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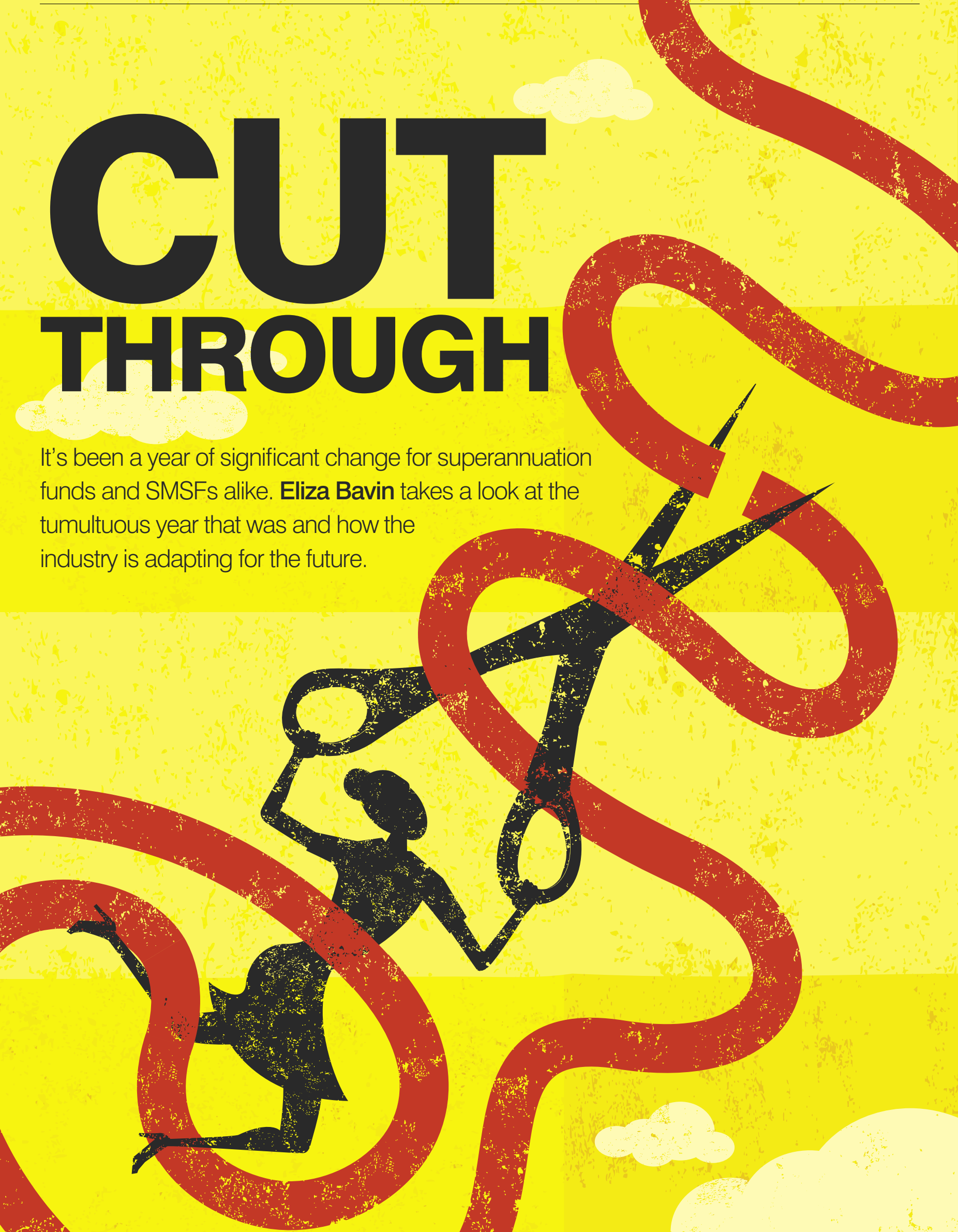
CUT THROUGH

It's been a year of significant change for superannuation funds and SMSFs alike. **Eliza Bavin** takes a look at the tumultuous year that was and how the industry is adapting for the future.



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It's not been an easy ride for the superannuation industry, from last years' Royal Commission and Productivity Commission reports, the industry has had no option but to adapt to the changing environment.

The sleeping giant of the Australian superannuation industry awoke in 2019 and increased regulation has plagued an industry that holds around $3 trillion worth of Australians' retirement funds.

Managing director at QMV Legal Mark Vaughan[01] says this regulatory push has helped the industry branch out and adopt a more innovative mindset.

"Many super funds that had been operating under a 'business as usual' model, in adopting change only when required by legislation, have taken a more pro-active approach toward the challenges and opportunities that the 'sole purpose test' demands," Vaughan says.

"The change has been varied, with a growing appetite of funds seeking to test the market for changes in their administration service model, assess the market for potential mergers and look to utilise technology-driven innovation to drive efficiencies within their supply chain."

The Royal Commission had a massive impact on the banks and their activity within super, especially around advice and insurance. The hope of increased regulation is an improvement in standards.

Fidelity International head of retirement solutions, Richard Dinham[02] says overall it has been a very positive thing for the industry.

"Some of the practices in place in the industry were not good value for money for members so a focus on member outcomes is a positive development," he says.

"However, it is also likely to result in more advisers leaving the industry, which has the potential to create an 'advice gap'."

The UK experienced this following the introduction of the governments' Retail Distribution Review, with the industry seeing a 20% reduction in the number of financial advisers between 2011 and 2016.

Much like the aftermath of the Royal Commission here, it was the banks who suffered the largest compression, losing close to 60% of their advisers.

This is a cause for concern here as well, with all of the 'Big Four' closing down their financial advice businesses.

While there has been a substantial amount of regulatory change resulting from the Royal Commission, adapting to such a significant reform agenda has been challenging.

"Transitioning operations, governance, and outsourced service arrangements to align with regulatory reforms does incur costs which are usually indirectly borne by members, but also result in strategic distraction. Constant tinkering can also heighten the compliance and operational risks related to administration," QMV partner Jonathan Steffanoni says.

Steven Carew[03], chief investment officer at JANA, believes that from an investment perspective Australian superannuation funds are faced with an increasingly demanding, complex and even confusing regulatory environment.

"Requirements or demands for greater or more detailed disclosure of investment costs, portfolio holdings, voting and engagement activity, and management of ESG and climate change risks present significant challenges for funds in terms of resources and developing effective communication channels to large membership bases," Carew says.

"Funds also face the challenging task of reconciling a greater focus on regulators on assessing their relative performance compared to other funds and the new member outcomes requirements, where funds are required to place greater emphasis on achieving defined outcomes for members."

These two measures are not necessarily compatible and may even openly conflict with each other, he adds.

One effect of which, has been industry consolidation, with smaller – and even larger – funds unable to keep up with increasing pressures.

Industry consolidation

Many super funds have struggled to meet the changes and require an increase in resources to address system enhancement and developments which typically leads to higher costs.

There have been a number of high profile mergers this year, including the recent joint venture between Equipsuper and Catholic Super.

New chief executive of the merged entity, Scott Cameron[04] says the decision to merge came from the boards of each fund recognising the industry requires funds to have scale.

"The amount of regulation and compliance is a big factor in the game. You need to be able to satisfy all those requirements. I understand the reasons for it, we're custodians for an industry with trillions of Australians' dollars, and there clearly needs to be a base-level of compliance and, in most cases, you need to be doing much more and staying ahead of the game," he says.

"To do that takes resources and in some cases the incremental amount of resources you need to bring on when you have a bigger fund is not as great; so you can get economies of scale there."

Cameron believes that it is because of this need to stay ahead of the regulation that smaller funds will struggle, if not already, then certainly as time goes on.

Bennelong account director, research relationships Stuart Fechner[05] agrees that the impacts of harsher regulation are arguably tougher and more challenging for smaller super funds than it is for those that are larger and well-resourced.

"In an ordinary business sense, within any industry this either tends to see prices increase or other costs cut, or a combination of both. A headline of increasing prices and fees within your superannuation would not be well received by members," he says.

"Thus, an option that many of the smaller superannuation funds have gone down is the merger path – sometimes to grow, but to some extent out of necessity in order to better keep up with the ever changing regulatory environment."

So, what about these effects on members? Steffanoni says the scale of efficiencies of consolidation is well known, and includes the ability of large Registrable Superannuation Entities (RSEs) to lower some costs when measured per member or per dollar.

"The increased bargaining power of scale also does enable larger RSEs to negotiate better commercial arrangements with service providers. There is also the possibility of additional scale enhancing a trustee's ability to pool risks to benefit members. All of these should benefit members if managed appropriately," he says.

Over time, we expect consolidation in the sector to fuel the growing trend of internalisation to reduce fees and secure capacity.
Steven Carew

However, Steffanoni warns that mismanagement of mergers can have a negative effect on members if funds don't remain attentive.

"While long term scale efficiencies created by a merger will flow through to such members in the long term, prudence and care is required by trustees in ensuring that any short and mid-term additional costs and risks associated with the successor fund transfer (SFT) are outweighed by the long term benefits and within risk tolerances," he says.

Members might be exposed indirectly to these risks, primarily in the form of increased costs, and therefore fees.

While the intended benefit of a fund merger is most obviously an increase in scale, Carew says it is too early in many cases to see definitive outcomes from this greater scale.

"The objective of most mergers is to reduce costs, across all aspects including investment, operations and insurance, and help improve member services," he says.

"In our observation, we are seeing mergers resulting in lower investment costs for members. Overtime, we expect consolidation in the sector to fuel the growing trend of internalisation to reduce fees and secure capacity in constrained areas such as small cap Australian equities."

Carew believes in the unlisted asset classes, greater scale will continue to drive growth in direct investments and co-investments where fees are much lower, or in some cases, nil.

Cost to the consumer

Superannuation fund fees have dropped for the first time since 2014, which many consider a good sign the Royal Commission has resulted in positive action.

According to Rainmaker research, the fees charged by the super industry prior to the Royal Commission fell from an average of 1.23% to

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1.11% in a year. The amount Australians paid in fees was upwards of $31 billion, down from over $33 billion in 2017-18.

It comes down to economics 101; the more competition there is in the market the lower the costs for consumers.

Dean Martin[06], chief executive of InPayTech, says if you don't have an efficiently operating market where people are able to "compare apples to apples" for the services they're getting, you won't see lower costs.

This is not to say he believes there should be as many super funds as possible, in fact it's quite the opposite. Martin believes we will see a rise in mega-super funds and this, in turn, will lead to better competition.

"There is an opportunity, with economies of scale, for mega-funds to present a better product at a lower price point but that needs to be balanced with competition," he says.

"Are there over 200 different segments of the market that need something different from this service? I would suggest that there probably isn't. What I mean by that is the fees should come down and members should get a better service, but all that needs to be played out in the market."

Cameron says that while part of the decision for Equip and Catholic Super to merge came from wanting to ensure fees can remain low. As a larger fund, with greater resources, they are able to deal with new requirements.

"As a profit-to-members fund we are very mindful of keeping costs manageable, but we need to look at that in light of investment returns and other services that we want to provide. So, in some cases it's about what we can now invest in to provide that better member experience," he says.

"So, I don't think the consolidation we are seeing is just about being able to keep costs down, though it is certainly a factor."

Changing the SMSF game

It is not just the big players who have been facing the struggles of regulatory scrutiny this year, with SMSFs also adapting to the changing environment. However, the challenges faced by SMSFs are different to those of the APRA regulated players.

One concern, for example, is the new rules around diversification. At the end of the day, superannuation exists, in a monetary sense, to provide for its members in retirement.

Bennelong's Fechner says the investment objective and how it is implemented is paramount to achieving this.

"Having a well-selected and appropriately diversified portfolio of investments is fundamental to achieving an appropriate return for every member's related level of or tolerance for risk," he says.

"I often say that it's about having 'funds for a purpose'. Some funds aim to achieve growth, some have a focus on providing income, and still others play a more defensive role and protect capital when growth assets are in negative return territory."

Such a combination of investments, he says, all come together to form an overall portfolio or fund, but it's the diversification across a portfolio that plays a significant role in not only helping to achieve the desired long term outcome or investment objective, but also as to how it's achieved along the investment journey.

I often say that it's about having 'funds for a purpose'.
Stuart Fechner

The Australian Taxation Office is encouraging people with SMSFs that have balances under $500,000 to consider returning to an industry or retail fund.

The ATO says this is the best option for those with lower balances due to poor performance of SMSFs in comparison to their APRA-regulated peers.

However, not everyone believes that this is the right call to make. Wealth O2 managing director Shannon Bernasconi[07] believes that, while diversification is key, in the current low-rate environment, retirees risk losing their savings if kept in a larger funds.

"Pension payments require liquidity in portfolios, pointing a spotlight on the cash rate the portfolio is earning. There are many super funds that are paying less than the RBA rate on cash, and when this is combined with the fees payable on cash, a pensioner can effectively be paying a super fund to hold their pension cash," she says.

"There is no regulation by APRA that enforces the platform provider of the super fund or the super fund itself to pay a minimum level of interest on cash."

Dinham agrees that one of the other major shifts in the industry has been an increased focus on post-retirement and decumulation, which he says is being driven by a couple of factors.

"With interest rates at all-time lows and likely to get even lower, retirees can no longer afford to leave their savings in cash if they want to generate the returns they need to generate an income and make their savings last throughout their retirement," Dinham says.

As a result, he says, retirees are being forced to take more risk, but also need to balance this with the need to protect their capital.

"People today are retiring with large retirement pots, having accumulated almost 30 years of savings since superannuation was launched in 1992. Previously, the focus has been on accumulating assets," he says.

"However, there is now recognition that there needs to be more focus on solutions for people post-retirement. "

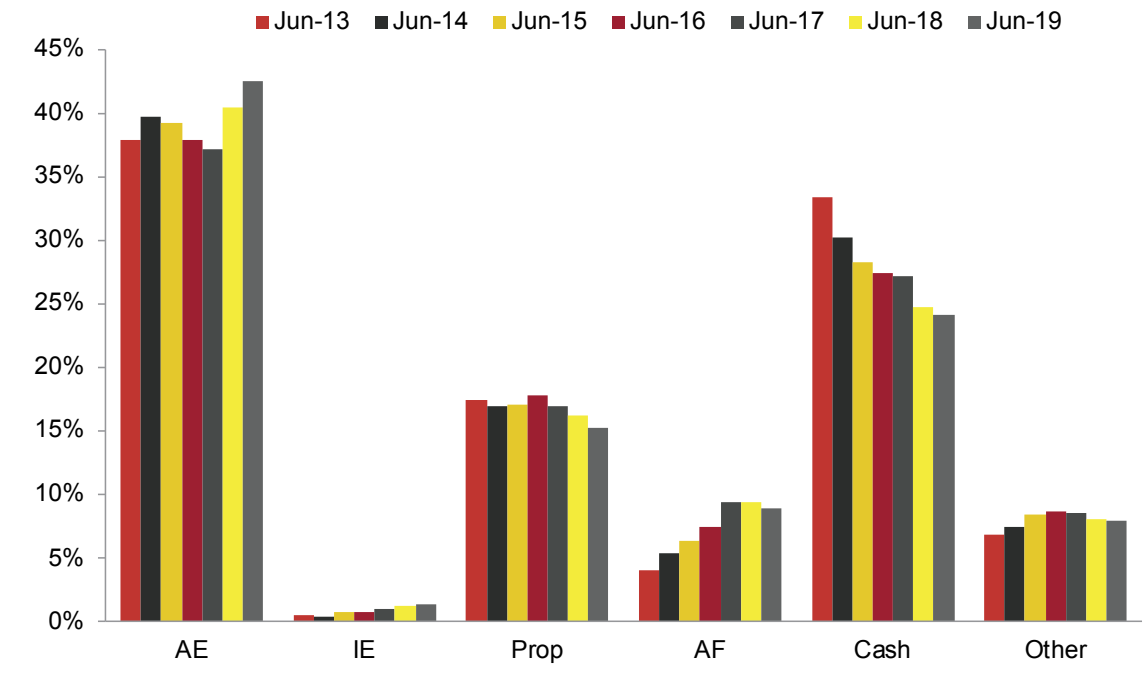
Everyone agrees the way to best protect your retirement savings, is through a diversified portfolio, but the ATO says that simply is not happening.

Diversification is key

ATO data shows that the majority of funds in SMSFs are held in cash and term deposits and in Australian listed shares.

Senior partner (SMSF) at Findex Kath Evans[08] says with closer monitoring by the ATO and increased scrutiny by independent auditors, people who are doing the wrong thing are slowly being eked out of the SMSF industry.

Figure 1. SMSF asset mix



Source: Australian Taxation Office, Rainmaker analysis

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WealthO2

08:
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Findex

09:
Phillip Ryan
managing director
Trilogy Funds
Management

"Generally trustees and members are more informed, better researched and have a greater awareness of the difference in the quality of service, product offerings, price and operating structures available to them," Evans says.

The ATO recently sent letters to trustees about the importance of diversification of assets while the Australian Securities and Investments Commission issued "red flag" indicators to advisers for them to consider when a client is thinking about opening an SMSF.

"This has been a timely reminder of the obligations of trustees in regards to fund investments, and in particular the preparation, regular review and updating of the fund's investment strategy," Evans says.

Findex provides over 8000 SMSF clients with administration services, and Evans says SMSFs still remain popular in the superannuation marketplace, despite both industry and retail funds continuing to look for ways to attract SMSF member to transfer across.

"We have found that levels of interest in opening an SMSF have remained fairly consistent over the last few years," she says.

"People asking questions about setting up an SMSF are generally well-informed and researched. They know what they want and are generally motivated by wanting some control over their super; for instance, they are inquiring about their investment options, such as direct property, unlisted investments or collectables."

While investing in equities is a good way to earn returns, it can often be the victim of volatility.

Trilogy Funds Management managing director Phillip Ryan[09] says that investing in income-focused investments like cash-style funds or mortgage-funds provide for a balanced portfolio while also reducing risk.

"Our funds aren't correlated to equities, in that you don't have the degree of exposure to volatility like you see in the share market. Our property trusts enable people to participate in the ownership of commercial and industrial property," Ryan says.

"For someone to try and do that in an SMSF would involve a large commitment of money, so this enables them to partake in investments which they otherwise wouldn't be able to get in to."

Ryan says that despite starting out as a stock guy himself, he was drawn to property because it gave him a greater sense of control.

"A person may have a choice over what shares, or equity trusts, you may go into but at the end of the day you've got no influence at all over the direction of a company. That's controlled by the board so, that's out of your hands," he says.

"But, with property you can touch and feel it, you can go visit the site- if it's a rented property you can see how the tenants are going etc. So, there is a lot more tangibility and control."

Ryan explains that if an SMSF is buying residential property for example, they can add value by painting or improving it by simply doing the garden. Something you simply can't do with a company.

Findex's Evans says that Australians are becoming more involved in their super, from retirees to Millennials and GenZ.

Likewise, Ryan says: "I'm an advocate for increasing financial literacy so people understand that the decisions they make now actually have consequences later in the future. So, it is important that a young person has an interest and an understanding of super now because before you know it, those 30 or 40 years are upon you."

The future is big and green

Society is the ultimate judge of what behaviour is and is not acceptable, and whilst there may be a lot of regulatory pressure on the super industry, there is also pressure coming from as a result of changing expectations in the community.

"This is no different within the superannuation or investment industry. Fundamentally this is what the Royal Commission was about – identifying and calling out actions that were not aligned with society's expectations," Bennelong's Fechner says.

Change is occurring to re-align this equation, Fechner says.

"ESG is very relevant within the investment industry and for the investment professionals that meet with companies and put a portfolio of stocks together," he says.

"Perhaps a decade ago there may have been a somewhat token reference to 'ethical' considerations, but today I feel that all investment managers have some element of ESG assessment represented within their investment process. They can't afford not to."

> *Institutional clients both in Australia and globally, expect asset managers to demonstrate their credentials.*
> **Richard Dinham**

If a company is seen to be doing the wrong thing across an area of ESG, today it is typically made public very quickly, scorned by society, and then often punished on the stock market, if it is a listed entity.

"A fund manager simply cannot ignore this, and in assessing stocks it's as much about identifying the losers and potential blow ups as it is the winners and those expected to outperform," Fechner says.

Fidelity's Dinham agrees ESG is becoming more important as society places greater importance on it.

"Members and super funds are moving these issues to the mainstream and expecting a rigorous and well thought through approach to these issues," he says.

"Institutional clients both in Australia and globally, expect asset managers to demonstrate their credentials."

It is not just a green future that we are looking at though; it is also a large one.

Asking Equip and Catholic Super's Cameron the answer is clear: "Consolidation is the way of the future."

"We are going to see a lot more of that activity because it is required to create scale, so funds are able to invest in the right things which can ultimately provide a better experience for members."

He is not the only one; JANA's investment chief anticipates the same thing.

"We believe the superannuation sector in future will be characterised by fewer larger funds that offer relatively low cost, 'core' products, and in their place, a group of more specialist providers catering for defined member groups," Carew says.

"What we are unclear of, and believe will be very interesting to observe, is whether the group of 'core' funds will seek to differentiate themselves in terms of investment philosophy, investment strategy, costs or product offerings, or whether we will end up with a group of homogenous funds that are completely focused on peer relativities and between which it is difficult to differentiate." **FS**