FRONTIER ADVISORS

The Frontier Line

Thought Leadership and insights from Frontier Advisors

The global shifts disrupting investment

Issue 110, December 2015

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $250B in assets across the superannuation, charity, public sector and higher education sectors. The fact our advice is fully independent of product, manager or broker conflicts, means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

The Frontier Line explores a range of investment issues and ideas to explain and illuminate areas for investors to be aware of and be thinking about. Our specialist and sector research teams constantly review and discover topics to provide new perspectives and enrich understanding of critical risks and opportunities.

Fiona Trafford-Walker: As Director of Consulting, Fiona is responsible for overseeing Frontier's investment consulting deliverables and provides advisory services to clients herself. Fiona started with Frontier/IFS in its inaugural year in 1994 and in 1997 took overall responsibility for the asset consulting business, which became Frontier in 2000 with Fiona as Managing Director. Fiona holds a Bachelor of Economics with first class Honours from James Cook University, receiving a University Medal, and holds a Master of Finance. Fiona is ranked number 4 in the world's top investment consultants by CIO Magazine, the only Australian to feature on the 2015 list. She is also a Non-Executive Director of the Link Group and is a member of the Investment Committee of the Walter and Eliza Hall Institute.

Frontier Advisors

Level 16, 222 Exhibition Street
Melbourne, Victoria 3000
Tel +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

The global shifts disrupting investment

Frontier Director of Consulting, Fiona Trafford-Walker, was recently invited to speak at the 2015 ASFA Conference, held in front of a record number of delegates in Brisbane. This issue of the Frontier Line is based on her presentation, which was one of four presentations delivered by a panel exploring the topic of global shifts disrupting investment.

Overview

The topic, "the global shifts disrupting investment", is a broad but important topic for all Australian institutional investors but particularly so for the superannuation sector. When I first spoke with ASFA CEO Pauline Vamos about this issue, I had so many ideas that I felt like I was surrounded with thought bubbles that I was struggling to bring into one coherent story. Then I decided to define one theme that would trap these bubbles and bring them in, and so I decided to focus my thoughts around what I think of as the member experience.

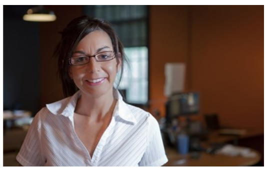
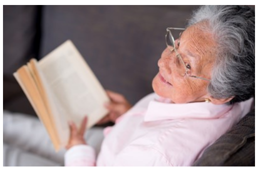
Ian Silk delivered a powerful opening address at the 2015 ASFA Conference challenging the industry on a number of fronts. There may have been some in the audience who felt different parts of Ian's message were aimed at different sections of the industry but my interpretation was that Ian was speaking to the sector as a whole, just as a member would. The services, options, fees, performance and product definitions of any superannuation fund reflect on the entire industry and so collectively we all contribute, both positively and negatively, to the brand of super, the retirement outcomes of Australians, and the overall experience that a member has with super over the course of his or her lifetime.

So as my thoughts evolved on this issue, in my mind I focussed on the member experience as the experience a person has with the superannuation and retirement system, from the day s/he joins a fund and makes that first investment option choice, to the day s/he shuffles off this mortal coil and maybe leaves an inheritance behind as a sign they were here, in a financial sense at least.

In many ways though, it actually starts earlier than that first day at work. Financial literacy in Australia is a long way from where it needs to be and my view is that this starts in schools – if kids can learn Mandarin, they can learn about asset classes and compound interest. Better financial literacy will also lead to a better member experience.

All of my thought bubbles eventually became about what disrupts the member experience, why is this so and what can we all do about it?



The system and lack of trust

The first place to start is with the system itself. For the member experience to be all it needs to be, people need to have trust in the system, and sadly trust in the global finance sector is lacking. A US-based firm called Edelman determines an annual trust barometer, via an online survey. In 2014, it did this in 27 countries with more than 33,000 respondents, so that's a statistically sound study by any measure.

In 2014, the finance sector globally was the least trusted of the 15 industries tested with a 50% trust level. Amongst the APAC population we were a little higher at 62%, which is certainly an endorsement of our system against our global peers, but it also means almost four in ten of our clients don't trust the finance sector. In Australia, the list of organisations that have failed their clients is way too long and sadly this list is full of previously venerable and trustworthy organisations.

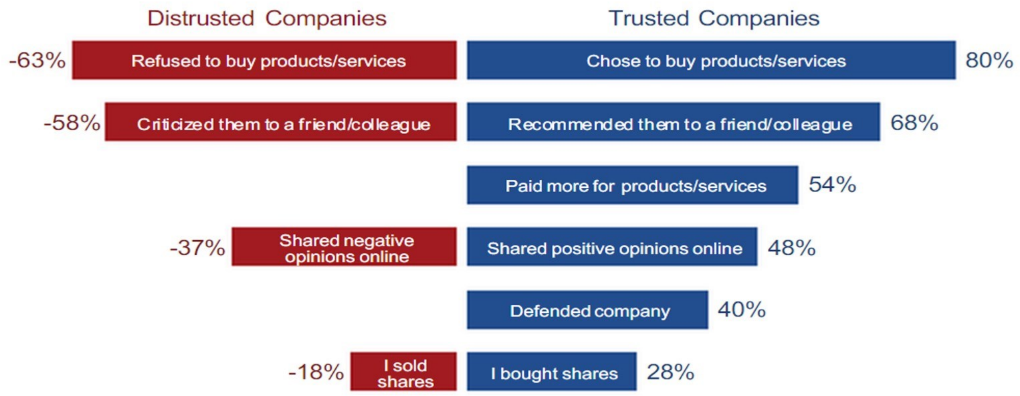
Rebuilding trust is critical to the member experience. Any one individual or organisation can have it, and many do, but we need the system to have it. Chart 1 from Edelman clearly shows the upside and downside from being trusted and distrusted.

We should not have to rely on regulators to make the system trustworthy and to protect the uninformed from the devious. We should not have to rely on codes of conduct and oaths to do the right thing. We should just know what the right thing is and do it. It's that simple. This might sound like a motherhood statement but to me it is a pretty fundamental and clear notion and one that is hard to argue against.

If we as an industry don't follow this ideal, then the system will weaken and the member experience will be less than it should be. People will also decide to do other things with their superannuation – look at the rise in SMSFs for example. From a system perspective the aggregate effect of shifts such as these will cause disruption as they will impact investment strategies and the ability of funds to capture the benefits from scale.

Edelman lists three steps to rebuild trust in the financial services sector. I know many funds do lots of these things already but perhaps a review of what your fund does against this might provide some new ideas.

Chart 1: The Edelman Trust Barometer



Source: The Edelman Trust Barometer 2015 in relation to behaviour based on trust, global actions taken over the past 12 months

Fiduciaries

As fiduciaries, trustees of superannuation and retirement funds have heavy burdens on their shoulders. They are responsible for the delivery of dreams. And with a compulsory savings system in Australia, I think the implied burden is even higher than one where people choose to, for example, buy shares in a listed company. And as the guardian of people's dreams, it is important to balance member needs with commercial concerns. I sometimes wonder if MySuper has turned superannuation funds into product providers and reduced their ability to act as genuine fiduciaries.

I look at the MySuper Dashboards all lined up to look like they are the same, but they are not. How is the average member meant to work this out? How will they know the cheap MySuper option with no track record is a new fund full of passive management and less diversification? Not that I am saying that paying less is a bad thing – but I think it's about value for money and selling a product for less than another product when someone might reasonably think they are similar products does not seem like the right thing to do to me.

The proportion of everyday working Australians who would actually understand the notion of active and passive investing would be very small indeed. They understand their area of expertise but not necessarily ours.

This issue of the role of the fiduciary is also a global trend that is causing some disruption. In discussions at conferences I attend around the world the topic comes up frequently. In some cases, fiduciaries are struggling with what it means to be a fiduciary, with the regulatory and compliance burden that comes with it and with the increasingly technical aspects in the investment decision making area. What this means in my view is that any individual in this role needs to make sure s/he can be the best trustee possible – be clear about his/her strengths and weaknesses, educate to fill any gaps, be engaged and ask questions. Trustees should take time to think about what they are there for – how are they balancing commercial considerations with their roles as fiduciaries?

The media

Ah, the media, and by media I don't mean the trade publications that work around our sector but the mainstream press. The papers that average Australian worker picks up and sees “$30bn wiped off shares today”, “market freefall”, and “superannuation funds in the red”. Of course, they don’t as often see “$30bn added to market today”, “market soars”, and “superannuation funds in the black”. I wonder how many people read these negative headlines and think twice about putting some extra money into their superannuation or even call their fund and change options. I think we can argue that most people are not very engaged with their superannuation until they get closer to retirement and their balances get larger. It’s at this point that some critical decisions can be made and the fact these get made with larger balances can have significant effects on any member’s ability to retire when they choose.

That said, people of any age can be influenced by what they read and younger people are also going to be influenced by the mainstream media. Who knows the impact that such emotive headlines will have on them when they do start that first job and need to tick a member investment choice option box. Maybe they will think that stock markets are just too risky – after all, who wants to invest in something that can lose $30 billion in a day?

So maybe they pick the Cash Option – this is in fact likely to be the riskiest option of all for a person with 40 years of work ahead of them.

So I would throw a challenge out to the mainstream press – the headlines you choose to use matter as does the way you choose to report. You can, and do, influence people’s decisions and hence their retirements and you need to start seeing the social aspect and utility of superannuation and retirement and report news that is genuinely newsworthy. On most days, it’s likely to be “market pretty normal today – some ups and some downs” and simply not worth a headline.

The challenge for us is to call out the media when we see the sensationalised headlines designed to sell papers, or more correctly in this digital age, to implore the reader to click now.

Climate change

My fellow ASFA Conference presenter Martin Skancke, Chair of the PRI Advisory Council, spoke with great passion about this area. What I would add is that from my experience, most trustees do agree climate change is a massive future challenge but it seems to get knocked off the near-term agenda by some economic or market crisis or another. I also think most people don't want to spend the retirement phase of their member experience in Gotham City, a dark and barren world, even with lots of money[1].

This doesn't mean funds should compromise returns to make investments – far from it, but an openness to funding ideas that might be able to offer solutions to climate change-related problems is a good idea as is making sure superannuation funds apply capital and manage their portfolios with an eye on this challenge.

Source: Batman (1989) as designed by Anton Furst

1. I am indebted to Saker Nasseibeh from Hermes for this reference.

Short-termism

In 2007, I gave a presentation about short-termism within a broader theme of "Investing in a global world". As I re-read it, I could be saying the same things now so clearly I have some work to do!

In it, I made read following statement, from an article by Li Jin called "How Does Investor Short-termism Affect Mutual Fund Manager Short-termism" (February 27, 2005).

"Fund managers face high incentives to perform in the short run. Such incentives largely come in the form of increased … assets under management on the upside, and firing on the downside.

As a consequence, fund managers might focus excessively on short-term performance, at the cost of long term profits.

…

Further causality tests demonstrate investment short-termism to be caused by investor short-termism, but not vice versa.

…

Institutional investor short-termism can also affect corporate decision making, given that institutions constitute an increasingly important investor class, and corporate managers will likely react to institutions' excessive focus on short-term performance by in turn exhibiting myopic behaviour."

That is, the behaviour of investors makes investment managers think and act short-term, not the other way around. This then forces companies to think and act short-term too.

Chart 2 shows the timeline for success for some very successful companies.

Bill Gates founded Microsoft in 1975, but it was eleven years before Microsoft went public, making him an "overnight success" worth $350 million. It took Steve Jobs two decades to become an "overnight dot-com billionaire" after establishing Apple in 1976. Larry Page and Sergey Brin started working on Google in 1996 but eight years later in 2004 Google eventually made it going public with a market capitalisation of $23B.

Somewhat differently Jeff Bezos founded Amazon.com in 1994 and took it public three years later, making him a multibillionaire. Amazon's initial business plan was unusual: the company did not expect a profit for four to five years; the strategy was actually more effective than his business plan predicted. very rare case.

Like good wine, good companies can often take some time to become good companies. Long-term investors such as superannuation funds need to remember this and the ability to take a long-term perspective allows for a higher level of patience in seeking optimal performance.

Chart 2: The basic order of influence

2. EFA 2005 Moscow Meetings Paper.

Australian funds punch above their weight

For more than fifteen years I have regularly travelled the globe to research many aspects of the investment world. One thing I have observed is that Australian investors punch above their weight – we have an innovative albeit imperfect accumulation system and we have taken an innovative approach to investments. Our system has generally performed at the level it has needed to in terms of generating real returns for members over time. Of course there are periods where it hasn't delivered and there are specific funds that have not met expectations but this has all been achieved in an environment of considerable regulatory change, the introduction of choice of fund and the resultant impact on peer awareness, and the worst economic and market crisis globally since the Great Depression.

The Mercer-Melbourne Institute ranks the Australian retirement system third after Denmark and the Netherlands and well ahead of the UK (9th) and the US (14th). This is a significant achievement for a small country, although perhaps there is a reverse size effect in this list as, like Australia, Denmark and the Netherlands also have relatively small populations.

Where we have underachieved is in the retirement space. I know a lot of work is going on there and it seems to me to be a perfect place to work collaboratively as most funds do not have critical mass. Those who have been part of the superannuation industry for more than two decades as I have will remember the early spirit of industry collaboration that helped our sector build such a strong foundation for today's system. The retirement space seems to be a perfect area within which to build and maintain our global reputation as smart and innovative investors.

Future maker or future taker?

Australian Doug Cocks wrote a book in 1999 called “Future Makers, Future Takers” in which he assessed what life could be like in Australia in 2050. While this book mainly focussed on economic growth, natural resources and social aspects, he did use some terminology that still makes sense for us today.

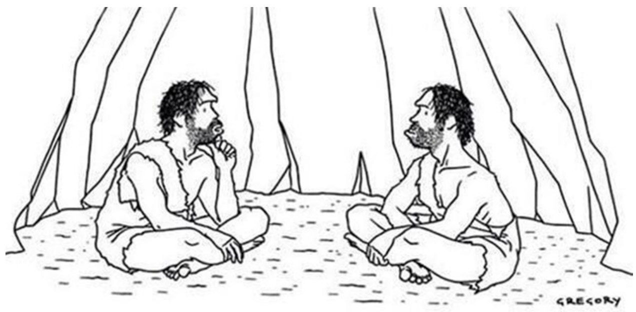
Firstly, he defined future makers and future takers. This expression is used more widely now in the context of climate change but I think it can also apply more broadly to our industry and the impact that we can all have. Trustees, as direct representatives of members’ interests, are at the top of the food chain and what they decide to do will make a difference. Boards, and their fund executives, can decide to be future takers where the status quo is accepted and driving the industry is left to the agents, many of whom are certainly trying to do the right thing. Or they can be future makers leading the debate and pushing hard to effect the changes needed for Australians to have the member experience they deserve.

The other concept Cocks mentions is that of “meliorism” which is the belief the world can be made better by human effort. In our sector, we can all do more to ensure the member experience is the best it can be by:

- doing all we can individually and collectively to engender trust in the system;
- being transparent and clear in how we describe what we are offering to members;
- calling the media out when they sensationalise negative news to create a click frenzy;
- continuing to be a global leader in investments and retirement but always thinking about ways in which we can do more;
- making good decisions for long-term benefit including how we can mitigate the risk of climate change on our planet and hence our portfolios; and
- being future makers and truly believing we can all leave this industry better than when we found it.

This industry is full of smart people and the human race has found a way to extend life spans from 30 to 90 years. We even found a way to get a man on the moon!

We can definitely do this.



“Something’s just not right—our air is clean, our water is pure, we all get plenty of exercise, everything we eat is organic and free-range, and yet nobody lives past thirty.”

FRONTIER ADVISORS