

Superannuation Efficiency and Competitiveness CIFR Submission to the Productivity Commission¹

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CIFR Submission to the Productivity Commission on Superannuation Efficiency and Competitiveness (Stage 1)

The Centre for International Finance and Regulation (CIFR) welcomes the opportunity to provide input to the Productivity Commission (PC) during Stage 1 of its investigation into the efficiency and competitiveness of the Australian superannuation industry. CIFR is well-credentialed to comment on the issues being raised around the efficiency of the superannuation system. It has sponsored 16 projects related to superannuation and investment management, which should ultimately generate 30-40 research papers. While most of these projects involve external parties including academics, many have direct involvement by CIFR staff, with some being completed using CIFR's own internal resources. The specific CIFR papers that are most relevant for the issue of efficiency and competitiveness of the superannuation industry are listed at the end of this submission, and may be accessed via either the CIFR website or from SSRN. Of particular note for the topic at hand is project SUP002 which examines the effectiveness of default funds (i.e. MySuper), and was led by CIFR's Research Director, Dr Geoff Warren. Our comments draw on this body of research, and benefit from the considerable investment industry experience of CIFR's internal team.

Rather than offering a comprehensive response to the PC's "Superannuation Efficiency and Competitiveness Issues Paper" of March 2016 (Issues Paper), we restrict our comments to matters where we believe that we have something to add. These comments relate to five areas:

1. Need to separate out the default segment
2. Recognising differences between retail and wholesale distribution channels
3. Measuring value-add from investments
4. Importance of other ancillary services
5. Note on the nature of economies of scale

1. Need to separate out the default segments

The *Super System Review* of 2010 led by Jeremy Cooper was on the right track in distinguishing between three groups of members: those who accept the default, those who exercise choice, and members of SMSFs. Unfortunately, the importance of this distinction appears to have been lost somewhere along the way (including by the Financial System Inquiry). We believe this distinction is so fundamental that system competitiveness and efficiency should ideally be assessed differently across segments. We recommend that, at the very least, the default segment should be separated out to be analysed in a different manner to other choice-driven segments.

An essential attribute of the default segment is that it contains many members who are placing reliance and trust in their fund provider and the system at large. This often occurs because they do not feel they have the skills or confidence to choose for themselves.² Further, effective competition will arguably NEVER be driven by members in this segment, given that many are unlikely to ever move beyond placing trust in others by accepting their recommendations or delegating their decisions.

Accordingly, efficiency (operational, allocative and dynamic) in the default segment rests on the effectiveness by which fiduciaries and other agents make decisions and design defaults in the best interests of members. Further, to the extent that 'competition' even exists in the default segment, it revolves around the process by which default members are directed towards their fund providers or other parties on which they rely. Given this, we recommend that the assessment of efficiency in the default segment includes input-based criteria that are designed to evaluate two elements:

² Evidence for these contentions arises from CIFR Project SUP002, specifically "Delegation, Trust and Defaulting in Retirement Savings: Perspectives from Plan Executives and Members" (July 2015).

- (a) The effectiveness by which fiduciaries and agents make 'choices' that benefit members; and
- (b) The extent of competition involved in the process by which those fiduciaries and agents are selected.

We recommend that such criteria be afforded considerable weighting in evaluating the efficiency of the default segment. However, these criteria may be used in conjunction with output-based measures of efficiency that focus on observed net value received by members.

Our main aim here is to raise the idea of separating out the default segment, rather than scope out how this might be done in depth. Nevertheless, we can offer some observations on how any assessment might be structured. There are two levels at which fiduciaries and agents make decisions on behalf of default members: the allocation of default fund provider, and design of the default product itself.

(i) *Allocation of default fund provider* – This occurs through various means, with influences including:

- Employers – in many cases, they hold primary responsibility for selecting the default provider(s);
- Advisers to employers – this includes tender consultants and sometimes financial advisers;
- Defaults mandated under industrial awards – the topic of the PC report of 2012, under review; and
- Membership of defined benefit funds – here the employer is the provider.

(ii) *Design of the 'default' investment products* – While default design is ultimately the responsibility of the fund trustee, in practice there will be heavy involvement from the internal management of fund providers. Default products specifically include MySuper in accumulation, but will eventually extend to CIPRs in retirement, which are expected to effectively operate as a 'soft default'.

An assessment of the effectiveness by which fiduciaries and agents make choices that benefit members should be made across both levels. Unfortunately, any assessment will inevitably involve an element of subjective evaluation. This might be undertaken by analysts who understand the industry, perhaps using scoring methods such as Likert scales. Listed below are the kind of aspects that could be assessed (possibly at broad sector levels, such as employers and fund providers, prior to aggregation):

- Legal responsibilities
- Governance structures
- Conflicts of interest
- Incentives
- Capability of decision makers
- Prudential oversight

With regard to assessing competition in the market for selection of fiduciaries and agents, the focus should be placed on the mechanisms by which members are allocated to default fund providers. This might involve identifying the party who directs the default member towards a provider (often the employer, possibly an adviser); and then assessing the process by which they select the default provider. It is expected that there will be considerable variation in competitive tension across various parts of the industry. For instance, considerable competitive tension will be brought to bear where a large employer engages a tender consultant to assist in selecting default providers and negotiating the fee. In other circumstances, there may be a lack of competitive process.

Outside of the default segment, members have decided to exercise choice by definition. Hence more traditional criteria to evaluate efficiency and competition might be applied, in line with the direction in which the Issues Paper appears to be heading. However, even here the system also operates on the basis of trust to some degree, most notably when the member relies on financial advice. Accordingly, consideration should also be given to assessing the extent to which certain agents in the choice segments are acting in the best interests of members.

In summary, the main implications of the above for assessing superannuation system efficiency are:

- *The default segment should be evaluated in a different manner to other choice-driven segments.*
- *Assessment should involve input-based measures aimed at evaluating the extent to which fiduciaries and agents who make choices on behalf of members are aligned with members and their needs.*
- *The assessment of competition in the default segment should focus on the mechanisms by which members are allocated to default fund providers.*

2. Need to recognise differences between retail and wholesale distribution channels

Retail versus wholesale (i.e. institutional) is a key fault line in the funds management industry. Compared to wholesale investors, retail investors often are: less skilled; have access to less resources; face greater information asymmetry; and, have lower volume of assets to invest. They are often more reliant on advice from others (e.g. financial advisers); and are given fewer opportunities to negotiate the fees they pay. Thus competition often fails within retail distribution channels; when meanwhile it can be working effectively in the wholesale markets. Distinguishing between retail and wholesale is hence critical to assessing efficiency and competition in the choice segment.

A key implication is that retail investors consequently end up paying much higher fees as a percentage of assets than wholesale investors. For example, active equity managers often charge retail investors a management fee of something like 1%-1.5% p.a.; but will offer near-equivalent products³ for 0.3%-0.6% p.a. to institutional investors such as superannuation funds. In the superannuation industry, headline fees can sometimes operate as 'rack rates' that are paid only by members who enter via retail channels, or have left their employer and have been transferred to the retail division. Meanwhile, large employers are able to negotiate discounts as much as 60-70 bps on the administration fee component on MySuper products on behalf of their members.⁴ The industry is rife with price discrimination. However, this is particularly acute across the retail / wholesale divide due to difference in information asymmetries and negotiating power.

In summary, the main implications of the above for assessing superannuation system efficiency are:

- *Assessment of competition in the choice segments should include separate evaluations of the retail and wholesale distribution channels. The presumption should be that competition differs significantly in these two channels, with failures in competition more likely to occur in the retail channel.*
- *Care should be taken in analysing efficiency using headline management fees, as they may not account for price discrimination. A better approach would be to compare aggregate returns versus aggregate fees or costs, where data is available.⁵*

³ The underlying investment process and management team is often equivalent, so that the retail and institutional versions are largely the same product. Differences include that institutional funds are often structured as separately managed accounts, perhaps with special requirements; and the cost of servicing institutions may be lower. Nevertheless, these aspects are a long way from explaining such large fee differences.

⁴ MySuper fee structures were discussed in the CIFR working paper "MySuper: A New Landscape for Default Superannuation Funds" (July 2014).

⁵ Focusing on asset-weighted outcomes is more relevant for assessing the system overall. Also, asset-weighted returns matter more for members than time-weighted returns, if total value-add is to be assessed over multiple periods.

3. Measuring value-add from investments

Superannuation fund members receive two types of outputs for the fees they pay: investment returns, and a range of ancillary services. Here we offer comments on how the value-added by the industry in terms of investment returns might be evaluated: we discuss ancillary services over the page under point 4. The Issues Paper raises the idea of examining “net (post-fee) risk adjusted return” as a benchmarking criterion (p21). There are numerous problems with using realised total fund returns to assess the efficiency by which investment management services are provided:

- Total returns are dominated by the performance of asset markets at large, over which superannuation fund managers and members have little control. If asset markets come under pressure, as they did during the Global Financial Crisis, then returns will inevitably be poor for the vast majority of investors.⁶ This does not necessarily indicate that the superannuation system is inefficient in the way it invests;
- An implausibly long time period is required to establish whether effective investment decisions are being made based on realized total returns. It can take decades for the ratio of signal to noise to reduce sufficiently for statistically significant inferences to be drawn;
- Historical returns reflect the outcomes of prior decisions, and the environment under which decisions are being made is in a constant state of flux. Managers get replaced, funds merge, the investment opportunity set changes, and investment processes evolve. Realized returns stemming from past decisions may have little relevance for the context under which decisions are being made today; and
- Some investment decisions are made by fund providers, and others by the members themselves by virtue of the investment options they select. On one hand, fund providers decide the investment strategy for their MySuper defaults. Here the returns received by the member might be attributed to the fund provider. On the other hand, if a member decides to invest in a choice product (say a conservative or an aggressive growth fund), the returns they receive will be partly attributable to that choice.

For the above reasons, realized returns are a very poor basis on which to assess either the current state of efficiency of the investment processes being used by the industry, or even how much value it has added historically. Nevertheless, making some assessment is necessary, given that investment returns are a critical component of value-add.

An alternative approach for evaluating performance is by measuring the value that is created relative to a reference benchmark portfolio.⁷ This establishes a counterfactual against which to gauge the effect of investment decisions made by the industry. Two possible forms for a reference portfolio would be: (a) specify the optimal portfolio under some objective function;⁸ or, (b) identify a comparable low cost, generic strategy. The optimal portfolio approach is theoretically superior but difficult to apply, especially as it ideally should be identified *ex ante*, and imposing a universal objective function may be inappropriate given member heterogeneity. Comparing industry performance relative to some low cost, generic strategy is a more practical approach, albeit more limited in scope.

⁶ The markets must be held by somebody. While it may be feasible for some investors to avoid market-wide losses, this can only occur if another party holds the assets and bears the loss. This aggregation constraint makes it near-impossible for major investor sub-groups, such as superannuation funds, to avoid losses associated with broad sell-offs in asset markets.

⁷ Another approach might be to benchmark the performance of Australian superannuation funds against pension funds overseas. However, obtaining a clean comparison would seem problematic given differences across systems.

⁸ One simple example of this approach seen in the finance literature is to estimate where a candidate portfolio sits relative to the mean-variance efficient frontier.

Our recommendation is that the evaluation should start with comparing the net returns generated by MySuper *balanced* default funds against simulated net returns from a fund invested in 70% growth and 30% income assets comprised of passively-invested listed securities, after allowing for taxes and other costs. Focusing on MySuper balanced funds offers the advantage of restricting the analysis to an important fund category that operates under some consistency of objectives. It may be possible to expand the analysis by applying a similar method to other products, e.g. lifecycle funds, selected choice products. The recommended approach would generate insights into the efficiency by which fund providers add value from the following combination of sources:

- Investments in alternative assets
- Active investment management
- Dynamic asset allocation

The main advantage of the approach is that it controls for the availability of returns from the markets at large, and thus restricts the focus to analysing decisions over which the fund provider has clear control. In addition, this approach should be able to extract meaningful insights from data over shorter periods, largely by factoring out the noise that arises from broad market fluctuations.

Nevertheless, the approach has a number of disadvantages. A static 70/30 benchmark may not be optimal.⁹ Accounting for risk is difficult under the framework. While tracking error might be estimated, it is not a relevant measure for fund members, who should be more concerned with the risk of inadequate retirement income. The approach only measures the efficiency related to certain decisions within a component of the system, specifically the effectiveness of the investment strategies pursued by fund providers. Extrapolating any findings to the system overall would hence be tenuous. For instance, if choice members were selecting sub-optimal products, or SMSF members making sub-optimal investment decisions, the approach would fail to pick this up.

In summary, the main implications of the above for assessing superannuation system efficiency are:

- *Value-add from investments should not be measured by examining realized returns at the total fund level, as these reveal little about the current level of efficiency of the investment process.*
- *Evaluating the value that fund providers have added relative to a reference benchmark based on passive investment in public markets is recommended as a workable approach, even though it only addresses certain components of the investment decisions occurring within the system.*

4. Importance of other ancillary services

We welcome the recognition within the Issues Paper that ancillary services comprise a component of the value created for superannuation fund members.¹⁰ We would like to underline the importance of assessing the broad range of services provided to members; and encourage the PC to call into question the perception that lower cost alternatives are necessarily superior. Superannuation funds have been expanding the scope and quality of the ancillary services they offer to members. While this has undoubtedly been a contributor to higher costs, the central issue is whether these services offer value for money. We applaud the PC's implied intention to give consideration to this issue.

⁹ The suitability of 'balanced' strategies such as 70/30 funds is open to debate. However, it is worth noting that academic research exists suggesting that they do a reasonable job; and some authors have found that maintaining high growth exposure outperforms lifecycle strategies in delivering retirement outcomes. Another issue is whether static asset allocations are sub-optimal relative to dynamic asset allocation if returns are predictable.

¹⁰ Ancillary services are explicitly mentioned in Table 2 (p21), and implied in the reference to 'user satisfaction with product choice and quality' in Table 3 (p24) and 'quality improvement' in Table 4 (p27).

Below is a list of some of the ancillary services that are provided to members:

- *Choice* – The system offers both choice of fund and of investment options. The scope of the latter varies across funds, but is sometimes extensive, extending to the ability to invest in single securities and managers.
- *Tailored defaults* – Lifecycle funds are an early example of a tailored defaults, which should ultimately extend to CIPRs.
- *Advice* – In addition to providing access to paid advice, a range of more generic advice is made available at zero cost, including general advice and calculators.
- *Insurance* – The premiums are paid by members, although there will be some administrative support.
- *Administration* – Funds administer the superannuation assets of their members, including providing support such as call centres.
- *Information* – This includes member reporting, and websites containing a range of materials.
- *Assurance through compliance* – Complying with the governing laws and regulations arguably provides members with some assurance that their assets are well looked after.

In addition to making a general comment about the importance of assessing these services, we would like to make a specific point around member heterogeneity and the value of tailoring and flexibility. Members are all different.¹¹ This is particularly the case in the retirement phase, but also applies in the accumulate phase. This gives rise to the possibility that more efficient solutions could be ones that offer tailoring or flexibility despite the higher cost. For instance, smart defaults may be preferable to lower cost, commoditised products. (This point is particularly relevant for the PC's Stage 2 investigations into alternative models for allocating default fund members.) Further, a degree of choice may be desirable so that members have the flexibility to construct their preferred solution when the need arises. The issue to be addressed is the efficient balance between cost and the scope to tailor towards a range of needs.

CIFR's research uncovers indications that the superannuation industry is moving towards more tailoring, on the basis that 'one-size-fits-all' approaches are sub-optimal. The current lifecycle funds might be considered as 'first generation', with many funds considering more tailored defaults. Funds are aiming to collect information about their members to support this move. The industry is also developing their advice offerings. These trends are probably a precursor to the offering of more tailored products, including CIPRs. However, they are undoubtedly adding to costs.

In summary, the main implications of the above for assessing superannuation system efficiency are:

- *A value should be placed on the benefits arising from more tailored solutions and flexibility when assessing system efficiency, noting that these elements are more valuable when members are heterogeneous. In doing so, allowance should be made for the fact that this can involve upfront costs, with benefits flowing over time.*

5. Note on the nature of economies of scale

Many observers appear to presume that superannuation is subject to economies of scale. While we agree that economies are available on the cost side, particularly with regard to fund administration, it is not necessarily true that economies of scale are readily available from the perspective of total net value add. The reason is that diseconomies of scale can exist in investment management. Diseconomies may arise from: attractive investments often being limited in magnitude; increased market impact as trade size

¹¹ The fact that member bases both within and across funds are heterogeneous in ways that are meaningful for design and choice of superannuation products became evident during CIFR research project SUP002.

increases; constraints on the mandate size that will be accepted by external active managers; loss of flexibility to move the portfolio when a fund is large; and possible drag from increased bureaucracy with size. Some strategies can help to mitigate the diseconomies of scale in investment management. These include: focusing on private rather than public markets (where size can be used to good effect); bringing assets in-house to manage;¹² greater use of passive management; or adjusting the investment process. Nevertheless, the effectiveness of these strategies is unproven.

Thus the nature of economies of scale is quite complex, especially when the focus is on assessing efficiency in terms of net value-add (as the PC is clearly aiming to do). For instance, one fund may respond to growth in assets by shifting to passive investment management, with the result that both returns and costs could fall.¹³ Another fund may respond by turning to private markets, which could lead to higher returns but higher costs.¹⁴ Whether net returns rise or fall, and which strategy proves to be the most efficient, is open to conjecture. Further, the fact that fund growth is often accompanied by strategic shifts in investment approach makes it difficult to evaluate whether economies of scale exist and hence to assess dynamic efficiency. Examining costs in isolation is insufficient as they are just one side of the equation, and will vary with the strategic response. A further problem is that any shifts in strategy can involve upfront costs, while the impact on returns can only be observed over long periods.

In summary, the main implications of the above for assessing superannuation system efficiency are:

- *Dynamic efficiency in the presence of growth in assets under management cannot be assessed by focusing on costs or fees as a percentage of assets. Allowance also needs to be made for potential impact of size on investment returns, including the possibility of diseconomies of scale in investment management, and any costs and benefits associated with the strategic response to those diseconomies.*
- *A specific issue at hand is that the growth in Australian superannuation funds has been accompanied by increasing allocations to high-cost alternative assets, which have helped restrict the scope for reduction in investment fees. This shift may well prove beneficial for members, although net value-add cannot be observed for many years.*

¹² In-house investment management is examined by CIFR under project F016.

¹³ While the debate over the efficacy of active management continues, evidence exists that institutional investors are able to access active managers that generate positive net returns after fees, even though retail investors may be unable to do so. A recent comprehensive examination of the performance of active managers employed by institutional investors around the world is: Gerakos, J. Linnainmaa, J. T. and Morse, A., "Asset Manager Funds", *Chicago Booth Research Papers*, No. 16-02 (February, 2016). Available at SSRN: <http://ssrn.com/abstract=2733147>. In addition, Australian equity managers appear to have been able to outperform after fees (members of CIFR management have been closely involved in the research in this area). In sum, great care needs to be taken in extrapolating the underperformance of US equity mutual funds to other situations, including the use of active management by institutional investors like superannuation funds.

¹⁴ These two contrasting approaches reflect that taken by the Norwegian sovereign wealth fund (focuses on managing public market betas), versus many of the larger Canadian funds such as CPPIB (private market focus, which is actively managed). Both approaches have performed well.

APPENDIX

CIFR Superannuation Research with Direct Relevance for Efficiency and Competition

Project SUP002 – Superannuation Default Funds (MySuper)

Project team: A. Butt (ANU), S. Donald (UNSW), F. Foster (USYD), S. Thorp (USYD), G. Warren (CIFR)

“CIFR Project SUP002 on Default Superannuation Funds: Summary of Main Findings and Implications”, August 2015

“Delegation, Trust and Defaulting in Retirement Savings: Perspectives from Plan Executives and Members”, July 2015

“MySuper: A Stage in an Evolutionary Process”, December 2014

“The Superannuation System and its Regulation: Views from Fund Executives”, July 2014

Project TSUP – MySuper Landscape (*commissioned project; joint with Chant West*)

“MySuper: A New Landscape for Default Superannuation Funds”, July 2014, W. Chant (Chant West), M. Mohankumar (Chant West) and G. Warren (CIFR)

Other Relevant Projects

“Efficiency and Design of Fees for Australian Investment Funds”, A. Ainsworth (USYD), S. Akthar (USYD), A. Lee (UTS), T. Walter (USYD) (*research underway with some very preliminary results; project T004*)

“The Use of Active Asset Allocation by Superannuation Funds”, by D. Carruthers (now at Frontier Advisers) (*commissioned research, undertaken in association with Schroders Investment Management*)

“In-House Investment Management: Making and Implementing the Decision”, March 2016, by D. Gallagher, T. Gapes and G. Warren (*Internal CIFR research; project F016*)