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A regular analysis of strategic issues in the institutional investment business

Deeper Perspectives

UK Drawdown's long road to opportunity

With pension freedoms increasing choice for new retirees in the UK, taking pensions in drawdown is now the most common choice, ahead of annuities. As a result, we have already seen growth in drawdown AUM, and expect this to continue into the future, especially with changing targets for DC workplace schemes.

However, product development within the drawdown range will need to occur to meet the necessary requirements of delivery for the end consumers.

The impact of pension freedoms and its rapid transformation of the retirement income market in the UK is becoming clearer. It is evident that pensions in drawdown are now the first choice product for new retirees. Sales exceed those of annuities, and AUM is growing at more than 20% per annum. This offers increased opportunity for investment suppliers to the retirement income market.

This growth in drawdown as a primary choice is resulting in changes to the targets of UK DC default targets. A majority no longer target annuities, and in the near future, drawdown or a 'blended' target (some mix of annuities, cash, and drawdown) are expected to be the dominant choices. New types of investment product are being aimed at the de-risking phase of DC default glidepaths in order to take advantage of this trend, and position themselves as being suitable for members who wish to remain invested into retirement on a 'to-and-thru' basis.

To date, most drawdown products have focused on smooth operation and tax-efficiency. We suggest that new types of drawdown will have to evolve to meet consumer demands and requirements.

One emerging type is 'blended' products, combining drawdown with an annuity in a single product, providing the retiree both certainty and flexibility.

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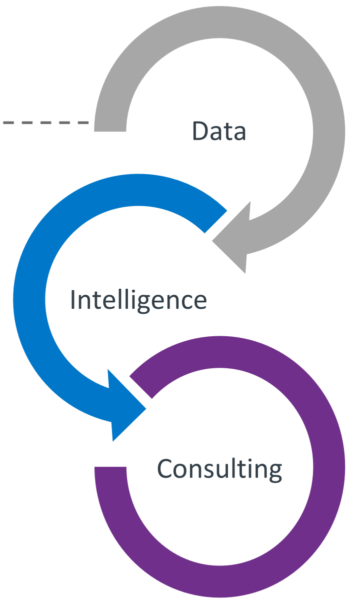
Spence Johnson is a Data and Intelligence consultancy focused on the global asset management business.

We use Money in Motion and our Intelligence

Spence Johnson's mission is to put data and intelligence at the heart of successful asset management businesses. This Deeper Perspectives is drawn from both our Money in Motion data, and latest Market Intelligence report focused on UK DC and UK Retirement Income.



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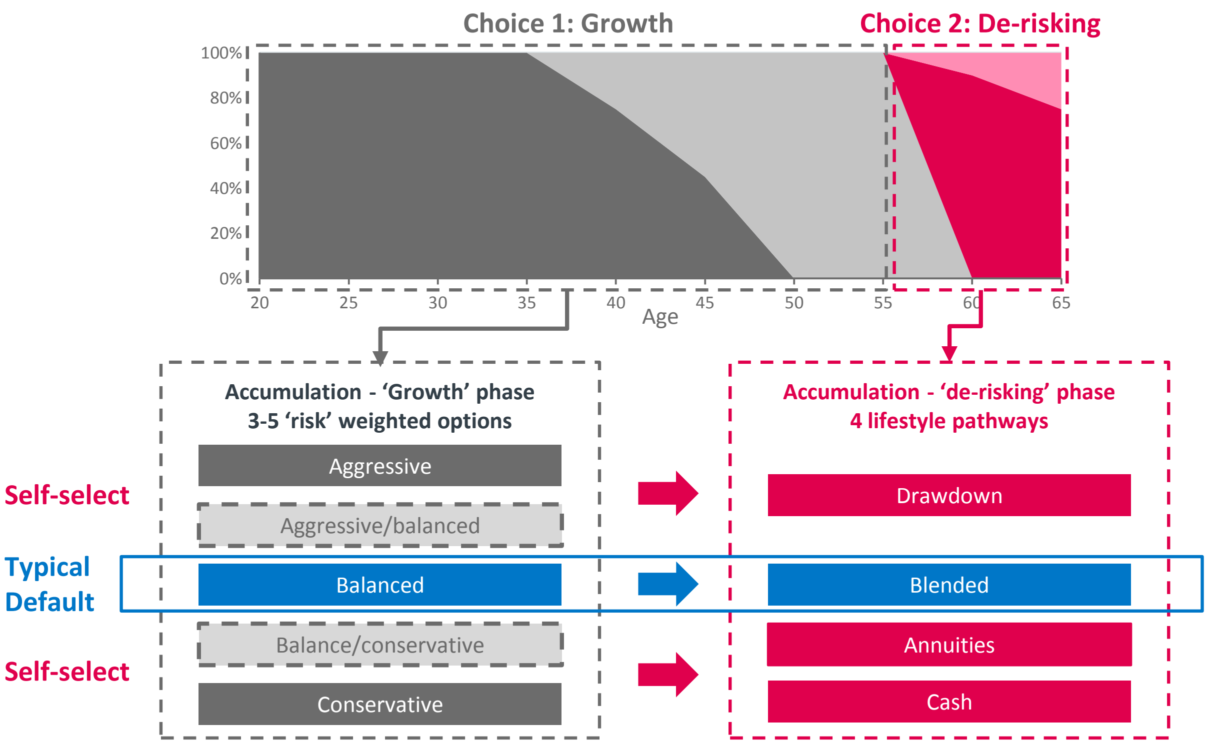
- European Diversified Growth & Multi-Asset
- European Smart Beta
- APAC Multi-Asset
- APAC Smart Beta
- APAC Wealth Management
- US Factor and Quantitative investing

DC Defaults are designed with 2 main 'choices'

Following analysis presented in previous reports of the two main options that UK DC schemes responding to pension freedoms were considering, here we present how these options have evolved into a range of choices regarding the design of the de-risking phase.

Default design process being considered by schemes looking to implement post-pension freedoms default designs



Since the 2014 Budget announcement that retirees would be granted the freedom to draw out up to 100% of their pension on their retirement, scheme fiduciaries and their advisers have been grappling with how the de-risking phase of lifestyle default strategies may need to be changed.

Historically lifestyle default strategy designs have targeted annuity pricing using a mix of cash and bonds. This design looks outdated given the collapse in annuity sales over 2014-15.

Those with smaller pots (<£30k) are likely to take cash. Auto-enrolment master trusts are therefore considering targeting cash as, in the next ten years, most of their members are likely to be retiring with small pots (Now Pensions have already enacted this redesign, for example).

Last year we spoke about the options that were emerging to target the different outcomes, this year we have created the above graphic to show how pension plan products are being designed to give schemes (and members) the flexibility to chose between the different options. Essentially post-pension freedoms schemes/ members are being presented with 2 broad scheme design choices :

- **Choice 1:** What level of risk do I/my members want in the 'growth' part of the accumulation phase?
- **Choice 2:** Which 'path' do I/my members require as a default in the run-up to their retirement (what traditionally has been known as the 'de-risking' phase of a lifestyle strategy)?

The list of options for each choice outlined in the boxes above can essentially be thought of as a 'menu' for the default design that an employer/fiduciary can choose for their members. So, as an example, a scheme with a more affluent workforce who are likely to choose to remain invested in retirement could choose an 'Aggressive' → 'Drawdown' default design and leave it to their members to self-select a different combination should this not be suitable for them.

The standard choice being offered by most bundled providers, however, is a default that is 'Balanced' → 'Blended' (as highlighted). A 'blended' glidepath will not target any one outcome directly but is likely to contain a mix of low-risk and growth focused components. The reason for this being the 'default' default option is:

- Members find it very hard to say with certainty what option they will pursue at retirement even 6 months beforehand.
- Given that members do not engage with the process, segmenting them and 'placing' them in a default option that seems best for them is fraught with fiduciary risks.

Freedoms have caused a change to targets

The move away from UK DC schemes targeting annuities following the introduction of the pension freedoms is clear in survey data we have received directly from schemes. Less than 10% of schemes intend to be targeting annuities in 2019.

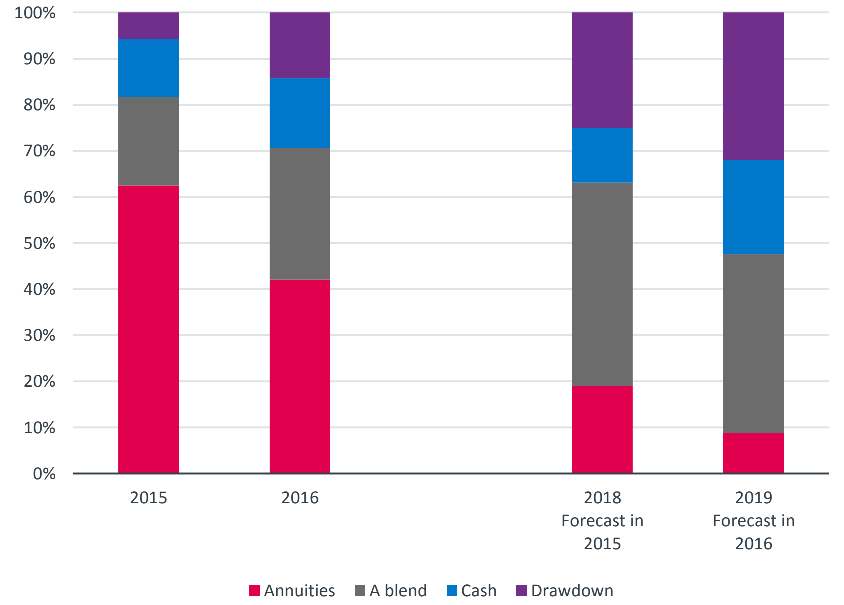
The shift away from annuities that has arisen as a result of the pension freedoms is clear in the response from our DC Monitor 2015 and 2016 surveys. Compared with the 62% of schemes targeting annuities in 2015, 42% of the respondents to our 2016 survey are now targeting annuities. The percentage of respondents targeting a blend of outcomes, cash or drawdown increased by 10 percentage points, 3 percentage points and 9 percentage points respectively.

Analysis of the future plans of schemes indicates that the decline in the number of schemes targeting annuities will decrease further. Their forecasts suggest that just 9% of schemes will be targeting annuities in 2019, which is an additional reduction from last year's forecast for 2018, which suggested that 19% of schemes would still have annuities as the target for their default funds.

By 2019, 32% of schemes are expecting to be targeting drawdown, 20% of schemes are expecting to be targeting cash, and 39% of schemes are expecting to be targeting a blend of outcomes.

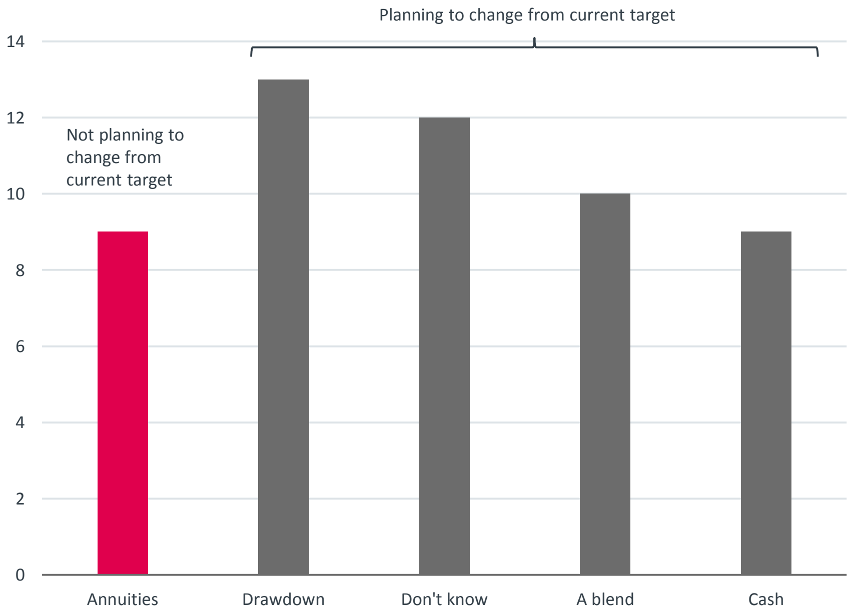
Looking just at the schemes which are currently targeting annuities, 25% are expecting to be targeting drawdown in three years' time, 17% of schemes are expecting to be targeting cash, and 19% of schemes are expecting to be targeting a blended outcome. 23% of schemes were unsure as to what they would be targeting in 3 years' time, and just 17% of respondents indicated that they would still be targeting annuities.

Outcome of glide path/lifestyling of default design targets currently and in 3 year's time
% of respondents, n=105 in 2015, n=126 in 2016



Source: Spence Johnson DC Monitor 2016 Chart ref: 109

Post-retirement options in three years for schemes currently offering annuities only
Number of schemes targeting annuities in 2016, n=53



Source: Spence Johnson DC Monitor 2016 Chart ref: 110

MA income and managed vol target de-risking

Over the past two years managers have launched a range of multi-asset income and managed volatility products either aimed at, or capable of, targeting UK DC assets in the de-risking phase (which has traditionally consisted of a 75% bonds and 25% cash mix).

Over the past two years managers have launched a range of multi-asset income and managed volatility strategies either explicitly targeted at capturing DC workplace assets in the 'de-risking' phase (such as SSGA's Timewise Target Retirement Choices, Schroders Flexible Retirement Strategy or LGIM's Retirement Income Multi-Asset (RIMA)) or at least capable of offering alternatives to the cash/bond mixes that have traditionally been used for this phase of DC workplace lifestyle default strategies.

Now that, post-pension freedoms, members no longer have to annuitise their DC savings at retirement, schemes may be considering reducing the extent to which they de-risk members as they approach retirement (especially if they are targeting drawdown for those members). While this suggests a movement away from traditional cash and bonds allocations, it should be noted that the introduction of pension freedoms did not change the fact that members' tolerance for absolute losses in their portfolios as they approach retirement decreases.

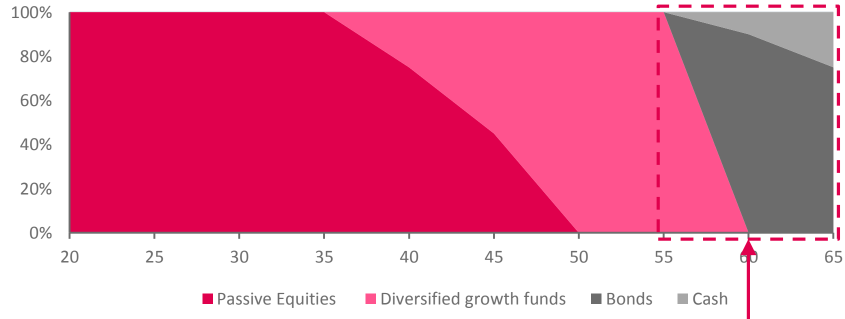
As such, recently launched multi-asset income products such as those listed in the table on this page are becoming increasingly attractive to DC schemes. These products enable schemes to offer members continued exposure to growth with often lower levels of volatility that might be experienced in a more 'traditional' DGF approach. This lower volatility is driven, in part, by the fact that the 'income' these products produce will not be distributed but reinvested. These products' income streams can therefore be presented as providing a relatively 'stable' foundation for their ongoing total returns.

Another appeal of these options is that they offer the possibility for a member to hold them into retirement (if the administrative and legal issues that are currently blocking wide scale development of to-and-thru solutions are resolved). As such, allowing schemes to 'future-proof' their investment designs by giving them the option to offer to-and-thru in the future.

In short, the stability, growth and income elements offered by these funds means they offer the possibility for default strategies to hedge against all possible current and future asset withdrawal methods.

Funds with the potential to be used in the de-risking part of DC default strategies

Multi-asset income and managed volatility strategies launched in 2014-15



Product type	Timeline	Manager name	Fund name
Managed Volatility	Q3 2015	SSGA	Timewise Target Retirement Choice
	Q1 2015	Schroders	Flexible Retirement
Multi-asset income/ multi-asset credit	Q3 2015	Allianz Global Advisors	Smart Income
	Q3 2015	Barings	Multi Asset Income*
	Q4 2014/ Q2 2015	Schroders	Global MA income/ EM MA income Fund
	Q1 2015 (re-launch)	BlackRock	Global multi-asset income
	Q1 2015	Newton	Multi-asset income
	Q4 2014	Aviva	AIMS Target Income fund
	Q3 2014	Kames Capital	The Aegon High Income fund
	Q3 2014	LGIM	Retirement income multi-asset (RIMA)*
	Q3 2014	Columbia Threadneedle	Global Multi-Asset Income
	Q2 2014	Invesco Perpetual	Global Distribution fund

Source: Spence Johnson analysis

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Drawdown sales overtook annuities in 2015

With the introduction of pension freedoms in April 2015, sales of drawdown products by ABI members in 2015 more than doubled from 2014 to £5.3bn in the UK. Meanwhile, the trend away from annuities continued, with only 82,000 new contracts in 2015.

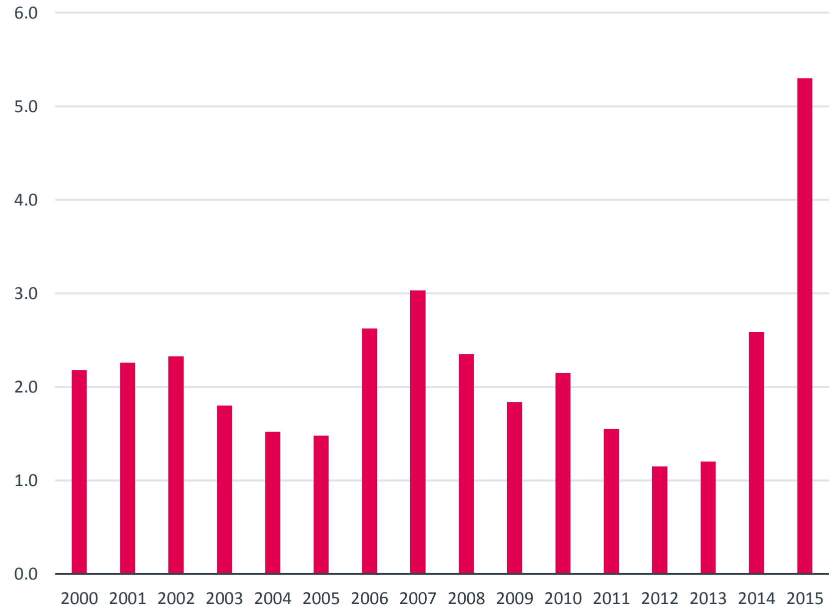
ABI data on drawdown sales suggest shows drawdown sales for its members have grew by more than 100% in 2015 (for the second consecutive year). From £1.2bn in 2013, ABI data reveals that drawdown sales for its members totalled £5.3bn in 2015.

The immediate cause of this growth is pension freedoms. Announced in April 2014 and introduced in April 2015, the option of drawdown was opened up to a wider market.

Meanwhile, as the bottom chart shows, annuity sales continued to tumble in 2016. The ABI data reveals that in 2015 there were only 82,000 annuity sales – down 56% on 2014, and 82% from their peak of 462,000 in 2009. The sales totalled £4.2bn, a fall of 39% from 2014, and 70% from their 2012 peak of £14.2bn.

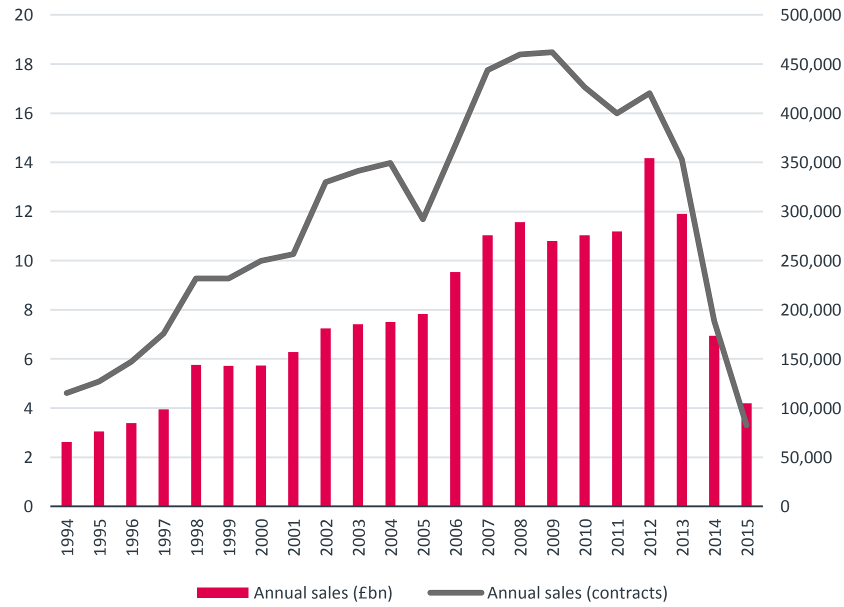
The fact that the fall in sales began in 2012 illustrates that, although exacerbated by pension freedoms, a trend away from annuities, driven by declining rates and poor perceived value, was already in place prior to 2014. While initial data from 2016 suggests sales have begun to stabilise the exit of many leading providers from the market suggest that these products will continue to face headwinds (especially if, as expected, interest rate remain low over the medium to long term).

Annual income drawdown sales of ABI members (2000-2015)
(£bn)



Source: RI75, RI415, RI817, RI818 (ABI), RI429 (IAA), RI821 (FCA), L3901, L3902, L3903 (ABI) Chart ref: 6

Annual annuity sales (1994-2015)
Number of contracts (rhs) and total annual premiums (£bn) (lhs)



Source: RI75, RI415, RI817, RI818 (ABI), RI429 (IAA), RI821 (FCA), L3901, L3902, L3903 (ABI) Chart ref: 7

Drawdown AUM has grown by 81% since 2012

In the three years that Spence Johnson has been analysing the drawdown market, it has grown from £50bn in 2012 to £91bn in 2015, an average of 22% p.a. Growth of 21% last year supports our assessment that drawdown will become the primary UK retirement product.

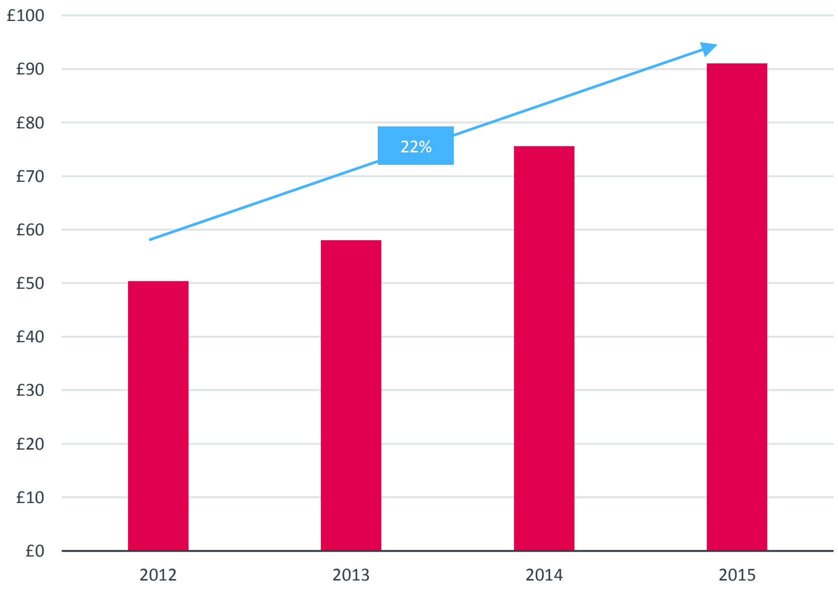
Since 2012, the assets invested in drawdown wrappers have increase by 81%.

This significant growth over a short time period supports our long-held prediction that drawdown will rapidly replace annuities as the central product offering in the retirement income space. This prediction has been turbo charged by the 2015 introduction of pension freedoms which removed the previous capped and flexible drawdown rules to allow people flexible access to their pension savings.

We continue to believe that the future of the retirement income market as it currently stands will likely, in large part, be contained within the drawdown market.

As a note, these figures for past years are slightly amended from those in last year's report, based upon improved data regarding certain providers.

Total assets invested in drawdown (2012-15)
(£bn)



Source: Spence Johnson analysis, Money Management Chart ref: 5

Drawdown design will continue to evolve

With the fall of annuities, drawdown has become the leading retirement income offering for retirees, but, with old drawdown products designed to cater for the 'affluent', industry experts agree new drawdown products are needed to meet the needs of the mass market.

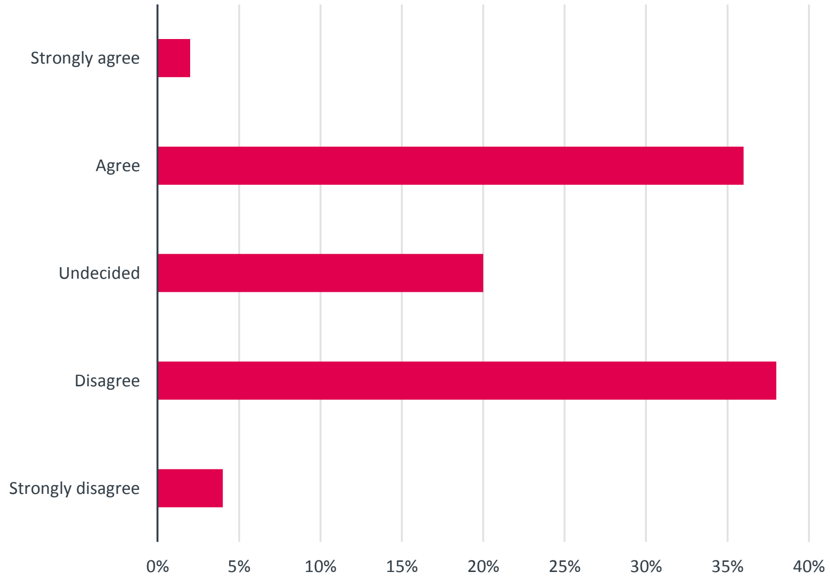
The results, also drawn from Equiniti's 2015 Retirement Survey of industry experts, clearly shows a strong demand for new retirement products, particularly when it comes to drawdown offerings.

The top graph shows that 42% of respondents to the Equiniti survey agreed that adequately meeting the needs of the UK retirement market over the next 5 years would require a new range of products. This demand was judged to be particularly strong when it came to drawdown offerings, with 72% of the respondents agreeing that traditional drawdown products no longer meet the requirements of the marketplace.

One of the main drivers of this demand is the need for drawdown products capable of delivering good value and outcomes for those with smaller pot sizes. As shown elsewhere in this report, traditional drawdown products such as SIPPs can often be both expensive and opaque when it comes to charging structures, features that are likely to be a particular hindrance to smaller investors looking for straightforward and often non-advised solutions.

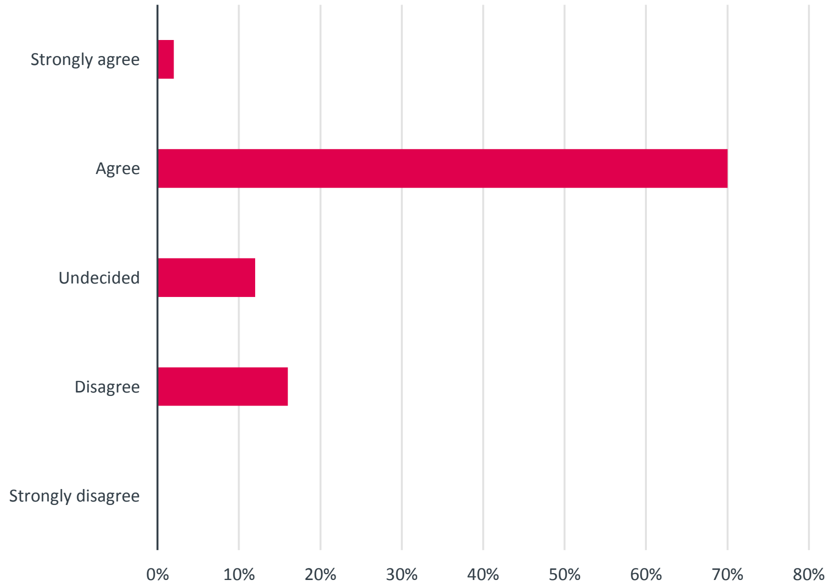
It is this demand that is driving some of the drawdown product development covered later on in this report. In addition, as those entering drawdown are likely to continue to require some form of advice, it is leading to the development of robo- and other 'simplified' advice solutions capable of adequately addressing the needs of the sub-£100k market.

The existing range of retirement products (perhaps blended) can adequately meet the needs of the UK market for the next 5 yrs
% respondents



Source: L3876 (Equiniti) Chart ref: 69

Traditional drawdown products no longer meet the requirements of the marketplace as there is a need for different pricing models to allow for smaller pot sizes
% respondents

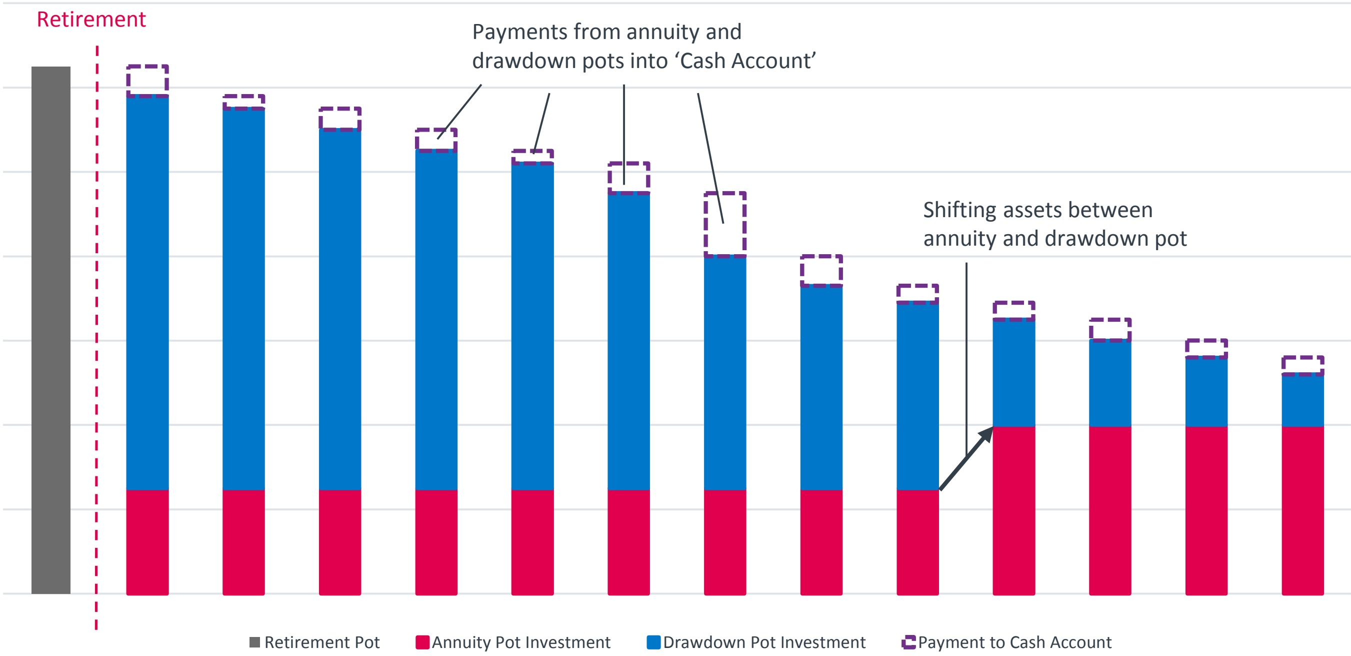


Source: L3876 (Equiniti) Chart ref: 70

Retirement Advantage – Retirement Account

Retirement Advantage's 'Retirement Account' is one of the first examples of the blended products we predicted would emerge as a result of pension freedoms: it consists of a guaranteed annuity combined with income drawdown offered together as a single product.

Retirement Advantage, 'Retirement Account'
Simplification of a Retirement Account strategy



Source: Retirement Advantage (L3957)

In 2016 Retirement Advantage launched 'The Retirement Account', a blended product that allows retirees to invest their pot in a guaranteed annuity and income drawdown, all within a single wrapper.

The annuity provides the certainty of income that many retirees require, while the drawdown offers flexibility. The retiree can distribute their funds between the annuity and drawdown as they see fit, and has the flexibility to re-distribute at any stage of their retirement. Payments are made into a single cash account, which the retiree when withdraws money from.

Once the annuity has started, the retiree will not be able to change the level of income, frequency or other benefits. However, they are able to use the annuity payments to reinvest into their drawdown fund (potentially for tax reasons), and able to purchase more annuity using drawdown funds.

A choice of funds for the drawdown element are available, both active and passive, as well as a range of risk profiles. These are on the following page.

The product is to be distributed through advisers, who will also recommend to the retiree how the fund should be split between annuity and drawdown.

Pension Drawdown tiered annual charge	
Initial set up	**£150**
Up to £25k	**0.6%**
£25k - £75k	**0.3%**
£75k - £150k	**0.2%**
Over £150k	**0.1%**
A further change can be levied if more than 12 switch requests are made within 12 months, or if additional services are required outside of normal administrative activities	

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March 2017 – Number 43- Insurance Asset Management
In the past, asset managers may have seen selling to insurers as pitching a range of products. In reality, due to the particular demands of insurers, outsourcing is an opportunity for asset managers to be active and help create a bespoke solution, unique to the issues faced by each insurer.

January 2017 – Number 42 – 2017 DGF's
Diversified growth funds have traditionally been focused on the UK institutional market, and DB pension schemes in particular. However, with lower forecast growth of DB for DGFs relative to DC, DGF providers are re-thinking their proposals.

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In this special edition of Deeper Perspectives we look at three of the major themes prominent in the global institutional asset management business in 2016

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As a result of the difficult situation faced by schemes, providers of 'solutions' have been the main beneficiaries of the continued growth in private DB assets.

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Strong growth from existing investors and emergence of new investors mean the region could see a close to doubling of addressable assets in the next 10 years.

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Smart beta growth reflects a face-off between more 'active' multi-factor strategies and more 'passive' alternative index approaches

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Partnerships, co-investments and asset pooling on the rise as Asian institutions take a more collaborative approach towards investments