

# The default dilemma

What to do when DC members can not or will not choose an investment option?

We look at four countries' solutions.

Pension funds around the world are continuing their shift towards the Defined Contribution (DC) model. Watson Wyatt estimates that, at close to US\$11,000 billion, global DC pension assets make up some 40 per cent of global pension assets, and are growing apace. DC is the dominant approach in markets as diverse as Australia (approximately 85 per cent of the pension market), Hong Kong (approximately 80 per cent) and the US (approximately 55 per cent). In the UK, where DC funds were minor players five years ago, they now account for one third of the market.<sup>1</sup>

<sup>1</sup>Source: Watson Wyatt Global Pensions Assets Study 2008.



This growth is focusing industry attention on DC pension plans' default options. Plan members' contributions are automatically channelled into their sponsor's default option or fund if they do not actively choose in which funds to invest.

Studies show that as many as 90 per cent of DC plan members in some countries choose this path of least resistance. With such large sums of money invested in default options, the stakes are high. It means that the majority of DC plan members in many markets rely on how this 'set and forget' money is invested to meet their savings needs for retirement.

Default options have several benefits. For members who lack investment knowledge they provide a simple answer to a complex decision. They have the added attraction of seeming to bear the stamp of approval of the employer.

The design and even the existence of default options are, however, fraught with difficult issues. A well designed default option can draw on best investment practice, which participants would otherwise not be able to access, and so will enhance their potential retirement savings. A poorly designed default option – or one that has no design, such as a money market fund – can jeopardise members' future income in retirement.

Once in a default option, studies show that members tend to stay there, either from inertia, under the mistaken impression that it is the least risky option, or that it best suits their circumstances.

This, in turn, raises the issue of fiduciary responsibility. Who is responsible for the asset allocation? What do you say to a 25 year old employee whose retirement pot, invested largely in age-appropriate risk assets courtesy of the default fund, has just halved in value along with the stock market? Long-term investment projections meet short-term loss aversion.

These and many other issues, including each country's cultural and regulatory framework, are driving the DC debate at present.

Some common threads are emerging. More and more countries seem to be leaning towards default investments that have a larger equity component, or change automatically from aggressive equity-based to conservative bond-based strategies along with the member's age (often called target date retirement or lifecycle funds).

The aim is to maximise employees' pension pot at retirement, as concerns grow about the looming shortfall in retirement savings. With the same goal in mind, more sponsors are starting auto-enrolment and auto-contribution programmes.

But there is still wide variation around the world as to what constitutes an appropriate default option, as an overview of four of the main DC markets shows.

## US

Plan sponsors' fear of being held responsible as fiduciaries has been one of the key drivers behind the development of default options in the huge US DC 401(k) market.

The main preference until now has been for 'safe' default investments consisting of stable value/ Guaranteed Investment Contracts, or simple money market funds. Ironically, this has made it trickier to set up better-designed default options under pending new legislation.

The 2006 Pension Protection Act created a 'safe harbour' for employers wanting to adopt auto-enrolment programmes for their members. Under subsequent Department of Labor proposals (still being discussed), employers would not be held liable for loss if they directed the savings of those members who failed to make an active investment choice into a 'qualified default investment alternative'. Three structures have been proposed: a lifecycle fund, a balanced fund and a managed account.

Studies have compared the risk and return of the first two, but managed accounts are thought to be less viable, mainly because of the extra costs involved and



member inertia. (Personal profiling is unlikely to work in a default fund which by nature does not require participant input.)

The proposals are also facing fierce lobbying from insurance companies who want their stable value offerings to be included in the list of qualified default investments.

Despite all the debate, there is already movement in the US market with most new auto-enrolment programmes opting for lifecycle funds as a default. Even within these funds the equity content can vary enormously, with some providers offering up to a 60 per cent equity weighting at retirement date, which is gradually rolled down post-retirement.

### Australia

Compulsory contributions in Australia see 9 per cent of workers' wages set aside for superannuation, or simply 'super' as retirement savings are often called. How much of this is allocated to default options is hard to gauge because of the complex structure of Australia's huge DC market.

Over the past five years there has been a strong trend for corporate plan sponsors to outsource responsibility for their DC arrangements to big platform providers known as 'master trusts'. The forerunners to these were industry-wide funds, which are still popular. The range of investment

options offered varies enormously, with master trusts typically offering a very large number of investment options, and industry and corporate funds typically offering a smaller number of investment options that broadly cover the risk-return spectrum. However, in most cases, the default option tends to be a 'balanced' fund, consisting of 60 per cent to 70 per cent in 'growth' or risky assets. Some funds do offer lifecycle or target date investment options, although these are not always the default option.

Whilst some master trusts ask simple age or risk-based questions to help employees choose target-date or diversified funds, strictly speaking, these employees have not been 'defaulted'.

So far, industry debate has centred more on expanding member choice. 'Super Choice' legislation in 2005 gave employees discretion over where to invest their contributions and therefore the ability to move from one super fund to another without changing employment, with default options taking a back seat. Little policy attention has been paid to them although the issue did surface during the Australian Parliament's 'Super Choice' discussions.

The reason for this laid-back attitude, in contrast to the US and UK, is that the design of default options in Australia is not perceived to be faulty. In a fairly mature DC market, a diversified

risk-based approach to investing is generally accepted, and default investments have generally performed well.

It helps that Australian equities have held up better than shares in other major DC markets.


### UK

In the UK, the default debate is being conducted in the shadow of uncertainty about the direction of the pension system. Concerns about the closure of DB schemes have shifted to fears that the DC plans that replace them will result in a huge shortfall in retirement provision in years to come.

The scene has been clouded by constant reviews of the system, leading to a blizzard of rule changes and trustees feeling vulnerable to liability charges.

Default options have come in for particular scrutiny, as this is where up to 90 per cent of members are invested. Trustees' fears of being held responsible have resulted in a 'lowest common denominator' approach to default offerings, consisting of balanced or basic equity/bond lifecycle products.

A recent Watson Wyatt survey found that 77 per cent of trust-based DC plans in the UK offer a default product. The number is increasing. Despite the increase in the use of default funds, some trustees are concerned that excessive reliance on these options could have legal ramifications.



The 'stakeholder' funds introduced in 2001 must, by law, offer a default option, and since 2005 this had to be a lifecycle strategy. Providers' approach to an appropriate lifecycle asset mix varies widely, but most UK lifecycle funds are 75 per cent bonds and 25 per cent cash at retirement. This is because the majority of the UK DC population use 75 per cent of their money to buy an annuity, but can take a 25 per cent cash lump sum. This contrasts sharply with the US and Australia where 'risk' assets can be run down after retirement in recognition of retirees' growing longevity. However, with the introduction of a draw-down option being made available to UK DC members, we would expect to see increased activity in this area.

Attempts are now being made to move beyond the 'lowest common denominator' approach to default options and include more diversified assets.

### Hong Kong

Some 80 per cent of Hong Kong's HK\$450 billion in pension assets is now in DC plans. The market is split into two types of plans – Mandatory Provident Fund (MPF) schemes, which account for nearly two thirds of DC assets, and voluntary Occupational Retirement Schemes Ordinance (ORSO) plans. MPF schemes are purely DC and have grown rapidly in

## Lifecycle or balanced – which is better?

Will plan members be better or worse off than expected by investing in one type of default fund versus another? Watson Wyatt compared the investment performance of a balanced and a lifecycle fund using average asset allocations observed in the US market<sup>1</sup>.

Given the same steady flow of contributions, investment returns are higher in the balanced fund than in the lifecycle fund. This greater wealth creation potential is because balanced funds hold more equities (with a higher expected return) later in the worker's career, when the portfolio is large.

However, the more aggressive approach of balanced funds also leaves members more vulnerable to losses as retirement approaches, when a small swing in investment returns could mean a huge amount of wealth lost.

The lifecycle fund appears to be better at safeguarding wealth in a market downturn, while still doing reasonably well in building wealth.

<sup>1</sup> See *Watson Wyatt Insider*, March 2007



recent years to overtake the older ORSO plans, which are a mix of DB and DC.

Default options in Hong Kong are dominated by cash or balanced funds. There is no way of knowing the take up of these options as sponsors are wary of making investment decisions for their members and strongly encourage them to make an investment choice, even if they lack basic knowledge. However, on the MPF side, employees who fail to make an investment choice have their contributions directed into money market funds.

The situation is different in ORSO schemes. There, default options are typically balanced funds with assets allocated 70 per cent to equities and 30 per cent to bonds, a higher equity bias than is considered usual for a balanced fund in most other countries.

Only the big ORSO schemes offer lifecycle products with an asset mix that changes automatically with the member's age, although this type of product is gaining a higher profile as dissatisfaction with DC retirement provision grows.

### Summary

So far, the main focus of debate has been on the low rate of contributions to pension funds. Many investors prefer instead to put their money in the stock market for short-term gain.

Many forces in different DC markets around the world are combining to highlight the importance of default options in today's pensions systems.

Although the issue of employer liability is still a stumbling block in some countries, clarification of plan sponsors' legal position in the US has already sparked a healthy debate about 'best practice' in default offerings, as well as the benefits of auto-enrolment and auto-contributions.

Above all, recognition is growing that well-designed default options can play a major role in shrinking the savings shortfall in DC funds and giving employees a better chance of a comfortable retirement.