AMP

FINANCIAL SYSTEM INQUIRY
COMMENTS ON INTERIM REPORT

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EXECUTIVE SUMMARY

Australia's superannuation system is serving the interests of individual Australians and the nation well.

However, there is an opportunity to introduce minor amendments to make the system more efficient. There is also a pressing need to investigate the retirement phase of superannuation so it can better meet the needs of an ageing population that is living longer, and that has changing retirement expectations.

AMP believes that national public policy settings and regulatory approaches should embed security, flexibility and efficiency in Australia's superannuation system.

Policy that encourages competition is also vital. Competition encourages innovation, broadens consumer choice and drives better outcomes for (retiring) consumers. Public policy and regulation needs to deliver competitive neutrality in the superannuation market. This is in the interests of consumers, industry players, and the nation.

The Financial Systems Inquiry's (FSI's) initial report made many valid observations and developed a number of informed policy options focused on the interests of consumers, and the Australian community.

There is little credible evidence to suggest that major change is needed in areas of superannuation identified by the FSI focused on the level of fees and charges across the industry and vertical integration.

Further, AMP believes that debate should not just consider fees, but absolute returns or risk adjusted outcomes to consumers; and it is notable that in this regard Australian has been one of the better performers globally.

Reforms flowing from the 2010 Cooper Review of the superannuation system that place downward pressure on fees and charges, including introducing MySuper products (which have cost the superannuation industry [and so consumers] more than $600 million), have only recently begun to have an impact in the market. Initial market behaviour suggests the new arrangements are reducing fees and charges. Good policy oversight dictates these reforms be given time to deliver their intended outcomes.

Public policy settings that accommodate a variety of financial advice models including vertically integrated models have generated clear benefits for consumers and the market in Australia and internationally. There is no case, based on evidence or the public interest, to change this policy. (Policy changes considered in the UK to dismantle vertical integration have been abandoned after analysis and discourse concluded vertical integration offered material benefits to the nation).

Issues that the pursuit of good public policy and the national interest suggest do need addressing include:

- Abolishing the costly and anti-competitive mandating of default superannuation funds in industrial awards
- Strengthening public confidence in the advisory sector
- Improving the quality of financial advice available to superannuation consumers

– Rationalising legacy financial products.

The FSI has rightly identified some of these issues.

One area that requires special investigation and public policy consideration is the nation's retirement income policies addressing the retirement phase of superannuants.

Societal changes not evident when these policies were developed in the early 1990s, including an ageing population that is living longer, vastly different community expectations of retirement, and structural pressures on public finances, means a review of policies is prudent and prescient.

Shifting our focus from accumulation to retirement incomes is also reflective of a naturally evolving and maturing system.

Such a review should consider issues canvassed in the 2014 Inter Generation Report, as well as tax and transfer payment issues that are out of scope of the terms of reference for the FSI.

Finally, AMP's primary concern as the operator of a bank is that capital requirements for all banks be based on competitive neutrality and not disadvantage smaller institutions; and that AAA rated prime residential mortgage backed securities should be recognised as HQLA2.

OBSERVATIONS

- When the differences of the Australian superannuation system are taken into account, there does not appear to be any evidence that the aggregate costs and fees of Australian default funds are high by international standards
- A sole focus on superannuation fees and charges does not take into account of risk-adjusted investment returns, which is what matters for long –term savings outcomes for consumers
- On an absolute returns basis, Australian superannuation funds have been one of the better performers internationally (and well above the OECD average). Indeed, 2012 OECD data shows that Australia was one of the best performing nations, well above the OECD average
- Contrary to the observation in the Interim Report, early analysis of MySuper offerings suggests efficiencies are occurring already
- AMP agrees there is scope for greater efficiencies in the superannuation system. We believe that this will be achieved over time via the MySuper reforms, as well as further moves underway to streamline and reduce the regulatory burden
- We also believe that greater efficiencies can be achieved by opening up the awards system and allowing any compliant MySuper fund to be a default fund under award structure. Such a policy change would reduce administrative burden on providers, ensure competitive tension, and ultimately enable employers to provide a fund that best meets the need of their employees
- AMP strongly supports a broad choice of financial advice models including a vertically integrated model of advice. Only vertically integrated companies have the financial capacity to invest in the development of new and high quality financial advice solutions for consumers, which ensure strong competition and innovation in the market. Vertically integrated companies with significant capital strength have the resources and brand strength to provide their advisers with high quality professional development, education and training (see AMP's announcement of August 21, 2014 at Appendix 3)
- The significant capital strength of vertically integrated companies means their customers are better protected in the event remediation is required
- There is no evidence that 'independent' advice is of any greater quality than advice from other business models; indeed advice from 'independents' has proved to be the most damaging to consumers and was the driver of the original Ripoll Inquiry
- The retirement phase of superannuation is underdeveloped and is worthy of concerted focus and debate with key industry groups before final policy decisions are made. Policy should be thoroughly debated and tested amongst a broad range of experts. This is a complex area and the risk of unintended consequences is relatively high
- Existing application of capital requirements across the banking sector are not competitively neutral. This imbalance has no compelling public policy rationale.

RECOMMENDATIONS

AMP recommends that:

- There be no change to MySuper arrangements. Initial indications are that MySuper is bringing costs down. AMP recommends a review of the MySuper regime be undertaken once its full impact is evident in the market
- The Australian Government not introduce a tender or auction process for default funds. The MySuper arrangements, developed and implemented at a cost of more than $600 million to the industry, will generate the most suitable competitive characteristics for the Australian superannuation system
- The costly process for selecting default funds in modern awards be abolished, and all APRA-approved MySuper-compliant products be able to compete equally in the default superannuation market
- Work on rationalising legacy financial products should resume as it drives mitigation of the increasing operational risk that such products create, and reduces costs in the system. The starting point should be to exempt legacy products from further regulatory changes unless it can be established clearly that there is rationale for including legacy products in the change
- The current regulatory model that supports a range of industry structures in relation to advice, including vertically integrated companies, should continue
- All three policy proposals detailed onp3-69 of the Interim Report be adopted, including raising minimum competency standards for personal advice, introducing a more transparent public register of financial advisers, and enhancing ASIC's powers to ban individuals from managing financial planning business
- Australia's retirement incomes policy be the focus of a specific and separate review by the Government, taking into account the outcomes from the Inter-Generational Report (IGR), the 2015 Tax White Paper, and the views of experts, specialist practitioners and other stakeholders in the policy area
- Industry, government and regulators work together to develop details of a retirement incomes framework that is in the best interests of the nation by way of the proposed separate review
- Principles recently developed by the Actuaries Institute to guide policy development for retirement incomes be supported in principle, and adopted in the recommendations of the FSI
- That mandatory annuities or pensions should not be introduced as this option does not reflect the diversity of consumer preferences, and therefore may not always be in the consumers' best interests
- A system of incentives supported by 'intelligent defaults' ('MyPension') and access to affordable quality financial advice is the best approach to facilitate engagement of superannuation fund members with their superannuation products and retirement income arrangements
- Any organisation that issues a retirement income product taking on longevity risk should require a licence to carry on life insurance business, to ensure proper capital support and management of the significant financial and policyholder equity risks that are characteristic of such products

- Appropriate grandfathering of retirement incomes policy arrangements be considered to help ensure transparency, manage an orderly transition, and contribute to community trust in the nation's superannuation system.
- Measures be taken to ensure competitive neutrality in Australia's banking system. These include:
    - Capital held by ADIs for credit risk should not be materially different between IRB and standardised ADIs, and
    - AAA rated prime RMBS should be recognised as HQLA2.

1. Introduction

AMP's initial submission to the Inquiry focused on three themes:

- The growth of superannuation/retirement incomes
- Competition in the banking sector
- The role of superannuation in national development.

Two of these themes (superannuation/retirement and banking competition) have rightly been addressed in detail in the Financial System Inquiry's (FSI) interim report.

In this second submission to the FSI, AMP develops further our initial thoughts on these topics[1].

This submission focuses on five policy issues most critical to evolving Australia's financial system, and that have a significant impact on the nation's economy:

1. The cost of superannuation
2. Vertical Integration
3. Quality of financial advice
4. Retirement incomes and
5. Competition in banking.

We focus on these issues in the context of a nation with an ageing population, increased life expectancy and changing retirement expectations, slowing economic growth and ongoing Commonwealth budgetary constraints.

These forces are placing additional pressures on the financial system to perform as effectively and efficiently as possible[2].

Discussion and recommendations on other topics (such as governance) have been directed towards industry body submissions and they are not included in this submission (AMP has included a summary of these positions in Appendix 1).

It is important to emphasise that AMP concurs with the overwhelming majority of the "observations" contained in the FSI interim report.

Similarly, the proposed policy options provide a comprehensive range of alternative policy approaches for consideration.

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[1] The third theme, "Superannuation in national development" was not explicitly addressed in the Interim Report, with members of the Financial Systems Inquiry noting that this was outside of the scope of the terms of reference at this time, in part due to the upcoming Tax White Paper. Whilst AMP agrees that the Tax White Paper needs to consider these issues, we still believe it is appropriate to provide some commentary on this theme in our section on Retirement Incomes.

[2] Refer AMP's initial submission for further discussion on these topics.

Of the 26 "observations" contained in the FSI report, AMP is directly affected by 15 of them, and we agree with most. We take issue, however, with the FSI's observation of fees and charges in the superannuation system.

AMP has traditionally argued that policy proposals should be based on national interest principles. In addition, two other factors are paramount to good public policy development: that any change in public policy should in aggregate be beneficial to the community, and there should be a smooth transition from the older policy framework to the new.

These principles underpin our response to the Interim Report.

We note also that some policy matters considered in the Interim Report have also been the subject of recent detailed reviews by earlier governments.

In June 2010, the Super System Review Panel (Cooper Review) delivered its final report to the Government on the, efficiency, structure, governance and operation of the Australian superannuation system. Most of these reforms were only implemented in 2013, with some starting dates deferred to 2014 and 2015.

AMP notes it is still very early days to assess what impact these reforms have had on the superannuation industry.

In a similar timeframe, the Future of Financial Advice (FOFA) reforms became mandatory in 2013.

The FOFA reforms seek to improve the trust and confidence of Australian retail investors in the financial services sector and ensure high quality financial advice is available, accessible and affordable. The reforms involve a statutory duty for financial advisers to act in the best interest of the client, and ban conflicted remuneration (including commissions and volume payments).

Substantial changes have been made to the superannuation system flowing from these reviews, many of which are still in the early stage of being implemented:

- The FoFA legislation (particularly the best interests duty) has yet to work its way through the system, but is already having a positive impact on the evolution of advice
- Despite MySuper being not fully implemented, those elements that are in place are showing signs of substantially reducing costs
- Similarly, the SuperStream proposals have yet to be legislated. It is estimated these changes will also generate efficiencies and again bring down costs.

The financial services sector has invested hundreds of millions of dollars in these proposals so far.

Should the FSI recommend a fundamentally new direction before these current policy initiatives have been given time to work, it would not only have a major cost impact (including on consumers) but will introduce additional complexity and change to a system that for many Australians, is perceived to be in constant flux.

AMP also recognises that a number of other Inquiries are underway, including the review of retirement incomes streams regulation, the Taxation White paper and the next Inter-Generational Report, and that these deliberations will canvass most policy issues and settings relevant to the nation's superannuation system, and retirees.

Fees and charges

Turning to the Interim Report itself, the FSI's observation that "there is little evidence of strong fee based competition in the superannuation sector" and that "operating costs and fees appear high by international standards" is challenged strongly by AMP.

To inform an evidence-based discourse and analysis of fees and charges in the nation's superannuation system, AMP commissioned Towers Watson to examine these preliminary observations. Towers Watson's report is at Appendix 4. The Towers Watson analysis concluded that when comparing like with like, there does not appear to be any evidence that Australian fund costs are materially greater than those of other comparable nations.

Historical data also shows that on an absolute returns basis, Australia has been one of the better performers internationally (and has been well above the OECD average).

Finally, when benchmarked against other nations, costs may be higher, but (net of cost) returns are also higher because of the weighting Australia has to different investment options and also the choice and flexibility of risk appetite. The Chairman of the FSI, Mr David Murray AO recently acknowledged higher fees may be warranted by funds able to generate a better level of performance[3]. These issues are canvased in detail under "Superannuation Fees and Charges" later in our Report.

It is tempting for commentators to view superannuation and its provision as a simple end to end chain of inputs to manufacturing products, and outputs of products, which are then packaged and distributed to consumers. In reality, the superannuation supply chain is one with inputs from legislative and regulatory sources, competitive market forces, customer demand and preferences, the market for the most attractive return for capital invested, as well as the demand for a return on return on investment from shareholders.

The manufacture and delivery of a superannuation product to the stage where it is available for purchase by a consumer, and its ongoing management to deliver outcomes for the consumer, incurs costs.

AMP believes that a competitive, market driven superannuation environment encourages manufacturers and retailers to compete for consumers based on cost as well as quality, simplicity, flexibility and choice, while at the same time improving consumer outcomes.

A key anomaly in the existing superannuation marketplace is the restriction of choice for employers to choose the default funds into which their superannuation contributions are paid under the awards review process.

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[3] The Australian, '*No caps for super fund fees, says David Murray*', 14 August 2014

All employers should be able to choose their superannuation fund appropriate for the relevant workplace, and should not be compelled to contribute to a fund mandated by an industrial award.

AMP supports fully the competitive participation in the market of all legitimately licensed and complying superannuation funds. It sees no evidence base to support arrangements that compel the superannuation contribution of any employee be paid into a specific default fund defined by an industrial award.

Good policy determines that the provisions of any industrial award should include that the interests of each employee is best served by employers being able to choose any complying MySuper fund as an option for default employee superannuation contributions.

Financial advice

AMP welcomes the Interim Report's comments on financial advice.

AMP supports particularly the observation that "affordable quality advice can bring significant consumer benefits" and that "improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice". The company believes this issue can and should be addressed immediately, and AMP supports the FSI policy proposals in full. AMP notes the Government has already moved to create a register of financial advisers and AMP supports fully this initiative.

The FSI interim report also discusses advice models and industry structure.

The Interim Report sought information as whether the recent trend of greater vertical integration in the wealth management and superannuation sectors was reducing competitive pressures and contributing to higher fees.

As cited earlier in this submission, AMP commissioned Towers Watson to review experience in the United Kingdom (UK), focused on the 2008 Retail Distribution Review into issues associated with vertically integrated structures[4].

Tellingly, the UK Government decided there were material advantages to consumers of vertically integrated financial services companies, and this model has been retained there. AMP encourages the FSI to engage with relevant policy makers in the UK to interrogate and understand the rationale for this decision.

Retirement incomes

Perhaps the most difficult policy area considered by the FSI relates to retirement incomes.

Again we agree with the FSI's observation that "the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees".

This is a very complex area, bringing together taxation issues with retirement incomes and transfer payments.

[4] The UK was chosen due to its market similarity and regulatory structure, as well as having recent experience in investigating the relative merits of vertically integrated models of advice.

The Australian Government will release its next IGR in late 2014, and has committed that its Tax White Paper will be finalised late in 2015.

AMP therefore considers retirement income policy should be considered separately from this FSI, given the central inputs of the IGR and national tax and transfer payments to the superannuation system.

However, AMP proposes the final FSI report contain retirement incomes guiding principles for future consideration by a separate and focused investigation.

Banking capital requirement

AMP agrees with the FSI observation that in the banking sector "the application of capital requirements is not competitively neutral". AMP supports applying the same capital requirements to all banks operating in Australia (see section 2 of this submission).

This requirement would meet good public policy tests for competitive neutrality, and provide a good platform for all of Australia's banks to compete on the same basis.

2. Superannuation

2.1 Superannuation fees and charges

FSI Observation

Section 4 of the FSI Report "Superannuation" made the key observation that there was little evidence of strong fee based competition in the sector.

In addition, the FSI also sought other information about vertical integration in the wealth management and superannuation sectors, particularly in regard to efficiency (p2-115).

AMP response

AMP disagrees with the FSI observation that there has been little evidence of strong fee based competition in the sector.

Further, AMP notes that the FSI Interim Report made a number of comments about fees charged by Australian superannuation funds when compared to overseas markets, drawing heavily from a report from The Grattan Institute published in April 2014[5].

AMP commissioned Towers Watson to examine The Grattan Institute's analysis and report its findings.

The Towers Watson report is provided in full at Appendix 4.

Towers Watson identified a number of discrepancies in The Grattan Institute analysis upon which the Institute based its findings, and its central conclusion that aggregate superannuation fees and charges were high in Australia by international standards.

The inconsistencies in The Grattan Institute analysis include these elements:

- The Australian superannuation system is predominantly defined contribution (DC) in nature, whereas other large pension systems around the work are still largely defined benefits (DB). Defined benefit schemes are significantly less expensive to administer than defined contribution schemes
- It is likely that the fees quoted for Retail funds in The Grattan Report (1% - 2%) include a significant component of distribution and advice costs and that the members affected by these higher fees are Choice members (i.e. they have actively selected the fund in question rather than being defaulted into it)
- In many cases Choice members are also in legacy products that are now closed to new members and generally these are more expensive to operate

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[5] The Grattan Institute, '*Super Sting: How to stop Australian's paying too much for superannuation*', April 2014

- Australia is unusual compared to overseas markets in that insurance cover is provided and is a key part of the superannuation system. Most Australian superannuation funds provide a default option for life and TPD insurance. This element is not considered in the analysis.
- That the Australian system has a number of complexities arising out of regulation and compliance, which result in higher operational and administration costs[6]. These complexities include:
  - The existence of multiple accounts, many containing amounts under $1,000; and the administrative costs of which are carried by superannuation funds. There are more than 28 million superannuation accounts. (The existence of so many duplicated accounts of less than $1,000 will begin to be merged from 2017 under the MySuper regime)
  - A system of superannuation that is not only prudentially regulated but also subject to ASIC consumer protection and disclosure standards (and therefore has significant reporting and monitoring requirements)
  - A complex taxation system that continues to undergo regular change.
- In Australia superannuation funds are predominantly administered in the private sector where all associated costs are passed onto members. In contrast, many employer sponsors in the jurisdictions quoted in The Grattan Institute report operate pension departments that manage and administer their pension plans. To the extent Australian investors invest in different asset classes to non-Australian investors, this will have an impact on the overall investment fees paid. To enable a 'like-for-like' comparison, analysis would need to be undertaken based on the same asset classes, or preferably, the same products.
- If the analysis was to exclude Choice members in retail funds, it is likely reported fees for default members in the Australian superannuation system would be closer to the reported level of expenses at 0.82% (comprising 0.3% administrative costs and 0.52% investment costs). The overall cost of the Australian superannuation system will ultimately depend on the relative size and cost of each sector, including the mix of default MySuper balances, and Choice balances and the proportion of assets held in the more or less expensive products.

The significant issues in any comparison of investment costs relate to the use of more expensive active management versus a passive approach, and the additional costs associated with diversifying asset classes.

AMP believes that a sole focus on superannuation fees and charges does not take account of risk-adjusted investment returns, which is what matters for long–term savings outcomes for consumers.

Active and passive management in listed asset classes

The Grattan Institute hypothesises that there are too many investors chasing active returns, with significant leakage from asset owners to their agents.

[6] Notably, even with these additional costs and expenses the OECD still ranks Australia as having 'moderate' administration fees relative to other countries, ranking 23 out of 40 countries and slightly above the middle of the range

However, Towers Watson concluded that this does not preclude a role for active management by a sophisticated investor.

At a reasonable fee (Towers Watson suggests no more than a 30% share of the 'alpha' – the return in excess of the expected return), informed investors can exploit opportunities arising from mispricing that occurs when some investors (i) don't have risk-adjusted return maximising goals, (ii) have lower levels of information, or (iii) exhibit behavioural investing biases.

Towers Watson concluded also:

- A certain level of active management is also beneficial to keep capital markets efficient (though it is not clear what percentage of the market needs to be active to fulfil this role). Active management is an important mechanism to make companies accountable for their performance and without it passive fund cash-flows will be directed to the largest companies (as defined by market capitalisation) without reference to their future potential cash-flows
- Australian investors are extremely fee sensitive and tough on fee negotiations, and the evidence suggests that Australian investors pay about the same fees as their overseas counterparts for equivalent mandates. Furthermore, investors are becoming more innovative in the search for active returns at lower cost, accessing some of the factor biases employed by active managers at lower fees.

Diversification and the role of active management

As indicated earlier, AMP believes that simple cost comparisons can often be misleading and there are many examples of where this may be the case.

AMP considers that investors should look more broadly at returns by focussing on risk-adjusted returns after costs. This important aspect of adjusting return for risk is barely mentioned in The Grattan Institute report.

One of the most effective ways of improving risk-adjusted returns is through the diversification of income streams, where improved reward for risk is achieved by investing in income streams that are not highly correlated.

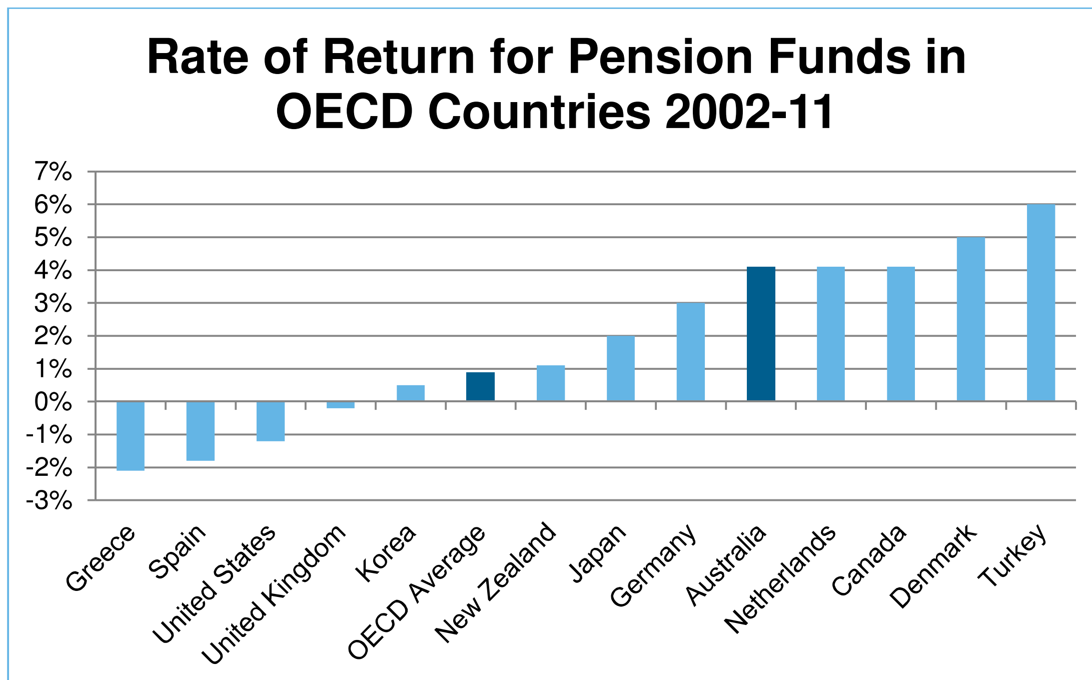
While some assets may incur greater explicit costs than others, the diversification benefits are such that such that the risk adjusted return expectations are materially better by including these higher cost assets.

When the differences of the Australian superannuation system are taken into account, there does not appear to be any evidence that the aggregate costs and fees of Australian default funds are high by international standards.

On an absolute returns basis, Australian superannuation funds have been one of the better performers internationally (and well above the OECD average). Indeed, 2012 OECD data shows that Australia was one of the best performing nations, well above the OECD average.

Chart 1 illustrates the rate of return for pension funds in the OECD countries for 2002 -11.

As can be seen from the chart, Australia's returns, including through the GFC are more than 4.0%, ranked 5 out of 14, and well in excess of the OECDs average, which is less than 1.0%.



Source: OECD (2012) "Global Pension Statistics" Accessed via: http://www.oecd.org/finance/financial-markets/globalpensionstatistics.htm

2.2 Fee based Competition

FSI observation

The FSI interim report makes the observation that there is little evidence of a strong fee based competition in the superannuation sector.

AMP response

As indicated earlier, AMP disagrees with this observation.

Superannuation fees have declined substantially over the period 2007-2013. This is reflected in AMP's margin guidance, which notes expected margin compression on investment related revenue to AUM of 3.5%-4.5% per annum over the MySuper implementation period to 2017. Average compression since guidance was initiated has been 3.5%. As MySuper plan transitions have now commenced, average compression is expected to be around the higher end of the range, through to 2017, as previously guided and may be volatile from period to period as MySuper transitions take place[7].

[7] AMP 2014 Half-Year Investor Report, p6

MySuper implementation

The MySuper system was established to reduce fees and costs over time. As noted, the MySuper regime has only been compulsory for future contributions to be paid into a MySuper product since January 1, 2014 and funds have until July 1, 2017 to transfer existing default balances.

Further, it is only since March 2014 that information on the pricing of all the MySuper products has been available publicly.

In the interests of good policy and competition, the impact of the new MySuper system needs to be afforded time to work. As at March 31, 2014, it is estimated that less than 16% of total superannuation assets are in a MySuper product.

While MySuper is still new, an analysis of those default funds listed on the Fair Work Australia website indicates a strong competitive market in the superannuation sector, evidenced by the range and product offerings.

The MySuper fees also exhibit fees and charges that are competitive and reasonable across the market landscape[8], as can be seen in the Table 1.

Table 1: MySuper Fees: Representative member with an account balance of $50,000

	Annual administration fee (Range)	Fee with indirect costs added (Range)	Average
Industry	$52 - $115	$340 - $698 (0.68% - 1.40%)	$520 (1.04%)
Retail	$50 - $117	$300 - $924 (0.60% - 1.85%)	$580 (1.16%)
Public Sector	$39 - $78	$315 - $658 (0.63% to 1.32%)	$435 (0.87)

AMP considers the MySuper arrangement should be allowed to mature. Greater efficiencies are most likely to occur over time, further consolidation across the industry, including streamlining current regulatory inefficiencies (e.g. allowing the rationalisation of legacy products).

[8] Note that the overall cost will of course depend on many factors, including the relative size and cost of each sector, which in turn will depend to some extent on the mix of default MySuper balances versus Choice balances, the proportion of assets held in relatively more or less expensive products within each sector, and how these change over time.

We note this is likely to occur because of the following factors:

- Full implementation of MySuper for default members. MySuper products are a relatively new concept. The new default contributions must be paid into a MySuper product only from January 1, 2014. Existing default fund balances must be only be transferred into a MySuper product from July 1, 2017. (As at March 2014, it is estimated that less than 16% of total superannuation savings will be in MySuper). Over the next few years, Rice Warner expects MySuper will cause average annual fees to converge to 1 per cent of assets from 1.12 per cent in 2012 – 2013. FSC research9 supports this assertion with research showing that fees have already fallen significantly amongst the FSC membership since the inception of MySuper
- Auto-consolidation is expected to deliver a sizeable reduction in the number of duplicated superannuation accounts containing less than $1,000. It will reduce overhead costs for funds, and lower member fees as a result and significant savings for Australians overall (as duplication of fees paid by individuals on multiple accounts will be eliminated. APRA's most recent Annual Superannuation Bulletin (revised February 5, 2014) indicates this trend with the number of member accounts decreasing by 3.4% for the year to 30 June 2013
- Further consolidation of the industry is also expected to impact positively on fees as this will provide economies of scale
- Cost savings that can occur through the rationalisation of legacy products, if the Government were to support the implementation of rationalisation proposals.

AMP agrees there is scope for greater efficiencies in the superannuation system.

We believe that this will be achieved over time via the MySuper reforms, as well as further moves underway to streamline and reduce the regulatory burden.

The FSI should also recognise the considerable capital investment that has been made by the sector into MySuper and other related initiatives so far.

Recent Financial Services Council reports estimate the total cost of implementing these reforms to be $665 million for FSC members (not including an additional $67 million in annual ongoing costs for relevant years).

To demonstrate the significance of this additional cost, the FSC estimates that $665 million is approximately 38 per cent of total administration fees charged by our members in a single year. Whilst in practice the actual cost would be amortised over a number of years the reforms remain a major contributor to cost in the system.

Put simply, the MySuper regime should be given the time to achieve the objectives that were set for it without further policy change.

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[9] RiceWarner, Superannuation Fees Research , 2014

Recommendation

AMP recommends that:

- **There be no change to MySuper arrangements. Initial indications are that MySuper is bringing costs down.**
- **A review of the MySuper regime be undertaken once its full impact is evident in the market.**

A potential auction process

The FSI sought comments on whether default fund management could be auctioned on the basis of fees to create stronger competition between funds (p 2-112).

AMP does not support this proposal.

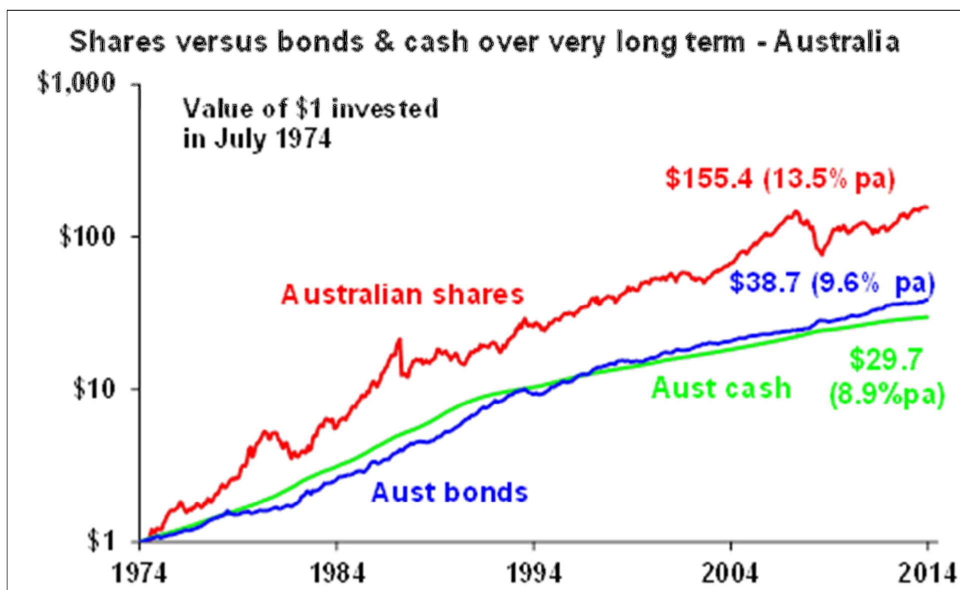
As noted earlier in this submission, the industry has committed substantial resources to MySuper in response to government policy directions.

The MySuper arrangements are generating price signals in the market among competing providers that, as cited earlier, appear to be generating the benefits of robust competition: lower price for consumers.

There is no evidence of market failure here.

These are the same signals that an auction system would seek to generate. These signals are already built into the existing arrangements.

Further, AMP believes that the introduction of an auction process would be detrimental because of the cost of short-term switching, an overriding focus on cost versus outcomes, and a likely tendency to weight asset allocation to lower risk asset classes. Such an outcome may deter people from investing in a range of markets which could lead to suboptimal outcomes. As an example, the chart below shows the compounded value of $1 over the last 40 years as invested in Australian cash, bonds and shares. It demonstrates that over the average Australian's working life, investment returns in Australian shares have outperformed both bonds and cash by a substantial margin. This has been true for any 40 year period in the last 100 years. Note in the graph on the following page the Y axis is logarithmic. Accordingly, investment in equities has served Australians well over the past 40 years.



Source: Global Financial Data, Bloomberg, AMP Capital

Good public policy management dictates that the existing arrangements, themselves a result of a robust interrogation of the superannuation system (Cooper Report, 2010), need to be given time to work.

Recommendation

AMP recommends that:

- **The Australian Government not introduce a tender or auction process for default funds. The MySuper arrangements developed and implemented at a cost of more than $600 million to the industry, will generate the most suitable competitive characteristics for the Australian superannuation system.**

2.3 Superannuation in awards

There are many factors affecting superannuation fees and charges.

AMP believes that a competitive, market driven framework will drive down costs, while at the same time improving consumer outcomes.

In this context, the present arrangements for selecting default funds within awards are costly, not transparent, restrict competition in the system, and therefore result in sub-optimal outcomes for consumers.

This issues needs to be addressed against the criteria of Australia managing a superannuation system that best meets the needs of retirees, and which meets a national interest policy benchmark.

AMP advocates that all industrial awards should allow any complying MySuper fund to be an option for employers to choose.

Recommendation

AMP recommends that

- **The costly process for selecting funds in modern awards should be abolished, and all APRA-approved, MySuper-compliant products should be able to compete equally in the default superannuation market.**

2.4 Vertical integration

FSI Observation

The FSI Interim Report (p2-105) states "a trend in the wealth management sector is towards more vertical integration. Although this can provide some benefits to members of superannuation funds, the degree of cross-selling of services may reduce competitive pressures and contribute to higher costs in the sector".

AMP response

AMP strongly supports a broad choice of financial advice models including a vertically integrated model of advice.

Vertically integrated companies have the financial capacity to invest in the development of new and high quality financial advice solutions for consumers, which ensure strong competition and innovation in the market.

Vertically integrated companies with significant capital strength have the resources and brand strength to provide their advisers with high quality professional development, education and training (see AMP's announcement of August 21, 2104 at Appendix 3).

Specifically, AMP considers that vertically integrated institutions offer the Australian community value because of the following considerations:

- Vertically integrated institutions are typically large and more conservative, and face considerable brand risk if they do not stand behind the quality of their advice.
- Vertically integrated institutions are also able to stand behind the advice their advisers give to customers, and facilitate remediation in the event that customers don't receive advice that is in their best interests.
- Large institutions are required to have comprehensive dispute resolution processes in place which are regularly audited by ASIC.
- Large vertically integrated companies also have a greater capacity to invest compared with smaller Independent Financial Advisers (IFA's) (both in terms of innovation and compliance) whose capacity for investment and scaling up may be limited. One example of this is in the arena of cyber security, where large institutions are able to leverage and exploit supplier relationships, leading edge subject matter expertise, and comprehensive information technology platforms to ensure consumer interests are protected.

- An integrated model allows more consistent customer-centric approach to be applied to product management and customer treatment. The provider has greater control across the value chain from definition of the target market, through product development, distribution strategy, sales process and service delivery
- Vertical integration may enable greater levels of customer access to advice compared with reliance on IFA's alone. A disaggregated industry (whether that disaggregation is achieved through separation of ownership or separation of operations) will be more expensive – especially for advice, which may ultimately reduce availability of advice
- A vertically integrated model also assists with industry compliance and monitoring, as ASIC is able to liaise with the large licensee/institution rather than try to engage thousands of individual firms.

Furthermore, there is no evidence that 'independent' advice is of any greater quality than advice from other business models; indeed advice from 'independents' has proved to be the most damaging to consumers and was the driver of the original Ripoll Inquiry.

Vertical integration - international comparisons

In its response to the FSI Interim Report, AMP asked Towers Watson to review industry structures elsewhere in the world (including in the UK to examine the outcomes of the UK's 2008 Retail Distribution Review).

In its report (see Appendix 4), Towers Watson found there was no evidence to suggest that overseas models operate differently (or more effectively) in providing advice through large institutions.

The US, Canada, The Netherlands, France, Italy, Germany and the UK do not require independence or prohibit vertically integrated financial services groups. To the extent that any restrictions or limitations apply, they have been designed to address prudential issues such as capital adequacy and risk management.

Towers Watson noted the United Kingdom had recently moved away from a proposal for structural separation.

- It is notable the UK's regulator, the Financial Services Authority, raised the following concerns about proposals to change vertically integrated structures.
- The potential impact of the proposal on consumer access to advice, especially among less affluent consumers, who were more likely to use restricted advice models and who might lose access if this form of distribution was removed
- Fears that existing customers of firms would suffer if the firms were required to change their model or withdraw their advice services
- Realignment of the industry needed to implement the structural separation would result in considerable disruption including the loss of advice capacity from the non-independent sector
- Lack of industry consensus and perceptions of self-interest on the part of some firms in seeking to exclude others from the advice market by influencing the future direction of regulation.
- In light of the evidence from both Australia and around the world, AMP recommends the existing regulatory model that enables a range of advice models (including vertical integration) continue.

Consumer Outcomes

2.5 Quality of financial advice

FSI Observation

The FSI recognises rightly the benefits of high-quality, affordable financial advice for Australians in its Interim Report, and that this is an important contributing factor in the ability of individuals to make appropriate saving and investment decisions.

AMP response

The need for improved access to financial advice has been recognised by the Australian Government, ASIC, industry and consumer groups alike[10]. Yet fewer than 40% of the Australian adult population have ever used a financial planner, and only 10% of Australians currently receive some form of financial advice.

AMP strongly supports the FSI's observation in Section 3-63 that "affordable, quality financial advice can bring significant benefits to consumers, improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower cost scaled advice".

Individuals are better off when they act on quality advice received from a properly qualified, professional adviser. Indeed, KPMG Econtech research commissioned by the FSC showed individuals with a financial adviser saved an additional $1,590 each year (after the cost of the initial advice) when compared to a similar individual without an adviser. These savings equated to an additional $91,000 upon retirement for a 30 year old Australian[11].

AMP is therefore supportive of an environment in which consumer confidence in the advice industry is high; AMP strongly supports three policy proposals detailed on Section 3-69 of the interim report:

- Raising minimum and competency standards for personal advice
- The introduction of an enhanced public register of financial advisers
- Enhancing ASIC's powers to include banning individuals from managing financial planning businesses

AMP has consistently taken a similar position for the last five years.

In the company's submission to the Joint Standing Committee for Corporations and Financial Services Inquiry into Financial Products and Services in 2009, AMP focused on the need for quality advice and a lifting of professional standards.

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[10] ASIC Report, *Access to Financial Advice in Australia*, 2010
[11] KPMG Econtech, *Value Proposition off Financial Advisory Networks Update and Extension*, 2011

In particular, AMP recommended:

- Any change to the advice framework needed to ensure that advice was accessible and affordable to middle class Australians
- ASIC worked with the finance advice industry to raise professional standards by strengthening the minimum experience and qualification standards for financial advisers
- financial literacy was improved and
- ASIC be appropriately resourced.

AMP has consistently backed up this position with action:

- AMP's adviser qualification standards are far in excess of the prescribed minimum standards.
- AMP established its own Academy – "Horizons" to train and develop highly competent financial advisers and increase the availability of advice throughout Australia with an increase in planners in the industry overall (including in remote areas)
- AMP was at the forefront in abolishing commissions on superannuation and managed investment products; commissions on AMP investment products were removed in July 2010 (2 years prior to legislation)
- AMP's advisers are required to complete additional accreditation programs
- AMP supported the Senate Economics Committee recommendation to establish a publicly available national register of financial advisers.

Recently, AMP announced three other measures to lift professional standards for financial advisers.

- All existing and new advisers must hold a Certified Financial Planner® (CFP), a Fellow Chartered Financial Practitioner (FChFP), or Masters in Financial Planning (MoFP) qualification
- A review panel (AMPs Customer Advice Review) will be established by January 2, 2015 to ensure the quality of advice in the event of a complaint
- A broad ranging ethics and decision making program for advisers will be developed in conjunction with the St James Ethics Centre[12].

[12] Refer AMP media release, '*AMP lifts adviser education standards and launches customer panel*', August 2014

Recommendation

AMP recommends:

- **The adoption of all three policy proposals detailed in Section 3-69 of the interim report**
  - **Raising minimum and competency standards for personal advice**
  - **Introducing a more transparent public register of financial advisers**
  - **Enhancing ASIC's powers to ban individuals from managing financial planning business.**

2.6 Product Rationalisation

FSI observation

The FSI noted ongoing industry concerns about operational risks associated with managing 'legacy products', and the significant costs of this, quoting an industry-wide operational cost of between $120 million - $350 million per year (p3-86).

"These costs represent an inefficiency drag on the funds management sector and, ultimately, a cost passed on to consumers" (FSI Interim Report).

AMP response

AMP has long supported introducing a framework to facilitate efficient rationalisation of legacy products where appropriate.

While supportive of a process to facilitate product rationalisation where appropriate, several barriers remain to enable processes to be implemented in an efficient manner.

Specifically these barriers include (although are not limited to) the following:

- Legacy Product Test: While no clear cut definition of "legacy products" currently exists, AMP advocates that the industry, in conjunction with the Government and regulators could develop an appropriate definition. A potentially simple, workable approach would be to classify any product that has been closed to new customers for more than five years as a legacy product
- No disadvantage to customer: The previous proposal presented in the 2009 Government paper on Product Rationalisation proposed a no disadvantage test apply at individual policy holder or member level. Setting the test at this level rather than at a group of policy holders/ member level imposes significant effort on the provider to seek individual consent from each member prior to any rationalisation. The ability to obtain individual consent from 100% of members is unlikely to be achieved. As a result, many of the benefits of product and system rationalisation will be lost as legacy products and systems will need to be maintained with fewer members eroding any benefits of scale of size of membership held on a product or system

- Taxation treatment: AMP notes that the FSI Interim Report proposes that any taxation relief issues should be considered separately in Tax White Paper process. AMP believes that it is difficult to consider a complete framework for efficient product rationalisation without consideration of taxation issues. Otherwise, outcomes such as bringing forward collection of tax and loss of tax benefits to members may result in such rationalisation initiatives being inappropriate for groups of members resulting in reduced benefits of product rationalisation for both providers and members.

AMP acknowledges recent initiatives, including introduction of Intrafund Consolidation and enhanced search capability for members to identify all of their superannuation holdings, provides improved ability to rationalise a members holdings where appropriate. However this approach deals specifically on a member by member basis, and as such does not provide industry a more complete platform for product rationalisation. As such AMP reiterates its support for further review and consultation on Product rationalisation for legacy products.

AMP has completed an initial review of the potential savings across both AMP and the membership base should an efficient product rationalisation framework be in place where it is appropriate to proceed with such rationalisation. These initial estimates have identified an annual saving of approximately $12m. We would therefore expect the industry-wide savings to be significant.

It is AMP's strong view that while consideration is being given to such consultation, that apart from essential tax changes, the starting point should be to exempt legacy products from further regulatory changes, unless it can be clearly established that there is an essential and overwhelming reason for including legacy products in the change.

This recognises that "legacy products" are maintained on ageing computer systems which, while operating effectively at a point in time, are expensive and complex to modify.

Consequently, any regulatory changes to legacy products are both disproportionately expensive and introduce a high degree of risk of system failure.

In addition, the nature of legacy products is such that most regulatory changes are not designed with legacy products in mind and do not necessarily produce sensible and meaningful results in legacy products.

Recommendation

AMP recommends that:

- **Work on rationalising legacy financial products should resume as it drives mitigation of the increasing operational risk that such products create, and reduces costs in the system**
- **The starting point should be to exempt legacy products from further regulatory changes unless it can be established clearly that there is rationale for including legacy products in the change.**

3. Retirement incomes

FSI observation

The FSI Interim Report made the following observations:

- the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees; and
- there are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

AMP response

AMP agrees with the above two policy observations.

The retirement phase of superannuation is underdeveloped and is worthy of concerted focus and debate with key industry groups before final policy decisions are made. Policy should be thoroughly debated and tested amongst a broad range of experts. This is a complex area and the risk of unintended consequences is relatively high.

Superannuation is a long-term savings vehicle to accumulate wealth to enable individuals to fund an income in retirement for life.

The specific characteristics of Australia's existing superannuation system, and the taxation and transfer payments system in which it operates, must be considered fully when considering how public policy settings can be calibrated to best meet the expectations of the community and individual Australians for financial security during the retirement phase of our lives.

For example, unlike the UK and other jurisdictions, the Australian taxation system does not impose death duties or inheritance taxes, which in the UK, encourage citizens to consider purchasing annuities to fund their retirement, rather than risk exposing sizeable proportions of their assets to taxation upon their death.

The twin aims of retirement incomes policy in Australia have been to reduce reliance on the age pension, and ensure an adequate retirement income.

Despite the success of the superannuation guarantee system to date, several issues have emerged that were not foreseen when the system was designed in the 1990's.

As AMP indicated in its earlier submission, these issues include increased life expectancy, an ageing population, changing retirement expectations, slowing economic growth and Commonwealth budgetary pressures. The world is now a very different place.

3.1 Need for a further Examination

AMP considers that because of the importance and complexity of retirement incomes policy, and because of the interdependence of this policy on a series of other reviews that are presently underway, the issue should be set aside for further examination.

AMP believes that changes to retirement incomes policy have far reaching implications on the economy, financial systems and social fabric.

As noted in the FSI Interim Report, "major changes to the retirement income system need to consider the policy settings in the tax and transfer system. These settings are outside the scope of the Inquiry's Terms of Reference."

Accordingly, we do not believe that it is possible for the Inquiry to propose effective policy settings to address retirement incomes.

The policy options raised in the Interim Report are those requiring additional consultation, including through Australia's Tax White Paper, the IGR and other studies.

AMP supports a review of the retirement income system to make sure that it delivers the objectives of maximising retirement incomes for members and ensuring Australians are able to manage their savings now and into the future.

Any policy proposals in regards retirement incomes should be thoroughly debated and tested amongst a broad range of experts as the risk of unanticipated outcomes is relatively high. For example, annuities, or even variable income streams, will not be optimal for everybody. Some people will be best served by taking their superannuation in retirement as a lump sum which they can then use to pay off their debts. AMP strongly believes that individuals, properly advised, are the best judges of their needs in retirement and how those needs can best be satisfied financially.

AMP also notes that providing individuals with poorly structured choice options can introduce significant anti-selection and undermine the financial viability of the retirement incomes market. Balancing these competing forces is complex and just one example of why we believe the design of any retirement incomes system should be the subject of its own thorough Inquiry.

3.2 Principles for Retirement Incomes Policy

The FSI Inquiry could, however, develop principles that could form the basis of a subsequent comprehensive investigation into retirement incomes policy that considers taxation, superannuation contribution levels, the Preservation Age, the Age Pension, workforce participation, aged care, health costs, etc. These principles could also be recommended by the FSI for consideration in the Tax White Paper.

AMP notes the paper by the Actuaries Institute, "Public Policy Positions on Retirement Incomes" dated May 2014.

In this paper, seven principles were proposed to guide retirement incomes policy, which AMP broadly supports in principle. These include the need for sustainability, flexibility, equity, efficiency, simplicity and frameworks that support competition.

Such policy principles should lead to policies that deliver low cost, simple easy to administer products that serve the needs of most retirees.

3.3 Policy and Product Options

While AMP does not believe the FSI should develop detailed policy options for retirement incomes policy, we believe it is appropriate to respond to some of the issues raised in the Interim report.

Accordingly, based on the fundamental principles of market mechanisms and incremental change combined with the seven principles outlined previously, we consider there are a number of measures that AMP believes should be supported and a number of measures that should not.

AMP supports the following:

- Providing incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks. AMP currently offers annuity products through its AMP North platform. Incentives for income stream products (or disincentives for lump sum payments) via altered tax and/or social security settings will be needed to make income products more attractive and decrease the proportion of superannuation balances taken as lump sums
- The extension of the MySuper regime to include retirement solutions with "intelligent defaults" to provide retirees with secure income streams[13]. Providing an opt-out of the default option (both at conversion and subsequently) would allow those retirees who are more engaged to make an informed decision (with advice) about how to structure their retirement savings. Incentives should exist to encourage funds being kept in an income stream product or suite of products (or disincentives should discourage lump-sum withdrawals)
- A more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests
- Removal of regulatory barriers to product development and innovation. A more flexible, principles-based approach to determining eligibility of retirement income products for tax concessions and their treatment under the Age Pension means-test would be preferable, so that product providers can have flexibility.[14]
- Issuing longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products, including considering offering a 30 year bond product
- Maintenance of the private sector as the appropriate sector to manage longevity risk.

[13] Note - Whilst there are arguments that any default product should include longevity risk protection, AMP would be hesitant to suggest this on the basis that it could lead to adverse outcomes for individuals.

[14] A particular live issue is that to obtain tax free status currently an annuity has to either be account based or a fixed income stream. The legislation does not currently allow for alternative structures, for example a 'halfway house' where the income stream varies according to the experience of the group.

AMP does not support:

- Maintaining the status quo. AMP does not believe that this will be effective in achieving the stated objectives, particularly as we believe that some current policy settings hinder the development of products to meet retirees' needs, and limit the take-up of products that are available
- Mandating the use of particular retirement income products (in full or in part, or for later stages of retirement). Mandatory annuities or pensions are not always in the consumers' best interests, and does not reflect the diversity of consumer and therefore diversity of outcome required. The cost of longevity guarantees can be significant and this may not be appropriate to the circumstances of all individuals
- Development of group self-annuitisation schemes. AMP proposes that the lack of guarantees in these schemes presents various risks, and that potential significant underperformance versus expectations could lead to a crisis of confidence in the retirement income system. AMP strongly believes that any product that takes on the management of longevity risk should require a Life Licence
- Increased provision of Government longevity insurance. AMP cannot see why government should enter into a commercial market such as the provision of annuities while there is no evidence of market failure.

Recommendations

AMP recommends that:

- **Australia's retirement incomes policy be the focus of a specific and separate review by the Government, taking into account the outcomes from the Inter-Generational Report (IGR), the 2015 Tax White Paper, and the views of experts, specialist practitioners and other stakeholders in the policy area**
- **Industry, government and regulators work together to develop details of a retirement incomes framework that is in the best interests of the nation by way of the proposed separate review**
- **Principles recently developed by the Actuaries Institute to guide policy development for retirement incomes be supported in principle, and adopted in the recommendations of the FSI**
- **That mandatory annuities or pensions should not be introduced as this option does not reflect the diversity of consumer preferences, and therefore may not always be in the consumers' best interests**
- **A system of incentives supported by 'intelligent defaults' ('MyPension') and access to affordable quality financial advice is the best approach to facilitate engagement of superannuation fund members with their superannuation products and retirement income arrangements**

- **Any organisation that issues a retirement income product taking on longevity risk should require a licence to carry on life insurance business, to ensure proper capital support and management of the significant financial and policyholder equity risks that are characteristic of such products**
- **Appropriate grandfathering of retirement incomes policy arrangements be considered to help ensure transparency, manage an orderly transition, and contribute to community trust in the nation's superannuation system.**

4. Competition in the banking sector

FSI observation

The Inquiry recognises the banking sector is competitive but concentrated, and application of capital requirements is not competitively neutral (Interim Report p2-9).

Smaller ADIs in the prime residential mortgage market are disadvantaged significantly by not using APRA accredited IRB models, which reduce the risk weighting for mortgages. Banks that use IRB risk weights have lower risk weights for prime residential mortgage lending than institutions that use standardised risk weights. This provides IRB banks a cost advantage for mortgage lending.

4.1 Regulatory Capital Requirements

The FSI called for views on the costs, benefits and trade-offs of several policy options set out in the Interim Report.

AMP's response

AMP's response to the FSI policy options may be summarised as follows:

- No change: with no change to regulatory capital requirements, the Big Four banks will continue to enjoy a funding and profitability advantage compared with the smaller institutions, and hence undermine competition and the role of the smaller banks. This is borne out by market share data (APRA), indicating the market share of the Major Banks in residential lending has increased from 75% to 84% since the Global Financial Crisis[15]
- Assist ADIs to implement IRB models: Given the homogenous nature of prime residential mortgages in Australia and in an effort to create a competitively neutral market, it is recommended the capital held by ADIs for credit risk should not be materially different between IRB and standardised ADIs. This can be accomplished in two steps:
    - First, APRA should remove the significant risk weighting differences between IRB and standardised approach in its Prudential Standards. This can be done either by increasing the risk weighting floors for IRB banks or reducing the standardised risk weights or a combination of both. This determination will depend on macro prudential and capital market considerations which are beyond the scope of AMP's response. After better aligning the IRB risk weightings, AMP believes the Australian market will be characterised by more robust credit standards if more ADIs used the IRB approach for the prime residential mortgage lending
    - As a second step to aligning prime residential mortgage risk weightings, APRA should help facilitate a process for regional/small ADIs, credit unions and building societies to obtain IRB status for the credit risk of their prime residential mortgages, in isolation to

[15] *APRA, Market Update 2013*

other lending done by the institution. By aligning standardised risk weights, a more granular approach could be applied, particularly by LVR band. This would require ADIs to hold more capital for high LVR loans and less capital for low LVR loans, thus encouraging prudent lending standards. A "standard eligible mortgage", with a 40% LVR versus one with 80% LVR, all other factors being equal, is risk weighted identically, which does not encourage more conservative lending.

4.2 Recognise AAA rated prime RMBS as HQLA2

The RBA provides a Committed Liquidity Facility (CLF) to banks to provide them with repo eligibility certainty for eligible liquid assets that do not fall within the APRA defined HQLA (in Australia, effectively government and semi-government bonds).

Eligible securities for the CLF include RMBS. Banks pay 15 basis points to the RBA for this facility.

If AAA rated prime RMBS were recognised by APRA as HQLA2, it would increase the pool of eligible liquid assets, reduce the amount of liquid assets for which the RBA would need to provide its liquidity facility, and assist ADIs meet the new Basel III liquidity requirements (due to be implemented on January 1, 2015).

Recommendation

AMP recommends that:

- **Measures be taken to ensure competitive neutrality in Australia's banking system. These include:**
    - **Capital held by ADIs for credit risk should not be materially different between IRB and standardised ADIs; and**
    - **AAA rated prime RMBS should be recognised as HQLA2.**

Regulators

– That the current arrangements in Australia for financial stability policy and regulatory coordination are also working well, and we do not see a case for significant change in this area

– That AMP strongly supports ASIC being appropriately resourced to continue to carry out appropriate supervision, however the funding model should be refined to ensure it is based on the work required to "appropriately monitor" rather than on a per capita basis.

Stability of Superannuation policy settings

– That if the goal of public policy is to maintain confidence in superannuation as a retirement savings vehicle, predictability and stability in policy settings is a must

– That an open market should continue to be the primary mechanism for maintaining an efficient, competitive financial system

– That stability and consistency in superannuation policy settings is crucial to restore consumer trust, and encourage participation and consumer engagement with and within the system. A lack of stability not only imposes additional cost but leads to an erosion of long term confidence and trust in the superannuation system.

Superannuation, sole purpose test

– That superannuation savings should not be used for other purposes (e.g. housing, education).

- Emerging issues for the Australian economy and financial system are longevity, an ageing population, healthcare costs and budget sustainability. The situation will become more problematic over time
- Nevertheless, the financial system (and within it, the superannuation system) appears to be working well; there is no need for radical change
- In order to fund adequate retired incomes, Australia – like all other developed nations – has the limited choice of either increasing taxes, increasing retirement age or increasing savings
- Our recommendations with respect to the superannuation system are that:
    - The existing SG system has worked well and must be allowed to reach maturity without further significant policy change
    - The role voluntary savings plays in ensuring adequate retirement incomes is crucial. In order to restore optimal interaction between the three pillars, Australians should be encouraged to make voluntary contributions to reduce pressure on the other two
    - Superannuation savings should not be used for other purposes (e.g. housing, education)
    - That there is no substantiated evidence that individuals spend their superannuation savings immediately on retirement and then revert to the pension
    - Mandatory annuities or pensions should not be introduced; and
    - With an ageing population, increased longevity, greater retirement expectations and likely greater health care costs, additional policy measures may be needed to ensure adequacy
- Superannuation already plays an important role in infrastructure provision
- Institutional investors are increasingly viewing infrastructure as an alternative to fixed income
- Institutional investors prefer mature assets and there is a demand by fund managers for brownfield developments
- The federal government could play a role in the development of economic infrastructure through targeted investment.

Media Release

Public Affairs
Tel: 02 9257 6127
Email: media@amp.com.au
Website: AMP.com.au/media

21 August 2014

AMP lifts adviser education standards and launches customer panel

AMP has announced it will implement a series of measures across its licensee groups that aim to significantly lift the bar on adviser professionalism and reinforce its existing commitment to stand behind the advice it gives to consumers.

AMP Group Executive Advice and Banking Rob Caprioli said AMP, as the largest advice network in Australia, will work with the regulators and lead the way for the industry to help restore confidence and trust in financial advisers and the advice they give.

"This is a critical time for the industry and the measures we've announced today go to the heart of what we do – offering financial advice to help people live better lives. This commitment builds on our record of significant investment in the standards of professionalism for our financial advisers," he said.

The measures are:

- All existing and new advisers must hold a Certified Financial Planner® (CFP), a Fellow Chartered Financial Practitioner (FChFP), or Masters in Financial Planning (MoFP) qualification.

  New advisers must complete this qualification within five years of joining an AMP licensee while existing advisers have up to 31 December 2019 to do so. These qualifications are post-graduate degree equivalent, making AMP's minimum requirements the industry's highest.

- An AMP Customer Advice Review panel will be established by the end of this year to review any customer complaint about the quality of AMP's personal advice when the customer is not satisfied with AMP's response through normal channels.

  If the panel finds the personal advice was not appropriate when it was given, the customer will be restored to the position they would have been in if the appropriate advice had been given. The panel, which will have an independent chair, will have the power to refund advice fees and compensate for losses.

- A broad-ranging ethics and responsible decision-making program for advisers will be developed in conjunction with the St James Ethics Centre with industry input. The program, which will be available to any financial adviser in the industry, will be in place by mid-2015.

“Customers expect us to provide them with quality financial advice that puts their interests first. So we take this very seriously and will continue to look closely at what we do to ensure we continue to provide the best advice possible,” Mr Caprioli said.

“AMP stands behind the advice its advisers give to customers. That’s the benefit of seeking advice from an adviser backed by a large and trusted brand like AMP. We can make things right for those customers who don’t receive advice that’s in their best interests. The announcement today takes this commitment a step further.”

The AMP Customer Advice Review panel will be chaired by an independent representative and comprise a CFP, FChFP or MoFP advice professional and AMP’s Chief Customer Officer, Paul Sainsbury.

The industry-wide adviser registry, which will be developed by ASIC, has the full support of AMP. When the ASIC adviser registry is finalised, it will be available via AMP’s website.

“Ensuring easily accessible public information on individual advisers, including their qualifications, is an important step to increasing faith in the industry but more importantly it will help Australians seeking advice to more easily compare and select financial advisers,” Mr Caprioli said.

The role ASIC plays in partnering with the industry to ensure high standards and good outcomes for Australians seeking financial advice is critical and AMP strongly supports the FSI Interim Report’s policy option to increase funding to the regulator.

The measures announced today have the support of the Financial Planning Association (FPA) and the Association of Financial Advisers (AFA). The FPA and the AFA have 10,000 and 3,000 members, respectively. AMP is liaising with these groups and calling on the industry to adopt these measures.

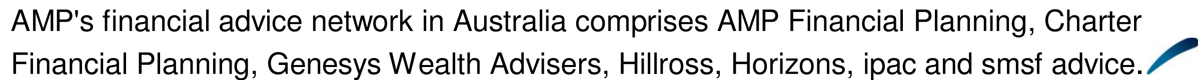
Enabling advisers to choose between a CFP, FChFP and MoFP ensures all advisers across the AMP Group have access to the relevant qualifications.

“This builds on the work that our financial planning academy, Horizons, is doing to recruit, educate and develop new financial planners. Horizons entry standards are already among the highest in the industry with a 10 week intensive academy course followed by a nine month supervised placement in a practice.

“The academy also works with universities to increase awareness of financial planning as a career choice for graduates via the AMP University Challenge,” Mr Caprioli said.

AMP is working with its licensees to ensure all AMP financial advisers have the necessary support to achieve the measures outlined today.

AMP's financial advice network in Australia comprises AMP Financial Planning, Charter Financial Planning, Genesys Wealth Advisers, Hillross, Horizons, ipac and smsf advice.



Media enquiries

Amanda Wallace
Phone: +61 2 9257 6168
Mobile: +61 422 379 964

Renae McGregor
Phone: +61 2 9257 6160
Mobile: +61 422 159 787

AMP Group Executive Advice and Banking, Rob Caprioli, will hold a media briefing immediately after the 9.30am AMP half year results media briefing at the same venue.

Venue: AMP, Level 25, 33 Alfred Street, Circular Quay, Sydney

All attendees must enter via the Ground floor on Alfred Street to register.

Teleconference: AUSTRALIA – Toll free 1800 838 758. NEW ZEALAND– Toll free 0800 447 258

Information for Financial System Inquiry submission

26 August 2014

TOWERS WATSON

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Section 1: Why has UK Government policy turned against annuities

The purpose of this section is to provide some perspective on why the UK is moving away from the annuitisation of retirement savings.

1.1 2014 Budget statement

In his 2014 Budget Statement, the UK's Chancellor of the Exchequer announced that, from April 2015, all restrictions on how people over 55[1] can access money saved in defined contribution (DC) pensions[2] will be lifted:

> *"Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want. No caps. No drawdown limits. Let me be clear. No one will have to buy an annuity"[3].*

Under the new regime, people will still be able to take 25% of their DC pension savings as a tax-free lump sum; beyond that, withdrawals will be subject to income tax at the individual's marginal rate (as is the case with annuity income). It would be incorrect to say that the UK had compulsory annuitisation before this change[4]. However, buying an annuity was the norm and was for many people the only practical option.

Most of the reasons for making this change are political – both in the sense that it is consistent with the beliefs of key decision makers and they expect it to be electorally advantageous.

The Government has highlighted ways in which the reforms could be beneficial for retirement outcomes but it acknowledges that there is a lot of uncertainty about how people will use their new freedoms. It has not yet published a proper impact analysis. Some of the likely consequences have hardly been discussed – for example, that less pooling of mortality risk will result in the "surplus" savings of people who die younger than expected going to their heirs rather than being used to boost the incomes of people who remain alive for longer than expected.

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[1] This age will rise to 57 in 2028. Where funds are accessed at younger ages, severe tax penalties usually apply.

[2] The change also applies to "cash balance" arrangements, where the defined benefit formula delivers a pot at retirement rather than an income in retirement.

[3] Budget Statement to House of Commons, Hansard, 19 March 2014, col.793

[4] Instead, people have been able to keep their savings invested and draw an income from them. In most cases, annual withdrawals are limited to a prescribed multiple of the annuity that the individual could purchase. The requirement to buy an annuity by the age of 75 was "properly" abolished by the Coalition Government in 2011. An earlier relaxation under the previous (Labour) Government allowed over-75s not to annuitise but there were conflicting signals as to whether this option was supposed to be for everyone or only for people with religious objections to pooling mortality risk.

1.2 The Chancellor's views[1]

George Osborne has a preference for policies that give freedom to individuals – as you might expect from someone who named his daughter Liberty.

His comment that "the State should not be imposing restrictions on individuals who have made tough choices to save for the future"[2] is sincere. He had used strong rhetoric on the subject of annuities a decade earlier, when he accused the then Government of having erected an "ideological brick wall" to relaxation of annuity rules and said: "To paraphrase the late, great Ronald Reagan, it is time to tear down that wall"[3].

The Chancellor has a reputation for being prepared to make big decisions, and is reported to have told friends that he entered Parliament because "politics is the only career in which you can actually get stuff done"[4].

1.3 Popularity and wealth effects

An opinion poll conducted shortly after the Budget found that 66% of voters said they supported the reform and only 8% said they opposed it (the rest did not know)[5].

Of course, many voters will not have noticed the announcement or even know what an annuity is, but the issue is likely to be very salient for those coming up to retirement. Steve Webb, the Liberal Democrat Pensions Minister, has reported that: "This is, I think, the first thing I have been involved in in government where I have had people walk up to me in the street and shake my hand."[6]

Low interest rates make the annual income that people can exchange their pension pot for appear worse value. Commentary on this usually skips over how monetary policy has also inflated the value of the pension pot being used to buy an annuity and how a subsequent improvement in annuity rates might be accompanied by a shrinking of the pension pot. The Budget reform may give people "permission" to focus on their pot size rather than the income it can buy, and to feel wealthier as a result.

[1] The author of this note had intermittent dealings with George Osborne when working for the UK Conservative Party between 1999 and 2005. The important thing to understand here is that he combines being the finance minister with being the Conservative Party's main strategist.
[2] Foreword to *Freedom and choice in pensions*, HM Treasury consultation paper, March 2014
[3] Finance Bill Committee debate, 8 June 2004
[4] Quoted in *George Osborne: The Austerity Chancellor*, by Janan Ganesh, Biteback Publishing, 2012. Recent newspaper reports have suggested that Osborne is mulling over whether to become Foreign Secretary if the Conservatives win the 2015 general election (in order to take charge of negotiations on the terms of the UK's European Union membership); in that case he might have a limited window to "get stuff done" as Chancellor even if his party remains in power.
[5] YouGov poll for *The Sun*
[6] Evidence to House of Commons Work and Pensions Committee, 30 April 2014

1.4 Budget Day theatre and political dividing lines

This was the penultimate Budget before the 2015 general election. The Chancellor needed a set-piece announcement and – with the fall in public sector borrowing having slowed – did not have money to spend. So one answer to the question “why do this now?” is another question that has nothing to do with pensions: “what else could he have made into the Budget highlight?” In a Coalition Government, big announcements have to be acceptable both to the Conservatives and to the Liberal Democrats. Policies that are “liberal with a small ‘l’” – such as this pension reform – are most likely to win support from both parties.

A well-kept secret leading to blanket positive coverage on the next day’s newspaper front pages was the perfect antidote to the so-called “omnishambles Budget” of 2012 (when, with the big positive stories having been trailed in advance, the media focused on trivial tax adjustments that were labelled “the granny tax” and “the pasty tax”).

Although the reforms seem obvious in retrospect, they were completely unanticipated. It took the Opposition Labour Party two or three days to sort out its line and make clear that it would support the reforms. In the meantime, the Leader of the Opposition was mocked for not addressing the Budget’s main announcement in his immediate response and the Conservatives had been able to push “we trust people with their own money, Labour don’t” as a dividing line[1].

1.5 Making pensions more attractive

The Chancellor believes that “you make pension saving more attractive when you give people greater freedom”[2] and that “we cannot expect people to save responsibly for their retirement if they do not believe they will get value for money from their savings when they come to access them”[3]. The fact that most other countries do not impose similar restrictions on the use of DC pension savings has also been cited as supporting the view that the UK does not need to.

1.6 Hope that new retirement income products will emerge

The Government believes that this reform can unleash innovation in the retirement income market, and that some of the new products will be welfare-enhancing. For example, changes to tax rules will allow insurers to offer “u-shaped” annuities that pay out more when pensioners are young and active and when they are old and need help, but less in the middle[4]. It will also be possible to withdraw money from a pension at around the time of retirement to pay for long-term care insurance.

[1] Conservatives seized on comments made by John McTernan, a former adviser to Tony Blair who subsequently worked for Julia Gillard. On the evening of the Budget, McTernan told the BBC’s *Newsnight* programme that reform was a bad idea because “you cannot trust people to spend their own money sensibly”.

[2] Evidence to House of Commons Treasury Select Committee, 3 April 2014

[3] Foreword to *Freedom and choice in pensions*, HM Treasury consultation paper, March 2014

[4] This was confirmed on 21 July 2014m, in the Government’s response to the *Freedom and choice in pensions* consultation

1.7 Annuities had received a hostile press

The Government has neither endorsed the common view that annuities are routinely bad value, nor defended them. It has limited itself to saying that "annuities will remain the right choice for many at some point during retirement" but that "some parts of the market are not working well for consumers"[1]. However, its reform taps into widespread anti-annuity sentiment – and those who want to buy annuities can still do so.

Both the suitability of annuities as a product and their value to consumers have been attacked in the media. Some pensions commentators had positioned the annuity as a high-risk irreversible purchase, highlighting how long people need to live to get their money back and how much they could lose if they die young[2]. Many consumer finance journalists start from the position that annuities are a bad deal and have diligently searched for new angles that play to that theme[3].

Several newspapers' money sections had been running campaigns around annuity reform, though their demands were nowhere near as sweeping as what the Government delivered.

Preliminary findings from the Financial Conduct Authority (which regulates annuity providers) had indicated that profitability was higher where annuities were sold to retained customers than when people had shopped around[4]. In much media commentary, not shopping around is linked to insurers' selling tactics.

1.8 Part of a wider pro-saving narrative

The policy was presented as part of a package of measures to reward savers. The Budget also increased the annual contribution limit for Individual Savings Accounts (which operate on a Taxed-Exempt-Exempt basis) and created pensioner bonds (whereby the Government offers pensioners dismayed by low interest rates a home for their savings, borrowing off them at a more expensive rate than it could borrow in the markets).

Partly, this is about doing something to appease a section of the electorate that is unhappy about negative real interest rates without changing monetary policy. But it also helps the governing parties to talk about moving the UK to a more sustainable economic model, which they have been discussing (intermittently) for some time: for example, George Osborne told the 2009 Conservative Party conference that: "We must move this economy from one built on debt to one sustained by saving and investment".

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[1] Quotes from the Government's response to the consultation and the original consultation paper, respectively

[2] Dr Ros Altmann, a high-profile pensions campaigner, is the most prominent example

[3] A few examples: Where annuity rates differ, this was reported as evidence that one provider was trying to rip people off (and not that they had particularly little appetite for that sort of risk); insurers were criticised for paying commissions to brokers but not returning this money to policyholders who buy direct; providers were criticised for selling standard annuities to people who might qualify for enhanced rates (these reports would not usually mention that standard annuity rates might worsen if more people buy enhanced annuities; a Government-funded price comparison site was revealed not to be "whole of market"; insurers have been criticised for not making it sufficiently clear that a man buying a single life annuity will not provide an income for his widow.

[4] *Thematic Review of Annuities*, FCA, February 2014; Towers Watson helped the FCA develop an approach to analyse profitability.

1.9 Acceleration of tax revenues

If people withdraw more money from their pensions early in retirement, this will bring forward tax revenues in respect of pension income. Under national accounts conventions, this change to the timing of tax receipts would make public sector borrowing look smaller during the next Parliament (albeit only slightly and superficially).

In some cases, it might also increase the total amount of tax that people pay over their lifetimes – for example, if earlier withdrawals mean that people pay tax on income now when they would have some unused tax allowance in subsequent years.

The Office for Budget Responsibility (which provides fiscal projections for the Government) assumes that the impact on revenues will be mildly positive until the 2030s, and will then become negative[1].

1.10 Intergenerational transfers?

There has been a lot of commentary about generational inequality, with pensioners largely protected from fiscal consolidation. The Government has not said this, but it *might* hope that these reforms will lead to some pension wealth being passed down to younger generations either through faster withdrawals or through inheritance of non-annuitised pension assets[2]. Of course, that only helps younger people whose relatives have significant pension wealth and will not usually involve the assets of existing pensioners.

1.11 Annuity reform made possible by State Pension reform?

Part of the historical justification for making people use their pension savings to provide a lifetime income was that they could otherwise spend their savings before falling back on means-tested State benefits.

A major overhaul of the State Pension system is being implemented for people reaching State Pension Age from April 2016 and the Pensions Minister has claimed that “because of State Pension reforms, all of this [annuity reform] becomes possible”. In part, his argument is that the new single-tier State Pension will be set about the guaranteed minimum income level for pensioners, whereas “if people blew the lot in the current regime… they end up below the poverty line”[3].

This is not particularly convincing. For one thing, this argument ignores the second component of the State Pension under the current regime (as a result of which, many people who “blew the lot” would still be above the minimum income level that the State guarantees for all pensioners through means-tested support).

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[1] *Economic and Fiscal Outlook*, March 2014, chart 4.1. This is sensitive to assumptions about how people will use the new freedoms. It also appears to assume that the accessibility of pensions to over-55s will not be exploited by people washing salary through pensions to avoid tax and National Insurance Contributions; some measures to discourage this have now been announced but more may be needed.

[2] The future tax treatment of these assets remains unclear, pending an announcement expected in November/December 2014.

[3] Steve Webb, Evidence to House of Commons Work and Pensions Select Committee, 30 April 2014

It would be more relevant to note that, by abolishing a means-tested top-up (which is typically quite small and often unclaimed) for people with small savings, State Pension reforms make it harder for people who don't quite "blow the lot" to claim extra help from the taxpayer. However, this is unlikely to be a major driver of the reforms: the Government expects most pensioners to be careful with their money and is not removing entitlement for other means-tested benefits; and some of the people affected would have been able to cash out their pensions under "small pot" rules in any case.

Moreover, the rules governing means-tested pensioner benefits that apply now or in the near future will only be part of the story. If the UK does end up with significant numbers of pensioners who are poor because they "couldn't have known that they'd live well into their 90s", there may be public pressure to use taxpayers' money to top up their State Pensions.

1.12 Views on DC asset allocation

The Pensions Minister has suggested that people spend too long with their retirement savings invested in less risky assets (both because annuities are largely backed by bonds and because pension plans automatically shift individuals' investments into annuity-matching assets in the run-up to retirement[1]).

However, this is unlikely to be a major part of the Government's thinking: the point has not been made by HM Treasury (the responsible department) and the reforms could have the opposite effect if people withdraw their pension savings and put the money in a cash account.

[1] On the latter point, see his interview with *Professional Adviser*, conducted on 8 July 2014

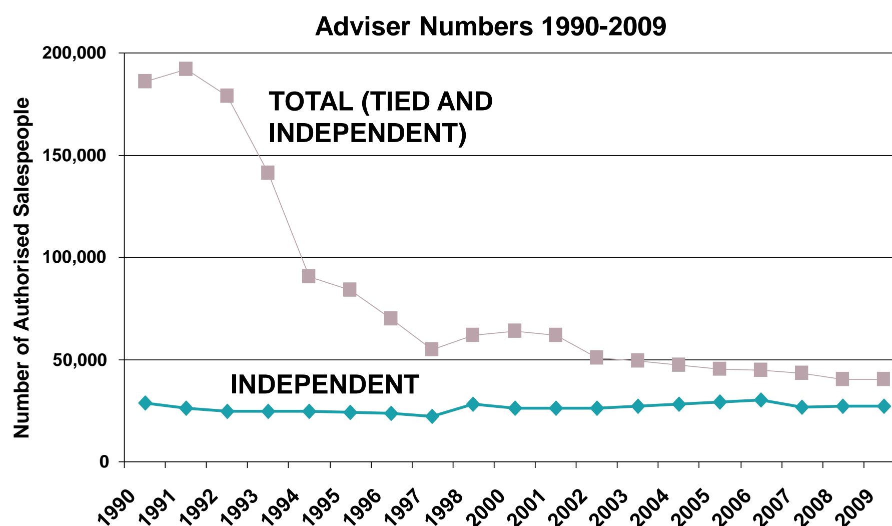
Section 2: Vertical integration in the UK life and retail investments market

The purpose of this section is to provide some perspectives on the following aspects of vertical integration and industry regulation of financial advisers in the UK:

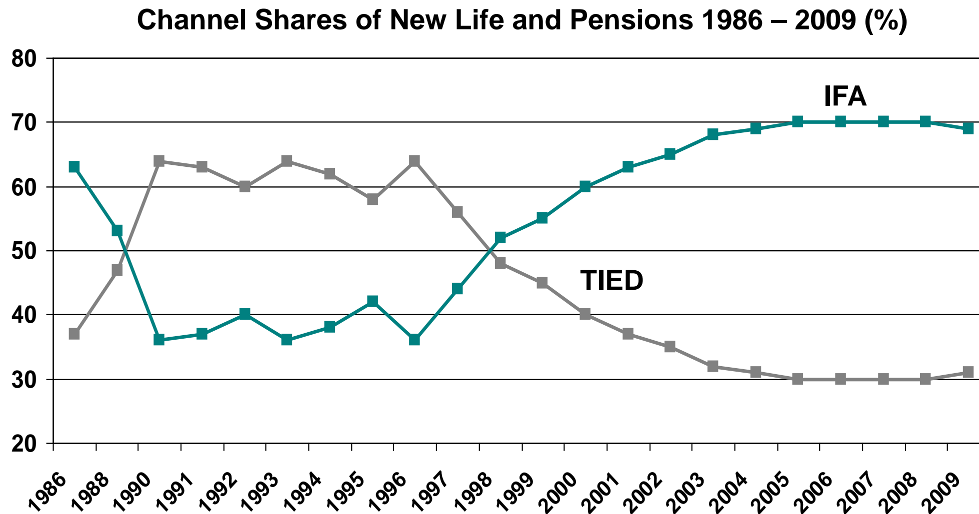
- The evolution of vertically-integrated businesses in the UK.
- The debate about structural separation between independent and non-independent advice considered as part of the development of the Retail Distribution Review (RDR) in 2008.
- The current approach to regulation of different types of advisory business models.
- Strategic arguments in favour of vertical integration.
- Examples of vertically-integrated models.

2.1 The evolution of vertically-integrated businesses in the UK

Distribution channel shares have varied considerably over the last 25 years, mainly in response to regulatory changes and resulting business pressures. The following charts show the evolution of seller numbers and channel market shares, split between tied and independent financial adviser (IFA) channels:



Source: Towers Watson estimates



Source: ABI

Tied distribution in the above charts includes direct sales forces and tied agents and banks, where applicable.

The key stages in the above evolution were:

- A scramble for tied distribution to secure market access in the period up to 1988, when polarisation of advisers between independent and tied was introduced for the first time.
- Subsequent rationalisation and closure of direct sales forces and tied agency channels in response to:
  - Poor performance in direct sales forces, which challenged the viability of existing models.
  - A series of industry-wide and company-specific business conduct problems which necessitated extensive reviews of past business and rectification of problems identified, further undermining viability and introducing unplanned volatility into financial results. While not confined to tied companies, much of the highest profile activity was concentrated in that sector.
  - Diminishing provider appetite for distribution and conduct risk, in the light of the above costs and reputational problems, which led to closures and divestments.
- The migration of capacity from sales forces to IFA firms as sales forces downsized and closed.

Currently, we estimate that there are around 32,000 financial advisers in the UK market, of which we estimate around 3-3,500 are working in direct sales forces. Most of the remainder are IFA or multi-tied distribution businesses with smaller numbers of Discretionary Fund Manager (DFM) and stockbroking advisers.

2.2 The 2008 RDR debate about structural separation between independent and non-independent advice

The objective of the RDR was to improve consumer trust and confidence in the retail investments industry by addressing a number of deep rooted problems, particularly:

- Lack of clarity about products and services and the status of advisers.
- Conflicts of interest (including incentives).
- Lack of robust professional standards for financial advisers.
- Consumer access to sources of advice.

In relation to the first of these objectives, during 2008, as part of the development process for the RDR, the Financial Services Authority (FSA), which regulates all providers of financial services in the UK, considered a radical structural separation of distribution business types, under which only firms satisfying independence criteria would have been able to offer regulated financial advice (personal recommendations). Tied or multi-tied companies, including vertically-integrated companies, would have been banned from providing advice and would have had to sell products only on a non-advised basis. This proposal was abandoned in late 2008 for the reasons described in 2.4 below.

For reference, the key FSA publications relating to this issue were:

- The Retail Distribution Review – Interim Report (April 2008) – proposals.
- Feedback Statement 08/6 (November 2008) – abandonment.

2.3 The April 2008 Proposals

The Interim Report followed on from previous consultations. It proposed a simplified landscape with three distribution components:

- Advice:
  - All advisers to be independent in status and operationally independent of providers.
  - Adviser remuneration to be determined without provider input.
  - Advisers must advise from across the whole of the market.
  - Advisers to meet minimum professional standards.

- Sales: A strictly non-advised service, either execution-only or guided sales without a personal recommendation being given. Providing access to the products of one provider only or a limited number of providers.
- Money Guidance: A proposed initiative to improve consumer education and capability with the aim of stimulating more consumers to seek advice and sales services.

The aim of these proposals was intended to clarify the status of different types of service by forcing a separation between independent advice and sales-advice provided by tied and multi-tied distributors. Had the split between advice and sales been implemented the latter would only have been able to sell without advice – i.e. without advisers making personal recommendations about the suitable course of action for individual customers.

It is likely that this would have reduced the appeal of tied models to consumers and that the reduced levels of sales persuasion (relative to fully advised models) would have reduced sales conversion and productivity. The viability of these sales-advice channels would therefore have been reduced and providers dependent on captive or multi-tied distribution would have had to modify their distribution strategies in order to sustain new business inflows.

2.4 Withdrawal of the proposal

Following consultation, the proposal for structural separation was abandoned and replaced by the arrangements which were implemented and which are described in the following section. The FSA gave the following reasons for not proceeding:

- Concerns about the impact of the proposal on consumer access to advice, especially among less affluent consumers, who were more likely to use restricted advice models and who might lose access if this form of distribution were banned.
- Concerns that the resulting FSA definition of advice would be inconsistent with broader definitions used under EU Legislation (MiFID, the Markets in Financial Instruments Directive).
- Fears that the existing customers of firms would suffer if the firms were required to change their model or withdraw their advice services.
- Lack of industry consensus and perceptions of self-interest on the part of some firms in seeking to exclude others from the advice market by influencing the future direction of regulation.

2.5 Towers Watson's view of the Interim Report proposals

At the time of the Interim Report, Towers Watson undertook analysis of the merits of the proposed structural separation. In summary our view was:

- The proposals did not adequately define "advice" and "non-advised", nor did they define or set out a desired end state in terms of consumer advisory outcomes. They were therefore a poor starting point for upgrading the quality and accessibility of financial advice.
- We emphasised the quality of advice in helping consumers in key strategy areas such as:
  - How to translate life goals into financial plans.
  - How much to save.
  - Risk/reward trade-offs.
  - Which product types and investments to use to meet their goals.

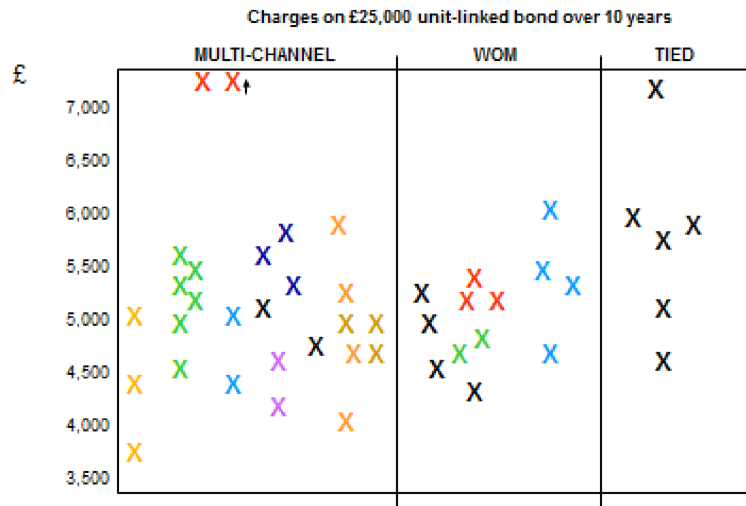
Our view was – and remains - that, in many product areas, competent delivery of the above strategy areas is more important than advice on provider selection, especially where product commoditisation means there is often limited scope for product differentiation. Quality of advice is therefore more important than whether the adviser has access to the whole market, provided that customer charges are not materially different or are justified.

- We also emphasised the quality and consistency of the customer experience and the potential role of large, robust organisations in its delivery, including provider-owned distribution channels.
- Our view therefore was that advice could be provided as effectively by tied firms as by independent firms, and that large vertically integrated firms could have advantages over smaller, poorly resourced IFAs whose capacity for investment and scaling up may be limited.
- The concept of independence used by the FSA (whole of market product access) was not aligned with more intuitive customer views of independence such as impartiality. This might lead to customer confusion and potentially poor purchasing outcomes.
- Whole of market access was already becoming less relevant due to some convergence of product availability at point of sale across independent and tied channels:
  - IFAs increasingly offering a limited range of products through the use of panels (albeit based on some form of whole market due diligence from time to time). Other factors in the IFA market included the growing use of platforms and Discretionary Fund Management services.

– Increased use of open architecture and best of breed multi-tied/gap-filling in the non-independent sector, which had the effect of increasing consumer choice, especially in relation to investment funds.

- Limited comparisons of product charges that we carried out in 2008 did not indicate that charges were higher in tied channels compared with multi-channel and whole of market firms.

Evidence on charge comparisons does not indicate clear advantage for Whole of Market (WOM) firms



Source: FSA consumer website, Tillinghast analysis

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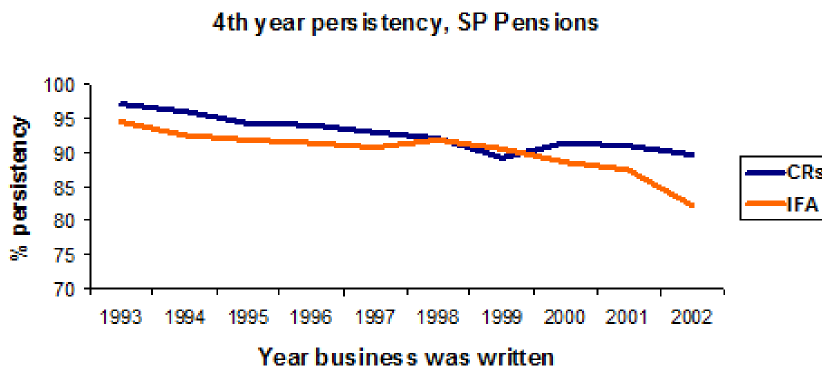
- Limited analysis of persistency data published by the FSA indicated equivalent or slightly better 4th year persistency rates in tied channels than for the IFA channel in respect of single premium (SP) pensions.

The FSA's persistency data does not indicate greater suitability or satisfaction in the IFA channel versus Company Representatives (CRs)



Source: FSA

© 2008 Towers Perrin

- The realignment of the industry needed to implement the structural separation would result in considerable disruption including the loss of advice capacity from the non-independent sector.
- Our prescription was that the FSA should:
  - Focus on the quality of advice provided, not just the status of the adviser (though clarity about the latter is important as well).
  - Recognise that the quality of advice is different from, and independent of, the breadth of the product range being sold.
  - Recognise the steps towards convergence between point of sale product and investment availability in different models.
  - Avoid structural changes which might inhibit capacity development, innovation and investment in advice provision and market development.
  - Therefore, retain the concept of financial advice in tied and multi-tied businesses.

2.6 The current approach to regulation of different business model types as implemented in 2013

Advice is available from both independent and restricted firms. Restricted firms include tied and multi-tied firms, including vertically integrated firms.

The following requirements apply to all advisory firms:

- There is a commission ban on advised sales of retail investment products. Instead, advice charges must be agreed between the adviser firm and the client. Providers can facilitate advice charge payments but must not influence the level or structure of the advice charges. Advice charges are, in practice, often structured in such a way as to look like pre-RDR commissions.
- Higher professional standards apply to all advisers, roughly equivalent to year one of an undergraduate degree.
- Improved disclosure of adviser status and the scope and limitations of the service available from the firm.
- The following apply in addition to independent advisers:
- The requirement to advise on a wider range of products, not just packaged investment products. In practice this may include products such as Investment Trusts and Exchange Traded Funds.
- The requirement to undertake “comprehensive and fair” analysis of relevant markets from which products may be recommended.

The following applies to vertically integrated firms:

- There must be no material cross subsidy between the product manufacturing and advisory parts of the firm. This means that advice must be financially viable in its own right.

2.7 Strategic arguments in favour of vertical integration

Generally, we believe the following to be arguments in favour of vertical integration in financial services distribution:

- It enables a more consistent customer centric approach to be applied to product management and customer treatment. The provider has greater control across the value chain from definition of the target market, through product development, distribution strategy, sales process and service delivery. There is less chance of the conflicting priorities of third party intermediaries weakening the integrity of the provider's customer proposition. Specific examples might include the development of products and services to meet the needs of customers rather than third party distributors and associated savings in servicing infrastructure. Overall, a more customer centric approach can deliver a number of benefits, including reduced conduct risk, improved customer satisfaction and lower unit costs.

- It facilitates market development and innovation. Providers are more likely to innovate if they have a more certain route to market, such as that provided by in-house distribution or specialist distribution controlled by business partners. The sales channel can be configured to address the situation and needs of the target market and the provider can work closely with the sales channel to maximise the effectiveness of the service provided to the end customer. In contrast, in established third party channels innovative ideas may not fit with the adviser's business model and may take considerable time to gain acceptance. New products and propositions often take off more slowly where providers have to rely on broker-type distribution – for example long term care in the US or Variable Annuity type products in the UK.

- It may enable greater levels of customer access to advice compared with reliance on IFAs alone.

- From the provider's point of view vertical integration may help reduce price competition at point of sale compared with broking models. Furthermore, greater control over the customer experience, enhanced customer data and insight and customer access should enable improved cross and up-selling and the realisation of brand recognition and loyalty.

Recently in the UK we have been involved in market research among consumers which indicated a high degree of willingness to seek advice and support from providers, rather than from IFAs: for example, 55% of affluent customers indicated they would prefer to receive advice from a provider.

Although conditions will vary from case to case, in general our experience when modelling different types of distribution structure is that the expected benefits of streamlined operations, improved control and business integration outweigh the potential disadvantages which might arise in relation to reduced customer appeal of narrower propositions and the associated risk of reduced share of customer wallet.

2.8 Examples of vertically integrated models

Life companies in the UK which currently operate direct sales forces include:

- SJP – around 2,600 advisers: Self-employed partnership model with experienced advisers, including many former IFAs. Wealth management proposition focussed on affluent clients, with extensive open architecture investment proposition. Strong business generation focus via personal prospecting (referrals, seminars, etc) and a fairly visible brand by the standards of UK advisory companies.
- Wesleyan Financial Services: Operates via professional affinities: doctors, dentists, lawyers, teachers with segmented sales force aligned with these segments. Employed, salaried sales force.
- NFU Mutual: Composite focussed on the farming and rural markets. Sales force is driven mainly by referrals from general insurance agents. Believed to demonstrate high productivity and business quality, presumably due to strength of affinity, quality of customer base and high quality of sales execution. Salaried employed sales force.
- Prudential Financial Services: New sales force established several years ago, understood to serve maturing Prudential customers that otherwise lack a financial adviser.

Common themes in the above examples are:

- Focus on clear target market (and relatively affluent target customers).
- We believe, relatively high productivity generated by lead generation and wider company support.
- In some cases (eg Prudential and NFU Mutual), we assume that the lead generation model used is capable of identifying customers with a high probability of taking action soon, either because a policy is maturing or because an introducer has identified a clear customer need.

We are not aware of any old-style mass market prospecting commission–only sales forces of any size operating in the UK.

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Section 3: Fees and cost in the Australian superannuation industry

The purpose of this section is to provide analysis and perspectives on some of the key findings of the Grattan Institute report published in April 2014, in particular in relation to the fees charged by Australian superannuation funds including the treatment of advice and distribution costs in the retail sector and where other costs may distort the comparison with overseas markets. We also provide a forward looking analysis of default MySuper products in Australia on a like-for-like basis with other funds.

The interim report of the Financial System Inquiry (Inquiry) released on 15 July 2014 states that:

"The operating costs of Australia's superannuation funds are among the highest in the Organisation for Economic Co-operation and Development (OECD), and the Super System Review concluded superannuation fees were "too high". The Grattan Institute estimates fees have consumed more than a quarter of returns since 2004. Although the Inquiry notes the difficulties of comparing costs or fees across funds, especially internationally, the evidence suggests there is scope to reduce costs and improve after-fee returns (see Chart 4.1). The Inquiry is investigating the costs and fees of the system further."

"That said, fees should not be considered in isolation. It is important that a focus on fees alone does not result in a shift towards lower-cost and lower-return asset allocations that would reduce after-fee returns. Ultimately, superannuation funds should be judged on their after-fee return for a given risk profile."

3.1 Key findings from the Grattan Institute report

One of the key findings of the Grattan Institute report (Report) is that "Australians pay too much for superannuation". Figure 1 in the Report shows that the cost of running the Australian superannuation system is much higher than the OECD average. The figure shows that average fees have dropped from about 1.38% of funds under management (FUM) in 2002 to 1.19% in 2013. This compares with a reported expense ratio of about 0.82% in 2013, and an OECD median expense ratio of about 0.45%.

- There are three main categories of costs that may be incurred by superannuation funds:
- Operational/administration costs;
- Investment costs; and
- Distribution/advice costs.

Each of these will vary significantly between types of providers and products.

Distribution/advice costs for Choice members should be excluded

The Report notes (Note 1) that "fees exceed reported expenses on average because some funds earn profit, pay commissions, or incur other costs." Presumably these differences mainly relate to the "Retail" segment of the superannuation industry, rather than the Industry, Public Sector and Corporate segments which are not run for profit and do not generally pay commissions or other distribution fees.

In a not-for-profit fund, to the extent that fees charged recoup more or less than the actual costs incurred, the difference is used to increase or decrease the investment return credited to members, or to provide additional services for fund members, or it is reserved for the future benefit of members. This means that, in respect of not-for-profit funds, the measure of fees charged to members is not necessarily an accurate reflection of the cost to members. Instead, a more accurate measure of costs is the expense ratio.

Figure 12 of the Report shows that fees differ markedly across the superannuation industry for a member with a $50,000 balance. "Many funds – mostly industry funds – charge fees at just under 1%. The fees of retail funds range from around 1 to well over 2 per cent a year."

It is likely that the fees quoted for Retail funds include a significant component of distribution and advice costs, and that the members affected by these higher fees are Choice members (i.e. they have actively selected the fund in question rather than being defaulted into it). Further, in many cases these Choice members will be in legacy products that are now closed to new members. Legacy products are generally more expensive to operate than current open products because of declining scale. Sometimes they run on out-of-date technology systems that are inflexible and costly to maintain. Operational inefficiencies like these only get worse over time as the number of legacy members reduces and the operational costs per member increases.

In order to make a fairer comparison with Default members in other jurisdictions, the fees and costs for Choice members should be excluded. By excluding these Choice members in Retail funds, it is likely that the reported fees for Default members in the Australian superannuation system will be closer to the reported level of expenses in Figure 1 of the Report (0.82%).

Operational/administration costs in context

Note 1 of the Report states that: "Australian expenses include some costs relating to the administration of insurance not incurred by some other systems. Industry sources suggest they could be as much as 1/3 of administrative expenses or around 0.1 per cent of funds under management (FUM) per year."

This indicates that total administrative expenses in the Australian superannuation system are around 0.3% of FUM, and the remainder (around 0.52%) would therefore be investment costs. In relation to these administrative costs of 0.3%, we believe that there may be other reasons (in addition to insurance administration) why they are reported as high as they are relative to other jurisdictions, including:

- The existence of multiple accounts;
- Benefit design differences;
- Regulatory and compliance costs; and
- Differences between employer sponsor administration (by Public Sector and Corporate funds)) versus private sector administration (including Retail and Industry funds who administer in-house).

Multiple accounts

Research published by the Financial Services Council (FSC) and DST Global Solutions (DST) in February 2012 states that: “Currently there are 28 million superannuation accounts or nearly three accounts for every working Australian. Accounts have proliferated as individuals have changed jobs without rolling over balances.” This does not include the five million accounts lodged with the ATO’s Lost Member Register.

The research goes on to say that: “The auto-consolidation reform is expected to deliver a sizeable reduction in the number of duplicate superannuation accounts containing less than $1,000. A simpler consolidation process with fewer low-balance accounts will reduce overhead costs for funds. This is expected to result in lower member fees and will lead to significant savings for Australians, as duplication of fees paid by individuals on multiple accounts will be eliminated.”

In APRA’s most recent Annual Superannuation Bulletin (revised 5 February 2014) for the year to 30 June 2013, the “number of member accounts decreased by 3.4 per cent during the year to 30.7 million.” Further, according to APRA’s Quarterly Superannuation Performance publication, total industry assets (which include the assets of self-managed superannuation funds and the balance of life office statutory funds) had increased to $1.84 trillion as at 31 March 2014.

Based on average dollar denominated fees of around $78 per annum (or $1.50 per week), if the number of member accounts reduces from 30.7 million accounts to 18 million, there would be up to $1 billion in fee savings and up to $1.5 billion in savings if the number of accounts reduces to 12 million.

Of course, in practice not all these potential savings may be realised as some fixed overhead costs will instead be spread over fewer accounts. On the other hand, we are also yet to observe the full impact of SuperStream and other e-commerce changes to improve the efficiency of the superannuation industry as we transition to more digital and automated systems.

Additional savings will rely on reductions in the average asset based fees charged to members. This may be achieved to some extent if further consolidation in the industry also reduces the number of relatively more expensive legacy products in the industry.

Benefit design

The Australian superannuation system is predominantly defined contribution (DC) in nature, whereas other large pension systems around the world are still largely defined benefits (DB) which are significantly less expensive to administer. Indeed, Figure 34 in the Report shows that most of the countries that have significantly lower expenses than Australia are predominantly DB ("where greater than 60% of assets are in defined benefit plans"). Note, Figure 34 includes 22 countries, the US Thrift Savings Plan (the defined contribution fund for US public servants) and the Swedish private pension system. All the countries in Figure 34 that are of similar scale to Australia with more than US$1 trillion in FUM (i.e. Canada, Netherlands and UK) are predominantly DB.

One of the main reasons why DB funds are less expensive to administer is due to the requirement for a DC fund to match assets and liabilities (i.e. members' benefits) at the individual member level. In a DB fund, the assets and liabilities are matched at the aggregate plan level. DC funds also typically offer additional features such as a variety of investment options that further increase the administration costs. As the balance shifts away from DB and towards DC in other countries, their average costs will begin to increase.

Regulatory and compliance costs

The Australian superannuation system is also highly regulated, with significant prudential requirements and reporting (APRA) as well as consumer protection and disclosure (ASIC). In addition, the taxation system that applies to Australian superannuation funds is very complex and subject to regular change, which adds considerable operational cost to the system. In such a highly regulated environment, the opportunity for significant reductions in operational costs is limited.

Employer sponsored administration

In Australia, superannuation funds are predominantly administered in the private sector (including Retail and Industry funds who administer in-house), where all associated costs are effectively passed on to the members. On the other hand, many employer sponsors in other jurisdictions run pensions departments that manage and administer their pension plans, and it is unclear how these operational costs have been included in the comparisons made in the Report.

In particular, it is worth noting that the US Thrift Savings Plan (TSP) and the Swedish Premium Pension Plan are government-run default funds that are publicly administered. Specifically, the costs of administering the TSP should include the cost of relevant public servant salaries, office rent etc. Those costs are still being incurred, even if not explicitly charged to the TSP.

It is not clear how the Report made allowance for this effect although it does say that “the fee charges do not reflect the true cost of the scheme as some costs are borne by employing government agencies and not by the TSP”. Another aspect of the US Thrift Savings Plan that reduces the reported expenses is the use of forfeited benefits (i.e. contributions forfeited by plan leavers prior to full vesting). The US Thrift Savings Plan uses them to offset costs and reports the net cost only. Clearly using forfeited benefits to offset fees does not lower the actual costs.

Investment costs

The main way that the operational efficiency of Australian superannuation funds can be reduced in the near term is through the auto-consolidation of multiple accounts. Over time, further improvements may be achieved through further fund mergers in the superannuation industry. However, it should be recognised that there may be limits to such efficiencies, as some scale inefficiencies may be introduced as funds reach a certain size. As mentioned above, the remaining costs in the Australian superannuation system (around 0.52%) are investment costs. In section 2.4 of the Report, it states that:

“Funds also incur substantial costs when they actively manage their asset portfolio – in other words, when they move assets around in search of the best returns. Many Australian pension funds do this despite strong evidence that passively managed assets perform better in most asset classes. Active management drags down returns by incurring explicit costs for research, analysis and other services. In some cases, there is evidence that fee negotiations do not extract reasonably expected value from external asset managers.”

We discuss the relative merits of active versus passive asset management, as well as the benefits and costs of diversification in asset management, in sections 4 and 5 respectively.

3.2 MySuper fees and costs

In April 2014, the Centre for International Finance and Regulation (CIFR) published a research report that examines the Australian superannuation default landscape following the introduction of MySuper: the product under which all default balances will be eventually managed.

MySuper products are required to have a standard set of fees available to all prospective members, although they may offer discounts on administration fees to some corporate arrangements. Fees are generally restricted to administration fees, investment fees, and certain transaction fees (on a cost recovery basis only).

MySuper is relatively new

In the Australian superannuation landscape, MySuper products are a relatively new concept. It has only been since 1 January 2014 that new default contributions must be paid into a MySuper product and it is not until 1 July 2017 that all existing default fund balances must be transferred into a MySuper product.

It is therefore too early to determine what impact MySuper products will have on the design and costs associated with default superannuation in Australia, including the impact that the improved transparency of fees and costs on the MySuper dashboard will have on the competitive landscape for default superannuation in Australia.

Table 5 of the CIFR report examines the fee structures for 94 of those MySuper products, excluding non-public offer funds with assets below $500 million, tailored MySuper products (i.e. corporate arrangements managed by another fund), and one outlier. In constructing the data, the authors incorporated lifecycle product fees as those applicable to a 50 year old member. Further adjustments have also been made for inconsistencies in the way that funds report their fees, such as the treatment of income tax and performance based fees. For this sample of 94 MySuper products:

- The average percentage investment fee was 0.61% of FUM;
- The average percentage administration fee was 0.28%, and other fees were 0.02% (or 0.30% in total); and
- The average dollar based administration fee was $77.31.

For a member with a $50,000 account balance, which is used for the standardised reporting of fees in product disclosure statements and MySuper product dashboards, the average total fee for the 94 MySuper products examined in the CIFR report was $532, or 1.06%. This result would be misleading for a member with a lower account balance, such as $10,000 where the average total fee would be 1.68%. For larger account balances the results are less misleading, with the average total fee reducing to 0.98% for a $100,000 account balance and 0.92% for $500,000. It should also be noted that the headline fees shown in Table 5 of the CIFR report may be overstated, particularly for Retail funds who may offer significant fee discounts to some corporate arrangements.

In August 2014, Plan For Life (Actuaries and Researchers) published the results of a survey which showed that total funds under management (FUM) of the 118 approved MySuper products as at 31 March 2014 had increased to $291.2 billion, or just under 16% of total industry assets of $1.84 trillion.

The mix of the 118 approved MySuper products by registered type is as follows:

- 38 Corporate, including sub-funds of industry funds and master trusts
- 9 Public Sector
- 45 Industry
- 26 Retail

The fee structures of the MySuper products can be summarised as a dollar denominated annual administration fees and indirect costs (including percentage based administration costs and investment management costs) expressed as a percentage of FUM. The indirect costs can vary from year to year, depending on variations in the FUM and variations in the costs (including the impact of performance fees as one example).

MySuper fees vary considerably

For the 45 Industry MySuper funds, the dollar denominated annual administration fees range from $52 to $115. When the indirect costs are added, the total annual fees charged for a representative member with an account balance of $50,000 range from $340 (or 0.68%) to $698 (or 1.40%). The average fee charged is around $520, or 1.04%. Of course, for a member with a higher account balance of say $150,000 these headline fees will be lower, ranging from 0.57% to 1.29% with an average fee of around 0.94%.

For the 26 Retail MySuper funds, the dollar denominated annual administration fees range from $50 to $117. When the indirect costs are added, the total annual fees charged for a representative member with an account balance of $50,000 range from $300 (or 0.60%) to $924 (or 1.85%). The average fee charged is around $580, or 1.16%. For a member with a higher account balance of $150,000 these headline fees range from 0.53% to 1.72% with an average fee of around 1.07%.

While the majority of the Corporate MySuper funds are only open to employees of the employer sponsor, a number of the Public Sector MySuper funds are “public offer” and are in fact very similar to Industry funds. For the 9 Public Sector MySuper funds, the dollar denominated annual administration fees range from $39 to $78. When the indirect costs are added, the total annual fees charged for a representative member with an account balance of $50,000 range from $315 (or 0.63%) to $658 (or 1.32%). The average fee charged is around $435, or 0.87%. For a member with a higher account balance of $150,000 these headline fees range from 0.58% to 1.21% with an average fee of around 0.79%.

MySuper Category	**$50,000 account *Low-fee***	**$50,000 account *High-fee***	**$50,000 account *Average***	**$150,000 account *Low-fee***	**$150,000 account *High-fee***	**$150,000 account *Average***
Industry	0.68%	1.40%	1.04%	0.57%	1.29%	0.94%
Retail	0.60%	1.85%	1.16%	0.53%	1.72%	1.07%
Public Sector	0.63%	1.32%	0.87%	0.58%	1.21%	0.79%

Overall cost of the superannuation system

The MySuper fees analysed above are based on a representative member with an account balance of $50,000, and also for a member with a higher account balance of $150,000, which is clearly not representative of the industry as a whole. The overall cost of the superannuation system will of course depend on many factors, including the relative size and cost of each sector, which in turn will depend to some extent on the mix of default MySuper balances versus Choice balances, the proportion of assets held in relatively more or less expensive products within each sector, and how these change over time.

It should be also noted that the introduction of MySuper as the default product only became compulsory for future superannuation contributions from 1 January 2014, and funds have until 1 July 2017 to transfer existing default balances into a MySuper product. It is therefore too early to assess what impact competition among the new MySuper products will have on the overall level of costs in the Australian superannuation industry.

As at 30 June 2013, Industry funds represented 20% of the superannuation industry, Retail funds 26%, Public Sector funds 16% and SMSFs 31%. The remaining 7% was made up of Corporate funds, PSTs and life office statutory funds. As at 31 March 2014, less than 16% of total industry assets were in a MySuper product.

Section 4: Active and passive management in listed asset classes

The purpose of this section is to discuss the relative merits of active and passive management in listed asset classes, as well as the impact of fees on investment returns.

4.1 Theoretical discussion of the relevant benefits of active and passive management

As famously outlined by Nobel Laureate William Sharpe[1] (and noted in the Grattan Institute report), the weighted average return (before fees) of all investors in a given market must be equal to the return of that market. As passive investors who invest in a standard market cap benchmark will, by definition, receive the return of the market (before fees and excluding minor differences due to imperfect implementation), the weighted average pre-fees return of all other investors (i.e. active investors) must also be equal to the return of the market. Active management is typically (significantly) more expensive than passive management as it involves research, which is unnecessary in passive investing, and higher transaction costs due to more frequent trading. Consequently, the weighted average post-fee return of active investors will be lower than the weighted average post-fee return of passive investors, which will in turn be slightly lower than the market return (which does not include any fees).

The 2012 revenues for global asset managers are estimated to be in the range of US$180 billion[2] to US$350 billion[3]. While some asset owners benefit from outperforming the market on a net of fees basis (and a significant proportion of these costs relate to investments made in private markets which cannot be accessed passively), the overall impact of these revenues is to transfer a significant amount of money from asset owners to asset managers. This raises an important question: why do asset owners use active management?

While Sharpe's thesis holds at the total market level, it does not imply that **all** active investors cannot consistently outperform the market after fees. "Active investors" in this context refers to all non-passive investors, ranging from professional investors to "Mum and Dad" investors. The level of sophistication of market participants varies widely which may allow certain investors to have an advantage over others. Specifically, assuming markets are not fully efficient, informed investors can exploit opportunities arising from mispricing that occurs when some investors:

i. Don't have risk-adjusted return maximising goals – such as an investor who only invests in high-dividend stocks because they value a strong income stream above the overall return of an investment;

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[1] William F Sharpe, The Arithmetic of Active Management, The Financial Analysts' Journal Vol. 47, No.1, January/February 1991, p. 7-9.

[2] Towers Watson's calculation from the data in Boston Consulting Group's *Global asset management 2013, Capitalizing on the recovery*, 2013.

[3] *The Complete Firm 2013: Competing for the 21st Century Investor*, Casey Quirk, 2013.

ii. Have lower levels of information or insufficient resources to successfully interpret the information available – such as an individual investor who has limited experience with financial markets and limited time and resources to devote to selecting investments; or

iii. Exhibit behavioural biases – such as risk aversion, where an investor prefer lower risk investments to higher risk investments despite the latter having better risk adjusted returns, or extrapolation bias where an investor appoints a manager or invests in a theme based on strong performance (or exits a manager or theme based on poor performance), despite mean reversion often occurring after these periods.

The extent to which investors can add value through active management is dependent on the ability to exploit these opportunities sufficiently to outweigh the additional cost of active management.

As a result, when determining whether to invest actively or passively, Australian superannuation funds should ask themselves two important questions:

1. To what extent are there active asset managers that can sufficiently exploit market inefficiencies to consistently add value after fees? And

2. To what extent can we, as an organisation, identify which active asset managers are likely to consistently add value after fees, and successfully appoint these managers and terminate managers that will not perform well in the future (after all costs)?

4.2 Historical comparison of active and passive approaches in listed asset classes

Below we present analysis of professional institutional Australian and global equities managers using data sourced from the eVestment Alliance database. We have used data from the ten years to 31 March 2014 for Australian and global equity managers to capture a meaningfully long, but still relevant performance period that would provide a deep dataset of managers to analyse. While we have attempted to ensure that this data is as robust as possible, we acknowledge that there are a number of flaws inherent in this dataset. The primary flaw is that of survivorship bias – managers that have performed poorly are much more likely to have ceased to exist and, as a result, their returns are less likely to be included in the database. We also note that returns are submitted by the relevant managers and, as a result, there is the potential for some selectivity in which products are included in the database.

In order to examine the ability of Australian superannuation funds to identify quality asset managers, we also present a comparison of active Australian shares options with a passive alternative.

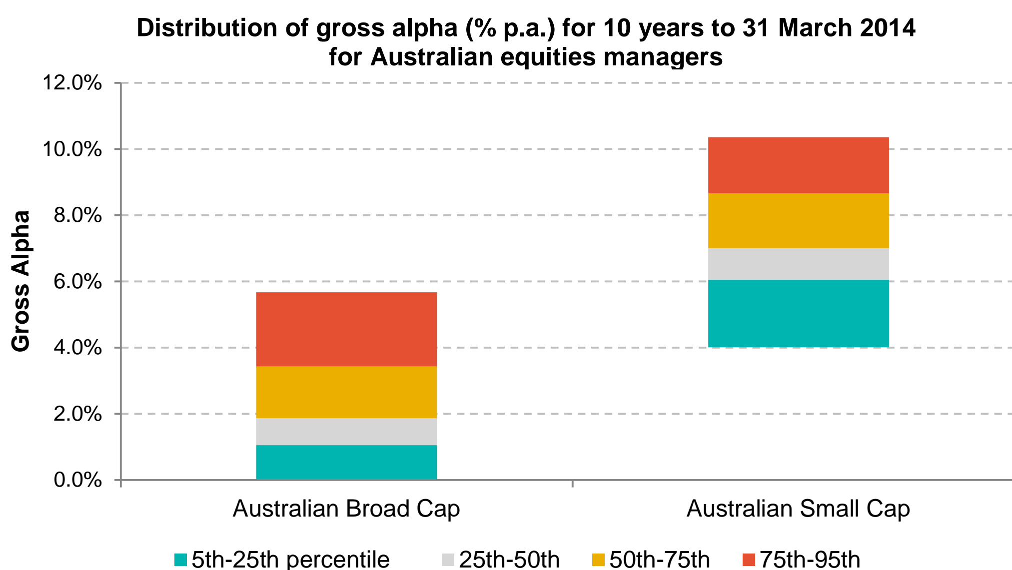
Given the potential deficiencies in the data used for this analysis, the conclusions that can be drawn about the performance of an "average" active manager relative to a passive equivalent are limited. However, this analysis does indicate that a large number of active managers have been able to add value after fees over the past ten years. We note that the ability to add value after fees may be partly a result of inefficiencies in the benchmarks, such as the benchmarks not fully reflecting the investable universe. Nevertheless this highlights the potential for asset owners who have skill in identifying quality managers to add value through an active management programme. In addition, the majority of Australian shares options included in the SuperRatings survey have outperformed a low-cost passive alternative net of tax, investment fees and implicit administration fees over the past ten years.

We note that the analysis provided in the sections below is backward looking and based on a specific time period.

4.3 Historical performance of active Australian equities managers

In this section, the term "alpha" is used to refer to the excess returns relative to the benchmark. For the purpose of this analysis, we have used the S&P/ASX 300 Accumulation Index as the benchmark for broad cap Australian equities managers and the S&P/ASX Small Ordinaries Accumulation Index as the benchmark for small cap Australian equities managers.

The graph below shows the alpha of Australian equities managers over the 10 years to 31 March 2014 **before fees**. The median broad cap manager added around 2% p.a. on top of benchmark returns, while the median small cap manager added around 7% p.a. on top of benchmark returns. While the median outperformance would be reduced by the fees payable for active management (for superannuation funds this is typically anywhere from 0.3% p.a. to 1.0% p.a.), these results suggest that most active large-cap managers included in this dataset provided positive net of fees outperformance compared with a passive investment, while most small cap managers provided strong net of fees outperformance of the benchmark.

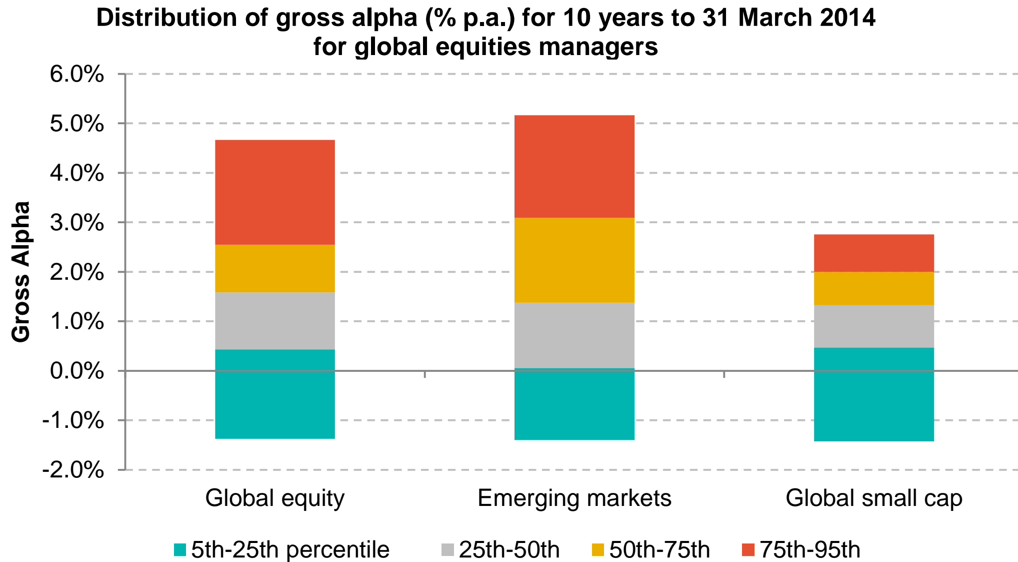


We note that small cap managers have historically generated significantly higher alpha than their broad cap counterparts. This suggests that the small cap Australian equities market is less efficient than the large cap portion of the market, most likely due to a much lower level of research coverage, in line with the hypothesis that less well researched listed markets offer opportunities for sophisticated investors to add value.

4.4 Historical performance of active global equities managers

For the purpose of this analysis, we have used the MSCI All Country World Index as the benchmark for global equities managers, the MSCI Emerging Markets Index for emerging market equities managers and the MSCI All Country World SMID Cap Index for small cap global equities managers.

The graph below shows the alpha of global equities managers over the 10 years to 31 March 2014 **before fees**. The results for global managers are less positive than for Australian managers, with the bottom quartile of managers only marginally outperforming the benchmarks before fees for global equities and global small caps and performing in line with the benchmark for emerging market equities. After fees, it is likely that the bottom quartile in each case underperformed a low-cost passive alternative. Nevertheless, the median manager in each case produced gross of fees outperformance of between 1% and 2%, which likely represents positive net of fees outperformance relative to the passive alternative, while the upper quartiles of the global equity and emerging markets data sets strongly outperformed their benchmarks.



4.5 Historical performance of Australian superannuation funds in Australian equities

In order to provide an insight into how successful Australian superannuation funds have been at adding value through active management on a net of fees and tax basis, we have compared the performance of Australian shares options offered by Australian superannuation funds with a low-cost passive option (the Mercer Indexed Australian Shares Option). Similar analysis could be performed for global shares or combined global and Australian shares options; however we have excluded this analysis because variations between the currency hedging levels of different options significantly skew the results.

The table below suggests that the majority of Australian superannuation funds have been able to outperform a low-cost passive alternative over one, three, five, seven and ten year periods. Over ten years the median fund has slightly outperformed a low-cost alternative net of tax, investment fees and implicit asset-based administration fees. While some funds have underperformed the passive alternative, this suggests that the majority of funds have been successful in identifying active managers that can add value net of fees.

Australian Shares option returns to 30 June 2014[1]	1 Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Example low-cost Australian Shares fund[2]	14.9%	9.4%	10.0%	2.5%	8.7%
Top quartile	17.2%	10.4%	11.4%	3.4%	9.2%
Median	16.4%	9.6%	10.4%	2.9%	8.8%
Bottom Quartile	15.4%	8.8%	9.7%	2.3%	8.2%
Number of investment options ranked[3]	77	73	68	59	41
Approximate rank of example fund[4]	66	41	45	38	24

1 Sourced from the SuperRatings Fund Crediting Rate Survey. Returns are net of investment fees, tax and implicit asset-based administration fees. Explicit fees such as fixed administration fees, exit fees, contribution fees and switching fees are excluded.

2 The example we have used is the Mercer Indexed Australian Shares Option. Prior to 2014 investment fees in this product were more than twice current levels - we have therefore adjusted returns prior to 2014 such that the current, lower fees levels (0.20% per annum) effectively apply over all time periods (to avoid biasing the case for active management by comparing against a 'high cost' passive option).

3 Excludes the example low-cost Australian Shares fund.

4 SuperRatings data is to two decimal places, while Mercer data is to one decimal place, so rankings are approximations. The Mercer fund is not included in the SuperRatings survey.

While we have attempted to compare funds on the same basis, we note that there are some limitations to the robustness of this data. There may be differences between funds in the way that fees are charged. In addition, some options have specific biases towards certain parts of the market, such as a large cap versus a small cap bias.

4.6 The implications of a widespread move to passive management

If a widespread switch from active management to passive management took place, the most obvious result would be a significant reduction in the fees paid by asset owners as a group. The sharp reduction in actively managed funds would also place significant pressure on asset managers, given the reduced total pool of fees, which would likely result in increased competition on fees between asset managers, and hence the potential for lower active management costs for asset owners, and an overall reduction in asset managers. The overall impact of a widespread switch from active management to passive management would be to reduce the income of the asset management industry and increase overall net of fee returns for asset owners. This does not necessarily imply that all asset owners will be better off, as some may switch to passive that otherwise would have added value after fees by successfully selecting high quality asset managers, however the overall impact on asset owners as a group would be net positive.

Nevertheless, we do not believe that a world where all asset owners invest passively is a desirable outcome. The discussion in the previous paragraph is based on the assumption that the returns of “the market” will be the same regardless of the level of active management and that, consequently, reducing the overall level of fees paid will, by definition, improve net of fee returns for asset owners as a group. While this assumption is likely to hold for quite significant moves from current levels of active management to passive management, there is a point where too much passive management could be negative for all asset owners, as active management can play a positive role in improving returns, even for passive investors.

The Grattan Institute cites Eugene Fama’s efficient markets hypothesis to suggest that “virtually all publically available information about the value of an asset is already incorporated into its price”. Regardless of the extent to which this is currently true in the real world of listed markets and ignoring differences between investors that may mean that the same investment has a different value depending on the investor (e.g. due to different tax treatment), if **all** investors pursued a passive approach listed markets would very quickly become inefficiently priced and the overall gross of fees return for a given market would very likely fall.[1] Active investors, who interpret new pieces of information and act accordingly, are a prerequisite for any level of efficiency in the pricing of a given market. In addition, many active investors play an important monitoring role, for instance monitoring the management of companies whose shares they invest in to ensure that management are working in the best interests of shareholders (although this is a role that sufficiently resourced asset owners can conduct themselves).

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[1] In fact, if every single investor invested passively, returns would be almost exclusively driven by flows in and out of a given market, as (in the absence of capital raisings, share buybacks etc.) the composition of the market would not change, even following the release of market sensitive information.

A certain level of active management is beneficial for asset owners as a group, including passive investors, as it helps to keep capital markets efficient. Indeed, in a perfectly efficient market, active investors are essentially subsidising passive investors by maximising overall gross of fee returns, while paying a much higher proportion of fees. If the level of active management was reduced significantly enough, it is likely that it would reach a point where the marginal benefit of reducing active management (lower fees) is outweighed by the marginal cost (lower market efficiency). In addition, active managers tend to trade more frequently than passive managers. As a result, a significant reduction in active management could result in a reduction in market liquidity.

It is not clear what percentage of the market needs to be active in order to provide an optimal balance between the cost of active management and improved gross of fee returns as a result of efficiency in markets. However, we believe that a reasonable proportion of active investors could switch to passive investing without meaningfully impacting the level of efficiency in major listed markets.

As a result, we believe that investors who do not have a meaningful competitive advantage that provides them with the opportunity to add value after fees from active management should invest passively or via low cost alternatives such as smart beta (discussed below).

4.7 Fees paid by Australian and global investors for active management

To the extent that Australian investors invest in different asset classes to non-Australian investors, this will have an impact on the overall fees paid. Therefore, we believe that comparing headline fees of two portfolios with very different asset allocations provides little insight, as it fails to take into account the objectives of the different portfolios, the importance of diversification and different fees for different asset classes (riskier asset classes, where greater scope to add value from active management typically exists, tend to be more expensive than defensive asset classes such as fixed interest). For instance, a fully funded defined benefit scheme may be able to invest in low risk, low cost (even for active management) fixed interest securities in order to meet its objectives, while an Australian superannuation fund offering a “Growth” option may invest in more expensive asset classes to achieve a better risk-adjusted return than could be achieved by investing only in passive public asset classes. We discuss the role of diversification in Section 5 of this report.

As such, when comparing the fees paid by Australian investors for active management, it is important to ensure that comparisons are made based on the same asset classes or, preferably, the same products.

From a theoretical point of view, market forces should dictate that large Australian investors, such as superannuation funds, pay very similar investment management fees to similar sized non-Australian investors for the same products. There are two key factors that suggest this should be the case:

- Large Australian investors can typically invest in off-shore pooled funds or via segregated mandates (depending on the size of the investor and the asset class). While there are some structures that may not be appropriate for legal or tax reasons, this should help to prevent asset managers from charging differential fees based on location; and
- If asset managers were able to charge higher fees to Australian clients than non-Australian clients, this would make Australian clients more attractive as investors. This should result in more competition between managers for Australian clients, which, in turn, should lower fees until Australian clients are no longer more attractive as investors than non-Australian clients;

Differences in fees should only persist if there are genuine barriers to Australian investors investing off-shore (such as a lack of available vehicles or mandates) and additional costs involved in servicing Australian clients (such as an increased client servicing burden) which make them less attractive than other investors. Where Australian investors invest in a locally domiciled pooled vehicle, there is the potential for non-investment costs (such as custody and administration costs) to be higher than for much larger US or European vehicles.

It is difficult to compile a comprehensive and robust data set which gives a meaningful insight into the actual fees paid by Australian investors compared with non-Australian investors. While asset managers are often willing to provide standard “rack-rate” fees, they are often reticent to provide data on the actual fees paid by different investors for their products, for commercial reasons, as well as to maintain their clients’ confidentiality.

In a survey of global equities managers with multiple Towers Watson clients (both Australian and non-Australian), the prevailing theme was that managers generally charge very similar fees for all clients, regardless of where they are based, with some dictating the same fee scale for all investors under a certain level of funds under management. Where fees are different between clients, these are typically the result of differences in the size of funds managed for individual clients, special fee deals for early investors or special fee deals for clients with multiple investments with a given fund manager.

The proviso to this is that some fund costs (such as custody and administration costs) can vary depending on the vehicle. We have found no evidence that Australian investors systematically pay higher fees for the same products than their overseas counterparts.

Where investors are large enough, the actual fees paid are dependent on negotiations between the individual investor and the fund manager. Anecdotally, a number of overseas managers have suggested that Australian investors are typically more fee sensitive and tougher on fee negotiations than their overseas counterparts; however we have not found evidence to suggest that this results in Australian investors paying less than their overseas counterparts for equivalent mandates.

4.8 Improved use of benchmarks/smart beta

The risks of standard passive approaches (based on market capitalisation indices)

One of our primary concerns with traditional passive management is that there is no active risk management involved – the asset manager merely holds the "market" as it is defined by a given benchmark, typically based on a market capitalisation index. As a result, any concentration of risk in the benchmark will inevitably result in a concentration of risk in the actual portfolio.

Investing in benchmarks based on market capitalisation results in a structural overweight allocation to those investments that are relatively expensive (as their market capitalisation will be higher than it should be) and a structural underweight allocation to those investments that are relatively cheap.

These risks involved in passive investing vary depending on the asset class and the benchmark used. Traditional fixed income benchmarks have inherent structural flaws since the most indebted issuers and sectors become the largest exposures in market capitalisation based approaches. Some benchmarks may contain relatively illiquid securities that are difficult and costly to trade, while providing limited diversification or risk-adjusted return benefits to offset these costs. Benchmarks that include a certain number of components (e.g. the S&P/ASX 300 Index) also lead to passive managers having to buy securities that are added to the index and sell securities that are removed from the index at a time when other market participants know that they will have to do this. As a result, active investors can front-run these trades, reducing the returns for passive investors and creating opportunities for active investors.

We believe that passive approaches are appropriate for many investors. However it is important to be mindful of these risks when investing passively.

Alternative benchmarks/smart beta approaches

There are a number of ways that investors can mitigate some of the specific risks involved in passive investing, identified above, without incurring excessive costs.

The simplest way in many cases is to define a benchmark that is more appropriate than the standard benchmark for an asset class. Examples of this include fixed interest benchmarks that cap the exposure to individual countries, currencies or issuers, thereby reducing the concentration of risk in certain areas. This could also be applied to highly concentrated markets, such as Australian equities, in order minimise the exposure to individual securities or sectors. The additional cost involved in using an alternative benchmark is likely to be low, although smaller funds may find it difficult to find an appropriate implementation method that uses the chosen benchmark.

Where market events regularly occur that expose passive investors to exploitation from other market participants, such as index re-weightings, allowing passive managers some scope to actively manage around these events can help to prevent this exploitation. Many passive managers already do this as part of their normal mandates.

Finally, there are a number of approaches that have arisen over recent years that seek to apply defined processes, some of which have aspects in common with the processes employed by active managers, in order to create a lower cost method of reducing risk or enhancing returns. These “smart beta” approaches have evolved due to the recognition that some of what was previously called alpha can now be captured in a systematic approach. Simplicity and transparency are preferable in these approaches, and the focus on a systematic process means that management fees can be significantly lower than for traditional active management.

Managing to an alternative benchmark, such as a sector or issuer-capped benchmark as discussed above, can be considered a type of low-cost smart beta approach. Similarly, an equities approach which weights stocks by some form of non-price based mechanism (such as equal weights, diversification maximisation, volatility minimisation or employing fundamental factors such as earnings, revenues and assets) thereby seeking to avoid the systematic overweighting of overpriced stocks, is another. Such approaches contain their own sets of risks, including the potential to underperform a traditional benchmark over reasonably long periods; however we believe that appropriate strategies can add value over the long term.

4.9 Conclusion

There are benefits and drawbacks to both active and passive approaches to investing in listed markets. We believe that there is scope for more passive management and an overall reduction in the fees paid by asset owners in listed markets. However, we do not believe that a wholesale move from active management to passive management would necessarily result in an overall improvement for Australian superannuation members as a group. Ultimately, the most appropriate method of investing in listed markets is dependent on the beliefs and abilities (including governance capability) of the individual fund.

Section 5: Diversification and the role of active management

The purpose of this section is to discuss the diversification benefits of unlisted and “more expensive” asset classes in the context of overall net of fee portfolio returns.

5.1 Relative merits of passive diversified funds and active diversified funds

Theoretical argument for investing in passive diversified funds

The Grattan Institute report (Report) suggests that “many funds achieve lower returns or higher risk than could have been achieved by a low-cost diversified holding of the same asset classes.”[1] This suggestion is based on analysis of actual returns, but also follows from Sharpe’s theoretical discussion of active management, discussed above. If the group of active investors in a given market must, by definition, underperform the group of passive investors in the same market after fees, it follows that, given the same allocations to each asset class, the average active diversified portfolio will underperform the average passive diversified portfolio after fees.[2]

One of the key underlying premises of William Sharpe’s assertion that, on average, active management destroys value after fees is that there is a defined market. Thus, this rule can be applied to any listed market that can be defined by a benchmark, for instance Australian equities, perhaps using the S&P/ASX 300 Index (or the broader All Ordinaries) as the definition of the market. In theory, a benchmark could be defined that includes all the assets in the world and the same principle would apply.

Implications of using only low cost, passive asset classes

While a standard listed market can be easily replicated to provide a passive exposure, the full set of investable assets includes a range of asset classes that cannot be accessed passively. While an investor who wants to invest in infrastructure can passively invest in a product that replicates a global listed infrastructure benchmark, this does not include the vast set of unlisted infrastructure assets in existence that can generally only be accessed by becoming a significant investor in each asset.

[1] Grattan, p. 40

[2] Note that this does not mean that some skilled investors cannot consistently outperform passive, either via successful active management within asset classes or through dynamic asset allocation.

The Report concedes that “the only caveat [to the relative attractiveness of low-cost diversified funds] is that high fee funds may offer investment in asset classes that low-fee funds cannot. If there are not well-developed and liquid markets in an asset class (such as in private equity, venture capital, property, infrastructure or in less developed economies), it may be possible for active management to exceed the returns from a passive portfolio with exposure to other asset classes for a while.” However, the Report also asserts that “these opportunities tend to be riskier than others and excess returns are usually eroded over time.” We believe that this point of view fails to recognise the two key attractions of unlisted asset classes:

1. Unlisted asset classes can provide significant diversification benefits which can result in a better risk-adjusted outcome for investors, even after fees; and

2. There are a number of reasons why asset classes that do not have well-developed and liquid markets may offer a risk-adjusted return premium over the long-term.

While the Report does briefly mention the role of risk, it is primarily focused on returns. In our view, investors should be focused on risk-adjusted return after costs. If this were not the case, all investors would invest in the asset class with the highest expected return after costs.[1] One of the most effective approaches to improving risk-adjusted returns is through the diversification of return streams (where an improved reward for risk can be achieved by investing in return streams that are not highly correlated to each other).

Correlation benefits of unlisted asset classes

Although the Report notes that exposures should be diversified, it doesn’t elaborate and also disregards the importance of the correlation between asset classes in determining diversification benefits (indeed the graph and accompanying discussion on page 45 of this report appears to be on the basis that all asset classes are perfectly positively correlated). Non-standard or unlisted asset classes often provide returns that have relatively low correlations with listed asset classes. For instance, unlisted property and unlisted infrastructure tend to exhibit much lower correlation with listed equities than listed property and listed infrastructure, particularly over shorter time frames. While active management of investments such as hedge funds can be expensive, the correlation of these funds with more traditional asset classes can be reasonably low, particularly for some (for instance market neutral) strategies. There are also a range of alternative risk premia that can be accessed which provide diversification away from reliance on movements in equities, interest rates and credit spreads. While non-standard and/or unlisted asset classes may result in higher explicit costs than other asset classes, the significant diversification benefits they can provide can result in better risk-adjusted return expectations for an overall portfolio, even after costs.

[1] We note that, if **all** investors actually did do this, prices would adjust and the expected return of this asset class would fall.

Costs exist at various levels, making comparisons extremely difficult

It is important to note that the explicit costs of these types of asset classes do not necessarily mean that, on a look-through basis, they are more expensive than listed asset classes. Asset classes that rely on skilful investment in traditional asset classes, such as some hedge funds and multi-asset funds, do generally come at additional cost. However, this is not necessarily the case for all “expensive” asset classes. For instance, comparing the explicit costs paid to the fund manager of an unlisted property vehicle to the relative cost of investing passively in real estate investment trusts results in the latter looking comparatively cheap. In actual fact, very similar property management roles and responsibilities can be contained within real estate investment trusts as implicit management costs. The costs still affect the net of fees return received, but will not be included in a headline investment management cost, as they would be for unlisted funds. In addition, by listing real estate on an equity market, additional mark-to-market volatility is added in place of the typical illiquidity risk contained in unlisted property vehicles.

Risk and return expectations differ for liquid and illiquid assets

The primary purpose of listing an instrument on a market is to make it easier for investors to access the instrument and, hence, to make it easier for companies to raise funds. Listed shares, for instance, are easy, and relatively cheap, to purchase, as well as to sell if an investor needs to convert the investment to cash or simply no longer wants to hold the investment. A listed equity market hence provides companies with both the mechanism to raise capital, by selling additional equity, and a means of making that equity more attractive as an investment (i.e. it is liquid and can hence be re-sold). All other things being equal, more investors are likely to be able to invest in a listed asset than an unlisted asset[1] and, even for those that can invest in both, the listed instrument is likely to be more attractive than the unlisted instrument to most investors.

As a result, it is not unreasonable to expect unlisted assets to provide a return premium over similar risk listed assets. Given there is likely to be more competition for listed assets, there is the potential for unlisted assets to be less expensive than listed equivalents. Moreover, given unlisted assets possess the additional risk of illiquidity – not being able to sell an asset at a reasonable price in a timely manner – they should offer a premium to investors who are willing to accept this risk.

Australian superannuation funds have numerous calls on their liquidity, including needing to be able to meet withdrawal and switching requests from members, fund currency hedging losses and provide committed capital when it is called. However, funds exist as a mechanism for individuals to save and invest over their lifetime of employment (potentially 40-50 years) and can continue indefinitely as older members exit and new members enter the fund. As a result, Australian superannuation funds are well placed to earn an “illiquidity premium” for investing in unlisted assets through at least part of their portfolio.

[1] For instance, an individual with a relatively small amount of funds to invest can buy a share in a listed property vehicle, but is much less likely to be able to invest in some unlisted vehicles or in a diversified direct property portfolio.

Passive diversified funds may still be the answer for some investors

We support the opportunity for funds to offer diversified options which include the use of active management, on the basis that, when well-structured, they can be expected to offer a superior reward for risk to cheaper, fully passive, diversified funds. Nevertheless, the idea of increasing the use of passive diversified funds by the Australian superannuation industry is not without merit. Passive diversified funds provide a low-cost method of accessing a reasonably well diversified range of asset classes through one investment. To the extent that funds are unable to add value through the selection of skilful asset managers in listed asset classes, passive diversified funds may provide an efficient method of accessing these parts of the market. However, limiting the available investments to cheap listed asset classes will reduce the ability of funds to diversify and, we believe, will result in poorer risk-adjusted returns over the long-term. Later in this section we provide forward-looking risk and return analysis of an example fund with and without unlisted assets to demonstrate the improvement in portfolio characteristics that increased diversification can provide.

We believe that two of the key advantages that Australian superannuation funds have are that (i) they have long-term investment horizons and (ii) many are large enough to access investments that smaller investors cannot. Restricting Australian superannuation funds from investing in more expensive (at least higher direct cost) asset classes would prevent them from utilising these advantages to access additional risk premia, such as the illiquidity risk premium.

5.2 Forward looking analysis of listed only strategies with more diversified options

In the table on the following page we outline two example portfolios:

- A “Passive Balanced” portfolio, which is a diversified fund that is fully passively invested and is currently available in the market[1]; and
- A “Diversified Including Unlisted” portfolio, which is comprised of 70% in the Passive Balanced portfolio, with the remainder invested in active unlisted asset classes.

Please note that the listed component of both funds is assumed to be passively managed.

[1] The asset allocation used in this example relates to the Vanguard Balanced Index Fund.

Asset Class	Passive Balanced	Diversified Including Unlisted
Australian Equities	22.0%	15.4%
International Equities (Unhedged)	19.5%	13.7%
Emerging Market Equities (Unhedged)	2.5%	1.8%
Australian Listed Property	3.0%	2.1%
Global Listed Property (Hedged)	3.0%	2.1%
Total Listed Growth Assets	**50.0%**	**35.0%**
Australian Composite Bonds	20.0%	14.0%
Global Sovereign Bonds (Hedged)	19.0%	13.3%
Global Government Related Bonds and Investment Grade Credit (Hedged)	11.0%	7.7%
Total Listed Defensive Assets	**50.0%**	**35.0%**
Australian Unlisted Property	-	4.0%
Opportunistic Unlisted Property	-	2.5%
Australian Unlisted Infrastructure	-	2.0%
Global Unlisted Infrastructure	-	2.0%
Hedge Funds	-	5.0%
Private Equity	-	2.5%
Multi-Asset Funds[1]	-	7.0%
Alternative Risk Premia[2]	-	5.0%
Total Unlisted Assets	**-**	**30.0%**
Total Portfolio	**100.0%**	**100.0%**

[1] Includes real return funds and risk parity funds
[2] Includes commodities, reinsurance, volatility and FX carry

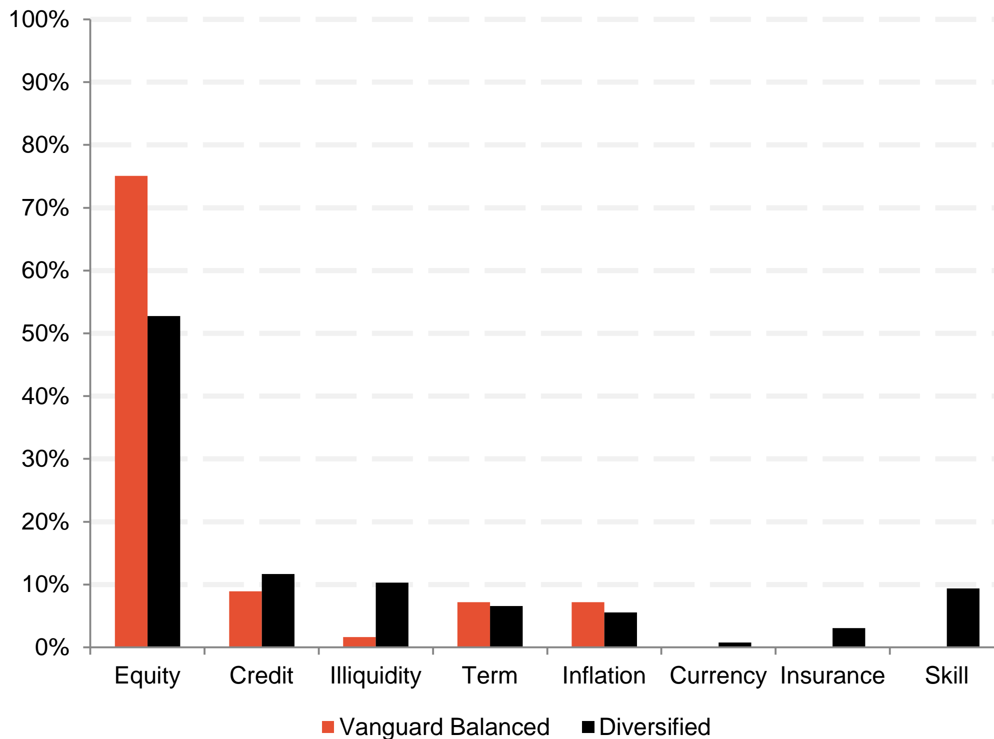
The table below provides risk and return expectations for both of these portfolios based on Towers Watson's long term modelling assumptions. The output shown is based on net of fees and tax assumptions. Listed asset classes are assumed to be implemented passively, with negligible fees, while unlisted asset classes assume "standard" fees which vary by asset class. The two portfolios have similar return expectations based on Towers Watson's long term modelling assumptions, with the Diversified Including Unlisted portfolio having a slightly higher expected return. However, the risk required to create these return expectations decreases with the increase in diversification. Whereas the Passive Balanced portfolio has an expected standard deviation of 7.6%, this reduces to 7.0% for the Diversified Including Unlisted portfolio. This reduction in risk is also reflected in a lower expected tail loss (expected return when financial markets are very adverse) and a lower expected frequency of negative absolute return years for the Diversified Including Unlisted portfolio. The efficiency of the Passive Balanced portfolio, as measured by the Sharpe ratio, is lower than that of the Diversified Including Listed portfolio. Finally, the probability of meeting a CPI + 3.5% return objective over 10 years is around 66% for the Diversified Including Unlisted portfolio compared with 63% for the Passive Balanced portfolio.

Return/Risk Measure (based on Towers Watson's long-term assumptions)	Passive Balanced	Diversified Including Unlisted
Expected Return (p.a.)	7.0%	7.1%
Expected Real Return (p.a.)	4.4%	4.5%
Standard Deviation (p.a.)	7.6%	7.0%
Sharpe Ratio[1]	0.37	0.41
Expected Tail Loss[2]	-8.2%	-7.0%
Expected Number of Negative Return Years in a 20 Year Period	3.6	3.1
Probability of Meeting a 3.5% Real Return Objective Over 10 Years	62.8%	66.2%

[1] The Sharpe ratio measures the return in excess of the cash return per unit of risk (expected volatility) as predicted by the Towers Watson asset model.

[2] The expected tail loss represents the expected return when financial markets are very adverse. It is equal to the expected return in the bottom 5% of return scenarios generated.

These results highlight the post-fee diversification benefits that unlisted asset classes can add to a portfolio. The key reason for these benefits is that the Diversified Including Unlisted portfolio has a more diverse range of return drivers than the Passive Balanced portfolio. The graph below highlights the differences between the return drivers of the two funds. The major difference is that the reliance of the Passive Balanced portfolio on the equity risk premium (which drives 75% of returns above cash) is significantly reduced (to around 53%). The majority of this difference comes from significantly increased exposures to skill and illiquidity, with a smaller increase in the exposure to credit.



Conclusion

Passive diversified investment strategies composed only of listed asset classes can offer some diversity and are available at low cost. However, higher cost asset classes that cannot be accessed through public markets offer diversification benefits that can result in higher risk-adjusted returns after fees. Additionally, higher explicit fees are not necessarily indicative of higher look-through fees, as these may reflect costs that are implicit in listed securities. We believe that restricting investments to only listed asset classes reduces the opportunity set of investments and could result in sub-optimal outcomes for Australian superannuation members.

In summary, in a Choice environment such as Australia, we believe that both low-cost index-based management and more active management will have appropriate roles to play, with many funds already employing a combination of both approaches based on informed decisions about their relative competitive advantages in employing active management. Indeed, there is already some evidence that there is greater use of low-cost index-based management approaches being adopted in their MySuper portfolios.