

DEFAULT FUNDS

The magic bullet

It is not possible to point to one single investment strategy as the perfect default solution for every DC member. But total return funds do present an appealing high-calibre option, says PETER BALL of JPMORGAN ASSET MANAGEMENT

THE OVERWHELMING majority of investment in defined contribution schemes is channelled into the default investment option, which is typically a passively managed equity or balanced strategy. However, a recent JPMorgan Asset Management white paper, *Putting total return and alternative investments at the heart of DC investing*, suggests that the majority of investors would benefit from a more dynamically-managed total return fund.

Conflicts of expectations and risk appetite

A large proportion of institutional DC assets are in a global equity fund or a balanced fund that is heavily weighted to equities. This would seem to be a very heavy concentration of risk. Does this very high pure equity exposure meet member needs? Fund managers now offer a wider range of products than they did previously, and so perhaps now is the time for trustees to reconsider this.

DC members are not risk-averse, they are loss-averse. They need to take risk to deliver the required returns, but what they really do not want is significant falls in their account values. If they can be put into a fund that offers sufficient long-term growth, yet manages downside risk, then it will far more closely match members' needs. These funds now exist: total return funds that aim to outperform a cash benchmark rather than a composite equity benchmark.

If fund managers can truly provide products that offer such a return profile then it does beg the question as to whether simple passive equity funds are suitable. It would seem they fail members in both the management and expectation of risk, resulting in a misalignment of the funds used with members' needs and expectations.

At JPMAM we believe total return funds offer a far better match with member expectations and requirements than traditional DC default/core options. Trustees should consider adopting a total return scheme to realign these needs and expectations more

effectively. This allows them to take advantage of a greater variety of investment opportunities, while limiting their exposure to the risk of market downturns and weakness.

Pension scheme members are likely to become increasingly sensitive to downside risk with the growth of the DC market. The vast majority of DC plan members invest in passively-managed default funds with a heavy UK equity weighting, suggesting they all have extremely similar investment profiles.

With such similar investment exposures, market volatility or weakness could impact investors' confidence in their pension provision more than ever before. Total return strategies could help to address this problem, offering the potential for consistent positive returns while actively managing and limiting downside risk. The highly explicit time/reward trade-off aspect of these types of funds can enable members to make a more conscious link between their investment expectations and the time to their retirement.

Adopting a total return strategy

Total return funds aim to deliver consistent positive returns through a long-only investment strategy that is measured against a cash benchmark, such as one-month GBP London interbank offered rate. Usually the fund's performance target will be set somewhere above the benchmark, over a specified period between three and five years. Typically investors should be prepared to allow more time for higher target returns. This objective to outperform cash is intuitive and explicit. For example, cash plus 5pc per annum, which should enable members to understand the potential returns they can achieve over their working life, based on current cash returns.

The simplicity of the fund objective (such as cash plus 5pc per annum) should ensure that members understand what their fund is aiming to deliver. Sadly, too many members do not understand what their global equity

funds are targeting or the downside risk inherent in them.

The great benefit of total return funds is their flexibility, with the ability to invest across different asset classes. Fund managers can adjust their strategies according to market conditions – through the use of equities, bonds, convertibles and cash – to mitigate risk and maximise potential sources of return. To further manage risk they can use derivatives to hedge against market volatility. Total return funds only employ long positions, and by limiting downside risk they should retain members' trust and be less likely to lose money in absolute terms.

Selecting a pension fund default option

Whilst DC investing ostensibly shifts the onus of investment decision-making onto members' shoulders, in reality most opt for the default option. It is not possible to point to one single investment strategy as the perfect default solution for every DC member. Total return funds do, however, present an appealing option, with the intuitive nature of these funds making it easier for members to consider the risk/reward profiles of a variety of schemes given the time horizon in which they hope to retire.

We do not suggest these funds should be a wholesale replacement for traditional relative return funds. But by introducing total return strategies as a default/core proposition, we believe DC schemes will be much better placed to meet the priorities that are most important to their members".

As the DC market grows and represents a larger proportion of UK pension assets, more needs to be done to ensure the key funds offered are designed to meet member needs and expectations, and members understand what their fund is aiming to deliver.

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