

# **Submission to the Productivity Commission**

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**In response to  
“How to Assess the Competitiveness and  
Efficiency of the Superannuation System”  
Draft Report, August 2016**

## **Background**

Behavioural Finance Australia (BFA) is a specialist consultant in the field of behavioural finance in the Australian market. It helps professional and sophisticated investors to apply behavioural finance insights to improve financial outcomes.

As the founder of BFA, I have consulted and presented to thousands of accountants, advisers, fund managers, super funds and self-directed investors in relation to behavioural finance concepts and applications. This includes working with:

- Accountants and financial advisers in relation to the provision of advice in the context of clients establishing and managing an SMSF;
- Major super funds in relation to using behavioural finance principles to enhance member decision-making and engagement, and in relation to how behavioural finance applies in the context of fund governance; and
- Fund managers in relation to avoiding behavioural biases in their investment decision-making processes that can lead to lower before- and after-tax returns.

I am also the author of “Applying Behavioural Finance in Australia: 12 Strategies for Fund Managers, Financial Advisers, Asset Consultants, Super Funds & Other Sophisticate Investors”. The book details opportunities to apply behavioural finance insights to improve outcomes across the financial services landscape.

More detail on BFA, my background and book are available at [www.behaviouralfinanceaustralia.com.au](http://www.behaviouralfinanceaustralia.com.au).

My comments in relation to the Productivity Commission draft report relate to the application of behavioural finance, and to considerations of effective investment decision-making across the Australian superannuation industry.

I note that the Treasurer's terms of reference referred to "the extent to which the system encourages optimal behaviour on the part of consumers, including consideration of the learnings from behavioural finance." I am pleased to see the importance of behavioural finance recognized so clearly in this context and that it has been referred to in some detail throughout the Commission's draft report.

Overall I am supportive of the approach the Commission has taken to behavioural finance. However, I thought it would be useful to raise a few additional points that occur to me as I read the discussion of behavioural finance in the draft report and reflect on the behavioural finance research of which I am aware and my experiences with its application in the Australian superannuation industry. My apologies if I have overlooked aspects of the report that already deal with these issues or have misunderstood the Commission's thinking in any way.

### **1. What evidence could the Commission assess to measure the application of behavioural finance by super funds?**

The field of behavioural finance is founded in a discipline of empirical analysis – what is quantifiable, testable and measurable. That is what has separated it from much of the theory and normative assumption that it has superseded. In my view, whether funds are taking an empirical, data-driven approach to applying behavioural finance should be one of the qualitative measures that the Commission should assess. The field of behavioural finance has no shortage of examples where doing what seemed to be right actually turned out to be wrong. It would be sadly ironic if in trying to apply behavioural finance principles the industry were to fall into the same trap.

### **2. Should the industry attempt to meet member preferences?**

When considering whether the system should meet member "preferences" we should recognise a lesson from behavioural finance that stated "preferences" can be highly context dependent and unreliable. Meeting member preferences where those preferences are merely illusory products of subconscious cues stand little chance of helping the member reach their long-term financial objectives. We should take great care in prioritizing meeting member preferences where they include an element of subjectivity. Based on behavioural finance research, some of the items listed in Box 3.1 (that I presume have been suggested as positive indicators of meeting member preferences – such as number of individual products and levels of switching), might actually be expected to have negative correlations with effective decision-making and long-term financial outcomes in some contexts.

### **3. Should the industry provide more quality information?**

Behavioural finance research shows that the provision of information is a double-edge sword. Providing high quality information sounds beneficial (and no doubt is in some contexts) but, if not presented in a way that can facilitate effective decision-making, can actually lead to worse outcomes. Quality

information, the context of its delivery, its quantum and impact on member behaviour need to be considered together.

#### **4. Do trustees act in member best interests?**

The discussion of whether trustees are acting in the best interest of members relies on a number of “rational” factors that have been shown to be relevant to effective governance. However, we should also recognise the evidence that suggests that professional investors (fund trustee boards and investment committees, as well as the equivalent governance structures within the fund managers some of them outsource to) can be subject to a range of decision-making biases, many of which are hidden from awareness. A conflicted board may actually produce a better outcome than an un-conflicted one that has been influenced by a strong anchor, or by the way a performance comparison or investment decision has been framed, for example. The former board might stand a chance of bringing the decision-making bias to conscious awareness and overcoming it. The latter, might not. The Commission should consider whether decision-making structures have considered these issues and have effective mitigants in place against them – directly, and/or indirectly (via their service providers). An equivalent to the empirical approach that I have suggested should be applied to member decision-making should also be applied to professional investment decision-making (including but often beyond standard performance attribution analyses). It is a common bias to believe that behavioural biases only apply to someone else. Decision-making biases apply in different ways to professional investors (individual and teams), but they apply nonetheless – sometimes more so.

#### **5. Does competition enhance fund decision-making?**

As discussed in the report, increased competition can sometimes hinder effective decision-making. In my experience this can include circumstances such as where funds make decisions that limit the possibility that they will under-perform their peers, rather than maximizing the possibility they will achieve member outcomes. Furthermore, more competition, if in conjunction with the delivery of more information to members (particularly if it includes short-term returns) and more member engagement (which means they might be more likely to act on the basis of to short-term returns) could lead to worse member outcomes. These things need to be considered together, each with a behavioural finance overlay and evidence of effective decision-making.

#### **6. Does the industry appropriately management tax on behalf of members?**

There are several behavioural biases that are relevant for professional investment decision-making in the context of tax management. Professional investors can be prone to overconfidence, leading to overtrading, too many fund manager switching decisions or tactical asset allocation changes. Each can lead to increased costs and taxes, without a commensurate increase in before tax returns. In each case the relevant decision-maker might genuinely believe the decisions were made in the best interest of members, although large-scale

research suggests that the outcome is often counter to this. Narrowly framing investment decisions around a single manager and fund complexity can also lead to tax leakage in multi-manager portfolios. A relatively simple behavioural finance checklist or “audit” can identify how many funds are likely to be impacted by some of these factors – and could be tracked over time.

I hope my comments are of some use.

Kind regards

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