

Lifecycle Fund

A Default Option for the New Pension System

***Jaiwardhan Vij
Research Assistant, IIEF***

NPS: an overview

Individual account defined contribution system

Centralised recordkeeping

Full portability

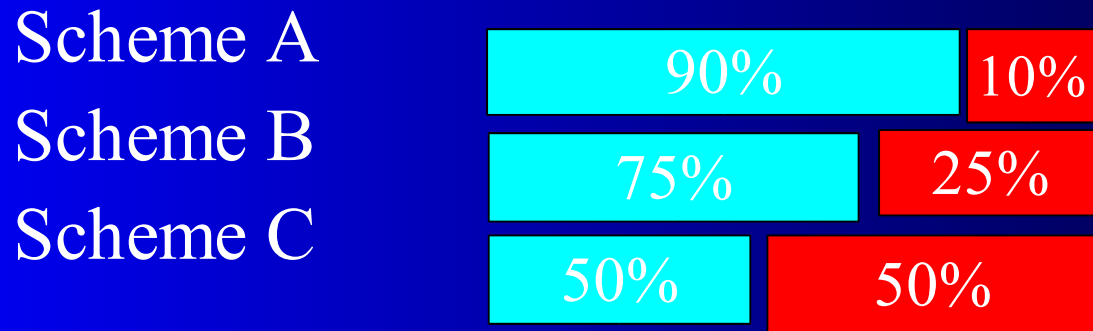
Private fund management



Partial annuitisation at retirement

Current status of the NPS

- ❑ Operational for central government employees since January 1, 2004.
- ❑ Eight state governments have joined and several others have expressed interest.
- ❑ Ordinance has been passed to set up the Pension Fund Regulatory and Development Authority (PFRDA).
- ❑ Soon to be operational for all citizens of India on voluntary basis.

Customer choice in the NPS



Income Fund  Equities Fund 

Default: No decision has been made

Challenges of choice

- Investors have low financial awareness.
- Those who are aware, do not take initiative.
- Large number of investment options confuse them.
- Investors who opt for a scheme may not re-balance their portfolio.

Most of them go into default options.

May be a role for public policy to build an investment option which could fulfil these materialistic gaps.

About Life-Cycle

- ❑ The idea behind a life-cycle fund, is first to grow and expand assets, then to preserve them near retirement.
- ❑ It is a fund which typically performs an asset allocation in the underlying funds on the basis of the age/risk tolerance of the investor.
- ❑ Aggressiveness in the asset allocation of a portfolio is directly proportional to the time period left to retirement of the investor or the risk taking capacity.

Types of Lifecycle Funds

Target allocation

Static allocation

Target allocation

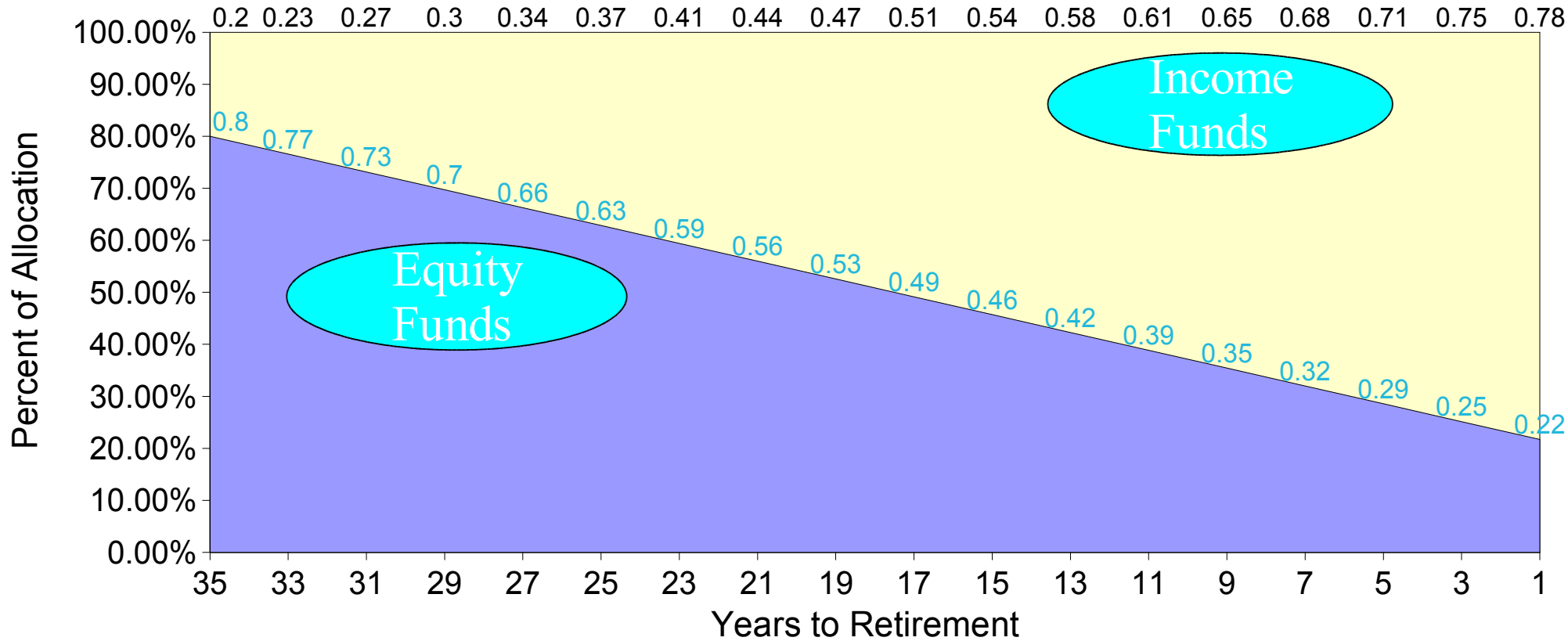
Investor responsibility is to select the fund on the basis of expected retirement date.

The portfolio adjusts automatically through the years to become conservative from aggressive as the retirement date approaches.

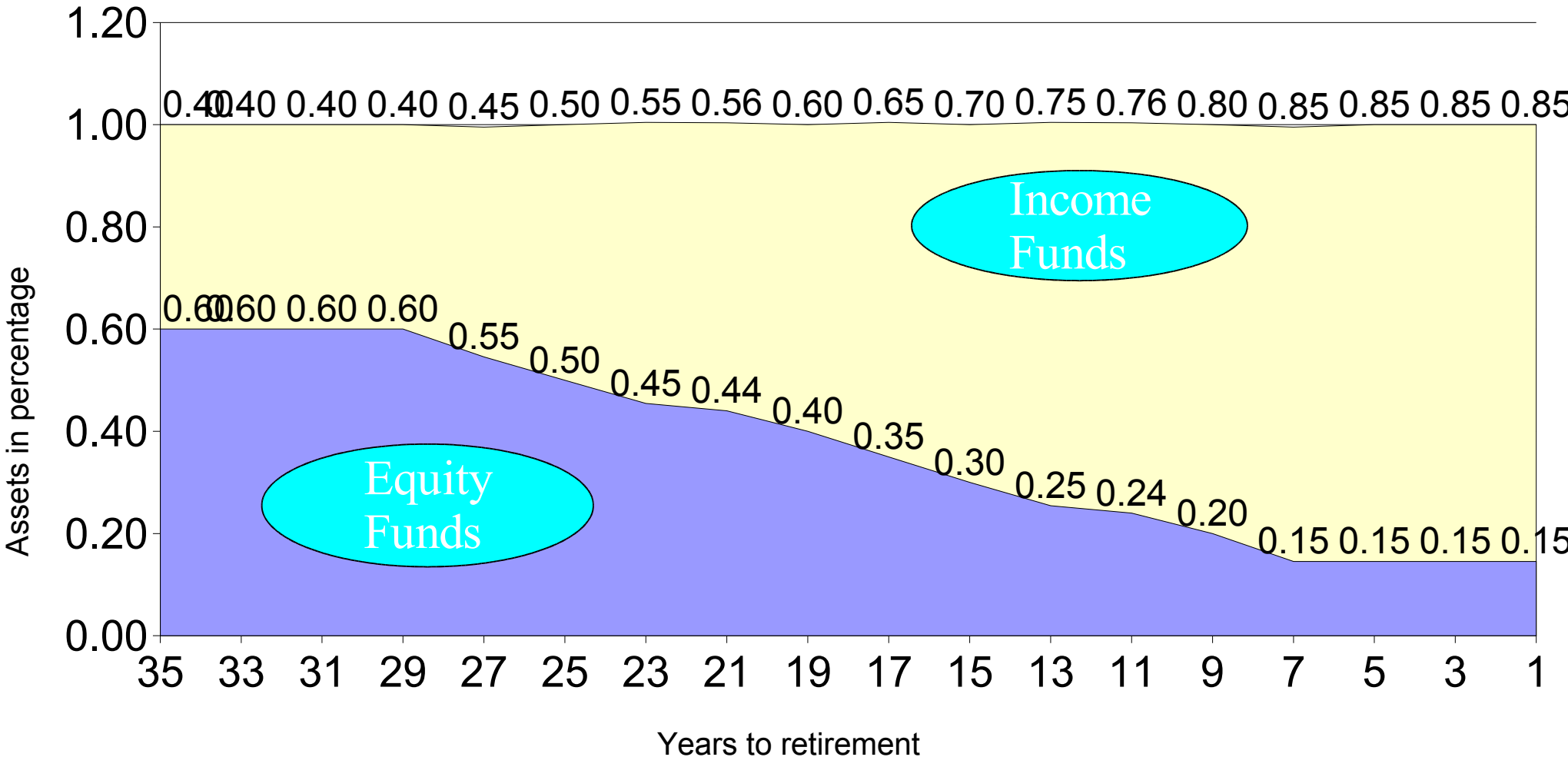
Static allocation

- ❑ The investor starts out with the portfolio that best fits his time horizon and risk tolerance at that point.
- ❑ The plan to choose and how to move the funds is in the hands of investor.
- ❑ These funds are appropriate for the investors that have a willingness and ability to be more involved in their investment decisions.

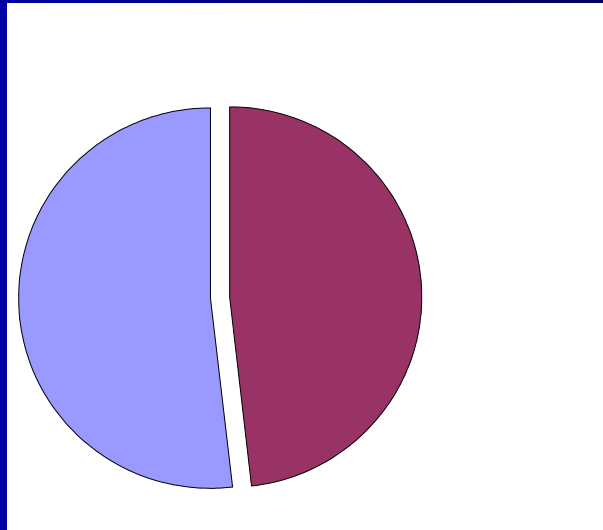
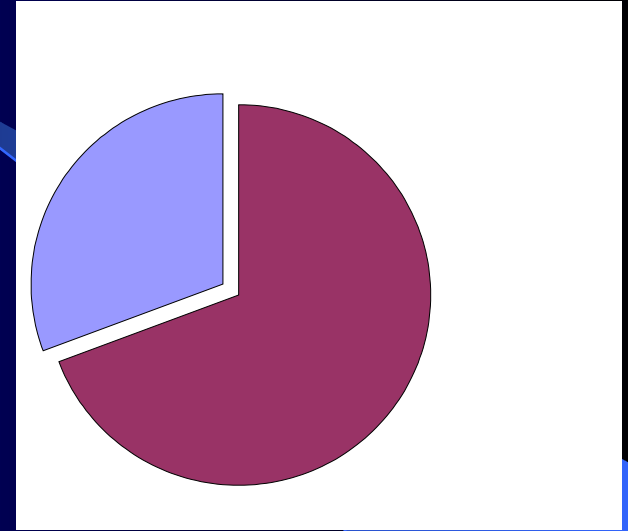
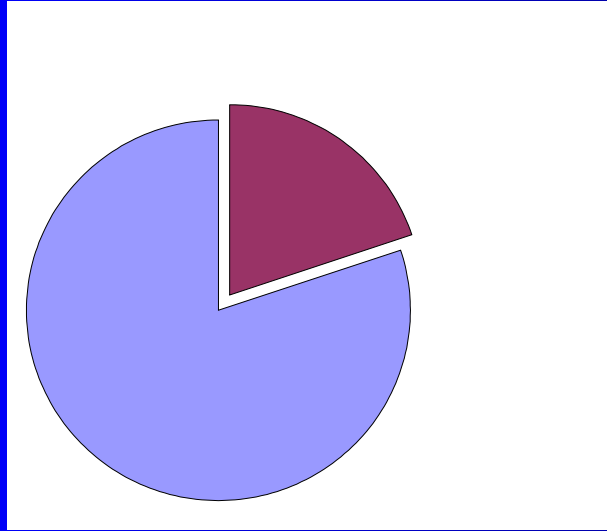
Target asset allocation



Target asset allocation



Static allocation



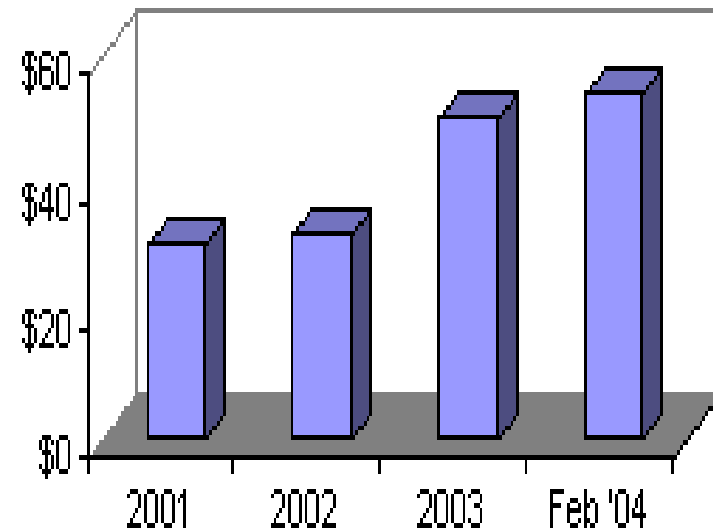
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Examples

401k Current Scenario

- ❑ 19% of companies offer the lifecycle funds, up from 9% in 1995.
- ❑ Total assets under management in all lifecycle funds is \$54.1 billion.
- ❑ Wide variations in fee structure 40 – 200 bps

Growth of Lifecycle Fund Assets (\$Billions)



Source: Financial Research Corporation

Sweden

- In 1998, Sweden introduced a second tier of mandatory individual accounts, the Premium Pension.
- Currently out of a total of more than 600 funds 6% are lifecycle funds with average fund fee of 61bps.
- 20% of total portfolios are in lifecycle funds.

Thrift Saving Plan (TSP)

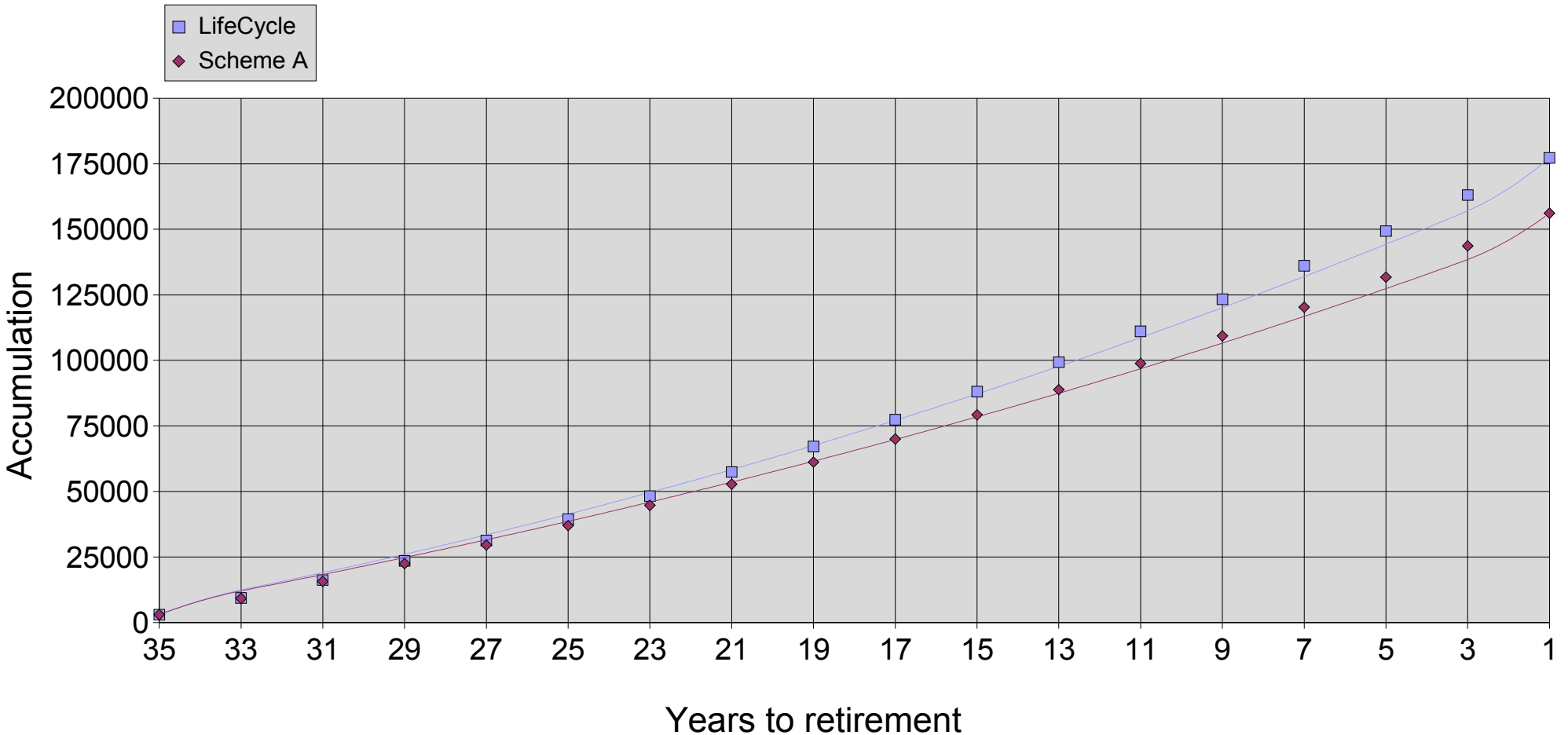
- In November, 2004 - The US Federal Retirement Thrift Investment Board engaged an Investment Consulting firm to assist in the development of lifecycle funds for the TSP.
- According to the Board, this was the next logical step in keeping the TSP consistent with best plan designs in the industry, from an investment perspective.

Target 2040 vs. Schemes A, B & C Assumptions

- ❑ Asset allocation **80%** in Equities and **20%** in Income Funds.
- ❑ Investment is Rupees **3,000** per annum.
- ❑ Real interest rate on Equity and Income fund is **4%** and **2%** respectively.
- ❑ Changes in Equities and Income Funds allocation every year is approximately **2%** of total assets.
- ❑ AUM based charge **80 bps**.
- ❑ In **35th** year maturity value would be approx. **Rs. 1,77,200**

Lifecycle Vs. Scheme A

Investment of Rs. 3000 per annum



Lifecycle Vs. Scheme B

Investment of Rs. 3000 per annum



LifeCycle Vs. Scheme C

Investment of Rs. 3000 per annum



ISSUES

- ❑ Two layers of fees, in most of the cases.
- ❑ Still a choice to be made.
- ❑ Risk profiles of any two people with same retirement date can not always be same.
- ❑ On one hand where lifecycle fund alleviates some of the burden for advisers to monitor portfolios, on the other it will provide less incentive to sell.

Conclusion

- ❑ Default conservative ? OR an investment option which may maximize the returns within an acceptable risk tolerance.
- ❑ Target / Static Lifecycle fund.

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Thank you