



The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

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AUSTRALIA'S PENSION 'VALUE FOR MONEY' BENCHMARKING RECOMMENDATIONS:

HOW THEIR IMPLEMENTATION COULD BE 'FAST-TRACKED' AROUND THE WORLD

"A slow but steady evolution in best practice on cost disclosure and reporting is changing the way pension funds think about the asset management industry as well as the way they structure their internal resources."

Investment & Pensions Europe
January 2017

"The sheer size of the superannuation system, combined with the compulsory and broad nature, makes the efficiency of the system paramount. Even small changes in efficiency can have significant impacts on the wealth and well-being of Australians."

The Australian Productivity Commission
November 2016

Cost Disclosure Is Not Enough

The January issue of IPE magazine contains an 11-page report titled "Light in the Fog? Fees & Costs". As background, it references emerging pension fund cost disclosure requirements by Swiss and Dutch regulators. For the UK, it references the developmental work of the Financial Conduct Authority (FCA) on 'value for money' measurement, and the pooling of Local Authority Pension Fund assets with the goal of delivering economies of scale and increased cost transparency.

There is of course, a fundamental problem with focusing on pension fund cost disclosure only. Cost information must be presented in a context that also addresses the value-creation question. It is 'value for money' that matters in pension fund management, and not whether costs are high or low relative to those of a comparable group of peers.

In the cited-above report titled "How to Assess the Competitiveness and Efficiency of the Superannuation System", the Australians demonstrate that they get this. It sets out assessment criteria and success indicators for the Australian pension system as a whole. Specifically, it sets out goals for the system, formulates assessment criteria based on these goals, and identifies indicators to facilitate the assessment. This *Letter* summarizes the sensible pension efficiency benchmarking proposals of the Australian Productivity Commission (APC) and offers a 'fast track' route to their implementation around the world.

The APC Proposals

Some time ago, the Australian Government set out the goal of its (Pillar 2) workplace pension system as "to provide income in retirement to substitute or supplement the (Pillar 1) Age Pension.....within the principles of fairness, adequacy, and sustainability". From under this broad aspirational policy umbrella, the APC asserts that the workplace pension system should target the best interests of pension plan members in both their accumulation and retirement phases. This framing highlights the importance of generating adequate long-term net returns, and also protecting member retirement balances and providing useful insurance.

With these policy ambitions, what are relevant system success assessment criteria? Or stated differently, how should pension system performance relative to the goals of generating adequate long-term net returns as well as adequate pension protection be benchmarked? The APC proposes that Australian benchmarking protocols should include similar metrics from other countries, from other periods of time, and from pre-established reference portfolios.

The APC's search for, and identification of a suite of performance benchmarks leads to a comprehensive list of indicators, facilitating "collective assessment, along with evidence-based interpretation and judgement". Specifically, APC's assessment framework has 5 system-level objectives, and 22 assessment criteria supported by 89 unique indicators. Importantly, most of the indicators rely on data already collected or that can be constructed from existing information sources. In broad terms, the indicators relate either to criteria to assess competition effectiveness in a pension system, or to assess its efficiency in producing pensions.

Criteria to Assess Competition Effectiveness

The APC wisely acknowledges that assessing how competition impacts efficiency in the pension services market place is a challenging proposition. On the supply side, is market concentration a good thing (e.g., creates scale economies), or a bad thing (e.g., leads to monopoly pricing)? On the demand side, in markets that suffer from asymmetric information, competition is often driven by irrelevant information (e.g., short-term investment performance) and unhelpful product proliferation. Does member engagement lead to them making more informed product and risk decisions? What is the role of decision defaults and opt-out architecture in plan design? Are these rules leading to better member outcomes?

Given these questions and considerations, APC suggests focusing on time series analyses. For example, is competition leading to a decline in industry fees and profit margins over time? Are the benefits from achieving economies of scale being passed through to better member outcomes over time (e.g., through improved service quality)?

Criteria to Assess System Efficiency

The APC report defines three types of efficiency (operational, allocative, and dynamic) in the development of performance indicators:

1. 'Net return' is a key system-level operational efficiency driver. Actual long-term net returns versus those of reference portfolios and of CPI+X benchmarks are both relevant indicators. Segmentation by member phase (i.e., accumulation or retirement), by asset classes, and by geography are also relevant. On the cost side, total costs should be captured and reported. They should also be disaggregated into the cost components so that the impacts of such factors as fund size, investment policy, and implementation strategies can be assessed and better understood.
2. On the allocative efficiency front, the APC will assess whether the pension system is providing the right information and vehicles to help members make good decisions about risk and retirement incomes. It will be important to distinguish between members' accumulation and retirement phases. Accumulation members need a simplified focus and long-term return compounding; retired members need help managing sequencing and longevity risks.
3. Finally, dynamic efficiency simply means improving operational and allocative efficiency over time. This would be confirmed by steady improvement over time in the system's operational and allocative efficiency metrics.

The APC report concludes by observing that the implementation of its recommendations "will be data-intensive". However, it estimates that 46% of the data requirements can be met from data that exists in the public domain, 37% can be gathered or purchased, and only 17% will have to be collected from funds or members.

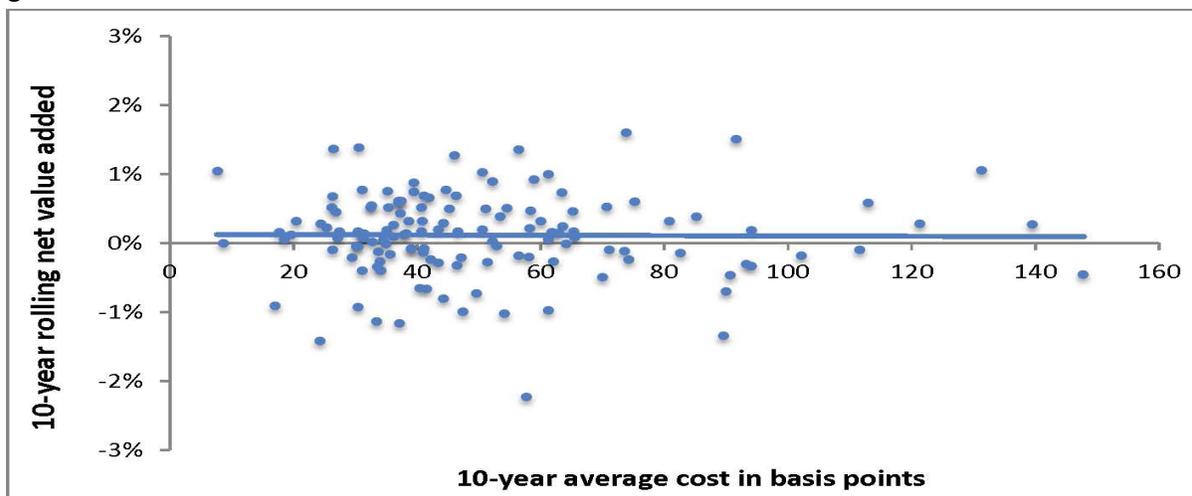
'Fast-Tracking' the APC Recommendations on Benchmarking Operational Efficiency

At first blush, implementing the APC recommendations seems like a challenging multi-decade slog. Happily, this does not need to be the case. The CEM Benchmarking Inc. organization has already designed and implemented many of the APC recommendations on an international basis, with the requisite pension organization databases going back to the 1990s. On the investment side, for example, CEM has extensive multi-national 'Net Return', Cost, Organizational Scale, Structure/Location, and Reference Portfolio data bases. Similarly, on the member services side, CEM has extensive multi-national Member Services Score, Cost, and Organizational Scale and Structure/Location databases.

These databases are close to ideal for benchmarking the kind of operational, allocative, and dynamic efficiencies the APC recommends. As just one example, Figure 1 plots the operational investment efficiency of the 133 pension funds from 8 countries with 10-years continuous investment data (2006-2015). Operational investment efficiency here is defined as {Net Return - Reference Portfolio Return}ⁱ. It is labelled Net Value-Added (NVA) in the graph and is plotted versus Average Operating Cost (OC). The average NVA for the 133 funds over this period was +0.11%/yr with a range from -2.24%/yr to +1.59%/yr. The average annual OC was 0.51%/yr, with a range of 0.08% to 1.48% of assets. Note that the reference portfolio returns were not reduced to reflect any implementation costs. A 0.10%/yr. cost assignment would raise all NVAs by 0.10%.ⁱⁱ

The large databases behind the calculations displayed in Figure 1 offer much grist for the operational efficiency research mill. For example, statistics confirm the visual observation in Figure 1 that there is no correlation between the 10-year NVA and OC numbers. In other words, on average, paying more for asset management did not raise the NVA in these 133 funds. Other recurrent research findings include a positive correlation between NVA and fund size, between NVA and proportion of the assets managed internally (especially private markets assets), and between NVA and governance quality.ⁱⁱⁱ

Figure 1 10-Year Net Value-Added versus Total Investment Costs - 2006-2015



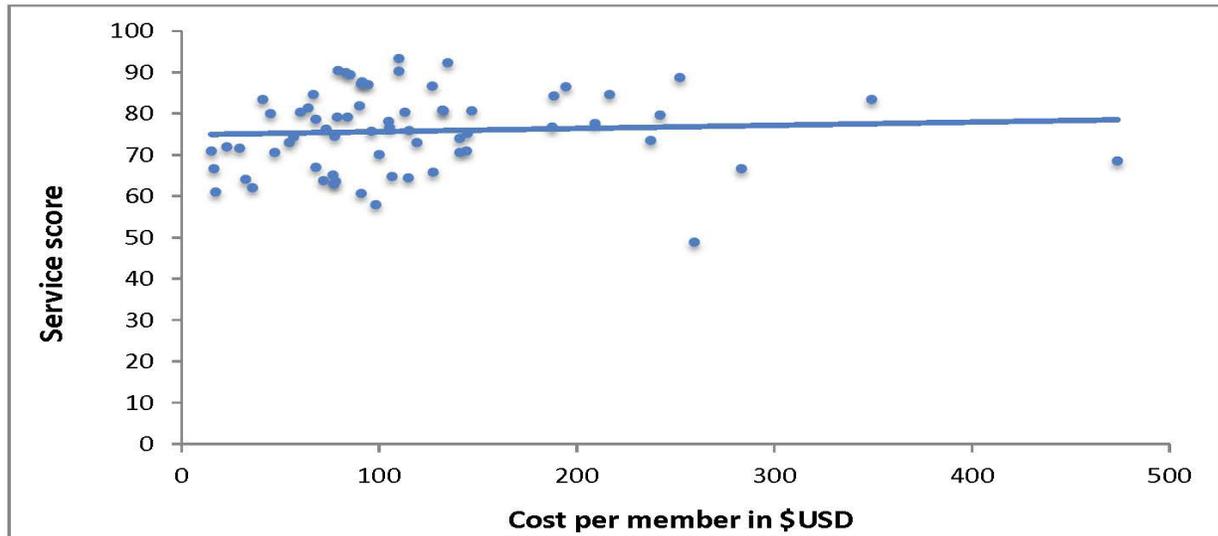
Source: CEM Benchmarking Inc.

'Fast-Tracking' the APC Recommendations on Benchmarking Allocative Efficiency

Measuring allocative efficiency means assessing whether a pension system is providing the right information and vehicles to help members make good decisions about risk and retirement incomes. To that end, CEM has been collecting member services data for some 20 years now. Specific metrics relate to features such as member communication and education programs, website and call center quality, information speed and accuracy, and data security. All this is aggregated up into an organizational Service Score scaled between 0 and 100. At the same time, all costs related to the member services function are aggregated up into an annual Cost/Member metric.

Figure 2 displays the Service Score vs. Cost/Member plot (all in USD) for the 68 pension organizations from five countries that provided the necessary data on 2015 (8 were Australian superfunds). The average Service Score was 76 around a range of 49 to 93. The average annual cost was \$117/Member around a range of \$15/member to \$473/member. Note there is now a slight positive correlation between Service Score and Cost/Member. That still leaves much to be explained why some participating organizations achieved a relatively high Service Score with a relatively low Cost/Member, while the reverse was true for other organizations.

Figure 2 Member Services Scores vs. Cost of Delivery - 2015



Source: CEM Benchmarking Inc.

Benchmarking Pension System Efficiency around the World

The Australian Productivity Commission is to be commended for its work in thinking through the proper goals of a pension system and how goal achievement should be benchmarked. This *Letter* points out that (a) its work is not only relevant in Australia, but in other countries with developed pension systems as well, and (b) much of what it proposes already exists.^{iv} Thus there is now a realistic opportunity to benchmark pension system efficiency (i.e., ‘value for money’) around the world in a logical, consistent, comparable manner.

Carpe diem!

Keith Ambachtsheer

Endnotes:

- i. CEM has developed standard definitions for actual compounded 10-year fund net return and for compounded 10-year reference portfolio return. Each fund supplies its own reference portfolio to reflect the fund’s own investment policy.
- ii. In other words, actually managing a reference portfolio is not cost-free; a 0.10% annual cost is not unreasonable.
- iii. Visit the CEM website www.cembenchmarking.com for access to research findings using its investment and benefit administration databases.
- iv. Full disclosure: I am a cofounder and co-owner of CEM Benchmarking Inc.

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