An Open Letter to APRA

APRA's Response

In response to the article, "APRA still failing members with passive versus active discussion", published on 14 January 2018 in Investor Strategy News, APRA took issue with the assertion that it is, "pushing super funds towards lower fee investment options".

As my research is the subject of the Article, I am on the one hand pleased that APRA has sought to clarify its position. On the other hand, the comments that APRA refers to do not, I believe, speak to the superannuation industry as loudly or clearly as its actions.

Specifically, neither referenced comment is made in the context of the impact of investment management fees on investment returns.

First, the referenced paragraph of APRA's submission to the Productivity Commission Issues Paper: Superannuation efficiency and competitiveness, dated 27 April 2016 states:

> "In that context, APRA notes that the lowest fee structure will not necessarily provide better outcomes for members over the long term. Enhancing overall long-term member outcomes by, for example, improved education and advice to support informed choices by members or more tax-effective investment management, may have a more material impact on long-term net outcomes for members than relatively small reductions in investment or administration fees. Optimising insurance arrangements to appropriately balance the cost of insurance with meeting member needs is also a relevant consideration in terms of overall long-term member outcomes."

While noting initially that lower fee structures will not necessarily provide better outcomes for members, the remainder of the paragraph make it clear that enhanced education and advice – which presumably requires higher administration costs to provide – may provide a benefit to members, and that **reductions in investment or administration fees will also provide a benefit**.

This would appear to be identifying a reduction in investment fees as a means of enhancing member outcomes.

Second, the referenced section in the Attachment to APRA's submission to the Productivity Commission Draft Report 'How to Assess the Competitiveness and Efficiency of the Superannuation System', dated 19 September 2016, states:

> "As APRA noted in our submission on the Issues Paper, a range of possible different investment strategies, and overall cost and fee structures, may be expected to deliver appropriate member outcomes over the long term. It is not necessarily the case that the lowest fee structure will provide better outcomes for members over the long term. Similarly, focusing on ways to enhance overall long-term member outcomes, such as more tax-effective investment management or reducing insurance costs, may have a more material affect over the long term than achieving relatively small reductions in investment or administration fees for members.
>
> When considering outcomes for members, a careful balance must also be struck between efficiency and sustainability – for both the RSE licensee's business operations and its service providers. In other words, lowest costs or fees are not always better; if costs are pushed too low, the quality and sustainability of the benefits or services provided is likely to suffer."

The first paragraph of this APRA submission primarily focuses on the benefits of tax-effective investment management and reducing insurance costs, while again suggesting that **reductions in investment or administration fees will provide a benefit.** The second paragraph is principally focused on the sustainability of the business of the RSE and its service providers.

Again, in this submission APRA states that lower investment fees would be a benefit to members, however neither paragraph appears to have a focus on the role of investment fees in superannuation funds' investment strategies.

The Role of Investment Management

As noted above, neither of the comments in APRA's submissions are made in the context of investment management fees and their impacts on returns.

When considering the role of active Investment Management, and hence investment management fees, in superannuation portfolios, there are two fundamental, and diametrically opposed, views:

1. Investment management fees are a **cost** to fund members, in that the return benefits of active investment management do not outweigh the fees paid. This position may be expressed in two forms:

    a. The Weak Form - the active returns generated are positive but less than the fees and costs incurred. Thus returns are reduced, but by less than the investment fees; or

    b. The Strong Form – active management does not generate any positive returns. Thus returns are reduced by the full amount of the investment fees.

    While APRA may disagree, it is without question the belief of the vast majority of participants in the superannuation industry that, based on their action and deeds, the Regulators (APRA and ASIC) hold this (Strong Form) belief. This is reinforced by this effectively being the definition of 'Indirect Costs' in RG 97.23, and ASIC and APRA's insistence that indirectly incurred investment fees be included either under this definition, or as Investment Costs.

2. Alternatively, investment management fees are seen as the **price** of accessing a source of investment risk and return – manager skill. Under this view the expected outcome of paying investment management fees is to **increase the net return to members** (or to at least have a non-negative expected net return).

    There is strong evidence that the vast majority of superannuation funds believe that active management is an investment strategy (or asset class) with positive expected net returns. This can be seen from:

a. The revealed preference that almost all superannuation funds do employ active management as part of their investment strategy – including at the asset allocation, investment style, asset class and security selection levels. Either every super fund is consciously not acting in what they believe to be the best interests of their members, or funds do actually believe that investment fees are a price worth paying for accessing the benefits of manager skill.

b. That super funds with lower investment constraints generally utilize higher levels of active management (and hence pay higher fees). Thus, retail super funds, which are typically more constrained by their platform structures, tend to have lower allocations to manager skill intensive investment strategies than industry funds. Similarly, the Future Fund, which is not as constrained by liquidity considerations, or by APRA and ASIC regulation, and therefore has the freedom to implement the most optimal investment strategy, employs greater levels of manager skill than industry super funds.

c. Evidence from fund returns which shows that options with higher levels of active investment management – and hence higher investment fees - have produced higher levels of net (after fee) returns.

APRA's Actions

While APRA may not agree, it is clear that the superannuation industry interprets the Regulators' (APRA and ASIC) joint position as being in favour of lower costs and fees – including investment fees – **irrespective of the effect on net investment returns to superannuation fund members**. This reflects a view across the majority of the industry that the Regulators believe that investment management fees are a cost that should be reduced or eliminated. Whether or not this is APRA's actual belief or not, this is a distinct case of actions speaking louder than the words referred to above.

The effect of current regulation, whether it is APRA's intention of not, is in fact to "push super funds towards lower fee investment options".

APRA's Position

If APRA actually believes that active investment management is a valid investment strategy with a positive (or at least non-negative) expected net return, and that

investment management fees are the price of accessing that strategy, then I challenge APRA (in conjunction with ASIC) to clarify its position by:

1. Making a public statement that APRA believes that active investment management is a valid investment strategy for superannuation funds (with a non-negative expected net return) and that investment management fees are the **price paid for accessing that strategy**, not costs that should necessarily be reduced or eliminated.

2. Issuing guidance to superannuation funds clarifying that **indirectly incurred investment management fees**, because they have a non-negative expected net return, **do not meet the definition of Indirect Costs under RG 97.23**, in that they are not, "a cost that superannuation fund Trustee / Directors know (i.e. believe) or reasonably ought to know (believe) will reduce the returns of the superannuation product or option". (An equivalent directive will also need to be made in respect of Investment and Performance fees in the Fees and Costs calculations in PDS's.)

3. Issuing guidance to Financial Advisers and Planners that the level of investment management fees is not a factor that needs to be, or should be, taken into account when determining whether an investment is in the best interests of investors, as **higher investment fees are not expected to be associated with lower investment returns**.

I encourage APRA and ASIC to assess and review their beliefs around the role of investment management fees, and hence active investment management, in superannuation funds, as many of the signals currently being given to the industry are creating perverse outcomes.

A thoughtful debate has developed across the investment industry in recent years, but largely without APRA and ASIC's involvement. I encourage your participation.



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17 January 2018

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Dear Mr Peterson,

An Open Letter to APRA - ASIC Response

We refer to your letter of 17 January 2018, titled 'An Open Letter to APRA' (Letter). In this Letter, you discuss the role of investment management and the impact of investment management fees on investment returns. This letter also comments on the purported position of both APRA and ASIC on this issue.

We would like to take this opportunity to thank you for sending your Letter to ASIC, and keeping us informed of issues that are arising in the fee and cost disclosure space. As you would be aware, ASIC has appointed Darren McShane to conduct an expert review of fee and cost disclosure in superannuation and management investments. The aim of the this review is to ensure that legislative modifications and regulatory guidance issued by ASIC will best meet in practice the objective of improving fee and cost transparency for consumers. The review is expected to be completed by the end of the first half of 2018.

Your Letter has been provided to Darren McShane, and we note the statements you make in paragraph 2(c) on page 4 of the Letter. This paragraph indicates that there is evidence showing the outperformance of options with higher levels of active investment management. We are interested in reviewing the evidence supporting this claim, and would appreciate it if you could provide us this evidence or direct us to its source.

If you have any queries, or would like to discuss this matter further, please contact me on (03) 9280 4226 or by email at james.champion@asic.gov.au.

Yours faithfully,

J. Champion

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