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Master Trust Default Fund Performance Review

Master Trust Insights - November 2020

2020: A year like no other?

Welcome to the latest edition of our Master Trust Insights, in which we assess the impact of Master Trust default fund performance on member outcomes.

Despite the economic outlook remaining hugely uncertain as a result of the COVID-19 pandemic, we expect the trend of schemes switching to Master Trust to continue unabated, and possibly at an increased pace, over the next few years. This will place even greater emphasis on the effective monitoring and comparison of providers. While recent fund performance is clearly an important factor in that endeavour, we believe it must be considered in the context of longer-term member outcomes.

With that in mind, this edition of Master Trust Insights provides a forward-looking assessment by examining how recent market events and fund performance have impacted the future retirement incomes of different members. In simple terms, and from the perspective of the majority of Master Trust members, who invest in the default fund, we answer the question: "What does this mean for me?"

Our core beliefs remain unchanged; we expect risk to be rewarded over long horizons and advocate effective risk management to support good outcomes for those closer to retirement. Our analysis shows there are a range of approaches adopted by providers, with some expected to support better member outcomes than others.

Member outcomes should be the key factor in setting all aspects of DC strategy and digital engagement can be hugely powerful in helping members understand:

- What level of income they'll need in retirement
- Whether they're on track to achieve that income
- How they might improve their chance of meeting an income target

Investment performance is clearly important in addressing those questions, but it should be considered alongside factors such as adequacy of contributions, retirement age expectations and how members wish to access their savings in retirement.

Our experience is that this type of approach enables more effective, targeted communications with members, which help them consider different aspects of their retirement planning and the levers they have at their disposal to make changes.

The result is a framework for enhanced scheme governance, informed investment decisions, improved member engagement and, ultimately, better member outcomes.

Navigating COVID-19

Given the economic backdrop, it's perhaps surprising markets have regained ground so swiftly since their lows in late March. The level of future uncertainty means the recovery should be considered a fragile one.

Our analysis shows member outcomes are likely to be back on track, relative to the position at the start of the year. However, variations in investment strategy across providers mean any future shock to markets could lead to meaningful differences in expected outcomes for members. For those nearing retirement, with little time to recover, this could necessitate some tough decisions about their retirement plans.

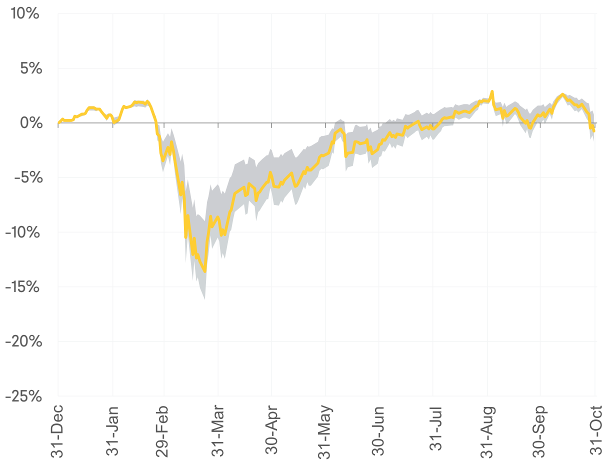
To illustrate this point, we've used our Member Outcomes Tracker to assess the impact of recent events on outcomes for some typical DC savers. Rather than focus on fund values, we've assessed what this year's market moves have meant for members' expected incomes in retirement.

The following charts show how each member's expected retirement income has changed (relative to the position at 31 Dec 2019) as the crisis has unfolded. In each chart, the dashed line is based on the average Master Trust investment strategy, which we've estimated based on the strategies of the providers sampled. The shaded regions show the potential variation in changes to expected income for members invested in lower or higher risk strategies.

Jasmine is 30 years from retirement, in the early part of her savings journey and has a modest level of savings. She is most concerned about making ends meet and does not view her pension as a significant priority right now.

Expected outcomes for members like Jasmine are now very close to December 2019 levels. Outcomes have been similarly affected across providers since most are holding large proportions of growth assets for younger members.

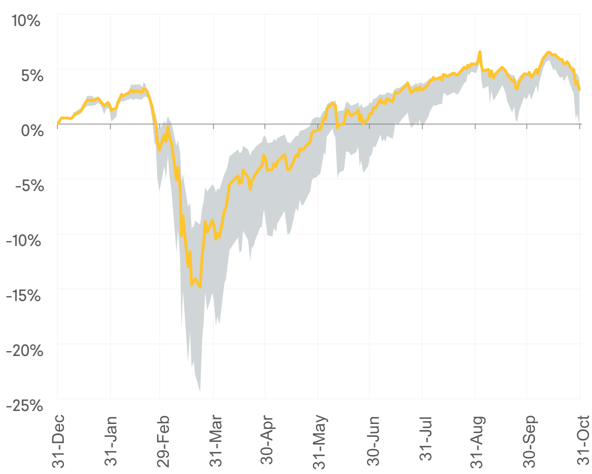
Jasmine has time on her side but it's important she maintains her pension contributions. The main risk here is Jasmine's current and future employment situation.



Louise is 5 years from retirement. She has a reasonably sized fund and is starting to think about her retirement choices.

There's evidence that some providers' investment approaches did a better job of protecting downside risk at the height of the market disruption than others. Louise's expected pension is now higher than it was at the start of the year under most strategies, meaning more effective risk management has not come at the cost of returns.

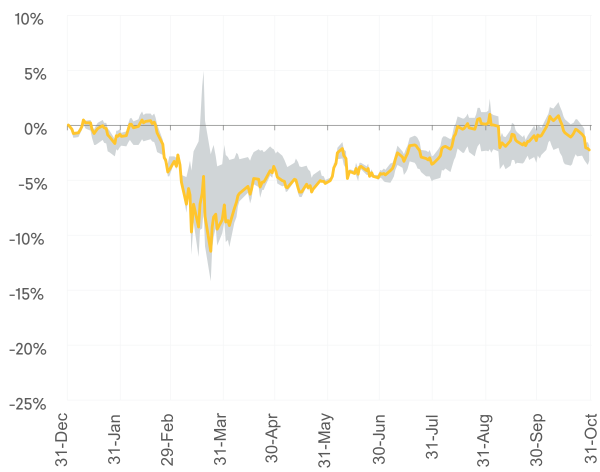
It's important Louise understands the risks associated with her investment strategy; a second market fall associated with a prolonged recession may have a significant impact on her pension.



David is 65, part of the "Baby Boomer" generation, and plans to retire next year when he reaches his State Pension Age. Certainty of his pension value is important as he plans to travel in the early years of his retirement.

David's expected pension is a little below what it was at the start of the year under most strategies; this represents a significant recovery since March when expected outcomes for members like David could have fallen by nearly 15%. Across the providers, there is a wide range of investment strategies in place for members approaching retirement, and the potential consequences of a market shock in the year before retirement are severe.

It's important David is invested in a manner that protects his pension, while helping him meet his retirement goals.



All charts based on market data to end October 2020

Stages of DC investing

Jasmine, Louise and David are in different phases of their savings journeys and it's likely that different investment strategies will be required to reflect their time horizons.

What is appropriate at different stages of DC investing?

Growth phase
Take on more investment risk for the prospect of higher returns. Short term risk mitigation is of dubious value.

Consolidation phase
The focus should shift to capital preservation and risk reduction.

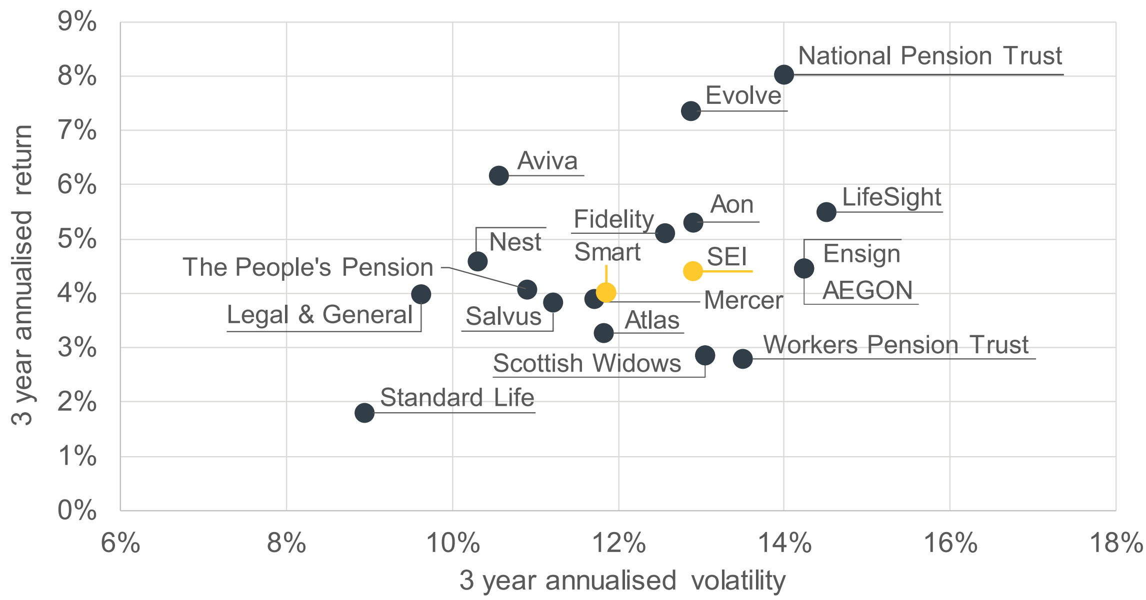
Pre-retirement phase
Risk should be dialled down. There is a need to move away from 'one size fits all' defaults and understand what members plan to do with their savings.

During retirement
- Chosen retirement path to reflect individual needs, typically a combination of cash and regular income.
- Income drawdown offers flexibility, but management of downside risk is key in order to support a desired living standard for remainder of life.

In the next section, we compare provider performance in the three years to 30 June 2020 and its impact on member outcomes in each phase.

Growth phase

The market turmoil of Q1 2020 has been masked by generally positive 3-year performance of growth phase funds. Providers have typically returned c.3-5% p.a. and the volatility range of 10-15% p.a. is consistent with the high equity allocations we'd expect to see in this phase.



1. Chart is based on net performance and volatility to 30 June 2020, supplied by the providers; SEI and Smart provided gross performance only.

In the growth phase, members are a long way from retirement and short-term risk mitigation through diversification of asset classes or active asset allocation is of questionable value. Cautious investment strategies may show relative outperformance during periods of market stress, but it's unlikely such outperformance will persist and lead to better member outcomes (versus higher volatility approaches) in the longer term.

Furthermore, lower volatility strategies are unlikely to achieve significantly better downside protection over long horizons. To illustrate this point, we've projected the range of potential pension outcomes for growth phase members of the Master Trusts in our sample.

Illustrating uncertainty in outcomes

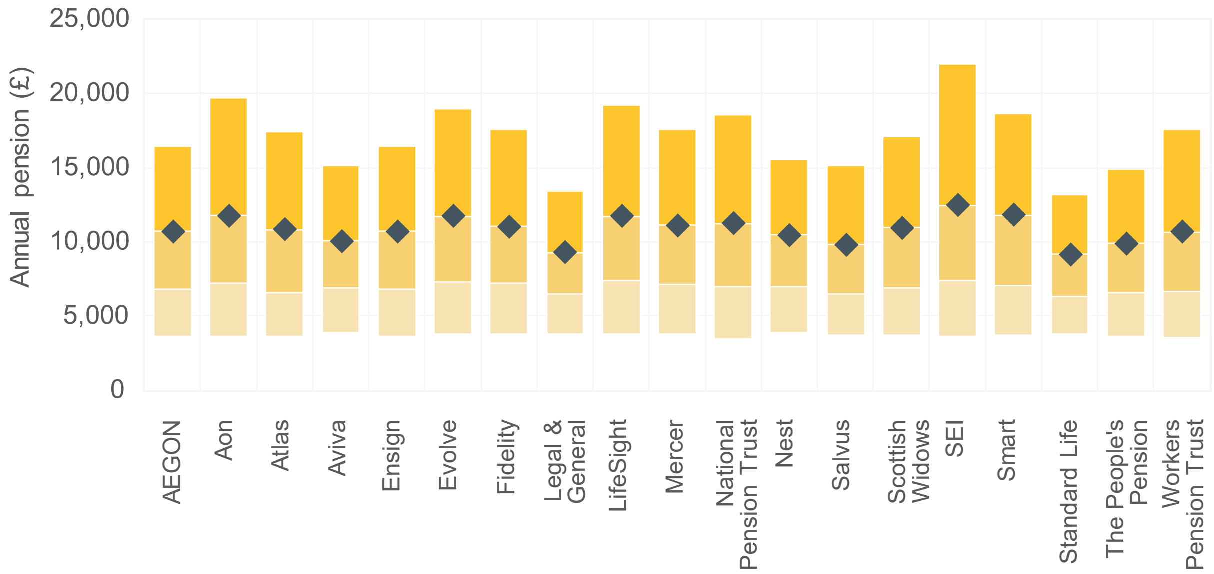
1 in 4 good scenario; there is a 25% chance the member will achieve this outcome or better.

This is the best estimate of the member's pension.

1 in 4 bad scenario; there is a 25% chance the member will achieve this outcome or worse.

1 in 20 bad scenario; there is a 5% chance the member will achieve this outcome or worse. We believe it's important to consider the potential impact of very bad outcomes since these could reduce the member's standard of living in retirement or necessitate unwelcome changes to their retirement plans.

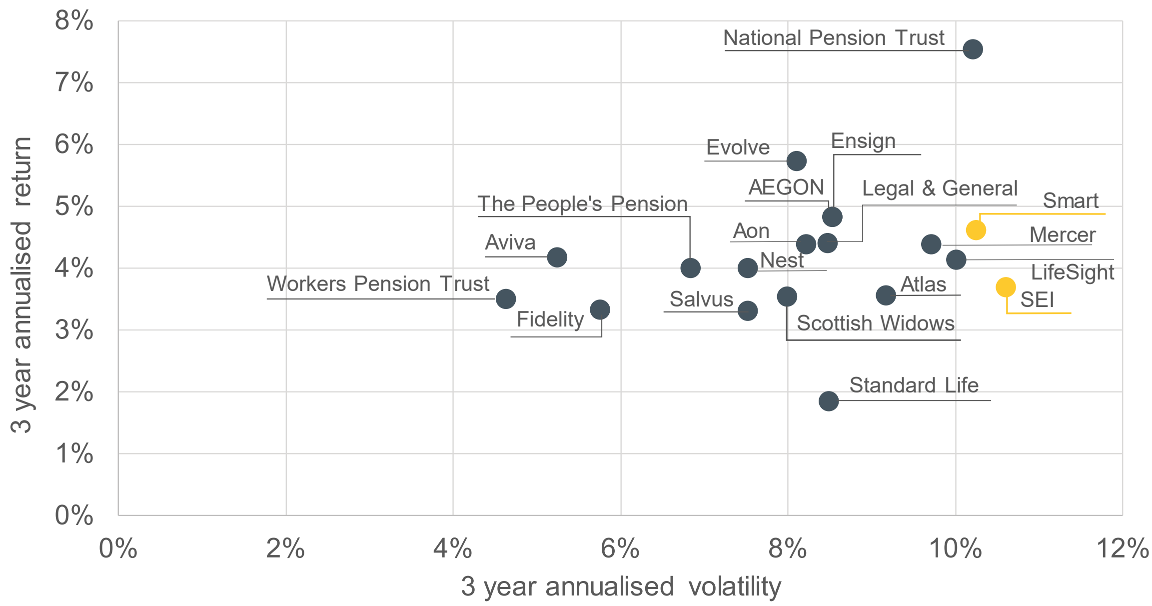
The chart shows downside outcomes are similar across the providers but there is greater upside potential for higher risk strategies.



1. Projections are based on a member 30 years from retirement on 30 June 2020, earning £30k p.a. and with a total contribution rate of 10% p.a.
2. The member is assumed to have a fund value of £50k on 30 June 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 30 June 2020.
3. SEI and Smart results are based on gross performance between 30 June 2017 and 30 June 2020.

Consolidation phase

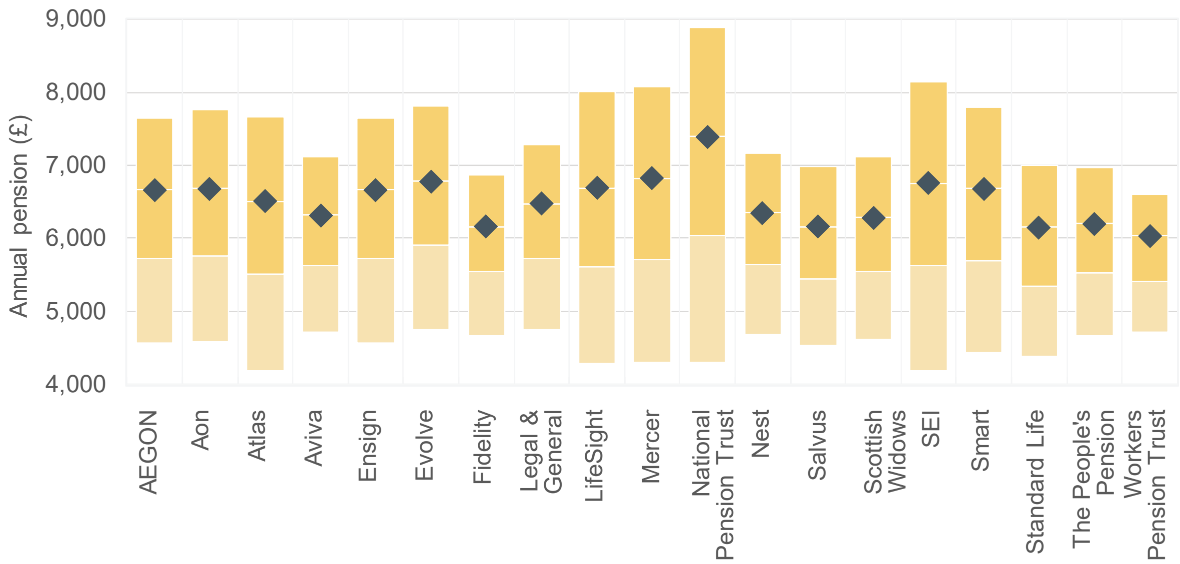
Similar to growth fund performance, providers have typically returned c.3-5% p.a. for consolidation phase members. In normal market conditions, we consider an annualised volatility of 6-8% p.a. to be broadly appropriate for members with 5 years to retirement. The chart shows most providers have exceeded this range, which may be explained (at least in part) by the heightened market volatility of early 2020.



1. Chart is based on net performance and volatility to 30 June 2020, supplied by the providers; SEI and Smart provided gross performance only.
2. Aviva volatility estimated using volatilities of component funds.

In the consolidation phase, we expect to see steady performance, with an increasing focus on downside protection. Short-term risk and protecting against negative returns are important because a member's outcome could be significantly impacted by a market downturn, with little time left for recovery.

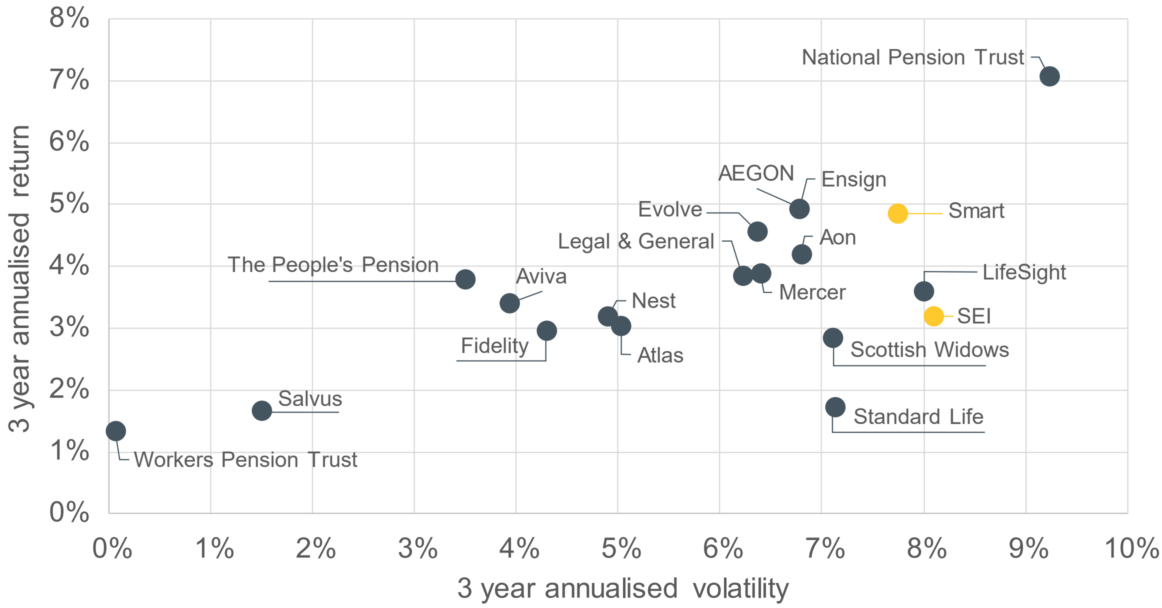
Our projections show the level of uncertainty in member outcomes (indicated by the height of each bar) varies significantly across providers. While riskier strategies may offer higher expected returns, they leave members close to retirement vulnerable to market shocks which could significantly reduce their pension.



1. Projections are based on a member 5 years from retirement on 30 June 2020, earning £50k p.a. and with a total contribution rate of 10% p.a.
2. The member is assumed to have a fund value of £150k on 30 June 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 30 June 2020.
3. SEI and Smart results are based on gross performance between 30 June 2017 and 30 June 2020.

Pre-retirement phase

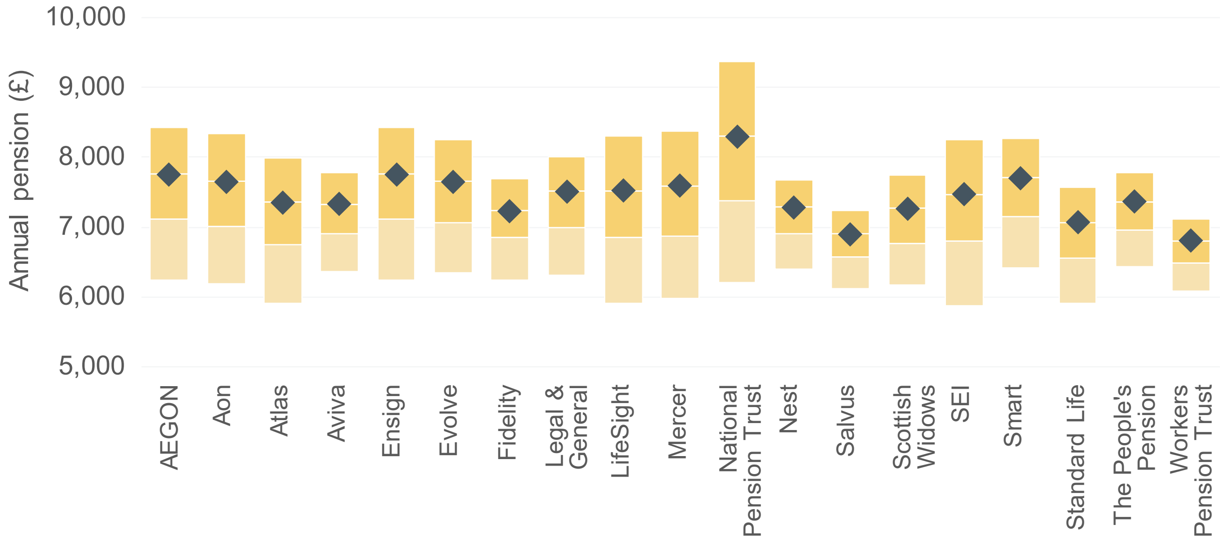
Pre-retirement returns have been generally strong but lie within a reasonably wide range of 1-5% p.a., which is indicative of differences in investment strategy across providers. For most providers, the underlying levels of volatility are higher than we would generally expect to see during this phase, but that perhaps isn't surprising in the context of recent market events.



1. Chart is based on net performance and volatility to 30 June 2020, supplied by the providers; SEI and Smart provided gross performance only.
2. Aviva volatility estimated using volatilities of component funds.

Investment strategy in this phase should be aligned to members' likely decisions at retirement. Reducing risk should be the norm, particularly as most people currently withdraw their DC pot as cash.

Again, our projections illustrate a range of investment approaches being implemented by providers. While the shorter horizon and more conservative investment strategies mean the range of potential member outcomes is generally narrower than in other phases, there is evidence that members in this phase may be assuming very different and potentially inappropriate levels of risk.



1. Projections are based on a member 1 year from retirement on 30 June 2020, earning £55k p.a. and with a total contribution rate of 10% p.a.
2. The member is assumed to have a fund value of £200k on 30 June 2017 and the relevant provider performance has been applied to calculate a fund value at the projection date of 30 June 2020.
3. SEI and Smart results are based on gross performance between 30 June 2017 and 30 June 2020.

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