McGING
ADVISORY & ACTUARIAL

ABN: 53 144 994 070

Level 13, 160 Queen Street
Melbourne VIC 3000
Phone (61 3) 8641 6970

service@mcging.com.au
www.mcging.com.au

26 August 2014

Mr David Murray AO
Chairman
Financial System Inquiry
GPO Box 8
Sydney NSW 2000

via online FSI submission facility

Dear Mr Murray

Financial System Inquiry - Second round submission

I write in respect of: *Superannuation - Efficiency / fees / competition*.

1 Setting the scene

I note and agree with the FSI Interim Report findings on page 2-99 that:

- "there is little fee-based competition in the superannuation sector", and that
- "this indicates there is scope for greater efficiencies in the superannuation system".

I also note and agree with the statements on page 2-102 that

- The Super System Review found that fees had not fallen in line with what could have been expected given the substantial increase in scale.
- (Industry Super Australia submission): This increasing level of economies of scale, coupled with technological advancement and efficiency dividends, should have resulted in a notable fall in the level of fees. This has not been the case.

2 A simple idea for reducing costs and fees

2.1 Costs & fees as dollar not %

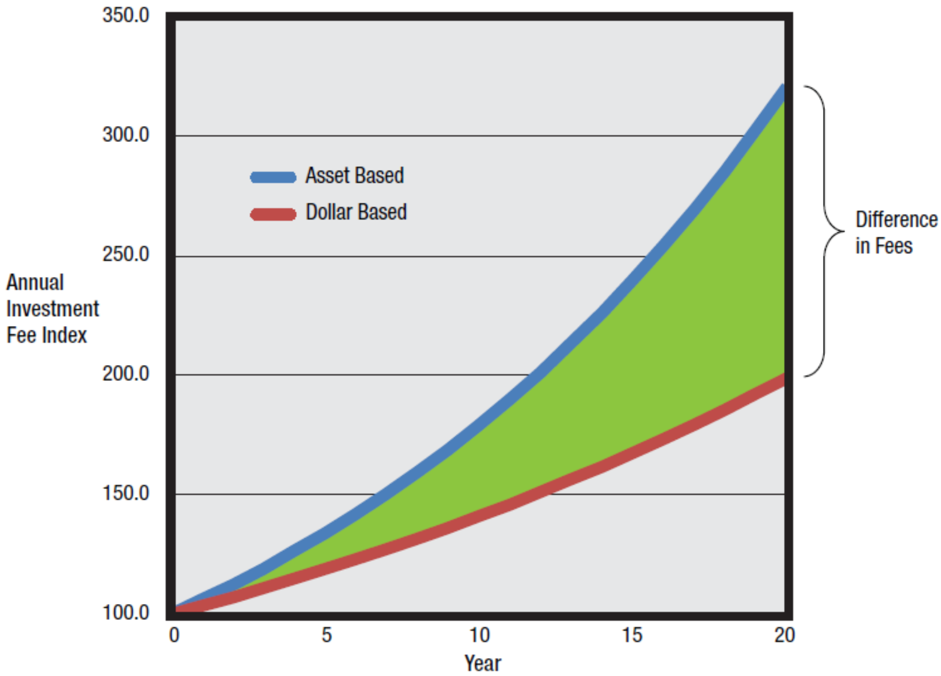
Remembering that simple is not always easy, and change is never easy, I recommend the Inquiry consider how the industry participants could move, or be encouraged to move, to

Base investment management contract costs and member fees primarily on dollars - not as a % of assets.

The principle applies to all asset management. In superannuation during the accumulation phase the situation is further magnified by contributions increasing over time with wages.

2.2 Illustration of impact of $ fees indexed to wages vs % of assets

Graph 1 following illustrates the big difference in fees paid by charging a member on a percentage of the asset value compared to a fixed dollar basis after allowing for increases based on wages inflation. By the end of 20 years, on this relatively generous basis (to the provider / asset manager) - see details below - a member's annual fee if asset based is double that of a wages inflation adjusted dollar fee.



Graph 1. Comparison of Dollar to Asset Based Investment Fees

Assumptions:

(i) Single accumulation amount invested at start.

(ii) Asset allocation based on APRA data for average of all APRA supervised funds.

(iii) Projected future average net investment return of 6% per annum after tax of 15%.

(iv) CPI inflation of 2.5% plus 1% additional real wages growth = 3.5% total wages/life style growth.

(v) Investment fee index of 100 at start which would be say $300 being say 0.6% of an asset value of $50,000.

Sources

This idea was first published in a paper entitled Reducing Retirement Income Costs written by Sean McGing in 2011 for the Actuaries Institute Convention.
http://www.actuaries.asn.au/Library/events/Conventions/2011/ReducingRetirementCosts-Paper.pdf

The Graph illustrating the effect was first published in the McGing Gazette in March 2014.
http://www.mcging.com.au/downloads/McGingGazette_Mar2014.pdf

2.3 Detailed Assessment from 2011 Reducing Retirement Income Costs paper

The following extract from my 2011 paper sets out a brief analysis followed by the recommended cost reduction action with supporting reasons and expected effects. They are just as applicable today.

EXTRACT of 3.6.3 Investment – asset management fees

Functional area: Investments

Primary Issue: Issue 1 – Costs are too high
Secondary Issue: Issue 2 – Lack of transparency around costs

Analysis
In recent years fixed dollar disclosures on member statements have revealed the large $ costs to members of the investment management organised by providers with asset managers on members‟ behalf. These investment management costs can be high and from the members‟ perspective and for most providers they rise with the account balances – not just with the investment returns. The fundamental question is what arrangement / structure provides the best service – i.e. the best net investment return after tax and fees for the member - while at the same time providing an equitable incentive to the asset manager to perform well, ensure a long term, stable and productive relationship to the benefit of all parties. This includes soundly running an asset management business which can recruit, train and fairly reward people with the specialist investment skills needed. There is wide variety around investment fees but fees as a % of assets is deeply entrenched. As reflected in the passive vs active debate, there is also a lot of discussion around what level of value asset managers provide over longer time horizons for the fees they earn. Given the volatility of markets it is very hard to pick future asset manager winners on value. Past winners may be just that. The high remuneration levels in the industry reflect how market movements, skill and luck can lead to big investment gains, or not. Reputation is critical and can be cult like. Trustees need to keep a view of the bigger picture and apply a rigorous and disciplined selection and monitoring process as well as using commonsense.

Retirement Income (RI) cost reduction action:

1. Use investment manager(s) that charge base dollar fees - not as a % of funds under management - as majority of remuneration.
2. Can still incorporate a reasonable but not excessive level of incentive based on target absolute and/or excess of benchmark performance once interests of member, provider and fund manager are aligned.
3. The large and growing global scale asset management market in Australia may attract global or local businesses with deep pockets who see an opportunity to offer more competitive, more transparent value based asset management fee arrangements. The GFC has distracted most world players for the last few years but that will pass. In Australia we need to have a more aggressive attitude on changing the costs elements of the business model to protect our members and ensure the long term survival and success of our local asset managers.

Reasons & effects
1. Flat dollar fee, rather than a % of assets, sharpens the focus for asset manager, provider and member
2. Better matches effort and work done with fair wages for that work done.

3. Is much more transparent to all concerned.
4. Reduces escalation and volatility of fees with market volatility.
5. In effect, with flat dollar fees, the brakes on fees are on by default, not having to be continuously applied and released.
6. Negotiations become negotiations on increasing fees.

2.4 Additional comments

A simple yet potentially profound change from investment costs and fees substantially % of assets to substantially $ based fees, would be a big change in culture for the industry. To change the culture, behaviour must change over a reasonable time frame.

We need strong, good leadership with members' interests at heart, to drive such a change.

The end prize is greater transparency and lower costs leading to a better superannuation system for members.

Yours sincerely

Sean McGing

About McGing Advisory & Actuarial

McGing Advisory & Actuarial is a Melbourne based boutique consultancy led by Sean McGing providing a personalised consulting service to directors, senior leaders and executives, and their support teams to deliver quality, valued advice in superannuation & wealth management, enterprise risk management, actuarial and investment consulting.