
# DC Code 11 – Value For Money

*BRIAN DELANEY*
*AON HEWITT*

In the summer issue, Denis Lyons at Aon Hewitt reviewed the Pensions Authority's Codes of Governance for DC Schemes, designed to assist trustees in 'delivering good member outcomes'. We examined the key to successful investment governance and highlighted solutions that trustees and sponsoring employers could consider to improve the overall level of governance applied to their DC Scheme to help members achieve better outcomes. If you missed this article, you can view it by clicking **here**.

We now turn our attention to **DC Code 11 – Value for Money**. This code sets out the Pensions Authority's view of good practice in ensuring that members receive good value from their pension scheme. DC Code 11 notes that a scheme provides value for money where the costs and charges deducted from members' contributions provide good value in relation to the benefits and services provided when compared to other available options.

Trustees should also consider the quality and range of the services paid for, as well as the costs of these, and should take account of what members value most and what alternatives are available. Services typically include administration, investment, governance and communications.

In addition to cost, DC Code 11 also recommends that trustees should focus on the performance of their service providers by considering factors such as investment return net of charges, whether providers meet the targets set out in service level agreements and the level of complaints received from members about services.

In this article, we will explore how pension schemes can achieve value for money from their investments. Specifically, whether active management achieves better results than passive strategies, the differentiators between the two and whether factor investing is the best of both worlds – low cost with active returns.

The focus on value for money has had a significant impact on the types of funds offered by trustees to their membership in recent years and not just in Ireland.

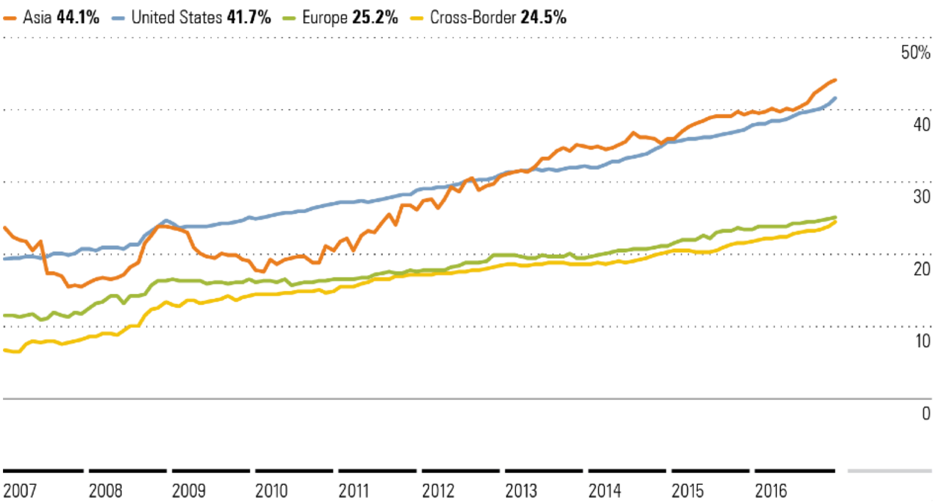
According to Morningstar research (March 2017), the trend towards passive or indexed investing, particularly in relation to equities, has accelerated sharply to become a dominant theme across the world, as demonstrated in the graph below.

- In Asia, 44% of assets are now invested in passive equity funds, double what was invested just five years ago

- The trend, at 42%, is similar in the United States

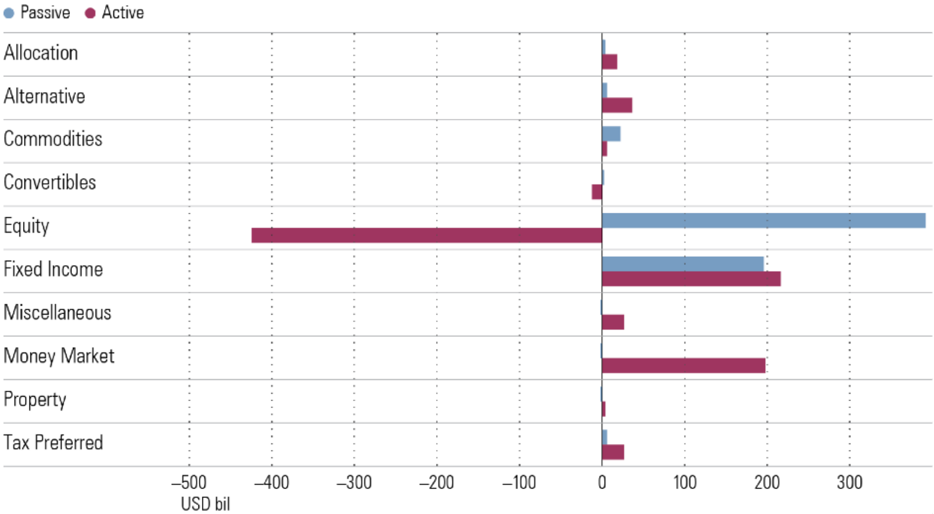
The Morningstar report also noted that the gap between active and passive fund flows has never been wider.

**Percentage of Assets Invested by Region in Passive Equity Funds**




Source: Morningstar

## Flow of Active and Passive Funds in the United States by Asset Class



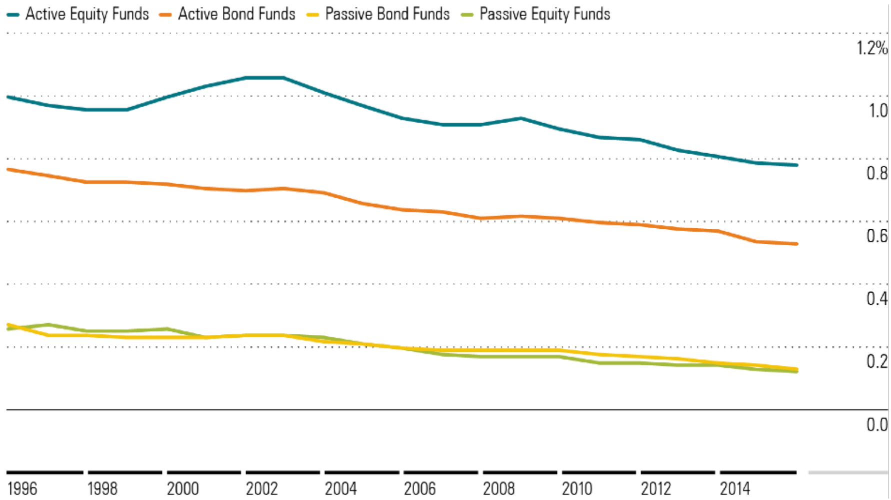

Source: Morningstar

US index funds received $492 billion in 2016, while active funds saw $204 billion in outflows. Again, the trend was most pronounced in the equity sector. US passive equity fund inflows accounted for $390 billion or 79% of total passive fund inflows, while US active equity fund outflows totalled $423 billion last year. (US active fixed income funds experienced inflows in 2016, offsetting outflows from US active equity funds).

Fees for active and passive funds have been trending lower for 20 years. However, there is still a significant difference between active and passive fund expense ratios, approximately 65 basis points for equity management. When compounded over 20 years, this cost differential amounts to 14%, a key driver for the structural shift towards passive investing as trustees focus on getting value for money for their membership.

While DC Code 11 emphasises the importance of delivering value for money for pension scheme members, the Code also highlights investment return net of charges as an important focus for Trustees. Indexed equity funds, by their very nature, deliver market returns before fees and deliver good member outcomes during advancing markets. However,

## Average Asset-Weighted Expense Ratio for US Funds



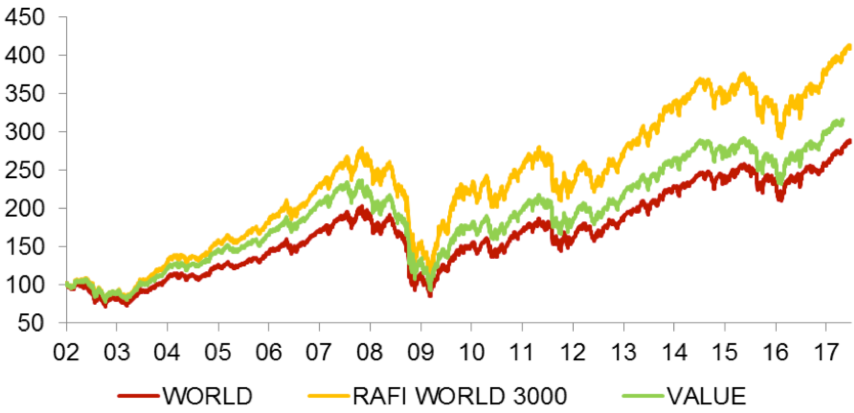

Source: Morningstar

during declining markets, passive fund investors suffer the full brunt of equity market declines. Unfortunately, active equity funds haven't done much better for investors. Only 4 of the 20 active global equity managers included in our inVision survey have delivered an annual return net of fees in excess of their benchmark over the last 10 years.

A new approach to active equity management, factor based investing (or fundamental indexation), is making waves in the industry and has become increasingly popular in recent years. Factor based investing offers an element of active management for passive fees. Factor based investing is a low cost, rules based approach that focuses on specific market factors, such as low volatility, value or momentum, in order to improve long term returns. The idea is to find a better way to invest in markets than using the universal benchmark – the market cap weighted index. (The problem with using market cap as a weighting criteria is that the largest and most popular companies have the biggest weight, whilst the least popular, have smaller weights.)

With fundamental indexation, the weightings are calculated using criteria, such as sales, cash flow, dividends and book value, making the index look very different from

**Relative performance of selected factor based MSCI indices 2002=100**




Source: DataStream

the market cap. The Research Affiliates Fundamental Index (RAFI) is generally the best known example and, as the chart shows, it has outperformed the market cap index over the past 15 years, hence the attraction for investors.

While past performance is no guarantee of future results, and acknowledging that factor based investing will go through periods of underperformance similar to every active investment strategy, we believe this new style of active investing should deliver better outcomes for members over time than a traditional passive investment approach.

For more information on how Aon's delegated defined contribution solutions can help your pension scheme please visit **www.aon.io/2vocHZi**

**ARTICLE AUTHOR**
Brian Delaney
Aon Hewitt

Suite 2, Slane House
25 Lower Mount Street
Dublin D02 V029

Tel: +353 1 6612427
Email: info@iapf.ie
www.iapf.ie

@iapf_info

iapf
representing pension savers