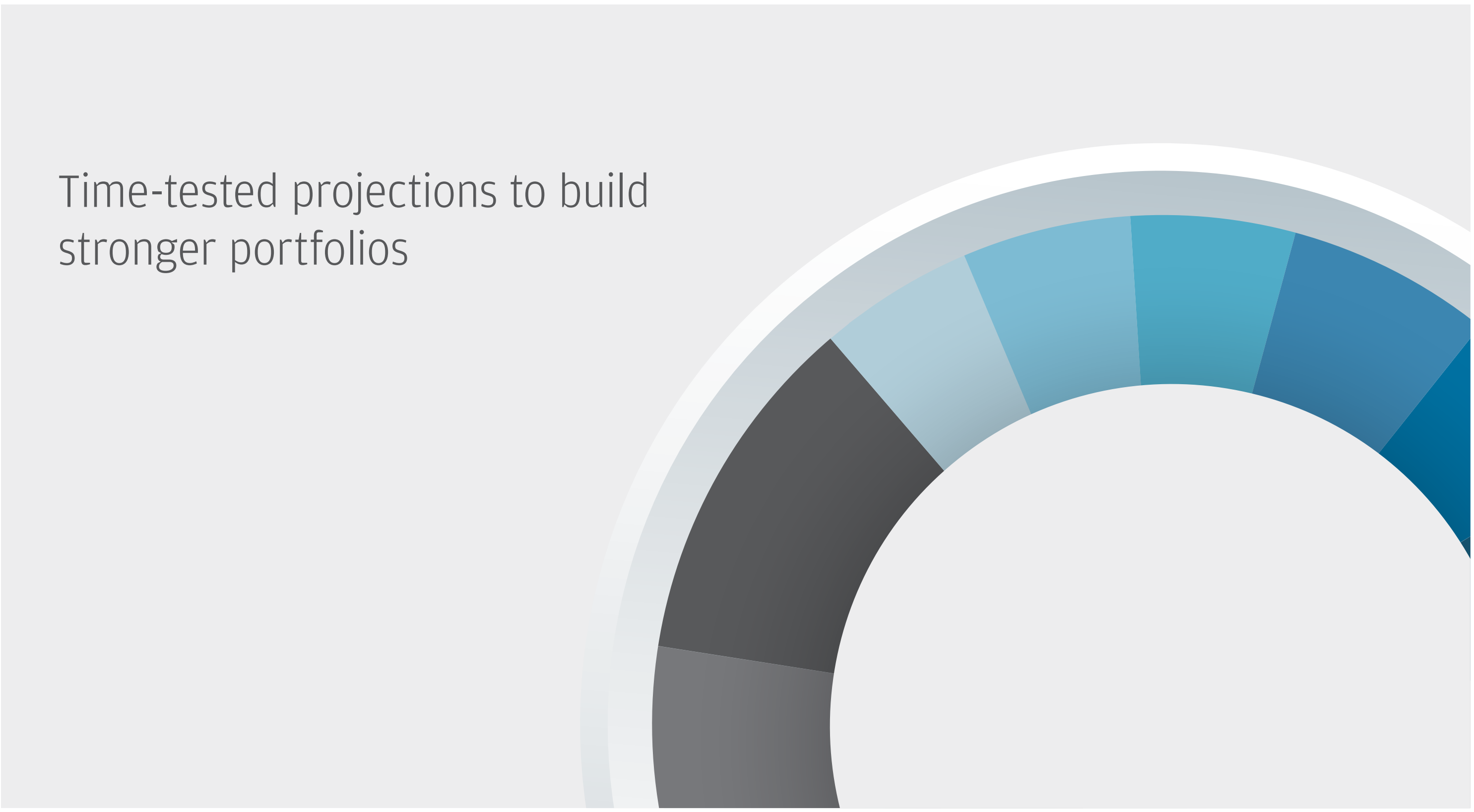
Helping improve DC members’ retirement outcomes—three practical steps still apply

Implications from our **2018 Long-Term Capital Market Assumptions**



AUTHORS

Anne Lester
Portfolio Manager and Head of Retirement Solutions

Sorca Kelly-Scholte
Head of EMEA Pension Solutions and Advisory Group

Annabel Tonry
Client Advisor,
UK Defined Contribution

Many defined contribution (DC) pension scheme members may be pleased with year-end 2017 results in their retirement plan statements, but the outlook for market returns over the next 10 to 15 years remains less than inspiring, according to J.P. Morgan’s 2018 Long-Term Capital Market Assumptions (LTCMAs). With modest global economic growth estimates broadly unchanged and return assumptions for many major asset classes flat to down relative to last year’s, members face an undiminished challenge as they look to ensure a financially secure retirement. DC pension schemes can’t control the markets, of course, but they can take three practical steps—now more important than ever—to help members reach the end of their working lives with the assets required to produce the income they will need in retirement.

J.P.Morgan
Asset Management

OUR LONG-TERM MARKET VIEW—MODEST RETURNS

Our outlook for global growth, on average, over the next 10 to 15 years is broadly unchanged from 2017 estimates, with developed markets at 1.5% and emerging markets at 4.5%. This translates to constrained, generally modest return expectations across most major asset classes, further impacted by the late stage of the current business cycle.

In an overall portfolio context, the expected return for a simple 60% world equity/40% world government bond (hedged) portfolio, in pound sterling (in our view, a reasonable proxy for the average asset allocation over a typical member's life span), has remained subdued at 4.26%, up very marginally vs. last year. The stock-bond frontier has shifted in a clockwise direction as expected bond returns have improved, given a slower, shallower road to interest rate normalisation, while elevated valuations, typical of the later stage of the business cycle, are expected to constrain equity returns (**EXHIBIT 1**).

As discussed in our 2018 Long-Term Capital Market Assumptions, analysis of the interplay between near-term cyclical factors and more enduring secular trends offers reason for cautious optimism. We see potential for technology-induced productivity improvements to help end a prolonged series of downgrades to trend growth. Nevertheless, investors can still expect to face a historically low return environment over the next decade.

WHAT DC SCHEMES CAN DO

The long-term outlook for capital markets rarely changes dramatically over the span of a single year, and pension schemes have little influence over its course. But, as we have emphasised many times, there are three concrete steps schemes can take to help improve members' retirement outcomes—appropriate in a low-return world and across all market environments.

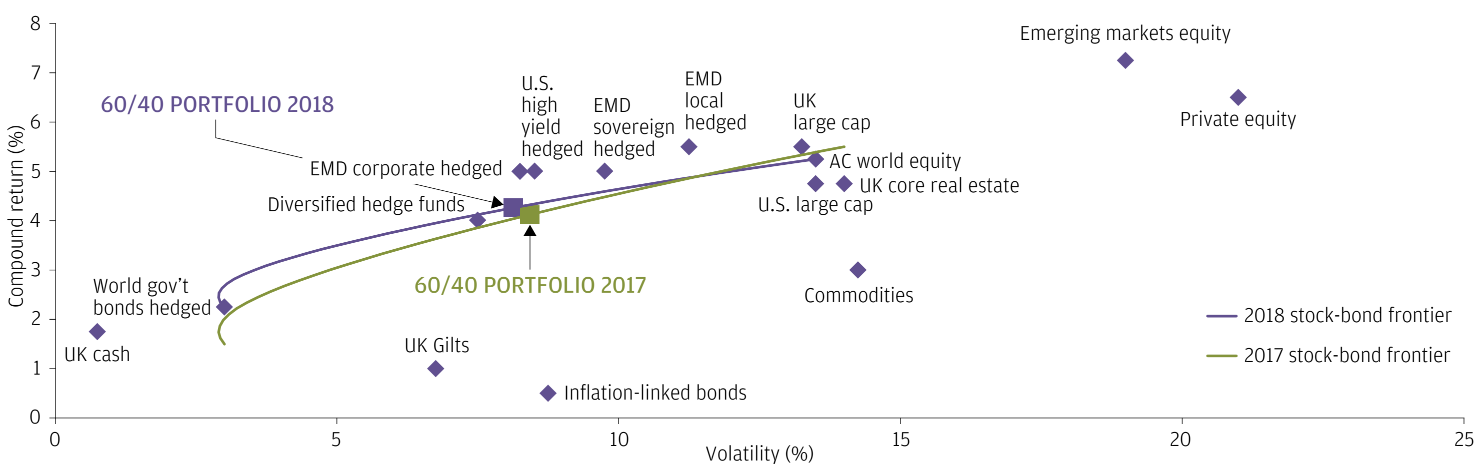
1 Encourage greater savings

Members need to save more and start early. Our latest long-term economic growth and market return assumptions, combined with longer life expectancy, validate members' concerns about the possibility of outliving their retirement savings. Saving more is the most obvious and effective way to improve retirement outcomes.

We believe the best approach to encouraging saving is to have a robust, well-designed default fund that allows members to focus on their savings levels rather than worrying about how to invest their assets. We know that sharp declines in the size of savings pots can cause members to reduce savings rates—or stop saving altogether. Steadier, more consistent returns are therefore vital in encouraging members to stay the course. With the minimum level of automatic enrolment contributions going up in April 2018, generally for both employers and employees, qualified schemes will need to make sure members don't opt out. Member communication will continue to be a top priority and should emphasise the benefits of saving early, saving regularly and saving enough.

Our 2018 Long-Term Capital Market Assumptions call for a very modest increase in returns for a simple 60/40 stock-bond portfolio

EXHIBIT 1: GBP STOCK-BOND FRONTIERS AND 60/40 PORTFOLIOS BASED ON 2018 VS. 2017 LTCMAS FOR RISK AND RETURN (%)



Source: J.P. Morgan Asset Management; estimates as of September 30, 2016, and September 30, 2017.

2 Focus on diversification

Return estimates for a simple 60%/40% stock-bond portfolio remain subdued. But, as seen in Exhibit 1, there are a number of asset classes clustering close to and even lying above the stock-bond frontier, implying opportunity for diversification and potential return enhancement. Extended credit and emerging market debt remain the bright spots in fixed income. Although the current credit cycle is rather mature, our long-term projections for credit spreads, defaults and recovery rates continue to imply a reasonable return uplift above government bonds.

The goal, of course, is not simply to offer a wider range of investment options within the self-select menu; that would leave the complex task of asset allocation to members. Default funds are intended to simplify the investment process for members, providing a strategy that shifts allocations in line with investment needs as members approach retirement. But these funds must be robust, broadly allocated and well designed in order to help members realise the true advantages of diversification all along the road to retirement.

Diversified growth funds (DGFs) are one approach DC schemes have used to help diversify their default funds cost-effectively. Now we are also starting to see DC schemes incorporate strategies into their default funds that traditionally have been used by defined benefit (DB) schemes, to help mitigate downside risk without compromising returns. These include multi-asset credit strategies, which can offer access to high conviction ideas across the credit spectrum. Another example: alternative risk premia strategies, designed to provide some of the diversification benefits of common hedge fund strategies but with increased transparency and liquidity—and generally without hedge-fund-like fees.

3 Employ active management

Keep in mind that there are two components of return: the portion due to the market itself (beta) and the portion resulting from active manager skill (alpha). Our Long-Term Capital Market Assumptions, by design, do not reflect returns from active management; they are estimates of index-based (or beta) returns, intended to inform strategic allocation or policy-level decisions over a 10- to 15-year investment horizon.

With a lower outlook for beta returns across most asset classes, alpha becomes an even more critical component for achieving required returns. Skilled professional investors can generate alpha through adept security selection and/or tactical asset allocation—opportunistically shifting assets across sectors, asset classes and regions as attractive opportunities present themselves. For example, insights into tangible investment opportunities associated with technological change (see our 2018 Long-Term Capital Market Assumptions), and the ability to tactically position portfolios through the late-cycle challenges ahead, present opportunities for alpha generation. And given the low correlation between the alpha and beta components of return, the active component can also help to diversify portfolio risk.

IMPLICATIONS FOR DC PLANS AND THEIR ADVISORS/CONSULTANTS

More than ever, a secure retirement requires saving adequately and investing wisely. We encourage DC plans and trustees who have not already done so to work with their plan advisors/consultants and evaluate the feasibility of the following actions for their plans:

- Focus on communications that will encourage greater savings and prevent members from opting out as automatic enrolment contributions increase.
- Look for cost-effective ways to ensure your DC default fund is broadly and effectively diversified to help members achieve a smoother journey.
- Select actively managed strategies with the potential to provide enhanced returns through both skilled security selection and tactical asset allocation.

It is true—the outlook for long-term capital market returns remains challenging. But these plan design and investment options can strengthen plans and help more members reach their retirement goals.

NEXT STEPS

To find out more, please visit www.jpmorgan.co.uk/dc or talk to your usual J.P. Morgan representative.

LV–JPM50227 | 05/17 000f2760-3b13-11e7-beed-005056960c63