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A Super Mess

By Theo Marinis

The flaw in the superannuation system revealed by the Royal Commission is the fact that few people actually understand the complexities or issues of what we have. And what we have is a mess which allows marketing spin and self-interest to distract long-term investors away from the sole purpose of superannuation – to provide funds for retirement.

The mess starts at the top. The very senior bureaucrats in Canberra who are advocating significant change to the industry are the people who invented the system we are suffering under. Now they are advocating new ways of looking after savings by appointing the Productivity Commission to a new oversight position.

Appointing the Productivity Commission to be the arbiter of the Top Performing Funds 'hit parade', or League Table, is mind-bogglingly foolish.

For a start, there is an absolute conflict of interest for these public servants, who along with our politicians, are entitled to a defined benefit pension in retirement, whilst the rest of us 'civilians', are left trying to decide which 'fund' performed best.

Instead of developing a league table, the Productivity Commission should be creating a clear understanding of superannuation terminology - and publishing that information. We need to compare with apples.

Industry funds, retail funds and Self-Managed Super Funds (SMSFs) are just tax structures which allow us to invest in the same underlying assets. Some structures cost more and some cost less – and some have different functionality – but that is a minor issue. The major issue is that Canberra senior bureaucrats should not be cheer leading for any structure, super fund or super sector.

What is vitally more important is for superannuation members to clearly understand how their money is allocated – but I haven't heard anything from the Commission or its proponents about this.

If it is to really add value to society, the Productivity Commission should actually set specifications for the various asset allocations labelled 'Defensive', 'Conservative', 'Moderate', 'Balanced', 'Growth', and 'High Growth' by a) asset class and b) their appropriate weightings to Growth vs Defensive assets allocations for each defined profile.

At the moment, there are no clearly defined benchmarks for these so-called asset allocation profiles – which means they are used more as marketing terms than as indicators of the level of investment risk and appropriate investment timeframes. As such, these labels are fundamentally misleading – and perhaps conveniently so.

To demonstrate this farce, leading Industry super fund and Productivity Commission hero HostPlus is currently able to market a fund as a 'balanced' portfolio when the asset allocation has a ratio of 90-98% growth asset exposure. *

Small wonder then, with markets booming, that the HostPlus 'Balanced' fund was the best performer in 2018!

In actual fact, this fund is a 'high growth' wolf, masquerading in sheep's clothing - designed to give members a false sense of security for a VERY aggressive portfolio.

This scenario also brings to mind the example of the MTAA Super Fund, which in 2008, just before the GFC, was ranked the best performer in 2008 (no doubt the Productivity Commission would have placed it top of the table as one of the best performing funds if it were charged with the proposed responsibility at the time).

Unfortunately for MTAA and its members, when the GFC hit, the fund lost $1.5 billion of members' cash because of being too heavily weighted in growth assets when the market cracked. *

This is often what transpires, when higher and higher returns are the focus with little regard for the associated risk.

It is my contention that if the Productivity Commission is given these 'League Table' ranking responsibilities, we will find ourselves wading through a new Royal Commission in the next decade as those who were burnt by the top 10 league chart put pressure on politicians to answer questions about why their investments underperformed. The Productivity Commission will replace APRA and ASIC in the 'frame'.

There seems to be a collective 'take-out' from the Royal Commission that somehow Industry super funds are 'good' and that Retail super funds and SMSFs are 'bad'. Recent media reports state that Industry Funds are currently recipients of transfers from Retail funds, which all plays well to a narrative that there is good and bad amongst the various methods of superannuation funding.

If we are to be black and white, Industry Funds are not the cheapest form of super fund available. Industry Funds are not the most flexible and they don't have the best insurance options. But they are still good. The same can be said for Retail funds and SMSFs.

What we need to consider is the make-up and investment approach ALL funds adopt and look across the same skyline. In other words, use a mandated description of what constitutes a certain style of investing. We need appropriate benchmarks, so we can ALL really compare the performance of a particular fund to the right benchmark for a designated risk profile. And we don't need self-interested senior bureaucrats trying to pick the winning superannuation fund of the future!

NO ONE can do that, least of all the senior bureaucrats and their masters in Canberra.

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* Read here: Stockspot Blog 'How super funds play the ratings game' by Chris Brycki

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How super funds play the ratings game (Part 1)

31 July 2018 (https://blog.stockspot.com.au/how-super-funds-play-the-ratings-game/) Chris Brycki (https://blog.stockspot.com.au/author/chris/) Financial advice (https://blog.stockspot.com.au/category/financial-advice/), Investing (https://blog.stockspot.com.au/category/investing/)

It's that time of the year again when super funds release their annual performance. This blog looks at how the funds twist their performance relative to other funds and indexing. The funds' PR is parroted by the ratings agencies whose tables and good news story are accepted at face value by the media.

Firstly, we look at how funds manipulate their inclusion into the categories set by the ratings agencies.

Defensive assets

ASIC defines defensive assets as cash or government bonds.

Cash is defensive because when market fall it holds its value.

High grade bonds can do one better and rise when share markets fall. History backs this up too; in each of the 6 times Australian shares had a down year in the past 20, bonds rose to cushion the impact.

Can other assets be defensive?

This very much depends on the opinion of the fund manager and there is strong history to demonstrate why their opinions might not end up as fact.

High income stream and low growth assets

Just because an asset delivers a big income stream does not make it defensive. Take Telstra. Most of Telstra's returns come from regular fully franked dividend income but its share price has dropped 60% since 2015.

Infrastructure and property assets

Much infrastructure and property is held in unlisted vehicles which raises 3 concerns:

- The value of the investment is the opinion of the fund manager and there is no way of knowing whether that value is credible given that there is no open market for the asset.
- The financial structure may see a return of capital reported as an income distribution.

- The investment is very illiquid and a sale is often extremely constrained by agreements with co-investors, including first right of refusal and so-called 'tag-and-drag' conditions. One critical characteristic of a defensive asset is to be able to sell it in a deep and open market.

The inherently risky nature of these investments is usually exposed towards the end of each market cycle when too much debt is loaded in to beef up returns. In 2008 the Real Estate Investment Trust (REIT) sector fell by a whopping 75% globally because these funds had created income which couldn't be sustained under high debts and falling prices.

During the Financial Crisis some super funds stopped members from transferring money out because they were unable to sell illiquid unlisted assets. One fund, MTAA super, lost $1.6 billion due to poor hedging of unlisted assets (https://www.theage.com.au/business/super-fund-controversy-highlights-the-need-for-greater-transparency-20110609-1fuvw.html). MTAA super lost its spot as one of the best performing funds in 2008 to become the second worst according to Super Ratings.

Creative definitions of defensive assets

In recent times many super funds have invented their own definition of a defensive asset which has helped to push them up the ratings.

Let's look at this year's top performing fund, the Hostplus default balanced fund which claims a 24% allocation to defensive assets.

The Hostplus website (https://pds.hostplus.com.au/5-how-we-invest-your-money) explains that in addition to cash and fixed income "some asset classes, such as infrastructure, property and alternatives may have growth and defensive characteristics".

Their self-defined defensive assets include infrastructure, credit, property and alternatives. These makes up 22% of the 24% portfolio allocation to defensive assets. Government bonds make up just 2% and there is zero cash!

Hostplus default balanced fund

DEFENSIVE ASSET	PORTFOLIO ALLOCATION
Infrastructure	5%
Credit	6%
Property	9%
Alternatives	2%
Fixed income	2%
Cash	0%
Total	**24%**

Source: Hostplus

This has enabled Hostplus to claim top gong in its chosen category.

Hostplus isn't the only one. Many of the top funds on this list have counted some other assets as defensive to make the *Balanced fund* weigh-in.

Top 20 performing balanced funds over 1 year to 30 June 2018

FUND & OPTION	RETURN OVER 1 YEAR
HostPlus – Balanced*	12.5% p.a.
AustSafe Super – MySuper (Balanced)	11.4% p.a.
AustralianSuper – Balanced	11.1% p.a.
Cbus – Growth (Cbus MySuper)*	10.9% p.a.
Club Plus Super – MySuper	10.8% p.a.
Equip MyFuture – Balanced Growth	10.7% p.a.
Sunsuper for Life – Balanced	10.7% p.a.
HESTA – Core Pool	10.6% p.a.
NGS Super – Diversified (MySuper)	10.5% p.a.
UniSuper Accum (1) – Balanced	10.5% p.a.
Mercy Super ASG – MySuper Balanced	10.4% p.a.
Intrust Core Super – MySuper	10.4% p.a.
Vision SS – Balanced Growth*	10.4% p.a.
QANTAS Super Gateway – Growth	10.2% p.a.
First State Super – Growth	10.2% p.a.
Media Super – Balanced	10.1% p.a.
CareSuper – Balanced	10.1% p.a.
Aust Catholic Super & Ret – Growth	10.1% p.a.
LGIAsuper Accum – Diversified Growth*	9.8% p.a.
Catholic Super – Balanced (MySuper)	9.8% p.a.
SR50 Balanced (60-76) Index	**9.2% p.a.**

*Interim results only

Source: SuperRatings

This prompted me to ask Hostplus CIO Sam Sicilia the following question:

Chris Brycki @chrisbrycki · Jul 30

Thanks for the reply Sam. What measure/s do you use internally to determine if an asset qualifies as defensive? Where can members find more info on the underlying investments and return history of the assets that make up the defensive 24% inside the Balanced option?

Sam SICILIA
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Replying to @chrisbrycki @David_Elia_ and 2 others

Chris - every asset has a growth and defensive characteristic. There are simply too many assets to detail the capital (growth) and income (defensive) characteristics of each. It suffices to say tha it is possible (albeit laborious) to do the math at the individual asset level.

11:55 AM - 30 Jul 2018

The Productivity Commission got a similar response from many super funds when asking about returns for individual assets. Only 5 of 208 funds were prepared to disclose them.

Unfortunately, super funds aren't required to disclose how they classify their investments on their website or to anyone. Not to members, to the Australian Prudential Regulation Authority (APRA) or ASIC! They also aren't required to share how each asset has performed or even what it is. This allows funds to play the ratings game without anyone holding them to account.

By all means Hostplus and other funds should be free to invest in illiquid unlisted infrastructure, alternatives and property assets.

Just don't call them defensive!

How Hostplus sells the 'success' of its balanced default fund

Hostplus chief executive David Elia puts the performance down to **active management (https://www.afr.com/personal-finance/find-your-super-fund-in-the-top-performers-20180725-h1340k)**:

"Over the past three years our balanced option did 10.16 per cent, while the index balanced option did 7.29 per cent, so that's almost a three percentage point differential. The [active] balanced option has outperformed across every time horizon" he says.

It's absurd that Hostplus compares its indexed balanced option which has 25% cash and bonds to its default balanced option with just 2%.

It would be fairer to compare it to an index fund with a similar amount of risk. For example, the Vanguard High Growth Fund has a 10% allocation to cash and bonds and generated the following returns over 1, 5 and 10 years after fees and taxes.

	HOSTPLUS BALANCED DEFAULT (2% BONDS AND CASH) 1.45% p.a. INVESTMENT FEE	VANGUARD HIGH GROWTH (10% BONDS AND CASH) 0.29% p.a. INVESTMENT FEE
1 year	12.5%	11.9%
5 years	11.0%	11.1%
10 years	7.4%	7.7%

Performance is net of investment fees and tax. Vanguard returns are for a super fund paying tax in accumulation stage.

Source: Chant West, Vanguard

When comparing much more similar funds, Hostplus performed **just below** an index fund over 10 years. That's not bad, most funds did a lot worse!

How ratings agencies support the misleading self-reporting

The ratings agencies don't properly query the allocations reported by the funds. This provides no check as to the real risk of the self-reported defensive assets.

In addition, the ratings agencies have a few additional problems of integrity which we discussed in what fund ratings won't tell you (https://blog.stockspot.com.au/what-fund-ratings-wont-tell-you/). To recap:

- Most ratings businesses only publicly announce the top performers and not the worst. This is because they are typically paid by the funds who they rate. Anyone who has seen The Big Short (https://blog.stockspot.com.au/lessons-i-learned-from-the-big-short/) would understand how problematic this conflict of interest is. It's why we publish the Fat Cat Funds Report (https://www.stockspot.com.au/fatcat/) to shed a light on the best and worst funds.
- Performance over 1 and 3 year periods is meaningless yet it becomes the major focus each year. You need to see how a fund has performed over a full market cycle (around 10 years) to have any idea how it performs in good and bad times.

Active or indexed super?

By our analysis (which we'll share in Part 2 of this series), over 90% of active super funds **underperformed an index fund of similar risk** over 5 and 10 years after fees and taxes.

Expensive fees for active management is precisely what causes most super funds to underperform. For every active winner there has to be an active loser (https://blog.stockspot.com.au/why-you-wont-beat-share-market/) and management fees drag down net returns.

There are always going to be a small number of funds who beat the index but that group is always changing. Many funds in the top lists this year have also spent time near the bottom when markets weren't as kind to them.

Winners always change. Fees are with you every year.

How to pick the right super fund

For those looking for a super fund with a low allocation to defensive assets, Hostplus might be one to consider. Let's be clear, Hostplus and other Industry funds are making some good investments including into venture capital and infrastructure projects that will benefit Australia.

However what shouldn't be making headlines and driving members to switch is how the fund performed compared to lower risk options in a rising market.

Chasing the latest returns harms investors

Over the last 10 years Hostplus has been one of the very few funds to **almost** generate enough extra returns to match an index fund of similar risk. Vanguard's high growth fund still beat it by 0.3% per year after fees and taxes over 10 years.

Compared to the disastrous bank owned retail super products (https://blog.stockspot.com.au/fat-cat-report-5-years/), industry funds consistently come out ahead. However that doesn't mean some stakeholders aren't massaging the truth about what drives returns and therefore what's in the best interest of members.

Will Hostplus be able to keep up with an index fund over the next 10 years? Maybe, maybe not. Based on history, the odds of a fund that charges 1.45% per year beating a low cost index fund across the market cycle is not high. Warren Buffett proved this when he recently won a 10 year bet that a Vanguard index fund would beat 5 expert-selected active fund managers.

Buffett backed the index fund which won by a massive 77%.

Look out for Part 2…

In Part 2 of this series we look at how to pick a super fund based on the 2 factors within your control and proven to drive return: risk and costs.

Each year our Fat Cat Funds Report (https://www.stockspot.com.au/fatcat/) shows that these 2 factors are by far the most important. Focusing on risk and cost rather than ratings and fund manager storytelling will help you cut through the spin and find a fund with the best chance of success.

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