Monday, 4 June 2018

Commissioner Peter Harris
Chairman, Stage 2 Enquiry Draft Report
The Productivity Commission

Dear Mr. Harris,

SUPERANNUATION: ASSESSING EFFICIENCY AND COMPETITIVENESS
SUBMISSION ON DRAFT REPORT: FINDING 4.3

I refer to your draft report finding 4.3 which states the following.

"The inclusion in MySuper of life-cycle products is questionable given the foregone returns they pose for many members' balances (with some foregoing higher returns by adjusting asset allocation as early as 30 years of age). Life-cycle products comprise around 30 per cent of all MySuper accounts, but are mostly suited to members who want to 'lock in' a lump sum for some immediate purchase after retirement. For other members, maintaining a balanced portfolio before and after retirement would maximise retirement and lifetime income. Life-cycle products are better suited to the choice segment."

As an expert in the area of default options in superannuation plans and someone who has spent several years researching life-cycle products around the world, I hereby submit my opinion on your findings in relation to the appropriateness of life-cycle products as defaults and suggestion that balanced portfolios are more suitable products for Australian workers enrolled in default options. With respect to life-cycle products, which are the fastest growing MySuper products in Australia, the most important consideration should be the design of these funds. I have published several studies (referenced below) in this area in peer-reviewed international journals. Basu and Drew (2009) was one of the first studies to suggest that life-cycle funds, which use an asset allocation glide path solely based on age, were not the most appropriate investment choices for many members.

However, a wholesale rejection of life-cycle products in favour of fixed allocation options (like balanced and balanced growth options), as the draft report seems to suggest, is not the right response. Tail events (like GFC) may not occur as infrequently in the future as they have happened historically and have the potential to wipe out a significant chunk of the retirement nest eggs of millions of workers very close to their retirement. A government mandated or recommended default design with high exposure to risky assets for older members near retirement would prove to be catastrophic in such circumstances. It is worth noting that the OECD Working Party on Private Pensions endorsed an ongoing roadmap for design of private pension plans, which included 'establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes' (OECD, 2012; 2013).

The appropriate policy response to the issue of default design would be to address the limitations of the current life-cycle products and offer members 'smarter' life-cycle products that would offer higher likelihood of securing healthy retirement savings for members along with prudent risk management near retirement. However, the design of such smarter lifecycle products need not be made unnecessarily complicated and laden with every possible member characteristic that ultimately makes it too difficult

to implement. Basu, Byrne and Drew (2011) has demonstrated the superiority of a simple target return based 'dynamic life-cycle' product design over conventional life-cycle as well as balanced portfolio designs. The dynamic life-cycle investment option adjusts asset allocation based on members' age but also by the members' portfolio balance vis-à-vis an *accumulation target*. (The *accumulation target* is based on their projected pre-retirement income which can easily be translated into a compound rate of return that is set as a target return for the life-cycle option over its lifetime.) The asset switching for such a life-cycle option is not unidirectional but dynamic i.e. the proportion of risky assets in the portfolio at any point in the member's employment horizon increases or decreases based on the account balance relative to the *accumulation target* set for that particular point in time.

Simply put, the dynamic life-cycle option proposed by Basu, Byrne and Drew (2011) is a 'target outcome' fund as opposed to conventional life-cycle options which are 'target date' funds. They provide a far superior likelihood of generating adequate retirement savings in the accumulation phase compared to the commonly available default options and therefore minimise the risk of shortfall in retirement. Simulation studies conducted by OECD, among others, also confirm that dynamic life-cycle strategies provide more optimal outcomes for members (Antolin, Payet, and Yermo, 2010). Research by the Investment Management Association (IMA), the peak body for investment management industry in UK, also supports the findings of paper on optimality of dynamic life-cycle strategies in their submission to Personal Accounts Development Authority (IMA, 2009)
.
Unlike other smarter life-cycle options that have been proposed (but not tested), the dynamic life-cycle investment option avoids unnecessary complexity in the design by singularly focussing on the target outcome for the member. Being a clear rule-based investment option, the 'dynamic life-cycle' product is easy to implement both as default and choice options. For example, a superannuation fund may choose a dynamic life-cycle product with 6% compounded return target as its default option. Similar products with a range of return targets (say from 4% to 10%) can be offered to members in the choice segment. As research cited above has shown, the dynamic life-cycle asset allocation principle results in a higher likelihood of members retiring with a balance that is close to their accumulation target than both the balanced and life-cycle options.

Poorly designed life-cycle products have had a history of underperformance in the United States. Our research has assisted several recent enquiries there into the performance of life-cycle products and exposed their limitations as defaults. For example, our paper was one of the nine studies reviewed by the U.S. Government Accountability Office to assess the future performance of target date funds (GAO, 2011) The commission has a historic opportunity to ensure Australian superannuation fund sector learn from the experience of other markets and come up with an intelligent yet practicable default product design based on outcomes that would enhance Australia's reputation for its innovative retirement system.

Yours sincerely,

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