2 April 2019

Submission in Response to ASIC Consultation Paper 308
Review of RG 97: Disclosing fees and costs in PDSs and Periodic Statements
Part I

I welcome and appreciate the opportunity to comment on the proposals set out by ASIC in:

- Consultation Paper 308: Review of RG 97 Disclosing fees and costs in PDSs and periodic statements (CP 308, January 2019);
- Attachment 1 to CP 308: Draft Regulatory Guide 97; and
- Attachment 2 to CP 308: Draft Amendments to Corporations Regulations Schedule 10 – Disclosure of fees and other costs (Sch 10)

I also appreciate the invitation to describe alternative approaches that would better achieve the objectives of the Superannuation Regulation and Fee and Costs Disclosure Regime (Disclosure Regime). To this end I have also given consideration to:

- Final Report of the Super System Review (Cooper Review: 2010)
- Report 398: Fee and Cost Disclosure: Superannuation and managed investment products (July 2014);
- Report 581: Review of ASIC Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements (McShane: July 2018);

McShane observed that, "**The breadth and intensity of reactions received during industry engagement, and the very fact that ASIC has committed to this external Review, suggest that some directional change should be considered**, if it can be done in a manner that is consistent with the **higher, overall, objectives** of the fee disclosure regime" (Emphasis added. McShane, p32).

Further, ASIC notes that, "We are keen to fully understand and assess the financial and other impacts of our proposals".

These observations forms the basis for this Submission.

As the key components of the present Disclosure Regime can be traced back to the Cooper Review of the superannuation system, this submission focuses specifically on fee and cost disclosure in superannuation, however the substantive observations also apply to Managed Investment Scheme (MIS) products. This general approach is discussed by McShane and is embodied in Recommendation 5:

> "ASIC should keep in view the subsidiary objective of reducing or eliminating the differences between fee and cost disclosure appearing in PDSs for MIS and superannuation products", (McShane, p96).

This Submission is presented in two Parts. This Part I, presents an analysis of the current Fees and Costs Disclosure Regime and the proposed changes to Sch 10 and RG 97. A number of recommendations for modifications to the current Disclosure Regime that logically follow from that analysis are presented.

Part II, presents more subjective proposals / recommendations that represent my personal views about alterations to the Disclosure Regime that may contribute to meeting the objectives of regulation of superannuation and MIS funds.

Outcomes of the current Fees and Costs Disclosure Regime

The central premise of this Submission is that the current and proposed Disclosure Regime is flawed, and is therefore producing a number of adverse outcomes. Specifically:

1. Consumers do not receive usable information that will assist them in making informed Value for Money decisions
2. The Disclosure Regime is not focussed on optimising net investment returns and creating Value for Money outcomes for consumers.
3. Misleading signals are provided to trustees concerning investment decisions, resulting in detrimental effects on funds, and thus consumers', long-term outcomes.
4. The Disclosure Regime discourages Trustees from acting in the best interest of consumers, exposing them to the risk of legal censure.
5. The Disclosure Regime is complex, impractical and costly for the industry.

Terms Used

Before proceeding to the body of this submission, it will be worthwhile clarifying a number of definitional items:

- **Consumers**: Multiple terms are used to describe super fund members and/or investors across the Disclosure Regime related documents. For simplicity purposes I will adopt the generic term 'consumers' for investors in superannuation and MIS products.
- **Fees and Costs**: These terms appear to be used interchangeably by ASIC across the range of documents reviewed. For simplicity I will simply refer to **Costs** unless quoting from, or using a term defined in, a document.
- **Costs are expected to reduce returns**: Draft RG 97.283 defines, 'Indirect costs' as, "amounts that you know or reasonably ought to know (or may reasonably estimate) **have reduced or will reduce the return** on the relevant product or investment option".

  This clause echo's Clause 97.23 in the existing version of RG 97, and section 101A in the Draft Amendments to Sch 10.

  It is interesting that ASIC only explicitly refers to Costs reducing returns to consumers in these clauses / sections, even though the treatment of costs as decreasing returns is uniformly consistent across RG 97 and all of ASIC's Disclosure Regime documents.

  In this submission the term '**Costs'** refers only to payments, expenses, etc., that are **known or expected to reduce returns** to consumers **by the amount of the payment**.
- **Price:** Unlike a Cost, which is an absolute negative, there are numerous payments that are made, in superannuation and elsewhere, where some benefit is expected to be received in return. These payment amounts are referred to herein as the **Price paid for that expected benefit**.
- **Price of Investment Management**: As will be explained below, it is reasonable for trustees to expect that superannuation products will receive benefits – typically in the form of increased investment returns – for payments made to investment managers. Therefore, **payments for Investment Management services are a Price, not a Cost** (as defined above).

- **Risks and Returns of Investments and Portfolios, and the Risk/Return trade-off**: The usage of the concepts of risk and return as they relate to either a single investment or a portfolio (product) comprised of a number of single investments, is generally muddled throughout the Disclosure Regime, and other regulatory documents[1].

  Without delving into complicated derivations, it can simply be stated that the following relationships actually apply in investment markets:

  - Each **individual investment** has a level of expected Investment Return and a level of expected Investment Risk – using whichever generalised risk measure is adopted.

    In general, we expect that the more Investment Risk that is associated with an individual investment, the greater the expected Investment Return over time. This relationship is termed the Risk / Return Trade-Off.

    Importantly, **the Risk / Return Trade-Off only applies to individual investments**.

  - A **Portfolio** is made up of multiple individual investments.

    The Return of a portfolio (Portfolio Return) is simply the weighted sum of the Investment Returns earned by each individual investment.

    On the other hand, the expected level of Portfolio Risk is not a simple linear relationship, as it reflects the interaction (correlation) of the Investment Risks of all of the individual investments.

    Importantly**, the concept of the Risk / Return Trade-Off does not apply to Portfolios**.

    [This fact, while quite elementary, frequently seems counterintuitive. This is because people commonly only considered the very few portfolios that make up the so-called 'Efficient Frontier' of possible portfolios. By its construction, an Efficient Frontier is an upward sloping line, as it only includes the approximately 1% of all possible portfolios that have the highest expected (or historical) return for each level of portfolio volatility. (In his seminal 1952 article, 'Portfolio Selection', Markowitz described the set of possible portfolios as the 'Attainable Earnings / Volatility Combinations'[2].)]

  Thus, in this submission I use the terms:

  - **'Investment Return**' and '**Investment Risk**' when referring to an **individual investment**; and
  - '**Portfolio Return**' and '**Portfolio Risk**' when referring to a **portfolio or product**.

- Throughout this Submission bold text represents emphasis added.

[1] For example APRA Prudential Practice Guide SPG 530

[2] Markowitz, H. (1952). Portfolio Selection. The Journal of Finance, No7, pp. 77-91.

Objectives of the Fee and Cost Disclosure Regime

A starting point in assessing the current and proposed Disclosure Regime is to review the higher, overall objectives that it is seeking to achieve. There are several sources through which these objectives are expressed, including ASIC's CP 308 and Report 398, the McShane Review and, the Cooper Super System Review and subsequent Stronger Super Reforms.

1. Consultation Paper 308

The initial paragraphs of CP 308 set out ASIC's objectives for Sch 10 and RG 97:

> "Within the scope of ASIC's powers, we are committed to ensuring that consumers who actively seek information about fees and costs receive **transparent and usable** fees and costs information to help them to:
>
> (a) **make confident and informed value for money decisions**;
> (b) **compare products; and**
> (c**) understand the fees and costs charged to them**." (CP 308 para. 2)

ASIC also states that:

> "We also want to **make sure that the fees and costs disclosure regime is practicable for industry** while ensuring the consumer objectives in paragraph 2 are met." (CP 308 para. 3)

Subsequently, ASIC notes that:

> "The key considerations for the [McShane] Review were:
>
> (a) **the value of the information** currently required to be provided in PDSs and periodic statements in relation to fees and costs, and **whether this assists consumers in making an investment decision**;
>
> (b) the extent to which the current fees and costs regime results in disclosure **which assists consumers** (including by contributing to market analysis) **in comparing superannuation products and managed investment products**;
>
> (c) the **practicalities of producing information** required for disclosure of fees and costs under RG 97, including the **cost to consumers** of doing so as well as whether it might **lead to decisions adverse to the long-term interests of consumers**; and
>
> (d) how the legislative modifications and guidance outlined in RG 97 could be amended to **improve clarity and ease of implementation**." (CP 308 p9-10)

Given the above, it would appear that ASIC's objectives for the Disclosure Regime, as defined in CP 308, can be summarised as being to ensure that:

i. Consumers receive usable information to assist them to make informed investment decisions;
ii. Consumers receive usable information that helps them to understand fees and costs charged to them;
iii. Consumers receive usable information that assists them in comparing superannuation and MIS products;
iv. The Disclosure Regime does not lead to decisions adverse to the long-term interests of consumers;
v. The Disclosure Regime is practicable for industry.

2. McShane External Review

McShane restates the above key areas of analysis (CP308 p9-10) and notes that the Review was conducted within the following Policy Framework" (McShane, p7)

> "**The starting premise is that fees and costs matter**, particularly in long-term savings vehicles where the effect of fees and costs compound and can have a substantial impact on consumer outcomes over time."
>
> "**Given that cost impacts matter**, it necessarily follows that **costs are a factor that should be taken into account when a consumer makes a decision about a financial product**."

Within the policy framework set out above, the objectives of fee disclosure are assessed by McShane as having one primary and three secondary objectives: (McShane, p7-8)

1) **the primary objective is providing consumers with information that they can use in making more confident and informed value-for-money decisions**;
2) secondary objectives of:
    a. framing the nature of the relationship between product providers and consumers;
    b. verifying how contributions and earnings will and have been used; and
    c. the provision of data and information about fund operations in a manner that can support analysis and policy development.

McShane also noted the constraint imposed in his review that:

> "To the extent that **the regulatory direction is constrained by the need to deliver the interpretation of the Stronger Super Reforms that ASIC has applied, then it is difficult to depart from the current approach or suggest any material changes to it**." (McShane p8)

Further, McShane observed that:

> "the primary policy objective of improving transparency of cost impacts is to **provide consumers with accurate and usable information** about cost impacts at the **level relevant to the decision being made** so that they can … more accurately and effectively make **informed decisions** incorporating those cost impacts." (McShane p28-29)

Moreover, as McShane notes, the main objective of section 760A of the Corporations Act is to promote:

> "**confident and informed decision making** by consumers of financial products and services while **facilitating efficiency, flexibility and innovation** in the provision of those services".

Importantly, McShane links the Fee and Cost Disclosure Regime to Stronger Super Legislation, and hence to the Cooper Review.

McShane therefore added the following three (3) additional objectives to those expressed by ASIC:

vi. Framing the nature of the relationship between product providers and consumers;
vii. The provision of data and information about fund operations in a manner that can support analysis and policy development; and
viii. Facilitating efficiency, flexibility and innovation in the provision of [financial products and] services.

3. **Report 398: Fee and cost disclosure: Superannuation and managed investment products.**

ASIC's Report 398, released in 2014, examined industry practices of superannuation and managed investment product issuers in relation to fee and cost disclosure. It noted that:

> "The intention of the fee and cost disclosure requirements is to **promote comparability of products**." (Report 398 para. 3)

The purpose of the project undertaken by ASIC is described as:

> "Consistent and accurate fee and cost disclosure is an important aspect of the disclosure framework. **It allows investors to accurately compare the products available to them and determine whether a particular product represents value for money.** It can also help them to decide how to use a product" (Report 398 para. 9)
>
> "Inconsistent and inaccurate fee and cost disclosure makes it difficult for investors to make informed decisions about their investments, and can reduce their confidence in the industry." (Report 398 para. 10)

ASIC identified and sought to address Key Issues, including:

> "One of the key objectives of the Stronger Super reforms was to **create a consistent disclosure regime** that **allows investors to easily and accurately compare fees between superannuation funds. The failure to achieve this poses significant risk to investors and undermines the rationale of the Stronger Super reforms**." (Report 398 para. 99)

Essentially, the objectives set out in Report 398 are consistent with those expressed by McShane and by ASIC in CP 308, however it is notable that in Report 398 ASIC recognises the risks to consumers' outcomes if the Disclosure Regime fails to achieve its objectives.

4. **Cooper Review: Objectives of Stronger Super and RG 97**

The core objectives of Superannuation Legislations, as they relate to fee disclosure, are derived from the Cooper Review as implemented via the Stronger Super Reforms. Cooper noted in its Super Policy Principles (Cooper, p4) that:

- "Transparency and disclosure are essential for the effective operation of the system, but **are not substitutes for well-designed products that work in members' interests**. Disclosure is a necessary, but not a sufficient, condition for ensuring that member interests prevail."

- **“Fees and costs matter**; they **detract from members’ retirement savings** and need to be **managed as diligently as the generation of investment returns**. Technological improvements, and innovation generally, should be encouraged to help lower costs and benefit members.”
- **“Governments should not seek** to direct super fund trustees to invest in particular assets or asset classes, nor **to prevent investments in certain types of assets or asset classes** unless there are prudential or regulatory reasons for doing so. This is regardless of how much it might seem in the national interest to do so.”

Philosophical framework of MySuper and the choice architecture model (Cooper, p9)

- “the **default setting** must always be one that reflects a positive judgment about the **most appropriate outcome for the consumer** (member) **in the eyes of the product provider** (being the trustee in the case of a superannuation fund).”
- “The aim of MySuper is **lowering overall costs** for members while supporting and encouraging a competitive market-based, private sector infrastructure for superannuation. The Panel’s objective is **to make super better value for money** and MySuper is designed with this in mind.”
- “While the Panel has not recommended a cap on fees, the Panel has recommended changes in legislation and regulation to **make fees more transparent and to assist members to compare fees across the industry**.”
- “MySuper includes a range of additional regulatory requirements which are designed to ensure that the trustee is truly accountable to members, that **the trustee is unfettered in its pursuit of the best interests of members** and that the costs of delivering MySuper are contained.” (Cooper, p10)
- “The MySuper product is intended to provide **a simple superannuation option** for members. It will be treated, for some purposes, as separate from other types of superannuation products, and operated so that **member interests are transparently paramount** and there will be an **enhanced focus on optimising net investment returns and reducing overall costs**.” (Cooper, p10)

The Cooper Review set out the following as key Objectives related to fees and costs:

i. Promote well-designed products that work in members best interests, as disclosure alone does not ensure that members interests prevail;
ii. The default setting must always be one that reflects a positive judgment about the most appropriate outcome for the consumer in the eyes of the product provider;
iii. Ensure there will be an enhanced focus on optimising net investment returns and reducing overall costs;
iv. Ensure that the generation of investment returns is managed diligently;
v. Ensure that the trustee is truly accountable to members;
vi. Ensure that the trustee is unfettered in its pursuit of the best interests of members;
vii. Ensure that disclosure does not distort products so that they do not work in members’ interests; and
viii. Governments should not seek to direct super fund trustees to invest in particular assets or asset classes, nor to prevent investments in certain types of assets or asset classes.

Taking the eight (8) objectives identified by ASIC in (CP 308 and Report 398), and McShane, along with the eight (8) set out in the Cooper Review (& Stronger Super), four (4) Core Objectives of the Cost and Fee Disclosure Regime can be identified and summarised as:

A. Value for Money

i. To make super better value for money.

ii. To ensure there will be an enhanced focus on optimising net investment returns and reducing overall costs.

B. Informed Investment Decisions by Consumers

iii. To ensure that consumers receive usable information to assist them to make informed investment decisions.

iv. To assist members to understand and compare fees across the industry.

C. Best Interests of Consumers

v. To ensure that the trustee is unfettered in its pursuit of the best interests of members;

vi. To facilitating efficiency, flexibility and innovation in the provision of financial products and services.

vii. To ensure that the Disclosure Regime does not lead to decisions adverse to the long-term interests of consumers (by distorting products so that they do not work in members' interests).

D. Practical for the Industry

viii. To ensure that the Disclosure Regime is practicable for the industry.

In reality the Disclosure Regime is failing to achieve any of these core objectives, when it comes to the long-term return / benefit of consumers, identified by ASIC and the Cooper Review. The principal source of these failures is the flawed treatment of the Price of Investment Management as a Cost that is deemed to reduce investment returns by 100% of the expenditure.

This view is echoed by many across the industry:

- "The introduction of RG 97 in September 2017 introduced significant distortions into fees and costs comparisons between funds".[3]
- David Hartley[4] (Retired Chief Investment Officer of Sunsuper, Director and Chair of the Investment Committee of Australian Catholic Superannuation Retirement Fund), noted that, "Current fee disclosure in the Australian superannuation industry is not transparent", which thereby creates, "compromised fiduciary duty", on the part of RSE's.

  Furthermore, Mr Hartley notes that the current fee disclosure regime, "is also encouraging investment strategies that will become increasingly concentrated in a narrow range of strategies, such as passive investment in a narrow range of publicly traded securities. The concentration of strategies introduces systemic risks to the economy. At the same time, other investment opportunities that could enhance the broader economy will remain starved of capital".

[3] Chant West Pension Fee Survey, December 2018
[4] Hartley, D. "Individual Submission to Australian Government Productivity Commission", (20 April 2016)

- Russell Clarke[5] (at the time, Chair of the global investment committee for Mercer's implemented investment portfolio) stated that the, "pressure to lower management fees across all asset classes in Australia had become extreme in the past three years and was threatening to negatively impact net-of-fee returns because [superannuation] funds were altering asset mixes away from more expensive, potentially higher returning, asset classes".
- Greg Bright[6] (Managing Director and Publisher, Investor Strategy News) noted that, "A major looming problem for super funds is that the very best managers in the world are not going to bother offering their services to Australian funds. Anecdotally, some have already started to ignore Australia in their asset-gathering activities. They are reserving precious capacity for other investors".

This Part I of this Submission addresses how this failure of the Disclosure regime to promote the desired objectives occurred, in two sections:

A. Issues related to the Cooper Review's analysis and recommendations; and
B. Issues related to the implementation of the Cooper Review's recommendations.

Analysis

A. Issues related to the Cooper Review's analysis and recommendations

There are, in hindsight, a number of issues with the analysis underpinning the Cooper Review's conclusions and hence recommendations. These include:

i. Manager Returns and Consistency

On page 75 the Cooper Review states, "The Panel is aware of the ongoing debate about whether there are fund managers that can consistently beat the market, after costs and taxes have been taken into account."

Reference is made to a number of publications and articles under Endnote 2 (page 91). Specific commentary on these publications and articles are set out in Annexure 1 to this Submission.

In summary, the results from the referenced material are not definitive, and in some cases are highly qualified by data issues such as the use of retail products.

On the question of **managers' ability to add value after fees**, there was some reported evidence of positive alphas (value added after fees), and some of negative alphas. In most cases, while there may have been limited evidence of statistically significant outperformance, there was also **no evidence of statistically significant underperformance**.

Thus, there was **no evidence to support the Disclosure Regime's treatment of the Price of Investment Management as a Cost that reduces investment returns by 100% of the expenditure.**

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[5] Clarke, R. "Mercer gets behind concerns over fee pressure". Investor Strategy News, (17 July 2016). www.ioandc.com/mercer-gets-behind-concerns-over-fee-pressure/

[6] Bright, G. "The ramifications of a 'relentless focus on costs and fees'". Investor Strategy News, (7 August 2016), www.ioandc.com/the-ramifications-of-a-relentlessfocus-on-costs-and-fees/

On the question of the **consistency of managers' performance** the 'debate' and level of analysis has moved on considerably since the time of the Cooper Review. As explained in my attached Research Notes ('Consistency of Manager Performance'[7] (see Annexure 4), and 'S&P Persistence June 2018'[8] (see Annexure 5)) virtually all previous 'analysis' of the consistency of manager performance (including that referenced in the Cooper Review) actually only assessed whether investment markets are static - a standard assumption of modern finance theory – which they are not in reality.

There is strong evidence that investment managers available to Australian superannuation funds do in fact perform consistently, and can therefore be selected in advance by trustees employing appropriate analysis and diligence.

ii. Ability of trustees to select managers who will outperform

The Cooper Review (page 75) notes. "In the superannuation context, there is the further complication of whether trustees **can pick in advance who those managers are going to be** [that will be able to beat the market, after costs and taxes have been taken into account]".

Reference is made to a number of publications and articles under Endnote 3 (page 91). Specific commentary on these publications and articles are set out in Annexure 2 to this Submission.

In summary, the 'evidence' presented in these articles is equivocal at best, although some results indicated that larger and more 'institutional' funds outperformed benchmark portfolios – and thus were successful at selecting managers who outperformed

Further, there is strong direct evidence that Australian Superannuation funds have successfully selected investment managers that add value after fees. This is illustrated in:

a) The article 'Three key issues with S&P's index vs passive scorecard'[9] (see Annexure 6); and
b) The Research Note 'The End of Active vs Passive'[10] (see Annexure 7)[11]

Of most relevance to the Disclosure Regime and this Submission is that none of the research referenced in the Cooper Review, or elsewhere, has found that trustee appointment of investment managers have reduced fund returns by 100% of the Price paid for Investment Management.

Thus**, the current Disclosure Regime's treatment of the Price of Investment Management as a Cost** - which reduces portfolio and product returns by 100% of the price paid - **is contradicted by every piece of research ever conducted on, and every return produced by, every Australian Superannuation Fund**.

[7] Peterson Research Institute, October 2017
[8] Peterson Research Institute, October 2018
[9] Cuffelinks, October 22, 2018
[10] Peterson Research Institute, May 2015.
[11] The Portfolio Risk Analysis tool 'PRIGIA' and the results of the analysis, were presented to ASIC in October 2013.

iii. Active Investment Management – Cost or Price

On page 116 of the Cooper review, the observation is made that:

"Many submissions argued that high investment fees can be justified where the fund achieves higher performance. However, no data has been provided to the Panel that supported the assertion that higher fees either across the industry (or for an equivalent asset allocation and risk exposure) correlated in any meaningful way with higher long term investment returns. **In fact, most research contradicts this view**."

The conclusion is then reached that: "**The impact of investment costs can be damaging to the members' net return and subsequently the members' retirement benefit**."

After analysis of the referenced research (see Annexure 3), the observation by the Cooper Review that "most research contradicts this view", is not supported. The referenced research can be shown to be either incorrect or irrelevant to investments by Australian Superannuation Funds.

The paper by John Bogle[12], the founder of index fund manager Vanguard Group, deserves comment. At one level, the Bogle article is irrelevant to institutional investment, due to its focus on retail investors and products. However, the paper was actually supportive of the use of active management by institutional investors. Specifically, Bogle's observation that "[the financial system] **creates substantial value** for our society", refutes two of the core academic arguments commonly put forward to support the use of indexed over active investment management by superannuation funds. These arguments are:

a. **That markets are Static and/or Random Markets**

   If either of these assumption of finance theory are correct, then no value can be created by investment decisions.

b. **The Zero Sum Game**

   The Zero Sum argument is premised on investment decisions not creating value.

Essentially, the 'evidence' relied on by the Cooper Review does not support its conclusion that, "most research contradicts" that higher fees are correlated with higher long term investment returns.

Furthermore, there is ample evidence that Australian Superannuation Funds **have successfully selected managers who add value** after paying the Price of Investment Management, thereby producing a positive relationship between higher fees and higher net returns to consumers. This evidence includes:

- The evidence presented in the attached Cuffelinks article (Annexure 6);

[12] Bogle, J.C. (2008),'A question so important that it should be hard to think about anything else', The Journal of Portfolio Management, Winter 2008, pp.905-102

- The results of the active vs passive experiment conducted by Australian Super and Hostplus[13] (see Annexure 8). This comparison of these funds' actively managed Balanced options to their risk-equivalent (as defined by the Disclosure Regime) Indexed - and hence low fees and costs - options, demonstrates the significantly lower returns over time received by consumers from a low cost (passively managed) approach to superannuation investing.

  The lower returns from the indexed (passive) products can be attributed to a combination of:

  a. Not receiving the net benefits of active management of investment in liquid markets such as equities, fixed interest and listed property; and

  b. Not having access to investments that only exist in combination with active manager skill, such as private equity, direct property, infrastructure, hedge funds, development opportunities, and royalties.

  While the data is not available to attribute the performance differential between these two contributors, it is clear that the **overall net return** to payment of the Price of Investment Management for Australian Super funds **is significantly positive**.

The Cooper Review was therefore not correct in concluding that, "The **impact** of investment costs can be **damaging** to the members' net return and subsequently the **members' retirement benefit**".[14]

Unfortunately, this unsupported statement, implying a **damaging impact** on consumers' retirement benefits from paying the Price for Investment Management, has been carried through into the core of the current Disclosure Regime as reflected in statements such as:

McShane Review:

- Policy Statement: "The starting premise is that fees and costs matter, particularly in long-term savings vehicles where the **effect** of fees and costs compound and can have a **substantial impact on consumer outcomes over time**."

  "Given that **cost impacts matter**, it necessarily follows that costs are a factor that should be taken into account when a consumer makes a decision about a financial product."

- McShane p28-29: "The primary policy objective of improving **transparency of cost impacts** is to provide consumers with accurate and usable information about **cost impacts** at the level relevant to the decision being made so that they can … more

[13] Comparing the Pair – Update Super Funds Index vs Active Options, Peterson Research Institute, January 2019.

[14] In essence the Cooper Review made an inductive error in assuming that 'a failure to prove implies proof of failure'. (i.e., a failure to prove the existence of a positive relationship between higher investment fees and returns, is proof that a negative relationship exists.)

accurately and effectively make **informed decisions incorporating those cost impacts**."

- Fees and costs are particularly important for investments that a consumer will hold for a long time (such as superannuation). This is because **the effect of fees and costs** on an investment can be **substantial** and can compound over time. (Draft RG 97.11)
- Consumer Advisory Warning (Draft RG 97.29)

  "Small differences in both **investment performance** and **fees and costs** can have a substantial **impact** on your long term returns."

In summary, there is no evidence in the material referenced by the Cooper Review, or that has been subsequently produced, that would support the view that the Price of Investment Management should be treated as a Cost which reduces the returns to consumers by 100% of the management fees paid.

On the contrary, there is significant evidence that, for institutional Australian Superannuation Funds there has been, and can be expected to be, a positive net benefit to consumers' long-term financial outcomes from paying the Price of Investment Management.

Conclusion to Part A

The treatment of the Price paid for Investment Management skills, which can be expected to increase investment returns (or at worst be return neutral), as a Cost with no gross return and a 100% reduction in net returns assumed, is the core source of the flaws in the current and proposed Disclosure Regime.

As demonstrated above, there is no evidence, in either the documents assessed by the Cooper Review, or in subsequent fund performance, that this is the case for Australian superannuation funds.

B. Issues related to the implementation of the Cooper Review's recommendations.

The treatment of the Price of Investment Management as a Cost is a fundamental flaw in the current and proposed Disclosure Regime. However, if the philosophical foundation and actual recommendations of the Cooper Review had been followed more closely, the issues associated with the current Disclosure Regime would not have arisen. Unfortunately, this has not been the case to date.

The clearest point of difference between the stance of the Cooper Review and the current Disclosure Regime, as reflected in CP 308 and McShane, is the philosophical stance around the role of disclosure. The Disclosure Regime has a narrow focus on providing consumers with information, through transparency and disclosure, for making decisions, whereas the Cooper Review's focus was on ensuring that members' best interests were paramount.

Indeed, one of the Cooper Review's '10 Super Policy Principles' was that:

> "Transparency and disclosure are essential for the effective operation of the system, but are not substitutes for well-designed products that work in members' interests. **Disclosure is a necessary, but not a sufficient, condition for ensuring that member interests prevail.**" (Cooper, p4)

This Principle has been lost in the implementation of the recommendations of the Cooper Review.

The Cooper Review was aware that information going to consumers, and the signals given to trustees, can have significant impacts (both positive and negative) on consumers' outcomes. Thus the Cooper Review had a high level of focus on efficiency, and optimising outcomes and net returns.

The disconnect between the Disclosure Regime's implementation mechanics and its underlying objectives - with insufficient awareness of, or willingness to remain open to, the larger setting - is creating compounding problems across the superannuation system. These problems are taking the entire Stronger Super Policy away from, rather than towards, its original objectives of efficiency, flexibility and optimising outcomes for consumers.

In particular, treating the Price of Investment Management, which can be expected to increase investment returns (or at worst be return neutral), as a Cost that reduces returns, causes ongoing distortions in consumer decisions, product designs, and trustees' investment decisions, which are detrimental to the long-term interests of consumers and the overall economy.

Optimal Investment Outcomes and Net Investment Returns

The key disconnect between the objectives of the Cooper Review and the current Disclosure regime occurred during the formulation of the Stronger Super Reforms.

The intentions of the Cooper Review for the MySuper product – and hence superannuation funds generally – is clear (Cooper, p10):

> "The MySuper product is intended to provide **a simple superannuation option** for members. It will be treated, for some purposes, as separate from other types of superannuation products, and operated so that **member interests are transparently paramount** and there will be an **enhanced focus on optimising net investment returns and reducing overall costs**."

For the Cooper Review Panel:

- MySuper was primarily simple, not low-cost;
- What is transparent is that that Consumers interests are paramount, not the level of fees and costs;
- There is a focus is on optimising net investment returns; and
- There is a focus on reducing overall costs

It is worth noting here that the emphasis in the Cooper Review is on creating a simple 'MySuper' product, and that while there is a focus on reducing overall costs, this is listed after, and is presumably subsidiary to, a focus on consumers' best interests and optimising investment returns.

It is also noteworthy that there is a **differentiation between 'net investment returns' and 'overall costs'**. This differentiation occurs throughout the Cooper Review reports.

What is particularly relevant is that the Cooper Review sees optimising net investment returns and reducing overall costs as **separate objectives**. It **does not say, or suggest, that** net investment returns are optimised **by** reducing overall costs, whereas this is the position – whether intended or not – of the Disclosure Regime.

Indeed implicit in the concept of 'optimising' is the belief that there are gross (and net) positives in the Objective Function that exhibit diminishing returns as a variable – in this case the amount paid for 'Investment Management' (or Manager Skill) – is increased. Thus, the Cooper Review's frequent references to optimising net investment returns **implies a belief that positive gross returns are earned by superannuation funds in exchange for the Price of Investment Management.**

A belief in the concept of the optimisation of net investment returns – and hence the existence of positive gross returns – is central to the Cooper Review:

- "The trustee would have to formulate and give effect to a single, diversified investment strategy at an overall cost aimed at **optimising fund members' financial best interests, as reflected in the net investment return over the longer term**. This does not mean that a trustee would have to provide the lowest possible cost investment strategy. **While there is an emphasis on low costs, this would not be at the expense of investment returns**. The Panel recognises the importance of asset allocation and that some investment strategies would be more costly to provide than others." (Cooper, p13)

  'Optimising' implies a net positive return to active management up to a point. We should assume that funds / trustees stop at the point of zero net marginal returns (or at least where average net return falls to zero).

- "Although there would not be an overall fee cap or other regulation of the cost of a MySuper product, a MySuper trustee would be required to operate with a clear and transparent justification for the investment strategy it formulates and the overall cost **and net return** to members." (Cooper, p13)

The **trustees' justification** would be that there is an **expectation that there are positive net returns** from the Price of Investment Management.

This belief is widely held by superannuation fund trustees. While it is implicitly held by all trustees who appoint investment managers (either external or internal) who charge a Price for their skill, many trustees also explicitly state their belief in a positive net return to the Price of Investment Management in publically available documents. For example (in alphabetical order):

- Australian Super: "We believe an active management approach is the best way to invest"[15]
- Cbus: "The Trustee believes active management can add value, net of expenses [in some markets]"[16]
- First State Super: "We use an active approach to asset allocation"[17]; and, "There are opportunities to create additional value by having our skilled fund managers identify niche or unique investment opportunities"[18]
- HESTA: "HESTA works with some of the world's most talented investment professionals that apply active management to provide a superior investment product, and more peace-of-mind for our members"[19]
- Local Government Super NSW: "LGS adheres to the guiding principle that several carefully selected investment managers and commingled unit trust managers will, over any reasonable period, produce: more consistency, lower volatility and risk, and better results."[20]
- Rest Super: "Rest seeks to capture market opportunities and manage downside risk by employing an active investment management approach"[21]
- Sunsuper: "the Sunsuper belief that investment markets are inefficient and present opportunities to add value through active management both between and within asset classes"[22]
- UniSuper: "At UniSuper, we position ourselves as active managers"[23]

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[15] https://www.australiansuper.com/investments/how-we-invest
[16] https://www.cbussuper.com.au/content/dam/cbus/files/governance/policies/Investment-Governance-Framework-Policy.pdf
[17] https://firststatesuper.com.au/investment-and-performance/investments/about-our-options/asset-allocations
[18] https://firststatesuper.com.au/blog/ever-wondered-how-we-invest-your-money
[19] https://www.hesta.com.au/stories/What-is-active-investment.html
[20] https://www.lgsuper.com.au/assets/PDS/Accumulation-Scheme/How-we-invest-your-money.pdf
[21] https://www.rest.com.au/member/investments/investments-how-we-invest
[22] Sunsuper Investment report for quarter ended 30 June 2018.pdf.
[23] https://m.unisuper.com.au/investments/investments-news-and-commentary/2018/10/09/investment-market-update-october-2018

- In discussing the philosophical framework of the MySuper choice architecture model, the Cooper Review noted that:

  > "the outcomes experienced by inert or disengaged consumers should have inbuilt settings that most closely suit those consumers' objective needs, **as assessed by the expert providers of the product or service in question**"; and
  >
  > "the default setting must always be one that **reflects a positive judgment** about the **most appropriate outcome** for the consumer (member) **in the eyes of the product provider** (being the trustee in the case of a superannuation fund)." (Cooper, p9)

  This philosophy reflects a belief that trustees, as the 'expert provider of the product', have scope to identify a 'most appropriate outcome' for consumers. Again this implies the optimisation of net investment returns and does not define this as minimising the Price paid for Investment Management by classifying them as a Cost.

- The Cooper Review flagged an expectation that superannuation funds should have a willingness to pay a Price of Investment Management for, typically more expensive, illiquid assets.

  > "Local funds **will increasingly find themselves competing** with large global funds, not just in markets for listed securities, but also for specific assets, such as **infrastructure, private equity and direct property**." (Cooper, Issues for the Future, p.6)
  >
  > "A number of submissions identified the trend towards super funds investing in alternative assets as one factor causing increasing investment management fees in industry funds, in particular, in recent years. The Panel believes that the trustees of **super funds are increasingly likely to have to consider investing in such investments** in coming years and is concerned to ensure that such considerations have **explicit regard for the cost implications** of each transaction and mandate." (Cooper, p.79)

  These sections of the Cooper Review envisage superannuation funds investing in illiquid / alternative assets, not being discouraged by regulation from investing in them. This endorses the expectation that funds should have an appetite to pay the Price for Investment Management, in order to earn the associated increased net returns and to optimise investment outcomes.

  This suggests that, while trustees should have regard for the Price of Investment Management – consistent with their responsibility to act in the best interests of consumers - it does not suggest that high fee investments should be avoided. This again demonstrates that the Cooper Review did not equate optimal returns to consumers with low cost.

- Instead the Cooper Review's focus was on optimising returns and making super **better value for money** for consumers.

> "The aim of MySuper is lowering overall costs for members while supporting and encouraging a competitive market-based, private sector infrastructure for superannuation. **The Panel's objective is to make super better value for money** and MySuper is designed with this in mind." (Cooper, p18)

Again the idea of making super 'better value for money' suggests an ability of trustees to alter either, or both, the 'overall costs for members' and the level of net investment returns. This suggests that either:

- Net investment returns could be increased for the same 'overall costs'; or that
- 'Overall costs' could be reduced for the same level of net investment returns; or that
- Some combination of the two could be achieved.

In each case higher levels of returns would be delivered to consumers as the 'in-hand' return to consumers is net investment return less Costs.

Note however, that this does not imply that the overall, or any specific, Price paid for Investment Management would necessarily be lower under the MySuper / Stronger Super Reforms than prior to the Cooper Review.

It is quite possible that the Cooper Review envisaged a situation where a fund would optimise investment returns by increasing the proportion and amount paid for the Price of active Investment Management, while reducing management and advisory fees as a result of product changes, scale economies and benefits from Superstream.

This is reflected in the Copper Review's view that its recommendations would not impact on trustees' investment decisions.

> "There is no justification for the assertion that MySuper would prevent trustees and fund managers from pursuing certain types of investment strategies that they might otherwise consider. The MySuper concept is predicated on trustees being required to design and implement an investment strategy that is for the benefit of members, which means trustees have to **weigh the expected returns of any strategy against considerations of liquidity, risk and cost**. The Panel is confident that trustees would be able to identify strategies that **offer competitive net** (that is, after taxes, fees and costs) returns to members within the regulatory framework governing MySuper." (Cooper, p19)

The concepts of 'weighing expected returns' against 'liquidity, risk and cost' again implies a trade-off with positive but diminishing returns. It does not imply minimising the Price of Investment Management.

This is not to say that scale economies are not available or should not be pursued. Generally speaking scale economies in the Price of Investment Management (whether passively or actively managed) should exist and be captured for the benefit of consumers.

Thus, to the Copper Review, MySuper (and the subsequent Stronger Super Reforms and Disclosure Regime) were founded on a **belief in a positive relationship between the Price of Investment Management and gross investment returns**, which would allow the trustees of superannuation funds to pursue consumers' best interests with the objective of optimising the return outcome for consumers.

However by the time the Stronger Super legislation was enacted, **the objectives had altered**. In Treasury's explanation of Stronger Super, MySuper is described as:[24]

> "a new low cost and simple superannuation product that will replace existing default funds."

with the **primary focus having shifted to 'low cost', and consumer interests and optimised investment returns having been dropped**.

As noted above, this transition away from Cooper Review's focus on ensuring that members' best interests were paramount, to the Disclosure Regime's more restricted focus on providing consumers with information, has remained, as demonstrated in McShane's observation that:

> "ASIC would suggest that the approaches taken in RG 97 and related instruments are directed at **implementing** and clarifying the **explicit or implicit legislative intention**. ASIC's view is that legislative changes to Schedule 10 made as part of the Stronger Super Reforms in particular, suggest a much more expansive approach to cost disclosure for superannuation funds albeit within the existing disclosure tools. Even though ASIC's modifications to the requirements have been extensive, this has been done within the framework of **implementing what ASIC considers to be the legislative and policy intention** of the relevant provisions including the adoption of certain approaches for superannuation products such as separation of different types of fee and cost elements …".
>
> (While the interpretation of the legislative intention may suggest a 'more expansive' approach to cost disclosure, it is not clear that the deepening in disclosure, should also be accompanied by the narrowing of the focus as has occurred under the Disclosure Regime.)
>
> "To the extent that the regulatory direction is **constrained by the need to deliver the above interpretation of the Stronger Super Reforms**, then it is **difficult to depart from the current approach or suggest any material changes to it**."

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24 The Treasury: Stronger Super Key Points http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/key_points.htm

This narrowing in focus in the Disclosure Regime is reflected in both ASIC Report 398 and the McShane review:

ASIC Report 398:

> "Consistent and accurate fee and cost disclosure is an important aspect of the disclosure framework. **It allows investors to accurately compare the products available to them and determine whether a particular product represents value for money.** It can also help them to decide how to use a product" (Report 398 para. 9)
>
> "Inconsistent and inaccurate fee and cost disclosure makes it difficult for investors to make informed decisions about their investments, and can reduce their confidence in the industry." (Report 398 para. 10)

McShane, (p7-8)

> "the objectives of fee disclosure is assessed as having one primary and three secondary objectives:
>
> 1) **the primary objective is providing consumers with information that they can use in making more confident and informed value-for-money decisions**;
> 2) secondary objectives of:
>   a. framing the nature of the relationship between product providers and consumers;
>   b. verifying how contributions and earnings will and have been used; and
>   c. the provision of data and information about fund operations in a manner that can support analysis and policy development.

While it is understandable that ASIC's focus is on implementing what it considers to be the legislative and policy intention (which presumably ASIC would have had input into defining), and that McShane therefore considered his External Review to be restricted in its ability to suggest changes to the current approach, **it does not follow however that the current Disclosure Regime is consistent with the overall objectives of Superannuation Regulation as defined by the Cooper Review**

Disclosure – Cooper Review Recommendations vs Current Regime

A fundamental difference exists between the Copper Review's recommendation around disclosure and the stance of the current and proposed Disclosure Regime.

Specifically, reflecting their belief that the Price of Investment Management was rewarded with additional positive gross investment returns, the Cooper Review specified that investment returns in the product option performance table – which corresponds to the Annual fees and costs disclosure under the current Disclosure Regime - would be quoted on a gross basis with the amounts paid as the Price of Investment Management reflecting the difference between gross and net investment returns. Amounts related to administration/operating costs (now Administration fees and costs) would then be deducted, along with taxes, to give the overall net return to the consumer.

The Cooper Review states that an outcomes reporting standard should be developed by APRA, in consultation with ASIC and industry, that would detail how this option performance table would have to be presented, including the requirement to report:

(a) gross investment returns for the investment option for 1, 5 and 10 - year periods;

(b) costs (investment and other) on a pre - tax basis for 1, 5 and 10 - year periods;

(c) investment returns net of all costs (administration and investment) and taxes for 1, 5 and 10 - year periods; and

(d) the number of negative quarters of investment returns the investment option has incurred in the past 10 years."

This required format is illustrated in Table 4.1 in the Cooper Review.

Table 4.1: A sample MySuper or choice investment option performance table

Investment Option: Blue Investment Option			
	Investment return information		
	10 Years	**5 Years**	**1 Year**
Gross investment return			A%
Less investment costs			B%
Net investment return (before all other costs and taxes)			C%
Less administration/operating costs			D%
Less net investment-related taxes			E%
Less net contributions tax			F%
Net return (after all costs and taxes)			**G%**

This proposal is specifically set out in Recommendation 4.9 of the Cooper Review (Cooper, p113).

The Cooper Review also noted under Section '5.5 Reporting of net investment returns'(Cooper, p111), the desirability of reporting gross and net investment returns in order to ensure greater transparency and accountability:

> "**revealing gross returns with tax and costs to give the net return** allows members and other stakeholders to analyse how costs and tax are managed. Standardised reporting showing both gross and net investment returns on an after-tax and after-cost basis would ensure **greater transparency and accountability**."

With the proposed reporting of both gross and net returns there is a clear delineation between 'investment costs' – which are assumed to contribute positive gross returns as part of return optimisation – and administration/operating costs, and taxes, which unambiguously reduce net returns to consumers by the amount of the cost/tax paid.

This policy was altered in the Stronger Super Policy and associated Disclosure Regime, with the reporting of gross returns omitted and all costs (Administration and Investment), treated in an undifferentiated way as detractors from overall returns.

In addition the Cooper Review proposed that the Product Dashboard would include a **Projected Total Annual Expense Ratio** (TAER) and a **relative fees ranking**.

The TAER was proposed as a forward looking estimate that captured all forecast expenses, which were explicitly **defined to include 'investment costs'**. The Cooper Review (Cooper, p118-119) set out that the:

> "Product Dashboard would be supported by the following explanations:
>
> (e) Projected TAER (Total Annual Expense Ratio) is the projected TAER for the investment option of the MySuper or choice fund. The projected TAER **captures all the forecast expenses (that is, investment and administration costs) of the option**. This projected figure would enable members to compare the **forecast expense ratio with the historical TAER achieved** by the investment option;"

Importantly, the TAER was **not envisaged as being used in comparisons between investment options**, whether offered by the same fund or an alternative fund, but was expected to be used to, "**compare the forecast expense ratio with the historical TAER achieved by the investment option**". That is the TAER was envisaged to be used for within-option not between-option comparisons.

This is consistent with the concept that trustees of different investment options would pay different amounts for Investment Management, in line with meeting their objective of producing an optimum return outcome for consumers. Clearly, the Cooper Review was of the opinion that what would be relevant to consumers considering a particular investment option is whether the investment strategy is expected to be different in the future than that employed in the past. To a significant degree this would be reflected in a material change in the expected TAER.

Equally, as the expected net return from paying the Price of Investment Management is positive (or at least neutral) then it would be meaningless, and potentially misleading, to use the amounts payed for Investment Management as a point of comparison between investment options, as the net effect of the Price of Investment Management is reflected in the historical and expected net investment return.

The Cooper Review also proposed the development of a ranking for between-fund comparisons. This would be based on fees charged for investing in an option. Specifically the Cooper Review (Cooper, p118-119) set out that the:

> "Product Dashboard would be supported by the following explanations:
>
> (f) Relative fees ranking ranks the **fees charged for investing in this option compared to all other options with the same aim**. The number of dollar signs shows that the option is in the lowest, second, third or highest fee group for options that have the same aim. This would be expressed on a gross basis (that is, before tax)."

It is important to note that the Cooper Review **did not suggest using the TAER,** which explicitly includes investment costs**, for this comparison**, nor is reference made to 'all expenses' as is the case in the TAER definition. Instead the reference is to 'fees charged for investing in this option'.

As this definition does not explicitly include investment costs, and as the Price of Investment Management is not expected to reduce returns, then the Cooper Review was recognising that the inclusion of investment management costs in the fee ranking would create misleading comparisons between products with the same (investment) aims.

An appreciation of this point is expressed in the Cooper Review (p79) in the differentiation between the fees and costs related to a particular fund, and their use in comparisons between funds:

> "Those recommendations are designed to give members, prospective members and regulators the ability to assess the overall picture of fees and costs, including those related to investment, that pertain to a particular fund, and to facilitate comparison between funds. Only in this way can market forces be expected to exert pressure on trustees to continue to strive for more efficient and cost-effective ways to deliver good investment performance."

Whether this was the specific interpretation and intention applied by the Cooper Review, as it appears to be, it is apparent that not including the Price of Investment Management gives the most consistent result in comparing like-with-like Costs for products with similar objectives.

Direct and Indirect Investment Costs

Sch 10 defines fees for superannuation funds. The proposed definition of 'Investment fees and costs' in Draft amendments to Sch 10 are given in section 209A 'Defined fees for superannuation products':

> "*Investment fees and costs* are fees and costs that relate to the investment of the assets of a superannuation entity and include:
>
> (a) **fees in payment for the exercise of care and expertise in the investment of those assets** (including performance fees); and
>
> (b) costs that relate to the investment of assets of the entity that are met through the use of reserves;
>
> (c) **indirect costs that relate to the investment of assets** of the entity"
>
> Further Section 101A defines indirect costs as:
>
> "any amount that:
>
> (i) a responsible person knows, or reasonably ought to know or, where this is not the case, may reasonably estimate has reduced or will reduce (as applicable) whether directly or indirectly the return on the product or option that is paid from or reduces the amount or value of:
>
> (A) the income of or the property attributable to the product or option; or
>
> (B) the income of or the property attributable to an interposed vehicle in or through which the property attributable to the product or option is invested;

The definition of indirect costs is more clearly defined in Draft RG 97.283 which defines, 'Indirect costs' as:

> "amounts that you know or reasonably ought to know (or may reasonably estimate) **have reduced or will reduce the return** on the relevant product or investment option".

Thus the definition of Investment fees and costs in the proposed Disclosure Regime **contains two different and incompatible definitions**.

- First, point (a) defines 'Investment fees and costs' as payments for investment care and expertise – or equivalently, the Price of Investment Management Skills.

  As established in Part A, for institutional investors, including Australian Superannuation Funds, there is strong evidence that **the expected gross return for payments for Investment Management is positive**.

  Furthermore, the Cooper Reviews expectation that fund trustees can optimise the returns to consumers requires that the net return is positive over some range, while the trustees of many superannuation funds have public stated a belief that active investment management provides positive expected net returns (i.e., after paying the Price of Investment Management) to consumers.

- Second, point (c) defines Investment Fees and Costs as Indirect Costs related to the investment of assets. Indirect Costs are defined as amounts (payments) that trustees know (or believe) **have reduced or will reduce the return** to consumers. This definition is incredibly strict, in that it requires that any indirect payment for Investment Management must have a zero expected gross return, and hence a net outcome that reduces the return to consumers by the full amount of the payment. Moreover, this definition is then applied to all Investment fees and costs throughout the Disclosure Regime.

The problem for the Disclosure Regime is that **these two classifications of Investment fees and costs are opposed, and thus inconsistent with each other**.

Specifically, superannuation fund trustees, supported by the available evidence, believe that payments for Investment Management will increase net investment returns, whereas the treatment of the Price of Investment Management in the Disclosure Regime is that these payments decrease net investor returns by the full amount of the payment.

This inconsistency lies at the root of the problems with the current and proposed Disclosure Regimes, and **contributes to the failure of the Stronger Super Policy to promote and achieve its objectives**.

It is the consequences of this inconsistency that have led to the industry expressing a, "breadth and intensity of reactions", during McShane's industry engagement, and that suggest to McShane that some **directional change should be considered**, if it can be done in a manner that is consistent with higher, overall, objectives of the fee disclosure regime" (McShane, p32).

In short, significant directional changes are required. However, the necessary changes are **material** and will **require a breaking of the constraints** imposed by the, "interpretation of the Stronger Super Reforms that ASIC has applied", (McShane p8)

Behaviour

We have now identified three key issues with the treatment of the Price of Investment Management:

1. Payments made for Investment Management services are a Price, with positive expected gross and net returns, not a Cost with zero expected gross and negative net returns.
2. The Disclosure Regime includes the Price of Investment Management in 'fees and costs', and applied it to all circumstances, whereas the Cooper Review only envisaged using Investment Management fees and costs for within-fund comparisons (i.e., past with future comparisons for the same product / fund).
3. The definition of Investment fees and costs for superannuation funds contains two inconsistent concepts – payments that are expected to increase returns, and payments that are defined as being expected to decrease returns – and treats them as the same things.

These fundamental flaws in the Disclosure Regime have wide-ranging detrimental effects on **consumer outcomes**. This occurs because fees and costs are viewed in the Disclosure Regime as important - as they should be – and are therefore required to be included and taken into account in many decisions related to product selection by consumers, and product design by trustees.

This impact is broad and significant:

1. **Financial Advice**
   - In RG175.374 "Licensing: Financial product advisers—Conduct and disclosure", ASIC specifically requires providers of financial advice to consider the costs of financial products when giving switching advice:

     > "When giving switching advice, advice providers must consider the benefits and disadvantages, **including the costs** and risks, of both the existing and new products or investment options."

     Note: 'switching advice' would include most 'buy' recommendations for superannuation and other financial products, as money in a bank account is a financial product: RG175.339.

     Also, while RG175 does not specify what 'costs' are referred to, for consistency they must be Fees and Costs as defined in RG 97.

     The **cost of a financial product** also goes to legislative duty to conduct a "reasonable investigation" into the financial products being recommended in s961B(1) of the Corporations Act 2001, and would also form part of the information required to be included in an SOA for switching advice under s947D.

- Further, in RG 175.377, the definition of appropriate advice specifically includes a reference to cost:

  > "Advice will often be appropriate under s961G if there are **overall cost savings** for the client and it would be reasonable to conclude these are likely to override the loss of benefits that are of value to the client."

- In addition, in example 19 in RG 175 (p94) – Advice is classified as inappropriate advice in part because the proposed new superannuation fund, "**will have higher ongoing fees than the combined fees of their old superannuation accounts**"
- The use of information provided under the Disclosure Regime in making investment recommendations is also recognised in RG 97 (Draft RG97.10)

  > "Financial advisers and other professionals can use the information you publicly disclose to the market to:
  >
  > (a) **advise consumers**"

- The use of Disclosure Regime information by third-parties such as financial advisers was also recognised in the Cooper Review (p101)

  > "recognition that, in an imperfect market, most **disclosure** needs to be **targeted to member proxies** such as independent advisers, regulators, researchers and analysts to enhance competition between funds and sectors"

Financial advisers are required under RG 175 to take into account the fees and costs of superannuation funds, as reported under the Disclosure Regime, when giving advice to consumers. Thus, **flaws in the Disclosure Regime** – particularly in relation to the classification of Investment fees and costs as a Cost that reduces net returns – will have a flow-through **effect on the advice and investment recommendations given to consumers**.

Specifically, consider the case of two superannuation products with the same aims and equal expected risks and returns as defined under the Disclosure Regime.

Further, assume that all items in the Fees and Costs Summary (as proposed in Draft RG 97) are the same for each product, with the exception of 'Investment fees and costs', which are:

- \$100 (20 basis points) for Product A; and
- \$200 (40 basis points) for Product B.

Thus, the 'Cost of product' for Product A would be \$100 less than the 'Cost of product' for Product B, even though the outcomes for consumers of selecting either product would be the same.

Under RG 175 a financial adviser would, after considering the costs of the products, be required to recommend Product A over Product B, even though the expected risks and returns – and hence outcomes for consumers – would be **identical**.

The result that advisers would be required to **recommend one identical product over another** suggests the existence of a **structural flaw** in the Disclosure and Advice regimes. Specifically, that flaw arises from the incorrect treatment of 'Investment fees and costs' in the Disclosure Regime.

2. **Price / Return Trade-off**

A further question related to the flaw of treating a Price (for Investment Management) as a Cost, is, 'at what level do differences in expected risks and returns equate with differences in the Price of Investment Management?'

By way of example, if the products in the above case were the Indexed and Actively Managed products offered by Australian Super (or Hostplus[25]: see Annexure 8), then how much lower do the Index product's annual fees and costs need to be to offset, in the adviser's assessment, the lower expected return of the Indexed product – historically of some 2% per annum less than the active product's return (net of all 'expense' payments including the Price of Investment Management)?

RG 175 would require that the 'disadvantages' of the higher Investment Management costs in the actively managed alternatives - which are the direct causes of the higher net returns and lower portfolio risks to consumers – would need to be taken into consideration as a negative by a financial adviser when giving advice in respect of the two products.

This would appear to be **in conflict with advisers' duty to act in the best interests of consumers, given that the actively managed products have clearly superior historical and expected risk/return outcomes for consumers**.

3. **Market Analysis**

The use of Disclosure Regime data for assessing the overall superannuation and investment marketplace also has potentially significant log-run effects.

Again, RG 97.10 envisages this use:

> "Financial advisers and other professionals can use the information you publicly disclose to the market to:
>
> (b) **analyse and benchmark the market**."

However, as noted by McShane, (p30) information for these purposes does not have to be catered for in the Disclosure Regime:

> "If necessary, policy and third-party analysts can obtain information from other sources including direct approaches to Providers and statutory returns."

[25] Comparing the Pair – Update Super Funds Index vs Active Options, Peterson Research Institute, January 2019.

4. Assessment of Outcomes

The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2019, which amends the SIS Act, includes the requirement for trustees to assess, on an annual basis, whether the outcomes that are being delivered by MySuper products are promoting the financial interests of MySuper members. The proposed legislation would require that:

> "In comparing a MySuper product with other MySuper products, the trustees must compare each of the following:
>
> (a) **the fees and costs that affect the return** to the beneficiaries holding the MySuper products"

As the Disclosure Regime defines all 'Investment fees and costs', as affecting (reducing) the return of the superannuation product, then trustees will be required to **treat as a detriment** in their assessment the expenditure of **an amount that they believe will**, and which can reasonably be expected to, **increase the net return** to consumers.

Further, the 'fees and costs that affect the return to beneficiaries' is most likely synonymous with the 'Cost of Product' defined in Draft RG 97.61. The Cost of Product is essentially the same as the TAER defined in the Cooper Review, in that both include all fees, expenses and costs, including those related to Investment Management.

Notably, the Cooper review recognised that the TAER should only be used for with-in fund comparisons, whereas the proposed **Annual Outcomes Assessment would use essentially the same measure inappropriately for between-fund comparisons**. This can be expected to introduce errors and biases in the Outcomes Assessment.

The Bill also includes the additional covenant that:

> If the entity is a regulated superannuation fund (other than a regulated superannuation fund with fewer than 5 members), the covenants referred to in subsection (1) include a covenant by each trustee of the entity to **promote the financial interests of the beneficiaries** of the entity who hold a MySuper product or a choice product, in particular returns to those beneficiaries (**after the deduction of fees, costs and taxes**).

Again, as costs in the Disclosure Regime include the Price of Investment Management, which is expected to improve the financial interests of consumers (beneficiaries), then it is unclear – and contradictory – as to how trustees would ensure their continuous adherence to this covenant.

Distortions in Investment Allocations

For the reasons set out above, the current Disclosure Regime creates meaningful **distortions and biases in the signals being given to trustees** about the value of the Price of Investment Management in superannuation funds. As noted previously by Hartley[26], Clarke[27] and Bright[28], as well as by many other industry participants in various forums, the Disclosure Regime is producing **changes in superannuation funds' investment allocations**.

The driver of these changes in investment allocations is the same competition identified by ASIC in Report 398 (para. 11). With the flaws in cost disclosure in current Disclosure Regime the opportunity exists for funds to 'game' the system by altering investment allocations. This allows funds to create the appearance of offering a level of investment returns commensurate with a particular level of Portfolio Risk, with lower levels of reported 'Fees and Costs'.

These changes are designed to reduce the amounts paid for the Price of Investment Management and thereby reduce the overall level of fees and costs reported under the Disclosure Regime definitions. These include:

- Decreases in the use of active investment management in liquid asset classes such as equities, fixed interest securities and listed property, with correspondingly greater allocations to index products;
- Limitations or reductions in allocations to illiquid, and typically higher cost, investments such as direct property, private equity, infrastructure, development opportunities, and royalties;
- Increased use of Risk Premia ('Smart Beta) strategies;
- Changes in the structure of investments such as increasing direct or co-investments;
- Internalisation of investment management; and
- The creation of indexed products.

These changes in funds' investment allocations represent changes away from those that would be implemented if trustees were able to pursue an unfettered optimisation of consumers' outcomes.

While it was the view of the Cooper Review that:

> "There is no justification for the assertion that MySuper would prevent trustees and fund managers from pursuing certain types of investment strategies that they might otherwise consider."

this is not the case in reality.

In practice **the Disclosure Regime does prevent (or at least discourage) trustees and fund managers from pursuing some investment strategies** because they are treated as increasing costs, and hence reducing returns to consumers.

[26] Hartley, D. "Individual Submission to Australian Government Productivity Commission", (20 April 2016)
[27] Clarke, R. "Mercer gets behind concerns over fee pressure". Investor Strategy News, (17 July 2016). www.ioandc.com/mercer-gets-behind-concerns-over-fee-pressure/
[28] Bright, G. "The ramifications of a 'relentless focus on costs and fees'". Investor Strategy News, (7 August 2016), www.ioandc.com/the-ramifications-of-a-relentlessfocus-on-costs-and-fees/

This difference between the Cooper Review's expected outcome and actual behaviour can be attributed directly to the inclusion of Investment fees and costs in between-product comparisons by financial planners and researchers as a result of their inclusion in the Fees sections as required under the Disclosure Regime. The Cooper Review did not envisage the use of Investment fees and cost in this way.

Changes in investment allocations away from those that would otherwise have been selected by trustees – and hence away from trustees' unfettered optimisation of consumer outcomes – will **generally not be in the best long-term interests of consumers**.

It is possible to calculate an estimate of the loss to consumers' long-term returns stemming from the investment distortions caused by the flaws in the Disclosure Regime.

- If we take the GIA analysis reported on in 'The end of active versus passive' Research Note[29] (see annexure 7), the amount of Manager Risk (expressed in a general risk measure) in Superannuation Funds' portfolios analysed ranged from 3%-5%.

  This was the equivalent of 20% to 30% of the Total Investment Risk in the Portfolios as of June 2009.

  The increment to net investment returns actually produced by the superannuation funds analysed was approximately 35 basis points (0.35%) for each additional unit (1%) of Manager Risk (Manager Skill related Investment Risk).

- Alternatively, if we consider the performance differential between Australian Super's and Hostplus Super's indexed and actively managed Balanced products[30] (see Annexure 8), there is an approximately 200 basis points p.a. difference in net returns. As there is 4%-5% Investment Manager Risk in the active Balanced products and none in the indexed products then the Total Investment Risk will be 4%-5% less in the indexed products.

  Thus there is an increase in net investment returns of 40-50 basis points (0.4-0.5%) for each additional unit of Investment Manager Risk (manager skill) in the active products.

These examples suggest that, over time, net investment returns to consumers should be increased by approximately 40 basis points for each additional unit of Investment Management risk purchased by trustees.

Conversely, a decrease in manager skill below the level that would otherwise have been selected by trustees acting in the best interests of consumers without the constraints and distortions introduced by the Disclosure Regime, would be expected to reduce net returns by approximately 40 basis points per unit of Investment Manager risk foregone.

[29] Peterson Research Institute, May 2015.
[30] Comparing the Pair – Update Super Funds Index vs Active Options, Peterson Research Institute, January 2019.

Using this level as a guide, and working on the assumption that the level of Investment Manager risk in Australian Superannuation fund portfolios has reduced by approximately 1% (1 risk unit) since the introduction of the Stronger Super reforms – which is my best estimate as a participant in and observer of the industry – then the cost to consumers of the distortions introduced by the Disclosure Regime are in the order of $4Billion per year for each Trillion dollars of assets effected.

To put the cost of the distortions created by the current Disclosure Regime into perspective, the Cooper Review estimated that the combined direct and indirect benefits to consumers of its proposed changes would be around $2 Billion per year per Trillion dollars in superannuation.

Thus, the **flaws and distortions** created by the errors in the introduction of the Disclosure Regime are, on a conservative estimate, **costing consumers twice as much each year in lost returns as the gains expected to flow from the recommendations of the Cooper Review**.

Inconsistency with Trustee Responsibilities

The Cooper Review, and all trustee related legislation and regulation, is clear that the primary responsibility of trustees is to act in the best interests of consumers.

> The philosophical framework of MySuper and the choice architecture model set out in the Copper Review (Cooper Review, p9), requires that:
>
> > "the default setting must always be one that reflects a positive judgment about the most appropriate outcome for the consumer (member) in the eyes of the product provider (being the trustee in the case of a superannuation fund)."
>
> This emphasis in the Cooper Review on trustees being free (and unfettered) in pursuing the best interests of consumers are also set out: (p10)
>
> > "MySuper includes a range of additional regulatory requirements which are designed to ensure that the trustee is truly accountable to members, that the trustee is unfettered in its pursuit of the best interests of members and that the costs of delivering MySuper are contained."
> >
> > As noted previously, 'best interests of members' are not synonymous with decreased costs.

The current Disclosure Regime, in being internally inconsistent in its classification of Investment fees and costs, and incorrectly classifying the Price of Investment Management as a Cost, places trustees in the position of **being forced to not act in the best interests of consumers**.

- Investment Beliefs vs Disclosure Obligations

  As noted previously, many – indeed the majority of – trustees believe that paying the Price for Investment Management will be beneficial to consumers by increasing net returns and thus improving outcomes. This may be explicitly stated, or implicit in their decisions to pay the Price for Investment Management.

  On the other hand, trustees are required under the Disclosure Regime to report amounts paid for Investment Management services delivered through

Trust or Limited Partnership structures (interposed vehicles), as indirect investment costs, which are defined as being expected to reduce the returns to consumers.

Thus trustees have been required to effectively **make a false statement** by reporting payments for Investment Management as an indirect cost – which are defined as being costs that trustees **believe will reduce returns** - under the Disclosure Regime, while they simultaneously state in public documents that they **believe that payments** for Investment Management **will increase returns**.

(Of course trustees have had the option of resolving this dilemma by declaring that they believe/expect that the Price paid for Investment Management in interposed vehicles will not reduce returns by the amount of the payments, and therefore not disclose them – however I am not aware of any trustees that have done so.)

This dilemma leaves trustees potentially open to legal censure.

Flexibility & Innovation

As McShane notes, the main objective of section 760A of the Corporations Act is to promote:

> "**confident and informed decision making** by consumers of financial products and services while **facilitating efficiency, flexibility and innovation** in the provision of those services".

The effect of the Disclosure Regime however is to restrict efficiency, flexibility and innovation in superannuation investments, while reducing the ability of consumers to make confident and informed decisions.

The Cooper Review was cognisant of the risks associated with regulation, and explicitly stated that the Government should avoid directing superannuation investments.

> **"Governments should not seek** to direct super fund trustees to invest in particular assets or asset classes, nor **to prevent investments in certain types of assets or asset classes** unless there are prudential or regulatory reasons for doing so. This is regardless of how much it might seem in the national interest to do so." (Cooper Review, p4)

However, distortions in the allocations to investments in some assets and asset classes away from those consistent with trustees' unfettered pursuit of the best interests of consumers, is a direct result of the Disclosure Regime.

This potentially has important macroeconomic effects. As noted by the Cooper Review (p6) the impacts of distortions in the superannuation system will also have wider effects:

> "The superannuation system will continue to be an important factor in the Australian economy and financial markets. The efficiency of the sector will have macro-economic effects. "

In many ways the distorted signals concerning investments communicated to trustees by the Disclosure Regime are having effects equivalent to the restrictions imposed on superannuation funds by the 30/20 rule. This rule, and associated legislation had the effect of restricting innovation and flexibility across the investment and superannuation industry.

This extended period of stasis was eventually broken with the overturning of the 30/20 rule, and equivalent regulations, following the recommendations of the Campbell Financial System review in 1979. However, it was recognised at the time that considerable damage was caused to the financial system and the superannuation system as a result of those restrictions.

Treatment of Investment Management between listed and unlisted entities

An ongoing area of concern has been the obvious difference in the treatment of the Price of Investment Management as a Cost to funds, whereas the price of management in listed companies is not reported as a cost. Concerns about the potential effects of this difference in treatments have been widely discussed.

This issue also stems directly from the treatment of the Price of Investment Management as a Cost in the Disclosure Regime.

Conclusions and Recommendations

The Cooper Review (p6) started from with the observation that Disclosure by itself is inadequate to meet regulatory objectives:

> "**Disclosure to members has failed to achieve its objectives**: Whatever the actual level of engagement and literacy among members, a regulatory model largely built around detailed disclosure and member choice has not worked for a substantial portion of the member population."

The Cooper Review also expressed that:

> "Transparency and disclosure are essential for the effective operation of the system, but are not substitutes for well-designed products that work in members' interests. **Disclosure is a necessary, but not a sufficient, condition** for ensuring that member interests prevail."

It is therefore perhaps unsurprising that the current Disclosure Regime is not, in and of itself, meeting the objectives of the Cooper Review or the Stronger Super Reforms.

The risk of such a failure were recognised. In its Report 398 (para. 99) ASIC identified and sought to address a number of Key Issues, including:

> "One of the key objectives of the Stronger Super reforms was to create a consistent disclosure regime that allows investors to easily and accurately compare fees between superannuation funds. **The failure to achieve this poses significant risk to investors** and undermines the rationale of the Stronger Super reforms."

Unfortunately the current and proposed Disclosure Regime suffers from a number of flaws related to both the conclusions reached by the Cooper Review and the subsequent implementation of its' recommendations under Stronger Super and the Disclosure Regime.

- The Cooper Review Panel drew unsupported conclusions around the efficacy of active Investment Management in promoting the best interests of consumers.

  However to give the members of the Panel their due, they were relying on the best, although flawed, evidence available at the time.

  Also, the actual **recommendations of the Cooper Review recognised a differentiation between Investment Management fees and costs and those related to Administration, Management and Advice**.

- During the formulation and implementation of the Stronger Super Reforms a number of important distinctions between those fees and costs that can reasonably be expected to enhance net investment returns (the Price of Investment Management) and those that can be expected to reduce net investment returns, became blurred.

  As a result fees and costs that can be expected to increase investment returns, and those that reduce investment returns are reported equivalently. The information disclosed to consumers therefore does not meet the objectives of being transparent and consistent and therefore does not allow investors to easily and accurately compare [relevant] fees between superannuation funds.

- In addition, the cost and fee information produced under the Disclosure Regime is required to be relied on across the superannuation system – in particular by financial advisers when giving advice to consumers, by researchers when comparing superannuation products, and potentially by trustees themselves when evaluation their products performance.

  Due to the errors and flaws in the structure of the Disclosure Regime, the information about fees and costs that is required to be taken into account by these users gives rise to inaccurate advice going to consumers, and distorted signals going to trustees and product designers.

- As a result of these flaws and signals, the investment decisions of trustees have been distorted away from those that would apply if they were acting only in the unconstrained pursuit of the best interests of consumers.

  The results of these distortions in investment decisions by trustees are having significant negative impacts on consumers' outcomes.

In summary, the identified inconsistencies and errors are embedded in the current and proposed Disclosure Regime. It is for this reason that so many issues have arisen with its interpretation, implementation and consequences. **These issues will not be resolved unless the core problem of the incorrect treatment of the Price of Investment**

Management as a Cost is addressed. Moreover, additional problems will arise in the future as the information from the Disclosure Regime is applied more broadly.

(For example, we currently have the inconsistency that one arm of Government (ASIC), through the Disclosure Regime, is discouraging investment in Australian active investment managers by Australian superannuation funds, while simultaneously another arm of Government (Austrade) is promoting investment with Australian active investment managers by offshore investors!)

McShane noted (p8) that:

> "To the extent that the regulatory direction is constrained by the need to deliver the interpretation of the Stronger Super Reforms that ASIC has applied, then it is difficult to depart from the current approach or suggest any material changes to it."

This may reflect the regulatory position, however the **impact of the Disclosure Regime is inconsistent with the objectives of optimising investor outcomes and should be addressed**.

Recommendations

1. The definitions of Fees and Costs should be modified to principally focus on the expected effects of payments and expenses.
    a. Those payments and expenses that are expected to reduce returns to consumers should be treated as Costs in the Disclosure Regime.
    b. Those payments and expenses that are expected to increase the returns to consumers should be treated as a Price. Prices would include payments and expenses defined as Investment fees and costs under Proposed RG 97.40

    The Price of Investment Management would also include the cost of internal investment management at a superannuation fund, as well as the administration and transaction costs initiated by investment managers that are currently reported under Transaction Costs.
2. Investment fees and costs should be removed from the Fees and Costs Summary, the Cost of Product Information, and Periodic Statements.
3. The fees charged by the trustee appointed custodian and administrator, while partly related to the investments held by the fund, should be included in Administration fees and costs. This reflects that this fee is the direct responsibility of the trustee and that higher fees will directly reduce net investment returns.
4. The Consumer Advisory Warning required to be provide in PDS's is misleading to the extent that it reflects the incorrect view that the Price of Investment Management reduces consumers' returns.

    The changes proposed in recommendations 1-3 will largely address this issue by having reported costs more reflect consumers' expectations, however one additional change is recommended and is highlighted on the draft version below (Draft RG 97.29)

Figure 1: Consumer Advisory Warning

DID YOU KNOW?

Small differences in both **investment performance and fees and costs** can have a substantial impact on your long term returns.

For example, **total annual fees and costs** of 2% of your account balance rather than 1% **could reduce your final return by up to 20% over a 30 year period** (for example reduce it from $100 000 to $80 000).

You should consider whether features such as ~~superior investment performance or~~ the provision of better member services justify higher fees and costs.

You or your employer, as applicable, may be able to negotiate to pay lower fees. Ask the fund or your financial adviser.

Thank you for the opportunity to make this Submission
If you would like to discuss any details please contact me

John Peterson
Director
Peterson Research Institute

Envision a group of superannuation fund trustees, accountants, solicitors, administrators, auditors and compliance staff cutting their way through the Stronger Super Reporting Forest. They're the producers, the problem solvers. They're cutting through the data and producing Schedule 10 and RG 97 compliant Reports, Statements, PDS's and returns.

ASIC is behind them, sharpening their skills, developing policies, writing Amendments to Regulations, issuing Regulation Guides, conducting Reviews, collecting data, and carrying out inspections.

It is time for everyone in the Australian superannuation industry, including the regulators, to climb the tallest tree, survey the situation, and loudly declare:

"WRONG FOREST!"[31]

[31] Paraphrased from The Seven Habits of Highly Effective People by Stephen R. Covey, 1989

Annexure 1

Manager Performance
Cooper Super System Review: Final report – Part One, Section 3, Endnote 2
Analysis of Publications and Articles

Endnote 2 observes that: “The accumulated literature in this area is vast. For recent Australian evidence related to this issue see:”

Jacqueline Humphrey and Michael O’Brien, 2010, ‘Persistence and the Four-Factor Model in the Australian Funds Market: A Note’, Accounting and Finance, 50(1), pp 103-119;

Carhart 4 Factor Model – *Did not find short or long-term persistence*

Richard Heaney, Terry Hallahan, Thomas Josev and Heather Mitchell, 2007 ‘Time-Changing Alpha? The Case of Australian International Mutual Funds’, Australian Journal of Management, 32(1), pp 95-112;

- “find evidence of time changing alpha using a sample of Australian international funds over the period from July 1995 to January 2005. Regardless, few international funds show consistent positive excess returns over the period.”
- “a fund could report both positive and negative alpha estimates over the study period and many of the funds in the sample exhibit this behaviour” (p14)
- “most of the funds that exhibited positive alphas in the first part of the study also exhibited negative alphas in the second part of the study” (p15)

Mean reversion

In the UK, Andrew Clare, Keith Cuthbertson and Dirk Nitzsche (2009) ‘An empirical investigation into the performance of UK pension fund managers’, Journal of Pension Fund Economics and Finance;

Pooled pension funds offered to UK pension schemes in the UK

“Limited evidence that funds outperformed their benchmarks”

(*Positive alphas after fees implies not decreasing returns by 100% of investment fee.)* p6

Persistence – Contingency analysis “no evidence of performance persistence amongst any of the pooled pension funds.” p7

Abrevaya and Jiang (2005) and Jiang (2003) have suggested an alternative, non-parametric, test for market timing

In the US, Jeffrey Busse, Amit Goyal, and Sunil Wahal, (2010) ‘Performance and Persistence in Institutional Investment Management’, Journal of Finance, 65(2), pp 765-79;

We assess performance by estimating factor models cross-sectionally for each product and by constructing equal- and value-weighted aggregate portfolios. Using the portfolio approach, the equal-weighted three-factor alpha based on gross returns is an impressive 0.35% per quarter with a t-statistic of 2.52. However, value-weighting turns this alpha into a statistically insignificant −0.01% per quarter. Correcting for momentum also makes a big difference: the equal-weighted (value-weighted) four-factor alpha drops to 0.20% (increases to 0.05%) and is not statistically significant. Fees further decimate (reduce to *one tenth?*) the returns to plan sponsors; the equal-weighted (value-weighted) net-of-fee four-factor quarterly alpha is 0.01% (−0.10%) and again not statistically significant.

But not negative by amount of fees on average

Fitting post the event

"Evidence of such persistence could represent a violation of efficient markets, and, for plan sponsors, represent an important justification for selecting investment managers based solely on performance. We judge persistence in two ways. First, we form **deciles** based on benchmark adjusted returns and estimate alphas over subsequent intervals using factor models. We calculate alphas over short horizons (one quarter and 1 year) to compare them to the retail mutual fund literature, and over long horizons to address whether plan sponsors can benefit from chasing winners and/or avoiding losers. Second, we estimate Fama–MacBeth (1973) cross-sectional regressions of risk-adjusted returns on lagged returns over similar horizons." p767

"Over evaluation horizons longer than 1 year, no measurement technique shows positive top-decile alphas" p768

Would not expect any top-decile alphas to repeat

What are the practical consequences of this? If one takes the strong view that there is no persistence, then one logical conclusion might be that plan sponsors should engage in entirely passive asset management. Lakonishok et al. (1992) point out that if plan sponsors did not chase returns, they would have nothing to do. Given agency problems, exclusively passive asset management is an unlikely outcome. Moreover, French (2008) argues that **price discovery, necessary to society**, requires some degree of active management. These arguments imply that some degree of active management must exist and that plan sponsors, in equilibrium, should provide capital to such organizations.

=> Benefit of active

In relation to hedge funds, John Griffin and Jin Xu, 2009 'How Smart Are the Smart Guys? A Unique View from Hedge Fund Stock Holdings', Review of Financial Studies, 22(7), pp 2351-2570;

Long equity positions only as reported in 13Fs

Time period to 2007 – lots of no skill hedge funds

Bogle, John C, 'Common Sense on Mutual Funds', 10th Anniversary edition, Wiley 2010.

Book

Annexure 2

Ability of Trustees to Select Managers who will Outperform
Cooper Super System Review: Final Report – Part One: Section 3, Endnote 3
Analysis of Publications and Articles

Note (3)

Hazel Bateman and Susan Thorp, 2007, 'Decentralized investment management: an analysis of non-profit pension funds', Journal of Pension Fund Economics and Finance, 6(1), pp 21-44;

> *This article is based on a very short time period (3 years to December 2004), adds back an arbitrary 50 basis points fee without differentiating between types of superannuation fund (e.g. retail vs industry), does not use actual investment related costs, and invalidly compares actual returns (created from ex-ante analysis) to an 'optimally weighted' portfolio (i.e. constructed ex-post).*
>
> *Even given these limitations Bateman & Thorpe found that as the number of mandates increased, funds were more likely to match or outperform the 'benchmark' / 'index'. (This would suggest that larger, more institutional, superannuation funds were better able to select managers who would outperform.)*

Amit Goyal and Sunil Wahal, 2008, 'The Selection and Termination of Investment Management Firms by Plan Sponsors', Journal of Finance 63(4), pp 1805-1847.

> *The Goyal and Wahal article found that for international equity mandates – presumably appointments by larger and more institutional funds – the post-hiring excess returns [over benchmarks] were positive and large.*
>
> *This suggests that large institutions were better at selecting managers who would outperform.*

Annexure 3

Investment Fees and Fund Returns
Cooper Super System Review: Final Report – Part Two, Section 1, Endnote 34
Analysis of Publications and Articles

Note (34)

Coleman, A. D. F., N. Esho and M.Wong. (2006). 'The Impact of Agency Costs on the Investment Performance of Australian Pension Funds'. Journal of Pension Economics and Finance, 5(3), 299-324;

> *The Coleman, Esho and Wong paper has data issues, being at a fund aggregate rather than option / product level, and the breakdown of costs between investment and other costs was not available. The analysis is also dominated, in number, by corporate funds which constituted 84% of the sample. It is now known that, even in 2010 when the Cooper review was released, corporate funds were rapidly being absorbed into Master and Industry Funds. This data issue is reflected in the category in the analysis with the largest firms by size, being firms of greater than $500 million of assets. Thus, the vast majority of the funds analysed by Coleman, Esho and Wong would today be considered to be of sub-efficient scale[32].*
>
> *While this paper did identify a negative relationship between returns and costs, it did not differentiate between the Price of Investment Management and other Management Costs.* ***The analysis was therefore incapable of differentiating between value added, or subtracted, by 'investment fees'.***

Sy, W. and Liu, K. (2009), 'Investment performance ranking of superannuation firms', APRA Research Working Paper <www.apra.gov.au/Research/Working-papers.cfm>;

> *The Sy and Liu paper, also suffers from benchmark construction issues – with Private Equity, Infrastructure and Hedge Fund allocations being aggregated under 'other' and counted, for benchmark construction purposes, as being equivalent to unlisted property – which introduces significant aggregate benchmark errors.*
>
> *In addition, the expenses used in the analysis was an aggregate of all fund expenses, and thus did not differentiate between investment related and other expenses. Thus, while the analysis found a significant inverse relationship between net performance and aggregate expenses,* ***the analysis was incapable of differentiating between value added, or subtracted, by 'investment fees'****.*
>
> *Even given these issues, Sy and Liu found the, "average firm performance being only slightly lower than their benchmarks". This finding:*
>
> *a) Suggests that significant gross investment value was being added for net returns to be only slightly below benchmark after subtracting the Price of Investment Management, and the Costs of Administration and Advice; and*
>
> *b) Provides strong evidence that the Price of Investment Management is not a Cost as currently treated in the Disclosure Regime. If it were actually a*

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[32] I do not express my personal views as to what would constitute a minimum efficient fund size in this submission.

Cost then virtually all firms analysed would have produced net returns significantly below their benchmarks.

Javier Gil-Bazo and Pablo Ruiz-Verdu, 2009, 'The Relation between Price and Performance in the Mutual Fund Industry' Journal of Finance 64, pp. 2153-2183;

J Chevalier and G Ellison, 1999, 'Are some mutual fund managers better than others? Cross-sectional patterns in behaviour and performance' Journal of Finance 54, 875-899; (*Off base, but supportive of manager skill*.)

The Gil-Bazo & Ruiz-Verdu and Chavalier & Ellison papers were based on mutual fund data, and are therefore not relevant to the institutional setting of Australian Superannuation Funds.

Bogle, J.C. (2008),'A question so important that it should be hard to think about anything else', The Journal of Portfolio Management, Winter 2008, pp.905-102.

The Bogle paper, apart from being irrelevant to institutional investment due to its focus on retail investors and products is, if anything, supportive of the use of active management by institutional investors in that:

a) Sixty (60) percent of the costs identified were brokerage. If 'brokerage' represents market brokerage transaction costs, then these are now essentially irrelevant at an institutional level. Alternatively, if 'brokerage' represents advice costs, then they are irrelevant to the question of whether active investment management adds value, net of the Price of that Investment Management, to institutional superannuation fund returns.

b) Bogle – who was the founder of index fund manager The Vanguard Group – notes that "[the financial system] creates substantial value for our society". Notably, the first source of value creation identified is the 'optimal allocation of capital among a variety of users'.

This observation is notable in that Bogle's belief in the ability of the financial system to create value is a ***refutation*** *of two of the core arguments put forward to support the superiority of indexed over active investment management by superannuation funds:*

a. ***Static and Random Markets****: Two of the key underlying assumptions of modern finance and portfolio theory are that markets in general, and investment markets in particular, are either Static (i.e. unchanging) or Random (i.e. efficient). In either case these assumptions rule out the possibility of investment managers adding value, as in neither case are managers able to gain insight into future investment risks and returns. Thus the net effect of active management must, by definition, be to reduce returns by 100% of the Price of Investment Management.*

In these situations, investment decisions by managers cannot alter market prices, or alter the allocation of capital in the economy, thereby creating value for society, some of which could be retained by investors in the form of positive gross investment returns. By believing that the financial system does create value for society

Bogle implicitly recognises that markets are neither static nor random.

(This view is also implicitly held by ASIC, as its Disclosure Regime documents reflect a belief that changes to legislation, regulation and supervision will alter the behaviour of superannuation trustees (product providers) and consumers, whereas in static or random markets legislation, regulation and supervision are incapable of altering economic outcomes.)

b. ***Zero Sum Game**: Another argument frequently made is that markets are a zero-sum-game, and thus the aggregate return to active investment management must be negative, being the return of the market, less the Costs (100% of the Price of Investment Management) incurred. Thus, while some managers may add value after costs, consumers must lose in aggregate.*

   This argument is based on markets being static, with the underlying assumption being that manger decisions cannot alter resource allocations, and thus cannot create value for society.

   Again, by expressing the belief that the system, 'creates significant value for society' by facilitating the, 'optimal allocation of capital among a variety of users', Bogle is also repudiating the Zero-Sum-Game argument

*The argument is appropriately summed up by Bogle in his observation in respect of **retail mutual fund investors** that, "No, it is not that the system fails to create benefits. The question is whether, on the whole, the costs of obtaining those benefits have reached a level that overwhelms them."*

This is a reasonable observation in respect of retail investors in retail fee charging mutual funds. It is however not relevant to institutional investors.

Annexure 4

Consistency of Manager Performance

This note summarises a presentation that I recently made to The Institute of Quantitative Research in Finance (Q Group) in Sydney, titled 'Assessing the Consistency of Manager Performance'.

The research, based on data published by Vanguard Australia this year[1], analyses the performance of actively managed funds available to Australian investors.

The analysis of 728 actively managed funds showed that **the performance of active managers' had been consistent** across the two 5-year periods to December 2011 and 2016. Statistically, **there was a less than 2 percent chance that the funds had not performed consistently**.

This finding, which aligns with previous analysis conducted by the Peterson Research Institute, is crucially **important to the way that Australian superannuation funds construct their investment portfolios, and hence the returns earned by members**.

In short, **if investment managers perform consistently then super funds are able to select managers who will add value in the future**.

These results indicate that Australian superannuation funds DO NOT invest their clients' funds 'randomly', or with the 'average' manager.

Furthermore, while reports that the average manager does or does not outperform an 'index' may make good headlines, in reality it is irrelevant, as if manager performance is consistent, then **super funds do not invest with the average manager**.

As part of the research presented, it was also demonstrated that all previously reported analyses of the consistency of manager performance did not actually assess the consistency. In fact past analysis has only assessed whether investment markets were static – which we all know, and which the previous analysis found, is not the case.

This previous analysis includes numerous academic papers and the widely publicised assessments carried out by Vanguard (in 'The case for low-cost index-fund investing' publications) and S&P Dow Jones (in their 'Persistence Scorecards').

The significant statistical results obtained in his research, strongly endorse the role of active investment management in Australian superannuation funds, and **reaffirm that trustees are acting in their members' best interest by pursuing an active investment approach**.

About the Author

John Peterson is the founder of Peterson Research Institute Pty Ltd, and has over 35 years of experience in the financial services and investment industry. John was a founding member of the Q Group.

Enquiries: john@prigia.com

The views and opinions expressed are those of the author. This is provided for general information only and does not constitute financial or any other advice.

1. https://static.vgcontent.info/crp/intl/auw/docs/literature/The-Case-for-Indexing-Australia.pdf?20171013|143516

Technical Notes

The assessment of the consistency of manager performance is based on comparing performance – in particular performance relative to other funds - in one period, to that in a subsequent period. In the Vanguard case that was assessed, 5 year performance to December 2011 is compared to the subsequent 5 years to December 2016.

This data can be presented in a ‘contingency table’ which plots the quartile ranking of the performance of managers / funds in the two periods against each other.

For example, in the table in Figure 1, which only considers the first period, we see that twenty-five percent of funds would be allocated to each quartile.

Figure 1

Period 1	
Quartile 1	25%
Quartile 2	25%
Quartile 3	25%
Quartile 4	25%

Figure 2

	Period 2			
	Q1	Q2	Q3	Q4
Period 1 Quartile 1	6.25%	6.25%	6.25%	6.25%
Quartile 2	6.25%	6.25%	6.25%	6.25%
Quartile 3	6.25%	6.25%	6.25%	6.25%
Quartile 4	6.25%	6.25%	6.25%	6.25%

In the contingency table (Figure 2) we see what would happen if investment markets were actually ‘random’ with no manager being able to perform consistently.

The 25% of funds in each quartile in Period 1, would have a random quartile ranking in Period 2. As a result the funds’ would be randomly distributed across the table, with each cell in the contingency table having $1/16^{th}$ (6.25%) of the total.

At the other extreme, if the world is **Static** (i.e. markets are in long-run equilibrium or are regularly repeating), then a fund that is in quartile one in the Period 1 **must repeat that relative performance in Period 2**, as the market and manager behaviour that results in first quartile performance is repeated in both periods. (Note that in a Static world there is no learning, so past behaviour is repeated.)

If we assume, for simplicity purposes, that there are 160 funds being analysed (10 per cell if allocated randomly), then the funds in Static markets must be found only on the diagonal of the contingency table, as in Figure 3. The ‘Pattern of Performance’ in the contingency table represents cells where the number of funds is greater than the expected number (6.25%, or 10 funds) in green, and less than the expected number in pink.

Figure 3: Pattern of Performance in Static Markets

Period 1 \ Period 2	Q1	Q2	Q3	Q4
Quartile 1	40	0	0	0
Quartile 2	0	40	0	0
Quartile 3	0	0	40	0
Quartile 4	0	0	0	40

Most previous analysis conducted assumes that investment markets are either Random or Static as these are the assumptions on which Modern Portfolio Theory is based.

These previous studies have typically sought to test whether top quartile performance in the first period (Period 1) is repeated in Period 2. (Implicitly they are also assessing whether second, third, and fourth quartile performance is repeated.)

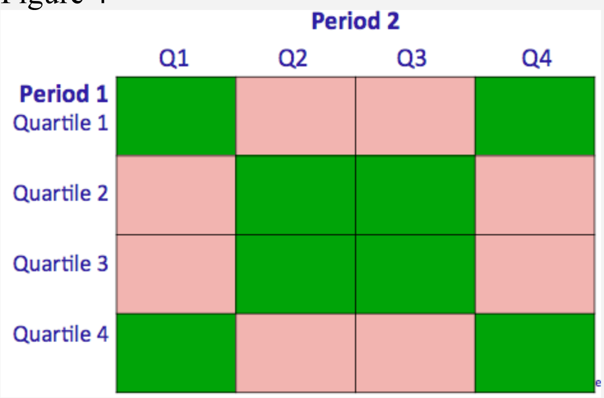
Thus they are testing whether actual manager returns are the same as the pattern of performance in Figure 3, and when finding that they are not, conclude that manager performance is not consistent. **What these studies are actually testing is whether markets are static, with their results showing is that real markets are not Static.** (Hopefully not a major surprise!) **However, these results say nothing about the consistency of manager performance**.

Of course the real world and real investment markets are neither random nor static. **The real economy and markets may best be described as Complex**.

If managers are performing consistently in Complex Markets, the pattern of performance will be different to that found in Random Markets (Figure 2) or Static Markets (Figure 3).

In Complex Markets, Inconsistent managers will be more likely to be found in the first and fourth quartiles in any period (i.e. the four corners of the contingency table), while consistent managers are more likely to be found in the second and third quartiles (i.e. towards the centre of the contingency table).

Figure 4



Thus the Pattern of Performance that will be found **when managers are performing consistently in Complex Markets is that shown in Figure 4**.

The actual Pattern of Performance found in a study of manager returns can be compared to this expected pattern. Furthermore, the likelihood (probability) that the actual pattern found is the same as the expected pattern – and thus whether managers are actually performing consistently – can be calculated.

When the Vanguard study was assessed in this way, it was found that there was a 98.46% probability that active managers in Australian were actually performing consistently.

Annexure 5
10 October 2018

Persistence of the Performance of Active Managers to June 2018

S&P Dow Jones Indices recently released their analysis of the Persistence of Australian Active Funds[33] performance for periods to June 2018.

The analysis, found that, ‘A minority of Australian high-performing funds persisted in outperforming their respective benchmarks or consistently stayed in their respective top quartiles for three consecutive years, and even fewer maintained these traits consistently for the five-year period’.

The conclusion by S&P Dow Jones Indices was that these results, ‘suggest weak performance persistence in top-performing funds in Australia across the three- and five-year periods’.

As explained in a previous Research Note (Consistency of Manager Performance: www.prigia.com), the analysis conducted by **S&P incorrectly assumes that repetition of quartile performance** (1st to 1st; 2nd to 2nd; 3rd to 3rd; and 4th to 4th) **is indicative of consistent active manager performance.**

In reality this pattern of performance will only occur where markets are in static equilibrium.

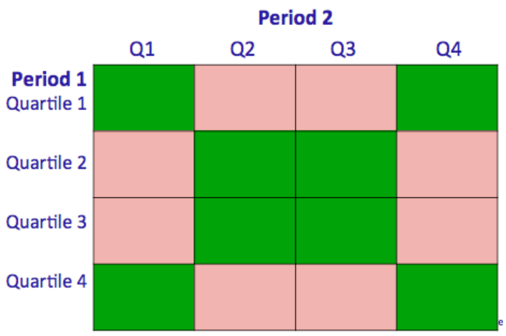
The only thing that S&P’s analysis is testing for is whether markets are static. Hopefully it does not come as a surprise to those involved in actual markets that the results of S&P’s analysis are consistent with markets not being static.

Importantly, this is the only conclusion that can be drawn from the analysis conducted by S&P – **the results say nothing about the consistency of manager performance**.

In real investment markets, some managers will perform well or poorly due to luck, while other will perform consistently by adding value. Managers whose results are significantly determined by luck will tends to be in the 1st and 4th quartiles of their peers, while consistent managers will tend to be in the 2nd and 3rd quartiles.

Thus, when active managers are consistently adding value the pattern of performance in the contingency table (transition matrix) will appear as in Figure 1, where a green cell represents more manager outcomes than random, and a pink cell fewer outcomes.

Figure 1: Persistent Pattern of Performance

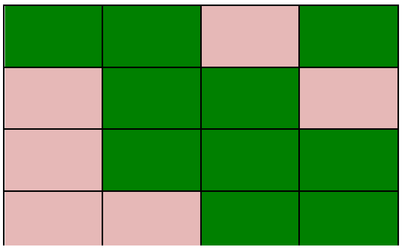


[33] https://us.spindices.com/documents/research/research-persistence-of-australian-active-funds-september-2018.pdf

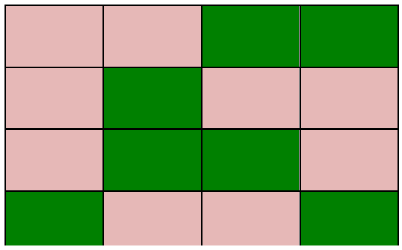
Whether the actual pattern of performance produced by managers is consistent with the Persistent Pattern of Performance can be assessed statistically.

The actual Patterns of Performance of the actively managed Large-Cap Australian Equity Funds (General Funds) in the S&P Dow Jones Indices Persistency analysis, over the two consecutive 3-year and 5-year periods to June 2018 are given below.

3-Year Pattern of Performance



5-Year Pattern of Performance



Over the consecutive 3-year periods to June 2015 and 2018, there was a **98.5% probability that active manager performance was persistent**; and

Over the consecutive 5-year periods to June 2013 and 2018, there was a **99.7% probability that active manager performance was persistent**.

Summary

As in previous periods, the S&P Dow Jones Indices analysis of the consistency of performance of Australian Equity Funds to June 2018 actually provides evidence that:

1. **Markets are not in static equilibrium; and**
2. **Australian equity managers exhibited strong consistency of performance.**

The strong consistency of performance implies that institutional investors, such as Australian Superannuation Funds, are able to identify and select managers who will add value in the future.

John Peterson

Peterson Research Institute

About the Author

John Peterson is the founder of Peterson Research Institute Pty Ltd, and has 40 years of experience in the financial services and investment industry. Enquiries: john@prigia.com

Annexure 6

Cuffelinks
Three key issues with S&P's index v passive scorecard
by John Peterson on October 23, 2018

S&P Dow Jones Indices recently released its updated Index Versus Active (SPIVA) Australian Scorecard covering fund manager versus index performance to June 2018.

The results of the analysis have again found that, with the exception of small-cap equities, the average Australian actively-managed fund underperformed comparable market indexes over the 1-year and longer periods. That is, more than 50% of active funds underperformed the index.

Unfortunately, the S&P SPIVA analysis is not comparable to, and is therefore irrelevant for, institutional superannuation funds, and may be for some individual investors.

Three key problems with the analysis

If we take Australian equities as an example (general or large-cap style), there are three problems:

1. Managers

The SPIVA analysis is based on over 300 actively-managed funds defined by Morningstar as large-cap. It is not disclosed how many managers actually manage these 300 funds.

From an institutional perspective, there are probably less than one-third that number of large-cap managers and strategies that would even be considered as potential investments, due to the tight compliance and eligibility rules they use.

2. Equal versus asset weightings

S&P Dow Jones Indices does publish some asset-weighted results (that is, weighting the results by funds under management, not giving equal weights to tiny and large fund managers) in the SPIVA. However, the tables of results which are the sources of the outperformance comparisons over 1, 3, 5, 10 and 15 years showing that x% of funds underperform the benchmark are based on equal-weighted returns. A manager with a small portfolio is given the same weight as one with many billions.

Notably, in the tables in the SPIVA Report which give both equal and asset-weighted return levels, the asset-weighted active funds outperform the equal-weighted funds by 30-50 basis points per annum. This suggests that either:

- larger investors are able to select better-performing actively-managed funds, and/or
- larger actively-managed funds have lower fee levels.

In either case, the asset-weighted funds would have had better performance relative to the index over time if these figures had been used for the outperformance comparisons.

3. Retail fees

The SPIVA analysis is based on fund performance provided by Morningstar, which are after-fee returns. Given the large number of funds (over 300), many have 'retail' fee levels. Moreover, even those 'wholesale' funds included would have fee levels significantly greater than those paid by institutional superannuation funds investing through mandates, and some options accessible by retail.

The charts in the SPIVA analysis which show cumulative (growth of a dollar) performance versus the benchmark show clear outperformance by the asset-weighted funds over the equal-weighted across essentially all periods, and for all asset classes (with the notable exception of small-cap funds). This indicates that larger investors select better performing investments.

Adjusting the results

If the SPIVA analysis was adjusted to reflect an institutional manager selection process and institutional fee levels, it would be likely that the average super fund investor would be found to consistently outperform the benchmark.

Actual results delivered by Australian super funds support this conclusion, with the SuperRatings SR50 Australian Shares Index of after-fee (i.e. actual) returns to super fund members outperforming the S&P/ASX 200 index (before fees) in every period (1, 3, 5, 10 and 15 years).

S&P Dow Jones Indices claim that they are 'the de facto scorekeeper of the ongoing active versus passive debate'. It should be born in mind that the SPIVA Scorecard is only relevant to retail investors, and even there, should be qualified by the above analysis.

[Editor's note: The SPIVA data is often quoted to demonstrate active manager underperformance, but it is not the only company which monitors managers. The latest Mercer Investment Survey results were recently released for September 2018, as shown below. Perhaps supporting John Peterson's analysis, Mercer shows the median Australian shares manager outperformed the S&P/ASX300 by 1.2% (9.4% versus 8.2%, before fees) over five years. Even after fees, this result is likely to show outperformance].

The medians (before management fees and taxes) for the Mercer Surveys* for periods to 30 September 2018 were as follows

	3 Mths (%)	1 Yr (%)	3 Yrs (%pa)	5 Yrs (%pa)
Median of the Mercer Australian Shares Survey	1.4	14.6	12.6	9.4
S&P/ASX 300 Accumulation Index	1.5	14.0	12.2	8.2
Median of the Mercer Overseas Shares Survey	6.3	19.2	12.6	15.3
MSCI World ex-Australia Index	7.4	20.8	12.4	15.3

* Universe data and rankings as at 9.56am on 17 October 2018. Stock returns are price returns. Index and stock returns are in Australian Dollar terms unless otherwise stated and sourced from Thomson Reuters Datastream.

John Peterson is the Founder of Peterson Research Institute Pty Ltd and has 40 years of experience in the financial services and investment industry. The views and opinions expressed in this article are those of the author. This article is provided for general information only and does not constitute financial or any other advice.

Peterson Research Institute

Global Investment Analysis (GIA)

GLOBAL INVESTMENT ANALYSIS

GIA

PETERSON RESEARCH INSTITUTE

The End of Active vs Passive

The Numbers Tell the Real Story

Active-Passive Arguments

There has been considerable discussion and argument over the last 25 years around the question of whether active management adds value to investment portfolios, or whether investing in market index portfolios would give better results.

The 'Active' argument is typically portrayed as being that markets are inefficient, and therefore the opportunity exists for managers to add value. This is an argument that is most strongly supported by the 'revealed preference' of institutional investors in Australia - superannuation trustees and their advisors – in that they have consistently allocated 20-30% of their investment risk budget to manager skill.

The Passive argument is that 'Active is worse' because of the costs involved. It is argued that investment managers do not add value, nor do so consistently, and therefore selecting managers that will add value in the future is too difficult, and in any case, markets are a zero-sum game. In each case the net effect of active management is to reduce returns by the management fees paid. Therefore, incurring management fees by allocating assets to active management is an unqualified 'bad'.

This Passive argument is most strongly supported by those academics who believe that markets are 'efficient' and by the 2010 Super System Review (Cooper Review) who's investment recommendations primarily focussed on reducing management fees.

The Real Question

What is missing in the whole active-passive debate are answers to the real question – **'Do portfolios with more manager skill outperform or underperform those with no, or lower levels of, manager skill?'**

The Active case is supported by the strong returns produced by superannuation funds, with the argument being that, "if the system works don't change it". The key difficulty with this argument is that it makes **no comparison between actual portfolios with different levels of manager skill**.

The Passive case is based on arguments about market efficiency, and the lack of skill demonstrated by investment managers under various measures. The passive argument is that, “if active managers cannot beat markets indices consistently, then the after fees return of a portfolio **must decline as more active skill is included**”. Again, the key difficulty with this argument is that it makes **no comparison between actual portfolios with different levels of manager skill**.

The Numbers Tell the Real Story

The Global Investment Analysis system allows us to analyse **actual outcomes**. The following charts look at the ‘Balanced’ and ‘Growth’ style portfolios that represented the vast majority of assets managed by superannuation funds in Australia.

Chart 1 plots the **actual after fees returns** for the 10 years to June 2013, against the **proportion of Manager Skill** (Manager Risk divided by Total Investment Risk) in those portfolios as at June 2009 (approximately the middle of the period).

Chart 1

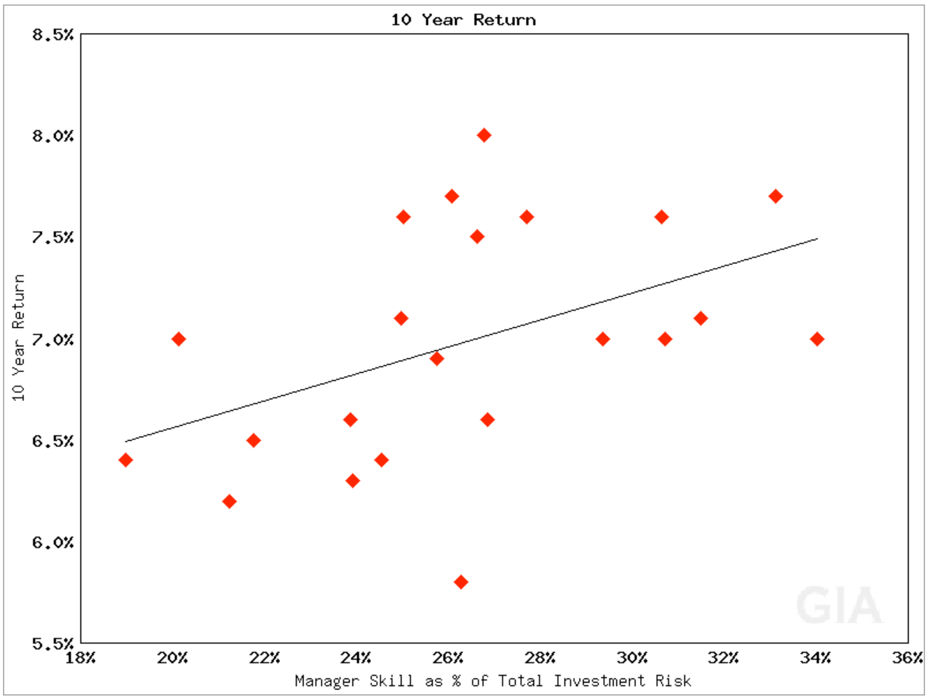


Chart 1 shows that **Manager Skill has added value** over this 10 year period, with the level of after fee returns increasing as funds increased their allocations to active Manager Skill.

Moreover this **value added has persisted**, with the investment returns in the 5 years to June 2005 (Chart 2: Manager Skill as at June 2004) and June 2010 (Chart 3: Manager Skill as at June 2009) both showing that the **after fees returns of actual investment portfolios has increased as more active Manager Skill is included**.

Chart 2

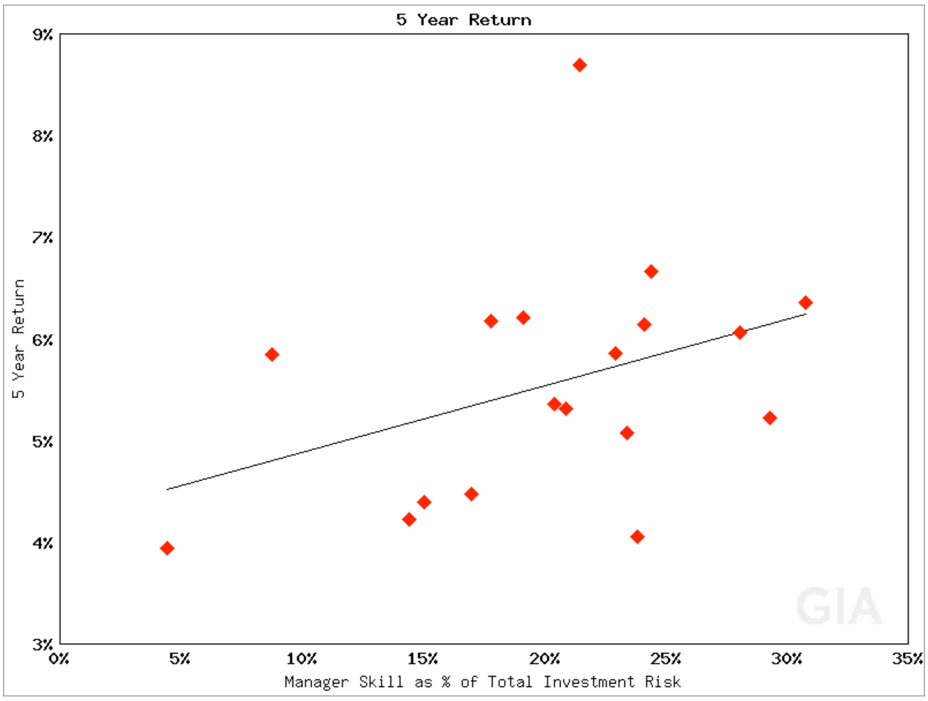
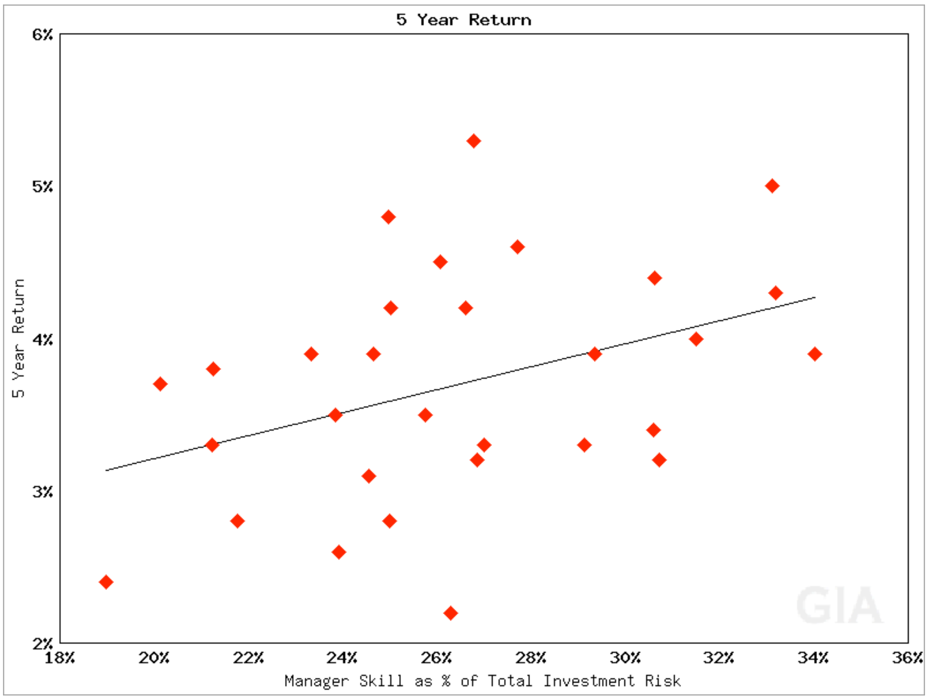


Chart 3



The End of the Active Passive Debate

If any of the three core arguments for Passive Investment Management are correct, then a portfolio's investment returns **must decline** as allocations to Active Management Skill increase. This would be represented in all of the Charts above by the **line of best fit sloping downwards to the right**.

The finding that **in reality funds with a higher allocation to Manager Skill have consistently outperformed** – i.e. that the line of best fit slopes upward to the right – proves that:

First, the **Passive Management arguments are not supported by the actual evidence**. As noted above, if either of the arguments is correct then the line of best fit **must slope downwards**. The fact that it **actually slopes upwards** requires, in logic and statistics, that the Passive Proposition be rejected.

(More precisely, the Passive arguments are incomplete, in that they fail to take into account the actual processes used by Institutional Investors to assess and monitor investment managers. In short, **Institutional Investors do not invest in the 'average manager'**.)

Second, and very importantly, through the processes they have used to select and monitor managers, **Australian Superannuation Funds have successfully identified and allocated funds to Active Investment Managers who have added value after fees**.

Conclusion

The 'Active-Passive Debate' is over. The real numbers tell the real story.

The important questions that now need to be addressed concern the appropriate level of Manager Skill in a portfolio, and the associated processes of manager selection and portfolio construction.

John Peterson
Peterson Research Institute
May 2015

Peterson Research Institute's Global Investment Analysis (GIA) system is provided free to Institutional Investors at www.prigia.com

This article is general information and does not address the personal needs of any individual. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.

Annexure 8

23 January 2019

Comparing the Pair - Update
Super Funds Index vs Active Options
by John Peterson

My original Research Note on the 'investment experiment' being conducted by Australian Super between active and passive (indexed) investment options covered the period to June 2017. This Note updates that analysis to December 2018 and includes the results for HostPlus Super's equivalent experiment.

The argument that indexed investment produces superior results than active investment appears to be the belief of Australia's regulators, who have enshrined reducing investment fees – and hence increasing index investment - as one of their primary objectives. This also appears to be the consensus belief in the financial press in Australia.

Given this near universal acceptance of the superiority of indexing, and the 'proof' that the average manager underperforms the index that is presented on a regular basis, **it would be expected that the index products available to superannuation fund members would show clear outperformance of active equivalents.**

In fact the reverse is the case, with equivalent actively managed investment options offered by Australian Superannuation Funds consistently outperforming their indexed counterparts.

Consider the results of Australia's largest superannuation fund, Australian Super.

Australian Super offers both the actively managed Balanced option, and passively managed Indexed Diversified options to members. These options are equivalent, with the characteristics of the two products being virtually identical when expressed in terms of the descriptors prescribed in legislation and regulation:

- both have 10 year recommended investment horizons;
- both have the same Risk of Negative Return (5 years in 20); and
- both have essentially the same long term return objective (CPI+4% p.a. and CPI+3% for the Balanced and Indexed Diversified Funds respectively).

As expected, the investment related fee of Australian Super's Balanced option (0.58%) is higher than that of the Indexed Diversified option (0.12%).

Similarly, **HostPlus** offers both an actively managed Balanced option, and passively managed Indexed Balanced investment option with equivalent characteristics.

- both have 10 year recommended investment horizons;
- both have the same Risk of Negative Return (5 years in 20); and
- both have essentially the same long term return objective (CPI+4% p.a. and CPI+3% for the Balanced and Indexed Balanced options respectively).

The investment related fee of HostPlus Super's Balanced option (0.71%) is higher than that of the Indexed Balanced option (0.02%).

Experiments
Probably inadvertently, both Australian Super and HostPlus Super have created ‘true experimental designs’ (technically the Post-test Only Design) to test the effect of the independent variable of investment approach (active vs indexed) on member investment return outcomes.

Given that in each case both the active and indexed options are offered by the same super fund (Australian Super or HostPlus), then all costs other than those associated with the investment approach should be similar, if not identical between the options. (In fact the transactional and operational costs are lower for the indexed options than the active options in each case.)

Therefore, the principal difference in overall costs and fees will reflect the differences in investment management fees between active and indexed management.

Furthermore, for both super funds, each option have been constructed by the same investment team and process (advisors, Investment Committee, compliance framework, etc.). Therefore differences in investment team and process are ‘controlled for’ and will not be contributors to differences in investment returns.

Thus, the difference in returns to investors between the active and indexed investment options, that have the same risk profile, will primarily reflect the **difference in net investment returns** between active and indexed management.

What do we mean by Indexed Management?
It is worthwhile clarifying what is meant when we refer to an ‘indexed’ investment approach.

Fundamentally, an **indexed investment approach** means that the investment portfolio is constructed in a way that **minimises investment related fees and costs (i.e. management fees)**.

In superannuation funds, investment management fees are minimised by investing in investment strategies that do not involve active management of assets, and therefore do not incur active management fees. Consistent with this, indexed investment products such as Australian Super’s Indexed Diversified option and HostPlus Super’s Indexed Balanced option:

a) Do not invest with active managers in liquid investment strategies such as equities, fixed interest and cash; and

b) Do not invest in investment strategies that only exist as a result of the application of manager skill such as Private Equity, Infrastructure, Credit, Hedge Funds, and Property

Thus, low-cost superannuation fund management – as encouraged / mandated by the industry’s regulations and regulators – means more than just the selection of indexed investments in liquid markets. It also means the omission of investment strategies that only exist because of the application of manager skill.

Results of the Experiment
Given the common, and widely believed, argument that active management produces 'below market returns' as a result of active management fees (due to the zero sum game, and the impossibility of selecting managers who will add value consistently) then Australian superannuation funds' indexed options, such as Australian Super's Indexed Diversified and HostPlus's Indexed Balanced options, should outperform their Fund's Balanced options by a substantial margin reflecting the differences in investment fees and costs.

i.e. Australian Super's Indexed Diversified option should outperform its Balanced option by at least 46 basis points per annum, while HostPlus's Indexed Balanced option should outperform by at least 69 basis points per annum.

In reality, the results of the experiments are exactly the opposite of what theory (and index managers and regulators) say will occur. The active managed Balanced options offered by Australian Super and HostPlus have consistently and substantially outperformed their indexed alternatives.

Table 1. Australian Super Investment Option Returns to December 2018 (p.a.)

Option	1 Year	2 Years	3 Years	5 Years	7 Years
Balanced (Active)	1.21%	7.22%	7.56%	7.84%	9.92%
Indexed Diversified	0.12%	4.66%	5.68%	5.47%	7.60%
Active Outperformance	**1.09%**	**2.56%**	**1.88%**	**2.37%**	**2.32%**

In the year to December 2018, the additional 'cost' of 46 basis points in investment management fees for the Balanced option, produced an increase in members' returns of 1.09%. Moreover, the actively managed Balanced option has consistently produced significant outperformance after fees of some 200 basis points per annum over the life of the Indexed Diversified option

Table 2. HostPlus Super Investment Option Returns to December 2018 (p.a.)

Option	1 Year	2 Years	3 Years	5 Years	7 Years
Balanced (Active)	2.17%	7.62%	8.44%	8.32%	10.11%
Indexed Balanced	-0.58%	4.22%	5.48%	6.18%	9.30%
Active Outperformance	**2.76%**	**3.40%**	**2.96%**	**2.14%**	**0.81%**

HostPlus's actively managed Balanced option exhibits similar consistent and substantial outperformance of the Indexed Balanced alternative.

Returns
How can this be? How can Australian Super and HostPlus's actively managed options outperform their indexed equivalent given everything that we read about the supposed 'superiority' of index funds?

In reality, the outperformance of the actively managed Balanced options is not surprising. It simply reflects the reality that institutional investors are able to select managers who add value after fees, and **do not invest with the average manager!**

Beliefs

It is notable that while index managers, regulators and journalists continuously espouse the superiority of 'low cost index management', this is clearly not a belief held by superannuation funds and their trustee / directors. This can be seen in the preferences revealed in their decisions to invest the vast majority of superannuation funds on an active basis.

Clearly Australian superannuation funds believe that active management (with corresponding higher fees) provide superior returns for members, and act accordingly in spite of the intense pressure applied to them to create 'low cost' (and thus low return) investment products by regulators and their policies (MySuper, RG97, etc.)

It is relevant that both Australian Super and HostPlus publically express in their PDS's an expectation that their Indexed options will produce lower returns for their members over time than their actively managed Balanced options (3% p.a. vs 4% p.a. over inflation respectively) even though the statutory expression of investment risks (an expectation of 5 negative returns over 20 years) is the same in all cases. (Notably Australian Super reduced the return target / expectation for its Indexed Diversified option from 3.5% p.a. to 3% p.a. over inflation in its latest PDS.)

Thus **both superannuation funds are expressing a belief that active investment management of their portfolios adds value by increasing investment returns after fees for the same level of investment risk!**

Risks

Finally, I would note that the reality is that actively managed investment options earn higher returns than indexed options. This is demonstrated in the ongoing experiments being conducted by Australian Super and HostPlus. It is also the case that over the last 7 years the Indexed options have had higher volatility of returns than the actively managed Balanced options. Mathematically, a lower actual (and expected) return, combined with a higher volatility of returns, implies that the Indexed options must have a greater expected frequency of negative returns than the Balanced options. (This is highlighted by the Hostplus Indexed option being the only one of the four considered in this Research Note to have had a negative return in 2018.)

John Peterson
Peterson Research Institute

About the Author

John Peterson is the founder of Peterson Research Institute Pty Ltd, and has over 35 years of experience in the financial services and investment industry.
Enquiries: john@prigia.com

The views and opinions expressed in this article are those of the author. This article is provided for general information only and does not constitute financial or any other advice.

2 April 2019

Submission in Response to ASIC Consultation Paper 308

Review of RG 97: Disclosing fees and costs in PDSs and Periodic Statements

Part II

I welcome and appreciate the opportunity to comment on the proposals set out by ASIC in:

- Consultation Paper 308: Review of RG 97 Disclosing fees and costs in PDSs and periodic statements (CP 308, January 2019);
- Attachment 1 to CP 308: Draft Regulatory Guide 97; and
- Attachment 2 to CP 308: Draft Amendments to Corporations Regulations Schedule 10 – Disclosure of fees and other costs (Sch 10)

As noted in Part I of this Submission, this Part II, presents more subjective proposals / recommendations that represent my personal views about alterations to the Disclosure Regime that may contribute to meeting the objectives of regulation of superannuation and MIS funds.

1. **Related / Associated Party Payments**

   As seen from the recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, an area of significant risk in superannuation is payments to related and associated parties.

   I believe that it would be beneficial for the industry to have any payments that had the potential to create agency risks due to their being made to related parties disclosed in PDS and other Periodic reports to members.

   The definition of associated / related should be as broad as practical so as to include any financial relationship that would potentially influence decisions by the trustee, including payments related to the internal management of investments.

   Such payments should not be regarded as Costs which would be reported in the Fees and Costs Summary as this would risk creating double-counting, but would best be reported as a separate item - in some ways equivalent to the reporting of executive remuneration in companies' annual reports.

2. **Risks and Returns in Superannuation Fund Portfolios**

   An analysis of the risk and return characteristics of Australian Superannuation Funds was reported in Part I of this submission. This analysis was produced on the Global Investment Analysis (GIA) risk analysis tool, which was demonstrated to ASIC in 2013.

   The GIA tool is based on an approach to fund risks and returns which explicitly takes into account the active investment risks in investment portfolios. This active (manager) risk makes up 20-30% of the overall investment risk in superannuation fund portfolios and is largely ignored in the analysis of funds' risk/ return characteristics.

   As offered in 2013, the GIA system is available at no cost to ASIC and/or APRA on a stand-alone basis. (An online version is available to any superannuation fund that wishes to use it, also at no cost.)

3. Investment Option Labelling

The Cooper Review (p109) discussed Investment option labelling in the context off the risk levels if investment products. They noted that:

> "Investment options offered by super funds are often identified by labels such as 'balanced', 'growth', 'capital stable' and the like. Currently, these labels have no standard meaning, resulting in reduced comparability. For example, some 'balanced' investment options have 80 per cent of so-called 'growth' assets, while others have as little as 60 per cent. Apart from anything else, existing investment option descriptions do not allow members to make informed decisions because they provide inadequate information about the expected returns and volatility of various investment options.
>
> The Panel does not believe that it would be feasible to mandate asset types and allocation ranges within the existing nomenclature or that it would be desirable to impose that level of rigidity on products. The Panel instead favours the introduction of a risk and return targeting framework in the formulation, disclosure and measurement of investment options and their performance."

The Cooper Review Panel implicitly recognised an issue with the current approach to assessing the risk exposures of superannuation funds – namely that risk is typically only defined by the allocation to physical assets in the product's portfolio.

In reality, the allocation to manager skill has important implications for the risk and return characteristics of a fund's investment portfolio.

By way of example, consider two funds with identical allocations to physical asset classes (and hence the same levels of Market Investment Risk, but with different amounts of Manager Investment Risk - due to one having appointed active investment managers over a greater part of the portfolio. All other things being equal:

- The portfolio with the higher allocation to Manager Investment Risk will have a greater overall allocation to Investment Risk. (Investment Risk = Market Investment Risk + Manager Investment Risk). This portfolio should therefore have a higher expected return over time.
- The portfolio with the higher allocation to Manager Investment Risk is also be likely to have greater levels of diversification in returns – as Manager Investment Risk is typically not correlated 1-to-1 with Market Risks – and would therefore be expected to have a lower level of Portfolio Risk.

  This is consistent with the results of the performance of the Australian Super and Hostplus actively managed Balanced products versus their Indexed products. While notionally having the same levels of market risks – as reflected in their expected frequency of negative return estimates – in reality, the actively managed funds have delivered significantly higher levels of net returns to members, with lower levels of portfolio volatility.

I would recommend that ASIC, in addition to the traditional approach to considering Investment Risk which only takes account of physical investment allocations, and hence only Market Risks, explore the incorporation of manager risks into its understanding of portfolio performance.

Under this approach the overall level of Investment Risk in the portfolio would be more relevant than the physical investment allocation and associated investment labels such as ‘Balanced’, ‘Growth’, etc.

If you would like to discuss any of the issues raised herein please contact me.

John Peterson
Director
Peterson Research Institute