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Your Future, Your Super package

I wish to comment on two aspects of the Government's Your Future, Your Super package, namely the "Underperformance" regime and the "Best Financial Interests Duty".

As background, I have been an investor for over 40 years, in both listed and unlisted companies. I am a Fellow of the Institute of Chartered Accountants (England and Wales) and a Fellow of the Securities Institute. I worked in direct investment in unlisted companies and infrastructure projects at an institutional level. For some years, I represented the Australian Shareholders Association on ASIC's Consumer Advisory Panel (the views here are my own).

Underperformance

Whilst there is a simplistic attraction to putting pressure on "underperforming" super funds, with the aim of making them "perform" better, these notions are complex and must be tested rigorously and fairly. I get some comfort from the fact that APRA, a body of great integrity and competence, will be establishing the test methodology, with some discretion, and conducting the tests. I hope that this entire process will be free from Government interference.

A fundamental problem – which should be solved first- is that there is a lack of standardisation of terms used to describe the main risk classifications of blended super asset options offered to fund members, especially between those called "Balanced" and "Growth".

The components of "growth assets" under such definitions could easily vary by 10% of the member's total assets, perhaps in some cases by as much as 20%, yet the funds use names that have the same classification. This vague terminology is very confusing for current and prospective members, and must cause difficulty for asset consultants and other professionals trying to make comparisons between funds' results. It likely results in many fund members being in asset groups that they don't understand, and thus with risk characteristics that they wouldn't choose if they had clear information. This makes it impossible to undertake a rigorous comparison between super products that claim to be in the same category. The whole of the super industry- especially actuaries, asset consultants and other relevant experts- needs to do substantial work to produce a more sophisticated agreed framework for asset categories, and benchmark construction. I submit that this major exercise is desperately needed, and should be allowed to run for at least two years before the question of "under-performance" can be tested.

A difference of say 10% within the boundaries of how funds' categories are defined for a classification like Balanced, Growth or High Growth could easily lead to a 1%pa

variance in fund returns that would be entirely justifiable. I.e. it would not necessarily be "under- or over-performance", but merely reflect the % asset range allowable for that terminology. Such variation is unhelpful. To implement a performance-assessment regime, especially with such radical consequences, is dangerous when the definitions have not been properly agreed within the industry.

In any case, how will APRA determine whether there was "underperformance"? I would hope that returns would be risk-adjusted, but can this be done accurately?

What measure will APRA adopt for "underperformance"? Will it be more than say two standard deviations of returns from the mean? I hope also that APRA would measure returns for rolling periods of least three years, preferably five years, not merely 12 months, to avoid penalising funds with poor short term returns but good medium term returns.

How will underperformance be ascertained? Will it be in an absolute sense, or measured versus externally constructed benchmarks like market indices, or relative only to the set of returns for the universe of super funds, or its relevant subgroups? How will benchmark returns be established for unlisted asset classes like Private Equity, Infrastructure and unlisted Real Estate?

Some asset classes like Infrastructure, or even more so Private Equity, take some years to mature; their early returns can be very low but long-term returns after five years or more can be very high. How will APRA allow for such assets to ensure that long-term investment strategy, made in good faith, is not penalised or discouraged?

Superannuation is a very long-term investment product: members and trustees should be thinking in terms of over 30 years, and many assets could justifiably be chosen by trustees with a 5 or 10 year time horizon in mind. Although the Government's proposed reform here is doubtless well-intentioned, there is a major risk that trustees will reduce exposure to illiquid and unlisted investments, to avoid being penalised for the factors above This would be rational but counter- productive: the exact opposite of what the Government claims that it wants to achieve.

A related problem, of a similar but more extreme nature, is that trustees will want to accumulate higher levels of very liquid/low volatility assets like cash and bonds. If a fund receives an unsatisfactory performance rating after a 12 month period, it would be prudent for it to increase its most liquid assets and sell down less liquid, higher volatility (but probably higher returning) assets. If it then received a second unsatisfactory assessment, it would confront a cash flow problem. It would be prohibited from taking new members, but still required to pay member benefits, including for those who wanted to transfer out or cash out entirely. Even with the best will, and competent handling and explanations, it's hard to see why a fund in this predicament would not face a large number of redemption/transfer requests. This could increase to a run on the fund- causing it to sell assets under great time pressure.

I fear that the Government's proposals may lead to serious distress for funds that are found to have underperformed, leading to forced assets sales and ever-diminishing returns for those members who stay in the fund. How can this be a good outcome?

It would be useful for APRA to consult on how it would respond to particular market cases. An instructive example would be the phenomenon over the last 5 years- and especially the last 18 months- of "value" equity funds suffering vis a vis "growth equities". That is not the fault of the fund managers, necessarily, but an entire group of equities falling out of favour in the market. Would it be fair to penalise trustees, and members, for such an overall market trend?

This regime, while superficially attractive to policymakers, will require great care and rigour by APRA to avoid punishing funds with "the benefit of hindsight".

Best financial interests duty (BFI)

The intentions expressed in 1.5 and 1.6 of the EM are, prima facie, reasonable. To the extent that there is genuine lack of clarity and understanding, as mentioned in 1.21, it would be well for APRA to provide better guidance to trustees. However it is difficult to avoid the conclusion that the substance of the matter lies in 1.20. The "numerous reports and hearings" are predominantly those of the Government- well publicised- in its frequent attacks on industry funds. As an industry fund member (but not union affiliated) I don't, of course, object to a high standard of justification for expenditure being required, but the government's cynicism and bias here is obvious. If, as has been reported, the industry funds in aggregate spent $40m in marketing and advertising last year, that would amount to less than 1 basis point of member funds. Money should obviously not be wasted, or misdirected, but the extent of the attacks is excessive and irresponsible- the cost to individual members is immaterial. Some obvious conflicts of interest- like trustees' attendance at sporting events and other expensive junkets- must be proscribed, but to ban, in effect, all marketing is silly, especially as there is a valid case that attracting more members will reduce costs per person.

There is a basis structural problem here. Funds that are run for profit can charge high admin or investment fees to their members, but ensure that all marketing expenses (for example)- or anything else contentious - are paid for by the promoting/ managing entity out of the gross fees earned and not *directly* out of member's pockets. Thus a for- profit fund could charge members say 250 or 300 basis points pa in various fees, however named, but ensure that no "grey area" costs are *directly* charged to members, i.e. those that might not pass the exclusive rule of the BFI test. Yet a non profit fund- for example an industry fund or perhaps a corporate fund- could charge members investment and admin fees of only 50bp pa, but also change 0.05bp pa for advertising. That fund would breach the new term of the law, even though the former fund was - overall- charging its members 5 or 6 times the amount of total costs. How does charging very high investment fees, for example, meet the BFI duty? This is an absurd and paradoxical result, caused by bad law.

The perverse conclusion would be for industry funds- and other non-profit funds so affected- to convert themselves into "for profit funds", charge slightly higher amounts of direct fees (especially investment fees) to their members, but pay any expenses that might otherwise not meet the strict term of BFI out of the gross fees earned. In this way members would be paying for such expenses only *indirectly*, as currently happens with for-profit funds run by banks and other major financial services providers. Thus I may currently pay 75bp per annum to my industry fund, in total

costs, and that might include 1 or 2 bp for costs that the new law might consider to be not in my best financial interest. The fund could transform itself into a for-profit body- doubtless at massive cost and inconvenience- and then charge me 80bp pa, but ensure that any “grey area” costs were paid from its own profits, not from the fund itself. I would be worse off, but the fund would comply with the new law.

Although this split between direct and indirect costs will enable the terms of the new law to be satisfied, the commercial result will be worse. I.e. members will be no better off, and probably worse off.

A further BFI paradox arises if a solution to the underperformance problem is to force underperforming funds to merge with another fund. Surely that would be detrimental to the members of the better fund- and thus illegal according to the new BFI duty. In that case, there would appear to be no option but for members to be forced out of the inferior fund, and for it to close, and each member left to arrange transfers of his/her balance to another fund. How would that work- and who would help and advise those members?

It is a pity that the under the guise of a seemingly reasonable desire to improve returns to members, the Government‘s greater objective is to maintain its attacks on industry funds and its support for for-profit funds which, with few exceptions, charge higher overall costs to their member. The Government’s bias- indeed cynicism- is patent and very disappointing. By all means encourage competition, fairness and honesty, but the playing field must be level. Australians deserve better than such an uncommercial and artificially constructed attack.

I want to highlight that many industry funds are public offer funds. My entire super is in the industry fund sector, even though I have never been a union member. The Government should know that a large amount of public money (probably well over $100B) in these funds is for members not affiliated with unions. Unfortunately it seems impossible to find statistics (at least from APRA) on how much public money is in industry funds. This would be a very useful statistic to gather. A further needed reform, which has long been in place overseas, is to require all public funds to publish more informative annual reports, and lists of their largest investments every 3 or 6 months.

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