

# **DFA AUSTRALIA LTD**

Final Submission to the Financial System Inquiry 2014

August 2014



# Overview

The interim report of the Financial System Inquiry correctly identified a number of issues around the adequacy of Australia's retirement income system.

Allied to this was the need for the delivery of sound, non-compromised financial advice and improved financial literacy.

These imperatives, the inquiry concluded, should be addressed against the core system principles of efficiently allocating resources and risks, maintaining stability and reliability in the financial and retirement systems, and ensuring fairness and accessibility for all Australians.

As a firm leading research into retirement incomes, grounding its approach in academia and working with independent financial intermediaries to advance investor education, Dimensional is well placed to help the inquiry with its objectives.

In our first submission, Dimensional suggested the government set as a key objective for the superannuation system the provision of adequate retirement incomes for all Australians. As part of this, we proposed a system that takes into account the varying needs of individuals for income in retirement.

With this in mind, we welcome the comments in the interim report about the need for the setting of clear goals in the retirement system and for the removal of structural impediments to people achieving their goals.

The following submission addresses some of the inquiry's specific questions and suggests a possible framework for addressing solutions that ensure the financial system is working to meet the financial needs of all Australians.

# Financial Advice and Consumer Literacy

We support the interim report's comment that affordable, quality financial advice can bring significant benefits for consumers.

There clearly are limits to what regulation can achieve. But, generally, Dimensional supports any initiative that promotes the professionalism of financial advice and its separation from product, so that the best interests of end investors are served.

Hastening the trend toward professionalism would be an overall increase in education standards and a requirement that the term "financial adviser" be legally separated from the role of facilitator or product advocate in all areas of advice.

As investors and savers tend not to engage seriously about retirement until their later working years, communication, education and advice need to be shaped to the perspectives, concerns and imperatives of different age groups. Better engagement in both the accumulation and drawdown phases can lead to better outcomes.

As such, we would recommend the Inquiry take a holistic view and see financial advice, consumer literacy and retirement innovation altogether. The focus should be on giving people **meaningful** information, not necessarily more information.

The ultimate test of any change should be whatever raises the odds of people reaching a given income target that enables them to fund their own retirement and meet their other financial goals. Improved engagement and education should be in support of that outcome.

In this, the focus of the system should be on showing people how meaningful factors within their own control (like working longer, saving more and consuming less today) can help drive the outcomes they are seeking.

# Retirement Incomes

We agree with the Inquiry's observation that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

As noted in our preliminary submission, we draw your attention to the work of Nobel laureate Professor Robert Merton, both in relation to the accumulation and drawdown phases.

Professor Merton, of MIT's Sloan School and a resident scientist with Dimensional, has been a global advocate for moving the focus of defined contribution accounts from lump sum targets to achieving a reasonable level of retirement income.<sup>1</sup>

If the goal is income for life after the age of 65 (or any other date of retirement), the relevant risk is retirement income uncertainty, not portfolio value. This requires a change of mindset in the Australian financial services industry, but it is undoubtedly the right course.

Focusing on managing income risk clearly has consequences for asset allocation and glide paths, but the experience of the GFC for many savers highlights the imperative of tackling these issues.

In practical terms, one way of superannuation funds and savers achieving this is through a liability-driven strategy. As in conventional DC plans, savings are allocated between a well-diversified risky portfolio and risk-free securities.

In addition, consideration in design might be given to the duration of appropriate fixed interest instruments and the effect of the age pension.

Instead of a mechanical asset allocation, the new approach advocated by Professor Merton takes on risk only when there is a low probability of achieving the desired income goal with less risky assets.

And when the goal is achieved, it takes as much risk out of the portfolio as possible. The benefit here is to reduce the negative effect of events such as the financial crisis in significantly undercutting an individual's capacity to fund their retirement.

The other benefit of this approach is to increase the likelihood of meaningful engagement with fund members. That's because the discussion becomes about managing the risk of retirement income needs.

**As few people can afford a full-time financial adviser, our suggested process ends up with an effective retirement system guiding savers to good outcomes and doing so through meaningful communication and clear, simple choices.**

<sup>1</sup> 'The Crisis in Retirement Planning', Professor Robert Merton, Harvard Business Review, July-Aug 2014 (attached)

As such Dimensional firmly supports the Interim Report discussion in Part 2 requiring superannuation funds to project retirement incomes on superannuation statements, with the income focus as a goal informing the asset allocation for each individual.

The other leg of this system is that it is a whole-of-life approach. It does not end at retirement. As members near the end of their working lives, their income needs are divided into three categories—minimum guaranteed income, conservatively flexible income and desired additional income.

- The minimum category is designed for life, protecting the retiree from longevity risk, interest rate changes and inflation. In the Australian context, this category incorporates the age pension.
- The second category is flexible income, derived from a portfolio of inflation-protected government bonds. In this case, both the portfolio interest income and the principal at each bond's maturity are used for income payments.
- The third category covers those who wish to invest a portion of their super in growth assets that hold out the possibility of earning sufficient returns to achieve their desired higher income.

We believe changes along these lines would address what the financial system inquiry has identified as a major weakness of the drawdown phase—the lack of income stream products with protection against longevity risk.

We note that on this score Treasury is separately seeking feedback on the regulatory barriers to increasing the availability of income products. We plan to provide further context and detail around this issue in our submission to that discussion paper.

On the inquiry's requested policy options, we would caution against mandating the use of particular retirement income products such as lifetime annuities. We have seen in the UK in recent months a move in the exact opposite direction of mandatory annuitisation because of rigidity and expense of such products. Indeed, anything that works against innovation might be counter-productive.

It is difficult to fully respond to some of the Inquiry questions in Part 4 without the objectives of the superannuation system first being defined.

But a first practical step would be for the government to begin issuing longer-dated bonds linked to inflation. This would support innovation in retirement income products that help to match liabilities to income without the cost of lifetime annuities.

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For now, the priority should be on removing regulatory and other impediments to spurring innovation. Indeed, as a fund management firm at the forefront of global innovation in this area, Dimensional stands ready to engage with regulators and the industry to bring this about.



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