Submission on Productivity Commission [PC] draft report on Superannuation: Assessing Efficiency and Competitiveness

I applaud the Commission's work. I agree with most of the draft findings and draft recommendations. The Australian superannuation system is now of a size and importance that it rivals the ADI sector, but its regulation (at least on reporting, disclosure and data provision) is years behind. Particular emphasis and urgency must be given to much greater transparency and granularity in reporting and disclosure, the need for consistency of terminology and benchmarking across the industry (probably overseen by APRA), and the use of longer term returns in PDSs and other member literature. Much of this material focuses on 12 month returns, which are clearly too short to be reliable. The industry is bedevilled by poor data and disclosure, as the PC states. It is appalling that APRA receives such inadequate data, especially by comparison with the frequency and quality of data obtained from the ADI sector.

I note that "administration" costs are not defined by the PC, so I shall take them to be <u>all</u> annual costs excluding investment management charges.

Draft Finding 2.1

The figures on P9 of the Summary Draft Report show a 1.9% pa difference in the long term average returns between the two main groups (not for profit [NFP] and retail funds). Clearly, the typical levels of fees and costs account for much of this difference, perhaps about half. Different approaches to tax (i.e. whether funds are managed to optimise after- tax or before-tax returns) would be relevant for some individual funds, but one would expect that they would be largely removed by these "whole of sector" figures being averaged over such large groups. It is possible that retail funds would have slightly higher "administration" (and marketing) costs (but excluding investment fees) than NFPs. There may also be different approaches to buy-sell spreads on entry and exit, but again one would think that these would be largely smoothed out over such large populations, and over 20 years, and they probably don't account for more than say a 0.1% pa difference between the sectors.

The report, and Draft Finding 2.1, states that there is significant variation in performance within and across segments, which is not fully explained by differences in asset allocation. This is true, but the important qualification is "what does the PC mean by "Asset allocation"?" Asset allocation usually refers to the % of assets in each of the main five or six conventional asset classes, but there is often a very wide range of different assets within each of these classes. The widest variation is probably met in "Australian Equities" –the term is usually understood to mean entirely listed equities. This description covers many different investment styles: eg blue chips, highly concentrated, active v passive strategies that aim to follow an index, small cap, income v growth, etc. The differing levels of franking credits earned by such styles may have a non-trivial effect on comparing overall after-tax returns from equity mandates.

Other major asset classes that are susceptible to large return fluctuations-even over quite long periods-are unlisted property and, more so, unlisted infrastructure. These may be dominated by large illiquid assets, which can be hard to value. Returns from private equity and other "Alternatives" can be very volatile and widely dispersed,

even over long periods. Some of these assets have been heavily weighted in some industry funds, more so than would occur in retail for-profit funds. Depending on the timing of acquisition and disposal (and valuation techniques used) they may have caused significant swings in returns, both good and bad. For example, MTAA Super (which I belong to) showed very good returns in its balanced and "target" funds until late 2008, because of its large weighting to infrastructure; however, values then fell sharply and the falls and weighting were so large as to affect its returns for the total portfolio, even when averaged over periods of 5 years or longer, until these periods dropped out of the averages. Within "infrastructure" there may also be inconsistency whether debt assets are included, or whether managers only include infrastructure *equity* under that classification, and allocate any related debt to the fixed interest class.

The PC's findings are not surprising, but the question of "asset allocation" in its broadest sense and its significance in accounting for differences of returns- even over the long term- needs deeper investigation by financial specialists.

Draft Finding 2.2

The finding is unsurprising: even assuming that there is no cost for external investment management, the annual costs for external administration of SMSFs are high and fixed. They are mostly over $1500 pa, and often double that. They are of course fixed costs, so have major adverse effects on smaller SMSFs. Too many members are seeking, or being persuaded to set up, SMSFs on the grounds of independence, without the trustees understanding how much extra investment performance is required to offset these costs. In most cases, a SMSF above $1m may be worthwhile, providing the trustees are competent investors, but a fund below $0.5m is likely to be too handicapped by the external costs.

Draft Finding 2.3

Please see my comments under DF 2.1. Also, have those members been defaulted into inappropriate *risk* categories, eg very low risk/low return funds, which would be unsuitable for a young person. It is unclear why the PC mentions a comparison with "conservative benchmarks" here. Does this mean a benchmark that is conservative for that particular risk category, or conservative in an absolute sense? If the latter, that is inappropriate methodology. It's relevant to note that the 10 years to 2017 (just) included the GFC crash, which had severe effects on many high growth strategies, and even on some balanced funds. These effects dragged down returns even when averaged over 5 or 7 year periods. This was a major disturbance to many investment sectors. It would be instructive to see whether the PC's conclusions remained if the analysis was undertaken instead over the 10 years to 30 June 2018, not 2017.

The second paragraph is true but unachievable: by definition half of all observations in a population will be below median, so those members can't be substituted (even hypothetically) into "median" returns without disturbing the value of the median. A more realistic and rigorous exercise would be to look at the dispersion of long term returns by quartile, ideally by decile. It is the *extent* of dispersion, rather than its fact, that matters. Also it would be ideal to evaluate these figures base on risk-adjusted returns, but I concede that the available data (especially self-reported by funds) may

be inadequate to do that with any degree of reliability. That is a pity, because the difference might be substantial. This is yet another reason why I applaud the PC's push for better disclosure and transparency.

Information Requests 2.1 and 2.2

Please see my comments above. Unfortunately, I believe the assumptions and data warrant some broad caveats. I sympathise with the PC's difficulty in drawing reliable and rigorous conclusions, given the unsatisfactory state of disclosure in the industry, and indeed even the lack of consistency of definitions and benchmarks. The market needs much better disclosure, overall and in detail, which must be reported to APRA and provided to all fund members at least annually, for all funds except SMSFs. These disclosures should preferably be audited. APRA or ASIC should appoint actuaries or other qualified professionals to do spot checks to ensure accuracy and rigour.

Draft Finding 3.1

I strongly agree; this is a major problem. Please see comments above.

Draft Finding 3.2

I agree with the PC's comments. There are at least two other matters that apply here. In some investment structures (for unlisted assets) assets may be held through feeder funds where retail investors are able to obtain access to assets that are usually available only to institutions. These structures typically involve two layers of fees; occasionally there may be three layers. For a long time, the industry's approach to reporting this was erratic, and often misleading. Following ASIC intervention, super funds have become more honest and consistent in aggregating the fees of these multi-tier structures, to disclose the true cost to members. I am not convinced that even now these arrangements are universally reported with full transparency; they were not in the past. It may be that the emergence of the true costs in such arrangements has partly offset the trend to lower fees caused by competition and reform, especially the introduction of MySuper. I understand that these reforms have reduced average retail fund fees by about 3 to 5 bp pa.

A second factor is that performance fees for investment management have been a feature that has emerged- or at least disclosed- over recent years. It would be useful to know, at a system level, whether the practice varies much between retail and NFP funds. Although in principle they are a good idea, they seem to be determined on only one year's returns, with no clawback for earlier or later poor returns. This appears to mean that members pay performance fees (often a large premium to the base fee) in good years, but get no offset in poor years. Thus over time it may be that total investment fees are higher than the published basic costs, and most members would not realise this. These fees seem to arise in all asset classes, but are largest in equities, infrastructure and Private Equity,

The final paragraph may partly reflect the difficulties (or unwillingness by managers) in closing and merging poor or large funds, and the inertia of fund members.

Draft Finding 3.3

Indeed- please see above. This sector needs better investor education and ASIC guidance to deter people from setting up SMSFs with balances below say $500K. There is far too much supply-side push here, playing to members' desire for independence and their over-confidence regarding their investment skills. .

Draft Finding 3.4

Agreed: could members be forced to change from poor funds by APRA, for example? Otherwise, is it a matter of shaming the expensive funds? Better disclosure would help. Public apathy is a problem. However, I think a good move would be to require the annual members' statements to show compound average annual returns for all of 1,3 and 5 years for that fund/option, and with a comparative, relevant benchmark for the same periods. It would also be good to provide the fund's total average investment and admin costs over the same periods, with comparison to relevant benchmark costs. Statements must now show (only) the annual costs, but without more context members can't tell whether these are fair.

Draft Finding 4.1

These qualitative findings (especially re the negative views) are rather disturbing. How rigorously have they been established, and over what sample sizes? I would expect that the vast majority of super fund members, especially younger ones, excepting SMSFs members, are generally ignorant about their super and /or unable to assess it usefully. (See also DF5.1, 5.2 and 5.3)

Draft Finding 4.2

I agree. The 40,000 is absurd, and reflects "me-too" options rather than genuine innovation or competitiveness.

Draft Finding 4.3 and Information Request 4.1

I think that they should continue to be allowed, but members under say 40 should not be encouraged to adopt them.

Draft Findings 5.1 to 5.3

I agree, and see my comments above re better disclosure and comparison info on annual member statements.

Draft Finding 5.4

I agree. There is already an additional problem: far too much supply-side promotion by service providers, and perhaps (still, despite regulators' efforts) property spruikers.

Draft Finding 6.2

I agree. There must be much tougher, and prompter, regularity and legislative action on all these points.

Draft Findings 7.1 and 7.2

Barriers to entry do not appear to be a problem: there are already many providers of investment management and administration services. Although there is apparent rivalry, much of it has a "me too" favour. Nearly all the benefits of the huge growth in scale have been kept by providers, not members. It is odd that, as the report says, (average) cost levels are little changed even for the industry funds sector. This suggests inefficiencies have emerged, with no obvious incentive to remove them.

Draft Findings 7.3 to 7.5

I partly agree. Although the introduction of MySuper has caused some modest reduction in investment management fees (at least in the retail sector), the proliferation of products and fund managers must reflect the above average fees that can still be enjoyed in the industry. I suggest that less than 20% of the scale benefits have gone to members. DF 7.4 is very important. Despite efforts by ASIC, the quality of disclosure of fees (and reporting generally) is still poor, inadequate and confusing. Much more work needs to be done.

Information Requests 7.1 and 7.2

I don't know, re 7.1, but I suspect that they wouldn't be large. Anecdotal comment is that tax treatment is a barrier, as is unwillingness of fund managers to appear to be a " loser" from a merger.

Part 8 No comment

Draft Findings 9.1 to 9.4

I agree. Fund governance has not kept pace with the strong growth of the sector, and is behind that regarded as normal in the listed company sector, and well short of best practice. As a general principle, fund governance should aspire -as far as possible- to meet the objectives of the ASX corporate governance council (draft 4th edition) principles that apply to listed Australian entities. Many super funds are larger than the market cap level required to belong to the ASX200, and several are larger than the market caps in the ASX50. Policy (and preferably regulation) should mandate such improvements within 18 months. There has been tiresome argument about the board composition of some industry funds, with absurd assertions made by both sides. The strong (average) outperformance of the NFP sector v the retail funds sector is obviously nothing to do with governance, but this should not prevent higher standards of governance being demanded anyway. This demand must be extended to transparency and integrity of reporting, not mere board composition.

Although the section is head "System governance" it is essential to improve the disclosure and reporting by funds. The reporting requirements for funds are utterly inadequate and feeble by comparison with what is require of listed entities. A super fund of $10B provides annual financial statements that are almost useless, and trivial by comparison with what a listed entity with only $10m of gross assets must provide each year.

The PC's full report makes a few references to public offer funds, but doesn't take further the fact that many industry funds have been public offer for many years. Because of the very poor level of statistics at both the fund and industry level- even at APRA- it is hard to estimate how many public member accounts there are, and what their total balances are. However, it is not unreasonable to guess that the figure is over $100B. Neither side in the recent silly debate on trustee boards and affiliations has taken the responsibility to the public members into account. The Government's legislative package is commendable and should be hastened.

Draft Findings 10.1 and 10.2

I agree. I hope that the proposed product intervention power for ASIC, and the design and distribution obligations, will NOT carve out superannuation from their scope.

Draft Findings 10.4

Although SMSF borrowing is not yet at a point to pose a systemic risk, it is undesirable policy to permit it. The responsible lending law should be extended to apply to trustees. Borrowing has probably accounted for many SMSFs being established, to hold geared property, even when not a suitable asset for those funds members, whether on cost or diversification grounds.

Information Request 10.1

These are good suggestions.

Draft Finding 11.1

Agreed As stated above the third sentence is impossible to achieve, but even a partial improvement is worth trying for and would be a material benefit to those members.

Draft Finding 11.2

Since the ATO has the data, I ask the PC to consider whether policy could be developed to mandate the ATO to merge forcibly all accounts of members with multiple balances, into either the fund holding their largest balance or the balance associated with their most recent contribution. This could be made on an opt-out basis subject to the ATO sending two prior written alerts to the member. Member apathy and confusion add to the structural flaws, (as noted in DF 12.2), even though inaction is detrimental to the member.

Draft Finding 12.1

The difference of 1.8%pa is of course large, but it is hardly catastrophic; it is probably similar in the non-superannuation investment sector. If the top10 and worst 26 are deciles (or perhaps subsets smaller than deciles), that doesn't suggest an embarrassing degree of dispersion of the fund population. More work, and very rigorous analysis, need to build on the PC report's foundations to discover the main causes of this dispersion, beyond the obvious one of differing costs levels.

Draft Finding 12.3 and Information Request 12.1

With respect, this is not a good idea, and creates many risks including moral hazard, and large and sudden shifts of cash held between funds. It fails to acknowledge the reality that substandard retunes are a feature of investment management in any market.

Draft Recommendations

I agree with all the Draft Recommendations, except as below.

DR2 I disagree

DR 3 Is it intended to be 10 funds over the whole universe of funds, or 10 per main asset class like property, international equities etc; or 10 per blended style like conservative, balanced and growth? Does the reference to four years mean that the "best in show" list would not change for four years- if so, that is much too long. One would want annual reselection.

DR 5 I agree, but consider having some or all trustees elected by fund members each year, like a listed company.

DR 10 I agree, and provide it with annual statements to members, as well as when otherwise required by regulation.

DR 12 I agreed, and legislate to apply this to all funds within two years.

DR 14 I agree. Is there merit in making life and income protection insurance subject to separate choices (both opt-in)?

DR 20

First point: should that process be audited?

Third point: when? This should be a priority.

Fourth point: yes, this is badly overdue. 18 months from when?

DR 21 Fourth point: agreed, but do you mean "performance" or genuine cost recovery (only)?

Richard Wilkins

13 July 2018