The retirement savings flexibility ushered in by the Budget is good news. We believe giving people greater freedom to spend their pension ‘pots’ as they want should encourage more to contribute to defined contribution (DC) schemes. But even with this new incentive, trustees will still need to work hard to keep their members saving for the 30 or 40 years they need to build a retirement pot big enough to justify their efforts. To keep people aboard, we think means making the journey as smooth as possible, while ensuring that returns meet members’ reasonable expectations.

A successful DC lifestyle default approach should therefore try to maximise the growth of members’ savings, while minimising unpleasant shocks. The balance between those two aims – return on the one hand and risk on the other – will change as the saver travels along the DC savings path. For most people, we think this journey divides into three stages (see chart):

— A **growth phase**, which lasts from when a saver starts work – typically in their 20s – to their early 40s. This period of roughly 20 years is when they can afford to take risks with their investments. Indeed, they need to take risks if they are to generate the growth that will turn their pension contributions into a decent nest egg in retirement.

— A **stable growth** phase, from their mid-40s to their mid-50s. During this period the saver’s need for returns becomes more balanced with the risks they face. Any growth can have much more impact on what is likely to be a bigger pot, but they have less tolerance for losses, as there is less time for them to make up for any downturn through further savings or investment returns.

— A **pre-retirement phase**, from their mid-50s on. At this stage, the balance starts shifting decisively towards risk: a loss for a saver in the years just before they retire is likely to be irretrievable, given the limited time they have to make it up. However, while the saver needs stability, they also need to take account of inflation and how they will generate an income once they give up work.

We think each of these phases requires different investment approaches to meet the saver’s particular requirements at each stage of their journey.
Focusing on the growth phase, we believe the emphasis here should be on keeping young members in the scheme and encouraging them to increase their contributions. It is important to build their trust by avoiding unwelcome bumps in their journey. Unfortunately, this aim may be at odds with what is best for them. They typically have few assets but lots of time ahead of them for saving. As a result, the younger saver is in a good position to maximise returns by taking risks with their savings. And, if things go badly and markets slide, they can still make up the deficit through further savings in a way that an older person can’t.

This makes them well placed to benefit from the compounding effects of their contributions over time, also known as ‘time-weighted returns’. A low-cost global equity fund might suit them well. However, we think a well-diversified growth fund designed to dampen volatility and protect against the worst losses may be better for a saver’s morale at this stage of their journey.

Either way, we would argue that it is vitally important for trustees to take account of the changing needs and psychology of the DC saver when choosing the building blocks for their default lifestyle strategies. And, given the changes heralded by the Budget, we think that means trustees and scheme sponsors should be actively reviewing their default strategies now.

To discuss the themes in this article further, please contact Stephen Bowles, Head of UK Institutional Defined Contribution at Schroders, on +44 (0)20 7658 4916 or email ukpensions@schroders.com.

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