Long-term saving in a short-term world

19th April 2024

1. Introduction and Pottinger's interest in this review

Pottinger is a global boutique strategy and financial advisory firm dual-headquartered in Sydney and New York. We have provided formal and informal advice to Treasury for nearly two decades, including in relation to various matters of national significance, pursuant to our various longer-term whole-of-government panel appointments.

Since Pottinger was founded in 2003, we have had a strong focus on the importance of applying long-term perspectives to short-term decisions and have developed extensive specialist expertise in this field. Arguably nowhere is this more important than in the superannuation sector, where individuals save for upwards of four decades to fund liabilities that lie far in the future (ie their retirement). To put this in context, employees earning their first pay cheques in 2024 may not begin drawing down their pensions until the mid-2070s.

Over the last 21 years, Pottinger has been active in advising both private sector and public sector clients in the financial services sector, as well as in areas such as infrastructure that are of particular relevance to some aspects of this review. As a result, the superannuation industry and the funds it manages are directly relevant to our business. By way of example, our activities include:

- Advising various companies in the superannuation sector on overall corporate strategy and transactions, including companies such as Australian Ethical and Future Super Group, as well as having active dialogue with many large investment managers and specialist superannuation fund providers, including industry super funds;
- Negotiating with funds that are direct investors into infrastructure, including high-growth asset classes such as renewable energy infrastructure, as these entities are potential investors into and counterparties to many of the transactions on which have advised over recent years; and
- More broadly, advising on a wide range of situations where the role of funds as a source of capital for both public and private companies is of particular relevance.

Accordingly, we have prepared this brief submission, offering our independent perspective on some of the matters raised in Treasury's discussion paper. We make seven recommendations, as follows:

- **Recommendation 1**: A fifth criterion for assessing the options should be introduced, which would take into account the prospective effect of the measures on the strength and competitiveness of the superannuation industry as a whole;
- **Recommendation 2**: Performance tests should not be simplified, as this will increase the risk that funds place too much emphasis on short-term results and/or adopt investment strategies that do not deliver optimal outcomes over the longer term;
- **Recommendation 3**: New benchmarks should continue to be added for new asset classes as and when they reach sufficient scale to have a measurable impact on overall fund performance;
- **Recommendation 4**: A secondary "member proposition alignment" test should be introduced, so that funds that perform modestly below the benchmark but continue to deliver results in line with a clearly stated member proposition are granted a longer period for short-term comparative performance issues to resolve;
- **Recommendation 5**: Additional time horizons should be taken into account as data is accumulated, eg 15 year and 20 year performance tests, in order to focus greater attention on long-term performance;
- **Recommendation 6**: The primary fund performance tests should reflect actual fees charged over the time-period in question, but with secondary allowance made for funds that had subsequently reduced fees; and
- **Recommendation 7**: We recommend that the review should give consideration to the risk associated with the cost of purchasing a lifetime annuity at the point of retirement, and how superannuation funds can best help members to address this risk.

Our submission provides further context to our recommendations, which are highlighted with blue shading below. We would be happy to discuss any element of it if this of assistance to the review.

2. Acknowledging the wider importance of the Australian superannuation system

The Australian superannuation system is one of the most efficient and effective in the world, measured both by the proportion of the population who are actively saving for retirement, as well as by cost/efficiency, an important contributor to the returns achieved for savers. This is a testament to the design of the scheme, the performance of superannuation fund providers, and effective regulation over several decades. Low costs, choice of fund and transparency on fund performance have all contributed to this outcome. As a result, Australia's superannuation system is well-positioned to contribute to the quality of life of many retired Australians now and in the future.

Whilst this review is focused on continuing to improve the performance of the Australian superannuation system for the benefit of superannuation fund members, we believe is also pertinent to recognise the contribution that this system makes to the Australian economy and society as a whole. In particular:

- **Economic impact:** Retirees represent around 16% of the Australian population – so ensuring that these people have adequate retirement funding is thus a meaningful contributor to the overall health of the Australian economy;
- **Financial market liquidity:** The scale of Australia's superannuation funds has provided an important source of capital for Australian listed businesses in particular – this has proved especially helpful during times of financial stress (such as the global financial crisis) where accessible domestic liquidity provided a helpful barrier against contagion from other markets; and
- **Long investment time horizons:** The long-term investment time horizon of superannuation funds means that they have a particular interest in the ownership of long-term assets that offer stable returns and in-built inflation protection, such as infrastructure. Availability of this type of capital is particularly important for Australia given its growing population and consequent need for investment in long-term infrastructure.

Each of the above factors are aligned with delivering attractive returns to savers over longer time frames.

Recommendation 1 (Q1): Accordingly, given the importance of the industry to the nation, we believe that a fifth criterion should be added to the criteria suggested, so that the options put forward are also assessed in terms of their prospective benefit for the "strength and competitiveness" of the superannuation industry as a whole. The "improves member outcomes" test does not address this, as it only considers the short-term impact on the member, not the longer-term impact on the ability of the superannuation fund in question to continue to offer cost-effective products that deliver suitable returns. Various aspects of the commentary in the consultation paper allude to the importance of the superannuation industry, but nowhere is this called out explicitly. This criterion would ensure that the commercial effect of applying the tests would align with ensuring the ongoing resilience and competitiveness of the sector as a whole.

3. Protecting investment strategies with long-term time horizons

Most business and some government financial decision-making is intrinsically short-term in nature, ie focused on outcomes over at most the next five to ten years. One reason for this is the widespread use of discounted cash flow models in decision-making, and the mathematical impact of using discount rates with an embedded "risk premium". Even for relatively low-risk assets, the discount rate may be as high as 10%, and for modestly higher-risk investments – such as infrastructure that is still at development stage – can be 15% or more. Meanwhile, some private equity investors target returns of 20% to 25%, and venture capital investors in early-stage businesses may target returns of as much as 40%.

Building the allowance for risk into the discount rate has the effect of making the future disappear – ie longer-term outcomes become almost irrelevant to the investment decision in question. These choices can and do impact the lives of ordinary people, and so it is helpful to keep in mind how financial decision-making tools translate into real life. We illustrate this below, from the perspective of a hypothetical 65-year-old grandmother with a child aged 35, a grandchild aged five and a parent aged 85.

Together, these four people have a remaining life expectancy of approximately 168 years. Once the logic of discounting is applied, however, this reduces to a 'risk-weighted' 28 years, just one sixth of the total.

Figure 1: Illustration of impact of discount rates

Person	Illustrative remaining life expectancy	Discounted at 15%	Proportion
Mother's parent (85)	8 years (ie 93) | 5% of total	5.16 years	65%
Mother (65)	23 years (ie 88) | 14% of total	7.36 years	32%
Daughter (35)	51 years (ie 86) | 30% of total	7.66 years	15%
Grandchild (5)	91 years (ie 86) | 51% of total	7.67 years	9%
	168 years	**27.85 years**	**17%**

Source: Life expectancy derived from ABS 2014a. In this example, we count the first year in full, and then reduce each subsequent year by 1/(1 – 15%).

Our objective here is simply to illustrate that traditional decision-making techniques place a very strong emphasis on the short-term and place very little emphasis on longer-term outcomes. In this example, 55% of the 'risk-weighted' total of 27.85 years relates to the next five years, and 81% relates to the first decade[1]. In other words, the years after 2035 – the sixteenth birthday of the grandchild above – are heavily discounted by this type of analysis.

Meanwhile, the inherently long-term objectives of an individual's superannuation fund, and the long-term nature of the costs of living in retirement that such a superannuation fund is designed to meet, create inherent tensions with near-term performance priorities for various stakeholders, including:

- Superannuation funds run by privately-owned (for-profit) companies, whose primary objective is to maximise returns to their own shareholders;
- Mutual funds, ie superannuation funds run on behalf of members without the need to deliver returns to external shareholders, but who nevertheless must ensure that performance meets the performance test benchmarks over the near term;
- Financial advisors to consumers; and
- Investment managers appointed by superannuation funds to manage pools of investments on their behalf.

Ultimately, this is a large and complex industry of vital importance to the economic wellbeing of all Australians, as well as the Australian economy. Appropriately, it is subject to extensive legislation and regulatory supervision. It has numerous stakeholders, many of whom are large, sophisticated and well-resourced institutions. Thus, whilst care should of course be taken in introducing any additional regulatory burden, the inherent complexity of the regime means that it merits sophisticated supervision.

Recommendation 2 (Q8): We recommend not simplifying the tests that are applied as the significant difference in risk/return profiles across different asset classes may result in superannuation funds choosing to adopt investment strategies and/or asset allocations that are sub-optimal for fund members over the longer term in order to reduce the regulatory risk associated with failing the performance tests in the short term.

This said, we also believe that it is important for the industry to operate within a stable and predictable performance testing framework, and so are supportive of the suggestion in the consultation paper that any adjustments to the regime should be designed so that any future revisions (such as the introduction of additional benchmarks for new asset classes) should be predictable in nature and thus straightforward to anticipate.

4. Ensuring access to the widest possible pool of growth investments

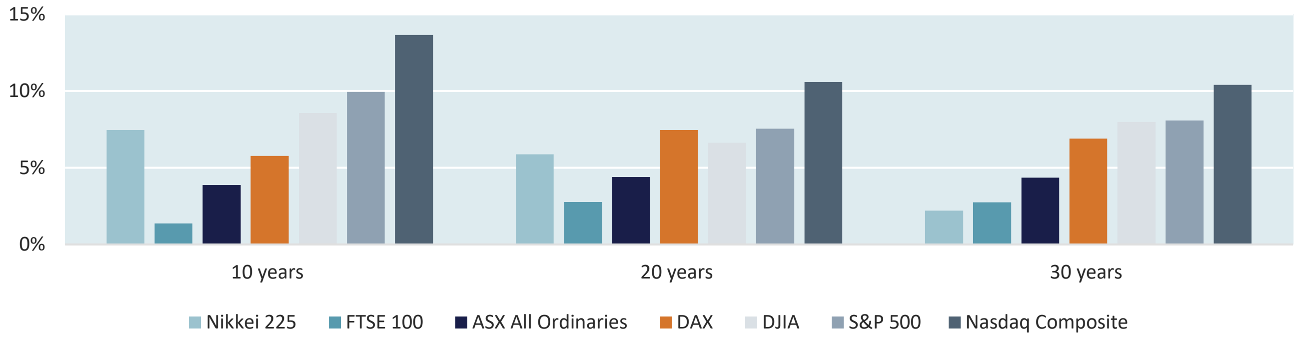
The Australian superannuation system already manages a substantial volume of investments and is continuing to expand. In practice, this means a growing need to invest in both offshore markets and alternative asset classes, as the ability to invest capital effectively in Australia is constrained by the supply of investments (and arguably exacerbated by low fixed capital formation, as outlined further below). As an example, NAB's Super

[1] For a more detailed explanation of these issues, please see our white paper Ending Accidental Time Bias

Insights Report published in November 2023, which surveyed 41 funds with combined assets under management of over A$2 trillion, identified that allocation to offshore investments had increased from 46.8% in 2021 to 47.8%, and that a significant majority of large funds intended to increase their allocation to offshore investments further in the next two years.

In addition, many of the companies listed on the Australian Stock Exchange are intrinsically lower-growth businesses and/or 'old economy' businesses. In contrast, stock markets in eg USA have more businesses whose growth is geared towards emerging industries. Historically, stock markets in USA and Germany have provided materially better returns than the ASX over various time horizons to 1st January 2024, as illustrated below.

Figure 2: Cumulative annual growth rate in index value – periods to 1st January 2004



Source: Pottinger analysis of CapIQ data

We recognise that, in part, these differences are due to a larger part of the return to shareholders being derived from dividends for Australian listed companies than for US listed companies, which the indices do not reflect. We show below the returns including dividends, using the relevant total return index (where available).

Figure 3: Total returns from investment in different benchmarks

Index	Total return index value at 1st January				CAGR (total return index)		
	1994	2004	2014	2024	10 years	20 years	30 years
Nasdaq Composite	-	-	4,581.05	17,911.70	14.6%	n/a	n/a
S&P 500	568.20	1,618.05	3,315.59	10,327.83	12.0%	9.7%	10.1%
Nikkei 225	-	13,351.03	21,582.43	63.659.32	11.4%	8.1%	n/a
DJIA	4,639.5	15,811.48	32,397.14	92,693.26	11.1%	9.2%	10.5%
ASX All Ordinaries	-	17,786.67	43,845.01	96,531.82	8.2%	8.8%	n/a
DAX	2,244.55	3,978.79	9,462.45	16,629.81	5.8%	7.4%	6.9%
FTSE 100	-	2,271.89	4,920.23	8,264.89	5.3%	6.7%	n/a

Source: CapIQ. The total return index accounts for both capital growth and dividends received. Total return achieved is shown as an absolute percentage

Even on this metric, the Nasdaq Composite index and S&P 500 index have significantly outpaced returns on the ASX over the last decade. In addition, over this time period the Australian dollar weakened by approximately 24% against the US dollar, equivalent to additional outperformance by US indices in Australian dollar terms of approximately 2.7 percentage points per year.

Looking forward, as we outlined in our 2022 paper for the Business Council of Australia, the Australian economy has several weaknesses linked to low fixed capital formation, low economic complexity and weakness in commercialising new technologies. Once again, these factors illustrate the prospective benefit of Australian superannuation funds investing in offshore markets and alternative asset classes.

Thirdly, at both a global and national level, the transition to renewable energy, as well as the associated themes of electrification of space heating and transport and industrial decarbonisation, are now driving the need for substantial capital investment globally. This amounted to approximately US$1.77 trillion in 2024, according to Bloomberg NEF data. We anticipate that this will be further augmented by accelerating investment in the next few years into the infrastructure required to support analogous improvements in the world's food supply chain. As a result, a new class of 'eco-infrastructure' is likely to emerge, as we outlined in our recent paper for the Club of Rome: Eco-infrastructure – A transformational opportunity for investors.

Thus, much of the investment required in both the energy transition and food system reform will likely be seen by investors as infrastructure. As a result, it will likely mostly be delivered in the form of private investments rather than by listed companies, again highlighting the importance of offshore markets and alternative asset classes to superannuation funds.

It is likely that the overall risk/return profile of each of the categories of investments alluded to above will be different from each other, highlighting the importance of utilising suitably tailored performance benchmarks rather than aggregate benchmarks.

Recommendation 3 (Q3, Q4, Q5 and Q6): Given the above, we recommend continuing to add new benchmarks for new asset classes as and when they reach sufficient scale to have a measurable impact on overall fund performance. Particular attention should be paid to emerging asset classes that offer an inherently different risk/return profile to existing asset classes.

5. Ensuring short-term performance criteria do not inhibit delivery of a long-term customer proposition

We note that many of the underlying issues that the performance tests are seeking to monitor (and address where appropriate) relate in part to managing the trade-offs between risk and return on one hand, and liquidity, choice and freedom on the other. As a simple example, investment in higher-risk investment classes such as private equity and/or venture capital may generate attractive returns over a time horizon of five to ten years but may deliver periods of short-term underperformance. Also, the underlying investments are highly illiquid and so these investments bring with them liquidity management challenges.

In addition, the nature and implications of these trade-offs will very likely be different for different cohorts of members, especially when comparing between eg those very early in their retirement savings pathway, those at mid-career who may have the ability to take on more risk, and those approaching retirement who may wish to adopt a more defensive stance as they approach drawdown.

Third, any given investment strategy may be impacted by unusual events that disrupt valuations over the near term but have little impact on longer-term performance. One recent example of this is the high returns generated by some oil and gas companies and energy trading companies due to the energy price volatility caused in large part by Russia’s invasion of Ukraine. Over the short term, this was favourable for index-tracking funds and unfavourable for funds that held low or no exposure to certain types of energy company.

These and other analogous factors may have an accentuated impact on the performance of funds that offer certain types of member proposition, including higher exposure to specific asset classes and/or the avoidance of certain types of investment (eg avoidance of investment in companies perceived by consumers to have poor long-term prospects and/or to be damaging to the environment or society). We note that younger generations have a greater interest in investment strategies such as ethical investing and/or impact investing which take account of both financial and non-financial performance criteria (such as environmental, social and/or societal impact). The superannuation assets of these cohorts continue to grow (including through inheritance), implying that these issues will become progressively more important to the management and performance-testing of Australia’s superannuation system.

These factors – as well as the significant differences in risk/return profile between different classes of investment – mean that there is scope for a fund to fail the performance tests in a given year, whilst still delivering results and returns in line with its member proposition.

Recommendation 4 (Q7): We recommend that consideration be given to introducing a secondary “member proposition alignment” test. This might be applied to funds that failed the performance test in a given year by a modest margin. Where a fund’s performance fell modestly outside the performance test range, but the fund continued to deliver results in line with a clearly stated member proposition, the fund would be granted a longer period than under the current regime for performance issues to resolve.

The objective here is to avoid penalising funds that operate longer-term investment strategies if their short-term performance is disrupted by factors that are inherently temporary in nature but the fund’s longer-term performance remains aligned with its proposition to members.

6. Encouraging a focus on long-term results

A typical superannuation customer will save for some fifty years before commencing drawdown of their pension – ie from first employment on graduation from high school or university until retirement age. This is set to increase to age 70 by 2035 and may well increase further in future decades. Accordingly, it is logical that fund performance should be judged at least in part over longer time horizons.

Recommendation 5 (Q24): We recommend that additional longer-term benchmarks should be added as data becomes available, so that fund performance is also judged over longer time horizons (eg 20 years).

In this context, we note that savers have the freedom to move their superannuation to another provider should the short to medium term performance of a fund prove disappointing. Nevertheless, by including performance tests based on multi-decadal time horizons, additional attention would be focused on the importance of performance over these longer periods.

7. Measuring real world impact on customers

The investment outcome for superannuation fund members is a function of the returns achieved after all fees, including administration fees. This is true irrespective of the time frame over which performance is being judged. Under the current performance tests, performance is judged based on historic investment performance, but fees are assessed based on fees charged in the most recent reporting period.

As a result, funds that had recently lowered fees might report higher apparent performance than those which had had lower fees over the long term. Conversely, a fund that had maintained low fees over the long term could fail the performance test whilst having delivered better returns (net of fees) than a fund which did not fail the performance test.

Recommendation 6 (Q41): We recommend that the primary fund performance tests should reflect actual fees charged over the time-period in question, as this provides a true like-for-like comparison of performance. Where a fund fails a performance test solely due to historically high fees (ie it would not have failed based on its current fee levels), this might not count as a failure for the purpose of the test in question.

We understand that historic fee data has not been collected for certain products. We believe it should not unduly onerous for funds to provide this data, so enabling assessment of fees on a lookback basis.

8. Refining and derisking the transition to retirement

Australia's superannuation scheme operates on a 'defined contribution' basis during the accumulation phase, ie when fund members are saving for retirement, meaning that members bear all the risk of investment performance. At retirement, fund members have the opportunity to convert some or all of these savings into what is then essentially a 'defined benefit' pension, by purchasing a lifetime annuity. To the extent to which members do so, investment performance risks are transferred to the lifetime annuity provider. The capital strength and liquidity of these institutions is highly regulated and closely supervised, and hence performance benchmarks do not have the same relevance.

Fund members bear considerable risk, however, as to the affordability of an adequate lifetime annuity at the time of retirement. In particular, whilst savers have the opportunity to derisk the value of their superannuation savings as they approach retirement (by adjusting the composition of the underlying investment portfolio), the cost of annuities themselves may still vary significantly during this period. We illustrate this with US dollar annuity rates below, as a long time series is readily available.

Figure 4: Historical US dollar annuity rates

Source: Thrift Savings Plan

For example, in the 19 months from July 2007 and February 2009, annuity rates fell from 5.63% to 2.75%, more than doubling the cost of purchasing an annuity (ie more than halving the annuity income that a retiree could purchase with any given investment). Similarly, in the period between June 2020 and December 2023, annuity rates quadrupled from 1.26% to 5.2%, thus dramatically increasing the annuity that a retiree could purchase. These shifts can thus prospectively have larger impact on the income accessible by a retiree in retirement than the investment returns achieved on their superannuation during the accumulation phase.

Recommendation 7 (Q29 to Q32) We recommend that the review give consideration to identifying what changes might be made to the superannuation system or the performance tests to help members assess how well superannuation funds address risks associated with the cost of acquiring a lifetime annuity on retirement.

Where a superannuation scheme member does not purchase an annuity, but rather draws down income and capital from their accumulating superannuation savings over time, they will remain exposed to the investment performance and costs of the fund in question. The essence of these risks is similar in nature to that during the accumulation phase, and so it would be logical for similar performance tests to be applied. We note, however, that the investment horizon will typically be shorter, reflecting the expected lifetime of a scheme member at retirement. As the latter will be in the order of 15 years, it may be appropriate to consider performance tests measured over eg a five or seven year time horizon.

9. Maintaining vigorous and deep competition in the superannuation sector

Vigorous and deep competition is especially important in the superannuation sector, not only because of the implications for superannuation scheme members, but also because the sector is the gateway to a substantial proportion of the capital available to Australian businesses. In this context, Australia's competition rules create an incentive for industries to consolidate until an effective duopoly is achieved, as seen in large sectors such as grocery retailing and airlines. Meanwhile, in the banking sector, the unofficial 'four pillars' policy has ensured that the four largest banks remain independent of each other.

To date, the superannuation performance testing regime has served to help reduce the fees charged to consumers, as well as to trigger the consolidation of some underperforming funds. Meanwhile, APRA's heatmaps provide additional transparency on a wider range of performance metrics. Importantly, amongst other things, these metrics demonstrate that performance is not a function of size per se and that (for example) mid-size funds can deliver excellent results for members over long time frames.

We anticipate that further consolidation is likely in the superannuation sector over the near to medium term. Nevertheless, we hope that the effect of regulatory supervision, including the performance testing regime, ensures that industry continues to comprise a diverse range of superannuation providers to ensure the strength and competitiveness of the sector as a whole.

10. Further information on Pottinger

Pottinger is a global boutique strategy and financial advisory firm dual-headquartered in Sydney and New York. We are an independent advisor to leading companies, state and federal governments, industry associations and growth stage companies on M&A, capital raising, corporate strategy and public policy. Our team has extensive experience of advising on and supporting long-term strategic development and growth across a wide range of industries, both domestically and globally. We are actively involved in the start-up ecosystem in Australia and offshore, focusing on B2B technology businesses and sustainability.

Pottinger helps organisations to adapt, innovate and transform, by providing insight and advice on strategy and public policy matters, as well as the negotiation and execution of M&A and financing transactions. Our combination of strategic thinking, M&A advice and financing capabilities allow us to find innovative solutions to the challenges arising in industries facing dynamic change and disruption.

Our team has exceptionally broad and deep strategic advisory and transaction execution experience, encompassing the world's top thirty countries. Examples include:

- Advice on market entry and growth, strategic repositioning, identification of new growth opportunities, spinouts and other forms of restructuring and advice on strategic investments, using our proprietary Destination-led Strategy® methodology, together with analogous advice to governments on public policy;
- Advice in relation to large and small-scale acquisitions, divestments and takeover responses for both publicly listed and private companies;

- Capital optimisation and financing advice for large enterprises and infrastructure project developers and investors, together with advice on commercialisation planning, capital strategy and capital raising for emerging companies;
- Specialist input in relation to the design, formation, restructuring, sale and dissolution of large-scale joint ventures and partnerships; and
- Identification and quantification of risk, by applying advanced statistical techniques to relevant data pools, thus simplifying decisions impacted by significant uncertainty.

Pottinger is 100% independent, owned by its employees and operates a completely conflict-free business model.