

Superannuation
Productivity Commission
Locked Bag 2, Collins St East
Melbourne
VIC 8003

14 June 2016

Subject: Superannuation Efficiency and Competitiveness

Dear Karen and Angela

We refer to our submission of 27 April 2016 responding to the Commission's Issues Paper of March 2016 entitled *Superannuation Efficiency and Competitiveness*.

In Attachment 3 of that submission (under Investment Fees), we noted that, from Mercer's experience as both a leading global asset consultant for major superannuation funds and a major buyer of investment services, our observation was that the Australian market for superannuation funds management is highly competitive and overseas fund managers frequently need to discount their rack rates to compete with the Australian market.

To test the validity of this observation, we sought comments from a number of global investment managers on the level of investment management fees in Australia relative to the global market, based on their own experience in distributing global products into the Australian market.

The responses we received are set out in the Attachment for the information of the Commission. We believe these comments provide strong support for the contention that, in a global context, the Australian institutional market place is very cost competitive for global investment managers.

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments, with assets of US\$140 billion under administration or advice. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Page 2
14 June 2016
Superannuation
Productivity Commission

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over \$50 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and more than \$20 billion in assets under management in Australia.

We would be delighted to meet with you during your Inquiry to discuss the above topics or other related matters where we may be able to provide you with additional insights into the Australian superannuation industry and operations. Please contact me on _____ or by email if you would like to arrange a discussion.

Yours sincerely

Dr David Knox
Senior Partner

Attachment: Global asset manager comments on Australian superannuation fund investment fee levels

The views quoted below have been provided in response to a Mercer request for comments on the level of investment management fees in Australia relative to the global market, based on the manager's own experience in distributing global products into the Australian market.

Important Note: The manager's name has been provided where they have consented to this. However note that where the manager name is provided, the comments do not necessarily represent a formal 'house view' of the organisation. Comments from the following 13 managers are set out in turn below.

- Manager A - J.P. Morgan Asset Management**
- Manager B - Franklin Templeton Investments Australia**
- Manager C - Invesco**
- Manager D - Insight**
- Manager E - AQR**
- Manager F - Cantab Capital Partners LLP**
- Manager G - anonymous**
- Manager H - Pioneer**
- Manager I - anonymous**
- Manager J - Baillie Gifford**
- Manager K - anonymous**
- Manager L - anonymous**
- Manager M - anonymous**

Manager A - J.P. Morgan Asset Management

"In essence:

- Australia is one of, if not the single most, fee sensitive and competitive markets we operate in.
- Anecdotal, institutional asset management fees in Australia would be 20-50% lower than other developed markets in which we offer institutional strategies.
- J.P. Morgan Asset Management only offers actively managed strategies, many of which have limited capacity. For limited capacity strategies, there is significantly reduced incentive to offer these strategies to Australian investors, at a heavily discounted price – when investors in other domiciles are prepared to pay standard fees for these. Some of our "best ideas" strategies are not offered in Australia due to market fees being significantly lower than other markets for these strategies.

- In Australia we are primarily focused on alternatives and international asset classes – we have made a strategic decision not to compete in Australian equities or Australian fixed interest as these sectors are already over-serviced with extremely low fee margins
- By Australian superannuation funds fixating on fee levels, rather than net returns, in many cases members' funds are not being invested in strategies which are more long-term in nature with higher alpha expectations and which may deliver stronger post-fee returns. In many funds are following sub-optimal investment strategies and the “race to the bottom” actually disadvantages member balances over the long term.
- The move to indexing and in-sourcing of asset management by superannuation funds further reduces the “investable assets” that a large number of global managers are competing for. In over 180-200+ managers competing in the active international equity space for fewer (but larger) mandates.
- Further adding to the mix – Australia is a relatively “high cost” country to do business in, with wages, travel and legal/regulatory expenses further reducing margins.”

Manager B - Franklin Templeton Investments Australia

“Franklin Templeton are a global funds management company with USD\$742.6 bn under management as at 31 March 2016 and offices in 35 countries. Franklin Templeton has had a presence in Australia for 28 years. The Australian office is our sixth largest office with US\$16.7 bn under management sourced from Australian and New Zealand institutional and retail investors.

As a global funds manager offering, in some instances, similar products in multiple jurisdictions, we are able to share our experience and offer a global perspective on investment management fees.

Reflecting strong fee based competition, investment management fees in Australia are highly competitive. In our experience, Australian clients with whom we interface and negotiate are sophisticated buyers of fund management products with a high level of understanding of investment markets and products. Besides the strong focus on fees, these investors are outcome oriented and the returns on their investment after fees are paramount. Positively, after tax returns are also receiving greater recognition. Individuals making manager selection and portfolio construction decisions are sometimes remunerated on the basis of returns and, at the least, are highly motivated to deliver competitive returns given the inherent measurability of their decisions. Some funds have adopted a “fee-budgeting” approach to building portfolios which is recognized as not being optimal from a return perspective but is indicative of the fee pressures that funds believe they face.

While there is a tendency for Australian funds to seek tailored product offerings which are generally more expensive to deliver and a short term focus is sometimes evident, the funds

management market is highly competitive on fees and there are a large number of suppliers. Registration and licensing requirements aside, the funds management industry has low barriers to entry. Superannuation funds may outsource investment management to global product manufacturers, such as Franklin Templeton Investment, local fund managers which may be part of larger multi product manufacturers or boutiques or larger funds can in-source.

Franklin Templeton's total effective fee rate across the Australian business is lower than other markets in which we operate, even when our low fee Australian equity business is excluded from the analysis. If you consider the same product distributed in different markets such as the Templeton Global Equity Funds (probably our most homogeneous product offering) Australian fees are very competitive. New business sourced from Australia is always the subject of fee negotiation.

We also have market data sourced from an external global consultant dated March 2015 which describes Australia as perceived to having the lowest fee levels across global industry participants reflecting the market structure, high bargaining power of superannuation funds and regulatory scrutiny. The report outlines regulatory and public pressure on fees resulting in fee sensitivity not seen in other jurisdictions. International fund managers know Australia has low fees but come to diversify their book and are willing to accept low fee levels. Large market participants (buyers) know each other well and are well aware of fee levels being charged.

Of course the risk in this acute fee sensitivity is that sub optimal portfolio structures are adopted, expensive (but high returning) asset classes are avoided and after tax, after fee returns suffer as a result.”

Manager C – Invesco

- “1. Where it concerns traditional listed markets (equities, bonds, property), the fee regime in Australia is very competitive to our regional & global peers. For example, our UK based global equity and bond teams are less willing to release capacity into Australia as they are selling these products at fee premiums within the EMEA region that could not be achieved here in Australia.
2. If the listed market is more capacity constrained (e.g. EM equities/Small Caps) the Australian market is less price sensitive and more on par with our regional & global peers.
3. In the non-traditional asset classes (Liquid Alternatives & Real Assets), the Australian market is also on par with our regional & global peers.
4. In the lower risk/return space (Passive, Enhanced Index) we have also found the Australian market to be very aggressive on pricing.”

Page 6
14 June 2016
Superannuation
Productivity Commission

Manager D – Insight

- “1. Generally fees achieved in Australia are 10 to 30 per cent less than in other major markets we operate in
2. Low fees cause us to restrict supply of our best performing investment strategies to Australia, particularly where the strategy is capacity constrained
3. Our view is that a lack of focus on net returns in Australia causes a large disadvantage to our superannuation investors. This is caused by a mix of MySuper misinformation, media and political ignorance in relation to how our industry actually works and is in fact aligned with investor interests.

The proof statement for the comments above is that Future Fund pay significantly higher investment fees than super funds and achieve demonstrably better net returns.”

Manager E – AQR

“AQR is a global asset management firm with over USD150 billion in assets under management across both traditional long-only equity strategies and alternative investment strategies, of which the firm is one of the world's largest providers. We offer investors access to these investments globally through separate accounts and comingled vehicles.

As part of a global business, AQR has worked with Australian superannuation clients for over a decade and today manage over AUD20 billion in assets for Australian clients. Over this decade, we have observed one persistent characteristic of Australian superfunds relative to their global peers- That is a focus on cost and value for money: Cost is a crucial part of any discussion with a superannuation fund with respect to any investment strategy- this is often very explicit and usually an early obstacle to be justified relative to the merits of the strategy before a conversation can be continued.

Looking at our client base today we observe that, of all of the major markets we operate in, Australian clients;

- 1) Have proportionately higher allocations to lower cost strategies relative to other regions
- 2) Have negotiated much lower base fees in exchange for performance contingent fees than any other region

These characteristics have meant that AQR does not actively discuss higher cost investment strategies with superannuation funds and in many cases we have developed lower cost variants of our strategies specifically for the Australian market.”

Page 7
14 June 2016
Superannuation
Productivity Commission

Manager F – Cantab Capital Partners LLP

“From our experience of dealing with superannuation schemes in Australia, we have found them very sophisticated investors, whose investment teams are comprised of experienced investment professionals. Supers are very attuned to the investment managers fees. A concern about the fees is common for all institutional investors looking after public money – pension plans in the US and the UK are a good example of that. In Australia, however, the fee discussion comes in more force than elsewhere, making the Australian superannuation market highly competitive. It is also not inconceivable to envisage the situations when cost preoccupation can compromise the investment decision making an investor chose the cheapest rather than the most suitable investment manager for them.”

Manager G - Anonymous

“We’re an investment management firm with offices around the world: US, Europe, Asia and Australia. We find that generally, the fees that we have to offer Australian clients (or prospective Australian clients) for our global strategies are often lower than we need to offer in other markets around the world. We certainly see more of a focus on fees here than elsewhere and it’s extremely competitive. We believe this can be both a positive and a negative for clients. The focus on fees by Australian clients/prospects and their willingness (and ability!) to negotiate us hard on pricing means they often get what we believe are very competitive fees. However, we would also argue that there’s too much of a focus on fees by many in the market (not only funds but surveys, media etc) rather than expected net-of-fee alpha. Our other offices around the world have much more success than us here in selling strategies that while they may have a higher headline fee, also have a higher expected net-of-fee alpha. For example, we have had more success in other regions with Global Market Neutral, Emerging Markets Small Caps etc. These strategies often can’t even be discussed in detail here due to the headline fee. In this respect, clients with a headline fee focus at the expense of everything else could potentially lead to sub-optimal outcomes in our view.”

Manager H – Pioneer

“When competing for institutional mandates in Australia, we have observed price competition to be very aggressive, when compared to similar sized mandates in Asia, the Middle East and Europe. This is unsurprising, given that many of our competitors are attracted to Australia’s large scale, continued industry growth and transparent regulation. Competition for business has, and will continue to, drive fees down.

Further, the more recent introduction and rapid growth of MySuper default offerings has placed greater focus on costs. This heightened focus on costs and fees is a two edged sword. At face value, lower fees provide a benefit to the investor, and this is healthy. However, a sole focus on costs is very likely to see global managers choose to distribute their limited capacity, higher risk, higher return and higher fee offerings to other markets in preference to Australia. Such a trend will not advantage the Australian investor.”

Manager I – anonymous

“[Manager I], among several other global Managers, participated in a confidential survey conducted by the FSC in late 2014 on the topic of fee competitiveness in Australia.... As background, we considered the investment products (global equity, emerging market equity, global property and global bonds) that those Managers sell into Australia and other jurisdictions around the world (US, UK, EMEA ex UK, AxJ and Japan) and calculated the weighted average fee of similar sized mandates in each region. It was clear from our analysis that the weighted average fee charged to Australian Institutions was considerably lower across each product set with a very modest exception in global bonds. On average across all Managers, global equity fees in Australia relative to other regions were 11bps lower, emerging equity fees were 13bps lower and global property fees were 6bps lower. As mentioned, global bonds were the exception where weighted average fees were marginally more expensive (less than 0.1% on average).

It is widely acknowledged and accepted within [Manager I’s] global business that the Australian market is the most highly competitive in the world with fee margin compression only continuing to accelerate. Personally, I think our industry bodies and many industry participants are right to continue to challenge this inaccurate perception that fees charged in Australia are not competitive globally – that’s simply not been our experience in this market over the past 25 years. I also believe we need to continue to challenge the debate around whether a ‘race to the bottom’ in fees without an appropriate consideration of net of fee returns, is really what’s best for our ultimate clients, the members.

The Australian market and the funds within it have undergone a radical transformation over the past decade and continue to do so with consolidation continuing and funds using the benefits of scale and experience to achieve lower costs.”

Manager J – Baillie Gifford

“Baillie Gifford have globally applied institutional fee scales for our clients worldwide. The fee levels are set in the domestic base currency to be as close as possible to our standard scale and do not change as a result of short term relative currency movements. We apply these fee scales with a high degree of rigidity. We are firm believers in the principle of treating all clients fairly, and hence we apply fee scales across countries and within countries with very little latitude to deviate. We have large number of MFN clauses in place with clients worldwide and we have little difficulty in agreeing to such clauses with new clients as we have our overriding principle to which we adhere of ‘treating clients fairly’.

It is our experience that the Australian institutional asset management business is highly competitive on fees. We distribute the same investment strategies (LTGG and Global Alpha) to multiple countries and find Australia is one of the keener markets on securing lower fees. There are other markets where our strategies are also distributed. These are often offered in a similar structure to that in Australia, whereby our strategy is ‘bundled’ into a broader offering which is then bought/owned by the ultimate customer/asset owner. It is our anecdotal observation that the Australian ‘bundlers’ (aggregators) apply very reasonable ‘on-costs’ to their customers for their added value in this chain, as compared to other countries where the on-costs applied by aggregators are outrageous. We have chosen on certain occasions not to participate in certain aggregator structures (not in Australia) where we feel that whilst our fees can (and do) offer the end asset owner the real opportunity of ‘alpha capture’ there are certain arrangements whereby an egregious middleman party is extracting such a high ‘aggregator’ fee that the end asset owners chances of gaining significant financial gain from skilled active management are much reduced. We do not observe this to be the case in Australia.

Our experience in Australia is that clients have been focussed on the correct metric – delivered alpha net of fees. In our written reports to clients we have a policy of showing cumulative returns since inception, net of fees vs. the benchmark. In other words, we endeavour to be as transparent as possible. (In certain instances, clients seem distracted to focus on absolute fee levels, which is unfortunate). Our feedback from clients (including in Australia) is this is valued information and it is lamentable that all other managers do not follow this procedure.”

Manager K - MFS

“In general we would be supportive of Mercer’s view that the fees in the Australian marketplace are quite competitive in the global landscape. Australia has neither the lowest nor certainly the highest fees, but rather is quite competitively placed.

MFS's pricing approach is to be as consistent as possible globally, given the realities of local market and client size, distribution and product mechanisms. Much of the regional variations in pricing are driven by one or more of these factors rather than some systematic premium or discount. At the end of the day, we feel market forces do prevail in largely ensuring parity, and we don't see Australia as an exception."

Manager L – anonymous

"In our experience, the debate in Australia around lowering fees misses the point completely when it comes to the fee paid to the underlying investment manager who is responsible for delivering a return to the end saver. While we would agree with many of the arguments against the numerous layers of fees that are charged by various intermediaries along the value chain, our experience in this market is the following:

1. Funds in Australia compete, it seems, to the death on offering the lowest fee to members. Members can't eat low fees but they can eat returns.
2. We are often approached along the following lines: "This is the fee budget our marketing people say we can afford. What can you give me for that?" Note that the "afford" comment has nothing to do with the return their members need but is driven entirely by what their marketing people believe will help them win money from other funds.
3. Many high quality managers simply no longer visit Australia and I know there are many world-class strategies within our firm that we will never bring to Australia, purely because the Australian fee budget doesn't allow for it.

At the end of the day, this industry's premise is to help members retire with dignity. By focusing on the goal (generating returns) rather than the politically popular (low fees argument) we have a far better chance of achieving that laudable goal. Australia stands at a crossroads in many ways with this fee debate and the impending retirement demographic. It is critical that our leaders display leadership and stewardship and focus the industry on what will help make money for members."

Manager M – anonymous

"In an effort to demonstrate the competitiveness of fees in Australia compared to the rest of the world, [the manager] compared a relatively homogenous approach and the fees associated by region. [The manager] is a substantial global investment manager across all asset classes but in this instance took a relatively standard global bond mandate and compared the fees for similar mandate sizes, similar guidelines and alpha expectations. We then ranked each of the mandates by effective fee and labelled them by region. The following regions were in the sample: Asia ex-Japan, Australia/NZ, Canada, Europe ex-UK, UK/Ireland/Africa and the US.

Page 11
14 June 2016
Superannuation
Productivity Commission

On this metric, the Australia/New Zealand region was equal to the UK/Ireland/Africa in terms of the lowest cost regions across the global book of business. The sample size was over 30 equivalent type mandates.

[The manager] views Australia as one of the most price sensitive markets in the world across global fixed income, global equities and multi-asset portfolios. All of our global competitors are active in Australia (whether they have an office in Australia, serviced from the region and/or represented by third party marketers). The consolidation in the market has created a smaller group of large asset owners who naturally have more pricing power. There is a strong demand for high capacity, low fee products. Low capacity higher fee products are less in demand and increasingly run the risk of not being marketed in Australia.”