MyConsultant

NEWSLETTER FEBRUARY 2013

Lifecyle Investing: Is it the answer?

Stronger Super allows a ‘lifecycle’ investment approach as an exception to the ‘single diversified’ portfolio rule for MySuper products. A lifecycle investment approach typically involves a portfolio where exposure to equities is reduced as members near retirement. Intuitively such an approach makes sense as members approaching retirement have higher savings and fewer years of working life, and as such, can become more risk averse.

There are many complexities to considering whether a lifecycle approach is indeed the ‘silver bullet’ that the industry has been yearning for. Relevant considerations include sequencing risk, selling down growth assets at predetermined points in time without consideration of the relative valuations can detract rather than preserve wealth.

So what work has JANA been doing to understand the role of lifecycle investing in future solutions? Outlined below is the experience of other developed nations with lifecycle investing and the findings of JANA’s research to date.

United States

Lifecycle funds (including Target Date funds) are a new concept by relative standards, tracing their origins back to March 1994 when Wells Fargo and BGI released a series. Gaining popularity in 2002, they represented just $15bn before almost doubling in size year-on-year until the Global Financial Crisis (GFC). In 2008, lifecycle funds represented a larger pool of Defined Contributions (DC) funds than risk based funds, as shown in Figure 1. Lifecycle funds are projected to become the largest DC strategy by 2020 with 96% of large pension plans’ default option now a lifecycle fund, as displayed in Figure 2.

Joshua Manning
Business Development Manager
Josh is a Business Development Manager having joined JANA from MLC Implemented Consulting in March 2012. Josh is responsible for working with institutional clients to understand their unique objectives and tailoring solutions to meet these. Prior to MLC, Josh worked for Macquarie Bank as an Account Manager progressing on to become Team Leader where he led a team responsible for developing and strengthening relationship with the bank’s key partners. He has also held an Account Management Team Leader position at Bendigo and Adelaide Bank. Joshua has a degree in Business Administration from Macquarie University and an MBA from Macquarie Graduate School of Management.

Figure 1: Assets in risk based and target date funds

Source: Strategic Insights/SMART_VOLT, Cerulli Associates

Their growth can be attributed to two main factors. In 2006, under the Pension Protection Act, lifecycle funds were classified as one of three Qualified Default Investment Strategies or ‘safe harbours’ for trustees against litigation. Secondly, plan sponsors have been seeking ‘autopilot’ strategies for 401K accounts (qualified defined contribution plans) minimising the need for member and sponsor involvement. Such lifecycle strategies have evolved in sophistication as shown in Figure 3. Criticism of such funds was particularly apparent through the GFC as the average lifecycle fund lost 32% of their value. The variability of product designed even between funds that have the same target date was significant, predominantly caused by a ‘to retirement’ or ‘through retirement’ focus. Other criticism surrounded related party transactions and excessive bells and whistles.

Europe

European lifecycle funds are structurally different to US funds and take a far more aggressive approach, by derisking just 5-10 years before retirement. However, the need for an automatic solution that protects members near retirement is similar. Outlined below are the experiences of a handful of European countries that embraced lifecycle funds.

Austria: First introduced lifecycle investing in 2004 as a target risk fund. Now almost all Pensionskasse schemes (the preferred means for employers to secure retirement for employees) offer a lifecycle option.

Netherlands: Lifecycle funds have grown to such an extent that in 2007, the Pension Act required all DC schemes to have a lifecycle default.

Sweden: In 1998, the government passed pension reforms increasing the use of lifecycle funds. Although lifecycle represent only a small segment of the market, their role has endured for over a decade.

There is modelling that suggests lifecycle is superior to other investment strategies as it protects members close to retirement from extremely negative outcomes. The reality, of course, is that the performance of lifecycle funds will depend on its risk profile versus conventional balanced funds. For example, if it has more equity risk and equities perform, it will do better, and vice versa. However, a member may also end up taking too little risk relative to their circumstances, and become excessively exposed to inflation and longevity risk.

**What is JANA doing about lifecycle investing?**

JANA is carefully considering the option of a lifecycle design and all its implications. As always, we have adopted a prudent approach and are undertaking the necessary research to ensure that any innovation is not just a marketing fad, but can deliver real benefits to members. From our research to date we highlight the following insights:

- An automatic glidepath (the path a target date fund takes to shift from growth to defensive assets) without regard for market conditions can have detrimental consequences, as selling after a market downturn crystallises losses and reduces potential to benefit from market recovery.

The GFC showed this with maturing lifecycle funds performing poorly in comparison to single-diversified options.

- For this reason, a 'reactive' (reactive in that the strategy responds to actual events) or actively-managed strategy is preferred.

- Regardless, a lifecycle approach, in itself, does not make a significant difference on average, with success primarily dependent upon the asset allocation of the individual portfolios.

- However, a well constructed reactive glidepath strategy can change the distribution of members’ retirement outcomes, improving downside protection (at a cost of forgoing potential upside). This may be desirable for a default superannuation investment option where risk control, rather than maximising returns, is the focus. Alternatively, the risk-controlled nature of the reactive glidepath could justify a higher allocation to growth assets in early years (compared to a typical default single-diversified option), potentially yielding an increase in retirement savings (our modelling suggests an increase of around 5-10% for the same level of risk).

- Assumptions can be made for cohorts of a plan’s membership, and a suitable reactive glidepath strategy can be tailored to the assumed needs of an ‘average’ member within each cohort.

- Importantly though, there is no single solution that will best suit all retirees as a single solution does not take into account an investor’s risk tolerance, spending needs, nor time horizon.

**Conclusions**

While it appears that there is lot to be gained from the concept of lifecycle investing, we have revealed just how complex it actually is. Indeed, JANA’s quantitative research shows that simple approaches could lead to worse outcomes for members but that a more active and intelligent approach could lead to material benefits.

On top of this there are the additional costs and complexity, as well as issues of member communications and implementation. Understanding members’ behaviours too will be very important, as we see a primary aim of introducing a lifecycle approach is to establish members’ confidence in their super savings.

For this reason, any approach will probably not be the same for every fund. Critical to the decision is having a full understanding of the characteristics of the membership of the fund, now and into the future.

In a today’s world where members are jaundiced by regular announcements concerning superannuation, what is important is that any changes made to their funds are resilient and are sound improvements on the current offerings. For this reason, JANA is progressing methodically through the maze, to assist clients in understanding the trade-offs that have to be made.

Lifecycle investing is not as simple as it first may appear, and it is one area where a cautious and prudent approach will be well rewarded.