Wave of Reform to Crash on Superannuation Industry

The superannuation industry is on the cusp of significant change and smarter trustee default investment options (Smart Defaults) are set to ride that wave. Already the objective of the industry has been agreed by Government as retirement outcome focused and is being legislated. No longer will the focus be yearly returns and current balance but rather projected retirement balances and incomes.

The rise of Robo Advisors is set to be repeated in the $452 billion MySuper segment

In the next few weeks the Productivity Commission will release the 1st report to government in a two part series, on the lack of productivity in the current system in achieving the objective and how that will be measured going forward. The industry will have to wait another month with the public release due in December. Many are keen to see it having already made technical submissions and been involved in debating the issues at industry round tables.

The 2nd part of the series, on competition and who gets to receive default members, is also underway with the Commissions Issue Paper released last month. Industry submissions closed on 28th October. The Commissions base case, outlined in that Issues Paper, is that there be no default. Just the possibility of this outcome is set to overturn current practices to focus on gaining members rather than employers through industrial award arrangements. In an already hot competitive environment, we are about to see 116 of Australia's largest entities aggressively compete in public for more members, be that via TV advertising, sporting sponsorships or product design.

Understanding the current industry structures and practices at a high level is not difficult despite the jargon and politicians gaffes. Similar to the Productivity Commission inquiry there are two basic structural elements at play. Firstly, when a new employee gets their first wage slip and they look to see where their superannuation contribution has gone! If they told their employer which super fund (just like they did with their bank account details) then all sorted – but if they didn't it goes to the Default Fund chosen by the employer or as part of the industrial agreement.

All the Commission is suggesting as its base case is that each employee must tell their employer where to send their money, just like they do with their wage – so that there is no default fund. Regardless of if this no default fund suggestion should or does prevail, a change to more competitive landscape based on the members retirement prospects will be the outcome. The 2nd element relates to when those monies arrive at the super fund – in which investment option should they be placed? Again, if the individual has told their super fund which investment option (e.g. Australian share option) then it's all done – if not, the money goes into the default investment option chosen by the trustee; usually a one size fits all "balanced" investment option (e.g. 70% growth assets / 30% income assets).

These default arrangements (by fund and investment option) are known as MySuper Funds and MySuper Products. They are important because they cover 14.5M accounts or approximately 80% of working Australians – most of whom are likely to end up on full or part Age Pension. MySuper has been progressively introduced from 2013 and will be complete by July 2017. Some funds introduced early to gain scale, others delayed to capture higher fees but all are now facing the impending reality – in order to survive and thrive, they need new members along with their fortnightly contribution inflows.

The government - of all persuasions - has realised this superannuation industry performance, and the MySuper segment in particular, must improve otherwise the already large future funding retirement gap (too few taxpayers to sustain the Age Pension) will be uncontrollable. They have gathered their forces and encircled the industry - be that the regulator APRA who is starting to apply pressure to merge (via the new scale test), the Commission through adding competition and measurement or legally through defining the retirement Objective.

So far the MySuper environment has been played out with funds providing more advertising, more sports sponsorships and seeking to promote lowest fees regardless of the impact on net returns or the retirement objective. Of course, spending member's money on advertising and at the same time charging lower fees can only go so far, with funds now turning to more efficient MySuper default option design. Approximately 1/3 of the industry has recently moved away from the homogenous product, being the one size fits all default option – regardless of a member's age or retirement lifestyle prospects, to an age only or first generation life-stage product. These life-stage products change the investment option (e.g. from Australian shares to cash) as members get older, nominally to reduce the risk of a big loss just before retirement – however they also have the advantage of not being as easy to compare on fees or net returns. While the focus on members stage of life is a usable pitch to attract and retain members, in practice it means lower risk, hence lower returns just as a members balance is the highest, leading to lower average retirement balances, retirement income and lifestyles. This is just the outcome the government is trying to avoid, hence the Commission establishing measurements against the retirement objective.

So the shakeout is on, the competition for which super fund a member goes to will ultimately come down to attracting the member and the member will be attracted by how well the fund investment option meets their retirement objective (using the Commissions measurement techniques). It is clear those measurement techniques will need to be over a historical period – funds know this and need to react now in order to have that track record in place. Considerable first mover advantages are at play.

Clearly a new technical solution to the MySuper default option is needed. It needs to concentrate on the objective (retirement), be measurable against that outcome and have results that outperform the current one size fits all default or the age based life-stage option. It would also be useful if it could be easily pitched to attract individual members, use behavioral economics to nudge individuals in the right direction to be more efficient - particularly in using their available investment horizons - plus encourage these 14.5 million disengaged MySuper members to make an investment option decision.

In that regard Choice Magazine on 24 October released *Project Superpower* completed with funding from Financial Literacy Australia and submitted it to the Productivity Commission. It highlights the need for this change stating:

> *"Now that we understand why people put off thinking about their super, we can design ways to help them take control of their saving," says Turner. "People want information, but they also want it to be easy. They need to be told why super should matter to them, and they need to be shown how to make the right decisions for their circumstances."*
>
> *"We need to reframe super from this boring, complicated thing, and get consumers thinking about it as the best saving they'll ever do."*

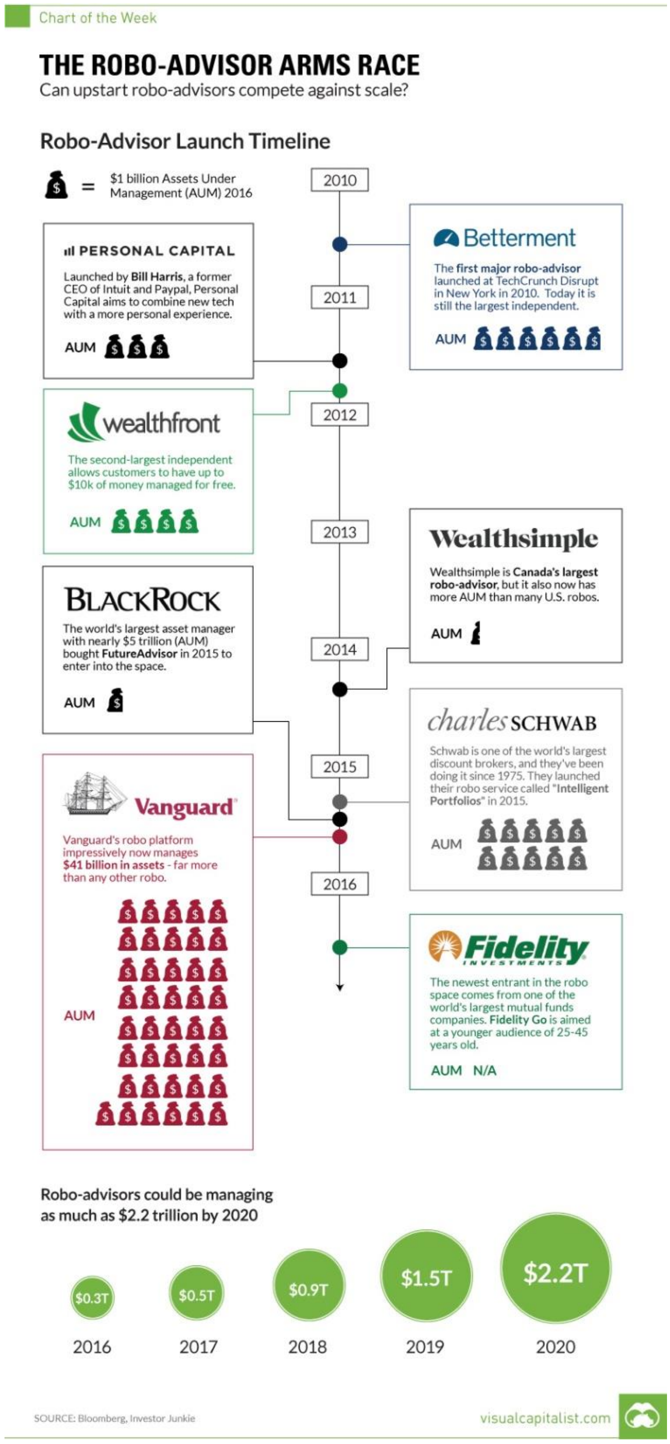
The required technical solution is here - it is new and innovative – the ground has been prepared and industry competitive environment is now ripe for introduction. As explained in this [2014 interview of Douglas Bucknell] by industry body FINSIA, [Trustee Tailored Super] has by design those desirable attributes. It is a product that he has been working diligently to introduce, including through encouraging change at the industry, regulatory and government levels.

Academics, including via the Centre for International Financial Regulation (CIFR) are referring to this next generation product as a Smart Default, terminology that has been adopted by the Productivity Commission. In the most recent [CIFR submission] dated 26 October to the Commissions 2nd inquiry on default fund selection CIFR notes:

- *"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, notwithstanding being required to offer a single MySuper product. This desire to increase tailoring has manifested in the emergence of lifecycle products, as well as increasing investment in member profiling, member engagement and advice. 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."*

Smart Defaults in many respects are similar to Robo Advisors. While technically not providing "advice" but rather a specialised fintech tool for trustees, Smart Defaults do have market attributes similar to these robo advice algorithms. The ability to provide at a huge scale, low marginal cost tailored outcomes to retail investors (members) automatically via established players is one, the ability to nudge decision making is another.

As outlined graphically below robo advisors have grown from nil to US $300 billion in 6 years and are headed to a predicted US $2.2 Trillion by 2020. The Australian MySuper market alone for Smart Defaults is currently $452 Billion and is expected to exceed $850 Billion in 2020.



Ref. [visual capitalist]

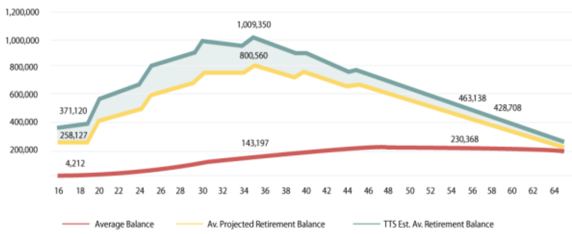
About Tailored Superannuation Solutions Ltd

Tailored Superannuation Solutions Ltd (TSS) is marketing a new product Trustee Tailored Super (TTS) – the next generation "Smart Default" for Australia's 116 MySuper funds.

The market size is $452 billion and currently growing at 17+%, including 9.5% in mandated contributions.

TTS is a specialised FinTech application which optimises projected retirement balances to members of MySuper funds by significantly boosting efficiency through tailoring to lifestyle prospects.

The product, as graphically demonstrated below increases returns by around one-third (over 1% p.a. increase on average MySuper fund real returns of 3.65%) and increases cumulative returns on average by more than 35% during the accumulation phase of members.



The graph summarises what TTS can achieve, is from the TTS Prototype, is consistent with the results from actual beta superannuation fund tests, past research and forms part of the Customised Report provided to trustees.

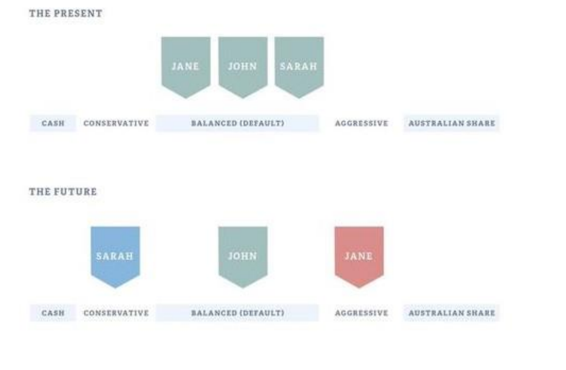
To illustrate at age 18, the current average balance of MySuper members is $4,212 and projected retirement balances average is $258,127. The application of TTS lifts the projected retirement balance average to $371,120 – an increase of 44%.

At age 55, current balances average $230,368 and projected retirement balances average $428,708. The application of TTS lifts the projected retirement balance average to $463,138 – an increase of 8%.

TTS will supersede current generic 'one-size-fits-all' practices by better tailoring investment strategies to the needs of members. It will evolve lifecycle products beyond simple aged-based strategies to include factors such as current incomes, current balances, and lifestyle factors.

TTS focusses on the Objective of Superannuation, currently being legislated and taps into an emerging market direction for MySuper funds which has been recognised by independent industry experts and commentators (Financial System Inquiry, Centre for International Finance and Regulation, Productivity Commission)

The processes involved are outlined below:



MEMBER	AGE	BALANCE	WAGE	FEES	RETIREMENT BALANCE	HURDLE	NEW INVESMENT OPTION
Jane	29	10,000	35,000	300	225,000	2	Agressive
John	49	20,000	60,000	400	120,000	2	Balanced
Sarah	61	60,000	100,000	700	85,000	1	Conservative

TTS is the only known fully implementation ready Smart Default product in Australia

TTS also generates significant public policy benefits by reducing pressure on Australia's struggling Aged Pension System.

Douglas Bucknell
Managing Director
Tailored Superannuation Solutions Ltd
28th October, 2016