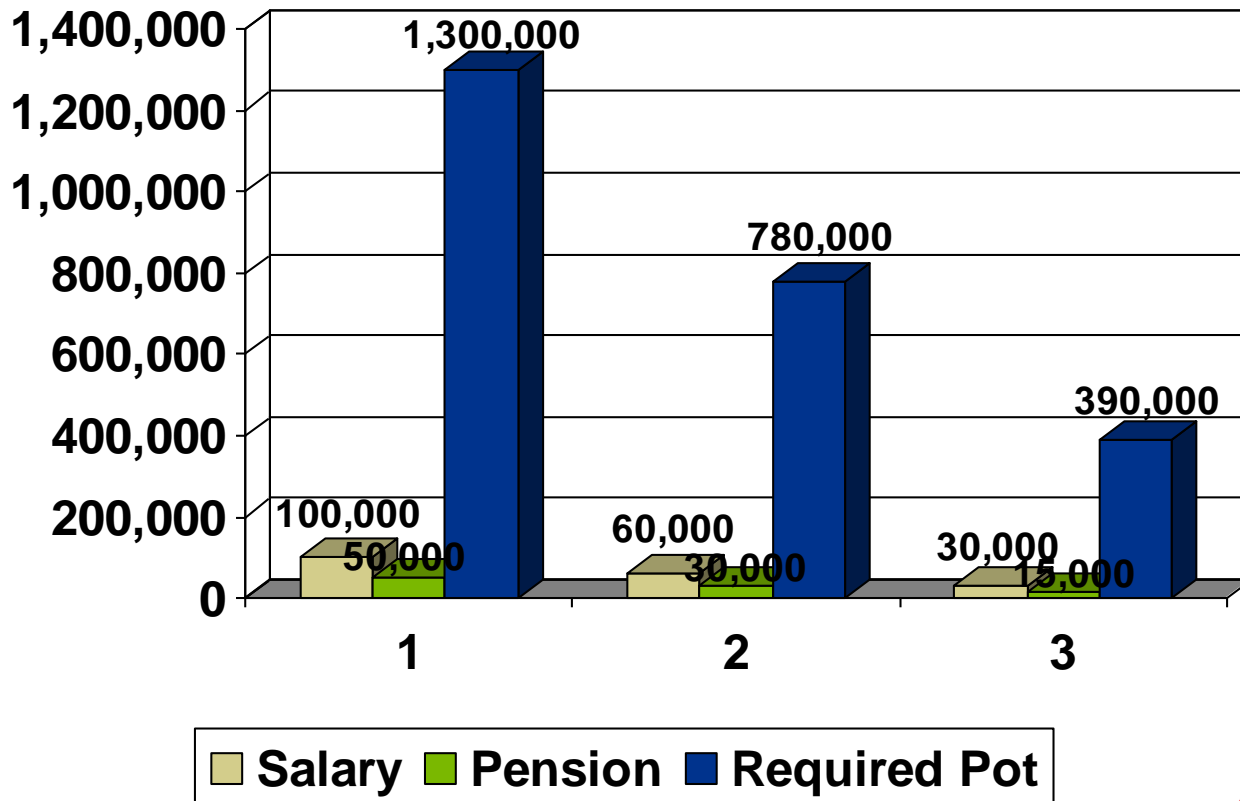


Most members are not saving enough and many may need to work longer

Savings Targets

How much is required to target 50% of salary?

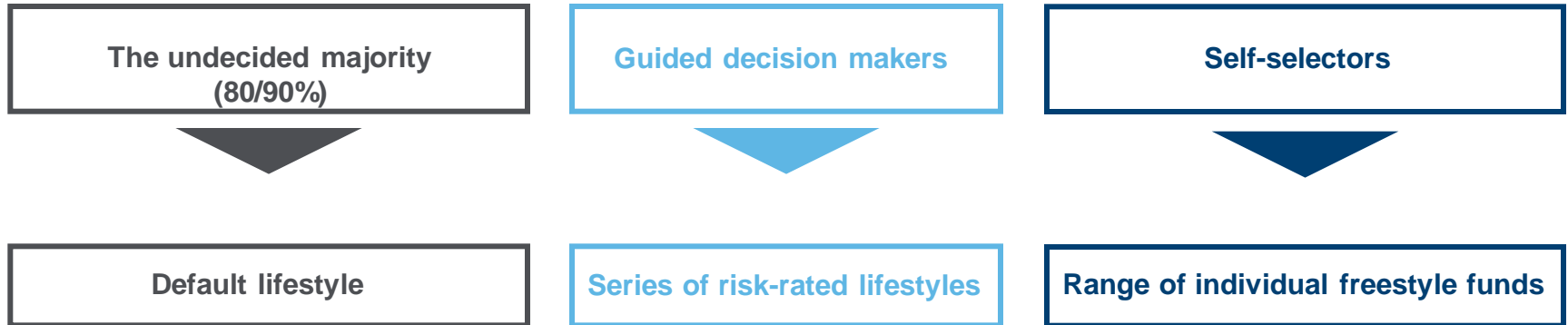
Between 12 and 14 times salary!



Making DC investment work

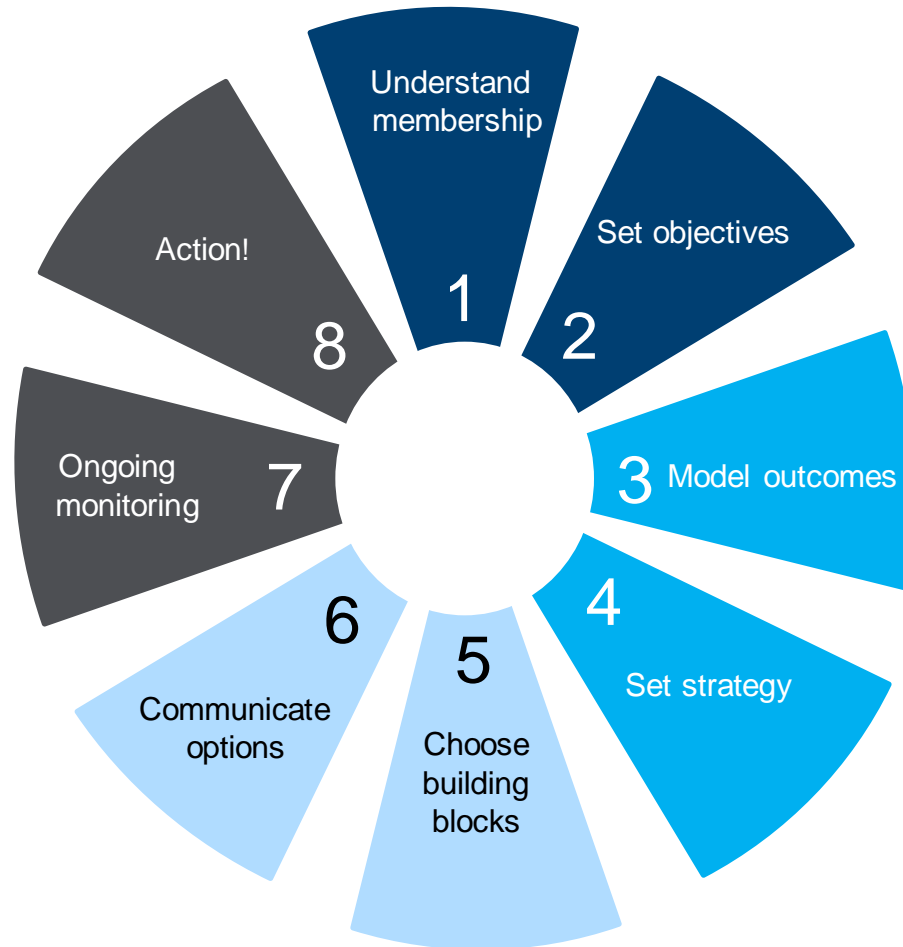
-a robust strategy

Setting strategy – is it all about the default?



Investment design needs to be appropriate for membership

How to set investment strategy



Understand your membership and set objectives



Member profile

Strawman 1

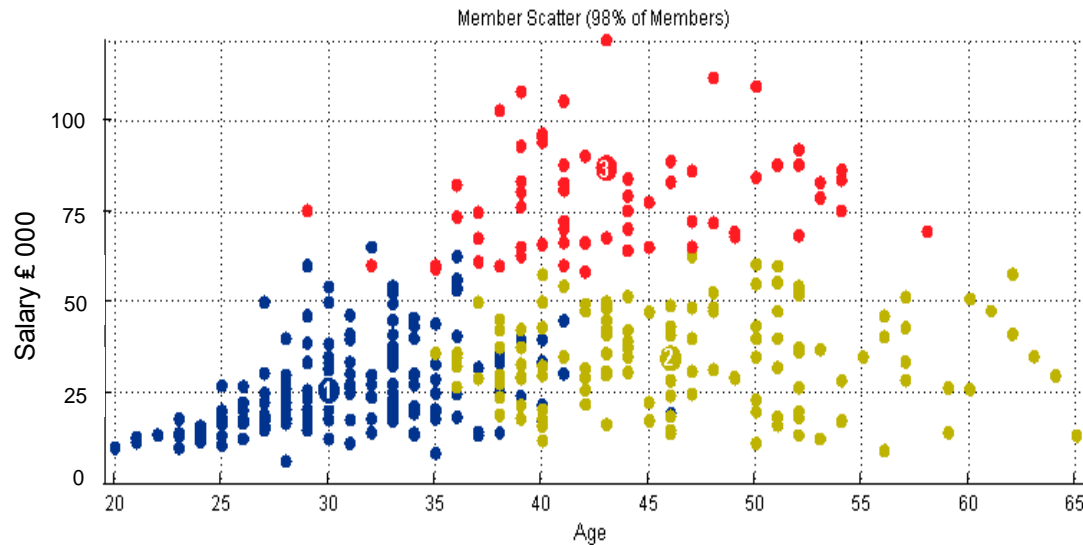
Younger members – high risk capacity initially, reducing later

Strawman 2

Older members – low risk capacity, but need for early growth

Strawman 3

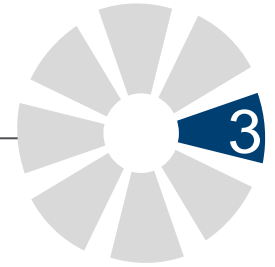
Higher earning, older members – high risk capacity



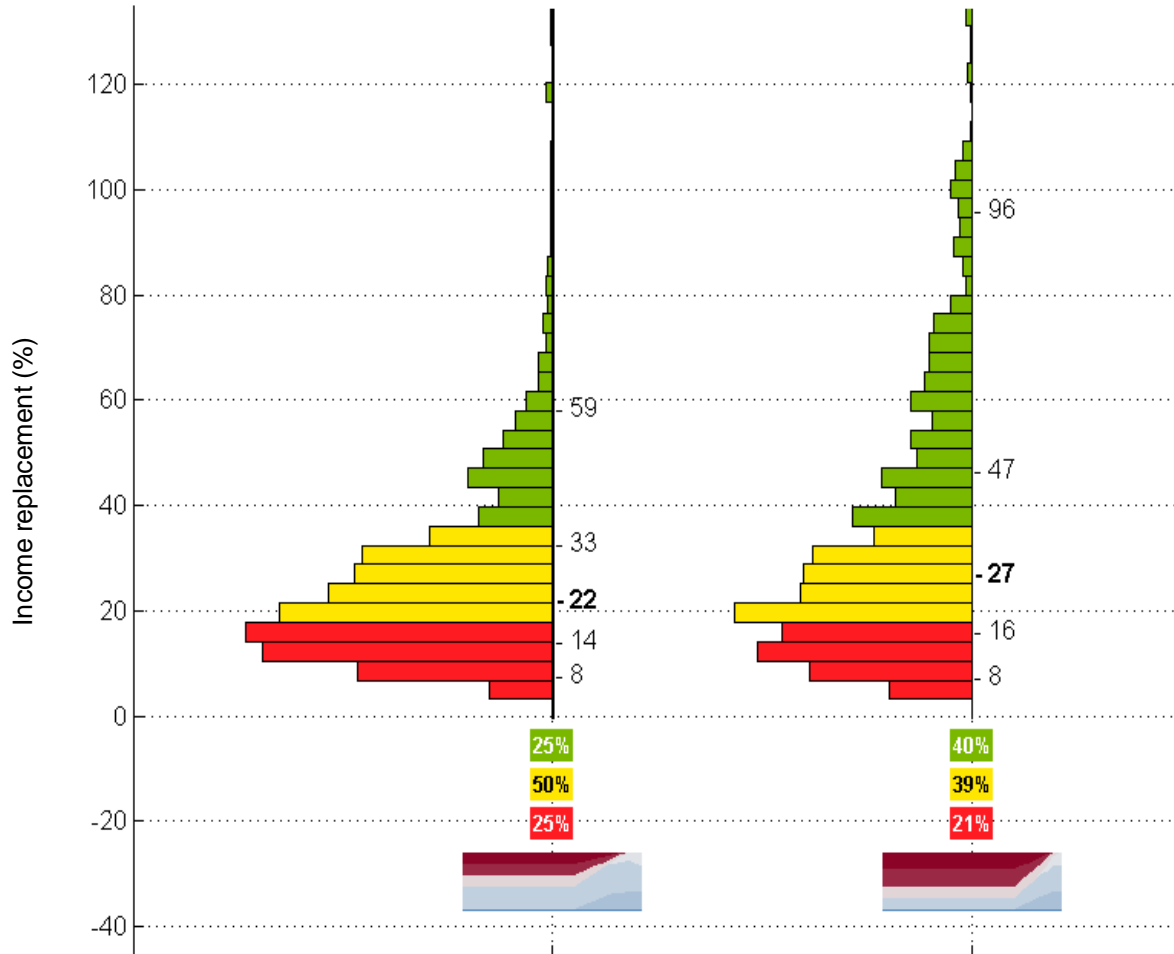
Take account of the needs and profile of the membership

Source: Aon Hewitt DC Analytics

Modelling to determine best fit

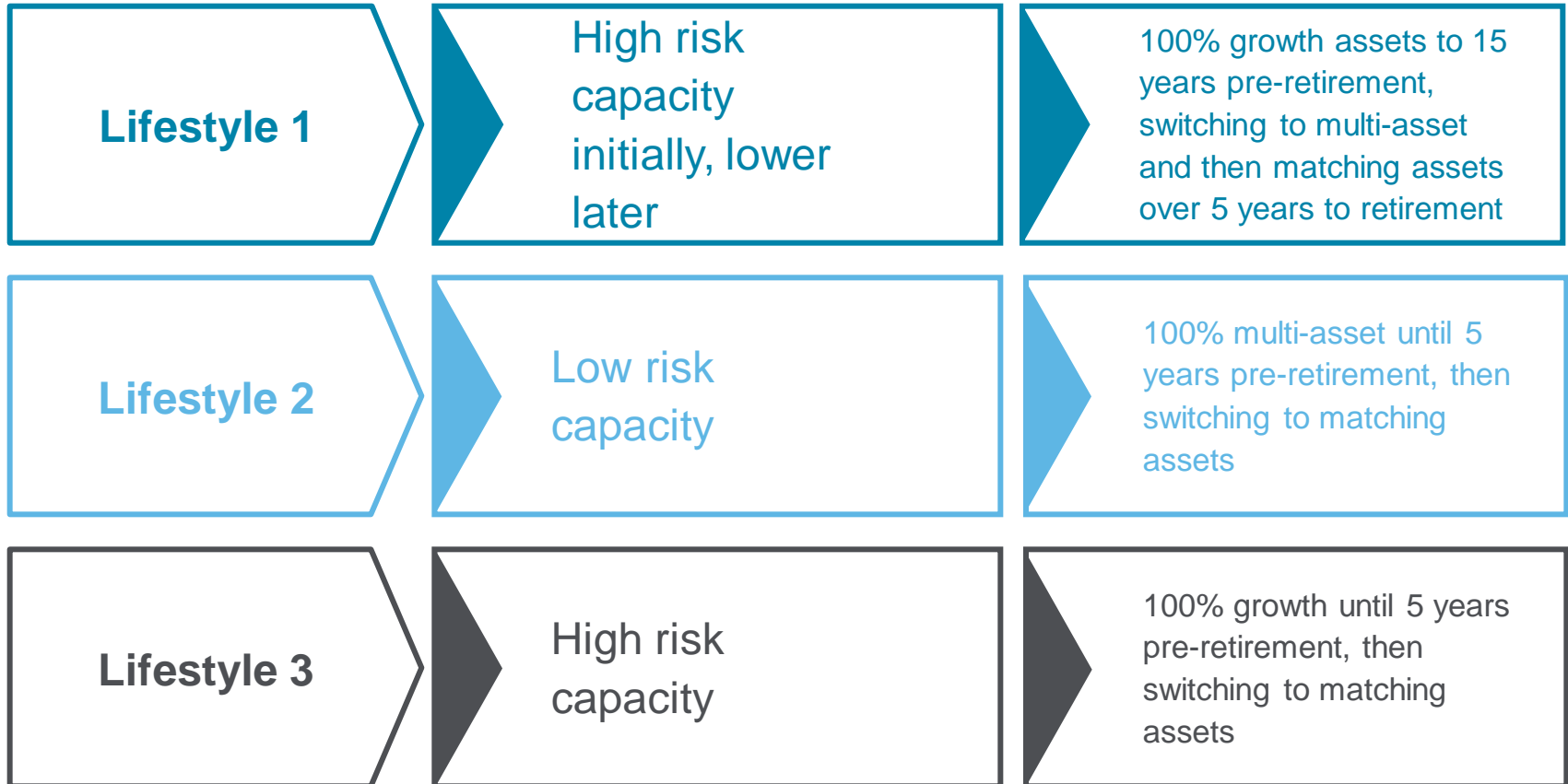


Stochastic projection of replacement ratio at age 65 - strawman 1

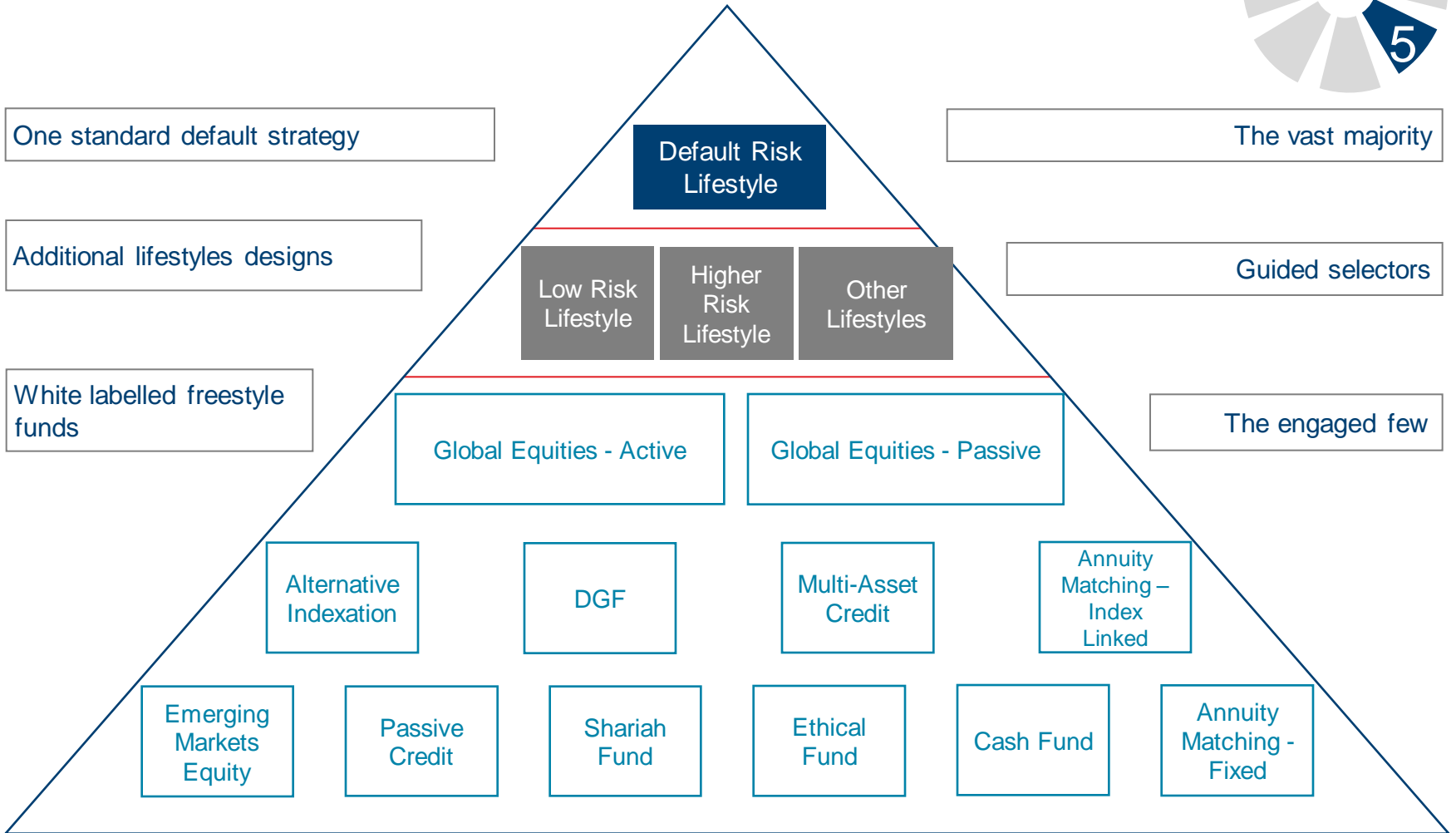


Understanding likely outcomes

Set strategy



Combining the right investment tools with strong governance



Linking to communication strategy



Russell

Russell aims to minimize risks

Russell is 51, single, has only his own income to rely on. He is not comfortable with risk.

Russell chooses the Cautious Lifestyle Approach.



Sarah

Sarah takes the high-risk option

Sarah is 33. Sarah thinks about how she can maximise the growth of her account. She feels she can afford to take some risk and chooses the Adventurous Lifestyle option.

Assist members in translating their circumstances to options

Monitoring what?



Monitoring

- Member choices / behaviours
- Member profile
- Market developments
- Performance including outcomes

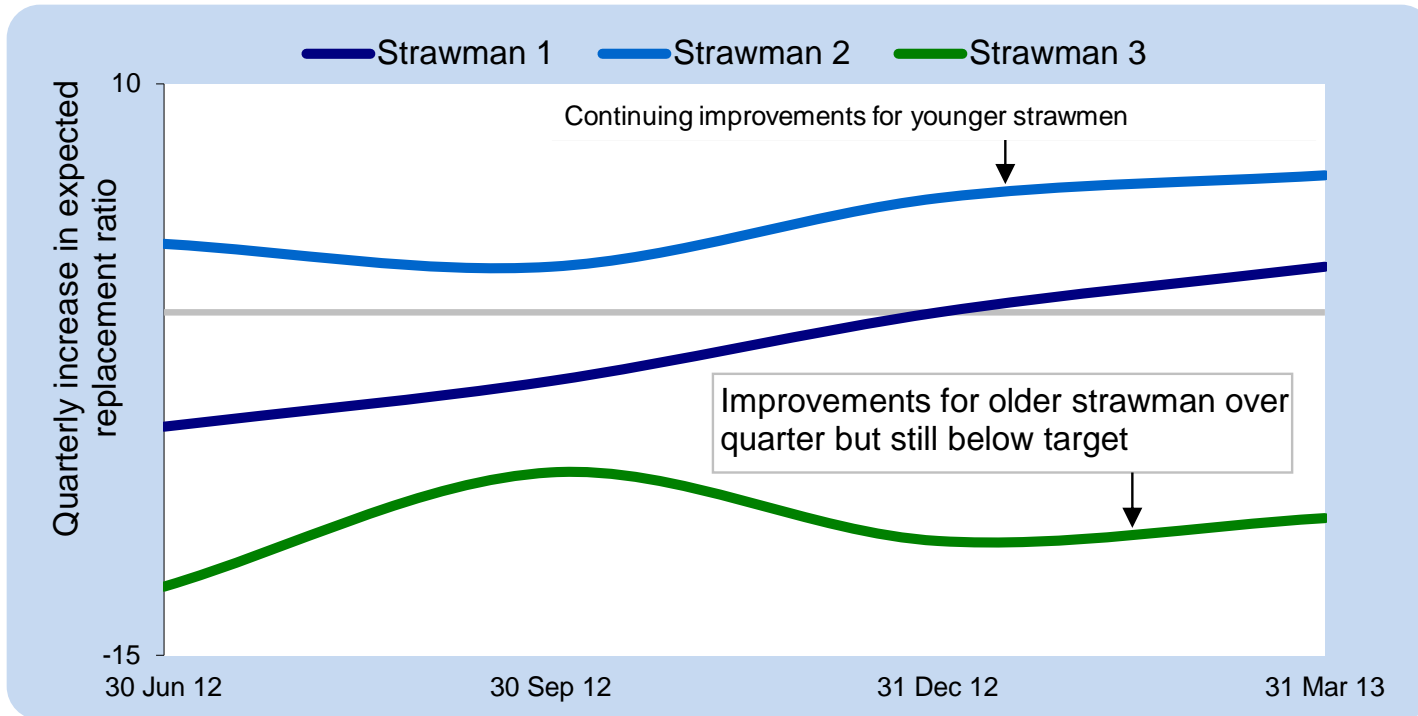


Action

- Communication
- Replace building blocks
- Further review

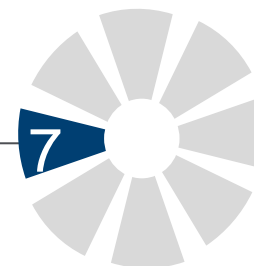
“Trustees should build flexibility into the review and assessment arrangements”

Monitoring outcomes



- Impact on replacement ratio is far more important than relative investment performance
- Performance in pre-retirement phase should also be compared to annuity rates

Applying DB thinking to DC.....



- Clear, colour-rated performance analysis provides red flags where more attention required
- Tolerances set depending on asset type and management style
- Set protocol for responses to red flags
- Assists DC trustees with difficult decisions they need to take on members' behalf

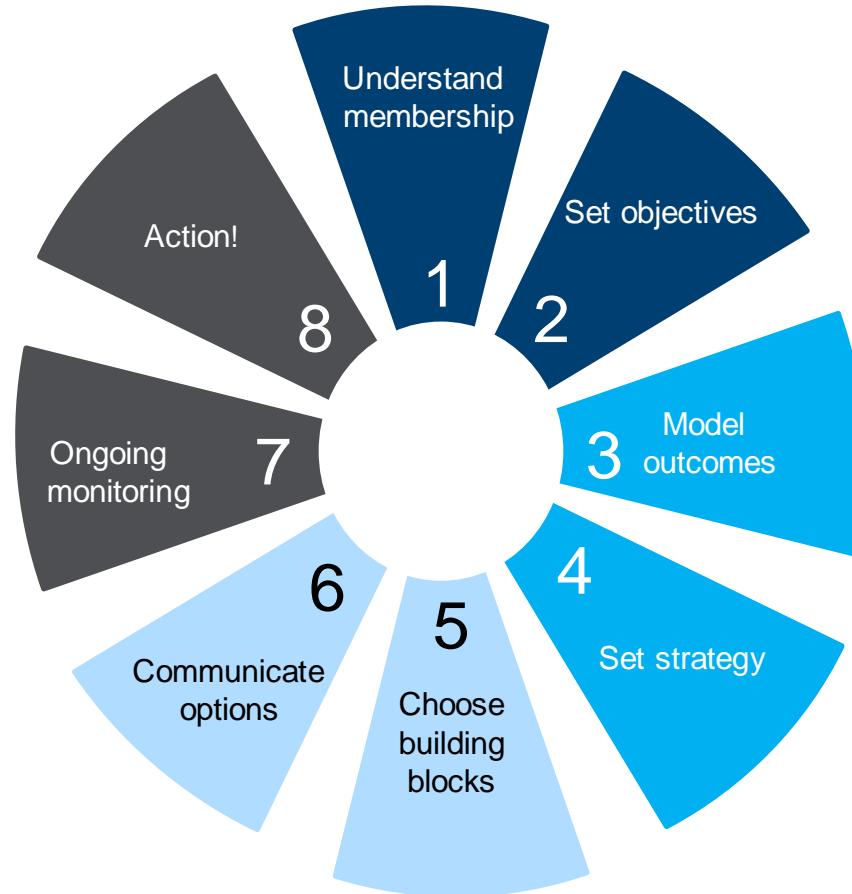
Dashboard	30.06.2013		Relative Performance (%)			Overall & action required
	Assets value (£'000)	No. of members	Quarter	1 Year	3 Years p.a	
Growth Fund	198.1	154	0.1	0.3	0.3	None
Pension Fund	80.2	65	-4.1	-8.7	-	Closer monitoring required
Pre- Retirement Fund	88.5	59	0.1	1.7	1.4	None
ABC UK Equity Index Fund	0	0	-1.0	4.6	3.4	None
XYZ Long Term Global Equity	0	0	-0.5	-0.3	1.6	None
ABC DGF	1.2	1	-4.0	-8.7	-	Closer monitoring required
ABC Absolute Return Fund	0	0	-0.4	7.3	5.6	None
	391.8					

Source: Aon Hewitt

"Trustees may consider setting mechanical triggers based upon the performance of investment funds against their benchmarks"

.....whilst accepting DC is different DB!

Take action!

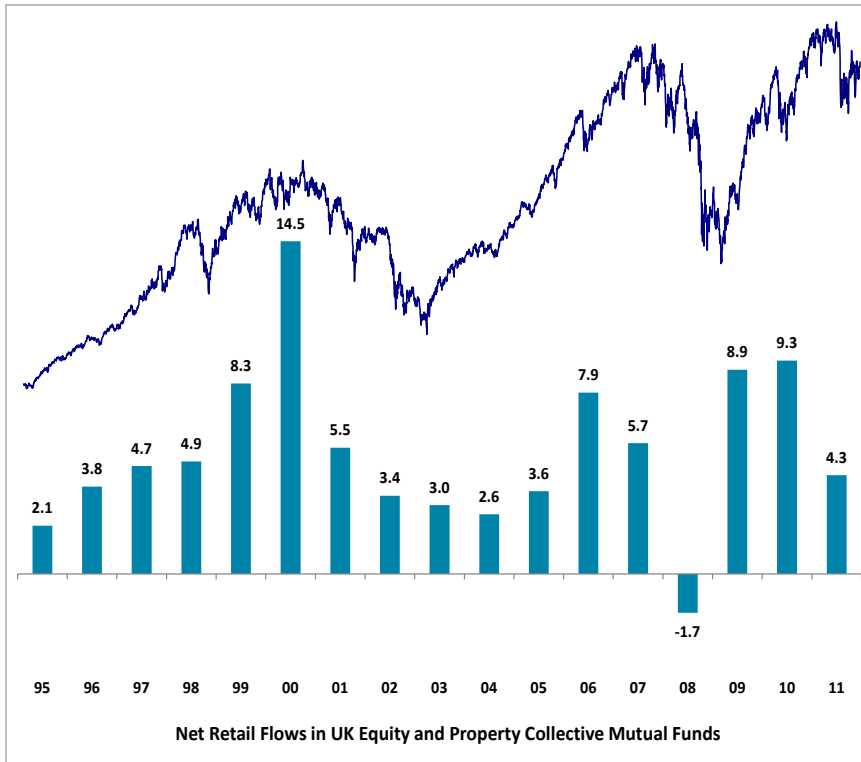


Source: tPR draft Code of Practice no 13

Making DC Investment Work

-the investment toolkit

Is extensive use of the default option a problem?



Source: Datastream, FTSE, Investment Management Association and AllianceBernstein

Typical default take up is 80-90% and is likely to increase if/when we have auto-enrolment*

As choice increases members engagement actually decreases

High and low levels of engagement are equally dangerous

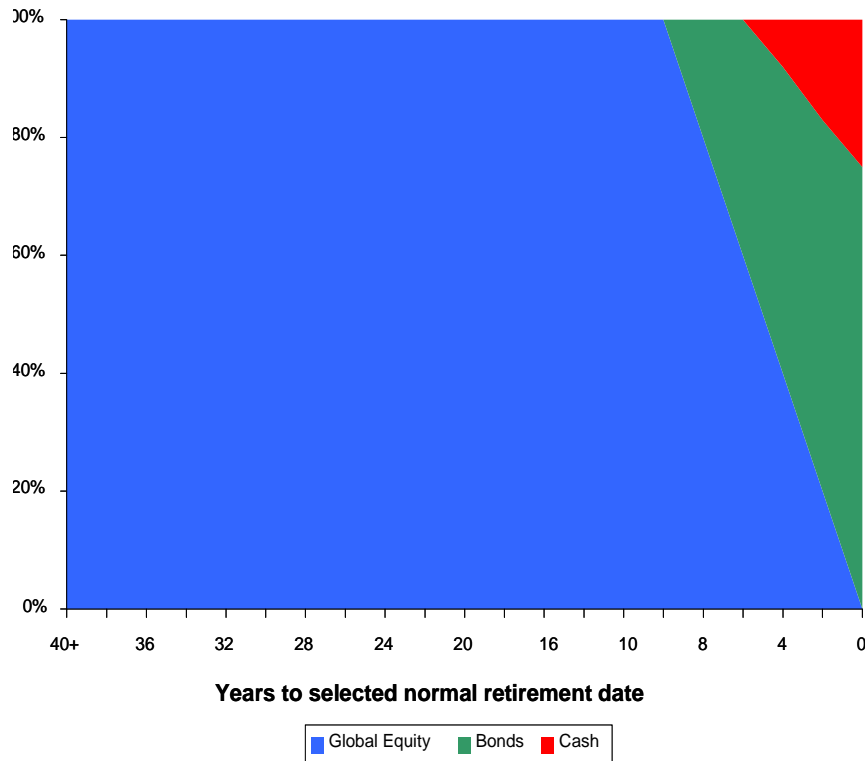
Members who self select without investment advice achieve annual performance 2.9% pa lower than those who get investment advice or invest in plan-managed funds.**

DC members are safer in the default option than self selecting...

* Source: Aon Hewitt

**Source: Aon Hewitt, study of US 401k plans

So are traditional default strategies fit for purpose?



All members have the same risk tolerance

All members will take income in the same way

All members have a similar financial “background”

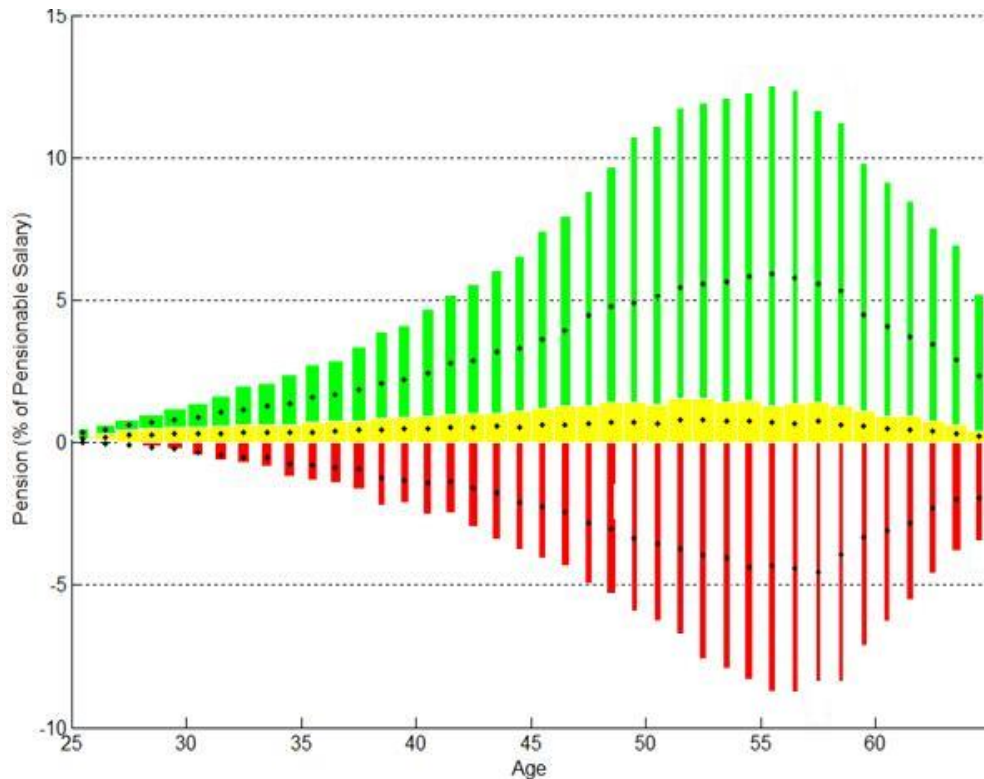
Diversification of growth assets is not important

Members have a positive experience in the investment markets

Traditional default options solve some, but far from all of the investment issues facing DC members

While DB pensions get de-risked...DC members increase their risk!

Potential change in pension



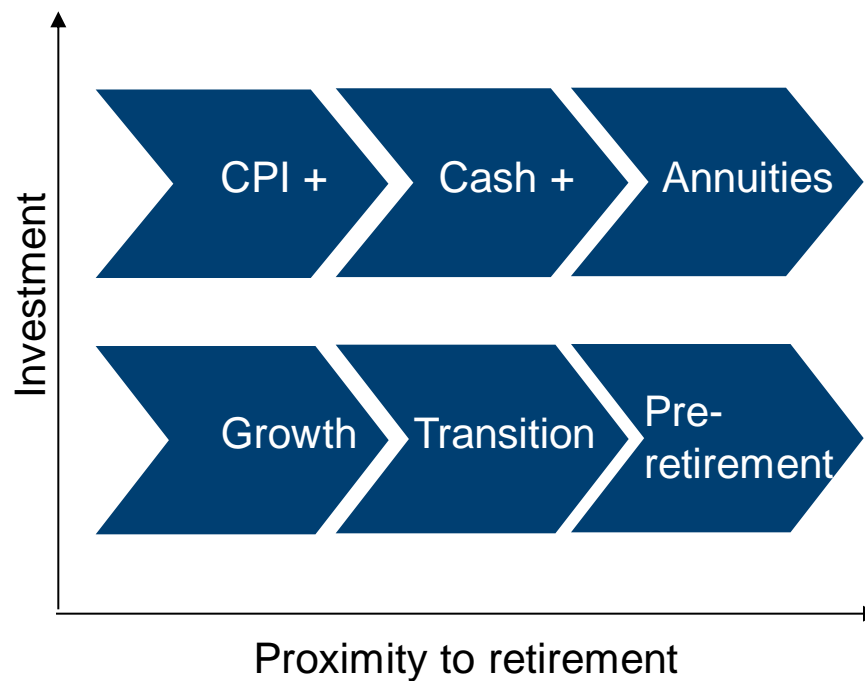
Default options are building up risk

Members close to retirement face losing the biggest amount

Biggest risks are taken when there's least time to recover from them

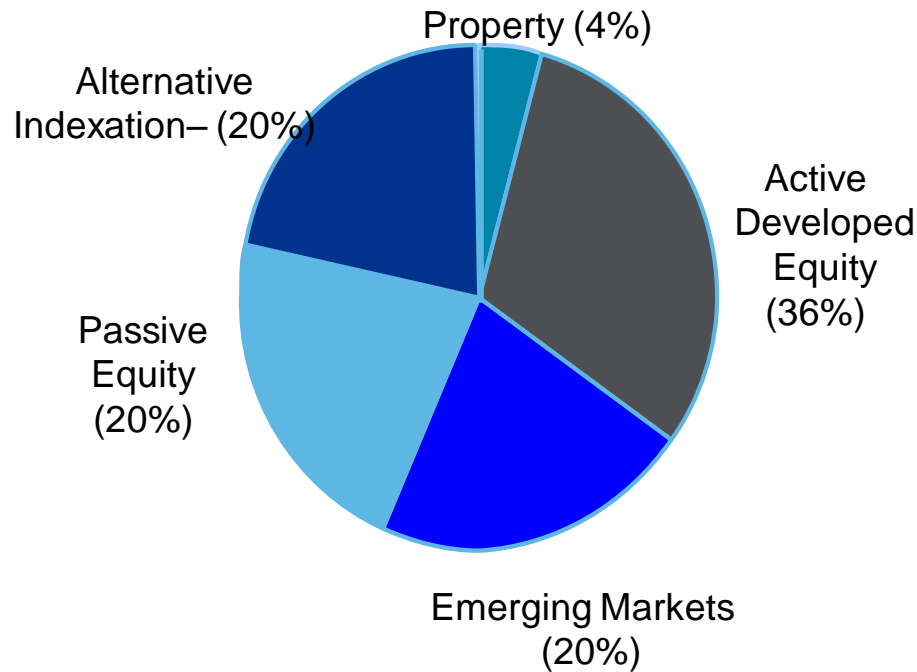
The accumulation of assets over time builds the risk of a catastrophic loss

Re-designing default solutions



Default funds should reflect the level of risk and return required by members whilst be sensitive to market conditions

Growth phase – be active (even if you are passive)



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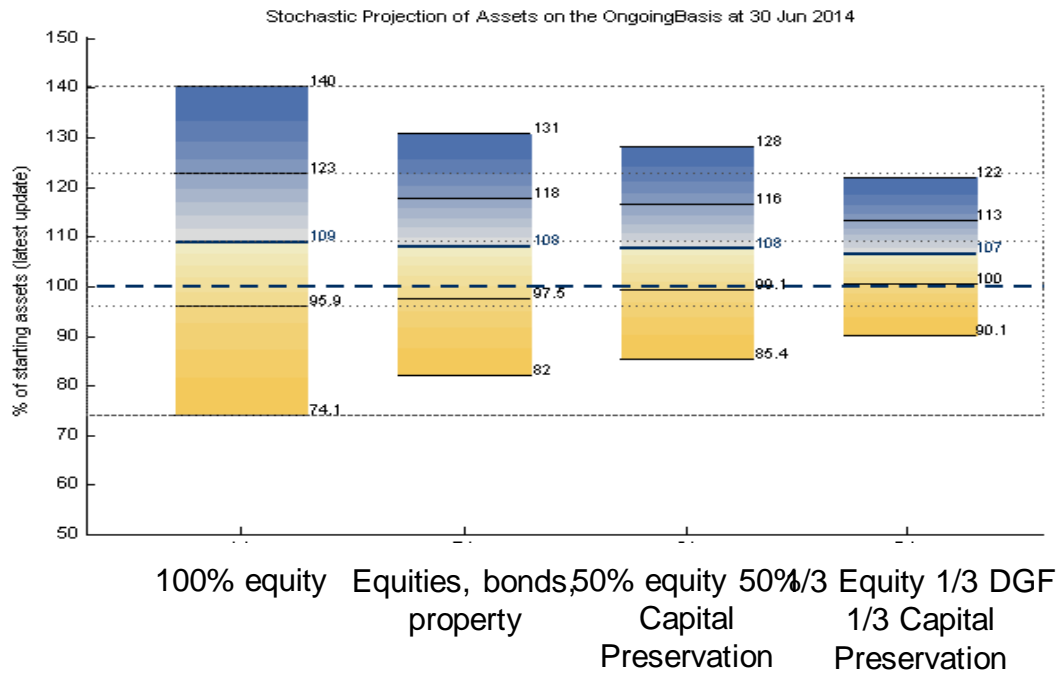
Key improvements:

- Alternative indices offer better risk adjusted returns to traditional market capitalisation weighted approach
- Emerging markets offer good value at current levels and long-term growth prospects
- Tactical positioning allows members to benefit from market developments

A more optimal and market aware portfolio can be created...even in a fee constrained environment

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Transition phase – start focusing on the downside



	100% equity	Equities, bonds, property	50% equity 50% Capital Preservation	Equity 1/3 DGF 1/3 Capital Preservation
Expected return p.a.	8.1%	7.8%	7.4%	6.5%
Volatility	19.3%	14.4%	12.7%	9.3%

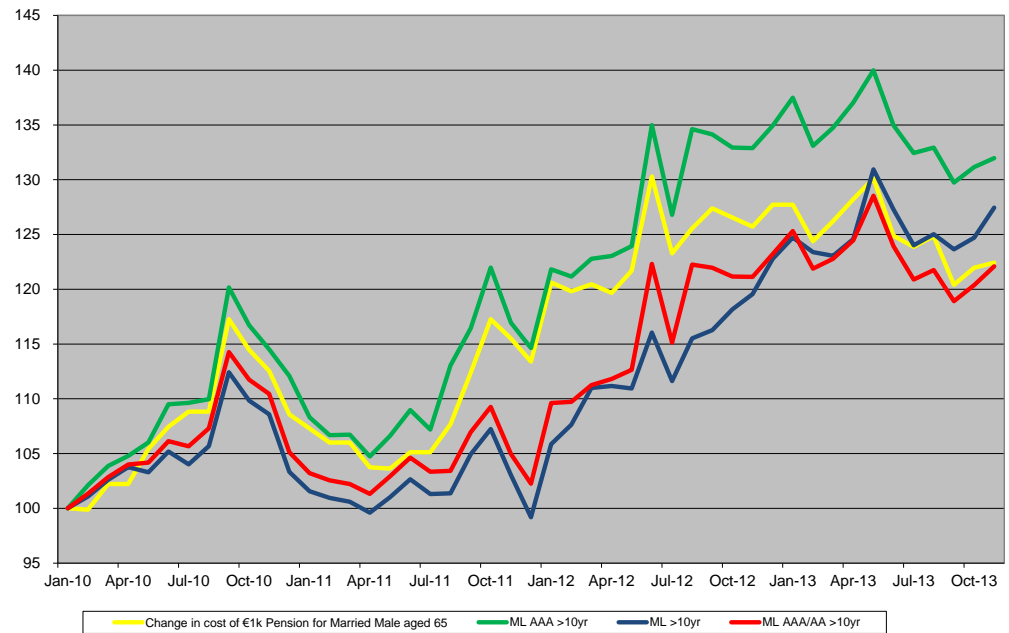
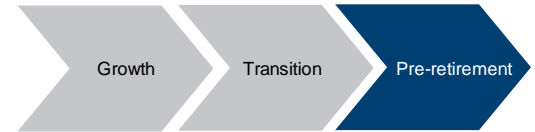
Diversification can materially reduce risk and is more important as retirement approaches

Better matching will make sure savings aren't eroded at the final hurdle

What will most members do at retirement?

Does the pre-retirement option suit?

Make sure that the default pre-retirement option provides the match you expect



Pre-retirement strategies should be closely monitored and suit the approach of the majority of members

Default funds – a call to action

Members can do a number of things on retirement:

1. The annuity rule:

- Members can take 1.5 times their Final Remuneration (subject to service conditions) as a tax free cash lump sum
- May have to buy an annuity under certain circumstances
- With the residual, may be able to take a taxable cash lump sum
- Use AVCs to transfer to an AMRF or ARF

Anyone lower paid or with a low pension pot will probably end up taking all their pension as cash as their pension pot is likely to be less than 1.5 times their salary plus 20k. If they have residual funds and have to buy an annuity it is likely to be small.

Default funds – a call to action

2. The ARF rule (they can take 25% of their pot as a tax free cash lump sum, and use the balance to take a transfer to an ARF subject to certain eligibility conditions ie guaranteed income).

Higher paid people with larger pots are likely to fall into this category

So:

Is the traditional default fund (switching into 75% bonds/25% cash over the 5 years to retirement) appropriate?

And if not, what are the consequences and the alternatives?

Default funds – a call to action

Are members taking benefits in the assumed way (75% annuity/25% cash)?

Our recent experience:

Scheme A:

7 members retired over the last 5 years and none have bought an annuity!

Scheme B:

1 member out of 95 have bought an annuity!

Scheme C:

2 members out of 7 have bought an annuity, but the value of the annuity was very small in proportion to the fund pot and was no where near 75% of the assets!



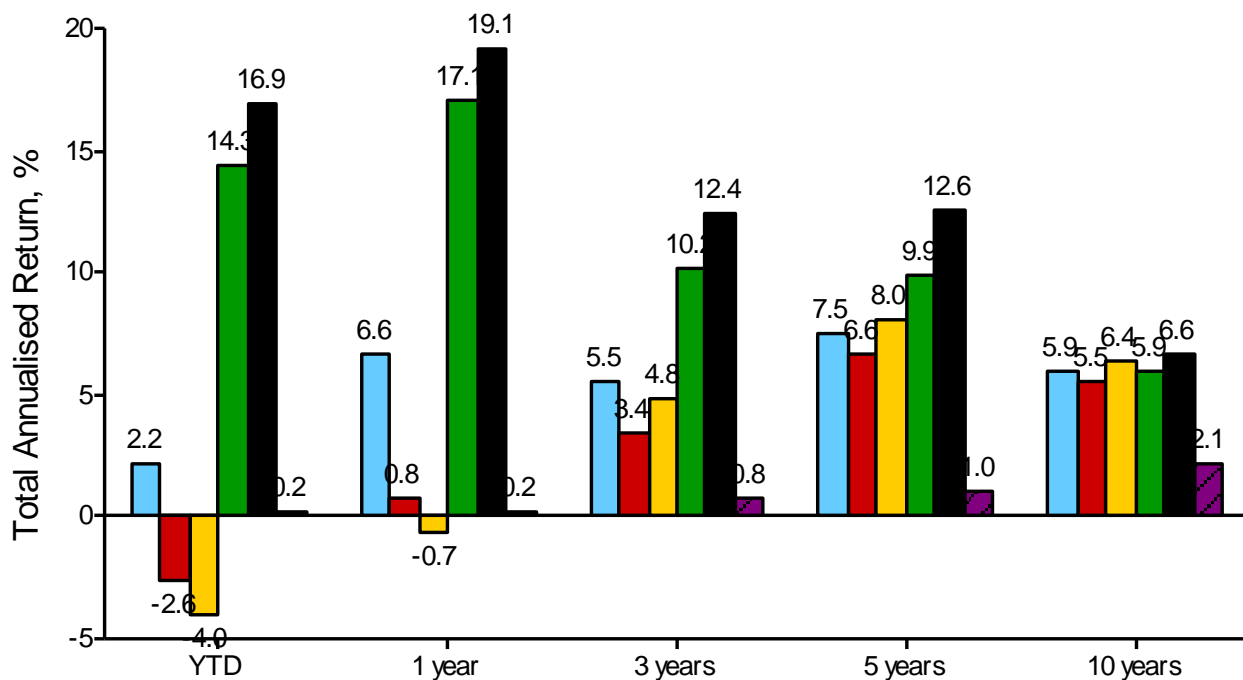
Default Funds – consequences of poor match

Beware of risk indicators showing bonds as low risk!



Performance to date

in EUR, November 2003 - October 2013



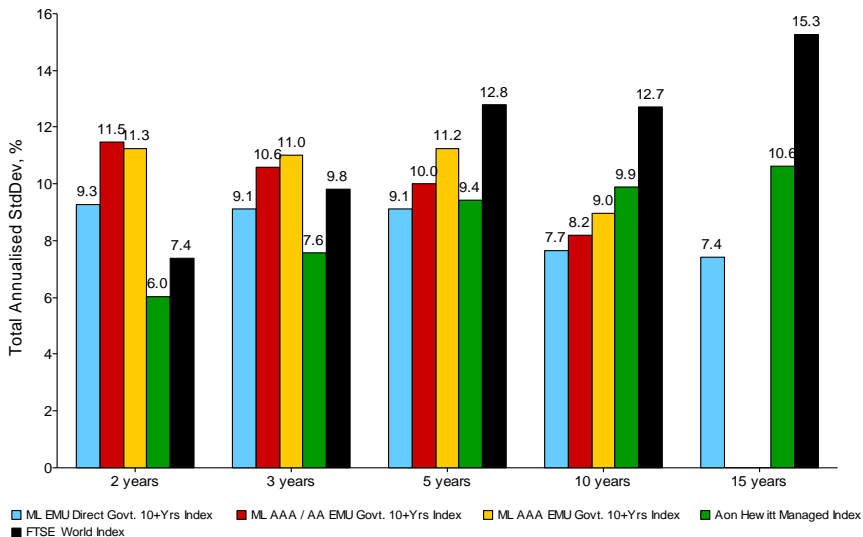
- ML EMU Direct Govt. 10+Yrs Index
 ■ ML AAA / AA EMU Govt. 10+Yrs Index
- ML AAA EMU Govt. 10+Yrs Index
 ■ Aon Hewitt Managed Index
- FTSE World Index
 ■ Index- Euribor

Default funds – a call to action

Bonds are not low risk, especially if not buying an annuity!!

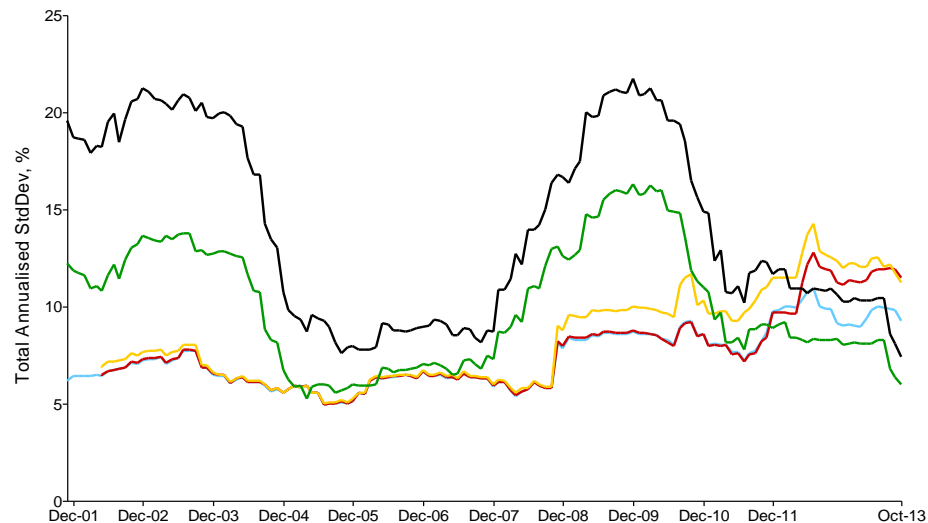
Risk to date

in EUR, November 1998 - October 2013



24 Month Rolling Risk

in EUR, Nov-01 - Oct-13



ML EMU Direct Govt. 10+Yrs Index ML AAA / AA EMU Govt. 10+Yrs Index ML AAA EMU Govt. 10+Yrs Index
 Aon Hewitt Managed Index FTSE World Index

Default funds – a call to action

New Lifestyle Profiles:

- Lower paid members are taking all their retirement benefits as cash
- Higher paid members are taking their benefits through an ARF after taking their Tax free cash
- Members with significant DB benefits are using their DC to fund their tax free lump sum
- There is a cohort of medium paid members where it is not obvious what they will do, but it could be some combination of cash / an annuity / an ARF

- 1. A Lifestyle that phases into cash is required!**
- 2. A Lifestyle that caters for someone who will remain in markets (ARF) is required!**
- 3. A Lifestyle that caters for annuity purchase is still required!**
- 4.And various combinations of all of the above are required!**

Default funds – a call to action: The How

Individual Lifestyle!

- Targets what each individual member is likely to *actually take* as tax free cash.
- Once off exercise say 10 years before retirement to work out likely maximum cash, and take into account projected salary / required annuity based on current fund, salary and service (basically a Statement of Reasonable Projection). This exercise could of course include any deferred DB entitlement or other pension benefit.
- Based on the outcome we can determine the member's glide path (what proportion of their estimated fund will be invested where at retirement). Then create an individual Lifestyle table for that member.



Default funds – a call to action: Examples

Individual Lifestyle!

	FROM DB STATEMENT	FROM SORP		CALCULATED								
	DB pension @ 65	Est Salary @ 65	Est DC pot @ 65	Service @ 65	Est Max cash	Balance of fund	Target DC pension (25% of sal)	Annuity fund target	Balance of fund	Target Cash	Target Bond	Target ARF
Joe, with DB benefits	20,000	100,000	100,000	30 yrs	150,000	0	5,000	0	0	100.00%	0.00%	0.00%
Mary, DC only	0	100,000	750,000	30 yrs	187,500	562,500	25,000	500,000	62,500	25.00%	66.67%	8.33%
Oliver, with DB benefits	10,000	100,000	300,000	30 yrs	150,000	150,000	15,000	150,000	0	50.00%	50.00%	0.00%
Sharon, with DB benefits	50,000	100,000	500,000	30 yrs	150,000	350,000	0	0	350,000	30.00%	0.00%	70.00%
Barbara, with DB benefits	10,000	50,000	100,000	30 yrs	75,000	25,000	2,500	25,000	0	75.00%	25.00%	0.00%
Eoin, DC only	0	50,000	750,000	30 yrs	187,500	562,500	12,500	250,000	312,500	25.00%	33.33%	41.67%
Peter, with DB benefits	5,000	50,000	300,000	30 yrs	75,000	225,000	7,500	150,000	75,000	25.00%	50.00%	25.00%
Niamh, with DB benefits	25,000	50,000	500,000	30 yrs	75,000	425,000	0	0	425,000	15.00%	0.00%	85.00%

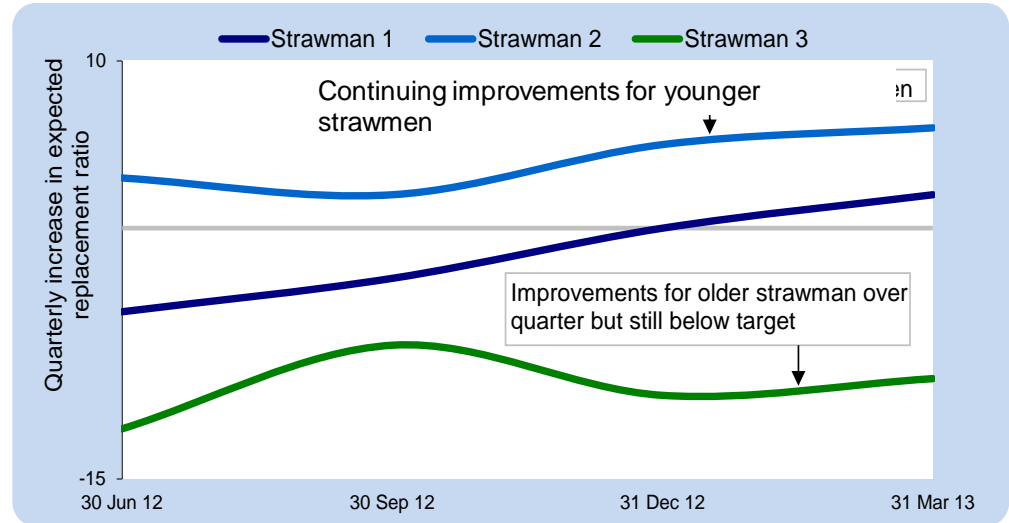
Conclusions: Better monitoring will avoid problems escalating

Quarterly investment monitoring alone is not sufficient

Monitoring of outcomes is key

Impact on replacement ratio is far more important than relative investment performance

Monitoring behaviors is critical – ie SORP, etc



Communications

Contribution discussions

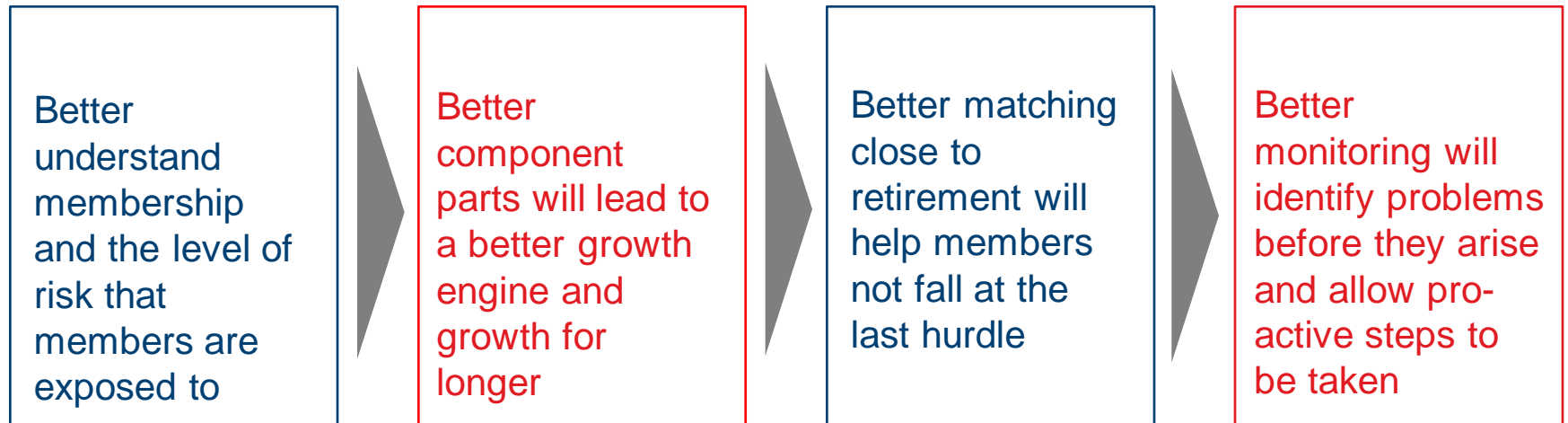
Investment changes

Monitoring should be focused on member outcomes

Conclusions: Default funds – action required!

- Default is key to members – they make bad choices and are generally disengaged
- The accumulation of risk towards retirement is likely to result in catastrophe for some members
- The current default model can be vastly improved!

What we can do:





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