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Wednesday, 19 June 2013

The Treasury
Mr Michael Wellham
Attention: Charter Group
Langton Crescent
PARKES ACT 2600

By Email: supercharter@treasury.gov.au

Dear Mr Wellham

Re: Charter of Superannuation Adequacy and Sustainability and Council of Superannuation Custodians

Thank you for the opportunity to make a submission.

We write to specifically comment on Point #2 of the terms of reference, specifically:

> *"The Charter should have sufficient scope and breadth to accommodate a maturing superannuation system against the background of structural changes in the economy, such as the evolution of the financial system and demographic change."*

As you are aware, the first of the 'baby boomer' cohort turned 65 years of age in 2011, and many in this group have entered the distribution (or income) phase of retirement. This is the point at which, for many Australians, the success (or otherwise) of years of retirement saving is realised. It is at this point that retirees get a very real sense of just how much of their pre-retirement salary is replaced by these savings (in conjunction with, most likely, the age pension).

We could frame the success of the superannuation system as its ability to replace pre-retirement salary levels for Australians. It is this sort of 'outcome-oriented' framing of success in retirement saving that will become more important as the superannuation system further matures and more and more Australians move into the retirement income stage of their life course.

One of the challenges for the Council of Superannuation Custodians is to ensure that against the key principles of the Charter, namely: certainty; adequacy; fairness; and sustainability, are framed from the perspective of the superannuant. That is, we move from the commonly used measures of success currently employed (largely, peer-aware, time-weighted return measures of success) to outcome-focussed frames of success (largely, dollar-weighted return measures, annuity-equivalent values and income-replacement measures).

By way of example, The Product Dashboard based on the exposure draft (ED) provided by The Treasury is framed using time-weighted returns (see http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2013/Superannuation%20Legislation%20Amendment%20Regulation%202013/Key%20Documents/PDF/Product-Dashboard.ashx).

From a Council of Superannuation Custodian's perspective, compliance with such a regime is simple for traditional balanced (or target risk) funds in Australia. However, the issue becomes far more complex with lifecycle (or target date) funds, and is even more problematic for outcome-oriented processes (where income replacement is the objective of the fund).

You will note that the *y*-axis provided in the ED is expressed in "Net Return Performance" terms, which is disconnected from an outcome-oriented frame. In our research, we use retirement wealth ratios and income replacement rates as the outcome measure of interest (Basu and Drew, 2009; Basu and Drew, 2010; Basu, Byrne and Drew, 2011). A further example of defining retirement outcomes could be to use the Association of Superannuation Funds of Australia (ASFA) modest and/ or comfortable standards as a common income benchmark against which to report performance (see http://www.superannuation.asn.au/resources/retirement-standard).

Regardless of the specific way the outcome is defined (ultimately all these metrics are relatively similar) they view "Net Return Performance" as one, and only one, of a number of inputs to the dollar-weighted outcome. Other variables include the current member balance, contribution level, age, targeted retirement date and objective.

We have simply 'eye-balled' the data used in The Treasury ED product dashboard example by way of illustration for this submission. If the net return performance presented in the ED was experienced by a 25-year old (with a relatively small balance), there would be few problems as this investor has a long investment horizon and the 10-year average annual return presented in the ED of around 6-7% p.a. is adequate.

However, what if we framed this as someone in the last decade of their accumulation journey? Rule-of-thumb analysis tells us that the average member accumulates about half their retirement nest-egg in their last decade of work. Our 65-year old (say, retired at the end of 2012) has experienced a decade of annual returns, according to the ED of between -12% to +24%, a range of around 36%.

Worse still, in the final two years of their accumulation phase (when the largest amount of wealth is at risk), they experience a sequence of -12% followed by -8%. The impact of this negative compounding for these two members, at very different stages of their life course, is vastly different.

We have set up a very, *very* basic illustration in an attempt to bring this to life.

Again, it is important to note that has not been audited and is 'back-of-the-envelope' in nature. It uses some rudimentary math and, in the best of academic traditions, simplifying assumptions, to bring the practical implications of the data used in the ED to this submission.

Wage	$ 60,000	
		RWR
Start of 2011 Balance	**$500,000**	8.3
Super Conts (9%)	$5,400	
Return (-12%)	-$60,000	
Start of 2012 Balance	**$445,400**	7.4
Super Conts (9%)	$5,400	
Return (-8%)	-$35,632	
Final Balance	**$415,168**	6.9
Wage	**$ 40,000**	
		RWR
Start of 2011 Balance	**$10,000**	0.2
Super Conts (9%)	$3,600	
Return (-12%)	-$1,200	
Start of 2012 Balance	**$12,400**	0.2
Super Conts (9%)	$3,600	
Return (-8%)	-$992	
Final Balance	**$15,008**	0.3
**nb: assumes end of year contributions and investment crediting*		

We can see from The Treasury's example (again, acknowledging we have just eyeballed the data) that the impact of the final two years of returns reported in the ED have a material impact (-12% in 2011, and -8% in 2012) for our hypothetical older investor - their retirement wealth ratio has fallen from 8.3x to 6.9x.

However, for our second, much younger investor, with the same return sequence returns, has actually improved their replacement level (marginally).

This is due to the fact that the contributions for the younger investor are sufficiently large (on a much smaller initial balance) to compensate for the impact of the negative return. Two members, in the same fund, have quite different experiences: one, increasing their replacement rate (marginally), the other, right at the critical time in their accumulation phase (the portfolio size effect, see Basu and Drew, 2009), dramatically decreasing the replacement level.

This form of sequencing risk is important and, as we have seen during the Global Financial Crisis (GFC) can have a dramatic impact for investors (see Basu, Doran and Drew, 2012; Doran, Drew and Walk, 2012; and, Bianchi, Drew and Walk, 2013).

The underlying theme of this submission is a simple one. Through a very basic illustration, we have highlighted the potential dangers that can arise by framing the key principles of the Charter (certainty; adequacy; fairness; and sustainability) using arithmetic average returns.

We wish the Charter Group every success in its important deliberations. Please do not hesitate to contact us if we can furnish any further detail regarding this matter.

With warmest regards,

GRIFFITH UNIVERSITY

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Dr Adam N. Walk
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Reference List

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