Building personal accounts: designing an investment approach

Key findings of the public consultation

November 2009

personal accounts delivery authority

helping millions save for their retirement

Contents

Foreword

Publishing the summary of responses to our investment consultation marks a significant next step towards developing investment recommendations to the trustee corporation of the personal accounts scheme.

Constructing an investment strategy that is suitable for the diverse needs of millions of personal accounts members is a significant and complex undertaking. This response document is the culmination of an unprecedented level of engagement and debate with more than a hundred organisations to make sure we get this central issue right.

The document incorporates written responses to our discussion paper, the outcomes of a series of roundtable debates held this summer and the experience of pension schemes internationally. We have captured industry best practice, new innovations and some of the latest research and analysis to produce this summary of our stakeholders' views and our emerging thinking.

I am extremely grateful for the time and goodwill that our stakeholders and other interested parties have committed towards shaping our thoughts. The quality of debate, the evidence provided and the best practice and experience shared have been impressive. This gives me confidence that we are on course to deliver an investment strategy that best meets the needs of all future members.

A number of areas where we have sought your views reveal an emerging consensus on a number of issues, such as the importance of understanding our future membership and the relevance of responsible ownership in the way members' contributions are invested. Other areas, for example what the overarching investment objective should be, demonstrate the complexity and variety of approaches that could be taken. Where there are mixed views we have committed to further engagement and research to ensure that the recommendations we make to the trustee corporation are based on the best possible information and evidence.

Many future members will have little or no experience of investment and most will have not saved for their retirement previously. Developing an investment strategy that provides ongoing confidence in the importance of saving and investing, a strategy that can be delivered at a low charge, and a strategy that improves the incomes in retirement of all members, will be amongst the most important things the Personal Accounts Delivery Authority (PADA) and the future trustee corporation do. The willingness to help PADA get this right from all who contributed to the consultation process reassures me that the recommendations we deliver to the trustee corporation will have broad support and most importantly, provide the best solution for scheme members.

I look forward to the ongoing debate.

Tim Jones
Chief Executive

Executive summary

Chapter one – Purpose of the response document

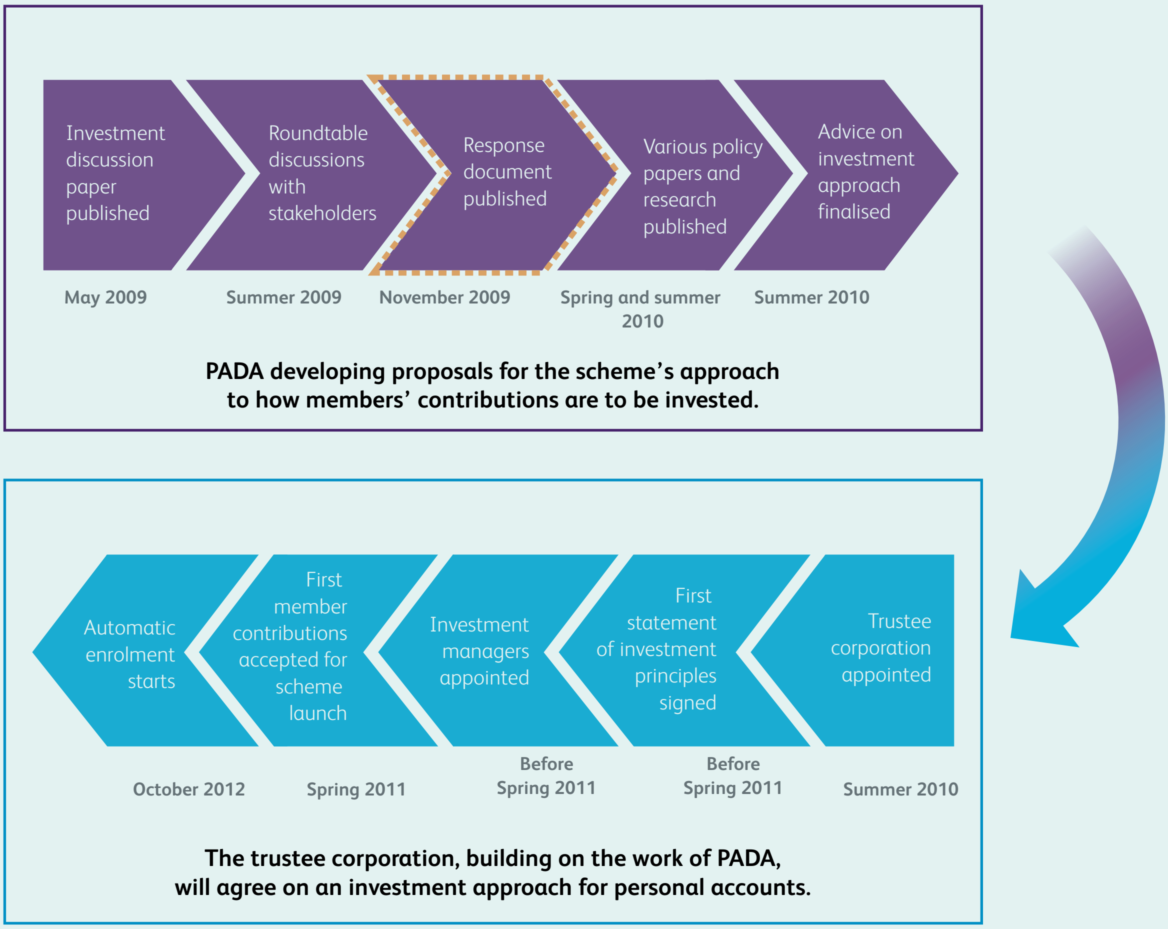
The purpose of the response document is to set out the key findings from our public consultation on the investment approach for the personal accounts scheme. As part of the consultation we published a discussion paper *Building personal accounts: designing an investment approach* and held a series of roundtable events.[1] We received 67 responses to the discussion paper and over 100 stakeholder representatives attended the roundtables. Throughout this process we have been particularly focused on who the personal accounts members will be and which approaches to investment and promoting confidence in savings will best suit their needs. Underpinning this is our objective to deliver a simple and low-charge scheme. The response document does not set out our recommendations to the trustee corporation for the investment strategy of the personal accounts scheme, but it does represent a significant milestone in the development of those recommendations.

The consultation gave stakeholders the chance to express their opinions and gave us the opportunity to learn from their knowledge, experience and expertise. We engaged a variety of stakeholders, both nationally and internationally – including the pension and investment industries, employer organisations, unions and consumer groups, academics and pension fund trustees. We are extremely grateful for the high level of support and the quality of responses we received from everyone. The input from this consultation has helped us to further develop our understanding and identify gaps in our analysis, as well as uncover new ideas for the design of an investment approach that best suits future members.

There are a number of areas where we now believe the way forward is clear, with both our research and stakeholders' views being aligned and these are highlighted in the document. There are other areas where stakeholder opinion is mixed and we feel further research and analysis is required. This response document does not signal the end of our engagement and we will continue to work closely with our stakeholders on these issues. Figure 1.4 sets out the next steps for the delivery of the investment approach of personal accounts.

1 PADA held a series of roundtable discussions on key aspects of the investment approach, from 15 June to 29 September 2009. The roundtables brought together a range of stakeholders to generate debate and uncover new evidence and ideas.

Figure 1.4 Next steps



Further information on this figure can be found in Chapter one.

Chapter two – Who will our members be?

"We are acutely aware that many of your members will come from a background of low financial capability. Many will also display a very low degree of engagement, often relying on the default arrangements for joining, for choosing a contribution rate and for choosing an investment fund."

Pensions Management Institute

Our stakeholders agreed that understanding members will be critical to designing the investment approach of the scheme. The investment approach needs to be built around scheme members' needs, wants and aspirations if personal accounts is to engender confidence in saving for retirement.

In the discussion paper we set out the key characteristics we thought were relevant based on research into personal accounts' future members. Our findings suggest that members are likely to have relatively less appetite for risk, find making financial decisions challenging and have little experience of investing or saving. Stakeholders confirmed that the Personal Accounts Delivery Authority (PADA) is on the right track in understanding what behaviours and characteristics members may exhibit.

Some respondents thought that earning profiles, levels of engagement and age should also play a role in designing the scheme. Other respondents thought that the way members respond to loss, or the possibility of loss, could also have relevance to the investment approach. They thought that members experiencing losses in their fund would be more concerning for some members than taking investment risk, and both managing risk and minimising losses over the life of a member's savings career will be important. Some respondents suggested that member characteristics such as gender, ethnicity and disability may also have an impact on the behaviour and contribution profiles of members. PADA is conducting further research on all of these suggestions to better inform our understanding of how the investment approach can best meet all scheme members' needs.

Ensuring the investment approach is suited to the scheme's membership has been central to our thinking. It is also vital that employers are comfortable with automatically enrolling their employees into a scheme that the employer has chosen. Feedback from employers and their advisors highlighted the importance of fund performance when they consider which scheme to offer to their workforce. Both our research and the views presented by stakeholders suggested that employers were equally keen for the investment approach of personal accounts to focus on the characteristics and circumstances of future members, particularly as the scheme is aimed at individuals who are on low-to-moderate incomes and who are unlikely to have contributed or had access to an occupational pension scheme before.

Chapter three – What should the scheme's investment objective be?

"If you don't know where you are seeking to go, you are unlikely to get there, and you can't measure whether you got there."

JA Pensions Consulting

Getting the investment objective right is perhaps the most pivotal step to ensuring that the investment approach can be designed to meet the characteristics and expectations of personal accounts members. Reaching a conclusion on the investment objective is essential to help the trustee corporation set the strategic asset allocation and to help members plan for their retirement with more confidence. The importance of the investment objective has been matched by the difficulty in finding consensus among our stakeholders as to what such an objective should be.

In the discussion paper we looked at how to go about reconciling an overarching objective for the personal accounts scheme with meeting the needs of its individual members. The chapter also discussed how personal accounts should communicate with members and how it can promote confidence in saving through its investment objective.

Stakeholders agreed with PADA's findings that regular contributions have more of an influence than investment performance in maximising members' incomes in retirement. There was little agreement on what the trustee corporation needs to do to encourage regular contributions into the scheme. Some stakeholders thought the trustee corporation should focus on what it thinks is in the best interests of members based on their economic circumstances, rather than relying on survey data that may suggest members have different attitudes to issues such as investment risk. They thought this was particularly the case if members are not likely to engage with the scheme. This could mean taking more investment risk than members indicate they are comfortable with in order to achieve potentially better outcomes in retirement. In contrast, other stakeholders argued that the most important factor for future members will be the preservation of their capital throughout their savings career. It was suggested that future members are more likely to have a savings mentality that is aligned with a building society, rather than an investment fund.

Respondents and roundtable participants agreed that the investment objective should be geared towards achieving adequate incomes in retirement for members, but there was little consensus as to what form this objective should take. Each of the three broad approaches discussed in the discussion paper – benchmark-driven return, target replacement income and best efforts – were observed by stakeholders to have strengths and weaknesses. Both target replacement and benchmark approaches were felt to be vulnerable to creating false expectations among members, while best efforts was commonly believed to be too loose a concept to communicate to members or to allow the trustee corporation to judge or be judged on their progress.

PADA acknowledges that it is unlikely there will be a consensus view as to what the overarching investment objective of the personal accounts scheme should be. After having listened carefully to the many opinions expressed by our stakeholders we feel that the likely characteristics of members and the importance of ensuring they see the benefits of saving for the long term points to a benchmark objective. The benchmark needs to be in line with the expectations of the scheme's membership, be easily communicated in a manner that has some meaning to them and give the trustee corporation a target that is clear and measurable. This suggests an objective that is aimed at achieving returns in excess of inflation, or cash, after management charges.

Of the many respondents who thought that a benchmark objective was the best solution, the majority thought that an objective that sought to generate returns in excess of inflation was the most suitable. We agree with this view and believe that such an objective will help create confidence by having an aim, at the minimum, to maintain the buying power of members in retirement. The trustee corporation can take an informed view on how much excess return above inflation should be targeted, and how much risk is appropriate over a member's savings career. The further research into the characteristics of future members being conducted by PADA will help shape this view.

Stakeholders agreed that maintaining members' confidence in the scheme will be of utmost importance and cited managing expectations, delivering consistent returns and minimising losses and robust governance as important factors to achieving this. Stakeholders also believed that effective communication will be central to building confidence. The strong message which we have taken from stakeholders is that any communication should be simple and concise, accessible and outcome focused.

The discussion paper also asked respondents how they felt about strategies for risk sharing in the scheme. While respondents appreciated that this could be an appealing concept for many members to minimise unevenness in member outcomes, most felt that it would be an unrealistic aspiration certainly in the early years of the scheme. Some respondents encouraged PADA to consider new strategies and seek to be innovative in this area going forward.

Chapter four – How should members' contributions be invested?

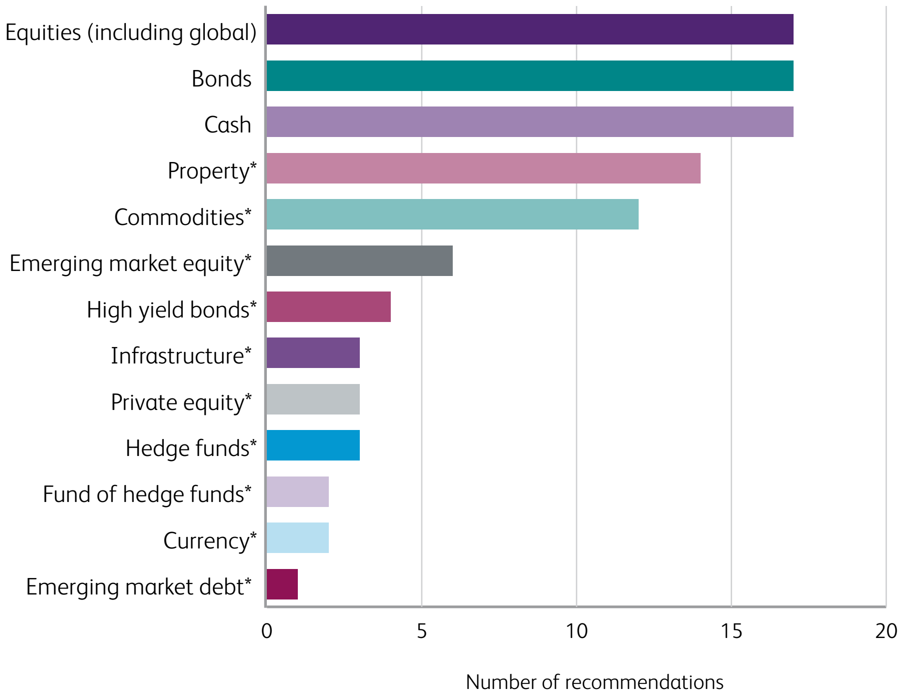
"We believe the trustee corporation should balance risk/reward objectives of the default fund against the effects different investment strategies may have on membership persistency."

AEGON

In the discussion paper we set out the key issues around the approach to asset allocation, investment management style and fund manager selection that the trustee corporation will need to consider in order to deliver the investment objective. We referred to evidence from academic research, existing funds, and best practice in the UK and internationally to help develop a picture of potential investment strategies for the default fund. We sought views on the types of asset classes, levels of diversification and what role, if any, tactical asset allocation or securities lending should play in delivering an investment solution that adheres to the principles of a low-charge scheme.

The majority of respondents agreed that a wide range of asset classes should be used alongside the traditional building blocks of defined contribution investment, such as equities, bonds and cash. Alternative asset classes were felt by most respondents to be suitable for a scheme that is likely to be significant in size and could offer important ways of increasing returns or managing risk. Most respondents who cited specific asset classes thought that property and commodities would offer appropriate diversification alongside traditional asset classes. The asset classes that respondents recommended personal accounts could use are shown in Figure 4.4. Although investing in alternatives was identified by stakeholders as creating challenges around liquidity, daily pricing and costs, they thought these challenges could be overcome.

Figure 4.4 Recommended asset classes



Source: PADA 2009
Base: The above chart shows the number of times each asset class has been mentioned by respondents
* These asset classes are defined in the glossary

Further information on this figure can be found in Chapter four.

Generally, respondents recommended the most dominant investment style should be passive management in order to meet the commitment to deliver personal accounts at low cost. Active management was thought to have an important role to play in areas where it can add value and where a passive approach is less effective or unavailable, such as smaller and less efficient equity markets and alternative asset classes. Respondents agreed that selecting good quality active managers that will consistently outperform is a difficult task.

Respondents were also divided on whether tactical asset allocation should form part of the investment approach. Strong views were expressed both for and against the effectiveness or suitability of tactical asset allocation. Most respondents were supportive of securities lending to generate additional returns for the scheme on the proviso that a clear and consistent policy is developed and security lending activities are carefully monitored.

Chapter five – Approaching retirement

"We believe the traditional lifestyling philosophy of de-risking the investment portfolio as a member ages is appropriate for the scheme. However, we believe a target-date fund strategy would offer a superior way of implementing the approach."

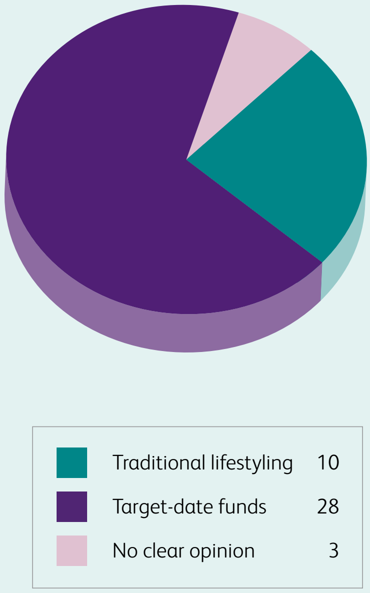
Alliance Bernstein

Ensuring members' contributions are invested appropriately throughout their savings career will be essential for achieving the best outcomes for personal accounts' members and promoting confidence in saving for retirement. As members approach retirement the strong view of respondents was that a lifestyling strategy should be adopted for the default fund.

In the discussion paper we discussed 'traditional lifestyling' and explored target-date funds as an alternative delivery mechanism. We sought views on how effective each version is in improving operational efficiency, lowering costs and managing risk effectively throughout an individual's savings career.

Nearly all respondents appreciated the need for lifestyling in the default fund and there was strong support for target-date funds and the perceived advantages they provide over traditional lifestyling. Respondents thought that target-date funds would be easier to communicate to members, be administratively simpler, have greater cost efficiency and offer increased flexibility. Stakeholders on the whole thought target-date funds would better suit personal accounts because of its likely size and its commitment to being a simple and low-charge scheme. Figure 5.1 shows the strength of support for a target-date fund approach.

Figure 5.1 Preferred method of lifestyling



Source: PADA 2009
Base: 41 responses to our discussion paper addressed this issue

Further information on this figure can be found in Chapter five.

Most of our stakeholders believed that although target-date funds are a more effective delivery vehicle for personal accounts, outcomes for members in retirement will still depend on a careful and considered asset allocation over the course of their savings career.

A number of stakeholders proposed a new approach to defined contribution investment. They thought that the traditional notion that younger individuals had a greater capacity for investment risk – as they had their careers ahead of them to make contributions and had more time to recover any short-term losses – may not match the characteristics or circumstances of likely members. These stakeholders argued that while younger members may have more capacity for taking investment risk early on, they are equally likely to have less experience of saving and may have less appetite for risk. The argument continued that in the early years of saving very little capital is accumulated and even if a significant amount of investment risk is taken, the investment return on a small amount of capital is relatively marginal and makes little difference to the final outcome at retirement. In order to persuade individuals that saving for retirement is worthwhile, stakeholders suggested that a strategy with lower levels of investment risk during the early years of saving may be more likely to encourage members to continue contributing and build up sufficient capital to provide the foundations for investment in growth assets in later years. PADA feels that this approach may have considerable merit for the future members of personal accounts.

Most respondents thought that alternative approaches to lifestyling, such as target-return ('banking') products, structured guaranteed return products, and constant proportion portfolio insurance, offer some advantages but these are outweighed by the disadvantages of increased cost and complexity. Respondents did not think they were appropriate for personal accounts given the remit to be a simple and low-charge scheme.

Chapter six – Responsible ownership and its role within the personal accounts scheme

"The Trades Union Congress believes that the personal accounts scheme should seek to integrate environmental, social and governance issues within an approach based on shareholder engagement and an active voting strategy. Thus the range of issues on which the personal accounts scheme would engage with companies and that would affect voting decisions would extend beyond corporate governance factors and include social and environmental issues."

Trades Union Congress

Since the publication of our discussion paper, the issue of how shareholders and particularly institutional shareholders approach their responsibilities as owners of assets has come under further scrutiny by government, regulators and the members whose pension savings are being invested. They have been increasingly considering corporate governance, market standards, principles of stewardship and interactions between institutional shareholders and companies as a coherent whole in exercising ownership rights. We summarise the latest developments in this field within the chapter.

In the discussion paper we addressed the subjects of corporate governance and responsible investment separately in different chapters. Throughout the consultation it has become clear that many of our stakeholders view these activities as being part of the same sphere – and in this document we have reflected that view and integrated the two chapters on corporate governance and responsible investment into a single chapter named 'responsible ownership'. The chapter looks at the extent responsible ownership should be pursued within personal accounts and how this could be best delivered within a low-charge scheme.

We define ‘responsible ownership’ as: “the responsible use of ownership rights attached to assets to protect and enhance shareholder value over the long term. This is achieved primarily through voting and engagement to influence companies to consider corporate governance, social and environmental risks and opportunities”.

Issues that respondents raised where responsible ownership will play a role for institutional shareholders in the future included: the importance of asset owners in ensuring the good governance of corporations; the role asset owners should play in trying to limit the likelihood of future financial downturns; the role that asset owners have in recognising issues of sustainability and the finite nature of the planet’s resources; the reputational impact on corporations who have poor labour relations or where child labour is used in supply chains; the impact on global wealth and asset value of climate change; and the opportunities and challenges presented by the move to a low-carbon economy.

There was broad consensus among our stakeholders that responsible ownership should feature in the investment approach of personal accounts. They believed that being a responsible owner decreases risks and can help improve financial performance. Many stakeholders recommended that the trustee corporation should formulate a clear aspirational policy on responsible ownership from the outset and then pursue a phased approach to achieve this objective as the size of assets under management grows. There was broad consensus that the benefits of responsible ownership should be applied to all funds and not only be considered for the default fund.

Although it was recognised by almost all respondents that responsible ownership, in some way or form, should play a role within personal accounts there was little agreement on how this could be best delivered. Respondents recommended either outsourcing – to fund managers or a responsible ownership overlay specialist – developing an in-house capability, or using a mixture of all three approaches. Respondents generally thought the method of delivering responsible ownership would develop and change as the assets under management grow.

The personal accounts scheme is likely to be responsible for investing significant amounts of members’ money in the future and has the potential to be an influential shareowner and holder of debt instruments in corporations in the UK and globally. We will continue to build on the evidence and information provided through the consultation to ensure that our recommendation to the trustee corporation on this important issue will deliver a responsible ownership policy that best suits all future members over the long term.

Chapter seven – Choice: How much is enough?

"We agree that too much choice can be detrimental to the success of a scheme. This is not only from the effect of too much information on choices confusing members such that they do not make a choice or join a scheme, but also where members do choose but make inappropriate choices and are less likely to review them after the event due to the effects of inertia."

Mercer

Like many defined contribution pension schemes, we expect the majority of members in the personal accounts scheme to be invested in the default fund. Given the potentially large and diverse membership of personal accounts, it is likely there will be some members whose financial needs and values require alternatives to investing in the default fund. In the discussion paper we consulted on what those fund choices should be and how they could be offered to members.

The majority of stakeholders supported offering some degree of choice outside of the default fund. They recommended keeping fund choices clear, simple and small in number to help members make sensible decisions and be consistent with a low-charge scheme. Stakeholders suggested offering different risk-graded funds to the default fund, an ethical fund and a religious-compliant fund, such as a Sharia fund. Nearly all respondents agreed that any funds offered should not retain the branding of the financial services provider. This was thought to be inconsistent with a simple and low-charge scheme and not in the interests of members. Taking this forward we will be conducting research into ethical and religious-compliant funds to better understand demand, the features that should be offered and how they can be best delivered at reasonable cost. There was general agreement that personal accounts should consider constraining the number of switches between funds made by members.

The case for lifestyling fund choices and dealing with the extra costs associated with these choices was less clear. Although the majority of respondents to the discussion paper argued that lifestyling should be applied to alternative funds in the same way as it is applied to the default fund, roundtable participants were divided on whether lifestyling should be applied to all, or only part of the wider fund choices. Similarly, respondents believed that costs should be ring-fenced between funds and there should be no cross-subsidy between the default and alternative choices, whereas roundtable participants were divided on this issue. Our research into alternative fund choices will look at the costs of offering these funds, and the impacts different costs may have on members.

Chapter one
Purpose of the response document

The purpose of this response document is to set out the key findings from our public consultation on the investment approach for the personal accounts scheme. The consultation informs our advice to the trustee corporation, which will be responsible for running a low-charge pension scheme for low-to-moderate earners. Ensuring that personal accounts is designed to its member demographic will be critical to the success of the scheme. These decisions will affect the retirement outcomes of members and will influence participation in the scheme and confidence in the benefits of saving.

As part of the consultation process, we published a discussion paper and held a series of roundtable discussions. We are very grateful for the high level of support and engagement we received from stakeholders and the ideas for long-term investment they put forward.

Purpose of this document

1.1 The Personal Accounts Delivery Authority (PADA) conducted a public consultation on the investment approach for the personal accounts scheme throughout this year. This was supported by the publication of our discussion paper in May 2009, *Building personal accounts: designing an investment approach*. The response document sets out the key findings from that consultation and outlines the next steps of our approach. **It is not the purpose of this document to set out recommendations on the investment strategy of the scheme.** We are very grateful for the high levels of support and engagement we received from our stakeholders. We have used the consultation process to draw on the considerable expertise and best practice in existence in the UK and internationally. Although the consultation period for the discussion paper has ended, we will continue to work with our stakeholders around new evidence and latest thinking, in order to design an investment approach that improves members' incomes in retirement and builds confidence in long-term saving. The background to this consultation is contained in Box 1.1.

How to read this document

1.2 This response document reports back what our stakeholders have told us, focusing on the questions we posed in the discussion paper. In writing this document we have assumed that our audience has read and is familiar with the discussion paper. We have used text boxes throughout the document to signpost key outputs of the consultation:

- Light green boxes contain issues where there is general agreement among the majority of stakeholders, although not necessarily all stakeholders.
- Grey boxes indicate where there were mixed opinions.
- Purple boxes indicate where we have identified further research is required.
- Burgundy boxes highlight different approaches suggested by stakeholders which personal accounts could adopt.

1.3 When we refer to stakeholders, we mean both respondents to the discussion paper and roundtable participants. The roundtable discussions are explained in paragraph 1.11. Words with technical meanings are

Box 1.1 Background to the consultation

In 2006, the Government set out a number of reforms to the UK's pension system to address widespread under-saving for retirement. As part of these reforms, from 2012 all employers must ensure that eligible jobholders are automatically enrolled into a pension scheme that satisfies the qualifying requirements. Eligible jobholders are those:

- aged 22 to State Pension Age
- working full or part-time
- earning at least £5,035[2] per year from a single job
- not participating in a qualifying scheme.

The reforms include the establishment of a new personal accounts scheme aimed at low-to-moderate earners. Personal accounts will be a defined contribution, occupational pension scheme. The scheme will be managed by a trustee corporation which will be independent from government and run as a not-for-profit organisation acting in the best interests of its members. PADA has been set up as the body responsible for overseeing the implementation of personal accounts. A guiding principle in developing personal accounts is the commitment to a simple and low-charge scheme.

PADA will be making recommendations to the trustee corporation about the most suitable investment approach to improve members' incomes in retirement. This consultation informs that advice. Publicly consulting on these issues is important to help ensure the recommendations PADA makes to the trustee corporation are the right ones.

highlighted in green and underlined in the text and defined in the glossary in Annex four. There are also a number of annexes which provide further information on our consultation process.

1.4 It was not possible to include in the response document every point raised or quotes from every organisation that participated in the consultation process, although we have read and considered every response. The majority of respondents were investment and pension professionals and we are grateful for their expertise and experience.

1.5 Personal accounts is being designed for low-to-moderate earners and in writing this document we were keen to make sure that the views of their representatives and employers were heard. At times we have drawn out opinions of consumer representative groups and employers and given them more emphasis. We also held separate roundtable discussions with these groups to seek out their opinions.[3]

2 In 2005-06 terms, and subsequently uprated on a basis determined by the Secretary of State.

3 *Setting the investment objective of the default fund: consumer representative groups*, London 15 June 2009; *Investment approach for personal accounts: PADA's Employee Representative Committee members*, London 12 August 2009.

1.6 We are grateful for the offers to provide more detailed information about respondents' solutions to the issues raised in our discussion paper. We will continue the dialogue with stakeholders on those matters. A number of responses also raised matters that were outside the scope of our consultation and outside of PADA's remit. We have forwarded these comments onto the responsible organisations.

1.7 The discussion paper explained that under the *Freedom of Information Act 2000*, all information contained in responses may be subject to publication. We have published all responses we received on the PADA website. We want to be open and transparent in our consultation process and accountable for the analysis of stakeholder opinion contained in this response document.

The consultation process

Responsible investment event

1.8 On 27 January 2009, the consultation process began with the responsible investment event which attracted a wide range of stakeholders. A purpose of the event was to bring experts and interested parties together to discuss responsible investment and its role within personal accounts. The key themes from the event were outlined in the discussion paper and, to avoid repetition, they are not reflected in this document.

Discussion paper

1.9 On 7 May 2009, the discussion paper was published. The discussion paper posed a number of questions we wanted our stakeholders to answer. These are listed at the end of this chapter. They focused on how the trustee corporation can develop an investment approach which best suits the characteristics of its members and is consistent with a low-charge scheme. These decisions will directly affect the retirement outcomes of members. They will also influence members' participation in the scheme and confidence in the benefits of saving for the long term. Respondents' answers will help us develop evidence-based recommendations to assist the trustee corporation in preparing the most suitable investment approach to improve members' incomes in retirement.

1.10 Stakeholders had 13 weeks to submit a response to the discussion paper up until 7 August 2009. The discussion paper generated much interest and we received 67 responses. The paper was made available on our website and was also distributed to interested organisations and individuals. Copies were provided to the devolved administrations in Scotland, Wales and Northern Ireland to help ensure those who will be affected by the reforms have an opportunity to comment. In addition, a stakeholder briefing was held on 7 May 2009 to provide an overview of the discussion paper. We also sought feedback from the PADA advisory committees[4] which represent the views of consumers, employers, and scheme managers and trustees.

4 The Consumer Representative Committee, Employer Representative Committee and the Scheme Management and Trustee Advisory Committee.

Roundtable discussions

1.11 PADA held a series of roundtable discussions on key aspects of the investment approach, from 15 June to 29 September 2009. The roundtables brought together a range of stakeholders to generate debate and uncover new evidence and ideas. Around 10-15 participants attended each roundtable which were conducted under the Chatham House Rule. This was to facilitate interactive discussions and encourage stakeholders to express their views and opinions. Each roundtable was specifically tailored to the topic being explored. Some roundtables involved presentations by guest speakers and targeted a particular type of stakeholder, while others were designed around open discussion and a range of stakeholders were invited. Through the roundtable discussions we spoke to over 100 representatives from over 80 organisations. Both national and international participants attended, from a range of disciplines and backgrounds such as academics, consumer representative groups, professional bodies, trustees and pension funds, intermediaries, employer representative groups, and the investment and pensions industry. A summary of the roundtables and a list of participants and topics are included at Annex one.

International experience

1.12 In addition to the roundtable discussions, PADA conducted a number of teleconference calls with similar schemes in other countries including Australia, New Zealand and the United States. This was to draw on best practice and learn from their experience.

Analysis of responses

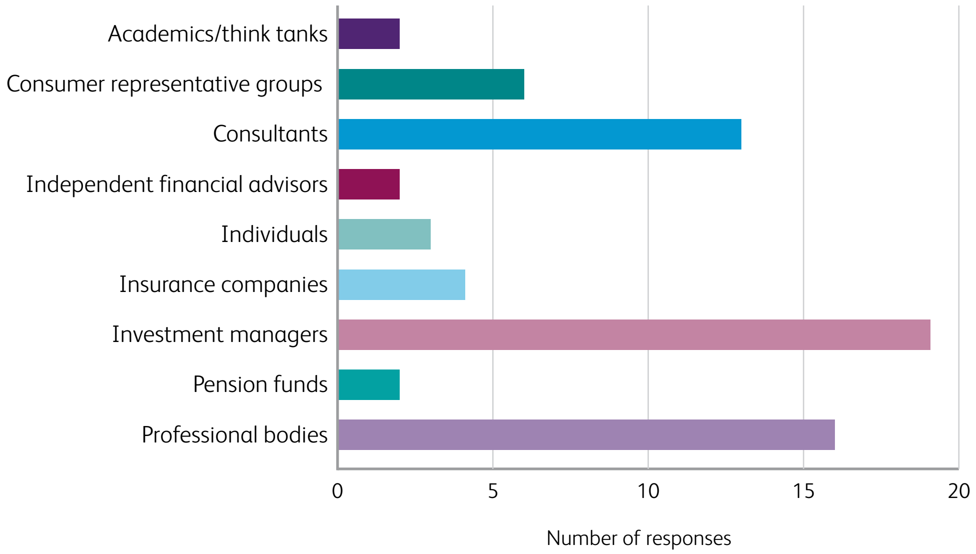
1.13 We received 67 responses to the discussion paper from a wide range of stakeholders. We have broadly categorised respondents into groups for the purpose of analysing their responses, as shown below:

- consumer representative groups
- professional bodies
- investment managers
- consultants
- insurance companies
- independent financial advisors
- academics/think tanks
- pension funds
- individuals.

1.14 It should be noted that these categories have been defined to assist PADA in understanding the perspective from which these organisations have responded and may not in all cases reflect the primary function of that organisation. Annex two lists each respondent according to organisation type and shows the breakdown of responses to each chapter according to organisation type.

1.15 Investment managers provided more responses to the discussion paper than other groups, followed by professional bodies and consultants. This is to be expected given that these groups are most familiar with investment. We were very keen to hear a wide variety of views and through the roundtable discussions we were able to draw on the views of stakeholders from both inside and outside of the investment industry. The breakdown of responses according to organisation type is shown in Figure 1.1.

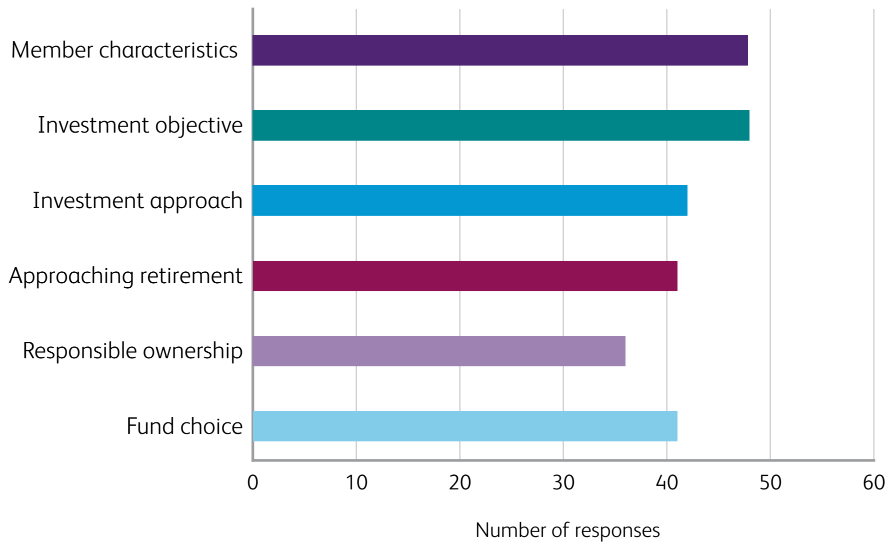
Figure 1.1 Responses by type of organisation



Source: PADA 2009
Base: 67 responses to our discussion paper

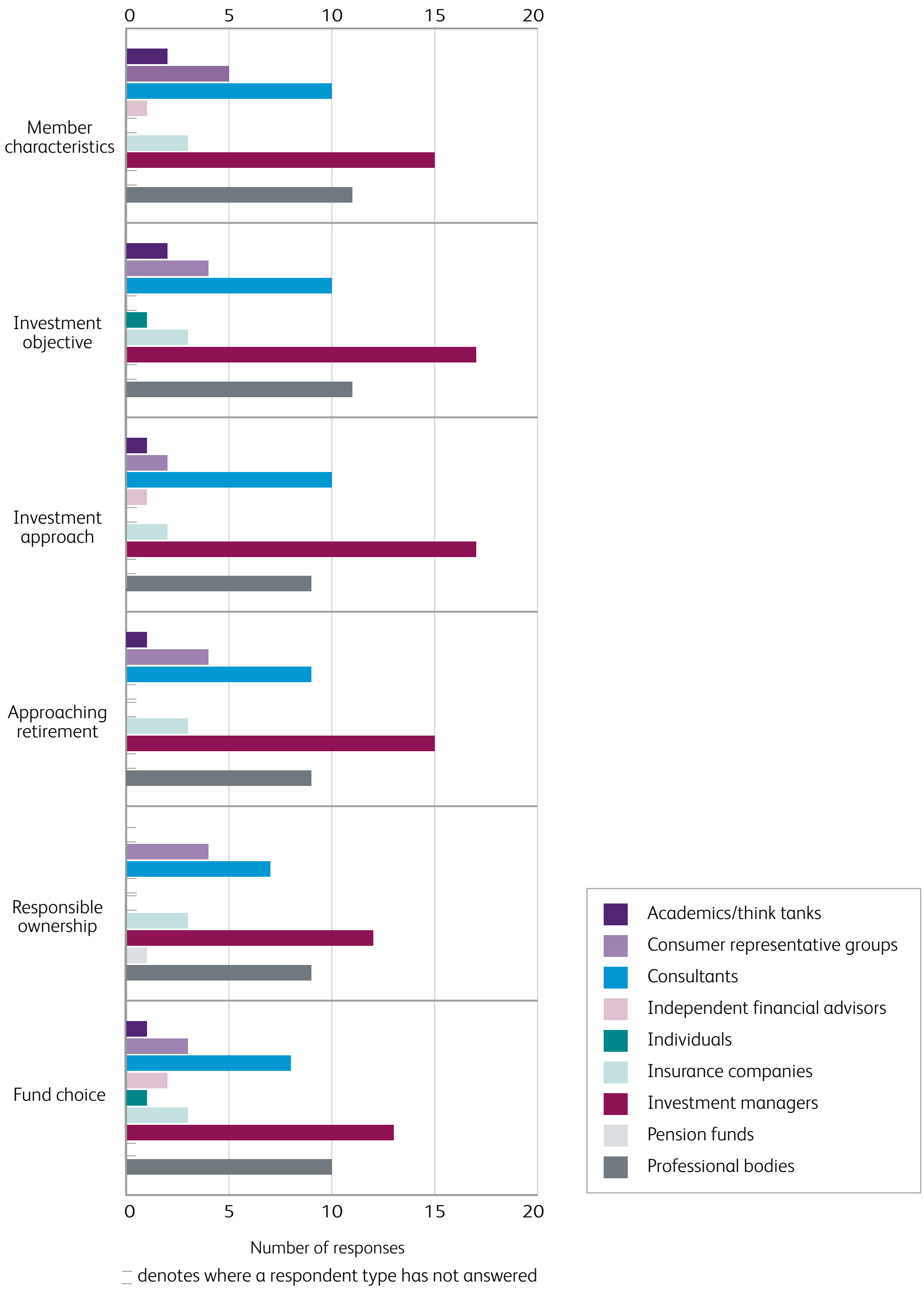
1.16 We received responses to all of the questions posed in the discussion paper. The topics of the investment objective and member characteristics generated the most interest from stakeholders. This suggests that our stakeholders also believe that understanding member characteristics will be the most important factor in designing the scheme. Their needs should be paramount when setting the investment objective. A breakdown of responses by topic is shown in Figure 1.2. Figure 1.3 includes a breakdown of responses by topic and type of respondent.

Figure 1.2 Responses by topic



Source: PADA 2009
Base: 67 responses to our discussion paper

Figure 1.3 Responses by topic and type of organisation

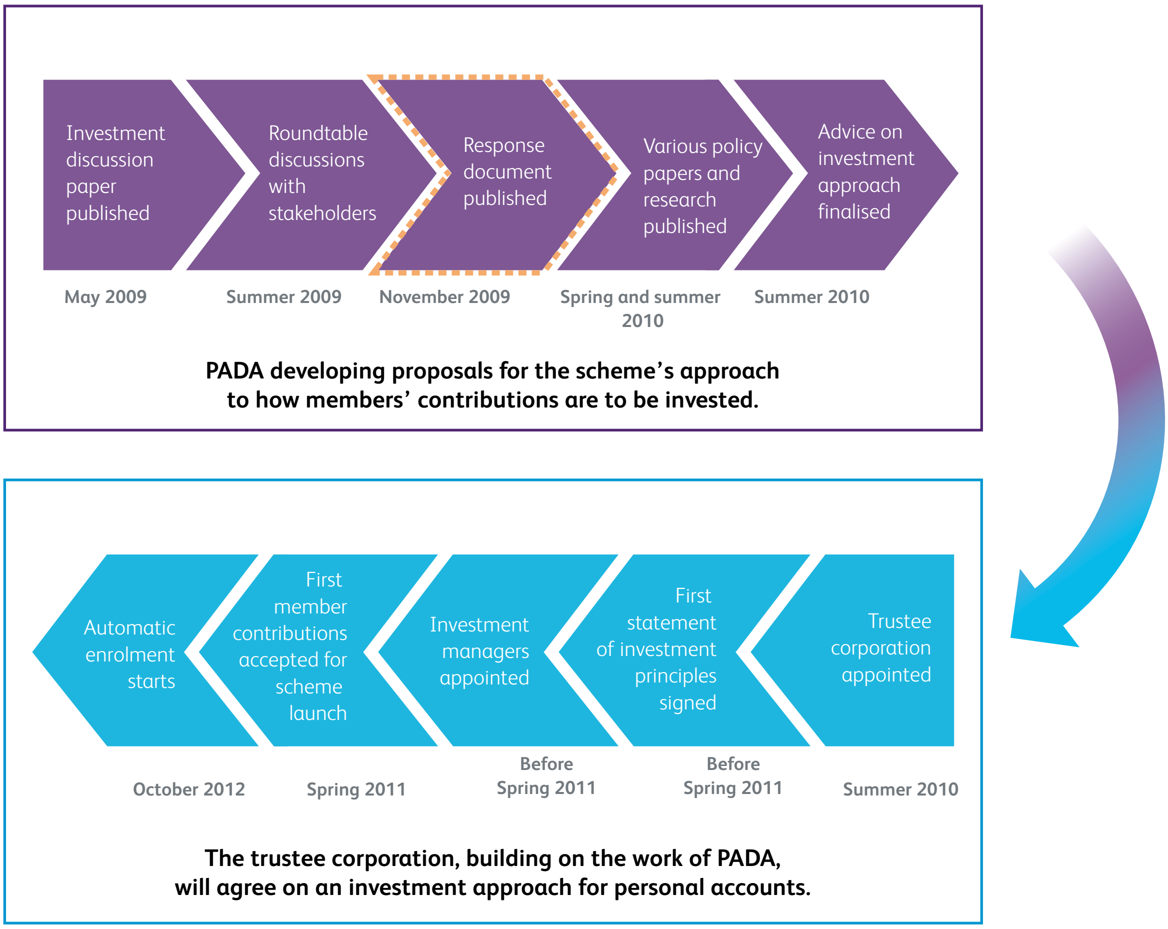


Source: PADA 2009
Base: 67 responses to our discussion paper

Next steps

1.17 There are a number of areas where we believe the way forward is clear, with both our stakeholders and research pointing in the same direction. There are other areas where stakeholders have identified gaps in our understanding which require further research. Further work is needed around areas where stakeholder opinion is mixed and our thinking is still developing. We will continue to work with our stakeholders on these issues through a series of policy papers and research to be published in the spring and summer of 2010. Our role is to develop proposals on how members' contributions should be invested in order to provide the building blocks for the trustee corporation to agree on an investment strategy for the scheme by 2011. Figure 1.4 sets out the next steps for the delivery of the investment approach for personal accounts.

Figure 1.4 Next steps



What the discussion paper *Building personal accounts: designing an investment approach* asked

2.1 Which member characteristics should influence the design of the personal accounts scheme?

2.2 From the evidence presented, what conclusions should we draw about our future membership?

3.1 The trustee corporation may have to strike a balance between what it believes members want and what it believes is the best investment solution for the majority of members. Where do you think this balance should be struck for the personal accounts default fund?

3.2 How should the different contribution profiles of members affect the scheme's investment objectives?

3.3 What should be the overarching objective of the personal accounts default fund and why?

3.4 What particular measures should the trustee corporation undertake to ensure that members can have confidence in the scheme?

3.5 How can the trustee corporation communicate to members in language that is readily understood, particularly around topics such as the investment objective for the default fund?

3.6 Are different approaches to sharing risk worth pursuing for the personal accounts default fund, or an alternative fund choice, and why? Please discuss implementation approaches and challenges.

4.1 In what situations should personal accounts use tactical asset allocation and why?

4.2 What are your views on how the personal accounts scheme can use alternative asset classes to benefit from potentially improved diversification and investment performance, while still meeting its needs for liquidity and accurate pricing?

4.3 Across which asset classes should diversification of the default fund extend?

4.4 What should be the balance between active and passive managers in the default fund, and is this consistent with a low-charge scheme?

4.5 Do certain asset classes favour a particular management style? Please provide evidence to support your response.

4.6 What approach should the trustee corporation use to identify active managers who are likely to outperform?

4.7 Should the personal accounts scheme participate in securities lending?

4.8 If so, what controls and limits should it impose, if any?

5.1 Is a traditional lifestyling mechanism appropriate for the personal accounts default fund, and if so why?

5.2 Would a target-date approach be appropriate for the default fund, and if so why?

5.3 Are alternative lifestyling approaches suitable for personal accounts, and if so why and how should they be implemented?

6.1 To what extent can the personal accounts scheme deliver high-quality corporate governance at a low cost?

6.2 How will this evolve over time as the scheme's assets under management grow?

6.3 How do we achieve high-quality corporate governance where assets are managed passively?

6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?

7.1 How can the personal accounts scheme engage in responsible investment in a cost-effective way?

7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practical and relevant?

7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?

7.4 If responsible investment is pursued, will the members be best served by building in-house capability or outsourcing?

8.1 To what extent should the trustee corporation offer fund choice, and what should those choices be?

8.2 To what extent should those funds be lifestyled?

8.3 Should the trustee corporation offer branded funds as part of the fund choice offered to members, and if so why?

8.4 Should costs associated with wider fund choice be spread, where possible, across all members, or only apply to those members who choose alternatives to the default fund?

8.5 Should there be a limit on the number of fund switches, or charges imposed after a certain number of switches, or neither for the personal accounts scheme?

Chapter two
Who will our members be?

In recommending an investment approach for personal accounts, it is essential the scheme is designed around the characteristics of its members. The scheme has been set up to provide access to an occupational pension scheme for low-to-moderate earners who currently do not participate in workplace pensions.

Respondents to the discussion paper were in agreement that members of personal accounts would be risk averse and find making financial decisions challenging. They also agreed that members will have little or no other pensions or savings provision outside of personal accounts. Nearly all believed these factors should influence the design of the scheme. Respondents identified two member characteristics where there were gaps in the Personal Accounts Delivery Authority's (PADA's) understanding. These were members' attitudes to loss, as opposed to risk, and the diversity of the target group of personal accounts. We will build on current analysis as well as conduct further research into these areas.

Feedback from our roundtable discussions indicated that for the most part, employers rely on intermediaries when choosing a pension scheme for their employees. Intermediaries will focus on fund range and performance when making recommendations to their clients, with both employers and intermediaries agreeing that personal accounts should consider its membership above all else.

2.1 In recommending an investment approach for personal accounts the central consideration PADA will take into account is who are the members and what are their characteristics and circumstances. In the discussion paper, we identified the key characteristics of the scheme's members based on qualitative and quantitative research.[5] The discussion paper focused on those characteristics expected of members when the new legislative framework comes into effect in 2012. We recognise that member characteristics and circumstances will change over time.

2.2 While it is possible to understand a lot about the characteristics of the potential membership of personal accounts, some uncertainty exists because identifying individuals who will become members of the scheme depends on whether their employer chooses personal accounts as their workplace pension. Since the publication of our discussion paper, we have continued to refine our analysis of the potential membership of personal accounts. Based on improvements to our participation estimates modelling, updated data, and new evidence and insight into employers' likely choice of scheme, we expect that around 10-11 million people will be eligible for automatic enrolment. Of these, we expect 3-6 million will become members of the personal accounts scheme.[6]

5 Collard and Breuer, 2009; Webb et al, 2008.
6 DWP, 2009.

What the discussion paper *Building personal accounts: designing an investment approach* asked

2.1 Which member characteristics should influence the design of the personal accounts scheme?

2.2 From the evidence presented, what conclusions should we draw about our future membership?

What you said

2.3 Chapter two of the discussion paper generated most interest, with 70 per cent of respondents addressing the questions. This included nearly the full range of respondent types. Respondents acknowledged that personal accounts will be made up of a wide and diverse range of people with different attitudes, needs and circumstances. Despite the breadth of membership, all respondents agreed with PADA's research on member characteristics. Our findings were supported by respondents' own evidence and experiences of defined contribution scheme members.

2.4 Generally, respondents thought the different member characteristics were linked and based on their economic circumstances. For the purposes of this response document, we have addressed each characteristic separately but respondents tended to discuss the characteristics together. They thought that because the target group are on low-to-moderate incomes they have less money to save or invest. This means they are less exposed to financial products and less inclined to take risks with what little savings they have. The majority of respondents cited risk aversion as the most important characteristic to consider in designing the investment approach.

Risk appetite

2.5 Respondents agreed that members will be less comfortable with the idea of investment risk and more cautious about how they want their contributions invested. Respondents acknowledged that there will be a minority of members wanting to take a risk-seeking approach. The concept of 'investment risk' is explained in Box 2.1. Most respondents thought risk aversion was the result of members having low levels of savings and limited financial knowledge. Some respondents thought this would change with the introduction of auto-enrolment into a qualifying pension scheme as members' financial knowledge and savings levels increase.

2.6 Other respondents were wary about relying on the research findings to predict the behaviour of members. Legal & General Investment Management cautioned that people often give what they perceive to be the 'right' answer in surveys and focus groups, but do not follow through with consistent actions. The Pensions Policy Institute thought that one consequence of the target group's lower levels of financial understanding was that they may not fully understand the consequences of taking investment risk and may not be able to fully express their attitudes on this issue. PensionDCisions also thought that members may not have well defined preferences when it comes to risk.[7]

7 PensionDCisions quoted the findings of Benartzi and Thaler, 2001.

Box 2.1 What is risk?

Generally, there are three types of risk with saving for a pension.[8] These are:

- Investment risk refers to the unpredictability of investment returns. This arises in part from the related concept of volatility, which is the sporadic movement in the value of an asset.
- Inflation risk means the possibility that one pound today will not be able to purchase the same amount of goods and services as one pound in the future.
- Longevity risk means as life expectancy increases there is a possibility that an individual's retirement income will not be sufficient.

This document focuses on investment and inflation risk.

Attitudes to loss

2.7 A number of respondents made the distinction between risk and loss. They thought that members' behaviour would be driven by their desire to avoid loss, rather than their aversion towards risk. Consumer representative groups at our roundtable discussions[9] argued that from the perspective of the scheme's members: ***"Loss is worse than anything else, members would prefer not to lose than to make some gains"*** and that ***"personal accounts should adopt a building society mentality with the aim to preserve capital."***

2.8 Loss is not a fixed measure and should be referenced to what an individual believed they had in the first place. How individuals experience or feel loss is likely to influence their behaviour. For example, one person's perception of loss may be different to another person's perception of loss. Our research suggests that there are a number of ways in which loss can be described, perceived or felt in a pension savings context. Some of these are:

- absolute or nominal loss – the drop in value of an individual's pension fund at the end of a period compared to the start of the period
- relative loss – the underperformance over a period between an individual's pension fund compared to the benchmark, such as inflation, earnings growth or interest rates, against which it is measured
- real loss or loss in real terms – the decline in the value of an individual's pension fund taking into account inflation, given that one pound today may not be able to buy as much in goods or services as one pound in the future.

8 Wilson, 2006.
9 *Setting the investment objective of the default fund:* consumer representative groups, London 15 June 2009.

2.9 A short-term loss due to fluctuations in markets may not impact an individual's income in retirement because it may be offset by gains later on in their savings career. However, different types of loss may impact an individual's behaviour and may even discourage them from making contributions or saving altogether. Individuals will experience loss differently. Some may focus on the drop in value of their pension fund or savings after taking into account inflation. While others may only be concerned with the performance of their pension fund compared to the benchmark in absolute terms. How members of personal accounts are affected by loss may have implications for the scheme's investment approach, or how information about members' accounts is communicated. If members behave to avoid certain types of losses, this may lead the trustee corporation to adopt a strategy aimed at generating more stable returns with controls in place to protect members' savings on the downside. It may also mean that communication with members on the size of their pension pots should focus on longer-term outcomes.

2.10 The emphasis that stakeholders placed on members' attitudes to risk and loss reinforces the need for risk to be managed throughout an individual's savings career to take into account their wants, needs and fears. How risk is managed depends not only on members' characteristics, but also the different stages throughout their life.

Mental accounting

2.11 A small number of respondents commented on the likelihood that members of personal accounts will exhibit mental accounting behaviour. Mental accounting can be likened to individuals saving money in different jars for separate purposes – such as, paying rent and saving for a holiday – and having different risk appetites for each jar.[10] For the personal accounts scheme, although members have only one account, it has been suggested they may be happier to seek greater growth with their employers' contributions if they believe their own contributions are being invested more conservatively.[11] Some respondents suggested that by framing communications with members in this way, personal accounts could balance members' risk preferences with the need to generate sufficient returns for their retirement.

10 Thaler, 1980; Thaler, 1999.

11 This is supported by findings of Collard and Breuer, 2008.

Research required

PADA has focused to date on our members' likely attitudes to risk. A number of respondents suggested that our findings may not reflect accurately what members would do in reality. Other respondents thought that for the target membership, risk and return as traditionally expressed when investing, is less relevant than the concept of loss. They stated that many in the target membership will be less interested in the gains achieved by taking investment risk and more concerned with their contributions losing value – even if it is just in the short term.

Behavioural economics suggests that in some situations, especially when individuals face complex financial decisions, it is their attitudes to loss rather than just their attitudes to risk, that may drive them to behave in a certain way. Prospect theory[12] also shows that people do not treat profits and losses equally. People find it easier to give up a profit than accept a loss. This suggests that fear of loss plays a disproportionate role in an individual's decision making process. In the most extreme cases of loss aversion, people are not prepared to accept any loss at all. Following respondents' comments to the discussion paper, PADA wishes to understand members' likely behaviour to both short-term and longer-term potential losses to their pension pots.

PADA has commissioned deliberative research into members' likely attitudes and likely behaviour when faced with a loss. For example, would loss cause members to lose confidence in saving and reduce or even stop their contributions? The research will also look into whether members may exhibit some kind of mental accounting behaviour when it comes to the possibility of loss of their contributions, compared to the contributions of their employers. This research will also provide further insights into members' perceptions of saving compared to investment.

The outcome of the research aims to give the trustee corporation a greater understanding of its members and, in particular, the behaviour they may exhibit when faced with inevitable downsides to investing rather than saving. We expect this research to be completed in the spring of 2010.

12 Kahneman, 2003; Kahneman and Tversky, 1979.

Financial understanding

2.12 Respondents agreed that members are likely to find making financial decisions challenging as they will have little experience of planning for their retirement or financial decision making. Most investment managers in answering this question highlighted that members of personal accounts are likely to view themselves as 'savers' rather than 'investors'. Members may have some experience of saving money in a bank account, but are likely to be unfamiliar and wary of investment products. Also, they may not understand the relationship between increased investment risk and higher expected investment return. Respondents concluded that the majority of members will be in the default fund of personal accounts, not because it may suit their personal circumstances, but because they will not feel comfortable making any choice about investment.

Savings behaviour

2.13 Respondents agreed that members are unlikely to be saving currently, or have significant existing savings to fund their retirement. Respondents believed that more immediate financial commitments, such as repaying their debts, paying their mortgage and family subsistence would take priority.[13] Fidelity International noted that individuals have a tendency to 'live for today' and seek gratification now, which makes it difficult to persuade people that investing money for their future is worthwhile.[14]

2.14 Respondents thought that personal accounts would be the only long-term savings vehicle of members and their main source of retirement income, other than the State Pension.[15] Respondents concluded that members will be less able and willing to sustain a financial loss in their pension savings, given they have no other retirement savings and the money could have been used to meet other financial commitments. A couple of respondents cited the turbulence in financial markets in recent years as compounding members' low appetite for savings.

General agreement

- There is strong consensus among our stakeholders that the scheme's future membership is likely to be risk averse, find making financial decisions challenging and have little or no existing savings. They were all in agreement that understanding the target group will be crucial to the design of personal accounts.
- One of the key considerations we will take into account in recommending an investment approach for personal accounts is who are the members and what are their characteristics.

13 This is supported by Thomas et al, 2009.
14 This is known as 'hyperbolic discounting'. People more often prefer smaller payoffs to larger payoffs when smaller payoffs come sooner in time relative to larger payoffs. People may therefore swap their long-term preferences/rewards for shorter payoffs resulting in making inconsistent choices over time. In the pension context, we know that despite showing long-term preferences for saving, individuals tend to reverse their long-term preferences for consuming now and 'living for today' (O'Donoghue and Rabin, 2000; Laibson, 1997).
15 Members are likely to have varied work histories and change employers, where some employers may use personal accounts as their workplace pension while others may not. This will mean that throughout their careers members may use pension schemes other than personal accounts.

Other characteristics

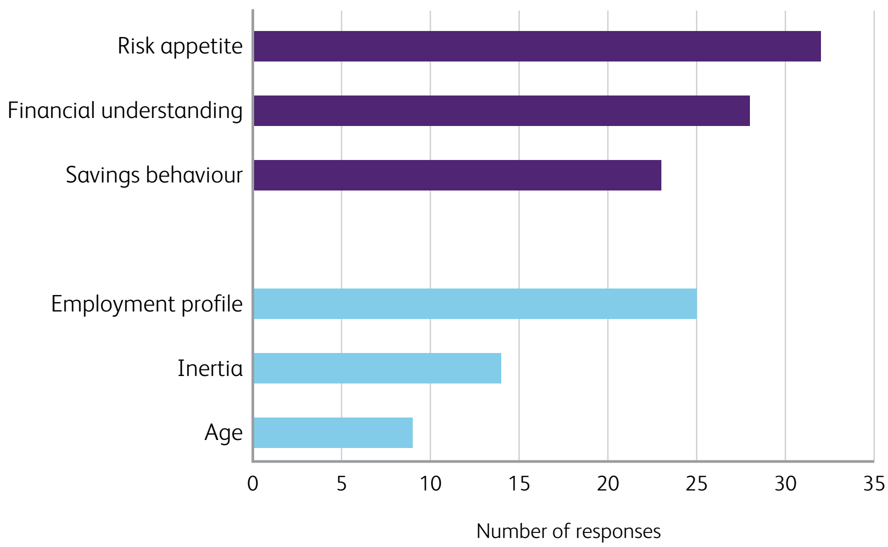
2.15 Although respondents agreed with PADA's research on member characteristics, which are shown in purple in Figure 2.1, many respondents identified other characteristics that they thought should also influence the design of personal accounts. Most of these were discussed in Annex two of our discussion paper and are shown in blue in Figure 2.1.

Employment profile

2.16 The majority of respondents suggested that low-to-moderate earnings and breaks in employment would be typical for members of the scheme. They thought that some members will only be able to save small amounts and will be unlikely to contribute continuously for 30 or 40 years. Age Concern and Help the Aged thought that low incomes and uncertain work patterns will mean that members have little choice about when to draw their retirement benefits. It argued that members will be less able to defer their retirement to make up for any losses in their investments. A couple of respondents argued that personal accounts will have more members earning moderate-to-high incomes than anticipated. They believed the scheme should be designed with moderate earners in mind who they thought were unlikely to have broken contribution profiles.

2.17 Some participants at the roundtable discussions[16] thought that the earnings profile of scheme members will follow the UK economic cycle. They believed that this should be taken into account in designing the investment approach, because the likely pattern of members' earnings will compound the fluctuations produced by investments that follow the UK economic cycle.

Figure 2.1 Member characteristics identified by respondents



Source: PADA 2009
Base: The above chart shows the number of times each characteristic has been mentioned by different respondents

16 *Investment approach for personal accounts: variety of stakeholders*, Edinburgh 14 July 2009; *Approaching retirement: variety of stakeholders*, London 10 July 2009.

Different approach

The roundtable discussions[17] prompted an interesting comparison between the likely earnings profile of members of personal accounts and the economic cycle. It was argued that our younger members' greatest assets will be their human capital, the returns from which are likely to be economically sensitive and probably more volatile than those in the general workforce. Members are more likely to have periods where they are not contributing, or where their levels of contributions fluctuate more. As a result their risk capacity is likely to be lower than economic theory would suggest and so we should be cautious about an equity heavy strategy where there are likely to be similar fluctuations or volatility.

General agreement

The majority of respondents thought that members of personal accounts are likely to be low-to-moderate earners and experience breaks in employment, and that this should be taken into account in designing the scheme.

Inertia

2.18 A small number of respondents, mainly investment managers, commented that members' interest in personal accounts is likely to be low and this should be taken into account in the design of the scheme. Respondents did not think this was a characteristic specific to the membership of personal accounts, but shared by the majority of defined contribution scheme members. Respondents argued that although members may say they are risk averse, their tendency towards inertia will mean that their risk and loss tolerance may be higher in practice. Respondents who addressed this issue thought this member characteristic will keep participation rates high. Respondents had different descriptions for this type of member as explored in Box 2.2. Their point was the same – that the majority of members in personal accounts will exhibit this behaviour and the default fund should be designed with this in mind. The concept of inertia is discussed further in Chapter three.

Age

2.19 A small number of respondents mentioned age as being an important member characteristic. There were two reasons put forward by respondents on why age should be considered in designing the investment approach.

2.20 Some respondents thought age was an objective and readily available measure of a member's risk capacity. Risk capacity is the amount of risk individuals **should** take considering their personal circumstances. Respondents compared this to risk appetite which is the amount of risk individuals **want** to take with their investments – a subjective measure.

17 *Investment approach for personal accounts: variety of stakeholders*, Edinburgh 14 July 2009; *Approaching retirement: variety of stakeholders*, London 10 July 2009.

Box 2.2 Member inertia

*"Our research suggests that most defined contribution scheme members are **accidental investors**. These investors are difficult to educate, since they see investing as a burden and lack the desire to learn. Their most important characteristic is inertia. So, although many may fear the prospect of seeing their savings fall in value, the evidence suggests that, when faced with the reality, their 'risk tolerance' – how they feel about their loss – is actually quite high. We believe the vast majority of members in the personal accounts scheme will be accidental investors. Only a small minority are likely to be truly 'engaged investors', who are confident in their ability to make investment decisions."*

Alliance Bernstein

*"The main obstacles faced by this investor group include behaviours such as passivity, procrastination, inertia, asymmetric risk-taking and loss aversion. Barclays Global Investors' assessment of the information presented in the consultation document indicates that the target population for personal accounts is likely to exhibit many of these behavioural biases. Our own research demostrates significant segmentation of scheme membership whereby 50 per cent to 65 per cent of the typical defined contribution population, do not take an active role in managing their own retirement accounts. These individuals are termed **'the silent majority'** – our research has shown they lack the time, interest or knowledge to successfully direct their own investments."*

Barclays Global Investors

*"Most defined contribution members can be described as **'reluctant'** or **'disengaged'** investors. These are the individuals who, for a range of reasons, are not prepared to make an active investment choice and instead passively accept the default fund."*[18]

Dr Byrne and Professor Blake

"Inertia: *people's tendency to inaction should keep the participation rate for personal accounts relatively high. However, the same tendency will militate against them increasing their contributions, which may lead to disappointment with the outcomes from personal accounts."*

Fidelity International

*"While the research into the potential audience of personal accounts was very thorough, the bottom line is that a vast majority of defined contribution investors, be they investing via the private sector or via personal accounts, are chronically **apathetic** towards long-term savings provision."*

Schroders

*"Studies that focus on member behaviour have shown that most members opt to ride out short-term volatility and stay invested in default investment options. One could assume that the level of **inertia** in personal accounts will be no less than the average defined contribution pension fund in the UK."*

State Street Corporation

18 Dr Byrne and Professor Blake refer to Byrne et al, 2008, in their response.

> *"Our experience of sponsoring a trust-based defined contribution scheme over many years, for a group of about 500 people, who would typically be expected to have a greater financial understanding and familiarity with investment matters than your target market, suggests that there was not a great deal of difference of engagement between higher and lower earners or between men and women."*
>
> **Wragge & Co**
>
> *"As shown by a large and growing body of research, and as described by PADA in the consultation document, inertia is a key behavioural trait that needs to be taken into account with regards to all aspects of scheme design. Inertia can be beneficial in terms of 'nudging'[19] people towards what they need, but it can also be highly problematic as people, for example, remain in defaults that are clearly not right for them... Members of personal accounts are more likely to be **'avoiders'** rather than 'planners' compared to average."*
>
> **PensionDCisions**

2.21 These respondents argued that young members have a high risk capacity as they have a long time horizon and possess two assets – their future income and their ability to adjust their objectives in the face of any losses. Respondents thought that the reverse would be true for older members who are likely to have a low risk capacity. Respondents suggested that the default fund should take a level of investment risk consistent with the likely risk capacity of members based on their age, and not their risk appetite. On a related point, most respondents thought that the membership of personal accounts will mainly consist of younger members. Strategies suggested by respondents for adapting the asset allocation depending on a member's age are considered in Chapter five.

2.22 Other respondents highlighted that the 'first generation of members' in personal accounts will include individuals who have been auto-enrolled into a pension scheme later in their working life, such as in their 40s and 50s. These people will only be saving into the scheme for a short period of time, but their outcomes will be central to building the reputation of personal accounts. The challenge will be achieving good outcomes for these members in order to generate confidence in the scheme as a whole. Members are likely to be swayed from saving by negative press reports and the personal stories of their friends and families. For this reason, respondents argued that personal accounts needs to consider the particular needs of the first generation of members and adopt a different investment approach to help ensure they achieve positive outcomes.

Mixed opinions

Some respondents identified inertia, or age, as member characteristics which should influence the design of personal accounts, while other respondents did not.

19 Sunstein and Thaler, 2008.

Respecting diversity

2.23 The Equality and Human Rights Commission (EHRC) referenced the importance of PADA's statutory principle[20] to respect diversity among members and prospective members of the scheme, when preparing recommendations for the trustee corporation. The EHRC highlighted that groups such as women, disabled people and ethnic minorities find it more difficult to access pension savings than others. Scope identified disabled people as facing particular challenges in saving for their retirement as they incur extra costs because of their impairment, and will require more funds during their retirement to cover these costs. Scope and EHRC argued that these groups typically have special requirements and challenges which need to be taken into account in all aspects of the design of personal accounts.

Attitudes of employers and intermediaries

2.24 Personal accounts will be just one qualifying pension scheme that employers can offer their staff in meeting their new employer duties. It is being designed to complement existing workplace pension provision. The reforms will increase access to workplace pensions for millions of people. The personal accounts scheme is being designed specifically for low-to-moderate earners who do not currently have access to workplace pension provision.

2.25 PADA conducted roundtable discussions[21] with employers and intermediaries to find out what they are looking for in the investment approach for personal accounts. By intermediaries, we mean those who advise employers on the most suitable pension scheme for their jobholders, such as

Research required

It is difficult to know with certainty what the demographics or circumstances of future members of the personal accounts scheme will be. The evidence we have collated to date suggests that compared to the working population as a whole, the target membership of the scheme is likely to incorporate a greater weighting of ethnic minorities and women. The picture on disabled people is less clear and has been identified as an area for further analysis.

The trustee corporation will have a fiduciary duty to act in the best interests of its members. Understanding what those interests are will be of central importance. Looking at whether characteristics such as gender, ethnicity, faith or disability have an impact on the behaviour and contribution profiles of members will be relevant information for the trustee corporation to consider. It may also have implications for how investment issues are communicated and products developed. PADA intends to conduct further detailed analysis into member demographics and, where necessary, commission new research to ensure the evidence the trustee corporation bases its decision making on, is robust and comprehensive.

20 *Pensions Act 2008*, section 80(1) "In carrying out its functions under section 79(2) the Authority must have regard to the principles in subsection (2)... (2) The principles are that … (f) diversity among members and future members of such a scheme should be respected."

21 *Investment approach for personal accounts: Employer Representative Committee members*, London 12 August 2009; *Investment approach for personal accounts: intermediaries*, London 3 September 2009

independent financial advisors, employee benefit consultants and accountants. Although jobholders will benefit from saving in personal accounts, it is their employer that usually chooses the pension scheme into which the employer and employee contribute. It is therefore important that the investment approach for personal accounts provides an appropriate proposition for employers of the target group of low-to-moderate earners.

2.26 Employer participants at the roundtable discussions were of the view that the investment approach of a scheme would impact the employer's choice of pension provision. It was thought that the investment approach of a scheme was more likely to influence an employer's choice where they viewed pension provision as part of the employee remuneration package.

2.27 Other employers who attended the roundtable discussions were not as concerned by the investment approach, but were keen not to get it wrong when selecting a scheme. Most participants believed that employers will rely on the advice they receive from intermediaries and therefore a scheme's investment approach would have more impact on the intermediary's decision making process.

2.28 Intermediary participants at the roundtable discussions agreed that the investment approach would form a significant part of their criteria in recommending a pension scheme to their clients. They generally look at the investment approach in terms of fund range and performance to ensure returns are appropriate for their clients. For a new pension scheme, such as personal accounts, participants said they would look for a robust investment process which is supported by extensive research. This would help them come to a decision on whether the scheme is likely to meet its investment objectives.

2.29 Themes emerging from the roundtable discussions are supported by research commissioned by PADA on the attitudes and behaviours of employers and intermediaries towards pension provision.[22] Box 2.3 explores this research further.

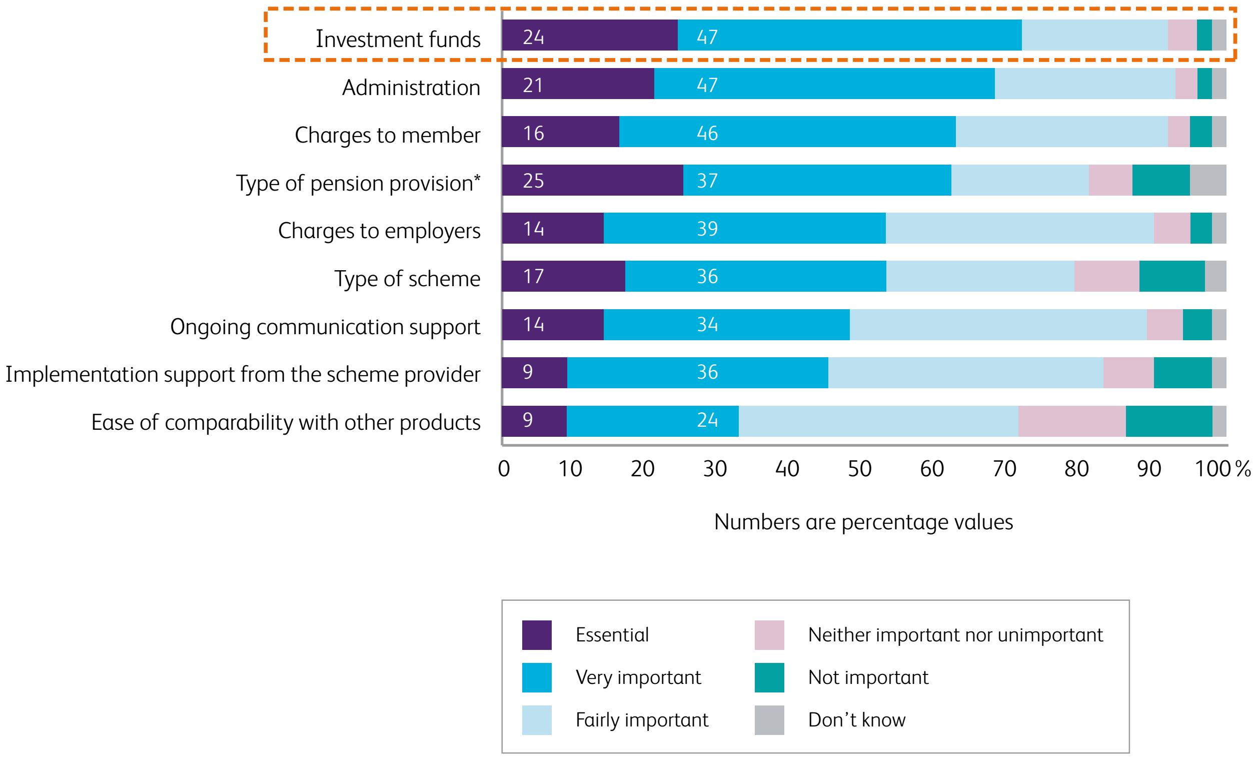
2.30 The research found that after fund performance and range, pension administration was a key factor considered by intermediaries. In comparison, the research showed when choosing a workplace pension scheme employers focus on the ease of set up and administration, followed by fund performance track record. A wide range of fund choice was one of the least important factors for employers. The research suggested that employers will rely on the advice of intermediaries when choosing a workplace pension scheme for their employees.

22 Birkett et al, forthcoming.

Box 2.3 Research on attitudes and behaviours of employers and intermediaries[23]

450 telephone interviews were conducted with intermediaries between 5 November 2008 and 31 January 2009, including independent financial advisors, employee benefit consultants and accountants. They were asked to rate how important the following factors were in influencing their decisions when choosing a pension scheme to recommend to a typical client. Figure 2.2 shows the results.

Figure 2.2 Intermediary research



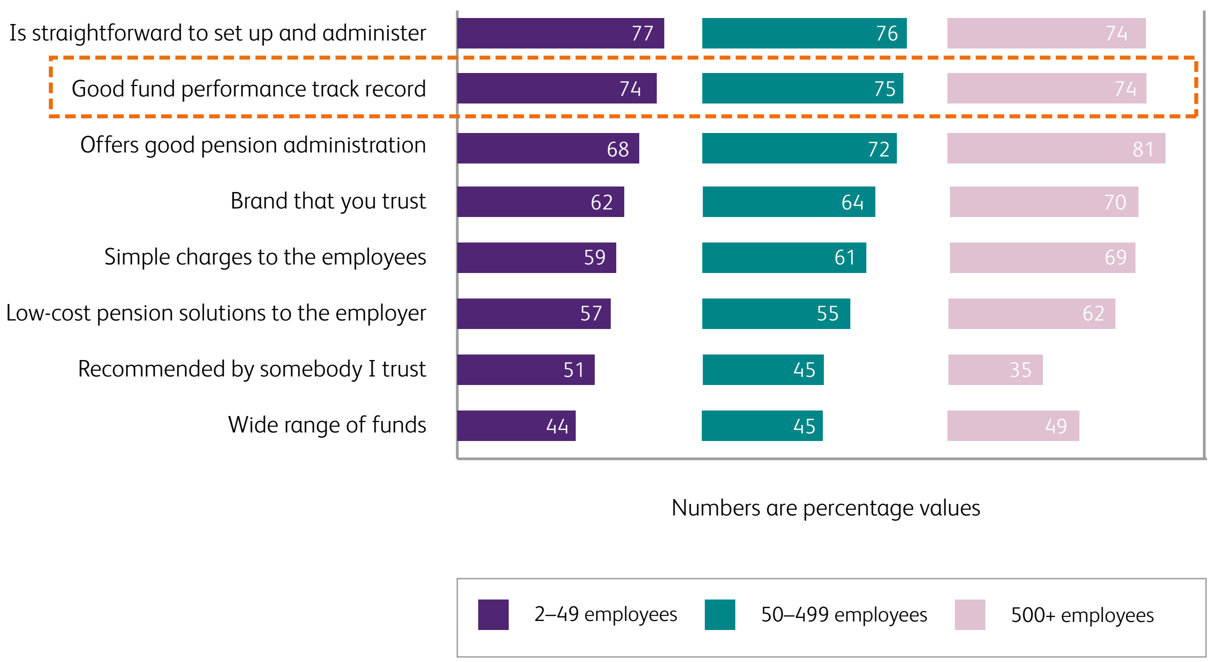
Source: Birkett et al, forthcoming.
*Type of 'pension provision' refers to either trust-based occupational or contract-based schemes.

23 Birkett et al, forthcoming.

Box 2.3 continued

Employers were asked a similar question on how important the following factors were in influencing their decisions when choosing a pension scheme for their employees. The telephone survey interviewed a representative sample of 3,079 organisations in the UK – small, medium and large employers. Figure 2.3 shows the percentage of respondents who classified the following factors as 'essential' or 'very important'.

Figure 2.3 Employer research



Source: Birkett et al, forthcoming.

General agreement and next steps

- Employers and intermediaries agreed that personal accounts should be seen to belong to members and its design should focus on meeting their needs.
- PADA will take into account the attitudes of employers and intermediaries, but our investment focus will remain on members and their characteristics. If this approach is taken, then it follows that the scheme will represent an appropriate choice for employers of low-to-moderate earners.

Chapter three
What should the scheme's investment objective be?

This key chapter tackled the broad and complex concept of developing an appropriate investment objective to meet the needs and characteristics of the scheme's members. The complexity and difficulty of this task was reflected in our respondents' answers.

Apart from achieving an adequate income in retirement, there was no consensus on the high-level principles or objectives that should inform the setting of the investment objective. Similarly, respondents disagreed on what type of investment objective would best suit the membership of personal accounts – best efforts, benchmark-driven return, target replacement ratio or a mixture.

Following careful consideration of all responses and the discussions at the roundtables, the Personal Accounts Delivery Authority (PADA) believes that at a minimum, the investment objective needs to deliver a solution that maintains at least the buying power of members' contributions. This lends itself to an objective which seeks returns in excess of inflation after management charges, which was the preferred benchmark of respondents who recommended this type of objective. We are conducting further research and modelling to inform the setting of the excess return target.

Respondents agreed that effective communication will be important in engendering confidence in personal accounts. Building confidence and trust is one of the biggest challenges the trustee corporation faces in implementing personal accounts.

3.1 The investment objective provides the foundation on which the investment strategy of personal accounts will be built. It will guide the asset allocation decisions of the scheme, as well as communications with members and stakeholders. The first step in ensuring that personal accounts is designed with members in mind is choosing an investment objective that matches their characteristics. We are also mindful of the fact that over the long term the vast majority of personal accounts members are likely to buy a lifetime annuity. It will be important that the trustee corporation understands the likely pattern of annuitisation in order to help inform both the investment objective and investment strategy.

3.2 The investment objective needs to be consistent with delivering a low-charge and value-for-money scheme. As JA Pensions Consulting, a respondent to the discussion paper, said: ***"If you don't know where you are seeking to go, you are unlikely to get there, and you can't measure whether you got there."*** This applies equally to the trustee corporation in making decisions on the investment strategy for the personal accounts scheme, as well as members in planning for their retirement.

What the discussion paper *Building personal accounts: designing an investment approach* asked

3.1 The trustee corporation may have to strike a balance between what it believes members want and what it believes is the best investment solution for the majority of members. Where do you think this balance should be struck for the personal accounts default fund?

3.2 How should the different contribution profiles of members affect the scheme's investment objective?

3.3 What should be the overarching objective of the personal accounts default fund and why?

3.4 What particular measures should the trustee corporation undertake to ensure that members can have confidence in the scheme?

3.5 How can the trustee corporation communicate to members in language that is readily understood, particularly around topics such as the investment objective of the default fund?

3.6 Are different approaches to sharing risk worth pursuing for the personal accounts default fund, or an alternative fund choice, and why? Please discuss implementation approaches and challenges.

What you said

3.3 This chapter generated high levels of interest among respondents, with around 70 per cent providing an answer. The question on what should be the overarching objective of the personal accounts default fund received most interest from respondents. The task of setting an investment objective for personal accounts is complex, involving the balancing of a number of competing principles. In drafting the discussion paper, we found Chapter three the most difficult to write. This was reflected in the roundtable discussions[24] and responses to the discussion paper where there was no consensus on this issue. Stakeholders acknowledged that each objective has its own advantages and disadvantages. Different stakeholders presented different conclusions, and at times, a variety of competing principles are referred to in the same response.

High-level principles or objectives

3.4 An emerging theme from the roundtable discussions was the possibility of having different layers of objectives for personal accounts. Discussion was around three levels of objectives: the first at scheme level, the second at fund level, and the third at different points along the de-risking glide path.[25]

3.5 Nearly all responses to the discussion paper have been framed in terms of the high-level objectives of personal accounts and what the scheme should be trying to achieve. Different principles have led respondents to different conclusions on what should be the investment objective of the default fund. The next part of this chapter focuses on the high-level objectives and how they influenced the different positions of stakeholders.

24 *Setting the investment objective of the default fund: consumer representative groups*, London 15 June 2009; *Setting the investment objective of the default fund: investment industry*, London 17 June 2009; *Investment approach for personal accounts: variety of stakeholders*, Edinburgh 14 July 2009.

25 Glide path refers to the switchover period from growth-type investments to assets like bonds and cash.

What members need or what members want

3.6 Stakeholders were divided on whether the trustee corporation should design the investment solution which it thinks is best for members, or what the survey data suggests members want. As discussed in Chapter two, our research findings suggested that members are unlikely to want to take much risk with their money.

3.7 The majority of respondents thought the trustee corporation should focus on what it thinks members need, based on their economic circumstances. They argued that members are not in a position to make an informed choice about the investment approach for the default fund. They referred to the research commissioned by the Department for Work and Pensions (DWP) which suggested that members find making financial decisions challenging and are unlikely to understand the relationship over the long term between increased investment risk and higher likely investment return.[26]

3.8 Schroders compared the position of the trustee corporation with the National Institute for Health and Clinical Excellence (NICE). NICE uses independent panels of professionals, patients and the public to provide guidance that sets standards for good quality healthcare in the National Health Service, based on the systematic review of evidence on the benefits and cost-effectiveness of new drugs and treatments. Schroders thought:

"Put simply, the level of knowledge required to make rational decisions on the medical treatments that should be made available, in the context of an environment where resources are finite, is simply too vast and complex to be dealt with by the general public. The same could be said of the investment decisions required in the context of personal accounts and defined contribution provision in general. The level of investment knowledge, which is required to make rational (not to be confused with perfect) decisions, is such that it means, in the main, the process has to sit with a body of professionals. Member choice has its place but it should be confined to areas where people have a fighting chance of making rational decisions, based on a degree of understanding."

3.9 In comparison, several respondents, particularly consumer representative groups, argued that the trustee corporation should move towards an investment approach which is broadly consistent with the risk tolerance of members. Those who favoured this approach believed that the focus needs to be on what members want. They felt this was preserving members' capital both in the short and the long term, otherwise any reductions in members' savings are likely to discourage them from making regular contributions into personal accounts. Whether volatility will impact a member's behaviour in terms of saving for their retirement is considered in the next section.

Member confidence or inertia

3.10 Nearly all respondents agreed with PADA's findings that regular contributions have more of an influence than investment performance in ensuring that members' incomes are more likely to be adequate in retirement. Research conducted by the Employee Benefit Research Institute (EBRI) looked into the impacts of income and

26 Collard and Breuer, 2009.

contribution history in achieving different target replacement rates.[27] Its research is explored in Box 3.1. Respondents were divided, however, on what the trustee corporation needs to do to encourage members to make regular contributions into the scheme.

3.11 Those respondents who thought the investment approach should reflect what members want argued that if pension pots fall in value, this will lead members to lose confidence in personal accounts. If confidence is lost, respondents thought this may reduce how much and how often members contribute. Respondents also thought that most members will be new to saving in a pension, and negative comments from the media and their friends about the performance of personal accounts will influence their opinions. They referred to the research commissioned by DWP which found that members are comfortable with saving, but wary of investment.[28] In the early years of personal accounts, respondents argued that the focus should be on preserving capital. This will help convince members that saving for their pension is worthwhile to encourage them to stay in the scheme and contribute regularly.

3.12 The Pensions Advisory Service explained the situation as:

"There will be a heavy responsibility on the personal accounts scheme trustees to ensure that decisions concerning the default funds reflect the actual views of what the membership wants, rather than what someone thinks they ought to want. Our experience, particularly in the current bear market, is that many defined contribution scheme members in equity-based default funds have been shocked at the decrease in the value of their funds. They claim that they never understood that the value of their investment could drop and by so much. While admitting that they received a booklet or other communiction explaining the nature of the fund, they claim that they could not understand it or they didn't read it as it was too long and technical. The unfortunate result of this has been that many have opted out, which, in an auto-enrolment environment, would rather defeat the purpose of auto-enrolment."

3.13 On the other hand, those respondents that argued the trustee corporation should do what it thinks is best believed that members would not become discouraged from saving if they experience negative returns. They argued that although members may say they are risk averse, because they are disengaged in practice their risk and loss tolerance may be higher. Some respondents thought that inertia can be beneficial in terms of 'nudging' people towards what they need.

27 Park, 2009.
28 Collard and Breuer, 2009.

Box 3.1 Research findings of EBRI in the United States

We spoke with the US-based EBRI to discuss its research on member demographics in 401(k) target-date funds. The research looked at how the scheme demographics relate to the levels and frequency of member contributions and the risk profiles of the target-date funds.

The EBRI is a private, non-profit, non-political organisation. It is committed to public policy research and education on economic security and employee benefit issues in the US. EBRI's membership includes a cross-section of pension funds, businesses, trade associations, unions, health care providers and insurers, government organisations and service firms.

EBRI has access to one of the largest datasets on employee participation of 401(k) pension schemes in the US. The EBRI's paper *Plan Demographics, Participants Saving Behaviour, and Target-Date Fund Investments*[29] explores whether the demographics of members within pension schemes effect member contribution rates and the risk profiles of target-date funds. The research also looks at glide paths for members in relation to their pension scheme demographics and considers the success of the glide paths in meeting target income replacement rates.

Some of the paper's broad conclusions on members' income and the length of time they contribute are:

- Members' contribution rates and target-date fund investments differ depending on the scheme's demographics.
- Looking at members with 90 per cent or more of their account balances in target-date funds, equity allocations differ depending on the scheme demographics. The funds where members have low incomes and short contribution histories tend to have lower equity allocations in the early or mid-working part of their careers. This compares to those funds where most members have middle or high incomes and median or long contribution histories. These funds tend to have higher equity allocations during the early or mid-working careers of their members.
- These trends may be related to members in schemes dominated by low income and short contribution histories having less 'risk capacity'. This may be because their income over their working career can be unpredictable. This tendency may also be the result of the choice of target-date funds by employers, but this conclusion needs further study.

The findings from the US suggest that member characteristics, in particular income and age, should be carefully considered when constructing target-date funds. The research also suggests that those in lower-income groups may have less capacity for risk. The empirical data from the US appears to support PADA's conclusions on the higher importance of members making regular contributions over a long period of time, compared to the impact of investment returns on members' income in retirement.

29 *Park, 2009.*

Research required

The recent economic downturn has had a significant impact on many pension savers around the world, particularly where saving has been through a defined contribution pension scheme. Serious falls in the value of pension pots and increased volatility have been recorded in most countries where individual pension saving is commonplace. Of particular interest to PADA is the impact this volatility may have had on individuals' behaviours. PADA is analysing existing data and designing research into the impact of investment volatility on the behaviour of members of defined contribution schemes. We want to know whether falls in the value of pension pots are linked to members changing their contribution patterns, or switching from their chosen scheme or fund. We will be looking at national, as well as international experiences, of member behaviour when members are confronted with significant drops in the value of their pension savings. We will be particularly focused on those systems or schemes where individuals have been automatically enrolled into occupational schemes, or state-mandated savings vehicles.

Short or long term

3.14 Stakeholders were divided on whether the focus on outcomes for personal accounts should be on the short or long term. Some respondents, particularly consumer representative groups, argued that any losses in the early years will have an adverse impact on member contribution and participation rates. They thought that the focus should be on minimising even short-term losses, although this may mean sacrificing higher returns in the long term. This is explored further in Chapter five and what impact focusing on capital preservation in the early years has on final pot size. Some respondents preferred this approach believing the most important factor in building the pension pots of members is regular contributions. As Age Concern and Help the Aged explained:

"For the default fund, PADA should err on the side of caution rather than the optimal investment solution. Members are likely to frame their decision in the context of what they know – 'savings' – and could feel surprised and let down if their contributions drop in value, even in the short term."

3.15 Other respondents thought that the aim of personal accounts is for members to save for their retirement, which is a long-term endeavour. They made the point that over the long term, building a sound investment solution from the start would engender confidence in personal accounts. They thought this was a better approach than sacrificing an adequate income in retirement to cater for the risk aversion of members in the short term. This tension was highlighted by respondents who described the long-term approach as ***"doing what is right and not necessarily what is easy"***, and the short-term approach as ***"reckless conservatism."***

3.16 The Confederation of British Industry argued:

> ***"The long-term nature of pension savings means that funds can afford to seek returns, rather than confining themselves predominantly to 'safe' or low-risk investments which are unlikely to deliver."***

3.17 Some respondents suggested that PADA should look at international comparisons on balancing risk and reward. The experiences of other countries in setting an investment objective for their schemes are explored in Box 3.2. Further information on these schemes is included in Annex three. Looking at other countries' pension schemes can help us learn from their experiences, but their situations cannot be directly applied to the UK because of differences in the broader pension systems.

Box 3.2 International experience

Australian Superannuation System

Membership of a superannuation system is compulsory, with employers contributing nine per cent but employee contributions being voluntary. There are a range of different funds on offer which employees can choose. If individuals do not make their own choice, they are made members of their employer's chosen fund. Generally, the default funds of the Australian system have tended to take a growth-driven approach with a high investment in equities. Many default funds have shown significant variations in returns. Around a third of the superannuation assets remain in the default funds. Given the Australian system is compulsory, there is no risk of members opting out of saving for their retirement when they experience losses.

Members are generally apathetic about their retirement savings, with there being low levels of employee contributions. Members only seem to become interested and active about their retirement savings when their pot reaches a threshold size, generally thought to be around the value of a new family car. Even with the global financial crisis there have been very few switches by members between investment options or funds. However, some funds have moved their strategic asset allocations towards safer assets. This has raised concerns about the focus being placed on the short term.

New Zealand KiwiSaver

Membership in New Zealand's 'KiwiSaver' is voluntary and individuals can choose to 'opt in' at any time. Employees over 18 years of age are automatically enrolled into KiwiSaver when they commence employment. Automatically enrolled employees then have 55 days to 'opt out' of the system.

Box 3.2 continued

Employees and employers are both required to make contributions into KiwiSaver. Employees may choose to join a KiwiSaver scheme chosen by their employer or choose their own scheme by contacting the scheme provider directly. If the employee does not make a choice they are defaulted into one of six funds chosen by the government. The default funds are run by six different providers and have been set up to take a conservative investment approach. They are primarily invested in fixed interest assets or cash, with only 15-25 per cent allowed to be invested in growth assets. Approximately one third of members are currently in default funds.

KiwiSaver was designed to encourage a long-term savings habit and asset accumulation by creating a savings culture in New Zealand, especially among people who had not made provision for their retirement. The default funds are consistent with the risk preference of many members with a focus on simple, low-cost and low-risk saving for retirement. Members in default funds are generally less engaged about their retirement savings than other members, with fewer switches between schemes or funds since the economic downturn.

United States 401(k) plans

The 401(k) plan is the major vehicle for pension savings in the US, covering 4 in 10 private sector workers. 401(k) plans, named after the section of the US tax code that created them, are defined contribution schemes where an employee contributes a portion of their pre-tax wages into an account, and their employer elects to match all or part of this contribution. Increasingly, employees joining these schemes are not making contribution decisions but are instead being automatically enrolled by their employer. The *Pension Protection Act 2006* provides a variety of incentives for employers to adopt automatic enrolment, including legal protection for employers selecting default investments.

Generally, members who are not automatically enrolled select their own investment options, usually from a broadly diversified set of options comprising equity, bonds and money market instruments. In rare cases, the employer will appoint a trustee to manage the investment decisions on behalf of the scheme's membership. Half of plan assets are held in mutual fund (unit trust) options and half are in other commingled fund arrangements. Many large employers encourage employees to hold some portion of their pension savings in company stock, but the proportion held in employer stock has been decreasing in recent years due to federal laws encouraging diversification of such holdings and lawsuits aimed at the practice.[30]

The average investment returns in 401(k) accounts dropped 29 per cent in 2008. Asset allocation across the system continues to be focused on growth with 61 per cent of assets invested in equities and 39 per cent in fixed income and money market instruments.[31] The stock market crash of autumn 2008 and global recession have had a minimal impact on 401(k) investor behaviour. Asset allocation switching rates have not been atypical, and the fraction of workers contributing to these plans has continued to rise, which may be partly a result of auto-enrolment.

30 Greater importance has been put on diversification. There has also been well publicised collapses of sponsoring companies, such as Enron, where people simultaneously lost their jobs and saw their stocks become worthless.

31 Vanguard, 2009.

Diversity or majority

3.18 Respondents acknowledged that personal accounts will be made up of a diverse breadth of people with different circumstances and careers. The bulk of respondents argued that given the variety of different contribution profiles, it was not reasonable to expect each of these to be considered individually when designing the investment objective. This sentiment was also expressed at the roundtable discussions by both consumer representative groups and the investment industry.

3.19 Respondents thought, at best, this approach would be too expensive, complex and create an administrative burden. At worst, given the range of possible combinations and limited information available on the personal accounts membership, respondents thought predicting individual contribution profiles was impossible and would lead to poor decisions. Aviva described the situation as:

> ***"There may be attractions in tailoring the investment to different contribution profiles of individual members, but identifying those members with erratic or broken histories in advance will be difficult and prone to error. Anticipating whether contributions will rise, fall or remain static will also be impractical."***

3.20 While arguing the different contribution profiles of members should not impact the setting of the investment objective, some respondents also thought that personal accounts should aim to satisfy the investment needs of the breadth of its membership. They thought auto-enrolment and PADA's statutory principle, to respect diversity among members and prospective members, made this necessary. Respondents, however, did not identify how this could be achieved without considering the different contribution profiles of members.

3.21 This led respondents who addressed the issue to argue against the suggestion of defining a 'median group of members' and setting the investment objective to meet their needs. Most respondents thought that the investment objective should be built around the contribution profiles and investment needs of the majority. A handful of respondents thought rather than skew the scheme towards the median member, the scheme should be designed with the needs of the less able and lowest income individuals in mind.

Research required

We are also conducting more research into the characteristics of the scheme's members as described in Chapter two, and will continue to refine our analysis on the likely profiles of members as new information becomes available.

Mixed opinions

Although respondents agreed that achieving an adequate income in retirement is the most important factor in setting the investment objective, there was no consensus on the high-level principles or objectives that should guide the trustee corporation in achieving this.

Confidence and communication

"Communication should not be overly concerned with investment performance as this can become disproportionate to the overall investment objective of the scheme. Instead, communication should be tempered by realism with regard to pension outcomes and how those outcomes will change in different circumstances. In simple terms the focus of the trustee corporation should be on educating members on 'how much' they need to save rather than 'how' they invest those savings."

National Association of Pension Funds

3.22 Building confidence and trust is one of the biggest challenges PADA faces in implementing personal accounts. Personal accounts will be a low-charge scheme designed for low-to-moderate earners, most of whom have never saved in a pension before. Earning their confidence and trust will be essential to encourage them to make regular contributions and stay in the scheme.

3.23 There was general consensus that one of the factors in building confidence in the scheme is effective communication. Respondents generally thought communication should be simple, concise, accessible and outcome-focused to reach members and prevent any misunderstanding.

- **Simple** – Nearly all stakeholders thought that the traditional language of finance and pensions will not be suitable for the membership of personal accounts. Members are likely to have low levels of understanding and be wary of investment. A handful of respondents thought having to translate technical concepts into simple language will result in wordy and lengthy communications.
- **Concise** – Stakeholders thought that members should be given brief and simple information because giving members more than this is likely to lead to confusion. For those members who want to know more, stakeholders believed more detailed information could be made available on the website or through other channels.

Research required

As suggested by a number of respondents, PADA is conducting qualitative and quantitative research with the target group for personal accounts to ensure the language used when communicating with them is suited to their level of understanding.

The purpose of the research is to ensure that any communications about the scheme, or about their individual pension pots, are as easily understood as possible. Specifically, the research will examine the ability of employers and jobholders to understand a range of existing pension terms. It will also aim to create a series of principles around any future vocabulary or language required by the scheme to ensure a consistency of approach and that language remains comprehensible.

- **Accessible** – Respondents argued that communications should be easily understood by members. Some respondents suggested that personal accounts should educate members to improve their financial knowledge and develop their understanding of the relationship between risk and reward. They thought this would help build member confidence in pensions saving and encourage regular contributions. Other stakeholders acknowledged the limitations of such education programmes. Respondents also identified the channels of communication that personal accounts will use as an accessibility issue. The general feeling was that although online and digital channels bring the benefit of being low cost, at all points in the process alternatives should be offered to members not able to use, or access, online and digital channels. Alternative communication channels might include telephone and letters.

- **Outcome focused** – Stakeholders believed that communication should focus members on what personal accounts is trying to achieve in the long term, which is increasing savings for retirement. They thought that members are likely to be preoccupied with the short term. This means short-term losses could damage their confidence even if these losses are unlikely to impact on their final pension pot. Stakeholders argued that scheme communications should help members focus on their long-term retirement outcomes, highlighting the important role their contributions play in building the value of their pensions. Projection tools showing how much a member's pot might be worth in retirement were thought to be useful.[32] Projection tools provide estimates based on current contribution rates and reasonable assumptions about salary growth, inflation rates, annuity rates and investment returns. However, some respondents thought such tools may create confusion for members if they believe projections represent guarantees on what they will get in retirement.

Mixed opinions

- Some stakeholders suggested that personal accounts should educate members to improve their financial understanding, while others acknowledged the limitations of such education programmes, or did not raise this issue.

- Personal accounts will be just one qualifying pension scheme under the auto enrolment legislation. There are already government-sponsored programmes in place whose aim is to increase the population's financial knowledge.[33] There is evidence to suggest that people's financial literacy and confidence increases over time as they interact with new financial products, and given the size of the personal accounts scheme and the fact that for many members this will be their first interaction with pensions or other investment vehicles, this is a significant potential benefit of the scheme. It is likely that interaction with the scheme and our communication strategy will help members on the road to financial literacy, but this will not be the focus of our communications.

32 This is supported by McAlpine et al, 2008.

33 The wide range of Government and Financial Services Authority-sponsored financial capability initiatives currently underway are set out in "Helping you make the most of your money: an action plan for financial capability", July 2008, HM Treasury/Financial Services Authority.

General agreement

There was general consensus among stakeholders that effective communication will be important in building confidence in the personal accounts scheme.

3.24 The other factors identified by stakeholders as building confidence in the personal accounts scheme were:

- Managing expectations by being clear and realistic on what members can expect to achieve by saving in personal accounts. Some argued that consistent and predictable outcomes will help members know what they can expect and help build confidence in personal accounts when this is achieved.
- Minimising losses, even in the short term, but particularly in the early stages of personal accounts when it has no track record. Respondents thought that poor performance will have greater impact on member confidence than good performance.
- A robust and transparent governance framework for the personal accounts scheme to provide members with confidence that their money is safe. 'Governance' refers to the role of the trustee corporation in ensuring the overall direction, effectiveness and accountability of the scheme.
- Having a set of explicit investment beliefs.Participants at the roundtable discussions[34] thought making these publicly available would help generate confidence and trust in the scheme. Investment beliefs are explored further in Box 3.3.

Box 3.3 Investment beliefs

Having a well defined and agreed investment objective is an essential element in assuring that the trustee corporation has a clear and articulated view as to what it is trying to achieve for its members. Through the consultation process and research we have also identified the benefits that an explicit set of investment beliefs can provide to the trustee corporation to enable it to achieve the investment objective.

An investment belief is an observation of behaviour in financial marketplaces. They are called beliefs as they are not a hard science but based on a credible explanation where different theories of financial markets and economics exist. There are generally four types:

- beliefs about financial markets
- beliefs about the investment process
- beliefs about the organisation
- beliefs around sustainability and governance.

34 *Investment beliefs: variety of stakeholders*, London 25 September 2009.

Box 3.3 continued

Having an explicit set of investment beliefs should lead to better informed decisions and increased accountability and transparency. Investment beliefs should provide the rationale for the 'statement of investment principles', although they are separate. The statement of investment principles sets out how the investment beliefs should be put into practice when making investment decisions.

Some examples of investment beliefs are:

- 'Diversification is a free lunch', ABP Pension Scheme
- 'There are normally additional returns available for investing in illiquid assets', BBC Pension Scheme
- 'There is a relationship between risk and return – higher returns generally require taking higher risk', City of Edmonton Endowment and Pension Funds
- 'Improving environmental, social and governance factors can improve the long-term financial performance of a company', New Zealand Superannuation Fund.

Traditionally, investment beliefs are used to improve communication among the trustees and their fund managers and guide them in their decision making. At the roundtable discussions, some participants suggested investment beliefs could play a broader role in building the confidence of external stakeholders in personal accounts. By explaining the how and why behind the investment decisions, investment beliefs are able to manage expectations and increase accountability and transparency.

There was recognition that although investment beliefs are primarily an internal document, they can also be made publicly available. Participants argued that the trustee corporation needs to consider this when developing its set of investment beliefs and how they are framed. They could be used to help develop confidence in the trustee corporation and legitimacy of the personal accounts scheme.

Although all participants agreed that personal accounts would benefit from having an explicit set of investment beliefs, which are made publicly available, there was no consensus on what they should be and how they should be used. There was agreement that the **trustee corporation itself** needs to decide on the scheme's investment beliefs, with guidance from PADA. The process of developing investment beliefs is as important as the actual beliefs themselves.

General agreement

Factors that were thought to help build confidence in personal accounts were:

- managing member expectations
- minimising losses
- a robust and transparent governance framework
- having a set of explicit investment beliefs.

Investment objective of the default fund

3.25 Respondents were divided on how the investment objective of the default fund should be defined. Most stakeholders acknowledged that no single option was perfect and each objective had its own advantages and disadvantages. Generally, stakeholders were in favour of one, or more, of the options described below. Many stakeholders thought all options were fraught with challenges and made their suggestions based on what was the least inappropriate choice, rather than what was necessarily the best solution. This theme emerged strongly at the roundtable discussions where the opinions of participants changed as the objectives were debated and their disadvantages identified. Box 3.4 contains examples of investment objectives suggested by respondents.

Best-efforts basis objective

3.26 A best-efforts objective involves allocating assets to investment managers to maximise returns for an acceptable level of risk, without defining any specific return or what is acceptable risk and for whom. Many respondents arrived at this option having rejected target replacement and benchmark-driven approaches.

3.27 The best-efforts approach was seen as the only option which did not carry the risk of setting a specific target that may not be reached for all members. Stakeholders identified a major disadvantage of the best-efforts approach as being too vague to be meaningful. This is both in terms of helping members to plan for their retirement and assisting the trustee corporation to monitor progress and measure performance.

Target replacement income objective

3.28 A target replacement income is an objective that expresses the required return from saving and investing as a proportion of a member's final (or possibly average) salary, either as the total pension pot or the amount of income available annually in retirement. Generally, this option was considered appropriate for the broad, overarching scheme objective, rather than the investment objective of the default fund. The arguments put forward for adopting a target replacement income centered on it being easy to understand and relevant for members. Some respondents also thought that a target replacement income helps focus members on the long-term benefits of saving, and this can help show them the relationship between contributions and the size of their pension pots.

3.29 The downside identified by nearly all respondents was that a target replacement income can be difficult to achieve for all members, all of the time. It depends on a number of factors which are outside the control of the trustee corporation, including contribution patterns and annuity rates. Some respondents thought that a target replacement income was particularly inappropriate for the members of personal accounts because they are likely to have broken contribution profiles. Stakeholders thought this would create unrealistic expectations and when the target is not reached for all members, this may discourage others from saving for their retirement.

Box 3.4 Examples of investment objectives

Target replacement income objective

"The Pensions Commission specified replacement income in relation to pre-retirement income, which is equivalent to a percentage of final salary. An alternative approach would be to specify the target in relation to a proportion of lifetime average earnings."

Pensions Policy Institute

"This income requirement should be communicated in 'today's terms', potentially as a proportion of current pensionable salary in order to avoid the need for investment jargon and improve understanding of their pension provision."

Deutsche Bank Advisors

"The objective should be to achieve a pre-determined level of pension (in real terms) at retirement, with the minimum (specified) level of risk exposure consistent with the objective."

JA Pensions Consulting

Benchmark-driven return objective

"For example, if the objective is to proxy a final salary scheme with a minimum of variability in pension payments between members with the same salary history and contribution record, then the investment strategy will be dominated by inflation indexed bonds since these will provide a close match for salaries which grow at inflation plus productivity increases. In this case an 'inflation plus' benchmark for the default fund is appropriate."

Dr Byrne and Professor Blake

Box 3.4 continued

"In order to preserve the real value of accumulated funds over time, the objective of the fund should be set in relation to inflation as measured by a broad based index such as the Retail Price Index."

Prudential

"There is also evidence that in the short term, cash and inflation are close as a proxy and therefore, we would suggest a cash based return target such as Base Rates + 2.5 per cent (equivalent to Retail Price Index + 4 per cent) would be most appropriate."

BlackRock

"A desire to achieve returns that do well versus benchmarks such as inflation, earnings, interest rates or Gross Domestic Product would represent sensible investment objectives."

Association of British Insurers

Best-efforts basis objective

"We believe that the overarching objective of the personal accounts default fund should be to maximise the risk-adjusted value of members' assets given their target retirement date."

Northern Trust

"To deliver a level of diversification appropriate to reduce risk while allowing consistent growth."

Friends Provident

"A best efforts approach may be more realistic for the scheme, to achieve the best returns for the lowest risk. This may be more difficult to quantify and communicate to members, but on balance we believe that trust is more likely to be maintained by this route than if real or perceived objectives are not met."

AEGON

Benchmark-driven return objective

3.30 A benchmark-driven return objective expresses the required return relative to an appropriate benchmark, such as inflation, earnings growth or interest rates. The general view emerging from the roundtable discussions was that a benchmark return would be the most appropriate objective for the personal accounts default fund, when compared to the other options available. It was acknowledged that, like income replacement rates, benchmarks do not represent a guarantee and may not be understood by all scheme members.

3.31 Nearly all respondents who addressed benchmark-driven return objectives thought their main advantage is they require the trustee corporation to set targets. This enables progress to be easily monitored and final performance measured. Some respondents also thought they could be readily communicated to members.

3.32 Inflation was the benchmark recommended by most stakeholders, followed by cash. Both benchmarks were thought to focus on capital protection and generating predictable returns, making them most appropriate for members of personal accounts compared to other benchmarks. The Investment Management Association believed that given the complex relationship between interest rates and inflation, a benchmark based on inflation would be more likely to help protect the value of members' contributions in real terms. It explained that:

"This leads to the possibility of a 'cash plus' benchmark, which would probably be the simplest approach for scheme members to understand, but would also require the trustees to investigate the relationship between cash returns and inflation over time, and to set the overall objective in such a way as to ensure a reasonable balance between capital protection and capital growth. The trustee corporation would have to be convinced that it sufficiently understood the relationship between inflation and cash well enough before embarking on a cash plus objective. The macro-economic experience in the UK prior to the mid-1990s suggests a need for consideration and care in this respect. It may be more appropriate to use an inflation benchmark, even if this may pose some educational/communication challenges."

3.33 Taking into account what our stakeholders have said, PADA believes an appropriate objective for members of personal accounts would be to seek returns in excess of inflation after management charges. A theme emerging from our consultation was that consistent and predictable outcomes, which reduce the possibility of loss even in the short term, would help build confidence in personal accounts and saving for retirement. Our stakeholders and the evidence also suggest members are likely to be 'savers' instead of 'investors' and focused on preserving capital.

3.34 A benchmark in excess of inflation will, at the very least, create a target of maintaining the buying power of members' contributions. The trustee corporation can take an informed view on how much excess return above inflation should be targeted, and how much risk is appropriate over a member's savings career. The excess return target can be adjusted at different times throughout a member's life to respond to factors such as age and their likely risk tolerance profiles at different stages of their career. As set out in this chapter, we are conducting further research into the scheme's members and their behaviour to inform this decision.

Mixed opinions and next steps

- There was no consensus on the investment objective of the default fund which best suits the membership of personal accounts.
- Following careful consideration of all responses and the discussions at the roundtables, PADA believes that, at a minimum, the investment objective needs to deliver a solution that maintains the buying power of members. This lends itself to an objective that aims for returns in excess of inflation after management charges. This was the preferred benchmark of respondents who recommended this type of objective. What the excess return target should be will be informed by an understanding of the likely contribution profiles for a range of members, the ages of members and their likely risk and loss profiles. This information will drive the degree of risk taken in relation to the benchmark. As set out in this chapter, we are conducting further research and modelling to inform the setting of the excess return target.

Different approaches – risk sharing

3.35 Fewer respondents answered the question of risk sharing directly. Instead, several focused on the issue of volatility smoothing or with-profits, where investment returns are held back in good years to boost and smooth return in bad years. Of those who addressed risk sharing within and across generations of scheme members, the majority thought that risk sharing in its current forms would not be appropriate for personal accounts, at least in the early years. Respondents thought that risk sharing may create challenges for delivering a low-charge and simple scheme. However, most respondents acknowledged that the concept of risk sharing is appealing to protect against unevenness in member outcomes in retirement, and thought these approaches were worth further investigation by personal accounts. For example, the Trades Union Congress explained that:

"We think it is extremely worthwhile to develop approaches that could collectivise risk and minimise volatility. This is an extremely exciting area of work with wider relevance in today's increasingly defined contribution world."

General agreement

The majority of respondents thought that given personal accounts' remit to deliver a simple and low-charge scheme, current forms of risk sharing may not be appropriate, at least in the early years, but the trustee corporation could look into innovations in this area in the future.

Chapter four
How should members' contributions be invested?

Like any other occupational pension scheme, the personal accounts scheme will be able to invest in a wide variety of asset classes, sectors and countries. How the scheme chooses between asset classes and the style it uses – whether active, passive or a mixture of management styles – is important. These decisions will determine the costs of the scheme and the returns achieved on members' contributions.

Nearly all respondents supported the inclusion of alternative asset classes alongside the traditional asset classes of equities, bonds and cash. Although respondents acknowledged that investing in alternatives may pose some challenges, in terms of liquidity, daily pricing and low costs, they also felt that these could be overcome. There was general consensus among respondents that a predominantly passive approach is best suited to the personal accounts scheme, but active management should be used in sectors and asset classes where it adds value. Generally, respondents were comfortable with the use of securities lending within personal accounts, but were divided on whether tactical asset allocation should be used.

4.1 The trustee corporation will need to decide what asset mix should be used to build the personal accounts default fund and how it should be managed to best meet the investment objective. These decisions will need to be consistent with a low-charge scheme and achieving returns that will improve the retirement outcomes of members. Decisions on where and how the default fund will be invested are known as 'asset allocation'. This refers to the mix of all the asset classes in a portfolio. Asset allocation will need to be used appropriately to manage risk throughout a member's savings career and help ensure the investment objective is achieved. Although the asset mix and management style will form part of a long-term view, it will be subject to regular reviews and changes to respond to the economic outlook and asset market valuations.

4.2 This chapter in the discussion paper focused on the key issues around asset allocation and fund manager selection. In a broad ranging discussion, we examined:

- the potential role of tactical asset allocation to complement the trustee corporation's strategic asset allocation
- the importance of diversification and how any single asset class was unlikely to strike an appropriate risk-return balance
- the advantages and disadvantages of active and passive management, including costs, performance risk and manager selection risk
- the potential benefits and constraints associated with a variety of asset classes.

What the discussion paper *Building personal accounts: designing an investment approach* asked

4.1 In what situations should personal accounts use tactical asset allocation and why?

4.2 What are your views on how the personal accounts scheme can use alternative asset classes to benefit from potentially improved diversification and investment performance, while still meeting its needs for liquidity and accurate pricing?

4.3 Across which asset classes should diversification of the default fund extend?

4.4 What should be the balance between active and passive managers in the default fund, and is this consistent with a low-charge scheme?

4.5 Do certain asset classes favour a particular management style? Please provide evidence to support your response.

4.6 What approach should the trustee corporation use to identify active managers who are likely to outperform?

4.7 Should the personal accounts scheme participate in securities lending? If so, what controls and limits should it impose, if any?

What you said

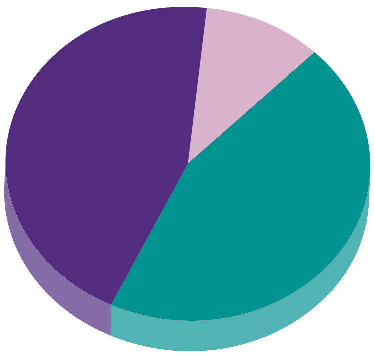
4.3 A large proportion of investment managers provided answers to Chapter four. Generally, their responses were more detailed and comprehensive than those from other organisations. Responses from consultants also featured heavily, while only a couple of consumer representative groups responded to this chapter.

Tactical asset allocation

4.4 The asset allocation for the personal accounts default fund is likely to be undertaken with a long-term investment horizon in mind to reflect the long-term nature of saving for a pension. This is known as strategic asset allocation. Because its focus is on the long term, the strategic asset allocation does not aim to benefit from shorter-term market fluctuations, either **to realise greater returns or to reduce risk.** A short or medium-term approach to asset allocation can be used to manage volatility and maximise short-term returns, this is known as tactical asset allocation.

4.5 Respondents were mixed on whether or not personal accounts should use tactical asset allocation. Of those respondents who expressed a clear opinion, approximately half were in favour of implementing tactical asset allocation, while around half were against using the strategy as demonstrated by Figure 4.1. Generally, investment managers were in favour, while all independent financial advisors, individuals and academics who answered the question were against. Professional bodies and consultants were both divided on this issue.

Figure 4.1 Tactical asset allocation



■	For	17
■	Against	17
■	No clear opinion	4

Source: PADA 2009
Base: 37 responses to the discussion paper addressed this issue

4.6 Respondents who recommended tactical asset allocation thought the approach could add value to personal accounts as a tool to manage risk and take advantage of market opportunities. They argued that over a member's savings life, a strategic asset allocation strategy is too rigid and cannot adjust to exceptional investment opportunities. These respondents thought that tactical asset allocation can bring flexibility and the ability to benefit from market timing and varying economic conditions. BlackRock believed that tactical asset allocation is a:

"…***key requirement given the membership. Members will expect the fund to invest in the right asset classes at the right time. They cannot understand why a fund would have a high equity content for example, if the trustee corporation or their advisors feel the market is going to fall. Tactical asset allocation also allows the manager/ trustee corporation to lock in profits after a good run, again in line with member expectations."***

4.7 A few respondents thought tactical asset allocation was best used as a de-risking mechanism in the glide path towards retirement:

"One area that lends itself to tactical asset allocation is the phased switch of growth assets to protection assets as a retirement date approaches, and the need for tactical asset allocation would reduce as a portfolio moved towards less risky assets over time."

Association of British Insurers

"Tactical asset allocation could have a place in this fund. For example, after a period of good market performance it may make sense to reduce the risk and therefore lock in profits in the period running up to retirement."

The Association of Consulting Actuaries

4.8 Respondents that were against the personal accounts default fund using tactical asset allocation cited complexity in communicating this strategy to members, high costs and scalability challenges. A range of respondents questioned whether tactical asset allocation can consistently add to long-term performance and believed that there is a lack of compelling evidence to prove this approach works successfully.

4.9 A handful of respondents made the distinction between tactical asset allocation and dynamic asset allocation. The former aims to benefit from short-term market fluctuations, such as pricing anomalies or strong market sectors, which do not distort the long-term objectives of the asset allocation strategy, while the latter approach focuses on the long term and constantly adjusts the asset allocation mix as market conditions change. Respondents argued that personal accounts would benefit from using dynamic asset allocation alongside tactical asset allocation.

This was explained by Allianz Global Investors as:

"Dynamic asset allocation is designed to address and manage the market risks over the capital market cycle, thus earning the risk premium in phases where it exists and limit absolute losses when not. This is different from a standard tactical asset allocation approach, which generates alpha from asset allocation decisions and may well complement a dynamic asset allocation, especially at turning points in the capital market cycle."

Mixed opinions

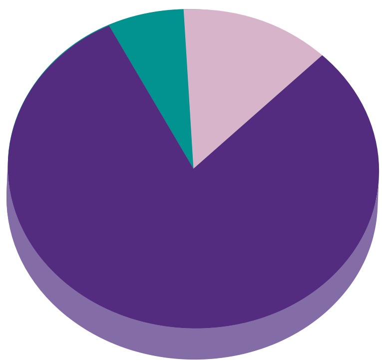
There was no consensus on whether tactical asset allocation is an appropriate tool to enhance returns or reduce risk within the personal accounts scheme. PADA will continue to explore the merits and challenges associated with tactical and dynamic asset allocation, before making its recommendation to the trustee corporation.

Alternative asset classes

4.10 Most pension schemes invest in the traditional asset classes of equities, bonds and cash. Some also invest in alternative asset classes such as hedge funds, private equity, commodities, infrastructure funds and property.

4.11 Nearly all respondents supported the personal accounts scheme investing in alternative asset classes and only a handful of respondents did not. This is illustrated in Figure 4.2. Investment managers expressed the most support, while consumer representative groups did not have a strong opinion on this issue. Respondents that recommended a purely passive approach were less supportive of alternatives but still acknowledged they could play a role within the strategic asset allocation of the default fund.

Figure 4.2 Alternative investments



For	37
Against	3
No clear opinion	6

Source: PADA 2009
Base: 46 responses to the discussion paper addressed this issue

4.12 Those in favour of using alternatives felt the main benefit was to diversify the default fund's assets. They believed that alternative investments are uncorrelated to the performance of traditional financial markets such as equities and bonds. Respondents thought this would result in improved risk reduction and investment performance. Some examples of what respondents said were:

"Alternative asset classes do offer both greater investment performance and increased diversification. The scale of personal accounts means that these could be added to the default fund. Provided they are only used in moderation, then the approximate pricing and illiquidity of these assets will not prove a problem."

Pensions Management Institute

"At the asset class level, we similarly believe the scheme can benefit from improved diversification by adding liquid alternative investments. The addition of alternatives has the potential to reduce portfolio volatility through most market conditions, thereby significantly improving the certainty of return."

State Street Corporation

"We therefore believe personal account members can access the benefits of alternative assets through a diversified growth portfolio. These strategies invest across equities, bonds and cash, as well as alternatives, and can offer an improved risk-adjusted return (equity-like returns over the long term but with lower levels of volatility). The benefit of having exposure to more illiquid alternative investments can be appreciated by those with a longer time horizon, while risk averse individuals should be attracted to a diversified growth portfolio in comparison to the higher levels of volatility inherent in a traditional, passive global equity fund."

JP Morgan

4.13 The minority of respondents that recommended not using alternative asset classes provided a number of reasons why. A couple of respondents believed that equities deliver better long-term returns than alternatives. Others thought that although alternatives have been uncorrelated with traditional financial markets in the past, different correlations may develop following the recent financial crisis. We will continue to monitor both the levels of correlation between different asset classes, including alternatives, and the stability of those correlations.

4.14 Some respondents also identified issues around transparency as a disadvantage of alternatives. This means that higher levels of governance and monitoring are required. Some respondents thought that alternatives would present challenges for personal accounts because of their lower liquidity, which means the holding cannot be converted into cash quickly. Difficulties around daily pricing of some alternatives were also highlighted by respondents. Fidelity International explained that:

"When one considers that many of the characteristics displayed by alternatives also go against some of the key principles for PADA investment – liquidity, low cost, lack of transparency, often infrequent dealing, and lack of member awareness and understanding – this further supports the use of mainstream asset classes only in the personal account funds."

4.15 Respondents that were in favour of alternatives recognised these challenges, but thought there were ways they could be overcome. Our roundtable discussions[35] also explored how alternatives could be used within the personal accounts scheme, as set out in Box 4.1. Respondents thought the challenges presented by some types of alternatives could be overcome by:

- the long-term investment horizon of personal accounts and potentially large volume of assets under management will mean that lower liquidity should not create any problems for the scheme
- vehicles, such as hedge fund replication and real estate investment trusts could be used to help overcome liquidity and transparency issues
- the types of alternatives and how they are implemented – much will depend on the knowledge and experience of the trustee corporation in determining how alternatives are used as part of the investment approach.

General agreement

- Nearly all respondents supported the use of alternative asset classes within the default fund.
- Although respondents recognised that investing in alternative asset classes can create challenges around liquidity, daily pricing and costs, respondents generally thought these could be overcome.

Box 4.1 Roundtable discussion on alternative asset classes

We held a roundtable discussion on alternative asset classes to explore whether, and how, alternatives should be used in the personal accounts default fund. The roundtable discussion focused on property, commodities, venture capital, infrastructure and hedge funds. Participants agreed there were clear diversification advantages and that alternatives benefit from a variety of risk premia, as illustrated in Figure 4.3.

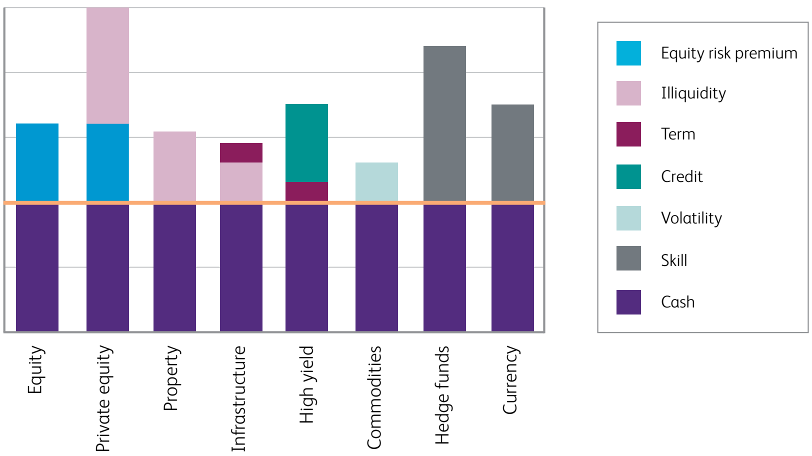
Respondents identified challenges and solutions to using any, or all, of these alternatives in the default fund of personal accounts:

- Some participants felt that difficulties around regular and accurate valuations of alternatives could be mitigated. This could be through the use of traded vehicles such as investment trusts. Also, participants thought that pricing and valuation issues could be limited if alternatives do not make up too great a proportion of the fund.
- Participants urged personal accounts to focus on the fee structure of alternatives relative to their average level of return. This is because, although the fee of an alternative may be higher, the relative return means the investment could still provide value for money. Fees should not be considered in isolation.

35 *Investing in alternative asset classes*: investment industry, London, 8 July 2009.

Box 4.1 continued

Figure 4.3 Illustrative risk premia for alternative asset classes



Source: Schroders

- Participants thought the lack of liquidity of some alternatives was less of a challenge. This is because personal accounts is likely to be growing in membership, meaning there will be positive cash flow into the scheme. Participants also thought the long-term nature of saving for a pension will mean the scheme may not have as great a need to convert assets into cash quickly. This means personal accounts could benefit from the risk premia attached to investments with lower levels of liquidity, such as venture capital and infrastructure.
- Participants believed investing in some alternatives, such as hedge funds, could potentially damage the reputation of the scheme. One way this could be avoided is by effectively communicating the investment approach of personal accounts. This means making it clear to fund managers how alternatives should be used and explaining to the media how the scheme uses alternatives and why.

What figure 4.3 tells us

A risk premium is the additional return over and above that provided by risk-free assets, such as government bonds or cash, which an asset should give an investor as a reward for bearing extra risk.[36] The chart shows the various additional risk premia (over and above cash) present in a selection of asset classes. For example, the chart illustrates that investors in private equity can expect to receive the highest premium due to that asset's exposure to equity and illiquidity risks. The following are definitions of the risk premia illustrated in the chart:

36 Risk-free generally refers to government issued securities as these are perceived to be free of credit risk. Sometimes it specifically refers to index linked government bonds as these are free of inflation risk also.

Box 4.1 continued

- **Equity** – The excess return that investing in the stock market provides over that provided by risk-free assets. This excess return compensates investors for taking on the relatively higher risk of the equity market. The size of the premium will vary as the risk in a particular stock, or in the stock market as a whole, changes. Higher risk investments should be compensated with higher premia.
- **Illiquidity** – Investors can expect a premium for risking investment in a security that cannot be easily converted into cash, or when converting to cash cannot be achieved at the fair market value.
- **Term** – When lending money, the term of the loan represents the length of time for which funds lent are unavailable to the lender. The longer the duration of the loan, the higher the interest the lender will require for the extended unavailability of their funds. A longer loan also means that the lender accepts exposure for a longer period to the potential for default of the borrower. Both of these factors justify why bonds with a longer term are expected to pay higher interest – this is referred to as the 'term risk'.
- **Credit** – Private companies and governments can raise funds by issuing bonds. Bonds issued by companies carry a higher risk of not repaying their debt in comparison to debt issued by governments. This risk is known as 'credit risk'. The larger the company's risk of not meeting its obligations, the higher the premium.
- **Volatility** – A security's price changes over time. Volatility in the price of securities refers to price fluctuations being unpredictable in direction and magnitude. High volatility means that a price can rise or fall more quickly and within a large range. The volatility risk premium reflects that assets tending to have more erratic price movements should offer higher potential returns.
- **Skill** – Active management is an investment approach that aims for returns in excess of a specified benchmark or absolute performance. The skill of active managers to exploit markets and the level of risk taken in order to produce performance varies. The higher the risk taken by active managers, the higher the premium.

In general the risk premium is considered positive. Particular risks merit particular positive rewards. Recent events demonstrate there are situations when investors are clearly not rewarded for the risk they take.

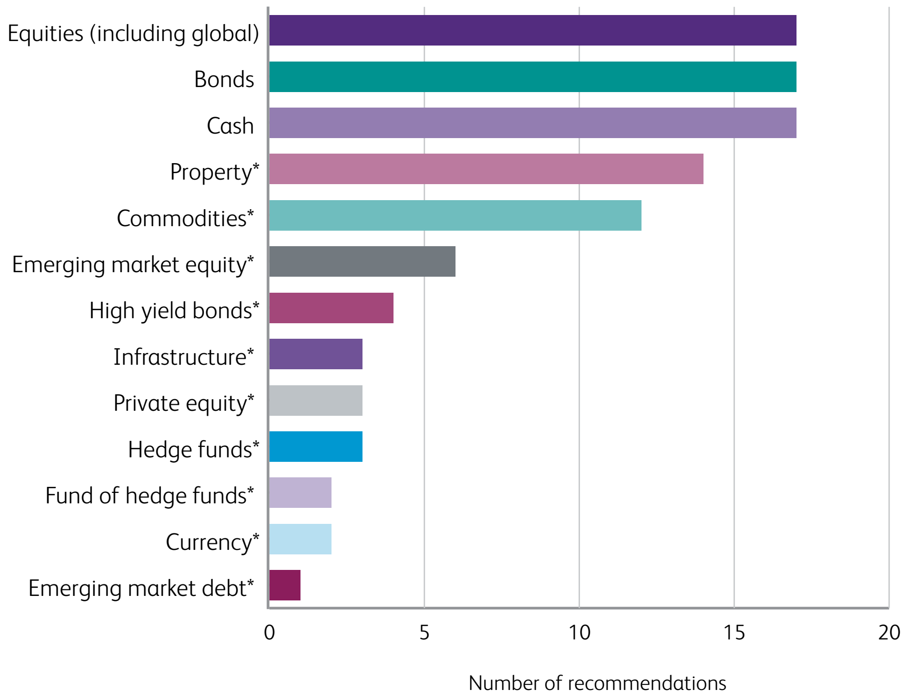
Choice of asset classes

4.16 The majority of respondents supported using a wide range of asset classes in the personal accounts scheme to achieve maximum diversification benefits. Each of the traditional asset classes of equities, bonds and cash were recommended by respondents, with property and commodities being the most popular alternatives to use alongside these. The asset classes favoured by respondents are included in Figure 4.4.

4.17 Virtually all of the investment managers that provided a recommended list of asset classes advocated the inclusion of property in the default fund. A high number proposed that commodities should also be used in the default fund. Insurance companies and professional bodies cited property and commodities as the most important diversifiers with mainstream asset classes. This recommendation was supported by participants at the roundtable discussion, who argued that the potentially large size of the scheme can give access to a better choice of investment opportunities within commercial property. Roundtable participants thought that commodities are useful because they diversify away from equity risk, although they can also be more volatile at times.

4.18 Emerging markets, high yield bonds, private equity, infrastructure and emerging market debt were also mentioned by respondents, but less frequently than property and commodities. It was argued by some roundtable participants that later stage

Figure 4.4 Recommended asset classes



Source: PADA 2009
Base: The above chart shows the number of times each asset class has been mentioned by respondents

* These asset classes are defined in the glossary

infrastructure investments are less risky than early stage developments. They also argued that there could be attractive buying opportunities in the coming years as governments worldwide are more likely to offer the chance to invest in their infrastructure projects to raise cash and reduce debt.

4.19 Stakeholders were divided on the use of hedge funds. Although some respondents have included this asset class in their recommended list, others expressed reservations about their suitability for personal accounts. Respondents were concerned about high management fees, the need to conduct an exhaustive due diligence process and the ethics of short selling.

4.20 In comparison, most roundtable participants were supportive of the use of hedge funds in personal accounts. They suggested that attitudes towards hedge funds are softening. This may be due to legislative changes proposed by the European Union and the greater focus on hedge funds by regulators and governments. Roundtable participants acknowledged that choosing the right hedge fund is critical to success, particularly in light of the Madoff scandal. While they thought that hedge fund replication strategies can reduce costs and increase diversification, such passive approaches mean that the Madoff-type situations are not screened out. Allenbridge HedgeInfo argued that:

"As part of manager selection, due diligence is necessary to avoid embarrassing participation in Madoff-esque blow-ups. As a result, we suggest active rather than passive investment in hedge funds. Many people do not realise how time consuming and complex a full due diligence is."

4.21 Some respondents gave further details as to why certain asset classes should or should not be included within the default fund:

"Real assets are important to ensure that the member's investment pot has protection from the corrosive power of long-term inflation. Exposure to absolute return strategies can provide a level of stability to the fund and bring further diversification benefits."

JP Morgan

"The diversification mix should be adjusted according to the age of the participant and emphasis should be on global assets rather than on a particular country, region or sector."

Alliance Bernstein

"Commodities might be too volatile for a personal account's risk/reward profile and hedge funds could be used, but returns would have to balance costs."

Society of Pension Consultants

"Tangible asset classes such as commodities are a great short-term diversifier, hence there are questions of whether commodities should be used within the default fund due to its long-term nature."

Barnett Waddingham

"We share the view that defined contribution pensions tend to be over-reliant on equities, and would wish to see an innovative approach to diversifying the asset base of the default fund. We are sceptical that some of the higher-risk investment vehicles that did well during the financial bubble would be appropriate for the default fund."

Trades Union Congress

General agreement

- There was general consensus among respondents that a wide range of asset classes should be used within personal accounts.
- Nearly all respondents believed that the traditional asset classes of equities, bonds and cash should be used in the default fund. The majority of respondents also recommended that the personal accounts scheme should invest in the alternative asset classes of property and commodities.

The use of active and passive management

"It is possible that a core and satellite approach could be most appropriate, whereby passive management is deployed for the bulk of the default fund (minimising cost), complemented by active fund management at the periphery, to fully exploit those asset classes which would benefit from such an approach. If no active management were to be applied to the default fund, then this would of course restrict the asset types which could be invested in, but would provide the lowest cost option."

Association of British Insurers

4.22 In order to implement the asset allocation decisions, the trustee corporation will hire external fund managers to invest members' contributions. A passive manager will aim to create and hold a portfolio of securities in the same proportion as the chosen benchmark, such as the FTSE All-Share. In comparison, active managers will aim to outperform the chosen benchmark by taking a view on the likely performance of the different markets, currencies and securities and rebalancing the portfolio accordingly. In the discussion paper, we focused on equity investment, but we recognise that active and passive management can be applied to a number of asset classes, as some respondents have identified.

4.23 The majority of respondents supported the use of passive management within personal accounts, but believed that active management may also have a valuable role to play. Respondents cited the need for low costs within personal accounts as the main reason why passive management is the more suitable option. Other reasons included the potentially large scale of personal accounts and questions about the sustainability of active manager performance in certain markets over the long term. A number of respondents cited the difficulty in finding good quality active managers in all asset classes as a hurdle. Hiring and firing managers at the right time was also identified as a challenging and resource-intensive task.

4.24 Respondents stated that active management should be used where it can add value, or where passive management is less effective. The choice between active and passive management is a practical decision based on which type of management can achieve the best returns depending on the market and asset class. Generally, respondents identified passive management as being most applicable to highly-traded, larger asset classes, such as developed market equities. Some respondents suggested that tracking a benchmark index in smaller markets can be challenging for passive managers due to the lower levels of liquidity and trading constraints.

4.25 The majority of respondents believed that active management was suited to smaller, less efficient equity markets and alternative asset classes. Respondents identified corporate bonds, followed by infrastructure and property, as suitable asset classes for active management. The majority cited small capitalisation and emerging market equities as less efficient markets, where there is greater information advantage and scope for out-performance by active managers. Some thought the scheme may gradually shift its mix of active and passive management as it matures. Mercer explained that:

"Each market should be assessed in terms of its efficiency and whether or not active management is expected to add value over the long term, net of fees. It should be recognised that active management is increasingly being associated with tactical asset allocation, currency management, hedge funds and other alternative asset classes, which offer absolute or inflation plus targets rather than market benchmarks. Passive versions of these asset classes may be difficult to replicate successfully. Asset allocation contributes a more significant part of total return than passive management which is not usually reflected in passive fund performance. The size of fees for active management would need to be evaluated against the potential for out-performance, although the size of investment by personal accounts will have an increasing influence in reducing these fees."

4.26 A handful of respondents were strongly opposed to active management being used for any asset classes because of their high costs and doubts over long-term performance. They argued that alternative asset classes can be accessed without the need for active management by using passive vehicles such as hedge fund replication strategies, investable commodities, property indices and exchange traded funds.

4.27 A small minority of respondents supported active management over passive because of its flexibility, diversification potential and broader investment opportunities. It was, however, accepted by these respondents that it may not be feasible to adopt this approach on a low-cost basis, particularly in the early days of the personal accounts scheme.

General agreement

The majority of respondents argued that a largely passive approach is appropriate for the personal accounts scheme as it meets the requirement for low charges, but active management should be used in markets or asset classes where it adds value and is the most sensible approach.

Active manager selection

4.28 Generally, respondents agreed that the active manager selection process for the scheme should either be delegated to a third party provider, or assisted to some degree by investment consultants. Some respondents also recommended creating a specialist in-house function to monitor, hire and fire active managers. Many argued it is difficult to find active managers who can produce consistent and long-term out-performance. Respondents recommended those responsible for selecting managers for the scheme should be well established and highly experienced.

4.29 Generally, respondents advised against relying on short-term past performance to aid in the selection of active managers. A number recommended the combined application of qualitative and quantitative factors, with greater emphasis placed on the former. A few respondents cited qualitative factors such as people, philosophy and process. Some respondents also provided frameworks for manager selection. The example provided by Mercer, is similar to those provided by other respondents:

"A comprehensive rating process to assess the potential for active managers to out-perform in the medium term could provide a framework for the trustee corporation to follow. Mercer rates managers on the basis of the four key factors:

- *Idea generation – how the manager arrives at their view on the relative attractiveness of different investments.*
- *Portfolio construction – how the manager translates its investment ideas into decisions on which investments to include in their portfolio, and the relative weightings applied.*
- *Implementation – how trades are implemented to achieve the desired portfolio structure.*
- *Business management – over the longer term, how the manager maintains and enhances its capabilities in relation to the above factors."*

Mixed opinions

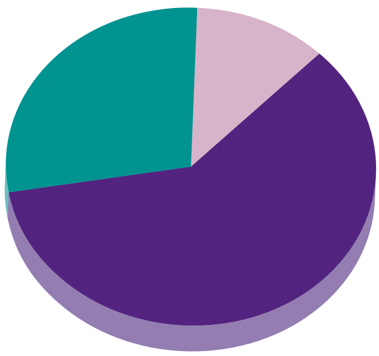
Respondents were divided on the best approach for personal accounts to identify active managers who are likely to outperform. However, most agreed that it is difficult to find active managers who can produce consistent and long-term out-performance.

Securities lending

4.30 A potential source of extra investment return for the trustee corporation would be for the personal accounts scheme to engage in securities lending. Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return. The lender receives a lending fee, which is reinvested to provide income while the security is lent out.

4.31 There was a majority view expressed by respondents that securities lending would be beneficial for personal accounts, as illustrated by Figure 4.5.

Figure 4.5 Securities lending



For	21
Against	10
No clear opinion	4

Source: PADA 2009
Base: 35 responses to our discussion paper addressed this issue

4.32 The main reason provided by respondents was the likelihood of achieving high returns with relatively low risk. A number of respondents thought that whether personal accounts should use securities lending will depend on balancing the potential benefits with the potential risks and this decision should be left to the trustee corporation. Those who believed securities lending should be used agreed that the risks will need to be managed effectively. They recommended the following criteria and practice should be applied by personal accounts when participating in securities lending. The scheme should:

- accept only high-quality collateral for security on loan, such as cash or government bonds, and/or require more collateral than needed to obtain or secure financing.
- ensure that 'daily mark to market accounting' is used to achieve adequate collateral. This involves assigning a value to the position held by a security daily, which is based on the market price for that instrument on that day.
- secure indemnity from lending agents in the event a counterparty will not settle an obligation for full value. Lending agents will generally provide for either the full return of lent securities to the lender, or the payment of the cash equivalent to the value of lent securities at the time of the default.
- confine lending to established markets with liquid securities.
- consult and follow codes of best practice, such as, the Bank of England's Stock Lending and Repo Committee's *Code of Guidance*,[37] the International Corporate Governance Network's *Code of Best Practice* or the Financial Services Authority's *COLL Rule Book* (section 5.4).[38]
- manage political and reputational risks. The trustee corporation of personal accounts could set guidelines for its custodians and employ rigorous controls for securities lending, such as only accepting high-quality collateral and voting on all stock.

4.33 The significant minority who disagreed that securities lending would be appropriate for the personal accounts scheme believed it comes with unacceptable or unnecessary risk. They thought the requirement for collateral to mitigate this risk serves to drive down the returns from lending. Another concern was that securities lending facilitates short selling. A few respondents considered this practice unethical and thought it was inappropriate for the personal accounts scheme.

4.34 Scottish Widows felt that securities lending ***"will add to complexity, cost and risk"***, while Friends Provident said ***"there is too high a downside in terms of controversy and media criticism than is warranted by the potential benefits".*** The two consumer representative groups that answered this question were both against securities lending because:

"Although there are fees to be earned from this activity, the activity is highly controversial and we believe that it would be inappropriate that such a high profile fund such as personal accounts should engage in it."

Pensions Advisory Service

37 Bank of England, 2009.
38 Financial Services Authority, 2008.

"Stock lending creates volatility in the stock market and militates against shareholders taking a long-term view of their investments, allowing those who buy the shares to act as traders rather than investors."

Trades Union Congress

General agreement

The majority of respondents believed personal accounts should participate in securities lending, but that activities need to be carefully monitored and a clear policy developed. Others thought the risks outweighed the benefits for securities lending. PADA will continue to examine whether the risks presented by some respondents outweigh the benefits before making recommendations to the trustee corporation.

Chapter five
Approaching retirement

Ensuring members' contribution_are invested appropriately throughout their savings career will be essential for achieving the best outcomes for members and engendering confidence in saving for retirement. This involves considering how much investment risk members can afford to take, and also when they can afford to take the risk.

Respondents recognised the need for lifestyling in the default fund of personal accounts. This was to both manage risk as a member nears retirement and reach a more suitable asset mix for how a member will convert their pension savings into a retirement income.

Target-date funds were identified as having benefits over traditional lifestyling in terms of ease of communication, flexibility and cost. The majority of respondents believed target-date funds were best suited to the members of personal accounts because they can be used in a low-cost and straightforward way to deliver an investment approach tailored to members' needs throughout their savings career.

5.1 In recommending an investment approach for personal accounts, we need to look at how, and to what extent, it can be tailored to suit members' needs throughout their lives, particularly as they near retirement. Unless the asset allocation is used to take into account the different stages of a member's savings career, it becomes difficult to achieve the investment objective at retirement. Ensuring members' contributions are invested appropriately throughout their savings career will be essential to achieving the best outcomes for members and building their confidence in savings. The technique most defined contribution pension schemes use as a member approaches retirement is lifestyling. In the discussion paper we explored target-date funds as an alternative delivery mechanism to improve on managing risk throughout a member's savings career. What we mean by 'lifestyling', 'traditional lifestyling', 'target-date funds' and 'glide path' is explained in Box 5.1.

Box 5.1 Definitions

Lifestyling – The approach to asset allocation that reflects where a member is in their savings career and how far they are from their expected retirement date.

Traditional lifestyling – A scheme member's assets are moved from growth-type investments such as equities, to bonds and cash, in order to manage risk as a member approaches retirement and reach a more suitable asset mix for how a member will convert their pension savings into a retirement income and/or a cash lump sum. This switching is generally performed automatically using a fixed formula based on how close a member is to the scheme retirement age. The units of one asset class in an individual's account are sold and units of a different asset class are bought.

Target-date funds – Target-date funds are similar to 'traditional lifestyling', but instead of switching an individual's savings from units in a higher to lower risk fund, the switch occurs at the level of the fund that corresponds to that individual's expected retirement date. Individuals are invested into a fund according to their expected retirement date. For example, someone expected to retire in 2030 would be placed, or could choose to invest their contributions in the '2030 fund'. The asset allocation in this fund would be changed over time to less volatile assets in the period leading up to 2030.

Glide path – The switchover period from growth-type investments to assets like bonds and cash.

What the discussion paper *Building personal accounts: designing an investment approach* asked

5.1 Is a traditional lifestyling mechanism appropriate for the personal accounts default fund, and if so why?

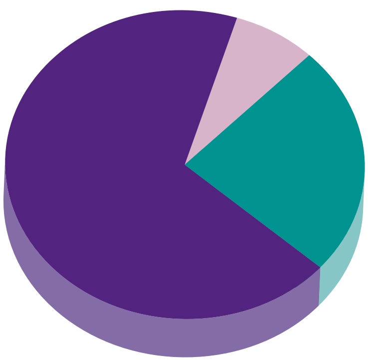
5.2 Would a target-date approach be appropriate for the default fund and, if so why?

5.3 Are alternative lifestyling approaches suitable for personal accounts, and if so why and how should they be implemented?

What you said

5.2 Nearly all respondents appreciated the need for some form of lifestyling in the default fund. A majority identified target-date funds as the more suitable option over the traditional lifestyling approach, as illustrated in Figure 5.1. Participants at the roundtable discussions[39] also agreed that target-date funds offer benefits over traditional lifestyling. Those in 'no clear opinion' category in the graph, recommended an alternative strategy or expressed no preference for a particular form of lifestyling.

Figure 5.1 Preferred method of lifestyling



Traditional lifestyling	10
Target-date funds	28
No clear opinion	3

Source: PADA 2009
Base: 41 responses to our discussion paper addressed this issue

Lifestyling at the fund or the individual level

"In our opinion, target-date funds are the only practical mechanism for delivering low-cost and simple investment to such a broad membership."

Fidelity International

5.3 Stakeholders thought that target-date funds would better suit the membership of personal accounts. The advantages that stakeholders identified target-date funds as having over traditional lifestyling were:

- They are **easier to communicate** to members. Members can relate to the retirement age of the fund and more easily understand why their savings have been placed in that fund. Respondents thought this was particularly relevant for members of personal accounts because they are likely to be new to investment and have lower levels of financial understanding. The Pensions Management Institute explained the situation as:

  "They may be more appropriate for personal accounts in that the concept is easier to understand for the membership, many of whom will be financially inexperienced and without access to financial advice or explanations."

- They offer **cost efficiency** and **administrative simplicity** that was thought to be beneficial for personal accounts in delivering a low-charge scheme. Respondents believed that because switching occurs at the fund level, this can reduce the overall switches made, and minimise trading and administration costs. Legal & General Investment Management explained:

39 *Approaching retirement: variety of stakeholders*, London 10 July 2009; *Investment approach for personal accounts: variety of stakeholders*, Edinburgh 14 July 2009.

"We believe that a target-date approach for personal accounts will be the most suitable means of delivering lifestyling at an acceptable cost and providing the trustee corporation the greatest flexibility to change the investment make up at any time should it choose to do so."

- They offer more **flexibility** for members changing their expected retirement date, which can be simply accommodated by moving members from one target-date fund to another. Some respondents thought this particularly suited the members of personal accounts because they are likely to have low incomes and uncertain work patterns, meaning they may be forced to delay or bring forward their retirement. This was described by the Equality and Human Rights Commission as:

  "Target-date, rather than applying a default retirement age is preferable because a single retirement age makes a presumption over the age at which an individual will wish to retire, whereas if the individual can select a target-date to retire this gives them choice and control over when they wish to retire."

- They more **easily accommodate** tactical asset allocation, discussed in Chapter four, and any adjustments that may be required to the investment strategy. Respondents thought this provides a degree of future-proofing where changes are relatively easy to make, for example, adjustments to the de-risking glide path if market developments require. This led respondents to believe that target-date funds can be more responsive to market conditions and the different stages throughout a member's savings career. Barclays Global Investors described the situation as:

  "Target-date funds are dynamic asset allocation solutions that take into consideration the essential requirements of retirement investing, incorporating both investor risk tolerance and investment horizon into the portfolio construction process."

- They focus members on the **long-term outcome** of retirement and draw attention away from short-term fluctuations in pot value. Some respondents thought that in focusing members on the long term they may also become motivated to plan for their retirement. This was described by Alliance Bernstein as:

  "The target-date fund is much simpler for the member, who does not need to contend with multiple changes of funds as they age, makes communication easier and keeps them focused on the long term".

5.4 In comparison, some respondents argued traditional lifestyling was not the best approach for the personal accounts default fund. They identified the main reason as being that traditional lifestyling is too rigid. Respondents felt that traditional lifestyling manages risk by mechanistically adjusting a member's asset allocation based on how close to retirement they are. They thought this approach would not help members who have been exposed to large market declines and need to make up for a shortfall.

5.5 Respondents pointed to this 'blind' switching as tending to lock in losses and not being appropriate given the potentially large and diverse membership of personal accounts. Allianz Global Investors described this shortcoming as:

"Lifestyling using a predefined intuitive stepfunction is a pure heuristic approach. The change in asset classes often happens quite rapidly and over a predefined interval before retirement. This approach does not make use of efficient change and composition of risky/non-risky assets in relation to a risk budget which depends on time to retirement."

5.6 Around a quarter of respondents believed traditional lifestyling was appropriate for personal accounts. They thought it had been tried and tested in the UK and found to be a reasonably successful strategy. Of those respondents, most acknowledged that there is scope for traditional lifestyling to be improved and made more flexible to suit the needs of personal accounts members.

Delivery mechanism at the fund or individual level

5.7 A common theme emerging from the roundtable discussions and responses to the discussion paper was that in terms of what lifestyling is trying to achieve, there is little difference between the two lifestyling approaches discussed. Respondents thought that target-date funds provide a more effective delivery vehicle with greater flexibility to manage risk throughout a member's savings career. Examples of what a couple of respondents said are.

"Our experience in the US market suggests that target-date funds are well understood by members, as is the case with the lifestyle concept in the UK. We believe that the investment considerations will be much the same and that target-date is simply another mechanism, like lifestyle, and so we do not feel there is a difference in volatility between the two approaches."

BlackRock

"We believe that the target-date approach is effectively the same structure as traditional lifestyling, but administratively easier to implement since it is not member specific."

Deutsche Bank Advisors

5.8 Some respondents pointed out that both approaches use a glide path to move members from growth assets to assets that more closely match how a member will convert their savings into a retirement income. Using a glide path should lead to a higher certainty of return, with volatility controlled through the asset allocation mechanism. Respondents noted this depends on whether the movement from growth to more defensively positioned assets takes into account the prevailing market conditions. If it does not, there is potential for negative returns and missing out on any market growth. Participants at the roundtable discussions suggested that the asset allocation strategy within target-date funds should be managed to better meet the needs of members throughout the life of a fund. The experience in the US was cited as an example of what can happen if the asset allocation is not managed appropriately. This is explored further in Box 5.2.

Box 5.2 Experience of target-date funds in the US

Target-date funds have been popular in the US since they were first introduced in the 1990s. They have recently become widespread in defined contribution pensions. This is partly because the strategies have received fiduciary protection under the *Pension Protection Act* as one of the default investments for automatic enrolment (so-called Qualified Default Investment Alternatives).

Some target-date fund providers have drawn strong criticism for their poor performance in the market downtown. 2008 saw returns on 2010 dated funds drop between 5.7 per cent and 39.2 per cent.[40] The variation in investment performance has led legislators and regulators to examine disclosure and asset allocation practices in target-date funds. The Securities and Exchange Commission, which regulates target-date strategies in mutual funds, and the Department of Labour, which oversees fiduciary aspects of pension schemes, held a joint hearing and are expected to propose enhanced disclosure for participants as well as a set of fiduciary guidelines for sponsors. The Senate Special Committee on Aging has also held a hearing.

The problem has largely arisen due to the asset allocations and disclosure practices in target-date funds at, and into the years, of retirement. There are no requirements to purchase an annuity in the US. Members can choose to purchase an annuity, defer use of the money until later in retirement, or 'draw down' – make regular withdrawals to provide for their retirement income. As a result, funds are managed as if a member will hold the fund throughout retirement. This means the funds can be volatile at, or near, retirement and any losses are locked in for individuals that take a large portion of their balance at retirement.

The lesson from the US experience is that target-date funds do not of themselves negate the need for careful and considered asset allocation over the course of a member's savings career. Although they offer an easy-to-use and easy-to-understand delivery mechanism, there still needs to be a clear focus on when and how individuals wish to convert their savings into a retirement income.

40 Vanguard, 2009.

Different approach

While some stakeholders argued that younger people should take a lot of investment risk, others thought that younger people are likely to have less savings experience and therefore may have less appetite for investment risk. They thought this would particularly be the case for members of personal accounts. Some stakeholders argued that because little capital has accumulated in the early years of a member's savings career – the pot is still building up – then the size of the investment return in the early years has relatively little impact on the final pot size.

Some stakeholders argued that establishing confidence in saving for the long term and reducing the possibility of individuals stopping their contributions may be more important than the investment return that could be achieved on a small amount of capital. They believed an approach that has lower levels of investment risk during the early years of saving may be more likely to encourage members to persevere and build up sufficient capital to provide the foundations for investment in growth assets in later years.

To test this hypothesis the Personal Accounts Delivery Authority (PADA) ran simulations for members starting to contribute from ages 22 and 32 based on 6 illustrative investment strategies as shown in Figure 5.2. This equates to members contributing for 44 and 34 years respectively. A base pensionable income of £14,953 in 2012 was assumed, which is the calculated median earnings based on Annual Survey of Hours and Earnings (ASHE) data for the target membership of personal accounts. For ease of comparison, all the calculated future pot sizes have been adjusted to 2009 real values – that is, the values have been corrected for the effect of inflation on the purchasing power of money. The simulations are used for illustrative purposes based on reasonable return assumptions and are not intended to give any indication as to the likely asset allocation recommendation that PADA will make to the trustee corporation.

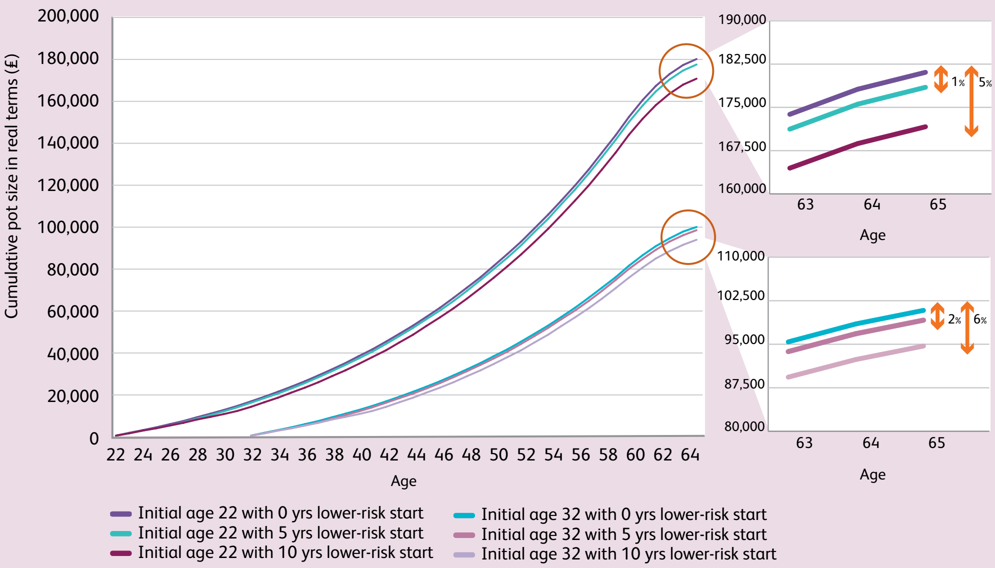
The first strategy was invested in 100 per cent equities with 5 years of lifestyling (rolling down from age 61 to a 75 per cent government bonds and 25 per cent cash portfolio by age 65). The second strategy had a low investment-risk start of **5 years** investing in a 60 per cent government bonds and 40 per cent corporate bonds portfolio, followed by 34 years of investing in 100 per cent equities and then five years of lifestyling. The third had the same profile as the second, but was invested in the government and corporate bonds portfolio for **10 years** followed by 29 years of investing in 100 per cent equities before 5 years of lifestyling. These asset class allocations have been selected to represent opposite ends of the risk spectrum and are used for illustrative purposes only. The comparison was applied to individuals who started their savings career at age 22 and then repeated for individuals who started their savings career at age 32.

The difference in **real** terms in final pot size for the 3 individuals who started saving at age 22 was:

- 5.2 per cent between the individual that had no low-risk start compared to the individual which invested in lower-risk assets for 10 years
- 1.4 per cent difference between the individual that had no low-risk start compared to the 5 year low-risk start.

For the scenarios where individuals started saving at age 32, the percentage difference between the final pot sizes increased slightly for the different scenarios.

Figure 5.2 Low-risk start has small impact on final outcome



Source: PADA 2009

Other considerations for lifestyling

5.9 The experience in the US shows it is important that personal accounts considers how much risk to take not only when approaching retirement, but also throughout a member's savings career. While a number of respondents identified age as a good way to determine how much investment risk a member can afford to take – with younger members having a higher risk capacity because of their longer time horizon and future income potential – this approach was questioned by stakeholders and is discussed in the 'different approach' box.

5.10 A common recommendation of respondents was that the de-risking glide path for members of personal accounts should be longer than is typical in other defined contribution schemes – perhaps commencing up to 15 years before retirement. Respondents thought this would help smooth volatility. This was supported by research provided by Scottish Widows based on a wide range of simulations of future investment conditions which found that a longer switchover period produces a better risk and return trade off.[41]

5.11 Some respondents thought personal accounts should use deferred annuities. Dr Byrne and Professor Blake suggested that deferred annuities could be used as a mechanism for managing longevity risk in the de-risking glide path. They explained that:

"The glide path to the retirement date would involve a systematic switch into deferred life annuities (NOT bonds) that start paying on the selected retirement date. This would help to hedge interest rate and longevity risks in the period leading up to retirement."

5.12 The Institute of Chartered Accountants in England and Wales also supported the use of deferred annuities and thought they could be utilised throughout a member's savings career. They felt that the default fund should be an index-linked deferred annuity based fund, which would provide greater certainty in retirement outcomes. PADA recognises the need to consider the management of longevity risk for members, even before retirement has started. Purchasing deferred annuities at an individual level is likely to create complex operational challenges. At this stage, PADA is exploring options at the fund level such as longevity hedging instruments for use in the default fund.

Alternatives to the lifestyling approach

5.13 Generally respondents thought, given personal accounts' remit to deliver a low-charge and simple scheme, the alternative approaches to lifestyling that were identified in the discussion paper may not be appropriate. The discussion paper explored the alternative strategies of target-return strategies, structured guaranteed return-products, stochastic lifestyling and constant proportion portfolio insurance. Although respondents thought that alternative approaches to lifestyling have some advantages, they believed these were outweighed by the disadvantages of increased cost and complexity and the need to customise such strategies at an individual level. Respondents thought this would not suit the potentially large membership of personal accounts, at least in the early years of the scheme. Some comments made by respondents about alternatives to lifestyling were:

41 Research from Barrie & Hibbert, commissioned by Scottish Widows.

"Some options allow members to 'bank' profits above expectations but this seems a burdensome complication at this stage. In due course, additional communication could be introduced to allow such options but at this stage we do not believe a cost/benefit analysis justifies such an approach."

Hewitt Associates

"Many of the alternative approaches will require capital backing by the provider of guarantees. This capital has to be paid for, and this is unlikely to be commensurate with the low-cost nature of personal accounts."

Pensions Management Institute

General agreement

- Nearly all respondents recognised the importance of lifestyling within the default fund of personal accounts.
- The majority of respondents believed that target-date funds provide benefits for personal accounts over traditional lifestyling.
- Respondents agreed target-date funds are a delivery vehicle only, which facilitate but do not replace a well-managed and intelligently-used asset allocation strategy throughout a member's savings career.
- The majority of respondents thought alternative approaches to lifestyling offer some advantages, but given personal accounts' remit to deliver a simple and low-charge scheme, they may not be appropriate, at least in the early years.

Chapter six

Responsible ownership and its role within the personal accounts scheme

In the discussion paper, we dedicated two chapters to corporate governance and responsible investment. Throughout the consultation process it has become clear that many of our stakeholders view these activities as part of the exercise of responsible ownership. For this reason we discuss these activities together in a single chapter that looks at to what extent responsible ownership should be pursued within personal accounts.

Responsible ownership is a rapidly developing area. Since the publication of our discussion paper, there have been a number of reviews into the role of engagement by institutional shareholders in improving the financial performance of the companies in which they invest. The personal accounts scheme is likely to be responsible for significant amounts of members' money in the future and has the potential to be an influential shareholder in corporations in the UK and globally.

Although there was agreement among stakeholders that responsible ownership should feature in the personal accounts scheme, there was no consensus on how it should be delivered within a low-charge scheme to best serve members. Voting of shares was considered the most fundamental component of a responsible ownership policy, and the majority of respondents agreed responsible ownership should be applied to all funds and not only the default fund.

6.1 In the discussion paper, we dedicated two chapters to corporate governance and responsible investment. Throughout the consultation process it has become clear that many of our stakeholders view these activities as part of the same sphere, although they call it different names. In this chapter we use the term 'responsible ownership' to refer to the bringing together of corporate governance and responsible investment. What we mean by 'corporate governance', 'responsible investment' and 'responsible ownership' is explored in Box 6.1.

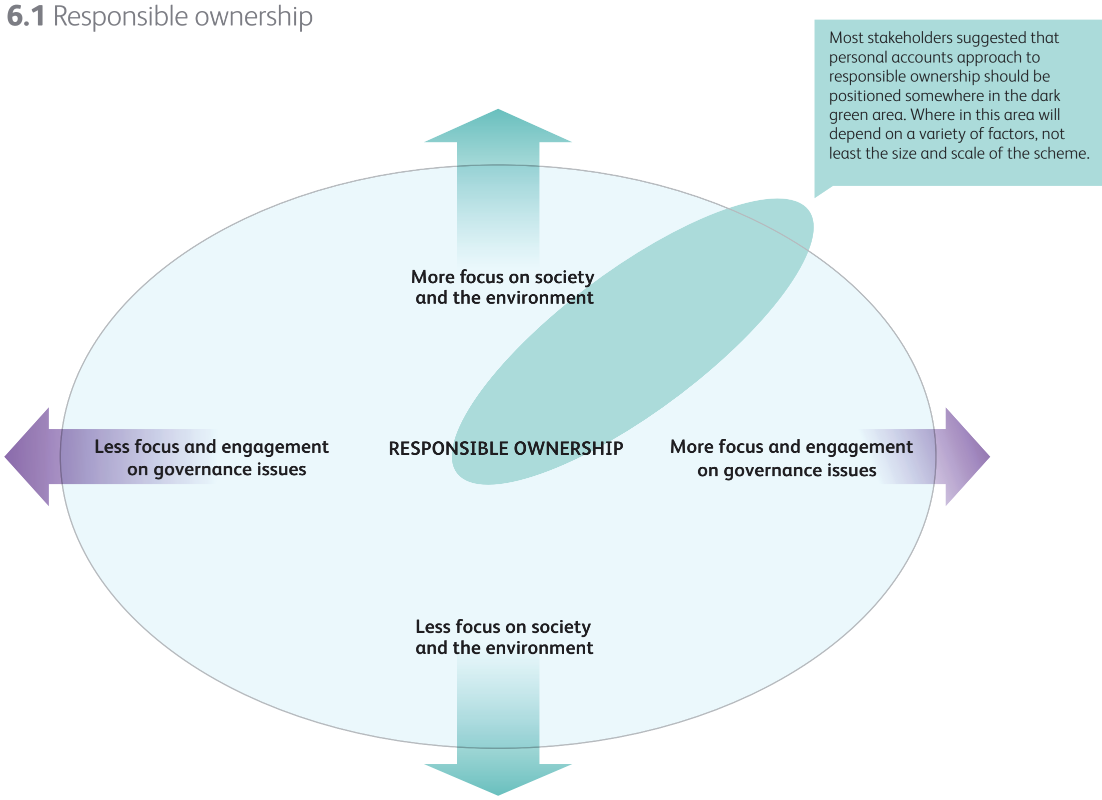
6.2 As a large institutional shareholder, personal accounts will be in a good position to exert influence over the companies in which it invests to protect and promote members' interests and to help improve the returns on their investments. This sphere of activity has come under increased scrutiny in recent months. Regulators and other stakeholders are now considering corporate governance, market standards, principles of stewardship and interactions between institutional shareholders and companies as a coherent whole in exercising ownership rights. We began the consultation process by asking our stakeholders to what extent corporate governance and responsible investment should be pursued within personal accounts. Both topics are covered in this chapter under the term 'responsible ownership'.

Box 6.1 Definitions

- **Corporate governance** involves the role institutional shareholders play in appointing the board of directors through exercising voting rights. This is to ensure appropriate governance, director remuneration, public reporting and accountability structures. Corporate governance can also include corporate engagement where the institutional shareholder builds a working relationship with the board of directors of the company in which it invests to ensure the directors discharge their duties for the benefit of shareholders.
- **Responsible investment** is an approach that focuses on corporate governance and engagement and how businesses manage their relationship with society and the environment over the longer term.
- **Responsible ownership** involves using the ownership rights attached to assets responsibly to protect and enhance shareholder value over the long term. This is primarily through voting and engagement to influence companies to take into account corporate governance, social and environmental risks and opportunities.

The trustee corporation will need to decide the extent to which it will pursue responsible ownership as set out in Figure 6.1. The bottom left of the circle represents responsible ownership at its most basic, consisting of some corporate governance activities such as voting and engagement. The top right of the circle places a greater emphasis on responsible ownership and includes a high level of voting and engagement, as well as taking into account environmental and social issues. At the roundtable discussion nearly all participants thought that personal accounts should start in the middle of the circle with a moderate level of responsible ownership and as the scheme's assets under management grow, increase the level of responsible ownership to sit within the top right of the circle.

Figure 6.1 Responsible ownership



What the discussion paper *Building personal accounts: designing an investment approach* asked

6.1 To what extent can the personal accounts scheme deliver high-quality corporate governance at a low cost?

6.2 How will this evolve over time as the scheme's assets under management grow?

6.3 How do we achieve high-quality corporate governance where assets are managed passively?

6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?

7.1 How can the personal accounts scheme engage in responsible investment in a cost-effective way?

7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practical and relevant?

7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?

7.4 If responsible investment is pursued, will the members be best served by building in-house capability or outsourcing?

What you said

6.3 There was broad agreement that corporate governance and responsible investment, referred to as 'responsible ownership' throughout this chapter, should feature in the investment approach of personal accounts. Of those that provided reasons for their answer, most respondents argued that there is compelling evidence that responsible ownership decreases risk and improves financial performance, which they felt clearly benefits members of personal accounts. The sentiment of most respondents is reflected in the following quotes:

"The personal accounts scheme will be one of the UK's largest institutional investors, so it is essential that its standards of corporate governance are high. Confederation of British Industry members would expect personal accounts to exert influence responsibly with a view to maximising the value of the investments they hold. The imperative to do so will only increase as the scale of the scheme's assets increases."

Confederation of British Industry

"Trades Union Congress would question the suggestion that responsible investment is necessarily associated with higher costs, and believes responsible investment can generate both financial and social/ environmental returns."

Trades Union Congess

6.4 The general view was that the resources devoted to responsible ownership by personal accounts should be proportionate to the size of the scheme. The trustee corporation of personal accounts, like all trustees of occupational pension schemes, has a fiduciary duty to put the interests of members first in all investment decisions relating to the personal accounts scheme. Respondents thought given environmental, social and governance considerations may improve investment returns, responsible ownership properly falls within the fiduciary duty of trustees.

6.5 A handful of respondents suggested that given personal accounts will be a large and high-profile institutional investor and under intense public scrutiny, it has a special responsibility for being a leader in this area. If it is not active in responsible ownership, they thought that personal accounts runs the risk of damaging its reputation and legitimacy. Some respondents went so far as to say the influence personal accounts could have on corporate behaviour should be used to improve the welfare of scheme members on issues such as equal pay. These respondents asked whether fiduciary duty should be seen as promoting an economy and society where the broader interests of beneficiaries should be served.

6.6 Of the respondents that considered this issue, most were concerned that such an approach could lead to politically or ethically based decisions which may not be in the best interests of all members. The Association of Pension Lawyers argued:

> ***"It would currently be a brave trustee that does not take the view that financial performance was the primary criterion in setting investment options to observe even if it held particular ethical beliefs."***

Policy on responsible ownership

> ***"We note that there are increasingly good arguments, including economic ones, for supporting responsible investment which include sustainability, but the process/procedures would need to develop over time, in line with the market."***
>
> **Institute of Chartered Accountants in England and Wales**

6.7 A number of respondents suggested the first step for the trustee corporation is developing a policy on responsible ownership. This would clearly express its views regarding the value of voting shares, engagement and responsibilities of ownership. It would also set out how the trustee corporation intends to incorporate these aspects into the investment process over time. The purpose would be to guide the trustee corporation and external managers in making decisions, and also hold the trustee corporation publicly accountable. Respondents thought that although the implementation and operating procedures may change as the scheme grows, the policy decisions should remain sustainable for the long term. This view was also shared by participants at the roundtable discussion.[42]

42 *Responsible ownership: variety of stakeholders*, London 29 September 2009.

6.8 Most stakeholders suggested a phased approach to responsible ownership depending on the size of assets under management to keep costs low in the early years, until personal accounts grows to create economies of scale. Very few respondents discussed in detail what activities should fall within the scope of corporate governance and responsible investment in the personal accounts scheme. Most respondents tended to answer the questions in the discussion paper by referring to delivery mechanisms. Of those stakeholders that addressed the issue directly, there was general agreement that in the beginning, responsible ownership should at least involve the voting of shares in the UK, as well as the monitoring of UK companies to identify risks in order to influence them to make improvements. A theme emerging from the consultation was that collaboration with like-minded owners is a cost-effective way of engaging with companies to improve their performance.

6.9 As the scheme's assets under management grow, stakeholders argued a higher level of responsible ownership should be achieved due to efficiencies of scale. Some stakeholders thought this stage should include both research into responsible ownership issues and influencing not only companies, but other parties to institute change at the public policy level. Some respondents recommended the trustee corporation needs to incorporate into its policy how it will apply responsible ownership practices to asset classes other than equities, such as bonds, fixed income, property and infrastructure. The Actuarial Profession explained the situation as:

"In the case of managing the effects of climate change it affects all assets and has to be taken account of, irrespective of any view taken towards the wider aspects of responsible investment."

6.10 All stakeholders regarded voting as being the critical and most basic component of a responsible ownership policy. Participants at the roundtable discussion generally agreed voting should not be considered a tick-box exercise, but research and thought needs to go into voting decisions to make the most of the ownership rights. Generally, stakeholders felt all shares should be voted in the UK and a pragmatic approach taken to overseas markets, where shares are voted unless time and costs are prohibitive. A handful of respondents also suggested personal accounts should disclose its voting record and advise the company and other investors ahead of stakeholder meetings of its voting intention and reasons to be more influential. Few respondents addressed the topic of securities lending. Of those respondents, most argued that securities lending is an acceptable practice that generates returns for the scheme's members. They recognised it can have an impact on ownership rights, but thought this was easily resolved by recalling all or part of the stock on loan when a contentious vote is called. Some examples of what our respondents said:

"Fund managers should be encouraged to take an active part in voting both overseas and in the UK."

Pensions Management Institute

"Pension Investments Research Consultants believes that the most sensible option would be for PADA to develop its own corporate governance guidelines and voting policy and apply this across all of its investments."

Pension Investments Research Consultants

"However, there is no point in voting as a tick-box exercise and votes must be used in a considered way. The Trades Union Congress believes that the personal

accounts scheme should aim to vote all its UK and overseas shares, recognising that it may take some time to build up the necessary expertise to vote in all overseas markets."

Trades Union Congress

"As the asset size of the personal accounts fund increases the National Association of Pension Funds would caution against an overly simplistic 'box ticking' approach to corporate governance as this type of approach may stop being effective with investee companies."

National Association of Pension Funds

6.11 Some participants at the roundtable discussion recommended that personal accounts should partner with other large pension schemes to help develop and implement responsible ownership. This approach would enable personal accounts to consolidate its influence and have a voice even in the early days of the scheme when assets under management are still low. It would also allow personal accounts to learn from the experience and approach of other well-established pension schemes that have been considering these issues for a number of years.

General agreement

- There was agreement that responsible ownership should feature in the investment approach of personal accounts.
- The majority of stakeholders recommended a phased approach to responsible ownership, depending on the size of assets under management to keep costs low.
- There was consensus that voting of shares is a fundamental component of a responsible ownership policy.

Different approach

Some roundtable participants suggested that personal accounts should partner with other large pension schemes in developing and implementing responsible ownership. Some of the pension schemes suggested by participants included:

- **The Government Pension Fund** – The fund supports the Norwegian government savings to finance the pension expenditure of the National Insurance Scheme and long-term consideration in the spending of government-petroleum revenues. As at December 2008 the scheme had £224 billion in assets under management.[43]
- **ABP** – A defined benefit scheme for government and education employees in the Netherlands. At the end of June 2009 the scheme had £153 billion in assets under management.[44]
- **Universities Superannuation Scheme** – A defined benefit scheme provided by UK universities, higher education and other associated institutions for their employees. At the end of March 2009 the scheme had £29 billion in assets under management.[45]

Respondents described these pension schemes as large institutional investors which have considered and developed policies on responsible ownership. Participants believed they would make ideal partners and personal accounts could learn from their experience and approach.

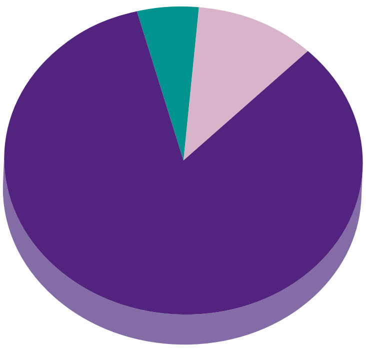
43 Norwegian Ministry of Finance, Second Stoltenberg Government, 2009. Historic exchange rate for date stated when converting assets under management figures to UK Sterling. Source: Bloomberg.
44 ABP, 2009. Historic exchange rate for date stated when converting assets under management figures to UK Sterling. Source: Bloomberg.
45 Universities Superannuation Scheme, 2009.

Default fund or all funds

6.12 The majority of respondents that addressed this issue argued responsible ownership should be applied to all funds and not only the default fund or an alternative fund. Figure 6.2 shows the breakdown of views.

6.13 The main argument respondents put forward was that if the trustee corporation believes that responsible ownership is necessary for the default fund because it reduces risk and improves performance, there is no reason why it should not be applied to all funds offered within personal accounts. Some examples of what respondents said are:

Figure 6.2 Recommendation for the scope of responsible ownership



All funds	31
Alternative fund only	2
No clear opinion	4

Source: PADA 2009
Base: 37 responses to our discussion paper addressed this issue

"We believe that responsible investment should be a matter for all fund choices as far as practical and relevant, but that the implementation approach will likely have to vary across the fund choices."

Northern Trust

"To have a separate fund would wrongly suggest that socially responsible investment carries an additional risk with adverse financial consequences. In practice we think that socially responsible investment is a benefit as opposed to a risk."

Lord Judd and Lord Joffe

"In principle, it should apply to all fund choices. This is because the case for responsible investment is based on financial risk and opportunity and the scheme's imperative as an asset owner."

UK Sustainable Investment and Finance

"Its impact and the way that it is conducted may be different for different sections, for example, index in the default compared to active choices outside, but it does not seem to be in the spirit of responsible investment to pick and choose where environmental, social and governance issues should or should not apply."

Legal & General Investment Management

6.14 A few respondents believed there is no compelling evidence to suggest responsible investment improves financial performance. They instead recommended that a responsible investment approach is offered as part of fund choice and not incorporated into the default fund. Some examples of what respondents said are provided below:

"We have seen no compelling evidence that the adoption of a socially responsible investment strategy enhances investment outcomes. We would not advocate adopting such a strategy in the default fund without such evidence, since responsible investment programmes are sure to increase costs. However, we understand that the trustee corporation will feel under considerable pressure to address this issue. As a result it should seek detailed advice in the prioritisation of social responsibility and investment merit in developing its views... The same policy should apply consistently to all investment choices, unless a fund has a specific socially responsible investment objective."

Alliance Bernstein

"Barclays Global Investors believes that 'responsible investment' is in itself an active decision on the style of investment philosophy and should only be offered as a self select option."

Barclays Global Investors

General agreement

The majority of respondents recommended that responsible ownership should be applied to all funds and not only the default fund or an alternative fund.

Best practice

6.15 A number of respondents argued personal accounts should follow 'best practice' in the area of responsible ownership. However, what respondents meant by 'best practice' was either undefined or varied widely. Some referred to principles or guidelines that institutional shareholders are encouraged to follow as best practice. Others thought these principles represent the minimum required, and that personal accounts should strive to achieve more. Given the recent challenges facing the financial sector and other corporate issues, it is likely that there will be some changes in this area in the future. We explore what respondents mean by 'best practice' and key initiatives that have taken place since the discussion paper was published in Box 6.2.

Box 6.2 Responsible ownership and best practice

An evolving landscape

Since we published our discussion paper in May 2009, the environment in which institutional shareholders pursue strategies of responsible ownership has been evolving. The financial crisis has brought the need for robust corporate governance into the spotlight, while issues such as climate change continue to gain prominence. Some of the key developments include:

- Sir David Walker's independent review of the governance of banks and other financial institutions. His first consultation paper included a number of draft recommendations concerning institutional shareholders and their interactions with companies.[46] In particular, it was recommended that the Institutional Shareholders' Committee, the Financial Reporting Council and the Financial Services Authority play a larger role in promoting engagement by owners on the basis of principles of stewardship. His final recommendations are due to be published on 26 November 2009.
- The Financial Reporting Council's review into the effectiveness of the Combined Code on Corporate Governance to determine whether any amendments are required.[47] The Combined Code sets out standards of good practice for UK listed companies on such issues as board composition and development, remuneration, accountability and audit, and relations with shareholders. The Financial Reporting Council will publish a final report in December 2009.
- The Asset Management Working Group of the United Nations Environment Programme Finance Initiative publication of its new report *Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*.[48] The paper builds on its first report[49] and provides "a legal roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment." It argues that integrating environmental, social and governance considerations into investment decisions is a legal responsibility. The paper also argues that investment consultants and asset managers have a duty to proactively raise environmental, social and governance issues as part of their advice to institutional shareholders and this duty must be embedded into their contracts.
- The development of the Institutional Shareholders' Committee's Principles of Stewardship into a code of best practice, following the recommendations laid down in the Walker Review.[50]
- The incorporation into UK law of the European Union's Shareholders' Rights Directive.[51] The aim is to better facilitate the exercising of shareholder rights, especially across European borders.

46 Walker, 2009.
47 Financial Reporting Council, 2009a; Financial Reporting Council, 2009b.
48 United Nations Environment Programme Initiative, 2009.
49 United Nations Environment Programme Initiative, 2005.
50 Institutional Shareholders' Committee, 2009.
51 *Companies (Shareholders' Rights) Regulations*, 2009.

Box 6.2 continued

What do respondents mean by 'best practice'?

A number of respondents recommended that personal accounts should follow best practice in the area of responsible ownership. For some respondents this is not a concrete concept but describes the broad approach adopted by the investment industry. Other respondents that described best practice referred to a number of principles or guidelines they thought personal accounts should follow:

- **United Nations Principles for Responsible Investment (UN PRI):**[52] These principles have been developed by institutional investors to reflect environmental, social and governance issues within investment practice. The most common recommendation by respondents was that personal accounts becomes a signatory to UN PRI. For some respondents this represents best practice, while for others this is the minimum standard to which personal accounts should aspire. Some respondents rightly pointed out that signatories are not required only to contract fund managers who have signed UN PRI, which we incorrectly suggested in our discussion paper.
- **The Combined Code on Corporate Governance, as published by the Financial Reporting Council:**[53] The Combined Code sets out standards of good practice relating to issues such as board composition and development, remuneration, accountability and audit, and relations with shareholders. A number of respondents believed this was an appropriate source of guidelines for corporate governance and engagement activity.
- **Institutional Shareholders' Committee's Statement of Principles:**[54] These principles are a comprehensive statement of best practice governing the responsibilities of institutional shareholders and investment managers in relation to the companies in which they invest, and are incorporated into the Combined Code. A number of respondents referred to this as being an appropriate source of guidelines for interacting with fund managers to optimise a responsible ownership strategy.
- **Securities Lending Code of Best Practice, as published by the International Corporate Governance Network:**[55] The code outlines three broad principles that apply to all areas of investment practice used to clarify the responsibilities of all parties engaged in stock lending. A number of respondents said these were useful guidelines for pension schemes in their stock lending activities.

52 Principles for Responsible Investment, 2009.
53 Financial Reporting Council, 2008.
54 Financial Reporting Council, 2008.
55 International Corporate Governance Network, 2007.

Achieving responsible ownership when assets are managed passively

6.16 Personal accounts is likely to invest in some passively managed funds. The majority of respondents believed the motivation and obligation for responsible ownership increases in this environment. Although the institutional shareholder cannot sell its shares – because a passive approach requires the fund to track the chosen index – it can still engage with the company and, if required, vote against the company's management. Respondents thought collaboration is possibly more important when adopting a passive management approach. A couple of respondents suggested personal accounts join up with owners of actively managed shares to overcome the challenges of pursuing responsible ownership with passively managed assets. A handful of respondents believed personal accounts should consider investing in funds tracking socially responsible indices, such as the FTSE4Good. The Association of British Insurers explained the situation as:

"Assets being managed passively should not mean a lower commitment to corporate governance. The Association of British Insurers believes that, as the option to sell assets is removed, the motivation and obligation to engage with the company increases in order to ensure shareholders' interests are being looked after."

6.17 On a related issue, some respondents thought pooled funds – a vehicle that groups together a number of investors' money that is invested in the same way – can disguise who owns the shares and reduce the influence an institutional shareholder has over the company. Respondents suggested this can be rectified through ring-fencing the funds so that they appear under the name of the institutional owner. This owner can then direct the fund manager on how their shares are voted.

Delivery mechanisms

6.18 Keeping costs low was a key driver in respondents' decisions about how responsible ownership is best delivered for personal accounts. Most respondents answered this question by suggesting one, or a mixture of, the options proposed in the discussion paper. These were:

- outsourcing to fund managers and selecting those with a more committed approach to responsible ownership
- retaining a third party provider, known as an 'overlay specialist', to carry out both research and engagement on responsible ownership on behalf of the personal accounts scheme
- building in-house capability to provide the trustee corporation with a dedicated responsible ownership team it controls.

6.19 The majority of respondents suggested the delivery mechanism should change as the scheme's assets under management grow and there is more money to devote to responsible ownership.

Fund managers

6.20 A large proportion of respondents said that using fund managers in the early days of the scheme would be the most cost-effective approach, but a number of these respondents did not believe this is the best approach when the scheme matures. Some respondents disagreed with the Personal Accounts

Delivery Authority's (PADA's) suggestion that better governance may be more difficult to achieve when using passive management. They argued governance performance depended on the fund manager, and does not depend on whether they use passive or active management.

6.21 Most respondents thought for a responsible ownership policy to be effectively implemented by the fund manager, this will need to be considered at the outset. They suggested the trustee corporation considers responsible ownership in its selection criteria when hiring fund managers, as well as in making it a requirement of their contract that they take into account environmental, social and governance considerations when making investment decisions. Respondents thought the fund managers' policies should be scrutinised alongside the voting and engagement records by the trustee corporation. This will help ensure managers have a track record of delivering responsible ownership and are able to incorporate these activities into their mandates at low cost. Some respondents also thought the trustee corporation should develop a detailed voting and engagement policy to guide fund managers in their decisions.

6.22 Some respondents were sceptical that responsible ownership could be delegated to fund managers if the trustee corporation aspires to achieve the highest standards. Although fund managers may claim to undertake high-quality responsible ownership, respondents felt in practice the level of activity may not meet the quality, breadth and depth required. They also cited potential conflicts of interest if other institutional owners that use the fund manager adopt different positions on particular issues. Stakeholders thought if personal accounts uses different pooled funds with different fund managers that invest in identical securities, there is a risk these managers may not vote in the same way on a given issue.

6.23 To mitigate these concerns, respondents suggested some in-house capacity be maintained to monitor fund manager activities to ensure they are meeting the standards in their contract. Some also suggested using a mixture of fund managers and overlay specialists. Each would have responsibility for different functions with respondents suggesting a variety of combinations involving voting, research and engagement.

Overlay specialists

6.24 A number of respondents supported the use of an overlay provider to oversee and deliver responsible ownership for the scheme. This approach requires an additional budget to cover the fees of the third party, over and above those paid to the fund managers. Generally, respondents supported using overlay providers and there were very few negative observations about this approach. However, a couple of respondents highlighted increased costs involved in using these specialists and the possibility that one client's interests are sacrificed for the benefit of another. Some respondents thought that using overlay specialists would mean that the fund manager no longer has total control over the assets being invested and this could prove challenging. Of those respondents that expressed an opinion on when this approach should be adopted by personal accounts, most favoured overlay specialists in the later years of the scheme.

In-house capability

6.25 Developing an in-house capability was the preferred approach once the scheme matures and assets under management can support the costs involved. Some respondents preferred this approach to be used at the outset as well. Most respondents thought this option represented a more thorough, hands-on approach where personal accounts could maintain a firmer control of its ownership activities. A handful of respondents thought this approach could be complemented by outsourcing some activities when needed, such as research and voting.

6.26 In the early years, a few respondents argued some in-house expertise will be needed to monitor the activities and performance of fund managers and overlay specialists. A couple of respondents suggested personal accounts would need at least one person for this role. They did not specify what scale would be required when the scheme had matured. Some examples of what respondents said are:

"At least initially responsible investment is likely to be best served by outsourcing. As time goes by it may be possible to build up an internal expertise in the area, but the cost should be weighed against the additional utility of doing so."

The Association of Consulting Actuaries

"Whilst we consider an in-house capability to be the most effective means of ensuring that the scheme's policies are put into effect; we recognise that the scheme may decide that such an approach 'is more likely to be a cost-effective option when the personal accounts scheme's assets under management have reached a significant size'[56] ***and therefore to use an overlay approach initially (in combination with incorporating environmental, social and governance capability into fund manager selection, instruction and scrutiny)."***

FairPensions

"Whilst requiring externally appointed managers to behave as active owners, we believe that it is essential that PADA retains an internal capacity to provide oversight of these activities among the manager base, and take the lead in representing members and clients in this area."

Universities Superannuation Scheme

Mixed opinions

There was no agreement on how personal accounts should deliver responsible ownership to best serve members within a low-charge scheme.

56 PADA, 2009.

Chapter seven
Choice: how much is enough?

Although we expect the vast majority of members to be invested in the default fund, either through choice or inaction, there will be some members whose needs and values require something different. This may be because of their financial situation or for other reasons, such as their religious and ethical beliefs. The trustee corporation is likely to offer some choice of funds within personal accounts to help meet the diverse needs of our members.

There was general consensus among respondents that having some fund choice is desirable, but these options should be kept clear, simple and few in number. Nearly all respondents agreed the trustee corporation should offer alternative funds that meet the requirements of those with religious and ethical needs, as well as those who have a different risk profile from that offered in the default fund. However, stakeholders did not agree on how the extra costs associated with alternative fund choice should be met – either by sharing costs across the entire membership, or individuals who invest outside of the default fund bearing the extra costs.

7.1 PADA expects the majority of members of the personal accounts scheme will invest in the default fund, through choice or inaction. However, some members are likely to want to choose for themselves how their contributions are invested. In particular, some members may have financial needs or values that require an alternative to investing in the default fund. In the discussion paper, we presented evidence that suggests that limiting choice to a set of diversified, risk-controlled investment options may suit members better than offering particular asset classes or securities from which they create their own fund.[57] It is important that issues around fund choice are carefully considered in the context of achieving a low-charge, value-for-money scheme that respects the diversity and choice of its members.

57 Iyengar et al, 2004.

What the discussion paper *Building personal accounts: designing an investment approach* asked

8.1 To what extent should the trustee corporation offer fund choice, and what should those choices be?

8.2 To what extent should those funds be lifestyled?

8.3 Should the trustee corporation offer branded funds as part of the fund choice offered to members, and if so, why?

8.4 Should costs associated with wider fund choice be spread, where possible, across all members, or only apply to those members who choose alternatives to the default fund?

8.5 Should there be a limit on the number of fund switches, or charges imposed after a certain number of switches, or neither for the personal accounts scheme?

What you said

"Choice comes at a price. In practical terms, additional fund options will lead to increased administrative costs and reduce economies of scale. The need to communicate complex information to members in clear and comprehensible terms is expensive and difficult to achieve. There is a danger that excessive choice will be counter-productive as it will increase costs and introduce additional risks. Additionally, offering a wide range of investment funds is likely to generate information overload which will work to alienate an already disengaged target audience that may have particularly low levels of financial literacy."

Institute of Chartered Accountants in England and Wales

7.2 The majority of respondents supported offering a limited amount of fund choice outside of the default fund. They thought choice was important to cater for the diversity of personal accounts members. In addition, even where most members will not make an active choice, respondents thought they would still want to feel as if they had an option and had not been 'railroaded' into the default fund. Reasons that respondents supported a limited fund choice included the need to keep costs low and avoid adding extra layers of complexity to the personal accounts scheme. Most agreed with the research identified in the discussion paper[58] which suggested that too much choice can lead to confusion and distract members from making sensible and informed decisions. Participants at our roundtable discussions[59] also agreed that fund choices should be clear, simple and few in number.

7.3 While the bulk of respondents suggested offering three to four fund choices, a handful recommended offering six to ten funds, or even more. These respondents thought this represented what they described as the 'optimal' amount of choice.

58 Iyengar et al, 2004.
59 *Member choice: variety of stakeholders*, London 12 August 2009.

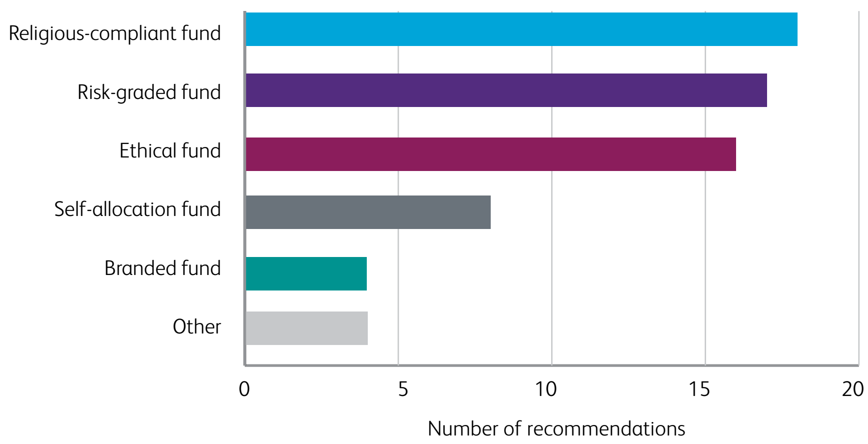
A couple of respondents believed having no fund choice at all is the best solution, but recognised some choice may be necessary. Alliance Bernstein said:

"We believe that the personal accounts scheme will meet its objectives at the lowest cost and with the lowest operational risk by having one default fund and allowing no choice. Indeed we believe that the trustee corporation needs to develop a very strong case why choice would be beneficial to the membership if it is to be offered. Research suggests that choice increases cost, whilst worsening the outcome for the average investor."

Types of funds

7.4 There was broad consensus among respondents that personal accounts should offer members different risk-graded levels of the default, a religious-compliant fund and an ethical fund. This is illustrated in Figure 7.1. The majority of participants at our roundtable discussions also supported this range of fund choice.

Figure 7.1 Recommendation of fund choices



Source: PADA 2009
Base: Fund choices recommended by respondents

Religious-compliant and ethical funds

"There should be a choice of funds for members. In particular to respond to an individual's religion or belief preference, such as a Sharia fund. However we appreciate that the numbers of funds should not be excessive so as to put members off making a decision."

Equality and Human Rights Commission

7.5 The majority of respondents suggested making available a religious-compliant fund, such as Sharia, and an ethical fund. Although there was strong support for Sharia and ethical funds, there was little elaboration on how such offerings should be pursued. Roundtable participants thought that choosing whose values to apply to an ethical fund could be challenging. Some participants argued that the same risk and return ratio used for the default fund should also be replicated in these fund types. PADA will be conducting research into ethical and religious-compliant offerings to better understand demand for these types of funds, their features and how they can be delivered.

Risk-graded funds

7.6 Alongside religious-compliant and ethical funds, a large number of respondents welcomed the idea of making available some risk-graded funds as alternatives to the default. Whether respondents suggested one or more risk-graded funds depended on how they viewed the objective of the default fund. Respondents that thought the default fund should represent a medium risk went on to recommend offering a higher and lower risk version of the default. In comparison, others that felt the default fund should focus on preserving capital suggested a single risk-graded option which takes higher risk than the default fund.

Other fund types

7.7 Whether to make available gilt funds, diversified growth, guaranteed and with-profits funds generated much less interest among respondents and were only recommended by a handful. Some participants at the roundtable discussion thought that both guaranteed and with-profits funds would be difficult to communicate and not easily understood by members. They thought that expectations of what these products are designed to do would need to be carefully managed.

7.8 A number of respondents, particularly investment managers and consultants, suggested the use of a 'self-allocation fund' which allows participants to build

Research required

PADA will be undertaking research to look at the appetite for ethical and religious-compliant funds among the target group. We have identified a need to further investigate Sharia and ethical fund offerings in particular. Further research and analysis will be carried out to help us understand required features, likely take up and costs of providing such funds and how they can be delivered in an efficient and simple way. This research is expected to be completed by late spring 2010.

and manage their own portfolio. This is achieved by giving members access to a small number of broadly diversified asset class funds. These could possibly be taken from the underlying constituents of the default fund. A few respondents believed this approach would allow engaged members to select an investment mix that is appropriate for them and matches their risk profiles.

7.9 Research into 401(k) schemes in the US where participants are offered the choice of building their own portfolios from a large selection of fund constituents, suggests that members would be better off staying in the default fund than building their own portfolio. These findings are explored further in Box 7.1.

Box 7.1 *The efficiency of sponsor and participant portfolio choices*[60]

This paper suggests that portfolio performance in 401(k) schemes is linked to both the investment options made available by employers and members' portfolio decisions. The research looked at nearly one million members in one thousand pension schemes. The research identified key portfolio shortcomings in 401(k) plans, attributing these to either the fund components made available to members, or member choices of those components. This research is based on the premise that members build their own portfolios from a large selection of fund constituents.

Some key findings:

- Where an appropriate choice of funds was offered, members generally did not make a choice and their savings pot was put into a default fund.
- Those who did not select fund constituents that provide for an appropriately diversified portfolio experienced a fall in their retirement fund by as much as 20 per cent over a 35 year working life.
- Members would have achieved a better result by splitting their investments equally between the alternative funds available, rather than investing in one alternative fund choice. This is because even a random allocation did better than a poorly informed choice.
- Even if the fund components provided to members were optimal, members still failed to make alternative fund choices that would give them the best outcomes. Members showed low levels of financial literacy and investment knowledge, meaning they often built poorly-diversified portfolios.

This research suggests personal accounts members will not be well served by having the choice of building their own portfolios from a large selection of fund constituents. The research findings appear to support PADA's thinking that offering a small number of readily-diversified, risk-controlled portfolios as part of its fund choice may be most appropriate. This is particularly the case where members of personal accounts are likely to find making financial decisions challenging and have little investment experience.

60 Tang et al, 2009.

General agreement

There was broad consensus that personal accounts should offer a limited range of fund choice consisting of different risk-graded funds to the default, a religious-compliant fund and an ethical fund.

Lifestyling

7.10 The majority of respondents to the discussion paper thought all scheme members need to de-risk when approaching retirement and that lifestyling should be applied to fund choice. Respondents saw no reason why lifestyling should not be applied in the same way to the wider fund choice as it is for the default fund. The Investment Management Association explained that:

"For those outside the default fund, there is no reason in principle why some form of de-risking process should not be applied in the glide path to retirement. This would be particularly relevant for those who have chosen a higher-risk option and who may not have had reason to revisit their choice over time. In such a situation, it might even be perceived as part of the trustee corporation's fiduciary duty to at least offer age-related risk adjustment at the appropriate moment (likely to be 10-15 years from retirement in line with the decision on the default fund)."

7.11 In comparison, participants at our roundtable discussion were divided on whether alternative funds should be lifestyled. Some thought lifestyling should be applied to all funds, while others argued it should only be applied to fund choice that is not motivated by financial reasons, such as choosing religious-compliant or ethical funds. They argued members who select a choice outside of the default fund for financial reasons are likely to have greater financial sophistication and may want to be left to their own devices to pursue their own lifestyling strategy. Other roundtable participants recommended offering members a lifestyled and non-lifestyled version of alternative funds to allow them to make their own decision. These options were also suggested by some respondents to the discussion paper that thought lifestyling should not be applied to all funds.

Mixed opinions

Although the majority of respondents thought that all funds should be lifestyled, roundtable participants were divided on whether lifestyling should be applied to all, or only some, of the alternative funds.

Branded funds

7.12 There is broad consensus among respondents that any funds offered should not retain the branding of the financial service provider, and instead should be offered to members as a 'personal accounts fund'. The most common reasons provided by respondents on why branded funds are not appropriate for personal accounts were:

- **Limiting the hiring and firing of managers**
  The use of branded funds complicates and restricts the flexibility of the trustee corporation to change fund managers, for example when they are under-performing.
- **Communication complications**
  The trustee corporation would have to inform members of manager changes in the branded funds. This may create confusion, particularly given members are likely to have little experience of investment. Members may also be unclear on the difference between branded and personal accounts funds, and think information provided on one applies to the other when it does not.
- **Additional costs and complexity**
  Using branded funds will add complexity to the scheme and is likely to incur additional costs. This was explained by the Pensions Management Institute as follows:

  "There are literally thousands of branded funds on the marketplace. It would be an inappropriate use of the trustees' scarce resources to undertake a whole of market search for appropriate branded funds and to maintain that selection under ongoing review. To make a selection of a few branded funds without undertaking a whole of market research exercise would create a false impression that the trustees felt that these were the best."
- **Reputational risks**
  If a branded fund which has been chosen by the scheme under-performs it may damage the reputation of personal accounts.
- **Effect of brand popularity**
  A member's choice may be influenced by brand name instead of the fund that is most appropriate for their needs.

7.13 A handful of respondents thought branded funds may be appropriate for personal accounts. They believed that branded funds would inspire member confidence and broaden investment choice and flexibility for members who require it. Some respondents also thought branded funds would be appropriate for religious-compliant and ethical funds because they would provide cost and operational efficiencies.

General agreement

Nearly all respondents agreed that branded funds are not appropriate for the membership of personal accounts or consistent with a simple and low-charge scheme.

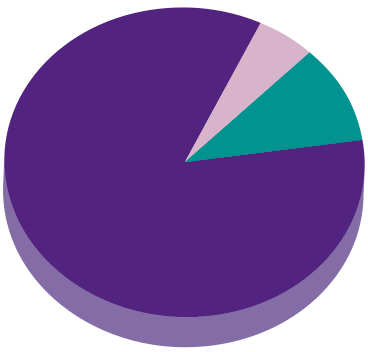
Costs of alternative fund choice

"Personal accounts should be focused on the large majority of its members who are not qualified to make informed fund choice and seek to deliver them the optimal outcome through the default fund. With such an ethos in mind, it would be wrong for members of the default fund to cover any of the costs of members who make an alternative choice."

JA Pensions Consulting

7.14 Almost all respondents believed that the extra costs associated with alternative fund choice should be borne by those members who exercise the choice and not the majority who remain within the default fund. Figure 7.2 shows the breakdown of views.

Figure 7.2 Should there be cross-subsidy of costs between fund choices



Yes	4
No	32
No clear opinion	2

Source: PADA 2009
Base: 38 responses to our discussion paper addressed this issue

7.15 The majority of respondents argued costs should be ring-fenced between funds and there should be no cross-subsidy between the default and alternative choices. Respondents thought this was the case, particularly where alternative funds have higher charges which are accepted by some members in the hope of greater returns. Some respondents thought this could be managed by effective communication around informing members of the charging structures and the extra costs associated with selecting an alternative fund.

7.16 A minority of respondents argued that the costs of wider fund choice should be spread across the whole membership. The Pensions Management Institute thought that keeping all fund costs the same would keep the scheme simple and exert a healthy pressure on the trustee corporation to restrict the growth of fund choice and maintain the cross-subsidy at a "modest level." A handful of respondents thought the administrative costs of offering fund choice should be spread across the entire membership, but the cost of managing different investment options should be borne by the individuals who choose the alternative fund.

7.17 Roundtable participants were divided on this issue. Some argued that costs should be shared given the majority of members are expected to be in the default fund and the cost of cross-subsidisation will be minimal, while others thought those who take advantage of fund choice should pay the extra charges. There were some roundtable participants who believed that cross-subsidisation should only apply to funds where the motivation was non-financial, such as religious-compliant and ethical funds.

Mixed opinions

Although the majority of respondents thought the individual should bear the extra costs for investing in an alternative to the default fund, roundtable participants were divided on whether the membership of personal accounts should share the costs associated with all, or some, fund choice. PADA's planned research into alternative fund choice will look closely at the costs of offering these funds, and the impact that different costs have on members.

Switching between different funds

7.18 The majority of respondents supported constraining the number of switches between funds made by members. They agreed with the research identified in the discussion paper[61] that suggested switching is often not in the best interests of members. Other reasons respondents identified for discouraging switching is that it creates an additional administrative burden which is inconsistent with a low-charge scheme.

7.19 Respondents argued that typical members will not switch, or will switch infrequently. Some thought there should be limits imposed on the number of switches permitted, others thought members should incur the costs themselves for any additional, or all, switches. Some respondents thought a time frame should be imposed on switching as well. For example, allowing members one free switch each year, or within a periodic window. The Trades Union Congress explained that:

"The suggestion of allowing a small number of free switches but then imposing charges for each switch seems to present a good balance between offering choice to members and protecting scheme value for all beneficiaries."

7.20 A small number of respondents believed imposing limits on fund switches was undesirable, because it could prevent members from responding to a change in their circumstances and make them feel "trapped" in a particular fund. Respondents observed where a limit is applied, members will be even more inclined to use their quota, rather than see it "go to waste". This may mean members make switches they otherwise would not have done if there were no limits.

General agreement

The majority of respondents agreed personal accounts should constrain the number of switches between funds made by members, either through imposing a limit, time frame, charges or a combination of all three.

61 Blake and Timmermann, 2005.

Annex one
Roundtable discussions

Setting the investment objective of the default fund: consumer representative bodies

15 June 2009, London

Aim of discussion: to gain feedback from consumer representative groups on the likely characteristics of future members of personal accounts and what will be important to them in terms of an investment objective that encourages them to save and remain in the scheme. The discussion focused on three main areas: the characteristics of our members, what will encourage these members to save and remain in the scheme and how to communicate with members.

Setting the investment objective of the default fund: investment industry

17 June 2009, London

Aim of discussion: to gain feedback from the investment industry on what are the key factors to consider when setting an investment objective for the default fund and which type of investment objective is best suited to personal accounts. Participants were divided into three groups to answer questions and then presented the outcomes of their discussion to the whole group.

Investing in alternative asset classes: investment industry

8 July 2009, London

Aim of discussion: to seek feedback from our stakeholders on the benefits of particular types of alternative investments and whether they would be appropriate for the personal accounts default fund. A panel of guest speakers presented on five types of alternative investments: hedge funds, infrastructure, private equity, commodities and property. The group then discussed whether these investments would meet the constraints and challenges presented by personal accounts.

Approaching retirement: variety of stakeholders

10 July 2009, London

Aim of discussion: to gain feedback from stakeholders on how personal accounts should invest members' contributions as they approach retirement. A guest speaker presented on target-date funds and the experience of the US in using these funds. Participants were then divided into three groups to answer questions and presented the outcomes of their discussion to the whole group.

Investment approach for personal accounts: variety of stakeholders

14 July 2009, Edinburgh

Aim of discussion: to gain feedback from our stakeholders on which type of investment objective is best suited to personal accounts and how personal accounts should invest members' contributions as they approach retirement. Participants were divided into two groups to answer questions and presented the outcomes of their discussion to the whole group.

Investment approach for personal accounts: Employer Representative Committee members

12 August 2009, London

Aim of the discussion: to seek the view of the Personal Accounts Delivery Authority's (PADA's) Employer Representative Committee on what employers are looking for in terms of the investment approach of personal accounts and what are the main factors they consider when choosing a pension scheme for their employees.

Member choice: variety of stakeholders

26 August 2009, London

Aim of the discussion: to seek feedback from our stakeholders on the types of funds the personal accounts scheme should offer members outside of the default fund.

A panel of guest speakers presented on five types of funds: diversified growth, with-profits, guaranteed, ethical and religious-compliant. Participants were then divided into three groups to answer questions and presented the outcomes of their discussion to the whole group.

Investment approach for personal accounts: intermediaries

3 September 2009, London

Aim of the discussion: to seek feedback from intermediaries on what they expect the investment proposition for personal accounts to look like and what factors are important when recommending pension schemes for their clients. Participants were divided into two groups to answer questions and presented the outcomes of their discussion to the whole group.

Investment beliefs: variety of stakeholders

25 September 2009, London

Aim of the discussion: to seek feedback from our stakeholders on whether personal accounts would benefit from having an explicit set of investment beliefs. Three guest speakers presented on investment beliefs: research findings on investment beliefs, investment beliefs from the advisor perspective and investment beliefs from the scheme perspective. Participants were then divided into two groups to answer questions and presented the outcomes of their discussion to the whole group.

Responsible ownership: variety of stakeholders

29 September 2009, London

Aim of the discussion: to seek feedback from our stakeholders on what steps the trustee corporation should take to agree on a policy on responsible ownership and what this policy should be.

Roundtable participants

Listed below is each of the organisations that attended one or more of our roundtable discussions. The organisations have been divided into broad categories. It should be noted these categories have been defined to assist PADA in understanding the perspective from which these organisations have commented and may not in all cases reflect the primary function of that organisation.

Financial services industry

- Aberdeen Asset Management
- Allenbridge HedgeInfo
- AllenbridgeEPIC Investment Advisers
- Alliance Bernstein
- Aviva
- AON Consulting
- Baillie Gifford
- Barclays Global Investors
- Barrie & Hibbert
- BlackRock
- Capital International
- Credit Suisse
- Deloitte
- F&C Investments
- Fidelity International
- Government Actuary's Department
- Governance for Owners
- Henderson Global Investors
- Hewitt Associates
- Hymans Robertson
- Knightsbridge Venture Capital
- KPMG
- HSBC
- IGNIS Asset Management
- Legal & General Investment Management
- LGT Group
- Manifest
- Mercer
- PensionDCisions
- Prudential
- Risk & Reward Consulting
- Sarasin & Partners
- Schroders
- Scottish Life
- SimplyBiz
- Standard Life
- State Street Corporation
- Towers Perrin
- Vanguard
- Watson Wyatt

Professional bodies

- Association of British Insurers
- Association of Pensions Lawyers
- Actuarial Profession
- Investment Governance Group
- Investment Management Association
- Society of Pensions Consultants

Trustees/pension funds

- ABP Pension Scheme
- Barclays UK Retirement Fund
- The Co-operative
- Independent Trustee Service
- Pension Protection Fund
- Universities Superannuation Scheme

Consumer representative groups

- Age Concern and Help the Aged
- Equality and Human Rights Commission
- Fabian Women's Network
- FairPensions
- Financial Inclusion Centre
- Financial Reporting Council
- Financial Services Authority Consumer Panel
- National Institute of Adult Continuing Education
- The Pensions Advisory Service
- Trades Union Congress
- Which?

Employer representative groups and intermediaries

- AWD Chase de Vere
- British Computer Society Payroll Group
- Bluefin
- The Chartered Institute of Personnel and Development
- Confederation of British Industry
- Defaqto
- National Association of Pension Funds
- Lighthouse Group
- Recruitment and Employment Confederation
- Tenet Group

Academics/think tanks

- CASS Business School
- Pensions Policy Institute
- Tilburg University
- University of Edinburgh
- University of Kent
- University of Oxford

Others

- The Children's Mutual
- Financial Times
- The Pensions Regulator

Annex two
Responses to the discussion paper

Listed below is each of the organisations that responded to our discussion paper: *Building personal accounts: designing an investment approach*. The organisations have been divided into broad categories for the purpose of analysing their responses. It should be noted these categories have been defined to assist PADA in understanding the perspective from which these organisations have responded and may not in all cases reflect the primary function of that organisation.

Respondent types

Investment managers

- Alliance Bernstein
- Allianz Global Investors
- Barclays Global Investors
- BlackRock
- Deutsche Bank Advisors
- Fidelity International
- Insight Investment
- Invesco Perpetual
- JP Morgan
- Legal & General Investment Management
- Mellon Asset Management
- Newton
- Northern Trust
- Prudential in partnership with M&G Investments
- RiskMetrics Group
- Russell Investments
- Schroders
- State Street Corporation
- Wisdom Tree

Consultants

- Allenbridge HedgeInfo
- Barnett Waddingham
- Bubble
- Hewitt Associates
- JA Pensions Consulting
- Jardine Lloyd Thompson
- Lane, Clark & Peacock
- Logica
- Mercer
- NP Wallum
- PensionDCisions
- Pensions Investment Research Consultants
- Wragge & Co

Professional bodies

- Association of British Insurers
- Association of Chartered Certified Accountants
- Association of Consulting Actuaries
- Association of Pensions Lawyers
- Depositary and Trustee Association
- Confederation of British Industry
- Institute of Chartered Accountants in England and Wales
- International Securities Lending Association
- Investment Management Association
- London Stock Exchange
- National Association of Pension Funds
- Pensions Management Institute

- Society of Pension Consultants
- The Actuarial Profession
- Tax Incentivised Saving Association Retirement Advisory Council
- UK Sustainable Investment and Finance

Insurance companies

- AEGON
- Aviva
- Friends Provident
- Scottish Widows

Consumer representative groups

- Age Concern and Help the Aged
- Equality and Human Rights Commission
- FairPensions
- Scope
- The Pensions Advisory Service
- Trades Union Congress

Independent financial advisors

- Mr Steve Buttercase
- Mr Eric Lambert

Academics/think tanks

- Dr Alistair Byrne and Professor David Blake
- Pensions Policy Institute

Pension funds

- Local Authority Pension Fund Forum
- Universities Superannuation Scheme

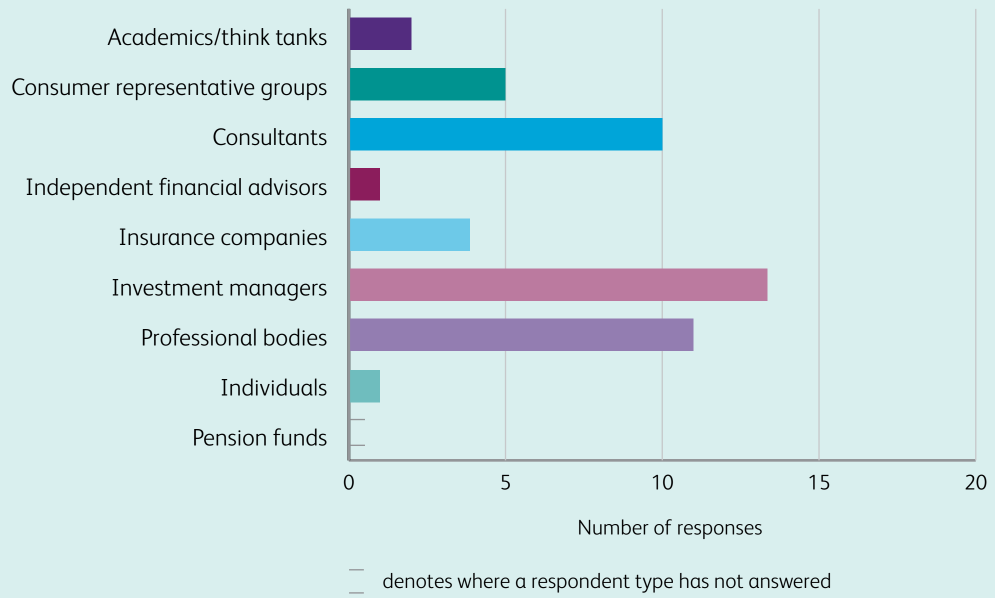
Individuals

- Lord Joffe and Lord Judd
- Mr David Tasker
- Mr Stephen Wynn

Breakdown of responses by topic and type of respondent

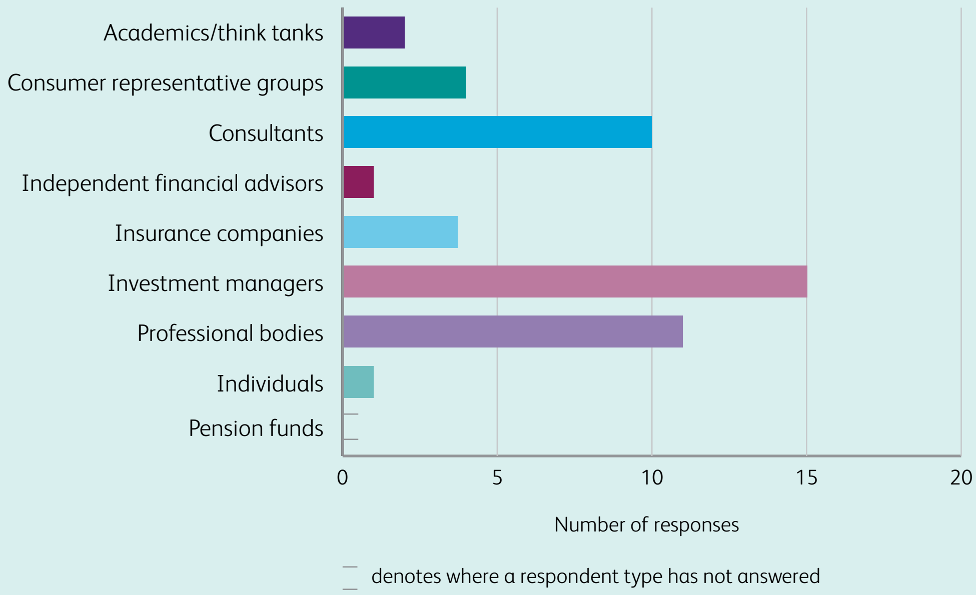
The graphs below provide a breakdown of responses by topic and type of respondent. This shows the levels of interest that topics generated from different types of stakeholders.

Figure A2.1: Member characteristics



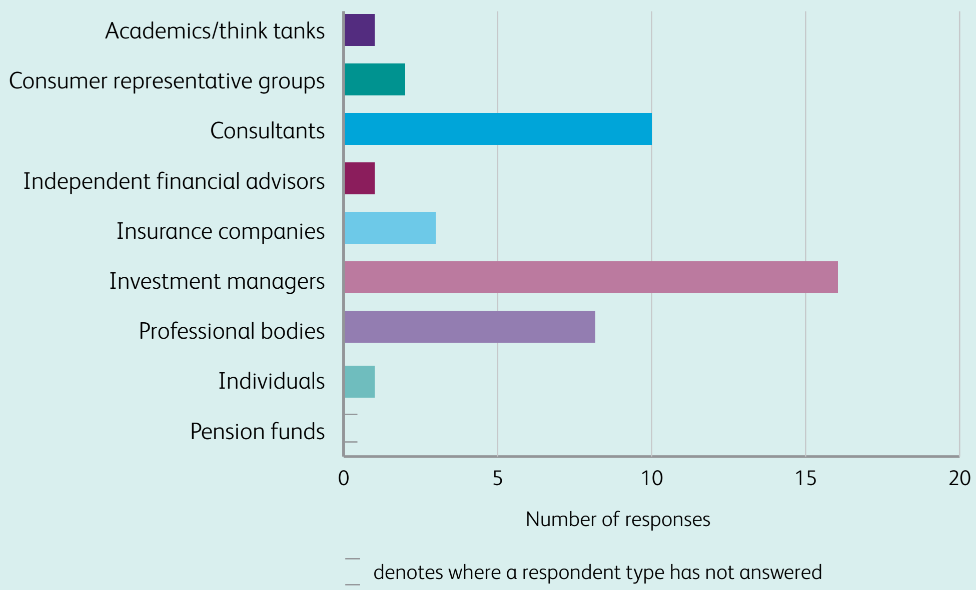
Source: PADA 2009
Base: 47 responses to our discussion paper addressed Chapter 2

Figure A2.2: Investment objective



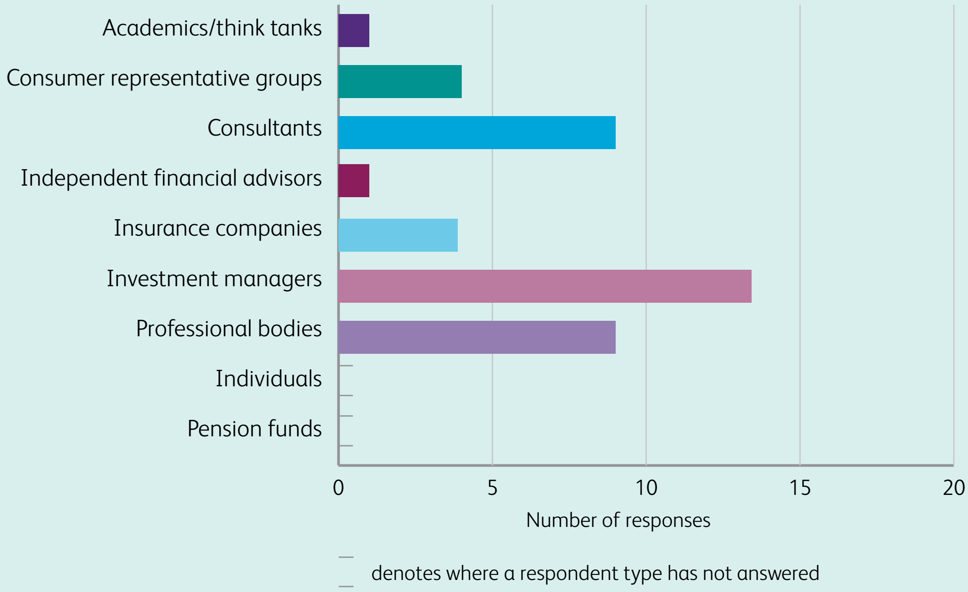
Source: PADA 2009
Base: 48 responses to our discussion paper addressed Chapter 3

Figure A2.3: Investment approach



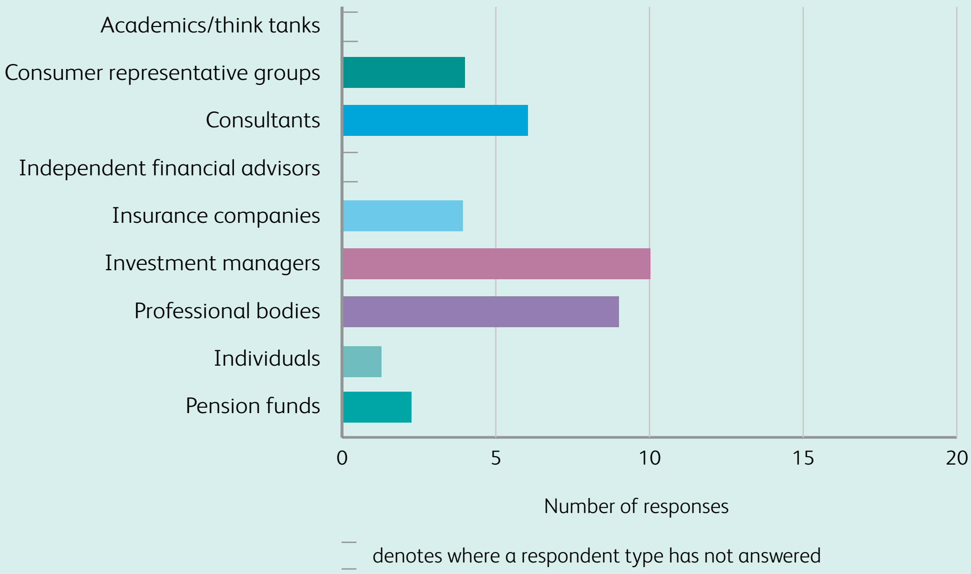
Source: PADA 2009
Base: 42 responses to our discussion paper addressed Chapter 4

Figure A2.4: Approaching retirement



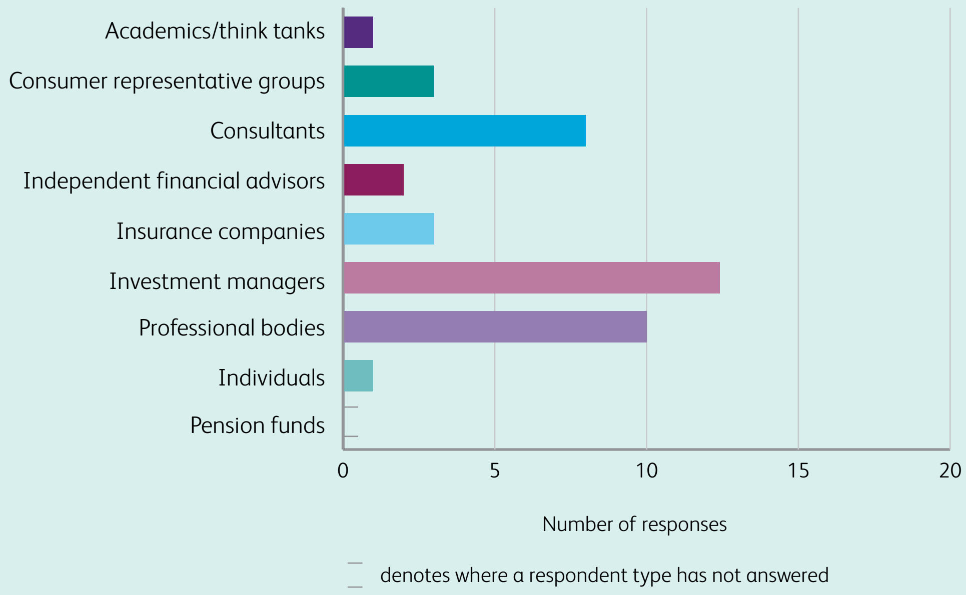
Source: PADA 2009
Base: 41 responses to our discussion paper addressed Chapter 5

Figure A2.5: Responsible ownership



Source: PADA 2009
Base: 36 responses to our discussion paper addressed Chapter 6

Figure A2.6: Fund Choice



Source: PADA 2009
Base: 41 responses to our discussion paper addressed chapter 7

Annex three
International comparisons

Australian superannuation system

The Australian superannuation system is underpinned by a universally available means-tested age pension set at around 25 per cent of average weekly earnings.

The superannuation system as it is today came into being in 1992 with the introduction of the Superannuation Guarantee. It is compulsory for employees aged between 18-70 years old, earning at least AUD$450 per month before tax. Members are not obliged to make a contribution themselves, however there is a compulsory 9 per cent employer contribution based on the employee's ordinary time earnings (effectively, their income). This employer contribution is taxed in the fund at a flat rate of 15 per cent, which is generally concessional, compared to the individual's marginal tax rate. Annual limits are placed on the amount of superannuation contributions that an individual can receive at the 15 per cent tax rate – for those under 50 years of age, the cap is AUD$25,000 and for those aged 50 and over, the cap is AUD$50,000 (only until 30 June 2012 as this higher cap was implemented as part of the transition period).

As an incentive for low to middle earners to save for their retirement, the Government provides a co-contribution to these people when they make additional personal (post-tax) contributions to superannuation. For every after tax dollar contributed to superannuation, the Government provides a matching payment of AUD$1.00. The maximum co-contribution payable is AUD$1,000 which is payable for individuals on incomes of up to AUD$31,920 in 2009-10. For an individual on more than AUD$31,920 and making a personal contribution, the Government will still make some matching contribution, but the amount is reduced until it cuts out at AUD$61,920. Take up of the co-contribution of those eligible is less than 25 per cent.

Self employed individuals may make personal contributions to superannuation and claim deductions for such contributions in order to receive the concessional tax treatment. Employees may also make contributions above the mandatory employer requirements up to their cap (through a salary sacrifice arrangement) and benefit from the concessional tax treatment.

There has been a decline in member contributions in recent times, but this could be attributable to regulatory changes as much as reaction to the global financial crisis.

The system is trust based. Employees choose their own scheme and most of these offer investment choice. If an employee does not make an active choice of scheme they will be automatically enrolled into their employer's chosen scheme. At 30 June 2008, of the total assets in the system, about 30 per cent remain in the default strategy.

Default funds are generally 'balanced funds', which invest approximately 52 per cent in equities, 17 per cent in fixed income and the rest in property, cash and alternatives.

In Australia, lifestyling of default funds is not as prevalent as it is in the UK.

Australia has a deregulated approach to investment, with the responsibility for designing appropriate investment strategies for their beneficiaries falling entirely on the trustees. However, it is common for trustees in the retail sector to rely heavily on the decision making abilities of their scheme members (and their financial advisors).

The Cooper Review, which is due to publish its final report by 30 June 2010, is looking carefully into the functioning of the system and particularly at the selection and structure of the default fund.

The Australian superannuation system is broadly structured as follows:

Corporate funds	Generally only open to people working for a particular employer or corporation. Sometimes ex-employees or relatives of an employee can also join the fund (employers may run their own plan or run it through investment managers or a master trust).
Public sector funds	Generally open to Commonwealth and State Government employees.
Industry funds	Sometimes open to everyone. Otherwise individuals can join if they work in a particular industry or under a particular industrial award and their employer signs up with the fund.
Retail funds	Open to everyone. They are run by financial institutions.
Self-managed super funds (also called SMSFs)	Open to as many as 4 individuals (who cannot have an employer/employee relationship).

Performance and members

The high equity holding of Australian superannuation funds has led to strong performance over the years, however the recent downturn has led to a small degree of switching to safer assets. Some funds may have mis-timed the market, but the long-run consequences are unclear.

It has been observed that there is a general apathy among members and switching is relatively rare. Indeed, when member initiated switching has taken place it has sometimes proven detrimental. Members are also relatively passive when it comes to fund choice.

Costs and outsourcing

Australian superannuation funds outsource the majority of investment management and administration functions.

It has been estimated that charges average around 1.21 per cent of which 1.02 per cent arise from administration, platform and investment activities. A significant issue is whether these costs are too high and what are the options for reform.

Interaction between employers and the system has been claimed to be administratively inefficient and as a result, expensive for the system. This has arisen for several reasons, including because breaks in members' service require new accounts to be created which subsequently have to be matched and aggregated.

Investment choice

Another notable feature of the Australian system is the popular SMSFs. Up to four individuals – often family members or business associates – can invest in any one SMSF, and they take on the role of the trustee themselves. This type of fund is more popular among those with above average earnings and larger pot sizes, with average member balances in SMSFs being 18 times the mean balance of accounts in other funds. While the number of SMSFs is still growing, the rate of growth has begun to decline.

There is a great deal of choice available to members of the Australian system – retail funds offer on average 112 investment options. This has contributed to higher costs, despite the fact that few members make active choices on their investments.

Ethical, religious and environmental, social and governance funds

There is surprisingly little demand for ethical or religious-compliant funds in the Australian system, however when demand arises, this can be well accommodated by the retail market. Environmental, social and governance issues are, however, gaining greater prominence in the larger superannuation funds, largely due to the influence of trustees and pressure groups, more so than a movement among members.

However, some trustees are concerned as to how incorporation of environmental, social and governance sits with their fiduciary duty. The Australian Prudential Regulation Authority is developing guidance around the possible tension between the implementation of environmental, social and governance considerations into investment decisions and fiduciary duty (as measured through the 'sole purpose test').

Industry funds

Members of industry funds tend to have smaller average balances relative to other types of funds. The average charges for these funds is estimated to be around 1.07 per cent of which 1.05 per cent arise from administration and investment management activities.

Despite this, the investment objective of these funds is not necessarily more conservative than that of other funds.

It is also worth noting that these industry funds tend to invest a greater portion of assets in infrastructure and private equity than typical funds.

New Zealand KiwiSaver Scheme

Framework of the scheme

The KiwiSaver scheme came into existence in July 2007. It was introduced to help address the problem of low retirement savings among New Zealanders. KiwiSaver is a defined contribution occupational pension scheme in which members are auto-enrolled when they commence employment, with the ability to opt-out.

Employees aged 18-65 are auto enrolled into the scheme, and then have between day 13 and day 55 to opt out, after which time employees who opt out have their contributions to date refunded.

Members can choose between 33 retail schemes which they may join directly (there are also around 20 employer schemes that their employees may join). Those who do not choose a scheme are automatically assigned either a government selected default fund – of which there are six – or their employer's choice of scheme.

Having selected a scheme, members have the ability to transfer their assets into another scheme. If a sponsoring company already has a superannuation scheme in place, it is not obliged to automatically enrol its new staff into KiwiSaver, but the company must make it available should the staff want it. The self-employed and unemployed can also opt in to KiwiSaver.

Members can choose to contribute 2 per cent, 4 per cent or 8 per cent of their gross wages. Generally, members can choose to switch their rate of contribution no more than once every three months (unless their employer permits it).

The sponsoring company must contribute an amount equal to 2 per cent of the employee's gross earnings, although the company can elect to contribute at a greater rate.

The government provides members with incentives for participation in the scheme, in the form of a NZD$1,000 tax-free ‘kick start’ payment, a tax credit of up to NZD$1,042.86 per year which matches the employee’s personal contributions, as well as a first home deposit subsidy.

Once a member has opted in to the scheme, they cannot opt out, and their pot is then only accessible once they reach the age of eligibility, currently 65 years, or after 5 years of membership, whichever is later.

Prior to the launch of the scheme there was a major information campaign to publicise the scheme. This has proved successful, with participation in the scheme exceeding expectations. This can also be attributed to successful ongoing communication strategies along with government incentives.

In the KiwiSaver scheme, there is an extensive evaluation programme to assess processes as well as outcomes. Scheme providers are also required to disclose their approach to socially responsible investing. The government oversees the negotiation of fees for the default providers, and the *KiwiSaver Act 2006* requires that other providers must charge fees that are ‘not unreasonable’.

Default funds

Many members of the KiwiSaver scheme are low-to-middle earners, and are risk averse. With this in mind, the mandate to the six default fund providers was to set a conservative investment objective. The default funds must invest 15-25 per cent in growth assets, with the rest being invested conservatively. The default funds are primarily invested in cash and fixed interest assets. The trustees of the schemes are responsible for setting their own investment objectives, within this remit.

KiwiSaver aims to be a simple and low-cost scheme that will help the population to build savings, as well as imbue a savings culture and develop financial understanding. This approach is facilitated, in part, by the fact that New Zealanders are entitled to a non-means tested state pension of 66 per cent of the average wage.

The default funds fared well during the financial crisis. This, coupled with the fact that the membership of default funds is typically less involved in the management of their savings, meant there was less change in switching behaviour than may have been expected.

Fund choice

Within the 33 KiwiSaver schemes, there is a degree of fund choice. The default schemes, for example, offer conservative, medium-growth and high-growth funds. There are some funds catering to specific demographic requirements, for example, a socially responsible fund aimed at the clergy of the Anglican Church.

Approximately 55 per cent of members make an explicit fund choice, with 34 per cent being allocated a default fund and the remainder going into a fund of their employer’s choice. However, 8 per cent of those who do make an active fund choice select one of the default funds. Approximately 39 per cent of the total amount of savings in KiwiSaver is invested in default funds.

There is a reasonable degree of public awareness surrounding socially responsible investment in New Zealand and members can make an active choice to invest in socially responsible funds. However, socially responsible investment is not incorporated into the strategies of the default fund. Fees for such choices are generally higher, and most members have not been prepared to pay the extra expense.

US 401(k) Pension Plans

Framework

The major vehicle for pension savings in the US is the 401(k) plan. 401(k) plans are defined contribution schemes, where an employee contributes a portion of their pre-tax earnings into their account, and their employer (sponsor) will usually elect to match all or part of this contribution. Contributions and investment returns are not taxed, but income in retirement is subject to income tax. Members can choose to make additional contributions from post-tax earnings, with the income arising being tax free.

The *Pensions Protection Act 2006* provides incentives for employers to adopt automatic enrolment of their employees into their workplace pension schemes. The Act pre-empts state laws that might affect plans adopting automatic enrolment provisions and provides additional non-discrimination safe harbour protections.

Generally, members select their own investment options, usually mutual funds comprising equity, bonds and money market instruments. Less frequently, the employer will appoint a trustee to manage the investment decisions on behalf of the scheme's membership. Many employers encourage employees to form some of their equity allocation from company stock, however this tradition has been decreasing in recent years.[62]

Accessing pension savings

Individuals must begin drawing from their accounts by the age of 70½ (and no earlier than 59 ½) – at an actuarially determined minimum rate of 'distribution'. Some funds allow members to borrow from their account at pre-defined interest rates, for a maximum term of 5 years (except for purchase of a primary residence).

The majority of 401(k) plans today include target-date, or 'lifecycled' funds, the popularity of which have grown steadily since they became 'qualified default investment alternatives' in 2006. However, there has been some controversy over the investment approach in such funds in light of recent market stress.

Asset allocation

The average investment returns in 401(k) accounts dropped 29 per cent in 2008. Asset allocation across the system continues to be focused on growth with 61 per cent of assets invested in equities and 39 per cent in fixed income and money market instruments.[63] Early indications suggest the stock market crash of autumn 2008, and the subsequent global recession has had little impact on 401(k) investor behaviour. Asset allocation switching rates have not been atypical, and participation as a whole has continued to rise, which is likely to be due in part, to auto enrolment. Participants in 401(k) plans are continuing to seek greater diversification in their portfolios, with allocations to sponsor company stocks continuing to decline.

62 Greater importance has been put on diversification. There has also been well publicised collapses of sponsoring companies, such as Enron, where people simultaneously lost their jobs and saw their stocks become worthless.

63\ Vanguard, 2009.

Annex four
Glossary

Term	Definition
Absolute return	The return an investment achieves over time, without comparison to the overall market, other assets or benchmarks.
Active management	An investment approach that pursues a return on investment in excess of a specified benchmark.
Alpha (investment)	A measure of the risk-adjusted return an active manager achieves on a portfolio in excess of the benchmark.
Annuity	An insurance product designed to provide a lifetime income in retirement in exchange for a single lump sum. There are various types of lifetime annuity which can, for example, pay money to dependants or keep pace with inflation.
Asset allocation	The proportions in which the holdings of a portfolio are spread across different types of financial instruments and asset classes.
Asset class	A specific category of assets or investments, such as equities, bonds, cash or property. Assets within the same class generally exhibit similar characteristics, such as similar risks and returns.
Asset mix	The classes of assets selected to construct an investment portfolio (see asset allocation).
Balanced fund	An investment portfolio which diversifies its holdings over a range of asset classes. By restricting investment in any one asset class, the remainder of the fund's holdings can then be invested in other classes of assets. This type of fund aims to be sufficiently diversified that if there is poor performance in one asset class then it is offset, at least partially, by better performance in another.
Bear market	The name given to a financial market that is in decline, catagorized by investor pessimism and fear. To be recognised as a bear market, as opposed to a 'correction', the market would have to decline a certain amount for an extended period. For example, an equity market may have to decline by at least 20 per cent over at least a few months to qualify as a bear market.
Behavioural economics	The use of developments from psychology to help understand how people make economic decisions in real life.
Benchmark index	A standard against which the performance of a security or portfolio of securities can be measured. Generally, broad market indices are used for this purpose.
Collateral	A security pledged by the borrower in order to protect the lender's interest for the duration of a loan.
Commodities	The raw materials used by industry and traded on specialist commodities markets.

Term	Definition
Constant proportion portfolio insurance (CPPI)	A capital protection tool where a floor value is set for the member's account and the asset allocation is structured around that floor value. The amount that is allocated to risky and less risky assets is a function of the difference between the portfolio value and the floor value.
Contribution	Used to refer to both employer and employee payments into the pension scheme, unless otherwise stated.
Corporate bonds	Debt issued by companies. They are usually tradable in a market.
Corporate engagement	This is where the institutional shareholder builds a working relationship with the board of directors of the company in which it invests to ensure the directors discharge their duties for the benefit of shareholders.
Corporate governance	Involves the role institutional shareholders play in appointing the board of directors and auditors of the company in which they invest through exercising voting rights. This is to ensure appropriate governance, director remuneration, public reporting and accountability structures. Corporate governance can also include corporate engagement.
Correlation	A measure of the relationship between two variables.
Counterparty	The other party to a specific transaction.
Currency	The global currency market is by far the largest financial market in the world. The main differentiator of the currency market, compared to other financial assets is that a currency only performs in relation to other currencies. In this way an investor must form a view that for example sterling will go up (or down) **against** the dollar or the euro, or other currencies. It is the relativity that makes currency markets interesting and challenging at the same time.
Daily pricing	The calculation of the latest market value of a fund's underlying assets on each business day.
Default fund	Some scheme members may not indicate how they would like their contributions invested. These members will have their contributions paid into a default fund set up for that purpose.
Deferred annuity	An annuity that is not scheduled to begin payments until a given date in the future. These annuities may be purchased with a single payment or with a series of periodic payments.
Defined benefit pension scheme (DB)	A pension scheme where the pension is related to the member's salary or some other value fixed in advance.
Defined contribution pension scheme (DC)	A scheme where the individual receives a pension based on the contributions made and investment return that they have produced. They are sometimes referred to as 'money purchase' schemes.
Deliberative research	Deliberative research builds on standard research approaches. It uses extended groups, workshops and forums to give participants more time and information than would usually be the case using traditional research techniques. It is particularly suited to more complex subjects. It can be used to explore how views change in response to information and arguments and to explore both less informed and, subsequently, more informed perspectives.

Term	Definition
Diversification	The spreading of an investment fund among countries, markets, sectors, asset classes and securities in order to distribute and control risk. This is an investment application of the everyday term 'don't put all your eggs in one basket'.
Diversified growth fund	An actively managed fund that aims to deliver high returns with low volatility, by investing in a range of 'growth' assets. This typically includes global equities, private equity, commodities, hedge funds and property. The low volatility depends on the assets within the portfolio having low correlations.
Draw down	An alternative to annuity purchase where a member defers all or part of a pension fund normally used to purchase an annuity. The pension fund remains invested and members can make regular withdrawals as their retirement income.
Dynamic asset allocation	This involves dynamically adjusting the asset allocation mix as market conditions change over time. Investment usually shifts between a zero-coupon bond or interest-bearing security and an underlying equity investment.
Emerging market	Developing or immature financial markets, usually outside of US, Europe or Japan, that are often not considered 'efficient'. Emerging markets will generally be less liquid, more loosely regulated and riskier than developed markets, however their economies are usually expected to grow more rapidly, hence investors will often accept the higher risk in order to benefit from the expected higher returns.
Emerging market debt	Bonds issued by emerging economies / countries.
Emerging market equity	Stocks issued by companies of emerging economies / countries.
Ethical fund	Ethical funds allow investors to align their investment portfolio to their own values. These funds use techniques, such as screening, to determine which companies they should invest in. Negative screening involves not investing in industries or individual organisations that fail certain non-financial criteria. Positive screening involves using similar criteria to select companies. or industries that perform particularly well against these criteria. There are also other techniques sometimes used, such as best-in-class and sustainable investment.
Exchange-traded fund (ETF)	A security that trades on a market much like a share, but represents a holding in an index-tracking fund.
Fiduciary duty	Sets out the broad parameters within which trustees must exercise the discretionary powers conferred by the terms of the trust.
Fund of hedge funds (FoHF)	A fund consisting of a number of other hedge funds. The underlying hedge funds can be chosen from a number of different strategies, or they can all be focused on the same strategy but use many different managers. The benefit of a FoHF set-up is that by diversifying the strategy or the managers, performance is said to be smoother and more consistent. The fees paid by the investor are higher due to the more complicated set-up.

Term	Definition
Gilt funds	Aims to provide a low, but stable and secure, return for very cautious investors. These funds typically invest in medium and long-term government securities.
Governance	The system and process concerned with ensuring the overall direction, effectiveness, supervision and accountability of an organisation.
Guaranteed fund	Seeks to provide some certainty to the investor as to the level of return they will receive. A common example is a guaranteed capital bond offered by high street banks. These products will typically pay, at the end of the five years, the greater of: • the initial capital invested or • the initial capital invested multiplied by the change in the FTSE 100 share index over the five year period.
Hedge fund	A fund that invests money in a wide range of different assets and is allowed to use investment strategies unavailable to standard funds. This can include short selling of securities and use of leveraged positions.
Hedge fund replication	A passive investment vehicle that aims to replicate exposure to the various returns available to hedge funds, without the high fees associated with directly investing in hedge funds.
High yield bonds	In the debt market, an issue of a bond is 'rated'. Such rating reflects how reliable the issuer is, in terms of their ability to repay debt in full or partially, on time or late. The scale of bond quality is as follows: government bonds (the most secure), investment grade bonds (issued by 'well regarded' private corporations). High yield bonds are issues of the next level down in terms of quality. In return for the higher risk of default high yield bonds pay a higher coupon (income return) to the investors.
Human capital	The property of an individual or individuals that can generate financial value as a result of skills, knowledge and hence ability to work.
Infrastructure funds	A fund that invests in one or more infrastructure projects, such as bridges, roads and ports.
Institutional shareholder	An institutional investor in its role as a holder of shares in listed companies. Institutional investor and institutional shareholder are often used interchangeably.
Investment approach	Term used to refer to both the investment objective and investment strategy of a pension scheme.
Investment horizon	Refers to the point in time when an individual expects to achieve his or her investment goal. In reference to pensions, this is usually at retirement.
Investment objective	The financial goal or goals of the funds within a pension scheme, which is used to guide the selection of investments.
Investment return	The amount gained or lost, usually expressed as a percentage, which was earned from an investment during the period in which it was held.
Investment risk	Unpredictability in the extent and timing of investment returns.

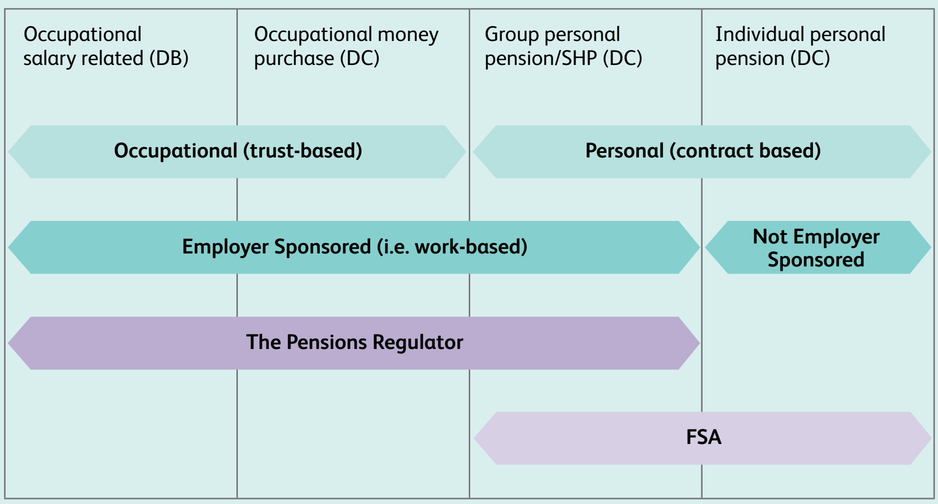
Term	Definition
Investment strategy	The investment strategy is the process undertaken to achieve the investment objective. The investment strategy evolves to meet the changing needs of members and different economic and market conditions.
Lifestyling	The approach where a scheme member's assets are moved from growth-type investments, such as equities, to bonds and cash in order to manage risk. The switch occurs as retirement approaches.
Liquidity	The ability to move cash into and out of other assets. The liquidity of an asset refers to how easily and how often it can be traded or exchanged. It also means the ability to trade an asset in exchange for cash.
Longevity risk	The risk that a person outlives the ability of their retirement assets to deliver sufficient income to sustain them. By buying a lifetime annuity, a person passes the longevity risk to the annuity provider.
Market price	The price at which a security is currently trading in the market.
Managed account	A bespoke service offered by investment managers to investors, where their assets are ring-fenced, that is, not pooled with other investors' assets, and invested according to that client's specific requirements.
Mental accounting	Behavioural economics (see above) has challenged the standard economic assumption that individuals treat all wealth types equally when trying to smooth their consumption over time. Instead, people consume different types of wealth at different rates such that they use internal 'mental accounts' to separate money for different designated purposes, for example, holidays, college fees and so on. Mental accounting behaviour refers to a type of apportionment behaviour. Such behaviour was found in the joint DWP-PADA qualitative research.[64]
Occupational pension scheme	Is a trust-based pension scheme set up by an employer and can be a defined benefit or defined contribution scheme. See 'work-based pension scheme' for further information.
Passive management	An investment approach that aims to mirror the performance of a financial index. This is normally done by either investing in the exact constituents of an index or by taking a representative sample of the index.
Private equity	A pooled investment vehicle used for making investments in the part of the economy that is owned and managed by corporations and individuals – such companies not being listed or traded on any organised financial market. Usually capital is invested in start-up, developing and restructuring companies.
Property	Property funds invest in publicly listed property companies and/or directly in property. Direct investment is usually in commercial property, retail space and office buildings, although it can also include residential property. Property funds invest in both UK and overseas property markets.
Prospect theory	An alternative to traditional utility theory in economics that seeks to describe the real-life decisions people make when taking risk and seeking returns.

64 Thomas, A, et al, 2009.

Term	Definition
Real estate investment trust (REIT)	A publicly-quoted company that invests in property and enjoys certain tax benefits as long as they meet certain conditions. One of these conditions is that each REIT has to be listed on a recognised stock exchange.
Religious-compliant fund	Religious-compliant funds allow investors to align an investment portfolio to their religious views. A particular form of religious investment is Sharia, which is based on Islamic law.
Responsible investment	An investment approach that focuses on corporate governance and engagement and how businesses manage their relationship with society and the environment over the longer term.
Risk free	This generally refers to government-issued securities as these are perceived to be free of credit risk. Sometimes, it refers specifically to index linked government bonds as these are free of inflation risk also (see index linked gilts').
Risk-graded funds	Risk-graded funds allow a member to select a fund that closely matches their risk appetite. Risk-graded funds may draw on the same range of assets available in the default fund, but in different proportions, so as to vary the risk characteristics. For example, this may result in higher risk and return, medium risk and return, and lower risk and return funds.
Risk sharing	Risk sharing within a pension scheme refers to methodologies for sharing risk among members of the scheme. The core risks include investment risk, longevity risk, and inflation risk. Most often, risks are shared between different generation cohorts of members, among workers only, pensioners only, or among workers and pensioners.
Securities	Financial instruments that can be traded, such as stocks and bonds.
Securities lending	The temporary loan of a security by an investor to a borrower in return for a fee (interest on the loan). Some stakeholders have referred to this as stock lending.
Short selling	Selling a security that the seller does not own at the time of the sale, and expects to buy back at a lower price in the future.
Socially responsible investment	An umbrella term that encompasses a range of investment techniques that focus on the environment, society, corporate governance and engagement.
Stochastic lifestyling	A method of determining the appropriate timing for asset allocation switches in the glide-path according to the results of stochastic modelling, which will take into account a member's initial objectives and likely investment outcomes based on current allocation.
Strategic asset allocation	Selecting the asset mix and the asset weights of a portfolio in order to meet its long-term investment objective.
Structured guaranteed return products	A product such a deferred annuity, which seeks to offer an investor some degree of certainty of the retirement income they will obtain. Often a large portion of the member's contributions are committed to purchasing this product, with the remainder being invested in high risk, high return assets.
Tactical asset allocation	Marginal adjustments made to the strategic asset allocation, on a short-term basis, to benefit from short-term differences in the relative worth of various asset classes. Such adjustments do not distort the long term view or objectives.

Term	Definition
Target-return strategies	These strategies measure performance against a long-term investment target set by the individual scheme member. A proportion of investments are moved to safer assets each time the target is exceeded. Target-return strategies carry additional costs due to administrative complexity and frequent switching transactions that are potentially required.
Trust-based pension scheme	A trust-based pension scheme is administered and governed by a trust deed and rules. The trustees are guided by law to ensure that contributions are managed in accordance with the terms of the trust deed and in members' best interests.
Venture capital	Venture capital is a strategy within private equity, referring to the early stages of a company's creation and development. It involves the financing of new and emerging companies that are at the pre-product or pre-revenue stage. This strategy is often regarded as the 'business of building businesses', and requires an entrepreneurial approach to investing.
Volatility	A statistical measure of how much a series of values move up and down around its average. The lower the volatility, the more concentrated the values are around the average.
With-profits fund	A type of pooled investment fund with 'smoothing' built in; that is – some of the excess returns in years of good performance are held back to help top up returns in bad years, such that in any given year the 'bonus' paid out to an investor is not significantly different to other years. With-profits funds may also share in profits, or losses, of the insurance company, rather than just sharing gains or losses with other members.
Work-based pension scheme	Can be trust-based or contract-based. The relationship between trust-based and contract-based pension schemes is highlighted in the chart below from the Pension Regulator.

Regulatory responsibilities



http://www.thepensionsregulator.gov.uk/pdf/discussionPaperGovernance.pdf

Annex five
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