Elston

Insights

11th September 2020

How Target Date Funds helped different cohorts of UK investors weather the COVID storm

- Understanding Target Date Funds
- Why a cohort-based approach makes sense
- The performance experience this year by cohort

What are Target Date Funds?

Target Date Funds are multi-asset funds whose risk profile changes over time, becoming less risky on approach to, and after the target date in the fund's name.

Investors, or their advisers, can use target date funds as an investment strategy that is purpose-built for retirement. By selecting a fund whose target date matches a planned retirement year, investors get access to an accumulation-oriented investment strategy prior to the target date, and a decumulation-oriented strategy after the target date. This makes target date funds a convenient "all-in one" fund which explains why they are often used as default funds within pension schemes, including NEST.

Why a cohort-based approach makes sense

It's common sense that the risk capacity for an investor's exposure to market risk is different at different stages of life and wealth levels.

For younger investors, where wealth levels are typically lower and time horizons are longer, there is a higher capacity for loss, hence a higher exposure to higher risk-return assets makes sense.

For older investors, where wealth levels are typically higher and time horizons are shorter, there is a lower capacity for loss, hence a lower exposure to higher risk-return assets makes sense.

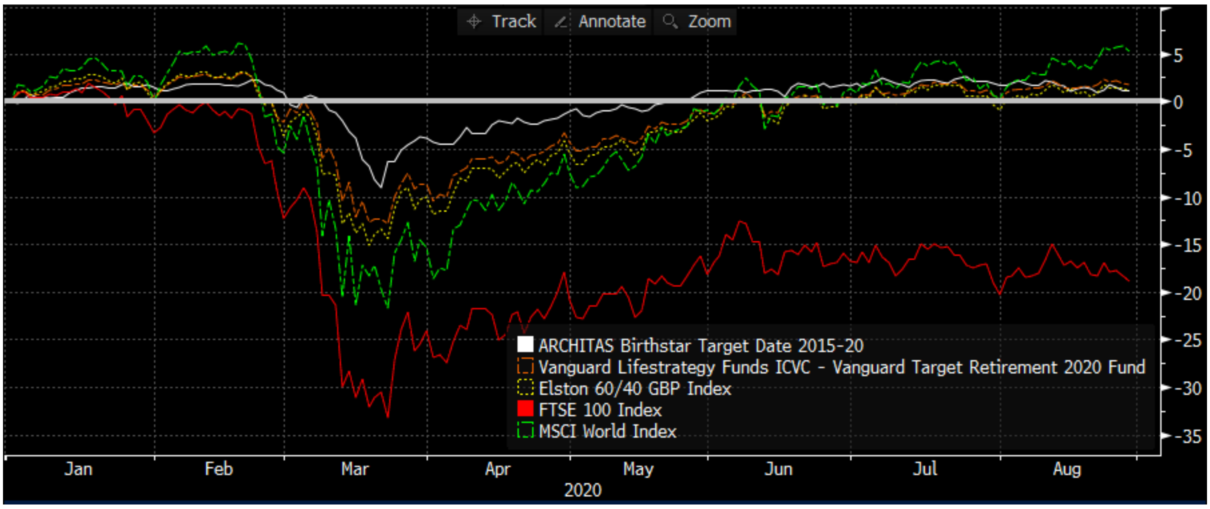
If customers can be segmented by cohorts, it makes sense that investment strategy can be too.

What is the performance experience for different cohorts this year (time-weighted)?

The 2015-20 Target Date Fund from Architas experienced a moderate maximum monthly drawdown of -4.71% in March 2020. By comparison, the 2020 Target Date Fund from Vanguard experienced a -6.66% drawdown. This contrasts with -9.37% for the Elston 60/40 GBP Index, -10.94% for MSCI World, and -13.81% for the FTSE 100, all in GBP terms.

In this respect, investors who were in default decumulation strategies, with lower capacity for loss, saw better mitigation of downside risk relative to a traditional 60/40 "balanced" mandate.

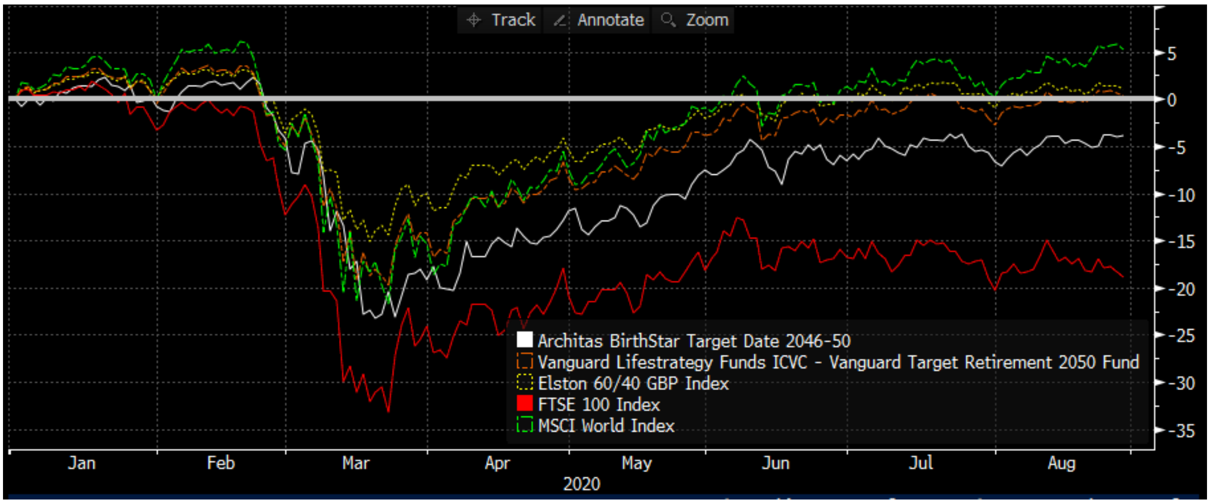
Fig.1. YTD performance of UK Target Date Funds (GBP terms) for those retiring 2015-20



Source: Elston research, Bloomberg data

For investors in accumulation with target retirement date in the future, a comparison of the 2050 Target Date Funds shows Vanguard outperforming Architas – presumably owing to a more aggressive equity allocation in its glidepath. Both ranges of TDFs clearly have a low domestic equity bias, given their outperformance of the FTSE 100.

Fig.2. YTD performance of UK Target Date Funds (GBP terms) for those retiring 2046-50



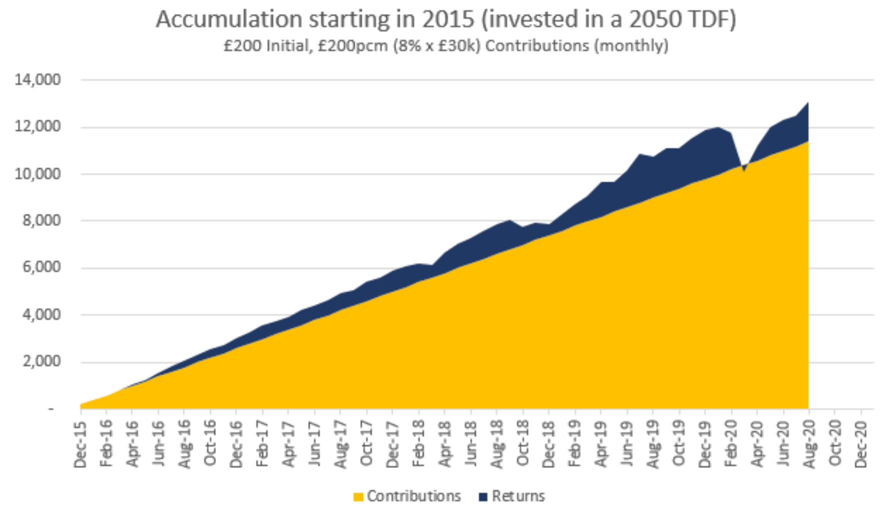
Source: Elston research, Bloomberg data

A look at money-weighted returns and impact on pot size (a.k.a. "outcome")

Whereas most performance analysis, as above, focuses on time-weighted returns, customer outcomes are based on pot-size – how an investment portfolio accumulates or how it decumulates in overall value terms.

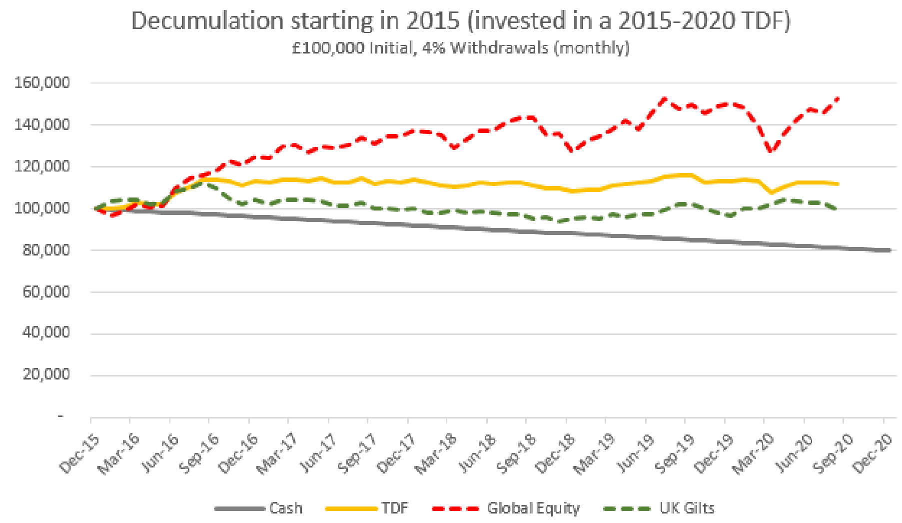
To look at this, we contrast the outcomes of both an accumulation investor and a decumulation investors who commenced investing or divesting in 2015, using some standardised assumptions.

Fig.3. Pot size for investors who started accumulation in 2015



Source: Elston research, Bloomberg data. Representative TDF (2050) Strategy: Architas BirthStar® 2046-50 Target Date Fund. As at 31/8/20. 8% monthly contribution rate applied to example salary of £30,000p.a. Values expressed in nominal terms.

Fig.4. Pot size for investors who started decumulation in 2015

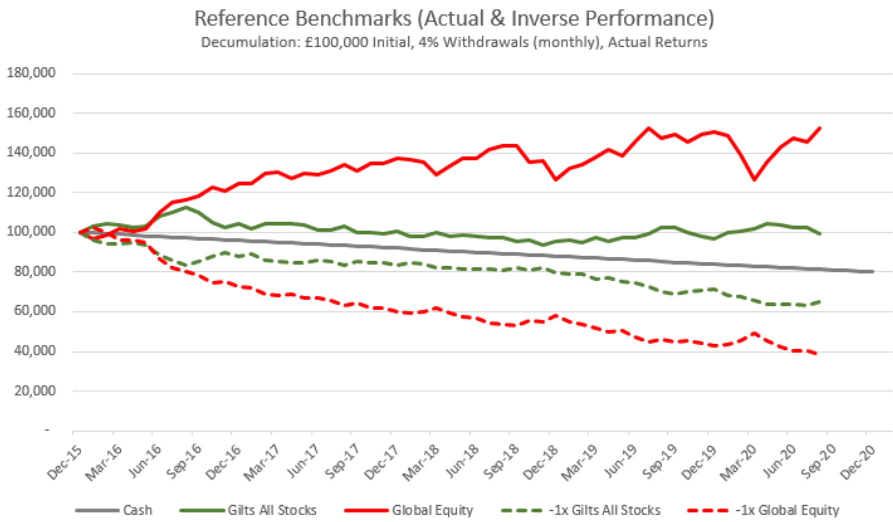


Source: Elston research, Bloomberg data. Representative TDF (2015-20) Strategy: Architas BirthStar® 2046-50 Target Date Fund. As at 31/8/20. 4% monthly withdrawal rate applied to initial pot size of £100,000. Values expressed in nominal terms.

Looking at the decumulation chart, you might be tempted to think it would have made more sense to have just held equities. On the returns side, yes of course. But that would disregard an investor's capacity for loss and the potential for "pound cost ravaging" had we been in a 5 year bear market, rather than a 5 year bull market.

To compare against a negative scenario, in Fig.5. we look at the performance of a portfolio in decumulation against Global Equities and UK Gilts, and also against the inverse performance (i.e. simulating a protracted bear-market) of Global Equities and UK Gilts, to express a mirror scenario of the last 5 years. The effect of pound cost ravaging would have materially and negatively client pot sizes, with a material risk of imminently running out of money.

Fig.5. Range of potential outcomes (actual & inverse market performance)



Source: Elston research, Bloomberg data. Performance of representative ETFs. As at 31/8/20. 4% monthly withdrawal rate applied to initial pot size of £100,000. Values expressed in nominal terms.

The aim of investment strategy in decumulation is to get a "goldilocks" level of risk and return over time. Enough return to keep pace with inflation. But not too much risk to avoid pitfalls. And all the while becoming more cautious as an investor's time horizon deceases, and capacity for loss declines.

How Target Date Funds could fit in with policy evolution

Ensuring there is some form of in-built lifestyling is a longstanding feature of consumer protections for pensions investment since Stakeholder times. Using behavioural finance in proposition design can provide a degree of consumer protection from poor outcomes for less confident, less engaged investors. That's why a growing number of regulatory interventions incorporate some form of built-in lifestyling. Whilst this is complex to achieve from an administrative perspective, the fact that Target Date Funds deliver lifestyling within the multi-asset fund structure makes them a useful product type for default investment strategies.

Fig.6. Key behavioural aspects and price anchors of policy interventions

Policy	Investment strategy	Behavioural nudge	Price anchor
Stakeholder Pensions (2001)	Lifestyling	Gradual derisking towards retirement date	1.50%
Workplace Pensions/Auto-Enrolment (2012)	Lifestyling or Target Date Funds (e.g. NEST)	Need to actively opt out of default strategy Gradual derisking towards retirement date	0.75%
Retirement Pathways (2021) [PS19/21]	Pathway Specific solution to meet each of four standardised objectives	Structured choice architecture Restrictive choice Excludes cash as default	0.75% "soft" price cap* (investment solution only, non-advised)
DB Pension Transfers (2020) [PS20/6]	Not specified. But new requirement to complare to workplace scheme.	Consider highly governed workplace scheme prior to individualised advice-led strategy	0.75% "soft" price cap** (investment solution only, excludes advice)
Non-workplace pension schemes [FS19/05]	Explore ready-made solutions (with lifestyling) using single or multiple pathways	Mitigate risk for consumers who do not wish or find it difficult to make investment choices	Weak price competition. Generally <1.50% for stakeholder personal pensions sold after 2012 (DP18/1)

Notes
*Retirement Pathways: there is no price cap specified by the regulator. Our definition of a "soft" price cap is because there was a request by the regulator to providers to consider the comparative cost of auto-enrolment solutions when designing non-advised pathways.
**DB Pension Transfers: there is no price cap specified by the regulator. Our definition of a "soft" price cap is because, under PS20/6, it will become a requirement for advisers to consider and analyse a transfer to a workplace scheme, in the first instance, where the hard price cap of 0.75% does apply.

What Target Date Funds are available to UK investors

In the institutional market, pension scheme trustees have access to target date funds from AllianceBernstein, BlackRock, and State Street.

In the retail market, individual investors and their advisers have access to target date funds from Architas (managed by AllianceBernstein), and Vanguard.

Conclusion

In summary, Target Date Funds are one of the most popular types of funds that UK investors have never heard of.

They are the format of choice for many auto-enrolment schemes because they consider the needs and characteristics of scheme members by age cohort.

We expect Target Date Funds to have a growing role to play in advisers' Centralised Retirement Propositions.

Find out more

For more insights and information on research, portfolios and indices, visit:

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