THE Frontier Line

Thought leadership and insights from Frontier Advisors

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Best in Show or Worst to Go?

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 $320B 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.

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Push for industry consolidation

There is an insatiable desire for consolidation of the Australian superannuation marketplace. This comes from regulators, politicians, industry bodies and other participants. The focus on what factors should drive that consolidation shift from choosing the best performing funds to removing the underperforming funds. However, identifying those funds that will either over or under perform in the future is no easy task, and it is paramount that members' interests are the primary consideration of any consolidation.

Compared to most other countries, the Australian superannuation marketplace is highly competitive.

There are less than 200 superannuation funds in Australia[1] (in addition, there are almost 600,000 SMSFs). In comparison, the US has nearly 555,000 employer sponsored retirement plans[2] and the UK has over 5,600 pension schemes[3]. At the other end of the scale, countries such as Singapore and Sweden have a state scheme which covers the majority of employees.

Over the ten years to June 2018, the number of APRA-regulated funds decreased from 466, a drop of around 60%. This consolidation has come with the explicit backing of APRA, which proclaimed as early as 2015 that "APRA's focus in the coming months will remain on ensuring that all trustees are proactively considering their future strategy and putting in place concrete plans to address the issues ahead. In some cases, this may mean planning for (a hopefully graceful) exit from the industry."[4]

The push for further consolidation came loudly from the Productivity Commission report, which noted that its proposed approach would "accelerate desirable industry consolidation"[5].

"We have (conservatively) estimated that cost savings of at least $1.8 billion a year could be realised if the 50 highest-cost funds merged with 10 of the lowest-cost funds".[6]

If, as it seems inevitable, further consolidation will occur, which funds will be in APRA's crosshairs? A few suggestions have been put forward by a range of groups within the industry:

- The current "scale test" which is aimed at the smallest funds.
- The most expensive funds should exit the industry.
- Employees should be defaulted into up to ten "best in show" funds.
- Entrenched underperforming funds should be forced to merge.
- A member outcomes test should sort the wheat from the chaff.

While each of these approaches looks superficially appealing, in practice there are a number of considerations which need to be understood. Indeed, there should be some evidence that any approach chosen will increase member outcomes and not simply reduce the number of funds.

[1] APRA Annual Superannuation Bulletin, June 2018

[2] Investment Company Institute, September 2018

[3] Pension Protection Fund, 2017-8

[4] https://www.apra.gov.au/media-centre/speeches/super-system-apras-watch-list

[5] Superannuation: Assessing Efficiency and Competitiveness – Productivity Commission, December 2018

[6] ibid

Small funds

Since 2013, trustees have been required to determine each year whether their MySuper product has access to sufficient scale, with respect to both assets and number of members. This requirement seeks to ensure that members of a particular MySuper product are not disadvantaged in comparison to members of other MySuper products.[7]

The obvious concern is that smaller funds will not have the scale and resources to efficiently provide services to their members; i.e. they will be more expensive than larger funds and/or they will provide inferior returns/services.

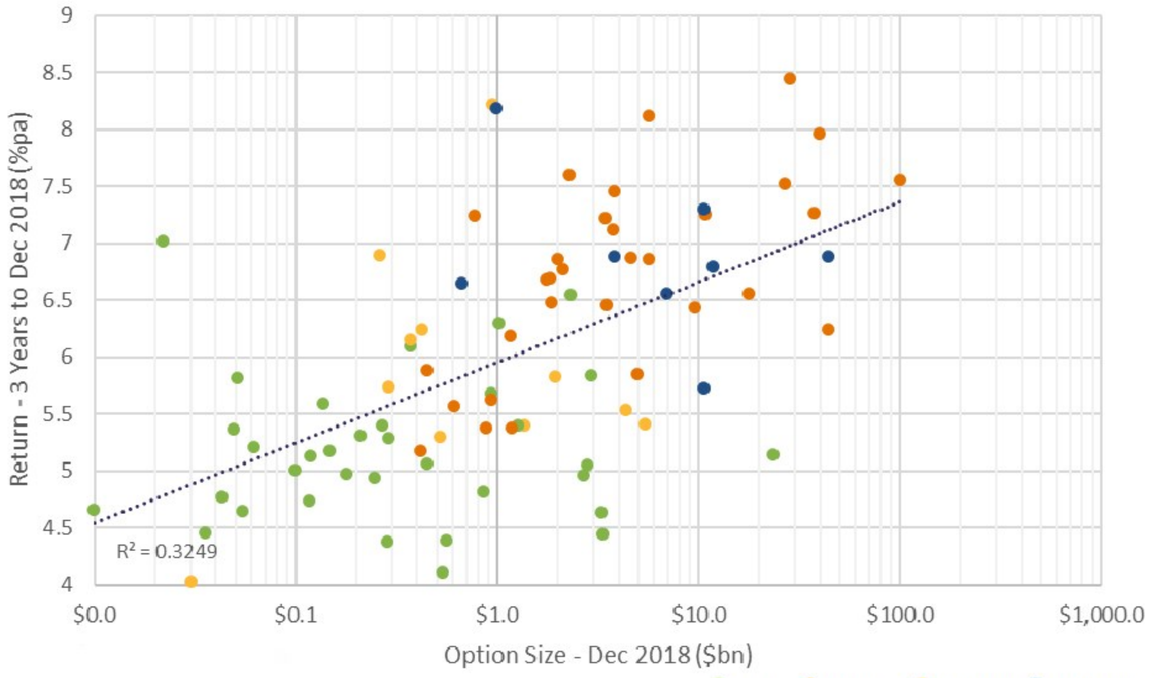
To test whether smaller funds have produced inferior investment returns, Chart 1 plots the relationship between the assets of each MySuper fund and its net return.

The analysis currently shows a clear relationship between the size of a fund and its three year return. Smaller funds have returned less than larger funds – funds with less than $1bn in assets returned 1% p.a. less on average than funds with more than $1bn.

However, not all smaller funds have underperformed, with two funds with about $1bn achieving amongst the highest returns over the past three years. Additionally, retail super funds dominate in the underperforming, smaller fund cohort, suggesting more factors than size are driving this performance differential.

In the next section we investigate whether this lower return for smaller funds is due to higher costs, or other reasons.

Chart1: Net Return versus Size



Source: SuperRatings, APRA, Frontier Advisors

[7]Section 29VN(b) of the SIS Act

Expensive funds

One of the reasons larger funds may have achieved higher returns is because they have lower costs. Whilst not specifically recommended by the Productivity Commission (PC), there is intuitive appeal in concentrating on the most expensive funds to make the superannuation industry more efficient.

Indeed, if the PC had followed this line of thinking, then the obvious recommendation would have dealt with SMSFs. As the PC report noted, smaller SMSFs (with less than $500,000 in assets) "perform significantly worse on average. This is mainly due to the materially higher average costs they incur (relative to assets) due to being small."[8]

Total costs

Leaving aside SMSFs, there are 44 superannuation funds with expenses (investment, administration and operating) greater than 1% of the scheme assets, based on 2018 APRA data.

Chart 1 highlights that smaller funds are in general more expensive than larger funds, indicating that there are some scale benefits.

Whilst the majority of the high cost funds are small, there are six funds which have more than $5 billion in assets and cost ratios greater than 1%.

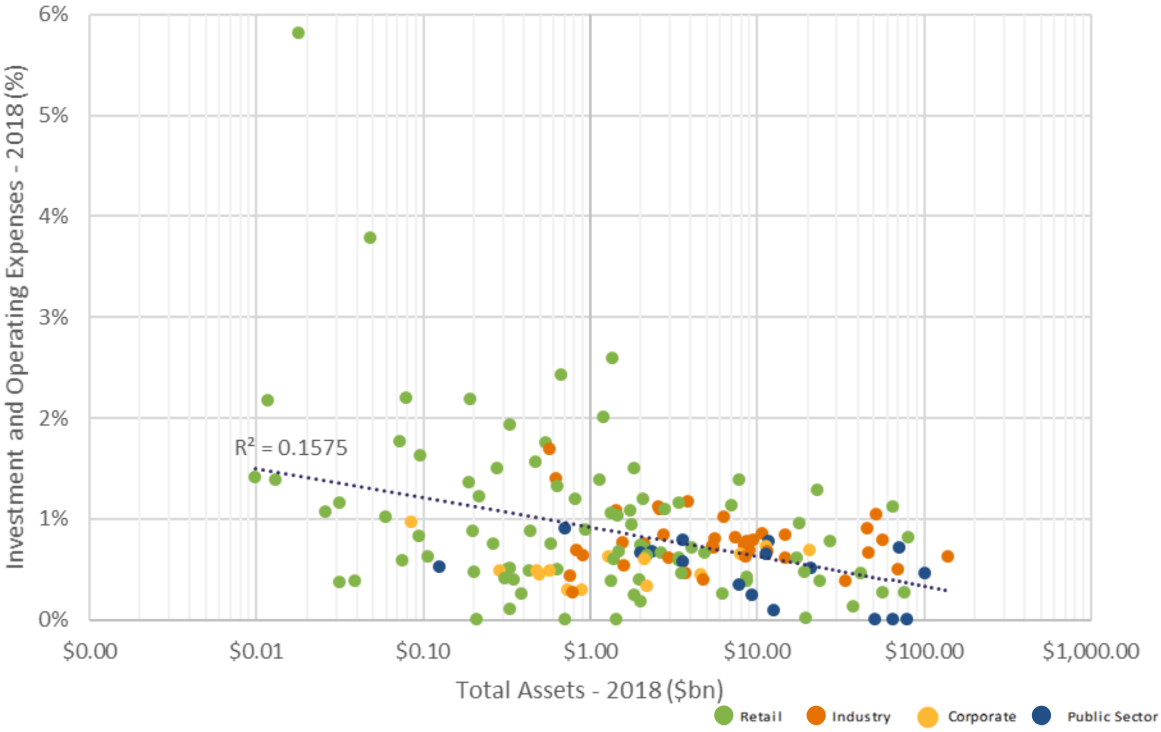
This includes Rest, Asgard and BT Funds, which all have more than $20 billion in assets – given their size it is difficult for these funds to merge with a larger fund to realise scale benefits.

Retail funds make up the majority of highest cost funds, accounting for 30 of the 44 high cost funds. This includes seven Eligible Rollover and Approved Deposit Funds, whose existence is challenged under the Protecting Your Super changes. It also includes a number of the new 'millennial-focused' funds.

Industry funds only account for eight higher cost funds, and this includes three funds which have announced merger proposals.

Interestingly, there are five funds which report no administration, operating or investment expenses – including the CSS and PSS funds.

Chart 2: Assets versus costs



Source: Frontier Advisors, APRA Annual Superannuation Bulletin Statistics – 2018

[8]Superannuation: Assessing Efficiency and Competitiveness – Productivity Commission, December 2018

MySuper Fees

A slightly different picture arises when analysing the fees charged to members of MySuper funds. For a start, not all funds analysed in the previous section offer a MySuper product. In addition, we compare the fee charged for a member with a balance of $50,000 (in line with the APRA reporting requirement).

Based on the 95 MySuper funds at December 2018, the average fee charged was $560 per annum – representing a fee of 1.12%. Indeed, only 23 funds offer a MySuper fund with a fee of less than 1% for a member with a balance of $50,000 – curiously this includes Rest, one of the highest cost funds.

Ultimately, members shouldn't be concerned if they are in a high fee fund, if the investment return after those fees more than compensates for the higher costs. It is the net returns that members should be comparing, rather than just the fees.

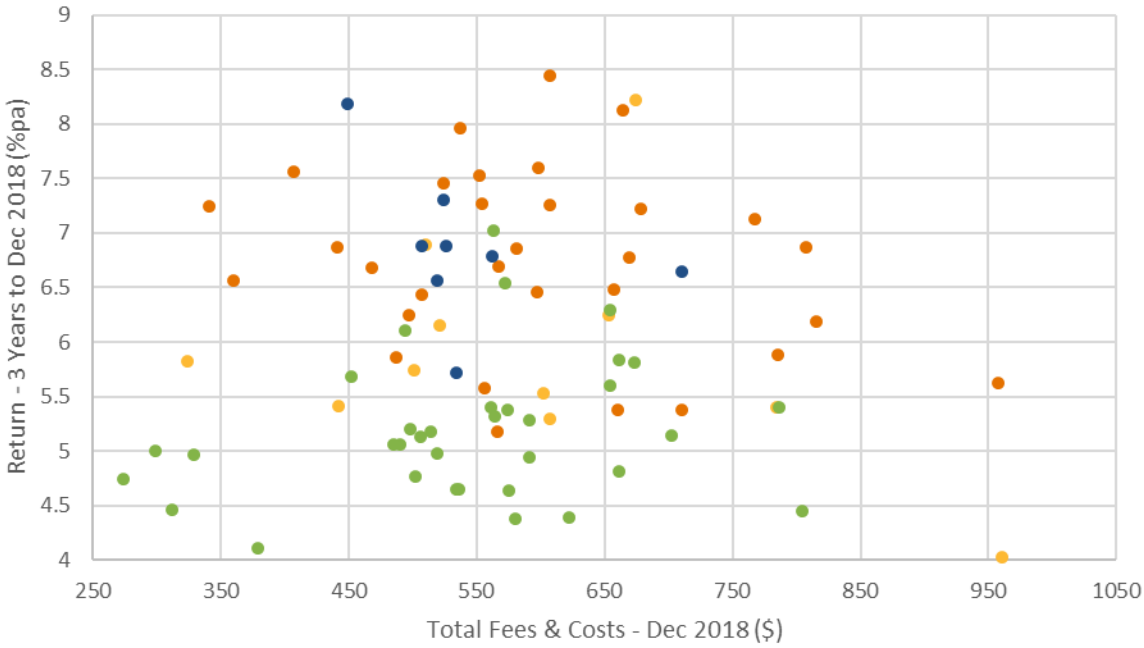
Interestingly, Chart 3 highlights there is no discernible relationship between the fee it charged for a MySuper product and the return it achieved after fees over the last three years. If fees were a key determinant of member outcomes, it would be expected that lower fee funds would have achieved higher returns after fees.

Of course, members will have higher and lower balances than $50,000 and this will affect the fee they are charged. Industry funds often charge a flat dollar amount (typically $78) for administration—this will result in a higher percentage fee for low balance members and a lower percentage fee for higher balance members. Conversely, retail funds usually charge a percentage fee for all members, which can appear relatively cheaper for low balance members and higher for high balance members.

One way a fund can keep its costs lower is to avoid investing in higher cost asset classes, such as property and infrastructure and/or invest passively. While not replicated here, Frontier's prior research into fees showed that investment fees have a weak positive correlation to net of fee return outcomes—suggesting that too great a focus on fees can be to the detriment of investment outcomes.

In the next section, we analyse investment performance in more detail.

Chart 3: Net return versus total fees & costs



Source: Frontier Advisors, APRA Quarterly MySuper Statistics—December 2018

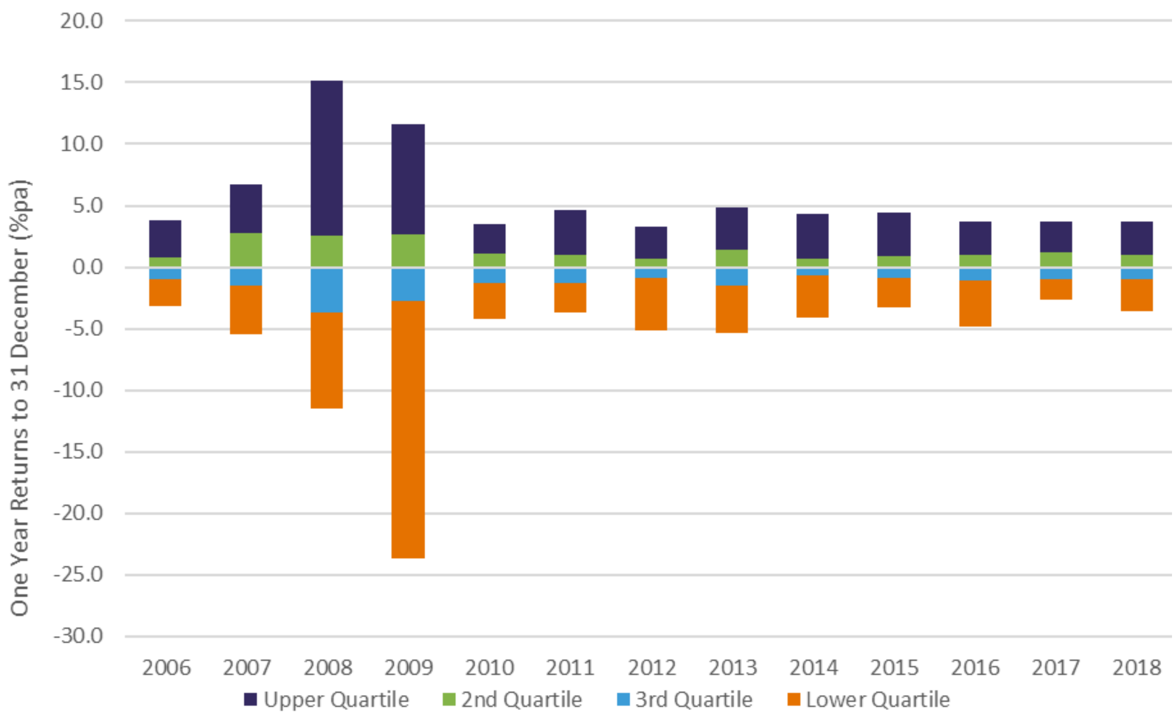
Investment performance

The investment returns a fund achieves will be the primary influence on a member's retirement benefit. Chart 4 highlights that there is a significant difference between the best performing fund and the worst in any year.

In most years, the difference between the best and worst funds ranges between 6-7% pa. However, the GFC saw a 35% difference.

The difference between a "good" fund (as characterised by a fund with upper quartile performance) and a "bad" fund (with lower quartile performance) typically averages around 2% p.a. If a fund was consistently in the upper quartile, this would result in significantly higher retirement benefits for that fund's members.

Chart 4: Excess returns



Source: Frontier Advisors, SuperRatings, Balanced (60-76) Funds

Identifying 'Best in Show' funds

Whilst not available to consumers, it is relatively easy for industry professionals to identify the best performing funds through surveys conducted by Chant West and SuperRatings. Choose your end date, your period of analysis and your peer group of funds and voilà. Choose a different end date, period or peer group and the results will be different, often markedly.

For example, the Table 1 identifies the top ten performing funds over the three years to June 2018, based on the SuperRatings SR50 Balanced Funds[9]. It also includes the ranking of those funds over the next six months and over the three years to December 2018.

The results of a 'best in show' list based on performance over three years to June 2018 would have been quite different if it had been based on performance over three years to December 2018.

As Table 1 shows, four of the top funds to June 2018 were no longer in the top ten just six months later.

This turn-around reflects how funds can be affected by different market conditions. The three years to June 2018 was generally characterised by good returns from equities and other growth assets. During this period, funds with a higher allocation to growth assets will have resulted in higher returns. The most recent six months (with negative equity returns) will have seen funds with higher equity allocations punished. A fund with a higher allocation to growth assets is not necessarily a "better" fund, just a higher risk fund.

Table 1: Performance Ranking

Fund	Rank: 3 Years to June 2018	Rank: 6 months to Dec 2018	Rank: 3 Years to Dec 2018
HOSTPLUS - Balanced	1st	35th	1st
Cbus - Growth (MySuper)	2nd	15th	3rd
AustralianSuper - MySuper Balanced	3rd	28th	5th
Catholic Super - Balanced (MySuper)	4th	36th	11th
Mercy Super - MySuper Balanced	5th	4th	2nd
CareSuper - Balanced	6th	20th	9th
Club Plus Super - MySuper	7th	7th	4th
UniSuper Accum - MySuper Balanced	8th	33rd	19th
Sunsuper for Life - Balanced	9th	8th	6th
AustSafe Super - MySuper (Balanced)	=10th	n/a	n/a
MTAA Super - My AutoSuper	=10th	29th	22nd

Source: Frontier Advisors, SuperRatings

[9] The SuperRatings SR50 survey does not include every super fund as not all funds elect to be in the survey. Some funds outside the survey, such as the First Super Balanced, have also performed well.

Identifying underperformers

Identifying the underperforming funds over the last three years is similarly easy. Whilst not naming the individual funds (lest this result in an unjustified run on these funds), eight of the worst performing funds over the three years to 30 June 2018 were retail funds. The two remaining funds were corporate funds.

Looking at the performance of these ten funds over the last six months highlights a different picture to the top performing funds. Eight of the worst performing funds over the three year period to June 2018 were also in the bottom ten funds over the subsequent six months (interestingly the two corporate funds jumped into the top 10 in this period).

Identifying persistent out and under performers

ASIC warns that "it may be misleading to imply that reliance on simple past performance figures would be a good way to select a financial product or service."[10]

To highlight that past performance is not necessarily a guide to the future, we analysed the outcome of choosing the best performing funds over the five years to December 2013.

We then tracked the performance of these funds over the following five years to December 2018. If past performance was a good guide, it would be expected that above average funds in the first period would remain above average in the second period.

Table 2 shows that if you chose an above average fund in the first five years, you had a 50% chance that this fund would be above average in the second period (i.e. no better than a toss of a coin). Almost a third of the above average performers become below average performers, and the remaining 20% were no longer in existence (typically having merged with another fund).

In contrast, if you chose a below average fund based on five year returns to 2013, 37% of these funds turned their performance around and become good performers. Similar to the above average funds, 30% were below average in the second period (i.e. poor in both periods) and one-third no longer existed.

Choosing a new fund (i.e. one which didn't have a five year track record to 2013) would not have been a good strategy – 63% of these funds underperformed.

Table 2: Performance consistency

	Five Years to December 2018			
	Above average	Below average	Exited	Total
Above Average	50%	30%	20%	100%
Below Average	37%	30%	33%	100%
New fund	37%	63%	-	100%

Source: Frontier Advisors, SuperRatings

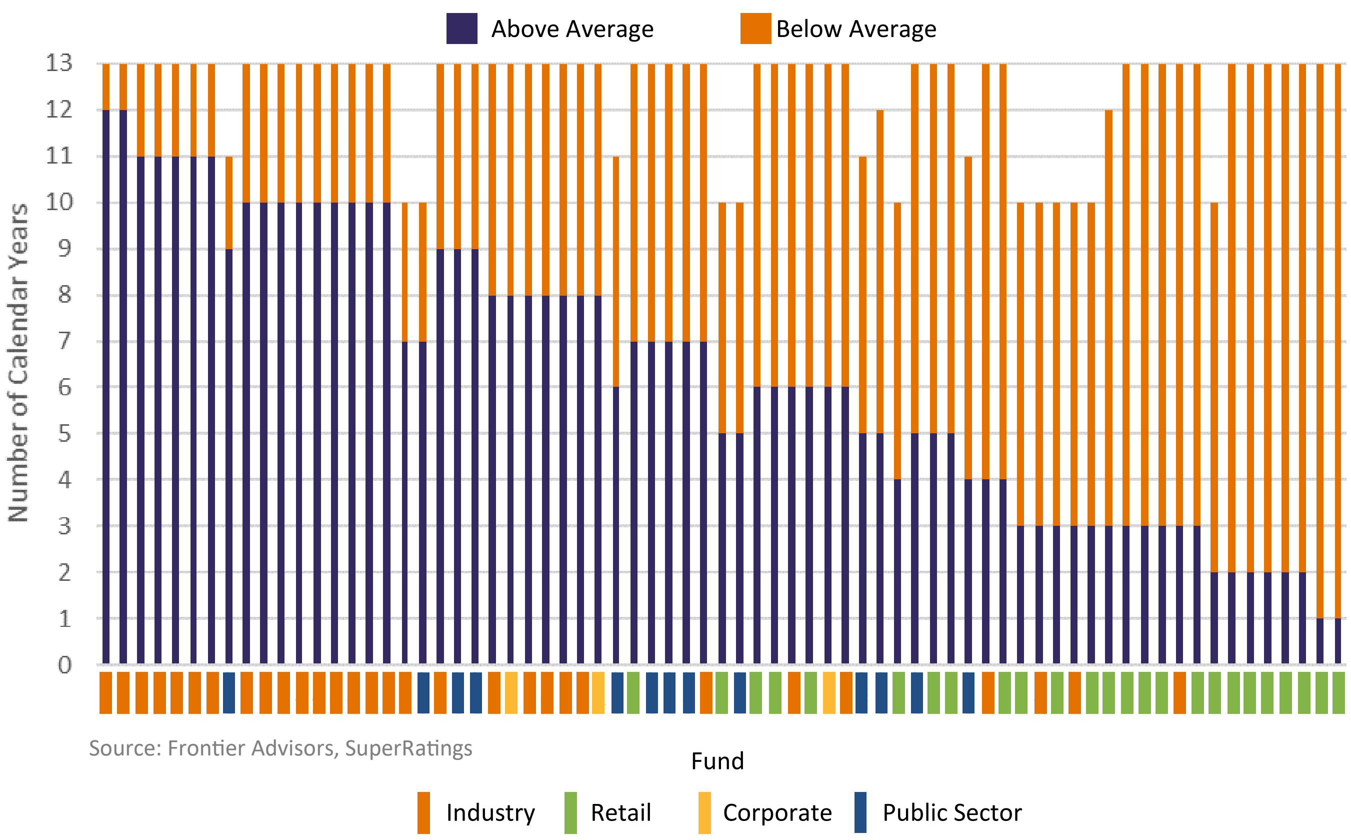
[10] ASIC RG53, The use of past performance in promotional material, July 2003

Another way to analyse performance persistence is to calculate the number of individual years a fund outperforms the average. Chart 5 below uses data over the last 13 calendar years since 2006, including only those funds which have at least ten years of history.

Two funds have outperformed in 12 of the 13 years and a further five in all but two years – remarkably consistent performance. At the other end of the scale, two funds underperformed in 12 of the 13 years and a further five in all but two years – remarkably persistent underperformance.

Industry funds make up 18 of the top 20 funds based on this measure. In contrast, retail funds account for 17 of the bottom 20 funds.

Chart 5: Annual performance



Source: Frontier Advisors, SuperRatings

Risk-adjustment

A question to consider is whether the top performing funds are "better" than other funds, or merely higher risk. Similarly, are the worst performing funds just taking less risk and therefore underperforming in bull markets?

There is no single definitive measure of risk – the level of risk the funds took to achieve their returns can be calculated in various ways:

Growth ratio – as growth assets are typically more risky than defensive assets, a fund with a higher growth ratio can be more risky, although this volatility may not show up in any particular year. Given funds self-report their growth allocation, this measure is open to some interpretation.

Standard Deviation – calculating the volatility of returns over the year provides one measure of risk, although measuring over longer periods will provide a better measure. Depending on the period, this measure can understate the risk taken by funds with higher allocations to unlisted investments as a result of valuation timeframes.

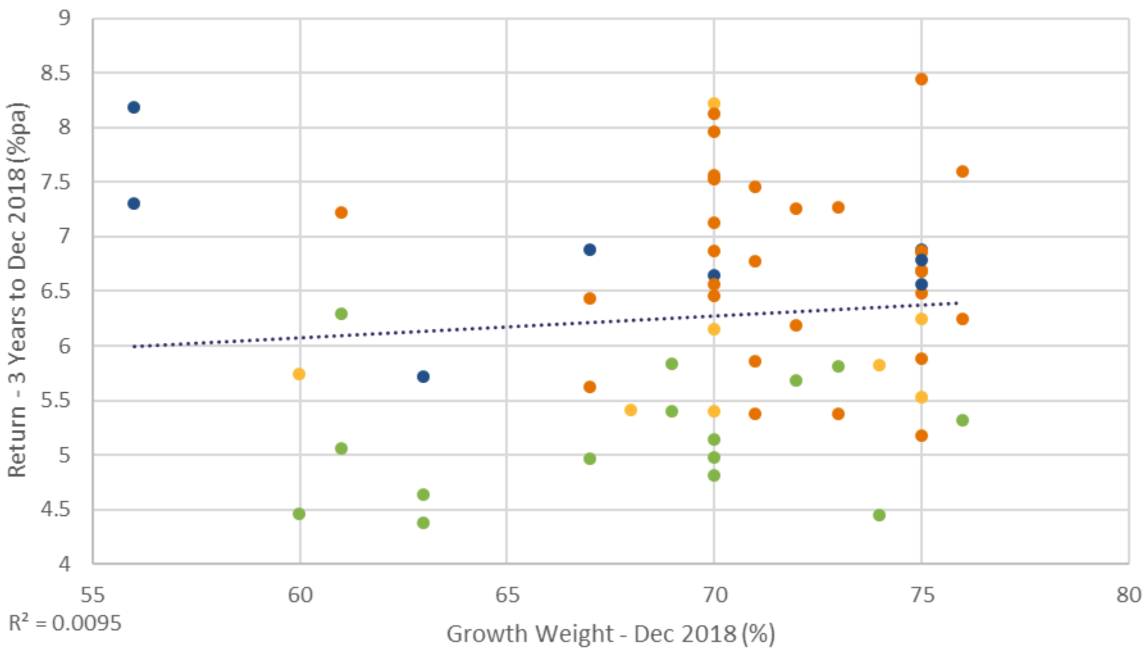
Standard Risk Measure – the expected number of negative returns in 20 years is another measure of investment risk.

Risk can be defined in other ways as well, with the ultimate risk for members being that their superannuation is not adequate for their retirement or that the fund is unable to pay benefits (for example due to liquidity issues).

Charts 6, 7 and 8 highlight the degree to which each of these measures of risk have affected funds' returns over the last three years.

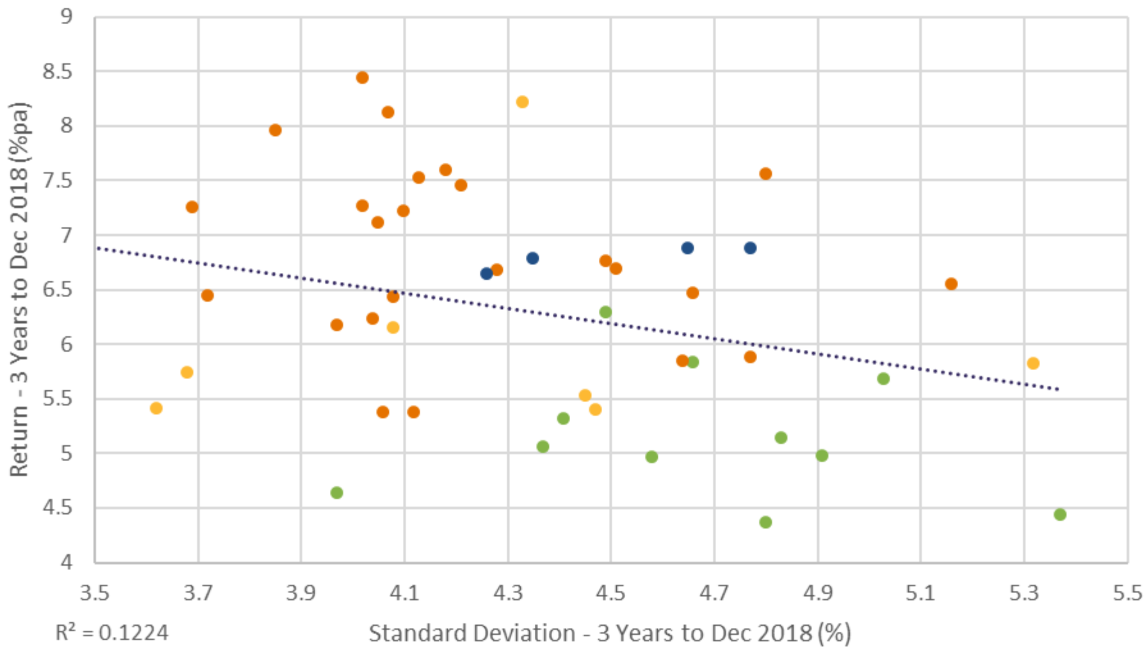
They also show a mixed view on the effect of risk on performance, but in all cases the relationship has been weak across the universe of funds. As much as anything, this reflects the difficulty in measuring investment risk. Investment risk measures are subject to calculation differences between fund, measurement difficulties and only provide one perspective on investment risk taking.

Chart 6: Net return versus growth allocation



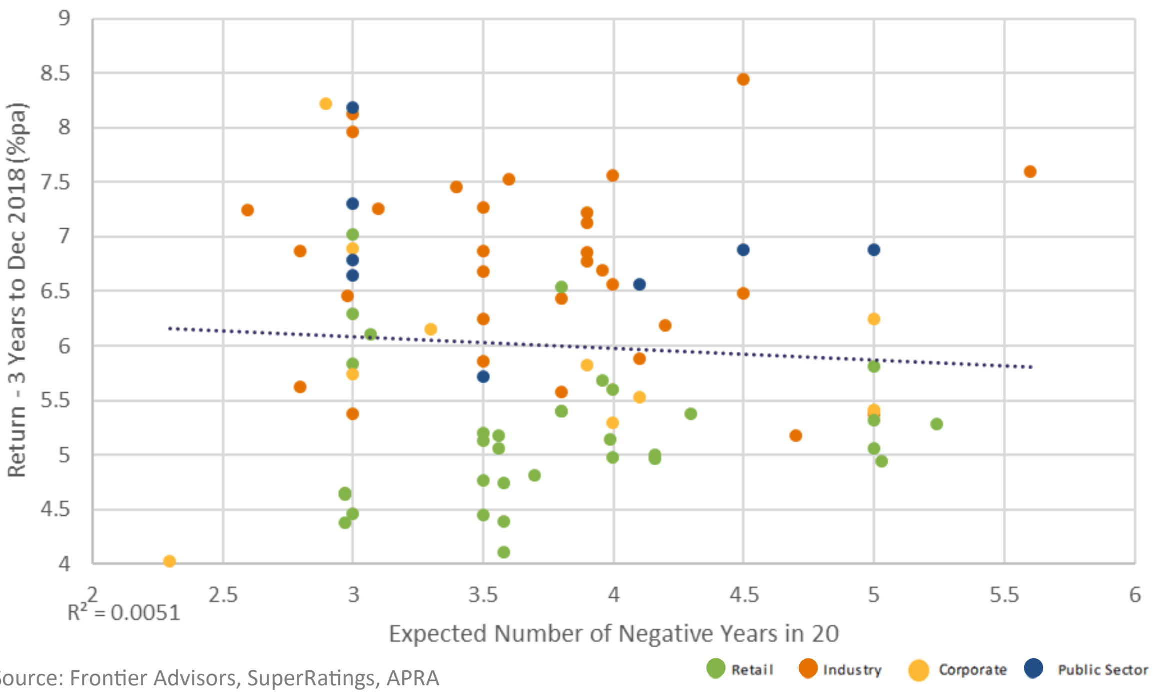
Source: Frontier Advisors, SuperRatings

Chart 7: Net return versus standard deviation



Source: Frontier Advisors, SuperRatings

Chart 8: Net return versus standard risk measure



Source: Frontier Advisors, SuperRatings, APRA

Member outcomes

APRA has recognised that scale is not the only factor that should be considered in assessing the quality and value of MySuper products. Any assessment of value for members needs to take a broader view that encompasses not just investment performance and fees, but also the nature and quality of the benefits and services being provided and the adequacy of the fund's governance and risk management frameworks and practices.

APRA notes that for many members, investment performance will be central to the assessment of outcomes achieved. However, in APRA's view, relying solely on net returns as a measure of outcomes, whether on a relative or absolute basis, is not sufficient.

Additionally, achieving reduced fees or costs may be an appropriate objective. However, seeking to provide the lowest relative fees and costs may not necessarily provide better outcomes for members over the long-term.

In August 2018 APRA wrote to trustees outlining their proposed methodology for assessing member outcomes and fund sustainability. After industry consultation, APRA released SPS 515 – Strategic Planning and Member Outcomes and SPG 516 – Outcomes Assessment, which will come into effect from January 2020.

SPG 516 outlines the metrics trustees need to consider to determine their outcomes assessment:

- Net investment returns, on an absolute basis, as well as relative to relevant benchmarks and risk/return targets over different time periods (e.g. one year, 3 years, 5 years and 10 years).
- Fee levels, including costs per member.
- Administration and operating expenses as a percentage of average net assets (operating cost ratio).
- Level and cost of insurance cover (by type of insurance), including measures of account erosion such as the premium as a percentage of salary or superannuation guarantee contribution.

In addition, APRA expects that forward-looking metrics will be a key component of the assessment, including:

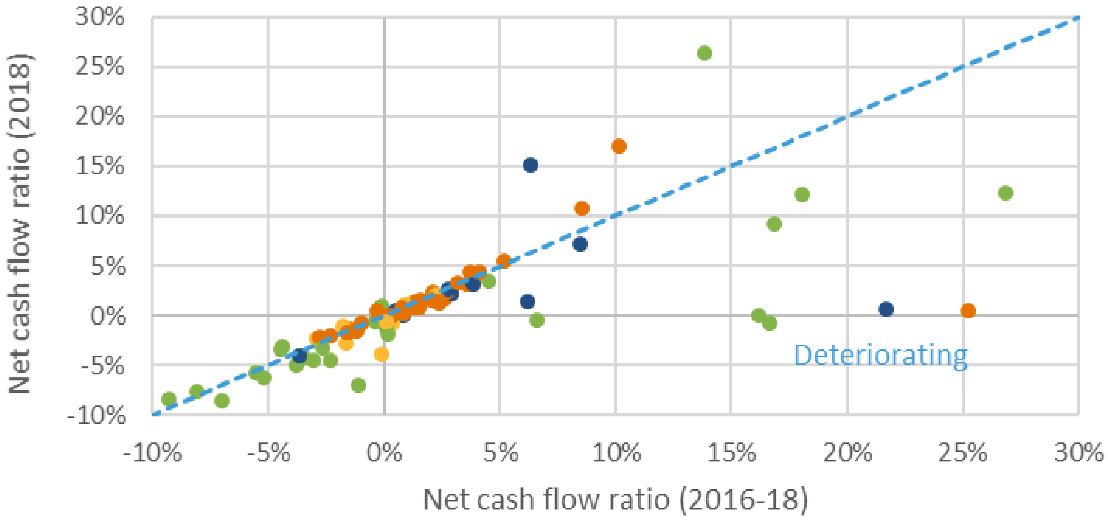
- Net cash flows as a percentage of average net assets (net cash flow ratio).
- Net member benefit outflow ratio.
- Net rollovers as a percentage of average net assets (net rollover ratio).
- Trends in membership base (such as number of members and accounts, and account balance size).
- Active member ratio.

APRA expects the assessment to be measured versus internal benchmarks and targets and additionally against external benchmarks (e.g. against other MySuper products in the market). The following charts show examples of the types of analysis that APRA is expecting.

APRA expects the outcomes assessment will have an integral role in informing each fund's strategic objectives and business plan. The assessment, as part of the annual review of the business plan, will provide a detailed understanding of whether a fund's business operations are delivering the outcomes it has sought for its members and is an important tool to identify areas for improvement.

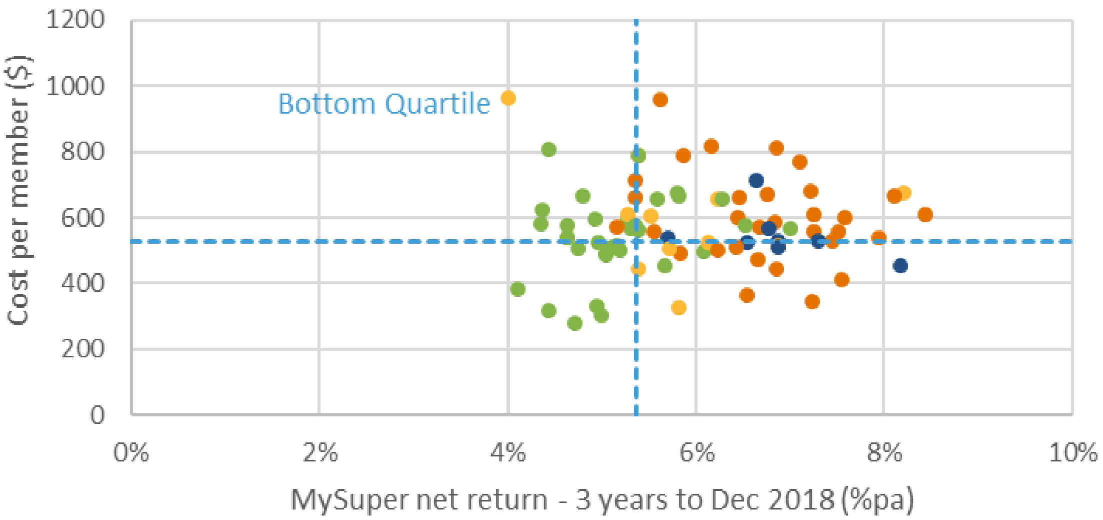
Where the outcomes assessment demonstrates a consistent pattern of underperformance in either absolute or relative terms, APRA expects the fund to actively consider whether continuing to operate in its current form is consistent with the fund's obligation to act in the best interests of members. Such funds should consider a merger or wind-up.

Chart 9: Net cash flows



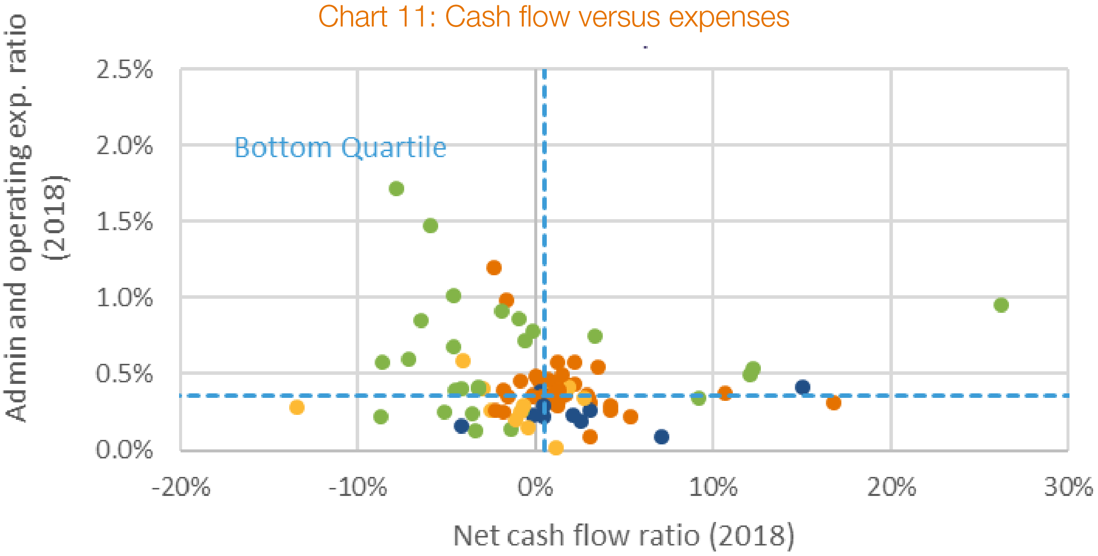
Source: Frontier Advisors, APRA

Chart 10: Net return versus costs



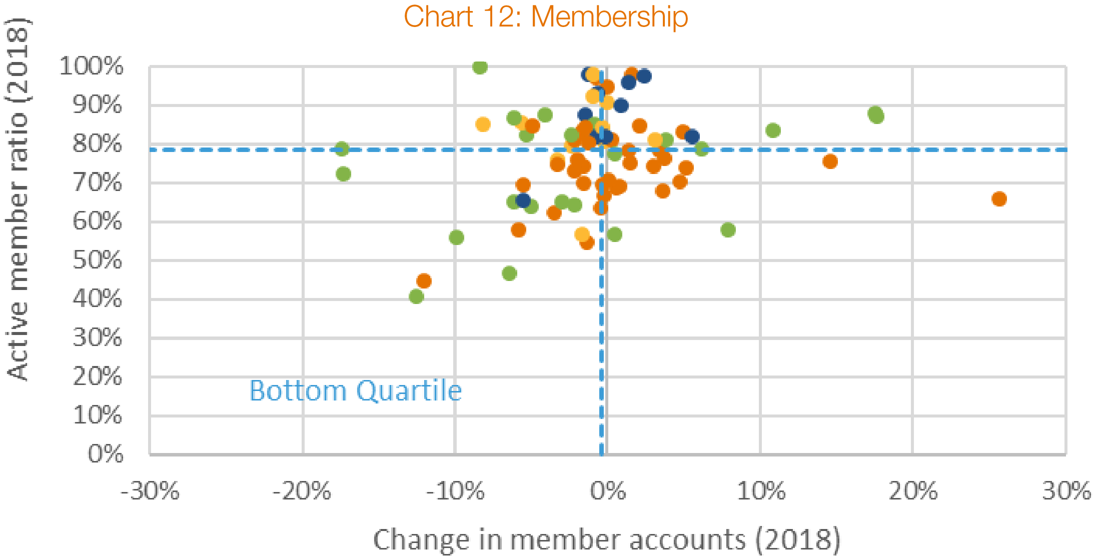
Source: Frontier Advisors, APRA

Chart 11: Cash flow versus expenses



Source: Frontier Advisors, APRA

Chart 12: Membership



Source: Frontier Advisors, APRA

The final word..

It is inevitable there will be further consolidation of the superannuation sector. The confluence of the Productivity Commission, Banking Royal Commission and a greater involvement by APRA will result in an increasing number of fund mergers.

Frontier supports improved efficiencies in the superannuation system.

Up until recently, merger discussions have been targeted at smaller funds. We think it is important to note that while there are certain efficiencies of scale achieved by larger funds, smaller funds have their own unique advantages and should not be discredited based purely on size.

We believe that a "best in show" approach as outlined by the Productivity Commission has the potential to introduce unintended consequences, such as a heavily peer-focused mindset, short-termism and diseconomies of scale.

Frontier believes the focus should be on the "worst" funds. However, identifying funds which will underperform in the future is no easier than selecting those which will out perform in the future. The devil will be in the detail to ensure that any test is not too prescriptive and easy to game.

As we've highlighted, a robust assessment across a wider range of factors is needed to be able to be satisfied that each fund is of appropriate quality and providing good value for its members. This would include:

- Investment performance measured across multiple time periods, and consideration of the level and nature of investment risk.
- Level of fees and costs, particularly where these are increasing.
- Size of assets and cashflow position, especially if the cashflow is negative.
- Fund governance, business management and trustee oversight.
- Other factors such as member services and other qualitative factors.

The focus should be on improved outcomes for members, not just less funds for the sake of it.

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