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SHOULD EMPLOYEES HAVE THE CHOICE OF SUPERANNUATION FUND?

by

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SHOULD EMPLOYEES HAVE THE CHOICE OF SUPERANNUATION FUND?

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INTRODUCTION

Under the Australian superannuation system two compulsory contributions to superannuation funds are made on behalf of employees: award superannuation contribution of three per cent of wage or salary arising from the Conciliation and Arbitration Commission's decision in 1988 to pay wage increases as superannuation and the Superannuation Guarantee Charge (SGC), introduced in 1992, which requires employers to pay a specified proportion of wage and salary (eight per cent from July 2000) into a superannuation fund.

Contributions under award superannuation are paid to the superannuation fund specified in the award while the SGC is paid to a fund chosen by the employer.

Thus, employees have no choice as to which fund their contributions are to be paid.

However, self-employed persons are able to set up their own superannuation funds, the "DIY funds", and self-manage these funds.

The Commonwealth Government has announced a policy of choice of fund in 1996 and introduced a detailed proposal in the 1997 Budget. Specific proposals for choice of fund were introduced into Parliament in December 1997. Originally introduced as Schedule 5 to the Taxation Laws Amendment Bill (No &) 1997, the choice legislation was re-introduced on November 12, 1998 in revised form as the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998. This Bill passed in the House of Representatives on February 16 1999, but debate on the Bill in the Senate was adjourned on February 1999 and the Bill remains in limbo.

The Wallis Committee endorsed choice of fund with some caveats in their 1997 Report.

We examine whether employees should have a choice of superannuation fund and whether this choice should be unrestricted. The basis of our examination is how can a contributor to a superannuation fund maximize their retirement balance. In doing so, we ask whether an employer can made a more informed choice about a superannuation fund than an employee.

THE CURRENT SUPERANNUATION ARRANGEMENTS

Current government policy has a policy of compulsory superannuation which requires that contributions to a superannuation fund are made for each employed person. Contributions are of two kinds: .

1. Under industrial agreements and awards; and
2. Under the Superannuation Guarantee Charge (SGC).

Prior to 1992 many awards has specified that wage and salary increases were to be paid as superannuation and not direct to employees. The National Wage case of 1987 had prescribed that three per cent of salary and wages was to be paid to a fund as specified under the agreement or award. Payments under these arrangements continue to be made for a large number of employees after the introduction of the Superannuation Guarantee Charge.

From July 1, 1992 employers have been required to pay a specified percentage of an employee's wage or salary into a superannuation fund. The Superannuation Guarantee Charge was originally set at three per cent with the intention that it would increase to 9 per cent by 2003. The current level, from July 2000, is eight per cent. Coverage of the employed workforce is high.1 The two types of contributions mean that most contributors have at least two superannuation funds. Some, particularly part-time and casual workers, would have more. In 2000, there were over 22 million individual superannuation accounts while the workforce was less than 10 million.

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[1] It was estimated in 1992 that that 79 per cent of the work force is covered by award superannuation. [The estimates made by the ACTU are cited in the Second Report of the Senate Select Committee on Superannuation (SSCS)p 14. Some employees, particularly casual or part time employees may not earn the minimum threshold as provided for in the SGC. The minimum threshold for award superannuation is lower than that for the SGC. APRA [2000] gives ABS data showing that 91 per cent of employees are covered by superannuation with 81 per cent of all workers and 36 per cent of employers, including self employed, covered by superannuation.

RATIONALE OF COMPULSORY SUPERANNUATION

Compulsory superannuation is hoped to increase national savings, to reduce dependence on government age pensions and to provide retirement benefits for contributors. The focus of this paper will be on the accumulation of funds to finance retirement.

Individual contributors to a superannuation fund wish to maximize the accumulated balance of their superannuation account at retirement; we do not examine the options for obtaining post-retirement income[2].

THE CASE FOR SUPERANNUATION CHOICE

(a) The Commonwealth Government's Position

The government's position is summarised by Kemp [1999]: "One major flaw in the existing superannuation is the lack of control Australians have over which fund is entrusted with their superannuation savings.

For many people, superannuation is their largest asset apart from their house. Yet there is no general right to choose a superannuation fund. Australian can choose the house in which they live, and make decisions about their other investments. They do not have these decisions imposed on them by their employer or through an industrial award.

In the same way , the Government believes that individuals should be able to choose their superannuation fund. It is simply unfair and unjustifiable that workers have no choice as to who manages their superannuation contributions."

The Commonwealth Government proposals for choice of fund have been before Parliament since December 1997 when they were introduced as Schedule 5 to the Taxation Laws Amendment Bill (No &) 1997. The choice legislation was re-introduced on November 12, 1998 in revised form as

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[2] Government policy is to encourage retired person to take retirement benefits in an income stream instead of the currently preferred lump sum benefit largely to discourage "double-dipping" i.e. spending the lump sum and then taking out the age pension.

the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998 which passed in the House of Representatives on February 16 1999 but has been in limbo in the Senate since February 1999.

The choice legislation offers employees the following alternatives:

1. a choice of four or more complying funds[3] or Retirement Savings Account (RSA)[4]; or
2. Employers can offer unlimited choice; or
3. Superannuation arrangements can be provided for in certified agreements, Australian Workplace Agreement or informal agreement

The default is to a fund or RSA nominated by the employer.

(b) Wallis Committee Recommendations

The Wallis Committee recommended that employees should be provided with choice of fund, subject to any constraints necessary to address concerns about administrative costs and fund liquidity. The basic recommendation was that where superannuation benefits vest in a member, that member should have the right to transfer the amounts to any complying fund. Where a member chooses to exercise that right, payments should be transferred to the chosen fund as soon as practicable, subject to controls necessary to maintain orderly management for the benefit of all fund members.

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[3] A complying superannuation fund is one which fulfils the requirements of the Superannuation Industry Standards (SIS) Act. Complying funds are usually characterised as Corporate funds (sponsored by private sector employers); Public Sector funds (sponsored by employers in the public sector); Industry funds (established under an award for the receipt of award superannuation contributions although such funds may accept SGC contributions) and Public Offer funds (which can accept contributions direct from the public as well as SGC contributions) (APRA, 2000)

[4] An RSA is a superannuation product offered by banks and is essentially capital guaranteed product. RSAs are a small part of the superannuation regime constituting about one per cent of total superannuation assets in 2000. (APRA, 2000)

WALLIS COMMITTEE CONCERNS ABOUT CHOICE OF FUND

However, the Wallis Committee saw member choice as raising several concerns:

1. Administrative costs for employers and funds are likely to be greater if freedom of choice is unfettered and can be exercised at will. If members exercise choice frequently, additional exit/entry fees may offset any increase in investment returns.
2. Choice also raises issues for fund liquidity. Investment strategies may need to be adjusted to hold more liquid assets and may result in greater focus on short-term investment performance. United States' experience suggests that investor choice has not led to higher volatility in fund liquidity.

The solution to these problems, as seen by the Wallis Committee, may be partly addressed by imposing some limitations on exit, such as a suitable notice period or limits on the frequency of change. Subject to these constraints, the additional competition engendered by choice is likely to put downward pressure on costs and to encourage rationalization of the industry.

The Wallis Committee considered that member choice would be successful in promoting competition only if consumers have appropriate information and it saw the joint responsibility of the industry and regulators to ensure that consumers are educated and well informed covering such issues as the rights of members, different life cycle needs and their implications for risk and return, and the benefits and costs of exercising choice.

The Wallis Committee recommendations come close to our position on superannuation choice but the Committee's views are based on the view that the present structure of superannuation in Australia is appropriate; our view is that active management of equity portfolios in superannuation is unnecessarily expensive and ineffectual. We do not deny that there will transitional difficulties but it is critical that the correct basis for choice of fund is established.

CONCERNS ABOUT CHOICE OF FUND

The 28th Report of the Senate Select Committee on Superannuation raised a number of concerns about choice of fund; the major ones were

1. the level of education about choice;
2. the preparatory work necessary;
3. the cost of implementation of a choice regime;
4. the adequacy of consumer safeguards;
5. the cost of distribution;
6. the default fund;
7. impact on fund members' final retirement income

Many of these concerns are to do with transitional arrangements but the most serious comment must be directed to the matter of contributor education. The Committee and the witnesses which appeared before it were overly impressed with the *status quo* whereas our analysis clearly indicates that the present structure of actively managed equity portfolios is not the preferred structure for the Australian superannuation industry.

INVESTMENT CHOICE

Investment choice is contributor choice of asset allocation. Our analysis shows that there is no clear cut basis to determine objectively the appropriate asset allocation except to say that a significant proportion of the superannuation fund should be allocated to equities. Contributors to superannuation funds have a less reliable foundation to make investment choice than they do to make a choice about superannuation fund.

The Wallis Committee saw the advantage of allowing member choice of fund would be to increase competition between funds and should, other things being equal, enhance efficiency in the industry. It also recommended that transfer costs, including those incurred as a result of regulatory requirements, should be transparent and reasonable.

CAN EMPLOYEES CHOOSE THEIR OWN FUND?

In answering this question it is important to understand that despite the range and number of superannuation funds in Australia there are two important characteristics about funds:

1. their holdings of equities; and
2. their style of management of equity portfolios.

In the long run the return to superannuation funds will be determined by the return to equities which enjoy a premium over bonds. Good long term to superannuation require that a high proportion of superannuation fund assets are held in equities; in the aggregate Australian superannuation funds hold over 60 per cent in equities. (APRA, 2000). The proposition that investors with a relatively long investment horizon should hold equities is supported by Levy and Cohen (1998). Mehra and Prescott (1985) give historical evidence on the equity premium and calculate it as in excess of six percentage points a year.

There are two styles of portfolio management:

1. active management; and
2. passive management.

Under active management, the investment managers choose a sub-set of equities in the expectation that this sub-set will earn a higher than market return, or, in other words will earn excess returns. The sub-set of equities will be varied in the light of changing circumstances. Active managers will also change the proportion of the portfolio held in equities.

On the other hand, a passive management investment strategy does not attempt to select equities but instead holds a portfolio which replicates a market indicator. For example, a passive manager who seeks to obtain returns equivalent to the S&P/ASX 200 index would hold a portfolio of those equities in this index in the exact proportion of the index. For example, if a company AAA Ltd had a weight of x per cent in the index, the passive portfolio would have x per cent of its value in AAA Ltd.

The great majority of superannuation fund assets are in the hands of active managers.

THE SELECTION OF A SUPERANNUATION FUND – ACTIVE OR PASSIVE MANAGEMENT

There has been a long running debate about the ability of active fund managers to out-perform the market and thus to earn excess returns, i.e. to achieve Ra > Rm. and to outperform passively managed funds i.e. to achieve Ra > Rp

The critical issue is thus "does active investment management add value?" This question has been the source of continued debate in financial economics since the contributions of Sharpe (1966), Treynor (1966) and Jensen (1968). One strand of literature finds that investment managers have little stock-selection ability consistent with the efficient market framework of Fama (1970) which maintains that equities markets are information ally efficient so that current prices fully reflect all information available to the market.

Research on performance from the United States by Malkiel (1995), Gruber (1996) and Carhart (1997) finds that the mutual fund management industry destroys value through under-performing benchmark returns, recommending a passive approach to the stock-selection problem. For instance, Gruber (1996) reports that the average mutual fund under-performs index returns by some 65 basis points per annum for the period 1985 through 1994. More recent results of Malkiel and Radisich (2000) show that index funds have produced rates of return exceeding those of active managers by 100 to 200 basis points a year.

By contrast, another strand of literature finds some limited evidence of stock-selection ability. Grinblatt and Titman (1989), Grinblatt, Titman and Wermers (1995) and Wermers (2000), find that mutual fund managers select stocks that outperform benchmark returns, consistent with the model of Grossman and Stiglitz (1980). However, Moskowitz (2000) notes that this second set of studies examines the individual equity holdings of funds, creating a 'hypothetical' portfolio for each fund that contains only stocks and does not account for transaction costs or expenses. Wermers (2000) reports that while the gross returns from equity holdings outperform a broad market index by 130 basis points per year, the net fund returns under-perform the same index by

100 basis points per year. Of this 230 basis points difference, approximately 160 basis points is split evenly between fund expenses and transaction costs, with the remainder attributed to bond and cash holdings.

We argue that the findings from the first group of studies are most relevant for superannuation fund members. This group considers the net return of funds (excluding transaction costs and management expenses) and analyses the entire portfolio return. Returns credited to superannuation accounts are the returns post transaction costs and expenses. Moreover, this approach allows fund members to evaluate the opportunity cost of active stock-selection for their superannuation assets.

The value (or otherwise) of active management for Australian superannuation investors is an area that has received little research attention. This is potentially important as active stock-selection results in a high-cost production function, as managers seek to execute stock trades at prices sufficiently different from full-informed prices to, firstly, compensate them for the cost of becoming informed and, second, to earn superior risk-adjusted returns for the investor.

Recent research considering this issue, contributed by Drew (2000), Drew and Noland (2000) and Drew and Stanford (2000; 2001a; 2001b), provides corroborating evidence of the experience in the United States. On a risk-adjusted basis, Drew and Stanford (2001a) find that the average fund under-perform benchmark returns by a range of 46 to 93 basis points per annum for the period 1991 through 1999. Moreover, Drew and Stanford (2001b) find that active funds are regularly terminated due to poor performance, with survivorship bias negatively affecting industry performance by a further 23 basis points per annum.

Drew and Stanford (2000) find that the marginal cost of active asset selection is far greater than its marginal benefit, arguing that fund members would achieve their retirement income objectives far more rapidly be engaging a low-cost, passive stock-selection technique. Evidence of the investment management industry destroying value for superannuation members has important implication for public policy. Gallery, Brown and Gallery (1996) argue that the poor performance of public and private sector superannuation funds provides no support for the assumed superiority of the private sector to deliver more efficient outcomes, challenging the market-based model for superannuation savings in Australia.

The findings of Drew and Stanford (2000; 2001a; 2001b) suggest that the stock market in Australia is remarkably efficient, with prices reflecting all available information. To mitigate the impost of value destruction and fund termination, we advocate a passive model of superannuation investment management.

EFFICIENT MARKETS HYPOTHESIS, EMH, AND CHOICE OF SUPERANNUATION FUND

The Efficient Markets Hypothesis, EMH, [Fama 1970] postulates that securities markets are informationally efficient so that it is not profitable to trade on the set of information available to the market and hence predicts that active fund managers will not be able to earn excess returns on a consistent basis. The EMH recommends a "buy and hold strategy"

The empirical evidence in Australia supports the EMH.

IMPLICATIONS OF THE EFFICIENT MARKETS HYPOTHESIS

The implications of the Efficient Markets Hypothesis are that:

1. no active fund manager can, over the longer term, produce higher returns than the market after allowing for risk, trading expenses and taxation;
2. investment performance which out-performs the market in the short term will not persist in the longer run;
3. Short term superior investment performance is a result of luck and not skill; hence a good short term performance is not an indicator of future performance.

The recommendation of the EMH is to pursue a passive or "buy and hold" strategy. This "buy and hold" strategy in the long term will produce superior investment performance to that of any active strategy.

Given that the performance of Australian superannuation fund managers is consistent with the EMH there are five propositions which define choice of superannuation fund.

Proposition One: There is no information available which allows anyone to select a fund with a long run superior investment performance.

Proposition Two: There is no information available which allows anyone to make a rational ex-ante selection of an actively managed fund

Proposition Three: An employer is likely to persist with an under performing funds manager

Proposition Four: a low cost diversified passive index fund should be the default choice for all superannuation contributors

Proposition Five: No superannuation contributor should change funds frequently; some changes in asset allocation may be appropriate over the life cycle..

Propositions One and Two define the extent of the adverse selection problem. Given an array of actively managed funds and information about their past performance, it is not possible for anyone to select a fund which produce excess returns in the future. Selection of an actively managed fund may be rationally and efficiently made by random selection.

Proposition One and Two rule out paternalism by employers. Even if employers have some financial expertise, they are unable to select an actively managed fund with any more confidence than any of their employees' random choice. If employers are confident of their ability to select superior managers, it is appropriate that they back this ability by offering to underwrite or guarantee the returns to the superannuation fund. One way to do this is to offer a defined benefit fund. It can be noted that, not only are most employees in accumulation funds, but a number of public sector defined benefit schemes have been closed to new entrants egg Commonwealth Public Service, NSW Public Service, Police Superannuation, and Australian universities.

Proposition Three defines the extent of the moral hazard problem: what mechanisms are available to ensure that an actively managed fund once selected continues to maintain its performance. An employer is likely to persist with an under performing fund. Harless and Peterson (1998) find that poor performance by US mutual funds can persist for sustained periods.

Under the current superannuation system there is no automatic mechanism to relieve poor investment managers of their mandates. The choice of and employment of funds managers is the responsibility of the trustees of individual superannuation funds. While trustees review the investment performance of managers, aided by the compilation of industry league tables and with the assistance of consultants, trustees are generally loath to sack poorly performing managers because this will reflect on their initial choice. Goetzmann and Peles (1994) argue that mutual fund investors in the USA are disinclined to switch from poorly performing funds because they are reluctant to acknowledge that their original choice of mutual fund was a mistake. Hence, trustees may persist with poor performers in the vain hope that performance will improve. Trustees, who require no specialized knowledge of funds management or superannuation, but who are elected by employees or appointed by employers, operate at a much lower level of standards than financial advisers and planners so they may simply be incompetent at making investment strategy decisions and in selecting managers. In some instances, especially in retail public offer funds, trustees and fund managers do not operate at arms length and are owned by the same entity. A usual arrangement for such funds is for the trustee and the funds manger to be owned by the same financial services provider. Finally, trustees may have other financial arrangements with funds managers or the ultimate financial services provider and may receive benefits from managers.

For all these reasons, poor investment performance may persist for some time if not indefinitely. The position is compounded by the fact that there is no current consumer protection service available to members of superannuation funds to complain of investment performance. Regulatory authorities are reluctant in the extreme to hear individual complaints about investment performance and individual members have no avenue of redress for inadequate performance.

Propositions Two, Four and Five define the appropriate type of superannuation fund to maximize long term returns. While a passively managed fund will not outperform the market, it will capture the equity premium minus minimal expenses. The choice of a passive fund will eliminate the downside risk of holding equities. The EMH recommends a "buy and hold" strategy which will ensure that the equity premium is gained. A "buy and hold" strategy necessarily requires very infrequent changes.

It is ironic that the economics of choice of superannuation fund indicate that there are relatively few choices to be made. There are some choices for which we have inadequate analysis: one important choice is the appropriate asset allocation over the working life of a contributor. This is an area which requires further and urgent research.

It is further ironic that current practice in the Australian superannuation industry is to offer contributors "investment choice" or choice of asset allocation. There is no rational basis on which a contributor can rely to make an annual choice of asset allocation.

Our analysis suggests that Australian superannuation industry is inefficient through a high level of fees being devoted to active management of equity portfolios. Our empirical analysis of superannuation equity fund managers indicates that lower fees would not reduce net returns to contributors.

This inefficiency can be considered in another way. Even if it were possible for individual fund managers to earn persistently excess returns, and we have shown that it is not, it is not possible for all equity fund managers to do so. Aggregated up, equity fund managers cannot earn excess returns; everyone cannot be above average. As the funds under management in the Australian superannuation industry rise, the proportion of Australian equities held by superannuation funds will rise so that by the law of large numbers the returns to equity fund managers will converge to the market return.

PRINCIPLES OF SUPERANNUATION CHOICE

The basic principle of superannuation choice is those who bear the risk of decisions about returns to superannuation should be able to make those decisions provided they bear the responsibility for the consequences of that choice.

Hence individual members whose Superannuation Guarantee Charge is lodged in an accumulation fund should have unrestricted choice of which fund is selected.

The converse of this principle is that any employer who wishes to constrain employee choice of fund should be required to underwrite or guarantee the returns from that fund.

The issue of a default Fund has been raised previously; in the context of the Commonwealth government's choice proposal the Default Fund is the employer's nomination. Our analysis clearly indicates that the preferred fund for employees is a passively managed fund with a buy and hold strategy. We would prefer to see the government mandate this type of fund as first choice for all employees[5] as that choice of superannuation fund became a decision to opt out of such a fund.

CONCLUSIONS

Our analysis unequivocally supports employee choice of superannuation fund and supports the basic proposition put forward by the Wallis Committee. However our analysis indicates that the Wallis Committee concerns about the level of switching between funds may be overstated. We would accept that there may be problems of transition but these can be resolved by a transitional policy.

Our analysis provides a strong critique of the current structure of the Australian superannuation industry by demonstrating that the focus on actively managed equity portfolios in inefficient and costly.

We have shown that concerns about the type of information provided to employees and the appropriate education for employees is entirely misplaced: there is no conceivable information available to anyone which would enable a rational ex-ante choice of an actively managed superannuation fund. One caveat is that true information about a superannuation fund costs may assist in selection to the extent that it distinguishes between active and passive funds. The only rational approach to choice under the current regime is a random selection.

[5] We do not develop this proposal at any length but the principles of such a mandate are very simple. The government would call for tenders from suitable funds to receive superannuation contributions. The compliance standards would require such funds to be low cost no load passively managed funds. New entrants would initially be randomly allocated to one such fund and would remain in that fund until they decide to opt out. The appropriate asset allocation for such funds cannot be specified but this question is on our research agenda.

We find that "investment choice" (choice of asset allocation) is not a substitute for choice of fund and that no-one has a rational basis to make frequent investment choice decisions.

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