

The case for a universal default superannuation fund

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Introduction

The existing superannuation system is built on a contradictory notion of the way people make financial decisions. On the one hand, the concept of compulsory superannuation suggests that Australians are myopic, irrational and have to be forced to save. On the other hand, when forced into the system, fund members are assumed to be informed and discerning investors, able to make rational decisions about how to allocate their retirement savings among a host of competing alternatives. Only one of these opposing views can be correct and it is the responsibility of policymakers to design systems that accommodate real-world human behaviour.

This paper sets out the case for the establishment of a universal default fund (UDF) for compulsory superannuation in Australia. To date, there have been a number of proposals for a single, government-back default fund, with variations in design. These are all based on the assumption that many workers will not make active choices about their superannuation, and that a well-designed system of defaults is needed.

The UDF would apply to between six and 16 per cent of the workforce, those workers who do not have a default fund specified in an award or industrial agreement.¹ The UDF would provide a safety net to the current awards-based system of defaults, but any worker would be able to opt into it. We estimate that, compared to a high-cost retail fund, a properly-designed UDF could add up to \$100,000 to the superannuation of an average wage earner who utilises this option over the course of a lifetime. It would also help solve one of the most intractable problems in superannuation, the proliferation of multiple and 'lost' super accounts that erode the retirement savings of millions of Australians.

In Appendix 1, we consider the option of capping fund administration fees at one per cent of funds under management, with an option to pay higher fees if fund members give express permission. Even without a UDF, capping fees at this level could raise the average account balance at retirement by \$35,000, and much more for the one in three workers who are currently affected by high fees.

The need for change

There are a number of reasons why the process of superannuation defaults needs to be overhauled.

The aggregate administrative cost of the Australian superannuation system is 1.35 per cent of assets according to Rainmaker Information;² Rice Warner Actuaries give a similar figure of 1.26 per cent,³ neither of which sounds substantial. However, given the \$1.1 trillion size of superannuation assets, this amount in fact represents a transfer of \$14.3 billion per annum from fund members to the financial services industry, equating to half the \$28 billion cost of providing the age pension—a payment that accrues to over two million retirees.

¹ Where such workers are covered by a low-cost fund, such as the corporate fund of a large employer, the organisation could apply for an exemption to the requirement to make the UDF the default fund. By 'low-cost' we mean having a total management expense ratio of less than one per cent of the superannuation balance.

It is possible that the award modernisation process will affect the number of workers covered by an adequate default fund.

² Rainmaker Information, *2009 Rainmaker Fee Review*, March Quarter 2009 Edition.

³ M Rice, *Superannuation Fees Report—Market Segment Analysis at 30 June 2006*, prepared for the Investment and Financial Services Association by Rice Warner Actuaries, May 2007.

<http://www.ifsa.com.au/documents/2007_0518_RWA%20Super%20Fees%20Research%20-%20FINAL.pdf>.

Administrative costs of 1.35 per cent have been estimated to reduce final super fund balances by up to 27 per cent or over \$130,000 for a worker on the average wage. To rephrase, this cost constitutes around one-quarter of a typical worker's total superannuation accumulation, a much larger figure than if expressed with reference to total assets.⁴ Whether this represents true value for money remains an open question.

High fees also impose costs on the public purse. People are expected to maintain themselves, wholly or partly, in old age and the government has provided very generous public subsidies by way of superannuation tax expenditures in order to attain this end. But substantial degrees of self-support are not likely to be achieved if, as at present, high fees reduce retirement lump sums by very significant percentages. The effect of the current system is to raise the proportion of retirees who are wholly or partly dependent on the age pension, which will inevitably result in higher government expenditure and a commensurate burden on taxpayers.

Most fund members are offered a choice of investment strategy, but 80 per cent do not take advantage of the offer;⁵ consequently, their assets are invested in the fund's default option.⁶ It is therefore imperative that default options offer members a sensible investment at low cost. There is evidence that many people regard a default option as implicit financial advice, which is a dangerous assumption.⁷

Currently, lost accounts are estimated to number 6.4 million, while inactive accounts represent another nine million.⁸ These accounts could be aggregated into a default fund that could potentially earn a better rate of return, particularly on small capital amounts that are currently protected but derive negligible earnings. A UDF based on low-cost passive management would provide a safety net for those workers who might otherwise fail to make optimal investment choices, thus ensuring that a decent retirement benefit is available to more Australians and not just to the wealthy.

The government recently issued a discussion paper, which explores options for delivering on the election promise to introduce a superannuation clearing house and allow automatic consolidation of superannuation accounts. While we support reform in these areas, we still regard the case for a UDF as a strong one.

The UDF could incorporate the following useful features (although these are not strictly essential for its operation):

⁴ The way that superannuation funds present costs can be highly misleading and distracts fund members from their impact on final balances. This issue is discussed further below.

⁵ L McDougall, 'An Analysis of Superannuation Fund Default Options', summary report of 2008 Honours Thesis, QUT, 2008, p. 3. The 80 per cent figure relates to industry funds only. The aggregate amount invested in default options is 46 per cent of assets (see Footnote 12), although the proportion of members who invest in the default strategy is higher than this because wealthier members are more likely than those with low fund balances to make active decisions about how their super assets are invested.

⁶ Default options are commonly in the form of a 'balanced' option with between 60 and 80 per cent in growth assets such as shares and property and the balance in defensive assets such as cash and fixed interest. This would usually not be the best investment mix for people a long way from retirement.

⁷ O Mitchell and S Utkus, 'Lessons from Behavioural Finance for Retirement Plan Design', in O Mitchell and S Utkus, *Pension Design and Structure: New Lessons from Behavioural Finance*, Pension Research Council, Oxford University Press, 2004, pp. 3–41.

⁸ Australian Treasury, *Australia's future tax system: The retirement income system—Report on strategic issues*, Australian Treasury, May 2009, p. 21.
<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm>.

- passive rather than active management based on investments in an index of Australian and international equities, together with cash and bonds⁹
- an age-based weighting towards equities to take account of changing needs across the life cycle¹⁰
- a reserve fund to smooth annual differences in returns
- government-backed annuity products designed to alleviate the financial 'risk' associated with living longer than average.

These features are explained in more detail below.

Reform of the financial services industry will be difficult due to the presence of an enormous and profitable industry with a stake in the continuation of the high-fee status quo and the absence of an active constituency for change. Establishing a UDF (in whatever form) is therefore likely to generate some opposition from vested interests such as the retail superannuation sector. However, a UDF is a practical solution to the problems outlined above and is therefore very much in the national interest.

Default options and the Choice of Fund policy

When people face complex investment choices without the ability to analyse them and select the most appropriate option, their decisions are often characterised by inertia, disinterest and procrastination, which can lead to sub-optimal financial outcomes. This remains the case even if they participate in financial education programs.¹¹ To take one example, investment fund members are disproportionately attracted to the 'middle' investment option, apparently because it inhabits a position between two extremes.¹² Such a choice is likely to be inappropriate both for the young (who should be heavily invested in equities) and the old (who should rely more on defensive investments like cash or bonds).

The Choice of Fund policy was introduced in 2005 and, for the first time, gave the majority of workers the ability to nominate a preferred superannuation fund for their compulsory employer contributions. Although it was designed to improve competition in the super sector and thus lower costs, Choice of Fund has not in fact done this. Nor is it likely to in the foreseeable future, given the way that competition actually works in a largely uninformed and apathetic consumer market. In Australia, less than 10 per cent of workers have actively chosen a fund and switching rates are as low as two to four per cent annually.¹³ The evidence clearly shows that most people simply accept the default option offered by their employer. But because there are presently no rules governing them, default funds are in some cases relatively high in fees and poor in performance. The cost of such 'non-choice' can amount to hundreds of thousands of dollars, as shown below.

⁹ Passive management means investment in a broad index of the share market with company holdings in proportion to their market capitalisation (value). This is the lowest-cost form of funds management; fees are typically a third to a quarter of those charged under active management. Bond portfolios can also be passive, and the UDF proposed in this paper would invest in both equities and bonds according to the age of the member.

¹⁰ Investors would hold a higher proportion of equities at younger ages. 'Equities' is another word for company shares. The case for age linking is explained later.

¹¹ G Gallery, N Gallery and K Brown, 'Superannuation Choice: The Pivotal Role of the Default Option', presented at the 12th Australian Colloquium of Superannuation Researchers, University of New South Wales, 12–13 July 2004, p. 2. <<http://www.docs.fce.unsw.edu.au/fce/Research/ResearchMicrosites/CPS/Natalie%20Gallery.pdf>>

¹² Mitchell and Utkus.

¹³ J Fear and G Pace, *Choosing not to choose: making superannuation work by default*, Discussion Paper No 103, The Australia Institute, November 2008, p. 16. <<https://www.tai.org.au/?q=node/9&pubid=2045>>.

Some retail funds present more than 100 investment options and most offer at least five to ten, but despite this huge range of choice the majority of fund members do not even elect to choose an investment option. At June 2008, 46.2 per cent of all fund assets were in the default strategy,¹⁴ with some funds reporting that up to 90 per cent of members are in this situation. Those who do exercise choice tend to be wealthy individuals with large balances.¹⁵

Investment choice has proliferated to the point where it actually threatens to reduce wellbeing and undermine consumer engagement. Very few people are well-educated in financial affairs,¹⁶ and where choice is exercised their decisions often turn out to be wrong. US studies have shown that the average managed fund underperforms the broad market index, and that the average investor in managed funds underperforms the average for all such funds.¹⁷ This is attributed to the human predilection to invest in risky assets when markets are doing well and to rely on capital-guaranteed investments when markets are doing poorly. Of course, the wise investor would do precisely the opposite. As financial decisions and products become more complex, the benefits of greater choice diminish and may even become negative.

The performance of default funds is not homogeneous. Gallery et al. note a spread in five-year returns among the top 10 funds of between 7.1 and 13.2 per cent, a huge difference if it were to be carried over a lifetime.¹⁸ They observe that:

Superannuation fund members face significantly different terminal superannuation values just because of differences among their superannuation fund's default investment option ... [M]any Australians' retirement wealth (or otherwise) will be determined by the 'accident' of working for a particular employer or in a particular industry.¹⁹

Similarly, a poorly performing fund can have a dramatic impact on retirement balances. In Australia, it has been found that retail funds underperform the not-for-profit sector in aggregate by about two to three percentage points,²⁰ a circumstance that can lead to a retirement lump sum being smaller by 40 to 60 per cent. This difference is not due to manager skill or asset allocation. Rather, higher expenses and taxes, both explicit and embedded, are the main component of average net return differences.²¹ Retail funds accounted for \$342 billion in superannuation assets, or some 29 per cent of the superannuation total of \$1,172 billion at June 2008.²² Given the wide variations in net performance between funds (even within sectors), it is important that workers are not placed

¹⁴ APRA, *Statistics Annual Superannuation Bulletin*, June 2008 (revised 10 June 2009).

¹⁵ Fear and Pace, p. 11.

¹⁶ Systematic biases in decision-making have been shown to apply equally to the highly educated and/or wealthy and to poor or uneducated people. In fact, the whole field of behavioural finance is predicated on institutional investors and large-scale traders making poor decisions due to human frailty.

¹⁷ In the US, the main index is the S&P 500 representing the top 500 firms in the US market weighted by market capitalisation. Calhoun finds that the average investor in managed funds in the US earned 4.5 per cent a year between 1987 and 2007 compared with the S&P's 11.8 per cent. See J Calhoun, *The 12 investment myths: why individual investors are failing miserably and how you can avoid being one of them*, Robert D. Reed Publishers, Bandon, 2009.

¹⁸ Gallery et al., p. 12.

¹⁹ Gallery et al., p. 13.

²⁰ See A Coleman, N Esho and M Wong, 'The impact of agency costs on the investment performance of Australian pension funds', *Journal of Pension Economics and Finance*, 5:3, 2006, pp 299–324.

²¹ See K Ellis, A Tobin and B Tracey, 'Investment performance, asset allocation and expenses of large superannuation funds', *APRA Working paper*, October 2008.

²² APRA, 'Superannuation industry overview, September 2008', *APRA Insight*, Issue 2, 2009, pp. 2–10. http://www.apra.gov.au/Insight/upload/Insight_Issue_2_2009_all.pdf.

in poorly performing funds simply because they do not make an active decision upon commencing employment.

Higher fees do not typically result in better fund performance; in fact, Sy and Liu show that higher operational costs are correlated significantly with lower net investment performance.²³ On a net-return basis, the average cost of active investing²⁴ is 0.9 per cent,²⁵ a large fraction of the total cost of management. The implication is that index (that is, passive) investors would, on average, be significantly better off over a lifetime than those who engage in active investment.

Average management costs rose from 1.67 per cent in June 2006 to 1.69 per cent in March 2008 for the top 14 retail funds, while for not-for-profit industry funds they rose from 0.75 per cent to 0.83 per cent.²⁶ The Choice of Fund policy was predicted by its advocates to result in increased competition and consequently lower administrative costs, but this has not occurred. Nor, as discussed above, are higher fees necessarily associated with better returns; rather, the opposite is true.²⁷ Costs have remained high because funds compete for the attention of intermediaries such as financial planners, who are often remunerated by commission.

Although the superannuation system has grown, which would suggest scope for economies of scale, the overall management expense ratio (MER) has remained relatively fixed at around 1.3 per cent of funds under management. It is unlikely that there will be member-initiated changes to fee structures because surveys have shown that the majority of members know little or nothing about the fees and charges that apply to their superannuation.²⁸

Choice of Fund has also been largely unsuccessful in lowering the number of multiple accounts, one of the most serious problems for policymakers. In fact, the number of accounts per employee has actually increased, 'suggesting that choice has not "empowered" consumers to take even the most basic action to improve their superannuation arrangements'.²⁹ There are 32 million superannuation accounts in existence, triple the number of people in the workforce,³⁰ and the result is considerable wastage across the superannuation system. Rice Warner has estimated that more than 13 million super accounts are completely unnecessary and accumulate fees of between \$1.2 and \$2 billion per annum.³¹ This estimate has since been revised down to \$1 billion,³² but either way it is a

²³ W Sy and K Liu, *Investment performance ranking of superannuation firms*, APRA Working Paper, APRA, 23 June 2009. <http://www.apra.gov.au/Research/upload/SA_WP_IPRSF_062009_ex.pdf>.

²⁴ Active investing is the opposite of passive (index) investing. It is based on the notion that the manager, through skill, can invest in ways that outperform the relevant index. For example, an Australian share fund might have as its performance benchmark the ASX 200 index or the all-ordinaries (the top 500 shares on the Australian market) and seek to achieve returns greater than the index. 'Net return' is the return to the investor after management fees are deducted.

²⁵ Sy and Liu, p. 16.

²⁶ The aggregate costs for these sectors as a whole are as shown in Table 1 in the Appendix.

²⁷ SuperRatings, *Fund Crediting Rate Survey—SR50 Balanced (60-76) Index June 2008*, 2008.

²⁸ S Vidler, 'Superannuation: choice, competition and administration cost', *JAPE* 53, June 2004, p. 36. <http://www.jape.org/component/option.com_remository/Itemid.26/func.startdown/id.68/>.

²⁹ Fear and Pace, p. vii.

³⁰ A Hattingh, J Ng and M Rice, *Consolidation of superannuation accounts*, prepared for CHOICE by Rice Warner Actuaries, November 2008. <<http://www.choice.com.au/files/f134049.pdf>>.

³¹ CHOICE, *The super secret: how multiple accounts cost consumers billions*, Research Report, November 2006, p. 2.

³² Hattingh et al., p.17.

large expense. Onerous administration and identification requirements act as barriers to account consolidation, a situation that is profitable for the organisations that administer the funds.

CHOICE points out that more than \$5 billion is held in low-return, high-fee eligible rollover funds (ERFs) managed by superannuation organisations. 'There are no incentives to locate the missing account holders (indeed funds profit from holding monies in ERFs) and many consumers are never reunited with their "lost" funds'.³³ While the Labor Government is currently addressing some of the barriers to account consolidation, the financial services industry continues to accrue much of the financial benefit associated with managing these lost or inactive accounts.

What is missing in the superannuation arena is a set of policy arrangements based on both the interests of disengaged fund members and evidence about actual behaviour. A more thoughtful use of default mechanisms has significant potential to result in better outcomes for many Australian workers in retirement.

Previous proposals for a government-run UDF

To date, there have been various proposals for a UDF. Some are based simply on the idea that one default fund is preferable to many, but do not detail how assets would be invested. Others have specified exactly how the investment and/or governance model would operate in practice.

Brown et al. proposed a government-run UDF, which would protect 'passive investors' against poor fund choices. Their rationale is that in the superannuation industry the twin priorities of protecting members' interests and promoting market competition are irreconcilable. Because superannuation literally forces workers to save, the government has an obligation to protect the savings of vulnerable members who are unable or unwilling to manage their investments themselves. Given the desire to reduce spending on the age pension, 'it is in both the government's and taxpayers' interests to ensure that those savings are not frittered away due to poor fund choices'.³⁴

Gallery et al. suggest that a UDF represents a viable alternative to adding more layers of regulation to an already complex system of privately-managed superannuation.³⁵

In 2006, the House of Representatives Standing Committee on Economics, Finance and Public Administration proposed '... that the government introduce a default superannuation fund for casual employees, so that when a casual employee does not wish to choose their superannuation fund, that employee is automatically placed in a government-determined default fund'.³⁶

CHOICE strongly supported this proposal and suggested it be extended to cover account balances held in ERFs.

³³ CHOICE, p. 2.

³⁴ K Brown, G Gallery and N Gallery, 'Informed superannuation choice: constraints and policy resolutions', *Economic Analysis and Policy* 32:1, March 2002, p. 87.

³⁵ Gallery et al., p. 16.

³⁶ Commonwealth of Australia, House of Representatives Standing Committee on Economics, Finance and Public Administration, *Improving the superannuation savings of people under 40*, Canberra, 2006, p. xxvii. <<http://aph.gov.au/house/committee/efpa/super/report/front.pdf>>.

Unlike the ERF system, this central fund must not be prevented from engaging in investment strategies that set out to provide a reasonable return to members. The pooling of ERFs and lost superannuation into the central fund would increase economies of scale and provide a holding point until employees enter full-time employment. Due to economies of scale and the absence of market failure it would be likely to charge lower fees than most existing ERFs.³⁷

Sy has argued for a national default option based on a simple indexing principle (see below) that could, he estimates, lower the MER to as low as 0.1 per cent,³⁸ although other administrative costs would be unlikely to be less than a further 0.2 to 0.3 per cent.³⁹ Sy supports the creation of a Retirement Growth Account (RGA), which would complement the existing Retirement Savings Accounts (RSAs) guaranteed by the government and operated by authorised service providers such as banks. Combinations of RGAs and RSAs could provide flexible retirement savings alternatives and be used to implement an age-based cash-equity mix.

Ingles saw a national default fund as one of a range of options for reducing administrative costs,⁴⁰ with his preferred approach relying on centralised administration of superannuation with asset management (and account administration) contracted out.⁴¹ This approach, while drastically lowering administrative costs (to an estimated 0.4 per cent MER), is unlikely to be politically palatable in the conceivable future because of the vested interests in an industry that generates in excess of \$14 billion a year in fees. Put simply, the superannuation industry has a massive stake in the existing system and there is no active constituency for change.

Principles for good default arrangements

Fear and Pace have argued that the following principles should govern any system of defaults in superannuation.⁴² Default funds should:

- be simple and effective while allowing participants to opt out if they prefer more choice or flexibility
- embody a rational approach to retirement preparation in the interests of fund members without the need for costly financial advice
- focus particularly on the needs of members who are a long way from retirement or whose accumulation benefits are relatively modest, since these people are the least likely to make optimal financial choices about their retirement

³⁷ CHOICE, p. 34.

³⁸ W Sy, 'Towards a national default option for low cost superannuation', APRA, mimeo, 2009.

³⁹ Other costs include general administration that covers, among other things, accepting monies from and paying monies to members, communicating with members and organising transfers in and out of the UDF. See E James, J Smalhout and D Vitas, *Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective*, World Bank, Washington DC, 2001, p. 15, where the estimate is that such costs equate to US\$20 to US\$25 per account. On a US\$10,000 account this would be 0.2 to 0.25 per cent. Such costs might be higher in the early years of a UDF but then gradually come down.

⁴⁰ 'Another option is to allow employers to fulfill their SG obligations through a simple residual scheme that would replace the existing penalty tax on those not paying SG benefits. If this scheme were sufficiently cheap to run and returns sufficiently attractive, it might gradually increase in importance as a cheap option for many small employers. The scheme could also function as a repository of funds for those changing jobs, in this way supplanting the many Approved Deposit Funds which often pay relatively poor rates of return.' See Ingles, p. 12.

⁴¹ Ingles.

⁴² Fear and Pace.

- be structured to maximise asset accumulation by allocating investments appropriately and minimising fees
- maintain fairness in the way that assets are accumulated and invested
- be designed to reduce the likelihood that members will make decisions based on how choices are presented rather than the financial outcomes that they embody.

Many default funds in industrial agreements are non-profit funds that already abide by some or all of these principles. Where a default fund is not specified in such an agreement, employers have a responsibility to nominate a super fund for those workers who decline to choose one. In many instances this is a difficult decision for an employer and there is currently no mechanism to ensure that such decisions are made in the mutual interests of both employers and employees. Because employers receive none of the benefits associated with high performance and bear none of the burdens of high fund-administration costs, they may simply choose the option with the lowest administrative requirements.⁴³

As Vidler has pointed out, ‘This lack of appropriate incentives on the part of the purchasing entity [that is, employers] explains why corporate employers tend to choose relatively expensive master trusts from retail providers over industry fund products’.⁴⁴ Fear and Pace estimate that for some six to 16 per cent of the workforce the nomination of the default fund is at the discretion of the employer, while for 64 to 74 per cent, the default fund is specified through industrial arrangements and is normally an industry fund. A further 20 per cent of the workforce is ineligible for Choice of Fund for various reasons.⁴⁵

Given the high level of ignorance among employees, it is not surprising that many seek advice from financial planners. But such advice cannot always be considered objective, since many financial planners in Australia are remunerated by up-front commissions and may also receive trailing commissions, annual payments that last for the life of the investment product. Financial planning groups are proposing to phase out commissions on super products but the process is likely to be slow.⁴⁶

A practice that is of increasing concern is that of ‘flipping’, whereby an employee who leaves employment is ‘flipped’ out of the low-cost employer fund and into a high-cost option provided by exactly the same retail fund. According to Industry Super Network (ISN):

The practice of ‘flipping’ workers out of discounted retail corporate plans once they leave their employer is well established within the retail superannuation sector. Many retail corporate plans are structured so that the discounted fees and group insurance rates applicable to members cease once a member leaves their sponsoring employer, and the member is flipped either to an a personal superannuation fund or an eligible rollover fund (ERF).⁴⁷

⁴³ Fear and Pace, p. 29.

⁴⁴ Vidler, p. 33.

⁴⁵ Fear and Pace, p. 44.

⁴⁶ The main retail fund group, the Investment and Financial Services Association, has released a draft charter proposing to abolish commissions on superannuation products from 1 July 2010. It wants the new system to be fully implemented by 2012 and its members to have moved to fee-based remuneration. But the proposals will only apply to new super accounts or plans. APRA figures show investors have more than 16 million retail super accounts. In fact, ‘the vast majority of these can be expected to continue to pay trail commissions to advisers once the new system is introduced’. See A Sampson, ‘Time to bite super commission bullet’, *Sydney Morning Herald*, 20–21 June, 2009.

⁴⁷ Industry Super Network, ‘“Flipping” exposed’, *Network News*, August 2009.
<http://www.industrysuper.com/networknews/issue4/page2.php>.

Analysis of fee research conducted by Rice Warner Actuaries for the Investment and Financial Services Association (IFSA) suggests that up to one million members have been 'flipped' from discounted retail corporate funds to more expensive retail personal plans between 2006 and 2008. The ISN notes that '... the difference in average fees charged by a large retail corporate plan and a personal retail super plan are considerable. Personal retail fund average fees are two and half times the average fees for large retail corporate plans'.⁴⁸ Flipping can be addressed either by regulation to ban the practice or by requiring that retail funds 'flip' the assets into the UDF when the member leaves an employer.

Fear and Pace propose six criteria for determining the suitability of default funds:

- cap ongoing fees and charges, with the cap to be determined by an independent regulator
- prohibit entry and exit fees to encourage mobility between funds
- prohibit the payment of ongoing financial advice fees, including commissions
- offer employers a clearinghouse service that can process payments to multiple funds simultaneously
- if contributions cease, keep members in the default fund rather than transferring their assets to a more expensive eligible rollover fund or 'personal plan' without their explicit consent
- follow up arrears in payments automatically.⁴⁹

A government-administered UDF would meet all these criteria while still generating good returns for members.

The impact of high administrative costs

While administrative costs of 1.35 per cent of assets do not sound substantial, they can in fact reduce the expected real return on accounts and final accumulations by over 25 per cent. For example, an average wage earner can expect to accumulate something like \$400,000 over a lifetime,⁵⁰ but without administrative costs the amount could be closer to \$530,000. It is of course impossible to remove such costs completely, but they can be reduced. Figure 1 below shows the differences in the expected lump sum if the real return is reduced by one or two percentage points (from five per cent real to four and three per cent respectively).⁵¹

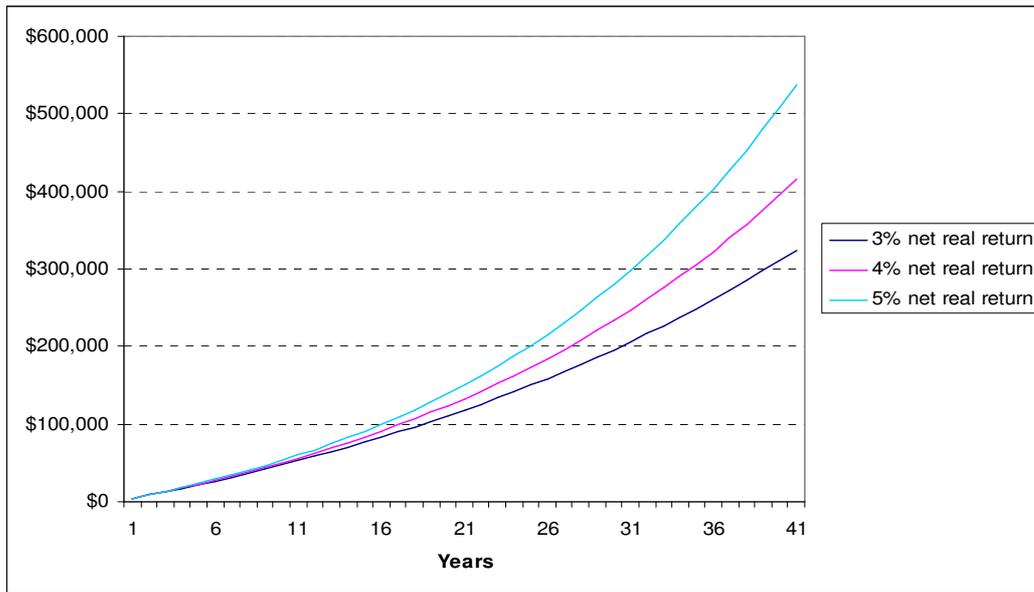
⁴⁸ Industry Super Network.

⁴⁹ Fear and Pace.

⁵⁰ A worker on full-time average ordinary time earnings would accumulate closer to \$500,000 over 45 years; we have discounted this figure to take account of broken work histories and/or part-time work.

⁵¹ The calculations assume that \$4,000 is contributed annually after contributions tax is paid, which is equivalent to the superannuation guarantee (SG) for someone earning \$1,000 a week (\$52,000 per annum). In fact the average full-time wage is 25 per cent higher, but this discount allows for less than full participation in the labour force. The calculations make no allowance for rising wages over time, nor for contributions beyond the level of the SG (nine per cent). Taking these other factors into account would further heighten the value of low fees.

Figure 1: Lump sum accumulation if fees reduce real returns by one and two percentage points



Source: Calculation by the authors as per Footnote 51.

Fees range from an average of 0.7 per cent per annum (not-for-profit public sector funds) to 2.12 per cent (for-profit retail funds).⁵² In some funds, fees as high as three per cent would reduce final super balances by 50 per cent or more.⁵³

In theory, it is possible at least to halve administrative costs with the following measures:

- greater use of passive management (see Footnote 7)
- abolition of fees for financial planners (\$2.4 billion a year on commissions and \$862 million on compulsory contributions)⁵⁴
- more centralised administration (for example, by eliminating multiple accounts).

Ingles proposed a government-run universal superannuation scheme that could have a MER as low as 0.4 per cent, similar to an approach used in Sweden.⁵⁵ A default fund might be able to achieve fees as low as 0.5 to 0.6 per cent (see below), which would be particularly beneficial for fund members currently afflicted by above-average fees and charges. The average super payout for those accessing the UDF would be raised by up to 25 per cent, corresponding to \$100,000 in total for an average wage earner over a working life.

⁵² Rice.

⁵³ The rule of thumb is that asset-based fees cause a 20-fold reduction in accumulation at retirement; for example, a one per cent fee reduces accumulation by 20 per cent. See P Diamond, 'Social security reform with a focus on Sweden', shortened version of a lecture delivered 19–21 October 1999 at Uppsala, 2000, p. 15. <<http://econ-www.mit.edu/files/634>>.

⁵⁴ Rainmaker Information, *Commissions Revenue Report*, prepared for Industry Super Network, July 2008.

⁵⁵ D Ingles, *Reducing administrative costs in the Australian superannuation system*, Discussion Paper No 77, GPPP, Australian National University, 2000, p. 10. <http://www.crawford.anu.edu.au/degrees/pogo/discussion_papers_previous/dp_77.htm>.

Bateman notes that administrative charges and taxes reduce the notional compulsory contribution rate to well below the nominal nine per cent mandated by law, in her example to 5.1 per cent.⁵⁶ In addition, conversion of a lump sum to an annuity also comes at a cost since the return on an annuity is not actuarially 'fair' (because the return incorporates a profit margin for the provider). Bateman argues that this loading reduces the retirement income received by a further 16 per cent.⁵⁷ In fact, hardly anyone purchases an annuity.

Regulations prevent the deduction of fees from small funds with balances below \$1,000 but this comes at the cost of earning zero interest. Small accounts receive no compensation for the time value of money and their value diminishes due to inflation,⁵⁸ a very profitable arrangement for funds that 'lose' customers with small balances.

The downside of complexity

The Choice of Fund policy is not delivering the benefits that were predicted at its introduction. As Fear and Pace have found:

[S]uperannuation fund members are, by and large, not making active choices and therefore not exerting the right kind of competitive pressures on super funds. Switching rates have been much lower than expected. In addition the number of multiple and lost super accounts continues to rise, suggesting that many employees are not transferring their balance when they join a new fund.⁵⁹

In a previous paper, Fear showed that 'choice overload' is particularly common in personal financial decisions. An estimated 40 per cent of Australians believe that there is too much choice in their financial affairs, but many are mistrustful of financial advisors because of their poor image.⁶⁰ Where financial advisors are consulted, people find that commissions can be very expensive over the life of an investment product.

The inherent complexity of financial products can inhibit rational decision-making. Because of the fear of losing money, 'many people may be unduly conservative in their investment decisions, for example choosing "capital stable" or "capital guaranteed" rather than "growth" products'.⁶¹ This is an example of the *endowment effect*, the well-documented tendency for people to value money that is lost more highly than money gained.⁶² It is exacerbated by basic misunderstandings about the difference between nominal and real returns on investment, sometimes referred to as *money illusion*.

There is compelling evidence that people make different financial decisions when the same data is presented in different ways, a phenomenon known as the *framing effect*.^{63,64} In fact, research has shown that the way options are presented is 'a more powerful influence on ...

⁵⁶ H Bateman, 'Retirement income strategy in Australia', *Economic Analysis and Policy* 32:1, March 2002, p. 5.

⁵⁷ Bateman, 'Retirement income strategy'.

⁵⁸ Vidler, p. 31.

⁵⁹ Fear and Pace, p. 27.

⁶⁰ J Fear, *Choice overload: Australians coping with financial decisions*, Discussion Paper No 99, The Australia Institute, May 2008. <<https://www.tai.org.au/>>.

⁶¹ Fear and Pace, p. 32.

⁶² D Kahneman, J Knetsch and R Thaler, 'Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias', *The Journal of Economic Perspectives* 5:1, 1991, pp. 193–206.

⁶³ Mitchell and Utkus.

⁶⁴ S Bernatzi and R Thaler, 'How Much is Investor Autonomy Worth?' *The Journal of Finance* 52:4, 2002, pp. 1593–616.

decision-making than the underlying risk and return characteristics of the investments being offered'.⁶⁵

The way that administration costs are presented by super funds can be highly misleading, particularly for people with little financial experience. Costs are typically described (as in this paper) with reference to the total balance, otherwise known as the MER. This generates numbers in the order of zero to two per cent, which sound relatively cheap. Given the major impact that fees have on final returns, a more meaningful way to present these figures would be in relation to the total *earnings* on the funds invested. Using this method, administration costs on a typical worker's superannuation would amount to 25 per cent, a much higher figure.⁶⁶ Highlighting the dollar amounts deducted from superannuation balances in this way would focus the attention of fund members on the costs involved and would also improve the ability of members to ascertain what *value* they are receiving for the costs they incur.

Consider the following example. Suppose a worker earning \$1,000 a week (\$52,000 per annum) is in a retail fund with real gross earnings of five per cent (that is, seven to eight per cent in nominal terms) and annual costs of two per cent of assets. Their employer makes compulsory contributions of nine per cent to their superannuation fund. After 40 years of work, their gross real accumulation, without fees, would have been \$508,490. But the actual gross accumulation after fees is \$310,650—a difference of nearly \$200,000 or 40 per cent of the pre-fee amount. Even a one per cent annual cost reduces the accumulation from \$508,490 to \$395,300, a loss of 22 per cent.

Unfortunately, the superannuation industry in its current form has an interest in presenting administration costs in a way that disguises their true impact. It is only through government intervention that funds can be forced to disclose the same information in ways that would be more meaningful to ordinary people.

Suggested design features of a UDF

The following principles are suggestions for the design of a UDF, rather than essential features. They are intended to flesh out the proposal without being prescriptive. Obviously any government implementing a UDF would need to pay close attention to these and other design features.

Passive management

Studies show that over a 20-year period only 10 per cent of managers outperform the market, a performance significantly worse than chance. Some managers do exhibit above-average skill, but 'picking winners from well-publicised performance league tables is unlikely to be a sound long-term investment strategy because of the costs in switching to chase yesterday's winners, whose winning streak is unlikely to persist'.⁶⁷

Collectively, of course, it is mathematically impossible for the average manager to outperform the market because administrative and transaction costs lower overall performance. Sy shows mathematically that the asset-weighted average return for all investors is equal to the market return minus transaction costs.⁶⁸ The implication is that any default fund should adopt

⁶⁵ Mitchell and Utkus, p. 16.

⁶⁶ This method would not work for negative returns. In that circumstance, a dollar figure would be a better guide.

⁶⁷ Sy, p. 10.

⁶⁸ See Sy, who has argued for a 'proportionate shareholding approach' to drastically lower MERs below even what would apply via the traditional indexation approach. A fund would hold the same proportion of outstanding shares in all ASX-listed companies as its proportion of total market capitalisation. Presumably, there would be

passive indexation as its investment style because of the lower costs involved. The only question then is what per cent of funds should be invested domestically and what per cent overseas; that is, what indexes the default should match.⁶⁹

Typically, index funds have MERs in the range of 0.3 to 0.4 per cent. For example, the Australian index tracker fund, ASX code STW,⁷⁰ has a MER of 0.3 per cent of funds invested. Of course, a default fund would have other administrative costs apart from fund management,⁷¹ perhaps raising the total to 0.5 or 0.6 per cent. This compares favourably to the current average of 1.35 per cent of funds under management.

Repository for inactive and lost accounts

As already noted, the proliferation of lost and inactive accounts is a significant policy problem. A UDF could be designated as the repository for all these accounts, saving members from incurring high fees that erode their account balances (or, as in the case of balances under \$1,000, prevent them from ever earning a real return on their assets). Transferring inactive and lost accounts to an index-style fund makes intuitive sense and is an appropriate way to manage the assets of workers who have not made active choices about their superannuation.

When an account becomes inactive, usually after a member leaves their job, the member would be notified that their balance is to be transferred to the UDF unless they request otherwise. If no direction is given by the member, the original fund would be responsible for transferring the balance within a certain timeframe. Existing inactive or 'lost' accounts—many of which have already been transferred into ERFs—could relatively easily be switched by the relevant fund to the UDF en masse, along with the personal details associated with each member.

Age-base weighting towards equities

Due to the high but volatile nature of returns to equity, UDF members should have a large exposure to equities early in life but an increasingly lower exposure as they grow older. A typical formula is that equity allocation should be 115 minus the age of the investor recorded

some lower cut-off to eliminate very small and illiquid companies. Alternatively, the ASX 200 or ASX 300 (the top 200 or 300 companies) could be used to guide investment. He estimates that a MER as low as 0.1 per cent is achievable using this approach. Transaction costs would be incurred only when there are new listings (initial public offers) and corporate actions (such as capital raisings). This form of passive investing would not require the use of commercial indexes or commercial index funds.

⁶⁹ The Australian share market comprises 1.4 per cent of total world stock-market capitalisation but is historically one of the best-performing in the world, with an average real return of more than seven per cent. See E Dimson, P Marsh and M Staunton, *Global Investment Returns Yearbook 2008*, produced by ABN AMRO Bank NV in association with The Royal Bank of Scotland and London Business School. <[http://www.london.edu/assets/documents/facultyandresearch/786_GIRY2008_synopsis\(1\).pdf](http://www.london.edu/assets/documents/facultyandresearch/786_GIRY2008_synopsis(1).pdf)>. It is impossible to predict whether this outperformance will continue, but on current evidence Australia is one of the best performing economies in the OECD. In the future, superior returns might be found in the BRIC economies (Brazil, Russia, India, China), which is a reason for including an international component in any index fund. An option would be to have, say, 50 per cent invested domestically and 50 per cent offshore, for example in the MSCI index (a stock market index of 1500 'world' stocks maintained by MSCI Inc., formerly Morgan Stanley Capital International). This domestic/foreign mix would yield diversification benefits and slightly smooth returns. However, the exact mix of overseas and domestic investment is a matter for debate. There is also the question of which index to follow in Australia. The broadest index is the All Ordinaries, but this forces the fund to hold 500 different shares. Very similar results can be expected from holding the ASX 200.

⁷⁰ Australian Stock Exchange.

⁷¹ These other costs relate to processing of incoming funds and payments, record-keeping, contact with members and the like.

as a percentage; that is, 95 per cent at age 20 and 50 per cent at age 65.⁷² It is a well-known finding that negative returns to equities are almost entirely absent after holding periods exceeding 10 to 15 years, even if one is buying-in during a boom.⁷³ This means that over an investment lifetime, young people have ample opportunity to make up for any negative returns early in life. Older people do not always have this opportunity and that is why the optimal allocation to equities may decline with advancing age.⁷⁴

Using a reserve fund to smooth annual differences in returns

The purpose of a reserve fund is to ameliorate the risk of superannuation returns being strongly negative under some market conditions. One of the explanations for the equity premium (the long-term outperformance of equities over cash and bonds) is that returns from equity investment are so unpredictable. Investors must be compensated by higher returns in order to shoulder this risk. This problem can be ameliorated by building up a reserve during good years and running it down during bad years. A UDF might therefore reserve half of all real returns greater than five per cent per annum while half of returns less than zero per cent would be subsidised. Over time, this would allow the building up of truly large reserves, which we suggest should be capped at 25 per cent of liabilities.

If such an approach had been taken in the past, it would have allowed the subsidisation of recent large losses associated with the global financial crisis—at its worst over 50 per cent, the largest historical drawdown of the Australian stock market. This would have prevented people heading into retirement from experiencing the same degree of unanticipated losses they are currently facing.

In case the subsidy should be needed during the time that the reserve fund is accumulating, the government could guarantee it in the short term. However, if the market return reverts to its long-term average yield of seven to eight per cent in real terms, the reserve fund could be expected to reach 25 per cent in 12 years.

The reserve fund is not an integral component of the UDF proposal, but is suggested here as a way of addressing doubts—engendered by the global financial crisis—about the traditional notion that equities are the best form of long-term investment. With smoothing of returns, investors can reap the benefits of the expected equity premium over cash and bonds of six to seven per cent per annum,⁷⁵ while being protected from large, unexpected fluctuations in value. The downside of the reserve fund is that it can seem unfair when members move in and out of the fund, as there are implicit transfers between new and old members. However, under Choice of Fund such movements are entirely voluntary.

⁷² This approach is not without its critics; see the discussion in Mitchell and Utkus, p.14.

⁷³ See for example, Dimson et al., Figure 14.

⁷⁴ See for example L M Viceira, 'Life-Cycle Funds', in A Lusardi (ed.), *Overcoming the Saving Slump: How to Increase the Effectiveness of Financial Education and Saving Programs*, Chapter 5, University of Chicago Press, 2009. This author suggests a 'menu' of life-cycle funds—conservative, moderate and aggressive; but this may be too complicated for the sort of default fund being considered here.

There have even been suggestions that there should be some gearing at younger ages to gain maximum benefit from the equity premium. Equities have outperformed cash and fixed interest by a wide margin, with the historical equity premium in Australia being in the order of six to seven per cent. See Dimson et al.

⁷⁵ According to Dimson et al., between 1900 and 2007 the Australian stock market generated the highest equity premium in the world—a 6.4 per cent gap in the annualised returns between shares and bonds and an even greater gap relative to cash. It would be unwise to expect that this gap would continue at such a high level.

Providing government-backed annuities

The use of reserves could provide a system of smoothing to take advantage of the higher returns from equities without the same degree of risk, which would be particularly valuable during the payout phase if the UDF were to offer annuities. Annuities are the best means of insuring against 'longevity risk', the risk of living longer than anticipated.⁷⁶ Fixed draw-downs, such as those currently promoted in superannuation, cannot address this risk.

Much higher returns are available from annuities if they are partially backed by equity investments. There have been many suggestions that the government should offer annuity products because it is becoming almost impossible for the private sector to offer them at a reasonable price with life expectancies rising so rapidly—by 2.7 months every year over the last century.⁷⁷ The UDF could become the provider of choice for those seeking an annuity.

Other features

The trustee of the UDF would be a public servant appointed by the government, with legislated responsibilities to administer the fund efficiently and achieve returns commensurate with the share-market indexes set out as the fund benchmarks. The relevant proportions and indexes (Australian equities, overseas equities, bonds etc) could be set out in regulations so as to be varied from time to time when considered appropriate.

Another important feature of any superannuation fund is the provision of death and disability insurance. This would need to be considered in the design of the UDF.

Conclusion

The objectives of reducing superannuation administrative costs and minimising complexity for workers can best be achieved by implementing a government-backed UDF that would:

- keep fees low by contracting out administration and employing a passive approach to investment
- become the default for any employer with a default fund not already specified in an industrial award
- be adopted by any employee at any time as the fund of choice
- become the backstop fund used by the Australian Taxation Office (ATO) when levying contributions on employers failing to comply with the superannuation guarantee (SG)⁷⁸
- be used to consolidate lost and/or inactive accounts

⁷⁶ Annuity markets are a considerable problem in Australia. It is not clear whether the best approach would be government provision of life annuities or policies to encourage private provision. As advised in a 2009 private communication from H Bateman, only 61 life annuities were sold in Australia in 2008.

⁷⁷ AIHW, 'Australian trends in life expectancy', 2009. <http://aihw.gov.au/mortality/life_expectancy/index.cfm>.

⁷⁸ The ATO enforces the SG by making it costly for employers that do not meet their obligations to employees. If employers do not pay on time, the ATO deducts an equivalent amount (the superannuation guarantee charge) and passes it on to the employees' superannuation fund. Unlike normal SG payments, this is not a deductible business expense so businesses are much better off paying their contributions promptly. See ATO, *What Employers Need to Know*, 2009, at http://www.ato.gov.au/content/downloads/Super_71038_Whatemployersneedtoknow.pdf. It would be a very simple matter for the ATO to alter these rules so that unpaid superannuation is diverted into the UDF. These contributions would be fully tax-deductible, making the do-nothing option a completely reasonable approach for employers. A tax and a 'contribution' are essentially equivalent, regardless of the language used to describe them; they simply differ on who receives the initial payment.

- act as a repository when members are moving their employment and do not wish to transfer their accounts to a new fund.

If properly designed, the UDF could add up to \$100,000 to the superannuation of an average wage earner who utilises this option over the course of a lifetime.

Past suggestions for a UDF have foundered because the superannuation industry benefits greatly from the current system and there is little constituency for change. It is the role of government to ascertain where the public interest lies and to give it proper weight in decision-making.

Appendix

Reducing super fees through regulatory control

The aggregate management expense ratio (MER) in the Australian superannuation system is 1.35 per cent while the average real return over the past 35 years has been four per cent after fees. Put another way, fees have reduced earnings on superannuation investments by one-quarter, corresponding to \$135,000 foregone over an investment lifetime for the average wage earner. Keeping fees down while not compromising net returns should therefore be a critical policy objective.

Only a minority of members face fees in excess of one per cent of assets and these are generally members of retail (for-profit) funds. 'Retail funds offered on an individual basis ... generally have expenses in excess of 1.5% with expenses of 2.5% or more for small retail products distributed by way of an adviser or other network ...'⁷⁹ Retail fund fees are driven in part by high marketing costs—typically around 45 per cent of total costs in retail financial markets—which bring very little benefit to the typical fund member.⁸⁰ By contrast, some public sector funds have cost ratios of 0.5 per cent or lower. Table 1 shows cost ratios by type of fund.

Table 1: Fees and expenses by superannuation segment—2009

Sector	Total fees
Corporate	0.87
Industry	1.07
Public sector	0.85
Retail	2.11
Small funds	0.79
Total	1.35

Source: Rainmaker Information.⁸¹ Additional data provided by A Dunnin.

We propose that fees be capped at one per cent of funds under management. If funds wish to charge more than one per cent either in aggregate or for a particular plan or option, they would need to seek written approval from each member affected. The written approval would acknowledge that:

- a) the member is aware of the general cap
- b) the fund in question imposes higher fees of x percent
- c) the member believes that the higher-fee product will nonetheless be to his or her net advantage.

⁷⁹ R Clare, *Are administration and investment costs in the Australian superannuation industry too high?* ASFA Research Centre, November 2001, p. 3.
<<http://www.superannuation.asn.au/ArticleDocuments/116/Absolute%20and%20relative%20costs%20of%20super.pdf>.

⁸⁰ James et al.

⁸¹ Rainmaker Information, *2009 Rainmaker Fee Review*.

This would ensure that members of high-fee funds are better informed about the fees they are being charged, and will be more likely to seek out a better deal if they are not getting adequate returns.⁸²

Funds that charge less than the one per cent cap would not need to seek written approval from members. Employers nominating their default fund (that is, the fund that employees are placed in if they do not make an active choice), would only be able to select a fund with fees that are within the cap.

Capping fees at one per cent would have very little impact on the not-for-profit sector (corporate, industry and public sector), which already achieves an expense ratio under one per cent. However, it would have a very big impact on the for-profit sector, where the average expense ratio is over two per cent and three to four per cent fees are not uncommon. APRA has shown that higher fees do not create higher returns; on the contrary, there is an inverse relationship and, in most cases, high fees do not translate into higher earnings.⁸³

The for-profit sector accounts for one-third of funds under management.⁸⁴ If fees in this sector could be halved, it would reduce the cost of superannuation across all sectors by 0.33 percentage points, bringing the average down to around one per cent and increasing the average retirement balance by up to \$35,000, with some individuals benefiting much more. The average increase in super fund balances would be \$100,000 over a working life for current members of retail funds (one in three workers).

In 2008–09, the average fees for workplace master trusts were 2.11 per cent but a number of funds in this sector were able to charge less than one per cent; for example, master trusts are able to offer generous discounts to their larger corporate customers. Using a \$10 million employer account, Rainmaker calculates that in 2008–09, workplace master trusts were able to lower their fees from 2.1 per cent to 1.3 per cent.⁸⁵ Rainmaker notes that ‘wealth management firms have been able to lower their fees simply by making their products less complex and making them available directly ... [R]etail wealth management groups have been able to more than halve their fees for Personal master trusts and even bring them below those charged by industry funds’.

There are a number of retail funds which have been able to bring fees down to one per cent or lower, demonstrating the feasibility of such a cap in the compulsory superannuation sector.⁸⁶ As Rainmaker observes, this ‘directly [challenges] the mantle of industry funds for being the sole champions for low cost super’.⁸⁷ Despite this, the average cost for personal

⁸² There are international precedents for setting fee caps on pension funds. For example, the Swedish system allows any mutual fund to participate in the pension system provided that they agree to a fee schedule, which is set by a government. See James et al., p. 28.

⁸³ Ellis et al.

⁸⁴ APRA, ‘Superannuation industry overview’. APRA put this percentage at 29 per cent but the figure for funds over \$50 million is 44 per cent. The many small funds in the self-managed super sector reduce the aggregate figure; however, some of these small funds would also use retail products and hence we assume a third as the relevant proportion.

⁸⁵ Rainmaker, *2009 Rainmaker Fee Review*, p. 8.

⁸⁶ These include BT Super for Life, AMP Flexible Lifetime Super Easy, IOOF Individuum, Virgin Super and max Super.

⁸⁷ Rainmaker, *2009 Rainmaker Fee Review*, p. 19.

master trusts was 2.39 per cent in 2008–09 compared with 1.09 per cent for not-for-profit personal funds.⁸⁸

Eligible rollover funds (ERFs), where many ‘lost’ super’ assets are placed, are a very expensive investment vehicle, charging 2.63 per cent on average. Despite having the simplest design of any super fund, the lowest number of transactions and the fewest investment choices (none), fees in this sector are the highest, rising as high as three to four per cent. By contrast, the lowest cost ERF charges 0.8 per cent.⁸⁹ Our proposal would mean that fees for ERFs could not exceed one per cent, which would prevent ‘lost’ super from eroding any more than is necessary.

Self-managed super funds (SMSF), which account for 30 per cent of all super assets, have a low aggregate cost of 0.79 per cent. Because of the steps involved in setting up an SMSF, which can require a high level of engagement with retirement planning, these would not be subject to any fee cap.

The intention here is not to ban high-fee products but rather to challenge providers of such products to ensure that they are delivering performance commensurate with the fee structures imposed. The public policy justification for this is, in part, that the SG system is compulsory so there is an onus on the government to ensure that it is shepherding workers into a reasonable form of long-term investment.

⁸⁸ Rainmaker, *2009 Rainmaker Fee Review*, p. 10.

⁸⁹ Rainmaker, *2009 Rainmaker Fee Review*, Table 12.

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