Managed/Consensus Funds as Default Options Need Retiring

By Joe Mottley, Clarus Investment Solutions

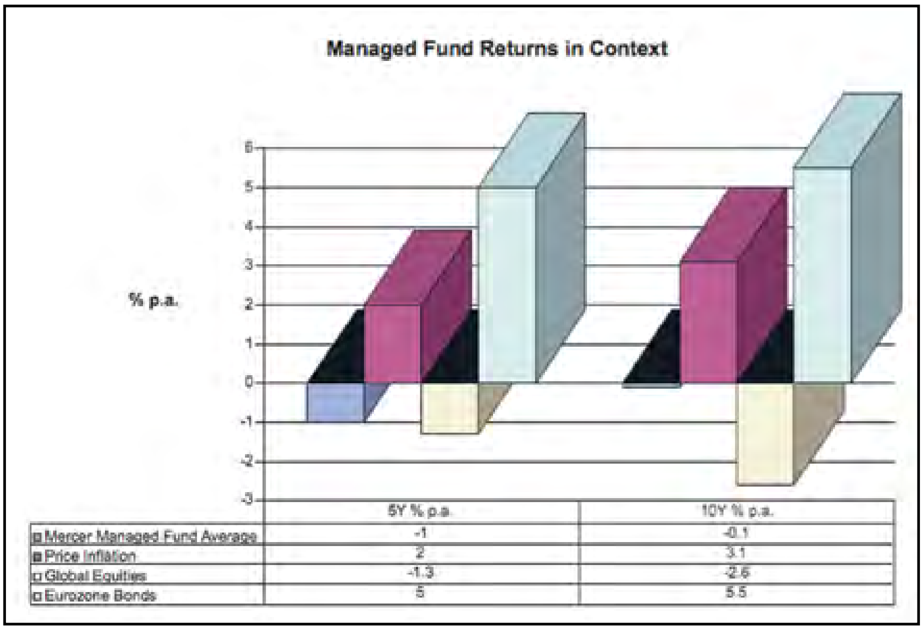
The expression 'elephant in the room' is probably over-used and the world of pensions certainly faces some over-sized issues. However, it is apt to describe the role of Managed/Consensus funds as the default option in by most DC pension schemes.

As we know, the default option takes the lion's share of contributions in most Irish DC pension schemes. That has been the case for years and seems very unlikely to change. A substantial majority of schemes use as their default a managed fund, its derivative consensus, or a lifestyle option with Managed/Consensus at its core.

I believe the Managed/Consensus offering is not at all worthy of such widespread use and that significantly better alternatives can and should be made available. Even if there is little pressure from members to change, I believe trustees/investment committees should be introducing alternative default options.

So What's Wrong with Managed/ Consensus Funds?

1. Crucially, they have failed to deliver over the past decade, as the chart shows. The average managed fund destroyed value by 0.1% p.a. in the 10 years to June 2009, against inflation at 3.1% p.a. While people will say that the markets were uniquely difficult over that time, they also threw up great opportunities: most obviously, investors in bonds reaped strong returns (5.5% p.a. on Eurozone sovereigns). Global equities, negative over the full period, still produced a cumulative 60% during the 2002-2007 recovery. Commodities returned a meagre 0.9% p.a. overall (CRB Total Return Index), but enjoyed multi-year phases of strength along the way.
2. The entire focus of most Managed/ Consensus Funds is performance relative to the peer group. There is a massive 'disconnect' from the actual savers/members who think and relate to 'absolute' return. In my previous role as a fund manager, I have addressed scheme members explaining that a negative return was a good achievement (when less bad than the peer group) only to be met with utter bemusement and, occasionally, hostility!
3. Because of their high and continuous commitment to equities, Managed/ Consensus funds have been too volatile for the 'default' investor. I believe equities are always likely to comprise a significant portion of long-term portfolios, but levels in excess of 70% involve volatility suitable only for high risk investors. (As an aside, it was inappropriate to represent funds with >70% in equities as 'Medium Risk' in pension scheme literature, as I have often seen.)
4. 'Managed' fund is a complete misnomer – 'managed' as offered by most providers means minor adjustments to positions which deviate modestly from the peer group. This is evident from even a cursory glance at the asset distributions at any point in time, or over time. It was demonstrated beyond argument by the communal position in Irish equities. At the end of 2006, for example, as the ISEQ index approached its peak, the average managed fund had a foolhardy 19.3% in Irish equities (representing one quarter of their total equity exposure). 12 of the 18 funds in the Mercer survey were clustered within 1.5 points of the average. The odds of such co-incident positions being derived independently are simply astronomical. Home country bias is observed globally but its scale here was extraordinary. The degree of overweighting was made significantly worse by the dominance of financials and a concentration within a small number of stocks. The majority of managed funds are clearly little more than 'closet' consensus funds and this is not what members think they are investing in.
5. An overwhelming body of data shows that active management in aggregate fails to beat passive. The fact that the vast bulk of the assets of managed funds are actively managed represents the triumph of hope over experience. Except where the manager has



demonstrated particular skill, lower cost passive management should be used.

'DG' Funds a Better Solution?

Diversified funds are a far more suitable than Managed/Consensus for use as the default option. While heavily equity-based strategies might well deliver better returns over the coming decades, more diversified funds should result in more stable outcomes, which better suit DC in general and Default in particular. In many ways DG funds are more like what managed funds should have been (in terms of using a broader range of asset classes), rather than the essentially 'one trick ponies' they became.

While a narrow and eclectic group, what is generally categorised as DG has two distinct sub-sets:

- Funds which are simply better diversified and
- Funds with considerable diversification and an absolute return objective framed as cash plus a margin

The first group is characterised by fairly static asset allocations – there is little or no attempt to generate return by tactical asset allocation. There is widespread use of Exchange Traded Funds, though little or no use of derivatives. Some have significant weightings in relatively illiquid assets such as property and forestry.

The Cash+ offerings are much more complex in terms of the breadth of asset classes employed and particularly their use of derivatives. They actively seek to contribute to return through tactical asset allocation.

The promise of equity-like returns with much lower volatility is surely something of a 'Holy Grail' in pension investing and where combined with performance objectives of Cash + 4-5% (gross) should surely resonate with trustees. The general lack of track record is a major problem but let's be honest, would you buy almost any fund which has been around for the last 5 or 10 years on the basis of its track record ?

The pensions industry has been characterised by conservatism and would normally wait for 3-5 years for the track record of new products/funds to be proven. This is too long to persist with Managed/Consensus (or lifestyle based around them) as default options.

Make no mistake, delivering equity-like returns with significantly lower volatility will be very challenging. Combining it with the delivery of Cash+ 4/5% per annum over 3-5 year periods is even more demanding. However, I believe most DG funds are by their very structure more likely to deliver superior risk/return outcomes. Those with a Cash+ orientation suit the default option even better, provided they are not run too conservatively.

A relatively easy way of replacing Managed/Consensus is to switch to using a selection of individual funds which produce greater diversification and over which the trustees have control. This can in many situations be done without changing from the existing provider(s). Medium/large funds could relatively easily construct a diversified fund of their own based around ETF /passive funds, almost certainly reducing costs in the process.

Those who are sufficiently convinced of the merits of DG might simply blend two DG funds as the new default option.

One way or the other, it is time to retire Managed/Consensus Funds.

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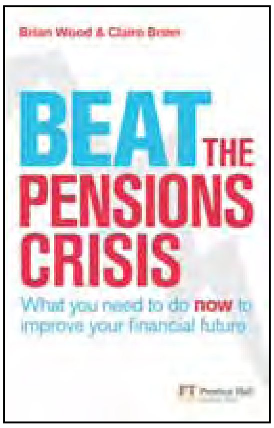
'Beat the Pensions Crisis'



In the early 1970's a fifty year old investing £100,000 into their pension could expect to receive £50,000 per year on retiring at 65. Now that same investment would return just £15,000 per year. As we live longer and have ever higher expectations of a comfortable and rewarding retirement, pensions are, quite rightly, becoming a major cause of concern.

'Beat the Pensions Crisis', by authors Brian Wood and Claire Brinn of Telos Solutions, a financial services management consultancy shows readers how to assess the pension options available to them, helping them to understand the benefits of each and decide which is best suited to them. Readers will learn how to evaluate their personal circumstances and understand how their lifestyle choices will have a direct impact on their future finances.

The book provides a valuable insight into crucial elements of planning for the future such as valuing existing assets, paying into a pension pot and knowing how big that pension pot needs to be.

'Beat the Pensions Crisis' has been written to help consumers take control of their pensions; cutting through the jargon and filtering the overload of information. The book inspires an active approach to help consumers make the best plans for their retirements.