Strategic Priorities for Super Funds (from a CIO's perspective)

David Bell – Chief Investment Officer

Mine Wealth + Wellbeing

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Trustee AUSCOAL Superannuation Pty Ltd
ABN 70 003 566 989
AFSL 246 864

Mine Wealth and Wellbeing Superannuation Fund
ABN 16 457 520 308

Mine Wealth + Wellbeing Financial Advice a business name of Mine Wealth and Wellbeing Services Pty Ltd
ABN 49 051 315 014 a Corporate Authorised Representative of the Adviser Network Pty Ltd ABN 25 056 310 699 AFSL 232729

Major Challenges Faced by Super Funds

1. Meeting the retirement outcome challenge
2. Two large portfolio management challenges
3. Other industry challenges (3)

Meeting the Retirement Outcome Challenge

Delivering very good, sustainable retirement outcomes to members

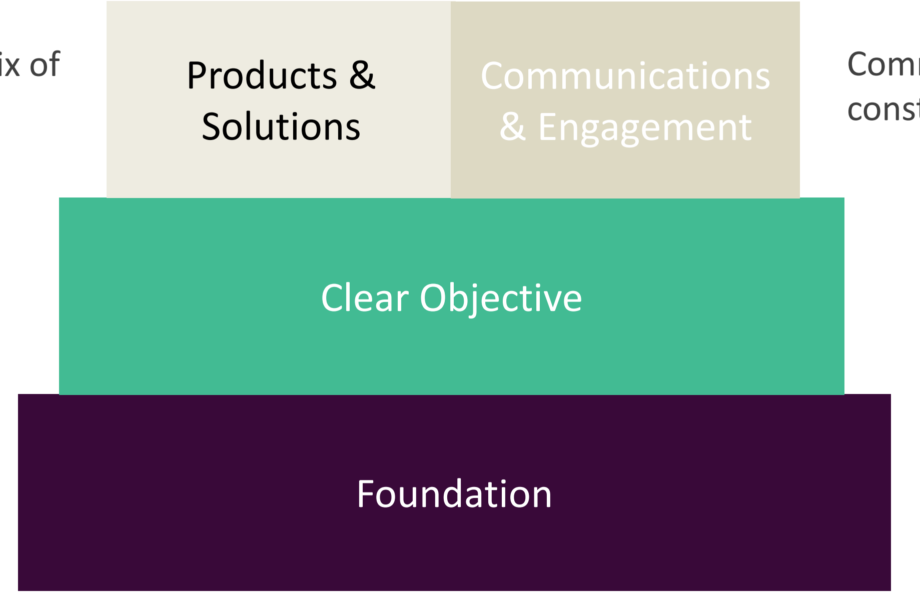
- **The industry is immature in terms of meeting the retirement outcome challenge**

The solution may be a complex mix of products, solutions and services.

Communication is critical – but shouldn't constrain the quality of the solution.

The industry lacks clarity on what it is trying to achieve for members in retirement.

Sophisticated model which can project the range of retirement outcomes a member can experience.



Meeting the Retirement Outcome Challenge

Technically we can define the retirement outcome problem as:

“A dynamic, integrated consumption and investment decision problem”

Meeting the Retirement Outcome Challenge

From a strategic perspective…

- Board / executive team education / knowledge
- Technical capability – management, staff, systems, culture
- Management structure
- Communication skills – across business / to members
- Clarity of purpose
- A measurement of success
- The policy roadmap (e.g. CIPR)

Portfolio Management Challenge 1

High risk portfolios are dominated by equity risk premia

- This is a risk problem – risk is coming from nearly all one source
- It may or may not be an expected return problem (subjective view)
- Equities provide important characteristics:
  - Reasonably high risk
  - Equities have low fees
  - Equities are generally liquid

Portfolio Management Challenge 1

High risk portfolios are dominated by equity risk premia

- Important constraints make this a difficult problem to solve
- It is hard to find assets / investment strategies (other than equities) which:
  - Provide high volatility (not easy for super funds to lever)
  - Are liquid
  - Have reasonably low fees
  - Provide a risk premia that intuitively makes sense
    - i.e. are fundamentally worthy of large allocations

Portfolio Management Challenge 2

Low risk portfolios are dominated by bonds

- This is a return problem – the long term outlook for real returns is modest to weak
- It may or may not be a risk problem (subjective)
- Bonds provide important characteristics:
  - Low risk
  - Bonds have very low fees
  - Bonds are generally liquid

  - The diversification benefits of bonds to stocks is somewhat debatable

Portfolio Management Challenge 2

Low risk portfolios are dominated by bonds

- Important constraints make this a somewhat difficult problem to solve
- It is hard to find assets / investment strategies which:
  - Can deliver a modest-reasonable long term real return
  - Are low risk
  - Have reasonably low fees
  - Are liquid
  - Can be applied in size

Other Industry Challenges 1

Illiquid asset allocations

- Funds which had higher allocations to illiquids have outperformed
- Funds which can allocate more to illiquids have:
  - Greater diversification opportunities
  - Greater opportunities to dampen volatility
  - The same or greater return opportunity
- Funds have unique cashflow characteristics
- Funds have varying interpretations of liquidity risk
  - Think ability to measure, understanding of consequences, peer group focus

Other Industry Challenges 2

Peer group focus

- There exists a large peer group focus
  - Arguably larger than ever
- There is little member-based argument to support a peer group focus
  - Besides possibly managing sustainability-risk of your super fund
- A peer group focus fails to account for the differences between funds:
  - Notably capability and cashflow profile

Other Industry Challenges 2

Peer group focus

- Specific risks due to a peer group focus:
  - Failure to focus (absolutely) on member outcomes (long term real returns and risk management)
  - Failure to address the two major portfolio management challenges
    - Because they increase peer group risk
  - May chase other funds which have outperformed due to luck rather than skill
    - Example: TAA
  - Long term retention of investment staff

Other Industry Challenges 3

Maturity and a long term focus

If the industry doesn’t mature sufficiently to one that is focused on the long term, recognises development of capability, and doesn’t step away from a peer group focus then how can it truly deliver the best retirement outcomes to members?