ASSOCIATION OF CONSULTING ACTUARIES

St Clement's House, 27-28 Clement's Lane, London EC4N 7AE
Tel: +44 (0)20 3207 9380 Fax: +44 (0)20 3207 9134 EMail: acahelp@aca.org.uk
Web: www.aca.org.uk

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PADA Investment Consultation Team
St Dunstan's House
201-211 Borough High Street
London SE1 1GZ

Email: pada.investmentconsultation@dwp.gsi.gov.uk

Dear Sirs

Consultation response to PADA discussion paper *Building personal accounts: designing an investment approach*

I am writing on behalf of the Association of Consulting Actuaries, in response to your consultation on the above.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. On the investment front, many of our members are asked to advise on scheme investment objectives and on asset allocation strategies appropriate to these objectives, taking into account each particular scheme's liabilities. They will analyse and monitor the investment performance of pension funds and advise on the selection of investment managers, when required.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

We hope you find the responses to the consultation helpful in finalising policy. Additionally, as an appendix to the response, we have included the responses made by companies to a selection of questions arising from the consultation paper that we posed in our ***ACA 2009 Pension trends survey***, which will report shortly.

Yours faithfully,
Brian St John-Hall
Chairman
ACA Investment Committee

ACA responses to consultation questions: Building personal accounts: designing an investment approach

2.2 Which member characteristics should influence the design of the personal accounts scheme?	We believe that the main factor that will need to be taken into consideration is the lack of financial understanding and sophistication of the members. It is difficult to see how this situation can be changed, at least within a reasonable timeframe, and this lack of sophistication is therefore likely to be a permanent feature. It is also important to take account of the low risk tolerance of the membership when designing the investment arrangements.
2.2 From the evidence presented what conclusions should we draw about our future membership	In addition to the above, the members are likely to be relatively low paid, and many of them may have no previous experience of making any provision for their retirement except that provided by the state. In the case of the lowest earners, other pressure on their financial situation, with more apparent immediacy than the need to secure an adequate pension, may give them an incentive to opt out of the personal accounts regime. Although this clearly touches on wider issues it does imply the need for careful communication to the potential members of the scheme.
3.1 The Trustee corporation may have to strike a balance between what it believes members want and what it believes is the best investment solution for the majority of members. Where do you think this balance should be struck for the personal accounts default fund?	We believe that the Trustee corporation should remain focussed on what it believes would be in the interests of its members and also those who would benefit by joining the scheme. However, it would clearly not be desirable to derive a theoretically best solution that alienated potential members and lead to a high opt out rates. There is a difficult balance to be struck, and we would lean more to the side of ensuring that the best investment solution is achieved rather than sacrificing this to make it initially more attractive to the membership. Over the long term we believe that building a sound investment solution from the start would engender more confidence and, as a consequence, lead to increased participation rates over the long term.
3.2 How should the different contribution profiles of members affect the scheme's investment objectives?	We do not believe that different contribution profiles should affect the scheme's investment objectives.
3.3 What should be the overarching objective of the personal accounts fund and why?	We believe that the overarching objective should be to focus on replacement income although we should note that a significant minority of the pension funds that we surveyed recently in our ***ACA 2009 Pension trends survey*** (in which we received 309 responses from schemes of all sizes) did favour a benchmark-driven return objective. The idea of operating under a best efforts framework proved to be much less popular. On balance we believe that a replacement income objective fits in more naturally with the purpose of pension provision and would be better understood by the potential membership.

3.4 What particular measures should the trustee corporation undertake to ensure that members can have confidence in the Scheme?	Clear communication and excellent administration are the foundation to inspiring member confidence. The key point about the communication is that it should be clear and understandable rather than attempting to provide exhaustive coverage. In addition to members with low financial sophistication it is probable that some potential members have will have low literacy skills and thought will need to be given as to how these members are reached. Additional information should be made available for members who do have a more active interest in financial matters, maybe by way of web-site and other methods to cater for members who do not have access to the internet. Poor administration can really damage the members' confidence in the Scheme even if every other aspect is managed to a high standard. Thought should be given as to how members interact with the administration and particularly for those who find dealing with financial issues stressful.
3.5 How can the Trustee corporation communicate to members in language that is readily understood, particularly around topics such as the investment objective of the default fund?	We do not believe we are the best placed organisation to provide commentary on this except to say that, as noted above, it is an issue of crucial importance and that consideration should also be given to the method of communication (to ensure that as many of the potential members are reached) as well as the content.
3.6 Are different approaches to sharing risk worth pursuing for the personal accounts default fund, or an alternative fund choice and why? Please discuss implementation approaches and challenges.	We do not believe that different approaches to risk sharing should be considered. Any method of risk sharing will lead to cross subsidies with some members benefiting whilst others lose out. Although it may be argued that cross subsidies are commonplace in the financial world (insurance, with profits funds) these are generally entered into as an active choice by the participants and have less level of 'compulsion' (by way of automatic enrolment) than is the case with this Scheme.
4.1 In what situations should personal accounts use tactical asset allocation and why?	Although it is not generally commonplace for defined contribution arrangements to use tactical asset allocation we believe that the economies of scale that are likely to arise in this Scheme make tactical asset allocation a practical proposition. Tactical asset allocation could have a place in this fund. For example, after a period of good market performance it may make sense to reduce the risk and therefore lock in profits in the period running up to retirement.

4.2 What are your views on how the personal accounts scheme can use alternative asset classes to benefit from potentially improved diversification and investment performance, while still meeting its needs for liquidity and accurate pricing?	Given that the members have a low risk attitude and that there is still a need to generate sufficient returns we believe that there is a role for the majority of alternative asset classes. If these are not used then the effective price paid by member to reduce the volatility of the investment may be too high. We accept that with some asset classes (especially private equity and infrastructure) there will be difficulties about pricing and transparency that will need to be address but believe these are secondary issues compared to the desirability of adopting a well diversified approach to investment management.
4.3 Across which asset classes should diversification of the default fund extend?	We believe that all of the major asset classes should be used in this respect.
4.4 What should the balance be between active and passive managers in the default fund and is this consistent with a low-charge scheme?	We believe that a high element in passive managers would be appropriate (this is consistent with our survey). In this way the majority of the assets would benefit from very low charges with the remaining spent on active management where it makes sense to do so. In particular we would note that many alternative asset classes can only be accessed by using active funds. In terms of the more common asset classes, consideration should be given as to where it makes sense to use active management. For example it is generally accepted that it is very hard for active managers to outperform in US large cap stocks whereas there is more scope in some of the less efficient markets and on a global basis. We believe that the above approach which would specifically use only active management where it makes most sense to do so, and with most of the assets managed on a passive basis is consistent with a low charge scheme and will not unduly constrain the overall asset mix.
4.5 Do certain asset classes favour a particular management style? Please provide evidence in support of your response	As noted above some asset classes need to be accessed through active management as it is an integral part of how the returns are expected to be generated (e.g. hedge funds, distressed debt). In general the board should consider how much of an asset class's return is likely to be explained simply by being in the market and how much due to active management skill.

4.6 What approach should the trustee corporation use to identify asset managers who are likely to outperform?	Fundamental research on each manager covering its business model, people involved, investment process and philosophy, etc. is the best way to identify an asset manager that is likely to outperform. Although such research cannot guarantee that a selected manager will outperform in the future it should act to increase the chances of selecting such a manager. In addition to the selection of managers, we believe that the board should also have a clear policy on when they will terminate a manager's appointment and importantly have a process in place that a replacement manager can be quickly implements and any transition smoothly achieved.
4.7 Should the personal accounts scheme participate in securities lending?	We believe the Scheme could benefit from security lending. However, the result of our survey indicated the vast majority do not favour allowing securities lending which could indicate the recent experience in this market.
4.8 If so, what controls and limits should it impose if any?	If the Scheme does decide to participate in security lending it needs to ensure that the collateralisation arrangements are secure and sufficient diversification of counterparties.
5.1 Is a traditional life-styling mechanism appropriate for the personal accounts default fund and if so why?	We believe a target date fund would be appropriate given that the potential size of assets attributable to any target retirement date will be large. This type of approach is much more flexible than operating to a pre determined investment strategy and in particular will allow account to be taken of prevailing market conditions close to the retirement date. In addition we believe that a target date approach would be administratively simpler than the other options. Having said this, we would note however that our survey of pension schemes indicated that most respondents were in favour of having a traditional life-style approach or offering both a life-style approach and a target date fund alongside this. Only a minority favoured a target-date scheme without a life-style option.
5.2 Would a target date approach be appropriate for the default fund and if so why?	A target date fund could be appropriate for the default fund although it was not the most popular option in our survey of pension schemes.
5.3 Are alternative life-styling approaches suitable for personal accounts, and if so why and how should they be implemented?	See above.
6.1 To what extent can the personal accounts scheme deliver high quality corporate governance at low cost?	We believe that the Scheme should take a pragmatic approach to corporate governance and work through the fund managers. As part of any manager selection exercise the Scheme should ask managers for their policies on this and the extent to which the Scheme is able to influence the general policies if they are found to be below the board's minimum expectations.

6.2 How will this evolve over time as the scheme's assets under management grow?	As the level of the Scheme's asset grows, and depending on the level of usage of segregated versus pooled funds there may be a case for developing in house expertise in this area or appointing a specialist firm to manage this aspect of the investment policy on behalf of the board.
6.3 How do we achieve high quality corporate governance where assets are managed passively	Depending on the size of the assets it may be possible for the Scheme to set up a segregated portfolio with a specific policy in terms of the exercise of voting rights.
6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?	We believe that the trustee corporation should participate fully in the voting of shares to the extent that it does not delegate this function to its fund managers.
7.1 How can the personal accounts scheme engage in responsible investment in a low cost way?	At least initially this function could be delegated to the fund mangers with guidelines drawn up by the board. However, for a dedicated approach this would means that segregated funds would need to be used.
7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practicable and relevant	To the extent that responsible investment is considered in the default fund then it should be applied for all fund choices to the same degree within any practical constraints. It would be difficult to justify apply one set of standards to the default fund and then saying that similar considerations should not be applied to other funds.
7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?	The cost of conducting the fiduciary duty in regard to responsible investment is likely to remain fairly static and be spread across an ever increasing asset base. We therefore believe that over the long term that it would be possible to discharge the fiduciary duty at a low cost when referenced to the asset base of the Scheme.
7.4 If responsible investment is pursued, will the members be best served by building in-house capability or out-sourcing?	At least initially responsible investment is likely to be best served by outsourcing. As time goes by it may be possible to build up an internal expertise in the area but the cost should be weighed against the additional utility of doing so.
8.1 To what extent should the Trustee corporation offer fund choice, and what should those choices be	The choice of funds should be sufficient to allow members to manage the investment risks they take, but not so wide as to offer a bewildering array of choices that serve only to confuse the membership. In addition, the research given did show that a lot of the membership was risk adverse, but there is still a significant group for whom this is not the case and they should be catered for as well. We also believe that the choices should also ensure that no specific group is disadvantaged by not

	having any realistic option that they can select. For example, dedicated ethical and Sharia funds could be made available. We would expect that a range of around fifteen funds would enable the Scheme to allow for most of the membership needs but even at this level care will need to be taken as to how they are communicated so as not to overwhelm the membership.
8.2 To what extent should those funds be life-styled?	We believe that any life-styling that does occur should be restricted to the default fund rather than more generally applied. If members are going to take an active choice away from the default fund it is likely to be indicative of a higher level of financial sophistication than the majority of the membership. There may however, be a case for making exceptions in the case where it is unlikely that a member who chooses a fund has complete freedom to choose the default fund (for example, in the Sharia fund) and in this case it may be worth offer one version with lifestyle and one without.
8.3 Should the Trustee corporation offer branded funds as part of the fund choice offered to members, and if so, why?	We do not believe that the funds should retain the brand of the service provider. There are likely to be occasions where the agreement with a manager will need to be terminated and it is likely to cause less confusion to the membership if a fund name can be maintained.
8.4 Should costs associated with wider fund choice be spread, where possible, across all members, or only apply to those members who choose alternatives to the default fund?	No. As noted in our answer to 3.6 we believe that cross subsidies within the Scheme should be avoided where possible.
8.5 Should there be a limit on the number of fund switches, or charges imposed after a certain number of switches, or neither for the personal accounts scheme?	It is likely that the majority of members will not switch or switch only infrequently. We believe that members should be charged for the switch and that such a charge should be taken out of the units they have. If this does not happen then member who do not switch will effectively be subsidising those who do.

If you wish to follow up any points in this response, please in the first instance contact our Investment Committee Chairman, Brian St John-Hall at brian.st.john-hall@hewitt.com

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