

# REST's submission to the Productivity Commission inquiry into default funds in Modern Awards

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## Executive Summary

The Productivity Commission has been asked by the Australian Government to undertake an inquiry into default superannuation funds in modern awards, including the design criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by Fair Work Australia

The Retail Employees Superannuation Trust (**REST**) welcomes the opportunity to respond to the Commission's inquiry.

On 9 December 2011, the Productivity Commission completed an inquiry into the overall retail industry. Its findings specifically impact REST's sponsoring organisations (employers and unions), stakeholders and, in particular the core demographic of our fund - the vast majority of our members who work in the retail industry.

The findings, which focussed on the rise in online retailing and its impact on traditional "bricks and mortar" retailers and retail workers, lowering the low value threshold exemption for GST and duty on imported goods to be lowered significantly, to promote tax neutrality with domestic sales, and regulatory burdens placed on the retail industry (planning & zoning, trading hours, workplace relations and inconsistencies across jurisdictions), are part of what formulate decisions about the 'benefits' the fund may offer to its members, both now and in the future.

**REST believes that the outcome of the Productivity Commission's inquiry into default superannuation funds in modern awards will have an even more fundamental impact as it relates to the relevance and objectives of design criteria relevant to benefits to members under existing superannuation structures.**

REST believes the current inquiry presents an opportunity to increase the level of understanding of decision-makers and the general community, about the superannuation sector. It is hoped that this increased understanding will, in turn, assist governments to make better decisions regarding the framework that governs default superannuation funds in modern awards.

Finally, we also believe it is an opportunity for superannuation funds and other stakeholders to put forward constructive and practical suggestions which will continue to improve the superannuation outcomes for everyday Australians.

Therefore, it is critical that the findings of this inquiry confirm a **best practice process** for the selection of default funds in modern awards and by doing so support funds to continue to develop and deliver the significant benefits already enjoyed by members of these funds, employers and the broader community into the future with absolute certainty.

**REST wishes to put forward the following key points in relation to this inquiry:**

### **1. Transparent and objective criteria to drive long- term performance and member outcomes**

The Productivity Commission is tasked with ensuring the design of key, relevant, transparent and objective criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards. This criterion might include:

- Appropriateness of the investment strategy of the default investment option of the fund in terms of risk and expected return
- Medium to long term net-of-costs investment performance of the default investment option;
- Level of fees incurred by members
- Scale of the fund and the level of services provided to fund members
- Suitability and cost of insurance provided by the fund
- Governance of the fund
- Fees incurred and other impacts on members if they cease employment with an employer.

It is also important that the criteria are linked to the expectations of the specific type of members covered by the modern award and the default fund's ability to structure the benefits and services which are most appropriate to those members.

While REST therefore supports the above criteria being used for assessing funds, the most **fundamental criterion** is the **ability to support and reflect the needs of the underlying core demographic of default members of the relevant fund**.

To achieve the best possible retirement outcomes for those default members (which in REST's case are predominantly drawn from the retail industry) requires historical observation by the relevant fund and decisions made at all levels of the fund which support that core demographic of default members.

While there may be a view that, generically the criteria outlined in the Productivity Commission's Terms of Reference will be reflected by the new MySuper products due to enter the market under the changes through Stronger Super, REST believes that, there are fundamental differences in the way in which a default fund designs and executes the benefits to be derived from each product – even though they may be outwardly designed to be comparable.

The nature and performance of the My Super product will depend on the particular demographic of the *relevant* part of the fund that they are supposed to reflect, and all superannuation trustees must take this into account when designing these products or they may not deliver what they were intended to in the first place - to ensure all Australians enjoy a secure retirement.

By definition only those funds whose default members are predominantly drawn from the industries covered by the relevant modern awards can meet these key criteria. This of course does not mean that these funds might necessarily meet all of the other criteria.

## **2. Industry funds such as REST are best placed and are in fact designed to meet the specific needs of its core default demographic member base**

As an industry fund tailored to the needs of our members, REST has already designed the investment strategies, objectives, ancillary insurance and support services of the fund to meet the needs of retail employees in such areas as:

- Excellent investment returns over the medium/long term
- Low fees based on the average members' account balances
- Lifestage insurance, geared to the members' demographics
- Excellent governance and compliance
- Low cost flat fee advice which is free for the first super related question
- Stability and certainty in members' expected outcomes.

Industry superannuation funds are **best placed to be listed as default funds in relevant awards** as they have tailored benefits to meet the employee superannuation requirements of relevant industries.

For example, REST was established in 1988 to exclusively meet the superannuation and insurance expectations of the unique nature of retail employees, and continues the process of monitoring and assessing the superannuation requirements of its members.

Generic default superannuation funds cannot be tailored to particular industry employees. Those funds do not have the history or capability of servicing the needs of a unique membership. They also do not have initial scale, or are able to offer tailored benefits to employees of particular needs.

Other funds can *duplicate* products with the use of MySuper but they cannot reproduce REST's capability and focus on retail employees, particularly for default members.

### **3. Role of industry funds and scale increase positive member outcomes**

Recent 2012 APRA research has shown that industry funds or 'not-for-profit' funds' performance increases with fund size.

The research stated that there are three channels through which members of these funds could potentially benefit from scale:

- 1) Better gross investment returns
- 2) Lower investment expenses
- 3) Lower operating expenses.

The research also showed **that while 'not-for-profit' funds are able to realise economies of scale, this is not evident in the retail sector.** This is because the structure of retail funds, in the sourcing and offering of their investment products is less conducive to capturing the benefits of scale.

### **4. Alignment of outcomes to benefit members, employers, unions and the community**

The design criteria for the selection of default superannuation funds in modern awards must primarily take into account the best interests of the default members of the relevant funds, as well as employers, unions and the broader community.

Specifically, the design criteria recommended for selection of default funds in modern awards must take into account the needs of the following parties:

- (a) **Default members:** who require low cost, simple products which deliver stable returns and are tailored to their particular needs and expectations
- (b) **Employers:** who require certainty, efficiency, administrative ease, not being required to act as a "de facto trustee" to be required to choose a default fund, which may not be in their employees' best interest
- (c) **Unions:** who, as employee representatives, can ensure in their negotiations with employers that the employees best interests are served
- (d) **Community:** in particular the impact on capital/debt markets and infrastructure projects generally which have flow effects to the community in terms of new capital works and projects that provide benefits to all members of society, as well as being able to support broader community initiatives such as financial literacy programs and cheap, accessible financial advice.

### **5. Periodic reviews undertaken by stakeholders close to the process**

REST supports a periodic review and assessment of superannuation funds which best meet the design criteria for nomination as default funds in modern awards in any particular industry.

However REST believes that such reviews should be undertaken by the key decision makers in the relevant industry being employers, and employee representatives including unions and their recommendations to the relevant body tasked with effecting such determination, currently Fair Work Australia.

## **6. More choice does not improve competition for Australians**

Choice of superannuation funds (for members) and for default funds (for employers) is still available in many modern awards, so the 'benefits' of competition are already present.

Opening up modern awards to more funds **does not increase** any advantages perceived to be delivered by competition and in fact reduces effective default fund selection.

For instance, the introduction of *Choice of Fund* was predicted to have significant positive impacts for members by many commentators, but the eventual take up by Australians has proved to be much lower than originally anticipated.

The outcome was that employees **either preferred to stay with their current super fund choices or were inactive and did not respond**. Consequently the positive impacts did not eventuate or at least not even close to the degree first thought.

Opening up the awards to more funds **may in fact have impacts on reducing scale of those funds** currently listed in the awards.

Removal of, or dilution of the existing default fund process in awards could lead to industry funds:

- Losing relevance and the connection to their membership base, as they are required to merge to acquire scale such that all will be multi-industry funds
- Having to compete against their peers and conglomerates to acquire new members thus increasing costs to members through greatly increased marketing budgets and other retail fund like initiatives.

In effect they will **become more like retail funds and lose the characteristics and potentially the benefits** that have largely delivered for their underlying demographic over time.

## Background

The Retail Employees Superannuation Trust (**REST**) is open to all Australians and is the largest superannuation fund by membership in Australia. It has over 1.9 million members with more than \$21 billion of funds under management, approximately 150,000 employers and an average member account balance of \$10,000.

REST was originally set up as a superannuation fund for workers in the retail and fast food industries in 1988. REST's membership comprises mainly younger retail workers with an average age of 31.5 (and a median age of 28 years). 22% of REST members are part-time and casual workers. 61% are females.

Apart from its industry division which comprises the majority of REST's members including all those covered by the modern awards or enterprise agreements, there are three other divisions - corporate, personal and pension.

With this unique fund profile, we feel it is important to provide input to the Productivity Commission's (**Commission**) inquiry as it will potentially have significant and deleterious impacts on the ability of REST to provide long term benefits to our members. There are also flow on effects impacting employers, unions, employer representative groups, as well as the financial markets and the broader community.

With MySuper, the default offerings throughout the superannuation industry will have similar characteristics that are prescribed by legislation. However, the notable differentiator is that industry funds provide for a very specific demographic, such as the retail industry, with a retirement savings vehicle uniquely suited to their needs. Since 1988, REST has been dedicated to serving the retail industry leveraging off the experience of our sponsoring employer and employee organisations, our directors and staff who interact on a day to day basis with the members that we serve.

Since inception REST has consistently strived to be a leader on issues affecting the retail industry as it relates to superannuation as well as broader community matters. For example in 2011 REST issued superannuation white papers with important findings on declining home ownership rates and Gen Y's (a core part of our REST's underlying demographic) attitude to wealth and superannuation. REST is also a keen supporter of Superfriend, the Industry Funds Forum Mental Health Foundation. Superfriend is a nationwide initiative aimed at improving the mental health and wellbeing of industry super fund members. REST's CEO, Damian Hill, is the current chair of Superfriend.

Through its work with Money Solutions REST has subsidised free access for all its members to Money Solution's educational website and provides for members to have a free piece of advice when joining the fund to get new members on their way with the retirement savings.

Other initiatives include:

- running free retirement planning workshops in and around regional centres across the various states;
- in 2009 REST provided information about how members could improve their mental wellbeing through its communications to members and employers including:
  - proactive ways to improve mental health; like sleeping well and reducing alcohol intake;
  - developing a healthier workplace for employees;
  - the facts about common disorders such as depression and anxiety, and less common illnesses like bipolar disorder; and
  - where to seek reliable help and support; and
- in 2008 REST launched a tailored member retirement package which included education booklets and personalised work books.

## **Modern awards**

About 45% of REST's membership are party to an industrial award. REST is nominated as a named fund in six main Modern Awards:

- General Retail Industry;
- Fast Food Industry;
- Hair and Beauty Industry;
- Restaurant Industry;
- Pharmacy Industry; and
- Mannequins and Models.

In the award which covers most of REST's members, the General Retail Industry Award, 2010, (see Annexure A), REST is one of five named default superannuation funds.

Under this award, employers can pay retail employees' superannuation guarantee (**SG**) and other contributions in the following ways:

1. to REST or another of the named superannuation funds; or
2. to a member's own choice of fund; or
3. to another superannuation fund under the grandfathering default positions provided that the employer was making superannuation contributions for the benefit of its employees prior to 12 September 2008, and provided that superannuation fund was an eligible choice fund (ie. a complying fund).

Accordingly, the General Retail Industry Award offers choice beyond the named funds if a member chooses, as well as a suitable safety net as a default offering where a member does not choose.

## **Enterprise Bargaining Agreements (EBAs)**

A further level of entitlements can be found in EBAs.

About 45% of REST's active membership is covered by an EBA. EBAs provide "better off" conditions than the relevant modern award. In some cases, the SG components specified in EBAs exceed the legislated minimum of 9 per cent. Wages and other conditions of employment can also be more generous to workers than under modern awards.

Woolworths, Coles and Myer are examples of three of REST's biggest employers which have EBAs in place for their employees. REST is a named fund in the EBAs.

## **Non-EBA and non-award members**

The remainder of REST's active membership (some 10%) are governed either by non-EBA or non-award arrangements.

NB - There are also some 16,000 members in Personal division (which are either not attached to employers or are self-employed) and 4,000 members in the REST Pension.

## **REST's industry liaison**

As a major superannuation fund, REST participates in a number of industry bodies including the Association of Superannuation Funds of Australia (ASFA), the Australian Council of Superannuation Investors (ACSI), the Australian Institute of Superannuation Trustees (AIST) and the Industry Funds Forum (IFF). These bodies provide an additional forum and advocacy to enable REST to better represent our

members' interests as part of a broader industry wide approach to the government and to other bodies in the broader landscape.

We also work closely with the relevant regulators - APRA, ASIC, AUSTRAC and ATO, to ensure that at all times REST continues to work compliantly and diligently while serving the best interests of our members.

### **REST's sponsoring organisations**

REST's historical sponsoring organisations are the Australian Retailers Association (ARA), and the Shop, Distributive and Allied Employees Association (SDA). REST also has representation by the Australian National Retailers Association (ANRA), Woolworths Limited, Wesfarmers Limited and Myer.



## Productivity Commission inquiry terms of reference

The Government has asked the Commission to consider the interaction of this inquiry with the design and implementation of MySuper which introduces a range of new standards for default superannuation products. Once MySuper is in place, only funds that offer a MySuper product will be eligible to accept default contributions or be listed as a default fund in modern awards.

### **MySuper criteria should not be the only criteria for default superannuation funds**

The MySuper component of the choice architecture model aims to provide a simple, cost effective product with a single, diversified portfolio of investments for the vast majority of Australian workers (roughly 80 per cent of workers) who are in the default option in their current fund.

MySuper is designed with two large groups of members in mind: 1) those who take no real interest in their super (at least not initially), and 2) those who choose to be in a large, low-cost and well-managed product where the investment strategy is designed and implemented by the trustee.

MySuper would have a number of features designed solely with the member in mind: specific trustee duties designed to deliver lower cost outcomes for members; increased transparency leading to better comparability, especially of costs and long-term net performance; provision of intra-fund advice; simpler communications; and an embedded retirement product. It has been designed to sit within the existing superannuation structures and is based on existing widely offered and well understood default investment options.<sup>1</sup>

Superannuation funds which satisfy only the MySuper “tick the box” criteria but are not tailored to particular employees or industries must, by necessity, adopt a “one size fits all” approach. These funds do not have the history of servicing the needs of a particular membership unlike the relevant industry funds. They also do not have initial scale or are able to offer tailored benefits to employees of particular needs.

Funds such as REST have tailored benefits, e.g insurance and investment needs to our underlying demographic and this will continue with our MySuper product. Other MySuper products will not have such a focused approach given the diversity of their membership base and public offer status and members might not get the same targeted superannuation benefits.

### **Opening up awards to all MySuper products as the sole criteria**

Opening up the awards to **all** default fund based products does not provide the optimum in pre and post retirement benefits to members, nor administrative cost and efficiency for their employers. Recent APRA research<sup>2</sup> shows that REST is consistently in the top 10 of the 200 largest super funds, ranked in terms of fund-level rates of return for five, eight and 10 years. A further APRA paper<sup>3</sup> held that members benefit from these larger fund sizes as they produced scale benefits such as better gross investment returns, lower investment expenses and lower operating expenses.

That study also held that those economies of scale are not evident in the retail fund sector, It held that the structure of retail funds, in the sourcing and offering of their investment products is less conducive to

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<sup>1</sup> Cooper Review-Super System Review: Final Report — Part One: Overview and Recommendations

<sup>2</sup> APRA, Statistics, Superannuation Fund-level Rates of Return, issued 29 February, 2012. REST was ranked 11<sup>th</sup> and 21<sup>st</sup> out of the 200 largest funds surveyed by APRA for five year annum ROR for the 2007-2011 period and 2004-2011 eight year period, respectively. See pages 30-34 of this submission.

<sup>3</sup> APRA, Effect of fund size on the performance of Australian Superannuation Funds, Dr James Richard Cummings, March 2012

capturing the benefits of scale. The study also held that retail funds also do not realise any reduction in variable costs from administering larger member balances.<sup>4</sup>

The capacity provided by scale facilitates the development of capabilities which provide comparative benefits advantages which, in turn, yield revenue and cost benefits. A good example is product development. Product development is costly and time consuming. It requires financial and human resources which smaller funds are less able to provide. Good product development however positions the fund to attract and retain more members. Pensions provide a good current example. The Baby Boomer generation, who generally hold the larger account balances, are increasingly moving into retirement and transitioning to retirement. There is therefore an increasing demand for flexible and functional pension products (which MySuper has so far avoided addressing). Those funds that can respond to this demand will be more successful in retaining their large balance members. They will also be able to attract members from other funds. Those funds which do not respond adequately risk significant reductions in their funds under management with flow on effects to investment management fees and returns. Those attracting the funds will conversely enjoy the scale benefits of increasing funds under management. It is also important to note that pension funds are not covered by awards but are a by-product from the successes of scale offered by the industry fund offering, which is covered by the award.

Increased scale results in broader insurance pools resulting in lower premiums for members. It can also result in a broader range of investments and improve a funds overall rate of return. Rate of return is regarded by APRA as a useful measure to assess a superannuation trustee's ability to deliver on the fund's investment strategy for the benefit of all members over the long term.

### **Periodic review of design criteria**

REST is in favour of a process being established whereby there is a regular periodic review of the selection and ongoing assessment of superannuation funds in modern awards using the MySuper product criteria, in particular scale, and provided that the funds are tailored to the relevant demographic of employees covered by the relevant award.

Trustees of retail funds may offer MySuper products but because they are new products for retail funds they may not have the advantages of "scale" targeted to a specific industry demographic. Instead a standard criteria of MySuper is imposed which does not take into account core demographic tailoring of benefits.

### **Impacts of default fund selection process on employers**

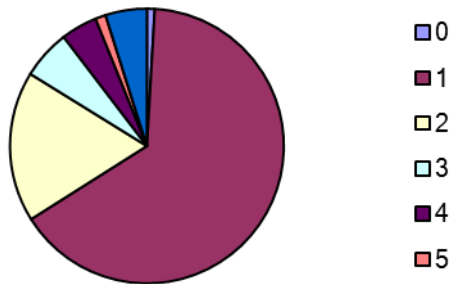
One of the advantages of the current structure is that employers do not need to be forced to make ill-informed, unsuitable and costly choices from multiple categories of default fund as the award nominates the fund for them. Choice of fund legislation also enables employees who want to elect their own fund and this exercise of choice is based on a conscious and informed decision.

An increase of funds would involve increased processing costs for employers. Data from an APA survey conducted in 2011 and presented to ASFA shows that 54% of employers offer a single default fund. The research also showed that smaller employers with 1-50 staff – which is similar to those contributing to REST – pay contributions to eight funds on average. If this was opened up to all funds (it is estimated that there will be in excess of 300 MySuper offerings under Stronger Super) the costs to employers in both time and money spent administering their employees 300+ default fund choices not to mention ongoing compliance costs and audit related expenses could prove unbearable for certain employers and an unnecessary drag on revenues for others.

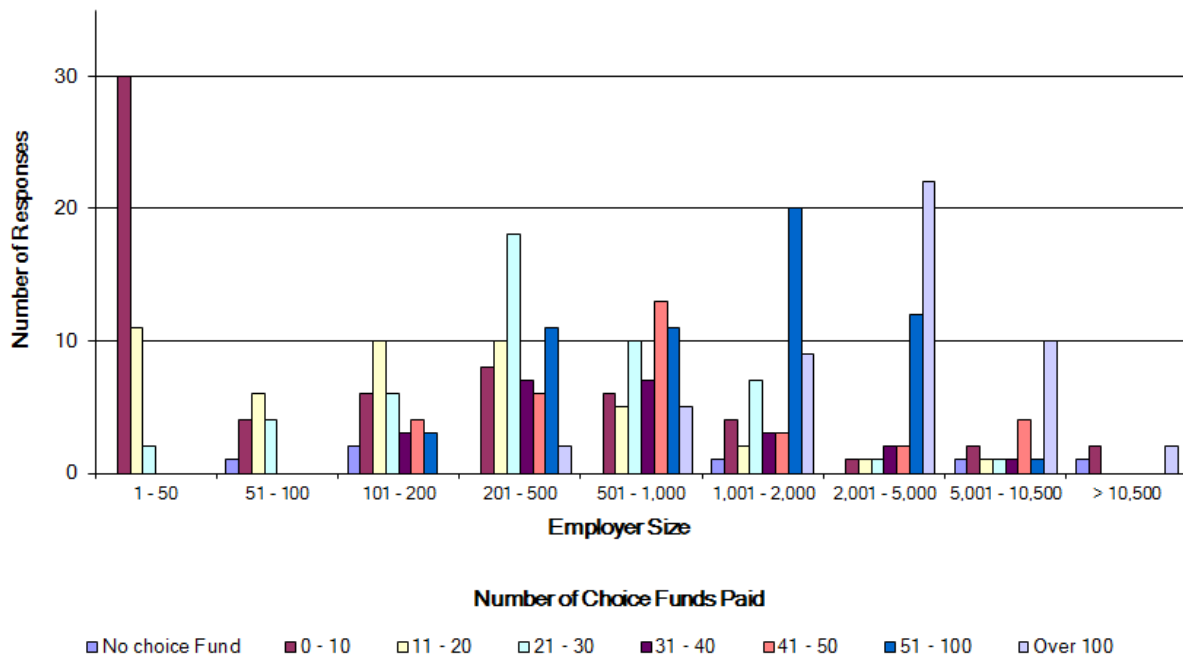
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<sup>4</sup> Ibid, page 31.

### Number of Default funds Offered by Employers



### Number of Choice funds Paid by Employer Size



Major retail employers have commented to REST that the use of clearing houses and efficient processing of superannuation contributions are key to supporting selection of funds. Clearing houses themselves are a critical component of efficient superannuation administration across larger employers. With large numbers of employees and many of these entitled to exercise choice of fund, the number of default funds which are required can be significant. Without the use clearing houses, larger employers would be overwhelmed. A clearing house is usually used for all non-default payments, which results in at most two remittances being required. However, this is assuming that there is only one default fund to pay to. Major retail employers have commented that there is no question that changes to the nominated default superannuation fund would cause some inconvenience, be it the need for system configuration, the use of disclosure material to employees and associated material to all recruitment locations, as well as the need to liaise with additional parties for contribution reconciliations and insurance claims.

Ultimately, employers would prefer to leave the responsibility for selecting default superannuation funds to those for whom it is core business. If this were to change, employers would need to make a choice of default fund which would provide them with an onerous and potentially challengeable duty of care to select the appropriate fund. It is possible that they will nominate a fund based on brand recognition such as one managed by a major bank unrelated to the relevance of the fund's product and benefit design. They could

perceive the bank's strength and financial security to be important factors (even though this is independent of the fund's likely performance).

Employers could come under pressure from groups of employees or from external marketing and promotions from other funds. Evidence of this short term impact is clear.

Employers are not necessarily qualified to make such decisions and it is possible that many employers would select a fund which is not geared to their employees' expectations – to the detriment of their employees. REST believes that employers would not want to be in the position where the selected funds in the awards are not tailored to the relevant demographics of the industry their employees work in. These employers may also find themselves acting as "defacto advisors" whereby they must choose the default fund from a very large pool and be challenged by their choices for their employees. If the fund is subsequently shown to not be suitable for their employees, then this may create disharmony in the workplace.

If the employer is in the retail sector and does not choose REST, it may still have a significant number of employees using REST. We expect many will already be members of REST when they began their careers and they will not perceive a need to change just because the new employer has a different default fund. Ultimately, the employer will have significant numbers of its employees as members of REST and in its chosen default fund. This would result in potentially significant variations in member insurance coverage, costs and fee levels, as well as investment risk and return strategies and outcomes within the same workforce and over numerous workplaces.

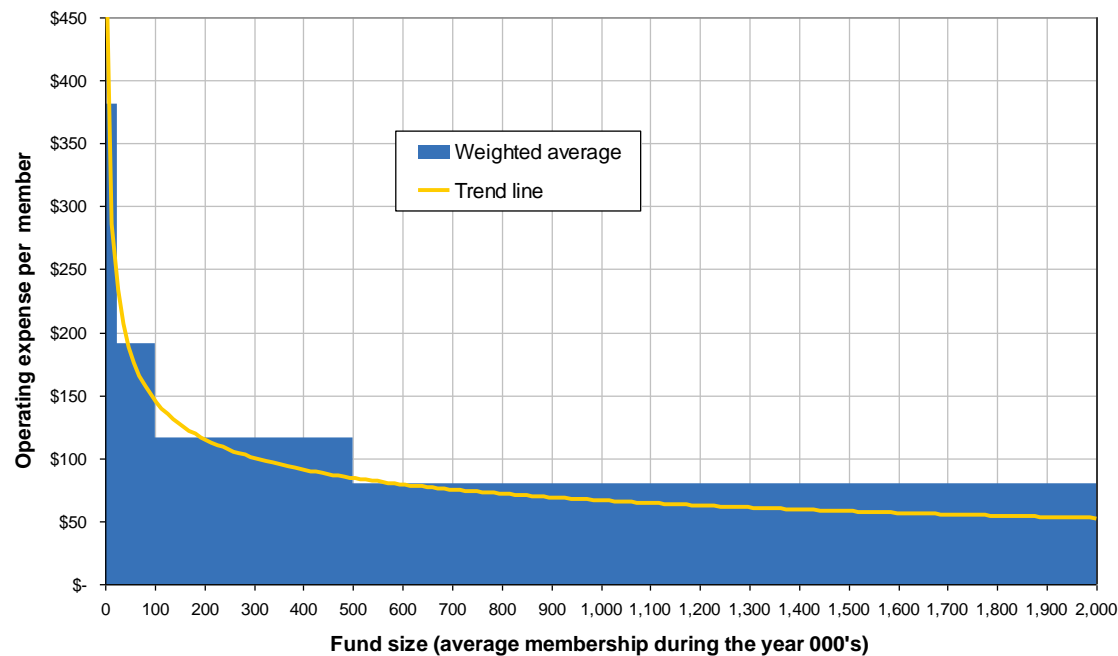
Employers may also use clearing houses to solve multiple fund contributions but it is also important to note differing insurance options from fund to fund some of which may be more generous than others and/or more expensive. This will put a "moral hazard" decision making process on the employer who would be at risk of not making the appropriate default fund choice in relation to death, TPD and IP insurance. In addition, contributions are usually out of the market longer when using a clearing house leading to potential loss of benefit for members.

### **Loss of scale**

If a fund loses membership through the opening up of default fund status in modern awards, this could impact on its ability to continue to offer the benefits of scale to its members.

REST has engaged consulting actuaries Rice Warner to ascertain impacts regarding possible loss of scale which has flow on effects for members and others interested stakeholders.

Operating Expenses per member by fund size (membership)  
(For assumptions, see Annexure B)

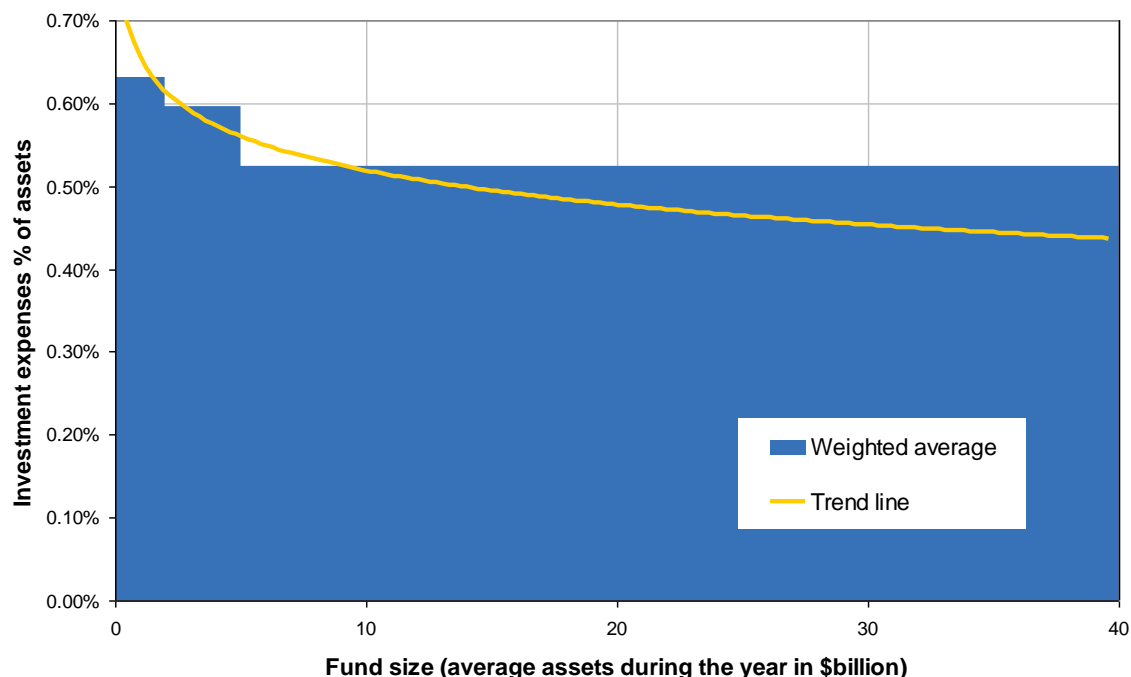


The graph above illustrates the clear scale effect with the bulk of the reduction in operating expenses flowing from scale generally achieved with a fund membership of 500,000 or more. With 1.9 million members, REST is at the top end of the scale. If membership was to decrease operating expenses would rise. Members remaining in REST would need to bear these additional costs.

Further, increased costs to members reduce the rate of return to members.

### Investment Expenses by fund size (net assets)

(For assumptions, see Annexure B)



The fitted log curve is based on the distribution of all data, not just the three points in the weighted average. A fall in assets could see a rise in investment expenses of around 2-3 basis points of fund assets. Again, these additional fees will be borne by the members that remain in the fund.

Loss of FUM results in higher cash outflows and increases the need for liquidity in the fund's default investment option. This could limit the ability of a fund to invest in less liquid assets such as infrastructure projects which typically are expected to provide higher returns than other assets classes but are illiquid and require significant capital investment. The reason for these returns can often be attributed to additional liquidity and risk premiums. We have estimated the possible reduction in returns for a default option with the removal of illiquid infrastructure assets could lead to asset allocations to infrastructure reducing to 0.

The removal of infrastructure based on the assumptions outlined above results in reduced gross returns.

### Investment impacts

With the introduction of MySuper, the default offerings throughout the superannuation industry will have similar characteristics that are prescribed by the proposed legislative changes. However, the notable differentiator is that industry funds support members with a very specific demographic, such as the retail industry, with a pre and post retirement savings vehicle uniquely suited to their income and lifestyle.

REST's Core Strategy was recently ranked as the best Public Offer Balanced option over the past decade by SuperRatings. This is extremely high recognition from one of Australia's most respected super research companies. Supporting this argument is SuperRatings September 2010 Crediting Rate Survey that states industry funds have out-performed for-profit funds over one, three, five, seven and ten years. The figures also reveal an almost two percentage point difference over ten years in the balanced option. REST is of the opinion that the long term underperformance of any fund should be considered on a fund specific basis and the prudential regulator should have the appropriate powers to assess.

We discuss the impacts of investment strategies, as well as provide responses to the **Productivity Commission Issues Paper** in relation to investment strategies which are set out in *italics* in Annexure C.

### **Other scale based impacts**

If major changes in membership arise in a particular fund, there would also be impacts on both members who remain or those who leave including:

- potentially higher fees charged by another fund;
- Changes to existing members' insurance - a reduction in a fund's membership would erode that fund's insurance pool. This would impact on the remaining members in terms of premium rates, cover and ancillary benefits and could potentially affect its future competitiveness (other funds with increased scale will enhance their offering whilst the old fund's offering potentially remains static);
- Reduced or ineligible insurance benefits under another fund;
- Differing investment performance for existing members including:
  - the impact of an indexing strategy versus a more broad based investment strategy; and
  - the impact of short term investment philosophy and liquidity requirements versus a higher allocation to infrastructure projects; and
- Doubling of accounts if members do not consolidate. This is already a problem which the Government initiatives of SuperStream are trying to overcome by allowing funds to take more active involvement with members' duplicate accounts.

#### **(i) The level of fees incurred by members**

The original compulsory superannuation architecture contemplated the effective operation of market forces, disclosure and competition (along with trust concepts) to resolve consumer issues surrounding complex products, structures and conflicts.<sup>5</sup>

However, the final report of the Cooper Review accepted that the model of member-driven competition through Choice of Fund (in the form of SG Act choice and consequent portability) has struggled to deliver a competitive market that reduces costs for members.

The Cooper Review also held that the failure of competition to deliver desirable outcomes for members encapsulated the broader issue in the superannuation industry as it currently operates: namely that it is remote from the member. The Review recognised early on that, for real benefits to flow to members, the superannuation system must operate from the member, not just the financial services perspective.

Industry funds like REST are not-for-profit organisations which have always put members' interests as a priority, accordingly tend to charge lower fees than retail funds. Further industry funds, such as REST do not pay commissions to financial advisers. For REST members the result is that lower fees result in higher incremental account balances available for long-term investment.

APRA research<sup>6</sup> has held that the annual fees to members are on average four times higher for retail funds than the

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<sup>5</sup> Cooper Review, final report, Part One, Overview and Recommendations, 2011.

annual fees charged by industry and corporate funds. This is regardless of whether the retail fund investor is directly investing or investing via a Master Trust. This difference is due in part to a greater reliance on percentage fees by retail funds relative to not-for-profit funds as well as retail funds having overall higher percentage fees.

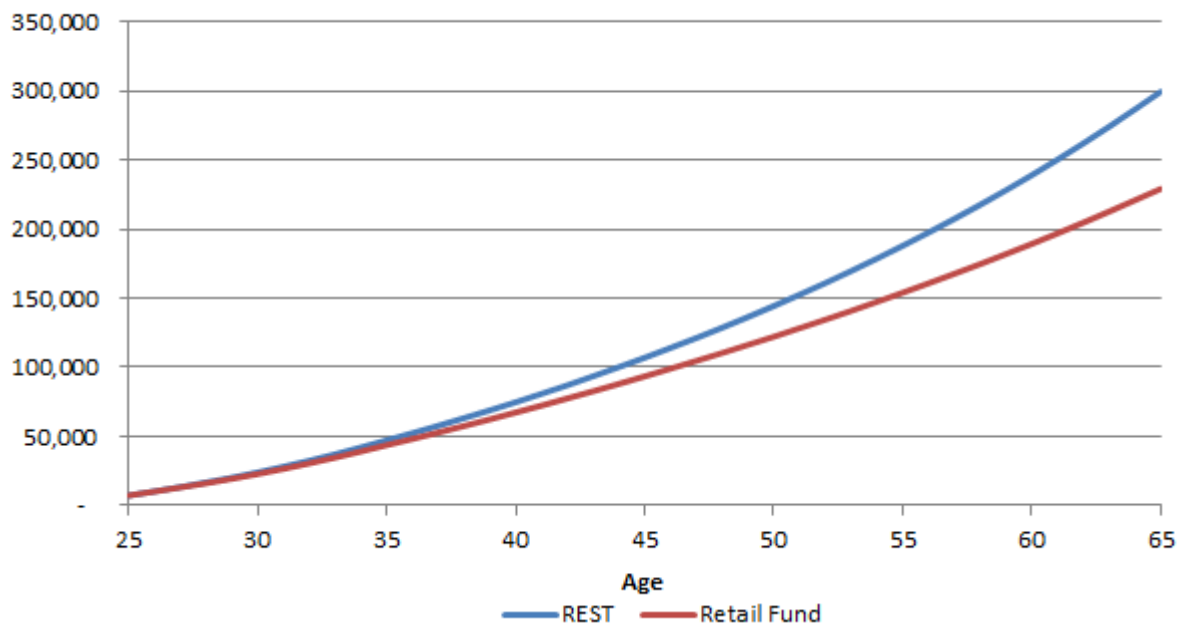
For the two annual fee categories that are common across all fund types (administrative fees and other fees) 85 per cent of retail funds charge a percentage fee and 50 per cent charge a flat fee, whereas for the not-for-profit funds 65 per cent charge a percentage fee and 81 per cent charge a flat fee. The average percentage annual fee charged by a retail fund is 2.1 per cent compared to an average percentage annual fee of 0.7 per cent in the not-for-profit sector.

With the introduction of MySuper, the amount of fees, while governed by a number of factors such as scale and scope, may still be higher for MySuper retail products than for MySuper industry fund products.

As a result, higher fees would reduce a member's investment returns and REST would expect that APRA's comparison between fees charged by retail and industry funds would still hold true in the MySuper environment.

REST has asked Rice Warner to model the impact of higher fees on a "typical" REST member within our core demographic.

#### Impact of Higher Fees (Choice) – Kate



This graph demonstrates the possible impact on Kate's balance of higher fees within a typical retail fund (non MySuper). Kate's balance at retirement is reduced from \$299,303 to \$229,069 in today's dollars) a difference of over \$70,000 or 23.5% of her balance at retirement if she had remained with REST.

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<sup>6</sup> APRA research, "Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds, 02 October 2008, Katrina Ellis, Alan Tobin, Belinda Tracey



**Assumptions: Kate is a 25 year old female on a salary of \$40,000 p.a. with a current account balance of \$7,500. She is currently in active employment and receiving employer SG contributions (including the proposed future increases of the SG to 12%), she does not make any salary sacrifice or after tax contributions into her account at any time over the projection; she has default insurance, she will experience future salary increases of 3.5% and she will retire at age 65.**

#### **Benefits of scale with fees**

Scale has an obvious flow on to the fees charged to members. In the table below we compare REST (\$20.4 billion in assets) with a significantly smaller industry fund (\$1.6 billion in assets). This alternative has been chosen as it is significantly smaller than REST (and so lacks the scale of REST) and it also competes for similar members to REST.

With the exception of investment fees (where the differential is minor and can be related to asset allocation), REST's fees are lower than the alternative fund. Indeed for a member with an account balance of \$20,000, annual fees in REST are \$202 compared to \$254 in the alternative fund. The alternative fund may need to address pricing in its MySuper offering to lessen this gap, whereas this will not be a significant issue for REST.

#### **REST v Alternative Fund fees**

	<b>REST</b>	<b>Alternative Fund</b>
Assets at 30 June 2011	\$20.4 billion	\$1.6 billion
Members at 30 June 2011	1.9 million	105,000
Member Fee (p.a.)	\$52	\$78
Asset Fee (% of assets)	0.10%	0.25% (account balance < \$150,000) 0.2% (\$150,000 < account balance < \$300,000) 0.15% (\$300,000 < account balance < \$1 million) 0.1% (account balance > \$1m)
Investment Fee – default option (% of assets)	0.65%	0.63%

#### **(ii) The scale of the fund and the level of services provided to fund members**

REST's scale and returns to members approach enables it to provide member focused value for money (based on investment returns after fees) in the Australian superannuation sector.

Deloitte Actuaries & Consultants<sup>7</sup> have confirmed the widely held view that larger superannuation funds have a definite cost advantage over smaller funds. The results show clear economies of scale in both administration/operations and in investment management.

<sup>7</sup> "Super fund size matters" Deloitte actuarial research, Wayne Walker, 4 June, 2009.

As part of Deloitte's ongoing research into the superannuation industry, the actuarial team analysed 60 industry funds looking at both their cost structures and the returns earned on their default options.

The study looked at the returns achieved by both small and large funds to see if there was any statistical evidence to suggest that smaller funds were able to generate higher returns to offset the generally higher costs they were incurring.

The results showed that on average most of them are not.

The study showed that while there are small funds that buck the trend, the larger funds with lower fees also generally delivered the better returns.

The report held that a part of these higher returns (net of fees and taxes) comes from the lower investment costs of large funds. Nevertheless the gap in returns between large and small funds is more than simply lower fees. Large funds appear to be delivering genuinely better investment performance to the bulk of their members who use the default option.

The combined impact of lower operational/ investment costs together with the higher returns achieved by large funds is enough to increase the retirement benefit of Australians by almost 25% over a working lifetime.<sup>8</sup>

It would appear that scale offers a clear potential for funds to deliver extra benefits to their memberships. This adds some logical impetus to the government's desire to rationalise funds into fewer and larger entities.

### **Benefits of scale with Administration**

Scale is also an important determinant in administration costs.

The provision of administration services has a significant fixed cost component especially in the provision of:

- Accommodation for administration and service centres;
- Infrastructure for administration and service centres; and
- IT systems.

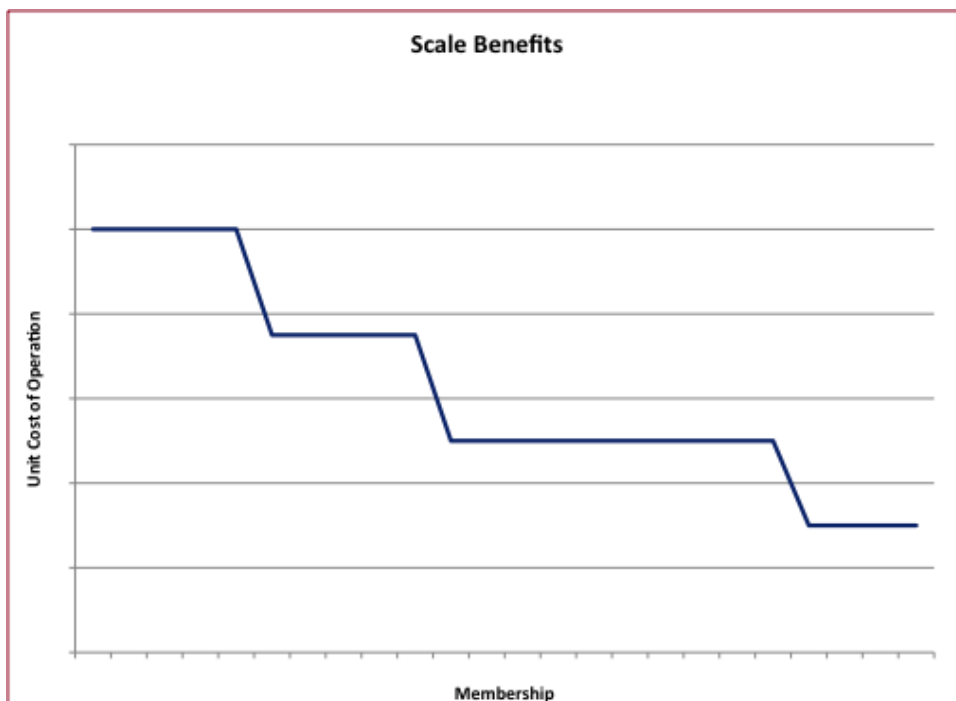
Most industry superannuation funds outsource their administration so there is already an advantage from sharing resources. This removes the need for the fund to hold direct capital, but it does not mean that the full scale advantages are met.

High volume equipment and systems operate at significantly lower unit costs from low volume equipment and systems. They require a significant capital commitment and therefore require a minimum business volume before they can be justified. Scale economies therefore generally operate in a stepped fashion as illustrated in the following chart:

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<sup>8</sup> Ibid

## Scale Benefits



Source: Rice Warner, 2012

Growth (whether this be organic or through acquisitions of other funds) can provide the scale economies to move from one step to the next. Conversely, reductions in membership can result in loss of these economies of scale.

### Benefits of scale with advice

The provision of financial advice is another member service which benefits from scale. REST offers a full advice service provided by an external provider, Money Solutions. Members are charged a flat fee depending on the type of advice requested. REST also offers free advice for the first single question asked by a REST member about superannuation. This is a service which is offered to REST's entire membership regardless of age or account balance. REST has found that a free service will encourage a greater number of members to seek advice and get on the right path at an early stage in life.

Rice Warner conducted market research in 2011 of telephone interview (593 members) and focus groups (98 members – a subset of the telephone interviewees), a series of which were held separately with members of three different industry funds. The members were predominantly those close to retirement, although the results can be extrapolated to younger members seeking simple advice as members were asked about attitudes to advice throughout their lifetimes. The following results were noted:

- 46% of members did not intend to seek financial advice about their retirement investment strategy – nearly all of these members had also not sought any earlier advice on single advice issues;
- 48% of members had received advice from their fund (after being approached by the fund as part of a marketing exercise) – of these 92% stated that they were satisfied with the advice. This illustrates that if members do seek advice, they tend to appreciate the value of it;
- A number of members who had obtained advice commented on how easy it was to obtain the advice. Indeed, two of three funds had staff onsite that could service "walk-ins" and a number of focus group members spoke of this as an extremely valuable service;

- Of those members who might seek advice from their superannuation fund;
  - 54% would prefer the advice to be provided by their super fund
  - 63% would be reluctant to pay more than \$500 for this advice; and
  - 86% would be reluctant to pay more than \$1,000 for this advice.

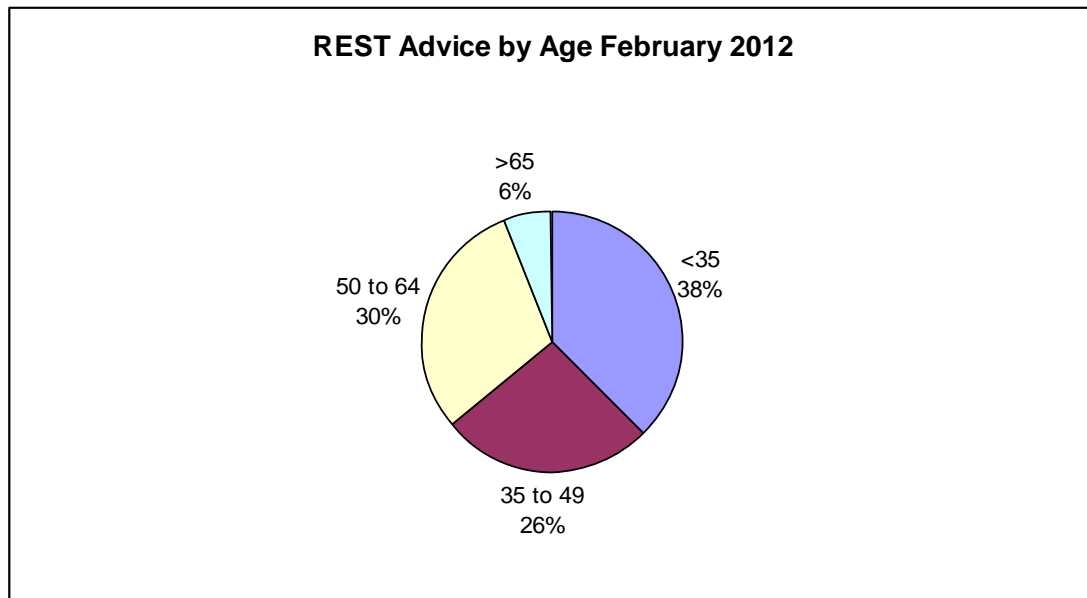
The above comments illustrate that:

- Members are cost conscious when it comes to buying advice
- A nil fee entry point is extremely attractive to members and encourages them to take up advice; and
- Once members receive advice, they generally appreciate it. By extrapolation, we would state that members who valued any initial advice which was more likely to be sought if it was free) would be more likely to seek further advice and pay a fee.

By offering free first issue advice, members are more likely to understand the value of advice and appreciate the impact it has on retirement outcomes. Without this option, it is possible that many members would never take up advice and not appreciate the difference simple strategies could have on their super.

Financial advisory businesses have high fixed costs – for compliance, research etc. Therefore, they require a minimum volume of business to be viable. Larger funds like REST can outsource this function but strike a much more competitive rate and agreed high level of service.

Further REST members have the benefit of having access to advice that they would not normally be able to obtain through other channels, given their low account balances and younger age group (see below).



**Pie chart supplied by Money Solutions. REST members who received advice from Money Solutions broken up by age groups.**

### **Benefits of scale with investments**

Scale benefits for investments do not just relate to costs. Larger funds also gain the ability to participate in investment opportunities which are not open to smaller funds. They can participate directly in special investment strategies and products to provide the benefits of long term opportunities like infrastructure projects and diversification. They also gain the ability to rely less on fund management intermediaries for some investments (e.g. overseas) and this provides better yields because of lower internal fees.

Reduction in scale clearly has the opposite effect. Should REST lose its considerable scale through member outflows, its members may lose the advantages they currently hold. An obvious one is its ability to be considered for large infrastructure projects, e.g. wind farms.

**(iii) The suitability and cost of insurance provided by the fund**

Insurance by its nature is scale dependent. Larger membership groups provide larger pools which provide actuaries with higher certainty of the outcome of total claims. This yields lower risk premiums. The administration of group life plans also benefits from scale because it too has a large fixed cost component. The administration component of premium rates will therefore also fall with increasing membership, or rise with decreasing membership. Premium rates therefore reduce with scale.

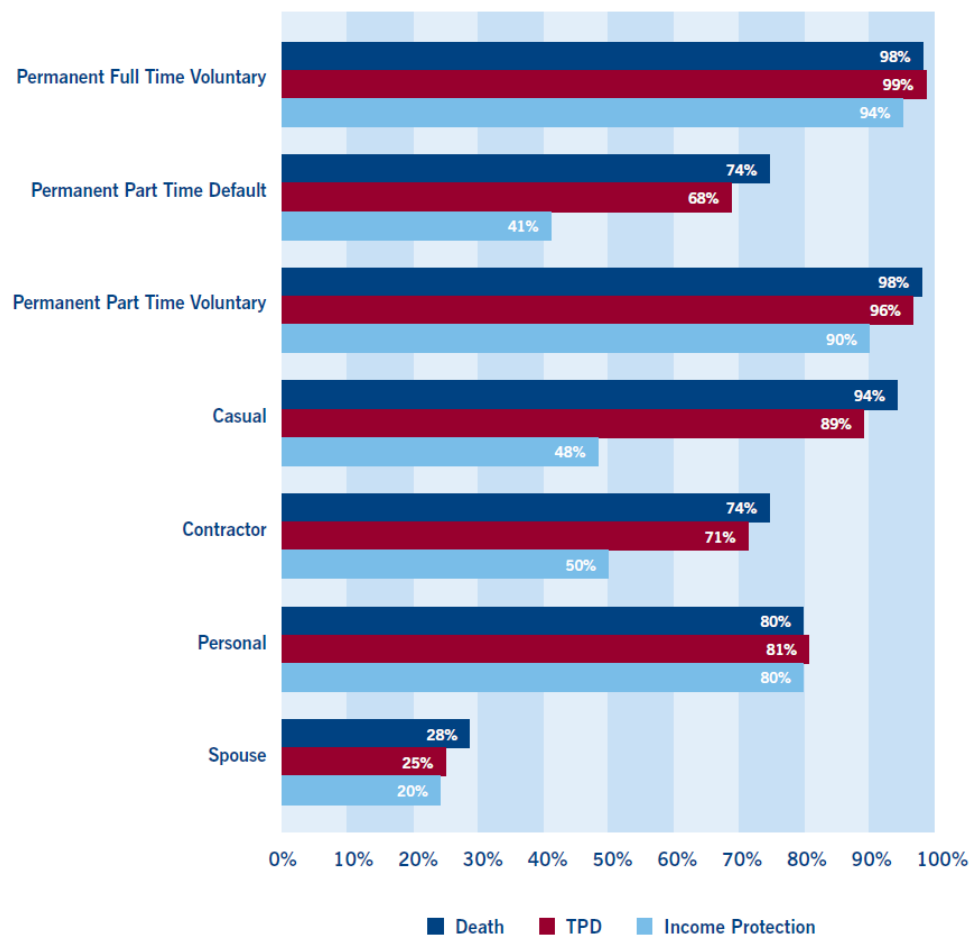
REST already operates one of the largest insurance pools in the southern hemisphere. Rice Warner has produced modelling which illustrate the competitiveness of REST's offering. A reduced membership will erode this pool and could potentially affect its future competitiveness. This will impact on the remaining members in terms of premium rates, cover and ancillary benefits (other funds with increased scale will enhance their offering whilst REST's offering potentially remains static.).

A key advantage of REST over retail funds (and indeed over many industry funds) is that its members are a homogenous industry. Therefore, premium rates are priced accordingly. The large membership provides significant scale for the insurer, which results in lower premiums and higher automatic acceptance limits. Further, the default levels of insurance in REST means that REST members can often get higher cover without medical evidence than in other funds. Competition and members benefits results from REST testing the market of insurers periodically.

It is also important to note the availability of cover. One defining feature of REST's current insurance offering is that default and voluntary insurance cover is provided for both part time and casual members for death, TPD and income protection cover.

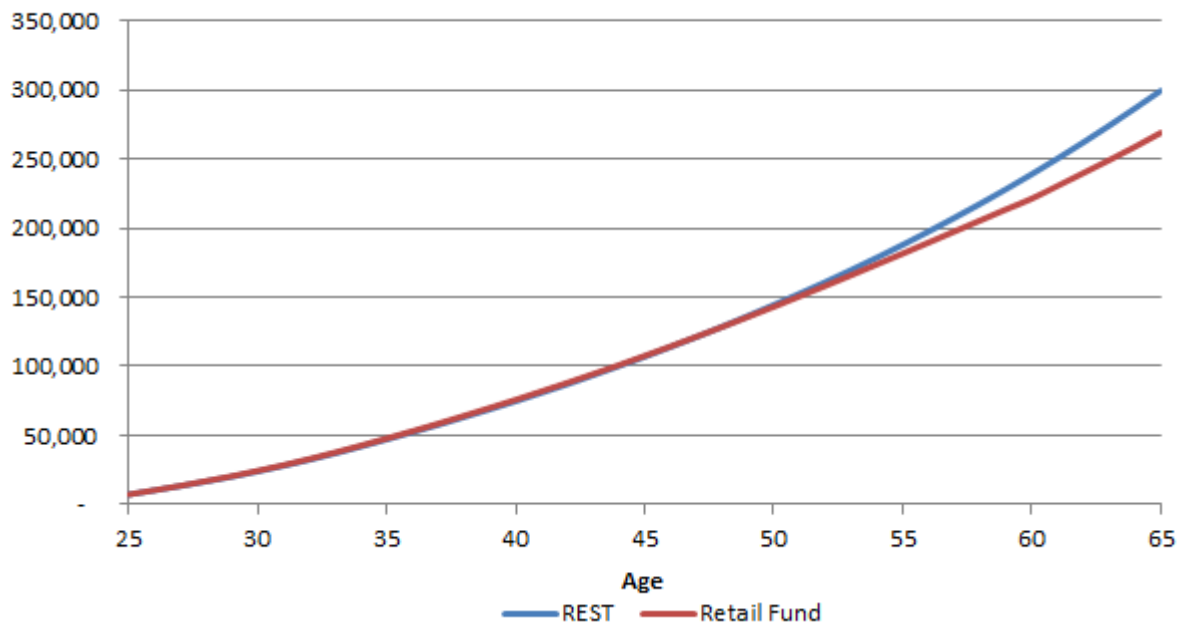
The graph over the page demonstrates that although nearly all funds provide full time members with access to all three types of insurance cover, only 74%, 68% and 41% of funds provide default cover for death, TPD and IP respectively to part time workers. Further only 48% of funds offer any income protection cover to casual workers. Casual and part time workers who are members in REST are able to access low cost insurance with generous benefits.

Types of Workers to whom Risk Insurance is available by type of cover for Employer Sections



## REST insurance comparison with a retail fund

### Impact of Higher Premiums – Kate



**Kate is a 25 year old female. The graph above demonstrates the possible impact on Kate's balance of higher premiums within a typical retail fund should Kate's employer be required to pay her SG to a retail fund, rather than REST. Kate's balance at retirement is reduced from \$299,303 to \$268,842, a difference of over \$30,000 or 10.2 % of her balance at retirement if she had remained with REST.**

Apart from offering cheaper premiums, insurance offered by industry funds such as REST can be more generous and tailored to members' needs.

However, insurance cover embedded in super comes at the cost of foregone retirement savings and earnings. In this context, REST holds the view that by offering insurance, trustees have an important role in setting appropriate insurance offerings or their members. Default insurance must be tailored for members who do not consider their insurance needs, and who rely on the trustee's judgment for adequate insurance. For members who do consider their insurance needs, they should be able to opt-out of cover entirely or to have access to additional cover.

Death and TPD insurance, in particular, must meet the needs of members so that they have sufficient benefits in the event that they need to access their retirement savings early. REST also holds the view that income protection insurance can complement these types of insurance by providing benefits when disability is believed to be temporary, not permanent (MySuper will not necessarily lead to any significant change in insurance benefits or premiums).

As a result of REST's intention to offer insurance that was more tailored to the needs of its members, REST Industry Super introduced new group life basic cover insurance arrangements for its industry fund members from 5 December 2008.

The new design of cover offered:

- “Life stage” approach for death cover with more appropriate levels of cover at different ages;
- “Living benefit” approach for Disability (Total and Permanent Disablement Cover - TPD and Income Protection (IP) cover with IP moving from a two year benefit to a long-term benefit and a smaller lump sum TPD benefit; and
- Reinstatement of cover without medicals.

The insurance package was tailored to the life of the average REST industry division member. Its aim was to protect members for their working lives, as their level of cover is indexed annually, to keep in line with changes in the cost of living.

### **Life stage death cover**

REST found with its previous cover that death cover was highest when members were younger and then reduced with age.

However younger people under 25 are generally single, have no dependents and have lower debt levels, meaning they have less need for a high level of death cover. REST found from its members that as people get older, life changes can include issues like finding a partner, having children and getting a mortgage. With increasing financial commitments, there is a need for corresponding increase in the level of cover. Life changes again when debts are paid off, the children have left home and members start to think about retirement and at this time the need for insurance cover reduces.

Accordingly to tailor insurance more suitable to its membership, REST introduced new death cover which provided a more appropriate level of cover in line with these different stages in life. Death cover now starts lower when members are younger, automatically increases when the need may be higher and then reduces again as members get older.

### **Living benefits**

REST previously provided members with a lump sum TPD benefit and a short term income protection (IP) benefit payable for up to two years.

Recognising that disability cover needs to provide for members through their lives, REST enhanced the IP cover so that it was payable (if a member is eligible) up to the member's 60<sup>th</sup> birthday, rather than just two years. For members disabled after age 58, a two year benefit period continues to apply while the member is disabled (or to age 65 if this occurs earlier)

The IP cover keeps paying an income beyond the previous two years to help meet living expenses while the member is disabled. It also includes an amount payable into the member's super which ensures that the member's super continues to grow for their retirement because as they are disabled and unable to earn an income, they will not have super contributions paid by their employer.

The IP cover works together with the TPD cover. While IP takes care of living expenses, REST's TPD cover aimed to cover the one-off initial expenses a member may incur from a serious sickness or injury, such as medical expenses or changes to their home. In recognition that most people's medical costs at commencement of disability will be similar regardless of age, REST changed the TPD benefit to a flat \$50,000 for most ages.

Another improvement was that REST extended TPD cover from age 65 to age 69 to reflect the fact that Australians are living and working longer.

REST also found that some members make decisions when they are young regarding insurance which is right for them at the time. However once the cover is cancelled, members usually can't get it back without



having to go through a medical process. REST made changes to make it easy for members aged over 25 to get cover again without medicals (subject to certain circumstances).

#### **(iv) The governance of superannuation funds**

The Cooper Report noted that retail funds' trustee boards seem to act more like the boards of shareholder-owned corporations, whereas trustees of other not for profit sectors tend to act more like traditional mutual superannuation trustees.<sup>9</sup> Relative to the other trustees, retail trustees have fewer directors, shorter (but just as frequent) board meetings, and are influenced more by retail fund executives on most key decisions. By contrast, trustees in the other sectors mostly make the decisions with the key influencers being the trustees themselves and their consultants.

The Stronger Super legislative and Prudential Standards provide for enhanced decision making requirements for trustee directors of superannuation funds. These proposals relate to Trustees of registrable superannuation entities (RSEs):

1. Create new duties for trustees of RSEs
2. Apply new personal liabilities for directors of corporate trustees
3. Impose additional duties on MySuper trustees
4. Replace the current capital requirements with a new duty to have an operational risk reserve.

These new duties have added to the existing director superannuation and corporations legislative requirements and have a strong focus on trustee obligations to act in the best interest of their members. There are also proposed requirements relating to have a tenure policy for the directors of the Board. REST also holds the view that it is important to strongly advocate the benefits of long-standing directors and what this brings to a fund's board and its members.

REST's view is that tenure, by itself, is a poor measure to assess the appropriateness of a director. It is the contributions made to the Board through their collective skills, education, experience and participation that are more relevant.

The REST Board is made up of individuals who have a wealth of retail industry and commercial experience in a corporate environment. Their long standing in-depth knowledge of the fund which can only be gained over a long tenure, together with their understanding of the industry adds huge value not only to the operation of the fund but also to the members and employers.

REST holds the view that current APRA based governance standards as well as those set out in the Stronger Super reforms are sufficient to maintain effective and appropriate governance of a superannuation fund.<sup>10</sup>

#### **The fees incurred and other impacts on members if they cease employment with an employer**

Since the introduction of the 'Choice of Super' legislation, switching rates between funds have actually declined from around 5 per cent in 2005 to 2 per cent by the end of 2009.<sup>11</sup>

A Roy Morgan Research report, based on over 50,000 interviews conducted annually, indicated that approximately 80 per cent of super fund switches come as a result of members changing employers or

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<sup>9</sup> Cooper Review, final report, Part one, Overview and Recommendations, 2011.

<sup>10</sup> REST's Governance structure and functions were rated as "robust" and scored "Well Above Benchmark" and within the top 25% of funds in the 2011 SuperRatings Benchmark Report.

<sup>11</sup> Cooper Review, final report, Part one, Overview and Recommendations, 2011.

employers changing default fund providers. Of those who default into a super fund chosen by their employer, or award, roughly 80 per cent are in the default investment option. Of that 80 per cent, anecdotal evidence suggests that approximately 20 per cent of default investment option members do choose to be in the default investment option. This suggests that approximately 60 per cent of members do not make active choices.

One of the key points of the Stronger Super reforms was to introduce a compulsory system which needed to be able to cater for these different degrees of engagement: the significant proportion of members who are not engaged with their super, or in a position to make the sorts of decisions required of them; and the informed, financially literate, or well-advised members.

Accordingly, if a member ceases employment with an employer and does not make a decision about their current super balance with the fund, they should not be forced to transfer into a more expensive or less appropriate fund from an investment performance or insurance product perspective.

REST has always taken the view that inactive members should not be penalised for their inaction and still should be able to benefit from staying in the fund and not pay any higher or additional fees.

As the retail industry is characterised by high employee turnover, if a REST member leaves their employer and joins another employer who participates in REST, then the member's benefit will continue to accumulate in their account, with no extra fees incurred.

If a member changes jobs and their new employer does not use REST, then the member can ask the employer to make their super contributions into REST if the member is eligible for choice of fund. Members can also leave their existing super with REST or roll over their money into another approved fund.

If a member leaves REST then the only fee payable (if applicable) is the withdrawal fee. The first withdrawal (regardless of full or partial) is free, then \$25 per withdrawal thereafter.

As a member changes jobs within the retail industry, and so long as REST is the default fund in the relevant award, the member would remain with REST throughout his or her working life. This has obvious advantages in that the member has:

- A consistent investment strategy through the working years tailored to that group;
- Consistent insurance (with no break in coverage) tailored to that group; and
- No transaction or out of market costs on leaving each employer (as the super remains with REST).

Under the modern award system as it currently stands, REST is protected for members such as these. However, if Awards are "opened up" to more default funds, then this will become less likely.

## **Conclusion**

REST welcomes the opportunity to contribute to the Productivity Commission Inquiry to increase the level of understanding of the benefits which REST uniquely provides in the superannuation sector. It is hoped that this increased understanding, will in turn, assist informed decisions regarding the framework that governs default superannuation funds in modern awards.

Accordingly REST believes it is critical that the findings of this inquiry confirm a best practice process that has:

- Transparent and objective criteria to drive long-term performance and member outcomes
- Periodic reviews undertaken by stakeholders close to the process
- Alignment of outcomes to benefit members, employers, unions and the community
- Recognition that industry funds such as REST have tailored benefits which meet specific needs of its core default demographic member base; as well as offering benefits of scale.

By adopting a best practice approach for the selection of default funds in modern awards, the Commission will enable funds to continue to develop and deliver the significant benefits already enjoyed by their members, employers and the broader community into the future.

## Annexure A

Excerpt from General Retail Industry Award, 2010 regarding superannuation

### 22. Superannuation

[Varied by [PR992745](#), [PR992915](#), [PR992916](#), [PR994449](#), [PR500810](#)]

#### 22.1 Superannuation legislation

(a) Superannuation legislation, including the *Superannuation Guarantee (Administration) Act 1992* (Cth), the *Superannuation Guarantee Charge Act 1992* (Cth), the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Superannuation (Resolution of Complaints) Act 1993* (Cth), deals with the superannuation rights and obligations of employers and employees. Under superannuation legislation individual employees generally have the opportunity to choose their own superannuation fund. If an employee does not choose a superannuation fund, any superannuation fund nominated in the award covering the employee applies.

(b) The rights and obligations in these clauses supplement those in superannuation legislation.

#### 22.2 Employer contributions

An employer must make such superannuation contributions to a superannuation fund for the benefit of an employee as will avoid the employer being required to pay the superannuation guarantee charge under superannuation legislation with respect to that employee.

#### 22.3 Voluntary employee contributions

(a) Subject to the governing rules of the relevant superannuation fund, an employee may, in writing, authorise their employer to pay on behalf of the employee a specified amount from the post-taxation wages of the employee into the same superannuation fund as the employer makes the superannuation contributions provided for in clause [22.2](#).

(b) An employee may adjust the amount the employee has authorised their employer to pay from the wages of the employee from the first of the month following the giving of three months' written notice to their employer.

(c) The employer must pay the amount authorised under clauses [22.3\(a\)](#) or [\(b\)](#) no later than 28 days after the end of the month in which the deduction authorised under clauses [22.3\(a\)](#) or [\(b\)](#) was made.

#### 22.4 Superannuation fund

[22.4 varied by [PR994449](#) from 01Jan10]

Unless, to comply with superannuation legislation, the employer is required to make the superannuation contributions provided for in clause [22.2](#) to another superannuation fund that is chosen by the employee, the employer must make the superannuation contributions provided for in clause [22.2](#) and pay the amount authorised under clauses [22.3\(a\)](#) or [\(b\)](#) to one of the following superannuation funds or its successor:

(a) the Retail Employees Superannuation Trust (REST);

[22.4(b) inserted by [PR992745](#) from 25Jan10]

(b) Sunsuper;

[22.4(c) inserted by [PR992915](#) from 28Jan10]

(c) Statewide Superannuation Trust;

[22.4(d) inserted by [PR992916](#) from 28Jan10; varied by [PR500810](#) from 01Jan10]

(d) Tasplan;

[22.4(e) inserted by [PR500810](#) from 01Jan10]

(e) MTAA Superannuation Fund; or

[22.4(b) renumbered as 22.4(c) by [PR992745](#), renumbered as 22.4(d) by [PR992915](#), renumbered as 22.4(e) by [PR992916](#), renumbered as 22.4(f) by [PR500810](#) from 01Jan10]

(f) any superannuation fund to which the employer was making superannuation contributions for the benefit of its employees before 12 September 2008, provided the superannuation fund is an eligible choice fund.

## Annexure B

### Page 14

#### Operating Expenses per member by fund size (membership)

This graph measures the variation in total Operating Expenses by fund size, measured as average total membership during the financial year to 30 June 2010.

Funds were separated into the following four categories based on membership size:

- Very small: fewer than 25,000 members
- Small: between 25,000 and 100,000 members
- Medium: between 100,000 and 500,000 members
- Large: more than 500,000 members

Settling on particular size bands in terms of number of members necessarily involves matters of judgment. In addition, these size categories were determined so as to obtain a representative sample of approximately equal number of funds in each group.

### Page 15

#### Investment Expenses by fund size (net assets)

This graph measures the variation in total investment expenses by fund size, measured as average net assets during the financial year to 30 June, 2010.

Funds have been separated into the following three categories based on asset size:

- Small: less than \$2 billion
- Medium: between \$2 and \$5 billion
- Large: more than \$5 billion.

These classifications were determined to obtain a representative sample of approximately equal numbers of funds in each group. Note that the classifications are independent of the classifications used to group funds by membership for the operating expenses analysis.

Investment expenses as a percentage of net assets for each group were calculated as the aggregate investment expenses for the group divided by the aggregate net assets of the group, ie the averages are weighted by net assets.

## Annexure C

### Investment impacts

- (i) **The appropriateness of the investment strategy of the default investment option of the fund in terms of risk and expected return**

#### REST's default investment option

REST's default investment option is the Core Strategy. Its asset allocation is 25% defensive and 75% growth, in a mix of share and bonds, property, infrastructure, alternative assets and cash. The mix is as follows:

Asset type	Target	Range
Australian Shares	20 %	15-45 %
Overseas Shares	25 %	5-35 %
Property	13 %	0-25 %
Infrastructure	6 %	0-15 %
Growth Alternatives	11 %	0-25 %
<b>Total Growth Assets</b>	<b>75 %</b>	<b>25-85 %</b>
Defensive Alternatives	5 %	0-25 %
Bond	10 %	5-75 %
Cash Securities	10 %	0-25 %
<b>Total Defensive Assets</b>	<b>25 %</b>	<b>15-75 %</b>

As at 1 March, 2011, the previous returns for the Core Strategy were:

Year ended	Percentage
30 June 2011	9.56 %
30 June 2010	11.40 %
30 June 2009	-7.82 %
30 June 2008	-3.95 %
30 June 2007	15.61 %
<b>Five year compound average</b>	<b>4.55 % pa</b>
<b>Ten year compound average</b>	<b>6.99 % pa</b>

By using this asset mix for the Core Strategy, REST has been very successful, both relative to its peer group and in terms of protecting its members from downside risk<sup>12</sup>. A broadly diversified portfolio and the employment of active management at several levels, including asset allocation, tilts within asset classes

<sup>12</sup> Source: SuperRatings report: Official complete list of super returns for Australia's largest funds 28/07/2010. REST's default option Core Strategy ranked number one performer of the decade, third over 7 years and 2<sup>nd</sup> over 3 years..

and employing active investment managers, has benefited members of the Core Strategy in both absolute and relative terms over many years.

By contrast, if passive or enhanced passive management of a large portion of the equities asset classes was introduced this would represent a significantly reduced opportunity set to provide competitive returns and effectively manage risk compared to the current structure of these portfolios. Additionally, we do not believe the cost savings achieved by investing a large portion of the equities asset classes in passive or enhanced passive approaches would adequately compensate the Fund's members for the likely reduced long-term returns and increased downside risk they would be exposed to.

### Core Strategy delivers net performance benefits to members

The following diagram shows REST's premier position when comparing other super funds' 10 year rolling investment performance relative to the investment management fees payable on a \$50,000 account balance:

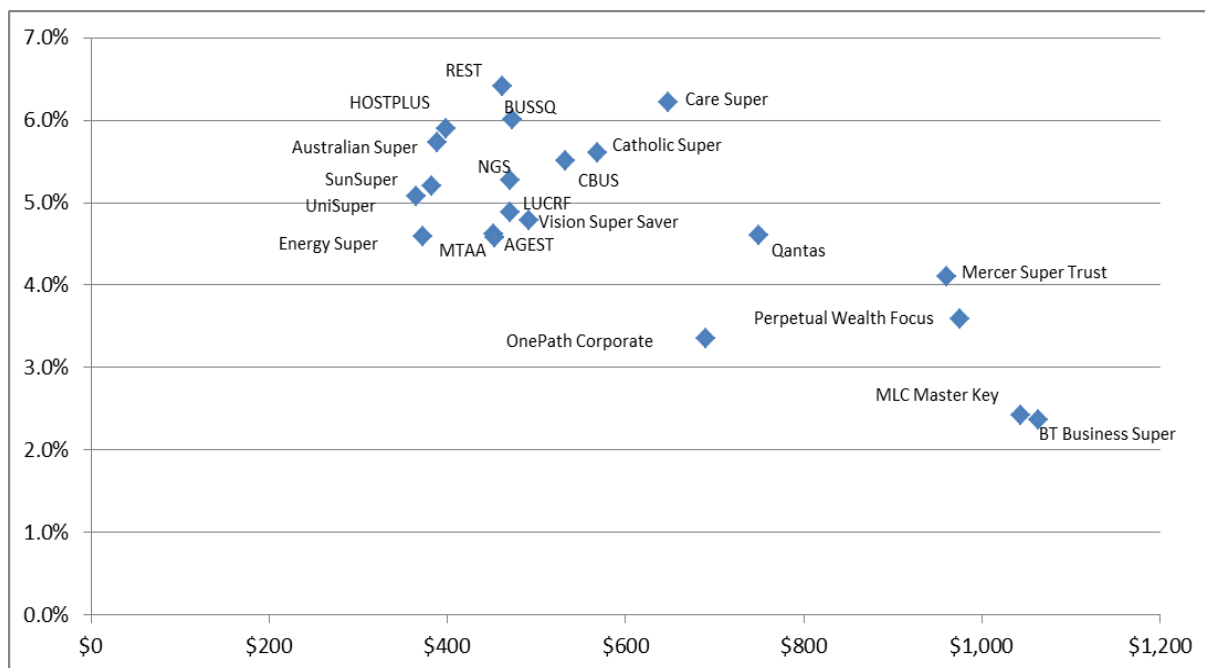


Diagram 1: Comparison of 10 year rolling investment performance and investment management fees based on a \$50K balance [Source: Appendix 1 data, less the large super funds who have less than 10 years' performance]

### The appropriateness of the Core Strategy's risk profile for REST members

The REST Investment Committee annually reviews the appropriateness of the Core Strategy default investment option. This review includes market valuations, risks, investment analysis and trends, structural changes in markets, membership demographics and changes (by age, balance) and review of the Investment Philosophy and Core Strategy objectives. This process is facilitated by its asset manager who also regularly review the target asset allocation of the Core Strategy and will make recommendations for change depending on the market environment.

### Performance of REST's Core Strategy against other funds

**Further data on REST's unique provision of investments, tailored to suit its members ensuring its strong performance in terms of costs and returns to members over the long term.**

Fund	Default option	Size (\$m) Dec-11	Objective	Target over 5 yrs (CPI 2.87%)*	Growth exposure %	Performance – longest avail / rank	Default option fee - \$50k acct balance <sup>13</sup>	Invest Mgmt fee (incl perf fee)
<b>INDUSTRY</b>								
REST	Core Strategy	16,112	CPI + 3%pa over long term (rolling 5 years periods)	5.87%	75%	6.41% 10 yr (1) 5.57% 7yr	\$462	0.65%
Australian Super	Balanced	27,641	To outperform the annual returns of the median balanced fund, and an annual average return of CPI + 4% over the medium to long term.	n/a	75%	5.73% 10yr (6) 4.89% 7yr	\$388	0.62%
SunSuper	Balanced	12,508	Beat inflation by 4%pa after investment fees and taxes over 7 and 10 years	n/a	71%	5.20% 10yr (18) 4.30% 7yr	\$382	0.61%
UniSuper	Balanced	7,045	To achieve returns (after Fund tax and performance fees) that are at least 3% p.a. more than inflation CPI over 3 yr rolling periods	n/a	70%	5.08% 10yr (21) 4.40% 7yr	\$365	0.50%
HOSTPLUS	Balanced	7,923	Achieve positive returns that exceed the return of the Conservative Balanced option over rolling three-year periods.	n/a	76%	5.89% 10yr (4) 4.76% 7yr	\$398	0.64%
HESTA	Core Pool	Unknown	CPI + 4%pa. Core Pool aims to optimise returns while in the short term achieving consistently better returns than the 90-day bank bill rate (adjusted for tax) and rarely having an interest rate less than zero.	n/a	74%	No performance available	\$530	0.81% (perf 0.10%)
BUSSQ	Balanced growth	1,612	For the annual rate credited to members to exceed the change in the Consumer Price Index + 4% per annum.	n/a	75%	6.01% 10yr (3) 5.14% 7yr	\$473	0.79%
Care Super	Balanced	3,722	To achieve returns after fees that exceed the inflation rate (as measured by the CPI) by at least 3%pa over a rolling 5 year period	5.87%	76%	6.22% 10yr (2) 5.14% 7yr	\$648	0.94% (incl perf 0.17%)
CBUS	Growth	15,650	Deliver an after tax return of inflation plus 3.5% a year over rolling five year periods	6.37%	74%	5.51% 10yr (10) 4.81% 7yr	\$533	0.83%

<sup>13</sup> Includes member protection costs



Fund	Default option	Size (\$m) Dec-11	Objective	Target over 5 yrs (CPI 2.87%)*	Growth exposure %	Performance – longest avail / rank	Default option fee - \$50k acct balance <sup>13</sup>	Invest Mgmt fee (incl perf fee)
Catholic Super	Balanced	2,638	To target an investment return, after tax and investment expenses, of at least 3.5% pa above inflation* 75% of the time, over rolling five-year periods. To achieve an investment return that ranks above the average in industry surveys of funds with a similar risk profile over rolling three-year periods.	n/a	70%	5.60% 10yr (10) 5.28% 7yr	\$568	0.70%
LUCRF	Balanced	2,343	To achieve a return (net of tax and investment expenses) that exceeds the increase in the CPI by at least 4% p.a. over moving 10 year periods, and to limit the probability of achieving a negative return to approximately 1 year in 5.	n/a	73%	4.88% 10yr (23) 4.03% 7yr	\$470	0.69%
Energy Super	Balanced	2,649	Achieve returns (after tax and other costs) over rolling five year periods of 3% above inflation	5.87%	71%	4.59% 10yr (28) 4.09% 7yr	\$372	0.42%
MTAA	Balanced	4,983	To out-perform (after tax and fees) the CPI by 4% a year over rolling 5-year periods	6.87%	65%	4.62% 10yr (26) 2.56% 7yr	\$451.40	0.70%
NGS	Diversified	3,088	To achieve returns of 3% above CPI per annum over rolling five year periods	5.87%	76%	5.27% 10yr (14) 4.91% 7yr	\$470	0.71%
Vision Super Saver	Balanced Growth	1,681	To outperform (after fees and taxes) the rate of increase in inflation as measured by the Consumer Price Index by 4% per annum over at least two thirds of all rolling five-year periods.	n/a	74%	4.79% 10yr (24) 4.33% 7yr	\$491	0.80%
First State Super	Diversified up to age 56. Balanced over age 56	Diversified: 12,935	Diversified: Target return: CPI + 3.75% pa over rolling 5-year periods net of tax and fees Balanced: CPI + 3.25% pa over rolling 5 year periods net of tax and fees.	6.62%	Diversified: 70% Balanced 50%	No performance available	Diversified : \$172 Balanced: \$147	Diversified 0.24% Balanced: 0.19%
<b>PUBLIC SECTOR</b>								

Fund	Default option	Size (\$m) Dec-11	Objective	Target over 5 yrs (CPI 2.87%)*	Growth exposure %	Performance – longest avail / rank	Default option fee - \$50k acct balance <sup>13</sup>	Invest Mgmt fee (incl perf fee)
AGEST (under merger with Australian Super)	Balanced	2,109	Consumer Price Index (CPI) plus 3.5% per annum after fees and taxes over the investment timeframe		75%	4.58% 10yr (29) 3.87% 7yr	\$453	0.66% (includes performance fee 0.06%)
QSuper	Balanced	18,340	To achieve an average return over rolling five-year periods of CPI + 4% p.a. after fees and tax.	6.87%	67%	No performance available	\$315	0.63%
GESB	Balanced Growth	582	CPI +3.3% pa over rolling 7-year periods, with a probability of 75%	6.17%	73%	7.07% 3yr	\$371	0.61%
Military Super	Growth	2,957	CPI plus 4.5% pa over rolling seven year periods	6.37%	85%	3.16% 7yr	\$215	0.4317%
<b>RETAIL</b>								
BT Super for Life	1970s Lifestage fund	222	To outperform the market in each asset class (before fees and tax) and outperform other funds with a similar mix of asset classes.	n/a	88%	6.86% 3yr	\$555	0.99%
AMP Flexible Super	Core Super Easy Balanced	352	Seeks to provide an index focussed solution to diversified investing. Through a process of diversified market analysis combined with selection of the most appropriate investment managers for each underlying asset class, this investment is designed to provide market tracking returns over 5 to 7 years.	n/a	70%	-1.74% 1yr	\$405.60	0.55%
Colonial First State Employer Wholesale	Balanced	13	To provide capital growth and income over the long term. Suggested time frame 5 years.	n/a	70%	-3.97% 1yr	\$760 to \$1,010	1.40%
Perpetual Wealth Focus	Balanced Growth	145	Aims to provide long-term capital growth and income through investment in a diversified portfolio with an emphasis on Australian and international share investments.	n/a	59%	3.59% 10yr (44) 2.59% 7yr	\$975	Not split out from other fees
MLC Master Key	MLC Horizon 5-Growth portfolio	3,310	No objective stated	n/a	85%	2.42% 10yr (54) 2.03% 7yr	\$1,043	0.73%
<b>CORPORATE</b>								
Qantas	Growth	2,983	To achieve a return that exceeds CPI by at least 4%pa over a 5 year period, after tax and fees	6.87%	70%	4.60% 10yr (27) 4.22% 7yr	\$750	0.50%

Fund	Default option	Size (\$m) Dec-11	Objective	Target over 5 yrs (CPI 2.87%)*	Growth exposure %	Performance – longest avail / rank	Default option fee - \$50k acct balance <sup>13</sup>	Invest Mgmt fee (incl perf fee)
AMP Signature	Future Directions Balanced	3,475	The portfolio aims to achieve a rate of return above inflation after costs over a 5 year period and to provide a total return, after costs and before-tax, higher than the return from the relevant benchmarks of the underlying investments.	n/a	73%	2.60% 7yr	\$685 to \$925	0.60%
OnePath Corporate	OptiMix balanced	1,692	The fund aims to achieve returns (before fees, charges and taxes) that on average exceed inflation by at least 5.0% p.a., over periods of five years or more	n/a	81%	3.35% 10yr (47) 2.30% 7yr	\$690	1.14%
BT Business Super	Balanced Growth	2,345		n/a	65%	2.36% 10yr (55) 1.93% 7 yr	\$1,063.20	0.70%
Mercer Super Trust	Mercer Growth	4,960		5.87%	71%	4.10% 10yr (36) 3.40% 7yr	\$960	Not split from other fees

Source: SuperRatings December 2011 Performance report, Funds PDS

\*\*there are many listed as 'n/a' because they their target return is not expressed over a 5 year period

## APRA research

APRA has also conducted studies regarding investment performance of registrable superannuation entity (RSE) superannuation funds in Australia study, retail trustees using balanced or growth investment strategies for default investment options on average generated significantly lower net returns than returns generated by not-for-profit trustees using balanced/growth investment strategies.<sup>14</sup> This finding is consistent with APRA's 13 years of statistical returns from 1995 through 2008. Although some retail funds earn relatively high net returns, and some not-for-profit funds earn relatively low net returns, on average, balanced and growth retail funds consistently earn less on a net basis than not-for profit funds.

*....” The evidence indicates that part of the net retail under-performance is due to embedded fees that are already incorporated by the investment vehicles used by these funds at the gross return level, rather than poor investment manager skill. Retail fund expenses, explicit and embedded, lower the net earnings of the retail sector relative to the not-for-profit sector...”<sup>15</sup>*

## MySuper impacts

Trustees of funds that offer a MySuper product will be required to fulfill a number of new duties in relation to the investment strategy and returns of the fund. These duties include:

<sup>14</sup> APRA research, “Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds, 02 October 2008, Katrina Ellis, Alan Tobin, Belinda Tracey

<sup>15</sup> Ibid

- to promote the financial interests of the members of the fund who hold the MySuper product, in particular returns to those members (after the deduction of fees, costs and taxes)
- to include in the investment strategy an investment return target over a period of 10 years and level of risk appropriate to members of the MySuper product.

**REST is already fulfilling these requirements currently and would question whether a retail fund would achieve this if it was a MySuper default fund included in an award given their need to focus on all members the majority of which will not initially be covered by the award.**

***Responses to Productivity Commission Issues Paper questions (all marked in italics)***

***To what extent do workers covered by different awards have different investment needs? Should any such differences be taken into account in the selection of default superannuation funds for inclusion in awards? If so, how?***

*A key part of setting the investment objectives and strategy of superannuation funds and default options within funds are that they must satisfy the profile of the fund's membership, including age, gender (particularly in the context of the distribution of contributions over a working life), distribution of member balance sizes, nature of work, portability of fund membership, etc.*

*Funds that have a large proportion of their membership derived from a member's coverage under an award may have a certain degree of homogeneity of characteristics.*

*For example, the profile of REST's membership is relatively young, predominantly female, with relatively low member balances, relatively high homogeneity of work nature, and there is currently high portability of superannuation fund accounts within the retail industry. REST's investment strategy is determined with reference to these characteristics. These may be less relevant for workers covered by different awards. In summary, there can be situations where workers covered by different awards have different investment needs and it may be appropriate for these differences to be taken into account in the selection of default funds in awards.*

***Should the investment strategy, investment return target and level of risk of the default investment option be factored into the selection of default superannuation funds for inclusion in awards? If so, how?***

*The investment strategy, investment return target and level of risk of the default option should be factored into default fund selection. As noted above, there are situations where workers covered by different awards have different investment needs and it may be appropriate for these differences to be taken into account in the selection of default funds in awards. If this is not the case (for example, the award covers a heterogeneous demographic), then a default option should have characteristics that are broadly suitable for members with a variety of risk tolerances (i.e. follow a well 'balanced' approach in terms of investment return target and level of risk).*

***Should lifecycle investment strategies be considered? If so, how?***

*Life cycle investment strategies are relatively complex. Ideally, these strategies should only be included if these are supported by strong member communication and engagement programs.*

***Fund expertise and performance?***

*Regardless of the investment strategy and risk profile chosen by a superannuation fund, fund managers need the skills and expertise to be able to execute that strategy successfully, and to refine it as required. One potential indicator of the success of a fund's investment strategy is its net performance (returns less*

fees, costs and taxes). Net performance could be assessed over a range of time periods with higher weighting to longer periods.

**Should a fund's investment management expertise be factored into the selection of default superannuation funds for inclusion in awards, and if so, how?**

A fund's investment management expertise should be factored into the selection of default funds. Investment management expertise should be assessed on both historical and forward looking parameters. While historical results can provide some indication of potential future success, a fund should have a robust framework for developing and implementing its investment strategy. Some of the historical factors that could be taken into consideration include net performance over a range of time periods, particularly long time periods; the number and magnitude of negative returns; the success in achieving the stated investment objectives and the fund's track record in terms of operational performance, regulatory reviews, stakeholder support, etc. Some of the factors on which a forward-looking assessment could be made include the fund's framework for developing and implementing its investment strategy, organisational stability/strength, governance structures, etc.

**How relevant is a fund's past net performance as an indicator of its potential future performance? What weight, if any, should be placed on the past performance of a fund in assessing its suitability for inclusion as a default fund in awards?**

See answer, below.

**If past performance is considered important in assessing a fund's suitability for inclusion as a default fund in awards over what time period should past net performance be assessed?**

Preferably, the performance should be reviewed over longer time periods such as 5 years and 10 years.

**How should funds with no net performance record (for instance, newly merged funds or new entrants to the market) be assessed?**

For newly merged funds, if there is a dominant fund in the merger, its performance track record could be used, or if there is no dominant fund, a composite of the performance of the two previous funds. In the case of new entrants, the performance track record of the manager's other products (whether Australian or overseas) could be taken into account, where relevant.

**Should net performance be assessed in absolute or relative terms? That is, should the top performing funds be selected (regardless of their absolute returns), or would funds be required to meet a particular target level of performance?**

The primary focus should be on the long-term performance of funds against their stated investment objectives. Relative performance can also be a useful tool for assessing historical performance but should only be a secondary consideration.

**The medium to long term net-of-costs investment performance of the default investment option**

For REST, the medium to long term investment performance of the default investment option is an important determinant for returns for members. For instance, if a short term investment performance approach was adopted through mandation of shorter terms, ie less than five years, or if increased choice of named funds within awards resulted in greater member churn, this may result in funds requiring increased liquidity as a percentage of FUM. Accordingly, a fund's FUM would be less stable and there would be a number of consequences upon various stakeholders as a result.

Recent APRA research<sup>16</sup> shows that REST, as one of the 200 largest super funds, ranked highly in terms of fund-level rates of return for five and eight years partly because of its size which is able to deliver economies of scale to members and potentially higher rates of return. Rate of return is regarded by APRA as a useful measure to assess a superannuation trustee's ability to deliver on the fund's investment strategy for the benefit of all members over time.

Medium to long term investments become more prevalent with scale. This is because scale benefit for investments do not just relate to costs. Larger funds also gain the ability to participate in investment opportunities which are not open to smaller funds. They can participate directly in special opportunities like infrastructure projects where significant amounts of capital are required to be injected. They also gain the ability to rely less on intermediaries for some investments (e.g. overseas) and can deal direct because of their size and this may provide better yields because of lower internal fees.

Investment returns generally benefit from scale both through lower fees and higher intrinsic investment returns.

Reduction in scale clearly has the opposite effect. Should a fund lose scale through member outflows, its members will lose the advantages they currently derive from scale. One of these is that ability to be considered for large infrastructure projects, e.g. gas pipelines and alternative energies such as wind farms. If a fund loses scale, other funds with bigger asset pools may be given priority.

The inclusion of industry funds such as REST as default funds in modern awards have contributed to the stability of these funds' membership and asset bases and stability in the level and growth rate of new cash flows received by the funds. It is likely that in circumstances where the risks of a loss of members and assets and/or lower future cash flows were higher, funds would potentially be more reluctant to allocate capital to investments that are less liquid and/or require a long investment time frames. Lower allocations by funds to these sectors, a risk most pronounced with respect to unlisted assets, could have a detrimental impact on business costs, productivity and innovation and therefore employment and growth in the Australian economy as more costly capital is required to be sourced off shore or via less traditional avenues.

Below, is a discussion on the impact of the long term approach of investing and its impact on different segments of the markets.

### **Listed Markets**

Listed markets are arguably less relevant to the consideration of the importance of certainty for funds allocating capital on a long-term basis given their liquidity and therefore the ability of funds to liquidate holdings in the event of the loss of members and assets.

However, if funds are less certain of the stability of their members and assets and their future growth, this may have an impact on the degree to which funds are willing to allocate to listed investments such as equities which require a long investment time frame. In particular, funds may be less willing to allocate to small and mid-cap companies, which have benefited for many years from superannuation funds, including industry funds, providing a stable source of long term equity capital.

Given their investment timeframes and the ability of many funds to tolerate the lower liquidity of these sectors of the Australian equity market, many superannuation funds have been able to allocate significant components of their Australian equities portfolios to mid and small cap companies.

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<sup>16</sup> APRA, Statistics, Superannuation Fund-level Rates of Return, issued 29 February, 2012. REST was ranked 11<sup>th</sup> and 21<sup>st</sup> out of the 200 largest funds surveyed by APRA for five year annum ROR for the 2007-2011 period and 2004-2011 eight year period, respectively.

In addition, the growth of superannuation funds including industry funds has enabled them to participate extensively in capital raisings, while their tax treatment has meant that superannuation funds have been major participants in off-market share buy-backs.

In times of market stress, the Australian equity market has been a major beneficiary of the substantial ownership by superannuation funds. For example, banks benefited from having part of their ownership base very stable during the global financial crisis, as have resources companies through periods of commodity price volatility.

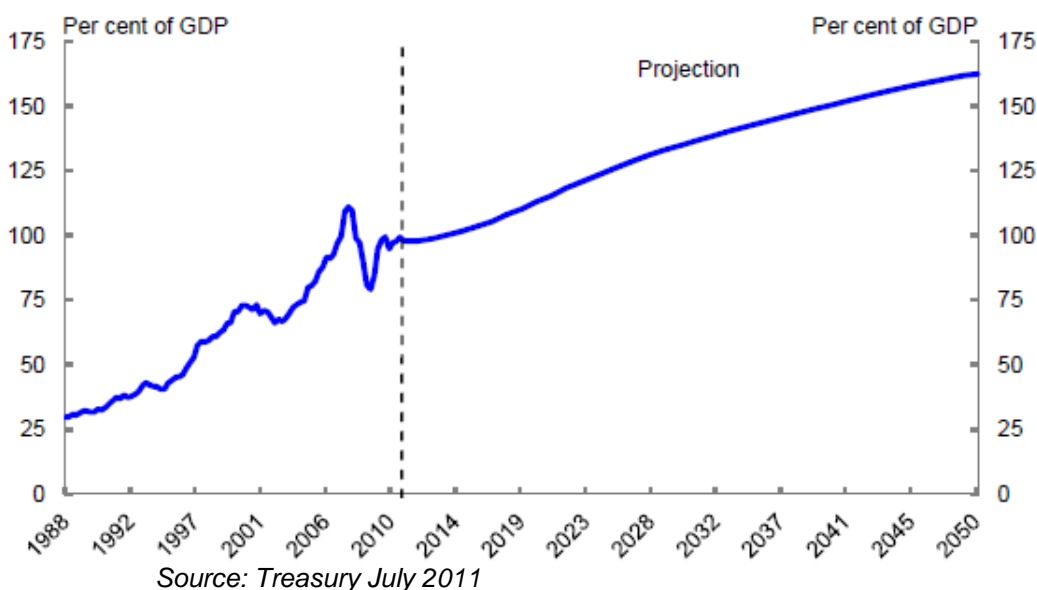
Research commissioned by REST shows the importance of the superannuation sector as an investor in the Australian equity market. The research estimates that Australian superannuation funds account for approximately \$450bn or 40% of the Australian share market, as measured by the capitalisation of the S&P/ASX300 Index of approximately \$1.120bn.

According to APRA statistics<sup>17</sup>, industry funds account for approximately 19% of total superannuation assets. Ignoring any differences in asset allocation between different fund types due to the lack of data, we therefore estimate that investments by industry funds in listed Australian equities account for a little less than 8% of total market capitalisation.

Future projections of superannuation assets are not widely available. Those that do exist vary widely in their projections, as small differences in assumptions can have significant effects on the results.

Recent Treasury modelling (July 2011) which takes into account the proposed increase in the Superannuation Guarantee (SG) rate, projects total superannuation assets to grow from around 100% of GDP today to approximately 112% by 2020 (the first year of the full 12% SG rate), 125% by 2025 and over 160% by 2050 (see chart below).

### Superannuation Assets



**Assuming GDP continues to grow at around 3.25% p.a. into the future, then total superannuation assets should reach approximately \$1.9tn (112% of GDP) by 2020 and \$2.6tn (125% of GDP) by 2025,**

<sup>17</sup> 'Quarterly Superannuation Performance', September 2011, Australian Prudential Regulation Authority, 8 December 2011



**using 2011 Treasury forecasts. Using the same Treasury forecasts, the Australian equity market capitalisation is expected to reach \$2.4tn by 2020 and \$3.4tn by 2025.**

It is clear that superannuation funds, including industry funds, are a very important provider of capital to Australian listed companies, and will need to remain so over coming years if the cost of equity is not to rise significantly. However, listed equities are a volatile investment and so a long investment time frame is required.

If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of these funds to allocate to the listed equity market, and in particular to the mid and small cap sectors where there is less liquidity. This in turn could place upward pressure on the cost of capital of Australian listed companies, thereby reducing business investment, employment and growth.

## **Unlisted Markets**

The value of stable capital is most clearly evident in the case of unlisted investments, where superannuation funds would be expected to be more reluctant to allocate capital in circumstances where the risks of a loss of members and assets and/or lower future cash flows were higher. It is considerably more difficult for funds to liquidate unlisted investments in a timely fashion at reasonable prices.

Research commissioned by REST has examined the unlisted markets by the three main asset types in which Australian superannuation funds invest - property, infrastructure and private equity.

## **Unlisted Property**

Unlisted property has historically represented a significant component of the asset allocation of Australian superannuation funds. These investments typically comprise office buildings, shopping centres and industrial properties around Australia which are held directly or through unlisted pooled vehicles managed by professional investment managers.

The research has undertaken an analysis of asset allocation data compiled by superannuation fund ratings firm and survey provider, SuperRatings. This data shows that the proportion of portfolios allocated to Australian unlisted property by Australian superannuation funds varies significantly, particularly by market segment.

The research's analysis of the SuperRatings data indicates that the overall average asset allocation of 'Balanced' style investment options to Australian unlisted property is approximately 6.0% but was 12.1% for industry funds. Of the 51 master trust products included in the survey, only four products held an allocation to unlisted Australian property, which is consistent with the research's observation across the master trust sector. Anecdotal evidence indicates that few SMSFs hold allocations to 'institutional grade' unlisted property.

The research observed that corporate superannuation funds are cautious to allocate new or additional capital to unlisted assets such as property as many of these schemes typically have a higher average membership age, lower levels of new membership growth and consequently have lower levels of net cash flow.

Analysis recently undertaken by RREEF Real Estate Research<sup>18</sup> found that the share of the investible universe of institutional grade property in Australia held by superannuation funds was 28.6% as at 31 December 2010. RREEF also estimated that Australian superannuation funds have \$91bn of their assets

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<sup>18</sup> 'Beyond Borders - The Push for Offshore Real estate Investing for Australian Superannuation Funds', RREEF Real Estate Research, February 2012



allocated to unlisted property, equivalent to \$144bn of gross asset value based on an estimated average loan-to-value ratio of institutional direct property of 36.6%.

Based research commissioned by REST and analysis of SuperRatings data, APRA's data of the total size of industry fund assets and the RREEF analysis, it is estimated that approximately one-third of the superannuation fund investments in Australian unlisted property are provided by industry funds such as REST.

In addition, Australian superannuation funds, as substantial holders of listed equities (as discussed in section 2 above), are also large investors in listed property trusts (REITs) listed on the Australian Stock Exchange. REITs are one of the largest holders of institutional grade property in Australia and therefore the figures above, which only account for direct holdings by superannuation funds in property assets, significantly understate the importance of superannuation funds, including industry funds, as investors in the property sector.

The RREEF report also estimates that between 2011 and 2020, an additional \$100bn of new stock will need to be added to the domestic institutional direct property asset base to meet the requirements created by economic and population growth. Australian superannuation funds, including industry funds, as major investors in this sector, would be expected to provide a significant component of the capital necessary to fund this addition to the property stock.

If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of funds to provide additional capital to the property market. This in turn could place upward pressure on the cost of capital for property development, thereby either limiting property supply and/or increasing business costs. These factors could have a negative impact on employment and growth.

### **Unlisted Infrastructure**

A recent report by Infrastructure Partnerships Australia<sup>19</sup> estimated that infrastructure investment by Australian superannuation funds is currently valued at between \$40bn and \$65bn. The report quoted data from actuarial consultant Rice Warner that indicated the average allocation to infrastructure by Australian superannuation funds was 5% in 2008.

Research of the SuperRatings data indicates that the overall average asset allocation of 'Balanced' style investment options to Australian unlisted infrastructure is approximately 4.3%, but was 8.2% for industry funds. Of the 51 master trust products included in the survey, only two products held an allocation to infrastructure. Anecdotal evidence indicates that few SMSFs hold allocations to infrastructure, which is a difficult investment class to access for non-institutional investors. Similar to the observation with respect to unlisted property, corporate superannuation funds are typically cautious to allocate new or additional capital to unlisted assets such as infrastructure as many of these schemes have ageing membership profiles, low levels of new membership growth, and lower levels of net cash flow.

Based on research of SuperRatings data commissioned by REST, APRA's data of the total size of industry fund assets and using the mid-point of the range in the Infrastructure Partnerships Australia report of the level of infrastructure investments by Australian superannuation funds, it is estimated that approximately 40% of the amount invested in Australian infrastructure by Australian superannuation funds is provided by industry funds.

The Infrastructure Partnerships Australia report comments as follows:

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<sup>19</sup> 'The Role of Superannuation in Building Australia's Future', Infrastructure Partnerships Australia

*“Australian governments at a local, state and Federal level face a significant challenge to finance and deliver the infrastructure that will underpin continued economic growth and social development. The challenges of rapid growth in population, forecast to exceed 37 million by 2050, the ageing of the population and the return of economic growth mean that capacity constraints in public transport, roads, freight and utilities will increasingly frustrate national economic and social objectives.”*

The report quotes studies undertaken in 2008 by ABN Amro (now Royal Bank of Scotland) that quantified required infrastructure investment in Australia at \$455bn over the next decade, and a study by Citigroup estimating \$770bn is required, including \$360bn of private sector finance.

It is evident from a number of recent reports and studies, and comments by governments at all levels, that substantial investments in infrastructure will be required in Australia over coming years. Most of these reports and studies identify superannuation funds as a significant source of capital for infrastructure development, and the Infrastructure Partnerships Australia report in particular canvasses the need for policy and other changes to facilitate a more conducive environment for superannuation funds to invest in infrastructure.

If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of funds to provide additional capital to finance infrastructure assets. This in turn could limit the number of infrastructure projects that can be undertaken and/or place upward pressure on the cost of capital for infrastructure development. These factors could have a negative impact on productivity, employment and growth.

## **Private Equity**

Research commissioned by REST of SuperRatings asset allocation data indicates that the average allocation to Australian private equity by ‘Balanced’ investment options is just over 1%, but for industry funds is approximately 3%. As is the case with unlisted property and infrastructure, it is believed that industry funds have been a major source of the investments in private equity by Australian superannuation funds.

From the research it is possible to observe that over recent years, Australian superannuation funds have become more sophisticated in terms of manager selection, skill, opportunity, etc and this is driving the quantum of investment in private equity locally. A big change over recent years has been the shift away from ‘fund of funds’ products to single manager exposures or managed accounts. The local market is quite restricted in terms of investable managers, and this has driven higher allocations to offshore private equity investments.

In summary, Australian superannuation funds play an important role in the domestic private equity industry, albeit probably at a lower percentage than ten years ago, and industry funds represent a significant component of this capital.

If industry funds are less certain about the stability of their members and assets and their future growth, this may reduce the willingness of funds to make additional investments in Australian private equity. This could restrict the flow of capital to start-up and expanding small and mid-sized companies, potentially limiting the number of companies that can access capital and/or placing upward pressure on the cost of capital. These factors could have a negative impact on innovation, employment and growth.