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9 November 2018

Superannuation
Productivity Commission
Locked Bag 2, Collins Street East
MELBOURNE VIC 8003

By electronic lodgement

Dear Sir/Madam,

SUPERANNUATION SYSTEM REVIEW SUPPLEMENTARY PAPER – INVESTMENT PERFORMANCE (OCTOBER 2018)

Vanguard Investments Australia would like to make some additional comments in response to the above report that was issued by the Commission on 26 October 2018.

We appreciate that at this late stage in the Commission's overall superannuation system review, commentary is only being sought on methodological and data aspects of the analysis in the Supplementary Paper – in particular, relating to the asset class benchmarking that the Commission has undertaken since publication of its draft final report in May, and in preparation for issuance of the final report at the end of 2018.

Recognising this limited scope for further commentary, there are some high-level observations to which we would like to draw the Commission's attention. These mainly revolve around the issue of **survivorship bias** in the Commission's analysis, and the related question of **representativeness** of certain of the results provided by funds relative to their true benchmark comparison indices.

Some specific concerns we would like to raise in this regard are:

1. We believe that the Commission's use of average returns for each individual year per fund and compounding these up to produce a 10 year forecast is problematic, given the significant potential for survivorship bias in the early years, with selection bias present throughout the time series.
2. In our view, the results provided for the period 2011-2018 showing the full distribution of fund returns are more meaningful, although we suggest it would have been helpful to plot the index returns against the distribution of fund returns. The distribution of returns using this approach is consistent with Vanguard's own research findings. These generally show that the dispersion of fund results widens when active management is employed, and dispersion tends to be wider for alternative assets than for active equity and bond funds.

3. We query whether the comparison with other global investors should have been included in this report. The time series doesn't directly align with that of Australia, and there is one set that misses the first part of the GFC (for Australia) while the global data set includes the full impact of the GFC. We believe this will meaningfully skew relative returns for Australian funds compared to global peers (in both directions depending on the asset class). In addition, there is no mention of how currency has been factored into the comparison of international assets.
4. The potential for some funds to provide particular product returns as a proxy also presents issues. The ability to provide the returns of existing products would likely put alpha significantly over the benchmark compared to the results of the true Australian equities asset class over the same time period (recognising that underperforming or closed funds will have been excluded). It is reasonable to expect that these issues will be present among those providing current product returns.

In order to suggest an alternative approach to the treatment of survivorship and selection biases in analyses of this kind, we would recommend a recent Vanguard Australia research paper, *The Case for low-cost index-fund investing*, published in March 2018[1]. While the methodology employed in this paper still requires assumptions for the treatment of merged and liquidated funds, our research has shown this methodology to be closer to the actual investor experience than if survivorship is not accounted for.

Please note that for present purposes, our aim is not to advocate the 'headline' topic of this Vanguard research paper about the merits of index fund investing as such, but rather to suggest a way survivorship and benchmarking relative to market indices can be addressed in large-scale quantitative research projects such as that which the Commission has undertaken. We recognise that the fund universe used in our paper is not directly comparable to the universe of super funds. However, we suggest it is a reasonably close analogue that addresses survivorship issues and might be adapted to the realm of superannuation performance benchmarking.

Summary and Conclusion

Vanguard has been, and remains, strongly supportive of the Commission's underlying approach of seeking to measure long-term superannuation fund performance relative to fund-specific asset allocation benchmarks. The work undertaken by the Commission has been a significant step in this direction, and we believe underpins a range of positive policy initiatives proposed in the Commission's Draft Report. In this regard, the comments above should be taken as raising questions of detail rather than of underlying intent or direction.

Nevertheless, we do feel strongly enough about these issues to raise them now in the context of the Supplementary Paper.

We also recognise that, given time constraints leading up to publication of the Commission's final report, full consideration of the approach to investment benchmarking will also likely need to carry over to a subsequent body such as the proposed independent panel for selection of eligible default

[1] Vanguard Australia, The case for low-cost index-fund investing (March 2018) https://static.vgcontent.info/crp/intl/auw/docs/literature/The-Case-for-Indexing-Australia.pdf?20181024|151531.

superannuation providers, should that recommendation remain in the Commission's final report and eventually be adopted by the Government.

Please contact me or Paul Murphy, Senior Manager Government Relations & Industry Policy
should you wish to discuss our submission, or require any further information about the issues we have raised.

Yours sincerely,

Robin Bowerman
Head of Corporate Affairs
Vanguard Investments Australia Limited