Deloitte.

Super System Review

Default Fund costs under the MySuper proposals

19 April 2010

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1 MySuper: the context for this report

This report details the results of our investigations into the projected costs of a large default superannuation fund established within the MySuper proposals currently being considered by the Review. The basis for this report was a draft discussion paper "MySuper: Optimising Australian superannuation". While this might differ from the Review's final recommendations we are advised that the key aspects of this paper (the Paper) that we mention in this report as influencing our conclusions remain valid.

Our brief

The scope of this report is described in an Official Work Order, which asked us to analyse the projected costs that a large default superannuation fund could charge for an average member with an account balance of $25,000 and for other account balances, assuming a number of investment strategies including:

- A typical balanced asset allocation;
- A defensive asset allocation;
- Use of alternative investments.

We are also asked to comment on the levers and variables involved.

The aim is not to provide definitive conclusions on the actual cost that might apply within a default fund but rather to provide information which can then be used by the Review for informed discussions with the industry.

1.1 This report

The results we present must necessarily be considered within the context implied by the MySuper proposals and we include in this report a brief description of those key features in the Paper most significant in determining costs.

It is widely recognised that there is a lack of quality and consistent data throughout the superannuation industry in Australia. It is not easy for individual Australians, let alone experienced industry practitioners, to compare and contrast performance and costs of funds. We describe the approach we have taken in arriving at the costs presented in this report and the data sources that we have used.

In broad terms we have chosen to subdivide costs into:

- Investment related costs; and
- Operating costs which include any fees paid to third party administrators where they are used as well as the cost of intra-fund advice.

It is our view that investment related costs should be related to the quantum of funds under management and should therefore be expressed as a percentage of assets. Operating costs however, are more correctly related to the number of members and we have, therefore, chosen to express these as a $ cost per member per annum.

All costs quoted in this report exclude any bundled advice and distribution costs as mandated under the MySuper proposals.

We have not taken into account the potential impact of SuperStream proposals in this report.

1.2 No single national default fund

The Paper states that every existing superannuation fund will be able to establish, within its current structures, a MySuper product. There will be no single national default fund but rather the opportunity for all existing superannuation funds to offer a MySuper product.

The Panel is conscious that the overwhelming majority of Australians find themselves in the default investment option of whichever superannuation arrangement they are in. Moreover, for many Australians the fund that they are members of is simply the "default fund" that applies to them because of their current employment or employer.

The Paper proposes that only a MySuper product will be able to qualify as a default fund and that any MySuper product can be nominated as a default fund under award or by an employer.

The Paper therefore anticipates a future where, as today, there are a significant number of default (MySuper) funds of different shapes and sizes.

Defined benefits are explicitly excluded from the MySuper proposals and from this report.

1.3 MySuper: conditions attaching

The Paper states that MySuper is predicated on providing a simple, cost-effective product with a diversified portfolio of investments for the vast majority of Australian workers who are invested in the default option in their current fund.

It is expected that the MySuper product offered by existing funds will essentially be based on their existing default investment option. While this does not require establishment of a separate pool of assets the Paper describes conditions that must be satisfied to qualify as a MySuper product.

These include:

- Separate accounting and reporting;
- Streamlined member reporting and disclosures;
- An obligation to accept all types of contributions;
- A single investment option is to be offered;
- Limits to cross-subsidies;
- Exclusion of bundled advice, but access to general and intra-fund advice in accordance with ASIC RG 200;
- No trailing commissions or ongoing advice payments;
- Basic insurance can be offered but with no commission or like payments;
- Certain requirements surrounding fees:
    - No entry fees
    - Buy/sell spreads demonstrably linked to costs
    - No non-explicit discounts and no rebates
    - Any performance-based fees must comply with Performance Fee Standards to be developed by the Panel in consultation with the industry.

The description above is not comprehensive but rather focuses on points relevant to this report.

1.4 Costs to be balanced against member benefit

The Paper expresses the objective of MySuper to be the availability of a low-cost, no-frills, base superannuation option to all Australians. In emphasising the importance of containing costs the Paper recognises the impact that costs have on the build up of retirement benefits. However, the Paper does not adopt cost as the only, or indeed the most important, measure of product quality.

To the contrary, it explicitly acknowledges that trustees can and will take decisions on behalf of members that increase costs because in their view the end result will be better outcomes for members. It is not hard to describe some such decisions: the view that a "higher cost" balanced investment strategy is better for members than a "lower cost" conservative strategy; the appointment of investment managers at a higher fee than others because of an informed view that they will produce higher net (after fees) returns.

MySuper takes the view that this is not only acceptable but a trustee obligation. The Review, however, seeks to impose greater transparency and accountability on trustees for those decisions.

This is an important point because if cost was the sole criterion then MySuper would encourage trustees to invest assets passively at dramatically lower costs. We know that some funds already invest part of their assets this way. However, the majority do not and many funds firmly believe that they can point to a track record where active investment management, albeit at a higher fee, has produced positive long-term added value for their members.

1.5 MySuper: key points

MySuper, therefore, builds on what exists today and it is expected that the core default investment options of any particular existing funds could form the basis for a MySuper product should they decide to offer one.

To qualify as a MySuper product it must meet certain standards regarding reporting and trustee duties and not include any bundled advice or distribution costs.

This has implications for the costs that we will initially see in MySuper products.

1. On the operations side, the starting position is existing systems and costs. MySuper will include intra-fund advice which will demand much more than a simple record keeping capability. Indeed much of the functionality associated with Choice and highly engaged members will need to be retained. We expect a single operational infrastructure serving all fund members (MySuper and Choice) and only relatively minor segregation of costs between the two.

   Provided that bundled advice and distribution is excluded, we can expect MySuper operating costs to be at or about current costs.

2. Investment costs range widely and depend on some basic trustee decisions including investment style, asset allocation and performance/risk objectives. Consequently, the estimates in this report should not be viewed as being exact and absolute. Instead we present projected costs for a range of basic trustee decisions. These costs represent a baseline with trustees always able to incur higher cost if they believe that in so doing they will generate sufficient extra net return to benefit their membership.

   Significantly, it will remain possible for funds to pool the buying power of all their members, MySuper and Choice both, in purchasing assets. Otherwise costs might increase due to loss of scale.

2 Data

The quality and quantity of publicly available data on the superannuation industry has not kept pace with the growth of the industry.

The lack of standard (and mandatory) reporting templates means that it is very difficult to compare cost structures between funds, between industry sectors and over time. This is true of fees, costs and profit margins earned by those who are providing services to the industry.

Costs are particularly difficult to assess because the annual reports of superannuation funds typically:

- Only record a small component of total investment related expenses; and
- Aggregate other expenses into a single amount which may or may not be described in the notes.

Proprietary data does exist within a number of research houses but is rarely comprehensive or readily comparable across the entire industry.

2.1 Sources of data

For this report we have relied on data that is available publicly, available from deep analysis of publicly available information, and from a range of internal research projects undertaken by Deloitte into the industry, together with the superannuation experience of our practitioners.

One research project is particularly relevant to this report.

Research into costs

In 2008, we undertook research to determine whether there existed scale economies and benefits within the Australian superannuation industry.

At that time we deliberately chose to limit our research to Australian Industry Funds.

There were a number of reasons for this but most relevant to this exercise was that the Industry Funds offered better access to data in that the funds themselves produce financial statements, which are by and large independent of related entities.

Our research examined:

- Annual reports to members, and where available, full financial statements for the fund. These were examined to reveal total operating costs as well as any additional (usually internal) investment costs incurred by the fund.
- The PDS for the default option, which allowed us to identify investment related costs deducted from the return (or unit price) delivered to members. The PDS also provided us with a statement of all member fees which then allowed us to calibrate fees against costs.
- Total fund statistics in terms of the number of members and assets under management to give measures of scale. This was easier to establish within an industry fund context as institutional operations have a number of products, and funds with infrastructure applied across them all.

For this report we have updated this research to allow for the impact of inflation.

More recently, we also surveyed a small number of large Australian superannuation funds across all sectors to gain insights into their responses to intra-fund advice.

The funds surveyed have a combined membership of some 5 million members and, to that extent, offer a reliable view of how the industry might deliver cost-effective advice to members. The responses to this survey, together with a significant amount of additional work we have undertaken over the past six months, gives us the ability to estimate the range of costs at which intra-fund advice could be delivered to members.

3 Describing costs

Set out below is a brief description of the approach that we have taken in presenting costs in this report. In particular it has become common in Australia to express total superannuation costs as a single statistic -- the MER for a fund. This equates all costs to a single % of assets.

However, this disconnects non investment costs from the factors that primarily influence them. Moreover, where such fees are paid to third parties and linked to a growing body of assets it builds in cost escalation.

Investment related costs are quite properly related to the assets under management. We would expect, other things equal, that the quantum of these costs would increase in broad proportion to the amount of assets.

Administration and operating costs are another matter. Many of these costs are transaction -based, while some are fixed. Fundamentally, we would expect that the larger the number of members, the greater the quantum of these costs. In this report we first present operating costs as an annual $ amount per member.

But industry practice is entrenched. These costs are also expressed as a % of assets.

To assist in comparison, when we aggregate all costs (investment plus operating) we do express total costs as a % of assets.

3.1 Investment costs

Investment costs come in a variety of forms and are heavily dependent on the way in which assets are managed and the type of asset held.

Scale influences structure

Smaller funds are less likely to be able to justify an internal investment staff. They will rely more on external advice, support and execution, with trustees and the secretariat devoting some of their time to investment matters. The Australian market place offers assistance in many ways.

As funds grow they approach a size where they can increasingly complement external assistance with internal skills and resources.

It is the overwhelming common practice in Australia for (all but the largest) funds to outsource stock selection decisions to external fund managers in the major asset classes. More recently and with the increase in the use of alternatives we have seen a number of funds also build up portfolios acquired directly, though selected with external advice and assistance.

Some of the larger funds have developed quite an extensive internal investment capability that assumes responsibility for managing a portion of fund assets as well as external supplier relationships, with a range of fund managers.

The size of superannuation funds in Australia is not large by global standards. The simple reality is that many do not have the capacity to put in place specialist internal investment skills and must rely on advice and assistance from third parties.

The asset consultants in Australia occupy a very important and influential position in determining where and how money is invested.

Implemented consultants

As a result of the above we have seen in Australia the rise of what are known within the industry as "implemented consultants". These are organisations which offer a “one-stop-shop” packaged investment capability to those funds that are unable to in-source some or all of the capabilities essential for investment management.

In their simplest form the implemented consultants deliver a service which includes:

- Asset allocation and portfolio construction advice and product;
- Manager research and selection;
- Ongoing monitoring of manager performance and consequent hiring/firing;
- Access to a range of diversified multi-manager portfolios, which typically include a balanced and a conservative option;
- Access to a range of multi-manager sector specific portfolios. Almost always these include the major domestic and international asset classes, and more recently have been extended into alternatives;
- The security afforded by the custodial arrangements put in place by the implemented consultants; and
- The ability to leverage off investment education materials developed by the implemented consultants and made available to their clients.

The implemented consultants operate in a very competitive market and we can draw on a large amount of data in estimating the cost to a fund of retaining their services. This is not intended to be a recommendation to use their services but rather recognises that implemented consultants do offer small to medium funds access to scale that is otherwise unavailable within the funds themselves.

Importantly, the fee charged by implemented consultants includes both:

- The consultants own costs for research, staff and a profit margin; as well as
- The fees that they pay to the managers that they appoint, which include margins for those managers.

From the fund's viewpoint the fees charged by the implemented consultant are regarded as a cost.

In this report we use the implemented consultant offerings as a proxy for active investment management for funds up to $2 billion in assets.

This figure is a little arbitrary and in our view is still a little below the (cost) breakeven point beyond which it would be possible for a fund to be able to actively manage diversified multi-manager portfolios via direct mandate.

Beyond $5 billion in assets we seek to estimate costs for active investment through a combination of an internal (to the fund) investment function and use of external managers appointed to fund specific mandates.

Active & passive investment

The alternative to active investment is passive or indexed investment. This is more popular overseas than in Australia but there are a number of specialist providers active in the Australian market.

Passive investment is much cheaper than active investment. Very large funds can invest in the major asset classes at close to "nil cost" and effectively capture market returns. It is also accessible to investors at all size points, including individuals. It can be achieved by physically holding assets and regularly rebalancing them or, at an even lower cost, through synthetic instruments.

Our decision to include passive investment in the analysis does not imply any statement from us on the pros and cons of active versus passive. Rather, it is a fact that funds can invest passively at much lower cost.

A decision to invest actively at a higher fee is, therefore, justified in the belief that to do so will generate extra return that more than offsets the additional cost. In fact, the bulk of superannuation assets in Australia are actively invested and many believe they can point to a track record of active management delivering added value.

In this report we show costs for both active and passive investment management.

Asset allocation

The other major factor influencing investment cost is asset allocation.

In this report we produce estimates for a Balanced as well as a Conservative investment portfolio.

We include two sets of calculations.

- For the first we construct a Balanced and a Conservative portfolio excluding some of the more costly alternative asset classes.
- For the second we then recalculate these estimates including some exposure to alternative assets.

We have chosen to build portfolio costs up from costs identified for each asset class. The portfolio costs are simply the weighted sum of the portfolio components. The asset allocation is shown for each portfolio.

Performance fees

We have noted the requirement that performance based fees only be permitted within MySuper products if they satisfy as yet unspecified conditions.

Performance fees in asset management have grown dramatically to the point where they sometimes exceed base fees within a given asset class and can be a material component of total manager fees within diversified portfolios.

The costs presented in this report are based on data, some of which might include an element of performance fees. We are not overly concerned with this. While it might result in our overstating MySuper costs to some extent, performance based fees are not prohibited in MySuper; they are only subject to conditions that are not yet known.

It is also widely known that there is increased scrutiny of performance fees in the wake of the Global Financial Crisis and some funds have openly spoken about acting to contain them.

Presentation of investment costs

In summary, we present estimated investment costs in this report in a way which allow comparisons to be made between:

- Active versus passive;
- Balanced and Conservative asset allocations;
- No exposure to alternatives or some exposure; and for
- Funds of varying sizes.

3.2 Operating costs

It should be possible to analyse operating costs, in total and in segments, within a superannuation fund as is done in other businesses. Unfortunately the data needed is not widely available.

We have been able to estimate total operating (i.e. all non-investment related) costs from our research and also from the annual statements of funds that do not have commissions, like payments, or the cost of extensive comprehensive advice on their P&L statements.

The research did not include funds that paid commissions or where platform fees were paid.

Some funds do include the cost of some elements of advice. Some large funds have internal planners but the cost increment when spread over all members is low (because of low take-up). Some smaller funds capture elements of intra-fund advice from their third party administrator and to this extent the costs we report are a little higher than they would otherwise be. Thus total operating cost has become our starting point.

We have drawn on other available sources, including our tender work, to estimate the costs that a third party administrator would charge funds of varying size. In doing this we have been aware that when administration is bundled with other services (especially asset management) it can be used as a loss leader. Moreover, the range of services provided under the generic label of administration varies widely and often include items that fall within what the Review has termed "bells and whistles". It is impossible to extract these out. Again, the effect is to slightly overstate fees charged by the third party administrators for a strict "no frills" administration service. However, we do not believe this is material.

Internal "trustee office" costs are the difference between the two.

We believe that we can reliably estimate the fees in the market. Moreover, those fees would be inclusive of profit to the provider at levels consistent with current industry practice.

3.3 Intra-fund advice

Our research indicates that the provision of personal advice (including intra-fund advice) is currently a major issue across all sections of the industry. Much thought and effort is going into how this can be delivered en-masse to members at low cost. For some this means identifying gaps in operational infrastructure and working out how to fill it. For others it means promoting capabilities that have been dormant in the past. For some it may mean radically rethinking operating structures and partners.

The reality is that intra-fund advice is in its infancy. It has not been widespread in the past. Most funds have hitherto restricted themselves to providing general information and in exceptional cases escalating contact via telephone for more complex queries. Some have introduced an ability to deliver a Statement of Advice in certain circumstances but use of this latter facility has not been widespread.

The significance of this is that an analysis of past costs will not include a significant component attributable to advice.

MySuper makes provision of intra-fund advice compulsory but envisages that it will be spread across the entire membership which will clearly add to costs.

The following graphic seeks to simply describe the "advice continuum" as this is central to the way in which we have sought to allow for intra-fund advice in this report.

Basic information	From knowledge to understanding	General assistance	Assistance on specific matters	More complex advice but still restricted to matters within the fund	Full comprehensive financial advice
The member should know what their current interest is	But what does this mean. The member should understand their benefits, entitlements and rights	The member is provided with general information that they may or may not use to assist them in structuring their participation in the fund.	The member is offered clearly defined or scoped assistance/advice on a particular matter – as it applies to the member. Commonly a single issue such as insurance, contributions, salary sacrifice	This is all about assisting the member as far as is possible in helping the member capture full value from their participation in the fund – as it applies to the member. It does not extend to matters beyond the fund and needs must be suitably qualified	Some need it, but at specific times

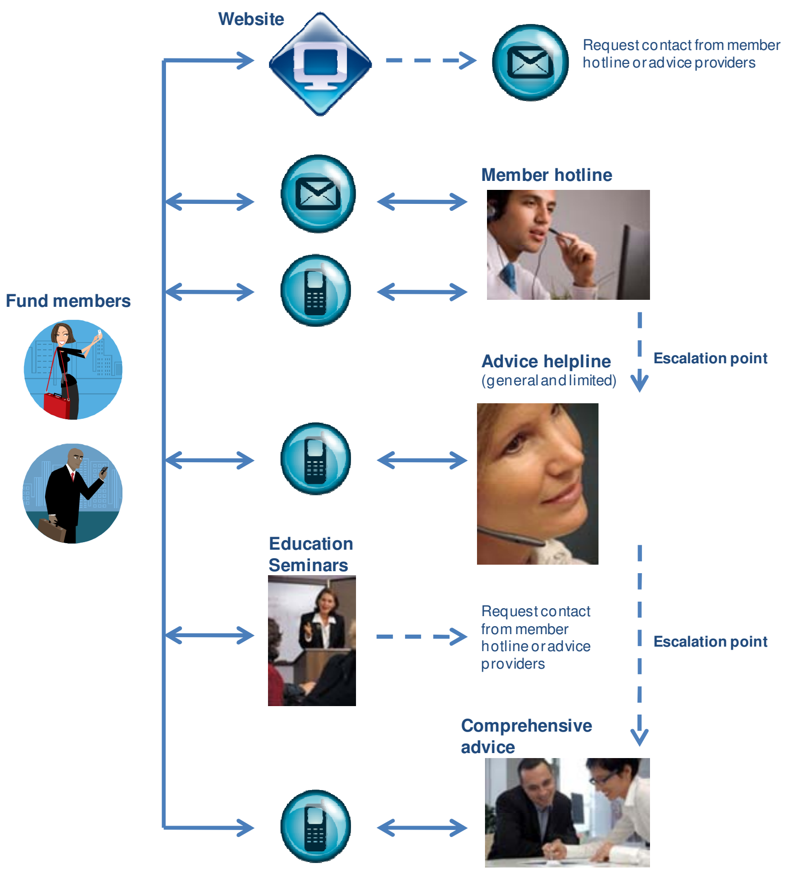
Most funds already provide assistance ranging between basic information and through to some form of general assistance. They do this through written material, statutory disclosures, tools on the website, and response to phone queries. Importantly, provided demand is manageable, the cost is (and can be) met from existing infrastructure.

Comprehensive financial advice usually involves face to face contact with a professional adviser. As such it is labour intensive and involves a significant cost. Some funds do offer this, but those funds upon which we have based our costs do so to a very limited extent, and of these many charge the individual member an additional fee for service. Our understanding is that a MySuper product will not package full comprehensive advice within its standard fee, though the members would be able to access this service on a user pays basis.

What remains is member specific assistance/advice on either a single issue or on a more complex matter, but in respect of matters relating to participation in the fund, as the areas that will generate the bulk of additional operating costs associated with intra-fund advice.

The cost of intra-fund advice depends on both the demand for this and the cost of delivery in each case. It is fair to say that a number of organisations are gearing up to provide third party services, linking into the existing administrative infrastructure of funds. Indeed, this is essential in order to provide the service cost effectively. In some cases there will be a need to materially upgrade administration system functionality, reliability and the training given to people in contact with members - but this is not a bad thing in itself.

A major challenge for funds is to efficiently put those seeking intra fund advice in touch with appropriately qualified people. The graphic below illustrates the process envisaged, as well as showing how delivery of intra-fund advice is intertwined with the administrative infrastructure of any fund. The better administration platforms are able to rapidly deploy existing (though latent) intra-fund advice capability without significant transition cost.



3.4 Insurance & insured benefits

It is proposed that MySuper products will be able to offer certain insured benefits and the Panel has asked the industry to respond with its views on what should and should not be permitted.

The reality is that insurance premiums and related costs constitute one of the largest items of expenditure of superannuation funds. Despite this we have decided that it would be inappropriate to include premiums as a cost item in this report because premiums for individuals vary according to the risk, amount of cover, and the type of benefit. At a fund wide level the total premium is highly dependent on the fund's demographic profile.

We adopt the view that an insurance contract for services and benefits is entered into between the trustee acting on behalf of members and the insurance company and should be assessed separately to other aspects of the fund's operations.

3.5 Costs & profit

Costs paid by a fund, or a MySuper product, to an unrelated third party service provider will include an unspecified profit margin to the provider.

Consequently, many of the costs that are cited in this report include service provider profit margin.

3.6 Uncertainty in costs quoted

In this report we present projected costs in a series of tables, expressed as either a % of assets under management or as an annual cost per member. We believe that the costs are reasonable, achievable and offer a realistic picture of what might be incurred within a no-frills MySuper product.

We have also described the process by which we have arrived at these numbers and it should be apparent that there is some element of approximation and estimation inherent in their calculation. The cost estimates presented should be regarded as being representative of a range of costs, anywhere within which it would be reasonable to expect that a MySuper product costs could lie.

4 Investment costs

Investment costs across the superannuation industry range broadly. It is impossible to generalise and any statement of costs must necessarily be presented within the context of:

- Whether the assets are managed actively or passively;
- The underlying asset allocation;
- The extent to which the trustee has decided to invest in alternative and illiquid assets in an effort to capture the benefits of diversification and the returns available in those asset classes;
- Scale.

4.1 Passive investment

Those who advocate passive investment contend that over the long term it is difficult to outperform the market and that investors should simply aim for market returns within a given asset class, minimise fees and devote attention to asset allocation which is responsible for the bulk of actual return.

In any case, the fact is that fees paid for passive management in the major asset classes are significantly less than for otherwise equivalent active management. Consequently, if we desire to illustrate how low asset management fees can be, then our starting point is passive management. Importantly, passive management is readily accessible by all Australian superannuation funds and individuals, if so desired.

Cost numbers

The following table shows estimates of costs for passive investment for funds of varying sizes.

Cost of investing passively (Basis points)									
Asset class	Asset allocation		Total MySuper fund asset size $ millions						
	Balanced 70/30	Defensive 30/70	<100	500	1,000	2,000	5,000	10,000	>20,000
Aust shares	30%	15%	25	15	10	5	4	2	1
Int'l shares	25%	15%	28	17	13	8	4	2	1
Emerging markets	5%	0%	70	55	45	30	22	16	8
Aust listed property	5%	0%	30	15	10	5	2	1	1
Global listed property	5%	0%	50	45	16	8	4	2	1
Aust FI	15%	35%	15	6	5	4	3	2	1
Int'l FI	10%	25%	25	10	8	6	4	2	1
Cash	5%	10%	10	5	5	3	1	<1	<1
Custody Costs**			4	4	4	3	2	1	<1
Overall portfolio cost (Basis points)									
Balanced option (70/30)*			31	21	16	10	7	4	2
Conservative option (30/70)*			24	14	12	8	5	3	2

* *Numbers shown should be viewed as centred within a range extending ±1-2 basis points*

** *Where the fund holds the assets via a mandate with the investment manager, otherwise close to zero.*

Comment

The costs quoted involve a direct relationship with the supplier of the passive products. We know that some funds offer passive options in the major asset classes as part of a broader investment menu. This allows individuals to select them if they choose to. Prices can vary widely.

We have not included Exchange Traded Funds in our analysis. These are readily available at costs lower than shown above.

It could be justifiably argued that a fund, no matter how small, will devote some internal resources to investment management. It will at least require access to some independent advice in arriving at a decision to invest passively, in deciding on the asset allocation/investment strategy and in deciding the organisation to appoint. Thereafter, it must necessarily monitor performance and periodically reassess the appropriateness of the arrangements in place.

This is undoubtedly true, and those costs would be in addition to those shown.

That said:

- It is our experience that a smaller fund would make key strategic decisions with external advice and then delegate broadly to the investment managers appointed. Performance would be monitored by the trustee and its secretariat, without a dedicated investment department. Periodically they would review strategic decisions, again with external advice.
- The larger the fund the more likely that it will have internal investment specialists and the broader the role that they will play in investment decision making. Practice varies widely depending on a number of variables. We do show estimates of these costs in the table showing active management costs. We have not included them here as it would be likely that a large fund would certainly hold a mix of active and passive investments, and might well bring the latter function in house if it could do so at lower cost.

4.2 Active management

Some degree of active management is undertaken by the vast majority of Australian superannuation funds.

Over the past decade there has been growth in the use of multi-manager vehicles for both sector specific investment and in the construction of diversified portfolios across the risk spectrum. This is one way to reduce manager risk through diversification, and also allows for more sophisticated portfolio construction between and within asset classes.

This approach raises scale questions. A small fund is limited in the extent to which it can diversify manager risk- appoint too many managers and the size of each mandate becomes sub-scale and uneconomic.

It is partly for this reason that the Australian market has seen the rise of implemented consultants who offer “packaged” multi-manager options at both the asset class and diversified portfolio levels. This allows small to medium sized funds to access multi-manager portfolios at a far lower cost than they could themselves.

However, there is no hard and fast rule. There are many smaller superannuation funds that deliberately eschew implemented consulting products, work actively with traditional consultants and manage multi-manager portfolios to mandates, review manager performance regularly and make changes to the manager line-up as appropriate. These funds acknowledge the higher costs entailed but point to evidence that this approach is in the best interests of members.

In our analysis we have assumed that smaller funds, investing actively, would use implemented products in the way described. It produces a lower cost but this is reasonable given the philosophy underpinning MySuper and the purpose of this report.

A small fund, indeed any fund, could still create its own multi-manager portfolio if it chose but that would involve a substantially higher investment cost and it would behove the trustee to justify those higher costs in terms of value to members.

There is legitimate difference of opinion about when it becomes more efficient and practicable to bring manager selection and portfolio construction in-house. In this report we have assumed that this occurs at an asset value somewhere in excess of $2 billion, but we are not wedded to this number.

In practice, we generally observe a gradual shift towards greater trustee office investment expertise and internal responsibility for decision making as funds get larger.

In our analysis we have assumed that funds with about $5 billion or more will manage assets internally to mandate, using a combination of internal resources and external advice and research. We have followed general Australian practice which employs managers to invest and has the internal department effectively working with the trustee to set strategy and "manage the managers".

We know that this approach is under active review by some large Australian funds.

To begin with we exclude investment in alternatives.

Cost numbers

The following table show our cost estimates.

Cost of investing Actively (Basis points) Excluding alternatives										
Asset class	**Asset allocation**		**Total MySuper fund asset size $ millions**							
	Balanced 70/30	**Defensive 30/70**	**<100**	**500**	**1,000**	**2,000**	**5,000**	**10,000**	**>20,000**
Aust shares	30%	15%	50	45	40	38	35	27	22
Int'l shares	25%	15%	70	55	50	48	44	38	34
Emerging markets	5%	0%	100	90	80	78	70	66	61
Aust listed property	3%	0%	40	35	30	28	25	21	19
Aust unlisted property	3%	0%	80	70	65	63	61	58	53
Global listed property	5%	0%	80	70	65	63	55	50	45
Aust FI	15%	35%	30	25	20	17	15	12	10
Int'l FI	10%	25%	30	25	20	17	15	12	10
Cash	5%	10%	25	18	12	10	7	5	3
Internal team***			8	7	6	6	6	5	4
Custody Costs**							3	2	1
Overall portfolio cost (Basis points)									
Balanced option (70/30)*			62	53	46	44	43	36	30
Conservative option (30/70)*			47	39	33	30	31	24	20

* *Numbers shown should be viewed as centred within a range extending ±2-3 basis points*

** *Where the fund holds the assets via a mandate with the investment manager, otherwise close to zero*

*** *Includes cost of asset consultants and external advice generally. Numbers shown are within a range of ±1 basis points*

Comment

A review of Product Disclosure Statements reveals that the fees deducted from investment returns for a “balanced” diversified portfolio vary for a number of reasons.

These include:

- Manager costs, which can and do vary widely. Some managers command a premium. Some managers are on performance based fees that themselves can be very significant;
- The actual asset allocation of what is called a “balanced” fund might itself vary materially between funds; and
- Many funds express all or part of the administration fee charged to members as a percentage of account balance and/or deduct it from the return.

For this report we have sought to isolate all non investment related “fees” deducted from returns and assume that the remainder reflect investment related fees paid to third parties. We then add all direct (internal) investment fees recorded in P&L statements, expressing them as a % of assets.

We are confident of the costs presented for funds below $2 billion given our experience in assisting funds go to the market for implemented services. We would fully expect the implemented consultants to offer a lower (basis point) fee for even larger mandates, thereby setting a “bar” to be met by those making a positive decision to construct their own portfolios.

The use of an implemented product does reduce the need for internal involvement but it does not by any means eliminate it. The trustee and its staff still have a responsibility to ensure effective oversight and to seek independent advice. Internal costs can still be material and for small funds appear even more significant.

For funds exceeding $5 billion, we have assumed that management is undertaken internally with external advice and assistance as required. There are not that many funds of this size, and so it is difficult to present statistically reliable numbers.

The numbers we use are based on our own internal research, and seek to mitigate the impact that performance fees have had in recent times.

4.3 Active management: with alternatives

The possibility of investing in alternative asset classes adds a new dimension to the analysis of potential costs.

There are a large number of asset classes which, may be defined as “alternatives”. Some have existed for many years, while some are relatively recent additions to the suite of options available to superannuation funds.

Alternatives can be complex...

There is also some controversy surrounding the nature and inherent character of some of these investments. Some are classified as “growth”, others as “defensive”. Yet some so-called defensive assets have been amongst those most exposed during the Global Financial Crisis.

The reality is that the nature and structure of these investments come in so many forms and guises that it often requires much greater scrutiny and research to fully understand them ahead of fully informed purchase.

... As can be estimating costs

In some alternative classes the investment by a fund is in a vehicle which itself invests in managers who deduct their fees before returns are credited to the investment vehicle. This last point highlights a potential difficulty that exists in measuring the cost of some “fund of fund” products. The only fee visible is that deducted by the direct vehicle. Downstream fees are not always quantified.

Liquidity

The other major characteristic of some alternative assets is that they can be relatively illiquid. This is compounded by the fact that some assets are unlisted and so it is necessary to have the assets periodically valued by professionals.

The result can be additional costs.

What we have assumed

To incorporate the effect of investing in alternatives it is necessary to make a number of assumptions.

1. Exposure to alternatives is something that differs markedly within different sectors of the superannuation industry and between funds. Generally, it has been the larger Industry Funds that have invested more into infrastructure and some other illiquid alternative classes, partly because they have had less need for liquidity than other more corporate based funds and partly because of their willingness to team together on major projects.
2. We have assumed that the exposure to alternatives will be limited to 10% of assets in each of the already described Balanced and Conservative portfolios. In effect 10% of those portfolios will be diverted to a bundle of alternative assets.
   i. The 10% alternatives in the Balanced portfolio will be split 70/30 between those alternative asset classes classified below as Growth or Defensive respectively. We call this the “Balanced Bundle”;
   ii. The 10% alternatives in the Conservative portfolio will be split 30/70 between those alternative asset classes classified below as Growth or Defensive respectively. We call this the “Conservative Bundle”;
   iii. The classification of alternatives into Growth and Defensive is somewhat arbitrary. Most do not fit naturally into this somewhat anachronistic (but still widely used) classification. It does not have any significant impact on the conclusions presented in this report.

Alternative “asset classes”	
Growth	**Defensive**
Private equity	Global credit
Global macro	Leveraged loans
Event - driven	Global high yield
Market neutral	Global listed infrastructure
Long short	Global unlisted infrastructure
Commodities	Infrastructure debt
	RMBS
	Hedge funds
	Fund of hedge funds (excluded)

3. Costs have been estimated from data we have seen in respect of some, generally larger, funds. However, it is difficult to translate this data into firm and precise estimates of the cost of alternatives. The numbers range widely and moreover, the nature of the assets involved often entails significant management costs, as well as increased time and effort from the investment wing of the trustee office.
4. Should we assume that smaller funds invest in alternatives? There is no doubt that some product manufacturers are seeking to satisfy the demand for such assets within smaller funds by offering “alternative” portfolios. Implemented consultants are introducing some exposure to alternatives.

But there are issues surrounding liquidity, and so we have not produced a cost number for alternatives for a fund below $100 million. For all larger funds we have used the same 10% exposure to the Balanced and Conservative alternative bundles;

5. Our work does bring us into contact with funds of all shapes and sizes. We generally observe lower allocations to alternatives in smaller funds and many restrict themselves to investment in only some of the alternative asset classes. This suggests that we could model exposure to alternatives and the respective Growth and Defensive bundles of alternatives by fund size. This adds another layer of complication to the analysis and acts to understate the scale benefits enjoyed by larger funds. After all, if these investments add value to members then funds should act accordingly. We have, therefore, adopted the same bundle and allocations for all fund sizes;

6. It is not always possible to invest passively in alternative asset classes. We have, therefore, restricted our analysis of alternatives to an extension of active management.

Cost numbers

This shows our estimate of costs where a portion of assets are invested in alternatives.

Cost of investing Actively (Basis points) Including alternatives						
	Total MySuper fund asset size $ millions					
	<500	1,000	2,000	5,000	10,000	>20,000
Overall portfolio cost (Basis points) Excluding Alternatives (see earlier table)						
Balanced option (70/30)*	53	46	44	43	36	30
Conservative option (30/70)*	39	33	30	31	24	20
Cost of alternative assets bundles						
Balanced Bundle**	182	151	140	109	101	89
Conservative Bundle**	153	125	116	89	77	67
Overall portfolio cost (Basis points) Including Alternatives (exposure 10% of total)						
Balanced option (70/30)***	65	57	54	50	43	36
Conservative option (30/70)***	50	42	39	36	30	24

* *Numbers shown should be viewed as centred within a range extending ±2-3 basis points*

** *Numbers shown should be viewed as centred within a range extending ±15 to 20 basis points*

*** *Numbers shown should be viewed as centred within a range extending ±3-5 basis points*

Comments

The table demonstrates the well known fact that investment in alternatives involves significantly higher fees than those generally paid in the more traditional asset classes. Nevertheless, our estimates suggest that some alternative exposure should be achievable at quite reasonable investment costs, even for relatively small superannuation funds.

Our calculations are based on 10% of assets being invested in alternative assets. The effect has been to increase overall portfolio costs by between:

- 5 and 13 basis points for the Balanced portfolios;
- 5 and 12 basis points for Conservative portfolios.

Scale is again the dominant factor, with the increase being:

- In excess of 10 basis points for the smaller funds; and
- In the order of 5 basis points for very large funds.

Alternatives classified as Growth tend to cost more than those classified as Defensive and it is also our experience that performance based fees can be significant and complex.

It is a separate question and one outside the scope of this report, whether such an exposure is appropriate given the specific factors that might be present within a given superannuation fund. We especially have in mind the need for liquidity.

We know that the technical justification for many alternatives is diversification and various protections against downward market movement. Our table shows that in some cases this does not come cheaply.

4.4 Investment costs in summary

We can draw together our estimate of the costs presented above into a single table.

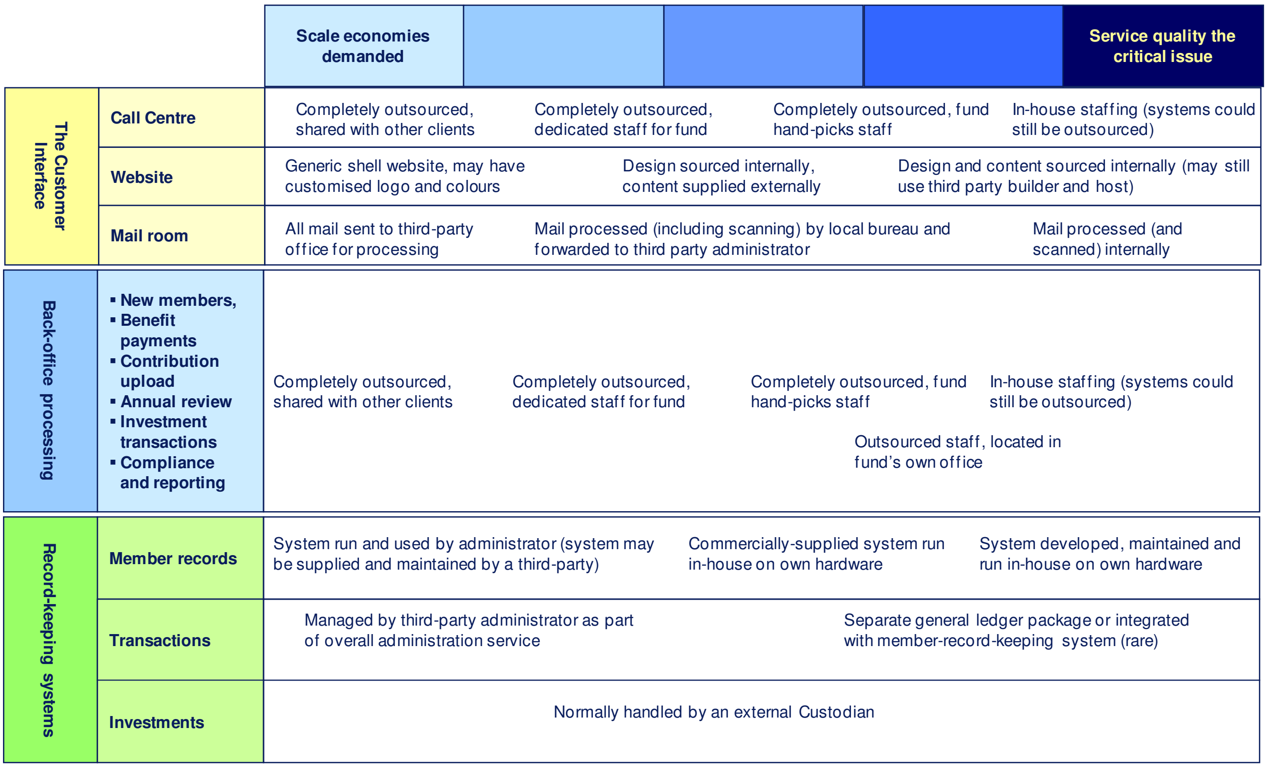
	Total investment costs (Basis points) Total MySuper fund asset size $ millions						
	<100	500	1,000	2,000	5,000	10,000	>20,000
Passive investment							
Balanced portfolio	31	21	16	10	7	4	2
Conservative portfolio	24	14	12	8	5	3	2
Active investment (excluding alternatives)							
Balanced portfolio	62	53	46	44	43	36	30
Conservative portfolio	47	39	33	30	31	24	20
Active investment (including alternatives)							
Balanced portfolio	---	65	57	54	50	43	36
Conservative portfolio	---	50	42	39	36	30	24

5 Operating costs

Operating a superannuation fund is a complex matter requiring a host of skills and infrastructure. It is rare for a fund to possess all of that which is necessary internally. Funds rely on partners to varying degrees.

The major exception to this is the major wealth management institutions that have built extensive in-house proprietary administration systems and have access to capital to invest in that infrastructure.

A difficulty is that the definition of administration and the services that it entails is itself evolving. The graphic below is based on internal work that we have done and seeks to show the range of functions and services and the potential breadth of partnering arrangements. It includes some elements of service related to investment



Where a fund sits and the policies it adopts depend in no small part on the overall business and competitive strategies.

5.1 Current industry practices

While industry practice varies widely we can draw some conclusions:

- Most corporate funds will partner with a third party to deliver the bulk of administrative services. The trustee office will typically consist of a secretary and support staff, which may or may not be full time, and where a major part of their role is to liaise and manage service providers;
- Industry Funds generally work with an administrator who undertakes day to day processing where scale benefits are most important, especially amongst the larger funds. Practice is much more variable amongst smaller funds where a number operate their own administration departments often using purchased software packages or using boutique administration service companies. It should be pointed out that a number of industry funds have taken equity positions in their administrator. In either event, a trustee office is maintained;

- Wealth management organisations generally maintain their own internal administration capability using purchased or purpose built administration software. An independent trustee office is maintained and this works closely with the administration arm;
- Public sector funds sometimes use a specialist administrator that evolved with the fund itself. In some cases these divisions have corporatized, and are now promoting themselves as third party administrators to the industry as a whole;
- There are of course exceptions to all of the above.

Specialist administration companies

There has been significant rationalisation amongst administrators over the past few years, as growing industry complexity and the importance of scale in delivering competitive outcomes and in justifying investment have become more important.

There are now, at most, only a handful (or so) of firms that have the depth and resources to be able to deliver competitive services to the mass superannuation market. There are a number of other firms that act as administrators to a relatively small client base but these firms rarely capture new business.

In part this reflects pricing which in the past has been insufficient to attract new entrants. The widely held view is that “administration is a low margin business” and that the bulk of revenue and profit from superannuation comes via asset management.

There is some element of truth to this but it is also fair to say that the inefficiencies in the superannuation system, many of which are described in the SuperStream paper, have made it more difficult for administrators, particularly the mass administrators, to achieve productivity gains and make the most of electronic processing in all its forms.

We have, therefore, seen the emergence of three distinct types of administration platforms over the past few years:

- High touch administrators who, notwithstanding aged systems, have developed the ability to electronically engage with members and through the use of web based and other functionality transferred much of the day to day transactions to what is effectively a user pays environment – in the same way as the banks have utilised ATMs. They have been able to contain costs somewhat and at the same time, have developed value add services for funds that want to engage more closely with their members. They generally resist all paper based transactions;
- The large mass administrators who possess scale and the benefits of incumbency. They too have some developed capability to move to a user pays transactional system but are hostage to the manual, paper based, member interactions that are all too common in this country. This also restricts their ability to reduce costs, contributes to significant amounts of rework, and has limited their ability to develop leading edge value add services to assist funds better engage with members;
- A number of small administrators who have just one or two small to medium size clients.

There is also:

- A latent administrative capability of high standard within the major wealth management organisations, which is essentially quarantined to the clients of those organisations. This is geared towards high touch. It is not usually sold as a standalone service; and
- A number of in-house administration functions maintained by individual funds.

5.2 Components of operating costs

It is therefore apparent that total operating costs are a combination of:

Third party administrator fees

Fees paid to external administrators which will include a profit margin. We acknowledge the view that administration margins are thought to be low. However, it is not within scope for us to consider or comment on an appropriate margin for the future. Should margins increase then this would clearly flow through to increased costs.

Internal costs

Internal or trustee office costs can include some costs that have traditionally been packaged under the administration heading, especially services central to member engagement. However, trustee office costs also include, to the extent not outsourced:

1. Trustee fees & support, including reporting
2. Staff salaries and associated on costs
3. Compliance, audit and statutory fees
4. Management of service providers
5. Insurance claims management
6. Internal IT and accommodation
7. Other corporate overhead
8. Postage, handling
9. Marketing and business development

Some funds have brought some of the functions typically provided by third party administrators in-house and for these funds we will see internal costs rise and third party fees reduce. A number of funds do virtually all administration in-house, have a relatively large number of employees and almost all operating costs appear on the funds P&L statement.

Intra-fund advice

Funds have been providing assistance to members for some time in a number of different ways and financing that assistance in ways ranging from user pays at one end to a general charge for all members at the other.

Calculators and useful information are now routinely provided on websites. Service centres increasingly include (at least some) people qualified to provide assistance beyond simple statements of fact.

A number of funds have gone further and (often with external assistance) are now enabled to deliver advice. We sometimes see simple and limited advice delivered at no extra cost to the member, which means that the cost is included in standard fees.

Many others are now considering how to respond to the ASIC RG 200, which is proposed to be a compulsory feature of MySuper.

At this point, we reiterate the central role that core administration plays in delivering intra-fund advice. Those funds delivering advice must have access to accurate and up to date information about the member and their current interest in the fund. They require what the industry terms a "single member view", where all member information is quickly and inexpensively available for use.

While this sounds simple, even rudimentary, it has proven to be a major and costly challenge for systems designed at a time when batch processing was the norm and where the only regular contact envisaged with a member was the annual mail out of statutory material.

Systems have, or are, in the process of being upgraded, as is the ability to reduce transactional costs through the use of electronic channels, and straight through processing. These capabilities are already in the DNA of the better administration systems, which are generally found amongst the corporate master trusts and the wealth management organisations.

Those not able to easily upgrade will need to seek external assistance, or contemplate more fundamental change, it in order to offer intra-fund advice at a reasonable cost.

Bells & whistles

The MySuper paper makes it clear that members of MySuper funds should not be made to pay for “bells and whistles” that they will not make use of and that their cost should be quarantined to “Choice” members.

We repeat here that in this report we have extracted all costs associated with full comprehensive advice and distribution as provided for in MySuper. Consequently, the points made in the next few paragraphs refer to whatever “bells and whistles” are associated with operational functionality, flexibility and the ability to engage with individual members to assist them.

We think it will be difficult to extract these costs as they are effectively built into the fund’s core operating infrastructure.

It makes little sense and would be uneconomic for a fund to maintain separate operating infrastructures for their MySuper and Choice products. We are firmly of the view that funds will have a single system.

We believe that in many cases it will be difficult for trustees and their providers to accurately account for the cost of that portion of infrastructure that is solely attributable to “bells and whistles” and suspect that it would only constitute a relatively minor part of the total cost. However, if that cost was quarantined then a relatively minor saving for the MySuper members could translate into a substantial increase in costs for Choice members.

A simple example can be used to illustrate this:

Suppose a fund is currently charging all operating costs at a fixed $100 per member per annum:

- MySuper members comprise 80% of members; and
- 10% of total operating costs are attributable to “bells and whistles”;

If we quarantine the cost of the “bells and whistles” to Choice members but assume that total fund costs do not reduce then:

- Costs charged to the 80% MySuper members will reduce by 10% to $90 per member; but
- Costs charged to the 20% Choice members will increase to $140 in order to make good the shortfall.

In fact, total costs might actually increase marginally, as funds incur the cost of allocating costs in whatever way is prescribed.

The figures are even more dramatic where the proportion of MySuper members is greater. If they are 90% of total members then the charge for Choice members would increase by 90% to $190.

Of course if the cost of bells and whistles is much lower, then the impact as well as the case for change is weakened.

5.3 Operating cost excluding intra-fund advice

We have a significant amount of data that we can use to provide estimates of costs excluding intra-fund advice, including our own research, results of tenders and other client work.

As already mentioned we believe that little intra-fund advice costs are included in the data that we have used and our research has excluded advice and distribution - though we know some marketing and sales costs are included.

Current operating infrastructure will underpin MySuper

Current fund systems, people and processes will form the basis of any MySuper product established by the sponsors of a current fund.

We are consequently comfortable that the costs presented below will be representative of the costs that could be experienced by MySuper products of varying sizes. These costs will, to varying degrees, include a "bells and whistles" component but we do not believe it is very significant and we see some difficulty in separating it out in practice.

Cost numbers

The following table shows operating costs (excluding intra-fund advice) for funds of varying sizes. All costs are expressed as annual amounts per member.

Estimated operating costs excluding intra-fund advice
for MySuper products of varying sizes
(as $ per member per annum)

Fund size: $millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: membership*	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Third party administration fees**	$124	$90	$78	$68	$57	$49	$43
Trustee office**	$120	$105	$71	$46	$31	$28	$23
Total operating costs (excl. advice)* **	**$244**	**$195**	**$149**	**$114**	**$88**	**$77**	**$66**

* *Assuming as instructed an average account balance of $25,000*

** *Actual third party admin fees will depend on the range of services contracted for. As already explained, this will possibly differ widely from fund to fund. In the extreme, if all administration is undertaken in-house it will be zero. But we will see a corresponding increase in internal (i.e. Trustee office costs). Because of the above, we can be more confident in estimating total costs. Our estimates are based on research that predates ASIC RG 200 and so, while we know there were some funds that were providing advice, the costs would be minor. We can, therefore, confidently add to this our estimate of the cost of intra-fund advice*

*** *Numbers should be taken as being centred on a range extending ± $5-$10*

Comment

These are significant variations in operating costs from fund to fund. The costs shown are representative of "averages" at the various fund sizes.

The table shows strong scale economies.

It is important to highlight that it is possible for smaller funds to access some of the benefits of scale by partnering with service providers who themselves have scale. This is true of many services, including administration. Yet, an administrator does incur quite high set up costs in putting a system in place for a new client and these are amortised over a number of years (typically 3 to 5). For a small fund this translates into a significant extra cost per member.

On top of this we know that some funds, including some that are quite small, have appointed third party administrators who themselves lack scale or have chosen to self administer.

The result is demonstrated in the table which shows small fund costs are much higher.

The evidence is clear. Larger funds are able, other things equal, to provide basic operational services at a lower per member cost.

5.4 Cost of intra-fund advice

Total intra-fund advice depends on two basic factors: the cost of delivering the service to each individual member and the likely demand for the service.

We refer to Section 3.3 where we presented a view that quality administration platforms were reaching the point where much of the advice was capable of being covered as part of ordinary business, through electronic and telephone contact.

This capability is largely recognised within current operating costs.

The major additional cost will be related to assistance on specific and more complex limited personal advice.

We are able to make some informed estimates of the cost of delivering general and limited advice to individual members from some of the work we have undertaken over recent months. A number of third party providers specialise in these services and provide some insights into fees.

Nevertheless, data is limited and we have had to make some assumptions on the extent to which unit costs would reduce with demand.

Having said this we should point out that opinions do vary and in discussions within the industry we have had opinions expressed that the individual cost of advice could be twice the estimates used in this report.

But, as will be seen, the total cost is incremental within total fund costs.

Member demand for this service is difficult to quantify. We do not hold strongly to the levels assumed in this report, though in discussion with funds they are not felt to be unreasonable.

Cost numbers

Estimated costs of intra-fund advice for MySuper products of varying sizes (as $ per member per annum)

Fund size: $millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: membership	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Demand for advice (% of total membership)							
General advice	10%	10%	10%	10%	10%	10%	10%
Personal advice	5%	5%	5%	5%	5%	5%	5%
Cost of individual piece of advice $							
Cost general	75	60	50	45	40	35	30
Cost personal	200	170	150	130	120	110	100
Total cost for total fund $pa	**$70,000**	**$290,000**	**$500,000**	**$880,000**	**$2,000,000**	**$3,600,000**	**$6,400,000**
Total cost $ per member per annum	**$18**	**$15**	**$13**	**$11**	**$10**	**$9**	**$8**
Total cost $ per member per week	**$0.34**	**$0.28**	**$0.24**	**$0.21**	**$0.19**	**$0.17**	**$0.15**

Comment

Calculated costs for advice are only a fraction of total operating costs and represent a relatively small charge for each (and every) member. To reinforce the point, we have in this table also calculated the effective weekly charge. This does not alter the cost, but is consistent with industry practice.

We have not included any cost for comprehensive advice in these calculations. Rather, we have assumed that if this was offered by a fund then it would be financed on a user pays basis. Those fees would be disclosed in advance of a member "purchasing" this additional service and under the MySuper proposals could be met out of the member's account balance.

5.5 Total operating costs

We can now draw all estimated operating costs together into a single table

Cost numbers

Estimated operating costs for MySuper products of varying sizes
(as $ per member per annum)

Fund size: $millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: membership*	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Third party administration fees**	$124	$90	$78	$68	$57	$49	$43
Trustee office**	$120	$105	$71	$46	$31	$28	$23
Total operating costs (excl. advice)* **	**$244**	**$195**	**$149**	**$114**	**$88**	**$77**	**$66**
Intra-fund advice****	$18	$15	$13	$11	$10	$9	$8
Total operating costs (incl. advice)	**$262**	**$210**	**$162**	**$125**	**$98**	**$86**	**$74**

* *Assuming an average account balance of $25,000*

** *Actual third party admin fees will depend on the range of services contracted for. As already explained, this will possibly differ widely from fund to fund. In the extreme, if all administration is undertaken in-house it will be zero. But we will see a corresponding increase in internal (i.e. Trustee office costs)*

*** *Because of the above, we can be more confident in estimating total costs. Our estimates are based on research that predates ASIC RG 200 and so, while we know there were some funds that were providing advice, the costs would be minor. We can therefore confidently add to this our estimate of the cost of intra-fund advice.*

**** *Based on the costs and volumes already described.*

Comment

One thing is clear: there are large scale economies in operating costs. It could be argued that there should be less scale effects in the delivery of advice than we have assumed and we acknowledge that might be true. But this does not materially change our conclusion because intra-fund advice is only a relatively small component of total operating costs.

Moreover, there are some funds where current operating costs (excluding bundled advice, platform fees and the like) are substantially higher than suggested in the table.

We are firmly of the view that the best way to describe fund costs is as an amount deducted annually from accounts, as they are logically related to fund membership.

5.6 Total operating costs: varying size of account balance

From an individual member's perspective, a charge of, say, $250 per annum consumes a far greater proportion of a $10,000 account than it would a $200,000 account.

In the next table we re-express the total annual per member operating cost as a % of the member's account for a range of possible account balances.

Estimated total operating costs for MySuper products of varying sizes
(basis points for varying account sizes)
&
Inclusive of cost of intra-fund advice

Fund size: $millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Fund size: membership*	4,000	20,000	40,000	80,000	200,000	400,000	800,000
Account size							
$10,000	262	210	162	125	98	86	74
$25,000	105	84	65	50	39	34	30
$50,000	52	42	32	25	20	17	15
$100,000	26	21	16	13	10	9	7
$250,000	10	8	6	5	4	3	3

* *Membership based on an average account balance of $25,000*

These estimates follow industry practice which has tended to only look at fees in terms of "MER". They show that a member with a $10,000 account in a $100 million dollar fund will likely find administration costs of the order of 2.62% per annum. Of course, in the same fund there might be a member with a $250,000 account. The $262 is only 10 basis points (0.10%) and looks, when expressed this way, very small.

All of these costs are before any investment related costs are deducted from returns, and exclude any bundled advice fees.

They serve to illustrate the inefficiency that results from any Australian having multiple "lost", and generally quite small, accounts steadily eroded by regular deduction of administration and other costs.

5.7 Operational reserves

We close this section with an observation about the superannuation industry's approach to establishing and maintaining operating and contingency reserves.

There is no standard. Some funds do maintain reserves but to varying amounts. Some funds rely on service provider contracts in whole or in part to meet costs of errors or rely on insurance arrangements to meet claims. Strictly, all funds should have clear and well thought through policies as part of their risk management plans.

We cannot be confident that this is being done in a way that renders the numbers presented in this report as being fully inclusive of adequate provisioning.

6 Total MySuper costs

We are now in a position to bring investment and operating costs together to estimate the total costs that could be expected under the MySuper proposals presented to us in the Paper.

It is clear that there will be no single answer. There are a number of factors that will influence total cost including:

- Scale, both in terms of assets and membership;
- Investment approach: active or passive
- Asset allocation; and
- Use of higher cost alternative asset classes.

The following table shows total costs as they might vary with changes in each of these variables. For convenience we have expressed all costs as a % of assets because users will compare these numbers with industry data that is almost always presented in that form.

Estimated total costs for MySuper products of varying sizes
(all costs expressed as basis points)
Investment costs + Operating costs (incl. intra-fund advice)

Fund size: $millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Passive investment							
Balanced portfolio	136	104	80	60	46	38	32
Conservative portfolio	129	98	76	58	45	37	32
Active investment (excluding alternatives)							
Balanced portfolio	166	136	111	94	83	70	60
Conservative portfolio	151	123	97	80	70	59	49
Active investment (including alternatives)							
Balanced portfolio		149	121	104	89	77	66
Conservative portfolio		134	107	89	76	64	54

7 Reliances and Limitations

We have relied on the accuracy and completeness of all data and other information (qualitative, quantitative, written and oral) provided to us for the purpose of this report. We have not independently verified or audited the data but we have reviewed it for general reasonableness and consistency. It should be noted that if any data or other information is inaccurate or incomplete, our advice may need to be revised.

This report has been prepared for the sole use of the Super System Review for the purpose set out in this report.

Yours sincerely

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