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INVESTING IN A WORLD OF DEFINED CONTRIBUTION PENSIONS

My wife is a member of an occupational pension scheme. As is the norm, in this day and age, it is a defined contribution (DC) scheme with a set of trustees who have appointed a pension consultant and a pension provider to help them meet all their legal requirements.
The ultimate responsibility for deciding how to invest new contributions and existing assets, like in all DC schemes is left to the member, in this case my wife. Naturally enough she looks to me to help her make this important decision as she (like most nurses) has limited investment knowledge. I of course would like her to invest her pension savings using a Value investing strategy but the range of choices she is given do not allow this.
Here are the choices she is allowed: three different funds or two "lifestyle" strategies. The three funds are as follows:

- Indexed Global Equity Fund
- Consensus Fund
- Capital Protected Fund

The two lifestyle funds are as follows:

- Consensus Lifestyle Investment Strategy
- Personal Lifestyle Strategy

In other words the trustees of this particular scheme have gone completely passive. No active stock picking is offered and this means there is no way of investing using a Value style.
So why is it that the trustees of this scheme have gone for this approach? Having done some research on the issue it appears that the trustees are following a very narrow interpretation of the guidelines set down by the Irish Pension Authority.
On the Pension Authority website (www.pensionauthority.ie) there is a whole section dealing with trustees and this includes a set of guidelines on investment.
The introduction to the guidelines states the following:
The purpose of these guidelines is to assist trustees of defined contribution (DC) pension schemes and their advisers in deciding on the investment choices to be made available to scheme members. This is one of the most important responsibilities that trustees exercise in overseeing pension schemes. Because schemes differ in terms of their membership size and profile (including, for example by reference to age and proximity to retirement) and other features, these guidelines are not prescriptive. Rather it seeks to identify the issues that trustees need to consider from the perspective of helping scheme members to make decisions appropriate to their circumstances and to maximise retirement benefits for a given level of contribution.

The Pension Authority clearly state that "*these guidelines are not prescriptive"*. In other words trustees have to be allowed a certain degree of flexibility in order to "*maximise retirement benefits for a given level of contribution."* The guidelines then go on to describe how they believe maximum retirement benefits can be achieved. This is quite a detailed document and I think the ultimate recommendations they make can be illustrated by the two worked examples they give at the back of the document. (I have included these worked examples in the appendix).
The first worked example is closer to the scheme in the private hospital where my wife is a member. I can imagine that the trustees of her scheme would feel that this applies to their situation: "*Based on their knowledge of the membership, the trustees decided that investment knowledge is relatively low and therefore decided that a smaller number of fund choices is appropriate*."
"With this in mind, the trustees choose the following fund options as being most appropriate for the membership:
• Default – lifestyle fund, de-risking from a managed fund (split circa 50/50 between equities and bonds) to 100% cash
• Cash
• Fixed interest
• Managed fund split circa 50/50 between equities and bonds
• Equity"

Telling trustees that an "Equity" fund should be a choice available to members of the scheme without defining whether it should be passive or active (or in my opinion telling them that both should be made available) shows that The Pension Authority are only providing very loose guidelines.
The Pension Authority in their guidelines do mention the risk involved in the active approach:
Investment manager risk: This relates to the risk that an individual investment manager underperforms the average market return. This cannot be interpreted as saying that a trustee should completely avoid offering active funds. I can therefore only speculate as to whether the trustees of my wife's scheme have thought about "Value Investing" or thought about finding a good "Value Manager". I can however, suggest that they appear to believe that passive is best.

In one way I suppose I should not blame trustees because many in the world of academia are still teaching "Efficient Market" theory and only a minority are slowly beginning to discuss behavioural finance and neuro-economics to explain why Value Investing can work.

The only way, therefore, that my wife could become a Value Investor is if she could convince all the other staff members in the hospital to petition the trustees to make a Value Fund available because as the guidelines also state: "*If trustees are satisfied that members are comfortable with a wider choice, this can be made available."*
From a practical point of view I just cannot see this happening. I just cannot see my wife's colleagues having the time or interest to learn about Value Investing and

therefore for the foreseeable future my wife is going to have to stay a passive investor with her biggest source of long term savings.

Rather than trying to convince a few hundred doctors, nurses and support staff that Value Investing is likely to be better than passive, I think there is a greater chance of convincing the Pension Authority that they should recommend Value Funds be made available by trustees. All I have to do now is try to make sure the next time the Pension Authority looks for submissions, I am ready to make the case.

APPENDIX

Investment options in practice – worked examples.
The following scenarios set out two worked examples of the issues trustees should take into account when they are setting the investment strategy for their scheme. The reasoning of the trustees in choosing the investment strategies for these schemes are for illustrative purposes only and are not intended to be prescriptive. Rather they seek to illustrate what application of the guidelines might mean for a typical scheme.
Scheme 1. The first scheme is a small scheme with between 10-15 members. The members earn salaries of €20,000 to €30,000 per annum. The employer pays 3% of salary into the scheme on behalf of the employees with no matching employee contribution. Despite trustee encouragement few if any members are contributing to an AVC. There is very low, if any, member engagement with the scheme. Two members have recently retired from this scheme and both members drew the entirety of their benefits as a tax-free lump sum.
With this salary band and low contributions being made, it is likely that no members will meet the requirements to pursue an ARF option.
Based on their knowledge of the membership, the trustees decided that investment knowledge is relatively low and therefore decided that a smaller number of fund choices is appropriate. In setting the default investment strategy for this scheme the trustees took into account the salary of the employees, the contributions being made to the scheme and the likely value of the fund for members at retirement and decided that the most likely form of retirement benefit would be cash and therefore a lifestyle strategy targeting cash at retirement was appropriate. Because of the likely lack of investment knowledge and the low level of engagement, the trustees decided that the default strategy should be lower risk, as they decided that the tolerance for investment losses would be relatively low. With this in mind, the trustees choose the following fund options as being most appropriate for the membership:
• Default – lifestyle fund, de-risking from a managed fund (split circa 50/50 between equities and bonds) to 100% cash
• Cash
• Fixed interest
• Managed fund split circa 50/50 between equities and bonds
• Equity

Scheme 2: This scheme is a large scheme with 500 members employed in the financial services industry. In this scheme there is a wide salary band reflecting the various roles within the company. The employer contributes 10% which can rise up to 15% if the employee contributes 5%. The majority of employees make the 5% contribution which is matched by the employer resulting in a 20% contribution overall.

There is a high level of engagement from members in relation to the scheme and individual financial advice is available. In this scheme a high number of members also make AVCs.

Based on their knowledge of the membership, the trustees concluded that investment knowledge is relatively high and therefore decided that a higher number of fund choices is appropriate. In setting the default investment strategy for this scheme the trustees took into account the salary of the employees, the contributions being made to the scheme and the likely value of the fund for members at retirement. Because of the higher levels of investment knowledge and the high level of engagement, they decided that the default strategy would be set at medium risk. The trustees identified that there are two likely forms of retirement benefits; the annuity option as well as the ARF option and so decided to offer two lifestyle options with one option providing a glide path to an annuity (the default) and the other option with a glide path to an ARF. With this in mind, the trustees choose the following fund options as being most appropriate for the membership:

- Default – lifestyle fund, de-risking to cash and bonds
- Lifestyle fund – medium risk fund with an appropriate glide path to post-retirement ARF investment
- Cash
- Fixed interest
- Low risk managed fund (with lower equity content)
- Medium risk managed fund (with medium equity content)
- High risk managed fund (with higher equity content)
- Equity
- Property
- Absolute return fund