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Improving Risk Management in DC

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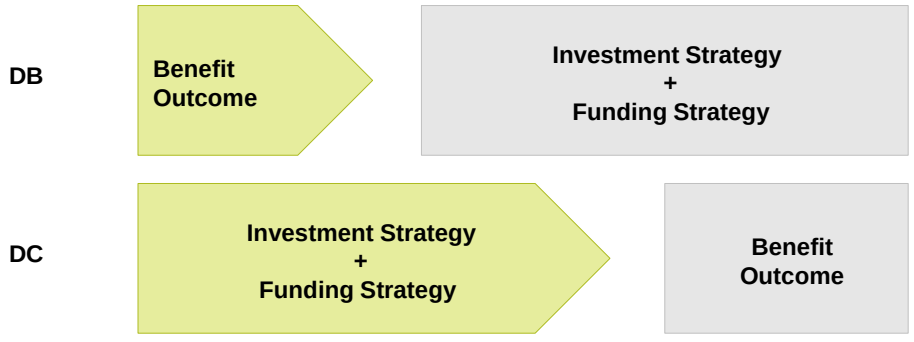
What is Good Risk Management About in DC

1. Understanding the difference to DB
2. The importance of the “Default” and meeting “Members Reasonable Expectations”
3. Being robust to assumptions about the future
4. Good governance
5. Dynamic asset allocation
6. Practical and flexible implementation
7. Not stopping at retirement
8. Guarantees?

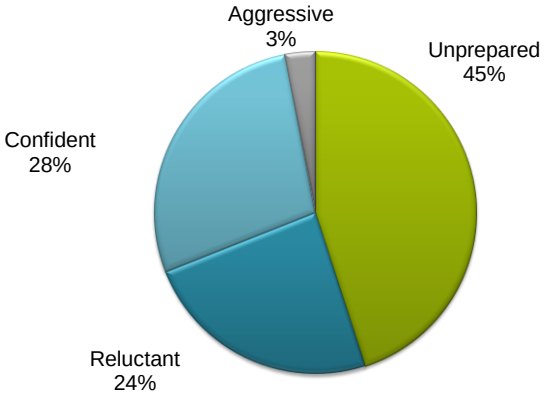
Will Concentrate on Investment Side – But Contributions Matter – A Lot

1. DC is not the same as DB



DB risk management focuses on the security of benefits and affordability
DC risk management focuses on the benefit adequacy for the member

Observation: Members Want/Need an "Expert" to Invest for Them



Unconscious/Conscious Delegators
45 – 97%

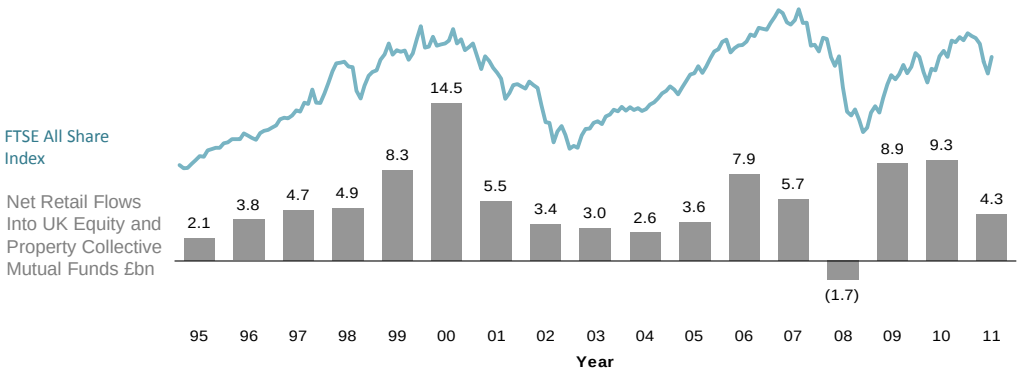
Sporadically Engaged
3 – 55%

Highly Engaged
3%

c80%+ of UK DC Members Typically Invest in the Default

Source: AllianceBernstein & Harris Research 2009 UK pension scheme members

Observation: Beware Engaged Investors



"Confidence" Does not Necessarily Mean "Competence"

Source: FTSE, Investment Management Association and AllianceBernstein 1 December 2011

Observation: The Majority of Self Selectors Underperform the Default

		% Participants Under Performing Target-Date Fund - Default	
Age Range	Target-Date Fund	"Bad Times" 2000-2005	"Good Times" 2002-2005
< 35	2040	68%	83%
35-45	2030	69%	79%
45-55	2020	57%	68%
55-65	2010	51%	57%
65-71	2000	41%	62%

Why? : Cost? / Behavioural? / Different Objectives?

Source: Ennis, Knupp & Associates 2006 report
Historical data for information purposes only

Observation: Engagement Models are Difficult and Costly to Risk Manage

- How does the Engagement model address the following?
  - Provision of sufficient information **and skills** to appropriate make choices
  - Behavioural risks
  - Maintain future engagement (deferreds etc.) and overcome inertia
    - **Beware the "Sales Model"**
  - Difference between making a choice and understanding
  - Not detracting from contributions and outcome engagement
- Someone is "on risk" for ensuring on-going engagement - **This is costly**

Choice Should be an Option

2. For Most a Default will Provide Better Risk Management

Reduce Costs	Bulk buying Investment Advice and Asset Management
Overcome Inertia	No engagement required to update
Manage Behavioural Biases	Reduce buy high, sell low likelihood
Improve Member Engagement	Focus shifts to savings rates

2. What A Member Could Reasonably Expect From A Default Fund….

……If They Ever Articulated It!!

- Clear objective
- Someone actively looking at/managing their funds on their behalf
- Someone with competence and experience "on the hook" for decisions
- Investment strategy updated to take account of changing:
  - Investment environment
  - Legislation
  - Member retirement patterns and needs
- Objective independent oversight

Traditional DC Default Strategies Fall Short

Observation: Managing a Default will Require us to Make Assumptions

Knowns
- Age

Known Unknowns
- Retirement Date
- Health and Longevity
- Dependents
- Employment History and Contributions
- Wealth at Risk
- Retirement Decisions/Ambitions
- Pensions Legislation
- State Benefits
- Future Markets and their Returns

In DB we only Needed to be Right for Mr Average
In DC we Need to be Robust to Real People Living Real Lives

Observation: A Vague problem with no Precise Answer

- We hear "If I define an outcome then I can manage investments better"

  "Everybody has a plan until they get punched in the face" Mike Tyson

- Example – Everybody takes tax-free cash and buys a level annuity on retirement at age 65 hence we should target 75% long nominal bonds and 25% cash at 65
  - Problem 1
    - Inflation shock
  - Problem 2
    - Retirement shock
  - Problem 3
    - Legislation shock

In DB we only Needed to be Right on Average

3. Age is the only certainty

- Default strategy needs to be **Robust** to all other assumptions

Observation: DC Trustees/Providers Need a Different Mind Set to DB

DB
Risk Taker Employer
An Engaged Investor

Trustees/Providers
Subject to Independent Oversight

DC
Risk Taker Employees
Unengaged Investors

Trustees/Providers
Are the Independent Oversight Providers

Observation: Investment Management Decisions

STEP 1 : Risk/Return Glidepath

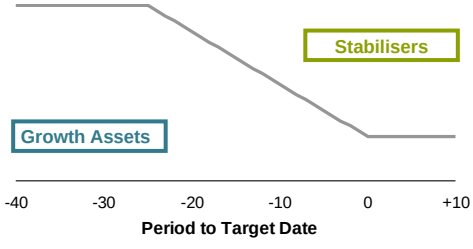
- c50% of the outcome

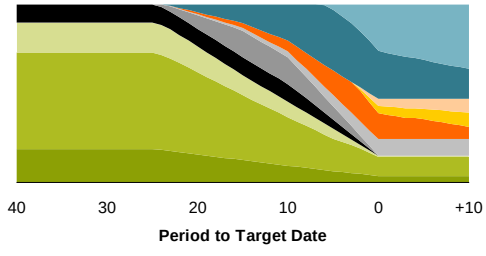
STEP 2 : Asset Allocation

- Asset classes
- Dynamic v Fixed
- c30% of the outcome

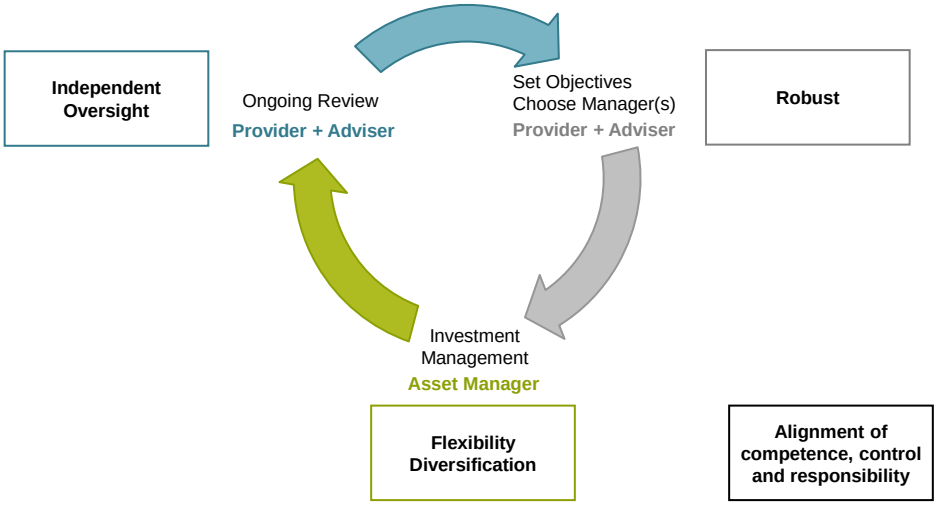
STEP 3 : Security Selection

- Active v Passive
- c20% of the outcome



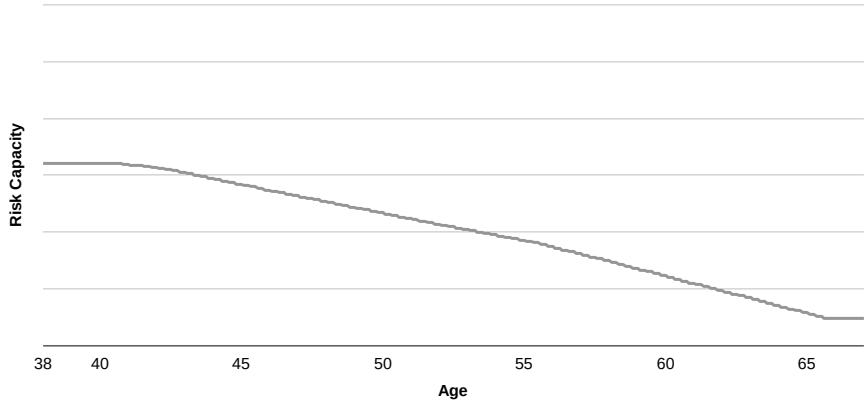


4. Risk Management Includes Good Governance



Observation: A Glidepath Captures Investment Objectives of Savers

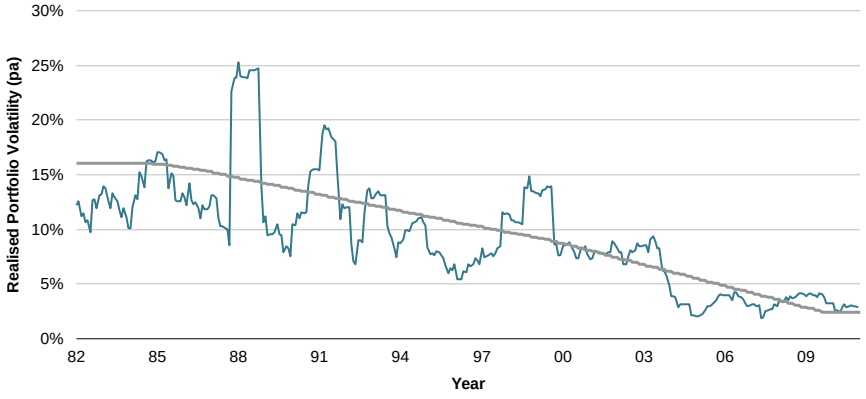
DC Example : Decreasing Risk Capacity of a DC Saver with Age



Mechanistic Management of Assets Against this Glidepath Assumes Constant Risk

Observation: A Well Diversified Strategy Can Fail if Managed Mechanistically

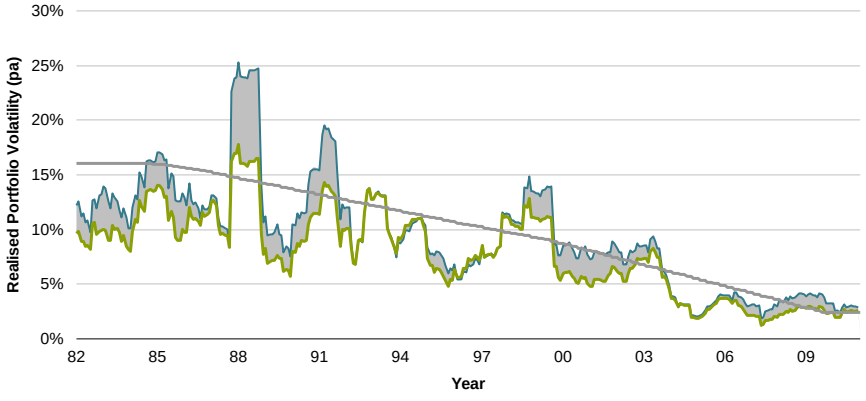
DC Example : Risk Capacity of a Saver Expected to Retire between 2008-2010
Realized Volatility of Portfolio



Source: Alliance Bernstein 31 December 1981 through to 31 December 2010
Analysis is simulated based on the current strategic asset allocation strategy of the AllianceBernstein Retirement Strategy Funds, this was not a live client strategy for the majority of this period.
Please read "Note on Simulation Results" in back of presentation for important additional information.
Volatility is measured in relative terms to a benchmark which is blended over the period from being 100% cash when the fund is 25 years from retirement to 25% cash and 75% bonds matching the annuity purchased when the fund reaches its target date.

5. Market Risk can and Should be Managed Dynamically

DC Example : Risk Capacity of a Saver Expected to Retire between 2008-2010
Simulated Realized Volatility of Portfolio if Market Risk Is Managed



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DC Example : Risk Capacity of a Saver Expected to Retire between 2008-2010
Simulated Realized Volatility of Portfolio if Market Risk Is Managed

"What you might do to manage risk for a young investor may be very different for an older investor"

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Observation: A Practical Investment Solution Needs a Number of Features

- Clear objective(s)
- Clearly allocated "Roles and Responsibilities"
- Age appropriate investment management, including
  - Dynamic Asset Allocation
  - Diversification of Asset Classes and Managers
- Be simple to communicate
- Be easy to change through time
  - Objectives
  - Asset allocation
  - Managers
- Represent value for money

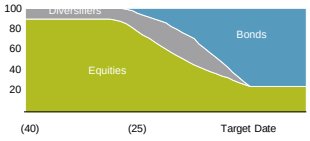
Observation: Flexible Target Date Funds

- A range of dated funds (1/3/5 year intervals) – Providing the member with a Single Fund for life

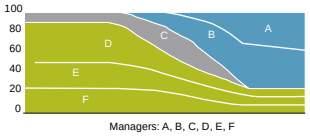
1999 to 2001	2002 to 2004	2005 to 2007	2008 to 2010	2011 to 2013	2014 to 2016	2017 to 2019	2020 to 2022	2023 to 2025	2026 to 2028	2029 to 2031	2032 to 2034	2035 to 2037	2038 to 2040	2041 to 2043	2044 to 2046	2047 to 2049	2050 to 2052	2053 to 2055	2056 to 2058

- Objectives - Customised to Plan members needs
- Investment managers - Selected by the Plan
- Asset allocation – By investment manager
- Security selection – By investment manager(s)
- Ongoing review – Undertaken by the Plan

Dynamic and Diversified Asset Allocation



Open Architecture Implementation



An Investment Solution to an Investment Problem

6. Flexible Target Date Funds Provide Best in Class Solution

✔ Clear objective(s)	Set by Provider and Advisers
✔ Clearly allocated "Roles and Responsibilities"	Objective Oversight
✔ Age appropriate investment management, including	By Design
✔ Dynamic Asset Allocation	Included
✔ Diversification of Asset Classes and Managers	Included
✔ Be simple to communicate	Single Fund for Life
✔ Be easy to change through time	Single Fund of Life
✔ Objectives	Simple and efficient to change
✔ Asset allocation	Simple and efficient to change
✔ Managers	Simple and efficient to change
✔ Represent value for money	Available from c30bps

As Chosen by NEST

Observation: A Single Life Level Annuity is not Good at Risk Management

Retirement Risk Management Requirement	Annuity	Drawdown Today	Importance at Retirement
Out-living your money	☺	☹	Low
Dying early	😐	☺	High
Investment losses	😐	😐	Medium
Inflation losses	☹	😐	High
Changing needs	☹	☺	High
Poor purchasing decisions	☹	😐	High
Time and Costs	☺	☹	High

Observation: Retirement Income Research Needed

- Study into how can we better deliver income choice
- Mixture of consumer and investment research
- **Retirement Bridge** proposed to meet retirees' expectations:
  - Choice
  - Flexibility
  - Accessibility
  - Potential for Growth
- Extension of accumulation solution
- A choice for all retirees (average pot size c£25,000)
- Spreads investment risk over a greater time period
- Current markets highlight the need


Retirement Bridge℠:
Providing a Real Choice for Retirees

Smoothing the transition from work into retirement

7. We Believe a Retirement Bridge is a Good Solution

Retirement Risk Management Requirement	Annuity	Drawdown Today	Retirement Bridge
Out-living your money	☺	☹	☺
Dying early	😐	☺	☺
Investment losses	😐	😐	☺
Inflation losses	☹	😐	☺
Changing needs	☹	☺	☺
Poor purchasing decisions	☹	😐	☺
Time and Costs	☺	☹	☺

8. Guarantees: The Holy Grail?

- Have built and delivered TDFs with inbuilt lifetime withdrawal guarantees in the US
- Non-trivial issues to be addressed
  - What is guaranteed?
    - Income or capital
  - What will members pay?
    - How much, fixed versus variable rate
  - Is it primarily a sales/communication mechanism?
  - How does the guarantee flex with real life events?
    - Early/late retirement , family
  - What does practical and best implementation look like?
    - Cost of administration, best execution and counterparty risk
  - Is it suitable as a default?
    - Surrender penalties

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Disclosures and Important Information

Market Risk:

The market values of the investments may rise and fall from day to day, so investments may lose value.

Interest Rate Risk: Bonds may lose value if interest rates rise or fall—long-duration bonds tend to rise and fall more than short-duration bonds.

Credit Risk: A bond’s credit rating reflects the issuer’s ability to make timely payments of interest or capital—the lower the rating, the higher the risk of default. If the issuer’s financial strength deteriorates, the issuer’s rating may be lowered and the bond’s value may decline.

Allocation Risk: Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others.

Foreign Risk: Investing in overseas assets may be more volatile because of political, regulatory, market and economic uncertainties associated with them. These risks are magnified in assets of emerging or developing markets.

Currency Risk: currency fluctuations may have a large impact on returns and the value of an investment may be negatively affected when translated into the currency in which the initial investment was made.

Capitalization Size Risk (Small/Mid): Holdings in smaller companies are often more volatile than holdings in larger ones.