Aon
Retirement and Investment

Refocusing what 'risk' means for DC Savers

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Introduction

DC pensions have been subject to exceptional rates of change, mostly driven by regulatory factors, over the last three years. The market is still reacting to a number these changes and will continue to do so for some time. Further, this focus on DC will continue as regulators look to ensure that policies driving the push to DC, and the flexibility offered within it, are successful. A particular area that we expect DC pension schemes to continue to develop and enhance are the investment options that they offer to members. Refocusing what 'risk' means for DC savers should be at the heart of this.

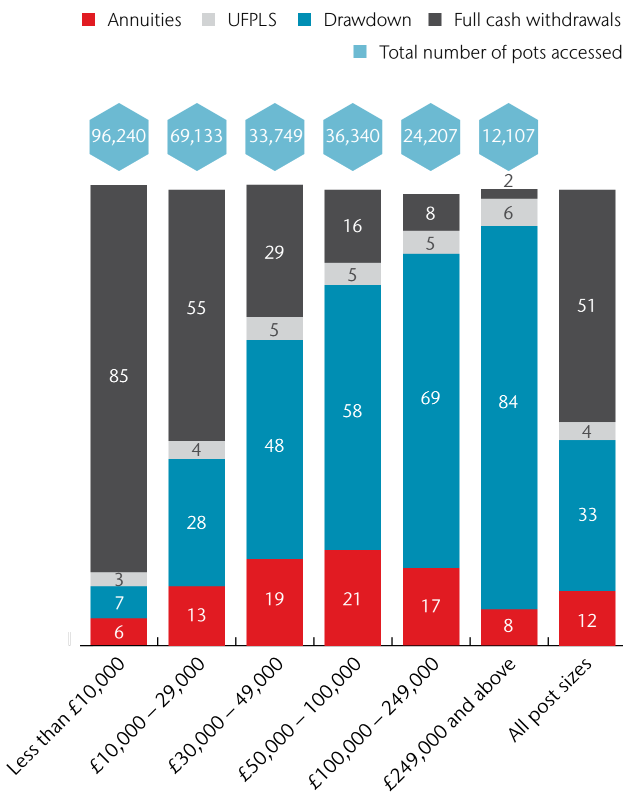
The UK pensions market has witnessed a decrease in the number of annuity purchases and an increase in the number of members choosing to flexibly access their retirement savings. This observation doesn't tie in with Aon's Defined Contribution Scheme Survey 2017 which found that 40% of default investment strategies in DC schemes still target the purchase of an annuity at retirement. Have default strategies continued to invest significantly in UK bonds because they felt 'safe'? Should we not be evolving DC investment strategies by looking to the future, not the past? Even where default strategies have moved away from annuity purchase, the focus was often on putting in place a low cost strategy using asset classes currently available on platforms that were familiar to trustees. Recent developments have widened the investment universe for DC, particularly within fixed income where diversification is key.

In 'Putting DC Members Front and Centre', we highlighted a need to return to first principles and ask "what are we trying to achieve?" Nearing retirement, investment strategies need to mitigate the key risks faced by members whilst also providing 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. In other words, as the price of an annuity rises, so should the annuity matching fund (and vice versa). With most DC savers choosing not to purchase an annuity, we need to think of risk differently. Regardless of whether members take their benefits as cash or draw them down as flexible income, the focus of risk should change to be on the absolute variability of outcomes, as well as the magnitude and duration of capital loss. In this context, **UK fixed income can be a risky investment!**

Fixed Income in the DC Market

UK DC pension schemes have traditionally adopted a simplistic, passively managed approach to fixed income investing both within the default and self-select range. Prior to the introduction of Freedom and Choice in 2015, DC default strategies were largely designed around an at-retirement portfolio that invested in: UK government bonds/gilts and UK corporate bonds (75%) and cash (25%). The rationale being that many DC savers would want to take their 25% tax free cash immediately and the remaining passively managed investments provided a good match for movements in annuity prices. With the new pension freedoms, annuity purchase has fallen significantly and represents only a fraction of the demand for savers entering retirement (as FCA data illustrates), but not all DC strategies have evolved.

Composition of product purchases made between October to March 2018 (by pot size) (%)



Source: FCA Data Bulletin September 2018

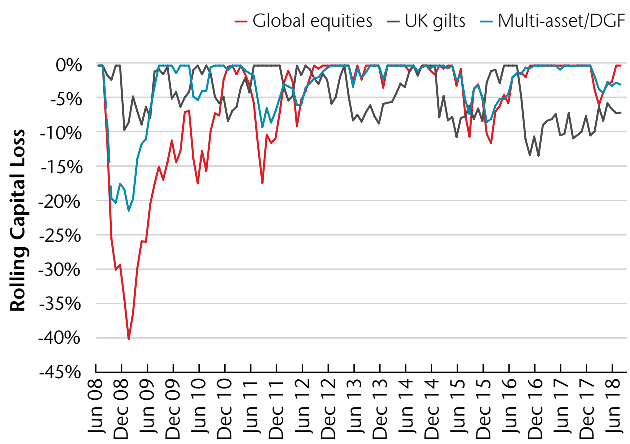
Aon's Defined Contribution Scheme Survey 2017 showed that 85% of members are still using the default option and that 40% of these default investment strategies target the purchase of an annuity at retirement. In the wake of Freedom and Choice, members should be aware that investing in UK fixed income has become much more risky.

Moreover, our DC Survey indicated that over 60% of respondents last reviewed their default arrangement within the last 12-months. Given the mounting evidence that annuity purchase has declined and will remain low, we should be past the 'wait & see' period.Maintaining significant investments in UK fixed income may have felt 'safe', especially as it was providing 10%+ returns each year, but this rationale was short sighted. Now it's time to refocus on members and achieving successful outcomes.

Regardless of whether members take their benefits as cash or draw them down as flexible income, how we think about risk should change. We should focus on the absolute variability of outcomes, as well as the magnitude and duration of the capital loss. The latter is a particularly important factor as the period leading up to a DC saver accessing their retirement savings is the most critical to avoid significant and sustained losses since there is little time to make them back. Fixed income investments have a big role to play, but not in the current form.

Traditional investment strategies that utilise passively managed funds and invest solely in UK fixed income can now be exposing members to significant unintended risks. Based on our research of capital loss generated by UK fixed income relative to global equities and different types of DGFs; we can see that these funds have not effectively protected those members accessing their savings against capital losses, especially since the Brexit vote as yields have generally risen.

Capital loss



Source: Aon, eVestment

Evolving the use of Fixed Income for DC Investments

We've observed that a number of default strategies generally 'de-risk' out of growth assets as DC savers progress through their career in order to invest in a mixture of cash (for tax free purposes) and bond funds nearing retirement. As bond funds used in DC tend to be restricted to the relatively concentrated UK fixed income market; they may not offer the same diversification opportunities and liquidity as global markets. Moreover, we expect that the trading costs in the UK's relatively less liquid market will be more expensive for members.

But there's a better way, by removing the UK bias and introducing diversified bond strategies that have the ability to invest across geographies and asset classes. The two main approaches that we have recommended to DC clients for a number of years are Multi Asset Credit and Absolute Return Bond Strategies as we expect that both will not only outperform UK bonds and inflation but also do so with lower levels of risk. This is borne out in our capital market assumptions (shown below) where we have highlighted the two main Multi Asset Credit and Absolute Return Bond Strategies available to DC investors.

Q2 2018 Asset Class	10 year Annualised Return	30 year Annualised Return	10 year Volatility	30 year Volatility
Fixed Interest Gilts	1.7%	1.9%	11.0%	12.5%
Inflation	2.0%	2.0%	–	–
MAC (Quality)	3.7%	4.7%	7.5%	8.5%
ARBS (Conservative)	2.8%	3.4%	3.0%	3.5%

Source: Aon
Please note that the table above is based on forward looking assumptions and actual returns may vary.

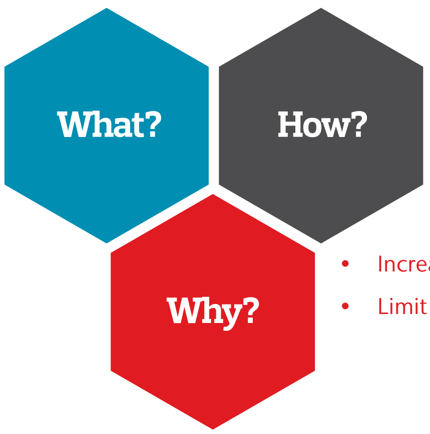
Absolute Return Bonds Strategies

Absolute Return Bond Strategies ("ARBS") are actively managed funds aiming to provide diversification and support capital preservation in all market environments.

The investment universe of ARBS is more limited than traditional multi-asset /DGFs with a focus on credit, government bonds and currencies.

Absolute Return Bond Strategies can be a useful addition to a lifestyle strategy in order to reduce volatility and increase diversification, by asset class and geography.

- Seek consistently positive results
- Typically low correlations to other strategies



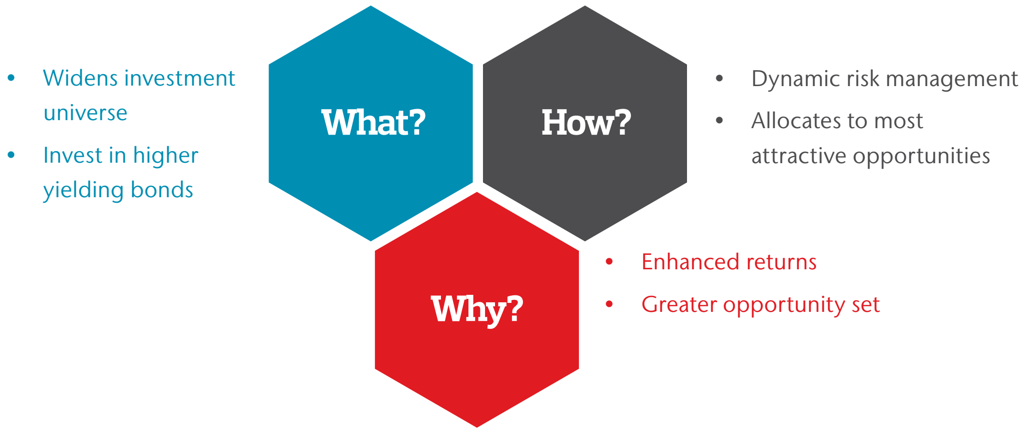
- Active asset allocation
- Take long and short positions

- Increase portfolio diversification
- Limit expected capital losses

Multi Asset Credit

Multi Asset Credit Funds ("MAC"), similar to ARBS, are actively managed funds that aim to access a broader range of credit opportunities than are available in the UK market.

These funds aim for higher returns and diversification with lower duration than a UK bond fund. Relative to ARBS, these strategies tend to have a higher level of correlation with equities.



Conclusion

For DC savers that are nearing the point of accessing their retirement savings, their investment strategy needs to mitigate the key risks they face whilst also providing flexibility to select different benefit options.

Since the introduction of Freedom & Choice, many members have chosen not to purchase an annuity, so we need to think of risk differently. Regardless of whether members take their benefits as cash or draw them down as flexible income, how we think about risk should change to focus on the absolute variability of outcomes, as well as the magnitude and duration of capital loss.

Global fixed income strategies, including Absolute Return Bond Strategies and Multi Asset Credit, can be used to replace or complement existing fixed income allocations, assisting you in addressing the needs of your DC members and achieving successful retirement outcomes.

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