

Defined Contribution Pension – Investment Services

We believe that all Defined Contribution (DC) pension plans, whether they are Trust based or Contract based, should be reviewed on a regular basis to ensure they remain modern, attractive, offer good value and make the best use of new technology and developments. Many industry bodies are now pushing for good governance on all DC pension plans even though it is only occupational trust based schemes that require it.

When reviewing DC pension investment options we do not believe that one size fits all. We understand that there is rarely a 'blank sheet' to start from and that any investment review, particularly where pensions are concerned, must recognise the long-term; changing investment options on a regular basis will lead to scepticism from members.

Appetite for Risk

A loss on paper is very different to a loss in real terms so when 'risk' or 'willingness to accept loss' are discussed it is important to ensure that they are put into context. For most members this is a long-term investment, which cannot be accessed until the minimum age (55). Changing patterns of retirement and the possible deferral of compulsory annuitisation will mean that some will leave their pension un-drawn beyond the date they cease to receive a full-time income. Individuals should consider accepting volatility in their pension plan and short term losses. We use a number of tools and questionnaires to help evaluate a member's attitude to risk.

Active versus Passive

We believe that both active and passive investment management styles have a role to play in a well diversified DC pension. Extra governance is required to ensure active managers are performing in line with their benchmark or if not, to ensure they have good reasons for the short term under-performance. There are many good active managers out there; but there are also plenty of poor ones.

We believe certain asset classes and markets are more suited to an actively managed strategy and concentrate our research on those areas. As well as our own in house research, we also draw on the expertise of external consultants and researchers. This allows us to keep up to date with recent market developments without the large overheads attributed to an in house research team.



Default Funds – help or hindrance?

Across the broad spectrum of defined contribution plans, the one thing in common is that the majority of members invest in the default fund. Whilst most default funds comprise a multi-asset fund with a lifestyle switching profile, we believe that people 'choose' this fund as they see it as implicit advice. We have received numerous comments to support this from members of defined contribution plans and it has been the subject of many academic reviews.

We do not believe that a default fund can be appropriate for the overwhelming majority of members. Ideally each member would seek independent financial advice and review their strategy each and every year. We know however that this will not happen.

Investor Psychology – increasing engagement

We are aware that many members may not have made investment decisions before. Through our experience and research we also understand that making investment decisions is not straightforward. As well as the technical difficulties involved with analysing the vast array of data and options available, there are also several behavioural traits which hamper good investment decisions. There are lots of studies which demonstrate this but below we have provided a summary of the main obstacles and behavioural challenges:

Choice and Information overload

- More choice is not always better. Studies suggest that offering too many options can cause the opposite of the desired effect and more people opt to use 'default' options.

Unstable and undefined preferences

- Individuals who do make choices, do not apply their logic consistently. For example, individual preferences to risk and time vary depending on the decision to be made.

Rules of Thumb

- To help solve complex problems, individuals tend to use several shortcuts or rules of thumb. Some rules of thumb work well but guidance is required to ensure individuals understand and use them correctly.

'Framing' effects

- Individuals are swayed by the way information is presented to them. It is particularly important to bear this in mind when, for example, presenting a range of investment options.

Procrastination and Inertia

- Individuals have a tendency to keep things as they are and put things off till tomorrow. Members should have the ability and confidence to follow through with investment decisions quickly and efficiently.

Overconfidence

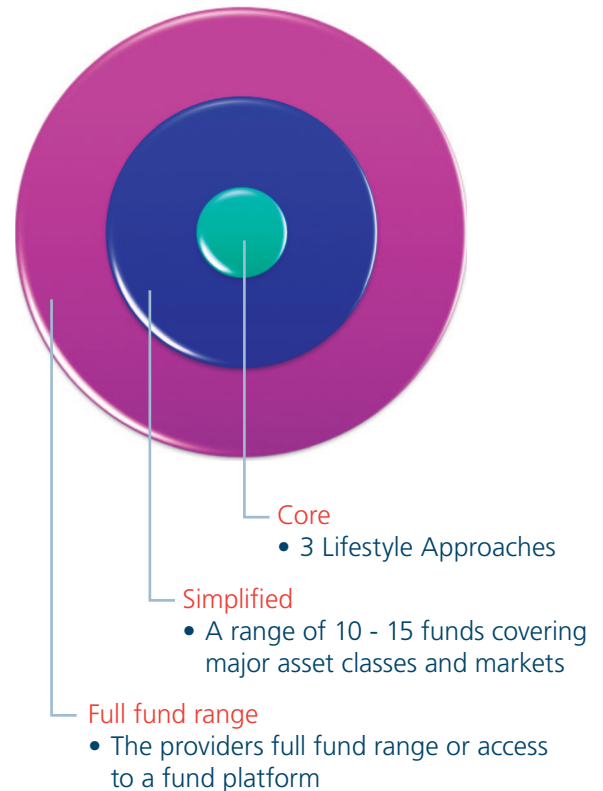
- Some individuals overestimate their knowledge, abilities and the precision of their information; which tends to lead to higher risk taking.

By bearing these challenges in mind when designing communication literature, many can be overcome or the effects of them diluted.

Tapia, W. And J. Yermo (2007), "Implications of Behavioural Economics for Mandatory Individual Account Pension Systems", OECD Working Papers on Insurance and Private Pensions, No. 11, OECD Publishing.

Investment options – our approach

All individuals will have a different level of financial sophistication. Some individuals will want to review the full fund range, whilst others will want a filtered view. This can easily be achieved by using a three stage approach.



Investment options

Our approach concentrates on the presentation of choice. By presenting a range of lifestyle options rather than one, and providing a simple questionnaire to help members choose the lifestyle option that best fits their risk preferences, we find that the concentration of investment is spread. We believe this approach has two main benefits;

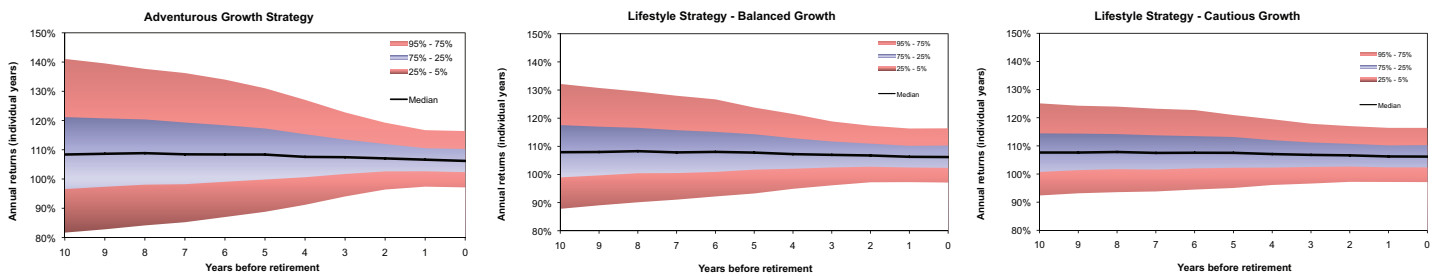
1. Member involvement in the decision making process is increased and this is likely to encourage them to read further investment and pension literature.
2. It protects the trustees or scheme sponsor from having a large concentration in a single investment option.

Typically we establish three lifestyle profiles termed cautious, balanced and adventurous. We generally recommend that these consist of passively managed funds because those people that are attracted to a lifestyle approach are less likely to actively review their investment decisions.

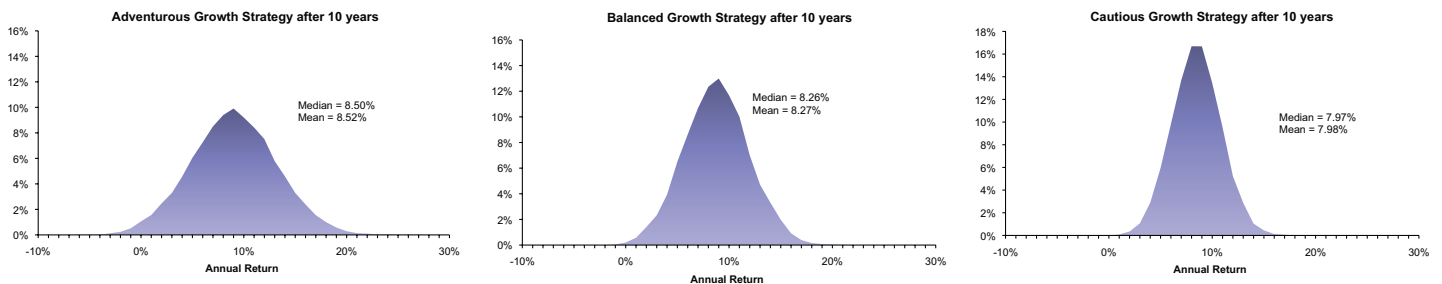
Investment options – Core

A questionnaire consisting of around 10 questions is part of the application process and based on the answers to these questions the member can select the lifestyle profile that best fits their attitude to risk.

We use our in house asset risk modeller, BWarm (Barnett Waddingham Asset Risk Modeller), to assist in the design of these lifestyle profiles with an emphasis on suitable asset allocations and lifestyle switching periods using the range of funds available and taking into account any system constraints. The charts below are an example of the output produced and identify the need for member education:



Graphs showing the distributions of return at retirement, after 10 years (equivalent to the spread of returns at retirement on the graphs above)

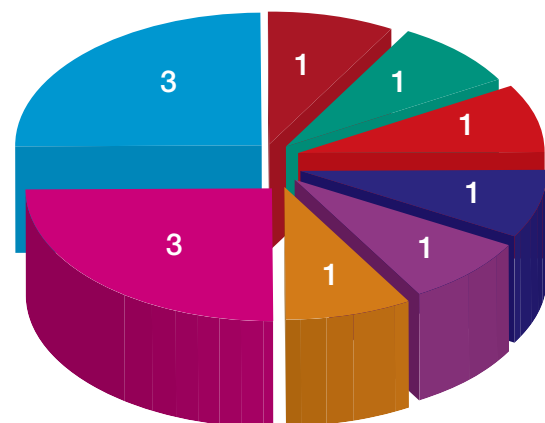


Investment options – Simplified range

We find this is commonplace in occupational schemes where the trustees wish to restrict the fund range to a manageable and governable level. Looking at the wide range of funds that are usually available, we discuss any scheme specific requirements before making any recommendations. We also draw on external fund rating agencies that many DC providers utilise, such as OBSR, Morningstar and S&P. Our view is that there is no point in re-inventing the wheel!

We believe that a range of around 10 - 15 funds covering the major asset classes and markets, using active and passive options, is ideal.

Total number of funds by Asset Class



- Cash
- UK Gilt
- UK Fixed Interest
- UK Index Linked Gilt
- Global Fixed Interest
- Property
- UK Equity
- Global Equity

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Employee Benefits

Investment options – Full fund range

Where individuals are provided with access to the full range of funds available, easy access to up to date, comprehensible information is a necessity. The ability to switch between funds readily and securely is a must, whether this is executed by an individual or a trustee.

We can assist with the review of investment platforms to ensure that there is an appropriate range of funds, that the price is competitive and that the administration platform that sits alongside the investment platform is robust.

New Strategies

There are a number of new strategies that are slowly gaining ground in the DC world such as Target Return, Diversified Growth, Target Dated and Ethical funds.

Many of these are widely used in Defined Benefit and private client investment practises but they are now becoming increasingly popular in DC pensions. There are also some innovative investment propositions from certain providers that are trying to compete with the dominance of the traditional 'lifestyle' funds.

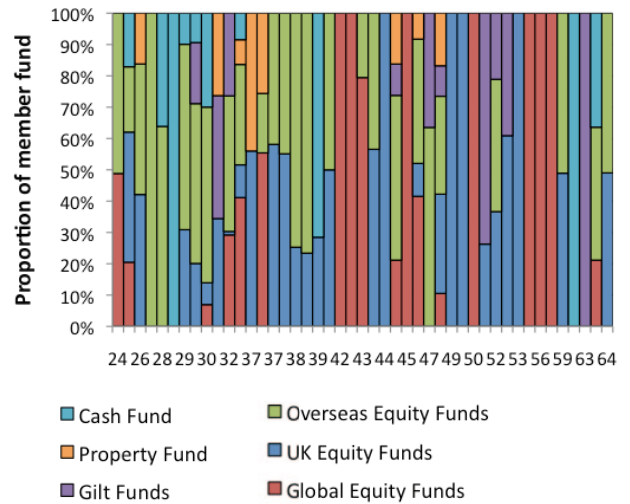
Through our ongoing research we keep up to date with these developments and are able to discuss whether they are suitable to be introduced for a DC scheme

Governance and Monitoring

We monitor fund performance against the appropriate benchmark(s) and report back to the trustees or scheme sponsors as agreed. Our appraisal will take into consideration the long term nature of pension investments but where appropriate query short term underperformance with the investment managers. Particularly over recent periods, investment funds have been particularly volatile and an actively managed fund can easily move from 1st quartile to 4th quartile over a short period of time. This does not concern us provided the manager has a strategy and has not deviated from his beliefs, commitments or the remit of the fund. Obviously, if a manager underperforms over a longer term then this could be cause for a review.

As well as monitoring funds, we believe it is important to review member activity. This allows us to determine the level of involvement of members, identify any trends and spot any potential issues or misunderstandings. One such area we review is the asset allocation or fund choice of members at various ages. You can see from the chart above that three members in their 50's are entirely invested in Global Equity Funds and one member in their 20's is in a Cash Fund. These could be as a result of conscious decisions by the members and a short term position, however by reviewing the investment movements we can identify the trends.

Each bar corresponds to one non-lifestyle member. The number below the bar is the member's age.



We offer the full range of Investment Consultancy services to all types of pension arrangement. We do not have a standard approach and will work with you to meet your needs and requirements. We are always open about fees and will quote a budget for any project or ongoing services.

For further information

For more information about our investment services please contact your usual Barnett Waddingham contact or email: employeebenefits@barnett-waddingham.co.uk

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