HEALTH WEALTH CAREER

MYSUPER – MARKET TRENDS

MAY 2016

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AT A GLANCE

OVERALL OBSERVATIONS

116

approved MySuper products as at December 2015, which is the same number as at December 2013.

43

RSE licensees do not currently offer MySuper products

MySuper products are made up of Retail (40%), Industry (38%), Corporate (14%) and Public Sector Funds (9%).

25%

of MySuper products by number have adopted lifecycle approaches, representing 32% of total default assets.

WHERE A MYSUPER LIFECYCLE APPROACH IS USED

A clear divergence in lifecycle implementation approaches observed, with Industry Funds in general opting for member switching, while Retail Funds are favouring cohort approaches.

Average exposure of 90% to growth assets at beginning of lifecycle, average of 45% at retirement.

Average age when de-risking begins is 41 years of age.

Most funds have elected not to use the maximum of four price points allowed by APRA for lifecycle strategies.

INTRODUCTION

More than two years have now passed since the introduction of the MySuper regulations and the mandatory requirement to invest all default contributions into an approved MySuper product. As the dust has now well and truly settled on the MySuper implementation, we take stock on how MySuper defaults have evolved over the last two years.

As at December 2015, there were 116 licensed MySuper products (the same as in January 2014), however there have been notable changes within the composition of this group. The table below outlines the number of approved MySuper products as at 31 December 2015, broken down by market type and whether they have opted to use a static or lifecycle investment approach. Lifecycle products have increased from less than ten prior to the introduction of MySuper, to 29 as at December 2015 (representing approximately $145 bn or 32% of total MySuper assets). Static SAA approaches continue to be the most common MySuper approach.

Table 1: MySuper product summary as at 31 December 2015

	Total	Static SAA	Lifecycle
Retail	46	25	21
Industry	44	42	2
Corporate	16	14	2
Public Sector	10	6	4
Total	116	87	29

Source: APRA
Note: Non-regulated super funds excluded

As at 31 December 2015, 103 RSE licensees have approval to offer MySuper products. Given the 146 RSE Licensees in existence today, this means a significant number (43) do not offer a MySuper product. There are several reasons why an RSE licensee may not seek APRA authorisation for a MySuper product, including:

- They have opted to offer 'choice' options only. We have observed several smaller funds with active membership bases contacting members individually to ensure that each member has expressed an active choice and as such are no longer a 'default member'.
- They have decided to 'outsource' their default investment option to other providers with an approved MySuper license.
- They are not covered by the legislation – for example, closed funds, Defined Benefit funds or trustees of Self-managed super funds.

While some elements of the broader industry changes (mainly around reporting and disclosure) are still being progressed, there is no doubt that the 1 July 2017 MySuper implementation deadline marks a significant milestone for how the savings of default members are managed.

DEFAULT INVESTMENT APPROACHES

The introduction of MySuper in 2014 has provided a catalyst for many Australian superannuation providers to reassess what is in the best interests of their members.

Traditionally, investment options with a static Strategic Asset Allocation (SAA) have been the mainstay of the Australian superannuation industry; however the MySuper process has encouraged many to question this long-standing approach and to change the investment mind set from "wealth maximisation" to one that is outcome focused. The issue of defining what level of investment risk is "in the best interests of members" has led to an increased interest in investment offerings where the underlying strategy is more aligned with a member's specific circumstances at different periods of his or her lifetime. The discussion surrounding the advantages and disadvantages of a lifecycle investment approach remains topical.

As highlighted in the recent Financial System Inquiry, the MySuper legislation has only focused on the pre-retirement phase despite the fact that helping members access an adequate and sustainable income in retirement is an overarching objective of the whole superannuation system. There is definitely broad recognition that more needs to be done to improve the options available to retirees to draw down their income in retirement. We note that an increasing number of superannuation providers are reviewing how their MySuper products need to evolve in an effort to provide default members with a more comprehensive investment solution that integrates with separate offerings targeted for the retirement phase. We expect this trend to continue and there to be more meaningful action from the industry in this area as the government provides further guidance around the evolution of post-retirement investment solutions.

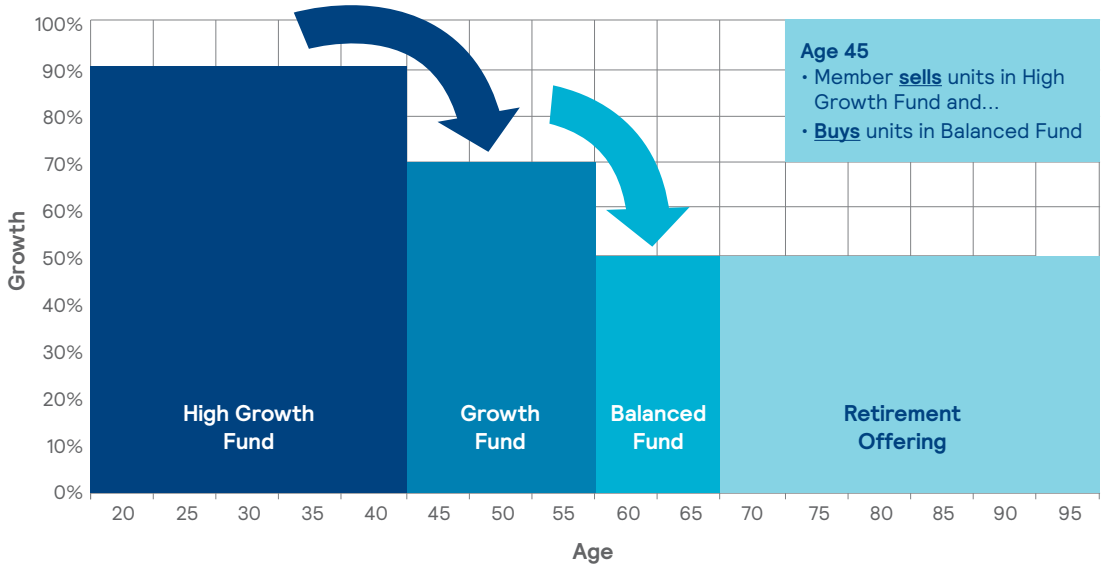
Much of the remainder of this paper considers the evolution of MySuper products that employ lifecycle investment approaches, as these approaches are becoming more prevalent. There are a number of superannuation providers that initially have rebranded their pre-existing static default option under MySuper, but are now investigating the adoption of a lifecycle default investment strategy.

IMPLEMENTATION OF A LIFECYCLE FUND

For those superannuation providers opting to offer members a lifecycle MySuper product, there are broadly two different implementation approaches being employed.

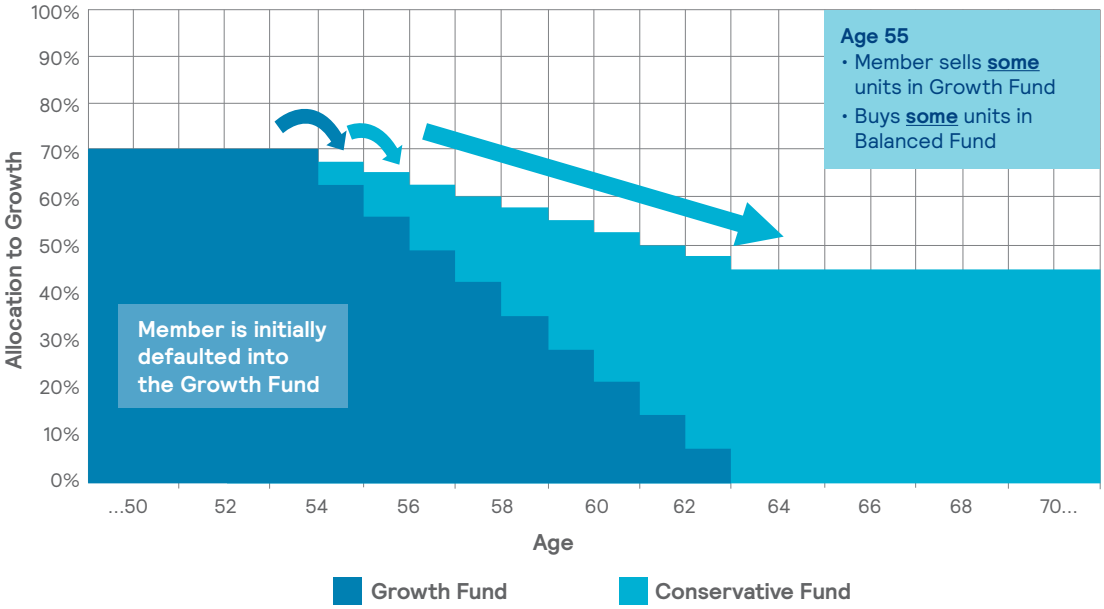
1. Member switching – this approach typically involves using a super fund's existing diversified options and systematically shifting members from the growth oriented options to the more defensive ones as they get older. This approach is illustrated under exhibits 1 and 2 below.

APPROACH 1: MEMBER SWITCHING (MARK I)



Note: Illustrative example only

APPROACH 2: MEMBER SWITCHING (MARK II)



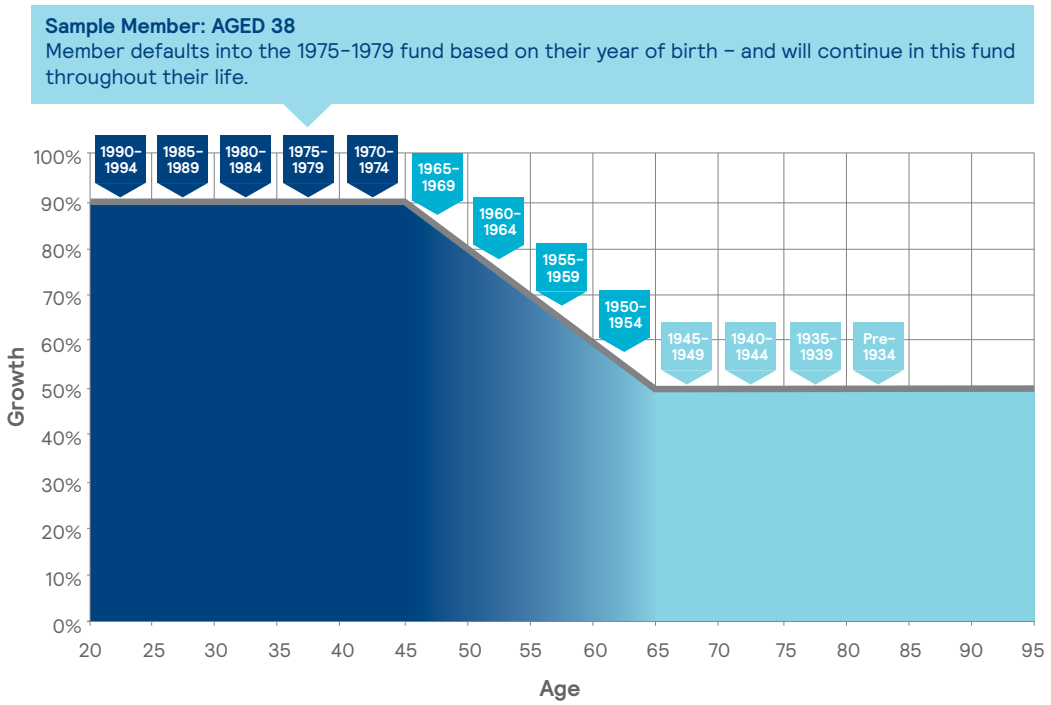
Note: Illustrative example only

While both approaches seek to reduce risk (measured by overall growth exposure) as a member gets older, we note that the first approach involves reducing risk via switches that are more infrequent and larger in scale. Given the principally systematic nature of these switches under an age-based lifecycle approach, it is generally accepted that gradually reducing the risk over time is preferable and a prudent way to minimise the chance of switching at the wrong time (e.g. just after a large fall in equities).

In general, member switching approaches that utilise the existing superannuation fund infrastructure are less complex and easier to implement from an administration perspective when compared to cohort funds (described below).

2. Cohort Funds – this approach involves creating a range of investment funds that are managed in line with what is deemed appropriate for members of broadly the same age. Rather than switching to different funds over time, members remain within the same cohort fund and the underlying strategy evolves as a member ages. This approach is illustrated under exhibit 3 below.

APPROACH 3: COHORT FUNDS (5-YEAR AGE BANDS)



Note: Illustrative example only

Cohort funds, as the name suggests, involves pooling members with similar characteristics (typically based on age) into an investment fund that is managed over time based on their common circumstances. A well-established form of cohort fund in the US is Target Date Funds, where the underlying strategy is broadly aligned with the date at which they expect to retire. The approach most commonly adopted in Australia is shown in the diagram above, where a member's date of birth is used to determine which cohort fund is most appropriate. This example shows the use of five-year age cohorts, whereas a number of Australian super funds have opted to use ten-year age cohorts for pooling members together. One of the common features of a cohort approach is that the default member remains in the same cohort fund until they retire, with the investment strategy underlying the cohort fund changing over time to reflect the characteristics of the members in the cohort.

It is often observed that not all static SAA default options are built equally and the same is true of lifecycle funds. As discussed, constructing a lifecycle fund can be implemented in a variety of ways and there are also a myriad of views on the 'shape' that the glidepath design should take in order to deliver the best outcome for members.

LIFECYCLE FUNDS UNDER MYSUPER – EMERGING TRENDS

Although the pool of lifecycle funds available in Australia is in its relative infancy compared to the UK and US, it is interesting to observe the different trends emerging as to how lifecycle providers approach constructing and implementing their product. Our objective is not to assess the advantages and disadvantages of these different approaches but rather to provide an overview of how lifecycle products can vary in a number of key areas.

Table 2: Lifecycle fund providers – market breakdown

	Total	Implementation Approach		"To" Retirement	"Through" Retirement
		Member Switching	Cohort Funds		
Retail	21	6	15	8	13
Industry	2	2	0	1	1
Corporate	2	2	0	2	0
Public Sector	4	4	0	3	1
Total	29	14	15	14	15

As at 31 December 2015. Source: Mercer, APRA.
Note: Non-regulated super funds excluded.

When looking at the lifecycle products being developed under MySuper, a clear division has emerged between the approaches taken by retail and industry super funds. Industry funds are generally less active in the use of lifecycle options and have to date favoured the member switching approach, with all industry super funds selecting this implementation approach for their lifecycle fund. In contrast, a clear majority of retail funds have chosen to offer cohort funds to their members.

Despite the fact that the MySuper legislation only covers the period up until retirement, it is noteworthy that around half of the MySuper lifecycle funds available in Australia at present are designed to go "through" retirement. The number of MySuper lifecycle funds adopting such a design has double over the last couple of years and we expect this trend will continue over time if the anticipated regulations and legislation governing default post-retirement investment solutions are announced and come into force.

In the tables that follow, we have listed some of the key features that need to be considered when designing the glidepath for a lifecycle fund and how the group of Australian lifecycle fund providers have approached each feature.

Table 3: Lifecycle funds – key features

	Minimum	Average	Maximum
Frequency of "de-risking" switches*	1	12	120^
Number of age cohorts**	6	9	16
Age at which de-risking begins***	21	41	75

* Only applies to 14 lifecycle funds using a 'member switching' implementation approach.
** Only applies to the 15 lifecycle funds that have opted for cohort implementation approach.
*** Applies to both member switching and cohort funds.
^ Represents a fund which undertakes monthly switches from ages 55-65.
As at December 2015. Source: Mercer, APRA.
Note: Non-regulated super funds excluded

FREQUENCY OF 'DE-RISKING' SWITCHES

"De-risking" switches refer to the systematic transfer from growth to defensive assets that occurs under a member switching implementation approach. We note that there is quite a wide range in the *frequency of 'de-risking' switches* underlying the fourteen lifecycle funds that have opted for a member switching implementation approach. For example, the fund that makes only one switch has opted to make a systematic move on behalf of members from a growth oriented diversified option to a conservative one once they have reached a pre-determined age. On the other end of the scale, another fund has opted to make incremental switches on a monthly basis between the ages of 55 and 65 that total to 120 over the 10 year period. For this particular fund, members are gradually transitioned from a balanced portfolio to separate retirement and cash pools. Future contributions will also be allocated between these pools based on the member's age. At retirement, it is expected that the member will be fully invested across the retirement and cash pools.

NUMBER OF AGE COHORTS SHOWN

The *number of age cohorts* shown above is indicative of how broad the age band is for each investment pool available to members. The frequency of "de-risking" switches within each age-band is not readily available information at this stage. Of the fifteen funds that take a cohort approach to implementation, eleven pool all members aged within ten-years of each other into the same investment cohort whilst four use five-year bands. While it might seem intuitive that having one-year cohorts (investment pools for members of every age) would be optimal from a tailored member solution design perspective, this clearly can be an administrative challenge and potentially cost-prohibitive for some superannuation providers. To date, no Australian superannuation provider has adopted such an approach.

AGE AT WHICH 'DE-RISKING' BEGINS

The *age at which 'de-risking' begins* can be a key determinant of the overall outcome members can expect to achieve when investing in a lifecycle fund. As evident in the table above, some believe the process of reducing risk should begin very early in a member's working career whereas others see merit in maintaining a higher growth exposure for later into a member's working life. We note that one particular fund (using a member switching approach) has opted to effectively have two funds underlying their lifecycle option, one for members under 75 and one for those aged over 75. This particular option will clearly skew the numbers in the table above. While maintaining a higher allocation to growth assets for longer generally results in a member having a higher expected balance at retirement, there is also usually greater uncertainty surrounding the outcome given the volatility associated with the higher growth exposure. This risk/reward trade-off is a constant consideration in the design of any lifecycle glidepath and highlights the importance of having clearly defined investment objectives.

The data in the tables that follow is based on the available information underlying the 29 MySuper lifecycle products in Australia as at 31 December 2015 (including both *member switching* and *cohort fund* approaches).

Table 4: Asset Allocation throughout Lifecycle as at 31 December 2015

Allocation to Assets	Minimum	Average	Maximum
Growth Assets at Start	72%	90%	100%
Growth Assets at Retirement	8%	45%	63%
If 'through' retirement - lowest allocation to growth assets	0%	34%	63%

Source: Mercer, APRA
Note: One MySuper lifecycle option switches members from one investment strategy once they reach 75 years old to a more conservative one is quite unusual and also skews the numbers in the table below. The fund for members under 75 has an 89% allocation to growth assets whereas the fund for those over 75 still has a relatively high growth allocation at 63%.

FEE OBSERVATIONS

Although the government's legislation has permitted there to be four separate fee levels ('price points') under a MySuper investment option, observations to date indicate that most cohort funds offering a lifecycle option have decided to charge a single investment fee. It should be noted that the ability to use more than one price point was a late concession by the government at the time and therefore was likely a contributing factor to there being a considerable proportion that have decided not to employ this flexibility to date.

The absolute investment fee underlying each lifecycle fund will clearly be influenced by the level of active management used over time. While this area keeps evolving, we observe that a number of retail funds have opted to employ passive management in some or all of their underlying portfolios.

ACCRUED DEFAULT AMOUNTS

A superannuation fund's Accrued Default Amounts (ADA) is defined by APRA as member contributions under which the member has given the trustee no direction on the investment option in which the contribution is to be invested. In the two years to September 2015, the total value of ADA's decreased by 76.5% to $51.9 bn, which also represented a 74.8% decrease in the member account composition of ADA's to 2.5 million accounts.

Under section 387 of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)*, all RSE licensees must transfer the existing balance of remaining ADA's to a MySuper product by 1 July 2017. The 62 RSE's that still have an ADA must provide APRA with suitable product in which to transfer remaining ADA's before 30 June 2016, or will be required to report the number of affected members and ADA values to APRA. This requirement may stimulate further change in the MySuper space.

CONCLUSION

Two years since the implementation of the MySuper legislation, the nature and range of default investment offerings continue to evolve. While default solutions using static SAAs remain the most common approach for MySuper providers, there is trend that lifecycle funds are growing in prevalence. Mercer expects that future improvements in administration systems and the adoption of investment strategies that are more representative of super fund member demographics will support the trend of adopting lifecycle strategies as the default investment strategy in Australia. In addition, due to APRA's requirement that all ADA's to be transferred by the 1 July 2017, we are likely to see more activity in this space over the next 12 months.

There are many layers to the debate as to what constitutes a well-designed lifecycle glidepath but there is clearly a growing consensus in this market that the ability to take a member's circumstances (even if this is primarily their age) into account when setting their investment strategy is a step in the right direction. This paper has considered some of those key features underlying the design and implementation of any lifecycle fund and demonstrated that there are currently a variety of different approaches being taken.

Importantly, any effort to tailor a member's investment strategy more closely to their particular circumstances is done with a view to increasing their chances of having an adequate and sustainable income in retirement. Now that the MySuper strategies of super funds are largely bedded down, we expect to see a greater focus on helping those same members improve their options when drawing down an income throughout retirement.

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