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Falling short term interest rates
The impact on cash funds

Summary and Recommended Actions

The result of the EU Referendum in June has caused a great deal of uncertainty in investment markets, which is expected to continue as details of the UK's exit from the EU are negotiated. In light of the potential negative impact to the UK economy of leaving the EU, the Bank of England has lowered the base rate to 0.25% p.a. in an attempt to support the UK's growth prospects. This monetary policy action was anticipated in advance by investment markets, with a base rate cut priced into the nominal yield curve. Following the Bank of England's 4th August 2016 announcement, market expectation based on forward rates is that the base rate will not return to its previous level of 0.5% p.a. for about 5 years.

The cut in the base rate will make it even harder for cash funds to deliver a positive return after charges. In light of this pension scheme decision-makers should consider:

- Reviewing the level of charges payable on cash funds, particularly those within Defined Contribution ("DC") schemes, and assess what this is likely to mean for net cash fund returns going forward. This should include cash funds offered as Additional Voluntary Contribution ("AVC") options within Defined Benefit ("DB") schemes.
- Approaching investment managers/pension providers to renegotiate the level of charges being paid by members, and to understand what steps are being taken to try to deliver positive returns on cash funds.
- Reviewing whether lifestyle structures within DC default investment strategies remain appropriate.

Consideration should be given to whether the potential impact of the changes should be communicated to members, also reminding them of the need to keep their target retirement age up to date.

The following note examines the impact on cash funds of an even-lower-for-longer interest rate environment and provides more detail around the reasoning for our suggestions.

If you would like to discuss these issues further, please get in touch using the details below or directly through your usual Deloitte contact.

Deloitte Total Reward and Benefits Limited
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Richard Slater – **ricslater@deloitte.co.uk**

Alistair Sutherland – **asutherland@deloitte.co.uk**

Will Aitken – **waitken@deloitte.co.uk**

Clara Golzarmanesh – **cgolzarmanesh@deloitte.co.uk**

Fiona Watson – **fiowatson@deloitte.co.uk**

Negative net performance on cash funds

The majority of cash funds are designed to provide investors with capital preservation and liquidity. However, in an environment where short term interest rates are very low, these funds will struggle to deliver positive returns once investment management charges have been deducted from the low yield achieved. This was already the case for a number of the more expensive cash funds in the market, but this issue will become more widespread now that the base rate has been cut to 0.25% p.a.

In anticipation of the base rate cut, some investment managers increased the average weighted duration of the holdings within their cash funds to benefit from the marginally higher yields available on longer term deposits (albeit the extent to which this is possible is limited). However, such action can only maintain returns over the short term, as any significant increases in duration could compromise the level of liquidity available within a fund. Ultimately, the returns available from cash funds will decrease over time as the underlying investments mature and are replaced by lower yielding securities. With the funds closely monitored by the rating agencies, there is limited scope for the funds to boost yields from other areas, such as moving down the credit quality spectrum.

The impact of this for investors is that once charges are deducted, the value of their assets held within cash funds is likely to reduce over time. This could have a significant impact for investors holding large sums in cash funds over a prolonged period of time.

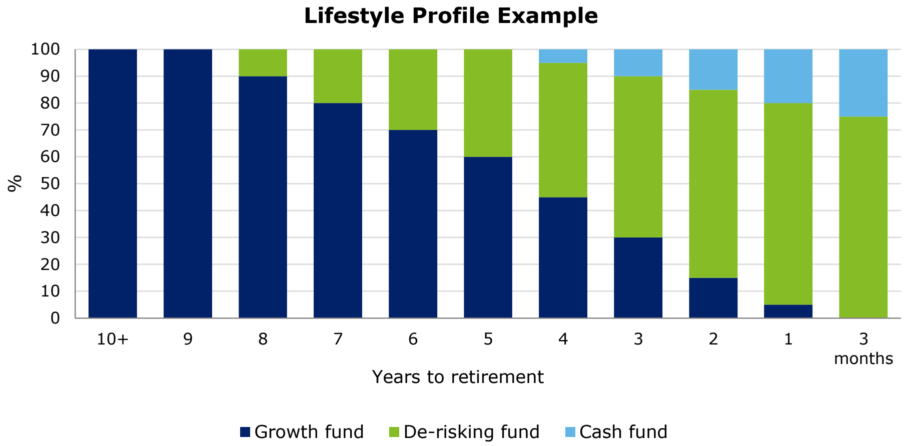
Cash funds in DC pension schemes

Cash funds remain the least volatile investment option for members of DC pension schemes. However, a prolonged low interest rate environment could lead to a net cost to members investing in these funds, eroding the value of their pension savings over time.

If it has been a while since member charges have been reviewed then DC pension scheme decision makers should consider approaching investment managers/pension providers with a view to renegotiating the level of charges being paid by members, particularly with respect to cash funds, as well as to ensure that they understand what steps are being taken to try to deliver positive returns in a low(er) interest rate environment.

DC default investment strategies

The vast majority of default investment strategies for UK DC pension schemes include the use of a cash fund in the final stages of lifestyling. The exact lifestyle profile will be scheme specific but a large number include at least a 25% allocation to cash on retirement. This is because cash funds are an appropriate matching asset where members are expected to take 25% of their retirement savings as a tax-free cash lump sum.



Whilst a gradual increase in cash fund holdings as members approach retirement is generally likely to remain appropriate on the grounds of providing capital preservation, we suggest that DC pension decision makers consider reviewing the level of cash fund investment in their default investment strategies and the time period over which lifestyling occurs. As part of this they should consider whether they are comfortable with this in an environment where the cash fund is potentially delivering negative returns after charges.

It is also important that member records regarding target retirement ages are kept up to date, as investment lifestyle switching is typically based on target retirement ages. If a member decides to retire later than their recorded target retirement age then a large proportion of their pension savings could be invested unnecessarily in a cash fund, which could erode the value of their final pension pot.

Other considerations include communicating with scheme members to make them aware of the potential impact on their pension savings and asking them to consider whether their target retirement ages on file are accurate. This could help to avoid large proportions of members' pension pots being unnecessarily invested in cash for long periods of time.

Individual fund options

Cash funds are also offered to members as individual fund options in DC pension schemes. Consideration should be given to making members aware that any prolonged period invested in a cash fund may erode the value of their savings in the current environment.

What about DB AVCs?

For cash funds offered as AVC options in DB schemes the situation is likely to be the same if not worse, as charges for DB AVC funds are typically higher than for equivalent funds in DC schemes. If this is the case it may be worth negotiating lower fees with fund providers.

Is there a good alternative to using a cash fund?

Some investment managers offer "Cash Plus" funds which target a slightly higher return at the expense of a couple of days of liquidity. For DC investors investing a portion of their pension savings in cash over a medium-term time horizon, such funds could reduce the risk of net negative returns in the current environment. However, the headline charges on such funds are slightly higher than on regular cash funds, so DC decision makers will need to be comfortable that they offer members value for money after allowing for charges and that the reduced liquidity does not cause any issues.

Risk Warnings

- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any suggestion in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

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