Master Trusts Unpacked

Default Investment Strategies

April 2023

Welcome

Welcome to the 2023 edition of Master Trusts Unpacked. In this report, we look back at the performance over 2022 and see how the big sell offs in equity and bond markets and the fall in Sterling has impacted the different master trust default strategies.

We hope that this report can help employers who are considering reviewing or selecting a master trust to understand some of the differences in approach to default design and how this can impact performance in different market conditions.

We also highlight some of the risks of a lack of diversification and how this has impacted performance over 2022.

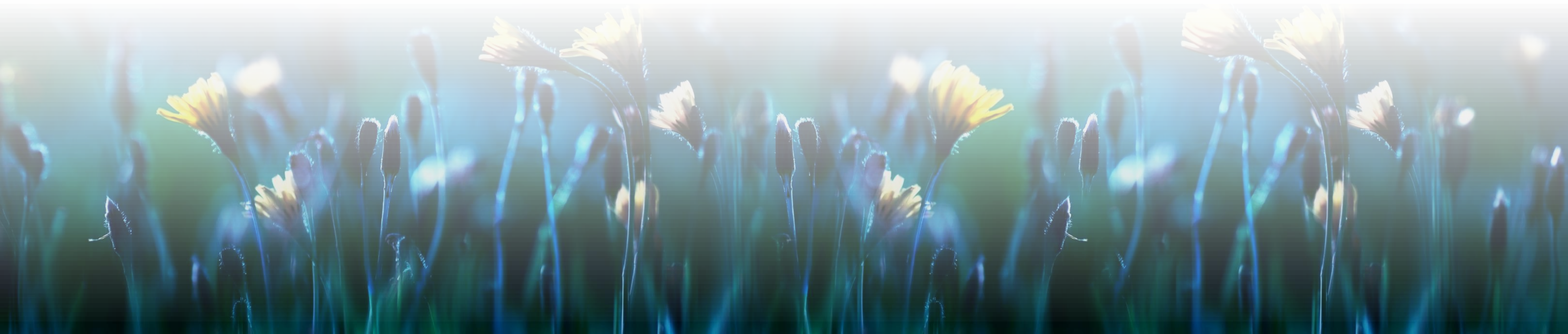
Looking ahead to 2023, we expect investment markets to remain volatile, which will provide tricky conditions for master trusts to navigate. We may see the gap widening between master trusts if lessons are not learnt from 2022.

We hope you enjoy reading the report.

This year we have taken a slightly different approach and decided not to name the different master trusts in our performance analysis. That's because we know past performance is only one factor that savers value and we do not want to detract from other areas of value that these master trusts offer.

Please speak to me, or your usual LCP contact if you would like to discuss the analysis contained in this report in more detail.

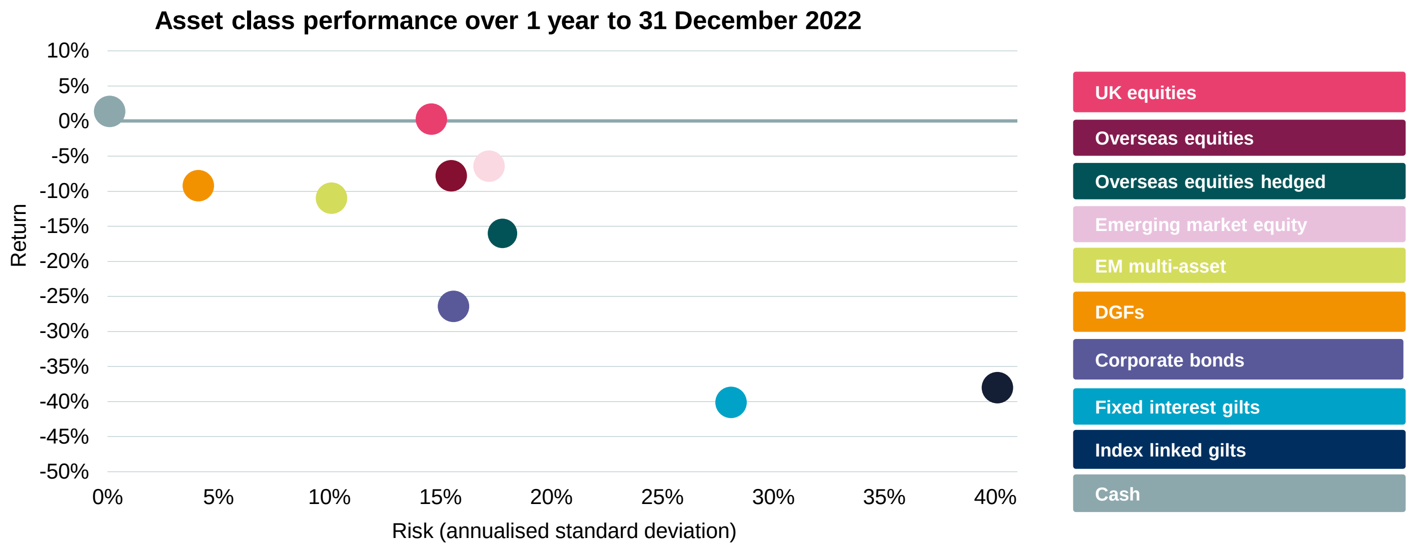
Nigel Dunn
Partner

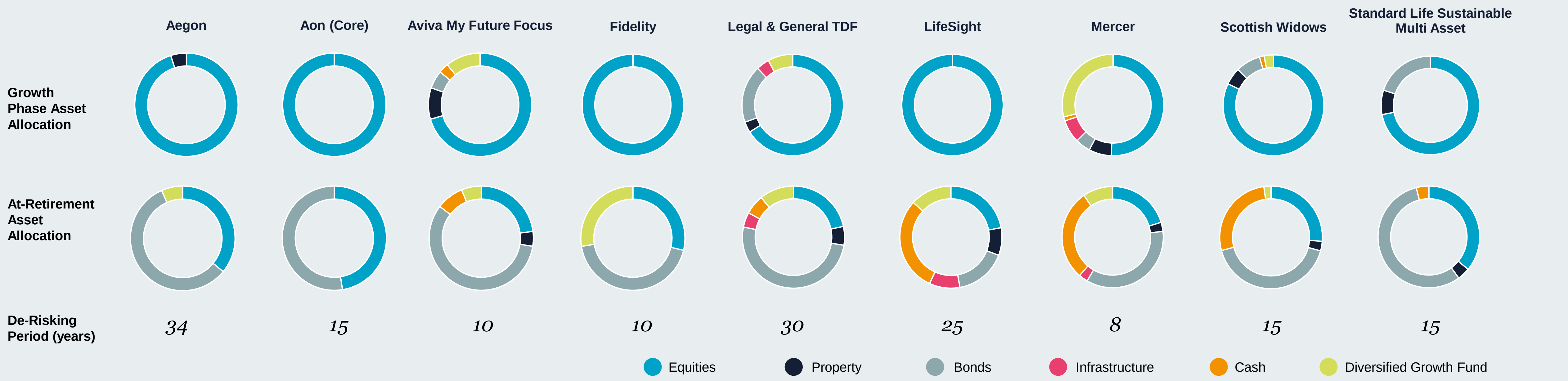


Nowhere to hide in 2022

During 2022 we saw huge falls in the performance of index linked gilts and fixed income following political turmoil in the UK. Overseas equities also experienced large losses, with hedged allocations seeing the largest losses, due to the fall in the value of Sterling. UK equities were boosted from historic profits in energy companies despite political pressures, outperforming most other regions.

Overall, master trust strategies had very few places to find returns so 2022 was all about loss mitigation. Those master trusts with high allocations to long duration bonds were most exposed to losses.





How did master trusts perform over 2022?

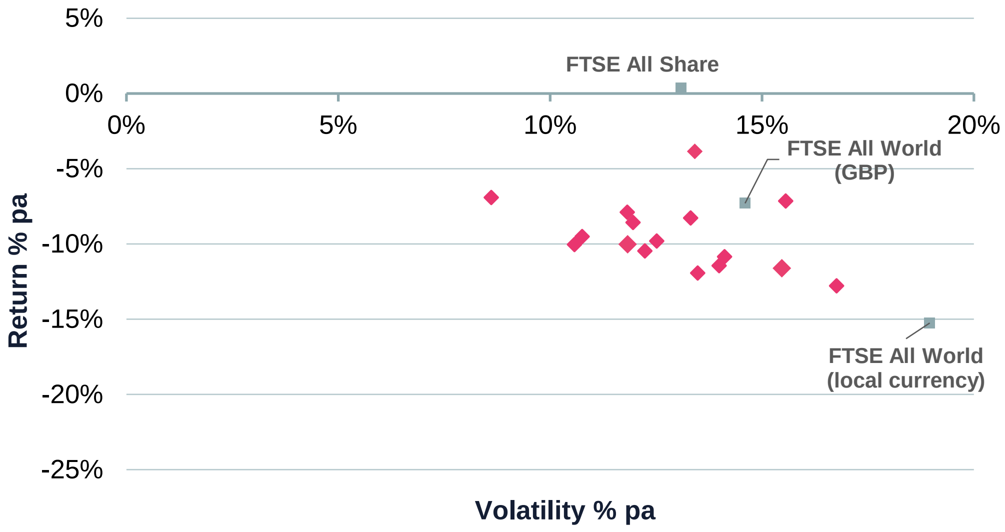
Equities struggle whilst diversification pays off

Within the growth phase, most master trusts hold a high allocation to equities, which experienced falls over 2022. Those strategies that currency hedge the growth phase saw even steeper losses of around -13% over the year. Top performers over the year were those master trusts that use a more diversified approach, including using allocations in shorter duration and overseas bonds.

In addition, strategies that use a factor based investment strategy also performed better, as value stocks such as energy companies outperformed growth stocks which make up a large proportion of the market cap index.

Factor based strategies and strategies with high levels of diversification provided the best returns over 2022 of up to c.-4% for members far from retirement.

Far from retirement - 30+ years to go



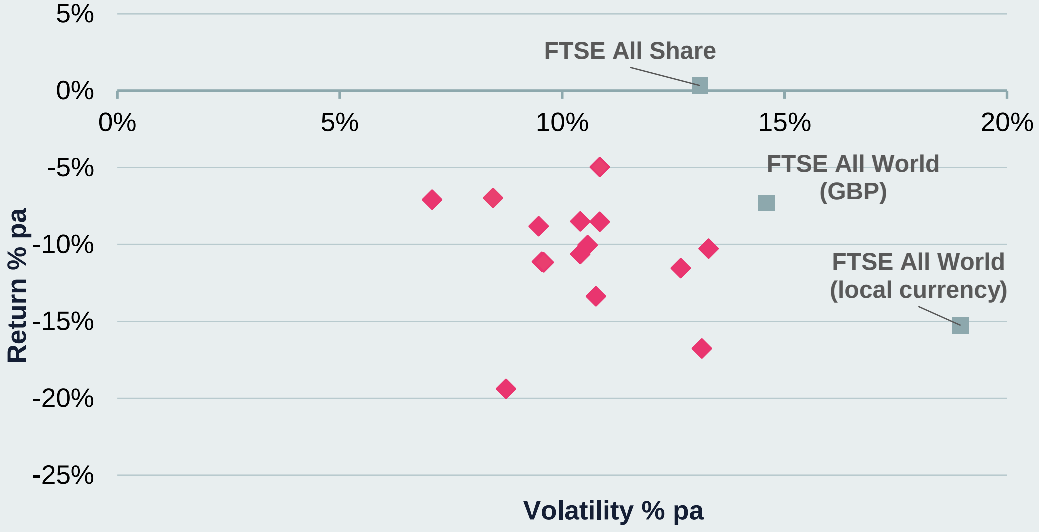
Large losses for some members near retirement

At five years from retirement there is huge potential for capital growth/loss compared to the growth phase as member pot sizes are generally much larger. Performance over this period is critical to member outcomes. Assuming members are cashing out at retirement then poor performance at this stage will not leave members sufficient time to recover their losses.

Unfortunately, this is the case for members in a number of master trusts as can be seen below. Those with the largest losses of c.-19% over the year held long duration bonds for diversification, and typically these strategies are fairly simplistic and static with no ability to avert the losses.

Some strategies were poorly positioned close to retirement, leaving members exposed to losses of c.-19%, which they are unlikely to recover in the short term.

Nearing retirement - 5 years to go



Source: Manager data and Bloomberg

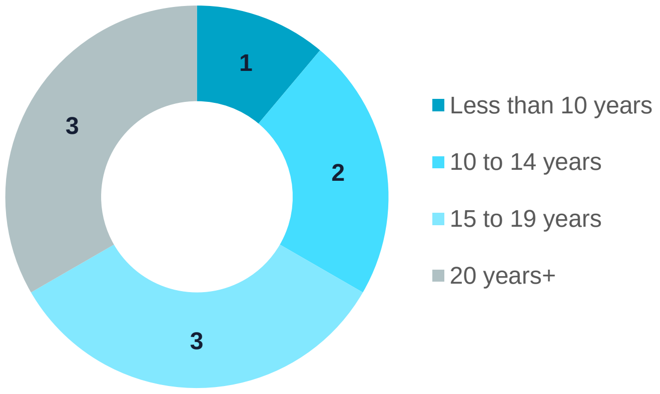
Glidepaths struggle to protect members

Some members lose out in the run up to retirement

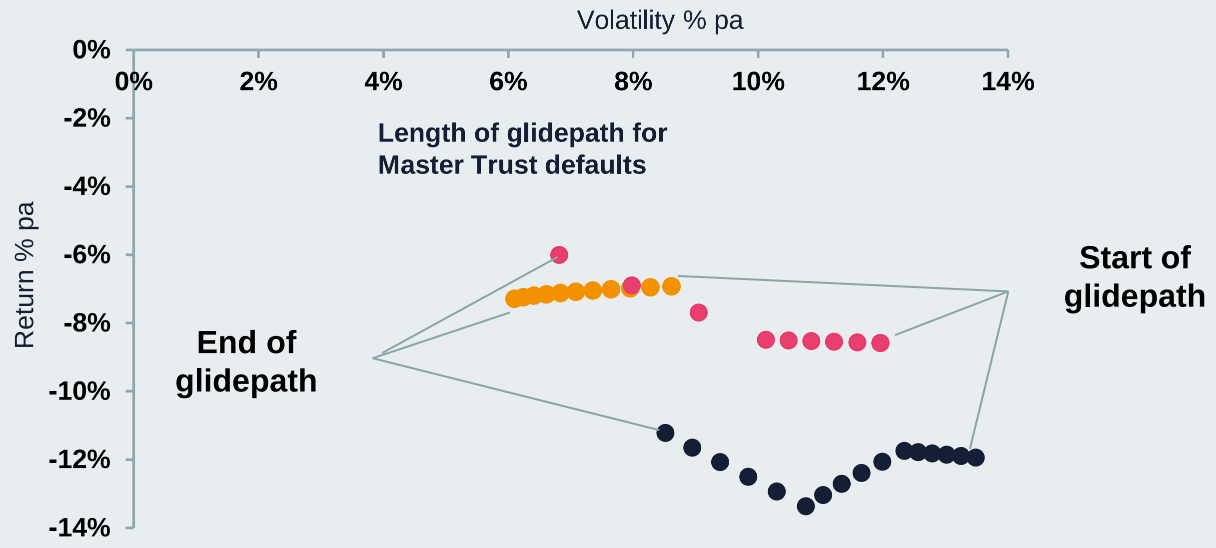
As members approach retirement, they typically move through a glidepath that changes their asset allocation from high risk to lower risk assets. The de-risking phase of these glidepaths can be as long as 30 years or as short as eight years so it's helpful to see how performance varies between these strategies.

Over 2022, we observed a wide variation in performance between providers in these glidepaths. Below we have singled out three providers that take different approaches to investment.

> *The design of the glidepaths played a key role in 2022, and from the chart to the right, its clear to see that some master trusts had mitigated the risks of long duration bonds whilst others hadn't.*



Number of Master Trusts



Highly diversified strategy

This strategy provided a consistently high return relative to other strategies across all ages of around c.-7%, as the diversification reduced volatility and protected members from the worst falls

Diversified with equity focus strategy

The higher equity content in the growth phase negatively affected returns for younger members. Returns near retirement of c.-6% were boosted due to an allocation to cash.

Equity/bonds strategy

Unusually, members in this strategy saw the biggest losses six years from retirement of c.-13%, due to a high allocation to long duration bonds at this point.

Source: Manager data and Bloomberg

Which is performing best over longer periods?

Master Trust Quilts - how do they work?

Each coloured section in the quilt represents a different master trust provider's performance over that year or longer term periods. Each master trust has been assigned the same colour each year and then these are ranked in order from best to worst.

Lack of consistency for most master trusts

The quilts demonstrate how performance from some master trusts can vary quite significantly from year to year whilst others have produced more consistent returns. Perhaps what is most striking in both charts is the difference in performance each year of the best and worst performing strategies.

Aside from 2022, equities have outperformed most other asset classes so those strategies with a high equity allocation both in their growth phase and near retirement have benefited. Those with a more diversified approach performed well in 2022 but have seen mixed performance in previous years.

The master trust quilts demonstrate how for some master trusts, relative performance can vary year to year whilst other have produced a more consistent return across the last five years.

Far from retirement - 30+ years to go

2022	2021	2020	2019	2018	3 year pa	5 year pa
-3.9%	25.9%	12.9%	23.5%	-2.4%	9.4%	9.1%
-6.9%	22.3%	10.1%	23.4%	-2.8%	8.6%	7.8%
-7.1%	21.1%	9.9%	23.1%	-3.4%	5.8%	6.2%
-7.9%	20.9%	8.4%	20.0%	-3.5%	5.8%	6.1%
-8.3%	20.3%	8.3%	19.6%	-4%	4.8%	5.7%
-8.6%	19.7%	8.2%	19.4%	-4.1%	4.6%	5.3%
-9.5%	17.3%	8.1%	19.1%	-4.2%	4.0%	5.3%
-9.8%	16.1%	7.5%	18.9%	-4.3%	3.8%	5.3%
-10.0%	16.0%	6.0%	18.7%	-4.3%	3.7%	4.6%
-10.0%	15.4%	6.0%	18.1%	-5.4%	2.7%	4.3%
-10.5%	14.6%	5.5%	17.6%	-5.7%	2.5%	4.1%
-10.8%	14.2%	5.2%	17.0%	-6.0%	2.4%	3.9%
-11.5%	11.7%	4.2%	17.0%	-6.7%	2.4%	3.6%
-11.6%	11.5%	4.1%	16.0%	-7.1%	1.6%	2.9%
-11.9%	11.2%	3.2%	15.6%	-7.7%	1.1%	2.8%
-12.8%	8.4%					

Nearing retirement - 5 years to go

2022	2021	2020	2019	2018	3 year pa	5 year pa
-5.0%	17.9%	8.6%	18.9%	-2.6%	5.8%	5.3%
-7.0%	13.2%	8%	17.9%	-2.8%	2.6%	3.8%
-7.1%	11.6%	6.1%	16.2%	-3.2%	2.6%	3.6%
-8.5%	11.1%	6%	16%	-3.3%	2.5%	3.5%
-8.5%	10.7%	6%	15.8%	-3.4%	2.1%	3.1%
-8.8%	10.4%	5.7%	15.6%	-3.4%	1.1%	3.0%
-10.0%	10.3%	5.7%	15.5%	-3.5%	1.1%	2.9%
-10.3%	10.3%	5.1%	15.1%	-4.0%	0.7%	2.5%
-10.6%	9.5%	5.1%	14.1%	-4.3%	0.2%	2.3%
-11.1%	8.4%	5%	14%	-4.6%	0.1%	2.1%
-11.1%	7.8%	3.7%	13.2%	-5.0%	-0.1%	2.0%
-11.5%	7.3%	3.5%	12.8%	-5.6%	-0.6%	1.3%
-13.4%	6.6%	2.8%	11.7%	-6.5%	-5.7%	-1.8%
-16.8%	6.5%					
-19.4%	1.3%					

Source: Manager data and Bloomberg.

Significant variation between provider returns

What do box and whisker charts show?

The box and whisker charts show the median return as an "x" and the first and third quartile returns as the box area. The line at the limits show the highest and lowest data points excluding outliers. Outliers are shown outside of this range as shown in 2022 and 2021 in the chart below.

Providers herd together but with some notable outliers

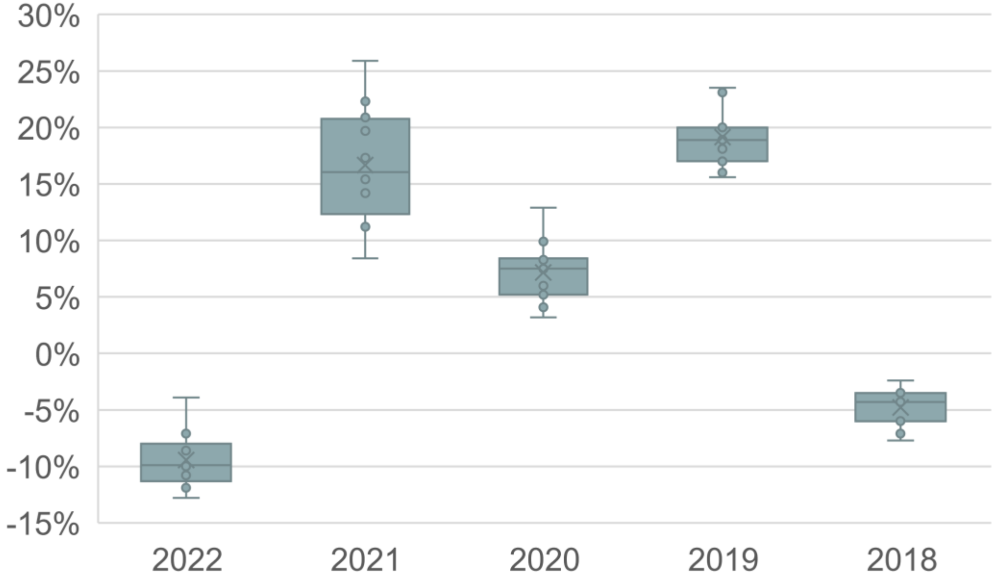
Most master trust default strategies target a drawdown or universal objective at the point of retirement, meaning that they generally continue to hold risky assets in the lead up to retirement.

Interestingly, the variation in performance nearing retirement between providers is smaller than in the growth phase, although there are outliers in 2022 and 2021. This highlights how although the master trusts target a similar amount of risk near retirement, some are exposed to tail risks, mainly through the lack of diversification within the strategies.

We have observed more variation in growth phase performance as some master trusts took more risk for higher returns. Near retirement, the variation is smaller but for some outliers where exposure to bonds was much higher.

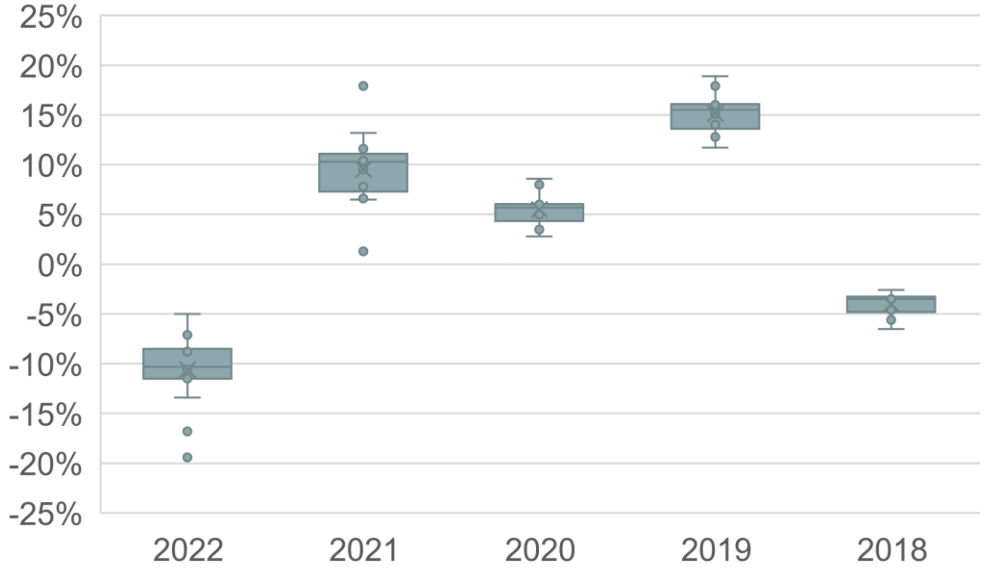
Far from retirement - 30+ years to go

Variation in returns



Nearing retirement - 5 years to go

Variation in returns



Source: Manager data and Bloomberg.

What are the key takeaways?

The key takeaways from this years report are:

- 2022 was a very difficult year in investment markets leaving very few ways for master trusts to deliver returns.
- Strategies with a high level of diversification performed best over the year, both for investments far and close to retirement.
- Some master trusts have been left with large losses due to high exposure to long duration bonds and it may be difficult for their members to recover from these loses before retirement.
- Factor based investing paid off and value stocks easily outperformed growth stocks in 2022.
- Over the longer term, it's clear some master trusts have benefited from high allocations to equity markets. Those that have used more diversification have seen mixed longer term performance.
- Approaching retirement, master trusts are shown to be delivering similar returns on the whole although there are some outliers due to a lack of diversification in some strategies.

The report has highlighted how important investment design is in delivering good outcomes for members and how analysis like this is required to avoid selecting a master trust with a poor investment strategy.

Looking forward to 2023, we are expecting further challenges in investment markets, which will benefit well diversified strategies. We hope master trusts are up to the challenge and deliver the returns that savers require and expect.

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