STATE STREET GLOBAL ADVISORS.

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Via electronic submission: nestresponses@nestcorporation.org.uk

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Dear Sir/Madam:

The Future of Retirement Consultation

State Street Global Advisors ("SSgA") appreciates the opportunity to comment on the 'future of retirement' NEST consultation paper.

For nearly four decades, SSgA has been committed to helping our clients, and the millions who rely on them, achieve financial security. We partner with many of the world's largest, most sophisticated investors and financial intermediaries to help them reach their goals through a rigorous, research-driven investment process spanning both indexing and active disciplines. With £1.2 trillion in assets, our scale and global reach offer clients unrivalled access to markets, geographies and asset classes, and allow us to deliver thoughtful insights and innovative solutions.

SSgA is the investment management arm of State Street Corporation and manages a number of investment mandates for NEST.

SSgA recently sponsored the Pensions Policy Institute ("PPI") research paper 'Supporting DC members with defaults and choices up to, into, and through retirement' - part of the '*Transitions to Retirement'* research program[1]. We think this qualitative research provides important insights for your consultation, and we refer to key findings where relevant below as 'Transitions'.

Q1. 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?

Our recent research surveys, including 'Transitions', support the view that retirement is becoming a more gradual process rather than a simple distinction of work one day and full-time leisure the next. DC Members increasingly expect to gradually reduce the amount of work they do, or move from their main career to a secondary career as they reach what were traditional retirement ages. In 'Transitions', most respondents could see themselves doing some work up to 70, some longer, either because they wanted to, or felt they needed to.

We believe DC members will increasingly want flexible access to their retirement assets in order to supplement their consumption as incomes from work reduce, and possibly also as a bridge until they become eligible for the state pension. They may also want lump sums to consolidate their financial position, for example to pay off mortgages, ahead of moving to part-time work.

Our research indicates that people do not have a firm understanding of how investing works and the majority do not know how their pension pot is invested or indeed whether it is "invested" at all. Experience suggests that people continue to talk about the "interest" that they earn on their pension which leads us to believe they consider pensions as akin to savings accounts rather than investment portfolios. This means that they are likely to consider pensions an extension of their bank savings account and will want, or indeed demand, to see it function in a similar way such as

[1] http://www.pensionspolicyinstitute.org.uk/publications/reports/transition-to-retirement-defaults

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having access to it as and when they need it, a regular stream of "income/interest", a chance to top up as when they can and ideally no chance of it falling in value.

In the absence of a mandatory retirement age, workforce management is becoming a key issue and employers want their DC members to 'come off their books' when their productivity starts dropping. This is particularly the case as older employees are generally on higher salaries, cost more in benefits, especially health insurance, and there is a perception that they may have lower productivity than younger colleagues. We believe that though the increase in the economic participation of the older workforce is something to be celebrated, the impact on employers of having workers not being able to afford to retire can be debilitating.

In our view, employers are looking for a pension scheme to help their employees plan for retirement at a reasonable age, encourage them to increase contributions, execute on the investment strategy in a reliable, predictable and transparent way and provide value for money; leaving the employer to focus on running their business.

Q2. How will the trends identified in this chapter evolve and what does this mean for DC design?

Research[2] shows there is a clear cohort effect, where many current retirees and those retiring in the near future, enjoy significant amounts of DB and state pension entitlement. These entitlements provide retirees with significant protection against inflation and longevity risk, meaning these risks can be given less emphasis in decisions to 'top up' DC assets. As prevalence of these entitlements reduces in the population, inflation and longevity risk will become more important, at least for mid earners and above where replacement rates from the single state pension are low.

Q3. 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 do not have any strong views on this question.

Q4. Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?

We believe this is only the case to the extent that the solutions need to be flexible to accommodate the heterogeneity of needs.

The knowledge of how people use saving accounts can be leveraged to create solutions that allow people to split their money according to relevant time horizons. For example, we would highlight the recently released retirement bonds issued by the UK Government - a one year and three year bond was released with differential interest rates. Most people should be comfortable with the idea of splitting their capital up into funds that target different time horizons with longer dated funds taking more risk and thereby increasing the chance of providing them with more return. It remains to be seen whether this type of approach is something they will engage with and actively choose, or something that is part of a default strategy.

Q5. 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?

Whilst the future behaviour of UK retirees cannot be fully predicted, we think that further in-depth research, such as that undertaken by the PPI in 'Transitions' and by NEST itself, can help to

[2] http://www.pensionspolicyinstitute.org.uk/publications/reports/transitio -that-pension-savers-need-to-make-at-retirement

predict likely actions. We also believe that evidence can be derived from the behaviour of participants in the more mature, and increasingly similar, US and Australian markets. On this basis we are optimistic that, over time, consumers will gain an increased understanding of the options open to them in addition to helpful heuristics that, together with innovative default products and effective guidance, will lead to improved and more flexible outcomes.

Overall, we understand that inertia is powerful and we would expect defaults and the path of least resistance to remain the biggest influences on choices and behaviour.

We believe it is imperative to track the actual behaviour following the reforms and of creating future-proof arrangements that can evolve if and when behaviour and needs change.

Q6. What member behavioural risks do providers need to manage?

We believe providers need to try to manage inertia and avoid inappropriate and undesirable outcomes such as members encashing all their pension money and putting it in a bank account which will result in them being moved to the next tax band. To prevent such situations, providers could put in place a policy of contacting members if they received an encashment request of more than a specific amount, for example £10,000, or walking members through an online process to ensure that they understand the result of their actions and what other options are available to them.

Q7. Are there other risks and objectives to be taken into account for DC savers approaching and in retirement?

We regard this list as comprehensive.

Q8. 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?

The 'Transitions' research suggests DC members only really form a firm view of retirement prospects one or two years out from actually retiring which suggests effective and behaviour-changing engagement will be a challenge in the years prior to this. Further to this, the PPI sample found it very hard to predict the actual date of their own future retirement. SSgA's own research indicated that most people can only frame their own anticipated retiring date within a five year 'window' even very close to retirement itself.

While increasing engagement is a positive aspiration we fear that even the most engaged consumer simply may not know the answer to these questions. We would stress the importance of well-chosen and well governed defaults to provide good outcomes for those members unable or unwilling to engage significantly with the choices they face or who are unable to predict their own position in to the future.

Q9. How can we help mitigate the risks associated with cognitive decline as people get older?

We believe the best way to mitigate these risks is to provide well-chosen defaults and retirement paths that are mapped out in advance in the earlier years of retirement and which require limited engagement from older retirees. Solutions such as pre-buying deferred annuities or the adoption of enduring powers of attorney may help in this regard.

Q10. What is the role of default strategies in the new regime and the run up to and throughout retirement?

A default investment strategy in the run up to retirement will be required on the basis that members do not form a firm view of how they will use their retirement assets until a short time

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before retirement. That default needs to be flexible enough to do deal with uncertainty of when people will retire and how they will use their assets, therefore it will need to have a hybrid objective rather than be optimised for any single course of action and retirement date.

The possible exception to this is for retirees in the immediate future, for whom encashment of small pots is the most likely course of action, though again there is uncertainty as to when they may want to do this.

Q11. 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?

We believe this is only necessary to the extent that auto-enrolled members retiring in the near future will have small pots and could be defaulted to a cash objective strategy.

The approach of using member data to split cohorts into different defaults only works effectively if there is a complete and holistic view of their retirement savings and even then, a large number of assumptions will need to be made on the what exactly a member will do with that money and when they will do it.

In general we are concerned that, in the near-term at least, any multiple-route approach that relies heavily on member engagement well ahead of the retirement date is untenable. Consumers have largely been disengaged in the accumulation phase and we believe that any meaningful engagement later will take a while to evolve. Even if engagement is achieved, a significant barrier is the fact that members just do not know how they may wish to interact with their DC savings in the future.

Q12. 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?

We believe it should remain the same, if only for the want of any other obvious anchor. However, we believe the asset allocation glide path should not be very sensitive to the precise date, in order to allow for the uncertainty of the actual retirement date (i.e. have a relatively shallow glide path).

Q13. 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?

In our view, the combination of mortality drag and the need to manage longevity risk makes the case for a continued role for annuitisation in later retirement. Conversion risk and issue of cognitive decline suggest that annuitisation should be done on a phased and/or deferred basis rather than the purchase of an immediate annuity at, say, age 80 or 85.

Q14. Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?

Please see answer to Q13.

Q15. Should deferred annuities be included in the toolkit for DC retirement solutions?

We believe they should be included with the role as described in Q13 above. We would also highlight the need to take account of the fact that the supply side of the market is not currently well developed.

Q16. Are there other ways of helping members hedge longevity risk?

We recognise that there may be a latent preference for longevity insurance and there is some evidence of this in 'Transitions' but we do not have any strong views on this question at this time.

Q17. Does investing through retirement, as an alternative to immediate annuitisation, have a significant role to play in meeting the retirement needs of DC savers?

We believe investing does have a role to play with DC members being keen to retain access to their capital while drawing an income which will require an investment strategy to generate reasonable levels of sustainable income. DC members using such a strategy face sequencing risk, where early poor returns can have significant negative consequences for the sustainability of income. Hence, it is very important to manage volatility, for example through active asset allocation or explicit, low cost, volatility controls. We also believe that people will be drawn towards well managed and governed low cost defaults in the same way that they are in accumulation. We do not anticipate that the UK Government's 'Freedom and Choice' changes will automatically lead to a nation of investment savvy retirees with the knowledge, time or desire to manage their own investment portfolios.

Q18. If you were designing a default drawdown strategy for NEST members, how would you do it?

We believe the most important characteristics of the default drawdown strategy are:

- Diversification
- Volatility management
- Low cost
- Focus on total return rather than just natural income
- Guideline payouts set by the trustee on a sustainable basis based on expected return but with scope for the DC member to vary
- Includes an option to include a deferred annuity from a late age

Q19. Should NEST consider some form of risk sharing as part of a solution for NEST members in retirement? If yes, what sort and why?

We do not have a strong opinion on this. We note that in general economies of scale and good governance can deliver many of the benefits often ascribed to collective approaches, as well as avoiding the communication complexities of a product that the vast majority of the population will not be familiar with.

Q20. Would there be benefits in combining a risk sharing approach and pure DC, and if so, what would these be?

Please see answer to Q19.

Thank you once again for the opportunity to comment on the important matters raised within this consultation paper. Please feel free to contact me should you wish to discuss SSgA's submission in greater detail.

Sincerely,

Nigel Aston

Head of European Defined Contribution, State Street Global Advisors