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Putting total return and alternative investments
at the heart of DC investing

Creating a new default option for pension scheme members

JPMorgan 

Asset Management

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Introduction

Defined contribution pension schemes are set to see huge growth in assets under management as they become the main source of occupational retirement provision in the UK.

Figures show that the vast majority of DC contributions go into a scheme's 'default' investment option – an equity or balanced strategy that is typically managed on a passive basis.

In this paper we will suggest that more attention needs to be paid to the type of fund that is offered by schemes as their default investment option. In particular, we wish to argue that the new breed of total return funds offer the most appropriate fit with DC scheme members' needs and expectations.

Finally we will illustrate how we believe total return strategies can be used successfully to meet the needs of a wide range of DC members at different life stages.

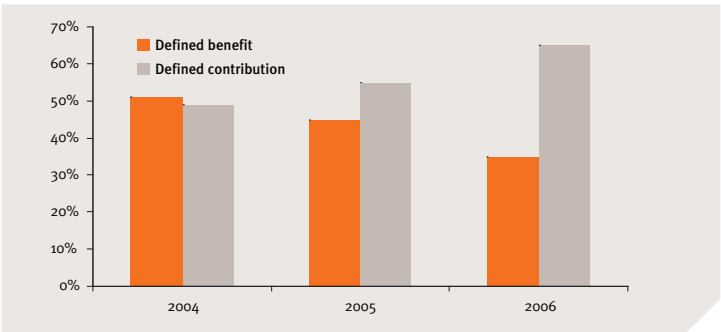
Part one: The growth in DC and the rise of the default fund

The growing trend for closure of defined benefit (DB) pension schemes both to new and existing members has created a boom in defined contribution (DC) plans.

According to the UK Corporate Pensions Survey 2007 by Towers Perrin, of 170 leading UK companies surveyed, just one-fifth offer a DB pension scheme to new hires and one-third of those planned to stop offering DB to new hires in the next two years. As a result of this trend, Hewitt reported in 2006 that the market share of DC schemes significantly outstripped DB schemes – 65% versus 35% (see diagram 1 below).

DC schemes currently only account for 5% of total pension assets under management in the UK according to Greenwich Associates – which equates to around £40 billion. But this figure is expected to grow to 20% by 2015. This means assets under management in DC schemes are set to grow to more than £160 billion in today's terms within the next decade – thereby becoming a significant proportion of the nation's retirement coffers.

Diagram 1: Market share in UK occupational pension market



Source: Hewitt DC and AVC Survey 2006.

The dominance of the default option in DC

DC investing ostensibly shifts the onus of investment decision-making onto members' shoulders. However, only a small proportion of DC scheme members appear to be making 'active' investment choices.

Hewitt Associates report that 7 out of 10 DC schemes have a default investment option – a fund into which a member's contributions will be invested if they do not make an active investment choice. Moreover, four-fifths of total assets under management in DC schemes in the UK are invested in the 'default' option.

The dominance of the default option can be attributed to a number of reasons:

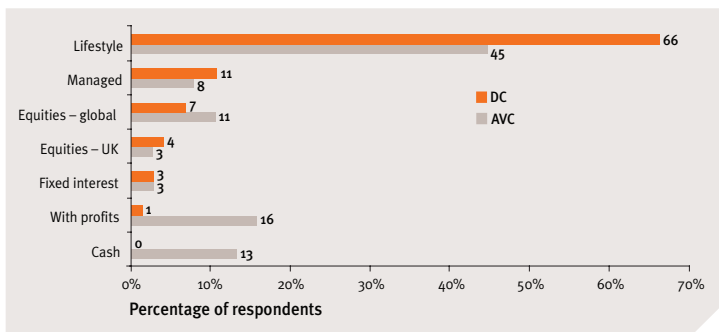
- 'non-active' investors automatically being invested in the default fund
- 'active' investors choosing the default option as a 'safe' choice
- lack of significant investment choice beyond the default option
- stronger marketing of the default option by scheme providers
- lack of clarity/understanding

What is certain, however, is that the default option has become the dominant area of investment for DC members. It is therefore incumbent on trustees to ensure that the default option is appropriate for the greatest possible number of members.

Characteristics of the default option

Research from Hewitt Associates shows us which type of investment funds have been selected by DC schemes as their default option. As we can see from diagram 2, the majority of schemes have chosen a 'lifestyling' option as their default. This option is designed to adjust a member's asset allocation in line with their age and time to retirement, starting with equities and moving into cash/bonds as retirement approaches.

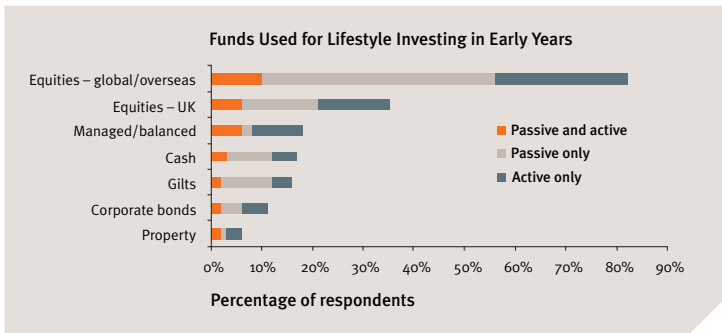
Diagram 2: Default fund options



Source: Hewitt DC and AVC Survey 2006.

If we analyse the breakdown of lifestyling funds further (see diagram 3) we see that in the early years – the years when members are looking to maximise growth – they are invested in either global equity or UK equity strategies. While many DC providers have opted for ‘global’ equity strategies, we would assume that these strategies are heavily UK weighted. They will typically be 50-60% invested in UK equities with the remainder of their portfolio held in global ex-uk equities.

Diagram 3: Lifestyle investment in DC



Source: Hewitt DC and AVC Survey 2006.

In addition, a relatively small proportion of this exposure is actively managed – the majority of providers still choose to offer funds managed on a passive basis that will directly reflect market returns.

In short, we can assume that the vast majority of DC plan members in the UK have almost identical investment exposure: passively-managed equities with a high UK element.

But is this the most appropriate investment proposition for a default fund? To answer this, let’s consider the key requirements of a default fund – both from the members’ and the trustees’ prospective.

1. What members expect from a 'default' fund	2. What trustees want from a 'default' fund
i. Simple-to-understand objective – members need the confidence that they understand at least conceptually how the default fund works and what it is trying to achieve on their behalf.	i. Easy to explain – trustees require an option whose benefits and broad technical workings can be explained easily to members including those with no prior investment understanding.
ii. Low absolute risk – members expect that the default fund will not expose their capital to undue potential for losses in absolute terms.	ii. Low relative market risk – the trustees must not be seen to be exposing members to excess levels of risk relative to the market.
iii. Growth potential – members expect their default fund to offer the potential to achieve good growth that will 'reward' them for choosing to invest in it rather than saving their money elsewhere (e.g. keeping it on deposit).	iii. Potential to achieve acceptable growth – the selected default fund must offer the potential to achieve sufficient growth to allow members to achieve an acceptable standard of living in retirement.

To a certain degree, the expectations of trustee and member are aligned in terms of simplicity and expectations for growth. Where we believe the two parties diverge is in their risk expectation – with each party coming from quite different perspectives.

Perceptions of risk

The trustee/sponsor's view of risk – The majority of trustees still consider risk primarily in terms of the culpability of exposing members to investment options that could lose money by taking excessive risks relative to the stock market.

In other words, many DC schemes are reluctant to direct scheme members to an actively-managed fund which could underperform or fall in value as a result of a fund manager's investment decision-making. Focusing on passively-managed funds avoids this 'risk' as any poor performance is simply a reflection of movements in the stock market – not the misjudgement of a fund manager who has been selected by the trustees.

In these terms, a passive UK-biased global equity product is a 'low risk' proposition for trustees/sponsors.

The members' view of risk – Members of DC schemes consider risk predominantly in absolute returns – how likely their capital is to fall in value and whether it will grow enough to provide a sufficient amount of capital at retirement. They view risk primarily in terms of the gamble they are taking by moving away from the security of cash – not in terms of moving away from a market index.

In these terms, we can easily see that members' definition of risk is not being met by the type of default funds that currently dominate the DC market.

Diagram 4 shows the sector average performance for a global equity life fund over the last 15 years to end-2006, while diagram 5 shows a close-up of performance during the last bear market.

Diagram 4: Performance of the Median Global Equity Life Fund over 15 years

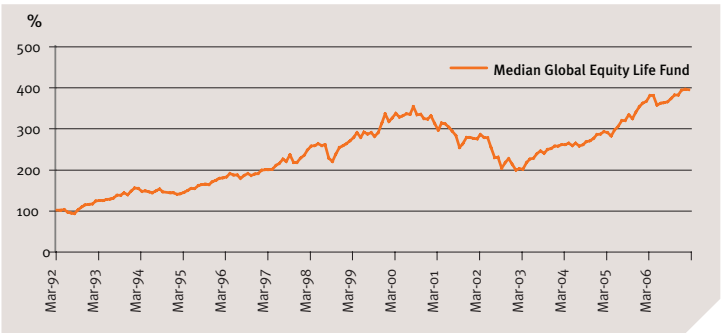
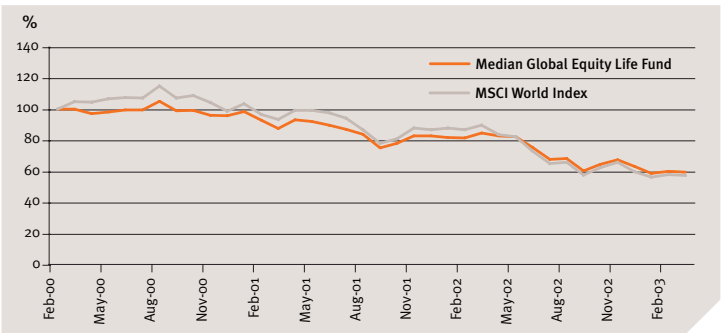


Diagram 5: Performance for the Median Global Equity Life Fund during the bear market (March 2000 – March 2004)



Over the period end-March-2000 to end-March-2003, the Median Global Equity Life Fund would have, on average, sustained a fall in value of 40%. Annualised volatility would have been 17%. However, the fund would only have experienced tracking error of 7% against the MSCI World Index, meaning that it would have broadly tracked global equity movements.

So while this type of strategy would have met the trustee's definition of low risk (close correlation to the market), it would certainly not have met the typical scheme member's criteria of minimal capital loss.

A conflict of expectation

Traditional default options may therefore be failing members when it comes to management and expectation of risk. What the DC fund provider and the member may consider to be low risk may be two completely different concepts. As a result, traditional default options may be significantly misaligned with members' needs and expectations.

Until recently, this misalignment between the member's and the product provider's concept of risk was academic. The persistent rise in equity markets throughout the 1990s meant that relative-risk strategies were delivering positive returns – the ultimate outcome was in line with members' own expectations.

However, the market volatility experienced since the end of the tech boom in 2001 has highlighted the conflict between institutional and member objectives and – in particular – the misalignment in their concepts of low risk.

To date, this misalignment has only been of marginal interest given the small size of the DC market. Within a pension environment dominated by defined benefit schemes, the impact of market falls on individual scheme members is indirect (albeit a significant contributing factor in the closure of many DB schemes).

As DC assets start to represent an ever-larger percentage of the nation's pension coffers – and scheme members therefore become far more directly sensitive to market falls – we believe this misalignment in perceptions of risk could become a major concern.

Should we see another bear market of the magnitude of 2001-2003, the potential for discontent among employees who are invested in their DC scheme's default option could be significant.

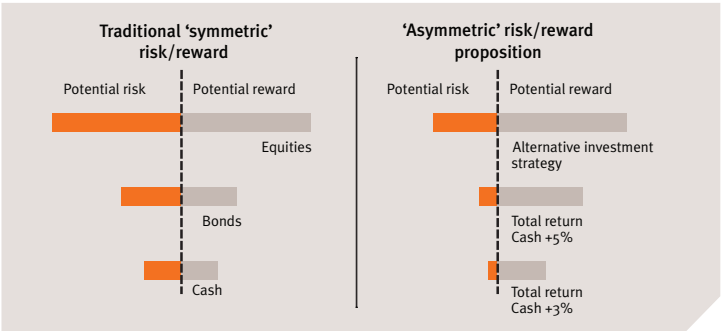
The need for asymmetric risk

Clearly, there is a conflict between two of a DC member’s key needs. Namely, members want to achieve good returns but they do not want to experience any material fall in their account value.

In conventional DC funds, risk has been highly ‘symmetrical’ – high reward requires high risk, while low risk only generates low reward. Whilst over the long term, pure exposure to equities offer strong potential to provide the level of return required, relatively few DC members are comfortable with the volatility they may have to experience along the way. Extreme market volatility may deter DC scheme members from contributing all together.

What DC members are asking for is ‘asymmetric’ risk – low risk with higher reward (see diagram 6). Until recently, there were no mainstream DC products that could provide this. However, we believe this demand for asymmetric risk can now be successfully accommodated through a new generation of funds known as total return funds. We shall look at these funds in detail in part two.

Diagram 6 – a new risk/reward proposition



Part two: Total return – the new default fund

What do we mean by total return?

‘Total return’ refers to long-only investment strategies that aim to deliver consistently positive returns by measuring themselves against a cash benchmark rather than a stock market index. Typically the cash benchmark is one-month LIBOR – the one-month rate of interest at which banks lend to one another and a common proxy for bank base rates.

Total return funds will typically have an objective to outperform their cash benchmark by a certain amount each year – this can range from 1% p.a. to 6-7% p.a.

To outperform cash, a total return fund has to take some additional risk and therefore still has the potential to fall in value. To address this potential for loss, a total return fund will usually specify a certain time horizon over which its target annualised return can be achieved. The higher the fund’s target excess return above cash, the longer the specified time that investors must be prepared to invest.

How total return funds achieve their target

The concept of total return investing has filtered through from the retail investment market, rather than the institutional pensions market. In particular, it has been fuelled by the introduction of UCITS III – the EU-wide directive that has given retail-marketed funds wider investment powers to use derivatives, hold money market instruments and mix different assets in the same fund.

Total return funds aim to achieve consistently positive returns through a number of tactics – some or all of which may be employed in the same strategy:

Diversification – a total return fund may have the flexibility to invest across multiple asset classes, including equities, bonds, convertibles and cash, in order to maximise sources of return and diversify risk.

Tactical asset allocation – while a total return fund may have a focus on bottom-up security selection, there may also be a strong focus on tactical asset allocation to ensure the fund has the optimum blend of assets to achieve positive returns throughout different market conditions. This asset allocation may be achieved through a derivatives-based overlay to allow stock selection to focus on best ideas.

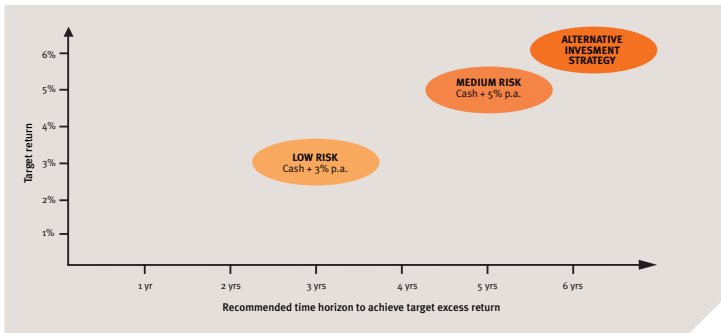
Derivative-based risk protection – derivatives may be used to protect against market volatility. However total return funds cannot – unlike absolute return/hedge funds – short sell in order to actively profit from market falls.

Neutral cash position – some very low risk total return strategies may have a remit to hold a 100% cash position when the manager does not expect sustained positive returns over the target time horizon from any other asset class.

Total return funds use different strategies to achieve their target excess return. Low-risk total return funds aiming for 3-4% p.a. above cash may focus on cash and bonds. Higher-risk funds may have a 'neutral' position of 100% equities with the scope to move into convertibles and use derivatives to limit downside risk. A higher risk alternative investment strategy has exposure to asset classes chosen specifically for their higher-return potential and low correlation.

What is fundamental to grasp is that while each of these strategies may have a different risk profile, all of them have a clear aim to achieve a positive return. What differentiates them is the level of target excess return and the time horizon over which this target excess return is expected to be achieved. This can be expressed graphically as a time/reward trade-off (see diagram 7) – something that DC pension scheme members may find easier to grasp than the traditional risk/reward matrix:

Diagram 7: The Total Return 'Reward/Time' trade off



Total return – meeting the needs of employer and employee

We believe total return investing offers the most appropriate proposition to meet the needs of both trustee and employee.

i. Simple objective

An objective to outperform the return on cash is highly intuitive and far more understandable from most members' perspective than an objective to outperform an equity or bond/equity benchmark.

We believe the total return concept is far easier for trustees and plan providers to communicate in their literature. Explaining to members, for example, that they have two core funds offering cash + 3% and cash + 5% returns can be done very simply. As a result, DC members should be able to understand and appreciate their pension plan far more.

ii. 'Low absolute risk'

Total return funds are more closely aligned with most members' assumption of what 'low risk' means – i.e. a fund that is less likely to lose money in absolute terms. By limiting downside risk, total return investing can limit the impact of future bear markets on members – again helping to maintain trust in the pension scheme.

iii. Strong growth potential

While limiting downside risk, total return funds still retain the potential to achieve strong growth that will 'reward' members for choosing it in their pension scheme. In other words, they can achieve the 'asymmetric' risk profile that DC members are – unwittingly – looking to achieve.

We believe that over the long-term a total return product with a target of cash +5% p.a. will deliver growth rates similar to those of traditional global equity funds. However the volatility will be less than equity funds.

iv. and also...an explicit reward/time target

In addition, total return funds offer a target growth return that is highly explicit. Targets such as cash +5% p.a. allow members to understand the objective of their fund more easily. Furthermore, members can project what returns they might achieve over their working life, based on current cash returns, although it must always be stressed to them that these targets are in no way guaranteed and that returns can decline when their benchmark interest rate drops. In this way, the connection between investing and aiming for one's retirement goals becomes much more explicit.

Performance may show periodic shortfalls against the target return and the fund will not benefit from strong equity market performance to the same extent as a fund which has no limitation on direct equity investing.

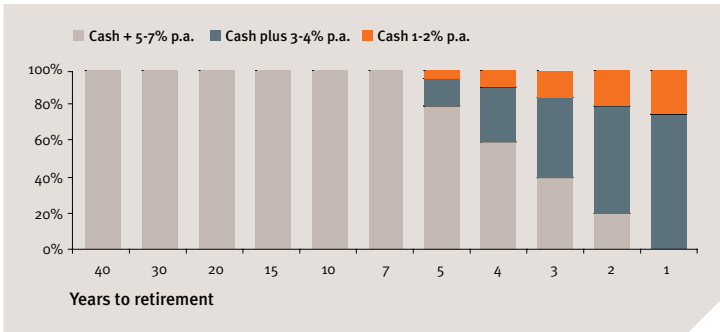
Part three: Total return for every DC member

We acknowledge there is no ‘silver bullet’ and no single investment solution can operate as the perfect default option for every DC member. However the highly intuitive nature of total return funds makes it far easier to offer a range of risk/reward profiles and allow members to identify the total return strategy that is most appropriate to them.

The total return time/reward trade-off shown in diagram 7 also allows members to make a clearer link between investment and their own circumstances. A young member with more than 30 years to retirement can see that they can easily afford to invest in total return funds with a time horizon of 5-7 years or more. As members get older, they can move to funds with a shorter time horizon, – ‘trading off’ time for a lower return.

In this way, total return funds could offer an appropriate alternative to traditional ‘lifestyling’ strategies as diagram 8 shows below.

Diagram 8: Using total return funds in a lifestyling strategy



Conclusion

As the DC market grows and represents a larger proportion of UK pension assets, it needs to be recognised that the power to invest or not invest shifts into members' control.

With the growth in DC, pension scheme members are set to become far more sensitive to downside market risk than they were in the defined benefit pension environment. The impact of market volatility – or indeed another protracted bear market – on employees' confidence in their pension provision could therefore be far more acute than it has been during previous market downturns.

It is vital that the asset management sector therefore finds a core investment option that is more closely aligned with the needs and expectations of members than traditional 'relative return' investment options that have been 'inherited' from the defined benefit market.

We believe that total return funds offer a far better match with member expectations and requirements than traditional DC default/core options such as global equity and balanced funds.

For example, total return funds offer the potential for consistent returns, and they actively look to limit downside risk. Moreover, they offer a highly explicit time/reward trade off that can allow members to make a much better link between their investment goals and their time to retirement.

Diagram 9: Total return – a better fit for DC member objectives

Member requirements	Total return default funds	Traditional 'default' fund
Simple objective	✓✓✓	✗
Low absolute risk	✓✓✓	✗
Growth potential	✓✓✓✓	✓✓✓
Explicit time/reward target	✓✓✓	✗

We do not for one moment 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 pension schemes will be much better placed to meet the priorities that are most important to their members.

How we can help

JPMorgan Asset Management is part of one of the world's largest financial services organisations. As such we have significant experience and expertise in traditional, total return and hedge fund management.

We firmly believe that the newer types of product will continue to sit alongside more established offerings for many years to come. Your clients are unique and each demands a bespoke suite of products blended to meet their personal requirements. Whatever the exact mix we're confident in our ability to offer a range of funds that fit the bill.

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