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Catch-97

Over the last month, the Trustee Boards of every large superannuation fund in Australia have publicly declared that they have breached their fiduciary responsibilities to their members.

This occured when superannuation funds start reporting their Indirect Cost Ratios under ASIC's RG97 (Regulatory Guide 97).

In short, everyone has become so caught up in what ASIC and APRA have said they want – i.e. for superannuation funds to report all investment related cost, in particular investment management fees of trust and other pooled investments, as an 'Indirect Cost' under RG97 – that no one has taken notice of what the Regulations actually say.

The key issue is that one of the key clauses in the RG97 Regulation, which defines 'Indirect Costs' – RG 97.23 – states: (emphasis added)

> 'Indirect Costs' means any amount that **the issuer knows**, **reasonably ought to know** or, where this is not the case, **may reasonably estimate will directly or indirectly reduce the return on the product or option** that is paid from, or the amount or value of, the income of or property attributable to:
> a) the product of option; or
> b) an 'interposed vehicle' in or through which the property attributable to the product of option is invested.

In other words, an *Indirect Cost under RG97 is a cost that superannuation fund Trustee / Directors know (i.e. believe) or reasonably ought to know (believe) will reduce the returns of the superannuation product or option*.

Thus, by declaring, as required by RG 97.23, that investment management fees for active investments held through trust vehicles are Indirect Costs, Trustees are **declaring that they believe that active investment management reduces fund returns by the amount of the investment management fees reported (i.e. by 100% of the fee paid)**.

Making such a declaration is likely to be problematic for several reasons:

1) If Trustees **actually believe** that investment management fees, as calculated under RG97, reduce the net returns of funds by the amount of the fees, then it is **very difficult to see how employing active management is consistent with trustee's obligations under SIS** to:
   - exercise their powers, "in the best interests of the beneficiaries" (52(2)(c)); and
   - for MySuper products to, "promote the financial interests of the beneficiaries" (29VN(a))

2) Even if Trustees believe that investment management fees reduce fund returns, it is unlikely that they believe that returns will be reduced by 100% of the fees paid. (For example, it would be difficult to argue that performance fees reduce the return on a superannuation product, when they represent only a portion of increased investment returns earned as a result of active management!) This suggests that even if Trustees actually believe that investment management fees reduce returns, only a proportion of the fees should be included in Indirect Costs.

3) Of course, in reality, virtually all superannuation funds state in their public documents that they **believe that active investment management increases returns**. (See the quotes in the appendix below.) It is difficult to see how Trustees will reconcile declaring that they believe that fees paid to active managers of trust investments are Indirect Costs and hence reduce returns, with their public statements declaring that they believe that active management increases returns after fees.

Such a 'Catch-22' situations may be trivial or even humorous, but not in this case.

Including investment management fees paid for active investment management in the Indirect Cost Ratio under RG97 places the Trustee / Directors of Australian Superannuation funds in the invidious position of admitting either that they have not been acting in the best interests of beneficiaries, or that they have made false statements to beneficiaries and potential members.

Of course there is another sensible course of action available.

Trustee / Directors can simply say what they have already publicly stated – that they believe that active investment management will increase the return of superannuation products or options - and that therefore **investment management fees are not Indirect Costs as defined by clause 97.23 of RG97**.

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Australian Superannuation Funds' Investment Policies

Quotes from public documents:

Australian Super
Australian Supers investment approach is underpinned by 4 core beliefs:

- Using active management where it can add value.

REST
… appointing active investment managers (i.e. manager selection) to manage the underlying investments where we believe the expected benefits exceed the costs of active management.

HESTA
We engage a range of professional fund managers to invest member's money …

CBA/Colonial First State
Our investment philosophy is based on these principles:

- We believe that active management can generate outperformance.

Westpac / Advance Asset Management
At Advance we handpick the best available investment managers in the market to create … investment solutions that deliver the best risk/return balance for our investors.

NAB / MLC
MLC identifies and hires from among the best investment managers in the world.

Unisuper
When appointing external managers we look for:

- A high level of investment insight, demonstrated through superior generation of ideas and a record of delivering good performance.

First State Super
Our investment managers are responsible for selecting high quality investments and taking advantage of market conditions to make sure we get the best possible returns for you.

Sunsuper
Sunsuper has a belief in active investment management.
We believe that active management, including enhanced passive management, will result in returns higher than returns from index managers, even after active management costs are taken into account.

CBUS
The fund invests primarily in active managers.