McGING GAZETTE

Superannuation
Retirement Income
Wealth Management
Life Insurance
Risk Management
Governance
Actuarial Consulting

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Spotlight on Financial Services including Superannuation

A number of Government investigations are shining a bright spotlight into the current practices of the financial services industry and the factors driving change. The major ones affecting superannuation and wealth management are the Financial Services Inquiry (FSI), Treasury's Review of retirement income stream regulation and the White Paper on the Reform of Australia's Tax System. These investigations force deeper thinking and greater transparency on industry practice and are catalysts for future improvements in product, service and costs reflecting the time invested in them by their secretariats and industry participants.

The FSI Interim Report has shone the spotlight particularly strongly on the level of fees stating

- "there is little fee-based competition in the superannuation sector", and that
- "this indicates there is scope for greater efficiencies in the superannuation system".

This edition of the Gazette explores two aspects of this. Firstly, below we report on our submission to the FSI, and later in A picture paints a thousand words, we illustrate the historical relative long term performance of asset classes against the levels of fees currently being charged.

September 2014

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FSI Submission by McGing Advisory & Actuarial

A simple idea for reducing costs and fees

This is the message in McGing Advisory & Actuarial's second round submission to the FSI on Superannuation - Efficiency / fees / competition. It expands on the "picture paints a thousand words" graph in the March 2014 McGing Gazette.

Costs & fees as dollar not %

Remembering that simple is not always easy, and change is never easy, I recommend the Inquiry consider how industry participants could move, or be encouraged to move, to

Base investment management contract costs and member fees primarily on dollars - not as a % of assets.

The principle applies to all asset management. In superannuation during the accumulation phase the situation is further magnified by contributions increasing over time with wages.

Illustration of impact of $ fees indexed to wages vs % of assets

Graph 1 following illustrates the big difference in fees paid by charging a member on a percentage of the asset value compared to a fixed dollar basis after allowing for increases based on wages inflation.

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Sean McGing
Director McGing Advisory & Actuarial

About McGing Advisory & Actuarial

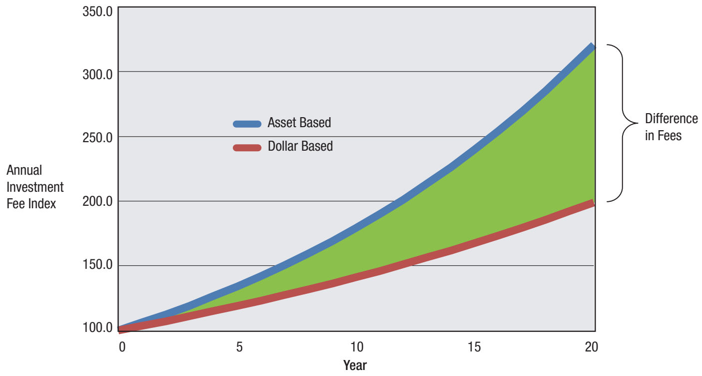
McGING ADVISORY & ACTUARIAL

McGing Advisory & Actuarial (MGAA) is a boutique consultancy led by Sean McGing providing a personalised consulting service to directors, senior leaders and executives, and their support teams. Sean is supported by a number of experienced employees and associated consultants who partner with Sean to deliver quality, valued advice. MGAA has five overlapping areas of focus:

- Superannuation & wealth management
- Boards
- Investment Consulting
- Enterprise risk management (ERM)
- Actuarial consulting

FSI Submission by McGing Advisory & Actuarial *(Continued)*

By the end of 20 years, on this relatively generous basis (to the provider / asset manager) - see details below - a member's annual fee increase, if asset based, is double that of a wages inflation adjusted dollar fee.



Graph 1. Comparison of Dollar to Asset Based Investment Fees

Assumptions:

(i) Single accumulation amount invested at start.

(ii) Asset allocation based on APRA data for average of all APRA supervised funds.

(iii) Projected future average net investment return of 6% per annum after tax of 15%.

(iv) CPI inflation of 2.5% plus 1% additional real wages growth = 3.5% total wages/ life style growth.

(v) Investment fee index of 100 at start which would be say $300 being say 0.6% of an asset value of $50,000.

Sources

This idea was first published in a paper entitled Reducing Retirement Income Costs written by Sean McGing in 2011 for the Actuaries Institute Convention.

www.actuaries.asn.au/Library/events/Conventions/2011/ReducingRetirementCosts-Paper.pdf

Detailed Assessment from 2011 Reducing Retirement Income Costs paper

The submission extracts from my 2011 paper a brief analysis followed by the recommended cost reduction action with supporting reasons and expected effects. They are just as applicable today. Reproducing just the latter here:

Reasons & effects

1. Flat dollar fee, rather than a % of assets, sharpens the focus for asset manager, provider and member.
2. Better matches effort and work done with fair wages for that work done.
3. Is much more transparent to all concerned.
4. Reduces escalation and volatility of fees with market volatility.
5. In effect, with flat dollar fees, the brakes on fees are on by default, not having to be continuously applied and released.
6. Negotiations become negotiations on increasing fees.

Additional comments

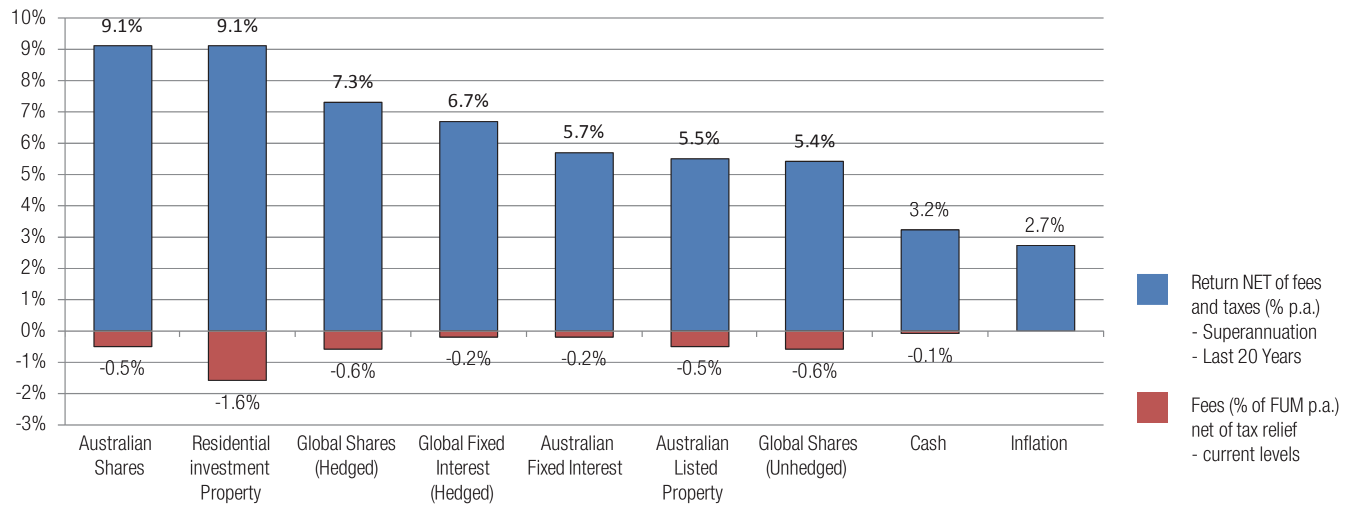
A simple yet potentially profound change from investment costs and fees substantially % of assets to substantially $ based fees, would be a big change in culture for the industry. To change the culture, behaviour must change over a reasonable time frame.

We need strong, good leadership with members' interests at heart, to drive such a change.

The end prize is greater transparency and lower costs leading to a better superannuation system for members.

Our full submission can be found at fsi.gov.au/files/2014/09/McGing_Advisory_Actuarial.pdf

"A picture paints a thousand words" Investment Returns vs Investment Fees by Asset Class



Graph 2. Investment Returns vs Investment Fees by Asset Class

Sources and Assumptions:

(i) 20 year Superannuation after tax and fees net investment returns to 30 June 2014 are from the ASX / Russell Investments 2014 Long-term Investing Report.

(ii) Fees are an indicative average for major industry funds for sectors other than residential property. Residential property fees are based on the DHA Residential Property Fund No 1 schedule of fees. We have used current fee levels reduced to reflect 15% tax relief.

Comment: Debate rages about high Australian Superannuation operational and investment costs compared to overseas Pension Funds. But we need to compare apples with apples. This graph illustrates that growth asset classes have higher fees and those asset classes which have historically had higher returns have also generally had higher fees.

Case Study - An enhanced Retirement Scheme for AFL Players

One of the most interesting jobs McGing Advisory & Actuarial has worked on in recent years has been assisting the AFL Players Association design and implement an enhanced retirement scheme for AFL players.

The need: The AFLPA recognises there is a long period of time between a player's retirement from playing professionally – on average in their mid 20s - and access to their superannuation from age 60. The AFLPA wanted to substantially improve the existing retirement benefits scheme for players in the medium to long term.

The challenge: Identify and balance the potential advantages, benefit amounts and costs of such an enhanced scheme, recognising funding is dependent on one element in the players' collective bargaining agreement, which in turn is dependent on the five year TV Rights deal ($1.25bn for 2012-2016).

The process: The AFLPA engaged McGing Advisory & Actuarial to assist with the design and modelling of the enhanced scheme.

- A key first step was the identification of good design principles for retirement benefit provision which we applied to the AFLPA's situation.
- We analysed the past experience of the longevity of players in the game and derived assumptions on numbers of new players joining, the rate at which players stopped playing by years played and age, as well as expected investment returns.
- We built a model, carried out active and retiring player and financial projections on both defined benefit and defined contribution bases, and as lump sum and annuity payments, to assist the AFLPA in understanding the dynamics at work and enabling informed decisions to be made.
- We considered the risks to the players and other stakeholders.

The solution: In the AFLPA's words "A Best-in-Class Retirement Scheme for AFL Players":

A defined contribution arrangement with the annual contribution ranging from $7,000 for a rookie to $20,000 for a tenth year player. A lump sum payout one year after retirement varying from 100% to a player who has played up to 4 years to between 20% and 30% for those playing longer. The balance of a player's account is retained for a further 5 years accruing investment returns. After that 5 year period, the account balance (including investment return) will be remitted to the player in periodic instalments over the following 5, 10 or 15 years.

The default investment strategy is to a conservative fund in the first four years of a player's career, changing automatically to a growth fund at the beginning of the 5th year reflecting the much longer term nature of the benefits.

Full details of the Retirement Scheme can be found at www.aflplayers.com.au/financial/

Risk Culture Measurement

This article considers risk culture in organisations in the context of implementing enterprise risk management (ERM) and the extent to which, and how, organisations identify, measure and seek to improve their risk cultures. It is based on the paper presented by Sean McGing and Andrew Brown to the Actuaries Institute Financial Services Forum in May 2014 and at an Actuaries Managing Risk Insights session on Superannuation in July 2014.

Risk culture in organisations

An organisation's risk culture describes the degree to which its culture encourages or limits the taking of risks and the opportunities that arise from those risks. It is about people's individual and collective behaviours. A culture constantly evolves through various stages of maturity.

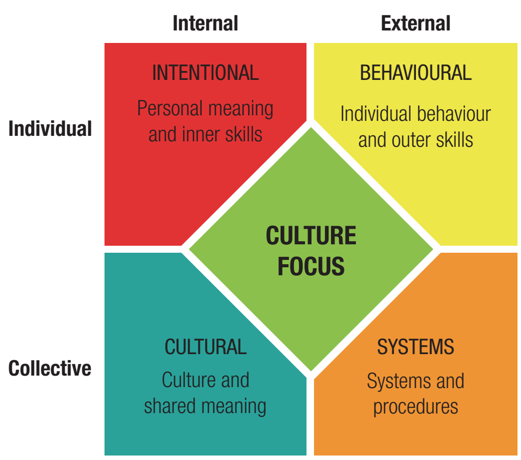


Table 1. Wilber's Integral Model

Ken Wilber, integral philosopher, has summarised four aspects of a system into his integral model. In any organisation, the way these four aspects operate together shapes the culture.

Source: Putz, M. (2006): AQAL: Journal of Integral Theory and Practice, Spring 2006, Vol 1, No 1, Integral Business and Leadership: An Intermediate Overview

The culture of an organisation is heavily influenced by its individual and collective behaviours. To move an organisation to a more mature risk culture requires an understanding of its people's behaviour(s), beliefs and mindsets. To support and reinforce any cultural change, it is also essential to have in place appropriate systems and structures.

Measuring risk culture

If culture is important to ERM, then we have to find a way to measure it. The case for measuring culture seems very straight forward – by measuring culture we are better able to assess the effectiveness of our attempts to shape or control it. In financial services APRA as the regulator effectively expects you to measure culture in order to manage it. But that has its challenges:

1. We need to be careful that any changes in results are due to changes in the underlying culture and not changes in how the measurement is being applied.

Risk Culture Measurement *(Continued)*

2. The harder that things are to measure, or the more subjective they are, the more likely it is for people to ignore or discount the results
3. Measurement of the culture isn't independent of the culture
4. The type of measurement that is appropriate will also depend on the stage of organisational maturity.

Methods of measurement

There are several ways to measure risk culture.

- Surveys
- Staff interviews
- Focus groups
- External stakeholder interviews
- Social media reviews
- Review of operational processes
- Training

You must balance quantitative with qualitative. Measuring regularly such as annually enables changes and trends to emerge and be assessed. Surveys and staff interviews are the most common and the easiest. The survey needs to be designed very carefully. It can be incorporated as part of the annual staff survey particularly if the organisation's risk culture has already evolved to a reasonable level where people are consciously aware of the culture and the impact it has on performance.

These measures broadly cover off Wilber's four quadrants.

Findings and insights into risk culture across industries

We undertook a pilot risk culture measurement exercise as part of our research. We conducted (mostly) face to face interviews with a limited number of Chief Risk Officers in organisations across financial services, education and energy. We also analysed and compared the online questionnaire responses by our interviewees. The most important aspects of an effective risk culture in their eyes were:

Andrew Brown, Director and Owner lead.first and Sean McGing, Director McGing Advisory & Actuarial.

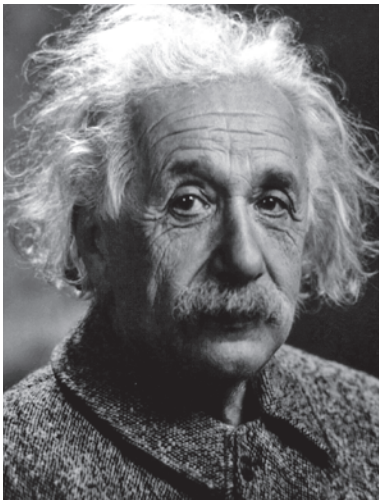
1. Tone from the top AND tune from the middle.
2. Open and effective communication in a safe environment.
3. Awareness, understanding and ownership of risk at all levels.

Insights we gained were:

1. The driving force behind best practice risk management across an enterprise is the evolving culture
2. There are more similarities than differences across industries / areas
3. Cycles are essential for learning. A long memory - of the bad events - helps.

Full paper available at www.mcging.com.au/index.php/publications/#erm

Words of Wisdom - What counts?



"Everything that can be counted does not necessarily count,
everything that counts cannot necessarily be counted"

- Albert Einstein

Comment: Einstein was a brilliant physicist and philosopher of science who also thought deeply and had a sense of the world around him. His words of wisdom can be applied directly to several of the themes in this month's Gazette:

- The culture of an organisation counts highly but is hard to count.
- In communicating investment risk levels, traditionally past volatility can be counted - as the historical standard deviation of returns - but other aspects such as a super fund member's aversion to even temporary loss of capital cannot necessarily be counted - at least not simply or objectively. And future volatility cannot be known for certain.

McGING
ADVISORY & ACTUARIAL

Level 13, 160 Queen St
Melbourne VIC 3000
Phone (61 3) 8641 6970
Mobile 0411 229 641

sean.mcging@mcging.com.au
www.mcging.com.au
LinkedIn: Sean McGing