

Cambridge University Assistants' Contributory Pension Scheme (CPS)

Hybrid Section

Factsheet 6 – Defined contribution (DC) Investment Guide

It is important that you are able to make informed decisions when considering the investment options connected to your DC account. The information presented in this factsheet is intended to give you a broad overview of possible investment considerations. If you are still not comfortable in making investment decisions then it may be appropriate to seek independent financial advice.

THE BASICS FOR INVESTMENT

It is common that a person's first real experience in dealing with the financial markets is when they start investing for retirement. And it is also their first encounter with the risks that go along with this action. This is why many anxious investors choose conservative – lower risk, lower return – vehicles for their money.

However, being too conservative may hinder you as you strive to accumulate the funds you will need to retire comfortably. Understanding risk and knowing you are investing for the long term will help ease your worry if the financial markets are occasionally causing your savings to drop in value. Three of the most common types of risk when it comes to retirement investment are:

Market Risk

Market risk is the chance that the return on your investment will be less than what you expected, and that the value of your investments could decrease, due to changes in the financial markets – usually the stock markets.

Inflation Risk

Inflation drives up the cost of what we spend our money on. In other words, it reduces the buying power of your savings. As your retirement savings build up, you must be mindful of the spending power of those savings in later years. One of the risks that you face later is not having saved enough to overcome the amount inflation takes out of every pound you earn and have saved.

For instance, if you manage to get a return of 4% p.a. on your investment but inflation averages 5% p.a. over the same period, you would actually be worse off because your savings have not grown to match price increases.

Annuity Rate Risk

If you decide to purchase an annuity at retirement, annuity rates will govern the cost of turning your savings into a pension (or annuity) when you retire. These rates tend to vary with factors such as economic conditions and life expectancy, and there is a risk that, if the rates are unfavourable when you come to retire, buying a pension could be more expensive than you had anticipated. It therefore makes sense to try to ensure that, even if the rates are not favourable at the time of your retirement, you still have enough money saved to achieve sufficient income in retirement.

Longevity Risk

Longevity risk is basically the risk that you might live longer than expected. This is obviously a good thing, but can cause you financial problems if you haven't budgeted for it. If you purchase an annuity at retirement, then your income is paid 'for life' – whether you live for five years or fifty. This means that the longevity risk sits with the life assurance company that you bought your annuity from. If you are taking an income directly from your pension account (known as drawdown) then as well as considering the level of income and the timing of withdrawals, you must also think about how long you might live for.

Your savings in the scheme are likely to be affected by all of these risks and you should bear them in mind when making investment decisions, although it is impossible to avoid risk altogether.

INVESTMENT CONSIDERATIONS

Your pension scheme gives you the means to achieve a more comfortable retirement – but besides simply joining the scheme, you need a financial strategy to ensure you get the most out of it.

You don't need to be an investment expert to make the right decisions regarding your pension savings – although a solid understanding of the basics will certainly help. Before you start making investment choices, there are several questions you should think through...

How many years until I retire?

The amount of time you have until your retirement should affect your investment decisions. If you still have most of your working life ahead of you, you can afford to make long-term investment decisions, which may mean being more prepared to risk short-term drops in investment value for the sake of greater gains in the long run.

If, however, your retirement is only a few years away, stability may be more of a priority in the investments you choose, as there may not be time for your investments to recover any potential loss in value.

How do I feel about risk?

Aside from the issue of the time you have until retirement, you need to ask yourself how you feel about risk. Are you a conservative investor, moderate or aggressive? Your attitude to risk will greatly affect the investment choices you make. An aggressive investor will be prepared to run the risk of investments that could suddenly drop in value on the basis that these same investments also have the greatest potential for large increases. A conservative investor, however, will prefer more stable investments that are likely to deliver steady but not spectacular growth.

How much do I currently have saved?

As your savings in the scheme build up over time, you should review your investment choices to ensure they remain appropriate. You may want to protect the savings you have by investing in more stable funds, or you may want to use your money to pursue higher returns and choose a more aggressive strategy.

What other sources of retirement income do I have?

Your savings in the scheme should never be considered in isolation. When deciding how much you would like your savings to be worth at retirement, you should take account of any other sources of retirement income that will be available to you.

These may include other pension entitlements from previous employments, State Pension provision, and any other benefits you could receive. Ensuring you understand the full picture when it comes to your retirement savings will enable you to make the right investment choices now.

INVESTMENT OR ASSET TYPES

Having thought about the various risks to which your investment may be exposed, you next need to become familiar with the major types of investment, or asset classes.

Broadly speaking, there are three main types of investment available to you in the scheme: equities (or stocks and shares), bonds (or fixed income investments) and cash. Each investment will return different rewards and each has distinct levels of risk. You have a diverse set of investments to choose from in your scheme. Each of these investments will fall under one of the major types – some may be a combination of two or three.

Equities

Equity investments (or stocks and shares) represent ownership in a company. They give your savings the opportunity to earn dividends (your share of the company's profits) and to grow through capital appreciation (the increase in value of your shares). Over the long-term, equities have often had greater returns than other asset types. However, they also carry greater risk than other investments, making them generally more suitable for long-term investment and for moderate to aggressive investors.

Bonds

Bonds, sometimes called fixed-income investments, represent a loan to a corporation or government. They are used to raise money to finance a project or business opportunity. The corporation or government promises to pay interest to the investor, usually at a fixed rate for a given period of time.

The level of risk involved will normally depend on the stability of the organization taking the loan. Gilts, for example, are loans to the UK government and are considered to be one of the most secure bond investments, although their value can still go down as well as up.

The more risky the loan (bond), the more the interest payment you'll receive, meaning that, as with other investments, the greater the risk, the greater potential for reward.

Bonds are generally more stable than equities, as they are less vulnerable to stock market fluctuations. They therefore generally represent a good medium-term investment for moderate or conservative investors.

Cash Funds

Cash funds are sometimes called money market investments. They are considered low risk and usually gain low returns on the principal (the amount of money originally invested). If you concentrate a large portion of your retirement account in investments that fall into this asset type, the growth of your portfolio may not outpace inflation. This means you may fall short of your retirement savings goal. Cash funds can, however, represent a safe short-term home for your savings in the time immediately prior to your retirement, when you may want to protect the savings you have built up from any sudden falls in the stock market.

Investment Class	Equities	Bonds	Cash
Timescale	Long-term	Medium to long-term	Short-term
Objective	Long-term capital growth	Steady income	Stability of value of investment
Risk	Aggressive	Moderate	Conservative

ALLOCATING ASSETS– THE KEY TO INVESTING

Allocating assets is the final piece in the investment jigsaw – and it's a very important one.

New investors, at times, tend to be overly conservative with their investment choices. By limiting your investments to only the most conservative choices, you could compromise your ability to live the lifestyle you would like during retirement. And that is the reason why asset allocation is so important.

Essentially, your allocation of assets is how you choose to spread your pension savings across the various funds and asset types available, investing in accordance with your goals and your attitude to risk. This will be the key to managing that all-important balance between risk and reward.

Asset allocation works by ensuring you own different categories of investments, so when some of the investments are down, others may be up. The result is an investment portfolio that has the potential to experience less fluctuation in value than the individual assets within each fund. For instance, if you have a portion of your savings in bonds as well as equities, your portfolio may not be dramatically affected if the stock market experiences a drop in value.

The variety of investment funds available to you range from conservative to aggressive. And each one will impact your pension portfolio at a different rate. Study all of them carefully. Remember, the mix you choose has a significant impact on the growth of your savings. Studies show that asset allocation decisions alone explain the majority of a portfolio's long-term performance – making the type of investment much more important than the performance of any individual equity or bond fund.

MORE INFORMATION

If, after reading these details, you still have questions about how to invest your contributions or how your pension scheme fits into your personal financial situation, you should talk to an independent financial adviser (IFA). To find a list of IFAs in your area, please visit www.unbiased.co.uk.

Please note that neither SEI, the Trustee of the SEI Master Trust nor your employer is giving you investment advice.

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