13 July 2018

Superannuation
Productivity Commission
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# Productivity Commission: Stage 3: Assessing Efficiency and Competitiveness – July 2018

As a global leader in implementing 'next generation' retirement solutions built around a retirement income goal, Dimensional Fund Advisors is well placed to comment on the retirement income aspects of the Productivity Commission draft report.

Over recent years, Dimensional has helped lead the discussion in Australia on retirement income solutions. These efforts include sharing information on the solutions we have developed for other defined contribution markets, engaging with global index providers to design indices that focus on managing retirement income risk, and sharing the contributions of Professor Robert Merton, a Nobel Laureate, MIT economist and resident scientist with Dimensional.

In this submission, we provide our thoughts on constructing appropriate benchmarks for retirement income, the role of lifecycle solutions in implementing efficient retirement solutions, the importance of providing meaningful information to pre-retirees, and concerns we have with 'best in show'.

## Information Request 2.1

*Are the assumptions underpinning the Commission's benchmark portfolios sound? If not, how should they be revised, and what evidence would support any revisions?*

The government has agreed that the primary objective of the superannuation system is to provide income in retirement to substitute or supplement the Age Pension. If this is the objective, then retirement income should be front and centre throughout both accumulation and retirement phases, including asset allocation, portfolio evaluation and benchmark construction.

In our opinion, the ultimate objective of an investment strategy (in this case, income in retirement) needs to underpin the benchmark design. If investment managers focus on a benchmark that is indicative of current or historical asset allocations which may not focus on retirement income, this may lead to suboptimal investment design and poor outcomes for members. The primary role of a benchmark is to evaluate how investment management decisions have performed over specific periods, but in isolation the performance of a portfolio relative to its benchmark may not provide insight into the quality of investment management or if past relative performance will persist.

An example of how retirement income can form the core of benchmark construction is the S&P STRIDE Index Series. These indices, jointly developed by S&P and Dimensional for the US market, draw from lifecycle theory to transition from growth assets to a hedged stream of inflation-adjusted income in retirement. They demonstrate how a low-cost, efficient, rules-based and transparent allocation can be formed to measure the effectiveness of solutions that manage risks relative to a retirement income goal.

## Information Request 4.1

*Should lifecycle products continue to be allowed as part of MySuper? If so, do they require re-design to better cater for the varying circumstances of members nearing retirement, and how should this be achieved? What information is needed on members to develop a product better suited to managing sequencing risk?*

Lifecycle solutions which incorporate an asset allocation shift in support of a retirement income goal should remain a valid MySuper option.

Modern lifecycle research highlights the importance of considering the entire lifecycle of an investor and the sources of capital for the goal when making asset allocation decisions. This requires that the retirement income goal be considered throughout the accumulation phase and not just in retirement.

We note the Productivity Commission's concern that lifecycle funds which shift from high equity allocations to fixed income might be giving up higher returns, with only marginal corresponding reduction in sequencing risk and little reduction in income volatility.

This is consistent with our own research into lifecycle funds. Reducing sequencing risk and income volatility requires that the asset allocation be adjusted over time in a way that matches the asset allocation to the retirement income goal. Simply reducing high equity allocations over time is not sufficient to provide individuals with good experiences if the shift does not reflect the retirement income goal. A better approach is to rebalance the equity allocation into assets that match the liabilities of the future income stream.

## Draft Recommendation 11: Guidance for Pre-Retirees

*The Australian Government should require the ATO to guide all superannuation members when they reach age 55 to:*
- *the 'Retirement and Superannuation' section of ASIC's MoneySmart website*
- *the Department of Human Services' Financial Information Service website*

To develop engagement, it is critical that trustees provide members with calculators that offer them meaningful income estimates during the accumulation and decumulation phases. The regulatory environment should be changed to allow for this.

Generally, we define successful retirement savings and investment approaches as those that allow members to move from working life to retired life without large shocks to their consumption. Such approaches should lead to steady retirement income and provide people the flexibility they require to meet the costs of unexpected life events.

Our experience is that providing meaningful information about projected retirement income *prior* to retirement as well as ongoing estimates *in* retirement builds engagement with members.

To be meaningful, retirement income estimates must be tied to the investment solution and intuitively communicate both the retirement income estimate and the expected volatility around that estimate. Retirement income estimates are reliable only if the member's solution robustly manages retirement income volatility in both the accumulation and decumulation phases.

By providing people with retirement income-based reporting *before* they retire, members can more easily assess their retirement readiness at a time in their lives when their actions, such as saving more, can make a meaningful impact to their retirement outcomes.

As member engagement tends to be infrequent, the information given needs to be sufficiently meaningful to encourage further engagement. On this score, our experience shows that retirement income calculators and reporting on expected retirement income are effective in building that engagement. We also believe that effective communication during both the accumulation and decumulation phases is vital to successful outcomes.

## Draft Recommendation 2: Best in Show Shortlist for New Members

*A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF). Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.*

The superannuation system should provide members with investment choices focused on retirement income. Our view is that a key component of these solutions should be to manage retirement income volatility through both the accumulation and retirement phases.

Therefore, any legislative guidance or rule-making should be outcome-based rather than prescriptive and should be appropriately enforced. Outcome-based guidance encourages innovation and competition. This in turn drives the creation of lower cost, liquid and more efficient retirement income-focused solutions.

For example, it might encourage the creation of accumulation-phase vehicles that provide members with greater certainty, long before they retire, about how much expected retirement income they can afford. Having members take appropriate actions in the accumulation phase is a primary way to ensure they are ready for retirement and do not have to rely mainly on the Age Pension. Also, we believe that accumulation-phase solutions managed with the goal of integrating seamlessly with decumulation-phase solutions providing steady retirement income are key to the successful adoption of the latter.

Our view is that prescriptive guidance and rules would increase the risk of members having access only to higher cost or incomplete solutions.

Finally, we are concerned with the focus of 'best in show' on past performance as a predictor of future performance. Many academic studies have concluded that past performance is not a predictor of future performance. Our own research on US mutual funds suggests that only a minority of US funds ranked in the top quartile (25%) based on previous three-year returns will again rank in the top quartile in the next three years. Extending track records to longer periods (5 and 10 years) shows similar results. Short track records, as proposed by the Productivity Commission, do not contain

sufficient information to identify management skill, and are unlikely to provide the desired predictability.

*Accompanying this letter, we have included thought leadership pieces on benchmarking retirement income products, lifecycle investing and past performance as a predictor of future performance that Dimensional researchers have authored and/or contributed to over the past decade. These pieces were prepared by our US affiliate for a US audience and were written in a US regulatory context. Terminology and references contain therein should be understood in that context.*