

SUPER SYSTEM REVIEW FINAL REPORT

CHAPTER 3

Investment governance

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KEY THEMES

Issue

Proper investment governance and investment efficiency play a role in better investment performance, but those factors are not always emphasised by trustees. The interests of investment advisers and managers are not necessarily aligned with the interests of members, and this conflict is not always properly identified and addressed by trustees. Remuneration and fee structures for investment managers can result in incentives that do not contribute to better results for members. Complex fee arrangements can make it difficult to know exactly what fees are being paid and this lack of transparency does not help members evaluate trustee performance.

Proposed solution

The Panel proposes measures, including:

- expansion of the factors to which a trustee must have regard when developing an investment strategy, including costs involved, taxation consequences and the availability of valuation information;
- a new 'performance fee standard' developed by APRA to reduce the possibility that trustees would agree to inappropriate performance fees for fund managers;
- a focus on managing investments for after-tax returns; and
- requiring trustees to have a proxy voting policy and disclose their voting behaviour on the fund website.

Benefits for members

Members will benefit from these measures to improve investment governance as:

- better governance can assist in better investment returns;
- retirement income will be boosted if the incentives for investment managers serve members' interests and inappropriate fees and fee structures are avoided; and
- member benefits can be enhanced if there is a greater trustee awareness of the taxation consequences for the fund of its investment strategies.

1 WHAT IS INVESTMENT GOVERNANCE?

The way in which the assets in super funds are invested is a key determinant of the success of the system. In a system that today is predominantly defined contribution in nature, the consequences of failures and/or inefficiencies in the investment of the assets are borne directly by members.

Good investment performance is dependent on a number of factors. Investment governance is one of them. The Panel recognises that good investment governance will not guarantee that a super fund delivers good investment performance. However, the Panel is convinced that poor investment governance puts at risk the achievement of the super fund's goals. Research in a variety of countries and analogous contexts supports this basic conclusion.¹

This chapter addresses the governance and efficiency issues that arise from the investment of super fund assets. It recognises the increasing diversity of models chosen by super funds and the complexity that underlies some of those models. In so doing, it seeks to identify specific instances in which the interests and incentives of participants in the model (such as fund managers and asset consultants) have the potential to conflict with the interests of the super funds (and their members) on whose behalf they act. It also identifies ways in which the complexity that has crept into the system has resulted in inefficiencies and a diffusion of accountability, and proposes some measures to address these trends.

2 OVERVIEW OF INVESTMENT STRUCTURES

As the industry has evolved, super funds have developed a variety of structures to invest their assets.

As a general rule, trustees delegate investment management tasks to external funds managers, usually on the advice of an asset consultant. In this model, the trustee generally retains control over the long-term strategic asset allocation of the fund, but decisions about which individual securities to buy, sell and hold (and in some cases which market to invest in as well) are taken by fund managers acting under investment management agreements. Physical custody, corporate actions and record-keeping are, in this model, undertaken by an independent custodian acting on behalf of the trustee. This model is implicit in the way the system is regulated by the SIS Act and remains influential in the way many people think about the superannuation system.

The past decade or so has seen the emergence of a variety of different structures and variations on this general model.

In some cases, the trustee invests not in the assets directly, but in pooled funds offered by third parties. This was historically the route chosen by small and medium-sized super funds that did not have the scale to justify the custodial and administrative costs of investing directly. This approach is still reasonably common today, even for relatively large funds, in areas where they struggle to attain sufficiently-diversified exposure on their own (for example, in the hedge funds and private equity 'fund of funds' segments). Usually, the third party responsible for managing the pooled fund is a fund manager. Sometimes, the pool is managed on an after-tax basis (for example a Pooled Superannuation Trust), but in most cases the pool is a simple unit trust, albeit one that is restricted to large-scale investors.

'Implemented consulting' is a variation on this model in which the asset consultant provides the vehicle that administers the investments of different super funds, as well as providing the advice that underpins that investment structure. For some providers, including both industry and retail funds, the asset consultant and even some of the asset management firms employed in the structure, are ultimately owned by the operators of the super funds themselves, albeit legally and operationally separate legal entities.

A second important model is the corporate master trust. In this model, the entire governance of the scheme including trusteeship has been passed on to external service providers operating on a commercial basis.

The third model that has emerged as important over the past decade has been the self-managed super fund (**SMSF**). SMSFs are dealt with separately in chapter 8.

A range of governance and efficiency issues clearly arise in each of these models and need to be addressed to ensure optimal operation of the system. Some of the key issues are:

- (a) the ability of super fund trustees to secure the interests of their members in their dealings with the funds management industry, especially those related to fees and mandate specification;
- (b) the alignment of interests between trustees and fund managers (or lack thereof), and the impact that has on the way in which fund assets are managed; and
- (c) the diffusion of accountability that occurs as a result of the multiple layers of responsibility present in some models.

3 OUTSOURCING TO FUND MANAGERS

Notwithstanding the diversity of investment structures employed by the trustees of Australian super funds, very few ultimately 'manage' the money themselves. In almost all cases, the selection of individual securities and instruments is delegated to specialised funds management firms. Trustees take direct responsibility for the overall design of the investment strategies to be followed, including the strategic asset allocation and rebalancing protocols and for the engagement of multiple managers in individual asset classes.

The Panel is aware of the ongoing debate about whether there are fund managers that can consistently beat the market, after costs and taxes have been taken into account.² In the superannuation context, there is the further complication of whether trustees can pick in advance who those managers are going to be.³ The Panel does not believe it ought to attempt to come to a definitive conclusion on this issue. Ultimately, the trustees of each superannuation fund are best placed to formulate the investment strategy most suitable for the circumstances of their fund, including how to mix active and passive management, the mix of growth, value and other styles and whether risk management overlays and other strategies are appropriate.

Even allowing for the potential impact that active management has on the efficiency of the capital markets, the system, and more particularly the members within it, bear the costs of this intermediation.⁴ The Panel therefore believes it is necessary for the industry to confront some of the

more obvious areas of inefficiency and leakage of value. The Panel's comments and recommendations in this section are made on this basis.

3.1 Fund managers are formally outside the superannuation system

The fact that the fund management of Australian superannuation funds is almost always outsourced to fund managers has a number of consequences for the regulation of the system.

3.1.1 APRA licensing of fund managers?

The first consequence is that because fund managers are not licensed under the SIS Act or some similar measure, APRA and ASIC have limited ability to regulate a key component of the superannuation system. This state of affairs is largely taken for granted in the Australian system. It is, however, significant in light of the different approach taken in the United States under the Employee Retirement Income Security Act (**ERISA**) which deems fund managers to be 'fiduciaries.'

On balance, the Panel is not in favour of APRA licensing fund managers. The absence of regulation in this area gives super funds access to a much wider range of fund managers than might otherwise be the case. It does, however, place responsibility on the trustees of super funds to conduct more thorough due diligence than might be required if a licensing regime (or similar) were in place. In particular, trustees in this jurisdiction must recognise that they retain sole accountability for investment decisions that are made on behalf of their members, even when those decisions are delegated to other parties.

3.1.2 A new statutory duty on fund managers?

The second consequence is that the relationship with the fund manager is, in most cases, purely contractual. What this effectively means is that notwithstanding the quite specific and onerous provisions in the SIS Act directed at the trustees of super funds, the majority of the assets in the system are managed by people who are not directly regulated by any of those provisions.

The Panel did consider whether fund managers should expressly be under a higher duty to members than is currently the case.

However, the Panel has decided against recommending such higher duty, believing instead that the cumulative impact of all of its recommendations in other areas will have sufficient positive outcomes for members.

3.2 Fund managers as agents⁵

When trustees delegate investment decision-making power to fund managers and asset consultants they have to deal with what are commonly termed 'agency issues'.⁶ These issues arise inevitably from the fact that the interests of the fund manager cannot be perfectly aligned with those of the super fund for whom the fund manager acts.

A number of potential agency problems are especially pertinent to the trustee-fund manager relationship. The Myners Report⁷ in the UK, for instance, identified that many fund managers were engaging in 'closet indexing' where they prioritise their business risk over the interests of fund members by constraining the amount of active risk they were prepared to take in investment

portfolios. The result was that funds paid for more expensive active management of their portfolio only to receive benchmark-like returns.

Academic researchers in Australia and elsewhere have also identified evidence of behaviour symptomatic of unresolved agency issues. This behaviour includes:

- (a) **Tournament behaviour:**⁸ fund managers adjust the level of investment risk in a portfolio according to whether their recent performance has been ahead or behind the relevant benchmark and hence whether they believe their retention as a fund manager (or their level of remuneration, where a performance fee was involved) for the super fund is at risk.
- (b) **Window dressing:** the fund manager temporarily adjusts portfolio holdings around disclosure dates to mask what is actually occurring in the portfolio.⁹ An analogous practice, sometimes termed 'portfolio pumping,' sees funds managers bid up the prices of illiquid stocks at the end of each month to artificially boost performance.¹⁰
- (c) **Herding:** in a highly competitive market where recent past performance relative to a benchmark is regarded as of paramount importance, fund managers may be reluctant to take investment decisions they believe will result in material divergence from their competitors.¹¹ This is reinforced by institutional factors, including the influence of asset consultants¹² and the attraction of 'momentum investing.'¹³ It is also exacerbated by the pressures on managers to stay 'true to label'. There is an inevitable tension between requiring a fund manager to stay 'true to label' and providing it with the flexibility to pursue the strategies it believes will add most value.

These types of agency issues are by no means unique to funds management. The typical response in other contexts is for the principal to design contracts in which the incentive to pursue self-interested strategies is limited, re-directed or, ideally, reoriented to align more closely with those of the principal. The Panel believes that the design of incentive structures and benchmarks, and most particularly the way in which fees are calculated and paid to fund managers, is a more appropriate mechanism for addressing these 'agency' issues than direct regulatory intervention. This is discussed in more detail below.

4 REMUNERATION AND INCENTIVE STRUCTURES

The fees charged by investment managers are a material component of the costs of running a super fund. These costs are in most cases passed straight through to members. Therefore, the level and cross-sectional variation in fund management costs across the system as a whole is not something that can be ignored. This is the case notwithstanding the Panel's view that trustees are in the best position, and ought to be held accountable, for all key decisions made on behalf of members. Specifically, the Panel believes that the trustees of super funds are best placed to ascertain how best to structure the remuneration arrangements they have with all outsource providers, including investment managers.

The Panel recognises that direct observation of the fees actually charged by fund managers is problematic. Many super funds negotiate fees differently from those recorded in stated fee schedules. It is also relatively common for fees to be 'tiered' in some way so that lower percentage fees apply to the proportion of portfolios that exceed certain dollar sizes. And, as noted in chapter 4, there is a wide range of ways in which the fees and costs are currently classified and disclosed.

Nevertheless, some general comments are warranted here to supplement the more detailed discussion of costs disclosure that appears in chapter 4.

4.1 Asset-based fees

4.1.1 Fee methodology

Fund managers in Australia are remunerated primarily by way of asset-based fees, that is, fees that are expressed as a percentage of the total assets subject to the contract. A number of submissions expressed a concern that remunerating investment managers via asset-based fees might not be the best way for trustees to secure the best interests of their members.¹⁴

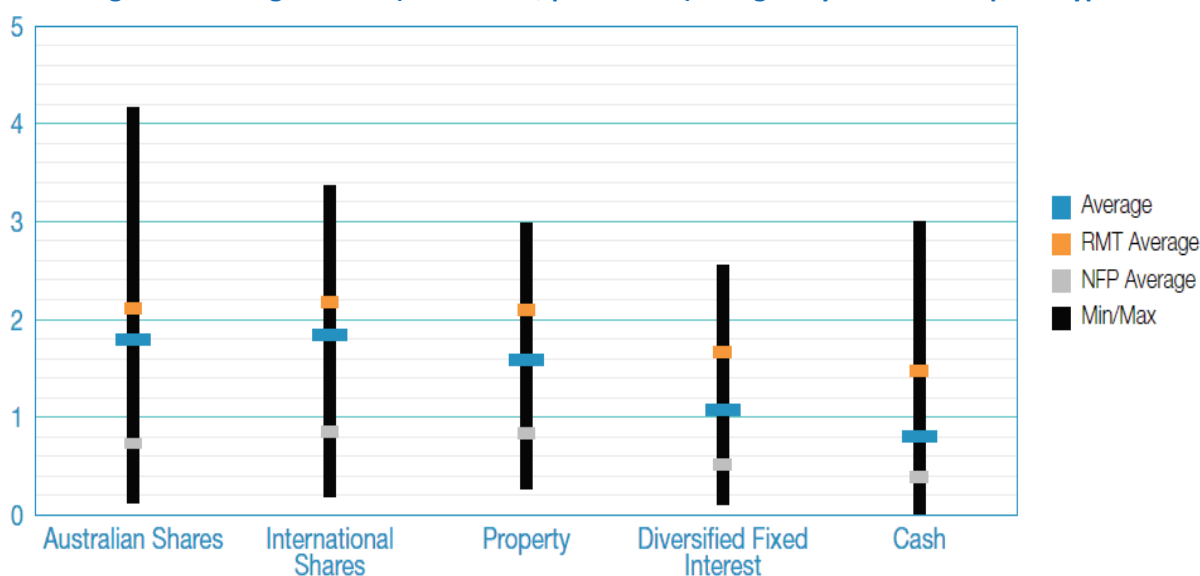
The connection between the fees charged for managing a portfolio and the quantum of assets in that portfolio is taken for granted by many in the superannuation industry.¹⁵ The Panel notes that the practice is broadly consistent with institutional investment practices (including pension funds) around the globe. However, given increasing economies of scale and the consistent flow of SG contributions, attaching the fee to the level of assets alone seems sub-optimal, as it is likely to lead to exponential growth in revenue for agents without a commensurate increase in underlying value to the members.

4.1.2 The relevance of the asset mix

The level of fees charged by investment managers typically varies according to the nature of the assignment. It is, for instance, typically more expensive for the management of growth assets such as shares and property, and relatively cheaper for the management of fixed income and cash assets.

Figures 3.1 and 3.2 below demonstrate that this variation in the investment management fees charged on different asset types is typically passed on to members. Most obviously, the variation is reflected in the fees charged on different types of investment options. Figure 3.1 charts the range of fees charged by super funds for different investment options offered to members.

Figure 3.1: Range of fees (% of assets, per annum) charged by asset class option type

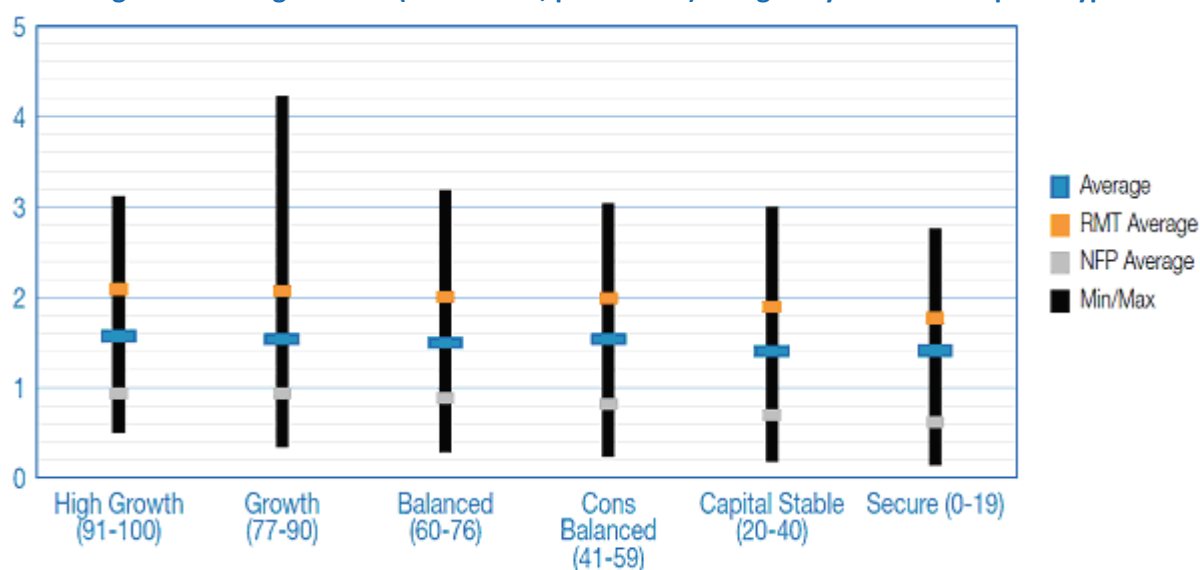


Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.

Note: RMT — Retail Master Trust; NFP — Not-for-Profit

The variation is also embedded in the fees charged on funds that are diversified across multiple asset classes. Figure 3.2 shows this relationship is most obvious in the not-for-profit sector, though it is evident across the population of funds as a whole.

Figure 3.2: Range of fees (% of assets, per annum) charged by diversified option type



Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.

Note: RMT — Retail Master Trust; NFP — Not-for-Profit

This variation has two important ramifications. First, it highlights that the investment strategy decisions taken by trustees in diversified funds have an important cost dimension. A number of submissions identified the trend towards super funds investing in alternative assets as one factor causing increasing investment management fees in industry funds, in particular, in recent years. The Panel believes that the trustees of super funds are increasingly likely to have to consider investing in such investments in coming years and is concerned to ensure that such considerations have explicit regard for the cost implications of each transaction and mandate.

Secondly, it emphasises the important role that costs disclosure has to play in the choice segment of the market. Prospective members need to be alerted to the fact that the investment management fees attached to the different options they may be considering might be quite different. This issue is taken up in the recommendations in chapter 4 that relate to the calculation and disclosure of fees more generally. Those recommendations are designed to give members, prospective members and regulators the ability to assess the overall picture of fees and costs, including those related to investment, that pertain to a particular fund, and to facilitate comparison between funds. Only in this way can market forces be expected to exert pressure on trustees to continue to strive for more efficient and cost-effective ways to deliver good investment performance.

Section 52(2)(f) of the SIS Act deems there to be a covenant in the governing rules of a trustee requiring it to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including a range of enumerated matters. The Panel's approach is to make a number of recommendations adding further investment governance matters to which the trustees would be required to have regard.

Recommendation 3.1

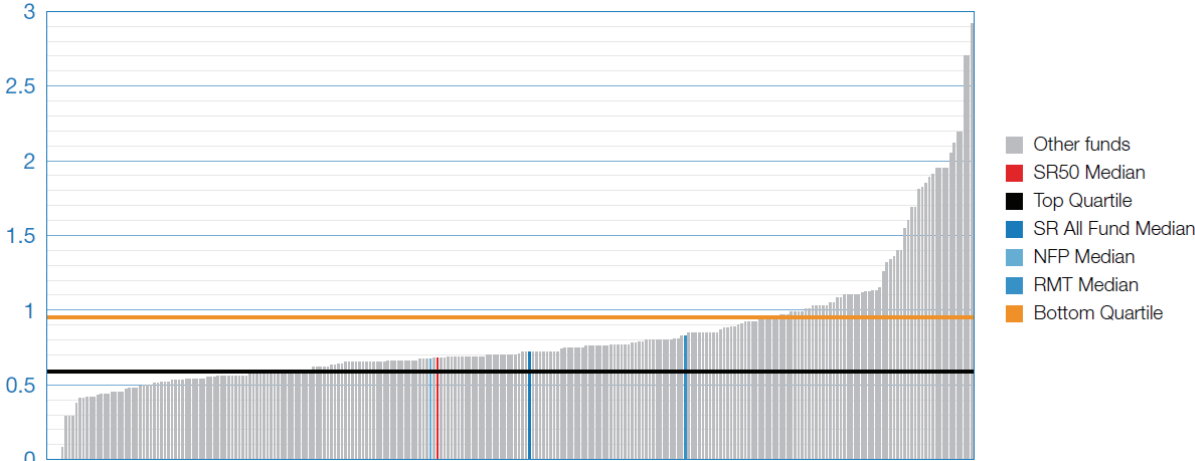
That section 52(2)(f) of the SIS Act be amended to include ‘the expected costs of the strategy, including those at different levels of any interposed legal structures and under a variety of market conditions’, as one of the factors to which APRA fund trustees must ‘have regard’.

4.1.3 Cross-sectional variation in investment management fees

Cross-sectional variation in fees is an inevitable part of a system, such as the Australian superannuation system, that relies on private market providers. A range is to be expected, but market forces might be expected to act as a discipline on the most expensive funds, to the extent that those funds are not delivering additional benefits.

Figures 3.1 and 3.2 both clearly demonstrate that the investment management fees charged by different funds can vary quite materially. Figure 3.3 below highlights that this is also true for super funds’ default options. What Figure 3.3 also highlights is that though the overall median is 0.72 per cent per annum, there is a sizeable minority of funds whose investment costs are materially greater than their peers. The Panel believes that the presence of disengaged members in the default options of super funds means this is a bigger problem than in situations where members can be assumed to have made an express choice to invest in specific options or funds.

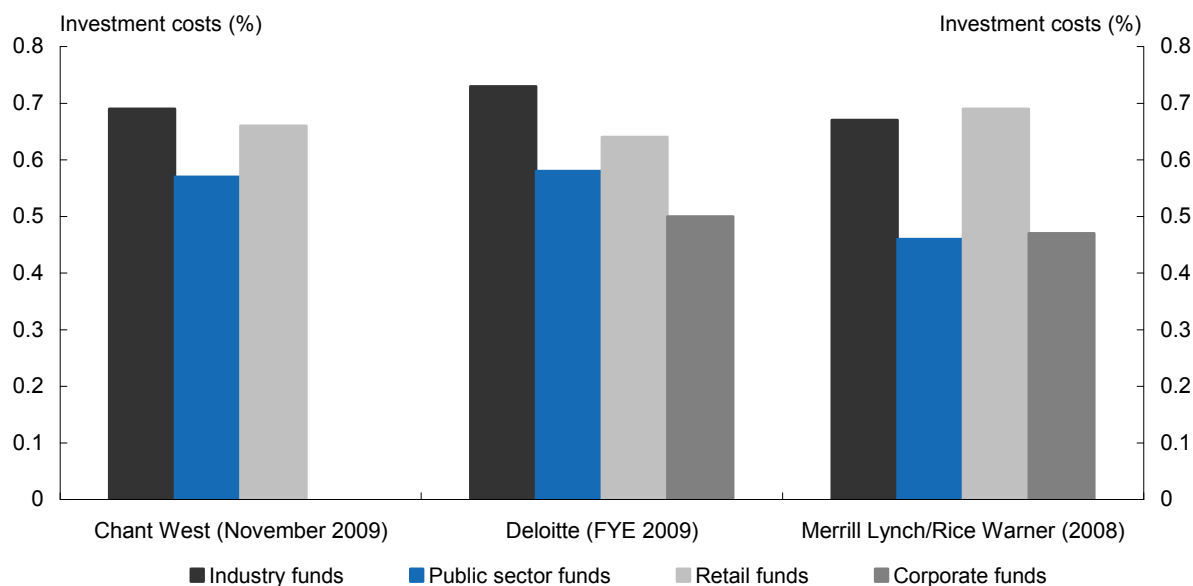
Figure 3.3: Investment management fees of default options



Note: The Not-for-Profit median default investment option fee is 0.67 per cent, the SuperRatings 50 Median is 0.68 per cent, the SuperRatings All Fund Media is 0.72% and the Retail Master Trust Median is 0.83 per cent. Source: SuperRatings 2010 Benchmark Report for the period ending 30 June 2009.

There is some evidence that investment management fees vary by segment. Figure 3.4 presents the findings of a range of researchers into the investment management fees of different segments. It highlights that though there do appear to be differences in the average investment management fees incurred by members in different sectors, these differences are not as great as is sometimes claimed, being of the order of 0.1-0.2 per cent per annum. The figure does not, however, have regard either for the potential that the investment strategies employed in each sector might, on average, differ, or that there may be significant variation between funds within the sectors.

Figure 3.4: Investment management fees by market sector



Source: Chant West, 'Good cost, bad cost — there is a difference,' December 2009, Volume 7, number 4. Deloitte unpublished survey data, May 2010. Merrill Lynch/Rice Warner: Banc of America Securities - Merrill Lynch estimates based on Rice Warner 2008 fee analysis.

4.2 Performance-based fees

Performance-based fees have been suggested in some quarters as a way to better align the interests of the fund manager with those of the member than either flat or asset-based fees.¹⁶ However, a number of submissions identified both conceptual and practical concerns with this argument, at least in its simplest form. The Panel shares some of these concerns.

Performance-based fees were until recently typically only charged by hedge funds or in the context of mandates relating to alternative assets. Quite quickly, they have become much more widespread with super funds in both the retail and not-for-profit fund sectors paying them in a range of circumstances. The Panel is also aware of some funds which are charging performance fees on investment options based on relatively unchallenging hurdle rates, which are most likely resulting in members paying higher fees for only average performance.

The Panel's view is that performance-based fees should be the exception rather than the rule in superannuation funds. Trustees should have the buying power to demand fully-focused, motivated and incentivised managers by reason of the price they contract to pay for those managers' services, and should not readily share member returns with fund managers in the hope that this will engender higher returns.

4.2.1 Conceptual/theoretical issues with performance fees

There are a number of conceptual issues with performance fees. The first of these is that the causal link between fund manager effort and investment returns achieved can be quite difficult to establish, particularly over short periods. Incentive remuneration based on past performance risks rewarding fund managers as often for luck as it does for skill. It is, therefore, unclear precisely what 'incentive' performance fees actually provide. Indeed, as long ago as 2001, the Myners review in the UK concluded:

“Overall, there is little evidence that incentive fees changed performance patterns, either for better or for worse.”¹⁷

Secondly, there is the potential for managers to maximise the value of the performance fee ‘option’,¹⁸ by taking higher active risk, or by adjusting the level of risk at key points in the performance measurement cycle.¹⁹ This is something that fund managers can directly manage.

Not surprisingly, this potential, an example of what is commonly termed ‘moral hazard,’ was widely identified in submissions.²⁰ As noted above there is empirical evidence of just such ‘tournament’ behaviour in some markets. One commentator has suggested that:

“performance fees will end up doing much more harm than good from the investors’ point of view unless the fees’ undesirable incentive to increase risk is thoroughly checked.”²¹

The Panel’s recommendations outlined below address this issue directly.

Lastly, performance fees are asymmetric in nature. This is the reason why Recommendation 3.1 expressly makes reference to the requirement for trustees to have regard for ‘*the expected costs of the strategy ... under a variety of market conditions.*’

4.2.2 Practical issues related to performance fees

A number of submissions noted that performance fees can introduce complexity into the fee, tax reserving and unit pricing calculation processes. They can also give rise to some difficult disclosure issues as well as comparability issues for current and prospective members. These are quite fundamental issues with which trustees need to become conversant, and solve, before they agree to remunerate fund managers via performance fees.

The Panel is, however, concerned that few trustee boards today have the in-house skills to perform the highly technical analysis required to evaluate the net effect of a dynamic portfolio of performance fees on their fund’s overall performance outcomes.

4.2.3 Empirical research on performance fees

The Panel was prepared to accept the possibility that trustees had in fact overcome these conceptual and practical challenges and were employing performance fee structures in ways that were in the interests of members. What little empirical evidence is available suggests that this has not been the case.

A recent study commissioned by Grant Thornton in the United Kingdom found that:²²

- performance fees do not generally affect performance, have a limited influence on manager behaviour and do not appear to stimulate better performance;
- over the five-year period from 2003 to 2007, on average, funds without performance fees performed slightly better than those with performance fees. Funds with performance fees have historically beaten their benchmarks 53 per cent of the time, while those without performance fees did so 59 per cent of the time;
- only 10 per cent of fund managers in the industry are ‘real stars’ who consistently beat their benchmarks without using leverage;

- performance fees can encourage fund managers to use more derivatives, change stocks more frequently or be more ready to go into cash or cash equivalents; and
- the principal effect of performance fees has been to increase financial returns to the management companies.

Anecdotal evidence together with a number of submissions received by the Panel suggest that the situation in Australia is much the same. The Panel therefore remains concerned that the practical issues implicit in performance fee arrangements have not been adequately addressed.

4.2.4 Implications for trustees

Having identified these issues and research findings, the Panel accepts that trustees should still have the freedom to negotiate performance-based fees if they believe it is in the best interests of members. This view was shared by a number of submissions.²³ The Panel does, however, query the level of inquiry and due diligence that is undertaken to ascertain that it is, in fact, in members' interests. No submissions contained any empirical data that demonstrated that performance-based fees produce better outcomes for members.

Nonetheless, the Panel's intention is to help trustees arrive at a workable set of principles for the use of performance-based fees in superannuation.

4.2.5 Regulations in other jurisdictions

In the United States, performance-based fees are regulated by the Securities and Exchange Commission (**SEC**)²⁴ and the Department of Labor.²⁵ The SEC rule only allows investment advisers to share profits with a 'qualified client'. Under ERISA, in simple terms, the fee has to represent reasonable compensation. The general idea of the regulations is that a fee that involves an adviser or fiduciary sharing the profits of the client is one that calls for special rules. The Panel believes that this sends a useful signal as to how such fees should be approached.

4.2.6 APRA performance fee standard

In light of all these factors, the Panel believes that APRA should develop a standard dealing with performance-based fees. The issues and principles to be addressed in the 'performance fee standard' should include:

- (a) **Application and setting of 'high water marks'** — that is the circumstances in which performance fees should be payable if a period of strong performance only occurs after a period of declines that have lowered the base from which the next period's performance fees are calculated.²⁶
- (b) **Clawbacks** — whether and if so when the manager should be liable to repay some or all of the performance fee from prior periods; particularly where it is based on short-term results.²⁷
- (c) **Taxation basis** — whether performance measurement should be on an after-tax basis even if fees are credited on the basis of an assumed 'average' tax rate and then subsequently adjusted for variances.²⁸

- (d) **Base fees** — How it can be shown that performance fee arrangements are predicated on a demonstrable reduction in base fees; that is that there is in fact an appropriate risk-sharing arrangement in place.
- (e) **Hurdles** — the need for performance fee eligibility to be assessed against a benchmark that is relevant to the asset class and timeframe being managed, not against simple measures like absolute market growth.
- (f) **Resets** — a prohibition on resetting hurdles or high water marks during the period to which the performance fee relates.
- (g) **Unit pricing** — The way that performance-based fees are unit priced needs to be very carefully managed and clearly disclosed.
- (h) **Longer testing period** — Ideally, though performance fees should be calculated on a rolling basis, for example every month, a much longer period (at least the previous 12 months or even longer) should be used to assess performance.²⁹
- (i) **Fee caps** — Whether there should be an upper limit on the fees payable by the trustee, and if so what that upper limit should be.
- (j) **Portfolio effect** — the effect of any performance fee arrangement on the fees paid in the portfolio as a whole.
- (k) **Disclosure** — Trustees must disclose performance fees clearly to members. Trustees should be accountable for agreeing to spend member money on these fees and should disclose what fees have been paid in prior periods so that members have at least some reference point as to what might be charged in future periods.

Recommendation 3.2

An enforceable ‘performance fee standard’ should be developed by APRA in consultation with industry.

Recommendation 3.3

No performance-based fees may be paid by the trustee of a MySuper product unless the payment conforms with the ‘performance fee standard’.

5 MANAGING FOR AFTER-TAX RETURNS

5.1 The problem

Members accumulate their retirement savings and retire on after-tax returns, not pre-tax ones and yet there is a wide variation in the extent to which most trustees and investment managers have regard to the optimisation of tax outcomes for members. This is a concern because, as a submission from KPMG noted:

“Tax is the single biggest expense for most superannuation entities. It should be constantly monitored and be part of an appropriate risk framework. Poor tax governance can mean diminished after-tax returns to fund members while compliance breaches can result in losses to present and future members.”³⁰

The relatively low tax rate on superannuation³¹ generally appears to cause trustees and managers to believe that the potential leakage from lack of careful tax management is minimal, but in a large super fund, even a few basis points can mean millions of dollars.

The benefits of dividend imputation credits and capital gains tax (CGT) discounts are only realised where the underlying investments are held at the time of dividend distribution, or for a specified period. Investment ‘churn’ or portfolio trading that ignores tax consequences can result in the premature turnover of assets where the potential after-tax benefits to members are lost.

Income on assets underpinning a pension under current tax rules attracts a zero tax rate. This gives retired super fund members a very strong interest in the generation of franking credits from Australian share investments (as these are credited to zero-taxpaying investors in the form of additional returns), but much less interest in capital gains tax discounts which have no value to non-taxable investors, unlike accumulation phase members who do benefit from CGT discounts. In other words, the pension phase creates quite distinct and conflicting tax considerations that, on one view, call for separate management altogether.

5.2 Industry practice

The underlying practical problem seems to be a by-product of standard funds management practice.³² Tax issues are more complex for investors that are not super funds and so fund managers do not necessarily manage non-super mandates in a tax-aware manner. Gordon Mackenzie (ATAX) commented in his submission to the Review;

“In 2006 ATAX researched the relationship between tax managers and fund managers in Australia financial institutions. What was observed was that there was very little integration between tax management and funds management in the financial services companies who responded to the survey. That lack of integration suggested that fund managers had limited regard to tax when managing their portfolios.”³³

Another group of researchers has commented to similar effect, that:

“Institutional equity fund management in Australia is principally focused on the pre-fee and pre-tax performance surveys of leading asset consultants.”³⁴

The same is true in the back-office. Many investment managers do not separate super from the rest of their operations. Therefore, with the exception of some very high level considerations, the Panel has concluded that super fund tax issues are not being given adequate priority by the industry.

The United States mandated after-tax reporting (as well as pre-tax reporting) for mutual funds nearly a decade ago.³⁵ IFSA, Morningstar and ASFA, together with FTSE, have all introduced initiatives to promote tax-awareness. But, this mostly focuses on investment manager behaviour, not on behaviour at the trustee level.

5.3 After-tax benchmarking

One of the reasons for the persistence of before-tax reporting in Australia is the near-universal use of market indices as the benchmarks to measure and compare performance. These indices merely record the rising and falling capital value of the securities covered by the index, plus any distributed income, generally weighted to the proportional market capitalisation of each security. These benchmarks typically do not take taxation into account.

As Gordon Mackenzie (ATAX) notes, other reasons include:

“the expensive IT systems that would be needed, lack of visibility of investors tax status, lack of post tax benchmarks and that some investors are not tax paying.”³⁶

The Panel though notes, as a move in the right direction, the recent development of the ‘FTSE ASFA Australia Index Series’, which covers the Australian equity market and is designed to better align investment decisions with tax positions.³⁷

5.4 Portfolio turnover

Turnover in the underlying holdings is an inevitable consequence of managing an investment portfolio. Contributions and withdrawals have to be effected and various forms of investment income (mostly dividends, interest and rent) have to be re-invested. Active management is another potential source of turnover, though the Panel notes that even passive (or index) investment management typically incurs some level of portfolio turnover.³⁸ There is also evidence that some forms of active management result in more turnover than others.³⁹

Portfolio turnover can be costly in terms both of the transaction costs incurred and its tax implications. Although transaction costs will typically be included in the evaluation of a fund manager’s performance, as noted above, the tax consequences typically will not.

5.5 The solutions

The Panel believes that the current failure of the super fund and investment management industry as a whole to focus adequately on investment returns on an after-tax basis is primarily an investment governance problem. That is to say, it is an issue for trustees and not simply for fund managers.

The Panel has four objectives regarding this issue:

- (a) trustees should have express regard for taxation issues at all stages of the investment process: strategy, implementation and monitoring;
- (b) managers should manage portfolios in a tax-aware manner for the benefit of members;
- (c) fund manager remuneration structures should be adapted to create more incentive to do so; and
- (d) there should be a system for reporting both pre-tax and after-tax returns and the publication of any investment return information solely on a pre-tax basis should be prohibited.

While the Panel is not suggesting that investment strategies be solely focused on tax considerations, it does believe that more effective tax management practices would ultimately lead to members receiving increased net returns. Estimates of the cost of this lost tax efficiency vary, ranging from around 5 basis points per annum (considering the impact of turnover alone)⁴⁰ up to some 200 basis points per annum on a more holistic basis.⁴¹

Ultimately, it is beyond the reach of this Review to define precisely what processes trustees ought to have in place to have due regard for tax. It is a complex, technical area. However, the Panel fully expects that the industry has the ability to work co-operatively to start to define processes and approaches (including the methodologies and key assumptions required) that will raise overall standards in this area. The Panel notes the valuable initiative taken by IFSA in this regard in the launch of its Guidance Note on the calculation of after-tax returns in July 2008.⁴² Several submissions indicated that awareness in this area is increasing,⁴³ albeit from a low base.

Recommendation 3.4

That section 52(2)(f) of the SIS Act be amended to include ‘the taxation consequences of the strategy, in light of the circumstances of the fund’, as one of the factors to which APRA fund trustees must ‘have regard’, and to ensure that trustees consider those taxation consequences when giving instructions in mandates to investment managers.

6 OTHER BARRIERS TO GOOD GOVERNANCE

6.1 Diversity of structures

The Panel recognises the value of allowing trustees to choose from a wide range of different funds management structures as they strive to get the best outcome for members.

6.2 Fees and costs

The technical complexities of measuring and reporting costs, fees and other leakages from superannuation funds are described in chapter 4. The lack of transparency in some fund structures can exacerbate this problem.

In complex funds management and investment transactions, there are many points at which prices are struck for any number of products, including foreign exchange and derivative dealings. These transactions will often involve a mixture of an express (visible) charge for the service, together with a spread (that is the difference between the bid and offer price in the relevant market). The implications of the spread and who is transacting as a counterparty are often more difficult to assess. Similarly, there are a number of implementation and execution issues where leakages can occur. These leakages can occur during portfolio transitions, order allocation and illiquid trading where unintended market exposures, wide bid-offer spreads on account adjustments and internal cash management fees can add to costs beyond expressed charges. Such costs will be invisible except under quite close scrutiny.

The Panel strongly believes that trustees have the same obligations to understand, monitor and manage the fees and costs incurred in the investment of the fund's assets regardless of the structure or number of intermediaries involved. Trustees should not be able to evade accountability for the success or failure of their strategies on the basis that any manager or underlying manager was incapable of providing information that the trustee would have had access to had they not chosen to delegate the task to another, or to invest in a product. In the Panel's view, a trustee that implements a structure in which such information is not available runs the risk of breaching its duty to act with due care and diligence. This is the reason why Recommendation 3.1 in this chapter expressly makes reference to the requirement for trustees to have regard for *'the expected costs of the strategy, including those at different levels of any interposed legal structures.'*

6.3 Valuation

The Panel fully expects that superannuation funds will increasingly be looking to invest their portfolios in strategies, securities and vehicles that are not market-listed. The trend towards investing in real estate, hedge funds and other unlisted types of assets is already well-established and the Panel believes that such exposures, if properly managed, can potentially offer valuable sources of returns and diversification for super funds.

One challenge posed by many such strategies is ensuring that there is a reliable, accurate and independently-verified process for valuing such assets, especially in times of market turbulence.⁴⁴ As a submission from MLC noted:

*"The accuracy and method of fund asset valuation is critical to the governance function of superannuation funds."*⁴⁵

A number of submissions noted the link between valuation (and potentially liquidity) of the underlying assets and the redemption and application terms offered by some funds.⁴⁶ Inaccurate valuations, especially where there is an undue lag in re-valuation of the underlying assets, can mean inaccurate unit prices (or crediting rates) and hence cause inequity between members.⁴⁷ The GFC also highlighted that they can be a precursor to investment losses.

The problem is compounded because deriving such a valuation, for instance on a complicated over-the-counter derivatives-based strategy, can be highly technical. In other circumstances, valuations may be subject to considerable uncertainty, such as when valuing a partnership or joint venture interest in which there are limits on transferability. The Panel is therefore strongly of the view that trustees cannot simply assume that a custodian, whether acting on its own or on advice from the product, security or structure provider, will be able to value such assets properly. Rather, trustees must satisfy themselves that there is a process (which may well include the custodian) that includes regular, timely input that is both expert and independent of the underlying product or service provider or security issuer. Absent such a process, the Panel is of the view that the investment of super fund assets in such strategies can only be regarded as imprudent.⁴⁸

Recommendation 3.5

That section 52(2)(f) of the SIS Act be amended to include 'the availability of valuation information that is both timely and independent of the fund manager, product provider or security issuer', as one of the factors to which APRA fund trustees must 'have regard'.

6.4 Voting

Another area where the lack of transparency can have implications is in the governance of the fund's underlying investments. There was a strong consensus in submissions that trustees should have procedures to ensure that the voting rights attached to the assets of the fund are being actively managed in the interests of members.⁴⁹ The Panel firmly endorses this view.

This does not, of course, mean that the trustee has to vote in each and every case. The decision on whether and how to vote can be delegated (for instance to a proxy consultant or a fund manager) so long as the delegation makes clear:

- (a) the obligation on the delegate to consider whether to vote in each case;
- (b) the requirement that the decision as to whether and how to vote must be made in pursuit of the best interests of members; and
- (c) that information on how votes were cast in respect of fund assets should be available to trustees routinely and on request.

Former UK Financial Services Secretary, Paul Myners, addressed these issues in a recent speech:

“Fund managers in most cases act as agents for clients, the ultimate owners of companies. As the agents of owners, the asset management industry is critically placed to ensure that companies in which they invest their clients’ money deliver long-term, sustainable returns. Not all fund managers offer ‘governance’ as part of their bundled package, but it is clearly incumbent on pension fund trustees and others in similar positions to ensure that someone is taking this role seriously on their behalf — and doing it well. The onus here should clearly be on the ultimate owner — the investment trust, insurer or pension fund. If the owner’s interests are not represented through effective stewardship, we cannot be surprised if agents substitute their own goals.”⁵⁰

The Productivity Commission, in its report into Executive Remuneration in Australia, made the following recommendation in relation to voting on remuneration reports and other remuneration-related issues:

“Recommendation 12

Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to super funds regulated under the Superannuation Industry (Supervision) Act 1993.”⁵¹

The Panel agrees that trustees should consider ways in which voting decisions can be communicated to members, perhaps on the fund's website. Consistent with the Productivity Commission's thinking, perhaps the Code of Trustee Governance suggested in chapter 2 could include principles dealing with the disclosure of voting decisions.

The Panel recognises that many trustees already have arrangements such as these in place.⁵² It also acknowledges the valuable work done by ACSI, ASFA, IFSA and other industry associations in

promoting more efficient, effective proxy voting by institutional investors such as trustees, and in many cases extending the investment governance processes even further into the realm of direct engagement with investee companies on corporate governance, sustainability and other issues.

Recommendation 3.6

All large APRA funds should publish their proxy voting policies and procedures, and disclose their voting behaviour to members on their websites.

ENDNOTES

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- 2 The accumulated literature in this area is vast. For recent Australian evidence related to this issue see Jacqueline Humphrey and Michael O'Brien, 2010, 'Persistence and the Four-Factor Model in the Australian Funds Market: A Note', *Accounting and Finance*, 50(1), pp 103-119; Richard Heaney, Terry Hallahan, Thomas Josev and Heather Mitchell, 2007 'Time-Changing Alpha? The Case of Australian International Mutual Funds', *Australian Journal of Management*, 32(1), pp 95-112; In the UK, Andrew Clare, Keith Cuthbertson and Dirk Nitzsche (2009) 'An empirical investigation into the performance of UK pension fund managers', *Journal of Pension Fund Economics and Finance*; In the US, Jeffrey Busse, Amit Goyal, and Sunil Wahal, (2010) 'Performance and Persistence in Institutional Investment Management', *Journal of Finance*, 65(2), pp 765-79; In relation to hedge funds, John Griffin and Jin Xu, 2009 'How Smart Are the Smart Guys? A Unique View from Hedge Fund Stock Holdings', *Review of Financial Studies*, 22(7), pp 2351-2570; Bogle, John C, 'Common Sense on Mutual Funds', 10th Anniversary edition, Wiley 2010.
- 3 Hazel Bateman and Susan Thorp, 2007, 'Decentralized investment management: an analysis of non-profit pension funds', *Journal of Pension Fund Economics and Finance*, 6(1), pp 21-44; Amit Goyal and Sunil Wahal, 2008, 'The Selection and Termination of Investment Management Firms by Plan Sponsors', *Journal of Finance* 63(4), pp 1805-1847.
- 4 R. Bird and J. Gray, Submission no. 3, p 3.
- 5 Agent here is being used in its economic not its legal sense.
- 6 Michael Drew and Jon Stanford, 2003, 'Is Super Safe? Principal and Agent Problems in Superannuation Funds', *Australian Economic Review*, 36(1), pp 98-107.
- 7 Myners P, 'Institutional Investment in the United Kingdom – A Review', March 2001, UK Treasury, p 85.
- 8 Terrence Hallahan and Robert Faff, 2009, 'Tournament behaviour in Australian superannuation funds: A non-parametric analysis', *Global Finance Journal*, 19, pp 307–322.
- 9 Morningstar, Submission no. 171, p 6.
- 10 David Gallagher, Peter Gardner and Peter Swan, 2009, 'Portfolio pumping: An examination of investment manager quarter-end trading and impact on performance', *Pacific-Basin Finance Journal*, 17, pp 1-27.
- 11 David Blake, Bruce Lehmann and Alan Timmerman, 1998, 'Performance Clustering and Incentives in the UK Pension Fund Industry', *Journal of Asset Management*, 3, pp 173-194; Torben Lutje, 2009, 'To be good or to be better: asset managers' attitudes towards herding', *Applied Financial Economics*, 2009, 19, pp 825-839.
- 12 Adam Clements and Michael Drew, 2004, 'Institutional Homogeneity and Choice in Superannuation', *Accounting Research Journal*, 17 pp 102-112; Natalie Gallery and Lynn McDougall, 'Don't Judge a Superannuation Default Investment Option by Its Name' *Australian Accounting Review* (forthcoming, 2010).
- 13 Nicole Choi and Richard Sias, 'Institutional industry herding', *Journal of Financial Economics*, 94, 2009, pp 469-491.

- 14 For example, Harry Fechner, Submission no. 106, p 17; ICAA, Submission no. 137, p 18; ISN, Submission no. 225, page 7 of the Q & A Report.
- 15 Several submissions cited the announcement in December 2009 by Frontier Asset Consulting that it would seek an alternative methodology for fees. However, this was the only example cited to the Review of a materially different approach.
- 16 For example, AIST, Submission no. 150, p 67; CHOICE, Submission no. 211, p 26; Mercer, Submission no. 170, p 81.
- 17 Myners P, 'Institutional Investment in the United Kingdom – A Review', March 2001, UK Treasury, p 85.
- 18 It is possible to treat the typical performance-based fee as effectively a call option on portfolio performance written by the trustee on behalf of the fund manager. It is possible to 'price' that option as the average expected revenue from the portfolio mandate. It then becomes possible to study the impact of imposing various fee conditions and to analyse the sensitivities against various assumptions such as the expected information ratio, tracking error, market return and so on.
- 19 David Blake, 'Pension Economics', Wiley & Sons Inc, 2006, pp 80-81.
- 20 For example, Institute of Actuaries, Submission no. 162, p 31.
- 21 Henrik Mathiesen, 'Incentive Risk from the Performance Fee and Remedies', 26 April 2010, <www.viaminvest.com/Insights/PerfFee.asp>.
- 22 Grant Thornton, 'Performance fees: a question of purpose', August 2008, <www.grant-thornton.co.uk/pdf/Performance_Fees_July_08.pdf>.
- 23 For example, IFSA, Submission no. 226, p 85; AIST, Submission no. 150, p 67; CPA Australia, Submission no. 156, p 16; ASFA, Submission no. 147, p 56; AXA, Submission no. 207, p 16.
- 24 Investment Advisers Act of 1940, Rule 205-3.
- 25 ERISA section 406(1)(b).
- 26 For example, ASFA, Submission no. 147, p 56; Morningstar, Submission no. 171, pp 7-8; Statewide, Submission no. 188, p 22.
- 27 For example, ASFA, Submission no. 147, p 56; Statewide, Submission no. 188, p 22.
- 28 For example, Warakirri Asset Management, Submission no. 57, p 4; CHOICE, Submission no. 211, p 26; Statewide, Submission no. 188, p 22.
- 29 For example, CBus, Submission no. 152, p 15; FPA Submission no. 224, p 33, NICRI, Submission no. 179, p 9.
- 30 KPMG, Submission no.397, p 4.
- 31 Unlike a normal managed fund where investors can be paying tax at rates anywhere between zero and the top marginal rate, an accumulation phase super fund pays tax at 15 per cent on its income and at 10 per cent on its longer-term capital gains. Moreover, the average tax rate in fact paid by funds can be considerably less than these headline rates. This is because funds can access franking credits on dividends, concessional tax rates on capital gains and potentially can utilise unclaimed prior year tax losses.
- 32 Watson Wyatt, Submission no. 195, p 10.
- 33 Gordon Mackenzie, Submission no. 429, p 2.
- 34 Kingsley Fong, David Gallagher, Sarah Lau, Peter Swan, 2009, 'Do active fund managers care about capital gains tax efficiency?', Pacific-Basin Finance Journal, 17, pp 257–270.
- 35 The Mutual Fund Tax Awareness Act of 2000.
- 36 Gordon Mackenzie, Submission no. 429, p 15.
- 37 FTSE ASFA Australia Index Series, <www.superannuation.asn.au/ArticleDocuments/116/FTSE-ASFA-brochure.pdf.aspx>.
- 38 Alex Frino, David Gallagher, Teddy Oetomo, 2005 'The index tracking strategies of passive and enhanced index equity funds', Australian Journal of Management, 30(1), pp 23-55.

- 39 Mercer-IRRC, 'Investment Horizons. Do managers do what they say?', 2010, <www.mercer.com/ri>.
- 40 Mercer, Submission no. 170, p 120.
- 41 Gordon Mackenzie, Submission no. 429, p 15.
- 42 IFSA, Guidance Note, No. 25.00, 'Product Performance - Calculation of After-tax Returns,' June 2008, <www.ifsa.com.au/documents/25GN_IFSA%20Guidance%20Note%20After-tax%20Returns_0625.pdf>.
- 43 Chant West, Submission no. 221, p 25; IFSA, Submission no. 72, p 62.
- 44 For example, AXA, Submission no. 34, p 3; KPMG, Submission no. 397, p 3; Rice Warner, Submission no. 233, p 12.
- 45 MLC, Submission no. 95, p 11.
- 46 For example, IFSA, Submission no. 72, p 11; KPMG, Submission no. 397, p 3.
- 47 For example, ISN, Submission no. 225, p 10 of the Q & A Report; PwC, Submission no. 85, p 5; REST, Submission no. 99, p 3.
- 48 Scott Donald, 2010, 'Prudence under Pressure' *Journal of Equity*, 4(1), pp 44-70; Andre Moore and Stephen Monage, 2007, 'Superannuation funds and alternative asset investment: issues for policy makers', *Jassa*, 3, pp 15-21.
- 49 For example, AIST, Submission no. 62, p 60; ACSI, Submission no. 61, p 8; CPA Australia, Submission no. 37, p 10; IFSA, Submission no. 72, p 52.; RIAA, Submission no. 29, p 3; S. Gilbert, Submission no. 21, p 2; UniSuper, Submission no. 56, p 17; Watson Wyatt, Submission no. 31, p 14; Unions NSW, Submission no. 370, p 14.
- 50 Lord Myners, Launch of the Asset Management Working Group Report, 9 November 2009, <www.hm-treasury.gov.uk/>.
- 51 Productivity Commission Inquiry Report No. 49, 19 December 2009, p 380.
- 52 For example, see the VicSuper proxy voting register: <www.vicsuper.com.au/resources/documents/Proxy_voting_August_2008.pdf>.

