

DC pensions A fruitful segmentation of the market

This note is about segmentation. Like an orange, the DC market in the UK is both one big thing, and several segments. We have found that the segments are each quite different. Without understanding the differences in the segments, you cannot understand the whole, well, fruit.

To the best of our knowledge, ours is the first attempt to look at the DC market comprehensively in segments. We suspect there is a reason for this. As everyone who has analysed DC knows - and then endlessly reminds us - the UK market is hopelessly poorly equipped when it comes to data. Nobody, including the industry's many Regulators and Trade Associations, has delivered comprehensive market statistics on corporate/workplace DC pensions, covering both Trust and Contract based schemes.

As a result, we are all heavily reliant for our information on surveys. Of which there are many, and very good they usually are too. But surveys can be dangerous. Inexperienced readers of a poorly positioned survey may think they are being given a comprehensive analysis of the whole DC market. In fact all the surveys that we have seen offer conclusions on only one or a few segments. And are therefore not comprehensive at all.

This is how myths develop. What is true about one segment of the market is often not true about another, but the so-called comprehensive truth is still passed around the industry, and solemnly repeated in articles and conference presentations until it emerges as an apparently indisputable fact. In this note we have identified several of these myths and replaced them with a more robust analysis of the facts as we see them.

This is not rocket science, and in research terms what we offer here is pretty basic stuff. The fact that it has not been done before reveals much about DC, which in many respects is an emerging market. The data relating to it is certainly still at a very early stage of development. We hope that what we summarise in this note may (ahem!) fruitfully contribute to the development.

“What is true about one segment of the market is often not true about another.”



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Understanding DC, segment by segment

Our clients believe that you cannot develop a coherent approach to the DC market, or indeed any market, without first dividing it up into segments.

So they ask themselves (and us) sensible questions such as:

- Which segments of the UK DC market will grow fastest?
- Which segments will generate us the greatest profit?
- Which segments will be most competitive?
- Which segments should they target?

We have considered a wide range of possible ways of segmenting the DC market. Our first principle is that segmentation should be based on customer characteristics/behaviour. A common mistake is to segment according to provider offerings or products - not very client centric.

After much debate, we have settled on the two key client characteristics/behaviours shown in the top diagram: *Scheme size* and *scheme structure*. These allow us to create four main and 16 sub-segments.

Scheme size Big company schemes* have very different needs to those of smaller ones, so segmenting the market according to those varied needs offers great insights. On pages 4-5 we set out in more detail why we think this is true.

Scheme structure By this we mean Trust or Contract-based. The behaviour of Trust based schemes varies widely from that of Contract based ones. We develop this in more detail on page 7. Within Trust based and contract based we have subdivided still further into categories explained in the blue box to the right.

We are not saying that size and structure are the only drivers of difference between schemes. One other factor, for example, is the sector of schemes. Schemes with the same size and structure but from different sectors may behave quite differently. So our segmentation will have to allow for exceptions, of course.

“Our first principle is that segmentation should be based on customer characteristics/behaviour.”

DC market segmentation

		Schemes			
		Larger		Smaller	
		Mega >5,000	Large >1,000	Medium >100	Small <100
Scheme structure	Trust based	1	2	5	6
	Platform user	3	4	7	8
Contract based	GPP and Stakeholder	9	10	13	14
	GSIPP	11	12	15	16

Trust based

Direct to manager Trust based schemes (mostly those set up in the early 2000s before the advent of platforms), and which source funds direct from managers without use of a platform.

Platform user These are schemes that make use of a platform, and this is more common for schemes set up since 2006 or so. The platform providers have very often in the past been asset managers flexible enough to work alongside TPAs and consultants. But this is changing fast as more insurance companies offer platforms to the Trust based market.


Contract based

GPP and Stakeholder Group personal pensions and Stakeholder pensions are the main contract based pension vehicles. Stakeholder is now no longer used for new schemes, although many schemes remain in existence.

GSIPP Group Self Invested Personal pensions have emerged in recent years as a specialist offering for those wanting more choice, and those wanting to invest in their Company shares through a pension.

* A big scheme is not the same as a big company scheme, because many big companies have very small DC schemes in terms of assets. Measuring scheme size not by assets, but by the number of members (as we do) helps to allow for this mismatch but we recognise it does not solve it.

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 Only through segmenting the market can you tell its story

There is a big danger in approaching the DC market without first segmenting it.

The size of the DC market is described as being somewhere between £300bn and £600bn depending on who you ask, and how the stock market is doing. In a paper we issued in late 2009 ('The DC Goldrush'*) we argued that the likely figure was much closer to £300bn than £600bn.

You may think that a market of £300bn (£600bn - whatever) appears attractive. It is a big figure, after all.

This is the dangerous bit.

The warning we offered in 2009 was that it was likely that only a small proportion of these assets were in large company schemes. Now, with a more carefully thought-out segmentation of the market, we can show in more precise way that the market is very heavily weighted to a few segments.

As summarised in the top diagram to the right, around 80% of the assets are in very small schemes of less than 100 members, and occupy just 2 of the 16 market segments. These schemes may or may not be within your reach or scope.

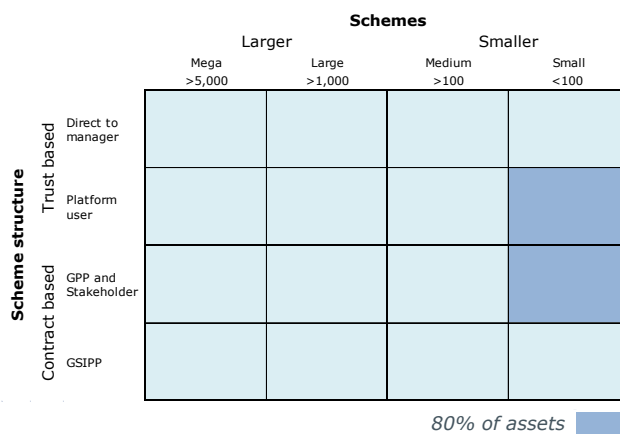
But wait for it - the real value of the segmentation comes in an estimate of how the growth rates of each part of the market will vary. We believe that growth will be strongest among larger scheme segments - the rationale for this is given in the DC Goldrush paper. Our relative growth estimates are summarised in the middle diagram.

The result of this varied growth pattern, if it were to happen as we suggest, is shown in the bottom diagram. There will be a shift in the relative proportion of DC assets from the right to the left of our market map. Where most of the assets are in very small schemes today, they will eventually be spread across larger schemes as well, as indicated in the bottom diagram.

Only by segmenting the market as we suggest can this story be told with any coherence.

“The market is very heavily weighted to a few segments.”

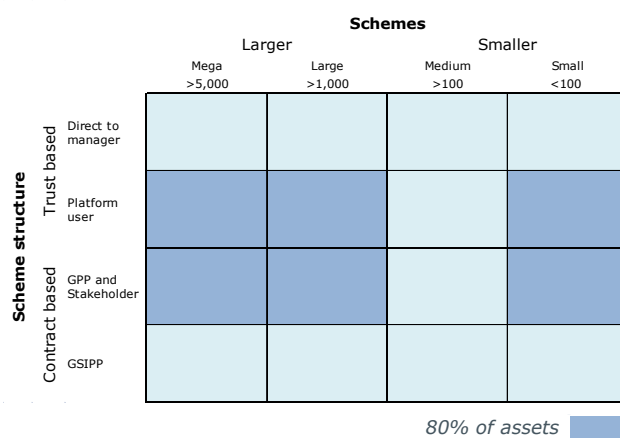
Location of 80% of DC assets 2010



DC asset growth rates by segment 2010-2020



Location of 80% of DC assets 2020



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No one survey covers the whole market

We think schemes should be segmented according to their size. But it is difficult to provide evidence of size differences between schemes because so little research has been done into this.

We can hear the splutters of disbelief at this remark: "Hold on! There are 101 surveys of the DC market, what on earth are you talking about?" There are indeed many surveys, but none of them look at the whole market. So they cannot compare the behaviour of small and large schemes.

You may want to skip this page if you are allergic to talk about research methods. However, we think you might want to address any such allergy, since it can horribly distort understanding of this market. Please do read on....

We have selected five of our favourite publicly available DC surveys, three by Consulting firms, two by Trade Associations. Each of the surveys are excellent pieces of work, but in each case (and this is true of all DC research we have seen) they are surveys of only a part of the market.

We have shaded the segments which we think they each focus on*. Between them they cover the market, or most of it, but individually they do not. The point is that it would be wrong to form conclusions about the whole DC market from any of these surveys. And in fairness to two of them, they make this limitation or focus very clear in their titles.

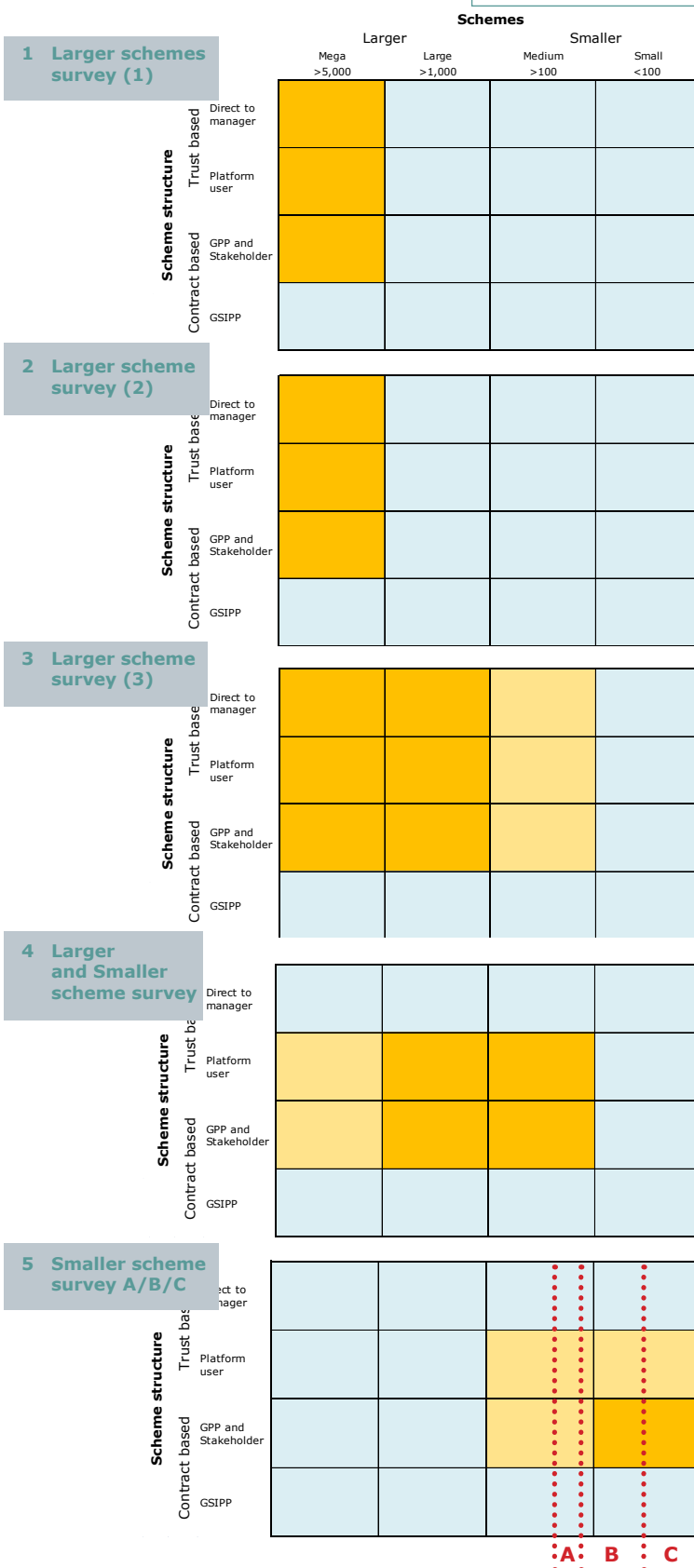
The first three surveys focus on larger schemes, the first two on what we have called mega schemes, and are also weighted towards Trust based schemes. The fourth strikes a balance: it focuses on some larger and some smaller schemes.

The fifth survey is a rare animal - it looks in depth at smaller schemes. On the previous page we argued that these smaller schemes are particularly important to understand since they represent over 80% of the market.

This fifth survey is rare for another reason - it analyses its results by size of scheme. So for our purposes it is effectively three surveys, each offering insights into one of the three size categories which we have identified on the bottom graphic as A, B and C.

Key

Focus of survey	
Partial focus	
No focus	



* The lighter shading shows a partial focus on the segment concerned, either because the sample of respondents in the segment was relatively small, or because the sample represented only a part of that segment.

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 **There are big differences between segments (1)**

Once you combine research data it is possible to see evidence that size is a driver of differences between schemes.

Each of the five surveys on the previous page tell us something about the behaviour of different segments. If we make the brave assumption that the surveys are consistent with each other in their definitions, for example of how a Lifestyle fund is defined (we told you this was brave) then we can combine the results to show a market-wide multi-survey comparison of the behaviour of schemes according to their size.

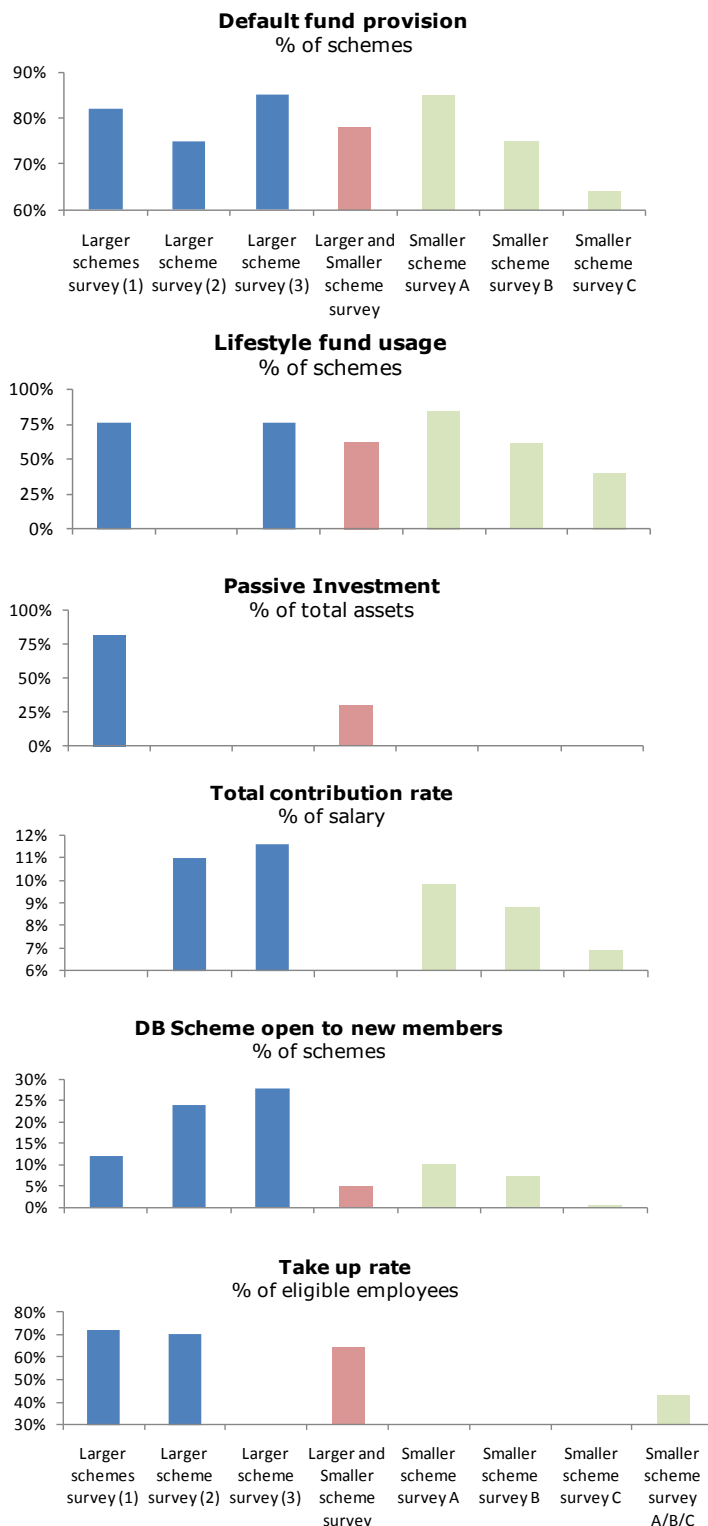
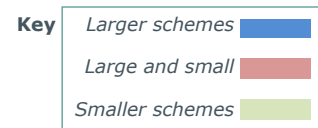
The five surveys (one of which sub divides into three, thus giving us seven observations for each measure) offer a range of six measures shown to the right which are common to at least some of the surveys.

In every case there are differences between the large and small schemes.

Default funds are provided less often by very small schemes than by large ones, and lifestyle funds are used less by smaller schemes. It also appears that passive investment is significantly less prevalent as schemes get smaller. Contribution rates are lower. DB membership is much less likely to be an option for new joiners at small companies. Take up rates appear lower among smaller schemes.

There are other relevant comparisons emerging from these surveys which we cannot show so neatly in graph form. For example Larger Trust based schemes predominantly use a third party administrator, while most smaller schemes use a single supplier which provides all their investment products. By contrast larger schemes tend to access many investment suppliers. Larger schemes tend to be Trust based and smaller ones tend to be Contract based - very small schemes use Stakeholder, while not so small ones tend to use GPP more. So it goes on.

Our conclusion - that that large and small schemes are very often quite different in their behaviour - is not pure guesswork - it is backed by a large amount of anecdotal evidence from interviews which we do not have the space to share with you here. So until someone provides a well run survey or census of the whole market which proves us wrong, we will continue to believe we are right.



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There are big differences between segments (2)

Size is one of our chosen 'behaviours' for segmentation. The other is the 'structure' of schemes - by which we mean Trust based vs Contract based. We explain why we think this adds a layer of insight.

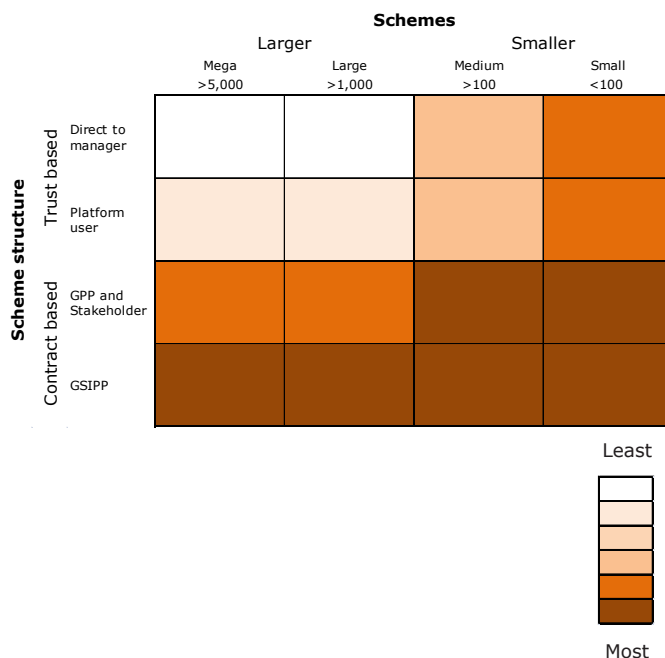
The most significant difference between Trust based and contract based schemes is in the services provided and bought: contract based schemes most often buy services bundled by one provider.

We show our segment-based analysis summarised in the diagram on the right. Use of bundled services is heavily concentrated among contract based schemes.

Examples of the way our segmentation sheds light on the market also emerge in the five surveys we highlighted on the previous page: among smaller schemes contribution levels are higher in Trust based schemes than Contract based ones. The survey of large schemes reveals that while passive funds are used a lot in default funds across all structure types, they are even more prevalent in Trust based schemes.

Another important reason for using Structure as the basis for analysing the market is that it makes a lot of data more usable - above and below the dividing line on our map between Contract and Trust based schemes the regulation of the market has been different, and separate data has been collected.

Proportion of schemes using a bundled service



“Contribution levels are higher in Trust based schemes than Contract based ones.”

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**Based on lack of segmentation, myths have developed**

Once you start to segment the data, you begin to think that sweeping generalisations about the market are in fact 'myths'.

We say myths, but what we really mean by this are statements about how the market overall behaves which should be better expressed as statements of how one segment(s) of the market behaves.

We sometimes hear examples of these myths and are always on the look out for new ones. There are three 'myths' that this analysis may help to challenge, shown in the blue box to the right.

One way of probing to test if a statement about DC is a myth is to ask for the source. And then to ask if that source is an analysis of the whole market, or just one bit of it.

In our experience you won't win many friends doing this, but you will avoid being given duff information.

Three myths in DC

The DC market is heavily weighted towards passive investment.

Once you understand the segmentation, and the difference in behaviour between segments, it becomes safer to express this as follows: 'Large schemes are heavily weighted towards passive investment'. Small schemes appear much less passive oriented. Since small schemes make up most of the assets, the total pool of passive assets in DC is probably a lot smaller than some may believe.

90% of schemes have default funds

It probably is true that 80% or more of members invest through the default fund, irrespective of the size of their scheme. That is what the surveys we have used in this paper consistently suggest. But this ratio (often called the Default ratio) should not be confused with another one, that we think of as the 'Default Fund provision ratio'. Not all schemes provide a default fund - and small schemes appear much less likely to have a default fund than larger ones.

The DC market is Open Architecture

This is the myth to end all myths. Open architecture, or even semi-open architecture does not exist in much of the market according to the surveys on the previous page. The majority of small schemes offer only one investment provider. Those who remain determined to describe the extent of Open Architecture in DC would be best to say that it 'predominates among the larger schemes'.

“We sometimes hear examples of these myths and are always on the look out for new ones.”

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 **Examples of further segment insights**

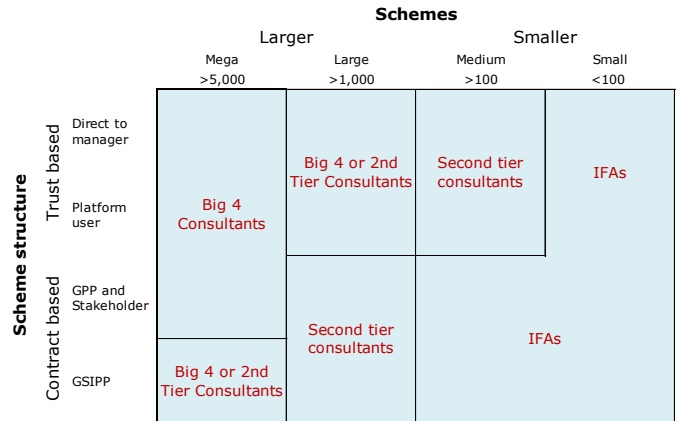
There are a number of other ways in which our segmentation can offer insight. We offer three examples.

Market drivers such as intermediation vary by segment as shown in the top diagram. The big 4 consultants are arguably only dominant in three out of the 16 segments. The overlap between the Big 4 and the Second Tier Consultants is clearly visible. The IFAs currently own the territory where most of the assets sit, but they do not occupy the segments which will grow in future.

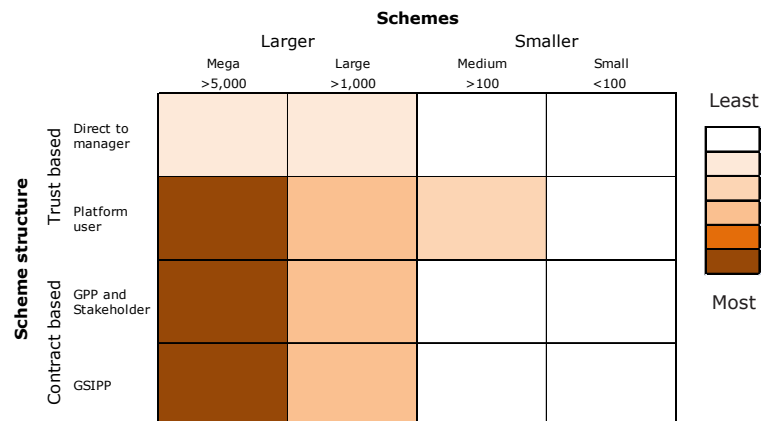
Attitudes can be mapped as well. In the second diagram we show how we think different segments will react to the emergence of the new Corporate Wrap models in coming months and years. They will appeal mostly in the larger scheme segments.

Supplier behaviour can also be tracked on this same map. In the bottom two diagrams, and based on publicly available information only, we show the location of the likely current client bases of two particular (unnamed) Pension Providers and our assessment of their future new client targeting strategies.

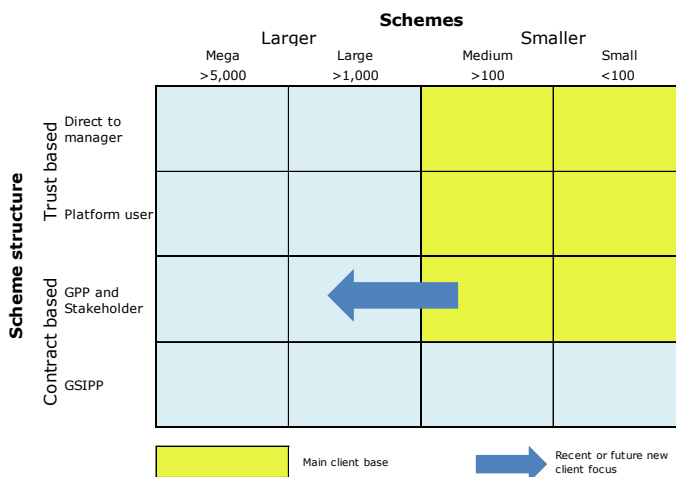
Typical advisers used



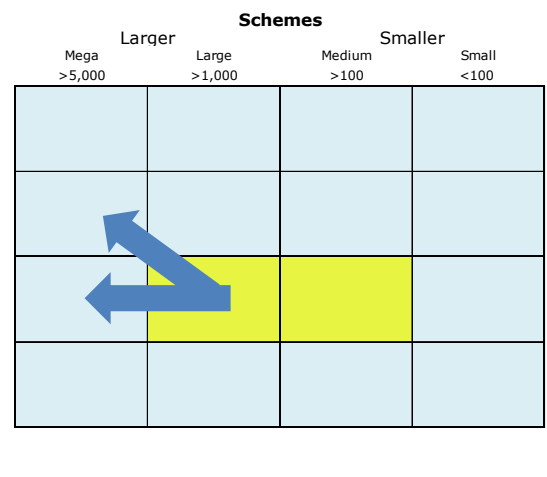
Likelihood of finding Corporate Wrap an attractive proposition



Provider X
Current and predicted future client base



Provider Y
Current and predicted future client base



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March 11 - Number 8 - Fiduciary Management - Getting to grips with the finer details Everyone has heard of Fiduciary Management. It has grown to become a prominent part of the institutional asset management and consulting business in Europe. And yet ... no one seems entirely clear what it is. We try to clarify.

March 11 - Number 7 - DC pensions - A Fruitful Segmentation of the market Like an orange, the DC market in the UK is both one big thing, and several segments. We have found that the segments are each quite different. Without understanding the differences in the segments, you cannot understand the whole, well, fruit.

Sep 10 - Number 6 - DC pensions - Collective Communications Solving the communications problem in DC Pensions will be helped by a new "collective" model, where members of many schemes are communicated to at the same time. This already happens in other countries, and we predict that it will start to emerge in the UK.

Nov 09 - Number 5 - DC pensions - The gold rush. Few people would associate the UK DC market with a gold rush. Now may be the time for a rethink. We go so far as to suggest that the DC gold rush could throw up a new pool of £600bn in assets.

Aug 09 - Number 4 - European Asset Management - How many futures? Planning has never been so tough. In this new piece we offer some highlights from the "Five Futures" Study that was published recently in partnership with Alpha Financial Markets Consulting. We hope you find it useful.

April 09 - Number 3 - Offshore Distribution - From Backwater to mainstream. As markets start to recover, we think that one of the most attractive opportunities will be catering to upwardly mobile professionals from developing markets via distribution networks in the International Financial Centres. We asked distributors in three of these centres what they wanted from their providers.

Feb 09 - Number 2 - Thought Leadership - A top tool for troubled times . 'Thought Leadership' is an ideal tool for the current climate. It delivers the Sales Team's need for fresh conversation openings in these fast-changing times, and Marketing's need for a low-cost communications channel in an era of vanishing budgets.

Nov 08 - Number 1 - Private Banking - Factories, Homes and Cottages. A new look at the architecture of private banking in Europe. As the dust eventually settles on the financial landscape, there will be two businesses less damaged than most: Private Banking and Wealth Management. Existing classifications give little clue to the underlying patterns. We suggest a new Segmentation.

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