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Insights into DC as featured in the Financial Times



Back to the future for pension plans

Taking a trip through time **Kevin Carter** reviews pension developments in the first of a series to explore new ideas.

The scene is some time in the future, and the place is the head office of the Forward Thinking Company.

Some 10 years ago, in collaboration with its pension fund trustees, the Forward Thinking Company (FTC) reviewed its global defined contribution (DC) pension plan arrangements and concluded that radical change was needed.

The pension system across the world was in a state of flux. In the UK, Lord Turner's long-term savings recommendations were yet to be acted upon, about 80 per cent of defined benefit (DB) pensions were closed as ballooning liabilities on the back of falling bond yields threatened to sink companies, and many people were justifiably suspicious of putting any money into any long-term savings scheme.

Believing it had a social responsibility towards supporting retirement planning

among its work force, FTC decided to make changes to improve the likelihood that the members' pension needs would be met in the long term and, importantly, to enhance its ability to attract and retain staff.

The aim was to shift its DC scheme into more generous territory. Given that DC assets accounted for about 25 per cent of pension assets globally and were growing quickly, the global firm was convinced it was the right trend to join, but not as it was currently structured. Its then employees were not only saving too little but found the concepts too complicated and spent too little time

"...the market place, being product and provider-led, gave little or no support to members' thinking or decision-making..."

on their investments. In fact, a survey of members showed that they had little appreciation of the task at hand with the majority significantly overestimating the size of their pensions pot at retirement.

To compound this, the market place, being product and provider-led, gave little or no support to members' thinking or decision-making, let alone their individual requirements. The best solution available was a lifestyle fund, which meant members would be 100 per cent in bonds when they retired. This seemed out of date given how long members were living after retirement. FTC decided the likelihood of progress was remote without radical change.

In talking to its advisers it seemed that investment 'gateways', where life companies and investment managers each provide their core offerings on a low-cost basis, gave hope of cost-saving and flexibility. Given that costs in retail DC provision around

the world seemed rather high, ranging from 1.5 per cent to 3.5 per cent in the worst cases, and therefore likely to seriously constrain asset growth (by around 30 per cent) during the lifetime of the plan, cost cutting seemed one of the most important considerations.

This led to considering a passive approach to investing, which was markedly cheaper and suitable for DC plans due to its governance friendly characteristics.

Yet it seemed this investment approach was limited to equities and bonds and was not able to deliver real asset diversity, which would provide better investment efficiency and genuine risk reduction. The possibility of diverse assets being managed actively and the rest passively seemed the right approach, and the gateway could accommodate this.

Having done its calculations, and taking the view that this could provide it with a competitive advantage, the FTC board agreed with the trustees to commit resources in two ways.

First, the company was to engage with its advisers and the industry to address the leakage caused by 'agency' issues associated with the current providers. Furthermore, in the absence of a national savings scheme, it decided to lobby for a 'mutual master trust' that would be owned by the members, hence aligned with their interests, while being low-cost through economies of scale.



Second, it was to commit resources to profiling members, to design a plan with the right attributes for them. Factors to be considered included: flexible retirement age, risk profiling including personal assets and liabilities, decision making support and designing effective communication.

At the same time the investment team was to look into downside protection, defining optimum fund choice and maximising investment efficiency. In addition, the DC plan was to be integrated with other company rewards so as to take a holistic approach to total personal remuneration.

Throughout the process FTC had been considering other, perhaps cheaper, options to pensions provision for its staff. But it concluded that the long-term interests of the company were best served by taking the course of action described, particularly as the issue of pensions and lifelong saving had become such an emotive and high profile issue among staff.

Justification of the chosen route came from the employees who, when surveyed, agreed to higher contributions in response to the company's proposed plans.

The next few months and years were particularly busy for the company, the trustees and their advisers as they moved towards applying a better solution to a more efficient model.

First came the task of building the right risk models and then a profiling approach that could categorise members so as to allocate risk appropriately. Second came the choice of efficient investment products that could include real asset diversity and down side protection, as well as addressing cost and choice issues.

Third came a call on industry/providers to establish a 'mutual master trust' to relieve some of the burden on companies, by providing a low cost complement to existing plans. The FTC set itself rigorous success criteria for these initiatives, so follow their progress in ensuing articles.

Kevin Carter is European head of Investment Consulting at Watson Wyatt.

Ideal retirement planning in a less than ideal world

Roger Urwin continues the fictional account of the Forward Thinking Company, set sometime in the future, and how it developed a tailored DC scheme.

One of the first actions the Forward Thinking Company (FTC) took once it had decided on an overhaul of its worldwide defined contribution (DC) pension arrangements, was to task the head of human resources (HR) with designing and implementing one truly global DC plan.

The goal was simple: a DC plan that produced a great value proposition for FTC's worldwide associates – one that would excite them and go a long way to meeting their retirement income needs.

Working with the newly established pensions executive*, the HR team recognised that a one-size-fits-all approach – used by most of its worldwide plans – was not fit for this purpose. It also recognised the plans that had concentrated on giving wide fund choice were not hitting the right spot either. The goal was finding a better 'sweet spot' between these two approaches. The working party made up of the HR team and pensions executive

quickly identified that in developing its DC blue print, it should establish its guiding principles to include:

- members' individual circumstances and needs are critically important; the DC plan can act as the individual's lead investment remembering, though, that the plan is just one aspect of members' financial planning
- risk preferences are individual and multi-faceted; in particular, tolerance levels and ability to accept risk changes over time
- there should be recognition that behavioural finance influences how members relate to DC investments
- solutions should be simple but not simplistic; members need to be provided with options that are easy to understand but there may be sophisticated investment products within this framework.

In reaching these guiding principles, the working party used the lifecycle model to inform their investment philosophy.

The model involves taking a holistic view of each individual's financial assets (with the DC assets centre of stage) alongside their human capital assets. The human capital assets can be seen as the individual's stream of future employment income net of the individual's outgoings.

The radical new design involved taking a combined view of human capital alongside net wealth. The human capital can be seen as largely bond-like in nature – a stream of income, hopefully reasonably stable and growing; so the investment in equities at young ages complements the substantial implied bond investment that most people hold in the many years of their future earnings.

“The human capital can be seen as largely bond-like in nature – a stream of income, hopefully stable and growing”

In the life cycle model, most young members would be guided to high equity and other growth asset strategies.

In this holistic model, it is best to think of the human capital as underwriting a 'deal' between the individual and their future; if the equity investment pays off at the expected return level or above, he or she gets to spend this risk premium at some future date and all is well.

If on the other hand, the equities do not pay off because a poor outcome occurs, the individual needs to be adaptable, and adjust their outgoings through lower spending, higher saving or delayed retirement, otherwise the savings are inadequate.

The lifecycle model suggests that because such a deal is one that a younger employee can pull off many more times than an older employee, all else being equal, he or she has the higher risk tolerance.

Following guidance from their advisers, the pensions executive decided the amount of risk that members should take would be the key driver for success. Accordingly, a web-based tool was designed to develop an individual risk appetite score. The approach to setting the score was new at the time. Risk appetite units were built up in a modular style through loading data on age, income, income expectations, outgoings,

wider financial data and personal risk preferences. The tool assessed current and future 'wealth' positions.

Critically, the company committed itself to provide professional guidance in completing this risk profiling; it argued it did not have to provide investment advice as a result.

This was deemed 'in sync' with lighter touch regulation regarding the provision of financial guidance and removed a potential liability that the company was concerned about.

Now it was time to flesh out the blueprint so that it could accommodate all the other requirements of the members.

Changes in demographic trends, which were already affecting many HR policies at the firm, were extended to facilitate flexibility in retirement age and complement life-long learning programmes to help employees enter full retirement gradually.

Worldwide, the politically sensitive topic of compulsion or auto-enrolment, was gaining greater acceptance in recognition of the fact that individual inertia regarding long-term saving posed a great threat to the success of DC. In FTC's DC design, the use of auto-enrolment and a few other auto features helped the company's role become more valuable to members who could more easily commit to a well

thought out DC investment strategy, rather than the previous approach of choosing from a number of DC funds.

The provision of the right type of investment solution was deemed critical to delivering value for the member. Instead of adding to the number of funds from which members could choose, the range was reduced but the sophistication increased in packaged solution form. Members could then make fewer, simpler choices that would steer them towards investment strategies that best fit their circumstances and risk preferences.

Now it was time to turn to the investment industry in the hope that it could provide cost effective investment solutions to meet the members' requirements for investment efficiency.

Roger Urwin is global head of Investment Consulting at Watson Wyatt.

*The pensions executive is:

- a non-profit organisation whose expenses are borne by members
- a mission statement exclusively devoted to maximising the value proposition to members
- governed by an independent board
- passes on the economies of scale of investing pre and post-retirement to members of the FTC Plan.

Simple, smart solution to satisfy all

Robert Brown continues the story of the Forward Thinking Company's creation of bespoke DC schemes

FTC's Pensions Executive was now halfway towards achieving its goal of designing and implementing a defined contribution plan that provided a great value proposition for its worldwide associates, while simultaneously supporting key corporate goals: the attraction and retention of outstanding employees.

Now it was time to determine the appropriate investment choices to offer, by exploring real asset diversity and new products, as well as addressing cost and efficiency issues.

The investment arrangements under the old DC plan had been set up with two factors in mind. First, it had been deemed important that assets should be liquid for daily valuations and second that members' limited familiarity with other asset classes precluded offering much access to asset classes beyond equities and bonds. In discussion with its advisers, the Pensions Executive's investment committee set to work to

"It was to move against the expensive trend of offering considerable choice"

change this. Its foremost challenge was to provide a few, simple choices that delivered bespoke sophisticated investment solutions cost-effectively and in a convenient format.

It began by establishing a 'layer' framework in which the strategies would be defined either as safety, growth or protection. This framework would make it easier to mix and match the strategies according to members' individual profiles and risk tolerances.

The safety assets fund included traditional low-risk investments, such as cash and bonds; the growth assets fund included equities alongside other liquid and illiquid

assets with higher risk and return characteristics, including alternatives. Protection strategies sought to limit the loss of capital either in the short or long term. It was considered important to make available capital protection options, such as Constant Proportion Portfolio Insurance (CPPI) approaches given the inherent 'riskiness' in the markets. To make this approach work, the next step was to find products that introduced real asset diversification into the strategies that could be combined in the packaged solutions to produce the desired risk and return characteristics.

The introduction of real asset diversity into the growth fund in particular was supported by research that showed that the probability of a negative return could be reduced by about a quarter over a typical UK diversified DC strategy.

Real asset diversity was explained by its advisers as the inclusion of such asset classes and diverse strategies as smaller companies, commodities,

private equity, funds of hedge funds, high yield and emerging market debt, GTAA (Global tactical asset allocation) and other skill-based strategies.

Using this approach, the investment committee felt satisfied it had defined a sufficiently robust investment framework that could cater for the full range of members' individual circumstances. The investment framework was integrated into the risk profiling tool so every individual's risk tolerance could be matched with an appropriate allocation between these strategies. Now it was time to address whether supplementary investment choice was required on top.

The Pensions Executive found it illuminating that more than half of DC investors did not know whether their pension account was currently invested appropriately for their needs. A key factor concerning DC investors was the issue of too much choice. The conclusion was clear. FTC would only offer the three strategies – no more choice was required as members could satisfy their investment objectives through the appropriate blend of the strategies.

It was, therefore, decided that a key feature of the investment framework would be to move against the expensive trend of offering considerable choice, and reduce the number of funds on offer.

Instead, it decided to move towards providing more sophisticated solutions in a packaged format so members could

make fewer, simpler choices to arrive at an investment strategy most suited to their circumstances and risk preferences.

It was concluded that the only way to make these available to members in an efficient way was through a mechanism known as an investment gateway – an approach that it adopted. The gateway had several advantages, but most importantly provided economies of scale and ease of access to the most appropriate investment management products. A long-term expense target was set: 0.5 per cent per annum for growth assets and considerably less for safety assets.

The investment team was now satisfied with its new investment framework. Importantly, most of the complex backend was packaged into three simple frontend elements, a growth assets fund, a safety assets fund and a protection strategy that allocates dynamically between the safety and growth funds.

Now it was time to address the post-retirement life cycle, given the poor deal that most members expected from the annuity markets.

Robert Brown is a senior investment consultant at Watson Wyatt.

Constructing a lifelong deal for employees

Roger Urwin continues the fictional account of how the Forward Thinking Company put the final touches on a new DC pension plan.

The Forward Thinking Company's pensions executive had now largely completed the task of re-engineering its defined contribution pension plan, but there remained a pivotal issue which needed addressing if the plan was to deliver its stated mission – a great lifelong deal for members.

The human resources task team had ensured that each individual had been profiled to determine their risk appetite in the context of their human capital, their wealth and their risk attitudes.

The investment committee had replaced excessive fund choice with two packaged investment options and a protection overlay strategy. These steps were achieved using existing technology and current investment vehicles and dealt with the pre-retirement lifecycle. The pivotal next step involved breaking new ground to establish a fund that

addressed the post retirement needs of their members.

While the firm had recently adopted a flexible retirement age policy, aimed at boosting productivity and satisfying its attraction and retention criteria, the pension plan did not mirror this development. Increasing longevity, which had influenced an HR policy shift, was now one of the key issues facing the pensions executive.

At that time, upon retirement, members faced an immediate switch, from a structured and sustainable financial situation (as long as they stayed employed) to an uncertain situation with diminishing prospects.

FTC provided different benefits in different countries. Typically, retirees either received an unsatisfactory choice of annuities, or simply a cash

sum. While FTC had no obligation to members after retirement, it wished to make a change to the plan that reflected changes in the real world, provided a better prospect of financial security in retirement and gave it an edge over competitors' pension plans. Through its advisers, FTC was introduced to the concept of mortality pooling aimed at giving members a much better deal upon retirement.

The simple theory was that a new fund would provide most of the benefits of an annuity but without the obvious cost. It was also based on the logic that taking out an annuity with its implied highly conservative investment policy made little sense when individuals have more than a 20-year time horizon; an increasingly common occurrence.

The pensions executive then set about designing the post-retirement fund,

having decided that the idea would not only set it apart from its peers and provide a natural complement to FTC's HR policy, but contribute a vital building block to the member friendly pension platform it desired.

First, as the pensions executive was set up as a non-profit organisation, it agreed it would be able to pass on all the proceeds of the pool. This was important in differentiating it from commercial annuity products, where built-in margins were a key factor in their unattractiveness.

Second, the post retirement fund was to be set up as a mutual arrangement between members so that, essentially, the deaths of some members produced survival credits for others.

Third, the investment committee agreed the fund would invest in existing underlying funds and strategies (safe and growth fund and protection strategy) and would start with a reasonably high exposure to growth assets which it would phase down over time.

In practice this meant that each year's retirees would invest in a new 'annuitised fund' to preserve fairness all round.

While the pensions executive was considering pooling as a solution to its members' post retirement lifecycle, its advisers suggested the possibility of pooling its assets with other employers to achieve economies of scale and

reduce costs further. The debate about these notional vehicles gave the pensions executive the impetus it required to precipitate the construction of a mutual organisation whose sole mission was providing lifelong value for its members within a master trust arrangement – the term 'Supertrust' seemed to catch on for this organisation.

From the outset the pensions executive had targeted annual costs of around 0.6 per cent of the fund, of which 0.2 per cent would cover investment guidance and individual risk profiling. While it received some criticism for not setting a more aggressive cost target its riposte was that good investment choice was worth the additional cost.

The FTC was all set to put its plans in to action. The Supertrust was created.

Key implementation details included the selection of the supervisory board and the appointment of the CEO. The pensions executive of FTC had now accomplished something unique among multinational companies. It had a DC arrangement that:

- engaged all members by catering for their individual risk levels and accounting for their human and financial capital
- established greater investment efficiency by addressing the surfeit of investment fund choice, introducing real asset diversity and at a highly competitive cost
- provided a post-retirement investment programme with annuity protection

- built a coherent single global pension plan that all its associates worldwide could enter and value.

Now was the time to deliver its promise to its members: a great lifelong deal.

Roger Urwin is global head of Investment Consulting at Watson Wyatt.

Blueprint for the future: a life-long deal

In the final article about the visionary DC pension arrangement devised by the fictional Forward Thinking Company, **Roger Urwin** sums up by interviewing the plan chairman.

Roger Urwin: What were the main factors behind the decisions you made several years ago to break away from the familiar mould of defined contribution (DC) design?

Forward Thinking Company: The old DC plan we had really wasn't fit for its purpose. In common with most other DC plans at that time, ours was lacking in three key areas: investment best-practice, engagement with members and value-for-money. We set out a simple new DC mission statement – delivering a great life-long deal to members. Every new design feature was driven by that simple proposition.

RU: Most DC experts believe that member engagement will always remain a problem because the vast majority of the workforce will not have either the financial literacy or willingness to commit DC planning time. But your membership profile is clearly different. How have you pulled this off?

FTC: It has been a combination of good thinking and good process. First, we

took a big leap to a holistic approach to pensions, considering not only age but also individuals' other financial pieces – savings, house, outgoings etc and their biggest asset of all – their future lifetime earnings or human capital.

What staff found appealing was that we were prepared to engage across all these elements – they appreciated our attempts to bring leadership to a key part of their lives. The process we use to do this is highly automated – we capture key data on all these pieces on a streamlined IT platform. That information is processed into efficient investment allocations and modelling projections of what they could collect, and when from their pensions pot.

We then use this technology to target personalised material to individuals triggered by key events. This is both across the plan for instance at salary review time and issue of benefit statements, and also in relation to the individual's personal life, for instance birthdays.

The same system helps people with their contribution options producing better alignment between their contributions and expected benefits. Having a more flexible retirement age is part of this too. But let's be clear, this engagement process does not come cheap. We spend 20 basis points a year – a third of our costs – on communication, the technology platform and giving members access to advice. One of the biggest mistakes in DC has been to run this piece of the process on a 'lite' basis.

RU: All the research studies have shown that the key to success in DC is giving the member a 'Goldilocks' dollop of risk – not too much, not too little. FTC has a unique risk profiling process to do this. How does it work?

FTC: The technical process is based on life cycle investment theory, only we use a lot more factors and it is pretty complex. But to our associates it's dead simple. Every day, when they log on, the first data they see is their profile. They can update it at any time of course. The system does a calculation

factoring in their profile that is a guide to their ideal risk exposure, and an ideal strategy. Of course, any member can override it, but the majority of our members appreciate the investment thinking captured and adhere to this auto-strategy. What this has done has solved that old issue about too much choice in DC. In our line-up, most people need to have access to just two funds: a safe assets fund and a growth fund. The life cycle risk profiling method works out how much to put in each.

RU: Yours was the first global DC plan to take in post-retirement investment. How is that working out?

FTC: The key to that was again forward thinking that resulted in our new structure.

The thinking was that good work on pre-retirement investment could easily be stymied by the reckless conservatism that people were adopting post retirement – annuities or simply too much in cash or bonds for the average 20-year horizon. Again FTC wanted to show financial leadership consistent with their DC mission statement.

So we set up a risk sharing fund for the post-retirement phase that allowed members to continue their life cycle strategy, and keep a growth fund allocation going, while sharing out longevity risks. What we've found is we can give people most of the benefits of a stable retirement income without the costs of an annuity.

RU: And this was created under a new Trust structure?

FTC: Yes. FTC made use of new DC protocols in several countries that allowed the company to set up a global DC mutual trust company – we call it the FTC Super Gateway. The mutuality produces alignment, and allows risk and cost sharing, without needing capital for risk transfers. That allowed us to attract outside companies to use the vehicle that proved critical in driving down average costs and driving up investment excellence.

RU: What is the importance of investment excellence to FTC?

FTC: Old DC was a poor investment set-up. To achieve our mission, we have to build in all the latest investment theory, and to get access to the most competitive strategies and managers on a worldwide basis. So our investment line-up is full of new thinking: new life-cycle theory, only two investment funds, massive diversity, use of leverage within the risk budget, protection strategies and many more. This approach has really improved investment efficiency. Independent studies have suggested we are able to get almost twice as much return from the risks taken relative to the old version. And this is still within our 60 basis points total cost.

RU: What's been your biggest pleasure in setting up the new plan and the FTC Super Gateway?

FTC: Two things really: to see good investment thinking pay off with good results for our members' retirements; and seeing the plan's value to the company as well as its members. We have shaken up a sleepy undervalued DC plan and turned it into a highly valued piece of the FTC's total reward programme.

It has proved itself as a key attraction and retention tool for FTC. At a time when some companies have been less committed to workplace pensions, I think we have shown how effective such plans can be. I genuinely hope other companies can share our experience going forward.

Roger Urwin is global head of Investment Consulting at Watson Wyatt.

These articles were prepared from the Thinking Ahead publication 'Achieving the goals of DC members'. For more information, please contact Carole Judd, Senior Investment Consultant, Thinking Ahead Group at carole.judd@watsonwyatt.com, 01737 274329 or Crispin Lace, Senior Investment Consultant, DC group, at crispin.lace@watsonwyatt.com, 01737 274047.

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W W W . W A T S O N W Y A T T . C O M

21 Tothill Street, Westminster, London, SW1H 9LL UK
Telephone +44 (0) 20 7222 8033 Fax +44 (0) 20 7222 9182

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