28 April 2017

Chairman Peter Harris AO and Deputy Chair Karen Chester
Superannuation
Productivity Commission,
Locked Bag 2, Collins Street East
Melbourne, Victoria 8003

E-mail: **super@pc.gov.au**

Dear Mr. Harris AO and Ms. Chester,

PRODUCTIVITY COMMISSION DRAFT REPORT- SUPERANNUATION: ALTERNATIVE DEFAULT MODELS

Dixon Advisory welcomes the opportunity to make a submission to the Productivity Commission draft report on the proposed alternative default models. Ensuring that superannuation is an effective retirement vehicle for all individuals is a vital policy area given our ageing population. The development of an appropriate default model must consider not only immediate efficiency but the long term impacts on consumers, the industry and government finances. Concentration of super capital and inflows within a small number of funds will not foster competitiveness and stability of the superannuation industry. To reduce the risk of adverse and systemic consequences over the long run more consideration of risk management and risk weighted returns must be brought into any default analysis and decision making.

By way of background, Dixon Advisory was founded in 1986 by Daryl Dixon, now widely recognized as one of Australia's leading superannuation advisors. Since then, Dixon Advisory has assisted individuals navigate the superannuation system, by providing easy to understand advice on a fee-for-service basis. We hold Australian Financial Services Licence number 231143.

The Dixon Advisory team are very familiar with all aspects of the superannuation system, providing advice to individuals within the four key sectors: public sector superannuation, industry funds, retail funds and SMSF's.

Dixon Advisory assists more than 20,000 families with their superannuation decisions, including over 4,500 families who use SMSFs, for which Dixon Advisory provides a complete administration service.

Dixon Advisory estimates, this makes it the fourth largest administrator in the $600 billion SMSF market.

Dixon Advisory employs more than 350 people in its 5 offices: Sydney, Melbourne, Canberra, Brisbane and New York (USA).

We thank you for allowing the opportunity to provide comments on this important issue. If you have any questions regarding Dixon Advisory's submission, please do not hesitate to contact me

Kind regards,

Nerida Cole

Managing Director - Head of Advice

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Assisted employee choice

Dixon Advisory Comment 1: Last resort fund

Including the option of either an Eligible Rollover Fund (ERF) or the Future fund, as the last resort fund where an individual does not make a choice, may further disincentivise the individual from engaging with any of the shortlisted default funds. Such an outcome would defeat the purpose of a default model for superannuation. Further, because the ERF or Future fund may appear as a feasible option for the un-engaged consumer, relying on the fund to nudge individuals to roll-out of a last resort fund into an approved default fund is not expected to be effective (based on the difficulties experienced by the ATO with the current system of lost or inactive accounts).

Dixon Advisory suggests a more efficient solution that would also overcome the need to use either the ERF or the Future fund as a last resort fund is to allocate members sequentially into the shortlisted default fund if they do not exercise a choice from the default shortlist within a designated period (i.e. 60 days)

The sequential allocation of members across a wide but well filtered and appropriately considered shortlist, may also help reduce some of the issues with the ordering of the shortlist and concentration risk amongst certain funds. This is vital to try to avoid monopolisation and a decline in overall competitiveness, risk management, investment efficiency of the default market.

Fee based auction

Dixon Advisory Comment 2: Addressing loss leading

As the Productivity Commission ('the Commission') notes on page 143 of their draft report, one of the concerns arising out of an auction process is that funds could use a short term 'loss leading' strategy to improve chances of being selected. This may then prove unsustainable and lead the fund to reduce the quality of its services or increase its fees, or to lose its status as a default fund which may result in significant disruption to members. Dixon Advisory suggests that the Commission require the Panel selecting the default funds to rigorously investigate and test proposed fees in the qualification stage. This will assist in determining whether the fee target proposed by the fund, is sustainable and realistic.

Dixon Advisory Comment 3: Passive funds management

There are significant consequences to risk and investment returns, by taking an approach that focuses predominately on fees. The fee based auction requires the fund to have a low fee arrangement in place to be competitive. Such an approach will incentivise superannuation trustee to take a very passive investment management approach – as this is likely to help in keeping fees low. However, index style investments and passively managed portfolios do not fully encompass tried and tested risk management practices, such as diversification and tactical asset allocation, which can greatly improve stability of earnings. Actively managed funds seek to manage risk and returns for example; via diversification into a broad range of asset classes, including niche and new investment classes, as well as portfolio management practices. This approach can add costs but when considered on a risk weighted returns basis, can optimise an investors long term outcome.

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Multi-criteria tender

Dixon Advisory Comment 4: Categories of funds

The Commission on page 172 questions whether the tender should either have several best overall performers shortlisted or a shortlist of best performers from particular categories.

Our view is a shortlist of best overall performers selected from particular asset class categories is preferred. This will help ensure an ongoing level of competition across different asset allocations and manage some of the pressure to homogenise products which is expected to increase as a result of this model (as discussed in Comment 6 below). This further reinforces why members should be given at least a designated time frame to make their own choice from the shortlist, before they are allocated via a sequential method.

Comments for all models

Dixon Advisory Comments 5: Evaluating risk and return

The maxim 'past performance is not an indicator of future performance' is a primary premise for any risk and return consideration. Risk and performance is largely determined by factors like timing, market performance and expected future market conditions. Measuring risk and return across different asset classes also requires appropriate consideration. Although evaluating past risk and return is very complex, without proper consideration within its evaluation metrics, the Commission runs the significant risk that members' monies will be allocated into riskier and volatile investment options than is understood. This has significant consequences on trust in the system, as well as capacity for individuals to fund their own retirement. We therefore emphasise the importance of using risk weighted performance criteria in any comparison measures across the funds.

Dixon Advisory Comment 6: Monopolisation and anti-competitiveness

The Commission needs to further consider the consequences of the proposed models and their impact on market stability and sustainable healthy competition.

- Funds which have niche or alternative investment approaches or are outside the core asset allocation of the default funds, including conservative and high growth portfolios, will find it difficult to compete for the default market. Consequently, in order to compete for the default market, investment strategies are expected to homogenise. Such market behaviour will lead to a reduction of funds offering investment approaches that fall outside the scope of the default market, which will further reduce the opportunities available for risk management and diversification. This poses significant risks to the individual super fund member and the long term sustainability of the system.
- New entrants and small funds will face increased barriers of entry due to a restricted market.
- The high focus on fee efficiency across all models is likely to widen the gap in efficiency between the default and non-default market, this in turn will create further monopolisation and exacerbate the problems outlined above.
- Default funds will have lesser incentive to expend on innovative practices (such as introducing member engagement services and tools) due to their focus shifting to maintaining their status quo default criteria.

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Dixon Advisory Comment 7: Modifying fund risk profiles

The Commission should contemplate a mechanism which will address the needs of more conservative members (i.e. those close to withdrawing or accessing capital). This may be an active approach where the member chooses their preferred asset class or allocation (similar to Comment 4), or a trigger approach which is activated once a member reaches a specific age (i.e. 55) resulting in the member being shifted into a more conservative option. Based on current demographics of members using the proposed default models, this is not likely to be a short-term concern, but the default design should contemplate this.

Dixon Advisory Comment 8: No consideration of insurance

Insurance is one of the primary mechanisms that help individuals and families recover from unforeseeable events and offer invaluable support for dependants in the event of death or total and permanent disablement of the primary earner or caregiver. Linking insurance as a primary safeguard is consistent with one of the subsidiary objectives of superannuation which is to "*be simple, efficient and provide safeguards*"[1]. Dixon Advisory suggests that the Commission consider developing qualitative metrics for insurance providers across the proposed models in order to safeguard selecting employees against unforeseeable events.

Dixon Advisory notes that consideration of insurance needs to encompass insurance portability. This will allow members to transfer insurance policies to new super funds and reduce their overall switching cost. This is especially relevant for members who may need to roll out of their fund if it becomes non-default compliant as proposed by the fee based auction and multi-criteria tender.

Dixon Advisory Comment 9: Employee selection

The Productivity Commission indicates that the fee based auction and multi-criteria tender will allocate a default superannuation fund to an employee on a sequential basis. Dixon Advisory suggests that employees should be allowed a 60-day window to select their preferred fund (which could be done via an on-line process), including from the short list. To simplify the process, the employer will need to initially provide the shortlist of default funds to the employee. If after 60 days the employee does not select a fund, they should then be sequentially allocated into a default fund from the shortlist. This suggestion will further promote basic employee choice and result in better risk preference alignment highlighted in Comment 4 above.

Dixon Advisory Comment 10: Qualification considerations

In the fee-based auction and multi-criteria tender model, the Commission has noted that any funds that have their default status revoked within a 4-year period will result in members of those funds be sequentially re-allocated to other default providers. The re-allocation of default members to other funds will result in significant costs to the members, the funds and the regulators.

To reduce the likelihood of funds being deemed non-compliant, it is vital that the appropriate metrics are agreed and researched by appropriate range of people with expertise in long term investment management. Some of these relevant considerations include:

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[1] Explanatory Memorandum, *Superannuation (Objective) Bill 2016, page 27* (viewed on 24 April 2017) <http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5762_ems_3e13dbab-f4b3-41a3-95c8-204b79c1ed92/upload_pdf/16172_173_174EM.pdf;fileType=application%2Fpdf>

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- Appropriately evaluating past performance and risk (as highlighted in Comment 5)
- The sustainability of proposed fees by funds (Comment 2)
- Setting appropriate criteria that will reduce the Panel's perceived bias in their selection of default funds (these may include conflict of interest provisions and integrity measures).

Further, to ensure fairness in re-allocating members, the Commission needs to consider whether re-allocated funds will have the same terms and conditions as the members' previous fund. This would specifically be relevant for the taking over of insurance on the same terms and conditions as the previous fund.

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