The Frontier Line

Thought leadership and insights from Frontier Advisors

Strategic transition of superannuation funds

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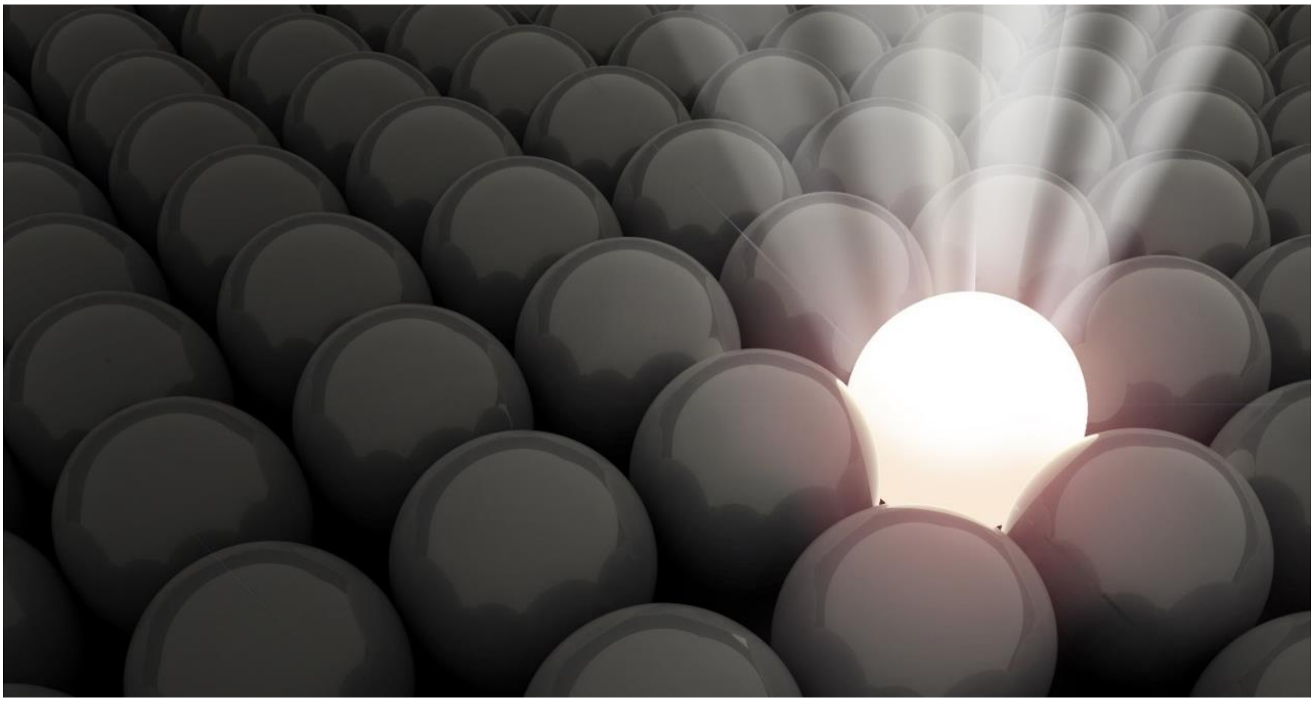

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Strategic transition of superannuation funds

Frontier has been advising the superannuation industry and superannuation funds for 20 years now and, for the first decade and a half, the rate of growth and change was continuous and constant, but steady. The last five years has seen the rate of change, in particular, accelerate and the prospect of reverting to the earlier, steadier pace is now a forlorn hope. In the twenty year period, all aspects of the sector have evolved dramatically, and will, without doubt, continue to develop and change.

In the most recent period, we have observed a more substantive trend underway involving the strategic transition of not for profit superannuation funds into complex financial services businesses. Frontier's view is that this transition is now set to accelerate. The key drivers for this transition are external and uncontrollable for an individual fund, and hence our conclusion is that the transition cannot be ignored or assumed to have no impact.

Instead, the changes and consequences from the transition need to be identified, embraced and used to create competitive advantage. To do so requires that thought and planning should already be occurring at the fund level to create and foster a strategic and organisational capability that can best manage this transition.

This edition of Frontier Line examines the recent and ongoing dynamic changes to the retirement savings and incomes industry that are causing this strategic transition. We also examine the consequences of the identified change drivers on the various dimensions of the superannuation fund enterprise, including on investment operations. The focus is on identifying the critical strategic issues that funds need to consider, and how these will interact, intersect, and drive superannuation fund business in the future.

Given the breadth of the topic, this paper is a perspective on our industry from a high level and covers a lengthy forecasting period. The thoughts and ideas presented are the results of the research and thinking undertaken by Frontier's Governance, Risk and Strategy Advisory Team, which advises funds on the three areas noted in its name.

We hope you find this paper thought provoking.

"The only constant in life is change"

Heraclitus

Change in the financial services industry is entrenched and endemic, no more so than in the retirement savings and incomes space. This is driven by a number of internal and external drivers of varying length, intensity and frequency. These are outlined in the following pages.

Retirement savings & income strategic landscape

The strategic landscape has changed significantly and the superannuation fund market place is no longer defined by the traditional sectoral classification of industry, retail, public sector, corporate etc. Frontier has identified two key market factors which largely define a superannuation fund now.

1. How much competition does your fund face for members and how truly competitive is your fund?
2. How retail (or individually customised) is your membership now, or going to be?

These factors are important because they impact a superannuation fund in multiple dimensions and across many business activities.

- The level and type of competition faced by many superannuation funds is starting to impact and influence organisational structures, operating platforms and business strategies. Fundamentally, as member balances grow they become more interesting prospects for others and competition for their custom is inevitable.
- Retailisation, and individual customisation, is having a similar broad impact across superannuation funds and is also influencing product range, liquidity and reporting.
- Philosophically, many superannuation funds are moving from simple trustee controlled businesses to complex, member driven enterprises which is affecting business planning in multiple ways.

Member, customer, regulator and legislation

The unrelenting pace and frequency of change in recent years has also been driven internally by the member and externally by the potential customer. Externally, and in addition, the regulatory and legislative overlay has been in flux for much of the past decade, and all four dimensions promise further activity in the next few years.

Rather than address the many aspects and issues potentially arising in the recent past and in the future from these complex internal and external drivers, we provide a high level summary across a number of dimensions.

Table 1: Drivers of change

Dimension	Issue
Regulation	• Stronger Super, reporting, policies • APRA Prudential Standards • Board composition
Legislations	• Future of default fund status • Further SGC increases? • Potential for review of concessional tax status? • Future of lump sums and aged pension
Competitive & market dynamics	• SMSFs – what is the best response, defence or attack? • Retail style platform or more focussed provider? • Competitive advantage and differentiators • Transition from retirement savings to retirement income • Insurance offerings and solutions
Product diversity	• Addressing market/member segments • Critical mass and cost of diversity • Default fund and customisation
Member interface	• Communications, use of technology • Brand and retention • Distribution • Financial planning approach • Administration paltform
Efficiency and costs	• MySuper • Price/cost strategy • Meeting market transactional benchmarks

The liability side of funds

Internally, the nature and characteristics of the typical superannuation fund's membership is evolving and the behaviour of the members is also changing. Frontier has undertaken some advanced modelling on member dynamics and member behaviour across many dimensions and, for the typical fund, the quantitative analysis supports what many have deduced from anecdotal information.

First, cash flow as a percentage of fund assets will decline over time, despite increasing Super Guarantee contribution rates. This reflects the effect of drawdowns post retirement and the increasing importance and size of account holdings of this demographic.

Second, despite new, mostly young employees entering the workforce and joining superannuation funds, and the retirement and death of older members, fund memberships are ageing and older members hold a larger proportion of invested funds. The latter point is particularly important as more and more of a fund's assets will come to support members who are retired or near retirement. This will obviously be an issue for future asset allocations, for the assets used to support particular types of retirement savings and income products, and for the design of the products themselves.

Third, switching between investment options within a fund is increasing in incidence. Not only that, the data shows that once a member switches, they are more likely to switch again in the future. This means that the patient, non-switching default fund members are diminishing in number and therefore the central importance of the default fund is declining. This is an early pointer to the retailisation posited earlier and to a looming focus on liquidity.

Chart 1: Net cash flows proportionately are falling

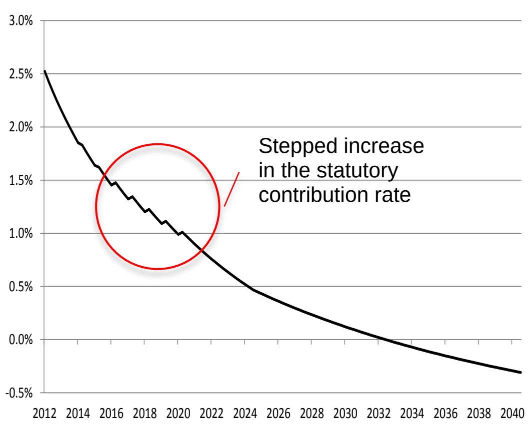
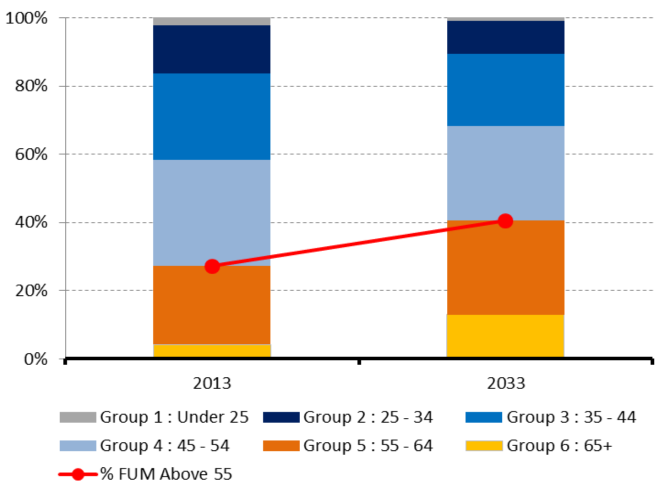


Chart 2: Fund membership is ageing



The liability side of funds

Chart 3: Members have started switching…

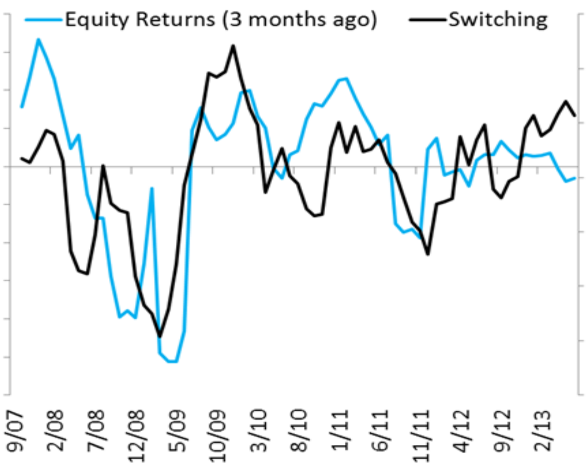
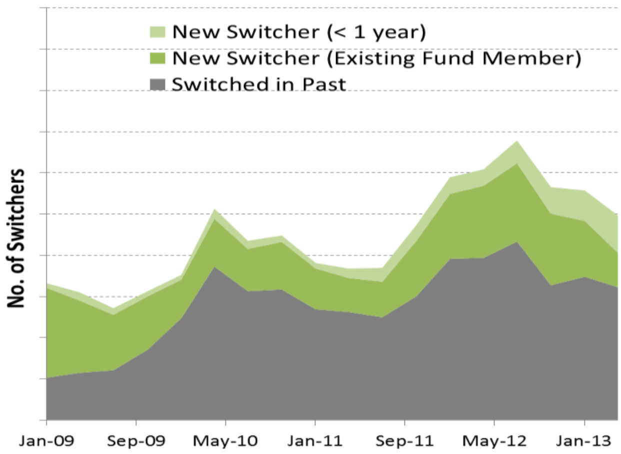


Chart 4: And are increasingly switching



"The dilemma I face, as a Minister in this space, is that we have all these different business models that intersect and having a one-size-fits-all regulation is very difficult in this area. What I do want to do where possible is apply some common principles, one of which I think is in the interest for everybody is, for example, more independent directors on superannuation boards and, where possible, for members to actually drive the process. What we want to build is a citizenry that has access to the lowest-cost, best-available financial advice and has multiple options to choose from because that choice encourages competition and will improve the service offering."

Assistant Treasurer, Arthur Sinodinos
at the SMSF Professionals' Association of Australia National Conference in Brisbane
February 2014 (Source: financialobserver, 20 February 2014)

Politics and policy

Politics is unfortunately an ongoing reality when it comes to superannuation and the next decade or so is unlikely to see any unified or depoliticised policy agenda in this space. The current Federal Government has promised a “hands off” approach to certain superannuation related policy settings, but is looking to be “hands on” in other areas.

The recently stated objective is for superannuants to be more engaged and “drive the process”, likely meaning an encouraging push down the retailisation path. As suggested in the recent quote from the former Assistant Treasurer, retailisation is part of a broader process of homogenising the not for profit sector.

Organisationally, and particularly in terms of governance, not for profit funds are very differentiated from peers in the financial services sector. This reflects both the origins and nature of the funds themselves.

This homogenisation push will have the effect of levelling the playing field from a new direction and implies that the broader retirement savings and incomes industry will soon look like the rest of the financial services sector, if the Government’s broad objective is met. Our view is that this policy outcome will only accelerate trends identified elsewhere in this paper.

A potentially influential review in terms of future policy settings is the Financial System Inquiry (FSI). The focus of the FSI is on the efficiency and effectiveness of the financial services sector, including superannuation, and the original Financial System Inquiry proceeded very much in this mold.

Again, however, the FSI will spend some time addressing organisational and industry structures and, as previously noted, on this issue the superannuation sector is the most diverse in the financial system. Benchmarking not for profit funds against the rest of the financial services sector is likely, and the benchmarking assessment will assess areas that have not been traditionally an institutional focus, or strength, for these types of business. Some possible benchmarking reference points are as follows.

- Competition and innovation – is the product range, diversity, customisation sufficient for members.
- Capital base and risk – who pays and who is at risk in failures, who provides liquidity, and how is capital provided for growth.
- Efficiency and administration – are transaction processing, speed and transparency consistent with finance sector benchmarks.
- Technology and consumer preferences – is information frequency, interactivity and customer access to an acceptable standard.

The search for new investment ideas

The investment world is changing significantly both in terms of investment practice and ideas, and information advantage.

- Lower prospective returns are forecast, and yield is in vogue.
- Technology and data accessibility is benefiting asset owners, but reducing information advantages.
- Behavioural biases are getting attention.
- Risk factor and risk approaches are influencing asset allocation approaches.
- Proactivity and new ideas are expected of funds and their advisors on a continuous basis.
- Investment markets are getting broader and deeper.
- Specialisation in asset management continues as does aggregation.
- Costs are a familiar focus, but are proving hard to reduce.
- Size and scale, or lack of, impact in a number of sometimes conflicting ways.

Irrespective, being "opportunistic" is the new black and the search for differentiated ideas continues at multiple levels. Funds can expect the quantum and pace of new ideas, and the search for the investment differentiator, to continue to escalate and all options and ideas require internal consideration and governance oversight.

The core issue is that the investment platform and the investment practices of a fund need to be able to accommodate and implement these before they can be considered. Secondly, the ideas need to be thoroughly tested for consistency with the overall investment philosophy.

Table 2 summarises the state of play on investment ideas.

Table 2: State of play on investment ideas

Investment dimension	Options and ideas
Portfolio management approaches	Scale, disintermediation, in-sourcing, internal management, increased control, liquidity
Tax, risk and liquidity management	In-house specialists, benchmarks and bespoke mandates, systems and management, asset and sector profiling
Strategic and dynamic asset allocation	Differentiation, illiquids allocation, DAA scope and frequency, sector and sub-sector tilts, capital and income split
Sector configuration and manager selection	Tilts, smart beta, concentration, frontier markets, IP transfer, access, partnering, activism
Fees, costs and implementation	Fee structures, insourcing, active/passive, transparency, competitor issues
Behavioural biases	Leveraging biases in decision making – loss/regret aversion, sunk cost fallacy, status quo preference, home bias, overconfidence, endowment effect (love owned things), anchoring/framing, "recency" effect, forecasting overconfidence

Business complexity

A number of composite factors are impacting funds in various areas above and outside those identified. We have categorised these under the broad heading of "business complexity". Many are both consequences of the strategic transition as well as being drivers of the strategic transition.

Table 3: Factors impacting funds

Factor	Impacts
Regulation	Reporting (to banking sector standards?), policies/procedures/compliance growing, additional portfolio monitoring, risk analysis, resourcing, technology requirements
Political	Liquidity management, tax efficiency, flexibility of investment platform and operating structure, custodian interface
Competitive and market dynamics	Platform complexity, speed and efficiency, granularity of monitoring and reporting, custodian interface, transparency, product design, innovation
Product diversity	Platform complexity, portfolio and investment monitoring, risk analytics and performance measurement, product design including retirement, resourcing
The member interface	Speed and efficiency, qualitative reporting, member direct communications, transactional accuracy
Efficiency and costs	Information access and speed, custodian interface, negotiating position, portfolio implementation approach, resourcing
Investment practice	Growing internal teams and experts, governance and decision making structures, remuneration, partner relationships, system requirements

Convergence of strategy

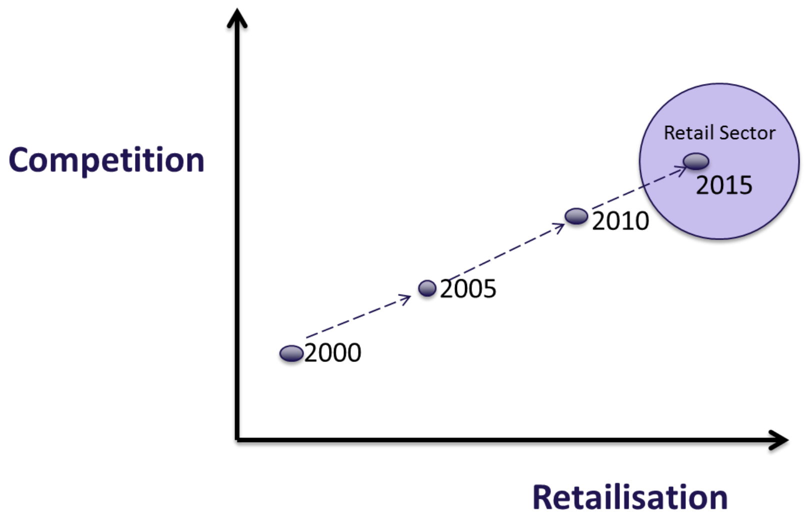
"Everybody, soon or late, sits down to a banquet of consequences"

Robert Louis Stevenson

The first and most obvious consequence of these change drivers is that, collectively, it is causing most not for profit funds to move to the same strategic space that the major retail players already occupy (refer graphic below).

This strategic space is a more difficult and challenging business environment than that faced in the past and one that requires some reconsideration of fundamental areas of the superannuation fund business model.

Chart 5: The race for the strategic space



Changing strategic narratives

For the last two decades, not for profit funds have been fortunate to have a clear set of differentiators that, in some cases, have become enduring competitive strengths.

These differentiators have arisen from the nature of the organisations involved, the culture and philosophies of these businesses and the clear objective to be different from the for profit sector. These differentiators have aggregated into a neat and successful strategic narrative which, for most not for profit funds, would include some or all of the following competitive strengths.

- Cooperation to deliver lower cost outsourced services.
- Portfolio differentiation, asset allocation and configuration.
- Comparatively small product range.
- A comparatively long term investment focus.
- Net of fee and tax performance focus and outperformance.
- Strong positive liquidity.
- Price and fees advantage.
- Benign membership with small average account balances.
- Differentiated director and board composition.

These historic not for profit fund competitive strengths and differentiators are now waning significantly, or are being removed by external competition, retailisation and strategic realignment.

The consequence of this is that any particular fund's points of difference will be defined against broader industry wide factors. Any fund will therefore be referencing competitive strengths in these fairly common areas, as distinct from the relatively obvious and easy differentiators of the past.

- Competitive strengths and differentiators will likely reside in these areas.
- Cutting edge technology and communications.
- Investing as lifestyle hobby in retirement.
- Brand strength and differentiation.
- Integration with non-super products.
- Depth and breadth of choice, control and customisation.
- The corporate interface.
- Focus on market segments, particularly the bigger account balances.
- Transparency, data and reporting.

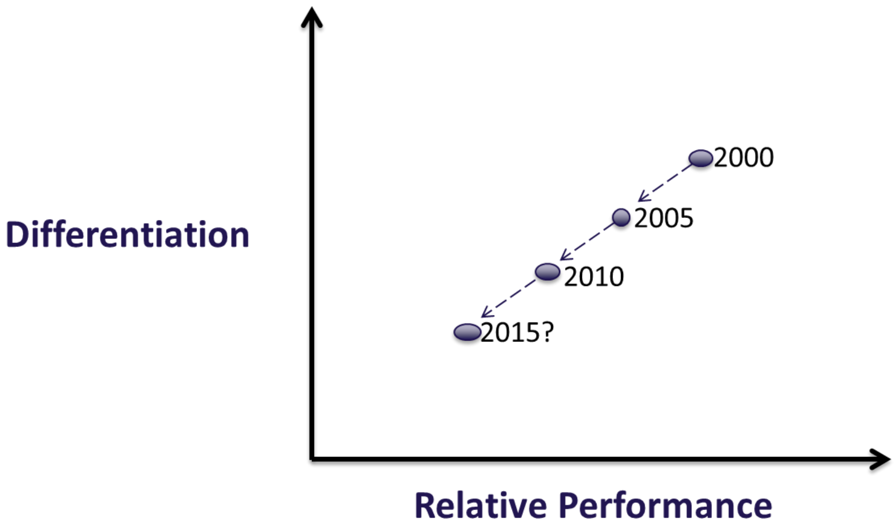
Convergence of performance

Convergence of business models and business strategies may also lead to further convergence of portfolio approaches and, by extension, performance. This may also be driven by business risk where the need to avoid fourth quartile performance is paramount, as may shying away from flighty investors seeking the latest top decile performer and causing liquidity problems in the future.

In addition, the “homogenisation” effect and changing nature of the differentiators may reduce performance as a focus of competitive advantage.

The consequences of all this for not for profit funds is set out in Chart 6.

Chart 6: The homogenisation effect



Sophisticated & complex investment platforms

A fund's investment platform is critical infrastructure in the delivery of the final products and services to members. Simple structures and supporting technology are rapidly being replaced by more complex and sophisticated platforms across the industry as funds respond to the new operating environment.

Key impacts and issues to consider centre around the core question: is your fund's investment platform ready for the strategic transition?

Table 4: Drivers around investment platforms

Dimension	Issue
Investment platform	• Fund sizes on the up but costs not dropping • Products increasing, including direct • Default fund is "liquidity and AA banker" – can this continue? • How are new products, liquidity support, paid for
Liquidity and valuation	• Will APRA force these two issues? • Switching and a maturing membership are having an impact now • Close monitoring will be the norm • Are data and systems up to the job?
Speed and efficiency	• Is quick information available? • Can decisions be executed quickly? • Is the response to competitors/markets quick enough?
Control	• Risk tools, including APRA requirements? • Increased transparency • Do members drive investments or does the trustee?

Benchmarks for investment practice rising

Investment processes, personnel and infrastructure will necessarily require enhancement as the change drivers impact the broader superannuation fund business and the investment portfolio.

The impacts and issues are many and varied as outlined below and centre around the core question: is your fund close to market benchmarks in investment practice?

Table 5: Drivers around investment practice

Dimension	Issue
Resourcing and capability	• Specialist staffing increasing • Technical, operational and external support more important • Resourcing vs market re internal staff? • But quality and cultural fit (and shift) are the keys
Infrastructure and operations	• Custodian interface critical • Business needs a base level of tools now for multiple requirements • Accuracy, maintenance, multi-user? • Standard of technology
Analytics, reporting and communications	• In-house analytics becoming the norm • Members/FAs/fund raters will ask for a lot more from here • As will IC/Board as complexity of business grows
Control	• In some areas speed is the differentiator • Who needs to decide what? • What is strategic, and what is operational?

The strategic transition: Are you ready?

"Before everything else, getting ready is the secret of success"

Henry Ford

The key issues and questions for superannuation funds that are in, or about to commence, this strategic transition can be summarised across three broad dimensions.

1. Do you have, or are you creating, the necessary **strategic capacity** for the transition, in particular:
   - Are your investment and administration platforms ready for this next phase?
   - Is your fund close to market benchmarks on investment practice and resourcing?
   - Is the organisational structure and business planning ready?
2. What are your **competitive strengths** and how robust and long lived are they likely to be in attracting and retaining members?
3. What are the **differentiators** for your fund now and in the future?

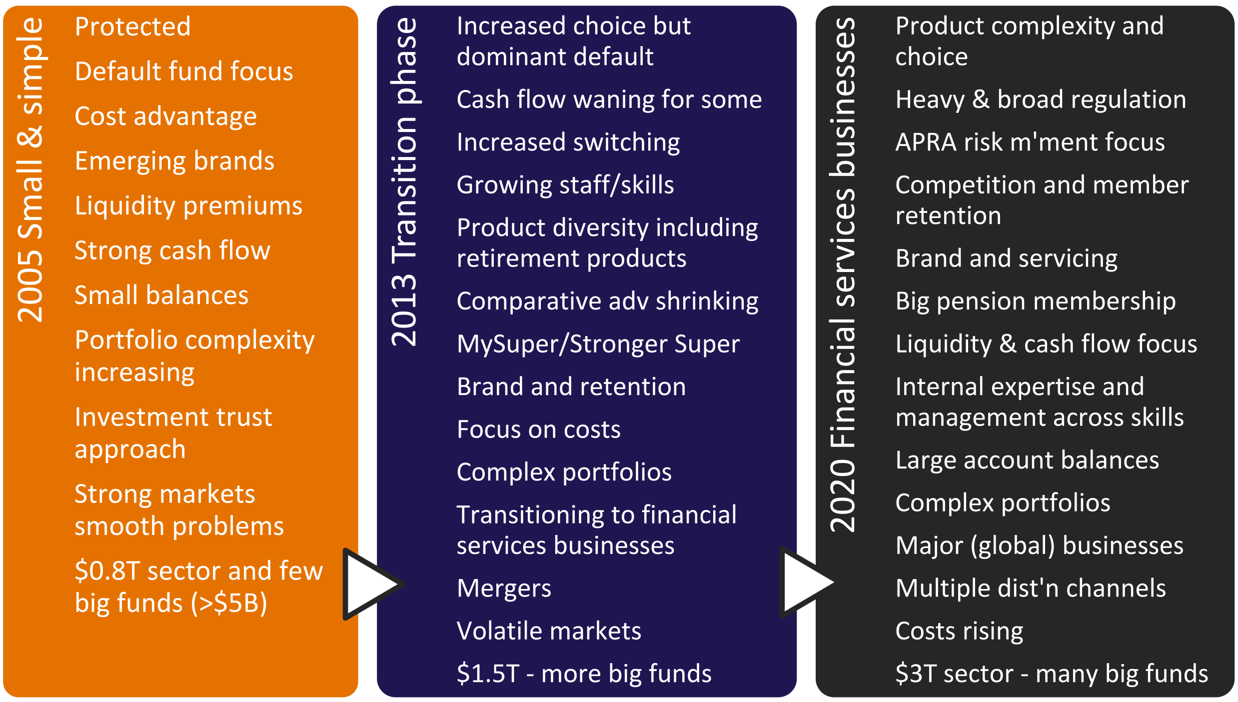
Inevitably, the change drivers identified in this paper will likely evolve, recast and change over time, as will some of the consequential impacts, meaning close attention needs to be paid to market forces and effects.

For Frontier, "being ready" means being prepared and tuned to the strategic transition underway and to your funds' individual transition path, and embracing it.

"Being ready" also means being focussed on the opportunities that will inevitably present to the new financial services businesses that will emerge from this strategic transition.

And, finally, "being ready" means having top quality partners and advisers that can recognise and help with the transition ahead.

Epilogue: The Strategic Transition. This graphic encapsulates the Frontier view of the evolution of superannuation funds in Australia. It shows the change from the end of the relatively benign, less complex, sheltered growth era in 2005, to the complex and challenging quasi steady state that is likely to eventuate for many funds from 2020 and onwards (if not before).



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