Investment Evolution

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Gerry Winters looks at the evolution of default investment strategies.

Changes to legislation allowing members to opt for different benefits at retirement have thrown into question the suitability of default investment funds which have been designed on the assumption that members would purchase an annuity at the point of retirement. Members now have the option of an annuity or an approved retirement fund (ARF) and a different level/calculation of tax free cash.

Another critical design assumption associated with default investment funds is being challenged – the underlying risk profile of the member during what is commonly referred to as the accumulation period. All default funds assumed that age and proximity to or from retirement age were the key factors when deciding on the underlying asset allocation. But there is much more to be taken into account when designing an appropriate investment strategy.

Trustees' role and responsibilities

It is the regulator's view that trustees must offer an appropriate default investment strategy. But just what is an appropriate default strategy?

Clearly, such an appropriate strategy should be built around the needs of the scheme members and recognise the different risk appetite and benefit outcomes of its members.

Evolution

The definition of an appropriate default strategy has changed greatly over the years. In the 1980s trustees' tended to use balanced funds as the default. The problem was that these left members with a continuing exposure to equities right up to retirement. For the most part the funds performed well and members had little cause for complaint. However, anyone who retired in the weeks and months following Black Monday in October 1987 will have good reason to argue that the balanced fund was not an appropriate investment strategy for their needs.

Lessons were learned and there was a move towards consensus-style funds in the 1990s. These funds relied on the "wisdom of the crowd" to a certain extent. The approach was to track the main investment managers in Ireland and match the investments they made in equities, property, bonds and cash. The aim was to deliver performance that was consistently in line with the average of all managed funds in the market.

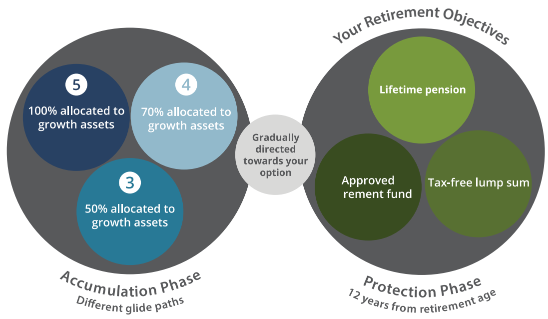
The issue again was that these funds were driven by the needs of the investment industry and had continuing exposure to equities up to retirement. There were certain built-in protections as exposures to different asset classes were automatically adjusted in line with market performance and sentiment. However, as we have learned time and again in investment markets, the crowd is not necessarily infallible and a further evolutionary step was required.

This step saw the move towards lifestyle strategies in the early 2000s. These strategies saw equity exposure reducing sharply to zero with assets moving into cash and bonds over the five years in the run-up to retirement. This was certainly an appropriate strategy at a time when cash and bonds were delivering respectable returns for comparatively low risk. However, in today's historically low yield market a further step along the evolutionary path is required.

Developing an appropriate default strategy

We believe that there are two component parts to a lifestyle strategy; the risk profile of the member and the expected benefit outcome at retirement of the member.

In developing an appropriate strategy trustees need to understand the likely benefits their members will take when they reach retirement age. For example, how many members are likely to have sufficient assets for the pension tax-free lump sum only, how many will elect a lump sum and annuity and how many are likely to elect the flexible retirement route which includes the ARF option?



This knowledge will allow the trustees to build funds for the protection phase which is most closely aligned with members' expected outcomes.

The trustees will then be able to offer different risk profiled options to members during the accumulation phase which will allow them to select a default fund more aligned to their personal appetite for risk. Linking both the expected member's benefit outcome and the member's risk profile provides a genuine, personalised lifestyle strategy which passes the "appropriate" test.