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Title: **Future Proofing**

Uncovering better analysis of industry fund costs with a focus on delivering enhanced member experience.

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Synopsis: The GFC, Cooper Review and Stronger Super have increased focus on cost efficiencies and member benefits, resulting in industry fund mergers becoming an inevitable conclusion for many trustees looking to achieve scale.

While merging arguably improves member outcomes for many funds, alternative options do exist which not only address the scale issue but may indeed deliver superior member outcomes.

In this first of a series of papers, we focus on better analysis of fund cost dynamics and long term solutions which provide a base upon which to deliver enhanced member services.

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Future Proofing

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INTRODUCTION

It wouldn't be an overstatement to say the topic of mergers has been discussed in the boardroom of every industry fund in Australia. The global financial crisis, the Cooper review into superannuation and the Government's initial response through "Stronger Super" have all increased the focus on cost efficiencies and pursuing member benefits, with achieving scale via fund mergers being an inevitable conclusion for many trustees.

While merging arguably improves member outcomes for many funds, there are alternative options for achieving scale efficiencies and the structures that may indeed deliver superior member outcomes. Russell's future proofing service helps trustees identify and develop these options.

To future proof a fund, trustees need new analytics that better capture and measure the evolving investment and cost dynamics of their funds and then have access to the long term solutions which will give them the base upon which to deliver services in the future. With future proofing tools, trustees will be able to assess how to respond to regulatory change, understand the consequences of growing scale in assets and members, better evaluate the benefits and costs of merger proposals, develop sophisticated partnership sourcing strategies and identify what cost strategy they should be pursuing.

To prepare for, and to flourish in the future, small and medium sized industry funds and their trustees will need to address key issues relating to costs and the member experience; relating to member returns both absolute and relative to peers; and relating to risk management. In this initial paper, we focus on costs and the member experience, particularly in the context of scale.

CHOICE OF FUND INCREASED COMPLEXITY

To understand the cost imperatives facing industry funds and to formulate effective responses to Future Proof those funds, it is necessary to retrace our steps and examine how we arrived at where we are today. The introduction of the choice of fund (choice) legislation in July 2005 was a catalyst for significant change in the competitive dynamics of the superannuation industry. Choice provided members with the ability to transfer from their existing fund to a new fund, increasing the spotlight on investment returns, expenses and charges, and benefits as members could vote with their feet on these key features.

While choice was a big step forward for superannuation members, the reaction by segments of the industry to the change in competitive dynamic varied widely.

Retail funds which had long focused on providing bespoke services tailored to the needs of the individual member were arguably better prepared for the growing competitive pressures. Their 'customer intimate' approach meant retail funds' proposition was already focused on value not price while significant investments in technology platforms, which was vital for providing these services, had already been made. Arguably, choice provided retail funds with the potential to better leverage their existing technology advantage by providing a clearly differentiated price and service proposition which could be more fully exploited by their in-house financial planning sales forces.

By contrast the reaction by industry funds to choice presented more of a challenge — continue with the value for money or operational excellence positioning that had driven success and growth prior to 2005 or reappraise the value proposition in light of the increased threat (real or otherwise) from competitors such as retail funds. Unless managed carefully, responding rapidly to choice by providing additional features and services but with a low cost, value for money proposition risked jeopardising the industry fund's operational excellence advantage.

By providing additional services and features, industry funds increased business complexity. Traditional fund activities - administration, investment, insurance and governance - needed to be supplemented by new activities such as member engagement services, provision of personal advice, product development and management, marketing and sales activities, retirement solutions and enhanced member education and communication services. These additional activities were not only complex but required trustee's to increase investment in technology and source new management skills and people.

The rapid pace of competitive change also meant little time was available for industry funds to fully assess and integrate, either through in-sourcing or outsourcing, these activities into the existing business model. Furthermore, trustees needed to develop the management experience and expertise to tackle the new complexity.

As industry funds enhanced their member services which in turn provided a bulwark against competition, they created a risk of increasing costs but with lower level of customisation and service compared to the retail sector due to a relative under-investment in technology. Indeed, changes in the cost base of member services pre and post choice demonstrates this point. In 2004 prior to the introduction of choice, the average cost for a $50,000 balanced member in one of the top 12 industry funds was 65 basis points per annum (source: Tria Investment Partners: "The price is not right" January 2011). Despite a doubling of funds under management between 2004 and 2009, which would normally be expected to provide scale cost benefits, member cost increased to just over 100 basis points, on average, annually, an increase of over 50%.

Ironically, while choice has increased the complexity and cost of managing superannuation funds, only a small minority of members are exercising their right of choice. In fact, switching rates between funds have actually declined from around 5% in 2005 to 2 per cent by the end of 2009 (Ref. Cooper Review Page 9).

THE COOPER REVIEW INCREASES SCRUTINY ON COSTS

Covering all superannuation fund sectors, the Cooper Review was announced in 2009 with terms of reference to review the governance, efficiency, structure and operation of Australia's superannuation system in the pursuit of maximising retirement incomes for all Australians while improving regulation and reducing business costs. In achieving this aim, the review determined the 'tail should not wag the dog'; member interest should drive superannuation outcomes, not service provider or other interests.

Selected Cooper review recommendations included:

- engagement - while members are compelled to make super contributions, they should not need to be financially literate or engaged to get the most out of the system
- MySuper - deliver a simple, well-designed, low cost default option suitable for the majority of members
- SuperStream - improving back office efficiency through a package of process, data and technology upgrades
- scale matters - seeking substantial benefits for members out of increased scale to achieve optimised outcomes for members
- governance - improving governance structures key to improving member outcomes

- helping members compare - improving data to allow 'like for like' comparisons of Fund performance and features
- whole of life focus - making trustees responsible for whole of life outcomes for members, not just the accumulation phase.

LIMITATIONS IN COST ANALYSIS AND IMPLICATIONS FOR FUND MERGERS

The package of measures proposed by Cooper was estimated to generate substantial dollar savings for members over the long term with a 40% cut in fees for the average member forecast. If achieved, this would lift final average superannuation balance by around $40,000 or 7% after 37 years.

At the heart of the Cooper Review were the MySuper and SuperStream recommendations which are designed to deliver true value for money services for default superannuation members largely through scale and simplicity.

In modelling costs for the Cooper Review, Deloitte estimated costs for investment management, administration and intra-fund advice separately based on existing data for superannuation funds. The interaction between the cost of these activities, other fund costs, growth in members and assets, and the impact on overall business complexity were not explicitly modelled. As Deloitte reported, cost modelling was generally impacted by a lack of publicly available fund data.

Deloitte modelling projected the total MySuper cost (investment costs, administration and intra-fund advice costs, expressed in basis points) for a $20 billion active balanced fund with alternatives to be 66 basis points per annum, which is low compared to the cost outcomes being currently achieved by many funds. Coincidentally, this is almost identical to the average cost outcome achieved by the top 12 Industry funds in 2004 (for a member balance of $50,000), as mentioned previously.

The analysis concludes that fund mergers and consolidations may be necessary to achieve scale cost benefits for members. However, the impact on investment complexity resulting from growing fund assets is not considered.

Other investment challenges associated with growing pools of assets that are not discussed include:

- the increase in technical governance skills required by trustees as investment complexity grows (Russell Research: Aspects of Good Investment Governance, February 2011)
- accessing increasing numbers of managers with growing monitoring, transition and other implementation costs and leakages
- the zero sum nature of active returns with implications for the capacity of active managers
- the costs associated with large and growing internal investment teams, and
- the challenges associated with accessing and managing global asset portfolios.

As a consequence of their modelling, Deloitte imply a hurdle for active versus passive management of approximately 30 basis points per annum. This reflects the estimated difference in total costs (investment plus operating including intra-fund advice in basis points) between managing an active balanced portfolio with alternatives and a passive balanced portfolio and appears supportive of active management.

The Cooper Review discusses the decision to in source or out-source investment activities in the context of fund asset size. Smaller funds are assumed to primarily use implemented solutions (though some retain control of manger selection) while larger funds increasingly blend internal investment resources with external managers. There are many shades of grey between these two boundaries where sophisticated sourcing strategies may deliver more efficient outcomes for members, both in investment returns and costs, regardless of asset size or complexity but this analysis is not included in the review.

The Deloitte cost analysis also doesn't explicitly address the drivers of diseconomies of scale or scope in administration:

- which operational activities should be in sourced or outsourced as assets and members grow
- how to develop and administer increasingly complex retirement solutions
- enhancing the overall customer experience
- the growing complexity of providing limited advice to individual members, and
- the impact of increasing demands on Governance, Risk Management and increased regulatory oversight.

These issues have the potential to significantly affect cost outcomes as funds grow by increasing fixed costs associated with business complexity.

Therefore, neither investment nor operating cost modelling allows for the increasing risk of diseconomies of scale or scope as business complexity increases with growth in assets and members.

RESEARCH INTO THE CONSEQUENCES OF GROWING SCALE AND COMPLEXITY

A lack of detailed fund cost data has generally restricted research into scale and cost outcomes for superannuation funds, however, two recent studies provide timely and valuable insights:

- "Economies of Scale and Scope in Australian Superannuation Funds", Helen Higgs and Andrew C. Worthington No 2020-15, Griffith Business School, and
- "The price is not right", Tria Wealth Management Research, January 2010

Research methodology

The paper by Higgs and Worthington provides a valuable insight into the practical issues faced by trustees who are managing significant growth in assets and members with consequent increase in business complexity.

In their paper, Higgs and Worthington estimate economies of scale and scope for 200 large Australian superannuation funds in 2009. Data for their study is sourced from APRA and is the first data released to enable this more detailed style of analysis. The analysis is useful to understand the cost dynamics operating in superannuation funds following the significant increase in assets and complexity over the past decade and appears to be the only detailed analysis of this nature.

Higgs and Worthington define costs comprehensively which potentially provides more explanatory detail than was possible in the Cooper Review. Like the Cooper Review, they define costs separately for investment and operating expenses but do not consider other costs related to advice.

Costs are further disaggregated for investments into investment, custodian and asset management fees and for operating expenses into management, administration, actuarial, director and trustee fees and charges. Four outputs are used to define each cost: for investments - cash flow adjusted net assets, number of investment options, proportion of total assets in the default option and five year rate of return for investment costs; and operating expenses - cash flow adjusted net asset, member numbers, net contributions and net rollovers.

They initially test separately for economies of scale per dollar value of assets managed and in the number of members. For economies of scale to be evident, the marginal cost of managing increasing assets or new members must be lower than the average cost of managing existing assets or members.

Findings show diseconomies of scale per dollar value and size complexity grows

Their analysis shows operating costs per member and dollar value of assets behave similarly to other industries, displaying a distinctly u-shape nature. The minimum efficient scale occurs at just over 1 million members and just under $20 billion of assets. Either side of the minimum efficient scale (MES) costs rise. They believe that diseconomies of scale above the MES could be due to "the increase in input prices as industry constraints on factor availability apply, the reduction in incentives and the growth in bureaucracy in large organisations, and the increasing lack of specialised resources in once small markets".

In contrast to operating costs, investment costs per member and per dollar value of assets managed are much flatter and more ‘L’ shaped as assets grow. This suggests that economies of scale in managing larger pools of assets are quickly exhausted for small, medium and large superannuation funds.

These results considered a single output (member accounts or assets) and are instructive in helping to understand the behaviour of the underlying costs in superannuation funds. However, superannuation funds produce multiple products and undertake other broader activities. The interaction of costs across multiple products and activities as growth in members and assets occurs potentially provides a far deeper understanding of the cost dynamics involved in managing superannuation funds.

To provide this analysis, Higgs and Worthington estimate a cost function for a superannuation fund that allows for multiple products and for the interaction of costs across these products with growth in assets and members. They use the cost function to measure scale efficiency across the range of products and on a product by product basis, and to also measure economies of scope. Economies of scope measure the efficiency of producing multiple products jointly, rather than individually.

Their findings can be summarised as follows:

- significant (i.e. 300% from 1999 levels) superannuation system growth in assets and members will deliver improving cost efficiency in both investments and operations
- cost inefficiency, when it does occur due to system growth, will impact operating costs before investment costs
- in contrast, the sourcing decision becomes critical as the system grows and superannuation funds deliver multiple products and services
- as a consequence, only the largest funds will benefit from full in-house production of administrative services, and
- for the typical superannuation fund there are substantial cost savings in contracting out many administrative functions, and
- in contracting out nearly all investment activities.

These findings are generally consistent with those of the Cooper Review. However, by using a cost function which allows for cost interactions between multiple products and services, conclusions can also be drawn with regard to the sourcing decision.

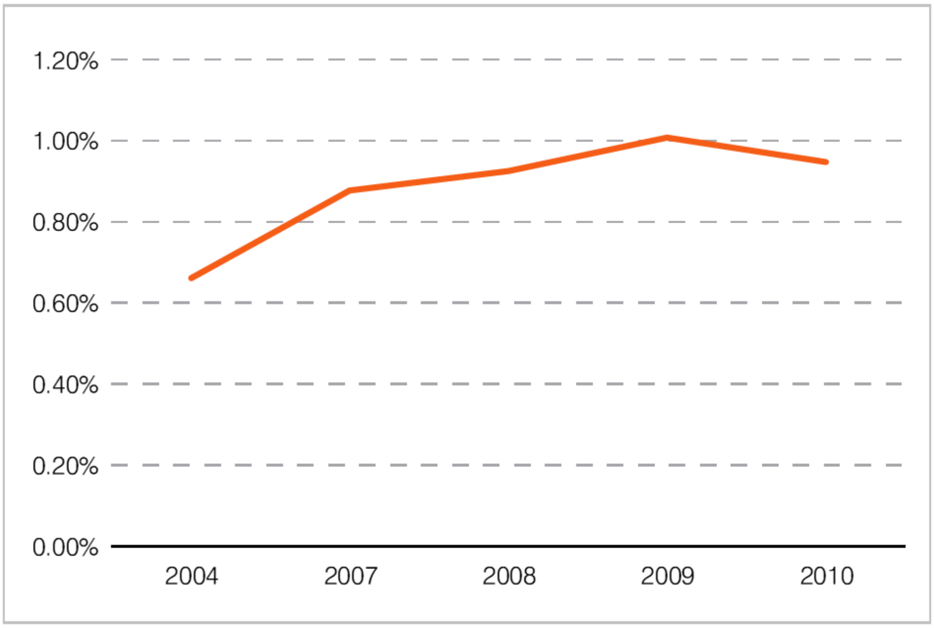
We also know from clients that they already experience the reality of the above findings as they seek to find or develop the resources needed to operate at a desired operational level, but find themselves limited by cost restrictions or other constraints leading to a concern of sub-optimal longer term performance. The sourcing decision findings suggest that growth through mergers and consolidation is only one way to achieve cost benefits associated with growing scale. Accessing scale benefits can also be achieved through sophisticated out sourcing of multiple fund activities and suitable partnerships. For many funds this may also be a more certain strategy to capture scale benefits compared with merging with larger funds where timing and delivery of scale benefits to members is clouded as business complexity grows.

MORE EVIDENCE BIG IS NOT ALWAYS BETTER

In their paper "The price is not right", Tria analyse the average pricing and cost strategy of the top 12 industry superannuation funds over the period 2004-2010 and find that while the significant growth in costs between 2004 and 2009 seems to have been arrested, funds need to regain control of their pricing.

The following chart shows the average cost base increase graphically for a $50,000 balance member.

Average effective price faced by a $50,000 balance member, top 12 funds



Source: Annual reports, product disclosure statements, Tria analysis

Tria reports a conversation with senior fund executives that reveals, at least for some funds, cost is an outcome of providing investment, administration and trustee services to members. The link between the cost to the member and the fund's value proposition may not be explicit; hence as competition and regulation create pressure for expanded services, complexity and cost grow in response.

Rather than use top down estimates of segment fee levels, Tria collected data which focused on the actual prices facing members of different account sizes. Cost data was collected for default option investment costs (including performance fees), member annual fees and other fees which include asset based fees, trustee operating costs, administration fees and member benefit protection costs.

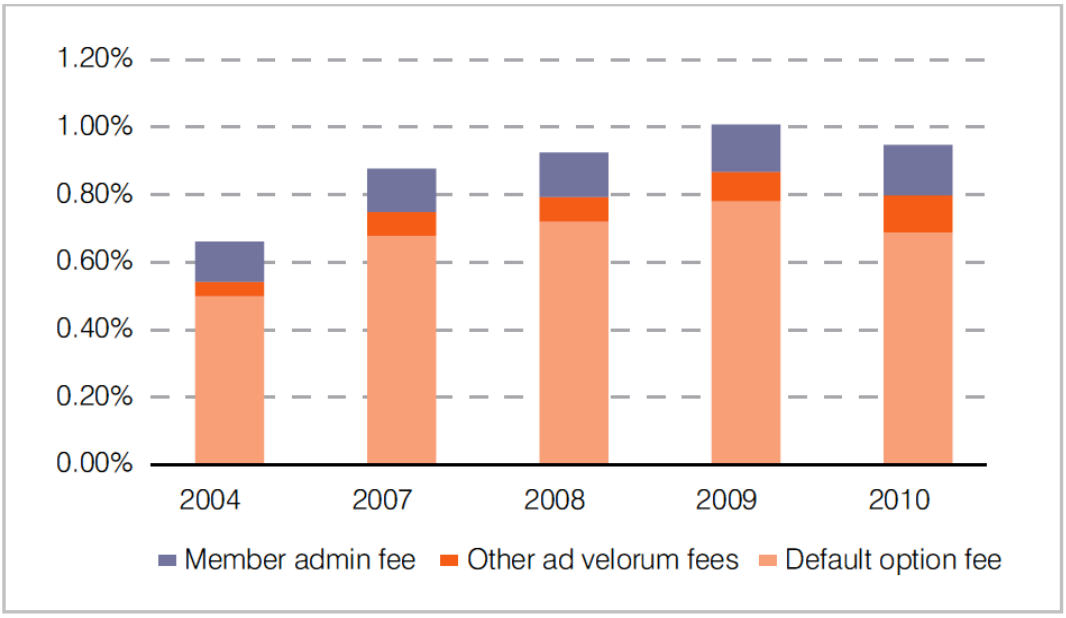
The following chart shows the annual dispersion of fees for the top 12 funds, highlighting that in 2010 a member with a $50,000 balance could experience a large cost base range of between 72 and 130 basis points, which reflects both the broad scale of funds in the top 12 and presumably the varying approach taken by trustees to cost base management.

Dispersion of fees, $50,000 member, top 12 funds

Source: Annual reports, product disclosure statements, Tria analysis

Analysing the composition of fees as shown in the following chart, shows that cost increase has occurred broadly across all categories of fees.

Composition of price by fee type



Source: Annual reports, product disclosure statements, Tria analysis

Over the period, investment costs have grown on average by 40%, member administration fees on average by 25% and other ad velorum fees on average by 275%.

As Tria report, the lack of any scale cost benefits over a period when assets have doubled is a concern, confirming Higgs and Worthington's finding that merging or consolidating to achieve scale may not deliver the expected outcome for members, particularly when business complexity is growing. This outcome highlights that the approach taken by trustees to managing the cost base of their fund may be equally important for achieving scale benefits as merging.

Tria recommends a four phased strategy for tstees to manage cost going forward: baseline the fund's current cost position, develop a pricing strategy, allow for future cost drivers (MySuper, retirement products, advice, member retention) and implement the pricing strategy.

As discussed previously, by expanding products and services post the introduction of choice, industry funds appear to have experienced a significant growth in their cost base which now threatens their value for money proposition. Business complexity has risen quickly and as experienced broadly in other industries growing complexity drives up fixed costs.

Complexity will continue to grow with implementation of Stronger Super and ongoing reform. Achieving control of costs while enhancing investment returns and member services in this operating environment may mean significant changes to how a fund has traditionally operated.

OTHER OBSERVATIONS ON FUND MERGERS

The need for greater transparency and accountability during the merger process

Given the potential downside impacts of fund mergers, it's puzzling that the merger process does not follow the same rigorous principles of transparency, disclosure and stakeholder engagement as those found in public company mergers.

Generally, a merger or acquisition proposal made by a public corporation is accompanied by a detailed analysis of the potential costs and benefits, including targeted synergies, to help shareholders decide whether to support or reject a proposal. By releasing the details of potential synergies and benefits, management is also accepting accountability for achieving the outcomes.

Trustees on the other hand are not required to reveal their decision making process and the potential costs and benefits that may be incurred or enjoyed through the fund merger process. This information would be valuable for members to help them understand the complex issues involved.

Furthermore, significant costs may be incurred in transitioning assets, merging fund structures, rationalising management teams and paying associated legal, accounting and other advisory fees or taxes. Without detailed analysis of the expected costs, fund members do not have the means to hold trustees accountable for managing the costs through the merger process and achieving the forecast benefits over the medium term.

Challenges associated with average member balances and illiquid asset allocations

More complexity is added if member average balances vary widely between the funds which are proposing to merge. A fund with an average member balance of $50,000 will already be experiencing different scale economies to a fund with an average member balance of $15,000. This difference in scale economies may be most significant for administration or related services.

A merger of these funds will ultimately spread available economies over the two funds and both groups of fund members should expect to enjoy better scale economies. However, it begs the question of whether the members of the fund with the higher average balance should be paid additional compensation by the members with the lower average balance for their extra contribution to scale economies, particularly regarding administration.

Another practical challenge is merging funds with differing exposures to liquid and illiquid assets. Liquid assets can be readily valued at traded market prices, thereby ensuring member equity is maintained in an asset consolidation. However, valuing illiquid assets, as demonstrated through the global financial crisis, is a complex activity where often only an approximation of fair value can be made. Ensuring member equity in such an asset consolidation may be very difficult.

None of this is to suggest that mergers should not be contemplated or cannot be designed to deliver potential economies of scale; however there can be other solutions which allow for the achievement of objectives without the need to grapple with the compromises usually needed to resolve issues of this kind.

MASTERING THE SOURCING DECISION: CREATING PARTNERSHIPS DEFINED BY MUTUAL BENEFIT

Creating successful outsourcing partnerships

While merging to achieve scale benefits is one strategy trustees can consider to manage fixed costs due to growing business complexity, recent research suggests that for many funds sophisticated sourcing strategies should also be considered. Depending on the circumstances of an individual fund, a sourcing solution may be more effective than merging to deliver the advantages sought from the merger and also deliver more certainty in achieving outcomes.

Knowing that these solutions exist and can work for smaller funds, can relieve the pressure which is undoubtedly building to “merge before it is too late to negotiate a reasonable outcome”

Much has been written about outsourcing strategy, particularly with regard to IT outsourcing, with some direct parallels for superannuation funds. In their paper “The evolution of outsourcing research: What is the next issue” from the 33rd Conference on System Sciences 2000, Lee, Huynh, Chi-wai and Pi find that “among the major trends in outsourcing, the change of relationship between the clients and the service providers is the most important trend. That is, the nature of outsourcing is evolving from merely relationship of customer and vendor to partnership relationship, defined as an interorganisational relationship to achieve shared goals of the participants.”

This change in thinking evolves the outsource relationship from a hierarchical, win-lose strategy to an equal value, win-win relationship and provides the basis for broader thinking on outsourcing strategy. Coupled with the limitations of even well specified legal contracts means that relationships between client and vendor need to evolve into long term interactive relationships where mutual trust plays an increasingly important role.

Within the framework of viewing outsourcing as a partnership, key steps that should be considered when determining a sourcing strategy include partnership motivation, partnership scope, partnership performance, the decision to partner or not and partnership contract. Closer alignment of interest between client and vendor facilitates broadening the scope of an outsource relationship to achieve the best possible performance and cost outcome with benefits potentially shared between client and vendor.

As an example, a superannuation fund can outsource some or all of its growing list of activities ranging from investment consulting, actuarial consulting, investment, implementation, administration, product development, retirement solutions, limited advice and member engagement services. Outsourcing of these activities has traditionally proceeded with multiple vendors, providing focus and independence but at the cost of lower connectivity, increased complexity and weaker alignment of shared goals.

Vendor services grow to cater for varied outsourcing needs

The emergence of vendors able to expertly provide most or all of the various activities that a superannuation fund undertakes creates the potential for broadening the scope of outsourcing activity.

A single outsource vendor may now be able to provide the full menu of functional activities potentially undertaken by a superannuation fund, allowing contracting to be framed as a partnership defined by shared alignment of goals and mutual benefit.

The potential to create a bespoke outsource partnering solution for a fund, which selectively combines both the individual strengths of the fund and the outsource provider, can ensure that member interests are maximised through the fund and the vendor sharing in the outcomes delivered.

This partnering relationship in turns puts a broader depth of resources within reach of the Fund:

- relieving governance pressures
- reducing risk – and in all likelihood risk adjusted reserves
- increasing access to markets and research, and
- resourcing product development.

RUSSELL'S FUTURE PROOFING

Future Proofing is a new service that aims to provide industry fund trustees with a superior toolbox and appropriate strategies to optimally manage investment and cost outcomes in an increasingly complex business environment.

Future Proofing is as much about efficient business management recognising the real objectives and positioning of the fund as it is about achieving optimal investment outcomes with a goal of helping trustees to:

- develop and model the current cost function of a fund, allowing for multiple products and services and the interaction of costs between these products and services
- using the cost function as an input, develop a pricing strategy that allows for future growth in assets and members
- integrate the provision of future services (MySuper, retirement products, advice, and member retention) into the pricing strategy
- integrate growing investment complexity into the pricing strategy
- develop a partnering based sourcing strategy as a key component of the pricing strategy
- model the costs and benefits associated with a particular fund merger, and
- plan and monitor implementation of the pricing strategy.

In an environment of rising investment and business complexity which is causing fixed costs to inexorably increase, Future Proofing will aid trustees of industry funds by providing the right information and metrics to plan and execute business success to deliver the best possible return and cost outcomes to members.

Disclaimer

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