

# NEST – The Future of Retirement

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*Submission from J.P. Morgan Asset Management*

## Consultation questions

**1. How will the trend for changing retirement patterns and provision affect what:**

**a. members need, and**

**b. employers want, from DC schemes in the future?**

There are several trends affecting retirement provision. The first is the trend towards later retirement ages. This is regarded as inevitable, given recent improvements in longevity, but it is not clear that everyone will be able to extend their working lives to the ages implied by the State Pension Age. In terms of retirement savings, this may mean that some people need to use their savings to tide them over until their State Pension Age.

The “freedom and flexibility” changes to UK pensions means that annuitisation is no longer compulsory (or, at least, difficult to avoid) at retirement. However, there is a risk that many individuals will exhaust their assets after only a few years in retirement. We therefore believe that many people – particularly those on lower earnings – will need some form of guidance in how they spend their assets throughout retirement and likely support from guaranteed income at retirement, whether this is through the mechanism of an immediate or deferred annuity, national pension benefits or personal (DB) benefits.

However, it is also important to note the imminent arrival of the flat rate pension, which will provide some protection for the lowest earners, and allows for some increase in flexibility.

For the employers, one concern that we have heard voiced multiple times, particularly by smaller companies and within manual labour-heavy industries is that they need employees to be in a position to retire at or around their expected retirement date ie: translate their savings into some form of income that enables them to stop working. These employers therefore need DC schemes focused on outcomes for members, and getting them to a safe level of replacement income at retirement. For some employers, especially those who are providing retirement provision as a result of auto-enrolment, DC pensions may be viewed as a cost of doing business rather than a paternalistic obligation. These employers may therefore want to avoid incurring additional administration fees, and to minimise the chances of any future liability in respect of current or past employees.

**2. How will the trends identified in this chapter evolve and what does this mean for DC design?**

The growing dependence on the DC market driven by the freezing of DB schemes, demographic changes and changes in make up of pension assets is a significant consideration for DC plan design.

When analysing the characteristics and needs of a DC scheme, the impact of auto-enrolment is significant, even in more mature DC markets. The observed plan contribution rates, balances and resulting income replacement rates appear lower as the adoption of auto-enrolment increases. However, when considering new savers affected by auto-enrolment were previously saving 0% into DC, overall savings rates have improved. The challenge of auto-enrolment, as acknowledged in this chapter, is the potential lack of investment and savings knowledge among these new investors. This is magnified by the greater flexibility and responsibility that is put into the hands of investors as we move further towards DC as the primary source of retirement savings. This requires significantly more education, communication and thoughtful plan design.

While communication may be more challenging, plan design that utilises less diversification and may be more conservative than the typical DB plan is potentially reducing the earnings potential for investors and is not an ideal solution as investors no longer have access to the previous DB investments. (Please see our response to question 8.)

**3. What conclusions should be drawn from the evidence presented on spending, housing wealth and debt for the needs of future NEST members in retirement? What other data on consumption and wealth should we be taking into account?**

We agree that consumption varies dramatically depending on individual circumstances. However, even when looking at aggregate trends, the path may not be linear. For example, the data provided on housing does not indicate the timing between retirement and reduction in mortgage costs, implying there may be a period in early retirement when mortgage spending is still high before the aggregate data provided materialises. In addition, combining the information provided on care costs and ageing demographics indicates that those costs will likely not materialise until much later in retirement. In reality, an aggregate path of spending may exhibit an immediate increase or plateau in spending just after retirement when leisure activities are at their highest and mortgages may not be paid off, then a decline towards 75 (reflected in the data provided in this chapter and ONS summary data) only to potentially increase again later in life as care costs become more significant in both residential cost and nursing/healthcare costs.

We do believe the data provided in this paper on housing, debt, care costs and inflation is a well formed representation of the main impacts to spending in retirement. One additional element to potentially consider is the impact of tax in retirement. Analysis from the DWP and our own internal analysis estimate income replacement rates to be around 70% of pre-retirement income. This incorporates both spending/savings changes as well as the impact of taxes when income levels decline in retirement.

**4. Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?**

We believe that all retirement solutions should reflect real member behaviour. The most appropriate way to design solutions is to understand what people actually do, not what we assume they do or even what they say they will do. We have carried out detailed member research on UK DC behaviour in the accumulation phase of retirement, which is reflected in our accumulation solution. While this research showed differing contribution levels, salary levels and dates of leaving the plan, we believe we have designed a solution that reflects the average behaviour of UK members.

We are looking to carry out detailed member research on behaviour into and in retirement. The ‘in retirement’ market may be more individual as members could leave the plan and seek a variety of solutions through a SIPP, an ISA, or buy an annuity for example, and we could therefore see wider disparity in behaviour. However, there will be commonalities that enable the design of default style solutions that are appropriate for a broad set of people. Across the market, the objective of generating an attractive and consistent income will be shared by the majority, while appetite for drawing down capital versus preserving it may be a differentiating factor. We believe it will be possible to meet different client needs through a suite of solutions, and possible to build solutions with the flexibility to be used differently by people with disparate spending patterns. What will be crucial is for individuals to have tools and services available to them that can help to define their retirement needs and select the most appropriate solution.

#### **5. Taking into account current retirement decisions, what people say they want and what the evidence says about behavioural biases, how are savers likely to act under the new freedoms?**

What people say they will do is often significantly different from what they actually do. The way in which people react to the new freedoms will be driven to a large degree by the way in which default options work and the guidance they receive. It is clear from the example of auto-enrolment and from initiatives such as “save more tomorrow”(R?) that inertia plays a significant part in the decision making process. Therefore if the default investments have a cash-like endpoint at retirement, and all communication is around the value of the funds, then a large number of people are likely to take their cash lump sum at retirement. If, conversely, the default at retirement is for the fund to convert to a drawdown product, and all communication before this point focuses on the payments that the retirement pot will generate, then it is more likely that the fund will be used to provide a steady flow of income in retirement.

#### **6. What member behavioural risks do providers need to manage?**

Understanding member behaviour risks is essential to developing investments which will be appropriate and supportive for members throughout their career. Members face a multitude of dynamic risks while saving into a DC scheme, some of which are specifically designed to be in the control of the members.

Member-controlled risks cover areas that hinge on member behaviour. These include:

- accumulation risk (failing to save enough to retire)
- member-user risk (misusing investment options with a resulting portfolio that is too conservative, too aggressive or under-diversified)
- and withdrawal risk (the timing and rate at which members utilise their assets). This last point is new to a large segment of the market, but based on insights from global markets, can be a significant risk to members in retirement.

At JPMorgan, we began analysing real-world individual member usage of US DC plans in 2005 and UK schemes in 2011. We have now gathered a decade of global DC member behavioural findings through vastly different market cycles and regulatory regimes. We have consistently observed two

interesting phenomenon. First, member inertia is exceedingly strong and movement into and out of investment choices, especially once defaulted, is very low on average. The second phenomenon is that when flexibility is granted, saving and withdrawal patterns are much more varied and volatile than most typical DC modelling would suggest. Our research, “Safely crossing the retirement finishing line”, highlights that a significant driver of DC success is how the size and timing of cash inflows interact with the size and timing of portfolio returns. This volatility in member-controlled cash flows, particularly in terms of accumulation and withdrawal risks, can amplify the volatility a member experiences.

There are several ways in which plan sponsors can help mitigate this potentially negative magnifying effect through effective plan design strategies such as automatic enrolment, contribution matching, automatic contribution escalation and appropriate default investment strategies. As investment providers, our focus is on introducing strategies that reduce volatility to help mitigate in both member-controlled and member-experienced risks.

## **7. Are there other risks and objectives to be taken into account for DC savers approaching and in retirement?**

In contrast to member-controlled risks, member-experienced risks are caused by factors that are largely out of the members’ control. These include:

- longevity risk (outliving retirement savings)
- market risk (being exposed to potential loss due to investment volatility)
- event risk (being exposed to potential severe loss due to a single extreme market event)
- inflation risk (losing portfolio purchasing power due to inflation)
- and interest rate risk (being exposed to potential loss due to rising interest rates).

These types of risks are usually best addressed through asset allocation choices. No one really knows what the future holds, either in terms of an individual’s spending needs, how long they will live or future market returns. However, there are some pragmatic observations that can be drawn from long-term historical trends and forward-looking expectations. Plan sponsors can apply these insights when selecting investment offerings that may help manage the uncertainties that inevitably come with retirement investing.

It is more important to understand how these risks impact each other than identifying or mitigating any one of these risks individually. Many of these risks are inversely related to each other. For example, mitigating equity market risk will often involve increasing fixed income exposures and thereby increasing interest rate risk. Building an appropriate diversified investment strategy involves balancing the risks together over time rather than placing an undue emphasis on one risk, thereby automatically increasing the risk of another.

## **8. What works in terms of communicating and getting DC savers to engage with decision making in the approach to retirement? How can we help members make good choices before and during retirement?**

As an industry we have a tendency to proactively over communicate to members. There seems to be a school of thought that if a member has been sent some information and not taken any subsequent

action, then what needs to be done is to send more information assuming eventually action will be taken. However, we believe we need to think about the way we communicate and why we are even communicating in the first place.

The single biggest factor that will affect a member's ability to retire is the amount they save. If this is the most important lever that can be pulled to affect income replacement levels, then member communications should focus solely on encouraging members to save more. Further information about how their money is invested should be available for members to access, if they wish, but there is no need to send it to them and dilute the key message about saving more. Communicate on matters that members can actually action i.e. whether they can afford to increase their contributions, rather than sending them every detail of the DC plan.

When it comes to communicating during the approach to retirement, we have to be realistic about when members will actually be in a position to make decisions. Most people simply will not be able to engage 10 or even 5 years before retirement so "wake-up" packs sent this early are likely to remain unread. Research would suggest that 2 years from retirement is probably the earliest people are able to properly start engaging with thinking about their retirement; however this may be too late to enact significant change in outcomes. Communication should be an ongoing process throughout someone's career.

Communications should be extremely simplified and focused on actionable decisions. Avatars or "people like you" may potentially be useful tools for members to relate to in their decision making. Simple decision trees that allow members to understand what the implications of their decisions may be – e.g. purchase an annuity and get a steady income for life, but no longer having access to your savings. Or if you take cash, you need to think about how long it will need to last you – 20k is a lot of money but spread over 20 years it's not much to live on.

#### **9. How can we help mitigate the risks associated with cognitive decline as people get older?**

There are a number of ways in which these risks could be addressed, but the safest approach is for people to commit when younger to solutions that will apply when they are older. This could mean the purchase of an annuity, investment in a fund that pays out a regular income with an age-appropriate strategy, or some other approach. However, the issue of financial decision in older age is a far broader issue than this, and we would encourage a much broader consultation on the subject.

#### **10. What is the role of default strategies in the new regime and the run up to and throughout retirement?**

As previously mentioned, member inertia is a significant driver of member behaviour and the use of default strategies. The role of a default strategy is to provide an appropriately diversified investment option to members who do not possess the time, talent or interest in managing the investments in their portfolio. While the design of the default option may need to be different in the pre-retirement accumulation phase versus the post-retirement decumulation phase, the importance of the default strategy remains. The need exists from the moment of initial investment into the DC scheme and continues until they make an active and individual choice to move their assets either in or out of the plan, whenever that choice takes place.

While member behaviour is often very diverse, understanding the behaviour of those most likely to be utilizing the default strategy is important in designing an appropriate default strategy. Providing defaulted members with a well diversified strategy with appropriate levels of risk is important. It is also important to recognise the risk to deriving the most appropriate default strategy from fee caps. The most appropriate default may well involve some sort of target date strategy, which itself would require changes to asset allocation over time. The lower any fee cap, the more difficult it becomes to provide the best diversified and dynamic asset allocation strategy.

**11. Should we consider having more than one default strategy for different types of member, and which variables can be reasonably used to differentiate member needs in the event of no member engagement?**

As discussed in question 10, the role of a default strategy is very important for members who do not have the time, talent or interest in selecting their own investments. Research has also shown that these members have difficulty selecting other attributes, such as risk preference, for determining an appropriate investment option. Therefore it is difficult to define a default option through information that requires member engagement and accurate responses.

Current default strategies are often determined by a single variable of member age, creating a single investable glide path. It is generally agreed that the amount of investment risk you take, especially in the accumulation phase of a glide path, should decrease with age. However, other individual characteristics of a member than can be gathered from available information, such as annual compensation, length of employment or type of employment, may not as clearly define one's risk tolerance or preference. Our research into member behaviour has suggested that the relative annual compensation of members does not make an appropriate measure of risk as the observed lower savings rates for lower earning members are partially offset by the higher proportion of national pension relative to higher earning members. They both need a similar level of investment growth to help get to a safe retirement. Other variables around type of member (for example, shorter duration / transient employees relative to long tenured employees) also do not make appropriate measures of an individual's risk tolerance.

Schemes may offer a range of multi asset options, but members being auto-enrolled will require a single default solution chosen by the sponsor.

**12. Based on the member evidence presented should the default target retirement age remain the same as state pension age? If not what are the alternatives?**

There is a strong argument for these ages to remain the same, because the state pension will be important for the majority of NEST's members. The fact that the state pension age will automatically adjust for changing life expectancy also makes this option attractive. However, it is possible that many of NESTS's members will be in jobs where working until age 67 or later will not be realistic – in particular those involving manual labour. This might suggest keeping the default target retirement age lower, as these funds could then be used as a buffer before the state pension age comes into payment.

**13. Based on the evidence presented, should purchasing annuity income be part of retirement planning for DC savers? If so - on average - what age should this purchase happen?**

J.P. Morgan research based on a dynamic withdrawal model using members' age and lifetime wealth level suggests that there is an important role for guaranteed income in retirement. Using a proprietary simulation framework, we examined various aging, lifetime income and retirement wealth scenarios. Holding age and retirement wealth fixed, there are two main findings regarding retirees' annuities.

The optimal withdraw rates at higher guaranteed income levels should be greater than that of lower annuity levels. The reason being higher secured income floor reduces the likelihood of extremely poor outcomes in retirement due to excessive withdrawals. At the same time, retirees with greater levels of guaranteed income should be more aggressive in their asset allocation, meaning larger equity allocations. As retirees have higher guaranteed income, their overall retirement income stream will be less vulnerable to any potential negative equity returns.

However, this guaranteed income could come from many different sources, such as the purchase of an annuity, national pension benefits or personal (DB) pension benefits. While the amount and role of guaranteed income is important throughout retirement in determining available income for annual expenses, overall risk tolerances and additional safe spending levels, the composition of the guaranteed income could change over time and therefore it is difficult to determine an overall appropriate level or timing of annuity purchase.

#### **14. Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?**

Iterative purchase of annuities and phased annuitisation can help to avoid spending all assets on an annuity when interest rates are low. However, there is only any benefit in this approach if funds are invested in non-matching assets that outperform annuity prices over the period of investment. This means not only beating the assets underlying the annuity price, but also outpacing the "mortality credit" implicit in annuity prices (that is, the portion of each annuity payment that represents the redistribution of payments from annuitants that do not survive). This becomes increasingly difficult as individuals get older and mortality rates rise.

#### **15. Should deferred annuities be included in the toolkit for DC retirement solutions?**

There is merit in using deferred annuities to provide some certainty of income at retirement by purchasing tranches of retirement income whilst working. However, because mortality rates are relatively low in the run up to retirement, investing can be an attractive alternative to buying slices of deferred annuity. This is because when the mortality credit is so low, it is relatively easy to outpace the investment returns underlying the deferred annuity, particularly when the additional risk capital required is taken into account.

Advanced life deferred annuities could offer an attractive way of limiting long-term longevity risk. Because mortality rates increase exponentially, only a small proportion of the pot at retirement is needed to provide longevity insurance, with the remainder being available to be drawn down. Given that it becomes increasingly difficult to self-insure against longevity as one ages, advance life deferred annuities may offer an important part of the toolkit.

However, the individual contract basis of an annuity and the resulting challenges to portability makes these investments difficult to integrate into any pooled fund structure, especially when combined with charge caps on DC defaults.

**16. Are there other ways of helping members hedge longevity risk?**

Another way of dealing with longevity risk is through advice, with members being kept continually appraised of the level of income they can safely draw down – and the appropriate asset allocation, dynamically managed through time– given their expected future life and other sources of income for example.

It is also important to recognise that all annuity strategies can be used to guarantee just part of the income rather than the entire pension, with the balance of a retirement pot being used to seek out stronger returns.

**17. Does investing through retirement, as an alternative to immediate annuitisation, have a significant role to play in meeting the retirement needs of DC savers?**

Investing rather than annuitising can make sense if an individual has sufficient funds to forego that they do not need the guarantees provided by an annuity. Investments alone cannot provide the guarantee of income for life, but staying invested through retirement can provide more flexibility of how and when income is used over time, which many investors will value. Investing is also more attractive the younger an individual is, due to the mortality credit mentioned earlier. Insurance companies face regulatory constraints on the investments that they can hold, and these constraints are reflected in the price of annuities. Following the removal of the requirement to buy an annuity, individuals can invest after retirement in a less restricted way. They – or the managers who invest their assets – are also free to take a broader view on the value of their retirement savings, focusing for example on the income provided as well as the market price.

**18. If you were designing a default drawdown strategy for NEST members, how would you do it?**

We believe such approaches will require innovation and are therefore interested in solutions that address the following issues:

- governance – including setting pay-out rules
- asset allocation and risk management
- flexibility for members
- incorporation of insurance for market and longevity risk.

Member behaviour analysis is critical to designing an appropriate solution. At present, with the new freedoms in retirement only coming into force from April 2015, it is difficult to carry out effective member research. However, for now, we know the current options available to members, we know that annuity sales have fallen roughly 50% from the March announcement to the end of 2014, and we know that people may want sources of income in retirement that take advantage of the new-found freedom (i.e., not an annuity or solution with a lock-up of capital). Knowing these factors, as well as understanding from our accumulation member research the average pot sizes and contribution levels, we could begin to think about an appropriate investment strategy.

With regards to portfolio design, we would begin by defining the objective and measure of success, reflecting our understanding of member needs. We would then think about these in relation to the risks that might hinder achieving the objective. For example, a retirement solution is a very long-term investment and needs to account for longevity risk, as well as the different market environments that can be experienced through time. It would also need to acknowledge cashflow volatility as members would frequently withdraw money, as well as being able to put in more. This would be balanced with the desire to use up the money efficiently, and not be overcautious resulting in under spending. Our approach would be to identify all the risks surrounding a decumulation strategy and seek to mitigate them, without over-emphasising one at the expense of another. While the initial asset allocation is highly important, the flexibility to move around this through time and a risk framework for doing so would be critical.

It would be extremely important for us to develop a strategy that is flexible so that we can adapt asset allocation through time to account for varying market conditions, as well as member behaviour changes through time and any new regulation. As the drawdown market evolves, we would proactively work with NEST to continue to ensure that the default solution is appropriate and has the potential to get as many members as possible safely through retirement.

**19. Should NEST consider some form of risk sharing as part of a solution for NEST members in retirement? If yes, what sort and why?**

Risk sharing – in terms of sharing risk between members rather than between the employer and the members – is in principle desirable. However, it comes with practical difficulties. Intergenerational smoothing – essentially smoothing equity returns over time – relies on equity values reverting to some fundamental value. Whilst this is a valid viewpoint, equities can depart from such a value for some time, perhaps years. This can result in perceived unfairness in the transfer of value, and even to adverse selection if investors are able to buy and sell units at will. Collective defined contribution (CDC) provides a further challenge as it potentially ties the member to a product with a particular income profile, reducing the choices that they would otherwise have under the “freedom and flexibility” proposals.

**20. Would there be benefits in combining a risk sharing approach and pure DC, and if so, what would these be?**

Risk sharing under pure DC is still potentially challenging, though there is a way in which one aspect of this approach could be used. This is in relation to annuities, and in particular advanced life deferred annuities. The consultation document correctly refers to the fact that annuities allow individuals to share longevity risk. However, whilst sharing the random risk of survival with each other, they transfer the risk of generally longer survival to the insurance company. This is the main reason that annuity providers must hold risk capital, which reverts to the insurance company if it is not required to cover higher-than-expected longevity. Because this longevity risk is proportionally greater for advanced life deferred annuities, the risk capital forms a greater proportion of the annuity price. This suggests that if annuitants could share the risk of greater longevity with each other, using a with profits-type approach they could also participate in the benefits of longevity only growing as expected, through increased pension payments. This is similar in principle to the way the ATP in Denmark works.

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