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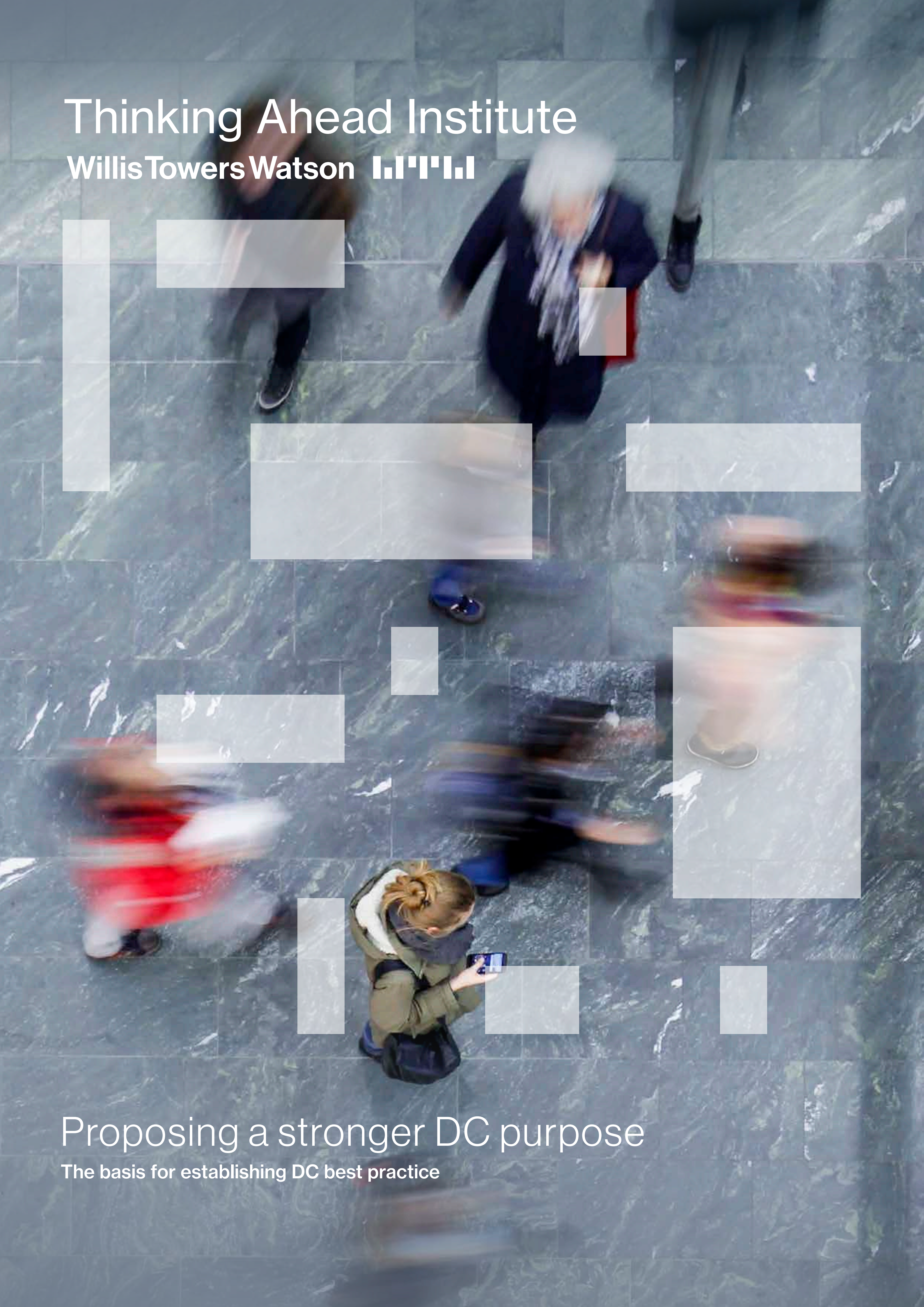

Proposing a stronger DC purpose

The basis for establishing DC best practice

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Contents

DC working group

This document has been written by members of the Thinking Ahead Group 2.0 (Jeremy Spira, Tim Hodgson) following the research and discussion conducted by the Thinking Ahead Institute's working group on enhancing defined contribution practice (the DC working group). The authors are extremely grateful to the members of the working group for their input and guidance but stress that the authors alone are responsible for any errors of omission or commission in this paper.

While the key objective of the group is to present to Thinking Ahead Institute members best practice principles for DC plans and how these could be more widely adopted, a secondary objective is to positively influence the investment industry outside the membership. We hope this paper serves both purposes.

The members of this working group are as follows:

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- **Ciaran Barr**, RPMI Railpen (UK)
- **Jaco van der Walt**, FirstRand Group (South Africa)
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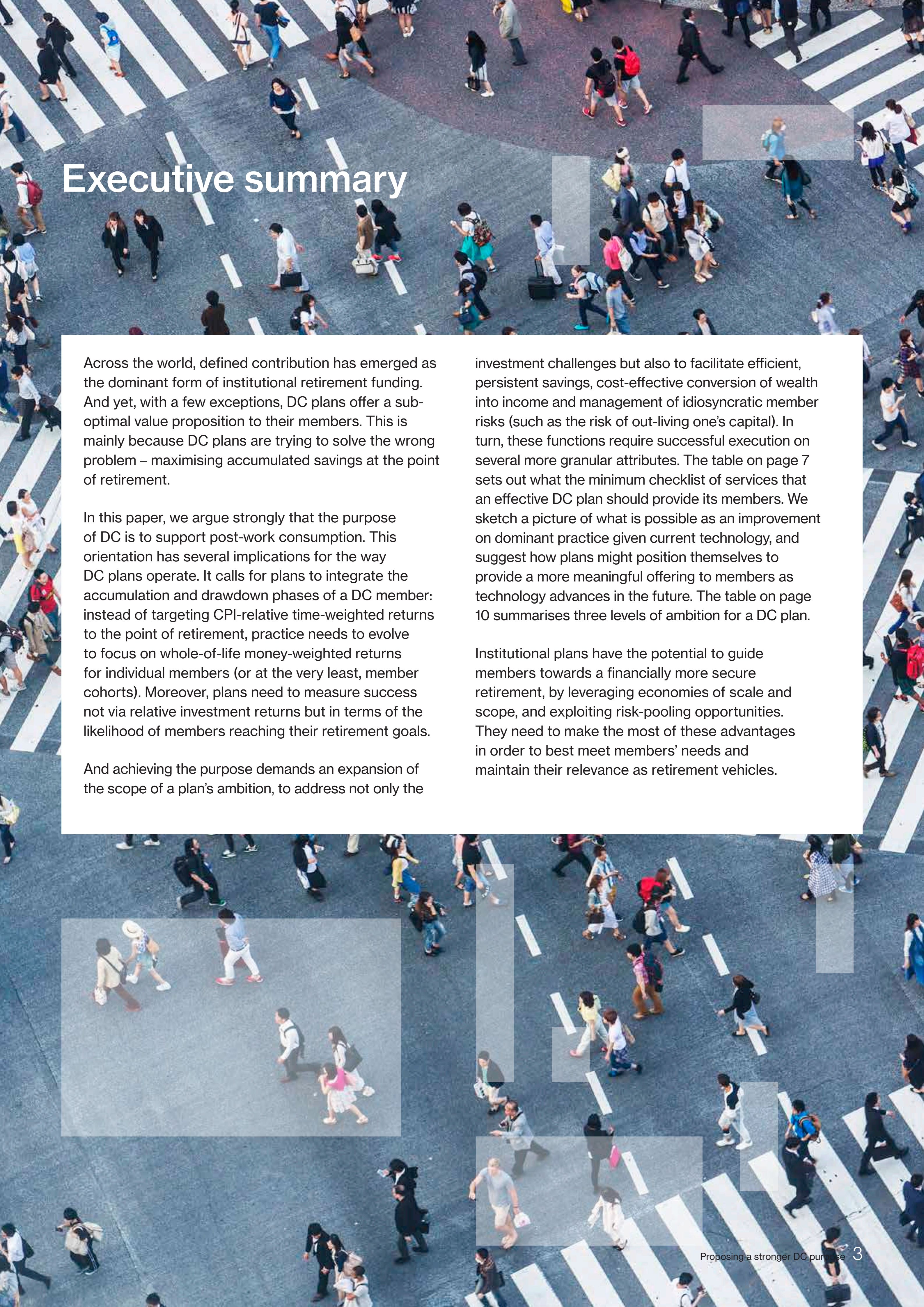


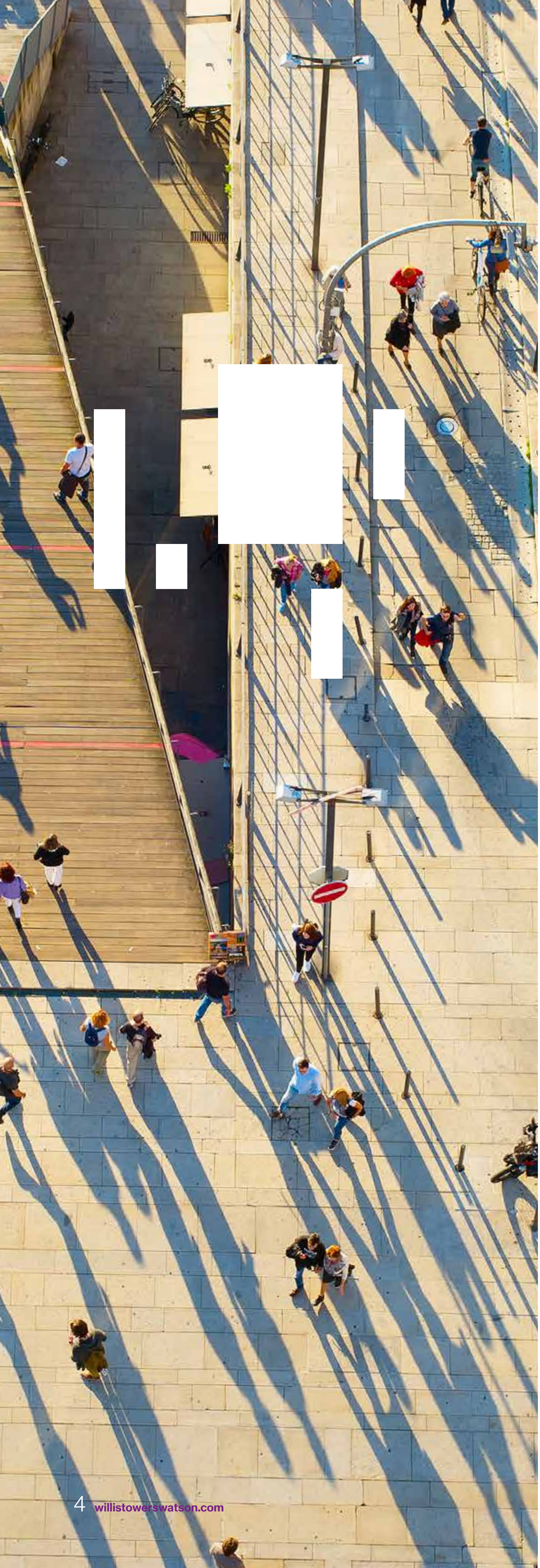
Executive summary

Across the world, defined contribution has emerged as the dominant form of institutional retirement funding. And yet, with a few exceptions, DC plans offer a sub-optimal value proposition to their members. This is mainly because DC plans are trying to solve the wrong problem – maximising accumulated savings at the point of retirement.

In this paper, we argue strongly that the purpose of DC is to support post-work consumption. This orientation has several implications for the way DC plans operate. It calls for plans to integrate the accumulation and drawdown phases of a DC member: instead of targeting CPI-relative time-weighted returns to the point of retirement, practice needs to evolve to focus on whole-of-life money-weighted returns for individual members (or at the very least, member cohorts). Moreover, plans need to measure success not via relative investment returns but in terms of the likelihood of members reaching their retirement goals.

And achieving the purpose demands an expansion of the scope of a plan's ambition, to address not only the investment challenges but also to facilitate efficient, persistent savings, cost-effective conversion of wealth into income and management of idiosyncratic member risks (such as the risk of out-living one's capital). In turn, these functions require successful execution on several more granular attributes. The table on page 7 sets out what the minimum checklist of services that an effective DC plan should provide its members. We sketch a picture of what is possible as an improvement on dominant practice given current technology, and suggest how plans might position themselves to provide a more meaningful offering to members as technology advances in the future. The table on page 10 summarises three levels of ambition for a DC plan.

Institutional plans have the potential to guide members towards a financially more secure retirement, by leveraging economies of scale and scope, and exploiting risk-pooling opportunities. They need to make the most of these advantages in order to best meet members' needs and maintain their relevance as retirement vehicles.



1. The blank page

Let us imagine for a moment that we lived in a society where no retirement system existed. Would we create one? If so why, and what would it look like? These questions are so fundamental that the answers might seem self-evident. Yet we believe that some close scrutiny of the essential purpose of a retirement system – and its implications – throws up some clear discrepancies between dominant current practice and best practice.

2. Rationale for a retirement system

The life-cycle hypothesis, formulated by Modigliani and Brumberg in the 1950s[1], sets out the economic basis for a savings system. The essence of the hypothesis is that for every dollar we earn, we can choose to either consume it (spend) or defer consumption to some future date (save). Saving is critical because we all face future contingencies that will require us to draw down our accumulated capital. Basically, we face a mismatch between our patterns of earning and patterns of consumption over the course of our lives. This is most pronounced over the period of retirement, when earnings taper off or cease completely but consumption needs remain – often long after productive employment has ceased. A retirement system seeks to help individuals overcome this mismatch.

The apparent simplicity of this ambition statement belies the complexity of its implications. The first, often-overlooked aspect is that a retirement system is, primarily, an income production mechanism, targeting peoples' consumption needs in retirement. In other words, there is a set of cash flows (either explicit or implicit) that the system should aim to produce in respect of each individual.

[1] Summarised in two essays: *"Utility Analysis and the Consumption Function: an Interpretation of Cross Section Data"* (Modigliani and Brumberg [1954]), and *"Utility Analysis and the Aggregate Consumption Function: an attempt at Integration"* (Modigliani and Brumberg [1979])

The second implication is that a functional retirement system serves as a mechanism for risk management. The fundamental risk confronting individuals is one of running out of savings in retirement or, put another way, being unable to sustain their desired consumption once they have stopped earning a salary[2]. This risk is predicated on a number of factors, including insufficient savings, inadequate net investment returns, the high cost of converting wealth into income, unexpectedly high inflation and excessive consumption relative to means. Some of these are controllable, some not. Together they present a complex set of challenges that calls for a sophisticated retirement savings approach. And collective vehicles offer several advantages for managing retirement risks over self-managed alternatives. These advantages include:

- Scale: the ability to provide services at lower cost by spreading fixed overheads across a wide member base
- Scope: the ability to incorporate more sophisticated investment approaches and access a greater variety of assets on account of running large pools of capital
- Risk pooling: combining the risks of many members to insure against adverse individual outcomes
- Risk sharing: offering some form of underwriting or balance sheet support to help smooth individuals' experience over the course of their lives
- Discipline: helping individuals overcome various cognitive biases – mostly relating to our natural inclinations to prioritise present over distant future needs and wants.
- Expertise: professionalised organisations (may) offer investment expertise, fit-for-purpose product design, an understanding of the market and regulations, and high quality administration

Of course, a system only works to the extent that the retirement plans it supports are able to deliver on its objectives. As we will see, this is not always the case. We submit that in order to achieve best practice, retirement plans need to have a clear conception of the purpose for which they exist, and align their operations towards the achievement of this purpose.

3. The shape of things

The defined benefit (DB) schemes that have dominated retirement provision over the past 60 years are in decline. Defined contribution (DC) arrangements have been introduced to replace them. The result is that new money is flowing predominantly into DC.

Several hybrid vehicles have emerged that attempt to combine the best features of DB and DC. While we applaud and encourage innovation, our view is that conventional DC schemes will remain dominant. In light of this trend, the remainder of this paper will concentrate on the appropriate purpose for a defined contribution plan, and how it should be structured to deliver this purpose. Most of the best practice principles we put forward apply equally (with minor adaptations in some cases) to other forms of retirement vehicle.

[2] In some countries, consumption needs will be met by pillar 1 pension provision

4. Purpose of a DC plan

A DC plan's primary responsibility is, unequivocally, to serve its members. We don't think this needs much explanation, suffice to say that when discussing purpose, we necessarily look at the reason for which the plan was created in the first place. The discussion of purpose is therefore directly related to how best to deliver the member value proposition.

In section 2, we alluded to the objective of overcoming the temporal mismatch between income and consumption. This can be restated in stripped-down form as **meeting individuals' lifetime consumption needs**.

Fulfilment of this purpose demands that the plan assist members with a number of inter-related functions. In short, the plan should serve as a lifetime **savings, investment, drawdown and insurance vehicle**.

Behavioural science tells us that people tend to mentally underweight the future relative to the present and respond emotionally to short-term market movements, resulting in poor financial planning. They also lack the ability to access (unaided and operating as individuals) appropriate, cost-effective investment instruments and cannot, on their own, pool idiosyncratic risks to which they are exposed (eg their unknowable longevity). Institutional plans help overcome these limitations, by "nudging" members into disciplined saving patterns and along appropriate retirement glide paths, backed up by administration and investment management offered at scale and with greater scope. They can guide members towards suitable drawdown solutions and pool members' experience to soften the impact of individual outcomes (either within the plan or via outsourced group arrangements).

DC plans may differ with respect to the ultimate beneficiaries of profit (or surplus). Some DC plans, set up by commercial providers, may be thought of as profit-for-shareholder. Others, established either by sponsors under trust or as vehicles to provide for state employees, may be thought of as surplus-for-member[3]. In both cases, however, the plan's primary responsibility is to the members.

5. Best practice attributes

While these functions (savings, investment, drawdown and insurance) help substantiate what is required in order to fulfil a member's retirement planning objectives, they do not fully communicate the extent of the required features. There are several essential cross-cutting and enabling responsibilities that must be fulfilled to deliver the member's value proposition. In essence, best practice demands that plans provide a comprehensive set of design attributes and operational activities in discharging their purpose. These are set out in the checklist below.

In designing this list, we contemplated ranking the elements in priority order, but decided against this on the grounds that:

- Factors may assume different levels of importance depending on where plan members are on their individual journey
- There is a degree to which elements are inter-related and mutually-supporting, and therefore need to be considered in conjunction with, rather than more or less immediately than, other elements

The ordering of the elements below should therefore not be regarded as indicative of relative importance.

[3] The concept of surplus-for-member is complicated, as there will invariably be different perspectives on how this surplus is allocated back to members. Almost invariably, some degree of inter-generational wealth transfer will be involved. The matter of distribution of this surplus is outside of the scope of this paper.

Best practice checklist

☐	Builds trust by demonstrating commitment (evidenced by track record) to delivering on members' goals	☐	Investment default option that integrates needs for growth and providing cash flows in retirement
☐	Facilitates and encourages consistent and adequate saving/ contributions	☐	Provides a limited range of investment building blocks to allow individual tailoring if desired
☐	Effectively accumulates savings to build wealth	☐	Offers a post-retirement 'core' option that spreads drawdown of wealth to meet lifetime consumption needs
☐	Takes advantage of government-endorsed tax incentives	☐	Provides financial support for dependents in the event of member's early death
☐	Accurate, secure administration	☐	Protects members' interests after they have stopped contributing
☐	Cost effective administration, communication and investment	☐	Portability of and access to assets/benefits in specific circumstances
☐	Offers a range of sufficient contribution levels with a default contribution option	☐	Empower members to make necessary choices through targeted, appropriate communication

This, then represents our conception of the core attributes required of a DC plan in order to support its purpose. We also considered a number of attributes that might fall into the "aspirational" category, including:

- The full range of return factors are considered within default investment strategy
- Plan offers access to financial planning and advice
- Plan maps default options to members' financial objectives and needs.

Having established our vision for what plans should seek to achieve, we now examine three levels of ambition, which can loosely be labelled dominant practice, the current version of best practice, and how best practice may evolve in the future.

6. Levels of ambition for a DC plan

DC1.0 – dominant practice

The simplest way to approach a DC plan is as an institutional (as opposed to individual) vehicle for accumulating workplace savings in a tax-efficient manner. This approach is convenient for a number of reasons:

- By focusing on accumulating savings, the plan's focus is restricted to a limited number of parameters, namely the contribution rate and the fund range offered, thus enabling economies of scale and scope and simplifying communication with members.
- The fiduciary's responsibility towards a member ends when that member retires or withdraws from the plan. In some instances members are given the option to retain their accumulated savings in the plan after retirement, within the range of funds on offer.
- Plans may offer members access to approved advisers or preferred providers of post-retirement solutions, but the final responsibility for deciding on which provider and solution to use rests with the member.

The natural predisposition of such a plan would be to attempt to maximise the time-weighted return on accumulated funds over rolling periods, with some risk management overlays.

Despite its simplicity (or perhaps because of it) we contend that this approach to DC provision is inadequate in terms of helping members meet their post-retirement consumption needs.

DC 2.0 – current best practice

Given the purpose of a DC plan that we have described above, progressive DC plans consider their obligations as extending *through retirement*, rather than the *'to retirement*' model of DC1.0, and incorporates consideration of actual member outcomes.

This presents some challenges. It is evident that DC plan fiduciaries manage only part of a member's assets (many members will have other savings), over part of the member's journey (most people will change jobs several times in their working life, and won't necessarily consolidate their retirement plan assets), and have only partial information (regarding their financial needs, health, family status, etc). Proper integration of accumulation and drawdown requires that DC plans formulate a conception of members' post-retirement income needs and fund for the associated cash flows in much the same way as a DB plan would fund for the pre-defined obligations to its pensioners. Given the incomplete information at their disposal, DC fiduciaries will need to factor in several variables, and make several simplifying assumptions, in order to arrive at a member's estimated liability profile.

From an investment perspective, the challenge shifts from maximising risk-adjusted return in DC1.0, to optimising the whole-of-life money weighted return on a member's DC assets. The constraints implicit in the optimisation are multiplied under the latter approach, but are a much more accurate reflection of the risks that members are likely to confront over the entire course of their lives.

It is not the intention of this paper to discuss the detail behind delivering outcomes under DC2.0 – that is the focus of a forthcoming paper. Suffice it to say that the demands on the plan are greater than they would be under DC1.0. We have already mentioned that employers have little vested interest in taking care of members' needs once they have retired. Meeting best practice therefore requires fuller recognition of the plan's status as an independent entity established under trust, and a commitment to understanding members' positions and to seeking to maximise the value proposition presented by the plan. This may sound self-evident, but taking on a more complex, onerous challenge is not always the easiest route to justify – particularly when success is difficult to quantify and the most readily available metrics (eg relative time-weighted investment returns) are more consistent with the simplified objectives of DC1.0.

That said, there are a number of more outcome-oriented measures that can help to define success under DC2.0, including:

- Persistence and sufficiency of contributions
- Measurement of members' progress relative to their lifetime funding glide-path.
- Members continuing along recommended post-retirement pathways

DC3.0 – aspirational, or the future of DC

Under DC2.0, we mentioned the challenges imposed on plans by having only partial member information. With the advent of big data, and its application in developing bespoke algorithms, this is beginning to change.

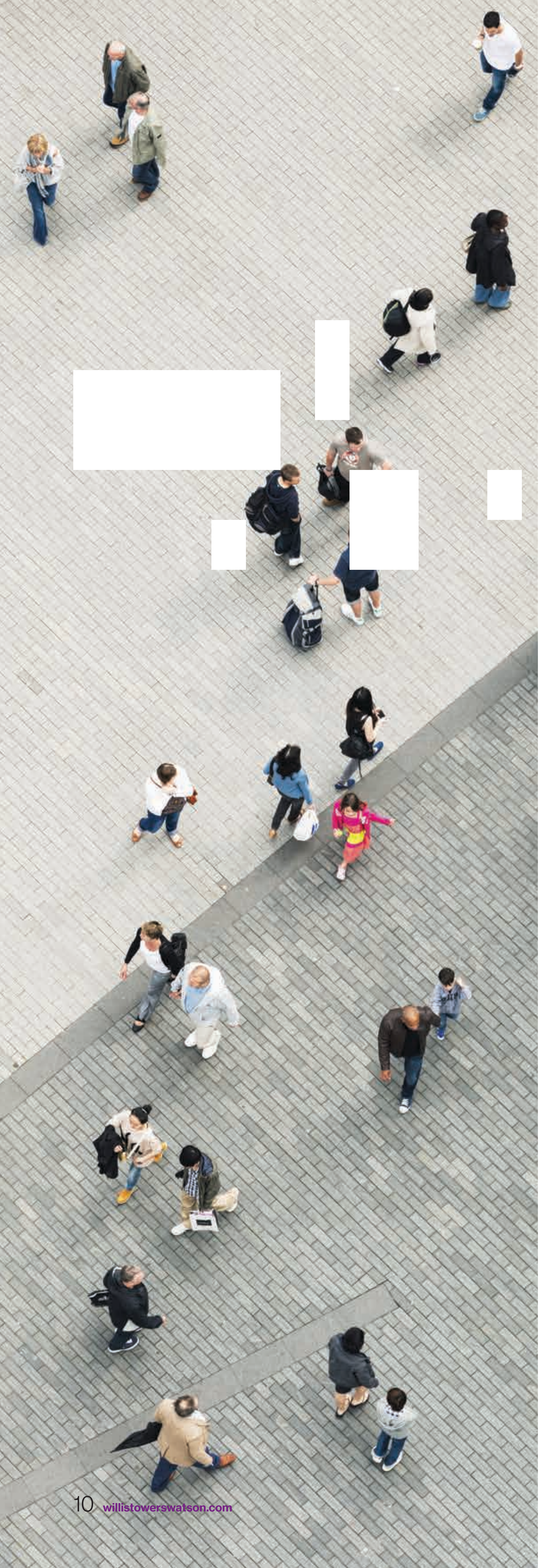
While at present it is not reasonable for plans to factor in members' other assets or personalised consumption profiles in determining their funding objective, in an ideal world doing so would be more consistent with the aim of helping manage members' lifetime savings and consumption. Furthermore, we envision a time in the not-too-distant future where the abundance of data will allow DC plans to offer individualised, integrated, whole-of-life wealth management – automated at scale.

In order for this scenario to become a reality, retirement plans will need approaches that integrate more advanced data capture and analytics. This is happening to some extent at fintech innovators, although they have yet to prove their credentials in an institutional context. Nevertheless, the retirement funding industry is not immune from disruption, and it is incumbent on organisations that want to remain true to their purpose and relevant to their membership to be open to new ways of delivering value.

There is also currently a regulatory constraint imposed on providing authorised advice. Until such time as DC plans are assured of some form of protection – often referred to as safe harbour – they will be reluctant to adopt a business model that tailors solutions to individual circumstances. That is, unless it becomes evident that the tailoring done algorithmically is superior for most members relative to the level of advice that is provided by humans, face-to-face (for some members only).

The table below summarises the three levels of ambition discussed in this section.

Plan conception	Governance objective	Implications for org design
▪ **DC1.0** Tax efficient workplace savings vehicle	▪ Facilitate access to range of savings products with some risk-based guidance ▪ Help maximise time-weighted returns given available investment options, subject to risk constraints	▪ Oversight of value-for-money, suitability and potential agency issues with respect to service providers ▪ Includes provision of individualised advice to assist members with pre-retirement planning and at-retirement decision-making
▪ **DC2.0** Post-retirement income provision vehicle	▪ Integrate accumulation phase with post-retirement consumption needs (factoring in pillar 1/state provision) ▪ Consistent with optimising whole-of-life money weighted return for member's DC assets, delivery of risk-managed outcomes in retirement	▪ Success metrics related to alignment and member commitment (persistence of saving), enabling member decision-making (particularly at and approaching retirement), management of risks that impact outcomes ▪ Compensation of governance entity members tied to achievement of success for the membership as a whole
▪ **DC3.0** Integrated whole-of-life wealth management vehicle	▪ Consistent with optimising whole-of-life money weighted return across all of member's assets	▪ Advanced data capture and analytics capabilities ▪ Algorithmic advice tailored to individual circumstances



Turning purpose into practice

In this paper, we have stressed the importance of a DC plan having a clearly defined purpose to guide its operations. Furthermore, we have given a clear steer on what we believe the orientation of this purpose should be, and its necessary supporting components.

Fundamentally, the purpose should align the actions of all stakeholders. This requires a process of socialisation, where inputs on refining the purpose are solicited and given due consideration and response. The process should be complemented by the establishment of explicit key performance measures that specify quantifiable (financial and extra-financial) 'success' over defined time periods, where success is defined in terms of members' interests and actual outcomes experienced.

And critically, the plan needs to ensure that its ambitions for what it seeks to achieve are supported by the appropriate levels of resources, be these financial, intellectual, human, or relational.[4]

Addressing the issue of purpose for a DC plan is but one piece of the retirement puzzle, and it should be considered in the context of the overall retirement system. We have in the past written about some of the global challenges confronting our aspirations to provide an adequate level of retirement saving for the population as a whole – we refer interested readers on this subject to our paper, "The impossibility of pensions".

Our intention in writing this paper was to highlight how current DC practice is only partially serving members' needs, and to look at how, through the process of revisiting a plan's purpose, this could be improved. We have outlined what we believe to be best practice in this regard, and have several exemplar organisations in mind who have succeeded in focusing their resources on what members truly need from a DC retirement vehicle.

[4] This alludes to the Integrated Reporting <IR> framework for assessing how organisations use inputs to create value, and groups resources used and value created according to six capitals. See www.integratedreporting.org

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

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About the Thinking Ahead Institute

The Thinking Ahead Institute seeks collaboration and change in the investment industry for the benefit of savers.

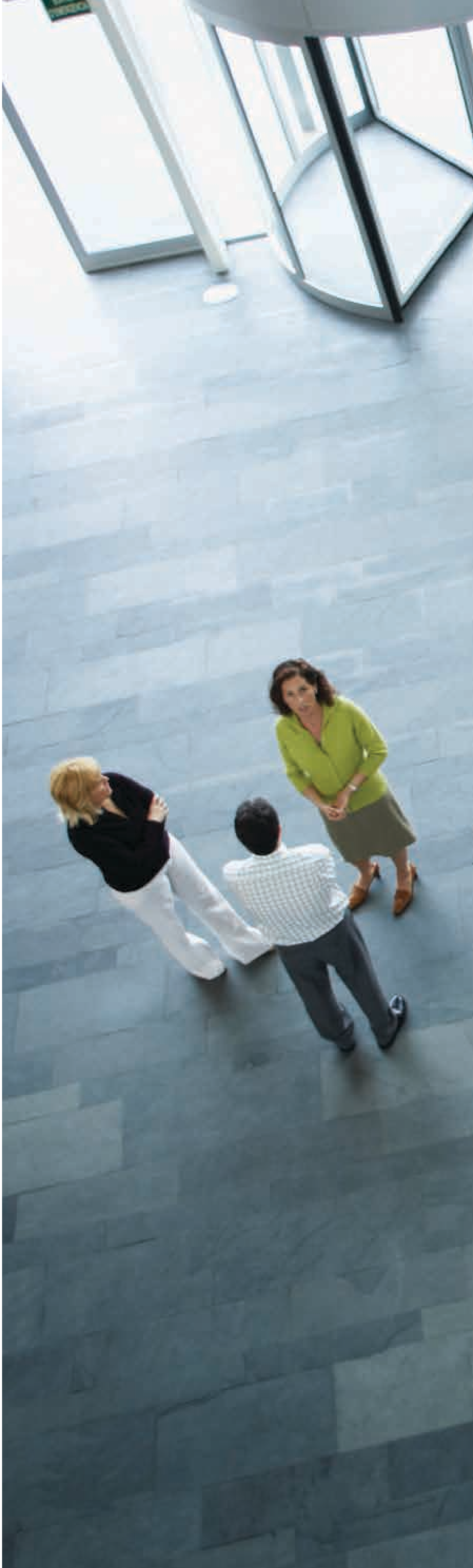
It was established by Tim Hodgson and Roger Urwin, who have dedicated large parts of their careers to advocating and implementing positive investment industry change. Hodgson and Urwin co-founded the Thinking Ahead Group, an independent research team in Willis Towers Watson, which was created 14 years ago to challenge the status quo in investment and identify solutions to tomorrow's problems.

What does the Thinking Ahead Institute stand for?

- Belief in the value and power of thought leadership to create positive investment industry change
- Finding and connecting people from all corners of the investment industry and harnessing their ideas
- Using those ideas for the benefit of the end investor.

The membership is comprised of asset owners and asset managers and we are open to including membership of service providers from other parts of the industry. The Thinking Ahead Institute provides three main areas for collaboration and idea generation:

- Belief in the value and power of thought leadership to create positive investment industry change
- Global roundtable meetings
- One-to-one meetings with senior members of the Institute.



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