

# DC | SPOTLIGHT

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Addressing investment volatility  
for the benefit of both the Employer  
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Optimise your  
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Reduce volatility  
and target returns

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A defining characteristic of DC schemes is that members are subject to mortality and investment risk. With an ageing population and historically low interest rates, what impact will this have on the purchasing power of our DC investments?

## Forward

As at the end of August 2011, many DC members were 25% worse off than they were 6 weeks previously. Falls in global equity markets reduced many members' pots, whilst the drop in bond yields increased the cost of buying retirement income via annuities. This is occurring at a time when the cost of buying retirement income via an annuity is at an all time high due to improving longevity and historically low interest rates.

Inappropriate investment strategies not only reduce employees' pension benefits, but also impact employees' perception of their employers' pension provision. And yet, correctly structured investment strategies could prevent this.

Investment volatility and material market falls are not new phenomena, having occurred during the 2000-2003 dot.com bubble and also during the 2008/2009 Credit Crunch, and I believe such events are likely to happen again.

At a time when the Regulator is encouraging 'houses to be put in order' prior to auto-enrolment, the DWP has issued guidance on the importance of appropriate default investment strategies. In this issue of DC spotlight we consider how to address investment volatility for the benefit of both the Employer and its employees.

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There is a theoretical view that if members are a long way from retirement, they will be more willing to accept the risk that comes with investing in more volatile assets, such as global equities. This is on the basis that over the longer term these assets should have enough time to provide adequate levels of reward for the risk taken. But do members actually appreciate the capital volatility that they are exposed to, and when it is experienced, how do they react? Also, should a member who is 5 years away from retirement be investing in the same way as a member who does not expect to retire for another 40 years?

# Market Volatility



The chart assumes 100% global equity investment – which might be the case for an individual who self-selects such an option, retires early from a lifestyle approach or is made redundant prior to a 'decumulation' phase kicking in – and approximates to the situation where a non-increasing pension is purchased (As is the case for around 90% of retirees presently).

It can be seen that the level of pension income a retiree could secure worsened considerably during the 2008/9 Credit Crunch. A member retiring with an initial pension of £10,000 per annum (payable for life) in June 2008 might have only received an initial pension of around £5,500 per annum had they retired in March 2009; a 45% reduction in retirement income over a 9 month period. Assuming 20 years of post-retirement longevity, this equates to a difference of £90,000 in nominal terms over the period of pension payment.

When members talk about investment risk, they tend to focus upon the risk that their investment may fall in absolute terms. But, there are many other risks to consider when devising the risk / reward profile of investment strategies.

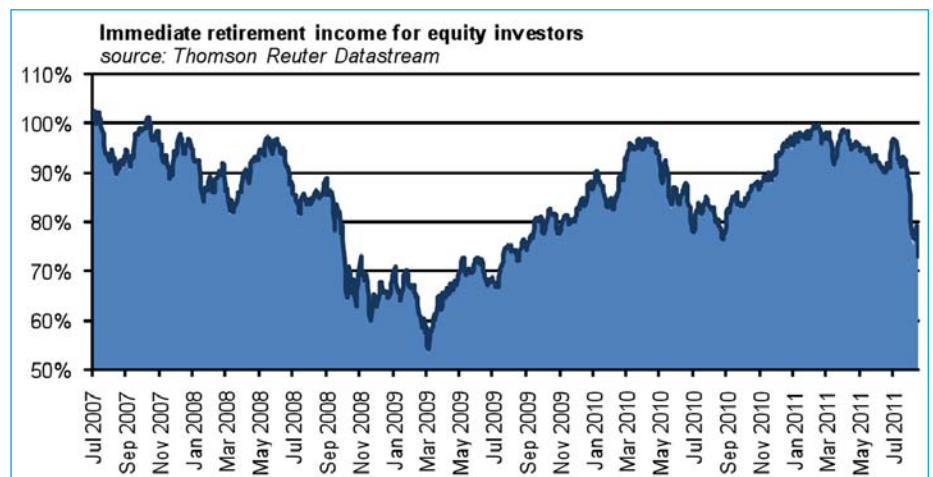
When DC members retire, they typically take 25% of their fund as a cash lump sum, tax-free under current legislation, with the remainder being used to buy a non-increasing pension annuity. During recent market volatility, if such members had been invested in an appropriate mix of corporate bonds, fixed interest gilts and cash, they would have been largely insulated against the 'conversion risks' associated with turning their accumulated savings into retirement benefits.

Unfortunately, inappropriate phasing structures or asset allocations have significantly impacted many members' emerging retirement benefits. Recent market volatility presents a timely reminder as to the risks which investors are exposed, and the need to periodically review the suitability of the arrangements in place.

## Retirement income – at the mercy of the markets?

The chart below represents the extent to which retirement income for an individual who retired in July 2007 might have changed had they reached retirement age at a later date, when expressed as a proportion of their July 2007 income.

Recent market falls have resulted in a deterioration of retirement terms which are not as severe as this. Nevertheless, using the same illustration detailed above, we have estimated that an individual retiring at the end of August could expect to be 25% worse off than if they had retired six weeks previously. ➡



There should be no illusions as to the level of potential volatility associated with equity markets.

## It is no longer the case that equities are the only 'growth' option

Many arrangements have exhibited considerable reliance on equity investment since their inception. This was during the 1990s for many DC arrangements and considerably earlier for a number of the DC AVC arrangements in existence. The market has developed considerably in the interim period and we are now in an era where there are a wide range of investment options and approaches available.

The development of the market should be of no surprise. Many DB schemes have been closed to new members for 10 years or more and several are now closing to future accrual. DC schemes have increased significantly in size – both in terms of numbers of members and asset values involved – and this trend will only accelerate as a result of auto-enrolment. DC provision is here to stay and focus on arrangements will only increase.

There is a strong case for clients who have not reviewed their DC arrangements recently to take the time to do so now. The Regulator is taking an active role in encouraging 'houses to be put in order' prior to the expected influx of assets resulting from auto-enrolment, and he has issued useful guidance covering responsibilities in order to assist with this. The DWP has issued further guidance on the construction and regular review of default investment options.

## Multi-asset investment – a more modern approach

We see a particularly strong case for the incorporation of a multi-asset element into many strategies. Multi-asset funds commonly seek to make use of a number of different types of investment (e.g. gold, insurance bonds, infrastructure investments etc), the principle being that all the investments are unlikely to falter at the same time as equities.

The chart below plots the returns of a number of multi-asset fund returns in the period since last quarter end. It can be seen that investors who have diversified from equities have been largely shielded from the recent market falls.

It should be noted that it is important to select the right multi-asset manager. There are now many multi-asset products in the marketplace, all exhibiting different approaches to portfolio construction and risk and we would expect some funds to be considerably more volatile than others

## Modernising lifestyle arrangements

Typically, lifestyle arrangements change gradually from equity to cash/bonds five years away from retirement, though there are variations on this theme. Although they do succeed in tapering the level of risk down as retirement approaches to a degree, such strategies are far from perfect. For instance, assuming a 5 year decumulation period:

- Should a member who is 2.5 years away from retirement hold 50% of their entire retirement savings in a class that has halved in value twice in little over 10 years?
- Should a member who decides to retire 5 years early (e.g. either on an informed basis or as part of redundancy exercise) be exposed to 100% equity-market risk?
- Do members appreciate the capital risk they are subject to? How will they react to such volatility?

The redundancy scenario is of particular concern as sponsors are most likely to run into difficulty at the point at which the economy is struggling – exactly when equity markets are likely to falter. In the event that a member does suffer a reduction in retirement income as a result of market falls, this could have serious implications – not least the potential need to defer retirement and work for longer. There is also the risk that sponsors could suffer

reputational damage and/or complaints as a result of the member's predicament.

It is relatively straightforward to make use of multi-asset funds to reduce the expected level of volatility during the growth phase and appropriately align asset allocation and phasing structures to mitigate conversion risks during the conversion phase.

## Next steps

There are various questions that we believe that scheme fiduciaries (trustees, governance committees and employers) should ask themselves:

### Does the current fund range/lifestyle arrangement stand up to scrutiny?

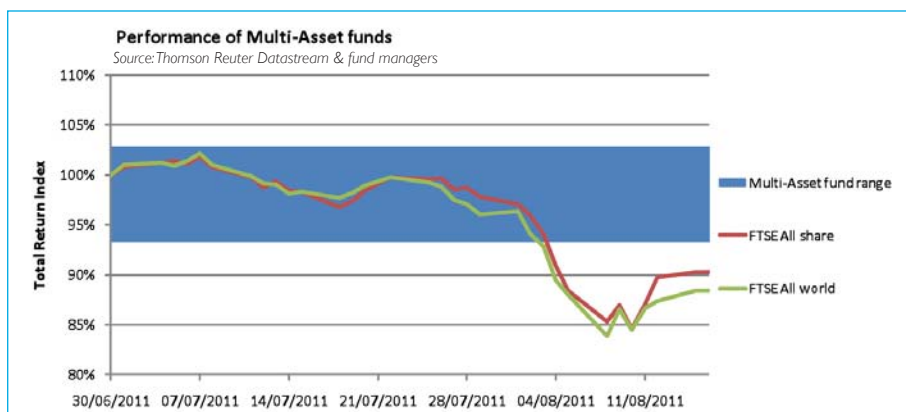
Are there new investment products that would reduce risk for members and the sponsor? Does the range itself need reviewing e.g. in light of the expected impact of Auto-enrolment?

### Do current fees represent value for money?

This is an area of particular focus of the Regulator at present. We would suggest that fiduciaries who maintain investments which are unjustifiably expensive (e.g. index tracking funds) or have underperformed their benchmark objective for a prolonged period of time – without an informed decision to retain the investment despite this – are exposed to potential action. However, as the Regulator has made clear, cheapest is not necessarily the best – analysis should consider net returns, not solely focus on the charge.

### Is the governance structure appropriate?

The quality of a DC arrangement falls squarely on the fiduciary. The DWP and Regulator are clear that default investment options should be regularly reviewed by the scheme fiduciary to ensure appropriateness. Is it time that your arrangements were reviewed? ■



# Multi-asset Investments

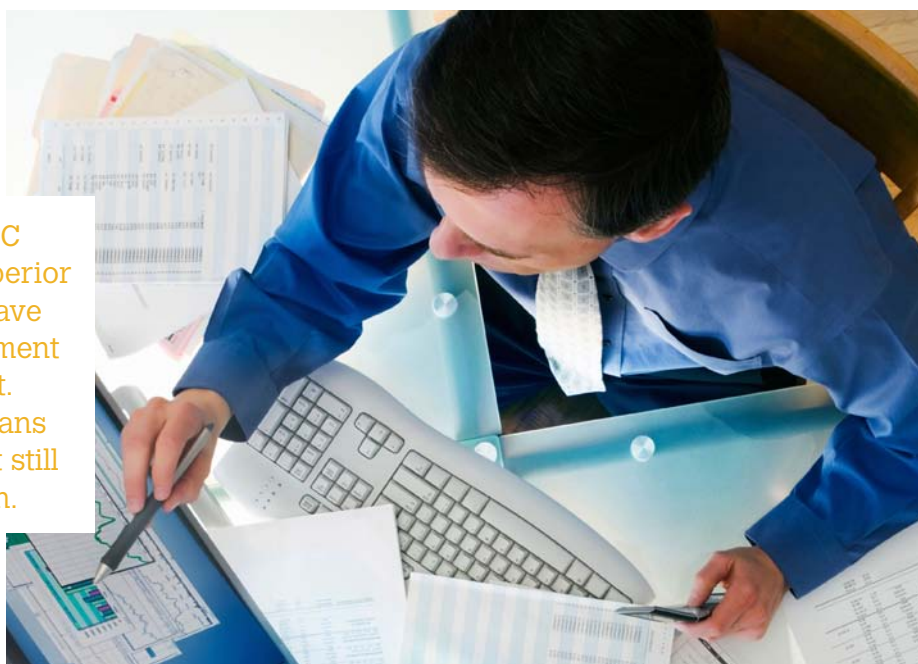
Before the credit crunch, all that DC scheme members wanted was superior returns. During and since, many have felt that on reflection risk management would have been just as important. Multi-asset investment offers a means of reducing capital volatility whilst still targeting a specified level of return.

Multi-asset investing is where a member can get exposure to a range of different asset classes that often tend to behave in different ways. Each has its own characteristics (and thus inherent volatility of returns) that make it worthwhile holding for the long run. But there may be times when one is doing much better than the other.

The theory is that by investing in a number of different assets, members are able to spread their risks and thus stabilise returns. For example, in an economic cycle different asset classes will fair better at different times. Bonds will do well when growth is weak and inflation is dropping. Equities will do better when growth recovers. So will property, but its cycle tends to be slightly different to equities. Commodities are useful when inflation is accelerating, whilst during stagflation, when growth may be slowing and interest rates high, cash is attractive.

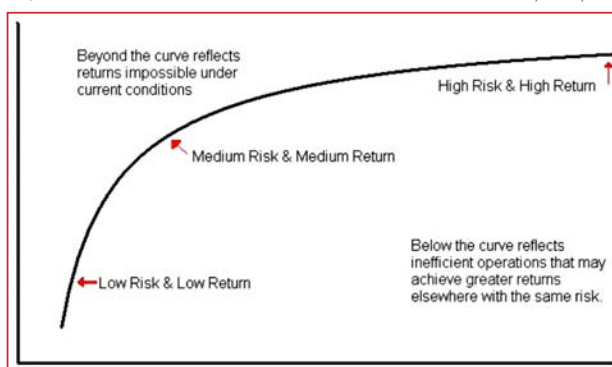
Over the last 10 years we have seen assets' performances move in different directions. In an economic recovery, equities go up, but bonds do not. In an economic downturn, Government bonds tend to perform well and equities not. This is called negative correlation, where assets are behaving in the opposite way to each other. Consequently, when such assets are combined together, it is possible to get a much smoother month-to-month risk return trade-off and thus less volatility.

Historically, DC schemes frequently offered members access to 'managed' funds which invested assets according to a fixed formula. Others offered 'consensus' funds which invest assets according to the average of all UK DB and DC pension funds. Whilst both investment approaches could be defined as multi-asset, neither can achieve the objective of minimising volatility for a given level of return. For this, analysis needs to be undertaken to identify the 'efficient frontier'.



## The efficient frontier

The efficient frontier describes the relationship between the volatility and return that can be expected from an investment portfolio. The efficient frontier gives the best return that can be expected for a given level of risk, or the lowest level of risk needed to achieve a given expected rate of return, as illustrated below:



In essence, appropriate diversification can increase returns without increasing risk, or reduce risk without reducing expected returns. Given the current environment, where assets go up and down on a regular basis, diversifying assets makes a lot of sense.

## What makes a good diversified investment?

Decisions need to be taken about strategic and tactical asset allocations and how they interact. It is important to select underlying managers who are strong in the chosen asset.

Strategic asset allocation represents a mix of assets that are appropriate for a member's risk profile to try and achieve a specific return or risk profile over a period of time. However, in

the shorter term, tactical opportunities may arise because of sharp moves in markets or opportunities because of the economic or credit cycles that enable exposure either within, or at the margins between, asset classes.

It may be possible to identify a suitable objective and risk profile for the growth element of a lifestyle strategy. In such a scenario a fund management company may be able to provide this via an existing fund, such as an absolute return fund. However, for others, such a fund may be a component aspect of an investment option afforded to members.

It is important to note that there is a vast difference in strategy amongst the different types of absolute return funds available. Those responsible for DC schemes need to understand what their members will be buying into.

Strategies are frequently different; some being equity driven, some credit driven and others are driven by macro-economic factors. Further, managers rarely stipulate a time period over which they will deliver their performance targets, meaning that there is a danger that members will feel confused.

Selecting an appropriate multi-asset investment strategy is only the start; like all other aspects, it must be continually reviewed to ensure it remains appropriate. ■

# Investment Governance

Many members believe investment options (and particularly default investments) are regularly monitored and reviewed on their behalf. Effective governance of DC arrangements is therefore important to address potential legal and reputational risks.



Investment governance is one of the most important aspects of DC provision. This has been emphasised by the Investment Governance Group (IGG), which is sponsored by HMRC and the DWP, and is chaired by the Pensions Regulator. It consists of trustees and other experienced figures involved in investment decision-making in trust and contract-based schemes; including providers, consultants and advisors. Members are also represented.

IGG's aim is to strengthen investment decision-making and governance for the benefit of members. The intention is that its framework of principles and accountabilities should be adhered to on a 'comply or explain' basis by all DC schemes. IGG's principles address key areas such as roles, responsibilities and accountability; fund choices / default strategy; and member communication.

All investment options should be continually monitored against quantitative and qualitative triggers to identify and address any issues at an early stage. This process should involve both performance reviews and manager analysis to identify any potential changes to strategy, process or management.

Once an investment option is on a watch list, criteria should be identified for improvement. If these are not met by a specified date, the underlying manager or investment asset allocation should be replaced. Assets should be transferred in such a way as to minimise cost, out of market risk and member confusion. Those responsible for DC schemes need to ensure that they can implement these processes for all of the funds they offer to their members.

Whilst the ability to effectively govern all of the investment options will impact the number of investment options, the ability of members to select appropriate strategies should perhaps be the driver. Behavioural economics tell us that offering too many investment options can be daunting for members and lead to them not making any decisions at all.

As well as ensuring the composition of investment options are appropriate, it is important to be prepared to make tough decisions and restrict the number of options available. This should, all things being equal, increase members' willingness to make a decision.

Sponsoring employers are recognising that long-term strategic human resource, legal and reputational risk need to be identified and managed, whether pension provision is made via a trust or contract-based approach. From an investment perspective, particular focus is required. ■



# Investments, Contributions and Retirement Planning

Current market volatility highlights the importance of ensuring that members' appreciate the interaction between where they invest and how much they will need to contribute to target a certain level of emerging benefits.

Members need to be able to understand that by contributing £200 per month and targeting a long-term return of 4% p.a., they may achieve their desired retirement income with a high degree of certainty. Conversely, if they wish to contribute less, they could adopt a more adventurous strategy, targeting a long-term return of 7% p.a., but need to appreciate that they may not reach their desired target and may achieve less than the more cautious strategy would have provided.

Continual review of all aspects is important if members are to effectively plan for their future. Each cannot be taken in isolation. For example, if a member experiences better performance than expected they could elect to target a higher level of benefits. Alternatively, if they

choose to retain the same target, they could either reduce the levels of contributions they make or adopt a less risky investment strategy. This would provide greater certainty of achieving their targeted level of emerging benefits. Conversely, if a member's investment experience is worse than anticipated, the member could choose to increase their contribution or adopt a less cautious investment strategy.

Members should be educated to understand the impact that an investment strategy may have on the required levels and timing of contributions. Only in this way can an individual decide when to join a pension arrangement, select the level of contributions to make and choose an appropriate investment strategy to adopt. ■



# Understanding Investment Risks

When members talk about investment risk, they tend to focus upon the risk that their investment may fall in absolute terms. However, there are many other risks to consider. For members, the risk / reward profile of investment strategies should tie in with their ability to pay contributions over their working lifetime.

The composition of the default fund and fund range made available to members should depend on some fairly basic facts:

- When are they planning to retire?
- Are they intending to take part of their pension as cash?
- How comfortable are they with investment volatility?
- How much risk can they afford to take?
- Do they want to actively manage their investments?

Because of this, members face a number of common risks which those responsible for DC schemes should consider and, where possible, address.

## Capital, inflation and currency risks

Capital risk is the potential that the absolute value of a member's pension account will fall. If, to avoid this, contributions are invested in cash, inflation may erode its relative value, necessitating increased levels of contributions, or else lower emerging benefits will be delivered.

There is a theoretical view that if members are a long way from retirement, they will be more willing to accept the risk that comes with investing in more volatile assets, such as equities, on the basis that over the longer term these assets should have enough time to provide adequate levels of reward for the risk taken. However, this is frequently not the case.

If an individual's benefit statement illustrates a lower value than in the previous year, despite having paid further contributions emotions can dictate that the logic of 'pound cost averaging' goes out of the window. This can have a profound impact on members' perceptions of the pension arrangement. This is where diversification of investments can be helpful.

A common approach to date has been to invest in equities, but in different geographical locations. However, given the increasing correlation of UK and overseas equity

performance, this will not achieve the diversification required. In addition, such an approach can introduce currency risk where any relative movements in exchange rates may give rise to an increase in volatility of these investments. Whilst currency risk can be hedged, there is a cost involved.

## Risk of inappropriate use of benchmarks

The FTSE PensionDCisions DC Growth Index reflects the asset allocation decisions made by UK DC pension plans in the growth phase of their default investment strategies. The latest available figures illustrate that over 90% of growth assets are invested in equities. Given the inherent capital volatility of such an asset allocation, this would not seem appropriate for many members.

Certain industry commentators are suggesting that the index offers a benchmark against which to develop a default investment strategy. However, there is a clear distinction between how the 'average' scheme is investing at a point in time against what is appropriate for an employer's specific scheme. When it comes to satisfying governance responsibilities, a statement to the effect that an investment strategy is similar to the 'average' will not be sufficient.

## Conversion risk

As members approach their target retirement age, the impact of conversion risks should be considered. When members retire, they are usually able to take up to 25% of their fund as a cash lump sum, tax-free under current legislation. The remainder is usually used to buy an annuity. Many members may feel that moving 100% of their investments into cash is a sensible approach to de-risking their investments.

However, this actually increases conversion risk as the cost of buying an annuity is not linked to the returns on cash funds, but to, amongst other things, the yields on bonds and gilts.

## Manager risk

Manager risk is another aspect to consider. Active managers aim to beat a benchmark, thereby potentially offering higher (or lower) returns than a passive manager. Consequently, they are considered 'more risky' than passive managers. However, passive management still involves manager risk as tracking methods vary from 'full replication' (holding every stock) to 'partial replication' (holding a sample of the index) in order to reduce costs. It should also not be forgotten that passive managers will always seek to track the market, even if it looks like it's about to fall off a cliff!

Investment risks are complex, but must be addressed if members are to receive a good level of income in retirement. ■

As members approach their target retirement age, the impact of conversion rates should be considered.



# Retirement Income

A defining characteristic of DC schemes is that members are subject to mortality and investment risk. While it is common knowledge that we are all living longer and that interest rates are at historic lows, the impact this has on the purchasing power of our DC investments is perhaps less well appreciated.

The cost of purchasing annuities is primarily subject to the underlying assets which insurance companies use to back these assets; Bonds and Gilts. We have therefore considered historic gilt yields and standard actuarial tables to create a proxy for annuity prices in 1971 and each decade thereafter. To consider what this might mean for future retirements, we have then considered the impact of future longevity improvements (at two different rates) and future long term interest rates (again, considering two different possible scenarios).

## Long term interest rates

Figure 1 overleaf shows how long term interest rates have varied since 1971: increasing from 1971 to 1981 and then falling each decade to the present day (obviously, with a lot of volatility in between that we are not showing).

## Life expectancy

Figure 2 shows how life expectancy for a man retiring at age 65, as predicted by standard actuarial tables has increased consistently year on year (blue). It also shows what would happen to life

expectancy if current improvement trends continue (orange) or if the rate of improvement reduces to a slower rate (purple).

## Putting these together

Putting these two sets of data together allows us to calculate the pension that a man aged 65 would have been able to purchase with a DC pot of £100,000 in 1971 and each decade subsequently. For illustration purposes, we have assumed that the pension has no increases in payment but does have a 50% pension payable to the member's wife following his death.





Fig. 1

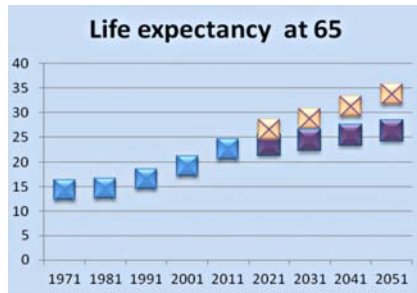


Fig. 2



Fig. 3

Between 1971 and 1981, the relatively moderate increase in life expectancy was more than offset by the increase in long term interest rates. Since 1981 however the purchasing power of DC funds has been hit by the double whammy of increasing longevity and falling interest rates. By 2011 £100,000 would only buy a pension about 40% of that it would have bought in 1981.

### What about the future?

Finally, we consider what this might mean for those of us whose retirement is yet to happen. To do this, we have looked at four possible scenarios summarised in the table below (the colours in Table 1 correspond to the colours used in Figure 4 below).

The resulting pensions purchased from a DC pot of £100,000 are shown in Figure 4. Again, these are for a man aged 65, with no increases

in payment and with a 50% spouse's pension payable on the member's death.

Aside from the obvious conclusion that £100,000 is unlikely to be a large enough fund to provide a decent retirement in 2021, never mind 2051 one key point stands out – the key to getting higher pensions in retirement is higher interest rates (the light purple and light orange bars). By contrast, different life expectancies have relatively little impact on the pension that can be purchased. It is also noticeable that the impact of improved longevity is greater when interest rates are low – the relative difference between the dark purple and dark orange bars (low interest rates) is greater than that between the light purple and light orange bars (high interest rates). However, if high interest rates are accompanied by high inflation (which they often are) higher initial pensions may not be so valuable after all!

### The need for support

So what does this all mean? Well, for one, it highlights the importance of encouraging members to regularly review their pension planning to ensure that they remain on target. And when members get to retirement, assisting them to select the most appropriate form of benefits for them personally, considering their individual circumstances, be that tax-free cash, an annuity pension for life or income drawdown, is vital as is ensuring they get access to the most competitive terms available. It is particularly important that members are supported in this aspect of retirement planning, as the difference in retirement income provided by selecting the most appropriate type of annuity for the individual can be, at times, as much as 100%. This makes it one of the most important investment decisions the member will make. ■

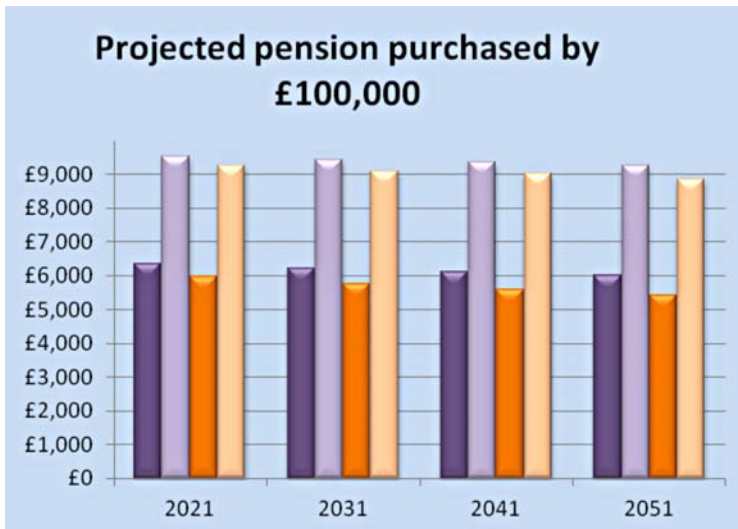


Table 1

	Current longevity improvement trend continues	Longevity improvement trend reduces
Low interest rates (4.25%)	■	■
High interest rates (8.5%)	■	■

Fig. 4



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In 2011 Xafinity was recognised as Third Party Administrator of the Year at the UK Pension Awards and in 2010 won the award for Pension Software Provider of the Year for the fifth time in six years. At the Pension and Investment Provider awards in 2010 Xafinity won Best Pension Administration Software and in 2009 were voted the best Third Party Administration Provider. Xafinity is the accredited software supplier to the UK Principal Civil Service Pension Scheme.



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