Charted territory

Kevin Openshaw, Milestone Group, on what the UK can learn from the Australian experience of switching to DC, as it goes down the same road

In a nutshell

- Australia has enjoyed pension freedom for decades, so it is instructive to look at its experience for what to expect for the UK
- there will be a sharp rise in the number and diversity of funds in the marketplace
- pension providers are going to have to do more with less to survive through leveraging specialised funds processing technology.

It is no secret that the UK pensions market is on the precipice of a major transformation. The seismic shift from defined benefit (DB) to defined contribution (DC) schemes continues unabated, accelerated by ongoing initiatives such the introduction of auto-enrolment, around which the dust is still settling. Added to this is the government's overhaul of the annuities market, introduced via sweeping reforms that took effect in April. Retirees now find themselves with far more freedom and choice regarding how they can access their retirement pot.

New as all this may be to the UK's green and pleasant shores, it is not uncharted territory. Australia, in particular, has journeyed down a similar path. Once weighted in favour of DB solutions (much like the UK more recently), now approximately 90% of the assets within its pension system are in DC plans. Radical as our annuity reforms may seem to us, Australian workers have enjoyed similar freedoms for decades.

As the UK market braces itself for change, it is instructive to look to antipodean experience for guidance and insight into how the market will evolve in response, and the challenges that may arise.

A more diverse ecosystem

First, it is important to recognise the fundamental change that the transition to DC represents for the marketplace and the nature of pensions more generally. At heart, the transition from large asset pots that are not tied to any individual investor, to many smaller asset pots linked and tailored to individuals and their needs and preferences (even though these smaller pots will typically be managed together). It also represents a fundamental transfer of investment risk away from the employer to the employee.

On the basis of Australian experience, a number of consequences are likely to flow from this. First, we will see (and are starting to see) a sharp rise in both the number and the diversity of funds in the marketplace, as providers scramble to create solutions that provide members with a range of options (including appropriate default schemes), tailored to a variety of risk-reward profiles. The removal of compulsory annuitisation will shift the focus of providers from providing an outcome at the retirement date to providing an outcome throughout the retirement period, considering their members' potential post-retirement needs. This will create demand not just for target date funds (TDFs), which aim for an outcome at retirement, of which we are already seeing an influx – but for whole of life fund solutions.

Similarly, the drive to deliver a more diverse set of outcomes in the UK will lead to an increased reliance on complex, hierarchical "fund of fund" structures, as master trusts and larger trust based DC schemes seek to farm out fragments of their portfolio to "best of breed" managers covering certain asset classes, sectors, regions and so on. The Australian experience suggests that as asset distributions across portfolios become homogenised over time, the ability to boast the "best" managers able to deliver returns will become a key differentiator, as providers flock to market new funds and solutions to trustees and pension schemes. The big challenge here for the master funds and large DC schemes will be the complexity involved in taking all these allocations and then blending them together in different ways to provide appropriate solutions for members.

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Another way in which the changes will probably affect the funds landscape is through a proliferation of master trust schemes, designed to allow smaller employers to bypass the headache of setting up their own solutions. Around 15 new such schemes have popped up over the past nine months in the UK; many more will follow. We are also starting to follow Australia in the creation of large funds capable of delivering scaled solutions for particular population segments with common lifestyles and needs, eg maritime workers, hairdressers.

A focus on fees

We can also expect (and, again, are already starting to see) a new found focus on fees, both in terms of their level and transparency. Since the shift to DC transfers risk to the employer, and fees now essentially represent a reduction in one's retirement pot, the issue will become highly politicised. UK schemes are already under intense pressure to "do more for less" and this will only intensify. This applies especially at the level of default schemes, where the government has, of course, already introduced a fee cap of 75 basis points. Delivering adequate DC outcomes within these confines is a tough challenge, but it can be done: some of Australia's superfunds are currently operating within 50 basis points, yet there is still a wide spectrum of fees. We could well see the mandatory cap come down further in future, no small challenge given that in the UK's far larger pensions space just one or two basis points equate to a lot of money.

For the Australian experience, there are different cost drivers at play. Significantly, the larger funds that have traditionally outsourced their investment management are now taking elements of this in house where they can source skills and technologies. This allows them to blend internally managed asset classes with outsourced investment management for asset classes such as alternatives and private markets, where specialist skills are needed. While overall this is having a positive downward effect on member fees, the politicisation of retirement savings as a government agenda continues to exert cost pressures through political tinkering with regulation and governance.

Additionally, tax issues around members contributing and withdrawing money from their pots will also likely shift into focus. Australia has tweaked its own tax rules in this area a number of times during and after its own transition, and we can potentially expect similar tinkering here in the UK.

New risks, new complexities

Another lesson to learn lies in the way the switch from DB to DC fundamentally cranks the complexity of fund management up a notch, in the way it introduces new risks and factors to consider.

First, we are fast approaching an era of higher liquidity risk. Managing accumulations is a very different (and far simpler) ball game than managing drawdowns, yet as with Australia we are approaching a demographic inflection point whereby the latter activity will come to dominate.

Second, DC plans, especially those realised in TDFs, face the thorny issue of sequencing risk. Traditional TDFs operate according to fixed "glide paths", where at certain points, for example, higher risk assets (such as equities) will be sold and lower risk assets (such as bonds) brought in as a replacement. The challenge here is that the success of a "blind" glide path will depend to a large (and arbitrary) extent on the timing of external market conditions. If an investor's fund happens to sell out of equities and into bonds just after a major market crash, the investor will lose out, and unfairly so. In Australia and the US, this has led to the creation of customised or dynamically managed TDFs, where managers have leeway to make judgment calls around the timing of these phases to minimise this risk. We will probably see the same in the UK, and this just means more added complexity.

Openshaw new landscape

Then there is the issue of longevity risk. As people continue to live longer, the shift to DC creates the danger that a member's asset pot on retirement will not be enough to see them through. This raises the prospect of reinvestment and post-retirement solutions, but predicting an appropriate investment path for a 65 year old is far more complex than doing the same for a 20 year old. The remaining lifespan is far more uncertain and far more vulnerable to unpredictable health events, for instance.

This risk will only be exacerbated by the new drawdown rules. Indeed, much of the controversy around the reforms in the press at the time of announcement centred on the danger of retirees immediately "cashing in" their pot for short term or frivolous needs, such as a new car or house, only to find themselves without an adequate income later in life and having to reinvest into the system.

Interestingly, Australia encountered the same difficulty during its own journey, with a similarly liberal system in place from the outset. It has since started to move in the opposite direction, tightening rules and placing more restrictions on when and how members can access their pots. It is quite possible that the UK will similarly tack back from its newly liberal system over time. The issue will only really come to a head as the next generation approaches retirement, as many in the current generation still have DB pots.

Technology – the magic sauce

Ultimately, what should trustees and fund managers take from all this? The overarching message from the Australian experience is twofold: complexity is coming; and funds will need to do far more, with far less.

At first glance, this presents a major dilemma for UK schemes. On the one hand, meeting the demands of the new marketplace will require a step change in the complexity of their operations. On the other, they will need to significantly reduce (or at least keep stable) costs to keep fees low. You do not need to be a genius to see the inherent tension between these two objectives.

However, there is a way to square the circle: technology provides the magic sauce. A large factor in Australia's ability to adapt and transition was down to pursuing extensive systems reviews early on. They were intended to ensure that the investment administration systems schemes had in place were capable of managing the new found complexity, while at the same time reducing costs.

Flexibility and automation are crucial here. Glide paths, diversified growth funds, funds of funds, dynamically managed TDFs, post-retirement solutions – all these new beasts set to inhabit the new DC landscape will drive operational complexity beyond the coping limit and flexibility of most systems in use today.

Attempting to adequately accommodate this increased complexity and need for flexibility, without the help of more contemporary automation, will inevitably lead to ballooning costs and make it very difficult for a scheme to offer competitive fees (and nigh on impossible to get within anything like a 75 basis point cap). Conversely, an approach that lowers costs but results in a lack of flexibility and inferior solutions will not cut the mustard in the new landscape.

For all the complexity to come, the biggest lesson from Down Under is relatively simple: pension providers are going to have to do more, with less, to survive. They are going to need to ramp up the complexity and flexibility of their operating capability, while also cutting costs. The only realistic way to achieve this is through leveraging specialised funds processing technology.

Kevin Openshaw is head of life, pensions and platform at Milestone Group; kevin.openshaw@milestonegroup.com.au