DC Investment Market Update

30 September 2022

A torrid time in markets, but how can we support members?

The past nine months has been a torrid time for global investment markets and consequently for DC pension scheme members. With inflation, particularly in the UK, rising rapidly and interest rates being increased, most major asset classes have seen significant falls in value over the first nine months of the year, with the exception of property (and some commodities such as oil). In this short piece we examine the impact on members at different stages of their pension journey and give some practical suggestions on actions pension scheme fiduciaries may want to take and how they might communicate with their members.

How bad has it been?

Over the first c. 9 months of 2022, the returns from the major markets have been as follows (figures to 30 September 2022).

Asset class / market	Index	Year to date return (%)
UK Equity	FTSE All Share	**-8%**
Global Equity	MSCI ACWI	**-9%**
Property	MSCI Property Index*	**+8%**
Commodities	Brent ($/barrel)	**+13%**
UK Corporate Bonds	iBoxx Corporates All	**-24%**
UK Gilts	FTA British Govt All Stocks	**-25%**
UK Index-Linked Gilts	FTA British Govt Index Linked All	**-29%**
Sterling vs. US Dollar		**-18%**
CPI inflation		**7%**

Source: Datastream *To August 2022.

Clearly, members at all stages of investment glidepaths will have seen falls in the value of their pension savings. Even those strategies targeting 100% in cash at the point of retirement will have delivered negative real returns over the past 12 months to September 2022. In this note, we examine the impact for members at each stage of the glidepath and potential actions you can consider.

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Younger members

- Short term performance will have been disappointing, but important to maintain a long-term perspective;
- Reminding of benefits of a long-term approach will be important;
- Consider reviewing your policy on currency hedging.

Mid-career members

- Similar messages in terms of performance, but more savings at stake;
- Consider level of support/guidance available;
- Are members' expected retirement ages reflecting reality?

Older members

- Key group given uncertainty;
- Annuity pricing has become much more attractive, with enhanced terms available for impaired lives;
- Members in the wrong strategy for their desired retirement path will be most impacted – drawdown and cash strategies will have outperformed approaches targeting annuity purchase.

What is the impact for younger members?

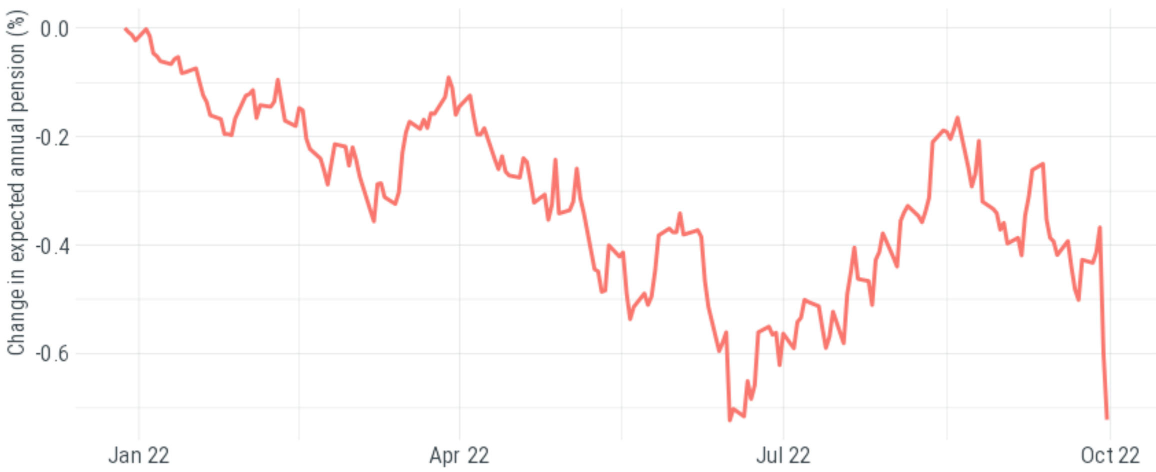
Impact of investment performance

For younger members in the early stages of their careers, most of their pension savings will be invested in growth assets such as equities. North American equities have performed worst in local currency terms (down 24%) with a shift away from the previously popular growth-style tech stocks such as Facebook and Apple. The strength of the dollar has meant that returns for UK investors invested in North America who are not hedged have fallen by around 8%. Since currency hedging will have had such a pronounced impact on outcomes, now might be a good time to revisit your beliefs in this area.

The worst performers in sterling terms have been European markets, down 19% over the first nine months. Overall, global equities have returned -9% over the year so far in sterling terms – disappointing but nothing like the falls seen in the early days of covid, at least for UK investors. Multi-factor and ESG-tilted approaches have so far performed similarly in 2022.

For younger members, falls in equity markets should not be a short-term concern. Not only are they many years from their retirement date but their future contributions are large in relation to the size of their pension savings. The benefits of pound cost averaging should mean that that there is a minimal impact on their long-term projected pot size. Members will also buy into markets at a low point which should benefit them over the long term. After all, members earn money-weighted rather than time weighted returns.

In the example to the right, our Member Outcomes Tracker shows that a 25-year-old member's projected retirement income from retirement is likely to be broadly unchanged (impact <1%), despite significant market turbulence.



The real issue?

The bigger issue, potentially, for many of these younger members is their ability to continue to make pension contributions, particularly if they are on relatively low salaries and struggling with the cost-of-living crisis and likely higher mortgage rates. It will be important for fiduciaries to monitor opt outs over the coming months and potentially consider working with the employer to establish whether members may be able to opt down in terms of their contribution rather than opting out. If they remain in the pension scheme, it's likely to be easier to get them to increase contributions again when the current inflationary pressure eases rather than to get them back into the scheme if they have opted out altogether.

What are the possible actions for fiduciaries?

- Consider the impact that any hedging has had on the performance of members' assets and re-visit your beliefs on currency hedging. Whilst hedging will have negatively impacted short term performance, now may not be the time to remove any hedged positions given the extreme weakness of sterling at the current time
- When communicating with younger members, remind them of the benefits of saving with a long-term mindset, and in particular of taking advantage of matching contributions from the company where appropriate (as well as tax relief!)
- Use simple examples to help members understand the benefits of pound cost averaging.

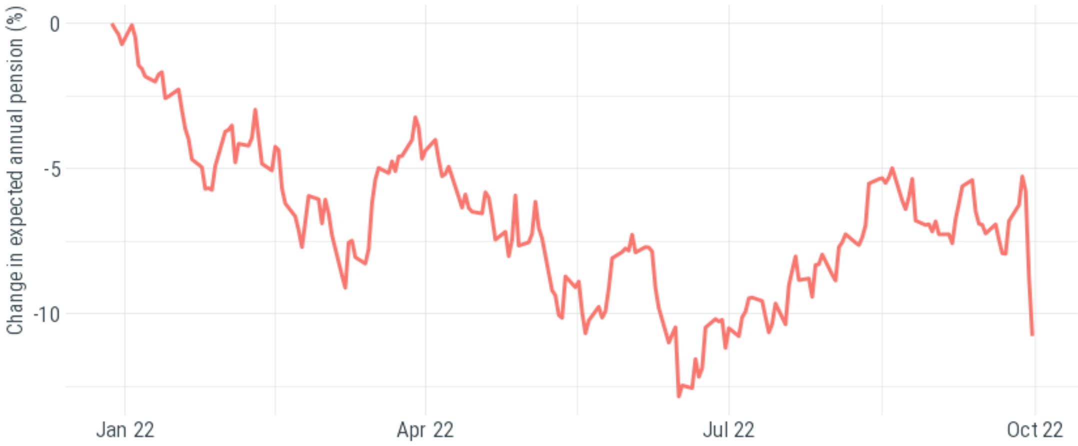
- Remind members of any other benefits that they may lose if opting out of the pension scheme (e.g. life insurance cover). This could be particularly important as we know that some people are already cancelling direct debits for things like car and home insurance.

What is the impact for mid-career members?

For those in their mid-careers, we would, in normal market circumstances, have expected diversified portfolios (including diversified growth funds - DGFs) to have protected against the ravages of markets. But with both equities and bonds falling in value, and generally only modest allocations to alternatives which have posted positive returns, there have been few places to hide. In broad terms, the so-called "market directional" DGFs have fallen more in value than those with an absolute return focus. However, the latter have generally failed to provide returns in line with their performance targets in recent years. In broad terms, DGFs have seen declines of around 2/3rds of equity market falls and have meaningfully outperformed bonds – suggesting that, at least to some extent, diversification has worked and that they have, at least in part, performed their role in terms of risk reduction.

We shouldn't forget that members at this stage of their career will often be those who have mortgages and are unlikely to have experienced a period of rising interest rates. So, increasing mortgage costs, coupled with rising prices of fuel and food, is likely to mean incomes under severe pressure in some cases.

The chart to the right shows the impact on projected retirement income potential from retirement for a member who is 15 years from their selected retirement date. This shows the anticipated income potential has fallen by around 10%, albeit this is not as bad as the position in June 2022.



The real issue?

Members who have already built up meaningful levels of savings will be seeing significant fluctuations in pound note terms. This could be concerning for mid-career members who may be starting to think about their retirement, yet the current cost of living situation means they need to prioritise short-term financial needs. Planning will be key for this group.

What are the possible actions for fiduciaries?

- Many of the same messages will be relevant for this group as for younger members although members in their mid-careers may have reached a point where the value of their investments is greater than the value of their future contributions. "Ride out the storm and continue to contribute if you can" messaging will be critical here as members will generally still be around 10 – 15 years from retirement and have time to see equity markets recover. However, this needs to be done against a wider appreciation of their challenging financial circumstances
- For people in this cohort, pension scheme fiduciaries may wish to liaise with the sponsoring employer to assess whether any wider financial guidance can be given to help these members manage aspect such as their debt more effectively.
- This may also be a good time to manage people's expectations around their likely retirement age. Many pension scheme members have a "selected" retirement date of 65. Is this still realistic?

What is the impact for members closer to retirement?

For members close to retirement, regardless of how they are invested, they will have seen falls in the value of their retirement savings over 2022. Naturally, members would not like to see falls in the value of their savings in the run up to retirement and may be concerned about what this means for them.

In the following table we summarise the anticipated impact on outcomes for members within a year from retirement for different glidepath targets based on market developments over the year so far:

Glidepath target	Portfolio at retirement	Anticipated change in	
		Retirement pot values (%)	Annuity income potential (%)
Drawdown	Diversified mix of equity, bonds, and alternatives	**-9%**	**+8%**
Cash	100% Cash	**-2%**	**+15%**
Annuity	50% corporate bonds, 50% UK gilts	**-20%**	**-5%**

Cash strategies have outperformed but beware impact on purchasing power
Many "cash" glidepaths target 100% cash (or cash-like investments) at the point of retirement. As shown above, these are expected to at least some extent, have protected members against falls in other markets. However, what this masks is the negative impact on the purchasing power of their pension savings. This impact could be compounded for members who leave their savings invested in cash – it's likely to be important for those remaining invested to participate in markets.

Drawdown strategies are likely to have fallen in value, but there are reasons to feel positive about income potential
Most drawdown strategies will have a mix of equities, bonds, and alternative assets, with the likelihood of falls in value over the year to date. Those with a higher exposure to bonds, and particularly to index linked bonds, may have seen poorer outcomes, with falls of over 20%. We should bear in mind that drawdown strategies are generally designed to be appropriate for those members who will draw down their pension savings over a period of their retirement i.e. provide a flexible income. On this basis, there is good reason to expect that members' savings should recover. With the rise in interest rates, members should expect to secure a higher level of income in retirement than they might have achieved at the start of 2022.

Annuity strategies are likely to have done their job, but members may have missed on improved outcomes
If members are invested in annuity strategies, and plan to buy an annuity, their post retirement income levels will have been largely protected over 2022. Significant rises in bond yields, leading to falls of around 30% on conventional gilts and around 40% in index linked gilts, should have been matched to a large extent by improvements in annuity rates. Indeed, figures from Hargreaves Lansdown suggest that for a pension pot of £100k, a 65-year-old male buying a fixed rate lifetime (non-escalating) annuity, with a 5-year guarantee, will now be able to generate around £6,637 per annum income against £4,950 at the start of 2022- an increase of 34%, as expected.

The real issue will come if these members plan to either take cash or draw down their income in retirement. For those members, their income after retirement is likely to be around 20% less than it was at this point 9 months ago.

What are the possible actions for fiduciaries?

- This is the toughest category to deal with. Many members will have entered 2022 with the expectation of retiring in the next year to two years. The impact of market falls on their pension savings is likely to have been severe. The messaging to these members needs to be carefully thought out and may involve them re-visiting their date of retirement. Clearly this could have wider implications for the sponsoring employer too.
- For those planning to take drawdown, the losses will only effectively be "realised" if they decide to cash in their pot at this stage and in doing so "lock-in" recent falls. If, say, they are only planning on cashing in around 4% of their pot each year, the damage is likely to be limited and if they remain invested in a multi-asset strategy after retirement, they should benefit from upside gains in the value of their investments over time.
- Annuities, which have generally represented poor value for many members over recent years and have been "off the agenda" for retirement planning, may have started to look more attractive for many people over 2022. Making sure that, where appropriate, members are given proper support to make their retirement decisions will be more important than ever. We know that around 60% of people could be eligible for an enhanced annuity and, depending on their circumstances, could achieve between a 20% to an 80% uplift in value over a standard rate annuity. We need to encourage our members away from telling people how healthy they are and how few units of alcohol they drink a week to being honest about the medical conditions they or their family face to ensure they get the best deal.
- Fiduciaries may want to revisit the long-term role of 'annuity' glidepaths, given those targeting drawdown continue to deliver better outcomes relative to annuity pricing, even if members still wish to purchase an annuity from retirement.
- For strategies targeting cash, further work is needed to assess how members could potentially be protected against any further inflation. However, we should bear in mind that most money market funds used within DC arrangements tend to reflect changes in base rates more quickly than in individual accounts, meaning members will benefit from remaining within the pension scheme rather than cashing in their pension assets and putting the money into a bank account – "better in than out" may well be the appropriate messaging here.
- Fiduciaries should take a close look at the selected retirement ages of their members and focus on those members who are past their selected retirement date in terms of communication. These will often be deferred members who may have forgotten about their pension

What other points are there to note?

Moving to a master trust arrangement?

For schemes moving from a trust based to a master trust arrangement, it will be vital to let members know that the falls in the value of their pension savings have been market-related and not a result of the move to the master trust arrangement. This will be vital in keeping people's trust in their pension arrangement going forward.

Are you planning a transition?

Given continued turmoil in markets and uncertainty about the short-term outlook, we'd advocate extra caution when planning significant transitions – particularly those involving material changes in market exposure. We would suggest increasing the level of monitoring of market and trading conditions in the run up to your planned transition.

Member Outcomes Tracker – Assumptions and methodology

The Member Outcomes Tracker approximates the impact of recent changes in markets on long term member outcomes, as measured by the expected annual pension incomes for a set of member personas. Member personas are defined based on age, salary, contribution rate, investment strategy, current fund value and retirement date. The persona assumptions used in this note are as follows:

Member	Age	Retirement age	Starting pot	Salary	Contribution rate
Younger	25	68	£1,000	£25,000	10%
Mid-career	50	65	£100,000	£35,000	10%
Older	64	65	£100,000	£45,000	10%

The Member Outcomes Tracker projects forward the value of each persona's fund value and future contributions to their retirement date and updates the projection on a daily basis, based on observed changes to market indices and yields.

For the purpose of the analysis included in this paper, we have assumed a glidepath investing in 100% unhedged global equity in the early years, and de-risking over the 10 year period to retirement into a blend of global equity (1/3), alternative assets (1/6), fixed income (1/3) and cash (1/6) for drawdown. We have assumed 25% cash, 37.5% corporate bonds and 37.5% gilts for annuity and 100% cash for cash glidepaths.

Future returns are based on the output of the Economic Scenario Service (ESS), the proprietary economic scenario generator developed and maintained by Hymans Robertson LLP. Below is a summary of ESS projected returns as at 31 July 2022:

The following figures have been calculated using 1,000 simulations of the Hymans Robertson Economic Scenario Service, calibrated for Guided Outcomes (GO) using market data as at 31 July 2022. All returns are shown net of fees. Percentiles refer to percentiles of the 1,000 simulations and are the annualised total returns over 1, 5, 10, 20, 30 and 40 years.

		Annualised total returns											
		Cash	Index Linked Gilts (medium dated)	Fixed Interest Gilts (medium dated)	Corporate Bonds (medium dated)	UK Equity	Overseas Equity	Private Equity	Property	Emerging Market Debt	Diversified Growth Fund	Inflation (RPI)	Inflation (CPI)
1 year	16th %'ile	1.5%	-5.1%	-4.6%	-5.5%	-12.0%	-12.2%	-19.0%	-9.6%	-6.6%	-4.0%	5.6%	4.7%
	50th %'ile	1.8%	1.9%	1.5%	2.4%	6.4%	7.1%	13.5%	4.2%	3.8%	5.0%	7.1%	6.0%
	84th %'ile	2.1%	9.6%	8.0%	10.0%	24.8%	26.2%	47.4%	20.9%	14.2%	13.3%	8.5%	7.4%
5 years	16th %'ile	0.8%	-2.0%	-1.2%	-1.0%	-2.7%	-2.8%	-4.7%	-2.3%	-0.9%	0.5%	2.4%	1.3%
	50th %'ile	1.6%	1.2%	1.4%	2.0%	5.6%	5.7%	9.5%	4.3%	3.0%	4.3%	3.8%	2.8%
	84th %'ile	2.5%	4.6%	3.9%	4.7%	13.6%	13.5%	24.4%	11.3%	6.6%	7.9%	5.3%	4.4%
10 years	16th %'ile	0.9%	-1.2%	0.3%	0.7%	-0.2%	-0.5%	-1.0%	-0.6%	0.6%	1.8%	1.8%	0.9%
	50th %'ile	2.1%	0.9%	1.7%	2.3%	5.9%	5.7%	9.8%	4.5%	3.2%	4.6%	3.3%	2.6%
	84th %'ile	3.3%	3.3%	3.0%	3.7%	11.6%	12.1%	20.4%	10.0%	5.2%	7.5%	4.9%	4.2%
20 years	16th %'ile	1.3%	-0.6%	1.6%	2.0%	2.1%	1.8%	3.0%	1.5%	2.3%	2.9%	1.3%	0.8%
	50th %'ile	2.7%	1.1%	2.3%	2.9%	6.6%	6.4%	10.3%	5.4%	3.8%	5.4%	2.7%	2.4%
	84th %'ile	4.4%	2.9%	3.1%	3.8%	10.7%	11.1%	17.9%	9.4%	5.2%	7.9%	4.3%	3.9%
30 years	16th %'ile	1.4%	0.0%	1.9%	2.3%	2.9%	2.8%	4.2%	2.3%	2.8%	3.5%	1.0%	0.7%
	50th %'ile	2.9%	1.5%	2.6%	3.2%	6.7%	6.7%	10.6%	5.7%	4.2%	5.5%	2.4%	2.1%
	84th %'ile	4.8%	3.2%	3.6%	4.3%	10.6%	10.8%	16.6%	9.1%	5.6%	8.0%	3.8%	3.7%
40 years	16th %'ile	1.4%	0.3%	2.0%	2.4%	3.5%	3.4%	5.0%	2.8%	3.0%	3.6%	0.9%	0.7%
	50th %'ile	3.1%	1.8%	2.8%	3.3%	6.9%	6.6%	10.6%	5.8%	4.3%	5.7%	2.2%	2.0%
	84th %'ile	5.0%	3.6%	4.0%	4.6%	10.3%	10.3%	16.2%	9.0%	5.9%	8.1%	3.6%	3.5%
	Volatility (Disp) (1 yr)	0.3%	7%	6%	8%	18%	19%	32%	16%	10%	9%	1.4%	1.4%

The current calibration of the model indicates that a period of outward yield movement is expected. For example, over the next 20 years our model expects the 17-year maturity annualised real (nominal) interest rate to rise from -1.2% (2.5%) to 1.1% (3.3%).

At each persona's retirement date, we approximate an annuity factor based on a single life, index-linked annuity and use this to convert the member's projected savings to an annual income. The output of the Member Outcomes Tracker is the percentage change in each persona's projected annual pension income over time.

The Member Outcomes Tracker is based on a number of assumptions and pension outcomes for actual members which may differ from the persona outcomes for a number of reasons, including but not limited to, differences between the persona profiles and actual member characteristics, differences between projected changes in markets and actual future changes in markets, changes in market indices being different to changes in the value of members' fund amounts, members choosing to convert their savings to income in different ways, and members changing contribution rates, retirement age or investment strategy between now and their retirement date.

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