NAPF

Securing the future of pensions

What do pension scheme members expect of how their savings are invested?

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Executive summary

This report presents the findings of research commissioned by the NAPF and undertaken by Opinium Research to gauge the level of awareness and interest UK pension scheme members have about both where and how their savings are invested.

The Pension Regulator's 2013 DC Code of Practice stated that: "Trustees need to be confident that outsourcing stewardship functions is carried out with the best interests of beneficiaries in mind." This research provides useful context for scheme trustees in considering their compliance with this Code.

It is hoped that the findings from this research may assist those responsible at the various points in the investment chain, whether they are a trustee, scheme manager, provider or fund manager, in thinking through their relevant responsibility in delivering good member outcomes.

Professor Kay in his 2012 review suggested that good practice in fund management naturally leads to stewardship activity; if so, how can this good practice be further fostered by pension schemes in the interests of individual savers?

Key findings from this research:

- Whilst the level of awareness as to where savings are invested is low, there is a significant latent interest amongst scheme members in knowing more. This interest is higher in those who are younger, working in the private sector and amongst higher earners.

- The clear preference of a majority of scheme members, even if it is more expensive, is for their employer to favour pension providers with strong stewardship offerings when establishing pension arrangements for their employees.

- There is a willingness amongst many scheme members to accept potentially lower investment returns in order that their savings are invested in a more 'ethical' fashion.

Key questions arising from this research for schemes and providers:

- Given these research findings, are the preferences of scheme members for effective stewardship of their savings being communicated along the governance and investment chain?

- Given the demographics of most DC pension schemes, how adequately are the stewardship expectations of fund managers conveyed within the default fund offered to employees?

- Can communication about where and how pension savings are invested be a useful tool for engaging younger employees with pension saving?

- How do schemes balance obligations to act in the best interests of scheme members with the feedback from respondents that a large proportion would willingly accept lower investment returns if their savings were invested in an ethical manner?

Context

An additional 6-9 million people will be saving into a pension in the next few years thanks to automatic enrolment. It is critical that people are automatically enrolled into pension schemes that provide value for money.

The NAPF believes that good governance is the cornerstone for good pension provision. With the vast majority of existing and future savers expected to remain in the default fund offered, governance is critical to driving good member outcomes at retirement.

Across all workplace DC schemes, in excess of 70% of members invest via the default fund and figures from the NAPF Annual Survey suggest that for DC schemes there is an average allocation to equities of 71% in the growth phase of the average default fund. This emphasises the vital importance of ensuring that default funds are designed and appropriately governed in order to best deliver good member outcomes.

In recent years there have been concurrently occurring policy discussions which have been largely happening in isolation of each other.

Firstly, there has been much debate about the rights and responsibilities of institutional investors and the agents within the investment chain. Professor Kay in his 2012 review of UK equity markets produced a range of recommendations which sought to achieve "a culture of stewardship throughout the equity investment chain". Kay surmised that good practice leads naturally to stewardship activity.

Secondly, there has been a lively and important debate about the level of costs and charges associated with pension provision, including the proposed introduction of a charge cap.

This research seeks to draw aspects of these two discourses together to ask, in achieving value for money and good member outcomes, are the interests and views of underlying scheme members being appropriately facilitated and reflected?

This research thus poses a number of questions, challenges and opportunities for those establishing and managing occupational DC pension schemes.

Overview of pension scheme investment governance

Whilst members of DC pension schemes have a degree of choice over where their money is invested, that choice is typically limited and is rarely exercised; a large majority of members rely on default investment strategies. The investment preferences of pension scheme members are not, therefore, typically revealed through their choices and it is important that all those involved in investing members' money – through the chain described briefly below – find other ways of understanding how people want their money to be invested.

1. Employer

Employers are required to automatically enrol most of their workforce into a pension scheme. Influenced by the number and demographic of their employees and the associated costs an employer will choose whether to set up their own pension scheme, use a master trust, or set up a contract arrangement with a pension provider. Depending on the choice made they will have varying levels of influence on, and responsibility for the design and oversight of the investment choices provided to scheme members.

2. Pension schemes

In each of the three options suggested the individual scheme member is reliant to varying degrees upon decisions made by others acting on their behalf.

a) A pension scheme governed by a board of trustees.

In this situation a trustee board will be responsible for investment governance - this includes the responsibility for setting and monitoring the default strategy, and for ensuring the long-term suitability of the funds underlying the default strategy.

In relation to the range of individual funds available for members to choose to invest in the responsibility of the trustees is limited to ensuring that the funds offered perform in line with the manager's stated objectives.

The Pensions Regulator's 2013 DC code of practice sets out the legal requirements and standards of governance and administration that trustees of DC trust-based schemes need to attain. One aspect of this Code is that trustees need to be confident that outsourcing stewardship functions is carried out with the best interests of beneficiaries in mind.

b) A Master Trust offered by a commercial provider or not-for-profit organisation.

In this circumstance, the employer delegates the pension arrangements to a scheme set up under trust providing pensions to employees of more than one unrelated employer. The trust will be governed by a board of trustees with the same responsibilities as described above.

In both of these cases the trustees will be advised by actuaries and investment consultants.

c) Arrange a contract-based DC scheme.

Alternatively, an employer with the assistance of advisers may select one or more pension provider, commonly an insurance company, to offer pensions to its employees. The resultant contract will be between the employee and the provider (Group Personal Pensions are like this). In such arrangements the provider takes the main responsibility for the administration, communication and compliance of the scheme.

There is no legal requirement for employers in these arrangements to take an active involvement in the operation of the pension scheme (except for paying contributions on time). Encouragingly however, many employers are establishing management committees to oversee the running of their pension scheme.

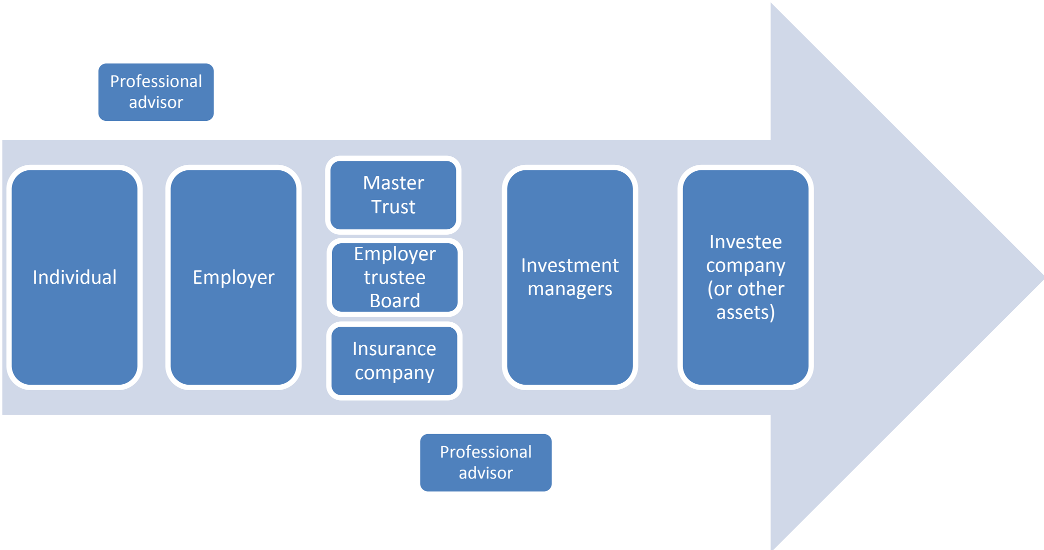
3. Investment managers

What do scheme members expect of how their savings are invested?

The trustees of the employer pension scheme or Master Trust, or the pension provider will subsequently award mandates to investment managers.

4. Investment managers

The investment managers in turn invest in a range of assets, including directly in public equities or indirectly via collective investment schemes such as open-ended investment companies (OEICs). These investments are performed using platforms, brokers and custodians.



What is stewardship?

In order to avoid common misconceptions it is also worth clarifying the concept of "stewardship" as discussed within this report.

Essentially as with much in pensions, it boils down to acting in the best interests of beneficiaries. In an investment context stewardship thus implies the management of funds to fiduciary standards. The 2012 Kay review identified the relationship between asset owners and asset managers as being key to establishing "a culture of stewardship throughout the equity investment chain".

Over the course of the past twenty years there has been a steady and evolving discourse with respect to the rights and responsibilities of institutional investors alongside an understanding that being engaged stewards of investments can mitigate risk and enhance risk-adjusted returns.

- 1992 - The term "stewardship" was first coined by Sir Adrian Cadbury in his "Financial Aspects of Corporate Governance" report.
- 2000 - The world's first regulation requiring disclosure by occupational pension funds of their policies on environmental, social and governance issues came into force in the UK.
- 2001 - The Myners Review asked whether institutional investors were acting in the best interests of their beneficiaries.
- 2009 – The Walker Report recommended the formalisation of the UK Stewardship Code to set out principles of best practice in stewardship by institutional investors and fund managers.

- 2010 – Heralded as the first of its kind in the world, the UK Stewardship Code was published.
- 2013 - The Pensions Regulator's 2013 DC Code of Practice states that: "Trustees need to be confident that outsourcing stewardship functions is carried out with the best interests of beneficiaries in mind."

Stewardship activity as articulated within the preface to the Stewardship Code "aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper." Further, the Code describes stewardship as being more than just voting. Activities may include: monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings."

Asset owners such as pension funds set the tone for stewardship not least through the mandates that they award to asset managers and thus in turn may influence behavioural changes that lead to better stewardship by asset managers and companies.

What is it not?

Micromanagement of investee companies is not an expectation of stewardship - that is the responsibility of Directors whom are elected by their shareholders. Instead what is expected is that, where issues are identified, an investor would actively engage with the company to ensure that they are addressed rather than hoping that action will be taken.

Furthermore, discussions of stewardship or responsible investment are often viewed with hesitation due to a misconception that what is being discussed is ethical and/or socially responsible investment (SRI).

Perfectly reasonably a range of investors have a desire to reflect their values in their investment portfolios and have been advocating for many years an approach that combines investment returns with a moral or ethical role for investing. This additional dimension is generally not driven by financial considerations but is there to ensure that the investment portfolios are congruent with investors' beliefs and values.

The concept of stewardship however, refers to an investment approach where investments are managed prudently, risks monitored, shareholder rights exercised and opportunities for sustainable performance taken.

Stewardship thus is not about greener or more ethical investments but about endeavouring to achieve better outcomes for their members.

Given a context of a shift from DB to DC pensions with the associated shift of investment risk to scheme members, this report thus explores whether scheme members themselves agree with Professor Kay that good practice in fund management leads naturally to stewardship activity.

Key research results

- When asked to identify the most important things to consider when choosing a provider for employee pensions, respondents suggested the most important factor is the level of costs and charges (65%). In addition nearly half (48%) of respondents felt it important to consider how transparent the pension provider is around where the money is invested (48%).

- Nearly 40% of respondents indicated that they were not aware of what their pension provider does with their money between when they put it into their pension and when they eventually take it out when they retire.

- Nearly two-thirds (65%) of respondents would be interested in receiving general information about how their savings are invested (e.g. are they invested in stocks and shares, property etc). A very similar proportion were also interested in receiving information about the industries/sectors, countries and specific companies their savings may be invested in.

- The top 5 types of information respondents would like their pension provider to provide or make available online are the:

  I. Performance of their fund over the previous 3 years (54%)
  II. Performance of their fund over the previous 12 months (52%)
  III. Costs and charges associated with managing and investing their savings (47%)
  IV. Companies their savings have been invested into (45%)
  V. Countries their savings have been invested into (36%)

- Although awareness amongst respondents is currently low, 60% of respondents indicated that they would be interested in their pension provider undertaking activities that support the long-term sustainable performance of the companies in which they invest.

- When respondents were asked to indicate which of two pension providers they would rather their employer chose on their behalf, provider A was more popular on both occasions where Provider A:

  - would take an active role in the companies they invest into but was 10% more expensive than Provider B with the same return on investments (53% opted for A with 17% opting for B); and

  - would take an active role in the companies they invest into but was 10% more expensive (than provider B) but would potentially in the medium term achieve a slightly higher and less volatile return on investments (61% opted for A with 12% opting for B).

- A large proportion of respondents (70%) felt it important for pension providers to invest in companies that concentrate on avoiding unethical practices, such as poor working conditions.

- When presented with a choice between two providers, nearly half (49%) of respondents would prefer their employer chose the provider which made a specific point of investing ‘ethically’ despite this fund likely achieving a lower return on investments and being more volatile.

About the survey

Opinium Research surveyed 1,064 UK adults (18+) with an occupational pension between 1-8 May 2014.

Respondents were asked a series of questions to gain a better understanding of the level of awareness pension scheme members currently have about where and how their pension savings are invested and the level of interest in knowing more.

The research looked to further understand if pension scheme members are interested in whether “stewardship” activities are being undertaken on their behalf. In particular the survey asked whether scheme members wished to see their employers positively considering the stewardship credentials of pension providers when establishing pension arrangements.

Demographic of the survey sample

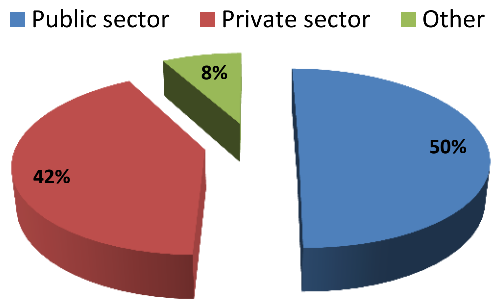
Amongst the 1,064 UK adults surveyed:

- A slight majority was male (56%)
- A majority were 55+ (59%), with 33% aged 35-54 and 8% aged 18-34
- A majority (62%) self-identified with a religion.

With respect to the employment status of respondents:

- A majority worked within the public sector (50%) as opposed to the private sector (42%).
- Approaching half of respondents worked full-time (44%) with 15% working part-time.
- 44% of respondents had a personal income level between £20 - £50k p.a; a further 34% had a personal income level below £20k p.a.

Fig. 3. Survey sample - employment sector



What do scheme members expect of how their savings are invested?

Fig. 4. Survey sample - working status

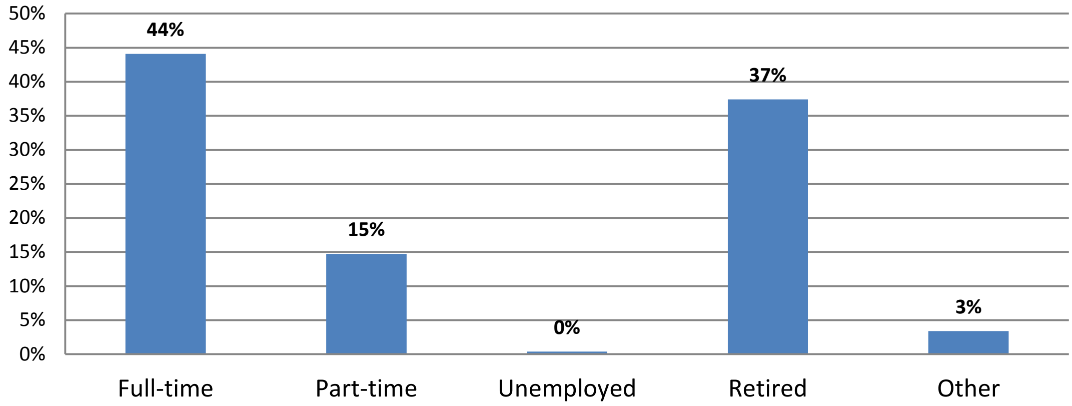
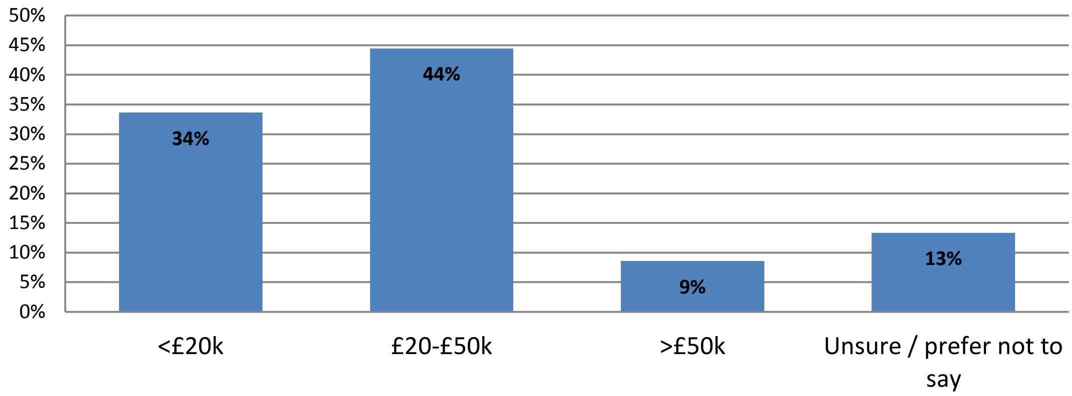


Fig. 5. Survey sample - personal income level



General understanding & interest

Consideration by the employer

The first tranche of questions asked of respondents were of a general nature and looked to assess the level of understanding and interest amongst pension scheme members in what happens to their savings between paying into a pension and retiring, often many decades later.

In the first instance we were interested in understanding at the outset at a general level which factors respondents felt were most important in selecting a pension provider.

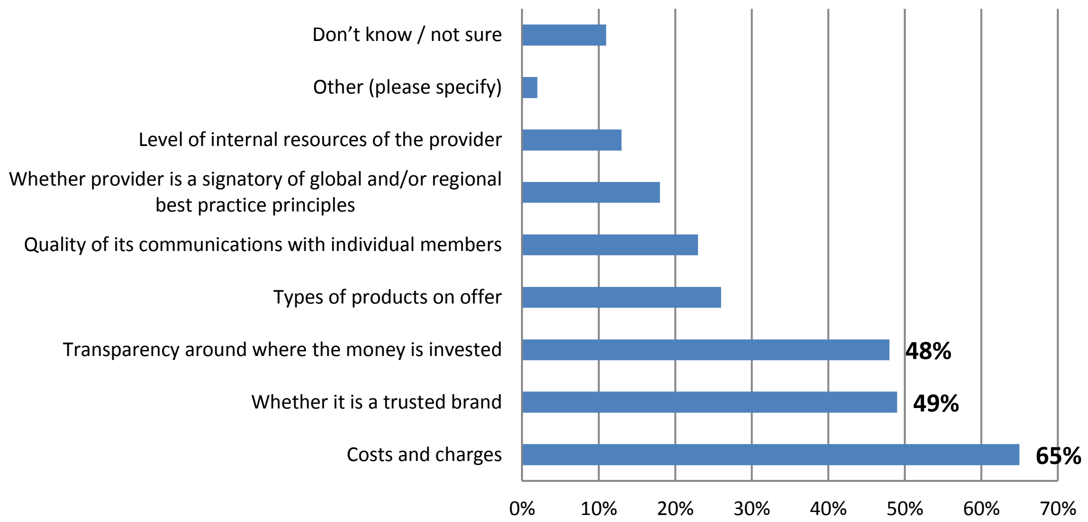
1. *Thinking about pension providers such as the one your company uses to provide employee pensions... What do you think are the most important things for an employer to consider when choosing a provider for employee pensions?*

The broad range of options provided covered the level of costs and charges, whether it is a trusted brand and the quality of its communications with individual members, through to the level of transparency around where the money is invested.

Perhaps unsurprisingly, those with an occupational pension would most want their employer to consider the associated level of costs and charges (65%) when choosing a pension provider for their employees. Given the potential significant impact that costs may have on the resultant pot that individuals will receive at retirement it is right that this issue is considered important.

The responses also indicated that scheme members consider that trust and transparency are important factors for consideration. Nearly half of respondents (49%) suggested that employers should consider the level of perceived trust of the pension provider and similarly 48% highlighted the importance of transparency around where the money is invested.

Fig. 6. The most important things for an employer to consider when choosing a provider for employee pensions



Understanding of how the money is used / invested by the pension provider

In an effort to gauge the level of understanding amongst scheme members as to what happens with their savings, the second question asked was:

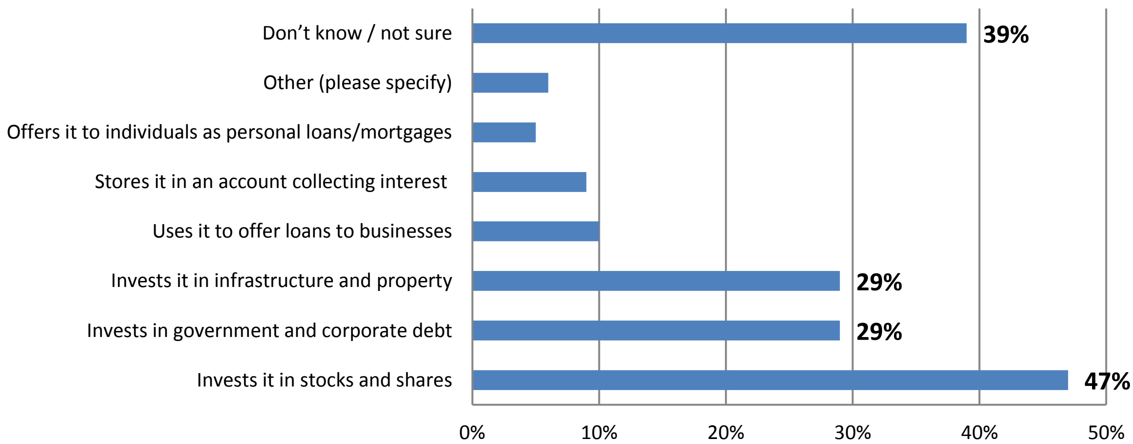
2. *Thinking about the workplace pension scheme you currently have, what do you think your pension provider does with your money between when you put it into your pension and when you eventually take it out when you retire?*

There does appear to be a general understanding amongst many respondents that their savings are invested on their behalf in stock and shares (47%) in which respondents estimated around 23% are invested in UK stocks and shares, 13% in EU stocks and shares and 17% in global stocks and shares.

Beyond the stock market, a proportion of respondents were also aware that their savings may be invested in government and corporate debt (29%) and infrastructure and property (29%).

There is clearly however, a significant proportion of scheme members who are unsure as to how their savings are used (39%). This uncertainty is higher amongst females (52%) those in the younger age group (18 – 34; 48%) and those working part time (50%).

Fig. 7. What do you think your pension provider does with your money between when you put it into your pension and when you eventually take it out when you retire?



Interest in knowing how their money is used / invested

Whilst, generally speaking, the level of knowledge amongst many scheme members with respect to where their savings are invested is reasonably low, is there an interest in knowing more? That was the question that we posed to respondents:

3. *Thinking about how your workplace pension savings are used by your pension provider, how interested or not are you in each of the following details.*
    - *General information about how my savings are used (e.g. are they invested in stocks and shares, property etc)*
    - *Which industries / sectors my savings may be invested in*
    - *Which countries my savings may be invested in*
    - *Which specific companies my savings may be invested in*

To judge from the responses received to these questions there is a substantial proportion of scheme members who are interested in where their savings are invested. There were similar levels of interest expressed in respect of general information about asset allocation (65%); industries and sectors (63%); countries (65%) and specific companies (63%) that individual's savings may be invested in.

The level of interest tended to be higher amongst those working in the private sector – e.g. 74% of those in the private sector were interested in at least general information about where their savings were used as compared to 59% of those working in the public sector. Interest was also higher amongst those with a personal income over £50k p.a. (82%) and those aged 18-34 (74%).

Fig. 8. Thinking about how your workplace pension savings are used by your pension provider, how interested or not are you in each of the following....

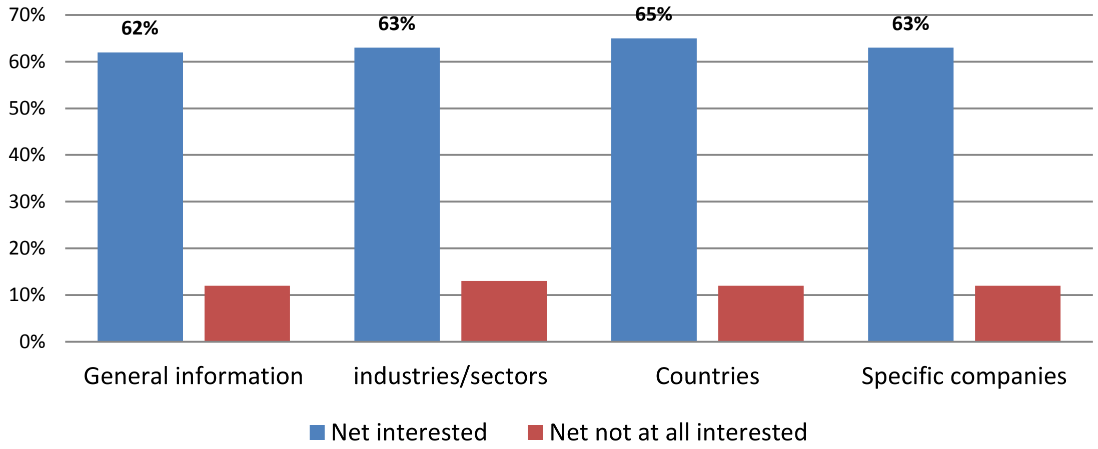
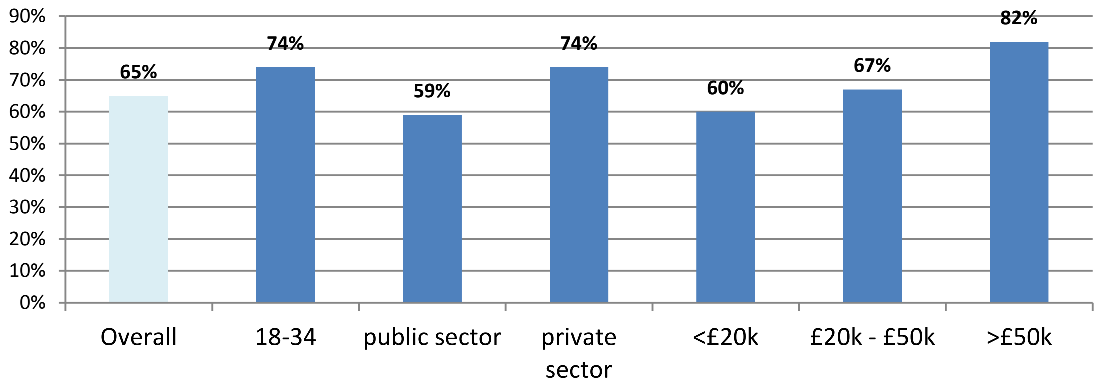


Fig. 9. Net interested - general information about how my savings are used (e.g. are they invested in stocks and shares, property etc)



Member communications

If the previous questions suggest a latent interest amongst scheme members in knowing more about where their savings are invested, does this present an opportunity to reflect upon the nature of the communications members receive? The next few questions explored this.

4. *How satisfied or dissatisfied would you say you are with how much information your company pension provider gives you about how your savings are used / invested?*

Despite their being an apparent level of interest in where their savings are invested, when asked how satisfied or dissatisfied they are with how much information their pension provider currently gives them about this respondents were broadly ambivalent.

Whilst 40% of respondents were either “very” or “quite” satisfied and the net-dissatisfaction was pretty low at 15%, the majority single response was “neither satisfied nor dissatisfied” at 38%. That said, and corresponding to the latent interest identified before, the level of net-dissatisfaction was higher amongst the younger cohort at 27% exceeding the level of net-satisfaction of 25%.

Expanding on this, respondents were asked:

5. *What sort of information would you like your pension fund provider to give you or make available online?*

There was a reasonably clear top 5 as per below.

1. The performance of their fund over the previous 3 years (54%)
2. The performance of their fund over the previous 12 months (52%)
3. Costs and charges associated with managing and investing their savings (47%)
4. The companies their savings have been invested into (45%)
5. The countries their savings have been invested into (36%)

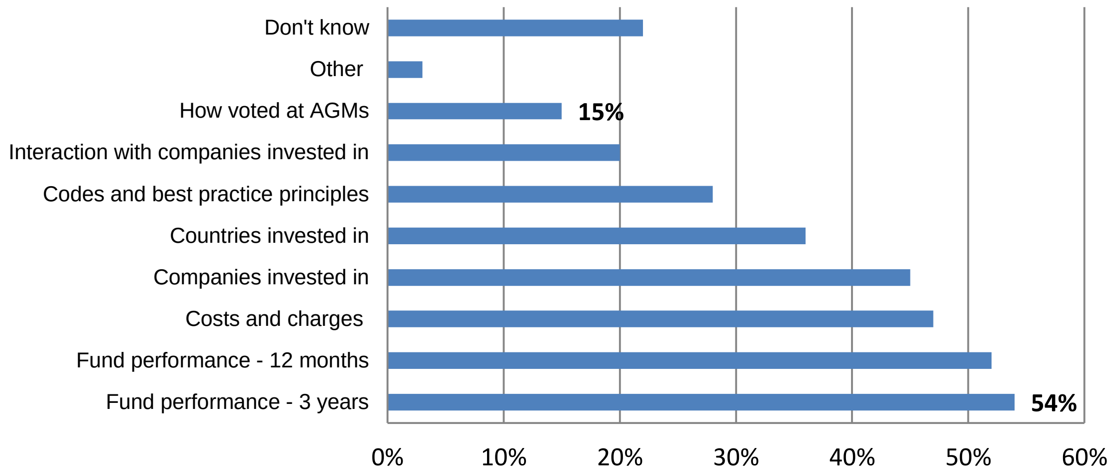
Quite understandably respondents were most interested in information about the performance of their fund and encouragingly overall there was a slight preference for this to be longer-term performance as opposed to the performance over the course of the past year.

Interestingly there was also a decent level of interest amongst respondents in receiving more information about where their savings are invested and the costs and charges that are incurred in managing these investments. Indeed, amongst the younger cohort the most desired information (44%) was the specific companies that their savings have been invested into.

Notably, despite much attention given in the media and elsewhere to votes at company Annual General Meetings (AGMs) not least following the 2012 Shareholder Spring, only 15% of respondents indicated an interest in receiving information with respect to how the votes attached to their shares have been used at AGMs.

> ➢ These responses suggest that greater narrative within reporting to scheme members (or being made available online) with respect to the where their savings are invested has the potential to better engage individuals, especially younger employees, with pension saving.

Fig. 10. What sort of information would you like your pension fund provider to give you or make available online?



Supporting long-term sustainable performance of investee companies

Awareness of pension providers taking an active role

Pension scheme members, as the respondents thus far suggest, have an interest in where their savings are invested, however, are they also interested in *how* the subsequent investments are managed. The next set of questions sought to explore this question.

The Pensions Regulator's 2013 DC Code of Practice states that: "Trustees need to be confident that outsourcing stewardship functions is carried out with the best interests of beneficiaries in mind."

The NAPF has also commonly asserted that, as institutional investors, pension funds are in a position to exert influence over the companies (and other assets) in which they invest to protect and promote members' interests and to help improve and protect the risk-adjusted returns on their investments. In turn this also helps to maintain the real value of retirement income.

For this reason, the NAPF has for a long-time been a vocal supporter of the UK Stewardship Code which aims to promote the long term success of companies in such a way that the ultimate providers of capital such as pension funds also prosper. Encouragingly there is a strong recognition amongst the UK's large occupational pension funds that they have stewardship responsibilities[1] and in turn they have been beginning to drive the market for stewardship amongst asset managers.

But how should this be translated in DC schemes. Respondents were asked whether they were aware of their pension provider taking an active stewardship role with their investee companies:

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[1] NAPF Annual Engagement Survey, November 2013

What do scheme members expect of how their savings are invested?

6. *Some pension providers take a more active role with the companies they invest people's pension savings into. Those managing the investments would monitor and actively engage with companies on things like strategy, performance, risk – including environmental risk - and corporate governance - including culture and pay. The idea is to promote the long term success of companies and thus enhance the long-term returns for savers. Are you aware of your pension provider doing anything like this?*

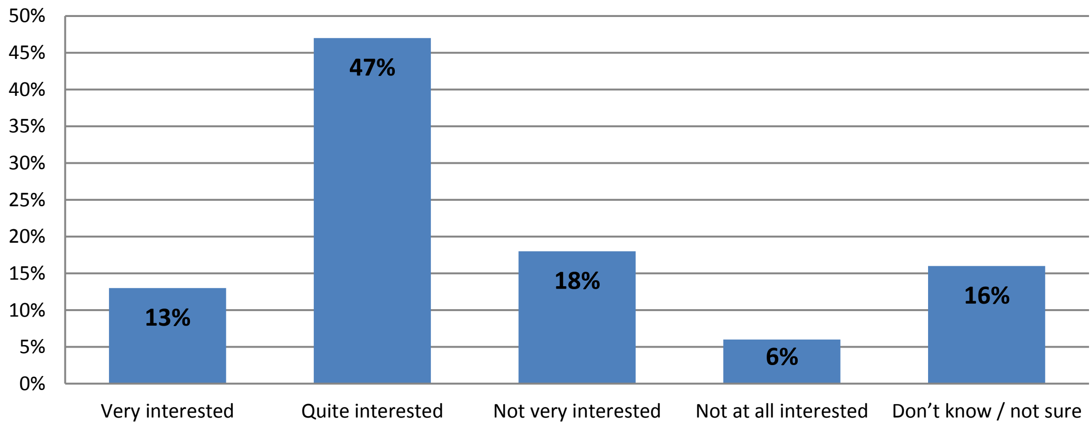
Given how distant individual scheme members are from their underlying investments and the issues already discussed with respect to member communications, it is perhaps unsurprising that awareness of stewardship activities being undertaken is very low (9%). Indeed, the majority of respondents are either not aware of their pension provider taking an active role with the companies they invest people's pension into (46%) or are simply "not sure" (45%).

However, is the low level of awareness a symptom of a lack of interest amongst scheme members? Respondents were asked:

7. *To what extent would you be interested in your pension provider undertaking any activities that support the long-term sustainable performance of the companies in which they invest into?*

The responses clearly suggest that scheme members as well as having an interest in where their savings are invested also have an interest in *how* they are invested - 60% of respondents indicaited that they would be "very" or "quite" interested in their provider undertaking stewardship activities.

Fig. 11. To what extent would you be interested in your pension provider undertaking any activities that support the long-term sustainable performance of the companies in which they invest into?



Pension provider preference

Of course having an interest is one thing, but what does this mean in practice and how does it fit into an environment of increasingly constrained budgets?

As articulated within the Stewardship Code, effective stewardship benefits companies, investors and the economy as a whole. In addition, robust independent research demonstrates that effective stewardship and integration of material environmental, social and governance (ESG) factors within investment decisions may lead to improved risk-adjusted performance, especially in the medium-long-term and are likely to provide protection against potential value destruction. Thus effective stewardship of their savings would appear to be self-evidently in the best interests of scheme members.

However, effective stewardship activities – monitoring and engaging with investee companies – requires resource and this is turn means additional cost for clients and as per earlier in this report, respondents clearly acknowledge that the most important thing for an employer to consider when choosing a provider for employee pensions is the level of costs and charges. Therefore leaving aside the wider financial, moral or fiduciary arguments for the undertaking of stewardship activities which the NAPF has previously addressed[2], the economic case for stewardship requires that there be demand for this investment approach despite the additional resource cost.

To explore this question, respondents were presented with a choice between two providers each of which achieved largely the same return on investments. This scenario was then presented again but this time it was suggested that the more expensive provider which undertook stewardship activities would also potentially in the medium term achieve slightly higher and less volatile returns.

8. *Please imagine that your company could choose one of two different providers for your company pension scheme:*

   The primary fund for Provider A takes an active role in the companies they invest people's pension savings into such as monitoring and engaging with the companies on strategy, performance, risk and corporate governance and voting at shareholder meetings.

   The primary fund for Provider B makes no extra effort to take an active role in the companies they invest people's pension savings into but is 10% less expensive than that for Provider A.

   The return on investments (after costs) that each provider gets would be largely the same as each other. Which provider would you rather your company chose provider A or provider B?

9. *Again, please imagine that your company could choose one of two different providers for your company pension scheme:*

   The primary fund for Provider A takes an active role in the companies they invest people's pension savings into such as monitoring and engaging with the companies on strategy, performance, risk and corporate governance and voting at shareholder meetings.

   The primary fund for Provider B makes no extra effort to take an active role in the companies they invest people's pension savings into but is 10% less expensive than that for Provider A.

   The return on investments (after costs) that provider A gives would potentially in the medium term be slightly higher and less volatile than that given by provider B. Which provider would you rather your company chose provider A or provider B?

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[2] NAPF Responsible Investment Guide, May 2013

What do scheme members expect of how their savings are invested?

In both scenarios respondents clearly preferred that their employer choose provider A irrespective of the additional associated cost of the fund. In addition, this result was pretty consistent across the age ranges, gender, religious denomination and employment sectors. Those with a higher level of personal income were on the whole the most favourable towards provider A with for example 70% of those earning over £50k p.a. preferring provider A in scenario B.

> ➢ Given the demographics of most DC pension schemes, should the stewardship expectations of fund managers within the default fund offered to employees be clearly conveyed?

Fig. 12. Scenario A

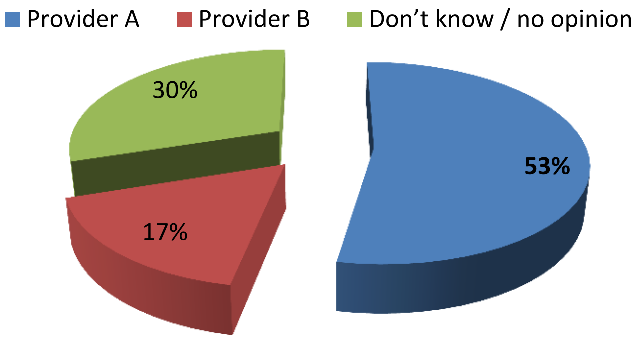
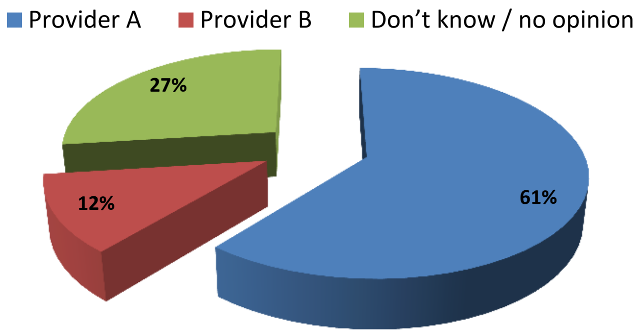


Fig. 13. Scenario B



The most important issues for engagement

If scheme members are interested in both *where* and *how* their savings are invested and would prefer their employer choose a provider which sought to be effective stewards of their savings, we were interested to understand which issues respondents consider are the most important for investors to engage with their investee companies upon.

10. *If the primary fund of your pension provider were taking an active role in the companies they invest in, what do you think are the most important issues for them to consider?*

Understandably the issue considered most important was the recent financial performance of the company (57%) with pay and conditions of employees (36%) and level executive pay (30%) a distance behind.

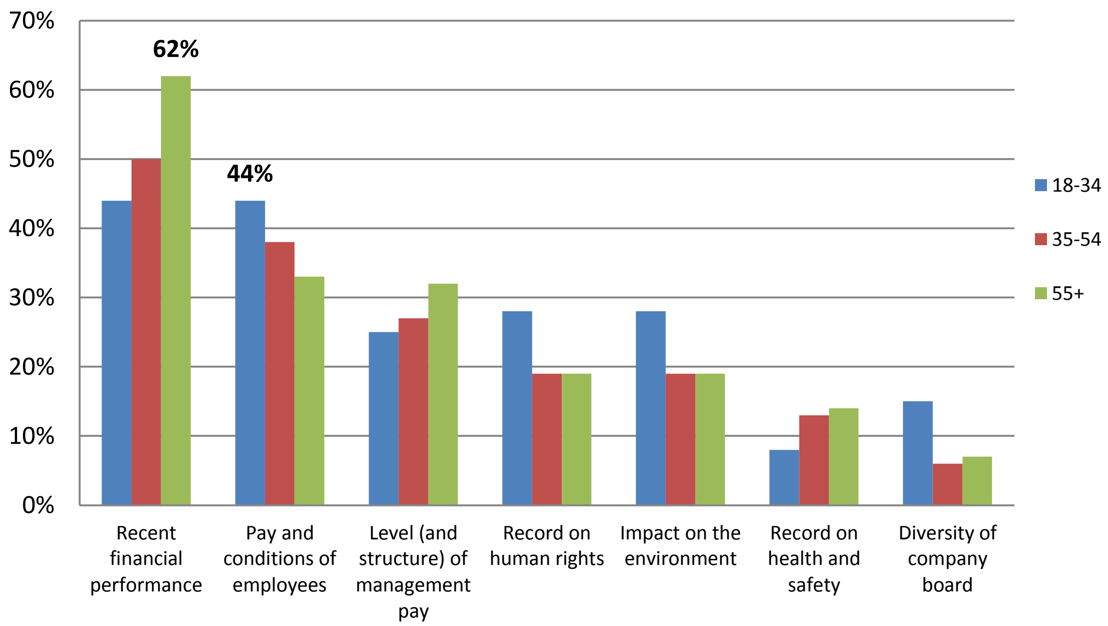
Notably despite the significant attention given to issues of executive pay, diversity and environmental impacts – all of which the NAPF agrees are important and material issues for many companies – these do not on the whole feature very highly for respondents.

Recent financial performance of the company	**57%**
Pay and conditions of employees	**36%**
Level (and structure) of pay for management	**30%**

Worth noting are the relative weightings given to the issues by the younger cohort. It is these employees with whom it is most important to engage with pension saving and whom will also be bearing the investment risk for the longest period of time. Given this context, it is worth noting that amongst 18-34 year olds the issue of pay and conditions of employees is considered on a par with the company's recent financial performance (44%); in addition issues related to human rights and environmental impact are also considered significantly more important than they are amongst the wider population (28%).

- Given the importance of good governance as the cornerstone for good pension provision how should schemes undertake active supervision of the undertaking of stewardship activities?
- Are there opportunities to engage younger savers with pension savings via the tangible impact their savings may be able to bring to bear on issues which they deem important?

Fig. 14. If the primary fund of your pension provider were taking an active role in the companies they invest in, what do you think are the most important issues for them to consider?



Ethical investing

The discussion thus far with respect to the merits and preference for effective stewardship has not been about pension schemes investments 'going greener' but about achieving better outcomes for scheme members. The objective being to decrease investment risk and improve risk-adjusted returns by being engaged owners and thus in turn achieve better outcomes for members.

However, what about considerations that go beyond those that can be quantified or measured? What about those factors which have a moral or ethical dimension? What about preferences for investment objectives which explicitly seek to achieve social and environmental objectives?

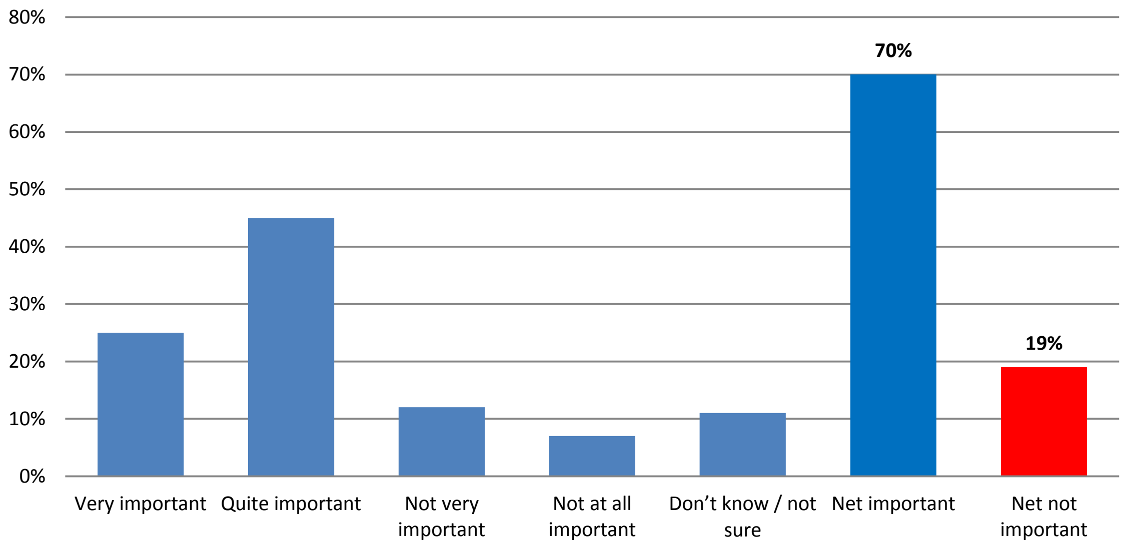
Many of the above would likely have a detrimental impact upon investment returns and thus the cash value of individual's pension pot. As such in terms of fiduciary obligations this is obviously a much more difficult area for those responsible to navigate. Is it sufficient to accommodate these aspects as part of the wider fund range offered to employees?

We sought to explore the preference for ethical investments with respondents. In particular we wished to examine the proportion of individuals that if given a choice would be willing to explicitly accept lower investment-returns for a more 'ethical' investment approach.

In the first instance we asked:

11. *How important or unimportant is it to you that your pension provider uses your money to invest in companies that concentrate on avoiding unethical practices, such as poor working conditions or environmental damage etc*

Fig. 15. How important is it to you that your pension provider uses your money to invest in companies that concentrate on avoiding unethical practices...



The result – 70% suggesting it important to avoid investing in companies with unethical practices – is perhaps not too surprising. After all, at a high level it is easy to agree that it is important to be ethical; the challenge however, comes with attempting to define the specifics of what is and is not deemed ethically acceptable. That said, despite this difficulty, there is evidently a desire amongst respondents that their savings are not invested in the worst offenders, and indeed, for 25% of respondents this aspect is considered very important.

- Given this, is there merit in best-in class tilts or 'worst-offender' screen investment strategies being accommodated within conventional fund offerings?

Ethics or investment returns

In order to test the importance allocated to the ethics of investment decisions respondents were presented with a choice between two providers for their company pension scheme. In the first scenario the choice was between an ethical approach and a conventional approach to investing. In the second scenario the choice was between an ethical approach and a conventional approach but which achieved higher and less volatile returns.

12. *Please imagine that your company could choose one of two different providers for your company pension scheme:*

    The primary fund for Provider A makes a special effort to invest in companies that adhere to ethical practices such as avoiding poor working conditions for employees or whose work has a minimal environmental impact.

    The primary fund for Provider B makes no special effort to invest in companies that adhere to ethical practices. They don't invest in anything illegal but otherwise the ethical practices of companies they invest in are just not a top priority.

    The return on investments (after costs) that each provider gets would be largely the same as each other. Which provider would you rather your company chose provider A or provider B?

13. *Please imagine that your company could choose one of two different providers for your company pension scheme:*

    The primary fund for Provider A makes a special effort to invest in companies that adhere to ethical practices such as avoiding poor working conditions for employees or whose work has a minimal environmental impact.

    The primary fund for Provider B makes no special effort to invest in companies that adhere to ethical practices. They don't invest in anything illegal but otherwise the ethical practices of companies they invest in are just not a top priority.

    The return on investments (after costs) that the fund offered by Provider B gets would probably be higher and less volatile than those that Provider A gets. Which provider would you rather your company chose provider A or provider B?

What do scheme members expect of how their savings are invested?

Reflecting the response to the previous question, in the first scenario 68% suggested that they would prefer their employer chose the pension provider which made a special effort to invest in companies that adhere to ethical practices. However, when an explicit financial trade-off was presented the proportion which would prefer their employer chose provider A dropped to 48% and there was a three-fold increase in the preference for provider B. Interestingly, despite the explicit trade-off inherent in this choice being presented it is still striking that the preference for provider A does still remain significant.

These findings are similar to those drawn out in similar research commissioned by the Defined Contribution Investment Forum[3]. In the DCIF research 77% of respondents favoured a social investment fund over a conventional fund; this preference dropped but still remained high at 44% even when respondents were told that they would receive an 8% smaller pot at retirement.

- Does this apparent willingness to accept a financial trade-off have implications for the investment approach of DC schemes?

Fig. 16. Scenario A

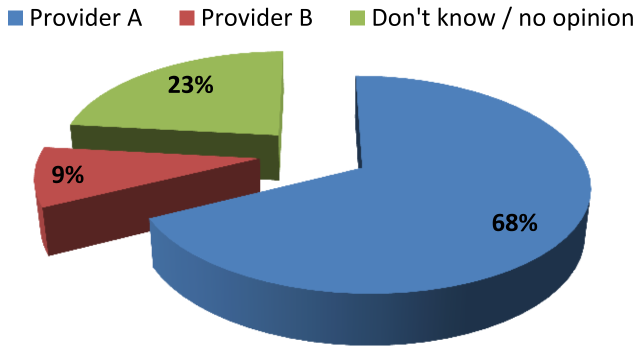
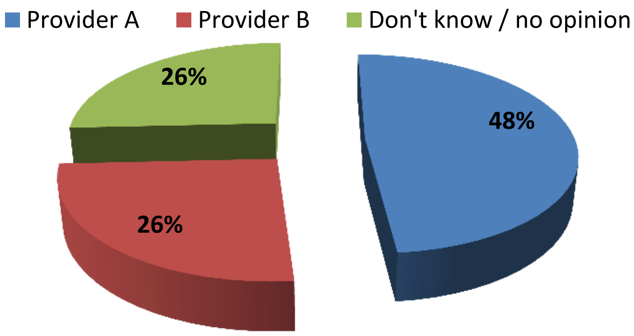


Fig. 17. Scenario B



[3] DCIF, Identifying new ways to engage with savers in Defined Contribution Pensions, March 2013

Conclusions

The continued transition of pension provision from DB to DC schemes is continuing at pace. Millions of people will be saving for their retirement due to auto-enrolment.

It is critical that people are being enrolled into pension schemes that provide value for money and are equipped to deliver good member outcomes. Rightly there has been considerable attention given to the level of costs and charges within DC schemes. However, is there a risk that the definition of 'value' is being too narrowly viewed and is being defined without the input of scheme members?

Across all workplace DC schemes, in excess of 70% of members invest via the default fund. Default funds account for a growing proportion of DC assets and are believed to represent 70% of DC workplace pension scheme assets today and are projected to account for 83% of all DC assets in 10 years. This emphasises the vital importance of ensuring that default funds are appropriately designed and governed to best endeavour to deliver good member outcomes.

Figures from the NAPF Annual Survey suggest that for DC schemes there is an average allocation to equities of 71% in the growth phase of the average default fund. In addition, whilst still relatively immature in scale, the pool of assets within DC workplace pension schemes is growing fast: one estimate is that the total DC assets in default funds today will grow in size by 3.5 times over the next ten years, equivalent to an annual growth rate of 13.5%.

Given the above context, there is self-evidently an opportunity at this still early stage to reflect on the increasing understanding of the benefits of and member preference for adopting a stewardship approach to investing. With increasing risk being borne by individual scheme members, it is right to regularly question whether the interests and preferences of the underlying scheme members – those individuals whose savings are being overseen by trustees, providers and investment managers – are being best served by current arrangements?

The research findings presented within this report suggest that whilst the level of awareness as to how and where pension savings are invested is low, there is a significant latent interest amongst pension scheme members in knowing more about where their savings are invested.

Given that distrust of the pensions industry is commonly the most powerful driver for people opting out of auto enrolment it is important to find a way to engage with new savers. These findings perhaps suggest the benefit in communicating in a holistic fashion with scheme members with reference to *where* and *how* their savings are being invested.

The findings also clearly suggest that a majority of scheme members would prefer, even if it was more expensive, that their employer favoured pension providers with strong stewardship offerings when establishing pension arrangements for their employees.

With an increasing consensus that effective stewardship is a: a) regulatory expectation, b) likely driver of long-term risk-adjusted returns, and c) preference of scheme members, d) contributor to the 'real' value of members' income in retirement there is a need for reflection amongst schemes, providers and indeed policy makers to ensure that this approach is appropriately encouraged and incorporated.

What do scheme members expect of how their savings are invested?

A large minority of respondents also preferred that there employer favoured providers with strong ethical investment credentials even when this may have a detrimental impact upon their investment returns. This poses a wider and perhaps more difficult question for schemes - how do they balance their obligation to act in the best interests of scheme members against a willingness to accept lower investment returns if their savings were invested in an ethical manner? Is the answer the provision of an opt-in fund or are there learnings than should be translated across to the default too?

In conclusion, good governance is the cornerstone for good pension provision. Whilst this has many aspects, one of which is overseeing the actions of investment managers as described in The Pensions Regulator's Code of Practice and the FRC's Stewardship Code. It is hoped that the findings from this research may assist those responsible in thinking through this responsibility by considering what scheme members consider is value for money and in turn what should be considered a good outcome for scheme members and how this should be delivered.

Professor Kay suggested that good practice in fund management naturally leads to stewardship activity; if so, how can this good practice be further fostered in the interests of individual savers?