trustee
tailored
super

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8 September 2016

Ms Karen Chester and Ms Angela MacRae
Commissioners
Superannuation
Productivity Commission
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Dear Commissioners

EFFICIENCY AND COMPETITIVENESS OF THE SUPERANNUATION SYSTEM

I am pleased to present the attached submission on behalf of Tailored Superannuation Solutions (TSS) in response to the Commission's draft report on "*How to Assess the Competitiveness and Efficiency of the Superannuation System*", released on 2 August 2016.

TSS is a successor entity to Fiduciarys Friend Pty Ltd, which provided a submission dated 20 April 2016 in response to your initial Issues Paper, "*Superannuation Efficiency and Competitiveness*" of March 2016. TSS is a new public unlisted company which was created in July 2016 to take the next steps to implement a Smart Default product called Trustee Tailored Super (TTS), through market development and product implementation over the next 12-18 months. The founder and former advisory board members of TTS are now all both directors and investors in the company, TSS.

Since our last submission, TSS has made progress on a number of other fronts, including:

➢ Finalisation of a fully operational and implementable prototype
➢ Marketing to individual superannuation funds
➢ Establishment of beta clients for further product testing and development.

Our interest in the Productivity Commission's inquiry is that we wish to highlight how Smart Defaults (and especially TTS as an innovative and specialised fintech application) can directly address your Terms of Reference to improve the efficiency and competitiveness of the superannuation system.

TTS is a tailored superannuation product designed to be applied to MySuper default funds during the accumulation phase. As such, it provides an alternative market-generated solution to a formal competitive process for allocating default fund members to products (which the Commission will be evaluating as the next stage of its inquiry).

Rather than a formal institutionalised process which will inevitably lead to a 'forced' consolidation of the superannuation market, smart default products such as TTS will enable MySuper funds to engage in active competition on the basis of product differentiation as part of strategies for:

- ➢ Member retention and growth
- ➢ Merger or takeover defence.

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, not by a government-imposed bureaucratic process that effectively 'picks winners' (and, by implication, 'losers') and therefore imposes a forced consolidation of the market to a degree of concentration which may result in oligopolistic or even monopolistic practices, thereby reducing competition and efficiency.

At this point of introduction to the market, we are now able to provide further information and quantification of the benefits of TTS, to supplement what was provided in our April submission. Specifically, recent testing with beta clients has confirmed our earlier research results which demonstrate an uplift of over 1% real per annum (average 35+% cumulative improvement during the accumulation phase) in projected retirement balances for MySuper fund members.

This substantial increase has the potential in its own right to significantly fill the impending National Retirement Funding Gap. However, our main intent in this submission is to inter-link specific issues raised in your draft Report, in particular Dynamic Efficiency (over time), with the emergence of 'Smart Default' products as a market-based alternative solution to a formalised tender process for default funds.

Please contact me should you wish to discuss this submission in further detail.

Yours sincerely

Douglas Bucknell
Managing Director
Tailored Superannuation Solutions Ltd

HOW TO ASSESS THE COMPETITIVENESS AND EFFICIENCY OF THE SUPERANNUATION SYSTEM?

Overview

As noted in the draft report this task is difficult because it is somewhat unique. Also as mentioned at the roundtable discussion it is fortunate the Commission has been given time and scope to cover the issue comprehensively. Naturally there may be concerns that too much ground is attempting to be covered. We don't seek further broad ground to be covered, rather that the study be narrow enough to focus resources specifically on the retirement outcome, not yearly performance.

In *Assessing the Competitiveness and Efficiency of the Superannuation System* our input is from a practical, fund by fund building block starting point, consistent with the introduction of a new product to market – however in designing our product we have had system wide issues in mind. Academic type respondents will usually approach their response from the opposite starting point, however melding these approaches will serve the commissions purposes well. We raise this matter in part because the draft report is absent any detailed discussion on how analysis over multiple dimensions is to be combined to form an overall 'system' view – in a practical sense. Maybe this was left out, with the view of addressing it later. We respectfully provide a view on how this may be achieved.

The objective is to measure over-all system efficiency. Frontier analysis can be a measure of current MySuper performance against potential and speak to the level of efficiency across the system. The difficulty is measurement, it must be over both a long period and a period relevant to the Objective – this is why we focus on projected retirement balances.

Fundamentally we reject propositions that placing members in the same investment option regardless of their investment horizon (time to retirement or age), and regardless of if they will retire on a million dollars (self-funded retiree) or the full Age Pension is efficient. Many studies will start with this status quo and assume members are invested in appropriate options by their trustee. The Commission should not accept these assumptions.

The draft report notes around 40,000 investment options are available. We respectfully suggest broader characterisation (equities, aggressive, balanced, conservative, cash) is appropriate for these purposes. However in exchange, rather than a static benchmark assessment, a focus on members available investment horizons until retirement is recommended. This approach will assist in including the 29 MySuper funds (almost 1/3 and growing) that currently use a (age only) life-cycle approach. We reject the concept of a single representative 'glide path' for growth versus defensive assets (target date approach), because we believe in tailoring to MySuper members retirement prospects. Rather we know multiple glide paths and hence multiple solutions are more efficient. Identifying the optimal portfolio(s) is impossible, however identifying better solutions for various members is achievable.

Introduction – Smart Defaults

The Commission's draft Report makes a number of references to 'smart defaults'. Smart Defaults use factors, other than just age, to tailor MySuper members into more appropriate investment options, with a view to enhancing member outcomes (in TTS case projected retirement balances). The need for smart defaults arises because MySuper members have not advised their trustees where to invest their funds (i.e. they have not selected an investment choice option) and effectively have devolved responsibility for their investment choices to their investment managers (i.e.

Trustees). Furthermore, it is the trustees' legislative obligation to both set the investment strategy and act in members' best interests (even though the members are not engaging).

The use of factors other than age, was permitted prior to the introduction of MySuper and is now codified in MySuper Regulation 9.47 and Superannuation legislation S29TC(2). However, at this point in time, we are not aware of any funds using factors other than age to optimise investment strategies for MySuper fund members.

Smart Defaults were supported in a 2015 industry survey and study by the Centre for International Finance and Regulation (CIFR) which recommended Smart Defaults given the limitations of existing practices.[1] The CIFR noted:

Previously lifecycle defaults were used in only a handful of funds, or offered as choice products with minimal take-up. While the wider availability of lifecycle offerings is welcomed in its own right, we contend that the main benefit is the potential for lifecycle approaches to eventually evolve into smarter defaults. This could occur via gathering additional member information, and using it to build more tailored glide-paths. Hence the implicit endorsement of lifecycle strategies within the regulations may have created a useful mechanism for greater tailoring and further innovation, and hence a way to address the problems associated with a 'one-size-fits-all' approach.[2]

The August 2015, CIFR Research and Survey confirmed that the industry's attention has moved to life-cycling, member engagement and tailoring to default members. It concluded:

"Smart defaults – As improved member outcomes are likely to result from the capacity of funds to tailor products, regulators and policy makers might aim to foster the development of smart defaults by accommodating the evolution of lifecycle products beyond simple age-based strategies."

What's Smart and what are the implications for efficiency

Conventional investment strategies generally seek to strike a balance between risk and return (the "risk/return trade-off"). That is, there is a **binary choice** between risk and return (more risk for more return or less risk for less return). Age only based life cycling also considers this same equation at different points in a members working life – typically reducing risk and return as members age (and their balance is at its highest), leading to lower retirement balances in exchange for lower sequencing risk. Smart defaults add another factor, in the case of TTS the extra dimension is time to retirement, such that the choice is **no longer binary**.

Instead, there are a broader range of options:

  ➢ more risk can be taken earlier in a working life for some bands of members, less so for others; and
  ➢ lower risk taken later in a working life as retirement approaches (sequencing risk), for some bands but not others.

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[1] http://www.cifr.edu.au/project/Structure_and_Responsibilities_in_Default_Superannuation_Funds.aspx

[2] http://www.cifr.edu.au/assets/document/CIFR SUP002 - Summary of Findings and Implications - August 2015.pdf

As a result, there are substantial implications for efficiency, particularly Dynamic Efficiency but also Allocative Efficiency and how they are measured.

Quantification of Efficiency

Fortunately, quantification and assessment tools are available and well known for Multi-Objective Optimisation otherwise known as Pareto Optimisation[3]. **Pareto optimization** is an area of multiple criteria decision making, that is concerned with mathematical optimisation problems involving more than one objective function to be optimised simultaneously.

The relative comparison point here is against well-known MySuper outcomes, as reported by funds on their websites, in PDS's or via the APRA Dashboard quarterly statistics.

In the absence of any other Smart Default information, we provide TTS results from the TTS prototype Application (App) using the 7,000 member test bed (refer to our initial submission). The results have now been generally confirmed as consistent compared to both prior TTS research and confidential Beta Client testing which we are now undertaking (using actual membership data and return/loss profiles). (As noted in our Covering Letter, we are now working with Beta Clients to further demonstrate the benefits of TTS.)

What is sought is **Pareto Improvement,** defined to be:

A change to a different allocation that makes at least one individual (band) better off without making any other individual (Band) worse off, given a certain initial allocation of goods among a set (band) of individuals. An allocation is defined as "Pareto efficient" or "Pareto optimal" when no further Pareto improvements can be made.

The graph below provides a high level summary of the efficiency improvements generated by TTS, with the collective average benefit above the current position, over time, being the difference between the top two lines. This demonstrates an uplift of over 1% per annum or cumulatively, on average, a 35+% increase in projected retirement balances over the accumulation phase – the key to the retirement income Objective of superannuation (at least for the accumulation phase – refer to our initial submission).

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[3] https://en.m.wikipedia.org/wiki/Multi-objective_optimization

Graph A - Illustrative efficiency gains from TTS
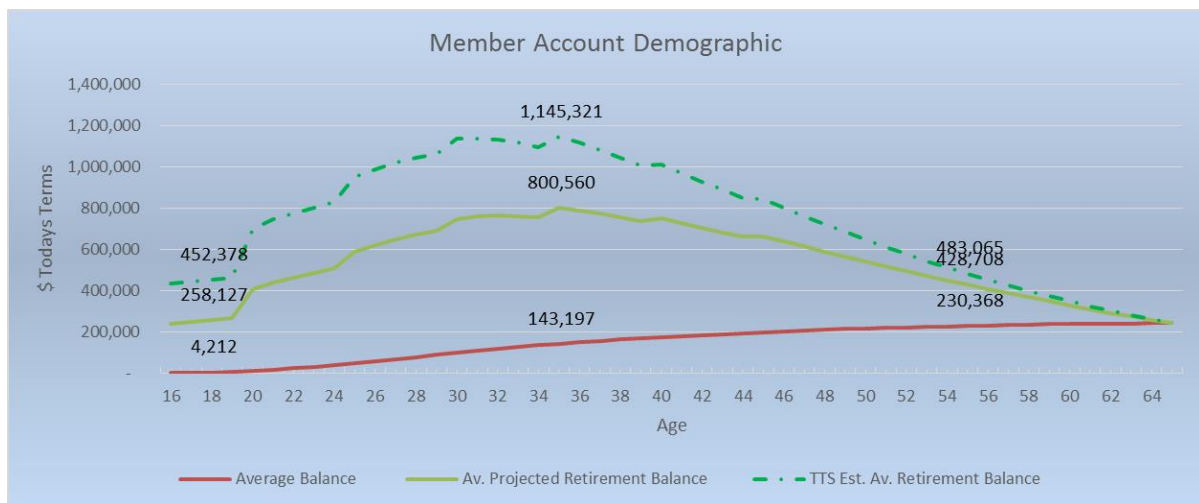
Graph A needs to be read vertically, for each age

To illustrate:

➢ At age 18, the current balance of MySuper default fund members in this fund averages $4,212 and projected retirement balance averages $258,127. The application of TTS lifts the projected retirement balance to $452,378 – an increase of 75%.

➢ At age 35, current balance averages $143,197 and projected retirement balance currently averages $800,560. The application of TTS lifts the projected retirement balance to $1,145,321 – an increase of 43%.

➢ At age 55, current balance averages $230,368 and projected retirement balance averages $428,708. The application of TTS lifts the projected retirement balance to $483,065 – an increase of 12%.

The area in Graph A between the light green line and the dark green line shows the Pareto improvement in dynamic efficiency (including the Allocative efficiency element)

It is axiomatic that the member current balance and projected retirement balance will converge towards retirement (age 65 in this case). Also, the cumulative benefits to be achieved by the application of TTS are greater for younger age groups.

It is worth repeating, at this point a summary of the TTS process as below in Graph B, however for fuller details refer to the initial submission.

In general, TTS applies a higher growth investment strategy for younger age groups. This shifts higher risk forward into the earlier working life of members, when they have sufficiently long investment horizons to ride out short-term volatility on the downside, whilst benefitting from higher long-term average returns. As members approach retirement (e.g. from age 55), risk is backed off, so that members can protect the higher balances derived from a more aggressive growth (and risk) profile in earlier years. Higher growth strategies can also be applied to other categories of members, such as those with higher projected retirement balances.

Graph B
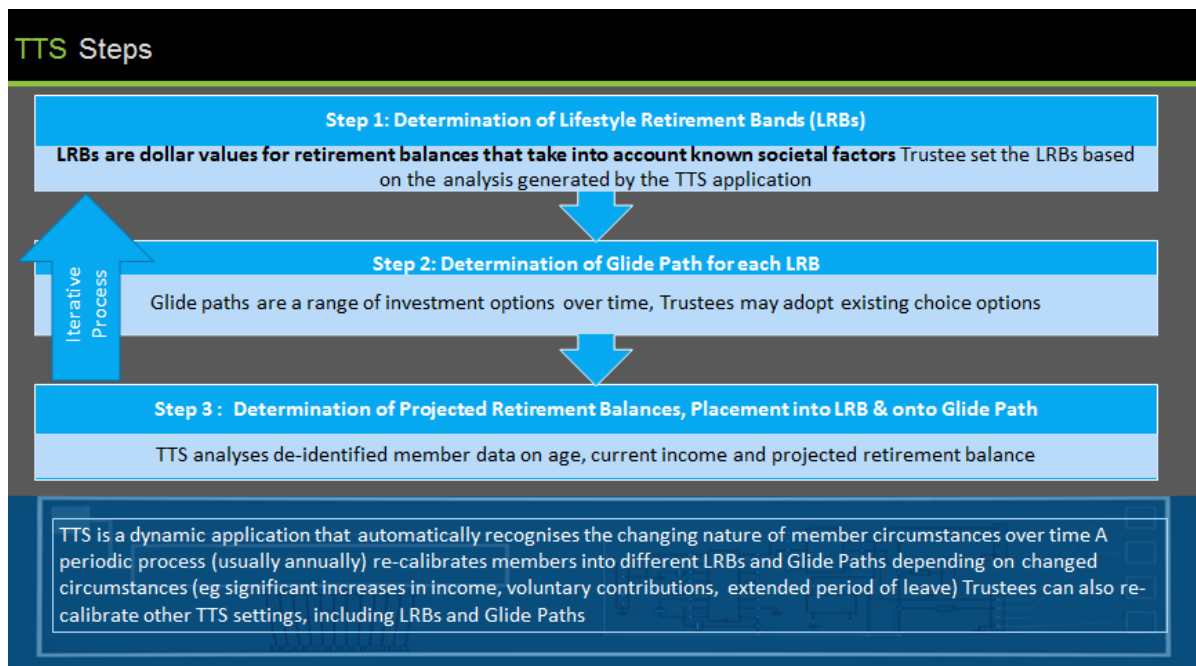
TTS is a dynamic application that automatically recognises the changing nature of member circumstances over time. A periodic process (usually annually) re-calibrates members into different LRBs and Glide Paths depending on changed circumstances (e.g. significant increases in income, voluntary contributions, extended period of leave). Trustees can also re-calibrate other TTS settings, including LRBs and Glide Paths, for example according to their judgments of changing risk appetites.

The two graphs below provide a detailed comparison of outcomes, both compared to the current MySuper (non-smart) default and TTS, plus between different bands of members.
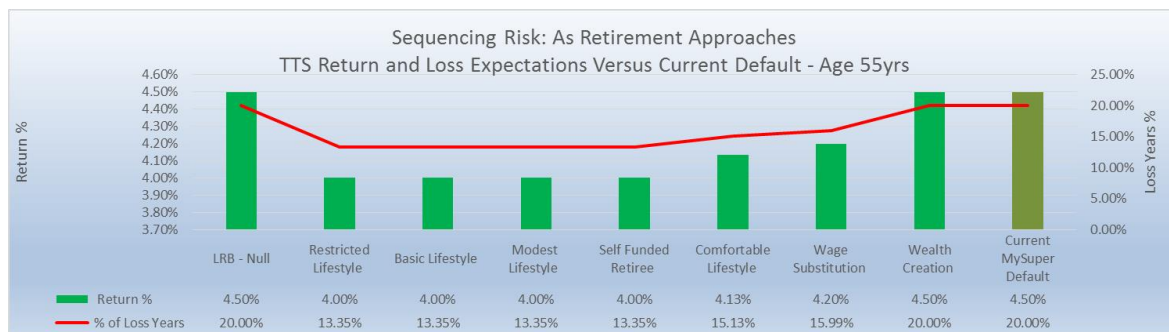
Graph C, which includes members of all ages, indicates a 1.23% p.a. real improved outcome on average compared to the current situation, before costs, using actual published data on the funds' own return and loss ratios per investment option (MySuper and Choice).

Graph D does the same but only includes those members over a given age – in this case age 55 years. Note sequencing risk is at or below the current non-smart default outcome for all bands and those bands with least risk tolerance have a relatively lower sequencing risk than the others.

Graph C

	LRB - Null	Restricted Lifestyle	Basic Lifestyle	Modest Lifestyle	Self Funded Retiree	Comfortable Lifestyle	Wage Substitution	Wealth Creation	TTS Weighted Average	Current MySuper Default
▇ Return %	4.50%	5.16%	4.43%	4.56%	4.89%	4.89%	5.53%	6.21%	5.73%	4.50%
▬ % of Loss Years	20.00%	22.57%	18.65%	19.40%	21.81%	21.48%	25.88%	29.69%	24.31%	20.00%

Graph D

Sequencing Risk: As Retirement Approaches
TTS Return and Loss Expectations Versus Current Default - Age 55yrs

	LRB - Null	Restricted Lifestyle	Basic Lifestyle	Modest Lifestyle	Self Funded Retiree	Comfortable Lifestyle	Wage Substitution	Wealth Creation	Current MySuper Default
Return %	4.50%	4.00%	4.00%	4.00%	4.00%	4.13%	4.20%	4.50%	4.50%
% of Loss Years	20.00%	13.35%	13.35%	13.35%	13.35%	15.13%	15.99%	20.00%	20.00%

Australia Wide Data

Clearly, it would be possible to calculate the relative improvement achievable by using a Smart Default for all of the 14.5 million MySuper member accounts (which we will refer to as **Option 1**) against the current situation. The ATO holds the required membership data (current age by year, balance and compulsory contributions for last year) – which is needed in order to calculate projected retirement balances at age 65 per member.

The average return and loss ratio data is available from the APRA Website for the 116 MySuper funds and industry average Choice option data is also available. In addition, the Commission has already indicated in the draft response it will collate 5, 10 and 20 year net returns and compare this to benchmarks.

A further option (which we will refer to as **Option 2**) would be to calculate the improvement per fund. We understand that the ATO also holds the name of the relevant fund for each of the 14.5 million members and the APRA data is also provided per fund.

Either of these two options could be used to quantify (in dollar terms and percentage terms) the aggregate allocative efficiency gains over time (dynamic efficiency), by investing MySuper members to meet the retirement objective of super, rather than (particularly) yearly, but also 5 or 10 year returns. More efficiency gains (approximately 1/3) can be obtained by using members known and available investment horizons to retirement combined with the Preserved nature of Super.

It also follows that there is a significant public policy benefit, in terms of a reduced dependence on the Aged Pension system and, therefore, the pressure on the limited financial resources of the Federal Budget. (It is recognised that only part of the benefit of a smart default product would substitute for Aged Pension payments. The rest of the benefits would simply accrue as improved lifestyle or standard of living improvements for members.)

In practice, it will be up to each fund and their Investment Strategy Committees (decision makers - see below) to optimise Smart Defaults. Naturally they will need methods, systems and tools, such as the TTS to achieve this outcome.

Solving a multi-objective optimization problem is sometimes understood as approximating or computing all or a representative set of Pareto Optimal solutions.

When decision making is emphasized, the objective of solving a multi-objective optimization problem is referred to supporting a decision maker in finding the most preferred Pareto Optimal solution according to his/her subjective preferences.

The underlying assumption is that one solution to the problem must be identified to be implemented in practice. Here, a human **decision maker** (DM) – such as a Fund's Investment Strategy Committee plays an important role. The DM is expected to be an expert in the problem domain.

The most preferred solution to optimisation can be found using different philosophies. Multi-objective optimization methods can be divided into four classes.

In so-called no preference methods, no DM is expected to be available, but a neutral compromise solution is identified without preference information. This would be the case for the whole 14.5M MySuper members and **Option 1 above**.

The other classes are so-called a priori, a posteriori and interactive methods and they all involve preference information from the DM in different ways. Option 2 above, may involve different objective rules based on the demographic profiles of the data per fund received from the ATO.

In practice, the Investment Strategy Committees (DM) will use their expertise and knowledge using an interactive method. In interactive methods, the solution process is iterative and the decision maker continuously interacts with the method when searching for the most preferred solution. In other words, an Investment Strategy Committee is expected to express preferences at each iteration in order to achieve Pareto optimal solutions that are of interest to him/her and learn what kinds of solutions are attainable. The following steps are commonly present in interactive methods:

1. initialize (e.g. calculate ideal and approximated nadir objective vectors and show them to the decision maker)
2. generate a Pareto optimal starting point (by using e.g. some no-preference method or solution given by the decision maker)
3. ask for preference information from the decision maker (e.g. aspiration levels or number of new solutions to be generated)
4. generate new Pareto optimal solution(s) according to the preferences and show it/them and possibly some other information about the problem to the decision maker
5. if several solutions were generated, ask the decision maker to select the best solution so far
6. stop, if the decision maker wants to; otherwise, go to step 3).

The above aspiration levels refer to desirable objective function values forming a reference point. Instead of mathematical convergence that is often used as a stopping criterion in mathematical optimization methods (see Option 1 and 2 above), whereas a decision makers preference is emphasised in interactive methods. Generally speaking, a method is terminated when the decision maker is confident that (s)he has found the most preferred solution available (taking into account cost, complexity and time considerations).

Our Purpose in pointing out this methodology is to:

- Assist in answering the question proposed on page 143.

> *Are there any other ways the Commission could assess dynamic efficiency in the superannuation system (in addition to looking at changes over time in operational and allocative efficiency)?*

- Reinforce that we consider Dynamic Efficiency to be of primary importance (despite the fact that it may be considered harder to measure)

In this respect we note the reports comments, with which we strongly agree.

> The Commission is proposing criteria that span all three aspects of efficiency: operational, allocative and dynamic. The Commission's assessment of efficiency will potentially have to consider trade-offs between short-run operational efficiency and long-run dynamic efficiency. For example, a high degree of competition and lean margins may increase the risk of entity failure that affects stability and confidence in the system. (Page 8).
>
> That **Dynamic efficiency** involves improving operational and allocative efficiency over time. Whereas operational and allocative efficiency assume current technological and other constraints, dynamic efficiency occurs when innovation and technological change increase the overall benefits that could be achieved in a competitive and efficient system. This can mean finding better products and better ways of producing them (Page 61).
>
> Dynamic efficiency (improvements to operational and allocative efficiency over time) is particularly important in the superannuation system, where decisions and their consequences span long time horizons. Dynamic efficiency can manifest in various ways. (Page 64).
>
> Assessing the efficiency of the Australian superannuation system - across the dimensions of operational, allocative, and dynamic efficiency - is a unique and challenging task for which there is little precedent. Most previous studies that have examined efficiency in the system have focused on operational efficiency and matters (such as returns and fees) which lend themselves to measurement. (Page 104).
>
> A core objective of the superannuation system is that it meets member preferences and needs, in relation to information, products and risk management, over the member's lifetime (chapter 4). Assessment of this objective is closely aligned with allocative and dynamic efficiency. An efficient system would provide the products and services people most value and want, and members would make decisions in order to maximise their wellbeing. This objective is equally relevant to the accumulation, transition and retirement phases, although the specific inputs and outputs may change. (Page 129)

However in light of the importance of dynamic efficiency and the comments above we do not yet fully understand the following suggestion (given the MySuper disengaged membership base):

"To minimise duplication, criteria for assessing dynamic efficiency will therefore rely mostly on the criteria and indicators (and changes over time) proposed in sections 6.1 and 6.2."

The comments in section 6 "*Maximising net returns (after all fees and taxes) on a given account balance is the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes*" are correctly focused. The use of long term (5, 10, 20 year historical net returns) is also appropriate (as pointed out includes risk of loss over time in net returns). **However would it not also be appropriate to align this to members varying investment horizons (time to retirement)?** This can be achieved through the use of Projected Retirement Balances.

The use of Benchmarks is appropriate; however the goal/Objective of Superannuation is not yearly returns but rather Retirement Incomes (a derivative of retirement balance). The approach we are suggesting aligns the proposed benchmarks to this objective by including time to retirement. **The Efficiency Frontier approach suggested by the Commission is useful but should be measured against the Retirement Objective of superannuation, not yearly returns. The graph E below provides a guide, however given the mathematical nature of this exercise we suggest an independent researcher with existing knowledge in the field be engaged to complete the frontier task (using our proposed option 1 or 2 above).**

To be clear, we are not suggesting that there is an optimal outcome or correct answer (in Graph E below all points A to H may be optimal) – rather that Pareto Optimisation technics provide a measurement tool to compare relative (efficiency) improvements against current MySuper outcomes (e.g. moving from point K - current MySuper efficiency level, for 1 of the 116 funds, to point D), given multiple objectives. In practice, Investment Strategy Committees will set their own objectives (which is appropriate). **What is considered right for one fund may not be as important to another (moving to point D or E can both be correct). Trustees may use some or all of the Commission's proposed 89 performance criteria in making some of those decisions, plus a fund's existing MySuper demographics will play a large part.**

Graph E

If a Fund moves from K to N, the relative efficiency gains in terms of the Objective of Super can be measured. Furthermore, the relative shortfall percentage required to get to the current known frontier position (D, E) is also more readily measured.

Using Option 1 (all 14.5M accounts), a single efficiency dot would be placed for the current MySuper outcome (against retirement income/balance – point K) and a further dot point placed based on the calculated outcome using Smart Defaults (which would be inside the A-H frontier curve – say point N, we estimate this to be in the order of a 35% outward movement).

For option 2, there would be new dot points placed in the graph calculated per fund - based on standard criteria – again on average we estimate with will be in the order of 35%.

We respectfully suggest that this is a more practical useable outcome than to have multiple (89) indicators – but still respects diverse opinions on the relative importance of each indicator.

Response to Specific Elements of the Draft Report

P.37 Risk management falls to members

Smart default products can also be used to gauge and manage sequencing risk (Fiduciarys Friend, sub. 7). Members can also manage sequencing risk by diversifying their superannuation investment portfolio and choosing less risky investments as they approach retirement. However, this presents a trade-off between managing sequencing and longevity risks.

We agree with this comment. However, the trade-off between sequencing and longevity risk will be different for different (bands of) members depending in part upon their projected retirement balance/retirement lifestyle. This is why it is important to shift the focus of attention on performance of superannuation funds away from short term (annual) returns and current balances of members towards projected retirement income (balances) as recommended by the Financial Systems Inquiry (FSI) – as funds will need to find better ways to deliver long term value to members, consistent with the objective of superannuation.

P59

There were, however, differences of opinion as to what level of retirement income the superannuation system should support:

- *to substitute or supplement the Age Pension (Murray et al. 2014a; Fiduciarys Friend, sub. 7)*

- *to provide a comfortable retirement income (ACTU, sub. 18; AIST, sub. 30)*

- *to maximise retirement income (Energy Super, sub. 19)*

- *to maintain standard of living in retirement, that is, maintain a certain level of pre-retirement income (SMSFOA, sub. 20).*

Following the consultation process, the Government announced it intends to legislate the overarching objective of superannuation suggested by the FSI:

To provide income in retirement to substitute or supplement the Age Pension. (Treasurer and Minister for Small Business 2016)

The Commission notes there are differences of opinion as to the objectives of the superannuation system. In reality, most of the statements embrace a similar objective, but are expressed somewhat differently, with subtle variations in emphasis, noting the difference between 'support' and members retirement aspirations.

P63

Operational or productive efficiency refers to producing the maximum value of output for a given level of costs. Alternatively, it can be defined as minimising the costs of producing a given level of output. This requires an understanding of system inputs and outputs, which can be defined more or less narrowly and can change depending on whether a member is in the accumulation, transition or retirement phase (David Hartley, sub. 12).

For example, in the accumulation phase, inputs into the system include the fees paid by members (reflective of costs incurred); while outputs include the return members earn on their contributions (taking into account the risks they take) and the level of service quality provided to members (such as call-centre services, web-based resources and education material) (CIFR sub. 10; Fiduciarys Friend, sub. 7; Mercer, sub. 31; Liu and Sy 2009, p. 27).

We agree with the definition.

Trustees have **two choices** to impact this metric, reduce costs to members or increase returns (e.g. tailoring) to members. We reiterate from our initial submission that a given level of output should be assessed against a standard metric such as a 1% real return. Table 1 below has been updated for the latest (March 2016) APRA figures, rounded and simplified.

Table 1

MySuper	$B	%	Ref. APRA Data
FUM ($B)	452.6	22+% (of Industry)	SRF 533.0
Total Av. Fees p.a. ($B)	4.7	1.05%	SRF 700.00
Av. Return (%)	16.5	3.65%*	SRF 700.00
Av Fee/1% return	$1.2B	0.28 bp	

The current cost to be minimised can either be described:

- In percentage terms, as 0.28 basis points in costs per 1% real return, or
- In dollar terms, as $1.2B in costs for every $4.5B real return received

We prefer the first or the simple pie chart below, the figure will change over time and we would be comfortable with a range being described (for example 25-30 basis points per 1 % real return).

Graph F
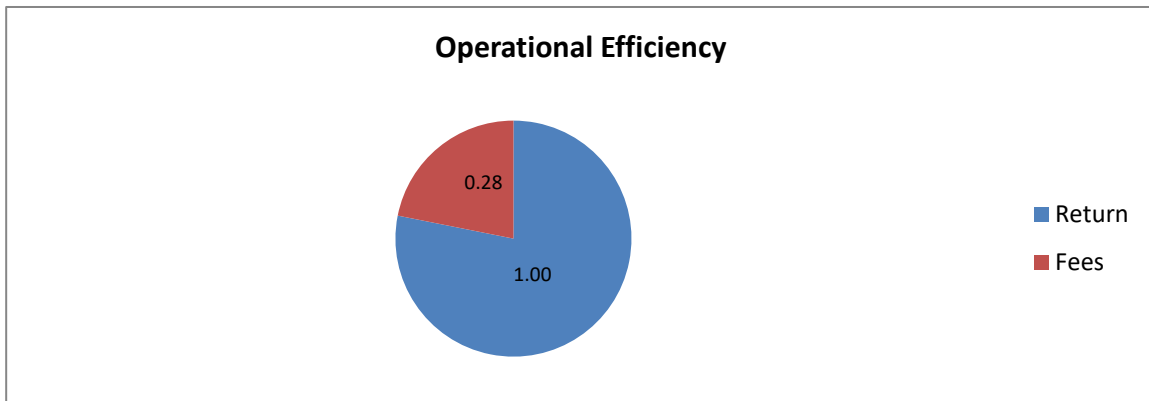
Trustees should be agnostic as to how the 1% average long run real return is achieved, as long as it costs 25-30 basis points or less. This is totally consistent with the *Maximum value of output for a given level of costs* criteria and Pareto optimisation.

Far too much emphasis has been placed on reducing fees in our view, in a race to the bottom (lowest fee provider), without due consideration of the (Pareto Optimal) goal of better retirement outcomes. This is in large part due the lack of a clear Objective (retirement) compared to annual (internally generated) KPI measures that are aligned with fund manager industry practice. This approach is unnecessary, short term and anachronistic for (disengaged) MySuper members.

For this reason, with Projected Retirement Balances now to be reported on Annual Benefit Statements (as recommended by FSI), we strongly advocate that **Projected Retirement Balance is the best KPI for the accumulation phase.** Higher Projected Retirement Balances will be the result through the achievement of *Maximised net risk adjusted return on member contributions during the accumulation stage, taking into account other features of the services provided to the member (via fees paid),* as proposed*.*

In other words, there is a need to shift the focus away from costs to **net returns**, as lowest cost is only a partial (and often poor) contributor to long term value enhancement. Indeed, a focus on costs can inhibit investment in value enhancing strategies where these nevertheless add to the cost base.

This move to a long term measure is consistent with average long term MySuper members' investment horizons to retirement. The inbuilt use of 10 year investment return and loss ratios via the APRA dashboard (or best current equivalent or the Commission 5, 10, 20 year net return numbers), plus the extended period to retirement embodied in the calculation of Projected Retirement Balances, looks through (avoids) short term fluctuations and market cycles.

> **P66**
>
> *Participants have expressed various opinions on the role and usefulness of competition in the superannuation system. For example:*
>
> - *the Australian Council of Trade Unions (sub. 18) suggests that competition in superannuation may lead to lower living standards in retirement*
>
> - *the Financial Planning Association of Australia (sub. 28) and Financial Services Council (sub. 29) ask whether optimal consolidation could increase competition*
>
> - *Fiduciarys Friend (sub. 7) rejects market consolidation as uncompetitive in the long term. These issues are discussed in chapter 5.*
>
> *While promoting competition often delivers more efficient outcomes, the relationship is not always straightforward, and there may be trade-offs in the superannuation system.*

The Commission has somewhat misinterpreted our position in these comments above. We are not averse to market consolidation *per se*. Some degree of market consolidation may be warranted from an efficiency perspective. There is a point at which too much market consolidation can become anti-competitive and hence inefficient, although it is often difficult to determine where that point may be.

Our argument was more specific. Essentially our position is that a tender panel process for allocating members to default funds will force consolidation through a government-imposed solution, not through natural market forces. As acknowledged in the previous paragraph, some consolidation may be necessary and desirable, but this should occur through natural market dynamics, not intervention in the market in a way which will result in a high and possibly excessive degree of market concentration.

We suggest both that both competition exists within the industry, as evidence by past mergers, but more importantly the individual demographics of funds are in themselves a source of competitive advantage and potential for efficiency gains. To explain, **Graph G** below provides the demographic of the TTS 7,000 member test bed. From our research, including through our confidential Beta Client testing, we are well aware that:

1. MySuper member demographics will be skewed (away from a Normal Curve) to younger members, because older members as their balances grow tend to leave MySuper (by making a choice option within their existing fund or moving to a SMSF, as they become more aware of the need to make sufficient provision for their approaching retirement).
2. Differences in MySuper fund demographics by age, current balance and projected retirement balance are significant. This is consistent with employment profiles of fund members (for example retail wages versus professional wages)

Graph G

Demographic Profile
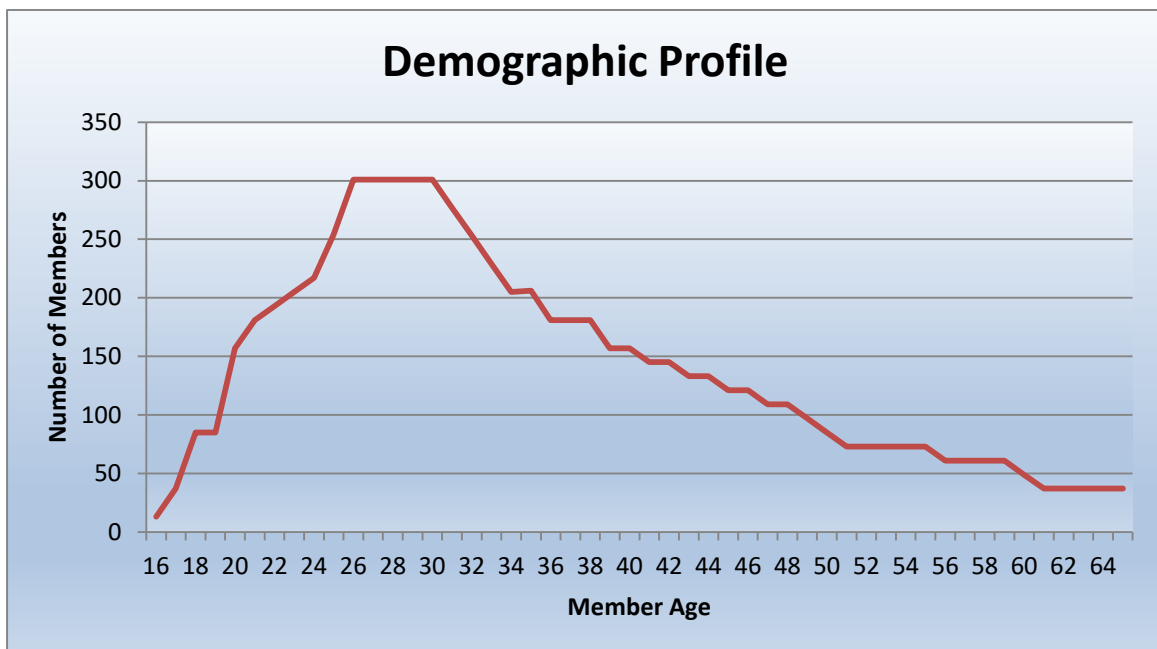
As noted above, we have no empirical evidence of the level of Optimal Consolidation. With reference to the Solving Pareto Optimisation section above, it may be possible to ascertain this level, using some **Pareto Improvement** technics however this would be somewhat subjective, dependent in part upon aligned demographics and other synergies and is beyond our purpose.

We simply state that a smart default product such as TTS can improve the efficiency of the market as it exists and the opportunity to improve that efficiency will decline as more mergers occur (but not necessarily on a proportional basis).

Furthermore, superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment.

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For example, allocative efficiency is likely to be enhanced when trustees choose the most appropriate insurance for their members (such as through the use of smart defaults[4]) and opt-out arrangements work well and are informed by high quality information about risks.

Considering that insurance premium payments are one of the largest impost on MySuper members' accounts, the ability to tailor insurance coverage amounts to projected retirement outcome is important. Over insurance through standardised unitised cover arrangements does not benefit the average member or taxpayers.

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[4]   While individual risk preferences may be difficult to reveal, 'smart defaults' should match members to products that are most likely to meet their needs given available information, such as age, gender, occupation and income. Smart defaults can also be used as an informational tool to recommend a particular level of insurance cover to members.

This element is covered by the TTS patent and it is our intention to address this in future versions of TTS (e.g. Version 2.0). However, it is important that introduction of Smart Defaults occur first, once introduced the move to tailor insurance will in effect be simpler.

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Several participants commented that in some cases, better outcomes could be achieved by a 'properly motivated' agent (for example, David Hartley, sub. 12), and that some level of member disengagement would be unavoidable. This elevates the importance of substitute policies such as the regulation of governance to address principal-agent problems (appendix H and chapter 6) and well-calibrated default arrangements (AIST, sub. 30; CIFR, sub. 10; Fiduciarys Friend, sub. 7).

Agreed. We do however desire and recommend measurement and accountability on efficiency outcomes for Smart Defaults – refer to Pareto Optimisation section above. This is particularly important given the mandated nature and regulated nature of superannuation. Further, Smart Defaults should 'nudge' member engagement with their retirement.

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The most relevant additional member data would likely differ depending on a member's phase in their life cycle. For example, in the accumulation phase, additional member data may include a member's investment risk preferences, projected retirement balance and what ancillary member support and education services they place the most value on (Fiduciarys Friend, sub. 7).

To elaborate on this point, funds are continually pursuing ways to achieve engagement with a greater proportion of their members. This will occur gradually and organically over time. However, there is always likely to be a high proportion of members, particularly younger members who are disengaged for a variety of reasons e.g. lack of understanding of the purpose, need, investment strategies

At the time when members eventually engage (this may occur gradually over several years), they should have a general sense that their trustee has been looking after them, and acting in their best interests while they were disengaged. This is consistent with the fiduciary duty of trustees.

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As far as the Commission is aware, there are no systematic publicly available data on the extent to which funds collect additional member information or how this influences their product and service design. That said, there are indications some funds are striving to find new ways to engage with members and collect additional member data (combined with techniques such as data analytics) to design more tailored default products, retirement income products and higher-quality member services (ASFA, sub. 42). Participants noted that greater tailoring of life-cycle products is currently inhibited by a lack of information about members, although barriers to the collection of more information were not elucidated (appendix D; Fiduciarys Friend, sub. 7).

> *The Commission recognises that better member data and more innovative product design are not guaranteed to lead to better member outcomes. The prospect of continued evolution towards smart default products combined with high-quality intrafund financial advice may overcome some of these issues.*

The connection between the collection of data, tailoring, smarter defaults and improved outcomes and payment thereof are interrelated. We welcome and expect these accountability aspects.

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Furthermore, there is currently little evidence of tailoring of life-cycle products to individual circumstances of members. Chant, Mohankumar and Warren (2014) reported that in the vast majority of cases, life-cycle products were calibrated purely to the age of the member and that greater tailoring of products by funds was inhibited by lack of information about members. Fiduciarys Friend (sub. 7) argued that incorporating factors such as current income and projected retirement balances into life-cycle products was essential to ensuring allocatively efficient outcomes. Others suggest that when constructing an asset portfolio for the transition and retirement stages, a focus on age is less instructive than a focus on the person's consumption needs.

We understand the current lack of tailoring for MySuper members, we respect the history of why this is the case, and we recognise the effort potentially involved in collecting data. However, we also understand that to evolve, to be more efficient and to concentrate on the retirement objective, the industry must embrace further change and innovation.

As is being realised across many industries, access to information (e.g. through digital technologies) is a powerful driver of change, especially for engaging more effectively with customers, clients, members and other stakeholders. Access to basic information on MySuper members will facilitate the emergence of the next generation of smart defaults. It will enable funds to better understand their members' needs, and to better tailor solutions to meet those needs.

This is especially important for MySuper fund members who, as disengaged members, have effectively devolved responsibility for their investment decisions to their Investment Manager (Trustee). Better tailoring through smart defaults will ensure Trustees better fulfil their fiduciary responsibility to MySuper fund members, and thereby improve allocative and dynamic efficiency of the superannuation industry.