Summary
- Scheme consolidation will be critical in reducing the difference in DC member pot sizes.
- Members of larger schemes tend to enjoy more sophisticated investment strategies and economies of scale.
- Members who proactively engage with their scheme are expected to achieve better outcomes than those who do not.

(S)pot the difference

Gill Wadsworth examines the many reasons why DC pot sizes may vary wildly, and what can be done to shrink the gap

Nine out of 10 people actively saving into a workplace pension scheme entrust their hard cash to a defined contribution (DC) scheme, according to the 2018/19 figures from The Pensions Regulator.

These schemes will eventually form the bedrock of retirement income provision for most individuals in the UK, which accounts for the widespread concern among savers and the pension industry as to their adequacy.

The 2019 *Schroders Global Investor survey* reported that a quarter (24 per cent) of non-retired people are uncomfortable as to whether they are saving enough for retirement. Meanwhile, a survey from the DC Investment Forum, published last November, found half of members who have not yet retired have not spent much time thinking about how they will manage financially in retirement, and 13 per cent have not thought about it at all. Also, a Sanlam survey of 1,000 adults, published in October, reported that people are four times as likely to know their lottery numbers off by heart than their target pension pot.

This level of discomfort and – perhaps more importantly – engagement represent red flags to those in the industry whose business it is to ensure investors end up with suitable retirement pots.

Sanlam group chief executive, Jonathan Polin, says: "Despite years of industry effort to turn the tide, engagement with longer-term savings is shockingly low. We are about to see a tidal wave of people coming into retirement who will be ill-prepared and severely disappointed when faced with their retirement reality."

Schroders' head of retirement Savings, Sangita Chawla, agrees, arguing that people are "not realistic about the lifestyle they want to enjoy when retired".

Rock solid rules

Typically, there are four widely accepted factors that influence ultimate DC pot size; how long one saves, how much they save, where they invest, and how much they pay in charges. The importance of each of these factors varies depending upon the individuals, but the first two – how much and how long one saves – are the most critical.

"The most important things are how early you start and the amount you pay in," says Salvus Master Trust head of sales, Bill Finch.

Redington director, Jonathan Parker, agrees, calling them rock solid rules, but irrespective of their solidity there is no escaping the disparities in pot size between members who may have contributed the same amounts over an equivalent length of time. It is then fees and investment strategy that create inequalities.

Fighting fair

In 2015, the UK government recognised the severe erosion excessive charges have on final DC pots and imposed a fee cap for auto-enrolled workplace DC default funds at 0.75 per cent. According to 2019 research from the Pension Policy Institute (PPI) and Columbia Threadneedle, reducing charges from 0.72 per cent to 0.45 per cent or 0.37 per cent could increase a pot size for a 22 year old median earner on reaching state pension age by around 6-8 per cent.

But while this prevented providers charging astronomical annual management charges, the cap did not protect members entirely.

According to a Work and Pensions Select Committee: "Not all charges are covered by the cap, and the full extent of charges outside the cap is not known. That makes it impossible to know how well the cap is working in practice."

Furthermore, the cap cannot ensure members get what they pay for, and there is no guarantee that the cheapest investment strategies represent the best value. For example, a member paying 0.75 per cent may end up with a larger pot than someone paying 0.5 per cent, simply because the more 'expensive' strategy delivers higher returns.

Parker says: "At some point *[the charge cap means]* you do start to constrain yourself in the types of investments you can access."

The key to truly levelling the playing field lies in creating economies of scale. Large single employer trusts and master trusts are usually able to negotiate more attractive fees for their members, than those smaller and less well-resourced DC plans, without compromising returns.

Parker says that as DC market grows and as smaller schemes choose to join larger multi-employer trusts, outcomes for members should start to equalise.

He says: "A lot of DC schemes are getting to a size where they can negotiate competitive rates, and while master trusts and big insurance companies already have massive buying power in the market."

Default discrepancies

Given that 95 per cent of DC members invest in the default, this makes the adequacy and efficacy of default funds paramount. Fortunately, these initially-unloved vehicles have become the jewel in providers' crowns since the advent of auto-enrolment and are given far more attention from policymakers, trusts and insurers. Nest, for example, has dedicated significant resources to ensuring they offer 'world-class investments', while contract-based providers rely on their independent governance committees (IGCs) to improve members' experience.

However, that does not detract from the variation in default fund performance. Analysis of nine default funds from large insurers, published by Punter Southall Aspire last March, shows a 5.9 per cent difference between the performance of the top and bottom funds. At the same time, the level of investment risk between these two varies by 3.2 per cent. And while no two defaults funds are the same, making like-for-like comparisons challenging, there is no escaping that there will be DC winners and losers.

According to the PPI, the likely losers will be those members whose funds lack the assets or investment expertise to invest in more esoteric assets. The institute says a median-earning 22 year old could increase their final pot by around 3 per cent by investing 15 per cent of funds in illiquids, yet these assets are largely ignored by UK schemes. PPI research shows three-quarters (76 per cent) of DC assets are invested in bonds and equities, plus 5 per cent in cash, with the remainder going to multi-asset and alternative funds.

Parker says: "DC schemes are reaching a position where size and scale is less of a constraint, and it is down to the governance and desire of IGCs or trustee boards to push the boundaries and invest in new asset classes."

And it is not just illiquid assets that might make a material difference to a DC member's pot. The PPI claim that investing in assets with good ESG credentials could increase that 22 year old's pension pot size by around 2 per cent.

Rules of engagement

Irrespective of whether an IGC or a trustee board is pro-ESG or illiquid assets, or they think members should increase contributions and save for longer – according to Finch – it will not make much difference unless members engage with their scheme.

Finch says: "Engagement is the most important element, but only once people realise their DC fund is a significant size and truly worth something, will they really take an interest."

In a bid to encourage that interest, in December the government closed a consultation exploring ways to improve the annual DC statement. The Department for Work and Pensions is now considering ways of standardising the statement in an 'engaging' template, as well as making it easier for members to understand costs and charges.

The overwhelming response has been positive to the proposed template, but whether the new statements engage members will largely depend on the widespread adoption by IGCs and trust boards.

There will never be equality of outcomes in DC since so many variables exist; not least the vagaries of the investment markets. Yet as scheme consolidation continues, investment strategies broaden and fees area managed, the disparity between members' pot sizes should be less stark. However, such advances can only do so much, and the ultimate success will depend on individuals taking responsibility for their pension savings.

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