**SHORT CHANGED: CONFLICTED SUPERSTRUCTURES**

Anthony Asher  
Visiting Associate  
Department of Actuarial Studies  
Macquarie University  
1 July 2004

**Introduction**

Are superannuation fund members short changed? The different types of Australian superannuation funds do charge significantly different fees. Some of the difference clearly arises from the quality and scope of the service offered. This paper investigates this and other less innocent explanations. Of particular concern are the conflicts of interest in some organizational structures.

The first section identifies the various types of funds. The second describes the major regulatory protections offered to members, which while offering protection against exploitation, can also give rise to additional expenses. The third section looks at market or regulatory failures that could be used to explain the apparently excessive charges. The fourth section turns to the different functions performed by the trustees of the funds, and identifies potential conflicts of interest as an alternative explanation. The fifth section looks at the costs associated with these functions for the different fund types, confirming the differences and identifying the main expense drivers. The final section concludes with topics for additional research and some policy questions.

1 Types of funds

Australian superannuation funds are classified in a variety of ways in legislation, and in the industry statistics published by the Australian Prudential Regulation Authority (APRA). It should be noted that there are inconsistencies in the definitions used for different purposes. This section sets out the main classifications. They are summarized in table 1 on the next page.

In this paper, we are concerned only with “complying funds”¹, contributions to which may be deducted for tax purposes and which qualify for favourable tax treatment of investment income. The funds can be divided in four ways:

1.1 By trustee

All superannuation funds, except Retirement Savings Accounts (RSAs), must be managed by a trustee. The trustee is generally a corporate body with its own board of directors but in some circumstances can be a group of natural persons. I refer to “trustees” in this paper to mean both types.

Until the 2004 changes to the Superannuation Industry (Supervision) Act 1993 (the SIS Act), only the trustees of public offer funds were licensed by APRA. They are known as “approved trustees”². The 2004 changes will require the trustees of

---
¹ Defined in part 5, division 2 of the SIS Act.
² Defined in section 10 of the SIS Act, but will fall away on 30/6/2004.
all APRA regulated funds to be licensed, with approved trustees falling into a separate class.

### TABLE 1: TYPES OF FUNDS

<table>
<thead>
<tr>
<th>Funds with fewer than 5 members</th>
<th>Employer sponsored</th>
<th>Approved Trustee</th>
<th>Public sector</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAF</td>
<td>P</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>SMSF</td>
<td>P</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Exempt ADF</td>
<td>N</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Funds with 5 or more members</th>
<th>Employer sponsored</th>
<th>Approved Trustee</th>
<th>Public sector</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Public sector</td>
<td>Y</td>
<td>Y: PO</td>
<td>N: NPO</td>
<td>Y</td>
</tr>
<tr>
<td>Industry</td>
<td>P</td>
<td>Y: PO</td>
<td>N: NPO</td>
<td>P</td>
</tr>
<tr>
<td>Retail</td>
<td>P</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Funds with special purposes</th>
<th>Employer sponsored</th>
<th>Approved Trustee</th>
<th>Public sector</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSTs</td>
<td>N</td>
<td>Y</td>
<td>P</td>
<td>P</td>
</tr>
<tr>
<td>ADF</td>
<td>N</td>
<td>Y</td>
<td>P</td>
<td>P</td>
</tr>
<tr>
<td>ERF</td>
<td>P</td>
<td>Y</td>
<td>P</td>
<td>P</td>
</tr>
</tbody>
</table>

**Key:**

<table>
<thead>
<tr>
<th>Y</th>
<th>Yes</th>
<th>PO</th>
<th>Public offer - approved trustee</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>No</td>
<td>NPO</td>
<td>Not public offer</td>
</tr>
<tr>
<td>P</td>
<td>Possibly yes or no</td>
<td>ADF</td>
<td>Approved deposit fund</td>
</tr>
<tr>
<td>SAF</td>
<td>Small APRA fund</td>
<td>ERF</td>
<td>Eligible rollover fund</td>
</tr>
<tr>
<td>SMSF</td>
<td>Self managed superannuation fund</td>
<td>PST</td>
<td>Pooled Superannuation Trust</td>
</tr>
</tbody>
</table>

## 1.2 By contractual parties

Another division relates to the parties that initiate the contract of membership.

### 1.2.1 Employer-sponsored

A fund is a "standard employer-sponsored fund" if all the contributions are made as a result of an arrangement between the employer and the trustees. The fund is "employer-sponsored" if the contribution is made as a result of an arrangement between the members and their employers.

APRA’s statistical collections effectively divide employer sponsored funds into three, based on the trustees’ perception of the fund. “Corporate funds” are

---

3 Defined in section 16 of the SIS Act
sponsored by a single employer or group of employers in the private sector. “Public sector funds”\(^4\) are sponsored by government or its agencies. “Industry funds” are sponsored by a diverse group of employers in the same or related industry, where the common link, and driving force, is often a representative union. The employers may be in the public or private sectors.

Members of employer sponsored funds may be given a choice of funds if the employer permits, and there is no award\(^5\) limiting such choices.

**1.2.2 Public offer funds**

Public offer funds\(^6\) are open to individuals, self-employed or otherwise, who then have a direct arrangement with the trustees, to which the employer may or may not be party.

Some employer sponsored funds, especially industry funds, have opened themselves to become public offer. More often, public offer funds have been set up by commercial companies initially for individuals, but also for groups of employers. These latter are the “retail funds” of the APRA statistics.

“Approved deposit funds” (ADFs)\(^7\) are public offer funds that are restricted in their operations to receiving a transfer of benefits from other funds, or certain payments from the Australian Tax Office (ATO). “Excluded” ADFs, which have only one member, are classified as small funds in the APRA statistics.

A “Pooled Superannuation Trust”\(^8\) (PST) is a unit trust in which other superannuation entities are the only investors. Assets of a life insurance company that back annuity products may also be classified as PSTs, and these companies may designate a further portion of their assets as “virtual PSTs”, or may invest these assets in PSTs. The assets backing life insurers’ annuity products are shown in the APRA statistics as the “balance of statutory funds”. Other PSTs are not counted in the statistical returns as to do so would double count superannuation assets. No statistics are collected for virtual PSTs.

RSAs\(^9\) are open to applications from individuals and operate like bank deposits. They are intended for people with small balances in their superannuation funds, or those who wish, for a short period, to make use of the capital guarantee they offer. They do not have registered trustees, and are not defined as public offer funds. The member has a contractual relationship with the bank or life insurance company, which then may be seen to have a fiduciary type responsibility to the account holders.

---

\(^4\) This definition is not to be confused with that defined in SIS Act section 10, which refers to funds set up by some law or under the control of a state body.

\(^5\) Awards made by the Australian Industrial Relations Commission, which is reluctant to require employers to contribute to a large number of different funds, and may require contributions to be made into any fund.

\(^6\) Defined in section 10 of the SIS Act

\(^7\) Defined by section 10 of the SIS Act

\(^8\) Defined by section 10 of the SIS Act and regulation 1.04 of the SIS Regulations.

\(^9\) Defined and administered in terms of the *Retirement Savings Accounts Act 1997*
1.2.3 Initiated by the members

There are small funds where every trustee is also a member of the fund. These are “self managed funds”\(^\text{10}\), which are regulated by the ATO not APRA, because there are no prudential risks.

Other small funds are set up by the members but the operations are delegated to a separate trustee. These are “small APRA funds”\(^\text{11}\), regulated by APRA because of the prudential risk.

1.2.4 Initiated by previous fund

Trustees face various restrictions\(^\text{12}\) in the amounts they can charge for administration fees. They are permitted, if they believe that some of their members’ accounts are too small to manage economically, to transfer those members’ benefits into “Eligible rollover funds” (ERFs)\(^\text{13}\). They do not require the permission of members to do so. ERFs are restricted in their charging and intended to provide low cost services for small accounts.

1.3 By benefit structure

Defined benefit (DB) funds are defined variously by the SIS Act\(^\text{14}\) as having at least one member with a prospective benefit related to salary or a fixed pension. “Accumulation funds”\(^\text{15}\) are defined as not being DB funds. The APRA statistical returns add an intermediate category of “hybrid funds” with both DB and accumulation members. The funds are however categorised subjectively by their trustees in the statistical returns, and may not be consistently defined. It appears that some retail funds with DB members are classified as accumulation funds in the statistics.

APRA statistics show that over two thirds of the assets in Australian funds are now in accumulation funds, with over 90% of the balance residing in funds defining themselves as hybrid. The accumulation funds can be divided further into those that offer choice of investment type, and those that go further and offer choice of investment manager. The latter are often called master trusts, but there appears to be no legal definition.

1.4 By manner of investment

The underlying assets can be held directly or via a range of alternative vehicles. Table 2, on the next page, shows the classifications.

---

\(^{10}\) Defined in section 17A of the SIS Act

\(^{11}\) These are defined as “certain small funds” in section 121A of the SIS Act.

\(^{12}\) In part 5 of the SIS Regulations

\(^{13}\) Defined in part 24 of the SIS Act

\(^{14}\) Section 83A of the SIS Act defines a DB fund as one having at least one DB member, and if a private sector fund, arrangements where the contributions are not hypothecated to members. Section 228 dispenses with the limitation on contributions but widens the definition of DB member to include members receiving a fixed pension. The SIS Regulations (1.03) use the section 228 definition, while the Superannuation Guarantee (Administration) Act 1992, which sets out the compulsory minimum contributions to superannuation funds, uses the definition from section 83A.

\(^{15}\) Defined in regulation 1.03 of the SIS Act.
2 Major regulatory protection

This section discusses the main regulatory protections offered to members that might be expected to limit the costs associated with superannuation.

The discussion is largely focused on:

- funds managed by people other than the members, that is the APRA regulated funds; and
- accumulation funds.

<table>
<thead>
<tr>
<th><strong>TABLE 2: MANNER OF INVESTMENT</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>APRA classification</strong></td>
</tr>
<tr>
<td>Directly invested</td>
</tr>
<tr>
<td>Placed with investment managers</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Through life insurance companies</td>
</tr>
</tbody>
</table>

2.1 Fiduciary responsibility

The commercial law framework for superannuation funds is based, in Australia, on the law of trusts. It is set out, inter alia, by Glover (2002):

“Investors, and more particularly members of superannuation funds enjoy significant protection from the common (or general) law. Corporate officers and advisers with whom we are concerned are disciplined at general law as ‘fiduciaries’. The term refers to the law’s code for the maintenance of the honesty and integrity of persons in positions of ascendency and trust. Its centrepiece is an ‘inflexible rule’ which prohibits fiduciaries, such as corporate officers and advisers, from putting themselves in positions where their interest and duty conflict.16

Their “interest” refers to their personal financial interests, their “duty” to their duty to members or perhaps shareholders. Glover goes on to identify conflicts of duty and duty where a director with more than one hat may owe different duties to the shareholders of different companies.

---

16 See *Bray v Ford* [1896] AC 44, 51; also *Phipps v Boardman*[1967] 2 AC 46, 123, (“AC” denotes House of Lords’ Appeal Cases)
He further points out that the traditional formulation of the rule is strict. “Possibility of a conflict is enough to attract the rule. ... Exposure of one’s self to temptation is made wrongful. Directors, as it were, are not given the chance to be dishonest.” He describes a failure in this area as fraud.

This prohibition is common in the rest of the world, where it is also sometimes included in the basic law of agency. Civil law jurisdictions, which do not recognise trusts, incorporate the provision in other law governing fiduciaries.

Fiduciary responsibilities also incorporate the requirement to be prudent, and a duty of care.

2.2 The main legislation

Superannuation funds are subject to various, largely concessionary, tax provisions set out in the separate *Income Tax (Assessment) Act 1936* and *Income Tax (Assessment) Act 1997*.

The rather confusingly named *Superannuation Guarantee (Administration) Act 1992* requires employers to make superannuation contributions on behalf of employees, currently at 9% of remuneration. The guarantee arises from the obligation placed on employers to guarantee that they have made the required contributions.

The SIS Act, and the *Superannuation Industry (Supervision) Regulations 1994* (the SIS Regulations) followed. They provide for compliance with tax, guarantee, and other policy issues, and for prudential supervision. They can be seen to codify, adapt and extend the provisions in the general law17.

2.3 Equal representation

The SIS Act requires half the trustees of standard employer-sponsored funds to be member representatives18. These may be directly elected or appointed by a representative union. Employer representatives may also be appointed by an organization representative of the employer’s interests. There may also be additional independent trustees. While employer appointed trustees may have greater technical knowledge, member appointed representatives may be able to assist in communication with the members. They can also provide some balance to possible conflicts of interest faced by employer trustees also interested in the profits of the employer.

Public offer funds that have standard employer-sponsored members only have to allow for policy committees, on which members will be represented, but which have no power beyond that of the right to be consulted.

Pensioners, if they exist, are not necessarily entitled to representation.

---

17 In particular, Part 6 of the SIS Act sets out provisions that require the trustees to be prudent and free from inappropriate influences (direction).

18 Part 9 of the SIS Act
2.4 Fit and proper

APRA has the power\textsuperscript{19} to disqualify inappropriate persons from functioning as trustees, and as actuaries and auditors. These powers are in the process of being extended by draft new regulations.

The skill level required of a trustee is that of trust law, which is of “an ordinary prudent person”\textsuperscript{20}, without any particular skills in the management of superannuation. The new regulations will however require the trustees as a whole to have “sufficient knowledge” to make “informed decisions” before a licence will be granted.

2.5 Investment

The protection of the general trust law against conflicts in the choosing of investments is overridden in at least two sections of the SIS Act.

Specific provision is made to permit investments at less than “arms length”\textsuperscript{21}. The protection given is that the price must be determined on an arm’s length basis. APRA says of investments made on an arm’s length basis: “The test to apply is to consider whether a prudent person acting with due regard to their own commercial interests would have made such an investment.”\textsuperscript{22}

There are also complicated provisions that expressly permit, but restrict, “in-house” investments in related parties, including the employer sponsor\textsuperscript{23}.

The requirement in trust law to invest prudently is made explicit and the trustee is required to develop a strategy that considers investment risk, diversification, liquidity and the ability to meet liabilities\textsuperscript{24}.

2.6 Accounting

Trustees are required to keep the assets of the fund separated from their own, and prepare minutes, records and annual accounts and to make them and any other relevant information available to members. The applicable accounting standards are described in appendix 2.

2.7 Risk management

The proposed changes to the SIS regulations will require trustees to have a formal risk management strategy and plan that will be checked by APRA. They must include a business plan and specifically address all the risk faced by the trustees and the fund, the following being mentioned:

\textsuperscript{19} Part 15, 16 and 17 of the SIS Act
\textsuperscript{20} Section 52 (b) of the SIS Act
\textsuperscript{21} Section 109 of the SIS Act.
\textsuperscript{22} Superannuation Circular No. II.D.5
\textsuperscript{23} Part 8 of the SIS Act.
\textsuperscript{24} These are set out in section 52(8) of the SIS Act.
\textsuperscript{25} Defined in part 5 of the SIS regulations in terms of the general power to make regulations set out in section 31 of the SIS Act.
Governance: relating to definition, delegation and segregation of responsibilities, outsourcing and fraud;

Operational: relating to information systems and records, strategy;

Investment: relating to market, credit or counterparty, liquidity, and

Insurance.

2.8 Limitation on charges

Some accounts of less than $1,000 are given “member protection” that prevents administration charges exceeding investment earnings25.

These are a rather wasteful element of the system. Given that $1,000 represents less than a year’s contributions for those on the minimum wage, the protection is of miniscule value relative to the benefits that will ultimately emerge. The many uneconomic small accounts that have arisen from guarantee contributions belong to part-time and casual workers with low wages and high turnover. A large proportion of these are held for young people who would be much better off if they had the money to repay their debts26. In other instances, members should rather be encouraged to consolidate their accounts than be given this trivial protection.

The member protection rules do however establish the principle that charges can be capped.

3 Market, regulatory and institutional failure

The real puzzle that this paper addresses is the difference in costs between retail and industry public offer funds. Retail funds charge members between 1% and over 4% per annum – apart from their upfront deductions of up to 5%. Industry funds offer an apparently similar if not identical service for charges of not much more than 1% per annum. They have much smaller accounts on average, and there are normally no entry charges. It is widely believed that the high costs of the retail funds are excessive due to some form of market or regulatory failure.

This section briefly analyses these possibilities.

3.1 Market failure

The standard economic explanations for market failures of this sort are monopolistic practices and information asymmetries.

3.1.1 Monopolistic practices

There appears to have been no significant study that has argued that there is a lack of competition in the industry. Given the relative ease of entry and the numerous participants, one might expect a high level of competition and low level of fees. There are at least 10 significant institutions that compete in the public

26 The notion that people should begin early to save for retirement is demonstrably wrong – certainly if they want to own their own home. This is because the net yield on superannuation assets is likely to be much lower than the interest on a mortgage, let alone other consumer debt.
offer market, and many other smaller players. The recent Productivity Commission review specifically investigated the effect of legislation on competition and barriers to entry and found no evidence of a lack of competition. Partly as a consequence, it recommended additional restrictions to entry in the form of compulsory licensing of all trustees, with a view to giving members additional regulatory protection.

Clare (2001) and Rice and McEwin (2002) ask the question on behalf of the industry bodies, and both conclude that charges largely reflect a competitive industry. The ACCC also found no evidence of lack of competition in a recent investigation.28

If fees are too high, it would appear to be necessary to look further for an explanation.

3.1.2 Information asymmetries

The providers of superannuation products know more than the members, and it may be that this information asymmetry prevents members, or their employers, from making fully informed decisions. This possibility has led to considerable debate about the adequacies of product disclosure. The disclosure issues relate to comparability of fee structures between different competitors, and to the disclosure of commission earnings by intermediaries. Some of the issues are discussed at greater length by Bateman (2001).

The Australian Securities and Investment Commission (ASIC) is responsible for regulating the appropriate behaviour of all participants in financial markets including the trustees of public offer funds. ASIC also regulates financial advisors. Recent legislative changes29 have set new standards governing the disclosure of information and requiring the licensing of financial advisors by ASIC.

There is no doubt that the fee structure of superannuation funds can be complex. An ASIC report (2003) is intended to provide a basis for determining a standard approach to disclosure. It lists seven different types of fees and makes some suggestion for uniformity. Further regulatory developments in this area seem inevitable.

It is however difficult to believe that the difficulties involved in interpreting this information are worse in this industry than in others. Superannuation charges are relatively simple compared with the inner workings of a modern motor car or personal computer.

The investment management component of superannuation charges is particularly transparent and subject to competition in mastertrusts that offer a wide choice. As discussed later however, fees do not appear to be particularly competitive.

---


28 Of the takeover by National Australia Bank of Lend Lease, it reports: “The merger does not breach the concentration thresholds in any possible market. A number of possible markets were examined: broad “funds management” market; “wholesale” and “retail” funds management markets; separate markets for life insurance, superannuation, retail investment products; and narrow markets based on particular products (the latter are the least likely market definitions due to considerable demand- and supply-side substitutability). Eg, wholesale funds management - merged entity 7.4%, post-merger CR4 35.2%; life insurance 22% and 60%; super 13.8% and 46.8%; retail investment products 20.3% and 50.3%.” http://www.accc.gov.au/content/index.phtml/itemId/511775

29 The Financial Sector Reform Act (2001) and consequential legislation that have made changes to the Corporations Act (2001).
Again, other factors would appear to be at work.

### 3.2 Regulatory or legal failure

Markets do require a consistent legal framework in which to operate.

#### 3.2.1 Fiduciary breaches

The inflexible prohibition of trust law against conflicts of interest and duty, described in section 2.1 above, is not always obeyed, nor enforced. It is often argued that it is inconsistent with modern commercial practices: mainly those of directors with many interests or large commercial firms providing advice to large number of clients. Teele (1992) provides an example, and gives instances of legal judgments and sections of the Corporations Act that have diluted the effects of the law as an argument that the prohibition is outdated.

“Everybody is doing it” is however a poor argument. It is easily rebutted by “but that does not make it right.” The requirement to avoid conflicts of interest and duty is an ancient legal doctrine that provides one of the foundations of the division of labour that allows for our current economic prosperity. It follows from the recognition of human frailness in the face of temptation. Undermining it undermines all contracts of agency, all delegation, all trusteeship, all professionalism.

The importance of fiduciary responsibility is particularly important in long term contracts such as superannuation. It is difficult, if not impossible for some employees, to change funds. Under such circumstances, the competition and symmetrical information at point of sale are of little importance. The essential question is to ensure that the fund continues to be managed on behalf of the members. Of course, the need to attract new members and retain those that do have the option to move does provide an ongoing competitive discipline, but it is not necessarily enough.

In Spitzer (2004), the New York attorney general who has successfully prosecuted a number of financial firms for conflicts of interest, makes the point that the conflicts have been institutionalised in many parts of the financial services industry. His efforts have led to apparently reputable organisations in the USA paying billions in fines and compensation. The scandal is similar in many respects to the mis-selling problems of the UK life insurance industry of the nineties. Conflicts of interest cannot, *prima facie*, be ruled out as an explanation for excessive fees in the Australian superannuation industry.

#### 3.2.2 Agency risk in the economics literature

Agency risks have been investigated in the economics literature over the past three decades although they are, perhaps surprisingly, not often mentioned in the context of market failure\(^{30}\). The cure suggested in the literature appears to derive from greater monitoring and the alignment of incentives\(^{31}\). The increased disclosure, which has thus far been the major regulatory tool in Australia, perhaps arises from this economists’ perspective.

\(^{30}\) Yielding 44 references in a Google search against over 3,000 in a search for “market failure” and “information asymmetry”.

\(^{31}\) Debatable perhaps, but see the Economist’s useful economics dictionary at http://www.economist.com/research/Economics
It is suggested here that the management of agency risks may lie more with a more appropriate application of the law of agency.

3.2.3 Specific prohibitions

The essential prohibitions in the law are:

- That an agent or trustee should not make a secret profit. A trustee is entitled to remuneration which must be disclosed, and in this context agreed to by the member or sponsoring employer.

- That an individual should not enter into any contract both as a principal and as an agent or trustee of another.

- More debatable, the agent or trustee should not make a profit, disclosed or otherwise, that could be seen to influence his or her decision to the possible detriment of their principals, the members.

These issues are examined in section 4, when we look at the functions of the trustees in greater detail.

3.3 Institutional factors

Before doing so, it may be helpful to look at some of the insights of “institutional economics”. Keneley (2004) makes reference to some relevant literature. She looks at two waves of changes in the Australian life insurance industry, when first the general insurers, and then the banks, entered the industry. Their entry can be explained by regulatory changes, and their success to the additional customer information available to these institutions, which allowed them to capture large parts of the life and superannuation market. Many analysts of the success, and otherwise, of bancassurance around the world would say that banks find it easier and cheaper to sell insurance because of their relationship with clients, who are frequently physically in the bank branches, and who also trust the bank. The ability to link insurance directly and indirectly to bank products is another important factor. Mortgage insurance is, for instance, a common bancassurance product.

There are a number of other theories – apart from the importance of information – that institutional theorists use to try and explain market failures.

3.3.1 Regulatory capture

Of some interest in this context is the theory of collective action that predicts that small organised groups can influence regulation and capture benefits from the rest of society. One example of this is the recognition that large organizations can, intentionally or otherwise, influence regulation to make it more difficult for small organizations to flourish.

The tax, disclosure and prudential regulations around Australian superannuation have reached an incomparable level of complexity. The main superannuation acts and regulations run to over 800 pages; the new financial sector reforms add 150,000 words to the legislation, while advisers must understand the difficult provisions of the two income tax acts and the Centrelink rules for social security benefit payments. These complexities cannot but entrench the position of large firms that can afford the necessary specialists, thus making competition more difficult and driving up the price of administration.
This point is recognised but then dismissed by the Productivity Commission report. It might perhaps be revisited.

3.3.2  **Rules of the game: investment cults**

The term “institution” is used in by institutional economists to refer more to “rules of the game” than to organizations. These are the different rules, values or cultures that direct behaviour at different times and places. Given common and not entirely unfair references to the “cult of the equity”, some consideration might be given to the belief system surrounding investment markets.

**Discerning skill and luck**

Investment managers, who allocate assets between the different classes and select different stocks on the basis of expected future yields, fulfil the important economic function of allocating savings to where it is most productive. If the investment managers are successful in their tasks, the expected return on all assets, after adjustment for risk, will be the same. Put differently, no manager will be able to outperform another when considered *ex ante*. The returns on different assets do however differ considerably from each other and from expected. The returns produced by different managers do thus differ *ex post* even in an efficient market.

It is a difficult problem to discern whether the difference results from skill or randomness. Behavioural economists have found people are prone to recognising random patterns where none exist. Ferson *et al* (2002) find that the problem can extend to experts using sophisticated statistical tools. Blake and Timmermann (2004) report findings that UK investors are influenced excessively by good past performance in spite of its meaninglessness.

The question about whether the investment performance of managers persists over time has been intensively researched. Carhart’s (1997) findings remain largely unchallenged. He finds weak evidence of persistent superior performance arising from funds that seem able to quickly capture new evidence in the market, but much stronger evidence of persistent underperformance. Part of this can be explained by excessive trading; the rest must come from the purchase or sale of investments at uneconomic prices. Coleman *et al* (2003) find some evidence of persistent underperformance. This requires investigation: a starting point would be to find whether conflicts of interest can explain the transactions concerned.

It is therefore likely that most investment managers do not differ in their skill levels, and – even where there are differences – that it is very difficult if not impossible to distinguish between good and bad.

**The management choice industry**

In spite of these difficulties, there is a small industry that attempts to assist retail investors to choose the best managers. This includes:

- the specialist media including sections of most newspapers;
- financial advisors to individuals;
- asset consultants, who largely advise companies;
- investment consultancies that collect and analyse data; and
- managers of managers, working for mastertrusts.
There appears to be no evidence that any of these are successful in distinguishing the investment performance of two apparently competent managers. They might however help avoid less reputable managers if these do not fall foul of the regulators.

Why then does this industry not then focus more intently on what appear to be excessive expenses? In spite of the advances in computers that should have reduced costs over the past 30 years, the charges made for investment management can be two or three times what they were in the sixties. They are also two or three times higher than the costs reported\(^\text{32}\). This represents a real puzzle given the competition within master trusts referred to earlier.

Taleb (2001) provides an insider’s view. He repeatedly makes the point that completely random results will lead to wide differences in the performance of different investment managers. Random differences are the result of luck not good judgement; people – and he includes himself in this - are not really able to distinguish between the two. The consequence appears to be that we are too easily persuaded to pay too much for investment management.

This position may be overstated. The excessive investment charges (even if they do exist) are a small percentage of assets, and make little difference when accounts are small. They may, in some instances, justifiably be ignored. As the fund matures and average balances increase, the amounts do however become considerable. It may be that members do not adequately appreciate the difference, which is why there are arguments for greater disclosure and investor education. This section suggests that education should mainly focus on teaching that past performance does not govern the future and that fees are more important.

3.3.3 Rules of the game: commissions

The early nineties saw the development of dissatisfaction with traditional front end loaded insurance savings contracts. In these, the entire first year's contributions might be allocated to selling expenses. The excesses of the front ended commissions led to a move to much smaller front end transfers and apparently small trail commissions, and to the greater disclosure of early exit penalties. The effect of this change was to reduce initial cash flows, but to increase the overall costs to the members – as explained in appendix 2. Even a 0.5 per cent annual trail will be worth 30% of the annual contribution after 30 years. It may be that the long term effects were not initially evident, and that changes will be made as the larger trails begin to bite. Many people are evidently making such changes, as can be seen by the growth in self managed funds, which are more cost effective once the value of the account exceeds some $100,000.

3.3.4 Social relationships

Another view comes from two sociologists. O'Barr and Conley (1992) - in a careful two year study of the culture and behaviour of nine large pension funds in the USA - confirm the author's experience of "surprising and sometimes disturbing" evidence of "an unsystematic approach" to investment decisions. They observe that "relationships are often more important than managing the bottom line in evaluating and deciding whether to retain managers."

\(^{32}\) Investment expenses reported by life insurance companies amount to some 0.2% of assets. Even allowing for some outsourcing, this is considerably lower than the 0.5% to 1.5% charged under typical circumstances.
Flows causing potential conflicts of interest or duty

1. Adviser owes principal duty to member, but paid by fund, trustee or life company - sometimes also with soft dollars.
2. Adviser rebates commission, so reducing superannuation account.
3 & 8. Adviser, trustee or group rebates or provides other benefits to employer.
4. Service providers make secret, discretionary or soft dollar payments to consultants.
5, 6 & 7. Trustee or group makes, possibly, secret profit from holdings in adviser groups, service providers and consultants, or exercises discretions to make a greater disclosed profit at the expense of the members.
9. Financial advisers receive, possibly, secret profits from service providers.
4 Trustee functions and potential conflicts

We now turn to the ways in which conflicts of interest may lead to excessive costs. Figure 1 shows the main cash flows in the superannuation relationships, and highlights flows that do give rise to potential conflicts of interest.

The discussion that follows is grouped around the main functions of the trustees: distribution, administration and investment.

4.1 Distribution

Something must bring the members to the fund initially. Once the fund is going, however, trustees must find ways of persuading the members or their employers to continue to contribute and to attract new members. This could also be called the marketing function.

4.1.1 Employer sponsored, non-public offer

The trustees of corporate and public sector funds deal directly with employers and members and avoid direct distribution costs. In many cases, the trustees wear two hats and are also directors or managers of the employer, but there is still a need to justify the fund’s ongoing existence, and to market its benefits.

Two hats do create a potential conflict of interest. This is a problem when discretionary benefits are discussed: managers have an interest in reducing the employer’s contributions but should also be thinking of members’ interests.

The equal representation rules do provide a balance. They can also be expected to create a certain competitive tension between the management and member representatives on the trustee board, although there is some debate whether it is all productive.

4.1.2 Industry public offer

Industry funds with direct links to employer sponsors avoid direct distribution costs, and also enjoy the benefits, if any, of a tension between member and employer appointed trustees. In some cases, trustees may not be members so there is the agency risk that they will pursue their own interests at the cost of members.

The non-profit nature of these funds also creates a tension identical to that between mutual and for profit insurance companies. While non-profits do not face the conflicts of interest between members and shareholders, it is widely held that their trustees or directors are not subject to the same level of discipline by policyholders, or members, that shareholders impose on the directors whom they elect.

In developing a distribution channel, the industry funds have relied on direct contact with employers, pressure from unions on employers to join and, more recently, on advertising to attract individual members.

4.1.3 Retail

Retail funds, on the other hand, are profit driven and require an active marketing function in order to attract and maintain members. The retail funds are mainly
invested in life insurance policies\(^{33}\), and have, in large measure, inherited their
distribution systems from the life insurers that initiated them. While
superannuation may be distinguished from life insurance, it is probably unhelpful
to make the distinction in this context. Many funds pay for life and disability
insurance for members. The remuneration of the sales channel will include
commissions from insurance sold to the same clients for insurance both inside,
and outside, the superannuation fund.

The life insurance sales system can be classified into four channels.

The traditional high pressure channel is paid purely by commission. The channel
is peopled by agents, normally in some “dealer group”, who may sell only one
company’s products, or brokers who may sell for more than one company. These
people have been described as the archetypal salespersons. A scholarly analysis
of their social status, and the extreme moral and financial pressures placed on
them is given by Guy Oakes in a series of papers and a book, reviewed by Smith
(1991):

The general thesis of this book is that these salesmen … are subject to two
inherently conflicting principles: a commercial idiom that stresses sales at all costs
and a service idiom that stresses concern and sensitivity for the needs of clients. …
the author reviews the five essential steps of selling insurance: prospecting,
approaching, interviewing, closing (making the sale) and providing service to
clients…. After presenting both idioms, he offers a brief discussion of the major
antimonies of the profession, namely, sacralization and manipulation, opportunism
and professionalism, toughness and sensitivity, sincerity and dissimulation. The book
ends with an analysis of the ways in which most salesmen succeed in remaining
ignorant of their own conflictual situation.

Given these unpleasantness and costs of this channel, it can be asked why the
system perseveres? Zultowski (1979) surveys research on the widespread belief
that life insurance “is sold and not bought” that provides some justification for the
high pressured approach. Depending on whether the agent or the policyholder is
being interviewed, policyholder initiatives explain only between 10 per cent and
50 per cent of sales in the US studies reported.

In Australia, however, where superannuation contributions are compulsory, this
argument cannot be said to hold. It might however be argued that the high
pressure sales forces actively search out small businesses and the self-employed
and contribute towards greater compliance with the law.

Berger et al (1997) investigate the co-existence of insurance distribution systems
with widely different charging structures. They find that the difference in the
charges is not translated into different profits, and conclude that the difference
lies in the quality of the service provided by the more expensive system. It would
be an exercise beyond the scope of this paper to determine whether any of the
participants in the industry earned monopoly type profits. What is clear is that a
significant proportion of the difference in charges between retail and industry
funds is required to pay for the additional costs of the distribution system. It is
however an open, and perhaps the most pressing, question as to whether the
costs are justified.

A conflict of interest occurs when commission remunerated salespeople purport to
be “financial advisors”, a conflict aggravated if they claim to be “independent”. A
strict interpretation of the law on conflicts would prohibit someone purporting to
give advice from receiving commission from a third party that depended on the

\(^{33}\) 57% of assets as can be seen below in Table 3
nature of that advice. The UK mis-selling compensation was based on a more lenient interpretation which required that advisors had to demonstrate “best advice”, which they failed to do.

In the Australian context, it would seem that members of corporate and industry funds do better than those in retail funds. If the best advice rule was applied, then similar demands for compensation might be made. The SIS and Corporations Act however expressly permit the payment of commissions to advisers, so undermining the strict interpretation of the general law. The Corporations Act disclosure requirements however extend to everyone involved in the sale of superannuation and investment products to the public – even if they do not purport to give advice.

There is another lower pressure channel that is also paid with commissions, but whose income is not entirely dependent on life insurance or superannuation sales. These people might also broker general insurance, be professional accountants or lawyers who occasionally recommend a product, or be based in a bank branch and serve customers’ other needs. Their business can be said to come to them: they are described as “farmers” against the “hunters” of the first channel who have to go and find their customers. Bank brokers, based in branches that generate leads, can be twice as efficient as those who have to prospect for clients.

To the extent that they are commission remunerated, they face the same conflicts as those in the first channel. To the extent that they cannot justify their commissions in terms of the need to find their clients, they may face a greater burden in justifying high commissions. A problem, recently investigated by ASIC (2004), develops when a company pays overriding commissions to apparently independent brokers - if they place larger volumes of business with it.

Some members of this channel will be charging fees for their advice and deducting commissions from these. There is then no conflict.

A third channel are the bank branches where employees who are paid by salary and bonus. Here it would appear to be the bank that faces the conflict. Glover (1995) suggests that banks may in some circumstances owe a fiduciary duty to their customers. To the extent that the bank, and not its employees, receives the commissions paid by the retail superannuation fund, and thus makes a secret profit, there is a conflict of interest between customers and bank. Determining the profit is not easy. Australian banks report relatively small profits from superannuation business, but the estimates given in the next section suggest that superannuation and investment management charges make up perhaps a half of their consolidated fee income from all sources, or 25 per cent of total revenue. The actual contribution to profit depends on a relatively subjective allocation of overheads, so cannot easily be determined.

The fourth channel is a direct through mail or internet. There is unlikely to be a conflict if the charges are adequately disclosed. A problem may result from endorsements for overpriced products. I am personally offended by offers from my banks that are priced at some four times the going market rate.

APRA statistics show that companies employed fewer than 10,000 sole “advisers” in mid 2003. These include some that sell only risk business. These statistics do not reconcile with company annual reports and have to be treated with some caution. The overall number appears however to be of the right order. No statistics appear to be available for brokers who would have contracts with a number of companies. A lower limit can however be gauged from the company with the largest number of “multi-company advisers”. This suggests that there
are over 5,000 brokers active in the market. Once all advisors are registered by ASIC\textsuperscript{34}, it will be in a position to provide more accurate statistics.

**4.1.4 Employers**

The compulsion to contribute to superannuation rests with employers. If not governed by an award, employers would appear common law duties of care and of good faith to owe their employees - when selecting an appropriate superannuation fund.

The decline in the number of corporate superannuation schemes over the past few years makes it clear that employers are finding advantages in merging their funds into larger industry and retail funds. APRA data on fund transfers shows that it is the latter that have usually benefited. The product disclosure statements (PDSs) of the retail funds however show that their charges for this type of business are considerably higher than those of the industry funds, and that it is common for commissions to be paid to intermediaries who initiate such a move.

The costs and other difficulties in administering residual DB benefits are apparently a significant factor in this trend. DB funds ought to be less expensive to run than accumulation funds because less data and less processing is required. The actuarial services required, however, create a significant overhead, which is increased by poor systems and control. Relatively small DB funds can be considerably more expensive to run than accumulation funds. While the retail funds define themselves as accumulation funds in the APRA statistics, some are active in acquiring hybrid schemes – a market that appears of less interest to the industry funds. Retail funds have apparently also been more flexible in accommodating other idiosyncrasies of the fund rules.

These may explain the success of the retail funds. I remain puzzled however by the number of accumulation funds that have been moved into retail vehicles. Is it because employers are reacting against union domination of the industry funds? Are the retail funds so very much more efficient administratively? Do the industry funds not give enough support and advice?

Perhaps one should be more suspicious. Does the employer receive benefits from dealing with a commissioned adviser other than advice on the superannuation fund? Is it possible that employers’ duties to their employees are being compromised by pressures from their bank managers? This might be suggested by the market share gained by the life insurance companies attached to the large banks. The growth in their assets over and above that of other life insurers, during the years 1998 to 2003, suggests that the large four banking groups captured over 70% of the flow out of corporate funds against their overall market share of 40%. This is an issue that might repay investigation.

**4.2 Administration**

Trustees have to collect contributions and keep records of all member details. They also have to pay benefits, or arrange to transfer assets to another fund. Other administration tasks include the payment of tax and levies, ensuring compliance with legislation and regulations, and amending the trust deed where necessary. The provision of life and disability insurance can, in this context, also be regarded as an administration service.

\textsuperscript{34} As is required by the Financial Services Reform Act 2001 – except for those offering tax advice and charging fees.
4.2.1 Outsourcing

Conflicts of interest can arise from outsourcing. There is no problem if the trustees pay for the costs out of the fee they charge to members. If the supplier of the outsourced service is paid, not from the trustee but, from the fund, then a conflict arises if the supplier is linked in some way with the trustee. The trustee directors face a conflict between their duty to the members and their interest in, or duty to, the supplier, if they are exercising a discretion when they choose and pay an outsourced supplier. In the retail fund sector, trustees and service suppliers frequently form part of the same group of companies. With industry funds, union appointed directors often have links with union owned suppliers.

A second area for conflict arises from the conflicts created when consultants to the fund make recommendations for outsourcing that leads to them receiving a commission from the service provider. An egregious example is to recommend unnecessary or expensive insurance and receive a commission on the premium.

4.2.2 Delegation

Not many trustees will be expert in superannuation and they are, therefore, largely reliant on expert help for the administration of their funds and the investment of assets. There may be a temptation to abdicate and yield power to the professionals. Being represented by lay (non-expert) trustees who control the professional service providers does however gives more power to members than alternatives that vest greater power in experts. It does need to be emphasized that the system requires some diligence on the part of lay trustees if they are to preserve the balance of power. Professional service providers will always face temptations to usurp power - for reasons of efficiency and of commercial interest.

These temptations can be seen in two of the trends currently observable in the retirement fund industry. The first is investment choice that devolves power of investment choice from trustees to members. Members are, however, in a weaker position when it comes to monitoring the value of investment management services. This surely explains some of the increase in costs that inexorably accompanies the introduction of choice. The second is the suggestion of paid professional trustees as recommended, for instance, in Myners (2001). This again has apparent advantages, but clearly weakens the position of the lay trustees in board meetings. If trustees want independent advice, they would be advised to contract for it rather than to surrender some of their powers.

4.2.3 Benefit discretion

Another area of conflict arises for trustees who are also members, when they amend the trust deed to alter the benefits, or exercise their discretion in the governing rules to increase benefit payments to themselves. This often involves the application of reserve funds. This issue is discussed in Maclean (2000), who discusses how this problem can be managed, and has been dealt with by the courts. It seems impractical to prevent members from being trustees. They do however need to be conscious of when their interests are affected, ensure that the interests are appropriately disclosed, and that they do not vote on such matters.

4.3 Investment

The money collected has to be invested with a view to providing members with the best possible mix of risk and returns. Trustees normally delegate the choice
of assets to a professional investment manager. The assets are normally held by a custodian, who buys and sells on instructions from the investment manager.

Outsourcing this function to organisations linked to the trustees potentially creates the same conflicts as outsourcing administration. Giving members the choice of investment manager removes this problem so long as the choice is unfettered and the members are given unbiased advice.

**4.3.1 Stock broking**

Investment however has its own peculiar institutionalised conflicts in the soft commissions that are payable by stockbrokers to investment managers, and occasionally to other investment advisors. These normally take the form of research services and terminals that are provided free if the stockbrokers commissions from the investment manager are sufficient. That the stockbroking commissions are seldom separately disclosed in the accounts of superannuation funds means that the profits are entirely secret and aggravates the problem.

This is not to recommend a narrow focus on the direct costs of dealing as this could be counterproductive. Every market dealer knows that a large buyer or seller can move the price of the most liquid stocks, and competent dealers can easily justify their charges. The charges should however be disclosed.

**4.3.2 Shelf fees**

Another conflict arises when investment managers are required to pay “shelf fees” for the right to be included on the investment menu of a mastertrust. If not disclosed, this would be a secret profit. Even if disclosed, it represents a conflict as the administrator may be biased into favouring those managers that offer to make higher payments.

**4.3.3 Business opportunities**

A more difficult element of the conflict of interest prohibition is that which arises from business opportunities. Investment managers may find unusual investments that they regard as good value, and face a conflict between investing on their own behalf and including them in their clients’ portfolios. Buying on own account first is clearly prohibited, but failing to buy the asset for the clients at all can be justified on the grounds that it was inappropriate (e.g. too speculative for trust money). This argument has dubious provenance as modern investment theory would suggest that risk is related to general exposure to the market and not individual assets. It is perhaps even more dubious when the assets are held in a superannuation fund for internal staff – as might happen in a financial institution - which then appears to outperform clients’ funds.

Best practice to manage this particular agency risk would appear to be for the investment managers to hold all their personal assets, especially their superannuation, in pooled funds that are available to their clients. This is required by some institutions, although has not found its way into the ethical codes.

The right to participate in potentially lucrative initial public offerings is an issue if the investment manager is allocated shares or underwriting commissions that are selectively passed on to clients.

**4.3.4 Self investment**

The exemptions for in-house assets in the SIS Act include significant accommodation for corporate superannuation funds to make investments in the employer - if they were made before the relevant part of the legislation was
passed. Public sector funds also face pressure to invest in the debt of the sponsor. In both cases, investment returns can suffer.

4.3.5 Adviser-linked investments

Also worth mentioning, because it has led to a number of APRA actions, is the practice of financial advisers recommending investment choices in which they have a personal interest. This is more prevalent amongst fringe operators, but major groups with private equity or other more exotic investment options are also compromised if the profits they make are not entirely disclosed and the information about the options not entirely unbiased.

4.4 Fee discretion

Trustees are entitled to remuneration for their services. The remuneration should however be disclosed and predetermined. A contract that permits the trustees to increase fees places them in an impossible position of conflict. Any increase clearly benefits them and harms the members; it cannot thus be permitted.

The problem seldom arises in corporate funds, where the trustees normally fulfil their duties as a part of their general work obligations. The same may happen with industry funds. They are however more likely to pay attendance fees, or in some cases fees determined by an external body such as the Remuneration Commission. To the extent that allowances can be objectively determined to compensate the trustees for expenses or losses incurred as a result of their trustee duties, these are not a problem. If the fees become significant, mechanisms need to be found to ensure that they are not determined by the trustees themselves.

It is common for retail funds to charge a fee that may be increased at the discretion of the trustee, normally with some period of notice. If the members are entitled to move their accounts, without penalty, to another fund then this may be an acceptable practice. If their accounts are locked in, by the decision of the employer for instance, then it might be that this discretion should not be exercised by the trustee.

4.5 Conflicts faced by directors

Some particular issues arise with directors of trustee boards.

4.5.1 Directors of Corporate Trustees

It would seem that the fiduciary duties of the directors of a corporate trustee are indirect, through their responsibility to the corporate trustee and its shareholders. In terms of the SIS Act\textsuperscript{35}, they have a duty to exercise "a reasonable degree of care and diligence" in ensuring the trustee fulfils its duties.

One would not be surprised if their remuneration was linked to the profitability of the trustee, nor whether their performance objectives should include increasing revenue or reducing costs. All of these could obviously be at the expense of the members, but as long as the actions taken were legal, then this would be unremarkable. It could be argued that a remuneration package that rewards them for increasing business is in the interests of members. It is inevitable that

\textsuperscript{35} section 52 (8)
they (or someone else) “bargain” with members for higher trustee fees – just as they will bargain with shareholders for higher packages for themselves.

They do obviously face conflicts in duty when making decisions that might involve the trustee in a conflict of interests. An application of the inflexible law would prohibit such decisions.

4.5.2 Life directors

The same comments apply to life insurance directors, in the general law, in the Life Insurance Act 1995 (LIA) and because 85% of their business is superannuation. In terms of the LIA, they are required to put the interests of policyholders first in the event of a conflict with those of shareholders. This would seem to prohibit them from exercising discretions to increase fees.

5 Costs and returns

This section looks in greater detail at the differences in costs between different types of funds, and discusses whether they might be a consequence of some market or regulatory failure.

5.1 Costs

Typical costs of the different types of funds are reported in Clare (2001) and Rice and McEwin (2002), in their survey of charges in the industry. This section more or less confirms their findings.

5.1.1 Underlying asset allocation

The costs of the different types of fund are reported to APRA, but not in a form that allows for easy comparison. The main reason is that expenses are not reported unless the assets are directly invested. Table 2 above shows the different types of indirect investment.

With some minor exceptions, investment expenses are not shown for assets invested through investment managers. Tax on investment income is not reported by the fund for investments through a PST or life insurer. Those funds invested wholly or largely through life insurance policies may report no expenses at all: the life insurer pays them all.

The accounts of the PSTs and the life insurers, but not of the wholesale trusts, are reported to APRA. It is possible therefore to estimate the underlying expenses.

Table 3 on the next page shows an estimate of the allocation of the assets of the different types of funds between these different investment channels.
TABLE 3: ESTIMATES OF INVESTMENT ALLOCATION

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Direct &amp;</th>
<th>Life insurance</th>
<th>Pooled -</th>
<th>Pooled -</th>
<th>Quarterly</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>millions</td>
<td>specialist mandates</td>
<td>companies</td>
<td>wholesale</td>
<td>retail</td>
<td>Survey as % of total</td>
</tr>
<tr>
<td>Corporate funds</td>
<td>$55,104</td>
<td>45%</td>
<td>7%</td>
<td>44%</td>
<td>5%</td>
<td>83%</td>
</tr>
<tr>
<td>Industry funds</td>
<td>$62,579</td>
<td>44%</td>
<td>3%</td>
<td>41%</td>
<td>12%</td>
<td>98%</td>
</tr>
<tr>
<td>Public sector</td>
<td>$115,767</td>
<td>87%</td>
<td>0%</td>
<td>10%</td>
<td>3%</td>
<td>100%</td>
</tr>
<tr>
<td>Retail funds</td>
<td>$192,316</td>
<td>10%</td>
<td>57%</td>
<td>26%</td>
<td>7%</td>
<td>99%</td>
</tr>
<tr>
<td>Small funds</td>
<td>$127,504</td>
<td>66%</td>
<td>12%</td>
<td>22%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Post retirement</td>
<td>$12,679</td>
<td>0%</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$565,949</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: APRA provided results of the Quarterly Survey and Superannuation Trends, December 2003

5.1.2 Allocating underlying expenses

The costs that have been incurred in the underlying vehicles can be determined by examining their APRA returns in the case of life companies and PSTs. The results are that life insurance costs appear to average some 1.9% per annum of assets; PSTs average some 0.7% of directly managed assets.

Using this information and the allocation from table 3, table 4 on the next page estimates the total costs that can be allocated to the different type of superannuation fund - before any deduction for tax, and without any allowance for profit margins by life companies and PSTs. As the funds are paying tax at 15%, members would probably be charged 15% less than that shown in the final column. For retail funds the profit margin may however be larger than the tax.

These costs do not include stockbrokerage, but probably include most other commissions. There may be other costs that are netted off income. The totals are roughly consistent with the published charges of the larger industry and retail funds. The approximations and incompleteness of the data mean that the results must be treated as mere approximations.

---

36 APRA’s Superannuation Trends reports the allocation to different types of investment managers, but does not break this down by type of fund. The Quarterly Survey of the over 350 funds with assets over $60 million does not cover the small funds, but accounts for some 94% of the assets of the remainder. It is likely therefore that the Quarterly Survey’s allocation between the different asset allocations can be used as a reasonable approximation for the whole. The small fund allocation to different types of investment manager is then estimated as the residual.

37 Life company expenses can be estimated from the December 2001 Half Yearly Financial Bulletin on Life Insurance. The PST information was obtained from a specially requested APRA statistical report.

38 It is not possible to allocate profit margins objectively between different types of business even if all the data is available. This is because the determination and allocation of overhead expenses is necessarily subjective.
TABLE 4: ESTIMATED TOTAL COSTS AS A PERCENTAGE OF ASSETS\(^{39}\)

<table>
<thead>
<tr>
<th></th>
<th>Direct charges</th>
<th>Specialist mandates</th>
<th>Life office addition</th>
<th>Wholesale addition</th>
<th>Retail addition</th>
<th>Total charges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate funds</td>
<td>0.48%</td>
<td>0.24%</td>
<td>0.07%</td>
<td>0.32%</td>
<td>0.07%</td>
<td>1.17%</td>
</tr>
<tr>
<td>Industry funds</td>
<td>0.65%</td>
<td>0.19%</td>
<td>0.03%</td>
<td>0.30%</td>
<td>0.18%</td>
<td>1.35%</td>
</tr>
<tr>
<td>Public sector</td>
<td>0.40%</td>
<td>0.39%</td>
<td>0.00%</td>
<td>0.07%</td>
<td>0.05%</td>
<td>0.91%</td>
</tr>
<tr>
<td>Retail funds</td>
<td>0.84%</td>
<td>0.03%</td>
<td>1.09%</td>
<td>0.19%</td>
<td>0.11%</td>
<td>2.26%</td>
</tr>
<tr>
<td>Small funds</td>
<td>1.22%</td>
<td>0.00%</td>
<td>0.24%</td>
<td>0.16%</td>
<td>0.00%</td>
<td>1.62%</td>
</tr>
<tr>
<td>Post retirement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.91%</td>
<td>1.91%</td>
</tr>
</tbody>
</table>

Source: APRA informal estimates

5.2 The big picture

The total costs of the entire industry can now be estimated. Table 5 on the next page shows the results. It is assumed here that life company profit margins are about 25% of costs\(^{40}\), and that banks account for some 60% of the industry.

While these assumptions are very approximate, it does appear to indicate that fund management charges make up perhaps as much as 50% of the non-interest fee, commission and other income reported by Australian banks\(^{41}\). This would explain, in large measure, the importance attached to the funds management by the banking industry. It would be interesting, although difficult, to investigate whether this plays a role in the high return on equity enjoyed by the big Australian banks, and whether this could be ascribed to a lack of competition.

5.3 Investment performance

Appendix 3 calculates relative investment performance for the different type of superannuation funds after taking the hidden expense differentials into account. Once this is done, it would appear that there is very little difference between the gross investment performance of corporate, industry, public sector and retail funds. This is to be expected and so tends to confirm the overall level of the charges determined here. While these results are inconsistent with the findings of Coleman et al (2003), the differences can be explained by the incorporation of the hidden expenses.

\(^{39}\) It is assumed that the specialist mandate fees are 60 basis points per annum, that wholesale holders (Corporate, Industry and Public Sector funds) of life insurance policies are charged only 100 basis points, and that retail unit trusts charge 150 basis points. These are not more than informed guesses.

\(^{40}\) Which can perhaps be justified by reference to the planned profit margins reported to APRA and found in the Half Yearly Financial Bulletin on Life Insurance?

\(^{41}\) As can be found in table 6 of Australian Banking Statistics on the APRA website.
### TABLE 5: TOTAL CHARGES

<table>
<thead>
<tr>
<th></th>
<th>Direct costs</th>
<th>Total charges</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ millions</td>
<td>$ millions</td>
</tr>
<tr>
<td>Corporate funds</td>
<td>260</td>
<td>700</td>
</tr>
<tr>
<td>Industry funds</td>
<td>410</td>
<td>900</td>
</tr>
<tr>
<td>Public sector</td>
<td>460</td>
<td>1,200</td>
</tr>
<tr>
<td>Retail funds</td>
<td>1,600</td>
<td>5,000</td>
</tr>
<tr>
<td>Small funds</td>
<td>1,600</td>
<td>2,200</td>
</tr>
<tr>
<td>Post retirement streams</td>
<td></td>
<td>300</td>
</tr>
<tr>
<td>TOTAL SUPERANNUATION</td>
<td>4,300</td>
<td>10,300</td>
</tr>
<tr>
<td>Other life company charges</td>
<td></td>
<td>2,200</td>
</tr>
<tr>
<td>Other public unit trusts</td>
<td></td>
<td>2,400</td>
</tr>
<tr>
<td>TOTAL FUNDS MANAGEMENT</td>
<td></td>
<td>14,900</td>
</tr>
</tbody>
</table>

- **Distribution**: 2,100
- **Administration**: 7,200
- **Investment management**: 5,600

5.4 Discussion

The overall charges can be looked at from different angles.

- Australians are paying some 3% of their total personal income as charges to the broadly defined fund’s management industry. This can be broken down into three.

5.4.1 Distribution

The cost of the distribution of retail products amounts to some 10 per cent of new contributions, which may be as much as 1.5 per cent of the income of perhaps 30 per cent of the Australian workforce. 10 per cent is higher than the charges disclosed, but the number includes the charges on rollovers from one fund to another in the numerator, but excludes the rollovers from the denominator. The justification is that rollovers are not new money, and marketing payments are particularly difficult to justify from a national or policy perspective. Including gross rollovers would halve the percentage, which would then be in line with disclosed costs.

These charges appear to account for over 40% of the total charges made by retail funds. The retail distribution channel provides some assistance with compliance with the superannuation guarantee legislation, and advice on:

- financial planning and budgeting;
• complex tax and social security regulations; and
• choice of manager and asset class.

While the first is necessary; much of the second and third is not. The regulations and tax could be greatly simplified, and the investment advice adds little value.

The costs seem to be excessive in some instances, particularly if decisions are being made by employers without sufficient consideration for the interests of members. There may well be instances of financial institutions and advisers abusing the trust placed in them by their clients.

Disclosure does not appear to have reduced expenses elsewhere in the world, and seems unlikely to do so here. A more rigorous interpretation of the common law conflict of interest prohibitions may be necessary to reduce these costs significantly. Prohibiting the payment of commission entirely would be draconian. An alternative might be to restrict the payment of commissions to circumstances where the intermediary does not purport to give advice. This might be easier to manage if such salespeople were to sell a limited range of products that are “CAT marked”\(^\text{42}\) as with the UK stakeholder pensions.

5.4.2 Administration costs

These account for about half the total charges. About a quarter however can be ascribed to self managed funds, which may cost as much as $7,300 each or $3,100 per member. It is difficult to explain this cost as being driven by flexibility – given the enormous range of investment choice available in public offer funds Roberts (2002) shows that the self managed funds make relatively little investment in direct property, which is the only investment unavailable in public offer funds.

Other candidate explanations are the costs of investing in retail funds, or the opportunities self management provides for tax and means test avoidance. Given that self managed funds provide entirely for relatively informed and wealthy individuals, who could use the industry public offer funds, and might anyway be expected to be able to look after themselves in negotiations with administrators, the latter seems the most likely driver. This is wasteful; tax avoidance is a negative sum game as the tax must be collected elsewhere and the costs are not recoverable – unless people obtain pleasure from the experience!

Allocating administration charges (before tax) to the larger funds produces $56 per member per annum for industry funds, $136 for retail, $168 for the public sector, and $328 for the corporate funds. These appear to be in line with published charges for the public offer funds. The cost of public sector and corporate funds may be understated to the extent that their administration is subsidised by the employer.

The differences in cost appear to be related to economies of scale, the difficulties of administering residual DB schemes and the profit margins of the commercial enterprises (guessed as 25% of costs). There may also be a difference in service levels. In the case of the retail funds it may relate to their more active quest for members, for the corporate and public sector funds it may relate to the higher average balances where members may take a more active interest in their accounts.

\(^{42}\) CAT refers to specific products with limits to Charges, wide Access and standard Terms.
Given that the retail funds appear to make an adequate profit at a flat annual charge of $140, we can make the heroic assumption that this provides a benchmark for a quality service. This would mean that the unnecessary administrative charges of the superannuation system were at least $1.5 billion – or about half the total. 80 per cent of this can be ascribed to the small self managed funds and appears to be related to avoidance opportunities.

The balance would appear to come from residual DB expenses. It may well be worth investigating ways of simplifying these: switching members to accumulation funds but providing investment guarantees.

5.4.3 Investment costs

These seem to average some 60 to 80 basis points annually, which is still shy of some of the charges evident on the websites of the large retail funds, and of the charges that are made for unit trusts. Members of superannuation funds therefore get a relatively good deal, even if the profit margin in these charges appears to be at least 50%.

While clearly extremely competitive given the vast choice available, the high profit margins that appear to be made for this function do perhaps merit further investigation perhaps along the lines suggested by institutional economics, outlined in section 3.3 above. Investment education could be encouraged that emphasises the random nature of investment markets, and the meaninglessness of most differences in past performance. Blake and Timmerman (2004) provide an interesting discussion.

The scope for a reduction in superannuation investment charges is probably less than $1 billion.

6 Conclusions

The higher costs of retail funds can be explained largely by the costs of distribution. While the distribution system also offers advice to members, much of it appears unnecessary. There appear also to be a number of conflicts of interest and instances of excessive charging.

Some of the distribution costs, and what looks like a greater amount spent on the administration of self-managed funds, arise from the complexity of the tax and social security codes and the many opportunities for avoidance.

Investment management charges also appear to be high relative to the underlying costs. This is difficult to explain as the costs are clearly disclosed, and there is significant choice and competition in this area. It might be, provocatively, explained by the prevalence of superstitious view of investment markets.

The main policy conclusions would seem to be that:

- Action should be taken where conflicts of interest are present.
- Tax and social security regulations should be simplified.
- Investment education could be encouraged that emphasises the random nature of investment markets, and the meaninglessness of most differences in past performance.
- Trustees should be expressly permitted to pay for financial advice for members without incurring a liability for wrongful advice.
Acknowledgements

Particular thanks are due to Merrie Hennessy and Neil Esho for their many inputs into the process of writing this paper. The author is employed by APRA, but the views expressed are his alone and cannot be ascribed to his employer.

REFERENCES


Clare, R. (2001), Are administration and investment costs in the Australian superannuation industry too high? ASFA Research Centre, Sydney


Teele, R (1992) The necessary reformulation of the classic fiduciary duty to avoid conflicts of interest or duties. Australian Business Law Review 22.2 99-113

Appendix 1: Accounting standards

• Australian Accounting Standards Board (AASB) powers

ASIC is responsible for section 155 (re fair dealing on issue or redemption) of the SIS Act, and for the AASB and accounting standards through the Australian Securities and Investments Commission Act 2001 (s.227). The Corporations Act applies AASB standards to corporations and unit trusts. The AASB is specifically empowered to set the national accounting framework and other standards (s.334) that regulators may apply to other entities, but it does not appear to have authority to set the standards for all superannuation funds. It would appear to apply to public offer superannuation funds when they disclose information relating to the issue of financial products (s.764A). Section 1017DA provides for regulations governing what, when and how superannuation funds give information to members. This could conceivably include the power to govern the form of information, but the regulations (7.9.37 (1) (e)) currently do not appear to do so.

• APRA powers

Section 13 (1) of the Financial Sector (Collection of Data) Act 2001 (the Collection of Data Act) gives APRA authority to set “reporting standards that are required to be complied with by financial sector entities” for “reporting documents”. These are defined to include all documents of a “financial or accounting nature”. The standards however strictly apply only to documents required for reporting to APRA.

• Application to Superannuation

The provisions of the Collection of Data Act clearly apply to reporting standards for superannuation funds in their reports to APRA. The instructions (such as those in respect of APRA’s SRF200) currently refer to AASB standard AAS3 in the calculation of tax expense.

APRA Superannuation Circular V.A.2 provides guidance for the preparation of accounts and suggests: “For the great majority of regulated superannuation funds, accounts prepared in accordance with AAS25 (Superannuation Funds) and audited on that basis will satisfy the SIS Act requirements.” The exceptions relate to funds that operate entirely through life insurance contracts.
Appendix 2: Commissions

There is clearly a need for a distribution network, and advice on income tax and means test management. If advice is desirable, how should it be funded?

1 Old system

When most advisors lived off front ended commissions on insurance policies, their business model would have been along the lines of:

- The agent would earn 50% of the first year’s premium on each new policy.
- If the average policy was equal to 2.5% of salary, then income per client would average:

\[
\text{Salary} \times 2.5\% \times 50\% = 1.25\% \text{ of salary}
\]

- The agent would need to sell about 80 policies a year to earn as much on average as his clients. As soon as he got to this level, he would be viable, and it could happen almost immediately. Life insurers would provide some bridging finance for the first few months of training and establishment.
- If his clients took out new policies every 4\text{th} year, an agent would need to build up a portfolio of about 300 clients.

Very few people proved able to find this number of clients, which meant a high turnover of agents, and high lapses. While policyholders lost money on lapsed policies, and life companies often lost money when building up agency forces, the main financial risks were taken by the agents themselves: 80% of agents dropped out in the first two years and often ended up with minimal income for the period.

2 New system

Front end loaded contracts have become unacceptable. The new commission structures are structured more along the following lines:

- Term insurance policies: 95% of first year commission and 16% of subsequent years.
- Superannuation: up to 4.5% of contributions – and rollovers - and 0.4% of assets.

It appears that most companies also allow the advisor to negotiate an additional commission: one large company limits these to 1.1 per cent of assets or $2,200 annually. In addition, there may be volume overrides payable to the advisor’s employer.

The distribution business model is now:

- Term insurance is cheap – the average person may pay perhaps ½ per cent of income in premiums, the agent is then earning .1% of each client’s income at the most.
- If people are paying on average 12% of their salaries into superannuation on which the agent collects 3%, and have accumulated a year of income as assets on which the agent collects 0.3% p a, then the agent will take:
3% of 12% plus 0.3% of 100% = 0.66% of each clients salary.

- This means that she needs only 130 clients, but she is however not viable until she has accumulated all 130. She therefore has to fund herself, and is in need of additional cash flow in the interim. This is not possible for most people, which would suggest that there will be very few new agents. It appears that this has been true for some years

- At the same time, the costs to clients are higher. 0.66% of salary (or assets) per annum represents total charges of about twice as high as the old front end load system, and reduces the total benefit of a lifetime’s investment by 20% or more.

**Vested interests benefit**

This system is obviously very much in the interests of existing financial advisors. As they reach retirement, they are apparently able to sell their renewals to the life companies and banks at multiples of between 2.5 and 4.

It should be noted that one way for new agents to make up their cash flow shortage in the short run, is to persuade clients to transfer their benefits from one fund to another, and take a commission on the transfer.

3 Fee based system

The most desirable system would be payment for advice was separated from the decision on how much and where to invest. It is however difficult for product providers to offend the financial advisers, who are their major sources of business and to advertise fee for service brokers. (Interestingly however, the Corporations Regulations provide for fee for service advisers who give tax advice to be exempt from registration under the Act.)

It is also difficult for the best intended trustees to change the system. Members would rather pay for advice indirectly through their superannuation fund than paying directly. There are tax and cash flow advantages of doing so. On the other hand, it would be a brave trustee who paid for advice for members from the fund:

- Would he be in breach of S62 of SIS Act, and the sole-purpose test?
- Could he be sued by members if the advice were proved to be inadequate?

Some clarification might be helpful.

---

43 Corporations Regulations (2001) 7.1.29 (4)
Appendix 4: Investment Returns

These returns are included here to show that the apparent difference in the investment performance of the retail and industry funds can largely be explained by difference in hidden expenses. The returns made to APRA are not intended to measure investment performance, and are not sufficiently detailed nor accurately completed to be reliable for this purpose.

### TABLE 6: ESTIMATION OF AGGREGATE GROSS RETURNS BY SECTOR

<table>
<thead>
<tr>
<th>Returns as reported to end June</th>
<th>Corporate</th>
<th>Industry</th>
<th>Public Sector</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>20.07%</td>
<td>15.85%</td>
<td>17.93%</td>
<td>12.02%</td>
</tr>
<tr>
<td>1998</td>
<td>10.13%</td>
<td>9.70%</td>
<td>9.72%</td>
<td>7.47%</td>
</tr>
<tr>
<td>1999</td>
<td>8.45%</td>
<td>9.35%</td>
<td>9.17%</td>
<td>8.83%</td>
</tr>
<tr>
<td>2000</td>
<td>13.21%</td>
<td>12.35%</td>
<td>14.63%</td>
<td>9.76%</td>
</tr>
<tr>
<td>2001</td>
<td>5.87%</td>
<td>5.43%</td>
<td>4.57%</td>
<td>4.94%</td>
</tr>
<tr>
<td>2002</td>
<td>-3.35%</td>
<td>-0.85%</td>
<td>-4.86%</td>
<td>-3.48%</td>
</tr>
<tr>
<td>2003</td>
<td>-0.53%</td>
<td>0.90%</td>
<td>-0.89%</td>
<td>-0.53%</td>
</tr>
</tbody>
</table>

**Adjustments for indirect charges:**

**Expenses:**

- 0.48%   0.53%   0.13%   1.48%

**Income tax paid**

- 0.12%   0.04%   0.00%   0.41%

**Capital gains tax**

- 0.32%   0.08%   0.01%   0.60%
- 0.09%   0.04%   0.00%   0.21%
- 0.05%   0.03%   0.00%   0.33%
- 0.16%   0.06%   0.01%   0.40%
- -0.01%  0.00%   0.00%  -0.01%
- -0.10%  -0.02%  0.00%  -0.36%
- -0.09%  -0.02%  0.00%  -0.23%
### Foundation units

<table>
<thead>
<tr>
<th>Year</th>
<th>0.70%</th>
<th>0.53%</th>
<th>0.39%</th>
<th>0.30%</th>
<th>0.22%</th>
<th>0.17%</th>
<th>0.12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Estimated gross performance

<table>
<thead>
<tr>
<th>Year</th>
<th>20.99%</th>
<th>16.50%</th>
<th>18.07%</th>
<th>15.20%</th>
<th>10.79%</th>
<th>10.31%</th>
<th>9.86%</th>
<th>10.09%</th>
<th>9.07%</th>
<th>9.96%</th>
<th>9.31%</th>
<th>11.44%</th>
<th>13.96%</th>
<th>12.97%</th>
<th>14.77%</th>
<th>12.34%</th>
<th>6.43%</th>
<th>6.00%</th>
<th>4.70%</th>
<th>7.04%</th>
<th>-2.92%</th>
<th>-0.30%</th>
<th>-4.74%</th>
<th>-1.79%</th>
<th>-0.07%</th>
<th>1.46%</th>
<th>-0.76%</th>
<th>1.24%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Arithmetic average

<table>
<thead>
<tr>
<th></th>
<th>8.32%</th>
<th>8.13%</th>
<th>7.32%</th>
<th>7.94%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Basis for estimates

Investment performance is based on reported quarterly averages from Superannuation Trends, except in the case of Corporate Funds, which have been determined from the larger funds that participate in the Quarterly Survey.

Indirect expenses are estimated from the reported expenses of the underlying investments in the case of life companies and PSTs, and estimates in the case of unit trusts.

Capital gains tax assumes a rate of 12.5%, on gross returns less 500 basis points, and that 50% of future benefits are counted.

Indirect income taxes are determined assuming tax at 15% on 4% of the underlying assets.

Foundation units arise from the front end loaded contracts previously sold, the costs of which are still being deducted from members’ returns. The amounts shown here are based on an informal estimate.