Surrey County Council Pension Fund

Prudential Lifestyle Strategy Update

Martin Willis

Barnett Waddingham LLP

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Surrey County Council Pension Fund – Prudential lifestyle strategy update

Introduction

The Administering Authority ("the Authority") of the Surrey County Council ("the SCC") Pension Fund ("the Fund") have requested that Barnett Waddingham ("we/us") undertake a review of the proposed Prudential lifestyle switches and provide our recommendation and advice on the suitability of the new lifestyle strategies being made available by Prudential. This forms part of our wider review of the Fund's AVC arrangements.

This paper summarises the high level background of the current position, the new options available and our advice on the proposed approach for the Fund.

Background

As a part of its restructure and refinement project, Prudential has taken the decision to close a number of old lifestyle strategies (lifestyles) that it has been operating. The Fund currently has members invested in three of the lifestyles which are closing and a replacement lifestyle(s) will need to be selected from the new options they have made available. They have confirmed that these options have been designed to be suitable for the way in which most members may draw benefits under current legislation.

Prudential have confirmed that it is possible for the Authority to construct its own default arrangement from the wider funds it makes available, but these will be subject to approval by Prudential's own investment team. We would suggest this approach is less suitable as the Authority would be seen to take on additional direct responsibility both for the initial suitability of the arrangement and continuing to monitor that suitability over time. This can be seen to bring additional risk and in using one of Prudential's 'off-the-shelf' approaches the Authority is building on Prudential's ongoing governance work and due-diligence.

Irrespective of what option is chosen as a default, any member can make their own choice from the options available and we would suggest that the Authority clearly communicate this along with how the default works and how it differs from the current investment choices.

The three impacted legacy lifestyles which members are invested in are known as:

- Optimiser 6
- Optimiser 8
- Optimiser 10

Prudential plans to conduct this change later this year, and has requested that the Authority makes a decision regarding the new lifestyles to which it wishes its members invested in the three closing lifestyles to be switched.

Prudential have stated that they will not be switching members' With-Profits investments. Members in this fund will see their savings stay where they are to protect the bonuses they have already built up. They can move their savings to one of the new lifestyles if they want to, but it will be important for them to consider carefully any change they make.

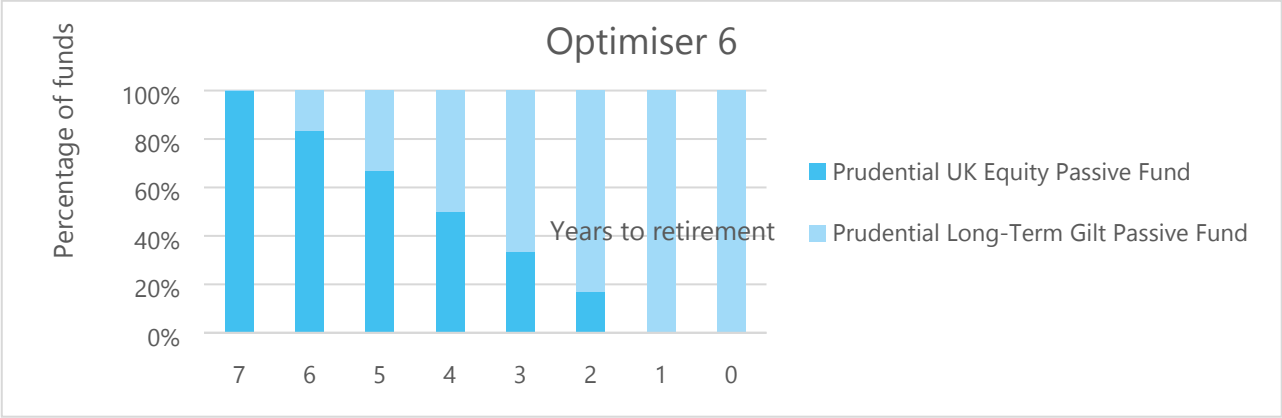
Equally, there will be no change for members who have chosen to self-select their own funds and their funds will continue to be managed as they are now. They will be able to continue to switch funds as often as they want without charge.

It is worth noting that the above includes members who invest in the Prudential Deposit Fund, but this fund is closed to although this fund is closed to new contributions. Unlike Prudential's unit-linked Cash Fund, this fund is backed by With Profits and applies a rate of interest whilst guaranteeing capital, and these guarantees led to Prudential restricting its availability. Those invested in this fund should exercise care when considering whether to transfer out. In comparison the Cash Fund is subject to an Annual Management Charge that means returns can be negative in some instances.

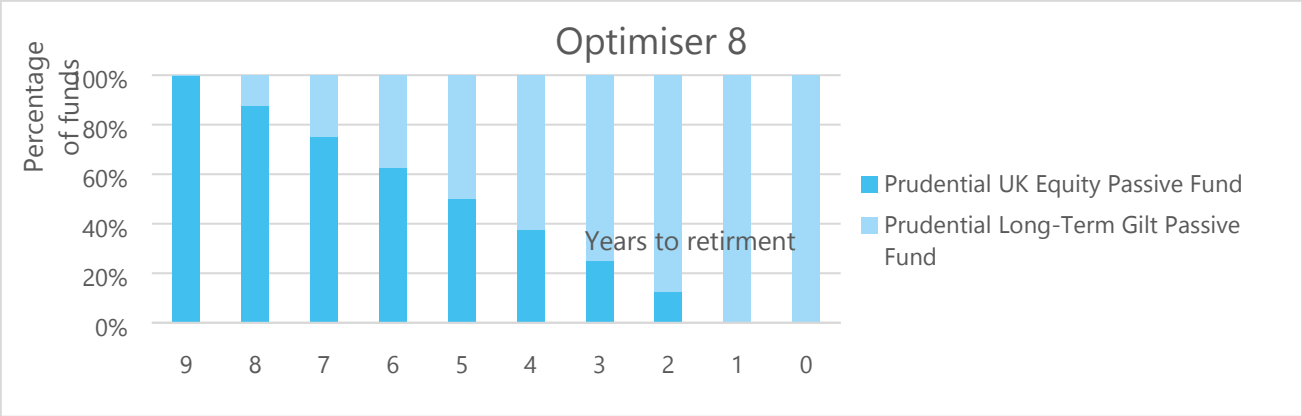
The current position

Below we provide a breakdown of the current lifestyle options and provide a commentary on the number of members impacted as well as the suitability of these lifestyles.

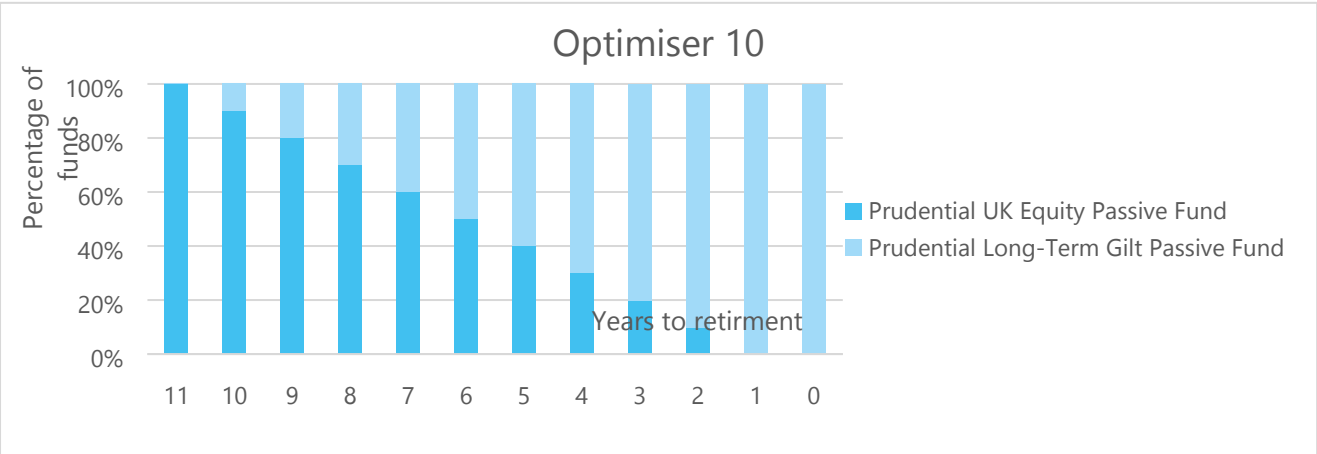
Lifestyling glide paths



There are currently 31 members invested in this lifestyle option.



There are currently 26 members invested in this lifestyle option.



There are currently 29 members invested in this lifestyle option.

All three lifestyles target the purchase of an annuity at retirement. Even though they all invest in the same two funds, they control the risk exposure that members experience on their approach to retirement by de-risking over different periods of time. The Optimiser 6 de-risks over the shortest period of time, remaining in the higher risk Prudential UK Equity Passive Fund for the longest and the Optimiser 10 starts to transfer across to the medium risk Prudential Long-Term Gilt Passive Fund the earliest. This style of de-risking is becoming less common with more modern lifestyles often using a wider array of funds to achieve their de-risking strategies over the same period of time.

Charges

Fund name	AMC	Further costs	TER
Prudential UK Equity Passive Fund	0.55%	0.00%	0.55%
Prudential Long-Term Gilt Passive Fund	0.55%	0.00%	0.55%

These charges are broadly in line with what we would typically expect to see from passively tracking funds in an AVC arrangement with administration included. Benchmarking of these costs falls outside of this particular paper.

Suitability

Considering all of the information above, we do not believe that the current lifestyle choices offer an ideal fit for members. The current target of purchasing an annuity at retirement is probably not representative of how members will take their AVC benefits and distinguishing between de-risking strategies by time rather than asset class is representative of older strategies.

Since pension freedoms came into place on 6 April 2015 members have been able to take their DC benefits in a variety of ways. Considering these members will have a DB pension it is unlikely they will use their AVCs to purchase an annuity. We believe that the majority of members will be looking to take their AVCs as cash due to both the ability to use the AVC funds to take wider Fund tax-free cash entitlements and the fact that they are likely to represent a small part of their overall pension provision. Even if members were not likely to take funds as cash lump sums, it is still possible that they would use funds for drawing a flexible income as opposed to purchasing an annuity, leaving the current default less suitable either way.

The new options

Prudential has introduced four new lifestyles that can be made available to members:

- Prudential Dynamic Growth IV Lifestyle targeting retirement options
- Prudential Dynamic Growth IV Lifestyle targeting 100% cash
- Prudential Dynamic Growth IV Lifestyle targeting an annuity
- Prudential Dynamic Growth IV Lifestyle targeting drawdown

Growth phase

Each new lifestyle strategy uses the Prudential Dynamic Growth IV for growth. It is also used for the default for their Group Personal Pension offering, so is closely scrutinised by their Independent Governance Committee.

The fund aims to deliver long term growth through investing in a diversified range of assets both in the UK and globally. At any time, the fund will invest at least 40% of its assets in equities but not more than 80%. Investments are managed across asset classes and across world markets with a focus on long run investment potential as forecast on a rolling 10 years basis. The fund may invest in a range of permitted assets which include equities, bonds, property and cash accessed directly or indirectly via appropriate fund vehicles. The fund may include other assets as deemed appropriate by both the manager and current regulations.

The current default growth fund is 100% equity based, however we have seen a move away from this approach over the past few years as more and more work has been done on member risk tolerances and 100% equity is commonly felt to be too aggressive for the average member's appetite for risk. Furthermore in focusing purely on UK assets, the current default growth fund has a low level of diversification relative to funds that invest on a global basis. This could result in additional volatility for members (particularly in relation to matters like Brexit). It is worth noting that currently all of the options in question use the same fund (which is relatively high risk) until de-risking starts.

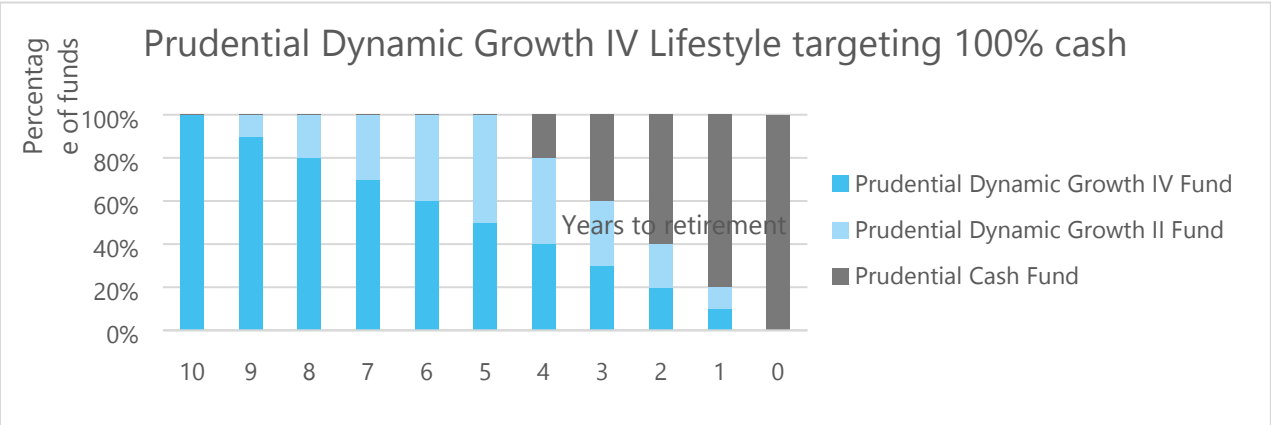
If members are switched to one of the new lifestyle strategies, it should be communicated to members that their growth phase will no longer be invested in 100% equities and that they may wish to self-select if they wish to have a higher (and equivalent) equity allocation. While we believe that this is well positioned as a default that will cater to members who do not make active decisions, it is important to highlight that default lifestyle strategies, by their nature, are not tailored to individual needs and members should be made aware of the other options available to them and encouraged to make choices that suit their personal situations.

Lifestyling glide path

All of the lifestyle glide paths de-risk over 10 years which in our view a widely used de-risking period in today's market. Rather than changing the length of the glide path to give members different risk exposures, these lifestyles use different types of funds and asset allocations to help members target different outcomes at retirement.

Prudential have suggested that if members have the option of taking all their AVCs as cash, then the Prudential Dynamic Growth IV Lifestyle targeting 100% cash may be a suitable replacement for the closing lifestyles. This transitions from the medium risk Prudential Dynamic Growth IV Fund into the medium to lower risk Prudential Dynamic Growth II Fund and finally 100% into the Prudential Cash Fund when members reach retirement.

We show the glide path below and feel that this is best suited of the new lifestyle options to the typical member's needs, as these AVCs are likely to taken as cash when they reach retirement for the reasons set out above.



Fund name	AMC	Further costs	TER
Prudential Dynamic Growth IV	0.62%	0.00%	0.62%
Prudential Dynamic Growth II	0.62%	0.00%	0.62%
Prudential Cash Fund	0.55%	0.00%	0.55%

The funds used by the strategy (other than the Cash Fund) are more expensive than the funds currently used but we believe this can generally be justified by more diverse asset holdings and higher level of continued ongoing governance.

As mentioned above it should be noted that the Authority has limited choice in this regard, and as such this decision is more about whether the proposed change is acceptable than whether it is ideal. For example the Deposit Fund may be a preferable option to the Cash Fund as it doesn't have the potential for negative returns. That fund is not available for selection though, and as the objective of that fund in the wider strategy is to provide capital preservation at the end of a de-risking strategy, it is the most suitable option available from the funds offered under this product. We would strongly suggest that any communication sent by Prudential is accompanied by a communication from the Authority covering points of this nature.

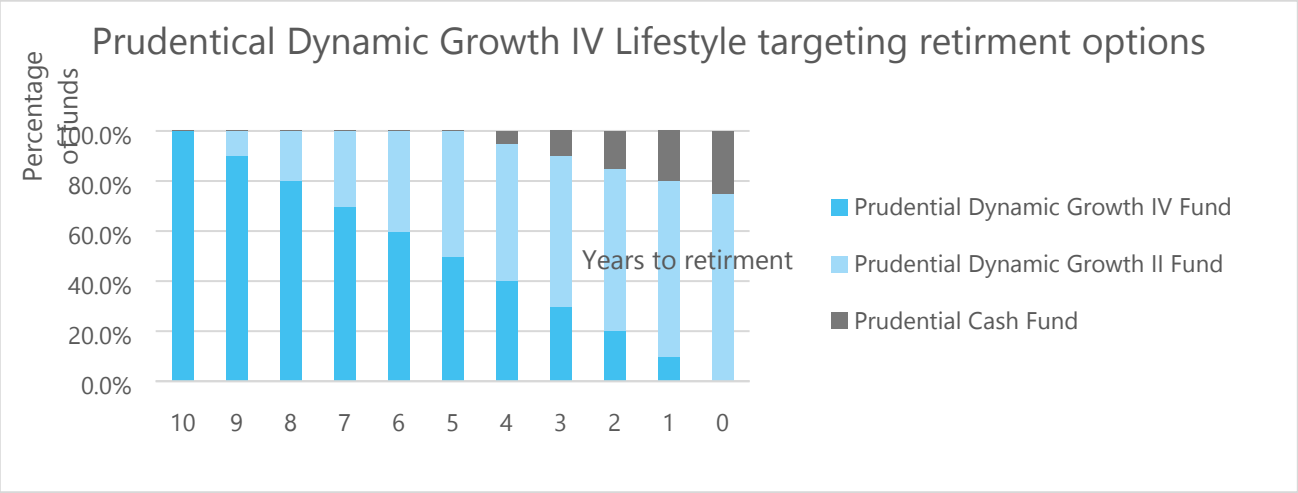
Conclusion and recommendation

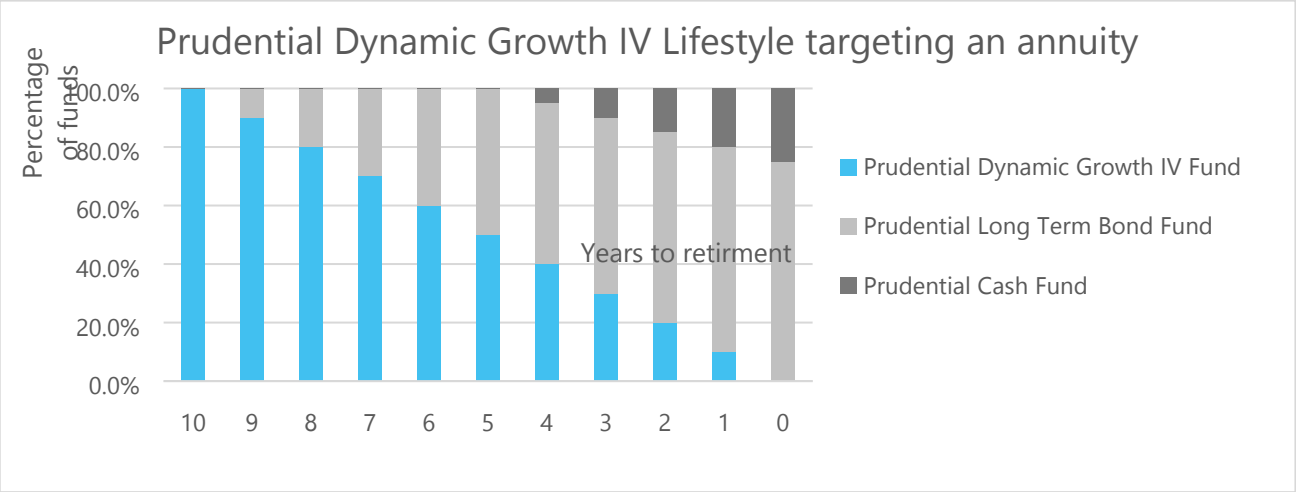
After a review of the different options that Prudential have offered, we have come to the conclusion that the proposal put forward by Prudential to switch impacted members into the Prudential Dynamic Growth IV Lifestyle targeting 100% cash is the most suitable choice for the Authority given the options available and recommend this course of action be taken. However, as with all default lifestyle strategies, we acknowledge that this strategy will not be the best fit for all members investment needs, as such we recommend that any communications which members are sent from Prudential regarding the switch are augmented by a letter from the Authority highlighting to members the steps and reasoning the Authority has used to come to this decision and encouraging them to review their own investment priorities when choosing investments that best suit their needs. We recommend this communication also sets out the other investment options available to members on a self-select basis, including the alternative new lifestyle strategies set out in the appendix.

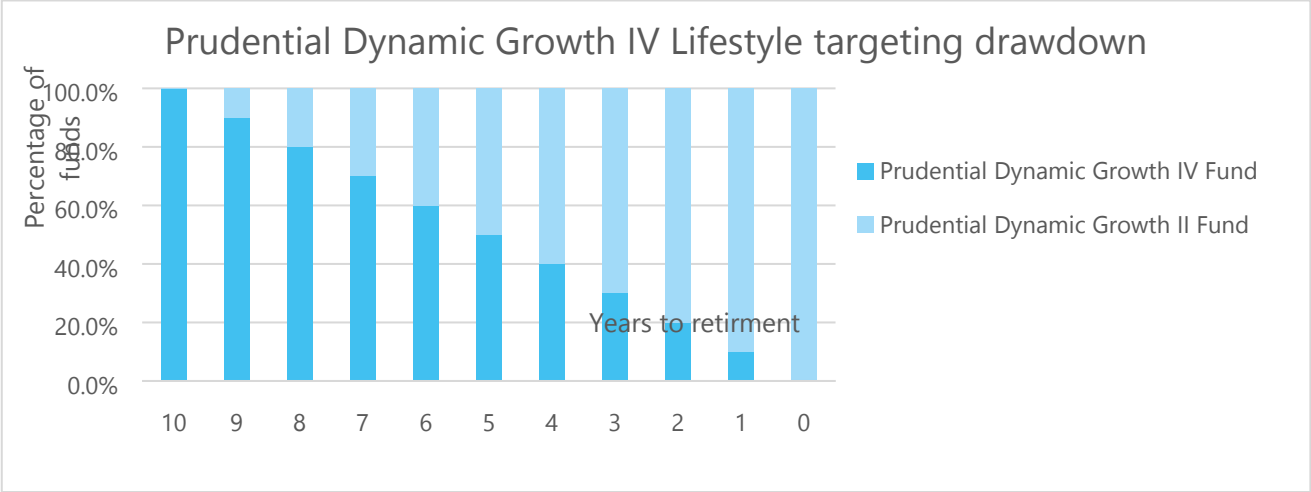
A similar communication can also be sent to members who are not being switched due to them having made a choice of funds or being invested in With Profits, explaining the options available.

We would welcome the opportunity to discuss this in more detail if you wish.

Appendix – Alternative new lifestyle strategies







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