Lifestyling: the Achilles heel in DC pensions

Why too much derisking is a bad thing

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- **Derisking in DC pensions stemmed from the historical rule to purchase an annuity on retirement.** Despite Pension Freedom scrapping the annuity requirement back in 2015, derisking (lifestyling) remains the accepted orthodoxy in the UK
- **Other DC pension systems, notably Australia, do not 'derisk with age' making the UK something of an outlier**
- **The cost of this excessive de-risking is twofold:**
    - **To the saver: The average performance drag is 2.3% per year, or around £12,000 to a typical £100,000 pre-retirement pension pot.** Every five-year period since data began (2013-2018) has seen lower returns to the de-risked/lifestyled cohorts.
    - **To the nation: Tackling excessive derisking could deliver a £10 billion-£25 billion boost to UK capital markets and investment.** The excessive de-risking in DC pensions contributes to the outflows and related decline of UK financial markets and the lack of capital to support domestic growth.

In August, I teamed up with Policy Exchange's James Vitali to publish Growing Pension Capital - Lessons From Australia, with a foreword penned by former Pensions Minister Baroness Altmann.[1] The report highlighted the steps the UK will need to take for defined contribution (DC) to emulate the success of Australian superannuation.

One key observation was that the UK DC system is too risk adverse, a hangover from the "safety first" approach of the defined benefit (DB) system. By contrast, Australia adopts a more proportionate approach to both risk and return.

The embrace – and overreach – of lifestyling and the resultant de-risking exemplifies the risk aversion within the UK DC system. This note expands in more detail to show how the glidepaths around de-risking are costing savers (and the country) excessively.

What is lifestyling?

Lifestyling is an investment approach that aims to progressively de-risk DC pension pots as savers get older. It is the accepted investment orthodoxy in the UK DC system. Under lifestyling, a glidepath is created towards de-risking savers' pension pots in the five to 10 years before retirement. Average equity allocations are lowered from around 75% to 25% in favour of fixed income and cash (Figure 1).

Lifestyling is embedded as the default approach for UK DC pensions. So for the vast majority of people who simply accept the risk profiles chosen by their trustees, lifestyling is deemed to be a "good thing" and they have their equity allocations cut as they get older.

Figure 1: How lifestyling reduces equity weights
(Average asset allocation for DC pensions, %)

	30 years before retirement	5 years before retirement	1 day before retirement
Equities	75	41	26
Bonds	9	35	44
Other e.g. property	15	19	13
Cash	1	5	18
Total	**100**	**100**	**100**

Source: Corporate Advisor Intelligence data for DC master trusts, 2023

Historical reasons for the UK to embrace lifestyling

The theory around lifestyling is anchored in the legacy requirement to purchase an annuity in retirement. Yet despite this rule being scrapped in the 2015 Pension Freedom reforms the lifestyling approach is still embedded in default DC options.

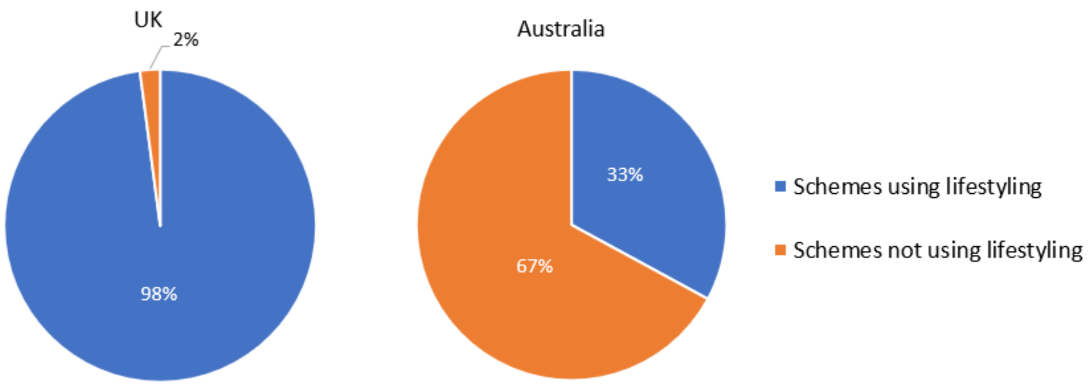
While most savers today do not simply retire and mechanically buy an annuity at state pension age, regulators still tacitly endorse de-risking.[2] So nearly all DC schemes use the approach for their defaults.

What approach to use instead? Look overseas for the alternatives in other DC systems.

Do other countries embrace lifestyling?

Other countries with DC systems do not embrace lifestyling like the UK. Australia, for example, runs the world's best known DC system – the famous superannuation funds. Their trustees face the same fiduciary duty as in the UK and have the same duty to run their schemes with suitable risk profiles. But most superannuation schemes avoid lifestyling (Figure 2).

Figure 2: Lifestyling is mandatory in the UK but avoided in Australia
(% of schemes using lifestyling for their default option, UK DC vs superannuation)



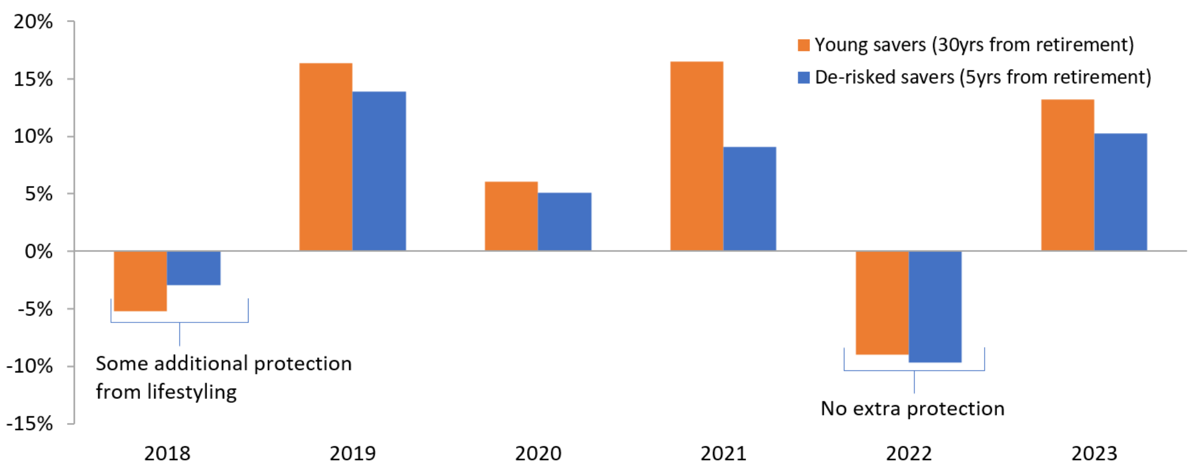
Source: Policy Exchange, August 2024. Based on APRA and Pension Policy Institute data.

The reason? Superannuation grew up without trying to mimic a DB system; it was created without any historical requirement to buy an annuity. In a way, Australia represents the logical conclusion of the UK's Pension Freedom reforms from a decade ago.

Does lifestyling work to lower drawdown risk?

As well as the link to annuities, lifestyling is also embraced in the UK as a way to lower drawdown risk. Derisking is intended to ensure there are no nasty shocks in the run up to retirement. Does it work? While it is true that lifestyled/de-risked cohorts fell less in 2018 (Figure 3), they failed to see the same protection in 2022.

Figure 3: Does lifestyling protect against drawdowns? Sometimes, sometimes not …
(Calendar year returns, %)

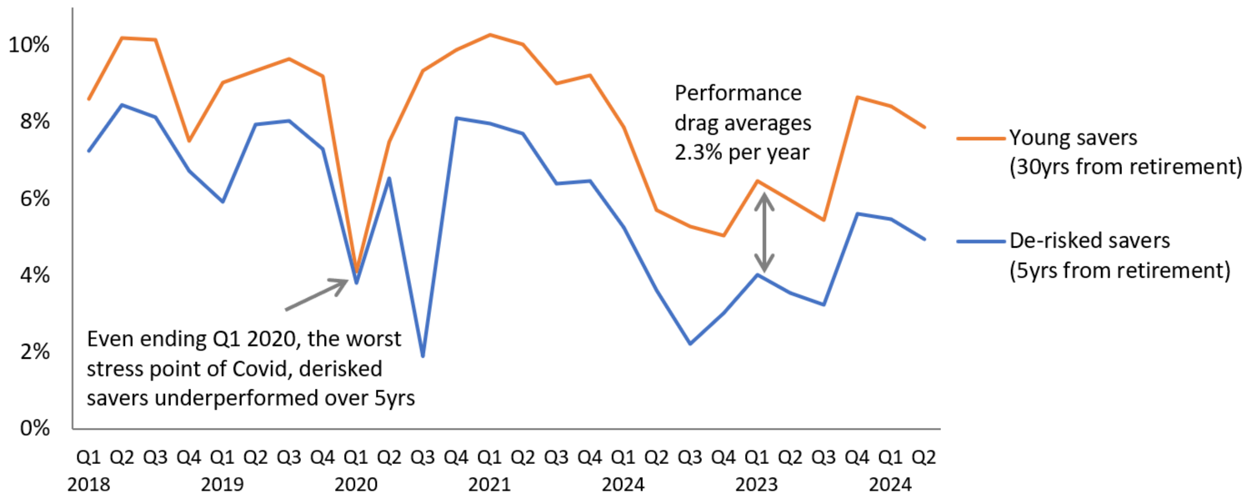


Source: Corporate Advisor Master Trust data, 2024

How much does lifestyling cost pension savers?

Shifting allocations from equities means savers miss out on stock market gains. With the lower risk portfolios typically applied five to 10 years before retirement, this is a long time for savers to be out of the market (Figure 4).

Figure 4: De-risking delivers lower returns over a five-year period
(Five year returns to the end of the period, %p.a.)



Source: Corporate Advisor Master Trust data, 2024

For the *median* saver: every five-year period since the data began has seen worse returns from the derisking approach. A 2.3% performance drags compounds quickly: the opportunity cost would be around £12,000 to a typical £100,000 pre-retirement pension pot.[3]

Even during certain *tail risk* events, lifestyling looks like a poor choice. For the five years ending 31 March 2020 (the date with the worst / most extreme Covid market impact), the derisked older cohorts saw worse performance than their younger counterparts (with five year returns of 3.8% versus 4.1% p.a.).

Our analysis shows how even during such extreme events, the limited protection from lifestyling fails to make up for the penalty of being derisked for so long.

Lifestyling is behind the weaker performance of UK DC versus Superannuation

Policy Exchange estimated a typical saver in the UK DC system has underperformed the equivalent Australian by around 0.7% a year since 2017. But our report also highlighted that within the same risk categories – ie, where the equity weights are similar – the performance gap falls to just 0.1%-0.2% per year (Figure 5).

Figure 5: UK DC returns versus Australian
(Since 2017 when comparable data began)

	UK Master Trusts	Australian Superannuation	Gap
All savers	5.3%	6.0%	-0.7%
High growth	8.7%	8.9%	-0.2%
Moderate growth	5.6%	5.7%	-0.1%

Source: Policy Exchange, 2024

The conclusion? The single biggest source of the underperformance is the greater prevalence of lower risk profiles (ie lower equity weights) in the UK. In other words, the risk-averse UK DC system means more savers in the lower risk categories. Lifestyling is the culprit.

Lifestyling in the press

The 2022 inflation and rate shock scenario put lifestyling in the press – for all the wrong reasons. The higher fixed income allocations in lifestyled products made for substantial losses.

"Why those retiring face 'massive' losses despite FTSE highs?"	Guardian
"Lifestyling: a hidden danger lurking in your pension pot"	Financial Times
"IFAs blast lifestyling as lifestealing"	Professional Advisor
"Lifestyle funds are from a bygone era"	Professional Advisor

Despite these public critiques there has been little comment from the regulator or industry groups. Lifestyling still remains the accepted orthodoxy – at least in the UK.

Reversing the capital flight from UK stock markets

The new chancellor has promised a "big bang on growth" to boost investments and savings.[4] The risk-averse nature of the DB system is well known. Less well known are the issues in the DC system highlighted here.

While this note is largely aimed at industry groups, ultimately political and regulatory buy-in will be required. So it is important to highlight that relaxing the lifestyling requirements wouldn't just help savers. It would also boost equity allocations, part of which would flow into domestic stocks and UK capital markets. The Pension Policy Institute has estimated that in 2023 the UK DC system had £600 billion of assets, a figure expected to reach to reach £1.3 trillion by 2030.[5] Of this, around 30%-40% is held in the near-retirement age category that would be affected by any changes to lifestyling requirements.

Diluting or scrapping lifestyling and boosting equity allocations for these savers could mean somewhere between £10billion-£25 billion flowing back into UK stock markets, helping reverse the decline of the London listed market and helping support economic growth.[6]

Conclusion

The biggest single performance impediment for UK DC is the risk aversion of the DC system. In the days of compulsory annuity purchases, derisking and lifestyling had some logic. But with Pension Freedom the approach looks increasingly misplaced.

UK trustees and regulators should consider diluting or scrapping lifestyling and replacing the default requirements with something closer to the Australian model of staying invested for longer.

For this change, trustees and regulators can take comfort from Australia as a best-in-class DC system that does not cut equity allocations as savers age. Superannuation was created without the "safety first" influence of DB. It has a more outcome-orientated culture that UK regulators have started (at long last) to emulate. In a sense, the more optimistic balance of return versus risk of superannuation is the logical conclusion of the Pension Freedom reforms.

It is time to encourage regulators, trustees and all involved in the DC system to take a more proportionate view of risk and return. There is an opportunity to create a virtuous circle. More savings means more economic robustness, more capital for economic investment and all underpinned by better investment outcomes for savers.

Notes and sources

[1] Policy Exchange, Growing Pension Capital – Lessons from Australia, 8 August 2024

[2] For an example of the FCA pressure to deepen pension providers adherence to lifestyling, even after pension freedom was introduced, see FCA paper CP15/30

[3] Opportunity cost based on a 2.3% performance drag for five years. Size of the typical pre-retirement pension pot is £107,000 – the UK median pre-retirement pension pot based on ONS data, January 2022

[4] Gov.uk, Chancellor vows 'big bang growth' to boost investment and savings, 20 July 2024

[5] Pensions Policy Institute, 2023

[6] £25 billion estimate based on a 5% lift to UK equity allocations for the pre-retirement cohort. This in turn is broadly the gap in UK equity allocation between young and older savers, based on Corporate Advisor Master Trust data, 2023

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