

25 August 2017

Australian Government
Productivity Commission
4 National Circuit
Barton ACT 2600

By email: super@pc.gov.au

To whom it may concern

Productivity Commission Issues Paper Stage 3

Superannuation: Assessing Competitiveness and Efficiency

Thank you for the opportunity to contribute to your study. Rice Warner would be pleased to provide research or advice to assist you with this important work. We have attached our submission which sets out our response to two aspects of the Productivity Commission Issues Paper, Superannuation: Assessing Competitiveness and Efficiency. We have also provided a separate submission covering insurance issues.

We have limited our comments to the technical questions related to:

- estimating the utilisation and pass through of economies of scale
- investment performance benchmarking.

We have not commented in this submission on questions regarding:

- member behaviour
- risk of poor Choice
- the risk of entrenching disengaged members in poor products.

However, we would point the Productivity Commission to recent information published by Rice Warner on these topics (<http://www.ricewarner.com/the-shift-from-disengaged-to-ill-informed-members/>), we are also available to discuss our previous research or content in this submission should you require further information.

We wish you well with this challenging work.

Yours sincerely

Michael Rice
CEO & Authorised Representative
Rice Warner Pty Ltd AFSL 239 191

RICEWARNER

Insight like no other

Superannuation: Assessing Competitiveness and Efficiency



Submission to Productivity Commission –
Superannuation Aspects

25 August 2017

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1. Executive Summary

1.1 About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives. Rice Warner is an independent firm of consultants, using actuarial skills and a strong research base to back its opinion.

Over the last three decades, Rice Warner has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds as well as many other participants in the industry (service suppliers to funds, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management and life insurance industries.

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1.2 About this report

This report forms Rice Warner's submission covering two aspects of the Productivity Commission Issues Paper, Superannuation: Assessing Competitiveness and Efficiency July 2017 ('Issues Paper'). Rice Warner has provided a separate submission covering insurance aspects of the Issues Paper.

In this submission, we have limited our comments to the technical questions put forward by the Productivity Commission (PC) related to:

- estimating the utilisation and pass through of economies of scale
- investment performance benchmarking.

Our response covers our answers to the specific questions set by the PC using our experience from our *Superannuation Expense Benchmarking Report* and *Stochastic Investment Modelling*.

1.3 Recommendations

1.3.1 Economies of scale

Our recommendations regarding the estimation of utilisation and pass through of economies of scale are as follows:

Methodology and challenges

- Cost function
 - Rice Warner finds that operating expenses vs. scale (members) follows a logarithmic trend.
 - Allowance in the cost function should be made for different benefit designs which can have a substantial impact on costs, but should not allow for elements over which funds have control e.g. decisions to insource or outsource functions.
 - The relationship between investment management costs and scale is complex, we recommend the PC attempt to benchmark this at the asset class level where possible.
 - Other investment expenses (e.g. asset consulting, custody) do exhibit scale benefits and can be estimated more easily using a cost function vs. funds under management.
- Realised scale
 - Realised economies of scale should consider that cost savings may be passed through to members in the form of enhanced services rather than simply fee reductions.
 - We refer the Productivity Commission to our previous research for the Financial Systems Inquiry, Rice Warner *Superannuation Fees, 2014*.

Survivor bias and merger activity

- Cost function
 - We recommend that the PC seeks to form a *time homogenous* estimate of the cost curve.
 - We caution against the ability of outliers to distort the shape of the cost curve.
 - Historical estimates of cost should be adjusted for inflation.
 - Consolidation is a legitimate form by which to achieve scale. Including funds both pre and post-merger would allow for the best *time homogenous* estimate.
- Realised scale
 - Estimates of realised scale should consider the position of members in incumbent funds at the start of the measurement period rather than assuming they were in the successor fund over the period considered.

1.3.2 Investment performance benchmarking

Our recommendations regarding investment performance benchmarking are as follows:

System level benchmarking

- We recommend reference portfolios use system level asset allocation as the basis given the fact that Trustees do not direct the asset allocation for 65% of the market.

- Taxes could be netted from the reference portfolio at 15% if the PC wished to give Trustees credit for optimising the tax position of the portfolio (through holding assets for the CGT discount or overweighting to assets with franking credits). Alternatively, the PC should use ATO statistics to guide assumptions regarding CGT discounts and franking if deducting tax on a 'like-for-like' basis is preferred.
- Fees for the reference portfolio should be based on the fees that would be charged for the liquid, passive and investable portfolio that it represents..
- We are generally comfortable with the asset class benchmarks the PC has suggested in its Stage 1 report.

Asset class level benchmarking

- Historical returns by asset class will be difficult to collect.
 - Surveys of funds would be the most direct and accurate method provided the funds have the available data, are willing to provide it and answer the surveys consistently.
 - Alternatively, the PC may consider using sector based investment options offered by funds as a proxy of the asset class return for the fund, such estimates will likely be more accurate for the not-for-profit sector.
 - Retail funds have greater diversity in products. We have indicated the cumulative percentage of assets represented by the ranked investment options in Section 3.3.1 (What is the best way to estimate long-term net returns at the asset-class level for the system and why?).
- We are generally comfortable with the asset class benchmarks the PC has suggested in its Stage 1 report.
- Unlisted assets should be benchmarked against the most similar index available, for example, a listed equivalent.

Historical vs. future performance

- We note that past performance is not an indicator of future performance.
- We recommend that the PC consider likely future performance of superannuation funds based on expected return and volatility estimates as part of its process.

Past performance is valid for:

1. Measuring the success of the whole system - has the industry achieved return greater than $CPI + x$?
2. Persistently poor performers can be identified and eliminated.

This report was prepared and peer reviewed for the Productivity Commission by the following consultants.

Prepared by

Peer Reviewed by

Nathan Bonarius
Consultant

Michael Rice
CEO

25 August 2017

2. Estimating the utilisation and pass through of economies of scale

2.1 Technical questions for participants

What methodology would you use to estimate unused scale economies and pass through of realised scale economies, and why?

What challenges would need to be overcome with that approach?

How material are issues around selection (survivorship) bias and how could this be controlled for?

How should the level of merger activity in recent years be factored into the analysis and the interpretation of results?

2.2 The Productivity Commission's suggested approach

Rice Warner has long examined the relationship between fund size and expenses as part of our annual *Superannuation Expense Benchmarking Report*. We would also point the PC to our previous work for the Financial Systems Inquiry which sought to examine the pass through of cost savings to members in the form of lower fees over the previous decade. This report can be found here:

<http://fsi.gov.au/files/2014/12/Superannuation-fees.pdf>

We note that the Productivity Commission has suggested two indicators for measuring economies of scale:

- Indicator 1: Cost function – regression of costs on FUM/Members
 - may control for other factors
 - possible allowance for selection (survivorship) bias in the data
 - will be used to estimate whether costs would be lower if there were greater consolidation of funds.
- Indicator 2: Realised scale
 - estimates realised scale economies using the cost function
 - evaluate whether scale economies are passed through to members through lower fees.

2.3 Methodology and challenges

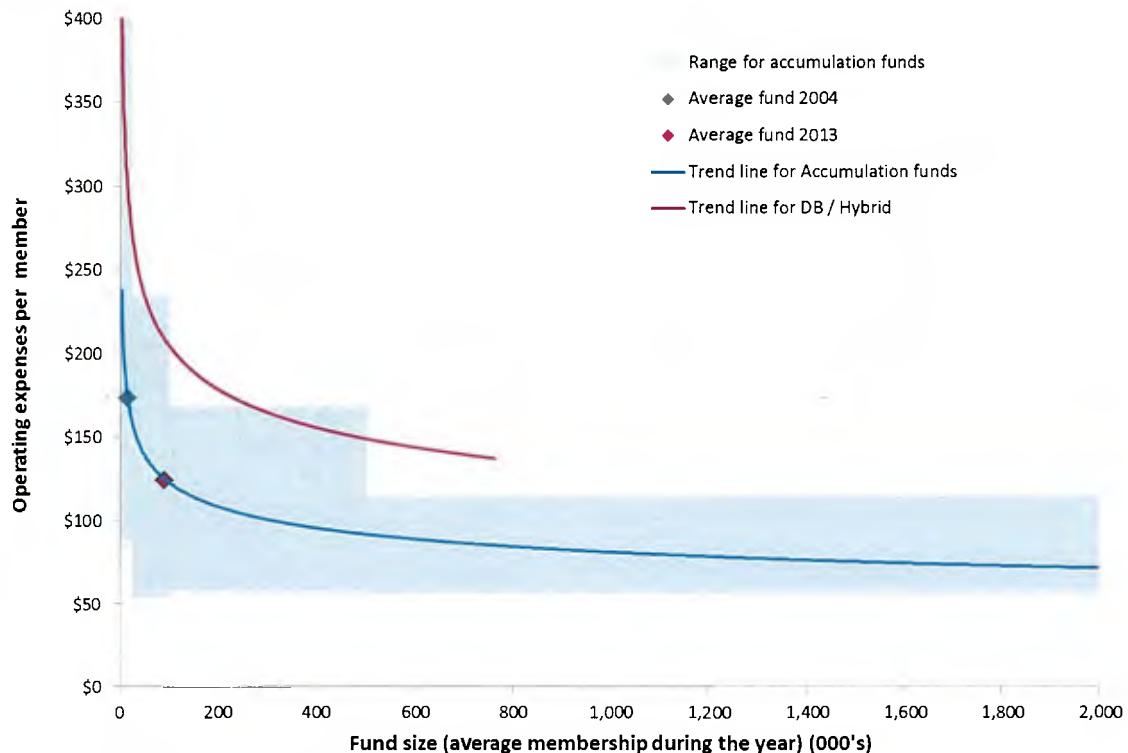
2.3.1 Cost function

For the first indicator, we would point to the work we previously provided to the FSI. We typically estimate the relationship between fund size and operating costs using a logarithmic function. This function is chosen because of the observed relationship between fund size and expenses, with most of the savings being made in the first 100,000 membership band, with flattening out of scale benefits in the tail of the distribution.

We note that costs will be lower if there is greater consolidation of funds. Thus the real question that the PC should address is by how much will they be lower. We also consider that larger funds make use of their deeper resources to provide enhanced services to members.

Graph 1 demonstrates the scale results of our previous work for the FSI which shows the relationship between operational expenses and scale. Defined benefits funds are more complex and (smaller), as such their trend line is shown separately.

Graph 1. Superannuation Operating Expenses vs. Scale



Source: Rice Warner *Superannuation Fees, FSI 2014*.

The PC when estimating its own cost functions should make allowance where the benefit structure results in higher costs, for example funds with:

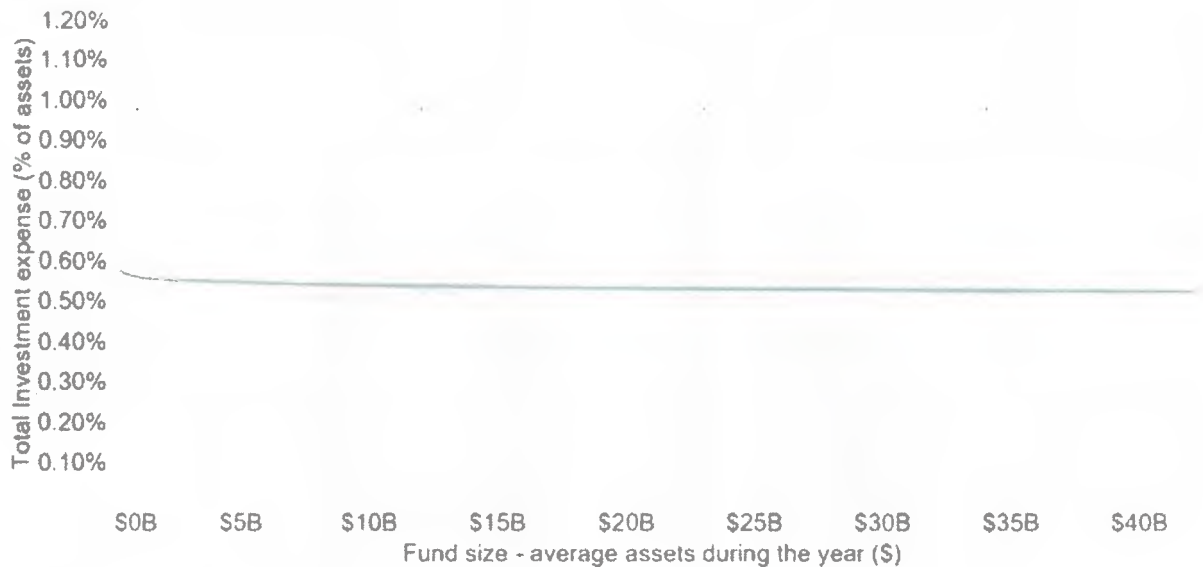
- defined benefits
- large pension divisions
- large numbers of Choice members
- insurance only benefits
- special purposes such as eligible rollover funds.

We would expect the PC would exclude factors over which the funds have more control e.g. decision to insource administration vs. use a third-party administrator.

The relationship between scale and investment management costs are more nuanced. Investment management fees typically comprise 90% or more of investment expenses. Whilst scale does impact on management fees, the scale effects are masked by major variations in management fees resulting from differences in asset allocation and strategy (e.g. the use of indexed investment approaches, which carry lower fees, and investment in 'alternatives', including direct property, which carries higher fees). Further,

funds may not fully realise scale benefits if they choose to make larger numbers of mandates rather than increase the size of existing mandates as scale increases. This is illustrated in Graph 2.

Graph 2. Investment management expenses vs. scale



Source: Rice Warner *Superannuation Expense Benchmarking 2016*.

We would suggest when attempting to measure the impact of scale on investment expenses that the PC collects data at the asset class level where possible to benchmark investment management fees (i.e. fees vs. mandate size). The PC could then separately benchmark other expense components, including custody and asset consulting expenses which exhibit a stronger relationship with fund size.

Given the PC will separately attempt to measure net returns, we expect that measurements of investment expenses should not be punitive based on asset allocation as more expensive asset classes (such as unlisted) might be correlated with fund size, but are expected to lead to better investment outcomes. Indeed, in many cases scale has enabled funds to pursue higher cost strategies (such as infrastructure) for which they forecast higher returns.

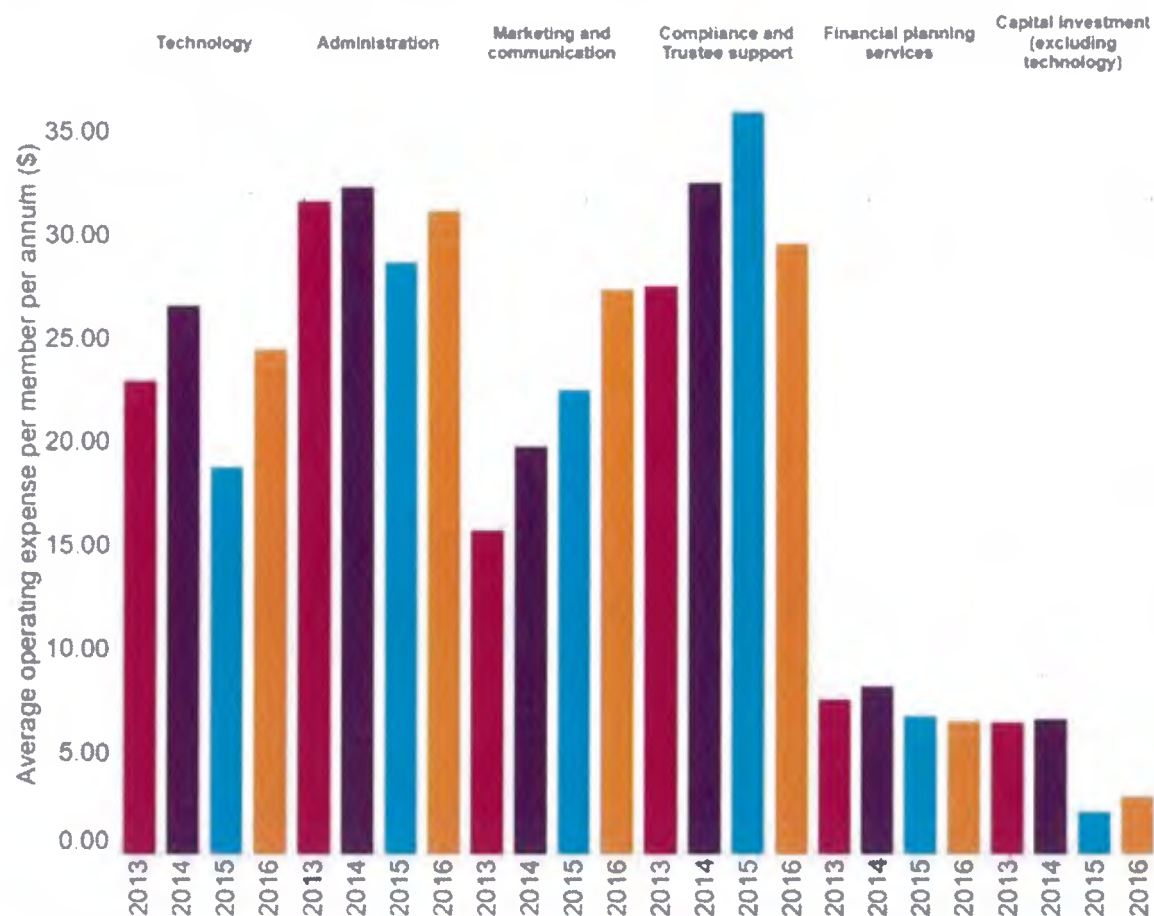
2.3.2 Realised scale

We would advise the PC that realised economies of scale in the superannuation industry have not always been used to reduce fees for members. Instead, cost savings in one area (say core administration) may be used to allow further expenditure in others such as member services. We again refer the PC to our previous report for the FSI which attempted to examine the change in fee levels over the period of a decade and then relate the changes back to fund activities¹.

Expenditure trends since 2013 are demonstrated in Graph 3 which highlights increased costs for marketing, communications, compliance and technology over the period considered.

¹ <http://fsi.gov.au/files/2014/12/Superannuation-fees.pdf>

Graph 3. Trend in operational expense components 2013- 2016



Source: Rice Warner Superannuation Expense Benchmarking 2016.

This makes the proposed task of the PC more difficult as an approach based purely on costs and fees will tend to underestimate the transformation of cost savings arising from scale into benefits for members.

Our fees research does show a relationship between scale and fees charged indicating that funds do pass on the benefits of scale to members (at least in part). A breakdown of this fee estimate from our latest Rice Warner Superannuation Fees Report is given in Table 1.

Table 1. Fund fees by sector and size at 30 June 2016

Fund size	Corporate	Industry	Public Sector	Retail
	(%)			
Under \$500 million	0.84	1.10	N/A	2.14
\$500 million to \$1 billion	0.76	1.17	0.95	1.86
\$1 to \$2 billion	0.75	1.03	0.34	1.51
\$2 to \$5 billion	0.64	0.94	0.93	1.69
Over \$5 billion	0.66	0.78	0.67	1.45

Source: Rice Warner Superannuation Fees Report 2016.

2.4 Survivors bias and merger activity

2.4.1 Cost function

One of the impacts of fund consolidation has been an increase in the average size of the remaining funds, especially when combined with the rapid growth of the system overall. There are clear scale benefits and most funds today are far better resourced than a decade ago. Despite this, there are many commentators, including Rice Warner, which believe fund consolidations will continue for some time to come.

An estimated breakdown of the number of funds by size is shown in Table 2 as well as historical estimates of the number of funds by sector.

Table 2. Number of funds at 30 June 2016 by size*

Fund Size	Corporate	Industry	Public Sector	Commercial [#]	Small APRA
under \$50 million	31	0	5	-	2,055
\$50 to 500 million	12	3	7	-	0
\$500 million to 1 billion	5	6	2	-	0
\$1 to 2 billion	5	5	1	-	0
\$2 to 5 billion	2	13	6	-	0
over \$5 billion	5	18	13	-	0
2016 Totals	60	45	34	105	2,055
2015 Totals	68	49	35	109	2,200
2014 Totals	81	52	34	107	2,745
2013 Totals	108	56	36	125	2,950
2012 Totals	122	60	37	133	3,201
2011 Totals	143	65	37	141	3,519
2010 Totals	169	68	37	152	3,869
2009 Totals	191	72	38	162	4,277
2008 Totals	227	74	38	166	5,539
2007 Totals	291	79	37	168	6,017

* A number of funds have been reclassified to provide a better breakdown of the market.

A breakdown of the number of commercial funds by size is more difficult to quantify as there are a large number of legacy products feeding into similar investment pools.

Source: Rice Warner *Superannuation Market Projections Report 2016*.

Typically, consolidation of funds has occurred through merger activities or the outsourcing of Corporate superannuation funds to Commercial Master Trusts or Industry funds. Generally, these mergers have resulted in higher cost funds being removed from the system, which results in the survivorship bias that the Productivity Commission is interested in adjusting for when estimating scale benefits.

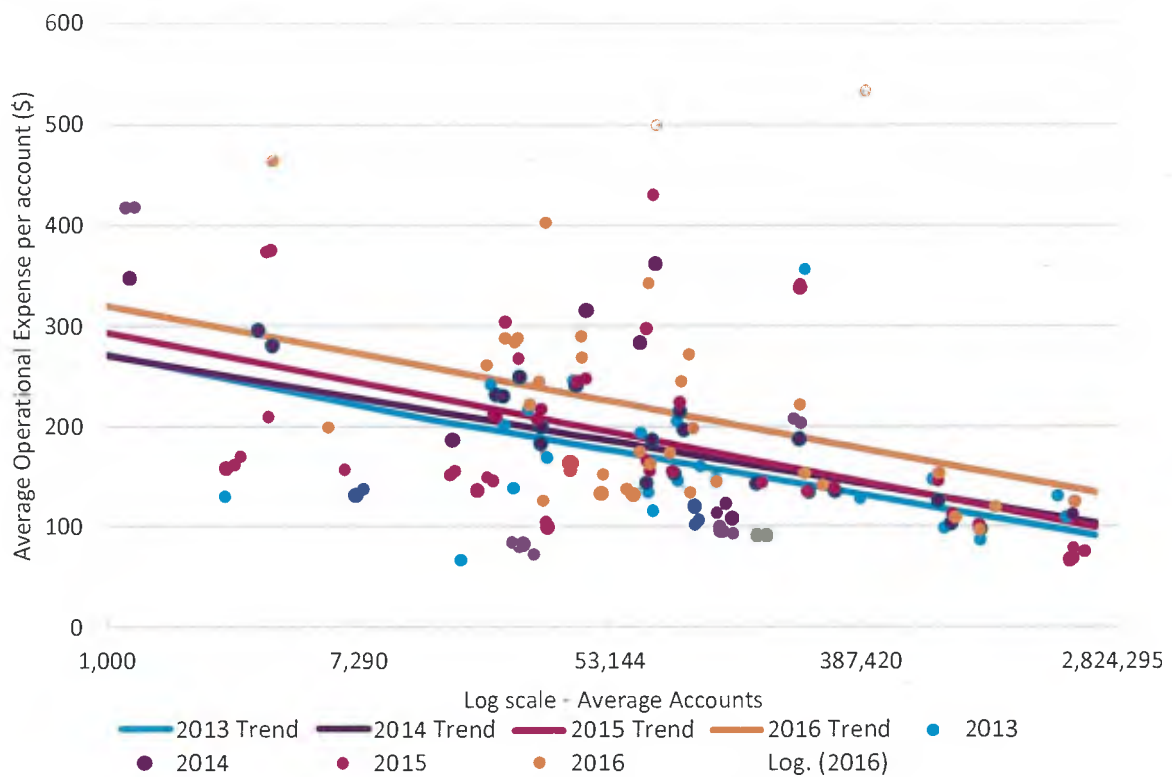
We believe that the PC should look for a *time homogenous* estimate of the cost curve in order to estimate what scale benefits will be achieved.

We note that general trends in operational expenses have tended to lift the cost curve upwards over time, which may mask effects of shifting the curve down and outward because of consolidation activity (see Graph 4). Consequently, we recommend the PC consider whether historical estimates of costs per member should be adjusted for inflation when estimating the cost curve.

We also caution against the influence of outliers with low scale, to lift estimates of the cost function due to the low number of funds in the tail end of the curve.

We would recommend that the PC consider a starting population of funds for the period at which they wish to begin their estimates of scale and include data points in the regression for each year until the present. Given consolidation activity is a legitimate way to achieve scale and reduce costs we do not see a problem with including funds in the sample of data points both pre and post-merger/consolidation.

Graph 4. Estimated operating expense curves 2013 – 2016 – accumulation funds – log scale



Source: analysis of Rice Warner *Superannuation Expense Benchmarking 2016 data*.

2.4.2 Realised scale

Whatever methodology the PC decides on, the results should reflect that mergers and consolidation of superannuation funds is a legitimate method by which Trustees have realised the benefits of scale. Consequently, estimates of costs historically should include funds that have since merged into new entities. Benefits that should have been achieved to date, should consider the movement of members to the successor funds and increased scale of the successor funds.

The PC should ensure any historical estimates of fees used to estimate whether benefits have been passed on to members, also consider the funds that existed in the past, rather than just looking at historical fees charged by the funds that exist currently (survivor bias).

2.5 Summary of recommendations

Our recommendations regarding the estimation of utilisation and pass through of economies of scale are as follows:

Methodology and challenges

- Cost function
 - Rice Warner finds that operating expenses vs. scale (members) follows a logarithmic trend.
 - Allowance in the cost function should be made for different benefit designs which can have a substantial impact on costs, but should not allow for elements over which funds have control e.g. decisions to insource or outsource functions.
 - The relationship between investment management costs and scale is complex, we recommend the PC attempt to benchmark this at the asset class level where possible.
 - Other investment expenses (e.g. asset consulting, custody) do exhibit scale benefits and can be estimated more easily using a cost function vs. funds under management.
- Realised scale
 - Realised economies of scale should consider that cost savings may be passed through to members in the form of enhanced services rather than simply fee reductions.
 - We refer the Productivity Commission to our previous research for the Financial Systems Inquiry, *Rice Warner Superannuation Fees, 2014*.

Survivor bias and merger activity

- Cost function
 - We recommend that the PC seeks to form a *time homogenous* estimate of the cost curve.
 - We caution against the ability of outliers to distort the shape of the cost curve.
 - Historical estimates of cost should be adjusted for inflation.
 - Consolidation is a legitimate form by which to achieve scale. Including funds both pre and post-merger would allow for the best *time homogenous* estimate.
- Realised scale
 - Estimates of realised scale should consider the position of members in incumbent funds at the start of the measurement period rather than assuming they were in the successor fund over the period considered.

3. Investment performance benchmarking

3.1 Technical questions for participants

On the system-level benchmarking:

- *In the context of the approach set out in the stage 1 Study to compare long-term net investment returns to a set of passive, liquid reference portfolios, which reference portfolios would most meaningfully inform the analysis? What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio? What fee levels should be applied to the reference portfolio? What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?*

On asset-class level benchmarking:

- *In the context of the approach set out in the stage 1 Study to benchmark long-term net investment returns at the asset class level, and given the available data, what is the best way to estimate long-term net returns at the asset-class level for the system, and why? Which listed benchmarks should be used for each asset class? How can the Commission best assess the investment performance of unlisted investments?*

3.2 System level benchmarking

3.2.1 Which reference portfolios would most meaningfully inform the analysis?

We note that the majority of system assets are in Choice rather than default products. Table 3 shows the split of Choice and MySuper assets with only 36% of system assets in MySuper (default) products.

Table 3. Estimated MySuper assets at 30 June 2016

Market segment	Pre-Retirement				Retirement	Total	
	Choice	MySuper	ADAs	MySuper and ADAs	Choice	All	MySuper
	(\$m)			(%)	(\$m)		(%)
Not-for-Profit Funds							
Corporate Funds	46,712	19,254	161	29.4	5,859	71,986	27.0
Industry Funds	151,078	295,973	2,472	66.4	40,369	489,892	60.9
Public Sector Funds	174,951	103,912	868	37.5	55,657	335,388	31.2
Subtotal	372,741	419,139	3,500	52.9	101,886	897,266	47.1
Commercial Funds							
Employer Master Trusts	59,340				-	148,349	
Personal Superannuation	223,526	54,646	34,363	24.7	-	223,526	15.8
Eligible Rollover Funds	740				-	4,937	
Commercial Post Retirement Products					211,945	211,945	
Subtotal	283,606	54,646	34,363	24.7	211,945	588,757	15.8

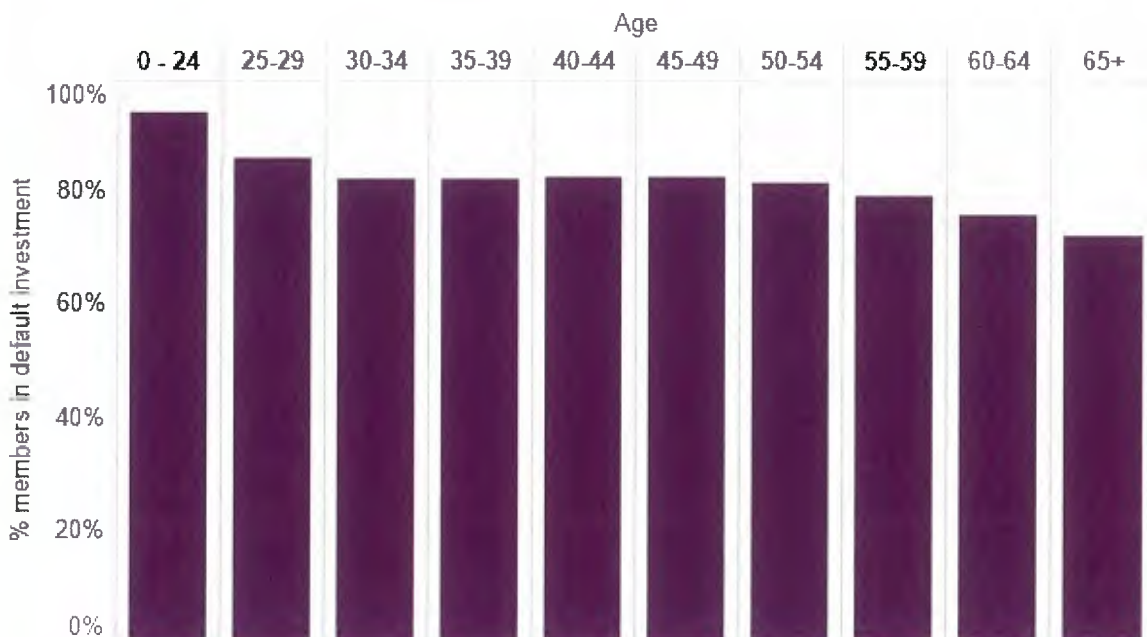
Market segment	Pre-Retirement				Retirement	Total	
	Choice	MySuper	ADAs	MySuper and ADAs	Choice	All	MySuper
	(\$m)			(%)	(\$m)		(%)
Self-Managed Super Funds							
Self-Managed Super Funds	276,486	-	-	-	347,337	623,823	-
Subtotal	276,486	-	-	-	347,337	623,823	-
Total Superannuation Market	932,832	473,786	59,200	35.6	661,168	2,109,845*	24.4

*Excludes unallocated reserves. Totals may not add due to rounding

Source: Rice Warner *Superannuation Market Projections Report 2016*.

Choice assets are growing and now represent 64% of pre-retirement assets compared to 49% at 30 June 2013² (when MySuper was introduced). As such, superannuation Trustees cannot bear responsibility for the asset allocation for 64% of system assets which are in Choice products. While they can manage the structures of Choice options within their funds, they cannot be responsible for Choice allocation. Further, SMSFs have no restrictions on asset allocations. We have provided further details on the percentage of members in default investment options and average asset allocation by age in Graph 5 and Graph 6.

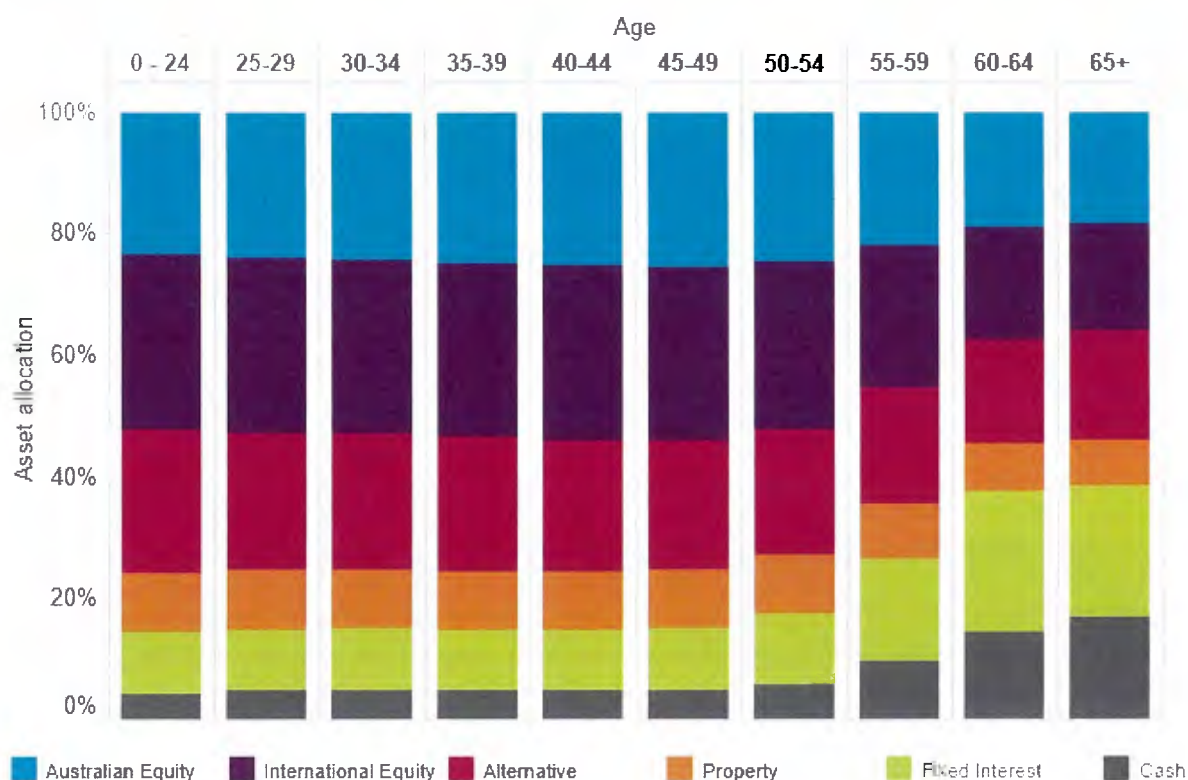
Graph 5. Percentage of members in default investment option by age



Source: Rice Warner *Superannuation Insights 2016*.

² Rice Warner *Superannuation Market Projections Report 2013 and 2016*.

Graph 6. Asset allocation by age



Source: Rice Warner *Superannuation Insights 2016*.

Given the lack of Trustee direction of asset allocation we would expect the reference portfolio to be based on the asset allocation of an *average* superannuation member weighted by FUM. Statistics on average industry level asset allocation should be obtainable through APRA and the ATO. The allocations should be adjusted based on the year being compared given the volatility in industry allocations to different asset classes, for example trends to invest in more illiquid assets as the industry has grown in scale or the flight back to defensive assets by Choice members during the GFC.

3.2.2 What is the best way to ensure that equivalent taxes are netted out of returns to a reference portfolio?

Trustees should attempt to optimise after-tax returns as part of acting in the best interests of members. It would be simple to apply the general rate of investment tax on superannuation investments of 15% for accumulation (and zero for pensions) to the reference portfolio when conducting the analysis. This gives Trustees credit for optimising the tax position.

Alternatively, if the PC viewed this as setting the bar too low (as all Trustees would get some tax benefits with minimal effort), the PC could make assumptions about:

- the volume of capital gains held over one year and subject to the one third discount in tax
- the availability of franking credits
- other deductions, such as fees and premiums (though we note these could also be considered to offset contributions tax).

These assumptions could be informed by historical experience through the use of statistics published by the ATO.

3.2.3 What fee levels should be applied to the reference portfolio?

Given the reference portfolio is based on liquid, passive, investable indices, the reference fees should reflect the same. We recommend the PC survey providers of such products (such as ETF providers e.g. Vanguard, Blackrock) to determine the level of fees that would be paid.

This ensures the benchmarking is done on a consistent basis and that allocations made by the industry to active or illiquid assets justify the additional fees through higher returns.

3.2.4 What are the most appropriate listed asset class benchmarks to use to calculate the returns to these reference portfolios?

We are generally comfortable with the examples of asset class benchmarks provided in the final report to Stage 1 of the PC's investigation into superannuation efficiency and competitiveness.

3.3 Asset class level benchmarking

3.3.1 What is the best way to estimate long-term net returns at the asset-class level for the system, and why?

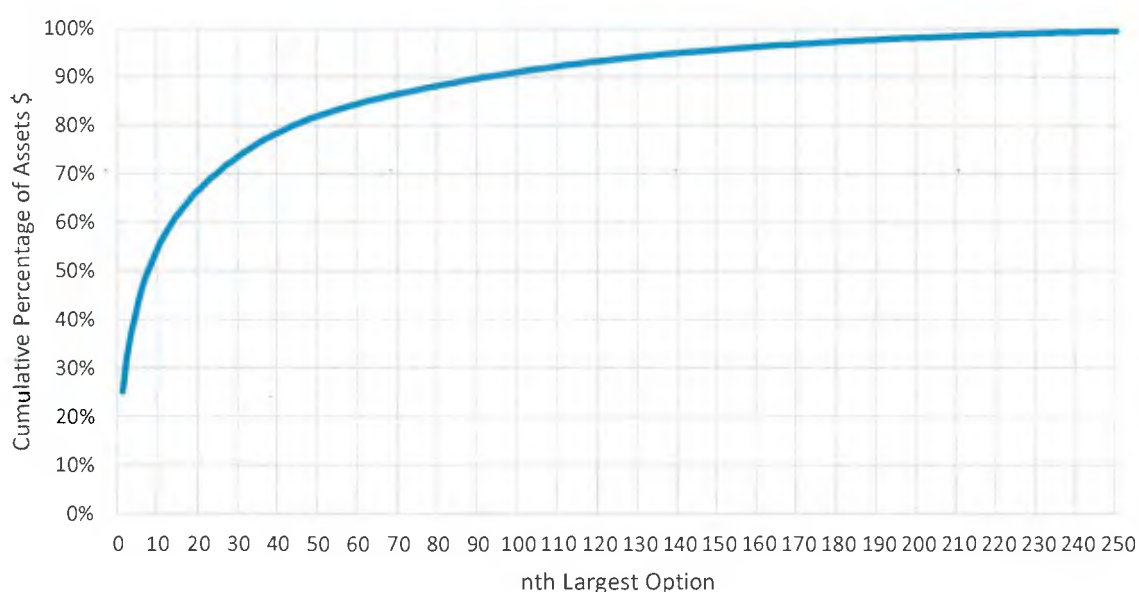
Unless the fund has a split at asset class level, historical returns are difficult to obtain because they are not published by funds or reported to APRA.

The most accurate estimates would be obtained by collecting the information directly from funds or the service providers of SMSFs. However, this may be time consuming and costly. The second approach would be to collect published returns for sector based investment options for superannuation funds (e.g. Australian shares).

- In the case of the not-for profit sector this should provide a good proxy of asset class returns as the diversified options typically invest in a mix of these sector based pools.
- For retail funds this is more difficult to estimate as there will be many sector based investment options to choose from operating in the same asset class. The product PDS will usually list a number of sector based options first which have the same brand of the product provider. These are often the options with the most FUM and would be most representative of asset class returns. This would be a good proxy to conducting a survey.

Graph 7 shows the cumulative percentage of assets invested by investment option for retail providers in Rice Warner's Superannuation Insights sample.

Graph 7. Cumulative percentage of assets in investment options by rank – retail funds only



Source: Rice Warner *Superannuation Insights 2016*.

This demonstrates that:

- a quarter of assets sit in the largest (typically default MySuper) option
- over half of assets are invested in the top 10 options
- two thirds of assets are invested in the top 20
- three quarters in the top 30 options, and
- the remaining tail is long but 90% of FUM can be accounted for by the top 90 investment options.

This analysis should assist the PC to evaluate how representative a sample of options would be for the returns by asset class without directly surveying retail providers (which would be the preferred method).

3.3.2 Which listed benchmarks should be used for each asset class?

We are generally comfortable with the examples of asset class benchmarks provided in the final report to Stage 1 of the PC's investigation into superannuation efficiency and competitiveness.

3.3.3 How can the Commission best assess the investment performance of unlisted investments?

The PC should assess the performance of unlisted investments against the most similar index which is available even though the index may be based on a 'listed' equivalent. Provide the asset class is a close proxy to what is being evaluated the unlisted vehicle should perform better if Trustees have paid the right price and have access to the illiquidity premium generated by these assets.

3.4 A note on historical vs. future performance

ASIC requires funds to state in marketing activities that past performance is not an indicator of future performance. Consequently, we would suggest that the PC also consider potential future performance as part of its assessment process. Indeed, many investment experts have been forecasting lower expected future returns as a result of the current record low interest rates and these returns may continue for some time. As a result, it is important to ensure that Trustees have set their investment strategies in a way to continue to earn real returns above inflation into the future.

Each year Rice Warner surveys the leading asset consultants and other investment professionals in Australia to understand their expectations for returns (gross of fees and taxes) from the various asset classes. Their estimates are combined and analysed across a range of asset classes and economic indicators over the short and long term.

Rice Warner uses a stochastic investment model to project asset returns into the future, based on the medium to long term expectations from this investment survey (which we have provided as a confidential attachment to this submission).

The projection measures the expected balance at retirement, longevity of retirement income and expected volatility based on a given asset allocation.

Our model forms the basis of our evaluation of competing funds in a tender environment and is also used as part of the scoring for the annual Conexus Financial Superannuation Awards.

We believe a forward looking approach is sensible to determine whether Trustees will continue to perform well into the future, especially given the overhaul of default investments that took place in 2013 when MySuper was introduced. Those changes mean that performance prior to this date will have been based on a different fund from the for retail providers.

3.5 Summary of recommendations

Our recommendations regarding investment performance benchmarking are as follows:

System level benchmarking

- We recommend reference portfolios use system level asset allocation as the basis given the fact that Trustees do not direct the asset allocation for 65% of the market.
- Taxes could be netted from the reference portfolio at 15% if the PC wished to give Trustees credit for optimising the tax position of the portfolio (through holding assets for the CGT discount or overweighting to assets with franking credits). Alternatively, the PC should use ATO statistics to guide assumptions regarding CGT discounts and franking if deducting tax on a 'like-for-like' basis is preferred.
- Fees for the reference portfolio should be based on the fees that would be charged for the liquid, passive and investable portfolio that it represents.
- We are generally comfortable with the asset class benchmarks the PC has suggested in its Stage 1 report.

Asset class level benchmarking

- Historical returns by asset class will be difficult to collect.

- Surveys of funds would be the most direct and accurate method provided the funds have the available data, are willing to provide it and answer the surveys consistently.
 - Alternatively, the PC may consider using sector based investment options offered by funds as a proxy of the asset class return for the fund, such estimates will likely be more accurate for the not-for-profit sector.
 - Retail funds have greater diversity in products. We have indicated the cumulative percentage of assets represented by the ranked investment options in Section 3:3.1 (What is the best way to estimate long term net returns at the asset-class level for the system and why?).
- We are generally comfortable with the asset class benchmarks the PC has suggested in its Stage 1 report.
 - Unlisted assets should be benchmarked against the most similar index available, for example, a listed equivalent.

Historical vs. future performance

- We note that past performance is not an indicator of future performance.
- We recommend that the PC consider likely future performance of superannuation funds based on expected return and volatility estimates as part of its process.

Past performance is valid for:

1. Measuring the success of the whole system - has the industry achieved return greater than CPI + x?
2. Persistently poor performers can be identified and eliminated.