9 November 2018

Deputy Chair
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003

SUPPLEMENTARY PAPER – INVESTMENT PERFORMANCE: SUPPLEMENTARY ANALYSIS

The Financial Services Council (**FSC**) welcomes the opportunity to provide comments on the supplementary analysis of superannuation fund performance by the Productivity Commission (**the Commission**).

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The FSC and our members acknowledge the efforts of the Commission in undertaking the supplementary analysis.

The FSC welcomes the improvements made by the Commission to its benchmarking approach in response to consultation on the Draft Report, while noting that there is still room for improvement.

The FSC and our members have engaged with the Commission throughout the data collection process in an effort to provide the highest quality data possible to assist the Commission's analysis. We would be happy to continue working with the Commission to refine the methodology.

Please contact me for any questions in relation to this submission

Yours sincerely

Michael Potter
Senior Policy Manager, Economics & Tax

Superannuation investment performance – supplementary analysis

Submission to Productivity Commission

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About the Financial Services Council

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Introduction

The Financial Services Council (**FSC**) welcomes the opportunity to provide comments on the supplementary analysis of superannuation fund performance by the Productivity Commission (**the Commission**).

The FSC and our members acknowledge the efforts of the Commission in undertaking the supplementary analysis.

A central part of the analysis in this supplementary report compares super fund performance against benchmarks that are tailored to the asset allocation of the relevant fund (or industry segment if the comparison relates to segment performance).

As the FSC indicated in our submission to the draft Commission report,[1] this tailored benchmark approach is an innovative and admirable approach that could address concerns that super fund comparisons are biased because of different asset allocations across funds. If implemented appropriately, the benchmark approach should improve fund comparisons, aid in policy making and improve the analysis of member outcomes.

However, as the Commission acknowledges in the supplementary analysis, there are several technical issues associated with implementing the benchmarking approach.

The FSC welcomes the improvements made by the Commission to its benchmarking approach in response to consultation on the Draft Report, while noting that there is still room for significant improvement.

The FSC welcomes the comment in the supplementary report that asset allocation is the largest determinant of net returns. This is an important development in the Commission's thinking since the draft report, where Technical Supplement 4 purported to show that asset allocation does not substantially affect fund returns.

Of particular interest to the FSC are the results in Figure 3, lower diagram (page10). This shows asset level performance by industry segment over the period 2011 to 2017, which is a shorter time horizon than in most other figures. This diagram shows there is a very significant underperformance problem for some not for profit funds for many asset classes, relative both to the median/mean, and relative to retail funds. This tail underperformance problem is particularly stark for Australian listed equity (around 4%), international listed equity (5%), and international fixed income (4.5%), but it is also present for cash (1.5%) and Australian fixed income (2%), with the only exception being listed property.

This result should be of significant concern, particularly when viewed in conjunction with the average asset allocation in the super system. The asset classes with tail underperformance by industry funds represent about 75% of average industry fund asset allocation.[2]

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[1] See: https://www.pc.gov.au/__data/assets/pdf_file/0019/230347/subdr186-superannuation-assessment.pdf
[2] Quarterly Superannuation Performance, June 2018

Noting the caveats on the data, this data supports several key points:

- There is a substantial underperforming tail in the default component of the superannuation system, strongly supporting the case for reforming this system to ensure underperforming funds improve performance or merge with better performing funds. The FSC continues to support the Commission's draft recommendation to strengthen the MySuper authorisation process to ensure that disengaged consumers are not disadvantaged by being allocated to an underperforming default fund (the FSC's detailed comments on the default system are contained in earlier submissions to the Commission).
- The performance results over a longer timeframe can be quite unreflective of the performance over shorter timeframes. This suggests that disruption and competitive pressures between sectors and funds, as well as regulatory reforms, may have contributed to improved performance over time.
- This data shows any supposed underperforming tail of retail funds does not exist in the most recent figures — in other words, the problem of the underperforming tail appears not to be a particular feature of retail funds.

We note that providing the data to support this kind of analysis can be complex, particularly for funds with many investment options who do not usually capture data for the entire fund at an RSE level by asset class.

The FSC and our members have engaged with the Commission throughout the data collection process in an effort to provide the highest quality data possible to assist the Commission's analysis. We would be happy to continue working with the Commission to refine the methodology.

The remainder of this submission sets out detailed comments on the benchmarking approach and related issues.

Detailed comments

As an initial comment, the FSC notes that many issues raised in our submission to the draft PC report have apparently not been addressed in this report, in particular:

- There have been major changes in the regulatory regime for superannuation over the period covered by the data, including the FOFA reforms and the introduction of MySuper. These two reforms have likely led to a reduction in fees and an increase in net returns over time; this means taking an average across this timeframe can provide quite misleading results about the latest performance of many funds.
    - As noted elsewhere in this submission, this is highlighted in the Commission's supplementary report in the lower panel of Figure 3 which suggests the worst performing super funds are not for profit funds when more recent data is used. Yet the Commission focuses on other longer term data series purporting to show the converse results.
    - We therefore suggest that it would be useful to look at other data over a similar shorter time horizon.[3]
    - We also note a number of actual or potential changes could substantially affect fees, particularly the Protecting Your Super reforms and possible changes to grandfathered commissions. These changes also mean additional caution should be used when using historical data to comment about the performance of the superannuation system or individual sectors of the system.
- Comparing all products across the superannuation system is comparing apples with oranges, particularly when comparing the performance of products where investment choices are made by the fund (eg MySuper and default investment options in choice) with products where choices are made by the member (eg platform products including retail master trusts and wraps).
    - The report implies that each individual fund is responsible for the asset selection within that fund, but this is clearly not correct for platforms. For example, on page 15, the supplementary report states the performance residual "reflects how well a fund is doing at securing exposure to an asset class, including via its intra-asset class investment strategy and the investment decisions of fund managers within those sub-classes (including for direct asset holdings)." This is not a correct characterization of how platform products work.
    - In relation to asset allocation and performance, a default investment option has nothing in common with a platform, but if both are offered inside one fund then the Commission's analysis has averaged their performance together. This approach is similar to worrying about the 'average' price of an apple at Coles, Woolworths, Aldi and IGA by averaging out the price each chain

[3] We note performance over short horizons may not reflect longer-term performance, although this is somewhat addressed by comparing performance against benchmarks.

    - charges for each apple variety. You can't buy an 'average' variety of apple and you can't invest in an 'average' super account in many large funds.
- The SuperRatings data on returns does not provide a genuine measure of net returns, because it excludes explicit fees such as fixed dollar administration fees, exit fees, contribution fees and switching fees. It isn't clear if the Commission has addressed this issue in the supplementary report's use of SuperRatings data (in Figures 13, 14, 15, 19, 20).
    - We note dollar based fees are more prevalent in not for profit funds, and percentage fees are more prevalent in retail funds, so this data issue adversely affects all the product and sector level comparisons.
    - Therefore, we recommend making appropriate adjustments to the SuperRatings data to incorporate those fees into the net return figures for greater accuracy.
- For some analysis, the Commission has 'spliced together' data from the MySuper era with data from before MySuper (in Figures 13, 14, 15, 19 and 20). For many retail funds, MySuper products bear little resemblance to older-style employee super products, and aggregating this data may not provide an accurate picture of performance trends. In our previous submission we raised concerns that this approach is problematic when this analysis includes non-investment fees; in many cases funds had substantially higher non-investment fees (and lower net returns) before MySuper. It is not clear if the Commission has addressed this issue in the supplementary analysis.
- The Commission's analysis includes legacy products. The supplementary report does provide some standalone analysis of legacy products, which is useful (eg Figure 21), but most of the rest of the report includes legacy and non-legacy products together. In general, legacy products should not be included with current retail products as this makes the analysis misleading. In particular, it does not represent the performance outcomes for new members to the relevant fund or to the super system as a whole.
- The APRA data does not have asset allocation data at a fund level before 2014 so the analysis based on APRA data in the draft report used an estimate based on asset allocations of default options. This estimate (broadly) requires the mix of growth vs defensive assets to be similar before and after 2014, but we understand this assumption does not hold for some funds, and the difference is significant. It isn't clear if the Commission has addressed this issue in the supplementary report.
- It also isn't clear if eligible rollover funds (ERFs) have been excluded from the analysis, in particular the section relating to fees using APRA and SuperRatings data (pages 43 to 50).

These issues remain concerning, and the FSC is disappointed that the Commission has not addressed these concerns.

In addition to these points, in common with our initial submission, the FSC makes these additional comments:

- The supplementary report provides an international comparison of performance and fees using the CEM Benchmarking data set. It would be useful for the Commission to provide a more detailed overview of this data set, including any caveats, to enable other parties to provide comments on the international comparisons.

- Some superannuation funds have some insurance only accounts and some 'normal' accounts. While some analysis in the supplementary report excludes funds that are *entirely* insurance only funds (eg Figures 7, 8, 9), it is not clear how the Commission has dealt with funds that are *partly* insurance only.
- As noted earlier in this submission, the lower diagram in Figure 3 shows a significantly underperforming tail of industry funds in most asset classes over the time period 2011 to 2017. This result is very different from the results shown in Figures 18, 19 and 20 which instead purport to show other segments underperform. This strongly suggests that the time periods are critical to analysing performance, and any alleged underperforming tail relating to retail funds has been largely or completely eliminated since 2011.
    - This Figure provide additional reasons to be concerned about analysis of fund performance over longer periods.
    - The lower diagram in Figure 3 also shows a smaller variation in asset-level performance by retail funds compared to not for profit funds.[4] We suggest these results warrant further examination by the Commission.
- The performance of small APRA funds (**SAFs**) appears to be excluded from most of the Commission's analysis. However, this is not clear and we recommend the Commission clarifies when SAFs are included or excluded from analysis.
    - Figures 7 to 10 and 23 relate to APRA regulated funds. *Prima facie*, this includes SAFs, but it isn't clear if SAFs are categorised as for profit or not-for-profit, or actually excluded (despite the coverage description).
    - It isn't clear if SAFs are included or excluded from the analysis relating to fees using APRA and SuperRatings data (pages 43 to 50).
- The hedging ratios used in the benchmark portfolio can cause significant differences in investment returns. For example, with global equities, the difference in return between hedged and unhedged can be very large, as shown in data in the attachment.
    - If a portfolio with particular hedging ratio is compared against a benchmark with the same hedging ratio, the comparison is much less problematic than comparing a portfolio against a benchmark with very different hedging ratios. As shown in the data in attachment, getting the hedging ratio wrong in the benchmark will cause the excess return to be mismeasured, in some cases by hundreds of basis points.
    - The Commission had "no strong evidential grounds for deviating from the assumptions in the draft report" about hedging (page 36 of supplementary report) — but these assumptions are particularly influential in determining the excess return and therefore require further consideration.
    - In particular, several FSC members have indicated that their effective hedging ratios are at times quite different from the assumed hedging ratios in the draft and supplementary reports.

[4] The variation in international listed equity performance appears to be about 750 basis points higher for not for profit funds versus retail funds; and for international fixed income, the difference in variation appears to be around 650 basis points.

- In many cases, the start of the analysis is during the GFC (2008). This could affect the results, as some assets may have fallen in value before the start date, while other assets fell substantially after the start date.
    - This amplifies the concerns expressed elsewhere in this submission that the longer-term performance figures may not be representative.
    - This issue particularly affects the international comparisons by asset class (Figure 5) with Australian figures starting in the middle of the GFC and international figures starting just before the GFC. Nevertheless, this result does show Australia performed well in most significant asset classes except for domestic listed equity, which is most likely to be affected by the GFC.
- The difference in benchmark portfolios between retail and not-for-profit segments is 20 basis points (compare Figures 8 and 9). This seems a low figure, given the well-known differences in asset allocation between the two segments, with retail funds having substantially greater weighting to conservative assets (and lower weighting to growth assets) due to the different membership demographics.
- The Commission presents the results of statistical analysis of some factors that might affect fund performance (see tables 2 to 4 and surrounding text). However, the discussion about statistical significance of the results is substantially flawed.
    - The reporting on significance in Tables 2 and 3 is incomplete or unclear and therefore these tables are very misleading.
    - It appears that exactly none of the results in Table 4 are significant at the 95% level, although this again is not completely clear.
    - Some of the text surrounding the tables discusses the direction and magnitude of results that are insignificant; it would be better practice to state these results are insignificant and not state the direction and magnitude. By definition, these results are statistically indistinguishable from zero so their direction and magnitude are not relevant. This comment particularly applies to the analysis around Table 4.
    - In addition, no summary statistics or diagnostic tests have been reported for any of this analysis.
    - Given these concerns, the Commission should put much less weight on the findings in this section, given the (apparent) lack of statistical significance in most of the results.

Overall benchmark concerns

The comparisons in the supplementary report of funds against benchmarks produces some overall results that appear to be unlikely.

In particular, there are super funds with returns that are greatly above the relevant benchmark. In Figure 18, two corporate funds are more than 200 basis points above the benchmark; in Figure 19, a number of funds are about 150 basis points above the benchmark; and in Figure 20 there is one fund about 150 basis points above the benchmark.

It seems very unlikely for outperformance of this degree to last for this long (10–12 years). These results starkly contrast with other results comparing funds against benchmarks. The S&P Dow Jones SPIVA scorecard for Australia found the benchmark performed better than most Australian funds: over the decade to December 2017, “more than 85% of international equity and Australian bond funds and more than 70% of Australian general equity and A-REIT funds underperformed their respective benchmarks on an absolute basis.” (note the FSC does not necessarily accept the SPIVA scorecard results; we are mainly raising the differences between the SPIVA results and the Commission’s results.)

- The SPIVA report relates to managed funds generally, but should be a useful comparison point with the Commission's findings given the substantial number of asset class investment managers utilised by each super fund.

The SPIVA results also differ from findings in the Commission's supplementary report finding majority outperformance or average outperformance against benchmarks:

- Funds on average outperformed the benchmark for most asset classes (Figure 1).
- In Figure 18, a majority of members (54%) and a majority of super assets (59%) are in funds that outperform the benchmark.
- In Figure 19, a majority of members (53%) and a majority of assets (51%) are in funds that outperform the benchmark.

Supplementary survey

- The Commission notes 12 super funds provided asset class performance figures for a product within a fund, rather than for the whole fund, due to data limitations. The Commission states the product-level data from these 12 funds was "broadly representative" of performance across the whole fund (see Box 2). However, some FSC members have indicated to the FSC that this may not necessarily be correct. The data provided often related to the default investment option and super funds are not confident this is "broadly representative" of fund level performance.
- In Box 2, the Commission notes in bold some reasons why the comparisons using the survey data should be interpreted cautiously. However, the summary of the paper (see page 1) does not mention these caveats even in brief, instead being definitive in its conclusions.
- Table 18 of the supplementary report relates to the response to the supplementary funds survey, and indicates that the named funds "submitted supplementary survey data after subsequent requests from the PC". This implies that the relevant funds were uncooperative with the supplementary survey, and only provided data after the funds failed to act on earlier requests from the Commission. However, several FSC members thus described in Table 18 do not accept this implied characterisation of their dealings with the Commission and indicate that they fully cooperated with the Commission's work on the supplementary survey.
    - We understand some FSC members explained to the Commission the substantial difficulties they were experiencing with collecting data; but this should not be interpreted as being uncooperative or an attempt to conceal underperformance.

Unexpected wider use of data from supplementary survey

The Commission's supplementary survey of superannuation funds, issued after the draft report, stated that the data on asset-level performance would be used for international comparisons and to investigate sources of underperformance (see letter to super funds attached). However, the use of this data in the Commission's supplementary report is substantially wider than this previous commitment — the data is used in the supplementary report relates to:

- Comparison of asset class performance against asset class benchmarks (Figure 1), including by industry segment (Figure 2)

- Variation in returns by asset class and by industry segment (Figure 3)
- Distribution of returns by asset class (Figure 4)

In that same letter to super funds, the Commission indicated asset class investment would be used for international comparisons and to improve performance benchmarks, but in the supplementary report the data was used for a comparison within Australia including a comparison between industry segments (Figures 24 and 25).

The FSC is disappointed in this approach and considers this wider use of survey data should have been formally disclosed to survey recipients before the release of the data, and preferably before the survey questions were sent to funds.

Data on global shares – hedged versus unhedged

Time period	Return Type	Hedged	Unhedged	difference
3 Month	Return	3.50%	5.13%	-1.63%
	Benchmark	4.83%	6.48%	-1.65%
	Excess return	-1.33%	-1.35%	0.02%
1 Year	Return	10.85%	18.05%	-7.20%
	Benchmark	11.53%	19.04%	-7.51%
	Excess return	-0.68%	-1.00%	0.32%
2 Year	Return	16.48%	18.12%	-1.64%
	Benchmark	15.74%	17.68%	-1.94%
	Excess return	0.74%	0.44%	0.30%
3 Year	Return	15.66%	13.44%	2.22%
	Benchmark	14.64%	12.69%	1.95%
	Excess return	1.02%	0.75%	0.27%
4 Year	Return	11.48%	14.33%	-2.85%
	Benchmark	10.98%	13.74%	-2.76%
	Excess return	0.49%	0.60%	-0.11%
5 Year	Return	12.23%	15.04%	-2.81%
	Benchmark	12.21%	14.88%	-2.67%
	Excess return	0.01%	0.16%	-0.15%
10 Year	Return	10.89%	10.24%	0.65%
	Benchmark	10.83%	9.66%	1.17%
	Excess return	0.06%	0.58%	-0.52%
15 Year	Return	9.99%	8.24%	1.75%
	Benchmark	10.48%	8.17%	2.31%
	Excess return	-0.49%	0.07%	-0.56%

Global Shares Hedged = MSCI ACWI (Net, Gross Prior to Oct 17)
Global Shares Unhedged = MSCI ACWI (Net, Gross Prior to Oct 17)

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29 May 2018

Dear

Superannuation system Inquiry — follow up on funds survey gaps

Today we released the draft report for our Inquiry into the efficiency and competitiveness of the superannuation system. A copy is available here: www.pc.gov.au.

We will now engage in extensive consultation through public hearings, submissions, release of other technical papers and expert roundtables before we finalise our report to the Australian Government later in the year.

You will see from our draft report that there remain some gaps in our evidence base from the funds survey. Data we had anticipated would be provided were not. For example, about 85 per cent of CEOs reported that their board regularly assesses the attribution of their fund's investment performance by asset class. But only 5 of the 114 responding funds provided returns data — an input to performance attribution analysis — for the 14 assets classes. Sixty funds provided nil responses.

As these data are important to our Inquiry, this letter is to advise that we will now again seek to secure these data from you to inform our analysis and final recommendations to Government.

Next Tuesday (5 June) we will be sending you a link to a short survey form for each fund for which you are responsible to assist our collection of this important data. We appreciate that our original funds survey was late last year and that much has happened in the financial services industry since then.

This follow up survey is going to focus on material gaps which preclude us from undertaking important areas of analysis:

- fund assets and returns by asset class. This information will be used to undertake a comparison of net returns by asset class with international benchmarks and indices. It will also be used to investigate sources of underperformance

- investment management fees by asset class. This information will be used to strengthen the comparison of investment management costs by asset class with international benchmarks. It will also be used to improve the assumptions regarding investment management costs in the performance benchmarks

- fund expenses by expense category and by source (e.g. outsourced non-associate providers, outsourced associate providers and in-house services). This information will be used to undertake a comparison of expenses between funds that do and do not use associate providers.

We will also provide some further guidance and a simpler structure for some of the questions.

Akin to the CEO governance survey, this survey will be undertaken in-house by the Commission. Survey responses will be received and stored securely within the Commission's IT environment, and will only be accessible to Commission staff working on the Inquiry. Responses will be de-identified in published data to protect the identity of funds.

In keeping with our inquiry processes, we will report summary statistics and analysis based on the data in a transparent way, and Inquiry participants will have the opportunity to provide feedback on this work before we finalise our report.

As with the original survey, where funds that received the survey and those that responded were listed in the draft report, funds that received this follow up request and those that complied will be listed in the final report.

Please return the completed survey within 15 business days, that is, by close of business Wednesday 27 June 2018.

If you require assistance with any aspect of the survey, please contact Lou Will

Yours sincerely

Karen Chester
Deputy Chair

Angela MacRae
Commissioner