Submission to Productivity Commission Inquiry into Default Superannuation Funds in Modern Awards.

Clear disclosure

One of the goals of the Inquiry is to design 'transparent and objective criteria' that facilitate effective comparison. The criteria set by the Productivity Commission Inquiry for assessment will define a group of superannuation funds eligible to be nominated as default funds in modern awards. However at some later stage, employee organisations or employers will need to choose a single default fund from among eligible funds. A careful and well-founded selection at this stage will depend on the clarity of disclosures by eligible funds against the criteria set by this Inquiry.

Employers or employee organisations choosing default funds need to be offered investment strategy information that is sufficiently clear and complete to allow them to choose a fund offering the appropriate default investment strategy. Although the introduction of MySuper will go some way towards standardising default investment options, not all default investment options in eligible funds will be the same. The key requirement is that a single investment strategy be offered to members of a given MySuper product. Employers choosing default funds will need to consider the investment strategy of alternative funds and weigh up the risk and expected return profile of those funds. Core financial theory predicts that rational individuals will make this decision by balancing the benefit of higher expected returns against the cost of greater volatility of returns. However recent studies of individual-level investment choices show that such choices are sensitive to the description of returns and risk offered to decision makers.

Related research on investment risk disclosure

In 2010 our research group conducted an experiment involving 1200 participants selected randomly from an online panel of over 600,000 Australians (Bateman et al 2011a,b). In the survey, participants were asked to select an investment for their superannuation balance, and all future contributions, from a very simplified list: a bank account (yielding a fixed 2% above inflation each year), a growth account (with expected return of 3.5% above inflation) and a 50:50 mix of both. Participants were asked to indicate the best and worst of these three accounts under (a) alternative levels of risk that (b) were presented in different ways.

Some of the risk presentations closely followed industry practice. (See Table 1 below.) Of particular interest is risk Presentation 6, which has been adopted as the standard investment risk description for superannuation fund product disclosure under APRA guidelines.

Table 1.

Risk presentation examples at growth account risk of 16% p.a.	
Ranges	
1	There is a **9 in 10** chance of a return **between** -19.5% and 32.5%.
2	There is a **1 in 10** chance of a return **outside** -19.5% and 32.5%.
Tails	
3	There is a **1 in 20** chance of a return **above** 32.5%.
4	There is a **1 in 20** chance of a return **below** -19.5%.
Frequency relative to zero	
5	On average, **positive** returns occur **12 years in every 20**
6	On average, **negative** returns occur **8 years in every 20**.
Frequency relative to bank account	
7	On average, **returns above the bank account** occur **10.5 years in every 20**.
8	On average, **returns below the bank account** occur **9.5 years in every 20**.
Range graph	
9	Graphical presentation of 1

The experiment varied the levels of risk of the growth account from 12-28% p.a. which changed the content of the presentations above. At the highest risk level, for example, Presentation 1 reads 'a **9 in 10** chance of a return **between** -34% and 55%'. If individuals have at least some distaste for risk and they understand what is going on, then there are certain account choices, or combinations of account choices they will not make. For example, individuals should never rank the most diversified (50:50) account as the worst; and if a participant chooses the safest account (bank) when risk is at its lowest level, then they should not switch to a riskier option when risk is at a higher level.

Participants made choices *inconsistent* with understanding of, but distaste for, risk at rates that varied from 14% to 37% depending on how risk was presented. When risk was presented as ranges or as a range graph, inconsistency rates were lower, around 20%. When risk was presented as frequencies around benchmarks, as in Presentation 6 (the approach nominated by APRA, after consultation with industry), inconsistency rates were higher, around 30%. Inconsistency rates were higher among younger participants (18-34 years), especially for the frequency presentations, and among participants with poor numeracy skills.

Our findings are supported by other academic studies. Similar range-based investment risk descriptions were rated by subjects as the most 'understandable', 'useful' and 'suitable' when compared with ten other formats (ratings scales, probabilities of losses, gains or targets, and a graph of the probability distribution of returns) in work by Vlaev, Chater and Stewart (2009). Range presentations were also linked to greater stability of risk preferences

when subjects were re-surveyed some months later. In general, ranges allow participants to balance possible gains and losses in their judgements, which is a crucial component of risk perception (Weber and Milliman 1997).

Moreover, when range information around an average is illustrated in the graph (as in presentation 9 in our study), inconsistency rates are lowest. Visual displays may help understanding of numerical risks by picturing proportional differences, allowing better comparisons (Lipkus 2007).

Implications: 'Appropriateness of investment strategy of default fund'

This body of research into financial decision making indicates that the ability of any employers or employee representatives to choose a default superannuation funds with an appropriate investment strategy will depend on the way that investment risk is communicated. Disclosure standards should aim to facilitate a rational comparison between risk and return. While there is more work to be done on understanding risk presentations, existing studies favour joint descriptions of both upside and downside return variability around an average, allowing either textual or visual comparisons between alternatives.

References:

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Vlaev, I., Chater, N., and N. Stewart, "Dimensionality of Risk Perception: Factors Affecting Consumer Understanding and Evaluation of Financial Risk," Journal of Behavioral Finance 10(3) (2009), 158-181.

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