

# NAB MLC WEALTH SUBMISSION

Productivity Commission Draft Report: Assessing the Competitiveness and Efficiency of the Superannuation System

*Investment Performance: Supplementary Analysis*

November 2018

## About NAB and MLC<sup>1</sup>

National Australia Bank Limited (NAB) is a diversified financial services organisation, headquartered in Australia, with a subsidiary bank in New Zealand and branches in Asia, the United Kingdom and United States.

NAB and/or its subsidiaries provide superannuation services, advice, insurance and investment solutions to retail, corporate and institutional clients, supported by a number of brands including MLC1, JBWere, Plum and NAB Asset Management.

Excluding the Pooled Superannuation Trust, there are 4 Registrable Superannuation Entities overseen by NULIS Nominees (Australia) Limited (the Trustee) providing superannuation and retirement solutions to over 1.2 million members.

NAB has one of the largest financial planning networks in Australia providing quality financial advice, insights and expertise.

For ease of reference, unless specifically referencing a product or registered superannuation entity by name, this submission refers to the combination of our superannuation entities and service providers under the banner of MLC Wealth.

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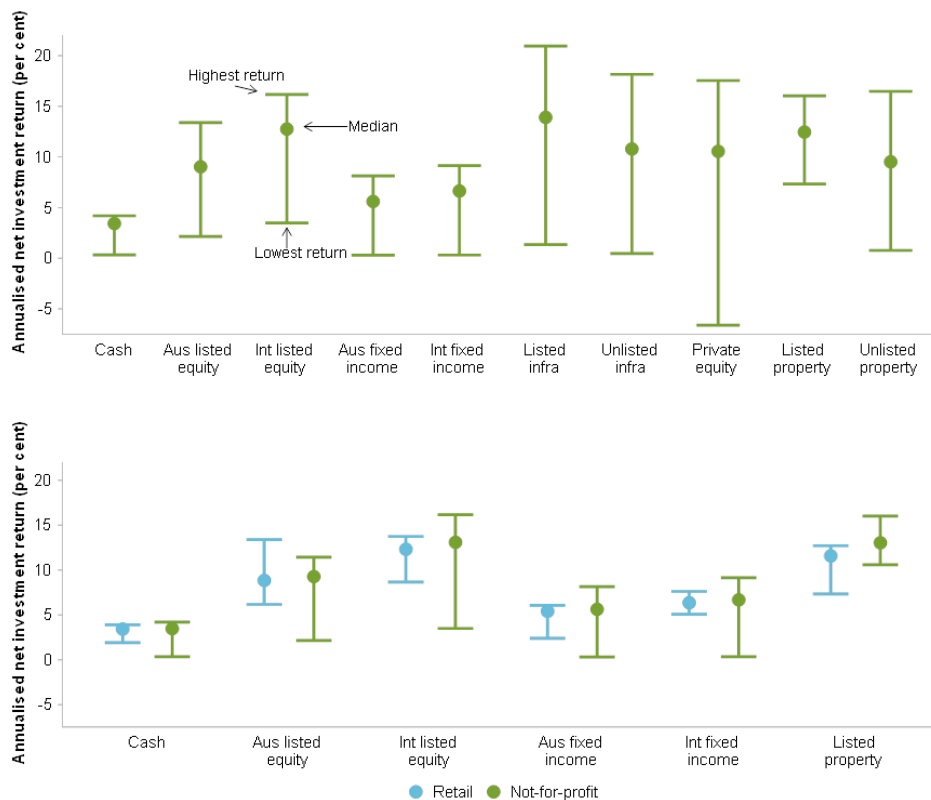
The Wealth division of National Australia Bank (MLC Wealth) appreciates the opportunity to provide our response to the Productivity Commission on the recently published ‘Supplementary Paper – Investment Performance: Supplementary analysis.’ (‘Paper’). This submission focuses on the Commission’s methodology and some of the conclusions it underpins.

We acknowledge the importance of the Productivity Commission’s (‘Commission’) work in assessing the efficiency and competitiveness of the Australian superannuation system and appreciate your engagement with us to date on this matter.

## A. Variation in Asset Class Returns reported

The variation in investment returns by asset class reported by the Commission in Figure 3 (reproduced below) captures data between the periods 2011 to 2017; this period saw historical low interest rates which supported the performance of growth assets and interest sensitive illiquid assets. The measurement of investment performance would typically require a dataset over a much longer period covering multiple investment cycles to ensure historical peak and trough market behaviour is captured; thus the short measurement period used by the Commission does not capture a full investment performance cycle and would impact the results of Figure 3 but also the accuracy of the reported distribution of returns by asset class in Figure 4 (page 12) and Table 1 (page 13) of the Commission’s draft paper.

Figure 3



Despite this, the observations reported in Figure 3 would indicate that over the Commission's measurement period, the median net investment return of the asset classes reported for Retail funds and not-for-profit ('NFP') funds are comparable. In fact, with the exception of listed property, the lowest returns in the graph are reported against NFP funds; it may be that the differential between the larger NFP and smaller NFP funds accounts for the large variance within the NFP asset class returns.

## **Investment Performance Attribution – the comparison of performance across segments**

The Commission's calculation methodology assessing the relative outperformance comparison between Retail funds and NFP funds is set out below:

Outperformance gap = administration expense gap + investment expense gap + tax gap + residual gap.

MLC Wealth draws out the following observations from the comparison of Figure 8 (Retail) to Figure 9 (NFP).

The large residual calculated by the Commission is of concern. While we understand that this includes all active asset allocation decisions, we would expect the residual to be small and not the main differentiator between segments. This raises concerns of the completeness of information and the validity of the model.

### **1) Anomaly with the System level Benchmark (BM) portfolio.**

There appears to be an anomaly with the System level BM portfolio return (8.3%) reported given it is higher than that reported for either segments (7.9% for Retail and 8.1% for NFP); alternatively it could suggest that the segment BM portfolio return reported could be incorrect; thus impacting the accuracy of the 'residual' value reported.

Given the material differences in the average asset allocation profile of the Retail segment when compared to the NFP segment, MLC Wealth would expect the difference in the reported BM portfolio return between the two segments (7.9% - 8.1%) to be much larger than -0.2%; a greater difference between the reported segment BM portfolio returns will see the size of the residual gap reported by the Commission being smaller.

MLC Wealth notes that Retail Funds offer significant choice of investment options to customers to meet the diversity of customer segments and their investment needs; customers that direct their investment in cash and more conservative investment options would see the average BM portfolio return for Retail Funds being lower (i.e. greater average allocation to defensive assets). In addition, NFP funds that hold significantly more unlisted assets (which Figure 3 illustrates the higher investment return potential but higher investment risk and liquidity risk attached) should see the BM portfolio return for the NFP segment being higher. The combination of these factors would support a higher BM portfolio difference between the two segments and a lower residual gap.

Without access to the Commission’s data (and the asset allocation differences in that data) and modelling, it is difficult for MLC Wealth to comment further.

## 2) The composition of the Benchmark Portfolio

MLC Wealth maintains the position that the composition of the Commission’s BM portfolio determined based on the average value of assets held across the segment (i.e. taking the average of each Fund’s asset allocation profile where each are likely to be diverse) together with the use of BM proxies and assumptions that are not representative of the assets held leads to the BM portfolio returns reported being inaccurate; thus impacting the difference in the ‘residual’ value reported.

MLC Wealth notes that within each individual asset class there are a number of different investment strategies which provide a stark difference in investment return and risk. Taking listed global equities as an example, where you invest (geography; developed markets versus emerging markets), how you invest (large capitalised companies versus small capitalised companies) and whether you hedge your currency risk or the extent of leverage within your global equities allocation leads to very different investment performance outcome and the need for the accurate selection and dissection of the right benchmarks as part of the Commission’s BM portfolio return.

Extending the example on global equities, the percentage exposure held in either hedged or unhedged passive global equities (MSCI ACWI) alone can provide material differences in the BM portfolio returns and responding to the constant change in the exchange value of currency as part of portfolio management will see the change in the hedge ratio; thus a constant hedge ratio within the BM portfolio is also problematic.

By not comparing a global shares portfolio against a relevant currency hedged benchmark would result in an excess return that is driven mainly by the currency differential and would not show “skill” in global shares. Also many diversified portfolio managers look at currency at a total portfolio level and may change currency weighting outside of the global shares portion of the portfolio.

<b>Global Shares (Benchmark Returns)</b>	<b>1 Year</b>	<b>2 Year</b>	<b>3 Year</b>	<b>4 Year</b>	<b>5 Year</b>	<b>10 Year</b>	<b>15 Year</b>
Global Shares Hedged (MSCI ACWI)	11.53%	15.74%	14.64%	10.98%	12.21%	10.83%	10.48%
Global Shares Unhedged (MSCI ACWI)	19.04%	17.68%	12.69%	13.74%	14.88%	9.66%	8.17%
Difference in Benchmark Returns (Unhedged - Hedged)	-7.51%	-1.94%	1.95%	-2.76%	-2.67%	1.17%	2.31%

MLC Wealth also maintains the position that the proxy benchmarks used for the average asset allocation to illiquid assets is particularly problematic given the stark difference in the investment behaviour of these assets and the difficulty of assigning a particular benchmark to reflect the average investment performance and risk behaviour of this group.

## 3) The average net investment return of the Retail Segment (5.1%) has underperformed in comparison to the NFP segment (7.3%).

The average asset allocation of the Commission's BM portfolio for the Retail segment does not reflect the actual product and investment experience of any MLC Wealth customer. As well, we note that customers of Retail funds are different to that of NFP funds and this material factor drives a difference in how investment performance should be interpreted.

**a) For Retail funds, the average asset allocation at the fund level is driven by member investment choice.**

The customers of NFP funds are more homogeneous as a group thus NFP funds are able to respond offering much fewer investment options and due to their customer cashflow profile, NFP funds on average are able to allocate more capital to unlisted assets. A younger demographic also allows NFP to allocate to a higher percentage of growth assets.

The Retail fund customer profile is more diverse in terms of demographics and customer segmentation. Many of MLC Wealth's customers choose, either via their Adviser or directly, their investment product and investment platform. Customers direct their investment in many single asset class or multi-asset class products across the investment return and risk spectrum. Customers who choose cash and more conservative options will increase the average fund asset exposure to defensive assets thus lowering the reported average net return.

Looking at the average net investment return of the Retail segment and how it is different to the average NFP investment return in isolation would ignore the fundamental differences between Retail and NFP funds as a distinct product offer.

**b) The need to focus on investment risk**

Growth assets and quality unlisted assets can provide the potential for higher investment returns, however the pursuit of higher investment returns attract higher investment risk and with respect to unlisted assets, higher liquidity risks. We have seen a very favourable investment environment post the Global Financial Crisis (2008) and funds with a higher allocation to growth and unlisted assets have on average delivered a higher relative net investment return. Despite this, growth assets can sustain periods of negative returns and unlisted assets can experience periods of significant drawdown in valuation. Funds with higher growth and unlisted assets are exposed to significantly higher investment risk and are likely deliver relative underperformance during times of market correction. Thus the comparison of Retail and NFP fund segment investment returns needs to reflect different customer investment risk preferences with the need for investment return comparison to be undertaken over a much longer time horizon covering multiple investment cycles.

Some of MLC Wealth's options are specifically focussed on lower investment risk and returning stable returns throughout a market cycle. The objective of these options is to beat an inflation (plus a margin) benchmark. By design, during a growth market, options such as these will not perform as well as options with a large percentage in growth assets, and neither should they as this is not their objective. The Commission's focus on the quantum of returns rather than a product level risk analysis will miss many of the intentionally designed features of these options.

This highlights a continuing focus of the Commission to only analyse investment returns without a detailed analysis of the corresponding risk. The time period available to the Commission has been a period of significant central bank intervention, ultra-low interest rates and ultra-accommodative monetary policies. This has led to a significant and outsized reward for risk assets which has significantly benefitted NFPs.

**c) The liquidity profiles of funds are different.**

The extent of unlisted assets held by funds need to consider the membership profile, the cashflow profile and the particular circumstances of the fund. Comparing the level of unlisted assets held by funds warrants the consideration of the fund’s particular circumstances.

**B. Comparison across MySuper products**

There are differences in how funds classify growth and defensive assets; these differences impact the comparability of investment returns for MySuper products and diversified investment products generally. Infrastructure assets as an example have growth and defensive characteristics; some funds will apportion some of the exposure to growth and some defensive while other funds will classify infrastructure as entirely growth or entirely defensive. The alignment of classification differences will support better comparability of investment performance.

To illustrate this point, captured below is an extract of the SuperRating Fund Survey comparing the performance of the MLC MySuper fund to the performance of equivalent NFP MySuper funds. Comparison of equivalence requires funds to have an equivalent exposure to growth assets; this is clearly not the case with the MLC MySuper fund with a much lower growth asset allocation. If the Plum-JANA Assertive fund (a MLC Wealth product) with a growth asset profile more akin to NFP funds was used, the relative investment performance is within a much tighter range.

The Plum-JANA Assertive option has a higher level of growth assets in line with some industry funds and should be used for performance comparison.

Industry Funds	Actual Growth Allocation#	1 Year (%) pa	3 Years (%) pa	5 Years (%) pa	7 Years (%) pa
HOSTPLUS - Balanced	91%	12.0	11.3	10.1	11.1
Cbus - Growth	87%	10.7	10.5	9.6	10.9
AustralianSuper	82%	11.9	11.0	10.0	11.0
Plum-JANA Assertive	83%	11.8	10.0	9.1	10.8
Sunsuper	80%	11.1	10.2	9.3	10.4
REST	77%	9.2	8.6	8.2	10.2
Median	-	9.6	8.5	8.1	9.5
Mercer	79%	10.5	8.4	8.1	9.6
MySuper/Pre-mixed Moderate*	68%	9.2	8.0	7.8	9.4
Russell iQ	73%	9.1	8.1	7.5	9.5
BT	70%	8.9	6.8	5.9	7.7

Source Returns: SuperRatings Fund Survey, September 2018.

\*The inception date for MySuper was December 2013. Returns shown are for the Plum Pre-mixed Moderate Option prior to December 2013.

# Actual Growth Allocation based on NAB Asset Management categorization of assets into Growth and Defensive. NABAM classifies property and infrastructure as ‘growth’ assets. There are no clear industry guidelines on asset class categorisations.

### **C. Governance Efficacy**

The Commission noted that there is some evidence that investment returns are influenced or correlated with fund governance efficacy but makes it clear that there may be correlation and not causation. In the Commission's draft supplementary paper, a fund's readiness to introduce a MySuper product and how fast the fund transferred default members to the MySuper product was used as a proxy measure for fund governance efficacy.

MLC Wealth would agree that the quality of the Fund's overall governance, which includes the Trustee's focus on governance, the calibre of the investment team and the robustness of the fund's overall investment governance framework can influence member outcomes including investment performance. However, each fund's product strategy with respect to launching a MySuper product by the legislated deadline is a matter for each fund taking into account member interest, the need to transfer default member assets in a prudent manner and the Fund's particular circumstances; thus the launch of the MySuper product by funds is not a good proxy measure for investment performance.

Once again, we thank you for providing an opportunity to provide our comments, if you have any further questions please contact Francine McMullen, Associate Director Government Affairs and Public Policy, National Australia Bank on [Francine.McMullen@NAB.com.au](mailto:Francine.McMullen@NAB.com.au).