Thinking Ahead Institute

The road to hell is paved with good intentions

Commentary on Australia's proposed Your Future, Your Super reforms

Protecting the innocent

The Thinking Ahead Institute ('Institute') is a global not-for-profit research and innovation hub sponsored by Willis Towers Watson and its investment organisation members. The Institute has a mission to mobilise capital for a sustainable future – for the benefit of the end saver. Australia's superannuation system is held in extremely high regard around the world. The Institute is therefore deeply interested in whether the proposed Your Future, Your Super reforms will further strengthen the Australian system for the benefit the super fund member (as intended) or, perversely, will weaken it (not as intended).

This document has been written by members of the Thinking Ahead Group (Tim Hodgson, Tim Unger) following a series of interviews with senior Australian investment professionals. The authors are very grateful to the interviewees for their input and guidance but stress that the authors alone are responsible for the opinions and any errors of omission or commission in this paper.

Free-form interviews were conducted between 16 and 24 November 2020. We did not seek to standardise the questions and so do not provide any form of quantitative results. Instead, the authors used the insights of the interviewees in combination with their own experience in systems thinking to project how the system is likely to evolve under the influence of the proposed reforms. We promised the interviewees that their comments would not be attributable to them or their organisations.

We are grateful to the following individuals, and to those not willing to be named:

- Damian Graham, CIO, Aware Super
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- Ian Patrick, CIO, SunSuper
- Jim Christensen, CIO, QIC
- Mark Delaney, CIO, AustralianSuper
- Sam Sicilia, CIO, Hostplus
- Sonya Sawtell-Rickson, CIO, HESTA

In addition, we have referred to written materials prepared by the Conexus Institute. They convened a working group of experienced investment consultants from a number of different firms. The working group carried out a detailed assessment of the proposed performance test, and has issued a paper outlining its findings, including an alternative assessment framework[1].

Finally, while multiple books and articles have influenced our thinking over the years, for this context we draw particular attention to *Assessing System-Level Investments, A GUIDE FOR ASSET OWNERS* by Steve Lydenberg and Bill Burckart[2]. The paper suggests (1) a holistic approach is needed ie don't just use one (simplified) data point, (2) qualitative judgements play an important role, and (3) application of normative considerations becomes part of the assessment process. A principles-based approach works well in such contexts. It is particularly applicable when complex systems, with their uncertainties and often competing stakeholders, are involved.

[1] https://theconexusinstitute.org.au/resources/your-future-your-super/
[2] https://www.tiiproject.com/wp-content/uploads/2020/04/Assessing-System-Level-Investments_FINAL_04-21-2020.pdf

Summary

We have chosen to use the aphorism ‘the road to hell is paved with good intentions’ as the title for this paper for two reasons:

1. The intentions of the Your Future, Your Super reforms are unquestionably good. The interviewees were unanimous in their support for what the government is trying to achieve. The degree of an individual’s support only seemed tempered by their level of concern as to whether the intentions would be met.

2. We believe that, in three important areas, the reforms will be counterproductive and will make member outcomes worse.

Member outcomes will suffer because:

1. Aggregate costs will rise

2. Long-term achieved returns will be lower

3. Systemic risk is likely to increase.

This paper takes the form of questions and answers. The three main points are discussed under question 1, with subsidiary effects (our opinion) noted under question 2. We then turn to consider global best practice (question 3) and offer some ideas on changes we would have preferred to see in answer to question 4.

Q1 | What, in your opinion, will be the main effects of the reforms?

The short answer is that we believe the reforms (if not modified) will eventually be counterproductive. They seek to improve member outcomes and yet members will suffer because:

1. Aggregate costs will rise

2. Long-term achieved returns will be lower, and

3. Systemic risk is likely to increase.

The first point is relatively easy to argue. Australia’s institutional DC system comprises a profit-for-shareholder (‘retail’) sector and a profit-for-member (‘industry funds’) sector[1]. Given the adoption of an identical investment strategy, retail funds have typically had higher costs than industry funds[2]. The higher costs reflect that (a) it is more expensive to recruit individual retail members than to recruit a new business with underlying employee members, and (b) paying a profit margin to a shareholder is an additional expense. By stapling one super fund to the member, all other super funds will now have

[1] Individuals can opt out of the institutional arrangements and run a self-managed super fund (SMSF)

[2] The introduction of the MySuper reforms has resulted in the investment fees on default superannuation products offered by retail providers declining to similar levels to those charged by the industry funds. However, this masks significant differences in asset allocations, with the industry funds typically having larger allocations to the more expensive asset classes, ie unlisted property, unlisted infrastructure and private equity.

to compete as if they were retail funds – in order to persuade individuals to unstaple themselves and restaple to a new super fund. This reform shifts the industry funds from a business-to-business operating model, to a business-to-consumer model with the associated increase in cost of acquiring new business[1].

The second point follows directly from the first. A higher cost of acquiring new business is certain and carries no obvious return benefits (perhaps slightly increased scale benefits), and so is likely to reduce the net return to members.

However, this is not the only way in which we believe long-term achieved returns will be lower. The performance test is likely to be counterproductive in that it will divert skill and attention away from maximising absolute returns towards the management of career risk – returns relative to the Your Future, Your Super composite benchmark. In the current super fund system, the risks and rewards of trying to maximise absolute returns are sort-of symmetrical and fairly muted. The peer group comparisons mean that getting it wrong, or right, in the pursuit of absolute returns will put a super fund at the bottom, or top, of the table (the symmetry point). The consequences of the ranking within the table will be an internal marketing team that is upset (or delighted) with the investment team and, at the margin, it might be possible to detect a weakening (or strengthening) of monthly cash inflows (the muted point).

The performance test is too blunt a tool to achieve the stated objective

The Conexus Institute convened a working group of Australian investment consultants to explore in detail the performance test. Willis Towers Watson was represented on the working group and so we adopt the findings of the group and have not performed our own modelling.

The working group concluded that:

- Any investment performance metric has shortcomings as it doesn't capture the full member outcome
- The statistical effectiveness of the Your Future, Your Super performance metric is weak. Across different case studies the likelihood of failing to identify a 'poor' fund as poor is 42% - 65% (similar to a 50% coin toss). In some cases the likelihood of a mistake – identifying a 'good' fund as poor – is 35%
- They believe the test will result in undesirable outcomes relating to how funds invest, may have some adverse impacts on consumers, and create a distorted industry structure (zombie funds). They expect a detrimental effect on both industry performance and individual consumer outcomes.

The statistical tests and papers are publicly available at theconexusinstitute.org.au/resources/your-future-your-super/

The bluntness of the test is hugely significant. Of the seven largest 'pension countries' that we track*, Australia is already the worst in terms of pursuing the proxy goal of peer performance (as opposed to member outcomes). This proposal accentuates an area where experts agree Australia already has an issue. The aim should be to get the best measure of prospective expected outcome; however the validity of proxying that with an 8-year performance test is really low.

* https://www.thinkingaheadinstitute.org/research-papers/global-pension-assets-study-2020/

[1] In effect, we are accusing the authors of the proposed reforms of falling for a fallacy of composition error – or of failing to anticipate second and third order effects in this complex adaptive system. It is possible for an individual super fund member to realise they are in an "underperforming fund" and switch to a better one thereby boosting their eventual account balance. But it is not possible for all super fund members to do this, particularly when the game is announced in advance – because the system then adapts. In this case by massively increasing marketing spend.

In the post-reform super fund system, the risks and rewards become distinctly asymmetric and the consequences become highly significant (as intended). Underperform the benchmark by 0.49%pa and ‘nothing happens’ but underperform by 0.5%pa and you are likely to have to exit the business[1]. Faced with those consequences, how would you manage the portfolio? To maximise the long-term absolute returns or to not-fail the performance test? In some market conditions, or for some periods of time, the two objectives may happily align but that will not be the case at all times or in all conditions. The reforms invite super fund investment teams to more fully emphasise the management of their career risk. Jeremy Grantham has written extensively on career risk, calling it the biggest driver of investment behaviour. By upping the ante on career risk, the reforms will change investment behaviour. It is our contention that this will act to reduce the long-term absolute returns achieved.

The third respect in which we believe the reforms might be counterproductive is in raising systemic risk. One of the implicit aims of the reforms is to compress the range of investment outcomes – by cutting off the underperforming tail. If that was the only effect on the range of investment returns then we would have no problem. However, the career risk point above makes it reasonable to assert that this is unlikely to be the only effect. We believe is it likely that herding behaviour will increase and further narrow the range of achieved investment returns. This, in turn, increases the correlation of member outcomes, meaning that when the DC system fails to deliver the expected, or hoped-for, returns, it fails to deliver them for all members at the same time. This then has implications for the pillar 1 (Age Pension) system and taxpayers. While we in no way condone the protection of persistently underperforming funds, a systems perspective shows that the problem must be managed without raising systemic risk[2].

Q2 | Do you think there will be other, subsidiary, effects?

The interviewees were generous in their opinions regarding likely effects and our notes were extensive. For the sake of brevity we will compress the ideas into three areas – business model, behaviours and investment.

Business model

We have already dealt with the major business model impact in question 1 above (increase in costs). Here we note that the reforms appear to have consolidation as an implied objective. It is well known that a consolidation wave had already been running in Australia for two or three years before these reforms were announced, but they certainly add to the momentum. Consolidation means increasing scale. Is this a good thing? On balance (and up to an unknown point), we would claim that it is good. It is true that large assets eventually get squeezed out of capacity-constrained investment opportunities, but other strategies become viable with size. There is arguably less competition for the high-hanging fruit. Scale also brings benefits in terms of attracting more and better people, and allows for investment in better systems.

[1] Technically a super fund failing a test has 12 months to rectify its performance but in reality, failing the first test will imply something like a 90% probability of failing the second test a year later. At this point the super fund then cannot accept new members, and whilst this is not necessarily terminal, the unanimous view from the interviewees was that a failed test would be an existential event.

[2] This third point could instead be phrased as a stifling of innovation. A systems view sees the aggregate of super funds as a search engine, constantly sifting through investment opportunities to find the best portfolio solution. Instead the performance test imposes the ‘correct’ portfolio solution top-down, reducing the need to innovate and increasing systemic risk.

To remain competitive on cost and capability terms, we anticipate that smaller super funds not wishing to merge will be forced to look at other routes for achieving the benefits of scale, such as outsourcing to an OCIO provider, or outsourcing the investment function to another super fund.

Behaviour

In truth, all the thoughts in this paper strictly belong under a 'changed behaviour' heading. Here we make three points. First is the always-true problem of regulating financial services: do you set rules or principles? Neither is perfect. But we can learn from history that bright people always find ways to work around rules, and the tighter you make the rules the easier they generally find it.

This leads to the second point: an increase in gaming. Because the performance test (as currently proposed) takes into account investment costs, but not admin costs then we can predict that investment costs will fall and admin costs will rise. Ways will be found to justify reallocating some costs between the two categories.

The third point is distinct and, arguably, more important for the long term. The behaviour of super funds will become less predictable, because it will now be contingent on the evolving path of returns. If behind the benchmark at the six-year point, what do you do? The answer will be contingent on a number of factors, not least the perceived short-term risk-return opportunities being offered by the market and the degree of underperformance.

This example suggests there will be a shortening of time horizons for some super funds. However, it also raises the concern that this could negatively impact on collaborations and partnerships *any* super fund may wish to pursue. Will global (including Australian) asset owners and asset managers now trust, as fully, that a super fund is in the partnership for the long haul?

Investment

Again, we choose to highlight two issues as particularly important, and then list a number of subsidiary points. The first is investing in the light of climate change. We are aware that beliefs on the topic vary and that it is an area that overlaps strongly with politics. However, *if* the science is broadly correct (and the Paris agreement and subsequent COPs suggest a large number of countries accept this) then the investment industry will either observe or participate in the biggest and most rapid re-plumbing of the economic machine history has ever witnessed. This implies there are significant risks to be avoided and opportunities to be exploited. These risks and opportunities will only enter the index benchmarks after the event, meaning that the reforms raise the risks for a super fund wishing to invest in anticipation of climate change. Or, more simply, the reforms will make engaging with climate change more difficult. Similarly, incorporating other ESG and sustainability considerations into the portfolio introduces tracking error risk relative to the performance benchmark, which may not be rewarded over the timeframe before the performance test "bites".

The second key point is that the reforms will push super funds away from a total portfolio approach and back towards a strategic asset allocation approach. We would liken this to going back to an old technology, one that is inferior in return terms by around 0.5% to 1%pa[1]. This links back to our lower long-term returns point in question 1. In effect, the reforms shift a reference portfolio from being

[1] Total Portfolio Approach (TPA), Thinking Ahead Institute, 2019

usefully operational (a guide to the opportunity set) to being detrimentally behavioural (the management of career risk).

The other investment changes we can expect include:

- The proportion in illiquid assets will drift down through time (no new allocations rather than pressure to sell down), although larger funds will probably be best able to maintain their preferred weight. Managing tracking error against the indices that will be used to benchmark these assets will mean an outflow of infrastructure, real estate and venture / private equity capital from Australia to overseas. If super members don't fund long-term infrastructure projects or innovation, then who will?
- An increased allocation to passive (index-tracking) investments. This will occur in those funds that do not wish to take the risk of underperforming the performance test and where funds believe that they can compete for members on aspects other than just relative returns. Fee considerations will increase the attraction, and therefore proportion, of index-tracking
- Downside protection may disappear from within products – the constant fee burn always harms against the test, while the payout could come after failing the test
- Skill in risk reduction will be underaccounted for in test, and we would expect a diminution in a skill that is not recognised.
- The timing of portfolio changes could be delayed to coincide with announced / reported strategic asset allocation changes (as this flows through to the performance test benchmark), rather than when it is most opportune to do so. This is linked to the move away from a total portfolio approach.

In short, absent a change in the test, investment will become progressively more constrained, further linking back to our argument that long-term returns will be lower than otherwise.

Q3 | In which direction do these reforms move the Australian system relative to global best practice?

The Thinking Ahead Institute has produced a series of papers on defined contribution (DC). These were the output of a working group that ran for three years between 2017 and 2019, and represent our best thinking on global best practice for a DC system. We therefore use the construct described in these papers to answer this question.

DC looks like an investment problem, but is actually a liability problem

The Institute's first DC paper – *Proposing a stronger DC purpose* – argued strongly that the purpose of DC is to support post-work consumption. It called for plans to integrate the accumulation and drawdown phases of a DC member: instead of targeting CPI-relative time-weighted returns to the point of retirement, practice needs to evolve to focus on whole-of-life money-weighted returns for individual members. We continue to stand by this ideal. In contrast the Your Future, Your Super reforms seem to take us backwards. The performance test clearly communicates the Australian DC system will be an

asset management system where the return over the latest 8-year period is all that matters. Rather, it should be a system that accumulates funds to meet future (*de facto*) liabilities.

Worse, the performance test is likely to de-skill – or, more accurately re-skill – the investment teams of the super funds. Previously they were engaged in the difficult and noble task of selecting from an ever-changing opportunity set, in order to produce the best possible return above inflation that they could. Generating absolute returns is hard as there is no forward benchmark to guide you (benchmarks always look backwards). But absolute returns are what retired DC members 'eat'. Now an additional and competing objective (which at times is likely to take precedence) has been introduced, the investment skill must be re-purposed to avoid underperforming the benchmark by more than 0.5% per annum. Technically the investment team could still vary the risk level, and still vary the composition of the portfolio, but 'people respond to incentives'[1] so these won't have the same priority in future.

DC is about managing the whole of a member's journey, not an 8-year piece

DC: the movie - It's a wonderful life or Oliver Twist built on the stronger purpose paper, putting the end saver at the heart of the defined contribution pensions story. It contains three key messages:

- DC pensions (as opposed to DC savings plans) are a form of social contract
- Understanding the true goal (income in retirement) is foundational and currently under-emphasised
- DC is an intertemporal risk management exercise – where the size and the mix of the different risks changes through the journey – calling for better-developed risk management strategies.

The paper notes that these three messages have "implications for every stage of how DC plans are run, potentially changing the approach to everything from contributions to investment to measurement to insurance to drawdowns."

Most DC systems around the world are savings plans, in that they are designed to accumulate a pot of money that the member takes control of at the point of retirement. Not wrong but, in our view, highly sub-optimal. The average DC member is ill-equipped to convert a pot of capital into a flow of income stretching over a couple of decades or more.

DC pensions, in contrast, sees the super fund assume the primary responsibility for dynamically managing the changing risks through a member's lifetime and providing the retirement payouts agreed with the member. This requires a social contract – "we will take decisions over your money on your behalf – but always in line with your financial best interests" – and social contracts require trust and an ongoing relationship.

The Your Future, Your Super reforms send a somewhat confusing message in this respect. The stapling of the super fund to the member is likely to extend the length of relationship between member and provider, but the performance test and online comparison tool are likely to diminish trust and reduce the relationship to a series of transactions through time. By increasing the focus on a rolling 8-

[1] In *Armchair Economist* Stephen E Lansburg wrote "Most of economics can be summarised in four words: "People respond to incentives." The rest is commentary."

year performance test, the proposals will ensure the Australian DC system remains a savings plan and will actively hinder any voluntary moves by super funds towards DC pensions[1].

The engagement tree – effective member engagement creates a stronger DC system

The final paper in our series (*The engagement tree*) advanced the hypothesis that effective member engagement creates a stronger DC system. It suggested five best practice principles for engagement:

1. Members are individuals and, where possible, should be treated as such
2. All communication should aim to help the individual
3. Respect the medium, as well as the message
4. Engagement bandwidth is limited – use it wisely
5. The organisational design implications are within your control.

The Your Future, Your Super reforms insert contingent, mandatory communications into a super fund's business-as-usual engagement. The intent of the reforms is clearly consistent with principle #2 – helping the individual identify and exit weaker providers. However, the reforms stack up less well against principles #1, #3 and #4. They will necessarily divert attention away from individuals and towards the aggregate portfolio (whether or not that portfolio is appropriate for the individual). By directing attention to an online comparison tool (changing the medium) they are likely to change behaviours (more transactional) – although changed behaviours appears to be a goal of the reforms. Finally, communicating a failed performance test will consume the entire engagement bandwidth and leave no room for wider context. If the performance test were 100% accurate in identifying poor super funds – and in not identifying quality super funds as poor – then this would not be an issue.

Q4 | What changes would you have made?

Assuming we are not allowed to duck this question, we would start with the same objectives as the reforms – to increase the rate at which individual super fund members can compound their contributions, and to weed out persistently poor super funds. Where we depart is in our emphasis on the complexity and adaptability of the system. So, we would wish to encourage a healthy ecosystem – but this is far easier said than done. For example, we have already agreed that system health can be improved by removing persistently poor organisations. But shouldn't there be room for new entrants too? In theory, yes, but in practice where scale effects exist, it is hard to imagine a new start up being feasible from this point. The exception would be a radical new innovation that rendered the current system, or a large part of it, obsolete.

In the absence of new entrants, we would look to promote system health through greater diversity – in contrast to the greater conformity we predict under the proposed reforms. So, we would imagine a system where super funds develop specialist niches, such as investing aggressively for 25-year olds, specialists in risk-reduction for the more risk averse, or specialists in transitioning 55-year olds towards

[1] For this reason we omit any discussion of our paper *Lifetime income - the DC system's missing design feature.* It describes the required steps to resolve the absence of lifetime income solutions, particularly the management of the longevity tail – a risk management option not available to individual members (only cohorts of them).

and through the point of retirement. We would argue that such a formulation carries lower systemic risk.

The mechanism for achieving the twin aims of viable specialisation and the weeding out of the persistently poor implies the need for a ‘quality score’ rather than a performance test. The ideal quality score would mean that super funds with quite different recent past performance could both be rated as the highest-possible quality, while the very best performing (over the most recent period) could be appropriately rated as only of mediocre quality. The easiest way to achieve this would be to convert APRA’s existing heatmap into a single quality score via a transparent algorithm.

A further change we would like to see requires the wave of a magic wand. Ultimately the integrity of the system we envisage is heavily dependent on the quality of the boards overseeing the super funds. By waving our wand we would increase (1) the quantum of investment expertise, (2) the diversity along as many dimensions as possible, and (3) the breadth of expertise (let your imagination run wild – technology experts, climate scientists, etc).

A magic wand is only necessary if we want to see instanteous improvements across all super funds. The more prosaic approach is to start an improvement plan, and to stick at it. Regulation can play its part in this by specifying minimum requirements and ratchetting them up over time. However, the idea here is more usefully brought to life via a case study. The governing board (the Guardians) of the New Zealand Super Fund (NZSF) is required by law[1] to subject itself to independent review every five years. The purpose of the review is to determine how “effectively and efficiently the Guardians are performing their functions” in relation to NZSF’s governance, investment model and performance, and to provide assurances that the organisation can meet its mandate and mission. We suggest this model represents global best practice for assessing asset owner organisations[2].

The last big-picture change we would contemplate for the Australian DC system is difficult, and our thinking is far from complete, so the suggestion is only tentative. As already mentioned, we see the system as complex and adaptive. This is both a strength, meaning that, most of the time, efficient solutions are found – and it is a weakness as the system can seek out sub-optimal solutions if the objective function is even slightly mis-specified. In plainer speak, ‘people respond to incentives’ as already quoted. Hiring more staff to provide a better member service is appropriate up to the point where there is no need to improve the service further. And paying higher salaries for better investment talent is sensible up to the point where the marginal increase in salary equals the marginal gain that talent can produce. We therefore see a clear role for regulation to monitor and, if necessary, cap total costs as this will be a difficult area for super funds to self-regulate.

Stepping back from these high-level thoughts and considering the proposed reforms directly, we would suggest the following:

1. Improve the statistical reliability of the performance test, or replace it with a better metric. For further detail please refer to the Conexus Institute work already mentioned

2. Better yet, upgrade the performance test into a dashboard of multiple metrics

[1] New Zealand Superannuation and Retirement Income Act 2001, Section 71 (and Amendment Act 2019)
[2] One of the authors of this paper, Tim Unger, was also an author of the most recent independent review of the Guardians. The review report is available on the NZSF website https://www.nzsuperfund.nz/nz-super-fund-explained/governance/

3. Even better, incorporate the performance test within an assessment framework that includes qualitative elements

4. Bias any online comparison tool towards organisational quality rather than recent past investment performance

5. Encourage, or require, APRA to be more aggressive in applying escalating sanctions to organisations that are shown to be weaker by its existing assessment framework

6. Staple the superannuation account to the member, not the member to the super fund. We believe this minor modification would achieve the desired cost savings through avoiding account proliferation, but would not carry such severe consequences for industry behaviour and aggregate costs.

Conclusions

In this paper we have argued that the proposed reforms will, in the main, move the Australian DC system away from, rather than towards, global best practice that truly puts member needs and outcomes above all other considerations. Specifically, we have argued that the proposed reforms are highly likely to be counterproductive by raising costs and systemic risk, and by reducing long-term returns. We have documented the other ways in which the reforms are likely to impact business models, behaviours and investment practice. We finished by suggesting alternative changes that we believe would benefit the Australian DC system both from a high level, and more directly in relation to amending some of the proposed reforms. We hope these thoughts are a useful contribution to the industry debate.

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Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.
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Since establishment in 2015, over [60] investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies; better organisational effectiveness and strengthened stakeholder legitimacy.

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