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## A Technical Note on Australian Default Superannuation Investment Strategies

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### Abstract

Superannuation has become more complex over time. Individual investors are inclined to seek the 'path of least resistance' and invest in default investment funds which are typically concentrated in high risk assets. Understanding how these funds will meet the individual needs of members relative to their changing circumstances can provide peace of mind and confidence in the market. Given the value of superannuation as an investment in terms of the economy, it is paramount that an appropriate mechanism be in place for default fund investors. This paper will clarify the existing position relative to default fund investment options and outline future research which will provide the impetus for change in terms of government policy, the financial planning profession and for industry superannuation funds.

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### Cover Page Footnote

I wish to acknowledge the support and encouragement of Graham Bowrey, Associate Head of the School of Accounting & Finance, University of Wollongong in preparing this paper.



# A Technical Note on Australian Default Superannuation Investment Strategies

Loretta Iskra<sup>1</sup>

## Abstract

Superannuation has become more complex over time. Individual investors are inclined to seek the ‘path of least resistance’ and invest in default investment funds which are typically concentrated in high risk assets. Understanding how these funds will meet the individual needs of members relative to their changing circumstances can provide peace of mind and confidence in the market. Given the value of superannuation as an investment in terms of the economy, it is paramount that an appropriate mechanism be in place for default fund investors. This paper will clarify the existing position relative to default fund investment options and outline future research which will provide the impetus for change in terms of government policy, the financial planning profession and for industry superannuation funds.

**Key words:** Retirement; fund choice; industry superannuation fund; default fund

**JEL Classification:** D14.

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## Introduction

The growth of superannuation (private pension systems) is a global phenomenon, to counter the financial burden of an ageing population. In Australia superannuation is part of the federal government's retirement income policy and is under continual examination. With the impact of the global credit crisis leading to reduced share market asset values and consequently reduced retirement funds, the review of superannuation look to include an assessment of 'investment, inflation and longevity risk' (Sherry 2009). With the majority of 'industry' superannuation fund members investing in high risk 'default investment strategies', how these funds cater for 'life cycle' issues, for example those moving into retirement, is uncharted.

This paper will commence with a review of superannuation 'life cycle re-balancing' trends overseas - the 'target-retirement-age' investment option in the United States and the asset allocation re-balance strategies in the United Kingdom. The next section will concentrate on the position in Australia, with consideration given to 'fund choice' and a 2008 proposed 'national default option'. This paper will conclude by outlining future research directions including the use of life cycle rebalancing to look at different investment strategies of superannuation members.

This study will contribute to the understanding of industry default funds and inform policy-making as part of ongoing superannuation review. By improving the retirement outcome for default fund members at the time of a financial crisis we facilitate a safer investment horizon and greater certainty of superannuation funding retirement income needs. This in turn promotes public confidence in the superannuation industry, which is in line with the Organisation for Economic Co-operation and Development's (OECD) reform of superannuation considerations.

## Background

The OECD has highlighted the need for careful assessment of superannuation schemes to ensure countries have sustainable mechanisms in place to cater for retirement funding given the ageing of society (OECD 2009). According to its 2008 publication, *Private Pensions Outlook 2008*, 'the ongoing financial crisis is affecting the retirement savings of millions of individuals around the world.' (OECD 2009, p.26). The OECD explains that a mix of insufficient levels of savings for private pensions, a trend to more risky investing of these private pensions by some countries, combined with a market correction will ultimately lead to greater reliance on public pension funding (OECD 2009).

In the United Kingdom (UK) studies by Blake, Cairns and Dowd (2001), Booth and Yakoubov (2000), Byrne et al. (2007) and Hibbert and Mowbray (2002) focus on default fund investment strategies and life cycle<sup>2</sup> re-balancing investment implications. Studies by Ameriks and Zeldes (2001), Basu (2008), Bodie (2003) and Mitchell et al. (2008) are based on the United States (US) experience of life cycle investing.

Australian studies have focused on 'fund choice', in terms of behavioural factors (risk tolerance) by Hallahan, Faff and McKenzie (2004) and McCarthy (2009), or demographic characteristics, such as age or gender (Langford, Faff and Marisetty 2006). An Australian Prudential Regulatory Authority (APRA) working paper by Sy (2008) consolidates much of the research in terms of a default investment strategy for Australian superannuation funds;

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<sup>2</sup> Life cycle strategies incorporate an automated move of investment assets away from growth to defensive assets as their retirement approaches

however, the contextual link between individual investors, current investment options and changing circumstances has not been adequately addressed.

## Superannuation in Australia

When an Australian person retires from paid employment, generally at the age of 65, they need to replace their wages to accommodate their future funding and spending needs. This replacement income may be sourced from their personal savings or, on a needs basis, from the Government via an 'Aged Pension'. Superannuation is a concessional-tax retirement savings vehicle established via a trust deed or legislation where the benefits are paid either as a lump sum or as a pension upon retirement from paid employment. The main benefit of using superannuation to provide for income in retirement is the associated tax concessions that apply on entry, while in the fund and on exit or via an income stream/pension. Additionally, certain superannuation strategies<sup>3</sup> can be employed to assist maximise aged pension entitlements.

In Australia, prior to 1986, superannuation was only available to a select number of employees, for example, those working for government-owned organisations. Typically the superannuation provisions were of a 'defined benefit' nature, wherein the employer paid a benefit on retirement based on a mathematical formula, usually related to the employee's salary on exit and length of service. With this type of arrangement the employer bore the risk of the amount of the investment or payment of benefits, with provisioning based on actuarial advice. Upon retirement if the retiree was ineligible for superannuation they had to rely either on other personal savings or a government age pension, if they qualified, to fund their retirement.

Following trade union representations in 1985, 'industrial award employees' - those employees in specific industries where their employment conditions are protected by State laws, became eligible for superannuation at a rate of 3% of income, payable into an 'industry' fund (a superannuation fund covering different employers, within one industry or sector) by employers. This change led to a greater number of employees becoming eligible for superannuation. These funds were generally accumulation funds, wherein the retirement benefit paid is the accrued savings together with any investment earnings (based on returns from the underlying assets). The risk, in terms of the value of the superannuation investment on retirement, shifted to the employee.

Legislative change in 1991 introduced the Superannuation Guarantee Charge (SGC), wherein *all* employees were to be provided superannuation by their employers, with the minimum rate of 3% to increase to the target (current) rate of 9% of income. While these funds were also typically accumulation funds, the point of access widened from a predominantly industry, corporate or public sector superannuation funds market into a growing retail sector.

There are currently a number of different pieces of legislation that cover superannuation in Australia. The Superannuation Industry (Supervision) Act 1993 (SISA) prescribes the legislative requirements for superannuation funds; enabling applicable tax concessions for regulated funds, while the Financial Services Reform Act 2002 (FSR) administers licensing and the rules associated with the provision of financial planning advice including advice in relation to superannuation. In support of these pieces of legislation APRA<sup>4</sup> supervises (regulated) superannuation funds in terms of prudential management. The impact of changes to the superannuation environment, including the associated regulations,

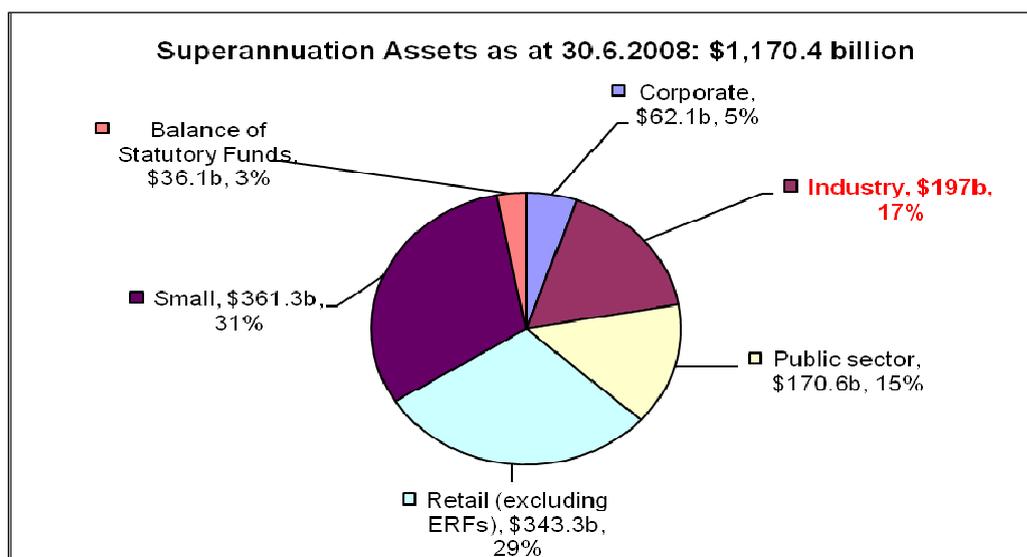
<sup>3</sup> For example, the use of an account-based pension for an income test strategy.

<sup>4</sup> The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance.

includes the phenomenal growth of Australia's invested assets, the shifting of responsibility of these investments to employees and substantial complexity in the nature and management of superannuation.

As at 30 June 2008, the Australian superannuation market held \$1,170 billion in assets (APRA 2009). Of this \$1,170 billion industry superannuation funds represented 17% of the market, worth \$197b as at 30 June 2008. The following diagram presents the breakdown of the superannuation market as at 30 June 2008.

**Figure 1**  
Superannuation Assets as at 30.6.2008, (APRA 2009)



Within this 'industry' segment, almost 74% of assets were held in the default investment strategy. A 'default investment strategy' is the automatic placement of investment funds into different types of investable assets, for example, shares, property and cash. Based on these statistics, the majority of employees accept the 'default' strategy and automatically adopt the underlying investment profile that is provided to them. While APRA shows the asset allocation of default investment strategies for industry funds having 65% in growth assets (shares and property), a 'further 17% were held in other assets' – later defined '... such as hedge funds'. By default most employees accept that approximately 82% of their retirement funds are in 'risky' investments; wherein no financial planning advice has been provided.

Default investment strategies are not unique to Australian superannuation. However the level of risk borne by Australia superannuation members is significantly higher than the risk members in other countries experience due to the lack of legislation on the weighting to be placed on default investments. In the UK the use of 'default' investment strategies are guided by legislation (Byrne et al 2007) that requires automatic re-weighting of the default investment asset allocation, to accommodate a cash-based pension at retirement (a life cycle approach). While in the US, also guided by legislation, investors have a choice of default funds: one with a stated investment asset allocation and the other targeted to planned retirement that includes automatic life cycle re-balancing. US policy relating to the funding of retirement income is based on the target retirement age investment (Towers Watson 2007). However as Australian retirees typically purchase market-linked pensions, the automatic re-weighting relative to life cycle changes is not a legislated aspect of industry superannuation fund 'default' investments. The following section will discuss the need for automatic re-

weighting relative to life cycle changes in industry superannuation fund 'default' investments.

## Demographic Trends

The shift away from defined benefit funds to accumulation funds is part of an international trend relative to the changing demographics (ageing) of society. Increased life expectancies combined with decreased mortality and fertility rates are the cause of an ageing population. More people will be retiring than working and this will result in employers being unable to continue to make defined benefit funds available as it will not be economically feasible.

In Australia, APRA data indicated that in 2008 only 4% of industry superannuation members are aged more than 60 years as at 30 June; 12% are aged 50 – 59; 30% are aged 35 – 49 with the balance aged below 35. Based on these statistics, the need for a life cycle re-balancing approach may not currently be a priority for industry superannuation as only a small percentage of members are about to retire, those aged more than 60 years. However in the next decade there will be a great need for a life cycle re-balancing approach to superannuation strategies.

In Australia since 1991 all employees are mandated to receive superannuation and this has led to the superannuation market in Australia reaching maturity while sizeable investment portfolios are accumulating. The investment outcome of superannuation to fund retirement income affects the country's retirement incomes policy and the individual in terms of meeting their lifestyle needs. The 'boom-bust' nature of investment markets creates uncertainty and concern about superannuation however as the ageing of the society continues such issues will become more problematic. As significant numbers of employees accept a default investment strategy, how these investments cater for their life cycle needs is important. While life cycle measures have been put in place in the UK and the US for default fund members through legislation that requires automatic re-weighting of the default investment asset allocation, there is no understanding of the options available for these investors in Australia.

## Life Cycle Re-balancing

The combination of a life cycle re-balancing approach in the UK is mandatory for industry superannuation funds (Byrne 2007). UK studies by Blake et al (2001), Booth and Yakoubov (2000), Byrne et al (2007) and Hibbert and Mowbray (2002) add to the layers of study in the area of default investment strategies and life-cycle re-allocation, albeit from a returns/outcomes focus. In the UK market, a retiree typically would purchase a cash-based pension; the re-allocation of assets to cash-based ones in the lead-up to retirement, on this basis, has merit. In the US a '401(k) plan' is an optional superannuation investment made available by employers for their employees to contribute a portion of their wages for retirement. It wasn't until 2006 when the Pension Protection Act came into place that a greater number of employers provided default investment strategy options. At that time the Department of Labour proposed a balanced fund and a lifecycle fund as two types of default fund investment strategies for consideration. So, in the US, lifecycle re-balancing can be provided as an 'alternative' type of 'fund' that a superannuation member chooses when they start their account to realign the underlying asset allocation from growth stocks to income to preserve capital as part of retirement planning (Towers Watson 2007). While the literature on studies of these plans broadens our understanding overall, none adequately consider the circumstances of the default fund investor, as most focus on optimal asset allocation or approaches of this nature.

The government and industry in Australia has recognised the limitations of industry superannuation default investment strategies relative to individual investors' circumstances. Sy (2008) proposes a simple and understandable option for most employees. The suggestion is that a national default option be adopted by fund managers (suppliers of 'industry' superannuation funds). The default option would require part of an employee's SGC be paid into a 'growth'-based investment account and the balance transferred to a 'cash'-based investment account, with the proportions based on the age of the superannuation member. Gallery et al (2011) have pointed out that, if left to the individual fund member to exercise and initiate this choice, lack of financial literacy and other factors may lead to poor outcomes.

Cbus (2009) is one example of an industry superannuation fund. This fund receives contributions on behalf of its nationally defined member group of construction, building and allied industry workers. Its default investment strategy has an exposure of 92% to 'growth' or risky assets, there are no re-balance options automatically available. According to the Cbus website, following the global financial crisis, a Cbus default fund investor had a loss of 14.6% for the 12 month period ending 30 April 2009. Based on a typical retirement portfolio of \$198,000<sup>5</sup> for a male aged 65, this could represent almost one year's funding of lifestyle needs<sup>6</sup> in retirement which could lead the investor being required to either work longer to make up the shortfall or retire and rely on government funding via the aged pension. The default investment strategy, based on a typical long-term investor, does not consider a member who is nearing retirement.

## Discussion and Future Directions

UK legislation stipulates the purchase of a cash-based annuity on retirement, conversely, Australian retirees are able to remain 'in the market' by purchasing market-linked pensions - there is no requirement for default funds to move away from growth investments to cater for the drawdown phase related to retirement. This means that there is no formal need for some funds to be invested in cash-based assets to protect against 'shocks' or market down-turns in the lead up to retirement. The need for life cycle switching from growth-orientated, long-term - risky to cash-based, short-term - safer assets leading up to retirement makes sense. However, the timing of switches and the nature of the safer assets to be used, are matters for further study.

Future research could be undertaken to simulate outcomes from existing arrangements based on many different possible investment strategies based on life cycle. To review the impact of volatility relative to capital available at retirement, a Monte Carlo simulation model could be used. Consideration might be given to 'baby boomer' investors – those on the cusp of retirement - relative to the inequity of anticipated retirement wealth from a shortened SGC savings period. This analysis could be completed to assist in providing a framework for policy proposals.

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<sup>5</sup> According to the Australian Bureau of Statistics

<sup>6</sup> Based on the concept of a "comfortable" lifestyle of \$40,000 per annum, refer to <http://www.superguide.com.au/superannuation-basics/a-comfortable-retirement-how-much-super-is-enough>

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