JLT

LET'S TALK

JLT EMPLOYEE BENEFITS OCTOBER 2018

AE WATCH: How does the performance of my DC default solution affect the retirement outcomes of my employees?

In the second edition of Auto Enrolment (AE) Watch, Maria Nazarova-Doyle of JLT Employee Benefits assesses the impact of DC default fund performance on member outcomes.

Earlier this year, Professional Pensions teamed up with JLT Employee Benefits to launch AE Watch, an initiative that examines the investment performance of DC default funds in a bid to enhance transparency in our industry.

In this instalment of AE Watch we look at hot-off-the-press data (as at the end of Q3) covering the growth phase of major defaults in the UK market – eight master trusts and nine contract-based providers – and we attempt to answer the important question: what does it all mean for savers? To find out, we analysed the difference between investing in the best- and worst-performing default funds and modelled how this might impact long-term outcomes for savers at retirement.

RISK VS RETURN

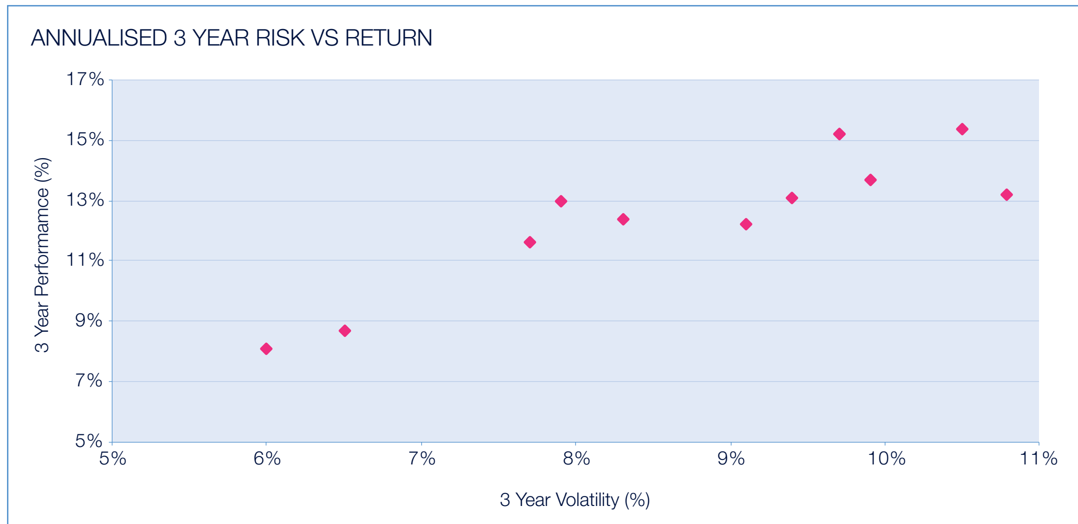
The graph and table illustrate the 3-year annualised performance of the growth funds investigated as at 30 September 2018.

GPP SOLUTIONS	MASTER TRUSTS
Aegon Default Equity & Bond Lifestyle*	The Aviva Master Trust
Aviva Future Focus 2	Aegon Master Trust
Aviva My Money My Future	Legal & General Master Trust
Fidelity FutureWise	The People's Pension
L&G WorkSave	Standard Life DC Master Trust
Royal London Balanced Lifestyle Strategy	Scottish Widows Master Trust
Scottish Widows Balanced Investment Approach	Mercer Master Trust
Standard Life Active Plus 3	Fidelity Master Trust*
Zurich Managed Passive Lifestyle	

*We note that from June 2018 Aegon and from July 2018 Fidelity have made changes to their main defaults. However, since these changes do not affect existing investors (Aegon) and will only be gradually rolled out (Fidelity), we believe that at this time it is appropriate to use the defaults presented in the table for comparison purposes

FUND	ANNUALISED RETURN	ANNUALISED VOLATILITY	MAX DRAWDOWN
Scottish Widows Pension Portfolio 2	15.4%	10.5%	-9%
Zurich Passive Multi-Asset 4	15.2%	9.7%	-9%
Mercer Growth	15.2%	9.7%	-8%
The People's Pension – Global Investments	13.7%	9.9%	-8%
Aegon BlackRock LifePath Flexi 2049-2051	13.2%	10.7%	-12%
Aegon Default Equity & Bond Lifestyle	13.1%	9.4%	-8%
Aviva My Money My Future Growth	13.0%	7.9%	-6%
Aviva Diversified Assets Fund 2	12.4%	8.3%	-8%
Royal London Governed Portfolio 4	12.2%	9.1%	-8%
L&G Multi-Asset	11.6%	7.7%	-5%
Fidelity Diversified Markets	8.7%	6.5%	-6%
Standard Life Active Plus 3	8.1%	6.0%	-6%

Source: Financial Express, JLT. Data is for 3 years to 30 September 2018, gross. Volatility is measured on a weekly basis. All figures are rounded.



Source: Financial Express, JLT. Data is for 3 years to 30 September 2018, gross. Volatility is measured on a weekly basis.

The results demonstrate a difference in returns between the best- and worst-performing defaults of around 7.3% p.a., with a difference in volatility between the highest- and lowest-risk funds of around 4.7% p.a.

There is generally a strong correlation between risk and return, although, in correlation with our analysis six months ago, some defaults have managed to use their risk budgets a lot more efficiently, therefore providing much better risk adjusted returns than others.

The funds analysed represent the growth phase of lifestyle strategies and are therefore used when members are younger - a time when savers can afford to take on more risk to try and achieve greater returns. Some of these defaults, however, adopt a very conservative approach to the accumulation stage. We believe that many defaults are taking on too little risk and as a result, many savers could be missing out on greater returns, potentially leading to a very large shortfall at retirement.

REAL IMPACT ON REAL PEOPLE

The three main factors that influence outcomes for DC members are investment returns, contributions and fees. While auto escalation and the charge cap are going some way to tackle the latter two factors, the selection of the default fund will be the main driver of the investment returns. The problem is that percentage returns don't really give a good feeling for what such large differences in returns might mean in the real world for a typical saver.

MEET MAX

Max is in his early twenties and earns £22,000 per year. He has just enrolled in his company's occupational DC pension scheme. He is now starting to save and both he and his employer are only making minimum AE contributions of 2% and 3% respectively, which will increase next April. Although he has no pension savings yet, he has many years ahead of him to work and save.

MEET HILARY

Hilary is 37 and earns £35,000 per year. She has already accumulated a pension pot of £23,000. Her total contributions of 10% make her better positioned for future retirement. Like Max, her default fund is currently in the growth stage and she has quite a long period of saving ahead

THE IMPACT OF DEFAULT PERFORMANCE ON SAVERS' OUTCOMES – A THOUGHT EXPERIMENT

We took the highest returns (15.4%) and the lowest returns (8.1%) from our default fund analysis and modelled the impact on Max and Hilary if they consistently received these highest and lowest returns over the period until they are 57 (the age at which both will be able to access their DC savings from 2028).

Note that we think this is very unlikely to happen in practice for several reasons:

- During the past three years covered by this analysis, equity markets have been in an unusually bullish risk-on environment, so the returns over the coming decades are most likely to be substantially lower than this on average. This will mean the pound value of the differences in outcomes should be lower than these assumptions imply.
- The coming decades will include risk-off periods where the lower risk default funds will probably outperform. This will rotate the leadership and reduce the dispersion of end results, so the difference between best and worst will be smaller.
- Finally, we would like to believe that any fund which consistently underperforms for decades is likely to be closed down so will not exist until Max and Hilary reach 57. This will reduce the cumulative difference between the best and the surviving worst.
- As the disclaimers usually say, past performance is not a guide to the future. This is true.

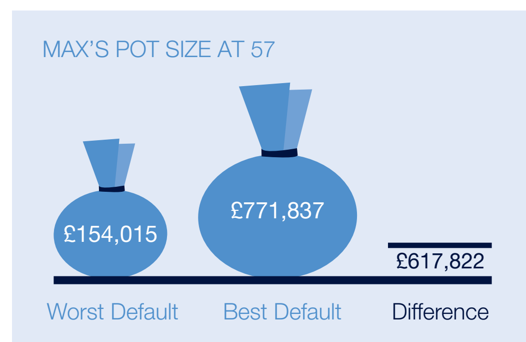
But as we do not have a crystal ball that will tell us what the market returns will actually be or how much the returns from the default fundswill vary, it is still useful to consider what the impact would be if the last three years were to repeat themselves many times over the coming decades.

Given these extreme assumptions, the potential dispersion of the savers' outcomes is astonishing, with a difference of over £500,000. Even if the size of the difference were only a fraction of this value, it would still have a material impact on the quality of life in retirement for Max and Hilary. It's also clear that due to the power of compounding, the potential impact can be far greater on Max as he has a longer period to invest. This underscores the importance of starting to save early into a good default fund.

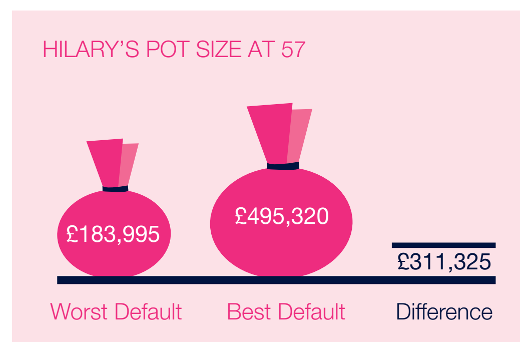
The performance data shown does not tell us which defaults will do well in future, but it does indicate that making a careful choice of default and monitoring the default through the years to ensure it remains appropriate is arguably the most direct way that employers can help influence the investment returns received by members. By the same token choosing the wrong default and leaving it unsupervised could do irreversible damage to a member's future wealth and retirement plans.

Importantly, we continue to only include defaults into the AE Watch where sufficient track record of data is available daily from independent sources and we are again calling for all providers to make the performance of their funds more accessible in order to increase transparency in our industry. It should not be acceptable that data on daily dealt investments becomes available months after quarter ends and can only be obtained via direct relationships with providers of DC products. As an industry, we need to collectively strive for transparent data provision that supports good quality decision-making.

MAX'S POT SIZE AT 57



HILARY'S POT SIZE AT 57



ABOUT US

JLT Employee Benefits is one of the UK's leading employee benefit providers offering a wide range of benefit and pension services, including administration, actuarial and pension consultancy, investment, Self Invested Personal Pensions (SIPPs) and Small Self Administered Schemes (SSASs) administration, flexible benefits, healthcare, benefit communication and financial education.

CONTACT

MARIA NAZAROVA-DOYLE
Head of DC Investment Consulting
+44 (0) 20 7309 8108
maria_nazarova-doyle@jltgroup.com

JLT Employee Benefits
The St Botolph Building
138 Houndsditch
London EC3A 7AW

www.jlteb.com

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