Deciding on Default Design

Target date funds and lifestyling

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Effective default strategy design sits at the heart of any defined contribution (DC) scheme, given the proportion of members who use this investment option. Consequently, trustees' choice of investment strategy and the charges applied to it are significant factors in determining the eventual size of an individual's retirement pot.

As a result, trustees must continually assess whether their default strategy remains fit for purpose. That means monitoring ongoing fund performance, but also ensuring that the overall strategy continues to be appropriate for both the scheme and its membership.

In this paper, we will explore two key types of default strategy: lifestyling and target date funds (TDFs). Both are well suited to the UK pension market and the decision to use one or the other will depend on scheme-specific factors such as size and approach to governance.

Lifestyle default strategies dominate UK DC pension savings at present. According to Spence Johnson, in 2016 £83 billion of the estimated £95 billion currently in UK default funds was held in lifestyle funds[1].

Could that picture change in future? A handful of large UK schemes, most notably master trust providers, have opted for a TDF-based default strategy rather than lifestyling. Looking to the future, Spence Johnson predicts that TDFs will form the basis for around 28% of default strategy assets by 2025, with £102 billion of assets in proprietary TDFs by that point — mostly concentrated in master trusts. In comparison, only around 3% (£3.1 billion) of UK default fund assets are currently held in TDFs.[1]

While TDFs' market share is clearly set to increase, Spence Johnson's prediction shows relatively modest UK growth in comparison to the US market, where TDFs are the default option in the majority of 401(k) plans. According to analyst Morningstar, assets in US target date mutual funds hit a new high of $880 billion at the end of 2016[2]. The US market is highly concentrated, with 70% of assets held by just three providers.

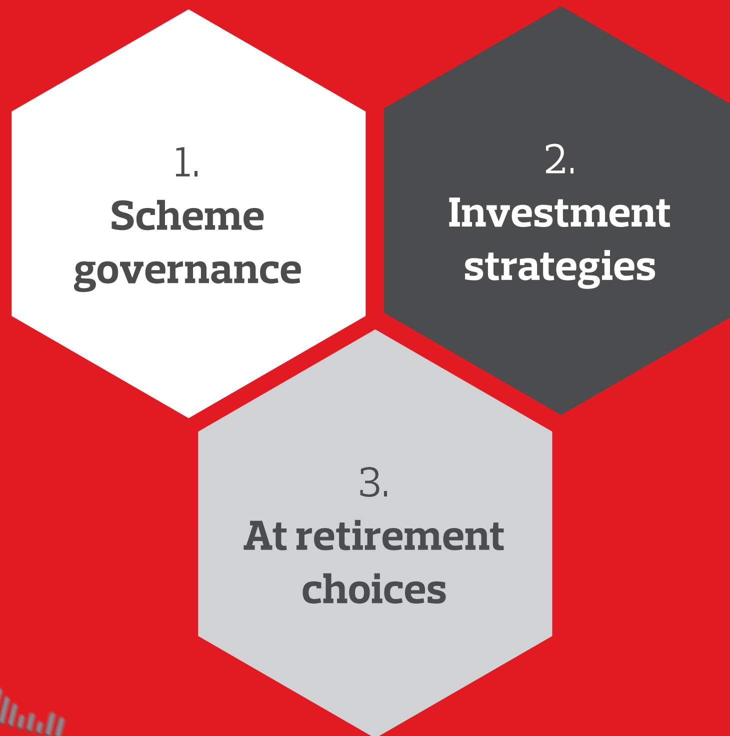
Both TDFs and lifestyle are well suited to UK DC plans of all types — contract-based (eg, group personal pensions), employer own-trusts and master trusts can all benefit from either approach. Both can be delivered within the default fund charge cap of 0.75% per annum and offer flexibility in targeting at retirement choices of cash, annuities or flexible drawdown. In very broad terms, both also take the same approach to investment — typically investing in growth assets with an appropriate level of risk while savers are younger, then moving into less risky assets as an individual's planned retirement date approaches.

However, there are some significant generic differences between TDFs and lifestyle defaults, which are summarised below. As the governance section of this paper shows, both types of strategy can also be tailored to the needs of individual schemes, so this is a general guide only.

Lifestyle	Target Date Fund
Units are purchased for members in individual funds that form part of the lifestyle strategy	Members select a TDF that matches their anticipated retirement date (eg, 2045 fund, 2050 fund)
Trustee or pension provider designs the strategy and controls asset allocation	Fund manager designs the strategy and controls asset allocation (although larger schemes may be able to design their own)
Scheme or pension provider manages movements between the underlying investments that make up the lifestyle strategy (via a pre agreed matrix) to facilitate de-risking, for example. This is usually done by the scheme administrator	Fund manager controls movements between underlying funds and asset classes (may go direct)
More simplistic in design eg invests in equities for growth and de-risks to bonds/cash	More sophisticated with individual strategy

1 Spence Johnson, Market Intelligence: Defined Contribution – looking beyond the passive approach (2016)
2 Morningstar, 2017 Target-Date Fund Landscape (April 2017) https://corporate1.morningstar.com/ResearchLibrary/article/803362/2017-target-date-fund-landscape/

In evaluating and comparing the current TDF and lifestyling markets, there are three core areas to consider, which are explored in more depth in the rest of this paper:



1. Scheme governance

"Choosing a TDF or lifestyle default strategy is primarily a governance decision. A lot comes down to how much trustees are prepared to delegate and what decisions they want to retain. In that context, there are pros and cons to each approach."

Joanna Sharples, Investment Consultant, Aon

Flexibility is a major consideration. In the UK market at present, most TDFs are 'off-the-shelf' products that are all-inclusive: glide paths and managers' tactical views, for example, are built into the design. A TDF manager will typically use its own underlying fund range in the product design, all of which will need to be held on a single platform. While this streamlines their governance, it can significantly limit choice and flexibility. As such, off-the-shelf TDFs may appeal most to smaller employer own-trusts with limited governance budgets.

TDFs may be less attractive to larger schemes that want to tailor their default strategy to closely match members' needs, and do not wish to be limited to a single supplier's or platform provider's funds. "While lifestyle strategies are sometimes perceived as outdated, they currently give larger schemes much more flexibility," says Joanna Sharples, Investment Consultant at Aon. "Trustees have control over the design of the glide path as well as asset allocation and the underlying fund managers used can be changed as required." But even within a lifestyle approach, making these changes is not always straightforward. Members must be informed and there is a significant burden of work for administrators.

White-labelling – creating a bespoke fund wrapped for an individual scheme: can help to reduce some of that burden in a lifestyling approach. Substituting managers and introducing new investment ideas is much easier, as those changes can be introduced without having to replace the entire fund. At present, white-labelled, custom-designed TDFs have not significantly taken off in the UK market. That may reflect the current size limitations of UK schemes — in the US where fund sizes are typically larger, there is already widespread use of customised TDFs and providers typically offer a broader range of TDF solutions.

Communicating with members about the basics of how the default fund works can be much more straightforward with a TDF. "Members simply have to pick a retirement date and that's all that's required. A scheme can offer 'nudges' over time to help members make sure they are on track, but there's no need to explain investment concepts within the fund, such as de-risking," says Milan Makhecha, Principal at Aon. "A pension will not be employers' and employees' main focus day-to-day and they may not want ever-more information. With TDFs you can introduce sophisticated investment ideas without having to educate members about all the underlying funds within them." Makhecha adds that, as the spotlight on at retirement decision-making intensifies, being able to explain the default approach easily to members will become essential.

Group personal pension (GPP) providers have started to explore the benefits of TDFs, although the majority are currently still using a lifestyle approach. Employers who have opted to use a GPP or master trust are typically looking for a low-maintenance solution, so are unlikely to want to spend more time than necessary on educating members. As such, getting consent from all members to make a move to a new lifestyle solution can be difficult, and may result in multiple, legacy lifestyle funds continuing within the scheme. It's also easy to overlook deferred members when making this sort of change.

"We've seen instances of clients getting frustrated by lifestyling within their GPP. They may have spent significant time reviewing a lifestyle default and bringing it up to date, only to find that members don't respond to communications and don't move to the new strategy. The GPP provider has its hands tied and can't make changes on members' behalf. In this context, the benefits of TDFs can be quite significant," says Makhecha.

2. Investment strategies

While both lifestyle and TDFs invest in growth assets in early years and reduce risk as members age, both offer a wealth of options for blended investment approaches and de-risking glide paths. As discussed above, off-the-shelf TDFs may be more limited by their reliance on fund platforms and often heavy use of in-house funds. In contrast, lifestyling benefits from many years of UK investment adviser experience. “Advisers often favour a lifestyle approach as, within reason, new ideas can be introduced with relative ease. It’s more difficult for them to do that with a TDF,” explains Makhecha.

In the future, TDFs’ multi-asset approach could be in their favour. Identifying a suitable way to access illiquid assets – such as property and infrastructure – has eluded almost all DC default strategies to date, regardless of their design. That not only limits investment opportunities, it also means that members could be missing out on potential higher returns from investing in long-term-hold assets.

Life platforms’ requirement for daily-priced and daily-access funds is one of the key barriers to illiquids’ inclusion in defaults. While, in theory, that should not be a concern in a long-term savings product, the ability to withdraw cash as a part of the at retirement reforms has kept liquidity in the spotlight. However, there are ways to resolve the problem. “As Australian super funds have shown, as long as communications are effective and you can wrap illiquids within a blended fund, you can manage liquidity and still invest in these long-term investments,” Sharples explains.

Another consideration when investing in illiquids is fund size. “As the size of schemes’ assets under management increases, we will see more interest in introducing illiquids, and that will favour bespoke TDFs,” says Sharples. “Larger, unbundled funds are likely to be the first to look at new ways of doing things and seriously consider illiquids, perhaps using a non-life platform. They may also be closer to their members and more able to stand behind the decision to introduce them, even though the cost is higher.” Once the concept of using more illiquid assets has been proven by bigger schemes through bespoke solutions, there may be more appetite for introducing them into mass-market TDFs.

The higher fund charges associated with illiquid asset classes will, however, remain a barrier for some. “Smaller schemes that are bundling administration costs into the charges paid by members will find it difficult to include illiquids and remain compliant,” cautions Sharples.

The charge cap also has implications for the balance of active and passive management within both lifestyle and TDFs. TDF fund charges typically do not include administration fees; this may limit their use by schemes building the administration costs into the ongoing charges. As a result, off-the-shelf TDF providers currently use passive strategies almost exclusively. And, while it is possible to change asset allocations within a TDF with relative ease, most managers will make strategic rather than tactical changes for the same reason. “We don’t see many TDF providers using active management at present,” says Sharples. “However, we are seeing more use of factor-based investing as a quasi-active approach.”

While any default strategy must focus on members who do not make investment choices, most schemes will also have a small number of self-selectors. TDFs can offer them more flexibility than traditional lifestyle approaches. An interesting feature of TDFs is that because each is a fund; members should be able to invest in a TDF alongside other self-select funds providing greater choice. When lifestyling is used, administration system constraints usually require members to select either a lifestyle or self-select approach, rather than a combination.

3. At retirement choices

Facilitating 'freedom and choice' at retirement has meant a major shift in default strategy thinking. Prior to the introduction of the reforms, targeting an annuity and assuming that a member's involvement with the scheme would finish upon retirement was often sufficient. In future, the picture is likely to be much more complex as members each decide whether to opt for cash, an annuity, flexible drawdown or a combination of all three.

The changes are still relatively recent and there is no long-term trend data for trustees to draw on when predicting members' behaviour at retirement. According to the Financial Conduct Authority, since the introduction of freedom and choice, 53% of members making withdrawals from their pension fund have taken their whole pot in cash[3]. This may be due to the relatively small size of today's DC pots and because many of these retirees will receive the majority of their pension from a defined benefit scheme. Over time, that trend is likely to change, and the number of whole-pot cash withdrawals is expected to fall.

As such, many schemes have adopted a 'wait and see' approach and are still evaluating what effect this will have on their default strategy. "Most lifestyle funds have stopped or plan to stop, solely targeting annuities at retirement and now offer three possible paths," says Sharples. "Most have opted for drawdown as the default, but are not providing paths beyond retirement or offering drawdown in-scheme. The money stays in the drawdown path until an individual member decides what they want to do."

Off-the-shelf TDF providers have approached at retirement in different ways. Most target drawdown as their default option, with a few currently targeting cash. A more significant differentiator is whether the fund enables members to remain invested after retirement.

"Some TDFs stop at retirement, whereas others continue to glide or de-risk beyond that point. But none have yet addressed post-retirement default solutions. The current approach is more about getting the member to approximately the right place and then seeing how the market evolves."

Joanna Sharples, Investment Consultant, Aon

[3] *Financial Conduct Authority: Retirement Outcomes Review, Interim Report (July 2017): https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf*

Shaping the future

The UK DC market is set to grow exponentially over the next decade. Spence Johnson[1] predicts that by 2025, it will be worth £1,040 billion, more than tripling its current size of £303 billion and showing growth of 13% per year.

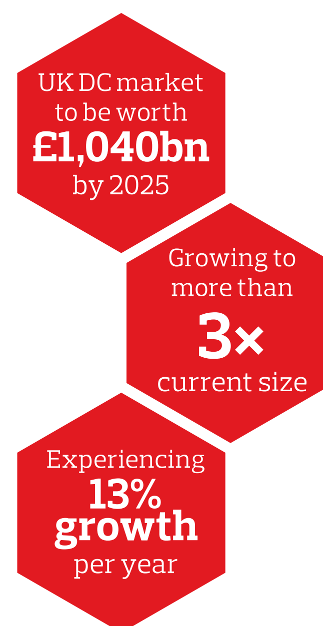
What does that shift in scale mean for default strategy design? “Lifestyle defaults will remain popular in the UK in the future,” predicts Sharples. “They are flexible and already widely used. From a governance perspective, many schemes and providers will look to make gradual changes within existing funds rather than wholesale moves, particularly as administration processes and member communications are embedded in the approach as well.”

While lifestyling will continue to hold sway for many schemes, smaller funds with limited governance budgets may see the benefits of an off-the-shelf TDF strategy. At the opposite end of the size scale, there may be increased interest from master trusts and very large schemes in building bespoke TDFs that are not dependent on life platforms. Access to illiquid assets is likely to be a key driver for this small group of schemes, which could result in a ‘ripple effect’ over time to off-the-shelf TDFs if the limitations of fund platforms can be overcome.

There is still no clear picture of how at retirement freedoms will ultimately affect the default fund market. Giving members the opportunity to target any one of three main outcomes (cash, annuities and drawdown), while enabling them to change their mind over time is the ideal, if challenging scenario. Whether to allow members to remain invested in the default after they have formally retired, or to target an end point after which they are responsible for their own pension pot, will continue to be a major decision for trustees. Both lifestyling and TDFs can be used to achieve that goal – but it is not straightforward in either instance.

Getting the default strategy right, in terms of design and governance, is critical as more members rely on them and as their retirement pots grow. Making sure that whatever strategy schemes follow is right for their members and delivers value for them must remain the overarching goal for trustees. Regularly reviewing that strategy and questioning whether it remains fit for purpose is equally valid whether your scheme uses a lifestyle or target-date approach.

Spence Johnson predicts[1]:



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