Revolutionising the UK Defined Contribution Market with the Protected Equities Strategy

The United Kingdom's Defined Contribution (DC) pension market is on the brink of a substantial transformation. Over the past decade, membership in DC schemes has experienced a meteoric rise, surging from approximately 1 million individuals in 2012 to an impressive tally of 26 million as of March 2023.[1] In this market the lifecycle model has always played a crucial role. This model dictates that the closer an investor gets to retirement, the more conservative the asset allocation becomes, typically shifting towards bonds and away from equities. This approach, while prudent, has often led to suboptimal asset allocations, particularly in the later stages of the lifecycle. Due to an initially low amount of assets in the later stages and the generally young member age, the investment focus has been on the early stages of this journey, often with little regards to the later stages. With investment pot sizes growing and members getting older, more assets are moving towards the later stages of the lifecycle which is causing fundamental changes within the DC market.

The lifecycle model has led to suboptimal asset allocations in the past. Changing demographics are causing fundamental changes within the DC market.

The DC market is currently characterised by its focus on cost competitiveness, often prioritising lower management fees over the actual value added by different solutions. This cost-focused approach, while beneficial for reducing expenses, has inadvertently resulted in many DC schemes with subpar asset allocations. Many higher-cost funds that could potentially add substantial value to portfolios were not designed with DC in mind and are hence not used. Our Protected Equities Strategy addresses this by being a solution to the DC market which was specifically designed with value for money in mind that aims to deliver real value to portfolios while being very cost competitive on a standalone basis to fulfil the low-cost requirements of the DC market.

Cost-focused approach can come at the expense of actual value-added by different solutions.
Protected Equities approach: Value for money at low cost with the aim to deliver real value to portfolios.

The Challenges of the Later Stages

Members within the mid-growth phase typically have substantial allocations in Diversified Growth Funds (DGFs). However, the performance of many DGFs over the past two decades has fallen short of expectations, failing to provide the anticipated equity-like returns with lower volatility. Often, the returns were markedly lower compared to equities, even while often suffering drawdowns of similar magnitudes. The fee structure of DGFs also tends to significantly exceed that of equity funds. Our historical data and modelling indicate that our Protected Equities Strategy would have outperformed DGFs, offering superior returns with similar risk levels. Moreover, the cost associated with our strategy stands as a mere fraction of the average DGF's fee.

Performance of DGFs has often fallen short of expectations over the past decades. Returns were markedly lower compared to equities.

A critical concern also arises for those approaching retirement. These later stages of the lifecycle often see an over-allocation to government bonds, money market funds, and low-risk bonds. This conservative approach results in low equity allocations, which is problematic considering a retiree's remaining life expectancy often exceeds 20 years.

Overallocation to bonds in later stages of lifecycle stands in contrast to long life expectancy of retirees.

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[1] https://www.mckinsey.com/industries/financial-services/our-insights/capturing-growth-in-the-evolving-uk-savings-and-retirement-market

This lack of growth asset exposure means retirement funds are not optimally invested and could be achieving higher returns. High bond allocations also pose an inflation risk, potentially eroding the real value of assets. However, the challenge lies in the fact that investors nearing retirement are often unable or unwilling to take on the volatility associated with a more aggressive portfolio, necessitating a solution that balances risk and return. Up to now, not enough has been done to address this problem, especially as the number of DC members along with their pots keep growing and the age of the average member is increasing.

Low risk tolerance leads to underinvestment in growth assets.

High bond allocations pose inflation risk with the potential of eroding real value of assets.

The Protected Equities Strategy: A Game-Changer

Herein lies the beauty of Protected Equities. This approach, which has been used by many institutional investors over the last decades, now presents a compelling proposition for the DC market. It offers investors in the mid-growth phase and nearing retirement a way to maintain or even increase their equity exposure without increasing their risk profile substantially. Protected Equities is a proven investment approach that allows investors to participate in the potential upside of equity markets while providing a level of downside protection.

Protected Equities: A way to maintain or even grow equity exposure without increasing risk profile substantially.

Our strategy employs a combination of equity investments and exchange listed options, that are used for risk reduction purposes, in order to construct a portfolio that aims to deliver long-term growth with reduced risk. We only use exchange listed options as they offer distinct benefits due to their regulated, standardized nature which increases liquidity, transparency and considerably diminishes counterparty risk.

Protected Equities aims to deliver long term growth with reduced risk.

In essence, the strategy seeks to 'protect' investors from the full brunt of potential losses during periods of market downturns. It does this by using options to 'hedge' parts of the equity component of the portfolio. If the equity market falls, the increase in the value of the options can offset, to some extent, the losses from the equity investments.

How Protected Equities fit in the Portfolio

The Protected Equities Strategy can be used to effectively replace and complement allocations in DGFs as well as bonds within the mid-growth and pre-retirement phases. When applied efficiently, the Protected Equities Strategy can increase the long-term expected returns of a portfolio without significantly altering its risk dynamics when replacing DGFs or bonds with it. It can also provide an essential diversification away from bonds and DGFs, which are especially susceptible during periods of high inflation and rising interest rates.

Effective replacement of either DGFs or bonds in the portfolio and benefits of diversification.

The Protected Equities Strategy comes in two versions tailored to different stages of the lifecycle:

- A version focused on protecting against **Tail Risks** that aims to limit annual drawdowns to less than 20%, exhibit a volatility of around 10-15% annually, participate at least 90% in positive equity market returns, and offer higher risk-adjusted returns than equities. This version is suitable for the **growth/mid-growth** phases as a complement or replacement to **DGF** funds.

Tail risk protection version is suitable for the growth/mid-growth phases as a complement or replacement to DGFs

- A **High Protection** version that aims to limit annual drawdowns to around 10%, keep volatility under 10% annually and provide higher returns than global bonds. This version is ideal for the **pre-retirement** phase, serving as a complement or alternative to **bonds**.

High protection version is suitable for the later phases as a complement or replacement to bonds

Protected Equities for the DC Market

The Protected Equities Strategy addresses all the essential requirements for funds within the DC market, including low cost, ESG and climate considerations, high liquidity and transparency, an attractive value for money proposition, and ease of access via various platforms. It is daily priced and can be traded daily, and as can be evidenced, it satisfies all DC-related regulatory reporting requirements.

Deliverable to DC schemes in a way that fulfils regulatory reporting requirements

As the DC market evolves, there is a growing demand for innovative products, particularly in the later stages of the lifecycle. In summary, the Protected Equities Strategy offers several compelling advantages:

- **Risk Mitigation**: The strategy is designed to limit the potential downside risk of equity investments. By using exchange listed options, the strategy can provide a buffer against losses during market downturns.
- **Growth Potential**: Despite its defensive nature, the strategy still allows investors to participate in the growth of equity markets. This is vital, especially for investors in later life stages who still need growth to ensure their savings last throughout retirement.
- **Flexibility**: The Protected Equities Strategy comes in different versions tailored to various risk tolerances and investment horizons. This flexibility enables it to be a viable strategy for different stages of the investment lifecycle.
- **Inflation Protection**: With its equity component, the strategy offers a degree of protection against inflation, a feature particularly beneficial in today's environment of rising prices.

The Protected Equities Strategy has been used by institutional investors for decades due to its appealing balance between risk and return. It's an approach that has stood the test of time, and with its recent availability to the DC market, it can serve as a powerful tool in improving investment outcomes of members throughout their journey to retirement.

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