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Douglas has over 25 years finance industry experience ranging from the investment side, with the Regulator, to member engagement, administration and trusteeship. He founded, invented and protected the world's first MySuper Smart Default, Trustee Tailored Super. He has executive management experience, most recently as CEO of a $100+M fund while also bootstrapping and undertaking Smart Default research in order to solve an industry wide efficiency problem. He specialises in complex change management.

Super Industry - Smarter MySuper Defaults

How a changed operating environment is driving competition for members, changes to governance, innovation take-up, mergers and performance measured against the retirement objective.

Are Super Funds being hypocritical?

Telling their members who have made an investment choice and are engaged (circa 20%), via their website information, calculators and advice models (Limited, General or Personal) to use the funds investment options (Australian Shares, Balanced, Cash etc.) based on their retirement lifestyle prospects and age.

But at the same time, for the disengaged MySuper members (circa 80%), those who have not made an investment option choice, most trustees funds do nothing. They just dump everyone in the same investment option bucket. This is despite knowing their projected retirement balances or incomes and now placing them on members' annual statements.

To be fair approximately 1/3rd of funds have moved since 2013 to an age based model for these default MySuper members (be that US styled Target Date or European Life-Stage). This approach blindly reduces risk (e.g. Balanced down to the Cash option, known as a Glide Path) automatically as members get older - just when a member's balance is highest. The result is lower risk of loss as retirement approaches, known as sequencing risk, which is important but at the huge cost of poorer average retirement lifestyle prospects and lower starting retirement balances.

So there is a problem. Most industry executives agree that current approaches are highly inefficient. Having 20 year olds in the same investment option as 60 year olds is wrong. So is having a 40 year old projected to retire on the full Age Pension in the same investment option as another 40 year old projected to retire with $1.6M in super.

Further the problem is important and a solution must be found in order to solve the impending National Retirement Funding Gap, reduce pressure on the super system for ongoing 'tax savings' and to act in members best interest for their retirement. The status quo is not going to achieve that new industry objective.

So it is not that funds and trustees are being deliberately hypocritical. Rather there is a need to find a solution and then be prepared from a governance perspective to accept a changed operating environment and innovate.

Innovation

The industry association ASFA CEO Martin Fahy warned publicly at their 2016 annual conference in his first major address since taking the role that:

"the superannuation industry is at high risk of being disrupted by the fintech sector. On top of that, 20% of people under 29 have indicated they are looking to change superannuation funds in the next 12 months*. We need to lift what we deliver to fund members, how we engage with them, and how we engage with government. People want to embrace the system, and we need to help them do that."*

"If we're going to be successful, we have to engage on our members' terms. If we don't, we will be disrupted. Fintech is currently focusing on banking and payments, but the large pool of superannuation money is not going unnoticed. We are next on the menu."

Innovation may be disruptive, but often it occurs in a collaborative manner and is necessary particularly when the operating environment changes. By definition it involves a changed mindset – to do the same thing/think the same way, produces the same outcome/solutions.

This is just as true in finance as elsewhere. For example conventional investment strategies generally seek to strike a balance between risk and return (the "risk/return trade-off"). That is there is a binary choice between risk and return - more risk for more return - less risk for less return. So look no further, do a loop, go back to the start, don't find a solution – keep the status quo. Right! No wrong the operating environment has changed.

The new retirement objective dictates that a third dimension, time to retirement be added, such that the choice is no longer binary. Instead, more risk can be taken earlier in a working life for some members, less so for others and lower risk taken later in a working life as retirement approaches, for some members but not others.

But what action are trustees and their investment strategy committees going to take?

The Productivity Commission in its recently released report noted Smart Defaults and the role they are set to play in the industry achieving efficient retirement outcomes – so not a bad place to start looking.

Further in the 26 October 2016 academic CIFR submission to the Commissions 2nd inquiry on default fund selection it was noted:

"Member heterogeneity makes it important to accommodate the ability to tailor and foster the development of smarter defaults. The potential for sub-optimal outcomes increases under 'one-size-fits-all' defaults in the presence of heterogeneity. The implication for the review of default arrangements is that care should be taken to engender the scope and incentive for tailoring, including fostering the development of smarter defaults.

In addition, recognising that members are different, many funds are looking for ways to enhance their capability to tailor to members. A key conclusion of the CIFR MySuper research is *that there is a need for smarter defaults to address member heterogeneity, especially given that many members accept the default they are offered as a matter of trust."*

This changed mindset will operationally involve two groups - trustee member services and investment teams - working together in a way that traditionally hasn't occurred, in order to solve in a new way an old problem.

Many of us know that these teams often operate in silos. That on the investment team side they believe it is easier to replicate through derivatives and overlays any outcome desired by the member team. Problem is that this investment approach involves complexity, including actuaries and assumptions, which members just don't get or trust. It also ignores the member heterogeneity efficiency gains alluded to above and the required trustee business strategy to appeal to members. Without new members, regardless of a funds size, net contributions will turn negative and ultimately the investment team's role turns to selling rather than buying assets.

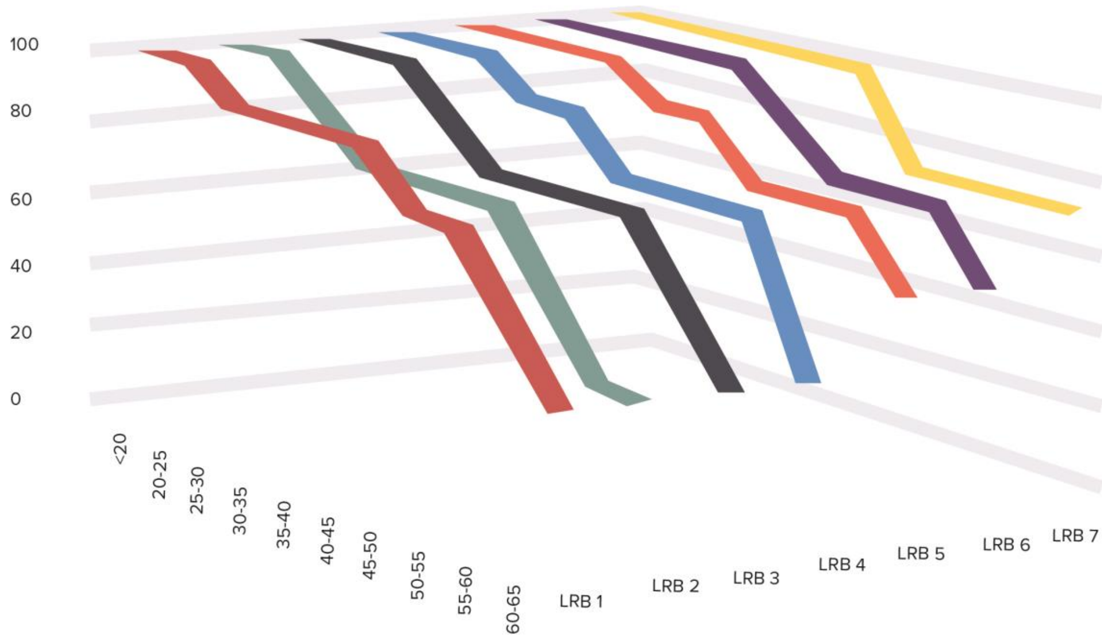
So successful funds need to attract (MySuper) members, nudge engagement and build trust with clear effective statements. Taking the easy path doesn't work. What's needed is a flexible approach to tailoring members by the existing investment options.

In this digital age, is it really the case that fund trustees and executives can't implement a way to better tailor investment options for their disengaged MySuper Members? Or is it that they currently lack the incentive to be innovative?

So what is this new method that's being referred to as the next generation Smart Default?

An example is called Trustee Tailored Super. It tailors default members into different streams (lifestyle retirement bands), based on their projected retirement balance (or its derivative retirement income). Then for each of those streams automatically provides different investment options (Glide Paths) based on a members' age.

It is depicted in the following graph. For example all members with a projected retirement balance, under say $50,000 are placed on the red glide path (LRB1), following that path those aged up to age 25 years are in 100% growth assets (Australian Shares Option), then between 25-45 they step down to 90% growth assets (Aggressive Option) etc. A different glide path applies to LRB2 etc.

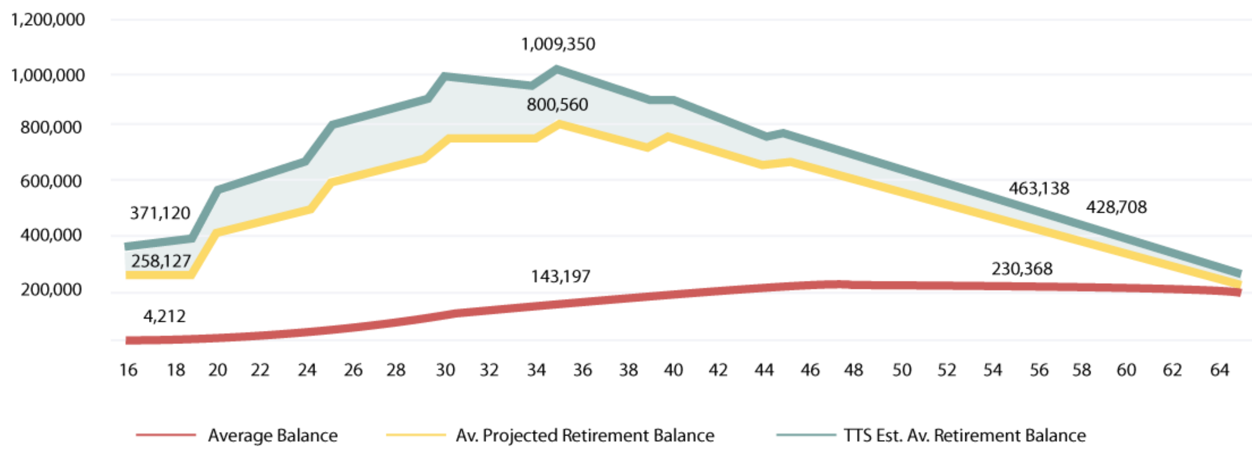


This Smart Default approach is more effective. By tailoring it can leave some MySuper members in higher return investment options for longer, while managing down the risk of loss as retirement approaches for others. Recent and ongoing testing, using funds own MySuper member data and their published investment option return and loss ratios, shows this can achieve an average 1% real per year improvement.

That as we all know from the 'Compare the Pair' adverts leads to an average 35+% improvement in retirement balances over a lifetime. This is depicted in the following graphic, with the improvement being the green shaded area.

The numbers indicate average current balance ($143,197 at age 35 years), average current projected retirement balance ($800,560 per annual statement) and the average projected Smart Default Retirement Balance ($1,009,350).

Furthermore this is a collation, member by member, using the funds own published returns per investment option. It can also be shown as average per lifestyle retirement band (LRB) or for different ages, including those approaching retirement.



So surprise, surprise it's not that there isn't a way to use digital and big data technics to improve outcomes, just has occurred in numerous other industries (think tailored medicines for example).

That brings us to governance. Why does the superannuation sector lack to the will to try something new, something that hasn't been road tested overseas beforehand?

Where is the leadership that is readily apparent in our other industries - both big and small - that have entered to digital age?

What happen to Super? Is it structural?

Is it because:

1. Funds are so used to ongoing huge contribution inflows that until now they haven't needed to compete for members?
2. Performance and executive KPI's so far have been based on investment returns not retirement outcomes (the new objective currently being legislated)?
3. Trustee directors are generally part time, arrive with mixed skills from their other careers - be that employer related or member representatives, and while genuinely interested in meeting their fiduciary duties (including to act in members best interests), they are reluctant to rock the boat and take personal reputational risk?

As the Investor Daily, on 29 November 2016 reported, forcing smaller superannuation funds to merge is unlikely to be in the best interests of members.

"The emphasis on increased scale and mergers as the mechanism to deliver efficiency has been a significant distraction to the determination of what actually drives efficiency and inefficiency in both large and small funds,"
said Ms. Mastrippolito NESS Super CEO.

"If the goal of a superannuation fund is to be efficient, rather than subject only small funds to scrutiny, it is our recommendation (to the recently closed Productivity Commission review) that all funds be required to publish an efficiency ratio and, where this ratio exceeds an industry benchmark, be required to justify their use of members' funds."

"If it is not scale which drives efficiency, the real issue to be addressed is looking beyond scale to what factors actually drive efficiency and what are the practices that detract from providing value to members that should be stamped out," said Ms Mastrippolito.

On the other hand, as the AFR, Chanticleer reported on 8 December in their Selfish and reckless trustees resist industry mergers, article:

"One of the most pressing and least talked about issues in the superannuation industry is the need for scores of smaller funds to merge with each other to protect the interests of members.

Unfortunately this much-needed process is being held back by the personal interests and concerns of super fund trustees who do not want to lose their jobs. This selfish and reckless approach to the governance of compulsory savings vehicles is definitely on the radar of the Australian Prudential Regulation Authority.

In November, Rowell told the annual conference of the Association of Superannuation Funds of Australia that APRA was progressively implementing the revised prudential framework for super. She made it clear that APRA expects much more than just compliance with the prudential standards. Rowell said all trustees should be continuing to lift the bar across all areas of their operations and that doing "just enough" was not good enough in terms of meeting community expectations."

So many funds will be forced to change their current approach, get with the digital age particularly in respect of member attraction and retention policies or merge. Maybe this does involve introducing independent professional directors or other executives that haven't been captured by the status quo.

Industry Consolidation

The operating environment, namely competition, retirement outcomes focus and governance issues have been under review and are changing.

- Competition for members is heating up. A recent report (by Third Horizon) shows 22 funds (20% of the MySuper Funds) have declining market shares and net contribution outflows.
- A few mergers have recently occurred, targeting a 0.15% improvement for members and a 10% consolidation is now considered likely given recent public speculation, including on 2 February 2017 by KPMG head of wealth advisory Paul Howes. He said it was time for APRA to start ramping up pressure on fund mergers because a number of small superannuation funds are continuing to bleed money and lose members.
- APRA has started to apply its legislated MySuper Member Assessment Test (otherwise known as the scale test). On 15 February 2017 APRA's Helen Rowell stated APRA will force the boards of the nation's worst superannuation funds out of the industry unless they improve their performance. Underperforming executives and boards will be invited by APRA to discuss their strategy for boosting returns, improving services and lowering costs for members.
- Rowell was also quoted on what is known euphemistically as Principle-Agent capture "At the end of the day I think it all comes back to really honing in and focusing on what's in the members' best interests rather than what's in the interests of the institution itself or the participants in the institution that have gained themselves from it," Rowell said. Rowell also said default funds and base products should deliver for everyone regardless of the choices they have made.
- ASIC has just started a review of the incentives given to employers by funds to make a fund the default and the Productivity Commission is midway through reviewing both the system for receiving default fund status in industrial awards and MySuper superannuation competitiveness and efficiency.

Competition

The hunt by trustees for new differentiated product offerings, that provide member attraction (direct or through default employer status) and retention (from members leaving to another fund or SMSF) strategies, is on.

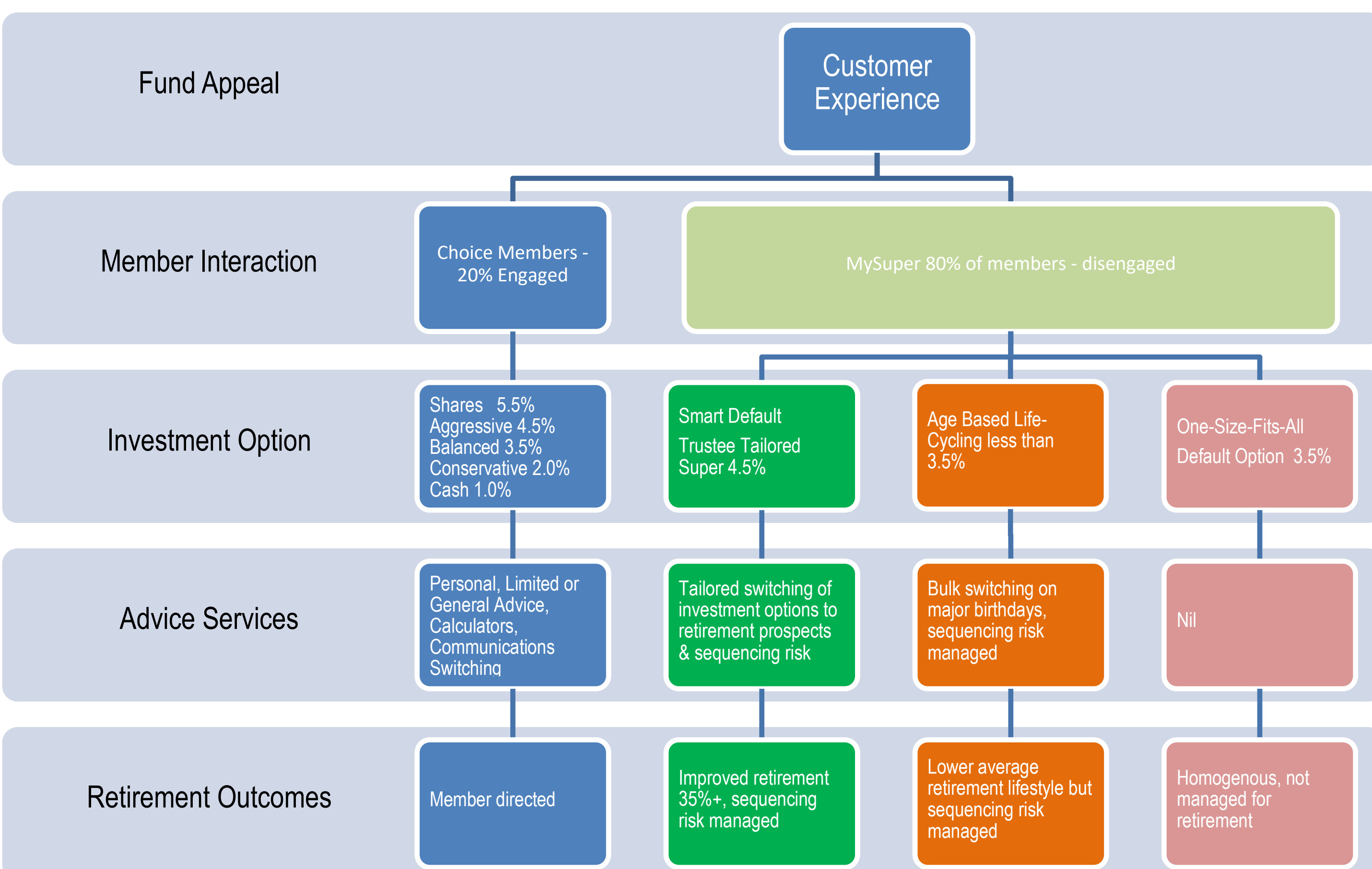
Reuters on 8 December 2016 reported that [Australian fund legalsuper resists 'pathway to mediocrity' merger pressure,] with Andrew Proebstl, chief executive of the $3 billion fund quoted as stating.

"The problem is that there is a fixation on growth for the sake of growth, which can be a quick pathway to mediocrity. Whether a fund is small, medium or large, it needs to have clarity of purpose and can deliver better value for its members relative to larger super funds,".

Trustees looking for a point of difference – a reason to continue to exist – will find it in their niche member demographic profiles, as has occurred other regulated industries (e.g. credit unions). All the better if these strategies can be readily audited as both outstripping economy of scale merger benefits (circa 0.15%) and more effectively converting contributions into that objective - improved retirement outcomes.

MySuper Member Attraction and Retention Strategies

The member experience graphic below, highlights the role of Smart Defaults in member attraction and retention strategies, plus how it is related to existing member channels (Choice, Age-Only Life-Cycling and One-Size-Fits-All). The blue channel describes the experience of members who make their own choices be that selecting an investment option or using a funds financial advice models.



The other channels describe the default offering, which covers around 80% of members and is reliant on the actions of the trustee. These members enter those channels either because their employer has chosen this fund for them (because of its product offering characteristics), due to it being listed in an Industrial Award (method currently under review for change) or because the member has selected the fund but not an Investment Option (e.g. Shares). Regardless effective attraction strategies must deal with this 80% of the membership base – be that via promotion to employers, industrial umpires or direct to employees. Furthermore member retention strategies rely on the same- approach.

In other words, its time trustees stopped being hypocritical – telling choice members what to do, but not bothering to act in the interest of the remaining 80% MySuper members themselves.

It will require some fund to lead, that fund will most likely be a smaller, more agile fund with more to lose and fewer conflicts. The directors and executive team should be roundly supported and recognised. Perhaps even given an innovation award. In 2016 there was no Superannuation Award for innovation provided by Conexus Financial owing to a paucity of new ideas in the industry.

It is exactly this type of Smart Default enhancement that concentrates on retirement objectives, driven by a competitive environment and open minded governance that is needed and is currently so obviously lacking.

A dynamic and competitive industry, with small and large players, competing to reduce the impending Retirement Funding Shortfall should not be delayed for fear of upsetting currently entrenched special interest groups. The retirement lifestyles of the vast majority fellow citizens are just too important to let that happen.