FAQ Superannuation

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In the pastime known as “advocacy by numbers”, averages are often used to advertise, cajole, or mislead. The airline on which you’re flying has an average delay of four minutes, but that knowledge is of little comfort when *your* flight has a two hour delay. You book a skiing holiday at a resort with an average 15 cm of snow cover, but the ground is bare when you arrive. In fact most planes leave on time but a few are severely delayed, snow falls either generously or not at all. “Averages” in such situations carry little meaning.

There has been a similar argument over superannuation charges. Those who defend the industry’s performance cite averages, while critics point out that many Australians are facing very high fees and charges.

The issue has risen in prominence recently. In part, this is because 16 years into the operation of compulsory superannuation, members’ balances are rising and people are therefore taking more interest – assets of superannuation funds doubled between 1996 and 2001. It is also because 2001 marked the end of a stretch of outstandingly high earnings by the funds. For many, their 2001 returns revealed a loss over the year. When earnings are high management fees may cause little concern. When earnings fall the impact of fees is far more noticeable.

Dr Hazel Bateman from the University of New South Wales has been researching the superannuation industry for many years. She is one of the authors of a major economic analysis of the industry[1], and in late 2001 she published a paper on disclosure of superannuation fees[2]. One figure in that paper, which showed that the average level of fees and charges was 1.7 percent of assets, captured a great deal of attention. It provoked a rejoinder from the Association of Superannuation Funds of Australia (ASFA) claiming that average fees were only 1.3 percent of assets.[3] The debate was also raised in the letters and columns of the financial press.

Analysis of the work by Bateman and ASFA shows that the discrepancy results from differences in data (ASFA had the benefit of more recent data), definitions of what constitutes a fee, and how an “average” is calculated (in technical terms, what weighting is used). But we may well ask why there is such a fuss about a difference of only 0.4 percent, and why there is concern at all with what look like small figures.

There are two explanations. First, fees of one or two percent are highly significant. And second, the “average” means little, for while most Australians belong to funds with reasonably low fees, some are in funds with very high fees. The “average” has no more meaning in superannuation than it has in airline delays or snow depths. (In her paper Bateman did not give prominence to the “average” figure, and she carefully qualified the term’s use, but such qualifications did not appear in the ensuing heated debate.)

When fees are taken as a percentage of assets the effect is the same as reducing a fund’s earnings by that same percentage. If a fund is earning twelve percent, a fee of one percent leaves eleven percent, but if it is earning only six percent that same one percent has a much higher proportional effect. The effect on one’s final retirement accumulation is roughly to reduce it by the percentage fee divided by the percentage real return. Thus, if the fund were earning a six percent return, a one percent fee would take roughly one sixth of the retirement accumulation – perhaps around $100 000 for a typical accumulation for someone who had continuous employment. (See Louise Sylvan's article in the Summer 2002 *Consuming Interest*). That's why the numbers are significant and why a difference of 0.4 percent does count.

An earning rate of six percent may sound low, but it's a reasonable long term expectation for a *real* return – that is the return after inflation. If a fund's nominal earning is nine percent and if inflation is three percent, then the real, after-inflation return, is six percent, for three percent of that return has to be used to restore the real value of the investment.

The period from 1996 to 2000, which many fund promoters use as a base for their claims of high returns, was one of unusually high returns. It covered the peak of the business cycle, and there were several once-off events which projected Australian stockmarkets to high levels. Superannuation, however, is an investment for the long haul, which has to endure recessions, external shocks and other business setbacks as well as the good times. While no-one can predict future returns, six percent is a more reasonable figure than the higher returns achieved over the late nineties.

Retail funds

The other point is that, while most Australians are covered by corporate or industry funds with reasonably low management fees, from 0.4 to 1.4 percent of assets, an increasing number rely on what are known as "retail" funds, with much higher fees. There are few funds charging the industry "average".

Corporate funds, as their name implies, are run by corporations for the benefit of their own employees, and industry funds are non-profit institutions governed by boards of union and industry representatives, set up under the agreements which accompanied the introduction of compulsory superannuation. Seven million Australians belong to industry funds, but these funds account for only a small proportion of superannuation assets, almost half of which are in the older corporate and public sector funds.

Table XX - Superannuation funds Australia 2001

	Members (million)	Growth in membership % p.a. '97 - '01	Assets $ bn	Assets per member $'000
Industry	6.9	8.3%	43	6.2
Corporate	1.6	4.4%	80	51.1
Public sector	2.8	-1.4%	110	39.9
Retail	11.2	12.0%	151	13.5
Small funds	0.3	13.1%	81	215.1
	22.8	8.4%	465	20.4

Source: APRA June 2001 return

Those who belong to industry and corporate funds have powerful bodies – corporations, unions and industry associations – looking after their interests. In many cases employers cover some of the administrative costs themselves. (That's one reason researchers find it difficult to make firm comparisons of administrative costs.)

But the the strongest growth in membership is in the for-profit retail funds, in which Bateman's analysis finds average fees of around 2.1 percent and ASFA's analysis 2.0 percent. Some fees on retail products are as high as 3.0 percent – enough to take half the earnings of a fund yielding 6.0 percent.

These fees are high because of marketing costs and the need to return a profit to their owners. There is also some suggestion that there is a relationship between fee levels and fund performance, but this is doubtful. While a passive and cautious investment strategy may result in low fees and low returns, there is no evidence that very high fees result in strong long term returns. In fact, as shown in Table 2 of Louise Sylvan's article, the low-cost industry funds seem to outperform the high-cost retail funds. There is also the valid claim that fees as a proportion of assets are high because balances are low. If so, we should see some reduction in the percentage over time, but there will still be a premium for marketing costs and profit.

Although many industry funds are open to external members, the self-employed and small businesses generally choose these retail funds. As in other markets, those with least power and least capacity to shop around pay the highest prices. In the case of superannuation the cost of that weakness in the market will not be evident for many years.

Compulsory superannuation was introduced a politically and economically expedient move in the mid 1980s. Since then, while there has been a large amount of tinkering at the edges, there has been little consideration of basic policies. The main question raised by the growth of retail funds is whether we should permit a compulsory levy, designed to provide national savings and retirement incomes, to be diverted to marketing costs and the profits of financial institutions.

References

1. Hazel Bateman, Geoffrey Kingston and John Piggott *Forced Saving: Mandating Private Retirement Incomes* (Cambridge University press UK 2001).

2. Hazel Batemen "Disclosure of Superannuation Fees and Charges" Paper prepared for the Australian Institution of Superannuation Trustees August 2001.

3. Ross Clare "Are Administration and investment costs in the Australian superannuation industry too high?" (ASFA Research Centre 2001).