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Reflections on the Productivity Commission's analysis of superannuation returns and performance

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Introduction

The recent draft report of the Productivity Commission presented a large body of analysis and findings on superannuation returns and performance. While these have stimulated a much needed debate regarding the efficiency of compulsory superannuation, some of the assumptions underpinning that analysis merit closer scrutiny. This short discussion paper seeks to reflect on those assumptions and how they impact the PC's recommendations.

1

Assumption: There is a consistent, identifiable group of top 10 'best in show' funds that will deliver outperformance over the longer term[1]

Analysis

The draft report of the Productivity Commission recommends that every four years an independent 'panel of experts' should nominate a list of 10 'best in show' superannuation funds, based on member outcomes measured primarily as historical net returns for members.

The arguments for limiting the number of 'best in show' funds to 10 based on investment returns alone appear limited. In practice, investment performance for the top 40 or more funds does not vary significantly. Historical 10 year fund performance data suggest returns do not drop away after the tenth-ranked fund.

Tables of comparative investment performance compiled by ratings agencies, such as SuperRatings, Chant West and Selecting Super, suggest the difference, in terms of average annual investment returns, between the top 10 funds and the top 20, can be a matter of 50 basis points (0.5 per cent), or even less. Between 40 and 50 funds are given upper level evaluations by the same ratings agencies. This suggests they are very likely to have equally strong products and services as any 10 supposed 'best in show' funds.

Rankings also vary significantly according to the time period examined. Data from ratings agencies indicate few funds manage to remain in the top 10, even over relatively short time periods, while others move in and out of the top 10 regularly. For instance, the top 10 MySuper products (in terms of average five-year investment performance) vary markedly between April 2017 and April 2018. Four MySuper products drop out and four join the list.

Over longer time periods the differences can be even greater. Data for Australian funds show some bottom quartile funds (in terms of average five-year investment performance) in 2012 actually move into the top quartile in 2017 (and vice versa).

Perhaps the best example of the limitations of the 'best in show' concept comes from the United States. Warren Buffett's Berkshire Hathaway has produced long-term returns of almost twice those of the U.S. equity market as a whole, yet his fund would be knocked out of the top 10 in a bull market (the most recent period) simply because it tends to underperform in the short-term when markets are on the rise. Berkshire has generated annual returns of 7.7 per cent over the last ten years, compared to the S&P 500 as a whole, which has delivered annualised returns of 8.5 per cent. However, over the last 53 years Berkshire has had an average return of more than 20 per cent per year.

1 Pages 35 and 119-120 of the Productivity Commission draft report

2

Assumption: An average blue collar worker could end up with a retirement balance of more than $1 million

Analysis

The Productivity Commission's modelling suggests differences in investment lead to retirement balances being hundreds of thousands of dollars lower (or higher). The analysis seems to indicate that an average blue collar worker earning $50,000 a year at age 21 will be able to retire at age 67 with $1.2 million in today's dollars, and that there are big differences in outcomes, depending on their fund[2].

However ASIC's MoneySmart calculators seems to suggest a very different long-term outcome.

For example, ASIC's methodology results in projected balances in today's dollars of less than $300,000 for the example above. An average blue collar worker on $50,000 a year is more likely to have a superannuation balance at retirement of between $250,000 and $300,000. This is a still a substantial amount that will make a big difference to his other standard of living in retirement, but it is well below the Productivity Commission projected amount.

Using reasonable assumptions, ASIC assumes ongoing contributions of less than $5,000 a year in today's dollars, and investment returns of less than 4 per cent p.a. in real terms, which are realistic returns over the long-term. The Productivity Commission analysis seems to assume an average blue collar worker will have a base increase in their nominal wage of around 4 per cent p.a., along with earnings growth due to promotion, of almost 1 per cent p.a. These calculations assume, illustrated by a chart in the draft report, that a typical blue collar worker who starts out on $50,000 p.a, will end up earning $140,000 p.a. in today's dollars.

In practice, the base increase in wages for blue collar workers has been well below 3 per cent p.a. for some time and is unlikely to increase beyond that level in the next decade as we enter a period of low economic growth. Few blue collar workers are in occupations that enjoy steady and regular promotions.

In addition, the Productivity Commission's calculations do not seem to have made sufficient adjustment for changes in future living standards. To provide realistic, long-term estimates of real retirement savings balances, it is necessary to deflate figures by the movement in average wages, not just the increase in the Consumer Price Index.

There is no question investment returns below benchmarks make a real difference to retirement balances and consequentially living standards in retirement but the impact is likely to be less than the Productivity Commission projections.

2 Box 1.6, page 89 and Cameo 2.2, page 120 of the Productivity Commission draft report

3

Assumption: Funds that miss out on a place in the top 10 'best in show' will be able to continue to compete to be included in the top 10 in the future[3]

Analysis

Net contribution inflows and scale are important for MySuper funds and not being chosen as a default fund by the proposed 'expert panel' would lead to a loss of new contributions and could lead to a significant number of existing members switching funds.

Missing out on a ranking in the top 10 could result in a negative, self-fulfilling prophesy, because the effect of missing out could impact the ability of a fund to compete.
Superior return outcomes are aided by the ability of a fund to invest for the long-term, in particular when it comes to certain asset classes such as unlisted infrastructure and private capital markets. These illiquid asset classes have been shown to produce superior return outcomes over the long- term. However, the ability to invest in illiquid asset classes is dependent on a regular flow of new contributions, in order to maintain liquidity.

More generally, funds affected by a slowdown in contributions, as a result of a ranking outside the top 10, could suffer a loss of scale and an increase in costs that would ultimately affect their ability to compete.

Missing out on a place in the top 10 could negatively impact contributions to a fund, leading to serious consequences for the fund and its members. The loss of default status would significantly weaken a fund's position in the market, as well as its ability to compete for a place in future top 10 lists.

3 Page 476 of the Productivity Commission draft report

4

Assumption: A top 10 'best in show' approach would lead to greater competition and better outcomes for fund members[4]

Analysis

A top 10 selection process may lead to behaviours that are not in the best interests of fund members; in particular in relation to risk and the pursuit of short-term rather than long-term returns.

Funds included in the top 10 would be likely to closely mimic the investment strategies of the other funds in the top 10, in order to reduce their chance of producing investment outcomes out of line. Innovative investment practices could be stifled and as a result, returns might be lower and clustered around the mean.

Return outcomes for investors in funds outside the top 10 are likely to be negatively affected. In their desire to outperform the top 10 and be part of the next group of 10 'best in show', funds are more likely to engage in risky strategies.

While it is likely that taking on more investment risk may increase performance in the short-term, and therefore the chance of inclusion in the top 10 the next time around, there is an equally high chance of under-performance for new and existing members in the years ahead.

The approach suggests a top 10 may have the unintended consequence of creating less competition among 'secure' incumbent funds and excessive risk taking by others.

4 Page 476 of the Productivity Commission draft report

5

Assumption:Funds can consistently achieve top quartile returns over periods of 45 years or more[5]

Analysis

It is possible for funds to outperform the general market for five or 10 years and be in the top quartile of funds in terms of investment performance throughout that period. However, over longer periods of up to 45 years or more, consistent outperformance is less likely. Over the medium to long-term, the investment performance of similar investment portfolios tend to converge.

Anecdotal examples suggesting persistent, long-term outperformance is misleading. Economic and financial cycles may favour certain asset allocations at specific points in time, but over the course of the long-term financial cycle, these impacts tend to even themselves out. Recent academic research into the investment performance of superannuation indicates investment returns tend to revert to the overall mean for funds over the longer term[6].

Investment performance is affected by the skill of the investment manager, yet skilled investment managers come and go. Those responsible for a successful investment strategy in one fund regularly move to other funds, or even start up on their own. In addition, successful investment strategies can be broadly replicated by competitors, with the result that fund performance ends up clustered around the same average investment return.

There is also a risk associated with size. When there is a small number of large funds, they can struggle to outperform the market, because the positions they take impact on the market itself. In other words, when they increase their allocation to a specific company or type of investment, the weight of their investment can drive up the purchase price of the fund, negatively affecting performance.

5 Cameo 1, page 12 of the Productivity Commission Report

6 Mean Reversion of Australian Superannuation Funds Investment Options, Emawtee Bissoondoyal-Bheenicka, Robert Brooks, Warren McKeown, Xibin Zhangb, February 2018

6

Assumption: Funds are underperforming if their investment performance is more than 25 basis points (0.25 per cent) p.a. lower than a benchmark constructed by the Productivity Commission[7]

Analysis

The definition of underperformance has a significant impact on conclusions about whether funds are delivering or not. In this regard, a margin of 25 basis points a year over a reasonably short period (between five and 10 years) does not allow for mean reversion of investment returns, something which typically happens over periods of 10 years or more. In addition, there does not appear to be a strong theoretical basis for the choice of 25 basis points, as opposed to 50 or 100 basis points, as the threshold for under-performance.

In arriving at its benchmarks for performance, the Productivity Commission makes assumptions about the tax rate for investment earnings during the accumulation phase, average returns from unlisted investments, and how funds hedge against currency movements. These assumptions have a significant impact on claimed under-performance. Small changes in these assumptions would lead to lower incidences of estimated under-performance.

The bigger picture problem is that comparisons of investment performance should be made over a longer time period than four years. MySuper has only been in place since 2013, so making a definitive call about overall performance seems ambitious.

However it is important to stress that ASFA is in favour of removing funds with consistently poor performance, from the system, as previously indicated by ASFA in its submission to the Productivity Commission (https://www.superannuation.asn.au/ArticleDocuments/711/201823_Productivity_Commission_Su perannuation_Assessing_Efficiency_and_Competitiveness_Draft_Report.pdf.aspx?Embed=Y).

ASFA supports the Commission's recommendation to elevate the standard of MySuper products for all default members, not just for new entrants to the workforce/superannuation. This would be an effective mechanism to take the industry forward. It would encourage under-performing funds to transfer their members to a better fund or to merge with another fund.

ASFA supports a prescriptive 'balanced scorecard' approach that clearly targets habitual under-performance. Any prescriptive criteria to lift the bar of MySuper more broadly would need to consider factors such as investment performance (long term and risk adjusted) and include qualitative and quantitative factors such as:

- success in achieving investment objectives
- quality of governance (including investment governance)
- fees and costs charged to members
- quality and value of insurance
- the provision of member services
- the trustee's risk management processes
- innovation including use of (and capacity to use) technology

Decisions about performance must be made carefully over a realistic time period and based on clear evidence if we are to ensure good funds are not removed in error.

7 Figure 2.9, page 116 of the Productivity Commission draft report

7

Assumption: Australian superannuation funds have net investment returns that are much lower than pension funds overseas, and higher administration and investment costs[8]

Analysis

The main source of data regarding long-term investment returns comes from the OECD, although it is relatively limited in that it covers only the past 10 years. It does reveal, however, that overall, superannuation fund fees in Australia are in line with those of comparable systems overseas (ie. defined contribution systems).

This topic is explored in some detail in an ASFA submission to the Financial System Inquiry (https://www.superannuation.asn.au/ArticleDocuments/280/ASFA_ResponseFSI_August2014.pdf.as px?Embed=Y)where it was concluded that superannuation fund fees in Australia are not out of line with fees for defined contribution funds in other countries, especially if allowance is made for specific differences in the average asset mix and services provided by funds.

Superannuation fund fees have also been declining in Australia as average account balances have increased (lessening the impact of fixed dollar administration fees) and as measures to improve efficiency take effect. According to recent Rice Warner research, average fees for superannuation funds declined from 1.26 per cent of assets in 2006 to 1.00 per cent in 2017.

While it is true that investment returns from Australian superannuation funds are relatively low compared to other jurisdictions over the ten year period to 2017, this reflects the impact of the Global Financial Crisis (GFC), which negatively affected returns from mid-2007 to early 2009. Australian superannuation funds tend to have higher exposures to equities relative to other countries, around 70 per cent compared with 30 per cent or less in most OECD countries. This had a disproportionately negative effect on returns during the GFC.

On the other hand, if we look at returns over the five years to the end of 2017, (a period that does not include the GFC), OECD data indicate Australian superannuation funds had the highest average return of any of the countries included in their survey[9]. Over this period Australian superannuation funds had average annual investment returns of 10.4 per cent p.a., 8.2 per cent higher than the rate of inflation over the same period, after fees and taxes.

From June 2019 onwards, Australia can be expected to be at the top or near the top of the investment return league table for pension funds, given the impact of the GFC will drop out of the investment return calculations for the most recent 10 year period[10].
Over the long term, returns from Australian superannuation funds are comparable to returns in international jurisdictions.

8 Page 133 of the Productivity Commission draft report

9 OECD, Pensions Funds in Figures data for 2017 linked to Pensions Markets in Focus data for the preceding four years

10 It also should be noted that in most other countries investment earnings are tax free in pension funds, compared to the headline rate of 15 per cent tax on investment earnings in Australia. Australian superannuation funds move even further ahead in terms of international comparisons if allowance is made for the payment of taxation.