



As scheme members' top choice, the default fund should offer robust and varied options, but this is rarely the case, **says Simon Chinnery**. However, the diversified growth fund could be the perfect solution

A STRONG CHOICE

The challenges facing defined contribution (DC) pension schemes are wide and varied, but are not insurmountable, according to a recent DC trustee survey undertaken by JPMorgan Asset Management and *Engaged Investor*.

The survey asked 88 DC trustees, pension managers and other stakeholders about their concerns, aspirations and hopes for the future. With more than two-thirds of the responses from trustees with a combined responsibility for more than 300,000 scheme members, we believe this is one of the most comprehensive surveys into DC pension provision ever conducted.

From my point of view as a representative of the asset management industry, perhaps the most interesting, and most pressing concern raised by the survey is the belief among a large number of trustees that the default fund offered to their members may not be appropriate. In fact, only 19% of trustees surveyed claimed they were 'very confident' in their choice of default fund, while nearly two-thirds of respondents did not believe the default fund was the best option for members.

Lack of knowledge

With a new age of investment options now available to market, trustees face a problem choosing which default strategy is best for their members, mainly due to a lack of knowledge and appropriate training. A third of trustees surveyed, for example, feel they only partially meet all the knowledge requirements demanded by the Pensions Regulator, while more than one in 10



The key to the success of diversified growth funds is their ability to offer asymmetrical returns – high potential returns but at a low risk to investors

actually admit that they don't meet the requirements at all.

Unsurprisingly, the survey shows that more than 80% of DC scheme members select the default fund if one is offered, and with the financial acumen of scheme members unlikely to improve any time soon, the doubt expressed over the suitability of default options is worrying. Even more so when you factor in the huge growth in DC assets over the last 10 years, the stubborn insistence of scheme members to grow older, and the challenge of providing post-retirement investment planning.

The survey suggests many DC trustees come from a defined benefit (DB) background, which may help to further explain some of their uncertainties. Although trustees generally receive product-related training (80% have had some DC training in the past 12 months) the survey does expose some disappointment over the amount and quality of information available from investment managers.

This is something the asset management industry needs to take on board. Improving the flow of information and education on DC products and services is key. This can aid members' understanding of what they are ultimately trying to achieve in saving for their retirement and what they need to do to best meet their objectives. Additionally, it can ensure the trustees meet their fiduciary responsibility to all their members.

Fund providers also face a major challenge developing more innovative DC funds so that trustees can not only help their scheme members achieve investment growth without exposing them to unacceptable risks, but also offer investment solutions stretching beyond retirement that focus on decumulation as much as accumulation.

More options needed

The scale of the challenge and the lack of DC experience in much of the trustee community is highlighted by the survey's investigation into the selection of funds for the default option. Most trustees still select funds that allocate assets according to the age of their members, or choose equity funds as their default option. Clearly these can provide potentially strong long-term returns, but with this opportunity comes risk – something many scheme members may be keen to avoid.

Choosing a suitable default for older members is especially tricky. With their pension pot now of greater importance, they are likely to be contributing most to the scheme to boost retirement funds and, with the new flexibility to defer drawing a pension from occupational schemes, many may still want to maximise the growth potential of their assets. However, they are also likely to be in greater need of capital protection as retirement approaches. In other words, they want to achieve good returns while also avoiding significant destruction to their pension pots.

Time to spread out

A possible solution could be provided by diversified growth funds, which typically hold a mix of assets to target better risk-adjusted returns. Although a significant number of trustees (41%) described alternative or diversified funds as being suitable for a default option, the reality is that few schemes to date have implemented such a default strategy.

The key to the success of diversified growth funds is their ability to offer asymmetrical returns – high potential returns but at a low risk to investors. Although pure equity investments provide the potential to generate the level of returns needed by most scheme members over the long term, few are comfortable with their volatility.

Using options to smooth returns by locking in growth at certain intervals is one way to lower the volatility of pure equity funds, but this strategy can be expensive, and can often sacrifice too much growth potential for protection. Instead, diversified growth funds aim to deliver the long-term returns, but at far lower volatility.

Diversified growth portfolios achieve this aim by combining multiple asset classes, selected for their low correlation to one another. Each asset class may – individually – have a relatively high risk-reward profile. However, careful blending enables these individual risks to be offset against one another.

Until recently, asset allocation for most UK pension funds has meant switching tactically between equities, bonds and cash. Diversified growth investing takes this principle much further.

Instead of standard core equities and bonds, diversified growth investing brings together a far broader array of asset classes with a strong focus on alternatives. Typically these may include:

- Global equities – to achieve diversified equity exposure including to the world's fastest-growing emerging markets;
- High-yield bonds – to provide higher return potential than investment-grade bonds while still retaining low correlation to equity markets;
- Commodities – to provide a hedge against inflation and return potential that is strongly linked to emerging market growth;
- Real estate – to provide further inflation-hedging protection plus reliable yields and good capital growth potential;
- Private equity – to provide long-term growth potential superior to public equity markets;
- Absolute return strategies – to provide long-short exposure to hedge fund strategies that can deliver returns in falling and rising markets.

As this list makes clear, diversified growth investing has a very strong focus on 'interest-rate sensitive' real assets such as property, commodities and, increasingly, infrastructure – all of which can provide pension scheme members with an effective hedge against the eroding effects of inflation.

By combining these high-growth asset classes with low correlation to one another, then actively managing allocation between them, it should be possible to retain high-return potential at reduced levels of overall risk.

It seems diversified growth strategies can be of part of the solution for DC scheme trustees looking to structure their default investment option. With over 80% of scheme members choosing the default option it is essential this investment option is engineered to be as robust as possible in any market conditions. For DC scheme trustees looking to help their members balance capital risks against capital gains, diversified growth investing is a promising place to start.

Simon Chinnery is client adviser for the UK institutional team at JPMorgan Asset Management