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# DEALING WITH THE RELUCTANT INVESTOR

Innovation and governance in DC pension investment

A Pensions Institute report for policymakers,  
employers, trustees, insurance companies, asset managers,  
consultants and financial advisers

*Alistair Byrne*  
*Debbie Harrison*  
*David Blake*

*April 2007*

## Dealing with the reluctant investor

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## List of abbreviations

<b>ABI</b>	Association of British Insurers
<b>DB</b>	Defined Benefit
<b>DC</b>	Defined Contribution
<b>DWP</b>	Department for Work and Pensions
<b>FSA</b>	Financial Services Authority
<b>GPP</b>	Group personal pension
<b>HMRC</b>	Her Majesty's Revenue & Customs
<b>IMA</b>	Investment Management Association
<b>NAPF</b>	National Association of Pension Funds
<b>PA</b>	Personal Account
<b>TCF</b>	Treating Customers Fairly
<b>SIPP</b>	Self Invested Personal Pension
<b>TPR</b>	The Pensions Regulator

## Foreword

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This is the fourth of our series of reports that focus on pensions issues of direct relevance to policymakers, employers, trustees, insurance companies, asset managers, consultants and financial advisers. *Dealing with the reluctant investor* examines the governance of defined contribution (DC) schemes with reference to investment choice and, in particular, the design of the default fund. We explain where and why the current system fails to support DC scheme members and what steps can be taken to address the problems. We examine the positive and negative features of current default models and draw attention to important innovations that have energised the DC investment world.

DC is the most common type of new pension scheme in the private sector and will continue to be so for the foreseeable future. In our 2005 report *Pyrrhic Victory?* we said that within five years the vast majority of private sector defined benefit (DB) schemes will close not just to new members but also to future accrual, forcing employees to rely on replacement DC schemes. We stand by this prediction and anticipate that the introduction of Personal Accounts in 2012 will accelerate this trend, as employers review their rationale for investing in pension benefits that are more costly to provide than the new government-endorsed national scheme.

Under DB the employer bears the investment and longevity risk. Under DC these risks are transferred to individual members, who must make complex decisions about the types of funds in which they invest their contributions. With the exception of their senior executives, it is unusual for employers to pay for face-to-face regulated investment advice and this lack of member-specific advice, as opposed to generic information and guidance, has a marked effect on the distribution of members across the available funds. Figures vary from scheme to scheme but the latest NAPF annual survey found that, where available, the default fund, on average, attracts the contributions of 94% of members.

Most DC members can be described as 'reluctant' or 'disengaged' investors. These are the individuals who, for a range of reasons, are not prepared to make an active investment choice and instead passively accept the default fund. The distinction between an active decision to choose the default fund and passive acceptance is important. We argue that the high proportion of scheme members who passively accept default arrangements raises important questions about the structure of the default fund and whether this can meet the needs of a large and diverse membership. We make recommendations, based on our research, to help the various parties involved in pension scheme design – including regulators – to do their utmost to help reluctant investors make appropriate decisions.

In conclusion, this report provides a thorough review and analysis of the DC investment market and provides recommendations that we hope will enable policymakers, investment companies and pension providers, employers, and trustees to ensure the best possible outcomes for the millions of employees who will come to rely on DC for their private retirement income.

This research was sponsored by Aon Consulting, Fidelity International, HSBC, Scottish Life, and Scottish Widows. We are extremely grateful to these organisations for their support. The sponsors have not sought to influence the conclusions of the report and they may not share the views expressed here. Finally, I should stress that the views in this report are those of the authors and not those of the Pensions Institute, which itself takes no policy position.

Professor David Blake, Director, Pensions Institute, *April 2007*

## Sponsors

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This research was sponsored by:

Aon Consulting  
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The Pensions Institute is very grateful for their support. The views expressed in this report are not necessarily shared or endorsed by any of these organisations. Furthermore, they have not imposed any conditions or requirements on the contents of the report.

## Acknowledgements

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Over 60 individuals and organisations took part in our research and we would like to thank the following in particular for the information and observations they provided, which helped us to frame our recommendations. Where we include participants' observations in the text, we do so on an anonymous basis to protect confidentiality and to enable us to 'tell it how it is'.

<i>AEGON Scottish Equitable</i>	<i>Mellon</i>
<i>Alexander Forbes Financial Services</i>	<i>Mercer</i>
<i>Aon Consulting</i>	<i>NAPPF</i>
<i>AXA</i>	<i>Northern Trust</i>
<i>B&amp;CE Benefit Schemes</i>	<i>Norwich Union</i>
<i>Baillie Gifford</i>	<i>Origen</i>
<i>Barnett Waddingham</i>	<i>Pensco</i>
<i>Berwin Leighton Paisner</i>	<i>PensionDCisions</i>
<i>BESTrustees</i>	<i>PIFC</i>
<i>BGI</i>	<i>Pinsent Masons</i>
<i>BlackRock</i>	<i>PricewaterhouseCoopers</i>
<i>Capital Cranfield</i>	<i>ProManage</i>
<i>Close TEAMS</i>	<i>Prudential</i>
<i>CMS Cameron McKenna</i>	<i>Sacker &amp; Partners</i>
<i>DC Link</i>	<i>SBJ City Division</i>
<i>DecisionsDecisions</i>	<i>Schroders</i>
<i>Deloitte</i>	<i>Scottish Life</i>
<i>Dunnett Shaw</i>	<i>Scottish Widows</i>
<i>Fidelity International</i>	<i>SEI</i>
<i>Friends Provident</i>	<i>Skandia</i>
<i>Hargreaves Lansdown</i>	<i>Standard Life</i>
<i>Hewitt</i>	<i>State Street Global Advisers</i>
<i>HSBC</i>	<i>The Pensions Regulator</i>
<i>Investment Management Association</i>	<i>The Pensions Trust</i>
<i>Jardine Lloyd Thompson</i>	<i>Threadneedle</i>
<i>John Scott &amp; Partners</i>	<i>Towers Perrin</i>
<i>JP Morgan</i>	<i>T Rowe Price</i>
<i>Kim Gubler Consulting</i>	<i>TUC</i>
<i>Law Debenture</i>	<i>Watson Wyatt</i>
<i>Lane Clark &amp; Peacock</i>	<i>Wragge &amp; Co</i>
<i>Legal &amp; General</i>	<i>Zurich</i>

## Preface

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For economic and demographic reasons that have been well documented, in the 21st century many finance directors no longer consider Defined Benefit (DB) pension schemes a rational investment. As a result, DC is now the most common arrangement for employees in the private sector who have changed jobs recently. According to the NAPF, whose members are the medium and large UK pension schemes, 2000 DB schemes closed between 1995 and 2005.<sup>1</sup>

Currently two-thirds of private sector employers offer a DC scheme and the average take-up is 50% of the workforce. In the small and medium sized company market, financial advisers and consultants report that DC is already by far the most common arrangement. With the exception of the largest and most paternalistic employers, the erosion of DB schemes still open to future accrual is inevitable, although the rate of attrition will depend on staff turnover.

DC can be trust-based ('occupational DC'), in which case the employer establishes the scheme under UK trust law and there is a board of trustees whose job it is to act in the members' best interests and negotiate on their behalf with service providers, including asset managers. The alternative is contract-based DC and here the contractual arrangement is directly between the individual member and the provider, typically an insurance company. The key difference between these two structures, therefore, is that in contract-based DC there is no entity recognised in law or regulation that acts solely on the members' behalf. Contract-based schemes do, however, fall under financial services regulation and Financial Services Authority (FSA) requirements for providers to 'treat customers fairly'. Our research reveals that the current trend in the private sector is not only from DB to DC, but also from occupational DC to contract-based schemes. The governance gap on investment matters associated with contract-based arrangements is one of the issues this report seeks to address and a subject of current interest for the The Pensions Regulator (TPR), which has issued a consultation paper on DC governance issues.<sup>2</sup>

The primary factors that determine the outcome of a DC pension plan during the accumulation phase are investment strategy - principally asset allocation - and the level of contributions. This report focuses on the former - the investment strategies offered by DC schemes and, in particular, the default fund provided for members who do not want to make an active choice. One-to-one advice for members is unusual due to the cost. Advisers report that group communications exercises are usually based on the assumption that the member will be in the default fund. Like it or not, most members assume that they are directed into the default fund and that this is a form of implicit or explicit advice.

The NAPF states that where a DC scheme offers a default option, on average 94% of members accept it, leaving a very small minority of individuals who presumably feel sufficiently well informed and confident to make their own investment choices.

The question this report raises is deceptively simple: how can a single default mechanism be structured so that it is appropriate for over 90% of employees?

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1. See endnotes on page 57



To discover the answer, in the fourth quarter of 2006 we undertook a thorough analysis of the DC investment strategies currently available to private sector employees in the UK. The fieldwork was supplemented by an online survey of over 50 carefully selected pensions experts, who gave their opinions on the ideal fund choices that should be offered by DC schemes. The respondents are all individuals who have a demonstrable expertise in DC investment issues. The survey results are summarised on page 13 and the full results shown in the Appendix.

We also conducted open interviews with over 60 pensions experts, either face-to-face or by phone. In many cases, these are the same individuals who participated in the survey, but the interviews allow for a more in-depth understanding of their views. The views of these individuals are reported on a non-attributable basis, which is our preferred style to allow interviewees to express personal opinions which may not reflect the views of their organisation. From these interviews we were able to build up a clear picture of the framework in which employers introduce DC, the advice they receive, current trends and innovations, and the nature of the problems that concern all parties involved in the design and delivery of schemes for the reluctant investor.

What do we mean by 'reluctant investor'? We chose this phrase as it describes well the individual who, for a range of reasons, does not make active investment decisions in the DC plan. This might be because the member has insufficient knowledge or confidence, even where information and education (but not one-to-one advice) are provided. It is, at least in part, due to the fear of getting the choice wrong and the implications this might have for the individual's retirement income. In behavioural finance terms this is known as fear of 'regret'.

It became evident during the course of our research that while employers and insurance companies usually were keen to do the best they could for scheme members, their good intentions stopped well short of taking a legal (fiduciary) responsibility for the outcome. A fiduciary duty is an important concept in law and implies the highest standard of care. Such individuals or entities are expected to look after the best interests of the individuals to whom they owe their allegiance. They must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the beneficiaries consent.

An important issue this concept raises for contract DC, therefore, is to whom advisers and providers owe their allegiance. If it is to the employer, then this suggests there is a serious gap in the governance regimes for pension schemes based on legal contract between the provider and the member, not the provider and the employer.

We found that advisers and consultants were prepared to take a fiduciary responsibility only where they were paid to provide regulated advice, either by the employer, who paid a fee, or through a commission paid by the scheme provider. Trustees of occupational DC schemes undertake the fiduciary role in terms of ensuring an appropriate fund choice for members but they are not authorised by the FSA to give regulated individual advice and they are often reluctant to respond to members' requests for guidance. In all cases, therefore, where a scheme offers a default, the underlying assumption is that this does not constitute an advised 'sale' in the regulatory sense and, therefore, that the member is responsible for the investment decision.

This collective reluctance to accept a fiduciary responsibility is being examined by TPR and in the coming years will be challenged. For while it is true that the action of offering a default does not constitute individual advice under the very precise regulatory meaning set out by the FSA, it is equally evident that reluctant investors assume that the default fund has been chosen to meet their specific needs. The pensions professionals interviewed for this report are fully aware that the risk of regulatory transgression is a powerful barrier to appropriate communications. This position must be challenged and changed. For the sake of the reluctant investor's welfare in retirement, common sense, we feel, should not be thwarted by regulatory semantics.

Trust-based schemes are regulated by TPR, while contract-based schemes are mainly overseen by the FSA. In March 2007, under the auspices of the Department for Work and Pensions (DWP), Paul Thornton began a review of pensions institutions, which includes an examination of the potential benefits of a merger between the FSA and TPR. In a consultation document Thornton observes that while the regulators did not think a merger appropriate, nevertheless, *'the boundaries between occupational pensions and other financial savings products are becoming more blurred and complex'*. This is certainly true for DC arrangements.<sup>3</sup>

At this difficult and complex time for the UK pensions market we hope this report will help shape the debate that surrounds DC investment and will encourage the various parties to DC schemes to explore the nature of governance in the context of the reluctant investor.

Alistair Byrne  
Debbie Harrison  
David Blake

## Key findings and recommendations

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### *Section 1: What is Governance in DC Investment?*

Common sense dictates that governance in DC investment should be about helping members make appropriate investment choices. Employers, trustees, advisers and providers all have a role to play in this process, but the precise nature of the role can be unclear.

It is relatively rare for DC members to receive formal (regulated) one-to-one advice. However, in practice many features of DC schemes may be accepted by members as implicit advice – that is, members perceive a recommendation, even where none is intended. One of the perverse consequences of current financial services regulation and perceptions of potential legal liabilities is that in many DC schemes expert professionals try to avoid shaping members' investment choices and leave the members largely to their own devices. This would appear to be counter-intuitive and counterproductive.

We recommend that regulators consider encouraging employers, trustees and advisers into taking a greater fiduciary role and protect them through 'safe harbour' rules that restrict liability, provided due diligence has been done. Clearly 'due diligence' in this context would need to be defined carefully but clearly. Key areas of application include selection of the default fund, the extent of investment choice offered to members, and in determining the nature of the information and advice that is provided to members.

### *Section 2: Governance and Default Funds*

Most of the pensions experts we surveyed said that DC schemes should offer a default fund for members who do not want to make an active investment choice. Equally, it is clear from our research that where a default fund is provided, the majority of members use it, many on a passive basis.<sup>4</sup> However, the selection process for the default fund often appears weak and this has a marked impact on the extent to which the choices made are in the best interests of members.

Many default funds are lifestyle funds, with most of the fund invested in equities for younger members and an automatic switching mechanism that increases the proportion in fixed income as the planned retirement date approaches. We highlight that some providers recently have developed 'target-date' funds as an alternative to lifestyle. The member chooses the fund that has a date closest to his or her planned retirement date and the fund manager manages fund risk and asset allocation with the target-date in mind. Target-date funds appear to have benefits in terms of their ease of communication and we recommend that employers and their advisers – and the government, in the context of personal accounts - consider this approach as an appropriate form of default fund.

Another alternative to the traditional lifestyle approach is the use of 'managed accounts'. This involves providing the member with a risk-based, tailored asset allocation, based on his or her circumstances. The advice is computer-based and takes account of factors such as age and income, as well as considering state benefits and retained pension rights elsewhere. Managed accounts appear to be an improvement on 'one-size fits all' lifestyle funds and employers and trustees may wish to consider adopting them for their DC schemes.

### *Section 3: Governance and Investment Choice*

Many DC schemes provide a wide range of investment choice, but most of the pensions professionals we spoke to suggested a narrower range would be more suitable for most investors. However, it was also evident that many employers, trustees and advisers are reluctant to take responsibility for selecting a pared down range from providers' platforms, given the risk of liability if the funds they choose do less well than those they exclude.

We recommend that employers and trustees consider carefully the possible detriment to their members from providing too much investment choice. They could be encouraged to provide more focused ranges by safe harbour guidelines that give them confidence that they will not be held accountable for investment outcomes provided the selection decision was taken with care.

In terms of the choice offered, few members are likely to want to tailor their own asset allocation using asset class building blocks. Instead schemes might offer pre-packaged, risk-graded multi-asset strategies. Three or five such strategies should meet most members' needs and may result in a lower proportion of members using the default fund on a passive basis.

Where schemes feel they should provide a wide investment range to satisfy active investors - and our general view is that they may well decide that they should not - we recommend some form of filtering is used, so that the majority of members need only select from a narrow core range of options and more specialist options are shown only to members who actively seek them because the core range does not meet their needs.

### *Section 4: Innovations in DC Investment*

Recent innovations in DC investment include diversified growth funds and portfolio insurance-type products that attempt to manage risk in a more dynamic fashion than traditional lifestyle. Diversified growth funds, which incorporate alternative asset classes that have low correlations with equities and bonds, appear to be an improvement on the traditional balanced managed fund that has come to rely too much on equity exposure. We recommend that employers and their advisers consider diversified growth as an option for the default fund or for use in the risk-graded multi-asset strategies discussed in Section 3. Issues remain in finding acceptable charging models for the funds and in communicating their features to DC members, but the general approach appears beneficial for members.

Structured, guaranteed and portfolio insurance-type products face potentially greater barriers in their use in DC schemes. There is a risk with such funds that members may misunderstand the nature of conditional and unconditional guarantees and also that certain guarantee structures might represent a form of reckless conservatism if used over long periods of pension scheme membership, due to the implicit costs of providing them. On balance, our opinion is the employers, trustees and advisers probably should not offer these products in their DC schemes. If they do, they need to take care to make sure they are appropriate and understandable for the members.

## *Section 5: Governance and Communications Issues*

Reluctant investors may fail to make good use of even the best-designed communications, and so we believe that the key is to target communications in a way that actively engages members, wherever possible. After the initial joining communication exercises, further communications could target members at a range of appropriate ages or in response to how the member is managing his or her account, for example where the asset allocation appears inappropriate for a given term to retirement.

The provision of risk profiling questionnaires and stochastic modelling tools that can help members understand the likely outcomes from their pension scheme would appear to be best practice, although the use of such interactive strategies amongst reluctant investors is generally quite low. Where these tools are provided, a key issue is to ensure that members wishing to make changes to their arrangements, after completing the analysis, can do so as easily and quickly as possible via 'straight through processing'.

## *Section 6: Investment for Personal Accounts*

The Government has proposed a new scheme of DC Personal Accounts for implementation in 2012, along with a system of automatic enrolment to boost take up rates. The design of the investment component of the proposed scheme raises most of the same issues discussed in earlier sections of our report. However, in some cases the issues are made more acute by the nature of the target market for Personal Accounts. For example, the high proportion of lower earners and first-time investors implies very heavy use of the default fund. Key issues include the extent and delivery of investment choice, as well as the nature of the default fund and the ability of the scheme to accommodate religious and ethical investment preferences. We recommend that the Delivery Authority for Personal Accounts and the Personal Accounts Board that emerges as the fiduciary for this national scheme, consider target-date funds as a feasible default mechanism. Out of the current models available (and others will be developed over the next five years) target-date funds appear to deliver an easy selection mechanism for members, while conferring maximum flexibility on the Board in terms of the decisions that surround the selection of the underlying asset allocation and investment style.

## Terminology

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The following list explains the technical terminology we use in this report.

**Contract-based pension scheme** A personal pension, for example, is a contract between the individual and the provider (this is also referred to as a 'retail' product, as compared with institutional occupational arrangements). Even where an employer offers a group personal pension this remains a series of individual contracts between employees and the provider.

**CPPI** Constant Proportion Portfolio Insurance – a portfolio insurance strategy whereby the proportion of the portfolio in risky assets is varied depending on the margin of safety between the current portfolio value and the value that is being protected.

**Default fund** This is the fund into which a member's contributions are directed if the member has not made an active investment choice.

**Diversified growth or 'new balanced' funds** Funds that invest across a range of traditional and generally non-correlated alternative asset classes, such as private equity, commodities and infrastructure. This asset allocation, which aims to reduce risk and volatility, contrasts with 'old' balanced funds, which typically have approximately 80-85% invested in listed equities.

**Governance** In the context of DC, oversight of the investment arrangements in a pension scheme with a view to ensuring that they are and remain appropriate for members. This includes issues such as selection of the default fund and the selection of the wider investment choice to offer members.

**Group Personal Pension** A contract-based pension scheme used for a group of employees in an employment context.

**Lifestyle or Lifecycle fund** An investment strategy where the asset allocation depends in some way on the age of the scheme member, typically by reducing investment risk as the member approaches his or her planned retirement date.

**Managed strategies** Multi-asset funds where the fund manager takes responsibility for the strategic, and possibly tactical, asset allocation of the fund.

**Multi-manager** An investment strategy where the portfolio is split between a number of different investment managers, each chosen on the basis of their particular expertise.

**Personal Accounts** The Government's proposed national DC pension scheme, aimed at lower earners and intended for introduction in 2012.

**Safe harbour rules** Regulations that exempt an organisation from prosecution or other legal action provided that it took appropriate care in reaching a decision.

**Stakeholder Pension Plan** Similar to a group personal pension but subject to additional legislative requirements as regards charges and scheme flexibility, amongst others.

**Target-date funds** A variation on lifecycle funds, in these funds the manager adjusts the asset allocation through time with a view to delivering a risk profile suitable for an investor looking to realise the investment on the specified target-date, for example in 2020.

**Trust-based pension scheme** Under an occupational defined contribution scheme, members' rights are safeguarded by a trust board in the workplace.

**Value-at-risk (VaR)** The maximum expected loss from a portfolio or investment over a specified period and with a specified probability.

**White label fund** Where a pension scheme creates a fund for the exclusive use of its members, subcontracting the management of the fund to one or more external investment managers

## Survey summary

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Our online survey was completed by 54 experienced professionals from the DC pensions market in the fourth quarter of 2006 and first quarter of 2007. Respondents included individuals who work for fund management companies, pension scheme providers and pensions consultancy firms, as well as pensions lawyers and professional trustees.

Full details of the results are shown in the Appendix.

In summary, the survey found that:

- 69% of the pensions experts we surveyed say that the typical investment arrangements in UK DC pension plans don't meet most members' needs.
- On average, respondents think that only 10-15% of DC scheme members understand the investment risks they face. Over half put the figure at 10% or less.
- 89% of the pensions experts say that a DC scheme should have a default fund.
- Respondents say that in their experience, where a scheme has a default fund, on average, 82% of members invest in it.
- 57% of respondents say DC schemes should offer a lifestyle fund as the default; 39% think DC schemes should offer lifestyle as an option that members can choose.
- Most of the pensions experts we surveyed think that DC schemes should offer a fairly narrow range of investment options:

Appropriate no. of funds	% of respondents
1 fund	0%
2-5	17%
6-10	57%
11-20	9%
20+	15%
Don't know	2%

## Timeline: The growth of DC in the private sector

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One of our interviewees suggested the following stylised timeline for the development of DC schemes in the UK. We thought it provided useful context for the analysis in our report. Obviously, the timings are approximate and, in some cases, there are differences in the timings between large and small companies.

### *1970–1990*

- DB schemes become the most popular form of pension benefit delivery due to very attractive tax breaks, buoyant stockmarkets and lower mortality assumptions

### *1990–1995*

- Growing cost of DB becoming more visible
- New companies opt for DC rather than DB
- Companies closing DB schemes replace them with trust-based DC
- 3-5 fund options
- Members paying investment fees, company paying administration costs

### *1995–2005*

- Changes in taxation, increasing longevity, and the bear market of 2000-2002 push most DB schemes into deficit. New accounting rules make the deficits transparent.
- New DC arrangements generally contract-based
- Lifestyle default
- 30-40 fund options in contract schemes
- Move to members paying all fees

### *2005 & beyond*

- Trust-based schemes widening the choice to 6-10 funds
- Contract-based schemes offering a fund range as core and specialist
- Trend from trust- to contract-based DC
- Alternatives to conventional lifestyle being developed
- Use of comprehensive modelling tools for DC members
- Group SPPs growing in popularity, although costs queried
- Personal Accounts and auto-enrolment with compulsory employer contributions scheduled for 2012

Source: Blackrock / Pensions Institute



## The research and recommendations in detail

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In this section we describe and analyse the current DC investment strategies, and explore the governance problems associated with contract-based DC in relation to investment choice.

Except where company names are mentioned in relation to specific DC investment strategies, comments from individual respondents in this research are non-attributable. However, we do indicate the professional role of the interviewees in the pensions market.

### Section 1: What is Governance in DC Investment?

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#### *The survey says...*

69% of the pensions experts we surveyed say that the typical investment arrangements in UK DC pension plans do not meet most members' needs.

Respondents, on average, think that only 10-15% of DC scheme members understand the investment risks they face. Over half put the figure at 10% or less.

In this section we ask the question, what constitutes appropriate governance in the context of DC and the reluctant investor?

DC schemes, and in particular the contract-based arrangements such as GPPs and stakeholder plans, are derived from a retail investment product – the personal pension – which is regulated by the FSA. This presents particular problems now that group DC is becoming the most common arrangement for private sector workplace schemes.

The understanding of governance as it applies to the investment and custody of defined benefit scheme funds is not transferable to DC. Governance for DC is about providing arrangements such that scheme members can make appropriate investment decisions.

*Governance is the key to managing the member's risk in DC. It's always been seen as critical to DB but, in my opinion, it is even more important for DC.*

*Pensions Lawyer.*

For members, understanding basic investment fundamentals and the confidence to make decisions are quite separate characteristics. Even where a member has a reasonable understanding of investment issues, putting this into action is a separate task. It is important not to underestimate the member's fear of making the wrong decision. This we contend is a major factor that explains the concentration of members in the default fund, which further implies that additional information and communications, although very important, will not by themselves convert the reluctant investor into an active one. Our research suggests that what most members want is not more information, but rather to have an expert make the investment decision for them.

The main problem arising from this situation is that many investment experts do not want to make decisions on behalf of members for fear of liability. As we discuss later in the report, this applies to various aspects of DC investment including the selection of default funds, the decision on how much investment choice to offer to members, and the nature of information and advice provided to members. We have the perverse outcome that experts – who have the skill and knowledge to make investment choices on behalf of members – prefer not to make them because of fear of liability if the decision turns out to be ‘wrong’. The consequence is that decisions are made instead by the members – that is, those who, on average, have very limited investment knowledge. We argue below for changes to law and regulation so that employers, trustees and others who are in a position to support members of DC schemes have less to fear from using their expertise provided they can show appropriate standards of care.

### *Differences in governance between trust-based and contract-based schemes*

Trust-based DC is used by the larger employers and can be established with a high level of governance via the trustee board. In theory, therefore, a scheme with a trustee board is better placed to ensure the members make appropriate investment decisions, as the trustees must act in the members’ best interests. The trustees are responsible for meeting relevant investment regulations, and investing funds in a manner consistent with the members’ best interests. Their approach to this should be set out clearly in the Statement of Investment Principles. In practice, however, the fiduciary role of the trustee board in relation to DC is mutable and open to interpretation. This means that the effectiveness of the trustee board can and does vary from scheme to scheme.

*Trustees of trust-based employer-sponsored DC schemes should differentiate themselves - from stakeholder/personal pension moneyboxes - by obtaining and applying the best and most sophisticated investment advice obtained by DB schemes. DC trustees should be encouraged to take paternalistic responsibility on investment matters and the legal framework should support and encourage that. Pensions Lawyer*

*The very large trust-based schemes can apply sophisticated techniques. For example, they can establish a platform of investment managers, they can bundle managers to suit the scheme, and they can provide access to a very wide range of funds, including managers not usually available to DC. Consultant*

*In a trust-based world, the selection of the asset managers is a fiduciary responsibility of the trustees. Consultant*

The lack of clear requirements for the trustees and the disconnection between their responsibility for the investment strategy and the outcome makes trustees err on the side of caution – they tend to steer clear of any action that puts them on the front line for reprisals in the event of member dissatisfaction and disappointment. Importantly, trustees are regulated by TPR, and are typically not authorised by the FSA to give specific, individual advice.

In some cases, trustees probably do not give DC the attention it deserves. Many trustees of occupational DC schemes are also trustees of a DB scheme and the latter presents the most pressing problems at present due to underfunding and the prescriptive requirements of the Pensions Act 2004. Consultants report that DB issues dominate trustee meetings and that DC frequently is sidelined almost to the point where it becomes an issue listed under “Any Other Business”.

*Trustees sometimes neglect DC. They have their head buried in DB problems.*

**Consultant**

*Trustee meetings for DC are inefficient. With DB the investment decisions affect the employer. With DC they affect the employee.* **Consultant**

Some schemes may benefit from having a separate group of trustees who oversee the DC scheme from those responsible for the DB scheme. This would suggest having a separate trust, which is the case in many, but not all, DC arrangements. That way, the DC scheme may get more consistent attention. A DC sub-committee is another possible option.

As regards governance of contract-based schemes, several advisers and consultants put forward the idea of establishing a board or executive, which would undertake some of the responsibilities of trustees. This could oversee the selection and monitoring of investment managers and funds, and take a role in determining the information and guidance provided to members. The employer could invite employee representatives on to the committee and invite advisers and providers to report to the committee. However, such a committee would lack formal legal responsibility for the pension arrangements – which are contracts between the employees and the provider - which might limit its effectiveness.

*While employers want to help employees make sensible decisions, they don't want any legal responsibility for the outcome. The answer is to establish a pension committee for the contract scheme, which can do everything that trustees did but without actually giving advice to members and having any legal responsibility.* **IFA**

*Trustees are not always best placed to supervise DC arrangements, but there should be a strong governance committee. Trustees often are reluctant to do much with what is members' money. I'm a big fan of intelligent governance but I'm not convinced a board of trustees is the right way to deliver this.* **Consultant**

As regards the role of investment consultants, some respondents suggested that trust-based DC gave the consultant the same commercial advantages as DB, in that they could advise but would not have to take responsibility for dealing with individual members.

*Few people want to take responsibility for the end-user in DC. Who wants to 'own' the compliance? The big consultants are the worst and the life companies have an advantage there.* **Asset Manager**

### *The role of the employer*

Many employees would like to turn to their employer for guidance on what to do with their DC pension investments. Employers, though, are often reluctant to help for fear of falling foul of financial services regulation or incurring other liabilities if the guidance they offer causes some disadvantage to members. There would seem to be merit in looking at what can be done to encourage employers to take a more active role.

*I am in favour of making the law easier for employers to stick their neck out a bit in what they can say to employees without fear of being penalised by a regulator or ombudsman.* **Pensions Lawyer**

The traditional way for the employer to offer support is to establish a trust-based scheme with a board of trustees. However, trust-based schemes are in decline, as employers move to the simpler, cheaper contract-based arrangement. This is not just a question of lower employer contributions – the move to contract-based DC decouples the scheme, its liabilities and its expenses from the company and directs all risk and expense towards the member. Under trust-based DC, the employer usually pays some or all of the costs, for example administration, whereas both administration and investment costs fall on the member in contract-based plans. Since pension tax simplification was introduced in April 2006 there has been no tax advantage in trust-based schemes. Previously members could take a higher tax-free cash sum out of a trust-based model, but simplification created a level playing field in this respect, with the standardisation of maximum cash at 25%. For all of these reasons insurance companies and financial advisers have a tremendous advantage in their bid to sell contract DC. It is a very attractive proposition to employers weary of the trust-related administration, cost and liabilities.

*Employers are switching to contract DC to put a distance between themselves and the scheme outcome, so that all they have to do is collect and forward contributions – they don't want to be involved in the fund choice. IFA*

*We have virtually no new business enquiries for trust-based DC. We have lost trust-based clients to contract-based schemes. The life companies' pitch is that they offer a more straightforward platform. Asset Manager*

*There is no longer a tax advantage to trust-based DC and it brings additional headaches. Asset Manager*

While employers are moving from trust-based to contract-based schemes to reduce their responsibilities, there are some indications that the regulators may wish to see employers take more direct responsibility for the oversight of contract-based schemes. The box on the next page highlights some important investment issues raised in TPR's recent consultation paper on DC regulation.

## *The regulation of DC investment*

In November 2006, The Pensions Regulator (TPR) published a consultation paper setting out how it intends to regulate DC pensions. Chapter 3 of the paper deals with investment and raises a number of important issues.

The paper notes four issues that TPR believes could contribute to poor investment practices:

- Inadequate processes for the selection and ongoing review of performance of investment managers and funds
- Provision of an inappropriate fund or range of funds
- Inappropriate design of the default fund
- Lack of member understanding

In terms of fund choice, the paper notes that the investment range must allow members to make choices that suit their circumstances, but that providing too wide a range increases complexity and may increase the risk of administrative errors being made.

TPR says that it intends to offer guidance on good practice in the following areas:

- Effective processes for selecting and reviewing investment managers
- Effective processes for the review of investment funds
- How to offer a well-designed fund or range of funds to suit member demographics
- Examples of different approaches to the design of default funds
- Examples of investment options including diversification
- Examples of clear and simple information that can be provided to members

Perhaps the most important part of the consultation paper is the section covering the Regulator's "expectations", which can be viewed as a description of the standards that need to be met. In the context of the trend – at least amongst smaller schemes – to move from trust to contract, it is notable that the expectation is addressed to "trustees, and where appropriate managers, providers *and employers*" [our emphasis]. This may suggest intent to take a wider view of responsibility in contract-based schemes used in an occupational setting.

The stated requirements are:

- There is a robust selection process for investment managers and funds, and regular performance reviews
- A suitable fund or range of well-managed funds is offered, especially in respect of the default fund
- Steps are taken to help raise members' understanding of investment decisions, level of risk and potential impact on benefits

The Regulator's guidance on DC investment issues can play a key role in helping employers and trustees to design their DC arrangements in a manner that is helpful for members. Obviously, the more clarity that can be provided the better. We argue in this report that employers and trustees may be encouraged to provide more support for members by safe harbour provisions that restrict liability for outcomes where appropriate steps have been taken in reaching a decision. If employers and trustees can show they have followed TPR's guidance then that may have some impact on any discussion of liability for poor investment results. However, formal safe harbour provisions might be more beneficial.

### *Implicit and explicit advice*

Many of the problems in DC investment could probably be solved by providing members with individual investment advice. However, this is quite rare due to the cost. Generic guidance obviously has a role to play, but some of the professionals we interviewed noted that it was typically not sufficient to enable members to make confident investment decisions.

*If the government is to provide all adults with free generic financial advice to help them deal with their affairs, then the responsibility for generic pension information would seem not to fall on the employer, though more paternal employers may choose to provide these in any event. I believe that most people actually need far more than generic financial advice at points in their lifetime, for example on joining, transferring, or retiring.* **Consultant**

Employers and trustees are wary of giving advice, but members would like some guidance from an expert. Furthermore, what the FSA defines as advice is a long way from the definition most employees would use. Many members will regard aspects of the design of their scheme as implicit advice. This is particularly true of the default fund, which members can easily regard as being chosen as being suitable for them.

*The selection and monitoring of the default fund or funds is absolutely critical to the success of the scheme and to good governance. It doesn't matter that the regulations do not regard this process as 'advice' in the technical sense. Effectively it is advice, since most members take the default option on the assumption that it has been selected specifically for those who do not want to make investment decisions.* **Trustee**

### *Summary and recommendations*

The definition of governance must be debated and established clearly in relation to both trust- and contract-based DC. While the FSA and TPR have said they are not interested in a merger, in the context of DC pension arrangements our research suggests that they must work as one body to provide combined regulation and models of best practice in relation to governance.

Each party to the scheme – and this could include any combination of the employer, trustees, adviser, consultant, life office and asset manager – should be set clear regulatory responsibilities. In exchange for taking a greater fiduciary role, they should be protected through the introduction of safe harbour rules.

By safe harbour, we mean provisions that relieve the employer, trustees or other party from liability for the investment outcome provided the decisions they take conform to the standards set out in the regulations. Details of safe harbour provisions used in the US are set out in the box on the next page. It is not compulsory for employers and others to follow the safe harbour guidelines, but doing so provides important protections which many will be reluctant to forgo.

Our argument is that provision of safe harbour provisions should encourage employers, trustees and advisers – the relative investment experts – to provide more support to members in investment decision-making. Key areas of application include specifying and selecting default funds, choosing appropriate ranges of investment choice, and providing members with appropriate information and guidance.

Obviously, care needs to be taken in developing and specifying the safe harbour provisions. They are likely to drive behaviour and if they are poorly thought out, that behaviour may be no better than the situation we have today. Nevertheless, we recommend the safe harbour approach as a possible way of ending the process of employers, trustees, and advisers distancing themselves from investment decision making in DC schemes.

### *US Safe Harbour provisions for DC default funds (“QDIA”)*

The US Employee Retirement Income Security Act (ERISA) provides relief from liability for investment outcomes for sponsors (“fiduciaries”) of DC pension plans, typically 410(k) plans, where members make their own investment choices from an appropriate range of funds on offer. This relief is known as a ‘safe harbour’. Some plan sponsors have worried about potential liabilities arising from the performance of default funds on the basis of an interpretation that default funds are not “chosen” by members. Many have responded by either refusing to have a default fund or choosing a low-risk fund, such as cash, as the default to minimise the chances of short-term losses. These decisions can create a number of adverse consequences such as discouraging employees from joining (because they must make a fund choice), preventing use of automatic enrolment (which requires a default fund), and encouraging recklessly conservative investment strategies.

The Pensions Protection Act of 2006 contains several measures designed to support the use of automatic enrolment, one of which is an amendment to the ERISA safe harbour provisions. The new provisions create a safe harbour where:

- Assets are invested in a Qualified Default Investment Alternative (QDIA)
- Members have been given an opportunity to provide investment direction but have failed to do so
- Members have been given notice 30 days before the initial investment and again 30 days before the start of each plan year about how their assets will be invested in the QDIA
- The plan offers a broad range of investment alternatives
- Members are able to switch out of the QDIA into the other funds

The regulations also provide requirements for the QDIA:

- It must not impose any transfer penalties on switching to other funds
- It must be managed by a registered investment manager or investment company
- It must be diversified so as to minimise the risk of large losses
- It may not invest employee contributions directly in employer-issued securities
- It may be a lifecycle fund, a target-date fund, a balanced fund, or a professionally managed account

A key point about safe harbour provisions is that they are not compulsory for sponsors to follow. The sponsor is free to choose an alternative course of action. The provisions do, though, give sponsors a firm steer as to what approach the government regards as appropriate. If the provisions are well-designed, they provide a powerful indication of best practice.

For more details see [www.dol.gov/dol/topic/retirement/index.htm](http://www.dol.gov/dol/topic/retirement/index.htm)

## Section 2: Governance and Default Funds

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### *The survey says...*

89% of the pensions experts we surveyed think that a DC scheme should have a default fund.

Respondents, on average, say that, where a scheme has a default fund, typically 82% of members invest in it.

57% of respondents think DC schemes should offer a lifestyle fund as the default, while 39% think lifestyle should be available as an option members can choose

In this section we examine what constitutes good governance in the context of default fund design. We also discuss lifestyle funds, given that lifestyle is a common approach for the default fund.

The results of our survey, together with other surveys such as the NAPF 2006 Annual Survey, show that typically more than 80% of scheme members accept the default fund, many of them passively. In the Building and Civil Engineering Benefit Schemes' (B&CE) stakeholder scheme for the building industry – the largest in the UK with 450,000 members – over 99% of members opt for the default.

The B&CE scheme provides a good indication of the behavioural characteristics of the target market for the Government's proposed scheme of Personal Accounts, in that its members are lower-to-median earners, typically first-time investors, and often with peripatetic careers. We believe the B&CE scheme experience is representative of the behavioural patterns that can be expected from Personal Account members and members auto-enrolled into an existing employer scheme, who previously have not shown any interest in joining.

Default funds, therefore, are essential for the reluctant investor, who is deterred from joining if membership involves making complex, often incomprehensible, investment choices. Default funds are obviously also required where automatic enrolment is being used. While reluctant investors may be willing and in some cases keen to understand what the outcome of the scheme means to them, in practice they do not feel confident enough to engage with asset class characteristics, inflation risk and investment risk. They want an expert to resolve these complex issues for them.

*It is tempting to suggest that a default should not be offered in order to force people to make a decision. However, thinking realistically, it is unlikely that we will, in the foreseeable future, get many people to engage with this decision, so I think a default is necessary and may produce better/less volatile results than would be true for people forced to make a choice. Insurance Company*

The NAPF 2006 survey reports that 83% of DC schemes have a default fund. Despite this widespread use, our research revealed growing concern amongst some advisers about the potential liability of employers, trustees and advisers for any problems arising in the default fund.



*By opting for the default fund the members assume implicit advice has been given and this is hugely worrying. This is the reason why some employers and their advisers don't want to offer a default – they want the members to make a conscious decision, although whatever fund they choose is likely to be lifestyled to cater for the fact that even if members make a decision on joining they rarely revisit this. But this is counter intuitive from the governance perspective – that is, what keeps employers, providers and advisers out of trouble is to offer a fund choice – but for the member this can be very confusing.* **Consultant**

*The real purpose of the default is to encourage people to join. Without it, people will see that they have to make complicated choices and will not join. But, there is a trend away from defaults in occupational DC because the trustees are afraid they will be held accountable for the outcome.* **Asset Manager**

*I am increasingly of the view that providers and employers can't escape liability for the outcome where there is a very large number of people in a default fund. Members who accepted the default will claim that they didn't actively choose it. We try to avoid this problem by making it clear at the sign-up that it is the individual's responsibility. Our contract explains that the member has a range of funds to choose from and that 'if you don't make a choice we will assume you have chosen the index tracking lifestyle fund'. The member has to agree to this statement in order to proceed.* **Insurance Company**

### *Choosing the default fund*

Independent trustees, asset managers, providers and advisers agreed that members generally see the default fund as implicit advice. We investigated the selection process for the default fund and found that employers using contract-DC usually delegate the choice to their adviser. The adviser, in turn, tends to recommend the default fund put forward by the selected provider. Historically this has been either a balanced managed or index-tracking fund, depending on the provider's areas of specialisation. This means that the default fund is not driven by buy-side needs, but by sell-side expediency.

*With stakeholders, the main driver is cost – so the default fund will be the life office's cheapest option. So, if you have an L&G stakeholder the default will be passive; Scottish Whatever's will be the active balanced managed fund. The [members'] 'choice' therefore, is illusory. Generally the consultant or IFA will select the provider, so the default is not a major consideration.* **Asset Manager**

The TPR consultation on DC governance – discussed in Section 1 – notes the intention for the Regulator to provide guidance on the process for selecting a default fund. This would seem likely to include issues such as considering the risk tolerance of members, the appropriate means of managing risk as members approach retirement, and the effective management of costs. As we argued in Section 1, it may make sense to go further and establish safe harbour provisions that protect the employer from liability for the outcome of investment in the default fund provided that appropriate care has been taken in the selection decision.

## *Lifestyle funds as the default*

Lifestyle (or lifecycle) funds switch members' pension fund assets from equities, or other growth-type investments, to bonds and cash as the planned retirement date approaches. A lifestyle overlay is a common component of default options and it serves two important purposes. First, it ensures that members are invested predominantly in equities, or other growth assets, for most of the accumulation years. Second, it ensures that members gradually switch from risky to safer assets in the few years before retirement to avoid the potentially disastrous impact of a market crash, or increase in annuity costs, at a time when earned income is expected to cease shortly.

The reluctant investor needs a fund that will cater for his or her needs throughout the accumulation phase and that also provides some flexibility in the run up to retirement. This flexibility is important, as the actual date of retirement is rarely certain and, with increasing longevity, employees may decide to continue working past their expected retirement date either on a full- or part-time basis. Extended working lives may also become more common following the introduction of age-discrimination legislation in 2006.

The lifestyle approach is common in practice, with the NAPF 2006 survey reporting that it is used as the default in 63% of DC schemes. However, there are differences of view over:

- The length of the lifestyle switching period
- The exchange of assets involved in the switch
- If lifestyling is even an effective strategy at all<sup>5</sup>

There is also a concern that where there is only one lifestyled default fund this gives rise to an over-concentration of members in a single fund. As mentioned earlier, this poses potential problems for employers in particular if members are dissatisfied with the outcome and complain that they were 'directed into' an inappropriate fund.

At present, lifestyling is mandatory for default funds in stakeholder schemes and optional for other DC arrangements. From 2012, all employers that plan to auto-enrol the workforce into the existing DC scheme will have to offer a lifestyled default.

*There's also the issue of liability. Some trustees see lifestyling as a tacit recommendation, others see it as encouraging apathy. However, proponents argue that the requirements of self-selection intimidate potential members. Consultant*

Pensions experts interviewed for this research broadly agreed that while lifestyle is a useful mechanism, it is also a blunt instrument, as it does not take account of flexible retirement income needs but rather assumes that the member will buy an annuity on the expected date of retirement. Therefore, the member is switched out of the main accumulation fund and into a fund that is, typically, 25% cash to provide the tax-free cash, and 75% fixed income, to hedge the annuity purchase risk. Obviously, this has to be questioned if, under the new post-A-day legislative framework, a single annuitisation transaction at the point of full retirement becomes less common.

*Is lifecycle targeting 75% bonds and 25% cash out of date following A-day, given phased retirement and drawdown?* **Consultant**

The variety of different lifestyle mechanisms that are in use across the DC market suggests that opinions vary about what is most effective. Different providers operate lifestyle mechanisms that start the switch into safer assets at any time from three to ten years (and in a few cases more) prior to the expected retirement date. Equally, the growth vehicle in use for the early years of membership varies across providers and can be a UK equity fund, a global equity fund or some form of balanced fund, with additional variations in terms of active or passive management.<sup>6</sup>

*Lifestyling is at the heart of the orthodox DC investment strategy. It is a logical precaution after the security of a DB promise. Ten years is becoming a common switching period but the loss of equity returns is significant – five years is better and it should retain some equity content throughout.* **Consultant**

*Lifestyle hasn't changed or developed for a decade. The thinking varies. Some argue that a three-year switch is optimal to allow for maximum growth but in practice it does not work. This is largely because people don't know when they are going to retire and three years doesn't give enough flexibility – nor does five in many cases. The current trend is towards an earlier start for switching. One of our clients decided to err on the cautious side and recently changed from five to ten years because of the uncertainty over actual retirement dates.* **Consultant**

The decision of the switching period is driven by two main considerations. The first relates to managing market risk: obviously a longer switching period provides greater protection from losses, but on the other hand imposes a cost in terms of reduced expected return, given the longer period in low-risk/low return assets. The other consideration relates to uncertainty in relation to the member's retirement date. A short switching period may mean that a member who is forced to retire a few years early is still heavily invested in equities – and a hostage to market conditions – at that point.

### *Target-date funds as an alternative to lifestyle*

Traditional lifestyle funds switch the member's balance from risky assets, such as equities, to safer assets such as bonds, as the planned retirement date approaches. Typically, this is achieved by switching the units of the funds the member is holding from, say, the equity fund to units in the bond and cash fund. An alternative method that simplifies unit holdings is the target-date fund.

Target-date funds work on a similar principle to conventional lifestyling, but the switching occurs within each dated fund. So, for example, a member expecting to retire in 2040 would buy the "2040 Fund". This would have an internal lifestyling mechanism and would start to switch into safer assets in, say, 2030 so that by 2040 the fund is 75% in fixed income and 25% in cash.

Target date funds have a number of attractions:

- Target-date funds may be easier for members to understand: they simply choose the fund that coincides with their planned retirement date and the manager does everything else. In this way they focus the member on the final outcome rather than on shorter-term performance.
- They are flexible and enable members to phase retirement by investing in more than one fund, or to change the retirement date by switching to a different fund. (*"I am no longer retiring in 2025 so I shouldn't be holding the 2025 fund."*)
- They may be easier to administer and lower cost than lifestyle. The member holds the same set of fund units throughout his or her period of membership and switching is done in large increments in the fund rather than as a series of small unit transactions.

The switching can be done on a mechanistic basis – as per lifestyle – or, potentially, on an active basis where a discretionary manager considers the timing of the switch and can respond to market conditions. In the latter case, it may make sense to allow faster than planned switching to safe assets, but not to allow slower switching given the potentially serious consequences if the manager gets that judgement wrong.

The table below shows Axa's retirement lifestyle target-date funds and their asset allocation as at March 2007. This is provided as an illustration of the nature of these types of funds rather than a comment on the specific nature of the Axa offering.

#### Asset Allocation (%) of Axa Lifestyle Retirement Funds – March 2007

Fund Target Date	2010	2015	2020	2025	2030	2035	2040	2045	2050
UK Equities	22	52	61	61	61	61	61	57	57
International Equities	13	32	37	37	37	37	37	38	38
UK Gilts	17	4	-	-	-	-	-	-	-
UK Corporate Bonds	26	5	-	-	-	-	-	-	-
International Bonds	21	5	-	-	-	-	-	-	-
Cash	1	2	2	2	2	2	2	5	5

Source: Fund factsheets on Axa website

Target-date funds may be appropriate for use as the default in a DC scheme. As with many forms of funds, providers may take different views on what is an appropriate asset allocation to support the target-date. This diversity is not bad in itself, particularly if we think of the problems created by the 'herding' of balanced fund managers in the 1990s. However, given diversity in the underlying asset allocations, employers, trustees and advisers need to make their selections very carefully with the member profile in mind.

In Section 3 below we discuss the idea that schemes should offer members a narrow range of risk-graded multi-asset strategies in order to simplify investment choice. There is no reason why this idea could not be used in conjunction with target-date funds. For example, each target-date could have funds with high-, medium-, and low-risk mandates. Equally, target-date funds could be constructed using the diversified growth ideas discussed in Section 4.

Perhaps the main disadvantage of the target-date fund idea is the potential for fund proliferation, which could create either administrative or communication difficulties. This issue is partly linked with the question of how many target-dates to cover, i.e. should there be funds for each year, or is using five year intervals sufficient?

### *Managed accounts or individual lifestyling*

Managed accounts represent another alternative to the traditional lifestyle fund approach. Under this system, members receive tailored fund allocation recommendations based on their specific circumstances. The recommendation is delivered by computer and takes account of the member's age, income and other particular circumstances. Importantly, it adjusts the target asset allocation to take account of the member's rights to state benefits and the asset allocation of retained pension rights held elsewhere.

The trend towards the use of third-party asset allocation services has been growing in the US. The employer has to go through a due diligence process to select the asset allocator and both parties are fiduciaries to the scheme. ProManage is one example of a third-party asset allocator operating in the US 401(k) market.<sup>7</sup> The effect of these services should be to break up the concentration that occurs in a single default fund and to avoid the 'one-size fits all' nature of lifestyle funds. While there will be an additional charge for the service, the automated nature of the service means it can be quite low, of the order of 10-15 basis points. For some schemes, this may be a better alternative than the traditional route of providing a default fund, accepting that the results will still be driven by the ability of the asset allocator to generate a product that is suitable for members.

### *Changing the default fund*

In trust-based schemes, trustees select the default fund and the investment range, albeit they will be led by the provider and the investment consultant. An important issue arises when they decide the existing arrangements are no longer appropriate, for example due to sustained poor performance by the investment manager or concerns about its future prospects.

Where trustees decide to make a change, they need to think about how to deal with members' existing holdings in the fund that has been removed. Often the approach taken is to inform members of the change and invite them to switch. Trustees often seem reluctant to close fund options entirely and force members to switch. The result can be large numbers of members invested in legacy funds, with complications in administration, communication and ongoing monitoring.

*Trustees are not bold enough; they are weak and don't want to try anything new. Where they do change an under-performing manager, many fail to ensure members automatically transfer. Instead they send a letter saying that there is now a new manager – and they leave it up to the member whether or not to switch. The result is that most members stay put and end up with under-performing legacy funds. The ideal way around this is manager of managers, with the trustees delegating the manager monitoring and replacement to a third party. But most trustees won't go for this. Consultant*

An alternative is to create a range of funds in the employer's name – e.g. the XYZ UK equity fund. This is sometimes known as a 'white-labelled' fund, where the asset manager provides the manufacturing on an unbranded basis. The trustees and / or their adviser can then appoint one or more managers per fund and monitor them, replacing managers where necessary. This avoids the above problem because members don't have to make any decisions – they are automatically moved to the new managers. White label funds can, in some senses, be regarded as being "future-proof".

The white label approach also allows combination funds to be set up with multiple underlying funds. In this case, the trustees would instruct the platform provider to maintain the benchmark split between each underlying fund and the platform provider would carry out regular rebalancing back to that benchmark. Thus a fund can be created that uses 'best of breed' managers in sub-asset classes. The trustees could, for example, create a fund that is similar in structure to the growth fund they use in their DB scheme.

The white label would appear to have benefits from a governance point of view and from an administrative perspective. It should be possible in contract- as well as trust-based arrangements. However, employers and trustees may be reluctant to adopt this approach for fear of liability should their investment decisions turn out poorly. Again, there may be a need for safe harbour provisions that reassure the decision makers that they will not be held liable for the outcome provided that they followed appropriate steps in taking the decision.

### *Summary and recommendations*

We recommend that trustees, sponsors and their advisers consider target-date funds as an alternative to traditional lifestyle. Some may also wish to consider using a managed accounts service such as ProManage. Innovative investment strategies such as diversified growth funds may also be sensible defaults for some schemes. We discuss these types of investment arrangements in Section 4 below. There is no particular reason why these types of approaches cannot be combined with the target-date concept. Trustees and other parties to the scheme design and selection may be prepared to be more innovative on default fund selection if, as we discussed in Section 1, safe harbours are available to restrict liability provided appropriate diligence has been taken in the selection process.

## Section 3: Governance and Investment Choice

### *The survey says...*

Most of the pensions experts we surveyed think that DC schemes should offer a relatively narrow range of funds for members to choose from. The respondents' views on the appropriate number of funds to offer can be contrasted with data from the NAPF 2006 Survey on the actual choice provided by DC schemes.

Number of funds	Survey: % of Respondents	NAPF Data: % of schemes
1	0%	6%
2-5	17%	14%
6-10	57%	35%
11-20	9%	21%
20+	15%	23%
Don't Know	2%	N/A

### *Too much choice?*

Beyond the default, most DC schemes offer a range of funds for the active investor. The NAPF 2006 survey reports that 94% of DC schemes provide members with investment choice. Twenty three percent of schemes offer members 20 or more funds to choose from and 10% of schemes offer 40 fund choices or more.

In the late-1990s contract-based schemes tended to compete on choice and fund range and made platforms of 100+ funds available. The retail market and IFA channel appeared to be the driver of the extent of choice.

*Consultants like 12-15 funds, including 1 or 2 lifestyle products. This comprises the usual regional building blocks plus specialist funds, for example, SRI [socially responsible investment] and Sharia. Insurance Company*

*Consultants want a focused range, but IFAs want a wide range they can advise on. Insurance Company*

Today most advisers and consultants recognise that a small range of asset class funds is preferable, but they do not always feel confident, from a liability perspective, in narrowing down the choice. Our interviews revealed that the selection of an appropriate range of fund choices in relation to membership profiles is hampered by fear that the selection and elimination process could create a liability if it goes wrong, i.e. members could later claim that they suffered because better funds were denied to them.

*There have been a lot of articles recently on the inadvisability of providing choice. I have to say, having just joined my own firm's GPP, which had over 200 funds to choose from, I agree with this. Pensions Lawyer*

*It is difficult for employers to pare down fund choice. Typically they will want their consultant to do it. Consultants are wary of cutting funds out of predetermined ranges – there is ‘regret risk’ that the ones they exclude will do well. Asset Manager*

We appear to have the unfortunate situation whereby intuitively experts believe that a small range of funds is appropriate – a view endorsed by TPR in its online learning programme for trustees of occupational schemes – but what is offered frequently is a much wider choice, even though this is confusing and unhelpful for the member.

While many of the professionals we spoke to noted that fear of legal liability prevented employers, trustees and advisers from offering narrow fund ranges to members, a few suggested the potential liability might lie, rather, in the failure to provide an appropriately focused range.

*There is a growing fear that members, who have little power when it comes to their providers, will turn their anger on their employers and seek legal advice. It is felt that it is only a matter of time before a member of either a trust- or contract-based scheme will take the employer to court, because he or she has too much choice with regards to investments, was not given any guidance with regard to the contributions and investment choice, and no-one explained the consequences or monitored what the member or providers were doing. Insurance Company*

Wide choice may also be inefficient from the asset manager and scheme provider’s point of view. Many fund options exist on the platforms with ongoing costs attached, but most gather few assets.

*It is difficult to get coverage where your fund is not the default. We do get some flow from schemes where the members are more sophisticated, for example employees at investment banks. Asset Manager*

*Does open-architecture work? No. The bulk of the contributions go to the default fund, so there is not much in it for third party asset managers. Asset Manager*

*You have to ask why so many funds are being made available to members when the take-up is so low. Where a range of funds is offered 57% are empty. If schemes can’t communicate the benefits of having so much choice and variety to the members – is it worthwhile having them? Consultant*

Beyond the reluctant investor, there may be members who want and need a wider fund choice. If schemes want to provide choice for this group, it is important they do so in a manner that does not impose costs and complexity on the vast majority of members with simpler requirements.

Employers and trustees who decide they do need to provide members with extensive choice (and they might not) should be prepared to establish an appropriate filter system for the investment range. This would involve creating two or three layers of fund choices, so that members with basic requirements need only consider the simple choice offered in the first tier and the wider range is only displayed to those who request it. The first tier could start with the default and a small range of multi-asset funds, with alternatives for those with ethical or religious requirements. A multi-manager or white label approach may be suitable for these funds, so that the member’s choice is based on asset allocation rather than high profile names in the investment industry. The second tier can



include a wider range of funds for investors who would like to tailor their own asset allocation or adopt particular investment styles.

As well as using filtering, our view is that fund choice for the more active investor should also be limited. It is unlikely that a fund platform that offers 200+ funds is appropriate for DC investors except in a very small minority of cases where the directors and executives of a company are advised on an individual basis. This part of the DC scheme can be separated out as a group SIPP, if necessary. The point can always be made that individuals with really specialist needs can opt out of occupational pension provision and get what they want elsewhere, accepting that for some this may mean a loss of employer contributions. The fund choice line has to be drawn somewhere and evidence suggests that fund proliferation has a negative effect on the majority of members.

### *Risk-graded multi-asset funds*

Many DC schemes offer a default fund, frequently a balanced managed fund or an equity index tracker, with lifestyling, and find that most of their scheme members passively accept this option. For members who want to choose their own investment strategy, there is typically a range of 'self-select' asset class building blocks (UK equities; European Equities, Corporate Bonds etc) that they can use to build a strategic asset allocation that meets their needs. However, most of the professionals we spoke to regarded this 'DIY' asset allocation as an extreme minority interest and this can explain the high proportion of members who end up in the default.

As we have discussed above, it is unlikely that a single default fund will meet the risk/return preferences of 80%+ members of the scheme. The issue may be that the default fund is the only 'packaged' option and moving from that to DIY asset allocation using individual funds is too intimidating for most members. One alternative to this, which is growing in use, is to offer a small number of packaged options that members may choose from. For example, the scheme could offer either three or five multi-asset strategies differentiated by the balance between risky and safer assets, with some form of lifestyle overlay to manage risk through time. Members can choose amongst them based on their perceived attitude to investment risk, and the funds can be described or categorised on that basis.

One way to characterise the funds is to give them names such as: Adventurous, Balanced, and Cautious (the "ABC" approach). These names attempt to differentiate the funds for the reluctant investor. Underlying the classification can be a more objective measure of risk, for example, where each fund has a target range for its value-at-risk or volatility parameters. Three funds would seem to be sufficient for this purpose. Although five funds is certainly feasible, it runs the risk of creating the very complexity the concept is meant to eliminate. ("Am I very cautious or just moderately cautious...?") There may be arguments for an even number of funds, although excluding the prospect of a 'middle option' again might introduce an unintended layer of complexity.

### *Limiting choice to two funds*

At the extreme, it is possible to argue that members only need two funds: an efficient growth vehicle that can be used to generate return through the earlier years of membership and a lower risk fund that can be used to protect the value of the pension fund (capital value or annuity purchasing value) nearer to retirement.

B&CE Benefit Schemes (B&CE) provides employee benefits to companies and workers in the building and construction industries. It provides benefits to 6000 companies and its stakeholder scheme is argued to be the largest in the UK with over 450,000 members. The scheme offers a very simple investment choice: there is a passively managed balanced fund (85% equities; 10% bonds; 5% cash) and a cash fund. The default is to invest 100% in the balanced fund until five years before the planned retirement date and then switch into the cash fund gradually over the remaining term. The vast majority of members (over 99%) go for the default, but those who do not can choose their own mix between the balanced fund and cash. Many providers use long maturity bonds as their safe fund as a hedge for annuity rates, but B&CE decided that capital preservation was more important to their members. A key part of the thinking in the simple investment design is that the target market for the scheme is not one where members have high levels of financial sophistication.

Some consultants argue that the two-fund approach might be appropriate for a wider range of companies. Watson Wyatt's 'Forward Thinking Company' research argues that DC arrangements should make available a limited number of cost-effective investment building blocks that meet the needs of most members when mixed in varying proportions. The blocks themselves may be sophisticated investment strategies, for example, diversified growth funds, but the communication of them can be simple and focused on what each strategy is expected to do for the member, for example "Growth" and "Safety" or "Capital Protection" funds. With such a combination, in theory just about any preference for risk can be accommodated. In practice, members may be reluctant to structure their own asset mixes from these blocks, but the scheme could offer a number of pre-packaged options.

Members can be provided with some kind of risk profiling questionnaire (see Section 5) to help them consider their attitude to risk. Some providers suggest that this type of approach has been helpful in reducing the percentage of members who end up in the default fund. The key is in making the fund choice more manageable for the non-expert, although it is fair to say that inertia remains strong and many members will, in any case, end up in the default fund.

*Risk profiling of members can be advantageous. You're more likely to offer a suitable fund range and to get positive member feedback. But it's labour intensive and there are regulatory risks. IFA*

A major influence on equity allocations in 'cautious' and 'balanced' funds is league table pressure and this creates problems due to 'herding'. For a number of years many UK-based DC providers have offered multi-asset funds in the form of 'balanced managed' funds. These typically contain a mix of domestic and international equities, fixed income assets, and sometimes property. While many started out as a reflection of the manager's view of an attractive diversified

growth strategy, peer group measurement in the form of league tables soon resulted in asset allocation herding with few fund managers prepared to depart significantly from the asset allocation of their peer group (which recently has been about 80-85% equity; 15% fixed income and up to 5% cash.)

*As regards fund classification, the ABI definitions are misleading. They imply a particular risk profile, which may not be accurate. Managers chase the sector average. Balanced managed can have up to 85% equities; the median currently is 82%. Cautious managed can have a maximum of 60% in equities. The incentives for asset managers to outperform are not aligned with the objectives of the members.*

**Insurance Company**

The move to multiple risk-graded managed strategies offers scope for asset managers to break free from the peer group allocations and reconsider what is an appropriate asset allocation for a balanced investor, a cautious investor, and so on. In the case of Scottish Life and Scottish Widows <sup>8</sup>, the providers have sought the advice of risk consultants Barrie and Hibbert in forming asset mixes that appear to be on the 'efficient frontier' of the risk return trade-off – that is, investment portfolios that give maximum expected return for a given level of risk.

It is worth noting that the providers adopting this approach may be taking a commercial risk. A significant amount of business in the pensions industry is sold on the back of fund performance, and league tables form the instrument of measurement used by advisers and consultants. By structuring the balanced fund in a way that is different from the sector median, for example holding 70% equity rather than 85%, you face the possibility that your fund will rank poorly in the league table on account of particular market conditions. This is a risk that not all providers appear to be prepared to take at present.

While the "ABC" approach appears to have merits, employers, trustees and advisers need to make sure the provider's interpretation of risk profile matches their own view. It is unlikely that many members will be able to do so for themselves. As we can see in the table on the next page, views on what is adventurous, cautious or balanced vary across providers. We are not saying that asset allocation herding is preferable, but employers need to be comfortable that the provider's view fits with their own and that members will find the descriptions helpful rather than misleading.

### Examples of risk graded managed strategies

Cautious	JP Morgan	Scottish Life	Scottish Widows
UK Equities	25%	15%	35%
Overseas Equities	25%	13%	35%
Fixed Income	49%	54%	30%
Property	-	18%	-
Cash	1%	-	-

Balanced	JP Morgan	Scottish Life	Scottish Widows
UK Equities	49%	30%	43%
Overseas Equities	34%	25%	43%
Fixed Income	14%	27%	15%
Property	-	18%	-
Cash	3%	-	-

Growth	JP Morgan	Scottish Life	Scottish Widows
UK Equities	30%	41%	50%
Overseas Equities	69%	34%	50%
Fixed Income	-	7%	-
Property	-	18%	-
Cash	1%	-	-

Source: company fund fact sheets, various dates. Cautious, Balanced and Growth are used a generic terms for the funds on offer, actual fund names vary by company. In each case, we take the asset allocation for the growth phase, i.e. at least 15 years to go to planned retirement date. Fixed income includes index-linked, gilts and corporate bonds. Some totals don't equal 100% due to rounding.

One issue raised by a number of pensions professionals was whether these types of funds should have descriptive names, such as "Cautious" or names based on factual aspects, such as the equity content ("The 75 Fund", which has a 75% equity allocation). The argument for the latter is that there is less risk of members being misled, for example where they interpret "Cautious" in a way that is different from the provider's view. However, elsewhere we make the argument that members will be better served by communicating funds based on *what they are expected to achieve* rather than on the asset allocation and investment style.

*It's particularly important that the literature explains risk in an accessible way. A common mistake is that members think that passive is low risk. The lifestyling also needs to be explained – the switch to gilts to hedge annuity risk does not prevent volatility. Members naturally assume that a 'safe haven' will not incur capital loss.*

Consultant

Finally, it is worth noting that the ABC approach does not remove the need for a default fund: some members won't complete the risk profiling questionnaire and some that do so still won't make an active choice of one of the three funds. It should, though, reduce the proportion of members going in to the default on a passive basis by providing a simpler menu for active choice.

## Investment Style: Active, Passive and Multi-manager

*The survey says...*

	% saying appropriate or very appropriate for DC	% saying inappropriate or very inappropriate for DC
Passive equity funds	92%	2%
Active equity funds	89%	4%
Multi-manager equity funds	82%	6%

Having decided on a broad asset structure, the next question is what underlying style of management is appropriate: active, passive or multi-manager. The choice may well come down to the governance mechanism and resources that are in place at the particular pension scheme.

An important consideration is what happens if an investment manager performs so poorly that replacement is warranted, or experiences changes that suggest future underperformance is likely. In trust-based schemes, trustees can replace the manager and this will be easiest where they have used the 'white label' approach discussed in Section 2. However, it is less clear what can be done in a contract-based scheme where the main legal relationship is between the provider and the employee/member. One argument put to us was that for this reason funds, especially default funds, in contract schemes should be passive, on the grounds that active management needs the trust framework for appropriate governance.

*Trustees can afford to chase alpha. Consultant*

The active or passive decision is also driven by the issue of costs, particularly in the case of default funds. Growing pressure on headline charge rates, and explicit limits in the case of stakeholder schemes, drives the decision towards passive, index-tracking funds.

*Whichever fund you offer for the default it has to be cheap to run – that's why we offer a UK index tracker. Insurance Company*

*Innovation through more fund choice isn't the answer. There's no right answer but a global equity tracker is probably best for the default fund. It's not just about active manager risk – it's about cost. Consultant*

*We start with the basic benchmark, which is indexation, and then consider what is the appropriate price to pay for investment 'hope'. Consultant*

However, it is important to avoid giving members the impression that a passive fund is low risk. Risk relative to the index is low, but overall asset class risk may be high.

Multi-manager may offer a middle ground between active and passive, providing the potential for active returns, but without the reliance on a single active manager. However, multi-manager often comes with the implicit assumption that the provider will pick the right managers and pre-empt problems by removing underperforming managers on a timely basis. While that will certainly be the intention, multi-manager does not of itself guarantee a successful outcome. Given the proliferation of multi-managers in the market, advisers and consultants should investigate the providers' processes carefully before making the appointment. Otherwise they face the same problems as with single managers and usually at an increased cost.

## Section 4: Innovations in DC Investment

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### *The survey says...*

57% of the pensions experts we surveyed think that certain aspects of liability driven investing (such as diversified growth funds) have a role to play in DC schemes.

78% of respondents think that diversified growth funds are either appropriate or very appropriate for use in DC schemes.

54% of respondents think that structured and guaranteed funds are either appropriate or very appropriate for use in DC schemes; 26% of respondents think they are either inappropriate or very inappropriate.

32% of respondents think that hedge funds are either appropriate or very appropriate for use in DC schemes; 54% of respondents think they are either inappropriate or very inappropriate.

### *Diversified growth funds*

A growing number of DB pension schemes are adopting liability driven investing (LDI) approaches for their assets. Typically, this means investing some of the scheme assets in a manner that should hedge changes in the scheme's liabilities, as a result of, say, a fall in interest rates, while adopting a more diversified asset structure for the assets which the scheme has available to generate investment growth. This is referred to as 'diversified growth' and means a greater role for asset classes such as private equity, property, commodities, infrastructure and, potentially, hedge funds.

*LDI ideas translate nicely into DC. LDI is two basic ideas, one using swaps instead of bonds, the second using diversified assets rather than just equities. However, there are issues in terms of the current pricing of swaps – they are expensive. Also while equities are transparent in their characteristics, some alternatives are not. We don't have the data histories. Moreover, you are exposed if you move away from the herd.*

**Consultant**

The rationale behind diversified growth funds (also known as 'new balanced') is that they create a more efficient risk/return trade-off than equities alone. This is an idea that seems to translate readily to DC – there is no particular reason why a diversified growth fund would not be suitable for use in a DC scheme, either as the default (where it can be lifestyled, if required) or as a fund for members to choose. DC scheme members are unlikely to be comfortable taking an investment view on alternative asset classes, but as we have argued above, if the assets are available in a packaged form and managed by the fund manager then members may be more comfortable. They don't need to understand traditional and alternative asset class characteristics, but only that certain asset class combinations can reduce risk and volatility.

*There are also difficulties in communicating the [Diversified Growth] approach, although maybe you could just not tell people what is in it.* **Asset Manager**

*We should probably communicate investment funds on the basis of “this is what it will do” rather than “this is what is in it”.* **Consultant**

A number of providers have launched diversified growth funds for implementation in DC. Examples include JP Morgan, Newton, Prudential and Schroders. The table below shows the current asset mix of these funds.

### Examples of Diversified Growth Funds

Growth	JP Morgan Diversified Growth	Newton Phoenix Multi-asset	Prudential Absolute Return	Schroders Diversified Growth
Target Return	8-10%	LIBOR + 2%	+ 5%	+ 5%
Equities	40%	35%	56%	52%
Bonds	-	22%	16%	-
High Yield	10%	4%	9%	13%
Property	15%	15%	10%	12%
Hedge Funds	15%	17%	5%	10%
Private Equity	10%	1%	-	3%
Commodities	10%	2%	-	5%
Currency Management	-	-	-	5%
Cash	-	5%	4%	-

Source: company factsheets and brochures, various dates. Totals may not sum to 100% due to rounding. Managers have scope for tactical asset allocation and these snapshots may not reflect the long-term strategic mix of each fund. JP Morgan figures are the typical mix.

One issue raised by diversified growth funds relates to management fees. In general, there is pressure from regulators, consultants and clients to reduce the fees charged on DC funds. However, diversified growth funds contain a number of specialist areas where management fees are typically high. It could be argued that superior (net) performance justifies these high fees, but where pressure is on the headline charge rate, that argument may not be considered.

*Diversified growth funds look a prospect, but there are questions over pricing, with consultants looking for low costs (less than 100 basis points).* **Asset Manager**

One solution to this problem may be to use low cost passive management where possible and desirable – for example, developed market equities – and to reserve the higher management fees for less developed markets or more complex asset classes, where it can be argued that there is greater potential for active management to be effective. This approach may lead to an average fee for the diversified growth fund that is within the range acceptable to the market.



### *Structured products, guarantees and portfolio insurance*

A number of providers now offer 'portfolio insurance' type arrangements for DC schemes. Basically, these work by incorporating portfolio management strategies that are designed to ensure, or help ensure, particular outcomes. Typically, this does not mean there is a guarantee from the provider, but merely that following the strategy in the past has enabled the fund to achieve the stated target most of the time.

One variant of this is the idea of return 'banking'.<sup>9</sup> In this approach the fund is initially invested in growth assets, for example equities, and a goal is set in terms of a target (absolute) return, for example 6% per annum after fees over the period through to retirement. The expectation is that, as retirement nears, the proportion of the fund invested in equities will be reduced and a higher proportion invested in safer assets. If equities do sufficiently well over any period, which pushes the cumulative return on the fund ahead of target, the excess is 'banked' by being invested in a safer asset, for example index-linked bonds. This is an alternative to lifestyle and an attempt to narrow the distribution of outcomes. The banking mechanism typically will include an incremental cost over and above that of the underlying funds, for example 10 basis points. The underlying funds themselves can be active or passively managed.

Research suggests that this approach can significantly reduce the risk of the DC fund in terms of the dispersion of outcomes, albeit at some cost in terms of lower expected return. In essence, the approach relies on a degree of mean reversion in equity performance, so that if markets do well in one period, they are likely to do less well in the next. In its purest form, this type of strategy should also involve raising the proportion of risky assets in the portfolio if the fund gets behind target in order to offer a better chance of catching up. One of the providers of this approach, the consultant LCP, has decided to offer an asymmetric version that does not have this risk-increasing feature. Their view is that few trustees or members would be comfortable with the idea of increasing equity exposure following recent losses. They have, however, had discussions with one employer with financially sophisticated employees, who would be prepared to implement a symmetric version of the strategy.

There are a number of important issues raised by these types of strategies. One difficulty is in communicating them to members. While members do not need to understand the algorithms used in the products, it would appear important that they have an understanding of what the strategy is trying to achieve, broadly how it works, and the circumstances under which it might fail to deliver the expected results. Even this may be too much for many DC scheme members. There is also the question of making sure that expectations are reasonable and can be met.

More generally, guarantees have a superficial attraction in DC. Members don't like investment risk, and guarantees give the impression that risk has been eliminated. The problems lie in ensuring the guarantee is not purchased at too high a cost in terms of the potential return, and in making sure members are not mistaken in terms of what they think they have been offered.

*I think there is strong logic behind capital protection at some level. I have tended to dismiss this in the past, as an industry purist, but there is no doubt that members like the comfort of guarantees. Asset Manager*

*Volatility is a real concern for most members of DC. On the one hand, you can pander to employees' desire to see minimal volatility in their returns by providing some type of guarantee as their investments go along, but on the other hand, guarantees are expensive to provide and the value of them is questionable for someone who is 30-40 years away from retirement. Consultant*

*Structured products, Constant Proportion Portfolio Insurance, and Target Driven Investing are all possibilities. The alternative is just to have a sensible asset allocation, for example target-date funds. Smoothing doesn't tend to work. People don't get what they expect. Asset Manager*

### *Summary and recommendations*

Diversified growth or new balanced funds seek to spread risk and reduce volatility by incorporating a much wider range of asset classes than most traditional balanced funds now do. This makes them ideal for a default fund, provided they can be delivered at acceptable cost. Use of index tracking in some of the asset classes may help to keep costs low. In Section 2 we discussed the use of target-date funds, and in Section 3 we discussed the use of a small number of risk-graded multi-asset strategies to simplify investment choice. We can see no reason why diversified growth funds cannot be used as part of these frameworks, for example by offering risk-graded diversified growth funds or overlaying a target-date perspective on the asset allocation.

Employers, trustees and advisers considering structured and guaranteed products in DC need to be cautious and probably should not offer them in their schemes. Such products need to be understandable to members, who, in turn, must be made aware of the possibility that the products may not deliver the intended outcome. Conditional guarantees are a particular concern, as these can be too complex for investors to understand and raise the prospect of mis-selling issues. Employers also need to be aware that guarantees can be a form of reckless conservatism, where the cost of the guarantee limits the upside return of the investments and delivers returns closer to cash than to equities.<sup>10</sup>

## Section 5: Governance and Communication

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### *The survey says...*

The pensions experts we surveyed, on average, think that only 10-15% of DC scheme members understand the investment risks they face. Over half of respondents put the figure at 10% or less.

89% of respondents think that an employer must or should provide generic pension information seminars.

39% of respondents think that employers should provide members with individual financial advice from a regulated adviser; 11% think that they should not.

68% of respondents think that employers should provide members with online financial modelling and risk-profiling tools; 6% think that they should not.

The DC communication challenge is similar to the debate on investment choice – you want to provide enough to be helpful but not so much that members are unable to make sense of it.

*DC plans and products have tended to be sponsor- and provider-led rather than being designed for the perspective of the member. Thus choice is given, but generally without sufficient communication or tools available to support the decision-making process that the member needs to go through.* **Consultant**

*Communications can be counter-productive. One client got the Finance team to draft the investment document – it was an inch thick and totally unreadable. While typically 80-90% of members end up in the default, in this case it was nearer 99%.* **Consultant**

*[Pension] communications and education in the UK is appallingly terrible.* **Asset Manager**

As well as providing basic information about investing for retirement and the products on offer, communication covers tools such as risk profiling questionnaires – discussed in the context of multi-asset funds – and stochastic modelling tools that allow members to do ‘what if’ scenarios in relation to changing investment choice, contribution rates or retirement dates.

Our overriding concern in this report is DC in the context of the reluctant investor. With this type of member in mind it is important not to overestimate what is achievable through communication. Inertia and low levels of financial literacy mean that many members won’t read information provided and even if they do they will either fail to understand or fail to act on the information. Few are likely to spend hours using online profiling and modelling tools. Those that do are likely to be relatively sophisticated investors already.

*Even where employers are prepared to pay for a good communication programme, there is only so much members want to hear. They want to know how the scheme works and what it will achieve. They don't want to hear about how equities work – their focus is on the outcome. Consultant*

There is also the question of converting communication to action. Previous research shows that effective communication can persuade DC scheme members that they should make changes to how their plan is being managed. However, it also shows that while many members may decide to make these changes, few follow through and the barriers that stop them can appear to be quite trivial.<sup>11</sup>

Some of the pensions professionals we spoke to observed that significant barriers to communications are embedded within governance and business relationship issues: employers weren't always keen to give the provider free rein on communications and where IFAs were involved, providers were reluctant to be too active for fear of undermining the adviser.

*We would like to do more [on communication] than employers will let us do.  
Asset Manager*

*We would like to do more on communication, but there is an issue for us in treading on IFAs' toes. Insurance Company*

Cost is another issue that has an impact on communication.

*The key driver on cost in any implementation is the level of communications, especially if you go for one-to-one advice. IFA*

*No one is prepared to advise members on asset allocation. Lack of advice to the end user is the key issue. Few employers will pay for individual advice for members.  
Insurance Company*

*I am concerned that all the focus is on the default fund – in a sense giving up on prospect of active member choice. Somehow, we have to try to reduce the proportion of members in the default fund. Members are not really in a position to exercise choice, but we should be looking to provide better advice and communications. However, no one wants to pay for this. Asset Manager*

Some argue that communication and education are futile. Certain DC experts in the US, for example, say that reluctant investors need autopilot devices such as default funds and that effort is better spent on these features than on education. Others argue a combination of approaches is required and that we must not give up on communication.

*Education and communication are critical to promote good investment decision-making, but there are limitations to achieving mass financial literacy. Consultant*

*We would prefer that members were engaged, but this won't happen for about 95% of this generation. We should, though, try to move people as far along as we can. Governance of the investment solution is key for 95% of the current generation.  
Consultant*

*The level of financial literacy in the UK is a hindrance to communicating pensions effectively. A fair number of people have neither the will nor the capacity to understand. Therefore financial education must come first. Even where people are financially able there is a level of pensions ignorance that is worrying. Packaged products and communications directed at key life stages could go some way in addressing this. Consultant*

Clearly if we are to improve financial literacy and confidence in the UK we must accept that there is a long way to go and cater for the current generation's needs.

### *Targeted communications*

Targeting is about giving people information that they are likely to pay attention to because it relates to a relevant point in their lives. Effective targeting may increase the response to communication efforts and raise the return on the cost and effort expended by providers, employers and trustees.

Perhaps the most obvious example relates to lifestyle strategies. Few 25-year olds are likely to pay much attention to the details of lifestyling in their pension plan, but a letter to older members a few years before the switching is due to start may get more attention. This could be useful to check that the member's requirements are the same as when the initial arrangement was put in place.

Communication may also become more salient when scheme members have more at stake – that is, when they consider that their fund value is substantial. This is subjective and so does not simply relate to the fund size but also relates to life stages and events.

*DC in the UK is immature, with low average account values. This may be a driver of behaviour. Investors may become more interested as fund values increase. Communication could be targeted on passing certain fund value hurdles, or on life events. Consultant*

Employers and trustees can use targeted communications to try to influence the behaviour of members who appear to be making mistakes.

*There is an onus on the pension provider to check the fund choices and to pick up on the outliers, such as a young person invested in a very cautious fund or fixed interest and an older person 100% invested in equities. You have to be careful not to give advice but it is possible to bring the situation to the member's attention. Consultant*

In the box on the next page we provide one example of where a provider used targeted communications in order to try to get scheme members who were following potentially inappropriate strategies to reappraise their approach.

### *Wake-up communications to members*

Fidelity <sup>12</sup> in Hong Kong were concerned that many younger scheme members had overly cautious investment strategies in their accounts. They wrote to these members noting the detrimental effect of inflation on cautious investment strategies and encouraged them to consider raising their allocation to other more appropriate fund choices.

A post card was sent to 6400 members who were aged below 45, had balances of at least HK\$2000 and who had 100% of their contributions invested in the capital protection fund. Six weeks after the campaign was launched balances totalling 2.5% of the value of member accounts had been switched from the capital protection fund to other funds. Of the members who switched 81% switched the whole of their balance, while the remaining 19% switched between 40% and 80% of their balances. While the results are fairly modest, it is possible that the cumulative effect could be stronger if the same message was followed up over a period of time. Also, as we discuss below, it is important to make sure that it is easy for members to make appropriate changes to their arrangements after receiving the message.

It may also be possible to engage pension scheme members by encouraging them to think about how their approach to retirement planning compares to that of their peer group. The member can consider how they are doing relative to “people like me”. This may make the issues more concrete and also help to show that any required improvements are feasible. PensionsDCisions, a newly founded consultancy, provides peer comparisons to members of DC schemes. More details are given in the box on the next page.

### *Peer group comparisons for members of DC schemes*

PensionDCisions is an independent provider of “high impact” reporting to DC scheme members. The service was trialled successfully by two blue chip employers last year. The key point of differentiation is that PensionDCisions aggregates raw administrative data to analyse investment decisions and savings rates of individual members. Personalised reports are delivered to members showing their asset allocation decisions, resulting performance and savings rates compared with their peers, while sponsors and trustees receive similar analysis on an aggregated basis for the entire scheme. The company explains: “In the past, the main focus for employees, sponsors and trustees has been how individual investment products perform against their respective benchmarks. Our service allows asset allocation and total portfolio returns to be benchmarked meaningfully for the first time.”

According to PensionDCisions, more than 80% of individual recipients surveyed provided positive feedback about the reports, while tracking of behaviour reveals that 34% of recipients took further action as a result of receiving a report. Crucially, the reports do not constitute financial advice, which reduces liability exposure for scheme sponsors.

The service is also used at the scheme level by trustees and sponsors to form a ‘bottom up’ picture of how each of their individual DC members is performing, and to identify distinct segments of the membership where tailored communications or other specific actions may be required. This information is relevant in identifying and managing many of the risks cited in the recent consultation on DC by The Pensions Regulator.<sup>13</sup> Peer group comparisons can be made across companies, e.g. within an industry, as well as within a single company. This can be particularly useful to trustees and scheme managers who wish to understand how their scheme is performing relative to others and to calibrate the quality of investment consulting advice.

### *Stochastic modelling tools*

It is important that DC scheme members understand that the outcome from their scheme is risky and that different courses of action, in terms of contributions and investment strategy, have different distributions of possible outcomes. Stochastic modelling is the appropriate tool for estimating what these different ranges of outcomes are. These models use simulation techniques to illustrate not just the most likely outcome from the member’s strategy, but also the possible range of outcomes. For example, the model might show that a strategy has a 50% chance of achieving a pension of at least £10,000, but a 1-in-20 chance that the outcome could be £6,000 or less.

A number of companies in the UK provide stochastic modelling tools applicable to DC pensions including DecisionsDecisions, Distribution Technology, LCP and Tillinghast. In many cases, these tools are made available to IFAs either directly, or via extranets run by providers. As we know, many employees in DC schemes do not have automatic access to advice from an IFA. Many schemes do, however, offer websites for members and a stochastic modelling tool may be a worthwhile addition to those sites.

One example of a pensions company providing modelling tools to DC scheme members is Pensco - a pensions management company based in Dublin. Its clients are typically DC pension schemes with membership ranging from 40-600 members drawn from a wide variety of industries. It offers an integrated administration/investment service where scheme members can access the DecisionsDecisions modelling tool, which is automatically populated with their details from the administration system. The members can see their chances of being able to retire on a particular level of pension, the impact of increasing their savings rates (up to allowable maxima) and are also given advice on where they should invest their money. Members can use an online questionnaire to assess their attitude to risk and receive an investment recommendation based on their attitude to risk and time to retirement. A member using this advice can transact online switches and can see the impact of these switches on the achievement of their retirement goal.

The 'click through' feature is very important in allowing members to follow up. Previous research has shown that even a modest barrier is likely to have a major impact on take up rates.<sup>14</sup> If a member can see that changes are required, but has to go off and request a 4-page form from HR to make the changes, most are not going to follow through.

The main downside in such modelling tools is that, in reality, relatively few members are likely to use them and they are of limited use where employees are not desk-based regular PC users. Another complication is in coping with state benefits and retained benefits (deferred pensions from previous employment), both of which are required to give members an accurate view of their prospects.

### *Summary and recommendations*

The provision of stochastic modeling tools and risk profile questionnaires to DC scheme members would seem to be best practice, although take up may be relatively low. Scope exists to tailor and target communications in order to engage with the reluctant investor; the more targeted the communication, the more likely it is to get a response.



## Section 6: Investment for Personal Accounts

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The Government has proposed a new national scheme of Personal Accounts to be introduced from 2012. These are intended to help reduce the number of people who are not saving for their retirement. They will be low cost and will use automatic enrolment to boost the take-up rate. Employers will have to automatically enrol their employees into the scheme or into a private arrangement of comparable quality. Members, however, retain the right to opt out.

Most of the issues we have discussed in this report are relevant to the new system of Personal Accounts. Indeed some potential problems become more acute under the 2012 reform. For example, with large numbers of lower earners and first-time pension savers in the system, default fund use will be very high. Furthermore, with a target annual management charge of 0.3% there will be no room for individual advice to members and little scope for more sophisticated investment strategies.

*With Personal Accounts someone has to take responsibility for getting the right outcomes for members – it has to be the government. If the annual management charge is 0.3% there will be no communications.* **Asset Manager**

*Personal Accounts will be implemented with something really dull.* **Consultant**

A wide choice of investment options in the system would seem counterproductive. There is no indication that the 600+ fund range in Sweden's Premium Pension System is at all helpful to members. In recent years, default fund use in that scheme has been high and evidence suggests most active choosers have done less well than the default fund.<sup>15</sup>

To the extent that it is felt necessary to have fund choice in the system, some form of filtering, as discussed in Section 3, could be used to avoid confusing less sophisticated members. Fidelity's proposal for 'Open Personal Accounts' where most members see only a limited range of funds, but those in search of more adventurous options can access a wider range, is a variant on this theme. Importantly, the cost of the more exotic choices is borne by those opting to use them rather than by the general membership.

The likely huge scale of Personal Accounts also creates potential issues. On the positive side, economies of scale should allow for efficient purchasing of the required investment and other services. Of more concern would be the prospect for concentration of large amounts of assets in the default fund to create distortions in the equity markets. This would be unlikely at the outset but may become an issue as the scheme grows.

*If Personal Accounts shunt millions more people into passive funds managed by a small number of asset managers, what will be the impact on the index?* **Consultant**

The active vs. passive debate is a thorny one for Personal Accounts. Even with a degree of separation through some form of governance board, active management implies government 'picking winners' while passive management leads to 'government sponsored' investment in a wide range of companies, not all of which will be politically acceptable. The latter is a more likely prospect given the desire to drive fees down.

*Vast scale will limit opportunities to differentiate from the benchmark.* Insurance Company

The nationwide nature of the scheme also raises the issue of religious or ethical considerations driving fund choice. The question, therefore, is at what point to draw the line between a minority requirement that is significant enough to be catered for within the scheme and a minority interest that is marginal enough to mean that the response is “if you want that you should opt out of Personal Accounts and get it somewhere else.”

Of the various strategies examined in this report it seems that target-date funds would be most appropriate for Personal Accounts. To reiterate our comments in Section 2, this would have several important advantages:

- Unwilling investors would find it relatively easy to identify the right fund for their expected retirement date.
- The availability of target-date funds would enable members to change their expected retirement date (say, by moving from the 2020 to the 2025 fund) and to phase retirement (by dividing contributions between the 2020 and 2025 funds).
- Target-date funds focus members on the outcome and draw attention away from short- and medium-term volatility.
- The Personal Accounts Board would have considerable flexibility in determining the underlying asset allocations and investment styles, and in the selection, monitoring and changing of fund managers without this having an impact on the members’ unit holdings.
- There would be no need to establish a separate lifestyle mechanism, which members might find confusing.

If target-date funds are adopted, there remains a question of deciding on the underlying asset allocation and risk profile. A diversified growth approach – as discussed in Section 4 – might have some merits, but will be difficult to achieve under the planned charging level. The intended level of charges means a passive equity strategy is more likely.

In terms of the risk profile, there are a number of issues to consider. Most members will be novice investors and many will be unnerved by volatility. This would argue for a lower risk approach, but there are dangers too in widespread ‘reckless conservatism’. Furthermore, many members will have relatively low incomes which would suggest limited *ability* to take risk, for example they may not have the capacity to save more to make up for past losses. However, for these lower earners the state pension and other benefits provide a floor in terms of retirement income, which may mean they can take more risk in their Personal Account.

### *Summary and recommendations*

In conclusion, based on current evidence, we believe that target-date funds should be considered very seriously by the DWP, the Delivery Authority, and the emerging Personal Accounts Board. However, as noted in the preface, innovation in DC investment is gaining momentum, and clearly it is essential for those responsible for the personal account regime to keep abreast of developments both in the run up to 2012 and thereafter.

## Appendix: Survey results

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We sent our online survey to approximately 70 senior pension professionals working in the DC pensions market and received 54 responses. The aggregated results are shown below.

### Which category best describes the type of organisation you work for?

Insurance company/pension provider	27.8%
Fund management company	14.8%
Employee benefits consultancy	33.3%
Independent financial adviser	7.4%
Pension scheme sponsor	0.0%
Trustee	1.9%
Other (Mainly pensions lawyers)	14.8%

### Do you think that the typical investment arrangements in UK DC schemes today meet most members' needs?

Yes	31.5%
No	68.5%
Don't Know / no opinion	0.0%

### What is the appropriate number of investment fund choices to offer in a typical UK DC pension scheme?

1 fund (i.e. no choice)	0.0%
2-5 funds	16.7%
6-10 funds	57.4%
11-20 funds	9.3%
20+ funds	14.8%
Don't Know / no opinion	1.9%

### Should a DC pension scheme nominate a default fund for use by members who are reluctant to make their own choice of investment fund?

Yes	88.9%
No	7.4%
Don't Know / no opinion	3.7%

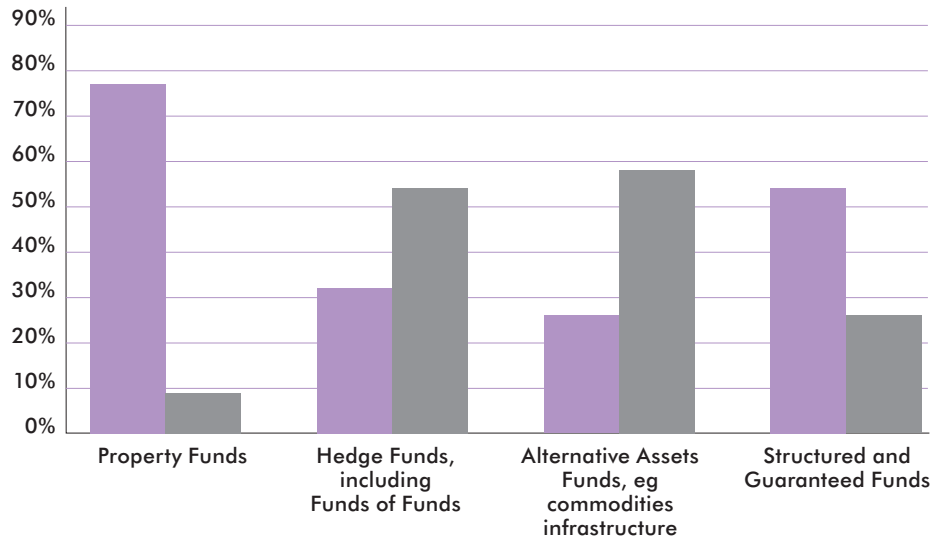
### Should DC pension schemes offer a lifecycle fund (i.e. a fund with age dependent asset allocation)?

Yes, as the default fund	57.4%
Yes, as something members can choose	38.9%
No	3.7%
Don't Know / no opinion	0.0%

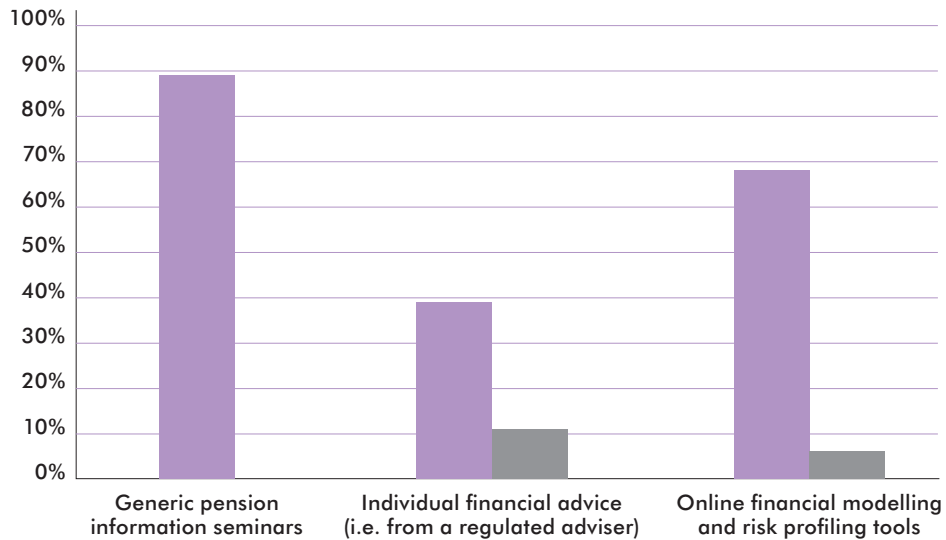
### Do any of the liability driven investing (LDI) techniques and products that are increasingly being used in DB schemes have a role to play in DC investment?

Yes	57.4%
No	27.8%

To what extent are the following investment products appropriate for use in DC pension schemes: **Total Appropriate** **Total Inappropriate**



Should an employer provide its pension scheme members with the following services: **Total Should Provide** **Total Should Not Provide**





Aon Consulting is very pleased to be sponsoring the Pensions Institute report on the investment issues relating to DC schemes, at a time when DC arrangements are becoming more mature and widespread.

Investment issues are a crucial piece of the jigsaw that determine the eventual size of pension benefits from DC arrangements. And yet, investment is probably the least properly understood element. Being able to fully educate the current, and future, average DC member in the minutiae of investments, so that they can make their own informed investment decisions, is a very long way off – if it ever happens. The ongoing closure of DB schemes to future accrual and the introduction of Personal Accounts will bring a vast new influx of members to DC schemes who have never had to consider investment matters previously. This will provide us all with fresh challenges.

We need to strike a balance between requiring all members to make their own individual decisions unaided, giving individual one-to-one advice and providing no practical options. The driver should always be to provide members with the 'best' outcome in relation to their retirement benefits. The twist, though, is that the highest potential benefit is not always what an individual is looking for – a feeling of comfort and security is an overriding concern of many, and we need to be careful of saying "we know best".

This report sets out clearly the challenges and opportunities for DC investment in the UK and it is for all of us in the pensions industry, including the Government, to take forward the ideas and recommendations, and enable DC to be a success story in its own right - not simply a poor substitute for final salary schemes.

Paul Macro, Head of DC Pensions  
Aon Consulting



The findings of this survey resonate well with Fidelity's own experience both in the UK and the US. It is interesting that in the US 401(k) market, where self-selection of investments has been the norm, plan sponsors and providers are adopting the target fund lifecycle strategy in very large numbers. In fact, they are appealing more and more to the positive effect of inertia to improve retirement outcomes through the use of automatic enrolment, automatic contribution increases and automatic asset allocation. This follows a generation of investors who through under-funding, too much investment choice, and/or poor asset allocation have not benefited from the 401(k) system to the extent that they could have done had they made different decisions.

This does not mean Fidelity and others have given up on engaging investors. Far from it. We continue to invest heavily in retirement planning and investment selection tools that can help more active investors get more from their savings, both in the build up to retirement and during it. Even so, we are realistic in recognising the phenomenon of the reluctant investor highlighted in this report and the importance of default arrangements in at least getting them started on the path towards a more prosperous retirement.

### **Fidelity International – An Established and Leading DC Provider**

Fidelity International is a well-established and leading provider of DC services for the corporate marketplace. In the UK alone, more than 330 pension plans now trust us with over £3 billion worth of assets.

Fidelity offers a wide range of products and services for both trust-based and contract-based DC pensions, including Group Personal Pensions, Occupational Pension Plans, Buy Out and Group Stakeholder Plans. Our comprehensive DC Fund Platform, which is available to both full service and investment only clients, covers all of the main asset classes and offers access to over 70 funds from Fidelity and other industry-leading managers.

The provision of defined contribution services to UK employers is a core business for Fidelity. We continue to invest substantially in our people, products and processes to ensure Fidelity remains at the forefront of service provision. In recognition of the excellence achieved across all aspects of our product offering we have been named DC Provider of the Year in 2003, 2004 and 2005/06. Whether clients are running a small start-up plan or a large, mature multi-site DC plan, Fidelity's financial stability and commitment mean we can offer a range of solutions to meet their needs.



At HSBC we always seek to be involved in the continuing pension's debate and to rise to the challenges faced by employers, trustees and members with regard to appropriate pension provision. We respond to changing customer needs with innovative investment and overall scheme solutions.

The pension landscape has changed rapidly over the last few years and one of the main drivers of this has been the fact that running final salary arrangements has become too much of a financial burden for many employers. As a consequence of this there has been a huge shift from DB to DC provision with the transfer of the investment and annuity risks to individuals. But what allowance has been made for the fact that the majority of individuals are ill-equipped to adequately deal with these important issues or even to engage at all?

In this report The Pensions Institute addresses some of the problems that investors face and the possible solutions open to asset managers and providers such as HSBC Investments or advisers such as HSBC Actuaries and Consultants Limited. It provides a thorough review of the DC investment market and stimulates debate as to what solutions work best for pension scheme members who are described as 'reluctant investors'.



The volume of media coverage of pensions, and the wider issues around retirement planning, has almost certainly been greater during the past few years than ever before.

This has probably resulted in a better understanding of the importance of individuals taking some responsibility for their own financial future. Yet, at the same time, many people are concerned about the risks - both real and perceived - that attach to any form of long-term saving.

Against such a background of uncertainty and confusion, it has become increasingly important to have impartial and thoughtful analysis of the diverse issues which are relevant to pension provision.

This report by the Pensions Institute focuses on several of these issues, notably those around the governance of defined contribution arrangements. This is a crucial subject which, in our view, has received insufficient attention in the past.

Scottish Life, the pensions specialist arm of the Royal London Group, is therefore very pleased to sponsor this important and topical report. We believe it will help improve people's understanding of some key issues that need to be addressed by the pensions industry. And in doing so, it should help ensure a better future for the "reluctant investors".





Scottish Widows is pleased to co-sponsor this report. It has highlighted the trend from DB to DC arrangements and the transfer of investment risk from employer to employee. We understand that employees are now being asked to make important investment decisions regardless of their level of financial savvy.

To add to the complexity that employees face, there has been an explosion of pension funds on offer. While the expansion of choice has been a positive move, it can overwhelm employees who aren't so well versed in the investment world. This has undoubtedly led to a high default fund take-up, particularly where members aren't receiving individual advice.

Last year we developed three risk/reward graded investment approaches to help make the investment choice simpler and more effective in meeting the needs of employees. By choosing one of these approaches, employees will access a balance of risk/reward that:

- Matches their chosen approach (Cautious, Balanced or Adventurous), and
- Takes their specific retirement date into account.

The approaches are populated with a number of portfolio funds with different asset classes and we switch investments into progressively more secure portfolio funds as the member approaches retirement.

The different asset mixes that populate the core investment approaches have been developed based on stochastic modelling by Barrie and Hibbert, an external firm of risk consultants, to ensure they have an appropriate risk/reward balance. There is robust ongoing governance of the asset allocation models provided by us with the assistance of Barrie and Hibbert.

We have also developed an interactive online tool to help employees identify their attitude to investment risk and reward. It will identify which of the three investment approaches is most suited to their needs based on their answers to ten simple questions.

Providing an investment approach that is divided into graded scales based on potential risk and returns but cutting across conventional asset classes is making the investment choice simpler and more relevant for members.

## About the Pensions Institute

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The objectives of the Pensions Institute ([www.pensions-institute.org](http://www.pensions-institute.org)) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions.

As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to the complex problems that arise in this field.

### *Objectives*

The Pensions Institute undertakes research in a wide range of fields, including:

#### **Pension Microeconomics**

The economics of individual and corporate pension planning, long-term savings and retirement decisions.

#### **Pension Fund Management and Performance**

The investment management and investment performance of occupational and personal pension schemes.

#### **Pension Funding and Valuations**

The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.

#### **Pension Law and Regulation**

The legal aspects of pension schemes and pension fund management.

#### **Pension Accounting, Taxation and Administration**

The operational aspects of running pension schemes.

#### **Marketing**

The practice and ethics of selling group and individual pension products.

#### **Macroeconomics of Pensions**

The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

#### **Public Policy**

Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions.

## Endnotes

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- 7 See [www.promanageplans.com](http://www.promanageplans.com)
- 8 Scottish Life and Scottish Widows are sponsors of this report.
- 9 Also known as a threshold strategy. See Blake, Cairns and Dowd (2001) *'PensionMetrics: Stochastic pension design and value-at-risk during the accumulation phase'* *Insurance, Mathematics and Economics*, 29, 187-215.
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- 11 See Mitchell and Utkus (2004) *'Pension Design and Structure: New Lessons from Behavioural Finance'* Oxford University Press.  
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- 13 TPR (2006) *'How The Pensions Regulator will regulate defined contribution pension schemes in relation to the risks to members'*.  
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- 14 See Mitchell and Utkus (2004) *'Pension Design and Structure: New Lessons from Behavioural Finance'* Oxford University Press.  
[www.pensionsresearchcouncil.org](http://www.pensionsresearchcouncil.org)
- 15 Cronqvist and Thaler (2004) *'Design choices in privatized social-security systems: Learning from the Swedish experience'* *American Economic Review*, 94:2, 424-428.