Dynamism in Action

Key Takeaways

- With plans for the introduction of auto-enrolment moving forward in Ireland, it is crucial that DC schemes have well designed default investment strategies.
- Periods of global market volatility reinforce the importance of managing investment market risk within DC schemes.
- Large falls in financial markets can seriously knock the confidence of DC savers and it is critical that default strategies seek to minimise losses.
- Using a fund with built-in volatility management, such as State Street Global Advisors' Timewise Target Retirement Funds, can achieve significant reductions in losses during market downturns — protecting members pots and maintaining confidence.

Savers react to gains and losses differently, exhibiting greater sensitivity towards losses.[1] Evidence suggests consumers are becoming increasingly sensitive to market shocks, placing more importance on protection from falls in value than the potential to increase income.[2]

How might we have expected members to react amid the market turmoil that ensued during 1987's Black Monday, the bursting of the technology bubble in 2000 or the Global Financial Crisis in 2008? These events all had the potential to significantly reduce members' pots and impact retirement outcomes. More importantly, now that we are in one of the longest expansionary US economic cycles in history could we be faced with another period of market turbulence?

Timewise Target Retirement Funds (Timewise) are designed to protect members' pots in times of turbulence. The insights of behavioural finance have played an important role in the design and management of these funds.

Three Layers of Volatility Management

Timewise employs three layers of protection to help potentially protect member's pots in volatile environments and avoid significant drawdowns:

1. Strategic **diversification** of asset classes.
2. Active asset allocation (via the **Flexible Asset Allocation Plus** Fund).
3. Systematic **Target Volatility Triggers** closer to retirement.

Market events in 2018 highlight the importance of these mechanisms. Here we look through each of them and show their impact on the funds.[3]

Layer 1: Diversification

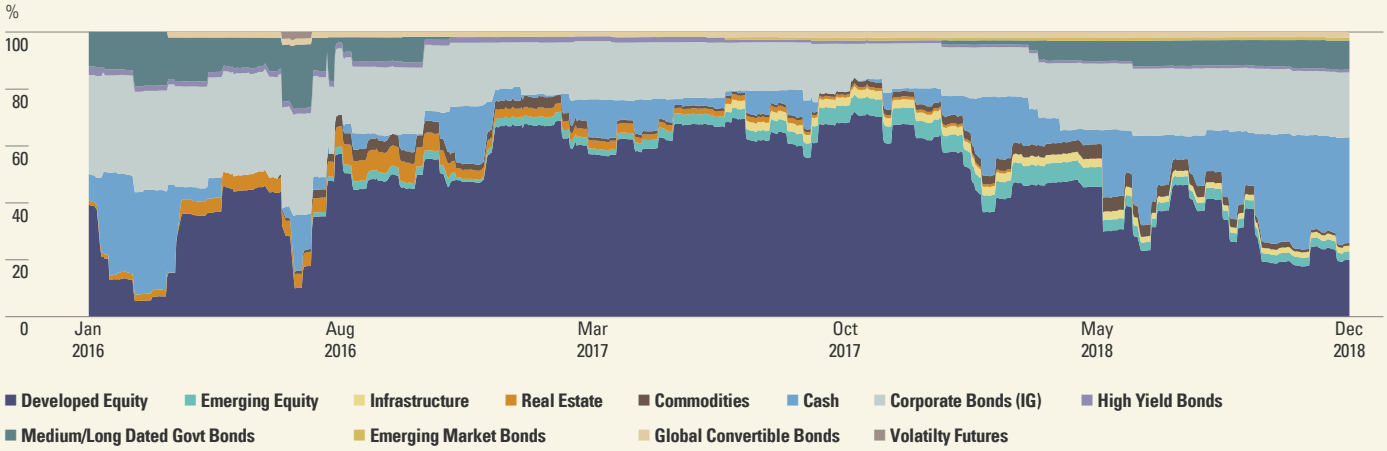
The potential benefits of diversification within investment portfolios are well documented, however, the degree of diversification employed should balance the risk taken with the reward received. Over-diversification can have a negative impact on the value of members' pots by 1) dampening investment returns and 2) incurring excessive trading costs. It is for this reason that we target the right level of diversification in Timewise by strategically allocating to the following building blocks:

- Developed and Emerging Market Equities.
- Smart Beta Equities.
- High Yield and Emerging Market Debt.
- Euro and Global Bonds.

Whilst strategic diversification can help to smooth returns over the long term, in the short term we do not believe that this alone is enough. An element of dynamic response to market movements is important, in order to protect members' confidence and not undermine the strides that have been made in getting so many workers into pension schemes to date.

The following two layers are the dynamic components that we use within Timewise to target a smoother journey for members.

Figure 1: The Right Assets at the Right Time



Source: State Street Global Advisors, Investment Solutions Group, as of 31 December 2018. For illustrative purposes only. **Diversification does not ensure a profit or guarantee against loss. Flexible Asset Allocation allocations are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.**

Layer 2: Flexible Asset Allocation Plus Fund

We recognise that different asset allocations are suitable for different market environments. The Timewise funds achieve this by actively varying their asset allocation in response to market conditions via our Flexible Asset Allocation Plus Fund. For example, in 2018 there was a significant increase in volatility, triggered at times by worrying escalations in the US — China trade war, as well as concerns over rising yields in the US and the impact this could have on growth. Using a variety of tools the Flexible Asset Allocation Plus Fund was able to efficiently dynamically exercise a wide range of growth assets, as illustrated in Figure 1.

Layer 3: Target Volatility Triggers

Heightened volatility can be damaging to returns across any time frame; however, the impact is intensified as members approach retirement since their ability to tolerate loss diminishes and they have less time to recover.

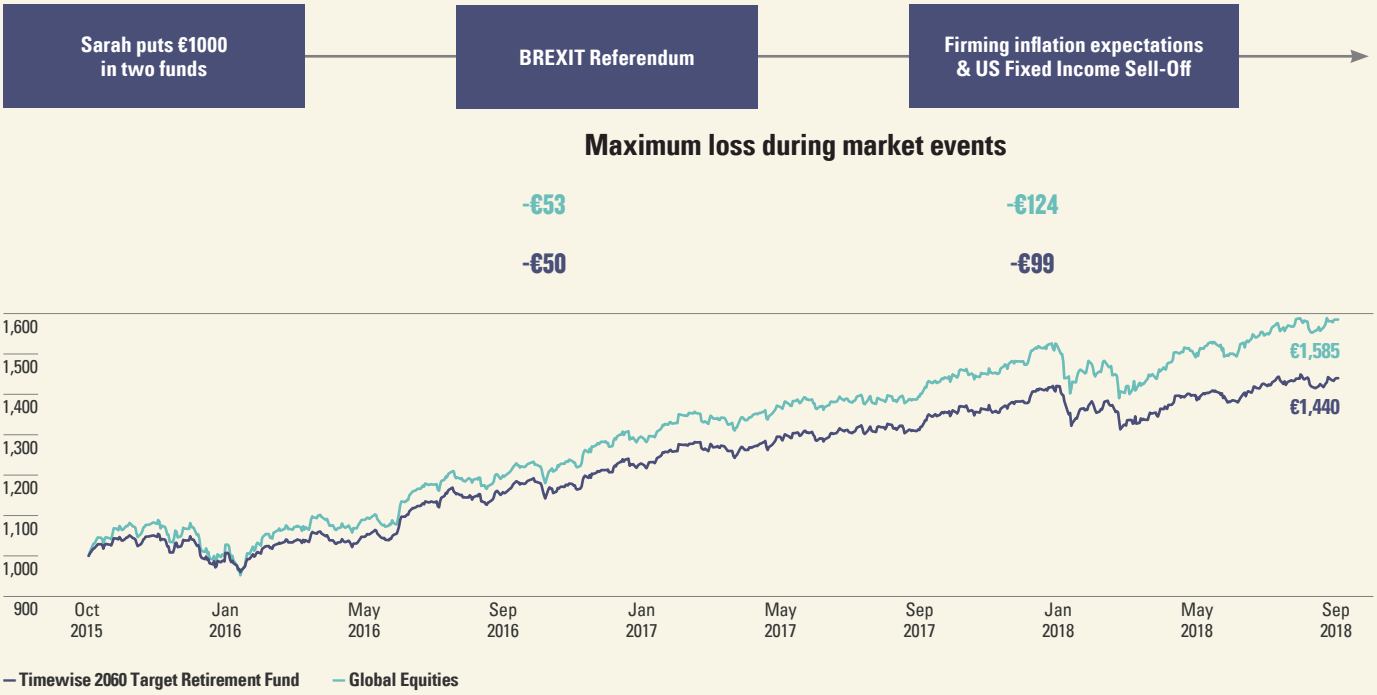
One way of helping to protect a portfolio against significant market upheaval is to reduce equity exposure when volatility is high. Target Volatility Triggers are a systematic monitoring and adjustment mechanism aimed at managing equity market volatility. They achieve this by targeting a volatility level and dynamically adjusting the level of equity if volatility spikes above the target level. The intention is to remain largely invested but potentially protect portfolios in the worst market drawdowns.

Timewise begins to introduce a 14% trigger on developed market equities and a 16% trigger on emerging market equities from 20 years before the target retirement date.

Making an Impact

Our recently launched Euro Timewise Funds are based on the design of our UK Timewise Target Retirement Funds which are currently live. Based on the performance of the UK Timewise Target Retirement Funds, Figure 2 shows the financial impact to a hypothetical pot of €1,000 during two market events. The three layers of volatility protection reduced the loss experienced during the market's unrest after the Brexit Referendum and the events in February 2018.

Figure 2: Maximum Financial Impact During Market Events — UK Timewise Target Retirement Funds



Source: State Street Global Advisors January 2019. The information contained above is for illustrative purposes only. Based on GBP Timewise Target Retirement 2060 Fund live performance. The GBP Timewise Target Retirement Funds are Managed Pension Funds and not available to investors outside of the UK.

[1] See Kaneman and Tversky's Prospect Theory (1979).

[2] Source: Ignition House for NEST 2014. Base=86 respondents. 62 participants placed high importance on "protection from falls in the value of my fund due to stock market movements". 46 participants placed high importance on "the potential to increase my income if stock markets increase".

[3] This paper refers to the EUR share class of the Timewise Target Retirement Funds. Live performance refers to GBP Timewise Target Retirement Funds which utilise the Dynamic Diversified Fund in place of the Flexible Asset Allocation Plus Fund.

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