Schroder Investment Management Limited
31 Gresham Street, London EC2V 7QA

Tel: 020 7658 6000   Fax: 020 7658 6965
www.schroders.com

Mark Fawcett
Chief Investment Officer
NEST Corporation
Riverside House
2a Southwark Bridge Road
London
SE1 9HA

30 January 2015

Dear Mark

The future of retirement – a consultation on investing for NEST's members in a new regulatory landscape

We are pleased to respond to your consultation 'The future of retirement – a consultation on investing for NEST's members in a new regulatory landscape'. Schroders manages £3.8bn of assets (as at 30 June 2014) on behalf of defined contribution pension schemes and therefore has significant experience in designing and delivering solutions for DC members. However, as an investment only provider we feel that there are certain aspects of your consultation that we are not well placed to comment on. We have therefore limited our response to the areas where we feel we have a material contribution to make and where we feel we are well placed to respond.

Consultation questions

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

As stated in Chapter two, what people say they want or intend to do isn't actually borne out in the decisions that they make. While having no additional evidence to support this, we very much agree with this view from our DC experience. We believe therefore that it is an extremely difficult environment in which to develop appropriate DC solutions, with the conflict between what members say they want being, in some cases, directly opposite from what they actually do in practise.

Members value choice but many are not in a position, either due to lack of knowledge or pot size, to be able to take advantage of it. By catering for and indeed promoting choice many schemes may be in reality increasing the potential for poor member outcomes.   .

The responsibility for schemes must be to provide defaults that are in members' best interests assuming that the members do not necessarily know what these are. It is up to the providers of the solutions that underpin these defaults to ensure that they contain an appropriate mix of risk and return objectives according to the different stages of the member's journey.

We believe that risk reduction as members approach retirement is entirely appropriate but many existing lifestyle approaches do not adequately manage risk. As you state in Chapter two, members have a strong desire to protect against volatility and loss and a desire for a predictable outcome. However, volatility is only one form of risk. Other risks exist but due to their complexity, the danger is that members look to 'familiar' assets such as cash that they perceive as low-risk. We have seen a trend towards cash as an endpoint with two arguments being made to support this:

- First, glide paths historically have aimed for an end point of 25% cash and 75% bonds to accommodate individuals who would take the maximum tax-free cash and purchase an annuity. If the assumption is that many members will now want to take 100% cash then some believe that logically the asset allocation should follow this with a 100% cash end point.
- Second, cash is a good protector of capital and is probably the asset class best understood by most people. As members approach retirement, their priorities switch from maximising returns to increasing capital protection and liquidity. It is argued that there is no simpler way to achieve both aims than by investing in cash.

These two arguments whilst appearing reasonable, unfortunately are not fit for purpose in the post Budget environment. Cash worked (arguably) before as in most cases, schemes not only knew that members would take 25% of their pot as a tax-free cash lump sum, but also when they were likely to take it. Post Budget, it is far from clear when members will take their benefits and what they will actually do - take cash, buy an annuity, leave their pot invested, take drawdown, or a combination of all of these options. Amidst such uncertainty we believe that cash makes much less sense. It will certainly protect the member's capital in the short term but it won't protect it against inflation and won't provide sufficient growth to support any drawdowns from their pot over the longer term. A further argument against cash is that it could imply an implicit recommendation for members to take 100% cash. Such a move may be detrimental from a tax perspective which again is an area not well understood by many people.

There are much better default solutions that can help keep members' options open at retirement by protecting their capital and providing growth in excess of inflation at a cost that is not prohibitively higher than a cash fund. According to our research a multi-asset fund is likely to outperform cash in any but the most adverse market conditions, or over very short periods.

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

Chapter three provides, we think, a very clear explanation of the risks faced by DC savers. We don't think that there are any other mat5erial risks and objectives that should be taken into account. However, with so many risks and objectives it is important for these to be prioritised and carefully managed. The priority order of the different risks and objectives changes through the member's journey to retirement and will be different for each type of DC saver (as segmented in Chapter three).

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

Defaults have become even more important given the new freedoms available to DC savers. We think it is potentially dangerous for anyone setting a default strategy to try and second guess a course of action (such as annuity purchase or drawdown) based on a set of assumptions that may or may not be borne out in practice. These assumptions can take no account of other relevant factors such as benefits from other schemes (including defined benefits) or other wealth. It is also dangerous to assume a level of financial sophistication based on pot size, employment type or any other factor.

In our view, defaults need to provide members with sufficient flexibility at retirement in order that all avenues remain open at the point that they decide how they would like to access their benefits. As stated in your Consultation document, this is only likely to be at, or very close to, retirement.

The approach taken in a number of Australian superannuation funds to default DC savers down a drawdown route in retirement seems at odds with the choice and flexibility introduced by the UK legislation. The introduction of choice and flexibility (backed up by the guidance guarantee) seems very much to be the objective of the new legislation.

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?

Please see our comments under Question 10 above. While notionally appealing in reality we find the idea of multiple defaults contradictory, as members would either need to make a choice as to which default would be most appropriate for them or someone would need to make this decision on their behalf. As previously outlined, given the vast array of variables involved we cannot see any robust and repeatable mechanism for any third party to undertake such a segmentation of their membership.

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?

Purchasing an annuity is the only way to provide the security that DC savers say they desire. However, there is an inherent distrust of annuity products and a feeling that they offer bad value in terms of rates (this would probably be mitigated by purchasing at an older age) and on death. We would support the argument raised in Chapter six that the negative perception of annuities might be reversed if the policies were to be restructured in some way to address their perceived all-or-nothing nature.

It also makes sense that DC savers should increase security as they get older so consideration should perhaps be given to a pre-planned strategy that involves purchasing an annuity at a later date (possibly age 80).

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

We could see that a protected drawdown solution - looking to combine the best features (and avoid the less desirable ones) of standard drawdown and annuity products – could be attractive for DC savers. Such solutions might promise a pre-defined level of capital drawdown over a specified time period (e.g. 5% p.a. monthly until age 80) while retaining a degree of growth potential with the objective of also delivering a final lump sum to the investor (which is not protected however) - that could for example then be used to buy a standard annuity at the more attractive pricing offered to an 80 year old. This could be developed into a solution where asset managers and insurance companies collaborate to deliver individualised products that deliver a certain drawdown payment for life - essentially by combining the protected drawdown solution with the purchase of a deferred annuity for each individual at the point of retirement.

It is also worth noting that pre-retirement DC default products should be designed with the objective of transitioning the member smoothly into solutions like those described above (and definitely not with the objective of purchasing a spot annuity). For example a suitable precursor for a protected drawdown product might simply be an accumulation share class of the same fund, so that the retiring member need only switch (at zero cost) between share classes of the same fund when becomes necessary. Or again, a pre-retirement growth fund with an embedded floor that locks in market gains would make sense as a precursor for other drawdown / deferred annuity type solutions.

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

One of the main dangers for DC savers in retirement is 'running out of money' through overestimating the amount that they can withdraw based on an underestimation of their life expectancy. This does not appear to be a concern for the government and it is unclear whether State Pensions / Benefits are intended to be a 'safety net' in this scenario. Unless members moderate the amount they draw down from their pots, they will need to take some investment risk to generate enough growth in order that their pots keep pace with their withdrawals.

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?

Yes. We believe that investing through retirement will be key for DC savers in order to manage their cashflow requirements in retirement. We think that we will see the development of 'natural income solutions' - where the 'annuity' is delivered in the form of true income, via equity dividends and/or bond coupons. The best quality solutions will invest in multiple asset classes generating the required income and employ active asset allocation and/or systematic risk management to ensure the strategy remains risk appropriate over time. Such solutions already exist in the form of regular unit trusts, with the ability to generate income of c.5% p.a. while seeking to grow capital in line with inflation, however, they are management intensive and do not currently price below the DC charge cap.

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:

- **asset allocation and risk management**

We believe that a solution such as the secure distribution – income for life type product described in our answer to Question 15 might be an attractive option for NEST.

We look forward to further engagement with NEST on this consultation and other matters. Please contact me should you require any further information.

Kind regards

Yours sincerely

Stephen Bowles

Head of Defined Contribution

On behalf of Schroders