DC Investment Strategies - Finding answers to the DC default question

DC pension schemes continue to grow in popularity in the UK, and as the DC market grows to represent a larger proportion of UK pension assets, members ultimately control whether or not to invest in their pension. However, while DC investing ostensibly shifts the onus of investment decision-making onto members' shoulders, in reality it appears that of those who choose to invest in their pension, most opt for the default option. **KAREN ROBERTON,** Head of Defined Contribution (DC), UK Institutional, JPMorgan Asset Management, examines the potential for total return funds to provide a suitable default option for DC investing.

SURVEY data suggests that four-fifths of total assets under management in UK DC schemes are invested in the 'default' option*, while the NAPF state that where a DC scheme offers a default fund option, on average 94% of members choose this option. The popularity of the default fund could be attributed to a number of factors, including; investors choosing the default as a 'safe' option, investments being automatically channelled into the default fund, a lack of clarity or understanding, and a lack of significant investment choice beyond the default option. Typically, the default option will be a passively managed equity or balanced strategy, even though a more dynamically-managed total return fund could be more appropriate for many DC scheme members.

Total return funds aim to deliver consistent positive returns through long-only investment strategies, and their performance is measured against a cash benchmark, such as 1 month GBP LIBOR, rather than a market index. Usually the fund's performance target will be fixed above the cash benchmark, combined with a time horizon over which the target should be realised. Investors should typically be prepared to allow more time for higher target excess returns above the cash rate to be met.

Karen Roberton, Head of Defined Contribution (DC), UK Institutional, JPMorgan Asset Management

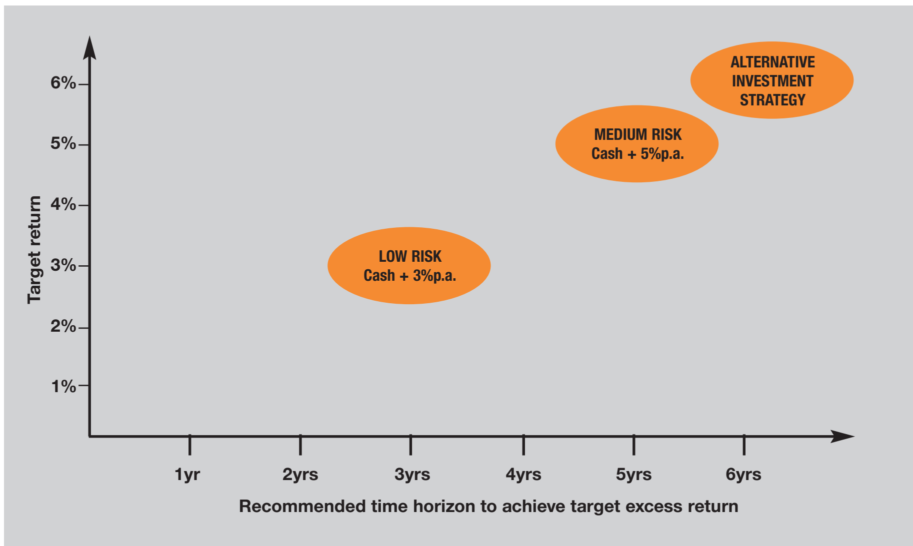
This objective, of outperforming the return on cash, is intuitive and should be clearer to understand for most members than the more abstract concept of aiming to outperform an equity benchmark. The explicit target, for example cash + 5% p.a., should theoretically enable members to project the returns they might hope to achieve over their working life, based on current cash returns. Whilst the targets are not guaranteed and returns could decline if the benchmark cash rate falls, projections based on cash rates should be more intuitive than calculating returns based on stock or bond benchmarks. Total return funds are therefore useful when considering risk/return objectives and the investor's retirement time horizon, making them

an ideal choice for a pension scheme's default investment option.

One advantage of total return funds is their ability to employ a variety of methods to achieve their target returns, including flexibility to invest across different asset classes. This means that while the fund manager can select stocks that he believes will take full advantage of a positive equity environment, in weaker stock market conditions he may move into bonds, convertibles or even cash to mitigate risk and maximise potential sources of return. They focus on bottom-up stock or instrument selection, usually combined with a highly tactical approach to asset allocation. Asset allocation could also be attained through a derivatives-based overlay, to allow stock selection to focus on best ideas. In addition, they can manage risk using derivatives to hedge against market volatility. However, total return funds can only profit from long positions and cannot sell short.

Different strategies are employed to achieve different excess return targets. A low-risk fund, would focus on cash and fixed income, whilst higher-risk funds may have a full equity portfolio and the scope to move into convertibles and other derivates to hedge risk and protect capital. Finally, a higher-risk investment strategy would have exposure to asset classes selected on the strength of their higher-return potential and low correlation. The graph below shows a reward/time trade-off for different levels of target excess return. At JPMorgan Asset Management we believe that a fund with a total return performance target of cash + 5% p.a. will deliver growth rates that are similar to those of traditional global equity funds but with a lower associated volatility.

The Total Return 'Reward/Time' trade-off



The majority of pension fund trustees may still consider risk in terms of exposing members to investment options that could lose money by taking excessive risks relative to the stock market. They may therefore be reluctant to direct scheme members to an actively-managed fund, which could underperform as a result of a fund manager's investment decision-making. In contrast, poor performance by a passively managed fund would simply be a reflection of the stock market. This, however, does not always match an investor's view of risk. For many investors, the risk is in moving away from cash, not moving away from a market index. Traditional default options may therefore result in a misalignment of strategies employed compared with members' needs and expectations. If trustees are bold enough to consider adopting a total return scheme as their pension plan default option, they could align the needs and expectations of members far more effectively. They could also take advantage of a greater variety of instruments whilst limiting their exposure to the risk of market downturns and weakness.

In contrast to the defined benefit environment, pension scheme members are likely to become far more sensitive to downside risk with the rise in the DC market. With the majority of DC members investing in passively managed default funds with heavy UK equity weightings, it could be assumed that they have almost identical investment exposure. Market volatility or weakness could also impact on employees' confidence in their pension provision more than ever before. Total return funds could therefore provide an instrument through which pension plans can align with the needs and expectations of members and take advantage of a variety of investment opportunities. In particular, total return funds offer the potential for consistent positive returns whilst actively managing and limiting downside risk.

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. The intuitive nature of this type of fund makes it easy for members to consider the risk/reward profiles of a variety of investment options and identify the total return strategy that they consider to be the most appropriate for them. Members can also take into consideration the time horizon in which they hope to retire when selecting the most suitable fund for their needs. We are not suggesting that total return funds should be a wholesale replacement for traditional relative return funds, but believe that they definitely have a place in the DC pension scheme armoury. By introducing them as a default or core proposition, DC pension schemes should be well placed to meet the needs of their members.

***Hewitt DC and AVC Survey 2006**