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How to analyse workplace pension default funds

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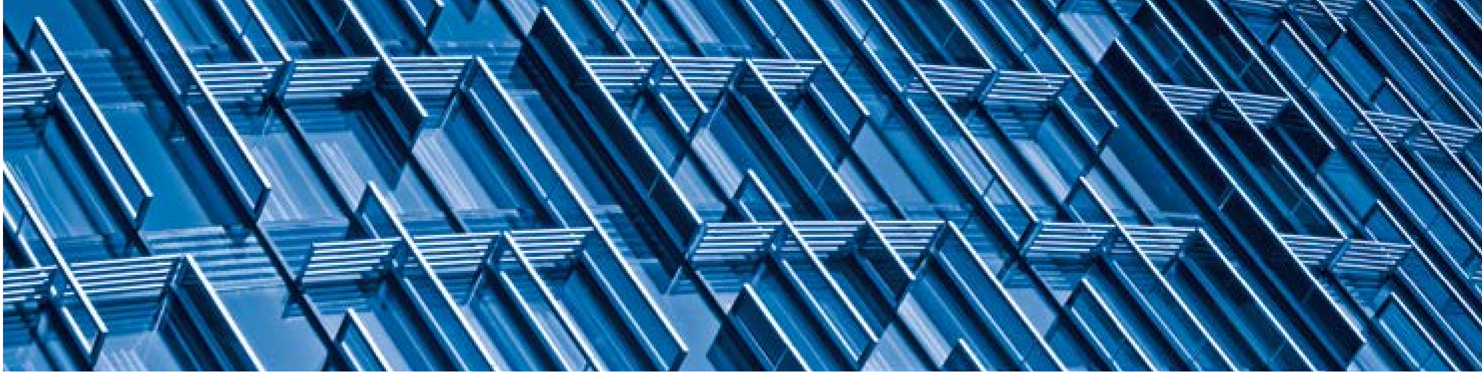
Contents



Introduction

This guide is now in its second year, as the original was extremely popular, supporting advisers through a transformation in the way they undertake due diligence on workplace pensions and default funds.

The purpose of this guide is to provide independent analysis of the workplace pension schemes available and their default funds. This is done by considering the key factors we feel advisers should understand, have an awareness of and be considering when reviewing the default funds on offer.

With around 9 out of 10 savers remaining in their pension default fund (99.7% in master trusts according to the Pension Policy Institute, October 2017), we want to help educate readers so they can confidently recommend a scheme based upon factual evidence.

We have split the guide into two parts:

Part 1	**Key factors to consider when reviewing default funds** We identify scheme structures and variations, then the key factors to consider when undertaking due diligence and scheme selection for the accumulation phase
Part 2	**Comparison of default fund facts** This is the technical area where we impartially analyse and compare the default fund options available for workplace pensions, across several different criteria, with the ultimate objective of empowering advisers to evidence 'value for money'

We hope you find this guide both informative and interesting.

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Learning objectives

This document is accredited by the CII/PFS and CISI for up to 60 minutes of structured CPD. Reading this document will enable you to:

1	Understand the different default investment strategies available, focusing on the accumulation phase
2	Identify the main differentiating factors to be considered between the individual default investment propositions, including: • The implications of socially responsible investment • The implications of investment committee oversight • The investment management procedures and responsibilities • The clarity, robustness and repeatability of decision making • How defaults are performing against benchmarks and peers • The suitability of the default and identifying value for money
3	Understand how the various default propositions in the market differ from each other to support market research and due diligence

Acronyms

The main acronyms used in this document are:

ABI	Association of British Insurers
AMC	Annual management charge
CPI	Consumer price index
DC	Defined contribution
ESG	Environmental, social and governance
IGC	Independent governance committee
RPI	Retail price index
TPR	The Pension Regulator

Why this guide is free and impartial

Independent insight	Defaqto is a financial information business, helping financial institutions and consumers make better informed decisions. We want as many people as possible to benefit from Defaqto's independent and unbiased insight
Unbiased and unrestricted	The Financial Conduct Authority (FCA) standard for independent financial advice requires research to be comprehensive, unbiased and unrestricted, and this is the philosophy we use when producing Defaqto's publications

Legal note

This study should not be considered as evidence to support any recommendations or endorsement of any specific provider or scheme. Advisers should conduct their own research and document their findings before recommending any solutions.

Background

By February 2018, all businesses in the UK will have enrolled their employees into a workplace pension, so it is worthwhile considering how this has affected saving in the UK workplace.

Table 1: Number of new UK employees in workplace pensions

2013	2014	2015	2016	2017	2018
1 million employees	3 million employees	5.2 million employees	6.1 million employees	7.7 million employees	8+ million employees

Source: The Pension Regulator (TPR), November 2017

Watch your language

As an industry we use the phrase 'default funds' to describe the funds consumers will invest in unless they choose something else.

The English Oxford Dictionary defines 'default' as being a *failure to meet an obligation*.

Using a word with such a strong negative connotation may not resonate well with target audiences, so we suggest advisers consider using more positive words that employer and employee clients can more confidently relate to. Examples of words as an alternative to 'default' include base, cornerstone, foundation and our personal favourite, core.

Part 1 – Key factors to consider when reviewing default funds

We invited all workplace pension providers known to Defaqto to participate; the following providers supplied data for the study:

- Aegon
- Aviva
- B&CE (The People's Pension)
- BlueSky Pensions UK
- Fidelity
- Friends Life
- LGIM
- National Pension Trust
- NEST
- Now Pensions
- OPT Pensions
- Prudential
- Royal London
- Salvus
- Scottish Widows
- Standard Life
- Welplan
- Willis Towers Watson
- Zurich Assurance

A complete list of the retail workplace pension providers and schemes known to Defaqto, that are open to new business in the retail arena, can be found in Appendix A.

Key factors to consider

Below are the key factors we believe should be identified and considered in any workplace pension due diligence process:

1	Good governance, what this looks like and how it is evidenced
2	The provider's financial strength and/or capability
3	The implications of investment committee oversight
4	The investment management procedures and responsibilities
5	The clarity, robustness and repeatability of decision making
6	How defaults are performing against benchmarks and peers
7	The suitability of the default fund and identifying value for money

We will go into detail for factors 3 to 7, which are those that are most related to investment (the main focus of this study).

Regulation and regulators

There are two types of workplace pension and it is therefore important to understand which type of pension scheme is being recommended. While there is insufficient room in this guide to compare the two types, they can be summarised as:

Trust based	Contract based
Uses a collective approach to investing whereby savers are beneficiaries of a trust	Each saver has their own 'contract' with the pension provider
Regulated by TPR	Regulated by the FCA

The implications of investment committee oversight

The remit for investment committee members is to work in the interests of the members and their pension fund monies. Researchers should look at the committee members that have the remit to run and manage the default fund and ascertain what, if any, conflicts of interest exist and how 'value for money' is being evidenced.

Governance styles to consider:

In-house	**Independent**	**In-house oversight of independent solutions**	**Independent oversight of an in-house solution**

Advisers should be looking for independent and impartial oversight and influence of the decisions being made. In workplace pensions, independence and impartiality can either be at the fund level, the asset allocation level and/or at the trustee/provider level where an in-house investment team may be accountable to independent trustees.

Independence is considered an important factor by both regulators (FCA and TPR) as a way to mitigate any potential for conflicts of interest. Indeed, the FCA has regulated that contract-based schemes should have an independent governance committee (IGC) that must publicly report to members on at least an annual basis.

The FCA has placed a duty on IGCs to scrutinise the 'value for money'. An IGC has a minimum of five members, the majority of whom must be independent, including an independent chair, and must:

- Act solely in the interests of relevant scheme members
- Act independently of the provider

Factors IGCs must report on include:

- Assessing the ongoing 'value for money' of the workplace pension scheme
- Acting solely in the interests of relevant scheme members (savers)
- Raising any concerns with the provider's board
- Escalating their concerns to the regulator, if necessary
- Reporting annually on what they have done

The TPR guidance is less around independence and more focused on trustees employing strong governance and protecting members' interests. Trusts have to produce a Chair Statement which contains much of the information in an IGC report, including how 'value for money' is being achieved.

Full details can be found in the defined contribution (DC) code, and advisers should familiarise themselves with this before recommending a trust-based scheme. It can be found at thepensionsregulator.gov.uk

Many schemes are run on a hybrid basis whereby either in-house staff oversee outsourced solutions or independent advisers oversee in-house solutions. It is not unusual to find some form of independent scrutiny and reporting being undertaken on the in-house decisions, and these reports can aid the selection process.

Impartial oversight and/or outsourcing to independent third parties does not necessarily increase costs; indeed the opposite can sometimes be true.

Advisers should look for schemes where the remit and incentives used to remunerate third parties match the needs and objectives of the investors. Importantly, look for impartial managers and trustees with the ability to appoint professionals to meet specific needs. They can then target them accordingly and easily identify failure potentially resulting in their prompt replacement.

The investment management procedures and responsibilities

There are three elements to consider here:

Investment strategy	Working practices	Individuals involved
This is not a simple case of selecting a passive philosophy over an active one. The key is to match the strategy to the profile of the employer and its employees. For example, if the workforce is primarily within ten years of retirement, a high-risk strategy is unlikely to be appropriate for the members.	How robust, repeatable and independent are the working practices used to govern the investment strategy? How can this be evidenced, and what breaches and changes have there been in recent years? You should also understand the control checks in place to make sure the working practices are being followed correctly and comprehensively.	This could potentially be more of an issue with smaller trust-based schemes. You should look at the control and influence individuals have and whether their knowledge, experience and expertise are sufficient to make such decisions.

As a final check, you should consider whether the combined process works in the best interests of members.

Investing responsibly

One of the growing factors we are seeing in the investment management space is a focus on investing responsibly and this is starting to translate into how workplace pensions are invested.

Investing responsibly is often confused with socially responsible investing. These are two, very different approaches, and so we have separated and explained them to aid understanding.

Socially responsible investing | **Investing responsibly**

Socially responsible investing

This is where an investment manager targets a specific investment philosophy or strategy based on investors' values.

Commonly investors will access socially responsible investing strategies via a collective fund that meets a specific values-led objective. Ethical funds or social impact funds, for example, might exclude companies on the basis of the harm they might do to society, such as tobacco or weapons companies, or seek to invest primarily in companies that are engaged in efforts to improve society, such as community investment funds or social housing projects.

Investing responsibly

This is where the emphasis is on the investment manager to be proactive in the performance of the capital under their management across the full range of financial and extra-financial risks.

Commonly investment managers buy and hold shares with little contact, if any, with the business in which they are invested. They arguably therefore have no influence over performance and are not employing their full skill set to maximise their investor's benefits.

Investment managers with a responsible investing remit are looking to maximise the performance of the funds under their control.

Environmental, social and governance (ESG) issues can undermine a business's bottom line, eg through fines, reputational damage and/or markets evolving in a way that is at odds with its business model. The thinking is that well-run businesses with sound environmental and social practices have a better chance of long-term success and profitability. In practice, this translates into an investment manager using their position to influence the businesses in which they are invested to maximise shareholder returns over the medium and long term.

Responsible investing is about effective fund management beyond just buying and holding a share

Common activities undertaken with ESG in mind include:

- Proactive discussions with key personnel to influence their thinking and plans where appropriate
- Indirect pressure such as not increasing their shareholding and voicing concerns about activities being undertaken
- Direct pressure such as voting at AGMs and selling shares

The clarity, robustness and repeatability of decision making

Having a clear, understandable and documented decision-making process is essential.

Advisers should be checking that there is a freely available, documented, clear structure and decision-making process in place. Questions should be asked about how the processes are managed and compliance checked. In particular, when exceptions have occurred, what impact have these had on savers?

Humans are not perfect and so the reality is that exceptions will have probably occurred at most providers. If a provider tells you they have not experienced exceptions or issues, you would be well served to question why.

The nature of workplace pensions, with minimum contribution levels connected to salaries, means that the value of the funds under administration will grow quickly and significantly.

While economies of scale can improve outcomes, it is asset allocation decisions which are proven to drive the biggest differences in returns. It is prudent to ensure that the scheme has sufficient diversification through how it accesses a market, eg exposure to the UK stock market being provided through more than one asset class, fund and/or manager can help to mitigate the issue.

Who has the most to gain and lose from the decision-making process?

Advisers should consider the ability of the scheme to invest while maintaining its investment strategy and ideal asset allocation weightings. Arguably, those schemes that can facilitate investment through diversification of asset classes and investment managers are best placed to meet this need.

How default funds are performing against benchmarks and peers

Many of the factors we have discussed so far are subjective, and not all providers will be able to answer all of your questions. Evidence-based analysis of the default fund is therefore critically important to evidence suitability and 'value for money'.

Benchmarking provides a clear parameter by which initial and ongoing suitability can be assessed and should be agreed with the client as being appropriate as soon as possible in the process. Advisers should also agree an appropriate timescale for the benchmark assessment period.

Providers' preferred benchmarks vary greatly across the industry, common examples including:

A	Cash + x% pa
B	Inflation (consumer price index (CPI) or retail price index (RPI) + x%)
C	Association of British Insurers (ABI) Mixed Investment 40-85% Shares
D	Volatility

Some providers combine options A, B and/or C with D, and this can be a good way to monitor both volatility (risk) and overall return.

We also see some providers opting to use composite benchmarks, ie different benchmarks for different elements of the assets held. While composite benchmarks may work well for providers and fund managers, they can be difficult for consumers to understand and are probably best avoided.

Advisers should also agree an appropriate timescale for the benchmark assessment period. Pension fund providers often talk about 20+ year returns, especially those investing in infrastructure projects (building railways, power stations etc). However, for many savers, 20 years will be around half of their working life and advisers could be seen as negligent, leaving their clients in a poor performing fund for that long.

At Defaqto, we consider anything less than three years' performance to be insufficient to draw any meaningful conclusion; ideally, one should be looking at five or more years.

Irrespective of the provider's preferred benchmark, we suggest advisers recommend a benchmark that is relevant and easily understood by both employers and employees. For many, we would expect this to be either option A or B, perhaps with D overlaid.

We will analyse the default funds against these benchmarks in Part 2 of this guide.

Default fund due diligence checklist

The most important factor when making recommendations is to meet the client's needs and objectives, whether they be individual or corporate. We suggest considering and documenting decisions made on the following points in your research:

		✓
A	Ascertain, agree and document advice needs • Clients' needs, objectives and aspirations • Profile of employees and turnover • Risk framework • Timeframes	
B	Provider's financial strength and capability • Would a contract, master trust, or own trust be most appropriate? • Does a contract based scheme hold an attractive AKG rating? • Does a trust based scheme hold Master Trust Assurance Framework accreditation (type 2 is the more comprehensive version)?	
C	Scheme strengths and weaknesses • Does scheme guarantee acceptance of employer and all its employees? • What groups of employees does it exclude or discriminate against? • Can the scheme facilitate tax relief for ALL employees? • Does the scheme provide access to alternative fund options, ie ethical and Sharia? • Check FCA and/or TPR website for authenticity of scheme (is it a scam?)	
D	Investment management procedures and responsibilities • Level of independence • Whether investments are sourced in-house and/or from third parties and the implications of the strategy • Does the investment strategy match the client, their needs and that of their employees? • Are there robust and repeatable working practices in place? • Are the individuals involved suitably experienced and qualified to manage the scheme?	
E	Clarity, robustness and repeatability of default fund decision making • Is there a documented and clear structure and decision-making process in place? • Is it being adhered to, and how is it compliance managed? • Is the fund of a sufficient size to be able to facilitate sufficient diversification and pricing to operate in the client's/saver's best interests?	
F	Benchmarking • Agree independent, relevant and easily understood benchmarks against which performance should be measured • Agree suitable timescales for these measures • Put in place an action plan to make sure measures are taken • Put in place an action plan for when underperformance is identified	
G	Assess value for money and suitability • Detail how the selected default fund compares to its peers in each of the above areas • Provide an overall assessment and summary of the decision-making process and rationale for ultimate selection	
H	Set periodic review dates for • Updating The Pensions Regulator • Ongoing scheme and contribution suitability assessments • Triennial reviews • Trustee meetings • Implementing additional employee benefits and pension/financial reviews • Implementing additional business financial planning (key man insurance etc)	

Part 2 – Comparison of default funds

Default investments are the funds in which contributions to workplace pensions will automatically be invested, unless employees are given and exercise their own investment choice, in which case there will be a range of funds from which they may choose.

With around 9 out of 10 savers relying on their pension provider's default fund to save for their retirement, it is very important employers choose a default fund that is appropriate for them. When comparing the default offerings in the main growth phase across the different organisations in this study, we used the funds shown in Table 2.

Table 2: Main default funds

Provider	Default fund
Aegon	Aegon Default Equity & Bond Lifestyle (ARC)
Aviva	Aviva Diversified Assets Fund II
B&CE (People's Pension)	B&CE Global Investments (up to 85% shares) Fund
BlueSky Pensions UK	Target Date 2038-2040 Retirement Fund
Fidelity	Fidelity Diversified Markets Fund
Friends Life	Aviva Pension My Future Growth FP
LGIM	LGIM PMC Multi-Asset 3
National Pension Trust	Balanced Growth Fund
NEST	NEST 2040 Retirement Date Fund
NOW Pensions	Diversified Growth Fund
OPT Pensions	OPT Growth Portfolio
Prudential	Prudential Dynamic Growth IV
Royal London	Royal London Governed Portfolio 4
Salvus	Cautious Lifestyle Growth Stage
Scottish Widows	Scottish Widows Pension Portfolio Two
Standard Life	Standard Life Active Plus III
Welplan	Welplan Growth Fund
Willis Towers Watson (LifeSight)	Drawdown Focused Medium Risk
Zurich Assurance	Zurich Passive Multi Asset V

Source: provider websites and factsheets

Benchmarks

Performance benchmarks vary greatly across the default funds reviewed, although most are one of (1) ABI Mixed Investment 40-85% Shares, (2) a composite benchmark or (3) cash or inflation plus 3 to 4% pa. Aviva and Standard Life do not have any performance benchmarks but instead use volatility targets; while Fidelity, NEST and Willis Towers Watson have both performance benchmarks and volatility targets.

Investment process

As can be seen from Table 3 there is a mix of manager structures across the main default funds reviewed: some keep fund management in-house, either using fund managers from elsewhere within their organisation or investing directly in securities; some default funds completely outsource to external managers; while a couple use both in-house and third-party managers.

Table 3: Main default funds – fund manager structure and investment approach

Provider	Active	Passive	Solution
Aegon		Yes	Aegon/BlackRock
Aviva	Yes	Yes	In-house
B&CE (People's Pension)		Yes	State Street Global Advisors
BlueSky Pensions UK		Yes	External managers via Alliance Bernstein and Mobius Life
Fidelity		Yes	In-house
Friends Life		Yes	BlackRock
LGIM		Yes	In-house funds
National Pension Trust		Yes	BlackRock
NEST	Yes	Yes	Amundi, BlackRock, BMO, HSBC, J.P. Morgan, LGIM, Northern Trust, RLAM, SSGA and UBS
NOW Pensions	Yes		In-house
OPT Pensions		Yes	BlackRock, Fidelity, HSBC, Henderson and LGIM
Prudential	Yes	Yes	BlackRock and M&G
Royal London	Yes	Yes	In-house and BlackRock
Salvus		Yes	BlackRock
Scottish Widows		Yes	Scottish Widows and SSGA
Standard Life	Yes		Mainly in-house funds
Welplan		Yes	LGIM
Willis Towers Watson		Yes	External managers
Zurich Assurance		Yes	BlackRock

Source: provider websites and factsheets

The main rationale for outsourcing to third-party managers is that no one manager can be the best across every single asset class, but instead one should source a specialist manager for each different area. The disadvantage of this method is that third-party managers are generally more expensive than managing the funds in-house; however, this may well be dependent on the available economies of scale and negotiating position.

In terms of investment approach (active versus passive fund management), there is also a mix. Active managers have the chance to outperform the respective index, but also run the risk of underperforming it. Passive managers, meanwhile, simply track the index and generally cost less.

There are many people who believe that use of active or passive managers depends on the asset class. For example, if the asset class is believed to be 'efficient' – that market is already highly researched and covered, leaving little scope left to outperform – then a passive manager will be used. If, however, a market is less researched and efficient, then an active manager is more likely to be able to outperform. As a result, some funds use a mix of the two approaches rather than one or the other.

Looking at it from a 'value for money' perspective, the passive strategy has the ability to control risk, diversification and costs and is therefore worth considering as an element within a default fund.

Asset classes

Table 4 shows the high-level asset classes in which each of the main default funds invest.

Table 4: Main default funds – high-level asset classes used

Provider	Cash	Fixed income	Property	Commodities	Equity	Derivatives
Aegon	Yes	Yes			Yes	
Aviva	Yes	Yes	Yes	Yes	Yes	Yes
B&CE (People's Pension)		Yes			Yes	
BlueSky Pensions UK		Yes	Yes	Yes	Yes	
Fidelity		Yes	Yes		Yes	Yes
Friends Life	Yes	Yes			Yes	
LGIM	Yes	Yes	Yes		Yes	
National Pension Trust		Yes			Yes	
NEST	Yes	Yes	Yes	Yes	Yes	Yes
NOW Pensions		Yes		Yes	Yes	Yes
OPT Pensions	Yes	Yes			Yes	
Prudential	Yes	Yes			Yes	
Royal London	Yes	Yes	Yes	Yes	Yes	
Salvus		Yes			Yes	
Scottish Widows		Yes			Yes	
Standard Life	Yes	Yes	Yes	Yes	Yes	Yes
Welplan		Yes	Yes	Yes	Yes	
Willis Towers Watson		Yes	Yes		Yes	
Zurich Assurance	Yes	Yes			Yes	

Source: provider websites and factsheets

As can be seen, all of the default funds will contain equities and fixed income. Some will also hold 'alternative' asset classes to varying degrees. The advantages of such asset classes are the greater potential for higher returns and diversification; however, they can also be more risky, expensive and less transparent.

Investing responsibly

Table 5 shows the attention given by the main default funds to investing responsibly, based on their factsheets and/or the relevant sections of the provider website (this table considers just the default fund – it is recognised that providers may have standalone funds in this area that employees can select from).

Table 5: Main default funds – investing responsibly considerations

Provider	Consideration given to ESG factors
Aegon	No mention
Aviva	No mention
B&CE (People's Pension)	No mention
BlueSky Pensions UK	No mention
Fidelity	No mention
Friends Life	No mention
LGIM	No mention
National Pension Trust	No mention
NEST	ESG factors are core to their investment strategy and their portfolio holds ESG-screened funds (alongside other funds); they are also known to exercise their voting rights and engage with company management when they have any concerns
NOW Pensions	Have a Policy of Social Responsibility in Investments
OPT Pensions	No mention
Prudential	No mention

Table 5 (cont): Main default funds – investing responsibly considerations

Provider	Consideration given to ESG factors
Royal London	No mention
Salvus	No mention
Scottish Widows	No mention
Standard Life	No mention
Welplan	No mention
Willis Towers Watson	Recognised in the statement of investment principles but such considerations are left to the discretion of the investment managers
Zurich Assurance	No mention

Source: provider websites and factsheets

Only a few of the default funds appear to give explicit attention to investing responsibly (including ESG factors), using their shares to vote and engaging with company management.

Performance

Performance numbers are now compared across the main default funds, in their main growth phase (unfortunately, some providers were unable to provide the data requested, at least within the required format and timescale).

It is generally agreed that longer-term numbers are more significant from a statistical point of view, and therefore we caution against decisions being made on one or two years of performance history. That said, with auto-enrolment having started in 2012, only six default funds have five years of performance history.

Table 6: Annualised returns

Provider	1 year	2 years	3 years	5 years
Aegon	11.6%	16.5%	11.6%	-
Aviva	11.8%	16.1%	10.7%	8.3%
B&CE (People's Pension)	10.8%	15.0%	9.9%	-
BlueSky Pensions UK	-	-	-	-
Fidelity	7.7%	11.6%	-	-
Friends Life	9.8%	16.7%	11.5%	-
LGIM	9.2%	16.5%	10.8%	9.6%
National Pension Trust	-	-	-	-
NEST	11.2%	15.7%	11.0%	10.9%
NOW Pensions	6.1%	7.0%	3.1%	-
OPT Pensions	9.7%	-	-	-
Prudential	11.1%	17.5%	-	-
Royal London	10.7%	13.4%	9.3%	10.3%
Salvus	-	-	-	-
Scottish Widows	13.9%	20.2%	11.8%	11.9%
Standard Life	7.9%	9.3%	6.6%	7.5%
Welplan	-	-	-	-
Willis Towers Watson	15.9%	-	-	-
Zurich Assurance	15.8%	21.8%	-	-

Source: data from Morningstar, ONS and providers to end September 2017; calculations by Defaqto

These figures, however, are returns only and take no account of the fund's volatility, ie the risk taken in achieving these returns. Information ratios, which are fund return minus benchmark return divided by the volatility of these 'excess' returns, do take risk into account.

These ratios have no units, but a higher number indicates better risk-adjusted performance. As mentioned earlier, though, there is no one benchmark for the whole industry. For this study, ABI Mixed Investment 40-85% Shares and inflation (CPI) plus 3% are used. Tables 7 and 8 on the following pages show information ratios with these benchmarks.

Table 7: Information ratios using ABI Mixed Investment 40-85% Shares benchmark

Provider	1 year	2 years	3 years	5 years
Aegon	0.49	1.20	0.86	-
Aviva	0.71	1.39	0.80	−0.29
B&CE (People’s Pension)	−0.01	0.10	0.04	-
BlueSky Pensions UK	-	-	-	-
Fidelity	−1.82	−0.57	-	-
Friends Life	−0.31	1.11	0.86	-
LGIM	−0.76	0.77	0.48	0.09
National Pension Trust	-	-	-	-
NEST	0.13	0.48	0.47	0.44
NOW Pensions	−0.87	−0.86	−0.89	-
OPT Pensions	−0.26	-	-	-
Prudential	0.13	0.79	-	-
Royal London	0.07	0.11	0.28	0.79
Salvus	-	-	-	-
Scottish Widows	0.95	1.59	0.70	0.79
Standard Life	−2.28	−1.76	−0.95	−0.74
Welplan	-	-	-	-
Willis Towers Watson	0.58	-	-	-
Zurich Assurance	1.44	1.61	-	-

Source: data from Morningstar, ONS and providers to end September 2017; calculations by Defaqto

On a five-year basis against the ABI Mixed Investment 40-85% Shares benchmark, Royal London and Scottish Widows have the best risk-adjusted performance. Over three years against the same benchmark, with a larger sample, Aegon and Friends Life have the best risk-adjusted performance, with Aviva very close behind.

Table 8: Information ratios using CPI plus 3% benchmark

Provider	1 year	2 years	3 years	5 years
Aegon	0.88	1.55	0.77	-
Aviva	1.10	1.47	0.72	0.47
B&CE (People's Pension)	0.44	0.72	0.38	-
BlueSky Pensions UK	-	-	-	-
Fidelity	0.38	1.30	-	-
Friends Life	0.66	1.61	0.83	-
LGIM	0.65	1.73	0.84	0.66
National Pension Trust	-	-	-	-
NEST	0.78	1.43	0.81	0.82
NOW Pensions	−0.01	0.21	−0.17	-
OPT Pensions	0.55	-	-	-
Prudential	0.72	1.64	-	-
Royal London	0.94	1.40	0.67	0.78
Salvus	-	-	-	-
Scottish Widows	1.06	1.54	0.67	0.71
Standard Life	0.48	0.94	0.42	0.53
Welplan	-	-	-	-
Willis Towers Watson	1.89	-	-	-
Zurich Assurance	1.38	1.60	-	-

Source: data from Morningstar, ONS and providers to end September 2017; calculations by Defaqto

Over five years against the CPI plus 3% benchmark, NEST has the best risk-adjusted performance, with Royal London close behind. Over three years against this benchmark, LGIM has the best risk-adjusted performance, with Friends Life and NEST very close behind.

Information ratios penalise upside and downside volatility equally. Most people would consider volatility caused by high returns to be acceptable, but volatility due to low returns to be 'bad'.

Sortino ratios differentiate 'bad' volatility of returns from total volatility by penalising only downside deviations and are an expression of the fund's return, minus the risk-free rate, divided by the downside volatility. The Sortino ratios for the main default funds are shown in Table 9 (again, these ratios have no units, but a higher number indicates better downside risk-adjusted performance).

Table 9: Sortino ratios using 0.5% risk-free rate

Provider	1 year	2 years	3 years	5 years
Aegon	4.11	5.35	2.27	-
Aviva	5.31	4.73	2.17	1.84
B&CE (People's Pension)	2.19	2.63	1.48	-
BlueSky Pensions UK	-	-	-	-
Fidelity	3.27	5.23	-	-
Friends Life	3.93	6.02	2.55	-
LGIM	3.60	8.00	2.84	2.42
National Pension Trust	-	-	-	-
NEST	4.90	7.50	2.94	3.01
NOW Pensions	1.82	1.13	0.42	-
OPT Pensions	3.25	-	-	-
Prudential	4.59	6.66	-	-
Royal London	5.83	4.59	2.04	2.55
Salvus	-	-	-	-
Scottish Widows	3.75	4.41	1.90	2.13
Standard Life	4.61	3.94	1.99	2.38
Welplan	-	-	-	-
Willis Towers Watson	26.25	-	-	-
Zurich Assurance	6.47	4.28	-	-

Source: data from Morningstar, ONS and providers to end September 2017; calculations by Defaqto

Looking at just downside risk, NEST has the best risk-adjusted performance over both three and five years. Friends Life, LGIM and Royal London are close behind.

The ratio for Willis Towers Watson is out of the normal range at 26.25; however, this is based on the findings for one year only.

Costs

In this section we will explain the different pricing structures and compare the impact of them on returns. To set the scene, charges can depend upon many factors including the size and profile of a particular employer and the adviser's relationship with the provider. In addition, the regulatory expectation is that 'value for money' is evidenced through the due diligence process.

0.75% pa

One area where workplace pension schemes are leading by example is the use of the maximum equivalent default fund annual management charge (AMC) which is set at 0.75% per annum.

While this provides some peace of mind, ascertaining exactly what is being charged for each element is not always easy. Some providers set a standard fee, while others charge a combination of fees, so making a like for like comparison is not always straight forward. This is an issue because for advice to be accurate, advisers need to include all costs in their research.

There are three different fee structures used across the workplace pension market:

a) Single AMC

b) Single fund AMC, plus administration, service and/or contribution charge

c) Variable fund AMC, plus a variable administration, service and/or contribution charge (we have called this bespoke in the text below).

Advisers will find that some schemes do not publicly state their fees, requiring an application to be made to the provider who will then offer a 'bespoke' rate.

Advisers should also consider who is paying fees, some schemes charge only the employee while others charge both the employee and employer.

0.75% may not be the full cost

To complicate the due diligence process further, the method used to calculate the AMC can exclude certain activities. This analysis is outside the scope of this document but both the FCA and TPR have produced guidance on this which they continue to update. We encourage researchers to keep up to date with the regulators guidance so they can understand what is and isn't included in each providers quoted AMC.

Default fund charges

In Table 10 below we have identified each scheme's headline charge.

Where schemes operate a bespoke charging structure we have used their maximum standard fee in our analysis. We have used this because we have assumed it to be the most common fee charged to SMEs, who make up the bulk of the workplace pension market. This does mean however, that some clients may pay a lower charge.

Table 10: Main default funds – standard charges

Provider	Headline	Bespoke	Notes and extras
Aegon	0.50%	yes	A mixture of AMC and admin/service fee
Aviva	0.75%	yes	A mixture of AMC and admin/service fee
B&CE (People's Pension)	0.50%	no	0.50% flat fee
BlueSky Pensions UK	0.75%	no	A mixture of AMC and admin/service fee
Fidelity	0.75%	yes	A mixture of AMC and admin/service fee
Friends Life	0.75%	yes	A mixture of AMC and admin/service fee
LGIM	0.50%	yes	A mixture of AMC and admin/service fee
National Pension Trust	0.75%	yes	A mixture of AMC and admin/service fee
NEST	0.30%	no	0.30% AMC + 1.80% contribution charge
NOW Pensions	0.30%	no	0.30% AMC + £1.50 per month admin fee (from April 18)
OPT Pensions	0.75%	no	A mixture of AMC and admin/service fee
Prudential	0.75%	yes	A mixture of AMC and admin/service fee
Royal London	0.75%	yes	A mixture of AMC and admin/service fee
Salvus	0.60%	yes	0.60% AMC + 83p per month admin fee
Scottish Widows	0.75%	yes	A mixture of AMC and admin/service fee
Standard Life	0.75%	yes	A mixture of AMC and admin/service fee
Welplan	0.60%	no	0.60% flat fee
Willis Towers Watson	0.75%	yes	A mixture of AMC and admin/service fee
Zurich Assurance	0.75%	yes	A mixture of AMC and admin/service fee

Source: provider websites and factsheets , 1 April 2018

The cost of costs

In this section we examine the effect of different charging structures by illustrating the value of a pension pot over 10, 20, 30 and 40 years. These calculations assume:

Salary at start of process	£25,000
Salary growth rate pa	2.5% pa
Investment growth rate pa	5.0% pa
Total contribution pa	8%

Please note that NOW Pensions and Salvus charge an administration fee in pounds and pence, and to reflect inflation, we have increased this element of their fee by 2.5% per annum.

Table 11 also includes two illustrative rates (0.40% and 0.70%) to show the impact and potential outcomes of these charges.

Table 11: Illustrative pension fund values

Charge	Providers	Value at 10 years	Value at 20 years	Value at 30 years	Value at 40 years
Zero	Na	£28,822	£84,364	£186,176	£367,089
0.30% +	NOW Pensions	£28,119	£80,942	£175,464	£339,464
0.30% +	NEST	£27,863	£80,207	£173,871	£336,381
0.40%	Na – illustrative rate	£28,227	£80,806	£174,143	£334,821
0.50%	Aegon, B&CE, LGIM	£28,080	£79,947	£171,289	£327,309
0.60%	Welplan	£27,935	£79,099	£168,494	£320,007
0.60% +	Salvus	£27,796	£78,705	£167,655	£318,413
0.70%	Na – illustrative rate	£27,791	£78,263	£165,756	£312,907
0.75%	** See list below	£27,719	£77,849	£164,408	£309,431

** Examples include: Aviva, BlueSky Pensions UK, Fidelity, Friends Life, National Pension Trust, OPT Pensions, Prudential, Royal London, Scottish Widows, Standard Life, Willis Towers Watson and Zurich Assurance

Observations:

- The pricing structure employed by NOW Pensions is the lowest standard rate in the market
- As an example of a fee on contributions, NEST's 1.8% seems high at first glance; however, as it is a one off cost, it is diluted over time by the low AMC of 0.30% pa, resulting in NEST being the second cheapest solution over the longer term
- The compounding effect of costs over the longer term can be significant. Advisers should consider the suitability of any fee structure recommended and document how they are evidencing 'value for money' for both the employer and the employees

Other costs to consider

Some of the more common fees to look out for that can be applied to the employer and/or the employees are:

- Allocation rates
- Annual investment/fund
- Annual management
- Annual product/scheme
- Change of contribution
- Difference between bid and offer prices
- Exit fees for employer
- Exit fees for individuals on death
- Exit fees for individuals on transfer
- Implications for individuals leaving employer
- Implications of suspending contributions
- Installation
- Retirement illustrations
- Reviews
- Statutory communications
- Time out of investment between changes
- Transactions per type/on time cost basis
- Transfer costs (in and out)
- Transfer illustrations
- Valuations

Questions to consider

- Can the provider explain their costs succinctly and then confirm them in writing in a manner you can understand and use with your client?
- How does the fee structure fit with the regulators' desire for 'clarity of cost', is it comparable to other schemes and can it be used to evidence 'value for money'?
- Considering the average age profile of your client's workforce, which fee structure has the potential to have the least compounding impact on individual member returns? (Table 11 may help with this)

Costs reduce returns, but cheap does not equal value for money

Conclusion

Default funds are now producing over five years of performance data. This gives advisers the facts to make evidence based recommendations.

Defaqto's database currently reports on over 70 retail workplace pension solutions, and this case study went through the key factors we believe should be considered when reviewing or selecting a default fund from these or any other solution.

The study then looked at and compared the default workplace pension funds. We saw a great variety in terms of benchmark, manager structure (in-house manager, third-party managers or a mix), investment approach (active, passive or both), level of diversification, attention paid to responsible investing, performance and charging across the funds.

With some of these attributes, such as manager structure, investment approach and attitude to responsible investing, the choice of provider and fund might come down to the investment beliefs of the employer or their adviser. However, in terms of the other more objective features, ie risk-adjusted performance and charges, some providers and funds are clearly more competitive than others.

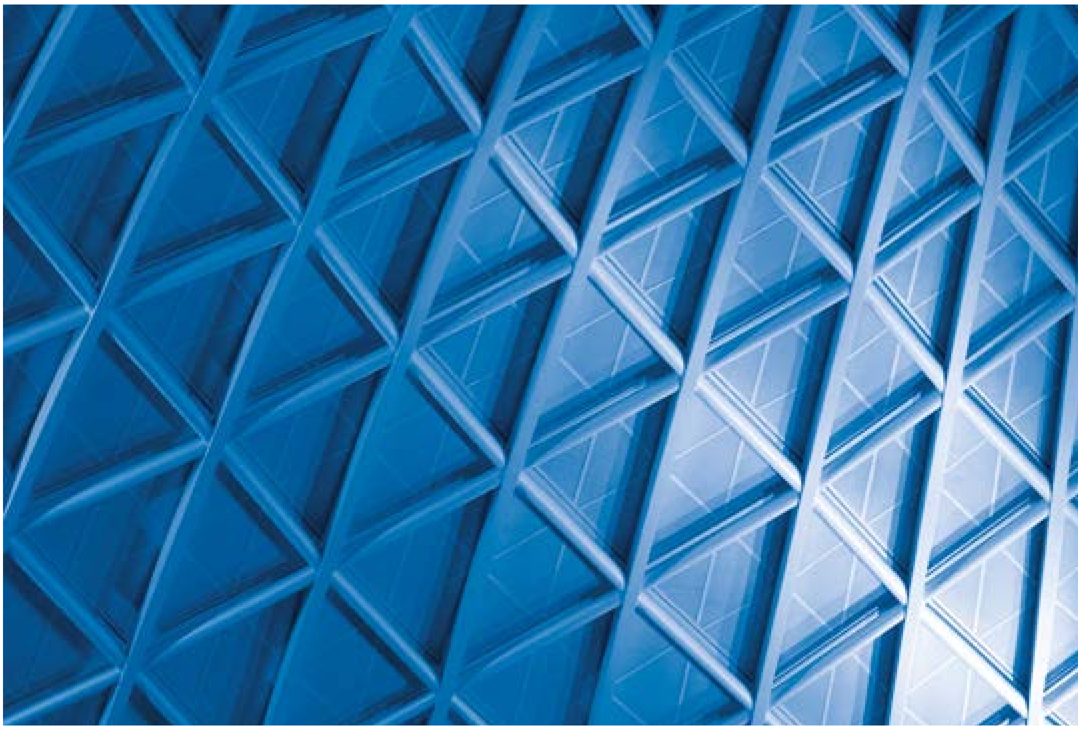
Bearing in mind the diversification in providers and clients, and their respective needs and objectives, it is not surprising that no individual default fund outperforms its peers in every subject area considered. That said, it is notable that some default funds consistently compare well to their peers across most subject areas, and arguably these represent the greatest opportunity for advisers to evidence 'value for money'.

Learning objectives

This case study is accredited by the CII/PFS and CISI for up to 60 minutes of structured CPD.

Having read this publication you should now be able to:

1	Understand the different default investment strategies available, focusing on the accumulation phase
2	Identify the main differentiating factors to be considered between the individual default investment propositions including: • The implications of socially responsible investment • The implications of investment committee oversight • The investment management procedures and responsibilities • The clarity, robustness and repeatability of decision making • How defaults are performing against benchmarks and peers • The suitability of the default and identifying value for money
3	Understand how the various default propositions in the market differ from each other to support market research and due diligence



Test yourself for CPD

In order to assess your knowledge following completion of this publication, why not work your way through the following questions?

All the answers can be found within the text.

1	Name the two regulators of workplace pension schemes.
2	At what percentage are pension default funds annual management fees capped?
3	Name four common benchmarks used by default funds.
4	List the main reasons why many default funds utilise passive (index) funds
5	What benefits are created by using a provider with a responsible investment strategy?
6	What does IGC stand for and which scheme type does it apply to?
7	Which regulator utilises the DC Code and which scheme type does it apply to?
8	Does ‘value for money’ mean the cheapest solution?

This publication is accredited by the CII/PFS and CISI for up to **60 minutes** of structured continuing professional development (CPD).

Name	
Signature	
Date	
CPD time recorded	

Send us your feedback

Your feedback is extremely important to us and we would be grateful if, after completing this publication, you would take a few minutes to complete a short survey. Your answers will be treated in the strictest confidence and the results of this will help the development of future publications.

The survey can be accessed at:

https://www.snapsurveys.com/wh/s.asp?k=144610976149

CPD answers

As a guide, your answer should include the following points:

1. TPR and FCA
2. 0.75%
3. Cash + x% pa, inflation CPI or RPI + x%, ABI mixed investment 40-85% shares, volatility
4. Increased equity diversification, lower cost
5. A company that benefits its consumers and the wider good is more likely to have longevity and perform better over the longer term
6. Independent governance committees are from the FCA and relate to contract based schemes
7. The DC code is from TPR and relates to trust based schemes
8. Value for money does NOT mean the cheapest option

Appendix A

Defaqto Engage, our investment planning software solution for financial advisers and paraplanners, details 76 different workplace pension schemes from 41 different providers (as at 17 November 2017), which are:

Acronyms

Ns	not stated

Tax relief method:

AS	At source
NP	Net pay arrangement

Provider	Scheme	Contract	Own Trust	Master Trust	Tax relief method
Aegon	CIMP - Single Charge Terms		Yes		AS
Aegon	GPP Plan - Flexi Menu	Yes			AS
Aegon	Workplace ARC SIPP	Yes			AS
Al Rayan Bank	Islamic Pension Trust			Yes	NP
Al Rayan Bank	Islamic Pension Trust		Yes		NP
Amber Financial Investments	Amber Pension Trust			Yes	Ns
Amber Financial Investments	Amber Pension Trust		Yes		Ns
Aon	Aon Delegated DC Bundled		Yes		NP
Aon	Aon Master Trust			Yes	NP
Aon	Bigblue Touch	Yes			AS
Ascot Lloyd	Ascot Lloyd Pension Trust			Yes	NP
Atlas	Atlas Master Trust			Yes	NP
Aviva Life & Pensions UK	Company Pension @ Aviva	Yes			AS
Aviva Life & Pensions UK	Company Stakeholder Pension @ Aviva	Yes			AS
Aviva Life & Pensions UK	My Money - Flexible Retirement A/C	Yes			AS
Aviva Life & Pensions UK	My Money - Workplace Retirement Ac			Yes	NP
Aviva Life & Pensions UK	My Money - Workplace Retirement Ac		Yes		NP
B & C E	The People's Pension			Yes	AS NP
BCF	BCF Pension Trust	Ns	Ns	Ns	Ns

Provider	Scheme	Contract	Own Trust	Master Trust	Tax relief method
BlackRock Life	BlackRock DC Trust-Based Scheme		Yes		NP
BlackRock Life	BlackRock Group Master Trust			Yes	NP
BlackRock Life	BlackRock Group Personal Pension	Yes			AS
BlackRock Life	BlackRock Group Stakeholder Plan	Yes			AS
BlueSky Pensions UK	TBPS			Yes	NP
BlueSky Pensions UK	TBPS		Yes		NP
BlueSky Pensions UK	The Crystal Trust			Yes	NP
Box Pensions	Box Pensions (Salvus Master Trust)			Yes	NP
Carey Corporate Pensions UK	Carey Workplace Pension Trust			Yes	NP
Carey Corporate Pensions UK	Carey Workplace Pension Trust		Yes		NP
Corporate Pensions Admin	Corpad Master Trust			Yes	Ns
Creative Auto Enrolment	Creative Pension Trust			Yes	NP
Fidelity International	Fidelity Group Money Purchase Plan	Yes			AS NP
Fidelity International	Group Personal Pension Scheme	Yes			AS NP
Fidelity International	Master Trust			Yes	AS NP
Fidelity International	Own Trust		Yes		AS NP
Fidelity International	Stakeholder Pension Plan	Yes			AS NP
Intelligent Money	IM Group SIPP/NEST Hybrid		Yes	Yes	AS NP
Legal & General	L&G Stakeholder Pension	Yes			AS
Legal & General	Worksave Mastertrust			Yes	AS NP
Legal & General	Worksave Pension	Yes			AS
Legal & General	Worksave Pension Trust		Yes		NP
Lighthouse Group	Lighthouse Pensions Trust			Yes	NP
Mercer	Mercer Master Trust			Yes	NP
National Pension Trust	National Pension Trust			Yes	NP
NEST	NEST Scheme			Yes	AS
NOW: Pensions	NOW: Pensions Trust			Yes	NP + top ups
OPT Pensions	OPT Pensions			Yes	NP
Prudential	Prudential Master Trust			Yes	AS
Punter Southall	Aspire Master Trust	Ns	Ns	Ns	Ns

Provider	Scheme	Contract	Own Trust	Master Trust	Tax relief method
Royal London	Retirement Solutions - Comp Pension		Yes		NP
Royal London	Retirement Solutions - GPP	Yes			AS
Royal London	Retirement Solutions - Group Stakeholder	Yes			NP
Salvus	The Salvus Master Trust			Yes	NP
Salvus	The Salvus Master Trust		Yes		NP
SEI	SEI Master Trust	Ns	Ns	Ns	Ns
Scottish Widows	Group Money Purchase Scheme		Yes		AS
Scottish Widows	Group Personal Pension	Yes			AS
Scottish Widows	Group Self Invested Personal Pension	Yes			AS
Scottish Widows	Group Stakeholder Plan	Yes			AS
Smart Pension	AutoEnrolment.co.uk Master Trust			Yes	NP
Standard Life	Good to Go - GFRP	Yes			AS
Standard Life	Group Flexible Retirement Plan	Yes			AS
Standard Life	Group Self Invested Personal Pension	Yes			AS
Standard Life	Group Stakeholder Pension	Yes			AS
Standard Life	Standard Life Master Trust			Yes	NP
SuperTrust	SuperTrust Master Trust	Ns	Ns	Ns	Ns
TPT Retirement Solutions	Flexible Retirement Plan (Smarter Pension)			Yes	Ns
True Potential	True Potential Group SIPP	Ns	Ns	Ns	Ns
TRUST|Pensions	TRUST|Pensions			Yes	NP
Welplan	Welplan Pensions			Yes	NP
Wessex Pensions	Wessex Pensions Trust	Ns	Ns	Ns	Ns
Willis Towers Watson	Lifesight			Yes	NP
Workers Pension Trust	Workers Pension Trust			Yes	NP
Zurich Assurance	GPP/ Deferred Group SIPP	Yes			AS
Zurich Assurance	Master Trust			Yes	NP
Zurich Assurance	Occupational Money Purchase Pension		Yes		NP

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Our experts research, collect and continuously assess over 41,000 financial products. Our process is extremely robust and is driven by over 60 specialist analysts who have unparalleled knowledge of financial products, services and funds in the market. Our independent fund and product information helps banks, insurers and fund managers with designing and promoting their propositions.

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