Rocky roads...

How have DC defaults performed in the volatile markets of 2022?

December 2022

Be a smart cookie and remember our 3 Ds approach to DC investing...

Don't panic...
Carefully consider all your retirement options in view of the changing market conditions and impact on your DC pot

Diversify appropriately...
Especially within the bond portfolio in your default strategy, where duration and regional allocation is impactful

Dynamism...
So the strategy is not locked into a fixed weighting allocation and can adjust when market opportunities materialise

DC pots start to crumble...

DC investors have generally seen favourable market conditions since 2000 with equities delivering positive returns in 15 of the 23 years (to 30th September) and bonds giving positive returns in 17 of the 23 years. In fact, there has only been three years when both asset classes delivered a negative return at the same time, although in 2015 and 2018 both asset classes gave single digit negative returns so the impact on DC members was less impactful than in 2022.

This year the challenge for DC investors has been driven by double digit negative returns from both equities and bonds, with both asset classes losing more than 20% over the year to 30th September 2022. For younger members with a longer time to their retirement date, there is plenty of time for their investments to recover, as indeed we saw in 2020 when the impact of Covid-19 first impacted on markets. However, for older members they have a shorter time horizon and the losses this year are likely to have an impact on the retirement plans of many. Whilst some providers have been able to partially soften the blow, especially those with a more dynamic strategy, our analysis of provider off the shelf default returns for older members suggests that most will have lost in excess of 10% of their DC pot over the last year.

In this paper we compare the different provider off the shelf default returns, as well as suggesting possible actions to take for older members.

In our previous papers we have focused on the 3 D's of DC investing, but primarily with a growth phase focus. This time, we apply the same principles shifting our focus to older members.

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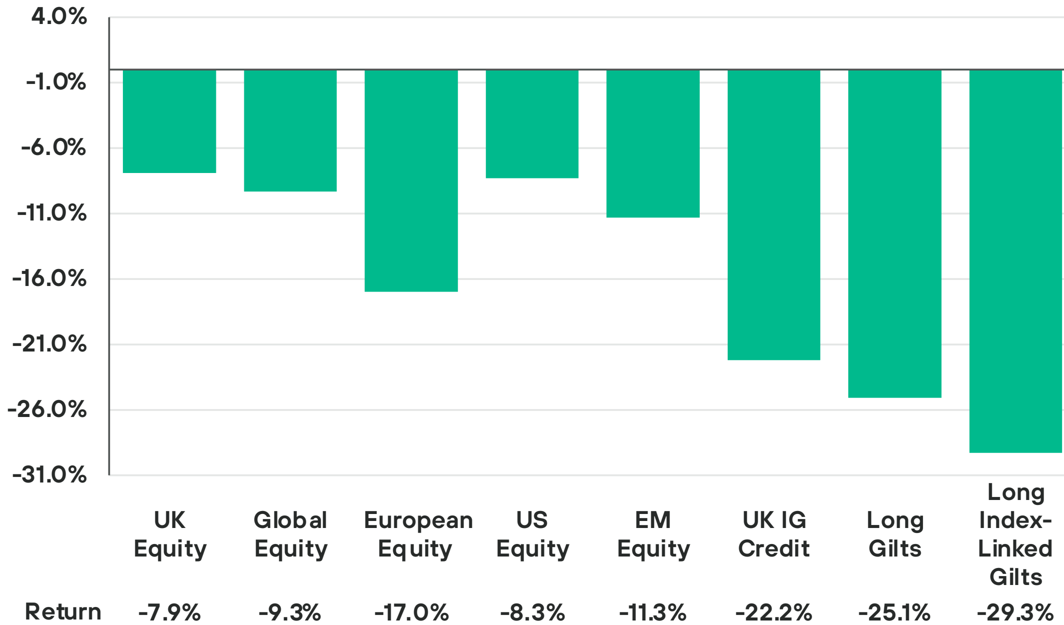
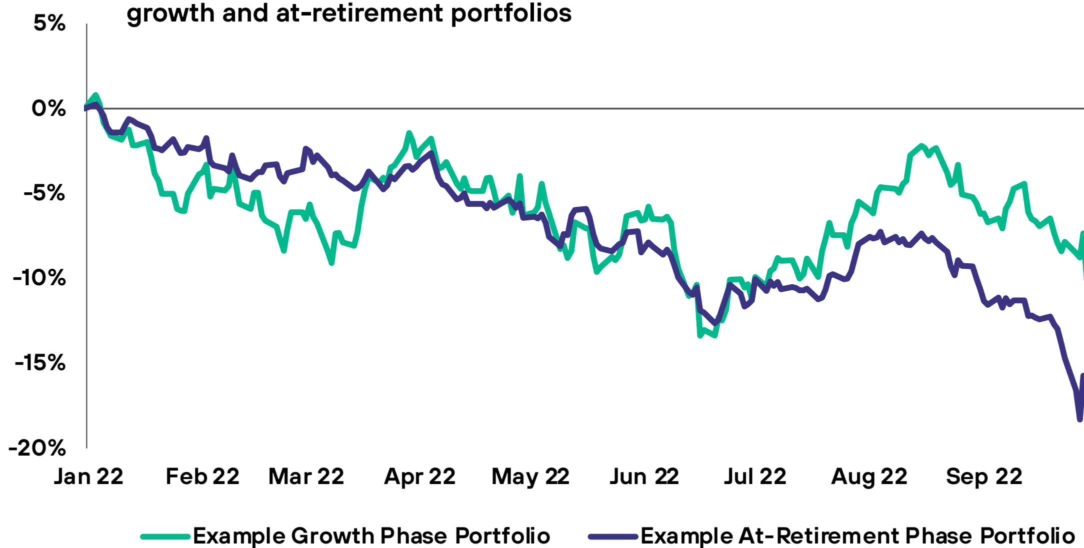
A downward roll





Note: Example growth phase portfolio composed of: 80% Global Equities (FTSE World (£) Index) and 20% Corporate Bonds (FTSE Non-Gilts (All Maturities) Index). Example at-retirement phase portfolio composed of: 25% Global Equities (FTSE World (£) Index), 25% Corporate Bonds (FTSE Non-Gilts (All Maturities) Index), 25% Index-Linked Gilts (FTSE ILG (All Maturities) Index) and 25% Cash (SONIA). Assumes no rebalancing. Gross of fees. Equity returns shown in £ sterling terms (i.e. no currency hedging).
Source: Refinitiv.

Market commentary...

- With all major asset classes delivering negative returns in 2022, there has been nowhere to turn to for DC investors
- The conflict in Ukraine has led to soaring inflation levels, with central banks responding by raising interest rates, with further rate rises expected and a recession being priced in

Growth phase...

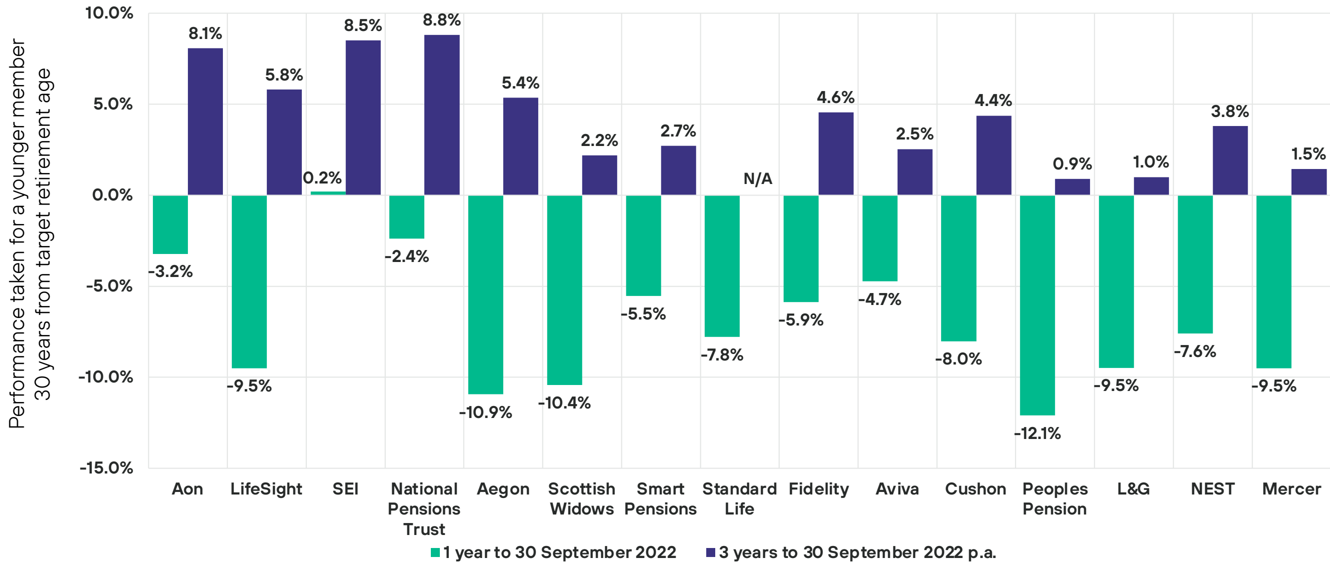
- Younger members some way from their target retirement date, are likely to be invested in equity heavy strategies, with all regions delivering negative returns in 2022 to date with a typical portfolio down by 10%
- Whilst recovery time may be longer than in 2020, younger investors can afford to sit tight and await a recovery in equity markets

At-retirement phase...

- Older investors have a shorter time frame and the greater losses incurred from both equity and bond exposures, will have been detrimental to their DC pot, with a typical portfolio down by around 15% in 2022
- These members may need to review retirement plans and potentially consider deferring retirement or delaying taking any DC benefits in the short term

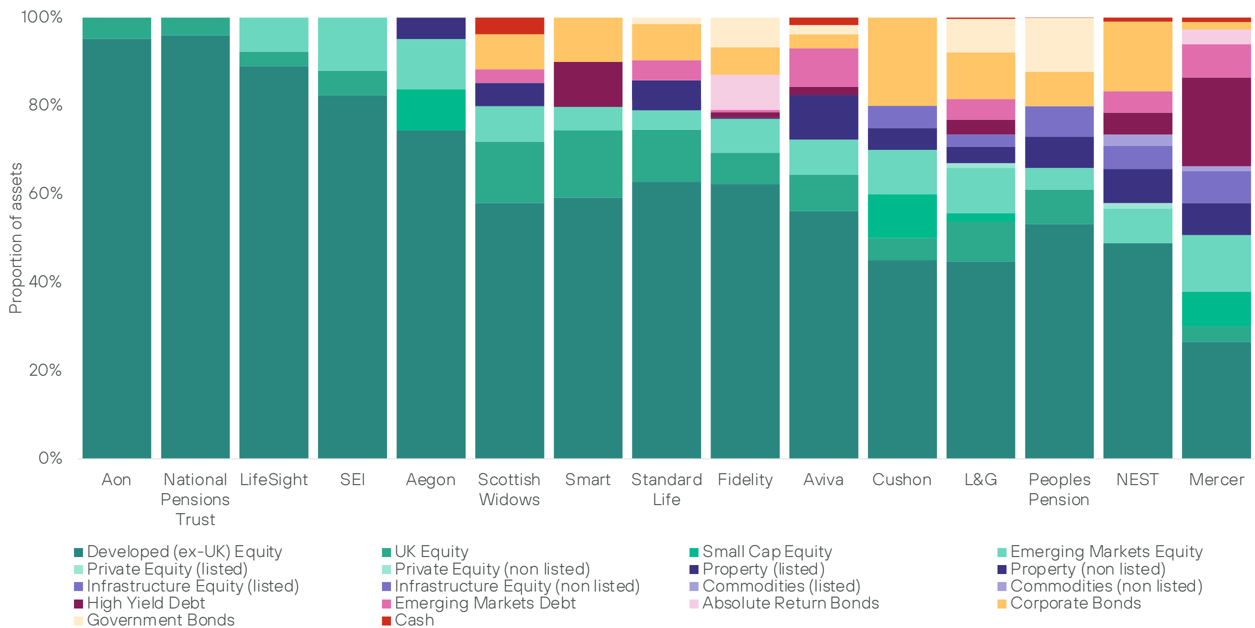
Younger members in the growth phase – 2022 performance

Default growth phase performance to 30 September 2022

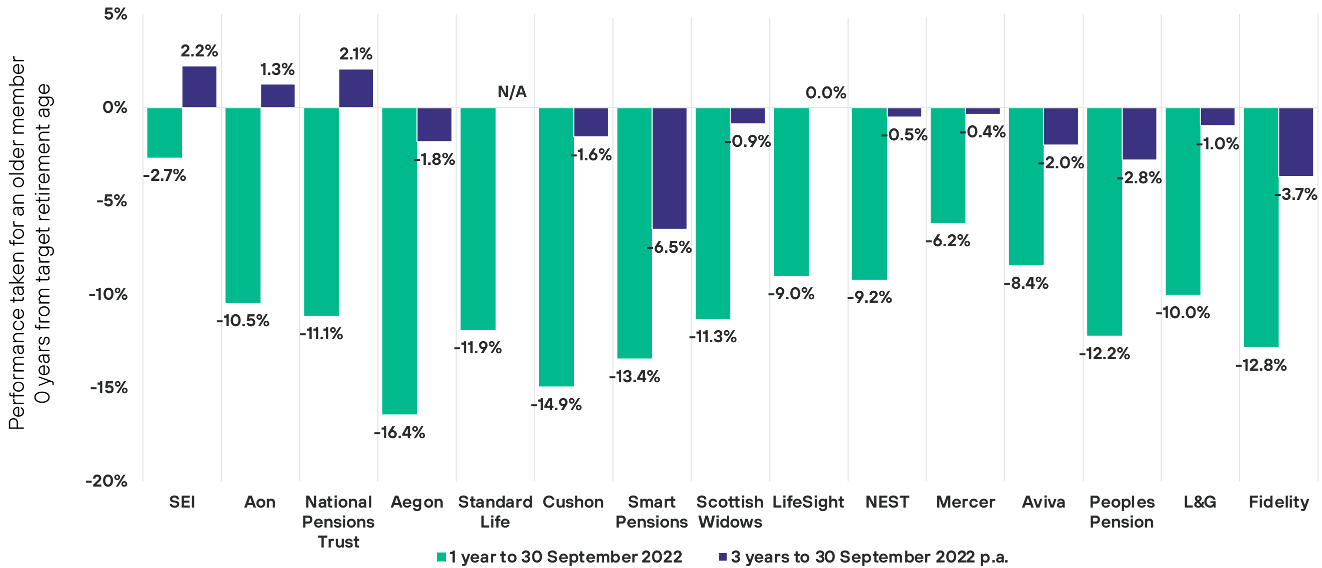


Standard Life strategy does not yet have a 3 year track record

Growth phase - asset allocation



Older members – at retirement performance



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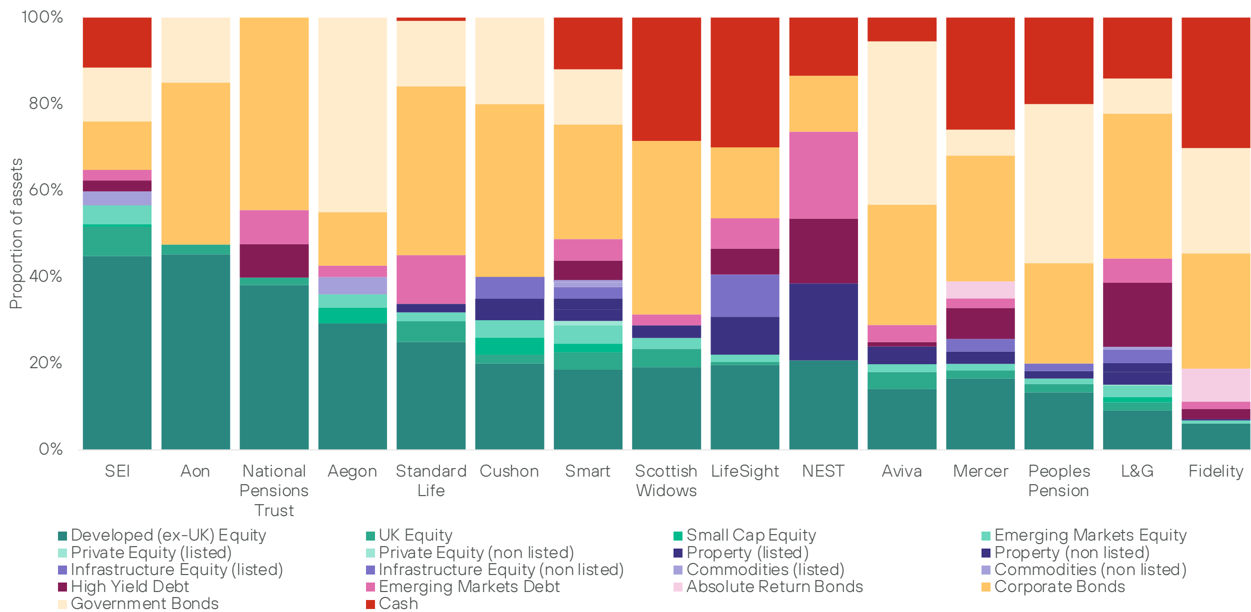
Older members - asset allocation



The proof of the pudding...

Younger members

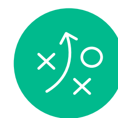
- Over the longer term, providers with pro-equity strategies have continued to deliver better longer term returns, than those with more diverse strategies in the growth phase. However, there is also a more noticeable variation of returns for those providers with all equity strategies and other factors like the level of currency hedging and regional tilts, as well as the degree of ESG integration, have had a more significant impact.
- The challenge for providers with more diverse strategies in the growth phase, is finding asset classes that are not correlated to equity returns but can still give long term returns that keep pace with equity market returns. To date this has been tricky for providers to achieve, although the increased potential for accessing more illiquid markets in the near future could see a change in approach.

Older members

- The bigger issue in 2022 is for older members, where retirement planning might need revisiting. Whilst strategies with greater equity exposure have delivered better longer term returns, over the last year all providers have delivered negative returns across the board. Furthermore, there is greater variance across the provider returns, so it is important to understand the approach your provider adopts in the final few years of investing in their default strategy, especially within the bond portfolio where shorter duration has been beneficial and overseas bond markets have outperformed the UK.

How significant is the exposure to cash in the default?

How are the underlying bond assets invested, especially the duration of the portfolio, the overseas allocation and the impact of any currency hedging taken?

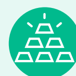


Does the default strategy allow the manager to be dynamic and adjust not just their high level asset allocation but also make adjustments within the bond portfolio?

Crunch time for older members...

- Whilst the problems in 2022 are as a result of challenging market conditions for investors, the reality is that there were few, if any, places for managers to turn to, in order to provide adequate protection to DC members.
- There is no silver bullet strategy that could be implemented and therefore the focus now should be on identifying the cohort of members affected and considering a communication and engagement strategy so they are in a more informed position to make decisions regarding their retirement plans. Each member will be different and guidance and advice should be sought.
- Whilst there have been some early positive signals of recovery in the fourth quarter of 2022, there is the potential for further rocky roads ahead for older DC members as market volatility in the current higher interest rate and rising inflation environment is expected to continue for longer. Suffice to say, the chances of becoming a DC millionaire in 2022 have been pie in the sky for most investors.

Checklist



Investments:

- How your default strategy is invested, and how has it performed?
- Is your provider looking to make changes to investment design as a result of markets?
- Have you reviewed your default strategy recently?

Communications:

- The average DC member may need help understanding why they have seen a fall in the value of their savings
- Make the most of what your provider has to offer but consider if this needs supplementing
- Challenge your provider on what they are telling members on the help-desk

Support:

- Be clear on the member journey 'approaching retirement'
- Do members have access to guidance and advice services? Are they clearly signposted? Do they link in with your broader financial wellbeing strategy and benefits?

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Data sources: DC Providers, Refinitiv, Isio calculations.

Returns shown gross of fees and may be estimated / based on unaudited values.

Past performance is not a guide to future returns.

We have used the following strategies and providers when compiling this report:

Aegon BlackRock LifePath Flexi
Aon Managed Core Retirement Pathway
Aviva My Future Focus
Cushon Sustainable Investment Strategy
Fidelity FutureWise
L&G Target Date Funds
LifeSight Medium Risk Target Drawdown
Mercer Smartpath Target Retirement Drawdown
NEST Retirement Funds
Scottish Widows Balanced (Targeting Flexible Access)
SEI Flexi Default Option
Smart Pensions Growth Moderate
Standard Life Sustainable Multi Asset Strategy
The People's Pension – Balanced Profile
XPS NPT Life Stage

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