Master Trust Default Fund Performance Review

Master Trust Insights

December 2019

The year of Master Trust authorisation

Welcome to the third edition of our Master Trust Insights review, where we compare the investment performance across the biggest Master Trust providers' default funds.

2019 will be known as the year of the Master Trust authorisation process, and the year that regulatory requirements on responsible investment and the Statement of Investment Principles became tighter.

As money continues to pour into Master Trusts following authorisation, performance monitoring and comparison becomes even more important. We expect to see a number of investment strategies picking up on ways to introduce responsible investment and ESG policies. It's still early days, but now is the time to start monitoring track records between those who have put more of an emphasis on responsible investment, and those who have not.

Market overview

In future years, the 12-month period ending 30 June 2019 will become one of the most informative when analysing the performance (risk and return) track records of DC default investment strategies in a "V-shaped recovery" scenario. The scenario will stack against the one that is most commonly used by those who were successful in de-risking during the much longer period from November 2007 to March 2009. The same approach (with perfect hindsight prior to the big market falls in 2008 and Q4 2018) to managing assets will have produced two very different outcomes:

- During 2008, the DC investment manager who de-risked earlier would have been satisfied in the member outcomes produced relative to other peers who had not. This track record would have compared favourably for the next 3 to 5 years. A crucial and valid question would be at what point the same manager decided to re-risk. Did they do it in 2009, 2011 or 2013? Perhaps the manager became a permanent bear. The answer to this question would have come out in any comparison post 2013. We have seen examples of DGF managers in different categories but many of them who had celebrated their track record during 2008 not being able to capture enough of the meaningful recovery that occurred later.
- During Q4 2018, the same DC investment manager who de-risked earlier, would have been satisfied for a brief moment. But in the majority of the situations we have seen, there was no material difference in track record compared to someone who had not changed their risk profile at all – the V-shaped recovery only meant that if you de-risked shortly before Q4 2018, then you also failed to capture the immediate return upside during Q1 2019.

In terms of the DC default investment strategies we are showing, it's clear that the majority of Master Trust providers have not materially changed their investment risk profile over the past year. The equity-heavy strategies are still outperforming relative to those with more defensive assets over a three year measurement period.

All performance data highlighted in this report is to 30 June 2019. We've shown performance data from a 1 year and 3 year period (often the longest period available).

Stages of DC investing

Recognising that there are distinct phases of a retirement savings journey which require a different investment approach, we've compared performance at each of these phases.

It's still early days for the Master Trust providers. We will no doubt see development of their propositions and strategies as assets grow and the market undergoes consolidation. Members have seen positive returns in all three phases across all providers. Markets have been very supportive and volatility has been low. The real test for these strategies is surely yet to come but there are some clear dividing lines and early signs of concern.

1

Some providers are far too focussed on short term risk mitigation in the growth phase (30 to 5 years from retirement). Over cautiousness is a real risk to good outcomes here.

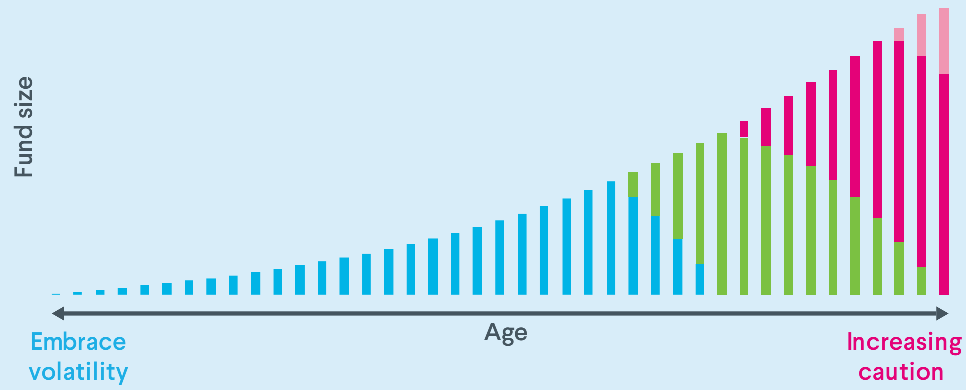
2

In the consolidation phase (5 years from retirement), simple, strategic asset allocation has performed better than complex, expensive dynamic asset allocation in terms of delivering strong returns for an acceptable level of risk. Strategic asset allocation (rather than dynamic) has outperformed on a risk adjusted return basis.

3

Members very close to retirement have benefited from some exceptional returns. However, many providers are carrying too much risk in this phase and a downturn in markets could significantly impact those close to retirement.

What is appropriate at different stages of DC investing:



Growth phase

Take on more investment risk for the prospect of higher returns. Short term risk mitigation is of dubious value.

Consolidation phase

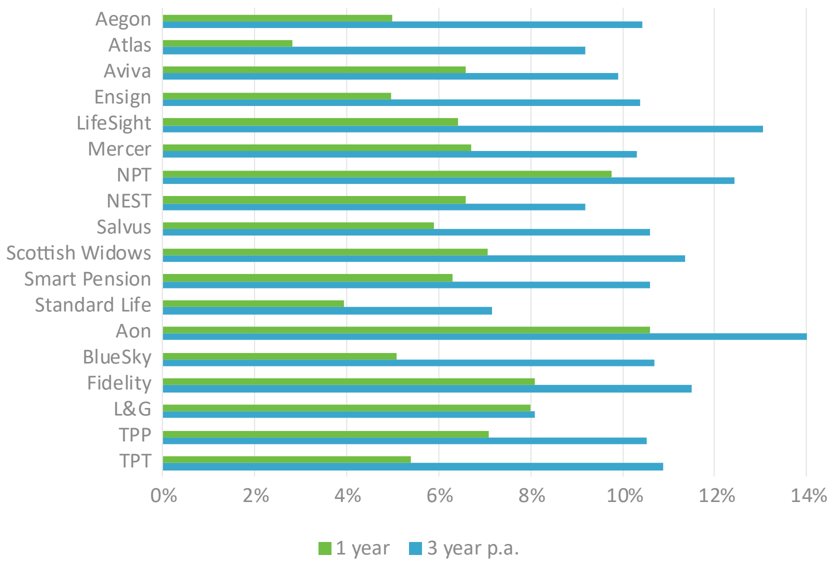
The focus should shift to capital preservation and risk reduction.

Pre-retirement phase

Risk should be dialled down. There is a need to move away from 'one size fits all' defaults and understand what members plan to do with their savings.

Growth phase

30 years from retirement – 1 year and 3 year performance



Objective in the growth phase

Take risk to maximise returns

Overall performance

Following a strong year for both equity and bond markets, the overall picture for funds in the growth phase is positive, with an average return of 6.5% over one year. Returns over three years per annum are also strong, with an average return of 10.6%. Looking more closely there is differentiation amongst providers, with some returns lagging considering the market backdrop. Although a long way from retirement, strong returns at this stage are important due to the potential for compounding returns through the years.

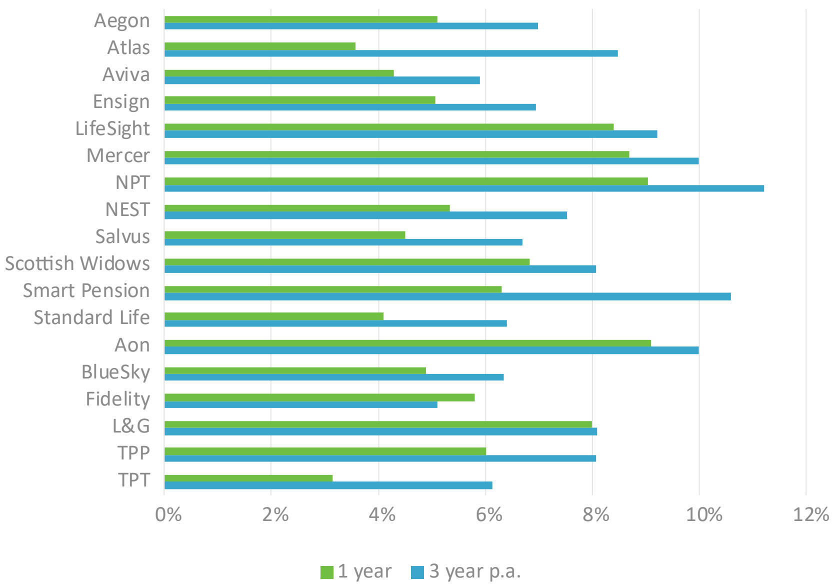
Our view

In this growth phase, where members are a long way from retirement, short term risk mitigation through diversification of asset class or active asset allocation is of questionable value. Regular contributions by the member provide their own diversification benefit as a result of pound cost averaging. Funds are relatively small, any volatility of performance is typically short term in nature and has a negligible effect on long term outcomes (markets recover, with members having purchased units at lower cost).

Recent history has been kind to risky asset classes. But even when the tide turns and a more cautious approach shows short term (relative) outperformance, over the long term, it is very unlikely that such an approach will lead to better member outcomes than a high allocation to riskier asset classes.

Consolidation phase

5 years from retirement - 1 year and 3 year performance



Objective in the consolidation phase

Capital preservation, solid returns and risk reduction

Overall performance

In the consolidation phase, we expect to see steady performance, with an increasing focus on down-side protection. There is a greater dispersion of returns at this stage amongst providers as the differing strategies shine through. At this phase, volatility becomes a key consideration as members begin to prepare for retirement, so it's not just strong returns that count. Over three years, the average return is 7.7%, with an average volatility of 6.1% over the same period.

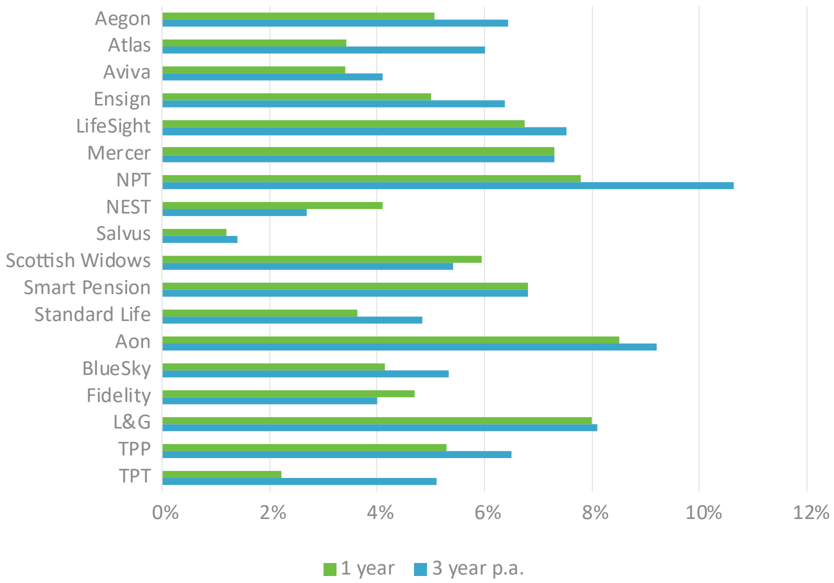
Our view

In this phase, when a member is within 5 years of retirement, a focus on short term risk and protecting against negative returns becomes much more important. With only 5 years to go, a member's final outcome could be significantly impacted by market downturns. The remaining contributions left to be paid could be insufficient for a member's fund to recover any market-driven loss.

Historically, more risk has been the market norm. In normal market circumstances we would consider an annualised risk measured by volatility, of between 6-8% to be broadly appropriate for members with 5 years to go to retirement. Markets have been relatively benign in recent times so we would expect provider's strategies to err towards the lower end of the 6%-8% range.

Pre-retirement phase

1 year from retirement - 1 year and 3 year performance



Objective in pre-retirement phase

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

Overall performance

In the pre-retirement phase, we expect to see a significant reduction in exposure to investment risk. It's surprising to see such strong returns at the phase, albeit in the context of strong positive returns across all asset classes. Over three years per annum, the average return is 5.9%, with one provider returning 10.6%. It's not surprising that this provider also has the highest level of volatility, recording 7.8% per annum over the same period. In times of market stress, strategies such as this would leave members exposed to significant levels of risk with no time to make up lost gains.

Our view

This is the phase where risk should be dialled down significantly and the investment strategy should be consistent with the member's decision at retirement. At present, due to low fund sizes, for many this decision will be to take their benefits as cash and therefore protection against negative returns is even more vital.

Some providers have taken the decision to not implement a risk reducing strategy as members approach retirement. They would argue that it's difficult to predict when members will retire. While this has paid off in recent times, we would caution against high levels of annualised volatility for members with only 1 year left to retirement. Other providers have made heavy use of bond allocations to lower risk. Our concern here is the potential for yields to rise sharply given current economic and political circumstances, which could deliver a nasty shock to members close to retirement.

Closing words

Our position remains consistent – accept market volatility early on (e.g. at 30 years to retirement and even much later on) and maintain this position. We do not know whether the next market downturn will be like 2008 (prolonged) or Q4 2018 (short and V-shaped). But we do know that for members further from retirement, the answer is not particularly useful if their pot is small and their contributions in years to come are meaningful, when compared to their current DC pot. Obviously, there will come a point when a market fall results in a material £ loss for members – at this point, the volatility figures in the table become important to highlight. The average de-risking glidepath will start and finish somewhere between 20 and 10 years to retirement with the length of the de-risking phase anywhere between 5 to 10 years. Within our results, the median risk and return profile has been consistent with an overall de-risking approach but there are also a number of different options on how to manage risk as a member approaches retirement.

There are two schools of thought on this:

The glidepath principle should be followed such that the volatility of an investment strategy should decrease as members get closer and closer to retirement. This may come in the form of introducing more defensive assets or it could come through a prescribed level of de-risking into cash if the glidepath is targeting cash at retirement. A non-glidepath approach could be risky – remember, at 5% volatility, the statisticians will say that a one standard deviation event will put your return into negative territory (especially in this low-yielding environment) and a two standard deviation would be quite severe for a 60-65 year old.

The counter to the above is supported by the concept that a member is likely to nominate their retirement age when they begin their job and unlikely to review it for a long time. The theory (and often in practice) is that members will not know exactly when they will retire and may be unwittingly de-risking their investment strategy (due to their rules-based glidepath) by selecting a retirement age much earlier than when they actually do retire. This would support maintaining a higher level of volatility even up to the point of retirement relative to the levels seen by those who support the first principle above.

Both schools of thought have merit, but one key message should come through in all of this. Make sure that your regular communications with DC members contain information reminding them of their nominated retirement age, what this means in practice if they are part of a lifestyling glidepath strategy and how to change this retirement age if they wish to do so. We are now in a well-established era of utilising modelling of member data to improve outcomes. The focus here should consider performance of investments, adequacy of contributions and knowing when and how members are likely to retire. There are many analytics and nudge behaviours around glidepaths and adequacies for retirement income targets, such as the PLSA's living standards. These must be considered to ensure that monies are delivering member value and a default approach is optimised, to and through, retirement.

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Key for charts

Aegon	Aegon Master Trust	**Scottish Widows**	Scottish Widows Master Trust
Atlas	Atlas Master Trust	**Smart Pension**	Smart Pension Master Trust
Aviva	Aviva Master Trust	**Standard Life**	Standard Life DC Master Trust (SLDCMT) and StanPlan
Ensign	Ensign	**Aon**	The Aon Master Trust
LifeSight	LifeSight	**BlueSky**	The BlueSky Pension Scheme
Mercer	Mercer Master Trust	**Fidelity**	The Fidelity Master Trust
NPT	National Pension Trust	**L&G**	The Legal & General WorkSave Master Trust and RAS Master Trust
NEST	National Employee Savings Trust (NEST)	**TPP**	The People's Pension
Salvus	Salvus Master Trust	**TPT**	Retirement Solutions

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