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September 2019

DC First Principles

Default design – Equity volatility is good volatility

There are a range of approaches taken by DC schemes in the accumulation phase with an apparent preference for often complex, multi-asset strategies. Our analysis suggests that individuals are not served well by complex default funds focussed on managing volatility.

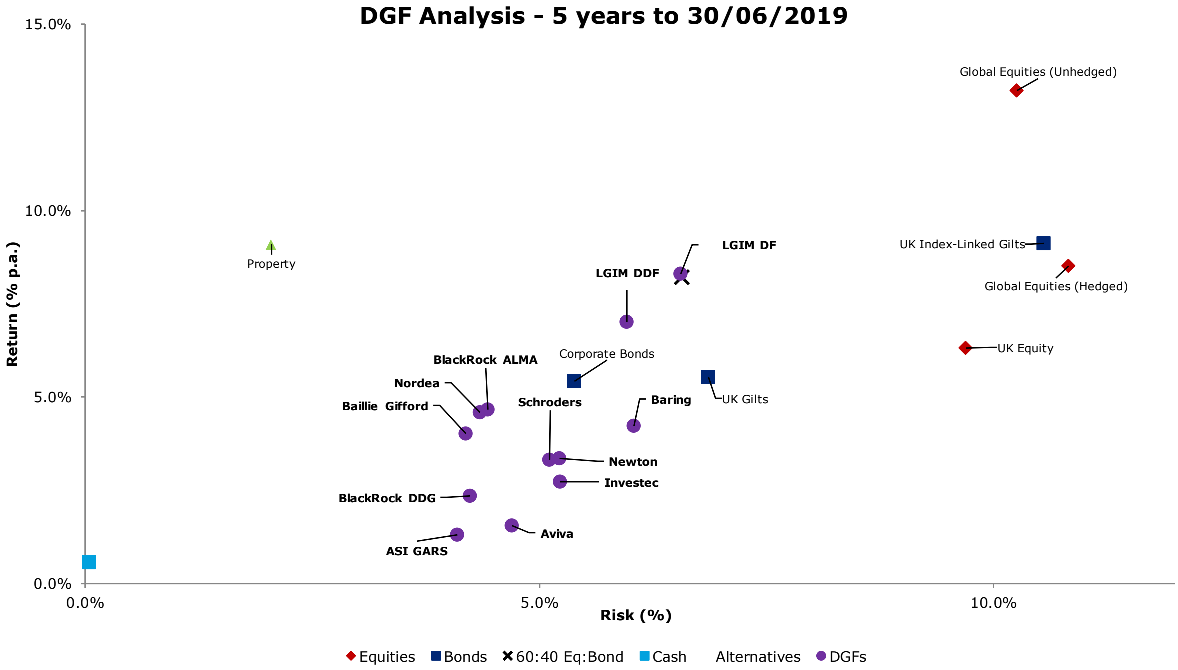
We have observed over recent years a trend towards the use of diversified growth funds and other multi-asset approaches within the accumulation phase, often with the objective of avoiding bouts of market volatility.

The first goal for many trustees and sponsors of defined contribution ("DC") schemes should be to facilitate superior outcomes at retirement for their members or employees. Whilst the future path of returns is ultimately uncertain, we are of the opinion that a multi-asset approach is sub-optimal and that complex strategies designed to control volatility will underperform a simple, passively managed global equity fund over a typical time horizon.

DGFs – lower volatility but lower return

At their inception, diversified growth funds ("DGFs") promised investors equity-like returns with less volatility. This had obvious theoretical appeal to investors and in the early years, shortly after the financial crisis, DGFs met investors' lofty expectations benefitting from the wide-ranging rally in risk assets and sharp decline in bond yields. More recently, these funds have fared less well, offering lower volatility than equities but also lower returns.

To illustrate the point, if an individual had contributed £250 a month for the last 5 years, that individual would be around **£4k or 20% better off** today if they had invested in a passive global equity fund instead of the median diversified growth fund.



A number of prominent DGFs have seen significant outflows as a result of the slump of performance in largely buoyant investment markets. Interestingly, assets under management have been protected to some extent by the prominence of such funds in pre-retirement strategies and in default arrangements of trust based DC schemes.

Recent performance trends have confirmed what we have long expected, that a diverse, multi-asset portfolio offering less volatility is unlikely to keep pace with equities over the long term. As such, given the long time horizon of the typical DC scheme member, DGFs are unlikely to offer improved at-retirement outcomes through superior returns. However, given that the choice to invest in DGFs is often grounded in the desire to avoid inferior returns, we consider below whether a combination of moderate returns and lower volatility has value for DC members.

Multi-asset vs equities

Contrary to many of our peers, we have championed the use of passive global equity funds in the accumulation phase.

The analysis summarised below illustrates how investing in a low cost, global equity fund results in superior outcomes for individuals and demonstrates the rationale for our view.

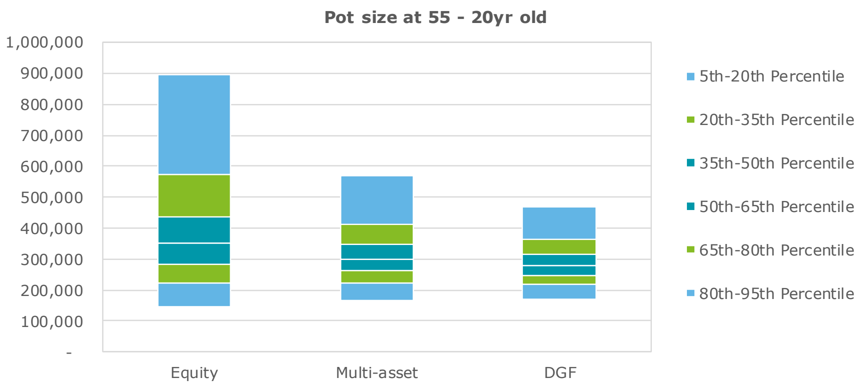
We assume that an individual starts work at aged 20 earning £20k p.a., receives annual salary growth of 4% p.a. and contributes 10% of their annual salary to their pension. We consider the distribution of this individual's potential pension pot size at age 55 (prior to any potential lifestyling strategy), from three different starting points (ages 20, 30 and 40)[1] and under three different investment approaches:

a) Passive **global equities**;

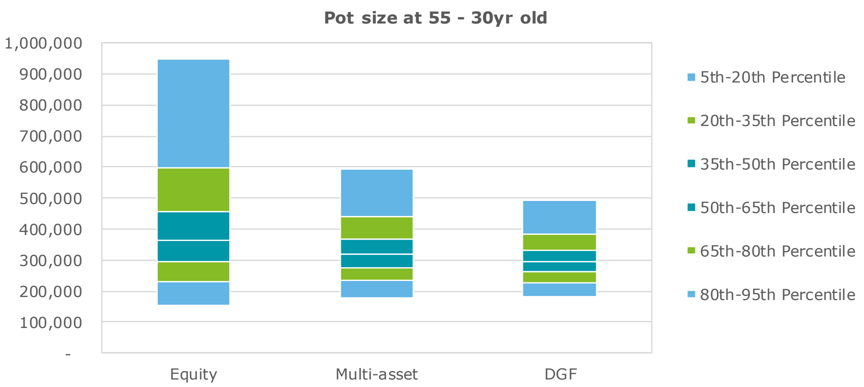
b) **Multi-asset portfolio** with 60% equity, 20% property and 20% corporate bonds;

c) **Diversified Growth Fund**.

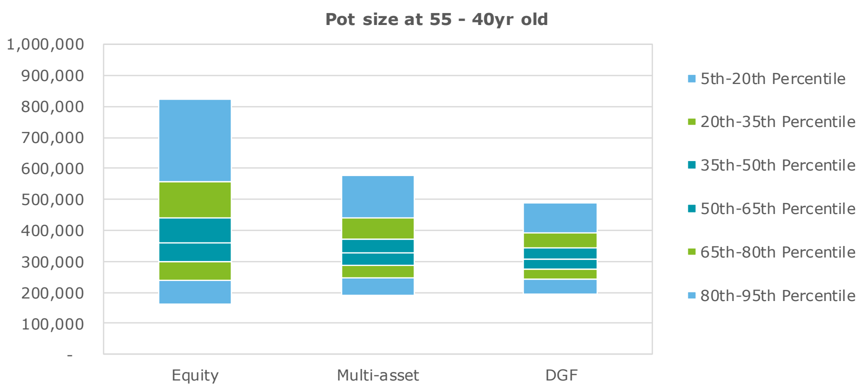
Aged 20	Equity	Multi-asset	DGF
Probability £250k	73%	69%	64%
Probability £350k	50%	34%	23%
Probability £500k	28%	10%	3%
Downside extreme	£146k	£165k	£170k
Expected (Median)	£350k	£299k	£279k
Upside extreme	£897k	£571k	£470k



Aged 30	Equity	Multi-asset	DGF
Probability £250k	76%	75%	70%
Probability £350k	53%	40%	29%
Probability £500k	29%	12%	4%
Downside extreme	£155k	£178k	£183k
Expected (Median)	£365k	£319k	£293k
Upside extreme	£947k	£595k	£492k



Aged 40	Equity	Multi-asset	DGF
Probability £250k	77%	79%	77%
Probability £350k	52%	42%	33%
Probability £500k	26%	11%	3%
Downside extreme	£162k	£192k	£196k
Expected (Median)	£360k	£329k	£308k
Upside extreme	£825k	£492k	£479k



1 For consistency, we have assumed that the starting pot size for the aged 30 and 40 scenarios assume the individual contributes from age 20, as described above, and that their pot grows in line with the expected return of each strategy.

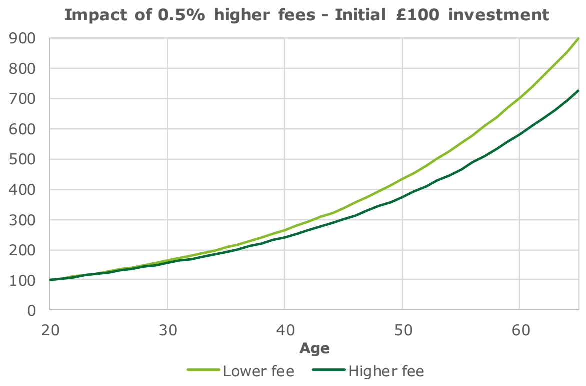
This analysis highlights that **equity volatility is good volatility**:

- Equity provides the **best median** outcome at each different starting age;
- Equities offer the **highest chance** of achieving the 3 target pension pot sizes shown (with the exception of 40 year old targeting £250k).
- Equity provides the largest potential downside (lowest 5^{th} percentile) but **relative losses in extreme downside scenarios are small compared to the significantly higher potential upside offered by equities.**

Importantly, the analysis provides clear justification for the use of passive global equity funds in the accumulation phase. As well as being **better off in the majority of potential outcomes** when compared to other multi-asset approaches, the **positive skew** in the distribution of outcomes dictates that the potential downside when investing in equities is proportionally lower than the potential upside. Whilst there is a reasonably small chance that an individual might be slightly worse off investing in global equities versus a typical multi-asset strategy, the potential upside is significantly higher.

Benefits of passive

When investing in global equities, we prefer a passively managed approach. Our preference is grounded in the fact that it is difficult for active managers to outperform in efficient global equity markets, especially over the long term. Furthermore, passively managed funds have much lower management fees.



Multi-asset solutions, often used as default arrangements for the accumulation phase, are typically actively managed with dynamic asset allocation and the exploiting of investment opportunities a core component of expected returns. With active management comes higher fees, an increased governance burden and an increased likelihood that costly turnover might be required.

Unfortunately for the individuals who invest in actively managed multi-asset funds, **higher management costs lead to inferior outcomes**, especially over the long term.

Summary

The **complexity of a multi-asset strategy is misplaced** in the context of DC investing. **Intricate strategies aimed at controlling volatility** within the accumulation phase **fail to enhance member outcomes**. In fact, we have shown how **equity volatility is good volatility** providing higher levels of expected return and a potential distribution of outcomes skewed to an individual's benefit. We fear that a misalignment between the interests of individuals and the investment consultants or managers advising trustees, governance committees and sponsors may be partially to blame. In our view, a **passive global equity allocation offers a simple, low cost way of generating superior member outcomes at retirement**.

Please contact ukdtrbinvestment@deloitte.co.uk if you would like to discuss this topic in more detail or for a more general conversation around how Deloitte can help achieve your scheme's objectives through an improved investment strategy.