

HYMANS  ROBERTSON

Master Trust Default Fund Review

Master Trust Insights - June 2021

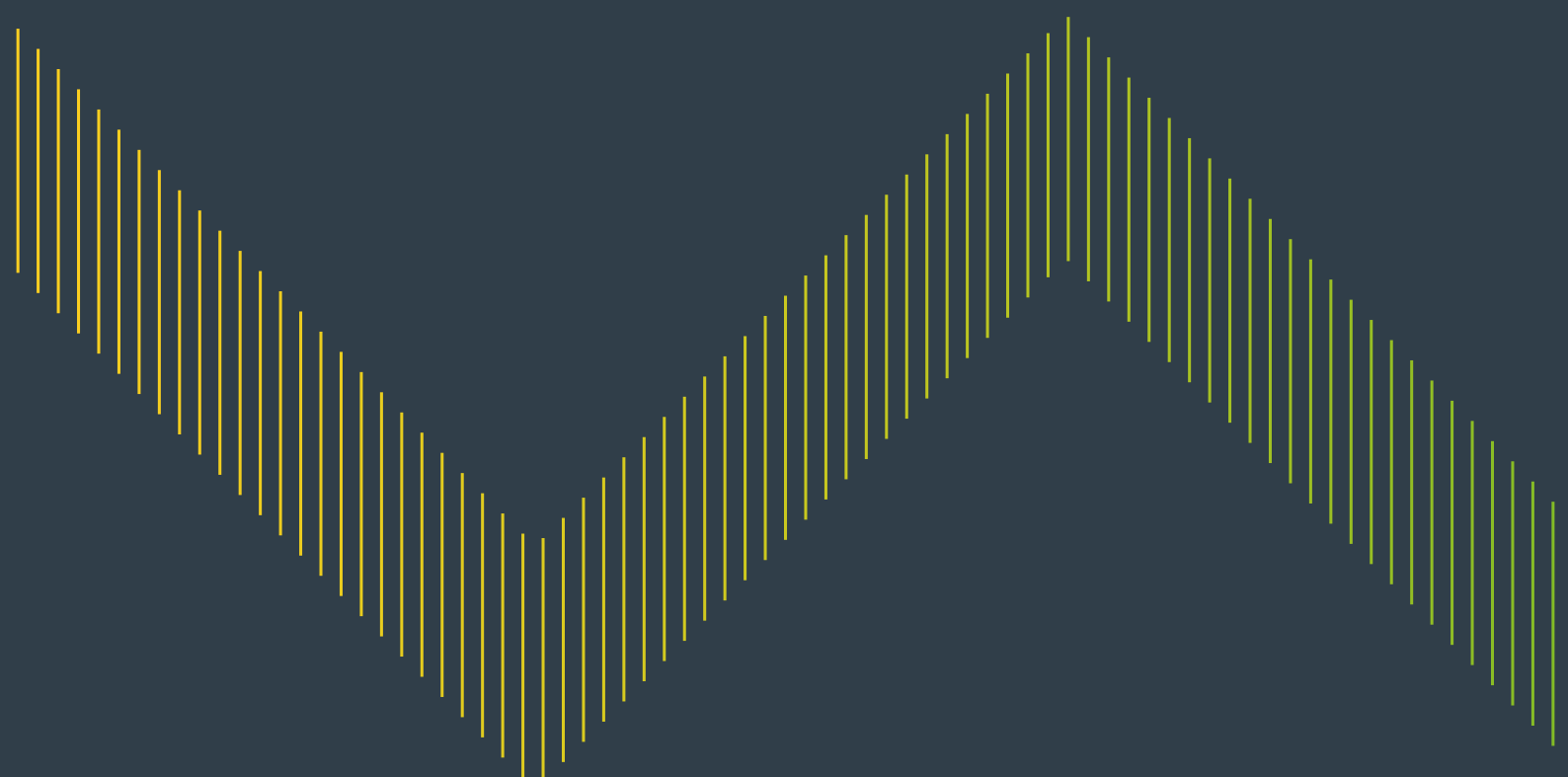


Focusing on member outcomes

Welcome to the latest edition of our Master Trust Insights, in which we assess the impact of Master Trust default fund performance on member outcomes.

We expect the trend of schemes switching to Master Trust to continue unabated, and possibly at an increased pace, over the next few years. This will place even greater emphasis on the effective monitoring and comparison of providers. While recent fund performance is clearly an important factor in this endeavour, we believe it must be considered in the context of longer-term member outcomes.

Our Master Trust Insights report provides a forward-looking assessment by examining how recent market events and fund performance have impacted the future retirement incomes of different members. In simple terms, and from the perspective of the majority of Master Trust members who invest in the default fund, we answer the question: “What does this mean for me?”



COVID-19: So where are we now?

Despite the economic turmoil of last year, our analysis shows member outcomes generally improved over the course of 2020 **if members stayed their course in an existing investment strategy**. This is due to the significant recovery in markets that took place after March 2020.

Against the backdrop of a successful UK vaccination programme and gradual easing of lockdown measures, this positive trend has continued during the first few months of 2021.

The extent of the improvement in outcomes for individual members will depend on where they are in their savings journey and how their funds are invested. We've observed clear differences in investment strategy across providers, which could lead to different outcomes for members in otherwise similar circumstances.

In the growth phase, we see a spectrum of risk-taking, from 100% equity strategies at one end, to more diversified, lower risk approaches at the other. Differences in strategy are more pronounced as members approach retirement and although members are facing reduced levels of volatility than at the peak of the crisis, it remains vital that older members understand the potential implications of how their savings are invested on their retirement plans.

In our last edition, we introduced our Member Outcomes Tracker and used it to assess how expected retirement incomes had changed since the pandemic emerged and the extent of the potential variation in outcomes across providers. We've now updated our analysis to 7th May 2021.

The following charts show how each member's expected retirement income has changed relative to the position at 31 Dec 2019. In each chart, the dashed line is based on the average Master Trust investment strategy, which we've estimated based on the strategies of the providers sampled. The shaded regions show the potential range of changes to expected income for similar members invested in different strategies.

Jasmine is 30 years from retirement, in the early part of her savings journey and has a modest level of savings. She is most concerned about making ends meet and does not view her pension as a significant priority right now.

Expected outcomes for members like Jasmine are now c.10% higher than pre-pandemic levels, with most members benefiting from high exposure to equities during the market recovery.

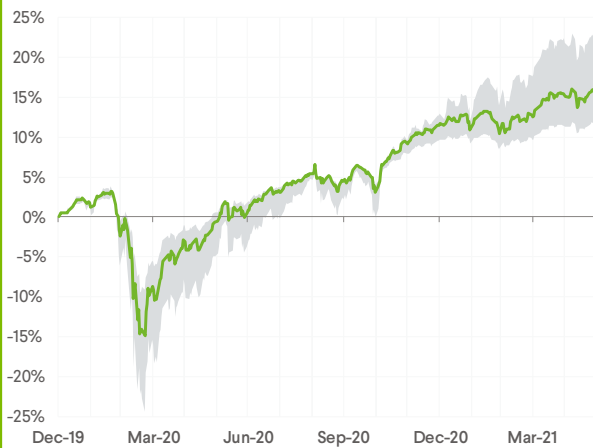
Jasmine has time on her side but it's important she maintains her pension contributions. Continued economic uncertainty as we emerge from the pandemic means Jasmine's main risk is her current and future job security.



Louise is 5 years from retirement. She has a reasonably sized fund and is starting to think about her retirement choices.

Members like Louise, who've been saving for many years but retain exposure to risky assets, have benefited most from the recovery in markets. Louise's expected pension could be between c.10% and more than 20% higher than it was at the start of the 2020, depending on her exposure to equity markets.

It's important Louise understands the risks associated with her investment strategy; any subsequent market falls associated with a prolonged recession may have a significant impact on her pension.



David is part of the “Baby Boomer” generation and plans to retire soon. Certainty of his pension value is important as he plans to travel in the early years of his retirement.

David's expected pension is higher than it was at the start of the 2020 under most strategies. However, the wide range of investment strategies in place for members approaching retirement means there could be a c.10% variation in outcomes for members like David, depending on their provider.

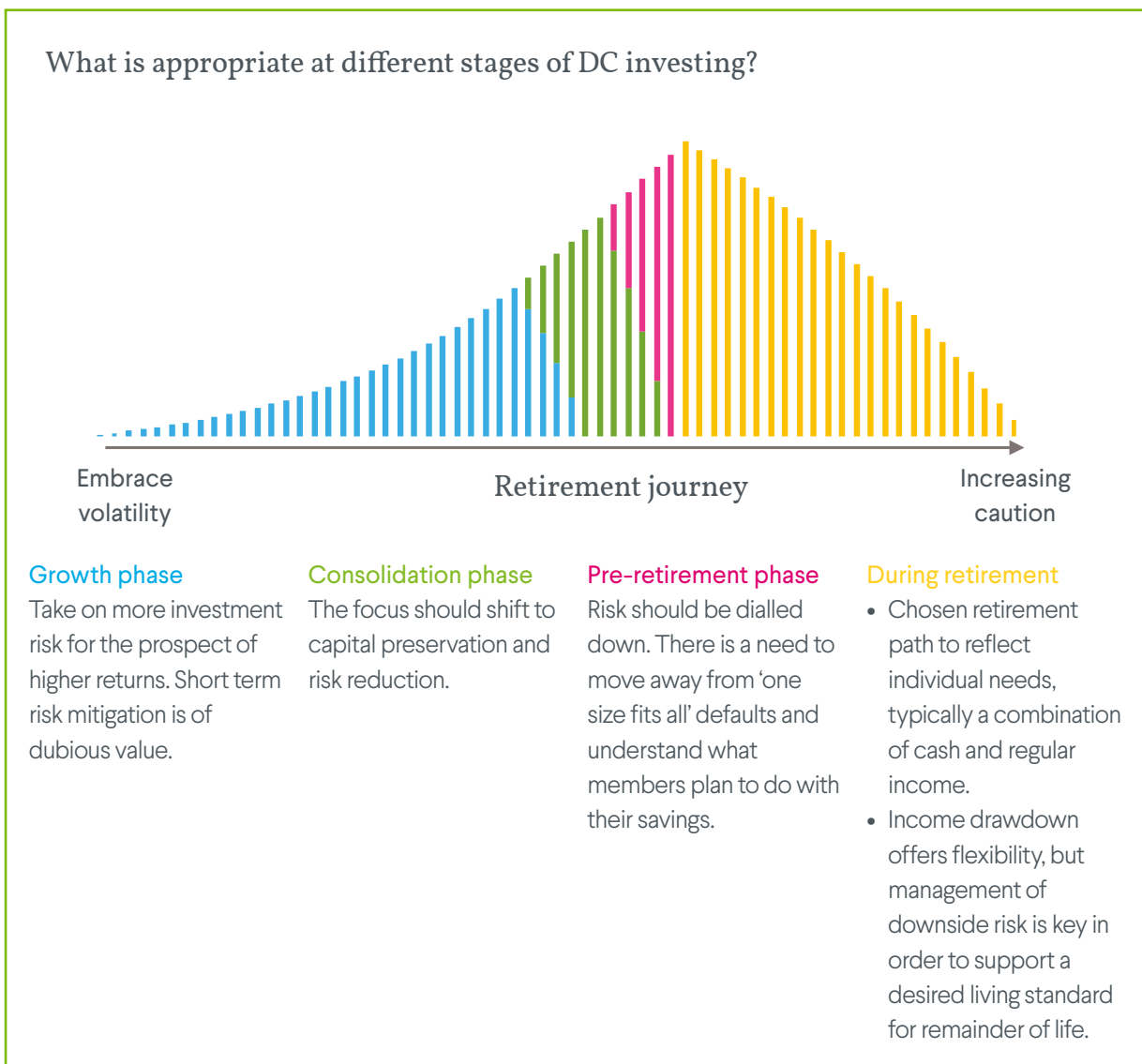
It's important David is invested in a manner that protects his pension, while helping him meet his retirement goals.



All charts based on market data to 1st June 2021.

Stages of DC investing

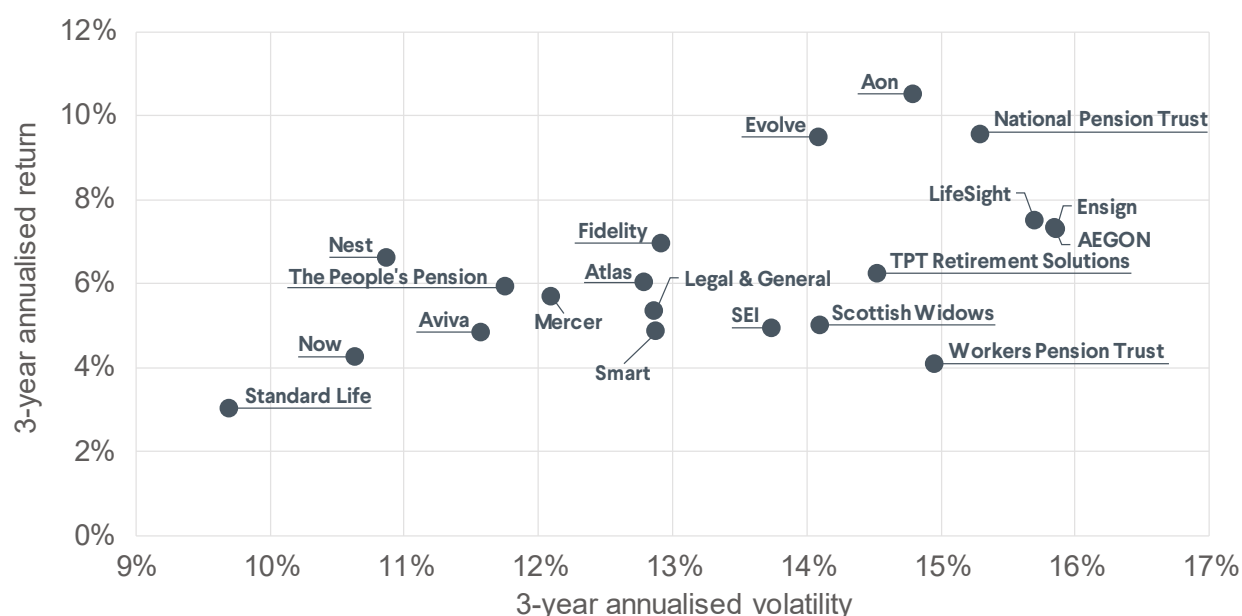
Jasmine, Louise and David are in different phases of their savings journeys and it's likely that different investment strategies will be required to reflect their time horizons.



In the next section, we compare provider performance in the three years to 31 December 2020 and its impact on member outcomes in each phase.

Growth phase

There is notable dispersion in growth fund performance, with most providers lying within a performance range of 4-8% p.a. Fund volatilities have typically been 12-16% p.a. and are consistent with the high equity allocations we'd expect to see in this phase.



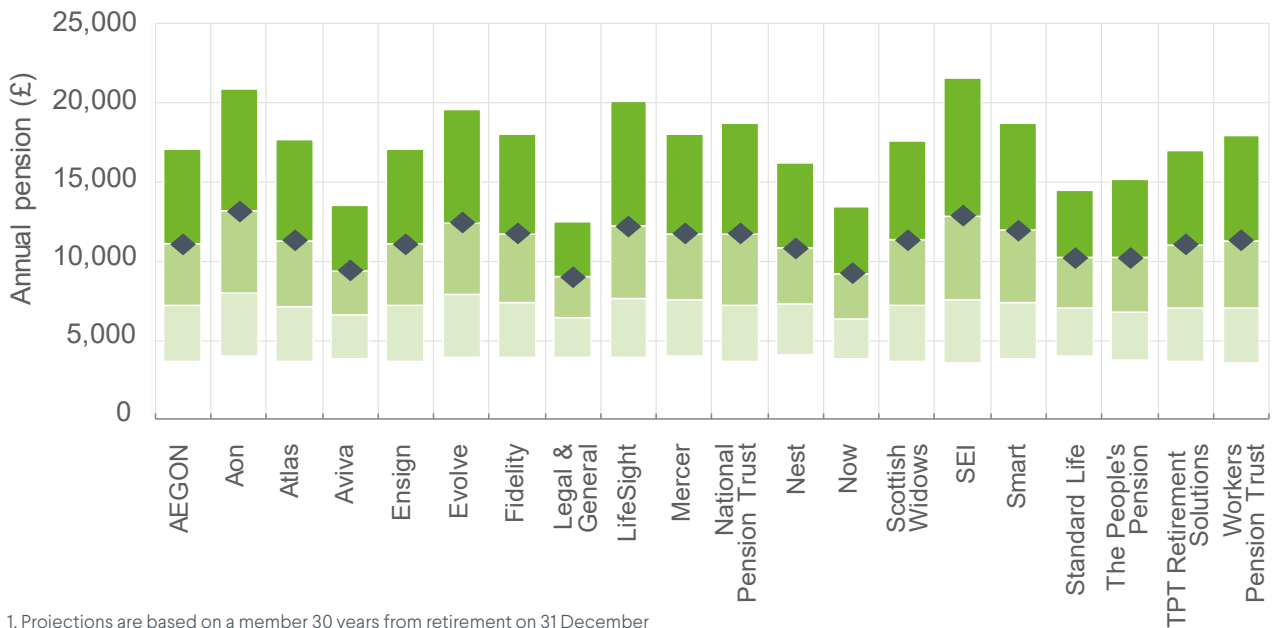
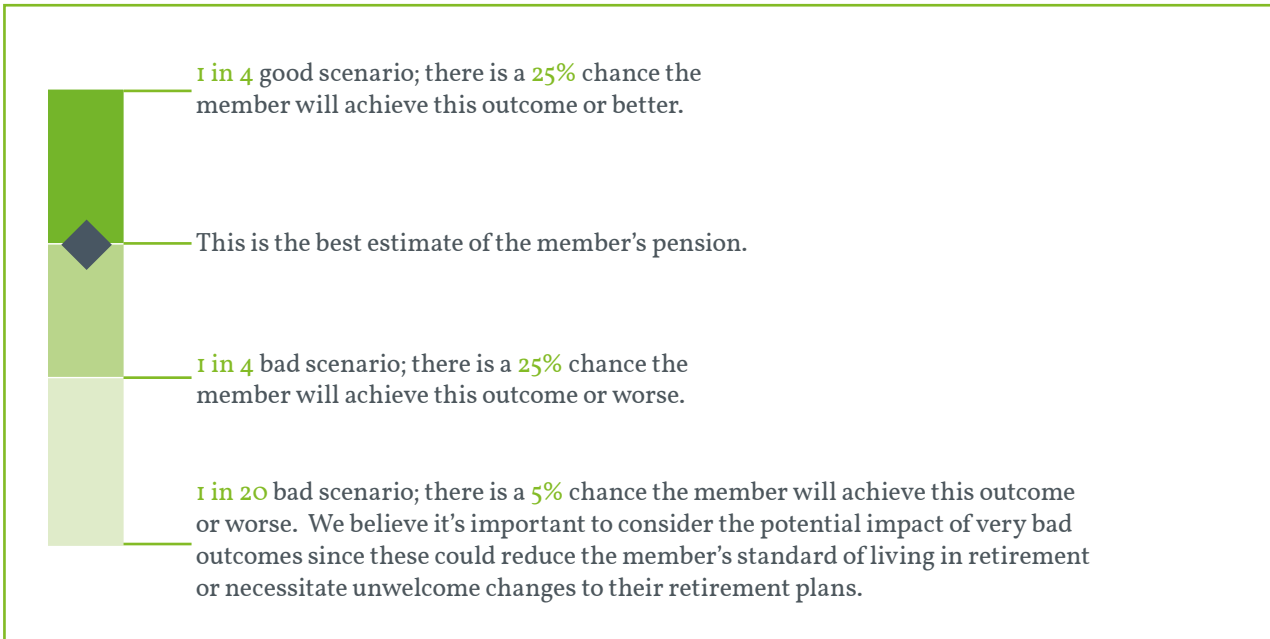
1. Chart is based on net performance and volatility to 31 December 2020, supplied by the providers.

In the growth phase, members are a long way from retirement. Short-term risk mitigation through diversification of asset classes or active asset allocation is of questionable value. Cautious investment strategies may show relative outperformance during periods of market stress, but it's unlikely such outperformance will persist and lead to better member outcomes (versus higher volatility approaches) in the longer-term. This was again the case in 2020 with two months of significant

market stress followed by one of the strongest recorded recoveries in history, which rewarded strategies with higher levels of growth assets.

Furthermore, lower volatility strategies are unlikely to achieve significantly better downside protection over long horizons. To illustrate this point, we've projected the range of potential pension outcomes for growth phase members of the Master Trusts in our sample.

Illustrating uncertainty in outcomes



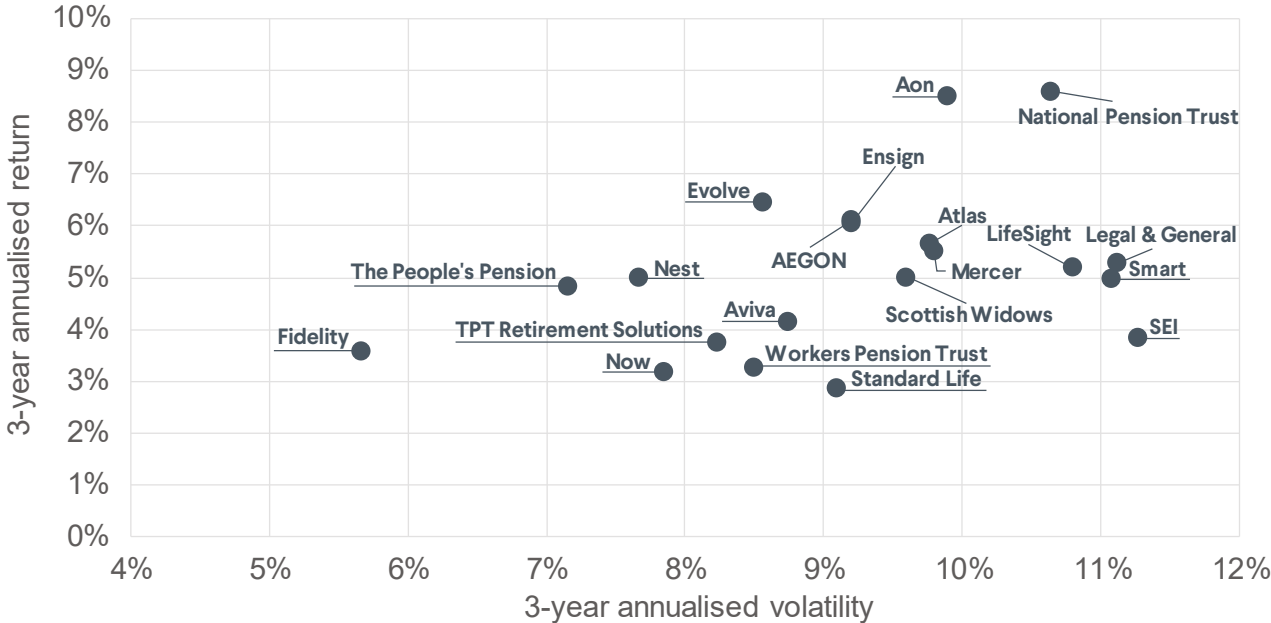
1. Projections are based on a member 30 years from retirement on 31 December 2020, earning £30k p.a. and with a total contribution rate of 10% p.a.

2. The member is assumed to have a fund value of £50k on 31 December 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 31 December 2020.

The chart shows downside outcomes are similar across the providers but there is greater upside potential for higher-risk strategies.

Consolidation phase

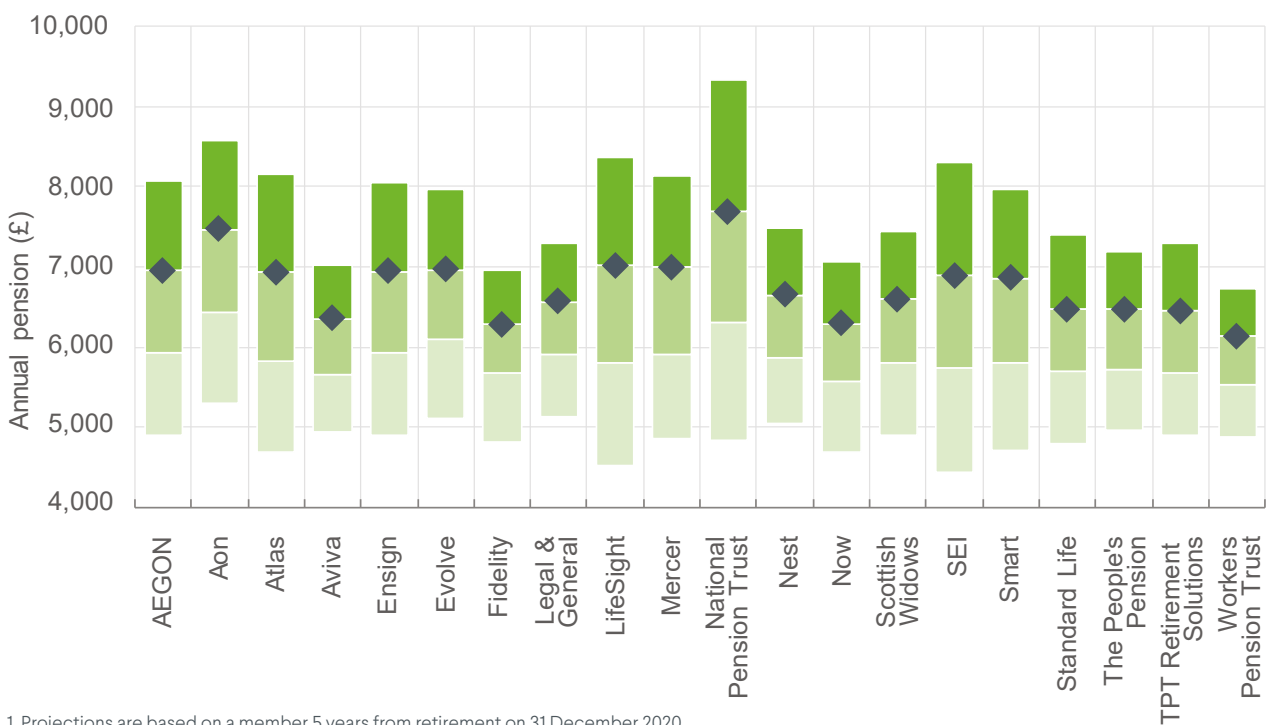
Providers have typically returned c.3-6% p.a. for consolidation phase members. Most providers have exceeded the volatility range of 6-8% p.a. we'd normally expect in this phase - perhaps unsurprisingly, given the heightened market volatility during 2020.



1. Chart is based on net performance and volatility to 31 December 2020, supplied by the providers.

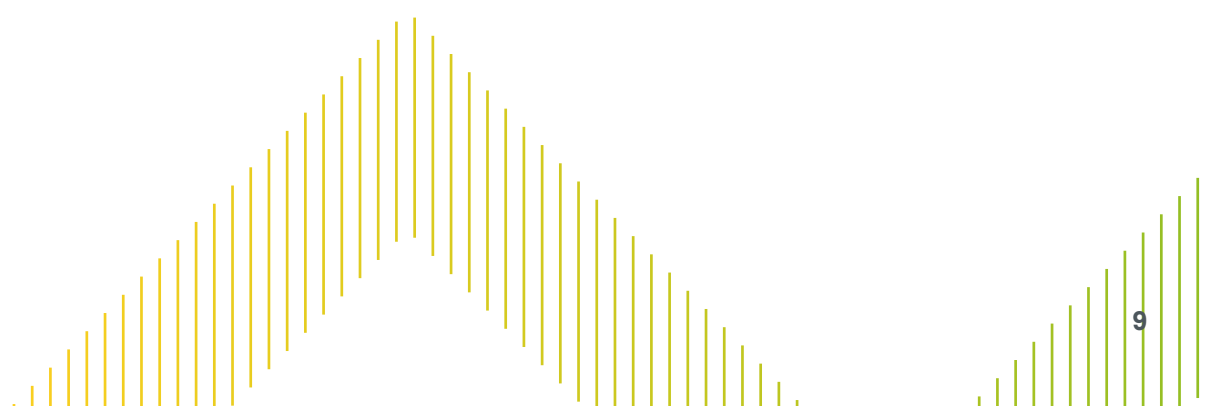
In the consolidation phase, we expect to see steady performance, with an increasing focus on downside protection. Short-term risk and protecting against negative returns are important because a member's outcome could be significantly impacted by a market downturn, with little time left for recovery.

Our projections show the level of uncertainty in member outcomes (indicated by the height of each bar) varies significantly across providers. While riskier strategies may offer higher expected returns, they leave members close to retirement vulnerable to market shocks which could significantly reduce their pension.



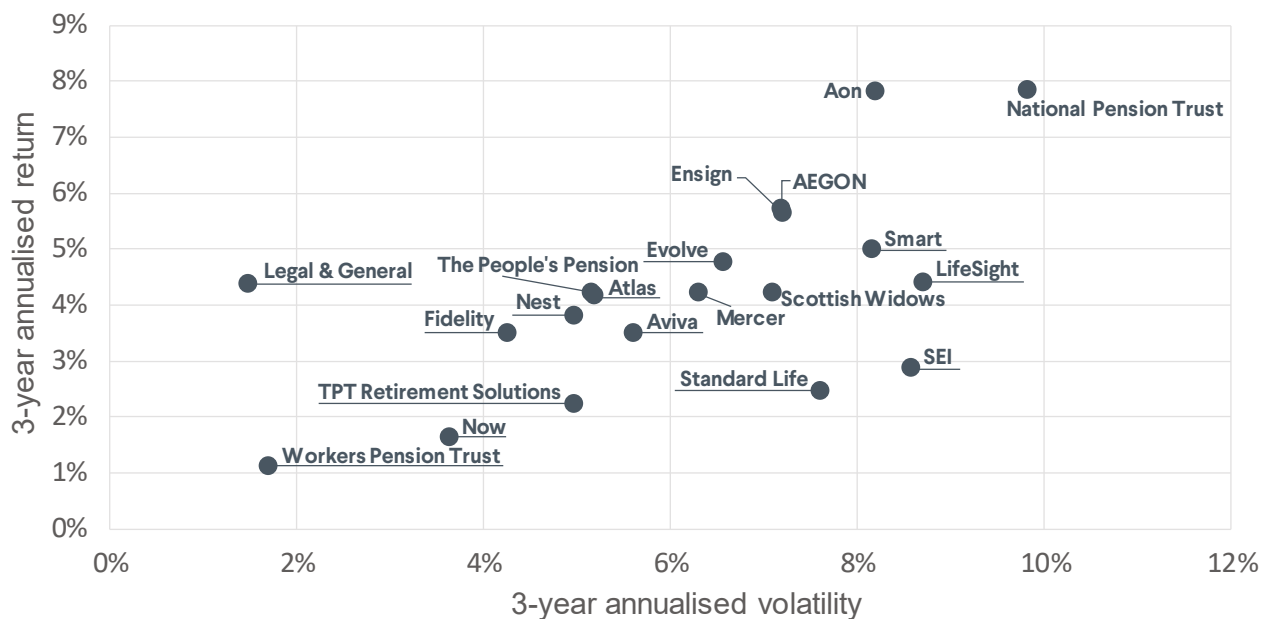
1. Projections are based on a member 5 years from retirement on 31 December 2020, earning £50k p.a. and with a total contribution rate of 10% p.a.

2. The member is assumed to have a fund value of £150k on 31 December 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 31 December 2020.



Pre-retirement phase

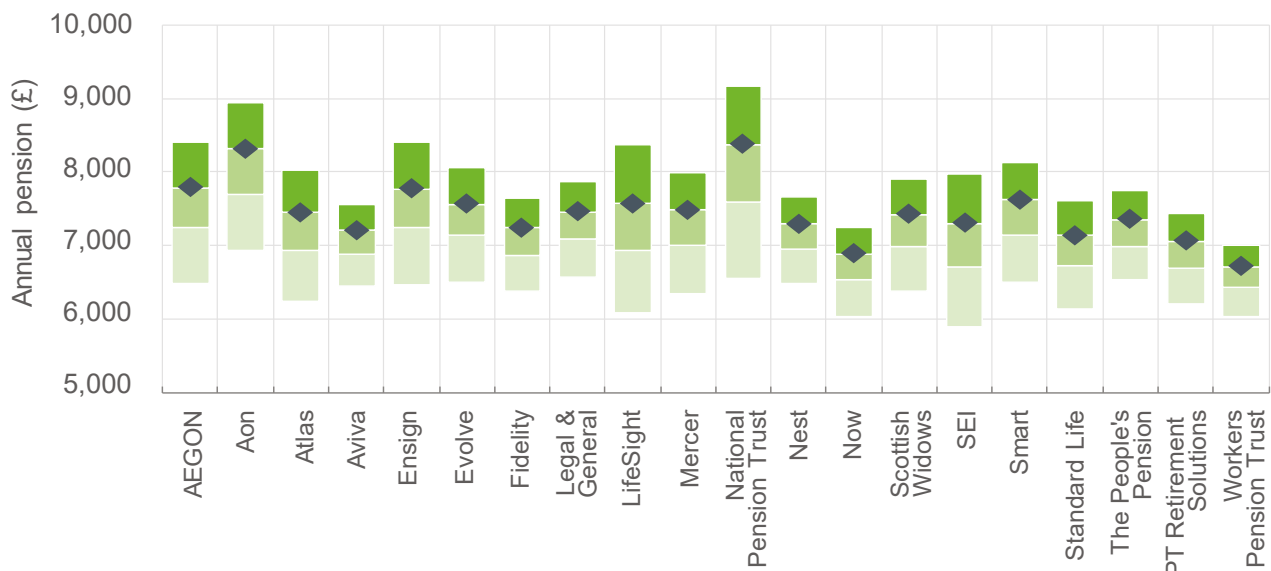
Differences in pre-retirement investment strategies are evident, with wide dispersion of default fund performance and risk across providers. 3-year returns have differed by as much as c.7% p.a. between providers and volatility has been higher than we would typically expect to see for members approaching retirement.



1. Chart is based on net performance and volatility to 31 December 2020, supplied by the providers.

Investment strategy in this phase should be aligned to members' likely decisions at retirement. Reducing risk should be the norm, particularly as most people currently withdraw their DC pot as cash.

Again, our projections illustrate a range of investment approaches being implemented by providers. While the shorter horizon and more conservative investment strategies mean the range of potential member outcomes is generally narrower than in other phases, there is evidence that members in this phase may be assuming very different and potentially inappropriate levels of risk.



1. Projections are based on a member 1 year from retirement on 31 December 2020, earning £55k p.a. and with a total contribution rate of 10% p.a.
2. The member is assumed to have a fund value of £200k on 31 December 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 31 December 2020.

In summary

Our core beliefs remain unchanged; we expect risk to be rewarded over long horizons and advocate effective risk management to support good outcomes for those closer to retirement. Our analysis has shown there are a range of approaches adopted by providers, with some expected to support better member outcomes than others.

Member outcomes should be the key factor in setting all aspects of DC strategy and digital engagement can be hugely powerful in helping members understand:

- What level of income they'll need in retirement;
- Whether they're on track to achieve that income;
- How they might improve their chance of meeting an income target.

Investment performance is clearly important in addressing those questions, but it should be considered alongside factors such as adequacy of contributions, retirement age expectations and how members wish to access their savings in retirement.

Our experience is that this type of approach enables more effective, targeted communications with members, which help them consider different aspects of their retirement planning and the levers they have at their disposal to make changes.

The result is a framework for enhanced scheme governance, informed investment decisions, improved member engagement and, ultimately, better member outcomes.

If you would like further information on this publication, please contact us or your usual Hymans Robertson consultant.



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