Chant West

Financial System Inquiry Final Report

Response to Superannuation Recommendation 10

March 2015

Comparing Apples with Apples.

About Chant West

Chant West is an independent superannuation research and consultancy firm established in 1997. We specialise in researching superannuation and pension funds, and are well known within the industry for our research capabilities and market commentary.

We publish our research in various forms, including CorporateSuper Research, PersonalSuper Research, Pension Research and, at the consumer level, our Super AppleCheck and Pension AppleCheck comparison tools. We publish regular performance and asset allocation surveys covering all the major public offer superannuation and pension products. We also publish a quarterly fee survey and a quarterly insurance premium survey.

Our research is used by many of Australia's leading superannuation providers and adviser groups. Over 7,000 financial advisers and eight million fund members have direct access to our research. The information we provide allows them to compare funds on an 'apples with apples' basis.

Our research also feeds into our consulting work, which in turn provides us with a special insight into the workings of the industry. Over the past 18 years, we have advised many large and medium-sized employers on their superannuation arrangements, including options for outsourcing investment, administration and member services. We have also advised many super funds on their outsourcing arrangements – administration, asset consulting and implemented consulting. Through our research and consulting, we have an intimate knowledge of the Australian superannuation market, including all the key players, their operations and efficiency.

Disclaimer

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1. Executive Summary

This report has been prepared in response to the Government's invitation for interested parties to comment on the Financial System Inquiry's Final Report recommendations. In particular, it focuses on Recommendation 10, which aims to improve operational efficiency during the accumulation phase of superannuation.

In its Final Report, released in December 2014, the Inquiry contends that the superannuation system is not operationally efficient due to a lack of strong price-based competition and that, as a result, the benefits of scale are not being fully realised. It argues that a major reason for this is the absence of strong consumer-driven competition, particularly in the default market where employers choose the default fund and their employee members are generally disengaged.

The Inquiry recommends introducing a formal competitive process by way of a tender to be undertaken by Treasury to allocate new default members to MySuper products. That is, unless a Productivity Commission review to be conducted by 2020 concludes that the Stronger Super reforms have significantly improved competition and efficiency.

We disagree with the Inquiry's premise and its recommendation. We do not believe MySuper fees are too high, or that a tender process is necessary to increase competition. We contend that, while consumers (i.e. fund members) are not driving competition, the funds themselves and their service providers are. Every day, in the course of our business, we observe funds and providers competing fiercely, and we believe this ensures competitive pricing.

There are more than enough players with sufficient scale to generate strong price competition. There are 16 MySuper products with assets over $10 billion, and they account for 64% of total MySuper assets and 62% of members. Between them, these products engage about 300 fund managers that they select from a universe of about 10,000 managers. It is hard to imagine in this environment that pricing is anything but competitive.

We certainly believe there are too many MySuper products and that fund consolidation is inevitable and desirable. This will be driven in part by the obligation that funds have to justify to APRA that their scale does not disadvantage their members relative to members of other MySuper products. Of the 116 MySuper products currently in the market, 87 have assets less than $5 billion and 48 have assets less than $1 billion. We believe that many of these smaller funds will find it hard to justify their existence, and that the resultant consolidation will be beneficial in terms of the overall efficiency of the system.

In its Interim Report, released in July 2014, the Inquiry made considerable reference to the Grattan Institute's report on fees in the Australian superannuation system *(Super Sting: April 2014)*. The Grattan report claims that Australians pay far too much for superannuation when compared with other countries. It also claims that higher investment fee funds do not generate higher gross returns and that low investment fees are the best guide to subsequent performance. We disagree with these claims, and we explained our reasoning in our second round submission to the Inquiry. We provide further evidence in this report.

The Grattan report recommends introducing a fee-based tender to select one or more funds to be the default fund for new entrants into the workforce. This is similar to the approach used in the Chilean pension market. In justifying this recommendation, Grattan claims that Chile's default fees are less than one-third of MySuper fees. We disagree with this claim and point out that it is based on an unfair comparison. Grattan's analysis of the Chilean system only covers administration fees, whereas its analysis of MySuper products includes both administration and investment fees. This distinction is material and important.

From our like-with-like comparison, it is clear that Australia's MySuper fees compare more than favourably with Chile's default fees. Our evidence is included in a research report that we prepared for the Financial Services Council and which formed part of its second round submission to the Inquiry.

Using OECD methodology for calculating fees, the average non-profit MySuper administration fee is 19 bps compared with 20 bps for the current Chilean default fund. The average non-profit MySuper investment fee is 63 bps compared with 27 bps for the current Chilean default fund. There are valid reasons for the difference in investment fees. Essentially, investment fees in Chile are so low because over 55% of assets are managed in-house, the vast majority of which are Chilean government bonds.

It is pertinent to note here that when Chile introduced its tender system in 2010 there were only five pension funds. Fees were generally considered to be high because of the lack of competition. The Government introduced the tender system with the objective of increasing competition and reducing administration fees. Five years on, Chile has six pension funds and there are serious doubts as to whether the pricing of the current default fund is sustainable.

In summary, we believe that there is strong price-based competition in the Australian market and that fee levels are reasonable and represent good value, especially for the majority of MySuper members of large ($10 billion plus) funds. Fees can – and will – be reduced as more funds reach that size and benefit from significant economies of scale. That will happen naturally as the result of organic growth, from contribution flows and investment returns, and from the inevitable consolidation that will occur once the APRA justification regime starts to 'bite'.

2. Key Characteristics of the Australian Superannuation System

We believe that any analysis of the Australian superannuation system requires an understanding of two important characteristics of the system and the consequences that flow from them.

2.1 MySuper vs Choice Members

The first is that there are two very different types of members that we will refer to as 'choice members' and 'MySuper members'. Choice members are engaged with their super and typically work in conjunction with a financial adviser to construct their own diversified portfolios of managed investments and direct holdings. MySuper members, on the other hand, generally invest in a single, pre-mixed investment option. This difference in itself has implications for fees. Choice members pay higher administration fees, because of the greater complexity of their accounts, and also higher investment fees because they are not getting the benefit of the scale of the entire fund.

Overall, therefore, choice fees are higher than MySuper fees. Choice members, who have consciously decided to adopt this approach, accept this fact presumably because they enjoy the greater control or they expect a better outcome – or both.

MySuper products are designed to be simple, low cost products aimed at disengaged members. Their fees should be, and are, lower than choice fees. When we are considering operational efficiency we need to be clear what segment – MySuper or choice – we are talking about. It makes no sense to combine the data to show an 'industry average' and then use that average to make inferences about MySuper fees.

Since about 60% of all members are in a MySuper product, when we refer publicly to the operational efficiency of the superannuation system we should make it clear that we are focusing on the MySuper market – not a combination of choice and MySuper members.

2.2 MySuper Members are Wholesale Investors

The second important characteristic to understand is that every MySuper member is a wholesale investor. No matter how large or small their account balance is, they all pay the same investment fee in percentage terms. That percentage fee is, of course, based on the fund's overall size, which is why scale is so important. In the case of AustralianSuper, for example, members' investment fees are based on assets of over $85 billion, regardless of whether their account balance is $10,000, $100,000 or $1 million. It follows that when we assess fees paid in MySuper products we should only make comparisons with fees paid in other MySuper products. It makes no sense to include choice products.

MySuper products are typically well diversified across all of the main asset classes. Most of them invest with several fund managers in most asset classes. Those managers are chosen for their investment ability and how they blend with other managers in the portfolio. We refer to this as 'multi-manager' investing. It follows that when we are comparing the performance or fees of MySuper portfolios we should only include multi-manager portfolios in the comparison.

As researchers, we are aware of the importance of these characteristics of the system and the need to take them into account so as to make valid, like-with-like comparisons. Unfortunately, much of the analysis in the Grattan report and in the Inquiry's Interim and Final Reports fails to recognise these subtleties. They place too much emphasis on industry-wide averages that are irrelevant and unhelpful to the debate.

3. Operational Efficiency

3.1 Competition within the MySuper Market

The Inquiry believes fees are too high in the default or MySuper market because members are mostly disengaged. It recommends introducing a formal competitive tender process to allocate new default members to MySuper products.

We disagree with the Inquiry's premise and its recommendation. While it is true that consumers, i.e. fund members, are not driving competition, the funds themselves and their service providers compete fiercely and this ensures competitive pricing.

Table 1 provides a snapshot of the MySuper market at June 2014. Including accrued default amounts (ADAs), we estimate that the MySuper market accounted for about half of the total assets of the Australian superannuation market (excluding SMSFs) and about 60% of all members.

Table 1: MySuper Products Overview – June 2014

Product Size	No. of Products	% of Total Assets	% of Total Members	No. of Members (m)
> $20 b	8	48	46	8.5
> $10 b	16	64	62	11.3
> $5 b	29	79	75	13.6
> $1b	68	98	97	17.7
< $1 b	48	2	3	0.5
$586 b	**116**	**n.a.**	**n.a.**	**18.2**

Source: Chant West

Notes

1. MySuper assets include our estimate of ADAs at June 2014
2. Members refers to the number of accounts

At June 2014, there were 116 MySuper products competing for default superannuation. Of these, 16 had assets over $10 billion and 29 had assets over $5 billion. There were 87 products with assets under $5 billion and, of these, 48 had assets under $1 billion. Clearly, there are enough funds with sufficient scale to generate vigorous price competition. Equally clearly, the number of smaller funds means that there is considerable scope for further industry rationalisation.

The 16 products with assets over $10 billion accounted for 64% of total assets and 62% of total members. That is a significant portion of the MySuper market.

Segmentation within the wider industry also adds to the competitive environment. Broadly speaking, the superannuation industry can be divided into three groups of roughly equal size: for-profit retail funds, non-profit funds and self-managed funds. Each segment competes vigorously for members.

Competition occurs not just at the fund level but also at the service provider level. For example, the 16 largest products engage about 300 fund managers in total, and they select them from a pool of about 900 managers that are highly rated by their asset consultants. This pool in turn is identified from a universe of over 10,000 managers worldwide. Given that this extensive pool of managers is competing in an industry with Government-mandated growth, it is hard to imagine the pricing funds negotiate with their fund managers is anything but competitive. Indeed, we know from first-hand experience that funds negotiate very hard with fund managers to get the best outcome for their members.

Given the highly competitive environment that funds and their service providers face, it is not necessary for individual members to put pressure on fees – their funds already do this for them and will continue to do so.

3.2 MySuper Fees

Given the highly competitive nature of the MySuper market, what level of fees do members pay and what scope is there for these fees to be reduced?

Table 2 provides a broad overview of total MySuper fees at December 2014. It shows the weighted-average fees for three product sizes and the range that accounts for 75% of products. Of the total fees, about 1/3 is for administration and 2/3 for investment. Taking the weighted-average total fee of all products (93 bps) and assuming an account balance of $50,000, the administration fee is $165 and the investment fee is $300 (i.e. $465 overall).

Table 2: MySuper Fees – December 2014

Product Size	No. of Products	Admin. Fee (bps)	Invest. Fee (bps)	Total Fee (bps)	75% Within Range (bps)
> $10 b	16	26	60	86	72 – 110
> $5 b – < $10 b	13	46	57	103	84 – 121
< $5 b	87	46	59	105	81 – 123
Total	116	33	60	93	80 – 130

Source: Chant West

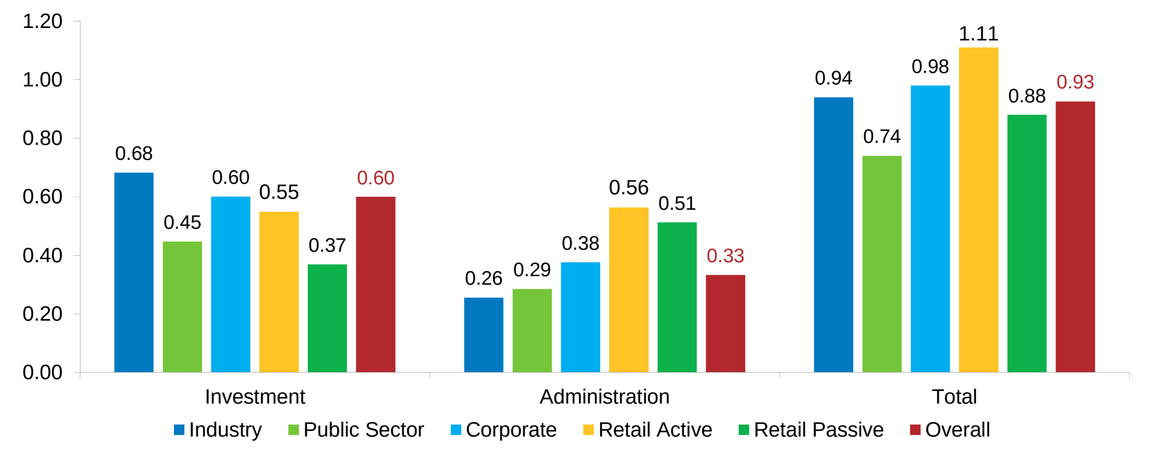
Notes

1. Fees are based on an account balance of $50,000
2. Retail administration fees have been adjusted for our estimate of large plan discounts

Total fees are much lower in large products, and this is all to do with administration. For example, in products with assets of over $10 billion members pay $130 for administration and $300 for investment (i.e. $430 overall or 86 bps). In contrast, in products with assets of less than $5 billion, members pay $230 for administration and $295 for investment (i.e. $525 overall or 105 bps). So while investment fees are broadly the same across all product sizes, there is a significant difference in administration fees between large and small products – about 20 bps or $100.

Another way to compare fees is to look at the different segments within the MySuper market. Chart 1 shows the weighted-average fees of each market segment at December 2014. We separate retail products into two categories: those that mainly use active management and those that mainly use passive management. This has a significant bearing on their investment fees as the chart shows.

Chart 1: MySuper Fees by Industry Segment (% pa) – December 2014



Source: Chant West

It is pertinent to note that the investment fees of public sector products and retail passive products are relatively low because of their high use of passive management. Also, the administration fees of retail products are relatively high because they include a profit margin element.

Fees do vary across the market, and this is not surprising when you consider the differences in service levels, investment approaches, disclosure practices and profit margins. On the whole, with a weighted-average total fee of 93 bps, we believe that fee levels are reasonable and represent good value. That is not to say they cannot be reduced, particularly administration fees.

We expect fees to fall progressively over time for a variety of reasons including:

- Ongoing competition
- Operating efficiencies, including the effects of SuperStream once the initial costs fall away
- Wider use of in-house investment management
- Scale economies as fixed costs get spread over an ever-increasing asset base.

As mentioned earlier, there is a significant difference in the total fees paid by members of large products and those of small products – 86 bps versus 105 bps – and almost all of this relates to administration, as shown in Table 2. About $10 billion in assets appears to be the ‘sweet spot’ where scale translates into lower fees, particularly administration fees. We believe that the number of funds in this category will grow as a result of contribution flows, investment returns and consolidation as a result of the APRA justification regime. We can see a situation soon where there will be 20 to 30 funds of this size, accounting for perhaps 80% of MySuper members.

Having said that, we do not consider the 105 bps average fee in the smaller fund category to be overly high, given the generally solid investment performance of these products and the level of services provided by many of them. It makes no sense to judge fees solely on their quantum. You have to consider what you get for what you pay.

3.3 MySuper Investment Performance

There is much debate about the relationship between investment fees and investment performance. Most professional commentators argue, as we do, that what is most important is performance net of fees and tax. This is what members 'eat'. It is acceptable to pay higher fees if the performance warrants it.

The Grattan report argues that higher fee products do not generate higher gross returns and that low fees are the best guide to future outperformance. Grattan also argues for a much greater use of passive investment on the grounds that it is cheap to manage. We disagree with Grattan on both counts. Furthermore, we believe that their analysis is flawed because it is based on inappropriate data.

Grattan's conclusions outlined above are based on an analysis of choice member data, which is essentially retail investor data. Yet, as we noted in section 3.1 above, 60% of all members are in their employers' default MySuper products and it is these members the Inquiry is most concerned about. These are not retail investors. As we explained in section 2, MySuper members are essentially wholesale investors, who benefit from the buying power of their funds. We believe that Grattan is drawing conclusions from data that has little relevance to the MySuper market. Our analysis, in contrast, focuses squarely on MySuper products, their fees and performance.

We believe that in the default MySuper market there is enough evidence to suggest that members of higher investment fee products have been rewarded with higher net investment returns. We have not conducted a rigorous study of all default products, but we have taken a meaningful representative sample to demonstrate our case.

We have chosen the 10 largest non-profit funds for comparison because (i) they account for a significant portion of industry assets under management (about $364 billion) and (ii) they represent a large proportion of the overall membership (about 9.6 million members). Also, each of them has had a consistent approach to investing for a long period of time and relatively stable investment teams.

Table 3 shows the relevant data for the 10 funds.

Table 3: Data for Ten Largest Non-Profit Funds – June / December 2014

Fund	Assets ($b)	Members (million)	Unlisted Assets (%)	Passive Management (%)	Investment Fee (%)	Performance Ranking (out of 52)
AustralianSuper	78	2.1	30	10	0.59	7
QSuper	51	0.5	21	58	0.44	8
First State Super	46	0.8	10	27	0.42	26
UniSuper	44	0.5	10	3	0.61	10
REST	31	2.0	18	0	0.70	1
Sunsuper	29	1.1	29	16	0.63	23
HESTA	28	0.8	30	16	0.74	16
Cbus	27	0.7	36	13	0.77	9
Telstra	15	0.1	21	0	0.64	2
HOSTPLUS	15	1.0	33	5	1.01	13
Total	**364**	**9.6**	**-**	**-**	**-**	
Weighted-Ave.	**-**	**-**	**23**	**18**	**0.61**	

Source: Chant West

Notes

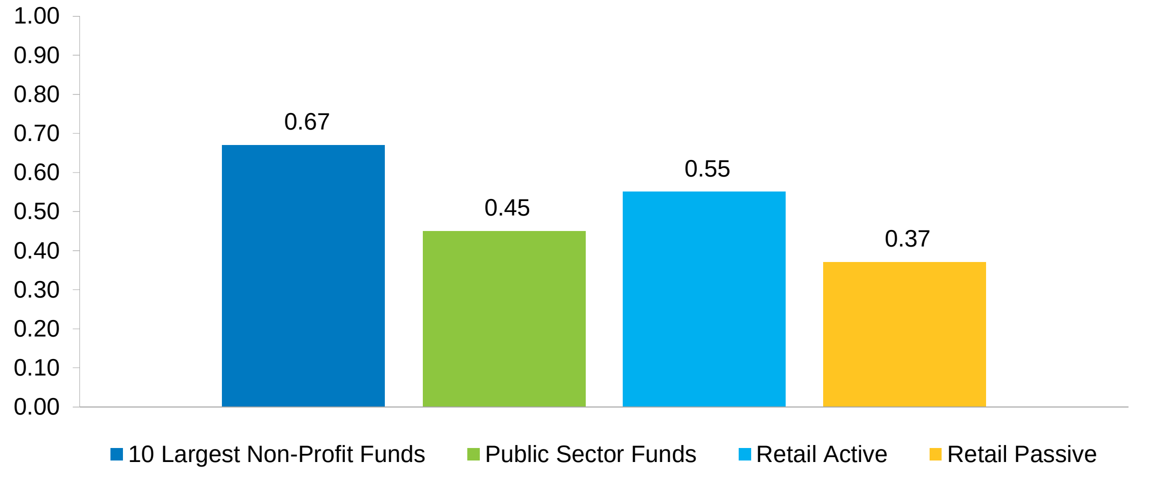
1. Fund data is at June 2014
2. Fees are at December 2014
3. Performance is for the default option over the 10 years to December 2014

When we look at the performance of these funds, we see that all but two them are either top or second quartile performers over the 10 year period, i.e. over the long term. The other two are around median performers. All 10 fall within the top half of the performance rankings.

With the exception of QSuper and First State Super, which both use a substantial amount of passive management, this group's investment fees tend to be higher than most other funds. Chart 2 clearly shows this.

It is this combination of past performance and investment fees that leads us to the conclusion that there is enough evidence to suggest that members of higher investment fee products have been rewarded with higher net investment returns.

Chart 2: Weighted-Average Investment Fees (% pa) – December 2014



Source: Chant West

Notes

1. Non-profit funds exclude QSuper and First State Super
2. 'Retail passive' products mainly use passive management

4. Default Fund Tender

We disagree with the Inquiry's premise that MySuper fees are too high and its recommendation that a tender process is necessary to increase competition and reduce fees. The Inquiry argues that a tender process would extend competitive pressures in the wholesale default market to the broader default market and lead to improved returns. The term 'wholesale default market' as used by the Inquiry refers to large employers that typically use a tender process to select a default fund for their employees.

Effectively, the Inquiry is seeking to create a situation where small and medium-sized employers receive the same pricing as large employers. Currently, equal pricing only occurs in the non-profit sector, where all default members pay the same administration and investment fees. It does not occur, however, among the for-profit retail funds that specialise in the corporate superannuation market. Here, funds typically offer a discounted administration fee within their MySuper product, where the level of discount depends on the scale benefits the employer brings to the table.

Across the industry, employer plans of any size can be offered a discounted administration fee and large employer plans (those with at least 500 members) can be offered either a discounted investment fee or a tailored investment option with a different fee. These principles were established in the Stronger Super legislation after much debate, and it is important to understand why.

Initially, the Labor government proposed that there should be uniform pricing for all MySuper members, but research we conducted for the Financial Services Council showed that the likely result would be that up to 750,000 workers would suffer an increase in fees. This was because the fees of larger employer plans would have to increase to compensate for lower fees in small to medium-sized plans. Common sense prevailed and fee discounts are now allowable.

We see no reason to change the principles already established in legislation. Nor do we see any merit in the suggestion of a tender process. The initial idea for this came from the Grattan Institute, and grew mainly from their observation of the tender system used in Chile. Grattan claimed that Chile's default fees are less than one-third of MySuper fees, but it based that claim on analysis that compared 'apples with oranges'. It only included administration fees for the Chilean funds, but included both administration and investment fees for the Australian MySuper products.

We would argue that not only did Grattan draw conclusions about fees based on inappropriate data, its tender suggestion ignores the fact that Chile has a very different market structure to Australia.

When Chile introduced its tender system in 2010 there were only five pension funds – four very large funds and one small fund. Fees were generally considered to be high because of the lack of competition. The Government introduced the tender system with the objective of increasing competition and reducing administration fees.

Five years on, Chile still has only six pension funds and there are serious doubts as to whether the pricing of the current default fund is sustainable. The Chilean model, therefore, has not increased competition in any meaningful way and it has resulted in a short-term reduction in fees that is likely to be reversed. We do not believe this is a model that Australia should seek to emulate.

Contrast the Chilean market with Australia where, at June 2014, there were 116 MySuper products competing for default superannuation. Of these, 16 had assets over $10 billion and 29 had assets over $5 billion. Clearly, there are enough funds with sufficient scale to generate vigorous price competition. This was not the case in Chile.

From our like-with-like comparison, which is included in the Financial Services Council's second round submission to the Inquiry, it is clear that Australia's MySuper fees compare more than favourably with Chile's default fees.

Using OECD methodology, the average non-profit MySuper administration fee is 19 bps compared with 20 bps for the current Chilean default fund. The average non-profit MySuper investment fee is 63 bps compared with 27 bps for the current Chilean default fund. There are valid reasons for the difference in investment fees. Essentially, investment fees in Chile are much lower because over 55% of assets are managed in-house at very low cost, the vast majority of which are Chilean government bonds.

The conclusion we draw is that Australia already has strong price-based competition, and to superimpose a Chile-style tender process would be neither appropriate nor necessary.