Productivity Commission Submission

Tailored Superannuation Solutions Ltd

Stage 3: Assessing Efficiency and Competitiveness – Draft Report

Comments on the Stage 2 and Stage 3 Draft Report

Due 13 July 2018

Executive Summary

Congratulations on this seminal report, completed in an environment of conflicting views and poor industry data provision. The draft report while lengthy is currently lacking in regards to efficiency aspects, especially Dynamic Efficiency including default services to MySuper members, and savings over time. This submission concentrates on those draft report deficiencies in order that they may be appropriately addressed in the final report.

On a professional level, as accepted by the Commission and highlighted in our hearing session and those of QSuper and Professor Michael Drew, the Commission still has considerable work to do in regards to dynamic efficiency and in understanding Smart Defaults in particular.

By way of summary, as articulated by Professor Drew (Livestream 3:30:30), dynamic life-cycling is robust and supported by Nobel Laureates, it is aligned to the (retirement) objective of superannuation, it involves improved money weighted returns over a working lifetime and Smart MySuper Defaults should be the 'best in show' default. The real question is if 'best in show' can any longer support a 'one-size-fits-all' model of 'allocating members to products'?

QSuper, (Livestream 1:31:30) also by way of summary, highlighted that one-size-fits-all falls well short of the optimal solution. That the Commission should recommend Smart Defaults to spur the industry into action - to lift the bar in the Default Segment not the (draft suggested) Choice Segment. That providing advice early, through a default and trustees automatically acting rather than waiting for MySuper members to engage is much preferred. That using a dynamic approach will show up under performers (one-size-fits-all 70/30 and age only static life-cycling) and introduce better continuous improvement practices. That the world follows Australia, we are the leaders with Smart Defaults being at the cutting edge. It is more than research and theory, they are not hard to do and funds have the data. Life-cycling using more than one factor to cohort improves outcomes, with analysis showing 80% of QSuper members are better off (even with their product only being partly implemented).

As we highlighted at the hearing and in our opening statement (included at Appendix A), **what investment (option) is four times more important to outcomes than which MySuper fund**. The Commission's highlighted **$1.3 billion per year 'best in show' benefit is only a quarter of the $5.0+ billion p.a. benefit from using Smart Defaults**.

Given the comparatively far higher value and lower disruption from introducing Smart Defaults, as a means of 'allocating members to products', the Commissions 'which' fund, not 'what investment' emphasis and lack of dynamic efficiency assessment to date, in the Draft Report is of concern.

The Draft Report, highlights that superannuation should place the member at the centre, but the Commissions focus on single investment option net returns places the fund at the centre. Assessing impacts on a member's retirement outcome, not a fund's performance is critical.

That imbalance can be readily addressed in the final report, by including multiple investment options over a member's accumulation phase, as set out and recommended in our initial Stage 3 submission.

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The analytical approach taken in using single investment option net returns is, as noted in the Draft report, a complex and fraught task, particularly given the conflicting and missing data plus varying two, five and ten year return histories amongst funds investment options.

Further in selecting the '10 best in show' as BT pointed out at the hearings, how the current, but recommended to be removed, default access regime benefits (from steady inflows and more stable liquidity) are included on a like for like basis, will be an issue.

One way to overcome this would be use Smart Defaults and the new Outcomes Test peer requirement. It would remove much of this issue by using a fund's existing Choice Investment options and their return and loss histories. The collective benefit would be $6.3 billion yearly.

The draft report does not yet meet the Commissions *'Principles for designing a model for a competitive process'.* By focusing on single 'balanced' default option net returns there is:

- Judgement based on default option net returns not a member's retirement outcome
- No encouragement for a long term asset allocation or member based investment strategy
- No drive for funds to innovate, to facilitate better default options into the market
- No dynamic assessment of how the default process can reduce Age Pension reliance.

Attempting to simplify the Commissions task by restricting analysis to single net investment option returns, by rejecting an analysis of changing investment options, asset allocation and investment strategy over a working lifetime, **is not fulling the Terms of Reference**.

That approach creates inconsistencies, which are evident throughout the Report (Appendix B). Currently, at several critical points throughout the Draft, alternatives to the single investment option analytical approach are dismissed or down played, supported by data that the Report itself confirms as wanting. In addition arguments used in support of that single static investment strategy approach are not deployed in regards to a more dynamic assessment.

A cost versus benefits analysis of the missing dynamic features is necessary. It involves a comparison of what funds are achieving for member's outcomes, not a simple ranking of existing funds past net returns (i.e. top ten in show) plus qualitative features.

At present there is a disconnect between the members outcomes test and the recommended fund selection model. The Commissions assessment approach used to date, is too simplistic and leads to conflicting conclusions. Further a funds own MySuper demographics' does influence Outcomes. The 'bar needs lifting' if the system is to be sustainable over the long term and this is the opportunity to do that through Smart MySuper Defaults, with or without 'best in show'.

Improving the efficiency of converting contributions to retirement lifestyles is the big issue, not which fund. That requires MySuper default segment innovation and access by funds to new members, in order to incentivise and make the investment case for that innovative change.

We doubt a 'best in show' selection panel and process is the best way to achieve that improvement. It will more than likely entrench current staid practices, unless also accompanied by the Commission exposing the evidence on Smart Defaults and recommending their use.

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Background

Smart MySuper Defaults, in their initial and simplest form tailor existing investment options – for example Australian Shares, Aggressive Option, 70/30 Default, 50/50 Balanced Option, and the Conservative Option - to members own projected retirement outcomes.

As such, they provide an alternative market-generated solution to a formal competitive process for allocating default fund members to products (that is intra-fund).

Further those (5) existing investment options, per fund, have established return and loss ratios (generally published) which are used, by allocating one tailored investment option per MySuper member. It is therefore known what the return and risk metrics are and the comparison between the one-size-fits-all default option and the new tailored option, for each member.

For example:

- 5.5% real p.a. in the Australian Shares investment option with chance of loss occurring 5 years in every 20 years, compared to
- the current one-size-fits-all 70/30 default of 3.65% real p.a. with a with chance of loss occurring 3.5 years in every 20 years.

These relative differences can then be amalgamated, member-by-member, to form a whole of fund comparison between tailoring and the one-size-fits-all default. It is this process that was provided to the Commission to test and audit, in detail, as part of our initial Stage 3 submission.

Data

Our method of tailoring provides trustees the SAAS tool to tailor investment options per member based on their own projected retirement balance. That projected retirement balance figure is already appearing on many annual member statements following a Financial System Inquiry (FSI) recommendation.

The data required is **AGE, BALANCE and CONTRIBUTIONS**, **data that is held by every fund already**.

Dynamic Nature of Work Patterns

The Commission has raised the problems caused by workforce casualisation, the 'gig economy' and gender on retirement outcomes.

Firstly Smart Defaults by providing an average 35% higher retirement balance solve many of these issues and provide many more viable retirement options including in respect of CIPR's.

Secondly, each year in our tailoring method retirement balances are re-projected. As a result they take into account higher contributions (increased wages/promotion), lower contributions (gig/casual work) and no contributions (maternity leave/retrenchment). The tailored investment option may change as a result or just because the member is a year older. These problems are as a result captured with a one-year lag in the tailoring effect, spread over the time until retirement.

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Tailoring

It is the Trustee who sets the Lifestyle Retirement Bands (LRB's/bands/cohorts) and glide paths (investment options at each age) for each LRB, based on their knowledge of the funds membership and demographics.

This may be informed by big data, deep dive analysis of existing members as described by QSuper at the hearings or it may be quantitative in nature based on maximising returns per LRB and/or constraining sequencing risk per LRB at given ages for example. That is up to the trustee, acting in members best interests, to decide. They as fiduciaries are best placed, already have legislated obligations and must act in members best interests.

It maybe that one fund, by way of example QSuper, decides that once a certain accumulation balance (projected retirement outcome or replacement income level in retirement) is reached, risk should be reduced for that cohort. They may have captured higher retirement outcomes for 80% of their members compared to 'one-size-fits-all' default and as a trustee be then satisfied with reducing risk. (Noting at this point their stated further pending product enhancements and continuous improvement process).

Others will take a different view, for example targeting improving average retirement balance outcomes by a third (35+%) while constraining sequencing beyond a given age (e.g. 55 years) to or below the one-size-fits-all level. That can involve using higher growth and risk investment options for younger members over the whole fund and for some members in certain LRB cohorts more risk for longer, than in other LRB's (i.e tailoring of investment options)

It requires consideration of a funds MySuper Demographics:

- the skew from the Normal Curve that occurs in MySuper fund populations (as MySuper member's age and their balance grows, many engage, leave and make an investment option selection).
- the dollar weighted impact because remaining older members typically have higher balances although that also varies by LRB cohort.
- Dynamic impacts. As higher growth assets (investment options) and returns increase a members balance and that improvement is compounded to retirement, members outcomes are enhanced along with their LRB cohort, which changes their relative ability to bear risk for longer.
- A members declining Human Capital and projected retirement balance

It is not a matter of knowing draw-down characteristics of each member (as the Commissioners at the hearings repeatedly suggested) or about providing personal financial advice. It is also not about a 'Cameo' member, as some members will remain in MySuper for life, but most will not.

It is about setting the Investment Strategy based on a funds own demographic. The comparison point of one-size-fits-all, for that Investment Strategy assessment is not hard to beat once members are placed at the centre. In fact it should already be regularly reviewed by trustees as part of their covenants.

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System Efficiency Impact

Smart Defaults can provide $5.0+ billion per year extra into MySuper members accounts through more efficiently tailoring default investment options compared to one-size-fit-all 'balanced' or age only life-cycling.

This substantial increase has the potential in its own right to significantly close the impending National Retirement Funding Gap, while also meeting the Commissions '*Principles for designing a model for a competitive processes*' and other Terms of Reference requirements, without undue market consolidation or the need for further legislation or regulation.

Consolidation of the superannuation sector may or may not be desirable from an efficiency perspective. Our point is that this should be determined by market forces, using member (retirement) outcomes and the Purpose of Superannuation as the determining 'survival of the fittest' criteria – not a fund's past net returns.

A government imposed bureaucratic process that effectively 'picks winners' (and, by implication, 'losers') may impose a forced consolidation of the market to a degree of concentration which may result in oligopolistic or even monopolistic practices, thereby reducing (long term) competition and efficiency.

With an APRA reported MySuper growth rate of circa 18% p.a., selecting the ten largest funds for the first four years, may conceivably result in those funds doubling in size and scale by the next round (after including mergers, Public Offer status impacts, and flow-on issues).

The scale argument could then be further used to perpetuate industry consolidation. Given the current industry structure and history, this approach will not encourage continuous improvement and innovation but rather a culture of herding and placing the fund not the member at the centre.

Furthermore existing non-selected funds are already and would continue pre-empt this outcome. It will more than likely to entrench current staid practices, unless also accompanied by the Commission exposing the evidence on Smart Defaults and recommending their use.

Leaving consolidation to the APRA Outcomes Test is otherwise preferable.

We are in the process of implementing Trustee Tailored Super (TTS) at one of the small indexed MySuper funds. The auditable extra tailoring benefit will exceed 100 bps real p.a. on average equating to 35% higher average retirement balances compared to one-size-fits-all.

In a fair assessment based on member-by-member retirement outcomes, that fund would be in your recommended top ten in show, irrespective of their current small size.

We have a currently available mechanism, which avoids much of the merger angst, for other funds to join this path, while maintaining the benefits from their own membership profiles.

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Appendix A - Opening Statement

Douglas Bucknell CEO,
Tailored Superannuation Solutions
Good afternoon Commissioners

1. Our interest, unlike most others, is principally in the efficiency of the system in **allocating default members to products – that is the Default Investment Option within a fund, not which fund.**
2. Allocating members to tailored investment products lifts retirement outcomes by $5+ billion yearly, being four times the $1.3 billion estimated by the draft recommended '10 best in show allocation approach'. It is therefore worth the Commissions effort to study it closely.
3. Our analysis shows that applying tailored investment options would lift average retirement balances for these members by 35% with a reduced risk of loss as retirement approaches. MySuper members put their faith in their Trustees to invest wisely on their behalf, yet Trustees have fallen short on their duties by using one-size-fits-all defaults.
4. We appreciate the positive references in the draft report to our prior submissions, and Smart MySuper Defaults generally, however Page 196 of the draft report is wrong**.** It should read that:
    a. **Sufficient data is held by all MySuper funds in order to implement an initial version of a Smart Default.** That data being age, balance and contributions, in order to produce the FSI recommended projected retirement balances per member. Those projections are already on many annual member statements
    b. Further that explaining a Smart Default to members is only a little more complex than the current explanation of the funds Choice investment options (Australian Shares, Aggressive, Balanced, Conservative etc.) and Age Only Based life cycling.
    c. Tailoring existing investment options is a classic case of 'a small change that can have a real impact in retirement' as highlighted by the Treasurer in the ToR.
    d. Smart Defaults are the only major 'default product allocation' innovation provided to the Commission that is on the horizon and implementation ready.
5. Regarding the comment that "the Commission is cautious about recommending the replacement of simple life-cycle products with 'smart' alternatives **at this stage**"; we seek guidance on how the Commissions caution might be removed?
    a. **Our submission provided methods for the Commission to run the test.**
    b. We hold auditable reports on funds, consistent with the Outcomes Test on over 100,000 members and $30 billion in assets, proving the 100+ bps p.a. average uplift.
6. This draft expression of caution is of course in stark contrast to the lack of caution shown in the Draft Report in the radical Best in Show recommendation.
7. The Draft Report approach **has dropped the ball on Dynamic Efficiency**, instead treating member's financial retirement outcomes as equaling annual net investment return of a MySuper Funds single balanced default option. We reject that approach as a secondary indicator only.
8. **Trustees should focus on member's retirement, not the funds net return.** They should not be so simplistic. The bar is set too low.
9. We fundamentally **reject propositions that placing members in the same investment option for life is efficient**, regardless of their investment horizon (time to retirement or age) and regardless of if they will retire on a million dollars or the full Age Pension.
10. Financial planners acting in a one-size-fits-all manner would be banned. **MySuper members are not all the same** and hence a one-size-fits-all approach is wrong.
11. Age Only life-cycling **does** lower average retirement balances, however comparing the same $129,000 starting balance of a 'one-size-fits-all balanced option' at age 55 years appears flawed. It again shows disregard for higher growth earlier and dynamically changing investment options over a working lifetime.

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12. Despite the poor data quality, the Draft Report uses restricted growth option performance above the default option return rate, but the reverse for conservative options, which is inconsistent with the equity premium axiom and many other long term academic and market studies.
13. We do **not believe** the Commission's intent, as the premier economic body in the country, was to attempt to overturn economic principles with such poor limited quality data – however, that conclusion can be reached based on the draft reports current findings.
14. Smart Defaults are complementary with account consolidation and the new APRA (retirement) Outcomes Test. That test fully applied will see funds forced to merge and account numbers fall.
15. "The Productivity Commission has made an accurate diagnosis of the shortcomings of Australia's superannuation system, but the 'Best in Show' remedy proposed is flawed"
16. "A Best in Show solution is bureaucratically-driven, rather than market-driven, and would simply create an oligopoly of a few powerful superannuation funds that would choke off competition. As we have seen in the Banking Royal Commission, powerful oligopolies lead to poor corporate cultures, gross mismanagement and lack of proper regard for the interests of customers (or super fund members)."
17. Elimination of innovation in MySuper in respect of big data and contraction to internally indexed single investment options by an oligopolistic few is the likely 'best in show' result. The Draft Reports approach has started chilling innovation and investment decisions already.
18. The Draft Reports arguments in support of this best 10 approach, are not equally used in respect of the Smart Default alternative of *allocating MySuper members to products* (that is investment options not funds), although it is of equal relevance to the terms of reference.
19. The draft report does not yet meet the Commissions ***'Principles for designing a model for a competitive process'.*** By focusing on single 'balanced' default option net returns there is:
    a. No encouragement for long term investing nor a focus on asset allocation or investment strategy. Trustees are being judged on the default option net return not a member's retirement outcome.
    b. No drive for funds to be innovative and facilitate new entrants, or default options, into the market.
    c. No dynamic assessment of the extent to which the process can reduce reliance on the Age Pension.
20. The draft reports missing elements **can be readily addressed in the final report**, by building upon the work already conducted and our submission detailed member-by-members testing suggestions.
21. "Smart Defaults would allow competition between funds to flourish through product differentiation. Vigorous competition based on retirement outcomes should decide which funds survive, not a highly contentious 'best 10' process which would create huge barriers to entry, stifle innovation and – most importantly – fail to advance the financial retirement interests of members"
22. The **crux of the difference is that the draft recommendation would**
    a. move members to historically better performing funds for $1.3bn in purported savings,
    b. **where the alternative, Smart Defaults would move members to better tailored investment options within their existing fund, for a $5.0 billion dynamic efficiency gain** and leave consolidation to the new APRA Members Outcomes Test.

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Appendix B – Specific Comments of the Draft Report

Given the raw size of the Draft Report, it would be easy to 'miss the wood for the trees', to skip over inconsistencies and not seek to correct misinformed elements.

To avoid that outcome we provide a colour coded response per page as follows.

Colour	Purpose	TSS View
Red	Comments unsupported or inaccurate	Disagree
Yellow	Comments used in an inconsistent or non-fulsome manner	More work required
Green	Points well made	Agree
Black	Sections included for clarity	No comment
Blue	Our comments	

P5

In this draft report we are asking and answering the questions set out in the assessment criteria we developed in our stage 1 study — which reflect prospective attributes of a competitive and efficient super system, and are within the scope of influence of the system. These criteria cover the system's contribution to members' retirement incomes, how it meets members' needs over their lifetimes, gains in efficiency over time,………

Has this been constricted to single net investment option returns and if so why?

P6

The findings in this draft report are focused on the outcomes for members in the super system, consistent with our remit to make recommendations in the interest of the wellbeing of the Australian community.

No they are focused on a fund's net returns.

P7/P8

The super system exists to support its members in retirement. As such, the outcomes delivered to members matter above all else. In the long term, members need strong investment performance and confidence that their balance is not eroded by unnecessarily high fees or insurance premiums. They also need access to products that meet their individual requirements.

Investment returns — net of all fees and taxes — matter most for members' retirement incomes.

This approach is new, and has not been previously applied to gauge the performance of the system as a whole. Importantly, it is agnostic of asset allocation and thus allows for a comparison of performance across the system by segments, funds and investment options (products).

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You have measured fund's net returns and compared that – not Outcomes delivered to members as suggested.

P23

Members are not always going to make good decisions

Many members simply default into a fund and product, and rely on the system to manage their super for them (whether out of trust, a lack of interest or an inability to compare products).

Around 40 per cent lack an understanding of basic investment options (such as growth, balanced and conservative). And about 30 per cent of Australians have rather low levels of financial literacy.

Low member engagement is not necessarily a problem. For many members, it is rational. Engaging takes time and effort, and trustees are charged with acting on members' behalf and in their best interests.

But currently trustees don't, they just dump all members in the same investment.

P24

In the default segment, competition is at best superficial. Members who default are typically disengaged and exert no competitive pressure — there is limited or no competition *in* the market. As a result, any competitive pressure within the default segment has to come from competition among the funds authorised to provide default products — competition *for* the market. This is not happening.

The process for listing default funds in modern awards has constituted a high barrier to entry for new entrants to the default segment. There is **no systematic pressure on funds to compete strongly once they gain access to the default market**.

Where is the discussion on the impact of homogenous one-size-fits-all-defaults on competition? Intra-fund competition? If all products look the same and a restricted award default access regime applies then there is an impact on incentives to innovate – hence government or regulator pushes are required.

P25

Default arrangements are a necessity in a compulsory super system to protect members who do not make their own investment decisions.

However, the original MySuper hurdle was set too low and significant variation across default products remains — especially in terms of investment strategy (and life-cycle products), performance and fees.

Relative to what? See also herding comments

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P27

The introduction of MySuper (also in 2012) was intended to reduce some of the variation in member outcomes

References please?

P28

There are yawning gaps in data

A further area of weakness is how data on the system are collected. The regulators' data collections are largely focused on funds and products, with a deficiency of member-based data.

The Draft Report falls into the same trap by using funds net returns not member based data.

P30

A package of improvements to benefit members

.. policy settings need to change to make it work better for *all* members.

Yes benefit all members by policy changes to Smart Defaults

P246

However, acquiring *impartial* superannuation advice can be hit and miss.

Not an issue with 'advice' imbedded in the default by trustees

P31

A new way to allocate defaults will put the focus squarely on members

Not really focus remains on a fund's net return

Importantly, the new default allocation would harness competition (and the innovation that flows from it) to deliver for members, not for funds and providers — in other words, competition *for* the market.

How? Guaranteed supply for four years, crowd herding, homogenous one-size-fits product!

P32

A new mechanism for allocating defaults

In a world of compulsion the onus is on government to ensure that default super is the system exemplar

To complement and bolster the outcomes test, funds should be required to obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison

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against other products in the market, and determination of whether members' financial interests are being promoted, at least every three years.

Agreed, onus is on government/Commission to test Smart Defaults.

We agree with the Outcomes Test audit and have data showing Smart Defaults provide 35% higher average retirement balances.

P48

A 'no frills' product with low fees that is allocated to a balanced (or balanced growth) portfolio is likely to meet the retirement needs of most Australians during the accumulation phase.

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.

The term 'likely' infers a probability assessment of alternatives has been undertaken. References supporting evidence and numbers should be provided.

We strongly contend that a no frills one-size-fits-all product produces a circa 35% lower average retirement outcomes on an auditable member-by-member basis. The Commission has been asked to undertake, and been provided the means by which assess, this false 'no frills' assertion. We hold auditable evidence contrary to the assertion made on over 100,000 members and $30 billion in assets.

The term 'maximise' used relative to 'retirement and lifetime income', asserts some dynamic assessment against the benefits over time has been made. At the hearings it was clear this work has not been done or understood. Further several parties pointed to independent evidence refuting this 'no frills' and 'maximise claims'. For example QSuper is quoted as highlighting 80% of their members being better off under a multi cohort dynamic default method.

'Retirement needs' don't arise 'during the accumulation phase', rather contributions are generally "Preserved" until retirement. At best this provides further evidence of either ill understood and considered conclusions or unfortunate group think. This has clouded whole sections and recommendations within the draft report.

At a professional level these references should be removed in the final report, until and unless that peer reviewed probability and maximisation assessment work is undertaken.

P82

The framework has been designed from the perspective of members' best interests.

The framework may have started that way, however in practice using a single net default option return per fund, means it has been applied from the perspective of a fund, not the member.

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P86

However, new evidence was required in some areas, especially in relation to members' outcomes and needs.

The evidence base for members, on the demand side, is comparatively sparse. To give one example, there are no official datasets of the distribution of total balances across members (aside from some one-off surveys).

To address data gaps, the Commission ran four surveys.

Where is the quantitative assessment on member outcomes? We have 100,000 'balances across members' but more importantly projected retirement balances as well. Those projected retirement balances take into account different contribution rates and are more valuable for this assessment. For example take John and Tom both aged 25 years, John has current balance of $50,000, Tom just $10,000 but is making triple the contributions. In assessing retirement outcomes the current balance differences or absolute number are not as informative as their project retirement balance in absolute or relative terms.

Members needs dynamically change due to various returns and investment options over time.

A survey of these disengaged members, at a given point in time, is of questionable value.

P89

The Commission developed a cameo model to simulate the effect of changes in different variables on a hypothetical member's superannuation balance, either at or during retirement.

The model is premised on a representative member who enters the superannuation system at age 21, retires at age 67 and dies at age 88.

In the base case, the member's fund delivers an after-tax (but before fees) investment return of 5 per cent a year (adjusted for inflation),

There is no changing investment return! This assessment is fund based using an 'average' of member's circumstances and a single investment net return per fund. The premise is not useful for the purpose used.

Further is it well known as members age and balances grow they leave MySuper. The normal curve is skewed to younger members. Extrapolating a 'cameo' to the performance of funds on average in lifting retirement outcomes is not appropriate.

P93

The size of, and variation in, net returns is critical to members' retirement incomes. But assessing the system's investment performance is challenging. The Commission's focus is on long-term performance, compared to benchmark portfolios that control for asset allocation. While the assessment is not an exact science, given data limitations, the Commission has erred on the side of giving funds the 'benefit of the doubt' in constructing the benchmarks.

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Yes, size and variation are critical to the member. Why hasn't that been assessed? Instead so far the Commissions focus is on a funds performance – controlled for asset allocation – not varied for the member circumstances. How about giving the member the benefit of the doubt in constructing benchmarks (based on them getting older each year and having different projected outcomes)?

P94

Delivering investment returns to members (net of all fees and taxes) is the most important way the system contributes to delivering the best possible retirement incomes. Persistently below par returns can lead to large foregone retirement balances. For example, the difference between a 5 and 6 per cent return can amount to a projected 23 per cent ($255 000) difference in retirement balances for a typical full-time worker (cameo 2.1).

Why has the Commission not yet used this same argument, equally forcefully in regards to dynamically changing investment options for a member over time? Being placed in the one-size-fits-all option returning 5% instead of the quoted 6% producing a 23% $255,000 lower retirement balance.

P95

The Commission's analysis, while also limited by data, affords a view across the entire system and its segments in terms of the investment returns ultimately being delivered to its members.

A focus on returns delivered to members

The Commission's overriding focus is on member outcomes. The most relevant outcome for members is the returns they receive after taxes and fees are netted out.

The Commission has also explored using member-account weighted returns, though this approach encountered greater data limitations (tech. supp. 4).

In the stage 1 study, the Commission flagged that the returns analysis would be done over 5, 10 and 20 year periods. The Commission has been limited by the time series of data available, and has sought to use the longest time spans for which comparable returns data exist and for which benchmark portfolios can be constructed — in most cases, 12 years. Both APRA and research firm data have been used, though both come with limitations and trade-offs

Poor data, applied to fund outcomes - not member outcomes.

P98

The arbitrary nature of benchmarks

Correct.

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P104

APRA fund-level data provide a useful starting point for evaluating system-level performance, Adjusting for asset allocation and weighting fund-level returns by assets makes use of these data more insightful as a proxy for fund (and system) performance.

Some participants contest the usability of fund-level data. A fund-level return represents an amalgamation of different products and investment options offered by a fund, and is therefore not necessarily reflective of the member experience in a particular product (such as a balanced or growth option).

The draft report states its focus is on members but confirms it is being measured at the fund and system level using proxy's. Member experience in different investment options over time is not reflected the analysis. While that experience using a single one-size-fits-all option may be 'reflected' in the work done so far, it is only a part the dynamic study required.

Figure 2.4 shows net returns to a range of types of investment options over 12 years, categorised by their allocations to growth and defensive assets (2005–2016). The similarity in returns for balanced, growth and high growth options likely reflects the time period used. An alternative 5-year view (2012–2016) reveals the expected relationship between risk and return — that is, options with a higher weighting to 'growth assets' yielded higher returns over this shorter time period.

This is an issue required to be sorted and tested against other studies (appears as though the Commissions figure 2.4 finding are outliers), prior the dynamic study above

P106

Overall, the volatility of returns to each option category is broadly in line with expectations. That is, options with higher allocations to growth assets (such as 'high growth' options) exhibit higher levels of volatility.

P108

While system-level analysis provides useful context, it potentially masks significant differences in outcomes across segments — such as the default, choice, accumulation and retirement segments

We are concerned that the Commission's findings in regards to long run risk v's return ratio's and premiums appear to be only consistent on one side of the equation (see figure 2.4 and comments above). Despite the poor data quality, the Draft Report uses restricted growth option performance above the default option return rate, but the reverse for conservative options, which is inconsistent with the equity premium axiom and many other long term academic and market studies. We do **not believe** the Commission's intent, as the premier economic body in the country, was to attempt to overturn economic principles with such poor limited quality data – however, that conclusion can be reached based on the draft reports current findings. The results appear to be 'outliers' when compared to other research and yet significant change is being recommended based on this analysis?

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P111

In the assessment of the all-important distribution of performance across funds and products, which best captures the real experience of members.

If that distribution across products is all-important why hasn't the commission studied it yet on a member-by-member basis? The real experience of members also includes dynamic changes up to retirement.

P113

The main purpose of most accumulation products is to grow balances for members' retirement.

Exactly but the Commission is yet to measure that.

P115

Assessing the performance of system and segment averages provides an important check on the overall efficiency of the superannuation system. However, averages hide significant variation in performance within the system and particular segments — which is what matters most for the experience of members.

Is there any evidence to support this first conclusion? What matters most to members is their retirement balance, lifestyle and outcome not the system or segment performance or that esoteric average.

P122

Some variation in performance is to be expected in the default segment, reflecting the different risk profiles associated with more conservative or growth-oriented asset allocations. However, there is no obvious rationale for having a significant dispersion in risk profile among default members. A simple balanced portfolio is likely to maximise lifetime returns (chapter 4).

False. Human capital theory has been ignored. Does the Commission believe a 64 year old has the same risk profile as a 20 year old. If so they should be mounting significant arguments against well-established financial planning practices and calling for radical changes including before the Royal Commission. This is at best very ill considered and worse verges on a No Care – No Responsibility approach. No evidence is provided in support of this 'maximise lifetime returns statement' – see comments on page 48 and above.

P130

Fees are not only the biggest driver of long-term net returns across funds, but are also a much more predictable indicator of a funds' investment performance (*ex ante*) than gross returns.

Maybe a fund's performance but not a member's outcome, that outcome is affected more ($5.0 bio p.a.) by the investment made rather than which fund and its fee level ($1.3 bn).

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P151

Conceptually, superannuation funds are not like other firms in the economy. They are required, by trust law, to act in the best interests of their members.

P153

Comparability across segments could improve with better disclosure

Analysis of trends in fees across segments of the superannuation system and over time is heavily compromised by poor data quality.

P167

This indicates scope for substantial system-wide improvement in member outcomes from mechanisms which ensure members are either actively choosing, or are being defaulted into, lower-fee and better performing funds.

Why is this 'substantial system-wide improvement in member outcomes' argument not also used for defaulting into better performing Smart Default investment options?

P171

Much of the superannuation system is failing to deliver the right products and services to its members.

While 'data is the new black', the industry's use of data to design better products and services has progressed slowly, while broader innovation has been stifled through regulation and policy uncertainty.

The Commission in fulling its Terms of Reference should seek to fix these issues yet that has not occurred in the draft report to date.

P172

A well-functioning and efficient superannuation system should ensure that it has a product range sufficient to meet people's sometimes varying needs ('virtuous variety') and that across this range, it matches products to people's needs as they age ('efficient matching'). It should do so at a price that is efficient.

Failures in these dimensions can adversely affect member outcomes through lower net returns or unwanted risks. A good system should provide a suite of products that are relevant to people's different needs over the life cycle and as the nature of work evolves.

Agreed, but not yet achieved by the report's recommendations. The goal is surely, first and foremost, consistent with the purpose of the superannuation system to provide for members retirement, to improve retirement balances, incomes and lifestyles not to maximise a fund's net return. The 'goals' (see below) are then desirable characteristics of the product range described above. These are the key features of a Smart Default.

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The goals would be to:

- allow members to maximise long-term net returns for most of the accumulation phase — a relatively simple task to achieve for most members.

Yes more risk and return for longer constrained by point 2

- provide asset allocation options that can meet *some* people's preferences for 'locking in', or at least reducing the variance of their balances, close to the point when they want to use these funds. The desirability of any product that seeks to do this *automatically* (life-cycle products) is not clear as it will depend on a member's risk appetite,

Agreed the goal is not-one-size-fits-all 70/30 or age only life-cycling – rather meeting 'peoples preferences' more often, via cohorts and LRB's. It is about lifting the bar higher and continuous improvement by the trustee in setting the investment strategy for the fund – not individual advice or the 'perfect' solution just a better one). If there is any 'unclearness' the Commission should clarify it as requested by undertaking the necessary assessment.

- cater for people's varying circumstances (including access to social welfare benefits), preferences and risks during retirement — a phase where the system should often provide solutions tailored to the individual.

This suggestion of waiting until retirement is akin to acting after the proverbial 'train has hit the wall'. Projected retirement balances are known and on most annual statements, why not use them, time and compounding to fix the problem during accumulation phase? i.e. Smart Defaults, trustees acting automatically in a tailored way during accumulation phase.

- take account of the potential changes to working patterns associated with the gig economy, reduced demands for automatable skills, interruptions to job continuity, and the risk of continuing wage growth inequality (an issue covered in chapter 1).

Each year in our tailoring method these factors are automatically taken into account. Those retirement balances are re-projected and used. As a result they take into account higher contributions (increased wages/promotion), lower contributions (Gig/casual work) and no contributions (maternity leave/retrenchment). The tailored investment option may change as a result. These problems are as a result captured with a one year lag in the tailoring effect, spread over the time until retirement.

- avoid products and system characteristics that lead to balance erosion.

A 'good' suite of superannuation products does not by itself meet members' needs, but requires a complementary product — disinterested advice — to achieve the goal of efficient matching.

Smart Defaults provide this automated disinterested advice embedded into the MySuper product.

An analogy is the health care market where product variety is huge and usually desirable, but good consumer decision making requires trusted intermediaries (clinicians).

Exactly that's what Smart Defaults do automatically via the trustee. Further just a medicines and treatments have evolved from one-size-fit-all, to cohorts by symptoms, to improves outcomes so should MySuper defaults.

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P173

The intangible concepts of 'satisfaction' and trust are therefore an easily overlooked dimension of members' needs.

The extent to which businesses meet peoples' needs is often dependent on engaged, informed and footloose consumers. Unfortunately, members are mostly not engaged, and while they may be bombarded *with* information (and marketing), it can hardly be said that they are generally able to make informed decisions.

Information is a two way street. The 'data age' has demonstrated the value to businesses of mining customer data to add value, yet the degree to which funds use this strategy appears nascent (section 4.5). More generally, this raises the question of the inhibitors of innovation and the degree to which the sector applies innovation in areas that best meet members' needs.

The gap between needs and products is a symptom of the interplay between fund conduct, product complexity, and cognitive biases (and knowledge) of members. Regulation, market structure and limited competition play a decisive role behind this interplay. Many of the policy improvements proposed elsewhere in this report will play a role in narrowing the gap.

However, some policies can directly target the tension between members' needs and the products delivered by the funds.

When trustees say one thing and do another trust is not built, it is diminished. This is the case with the one-size-fits-all default and choice options. Trustees via websites, information and advisers tell members to take into account their time to retirement and expected retirement outcome in selecting an investment option but trustees do not do that yet themselves despite knowing the projected retirement balance.

With disengaged members, the industry and trustees need a push by government and the Commission to innovate and lift the bar higher. The outcomes test is a good start, assessing Smart Default outcomes and the 35% average retirement improvement would be better and is appropriate. It would have a bigger impact compared to all the other Commissions current recommendations. It is a policy directly targeting that tension.

P179

About half of member accounts are in default products. Product variety is moot for such members.

Why? By moot, do you mean subject to uncertainty or of no practical relevance? With an obligation for trustee to act in members best (retirement) interests and a 35% improved outcome on offer it is of very significant relevance.

P181

During the accumulation phase, members' needs are *typically* similar.

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False, where is the evidence and references? Has Human Capital Theory been considered? A member with a projected retirement balance of $100,000 has different needs to a member projected to retire on $1.6 million, as does one aged 20 years versus one age 64 years old.

In general, holding a portfolio weighted towards growth assets with a modest share of low risk assets (bonds and cash), will maximise lifetime returns. Long-run historical data show that balanced funds have performed very well, even in comparison with more aggressive strategies (chapter 2).

Evidence, peer review and references are required for this 'maximise' assertion. As noted the work in chapter 2 runs contrary to the risk return and equity premium studies completed worldwide, recently in Australia and that forms the basis of significant elements of economic theory and work by Nobel Laurettes and others.

Despite noting the poor data quality, the Draft Report uses restricted growth option performance above the default option return rate, but the reverse for conservative options, which is inconsistent with the equity premium axiom and many other long term academic and market studies.

We do **not believe** the Commission's intent, as the premier economic body in the country, was to attempt to overturn economic principles with such poor limited quality data – however, that conclusion can be reached based on the draft reports current findings.

P188

A 'no frills' product with low fees that is allocated to a balanced (or balanced growth) portfolio is likely to meet the retirement needs of most Australians during the accumulation phase.

A better designed and modernised default allocation could act as a trusted benchmark for better member decision making across the entire system.

See above regarding 'individual member retirement needs during accumulation phase'.

System wide, the retirement needs of most Australians, is a broader more holistic question. With the long-term sustainability of the system in real doubt due to:

- the increasing retirement funding gap ($1.5 trillion growing to an estimated $8.7 trillion in 2050 – World Economic Forum May 2017),
- 4.5 workers funding each pensioner now compared to only an estimated 2.7 in 2050 (Federal Treasury 2016 budget papers), and
- 75% of retirees in 2050 predicted to still be reliant on the Age Pension.

Further, with 15 million MySuper accounts, owned by well over half the working population which are predominantly those who will end up on the Age Pension, it is not appropriate to make this 'likely' statement without hard evidence (published and peer reviewed against alternatives) and a comparative probability analysis.

This is why we asked the Commission and Treasury to undertake the analysis and why we provided the methodology in our first submission. An auditable, member-by-member 35% average improvement in retirement outcomes being $5.0 billion per year is on offer. A better-designed default allocation system is the introduction of Smart MySuper Defaults.

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Recommending that, with or without 'Best in Show', will lift the bar, provide the benchmark and provide better decision-making (by trustees) across the system. It is not a Choice segment issue.

P192

The key driver of this is that earnings and thereby contributions rise over time.

In the vast majority of cases, life-cycle products are calibrated purely to the age of the member.

All members covered by such products can expect lower retirement balances in exchange for reduced sequencing risks.

Age only life-cycling does reduce average retirement balances compared to one-size-fits-all 70/30 defaults – however this is not the case for Smart Defaults they lift Outcomes by 35%.

The methodology used (supplement 4 P35) for Age-Only life-cycling comparing the same $129,000 starting balance of a 'one-size-fits-all balanced option' at age 55 years appears flawed. It again shows disregard for higher growth earlier and human capital considerations.

P193 /194

Depending on its design, a life-cycle product in the accumulation phase is more valuable for someone who …

However, for others who do not fall into this category, maintenance of a riskier portfolio both before and, for a period, after retirement can make sense

'Life-cycle' products come in so many forms that they cannot address members' concerns about sequencing risks.

It is not that Age Only life-cycling comes in 'so many different forms' but rather because they:

use only one glide path per fund. That glide path is set for one cohort's circumstances, (often those most exposed to sequencing risk impacts e.g. facing a full Age Pension retirement) ,

use only age as the cohorting factor. Two 50 year old members can have very different projected retirement balances and lifestyles

do not take into account members changing circumstances (and projected Outcomes) in a dynamic way over time

The Age-Only life-cycling method is too inflexible

P195

Shifting away from simple life-cycle MySuper products would involve some (surmountable) challenges, but a transitional period would be required.

We are ready to implement now.

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P196

A MySuper default of this form would represent a more sophisticated version of existing life-cycle products. In principle, there is merit in a smart option of this kind. However, the devil is in the detail.

No devil – just auditable numbers

- A well-designed product would require more detailed information about members than is often collected, …. a prerequisite for an individually-customised product.

False – every fund has the data (age, balance and projected retirement balance (or contributions to calculated that figure per member)

- a complex product of this kind would require much more careful assessment than existing default products to ensure they were meeting members' needs.

This assessment is in line with the New Annual Outcomes Test and we can provide an actual fund Test Framework and Report to the Commission. We highlighted the required assessment methodology in our first submission.

- The algorithm underpinning the investment strategy for enrolled members would need to be tested to verify that its actual design benefited most fund members.

Agreed, see above it. It would also be part of the funds PDS, on the website and elsewhere.

Some have argued that proposed smart options have not verified their benefits (as cited in Stewart 2017).

That was an off-the-cuff response by an entrenched industry participant.

- There is an open question about how smart is smart? Conceptually, a smart default brings together two usually separated services — financial advice tailored to the person and an investment strategy. The 'advice' in this case would be based on an algorithm that matched asset selection to the (changing) traits and inferred or measured preferences of a person. However, it is far from easy to determine the marginal gains (and risks) from varying levels of smartness for highly heterogeneous members.

The starting version of a Smart Default, does bring together or imbed 'advice' within the investment strategy automatically to improve upon one-size-fits-all. It is a better, rather than best solution. Future versions will be smarter again and include additional factors, perhaps eventually beyond those currently permitted in Reg 9.47.

It is easy to determine marginal gains per cohort (LRB). The methodology to determine that was provided as part of our first submission to the Commission. See also outcomes report framework.

The Draft Report elsewhere (eg. P122) states these members have the same needs – yet at this point hey heterogeneous – of course they are all different.

- It would be very hard to explain such a product to a member, though that should not, by itself, preclude smart options.

No – not hard. Not much more detail than a combination of current choice option detail and age-base life-cycling information but tailored to that member in annual statements. Tailoring of

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information to the member is already being done elsewhere. It may nudge engagement and investment option selection.

Against that background, the Commission is cautious about recommending the replacement of simple life-cycle products with 'smart' alternatives at this stage. That does not preclude their use as a voluntary offering in the choice segment, which would provide an avenue for testing their value for members.

We seek guidance on how that caution can be removed. No such caution is being shown in regards to 'Best in Show' which will be far more disruptive and potentially involve moral hazard.

The suggested use as a voluntary choice product fails to understand and appreciate Smart MySuper features. The suggestion is puerile.

P201

Simple is wrong

If 'simple' is generally right in accumulation, it is wrong in the drawdown phase.

No simple is not right, it causes a 35% lower retirement outcomes – see above. Waiting for the lower retirement outcome problems to be apparent at retirement rather than dealing with it during accumulation phase, treats the symptoms not the disease. Smart Default treat the disease and are a cure.

P211

This is an overly pessimistic perspective. It may be imperfect, but data management has improved.

Processes that allow easier engagement with members, such as mobile apps and online access, are relatively common (chapter 5), and yet did not exist at all in 1993. ASFA (sub. 47) provided examples of innovations across the retail and wholesale markets, including: digital delivery of disclosure material; member self-service; robo advice; education and engagement; more targeted, bespoke products; cloud computing; service providers; distribution; and electronic binding nominations. While still in a fledgling state, tax and regulatory changes have encouraged the development of new annuity products, and new entry into an area almost entirely the preserve of one fund. There is a greater awareness of the importance of member engagement. Some novel experiments using behavioural insights have suggested better ways of presenting information to change member behaviour (Hiscox et al. 2017). The industry has generally highlighted areas where innovation has, or is, occurring (box 4.4).

There are some gaps. The translation from member and financial data to informed decisions is haphazard and primitive.

The Commission's policy recommendations are likely to intensify genuine competition, and with it, innovation.

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The references we made and are quoted on, relate to the MySuper Default segment. The percentage of members engaged has barely moved and the number of MySuper accounts is growing. The innovation commented upon above relates to choice segment. The Commission's recommendations regarding MySuper, in particular 'best in show' impact the former not he later and hence our concern relating to stifling innovation rather than enhancing it.

P219

For some individuals the time costs associated with engagement mean that it is not rational to be continually engaged — especially when trustees are required by law to act in members' best interests.

However, there are a range of negative outcomes associated with low engagement. Members may: not choose the investment option or insurance product that best meets their needs;

An efficient superannuation system needs to deliver efficient and competitive outcomes for those members who choose to remain disengaged. While the Australian Government's MySuper reforms have made some inroads, more could be done (chapters 11, 12 and 13).

P224

Across a range of surveys, the evidence suggests that around 25 to 30 per cent of Australians lack an understanding of basic concepts (such as risk-return trade-off, investment diversification, how share market movements can affect superannuation balances and knowledge of superannuation)

P225

45 per cent of respondents believed that consumers did not understand that higher reward often meant higher risk

P236

Concluded that 'people don't want more information — they want help to make decisions' (Souvlis et al. 2017, p. 32).

A well-designed and efficient system will cater for these different needs across different types of members at different stages in their lifecycles in the most cost-effective way.

P237

The need for well-designed information and advice also varies across members with different characteristics, and over the life cycle — with disengaged members often needing very little while different types of engaged members have a variety of requirements (box 5.4). A well-designed and efficient system will cater for these different needs across different types of members at different stages in their lifecycles in the most cost-effective way.

Agreed. Good Smart Default product are needed though for disengaged members across their life-cycling and they are cost effective.

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P238

When members are disengaged… they require little as they rely on the default system to choose a fund and then select investment options and some features (mainly insurance) on their behalf.

Agreed – they are relying on the system – trustees acting for them in their best interests – one-size-fit-all lets them down by 35% on average over their life time.

P246

However, acquiring *impartial* superannuation advice can be hit and miss.

Largely fixed by Smart Defaults for MySuper

P247

Some commentators have forecast that digital advice is likely to be the next digital disrupter in the Australian superannuation system, with 'products that targeted specific demographics, such as millennial savers or self-directed retiree investors' (Kendell 2017, p. 1; North 2017). The Australian Treasurer and the UK's FCA also expected that, due to its lower cost and convenience, digital advice could become more popular in retirement income markets (FCA 2017; Morrison 2017).

However, digital advice requires good design.

It's time this was implement in the default segment

P248

In the *default segment* the main trend has been the (regulatory induced) introduction of MySuper products — 108 in the market at December 2017 (APRA 2017g).

Government involvement is warranted to introduce Smart Default innovation

P382

However, many funds were unable to provide data in response to the Commission's funds ……….it also raises questions about the adequacy of any performance attribution work being undertaken. Such work should have rendered such a question easily answerable — and could arguably imply a contumelious disregard for members by those who elected not to respond.

P426

But a closer look reveals muted competition. Disengagement among members in the default segment means competition is reliant on fund rivalry. But there is neither competition *for* the market (that is, between funds for the right to provide default products), nor *in* the market (that is, from rivalry between funds to become an employers' default provider) (chapter 7). Processes for listing default funds in awards constitute an effective barrier to entry.

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The issue of a homogeneous one-size-fits-all MySuper Default offering is key. Replacing that with Smart Defaults per fund based on that funds own demographics and investment option return and loss history, to target retirement outcomes will produce competition in the default.

P431

Members' needs are fundamentally simple during the accumulation phase — high net returns, low fees, good disclosure by funds and transparent product features. These needs can be well served by 'no-frills', low fee products with a balanced or balanced growth asset allocation.

False, needs are not simple, this is the period when fixing the issue can solve it and when compounding has time to work. The most experienced and skilled executives at funds are engaged to deal with the issue for MySuper members and they should be allowed, encouraged (even forced) to bring their best to the table rather than be constrained or let off the hook with a 'no frills' 35% poorer policy endorsed solution. Society has not accepted financial planners getting away with such a simple lazy solutions, trustees and their executives should also be held to account.

P432

The superannuation system has not kept pace with the needs of members.

P468

Yet our super system remains stuck in the past.
It is time to modernise the super system. The investment performance of the system has been mixed and, as the Commission has found in this inquiry, policy change is needed to make the system work better for *all* members — especially those who are clearly not well served by the current system (chapter 11).
Current default arrangements do not promote member engagement.

P483

A well-performing super system requires funds to strive to meet the needs of individual members.
Robust competition between funds is essential, because competition is a driver of innovation. With ongoing advancements in technology, funds need to be continually improving their products and services to meet the needs of existing and prospective members. Indeed, many are already doing this.

Correct. One-size-fits-all 70/30 may have been the only known place to put the much smaller amount of monies from members who didn't select an investment option in 1992, but in 2018 there are alternatives and it should be no longer acceptable.

Not in the default segment.

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