The hidden trade-off in DC pensions

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Introduction

DC investors are making a costly trade-off that many are completely unaware of. The focus on daily liquidity in DC pension products might provide members with the ultimate flexibility governments want them to have, but the vast majority of members neither use that flexibility nor realise the hidden cost at which it comes. Research points to a potential gain of five percent or more if DC pension pots were allowed to invest in illiquid assets.

As the pensions environment and demographic changes place ever more pressure on individuals' retirement savings, governments can no longer afford to ignore this issue and must launch consultations on the sense behind both daily liquidity and charge caps. Savers deserve to know about the compromises they are being forced to make. It is time for a serious rethink.

1. Is daily dealing really necessary?

The move towards daily trading has no basis in sound reason from a typical member's perspective. It was born of competition between administrators who differentiated themselves from their peers based on the speed at which they invest/disinvest member contributions. This meant a shift from monthly to weekly and, ultimately, daily trading.

The perceived greater efficiency this created lured people into believing it must be good. Regulators, keenly focussed on promoting flexibility in pensions arrangements, certainly seem to have adopted this view, which is clear in the liquidity constraints placed on mutual fund structures such as UCITS funds and in how they regulate the pension provision market.

But in the rush for ever-more rapid trading, people were not thinking about the impact that trend would have on investment outcomes.

In reality, most people don't make use of the flexibility today's DC pension framework affords them. And if flexibility means lower returns, then that should also be explained to savers given the compromise they are being forced to make.

The vast majority of pension scheme members would probably find monthly trading acceptable. Evidence from around the industry suggests few trade more frequently than this, even when markets are behaving in a manner that should create considerable concern.

Vanguard data, for example, shows that, in the US during 2008 and 2009, DC member activity remained largely unchanged despite the dramatic period of market volatility. Their data[1] shows only 16% of DC plan participants traded in their retirement accounts in 2008 and a year later that figure was down to 13%.

In the UK, The Pensions Regulator, in a 2012 report[2], found only 24% of 'deferred members' – members who are no longer employed by the firm offering the scheme – looked into transferring their funds into another scheme. A mere 7% had looked into changing the funds or risk profile of their investments since leaving the employer.

Meanwhile, the Department of Work and Pensions assessed in 2012 that just under 90% of individuals who will reach retirement between 2050 and 2060 have one or more 'dormant' workplace pension pots.[3]

More recently, the UK Government has banned the practise of charging higher fees to deferred members compared to active contributors for fear it could have a material impact on retirement outcomes. For many pension schemes they have until 6 April 2016 to enact this change. The fact this unfair charging system was allowed to prevail for so long demonstrates the inertia of DC savers. Had enough people noticed, action would have been taken much sooner.

In the US, the Government Accountability Office has been reviewing the legal situation with regard to forced transfers and inactive accounts after it became clear members found it hard to keep track of their savings and to navigate the transfer process, which, in the case of pots totalling less than $5,000 can be forcibly transferred into individual retirement accounts (IRAs), which often end up sitting as cash and where fees can outstrip returns. So far, no action has been taken to change the situation, which clearly leaves investors sitting on (often several) small pots of highly liquid investments. This is not an ideal outcome for a long-term investor.

2. The cost of liquidity

Insisting on liquidity also has a material impact on retirement outcomes, but, so far, this has been overlooked by pensions regulators.

Through silence on the matter, the regulators support the continued focus on daily liquidity, which only really benefits the small minority of members who actively trade their pension pots, and are ruling out the ability for the majority to avoid this liquidity drag. Yet, people saving for their retirement are naturally long-term investors and should be able to reap the additional rewards available for being able to take the long-term view.

Access to many forms of alterative investment, such as infrastructure, property, hedge funds or private equity, is limited to listed vehicles in those asset classes. However, listed vehicles rarely capture the full scale of premium available as they do not offer the same economic exposure.

To achieve this liquidity such vehicles have to maintain a higher margin of cash to allow for redemptions than is necessary in reality. With returns on cash being so low relative to other investments, this is a significant opportunity cost over the lifetime of a pension pot.

[1] Vanguard, Resilience in volatile markets: 401(k) participant behavior September 2007-December 2009, March 2010
[2] The Pensions Regulator, Survey of DC Pension scheme members, August 2012
[3] Department of Work and Pensions, Small Pots and Automatic Transfers Impact Assessment, 21 May 2012

This liquidity drag presents a material cost to DC members, however. Modelling shows that over the average life-time of a pension pot, the differential between a fund that could invest in illiquid assets and one that can only invest in liquid versions of illiquid assets (such as REITS instead of actual real estate) was in the order of five to ten percent. That is a meaningful differential.

In May 2013, the Defined Contribution Investment Forum (DCIF) issued a paper[4] suggesting DC pension funds were missing out on both the illiquidity premium and opportunities for portfolio diversification because of the greater focus on liquidity compared to defined benefit pensions. This cost them a benefit of as much as 5% in additional pension, according to their analysis.

If savers are not making use of the flexibility afforded to them by the daily liquidity and pricing requirements under the current DC framework, then 5% seems a costly trade-off for them to be making, especially if they are not aware that is the case.

3. Charge caps are dangerous

The imposition of charge caps, such as the 0.75% cap placed on DC investment products in the UK, make matters worse.

That small amount must include administration and asset management costs and leads to a situation where well diversified and intelligent strategies are given up in exchange for passive investments in large-cap stocks. They effectively rule out any chance of being able to include illiquid assets, such as property, where management costs are higher, even though it may present good value for money once the potential returns are also taken into account.

Instead, charge caps encourage cheap and cheerful asset strategies and fund management even though long-term savers should be open to higher-cost strategies if the potential for return generation is also higher.

4. The societal cost of excess liquidity

The loss to savers associated with excess liquidity is not just financial. Many illiquid investments are good for the economy and for society as a whole. Investment vehicles designed to fund noble projects, including hospitals, bridges, toll roads and other infrastructure projects, for example, are sorely needed to keep society moving forward, especially as developed countries find themselves heavily indebted and reducing bank balance sheets are curtailing traditional sources of capital to fund such projects.

Retiring into a world that lacks the cumulative economic and societal benefits of infrastructure spending over an extended period, would materially change the quality of life today's savers would experience in their retirement.

Although this impact is harder to measure in numerical terms, it is an oft-underestimated impact of the focus on liquidity.

[4] Defined Contribution Investment Forum, Mind the Gap, The case for relaxation of daily dealing requirements for DC Pensions funds, May 2013

5. Conclusion

If governments and pensions regulators consider improving savers' outcomes to be one of their key goals, then they really should be more interested in exploring the true cost of the liquidity that is unnecessarily imposed on members.

Because of the charge cap and requirements imposed on funds included in DC pension schemes to offer daily liquidity, savers are foregoing the opportunity for material additional returns and being exposed to this liquidity drag.

The cost to tomorrow's pensioners and to society as a whole is significant and governments, as a minimum, have a moral obligation to create transparency around this issue and educate investors about the hidden and unrewarded trade-off of excess liquidity, which will be felt both financially and in their quality of life.

This paper should be seen as a call to governments to engage in an active dialogue with the investment community in a serious attempt to think more carefully about the hidden costs of excess liquidity in DC pension schemes.

The views and opinions expressed in this paper are those of Zuhair Mohammed and not of Aon Hewitt.

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Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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