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Long term superannuation investment performance

Research Report - Update

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Industry Super Australia

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About Industry Super Australia

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SUMMARY

Superannuation assets have increased to over $1.6 trillion as at June 2013. For most Australian households, superannuation represents the largest component of wealth outside equity in the family home.

Differences in performance, even small differences, have a significant impact on accumulated retirement savings over time. This paper updates and adds to the summary of research on performance released by ISA in September 2011. The analysis utilises official APRA superannuation performance data.

The key findings are that:

- On average, retail funds have underperformed not-for-profit funds (public sector, corporate and industry funds) by over 2% pa for 16 years.

- At 3.56% pa over 16 years, average retail fund returns are lower than a naïve benchmark investment strategy (equal weightings in cash, domestic equities and foreign equities) after tax and costs, and even fall short of cash (term deposits) over the same period. The three not-for-profit sectors outperform these benchmarks.

- Underperformance compounds over time with dramatic impact. Over the sixteen year period, if retail funds had earned industry fund returns, Australian retirement savings would currently be $88 billion higher.

- Recently released research by Deloitte Access Economics has established that superannuation fund performance between 2004 and 2012 shows persistence; reinforcing earlier findings for different time periods by APRA researchers (APRA, 2009; Sy and Liu, 2009). In funds with over $1 billion in assets (holding $630 billion in assets and over 24 million accounts), most of the top third ranked funds in the first half of the period were also ranked in the top third in the second half. This is a statistically robust finding as the probability of this happening by chance is less than one in 2000.

- Economies of scale continue to be evident amongst not-for-profit funds but not among retail funds. On average performance among not-for-profit funds over the eight years improves by around five basis points per $1 billion in assets. Average outperformance by not-for-profit funds increases from 1.5% among smaller funds to 3% for the largest funds (assets of over $20 billion).

- One cause of retail sector underperformance identified in recent years is the excess price paid by retail funds for outsourced services provided by related entities. Outsourcing by retail funds to related parties costs members of those funds 81 bps per annum on average, relative to the price paid to non-related parties.

1. Introduction

Discussion of superannuation fund returns often focuses on short-term performance. This is fuelled by monthly publication of returns by competing ratings agencies. Rolling returns for periods as short as a single month are regularly discussed.

However, a member's retirement income is determined by their superannuation fund's long-term performance. This paper is the second update of analysis originally undertaken by ISA in September 2011 *A Comparison of Long-term Superannuation Investment Performance*. The updated analysis now includes the 2012 financial year, covering a 16-year period from 1996.

The research again points to significant differences in long-term superannuation fund performance based on fund governance structure. Funds governed by representative trustees and run on a not-for-profit basis consistently outperform those funds run for profit by banks and life insurers.

Over the 16 year period, average annual returns to funds in the not-for-profit sectors – public sector, corporate and industry funds – have been more than 2 per cent better than average returns to retail funds. Indeed, despite unbroken Australian economic growth over the period of study, retail funds have not even matched the returns of risk-free investments such as term deposits.

If retail funds had earned average industry fund returns over this 16 year period, Australia's superannuation savings would now be around $88 billion higher. Retail super fund underperformance has severely harmed future and current retirement incomes. It is also detrimental for the Australian economy, *preventing* Australia's capital base being deeper, its net foreign debt position more favourable, and its economy more productive.

This paper also updates analysis of economies of scale by profit orientation, confirming the previous finding that the members of not-for-profit funds benefit from economies of scale in the form of higher net returns on average, but the members of retail funds do not. It also recognises research by APRA that finds that economies of scale are evident in retail fund cost structures, despite these not being passed on to members in the form of superior net returns.

The paper includes an update of the analysis by Deloitte Access Economics, commissioned by ISA, highlighting persistence in superannuation fund returns. The original DAE report is available at ISA's website. As the authors observe, persistence in returns is due to profit orientation (which does not change) being a determinant of returns.

All returns discussed in this paper are net of all fees and taxes – the returns to which the investor is entitled. The data on superannuation returns is published by APRA, as discussed in Section 8.

2. Returns and volatility over the Global Financial Crisis

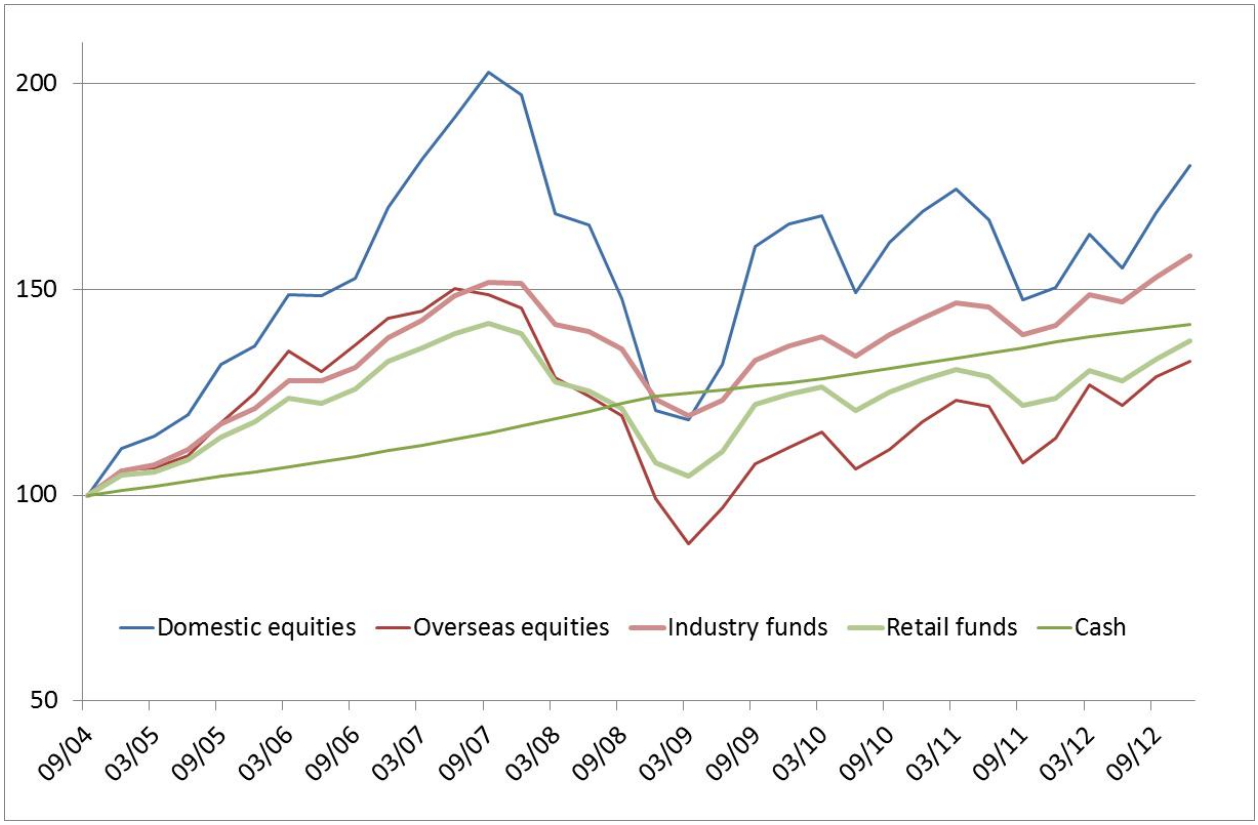
The year to June 2012 was a continuation of an extremely difficult period for investors globally, including Australian retirement savers. The performance figures in the APRA Quarterly Superannuation Statistics for funds with $50 million or more in assets (beginning in September 2004) clearly show how superannuation balances have fluctuated since 2007.

Figure 1 shows how returns in domestic and foreign equities drove superannuation returns up to a peak in late 2007, followed by collapse during the GFC, a partial recovery and ongoing volatility.

Industry funds have been affected by the volatility, but at a lower level than equity markets due to broad diversification, including in asset classes such as unlisted property and infrastructure.

On average, performance in industry funds has been superior to the performance of retail funds throughout the period – before, during and after the GFC.

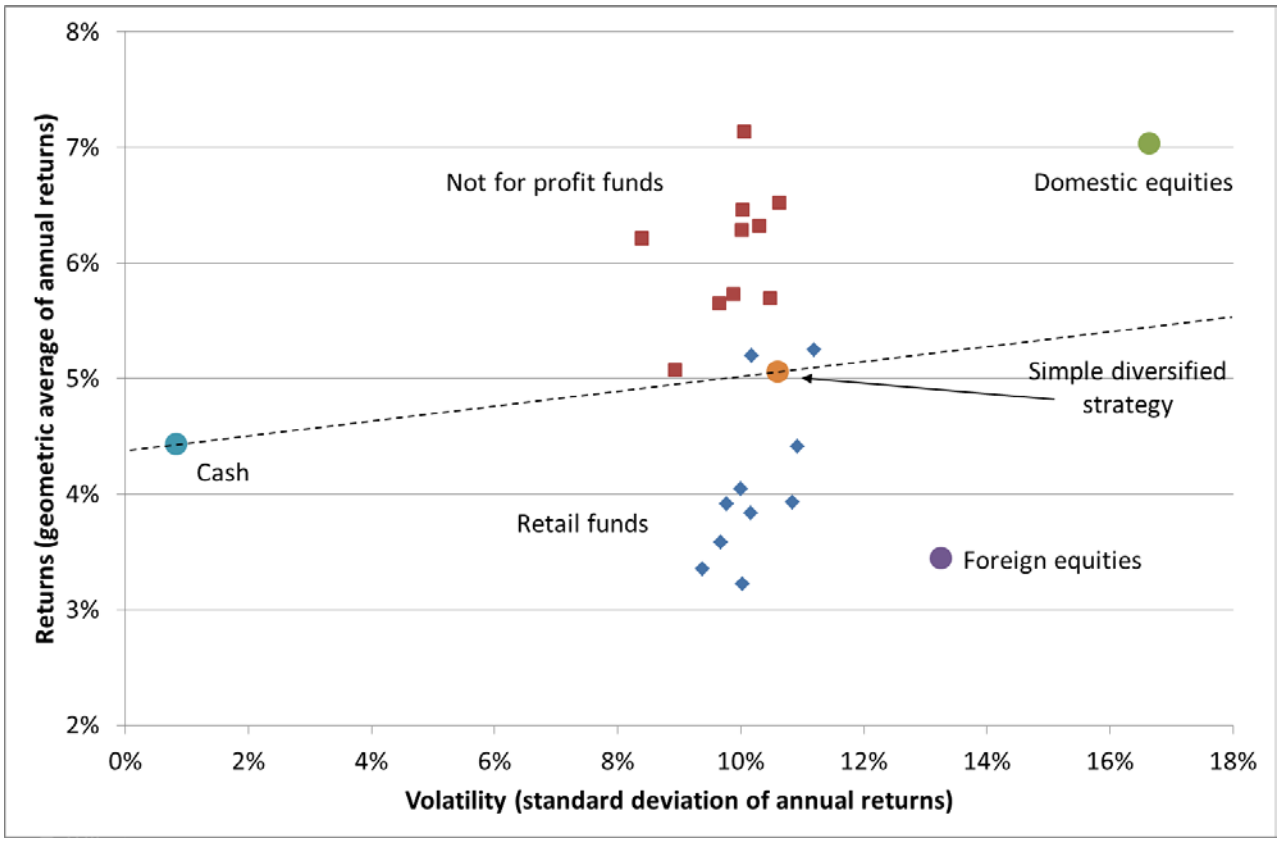
Figure 1 Superannuation fund performance during and since the GFC, September 2004 – December 2012



Sources: APRA (2013) *Quarterly Superannuation Performance,* Frontier Investment Consultants (2013) *Proprietary dataset.*

Figure 2 compares returns and volatility in the ten largest not-for-profit and retail funds to cash, domestic and foreign equities, and a simple diversified strategy, between 2004 and 2012. It shows that both retail and not-for-profit funds have similar volatility to the simple diversified strategy; although the level of returns differ. The top ten not-for-profit funds include eight industry funds, one corporate fund and one public sector fund. Retail fund returns are comparable to the return on foreign equities while industry fund returns are more akin to the higher return on domestic equities.

Figure 2 Return and volatility – 10 largest not-for-profit and retail funds, June 2003 – June 2012



Sources: APRA (2013) *Superannuation fund level rates of return,* Frontier Investment Consultants (2013) *Proprietary dataset.*

3. Long-term returns

Over the sixteen financial years between 1996 and 2012, the average net return of APRA-regulated funds is 4.81% pa (Figure 3).[1] Public sector funds have an average return of 6.17% pa, while corporate funds have an average return of 5.65% pa and industry funds 5.29% pa, all of which are above the industry average. Retail funds have an average return of 3.56% pa.

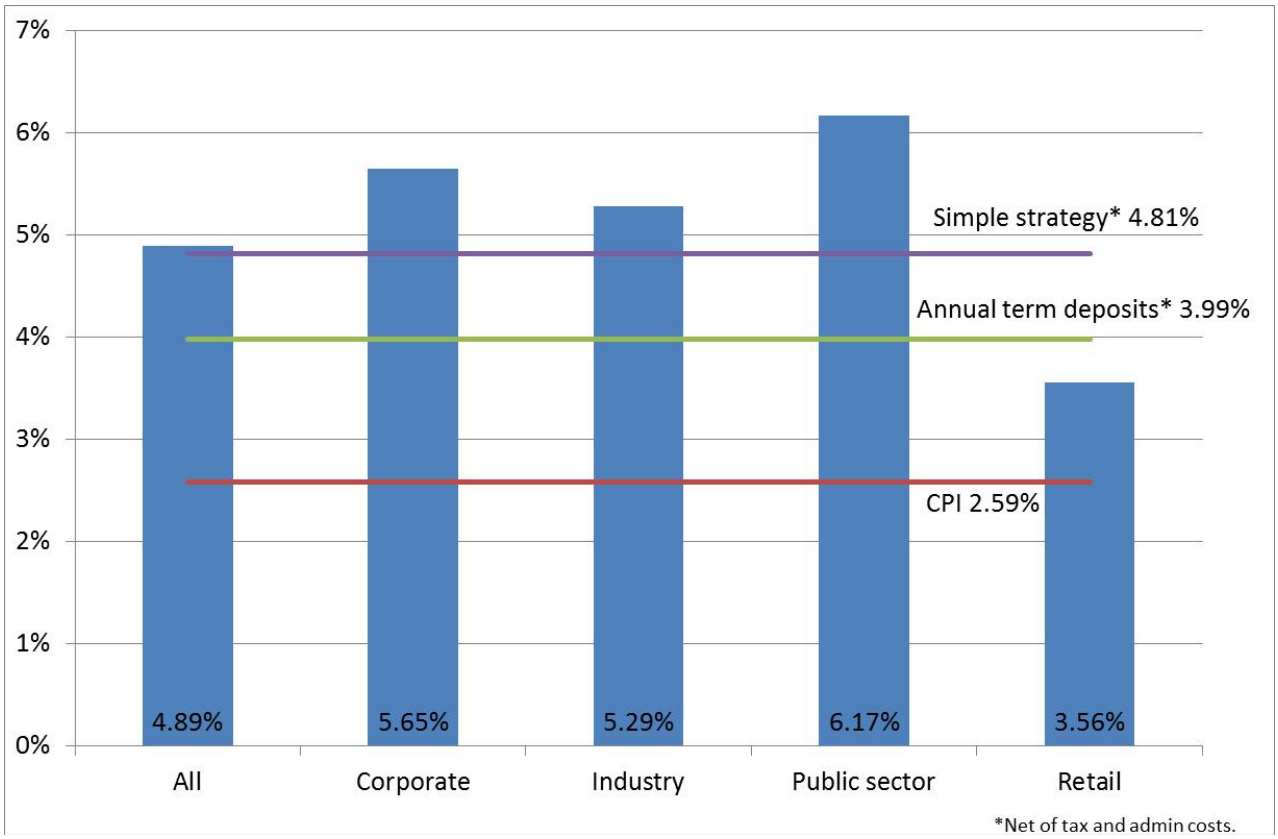
Based on these average rates of return, $100 invested in a retail fund in 1996 would be worth $175 in 2012, compared to $241 in a corporate fund, $228 in an industry fund or $261 in a public sector fund.

The average net return in 2012 is 40 basis points lower than the return calculated over 15 years to 2011. This reduction is mainly the result of weakness in domestic equities, reducing 7 per cent between 2011 and 2012. Foreign equities were marginally down, while cash remained relatively constant.

To establish the level of value add of the various sectors, long-term performance is compared to benchmarks: the inflation rate (CPI), the rate of return on annual term deposits (a risk-free investment available to retail investors) and the rate of return on a simple diversified investment strategy (1/3 cash, 1/3 domestic equities, 1/3 foreign equities).[2] For consistency with superannuation net returns allowance is made in each benchmark for superannuation earnings tax and an estimate of minimum common administration cost (25 bps).

[1] The rates of return are geometric means.
[2] The indices used in this analysis are the S&P/ASX 300 (SPASX300ALL), MSCI World ex Aust net divs (AUD) (MSCIXA) and MSCI World ex Aust Hedged (AUD) (MSCIWOH). RBA data is used for term deposits.

Figure 3 Annual rate of return on large APRA funds by sector, relative to benchmarks, June 1996 - June 2012



Sources: APRA (2013) *Annual Superannuation Statistics,* ABS (2013), CPI Category 6401.01, Frontier Investment Consultants (2013) *Proprietary dataset.*

4. Persistence in returns

The underperformance of retail superannuation funds relative to not-for-profit funds has been discussed in published research now for a decade.[3]

Sectoral performance is the aggregate performance of individual funds within each sector. It is reasonable to investigate, therefore, whether persistent underperformance (or outperformance) is also evident at the individual fund level. Statistical analysis by Deloitte Access Economics (DAE) demonstrates that it is.

Last year, funds for which 8 years of fund level performance data was available were grouped into tertiles (three groups by ranking: highest, middle and lowest) based on geometric mean net return performance in two four year periods: 2004-2007 inclusive and 2008-2011 inclusive. A 'transition matrix' (Figure 4) was prepared tabulating the funds according to their rankings in both periods.

If past returns offered no guidance as to future performance, the funds would be distributed evenly across the matrix. In fact, the analysis found concentrations of funds in the corners at top left and bottom right (representing consistently high or consistently low performance), and the much lower numbers of funds in the opposite corners (representing a reversal of form), indicate there is persistence in performance. Econometric analysis showed this pattern was statistically significant both for all 172 funds for which data was available, and for the subset of 90 major funds with over $1 billion in assets.

[3] See Coleman et al (2003), Ellis et al (2008), APRA, (2009), Sy and Liu (2009).

With the recent release of 2012 fund level performance data, APRA's fund level rate of return series is now available for nine financial years (2004 – 2012 inclusive), although the number of funds with nine years data has decreased due to fund consolidation from 172 to 150. In order to keep this analysis consistent with the June 2011 update released in 2012, the data is shifted forward one year, so that the two four year blocks now cover 2005-2008 and 2009-2012.[4]

A fund in the top third of the distribution in the first period has close to double the probability of being in the top third in the second period as it does of being in the bottom third.

Econometric tests of this data establish that the level of prediction is statistically significant at the 99% confidence interval (p-value = 0.0015).

Figure 4 Transition matrix - All 150 multi-asset class APRA-regulated funds with 8 years performance data (2005-2008 to 2009-2012)

		2009-2012			
		T3	T2	T1	
2005-2008	T3	21	20	9	50
	T2	18	16	16	50
	T1	11	14	25	50
		50	50	50	150

Note: T1 = bottom 1/3 funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds

Figure 5 Transition matrix – APRA-regulated funds with 8 years performance data with over $1b assets (2005-2008 to 2009-2012)

		2009-2012			
		T3	T2	T1	
2005-2008	T3	13	11	4	28
	T2	9	10	10	29
	T1	6	8	15	29
		28	29	29	86

Note: T1 = bottom 1/3 funds, T2 = middle 1/3 of funds, T3 = top 1/3 of funds

Sources: APRA (2013) *Fund level performance data and profiles.*

For the same test based on the 86 funds with over $1 billion in assets (down from 90 in 2011) the result is also statistically significant at the 99% confidence level. Of the 28 funds in the top third in the second period, close to half (13) came from the top third in the first period and only four came from the bottom third. Of those in the bottom third in the second period, more than half were in the bottom third

[4] Analysis based on alternate divisions of the data, including into 5 and 4 year periods and 4 and 5 year periods, all produced results statistically significant at either the 99 per cent or 95 per cent level.

previously, whereas only four were in the top third. The chance of randomly achieving this result is less than 1/200 (p-value = 0.00336).

The conventional thinking around super fund performance is that past performance is not a reliable indicator of future performance. However, this new research, based on rigorous long term data, clearly shows that there a number of factors which do lead to consistent outperformance by super funds.

The reason the statistical significance of persistence is stronger among larger funds is that persistent differences in performance are due to differences in governance and profit orientation, and these differences are more powerful at scale, as is discussed in Section 7, below.

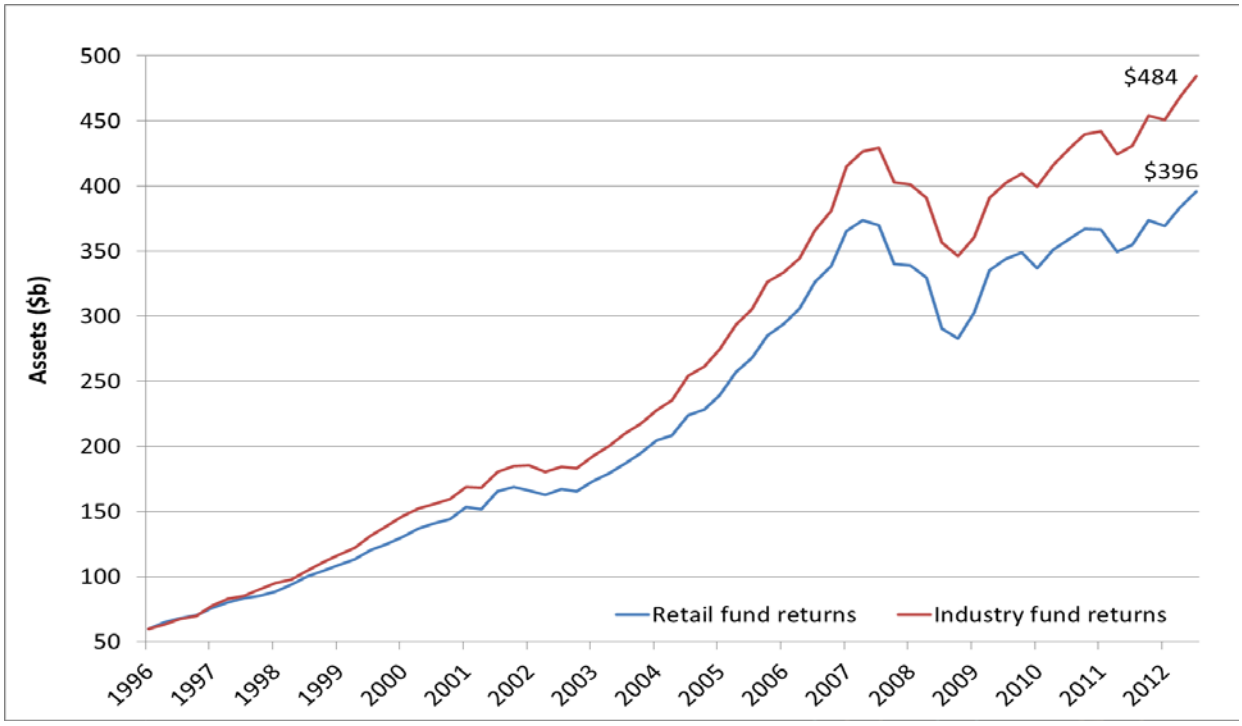
5. The cost of retail fund underperformance

The retail sector is the largest sector of APRA-regulated superannuation funds with $371 billion or 40% of assets under management as at June 2012.

Each year of underperformance costs Australian retirees and workers billions of dollars in interest income foregone.

Figure 6 illustrates how retail fund assets would have grown if they had earned industry fund returns since 1996. With industry fund returns, the retail sector would have grown to $484 billion by June 2012, an improvement of $88 billion.

Figure 6 Retail sector superannuation asset growth, with actual returns and industry fund returns, June 1996 - June 2012

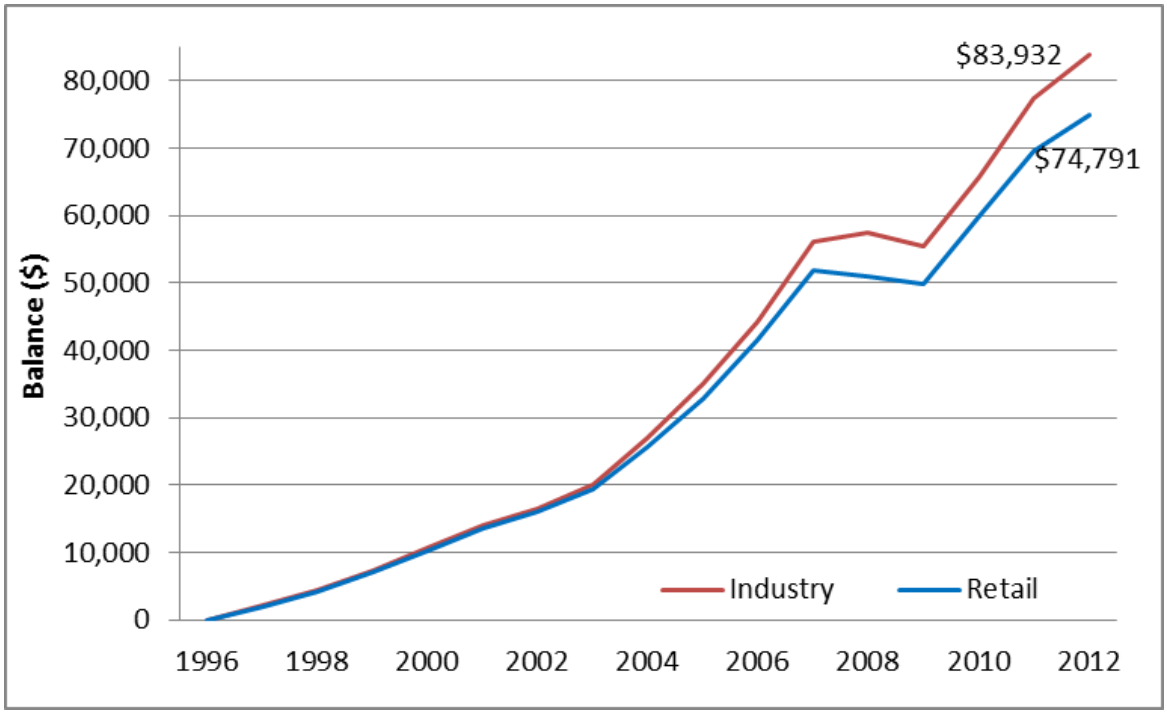


Source: APRA (2004) *Supertrends,* APRA (2013) *Quarterly Superannuation Performance.*

Comparing industry and retail fund returns at the individual level shows how the difference in returns influences an individual's superannuation balance at retirement. For example, a male earning average weekly ordinary time earnings between 1996 and 2012, with an account balance of zero in 1996, will have around $9,100 more in their superannuation if they earned industry fund returns, compared to retail fund

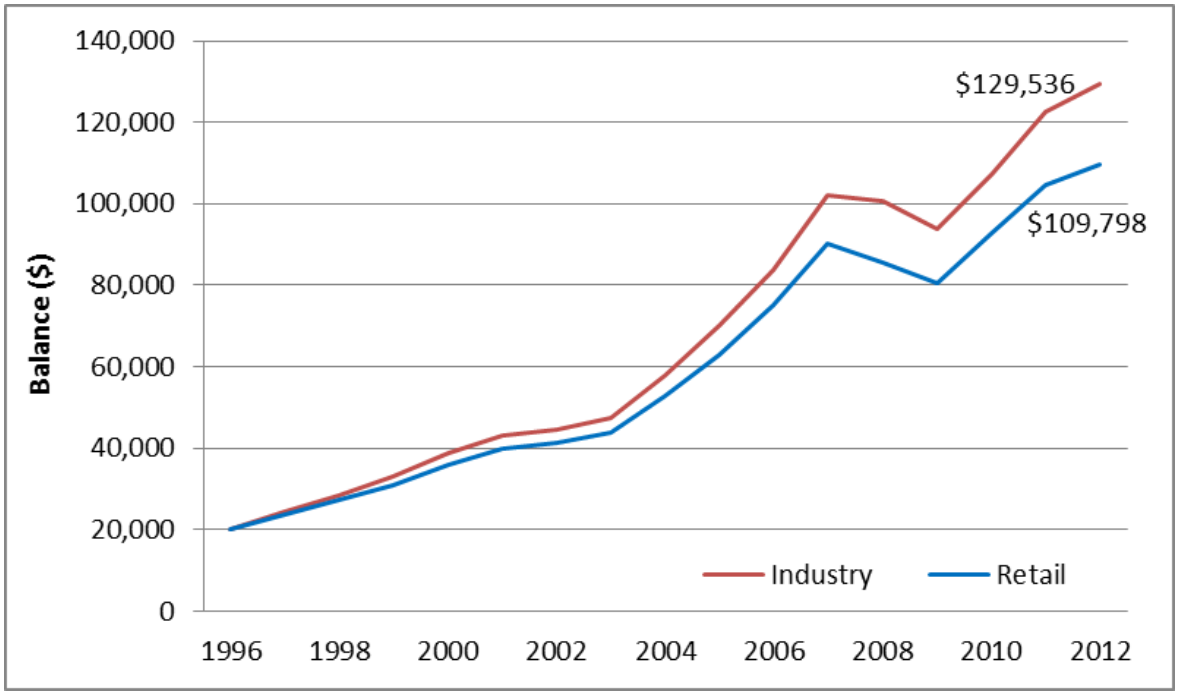
returns. This is an eleven per cent difference based on fund earnings alone. This difference would be exacerbated if the individual made additional contributions above SG throughout their working life. The two figures below compare the account balance of an individual with industry and retail fund returns. Figure 7 assumes a nil starting balance, and Figure 8, a starting balance of $20,000. The second example shows the account balance of an individual with industry fund returns to be 15 per cent higher than an account balance based on retail fund returns.

Figure 7 Account balance for an individual – industry fund returns versus retail fund returns, starting balance of zero, June 1996 - June 2012



Source: APRA (2004) *Supertrends,* APRA (2013) *Annual Superannuation Statistics.*

Figure 8 Account balance for an individual – industry fund returns versus retail fund returns, starting balance of $20,000, June 1996 - June 2012



Source: APRA (2004) *Supertrends,* APRA (2013) *Annual Superannuation Statistics.*

6. Economies of scale

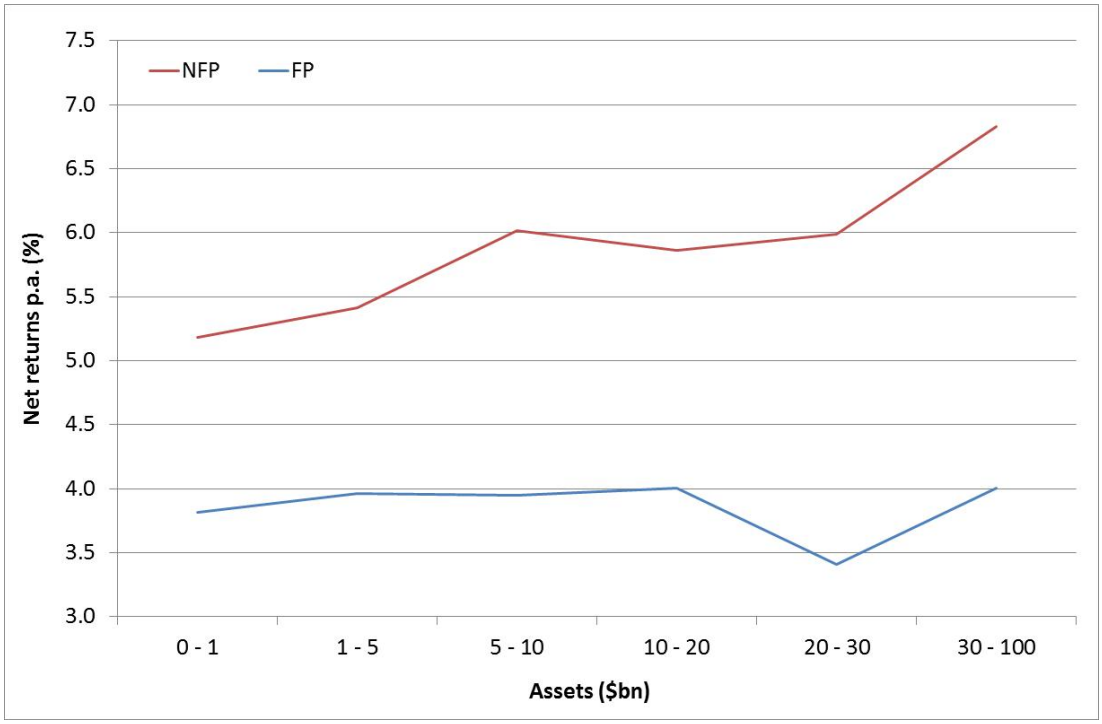
Figure 9 displays average rates of return for the nine financial years from 2004 to 2012 for superannuation funds grouped by profit orientation and size in assets.[5] Average performance improves with scale for not-for-profit funds but does not for retail funds. Average outperformance by not-for-profit funds increases from 1.5% among smaller funds to 3% for the largest funds (with assets over of $20 billion).

Regression analysis confirms the statistical significance of the relationship between size and rates of return amongst not-for-profit funds (at 99% confidence interval) but not retail funds. Figure 10 shows the scatter plot as well as the regression line and regression statistics. On average performance among not-for-profit funds over the eight years improves by around five basis points per $1 billion in assets.

Either economies of scale are not available to retail funds, or the benefits of scale economies are not passed on to members. Recent research by APRA researcher James Cummings suggests that it is the latter. In particular, Cummings finds that retail funds do exhibit economies of scale, at least in relation to *administration costs* (2012: 30). Evidently, 'the structure of retail funds… is less conducive to capturing the benefits of scale' for their members.

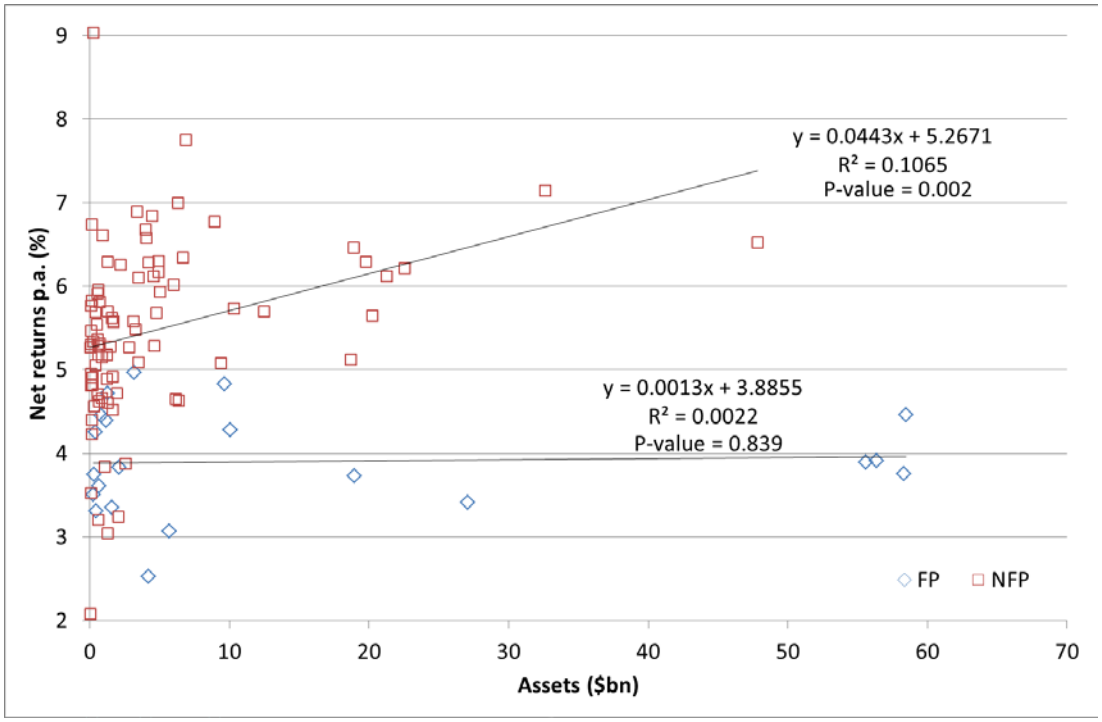
[5] Funds are grouped as fund families, with asset-weighted average returns calculated for all retail funds within the same conglomerate.

Figure 9 Fund level rates of return, averages, by profit orientation and size 2004-2012



Sources: APRA (2013) *Fund level performance data and profiles.*

Figure 10 Fund level rates of return by profit orientation and size 2004 – 2012



Sources: APRA (2013) *Fund level performance data and profiles.*

7. Outsourcing to related parties

The economies that Cummings identified on the administration side (for funds of both profit-orientation) are only evident for not-for-profit funds when it comes to investment management.

Cummings concludes that large not-for-profit funds are able to use greater bargaining power to get more attractive prices for investment management.

To explain the lack of such economies on the retail fund side, Cummings looks to another working paper by APRA researchers Liu and Arnold (2010). This paper found that retail funds on average pay substantially above market rate to service providers *if they are related parties*. The funds management of large retail funds is generally provided by funds managers that are related parties.

Liu and Arnold found that across a range of outsourced service retail funds paid 81 bps more than market rate (133 bps instead of 52 bps) to related parties than to non-related party service providers.

Of particular note was the differential on administration costs. Payments to non-related party providers were $64.39 per member pa for a median cost fund, compared to $358.17 per member pa to related party providers. This represents a more than five-fold mark-up of cost.

8. Data and methodology

The data on superannuation returns used in this analysis is published by the Australian Prudential Regulatory Authority (APRA). The relevant publications are the *Annual Superannuation Bulletin*, *Quarterly Superannuation Performance* (and its pre-cursor *Supertrends*), the tables in *Insight* 2007 Vol II, and *Superannuation Fund-level Rates of Return*. APRA performance data is comprehensive (covering all funds and all customers), is consistent with audited accounts, and is net of all fees and tax.[6]

The analysis also utilises data on inflation and asset class investment performance. Inflation data is drawn from the ABS and is publicly available, as is data from the RBA on term deposits. Performance data on other asset classes is drawn from proprietary Frontier Investment Consulting data sets.

8.1 Performance and volatility

For consistency, the investment benchmarks are adjusted for superannuation tax and minimal administration cost. The rate of superannuation tax applied is 15% for cash and foreign equities and 10% for domestic equities. A total of 25 basis points are applied as a common administration cost.

The data for this chart is attached below at Table 1.

8.2 Cost of underperformance

This analysis adjusts for a break in series in APRA superannuation data. The assets of retail funds as at September 2004 is different in the *Supertrends* data, which ended at September 2004, from the *Quarterly Superannuation Statistics,* which began at the same date. Specifically, the later series had $209 billion, around 3% lower than the earlier series, which had $215 billion.

To ensure this break in series does not influence the comparison, and is consistent with the current series, the data for retail fund assets in the period *before* September 2004 is reduced by the percentage difference at that time.

[6] For a more comprehensive discussion on the APRA statistics see the original research, Vidler (2011) p. 10-11.

8.3 Persistence

Data for the persistence calculation is drawn from APRA Fund level performance data, which is available for the eight financial years from 2004 to 2012. There is performance data available for all nine years for 150 funds after Eligible Rollover Funds (ERFs) are excluded and three outliers, as they have a near zero volatility, implying holdings in cash. As these are clearly a distinct sub-population of funds, these are also excluded. In the Deloittes Access Economics paper on persistence, a number of statistics are calculated with and without this sub-population.

8.4 Economies of scale

The economies of scale analysis also uses APRA's fund level rates of return. 'Fund family' rates of return are calculated as an asset-weighted average return for all the retail funds run within the same economic entity or conglomerate.[7]

The regression analysis is applied to fund family returns. Four funds were excludes as outliers as they are more than two standard deviations above or below mean returns. [8]

Sources

Data

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[7] Staff funds available to some or all staff within a conglomerate are not included in fund families as they have different governance models and different profit orientation.

[8] The funds removed for having outlying performance values (greater than two standard deviations away from the mean) were: Goldman Sachs & JBWere Superannuation Fund, The Employees Productivity Award, Superannuation Trust, Commerce Industry Superannuation Fund, and Australian Christian Superannuation fund. The dataset also does not include ERFs.

Other

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Table 1. Annual return and volatility, Large not-for-profit and retail funds, 2004-2012

Fund name	Fund type	Net assets (2011) ($b)		2004	2005	2006	2007	2008	2009	2010	2011	2012		Geometric average return	Standard deviation of return
AMP Superannuation Savings Trust	Retail	51.9		10.1%	10.5%	12.9%	13.6%	-9.%	-13.4%	8.2%	6.6%	-0.3%		3.9%	9.8%
Colonial First State FirstChoice Superannuation Trust	Retail	43.2		10.5%	10.3%	13.3%	13.%	-12.4%	-11.7%	9.4%	7.3%	-1.0%		3.8%	10.2%
Retirement Wrap	Retail	34.2		11.6%	10.2%	11.5%	12.8%	-12.5%	-10.4%	7.9%	5.5%	-0.6%		3.6%	9.7%
The Universal Super Scheme	Retail	33.9		12.7%	11.7%	14.1%	14.4%	-10.2%	-14.7%	10.4%	6.8%	-0.5%		4.4%	10.9%
OnePath Masterfund	Retail	26.1		9.5%	10.9%	8.8%	13.5%	-8.9%	-12.8%	9.4%	5.1%	-1.8%		3.4%	9.4%
ASGARD Independence Plan Division Two	Retail	15.8		12.%	12.3%	10.7%	13.9%	-11.7%	-10.5%	8.7%	7.2%	-2.%		4.0%	10.0%
Mercer Super Trust	Retail	15.7		12.8%	12.5%	14.%	15.4%	-7.9%	-12.9%	7.9%	8.6%	0.5%		5.2%	10.2%
MLC Superannuation Fund	Retail	13.2		12.2%	11.8%	13.8%	14.2%	-13.3%	-12.5%	8.9%	5.5%	-0.4%		3.9%	10.8%
IOOF Portfolio Service Superannuation Fund	Retail	12.9		11.1%	11.2%	13.%	13.6%	-12.7%	-10.5%	1.9%	6.7%	-1.3%		3.2%	10.0%
Plum Superannuation Fund	Retail	10.7		14.4%	12.5%	15.3%	15.8%	-9.5%	-14.2%	10.4%	7.6%	0.1%		5.3%	11.2%
AustralianSuper	Industry	47.8		13.9%	12.8%	18.6%	17.3%	-5.9%	-12.4%	8.7%	8.9%	1.1%		6.5%	0.4%
Unisuper	Industry	32.6		15.9%	16.5%	15.8%	15.6%	-6.7%	-9.5%	9.4%	9.0%	2.2%		7.1%	0.7%
Retail Employees Superannuation Trust	Industry	22.6		12.3%	12.0%	12.7%	14.9%	-5.1%	-7.9%	10.5%	8.3%	1.1%		6.2%	0.3%
Sunsuper Superannuation Fund	Industry	20.2		13.1%	13.2%	13.2%	15.6%	-5.9%	-11.4%	8.4%	8.6%	-0.3%		5.6%	0.1%
Health Employees Superannuation Trust Australia	Industry	19.8		15.5%	13.2%	13.6%	16.3%	-6.1%	-11.8%	9.3%	9.2%	1.5%		6.3%	0.5%
Construction & Building Unions Superannuation	Industry	18.9		14.0%	13.0%	16.4%	17.2%	-4.9%	-11.8%	8.3%	8.2%	1.6%		6.5%	0.5%
Public Sector Superannuation Scheme	Public Sector	13.0		14.3%	13.9%	13.7%	17.2%	-2.1%	-14.9%	10.1%	7.2%	1.8%		6.3%	0.6%
Telstra Superannuation Scheme	Corporate	12.5		9.4%	13.0%	16.8%	16.9%	-8.3%	-11.6%	9.3%	10.4%	-0.3%		5.7%	0.2%
HOSTPLUS Superannuation Fund	Industry	10.3		13.1%	13.1%	14.4%	15.8%	-4.5%	-13.0%	6.8%	9.2%	0.6%		5.7%	0.2%
Victorian Superannuation Fund	Industry	9.4		11.5%	10.2%	13.1%	14.2%	-6.2%	-10.9%	6.5%	9.7%	0.8%		5.1%	0.3%
Investment Benchmark (net of tax and admin cost)															
Cash				4.3%	4.5%	4.6%	5.2%	6.0%	4.4%	3.1%	4.0%	3.7%		4.4%	0.8%
Domestic equities				19.3%	23.2%	21.4%	26.0%	-12.6%	-18.6%	11.5%	10.5%	-6.6%		7.0%	16.7%
Overseas equities				18.4%	5.3%	15.7%	12.9%	-15.0%	-18.9%	8.0%	11.9%	-0.1%		3.4%	13.3%
Simple diversified strategy				14.0%	11.3%	14.7%	16.3%	-9.0%	-12.3%	7.8%	8.8%	-1.6%		5.1%	10.6%