



June 2018

ASYMMETRIC INFORMATION, INVESTING, AND PLAN MEMBER WEALTH EXTRACTION: NEW EVIDENCE FROM SWEDEN AND AUSTRALIA

“Wages in the Swedish financial sector have experienced an extraordinary increase over the last few decades. However, we find no evidence that the selection of talent into finance has improved. This suggests that finance workers are capturing substantial rents that have increased over time.”

A new academic research paper by
Profs. Bohm, Metzger, and Stromberg

“The lacklustre investment performance of the Superannuation System may be attributed significantly to Retail Funds, which underperform other Public Offer Funds, on long-term averages, by about 2% per annum.”

“The current government seems to be doing its best to destroy Australian superannuation. The Bill for “strengthening trustee pension arrangements” actually weakens them and therefore should be rejected by Parliament.”

Wilson Sy, former Head of Research
Australian Prudential Regulatory Authority (APRA)

“Capturing Substantial Rents”

One of the more interesting academic research papers I have read recently is titled *“Since You’re So Rich, You Must Be Really Smart: Talent and the Finance Wage Premium”*. In it, authors Bohm, Metzger, and Stromberg note that over the course of the last 25 years, the already high relative compensation levels of people working in the Swedish finance sector rose from 120% of average private sector wages to almost 170%. They point to similar findings in other developed countries. They posit that in properly functioning labour markets, these material relative increases should have been due to the rising relative skills and hence rising productivity of people working in the finance sector.

They go on to test if this was really the case. To that end, they develop a unique database of innate talent metrics (both cognitive and non-cognitive) for the Swedish labour force to test if entrants into the finance sector over the last 25 years exhibited a greater rate of increase in talent than entrants into other sectors of the economy. They found that this was not the case. So what then explains the increasing wage gap between people working in the finance sector and those working in other sectors? As a possible explanation, they note the rising profitability of the finance sector relative to other industry sectors, not just in Sweden but elsewhere as well. And what might be causing this? They point to ‘imperfect competition’ leading to ‘excess profits’ which the finance sector shares with its workers.

But what causes this ‘imperfect competition’ and these ‘excess profits’ in the finance sectors of the developed economies? That question fell outside the scope of the paper. In my view, the answer lies in the ‘asymmetric information’ thesis of Nobel Prize Laureate George Akerlof. He posits that in markets where buyers know less about what they are buying than sellers know about what they are selling, buyers will pay a too high price for too little value. It is hard to think of larger markets around the world where this is the case than the markets for financial services. Ergo, we have a logical explanation for the financial services markets’ ‘imperfect competition’ and ‘excess profits’ phenomena: commercial financial services firms use their information edge over their clients to their advantage by charging them too much for services in relation to their value.

Recent empirical work in Australia by Wilson Sy, the former Head of Research at the Australian Prudential Regulatory Authority (APRA), confirms the validity of the Akerlof asymmetric information thesis once again.ⁱ

Australia’s ‘Super’ System After 25 Years

Sy presents his extensive research findings on the performance of the institutional component of Australian superannuation (i.e., pension system) in two recent papers titled: *“Financial Performance Trends of Australian Superannuation: System and Sectors”* and *“Impact of Asset Allocation and Operational Structure of the Investment Performance of Australian Superannuation”*. The first study covered the 1997-2016 period. Some key conclusions from this study are:

- Institutional Super assets grew at an almost 10%/yr. rate over the 1997-2016 period, from about A\$400B (62% of GDP) to A\$2.1T (124% of GDP).
- The System is maturing with payouts expected to exceed contributions in a decade or so.
- The estimated System net investment return (i.e., after investment expenses) was 6.1%/yr., with other organizational operating expenses of 0.6%/yr. reducing that to a pre-tax return of 5.5%/yr.
- Splitting institutional Super assets into Not-For-Profit (NFP-64%) and Retail (36%) sectors, the net investment returns were 6.7% and 5.4% respectively. Other operating expenses of 0.4% and 0.9% respectively, reduced those returns to 6.3% and 4.5% respectively, a pre-tax return gap of 1.8%/yr. over the 19yr. period.ⁱⁱ
- With institutional Super assets at \$2T and a Retail Fund market share of 36%, the implication is that with an annual return shortfall of 1.8% relative to NFP Funds, Retail Fund participants forfeit a collective A\$13B/yr. as a result of not being members of a NFP Fund. This A\$13B is effectively an annual wealth transfer from Retail Fund participants to Australia’s for-profit finance sector.

The second study with more asset allocation and operational structure data covered the 2004-2016 period, with some additional detail on asset allocation available for the 2014-2016 period, leading to the following key conclusions:

- For any timespan of five years or more, Retail Funds materially underperform NFP Funds, averaging about 2% per annum.
- Despite more conservative asset allocations, Sharpe ratios showed poor risk-reward trade-offs for Retail Fund members.
- The benefits of scale economies were passed on to members in NFP Funds, but not in Retail Funds.
- A detailed analysis of the 2017 Annual Report of the Commonwealth Bank of Australia (CBA) showed that the average cost of its Retail Funds on offer were between 2-3 percentage points higher than the comparable costs for NFP Industry Funds. All other things equal, these higher costs will reduce the ultimate pensions generated by 40-50%.

In closing, Sy poses the obvious question: what is the cause of these materially different financial outcomes for members in the NFP and Retail sectors of the Australian superannuation industry? His answer is a simple one: it lies in the differing motivations of the trustees of NFP Funds and Retail Funds. The former focus on plan member needs, the latter on the needs of the shareholders of the corporations providing Retail Fund services.

Thwarting an Attack on Member-Focused Governance Structures

Given the realities set out above, one would think the Australian Government would address this continuous, ongoing wealth transfer from members of Retail Funds to their commercial sponsors. In fact, for some time, the reverse seemed to be the case. It started with a campaign by the financial services industry to discredit the governance structures of NFP Funds because the trustees were appointed by bodies representing plan members and their employers. Ergo, they failed the ‘independence’ test, which the financial services industry defined as independent from plan members and their employers.ⁱⁱⁱ

Bizarrely, in response, the Australian Government drafted legislation “to strengthen trustee arrangements” requiring that at least 1/3rd of trustee boards and the board chair be ‘independent’ from plan members and their employers. The rationale was that such a measure would improve the quality of super fund governance. In response, Sy and others pointed out that the legislation’s definition of independence opened up the possibility for agents of the financial services industry to infiltrate the boards of NFP Funds, and to swing the provision of services such as investment management towards commercial organizations with which they were affiliated. Real ‘independence’, they pointed out, should mean independence of conflicts of interest. By this more sensible ‘independence’ test, Retail Funds failed miserably, with some 60% of Retail Fund board members having one or more affiliations with commercial financial services providers.

Happily, sanity prevailed in the end, with the counterproductive legislation “to strengthen trustee arrangements” withdrawn this past December. Even better, a Royal Commission was formed to study the behavior of Australia’s finance sector. According to recent media coverage, Australians are being treated to an ongoing litany of “lax oversight, self-dealing, and deception”.

Really Strengthening Trustee Arrangements

None of this should be taken to mean that selection processes for board members of pension organizations cannot be improved. They can be, and this is not just the case in Australia, but also elsewhere in the world. Recall, for example, the respective Board selection processes of *California Teachers’ (CalSTRS)* and *Ontario Teachers’ (OTPP)* in last month’s *Letter* on integrated reporting in pension organizations. This is what the *Letter* reported:

- CalSTRS has a 12-member Board partially elected by plan members, partially appointed by the Governor, and partially ‘ex officio’ (e.g., the State Treasurer, Comptroller, and Director of Finance). There was no reference to an ideal set of collective skills and experiences the Board should possess. The Board approves investment policies and rules, ensures benefits are paid according to the law, and hires the CEO and CIO. There are six Board committees: Appeals, Audit and Risk, Benefits and Services, Governance, and Investment and Compensation.
- OTPP has an 11-member Board appointed jointly by the Ontario Teachers Federation and by the Ontario Government. Key attributes in searching for Board members and in Board composition are expertise and experience in accounting, actuarial practices, banking, business management, economics, education, information technology, and investment management. There are six committees: Audit/Actuarial, Benefits Adjudication, Governance, HR/Compensation, Operational Risks, and Investment. The Board as a whole acts as the Investment Committee, and approves investment limits. It also controls funding policy by taking full responsibility for the economic and actuarial assumptions that drive asset and liability projections. As a professional board, OTPP’s sponsors believe board members should be compensated.^{iv}

The point here should be clear. Only having a member-focus is not enough. A functional board of a pension organization also has the expertise and experience to effectively oversee the workings of a complex financial institution. The traditional 'either-or' framing of 'representativeness vs. expertise/experience' is bogus. It is not 'either-or', but 'and-and'.^v

A Class Action Law Suit Perhaps?

This 'and-and' message comes through clearly in the Rotman-ICPM Board Effectiveness Program (BEP) for board members of pension and other long-horizon investment organizations.^{vi} A key session on 'fiduciary duty' in the week-long program hammers home the duty of 'impartiality'. In plain language, it is illegal to favour one group of stakeholders (e.g., services suppliers) at the expense of another group (e.g., plan members). Perhaps a class action law suit by Australian Retail Fund members against their trustees is needed to make this absolutely clear.^{vii}

Keith Ambachtsheer

Endnotes:

- i. See our May 2017 Letter for additional evidence.
- ii. The NFP sector of Australian superannuation has three components: Industry, Public Sector, and Corporate.
- iii. Ironically, one of the leaders of this financial industry campaign to discredit the governance of NFP Funds was David Murray, former CEO of the Commonwealth Bank of Australia (CBA). CBA was referenced in the Wilson Sy's research as one of the high-cost providers of Retail Fund services. During recent Royal Commission hearings, one of the Commissioners singled out CBA as "the Gold-Medallist in Fee-For-No-Service".
- iv. The OTPP Chair's 2017 compensation was C\$190K, board members were paid between C\$110K and C\$90K depending on their responsibilities.
- v. OTPP outperformed its reference portfolio by 0.7%/yr. over the last 10 years, while CalSTRS underperformed its reference portfolio by 0.9%/yr. over the last 10 years. Arguably, a lot of this 1.6%/yr. performance spread can be attributed to the different governance structures of the two organizations. On a \$200B portfolio, the return spread works out to an additional \$3B+/yr. of value-creation with the OTPP governance structure.
- vi. The 12th offering of the BEP program is scheduled for the week of November 26-30. Go to <https://icpmnetwork.com/icpm-events/board-effectiveness-program/> for more information.
- vii. The Australian Productivity Commission released its 525 page report titled "Superannuation: Assessing Efficiency and Competitiveness" on May 28. A significant part of the Report is devoted to assessing the governance quality of super funds. Its findings included a lack of focus on improving board selection, board effectiveness, and independent board quality assessment in many cases. It also noted a 'related party transaction problem' in a number of funds. The Commission made a number of recommendations to address these identified problems. The Report is in draft form, with comments on its recommendations invited. We will submit this Letter to the Commission as a comment on its Fund governance recommendations.

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Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com