

# **Submission to the Productivity Commission's Assessment of the Efficiency and Competitiveness of the Australian Superannuation System**

## **Comments on the Draft Report**

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I congratulate the Productivity Commission on the Draft Report and Public Hearings. I particularly endorse the Commission's awareness of the importance of the Net Investment Returns to members, rather than having the misguided concentration on 'cost reduction' that has been the focus of regulation and discussion to date, to the detriment of members long-term outcomes.

This submission represents my own personal views, informed by both my own research and almost four decades of direct involvement in the investment industry.

While most of the recommendations of the Draft Report appear to be reasonable and practical, this submission provides comments on three interrelated matters:

1. *Investment Performance Measurement and Benchmarking*
2. *The proposal to select 'Best-in-Show' superannuation funds as Default Funds via the use of an Expert Panel; and*
3. *Investment Management Fees.*

### **1. Investment Performance Measurement and Benchmarking**

The analysis comparing fund and investment option performance versus tailored benchmarks is a useful attempt at resolving the many problems inherent in using a benchmark in performance assessment. Unfortunately, it appears that the Commission may have formed an overly optimistic opinion as to the reliability and usefulness of this approach. There are multiple weaknesses in basing the assessment of fund performance on asset allocation benchmarks, including:

- a) There is nothing that makes any particular asset allocation (or benchmark) intrinsically or objectively 'good'. Therefore it is not possible to describe a deviation from a benchmark - in either allocation, volatility or return - as risky or 'bad'.

This fact is generally not appreciated. However, as actual volatility and return characteristics of a particular asset allocation in the future cannot be known when it is established - as future asset class behaviour is subject to uncertainty – then the only thing that can be known with certainty is that expected characteristics and relationships (such as level and variability of returns, the relationship between asset market behaviour (correlations), and the relationship with liabilities) will not eventuate. This is hardly a feature that justifies using a particular asset allocation as a meaningful reference point against which to assess fund performance

- b) The method used to determine the tailored benchmark asset allocations (BP1 and BP2) as described in Technical Supplement 4, is likely to have captured some aspects of active asset allocation decisions in the returns of the benchmarks. Ideally, a performance reference (or benchmark) would be defined at the beginning of the investment period and assessed at the end. (i.e. the assessment would be against an out-of-sample result.)

In this case it appears that the asset allocation of the BP1 and BP2 benchmarks were varied across the period, with no evidence provided that this change represented anything other than active decisions to move away from the then applying asset allocation at the fund level.

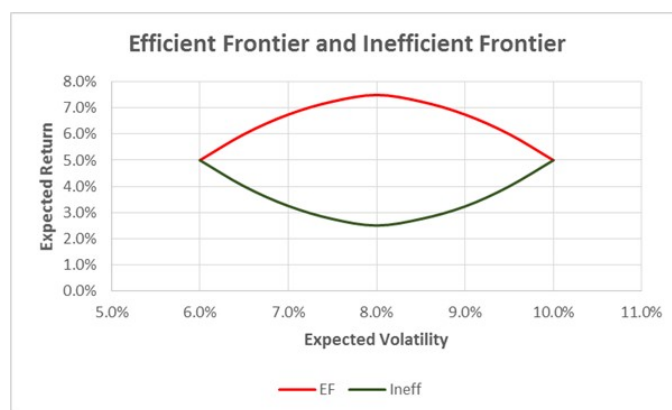
- c) The pool of investible assets is not static. This is particularly relevant over the investment period of the superannuation fund member – 40 plus years – but can also be significant in shorter time periods. For example, over the last 40 years the following changes occurred in the available set of investments;
  - a. Abolition of the 30/20 Rule
  - b. Currency exposures in overseas assets following the floating of the Australian Dollar in 1983
  - c. Over the counter instruments (swaps, options, etc.)
  - d. Infrastructure (evolved from the mid-1990's as an investible strategy)
  - e. Fund-of-Fund Hedge Fund and Private Equity strategies – now largely abandoned at an institutional level
  - f. Volatility instruments (VIX, XIV, etc.)
  - g. Factor strategies (multiple types)
  - h. Exchange Traded Funds
  - i. Direct Lending Credit strategies

As a result any asset allocation benchmark will require regular review and updating, which invalidates its use as a performance reference.

- d) The expected, and actual, future results from any asset allocation is very uncertain – far more uncertain than is reflected in the Draft Report.

By way of explanation, we typically see, and hence perceive asset allocations in terms of expected portfolio risk and expected portfolio returns. Most commonly these asset allocations are represented by an ‘efficient frontier’ of portfolios as shown by the red line in Figure 1. (Note: Technically, the Efficient Frontier’ is the portfolios with the highest expected return for each level of expected volatility – i.e. the full red line - however commonly only the upper-left segment is plotted.)

**Figure 1**

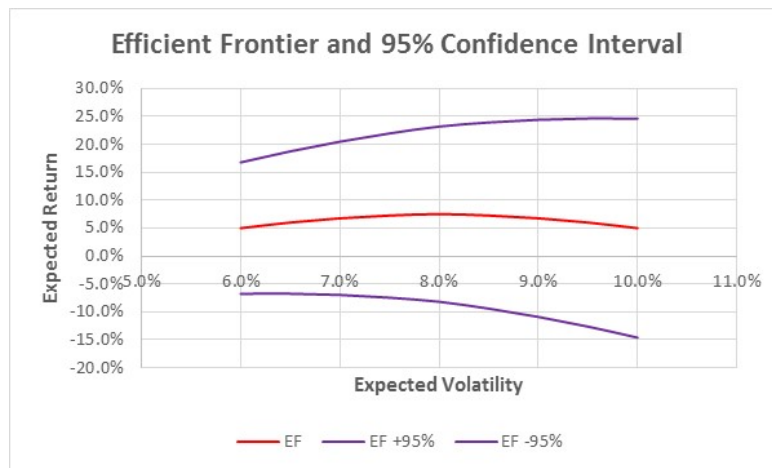


Additionally, as ‘efficient’ portfolios make up only a very small proportion (approximately 1%) of the possible portfolios given by a reasonable set of expected returns, expected volatilities, expected correlations, and allocation restrictions, it is useful to also plot the ‘inefficient frontier’. This is in green in Figure 1.

The common practice of plotting the efficient frontier asset allocation as a line is highly misleading, in that it ignores what the horizontal axis (Volatility or Standard Deviation of returns) actually represents.

Under the scientific method it is normal practice to provide a measure of potential error or uncertainty of the outcome – i.e. the level of expected returns. This can be done in several ways, however in this case the most applicable method is to construct a Confidence Interval (CI) around the expected outcomes. The 95% CI around the efficient frontier in Figure 1 is plotted in Figure 2.

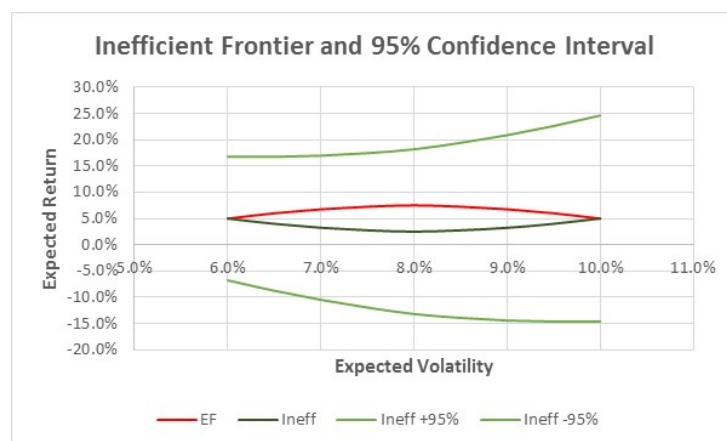
**Figure 2**



As can be seen from Figure 2, the range of returns within which the asset allocation portfolios on the efficient frontier can be expected to fall, with a 95% probability, is very wide – specifically 1.96 Standard Deviations (or 1.96 times the Volatility as Volatility equals Standard Deviation), either side of the efficient frontier.

Moreover, if we also plot the 95% CI for the inefficient frontier (see Figure 3) we can see that the Confidence Intervals for the efficient and inefficient frontiers overlap virtually completely.

**Figure 3**



In other words, there is virtually no statistical difference in the future return to be expected from any of the possible asset allocations (or benchmarks).

For these, and other reasons, the use of benchmark asset allocations in the assessment of fund performance is flawed. It follows therefore that selecting a particular level of

underperformance of the benchmark - 0.25 percent, or 25 basis points is widely suggested in the Draft Report – is meaningless and almost certainly misleading.

I also note that the Commission perceives an, ‘evidentiary need to analyse long-term investment performance by asset class — to afford an international investment performance comparison and a more robust system assessment’ (p91). It is not at all clear that this perception has merit.

An analysis of asset class returns will not provide useful information about the performance of funds and options at an overall level – and hence assist with ‘system assessment’. It is well recognised by practitioners that attempts to build-up overall fund performance from sector level attributions is not meaningful. Any measurement insight quickly gets swamped in a sea of cross-product (interaction) terms. The most practical, and meaningful, approach is to work with the highest level of aggregated data available – in this case fund level performance. It is likely that the same challenge would apply to ‘international investment performance comparisons’.

Note: This observation is consistent with observation on page 16 of my September 2016 submission to the Commission that, ‘This is a basic characteristic of complex systems in general, where the overall pattern of outcomes can be difficult, or impossible, to identify from the analysis of only a small part of the whole’.

I would therefore counsel against any expectation that asset class level performance assessment would prove useful in the assessment and selection of funds for inclusion in a ‘Best-in-Show’ list. The nature of the complexity of markets (Note: complex not random) is that it will be exceedingly rare for any fund to add value in all asset classes simultaneously in any particular period. If this were included as an assessment criteria, then the set of Best-in-Show funds would almost certainly be empty.

## **2. ‘Best-in-Show’ Superannuation Funds and Expert Panel**

The idea of appointing a panel to select ‘Best-in-Show’ funds has a conceptual appeal, however such an approach is fraught with multiple issues, which almost certainly make it unworkable as proposed. I will comment on a limited number of specific aspects:

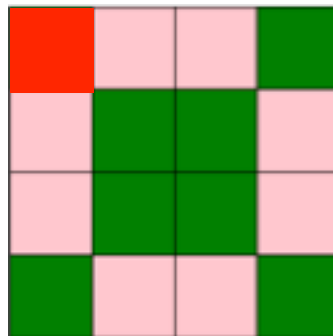
- a) **Fund Selection:** The task that the Panel is to be set is essentially the same as the process used by investors (including superannuation funds) to select investment managers. The best practice approach to manager selection is an inherently subjective process, with the assessment of past performance used primarily as a

checking procedure – i.e. to confirm whether past performance reconciles with the managers skills and investment approach. Under such an approach underperformance of a ‘market benchmark’ in certain market conditions, or over a period of time, may be confirmatory, and not a reason to form a negative view.

Further, the September 2016 submission noted that managers who performed consistently would be found in the second and third quartiles of relative performance. The same applies to superannuation funds, with the optimal fund for a ‘whole-of-working-life’ investment outcome being one who consistently adds value over time, while avoiding extreme outcomes along the way as a result of good and bad luck.

I have included below (Figure 4) a slightly modified version of the Pattern of Performance that would be expected when active managers are adding value in complex markets.

**Figure 4**



In this case, those managers who performed in the first quartile in both the first and second periods – which we have determined will be primarily due to luck – are highlighted in red. If we consider the Sharpe Ratio (which like all concept of ‘risk adjusted’ returns is based on calculating a ratio of return to volatility), then the reality will be that a preponderance of the managers with the highest Sharpe Ratio will be found in the upper-left corner. (The reason for this is that volatility is actually quite stable relative to the dispersion of returns, and therefore the volatility of most managers will be largely similar.)

The implication is that those managers with the highest Sharpe Ratio’s will tend to be those who are the least consistent, but have happened to have had back-to-back lucky results. The same concept applies to all other forms of statistical ‘risk-

adjustment'. It also applies equally to superannuation funds as it does to investment managers.

Given the above considerations there is unfortunately no evidence to support the assertion on page 35 of the Draft Report that, "Our changes to default allocation will immediately benefit new entrants to the workforce by placing most in a fund that is **likely to deliver the best outcomes**", (emphasis added).

In short, the task of selecting those funds who will be the best performers going forward is extremely difficult, and requires significant appreciation and understanding across a wide range of assessment criteria. I suspect that the proposal in the Draft report underestimates the difficulty inherent in selecting the Panel.

- b) The proposal to select 10 'Best-in-Show' superannuation funds as default funds will elicit **behavioural responses** from industry participants which are very likely to produce unintended consequences.

The Commission appears to be underestimating the impact on 'Best-in-Show' selection on flows to, and thus the economic value to be gained by, the ordained funds. Specifically, I refer to Figure 13 on page 36 of the Draft Report and associated analysis. The analysis does not take into account the behavioural response of financial advisers who, under the new regime, will be motivated – indeed probably required – to recommend allocations, including switches, to 'endorsed' funds to clients when giving advice. Thus, the financial benefit for a fund of inclusion on the Best-in-Show list is likely to be much more significant than anticipated. Of course, the corollary also applies in that a failure to be included on the list is likely to have greater adverse effects on funds in terms of slower growth (or net loss) in members over time, with related negative scale impacts.

- c) Selection of a Best-in-Show list will potentially have unintended adverse effects on innovation and competition across the industry by restricting the entry of new participants and products. Specifically, potential new entrants will find it less attractive under the proposed regime as financial success will depend not only on factors under their control, such as product characteristics, distribution and

marketing, but also on the uncertain prospect of being selected on the Best-in-Show list at some indeterminate time in the future.

While members of the Panel may be selected using defined criteria and with the best of intentions, the reality is that the current consensus views – or orthodoxy – will tend to dominate the Panel’s perceptions, and this will almost certainly favour the incumbents. A few examples of this effect include:

- a. In the late 1970’s / early 1980’s the management of superannuation fund assets was dominated by the large mutuals, specifically AMP and National Mutual, and the banks. Around that time a number of innovative new superannuation fund managers such as Bankers Trust (BT) and County Natwest emerged. While in hindsight the new skills and approaches introduced proved highly effective and beneficial to funds and their members, it is highly unlikely that these managers would have been accepted and endorsed as being Best-in-Show by a Panel unconsciously steeped in the then current orthodox views around ‘best practice’.
- b. In the period leading up to the stock-market crash in October 1987, a significant number of superannuation fund trustees, on the basis of what was perceived by them to be the ‘best’ available independent advice, switched managers from BT to other ‘higher performing’ fund managers such as Equitilink, SPAL and ANZCAP. (In the year to June 1987 the BT fund had earned only 50%, while the higher performing funds had earned 70% plus.) After the October crash many of those same superannuation funds returned their investments to BT – but often with only cents in the dollar remaining. A Panel selected prior to the crash in 1987 would have been likely to have a very different set of members than one selected post October.
- c. Towards the end of the 1980’s and in the early 1990’s, partly in reaction to the October 1987 stock market crash, the superannuation industry consultants, in particular led by what was then Tower Perrin Foster & Crosby (TPF&C – now part of Willis Towers Watson), strongly endorsed superannuation funds that they advised implementing new investment strategies based on the adoption of long-term static (a.k.a. Strategic) asset



allocations implemented through specialist, rather than diversified multi-asset class, managers. This was viewed / sold as ‘best practice’ at the time. Of course today all investment consultants endorse, and sell, non-static (i.e. dynamic) approaches to asset allocation, and many superannuation funds are recreating diversified multi-asset class managers through the insourcing of their investment functions.

- d. As a final example I refer to the apparent ‘capture’ of the superannuation industry’s principal regulators (APRA and ASIC) by the current academic orthodox view that, ‘as investment managers cannot consistently add value, or that if some can it is impossible to select them in advance, then all investment management fees are ‘bad’ and fund members will unambiguously benefit by reducing investment costs’. This argument is clearly fallacious, however this has not stopped the introduction of distorting ‘fee and cost reporting’ arrangements (including, but not limited to RG97), which, as demonstrated in my previous submission, are currently costing superannuation fund members billions of dollars each year in foregone returns. (I should note that at the time of writing, the Report of ASIC’s Review of Fees and Costs Disclosure in Relation to Superannuation and Managed Investment Products, while imminent, has not been released.)

It is also worth being cognisant of the glaring inconsistency between the positions of ASIC and APRA, who reject the possibility of selecting managers who can outperform, and the Commissions proposal to establish a Panel to select managers (i.e. funds) who will outperform. While I see significant difficulties in the Commission’s proposal, I do however strongly support the view that it is possible, although difficult, to select managers who will add value going forward.

In summary, the proposal to establish an expert Panel, with the objective of selecting a set of 10 ‘Best-in-Show’ funds to constitute a default list, has significant challenges. On the other hand, such a Panel may be very appropriately used in selecting funds that should be removed from the industry under, or in conjunction with, an Elevated Threshold for MySuper authorisations. I can see significant benefits in having this process overseen and decided upon by an expert Panel, rather than by a regulator.

### 3. Investment Management Fees

The Draft Report observes correctly that higher fees reduce returns to members. However, there is insufficient differentiation between the impact of different types of fees.

Few would argue that reducing administration fees, and scale related reductions in investment fees, are beneficial and contribute to higher end balances for members.

On the other hand, the payment of investment fees to active investment managers by superannuation funds has contributed to higher net returns and balances. While it is tempting to launch into a full analysis and explanation of this assertion, it may be more appropriate to give two common sense and public examples of where and why this occurs:

- a) First, the Productivity Commission, in its Draft Report on the Assessment of the Efficiency and Competitiveness of the Australian Superannuation System of April 2018, calculated the returns for two asset allocation ‘benchmarks’ – BP1 and BP2 – against which to compare funds’ performances.

Based on the explanatory information contained in Box 2.2 (page 95) and Technical Supplement 4, it appears that the principal difference between BP1 and BP2 is that unlisted asset classes - in particular Direct Property, Infrastructure and Private Equity – are incorporated into BP2, whereas all asset classes in BP1 are listed.

The return sources provided indicates that most, if not all, of the listed asset classes are described by passive market indexes (net of fees and tax effects). Alternatively, the unlisted asset classes have the characteristic that they do not exist without the application of manager skill, and hence the incurring of active manager fees.

**The most important result found by the analysis conducted is not how funds performed relative to the benchmarks (this is discussed under (1) above), but the fact that in all cases the higher fee BP2 benchmarks materially outperformed the lower fee BP1 benchmarks.**

While the 2006-2015 return of 5.49% p.a. for the BP1 benchmark is reported in Figure 2.3, the return for BP2 appears to have been omitted. In any case, a visual

inspection suggests that BP2 outperformed BP1 by more than 0.5% p.a. over the period. This underperformance by BP1 is significantly larger than the 0.25% p.a. margin suggested by the Commission (p 95) as the threshold for identifying ‘underperformance’.

The important issue, that is largely ignored in the debate around the cost or benefit of investment management fees, is that there are two effects that occur when investment management fees are reduced:

- i. Actively managed investments in core asset classes are reduced and replaced by indexed strategies; and
- ii. Asset allocations to investment strategies that only exist as a result of the application of manager skill – such as Unlisted Property, Private Equity, infrastructure and Hedge Funds – are reduced.

Both of these adjustments can be expected to reduce fund returns over time. The Productivity Commission’s analysis highlights these effects

- b) Second, two large superannuation funds have, whether consciously or not, been conducting scientific experiments that compare the impact of reducing fees on superannuation fund returns. Specifically, both Australian Super and Hostplus have created indexed (i.e. low investment management fee) investment options with essentially the same risk and return expectations as their actively managed Balanced investment options.

The return from these strategies for the 7 years that the experiments have been running are set out in Figures 5 (Australian Super’s options) and Figure 6 (Hostplus’s options).

**Figure 5:** Australian Super Active and Passive Investment Options to June 2018

Option	1 Year	2 Years p.a.	3 Years p.a.	5 Years p.a.	7 Years p.a.
<b>Balanced (Active)</b>	11.08%	11.76%	9.30%	10.51%	9.81%
<b>Indexed Diversified</b>	9.41%	9.05%	6.88%	8.01%	7.34%
<b>Active Outperformance</b>	<b>1.67%</b>	<b>2.71%</b>	<b>2.42%</b>	<b>2.50%</b>	<b>2.47%</b>

**Figure 6:** Hostplus Active and Passive Investment Options to June 2018

Option	1 Year	2 Years p.a.	3 Years p.a.	5 Years p.a.	7 Years p.a.
<b>Balanced (Active)</b>	11.67%	12.43%	9.90%	10.85%	10.14%
<b>Indexed Balanced</b>	9.61%	9.93%	7.29%	9.38%	9.33%
<b>Active Outperformance</b>	<b>2.06%</b>	<b>2.50%</b>	<b>2.61%</b>	<b>1.47%</b>	<b>0.81%</b>

It is important to note that each of these funds' actively and passively managed options were constructed by the same investment teams with the same investment approach and philosophy. Thus the differences in asset allocations and performances can only be attributed to the different investment fee objectives.

What is very clear from these results is that the passive / indexed options have both significantly, and also consistently, underperformed their actively managed – and thus higher investment fee – stablemates. It is also notable that this outperformance has occurred over the last 7 years and is not the result of lower falls in returns during the GFC.

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