



Australian Government

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# ASFA 2009 Conference: 'Super in the New Age'

## Scale, focus and alignment

Jeremy Cooper  
Chair  
Super System Review

12 November 2009  
Melbourne Convention Exhibition Centre

## Introduction

1. I am coming to the conclusion that there are three key ingredients for success in superannuation:
  - (a) Scale;
  - (b) Focus on maximising long-term net investment returns; and
  - (c) Alignment with member interests

How many Australian super funds have really got all three?
2. According to this view of the ingredients for success:
  - (a) The absence of one or more of them is likely, in one way or other, to mean lower retirement savings for members or to make the fund more exposed to fundamental governance issues.
  - (b) Having all three, on the other hand, is much more likely to see better outcomes for members.
3. I have some questions I want to throw out to all of you; questions that might reverberate around during the Review process that we can all have a go at:
  - (a) Where is super in the food chain? Is it an upside down industry where the servants rule the roost? Normally, the person with the cheque book calls the shots. Why does it look different in super?
  - (b) Does the funds management tail wag the superannuation dog?
  - (c) How come super funds tolerate so many of their agents turning fixed costs into upwardly variable ones in the shape of asset-based fees?
  - (d) What is super? Do we have the courage to create a uniquely Australian version of long-term retirement savings? Why not? We started something pretty gutsy in 1992, we just need to take it to the next level.
  - (e) What are the Canadians doing differently from us that makes them able to bid for assets outright that we can only own in bits?

## A bit about the Review

4. Since starting this job in mid-July, I have attended over 70 formal meetings – speaking with representatives from industry groups: ASFA, IFSA, AIST, FPA, ISN; SPAA – the list goes on; boards of trustees from funds in various sectors; fund managers; CEOs of funds; regulators; SCT; government;

superannuation lawyers; financial advisers; academics; professional service providers to the super industry in areas such as administration, technology and audit.

5. I have also started conversations with participants in foreign jurisdictions – Canada, Chile; and spoken to some global leaders in pension thinking: Keith Ambachtsheer, Don Ezra, Knut Kjaer and there are many more to come.
6. In response to the first phase of the Review - Governance - we got well over 100 submissions. Importantly, in a Review that is all about the members, we got a good number of responses from members themselves, canvassing issues like insurance and death benefits, disclosure, portability and fees.

## Emerging themes

7. So what are some of the big themes?
8. Most of the submissions support the current trust model.
9. Most of the submissions did not support legal 'codification' of a trustee's common law duties into SIS. However, many submissions were concerned about the confusion for trustee directors surrounding the treatment of conflicts of interests and duty in the Corporations Act, the general law and the SIS Act and the priority of interests.
10. Nearly all submissions were against the government directing funds how to invest.
11. Many submissions supported the idea that trustees should get relief from liability where members made their own choices.
12. Most submissions agreed that, while UNPRI principles are useful, they should not be mandatory.
13. A lot of submissions supported the current regulatory framework while others recommended a single overarching superannuation regulatory body.
14. Most submissions agreed that the current system was complex and recommended small and large measures to remedy this.
15. There is a variety of views surrounding trustee education, from those advocating mandatory education and skill evaluation for all trustees to those who believe that the current arrangements are adequate.
16. Most did not support giving a standards-making power to APRA.
17. Most were against mandatory consolidation of funds and suggested that the issue of scale would work itself out in due course, with smaller funds either finding a niche for themselves or being amalgamated into larger funds.

## Ain't broke...

18. If I had to try and pinpoint the tone of the submissions, what Dennis Denuto from *The Castle* would call 'the vibe', it is that the system ain't broke. There is a general view – and this is an observation not just confined to the submissions – that in light of the improved economic outlook, the super system looks to have done us well over the last 20 years and weathered the GFC. So, in other words, with a tweak here or there: she'll be right, mate!
19. But, I disagree. This is the status quo. The Review is not so much a backward-looking assessment of where we have come from and the fact that we survived the GFC. The Review is trying to find out whether we really think the current way we do superannuation in Australia is as good as it could be in serving the long-term interest of members. Will our current thinking last us another 20 years? This perspective puts a bit of strain on the ain't broke view of the world.

## The New Age

20. The theme of this conference is super in the New Age. Now whenever anyone talks about 'New Age', it conjures up images of Byron Bay, aromatherapy and books about dolphins and self-healing.
21. But I know what Pauline intended with this theme. It was to challenge us to think with vision, with imagination, about super for the next generation. And it's when I do, that I see that the 'ain't broke' conclusion is logical as far as it goes, but it is not the whole answer. Why? Because it is a failure of imagination.
22. Let's have a think about what the Australian superannuation landscape could look like in 2025.

- Overall industry scale                      \$3 trillion<sup>1</sup>
- APRA-regulated portion                      \$2 trillion

(This is much more conservative than some estimates. For example, Deloitte has forecast that the system might be valued at nearly \$7 trillion by 2028.)<sup>2</sup>

What if, out of the APRA-regulated portion, there were say 27 large funds, rather than hundreds?

Under this hypothetical scenario, three of the funds could be around the \$200bn mark, another four at the \$100bn mark and

<sup>1</sup> The inflation adjusted figure is just under \$2 trillion, so the system more or less doubles in real terms.

<sup>2</sup> See *Dynamics of the Australian Superannuation System - The next 20 years, 2009-2028*. March 2009 [www.deloitte.com/dt/cda/doc/content/Deloitte\\_Dynamics\\_of\\_the\\_Australian\\_superannuation\\_system.pdf](http://www.deloitte.com/dt/cda/doc/content/Deloitte_Dynamics_of_the_Australian_superannuation_system.pdf)

the remaining \$1 trillion, comprising another 20 funds, with an average size of \$50bn each.

- Biggest fund \$200 billion
- Average fund size (27 funds) Approx \$75 billion
- Total super assets/GDP 110%
- SMSFs/total super assets 36%
- Accumulation/post-retirement assets 2:1

23. To our current way of thinking, a fund of \$200bn is like a social welfare system in its own right. Where would a vehicle like this invest? How would it invest? Where would we get the leadership, patience and discipline to run vehicles like this? Would our current superannuation mindset position us adequately for a future that looks like this?
24. Vehicles like this would need to be players on the global landscape. Are we thinking in these terms? I am not sure. Nearly everyone has a vested interest in the status quo; except perhaps the members.

## Governance Challenges: 2025 and beyond

25. Looking ahead to the hypothetical 2025 scenario where funds have consolidated, you can quickly see that the issues take on a different complexion from those that are currently being debated.
- What happens when super funds become the dominant source of capital formation? There will be obvious governance implications for funds.
  - Will funds predominantly own major assets directly, either alone or in partnership, cutting out expensive intermediaries, agency costs and ownership structures? Will funds engage much more in direct private equity-style investing?
  - Funds will be forced to engage with global corporate governance responsibilities because they will have such significant ownership stakes in globally relevant assets. How will funds cope with this?
  - Will stakeholder relations become one of the dominant focuses of super funds that are so large, particularly if they are playing a key role in post-retirement pensions and annuities as well?
  - Will we be able to attract Australians with the skills, leadership and capacity to govern such significant investment vehicles? Will most large funds have to look for

international directors to bring the requisite global perspective to their trustee boards?

- What macroeconomic and political issues arise? Does it look like the system itself is appropriately governed?
- Do funds run into the 'too big to fail' problem like banks?

## The superannuation dog

26. What is super? Is it just another financial product or is it something more nuanced that deserves its own rules and credo? Is it, as Alan Kohler put to me in a recent interview on *Inside Business*, an industry in the normal sense or part of our social infrastructure?<sup>3</sup>
27. When the concept of compulsory, defined contribution super was introduced, the government allowed private industry to provide all the moving parts (this was, and is, called 'funds management'). So, in that sense, super is an industry, with lots of participants providing services for profit. However, we all know super plays a social purpose. It provides retirement income and is supported by the tax system and a time horizon of up to 40 years or much longer in some cases.
28. Funds management is a cog (albeit an important one) in the wheel of superannuation. It is a well-established and highly-developed tool for turning assets into units of value and managing them in pursuit of superior returns. Yet you could be excused for thinking that super was meant to serve funds management; to shape itself around the funds management way of doing things. This, of course, might have been the case in 1992, but super needs to stand on its own two feet now. It needs its own agenda and identity.
29. So, am I saying that the funds management tail still wags the super dog? I would have to say it looks like it. Let's step through it:
  - Most trustees still outsource investment management.
  - It also seems that the industry overall confuses the consumption of investment products and investing. It is hard to tell who is wagging who on this one.
  - Everyone talks and pays on a before-tax basis when members only get the after-tax returns. This is definitely the tail wagging the dog.
  - An industry that outsources to such a large extent seems to be purpose built for ambiguity and lack of accountability; a condition that favours the interests of everyone but the members.

<sup>3</sup>

<http://www.abc.net.au/insidebusiness/content/2009/s2723431.htm>

- Trustees agree to before-tax performance fees that are skewed to encourage short-term behaviour.
  - Nearly everyone pays percentage of asset-style fees; fees that turn largely fixed costs into ones that grow with assets under management. Why don't trustees have more power in negotiating better structured and lower fees?
  - Trustees are far too concerned with peer group risk. This is a funds management mentality, not a super fund one.
  - IFSA's model investment management agreement is generally the starting point for all mandates to funds managers. What about one drawn up by the super industry? After all, who has the cheque book?
  - Embedded provisions in trust deeds mandating the use of related party service providers.
30. As a recent editorial in *The Australian Financial Review* observed that: 'a plethora of intermediaries stand between the stockholder – or in this case, the member – and the end investment of their money?'<sup>4</sup> Are super funds captive to their agents and service providers and believe that they have no option?

## A taste of a different model

31. We are presently being given a taste of the potential power of superannuation funds by two large Canadian pension funds: Ontario Teachers' Pension Plan (**Teachers'**) and Canada Pension Plan (**CPP**) at the moment in their unsolicited bid for Transurban Group. Now I have no idea whether Transurban is a good business or whether they would get a good deal at their bid price. That is for others to assess. What I do know is that I pay Transurban money every time I drive to Tullamarine. If this deal goes ahead, it will feel odd that when my car's e-Tag beeps, I will be contributing to the Canadian pension system. *The Weekend Australian* (November 7-8) had a perfect cartoon by cartoonist Peter Nicholson<sup>5</sup> of two red-faced drivers growling at their e-Tag reader at it blurted out: "BEEEP!!!! You have just helped pay someone's super in Canada."
32. But this development gives rise to some observations about the twin concepts of scale and focus.
33. CPP and Teachers' have a combined value of roughly C\$200 billion, approximately C\$110 and C\$90 billion, respectively. This clearly gives them scale. In Australia, you can count on one hand the funds that have assets of more than \$25 billion with the largest topping out at just over \$40 billion.<sup>6</sup>

<sup>4</sup> *The Australian Financial Review*, 16 October 2009, p58.

<sup>5</sup> [www.nicholsoncartoons.com.au](http://www.nicholsoncartoons.com.au)

<sup>6</sup> AMP Super Savings Trust - \$42.872bn at 30 June 2008 – Source: APRA Statistics, Superannuation Fund-Level Rates of Return issued 20 August 2009.

34. This puts us and our funds at a significant disadvantage in the global retirement savings investment landscape. One single fund is unlikely to be in a position to bid for Transurban when such a deal comes in at around \$7 billion. The numbers just don't stack up. So that's one benefit of scale and the opportunity scale can deliver to members.
35. Alan Kohler said, on ABC1's Inside Business just this last Sunday, that he thought the Australian superannuation industry was locked into fund managers trading equities for short-term returns. Kohler predicted that, with listed infrastructure having been a poor performing asset class for some time, short-term focussed fund managers are likely to sell Transurban to the Canadians, who have a much longer-term focus. If that happens, it will look like the Canadians' scale and focus on the one hand will have trumped the Australians' lack of those characteristics on the other. We will, of course, have to wait so see what happens.
36. It is, of course, worth remembering that both of the Canadian pension funds are government-sponsored DB funds run under an arm's length, independent model. Could it be that the scale and greater alignment obviously available under that model means that we will continue to have our lunch cut for us by these Canadian funds when they see Australian assets that are attractive to them? Will we just have to accept this as a limitation of our system, given its structural differences? In other words, can a system built on defined contributions and 30-day portability under SIS<sup>7</sup> aspire to this kind of investing? This is a serious question for the Review.

## One big train set

37. Another example in a similar vein is Berkshire Hathaway's purchase of Burlington Northern Santa Fe (**BNSF**) in a deal valuing the company at US\$44 billion. One commentator described it "a solid, extremely entrenched business that will throw off cash for decades ahead".<sup>8</sup> Let's look at the numbers for a minute. Top line revenue of US\$18 billion a year. How would that feel in a super fund? Free cash flow estimated by one analyst<sup>9</sup> will be US\$870 million this year (down from previous years).
38. Just for the fun of it, I had a look for some stats on BNSF:
  - (a) 32,000 route miles. Enough to cross the US 10 times.
  - (b) On average, 220,000 freight cars are chugging along at any particular time.

<sup>7</sup> SIS Regulation 6.34(5)

<sup>8</sup> John Gapper, 'Omaha's sage makes "all-in" bet on BNSF' *Financial Times*, 4 November 2009 p 18.

<sup>9</sup> Davenport & Company, mentioned in Lex column, *Financial Times*, 4 November 2009.

- (c) BNSF is actually a collection of 390 railroad lines merged or bought over the past 150 years.
  - (d) Hauls enough grain each year to supply 900 million people with bread for a year.
39. Now I'm not suggesting for one moment an investment on this scale, away from home and in an industry that many would regard as a capital-intensive dinosaur, but the point is all about the direct ownership of assets that generate cash. Equally important is the by-passing of expensive and opaque ownership structures with excessive leverage and fee leakages that have characterised the Australian infrastructure model so far.
40. Why is it that so few Australian super funds make takeover bids and line up to buy entire businesses and assets?
41. After all, on the scale that Australian super funds are going to have to operate in the future, investing is going to have to be much more than just trading pieces of paper to make short-term profits. Increasingly, it has to be about getting access to real cash flow.
42. But it's even more fundamental than that. It is about staking rights as an owner of substantial amounts of capital. Super funds have to start acting like they are at the top of the food chain and must start using their power more overtly in the best financial interests of members.
43. This also includes getting much more active in the governance of underlying investments. It seems that the global investment community is heading towards 'ownerless corporation' syndrome where share trading completely takes over from share ownership (ie the world of high frequency trading or HFT). UK Financial Services Secretary, Paul Myners, is warning about this in the UK, concluding in a very recent speech:<sup>10</sup>

Fund managers in most cases act as agents for clients, the ultimate owners of companies. As the agents of owners, the asset management industry is critically placed to ensure that companies in which they invest their clients' money deliver long-term, sustainable returns. Not all fund managers offer 'governance' as part of their bundled package, but it is clearly incumbent on pension fund trustees and others in similar positions to ensure that someone is taking this role seriously on their behalf – and doing it well. The onus here should clearly be on the ultimate owner – the investment trust, insurer or pension fund. If the owner's interests are not represented through effective stewardship, we cannot be surprised if agents substitute their own goals.

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<sup>10</sup> Lord Myners, Launch of the Asset Management Working Group Report, 9 November 2009 - [http://www.hm-treasury.gov.uk/speech\\_fsst\\_091109.htm](http://www.hm-treasury.gov.uk/speech_fsst_091109.htm)

I believe the answer lies with clients of fund managers taking a much greater interest in the care exercised over the management of assets bought and held on their behalf by their fund managers. Government can facilitate the right framework and make clear the legal basis for fiduciary responsibility, but the principle drivers for change must be the ultimate owners. They must insist on at least some of their portfolio managers taking a serious responsibility for governance - and they must recognise that this will require skills beyond those of management [of] styles that focus on trading and/or eschew a governance responsibility (and skills that needs to be appropriately incentivised and compensated).

## Scale

44. In its 2008 report, the Ontario Expert Commission on Pensions, led by Harry Arthurs, found that the cumulative effect of the advantages that large funds have over small funds is extremely significant. These include lower investment fees, in-house investment expertise, private placement capabilities, ability to spread investment risk through diversification, reduced administrative unit costs, and enhanced availability of education, information and service.<sup>11</sup>
45. I mentioned earlier that I had benefited from conversations with some of the world's leading thinkers on pension systems. One such person is Keith Ambachtsheer, director of the Rotman International Centre for Pension Management. He believes that increased scale expands the capabilities of pension funds, while also enhancing their operations and lowering costs.
46. The sorts of ideas that Keith has are that larger funds can invest in asset classes like direct real estate, infrastructure and private equity and earn a genuine illiquidity premium that is not available to smaller funds.
47. He believes it is cheaper to do things internally than to outsource, but only for big funds who can afford to hire the talent. He thinks the scale sweet spot where a fund starts to see these benefits is over US\$25 billion.

## Scale again

48. The Thrift Savings Plan (**TSP**) is a United States retirement savings plan for civilians who are, or previously were, employed by the government and for members of the uniformed services. The TSP is a defined contribution (DC) plan and is administered by the Federal Retirement Thrift Investment Board. The TSP is quite different in its function from Australian superannuation, being partly to house an automatic 1% contribution from the government, but also a voluntary savings vehicle to encourage personal contributions of up to US\$16,500 a year with matching employer contributions. However, it is the construction and pricing of the

<sup>11</sup> Ontario Expert Commission on Pensions, *Final Report of the Commission: A Fine Balance – Safe Pensions - Affordable Plans - Fair Rules* (2008) pp 183-185  
[http://www.pensionreview.on.ca/english/report/Pensions\\_Report\\_Eng\\_web.pdf](http://www.pensionreview.on.ca/english/report/Pensions_Report_Eng_web.pdf)

funds management side of things that is the most striking example of the benefits of scale and simplicity.

49. The TSP has about US\$200 billion in funds under management, with just over four million members. TSP uses a passive management strategy (currently using Barclays Global Investors as asset managers) by investing in various US and global equity indices and in fixed interest. There are only five core investment options, with five additional lifecycle funds using the core funds in their asset allocation. The TSP charges ultra-low fees to its members, being 1.8 or 1.9 basis points (ie 0.018% or 0.019%) a year. This is not a typo.
50. What would the Australian landscape look like if a product like this were available here?

## Alignment

51. Aligning the interests of funds and fund members is also a key ingredient.
52. As I mentioned, many submissions to the Review so far have been concerned about the conflicts that seem inherent in the system for trustees and their directors and employees. These conflicts encompass conflicts of interest (especially in the retail sector) and conflicts of duty in all sectors. As you know, a trustee has a fiduciary duty not to put themselves in a position of conflict.
53. For a minute, just consider what benefits could flow to members if the interests of all those involved with super were fully aligned to the members' interests. That seems self-evident. Why, then, should members tolerate a system where all the 'working parts' aren't aligned for the purpose for which super was intended?
54. Perhaps you will argue that this is too simplistic and that conflicts are bound to arise in all arrangements. However, there is no doubt that there are many changes that could be made to improve alignment of interests.
55. A case in point is so-called 'peer group risk'. Peer group risk is an example of a massive conflict of interest and lack of alignment with members' interests. Here, the Future Fund is showing the lead. On page 12 of its 2008/09 annual report, it explains that the board of guardians believes that 'peer group risk should not be used to shape strategy.' How many other Australian super funds could say that? Yet, this is precisely what long-term investing, and transactions like buying toll roads, calls for.
56. How has it come to pass that the commercial conflicts and the conflicting duties that directors might have to service providers have become so acceptable?

## Conclusion

57. Economist Joseph Schumpeter said: "Pessimistic visions about almost anything usually strike the public as more erudite than optimistic ones."<sup>12</sup>
58. Before I am accused of pandering to this mentality, I want to be clear that the message about where our super system can go is not one of pessimism, but of immense optimism. Our country could quite easily be on the cusp of another step in building one of the most significant retirement savings pools in the world. We just have to make some adjustments in our thinking about what superannuation is.
59. As an industry, I invite you to think laterally, with vision and creativity about what this industry can become and what members will need. I want to thank you for your willingness to engage, for making submissions, and such high quality submissions at that, and to encourage you all to continue to embrace the opportunity that this Review presents.

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<sup>12</sup> McCraw, Thomas K (2007), *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*, Cambridge, MA, Harvard University Press.