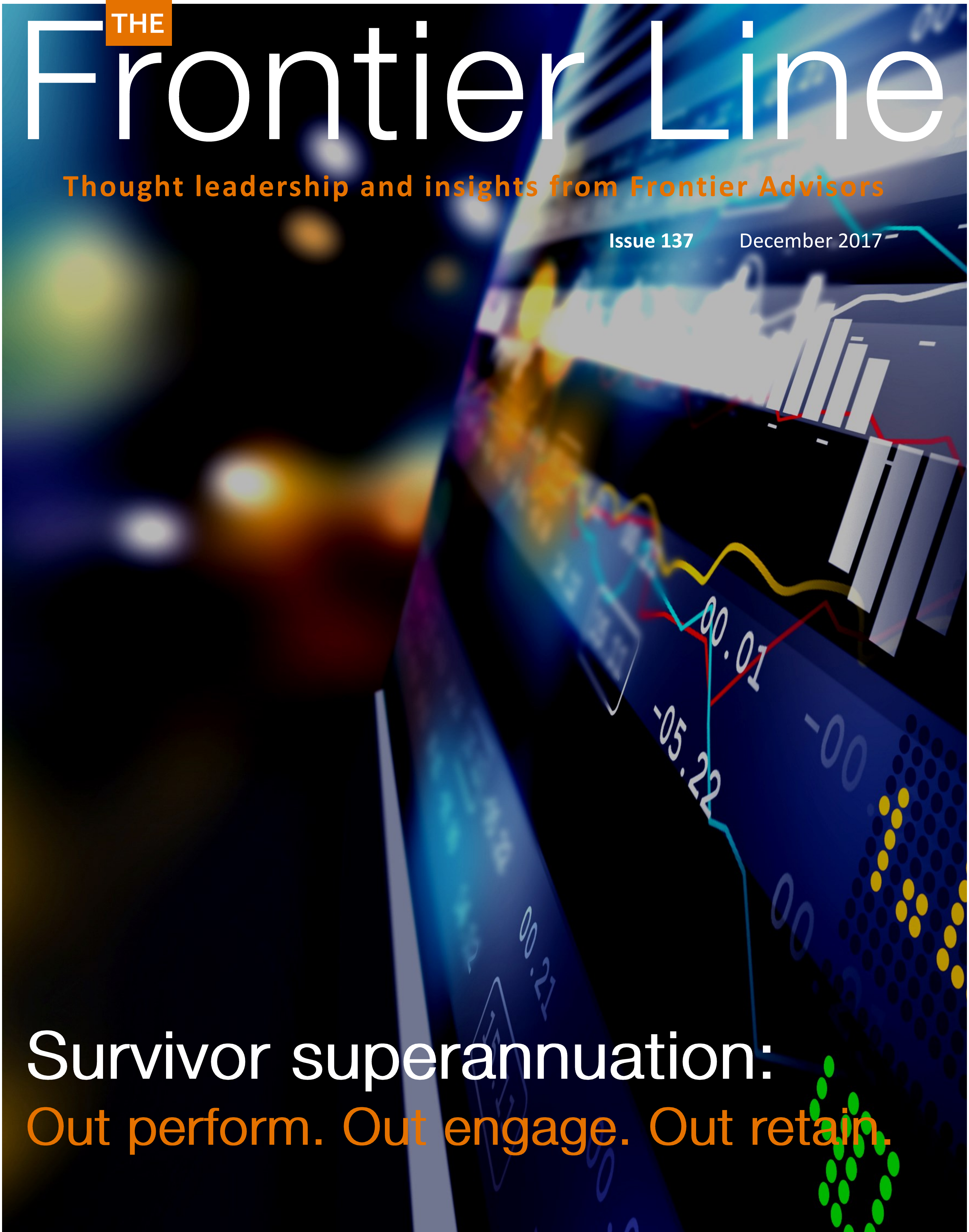
THE

Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 137 December 2017



Survivor superannuation:
Out perform. Out engage. Out retain.

FRONTIER
ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $265B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

David Carruthers

David is a Principal Consultant and is Head of Frontier's Member Solutions Group. He conducts research and provides advice in the area of retirement strategy and product development for superannuation funds.

Prior to Frontier David spent nineteen years at Mercer in roles that included global product management in the areas of Investment Data and Analytics and Wealth Management and in the design and implementation of Mercer's GIMD database. He also worked with Mercer in London as the Head of Investment Information Services for Europe and was a member of the Executive Group responsible for the operation of the UK practice. Prior to joining Mercer, David was at Towers Perrin for around six years, working with a number of clients in an investment advisory and research capacity. David holds a Bachelor of Economics from Macquarie University and is a Fellow of the Institute of Actuaries (in both the UK and Australia).

Survivor superannuation

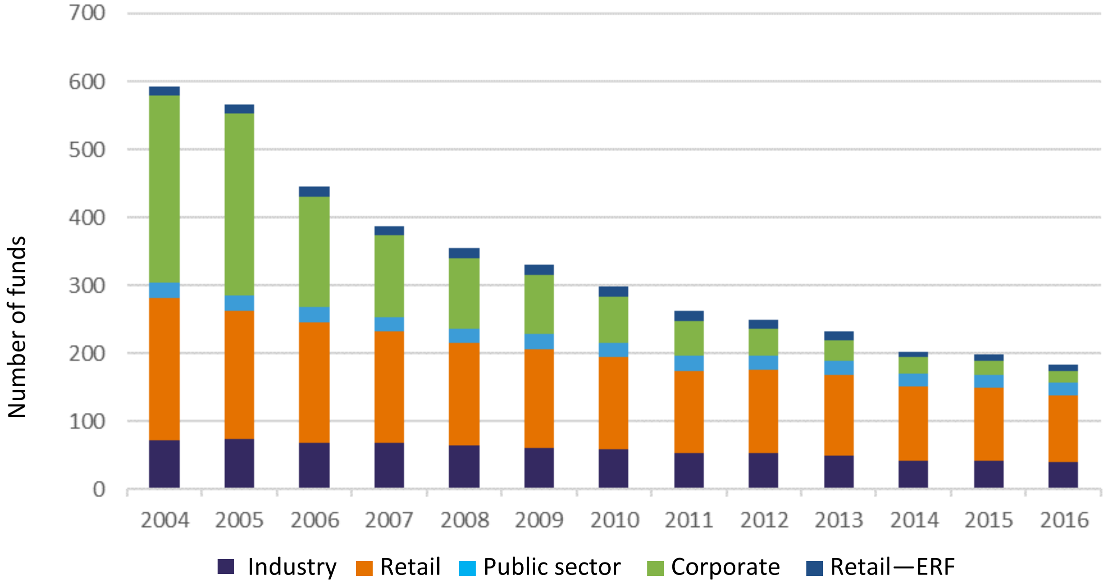
Superannuation funds continue to operate in a challenging environment. While investment markets have been relatively benign in recent years, declining membership, negative cash flow and government regulation continue unabated. With many in the industry predicting significant consolidation over the coming years, some funds are facing the prospect that their continued existence is under threat.

Despite the significant consolidation of the last 25 years, the introduction of MySuper requirements saw the number of fund mergers slow over the last few years. The chart below highlights the consolidation of funds (excluding SMSFs, small APRA funds and funds with non-disclosed assets) since the introduction of Choice of Fund legislation more than a decade ago.

We predict the pace of consolidation will pick up over the next few years. The Productivity Commission is assessing the competitiveness and efficiency of the superannuation system, and has put forward structures which would have a dramatic effect on the default fund market. APRA is assessing the quality of member outcomes, noting that "funds are facing sustainability challenges"[1]. The new member outcomes tests look to be giving APRA an increased ability to target poorly performing funds.

Recently we've seen a number of mergers announced:

- Transport Industry Super merged with Catholic Super in December 2016;
- Kinetic Super and RBA Officers' Super Fund are rolling into Sunsuper ;
- Rio Tinto announced that it was merging into Equip Super;
- ANZ sold its wealth management business to IOOF;
- Aon announced an alliance with Equity Trustees; and
- Concept One has merged with WA Super.



Source: APRA

[1] APRA Insight, Issue 1 2017

State of play

Based on the most recent APRA data released as at June 2017, there are 233 funds with more than four members. This is broken down in the table below.

Fund type	Number	Breakdown
Public sector	37	This includes 19 exempt public sector schemes
Corporate	27	2 funds with >$10 billion in assets 6 funds with between $1 billion and $10 billion 9 funds with assets confidentially reported
Industry	41	9 funds with >$10 billion in assets 24 funds with between $1 billion and $10 billion 6 non-public offer funds with less than $1 billion
Retail	117	27 funds with assets confidentially reported 25 bank/AMP/IOOF owned funds 12 non-public offer funds 33 funds using outsourced REs (2 >$10 billion) 20 Other – 1 >$10 billion – 11 between $1 billion and $10 billion
ERFs & ADFs	11	8 Eligible Rollover Funds 3 Approved Deposit Funds
Total	**233**	

Consolidation

For each fund type, we examine the degree to which consolidation is likely to occur.

Public sector funds

The majority of public sector funds are large, with only two of the 18 APRA-regulated funds having assets less than $1 billion. Five of the funds are Commonwealth entities, and it's unlikely they would be affected by consolidation.

The majority of the other funds are state-based. It is possible that two state-based funds merge to expand their geographic footprint and become a national fund. More likely, however, is that two funds from the same state combine.

That said, and despite the RBA fund's merger, fund consolidation in the public sector is likely to be low.

Corporate funds

In contrast to public sector funds, most corporate funds are small, with only four funds greater than $5 billion. This included the Rio Tinto fund, which made the decision to merge with Equip Super.

In our opinion, it's likely that many of these funds will:

- Merge with another fund;
- Outsource many of their services to outsourced providers; or
- Continue on in rundown mode. Currently nine of the existing corporate funds have so few assets, that APRA does not release their data "to maintain member privacy".

It's likely that the number of corporate funds will continue to reduce significantly.

Industry funds

The fund consolidation trend has largely bypassed industry funds to date. Since the introduction of MySuper, the number of industry funds has declined from 49 to 41.

It's highly unlikely that any of the largest industry funds will disappear – they are much more likely to be recipients of merger activity.

However, funds with less than $1 billion in assets will need to have consistently strong investment returns and low fees, and/or a strong and unique selling point to justify their continued existence. Concept One and Transport Super have already gone down the merger path in recent times.

Those funds with between $1 billion and $10 billion occupy the most interesting space. Those at the top end of this range are likely to be looking to takeover other funds to put themselves into the mega fund range. Funds at the bottom of the range will be trying to avoid their larger brethren and maybe looking for a "merger-of-equals". A few others, like Kinetic Super, will seek out mergers with a very large fund.

There will be consolidation within the industry fund category, but it's likely to be slower than APRA, and others, would like.

Retail funds

Retail funds account for over 50% of the funds, but only 36% of the total assets – reflecting that many retail funds are smaller.

Almost a quarter of the funds categorised as "retail" by APRA actually reflect a corporate membership and are best thought of as corporate funds. The majority of these funds are sufficiently small that APRA doesn't release their fund size due to member privacy. Few, if any, of these funds have a longer term future, but they may continue for many years until the last member has left the fund.

Another 20% of the retail funds are bank or large financial provider affiliated. For example, Westpac has ten superannuation funds across the BT, ASGARD, Westpac and Advance brands. Consolidation within providers will occur (and is already occurring), but it will be as a result of product rationalisation rather than consolidation pressures.

A further quarter of the funds are managed by outsourced responsible entities (such as Diversa). These funds consist of:

- The new disrupters, such as Spaceship Super and Grow Super. Often these are merely brands of the RE's superannuation fund;
- Adviser focussed offerings, aimed more at SMSF funds. HUB24 and Symetry are a couple of the more successful examples;
- A small number of large funds offered by full outsourced providers, such as Plum, Mercer and Russell.

Of the remainder of the retail funds (~30%), most have less than $2 billion in assets. Like other smaller funds, these funds will need to ensure that they are providing quality outcomes for their members. No doubt, APRA will take a close look at the fees these funds are charging their members and the resulting net returns.

Judging member outcomes

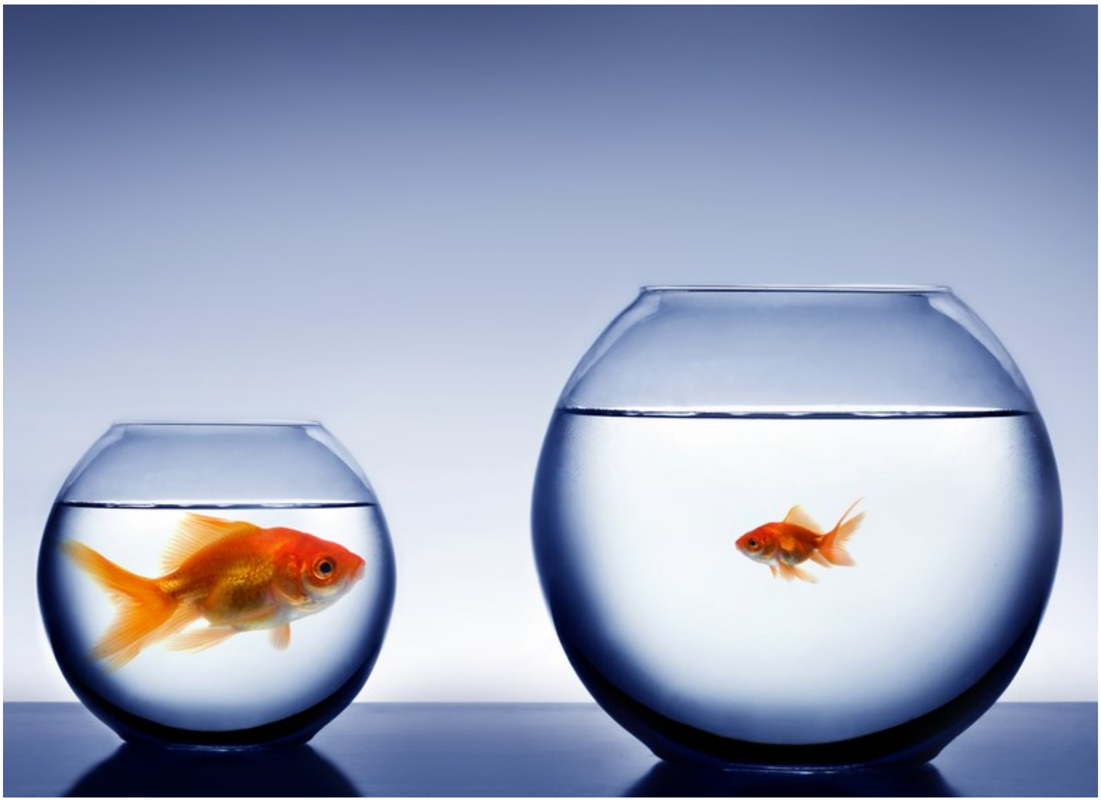
In July 2017, the Federal Government announced a package of measures, one of which was to "strengthen default MySuper products including a stronger annual assessment of MySuper product outcomes to ensure the investment and insurance strategies, fees, scale and returns are promoting the financial interests of MySuper members"[2].

The new legislation will provide APRA with greater powers to intervene in the running of super funds that are found to be in breach of their duties to act in their members' best interests. Specifically, the new member outcomes test replaces the "scale test", recognising that asset size is not the only determinant of a successful superannuation fund – indeed a number of smaller funds are providing better net returns than much larger funds.

The legislation, currently before parliament, will require MySuper funds to make an annual assessment that includes consideration of:

- Returns;
- Costs and fees;
- Investment strategy; and
- Insurance offerings.

The details of the assessment will be prescribed in regulations which have not yet been released. However, APRA highlighted four metrics in their letter to RSEs of 31 August 2017. These measures are not exhaustive and APRA has not formalised the calculation methodology, which will reportedly be reviewed and refined over time.



[2] Kelly O'Dwyer, Media Release 24 July 2017

Net cash flow

This chart shows improving and deteriorating net cash flow ratios for RSEs authorised to offer a MySuper product. The Y-axis shows the annual net cash flow ratio for financial year 2016, and the X-axis shows average net cash flow ratio for financial years between 2014 and 2016.

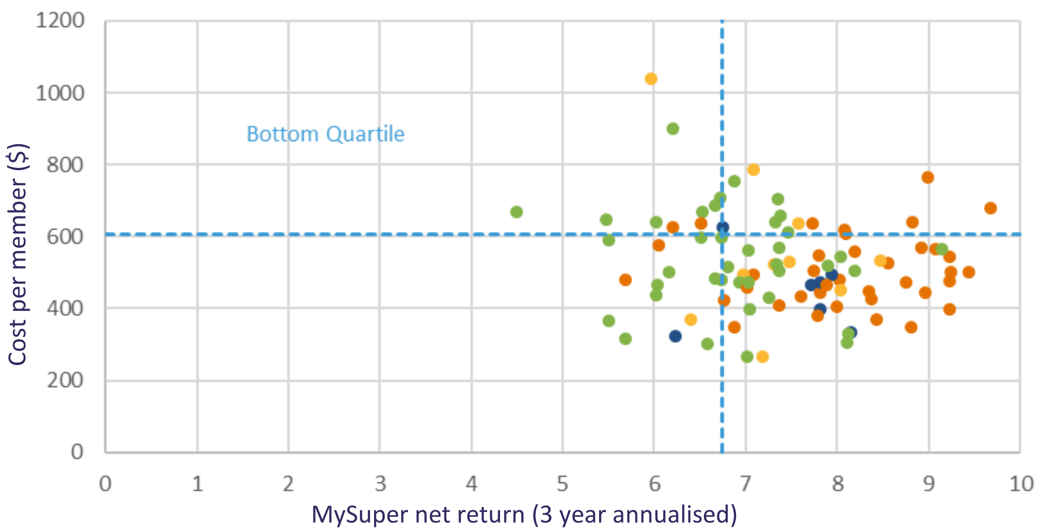
APRA will pay particular attention to RSEs where their net cash flow ratio is both negative and deteriorating.

Source: APRA, Frontier. 2016 financial year

Net return and fees

This chart represents financial outcomes for MySuper product members across different RSEs. The Y-axis shows cost per member as at June 2017, and the X-axis shows annualised net return of MySuper products for the three years to 30 June 2017.

APRA will pay particular attention to RSEs whose net returns of MySuper products are below the 25th percentile, and with costs per member above the 75th percentile.

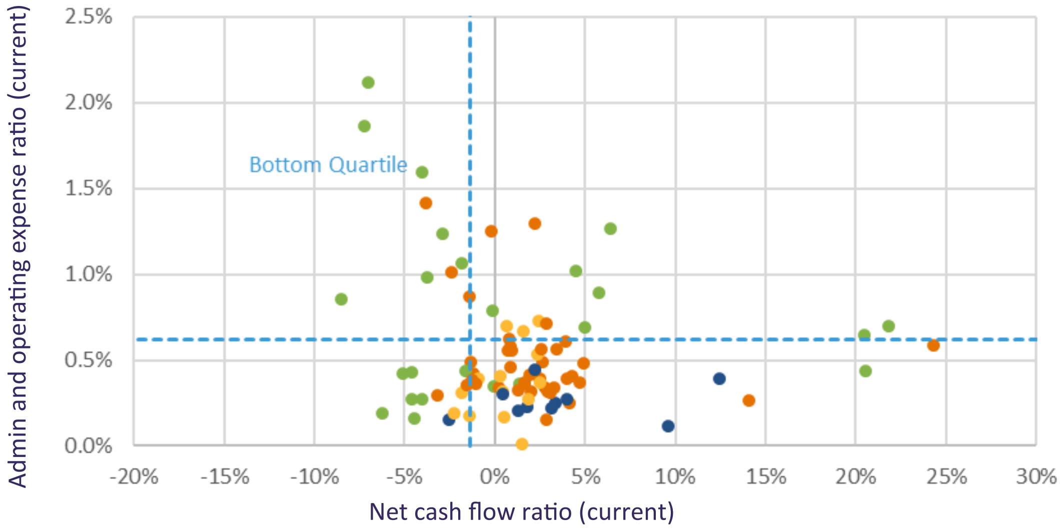


Source: APRA, Frontier. 30 June 2017

Cash flow and cost

This chart shows administration and operating expenses, and net cash flow ratios of RSEs authorised to offer a MySuper product. Both the Y- and X-axis show annual data for the year ended 30 June 2016.

APRA will pay particular attention to RSEs with negative net cash flow and high administration and operating expense ratios. Persistent negative net cash flows over time may lead to an increasing expense ratio as RSEs lose scale and fewer members absorb the same level of administration and operating costs.

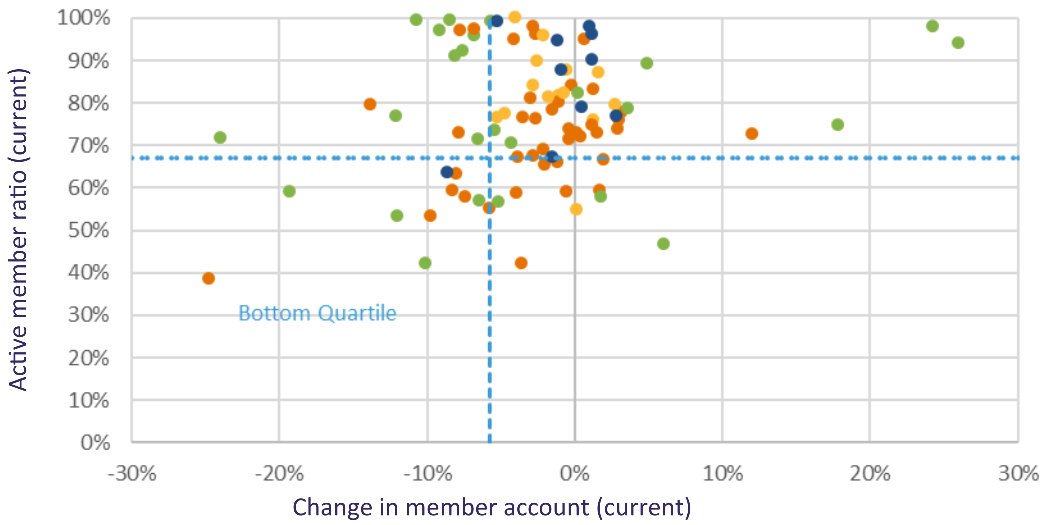


Source: APRA, Frontier. 2016 financial year

Member engagement

This chart shows the level of active membership and membership growth of RSEs authorised to offer a MySuper product. Both the Y- and X-axis show annual data for the 2016 financial year.

APRA will pay particular attention to RSEs with low levels of active membership and a declining membership base, given the potential implications with respect to member retention and ability to maintain scale.



Source: APRA, Frontier. 2016 financial year

The final word…

Despite significant consolidation over the last decade, as far back as 2015 APRA turned up the heat on consolidation saying it expected more mergers. Helen Rowell, deputy chairman of APRA, announced "APRA .. expects that there will be a continuation of the industry consolidation trend"[3].

The proposed member outcomes test provides APRA with a "larger stick" with which to force funds to transfer members to another fund, where their fund is unlikely to operate in the best interests of its members.

At a Senate estimates hearing in May this year, Ms Rowell said APRA had identified a target group of 20 to 25 MySuper fund in its sights.

Funds will need to ensure they have a robust, realistic business strategy to deliver quality member outcomes. After all, funds need to focus on acting in members' best interests rather than merely trying to survive for survival sake. Understanding how their fund looks against APRA's proposed metrics, together with a plan to address any weakness will be key.

[3] Australian Financial Review Banking and Wealth Summit, April 2015

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266