

19 August 2014

Mr David Murray AO
Chairman
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Submitted Electronically

Dear David,

Thank you for the opportunity to provide feedback and comments on the Financial System Inquiry Interim Report (“the Report”). We believe that the Financial System Inquiry is important in setting out a roadmap for the future state and regulatory structure of the financial system in Australia. Given the tremendous growth and development of financial services since the Wallis inquiry and lessons of the Global Financial Crisis, such a review is timely.

Schroder Investment Management Australia Limited (“Schroders”) is one of Australia’s largest wholesale funds management companies. As at 30 June 2014 we managed \$48bn on behalf of clients in Australia across Australian equities, global equities, fixed interest and outcome orientated (CPI+5%) strategies. Schroders was established in Australia in 1961 and the Schroder Australian Equity Fund was set up in 1964 and is one of the oldest unit trusts in Australia.

Our clients are predominantly superannuation funds, retail multi-manager funds, large government related asset pools and individuals via financial advisor related advice networks. Schroders Australia is part of the Schroders Plc group, a London stock exchange listed firm majority owned by the Schroder family that manages nearly A\$500bn on behalf of institutional and retail investors, financial institutions and high net worth clients around the world.

We have prepared this submission in the context of Schroders being a significant participant in the financial services system in Australia as a manager of substantial superannuation and other savings, interfacing across the system with the major financial sector participants and an allocator of capital in domestic bond and equity markets. As a predominantly institutional and wholesale manager of assets with no direct retail market distribution, no superannuation, banking or insurance products of our own and no transactional investment banking activities we believe we are in a position to make relatively objective comments on the structure of the financial services industry. We note that on behalf of our clients, we are a shareholder of relatively significant size in a number of listed financial services firms in Australia and globally.

Recognising that there will already be a considerable number of submissions made to the Inquiry that detail specific issues we have kept our submission here to some more high level, but in our view critical, issues along with some specific remarks in relation to the superannuation system.

Sizing the System

There has been considerable discussion in the media and elsewhere about the growth in the superannuation industry over the last decade and, as a consequence, its size and importance to the economy relative to the banking and insurance system.

However, in understanding the potential for efficiency gains and the impact of regulatory or other changes on the system it is important to put the relative parts of the financial system into context. We do this in two ways, firstly by examining the total economic exposure of the industry (e.g. size of balance sheet) and secondly by examining the revenue stream of the industry. The former is important in understanding the potential for impact in the broader economy while the latter is important to understand the potential for efficiency gains.

This is particularly the case in financial services whereby revenues of the industry are effectively a tax on capital flows. Provided these taxes are reasonable and improve the overall functioning of capital flows they are beneficial to the broader economy. To the extent these taxes are distortionary or “rent-seeking” they detract from the overall growth potential of the economy and potentially increase systemic risk.

The following table sets out the balance sheet and revenue for different parts of the financial system.

Institution/Sector	Assets (\$bn)	Revenue/Expense (\$bn)
Banking	2,978	>80*
Life	270	12.8
General Insurance	254	45.4
Superannuation	1,837	16.9
- Default Superannuation	411	<4*
Top 4 banks	2,368	77.3
Top 4 life	205	5.0
Top 4 general	113	40.2
Top 4 superannuation	179	1.1
	Size (\$bn)	
Australian GDP	1,511	
Australian Stock Exchange	1,562	
Australian Corporate Bond Market	147	

Source: Banking data APRA June 2104, Superannuation data APRA March 2014, Insurance data APRA December 2013, FSC-Rice Warner 2013 Superannuation Fees Report, Top 4 banks from Factset last reported, Individual Superannuation fund data APRA as June 2013, Other data Factset, ASX, Schroders. Insurance revenue based on gross premiums at group level. Note while data is at differing dates over last 12 months due to availability we do not believe this materially changes the figures above. *Schroders estimates.

It is clear from the above table that the banking system is the largest in terms of financial impact, followed closely by the superannuation system. However in terms of the “revenue” extract, superannuation is significantly lower than all other sectors, particularly default superannuation.

While it is instructive to examine the life and general insurance sectors in terms of size and concentration, clearly the premium income is not a good measure of total expenses in those sectors as a substantial portion of this is returned via policy claims.

The services provided to the economy by the banking and superannuation systems can be broken down into three broad groupings:

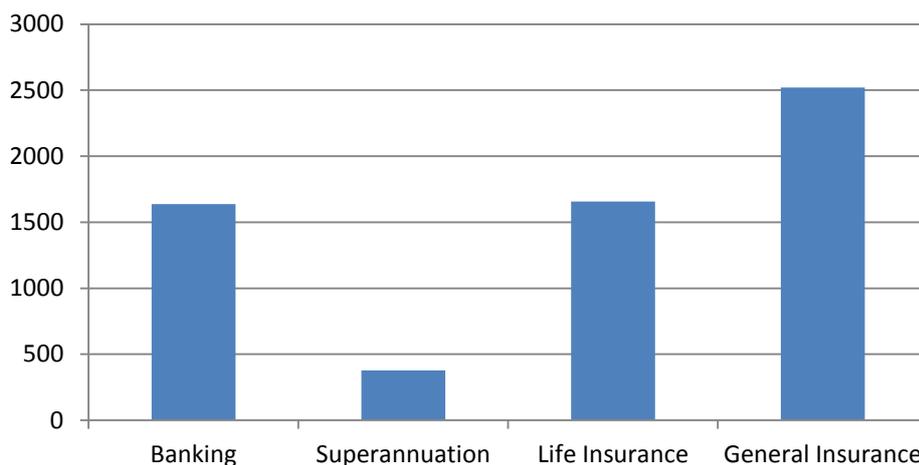
1. Savings - a store of wealth for savers and the provision of products to help grow that wealth;
2. Transactional services – payments, administration etc
3. Investment - allocators of capital in the form of debt or equity to households, governments and businesses.

It is helpful to consider the “cost” of the provision of each of these services, the degree to which there is competition and the structural biases in the system that can lead to an increase in the overall risk of the system.

Competition across the System

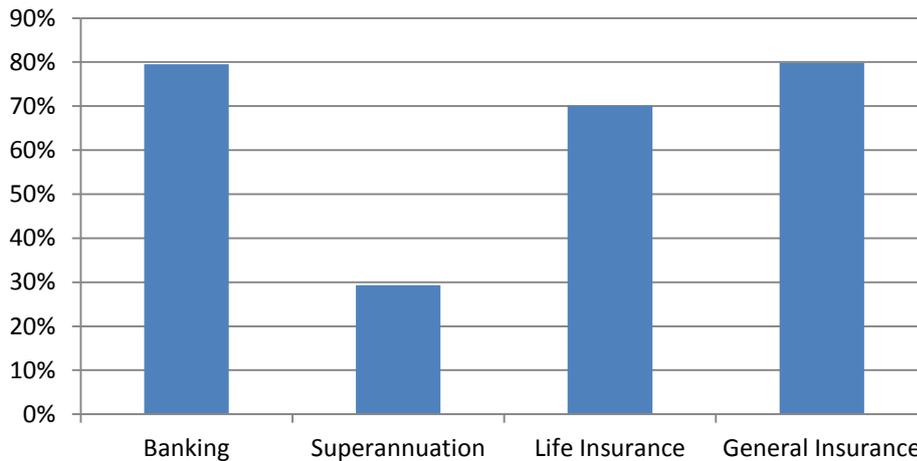
In understanding where there is competition across these industry sectors it is worthwhile considering the Herfindahl-Hirschman Index¹ (HHI) for each. In the charts below we show the HHI index and market share of the top 4 participants across banking, superannuation, life and general insurance.

HHI Index



¹ The HHI is a common measure of industry concentration and provides a score from 1 to 10000. The closer the HHI is to 10,000 the greater the level of concentration (and the lower the implied level of competition) in an industry. An industry with 1 participant (and 100% market share) gives a score of 10,000; 2 participants with equal shares 5,000; 4 participants equal shares 2,500 and 100 participants equal shares 100. Where a small number of players dominate an industry the score is significantly higher.

Top 4 Market Share



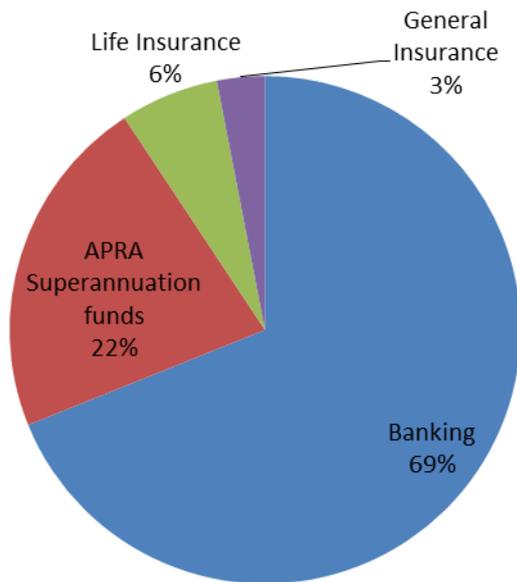
Source: Schroders calculations based on available APRA statistics. HHI based on assets. Superannuation assets are based on all large plans from APRA over \$50mn (\$944bn in total). Inclusion of SMSF's or focus on default superannuation only would produce even lower HHI scores.

The Report states that competition should be assessed indirectly using a range of indicators, *“including market concentration, barriers to entry, margins, profitability, operating costs, switching behaviour, firm behaviour and customer satisfaction.”*

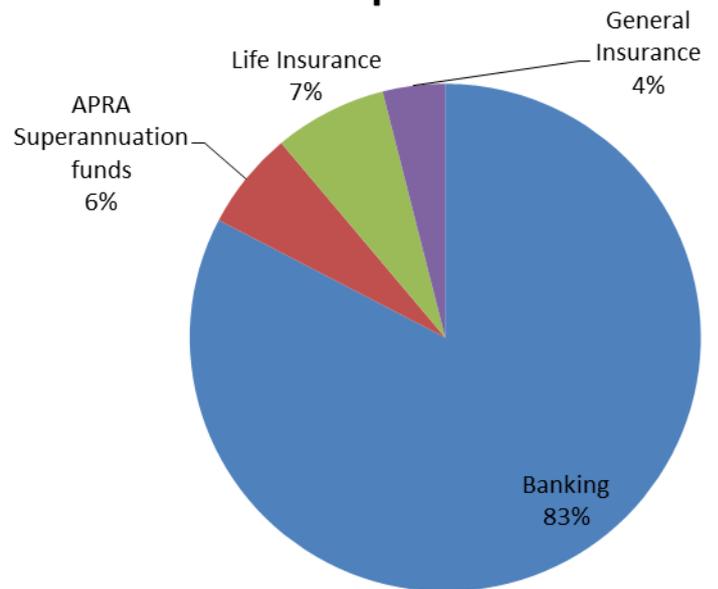
A cursory examination of the above charts would suggest that there is significant concentration and consequently less competition in the banking, life and general insurance sectors than exists in superannuation. It should also be noted that the barriers to entry in banking and insurance and the regulatory framework are significantly greater than in superannuation (e.g. minimum capital and reserving requirements).

Likewise, an examination of the total system assets and top 4 institutions aggregate assets as per the charts below highlights the importance and overall dominance of the banking system in Australia.

Total System Assets



Top 4 assets



Source: Schroders based on APRA statistics. APRA Superannuation funds is large funds over \$50mn and excludes SMSF's.

As a final point of perspective and in consideration of the systemic risks posed by these different segments of the financial services industry, we can examine where the capital allocation of the banking and superannuation sectors is directed.

64% of the banking system loans or \$1.27 trillion are “invested” in owner occupied and investment related residential housing, versus \$547 billion in non-financial (i.e. corporates) debt funding.

By contrast, the \$944 billion non-SMSF segments of the superannuation industry (funds with more than \$50mn in assets) invest virtually zero in residential housing and \$253 billion in Australian equities, \$96 billion in Australian fixed interest (corporate and government), \$80 billion in property (mostly Australia) and \$105 billion in cash deposits and short term bank bills and government debt, with the remainder in offshore debt, equity and property. Substantial investment in infrastructure assets (some debt, some equity) would be included in these figures.

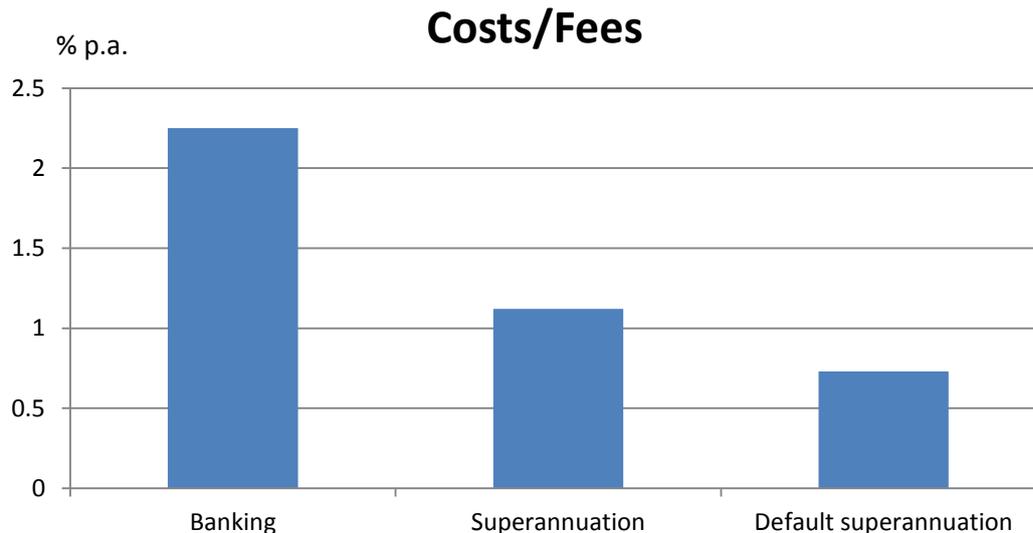
Consequently the structural risks of the superannuation system are significantly lower and its allocation of capital across the Australian economy considerably more diverse than the banking sector.

Comparative Costs

Both the banking and superannuation systems have substantial overlap in terms of their provision of two primary services:

1. Wealth store and accumulation for savers
2. Capital allocation and business funding

The costs of these services can be observed as the Net Interest Margin charged by the banking system (albeit we recognise there may be cross-subsidies involved in this) and the overall expense ratio of the superannuation system as set out in the chart below.



Source: RBA, FSC-Rice Warner Superannuation Fees Report 2013

We would note that the above is not intended as a defence of superannuation fees per-se but an attempt to put into perspective the different segments of the industry involved in the store of wealth and capital allocation in the economy.

While the banking system comes with a higher degree of systemic risk and significantly lower diversity of funding across the Australian economy than superannuation, this comes at somewhat higher costs.

Where regulation requires significant capital provision (e.g. banking, life insurance, annuities) this is highly likely to result in lower levels of competition, higher frictional costs to providers in order to provide a return on this capital, higher implicit compliance costs and therefore lower returns to investors. Given that end consumers (and taxpayers) always bear the end costs of any weaknesses or failures of intermediaries in this process, we are strongly of the view that further intermediation in financial services should be avoided where possible.

Comparative Conclusions

It is clear from the analysis above that the banking system is considerably less competitive than the superannuation system, is systemically more risky and extracts a greater cost from the overall economy. That said, the purpose of the banking system in terms of the transactional objectives is quite different to that of superannuation and one would expect some differences as a result. However, we would make the following observations from our analysis above and experience in the sector:

1. Reforms that result in greater competition in the banking system and greater diversification of the liability exposure of banks (e.g. less housing, more corporate) would be advantageous to the overall economy and reduce systemic risk – this may include changes to the measures for risk weighted assets and/or capital calculations to ensure greater consistency across the banking system but also to deter an over-exposure to one or more sectors within the economy (e.g. housing);

2. Reforms that lower competition in the superannuation system or encourage a concentration in risk exposures of that system should be avoided. In particular, changes that encourage greater uniformity in the asset allocation of funds or a reduction in the competition via further vertical integration of providers are unlikely to be in consumer's longer term interests. We explore this further in the following section.

Superannuation System Costs

We now turn our attention to the specific costs of the superannuation system and address some of the data on superannuation fees and costs and its implications on the structure of the industry that has been presented to the Inquiry.

The principal objective of superannuation is to provide an income stream in retirement. The purpose of the superannuation system in Australia was to take pressure off the age pension and ultimately result in a greater proportion of Australians being self-funded or at least part-funded in retirement. In our mind, the ultimate measure of "performance" is essentially to what degree these objectives have or are likely to be met.

Obviously it is difficult to measure performance in this way as it is a function of so many variables, including life expectancy. To better understand then the performance of the Australian system in a measurable way we need to analyse the directly controllable aspects of the accumulation and decumulation process.

In particular, the net value of the benefits derived by members of the system will always be a function of:

$$\text{Contributions} + \text{Investment Earnings} - \text{Fees} - \text{Taxes}$$

We would explicitly note that this ignores the ancillary benefits that come from having a large pool of essentially ungeared capital available for investment and the consequent capital market and economic efficiencies that result. We view these as being difficult to accurately quantify, but would not diminish their importance.

Where contributions for most participants are effectively set by regulation and taxes are largely outside of the scope of the individual (and this Inquiry) to influence, net investment earnings and fees are two critical variables to determining the level of retirement income an individual will receive.

By example, a 1% increase in net investment earnings (and no other changes) over the entire working and non-working life of a typical member would result in an increase in the superannuation income stream payable from age 65 of around 39%. Likewise, a decrease in the fees payable of just 0.1% p.a. for no change in the investment earnings would result in an increase in the final retirement income stream of approximately 3.5%².

What does that mean in dollars? In the first example, a 39% increase in the income stream as a result of the 1% additional investment earnings would equate to a lump sum of about

² Strawman example based on a member aged 20 who contributes 12% of salary to age 65 then draws down for a further 20 years. Salary inflation assumed to be 1% greater than price inflation, with price inflation used as the indexation figure for the drawdown period. Real returns initially set at 3% p.a. net of fees and tax, fees at 0.8% p.a. Contributions taxed assumed at 15% throughout. No further allowances for tax, fees, additional contributions or insurance.

\$180,000 in today dollars. The 3.5% increase as a result of the fee reduction of 0.1%p.a. would equate to a lump sum of about \$16,500 in today dollars. Neither of those figures are immaterial. For the record, a decrease in contributions tax from 15% to 10% would increase the retirement income stream by about 5.9%³.

If we exclude contributions and tax as outside of the industry's control, the two most critical aspects to assess in respect of the performance of the Australian superannuation system are consequently fees and investment returns.

Comparing Superannuation System Fees

While it is important to benchmark the Australian system and consider where gains can be made, we must remember that no two systems are alike and the Australian system is unique in a number of ways. In particular, in making international comparisons we should be conscious that as far as possible, we compare like with like.

The key characteristics of the Australian system and by consequence how it should be compared with other systems are:

1. It is defined contribution – Defined contribution systems that entail relatively constant (e.g. daily) unit pricing type methodology and the individual application of member contributions, tax etc with regular reporting to members of their individual account balance are significantly more complex to administer than defined benefit systems where no individual accountability at the member level is required. This complexity increases as one overlays a myriad of different tax structures and rates across time periods and members.
2. It allows for choice – of both fund and investment option where provided within that fund. This imposes additional constraints in terms of administration, liquidity of investments and scalability that add to cost and complexity. The degree to which choice is a useful characteristic is of course a matter of debate, however in making comparisons with other systems we need to be conscious of the costs imposed by choice.

In comparing the Australian system with international systems, the most appropriate comparison in our view would be other systems that are materially defined contribution in nature and specifically to compare the default structures rather than the full member choice structures, albeit in Australia default providers must absorb some of the costs of provision of choice.

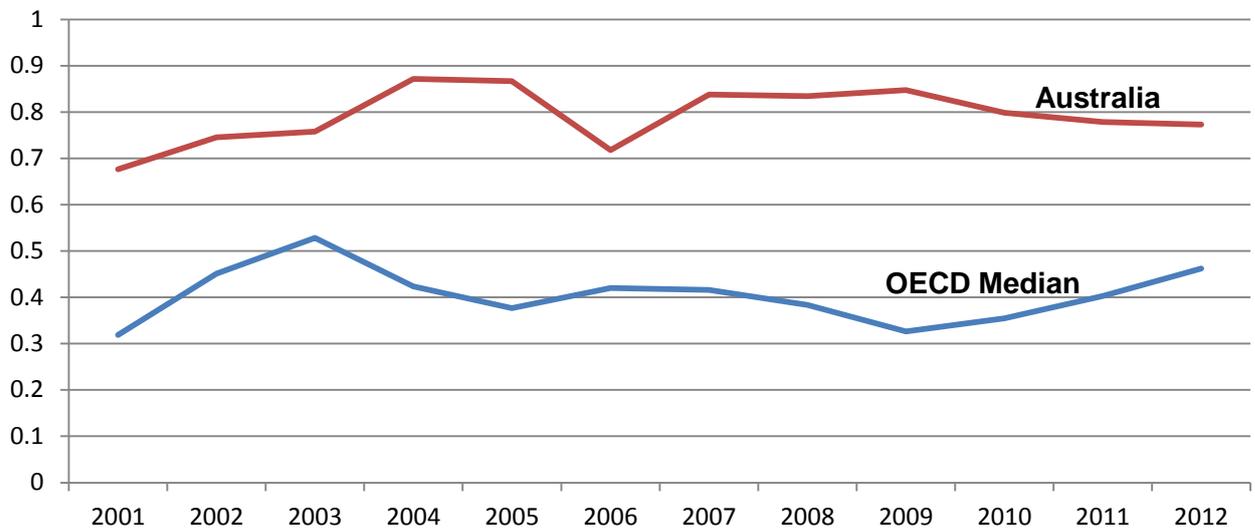
The Grattan Institute Report on Superannuation “Super Sting: how to stop Australians paying too much for Superannuation”⁴ makes a number of assertions about the Australian superannuation system and comparisons with the other overseas systems. In particular the report compared Australian expenses with the OECD median expense of other pension schemes and concluded that the expenses in the Australian system were considerably

³ Dollar figures have been calculated on the strawman example assuming a starting salary of \$40,000 p.a. indexed at 3% p.a. to age 65.

⁴ Minifie, J., Cameron, T., and Savage, J. 2014, Super sting: how to stop Australians paying too much for superannuation, Grattan Institute.

higher than the OECD median. The basis for this claim and the accompanying chart is data from the OECD Statistics Extracts database.

Australian and OECD Median Expense Ratio's in % from Grattan Report

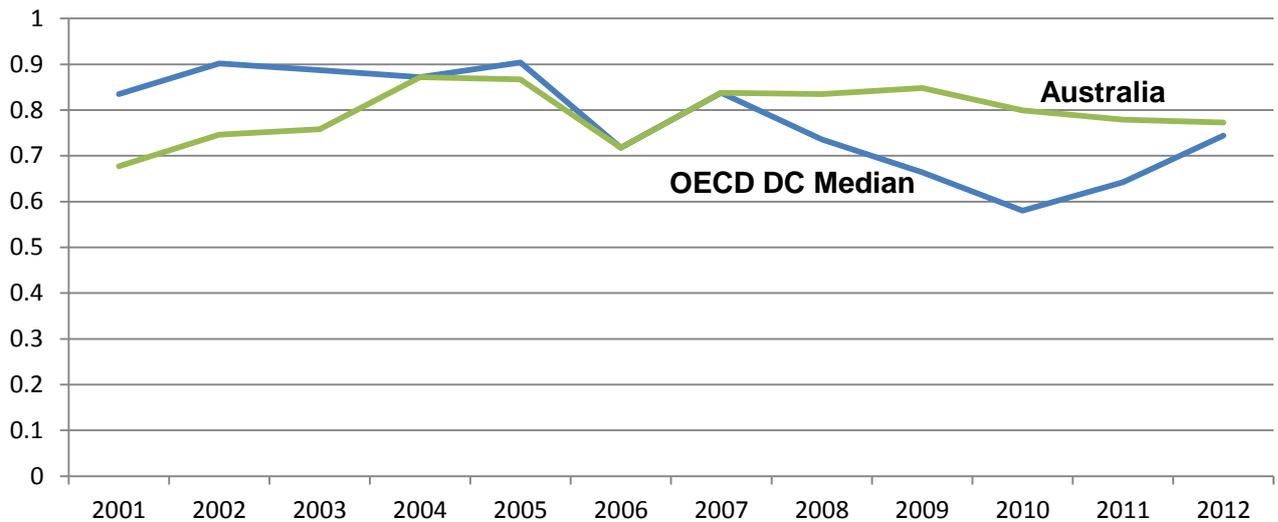


Source: OECD Stat Extracts. Note that the "Fees" line in the Grattan report has been excluded as this comes from a separate data source that is not consistent with the above data sources. We address the fees issue elsewhere in this report.

The countries in the OECD median are only those countries where data is reported in a format that makes it possible to extract total fees. The represented OECD median rate used happens to exclude the US and Japan and the UK market, which is included, is a defined benefit pension market. Consequently, the comparison isn't so much with the OECD, but rather a group of much smaller countries with a myriad of different pension systems.

More sensibly, if we construct an average of the predominantly DC only markets from the same OECD data set, we end up with a considerably higher median fee as per the table below.

Australian and OECD DC Median Expense Ratio's in %



Source: OECD Stat Extracts, Countries included are: Australia, Chile, Czech Republic, Estonia, Greece, Hungary, Iceland, Israel, Mexico, New Zealand, Poland, Slovak Republic, Spain (yes, hardly global powerhouses, but that's what's in the OECD survey).

Note also in the above table that the average equity allocation of the DC countries is 21.7% (excluding New Zealand where there is no data in the OECD Stats Extract database) versus the average equity exposure for Australian funds from the OECD database of 71.1%. Obviously, Australia has similar fees to the OECD average with more than 3 times the exposure to growth assets which are commonly accepted as being more expensive to manage.

Importantly, comparing the above data for the whole Australian system with the breakdown through time of the different wholesale (mostly default) fund subcomponents of the Australian system we can see that there has been a reasonable drop in average fees through the last decade, particularly for the Industry and Large Corporate Super Master Trust segments where the bulk of private sector assets are placed.

Wholesale fund fees through time in %

Sector	Segment	Fee rate %						
		2013	2011	2010	2008	2006	2004	2002
Wholesale	Corporate	0.78	0.79	0.80	0.73	0.78	0.75	0.86
	Corporate Super Master Trust (large) ¹	0.86	0.83	0.87	0.79	0.81	1.14	1.24
	Industry	1.07	1.13	1.26	1.07	1.13	1.18	1.23
	Public Sector	0.76	0.82	0.81	0.69	0.70	0.66	0.63

Source: FSC- Rice Warner Superannuation Fees Report 2013. 1. Excludes employer plans with less than \$5mn in assets.

The important information from the above table is that average fees for the wholesale segment of the superannuation market, which reflects mostly default members (but would include some choice members and the costs of the choice infrastructure) are in the order of 80 to 100 basis points and have fallen quite substantially in the last decade. This is during a period of rising investment complexity, regulatory and compliance requirements.

In summary, in comparing DC fees from around the world for default style schemes it is not obvious that Australia is materially different from the OECD average. We would not disagree that the Australian system could be cheaper by making structural changes – specifically by re-introducing defined benefit schemes or completely removing member choice – however these would be quite different policy settings from what we have today (and come with other issues).

It is our view that a more sensible benchmarking exercise would be to compare the various components of the Australian superannuation system fees with those offshore markets – especially administration and investment management. The following table from the FSC-Rice Warner report breaks down total fees by key activity. Again we have only examined here the wholesale data, albeit interested readers could look to the full report for the complete analysis.

Fees by Superannuation Segment

Fees by superannuation segment – Year to 30 June 2013						
Sector	Segment	Operating	Investment management	Operating & investment management ¹	Advice	Total fees ¹
		(%)				
Wholesale	Corporate	0.26	0.49	0.76	0.02	0.78
	Corporate Super Master Trust (large)	0.22	0.45	0.67	0.19	0.86
	Industry	0.41	0.62	1.03	0.04	1.07
	Public Sector	0.20	0.52	0.72	0.04	0.76

Source: FSC-Rice Warner Superannuation Fees Report 2013

It is clear from the above table that operating costs (e.g. administration, marketing and governance) are significant part of the total fee. “Advice” is also a key component for Corporate Super Master Trusts.

A key element of the MySuper reforms was the introduction of a simplified and ultimately cheaper default option for members who do not make an active fund or investment choice. While these funds are still relatively new, in time we will have an even better understanding of true “default” fees and how these are changing. The FSC – Rice Warner report did undertake some initial analysis on these MySuper fund fees with the results outlined in the table below.

Average Fee by Account Balance – MySuper Funds

Average fee by account balance (% of assets)					
Segment	Average \$ per member fee	Average % of assets fee	\$5,000	\$20,000	\$50,000
2011					
Corporate	47	0.62%	77	170	355
Retail	64	1.61%	144	385	867
Industry	68	0.76%	106	220	449
Public Sector	28	0.58%	57	144	317
Total	63	0.92%	109	248	525
2013					
Corporate	81	0.69%	115	219	426
Retail	72	0.82%	112	235	481
Industry	74	0.72%	110	217	433
Public Sector	29	0.64%	61	156	347
Total	69	0.73%	106	215	433

Source: FSC- Rice Warner Superannuation Fees Report 2013

It is clear from the above that when we start to consider only default fund members, realistically, the total fee is in the order of 70bp – 80bp – or circa \$450-\$500 per member per annum. This is a long way from the \$1300 per member suggested in the Grattan Report.

While there is no breakdown here between operational/administration expenses and investment management expenses, our expectation would be that administration expenses are still a relatively significant part of the cost structure of MySuper default funds. We would recommend that a reporting structure be put in place that collects this information and that regulatory change be considered to reduce administration expenses. In our view the consumer benefit from expensive administration is minimal.

Global Benchmarking Examples

In looking globally there are a number of specific countries and/funds that are used as examples of better practice. These include:

1. The Chilean default tender system. Note that it requires some estimation to determine the true fees of this system and we believe there are a number of misunderstandings as to what those fees include and don't include in some studies that have been undertaken. From the OECD:

“One of the great difficulties produced by the Administrators’ charging structure is that it makes it impossible to measure their efficiency in managing the resources directly, because the commissions that members are charged cannot be compared directly with the yield obtained by the Pension Fund. This is why an estimation is given here of what the annual percentage commission charged by

the pension fund on the member's account balance would be, according to the commissions' structure."⁵

There are three points worth raising with respect to the Chilean system. Firstly average fees are in the order of 60bp (albeit this is difficult to ascertain as fees are based on contributions not assets), however this excludes funds management fees and insurance premiums. It is the administration fee only. Secondly, we see a big danger in a system that ultimately drives towards an oligopoly or duopoly being responsible for the bulk of Australia's savings pool. As noted in the opening segment of this report there is safety in at least some diversity of capital allocators in the economy. Thirdly, if we were to focus purely on cost as the selection criteria (or predominantly on cost) this would push the system towards a mostly passive investment structure. A system the size of Australia's invested mostly passively would substantially increase systemic risk and raise the likelihood of market distortions. The Australian system is currently in the order of 18 times the size of the Chilean system and growing at a faster rate.

As a global investment manager with operations in Chile, it is our experience that fees for investment management services are no cheaper there than elsewhere for the same size of mandate and approach.

2. The NZ Kiwisaver default tender system – average fees are 55bp, however these funds are required to only have 15-25% in growth assets and are consequently significantly more conservative than Australian default funds. Large funds in Australia already offer fees at this level for conservatively invested members.
3. The US Thrift Savings Plan – extremely low fees but this is a captive audience, entirely passively managed and with non-investment related fees paid for by the employer. Interestingly the US 401(k) system which is more akin to the Australian system in terms of DC operation and member choice has average fees of 1%⁶ - somewhat higher than Australian average default fees.
4. Swedish Premium Pension System – centralised administration which reduces admin fees to circa 10bp or less and a lifecycle (passive) investment option with fees of 5 to 12 bp. Total fees are circa 30bp per individual. The choice element of the Swedish system then allows members to select effectively full retail options from over 800 fund choices. Clearly centralised administration materially reduces cost.

The Australian Centre for Financial Studies in conjunction with Mercer⁷ has undertaken a global benchmarking study on a range of factors including adequacy, sustainability and integrity. On that ranking the Australian system sits in 3rd place behind Denmark and the Netherlands (which is defined benefit).

⁵ OECD, "Chile, Review of the Private Pension System", October 2011.

⁶ Erikson and Madland, "Fixing the Drain on American Retirement Savings", Centre for American Progress, April 2014.

⁷ Melbourne Mercer Global Pension Index, October 2013.

Melbourne Mercer Global Pension Index

Grade	Index Value	Countries	Description
A	>80	Denmark	A first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity.
B+	75–80	Netherlands Australia	A system that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system.
B	65–75	Switzerland Sweden Canada Singapore Chile UK	
C+	60–65	Nil	
C	50–60	Germany USA Poland France Brazil Mexico	A system that has some good features, but also has major risks and/or shortcomings that should be addressed. Without these improvements, its efficacy and/or long-term sustainability can be questioned.
D	35–50	China Japan Korea (South) India Indonesia	A system that has some desirable features, but also has major weaknesses and/or omissions that need to be addressed. Without these improvements, its efficacy and sustainability are in doubt.
E	<35	Nil	A poor system that may be in the early stages of development or a non-existent system.

Source: Mercer Global Pension Index, 2013

Investment Management

We note that the FSI Interim Report has requested further information on the benefits of active management for members of superannuation funds.

While it is clear that active management in aggregate at the asset class level is a zero sum game less fees, this is a particularly misleading statement when applied to the professional investment management industry. In addition it also ignores the critical aspect of asset allocation and the need for a more active approach⁸. The reason so many institutions globally utilise active asset management is, in part:

1. A recognition that the universe of active managers to which this statement applies is significantly larger than the universe of professional money managers (e.g. every direct investor in the equity market who doesn't own the index is an active manager);
2. The fees paid by institutions for active management are substantially lower than retail fee scales on which most "active vs passive" analysis is conducted, and consequently the hurdle rate is considerably lower for institutions;
3. Risk is an important consideration in the trade-off not just return and investing in the index does not manage risk, you take what is on offer in the index;
4. The universe of available investments to an active approach is often broader than that in the "index";

⁸ See Attachment A to this submission: Cooper, Doyle, Durack and Stevenson, Schroder Investment Management Australia Limited "Why strategic asset allocation is flawed", March 2012.

5. Index management is cheap (but not free as often assumed) as a result of simplistic and pre-determined investment weightings. In almost all cases this does not equate to a risk or return outcome which is necessarily superior to active management nor tax efficient;
6. While some subcomponents of the asset allocation can be passively managed the overall fund exposure needs to be actively managed.

We would, and have highlighted before, that the real benefit of asset management is in fact managing exposure to the asset classes itself, not just the management of the sub-asset classes which is where most “active vs passive” research is conducted.

There are a number of academic studies that support the case for active management of institutional assets from around the world:

“On average, the large pension funds in our sample seem to be able to provide value to their clients using active management across asset classes, after accounting for all costs and after risk-adjusting. Pension funds obtain 21 basis points annual alpha from market timing, and about 45 basis points annual alpha from security selection.”⁹

“We document that cost levels for pension funds are considerably lower than those of mutual funds. This may be primarily due to pension funds’ larger sizes, which may result in higher bargaining power and / or more efficient operations. Specifically, large pension funds have much lower costs than smaller funds. For example, the largest 30% of DB funds have costs of about 15 basis points a year, versus an average cost of 40 basis points a year for the smallest 30% of DB funds. We find that the domestic equity investments of US pension funds tend to generate positive abnormal (i.e., risk-adjusted) returns after expenses and trading costs. This seems in sharp contrast with the average underperformance of mutual funds.”¹⁰

From an Australian perspective, a brief examination of the Mercer Investment Survey for the periods to 30 June 2014, shows the outperformance of median performance of active managers vs the relevant index as follows. There is no zero sum game at work here.

Excess Performance of active investment managers to 30 June 2014 (before fees)

Excess performance (% p.a.)	1yr	3yrs	5yrs	10 yrs
Australian Equities	1.1	1.3	0.9	1.2
Global equities	0.3	0.2	0.7	0.8
Australian Bonds	0.4	0.4	0.8	0.3
Aus Small Cap Equities	7.9	12.4	10.8	7.2

Source: Mercers, Analysis of Long Only managers versus relevant benchmark

We note that these are not asset weighted (and nor are most active vs passive surveys), however it does appear that the average professional money manager in Australia outperforms the relevant index. Why the paradox if this is a zero sum game? Again, the

⁹ Andonov, Bauer and Cremers, “Can Large Pension Funds Beat the Market”, May 2011.

¹⁰ Bauer, Cremers and Frehen, “Pension Fund Performance and Costs: Small is Beautiful”, April 29, 2010.

professional investment management industry is only a portion of the total active assets in the market under active management. It would be our assertion that non-professional holders of listed assets provide the opportunity for professional active managers to outperform. This is particularly obvious in the Australian small cap equities sector where the outperformance of professional managers is quite high.

This concurs with the decision by most superannuation funds in Australia to utilise active managers for major listed asset classes as the fees they pay would generally be lower than the historical outperformance of the average manager.

We would also make the observation that given the current size of the superannuation system and its growth rate, any structure that increased substantially the purely passive implementation of the investment would be systemically quite risky when applied across the entire market. In particular we note:

1. Purely passive approaches to a large part of the equity market are associated with rising cross-sectional risks in equities and higher overall systemic risk to equities:

“We establish that the rise in popularity of index investing contributes to higher systematic market risk. More indexed equity assets corresponds to increased cross-sectional trading commonality, in turn precipitating higher return correlations among stocks.”¹¹

2. A passive approach to fixed interest (for which there is no theoretical underpinning unlike equities) would be particularly distortionary and risky as investors would hold the largest debt stakes and continue to allocate to those debt stakes of the most indebted nations and companies.
3. Passive approaches to asset allocation take no account of the very volatile nature of fixed asset allocations (see above mentioned Schroders paper on strategic asset allocation).
4. A passive approach would mean that the only enterprises that get funding would be those that are already significant parts of established benchmark equity or debt indices.

Passive investment approaches can be appropriate for a part of the overall investment strategy of a fund and are used to differing degrees. However a structural bias in the industry to forced passive holdings would, if large enough, have a negative consequence on overall systemic risk and the capital allocation process within the economy.

Lastly, in respect of the Grattan performance analysis, considerable use has been made of the “APRA Fund Level Performance Statistics”. Interested readers should note that these performance statistics are at fund level (as stated) rather than at the level of the investment option. As such, a fund with a high proportion of “balanced” members, will likely achieve quite different fund level results to a fund with a higher proportion of “conservative” members even if the performance of the underlying investment options for each fund are identical. There has been considerable discussion in the past about why the APRA level fund data is meaningless, so it is not worthwhile reconsidering here, suffice to say that any analysis of performance of funds would be better based on the performance of the underlying options

¹¹ Xiong and Sullivan, “How Passive Investing Increases Market Vulnerability”, August 20, 2011.

not APRA data. High fee “retail” funds (which are not default funds anyway) have significantly greater dispersion of members away from the balanced option than do industry and public sector funds. They also incorporate substantial allowances for Advice and related fees – they are not default options.

Conclusions and Recommendations

We see a number of areas where superannuation funds could further reduce costs.

1. Continuing to use the benefits of size and scale to lower costs of third party providers. In particular we would recommend that superannuation funds be required to further detail their operating expenses by explicitly reporting:
 - a. Aggregate expenses paid to third party providers of fund management services;
 - b. Aggregate costs related to marketing and distribution of the fund;
 - c. Aggregate costs related to member administration.

Such reporting will mean that in the future it is easier to ascertain where value is being added by the industry and the costs associated with various activities in superannuation. In particular, it would make it easier for consumers to identify where they are receiving value for money and where they are not (e.g. the proliferation of passively managed funds at fee levels similar to actively managed funds).

This approach should be seriously considered in the case of vertically integrated players as there is considerable scope for cross-subsidy.

2. Greater utilisation of less expensive asset classes – it is not so much a question of active vs passive, but where are you active, where are you passive and what don't you pay for. Alternative assets have been a key contributor to high investment costs and so the hurdle required for investment should be that much higher. Trustees are already required in the MySuper regime to explicitly take account of the costs of different investments and the net benefits to members. This should be allowed to play its natural course.
3. Administrative efficiencies - administration takes up a sizeable portion of total fund fees and more efficient administration, even more centralised administration, the use of TFN's to reduce multiple accounts etc could all be avenues to reducing costs. We would argue it is somewhat unfair to criticize the SuperStream initiative at this point as having not reduced costs when it hasn't actually started, however we do believe that substantial aggregate savings in superannuation costs could be made by:

- a. Adopting a centralised administration platform for all default superannuation members with a clear superannuation identifier – e.g. TFN or a specific identifier as with say a Medicare number. Providers of MySuper products could then concentrate on the provision of the investment service rather than administration. This would also allow a centralised reduction in multiple default accounts and reduce the likelihood of lost superannuation accounts. Effectively a “wrap platform” for default superannuation.
 - b. Reducing the complexity of superannuation administration by simplifying the tax treatment of the historical superannuation components and the regulations relating to say preserved and non-preserved components.
 - c. Limiting the degree to which choice of fund and choice of investment option can operate within the default fund segment.
 - d. Continue to enable migration from paper based error prone transacting in both superannuation and the broader savings industry (eg. The requirement for a signed, multi-page PDS to make an investment) to electronic transacting via regulatory reform.
4. While we have not focussed specifically on SMSF's in this report, given the concentration in the banking system on residential housing and related investments it does not seem prudent to encourage greater investment in housing and related investments, particularly leverage of such investments, in the superannuation system.

Similar to our comments above in relation to the banking sector, we would observe that regulatory changes that result in a dramatically increased concentration of the assets in superannuation sector are unlikely to improve long term competitive outcomes for consumers and are quite likely to result in an increase in systemic risks in the broader economy. Greater use of vertical integration and the reduction in the number of superannuation funds that resulted in sector concentrations anywhere near the banking or insurance industries would not be in members interests.

We attach a further paper that may be of interest to the Committee in relation to the issues with life-cycle strategies and the need for product structures to incorporate a greater emphasis on the achievement of objective outcomes rather than peer group relativities – see Attachment B “Enhancing Default Investment Strategies”.

We would be happy to discuss any aspect of this submission with the Committee of the Inquiry.

Kind Regards



Greg Cooper
Chief Executive Officer

Attachments:

A: Why Strategic Asset Allocation is Flawed, Schroder Investment Management Australia Limited, March 2012

B: Enhancing Default Investment Strategies, Schroder Investment Management Australia Limited, March 2014