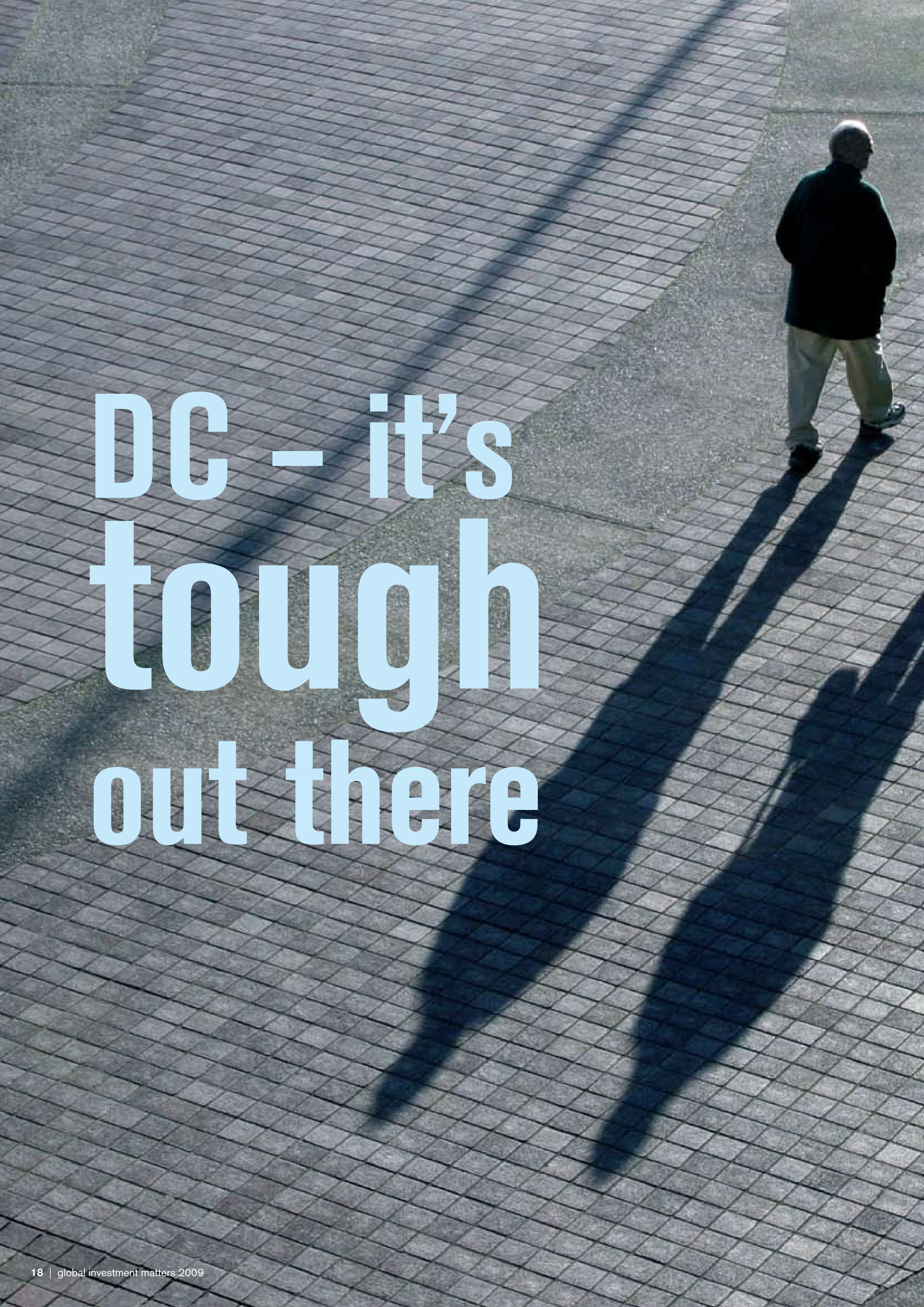

DC – it's tough out there

The exceptional market performances we have seen in 2008 are being felt as huge shock waves across the pensions world. Arguably the biggest impact will be seen in the DC world. With members of DC plans feeling the full force of investment risks and returns, many doubts will surface about the design and even the viability of DC plans. We argue that while DC success does look a lot harder to achieve now, this may well act as a wake-up call to build stronger, better design and execution at a critical time.

The global financial crisis has had a number of impacts on the DC world. These four are the most evident so far:

- major difficulties for many of those at or approaching retirement with sizeable DC pots
- more subtle challenges for all others in DC plans with time to adjust to new investment conditions
- some members will respond with increases to their risk aversion, potentially at the wrong moment
- overall, the confidence in the DC value proposition has been undermined.

The issue which is highlighted most is the question of investment design and execution of DC programmes. In this area it is worth noting the quiet revolution that has taken place in the US towards using default strategies and target date investment funds. These changes appear to give a robust answer as to how to deal with market turbulence.

There have always been two schools of thought on DC choices. There is a singular approach that majors on one diversified investment fund and so relies on the sponsor for the results (call this the 'paternalism' approach). There is a multiple choice approach that passes responsibility for the results to the members (call this the

'libertarian' approach). What is striking is the US development towards adopting a combination of both.

Thaler and Sunstein's best-selling book 'Nudge'[1] sets out the case for this combination as an example of 'libertarian paternalism'. With paternalism, those with authority (the plan sponsor) provide good investment design targeted at a reasonably typical member. With libertarianism, anyone can either accept the 'nudge' to this default or select something a bit different (and 'Nudge' suggests that this choice has to be easy – in today's technology, one click away).

Good DC design uses a lifecycle strategy. It takes standard membership profiling data and tailors a 'glide path' strategy altering asset allocation with age and years to retirement. The essence of most glide path designs is the way the asset allocation captures a return premium from risk for the younger ages before de-risking the DC pot in the run-up to retirement. This method is well established in the UK, where lifecycle strategies now have around 80 per cent share of most DC arrangements.

The US has come to this design feature along a different path. Plan sponsors worried about the consequences of having such an undue influence on members' returns. In a litigious society, the sponsors were not keen for too much responsibility until the Pension Protection Act helped them with heightened safe harbour provisions. Quickly the 'target date fund' (a lifecycle strategy in a fund which is designed for retirees in a particular year) has become the most popular option in DC arrangements.

The merits are clear. The sponsor nudges the member to a strategy that has an answer to the vicissitudes of equity markets. The nudge is complemented by a 'notch', a number of small steps that a member can take in interpreting their unique circumstances. Perhaps this is a notch up the risk scale or down. All these 'off-centre' choices in new DC designs are one click away.

So how did DC plans using glide paths get on last year? It is rather early to judge. We do know that those in 2008 or 2009 target date funds would have had low equity exposure and would be in good order for retirement. In contrast, those in DC plans with standard managed fund strategies would have a retirement group in bad shape.

Globally, a large number of members of DC plans had some protection through their glide paths. The precipitous fall in market values is likely to create conditions for greater focus on lifecycle strategies and target date funds. It will also lead to more take-up of the lifecycle approach

where defaults have not yet adopted this. It is interesting to note that the DC system that attracts widest admiration globally – Australia – has been one of the slowest to introduce this innovation.

At a defining moment in the DC industry, it is worthwhile ending with a few comments on where we go next. We have three suggestions on what will develop, all of which can lay the foundations of better DC practice:

- new investment innovation in which plans gain more of the best elements of DB investment practice, such as use of liability driven investment (LDI), or use of insurance-type strategies
- application of new technologies to capture personal circumstances, allowing more customisation of investment strategies, with 'nudge and notch' designs informed by better behavioural understanding
- new integration of finance with the changes to 'retirement' as we know it; this involves how 'later-lifing' – a mixture of work, leisure and education in later life can be financed by the continuation of the lifecycle investment approach.

In conclusion, is the DC model damaged? Yes it is. We will experience a much lower level of trust in the system for quite a while. That will even mean lower contributions.

Is the damage fatal? No, DC can and will bounce back. The success of its recovery will depend critically on innovation.

[1] Nudge: Improving Decisions About Health, Wealth and Happiness, Richard H Thaler, Cass R Sunstein, 2008