4 Investment performance

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| Key points |
| * Retirement outcomes for superannuation fund members depend in large part on the long‑term investment performance of superannuation funds. Small improvements in annual net returns (returns after the deduction of fees, costs and taxes) can lead to significant increases in accumulated returns upon retirement. * The Stronger Super reforms prescribe new disclosure requirements for investment strategy, risk, performance, fees and costs, and scale for all MySuper products. These disclosures will enhance comparability between products and are expected to improve the consumer demand response to superannuation product offerings. * Each MySuper product will be required to have a single, diversified investment strategy (which may be a lifecycle approach), including a clearly articulated investment return target and level of risk. * No minimum investment performance criteria will be required for MySuper products. * Only particular types of fees will be allowable for MySuper products. Some categories of fees will be limited to cost recovery, though investment and administration fees will not be capped. * Trustees of funds that offer a MySuper product will be required to consider whether the scale of the fund negatively affects their ability to promote the best interests of their members. * When determining if a MySuper product should be listed in an award: * The appropriateness of the MySuper product’s long‑term investment return target and risk profile (for employees who derive their default superannuation product in accordance with a given modern award) should be a consideration, as a primary factor. * The expected ability to deliver on its MySuper long‑term investment return target, given its risk profile, should be a consideration, as a primary factor. The appropriateness of the investment strategy and previous success against its objectives are relevant. No threshold investment return target or risk profile should be set. * The appropriateness of the MySuper product’s fees and costs should be a consideration, in terms of the product’s long‑term investment return target and risk profile, and the services provided. * The MySuper scale requirement is appropriate, and no greater prescription with regard to scale is required to list default products in modern awards. |
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This chapter includes analysis on the scope for additional prescriptive criteria relating to investment performance (that is, net returns to members) to be considered in the selection and ongoing assessment of superannuation products for listing in modern awards. The chapter considers these in the context of the Stronger Super reforms.

The chapter covers the case for an additional criterion relating directly to investment performance, and in particular, the ability to deliver on investment objectives. It also includes consideration of criteria that relate indirectly to investment performance, namely: investment strategies and objectives; fees and costs; and economies of scale. Investment strategies and objectives largely determine the path to investment performance. Fees and costs influence net returns to members, though their actual effect will depend on the value for money they provide, and economies of scale can lead to higher net returns to members.

## 1 Investment strategies and objectives

An investment strategy guides the allocation of assets among various investment options to meet the investment objective (such as the investment return target), or objectives of the fund, taking into account the fund’s risk tolerance. A defensive investment strategy allocates assets to minimise the risk of losing value, and in contrast, an aggressive investment strategy allocates assets to achieve maximum return, usually taking on additional risk. A balanced investment strategy portfolio falls between these two extremes.

When formulating, documenting and giving effect to an investment strategy, trustees are required to consider the likely return and risk, diversification, and liquidity of investments. Trustees must consider the risk tolerance of members when setting the risk profile for the fund (Jones 2011).

### Stronger Super reforms

Though MySuper trustees will be required to formulate, give effect to, and publish a single, diversified investment strategy, MySuper products will not be required to employ any particular investment strategy, pursue any particular investment return target, adopt any particular risk profile, or include any particular asset class. This reflects the view that trustees are best placed to make these decisions, and that if trustees were required to make particular investments, this would limit their capacity to pursue investment opportunities in the best interests of members (Treasury nda).

As a result, investment strategies are likely to vary among MySuper products, though this will be tempered by the overarching focus of MySuper products — ‘low cost and simple’ (Australian Government 2010d).

Trustees will be required to clearly articulate the investment return target (over a rolling 10 year period) and the level of risk being taken to achieve this return, and justify why these are appropriate for the membership of their MySuper product. They will also be required to outline the investment strategy they have adopted to deliver on these objectives and to regularly review the investment strategy. Trustees will also be required to have regard to additional factors when developing an investment strategy, including: the availability of valuation information; the expected taxation consequences; the expected costs of the strategy (such as brokerage); and the appropriate due diligence in the selection and monitoring of investment options made available to members (Shorten 2012d).

#### Lifecycle investment approach

Trustees will be able to choose a lifecycle investment strategy as the single investment strategy for the MySuper product (Australian Government 2011a). A lifecycle investment strategy is a tool designed to reduce risk as members get closer to retirement age. Where a lifecycle investment strategy is adopted, trustees would automatically move members into a different investment mix, based on their age.

### Scope for additional criteria relating to investment strategy and objectives

#### Participants’ views

Inquiry participants did not support prescribing a single specific type of investment strategy, or investment return target and level of risk as a criterion for listing default superannuation products in modern awards. However, one inquiry participant contended that all listed superannuation products should have a risk profile *no greater* than that found in a balanced investment strategy (Unions NSW, sub. 13). In contrast, Mercer contended that superannuation products listed in modern awards should not all be similar in terms of their investment strategies and services, preferring a diverse range (sub. DR68). The Corporate Super Specialist Alliance (CSSA) commented that it was ‘difficult to conceive’ (sub. DR56, p. 3) that the same investment strategy would suit every person employed under an award.

A small number of participants argued that the *appropriateness* of the investment strategy, or the investment return target and level of risk, should be considered when listing default superannuation products in modern awards. The Australian Hotels Association contended that decision makers should consider the appropriateness of the investment strategy for the industry workforce (sub. 10). CPA Australia considered that the appropriateness of the investment strategy for the employees covered by the award should be taken into account (sub. 39). The CSSA indicated that the appropriateness of the MySuper product’s investment return target and risk profile for employees who derive their superannuation product in accordance with a modern award, should be a primary factor when listing default superannuation products (sub. DR56).

Another participant pointed out that, regardless, decision makers need investment strategy information that is clear and complete to allow them to make informed decisions (Centre for the Study of Choice, UTS, sub. 22).

On the other hand, some inquiry participants did not support ‘investment strategy’ as a consideration when listing default superannuation products, often on the grounds that MySuper was adequate in this area. For example, Tasplan contended that due to the MySuper authorisation process, investment strategy, or investment return target and level of risk factors, should not be considered in the listing of superannuation products (sub. 6). Other participants considered that the focus should instead be on long‑term returns (for example, the Australian Institute of Superannuation Trustees, sub. 20). The diversity of views on this matter is illustrated in box 4.1.

Views were expressed about the appropriateness of offering a lifecycle investment option in default products. For example, the Australian Institute of Superannuation Trustees (sub. 20) considered that the presence or not of a lifecycle option should have no bearing on default listing. DFA Australia (sub. 21) considered that a lifecycle strategy can limit investor outcomes, unless it takes into account factors other than age, such as personal retirement income objectives.

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| Box 4.1 Investment strategy and objectives as criteria for selecting default products — some perspectives |
| Should be considered  On a broad scale, Fair Work Australia should assess the appropriateness of the default investment option of the fund in terms of risk and expected return. This would include an analysis of medium and long term asset allocation, the manager selection and review process, the overall investment philosophy … (NGS Super, sub. 18, p. 2)  ISN proposes a process for the selection of default funds within awards that will require Fair Work Australia to consider the relevance of … fund strategies and services to each award … with reference to the demographic within the jurisdiction of the award. (ISN, sub. 27, p. 43)  Should not be considered beyond MySuper requirements  Some participants regarded that the MySuper requirements alone were sufficient, so that a separate investment strategy, or investment return target and level of risk, criterion was unnecessary. For example:  … these factors will be covered in the fund’s successful completion of the MySuper licensing process with APRA. (REI Super, sub. 26, p. 3)  Some participants regarded that the focus should be on long‑term returns. For example:  … investment strategy is important but it is the long term outcome that matters most … There is sufficient new regulation of investment strategy requirements for superannuation funds generally and for MySuper offerings … including new investment strategy covenants applying to trustees. (AustralianSuper, sub. 36, p. 9) |
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#### The Commission’s view

The Commission does not believe that a specific type of investment strategy, or specific investment return target and level of risk, should be prescribed for the selection and ongoing assessment of superannuation products for listing in modern awards. Indeed, the Commission considers that the likely variability of MySuper investment strategies is desirable as it will result in a range of products that can meet the potentially diverse needs of superannuation members. It follows that listing a range of default products in modern awards is desirable as it will facilitate employers selecting products that meet the needs of their employees (chapter 8).

Though the Commission sees no case for additional prescriptive criteria to be applied in this area, the Commission regards the investment return target and level of risk, and the investment strategy employed to deliver on these objectives, as important factors for consideration because they largely determine the path to delivering long‑term investment performance (section 4.2).

The Commission recognises that the Stronger Super reforms already require MySuper trustees to set an investment return target and level of risk (and the investment strategy to deliver these) that is appropriate for the entire product’s demographic. The Commission considers that the selection and ongoing assessment of superannuation products for listing in modern awards should go one step further, and consider if the investment return target and risk profile are appropriate for the employees who derive their default superannuation product in accordance with a modern award. The Commission recognises that there will be challenges in gathering adequate data to understand the characteristics of these employees (chapter 9), but, notwithstanding this, an assessment of the broad appropriateness of a MySuper product’s long‑term investment return target and risk profile should be given primary consideration among a range of factors.

The Commission notes that the Stronger Super reforms give trustees the option of offering a MySuper product that employs a lifecycle investment strategy. The Commission believes that where a lifecycle strategy is offered that product should be evaluated on the same basis as other products, that is ― according to the appropriateness of its long‑term investment return target and risk profile.

Recommendation 1

The selection and ongoing assessment of default superannuation products for listing in modern awards should include consideration of the appropriateness of the MySuper product’s long‑term investment return target and risk profile for employees who derive their default superannuation product in accordance with a given modern award (as a primary factor).

## 2 Investment performance

### The importance of investment performance

The success of a superannuation fund’s investment strategy is determined by its long‑term investment performance. Net returns — that is, returns after the deduction of fees, costs and taxes — can be highly uncertain and variable over time, and are influenced by factors such as asset allocation and the level of expenses. Small improvements in the annual net return of a superannuation fund or product can lead to a significant increase in accumulated returns for members, given the long time frames over which superannuation assets are typically accumulated.

Though the industry itself often focuses on the relative net return of different types of funds, for the purposes of this inquiry, it is useful to look at the relative net return of current default funds (that is, those listed in modern awards) and non-default funds (that is, those not listed in modern awards).

The investment performance of default funds listed in modern awards has been relatively strong when compared to non-default funds. Over the eight years to 30 June 2011, default funds averaged an annual (after tax) rate of return of 6.4 per cent, compared with 5.5 per cent for non‑default funds, and default funds collectively outperformed non-default funds in each year except 2009 (figure 4.1).[[1]](#footnote-2)

Figure 4.1 Superannuation fund performance**a, b, c, d**

Default funds versus non­‑default funds

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a Based on APRA-regulated superannuation funds for which return data are available for all years 2004–2011. b Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA‑regulated funds and single‑member approved deposit funds. Self managed superannuation funds regulated by the Australian Taxation Office are excluded. c Includes Eligible Rollover Funds. d Default fund data based on superannuation funds listed in modern awards (as at September 2012), for which return data are available for all years 2004–2011.

*Sources*: Productivity Commission estimates based on APRA fund‑level profiles and financial performance data 2011 (APRA 2012j); FWA (2012e).

### Stronger Super reforms

Current regulatory arrangements do not prescribe return targets for superannuation funds. However, MySuper trustees will be required to promote the financial interests of members, and deliver value for money over the long term. This focus reflects that most members would be expected to remain in superannuation for a considerable period, and therefore it will be generally appropriate to manage returns over the long term (Shorten 2012d).

In promoting the financial interests of members of a MySuper product, trustees will be required to focus on net returns to members. Returns to members are described as ‘those amounts placed into member accounts through an increase in their unit price or credited to their account, which are a result of investing the member’s balance’ (Shorten 2012d, p. 13).

The Stronger Super reforms will enhance comparability between MySuper products (and choice investment options), and make performance more transparent. Funds regulated by the Australian Prudential Regulation Authority (APRA) will be required to calculate (gross and net) returns in a standardised way for MySuper products and choice investment options. Under legislation currently before Parliament, APRA will be required to publish quarterly information on net returns for MySuper products (Shorten 2012a), and trustees will be required to disclose the information regarding choice products (Australian Government 2010d). APRA is currently in consultation on the new reporting standards for superannuation, which are due for release in the first half of 2013 (APRA 2012g).

Further, all APRA‑regulated funds will be required to disclose the investment return target (over a rolling 10 year period), and the number of times the target has been achieved, together with other information — including the average fees charged in relation to the product on a per member basis and liquidity information — for their MySuper and choice investment options, on a product ‘dashboard’ (Shorten 2012a).

### Scope for additional criteria relating to past performance

One key question is the extent to which past investment performance (net returns) should be taken into account when selecting default products for listing in modern awards, including whether a particular absolute or relative level of past performance should be met before a MySuper product could be considered for inclusion.

#### Participants’ views

Some inquiry participants suggested that overall past investment performance is an important criterion for listing MySuper products in modern awards — either as the prime consideration or in conjunction with others. For example, the Industry Super Network (ISN) proposed that past performance should be the prime criterion:

Recognising that the principal objective of superannuation is improvement in retirement outcomes, long term net returns must, therefore, be the prime criteria on which the suitability of superannuation funds to be named as defaults is judged. (sub. 27, p. vi)

Cbus considered that funds with default status should have ‘a history of strong investment returns in its default product’ (sub. 15, p. 4), and AustralianSuper considered that:

… the medium to long term net‑of‑costs investment performance of the default investment option [is] the single most important criterion to include. This more than any other aspect has the largest impact on a member’s retirement outcome. (sub. 36, p. 5)

The Actuaries Institute argued that past investment performance should be one of a number of considerations:

Past investment performance (net of investment fees, costs and investment taxes) is one of the many factors that should be considered when assessing the investment capabilities of a fund. (sub. 45, p. 3)

Some participants stated that default funds should be selected from a list of the highest relative performing funds, with selection, therefore, based on investment performance relative to industry peers. For example, the Australian Council of Trade Unions (ACTU) recommended that:

… only those MySuper compliant products that APRA report as being among the top 100 best performing in terms of net returns to members over an extended period (such as 10 years) can be eligible for inclusion as a default in an award. (sub. 29, p. 11)

Along similar lines, ISN recommended that persistently low relative net returns be used to exclude products (albeit as their second preference to setting a performance benchmark for including products) (sub. DR62). Other participants expressed concern with such an approach. The Law Council of Australia noted that the resulting list may require frequent updating as a ‘position in a “league table” in terms of [performance] may vary widely over even relatively short periods’ (sub. 23, p. 3). However, ISN argued that updating should not be required more than annually (sub. DR 62).

Another approach is to use a minimum return threshold. ISN contended that an appropriate minimum performance benchmark should be set to ensure:

… that only those funds which have demonstrated a capacity to deliver superior returns to members over the long‑term should be considered for inclusion as default funds within modern awards. (sub. 27, p. 6)

Similarly, Eldercare was of the view that:

Only those funds that meet a minimum performance threshold should be able to apply to be named as default funds in awards … (sub. DR57, p. 1)

One participant pointed out that an understanding of the drivers of past performance is necessary if past investment performance is to guide fund selection. The Association of Financial Advisors stated that:

What is essential is an understanding of the reasons for historical out-performance and whether this is genuine and whether it is sustainable and risk effective. (sub. DR73, p. 3)

A number of participants considered that past performance is no indicator of future performance, and did not support its use as a criterion for listing in modern awards (Association of Financial Advisors, sub. DR73; CSSA, sub. 35; FSC, sub. 30; Tasplan, sub. 6). For example, CSSA stated that past performance is ‘a very dangerous thing to base any sort of recommendation on’ (trans., p. 141), and that:

… history shows us that a fund which outperforms in one year may not do so in the next … (sub. 35, appendix C, p. 5)

One participant considered that published return data may be unreliable, resulting in erroneous and unfair ranking of funds. Rural and Regional Promotions stated that:

Whilst ASIC for example publish reports of fund performance these reports are usually provided to ASIC by the individual funds, also it does not appear to address the issue of published returns versus crediting rates. (DR86, p. 1)

If a past performance threshold was implemented, trustees might adapt their investment return target to maximise the chance of their MySuper product being listed. This may have unintended consequences. The Actuaries Institute noted:

… the imposition of a target level of investment performance would likely constrain the level of risk that a fund would then be prepared to accept, which would potentially lead to lower investment returns over the long term. (sub. 45, p. 3)

##### Past performance in the context of meeting investment objectives

Some participants took the view that past performance should be taken into account, but in the context of a fund’s stated investment objectives, so that an assessment of the ability of fund trustees to meet their objectives, albeit in the past, could be made. The Australian Institute of Superannuation Trustees considered that products with default status should be selected on the basis of:

… past performance based on 10 year rolling net returns, assessed against each fund’s investment objectives and target returns. (sub. 20, p. 4)

Similar views were put by REST Industry Super, which stated that:

The primary focus should be on the long‑term performance of funds against their stated investment objectives. Relative performance can also be a useful tool for assessing historical performance but should only be a secondary consideration. (sub. 47, p. 36)

##### A long term view of performance

Participants regarded the period over which past performance is measured to be important. The Actuaries Institute argued that the past performance measure adopted should be ‘aimed at reducing scope for trends in relative performance to be distorted by … performance in recent years’ (sub. 45, p. 3). In the context of past performance, Rural and Regional Promotions stated that:

[s]uperannuation is a long term investment and quarterly performance reports can lead to short term speculative investing by fund managers … (sub. DR86, p. 3)

In this vein, ISN contended that they support ‘the inclusion in awards of funds that can demonstrate high net returns over the *long‑term*’ (sub. DR62, p. 17, emphasis added). legalsuper contended that:

… long-term investment performance should be considered over 10 years. (sub. 19, p. 4)

##### The past performance evidence base: the question of persistence

Several participants argued that research supports the use of past performance as an indicator of future returns. The ACTU contended that there is ‘… a statistically significant level of persistence in fund returns’ (though they noted that past performance does not guarantee similar future performance) (sub. DR77, p. 5). ISN stated that a range of research (including work commissioned by them) found that:

… persistence in relative returns has been a feature of the Australian superannuation market. Most relatively strong performers in one period are relatively strong performers in subsequent periods. (sub. DR62, p. 11)

Cbus argued that the performance persistence evidence provides an adequate basis for using past performance as a stand‑alone factor in selecting default funds (sub. DR81).

#### The Commission’s view

The Commission recognises that using past investment performance as a prescriptive criterion when listing default products in awards is intuitively appealing, but has concerns about using past performance as a stand-alone basis for selection.

Regulators globally have recognised the risks to investors of using past performance as a predictor of future performance. This is reflected in the ASIC requirement that a declaration to this effect is included in promotional material for financial products and services (ASIC 2003). The nature of past performance as an ‘unreliable predictor’ was reflected in practice by the Australian Industrial Relations Commission in deciding which default funds to list in modern awards (chapter 7). This conclusion is supported by an extensive body of research literature revealing a lack of consensus on performance persistence among both highly and poorly performing funds. Although some studies do find persistence among some fund categories (for example, Delaney, Watson and Wickramanayake 2011), many studies do not (box 4.2).

The different results between and within studies may be explained by different approaches to the research question. Specifically, results vary according to methodology, performance measurement metrics, and time periods used for analysis (for example, Delaney, Watson and Wickramanayake 2011). In many studies, results differ depending on whether raw or risk‑adjusted returns are used (for example, Hallahan 1999). ASIC consider that investment return metrics are more meaningful if adjusted for risk (ASIC 2002, and confirmed pers. comm., 28 September 2012).

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| Box 4.2 Performance persistence in superannuation funds |
| An extensive body of research reveals a lack of consensus on performance persistence. Where evidence of persistence is found, it is often identified in a category with particular characteristics, rather than in support of persistence for all categories of funds. This limits the extent to which past performance can be relied upon.  Recent Australian research   * In one recent study, some performance persistence was evident. Of formerly top−ranked funds, 43 per cent were subsequently top−ranked, 37 per cent mid−ranked, and 20 per cent in the lowest rank. The results were similar for funds formerly in the bottom rank. Persistence was more pronounced for large funds (with more than $1 billion in assets), though this may be limited to large not‑for‑profit funds. The performance measure was not risk-adjusted (Deloitte Access Economics 2012). * Another recent study found no *general* support for ratings predicting future performance, though some persistence was found among certain categories. Some fund types among higher‑rated funds significantly outperformed in subsequent periods. Funds with the lowest rating severely underperformed in subsequent periods. The study used risk-adjusted fund ratings (Delaney, Watson and Wickramanayake 2011). * In another study, some performance persistence was evident. Of formerly top performing firms (that is, where the aggregate of all their investment options perform in the top rank), 50 per cent had a probability of being top‑ranked from one period to the next, and of firms formerly in the lowest rank, 57 per cent had a probability of being bottom‑ranked from one period to the next. The results show a decline in rank persistence among Australian superannuation firms over time. The performance measure was risk‑adjusted (Sy and Liu 2009).   Other Australian research  Various studies found:   * no support for the predictive power of (risk-adjusted) fund ratings (Gerrans 2006) * no support for performance persistence, once adjustment for risk was applied (Bilson, Frino and Heaney 2005) * no support for persistence using a risk-adjusted performance measure (Drew, Stanford and Veeraraghavan 2002)   past performance is an unreliable guide to future performance. The study employs several methodologies. Some short term (risk‑adjusted) performance persistence was evident for fixed interest eligible rollover funds, and there were ambiguous results for multi‑sector funds. Ranking persistence (risk‑adjusted) was evident for fixed interest eligible rollover funds among top performing funds (Hallahan 1999). |
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Several factors would make the practical application of a relative performance measure challenging, and some of these may lead to undesirable outcomes:

* Conscious of the risk of producing an outcome that is relatively poor compared to other funds or products, funds may be less responsive to changing market conditions. This could be detrimental to market-wide performance.
* At the practical level, there are numerous ways to measure performance and apply performance criteria. It would be difficult to find a measure that would be seen by all as accurate, consistent and that allowed for full comparability between funds.
* Minimum return targets or ‘league table’ approaches would require updating, which could be disruptive to funds (and their members) that are around the cut‑off point (chapter 8).
* Other issues include:
* how to value, and how often to value, unlisted assets that are not traded on an open exchange
* how to account for new funds or products with no performance history.

Due to the lack of consensus in the performance persistence literature, the regulatory guidance and the practical difficulties of applying a performance measure, the Commission is not attracted to using relative investment performance as a prescriptive criterion per se.

Though the Commission sees no case for an additional prescriptive criterion to be applied to past performance in default superannuation products, the Commission accepts that in assessing a fund’s ability to deliver on its MySuper investment objectives, both the appropriateness of the investment strategy and the track record of the product should be factors in the evaluation mechanism. The ‘track record appraisal’ should include an assessment of the past performance of the product against its objectives, and against the market more broadly. The Commission recognises that, as a consequence, decision makers will need to assess close substitutes to understand ‘past’ investment performance of new products.

Further, the Commission considers that where performance is taken into account in making that judgement, decisions should be weighted heavily in favour of long‑term performance. That said, short‑term information may ‘flag’ a pending change in long‑term performance and should not be ignored, but instead form part of the overall monitoring of fund performance.

In the Commission’s view, therefore, a fund’s past long‑term investment performance should not be used in the selection and ongoing assessment of superannuation products for listing in modern awards per se. Instead, it should be used to provide some guidance on a fund’s expected ability to deliver on its MySuper product’s long‑term investment return target, given its risk profile. The latter is a valid factor to consider, and should be given primary consideration among a range of factors.

Recommendation 2

The selection and ongoing assessment of default superannuation products for listing in modern awards should include consideration of the fund’s expected ability to deliver on the MySuper product’s long‑term investment return target, given its risk profile (as a primary factor).

## 3 Fees and costs

Superannuation funds incur investment and operating costs. Investment costs are related to the asset allocation and approach to risk taken by the fund, and whether the assets are managed actively or passively. Operating costs are those that are not directly linked to the investment portfolio, such as administration and compliance costs. The level of overall costs can make a significant difference to the ultimate retirement benefit received by fund members.

### Understanding fees and costs

The investment and operating costs of a superannuation fund can be passed on to members directly in the form of fees. In contrast, some costs are not charged as fees to members and are not always disclosed to members. For example, some costs are allocated against all the assets of the fund (or product), paid out of reserves, or deducted from investment returns. In particular, payments to third parties are not always disclosed to members.

Typically, investment costs are distinguished from operating costs. This assists comparability between funds or products. It also assists members in understanding whether they are obtaining value for money, such as whether the operating costs reflect the quality and timeliness of the services they receive.

### Stronger Super reforms

Stronger Super reforms seek to ensure that MySuper members are charged for costs that are representative of those associated with their account, as well as to aid comparison between MySuper products.

Under the Stronger Super reforms, trustees of MySuper products must disclose all fees to members and may only charge the following fees:

* Administration fee — relating to the administration or operation of the fund (including intra‑fund advice).
* Investment fee (including performance-based fees, subject to limitations).
* A buy–sell spread (limited to cost recovery) — relating to transaction costs incurred in relation to the sale and purchase of assets.
* A switching fee (limited to cost recovery) — relating to costs of switching in and out of a MySuper product and from one choice product to another choice product.
* An exit fee (limited to cost recovery).
* An activity fee (fees for member‑specific costs, limited to cost recovery).

Trustees will also be able to charge an advice fee for some additional forms of financial advice, and an insurance fee (chapter 6). Charging an entry fee for MySuper products is prohibited. Trustees will also be prohibited from deducting any amount from a MySuper product that relates to making a commission payment to a financial advisor (Shorten 2012a).

There must be equal treatment of members by giving all members of a MySuper product:

* the same fees (except: where a discounted administration fee is offered to employees of particular employers; for lifecycle investment strategies where investment fees can be charged according to age cohort; or for financial advice and insurance fees)
* protection against fee subsidisation (since one employee should not be favoured over another where they have the same employer).

In addition, trustees must attribute costs fairly and reasonably across all MySuper products and choice products offered by the fund. This is intended to prevent MySuper members from cross-subsidising other members (Shorten 2012a, 2012b).

A range of Stronger Super reforms are expected to reduce costs, ultimately benefiting members. For example, over the longer term, SuperStream is intended to reduce administration costs for funds. Further, trustee duties will include promoting the financial interests of MySuper beneficiaries, with a particular focus on returns after the deduction of fees, costs and taxes (Shorten 2012d).

#### Improving transparency

Comprehensive data on costs, including fees, are not currently available, though this will change under Stronger Super. All APRA‑regulated funds will be required to calculate fees in a standardised way. APRA will be required to publish quarterly information on fees and costs (and net returns) for MySuper products, and trustees will be required to disclose the information regarding choice products. APRA will have additional powers to collect information on a ‘look-through’ basis. This will enable APRA to obtain more complete and comparable data — particularly in relation to costs — including payments to third parties that are otherwise undisclosed to members (Australian Government 2010d; Shorten 2012a).

The new reporting standards (section 4.2), yet to be released, will provide the exact details of APRA reporting requirements for superannuation entities, including those related to fees and costs. The APRA discussion paper on the reporting standards for superannuation indicates what is currently preferred. It includes the separate reporting of investment and operating cost categories, and a number of sub‑categories within them. It also includes payments to third parties, so that investment costs are captured whether or not they are charged explicitly (APRA 2012g).

The exact data that will be published by APRA — from the data that will be ultimately collected under the new reporting standards — are not yet clear, and have not as yet been the subject of consultation.

### Scope for additional criteria relating to fees and costs

The Stronger Super reforms will limit some fee categories to cost recovery (that is, to the underlying costs that relate to the fee) and, therefore, protect the interests of MySuper members by restricting the size of the fee imposed. However, the Stronger Super reforms will not place limits on investment and administration fees, providing trustees with some flexibility.

The requirement that trustees allocate costs fairly between MySuper and choice products, and the Stronger Super transparency measures, including the ‘look‑through’ reporting of investment payments to third parties (above), will support the fee‑related reforms. However, the exact details of these requirements will remain unclear until early 2013, and the resulting data ‘completeness’ and product comparability is likely to remain uncertain for some time beyond their implementation in July 2013.

#### Participants’ views

Many participants recognised the centrality of fees and costs to the ultimate net returns to members. For example, the Department of Education, Employment and Workplace Relations and the Treasury jointly commented, in the context of the appropriateness of fees and costs charged to members, that:

Net returns (that is, returns after the deduction of fees, costs and taxes) … must be the core criteria used to assess fund performance. (sub. DR89, p. 6)

Only a small number of inquiry participants argued that a fee limit should apply for products to be listed as default products in modern awards, though the benefits of low‑cost options are recognised (for example, Employment Law Committee of the Law Society of NSW, sub. 11). In contrast, REI Super stated that imposing an investment fee limit ignores that ‘… there may be a case … for higher investment fees if active investment management produces higher net performance to members’ (sub. 26, p. 3). In addition, imposing a fee cap may have the unintended consequence of ‘… providers pricing their products at the maximum amount’ (FSC, sub. 30, p. 21).

Other participants believe that the fee rules prescribed for MySuper products are sufficient. The Financial Services Council pointed out that pro-market competition reform has benefited consumers, suggesting that if competition were increased among default products in modern awards, no fee limit would be required (sub. DR80).

Other participants recognised that fees should be one consideration in the selection and ongoing assessment of default products, but fell short of suggesting a limit should be imposed (for example, CPA Australia, sub. 39).

The Actuaries Institute pointed out that when considering this issue, it is ‘vital’ that all costs, and not just fees, are taken into account so that those that are paid indirectly by members, as well as those that are paid directly, are taken into account (sub. 45). Another participant voiced concerns about costs that are paid indirectly by members as a result of third‑party transactions:

… investment structures can allow [costs] and profits to be moved down a chain of entities, rather than being reflected in headline fees. Accordingly if fee comparisons are to be made they should, if possible, adjust for these variations. (DEEWR/Treasury, sub. DR89, p. 7)

In supporting fees and costs as a consideration in listing default products in modern awards, the Actuaries Institute also contended that fees and costs associated with investments should be considered separately from those associated with the fund’s operation. Some participants also emphasised the importance of understanding value for money. In this vein, the Actuaries Institute contended that the appropriateness of the fees and costs associated with investments should be considered in terms of the investment return target and risk profile, and that operating fees and costs should be considered in terms of the services provided (sub. DR60) (box 4.3).

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| Box 4.3 Fees and costs as a criterion for selecting default products ― some perspectives |
| Should be considered  Fees should only be a consideration when a fund is demonstrably charging an unreasonably high fee for administration, or where investment fees are unreasonably high on a like-for-like basis. (AIST, sub. 20, p.12)  CPA Australia believes [the] level of fees … should be considered when determining the suitability of a default fund … All criteria should have equal weighting. Importantly, the focus should be on the overall value or benefit provided to members. (CPA Australia, sub. 39, p. 2)  Fees and costs need to be one of the factors considered when choosing a default fund in an Award or agreement. (Actuaries Institute, sub. 45, p. 4)  Should not be considered beyond MySuper requirements  … the process for authorisation of a MySuper product factors in fees. (Tasplan, sub. 6, p. 4)  Fees should not be a factor beyond the standards set by MySuper. It is the net return to members and services provided which are important. (Unions NSW, sub. 13, p. 5)  Other comments  Low or no cost options should be considered in any review for younger workers. (Employment Law Committee of the Law Society of NSW, sub. 11, p. 1)  In looking at products, it is not possible to look at fees alone. (Association of Financial Advisors, sub. DR73, p. 3)  A maximum fee limit should apply to all superannuation products listed in awards. The decision about whether the member would benefit from a higher-fee fund should be made by each individual member, not by anyone else on his/her behalf. (Australian Hotels Association, sub. 10. p. 8) |
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#### The Commission’s view

The Commission sees no case for additional prescriptive criteria in relation to fees and costs. In relation to fees, a blanket cap on fees could impede optimal investment performance outcomes. In terms of investment fees, setting a fee cap risks decision makers and trustees focussing on costs to the detriment of investment performance. The imposition of such a cap could prevent funds offering a MySuper product that delivers better outcomes for members, such as one with a highly diversified investment strategy and a higher return target, with the same (or lower) risk profile. As trustees become reluctant to increase their expenses, including investment management expenses, this could lead to a ‘race to the bottom’ in terms of performance.

Though the Commission does not support a blanket cap on fees, it supports the cost recovery limits prescribed for MySuper products that apply to some fee types (such as for switching and exit fees). This is because a cap on these fee types will lower overall costs to members, emulating the outcomes of competitive market forces.

Though the Commission does not support additional prescriptive criteria in relation to fees and costs, it regards them as valid factors for consideration in the assessment of products to be listed in modern awards. Firstly, the Commission recognises the benefit of taking into account all the costs, as well as the fees, associated with a MySuper product, as a focus on fees alone may ignore costs that are indirectly attributed to members and ultimately reduce net returns to members. All the costs and fees should be taken into account, to the extent that this information is available. Secondly, in doing this, consideration should be given to the value for money to members, given the MySuper product’s long‑term investment return target and risk profile, and the services provided to those members.

The Commission acknowledges the benefit of distinguishing between investment and operating costs in understanding delivery of value for money to members, and of taking into account payments to third parties. However, until the new reporting standards are bedded down, and the public availability of the data collected under these arrangements is clear, the extent to which this will be possible remains uncertain.

Recommendation 3

The selection and ongoing assessment of default superannuation products for listing in modern awards should include consideration of the appropriateness of the fees and costs associated with the MySuper product, given:

* its stated long‑term investment return target and risk profile
* the quality and timeliness of services provided.

## 4 Scale

Scale refers to both the number of members and value of assets in a superannuation fund. Economies of scale will result if there are fixed costs that are distributed across a greater number of members/value of assets, and these reduced costs (per member or dollar of assets) may benefit members in the form of lower fees and costs and improved net performance. In the case of superannuation funds, economies relating to size of membership can be achieved in such areas as the collection of contributions, record keeping and marketing (Impavido, Lasagabaster, and García‑Huitrón 2010). Economies relating to the size of the assets can be achieved through lower investment‑related transaction costs. Economies associated with size of membership and assets are interrelated to the extent that additional members will add to the asset base.

### The scale of superannuation funds

The scale of superannuation funds by asset size increased over the period 2004 to 2007 for all fund types, before the effects of the global financial crisis took their toll. Assets increased again between 2010 and 2011 (figure 4.2). The scale of superannuation funds has increased over the same period that expenses have trended downward, suggesting that falling expenses may be a result of increased scale economies (for example, Deloitte 2010).

### Stronger Super reforms

Current regulatory arrangements do not include a scale test for superannuation funds. Though Stronger Super reforms will not prescribe scale requirements for funds that offer MySuper products, trustees will be required to consider scale.

In the process of seeking MySuper authorisation, a trustee will have to demonstrate to APRA that the product has access to ‘sufficient scale’ to provide net returns that are in the best interests of members (or, for a new entrant, that they have a credible path to achieving sufficient scale). MySuper trustees must implement the ‘scale test’ on an annual basis. Where trustees determine that assets or members are insufficient to meet the scale test, they must take appropriate action to meet their obligations. APRA will provide prudential guidance on relevant considerations for trustees in rectifying insufficient scale (Shorten 2011b, 2012d). APRA have indicated that in this regard, their concern will be long‑term performance, and there would be ‘no concerns with a small fund that was performing well’ (APRA 2012d, p. 3).

Figure 4.2 Scale of superannuation funds by asset size**a, b, c, d, e**

Default funds versus non-default funds, indexed

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a Based on APRA-regulated superannuation funds for which return data are available for all years 2004–2011. b Excludes pooled superannuation trusts, exempt public sector superannuation schemes, small APRA‑regulated funds and single‑member approved deposit funds. Self managed superannuation funds regulated by the Australian Taxation Office are excluded. c Includes Eligible Rollover Funds. d Default fund data based on superannuation funds listed in modern awards (as at September 2012), for which return data are available for all years 2004–2011.e Based on cash flow adjusted net assets.

*Sources*: Productivity Commission estimates based on APRA fund‑level profiles and financial performance data 2011 (APRA 2012j); FWA (2012e).

Further, other Stronger Super reforms are expected to increase the scale of superannuation funds. New operational risk financial requirements will require APRA‑regulated funds to hold a minimum level of operational risk reserves (APRA 2012b). These higher capital standards may accelerate merger activity. This will complement the ongoing restructure of the superannuation industry that has already seen a significant number of fund consolidations in recent years (AMP, sub. 52) (chapter 2). Ongoing consolidation will be supported by the recently announced capital gains tax relief provisions for superannuation funds (Shorten 2012h), regarded by some as a prerequisite for ongoing merger activity (Asset Super, sub. 32).

### Scope for additional criteria relating to scale

#### Participants’ views

Few inquiry participants believe that scale should be considered when listing superannuation products in modern awards, but some recognised scale benefits. For example, REST Industry Super contended that scale facilitates the development of business capabilities, and may result in a broader range of investments and improved overall rates of return (sub. 47). Further, where scale exists, it may be used to reduce costs.

Scale allows a trustee to negotiate better rates with service providers such as investment managers, administrators and custodians. (AMP, sub. 52, p. 6)

Most participants believe that the MySuper scale requirements are sufficient, and that no additional scale requirements should apply (box 4.4). One participant indicated that scale economies could be accessed, even by small funds.

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| Box 4.4 Scale as a criterion for selecting default products — some perspectives |
| Should be considered  Entry to awards after 2013 [should] be conditional on funds being able to prove to APRA that they have operated [on] an equivalent of a scale … that would make it appropriate for award inclusion. (ACTU, sub. 29, pp. 11–12)  Should not be considered beyond MySuper requirements  Funds will be required to make their own assessment of scale to ensure that they are able to offer a MySuper product that is in their members’ best financial interests. As this process is a threshold MySuper criteria, it should not be a criteria that is duplicated in the selection of funds in awards. (AIST, sub. 20, p. 16)  We believe [scale] is adequately addressed in the MySuper licensing process and ongoing ‘scale test’. (REI Super, sub. 26, p. 5)  There is no ideal fund size in assessing member value. Regardless, the MySuper framework contains a requirement that a MySuper trustee annually makes an assessment of scale. (FSC, sub. 30, p. 24)  We do not believe that scale should be a deciding factor as smaller or specialised funds may provide the necessary value to employees in a particular industry or achieve scale through pooling administration or investment resources. (CPA Australia, sub. 39, p. 2)  … it is not the case that … returns [always] increase in sync with fund size increase. (Tasplan, sub. 6, p. 5).  Lower costs are irrelevant if the benefits are not passed on as lower fees and better returns for members. Large retail funds benefit from scale, but the data show their cost savings go to profit for shareholders and not to benefit for members. (Wilson Sy, sub. DR58, p. 1) |
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The Transport Industry Superannuation Fund pointed out that:

The way the fund works due to its small size is to outsource for expertise and to achieve scale and efficiencies and they do that in the areas of corporate governance, investment and [administration] and promotion. (trans., p. 147–8)

One participant spoke out more strongly against using scale as a criterion, contending that there is ‘no generally valid relationship between scale and the cost of running superannuation funds’ (Wilson Sy, sub. DR58, p. 1).

#### The Commission’s view

Imposing a prescriptive scale criterion that requires a minimum fund size would ignore the possibility that superannuation funds can access ‘scale advantages’ in a number of ways other than through internal growth or merger activity. The outsourcing of administrative or investment components can realise similar benefits (such as by using organisations that offer a ‘one‑stop‑shop’ investment capability) (Deloitte 2010).

The imposition of a prescriptive scale criterion that requires a minimum fund size could also penalise small well‑performing funds, and might have the unintended consequence of shutting out new and smaller players, preventing competition.

Further, a prescriptive scale requirement would ignore that scale is just *one* factor among many that influence fund investment performance. Such a requirement would risk introducing ‘false security’ for decision makers, and may divert focus from other important considerations.

The MySuper ‘scale test’ is a flexible approach without the disadvantages outlined above, though its success will depend on the thoroughness with which APRA reviews each MySuper application, and the extent to which it monitors the annual ‘scale test’ review.

The Commission considers that the MySuper requirement for trustees to consider scale is appropriate, and that no greater prescription of scale is required.

Recommendation 4

The selection and ongoing assessment of default superannuation products for listing in modern awards should not include scale as a specific factor for consideration over and above the MySuper ‘scale test’.

1. The rate of return is the ratio of money gained or lost on an investment, to the amount of money invested. This analysis compares the performance of current default funds to non‑default funds. It is based on average performance of groups of funds and gives no indication of dispersion around the average. [↑](#footnote-ref-2)