Member Research Brief

Research to support the investment strategy

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Important information

This document gives information about our research findings only. Further information is available from NEST.

We use the term NEST to refer to the scheme's legal name, the National Employment Savings Trust. We sometimes also use it to refer to the scheme's Trustee, the National Employment Savings Trust Corporation.

Executive summary

The purpose of this report is to summarise the research into potential members that has informed the investment approach. It focuses mainly on:

- Risk capacity: the ability of the membership to take investment risk. We see this as a function of various demographic characteristics, notably earnings and wealth. Principally, it is the ability of the membership to deal with investment loss.
- Risk preferences: the attitude of the individual to savings and risk.

To some extent, these complement each other, people who are better off are more likely to have a higher personal tolerance for investment risk.

Risk capacity

The main characteristic of the target group is its diversity. It contains a wide range of individuals working across the private sector. In some respects, most notably median average earnings, it is similar to the population working in the private sector as a whole.

The target group is, though, strikingly different to the population currently saving into a pension, working in the private sector and eligible for the automatic enrolment reforms. Notably, while median earnings in the target group are c. £19,800, median earnings of those contributing to a pension are c. £30,600 a disparity of c. £10,500.

This disparity is replicated across a series of characteristics. Those with pensions are more likely to have higher levels of savings and to work in managerial or professional jobs. They are also likely to have a higher level of education and be older. As such, the average risk capacity of the target group is considerably lower than that of those currently saving into a pension.

Risk capacity is also related to experience with financial products and investments as well as financial education and confidence with numeracy. These factors are often bound together under the terms financial capability or financial literacy. Some in the target group are likely to be unfamiliar with investment material and concepts. As a consequence they may find making investment decisions, for instance selecting appropriate funds, challenging. NEST did not find any evidence that available financial education interventions are likely to improve the investment decision making capability of the target group prior to automatic enrolment.

Risk preferences

The target group is split between those who are actively risk seeking and those who are risk averse. On balance the target group is more risk averse than risk seeking with a large proportion (37 per cent) of the target group favouring taking no risk whatsoever with retirement savings. Risk preferences also trend by income with those on lower incomes being more likely to be risk averse than those on higher incomes.

Executive summary (cont)

New qualitative research also shows that the target group tends strongly towards loss aversion. The research showed that the target group are likely to have negative and emotional responses to investment loss. The research observed: disappointment, anger, surprise and incredulity when research participants were confronted with hypothetical investment losses. Loss was also felt with a sense of immediacy and was not considered within the context of a long-term savings vehicle. Stated responses to hypothetical investment loss included cessation of contributions and switching of funds.

It is possible for people to be risk seeking and also strongly loss averse. People may be comfortable in the abstract or under experimental research conditions with the notion of investment risk. When confronted with the reality of an investment losing value, they may have a negative reaction that could not be anticipated from their self-reported level of risk tolerance. The research found this to be the case most strongly among younger people. Young people self-report higher levels of risk appetite, research shows they may be the most loss averse in practice and most likely to take action if confronted with loss.

The findings support other evidence suggesting that those without pension schemes are less likely to have a good knowledge of how defined contribution (DC) pensions function and may assume that they are similar to a long-term savings account. Those who have experience of pensions, meanwhile, are likely to be more knowledgeable about investment.

It is estimated that up to around half of workers who will join NEST will have saved in some form of occupational pension in the past. Many of these individuals will have had experience of a defined benefit (DB) rather than a DC scheme. However, although they may be aware of pension products, their capability to accept risk in investment is more likely to be aligned with their current circumstances, that is, driven by earnings rather than previous experience.

Investment choices

Inertia

NEST has examined the available international evidence on DC pension reform, where automatic enrolment is a component. Much of this is based on behavioural economics and suggests that those who have been automatically-enrolled into a scheme will be largely inert once they have become members. Briefly the literature suggests that:

- Automatic enrolment makes default funds much more important than they otherwise would be. The available international evidence relating to schemes similar to NEST suggests that unless spurred into action, automatically enrolled employees are very likely to remain within scheme's default fund. Sizable majorities (between almost 7 in 10 and 9 in 10) of those automatically enrolled into DC pension schemes in the US, Sweden and Chile invest exclusively in the default fund.

Executive summary (cont)

- Participants tend to adopt the default contribution level.
- People saving into US 401k pension schemes have, in the main not reacted to the market volatility stemming from the recent financial crisis.

While savers in US 401k schemes have been largely inert through the downturn, we believe that savers in UK DC schemes may have been more active in shifting their asset allocation or in ceasing contributions during the recent financial crisis.

Ethical and Sharia compliant fund choices

NEST also conducted research into target group preferences for ethical investment and demand among Muslims for a NEST Sharia compliant investment fund.

Research into the target groups' priorities for an Ethical fund showed that the target group were most concerned about "global" issues. The target group were most keen for a NEST ethical fund to have an appropriate stance on child labour, exploitation and human rights violations. These were identified as the most important or motivating screening criteria.

Research into demand for a Sharia fund showed that some Muslims felt they would opt out of the scheme if informed at the outset that their money was being invested in industries forbidden under Sharia law – or would feel they ought to opt for a Sharia compliant alternative if they knew it was available. However some would remain in the scheme regardless. The research also suggested that few Muslims in the target group were currently aware of or were using Sharia compliant financial products.

Introduction

Purpose of this document

1.1 The purpose of this report is to summarise the research into potential members that has informed the investment approach. In developing the investment strategy we have considered three factors, two of which are characteristics of potential members:

- Risk capacity: is the ability of the membership to take investment risk. We see this as a function of various demographic characteristics, notably earnings and wealth. Principally, it is the ability of the membership to deal with investment loss. Risk capacity is the subject of the first section of this document.
- Risk preferences: are the level of risk people are comfortable taking. This is the subject of the second section of this document.
- Risk need: is the level of risk the membership need to take in order to achieve a given investment objective to generate a required income in retirement.

1.2 This report discusses the first two of these factors: risk capacity and risk preferences and their presence and distribution in the target group.

1.3 We are interested in:

- the extent of the risk capacity of the target group and how this differs to the risk capacity of current pension savers
- the spread of risk preferences and loss aversion within the target group.

The report also summarises a selection of insights from the behavioural economics literature that are relevant to DC schemes in the context of automatic enrolment. It goes on to outline research commissioned by NEST into Sharia and Ethical investment fund options.

1.4 Much of this work has built on the understanding we developed as part of our investment consultation. In order to understand these characteristics we have conducted further research into likely future members. This has involved a range of different projects and methodologies. A list of forthcoming publications and other research conducted by NEST is contained in Annex B.

NEST's target group

1.5 NEST's target group are a subset of those eligible for the reforms outlined in the Pensions Act 2008. We know that NEST's eventual membership will be mainly drawn from within this population. This target group comprises all those:

- in employment in the private sector
- working full - or part-time,
- earning more than £7,475 (in 2011 terms)[1]
- aged between 22 and State Pension age
- who do not have a qualifying pension scheme.

[1] This figure (currently in November 2011 terms) was set out in section 5 of the Pensions Act 2011. It will be reviewed every year by the Secretary of State. When section 5 comes into force it will replace the Pensions Act 2008.

Introduction (cont)

1.6 The composition of NEST's membership is likely to be different to the composition of this group. It is not currently possible to predict how it will vary: all we currently know is that NEST's membership will mainly be drawn from within this large group.

1.7 Once NEST has members, our approach will shift towards understanding in more depth those who have actually joined the scheme. In *the interim, the target group remains the best proxy for NEST's future membership.

1.8 This document also discusses what is termed the 'pensioned eligible' group. This group meet all the criteria for automatic enrolment but are currently members of a qualifying pension scheme.[2] As current customers of the pensions industry, it is often more useful to compare the target group to them than to compare the target group to all people working in the private sector.

2. We use the proxy of a 3 per cent employer qualification as the lower limit for a qualifying scheme.

Introduction (cont)

Box 1: Making automatic enrolment work

Following its formation in May 2010, the Coalition Government established a review of the pension reform programme. This review known as *Making Automatic Enrolment Work* took place over the summer of 2010. It proposed several changes to the scope of the automatic enrolment reforms, which were subsequently adopted by the Government:

- Raising the earnings threshold for automatic enrolment to fall in line with the income tax personal allowance (from £5,035 to £7,475*).
- Introducing an optional waiting period of up to three months before a worker needs to be automatically enrolled into a workplace pension.

These changes altered the size and scope of the target group for the reforms.

Much of the research conducted by NEST was done before the end of the review and therefore used the previous wider definition of the target group.

We do not feel, though that the shift in the definition of the target group has altered the validity of the research when used in the manner we have used it.

* This figure (currently in November 2011 terms) was set out in section 5 of the Pensions Act 2011. It will be reviewed every year by the Secretary of State. When section 5 comes into force it will replace the Pensions Act 2008.

Target group demographics

Summary

Risk capacity is the capacity to take on investment risk. In part, it is the ability to deal with the consequences of loss. We see risk capacity in the target group as being a function of particular characteristics, mainly those related to the ability to earn and save money.

Evidence suggests that risk capacity trends more closely with earnings and income compared to any other demographic characteristics. Therefore we suggest that the risk capacity of the target group is substantially lower than that of those eligible workers currently saving into a qualifying pension scheme. The target group have:

- lower earnings: median earnings in the target group are c. £10,000 lower than in the pensioned eligible group
- lower savings.

Furthermore, some in the target group are likely to be unfamiliar with investment material and concepts. As a consequence they may find making investment decisions, for instance selecting appropriate funds, challenging.

2.1 This section examines the demographic characteristics of the target group and suggests how risk capacity is related to, and varies with, each characteristic and how they are related to the ability to deal with the potential downsides of investment risk. We see individuals' risk capacity rising in line with their earnings and savings. Most importantly, we are interested in the ability of the target group to deal with interim and absolute loss.

2.2 As such this section takes in factors that affect earnings and earnings over time, such as age and education. It also looks at capital accumulation; patterns of savings, investments, debt and housing tenure.

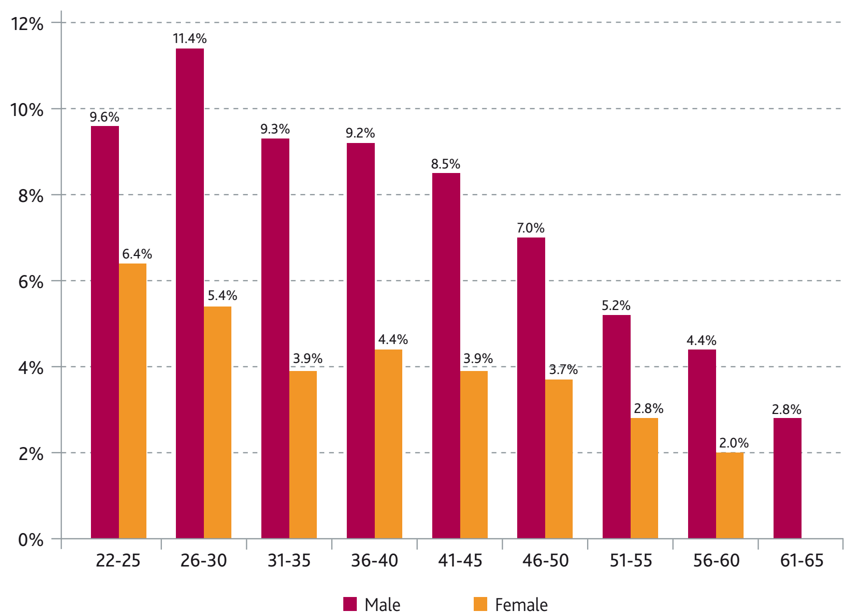
2.3 The investment consultation pointed out the need to conduct further research into the demographics of the target group. This section is a summary of the conclusions of this work.

Target group demographics (cont)

Age and gender profile

2.4 The target group contains more men than women. Just over two-thirds (67 per cent) of the target group are men.[3] They are also more likely to be young compared both to the working age population and those with qualifying pensions: 33 per cent are aged between 22 and 30 and 60 per cent are aged between 22 and 40.

Figure 1: Age of the target group by sex



Source: FRS 08-09/NEST calculations

3. FRS 2008-09/NEST calculation.

Target group demographics (cont)

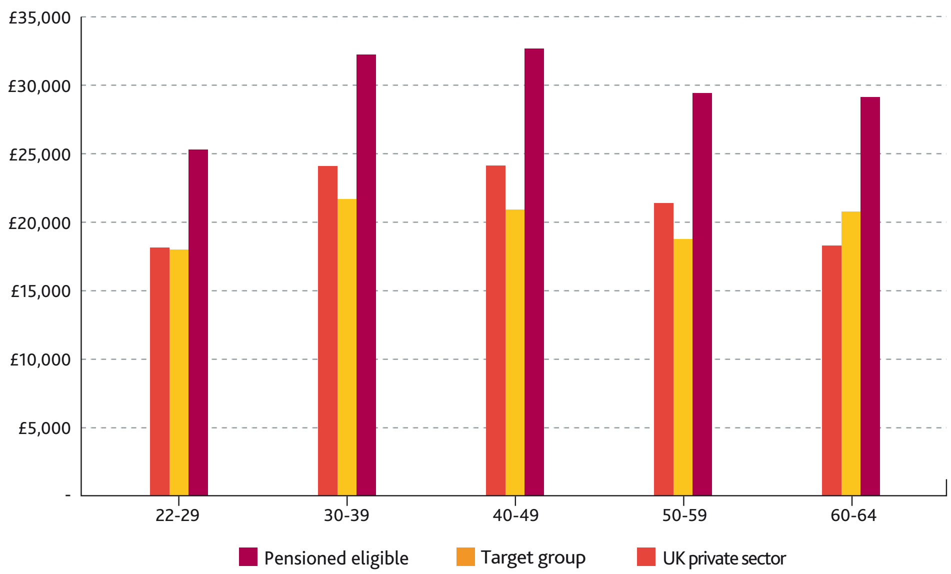
2.5 Analysis of current pension scheme membership suggests that there is no difference in the proportion of males and females who are saving in a work based pension scheme. Around 44 per cent of eligible male workers are members of a pension scheme, compared to around 43 per cent of females, which suggests that the ability to invest in a pension scheme does not vary by gender. It is not clear whether this pattern will repeat itself within the target group.

Earnings

2.6 Analysis of the earnings distribution of the target group suggests that average earnings for those in the target group are slightly less than average earnings for all those working in the private sector.

2.7 Figure 2 shows how average earnings for the target group compare to those for the private sector and the pensioned eligible group. It can be seen that the target group earn considerably less than those eligible employees currently saving into a pension scheme. Median earnings for the whole of the target group are £19,800, while in the pensioned eligible group they are £30,600. In other words, current customers of the pensions industry earn, on average, over £10,500 more than those not saving in a work based pension.

Figure 2: Target group earnings compared to UK private sector earnings and pensioned eligible earnings



Source: ASHE 2009/NEST calculations

Target group demographics (cont)

2.8 When we consider earnings of the target group at the lower end of the earnings distribution we see that around 3.8 per cent of the target group earn at or around the National Minimum Wage. A much more substantial proportion of the target group, though, earn less than £8 per hour (33 per cent) compared to 25 per cent of all in the private sector.

Table 1: Percentage of the target group earning the National Minimum Wage

	Men	Women	Total
All workers*	1.8%	3.2%	2.5%
Eligible Population	1.8-2.0%	2.9-3.2%	2.2-2.4%
Target Group**	3.0-3.4%	4.5-5.1%	3.7-4.0%

* All employees aged 22+. Source: Low Pay Commission ** Figures 95 per cent confidence intervals based on NEST calculations using LPC methodology. Source: ASHE 2009.

Source: DWP (2011) Workplace Pension Reform: Earnings Characteristics of the Eligible and Target Groups[4]

4. DWP (2011) Workplace Pension Reform: Earnings Characteristics of the Eligible and Target Groups, can be found at: http://research.dwp.gov.uk/asd/asd1/adhoc_analysis/2011/wpr_eligible_target_groups.pdf

Target group demographics (cont)

2.9 The relationship between the earnings of a worker in the target group and their overall household income is not straightforward Often, people on lower incomes are in households with much higher total incomes due to a spouse or partner having higher earnings. About half of those with earnings under £15,000 live in households with earnings of more than £25,000 and just over 2 in 5 live in households with incomes of more than £40,000.

Table 2: The relationship between earnings and income

		Annual household earnings					
		Less than £25,000	£25,000 to £40,000	£40,000 to £55,000	£55,000 to £70,000	£70,000 and over	Total
Target group	£7,500 to £15,000	49.2%	28.2%	12.0%	5.5%	5.1%	100.0%
	£15,000 to £25,000	36.4%	30.0%	20.4%	8.0%	5.2%	100.0%
	£25,000 to £35,000	-	44.8%	25.4%	17.1%	12.7%	100.0%
	£35,000 and over	-	9.7%	24.1%	20.2%	46.0%	100.0%
	Total	28.4%	29.2%	19.5%	10.6%	12.3%	100.0%

Source: FRS 08-09/NEST calculations

Target group demographics (cont)

2.10 While earnings are an important indicator of peoples' ability to save for retirement and ability to cope with investment risk, they are not the only indicator of people's wealth. It may be that many of those at the lower end of the earnings distribution are secondary earners in their family and may intend to rely on a partner's pension in retirement.[5]

Employment

Industry sectors

2.11 The target group are spread across all industry sectors, but as Table 3 shows, almost 3 in 5 of the target group work in just three sectors. 20 per cent work in the wholesale, retail and motor trades, 19.7 per cent work in real estate and business activities and 19.5 per cent work in manufacturing.

5. Continental research

Target group demographics (cont)

Table 3: Target group by industry sector

	Eligible group*		
Industry sector	**Pensioned**	**Un-pensioned (target group)**	**Proportion of target group**
Wholesale, retail and motor trade	32.6%	68.0%	20.0%
Real estate and business activities	39.7%	61.1%	19.7%
Manufacturing	48.7%	52.1%	19.5%
Construction	30.6%	70.2%	11.7%
Transport, storage and communications	50.3%	50.4%	9.8%
Hotels and restaurants	15.9%	84.8%	6.2%
Other community, social and personal	39.6%	60.9%	5.9%
Financial intermediation	76.6%	24.1%	3.2%
Agriculture, hunting and forestry	31.9%	68.1%	1.1%
Electricity, gas and water	66.5%	34.8%	0.9%
Mining and quarrying	69.0%	32.0%	0.6%
Private households with employed persons	0.0%	100.0%	0.2%
Unclassified	48.3%	53.9%	1.2%
Total	43.3%	57.4%	100.0%

*Components of the eligible group may not sum to 100% due to the way the target group is defined
Source: FRS 08-09/NEST calculations.

Target group demographics (cont)

2.12 A much smaller proportion of the target group work in hotels and restaurants (6.2 per cent), despite less than 16 per cent of eligible workers in this sector being in a work based pension scheme.

Occupations

2.13 As with industry sector, the target group are spread across the range of occupations. The pensioned eligible group, however, are much more likely to be in managerial and professional occupations than the target group and correspondingly less likely to be in routine occupations.

Table 4: Target group by occupation

	Eligible group*		
Occupation	**Pensioned**	**Un-pensioned (target group)**	**Proportion of target group**
Higher managerial and professional occupations	63.9%	36.7%	12.7%
Lower managerial and professional occupations	47.5%	53.5%	25.5%
Intermediate occupations	42.7%	57.8%	11.6%
Lower supervisory and technical occupations	37.8%	63.3%	15.5%
Semi-routine occupations	32.7%	68.0%	16.1%
Routine occupations	21.0%	79.2%	17.5%
Other	29.0%	72.4%	1.1%
Total	43.3%	57.4%	100.0%

*Components of the eligible group may not sum to 100% due to the way the target group is defined.
Source: FRS 08-09/NEST calculations.

Target group demographics (cont)

2.14 The fact that more employees in managerial occupations have a pension scheme is not surprising and this relationship is mainly related to earnings. On average managerial workers are likely to earn higher incomes, and so pension scheme membership rates are higher.

Level of education

2.15 Level of education is relevant for two reasons. Firstly, we were interested in links between level of education and financial capability: whether or not those with higher level qualifications would be able to take more sophisticated investment decisions with confidence.

2.16 Secondly, it seems plausible that some members would be more likely than others to leave the NEST target group over time. These are likely to be younger workers, who may enter NEST in the early part of their careers and then gain higher level qualifications during the early stages of their career and move to a job that offered a different occupational pension scheme.

Qualifications

2.17 Table 5 shows that within the private sector eligible group, pension scheme membership is related to the level of qualifications, with those workers holding higher educational qualifications being more likely to have a pension scheme than those with lower level or no qualifications.

2.18 However, we can see that over a third of the target group is made up of people with a higher qualification or a degree level qualification. Those workers with lower level GCSE (or equivalent) or no formal qualifications make up just 10 per cent of the target group.

Target group demographics (cont)

Table 5: Highest level of educational qualification attained

	Eligible group*		
Education level	**Pensioned**	**Un-pensioned**	**Proportion of target group**
Degree level qualification (or equivalent)	53.5%	46.5%	25.4%
Higher educational qualification below degree level	52.0%	48.0%	8.5%
A-levels or Highers	44.9%	55.1%	10.9%
ONC/National level BTEC	42.3%	57.7%	8.0%
O/GCSE equivalent (A-C) or O/CSE equivalent (1) or Standard Grade level 1-3	41.2%	58.8%	25.7%
GCSE grade D-G or CSE grade 2-5 or Standard Grade level 4-6	34.0%	66.0%	7.5%
Other qualifications (including foreign qualifications below degree level)	34.0%	66.0%	11.3%
No formal qualifications	33.9%	66.1%	2.7%
Total	45.1%	54.9%	100.0%

*Components of the eligible group may not sum to 100% due to the way the target group is defined.
Source: FRS 08-09/NEST calculations.

Target group demographics (cont)

Numeracy, financial literacy/capability and financial education

2.19 There is a range of financial skills present in the general population. We believe that this will be mirrored in the target group. Research suggests that many in the general population have difficulty interpreting investment information and subsequently taking investment decisions. Many also lack higher end numeracy skills that drive the ability to understand and interpret investment information.

2.20 Information examining the level of numeracy in the UK adult population is now dated with the last major survey having taken place in 2003.[6] The survey found that:

- 53 per cent had numeracy skills at or above level 1 (grades D-G at GCSE)
- 25 per cent of the population had numeracy skills at entry level 3 [7]
- 16 per cent of the population numeracy skills at entry level 2
- 5 per cent of the population had numeracy skills below entry level 1.[8]

2.21 Adults are expected to be able to interpret complex graphical information and deal in a more sophisticated manner with fractions and percentages at or around level 1. This suggests that a sizable proportion of the working population may have difficulty interpreting information shown in those ways.

2.22 Research for the Association of British Insurers (ABI) used simulated fund choice to show how the general population copes with assessing the characteristics of investment funds. Given the similar levels of educational attainment in the general population and in the target group, there are few reasons to believe that the target group is likely to have any more success in performing the tasks set by the ABI's researchers. While the purpose of the ABI work was to show how communications design could improve investor decision making (which it can), it also shows how people may be challenged by seemingly simple tasks.

2.23 Participants were initially shown a single risk disclosure sheet for a high-risk equity fund. This sheet contained only text and figures. Then they received several sheets which used a range of graphical tools to present risk information. The participants were asked to identify specific information on each sheet.

2.24 Participants were then shown four further risk disclosure sheets and asked to rank the five funds in order of risk and return at two different time horizons. They also had to discuss their suitability for a series of fictional investors.

2.25 The ABI found that in phase 1 of the research around 4 in 5 of their participants struggled with the tasks and were not able to answer simple factual questions about the funds accurately.[9]

6. DFES 2003 Skills for life report. 7. Entry level 3 equates to numeracy skills below level 1, i.e. below a grade G at GCSE. 8. JD Carpentieri, Jenny Litster and Lara Frumkin (2010) Adult numeracy, a review of the research http://www.bbc.co.uk/learningoverview/research/impact_of_low_numeracy.pdf. 9. Driver R et al (2010) Helping consumers understand investment risk http://www.abi.org.uk/Publications/51988.pdf

Target group demographics (cont)

2.26 In response to the investment consultation, we reviewed the academic literature on financial education. NEST did not uncover any research that suggested that financial education interventions could have substantial positive impacts on ability to take investment decisions. We speculate that the skills required to take complex decisions of this sort are influenced heavily by formal education and, without further intensive training, are hard to influence thereafter.

2.27 Our review did find research suggesting that large-scale interventions delivered at company level or through formal education could improve savings rates. These, though, are cost prohibitive for an institution like NEST to implement.[10]

2.28 We remain unsure as to how far skills actually affect behaviour in practice. Box 2 shows how highly educated people on their way to elite jobs in business can make elementary mistakes in selecting investment funds.

Box 2: How does financial capability work in practice?

Choi, Laibson and Madrian (2006)[11] examined the approach of Wharton MBA and Harvard college students to mutual fund investing. Aside from the business focus of their education, this test group had SAT scores averaging in the 98th and 99th percentile nationally and can be considered much more able than the average investor.

The authors presented their test subjects with four mutual funds that were all substantially similar: tracking the S&P 500. They were asked to choose a fund in which to invest $10,000, following receipt of standard investment information, for example fund prospectuses.

In the control group without fee information, 95 per cent of test subjects did not minimise fees when picking funds, which was the only real differentiator between the funds. In the group with fee information, 85 per cent did not minimise fees. This shows that the impact of the provision of fee information was small. Furthermore, the group provided with information regarding historical performance, chased historical performance even though these funds had higher fees.

10. De Meza D et al (2008) Financial capability: a behavioural economics perspective http://www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf. 11. Choi J et al (2006) Why does the law of one price fail? http://www.som.yale.edu/faculty/jjc83/fees.pdf

Target group demographics (cont)

Ability to access advice

2.29 The available evidence suggests that the target group are unlikely to have access to independent financial advice. Analysis for the ABI suggests that the full current pre-Retail Distribution Review (RDR) cost of financial advice is £670 per person, including unsuccessful sales.[12] While the scope of post-RDR charging structures is still unclear, this figure acts as an approximate guide to which individuals can and are likely to pay for financial advice.

Communications and vocabulary

2.30 The investment consultation highlighted the need to conduct further research into how to discuss pensions and related matters with the target group. NEST approached this by commissioning primary qualitative research with the aims of:

- exploring comprehension around key terms and phrases
- evaluating degrees of comprehensibility
- investigating alternatives for hard-to-understand terms and phrases
- testing terms and phrases across the target audience base of jobholder and employers. This was to ensure that comprehensibility and simplification at one end of the financial capability spectrum did not patronise at the other end.

2.31 The output of this research is NEST's Scheme vocabulary guidelines, which was published for internal use in January 2011.

12. CRA associates (2010) Cost of Providing Financial Advice, ABI Research Report No22.

Target group demographics (cont)

Savings and debt behaviours

2.32 Current savings behaviours of the target group were explored in the Department for Work and Pensions report Individual's attitudes and likely reaction to the workplace pension reform 2007.

Table 6: Savings and investments in the target group

	Annual earnings				
	£5,000 to £14,999	£15,000 to £24,999	£25,000 to £34,999	£35,000 +	All respondents
No savings or investments	14%	7%	1%	2%	9%
£1-£999	34%	29%	16%	9%	27%
£1,000-£4,999	11%	19%	16%	8%	14%
£5,000-£9,999	7%	13%	19%	14%	11%
£10,000-£19,999	6%	6%	9%	8%	9%
£20,000-£29,999	2%	2%	5%	8%	4%
£30,000+	11%	5%	14%	35%	8%
Don't know	7%	8%	6%	5%	7%
No response	10%	11%	13%	11%	11%

Source: DWP Individuals' attitudes and likely reactions to the workplace pension reforms 2007[13]

13. DWP (2008) Individuals' attitudes and likely reactions to the workplace pension reforms 2007 http://research.dwp.gov.uk/asd/asd5/rports2007-2008/rrep550.pdf

Target group demographics (cont)

2.33 Around 8 per cent of the target group had savings in excess of £30,000 while 9 per cent reported having no savings or investments. 27 per cent reported having from £1 to £999 of savings and investments and 14 per cent had from £1,000 to £4,999. This suggests that median savings in the target group are c. £5,000.

2.34 The limitation of this data is that we are unable to compare the savings to the population as a whole. However, the 2006/08 wealth and assets survey suggests that median financial wealth for the whole population was £7,200. While these figures are not exactly comparable, they suggest that savings are lower among the target group even before differentials in pension saving and property are accounted for.[14]

Table 7: Proportions of target and pensioned eligible group by standard occupational classification (SOC) code and median financial wealth in each

	Pensioned eligible	Target group	Median wealth
Large employers and higher managerial	63.9%	36.7%	£37,700
Higher professional	47.5%	53.5%	£32,200
Lower managerial and professional	42.7%	57.8%	£13,400
Intermediate occupations	37.8%	63.3%	£6,500
Small employers and own account workers	32.7%	68.0%	£7,000
Lower supervisory and technical	21.0%	79.2%	£3,300
Semi-routine occupations	29.0%	72.4%	£1,000
Routine occupations	43.3%	57.4%	£900

Notes: Financial wealth excludes pensions savings. Median wealth is for the population in employment.

Source: FRS 08-09 and Wealth and Assets Survey 06-08

14. ONS (2009) Wealth in Great Britain 2006/08 http://www.statistics.gov.uk/downloads/theme_economy/wealth-assets-2006-2008/Income_annex_final.pdf

Target group demographics (cont)

2.35 Table 7 compares the proportions of the target group and eligible group in each occupational group. It also shows the median financial wealth in each group.

2.36 As can be seen, financial wealth is highest among those with professional occupations and lowest among those with routine occupations. Unsurprisingly, occupational segments with the lowest average wealth have a higher proportion of target group workers.

2.37 The majority of the target group are carrying some form of non-mortgage debt. 19 per cent have debts of more than £10,000 with 12 per cent having between £5,000 and £9,999 and 14 per cent having between £1,000 and £4,999. 42 per cent have no debts.

Table 8: Debt in the target group

	Age group				
Debt	22-29	30-39	40-49	50-64	All
No debt	28%	40%	41%	63%	42%
Less than £1,000	12%	17%	15%	8%	13%
£1,000-£4,999	13%	18%	15%	10%	14%
£5,000-£9,999	18%	8%	14%	9%	12%
£10,000-£29,999	20%	7%	7%	5%	10%
£30,000-£49,999	2%	3%	1%	1%	1%
£50,000 or more	0%	•	0%	1%	•
Don't know	3%	1%	4%	2%	2%
Did not respond	4%	7%	5%	2%	5%

Source: DWP Individuals' attitudes and likely reactions to the workplace pension reforms 2007[15]

15. DWP (2008) Individuals' attitudes and likely reactions to the workplace pension reforms 2007 http://research.dwp.gov.uk/asd/asd5/rports2007-2008/rrep550.pdf

Target group demographics (cont)

2.38 Across Tables 6-8 we see that the majority of the target group are comfortable with the concept of some forms of saving, as well as having experience of holding debt. We would expect target group members, taking into account their lower earnings, to be less able to save than the higher earning members of society. However, the capability of target group members to save is an integral part of their likelihood of remaining in a pension scheme if automatically enrolled.

Housing tenure

2.39 Over half the target group are home owners with 51.9 per cent owning with a mortgage and 16.4 per cent owning their house outright. Relatively few are in social housing (11 per cent) and 20.7 per cent rent privately.

2.40 Home ownership is more common still among those with a pension scheme, and there are relatively small proportions of those eligible for the pension reforms in rental accommodation (c. 25 per cent across the board).

Table 9: Housing tenure in the eligible group

	Eligible group*		
Housing tenure	**Pensioned**	**Unpensioned (target group)**	**Proportion of target group**
Rented from council	21.3%	78.7%	5.2%
Rented from housing association	23.0%	77.0%	5.8%
Rented privately unfurnished	25.7%	74.3%	14.2%
Rented privately furnished	25.0%	75.0%	6.5%
Owned outright	47.2%	52.8%	16.4%
Owned with mortgage	49.8%	50.2%	51.9%
Total	43.3%	56.7%	100.0%

*Components of the eligible group may not sum to 100% due to the way the target group is defined.
Source: FRS 08-09/NEST calculations

Target group demographics (cont)

2.41 Housing tenure also provides an understanding of an individual's potential equity levels in retirement. It's widely acknowledged that downsizing the home is a key method of financing retirement for a number of people. It could be seen that with the perceived greater security of property, home owners have greater capacity for risk in financial investments.

Ethnicity

2.42 The investment consultation suggested that the target membership of the scheme would likely contain a greater membership of people from Black and Minority Ethnic (BME) groups. Whilst latest evidence suggests that the volume of workers in the target group from BME groups may not be disproportionate to the volume of minority ethnic persons in the population, we do know that eligible minority ethnic workers are likely to be an important subset of potential NEST members.

2.43 Around 11 per cent of the UK population are from a minority ethnic group and around 10 per cent of the target group are members of a minority ethnic group. We know that a people from a BME group are less likely to be employed (60 per cent employment rate compared to 74 per cent employment rate for general population) and we also know that those who are in employment are less likely to be pensioned (around two-thirds of eligible people from minority ethnic groups have no pension, compared to 55 per cent of eligible non-BME people who have no pension). Therefore in aggregate eligible BME workers are more likely to be in the target group than others in the eligible group.

2.44 People from a BME group are more likely to be low earners, although not much more likely. 44.57 per cent of the non-BME target group are in the lowest earnings band, while 51.24 per cent of the BME target group are in that same band. Proportions, however, of BME and non-BME in the upper earnings bands are reasonably similar with a difference of c. 0.5 per cent between the two groups in the highest earning band. The data also suggest that around two in three of the BME women in the target group are low earners.

2.45 There is significant overlap between some religious groups and some BME groups. As such, people from certain BME groups may have different investment needs in relation to the NEST product, specifically some Muslim members of the target group may prefer a Sharia compliant fund. This issue is discussed later in this document.

Target group demographics (cont)

Table 10: BME earnings in the target group

	Gender	£5,000 to £14,999	£15,000 to £24,999	£25,000 to £32,999	£33,000 and over	Total
BME	Female	2.2%	1.0%	•	•	3.5%
	Male	3.6%	2.6%	0.8%	0.9%	7.8%
BME total		5.8%	3.5%	1.0%	1.0%	11.3%
BME percentage of total in each earnings band		51.2%	31.2%	8.7%	9.0%	100%
Non-BME	Female	23.1%	9.1%	1.8%	1.5%	35.5%
	Male	16.4%	22.0%	7.8%	7.1%	53.2%
Non-BME total		39.5%	31.1%	9.5%	8.6%	88.7%
Non-BME percentage of total in each earnings band		44.6%	35.0%	10.7%	9.7%	100%
Total		45.3%	34.6%	10.5%	9.6%	100%

Source: FRS 2008-2009 /NEST calculations

Target group demographics (cont)

Disability

2.46 The investment consultation raised the importance of disabled people participating in NEST. NEST has responded to this by looking in greater depth at how disabled peoples' interaction with the scheme may be different to that of non-disabled people.

2.47 Disability is an immensely broad category with many disabled people having little in common with one another save for meeting the Equality Act 2010 criteria, as shown overleaf in Box 3. The experiences of someone with mental health issues working in construction will be very different to the experiences of a deaf office worker.

2.48 For those reasons, while it is important to understand the presence of the disabled population as a whole in the NEST target group, it is often better to look at individuals' characteristics other than disability, for example earnings, in order to understand their needs in relation to the NEST product.

2.49 Just less than 1 in 5 of the working age population meets the Equality Act 2010 definition of disability. This equates to just over 7.6 million people. Women (19.6 per cent) are slightly more likely than men to be disabled (18.5 per cent), with the average being 19.1 per cent.[16]

2.50 Of this group, 47.7 per cent are in employment, compared to 75.5 per cent of the non-disabled population. Disabled men are slightly more likely (47 per cent) to be in employment than disabled women (45.8 per cent). Employment rates are much lower for those that state that they are both disabled for the purposes of the Equality Act 2010 and also work-limiting disabled, giving an employment rate of 32.3 per cent for men and 34.5 per cent for women.

16. Williams B., Copestake P., Eversley J and Stafford B. (2007) The Experiences and Expectations of Disabled People, ODI, Williams B., Copestake P., Eversley J and Stafford B. (2007) The Experiences and Expectations of Disabled People, ODI, http://odi.dwp.gov.uk/docs/res/eedp/eedp-full-report.pdf

Target group demographics (cont)

2.51 The available evidence suggests that disabled peoples' presence in different industries follows a similar pattern to non-disabled people. As such, disabled people are represented across all industry sectors.

2.52 Disabled people are more likely to have broken work histories than non-disabled people with many reporting that they have left work for a reason related to their impairment. Intuitively, this is likely to be matched by a similarly disrupted savings history.

Box 3: The Equality Act 2010

This Act defines disability as:

A physical or mental impairment which has a substantial and long-term adverse effect on a person's ability to carry out normal day-to-day activities.

This is a relatively broad definition of disability that takes in many different impairments and health conditions.

Target group demographics (cont)

Comparing the target group and the pensioned eligible group

2.53 The main theme that emerges from this section is the difference in the demographic characteristics between the target group and the pensioned eligible group. At a basic level, those currently saving into pensions are, on average, paid much more than those who do not.

2.54 Aligned to this is the fact that those eligible employees who are saving into a pension scheme are more likely to work in managerial professions and have a higher level of education. Consequently, they are more likely to be able to cope with the downsides of investment risk and are so better placed to take such risk.

2.55 Furthermore, we feel that current investment products are more likely to be designed with the needs of this group in mind.

2.56 Since NEST's target group is, as a whole, significantly different to the pensioned eligible group, NEST has designed its product around the specific needs of this target group.

Box 4: What is a typical target group member?

While the main characteristic of the target group is its diversity, it is still possible to suggest a typical target group member. On balance, the typical target group member would be:

- a male
- earning around £17-18K
- under 35 years of age
- not used to saving.

Risk preferences

Summary

While those who have experience of defined contribution (DC) pension saving are more knowledgeable in investments, research into those who have not saved into a DC pension before shows widespread lack of knowledge about how these pensions function. They are seen more as a long-term savings vehicle than an investment that may fluctuate in value.

The target group is split between those who are actively risk seeking and those who are risk averse. On balance the target group is more risk averse than risk seeking with a large proportion (37 per cent) of the target group favouring a zero-risk approach to retirement savings.

Risk preferences also trend by income. Those on lower incomes are more likely to be risk averse than those on higher incomes.

While there is a spread of preferences around risk and risk aversion, there is little evidence of the same spread around loss aversion. The target group are largely loss averse and exploratory research suggests that responses to investment loss are likely to be negative and strongly emotional.

It is possible for people to be risk seeking and also strongly loss averse. People may be comfortable in the abstract or under experimental research conditions with the notion of investment risk. When confronted with the reality of an investment losing value, they may have a negative reaction that could not be anticipated from their self-reported level of risk tolerance. The research found this to be the case most strongly among younger people. Young people self-report higher levels of risk appetite, research shows they may be the most loss averse in practice and most likely to take action if confronted with loss.

3.1 This section looks at the target group's risk preferences: to what extent the target group are risk seeking or risk averse in the context of investment.

3.2 Responses to the investment consultation suggested that NEST members would be risk averse. Quantitative research into this issue shows a mixed picture. NEST will maintain a research focus on the target group's risk preferences over the course of scheme launch and into the future. Qualitative research into loss aversion shows strong and emotional reactions to investment loss, especially among those with no experience of pension saving.

Attitudes to pensions

3.3 The whole financial services industry has been shaken by the recent financial crisis. Trust in financial institutions has fallen and reputations will likely take some time to recover.

Risk preferences (cont)

3.4 Regarding the safety of pensions, there has been no change between 2006 and 2009 in the proportion (26 per cent) of the population who see paying into an employer sponsored pension scheme as the safest way to save for retirement. There has been a large increase in the proportion who state that paying into an employer sponsored pension scheme is the best way to make the most of their money.

3.5 This is in direct contrast to the fall in the proportion who think that property is the both a safe way to save for retirement and the best way to make the most of their money. This evidence perhaps suggests that due to the financial crisis that peaked in the period between the surveys, confidence in investments such as property has fallen in favour of pensions.

Table 11: Trust in pensions 2006-08

	Safest way to save for retirement		The way to make the most of your money	
	2006	2009	2006	2009
Paying into an employer sponsored pension scheme	26	26	9	16
Paying into a personal pension scheme	17	19	6	8
Investing in the stock market by buying stocks or shares	•	•	8	9
Investing in property	26	19	47	31
Saving into an ISA (or other tax-free savings account)	15	19	13	15
Saving into a high rate savings account	10	9	10	13
Buying premium bonds	2	3	1	1
Other (please specify)	12[17]	2	1	1

Source: Department for Work and Pensions (DWP) Attitudes to pensions, the 2009 survey

17. No individual "other" answer was given by more than a few respondents.

Risk preferences (cont)

3.6 Importantly, compared with 2006 paying into an employer sponsored pension scheme is now seen as a better way to make the most of money than other savings products such as ISAs and savings accounts.

Levels of knowledge about DC pensions

3.7 Research into the UK population's level of knowledge about DC pensions shows a mixed picture. Relatively high proportions are aware of the link between DC pension performance and the stock market. By contrast only a small majority are aware that pension funds cannot be accessed at any age.

Table 12: Knowledge of private pensions, 2006 and 2009

Knowledge of private pensions questionnaire where respondents answered TRUE	2006	2009
If you are contributing to a personal pension or a stakeholder pension scheme, its final value will depend on how well the stock market performs	61%	73%
You can access the money you pay into a private pension scheme at any age	52%	52%
If you are contributing to a personal pension or a stakeholder pension scheme, some of the money you have built up will be used to finance the running of the scheme	•	73%

Source: DWP Attitudes to Pensions, the 2009 survey[18]

18. DWP (2010) Attitudes to Pensions, the 2009 survey http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep701.pdf

Risk preferences (cont)

3.8 Qualitative research with people who did not have experience of DC pensions shows lower levels of knowledge.[19] The research suggests that members of the target group with no experience of pension savings are likely to see a pension fund accumulating value in a manner similar to a building society account despite this not being the case. Often the target group see themselves as passive savers rather than active investors. They are similarly unaware that it is normal for the value of a fund to fluctuate over the long term.

3.9 A minority of participants with experience of having a pension scheme showed more understanding of pensions as a form of investment than those who had no experience of pensions.

Attitudes to risk

3.10 Responses to the investment consultation suggested that future members of NEST are likely to be risk averse. Research into the target group's level of risk aversion shows a mixed and at points polarised picture with the target group tending towards risk aversion.

3.11 When offered a neutral choice between playing it safe with savings and taking investment risk, the target group tend towards risk aversion. 76 per cent agree that to play it safe is preferable.

19. Opinion Leader (2010) Responses to Volatility and Loss (unpublished).

Risk preferences (cont)

Table 13: Whether it would be better to play it safe with savings even if investing in higher risk investments could make you more money

Agreement	Target group %	General population %
Agree strongly	29	8
Agree	47	60
Neither agree nor disagree	13	13
Disagree	10	17
Disagree strongly	2	1
Agree	76	68
Disagree	12	18

Source: DWP Individuals Attitudes and Likely Reactions to the Workplace Pension Reforms 2009[20] DWP Attitudes to Pensions, the 2009 survey[21]

3.12 A comparison of the target group with the general population suggests slightly higher levels of risk aversion among the target group. A higher proportion (76 per cent) agreed that it is better to play safe with 29 per cent agreeing strongly, as opposed to 8 per cent in the general population.

3.13 DWP and National Centre for Social Research (NATCEN) used an established measure of risk preference: constant relative risk aversion (CRRA) to quantify risk preference. This involved a thought experiment outlined in Box 5.

3.14 Quantitative research into risk preferences shows a striking degree of polarisation within the target group. 44 per cent of the target group are categorised as risk averse with 37 per cent uncomfortable with taking any investment risk. Only 7 per cent sit within the middle category of the distribution as mildly risk averse while 40 per cent are categorised as risk loving with 5 per cent being willing to subject all of their hypothetical fund to investment risk.

20. DWP (2010) Individuals Attitudes and Likely Reactions to the Workplace Pension Reforms 2009 http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep669.pdf
21. DWP (2010) Attitudes to Pensions, the 2009 survey http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep701.pdf

Risk preferences (cont)

Table 14: CRRA risk profile by income band and by age

CRRA classification	<£15,000	£15,000-£24,999	£33,000+	Age 22-39	Age 40-64	All ages
Risk averse	50%	41%	29%	39%	49%	44%
Zero per cent	*44%*	*33%*	*27%*	*32%*	*44%*	*37%*
Mildly risk averse	3%	6%	21%	7%	7%	7%
Risk loving	37%	43%	42%	44%	36%	40%
100 per cent	*5%*	*7%*	*7%*	*6%*	*5%*	*5%*
Don't know	10%	9%	8%	10%	9%	9%

Source: DWP (2010) Individuals' attitudes and likely reactions to the workplace pension reforms 2009[22]

3.15 Risk preferences trend by income with those on incomes of less than £15,000 being substantially more likely than those on incomes of more than £33,000 to be risk averse (50 per cent as opposed to 29 per cent).

3.16 Risk preferences also trend by age. Younger people are significantly more likely to be risk loving than older people (44 per cent of 22 to 39-year-olds as opposed to 36 per cent of 40 to 64-year-olds).

3.17 Research detailed in the next section suggests that while younger people are more likely to be risk loving than older people, they may be equally or more intolerant of investment loss. Younger people may be more willing to take investment risk but that does not mean that they are more willing to deal with the potential downsides.

22. DWP (2010) Individuals' attitudes and likely reactions to the workplace pension reforms 2009 http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep669.pdf

Risk preferences (cont)

Box 5: The experimental method behind the CRRA classification

The CRRA classification was arrived at through a thought experiment asking how participants would invest their savings for retirement. Specifically, the exercise asked respondents to imagine a situation in which:

- they were planning to retire in three years time
- over their working life they had saved a sum of money that is equivalent to around three times their current salary as their main source of income for when they retire
- they wanted to invest this money over the next three years
- they were offered an investment opportunity with a 'well-known' bank where there was an equal chance of doubling the amount they invested or losing a third of the amount invested
- they could invest all, some, or none of their savings with the bank in the investment opportunity described; and
- any money not invested would be placed in a savings account with three per cent interest every year they save.

On the basis of this information, respondents were invited to provide either a percentage or monetary amount that they would be prepared to invest. Any monetary values given were converted into percentages, and those percentages were then used to classify how financially risk averse respondents were in the form of a CRRA score.

People who rejected the offer, or who were only willing to invest a small percentage of their savings (up to and including 16 per cent) in the investment opportunity, were classified as risk averse. Those willing to invest slightly more of their savings, although not quite a third (17 to 32 per cent), were classified as mildly risk averse, and those willing to invest a third or more of their savings (33 per cent and upwards) were classified as being risk loving.

Risk preferences (cont)

Understanding reactions to volatility and loss

3.18 Understanding reactions to volatility and loss was a large-scale qualitative research project stemming from submissions received during our investment consultation. We were interested in understanding to what degree the target group displayed loss aversion as well as risk aversion and to what degree this might drive investment behaviour. The research was conducted with a cross section of the target group, taking in a range of ages and incomes. While it focused on people who had no experience of pension saving, the sample also included people who had some experience of private pension saving.

3.19 Participants were allocated a hypothetical pension and discussed a series of scenarios in which this hypothetical pension lost value. Findings from this suggest that the target group are often strongly loss averse. They displayed quite emotional responses to loss during the research: disappointment, anger, helplessness and often surprise and incredulity being typical. When participants' hypothetical pension lost value, they wanted to know where the money had gone and who to blame for losing it.

3.20 Pension loss was also felt with a sense of immediacy and was not considered within the context of a long term savings vehicle. Participants talked about the loss as if it they had less in their current account or wallet than they expected to have, given what they had put in. It was commonly thought that pensions grew slowly but steadily in value, in line with their contributions and with a modest amount of gain. A loss was seen as an anomaly or a fault, particularly by those who were un-pensioned, as they did not understand the difference between pensions as a form of investment and savings accounts that accumulated with interest.

Differences by demographics

3.21 The research suggests that those with past experience of pension saving were less loss averse than those who had no past experience. Participants with a pension were less drawn to pension investment strategies that involved the lowest chances of loss (and the lowest chances of gain) among the strategies offered in the exercises used during the research. Such differences between pensioned and un-pensioned participants were far from dramatic or consistent, however.

3.22 By contrast people on lower incomes and younger people were seen as more likely to be loss averse. While some younger participants in the research were more willing to contemplate higher levels of investment risk, they were not similarly likely to accept investment loss. Some of the strongest reactions to investment loss were observed among the younger participants.

Risk preferences (cont)

Differences by nature of loss

3.23 Different types of loss resulted in different strength of feeling. Loss of contributions was felt more negatively than loss of gains. Contributions were felt to be sacrosanct so where loss was of some or all of previous investment gain, the reaction was less strong. However, examples of loss of gains prompted many to question the point of saving in a pension if this outcome was a possibility.

3.24 The risk of inflationary loss, which preserved the face value of contributions but not their spending power, was only appreciated with prompting and tended to be seen as less alarming and blameworthy than absolute loss or relative loss.

3.25 A consistent run of interim losses over several years was regarded as more alarming to participants than an equally large loss in total that was experienced in a single year or intermittently in three years out of five, for example. Participants tended to think that consistent losses foretold an inability to improve in future.

3.26 Some participants with experience of having a pension showed more understanding of pensions as a form of investment than those who had no experience of pensions.

3.27 When faced with a hypothetical interim loss, participants rarely articulated a long-term view of pension performance to balance their immediate and tangible sense of loss. Furthermore, a general lack of understanding of pensions as investments prevented participants from considering the possibility of compensating gains in future.

The extent to which people are motivated to protect against loss

3.28 When offered three possible investment strategies for a pension, participants were somewhat more inclined to select the one that offered a medium chance of loss and a medium chance of gain. The option offering a low chance of loss and a low chance of gain was more popular than the most aggressive one (high chance of loss and a high chance of gain), but the most loss averse strategy was not the most preferred, despite participants' strongly negative reactions and attitudes to loss.

3.29 Those on the lowest incomes (earning at or around National Minimum Wage), were somewhat more likely than those earning more to prefer the investment strategy that minimised the chance of loss, as were those without a pension, in contrast to those who had experience of having a pension.

The extent to which the target market might seek a loss avoidance strategy

3.30 On the whole, a loss in the value of a pension fund prompted such strong negative feelings that participants thought they would take loss avoidance action if such a loss were to occur. Stopping contributions was the most common response, but it was not clear whether participants factored the loss of employer

Risk preferences (cont)

contributions into their judgements about this course of action. Stopping contributions was accompanied in the thinking of some participants by considering alternative means to save for the long term that would not involve the possibility of losses occurring.

3.31 Some participants thought it would be appropriate to monitor the situation to see if losses continued into a consistent pattern, which would make them more alarming. Their patience varied, but some said they might 'wait and watch' for up to three years. Some participants were also keen to seek information and advice. Despite being blamed for losses, pension providers along with Independent Financial Advisers and Citizens Advice Bureaux were most commonly suggested as suitable sources.

3.32 Participants only considered switching the funds in which their contributions were invested when stimulus material had been provided explaining this possibility. Invariably, switching was discussed in terms of reducing the possibility of the losses that participants had hypothetically experienced.

3.33 Younger single people without children presented as the most prepared to take an immediate loss avoidance strategy. This might be explained by young people being more likely to discount the long term and having even less understanding of and exposure to pensions.

Whether there are circumstances that mitigate against loss avoidance action being taken

3.34 Participants volunteered three suggestions for 'softening the blow' of pension losses. They wanted:

- Clear explanations of what had happened to 'their money, not technical descriptions of investment strategies
- Reassurance about what was being done to prevent future losses and to recoup the amount that had been lost
- Personalisation, in the form of more helpful statements and a named contact within the pension provider's organisation from whom information about a loss could be obtained.

Investment choices

Summary

Automatic enrolment makes default funds much more important than they otherwise would be. Unless spurred into action, majorities (between almost 7 in 10 and 9 in 10) of those automatically enrolled into DC pension schemes in the US, Sweden and Chile invest in the default fund. Participants tend also to adopt the default contribution level.

While savers in US 401k schemes have been largely inert through the downturn, we believe that savers in UK DC schemes may have been more active in shifting their asset allocation or in ceasing contributions during the recent financial crisis.

Research into the target groups' priorites for an Ethical fund showed that global issues came out as most important overall with child labour, exploitation and human rights violations identified as the most important/motivating screening criteria.

Research into demand for a Sharia compliant fund showed that some Muslims felt they would opt out of the scheme if informed at the outset that their money was being invested in industries forbidden under Sharia law – or would feel they ought to opt for a Sharia compliant alternative if they knew it was available. However some would remain in the scheme regardless.

4.1 This section examines aspects of the research we have conducted in order to understand how the target group may approach some of the investment choices they are faced with. This has involved looking internationally at similar schemes that operate under automatic enrolment and also at specialist fund choices: the Sharia compliant and Ethical options.

4.2 In the case of the Sharia compliant and Ethical funds, there was a presumption both from the market and other stakeholders that we would be offering both. We conducted research in order to understand the demand for a Sharia fund and how Muslims could react if one were offered. In respect of ethical investment, we examined which ethical principles the target group thought should be the priority for a NEST investment fund.

Investment choices (cont)

Inertia/defaults

4.3 Much has been written about the impact of automatic enrolment on participation rates in pension systems. This is a brief review of the most salient points. Research into what is known as inertia underpins the automatic enrolment reforms. Inertia is the tendency to accept a default position and then tend towards inaction once automatically enrolled in a pension scheme.

4.4 Research by Madrian and Shea (2001)[23] and by Choi et al (2001)[24] , among others, helped reshape the retirement savings debate by showing that automatic enrolment in 401k plans was associated with a dramatic rise in plan participation across all social classes.

4.5 This research went on to establish the strong influence of default effects across other aspects of 401k plan participation, most notably contribution rates and investment allocation. In both cases, people have a strong bias towards the default. While individuals may value choice in the abstract, therefore, they may not automatically exercise it when it is offered.[25]

4.6 It is has been important for us to understand how far these effects might manifest themselves under automatic enrolment in the UK. We have reviewed the international literature on pension reform in order to arrive at a view.

Inertia and fund choice

4.7 Evidence from the US, Sweden and Chile suggests that automatic enrolment makes default funds substantially more important.

- In the USA, Vanguard found that new hires into a 401k plan featuring automatic enrolment were three times more likely to invest 100 per cent of their contributions in the default fund (67 per cent versus 21 per cent).[26]
- Rodzinka and Tapia show that 70 per cent of Chileans in the multifunds system do not make an active investment choice.[27]
- Cronqvist and Thaler (2004) show that three years after launch, only 8.4 per cent of Swedes enrolled in the PPM system were making an active fund choice. The Swedish experiment in the aggressive advocacy of choice under automatic enrolment is set out in Box 6.

23. Madrian B and Shea F (2001) The power of suggestion: Inertia in 401(k)participation and savings behaviour, Quarterly Journal of Economics. 24. Choi et el (2001) For Better or for Worse: Default effects and 401(k) Savings Behavior. 25. See for instance Iyengar S. (2010) The Art of Choosing, Little, Brown for an extended discussion of this. 26. Vanguard (2007) Measuring the Effectiveness of Automatic Enrollment https://institutional.vanguard.com/iip/pdf/CRRAUTO.pdf. 27. Rodzinka E and Tapia W (2007) Survey of Investment Choice by Pension Fund Members, OECD.

Investment choices (cont)

Box 6: Inertia and choice in Sweden

Cronqvist and Thaler[28] (2004) analysed investment choices in the Swedish national occupational pension scheme, which launched in 2000. At launch, there were 456 funds to choose from. Prompted by a substantial publicity campaign and aggressive advertising, two thirds (66.9 per cent) of those being enrolled in the scheme (all adult Swedes born after 1938) selected their own portfolio.

Three years after launch, only 8.4 per cent of Swedes enrolling in the scheme were making active investment decisions. This suggests that inertia will manifest under automatic enrolment unless marketing efforts to emphasise choice are maintained.

Active choosers in the Swedish scheme tended to select higher levels of equity exposure than the default fund (c. 96 per cent), more active management and consequently funds with higher fees (77 basis points higher than the default fund).

Critically, investors then did not alter their asset allocation: c. 2-3 per cent of Swedes made changes in the first three years of the scheme operating despite the end of the dotcom boom. This suggests that exposing inexperienced, automatically enrolled investors to a high degree of choice can have significant negative effects.

4.8 Our conclusion is that default effects in fund choice are potentially extremely powerful provided that inertia is not deliberately disrupted. Where inertia is disrupted, for instance by deliberately encouraging choice, plan designers must take extreme care to ensure that investors do not make fund choices that harm their retirement prospects.

Inertia and volatility

4.9 The investment consultation identified the impact of volatility on savings behaviour as an important area for further research. Responses to the consultation raised the issue of whether or not volatility would disrupt the inertia common in automatically enrolled pension scheme participants. In order to understand this further NEST looked at international comparator schemes, especially those where automatic enrolment is used.

4.10 Evidence from the early stages of the financial crisis suggested that those saving into a DC plan did not shift their asset allocation or cease contributions in response to the immediate aftermath of the collapse of Lehman Brothers.

4.11 Over the course of the downturn, there is little evidence of increased loan activity or cessation of contributions suggesting that volatility did not significantly change behaviour for the majority of DC plan savers.[29]

28. Cronqvist H. and Thaler R. (2004) Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience http://faculty.chicagobooth.edu/richard.thaler/research/pdf/designchoices.pdf
29. ICI (2010) Americans Committed to Saving for Retirement: ICI Year-End Data http://www.ici.org/401k/news/10_news_trow_am_saves

Investment choices (cont)

4.12 More recent research conducted for the Investment Company Institute suggests that 37 per cent of those with financial investments (including DC plans and other financial products) in the US changed their asset allocation to be more conservative in response to the financial stresses of the preceding three years. 11 per cent had changed their asset allocation to be less conservative.[30]

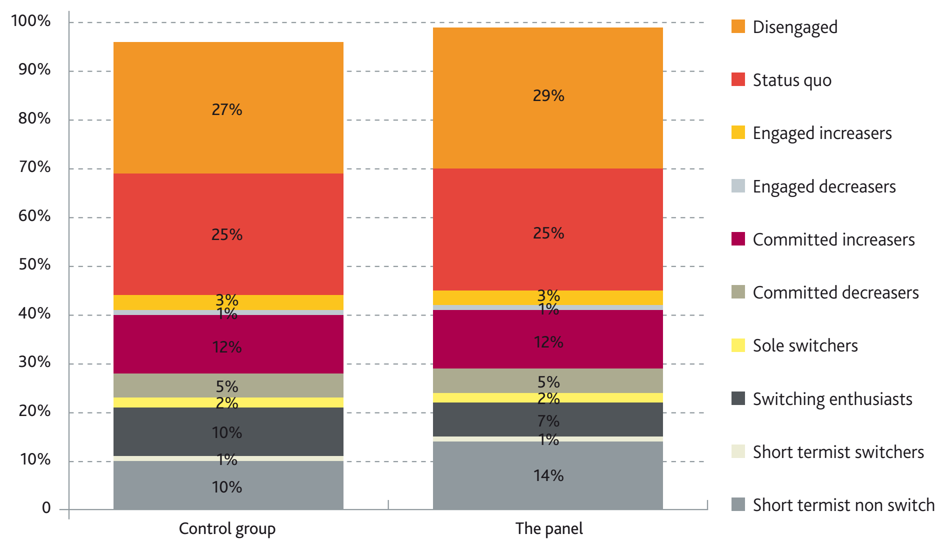
4.13 While useful, this does not necessarily indicate shifts in DC plan activity and could be explained by movement out of retail mutual funds and into lower risk products.

4.14 NEST commissioned research into the behaviour of existing pension savers in the UK. This was done with a control group and a panel group similiar to NEST's target group, albeit with an earnings ceiling of £35,000. The research shows the contributions and switching behaviour of these groups between December 2007 and September 2009.

4.15 A majority of the panel did not take any action at all in the period observed (54 per cent, disengaged and status quo). 15 per cent stopped contributing to their pension while 15 per cent increased contributions.

4.16 14 per cent engaged in some form of switch activity. From the data it is hard to tell how well timed this was and impossible to tell whether the change in asset allocation was well chosen.

Figure 3: UK pension savers reactions to Lehman Brothers collapse and the subsequent banking crisis



Source: PensionsDCisions (2010)[31]

30. ICI (2011) Commitment to Retirement Security Investor Attitudes and Actions http://www.ici.org/401k/news/11_news_com_ret. 29. PensionsDCisions (2010) Unpublished research for NEST.

Investment choices (cont)

Table 2: Pension DCisions reaction groups

Reaction group	Description
Disengaged	Disengaged pension members have never made any contributions wwand have no switch activity during the period
Status quo	Individuals who make regular contributions and have not made any contribution rate change or switches
Engaged increasers	Engaged increasers are members who have increased their contribution rate and made switch instructions over the observed period
Engaged decreasers	Engaged decreasers are members who have decreased their contribution rate and made switch instructions over the observed period
Committed increasers	The committed increasers raised their contribution rate during the financial crisis without changing their portfolio mix
Committed decreasers	The committed decreasers reduced their contribution rate during the financial crisis without changing their portfolio mix
Sole switchers	Sole switchers did not make any contributions into their pension pot but have made switches during the financial crisis
Switching enthusiasts	Switching enthusiasts switched their assets around Q4 2008 without changing their contribution rate
Short-termist switchers	Short-termist switchers have made switches and have completely stopped contributing after the financial crisis
Short-termist non-switchers	Short-termist non-switchers have completely stopped contributing after the financial crisis and have had no switch activity during the observed period

Investment choices (cont)

4.17 Even though these findings are informative, there are reasons to consider carefully what this data means for NEST's investment strategy. While the panel are a good match for the target group in some respects, they are also current pension savers. We expect them to be more engaged and knowledgeable having opted in to a DC product. We also do not have a comparator period of sustained growth against which to benchmark behaviour during the crisis.

4.18 Those caveats aside, it seems that the financial crisis did have an effect upon pension savers in the UK. While the populations are not sufficiently comparable to be sure, it is possible that UK pension savers have been less inert and more active than US 401k savers through the downturn.

Other fund choices

Ethical investment

4.19 Given that there was a strong presumption that NEST would offer an ethical fund, NEST conducted qualitative research with people who would consider using an ethical fund into how this choice should be configured. Offering an ethical fund raises the inevitable question: "Whose Ethics?" We felt it best that the ethical fund offer was informed by the ethics of the target group.

4.20 Awareness of the concept of an ethical investment was limited and most respondents did not consciously make ethical choices in their day-to-day lives. Those that did made a definite trade-off between ethics and price/quality.

4.21 There were differences by gender – the men tended to be more cynical towards ethical investments and more likely to raise spontaneous questions about risk and return.

4.22 Respondents found it comparatively easy to evaluate negative screening criteria, in other words the types of investment they would like to avoid. However, they found it harder to make a judgement on an ethical investment using positive criteria, in other words what they would like to invest in.

4.23 There was a degree of consistency in the most important negative screening criteria, which tended to be social in nature and global in scope. Global issues came out as most important overall with child labour, exploitation and human rights violations identified as the most important/motivating screening criteria.

4.24 Particular negative screening criteria – alcohol, tobacco, gambling and pornography – were consistently singled out as unimportant or irrelevant to most respondents.

4.25 Although many green issues were seen as important, respondents were unhappy with the idea of an ethical fund that focused too much on these.

Investment choices (cont)

Sharia compliant investment

4.26 NEST conducted qualitative research with Muslim members of the target group in order to understand potential demand for a Sharia compliant investment fund. The research showed a mixed picture with some Muslims favouring a Sharia compliant option and others being ambivalent or disinterested.

4.27 There was very little take-up of formal Sharia financial products among Muslim participants, and despite some interest, few were actively seeking out such products. This was primarily due to the strong perception that they were more expensive than mainstream financial products.

4.28 With regard to automatic enrolment, some Muslims felt they would opt out of the scheme if informed at the outset that their money was being invested in industries forbidden under Sharia law – or would feel they ought to opt for a Sharia compliant alternative if they knew it was available. However some would remain in the scheme regardless.

Other religions

4.29 NEST conducted research into the demand for investment funds based around religions other than Islam. We concluded that the demand for these funds was likely to be limited.

Appendix A: Methodologies

Our research uses a number of different methods, with different methods appropriate to different types of questions. Some of these are outlined below.

Qualitative research

This exploratory research focuses on understanding and 'why' questions, seeking in-depth diagnostic information on the reasons behind attitudes, behaviour, wants and aspirations. Qualitative research is:

- exploratory – seeking to gather knowledge in an area where there is little existing evidence
- investigative – asking how any why questions and seeking to understand the dynamics of attitudes and mindsets
- explanatory – seeking to explain attitudes and possible behaviours.

This type of research is relatively small in scale and composed of in-depth interviews and group discussions. It provides indicative insight but not percentage figures.

Deliberative research is a particular type of qualitative research. This was used for the Understanding reactions to volatility and Loss study. Deliberative techniques seek to explore what people think and feel after exposure to information, arguments and/or scenarios. It can be useful to explore complex topics where levels of understanding amongst the research group are low or misinformed. It gives participants more time and information than is the case in traditional research, with the use of longer discussion groups or workshops and/ or reconvened meetings.

Commonly, it also uses hypothetical situations to attempt to understand how participants may react if those situations occur in real life. It is important that any education is done as neutrally as possible and that hypothetical situations are realistic to avoid biasing the research.

Quantitative research

This research focuses on description and 'what' questions, seeking numeric information on the extent of attitudes and behaviour in a given population, for example what percentage of people hold certain opinions or behave in a certain way.

This type of research is larger in scale and may involve hundreds or thousands of interviews, and is designed to provide results which are representative of the population being researched within certain confidence limits. This type of research is less useful for providing answers to 'why'-type questions.

Along with NEST's own surveys, we draw on quantitative data outlining demographics from National Statistics sources, especially from ASHE (Annual Survey of Hours and Earnings) and the FRS (Family Resources Survey). These are large-scale survey-based quantitative sources. In the case of the FRS, this is self-reported information, whereas ASHE is information on employees recorded by the employer.

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Table 3: Research conducted by NEST

Survey/data source	Subject matter	Reasons
DWP Individuals' attitudes survey 2010	Attitudes to the automatic enrolment reforms	To investigate the attitudes of individuals to planning and savings in later life. A national representative sample of 1,000 eligible un- pensioned jobholders
Understanding reactions to volatility and loss 2010. NEST and 'Opinion Leader' research agency	Target group's attitudes to volatility and loss	To investigate the target group's concept of loss and likely reactions to being aware of loss in their pension pots
Desk research – comparisons of NEST with US/international experience	Loss/inertia	To investigate international experience of comparable pension saving
Member's Sharia research	Fund choice (Sharia on members) – NEST and MORI	To understand more about what demand exists for Sharia compliant financial products in the UK. A large-scale qualitative sample of Muslims in NEST's target group
Employer's Sharia research	Religious funds (Sharia on employers) NEST and research panels	To find out whether offering a Sharia fund would make the scheme more attractive

Appendix B: Bibliography (cont)

Survey/data source	Subject matter	Reasons
Investment strategy	Investment consultation	To get feedback on various investment approaches. 67 written responses were received and over 100 attendees came to 6 workshops Responses came from a mixture of academics, consumer groups, unions, employer organisations, pensions industry, investment industry, intermediary community
Ethical investment research	Target group's attitudes to ethical investment	Understand which aspects of ethical investment are most important to the target group

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