

# DC Seminar



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IAPF DC Seminar   16.09.2008

[www.iapf.ie](http://www.iapf.ie)



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There is much evidence that shows that members of defined contribution schemes do not make rational investment choices. This seminar will examine whether this is because they are completely helpless or whether they are just not getting the correct help. It will look at the legalities and practicalities of offering investment options, tools and advice to members of DC schemes.

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Consider:

- Members do not make rational choices – is this true?
- What does “helpless” mean?
- What does “correct help” mean?

- “Many, if not most, individuals cannot be regarded as ‘intelligent consumers’ when it comes to understanding and assessing different investment strategies for their defined contribution pension plans”


Blake, Cairns & Dowd, Pensions Institute (London) (2008)

Do you care about saving?



What motivates you to save?  
Is pension just down to your employer?



 **What Members Say ...**

*Do you know how much you'll need to retire on?  
"Good God no... none at all."*

*"...some form of calculations table which would show the value of making higher or lower contributions. [I] would find this useful as [I] have no idea of the value of my current contributions or the value of increasing these."*

*"It's all pretty misty to be honest.  
My money is going in somewhere and hopefully I'll get it back one day."*

*"We really just need to know the bottom line in black and white – if you carry on with current contribution rate, you would get x / whether you can or should afford to increase your contributions."*

*Why did you select the Lifestyle Fund?  
"Don't ever remember being asked."  
Do you feel you need more information about investments?  
"Yes, absolutely. Although not lots of detail. It would need to be in layman's terms."*


*"The email for this survey and this phone call has been the most useful piece of pension communication I've had so far. I just want the basic information and someone to talk to explain things."*

*"Not worth the investment.  
An extra 1% won't make much of a difference."*

*When would you ideally like to retire?  
"60"  
Do you know how much you need to save to meet your retirement objectives?  
"No idea"*


*"Online banking is much simpler"*

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 **Themes**

- Who provides the help?
- Importance of Scheme Design & Enrolment
- Importance of Investment Strategy and Default Strategy
- Member Engagement

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 Help


Who provides the help?

- ✓Employer
- ✓Trustee
- ✓Consultant
- ✓Administrator
- ✓Actuary
- ✓Life Assurance Company
- ✓Legal Advisor

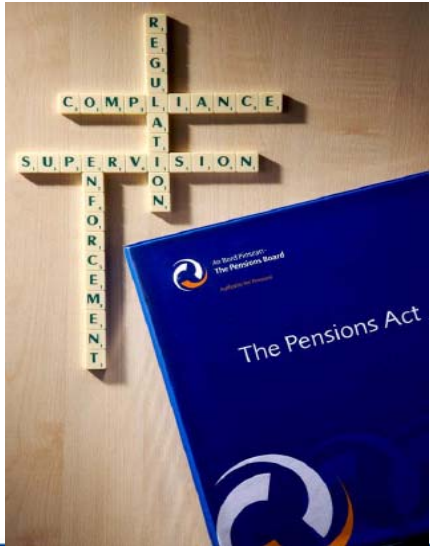
Who should provide help?

Trustees!

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 Help

- Giving advice can result in liability
  - for negligent advice
    - Insufficient help
    - inadequate final account
    - inaccurate choices
    - inadequate pensions
    - potential disputes
- Correcting errors expensive



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- Auto-enrolment

- Auto-enrolment or not?
- Research indicates that people find pensions difficult: so – they use “rules of thumb”:

*How do I avoid the difficult decisions; don't join.*

- Or, they suffer a failure of willpower:
  - *I know I should join, it's hard – I'll do it soon.*

- If in a scheme the first heuristic becomes:  
*How do I avoid the difficult decisions; stay in.*
  
- This buys time for another phenomenon:  
Herd behaviour/groupthink - alignment with other members is reassuring  
*I'm in the club – we can't all be wrong*
  
- Auto-enrollment 401(k) plans have 4x as many members – 86% membership

“It is possible to produce well designed DC plans but these need to be designed from back to front (that is, from desired outputs to required inputs) with the goal of delivering an adequate targeted pension with a high degree of probability”

Blake, Cairns & Dowd, Pensions Institute (London) (2008)

- Trustees determine the most appropriate asset classes to make available to members and must consider:
  - Are the fund selections adequate and appropriate?
  - Are the fund managers best in class?
  - Is the default option meeting the needs of members?

- Members should take account of three main risks in their working lives:
  - Real growth risk (pension adequacy)
  - Capital risk (account fluctuations)
  - Pension conversion (pension fluctuations)

### Needs

1. Appropriate and sufficient range of options to match needs of members
  - Growth
    - High risk
    - Diversified risk
  - Income protection
  - Capital protection
2. Best available providers
  - Employ active management where you have high conviction in manager skill
3. Cost control
  - Passive management delivers bulk of return at much lower cost (less "leakage")

### Aspirations

1. Superior diversified (i.e. default) option
  - Wider spread of asset classes
  - Reduced Irish "tilt"
2. Better use of and access to skill
3. Expanded choice
  - Property
  - Emerging markets
  - Hedge funds
  - Private equity
  - Commodities

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*Range of investment options is about better choice not more choice”*

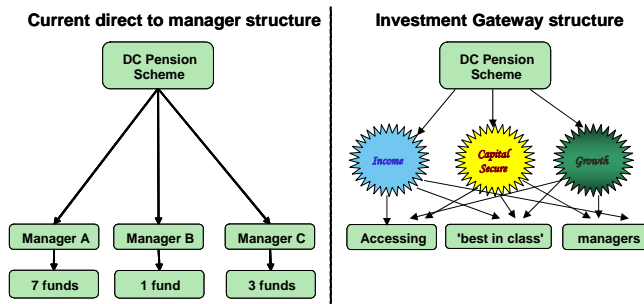
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- What would we like to see in ten years' time?
- Consider the Forward Thinking Company (FTC)
  - Who felt the market was very product and provider-led
  - Individual member requirements poorly supported
  - Member confusion
  - Inefficient investment strategy
  - Radical change needed

- Better rather than more choice
- 'Layer' framework of 'retirement income', 'growth' and 'capital secure' investment strategies
- Only these three investment strategies available to members



- Implementation of the three investment strategies through an investment gateway – bespoke funds
- 'White label' funds



- Are there risks with white label approach?
- What does “low risk” or “cautious” mean?
- Consider two examples:

(a) 40 year old members: On earning €40k Vs €140k; Do they have the same risk profile? What do they understand by risk (*you cannot assume risk profile*)

(b) It means the cash fund to a 65 year old BUT the 100% equity fund to a 25 year old (for whom a cash fund would be high risk – relative to inflation) (*label means a different thing to different people*)

## Importance of investment choice

An experiment in 2001 shows tendency to distribute funds evenly across number of available choices eg 50% in each of two funds Vs 33% in each of three funds

\*Source: Benartzi, Thaler 2002

Low risk	50%
High risk	50%

Low risk	33%
Medium risk	33%
High risk	33%

Research shows significant framing effects

- Four funds A (low) B & C (medium), D (high)
- B & C are the same
  - Investors choose three times
- Asked to mark choices on forms with ABC, BC and BCD
- C preferred over B by 29%, 39% and 54%.

Source: (Benartzi, Thaler 2002)

A (low)	A		A	A%
B	B		B	B%
C	C		C	B%+29%
D(high)	B		B	B%
	C		C	B%+39%
	B		B	B%
	C		C	B%+54%
	D		D	D%

Suggests naïve heuristics – pick the middle/second one

- This is clearly why we have to keep communications simple and explain options etc
- How do we help those who are too scared, puzzled, overwhelmed, disinterested ... Helpless
- Introduce default fund or structure

- Take account of employees: salaries, prospective target fund; retirement age; contribution levels
- This should be a significant factor in default fund design and the approach to lifestyling which is likely to be a fundamental part of a design

Source: Blake

- Trustees should decide prudently and after consideration

- Trustees' job - Nestle (1993) - Trustee is to be judged “**not so much by success as by absence of proven default**”
- Pensions Act: Where rules provide for member directions, the Trustees shall ...
  - (i) determine the different types of investment; and
  - (iv) take reasonable steps to provide the further information **necessary** to enable the members **to make informed decisions** about the different investments.


- SIPP requirements – what is the “strategic asset allocation w.r.t. the nature and duration of pension liabilities” in a DC scheme – is this unhelpful?
- Trustee statutory protection – not available for the default fund as default fund investment implies failure to educate – get extra protection in your deeds
- Schedule I disclosures do not get you out of trouble
- Properly designed default funds are not easy

**If scheme design/default design rethink helps  
would a Regulatory rethink help?**

- Many may feel helpless and it is suggested in certain research that many are but this need not be the case
- Education is available but individuals need to take ownership (and control) of their own financial position and not depend on others.
- Engagement is required by employers to communicate the advantages of saving for retirement
- Trustees and employers need to proactively address scheme design but must start out with what they want at the end and work back from that



- Pensions Booklet
- Member Statement
- Trustee Annual Report
- On line access
- Simplify information available

***“Communication is not just about booklets and statements”***

 **Three step approach to engagement**

<p><b>Step 1</b> Know how much you'll need</p> <p><b>Step 2</b> Save as much as you can</p> <p><b>Step 3</b> Make your savings work as hard as possible</p>	<p>Creating a consumerist approach</p> <p>Interactive games and profilers</p> <p>Driving self-service</p> <p>The wider financial perspective: work, life and money</p>
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 **Engagement – value proposition** 

Member perspective	Trustee perspective
<p><b>Value appreciation</b></p> <p>How much of my overall reward package does this make?</p> <p>How can I increase the value?</p> <p>Which option is of more value to me?</p> <p>When should I start if I want maximum value?</p> <p>How much can I afford?</p>	<p><b>Value appreciation</b></p> <p>How much of my overall reward offer does pension contribute?</p> <p>How can I maximise the value of the pension investment?</p> <p>How far do I go to ensure employee understanding of the value of pension benefit?</p>

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## Engagement – key points from all of this

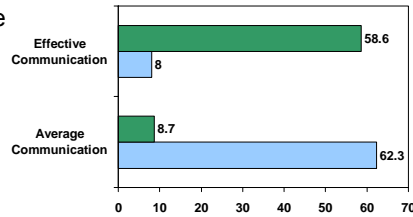
Levels of engagement are fickle and will be influenced by many factors in your control...and some out of your control

'Engagement' may seem daunting as an objective – but you can make a start from your very next pension activity

It is important to understand current level of engagement and reasons why

Engagement is a long term ongoing commitment

Create the desire in the employee to take and own the action



■ High Satisfaction  
■ Low Satisfaction

*Watson Wyatt Pension  
Research Forum:  
Retirement  
Attitudes Survey*

## Member engagement – research

Action	Planned change	Actual Change	Non attendees
Increase cont rate	28%	8%	5%
Change fund selection	47%	15%	10%
Change allocation rates	36%	10%	6%

Source: Choi, Laibson, Madrian & Metrick (2004)

**Exploiting technology**

- Online admin
- Benefit statements
- Profilers and modellers
- Webcasts
- Library
- Online polls

Information &amp; action in one place

**Joining the dots**

- Flex
- Total reward

Self-service creates  
responsibility & ownership

- More can be done to get “willing” members more useful help. Better tools, better education, better scheme design – improved path of least resistance
- More passive help can be given to those not in schemes or not willing to choose when in (the helpless)– compulsory auto-enrolment in DC, better default fund designs

Hopefully we have given you the tools,  
information and education for you to make  
your own choice having of course assessed  
your own attitude to risk ...

... we would be delighted to help but sadly  
are not qualified to assist you with this  
choice and suggest that you take independent  
advice before reaching a decision.

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