Chant West

Productivity Commission – Superannuation

Stage 3 Supplementary Submission

November 2018

Comparing Apples with Apples.

About Chant West

Chant West is an independent superannuation research and consultancy firm established in 1997. We specialise in researching superannuation and pension funds, and are well known within the industry for our research capabilities and market commentary.

We publish our research in various forms, including CorporateSuper Research, PersonalSuper Research, Pension Research and, at the consumer level, our Super AppleCheck and Pension AppleCheck comparison tools. We publish regular performance and asset allocation surveys covering all the major public offer superannuation and pension products. We also publish a quarterly fee survey and a quarterly insurance premium survey.

Our research is used by many of Australia's leading superannuation providers and adviser groups. Over 7,000 financial advisers and eight million fund members have direct access to our research. The information we provide allows them to compare funds on an 'apples with apples' basis. We rate superannuation and pension funds and have developed a ratings methodology that considers investments, member services, fees, insurance and organization in determining the rating for each product.

Our research also feeds into our consulting work, which in turn provides us with a special insight into the workings of the industry. Over the past 20 years, we have advised many large and medium-sized employers on their superannuation arrangements, including options for outsourcing investment, administration and member services. We have also advised many super funds on their outsourcing arrangements – administration, asset consulting and implemented consulting. Through our research and consulting, we have an intimate knowledge of the Australian superannuation market, including all the key players, their operations and efficiency.

Disclaimer

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1. Introduction

This report has been prepared by Chant West to provide feedback on the Productivity Commission's paper titled, 'Supplementary Paper – Investment Performance' that was released in October 2018.

Our responses cover a range of different issues including problems with the data used, how the data is used and also some particular issues with how the benchmark performance has been calculated.

2. Overall comments

2.1 Data Issues

The purpose of the Productivity Commission is to analyse the superannuation system to assess its efficiency and competitiveness. In order to do this, the Commission requires reliable data upon which to base its analysis.

Ideally, this data would be provided by APRA, which is both the prudential regulator and statistics provider for the industry, and it would include data at the product level for all superannuation entities. It is important to use data at the product level as that is the level at which members experience their superannuation fund and surely the purpose of any analysis should be to assess members' actual outcomes. However, APRA's data is generally limited to fund level data and for retail providers each fund generally includes a number of different products – some which are open to new members and some which are closed legacy products. The analysis of fund data for retail funds using fund-level data will thus be an average of a number of different arrangements and will not be reflective of any particular member's experience. For this reason, fund-level analysis of retail funds has very limited value and may be misleading.

APRA does provide some data at the product level, for MySuper products, but this data is only from 1 January 2014 and there are problems with some of this data, especially in relation to fees.

Because of these issues, the Commission has sought data from research houses that specialise in superannuation. But this data also has some problems as it does not cover all products and it suffers from selection and survivor biases.

We understand that the Commission can only use data that is available to it and that all its data sources have significant limitations. The lack of reliable data has made it very difficult for the Commission to perform its role effectively and to use the data available to it to make solid, defensible conclusions about the system.

It is critical that the superannuation industry can stand up to independent scrutiny in terms of the outcomes it is providing for over 10 million Australians. But the lack of reliable data means the outcomes it is providing to members are relatively opaque to a comprehensive independent analysis of the system such as that conducted by the Commission. This needs to change. The quality of data available must be improved and targeted to those metrics that clearly demonstrate member outcomes. Indeed, it would be appropriate for the government to commission a regular review of the superannuation system, although this would not need to be done by the Productivity Commission. Ideally, when the next review is done, much better data is available upon which a comprehensive analysis of the system can be conducted.

We recommend that APRA works with the Commission and the superannuation industry to determine the data that is required to assess the efficiency and competitiveness of the superannuation system on an ongoing basis and for APRA to commence a program to source this information from the funds that it regulates. This data would be very useful for such periodic system analysis but also very useful for APRA as it assesses the efficiency and competitiveness of funds as part of its supervisory role. Further, this data could be used by superannuation funds to compare the outcomes they are delivering to members with other funds and should drive some of their strategic decisions. If APRA was to gather such data on an ongoing basis it may require additional funding, but this would be warranted if it meant it could provide a true picture of the outcomes the industry is delivering to members.

2.2 Retail fund performance – some issues

While we agree that industry funds have outperformed retail funds for options with a similar level of growth assets, we believe the differential shown in the report both for the fund-level analysis and MySuper analysis is overstated.

Table 1 shows the median performance, net of investment fees and tax, of growth options (61-80% growth assets) in our Multi-Manager Survey. It shows industry fund performance has been 0.6-1.2% pa ahead of retail funds over periods from 5 years to 15 years for these options with similar levels of growth assets.

Table 1: Performance by Industry Segment (Results to 30 June 2018)

	1 Mth (%)	Qtr (%)	1 Yr (%)	3 Yrs (% pa)	5 Yrs (% pa)	7 Yrs (% pa)	10 Yrs (% pa)	15 Yrs (% pa)
Industry Funds	1.5	3.4	10.3	8.5	9.7	9.1	6.9	8.1
Retail Funds	1.1	3.3	9.0	6.9	8.5	8.4	6.3	7.2

*Performance is shown net of investment fees and tax. It is before administration fees and adviser commissions.

We believe that performance should be compared on a net of investment fees and tax basis, ie net investment returns, as it isolates investment outcomes from other inputs such as administration fees and allows a more focussed analysis of performance that is not clouded by other issues not related to investment skill and outcomes. Administration fees cannot be ignored but they should be separately analysed. And clearly, when administration fees are also considered, the difference between industry and retail funds is greater due to retail funds' higher fees, on average.

A key problem with using performance on a net of 'everything' basis, which is the case for both the fund-level data and MySuper product-level data in the Supplementary Paper, is that any critical information about changes in administration fees over the period will be lost in the data. Indeed, retail funds decreased administration fees significantly from 1 January 2014 through their MySuper products so that the current level of is much lower than the administration fees (and adviser commissions) built into pre-MySuper products. This critical change of practice in retail funds means that the net of 'everything' performance used for retail funds before 1 January 2014 is no longer reflective of members' experience.

Further, while the fund-level analysis is a reasonable approximation of the experience of members in industry funds, it does not reflect the experience of members in retail funds which often have several different products in the fund, all with different fees and performance. Some of the products will be open products and some will be closed legacy products which will typically have higher fees. The problem with this analysis is that it will show the average of all these products which will not reflect the experience of any member.

A better representation of retail super would be provided by separately showing metrics for open products and legacy products. This would illustrate that the fees and performance of the open products are better than the retail average, but still behind industry funds, and the legacy products will be clearly shown to have, on average, higher fees and worse performance. This much more accurate picture of retail funds' member outcomes would greatly assist in determining strategies to improve outcomes for retail fund members and would be likely to generate a much more focussed imperative to deal with these legacy products through a range of means, including the removal of barriers to transfer members from legacy products to better value products.

The problem that the Commission is likely to find if it wanted to do this analysis is that the APRA data does not separate open retail products from legacy retail products. Once again, this is a good reason to start to source data at product level, both for open products and legacy products.

When we turn to the product-level analysis of MySuper, there is a different problem with the retail fund performance that has been used in the analysis. Page 42 of the Supplementary Paper explains that current MySuper products have been connected with pre-cursors for the purpose of calculating performance. In the case of retail funds these pre-cursors were pre-MySuper default options which had higher administration fees and adviser commissions. Since the SuperRatings performance data used for the MySuper analysis is net of 'everything', ie investment fees, implicit administration fees and tax (but gross of explicit administration fees), the higher administration fees and adviser commissions will be reflected in retail funds' MySuper performance. On one level, this is fair as it shows what members have experienced from these funds over the 11 years to June 2018. However, if the purpose of the Commission's analysis is to determine the likely ongoing experience of members in these funds, such past returns are not indicative of what a member will experience in these funds as the days of high administration fees and adviser commissions in these products are no more. An analysis of performance net of investment fees and tax would provide a much better picture of retail members' current experience.

Further, the MySuper options provided by most retail funds are now lifestage options where asset allocation varies with age, starting with a high level of growth assets at younger ages (about 90%), moving to a more conservative level of growth assets at older ages (generally about 50%). This makes it more difficult for the Commission to assess performance of these options as performance will vary with age. Page 29 of the Supplementary Paper notes that the Commission has used the largest balanced lifestage (ie 61-76% growth assets) for its analysis of retail fund MySuper performance since 1 January 2014. This typically means the 1960s cohort lifestage. The problem is that this cohort currently has only about 64% growth assets, compared with the average not-for-profit 'balanced' MySuper with about 72% growth assets, according to Chant West data. Over the past few years of strong investment performance, the additional growth assets in industry fund MySupers will mean stronger industry fund performance due to this factor alone. And yet if a weighted average performance of lifestage options was used, the retail performance is likely to be better as most members are in younger cohorts that have more growth assets and have experienced higher performance over the last few years.

2.3 International comparisons

Any international comparison of performance needs to be treated with great caution as the disclosure practices vary from country to country and factors relating to currency and the inherent risk in certain jurisdictions at different points in time will vary.

However, it is particularly unhelpful to compare performance over different periods as has been done in the Supplementary Paper, ie 2008-2017 performance has been used for Australian funds and 2017-2016 performance used for international funds. While it is true that 2006 and 2017 both had relatively high returns, there was significant variation in returns for some asset classes for these periods which will skew the results. We would recommend using the same period for Australian and international funds if this analysis is to be included in the final report.

2.4 Fund size

Page 28 of the Supplementary Paper reflects that a possible reason for the variation of residuals across funds is that larger funds may have an advantage through greater flexibility in how they implement their investment strategy and greater access to different types of assets. We agree that fund size can be a factor that affects fund performance.

Table 2 shows the performance differential between large and small not-for-profit funds over various periods to 30 June 2017. It shows a consistent 0.8% - 0.9% pa difference in investment performance over all periods shown. For 'large' funds, we have included the 10 largest in terms of assets (all about $20 billion or over) and for 'small' funds we have included those under $5 billion.

Table 2: Not-for-profit funds: large vs small – median performance to 30 June 2017 (% pa)

	3 Years	5 Years	7 Years	10 Years
Large funds – 10 largest funds	8.6	10.9	9.4	5.6
Small funds – under $5 billion	7.7	10.0	8.6	4.7
Difference	**0.9**	**0.9**	**0.8**	**0.9**

*Performance is shown net of investment fees and tax for each fund's main investment option with 61-80% growth assets.. It is before administration fees and adviser commissions.

We agree that larger funds perform better on average as they typically have access to a wider investible universe including unlisted property or infrastructure assets that they can access either directly or through co-investment opportunities. These are assets that would often not be available through pooled arrangements or would be available for a higher fee. Larger funds are also able to negotiate lower fees from their investment managers due to their scale and can insource some functions to reduce cost. Finally, larger funds can employ highly capable in-house investment teams to construct portfolios and assess managers, complementing the input from their asset consultants. However, not all large funds are strong performers and not all small funds are weaker performers. What the table does show is the advantage that scale can provide if used well and the challenges of producing strong performance for small funds.

3. Validity of the Benchmarks

3.1 Benchmarking assumptions

Our previous submission to the Commission in response to the draft report raised a number of concerns with the composition of the benchmarks used. We are pleased that most of our concerns have been addressed, through the use of an unlisted property benchmark for the whole period (rather than listed property for part of the period) and the use of a composite equity/bonds benchmark for 'other assets'. These changes would have reduced the average benchmark return. We also agree with a reduction in the 'indirect investment expenses' including custodian and asset consultant costs which would have increased the benchmark for the average fund by a similar amount.

However, we still do not agree with the treatment of tax in the benchmark portfolios in the Supplementary Paper. The draft report used an average tax rate of -1.97% over the period 2005 to 2016 which was based on APRA data. Similarly, in the Supplementary Paper, when the benchmarks are adjusted for tax in Figures 7, 8 and 9, there is nil tax impact at the system level, a tax credit of 1.3% for retail funds (ie 0.1% tax credit for a 7.9% return) and a tax rate of 2.5% for industry funds (ie 0.2% tax paid for a 8.1% pa return). Such a minimal tax rate seems to be at odds with the experience of super funds. The Supplementary Paper does seem to adopt a different approach in its MySuper analysis, using an average tax rate for 2008 to 2018 of around 5.8% which is consistent with our recommendation of using a tax rate of about 6% for tax. The impact of this factor for the system level analysis is significant as if a 5.8% tax rate was deducted from the system-wide return of 8.3% this would reduce the benchmark by about 50 basis points – this may explain some of the large residual at system level and for retail funds.

We understand that APRA's data on tax paid by each fund is probably the only available data for this purpose and we can understand why the Productivity Commission has used this data. However there appears to be problems with this tax data, as there is with APRA's fee data, and we don't believe this data should be relied upon for such an important component of the analysis. We believe it would be more appropriate to use an accepted average tax rate for the whole period such as 5.8% or 6%. This should significantly reduce the benchmark returns.

On a related note, it is also strange that the system-wide benchmark return of 8.3% pa is higher than the benchmark returns for both not-for-profit funds (8.1% pa) and retail funds (7.9% pa). This may indicate problems with some of this fund-level data and analysis.

3.2 Benchmarking results

Page 40 of the Supplementary Paper suggests that even fewer funds and products met the benchmark in the updated analysis using the adjusted benchmarks and an additional year of data (ie only 26 funds achieved the benchmark for 2005-2017 vs 47 funds met the benchmark in the draft report for 2005-2016). We are surprised that the changes to assumptions described above and the addition of an additional year would have such a significant effect. We would have expected that the benchmark changes (assuming very little impact evident from a different treatment of tax) would have led to a similar number of funds meeting the benchmark. The reason for this significant change is not really explained in the Supplementary Paper.

A more general comment should also be made about using the average asset allocation for the segment, or each fund's asset allocation, to determine the benchmark portfolio. Effectively, this reduces the comparison between a fund's performance and the benchmark to one of asset selection, as it controls for asset allocation. That is, the performance compared to the benchmark simply shows how funds' investments in each asset class have performed compared to the benchmarks of the asset classes in which it invests.

This approach gives no credit to funds for their asset allocation decisions, which are widely accepted as the main driver of value for superannuation fund members. Funds that have led the way in terms of diversifying their portfolios with meaningful allocations to unlisted property, unlisted infrastructure and private equity are not given credit for these strategic decisions in the analysis but their performance is simply compared with the benchmarks for each asset class.

We believe a more helpful analysis would be to compare performance to a benchmark portfolio that does not include these strategic asset allocation decisions to diversify portfolios. For example, the benchmark portfolio could consist solely of listed assets, such as BP1 used in the draft report. Using such a benchmark portfolio for each fund would provide much more useful information on the value added through both asset allocation as well as asset selection within those asset classes.

We also have some concerns with the decomposition of performance in Figures 6 to 8. In particular, the very large residual especially for retail funds (1.7% pa) may be an indication of significant measurement problems, perhaps related to the issues for retail funds raised earlier in this submission. Only a small part of the residual can be explained by indirect investment costs (ie investment costs of underlying vehicles that are not charged directly to the member but are deducted from returns). In addition to this, the investment expenses used in the decomposition are far too low (ie. 0.1% pa for retail and 0.3% pa for industry funds) as the average investment fees and costs were about 0.60% pa for both not-for-profit and retail funds MySuper products in June 2017, according to our June 2017 Super Fund Fee Survey. If more realistic tax and investment expense numbers are used (eg. 0.50% for tax and 0.60% for investment expenses), the residual for retail funds would reduce to about 0.6% pa and the industry fund positive residual would grow from 0.20% pa to about 0.80% pa, suggesting strong asset selection from industry funds. We recommend the Commission review the decomposition of performance for its final report. This may be a more realistic assessment of how fund performance relates to relevant benchmarks.