Incentives and outcomes: Our odd superannuation system

Market minds

Chad Slater

My firm is no slave to the Warren Buffett school of value investing, but we do read widely and I've always respected Charlie Munger in particular – I think he never gets the credit he deserves. He really is the closest to a polymath I have seen in investing, and he is unfairly reduced to a moat investor who buys quality companies, which is shorthand for Buffett investing these days.

Poor Charlie's Almanack, a collection of his speeches published in 2005, recalls one of his most important speeches given in 1994 at Harvard on the psychology of human misjudgment. One line always stood out: "Show me the incentives and I will show you the outcome." If you are a young analyst and remember nothing else, remember that.

So how is that relevant to superannuation? Let's start with your mandated 9.5 per cent super contribution which has created the world's fourth largest pension pool.

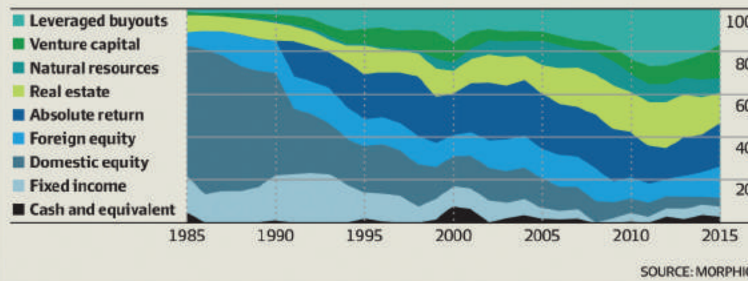
Australia has ended up with a separation between the decision to save (individually mandated, unlike the US's 401k plan) and the person who oversees it (the industry/retail superannuation fund). Munger would see straight away that we've opened an "agency risk" problem.

This is one of the many ways we are odd. What's the incentive for institutional super funds? Don't fail alone. So they herd (and I'm not picking on industry funds – retail funds have done worse). The money will come in every month so you focus on what you can control – fees.

To overcome this, governments encouraged the growth of SMSF investors to give "choice". Yet choice in financial services is a curious concept. You rely on heuristics or mental shortcuts ("a friend said they were good" or "I know that stock"), which is another of Munger's psychology biases.

You are also being asked to make choices that affect you 30 or 40 years from now – another thing humans are bad at. You can measure super fund performance, but this fails to account for how good and bad behaviour in super is rewarded and punished. Together this has fuelled characteristics in asset allocation that you don't see offshore: nearly all the money is in local equities and local bonds with little in hedge funds or alternative assets.

If we compare this to the Yale endowment allocation (another long-term pension plan), it's chalk and cheese. Yale has moved away from using vanilla equities to construct its portfolio and uses a lot of what would seem exotic, to many readers, asset classes. Fees matter, but I'd argue and Yale seems to agree, so do risks.



Which brings me to the last risk: when I look at Australian superannuation today, I see a sector that is massively long sequencing risk. This is the risk that your investment experiences poor returns before good ones, but you need the money, thus locking in losses.

As the boomers move into retirement this risk rises. One way to address sequencing risk is to use hedge funds or absolute return strategies. But how can a regular investor possibly know or choose between the myriad of hedge fund options from leveraged buyout through to venture capital?

I'd suggest there are two parts to the solution. Firstly all default options revert to government-run schemes with defined target returns. The move to letting individuals set their retirement target asset allocation and choices doesn't work for the average investor, as reported by *The Australian Financial Review's* Angus Grigg. One innovation from Sweden could be to create a series of funds, each one managing a cohort of a certain age to their appropriate liquidity and return profile.

That way illiquid assets (infrastructure) could be held easily within the fund with the lowest sequencing risk. Individuals could still opt out if you wanted. The second is for the government to mandate that any fund over $10 billion allocate 5 per cent to small or new managers within the alternatives sector.

The last of the oddities of our super model is the lack of diversity in the funds manufacturing pool. Australia has over 150 Australian equities managers and probably less than 20 "pure" Australian equity hedge funds. The UK market produces a larger range of fund managers despite not being that much larger in population and savings pool and I believe that reflects the diversity of client types: endowments through to pension pools and family offices.

The market for your retirement savings isn't a capitalist market and shouldn't be treated like one. If going to mandate compulsory savings, why not build a world-class funds management sector to support it? There is no reason for hedge funds to be run only out of Hong Kong or Singapore (I don't buy the tax argument, again, look at Britain).

Munger's awareness of agency risk suggests large funds are unlikely to want to work with smaller or newer firms unless the government legislates it, despite both types producing better risk-adjusted returns.

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