

# Superannuation: Assessing Efficiency and Competitiveness

## Submission to Productivity Commission: Comments on the Draft Report of April 2018

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### **INTRODUCTION**

It is very pleasing to read the detailed work undertaken that aims to improve retirement income outcomes for Australians, congratulations. I can see that many of the recommendations will improve the outcomes for members of superannuation funds.

However, I wish to comment on two aspects of the draft report

- the misleading nature of one impactful conclusion in the draft report that has been sensationalised by the press and that forms, in my view, a false basis for numerous recommendations relating to Best In Show, and
- so called life cycle strategies (re Information Request 4.1).

### **SUMMARY CONCLUSION**

- Best In Show
  - I believe that the basis for developing a “Best In Show” list is flawed.
  - Regardless of the above comment, the proposed use of such a Best In Show list creates a massive contingent liability for the Australian Government.
- So called life cycle strategies
  - are unsuitable for default investment strategies
  - but may offer enhanced retirement outcomes if tailored for individuals (or cohorts) AND applied over “whole of life” investing, i.e. seamlessly through both accumulation and retirement. But the industry as a whole is far from ready for such a structure.

### **DETAILS: “BEST IN SHOW” CONCEPT**

1. I refer to statements such as<sup>1</sup>

“The wide dispersion in fund performance over the long-term has large implications for members’ retirement incomes. For example, a typical full-time

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<sup>1</sup> Page 10, Overview of Draft Report, April 2018

worker in the median fund in the bottom quartile (in terms of investment performance) over their lifetime would retire with a balance 53 per cent (or \$635 000) lower than if they were in the median top-quartile fund (cameo 1)."

2. and DRAFT FINDING 2.3

"There is wide variation in performance in the default segment ..... If all members in these underperforming products received the median return from a top-10 MySuper product, they would collectively be \$1.3 billion a year better off. Being in an underperforming product means that, on retirement, a typical worker (starting work today) is projected to have a balance 36 per cent lower (or \$375 000 less to retire with)."

3. I then note the connection from these findings to part of the selection criteria for the "Best In Show" Shortlist for new members<sup>2</sup>

*"The shortlist should be developed by an independent expert panel ..... It should particularly consider long-term net returns and fees, as well as each applicant's investment strategy, intrafund advice, governance and track record on identifying and meeting member needs."*

4. and the report is very clear that one expectation from this process is better future investment performance<sup>3</sup>

"How will members benefit?"

Our changes to default allocation [using Best In Show funds] will immediately benefit new entrants to the workforce by placing most in a fund that is likely to deliver the best outcomes — with a potentially large impact on members' balances at retirement."

First problem

Whilst the PC's findings in points (1) and (2) above clearly illustrate the long term impact on one's account balance at retirement from a range of performance outcomes using perfect hindsight, it is very difficult to translate that observation into practice by forecasting which individual funds will deliver better future long term return outcomes.

To assist explain this, consider the considerable resources expended by superannuation funds aiming to select suitable fund managers to manage part of their assets. In public, many say that investment performance is not key and that they largely rely on other considerations. But, mandates won and lost often follow recent short-term performance (industry observations and also supported by a research project by a leading wholesale asset consultant). Furthermore, past performance is not a useful indicator of future performance (even when style and

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<sup>2</sup> Page 34, Overview of Draft Report, April 2018

<sup>3</sup> Page 35, Overview of Draft Report, April 2018

process are accounted for). In a confidential project I undertook for a client analysing predictability of fund manager performance rankings, there was essentially a zero correlation between past and future rankings in each asset classes and within sub sections of some asset classes. I also note that the most consistently ranked investment process for listed equities is one that follows the benchmark (periodic S&P analysis in various countries including Australia shows that benchmarks are regularly around the top quartile performance boundary).

Lastly, a common phrase in disclaimers for investment products relates to “past performance is not an indicator of future performance”.

Thus I believe that the concept of aiming to determine funds expected to deliver better future investment performance for inclusion in the Best In Show is flawed.

### Second Problem

Having said that, I agree that at any point in time one can theoretically perform an assessment of other factors relating to, for example, “*investment strategy, intrafund advice, governance and track record on identifying and meeting member needs.*”<sup>4</sup>

However, is this practically possible?

- Most people with the skills and experience to undertake this independent analysis will be employed in some capacity in the industry resulting in lack of independence. At best one may be able to identify some people who have left active work within the industry. But even they will need to rely on extensive research in order to have any hope of obtaining sufficient information to make assessments of funds relating to the selection criteria. Unfortunately such research will undoubtedly be performed by industry participants and probably lack independence.
- As the PC itself has found, obtaining the necessary information from Super Funds is difficult. This is likely to also be reflected in information required to undertake the assessments for a short list. However, since the stakes are very high for funds (to be included on a Best In Show list) and one would expect that they will have a strong incentive to provide the relevant information for assessment to be included on the Best In Show list. If this list is implemented, it will be interesting to see how funds respond!
- If most criteria are subjective, then the composition of funds in the Best In Show list will be dependent on the composition of the Expert Panel, i.e. different decision makers will make different decisions. This is analogous to different asset consultants having different recommended managers and different asset allocation advice. If past performance is a significant criteria, then the list will be more objective but, as pointed out above, the resultant list will represent a historical better performing list and is likely to have little relation to future results.
- Unlike decisions by Super Funds in manager or asset selection where the manager or asset specific risk can be significantly diversified away, the fund specific risk from a person being in only one super fund can not be diversified

since it is impractical for a member to diversify this risk by investing in multiple funds, let alone an aim of the PC to avoid multiple accounts.

Hence, I believe that there are practical difficulties in establishing a Best In Show list that will actually prove its worth in the future.

### Third Problem

One can almost guarantee that some of the funds in the Best In Show list will be underperformers in the future. For some margin of under and outperformance, it would not be unreasonable to expect that about a third of Best In Show funds turn out to be underperformers in the future, another third outperformers and the remaining third around average<sup>5</sup>.

How will members react when they realise that the Best In Show fund they are a member of turns out to be an underperformer? Will there be future class actions against the Government to fund the significant differences between the account balance that each member could have achieved from, say, the median performance of the actual top 10 performing funds (using hindsight) and the member's actual much lower account balance in the fund they invested in; a fund that the Government established Expert Panel set as one of the defaults. Based on the differences outlined in the PC's Draft Report (e.g. as quoted above in points (1) and (2)), there could be significant amounts of tax payer money at risk.

Perhaps the Best In Show funds may be mandated to include a "past performance is not an indication of future performance" disclaimer, but that would make a complete mockery of the whole process.

Regardless of the first and second problems raised above, the planned use of a Best In Show list raises a significant contingent liability for both the Government and potentially members of the Expert Panel.

## **COMMENTS RE: INFORMATION REQUEST 4.1 LIFE CYCLE PRODUCTS<sup>6</sup>**

The text below is an extract from a course I wrote for the Master of Applied Finance degree from Macquarie University's Applied Finance Centre. One of the course's aims is to analyse "*whole of life investing with the main focus on funding expenditure in retirement*"

There is some debate regarding the usefulness of target date funds or glide paths for funding retirement outcomes. In some unpublished by Peter Vann (2014), the effectiveness of target date funds and glide paths was compared to typical static asset allocations for funding retirement outcomes. Vann showed that

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<sup>5</sup> Assuming a lack of correlation (or even low to modest correlation) between past and future performance.

<sup>6</sup> I note that the PC uses the term "life cycle" to refer to investment strategies where the asset allocation changes over time (generally through the accumulation phase). Whereas I use the term "glide path" so as, inter alia, not to cause confusion with a different use of the term, namely "life cycle" in Modigliani's Life Cycle Hypothesis. Modigliani received a Nobel prize in 1985 "for his pioneering analyses of saving and of financial markets" and referred to his Life Cycle Hypothesis of saving in his Nobel prize speech, hence I respect his higher authority.

“...whilst glide paths potentially can offer better retirement outcomes, the shape of the glide path needs to account for a member's age and fundedness. If one starts reducing the allocation to growth too early or too fast, then many members will reduce their retirement outcomes and be worse off than adopting the optimal static asset allocation for their circumstances”

It was shown that a glide path which delivered the highest SWR [safe withdrawal rate] for the particular situation delivered a small benefit in higher SWRs compared to a static asset allocation. But the research also showed that the optimal glide path trajectory was quite idiosyncratic. Hence Vann concluded that a) the good old balanced fund is quite robust and b) optimal glide paths can be obtained, but they need to be developed for each person (and he suspected that they require monitoring over time but this has not been studied yet).

**Based on the above commentary and other times that I have analysed glide paths, I would not encourage their use for default investment strategies in the accumulation or retirement phase of superannuation.**

However, there could be merit in a “whole of life” strategy where asset allocation is adjusted over time for individual members (or cohorts of members), but I observe that there are currently too many practical difficulties such as

- a) the current separation between accumulation and retirement strategies
- b) the current lack of access to member data that funds would require (personal communication with many funds), and
- c) the current inability of the industry to apply Occam's razor when considering solutions to the retirement challenge.

The industry needs to, at a minimum, evolve past the above issues before any worthwhile practical “whole of life” member tailored asset investment strategy solutions can be developed that in theory should provide better retirement outcomes for individual members.

There is one large innovative superannuation fund that has implemented the initial steps towards this goal. But whilst they are an industry pioneer, I suspect that they have many hurdles to jump and more trails to blaze whilst they aim to deliver a “*financial wellbeing objective [better retirement outcomes for members] <sup>7</sup>; [by] moving towards individualisation (“a cohort of one”)..... [and] adjust investment strategies over time*”<sup>8</sup>.

## **CLOSING COMMENT**

I sincerely hope that the resultant actions following further considerations of the recommendations relating to a Best In Show list do not undermine the good work presented in other areas of the Draft Report.

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<sup>7</sup> Words in square brackets are inserted by me for clarity

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[http://www.actuaries.org/cancun2017/Presentations/9.%20Bnic%20Van%20Wyk\\_Presentation.pdf](http://www.actuaries.org/cancun2017/Presentations/9.%20Bnic%20Van%20Wyk_Presentation.pdf)