



# Talking to a generation

afford to take, and then attitude to risk becomes relevant.”

The received wisdom in fund management is that to amass any meaningful long-term return, investors need to take a healthy dose of risk. However, because funds that contain a growth element are invariably statistically volatile they are described as ‘high risk’, deterring many investors from making the most sensible long-term investment decision.

A pension manager at a large food manufacturing company in the UK explains the concerns of many in his position: “The definition of risk is part of the problem; it is driven by volatility rather than perhaps from a member’s perspective of looking at risk against what they are trying to achieve. That piece is not well understood and we need to get the message across in terms of how trustees and fund managers badge their funds. If you use the words ‘cautious’ or ‘low risk’ then you ought to define what is meant by risk in that context.”

An equity fund may be high risk in terms of volatility, but investing in cash runs an even higher risk of building up an inadequate pot at retirement. The surest way of painting a bigger picture for members to fully understand all the risks they run is to provide independent advice on a one-to-one basis. But with all but the most generous of companies unwilling to meet this cost and with members unlikely to foot the bill themselves, providers, consultants, employers and government need to work on improving the generic information available.

Barker says: “While we are not going to be able to educate everyone to be an investment expert, we could go further with providing tools which indicate what a professional would do given the individual’s circumstances.”

Providers, however, remain reluctant to bring additional complexity to the communication process for fear of confusing, rather than illuminating, members. Julian Webb, head of DC at Fidelity International, says: “The starting point is to keep communication as simple as possible because there is a much better chance people will engage in the message that you are trying to deliver.”

Similarly Louise Barrie, head of DC client service at Legal & General Investment Management, argues it is impossible to keep communication simple if discussions about risk go beyond volatility. She

suggests given that the lion’s share of DC members fall into default options these are where the focus for improving communication should lie.

“In the institutional DC space people are not making decisions; they are defaulted into a fund. Historically defaults have done the job but I think they need tweaking and refining. We are already seeing the evolution of defaults where one scheme might offer three or four default funds with different risk profiles to suit members depending on their age and circumstances,” Barrie says.

Alex Thurlcy-Ratcliff, head of multimedia at Shilling Communications, argues that: “One could say definitions of risk are irrelevant – members all choose the default anyway. This is primarily because investment choice depends on members’ level of investment expertise. A simplified approach is valuable in helping members who rely on the default to appreciate that there is a degree of variability in investment performance. On the other hand, it’s a very coarse rule of thumb and doesn’t reflect reality in any way.”

Sceptics, however, fear that pension providers are shying away from explaining risk outside of volatility because they simply do not know how to do it – and are afraid of the regulatory or legal liabilities they could run if they are accused of misleading investors. Volatility-based explanations are tried and tested; anything further breaks new ground, and no-one seems willing to venture into the unknown.

One area where this problem has been circumvented by pension providers is online, using modellers and other interactive tools which allow members to project ‘what-if’ retirement scenarios to test their contribution rates and fund choices. This paints a more powerful picture of the impact different decisions make on retirement pots, but much more explicit information about investment risk is still needed.

“Although the number of

individuals comfortable with using online tools is growing, more can be done by personalising hard copy material, such as the inclusion of risk-related information on annual statements,” says Barker. “Ideally, based on the member’s actual investment choice, they would enable information along the lines of ‘there is a 50% chance your pension will be worth half of your pay at retirement, if you increased your contribution by x% or invested in certain assets, this probability increases to 75%.”

Ironically, it is the Government that ultimately may set the standards in this area. Having been criticised for decades for failing to properly teach schoolchildren and adults about finance, the proposed pensions

“Providers remain reluctant to bring additional complexity for fear of confusion”

reform project – which involves auto-enrolling millions into a pension scheme for the first time – will demand a massive communications campaign. The core target audience for pensions reform are the low paid and the disengaged – the very individuals likely to be disinclined towards investing in anything labelled ‘high risk’, as the Department for Work and Pensions (DWP) has already identified in its own market research.

How the Personal Accounts Delivery Authority, the DWP quango responsible for setting up NEST, the new nationwide DC pension scheme, tackles this problem could well set the tone for all other private workplace plans. Whether pensions providers like it or not, the definition of ‘investment risk’ must evolve in the next decade as a new generation of retirement savers come on stream. ■

## statsandfacts

### 10-15%

The average proportion of DC scheme members who understand the investment risks they face as estimated by 54 pension professionals. Source: Pensions Institute, April 2007

### 29%

The percentage of employees who expected their pension to cover between half and two thirds of their final salary. Source: Mercer, September 2007

### 36%

The proportion of trustees who feel their default fund is actually the best option for members. Source: Engaged Investor/JPMorgan Asset Management, October 2008

### 45%

The percentage of trustees who believe it is their responsibility to ensure members are educated fully to be able to make informed decisions about their fund choices. Source: Engaged Investor/JPMorgan Asset Management, October 2008

Investment risk must be re-defined and better explained if savers are to prepare for retirement, says Gill Wadsworth



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Communication has always presented a dilemma for providers of defined contribution (DC) pension schemes. The diversity of a typical workforce means delivering a single message about retirement saving is inevitably inadequate, yet attempting to tailor literature to each member is costly and can prove impractical. Consequently the vast majority of DC communication is kept simple and generic to avoid alienating members and to appeal to as broad a spectrum as possible.

However, where providers were once applauded by trustees for simplifying interaction with members, they now face mounting criticism for failing to translate the

finer nuances of investment risk, which leaves savers vulnerable to selecting the wrong funds.

In particular fund managers and life insurers have been accused of defining risk too narrowly as ‘volatility’ without explaining other equally relevant factors. For example, fund labels such as ‘high’, ‘medium’ or ‘low’ risk are usually based purely on statistical measures of deviation against a benchmark – critics would doubt the relevance of this measure to the average investor. Does high volatility mean high risk?

David Barker, principal at Mercer, says: “Defining investments as low, medium and high risk isn’t very helpful. The question we are trying to answer is how much risk can you

