LCP INSIGHT CLARITY ADVICE

Master Trusts Unpacked

Default Investment Strategies

May 2022

Welcome

Welcome to the first edition of the Master Trusts Unpacked report, in which we assess the impact of master trust default fund design on member outcomes.

The pensions market is evolving rapidly and master trusts are playing an increasingly significant role, as small employer-centred trust-based schemes are encouraged to consolidate. The investment strategies of master trusts, and the returns they provide, becoming increasingly more important to more and more UK DC pension savers.

Master trusts have taken different approaches to designing their default strategies. The key difference amongst providers is in their asset allocation, notably their allocation to risk assets during the growth phase. Variation in the length of the de-risking period, including de-risking post-retirement, is also evident across the market.

Ultimately, the design decisions master trusts take about their default strategies determine the extent to which they are likely to provide good outcomes for DC pension savers.

Nigel Dunn
Partner

In this paper, we explore some of the key differences between providers' approaches to default design and what that implies for:

- **Growth:** Have providers' strategies raced ahead or trundled along in recent years?
- **Consolidation:** How smooth is the transition from the growth phase to retirement and why does this matter?
- **Shocks:** What impact does default design have on members' exposure to the risks of climate change?

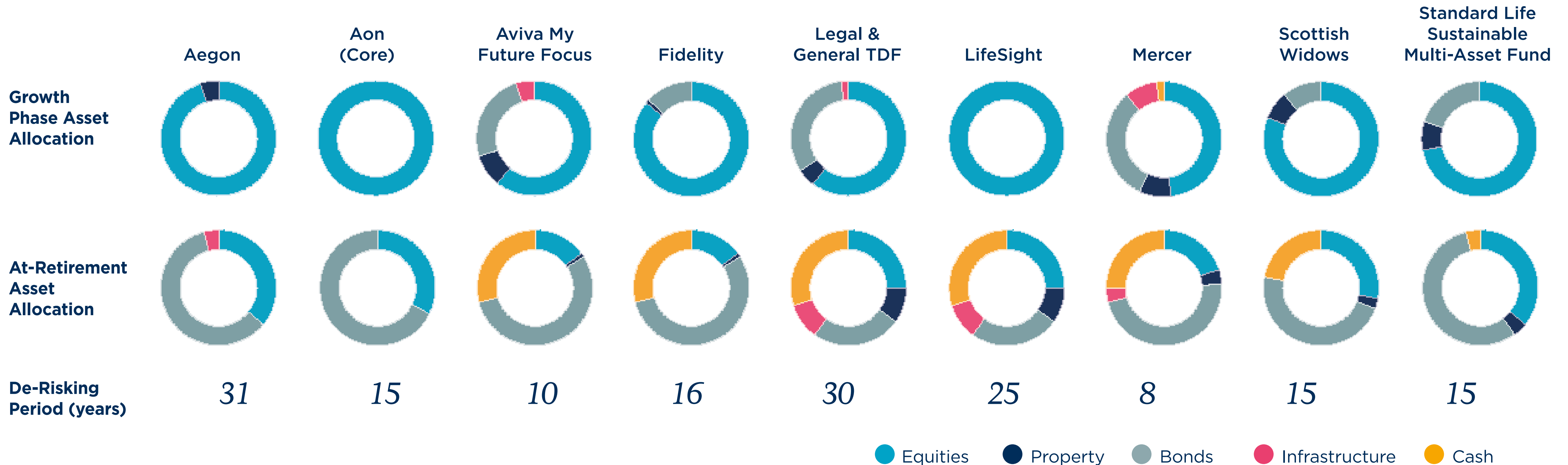
The data in this report is based on LCP's proprietary DC research programme. We would like to thank providers for taking part in our research.

Default design

Significant variation in how master trusts structure their strategies

Despite the perceived uniformity of master trusts amongst many corporate sponsors, not all master trusts are created equal. The design of their default strategies differs considerably and is governed by a number of factors, including their investment philosophy, membership base, and client acquisition strategy.

Below, we've set out the approaches used by some of the main commercial providers in the market to illustrate how defaults can vary. We've selected these providers as they are some of the most active in the consolidation of the traditional trust-based sector.



Going for growth

How do master trusts' growth phases compare?

Over the last 5 years we have seen strong performance from equity markets, which has led to dispersion in performance across the master trust market, with those betting big on equities winning out over those taking a more diversified approach.

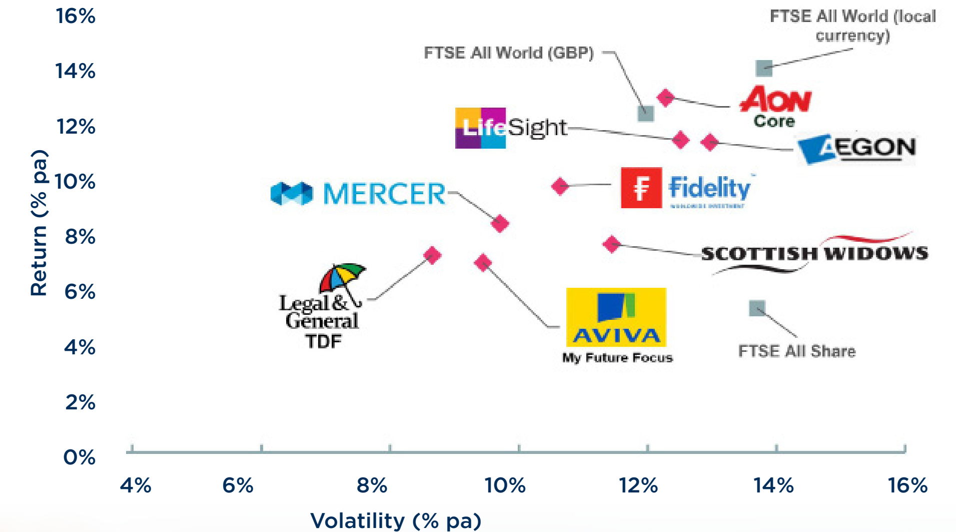
The chart shows the performance of master trust default growth phases over the last 5 years. Those providers that allocate to c.100% equities like Aon, LifeSight, and Aegon in the growth phase have benefited the most, whilst others, like Aviva and L&G, have seen lower returns due to their diversified approaches.

Those master trusts whose growth strategies are equity heavy have, in general, experienced the highest level of risk. This is to be expected and is a key consideration when selecting a provider, as membership populations have different risk appetites depending on a range of factors (e.g. age, earnings, etc).

It's striking to see the difference in outcomes between providers but this has been a consistent picture over recent periods. Of course, member outcomes are also a result of returns across the journey to retirement and the level and timing of contributions. We look at this in more detail later in this report.

The best performing master trust achieved a return of around double that of the lowest performing master trusts for c.3% more risk

Risk vs Return of Master Trust defaults over 5 Years to 31 December 2021



NB: Providers in chart have been selected for comparison purposes.

Consolidating gains

Different approaches to the pre-retirement phase

Understanding the retirement target of a default strategy and whether that is likely to be appropriate for members is crucial when selecting a master trust solution. Providers target different retirement targets and this has clearly influenced their strategy design.

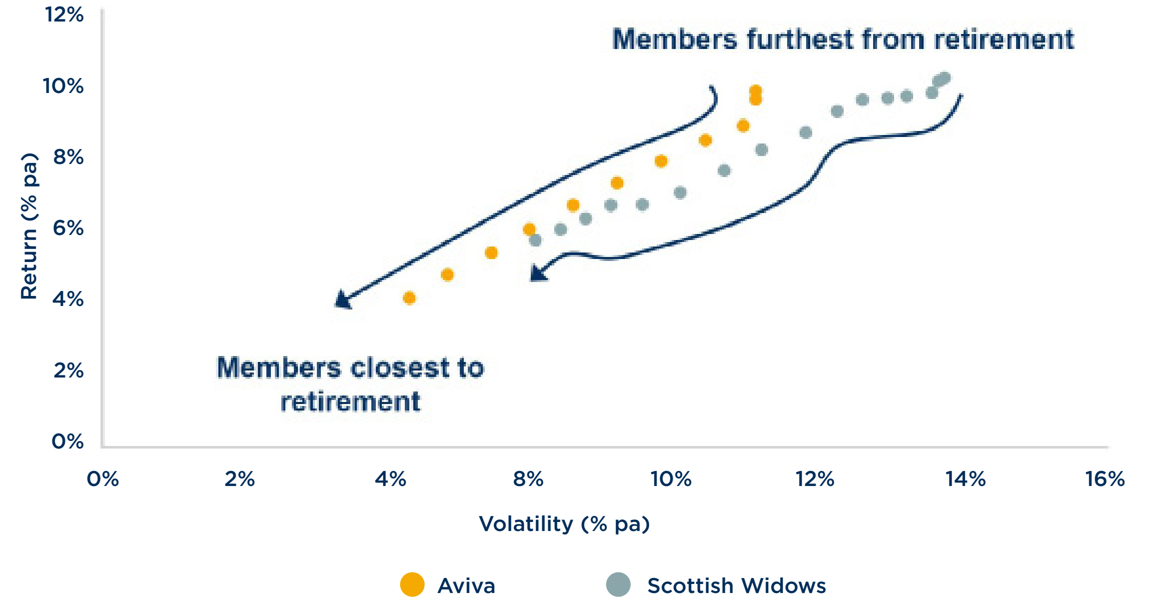
Scottish Widows PIA and Aviva My Future Focus illustrate what these different approaches to default design can deliver. The higher allocation to risk assets at retirement in Scottish Widows' strategy is designed to suit its drawdown objective, whereas My Aviva Future Focus targets a 'catch all'[1] objective.

The chart shows how the risk and return changed for each strategy depending on members' proximity to retirement. The strategies have a similar return for those members furthest away from retirement, though Aviva achieved this with lower volatility, due to a higher level of diversification.

Members closest to retirement in Aviva My Future Focus achieved lower returns that those in Scottish Widows as a result of a higher combined allocation to bonds and cash, but also experienced a lower level of risk.

Aviva's greater diversification over the lifestyle enables it to have a shorter de-risking period (10 years) compared to Scottish Widows (15 years), as it is less exposed to volatility and market timing risks. To an extent, Aviva's shorter derisking period compensates for its lower overall allocation to risk assets.

Overall, we see a smoother journey for members in Aviva Future Focus compared to Scottish Widows PIA, albeit with slightly lower returns for members at retirement due to the universal target.



> *All master trust defaults use either a lower risk catch all retirement target or a higher risk drawdown retirement target.*

[1]A 'catch all' approach is agnostic about the access choice members will make at retirement.

Thinking about member outcomes

Will everyone get to their retirement goal?

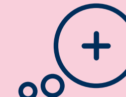
The outcomes that master trusts are on track to deliver are governed by a range of factors. Some master trusts expect to grow pot size by taking more risk in the growth phase and de-risking over a relatively long consolidation phase. Others have taken the opposite approach, employing relatively modest allocations to risk assets and de-risking over a shorter timeframe.

LifeSight and Aon are on track to deliver the highest outcomes for members on average. In both cases, their strategies target 100% equity in the growth phase and de-risk to an at-retirement allocation that maintains a relatively high level of growth assets. Using the **PLSA's Retirement Living Standards** to measure potential outcomes, our modelling shows that these two providers have a similar proportion of members expected to achieve a "moderate" outcome. However, Aon has a higher probability that members will achieve a comfortable outcome, due to its shorter de-risking phase of 15 years vs 25 years for LifeSight (though it's worth noting that Aon continues to de-risk post-retirement).

Delivering a comfortable outcome is likely to be more challenging for providers, with contribution levels likely to have to increase for members of all master trusts to have a high likelihood of achieving it. No matter how good, default design can only get members so far towards achieving their goals.

Being the providers most likely to deliver the highest outcomes means LifeSight and Aon are also the providers with the widest spread of expected member outcomes at retirement. This paradigm means these strategies might not be suited to all memberships, especially where members need a higher level of certainty on the level of the expected retirement benefits.

We think that **most members** on an **average UK salary** will be **targeting** the PLSA's moderate outcome at retirement, so its important to **know which providers** are expected to deliver on this goal.



Our modelling shows only 2/3 of master trusts are expected to deliver an average outcome in line or above a moderate retirement living standard.

RETIREMENT LIVING STANDARDS

£20,800
(Moderate living standard)

AON Core

£24,700
(Median expected income)

LifeSight

£23,700
(Median expected income)

Modelling and assumptions as at 31 December 2021. Based on a starting salary of £30,000 and 12% contributions with a real salary growth rate of 1% pa for a member with 40 years to retirement. All calculations assume the presence of a full State Pension. Inflation is assumed to be 2.5%.

Mitigating the risks of climate change

How does climate change impact member outcomes?

Climate change is one of the major risks DC members will face in their lifetime and this will also impact the returns of their pension. At LCP, we have partnered with Ortec Finance to assess the climate impact in different scenarios including:

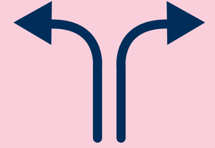
- **Paris Orderly** – assumes global economies transition to well below 2C in line with the Paris COP 2015 targets.
- **Failed transition** – assumes only existing climate policies are implemented and temperatures exceed 4C.

Here we show how the expected average outcome for Aegon's and L&G's defaults is impacted in each of these scenarios compared to a climate uninformed base case. Aegon is impacted more than L&G in both scenarios, and particularly the failed transition, which is typical of strategies with higher exposure to the equity market.

All providers have taken steps to mitigate the impact of climate change, which we assess as part of our research, but there is still more to do.

Our modelling suggests 4 in 9 master trust strategies could see a 20% fall, or greater, in member outcomes under a failed transition.

Aegon and L&G have taken very different approaches to default design, with **Aegon targeting a significantly higher proportion of equities** throughout the lifestyle and **L&G taking a more diversified approach**. These different approaches have clear consequences for the impact of climate change on member outcomes.



	AEGON	Legal & General Pathway
Orderly transition	-6%	-5%
Failed transition	-20%	-14%

Modelling as at 30 June 2021 scenarios, 31 December 2021 market conditions.

LCP's climate scenarios were developed in partnership with Ortec Finance.

Conclusion

Key considerations for default design

Master trusts have structured their default strategies in different ways, taking account of their investment philosophies and the characteristics of their membership base.

It's clear that high levels of risk are required for members to have a reasonable chance of a good outcome at retirement. However, this entails members tolerating volatility, particularly at times of market stress. Such members may also be more exposed to the negative impact of climate change on markets unless their provider has taken steps to mitigate their exposure to affected sectors through tilts and good stewardship practices.

In summary, default design is essential to the outcomes members are likely to achieve, and corporate sponsors and trustees should take the time to understand the differences between providers as part of any master trust selection.

1 *Ensure default design and performance is not forgotten about when selecting a master trust*

2 *Think about the outcomes your members expect from their pension savings*

3 *Investigate the potential impacts of climate change*

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