EXPERT OPINION

DC Governance and Risk Management

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Governance and Risk Management are closely intertwined in ensuring successful investment outcomes for members of defined contribution pension schemes. A strong governance structure is required to effectively identify, monitor and control the particular risks faced by members. These come in a number of forms which can evolve over time and vary in importance depending on the time left until retirement.

In this article we identify some of the key risks and briefly consider how they might be managed and mitigated.

What is Risk?

We can consider risk from a number of perspectives when it comes to DC pensions. First, there is the issue of adequacy of contributions. If members fail to set aside sufficient savings and fail to do so from an early age they are taking a major risk with regard to living standards in retirement.

A lot of media attention has been focussed recently on lack of pension coverage and how auto-enrolment can address it, but that is only part of the picture. If the level of contribution, be it employer driven or member driven, is inadequate, we will continue to face the so-called pensions 'time bomb' as our population ages.

To mitigate the adequacy risk it is important for DC plan trustees and sponsors to get to know their members and structure appropriate communications to encourage adequate and early participation. One way of doing so is by using data analytics. DC Analytics works by analysing each member's current details and projecting their expected retirement outcome for a particular set of circumstances.

The annual benefit statement is also a useful means of selling the message on contribution adequacy.

Knowing your members is a key requirement when it comes to setting investment strategy. Recent Pensions Authority guidance recommends that trustees determine and understand their members' capacity for risk and that they provide a default investment strategy which reflects the profile and needs of the scheme members.

Investment Risk

In setting DC plan investment strategy three main risks need to be addressed and these can vary in importance at different times and in different member circumstances:

- *Real Growth Risk:* If investment returns do not at least keep pace with inflation the member's pension pot will lose purchasing power as it accumulates over time. This is a crucially important risk for younger members with long term savings horizons. Investments which are most likely to address this risk and provide real growth, such as equities, can involve significant risk in terms of volatility of returns but are low risk in terms of long term growth prospects.

- *Capital Value Risk:* This is the risk that investments suffer a significant fall in value, which becomes more important closer to retirement, when there may not be sufficient time to make up any losses in fund value. It can also be important at younger ages in terms of assurance for members that they will recover any short term losses and will not be discouraged from savings. Appropriate communication is necessary to prevent inappropriate decisions being taken by members in response to asset value fluctuations

- *Pension Conversion Risk:* this is the risk that as a member approaches retirement, the investments held are not in line with how they plan to draw down their retirement income. For example, in many plans the Default lifestyle strategy entails a significant allocation to bonds which may provide a good match for a member who plans to buy an annuity but is a high risk strategy for a member planning to invest post retirement for income drawdown, or an AVC only member who is planning to take a full cash lump sum.

Investment Risk	Timescale when risk should be in focus for members	Risk Metric	High Growth (Equities)	Diversified Growth	Euro Gov Bonds	Cash
Growth Risk	Greater than 10 Years to Retirement	10 Year Expected Return				
Capital Value Risk	Less than 10 years to retirement	Volatility of return and cumulative drawdown				
Conversion Risk – Matching Cash	Less than 5 Years to retirement	Correlation with how members plan to fund retirement income				
Conversion Risk – Matching Annuity Purchase	Less than 5 Years to retirement					
Conversion Risk – Matching Approved Retirement Fund	Less than 5 Years to retirement					

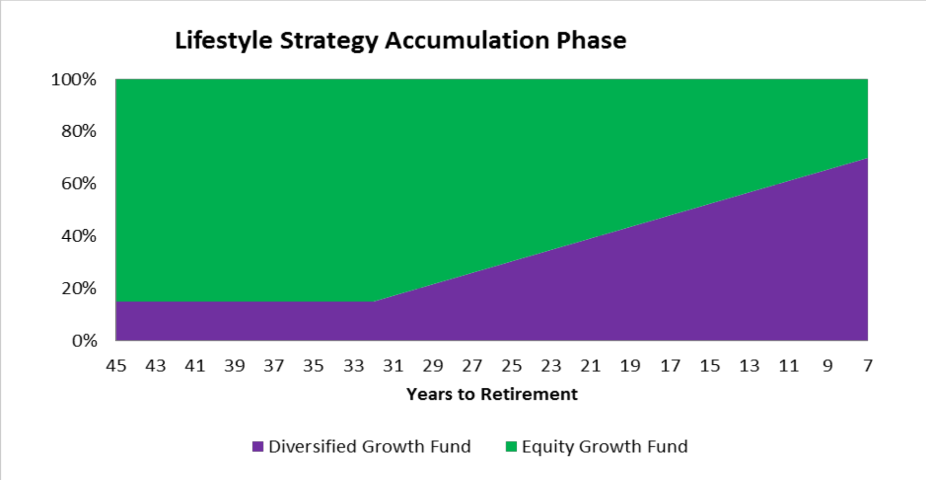
Investment Risk Mitigation

Taking account of all these risks requires provision of a core range of investment options with sufficient choice to address member needs through all phases of their retirement savings, from the early stage accumulation period up to pre-retirement drawdown planning. The Heatmap above illustrates the type of asset classes commonly used and their suitability at different career stages, green denoting most suitable and red least suitable. For example, cash and bonds are not suitable asset classes for addressing long term growth risk for younger members but have a role pre-retirement particularly if buying an annuity.

Lifestyle and Default Strategies

The most efficient means of ensuring members choose the correct strategy is via an appropriately designed Lifestyle strategy which would also act as the Default option for members who do not make an active selection. In common with global experience, the majority of DC plan members in Ireland fall into the Default category so selection of the most appropriate Default strategy is a key decision to be made by trustees.

We favour a lifestyle strategy which has the flexibility for altering investment allocations on an age related basis, providing younger members with high growth options and introducing a higher allocation to lower risk, multi asset options as members grow older, their pension pots grow larger and capital value risk becomes important.



Pre-retirement Lifestyling

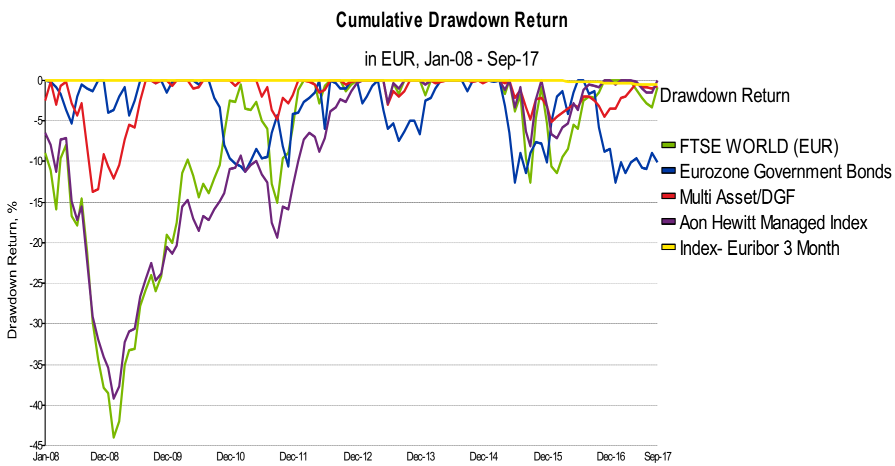
Nearing retirement, investment strategy needs to provide flexibility to select different benefit options. Historically, this de-risking phase was limited to using annuity-matching funds, aiming to reduce risk relative to the change in annuity prices. However, as members now have the freedom to choose not to purchase an annuity, we need to think of risk differently. We should focus on the absolute variability of outcomes, as well as capital loss. In absolute terms, bonds have been more volatile than multi-asset/DGF investments in recent years, and at current low yield levels are at risk of negative returns. So unless a member plans to buy an annuity, bonds are an unsuitable asset for preretirement planning and a different strategy is required for those planning income drawdown via an approved Retirement Fund or planning to take primarily a cash lump sum on retirement.

Asset and Manager Risk

Other risks to be considered in setting and implementing strategy include:

- **Manager Risk:** Where members are exposed to the actions or decisions of a sole active investment manager, this can lead to sub-optimal returns if the manager consistently underperforms its target return or benchmark index. There is also exposure to the risk of changes in the manager investment team. Significant manager monitoring is required to ensure continued suitability plus it is essential to be able to respond rapidly if change is warranted. These considerations have contributed to a significant shift towards passive or indexed management, particularly for high growth equity investment options. Indexation removes manager risk, although market risk remains and can be more significant than with active strategies. In a previous article we have detailed how alternative indexation can diversify the market risk and bring some of the benefits of active management to passive strategies.

- **Failure to meet investment needs:** This is the risk that the number and type of funds offered are sub-optimal for the needs of members and/or that members choose inappropriate funds for their target requirements. For example, protection against capital value risk requires investment in asset types that provide real protection against significant drawdown in value. Actively managed diversified growth funds (DGFs) have proven ability to protect in times of market distress, as illustrated in the chart. Cumulative drawdown from DGFs has been significantly lower than that of equities and traditional managed funds; more recently, it has also been lower than drawdown from government bonds.



Source: Aon Hewitt and investment managers

- **Value for money:** Is another risk factor to be considered in selection of appropriate funds and managers. Trustees need to ensure that the fund solutions they choose carry appropriate fees for the asset class and offer a reasonable prospect of delivering the projected returns after fees are taken into account. This consideration is particularly important in the current low interest rate environment where traditionally low risk strategies such as cash and short-dated bonds may well carry negative returns after fees.

Governance and Risk Mitigation

Awareness of member needs, investment innovation and product development can provide the tools needed to deliver better outcomes but responsibility for action rests with trustees and sponsors. Strong governance is required to successfully monitor and manage investment risk and for most trustees the time and resources available to them are insufficient for the task. Delegation of certain responsibilities via fiduciary management and/or Master Trust options is one solution which is becoming increasingly popular as trustees face more intensive scrutiny of their stewardship by the regulator. Under fiduciary management trustees retain overall responsibility but delegate key tasks such as:

- Manager selection and monitoring
- Implementation of portfolio adjustments to achieve best efficiencies and returns
- Fee negotiations using the advantage of bulk buying power

Combined together, efficient management of these tasks via delegation should free up trustees to focus on the key overall strategy decisions to produce optimum outcomes for DC members.

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