A smarter path to retirement outcomes

Schroders Defined Contribution Conference 2016

Fred Dopfel
Senior Adviser, Schroders

@SchroderPension

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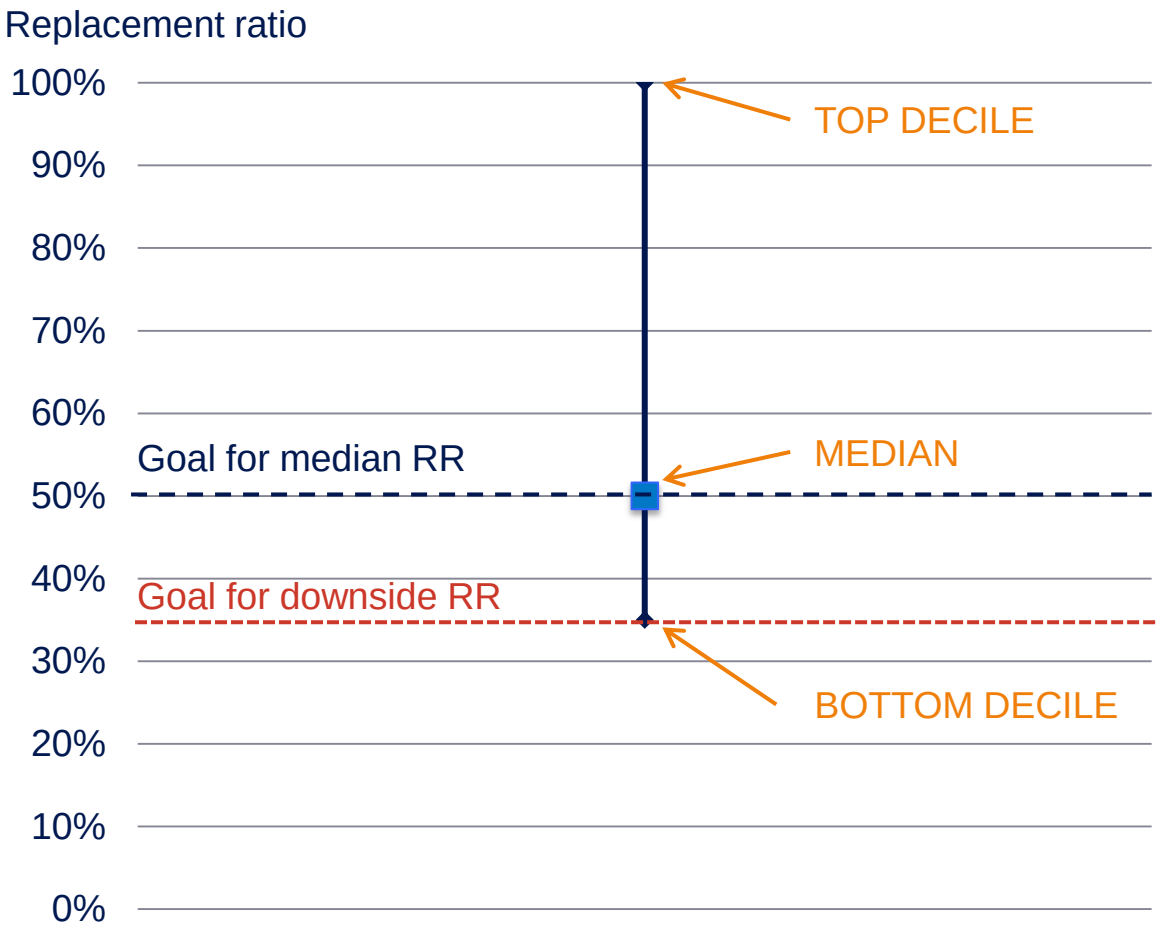
Outline

- Defining successful retirement outcomes
- Comparing static asset allocations: *glidepath vs balanced*
- Comparing *dynamic* with *static* strategies
  - How much skill is needed?
  - What is the impact of higher fees?
- Conclusion: Making the right trade-off between skill and fees

Defining successful outcomes

Restating the problem

- **Success is defined by the Replacement Ratio (RR)**
  - RR = retirement income as percentage of final income
  - **50% target**
  - **35% downside limit**
  - Assume that **25%** comes from other sources (e.g. state pension)*

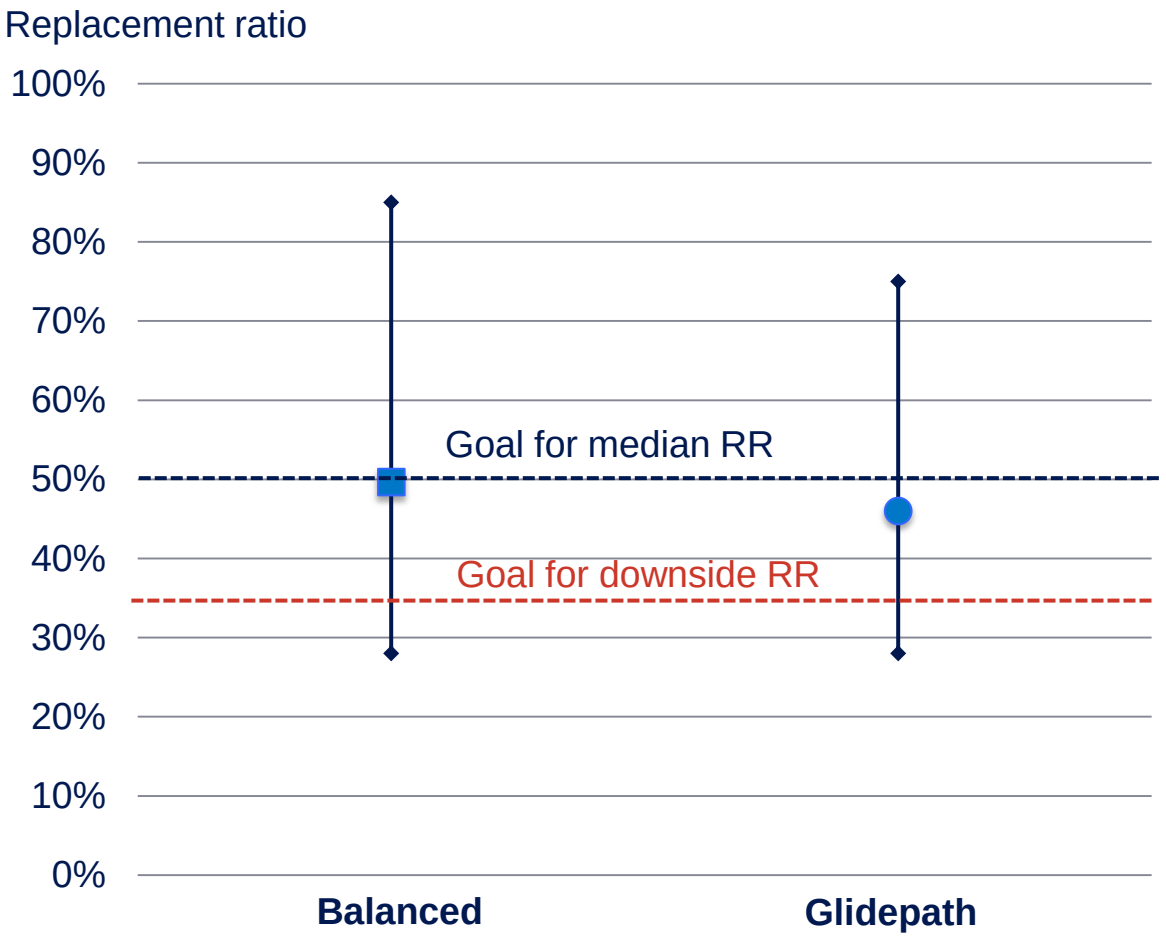


*Source: "The Real Deal: 2012 Retirement Income Adequacy at Large Companies" by Aon Hewitt Consulting, 2012

Static glidepath vs static balanced

Comparison of outcomes

- **Outcomes are very uncertain**
  - Neither static approach is successful
  - Balanced > Glidepath in 2/3 of cases
  - Glidepath > Balanced in 1/3 of cases
- **Strategy selection necessarily involves a <u>forecast</u> of returns**
- **Why not consider a dynamic strategy?**



Source: Schroders, May 2016. Results are approximate

A simplified dynamic strategy

Diversified growth

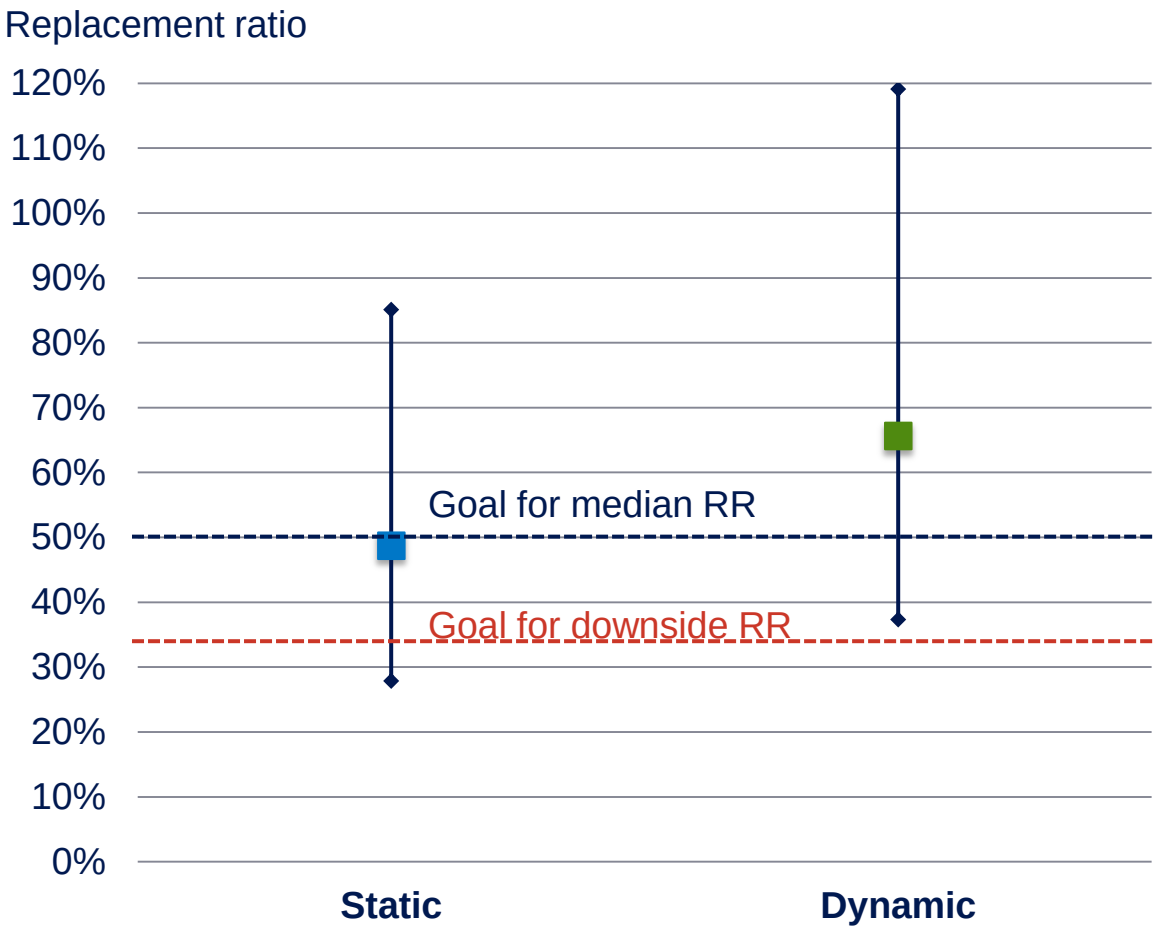
- **Forecast of future market performance varies:**
  - **High, medium or low**
- **Dynamic manager adjusts the portfolio based on market forecast:**
  - **High ➔ Buy:** *increase* equity holdings 15%
  - **Middle ➔ Hold:** *maintain* equity holdings
  - **Low ➔ Sell:** *decrease* equity holdings 15%
- **With investment skill, we "get it right" 2/3 of the time**
  - **We "get it wrong" 1/3 of the time**

Source: Schroders, May 2016

Dynamic vs static

Comparison of outcomes

- **Dynamic strategy yields successful retirement outcomes**
- **This assumes low cost and high skill (p=2/3), but not superhuman skill**
- **But what happens with lower skill and higher cost?**

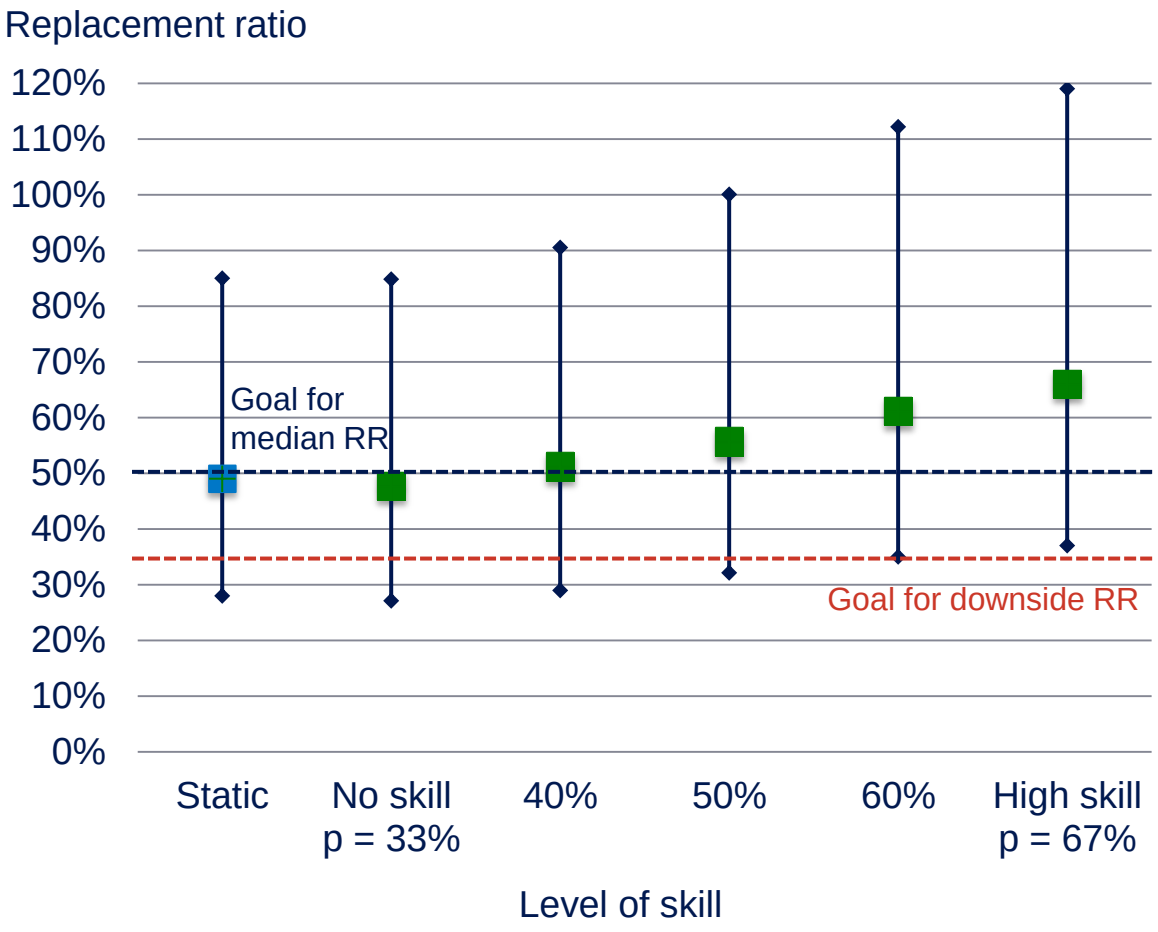


Source: Schroders, May 2016. Results are approximate

Impact of level of skill

From “no skill” to “high skill”

- **Dynamic strategy shows <u>substantial improvement</u> at moderate to high skill**
- **Marginal improvement at low skill**
- **Dynamic is worse at “no skill,” but not too damaging**

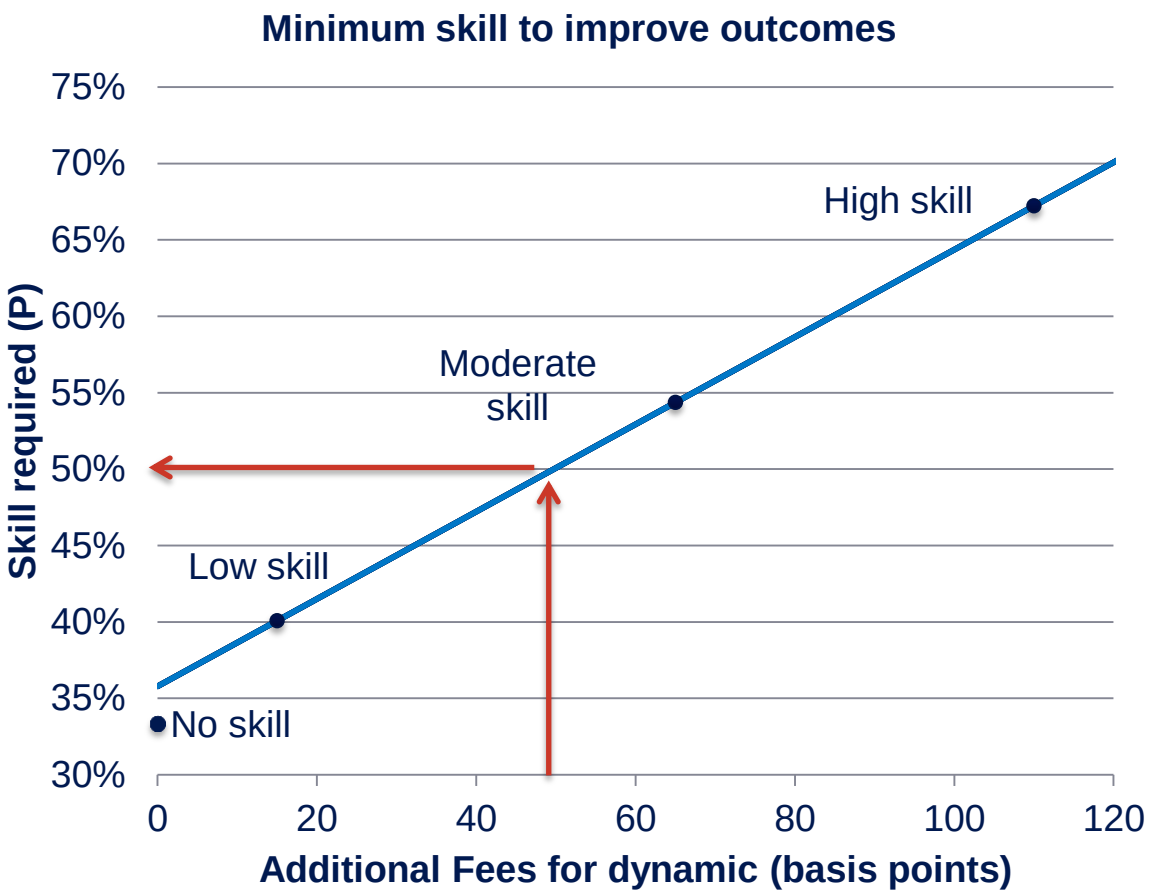


Source: Schroders, May 2016. Results are approximate

Impact of higher cost

Additional cost associated with dynamic

- **More fees imply the need for more skill to break even**
- **How much could be justified for a manager with only middling skill?**
- **Example (red arrows): "If additional fees for dynamic are 50 basis points, then you need skill of p = 50% or better"**



Source: Schroders, May 2016. Results are approximate

Beliefs and best choices

What are your beliefs?

Beliefs:	**Best choice:**
"I want lower volatility towards retirement"	➔ Glidepath
"Any dynamic manager is more likely to be wrong than right"	➔ Index (lowest fees)
"I want better outcomes, and believe *some* managers may have *some* skill"	➔ Dynamic strategy (performance is improved via skill, after fees)

Source: Schroders

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