

Dimensional Submission to the Productivity Commission Inquiry into Default Superannuation Funds in Modern Awards

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1. Introduction

Dimensional appreciates this opportunity to submit a paper to the Productivity Commission (PC) on Default Superannuation Funds in Modern Awards. The Issues Paper requests comment from industry on many and diverse factors that would impact the way Australians are offered or chose a default superannuation fund. As part of the genesis of the Issues Paper, we recognise and agree with many of the findings of the Cooper Review (June 2010).

The maturing of Australia's superannuation industry and recent upheaval in financial markets have provided an opportunity for the financial services industry to examine its assumptions about how to generate the best retirement outcomes for fund members. As a global asset management firm whose approach is grounded in academia, Dimensional has been thinking about these issues for some time. Our view is that many of the perceived problems around generating adequate outcomes are due to the industry using out-dated frameworks.

This submission provides fresh thinking, based on our experiences in Europe and the US, on how to approach the challenge of maximising retirement incomes while minimising the risk of extreme events wiping out participants' savings. We believe this approach is consistent with the Federal Government's desire to improve the efficiency, transparency, fairness and adequacy of our retirement savings system.

This submission will focus on the areas where Dimensional believes it can add value and where it has expertise. As a wholesale funds management firm we do not currently offer superannuation funds to the public. We therefore believe we can provide comment to the Productivity Commission in the following areas as per the Terms of Reference delivered by The Hon Mark Arbib Assistant Treasurer (6 Feb 2012) Scope of the inquiry:-

Scope of inquiry

1. *The Commission is to design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia*
2. *The criteria designed by the Commission should be transparent and objective. In considering criteria for determining whether a superannuation fund is appropriate to be nominated as a default fund in a modern award the Commission could have regard to the following:*
 - § ***The appropriateness of the investment strategy of the default investment option of the fund in terms of risk and expected return*** (Dimensional emphasis)
 - § *The medium to long term net-of-costs investment performance of the default investment option*
 - § *The level of fees incurred by members*
 - § *The scale of the fund and the level of services provided to fund members*
 - § *The suitability and cost of insurance provided by the fund*
 - § *The governance of the fund*
 - § *The fees incurred and other impacts on members if they cease employment with an employer.*

This submission will suggest that trustees of MySuper funds should continue to innovate and seek to improve the retirement outcomes of their members. Dimensional believes that there are new and effective approaches to providing a retirement income solution for members that will require legislative and regulatory flexibility. The current MySuper legislation allows for lifecycle approaches, but the current approach to lifecycle funds limited by age leads to sub-optimal outcomes. Trustees, and the industry, must continue to search for better ways to provide for both engaged and unengaged fund members, so that Trustees fulfil their heightened obligations to their members under MySuper.

2. About Dimensional

Dimensional, which was established in 1981, is a wholesale funds management firm with approximately \$240 billion in assets under management globally, including about \$19 billion on behalf of Australian and New Zealand investors. Our clients are institutional investors and fee based advisers who access our funds through an administration platform. Our approach is structured, non-forecasting and our fees are low. We are not traditionally active in the sense of making forecasts or timing the market. But neither are we traditionally passive in the sense of trying to match commercial indices.

Recently, Dimensional has expanded its offering to include a retirement planning and investment solution developed by Nobel laureate and Harvard Business School University Professor Emeritus Robert Merton. He is currently Resident Scientist at Dimensional. Professor Merton has been working on the issue of providing a satisfactory income in retirement for individuals for 30 years. He considers it one of the most complex issues in modern finance.

3. The Dimensional Approach to Retirement Income

Any market is made up of many individuals whose needs and requirements are all different. The Australian superannuation retirement market is mostly served by defined contribution superannuation funds whose default asset allocation is normally 70% growth / 30% defensive¹. However, given different individual needs, the suggestion that one single asset allocation setting for all the members of a fund will satisfy every member's needs is very difficult to agree with. As a result, the idea behind our approach is to provide many of the benefits of a defined benefit plan (targeted, inflation-protected retirement income) within the context of a defined contribution plan to satisfy individual members' needs.

Our evidence-based approach seeks to manage individuals' assets to produce a desired and tailored income stream for those individuals in retirement, rather than trying to maximize portfolio value for a cohort of people. We see this as a simple, transparent and effective solution for members in a superannuation fund who are either overwhelmed by choice in retirement savings options, do not feel comfortable or skilled in making investment decisions or are just not sufficiently engaged to make the important decisions.

At each step the focus is to maximise the probability that individual members will reach their retirement income goals and to minimise the risk of the member ending up below a certain minimum income. The real risk in any superannuation scheme is the risk that there will be too little income in retirement, and that the fund fails to take into account the unique circumstances of individual members.

The goal of Dimensional's process is to find a better way to address a participants' real need — the means to purchase a lifetime inflation-protected income stream in retirement. To this end, the Dimensional Defined Contribution solution has taken some of the best academic thinking and advances in managing risks relative to participants' goals and combined this approach with low-cost, value-added

¹ Towers Watson March 2012 "Finding the balance- Strategies to improve post retirement investing", page 3 shows the average growth allocation of pre-retirement default investment funds to be 74%

investment strategies to develop a risk-managed retirement planning process to help every participant prepare for retirement. Although aimed at the individual, our approach requires scale to operate effectively. As such Dimensional will continue to offer wholesale services, not personal financial planning services.

4. Is This Approach just a Lifecycle Fund?

The solution outlined above is already being implemented in Europe, USA and the UK. The approach is similar in concept to existing lifecycle or target-date funds, but with significant improvements that reduce the investment risks to individuals that can be inherent within these funds.

We see existing lifecycle funds as limiting the prospect of successful investor outcomes. This is because they focus on the volatility of returns, which is not a good measure of shortfall risk (the risk that there will not be enough to fund the persons retirement income needs). Similarly, we see target date funds as limited because they aggregate individuals' assets according to only one factor – their retirement date (or age). They target a glide path for the investment profile, but not the goal of a specified income in retirement. Importantly, they do not consider inflation, changed market conditions or the impact these and other factors should have on a person's asset allocation of their superannuation savings.

4.1 Current MySuper Lifecycle Exception

Dimensional strongly supports the Federal Government's approach to its review of superannuation and the aims of making the system stronger, more efficient and better able to ensure members receive an adequate income in retirement. Making the superannuation system more effective in providing retirement income streams is also at the core of Dimensional's thinking.

With respect to the MySuper core criteria, Dimensional believes that there is a strong case that default funds provided to members – irrespective of their individual level of engagement with their super – have the following features:

- a single diversified investment strategy,
- be universally available to members of a fund, and
- use consistent administrative and fee processes.

Dimensional is particularly supportive of the 'lifecycle exception' contained at section 29TC(2) of the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 reproduced below:

29TC Characteristics of a MySuper product

- (2) A ***lifecycle exception*** is a rule under the governing rules of the fund that allows gains and losses from different classes of asset of the fund to be streamed to different subclasses of the members of the fund who hold a MySuper product:
- (a) on the basis, and only on the basis, of the age of those members; or
 - (b) on the basis of the age of those members and other prescribed factors; or
 - (c) on the basis of the age of those members and other prescribed factors in prescribed circumstances.

Dimensional understands that the Government and APRA are currently considering the form that the regulations should take in regards to defining what "prescribed factors" and "prescribed circumstances" should be taken into account under the lifecycle exception. In this regard, Dimensional made submissions to the Parliamentary Joint Committee on Corporations and Financial Services on MySuper Core Provisions. In particular, Dimensional recommended that the regulations are drafted with sufficient flexibility to provide for solutions that give

consideration to the circumstances, experiences, goals and existing assets of individual members.

Dimensional strongly believes that trustees should not be exempt from seeking to personalise the investment process just because a member elects for the default option. That MySuper is primarily designed for disengaged members should in our view heighten, not lessen, the need to manage the risk that members do not achieve their individual retirement income goals.

A simple lifecycle fund based solely on the age of individual members ignores the fact that members still have individual retirement goals in terms of the level of income they will require at the end of their working lives. Rather than a simple 'set and forget' investment strategy, our solution is designed to take account of other factors and requires the trustee to monitor both the overall investment strategy and each member's basic circumstances, to ensure that necessary adjustments are made to the 'flight path'.

At this early stage we do not know how APRA will enforce the MySuper legislation, or how regulations will be created to guide the industry. However Dimensional does believe that using a simple age based lifestyle fund approach for a MySuper fund will lead to unsatisfactory outcomes for members. The factors that should be included, either in regulation or legislation, are:-

- age,
- member salary and contribution rates,
- personal retirement income objectives,
- desired retirement age,
- members' personal investment experiences and
- the age pension.

5. MySuper Success Requires Innovation from Industry

Trustees of superannuation funds nominated in awards or enterprise agreements will need to create MySuper offerings to continue to accept contributions. Trustees of these funds will continue to look for scale through fund mergers, as members expect their default fund provider to deliver at least a minimum standard investment, education and retirement experience.

The PC Issues Paper (Section 4 page 7) challenges the industry to discuss selection criteria for default superannuation funds. Dimensional suggests that the selection criteria should not be confined to default funds, and the criteria we discuss above could be included in a review of all criteria for the selection of an investment strategy. For example workers covered by different awards will have different needs, as their personal circumstances will all be different. The simple age based lifecycle approach will aggregate their investment exposures in age cohorts, and not take into account their differences in salary, their current superannuation savings, their expected retirement age, their total assets or their future income.

An age based lifecycle approach is a positive step in the legislative framework, but current legislation for default MySuper Fund structures does not extend to the individual member approach embodied in Dimensional's defined contribution solutions. We have no doubt that other firms will be attempting to bring new ideas to help trustees fulfil their obligations to members, but the current default investment strategy shown in most 70% growth/30% defensive Defined Contribution Default funds is not conducive to innovation. We suggest a more open approach with less restrictive conditions will see the industry provide new ideas which will benefit members.

6. Risk Profiling

Another useful measure introduced in the MySuper legislation is the concept of risk profiling. A MySuper fund shall be rated on a 1-7 scale to give members an idea of the investment risk they will be exposed to when they invest in that fund. In a static asset allocation 70%growth/30% defensive fund world, this will be an interesting data point for MySuper members.

However in the innovative world of MySuper where lifecycle funds based on many criteria in addition to age have individual asset allocations set to achieve individual member's goals, an aggregate risk score is not relevant. The real risk to be managed is the risk that a person does not achieve a satisfactory income in retirement. The risk measured at fund level through the MySuper profile score is a completely different kind of risk.

7. Conclusion

The maturing of Australia's superannuation industry and recent upheaval in financial markets have provided an opportunity for the financial services industry to examine its assumptions about how to generate the best retirement outcomes for scheme members. Dimensional has been thinking about these issues for some time.

This submission provides fresh thinking, based on our experiences in Europe and the US, on how to approach the challenge of maximising retirement incomes while minimising the risk of extreme events wiping out participants' savings. We believe this approach is consistent with the federal government's desire to improve the efficiency, transparency, fairness and adequacy of our retirement savings system.

Our evidence-based approach seeks to manage individuals' assets to produce a desired and tailored income stream for those individuals in retirement, rather than trying to maximize portfolio value for a cohort of people. We see Dimensional's defined contribution approach as a simple, transparent and effective solution for members in a superannuation fund who are either overwhelmed by choice in retirement savings options, do not feel comfortable or skilled in making investment decisions or are just not sufficiently engaged to make the important decisions. Although aimed at the individual, our approach requires scale to operate effectively. As such Dimensional will continue to offer wholesale services, not personal financial planning services.

Dimensional believes that current default fund frameworks constructed around a standard 70% growth 30% defensive static asset allocation will not provide Australians with adequate retirement incomes. The industry needs to innovate to create services that are capable of recognising each person's unique circumstances, and managing the interest rate, market and inflation risks according to their individual needs. Performance measurement should be aimed at that individual, whilst fund level scorecards provide less useful but still necessary measures.

Dimensional would welcome the opportunity to discuss its approach with the Productivity Commission during its inquiry into Default Superannuation Funds in Modern Awards.

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Appendix

About Dimensional

Dimensional builds diversified portfolios around known dimensions of risk. We focus on consistently capturing those risk premiums and adding value through efficient implementation and ongoing management. Our innovations have been developed on a global basis with the express aim of maximising investors' ability to have a good investment experience and mitigate capital loss.

Formed in 1981, Dimensional's foundations are in academia. Our investment strategies are informed by the research of such prominent financial economists as Professors Eugene Fama of the University of Chicago and Kenneth French of Dartmouth College. Our confidence in the capital markets frees us to think differently about investing. Over the past 30 years, we have translated financial science into real world investment solutions, and through our innovative approach, investors have captured what the market delivers in all its dimensions.

The firm inaugurated its strategies in 1981 with early research into the stronger performance of small cap stocks. Later, a comprehensive analysis of stock prices worldwide deepened the strategy repertoire and set a new standard for portfolio design. This evolution reflects an abiding belief in financial science and the efficacy of capital markets.

We see markets as an ally, not an adversary. Rather than trying to take advantage of the ways markets are mistaken, we take advantage of the ways markets are right--the ways they compensate investors. The firm designs portfolios to help our investors capture what the market delivers.

Dimensional is owned primarily by employees and directors, and manages assets exclusively for institutional investors and the clients of accredited fee based financial advisors. From offices in Austin, Santa Monica, London, Sydney, and Vancouver our professional staff supervises portfolios and services clients twenty-four hours a day.

DFA Australia Limited is the wholly owned Australian subsidiary of Dimensional Fund Advisors and is licensed to provide funds management services in Australia and the US. DFA Australia Limited was established in 1994 to trade securities listed on the Asia Pacific stock markets on behalf of Dimensional's US institutional investors and the clients of US financial advisors.

Research

A scientific priority runs deep through Dimensional. We have a high regard for research, process, and time-tested data. We do this through deep working relationships with leading financial economists. By acting as a conduit between scientists and practicing investors, Dimensional has pioneered many strategies and consulting technologies now taken for granted in the industry.

Dimensional's process explores every aspect of dynamic real-world markets, including portfolio architecture, trading methodology, and tax management. Our investment staff is involved in research efforts through its daily trading activities, resulting in market studies, and Investment Committee participation. Clients benefit when research and experience combine to solve new investment challenges. As often as a research innovation generates a new technology, a client need or investment problem drives a new solution.

Dimensional has forged deep working relationships with some of the world's leading financial economists to bring their latest theories and research to practice. Though bound to a rigorous scientific process, we also have an instinct for knowing what works with investors. Financial science leads the way in understanding risk and return in securities markets. By maintaining a continuous feedback loop between the academic community, practitioners, and clients, Dimensional is always researching tomorrow's solutions today.

Academic Leaders

Professor	Affiliation	Expertise
George M. Constantinides , University of Chicago	Board Member of Dimensional's US Mutual Funds	Asset Pricing, Capital Markets Research
Eugene F. Fama , University of Chicago	Board Member of Dimensional Fund Advisors, Consultant for Dimensional's Fixed Income and Value Strategies	Efficient Markets Hypothesis, Random Walk Hypothesis, Capital Markets Research, Multifactor Model, Definitive Finance Text, Tax Research
Kenneth R. French , Dartmouth College	Board Member of Dimensional Fund Advisors, Consultant and Head of Investment Policy	Capital Markets Research, Multifactor Model, Tax Research
John P. Gould , University of Chicago	Board Member of Dimensional's US Mutual Funds	Applied Price Theory, Former Dean of University of Chicago Graduate School of Business
Roger G. Ibbotson , Yale University	Board Member of Dimensional's US Mutual Funds	Capital Markets Research, Comprehensive "SBBBI" Database (with Sinquefeld), Data Consultant Firm
Edward P. Lazear , Stanford University	Board Member of Dimensional's US Mutual Funds	Labor and personnel economics
Robert C. Merton , Harvard University	Resident Scientist	Optimal Lifetime Consumption and Portfolio Allocation Theory, Asset Pricing Theory, Valuation of Derivative Securities
Myron S. Scholes , Stanford University	Board Member of Dimensional's US Mutual Funds	Capital Markets Research, Options Pricing Model
Abbie J. Smith , University of Chicago	Board Member of Dimensional's US Mutual Funds	Capital Markets Research, Financial Accounting Information, Corporate Restructuring, Corporate Governance
Sunil Wahal , Arizona State University	Consultant	Capital Markets Research, Transaction Costs Research, and Trading and Portfolio Management Practices