

25 August 2014

The Chairman  
Financial System Inquiry  
By on-line submission

Dear Sir,

### Submission to the Financial System Inquiry

#### Our Key message:

- **Active Management:** The Financial System Inquiry Interim Report (“Interim Report”) draws on analysis which does not sufficiently scrutinise the role of active management as the causal factor in the resultant lower returns. Further, the analysis referenced in the Interim Report needs greater scrutiny to remove factors such as fund size. Any analysis on this issue has to be based on the fees typically associated with large scale superannuation funds, not retail products, as in Arnhem’s experience, active management fees are a relatively modest part of the overall expenses of a scale superannuation fund. Through the review of the wholesale league tables, there is at least superficial evidence that in the Australian context, active management adds value after wholesale fees.
- **Income Stream Product:** Equities are a good source of retirement earnings, especially in the context of life expectancies of almost 20 years. Having a default option of a traditional income stream product would deprive retirees of the longer term wealth generating characteristics of growth assets. Australian Equities have had a solid track record in meeting target retirement outcomes. In this regard, we believe the focus of policy change should be on how quickly retirees can draw down their retirement savings.

Thank you for the opportunity to provide comment on the Interim Report. Arnhem Investment Management is a Sydney based Australian Equity Fund Manager, with approximately \$4b of funds under management.

Arnhem wishes to provide feedback on two points:

**1. To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members? (2-115)**

Arnhem has seen an increasing trend for superannuation funds to utilise index management with the primary aim of reducing fees. In many cases this has been done without a clear analysis of the post-fee outcomes of that decision. Thus we welcome the focus of the Financial System Inquiry (“FSI”) on post-fee outcomes.

To better understand the role of active management, we believe it is appropriate to focus on the costs and benefits of this service. The work by the Grattan Institute referenced by the Interim report (note 52) provides some insights in this regard, but we believe this should be interpreted with

care. In particular we believe the comments that “active management of superannuation assets increases costs but not post-fee average returns in the sector” is based on incomplete analysis and deserves further scrutiny. The Grattan Institute’s analysis is based on correlations between fees paid and investment outcomes. This analysis does not appear to properly adjust for the correlation between fund size and fees paid. Compared to smaller funds, larger funds are more likely to have lower relative fees despite having similar allocations to active management. The relative outperformance of larger funds may instead be due to the higher incidence of professional manager selection and oversight, rather than the prevalence of index management amongst these funds. That is to say, the analysis referenced does little to demonstrate that there is any causation effect between active management and poor investment outcomes after adjusting for other factors such as the size of the fund or whether the fund offering is retail or wholesale.

While Arnhem is not in a position to provide in depth analysis in answer to this question, through the review of the wholesale league tables, there is at least superficial evidence that in the Australian context active management adds value after wholesale fees. For example, the most recent 5 years performance for Australian share fund managers in the Mercer Investment Performance Survey shows that the average manager outperformed the ASX S&P 200 by 1.0% per annum before fees<sup>1</sup>. For the 5 year period that preceded this, the average Australian share fund manager outperformed by 1.8% relative to the market index.<sup>2</sup> Adjusting for survivorship bias, we would be surprised if the average manager was not in a net positive position after adjusting for the level of fees charged to institutional superannuation funds.

The Interim Report notes William Sharpe’s comments that if properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. While that is a truism, Arnhem believes, the question that needs to be answered is whether the average professionally managed Australian equity fund outperforms the average return achieved by retail investors and the Australian component of offshore investors by an amount sufficient to offset their fees.

**2. If part of retirees’ superannuation benefits were to default into an income stream product, which product(s) would be appropriate? (section 4-32).**

The question posed does not define what an “income stream product” is, but conventional wisdom would suggest that as you approach retirement you should move your savings into more conservative products. Indeed there is a great deal of merit in constantly reviewing your mix of assets but one should not lose sight of the fact that the average life expectancy of a male retiring at age 65 is currently around 18.5 years and a female 21.5 years<sup>3</sup>. One in four men retiring at age 65 will live at least another 25 years (to age 90), while one in three women will live past that milestone.<sup>4</sup> With a life expectancy of this duration, the greatest financial risk for many retirees will be outliving their savings and having to rely on a public pension.

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<sup>1</sup> Mercer Investment Performance to 31/7/2014

<sup>2</sup> Intech Performance Survey to 31/7/2009

<sup>3</sup> Australian Life Tables 2005-07

<sup>4</sup> Australian Life Tables 2005-07

In response to this question, Arnhem contends that the income and capital generation capabilities of Australian shares have actually exceeded that of more conservative income stream products when viewed over the term of the life expectancy of someone in retirement.

Let us take, for example, a couple aged 65. The Association of Superannuation Funds of Australia (ASFA) has suggested that a couple will need a combined income of \$57,665 per annum to retire with a comfortable lifestyle. Let us assume the goal is to remove reliance on the public purse to the greatest extent possible. For this couple to fund themselves with an annuity product, it would cost \$1,153,300 (based on the Challenger Liquid Lifetime Annuity with Partial Indexation)<sup>5</sup>. As cross reference, based on 2.5% inflation and 5% investment return per annum, you would need \$1,043,794 (not allowing for tax).

This amount is many times the superannuation balance of the average retiree. If a retiree was forced to take out an annuity product, with a more typical superannuation balance (of say \$300,000), they would be buying a lifetime income stream in the order of \$15,000-\$17,000. While this would provide some certainty; it would unfortunately be the certainty of poverty, if you were to exclude government support.

Indeed, if a retiree did have a balance of greater than \$1,043,794 (calculated above), Arnhem contends that they would have historically been better off leaving all their money in Australian equities. To demonstrate this we model an Australian equity fund with this starting amount which is being used to fund a retirement income stream equivalent to \$57,665 as per ASFA's recommended annual income stream. In years where the dividend stream does not provide the required inflation adjusted income stream, shares are sold to meet that income objective (i.e. capital realised). Essentially, if you don't run out of capital, you have met your retirement income requirements. The results of this modelling show that in many cases your estate will end up with far in excess of your starting capital, allowing you to leave a financial legacy for your family. In our analysis, we don't discount both numbers back to the start of each "retirement year". This enables better comparisons of outcomes across time.

By way of example, let's look at a couple who retired in 1965, with the equivalent of \$1,043,794 and a requirement of a retirement income of \$57,665 indexed by 2.5% per year. The table below looks at the capital value of an Australian equity investment (we assume index performance) which is used to fund retirement. By the end of 25 years, even after living off income and capital, the couple would have had an asset worth over \$5m.

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<sup>5</sup> The Challenger Liquid Lifetime Annuity has been used as a reference point given the availability of pricing information. This product provides a withdrawal option in the first 15 years of retirement. While we estimate that this is a modest part of the overall cost of this product, for certainty, we have based our analysis on the slightly lower calculated cross referenced balance of 1,043,794.

**Table 2: Year Equity Fund for Income Model 1965-1990**

	Start of Year Capital	Income Required	Income Generated	Capital Realised (Income Reinvested)	End of Year Capital
1965	1,043,794	57,665	40,740	16,925	897,610
1966	897,610	59,107	35,034	24,073	905,334
1967	905,334	60,584	35,336	25,249	1,188,842
1968	1,188,842	62,099	46,401	15,698	1,582,722
1969	1,582,722	63,651	61,774	1,877	1,722,518
1970	1,722,518	65,243	67,231	-1,988	1,361,534
1971	1,361,534	66,874	53,141	13,732	1,316,926
1972	1,316,926	68,546	51,400	17,145	1,561,786
1973	1,561,786	70,259	60,957	9,302	1,127,844
1974	1,127,844	72,016	44,020	27,995	736,284
1975	736,284	73,816	28,737	45,079	1,048,008
1976	1,048,008	75,661	40,904	34,757	985,596
1977	985,596	77,553	38,468	39,085	1,051,033
1978	1,051,033	79,492	41,022	38,470	1,155,389
1979	1,155,389	81,479	45,095	36,384	1,541,574
1980	1,541,574	83,516	94,936	-11,420	2,211,270
1981	2,211,270	85,604	79,612	5,992	1,839,565
1982	1,839,565	87,744	85,029	2,715	1,496,751
1983	1,496,751	89,938	105,947	-16,010	2,406,659
1984	2,406,659	92,186	98,446	-6,260	2,260,188
1985	2,260,188	94,491	131,429	-36,938	3,161,545
1986	3,161,545	96,853	172,462	-75,609	4,715,584
1987	4,715,584	99,274	123,797	-24,523	4,245,892
1988	4,245,892	101,756	216,845	-115,089	4,903,143
1989	4,903,143	104,300	317,114	-212,813	5,652,021
1990	5,652,021	106,908	277,487	-170,580	4,555,021

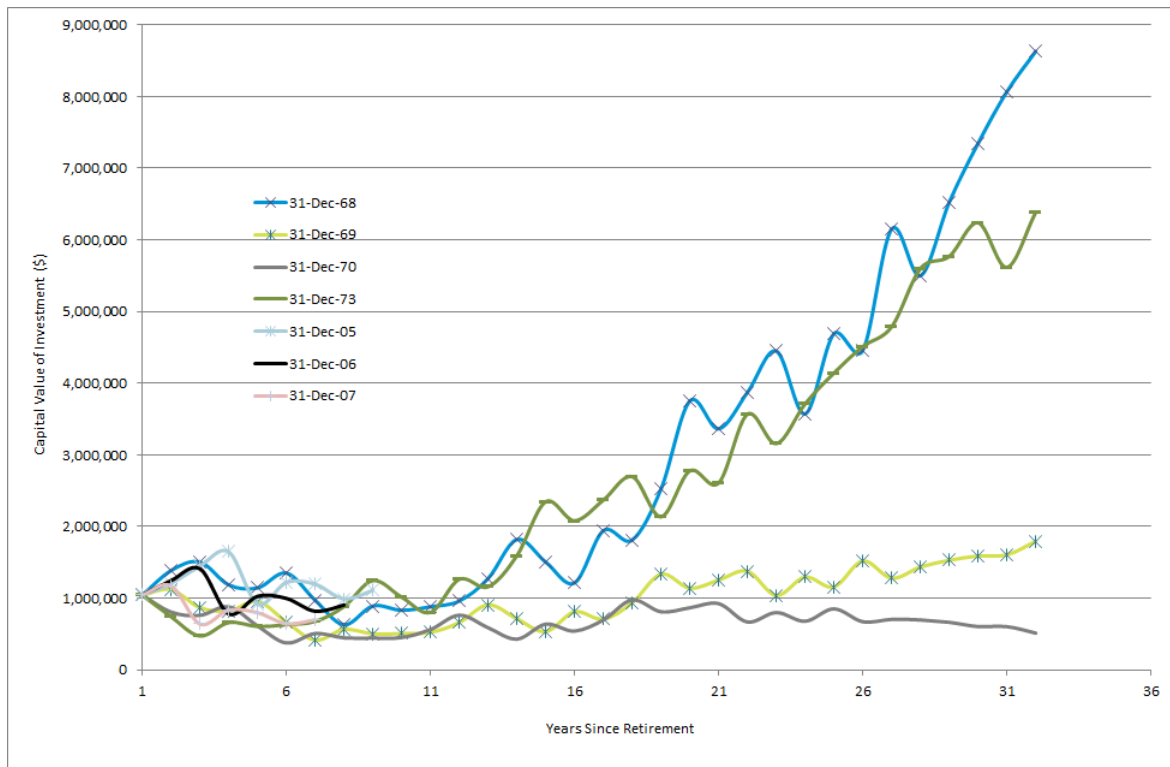
Source: Arnhem Investment Management. Past performance is not a reliable indicator of future performance.

Notes to analysis: No adjustment was made for tax. No allowance is made for the benefit of franking. ASX All Ordinaries Index performance is assumed for all investment outcomes. Share yield is not available prior to 1980, so we have assumed a 3.9% yield which is 85% of the average yield for the period 1980-2010. This table, along with the rest of the analysis in this section is based on the current value of money. This effectively scales the starting capital and income requirements equally, such that the outcome is equivalent but the dollar values are more comparable between retirement years.

Furthermore, we have modelled retirement scenarios for every year from 1965 to 1989 (being the last year for which a full 25 year retirement scenario can be modelled) and for partial periods from 1990 to 2007, using the same set of assumptions. Our starting year of 1965 was selected based on availability of data.

Of course, not every scenario results in as positive an outcome as the example shown above. In Chart 1 below, we look at some of the retirement base years that generate larger negative capital outcomes in the early years. That is, retirees would have experienced years when their initial capital position is substantially eroded via drawdowns of capital in order to maintain their income levels. This chart also includes the early development of some more recent experiences which incorporate the years immediately before the Global Financial Crisis (2005/2006/2007). In each and every case, including the worst experience, initial equity investments would have sufficiently funded a retirement income for at least 25 years, and in many cases provided a capital legacy.

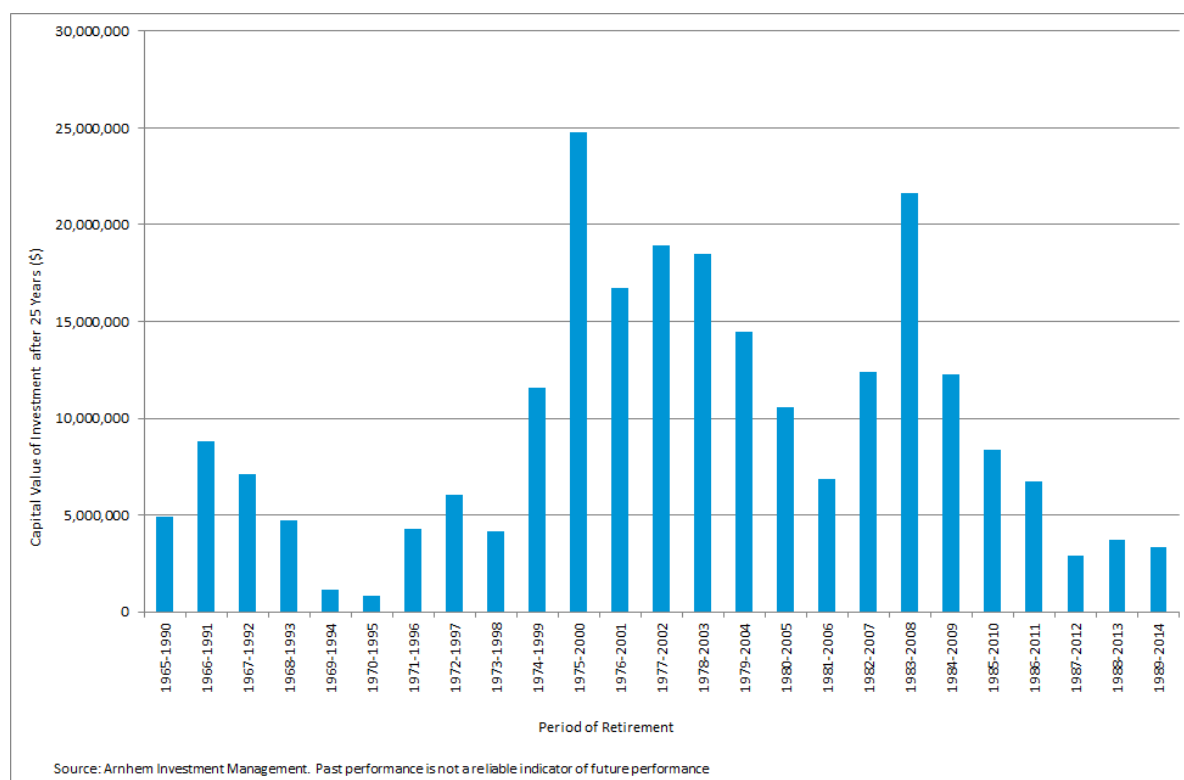
**Chart 1: Capital remaining after living Expenses**



Source: Arnhem Investment Management. Past performance is not a reliable indicator of future performance.

Chart 2 shows the capital position of a retiree’s portfolio after 25 years for each of the retirement years we have modelled. While we have shown outcomes after 25 year, all years of retirement show net positive capital remaining after 35 years of retirement (age 100).

**Chart 2: Capital Position of Portfolio after funding Retirement for 25 years**



It should also be noted, that this modelling assumes that spending power (inflation) increases by 2.5% each year. However, Australia has experienced two periods of inflation well in excess of this. Would an equity portfolio have been able to maintain real purchasing power, while funding retirement, through extreme events? Based on historical Australian equity benchmark performance, the starting balance of \$1,043,794 used earlier can accommodate inflation of up to 3.5% in all but one retirement year (1970). Lifting one's starting capital to \$1,200,000 would enable coping with inflation of up to 5% in all years. One can take some solace from the fact that since 1993 the RBA has had an inflationary target of 2-3%.

It is also worth also considering a retiree with a more modest retirement savings. We noted above that a retiree with \$300,000 could afford to buy a lifetime income stream in the order of \$15,000-\$17,000. Alternatively this retiree could have invested in a portfolio of Australian equities and taken an income stream of \$17,000 per annum. Once again, in all cases their retirement saving would have lasted at least 25 years. In contrast to an annuity product, in most cases the retiree would have been able to lift their income draw down above \$17,000 after sufficient growth in their capital base.

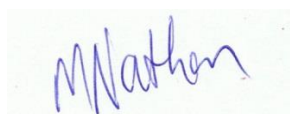
We believe there are several key points to be drawn from this:

- Australian Equities have proven themselves historically to be a very sound source of retirement income. This is not to say that year by year sequencing of performance does not pose a risk.
- In many circumstances traditional “income stream products” are too conservative an option for those retiring at age 65 given their longevity. On balance, having an traditional income stream product as the default choice would deprive retirees of the longer term wealth generating characteristics of growth assets. This comment is made in the context of current

life expectancies of close to 20 years.

- Policy should be more focussed on limiting access to superannuation lump sums, as this may solve some of the issues highlighted in the Interim Report.
- Retirees may find the capital volatility of a majority equities portfolio unsettling and may not take solace from the fact that holding all their retirement funds in Australian equities has historically adequately funded ones retirement. Thus, a diversified asset exposure would likely result in better behavioural outcomes.

We would be happy to discuss our views further if required.



Mark Nathan

Managing Partner