Planning for retirement: Long-term savings and investment in Germany

Executive summary

Ensuring adequate retirement income for all is a crucial area of social policy, targeting the well-being and financial independence of individuals in later life. Effective retirement systems that see long-term savings productively invested are also an important driver of economic growth, able to fuel innovation and job creation. 60 years after the formalisation of the pay-as-you-go state retirement system in Germany, changes to demographics and employment trends have created a need for reform, to ensure the system remains fair and sustainable for generations to come.

For most workers in Germany today, the state pension alone may not provide the future income they hope for, to enjoy a longer but likely more expensive retirement. The Government will need to build on the reforms of the past two decades, and help individuals harness a balance of state, workplace and private retirement provision. We believe increasing coverage of workplace schemes – targeted in the Occupational Pension Reform Act recently approved by the German Parliament – phasing out the use of guarantees, and ensuring effective investment will be key.

The good news is that many individuals in Germany save conscientiously, and the need to make retirement provisions alongside the expected state pension is widely recognised. However, the absence of a widespread investment culture means savings held in cash are missing out on the chance of potential investment returns. Revitalising private pension schemes to ensure they are an attractive, simple way to get savings appropriately invested could benefit everyone. Pensions assets invested in the German economy could contribute to growth, stability and prosperity for Germany and its citizens.

A holistic policy approach that bolsters each of the three pillars of retirement provision – state, workplace and private – is essential. Government and industry must work together to help make preparing for retirement easier, with clear messaging, simple tools, and outcomes focused solutions.

In this ViewPoint, we leverage behavioural and attitudinal insights from BlackRock’s Global Investor Pulse survey to examine long-term savings and investment trends in Germany. We begin by briefly setting the scene with a snapshot of the widely-acknowledged demographic factors. We then examine current barriers to achieving adequate retirement income, and conclude with recommendations for Government and industry to work together to develop a range of solutions.

The opinions expressed are as of June 2017 and may change as subsequent conditions vary.
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KEY RECOMMENDATIONS

GOVERNMENT INITIATIVES: Commitment to a stable, sustainable, three-pillar retirement system

- Maximise coverage of and participation in workplace schemes, by minimising firm-level exemptions when introducing auto-enrolment.
- Guarantees hinder small and Mittelstand firms (SMEs) from offering workplace schemes, and result in poor investment allocation. Build on the Occupational Pension Reform Act, and commit to phasing them out. In their place, harness industry solutions that offer a degree of planability.
- Maintain tax and other incentives for employers to actively support for workplace schemes beyond the statutory minimum, including SMEs.

JOINT GOVERNMENT AND INDUSTRY INITIATIVES: Reduce reliance on cash savings and the state, increase confidence to act

- Develop simple messages that embrace all three pillars of the retirement system, and give individuals clarity on what key actions to take, depending on their stage of life.
- Develop a broader investment culture, to help individuals achieve better potential returns.
- As uptake of traditional advice declines, leverage technology and automated forms of advice and guidance. Support education on key financial concepts by reiterating consistent messages, and providing clear product information.

INDUSTRY INITIATIVES: Dismantle barriers to investing

- Develop outcomes-oriented retirement investment solutions that reflect the diverse employment paths and greater need for flexibility of workers and retirees today.
- Provide transparent, comparable information on cost and risk, to give individuals confidence that they understand their investments. Articulate why ‘value for money’ is more than just buying the cheapest product.
Evolving demographics in Germany

The demographic trends are well-documented: today’s workforce must prepare for the reality that their pension will need to last far longer than in previous generations. To help them achieve this, the pension system must be revitalised, and inspire greater confidence and engagement. Efforts to this end should build on the foresighted but fragmented policy response to date, to form a holistic approach. While challenged with one of the fastest rates of population aging in Europe, Germany also has an opportunity to position itself at the forefront of retirement policy solutions.

60 years of pay-as-you-go

When the basis of the present day pay-as-you-go retirement system was formalised in 1957, a sizable working-age population paid into the system, to support a small retired population. By 2017 however, the population of Germany has undergone a structural transformation, with the ratio of old to young increasing substantially. The cost of supporting a growing cohort of retirees now weighs heavily on the young, who are paying more into the system, but likely to receive less during their own retirement.

Family, housing and work patterns

Family: Starting later, living longer
Since 1957, typical trajectories towards milestones such as starting a family, buying a home, working and retiring, have also changed. With women on average having children later, parents may find that they reach retirement with younger, less financially independent children than previous generations. At the same time, their own parents may also require support for longer. These costs will need to be factored in when calculating future income needs.

Housing: Low home ownership rates
At 51.9% in 2015, the rate of homeownership in Germany is below the EU average of 70%, and indicates that many German retirees will likely be paying ongoing housing costs in old age.

Workforce participation
The economic turnaround in Germany since the last major pension reform, with unemployment rates falling from almost 8% in 2001 to below 4% in 2017, is good news for more complete employment histories and pension contributions. The International Monetary Fund (IMF) points out though that in order to buffer the sharp decline of the projected working age population after 2020, the progress in reducing unemployment must be extended further, to achieve greater workforce participation. This includes female workforce participation in particular, and reducing early exits from the workforce overall.

The gradual increase of the statutory retirement age to 67 by 2030 reflects this need, and faced with similar demographic trends, retirement ages across Europe are edging up. 67 is the new 65. However, just as important is dismantling barriers for those who would prefer to continue working (e.g. effective loss of pension wealth) and ensuring flexibility for those wishing to accrue a few more years of income.

According to the BlackRock Global Investor Pulse survey, 39% of individuals in Germany would like to continue doing some paid work beyond retirement, compared with only 30% wanting to fully retire. The Flexible Pension Act, effective July 2017, seeks to provide this flexibility.

Exhibit 1: Demographic structure changing over time

Source: Destatis Statistisches Bundesamt, data retrieved June 2017. 2017 and 2037 are projections. Aggregate chart visualisation by BlackRock.
Old age poverty risk factors

For the workforce of today, and retirees of tomorrow, the biggest risk factors to meeting the increasing cost of retirement, and avoiding financial dependence on the state in old age are, in our view, interrupted employment histories, patchy coverage of workplace pension schemes, and disappointing returns from overly conservative, low-yielding investment. The changing nature of employment, and the increase in self-employment and other non-standard arrangements, must also be reflected in the retirement system, to ensure that those outside of traditional employment are not left without adequate retirement provision.

Exhibit 2: Employment types, in %

What this means for generational fairness

Individuals in work today must prepare for a longer and likely more expensive retirement than previous generations. While the vision of full state provision of retirement income has long been relinquished, the ambition level of an effective retirement system overall should still extend beyond the basic prevention of old age poverty and state dependency. Next to ensuring standard of living and long-term sustainability, it must also seek to maintain consumer spending power. Generational fairness is at risk if declining spend by either those in retirement, or those preparing for it, impacts domestic consumption and economic growth.

While the young are hardest hit by the effect of changing demographics on the future value of the state pension, they also have the greatest opportunity to address their future retirement income needs; through a combination of state, workplace and private schemes that leverage their longer career and investment horizons.

A generationally fair system for the retirees of the future will require a broad palette of flexible, outcome-orientated solutions that reflect the diversity of career paths and life journeys today. We draw on insights from our proprietary Global Investor Pulse survey as we explore the options for achieving adequate retirement income.

BlackRock Global Investor Pulse
A study of consumer behaviours and attitudes to saving and investment

One of the largest global surveys ever conducted, the BlackRock Global Investor Pulse survey in 2017 interviewed 29,500 respondents, in 19 nations:

• In North America: the US and Canada
• In Europe, France, Germany, Italy, the Netherlands, Spain, Sweden, and the UK
• In Latin America, Brazil, Chile, Colombia, and Mexico
• In Asia, China, Hong Kong, India, Japan, Singapore and Taiwan

The German sample included 2,000 respondents.

All respondents were main or joint household financial decision makers, but otherwise no income or asset qualifications were used in selecting the survey’s participants, making the survey a truly representative sampling of each nation’s entire population. Executed with the support of TNS, an independent market research company, the survey took place in February 2017. The study has been running for 5 years.

Barriers to achieving adequate retirement income

Personal responsibility for ensuring adequate retirement income is widely acknowledged by individuals in Germany (86%), according to our research, however this is not necessarily reflected in behaviours. Government and industry must work together to help make it easier for individuals to take action. In this section, we address:

• Complexity of the system
• Three-pillar model: Holistic approach essential
• The false comfort of guarantees, cash, and conservative investments
• Managing the pre-retirement (accumulation) and post-retirement (decumulation) stage

Complexity of the system

Numerous foresighted reforms to the German retirement system over the past two decades have sought to mitigate the impact of demographic change, by bolstering workplace and private schemes. New measures include the Flexible Pension Act (Flexirentengesetz), effective from July 2017, and the Occupational Pensions Reform Act (Betriebsrentenstärkungsgesetz), recently approved by Parliament and due to be effective January 2018, also target a revitalised workplace pension system. The latter builds on the foundation of data provided by the Pensions Report 2016 and the Pension Insurance Report 2016.
The challenge, however, is that continual adjustments to complex retirement systems, while well-intentioned, can be confusing to individuals, and risk decreasing confidence and participation. A 27-year old today may live through ten different governments before retiring in ~ 40 years’ time, each of whom may make changes to the regulatory regime for pensions. Continuous tinkering inhibits effective planning for the future. Once necessary reforms have been introduced, the Government should aim to maintain a long-term sustainable framework, seeking not just broad social acceptance, but continuing to seek cross-party political support for key retirement measures. This could be achieved by establishing an independent commission, or the creation of a non-partisan office of responsibility for retirement.

**Three-pillar model: Holistic approach essential**

Pension reform is too important to be viewed piecemeal. To effectively tackle the barriers to individuals taking greater control of their retirement income, a truly holistic approach will be needed. This should resist the temptation to base policy on assumptions reflecting Germany’s current economic growth and employment levels, as these factors are subject to fluctuation, and hard to predict over the long term. A sustainable and generationally fair retirement system will combine the three pillars of retirement provision, and should help individuals answers key questions such as, ‘How much money can I expect to live on in retirement?’ and ‘What action should I take?’

Choice of terminology matters in setting expectations. The positioning of the state pension as a ‘foundational layer’ to build on may inadvertently perpetuate the impression that ‘additional’ options are just that – optional extras. Clear communication should reinforce the message that utilising all three pillars to achieve a total retirement income is prudent for most individuals, including low earners.

**Exhibit 3: The three-pillar model in Germany**

<table>
<thead>
<tr>
<th>PILLAR 1 State pension</th>
<th>PILLAR 2 Workplace schemes</th>
<th>PILLAR 3 Private schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Contribution rates, replacement rates and statutory retirement age subject to debate</td>
<td>• Defined benefit schemes, and defined contribution schemes with guaranteed minimum pension</td>
<td>• Riester plans</td>
</tr>
<tr>
<td></td>
<td>• Defined contribution schemes with no guarantees – as introduced in the Occupational Pension Reform Act</td>
<td>• Non-Riester retirement and savings schemes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Rürup / Basis</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Vermögenswirksame Leistung</td>
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<tr>
<td></td>
<td></td>
<td>• Proposed Pan-European Personal Pension (PEPP)</td>
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</tbody>
</table>

**Pillar 1: From state provision to a three pillar balance**

While the state pension represents a substantial proportion or even sole source of retirement income for many current retirees, the Ministry of Labour and Social Affairs acknowledges in the Pensions Insurance Report 2016: “The roll back of the replacement rate before tax makes clear, that the state pension alone won’t in future be sufficient to maintain the standard of living from working years to old age. In future, the standard of living will only be maintained if the financial opportunities of the old age income legislation and state support are used, to build additional provision.”

**17 years of pension reform**

- 2017 – Occupational Pension Reform Act (Betriebsrentenstärkungsgesetz), effective January 2018
- 2016 – Flexible Pension Act, effective July 2017
- 2014 – Introduction of retirement at 63 for qualifying individuals with 45 years of contributions
- 2013 – Pension Reform Act (Altersvorsorge-Verbesserungsgesetzes)
- 2008 – Introduction of €200 incentive to open a Riester plan by 26th birthday. Wohn Riester also introduced
- 2007 – Commitment to gradually raise statutory retirement age from 65 to 67, by 2030 – beginning in 2012
- 2005 – Rürup plans introduced, closing the gap left by Riester plans, which were not available to the self-employed
- 2003 – Pension Insurance Sustainability Act
- 2002 – Private ‘Riester plan’ pension schemes introduced, and supported by state subsidised incentives
- 2001 – Riester reform, resulting in greater Government support for workplace and private retirement solutions

For illustrative purposes only – list not exhaustive.
Although the ideal level of the income replacement rate — the value of the state pension in relation to the average salary — has been hotly debated in recent years, this figure alone is not a measure of concrete income, but a relative value. We believe what matters to the retiree is their total monthly income in real terms. As the Government extends the policy horizon beyond 2030, the counterbalance to the falling replacement rate must, in our view, be a commitment to bolstering the coverage and attractiveness of workplace and private schemes, and ensuring capital is appropriately invested.

Pillar 2: Workplace schemes: Coverage, participation and plan design

Since individuals already trust their employer with significant amounts of personal information, the latter are well-placed to help their employees take first steps to investment. The effectiveness and attractiveness of workplace schemes must, however, be improved, including phasing out guarantees for new workplace pension schemes, and ensuring that all employees have access to a workplace pension. As generating proactive individual engagement in workplace pensions will likely remain a challenge, the focus should be on designing strong default products, with potential for more engaged employees to choose from a range of investment choices. We believe defaults must have the potential of delivering appropriate target returns.

The critical importance of ensuring that workplace pensions deliver meaningful returns, for the sake of current and future domestic consumption and growth, should not be underestimated. Guarantees and regulatory constraints exacerbate the problem of underfunding, by restricting investment managers from diversifying portfolios into higher yielding assets. These asset classes appear underrepresented in Germany by international comparison.\(^\text{12}\)

While intended to increase employee uptake of workplace schemes, the auto-enrolment provided for under the Occupational Pension Reform Act falls short of mandating all firms to auto-enroll their employees into a suitable scheme, instead enabling employers to choose whether to operate automatic enrollment.\(^\text{13}\) While we note the intention to review the success of the provision by 2023, this is in our view a missed opportunity to make progress now, on increasing coverage and participation. A phased but nation-wide approach, moving from larger to smaller employers, may be more effective in ensuring majority of employees have a pension.

Pillar 3: Private schemes: Riester, Rürup and beyond

While private pensions are not common among those already aged 65+, there has been greater uptake in the working population through Riester plans, Rürup plans, and other schemes. They represent diversification for those with state and workplace schemes, and are particularly important for individuals without access to workplace scheme, such as the self-employed.

It is widely acknowledged, however, that despite significant uptake since the launch of the Riester plans in 2001, and the Rürup in 2005, the popularity of such private pension schemes has waned in recent years, evidenced in a stagnation of new accounts, and a long tail of accounts with low values.\(^\text{14}\) While returns have disappointed, and some products have been costly or complex, this pillar nonetheless remains significant in providing access to capital markets return potential, and a tool for getting cash off the sidelines, and productively invested in the economy.

The false comfort of guarantees, cash, and conservative investments

Germany, as a nation, has the largest excess of savings (over consumption and investment) in the world; and a household saving rate of around 10% – more than twice the EU average.\(^\text{15}\) In marked contrast to many other countries, the main issue is therefore not getting individuals to save more, but to save and invest more efficiently. However, when it comes to both workplace schemes and private savings, the consumer bias towards the perceived security of guarantees, cash and conservative investments is set against this objective, and could ultimately harm outcomes.

Guarantees

Most consumers are unlikely to be aware of the high opportunity-cost they are effectively paying for the guarantee on their workplace pension. What’s more, guarantees force managers into a highly conservative asset allocation, leaving them unable to maximise values, or take full advantage of risk diversification. As a result, individuals risk receiving a significantly lower income than without guarantees. The Ministry of Labour and Social Affairs acknowledges these disadvantages: “Minimum income i.e. guarantees have, from the employee perspective, the advantage of offering high degree of planability. However, according to many experts, guarantees also have disadvantages. These include primarily, that capital allocation must be very conservative, in order that the minimum income can be fulfilled. An opportunity for a better return is thereby lost.”\(^\text{16}\)

The bottom line is that guarantees and existing restrictions on risky assets, including equity and infrastructure, restrict the target returns that the product can hope for. The introduction of a framework for employers to elect to offer

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\(^{\text{12}}\) Source: BlackRock Global Investor Pulse, 2017

\(^{\text{13}}\)

\(^{\text{14}}\)

\(^{\text{15}}\)

\(^{\text{16}}\)
new defined contribution pension schemes, without guarantees, has the potential to help solve several problems:

- Free from liability for any shortfall, the risk for firms to offer a Defined Contribution (DC) workplace scheme is far reduced. This removes a key barrier to increasing coverage, particularly for small and Mittelstand firms, many of whom are unable to accept the liability of guarantees.

- Free from guarantees, capital can be more effectively allocated to a wider range of assets. This also opens up a new channel of capital to the economy.

- Additionally, DC models raise the potential of increased portability of workplace pensions, reflecting mobile careers.

The requirement, under the Occupational Pension Reform Act, for DC schemes to be collectively negotiated by the social partners—intended to emphasise public service and engender trust—should, however, not be allowed to form a barrier to certain firms or industry groups to offer guarantee-free schemes.

**Cash savings: The risk of taking no risk**

Individuals in Germany are conscientious savers—67% have started to save for retirement (see Exhibit 4). However, beyond workplace pension plans, 70% of German savings are held in cash (see Exhibit 5). While intuitively comforting, cash alone is unable to generate an additional return, to help individuals meet their income needs in retirement. Relying on cash will require that greater contributions are set aside during an individual’s working life, which may simply not be possible for many, and will impact the spending power of those who can. Investments of key importance to widely diversified portfolios remain under-represented: on average, equities account for 9% of savers’ portfolios in Germany, with property amounting to 7%, multi-assets 4% and bonds to 3%.

**Barriers to moving out of cash**

The 65% of individuals in Germany that reject the idea of taking further steps out of cash have an average cash allocation of 82%.

Barriers to moving out of cash include:

- ‘It’s too small an amount to make it worth it’: 37%
- ‘I want quick access to my money’: 25%
- ‘I would prefer to keep money in cash as a safety net’: 19%

**Exhibit 5: Average asset allocations in Germany**

Investment in equities is associated by many with risky speculation, however, Germany’s interest rates among the lowest in the world (only those of Japan and Switzerland are lower). German savers invested in domestic sovereign bonds will therefore receive lower returns than individuals in most of the rest of the world, for comparable maturities of their own domestic sovereign bonds.

Individuals missing out on the benefit of long-term compound interest may need to take serious remedial measures to improve their pension as they approach retirement, or face the prospect of poverty in old age. Most individuals in Germany are aware of this. According to the Global Investor Pulse survey, respondents throughout Germany concede that on average, they hold more than double the amount of cash considered to be advisable. However, fewer than 1 in 10 are actively looking to take steps to invest more of their cash, which compares with similarly low figures in Italy, France and Netherlands.

**Exhibit 4: Individuals in Germany more likely to be saving for retirement compared to other countries in Europe**

<table>
<thead>
<tr>
<th>Country</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>61%</td>
<td>39%</td>
</tr>
<tr>
<td>Germany</td>
<td>67%</td>
<td>33%</td>
</tr>
<tr>
<td>Italy</td>
<td>47%</td>
<td>53%</td>
</tr>
<tr>
<td>France</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>48%</td>
<td>52%</td>
</tr>
<tr>
<td>Sweden</td>
<td>59%</td>
<td>41%</td>
</tr>
<tr>
<td>Spain</td>
<td>47%</td>
<td>53%</td>
</tr>
</tbody>
</table>

Source: BlackRock Global Investor Pulse Survey 2017
Absence of investment culture, but millennials interested

Only 23% of individuals in Germany agree with the statement 'investing is for people like me'. Those who do agree tend to be much more affluent. It will be necessary, however, for most individuals to take on some risk in order to have the chance of generating an appropriate return. The alternative is that they will need to either save significantly more each month, work for longer, or reduce their standard of living.

More encouragingly, young adults in the 25-34 age bracket are less reluctant to invest than other age groups. This group has the greatest opportunity to get on the right course early, and take advantage of longer contribution periods. Millennials assess their financial future most positively and are the only age group for which capital growth is more important than capital preservation: 36% of them want to grow their wealth. The younger generation are also much more likely to make investments online. More than half of those aged 25-44 would consider purchasing an investment online, compared to less than a third of those aged 65-74.

How long-term, well-diversified products can reduce risk

The biggest financial goals among individuals in Germany overall are saving money (44%) and preserving wealth (38%), versus growing wealth (23%). This may be because many people associate investment with stock picking, market timing, or other higher risk activity. However, long-term, well-diversified products such as investment funds can help protect against overexposure to any particular risk. Industry and Government need to work together to ensure that this is well understood, and make it easy to access simple, appropriate investment products that offer Germany’s already large savings the chance of better potential returns.

<table>
<thead>
<tr>
<th>Exhibit 6: Awareness and appeal of benefits of investment funds among individuals in Germany (figures in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aware</strong></td>
</tr>
<tr>
<td>Lower risk because they typically invest in a basket of investments</td>
</tr>
<tr>
<td>Managed by investment experts</td>
</tr>
<tr>
<td>Range of funds available so I can pick one to meet my requirements</td>
</tr>
<tr>
<td>The investments held in the fund can be adapted to address market movements</td>
</tr>
<tr>
<td>Less hassle</td>
</tr>
<tr>
<td>Lower cost</td>
</tr>
</tbody>
</table>

Source: BlackRock Investor Pulse Survey 2017

Lack of understanding around the benefits of funds

Around a third of individuals in Germany (36%) don’t know enough about investment funds to understand their risks and benefits.

Source: BlackRock Global Investor Pulse Survey 2017

Managing the pre-retirement and decumulation stage, and longevity risk

Introducing flexibility

With a binary understanding of work and retirement fast becoming a thing of the past, phased and flexible solutions are needed. These should provide individuals more autonomy to determine their own retirement date, and remain invested to some degree once they do retire, to protect against the risk of outliving their savings. The move to introduce greater flexibility around the retirement age is well underway, with the Flexible Pensions Act.

Flexible Pensions Act

Effective from July 2017, the Flexible Pensions Act introduces greater flexibility to the transition from employment to retirement, and is designed to make working beyond the statutory retirement age more attractive, to those who would like to accrue a few more years of pension contributions, or work part time.

Key elements of the new legislation include:

- **Employees** will automatically be entitled to earn an additional €6,300 per year. Any excess will accrue in the partial pension. For those in the pre-retirement phase, the age at which individuals can make top up payments to their pension is lowered from 55, to 50.

- **For employers**, retaining employees beyond the statutory retirement age is made more attractive, through the discontinuation of contributions towards unemployment benefits.

Workplace and private schemes: Understanding the decumulation phase, and longevity risk

According to the IMF, workforce participation has increased among the 55-65s, coinciding with reduced options for early retirement for most, and the low overall unemployment rate, but not for those older than 64. BlackRock’s Global Investor Pulse survey suggests that individuals in Germany have not yet fully taken into account a current life expectancy of 81, and the reality that for many, this may entail working past 65 in order to maintain their standard of
A consequence of longevity is that for retirees with workplace and private schemes, the decumulation phase is increasingly no longer a case of simply spending the pension pot they’ve accumulated. For those who have made the decision to retire from working life, concluding the accumulation phase, solutions need to be available to help them manage the decumulation of the workplace and private pension pots. Reflecting longer retirements, most need to remain financially engaged and invested in appropriate products that leverage longevity of investment horizon, and protect against risk of outliving savings. Government should provide clear guidance on the decumulation phase.

**Alternatives to annuitisation**

In the UK, the requirement to annuitise pensions at retirement – that is, to purchase a retirement investment product offering a fixed income – was removed in 2015. Retirees may now access a 25% tax free lump sum, but are taxed on any further capital they withdraw. In the Netherlands, in 2016, pensions freedoms were announced, which will remove the requirement for members of Defined Contribution (DC) schemes – those that invest member contributions without guaranteeing the return – to annuitise at 65. For industry, longer retirements require a rethink of traditional lifecycle products, and a shift from developing investment products that take individuals ‘to retirement’, to new products that support individuals ‘throughout retirement’. One of the most important elements is ensuring that individuals do not de-risk too soon.

In the past, lifecycle solutions were effective in transitioning individuals from investment, into an annuity style product on retirement. However, they increasingly need to accommodate multiple outcomes, including traditional annuities, but also capital protection and drawdown opportunities. One of the challenges with compulsory annuitisation on retirement, such as previously existed in the UK, was that it forced many people to reduce their exposure to potential future market growth too soon. The essence of lifecycle solutions currently being developed is that they continue to provide simplicity for the individual, but can be underpinned by research and investment insight that will help meet the goal of delivering financial independence, so that individuals can maintain their standard of living without running out of money. The emphasis should be on flexible solutions with well thought-out defaults, rather than endless choice for consumers that serves more to confuse than enable. With overwhelming choice comes the anxiety of making the right decision, and the risk of compensating through an overly conservative approach.

**UK National Employment Savings Trust**

**Target date default funds, and phased investment**

Following the introduction of auto-enrolment in 2012, employers in the UK may choose the pension provider that they enroll their employees into, but the National Employment Savings Trust (NEST) was established by the Government to ensure that all employers would have access to a suitable pension scheme. So far, employee opt-outs have been just 8% from the NEST scheme, and 10% overall.

Once newly enrolled into the NEST scheme, employees in their twenties are invested in a foundation stage for approximately 5 years. Employees joining the scheme when they’re older go straight into the growth phase, with a higher allocation to equity, which lasts for about 30 years. This is gradually rebalanced to a more conservative asset allocation for the 10 years prior to retirement.

While these target date funds are the default option, NEST members can also choose from a number of other fund choices. NEST targets a benchmark return of 3% above inflation after all charges over an economic cycle, but aims to beat this.

Source: www.nestpensions.org.uk

**Recommendations for Government and industry to help individuals achieve their retirement income goals**

In the following recommendations, we consider how to increase the confidence and financial capability of individuals to engage effectively with their own retirement planning. First, we consider steps the Government should consider, to build on the progress made in recent reforms and support individuals in preparing for their future income needs. Second, we explore areas where the Government and industry should work together. Finally, we look at the role of industry in bringing down barriers to investing, and increasing trust in the tools, products and services it offers.

**Government initiatives: Commitment to a stable, sustainable, three-pillar retirement system**

1. **Maximise coverage of and participation in workplace schemes, harness behavioural nudges**

**Support for broad use of auto-enrolment**: In our view, the cases in which employers are exempted from providing automatic enrolment, or auto-enrolment, should be limited, to give the majority of employees the opportunity to save for retirement through a workplace scheme that will invest their contributions effectively. Rather than allow firms to decide whether to adopt auto-enrolment at all, a phased approach for all employers could be more effective in achieving this goal.
Evolving work patterns: With evolving work patterns and increased self-employment, the issue of access to and portability of pensions increases. Leveraging workplace schemes, a number of scenarios should be explored:

- **Individuals who move into self-employment after a period of employment**: The solution may be finding a mechanism (other than payroll deduction) for the self-employed to continue to invest into pre-existing schemes.

- **Individuals who are self-employed but contracted to work primarily for one organisation for a period of time**: Contracting entities could perhaps facilitate deductions directly to the individual’s own scheme.

‘Save More Tomorrow’ schemes: As a second step after auto-enrolment, auto-escalation schemes, such as ‘Save More Tomorrow’ pioneered in the US, help individuals save more without cutting spending. These simple schemes allow individuals to pre-elect a percentage of any future pay increases for investment into their pension. This helps address issues of affordability of pensions to new entrants to the workforce, many of whom start out as low earners.

CASE STUDY: Auto-enrolment in the UK

Auto-enrolment schemes that leverage behavioural insights have yielded significant results in ensuring uptake of retirement provision in other markets. In the UK, employers are required since 2012 to enroll their employees into a pension scheme automatically. This ‘nudge’ has increased by 6 million the number of workers with a workplace pension, and helped normalise the need to save for retirement. Under UK requirements, the minimum contribution is made up of money from a worker’s pay, money from their employer and tax relief from the government, starting at 2% of employee pay, but rising to 8% by 2019. A 5-year phased introduction has seen larger employers go first, with smaller firms enrolling their employees by 2017.

Exhibit 7: Phasing of minimum contributions

While still in its early stages, the perception of auto-enrolment in the UK is increasingly positive. Approval of auto-enrolment as a good idea has increased from 63% in 2011, to 77% by 2014.30

‘Investing is not for people like me’

Contrary to the intuition that a change in behaviour must follow a change in attitude, attitudinal change may often follow changes in behaviour.31 This suggests that employers can help support the change in behaviour e.g. auto-enrolment, and this first step may be significant in overcoming the perception that investing is ‘not for people like me’.

2. Commit to phasing out the use of guarantees in workplace schemes, building on recent reforms

Phase-out guarantees: Improve the effectiveness and attractiveness of workplace schemes. The drop in funding levels of workplace pensions, following years of low interest rates, represents a gap that must be closed. Capital guarantees restrict investment managers from diversifying portfolios into higher yielding assets, such as equity or infrastructure. Better capital allocation that takes advantage of the long investment horizons typical of pension schemes could alleviate the need to raise contribution rates.
Leverage industry solutions that aid planability: As employers and employees digest the paradigm shift of guarantee-free DC schemes, a number of industry solutions could provide a degree of planability:

- Defined Ambition schemes: The employer sets a target return, shared with the employee, but not guaranteed. The advantage is that the provider can invest in more volatile but higher yielding asset classes, which should give better returns over the long term. The employee has a reasonable ‘ambition level’ of return, but the employer is not restricted by the liability for covering potential shortfalls.

- Lifecycle investing and target date funds: The concept of ‘lifecycle investing’ is that an investor’s asset allocation should change as they go through life, to manage different risks at different points in their life based on their time horizon. This investment approach should aim to deliver income during retirement that is consistent with spending patterns prior to retirement. What individuals should expect and want from a lifecycle product is the ability to have consistent spending throughout their lives. This is a simple idea that can be applied in different ways.
  o In the UK, lifecycle approaches typically move an investor automatically between different funds as they age, in a process known as ‘lifestyling’.
  o In the US, target date funds are common, and do the same thing within one investment vehicle, by tapering off risk as members approach retirement. We believe a properly designed target date fund should be able to accompany and help support an investor throughout their entire life from the accumulation to the decumulation phase.

- Education: The impact of risk reduction through diversification, long-term investment horizons, and the value of compounding of returns are not widely understood. Around a third (36%) don’t know enough about funds to understand their benefits, but for those who do, their lower risk is the most appealing benefit.32

3. Maintain tax incentives for retirement saving

For savers: Commit to easy to understand, transparent treatment that incentivises appropriate investment

- Tax reliefs targeting low earners: We support the use of tax reliefs targeting lower and middle income earners. The benefit to savers is that more capital is invested for longer, allowing compounding of return on capital plus the value of tax relief. This should generate larger pension pots and increase the likelihood of individuals being able to achieve their retirement savings goals.

Make tax easy to understand: To make it simpler, rather than using percentages, this could be shown in monetary figures, as the State putting in e.g. €1 for every €3 put in by the individual from net salary – or even more simply ‘Buy 3, Get 1 Free’.

For employers: Incentivise employers to maintain support for workplace schemes, including small and Mittelstand firms, with contribution matching and payroll management:

- Maintain employer incentives: Government should recognise the valuable role employers can play in encouraging high rates of retirement savings by matching contributions, and by maintaining an easy-to-use administrative framework for employees. Government should continue to incentivise employers to make matching contributions as these provide material support for individuals.

- Simplify the complex array of workplace pension vehicles: Whether taking the direct pension promise or external approach, many of the methods for employers to provide their employees with a workplace pension require significant legal, tax and pension administration capabilities. Consider where simplifications and alignment could help employers to help their employees.

4. Target long-term stability for the retirement system, by seeking cross-party support for key measures

Dependability: Preparing for retirement is a long-term process, and building the necessary trust and engagement requires dependability. Pension reform must therefore rest on a long-term strategy that individuals can rely on. Frequent change makes the retirement system complex to navigate, and may discourage proactive engagement. As the need for individuals to take action with regard to their retirement grows, it is vital the system is as clear and simple as possible. It is therefore important that reforms are not reversed by successive governments.

Cross-party support: Whatever the constellation of current and future coalitions, cross-party support should be sought for key measures, to ensure stability over the long term. Once necessary reforms have been made, establish a framework to distinguish between major policy changes requiring cross-party support, and second tier tweaks.
Joint Government and industry initiatives: Reduce reliance on cash savings and the state, increase confidence to act

5. Develop simple messages that reflect all three pillars of the retirement system, and helps individuals understand when and how to take action

Clear three-pillar messages: With use of traditional financial advice stagnant, the Government should provide clear ‘rule of thumb’ guidance to help guide savers out of cash-only savings, and harness technology and automated advice to help deliver guidance. Industry must provide clear information that increases transparency around costs, and enables comparability of products and services.

Engaging, consistent and standardised guidance: A system is needed that provides access to guidance that enables individuals to combine all of their various sources of potential income, and make informed decisions. Individuals will benefit from clarity and consistent messaging across the industry as to what they need to save to achieve a given level of income. There will be a greater impact if individuals are able to access holistic financial advice across all their assets so they have a full understanding of both their financial assets and liabilities.

6. Develop an investment culture, to benefit from better potential returns

Understanding compound interest: The later that individuals leave preparing for retirement, the more expensive it becomes. The risk of needing to work longer to generate sufficient income grows. Key to tackling this is establishing clear messages to encourage individuals to invest appropriately, and early enough to benefit from compounding of returns.

Understanding future income needs: Our research shows that many individuals underestimate the amount of savings they will need to generate a certain level of retirement income. They need to understand how much income their savings may generate when they retire. Simple metrics could help, such as how much income a pot of €100,000 would buy now, and in 10 years’ time. We recommend illustrating likely future income from a Euro saved when an individual is in their ‘20s, ‘30s and ‘40s.

Support appropriate investment into a wide range of asset classes: Auto-enrolment helps individuals into investment, and default strategies are crucial in mitigating investment risk-aversion. From an investment perspective, it is essential that individuals have access via their workplace or private pensions to a wide range of appropriate asset classes in which to invest. Long-term investment also contributes to growth for the economy, and pension fund investment forms the bedrock of this funding. Individuals should receive an illiquidity premium for locking their savings away. Regulatory constraints for some retirement vehicles, restrict allocation to risk capital including equity and infrastructure, and close off a potential funding stream for companies and infrastructure projects.

7. As uptake of traditional advice declines, find new ways to support financial capability

‘Thumbs and nudges’: Given the challenge in encouraging individuals to invest their cash effectively, more consistency is needed in both in the content and delivery of financial education. The ‘thumbs and nudges’ approach could help raise awareness of the need to invest earlier.

Euros, not percentages: As many individuals find percentages challenging to understand as a monetary figure, we suggest using euros and cents in illustrative examples. It is essential that individuals receive consistent and helpful messages from industry, employers, charities and the official sector on effective savings and investment habits.

BlackRock’s Cost of Retirement Index (CoRI®)

In the US, UK and Japan, the CoRI indexes use institutional analytics to set out the estimated cost today of one unit of currency, e.g. $1, £1, or 1¥, as annual income in retirement. The indexes aim to help investors and advisers estimate annual retirement income based on savings. Investors use their age and current retirement pot to receive an estimated annual retirement income. By focusing earlier on whether they are on track, individuals have more time to act to help reach their desired annual retirement income. Possible options include adjusting current spending patterns, saving more, retiring later or gradually phasing in retirement.33

Subject to regulatory approval. This is a US product/tool and not yet available in Germany.
The cost of doing nothing: Savers need to understand that there is a risk and a cost attached to doing nothing. Remaining in cash is not the ‘safest option’ in a low interest environment.

8. Harness technology to provide individuals oversight and control of progress towards retirement goals

Create a pensions dashboard: Armed with a clear picture of all their future income streams, individuals are much better able to recognise where there’s a gap, and take appropriate action. The focus should be on the probability of generating a given income in retirement, rather than current capital values. We do not underestimate the complexity of bringing together data from multiple schemes, but this is key to supporting individuals to take more control.

State pensions calculator: The Government should also provide clarity on what an individual is entitled to under the State Pension, by developing a pensions calculator. In this way people can easily work out what they can expect from both private and public sources and what they need to do to address any shortfall.

Account aggregation and pension trackers: Younger workers moving jobs frequently may have contributed to multiple state, workplace and private pension schemes. Account aggregation technologies enable them to see all of their accounts in one place. Advances in technology mean that there’s greater potential than ever before to develop simple digital tools that aggregate an individual’s future predicted retirement income from all sources, and provide a holistic view of what their future total retirement income is likely to be. The focus should not be on current capital values, but on the future retirement income that it may deliver.

Digital identity: We support wider industry initiatives to develop a digital identity, providing individuals a single point of entry to a range of financial service providers such as insurers, banks, and asset managers. This would reduce complexity for individuals, with the added benefits of anti-money laundering and know your customer procedures being completed once, up front. A Digital ID would aid the development of digital account aggregation applications, especially if linked to a facility that would update an individual’s profile as their circumstances change. Together, these technologies could contribute significantly to giving individuals control of their retirement savings.

Industry initiatives: Dismantle barriers to investing

9. Developing outcomes-driven retirement investment solutions that meet the needs of workers today

Outcome-driven solutions: Outcome-driven solutions should help individuals to prepare for retirement during their working life and as well as support during retirement. Traditional lifecycle solutions need to evolve for the new world and be designed with the latest glidepath insight.

Simpler long-term savings products: Pension products provide an important link between long-term savings and investments. They must be easy to understand and to explain. Increasingly, products will need to serve individuals not only as they prepare for retirement, but also during retirement. With many people expected to live up to 30 years after retirement, they must consider the risk of significantly reduced incomes if they do not maintain investment exposure in their retirement portfolios, or if they annuitise too early.

Flexible products: Pension providers have a role to play in designing flexible products. The traditional ‘at retirement’ design of lifestyle funds will require more flexibility to adjust asset allocation to meet the different outcomes its members may require. A fund targeting cash withdrawals might move assets to cash during the de-risking phase, but another targeting drawdown might shift some equity exposure into a more stable multi-asset strategy. As retirement evolves, so must the available products and solutions.

Simple products: Rather than overwhelming choice, focus on simple outcomes oriented products that give confidence and reduce the anxiety of selecting the right one.

10. Provide transparent, comparable information on cost and risk, to help individuals understand their investments

Standardise disclosures: Increased transparency helps investors make decisions. Due to a siloed regulatory approach, multiple regulations currently seek to implement new requirements for cost disclosure, each containing differing technical provisions and implementation dates. These include the Undertakings for Collective Investment in Transferable Securities Directive (UCITS IV), Markets in Financial Instruments Directive (MiFID II), PRIIPs and the Insurance Distribution Directive (IDD). The implementation of the Government’s Occupational Pension Reform Act also includes cost disclosures. A standardised disclosure of fees and charges would be helpful.
**MiFID II**: The upcoming cost disclosures in MiFID II are designed to provide full cost transparency through the full distribution chain, enabling investors to compare costs of asset managers and relevant intermediary services. We recommend focusing on effective disclosure that provides for: (a) the administration costs; (b) the ongoing fund management charges; (c) any advisor charges; (d) transaction costs and (e) taxation.

11. **Articulate why value for money is more than just buying the cheapest product**

**Cost is just one aspect of value**: ‘Value’ is not just product cost, but includes assessing risk, performance and quality of servicing too. While scheme charges (the total cost of portfolio management, administration, advice and underlying transaction costs) can all contribute to the level of net returns, it is also important that the industry explains how higher charging strategies may add additional value. Charges caps could imply that cheaper is better, but this is an oversimplification. The focus should be on likely outcomes, as well as costs. We portray this as an equation:

\[ \text{Contributions} \times (\text{Investment returns} - \text{costs}) = \text{retirement pot} \]

**Contribution levels are crucial**: The level of contributions is the most important part of the equation. It is for the individual to decide – ideally with the benefit of auto-enrolment and employer matching contributions – the right level of contributions for them. Cost adjusted investment return is then the second key determinant of success. The role of an investment manager is to find the right balance between investments within relevant cost constraints.

**Risk mitigation**: Strategies that have the potential to deliver higher investment returns or increased risk mitigation should not be excluded purely on the basis of cost. Risk mitigation strategies also become increasingly important as people approach their retirement or draw down date and while these strategies may have an additional cost they are important to helping people meet their goals.
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Endnotes

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33. The BlackRock CoRI Retirement Indices (“CoRI Indices”) are a suite of age-based Indices designed specifically for individuals aged 55 to 74. Each CoRI Index seeks to track the changes over time in the estimated cost of lifetime retirement income for individuals who turn or turned 65 in the year specified in the Index. It does this by providing a daily ‘level’ that can be used to estimate how much annual lifetime retirement income an individual’s current retirement savings could generate. The CoRI Retirement Indexes and the CoRI tool do not guarantee future income or protect against loss of principal. There can be no assurance that an investment strategy based on the CoRI Retirement Indexes or the CoRI tool will be successful. Indexes are unmanaged and one cannot invest directly in an index. The CoRI Retirement Indexes are maintained by BlackRock Index Services, LLC (the "Affiliated Index Provider"), a subsidiary of BlackRock, Inc., that designs, sponsors and publishes indices for use in portfolio benchmarking and portfolio management. While the Affiliated Index Provider publishes descriptions of what the CoRI Retirement Indexes are designed to achieve, the Affiliated Index Provider does not provide any warranty or accept any liability in relation to quality, accuracy or completeness of data in respect of the CoRI Retirement Indexes, and does not guarantee that the CoRI Retirement Indexes will not deviate from their stated methodologies. The Affiliated Index Provider does not provide any warranty or guarantee for Affiliated Index Provider errors.
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