Original Article

Choosers, users, winners and losers: Observations on defined contribution

Received (in revised form): 8th September 2011

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ABSTRACT Defined Contribution (DC) participants rely on third parties such as trustees and their advisers directing crucial decisions on their behalf. This forms a peculiar symbiosis that this article examines, identifying and offering four observations on *choosers* and *users*:

1. All default funds are not equal. The choice of entity to guide fund strategy is central to its success and has a significant influence on asset allocation and ultimately on the risk and return experienced by participants.
2. It is not just about the destination. A piece of research that we recently did for the National Employment Savings Trust shows that many plan participants react badly to market volatility and may make adverse saving and investment decisions if they see their fund drop.
3. There is no such thing as an average consumer. Recent work on segmenting members based on revealed preference and actual performance indicates that understanding of DC consumers is relatively rudimentary. We have much to learn from other industries such as the retail industry.
4. Engagement is important to both the member and the sponsor and can be measured and monitored objectively.

Finally, a brief conclusion about how we might better judge good and bad outcomes in DC.

Pensions (2011) 16, 235–243. doi:10.1057/pm.2011.21

Keywords: Defined Contribution/DC; default funds; pensions; customer engagement; risk and return; NEST

A DIFFERENT WAY OF LOOKING AT DEFINED CONTRIBUTION (DC)

It has always struck me that, from the individual's perspective, the difference between Defined Benefit (DB) and DC is straightforward. A DB

pension is essentially something that is done *for* its members, who are largely passive. A personal pension, on the other hand, demands some interaction from an active consumer. Unfortunately, unlike most products, a pension is something that the majority eventually recognises its needs, but no one really gets excited about buying. Because of this (and until pension participation in the United Kingdom is truly mandated) it seems

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inevitable that some influence needs to be exerted to encourage the public to part with its hard-earned cash. Alongside the incentives of tax breaks, the formidable marketing power of large financial institutions and soft compulsion through auto-enrolment, the most effective agent in nudging the hesitant saver towards a pension seems to be the involvement of a supportive sponsoring employer.

As well as contributing to the plan, the employer and its agents also act as the stewards of the arrangement, making numerous fundamental decisions on behalf of the membership. Although perhaps inevitable, the presence of these third parties directing crucial elements of the product on behalf of a reluctant customer makes for a peculiar symbiosis. For those steering and sponsoring the DC plan it must sometimes seem that serving the individual needs of a disparate membership is a distracting complication (especially compared with DB). For the DC consumer it is even worse. It must be like buying a car you do not really like (but that typically has high running costs) to travel somewhere you do not want to go and then asking someone you may have little faith in to blindfold you and drive there over the bumpiest road they can find; without a map.

This article examines this strange interdependency, identifying and observing the parties I am going to call *choosers* and *users* and then considering how we might determine the winners and losers in the partnership.

I am calling *choosers* the entities that make numerous decisions on behalf of the member; principally the sponsor and trustees together with the advisers who guide them. They are jointly responsible for selecting the various service providers that run the plan and then configuring the choice architecture within it. Their choices have a profound effect on the outcomes experienced.

The *users* of the product are the individual consumers within the DC plan. They are sometimes self-directed and active, but tend to be perceived as generally uninterested. The most vital measure of the effectiveness of any DC plan should be the ultimate outcomes experienced by these members, but sadly they are largely ignored

in that respect, with the main focus of the market being on other links in the value chain. Put another way, it seems to be a world largely constructed for the benefit of the *choosers*, not the *users*.

It is a broad subject and all that I would hope to offer in this brief paper are a handful of observations based on recent analysis we have conducted:

- two reflections on *choosers*;
- two on *losers*; and
- a few words on *winners* and *losers*.

TWO OBSERVATIONS ON CHOOSERS

Chooser observation 1: All default funds are not created equal

Nowhere does the odd synergy of *chooser* and *loser* have more impact than in the area of investment fund choice; specifically in the construction of the scheme's default fund. Across both trust and contract plans in the United Kingdom, *Turning the Lights On*¹ reports the average number of fund choices in DC plans as 42, versus 19 in the United States. Surprisingly, the average number of choices in the United Kingdom has trended upwards, explained in part by a higher number of contract-based plans observed in this year's report. It is too many! Most *users* are ill equipped to make these sort of complex decisions and predictably most (81 per cent in 2011) end up in the default strategy. So what sort of influence over the default do the *choosers* wield?

Within default, one of the most critical choices that can be made on behalf of the *user* is that of adviser selection. The appointment of an entity to guide fund strategy and any de-risking glide path is central to its success or otherwise. The choice of one consultant over another has a significant influence on asset allocation and ultimately on the risk and return experienced. Within the sample covered by *Turning the Lights On*, default asset allocations remain heavily tilted towards equities during the growth phase, with an average total equity allocation in excess of

Figure 1: Three year risk and return outcome for UK investment consultants as at December 2010.

80 per cent. However, asset allocations continue to vary widely depending on which investment consultant is selected, leading to significant variations in the risk and return experienced by employees across DC plans (see Figure 1).

While three years is a relatively limited period to observe performance, many of the solutions implemented do not have longer track records. It will be important to see how performance evolves as further time passes; however, we can start to see emerging valuable insight into the different levels of risk exposure across workplace schemes.

As the boundaries between fund management and consulting continue to blur, the question of whether to empower consultants or asset managers with responsibility for asset allocation is also growing in importance. For example, the approach to objective setting for default funds in the United Kingdom is markedly different from the United States. More than 60 per cent of UK

plans target asset class benchmarks and employ passive strategies, virtually guaranteeing that they will achieve their objective. In contrast, more than 90 per cent of our observed US plans follow a target date strategy, and it is far more common for responsibility for asset allocation to be delegated to the fund manager. Evidence from the United Kingdom shows that where responsibility is delegated to fund managers, the level of diversification tends to be higher, with a beneficial impact on the risk–return balance.

The game is changing. It is no longer acceptable simply to ensure that a DC default strategy hits its benchmark. Consumers largely do not care about benchmarks – they care about outcomes, and as DC schemes mature, consumers will increasingly scrutinise the quality of investment stewardship from their employer. Missing a well-devised investment objective could prove substantially superior to hitting a plain vanilla index target, in terms of the ultimate

value delivered to consumers. In short, the days of hiding behind simple benchmarks are numbered.

Figuring out what asset allocation approach best fits the needs of employees, setting a well-considered objective that drives the right asset allocation behaviour, and assigning responsibility for this asset allocation are weighty challenges that, ultimately, affect the reputation of the employer as well as the financial security of its employees. *Choosers* have the opportunity to exert significant influence over the *user's* outcomes and these responsibilities should be taken extremely seriously (and monitored diligently).

Chooser observation 2: It is not just about the destination – it is about the journey too

I mentioned earlier that the road to retirement can be a bumpy one. Although retirement outcomes are the litmus test of good DC provision, it is important to remember that participants would not make it to the end of the ride if they get off too early. In other words, if you stop saving along the way, you will never have an adequate retirement income. Our recent work with the National Employment Savings Trust (NEST) looked at this specific challenge.

NEST is intended to be easy to understand. The scheme design, investment options, administration and communication material are designed to be straightforward, helpful and convenient for its members. This is especially important, as the intended target market for NEST is predominantly those who have never saved in a pension before; indeed many will have never saved at all before joining the scheme. If the typical membership of a DC plan can be characterised as inexperienced, unknowledgeable and often unwilling to take control, then the constituency of NEST takes that to the *n*th degree. The *choosers* involved with NEST needed to do something to ensure that the *users* are cushioned against influences that may adversely affect their retirement outcomes.

It has long been assumed that, as far as asset allocation in the default fund growth phase is

concerned, 'mother knows best'. That is to say, that, it is considered advantageous for people to be heavily invested in equities as those are the powerhouse of return seeking assets. Sure, there might be uncomfortable knocks on the way, but that is fine as pound cost averaging means you are buying cheap fund units and it will all come good at the end. After all, DC members are inert, are not they, so would not they plough on regardless and thank you when they retire? Moreover, you do not need to worry about the last few years as lifestyling will de-risk the portfolio. Good theory, however, the problem with these commonly held beliefs is that there has been very little empirical study into how different cohorts actually do react to market downturns. Guesswork has prevailed and, while arguments can be made about the long-term benefit of higher expected returns from riskier investments, any negative impact from a tendency to reduce saving, or from adverse asset allocation decisions, in response to volatile conditions could significantly outweigh this benefit, leading ultimately to a lower level of assets being accumulated.

With the primary objective of designing a default investment strategy, NEST needed to understand how consumers in its target market react to investment risk, in particular, whether these consumers exhibit a tendency to drop contributions in response to negative investment conditions. NEST's target market comprises primarily of low-to-moderate income jobholders. The received wisdom suggests that where individuals with this income profile are automatically enrolled into a pension plan, they will most likely remain in the default investment strategy and make little or no changes to the percentage they contribute – apathy prevails. A general lack of transparency and insight into customer-level activity has made it difficult to confirm or refute this assertion.

In considering the appropriate asset allocation strategy for NEST's default solution, it was critical to understand how consumers react to the sort of stock market turbulence exhibited during the global financial crisis and first signalled by the collapse of Lehman Brothers. To try to answer

this question NEST commissioned DCisions to provide robust insight on this issue, with a particular focus on understanding consumer behaviour before, during and after the peak of the global financial crisis.

Using data from CuBIT, our proprietary insight platform, which contains data on a market representative sample of end consumers, a panel was selected which contained a distribution of consumer profiles consistent with the NEST target market. DCisions selected consumers within CuBIT, who were in continuous employment during the relevant period, and the demographic distribution was then filtered to fit the criteria for those eligible to join NEST. DCisions also weighted the panel to ensure it was representative of NEST's target market distribution. After locking down the panel, each individual's contribution and switch activity was analysed relative to the volatility of their personal retirement portfolio. Several different groups were identified, which exhibited distinct behavioural reactions during the financial crisis, and which could be cross-referenced with demographic characteristics such as age, salary and gender.

The data proved that consumers *did* react to the financial crisis. There was a marked change in behaviour in terms of both contribution and switch activity. Over the observed time period, almost half the population experienced some sort of reaction to the market conditions. The received wisdom was wrong; inertia did not always rule.

These reactions could be categorised into distinct behavioural groups, with respect to both saving and investment decisions. Contrary to general conjecture in the market place, lower-to-moderately paid earners did respond to the financial crisis. The behaviours observed included consumers who stopped their contributions altogether and those who increased the movement of money between funds in their workplace savings pot. The analysis concluded that the entire target market is unlikely to react uniformly to investment risk and return and that customer segmentation is important to make sense of how behaviours vary historically, and are likely to vary in future, across the target market.

Mark Fawcett Chief Investment Officer, NEST commented *By using data sourced from CuBIT, NEST has increased its understanding of the potential saving and investment behaviour of its target market, providing important inputs for decision making on investment and communication strategies for the benefit of future members.*

TWO OBSERVATIONS ON USERS

User observation number one: There is no such thing as an average consumer:

Products, services and the supporting communication to DC members have tended to polarise to one of two extremes. At the extreme, it has been assumed that everyone's attitudes, behaviours and personal circumstances are so particular and distinct that the only solution is individual holistic financial advice. This model is unsustainable given the constraints of the Retail Distribution Review and the general reluctance of both employers and their staff to pay explicit fees for financial guidance.

Alternatively, at the other pole there has been a tendency to assume that the DC membership is a homogenous group of average people who are generally passive and unmotivated when it comes to responding to a call to action. Both the Treating Customers Fairly rules and the trustee requirements to be equitable are often wrongly interpreted to mean having to treat everyone the same. Fearful of risking censure the approach of the *choosers* has effectively been, 'if you throw enough communication mud eventually some of it might stick to the member's wall'.

Intuitively it feels like both extremes fail to describe the real situation. People are not all the same clearly, but are there types of members who can be identified accurately based on their behaviour and attributes? If we believe that people are neither uniform nor infinitely varied with respect to their pension lives, then how are we to economically and effectively serve their different wants and needs? Again, conventional wisdom has led to a crude segmentation at best, supposing two main axes of discrimination and

really only judging these from the *chooser's* perspective:

- first wealth (the wealthier, the more attractive to those tasked with managing the money);
- second age (the older, the more likely to be 'engaged' and therefore more likely to respond to sales messages).

Most other groups have been put into the 'too difficult' box. This is a pretty big box too, usually determined by whether or not members are in the default investment strategy.

The idea of deriving different treatment strategies for individuals based on their observed activity and resulting outcomes is largely unexplored in DC pensions. However, most other consumer-facing industries employ some sort of segmentation or Customer Relationship Management strategy as a way of efficiently serving customers divided into cohorts with similar qualities. Being able to group customers effectively and then monitoring the ongoing impact of interventions over time is well understood in sectors such as grocery, with the strategic marketing methodology of the Tesco ClubCard being the most widely known and visible example in the United Kingdom. So, if this approach works in other industries why is it much less prevalent in workplace savings, where the decisions and consequences are so much more critical to the *user* than the contents of the weekly shopping basket?

The simple answer is that the record keeping systems on which the *choosers* rely just are not up to the job. Just as Tesco, whose own systems were not built with the consumer in mind, required the intervention of a third party – dunnhumby – to implement the data processing and analytical firepower to crunch the numbers. The DC pensions industry is similarly lacking in capability. The administration systems of the bundled pension providers and Third Party Administrators simply are not built to interrogate activity and results at a consumer level. They are built for the *choosers*, not the *users*. The only way of designing products and communication campaigns effectively is to

thoroughly understand the consumer. Otherwise you are just guessing.

DCisions created a segmentation model of DC consumers, Elements.^{2,3} The resulting evidence, once again, contradicts what was previously thought – the beliefs that the industry has relied upon are flawed. DC consumer behaviour is much more nuanced than currently understood. Our evidence shows that there are active and engaged (and therefore, presumably attractive to the *choosers*) individuals across the life stage and wealth spectrums. It seems that relying on those simple indicators alone is prone to error. Our segmentation shows that it is a combination of demographic and behavioural factors that enables you to truly understand consumers and what motivates them.

A particular example to demonstrate how a detailed examination of revealed preference can shed light is the case of deferred members (or 'leavers' in the case of contract-based). These have been typically characterised by the *choosers* as being passive or dormant with an assumption that it is best not to wake them up lest they do something detrimental to the long-term interests of the asset managers whose driver is to retain funds under management at all costs. Our research has led us to see that there are two distinct types of deferred members. The first appear, indeed, to somewhat inert, in their deferred account at least. However, they do demand further enquiry to determine if they can be converted to engaged customers (more of that later). The second, however, are already active, engaged and worthy of targeted treatment strategies that recognise this.

User observation number two: Engagement is important (and measurable)

The more enlightened players in the market are starting to close the gap between the *choosers* and *users*. One of the things that exemplify this is the quest for 'engagement'. This is a somewhat nebulous concept, but seems to mean to most people the characteristic of individuals interacting with their plan; in short, the transformation of *users* into *choosers*. This is presumably good for all

stakeholders. For the *user*, who is taking control of his/her financial future and assuming the requisite responsibilities; for the providers or asset manager who achieve stickier and increased funds under management and, critically, for the sponsor who receives some return on their investment by having an appreciative audience (with the mythical HR upside of better talent management a result). However, if we take it as self-evident that an engaged audience is desirable, then we have an associated problem. How do we measure it and how do we know when we have achieved it?

The current measures for engagement (where they are employed at all) typically fall into one of two equally unsatisfactory camps. Both are well-intentioned, but equally subjective, inconsistent and qualitative. The first method of measuring engagement typically happens in order to justify a communications exercise or scheme design change. We tend to just ask people something like – ‘how do you feel about your pension?’ Unsurprisingly, this will tend to increase positively after virtually any campaign, thus justifying the cost of the exercise and allowing everyone concerned to pat themselves on the back. The second approach is to just look at the participation and default rate: ‘60 per cent of staff has joined, therefore the others are not engaged; 80 per cent are in the default, therefore they are not really interested’. This is a dangerous assumption to jump to, particularly in the cases of defaulters and is exacerbated by the fact that most providers cannot distinguish between those who

have chosen the default and those who have not chosen anything at all (‘true’ defaulters). Many will have chosen the default consciously, feeling it is recommended or endorsed by the sponsor or trustees. Moreover, it is a crude metric as there are many other ways of interacting with your plan away from fund choice.

At DCisions, we have found that if you can combine and measure effectively the multiple ‘engaged’ behaviours that *users* exhibit then you can derive an objective and relative measure of engagement over time. More importantly, you can then track accurately changes in it; an engagement index, if you like, based on an individual, segment, scheme or population level.

This is how we do it: for each individual customer we calculate a single engagement score via a principal component analysis that captures the multiple ways an individual can interact with an account. Activity around switches, fund selection and contributions are all taken into consideration in the construction of the engagement score.

Figure 2 shows changing levels of engagement over time for the different segments within Elements, here based on two axes only – total contribution and switch amount.

You will see that different segments exhibit markedly different levels of engaged behaviour. We have also found that engagement levels of the different segments themselves alter depending on external factors. Market volatility, for example, affects different cohorts in different ways.

Figure 2: Movement in engagement behaviour.

The need to monitor engaged behaviour is becoming increasingly critical as the market accelerates towards contract-based arrangements (workplace personal pensions in the new argot). Even more so than in trust-based DC, the member of a personal pension really is on his or her own, without even the trustees to hold their hand. Now to improve the situation and encourage the effective operation and good outcomes that the Regulator is advocating we can go two ways. First, we can make contract-based look just like trust-based, with enhanced oversight and governance and some sort of fiduciary responsibility sitting alongside the member. The alternative is to treat the plan as the consumer-facing product it is. Both approaches are valid, but since many employers have taken the second route, principally because of the appeal of lighter touch governance we must presume that it will prevail. If that is the case then the ability to judge engagement is essential.

'IT IS NOT ENOUGH TO SUCCEED; OTHERS MUST FAIL' (GORE VIDAL)

Winners and losers

At the moment, the DC pensions market is very focused on the *choosers*. Asset managers design

funds in the hope of getting them onto platforms; product and platform providers are intent on keeping their distributors, the consultants, happy, and advisers concentrate on serving the sponsor and trustees. The poor old consumer, right at the bottom, tends to be a little neglected. To date, as they have had little impetus to become actively involved with their product these actual owners of the asset have been content to let the *status quo* continue. The problem with this situation is that there is a huge chasm between those responsible for building and running funds and products and those actually consuming them. This has led to a myopic view and to manufacturing products that are not always built with the member in mind. As a consequence, reporting of progress has focused on how those products have performed rather than what people themselves have achieved with the result that it is very difficult to say who is a *winner* and who a *loser*. The point is this – reporting on the performance of investment products is only half the story. It is how people blend and switch those products and their own specific savings trajectory that makes them unique.

Figure 3 makes this point clearly. Although the majority of members in the scheme illustrated are

Figure 3: Three year annualised risk and return of customers from DCisions' CuBIT database.

in the default fund there is a large dispersion of risk and return signatures with correspondingly large differences in returns.

So, we should judge success or otherwise at the member portfolio level, not the product level. Similarly, there is not much point looking at just reward. You have to look at risk as well. Just as John Harrison discovered an accurate way of measuring longitude, saving the lives of many sailors who had hitherto relied solely on latitude, so we must begin to measure risk, the second coordinate of performance, and report it more effectively. Otherwise if we fail to take both into account we are in danger of DC members becoming becalmed in the doldrums of cash or running aground on the rocks of an undiversified equity approach. One of the only ways of judging success is to answer the question: 'are you getting good return for the risk you undertake and how many units of return are you getting for every unit of risk?

THE FINISH LINE

It is a DC world but it is not yet a DC *user's* world. It is crucial that the experts entrusted with guiding DC plans – the *choosers* – continue to strive to do the best for their members.

Increasingly, however, it is equally crucial that those who will ultimately rely on the retirement income provided by DC plans – the *users* – start to get to grips with their growing responsibilities. Through more advanced analytics and an increasingly thorough understanding of the behaviours and motivations of both groups they will start to work together and hopefully cross the finish line together.

NOTES

- 1 Turning the Lights On (DCisions, 2011, Report).
- 2 Elements (DCisions, 2011, Segmentation model).
- 3 Elements is DCisions' consumer segmentation model, based on objective analysis of consumer transactions over time. The process is incorporated over 90 separate variables, for example contribution rate, switch instructions, portfolio make-up, and so on.