

# **Establishing an academic research program with the superannuation sector**

Discussion Paper

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Association of Superannuation Funds of Australia

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## Introduction

On 5-6 July, Monash University and the Commonwealth Scientific and Industrial Research Organisation (CSIRO) brought together a small group of academics, government and superannuation industry executives for a conference/workshop to discuss the merits of establishing a research alliance.

The CSIRO/Monash Superannuation Research Alliance proposes to establish a collaborative research effort focused on two issues:

### **Superannuation funds and the economy**

The national challenge is how to facilitate investment by superannuation funds in the new economy, innovation and productivity, and in infrastructure, by creating investment/asset markets that operate efficiently and effectively.

### **Relationship between individuals aged 60-plus and the economy**

Here the national challenge is how to create work/life/health choices and financial products that deliver optimum lifecycle outcomes for those aged 60-plus as well as their dependents, superannuation funds and the economy.

ASFA CEO Pauline Vamos presented a key note speech to open the conference which highlighted ASFA's understanding of the importance of superannuation to the national economy. In 2009 ASFA commissioned The Allen Consulting Group to produce the first research report that specifically examined the impact that superannuation had on Australia's gross domestic product (GDP). The report found that the Superannuation Guarantee may have increased the household saving rate by up to 1.5 to two per cent of GDP.

ASFA's work in this area has continued, most recently focusing on fixed interest investments with the release of the Discussion Paper *Developing Australia's fixed interest markets*. In coming weeks ASFA will release a further Discussion Paper on the challenges of investing in growth assets.

ASFA believes the establishment of the CSIRO/Monash Superannuation Research Alliance is timely.

We understand that there is increased interest among policy makers, consumers and academics on the impact of superannuation. ASFA welcomes this interest. Superannuation is of interest to all Australians and we all have a role to play in understanding the impacts that superannuation can have.

We look forward to working with the initiative on a range of future research projects.

For more information on ASFA's work on superannuation and the Australian economy contact:

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## Why superannuation is different

There is a significant body of academic research that focuses on finance and investment. Superannuation and pension funds are often seen as a subset of the pool of capital that makes up global investment markets.

While investment markets are necessarily made up of investors with a range of different objectives, superannuation and pension investors have a long-term focus, which can be different from other investors. In the Australian context our superannuation system has been established for a specific purpose; to provide Australians with income in retirement to supplement the Government Age Pension.

According to the Organisation for Economic Cooperation and Development (OECD), the global pool of pension assets is USD 19.3 trillion. In Australia, our superannuation pool is around AUD 1.3 trillion. One of the challenges that superannuation and pension investors have is that the investment environment in which funds operate does not necessarily reflect the interests of long-term investors. In recent years pension funds have begun to work collaboratively on a global level to ensure their long-term interests are reflected in investment decision making. A good example of this work is the establishment of the United Nations Principles for Responsible Investment which aim to integrate environmental, social and governance (ESG) factors in investment decision making on the basis that these factors can have long-term impacts on the ability of pension funds to generate long-term sustainable investment returns.

The reason that superannuation has a different focus is because super funds have responsibilities both as an asset owner and as a fiduciary.

### Asset owner

As an asset owner, the focus of a superannuation fund is on the way that the whole of a superannuation investment portfolio delivers investment returns in the long term. Superannuation funds must balance the objective of delivering short-term investment returns with an understanding that superannuation fund members are long-term investors.

As an asset owner, superannuation funds bring a different perspective to portfolio construction. Funds must balance asset correlation, risk budgeting and tactical asset allocation to take advantage of particular opportunities. Chief investment officers of superannuation funds need to take a holistic investment perspective; they need to be aware of the demographics of their individual fund, which can impact on risk appetites of members.

### Fiduciary duties

Superannuation trustees have a fiduciary duty, enshrined in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and trust law, to serve the best interests of their members. This fiduciary duty means that the focus of a superannuation fund is on making decisions that serve its members' interests. When a superannuation fund operates in a commercial environment this means that the trustee must serve the interests of members ahead of the interests of shareholders. The focus of superannuation fund trustees is not just on managing existing wealth; a core part of superannuation is to ensure that members understand the impact contributions have on future benefits.

## Why is there a current focus on superannuation?

There are a number of reasons why there is currently increased focus from a range of stakeholders around superannuation but there are three particular reasons worth highlighting:

- the size of the superannuation pool is growing;
- the baby boomer generation is now retiring; and
- investment volatility.

### 1. The size of the superannuation pool is growing

Total estimated superannuation assets increased to \$1.38 trillion in the March 2012 quarter. Over the 12 months to March 2012 there was a 3.6 per cent increase in total estimated superannuation assets. There was \$20.1 billion of contributions in the March 2012 quarter, comprising \$6.6 billion to industry funds, \$6.5 billion to public sector funds, \$6.3 billion to retail funds and \$0.9 billion to corporate funds.

Deloitte's report, *The Dynamics of the Australian Superannuation System: the next 20 years 2009 – 2028*, projects superannuation assets will grow to \$2 trillion by 2014, \$3 trillion by 2019 and \$7 trillion by 2028.

By comparison the latest statistics from APRA reveal that the total deposits of the whole Australian banking system stand at \$1.5 trillion.

What this means is that superannuation has become just as important as banking deposits as a form of national saving. This has implications for both the structure of the economy and for the overall interest of stakeholders.

As the superannuation pool increases in size it is to be expected that there will be increased attention on the impact of superannuation on the national economy. It has become a regular occurrence for academics, journalists and politicians to comment on the opportunity for superannuation funds to invest in particular ways that maximise social and economic impacts.

We should not shy away from these discussions. Superannuation can, and does, play a role in economic development. But in order for these debates to progress, future debates around the role of superannuation need to be informed by an understanding of the way in which superannuation works and the practical limitations which can be achieved. Academic research can make a valuable contribution to these discussions.

### 2. The baby boomer generation is now retiring

There were 5.5 million people born between 1946 and 1965; the baby boomer generation. Over the last decade the proportion of people aged 65 years and over has increased from 11.1 per cent to 13.6 per cent. During the same period, the proportion of the population aged 85 years and over has more than doubled from 0.9 per cent at 30 June 1990 to 1.8 per cent of the total population at 30 June 2010.

The importance of baby boomers does not just relate to their sheer number, it also relates to the fact that the combined number of Generation X and Generation Y do not add up to the number of baby boomers. The large number of baby boomers means that as a group they are politically influential and have the capacity to shape Government policies. This in fact has happened over the last 40

years; the provision of free education when Whitlam was elected and the baby boomer first came to work, and universal health when the baby boomers started having families are two clear examples of the political power of this generation.

As baby boomers approach retirement it is unsurprising that they have a stronger interest in their superannuation. Baby boomers' retirement balances have been impacted by the global financial crisis (GFC) and many baby boomers are not in as strong a financial position as they would have hoped.

A quote from a recent report, *Ageing Baby Boomers in Australia*, produced by Seniors Australia, illustrates the challenge that baby boomers are facing as they engage with their superannuation late in their working lives:

*Yes, I'm a person who was – I'm a mother who worked part-time all my life and I didn't pick up super until somewhere around about 1988, so I've been in and out of the workforce with a minimal amount – when they finally gathered it all into the same fund, they had to go to six super funds to find all of my money to put it in, I can't live on my super.*

The retirement of the baby boomers brings into sharp focus the reason that Australia's superannuation system was established in the first place – to provide retirement incomes to at a minimum supplement the Age Pension. Superannuation is now entering the stage of maturity, both in terms of system design and the lifecycle of a large portion of super fund members. The retirement of the baby boomers will have many impacts on the way superannuation funds manage investments and service members. One area the superannuation industry is examining is the difference in attitudes to investment losses between those members in the accumulation phase and those in the retirement phase. Academic research on loss aversion of retirees would make a valuable contribution.

### 3. Investment volatility

The volatility of investment markets following the GFC has made many people question whether the asset allocation strategies of many superannuation funds are appropriate, particularly for baby boomers approaching retirement.

One of the things we do need to appreciate is that the level of investment volatility we are experiencing at the moment is unprecedented. A recent influential report by Professor Amin Rajan, *Market Volatility: Friend or Foe* (a global survey of 289 asset managers, pension plans, pension consultants and fund distributors, managing total assets under management of \$25.2 trillion), predicts that volatility will continue with 78 per cent of respondents to the survey anticipating prolonged turbulence.

According to the report, the last four years have been the most volatile in the history of equity markets with price fluctuations of four per cent or more in intra-day sessions occurring six times more than they did on average in the previous 40 years. Extreme spikes in market volatility and asset class correlations have been common.

Some causes of the global volatility are known, with the de-leveraging of the "mother of all debt bubbles in the West" being the primary cause.

However other factors that are contributing to volatility include high frequency trading (HFT) which

caused the 2010 markets 'flash crash'. By 2010 HFT accounted for over 70 per cent of equity trades in the US.

The focus of media on investment volatility has the potential to un-nerve investors. ASFA's anecdotal feedback is that while the number of switches made by superannuation fund members at times of heightened market volatility is low in absolute numbers, it is significant in terms of the size of individual account balances.

The challenge for superannuation funds is to manage volatility risk, both in absolute terms through asset allocation and by communicating to members at the same time as they are receiving messages from a variety of sources that focus on the downsides of investments.

## ASFA Research priorities

The CSIRO/Monash Superannuation Research Alliance conference is focusing on two specific research themes; superannuation and the economy and superannuation and ageing. Both of these areas are of current policy interest to ASFA.

### 1. Superannuation and the economy

In September 2009 ASFA produced the report *Better living standards and a stronger economy: the role of superannuation in Australia*.

The findings of the report included:

- For most households, superannuation is the largest asset after the family home (this has implications given the proportion of Australians owning their own home is declining).
- Empirical evidence indicates that the Superannuation Guarantee may have increased the household saving rate by up to 1.5 to two per cent of GDP.
- Without superannuation, investment would have been \$14 billion or 4.5 per cent lower than it actually was in 2008 (\$312 billion) and capital stock would have been almost \$144 billion less. Without superannuation, GDP would have been an estimated 1.8 per cent lower in June 2008 than it actually was.

In August 2011 ASFA's second report found increasing the Superannuation Guarantee to 12 per cent, if implemented in 2013, would raise GDP by 0.33 per cent by 2025 compared to a no-increase scenario. In 2010 dollar amounts, this is an extra \$5.463 billion for the economy as a whole in 2025 compared to the no-increase scenario.

ASFA is currently working on three key policy areas; fixed interest investments, infrastructure and investing in growth assets. ASFA's focus is on identifying impediments to investment for superannuation funds that are preventing the maximisation of benefits to superannuation fund members and the Australian economy.

### Infrastructure investment

According to research from Rice Warner, APRA-regulated super funds in Australia allocate around five per cent of their total asset allocation to infrastructure assets. Not all superannuation funds invest in infrastructure. Of the one-third of superannuation funds that do, infrastructure investment can make up between two and 10 per cent of the total portfolio.



Investment in infrastructure can play an important role in boosting national productivity. Research has demonstrated the potential for network effects to apply. That is, investment in infrastructure can have a system-wide benefit by, for instance, improving the efficiency of the whole road system.

In April 2011 ASFA released a Discussion Paper that recognised the contribution superannuation funds can make to the Australian economy by investing in infrastructure, but bemoaned the lack of investment opportunities and dialogue with the superannuation sector on infrastructure investment. ASFA proposed that the Government establish a working group to bring together stakeholders to develop a common approach and investment pathway.

The Infrastructure Finance Working Group, which was subsequently established by Infrastructure Australia, recently released its public report examining impediments to investment in infrastructure. The Federal Treasury has been tasked by Government to examine the report and provide recommendations to Government. ASFA has met with Treasury officials to discuss their key areas of interest and will continue the dialogue. Academic research could play a valuable role in articulating the productivity benefits of private investment in infrastructure.

### **Fixed interest investment markets**

The Federal Treasurer convened a meeting of major superannuation funds, corporate treasurers, investment banks and treasury officials on 13 December 2011 to discuss the challenges of developing a deep and liquid corporate bond market in Australia. A significant focus of the forum's discussion was the role that superannuation funds could play in encouraging the development of a market. From a public policy perspective, developing Australia's corporate bond market may provide an alternative funding mechanism for smaller corporations than reliance on bank funding. There is concern in Government that banks' reliance on wholesale debt markets makes Australia particularly vulnerable in the event that either markets freeze or margins rise. ASFA's recent Investment Interchange event, which featured a keynote speech by Ken Henry, had a panel of experts debate issues around Australia's corporate bond market. ASFA has since released a Discussion Paper and formed a working group that is operating as part of a broader industry research initiative to examine impediments to the development of Australia's fixed interest capital markets.

There is no silver bullet in developing a deep and liquid corporate bond market. Detailed research that examines global bond markets and the role of liquidity would be a valuable contribution to the industry's discussion.

### **Growth investments**

Superannuation funds invest in growth assets principally through investing in Australian equities and venture capital.

ASFA has been researching long-term challenges to investing in growth assets. While our work is still in its initial stages, our early conclusion is that Australia's equity markets face reputation and concentration risks that have the potential to impact significantly on superannuation fund investments if not addressed.

### **Diversification of ASX 200**

One of the issues that Australian superannuation funds face investing in the ASX 200 is diversification among industry sectors. ASFA research, with data supplied by State Street Global Advisors, analyses the structure of the ASX 200 over the last 20 years. In the early 1990s the materials sector peaked at 45 per cent of market capitalisation of the ASX 200. Over the next

decade this declined until it was below 15 per cent by the turn of the decade. Over the last 10 years the materials sector has steadily climbed, hitting over 30 per cent in 2010. The changing market structure of the ASX 200 has implications for the superannuation industry.

The Government's Mid-Year Economic and Fiscal Outlook (MYEFO) projected that Australia's terms of trade would rise 1.75 per cent in 2011-12, before declining 5.25 per cent in 2012-13. The medium-term projections assume that Australia's terms of trade will decline by a further 20 per cent over the subsequent 15-year period. It is not likely that a decline in Australia's terms of trade will correlate directly with the capitalisation of the ASX 200 however we can expect that, all things being equal, a decline in commodity prices will impact on the valuations of companies in the materials sector.

The impact of the structure of the ASX 200 on long-term investment opportunities was recognised recently by *Australian Financial Review* columnist David Bassanese who asked the question whether Australia is indeed the lucky country or a one-trick pony? Bassanese argued that Australia's market has become increasingly dependent on the resources sector:

"Despite the ongoing mining boom and the health of our banking sector, there's a growing risk that Australia's high exposure to the resources and financial sectors could continue to hold back relative market performance. That's especially so if a new global technology boom is getting under way and/or population ageing creates further opportunities in the health industry. We may already be seeing hints of the 'derating' of Australia in that our market's price to forward earnings ratio has already fallen back to a significant 10 per cent discount to the US market."

The structure of the ASX is of material interest to superannuation funds. It is in the interest of the superannuation industry to encourage the diversification of the ASX. A diversified ASX provides superannuation funds with a broad range of investment opportunities that funds can invest in according to their different risk and return objectives. By contrast, if the ASX continues to concentrate around mining and resources company stocks, then this is ultimately likely to impact on the allocation by superannuation funds to Australian equities. The listing of companies involving new industries, services, products and markets would provide superannuation fund investors with new investment opportunities which would balance the impact of the projected medium to long-term decline of commodity prices as forecast by the Australian Government's MYEFO.

#### Small caps and venture capital

Australia has a weak venture capital market (investing only \$120 million in 2011) with most innovative companies listing on the ASX instead of seeking private capital. There are currently 2,222 companies listed on the ASX with a total market capitalisation of around \$1.2 trillion. While there are a large number of companies on the ASX, the market is skewed with a small portion of companies having a large capitalisation (the bottom 1,300 companies in the ASX only have a market capitalisation of \$47 billion). Figures from Rainmaker reveal that the superannuation sector currently invests \$21 billion in small and medium caps, making this a much more significant part of portfolios than venture capital.

The evidence already suggests that listed markets are the vehicle that entrepreneurial companies choose to raise capital. The bottom 1,300 companies on the ASX, many of which are innovation companies, have a market capitalisation of \$47 billion compared to the size of Australia's unlisted venture capital industry at \$2.3 billion.

The choice of capital markets as a capital-raising vehicle for entrepreneurial companies is likely

to continue, principally because Australia's superannuation system is constrained around its investments in unlisted assets due to choice of fund rules that allow individual super fund members to transfer their assets to another fund. The impact of choice of fund is that superannuation funds can only invest a portion of assets in unlisted assets. Venture capital also competes against other unlisted assets such as infrastructure and property that have a strong track record in delivering long-term investment returns as well as contributing to economic growth.

While the ASX is the mechanism which small companies already use to raise capital, and in which superannuation funds already invest \$21 billion, there is a need to acknowledge the challenges that investors face investing in small caps, including the lack of liquidity, volatility of share prices and lack of research data. Compared to large cap companies there are also concerns around the management capacity of small cap companies, in particular around a range of ESG risks. As an example, the ASX advises it has 15 companies listed that solely operate in Mongolia due to their presence on the ground in that country. While micro-caps represent a small component of market capitalisation, they represent a risk to the integrity and reputation of the market if ESG risks are not well managed among these companies.

Academic research around the diversification of the ASX, liquidity issues of small caps, impediments to the listing of innovation and technology stocks, and ESG risks in the resources sector would be valued.

## 2. Superannuation and ageing

ASFA has focused considerable policy work around the development of future retirement incomes policies that address longevity risk.

According to the Treasury *Intergenerational Report*, over the next 40 years the number of Australians aged 85 and over is projected to more than quadruple, from around 400,000 in 2010 to 1.8 million by 2050.

The ageing of our population is largely in response to improvements in life expectancy. In 1983 an Australian female reaching the age of 65 could expect to live, on average, for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002 these figures had risen to 21 years for females and 18 years for males.

Most Australian retirees take lump sums or make use of account-based income streams. Currently, sales of life annuities and deferred annuities are minimal, although term annuities are becoming more popular due to the uncertain investment climate.

Annuity demand has been low in Australia however and is now considerably lower than it was a decade ago. The decline in annuity demand was partly due to changes in taxation and regulation in 2004 and 2007, when the Australian Government reduced the assets test exemption for complying income streams and made superannuation benefits tax free for those aged 60 or over. More recently, sales of term annuities have increased in response to investor concerns about the level of investment returns from equity investments and the volatility of such returns.

However, the predominant type of superannuation product in retirement remains the account-based income stream (commonly known as an allocated pension).

## Ageing is multi-dimensional

While ASFA is continuing work around the policy setting for retirement income products, ASFA also understands that ageing is a multi-dimensional issue. Financial products are just one part of what is a complex, global challenge that will shape economies and societies over coming years.

ASFA has begun work to understand the different dimensions of ageing. One dimension is to understand that as people age they spend differently.

ASFA has introduced a new ASFA Retirement Standard that specifically examines expenditure of 90-year-olds. ASFA's analysis indicates that budget standards for those aged 90 differ substantially in a number of ways from budget standards prepared in regard to the expenditure needs of retirees aged 70. The main differences arise in regard to the transport and leisure groups. Those aged 90 have relatively low participation rates in motor vehicle use and overseas holidays and that reduces expenditure in these expense categories. The main areas where those aged 90 have additional expenses are household services and health. The net impact of these various factors is that ASFA Retirement Standard figures for those aged 90 are slightly lower overall at the modest standard. At the comfortable standard, expenditures are about 10 per cent lower in aggregate largely due to the elimination of relatively costly leisure activities for those in that age group and standard of living.

Other 'ageing' issues that ASFA is seeking to develop its understanding of include:

- Risk aversion: how attitudes to investment risk change with ageing.
- Customer service: how will customer service expectations of superannuation funds for retired members differ to members in accumulation stage?
- Transition to retirement: what incentives and management will be required for employees who are transitioning to retirement?
- How are Australia's cities equipped to handle the transition to an aged population? What changes will be required and how can the superannuation sector facilitate changes through its investments?
- What are the impacts of *Intergenerational Report* projections on the future fiscal position of governments on retirees in areas such as future provision of health and aged care services? What are the potential impacts on the superannuation sector in terms of investment opportunities and expectations of retired fund members?