

Media Comments 2010

David Blake, director of the Pensions Institute at City University's Cass Business School, assesses contract-based DC pensions investment as 2012's reforms approach. Jenny Keefe reports for *Employee Benefits Magazine*, February 2010

Contract-based defined contribution (DC) pension schemes are the pensions equivalent of Ugg boots - they are loved and loathed in equal measure. In the UK, DC schemes are managed in two ways. They are either trust-based, where the employer provides a trust to represent employees' interests, or contract-based, where employees deal directly with the pensions provider and make their own investment decisions.

Contract-based schemes are cheap and easy to run, but many believe they have a downside because there are no trustees to protect members' interests. David Blake, director of the Pensions Institute at City University's Cass Business School, says: "The most important issue with contract-based DC pensions relates to governance. Trust-based schemes have a trustee board, which does all the due diligence work on key aspects of scheme design.

"Trustees pick appropriate minimum contribution rates and decide the range of retirement income options. They make asset allocation decisions, deciding how much will be in equities and how much in cash, and they choose the specialist investment advisers to carry it all out. Contract-based schemes do not have a board of trustees to provide such good governance.

"There is just the general impression that the default investment funds are not well designed to achieve their required purpose: a good-value retirement income for money that has been invested for so long."

Trustees not investment advisers

Of course, trustees, many of whom are employees, are not investment advisers. This raises the question of whether it would be better for staff to save on administration fees and just give the cash to an insurance company to manage through a contract based scheme. "If significant contributions from both employer and employee are going to be invested over 40 years, then it pays to get an appropriate, dynamic investment policy in place," says Blake.

He concedes that "trustees do not have the skills to do this", and says it is worth appointing a good investment consultant.

When choosing between trust- and contract-based schemes, much depends on an organisation's size, says Blake. "Small employers with low governance budgets will find it easier to hand the contributions over to an insurance company, especially if employees are not sufficiently interested to become trustees. It is this situation the National Employment Savings Trust (Nest) [formerly known as personal accounts] is intended to deal with.

"Larger employers with a workforce more interested in pensions might go down the trust-based route. The future, however, could be Nest for small employers and trust-based DC schemes for larger employers." Nest is due to be introduced in 2012 as part of the government's pension reforms, which will also see the introduction of auto-enrolment, and compulsory employer and staff contributions.

Feeling the economic pinch

Like other investments, contract-based schemes are still feeling the economic pinch. "Very few investment assets have done well in the recession," says Blake. "Equities led the way with falls of more than 25%. Yet, where the default fund in a contract-based scheme was an insurance company's managed fund, which, typically, has a significant holding in bonds, this might have fallen less than funds with heavier equity weightings. But where the managed fund had a large holding in bank bonds, these would have performed badly, too."

Some employers have encountered criticism that they have used the absence of trustees to cut their contribution rates to contract-based schemes. But Blake has not seen any evidence of this. "It is more likely that employer contributions were not that high in the first place," he says. "Employers do not currently have to contribute to stakeholder pension schemes."

Governance is not the only issue bothering Blake. "There is also the general impression that, with contract DC schemes, everything is commission-driven on the part of providers," he says.

New FSA rules

But new rules proposed by the Financial Services Authority (FSA) could knock such practices into shape. The FSA's Retail Distribution Review, published in December last year, could mean consultants and advisers will no longer be able to cash in on commission from sales of group personal pensions (GPP), stakeholder pensions or group self-invested personal pensions (Sipps). The new rules will come into effect by the end of 2012.

"The FSA is proposing to end commission and replace it with fees for advice," says Blake. "It is likely the greater transparency this will bring will result in fee income being lower than total commission over the life of a typical scheme. Given that contract-based schemes come under the auspices of the FSA, this is likely to lead to advisers being much less willing to market the schemes."

Which brings us to Nest. Under the new system, employers will be obliged to enrol staff into a company scheme or open a Nest, to which they both must contribute. Significantly, the new schemes will be trust-based, run by not-for-profit trustee body, the Nest Corporation. "The Personal Accounts Delivery Authority is, in a sense, the predecessor to the trustee board," says Blake. "It is putting a lot of effort into good governance planning, for example design of the default fund, which 90% of members are expected to adopt."

Need to increase take-up

"The government has learned some lessons from the poor take-up of stakeholder schemes. The most important of these is the need for auto-enrolment to increase take-up. If auto-enrolment fails because employers encourage employees to drop out, then the only remaining solution is mandatory participation. Even then, the 8% combined minimum contribution into Nest is not going to generate that big a pension in retirement above the state pension, especially when means testing could leave a number of people with little additional net benefit from their additional pension savings."

So the introduction of Nest could mean contract-based plans are on the way out. "The new accounts will be trust-based, so auto-enrolment into these will do little to improve the share of contract-based schemes in the future," says Blake.

He adds the new pension contribution limits for high earners could result in fewer contract-based schemes because staff on high incomes are less likely to be in this type of plan. "The importance of DC plans will continue to increase as [employers] move away from defined benefit provision. But contract-based DC schemes are likely to decline relative to trust-based DC plans."

Blake's top tips for contract-based DC pension investment

- Look long term. Remember that a pension scheme can last for more than 70 years: 40 years of contributing and 30 years of providing income.
- Bolster governance. Review the scheme's governance arrangements. Is it possible to introduce the equivalent of a trustee board to oversee investment performance and other issues?
- Add up contributions. Regularly review both employer and employee contributions to ensure workers are amassing enough to fund their retirement. Consider future investment returns and changes in members' life expectancy.
- Ditch dud defaults. Make sure the default investment fund offers decent returns without excessive risk.
- Keep a balance. Ensure the default fund shifts to lower-risk asset investments as employees come up to the age at which they want to retire.
- Earn extra income. Make sure workers have access to a range of annuities, including joint-life annuities for those with a partner and impaired-life annuities for people with a health condition. Encourage employees to shop around before buying an annuity.

Admin woes will distract from NEST investment strategy, *Professional Pensions*, By Emma Dunkley, 29 Jan 2010

The "administrative nightmare" of auto-enrolment into National Employment Savings Trust will divert necessary attention from the scheme's investment strategy, the Pensions Institute warns.

Director professor David Blake said keeping track of contributions for migrant and casual workers will be a major challenge for NEST Corporation and it could face problems managing cash flows.

He said: "Think of the problem of dealing with seasonal farm workers living in tents and moving every few weeks to another job. Think what would happen if there was a slight mistyping of their name or National Insurance number when this happened."

He added: "Tim Jones will be concerned to ensure that the money collected is properly allocated to each member's account. He will be far less concerned with investment strategy and stock market movements - the biggest problem will be losing track of cash flows."

A number of people previously recommended collecting contributions for NEST through the National Insurance system, however Blake said the government knew it could not cope with this degree of transactional frequency.

He added: "That's why the government went for a private sector solution."

Blake said PADA also wanted the default fund in auto-enrolment to be fairly low risk in the early years, in order to avoid any reputation damage if there are big falls in the value of members' accounts.

A PADA spokesman said: "PADA is very much focused on achieving excellence for both the administration and the investment strategy."

Genuine active managers can add value, By Marcus Whitehead, *FTfm*, January 10, 2010

Within the investment management industry there is the eternal question – does [active management add value](#)? To better inform the debate, I have reviewed the latest academic research in this area from both sides of the Atlantic and come to some interesting conclusions: passive is rational, closet indexing is not and unconstrained active may just be where the skill is.

The investment market rings with the Financial Services Authority's risk warning that past performance is not a guide to the future. Despite this there is a strong perception that in making decisions to hire and fire investment managers many pension schemes are strongly influenced by past performance – good or bad, and that this can lead to manager changes that add little to performance and in fact can be outright detrimental.

Research on decisions by more than 2,000 UK pension schemes over a 20-year period by [Blake, Timmermann, Tonks and Wermers](http://www.pensions-institute.org/workingpapers/wp0914.pdf) (<http://www.pensions-institute.org/workingpapers/wp0914.pdf>) in 2009 suggests managers were typically fired having significantly underperformed a UK equity benchmark, managers were appointed having recently outperformed the benchmark and that both the fired and hired investment managers produced returns broadly in line with the benchmark index after the change – that is they both performed in line with an index tracker.

A study by [Goyal and Wahal](#) in 2008 looked into similar hiring and firing decisions by US plan sponsors. It showed US equity managers were typically fired for poor performance and hired after significant outperformance. As in the UK, the outperforming manager, once appointed, typically produced returns broadly in line with the index. The fired manager proceeded to outperform the benchmark in the period after their removal.

This leaves us to conclude that pension schemes have failed to consistently add value when changing investment managers. But can active equity managers add value for pension schemes in the first place?

Research into more than 700 pooled funds available to UK pension schemes over a 25-year period by Clare, Cuthbertson and Nitzsche in 2009 found there was little evidence the managers studied could outperform their benchmark index. They also studied “performance persistence”, – whether a manager outperforming in one period tended to outperform in the following period – again they found little evidence of persistence.

A further piece of research comes from the US by Busse, Goyal and Wahal, in 2008 where more than 4,000 US institutional equity funds were analysed over a 16-year period. They found no evidence of manager outperformance on average and also no evidence of performance persistence.

Therefore it seems rational for many UK pension schemes to select a passive manager, as the average equity manager has not exhibited skill and schemes have struggled to identify outperforming managers, despite being strongly influenced by past performance.

However, the academics seemed to bemoan the lack of depth in the data they had available, as they were working off little more than quarterly investment performance data. To dig deeper, we have to look to retail investment funds and in the US, in particular, where these funds must disclose full portfolio holdings on a quarterly basis.

Research into US equity retail funds by [Cremers and Petajisto](#) in 2009 used data on more than 2,500 funds over a 24-year period. They analysed the concept of “active share”, which is the proportion of a manager’s portfolio that does not overlap with the benchmark index. They define a closet indexer as a manager with an active share of less than 60 per cent. They found that managers with a high active share, the concentrated stock pickers, significantly outperformed the closet indexers. They also investigated past performance alongside a manager’s active share, and found outperforming managers with a high active share showed strong performance persistence.

So have we found the Holy Grail – pick top performing managers with a high active share? As ever, there are lies, damn lies and statistics and one piece of research is not an irrefutable proof. However, for investors committed to active management, the message is clear that closet indexers should be avoided and the focus should be on genuine active managers.

Marcus Whitehead is a partner of Barnett Waddingham LLP