

Super System Review Submission – Phase 2: Operation and Efficiency

Structure of This Paper

This paper addresses many (but not all) of the points raised in the *Operation and Efficiency – Issues Paper*. Some issues are not addressed – they are outside of my experience. Numbering is included to match the points raised in the *Issues Paper*.

My background covers investment due diligence, risk management and portfolio management, across both traditional and alternative assets. I worked at Colonial First State for twelve years and now I run my own advisory firm, St Davids Rd Advisory. My firm is a signatory to UN PRI (service provider). My experience with superannuation funds has been as an underlying investment manager (and potential manager) for some super funds, as advisory clients (potential clients), and general interest in the sector.

Summary of Key Points

- I urge the review to recommend structures to reduce the systemic risk that comes from the liquidity mismatch between portfolio assets and the liquidity available to underlying investors. There are three key approaches:
 - o Potentially reducing the liquidity offered to members (and promoting a longer term outlook in the process)
 - o Reducing the allowable exposure to illiquid assets for funds offering high liquidity
 - o Implementing formal rules for liquidity risk management similar to prescribed rules for banks and life companies

- While fees are important I feel sometimes the industry focuses more on fees than net returns. The latter is clearly more important. I think it should be left to the trustee board to decide a fee budget and be held accountable for net returns. A healthy research and review industry will assess the outcomes

- I believe the industry should make the dramatic change from an industry defined by asset allocation splits (eg. 70 / 30 Growth / Defensive) to one where funds target a level of total risk and manage total member outcomes. Key benefits:
 - o This would promote much needed improvements in risk management
 - o The largest source of risk (asset class exposure) becomes an active, not a passive, decision

- Less focus on benchmarking and a greater focus on total member outcomes
 - If well managed it will be easier for members to understand what level of risk they are exposed to
- Finally, I believe in the competitive industry model and that competition will lead to the best managed funds (in terms of performance, features and price) experiencing the largest market share. Competition could be better overseen if there were more resources researching and reviewing the super industry. Government could encourage this by financially sponsoring a greater amount of research

4.1 General

Key Theme

Is the superannuation industry just another industry or is it a distinct and special sector deserving different treatment because it is largely a piece of social infrastructure provided by the private sector?

I question whether there is any such thing as “just another industry”. Industries provide a service or a product, they employ people and they have their own unique competition structure. The Government may influence industries in many different ways including through subsidisation, tariffs, tax structures and regulatory oversight.

With respect to the super industry I think that undoubtedly it is important to view it as a service industry more than a product industry. It is also important to recognise that the Government is effectively outsourcing the retirement savings process (and outcomes) of working Australians and as such should feel free to inject itself into the industry as much as it feels appropriate.

6.1 Technology

6.1.2

The issue of unit pricing frequency is interesting. In my view there are three key issues which are somewhat inter-related:

1. Service to members. Some funds, particularly retail super funds highlight pricing frequency as an improved service to members. The issue is whether this is advertising push or whether more frequent liquidity is valued by members
2. Can accurate pricing be achieved? Once super funds invest in illiquid, difficult to price assets the complexity of unit pricing increases. More frequent pricing will increase the reliance on pricing estimates, pricing to model, and also stale pricing techniques. No matter which way the fund is mispriced (over or under-stated) some investors will benefit at the expense of others. Is this fair? Currently there are no standards in place defining what is an acceptable

level of mispricing or what is an appropriate exposure to difficult to price assets in this respect. Nor have trustee boards generally defined their own standards in this regard

3. More frequent liquidity offerings, supported by more frequent pricing, increases the liquidity mismatch and hence liquidity risk. All else being equal, funds offering more frequent liquidity should hold a greater proportion of liquid assets. One solution for this is side-pockets, meaning a portion of a member's exposure to illiquid assets is held aside. I imagine this would be an administrative nightmare

Moving all funds to a daily liquidity / daily pricing regime is dangerous from the perspective of points (2) and (3).

What does it mean if different funds offer different liquidity / pricing features? I would suggest not that much as long as the features are explained clearly to members, perhaps some standardised wording (eg. "There are funds that offer daily liquidity / pricing but we choose to offer weekly because...")

I have an overriding concern that the systemic risk created by exposures to illiquid assets will not be addressed in this review. I think it is vitally important that any source of systemic risk that can be removed from the industry is removed. Any failure of a super fund can only be damaging for the system as a whole.

In this respect, if there is no implementation of rules for managing liquidity risk (exposure to illiquid assets etc), then I suggest that rules should be put in place to restrict the level of switching and so forth. I hope for the former and that formal liquidity risk management procedures are put in place.

6.2 Default Funds and Default Investment Options

6.2.1

I think the issue of employer selection of default funds can be dealt with effectively through competition. As the competitive landscape continues to develop there will be greater ability to compare performance and features. Any move to increase the regulatory obligations of trustees and review of those selecting the default funds will only improve the situation.

From this I would then expect the funds which offer the best combination of performance, features and price will be the ones that succeed.

6.2.2

I am unconvinced that a Government-operated national default fund would be able to operate more efficiently than many of the large current players in the industry (both retail and industry funds). I

suggest a better option would be to define a set of services and allow large funds to tender for the business of being one of a small number of nominated default funds (for a fixed period of time).

6.2.3

I don't think it is appropriate that everyone is lumped in the same default option. This is partly because of the different life circumstances of members. It is also partly because the definition of the default option asset allocation (70 / 30 growth / defensive split) does not appear well researched and appears more a legacy item.

The concept of life-cycle investing and glide paths is an interesting one. In some respects this attempts to automate the investment planning advice provided by financial planners. Compare this to a well defined investment planning advice process:

- Best practice investment planning involves the investigation of three areas of a client's situation:
 1. A goals assessment of the client. This is then interpreted into a set of key financial targets. Examples of questions include:
 - o When the client wants to retire
 - o What type of retirement lifestyle would they like
 - o How hard they want to work
 2. An assessment of emotional risk capacity. Some clients find the experience of volatility of returns traumatic and may then look to switch out at inappropriate times (drawdown)
 3. An assessment of financial risk tolerance. Does the client have a current situation where they can tolerate loss? While this issue tends to address non-super investment it is still relevant for some investors close to retirement, or even wealthy investors (who can fund more risk but also have the luxury of reducing risk as their outcome is more assured)

These issues are then worked through with the client (a trade-off process) to determine, with the client's input, an appropriate level of risk for the client.

A life-cycle / glide path approach ignores important qualitative and financial issues associated with the client. It is a rules driven approach and may in some cases result in a worse outcome (eg. a member plans to continue working post-retirement age so has the financial capacity to remain in a higher risk range).

Effectively there are two choices on this issue:

1. A life-cycle approach, which on average will do a reasonable job but there will be instances of poor outcome

2. A greater, perhaps mandatory use of financial planning advice (perhaps provided by the fund itself) to determine a blend of two or three default fund risk options which can then be blended

Note also the other issue with life-cycle investing in super funds is that it will make low cost investment planning more difficult because financial planners are obligated to look at all of the clients exposures and life-cycle exposures are not consistent over time, hence involve more ongoing review and cost to the client.

Finally, it is amazing how much of the industry still defines itself by asset allocation blends. The last part of (6.2.3) refers to what are basically some simple asset allocation models – surely super fund investment managers are using techniques far more complex than this already? Perhaps they are not because the industry has created a benchmarking mindset by defining fund risk as asset allocation mixes (split between growth and defensive assets). In doing so (by defining risk as an asset allocation blend) the following outcomes are likely:

- Variable level of risk experienced in different environments because total return risk is not actively managed
- An inability to predict the future level of risk
- The only way to educate investors on the risk of their investment option will be to analyse historical returns – not necessarily the best technique
- The super fund investment managers will be at least somewhat benchmark focused rather than total return focused

At the risk of sounding negative on the current industry position I would like to pitch once more the concept for super fund investment managers to operate options defined by a percentage level of risk rather than by asset class exposure. This could be called risk targeting. Some of the benefits:

- Asset allocation decisions would no longer be outsourced to the end member. Investment managers, generally well skilled and highly paid, would be responsible for this
- Super funds would be responsible for managing total investment risk rather than benchmark risk. I believe there are many areas lacking in current risk management practices and I have concerns these areas will not be improved. A change as large as this would force a major review of risk management practices on to the super fund industry
- By targeting a risk number, members can make better assumptions of what downside risk they should expect whereas the risk in asset classes is difficult to forecast and tends to rely on historical analysis (which failed investors during the GFC)

6.2.4

My views on the design of a default investment option are largely addressed in (6.2.1), (6.2.2) and (6.2.3).

6.2.5

I cannot see any basis for limiting the number of investment options, particularly in the retail sector where the investment manager bears establishment costs and any economic losses.

However the failure of many options during the GFC is an example of the lack of risk management, stress testing and scenario analysis evident in product design. While the onus must be on the managers and trustees of the fund, what could be done to improve the situation so these failings will not happen again? Two suggestions:

- Greater risk management guidelines, particularly in the area of liquidity risk
- Optional greater review by the regulator of new options prior to implementation

6.2.6

This issue of stickiness and member liquidity is somewhat addressed in (6.1.2). I believe (and have great fear that) the industry underestimates the systemic risk that comes out of the liquidity mismatch between assets and underlying member liquidity rights. It is a difficult predicament:

- If the industry wants to emphasise choice there needs to be some liquidity but potentially not as much as we may think – for instance what is wrong with only being able to transact monthly if we are encouraging long term investment?). Dealing with illiquid assets through lock-ups or sidepockets would be difficult to achieve cost effectively from an operational perspective. I believe the best solution in an industry of choice would be to limit the exposure to illiquids based on the liquidity offered to members
- If the industry wants to reduce the emphasis on choice then I would support winding back offered liquidity as this would reduce the systemic risk I believe exists across the industry
- The concept of offering quite illiquid options to support infrastructure investments etc is interesting. I view it as having merit as it allows exposure to these asset classes with low systemic risk. However there is always the risk of special cause redemptions (eg. illness) that needs to be managed. I am in favour of separating the risks of liquid and illiquid investments.

7.2 Employers

7.2.1

I cannot see how company and industry representatives can add significant value to members by sitting on the trustee board of a super fund. Obviously they want to ensure that the fund is managed in the best interests of their employees. This could be achieved through other measures such as contractual performance reporting or a representative sub-committee which is the central linkage point between the trustees and the employer / industry. Any proposal to increase the obligations of a super fund to be similar to those of public companies will also reduce the need for

company and industry representatives on the trustee board. This will improve governance and the confidence of the governance in the super system.

7.3 Investment Managers

The reliance (and any potential over-reliance) on active management is the decision of the trustee. In an environment of healthy competition and good information reporting any underperformance will be recognised by the industry and should be reviewed by trustees. Whether there are adequate review processes is an important issue (though not addressed in this section).

In my view the reliance on active management is partly a result of the semi-fixed asset allocation mindset of super fund managers which is driven by asset allocation definitions of risk profiles. Super funds tend to be 'industry benchmark aware' and take their active risk through active manager selection.

One concern throughout this review is the theme of reducing costs, both direct and indirect. In some cases, particularly active management, you have to spend money to make money. I don't think this decision should be made on behalf of trustees. It is their decision to make. However I think it is important that the key comparison is performance net of fees, not fees itself – that is secondary in my view. In an environment of good governance a super fund which spent high fees but underperformed would be called to account. Creating this level of governance and review is important.

7.5 The Value Chain

My largest concern, coming from an investment management background, is the focus on fees versus returns net of fees. While I am sure all agree that net returns are most important there is a constant industry focus on fees. Perhaps this is because it is difficult to fairly compare net returns (due to asset allocations, exposure to illiquid assets etc).

I can see the benefits of attempting to reduce administration costs (to a point – you never want services to be delivered uneconomically as long term quality service delivery is put at risk). However in the case of investment management fees I do not think there needs to be the aim to reduce fees across the industry. Every trustee board should recognise investment management costs as a negative impact on net returns and be able to justify their expectations of additional returns for each active investment.

The framework for trustees assessing whether the investment management fee is justified is always based on expected returns. This can be broken down to two features which multiply together to create an expected active return:

1. Quality of the manager / process, combined with the inefficiency / opportunity in the space they are investing – this can all be assessed by a forward looking Sharpe Ratio
2. Quantity of risk – all else equal, the more active risk a manager takes the higher the level of expected active return (provided the increased risk does not create any systemic or non-normal risks)

8.1 Performance Data and Other Comparative Information

8.1.3

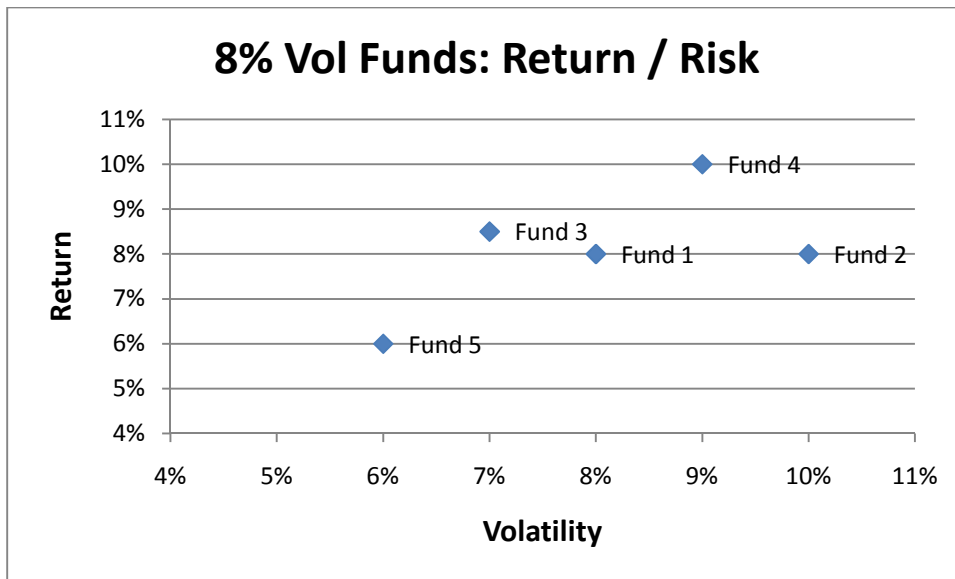
A feature of healthy competition is the ability to compare products and services. In this respect anything APRA (or another body) can do to create a better basis for performance comparison is beneficial.

I believe it is important to look at all investment options. If a particular investment option has no direct competitors then this in itself is useful information.

The lack of focus on risk is an anomaly for the super fund industry versus other parts of the financial sector. Any improvements here would be beneficial.

Finally, mentioned throughout the document is the suggestion to move to a risk targeting basis. This would make comparison of options easier (eg. compare all the funds targeting 8% volatility).

Currently two funds in the same category but at opposite ends of the defined asset allocation range can have quite different performances yet both have done an equally good job from an active return perspective. An example chart for comparison is below:



In viewing the chart above:

- Fund 2 has taken more risk without delivering higher returns – can they manage their risk profile?
- Fund 4 has taken more risk but this has been rewarded. Still this was not the level of risk the member expected
- Fund 5 has been too conservative. This is not good from the perspective that the member may not be taking enough risk to meet their financial goals
- Fund 3 has managed risk well but managed to deliver good returns

8.1.4

All of the mentioned features (tools, metrics etc) would provide useful information. It would be an additional burden on the industry to produce this information (both funds and regulators). However public disclosure of this information may lead to process change by the super funds themselves (eg. reduce churn etc).

8.1.5

I believe there is a lot of merit in after-tax reporting. There is a risk it may adversely change investment management behaviour – eg. a desire to defer the realisation of capital gains on ‘winners’ which subsequently fall in price. However this is just another risk for trustees to oversee.

Another issue is that different super funds will have different starting points (ie. different levels of embedded realised gains etc). This will make direct comparison difficult.

8.2 Information Given to Members

8.2.5

I think there is relevance in using consumer friendly techniques to explain things like fees. But why not use the same approach to explaining risk etc? You would also need some text to explain that lower fee products may achieve lower net returns because they have less active management.

8.2.8

In an industry which actively promotes governance and one that has a fiduciary responsibility I can see no significant reason to not disclose remuneration.

8.2.10

The area of research on super funds is an area of concern. The positive intent is there with the researchers but I don't think there is sufficient resourcing. The problem is one of a lack of natural buyers of these services. While true that companies will pay for these services when appointing a super fund, this information is valuable for individuals as well in an environment of choice yet it is difficult to access.

In the previous submission I proposed that the government sponsors an independent group to act as a "Regnan-equivalent" of the super industry, monitoring the governance practices of super funds. Another option could be to provide financial support to some of the existing research firms (eg. in the form of research grants) to accelerate the development of this component of the industry.

9.3 Fees and Charges

9.3.1

I think good governance will control fees. If there is any likelihood of increasing the oversight of fund governance then rules like this will not be necessary. However if there are unlikely to be any recommendations to improve the oversight of fund governance then perhaps some controls like this are necessary.

9.3.6

From my experiences in the hedge fund industry of the different transaction cost and exit fee models, there is unfortunately no perfect model. A buy-sell spread is probably the most appropriate model but it fails in extreme markets because the spreads are fixed and in practice transaction costs, particularly market impact costs, vary. In illiquid markets the transaction costs experienced are likely

to exceed the spread and remaining investors will not receive fair treatment relative to redeeming investors.

9.4 Percentage Remuneration

In my view the external model is a legacy issue that has been driven by a number of factors:

- Knowledge and skills – I don't think historically the skillsets (within the teams or at a trustee level) have been strong enough to move confidently in this space
- Operational and risk capability – the operational, risk and transaction capability is a significant build out, especially if only on a small proportion of the portfolio. There is also the risk of transactional errors and operational mistakes. In the majority of cases if an external fund manager makes these types of errors then they will make good these losses with their own capital
- Broad range of activities – there may be some areas where internal management is too difficult. So in effect any model is likely to involve a combination of approaches

I don't think it is necessary to promote change. I think all trustees should be able to explain their positioning, like they have to do on many other issues. So in this respect, any recommendations to increase the ongoing research and review of super funds will assist.

It is worth noting that funds are getting bigger and more highly skilled people are entering the industry at CIO, CEO, trustee, analyst and operation levels. I anticipate a greater level of internal management.

9.6 Performance Fees

I disagree with the notion that performance fees are counterproductive for members. If the performance fee structure is well designed (hurdles, high watermarks etc) the structure can result in a great alignment of interest between investment manager and member. If an investment manager produces true outperformance then I see no issue with the manager retaining a portion of this; the member is still better off.

9.6.1

I see no need for performance fee design standards as the range of investment management products is broad and complex and it is unlikely that one set of standards could apply well across different types of products. Rather I believe the onus should be placed on the super fund investment managers, and ultimately the trustees to be able to detail how they believe the performance fee structure is appropriate. Again, any recommendations to increase the level of review and ongoing research of super funds will improve this area.

9.6.2

The issue of discounting fixed fees to facilitate performance fees is addressed in (9.6) and (9.6.1) – the responsibility of the entire fee structure should rest with the super fund investment managers and the trustee board.

10.1 Clearer Statement of Beliefs and Objectives

I think a statement of beliefs and objectives would be useful. I think the researchers / reviewers of the super funds could drive the creation of what information is most important. However the overall benefits are likely to be limited as retail funds and industry funds will draw their standard lines.

10.3 Competition

10.3.1

I think choice is a great thing but I do feel it is also a luxury item. I think the theme of low cost default funds for those unlikely to use choice is a great idea for ensuring appropriate balance.

10.3.2

I don't think it is really the case that super funds are pricetakers (having sat on the other side of the fence – external investment manager). The trend to internal investment management capabilities will also continue pricing pressure.

I think it is important to respect the downside risk of a manager who has high business risk (due to offering uneconomical fees): the wind up expenses are something a trustee would not want to be exposed to.

10.3.3

My views on internal management versus outsourcing are addressed in (9.4).

10.4 The Cost of Short-Termism

10.4.1

I believe short-termism and 'peer risk' are significant issues that I have reflected on throughout this document and also Phase 1. To summarise:

- Many super funds, particularly unofficially, highlight peer group risk as something they manage more than total return risk
- There is a feedback loop of poor performance relative to peers resulting in outflows which, all up, is probably not great for remaining members (transaction costs, portfolio balance etc). While this is an issue, I don't believe it outweighs the need to manage investor outcomes (total return investment risk)

Proposed solutions:

- A risk targeting framework rather than an asset allocation framework for defining funds. This has the following impacts:
 - o This will create greater alignment – trustees are responsible for managing total risk rather than active risk
 - o Managers can be assessed on their performance of managing risk (measured on a post-basis)
 - o Splits such as 70 / 30 (growth / defensive), which dominate the risk of a portfolio will no longer be a base case position – it is important that the key sources of risk are carefully considered
- Longer term timeframes for performance comparison highlighted as key (eg. 5yr). Low industry recognition of 1yr numbers etc