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Workplace Defaults: **Better Member Outcomes**

Research by The People's Pension and State Street Global Advisors

the people's pension

STATE STREET GLOBAL ADVISORS

Foreword

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Default funds are crucial; a well-designed and well-governed investment strategy that is suitable for most members and avoids the need for individuals to make complex investment choices.

There is often discussion about engaging members with their pension savings. To the extent that engagement leads some members to stay enrolled in the plan or consider how much they need to save for the retirement they want, it is helpful. There is no evidence that engaging most members in choosing their own investments is achievable; or, indeed, desirable.

This paper looks at the evidence on investment choice and documents some of the pitfalls for individual investors and the financial impact these could have on their retirement outcomes. The findings support the idea that members will typically achieve better outcomes through being invested in robust, well-governed defaults.

We hope the key messages from this research are helpful to scheme sponsors, trustees, policymakers and members themselves. As ever, we have enjoyed collaborating on this research and we look forward to discussing it with you.

Executive summary

Automatic enrolment has had a huge effect in raising pension scheme participation in the UK. Once in the scheme, members rely significantly on investment returns to get the pension outcome they need.

In this paper, we show why most members are better off in well-governed default investment strategies, rather than making their own detailed investment fund choices.

Firstly, evidence has shown that individuals are prone to behavioural biases which can lead to suboptimal outcomes when making complex financial decisions. In the following pages, you will meet four pension saver personas, illustrating pitfalls we have observed in the UK pensions industry:

Performance Chasing Patricia – Buy high, sell low
Patricia is attracted to strongly performing funds, however, loses faith when these funds begin to do poorly. The result is a strategy that buys high and sells low, and generates poor returns.

Eggs in One Basket Elliot
Elliot chooses to invest his money in a single theme, sector or stock, resulting in an under-diversified portfolio.

Cautious Connor – Not taking enough risk-members tempted into safe investments
Connor favours capital preservation over return and therefore invests in low risk assets. The result is a recklessly conservative portfolio.

Forgetful Fiona – Setting an investment strategy and not reviewing it as circumstances change
Fiona is a busy person and can't find the time to review the investment strategy that she set a number of years ago. The result is an investment strategy that is no longer suitable for her circumstances.

When modelled, all four of the strategies adopted by our pension saver personas produced lower accumulated pot sizes or more risk compared to a typical workplace default strategy.

We also show the impact and importance that fees can have on a member's pot size in retirement. Members switching out of their workplace pension default may end up incurring higher charges. The difference between charges of 30bps and 90bps over a typical pension saver's career could amount to a difference in pot size of £31,469.

Finally, we show that the average active fund typically underperforms the index. Whilst investors may believe that active managers will be able to deliver high returns, it will be challenging for them to identify successful managers in advance.

From these findings, we conclude that good default investment strategies result in better outcomes for members. Good defaults are a result of robust governance, ensuring that member's interests are protected and the investment strategy remains suitable on an ongoing basis. Workplace pension savers may also benefit from the economies and governance benefits delivered by scale.

Contents

Background

Why we wanted to do this study

Automatic Enrolment has been successful in laying the foundations for a comprehensive DC pensions system in the UK. There are now nearly 18 million members participating in DC workplace pensions, representing 84% of eligible employees.[1]

While joining the pension scheme and contributing adequately are crucial decisions in ensuring good outcomes for members, investment returns play a very important role in ensuring adequate retirement income. Later on we will show that the difference between holding cash and investing in a workplace default could amount to £246,879 over a typical working life.

Most members are invested in a default multi-asset fund constructed by their pension provider, which follows a lifecycle approach.[2] The level of risk that members are subject to will be based on their age and distance to retirement, with the asset allocation becoming more conservative as members approach their expected retirement date. Many defaults use low cost index tracking funds and are also well diversified to manage risk for members.

Member-first governance leading to appropriately constructed defaults is key in achieving good outcomes for members. This paper looks at evidence to support the importance of and focus on well governed default strategies. It looks at the potential pitfalls should members decide to – or be encouraged to – make their own investment choices, especially where they choose to switch out of their workplace pension schemes to do so.

The Australian Defined Contribution pensions system – the most similar system to the UK's new DC system – offers compelling data. The Australian government sponsored Productivity Commission recently examined the efficiency of the AUD $2.6 trillion retirement savings system in detail and found that "choice options" produced lower returns in aggregate than simple, single investment option default funds and have higher charges.[3]

According to the Prudential Regulator, over the decade between 2005 and 2016, Australian retail superannuation funds returned 4.9 per cent, net of investment and administration expenses, and taxes. By comparison, industry-wide funds operating on a default fund basis returned 6.8 per cent.[4]

The Productivity Commission also reported that almost half of choice investment options, which account for 40 per cent of assets, delivered returns of more than 0.25 percentage points below their tailored benchmark.[5] The poorer average investment returns generated by retail should be considered alongside scandalous revelations about the sector's misconduct revealed in the course of the 2019 Royal Commission. Numerous instances of retail funds putting the financial interests of their owners – chiefly banks and wealth managers – before the financial interest of their members emerged.[6]

[1] Department for Work and Pensions, "Auto Enrolment Evaluation Report" (2018) .The ineligible population which totals nearly 10 million includes all those earning under £10,000 per annum and all those under the age of 23).
[2] Pensions Policy Institute, "The Future Book" (2017). Master Trusts / multi-employer schemes had a higher proportion of total members invested in the default fund at 99.7% on average).
[3] Australian Government: Productivity Commission, "Superannuation: Assessing Efficiency and Competitiveness" (21 December 2018)
[4] Table 9A: https://www.apra.gov.au/sites/default/files/annual_superannuation_bulletin_june_2018_1.xlsx.]
[5] Table 9A: https://www.apra.gov.au/sites/default/files/annual_superannuation_bulletin_june_2018_1.xlsx.]
[6] Royal Commission, "Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry" (February 2019)

Pension scheme members making their own detailed investment choices face the following challenges which may lead to poorer outcomes, especially if they do not benefit from good quality advice:

1 There is well-documented evidence that individual investors, driven by behavioural biases and the complexity of the decisions with which they are faced, make avoidable mistakes which can reduce their long-term returns

2 Retail investment products generally have higher fees than workplace defaults, creating a drag on performance and ultimately causing detriment to the value of members' pots

3 Finally, only a minority of actively managed funds provide superior returns to index based approaches, and it is extremely challenging to identify in advance the funds that will consistently outperform.[7]

While good advice can help guide members to funds tailored to their circumstances, we know that the vast majority of members do not have access to, or cannot afford professional financial advice. Members with no access to advice may make investment choices that are not in their own best interests.

As Keith Ambachtscheer notes of the Canadian experience "....the value-adding investment results of fiduciary principles-driven pension funds (i.e. defaults) contrast sharply with the material value-losing performance of retail mutual funds. As a result, fiduciary principles-driven pension funds will easily generate twice the pension per dollar of retirement savings than a dollar invested in the average mutual fund."[8]

[7] Financial Conduct Authority, "Asset Management Market Study" (2019). "There is no clear relationship between charges and the gross"
[8] The Ambachtsheer Letter, May 2016, quoting Profs. Linnainmaa, Melzer, and Previtera who studied the investment portfolios of over 5,000 Canadian financial advisors and of over 500,000 of their clients over the 1999-2013 investment period. The data was provided by three Canadian mutual fund dealers. The study compared the investment behaviour and results of a large sample of mutual fund investors and those of the financial advisors who advise them. There was a strong correlation between how advisors advised their clients to invest, and how they invested themselves. While their clients underperformed their passive benchmarks by an average 3%/yr., the advisors' own portfolios underperformed by an average 4%/yr. The researchers conclude that in too many cases, advisors are drawn into the industry with the misguided belief that the combination of high-fee funds and high turnover will improve investment performance).

Evaluating choice architecture

People within UK pension schemes will have different approaches to investment:[9]

1. The vast majority of people do not have the time, resources or expertise to design and manage their own investment strategy. They do not engage and remain in the default strategy by default. Some may have little awareness of how (or even if) their money is invested.

2. A smaller minority actively choose the default strategy as the best available option having made an evaluation of whether it suits their needs.

3. Fewer again look to make their own active fund choices, to reflect specific needs or confidence because they think they can do better than the default.

In this paper, we show that it is rarely the case that individuals are better off making specific active investment choices with their pension assets. There is, though, a case for offering a structured range of choices within the workplace pension scheme meeting different objectives or preferences:

Differences in retirement destination, e.g. annuity or drawdown

Differences in risk tolerance

Particular religious or ethical preferences

This choice architecture is likely to comprise a small range of pre-packaged lifecycle strategies, where the asset allocation and investment selection is under fiduciary control – as per the default – but the member is choosing the destination and the risk to be taken getting there. This is fundamentally quite different from a member choosing individual fund building blocks to create their own journey. And, we should not underestimate the challenge for many people to define their preferences and make choices even at this level of detail.

[9] Bobadilla-Suaez, Sustein and Sharot. "The Intrinsic Value of Choice: The Propensity to Under-Delegate in the Face of Potential Gains and Losses" (July 2017)

Evidence on financial literacy

One reason why default funds are valuable is because financial literacy overall is relatively low. According to the OECD / INFE 2016 Study of Adult Financial Literacy Competencies, adults in the UK ranked 15th out of 30 countries measured in the survey. Financial Capability concluded that "the complexities of the financial system, changes in social attitudes and a retail-led culture have all outpaced the ability of [UK] consumers to develop individual money management skills."[10]

There is a desire to improve financial literacy, but aiming for the average member to become their own chief investment officer is a bit like taking up climbing by seeking to ascend Mount Everest.

Investing for retirement is, quite simply, hard. Nobel Prize winning economist Peter Diamond, writing with Nicholas Barr from the LSE neatly summarised the challenges:

15th

According to the OECD/INFE 2016 Study of Adult Financial Literacy Competencies, adults in the UK ranked 15th out of 30 countries measured in the survey.

> "The behaviour of financial assets over time is complex and understanding is limited by the variation over times in the stochastic properties of asset returns. It is not easy to tell which investment managers are good and which were lucky. The determinants of the risk-return frontier are not simple to understand. Compounding the problem, decision-making requires repeated adjustments, i.e. it is not an event but a process. What is involved is not like buying a car, where a person can do some research and make a decision."[11]

[10] https://www.fincap.org.uk/en/articles
[11] Designing a Default Structure, Submission to the Inquiry into Superannuation: Assessing Efficiency and Competitiveness: Nicholas Barr and Peter Diamond

Investors often make mistakes

How investors think

Investors are human. It is well documented that humans are prone to behavioural biases which affect the way we make decisions including financial ones.

For example, people use mental short cuts to make decisions – which simplifies things but may not lead to the best outcomes – and can be influenced by the way things are presented or framed.

Behavioural research also suggests that individuals can be nudged towards particular choices and outcomes. The UK's automatic enrolment system uses inertia to nudge people towards retirement saving. Pension plan membership becomes automatic and easy, while opting out needs conscious effort. As a result, private sector pension participation increased from 55% to 84% (of the eligible population) over the period 2012-2018.[12]

The behavioural bias towards inertia is only one of many. Other examples of behavioural biases that individual investors including pension savers have exhibited are:

- **Overconfidence –** an excessive belief in own ability to pick top performing stocks
- **Over-extrapolation –** extrapolating from just a few years of returns into the future
- **Mental accounting and narrow bracketing –** making investment decisions asset-by-asset rather than considering the whole investment portfolio
- **Framing, salience and limited attention –** overestimating the value of a product because it is presented in a particularly attractive way
- **Decision-making rules of thumb –** for example, splitting investments equally across all available funds rather than making a careful allocation decision
- **Persuasion and social influences –** choosing a fund because a friend / family member has done the same[13]

The next section of this paper discusses how those who have chosen to make their own investment decisions might receive poorer outcomes compared to those in defaults. In each case, we have introduced a persona for ease of reference throughout the remainder of this report.

[12] Department for Work and Pensions, "Automatic Enrolment Evaluation Report" (2018)
[13] Erta, Hunt, Iscenko and Brambley,Financial Conduct Authority, "Applying Behavioural Economics at the Financial Conduct Authority" (April 2013)

Mistakes investors make

Mistake

#1

Introducing, Performance Chasing Patricia.

DALBAR has studied investor behaviour since 1985 and has found that the average investor consistently earns less return – in many cases, much less – than the average investment mutual fund. The studies, conducted annually, have shown that the average investors have consistently underperformed the index with the exception of just a few periods.[14]

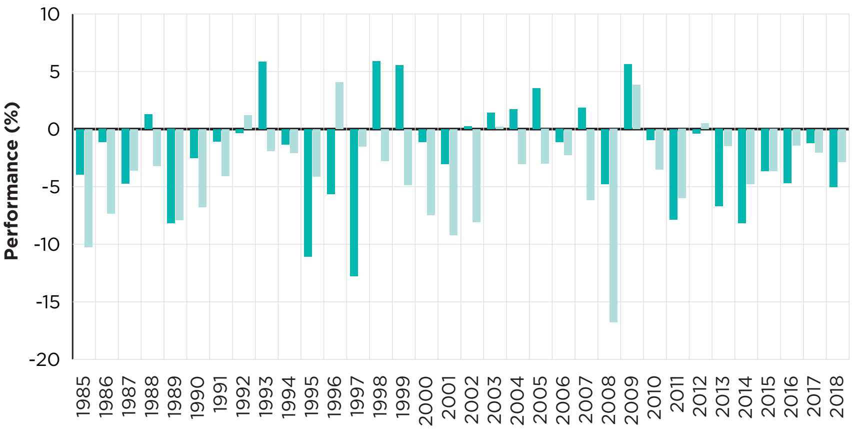
Chasing past performance

It is superficially attractive to buy into a strongly performing fund, expecting that strong performance to continue. Perhaps a high profile retail fund that has done better than your workplace default fund short-term. But past performance may not be a guide to the future.

Some investors will find that the fund they expected to do well begins to do poorly. At some point they will lose faith and sell out. The result is a strategy that buys high and sells low.

There is evidence to this effect that shows the average fund does less well than the market index, but the average investor earns less than the time weighted return because of their poor (buy high, sell low) timing decisions.

Average Investor Performance v Index[15]



- Average Equity Fund Investor Outperformance of S&P 500
- Average Fixed Income Fund Investor Outperformance of Bloomberg Barclays Aggregate Treasury Index

Outperformance is calculated as average investor performance minus the index performance for that period.

DALBAR also showed that over the past 20 years, equity mutual fund investors rarely held the same fund for more than four years indicating that one of the sources of poor performance is too much trading activity, attempting to time the market.[15]

[14] DALBAR, "Quantitative Analysis of Investor Behaviour" (2018)
[15] Fidelity, "The Guide to Diversification" (2019)

Mistake

#2

Introducing,
Eggs in One Basket
Elliot.

Putting all their eggs in one basket

Most workplace default strategies are highly diversified to manage volatility. Investors choosing their own funds may fail to diversify as widely. This could be based on chasing performance as per the previous section; it could be based on overconfidence that a particular theme, stock or sector is a sure winner (dot com, tech, etc.). Equally, it could be an attempt to reduce risk by investing only in the familiar, local investments (home bias), preference for tangible investments (property etc.).

The result is an under-diversified portfolio, and probably more risk than is necessary.

In 2000, Sweden introduced its Premium Pension System which was characterised by its "pro-choice" policy. Members in the plan were encouraged to choose their own funds from a list of 456.

In 2004, Thaler and Cronqvist studied the behaviour of plan members, including a comparison of the asset allocation of the Swedish Social Security default with the average actively chosen portfolio. They found a significant home bias as well as a tendency to choose more expensive active funds by those members who had actively chosen their portfolio:[16]

	Percentages	
Portfolio Characteristic	**Default**	**Average actively chosen portfolio**
Regional allocation (%)		
Sweden	17	48
Americas	35	23
Europe	20	18
Asia	10	7
Indexed	60	4
Fee (%)	0.17	0.77
Beta	0.98	1.01
Ex post performance (%)	-29.9	-39.6

[16] Thaler and Cronqvist, "Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience" (2004)

Mistake

#3

Introducing,
Cautious Connor.

Not taking enough risk

In times like we've experienced in the last few months, it may be tempting for members to move their savings into "safe" investments. However, we have to remember that pension investing is long-term. Most investors are not saving at high enough rates and need a good real return to achieve a retirement pot big enough to fund their retirement. This means taking some investment risk and experiencing some bumps along the journey, which isn't a bad thing given the long-time horizon of pension investing.

Some investors may favour capital preservation over real return, or fail to understand the trade-off. Often called money illusion[17] which is the desire to preserve today's pot, say £1,000, but not appreciate that £1,000 in the future will be less than it is today because of inflation.

The result is a recklessly conservative portfolio.

In 2017, we jointly commissioned Ignition House to carry out the study, New Choices, Big Decisions[18] which found several cases of people aged 55 and over able to access their savings due to pension freedoms and parking their pension savings into a cash ISA without thinking of the long-term consequences, with 50% withdrawing a cash lump sum from their pension to re-invest into and ISA.

In a follow up study, Ignition House interview people who had opted out of their pensions:[19]

"There is no guarantee that you will get anything back. My money is in ISAs now, I don't know why, I just think they are safer than pensions. They are in a bank and the bank carries you for so many thousands of pounds, so I would be covered, whereas with the pension, I don't think I would be."
Female, 52, Opted Out

In its recent study of the non-workplace pension market, the FCA found that cash was among the top five most popular investments for several schemes.[20]

[17] Keynes, money illusion occurs when "individuals do note accurately take inflation into account (1936)
[18] Ignition House, "New Choices, Big Decisions" (2017). 19 people out of 38 making decisions at retirement took a lump sum withdrawal to reinvest into an ISA
[19] Ignition House, "Should I Stay or Should I Go?", (2018)
[20] Financial Conduct Authority, "Effective Competition in Non-Workplace Pensions" Feedback Statement 19/5, (July 2019)

Mistake

#4

Introducing, Forgetful Fiona.

Forgetting to take account of changing circumstances

Inertia is strong. People are busy with conflicting calls on their time. They may procrastinate on decisions that are difficult or uncomfortable.

Inertia has been positive in allowing automatic enrolment to boost pension plan take up, but the issue here is the investor who makes an active choice of a fund for their pension may not keep that decision under review as circumstances change. This could be changes to the prospects for the investment (market outlook, fund manager etc.) but more fundamentally is likely to be changes in the investors' circumstances.

Most default strategies follow a lifecycle approach that adjusts the risk in the fund over time to be suitable for the investors time horizon.

The level of risk in the fund will be reduced as the retirement date – when the funds will start to be drawn down – approaches.

1

Over a sixteen year period, the average number of trades that individual investors made was just one.[21]

It is likely that many investors who choose their own funds may fail to make this adjustment.

Revisiting our example of the Swedish Premium Pension system, where a majority of individuals were encouraged to select their own funds by a very expensive one-off government funded call-to-action campaign. However, most savers "set it and forgot it," failing to revisit their initial fund selection. Over a sixteen year period, the average number of trades that individual investors made was just one.[21] Even revelations of fraud among some of the available funds failed to move 'one and done' savers to overcome inertia and revisit their original choice.

[21] Henrik Cronqvist, Richard H, Frank Yu, "When Nudges are Forever: Inertia in Swedish Premium Pension Plan", (2018)

Impact of investor mistakes

Based on past performance, we have simulated the potential mistakes 1-4 assuming the investors were saving for a period of 33 years starting in 1986. They had monthly contributions of 8% throughout their career, a starting salary of £25,000 and wage growth of 2% per year.

Persona	**Mistake**	**Ending pot size**	**Maximum drawdown**	**Annual volatility**
Work place default	Equity – Bond glide path	£429,250	11.6%	14.1%
Performance Chasing Patricia	Buys at the top of bull markets and sells at the trough (if market rises 20% Patricia buys and if market drops 20% she sells)	£255,995	19.2%	12.6%
Eggs in One Basket Elliot	Invests only in UK stocks	£398,380	17.6%	15.0%
Cautious Connor	Invests in a money market fund rather than default	£182,371	0.0%	1.2%
Forgetful Fiona	Buys a fund – say equities – and doesn't lifecycle (same as Elliot for modelling purposes)	£398,380	17.6%	15.0%

For comparative purposes, we have presented results for a simple workplace default, gliding from 80% equities / 20% bonds to 40% equities / 60% bonds.

The workplace default in the example de-risked as the member approached retirement age and hence balanced risks over time.

These results simply illustrate of how workplace defaults can successfully overcome the negative impacts of behavioural biases that are inherent in individual investors.

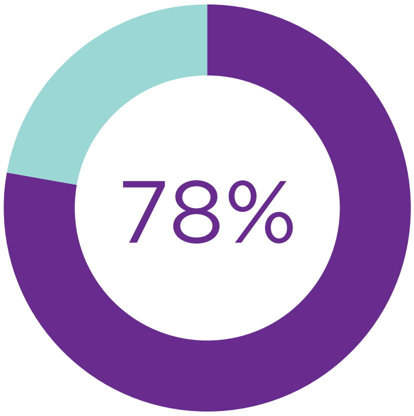
The impact of fees

Individuals do not pay enough attention to fees

Fees are a necessary part of any financial product. Ultimately fees paid reduce the value of members' pension pots, and therefore high fees can have a negative impact on member outcomes if they are not correlated with superior returns.

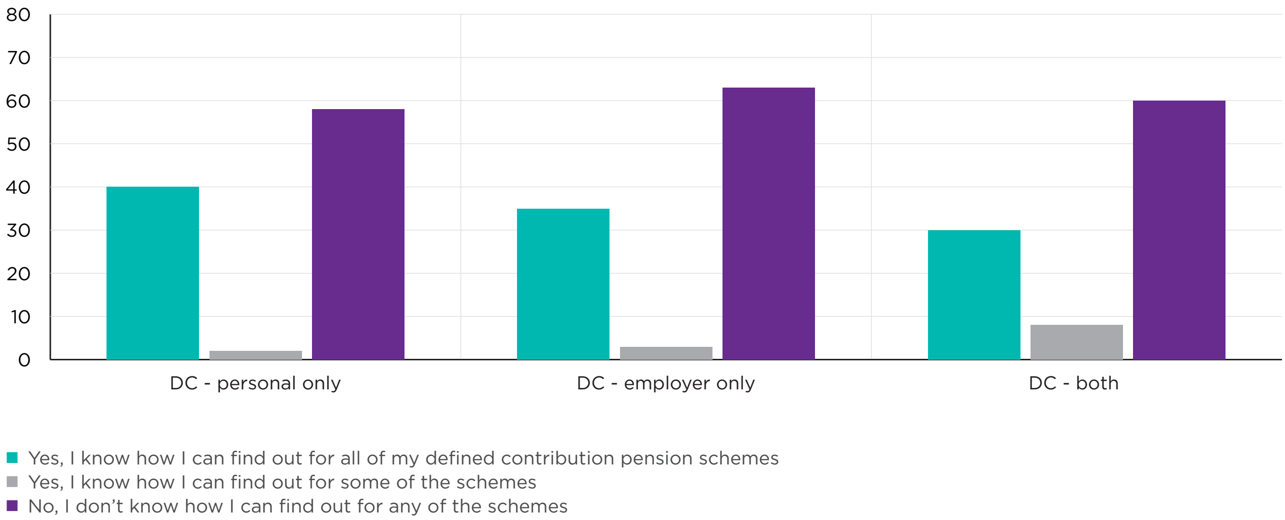
We generally find that retail investors are subject to higher fees and their lack of attention paid to charges means that competitive pressure is not applied to the industry to lower fees.

The FCA Financial Lives Survey not only found low awareness of charges but also revealed that the majority of members did not know how to find out about their charges.[22]



The FCA Financial Lives Survey found that 78% of DC customers were not aware of the charges on their pension.

FCA: Do consumers know how to find out what charges they might pay:[23]



[22] Financial Conduct Authority, "Effective Competition in Non-Workplace Pensions" Discussion Paper, (February 2018)
[23] Financial Conduct Authority, "Effective Competition in Non-Workplace Pensions" Discussion Paper, (February 2018)

Retail product fees are complex

Fees for investment are often complex, perhaps sometimes deliberately so. Even when made simple, however, to the extent that they involve apparently small percentages on large amounts, research has shown that many people do not understand the impact they have.

This means that people will find it difficult to effectively compare fees between providers and make decisions.

In the FCA's recent consumer research, the following behaviours among members of non-workplace pension schemes were observed:[24]

- Product fees were not considered
- Cost was given a brief thought, but product fees were assumed to be marginal and consistent across providers
- Product fees were thought to be payable only at outset, not ongoing
- Cost was considered and concluded to be a very low amount ongoing and therefore acceptable (little to no benchmarking taking place given the issues with comparisons described earlier)

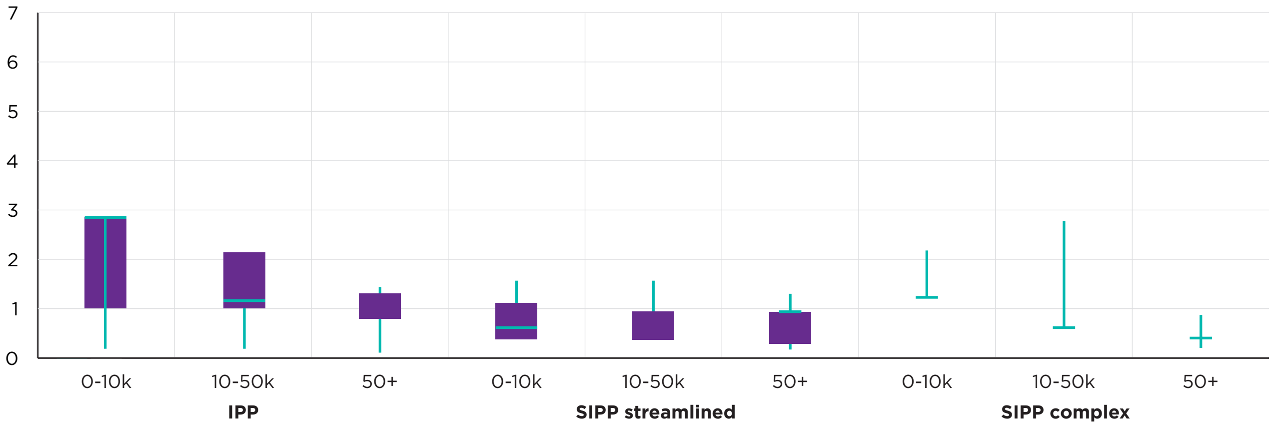
Fees on retail products are typically higher than workplace defaults

In its Feedback Statement: Effective Competition in Non-Workplace Pensions, the FCA found that on average charges were more than 1% in the non-workplace pension market.[25]

[24] Financial Conduct Authority, "Non Workplace Pensions Consumer Research" (October 2018)
[25] Financial Conduct Authority, "Effective Competition in Non-Workplace Pensions" (July, 2019)

The chart below shows data gathered by the FCA on the distribution of total charges by pot size. The sample includes providers reporting a single charge figure including both product charges and fund charges.

Fig 3.5 Distribution of total charges by pot size – Set 1[26]



In contrast, in 2018, Willis Towers Watson published that the average annual management charge (AMC) for the default funds of FTSE 100 arrangements was 0.36.[27] Whilst additional expenses will be charged on top of the annual management charge, our conclusion is that on average, workplace defaults have lower all-in fees than retail funds. The average member charge of the Pension and Lifetime Association Members stands at 0.46%.[28] The new mass market auto enrolment multi-employer schemes are providing even the smallest employers and low income employees with an average charge of 0.50%.

The table below shows simulated outcomes at differing fee levels.

Fee level[29]	Pot size after 40 years of investing in a 60% equity, 40% bonds portfolio
30bps	£265,644
50bps	£254,650
90bps	£234,175

[26] Financial Conduct Authority, "Effective Competition in Non-Workplace Pensions", Feedback Statement, (July 2019). Set 1 includes providers who reported a single charge for both product charges and fund charges
[27] Willis Towers Watson, "FTSE 350 DC Pension Scheme Survey" (2018)
[28] Pensions and Lifetime Savings Association, "Costs, Charges and Governance in DC Schemes", (2019)
[29] Modelling by State Street Global Advisors. Models based on simulations taking into account assumed return and volatility. Assumes starting salary of £25,000 increasing in line with inflation. 8% contributions made per year.

Barr and Diamond's analysis of overseas fees

In their 2017 paper Designing a Default Structure, Barr and Diamond highlighted other examples where retail and institutional fees are at huge variance:[30]

> "As has been learned repeatedly since Chile initiated the mandate of funds from private suppliers, competition often takes place through advertising rather than by offering lower prices. The results include (a) higher prices than the simplest model-based conclusion of marginal cost pricing, and (b) diverse pricing of uniform (or nearly uniform) products. Moreover, this process does not deliver enough information about the choices. In particular, markets with significant frictions have incentives for suppliers to obscure some aspects of the full product."

[30] Nicholas Barr and Peter Diamond, "Designing A Default Structure, Submission to the Inquiry into Superannuation: Assessing Efficiency and Competitiveness" (2017)

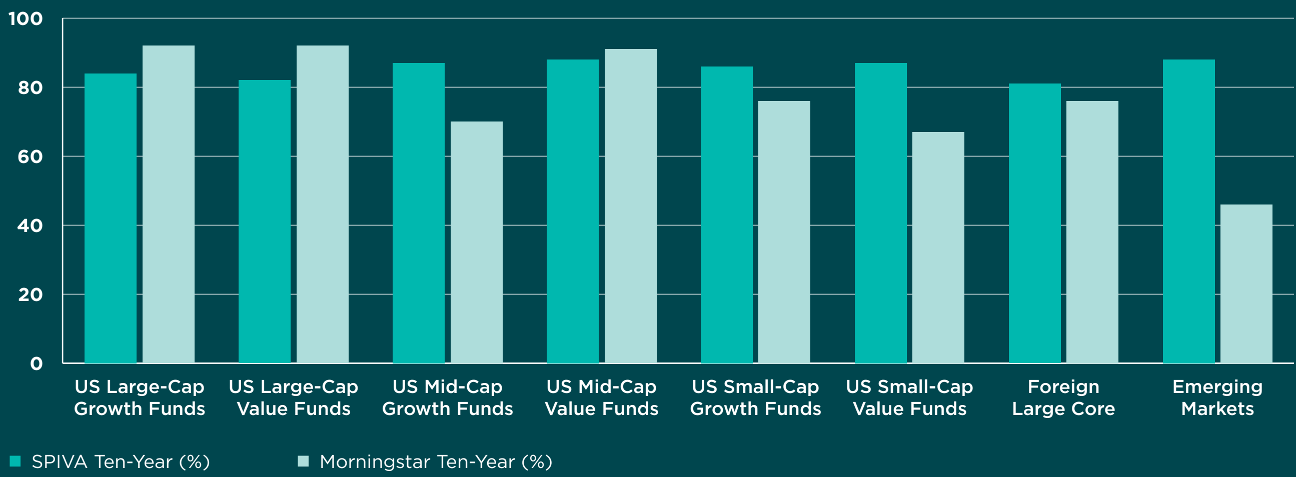
Active funds

It is difficult to identify good active funds

Many workplace defaults invest a significant proportion in index based funds, which keeps cost low. Investors may believe that an active manager will be able to deliver higher returns and manage risk more effectively thus warranting paying higher fees.

But it is challenging to identify those successful managers in advance. Past performance is not necessarily a guide. We know that the average active fund typically underperforms the index net of fees.[31] The chart below shows the percentage of funds which underperform their equivalent passive index:

Morningstar versus SPIVA 10-year results through 31 Dec 2018



We also know there is limited persistence of outperformance so it is hard to identify those managers who will do better than the benchmark consistently. Again, there is the risk of buying high and selling low – buying a fund that has outperformed, experiencing poorer performance and then losing faith and selling out.

With in-depth research into management processes, i.e. provided by well-resourced investment consultancy or advisor firms, good managers might be identified. However, in reality, many members if encouraged to D-I-Y invest, would not have access to this specialist advice and could not replicate this research process.

The Financial Times reported in the wake of the collapse of Neil Woodford's retail investment empire: "Active funds promoted by brokers as part of "best-buy" lists have overwhelmingly underperformed equivalent passive funds over the past three years... UK active equity funds recommended by three prominent buy lists...Fees for active funds are typically 10 times those of tracker funds."[32]

[31] S&P Dow Jones Indices LLC, Morningstar Active/Passive Barometer, CRSP. Data as of 31 Dec 2018. Underperformance is based upon equal weighted fund counts. Fund percentages are Net of Fees. All index returns used are total returns. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.
[32] https://amp-ft-com.cdn.ampproject.org/c/s/amp.ft.com/content/34058e86-d0a5-11e9-99a4-b5ded7a7fe3f)

Closing remarks

What does good governance look like?

Good governance encompasses fiduciaries who act in the best interests of members, with clear objectives and appropriate skills and resources.[33]

We have made the case for the value of good default investment strategies in achieving good retirement outcomes for pension scheme members.

Good defaults are the result of robust governance, in alignment with members' interests. Robust governance ensures that defaults adapt to ongoing changes and remain suitable for members:

Legislation and regulation

We have seen, and will continue to see, changes in the pensions landscape as a result of legislation and regulation. This could impact savings rates, pot sizes, product innovation and more.

Member characteristics and behaviour

Member needs may change over time as people increasingly look to DC as a source of retirement income and focus shifts away from DB.

Our population is ageing and living longer and therefore we can expect that people will be working longer.

Investment environment

In the past three months alone, we have seen significant swings in the market. The investment and economic backdrop has changed, and will continue to change over time.

Scale is also important. It supports the resources required to deliver good governance and allows the fiduciary to achieve good value for members through size driven economies, in purchasing investment management and other services.

[33] Clark and Urwin, "DC Pension Fund Best Practice Design and Governance", (2010)

Appendix: Lessons from overseas

Case Study: Australia Productivity Commission Report

Australia has a well-established and large pension ("superannuation") system. While participation is mandatory, most members can choose their own fund if they don't want to use the default chosen by their employer.

Large superannuation funds in Australia can be loosely divided into two groups. The first is not-for-profit funds which includes "industry funds" (which grew out of the union movement), funds for government employees, and a handful of employer funds. The second is "for-profit" funds, sometimes called "retail" funds, which are offered by banks or insurance companies.

But there is a third fund type in Australia; the "Self-Managed Superannuation Fund" or SMSF. In short, these are members who have decided to do it all themselves.

In late 2018 the Productivity Commission, an independent government advisory body, completed an exhaustive three-year review into the superannuation system. The aim of the review was to assess the efficiency and competitiveness of the system. The conclusion, that on every measure of long-term investment returns the pensions funds of the non-profit sector outperformed, was striking.

This report should be read alongside the higher profile Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (208/19), which disclosed numerous examples of bank and wealth manager owned – retail sector – pension funds putting the financial interests of the owner and its employees above the financial interests of the members. "In almost every case the conduct in issue was driven by the relevant entity's pursuit of profit but also by individuals' pursuit of gain, whether in the form of remuneration for the individual or profit for the individual's business. Providing a service to customers was relegated to second place. Sales became all important. Those who dealt with customers became sellers. And the confusion of roles extended well beyond front line service staff. Advisers became sellers and sellers became advisers."[34]

Large Superannuation Fund types:

1. **Not-for-profit 'Industry' funds**
2. **For-profit 'Retail' funds**
3. **Self-managed Superannuation Fund 'SMSF'**

[34] Royal Commission Final Report, vol 1, p.1

Among the Productivity Commission's findings relevant to the UK are the following:[35]

Multiple Accounts:	"A third of accounts ... are unintended multiple accounts. These erode members' balances ... in unnecessary fees and insurance." The review stressed the need for most members to have their retirement savings in one pot, rather than spread out between providers.
Fees:	"Evidence abounds of excessive and unwarranted fees in the super system. Reported fees have trended down but a tail of high-fee products remains entrenched, mostly in retail funds." In fact, the review noted that close to 60% of members do not understand their fees and charges.
Investment Returns:	"While some funds consistently achieve high net returns, a significant number of products underperform, even after adjusting for differences in investment strategy. Underperformers span both default and choice, and most (but not all) affected members are in retail funds."
SMSFs:	Large SMSFs earn broadly similar net returns ... but smaller ones (with less than $500 000 in assets) perform significantly worse on average. This is mainly due to the materially higher average costs they incur due to being small.

The default carries a heavy burden in Australia and receives plenty of attention in the report: typically less than 10% of members switch in any year, and only a third of members have ever changed their investments, concentrated in the high net worth Self-Managed Super sector.

Of particular interest is a section headed "Members are not always going to make good decisions." Here the report notes that low engagement from members is not necessarily a problem: "Indeed, low engagement is to be expected in a compulsory and complex system that covers the bulk of the population. In some cases, disengagement can also be a consequence of cognitive constraints and behavioural biases, such as myopia, loss aversion, and a tendency to procrastinate."

While the report is critical of how members in Australia are directed to default funds, the report notes that "The default segment outperforms the system on average."[36]

The combined impact of the Productivity Commission and the Royal Commission has been a shift in pension assets from retail to industry funds, with analysts predicting the latter becoming the funds of choice for an increasing proportion of higher net worth individuals too. A recent KPMG report predicted that industry funds will overtake retail funds, holding the largest market share at just over $2 trillion in assets by 2029.[37]

[35] As one might expect, some of these findings are controversial
[36] Australian Government: Productivity Commission, "Superannuation: Assessing Efficiency and Competitiveness" (21 December 2018)
[37] KPMG, "Super Insights 2019", (April 2019)