HYMANS ROBERTSON

Master Trust Default Fund Performance Review

Master Trust Insights

September 2018

A growing market for Master Trusts

The rise in the use of Master Trusts over the past 6 years has been phenomenal, going from a relatively niche option serving the needs of smaller employers, to often being seen as the DC vehicle of choice today.

Since the introduction of auto enrolment in 2012, membership of Master Trusts has increased from 270,000 in early 2012 to almost 10 million this year[1]. Master Trusts now account for 42% of the workplace pensions market[2], and that figure is likely to continue to rise in coming years.

Increasingly, Master Trusts are viewed as the DC vehicle of choice for employers - this is largely due to the attractiveness of fully outsourcing DC delivery but, at the same time, retaining the attractive features of occupational pension schemes. Coupled with economies of scale and the significant downward pressure on pricing, it's easy to see why they have appeal and why the market is expected to grow to £300bn by 2026[3].

Following on from the first edition of our Master Trust Insights review last year, we were keen to again compare the investment performance across the biggest providers' default funds. Recognising that there are distinct phases of a retirement savings journey which require a different investment approach, we've compared performance at each of these phases.

Most Master Trusts are relatively new and as such we have shown performance data from a 1 year and 3 year period (often the longest period available). All performance data highlighted in this report is to 31 March 2018.

Master Trusts

42%
of workplace
pensions market

Serving
10 million
members

£300bn

Projected size of
Master Trust market by 2026
£300bn

[1] The Pensions Regulator 2018
[2] The Pensions Regulator 2018
[3] Hymans Robertson Research 2018

Stages of DC investing

It is still early days for the Master Trust providers. We will no doubt see development of their propositions and strategies as assets grow and the market undergoes consolidation. Members have seen positive returns in all three phases across all providers. Markets have been very supportive and volatility has been low. The real test for these strategies is surely yet to come but there are some clear dividing lines and early signs of concern.

1

Some providers are far too focussed on short term risk mitigation in the growth phase (30 to 5 years from retirement). Over cautiousness is a real risk to good outcomes here.

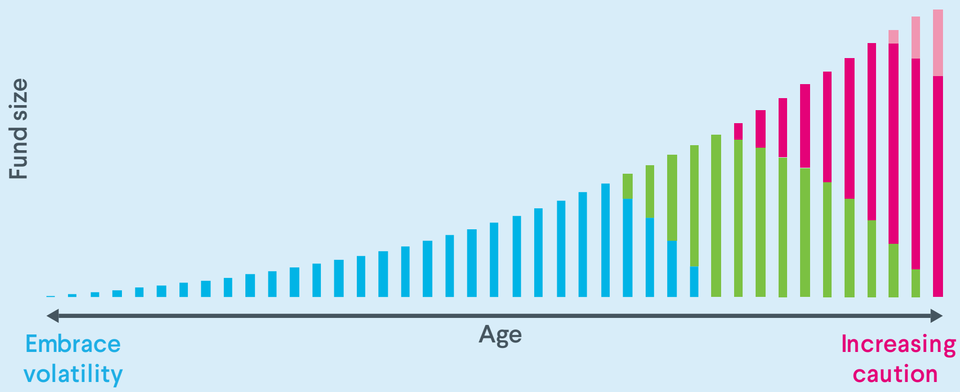
2

In the consolidation phase (5 years from retirement), simple, strategic asset allocation has performed better than complex, expensive dynamic asset allocation in terms of delivering strong returns for an acceptable level of risk. Strategic asset allocation (rather than dynamic) has outperformed on a risk adjusted return basis.

3

Members very close to retirement have benefited from some exceptional returns. However, many providers are carrying too much risk in this phase and a downturn in markets could significantly impact those close to retirement.

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

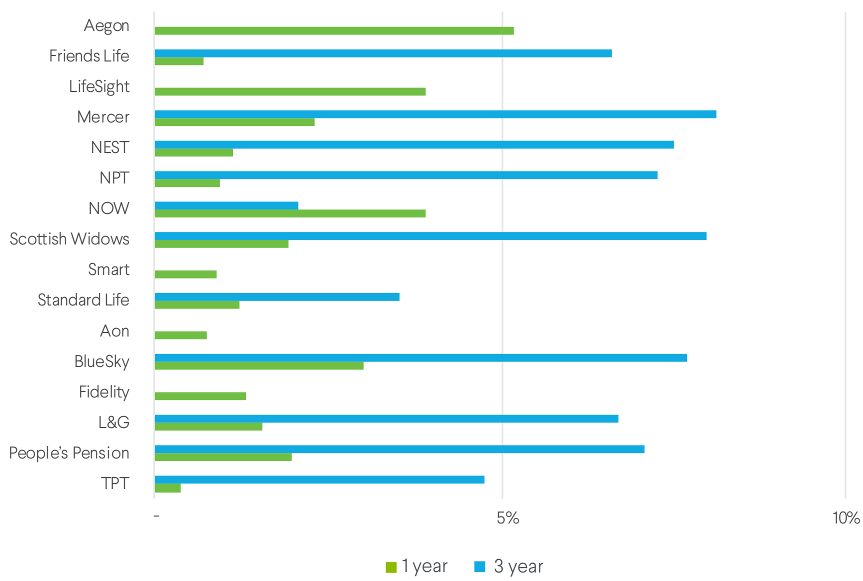
The focus should shift to capital preservation and risk reduction.

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.

Growth phase

30 years from retirement - 1 year and 3 year performance



Objective in the growth phase

Take risk to maximise returns

Overall performance

The last year has seen relatively low returns with the median performer delivering just 1.5%. This can be attributed to a poor return from growth assets in Q1 2018. Despite this, the same theme continues – growth assets continue to outperform defensive assets and glidepaths with higher exposures to growth assets continue to outperform those that are more defensively positioned.

There is a large difference between the best and worst performer over 3 years of over 6% p.a. This leads to a difference of over 18% compounded over that time. This can mean a difference of 10% in the value of a member's DC pot in just 3 years (based on an individual with a salary of £24,000 a year, receiving an 8% contribution (£160 per month) and with a starting value of £1,000, nat taking into account any changes to salary).

Those funds that have followed more diversified approaches typically have lagged over the past eight years. This means there is significant pressure on these strategies to deliver downside protection in a falling market, having already failed to capture much of the upside potential in what has been one of the strongest bull markets in history.

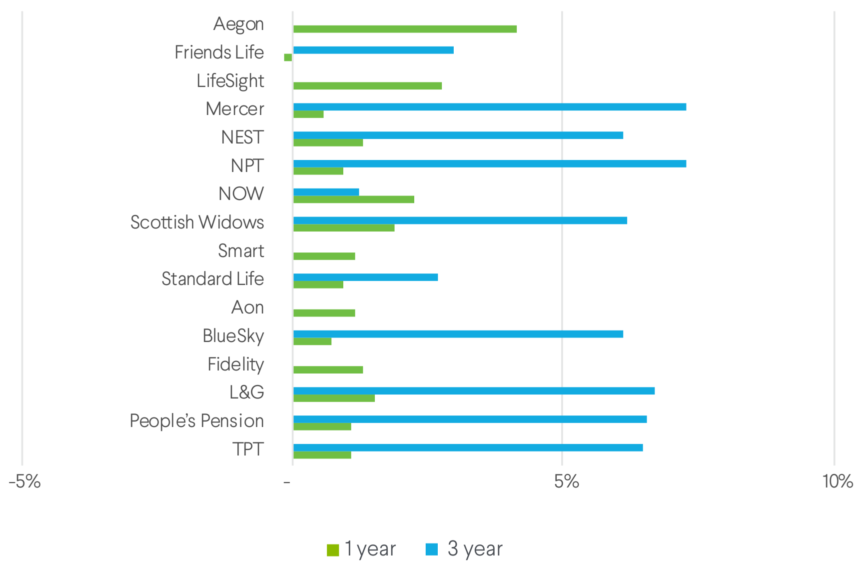
Our view

In this growth phase, where members are a long way from retirement, short term risk mitigation through diversification of asset class or active asset allocation is of questionable value. Regular contributions by the member provide their own diversification benefit as a result of pound cost averaging. Funds are relatively small, any volatility of performance is typically short term in nature and has a negligible effect on long term outcomes (markets recover, with members having purchased units at lower cost).

Recent history has been kind to risky asset classes. But even when the tide turns and a more cautious approach shows short term (relative) outperformance, over the long term, it is very unlikely that such an approach will lead to better member outcomes than a high allocation to riskier asset classes.

Consolidation phase

5 years from retirement - 1 year and 3 year performance



Objective in the consolidation phase

Capital preservation, solid returns and risk reduction

Overall performance

Again similar to the growth phase, 1 year performance has been low, with the median performer delivering a return of 1.2%. 3 year performance is much closer across the board (around the 6% mark) however, there are a number who have outperformed on a relative basis. This would suggest that most strategies have similar risk and return profiles 5 years out from retirement. A 6% annualised return over three years is reasonable at this stage of a member's career. There has been less upside capture in favour of downside protection, but we believe this is appropriate when members are approaching retirement.

It is notable that those providers who have performed best employed a more strategic asset allocation approach at this time, questioning the value of a more dynamic approach.

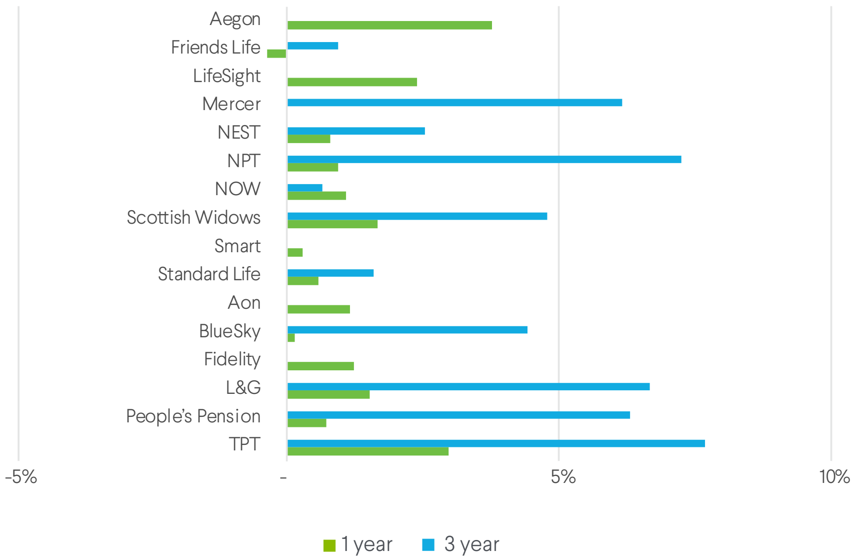
Our view

In this phase, when a member is within 5 years of retirement, a focus on short term risk and protecting against negative returns becomes much more important. With only 5 years to go, a member's final outcome could be significantly impacted by market downturns. The remaining contributions left to be paid could be insufficient for a member's fund to recover any market-driven loss.

Historically more risk has been the market norm. In normal market circumstances we would consider an annualised risk measured by volatility, of between 6-8% to be broadly appropriate for members with 5 years to go to retirement. Markets have been relatively benign in recent times so we would expect provider's strategies to err towards the lower end of the 6%-8% range.

Pre-retirement phase

1 year from retirement - 1 year and 3 year performance



Objective in pre-retirement phase

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

Overall performance

At this stage of the strategy, positive, steady returns protecting against market volatility is most important and whilst it is pleasing to see the majority of strategies delivering positive returns, there is one which delivered a negative return - effectively reducing the member's retirement saving just before they may wish to access it.

Even with those that achieved a positive return, there are signs of too much risk being taken, with the variation of returns ranging from 0.1% to almost 4% over 1 year returns, which is a crucial objective at this part of a member's career.

Our view

This is the phase where risk should be dialled down significantly and the investment strategy should be consistent with the member's decision at retirement. At present, due to low fund sizes, for many this decision will be to take their benefits as cash and therefore protection against negative returns is even more vital.

Some providers have taken the decision to not implement a risk reducing strategy as members approach retirement. They would argue that it's difficult to predict when members will retire. While this has paid off in recent times, we would caution against high levels of annualised volatility for members with only 1 year left to retirement. Other providers have made heavy use of bond allocations to lower risk. Our concern here is the potential for yields to rise sharply given current economic and political circumstances, which could deliver a nasty shock to members close to retirement.

Closing words

One of the conclusions from the CMA's provisional decision report was that there needs to be more transparent information around the value that investment advisers bring to trustees and governance committees. At Hymans Robertson, we believe that this type of report can help the industry in the long term and help trustees assess whether their pension arrangement is meeting their objectives and improved member outcomes. While even a 3 year time horizon is too short, our aim is to gradually move the focus from short-term performance to longer term metrics on member outcomes and risk-adjusted performance. In the meantime, the analysis in this report is already demonstrating variation in performance (and hence member outcomes). Over a longer time horizon, it would be quite difficult to justify the "value for money/member" proposition if performance variation is still significant.

Key for charts

Aegon	Aegon Master Trust	**Smart**	Smart Pension
Friends Life	Friends Life Master Trust	**Standard Life**	Standard Life DC Master Trust (SLDCMT) and StanPlan
LifeSight	LifeSight	**Aon**	The Aon Master Trust
Mercer	Mercer Master Trust	**BlueSky**	The BlueSky Pension Scheme
NEST	National Employee Savings Trust (NEST)	**Fidelity**	The Fidelity Master Trust
NPT	National Pension Trust	**L&G**	The Legal & General WorkSave Master Trust and RAS Master Trust
NOW	NOW: Pensions	**People's Pension**	The People's Pension
Scottish Widows	Scottish Widows Master Trust	**TPT**	TPT Retirement Solutions

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