Where pension investments are going

Lesley-Ann Morgan, global head of defined contribution and retirement strategies at Schroders UK, shares insights into post-retirement default strategies and drew parallels between SA's retirement fund industry and elsewhere in the world, specifically the UK and Australia.

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What's been happening in the UK?

After a few years of pensions freedom reform (the 2015 legislation that gave UK retirees full flexibility over how they spent their pension pots, thus doing away with compulsory annuitisation) the Financial Conduct Authority (FCA) looked into exactly what people were doing with their money in retirement.

The idea behind pensions freedom is that individuals could exercise choice with their investment strategy, such as investing in a guaranteed annuity, a living annuity (called a 'drawdown') or even taking it wholly as cash. What the findings revealed, however, is that instead of using the new choices available to them, most people had simply been taking the entire pension amount as cash, even though they had to pay the tax on a high portion of it.

"It has fast become apparent that annuities were losing popularity, and going forward a mix of drawdowns (including those from a living annuity) might be best, just to keep the flexible options open," says Morgan, The takeout is that it is extremely challenging to come up with a single, effective default post-retirement solution. And there cannot be a one-size fits all approach, she says.

Default investment pathways: all about choice

The FCA then proposed that companies should ask their employees what their desired retirement outcomes were, and then find a default pathway (solution) that most closely matched that retirement choice. Naturally, when given the choice, people chose outcomes that were completely impractical: “As much income as possible at retirement, thank you, it should last forever and with no risk at all, please.” Simply not viable.

What about lifestaging? Is it out-moded?

Similar to SA, default funds in the UK have historically made use of a lifestaging strategy. Commencing within 10 years of retirement, employees’ investments are gradually moved from riskier growth assets such as equities towards safer, interest-bearing assets. Historically these designs had large allocations to fixed income because people were being forced to buy annuities. But we can all agree, says Morgan, that a default fund with high allocations to fixed income or cash at retirement is potentially a lousy place to be when one needs to draw an inflation-linked income over an extended period, with less returns than other paths.

The push to passive

Several years back in pre-retirement, the FCA brought in a charge cap for the default for pre-retirement: 75 bps, including admin fees. This was an attempt to ensure that people who did not engage actively with their investment decisions would not be subject to excessive charges. The unintended consequence of this, however, was a significant move to cheaper passive investments. However, pushing everyone down a passive path could arguably lead to sub-optimal retirement outcomes.

So what’s happening Down Under?

The interesting disparity between Australia and the UK in terms of post-retirement trends is that the UK initially had compulsory annuitisation in place, this was completely done away with in 2015. On the other hand, because Australia only has living annuities in place, guaranteed annuitisation should be introduced (according to the *Murray Review*).
How could two countries so similar in terms of their mortality rates come up with solutions so completely opposite?, Morgan asks.

In truth, Australia had never really embraced annuities, primarily because it just didn’t make sense in terms of the country’s tax laws. This in stark contrast to the SA and UK experience.

Frugal living and inheritance tax planning

Because people typically don’t use guaranteed annuities in Australia, they worry that they might live longer than expected. As a result, they are living a lot more frugally than they need to, and using their DC superannuation funds as a tax-efficient way to pass on their legacy to their children when they die.

Self-insurance

Australia too is planning default regulations to provide some income certainty. It’s likely they won’t go the full annuity route, though, says Morgan.

Instead, the major funds will essentially self-insure. It is likely we will see an entirely different set of dynamics play out in Australia, reflects Morgan.

Deferred longevity risk

The common consensus is that default design in Australia will probably be delayed to 2019, and people will, in all likelihood, place their money in a living annuity with a portion going into a deferred longevity risk-sharing arrangement.

One of the issues about designing something with deferred longevity risk hedging built in, is determining when people have to make that choice? If it's early on, at say 65 when they first retire, people complain that they've locked that money away and would therefore rather defer that decision to say, age 80. The problem with deferring is that cognitive ability starts to fade well before the age of 80 and if you leave that decision to someone in their 80s, there is an implied moral risk that a 'well-meaning' family member may attempt to assist in an 'unethical' way under the guise of beneficence.

Resolving the underfunding conundrum

"All we ever hear about is preservation preservation preservation," says Morgan. It's a universal problem in South Africa that individuals do not preserve retirement savings when they change jobs and this is widely accepted to be a major reason why we are all underfunded at retirement. The concept of underfunding implies that you have insufficient capital at retirement to support your future withdrawals. So, how do we deal with this issue in an investment sense, asks Morgan? The obvious options are:

- Take as little capital risk as possible, put it all into bonds, and eke out a living. Risk: it won't last me my retirement but at least it will be safe.
- **OR** maximise your risk and put as much as possible into growth assets such as equities (75%) and put rest into something else and hope for the best. Risk: you could suffer potential irrecoverable capital losses if the markets fall in the early stages of retirement.
- **OR** you can take a punt on multi-asset active management and hope to close the funding gap. Risk: attempting to time asset class switches can similarly erode your nest egg.
- **OR** do you take the certainty of an income from a guaranteed annuity. Risk: it gives you a level of income below the level of consumption required by most people.

Juggling objectives

The trick here is trying to juggle two directly opposing objectives - trying to achieve a suitable level of income, while minimising the probability of bankruptcy prior to death.

"What we've come to realise," says Morgan, "is that investment alone is never going to save the day. At best it can help make up some of the shortfall. People have to recognise that saving is important. The most successful financial education has been shown to happen at the point of decision (ie, close to retirement) rather than early on when you sign up to a job, and it is important to note that many young people currently don't grasp the basic fundamentals. This education should also include an essential element that creates an awareness of the role debt plays.

"Obviously, contributions have to be a big part of the picture and we cannot escape the fact that we're all hopelessly underfunded. But there are problems with compulsory savings due to the low socio-economic status of some. So, the ideal would be to introduce 'compulsory with opt-out', like in the UK. Interestingly, this has been a popular option and opt-outs have been surprisingly low.

This could be especially favourable for those at the lower end of the income scale who may not be able to afford to contribute at all stages of their life. You have to start, but at least you can choose to opt out. Clearly, we all have to work longer and defer retirement, but the reality is that while we can keep on extending the retirement age, we just never catch up because we're too far behind."

Designing hybrids

So the obvious answer, says Morgan, would be to maximise returns prior to retirement age, ie getting people to take as much risk as possible when they are younger, and this could mean allocating to non-traditional asset classes and perhaps even using leverage in pre-retirement years.

“Ultimately, my passion lies in designing hybrids,” concludes Morgan, “because they help you to continue growing your assets when you haven’t saved enough”. For example, the ‘with-profits’ concept might also be a viable answer. We might even consider solidarity risk sharing, the concept of pooling and sharing losses.

Or should it be each for his own? Culturally, there is no obvious choice. And the ultimate question remains, can a default be designed in post-retirement? Or are there just too many variables?