NAPF SUBMISSION TO THE PERSONAL ACCOUNTS DELIVERY AUTHORITY CONSULTATION ON INVESTMENT

SECTION 1 - INTRODUCTION

1. The National Association of Pension Funds welcomes the opportunity to respond to the consultation document *Building Personal Accounts: designing an investment approach* issued by the Personal Accounts Delivery Authority (PADA) on 7 May 2008. During 2009 representatives from the NAPF Executive and Investment Council have participated in a series of interactive seminars on aspects of investment strategy.

2. The NAPF supports the 2012 reforms, especially the introduction of auto-enrolment and mandatory employer contributions, and - as a means of providing a workplace pension to those who currently do not have access to one - the creation of the Personal Accounts scheme.

3. This submission sets out the NAPF's general views on PADA's investment approach as set out in their discussion paper and also contains the responses to the specific questions posed.

About The NAPF

4. The NAPF is the leading voice of workplace pensions in the UK. Our 1,200 pension fund members provide pensions on behalf of more than 15 million people and have combined assets of around £800 billion.

SECTION 2 – NAPF GENERAL COMMENTS

5. The main focus within the consultation document is to obtain responses from a wide range of stakeholders on what should be PADA's recommendations on investment matters to the trustee corporation.

6. Given the potential size of the Personal Accounts scheme the investment strategy implemented by the trustee corporation particularly in relation to the default investment fund could influence future default investment design in all DC schemes in the UK.

7. Having reviewed *Building Personal Accounts : designing an investment approach* the NAPF would like to make the following points :

- **Role of the trustee corporation**: While we support PADA's work in producing a recommendation to the trustee corporation on the best investment approach for the Personal Accounts scheme, we wish to highlight that it should only be that, a recommendation, and not a prescription. In our view, the trustee corporation will be the best placed to make decisions about the investment approach to meet members needs. This will be especially true over time as it will be able to adjust to the prevailing economic and investment conditions.

- **Focus on pension outcomes**: PADA should not underestimate the difficulty that many scheme members will have in understanding how much pension they can hope to achieve and what they can do to influence it. The trustee corporation should therefore focus on providing information to help members effectively manage their pension outcome. This is more important than helping members understand and make investment decisions and choices. In simple terms the focus should be on educating members on "how much" they need to save rather than "how" they invest those savings.

- **Investment objective – target replacement rate**: The over-arching investment objective should be to achieve a target replacement income, which when combined with the expected income from the state pension system (both the Basic State Pension and S2P), will provide the pension outcomes identified by the Pensions Commission. They recommended that for someone on average earnings, the combined replacement rate of both State pensions and Personal Accounts should amount to around 45% of previous earnings (with around 15% coming from the Personal Accounts savings).

- **Communicate no guarantees given**: However, it is important, that it is recognised and explained that the objective cannot be guaranteed. As a result, the objective will also share some of the characteristics of a *best efforts* approach which seeks to reduce volatility and produce returns which encourage persistency of scheme membership. When communicating the target investment objective, the trustee corporation should set out the range of expected outcomes, running from good to poor to help illustrate that the objective is not guaranteed.

- **The right balance of risk and return**: The investment objective must be determined with the characteristics of potential scheme members and their desired pension outcomes in mind. In light of this, the trustee corporation should seek to provide an appropriate balance of risk and return to those members who do not engage. Protecting members from the impact of market volatility is also an important objective as inaction may reduce take up of Personal Accounts and undermine the long-term objective to provide an adequate pension for all individuals who do not have access to a workplace pension.

- **Asset classes**: The investment approach should consider all viable asset classes which can deliver attractive long–term returns and consideration in each asset class should be made as to whether active management can demonstrate that it can add value relative to the additional fees incurred.

- **Fund choice**: The Personal Accounts scheme should, on the basis of design simplicity, have a low risk default fund (passively managed unless active management can demonstrate real value net of fees) plus a small range of other investment options managed on an active or passive basis as appropriate.

- **Target date funds**: We believe it is appropriate to look beyond conventional lifestyle strategies and consider the use of target date funds as a possible method of de-risking as members approach retirement.

- **Corporate governance**: Good corporate governance practice including engagement should be encouraged in keeping with the aspiration for the Personal Accounts scheme to be an exemplar for all aspects of good governance.

- **Responsible investment**: If such a policy is implemented, it must be in the best interests of the scheme members and be applied consistently across the scheme and not only for the default fund.

SECTION 3 – NAPF COMMENTS TO SPECIFIC QUESTIONS

8. This section provides the NAPF's responses to the specific questions raised chapter by chapter by PADA in their discussion paper.

Member Issues - who will our members be?

Question 2.1- Which member characteristics should influence the design of the Personal Accounts scheme.

9. A lack of engagement with long term saving, high risk aversion and general investment ignorance displayed by the target group should guide the investment design towards a simple low risk approach for the Personal Accounts scheme.

Q2.2 – From the evidence presented, what conclusions should we draw about our future membership?

10. PADA's own research supports the current view that potential scheme members will have a minimal level of engagement regarding financial decision making. The target audience for Personal Accounts is expected to be a largely disparate group which has either limited or no investment knowledge. Initial members are expected to :

- Be highly risk adverse and not have the resources to cope with financial loss – falling fund values are likely to encourage future generations to opt out of the scheme;
- Have variable work patterns and in many cases breaks in their contribution history which will also vary in length;
- Have a wide age range and will include those in their forties, fifties and older who will have a shorter membership period to retirement. This group may not build up sufficient assets to purchase a pension and are therefore likely to opt for trivial commutation.

Investment Objectives

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

11. According to the evidence provided by PADA, a tension exists between the likely preferences of future members as regards the size of the pension outcome they would like to receive and the riskiness and volatility of the assets they would like to invest in. In simple terms, while potential members have indicated they would like the largest pension possible, they would like to achieve this via low risk and thus potentially low returning assets. The consultation document also demonstrates that the greatest threat to pension outcomes is years of non-contributions (potentially due to members ceasing contributions due to seeing their pension pot fall in value) rather than the risk of achieving modest rather than superior investment returns.

12. In light of this, we suggest that the trustee corporation should do all that it can to reduce the risk of non-contributions. This is likely to involve opting for low risk and low volatility assets (possibly only in the early years of contributions), choosing a fund with *absolute return* characteristics, or using some king of protection strategy as is popular at the moment with certain savings products.

13. The trustee corporation should also consider undertaking further analysis of the target group to consider whether the expected pension from Personal Accounts when combined with State pension benefits will provide a positive pension outcome given the low risk investment approach it is assumed the majority of the target group will favour.

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

14. We do not feel that different contribution profiles should impact substantially on the scheme's investment objectives. However, by offering a small range of additional funds, other than the low risk default fund, those members who have irregular earnings may be able to smooth out the investment of their contributions by initially investing in a cash fund and subsequently spreading the investment into a higher risk fund.

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

15. The over-arching investment objective should be to achieve a target replacement income, which when combined with the expected income from the State pension system (both the Basic State Pension and S2P), will provide the pension outcomes identified by the Pensions Commission. They recommended that for someone on average earnings, the combined replacement rate of the two State pensions and Personal Accounts should amount to around 45% of previous earnings.

16. However, it is important, that it is recognised and explained that the objective cannot be guaranteed, As a result, the objective will also share some of the characteristics of a "best efforts" approach which seeks to reduce volatility and produce returns which encourage persistency of scheme membership. When communicating the target investment objective, the trustee corporation should set out the range of expected outcomes, running from good to poor to help illustrate that the objective is not guaranteed.

17. Protecting members from the impact of market volatility is also an important objective, as doing so will reduce the risk of opt-outs and encourage saving. The use of diversified growth strategies, absolute return funds and/or protection strategies may help to meet these objectives.

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

18. The best way to ensure that the trustee corporation operates the scheme in the best interest of members is to set this belief as a specific goal of the investment objective and to clearly underline its independence from other influences be they the Government of the day, the media or pressure groups. The trustee corporation should ensure that it can operate independently purely in the interests of the membership as a whole. Confidence in the scheme will grow from a strategy which is based on controlling volatility in investment performance and which seeks to produce the best pension outcomes for members with this constraint. It is expected that scheme pension plus State benefits will constitute the replacement retirement income for the target group.

19. Regular feedback from members on the type and clarity of communication materials they receive from the trustee corporation will also provide useful evidence of the success (or otherwise) of the communications strategy for Personal Accounts as the scheme develops.

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

20. Adopt a clear "plain English" communication strategy with regard to the impact of risks on the investment objective, rather than just providing general commentary that investment risks exist. Focus on realistic expectations of risk and return with due regard given to the downside as well as the average expected outcome.

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

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

22. The default "fund" could be a default "matrix", like current lifestyle designs, but structured so that whatever investment choices members make in their early years of scheme membership they can be confident that the downside risks are being significantly reduced as they near retirement.

Investment Approach

Q 4.1- In what situations should Personal Accounts use tactical asset allocation and why?

23. Long term asset allocation is the biggest driver of investment risk and returns. Short term tactical asset allocation (TAA) can add additional return, although it can also be negative. TAA is an approach that needs to be considered by the trustee corporation along with other active management approaches, against the additional fees that it would incur.

24. As the Personal Accounts fund is expected to be very large by asset size in due course, active management will become increasingly difficult to do well on a consistent basis. For reasons of scale, tactical asset allocation may be deemed to be outside the scope of the default fund in Personal Accounts.

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

25. Certain alternative asset classes (eg property and commodities) will have a role to play as a diversifier if the trustee corporation decide to offer a diversified growth fund, either within the default fund, or as an alternative fund. The best way of meeting liquidity and pricing needs would be via unitisation.

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

26. If a diversified growth fund is used as the default approach, or as part thereof, all asset classes should be considered by the trustee corporation based on their liquidy, their risk, their correlation with other asset classes and their expected return. The governance requirements implicit in a very wide ranging asset allocation could be onerous and could ultimately restrict some asset classes from being included in the investment approach..

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

27. Given the cost constraints of the Personal Accounts scheme the emphasis should be on passive management except where either active management is required to access the market return (beta) or where the trustee corporation feel the investment return from an active approach will justify the additional fees involved.

28. It should also be borne in mind that after a number of years the scheme will have substantial assets, and in some markets the scheme will be capacity constrained from taking an active approach as any benefit from active management will be lost in market impact and other transaction costs. The different governance requirements, in terms of monitoring, review and execution will also need to be considered in determining the number of managers involved and the split between active and passive management.

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

29. Less liquid asset classes (e.g. property, emerging market debt and corporate bonds) and those without market benchmarks such as private equity may be better suited to active investment management.

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

30. It is important that the trustee corporation considers its investment governance arrangements and a number of options exist. We would expect that the trustee corporation will delegate its investment powers to an experienced investment sub-committee to determine the approach to be taken to select managers whether they be active or passive. This could involve either establishing an in house investment team to monitor and select managers or the selection of an investment consultant with a proven track record of successful active manager selection / de-selection.

Q 4.7 – Should the personal accounts scheme participate in securities lending?

31. Annual fees from securities lending can add substantially to investment returns at a relatively low risk, so provided the financial risks associated with collateral are properly managed and that stock is recalled for contentious votes the trustee corporation should give serious consideration to instigating a securities lending programme.

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

32. A requirement for high quality collateral, spread across a number of diversified counterparties. A robust process of careful regular monitoring and reporting to all relevant parties should also be established. The fee income received from securities lending should be reviewed against the additional risk incurred on a regular basis by the trustee corporation.

APPROACHING RETIREMENT (derisking)

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

33. If members using the default fund are likely to draw pension from State pension age then the need to reduce risk on the glide path will be reasonably predictable. Consequently a de-risking approach that manages the transition between return seeking and risk reducing assets seems appropriate.

34. Although lifestyle strategies have become the conventional method for de-risking within default funds the NAPF believes the trustee corporation should also consider a target date approach for the Personal Accounts scheme and, on balance, would support a target date approach [mainly] for the reasons given in Q 5.2 below.

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

35. Yes. The bulk of the target group will probably have some retirement date in mind, although getting members to engage and agree what their target date is, may be difficult. It would seem appropriate and be potentially easier to communicate a target date approach. However, the flexibility for members to alter their retirement date and change funds, as their circumstances change, will be very important.

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

36. We do not see that there are any significant differences regarding the potential members of the Personal Accounts scheme that would necessitate any different lifestyling or target date a arrangements from those available within other UK DC pension schemes.

CORPORATE GOVERNANCE

Q 6.1 – To what extent can the Personal Accounts scheme deliver high-quality corporate governance at a low cost?

37. The NAPF would encourage the trustee corporation to adopt a sensible policy of engagement with investee companies as good practice. Greater transparency through the publication of the voting record of the Personal Accounts scheme would also demonstrate a commitment to better corporate governance.

38. Voting UK stock is relatively straightforward and is to be encouraged as a process which can be expected to add value as the Personal Accounts scheme develops and assets grow.

39. If the trustee corporation decide to hold substantial amounts of non-UK stock in the long term we recommend it should work together with other global investors to improve corporate governance in all markets, to bring them up to UK standards, and to help bring best practice to the UK from other markets.

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

40. As the asset size of the Personal Accounts fund increases the NAPF would caution against an overly simplistic 'box ticking' approach to corporate governance as this type of approach may stop being effective with investee companies.

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

41. By holding a position in all stocks in a market the best way for passive managers to enhance returns is to improve corporate governance in the whole market, and we would expect the trustee corporation of the Personal Accounts scheme to be a leader in this area.

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

42. The trustee corporation should vote stock when and where they are able to. Voting stock outside of the UK can produce certain localised difficulties (i.e. where a fund holds different assets within the capital structure of a foreign company conflicts of interest may arise).

RESPONSIBLE INVESTMENT

Q 7.1- How can the Personal Accounts scheme engage in responsible investment in a cost-effective way?

43. The trustee corporation could encourage the development of indices and benchmarks on passive funds which take more account of responsible investment issues.

44. Engagement with investee companies may permit a more flexible approach although cost may be an issue as an active engagement strategy may cost 1-2 basis points (bps) per annum.

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

45. If a responsible investment policy is adopted it should operate across all fund choice(s) within the Personal Accounts scheme taking into account the benchmark holdings across all those options. This uniform approach would be consistent and easier to implement and allow responsible investment to become embedded in the investment culture.

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

46. The trustee corporation must decide if the cost of responsible investment will be in the best interests of scheme members in the long term. The trustee corporation should focus on those issues which will have an impact on the largest investments over the longer term rather than specific activism which can be costly.

47. The trustee corporation should not assume any guarantee of superior investment returns as a direct result of adopting a responsible investment strategy – at present there is insufficient empirical evidence to support such a view.

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

48. The cost of implementation will be the overriding determinant of introducing a responsible investment approach as a core part of the investment objective for the Personal Accounts scheme. Outsourcing may initially be the cheapest option with the possibility to develop an 'in house' capability over time.

INVESTMENT FUND CHOICE

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

49. At commencement of the Personal Accounts scheme the trustee corporation should offer a low risk default fund plus a small range of additional funds including a fund or funds which is/are deemed higher risk. However, in the case of such *high risk* funds the risk of poor returns as well as good ones should be properly communicated to scheme members. This range of choice could be achieved through the use of greater diversification of assets including a single fund or funds with a greater equity exposure.

50. However, it is worth noting that, in terms of simplicity and cost control, the trustee corporation should also seriously consider not offering any fund choice within the Personal Accounts scheme at commencement. The trustee corporation could retain the option to add more funds at a later date (possibly after completion of the initial scheme review in 2017).

51. On balance the NAPF would support a limited range of fund choice being made available.

Q 8.2 - To what extent should those funds be lifestyled?

52. If a target date fund is not chosen as the default fund it would seem appropriate for the trustee corporation to apply a lifestyling strategy to the default fund. If any additional fund choices are offered lifestyling could be applied to them initially with the option for members to *opt out* on the basis that the investment risks of withdrawal from a lifestyling approach were fully understood.

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

53. We believe the trustee corporation should only white label the funds as this allows an easy exit strategy if performance or corporate issues relating to a specific fund provider or providers should arise.

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

54. All additional costs should be borne only by those members who incur them by exercising wider investment fund choice and not be spread across the entire scheme membership.

Q 8.5 - Should there be a limit on the number of fund switches, or charges imposed after a certain number of switches, or neither for the Personal Accounts scheme?

55. The trustee corporation should reserve the option to impose charges related to switching costs at a later date once a sufficient volume of evidence of scheme member activity has built up ie switching between funds may be minimal in practice as member engagement is expected to be low. Such transparency, if introduced, would ensure that no cross subsidy was taking place between active and non active 'switching' members of the scheme. The adoption of lifestyling or target date funds should help negate the need to switch for de-risking purposes.

56. However, given that in the initial years of the Personal Accounts scheme there are likely to be substantial contribution inflows into the fund the trustee corporation may wish to consider a single price approach where any withdrawals will always be crossed with new contributions.

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