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SUPER'S SUCCESS

is not guaranteed

By Philippa Yelland and Amanda White

Jack Gray has been a contrarian voice as superannuation marks 20 years of existence.

The academic and company director has criticised the industry for its migration away from a defined benefit system.

Meanwhile, Pauline Vamos, CEO of ASFA, paid tribute to both Labor and Coalition Governments and their recognition of the “desirability, indeed the necessity, of compulsory superannuation” at a \$298 per head gathering of more than 250 industry executives at Parliament House on August 16. Colin Tate, publisher of *Investment Magazine* attended the event.

Speaking at the function, Bill Shorten, Minister for Financial Services and Superannuation, reminded the attendees that average Australians need a 70 per cent replacement rate of their accustomed income to live comfortably in retirement, but only 35 per cent of the population are in that category – which shows the urgent need for lifting the super guarantee to 12 per cent.

However Gray argues for a structural change in superannuation. “Making the funds defined contribution and leaving decisions to individuals has predictably created a massive agency ecosystem that spans trustees, consultants, managers, internal staff, lawyers, custodians, financial planners,” he says.

“They all extract economic rent - often through over-servicing,” Gray says.

The irony in this is that Gray is a former investment manager and fund executive. He is now an academic but also a director of Brookvine, a placement agency. He admits the contradiction.

Gray believes the Australian system abandoned defined benefit funds too early. The “radical idea” of going back, he says, is not out of the question. “It just requires courage.”

He advocates the Dutch approach of developing a defined benefit-like system that is portable, risk-shared and still has a nominal guarantee.

“My big policy idea for designing an optimal retirement system is to drag all the supposedly smart over-paid financial engineers out of Wall Street and ‘re-educate’ them to finally do something of social value and develop a modified defined benefit scheme that avoids the problems of lack of portability,



Prime Minister Julia Gillard, ASFA CEO Pauline Vamos and Minister Bill Shorten

Australians need a 70 per cent replacement rate of their accustomed income to live comfortably in retirement, but only 35 per cent of the population are in that category



Investment Magazine publisher Colin Tate and Prime Minister Gillard

inequity and balance-sheet risk.

“Is it a bit too radical? Sometimes a collective approach generates far superior individual results. It certainly does with insurance and other forms of risk-sharing,” Gray says.

At the Canberra function, Shorten said that women continue to be disadvantaged because they live longer than men but on average have super balances that are 30 per cent lower.

“Currently, around 2.1 million women get no tax benefit from contributing to superannuation, due to the 15 per cent superannuation contribution tax being at or below their income tax rate,” he said.

Vamos said that when the then Treasurer John Kerin introduced the superannuation guarantee in 1991, said, he noted the system was vital to ensure that all Australians had a secure income in retirement.

Event attendees amounted to a roll call of the of the Australian super industry, both past and present. Stalwarts included the Kerin and Tony Cole, current Mercer partner who was Treasury Secretary from 1991 to 1993. Garry Weaven, current chairman of Industry Funds Management, and who was assistant secretary at the Australian Council of Trade Unions was involved in the industrial campaigns that preceded compulsory super, also attended. ■

New board ends MTAA Super's rocky road

By Brett Cole

Pressure from the superannuation regulator, the Australian Prudential Regulation Authority (APRA), has forced MTAA Super to change its board structure.

The \$6 billion industry fund formerly had four employer and four member representatives as well as an independent chairman. It will now have three employer and three member representatives and three independent directors.

Bob Allen, an employer nominated director, and Mark Perica, a member nominated director, will leave the board. A recruitment firm has been hired to search for new appointments to the board.

The changes coincide with the announcement that Michael Delaney, CEO of the \$6 billion MTAA Super, will retire in November. A search for the fund's new CEO is under way.

Fiona Reynolds, CEO of the Australian Institute of Superannuation Trustees, says: "MTAA Super was not set up as a traditional industry fund but as an employer association and that has led to perceptions that the fund, rightly or wrongly, wasn't properly run."

"The regulator is happy to see the changes made by MTAA Super," says Reynolds. "There had been an ongoing observation of the fund by the regulator who had stated concern about its governance."

In a statement, John Brumby, chairman of MTAA Super and a former Victorian Premier, said: "The changes will not only broaden and strengthen the board of directors but renew and refresh management of the fund."

Andrew McCutcheon, APRA's spokesman, says the regulator cannot comment on MTAA Super.

Brumby's predecessor, John Rickus, says superannuation funds must publicly disclose more details about their investments and operations.

"The level of reporting requirements imposed by APRA is nothing like the reporting requirements of listed companies," says Rickus. "It should be."

MTAA Super says it will publish its audited accounts on its website and the remuneration of its directors and top five executives.

The new board will be in place by November, MTAA says. It hopes to appoint a new chief executive by this year.

Delaney, the former private secretary to Gough Whitlam, has been CEO



Michael Delaney

MTAA Super was not set up as a traditional industry fund but as an employer association

since the fund for the Motor Trades Association was established in 1989.

The fund's investment returns, which an MTAA Super spokesman declined to disclose, have suffered after the bankruptcy of Lehman Brothers in September 2008. As much as 70 per cent of its capital was invested were in unlisted assets such as private equity, property and infrastructure at November 2008. These asset classes endured steep falls as the world went into recession.

MTAA Super's 'balanced' investment option still has 50 per cent of its investments in unlisted assets.

In 2009 the fund suffered a \$1.9 billion loss due largely to a derivatives contract and a drop in value of its Australian share portfolio.

David Lording, MTAA Super's spokesman, says Delaney wasn't available for comment. The switchboard at MTAA Super in Canberra refused to place calls to Delaney's office or to place a call to Brumby.

Hostplus, the superannuation fund for tourism, hospitality and sports workers, is the only other fund in Australia with a similar board structure to MTAA Super, says Reynolds, after it came under regulatory scrutiny. ■

Ryan fights age-old prejudices

By Philippa Yelland

Susan Ryan is putting everyone on notice that age discrimination is prejudice. Her mission for the next five years is to expose offenders and reward those working for its eradication.

Ryan, who recently became Australia's inaugural age discrimination commissioner, had first-hand experience of prejudice early in life. As a student teacher, she became engaged to marry - only to be told she could not continue studying and also would have to repay her teacher scholarship money. The only



Susan Ryan

reason for the termination was that she was female. In contrast, male students could marry and continue studying on full scholarships.

This, and other experiences, fired Ryan's determination to fight against discrimination and prejudice. In 1975, she became the ACT's first female senator after campaigning under the slogan, 'A Woman's Place Is In The Senate', and she stayed in the upper house until 1988.

During the 1980s, she notched up two important positions: Minister assisting the Prime Minister Bob Hawke

on the status of women from 1983 to 1988 - and driving the landmark *Sex Discrimination Act 1984* - and Federal Education Minister, again under Hawke, from 1984-87.

Fast-forward to the middle of last month, and Ryan's appointment for a five-year term as the country's first commissioner for age discrimination. This position is a result of the Gillard Labor Government's election promise to appoint such a person and fund the office with \$4 million over the next four years.

Anticipating suggestions of jobs for the girls, Ryan says she came to the

position at arm's length from the Labor Federal Government: the first approach came from an executive search firm.

"It wasn't a political appointment," she says. "Ultimately it was the decision of the Attorney-General."

Apart from her political credentials, Ryan has been AIST president, and independent chair of the IAG & NRMA Superannuation Plan. She's just finished 13 years on the council of the University of New South Wales and has been in the fray with community campaigns for human rights protection.

After just a week in the Age Discrimination Commissioner's chair, Ryan is already in command of the agenda. She is graciously firm in her articulation of what drives discrimination based on age.

"Fundamentally it is prejudice, and my job is to unravel that prejudice. Age is the big one because it affects everyone eventually."

Old age is one of the certainties of life, besides death and taxes. The Australian Bureau of Statistics, in 2008, projected that people over 65 would comprise 23 per cent of the population by 2056 - almost double the 13 per cent recorded in 2007.

Ryan sees at least seven problems that unjustly impact the elderly: the superannuation guarantee (SG) and voluntary contributions, group insurance, age discrimination legislation, workers' compensation, employers and re-training.

The first concern is that the 9 per cent SG does not generally apply to workers over 70 years. Ryan says increased longevity and health mean people should be able to work for as long as they are able to and, for many people, that is past 70.

"First, it is the right of the person," she says. "Second, there are economic benefits to the person. And third, because of the economic

benefits in general. Part of my job is to address this.

"The history of [the SG cut-off] was to ensure that people were using their super for retirement and not as a tax-free way of building their assets. Basically, at some stage, you have to take your super and live off it, but whether that's at 70 or 75, that's open for public debate. We'll be raising it with Treasury and the tax office."

Fundamentally it is prejudice, and my job is to unravel that prejudice

Ryan has secured a place at the government's Tax Summit in October to prosecute this case.

The next problem is that personal super contributions are outlawed after age 75. "The theory is that by age 75, you should be able to live on what you've saved. But this age cut-off needs to be re-examined." ■

J.P.Morgan

ETF Trends in Transition Management

The transition management industry continues to evolve as new products allow for implementation of strategies to maintain exposure and minimise risk. Although global use of exchange traded funds (ETFs) is common for international institutional investors, the uptake locally is still far off the pace.

At J.P. Morgan we have seen increased interest from clients looking to implement ETFs to maintain market exposure. Since they are exchange traded, the pricing is transparent and settlement is simple unlike most derivatives which require independent pricing or separate clearing.

The advantages of ETFs in transitioning

The main benefits of ETFs are the simple transparent nature of the vehicle allowing for investors to remain equitised and reduce risk while in the transition phase. With a wide variety of choice offered on local and global exchanges, it means managers can now gain exposure to a large range of asset classes and sectors without the use of derivatives.

ETFs also allow for ease of asset allocation which means managers can tilt sectors easily to gain the exposure they are after if they believe in a short term macroeconomic trend or wish to quickly implement an asset allocation change. Evidence of this was seen with managers tilting portfolios towards Japan after the short term volatility of the earthquakes.

How to choose the right ETF

Although on the surface ETFs may look the same, there are many aspects to consider such as its liquidity, management fees, assets under management and how the vehicle achieves its returns, e.g. does it physically hold the underlying assets.

With a universe of literally thousands of ETFs to choose from globally, J.P. Morgan can assist in the selection process, and trading and creation of units, allowing clients to achieve their desired exposures within an appropriate risk framework.

With clearly defined benefits in transition management, ETFs are gaining interest past multi managers to local institutional investors and superannuation funds. As the ETF market continues to expand and demand continues to rise, J.P. Morgan is uniquely positioned to navigate clients through a complex and evolving market.

To find out more log on to www.jpmmorgan.com.au/tss or contact Stuart Zanchi at stuart.r.zanchi@jpmorgan.com

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Investment risks, myths headline FSC agenda

By Philippa Yelland

The big agenda issues for the FSC conference were ESG non-reporting, longevity unpreparedness, and market myths.

Speaking at the FSC conference last month, ACSI chief executive, Ann Byrne, said 15 per cent, or 30 companies, in the S&P/ASX 200 do not report their environmental, social and governance risks.

In tandem with Byrne's comments, ACSI and FSC published *ESG Reporting Guide for Australian companies*, a set of recommended guidelines to which the two groups want companies to adhere so a more complete and consistent view of ESG issues is compiled.

Byrne says mining companies such as BHP Billiton and Rio Tinto are "leading the way" with ESG risks reporting.

But, not enough information comes from building, construction, manufacturing and energy companies, she said.

On the second day of the FSC conference, the annual FSC and PwC survey of industry CEOs showed that bosses of major wealth managers in Australia have lost confidence that they will overcome the challenges of an ageing population.

A mere 15 per cent of CEOs believe that problems such as the \$900 billion savings gap can be overcome, compared to 44 per cent last year.



Justin Fox

FSC CEO John Brogden said the debt woes in the US and Europe and market volatility have made consumers, and therefore wealth management bosses, less confident.

Colonial First State's CEO, Brian Bissaker, said conservative actions such as cutting expenditure and hoarding money in a bank account showed that Australian were already bridging the large savings gap.

The household savings rate was higher than it has been in the past 20 years, he said, and people were paying off debts rather than spending.

Pauline Blight-Johnston, managing director of re-insurer RGA and a director of the FSC, said "what consistently amazes me is that, as an industry, we don't get it onto the Government's agenda when the human train wreck is coming".

The solution was not annuities and lifecycle investments, but legislation determining how people invest in retirement. "It's not a product solution. It's a policy solution," she said.

On the conference's third day, Justin

As an industry, we don't get it onto the Government's agenda when the human train wreck is coming

Fox, editorial director of the *Harvard Business Review*, said a revolution in finance theory in the past decade had led to a rethink of many investment ideas – for example, the notion that financial markets were rational and efficient.

Fox, who is also the author of *The myth of the rational market: a history of risk, reward and delusion on Wall Street*, said other myths include:

- risk can always be quantified
- risk is equivalent to historical volatility
- financial markets are inherently stable
- corporations should use as their guiding light the movements of financial markets, and
- stock prices should provide direction to CEOs, CFOs and boards of directors on what decisions to make.

In the past six months or so, Fox said, yields on US Treasury bonds have not moved much. "Does that mean that markets are really, really smart," he asks, "and they can see through all the name-calling and posturing in Washington?" ■

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Combating human and heavenly crises

By Simon Mumme and Brett Cole

Some risks can be controlled. Some are blindside shocks. Last month, superannuation fund executives gathered in Melbourne to discuss how the varying risks threatening their businesses can be managed.

A GREATER RECESSION

Nick Bullman is a bear. A big bear. But one who wears exquisite gold cufflinks with French cuffs and a bespoke double-breasted suit.

"All the data coming out of the major economies including China and India are trending down," said the founder of CheckRisk, which analyses economic and financial market data.

"We're entering a recession that has the potential to be deep," he said. "I fully expect quantitative easing three and four. The central banks will print money until there are no trees left."

Bullman, a former hedge fund manager and equity trader with Goldman Sachs, said financial markets are in a non-discerning frame of mind.

"Markets are treating everything the same," said Bullman, whose small company is based in Bath, England.

He's not surprised by recent market volatility.

"Markets will continue to spiral downwards until we're paid to take risk," he said. "You better be in very liquid assets. Agricultural commodities, gold are among the best places to put your money."

He said markets may never again perform in the way they have in the last three decades.

"The period of 30 years of stable returns where risk was mitigated are over," said Bullman. "Pension funds will have to move to a much more dynamic asset allocation."

STAYING AFLOAT

The severe flooding in Queensland last January was a state-wide natural

disaster.

It affected 60 per cent of the population. Among the businesses impacted were superannuation funds headquartered in Brisbane.

As floodwaters increased the volume of the Wivenhoe Dam rise from 16 per cent to 175 per cent of capacity, panic levels among some employees at the Milton office of BUSS(Q) shot up just as fast.

"It was important to tell the panic merchants to go home," David O'Sullivan, CEO of the \$1.5 billion fund, said. These people were given the following message: "Please go home. You're not useful."

The cooler heads at the fund tried to remember where its disaster recovery plan (DRP) was filed. Once it was retrieved, senior staff decided which parts of it would apply flooding to their situation.

This is typical, according to Daniel Shields of RiskLogic, who said a DRP should never be an instruction manual because each disaster has a different nature. It is a guide or "roadmap" to dealing with emergencies.

Rosemary Vilgan, CEO of QSuper, was on holiday in Europe when the flood came. She and Bob Scheuber, chairman of the fund, discussed whether she should return to lead the organisation's response to the disaster.

They decided against it. Vilgan did not want to send a signal to staff that the organisation could not manage without her.

When work resumed QSuper set up a team to focus on life claims triggered by the flooding.

Fund executives also managed problems experienced by staff members during the disaster. Robyn Petrou, CEO of Energy Super, said one employee had lost their house to the waters but did not let colleagues know for two weeks. Meanwhile their family was existing without a home. ■

All the data coming out of the major economies including China and India are trending down



Rubbing shoulders with fraudsters

Meet the typical fraudster:

- 38 years of age
- Has worked for five years at his current employer and has been in a non-management role for the past three. Perhaps they feel entitled to a promotion or more pay but this has not been awarded
- Earns an annual salary of \$113,000 but this respectable package is supplemented by committing fraud that averages \$229,000 in value
- He is motivated by greed, acts alone and has no known history of theft
- Detected by his employer's internal audit controls 12 months after committing the fraud

Peter Morris, director at KPMG Forensic and a former detective with the Australian Federal Police, said only one-third of frauds are detected primarily because organisations have poor internal auditing processes. It takes an average of 372 days to detect fraud, he said. Most frauds are motivated by greed and the pursuit of richer lifestyles or to fund gambling addictions. Employees are best placed to detect fraud, Morris said, as changes in the lifestyles and behaviours among co-workers trigger suspicions.

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Data frontiers

Bank of America (BoFA) says it is not a financial services company. Like Google and Facebook, it considers itself an information business, says Ben Lever, senior research engineer at NICTA, an Australian information and communications technology research centre.

Lever says BoFA wants to know more about its customers. It analyses their transaction data to detect changes in financial behaviour. This provides opportunities to engage people to improve customer service or sell products.

For example, if a customer begins shopping at childcare stores regularly it is an indication they may be preparing to raise a family or bring their next child into the world. BoFA can then enquire if the customer would like to increase their level of insurance now that they have one or more dependents. Or they may want more credit as household costs increase.

Here BoFA is attempting to “monetise data,” Lever says.

This shows how companies can exploit a new development in society called ‘big data’. This catch-phrase describes how the volume, velocity and variety of data are rapidly increasing as people generate information every day in business and personal lives.

Increasing use of the internet and new communications devices, particularly smartphones, are the drivers of big data. Through these mediums we are generating more data than ever before. It is being transmitted at faster speeds. And we are being exposed to a greater variety of information than in any period.

We are now generating zettabytes. A zettabyte is a unit of information storage so immense that no system in existence can contain one. In 2010, 1.2 zettabytes of data was generated. This is enough to build a wall of iPads 20 feet high around the South American continent, Lever says.



Simon Mumme

Every 18 months we double the amount of digital content in existence.

Web companies are the “pioneers” of big data, Lever says. Their data sources are the browsing histories of internet users. Facebook, for instance, learnt the value of information about people’s friends and social lives. However few other businesses recognise its value of big data.

Superannuation funds can learn some lessons from BoFA. They can track the contribution histories of members and contact them if money stops flowing in. Or, they can monitor members’ behaviour during rough markets and ascertain character types. As members approach retirement they can get in touch to offer advice about protective investment strategies.

Companies that mine big data are employing ‘data scientists’ who aim to understand how this information can be used to become more competitive. There is no way to learn these skills but to practise them, Lever says. No courses or off-the-shelf products can help businesses synthesise massive volumes of data.

Most information businesses develop their own analytical capabilities. It’s an investment. “The expense is really in the people performing the analytics rather than on technology,” Lever says.

Bank of America wants to know more about its customers. It analyses their transaction data to detect changes in financial behaviour

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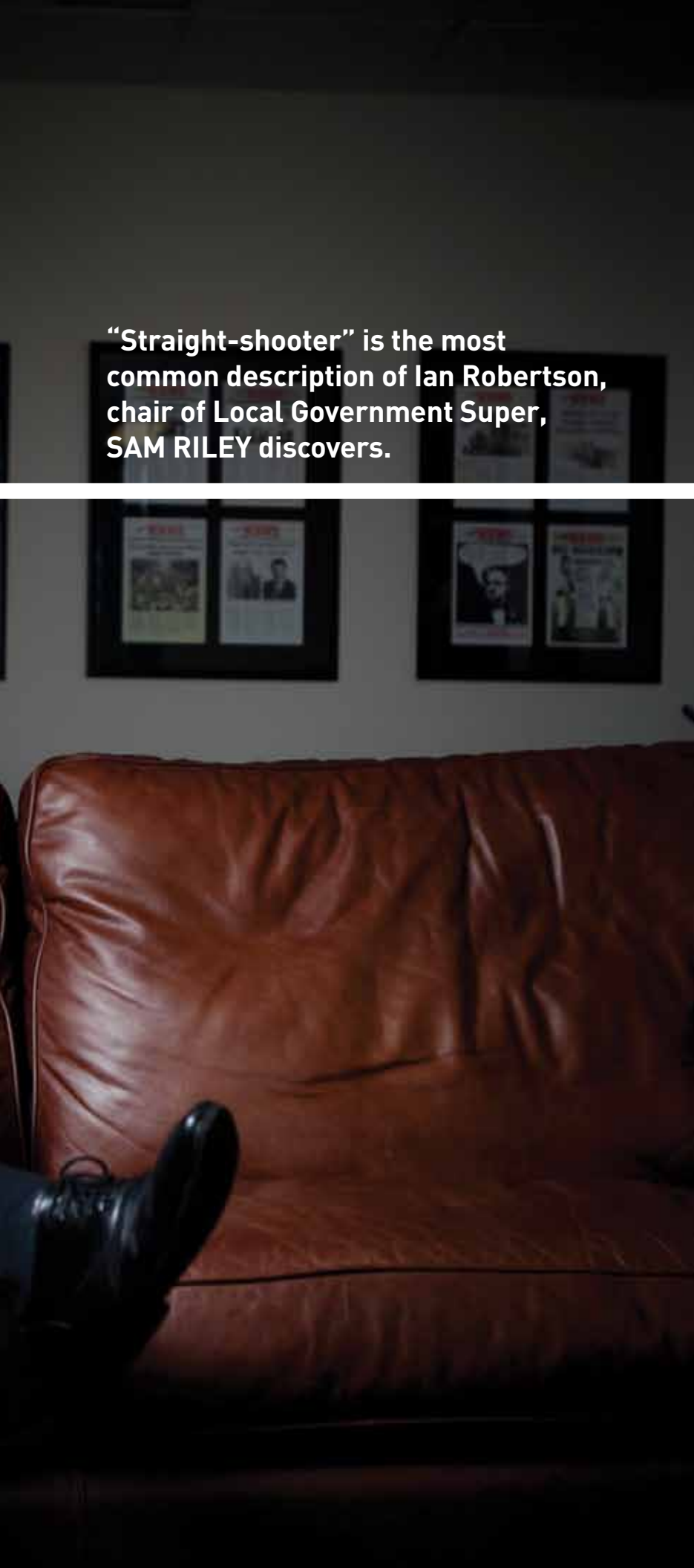
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Green & mean





“Straight-shooter” is the most common description of Ian Robertson, chair of Local Government Super, SAM RILEY discovers.

As a union secretary, Ian Robertson is used to delivering blunt messages - it's an approach that hasn't changed in 14 years sitting on the board of the \$6.2 billion Local Government Super (LGS).

“I suppose I don't put up with wankers or posers,” the chair of the LGS investment committee says, when asked about his straight-shooting reputation.

It was an approach that put some establishment noses out of joint when he was chair of the Australian Institute of Superannuation Trustees (AIST) from 2007 to 2010.

But Robertson, who first pushed for LGS to drop its investments in tobacco in 1998, says he will not relent from challenging fellow trustees in other funds to match their words with deeds when it comes to concrete action on environmental, social and corporate governance (ESG) issues.

Earlier this year LGS, along with Cbus, HESTA and MTAA Super, were the only large Australian funds to vote in favour of a resolution to amend Woodside Petroleum's constitution requiring the company to disclose its carbon-price assumptions.

Robertson says it was a crucial litmus test for Australian funds, which separated those that had merely aspirational green marketing statements from those prepared to demand a greater level of transparency from companies in which they were long-term shareholders.

“While ever funds can get away with saying they are UNPRI signatories and that ‘we belong to the IGCC’, but in reality do absolutely nothing other than that, they will,” Robertson says.

LGS has taken an active role in developing a range of innovative in-house strategies for tackling climate change and equity market risk in its portfolio.

This year it has extended a “socially-responsible overlay” across all its investments.

This involves applying ESG principles to both its actively- and passively-managed equity assets, and an ongoing effort to measure its carbon risk across its entire portfolio.

In addition, the fund is working on ways to hedge climate-change risk across all the asset classes in which it invests.

The fund has used external advisers Mercer to look at the overall carbon exposure of its portfolio, and uses other sustainability consultants to advise on what companies pose a potential risk.

Since 2004 it has not invested in Australian

companies that derive more than 10 per cent of their revenue from a range of areas, including armaments manufacturing, nuclear energy, uranium mining and the logging of old-growth forests.

Earlier in the year it extended its socially-responsible overlay to its international equities portfolio.

LGS presently indexes 50 per cent of its Australian equities portfolio and 40 per cent of its international equities portfolio. It has gradually increased its passively-managed mandates after re-examining its approach to equities in 2009.

It also indexes a sizeable portion of its bond portfolio.

The socially-responsible overlay the fund designed allows LGS' internal investment team to short a particular stock in the index to hedge against its potential ESG risk.

Usually between 1 and 2 per cent of the portfolio is shorted to hedge against ESG risk.

Robertson says the policy has worked well in the past. He cites a recent example where the fund shorted News Corp because of long-running concerns over its corporate governance structures - this was ahead of the phone-hacking scandal.

While the shorting strategy can create short-term pain, LGS calculates that over the last five years the policy has added 14 basis points to returns.

LGS has bolstered its ESG

capabilities, recently appointing Bill Hartnett as its sustainability manager.

Robertson says Hartnett is looking to increase engagement activities, including muscling up LGS's approach on executive pay and remuneration.

"We never quite got the idea that a recommendation would go out from ACSI about rejecting a remuneration report, but the chairman of the remuneration committee would be up for re-election as a director and we would vote for them," Robertson says.

"Now we will vote against him or her."

Robertson, who is secretary of the Development and Environmental Professionals' Association - a union representing NSW local government workers - says superannuation funds need to push harder if they want genuine change around how companies manage potential ESG risks.

"Being a union official, I realise that the time for asking nicely runs out and you either go away or you try and nail them," he says.

"Sometimes, merely asking doesn't work, and you have to see if you have other options."

Robertson is scathing in his assessment of some of his fellow union trustees who sit on the boards of industry funds across the country.

"It [a board position] is often treated like a sinecure for a reward for service to the movement and you sit on that

It was a classic marriage where someone went with two-thirds of the assets and only a third of the control, and no pre-nup

14

basis points is the amount added to returns in the last year by short-selling to hedge against ESG risk

board and don't have to do very much, and it's not going to be a challenging experience for you," he says.

"It is something where you can just pad the ball down the wicket for a while and just take a fee."

During his time at the fund, LGS has not been shy of a stoush.

Robertson was a vocal critic of alleged backroom moves to merge Energy Super with Local Government Super under the previous Labor State Government.

"It was a classic marriage where someone went with two-thirds of the assets and only a third of the control, and no pre-nup," he says when describing this period in the fund's history.

"In terms of an arranged marriage there wasn't much compatibility."

The fund's management arrangements with FuturePlus still have three years of a four-year agreement to run.

But Robertson says FuturePlus is "on notice" and that any future decision on extending the management arrangement will be made on "market considerations rather than mates' rates".

Robertson is also a strong advocate for the fund taking a position on the carbon tax, saying that as an investor it would engage with companies that became part of an armada of business interests lining up to oppose the policy.

"Think about all of these strange federations of businesses that are setting up to fight the carbon tax: industry funds and all Australians are shareholders in those companies involved," he says. "We would be more interested in them



saying ‘well there is an inevitability about carbon risk that we should be managing’”

Robertson says that a key point in the development of the fund was when LGS appointed its first chief executive officer, Craig Turnbull, three years ago.

The fund had previously shared a CIO with Energy Super.

Since his arrival, Turnbull has looked to bolster LGS’s approach to risk management generally, with ESG considerations playing just one part of that.

The fund is four months into a trial of an indexing methodology it has developed in-house to de-risk when key market factors are triggered.

The indexing methodology is a systematic strategy that covers a range of indicators in the 12 largest equity markets and looks at such things as economic growth outlooks, inflation, currencies and bond yields.

Described by Turnbull as similar to an “early warning system” the strategy is designed to retreat to cash to avoid potential downturns.

The fund has trialled it across 5 per cent of the overall international equities portfolio and Robertson said the fund was generally well-positioned defensively before the market hit turbulence in August.

But the strategy has been designed to be scalable.

At the end the financial year to June, the fund achieved about a 9 per cent return for higher growth options and 7 per cent for more conservative strategies.

It offers six different strategies to members, from high-growth to cash.

Despite Australia’s superannuation funds looking at a period of consolidation as the government’s sweeping reforms to the industry start to take effect, Robertson said he does not expect mergers with other local government funds.



“My expectation in five to 10 years is that we will still be Local Government Super,” he says.

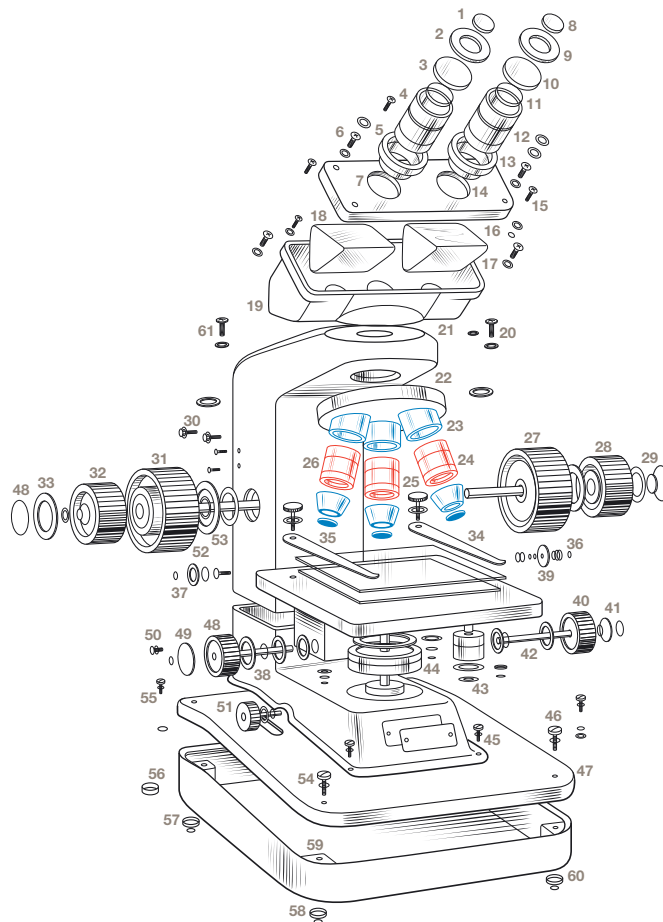
“There is some merger activity with other local government super funds, but none of them are interested in responsible, sustainable investment anyway.

Having seen the fall-out from a badly planned “marriage” between Energy

Super and LGS during his tenure at the fund, Robertson says any future partner would need to share a focus on sustainable investment.

“At the moment that compatibility doesn’t exist and if we sat down with a merger partner it would have to be with someone who thought the same sorts of things we thought,” he says. ■

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BREAKING BANK

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They are still the chief gatekeepers to hundreds of billions of dollars of superannuation capital and help develop many of the ideas and instil much of the discipline that is used to invest it. But as funds continue to grow and employ investment staff to assert more control over their portfolios, how can asset consultants adapt to stay useful? SIMON MUMME reports.

Inevitably, the money flows in. It compounds over the years and suffers the gyrations of financial markets. It belongs to millions of Australians but is managed by a relative handful. You could gather the most influential people investing this wealth and their advisors in a single room.

For most of the history of superannuation, investment consultants have been the gatekeepers to this wealth and have instructed funds about how to invest it. This hasn't changed. But as funds grow beyond \$20 billion or \$30 billion it has become common for them to hire investment professionals to focus on asset classes and report to CIOs implementing these strategies. Consultants are no longer guides to the investment world for these funds. They are partners on the journey.

Fiona Trafford-Walker has been at the helm of Frontier Investment Consulting, which advises \$117 billion, since its origins as part of Industry Fund Services in 1994. In theory, she says, investment staff within funds can replace consultants. "But our hypothesis is there is more need for people like us as a sounding board for ideas." She says Frontier's knowledge of funds' histories advances this case. "That level of experience is valuable."

For Towers Watson, this change causes it to engage more "deeply" with larger clients, says Graeme Miller, head of investment at Towers Watson. These clients "expect more specialisation, deeper research and an extension of their internal resources" from investment

consultants.

Consultants exist to provide expertise. In days gone by their value proposition to super funds was straightforward, says Brett Elvish, director of Financial Viewpoint and a former boss of investment consultant Intech, now called Ibbotson Associates. Today it is more complex.

"Standing up in front of a client and articulating expertise is a very different role than partnering with a client," Elvish says. "Australian asset consultants have had a far more dominant role than anywhere else in the world. That's slowly changing. They're moving away from being dominant to becoming more of a resource."

Elvish has advised investors who use consultants this way. He has seen them ask for specialist advice on asset classes and strategies instead of comprehensive guidance for their portfolios.

"What we've seen is a gradual broadening of the research base," Elvish says. "That is consistent with providing more specialised services in particular areas."

Russell Investments is an example of this. As it attempts to re-build its Australian consulting business, it has hired people to focus on aspects of investing that it believes are crucial for Australian institutions. Nicole Connolly, for example, was hired from Telstra Super to advise on alternative strategies, and Raewyn Williams was hired from Queensland Investment Corporation to concentrate on after-tax investing. These are all people who, in their previous jobs as investors, have "touched the money" and provide specialist advice, says Greg Liddell, director of consulting.

These specialist services can be used by funds of all sizes but are suited to larger investors. There are not many of these big, \$20 billion-plus, investors. This spurs Warren Chant, director of superannuation research and ratings business Chant West, to say the growth of investment teams within superannuation funds is over-hyped.

"Not many funds have strong internal resources," he says. "You could name them on one hand easily."

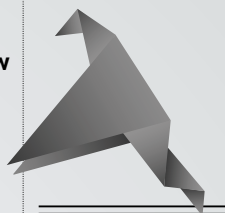
But they indicate a future that consultants are preparing for. In 2009, Mercer Investment Consulting restructured its global business to adapt to investors seeking expertise beyond that provided by generalists. It created research teams, or 'boutiques', that focus on different aspects of investing, such as dynamic asset allocation, alternatives or sustainability risks. Graeme Mather, head of the business in Australia and New Zealand, which has \$152 billion in funds under advice and management, says Mercer is prepared to garner clients who seek specialist input.

"The role of the generalist consultant is gone," Mather says. "The relationship manager is like a conductor. They can play a few instruments but is not an expert with all of them."

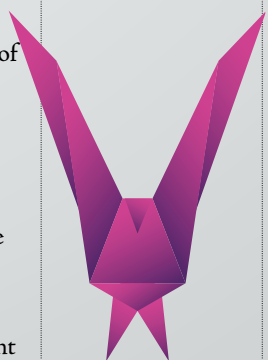
JANA Investment Advisers, whose funds under management and advice total more than \$167 million, engages most types of institutional investor in Australia and New Zealand. Its clients include smaller institutional investors, charities and large superannuation funds. Ian Patrick, CEO of JANA, says "the nature of client relationships is more diverse than ever". The days of smaller superannuation funds overseen by trustee boards or investment committees that meet quarterly are over, he says. "They are fewer in number than even five years ago."

It is more common for clients to call upon research specialists within JANA for insights on specific aspects of investment. "But this doesn't detract from the fact that, in my view, the primary relationship person with each client has a very weighty responsibility to address the significant issues and provide leadership for specialists," Patrick says. "You can't allocate tasks and assume they come together in a seamless fashion for the client. You still need that central relationship person to synthesise all of those views."

This illustrates how the "mechanisms"



Australian asset consultants have had a far more dominant role than anywhere else in the world. That's slowly changing. They're moving away from being dominant to becoming more of a resource



of asset consulting are changing as large funds hire investment staff. The aim of the business – to help clients meet their investment objectives – will always remain. But consultants will adapt to how funds do business. “Do I know what form this will take? No,” Patrick says.

Throughout its 40-year history, Cambridge Associates, a US-headquartered investment consultant, has kept the endowment funds of Yale, Harvard, Princeton and Stanford universities, which are some of the world’s most successful institutional investors, as clients.

“They are very different now compared to what they were,” says Eugene Snyman, managing director of the consultant’s Australian office. “They have in-sourced significantly. And we have adapted to remain relevant.”

The endowment funds were among Cambridge’s early clients. It now advises 930 institutional investors. Each has different demands: capital markets research, manager research or advice on specific challenges in asset classes. “No one approach fits all,” Snyman says.

Since it began advising Australian investors in 2000, Towers Watson’s business aim has remained unchanged, Miller says. It is to hire and retain smart people who can consistently take great ideas to clients. The business now advises investors managing about \$177 billion. As the superannuation and investment industries consolidate it is impossible to accurately predict what funds will ask for in the next 10-to-15 years, Miller says. “But if we stick to this principle, as a business we will be successful.”

BEING POPULAR IS TOUGH

“Ultimately, it’s a very hard job,” Elvish says. “There are countless funds managers kicking down your door, wanting to speak to you. There is a never-ending array of products and investments that clients want to consider. And there is a limited amount of resources and time.”

Nearly every funds manager wants to know the investment consultants. In

turn, these gatekeepers to deep pools of institutional money rely on managers as sources of ideas. “Consultants are fortunate,” says Chant, who regularly helps funds choose consultants. “They have the benefit of talking to many managers regularly and getting the benefit of their ideas.” He believes the “real idea-generation” within consulting businesses is sourced from funds managers.

But it takes time to find managers worth listening to. “Every single day we get knocks on the door from funds managers telling us they have hugely compelling ideas for our clients,” Miller says. “But the reality is that the majority of ideas and opportunities we come across, we reject.”

He says the best funds managers have “a lot of intellectual property and brain power” that benefits Towers Watson and its clients. Conversely, some of the “richest ideas” the consultant taps into have come from the investment staff of large funds. Like most consultants it is connected to many sources of ideas. Its job is to pick the best and help clients implement them – but also to challenge clients.

“I think a lot of institutions are subject to status-quo bias,” says Gareth Abley, head of capital markets at MLC Implemented Consulting and the former boss of its \$12 billion implemented consulting business. “It’s much harder to get a new idea into a portfolio. The hurdle for something new to get in is much higher but there is a level of acceptance and stickiness when something is already in.”

As a result, institutional investors usually adopt new ideas slowly. This can be detrimental and policies for proving new ideas – and for testing existing ones – should be applied rigorously, Abley says.

MONEY TALK

Ideas are currency for consultants. Miller describes Towers Watson as an “ideas business” focusing on research. Its best-known research team is the



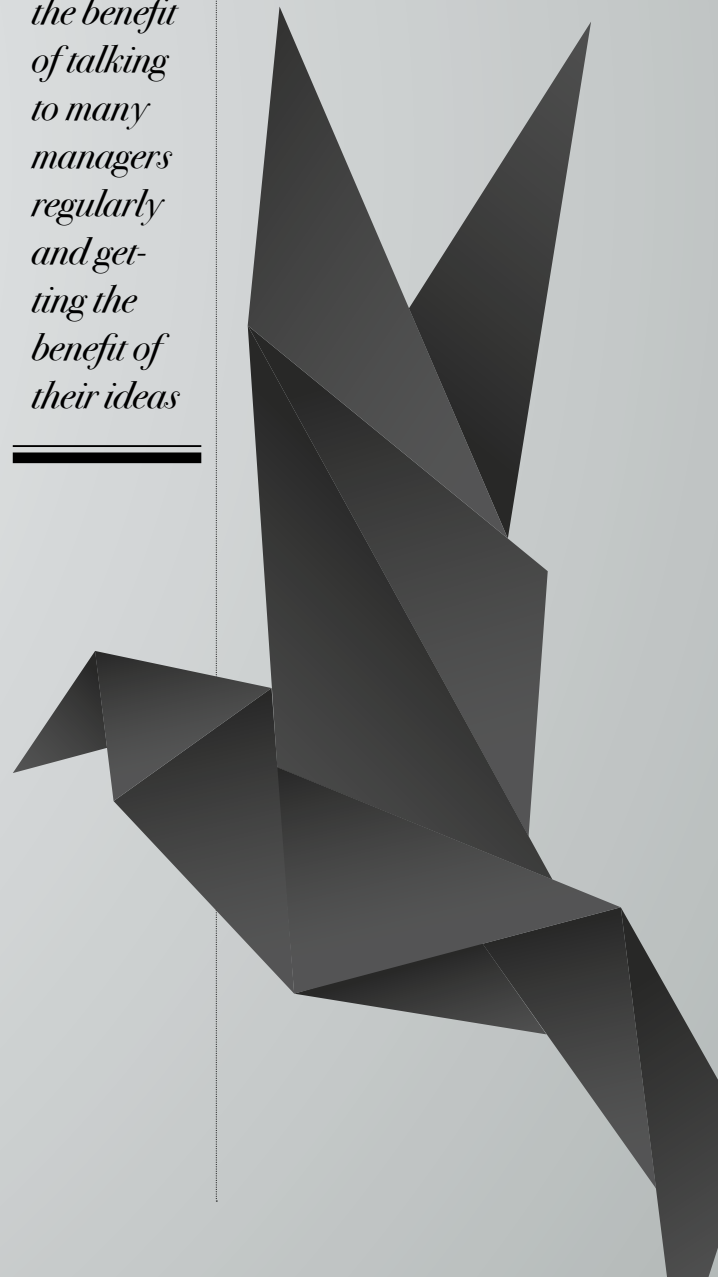
Graeme Miller

Consultants are fortunate. They have the benefit of talking to many managers regularly and getting the benefit of their ideas

Thinking Ahead Group (TAG), set up 15 years ago by Roger Urwin and Tim Hodgson. Headquartered in the UK, it is led by Hodgson and has seven full-time members who are supported by contributors in Towers Watson offices around the globe, such as Tim Unger in Sydney.

“Their job is to sit in a room and think,” Miller says. “TAG has a blank sheet. Out of every 100 or so ideas that TAG looks at, perhaps seven or eight might be considered worthy of being included in clients’ portfolios. Quite possibly, only two or three might be included.”

“When the team comes up with an idea they believe offers a rich reward for risk, you can be very certain that everyone



in the organisation takes notice.” These ideas are like “nuggets of gold” that can be brought to clients, Miller says.

Hodgson says TAG is not focused exclusively on risks and opportunities within financial markets. It explores the interconnections between politics, economics, society, environment, technology and finance. “There are very few self-contained problems,” Hodgson says.

Its ideas span the world. The team members are “specialist generalists” who assess how interconnections ultimately impact investment portfolios. “For TAG we need individuals who are enquiring, discontented and dissatisfied with the status quo.”

Hodgson quotes Henry Ford, who invented assembly lines for automobile production, to substantiate this: ‘If I had asked people what they wanted, they would have said faster horses.’

Towers Watson does not request that TAG’s ideas manifest regularly in clients’ portfolios. It wants to see “pure research and development.”

At any time, TAG has a number of “thoughts” that are active and at varying stages of development, he says. For example, something that is “bugging” him is how investing, which in economic terms can be seen as deferred consumption, impacts asset values in public markets. “When baby-boomers are saving for retirement, what happens? Is it that all they did was increase the price:earnings (P:E) ratios [of equities]? Now they’re selling and there is no-one to sell to. Those P:E ratios will fall and they will not have saved as much as they thought.”

In 2009 the group named extreme risks for investors, such as solvency, hyper-inflation or deflation, and policy risk. It has made two additions: resource



Warren Chant



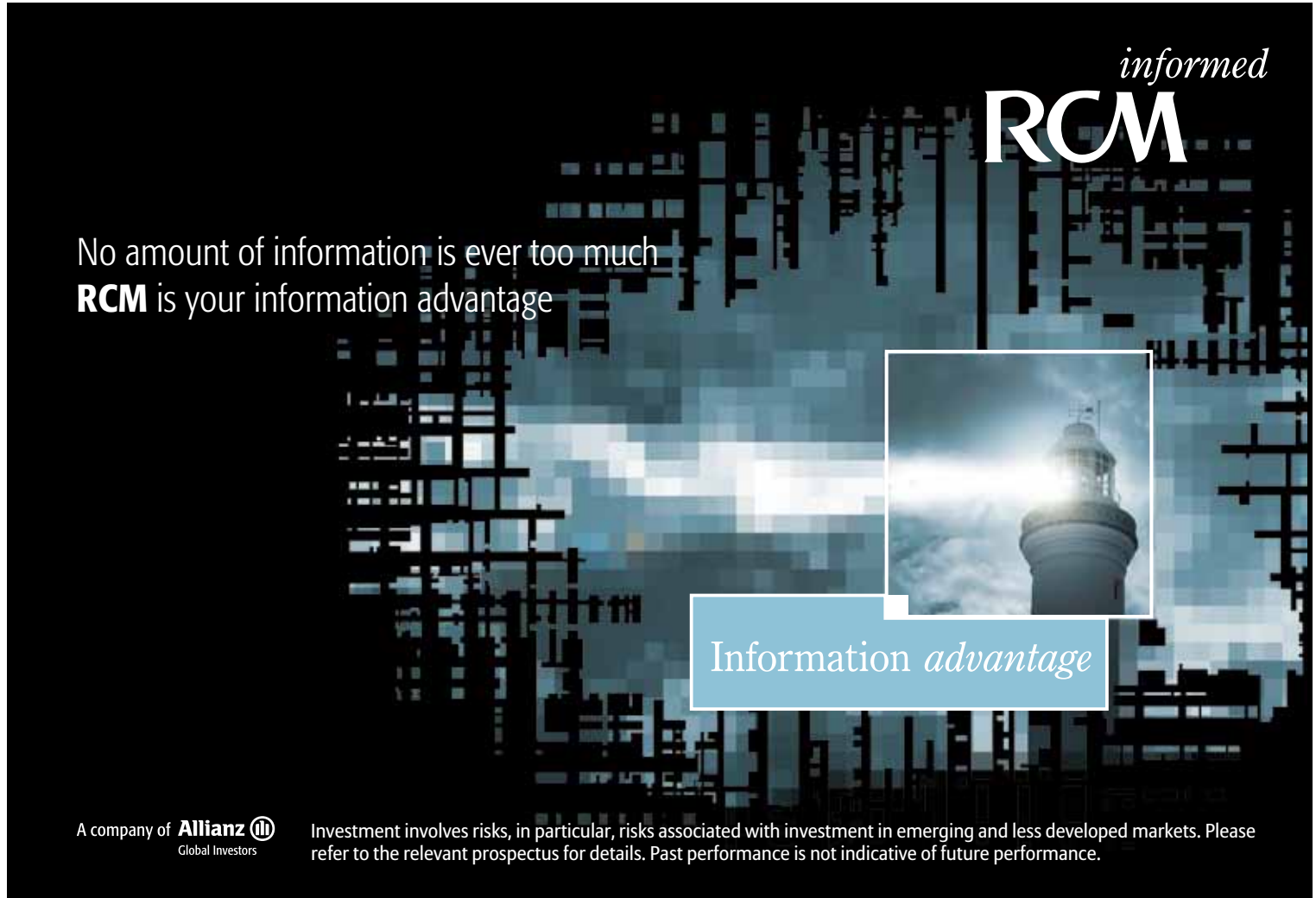
Graeme Mather

scarcity and infrastructure failure, which allude to society’s dependence on infrastructure and power to function.

It is also canvassing ways it can work more closely with, or “co-innovate”, with selected clients rather than develop ideas on its own. “We would like to work with a subset of clients and dedicate resources to it.”

Frontier also aims to develop research ideas with funds. In a re-structure of the business in June, Trafford-Walker became director of consulting after relinquishing management duties to Damian Moloney, the former long-term CEO of Industry Funds Management, who became the consultant’s first chief executive.


It also created an investment committee, led by Trafford-Walker and staffed by senior consultants, to develop ideas and take them to clients more quickly. This month, the committee



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will hold its first “ideas forum”, in which staff members are encouraged to pitch ideas they believe to have a lot of merit, Moloney says. The committee will select the best and present them to funds.

“Clients want to share ideas more often and hear a lot about what we’re doing earlier in the process rather than at the tail-end,” he says. “Ideas diminish in value very rapidly. Clients want to continue to get returns by moving first.”

There seems to be a common trait between Cambridge Associates and the university endowment funds it has advised for decades. The “collegial” regard among staff furthers the consultant’s investment thinking, Snyman says. Paul Liu, who relocated from California to join Cambridge’s Sydney office in May, says “the academic aspect” distinguishes the consultant from competitors.

Company-wide conference calls, held each month, help relay investment ideas and spur debate. Approximately 200 consultants, 150 analysts and 210 researchers participate in the hour-long discussions. Staff members are encouraged to research outside their areas of expertise, which helps enrich the intellectual property of the business. They are also rewarded for sharing ideas. People who “keep their cards close to their chests” do not fit in, Snyman says.

GLOBAL VS LOCAL

Warren Chant knows Australian asset consultants very well. For a decade, his company has been hired by super funds to compare and select investment consultants. It runs about five such



Damian Moloney

Every single day we get knocks on the door from funds managers telling us they have hugely compelling ideas for our clients. But the reality is that the majority of ideas and opportunities we come across, we reject

tenders each year and assesses most consultants annually. “We know them very well. We research asset consultants in the way they research funds managers,” Chant says. The company scrutinises their ability to monitor and interpret capital markets, craft investment strategies and assess funds managers.

Like other researchers, Chant asks for how much longer Australian consultants can compete against their global rivals who have overseas offices and argue they have better access to managers worldwide.

“JANA and Frontier will say they have been going overseas to do research for many years,” he says, “and because they have dual roles in consulting and research they can talk about managers they have met and researched.”

The investment performance of the domestic consultants’ clients parallels that of funds advised by global consultants, he says.

“We say to clients that both models work and that both have shortcomings. But we don’t buy the argument that there is enough proof that international firms are better.”

JANA consultants’ dual roles as researchers and advisers is important, Patrick says, because clients put a lot of trust in JANA’s capital markets analysis and assess recommendations based upon this work. “You don’t do research for the sake of research,” he says. Moloney says Frontier is more confident in rating managers if it has met them face-to-face rather than rely on reports from colleagues offshore.

Chant says the most significant change in Australian consulting has not been the expansion of funds’ investment teams but the global consultants’ adoption of dynamic asset allocation (DAA) strategies.

These techniques allow funds to be more responsive to changing market environments by adjusting their asset allocations to take advantage of mispriced assets over three- and five-year periods. Since the financial crisis, Towers Watson, Mercer and Russell have come to market

with DAA services. However JANA and Frontier have done this for years. "It's in their DNA," Chant says. It has accompanied their long-term investment advice.

Funds will need to keep watch on global consultants, he says. "It does take time to learn these skills."

Cambridge sees long-term investment strategies and DAA as being joined at the hip. It is one reason why it prizes the research of its capital markets research team: this work informs the tactical moves Cambridge recommends "so clients don't get whip-sawed by market moves," Snyman says.

People in superannuation often murmur about the conflicting interests of some consultants – such as Mercer, JANA and Russell – who provide a blend of advice and funds management known as 'implemented consulting'. Frontier is committed to advisory only. Towers Watson, meanwhile, oversees more than US\$50 billion in 'fiduciary management' services in offshore markets. Through this service the consultant sets makes all of the investment decisions but clients hold the contractual relationships with service providers, such as funds managers and custodians. Miller has no intention of marketing this service in Australia any time soon.

"JANA, Russell, Mercer say yes we do," Chant says, referring to the conflicted interests of advisory and implemented consulting, "but they're manageable." The consultants say their advice is independent from their funds management businesses. Only they know the truth. But it may not be so bad if some of the discipline of funds management crept into their advice: "It's different when you have to pull the trigger," Chant says.

"What they say is the downside of the conflict is offset by the upside of being an investor. This

intellectual property is being used by the traditional consulting side."

Elvish agrees. The benefits of providing implemented consulting are stronger understandings of risk management and compliance. "When you're making investment decisions," he says, "you've got to be accountable for them. So the nature and rigour of business decisions change."




Ian Patrick

GENERATIONS

Among the major consultants, Chant believes JANA is the most prepared for succession. Evidence of this is Ken Marshman's move from running the business to becoming the company's first head of investment outcomes in 2009. This paved the way for Patrick to become CEO.

Other JANA veterans - David Holston, Jim Lamborn and John



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Coombe, who are all executive directors - are no longer heads of research. These responsibilities have been assigned to younger people rising through the organisation. "JANA is very good at bringing up the next generation," Chant says.

A major strength of the two large domestic consultants is their deep roots in Australia. The businesses have been built on the work, experience and - to no small extent - the personalities of Marshman, Trafford-Walker, Coombe and Frontier's deputy director of consulting Kristian Fok. This is irreplaceable. But Patrick and Trafford-Walker say that successors are rising from within their Melbourne and Sydney offices. Chant agrees. "They probably have the strongest client base and breadth and depth of consultant [staff]," he says.

Frontier is making a big effort to showcase the depth of experience in the business. Trafford-Walker, who has worked with some Frontier clients since the mid-1980s and been involved in the execution of their investment strategies, acknowledges the difficulties of succession.

"People get attached to people," she says.

Global consultants are much larger organisations. Staff members on the ascent can rise through domestic offices or move through the ranks offshore and be posted to a senior position in Australia. Succession is not as clear as it is in the domestic firms.

As consultants broaden their research scope and strive to deliver specialist knowledge, they need to hire and retain talented people. Losing them can threaten this business model.

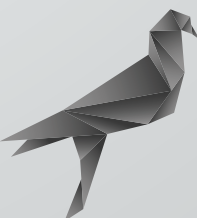
"If you get people right it leads to success," Mather says.

Arriving at the helm of the Australia and New Zealand business from London in May 2010, Mather has encouraged staff to take ownership of their ideas and make them a compelling offer for clients. "I have tried to change the culture of the business to be more innovative and free-thinking," he says. It is important to



Eugene Snyman

The role of the generalist consultant is gone. The relationship manager is like a conductor. They can play a few instruments but is not an expert with all of them



Australian investment consulting market

Investment consultant	Global investment professionals	Local investment professionals ²	New local hires 2011 (net)	Number of clients ¹	Funds under advice \$m
Cambridge Associates	1053	6	0	6	2,300
Frontier Investment Consulting	36	36	0	18	117,237
Ibbotson Associates	120	13	0	3	18,400
JANA Investment Advisors	50	50	0	52	167,399
Mercer Investment Consulting	1042	82	6	66	151,597
Russell Investments	520	62	2	13	61,396
Towers Watson	560	32	3	45	176,758
TOTALS	3,381	281	11	203	695,087

Source: Financial Viewpoint

* Clients defined as retained advisor providing a broad range of services supporting multi-asset class investments (excludes implemented consulting)

1. Client information as at 30 June 2011

2. Local investment professionals includes implemented consulting investment professionals

make sure that opportunities for staff to further their careers are visible.

Motivating people through non-financial means - by making them responsible for the success of their ideas and running "soft" profit-and-loss tallies within teams - is important. And even though consultants can't reap the same pay as the funds managers they rate, remuneration must be competitive.

Miller says the best way to retain talented people is through a strong corporate culture focused on investment research. Proof of Towers Watson's supportive environment for researchers is that no staff member has ever left to join a competitor. Junior staff know the way to progress through the business is by completing meritorious research.

Perhaps Cambridge Associates can make the most convincing claim to deeply valuing its employees: the company has never fired an employee for "economic reasons", such as cost-cutting in rough markets, Snyman says. Senior people took pay cuts instead as Cambridge looked for other ways to save money. "Many consulting firms had big lay-offs during the financial crisis," Snyman says. "Nine months later, they were on recruitment drives."

Liu relocated from the company's Menlo Park, California, office to Sydney in May. "It's largely the culture that has convinced me this is a place to stay for a long time," he says. When was he hired into the California office, located near the

venture capitalists on Sand Hill Road, his direct boss was a 25-year veteran of the company. "He mentored me for the first four years. That's quite a common practice across the firm." The consultant's ideas and those of its clients were shared with the newcomer. Responsibilities were given later. "After a few years I was given the option of leading the relationship."

Most consultants spoken to for this story participate in the Pete Lee survey measuring investors' satisfaction with the advice they receive. Sure, this qualitative feedback is nice, Trafford-Walker says. But as a measure of success it isn't as important as the real returns superannuation fund members receive - particularly because many of these people rely on funds because they can't manage retirement savings themselves.

"We're here to earn good returns for members. That's how I judge myself," she says. "A client is a client, but it's the nurses in HESTA and builders in Cbus that receive the returns."

Frontier's clients may not accept all the investment advice they receive. Nevertheless the most important measure of success the consultant makes is clients' aggregate performance over the medium-term. ■



Collateral Management Services: The Outsource Solution To Optimise Counterparty Risk Reduction

By: Greg O'Sullivan

The hard lessons of the financial crisis of 2008-2009 continue to underscore the critical importance of identifying, managing and mitigating systemic risk. While Australia weathered the crisis comparatively better than economies elsewhere, its investors, asset managers and regulators share this concern.

Efforts to address counterparty risk, in particular, are focusing attention on the key role of collateral as a risk mitigation tool. Indeed, many financial regulatory initiatives now under way in the US and Europe, for example, seek to further this role. As a result, collateral management is growing both more complex and costly. In light of this trend, investment managers are turning increasingly to the comprehensive outsourcing capabilities of third-party providers.

Facing counterparty risk

Collateral requirements have long been routine for many derivatives transactions, but in the over-the-counter (OTC) market they are often inconsistent, based upon arrangements reached between the two parties to these typically non-transparent bilateral trades. In the event of default, the parties may have little recourse than to liquidate any collateral held.

The dangers of under-managed counterparty risk emerged as a notable highlight of the GFC. With potential exposure often unknown, its destabilising impact helped spread disruption across financial markets. The experience served to illustrate the palliative uses of collateral to mitigate risk, therefore curbing runaway ripple effects.

Now that collateral management is rapidly becoming a vital operational function it is likely to assume greater visibility as the result of heightened investor awareness and, where applicable, a regulatory shift to minimum collateral requirements for all derivatives trades. These developments are leading to widespread efforts to more effectively manage collateral. The sums at stake reflect the challenge: total collateral in force across the OTC derivatives market is currently estimated at \$2.9 trillion, of which about 80 percent is held in cash.

Complexity and cost: the provider solution

Yet as investment firms look to bolster their collateral management operations, administrative complexity and rising costs stand in their way. For example, many transactions call for daily monitoring to determine exposure and track the movements of associated collateral assets. At the same time, while daily collateral portfolio reconciliation is a recommended practice, surveys report that as few as 31 percent of affected market participants actually do so. Effective collateral management requires robust data capabilities, risk analytics and



Greg O'Sullivan

specialised decision-making skills. The human and technology infrastructure needed to do the job can burden already-strained budgets.

Faced with the task, a growing number of investment managers view outsourcing as an advantageous solution. Executed well, the decision to outsource can help significantly to control the risk, time and cost inherent in administering a collateral program across a range of products and markets. Partnering with a third-party provider offering end-to-end service can enable managers to focus their efforts on their core investment and client-facing services, while assured that their collateral function receives the attention necessary even in periods of market turbulence.

Before deciding to outsource this key function, however, managers must have a clear understanding of what to look for in a provider in order to exercise care in their selection. As policymakers, regulators and investors alike respond to the aftermath of the crisis, never before has collateral management presented such formidable challenges. To meet the test, a provider must have an overall proven record of reliability, flexibility, transparency and expertise. Specifically a collateral management outsourcing program should feature the following best-practice characteristics:

Flexible end-to-end service across instruments and business lines

- A collateralisation process across multi-year lifespans that encompasses exposure calculation, profiling and eligibility validation, daily pricing and substitution, margin call management, and robust exposure reporting
- Daily monitoring of counterparty risk to calculate exposure, as well as aggregate

and reconcile posted and pledged positions wherever located

- Netting capabilities across products to leverage available assets
- Higher-value-added services, such as collateral enhancement, where needed

Leading-edge data capabilities supported by a policy and record of transparency

- Robust reporting — delivered according to the clients' need — that provides a comprehensive overview of collateral and counterparty exposure across all collateral assets, as well as supporting trade data
- Secure personalised online Web access

State-of-the-art technology

- Demonstrated scale and flexibility to adapt to client requirements and changing regulatory needs
- Long-term commitment to technology investment

Expertise across assets and across markets

- Ability to stay ahead of regulatory change
- Deep understanding of the derivatives market
- Systemic risk awareness

As one of the world's leading global investment services providers, State Street's rich experience in the derivatives market has not only shaped a collateral management program that embodies these practices, but helped make them industry standards. Clients can elect either its full-spectrum middle-office suite of services, or individual components tailored to their needs. State Street complements its world-class technology infrastructure with a network of centers of excellence (including one such in Australia) to provide a wide range of collateral solutions geared to multiple currencies, instruments, business lines and markets.

With today's expanding emphasis on risk awareness, collateral management will continue to grow in importance. For investment managers, partnering with a trusted provider can help optimize this critically useful risk reduction tool.

Greg O'Sullivan is vice president and head of sales for State Street Global Services.

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VIEWS FROM THE WORLD'S END

Australian small-cap equity managers are bracing for a rough time as headwinds batter retail companies and speculation grips the resources sector. PHILIPPA YELLAND and SIMON MUMME report.

Erik Metanomski is bearish. He believes investors are entering an even tougher market. It is possible that “massive panic” can spread globally as U.S., U.K. and European governments struggle under burdensome public debt, he says.

Metanomski, the well-known Australian equities investor who founded MMC Asset Management, has teamed up with David Prescott to form deep-value funds manager Lanyon Asset Management. They say stock-pickers can profit as Australia nears the end of a “surreal” period in its social and economic history.

“Consumer spending grew for 15 years straight on the back of rising levels of leverage that we had never seen before,” Metanomski says. “I don’t think what was occurring then was normal. I think we’re going back to normal. People are still living in the last 10-to-15 years of unprecedented growth in house prices, consumer retail, debt and liquidity to keep prices at artificially inflated levels.”

People in the U.S., Europe and the U.K. have experienced this. “Now Australia is topping out.”

This is good news for small-cap funds managers aiming to buy good stocks

cheaply - but only if they can stay in business. “Generally, in tougher markets, history tells us the casualty rate is highest among small-cap funds,” Metanomski says. Investors’ conservatism drives them to the liquidity in the large-cap market.

But it pays to take risk in the small-cap market, says David Aylward, founder and managing director of small-cap manager Tribeca Investment Partners. He says small-cap investing provides attractive investment opportunities because the companies are typically “under-researched, undiscovered and [are] an opportunity to invest in emerging opportunities”.

Market capitalisation in the Australian equity market is very concentrated in the top 10 to 20 stocks, so brokers concentrate their efforts in this narrow band, says Aylward, who’s managed Tribeca’s small-caps portfolio for 12 years.

Bottom-up research focusing on small-cap companies - where there is greater opportunity to add value through direct company and industry analysis - can give active managers an edge over a passive benchmark such as the S&P/ASX Small Ordinaries, he adds.

DEBT AND BURIED

This investigative approach is needed. Paul Bruncker, an equity strategist JP Morgan, says the good days of solid earnings growth among Australian large-cap stocks, which was achieved despite their size, may be coming to an end.

In principle, the earnings growth of large-cap stocks converges towards the growth rate of gross domestic product (GDP) as industries become mature. It becomes hard for big stocks to outgrow their industries.

“What can postpone this evil day is rising margins,” Bruncker says. “The 2000s saw exactly this in Australia, as consolidation led to industries becoming more oligopolistic.”

But this phase of consolidation has run its course, Bruncker adds, and is in some cases reversing. This line of thinking is confirmed by S&P’s research showing that, with the exception of Australian small-cap equities, many active managed mutual funds underperformed their relative benchmark over five years.

Guy Maguire, S&P Indices’ head in Australia, says efficiency in the large-cap equity market will remain a “challenging space” for Australian managers, especially



David Prescott and Erik Metanowski

because financials and resources are a significant part of the S&P/ASX 50.

Anticipating tough times, Metanomski and Prescott are searching for companies with strong balance sheets and resilient revenues. For instance, they have invested in major cinema groups because they have found that consumers in recessions are more likely to choose cinema instead of concerts or the theatre as it is a cheaper means of entertainment.

Tribeca's Aylward believes there are cycles when small companies either collectively beat or lag large caps for periods of time. "There is a cyclical element, but we say that that is difficult to pick," he says. "We believe clients are better off with a permanent allocation and then trying to get the alpha in the small-cap market, which is persistent."

One cause of consistent gains from small-caps, Aylward says, is information arbitrage, which is the ability to gather new information about companies. "Information arbitrage really does exist. Managers who are skilled in picking small-cap stocks can have that information advantage," he says.

Brunker sees little or no support for the buying the "beta" of the small-cap market. Attempts to beat the market usually provide richer rewards. He bases these views on four considerations:

1. *Strategic beta:* JP Morgan does not support this argument. It says the evidence for a persistent small-cap effect in Australia is not convincing;

2. *Tactical beta:* There is some support for the market-timing argument but cyclical conditions are not currently in favour of small-caps at the moment;

3. *Strategic alpha:* JP Morgan supports the case for alpha potential in small-caps. This is based on evidence of ongoing inefficiency in the sector and the past performance of managers; and

4. *Tactical alpha:* Because large-cap equities face earnings headwinds, the case for gaining tactical outperformance from small companies is strong.

Commenting on the third view, Mercer principal David Carruthers says the median manager in Mercer's



David Aylward

Despite efforts to develop fruitful relationships with the bosses of companies - to learn about how they run businesses and their levels of integrity - their questions sometimes result in blunt and foul-mouthed orders to immediately leave the premises

Australian small companies survey (focusing on stocks outside the top 100) has outperformed by 5.9 per cent a year over five years, and 4.7 per cent a year over the 10 years to June 2011. Even the lower-quartile manager has delivered excess returns over many rolling three-year periods, he adds.

ALL THAT GLITTERS

The imperative of undertaking proprietary research means active small-cap funds managers develop their own views on sectors and specific stocks.

Many, however, such as Simon Conn at Investors Mutual and Shane Livingstone at Legg Mason, currently exercise similar caution about the resources sector.

Conn says the "abnormally high percentage of the index in resources" underscores the crucial need for disciplined stock-picking. "There have been two booms and one significant correction in this sector in the last five or so years. Discipline is critical in avoiding much of the speculation within this segment of the market.

Livingstone says roughly 40 per cent of small-cap stocks in the S&P/ASX Small Ordinaries Index are in mining and energy businesses. An ancillary sector, mining services, has also grown substantially.

"Recent weaknesses in mining services company share prices would suggest an implicit downgrade to global spending on mining projects. But so far, those exposed to mining volumes have seen no weakness in their order books," he says.

Retail stocks send mixed messages. In the same month that big retailer David Jones announced a significant earnings downgrade, Kathmandu, a small-cap business, announced a significant earnings upgrade.

"Consumer spending may be weak, which is a challenge for all to face, but there may be other attributes to compensate," he says. "A vertical business model, strong store rollout strategy, good management and high gross margins

could be just the keys to protecting earnings rather than selling out and buying a low-growth utility company."

SLUGGING IT OUT

Unlike most institutional funds managers, Lanyon is not committed to being fully invested. In late July, it held 12 stocks and held 45 per cent of its assets in cash. At MMC Asset Management, Metanomski held an average of 40 per cent of his portfolio in cash.

He says investors should first invest in assets providing maximum downside protection before pursuing rewards for taking risk.

Lanyon competes against the ASX Accumulation Index as a benchmark - but only because it *has* to have a benchmark, Metanomski says.

The investment industry's obsession with relative performance is a "fiasco," he says. Metanomski asks: if the market falls by 20 per cent, and a funds manager has delivered -10 per cent to retirees, will they telephone their client and tell them they've had a great year? he asks.

"They've had a bad year. A loss is a loss. Relative [returns] don't come into their thinking," he says.

Metanomski and Prescott are willing the onset of deleveraging in Australia - despite the business pressures it will bring - so they can once again buy good stocks cheaply.

They begin each working day by looking at which stocks have fallen to their lowest prices in 52 weeks. It was a daily habit of value investing doyen Benjamin Graham.

"There might not be anything worth looking at. Sometimes there might be good businesses," Metanomski says.

David Prescott says this provides many stock ideas. "I particularly like the words, 'non-investment grade,'" he says.

This initiates Lanyon's research, which is driven by Metanomski and Prescott, and is not based on research from brokers.

Despite their efforts to develop fruitful relationships with the bosses of companies - to learn about how they

run businesses - their questions sometimes result in blunt and foul-mouthed orders to immediately leave the premises.

Their way of investing is neither art nor science. It's grit. "I'm a slugger," Metanowski says. "I'm a number cruncher. I slowly but surely get there."

DURABILITY

Despite the cooling housing market, Conn is bullish on paint companies Dulux, Cabots and Selleys. These companies have long histories of profitability, strong management teams and good balance sheets.

Both Investors Mutual and Legg Mason are focused on the financial services sector. Conn says Thorn Group, which includes Radio Rentals, is well-placed in the current market. It's doubled its profit in the first three years of its life as a listed company, and will grow its earnings in the slower economy.

Through its Radio Rental stores, Thorn rents household goods to consumers who cannot afford to buy them outright. Conn says the core business benefits in times of increased household stress as the potential number of customers grows at these times.

Thorn's earnings have also recently grown through buying debt collection agency NCML. This was done at an "attractive price" and it expands the range of their financial services capabilities, particularly into the commercial segment, Conn says.

Livingstone says the best sectors or companies investors can be exposed to "are those that are less at the mercy of sudden changes in sentiment". Their revenues will be more resilient in tough times.

"While easy to say, they are not that easy to find as the companies must also be reasonably priced, have

strong management with a track record and options available to exploit," he says.

A good example is FlexiGroup, a financial services business focused on small-ticket lending. The company came to the market in 2006 with its major business leveraged to sales of IT and electronics equipment through Harvey Norman stores. Since then it has exploited the departure of most of their competition during the financial crisis



Simon Conn

and diversified into other rapidly growing areas, such as interest-free loans for household purchases such as solar panels, vendor finance, mobile broadband and lay-by purchases.

Stock tips may differ, but small-caps funds managers are united in their view that an era in Australia's economic history is closing. But the world is not ending. ■

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Kevin Gundle

Turf war: hedge FoFs, consultants clash

Hedge fund-of-funds offering advisory services and customised portfolios are directly competing with specialist hedge fund consultants. Which is more capable of meeting clients' needs? PHILIPPA YELLAND and SIMON MUMME report.

Kevin Gundle is not firing shots at hedge fund consultants. He wants some questions answered.

Gundle is CEO of Aurum, a London-based hedge fund-of-funds (hedge FoF) managing \$2.2 billion. He will speak at *The New Alternatives conference*, held by Conexus Financial, publisher of *Investment Magazine*, in Melbourne this month. For the past 16 years he and his team have run commingled and customised portfolios of hedge fund strategies for institutional investors. Staff members stand "shoulder to shoulder" with many of their clients by investing personal money in the commingled fund, he says.

For years, hedge FoFs have managed customised portfolios of hedge fund strategies for investors alongside off-the-shelf, commingled vehicles.

But the structural weaknesses of these ready-made funds, such as an additional layer of fees and the threat of investors withdrawing money *en masse* - like many did in 2008 - and compromising the success of remaining investors, has made customised portfolios more appealing for investors.

Some hedge FoF managers, such as K2 Advisors and Ramius, also provide ratings of managers to institutional investors running their own hedge fund programs. Research into the relative appeal of strategies in changing market

conditions can also be part of the service. In such an arrangement, the hedge FoF does not invest a single dollar. They compete directly with consultants.

In turn, consultants guiding investors through hedge fund land sometimes invest money on their behalf. The problem with this, Gundle says, is the results can be opaque. He sets a challenge for consultants who run money: "publish performance and see how you've done."

Jim Vos, co-founder and CEO of Aksia, an independent hedge fund research and advisory firm headquartered in New York, agrees this may be true of some generalist consultants. But Aksia has always provided research and advice to institutions building their own hedge fund programs.

On the other side of the Atlantic Ocean, Simon Ruddick, managing director of Albourne Partners, picks his words very carefully. Albourne wants it understood that the consultant does not do implemented consulting, nor does it rate fund-of-funds.

"We do not take on discretionary mandates and we do not help clients to pick fund-of-funds. We can understand why hedge FoFs might be especially concerned by consulting firms that do both," Albourne says.

Gundle's criticisms apply to only a few consultants that he has encountered. He believes many gatekeepers - and he lists the Melbourne-headquartered JANA Investment Advisers among them - manage assets competitively and genuinely put clients' interests first.

WITHOUT A TRACE

Gundle is wary of consultants who run implemented solutions without a performance history and transparency record comparable to those of successful hedge FoFs.

"A lot of the governance issues that hedge funds confronted some time back are still playing out in the implemented world," Gundle says. "It's confusing for trustees. It's opaque. There is no measure of how implemented solutions perform relative to how a product has performed in the market."

Gundle says Aurum has always been "100 per cent transparent" with its clients and prospects. It did not withhold - or "gate" - client capital during the financial crisis. Its investors could withdraw money at will.

"A lot of managers complained, saying: 'They were using my fund like an ATM'. Well that's bloody well right. It's their money. They can use it as they like," he says.

He asks whether implemented consultants invest their personal money in their strategies.

"That's a very important metric to assess the amount of shoulder-to-shoulder commitment," he says.

Vos says investors should be suspicious of any consultant promoting the hypothetical performance of a paper portfolio based on their recommendations.

"Such numbers can be easily manipulated by assumptions about timing and ex-post selection, exclusion of share classes

It's confusing for trustees. There is no measure of how implemented solutions perform relative to how a product has performed in the market

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Alternative investments can involve significant risks and the value of an investment may go down as well as up.



and other factors," he says.

"Investors should focus on actual, realised investment performance in hedge funds of a consultant's clients."

Like hedge FoF managers, consultants research the investment strategies and operational strength of managers. They manage a buy list. Gundle would like to see how the aggregate performance of the funds they recommend to clients - including any that have gone out of business - stands up against a widely-used index of hedge fund returns.

Vos says clients' net performance in hedge funds recommended by Aksia should be used to measure the value of the consultant's advice. This can be done by grouping clients' performance into an equally-weighted composite index or, subject to permissions, anonymously displaying the annualised performance of clients against hedge fund indexes.

Gundle suspects that some consultants primarily recommend large funds that can absorb more client assets, and that they overlook emerging managers with less capacity.

"You recommend it and sell it to as many clients as possible. So you tend to get crowding in many of the biggest names," he says.

He points to the finding that hedge fund managers with more than \$1 billion attract more than 85 per cent of the capital flows into the sector.

"The crowding of big league managers on buy lists denies the investors an opportunity to invest in some of the smaller, less well-known managers. These managers have the chance to outperform because the larger your capital base, the greater the chance your performance will be compressed," Gundle says.

Some investors only want to be in the largest funds. It's their perception of lowering business and reputation risk, even if it does come at some cost

Vos says this is the danger of maintaining a "buy list" and adds that Aksia has never done this.

Ruddick says this can apply to consultants with small teams that can only cover a small number of the largest funds. Albourne, with more than 200 employees, is not among them. Collectively, its clients are invested in more than 2,000 funds.

"However some investors only want to be in the largest funds. It's their perception of lowering business and reputation risk, even if it does come at some cost," Ruddick says.

The percentage of client capital that Aksia allocates to emerging managers depends on clients' investment philosophies and preferences. It ranges from nearly 75 per cent to almost zero.

However, in 2009, established managers enjoyed the stability, deal flow and capital base to take advantage of the large investment opportunities available. They became Aksia's focus.

But in 2011, managers of between \$300 million and \$1.5 billion are absorbing much of Aksia's attention.

In contrast, Albourne allocates a small amount to emerging managers.

"If it were large, they wouldn't be emerging managers," Ruddick says.

"Our clients represent about 15 per cent of the market. We were seeing a resurgence of interest in emerging managers but the current macro turbulence may quell this. Emerging managers have less secure banking lines, which matters a lot in some strategies." ■

In search of new alternatives

There is now an academic grounding for unconventional investment strategies that don't fit neatly into the alternatives category. SIMON MUMME reports.

It wasn't meant to be like this. Sona Blessing watched as the performance of hedge fund strategies and public markets sank together as the financial crisis struck. Even before September 2008, Blessing, then a hedge fund specialist at a Swiss private bank, aimed to better understand what was causing the returns of the purportedly uncorrelated strategies to fall in line with listed markets.

"If the assumption is that you earn returns by taking on risk, I was trying to understand where the source of the risk was," Blessing says. "This helped me formulate the hypothesis that if the source of risk lies outside financial markets it should be insulated from the vagaries of those markets."

It took six years of research to test the idea. In this time, Blessing, who will speak at The New Alternatives conference, presented by *Investment Magazine*, joined hedge Opalesque, an alternative investment news and commentary website, as director of research and now moderates its online radio programs.

She defines financial market "vagaries" as conditions when financial markets are "stressed", including the market rout triggered by Standard & Poor's downgrading of US government debt to its second-strongest rating of AA+, which sent shockwaves through markets but do not significantly impact the real economy.

The research led her to analyse the origin of investment risk outside financial markets and her work with Opalesque's research platform A SQUARE exposed her to experts and managers running strategies using underlying assets such as

timberland, insurance-linked securities (ILS) like catastrophe bonds, shipping and securitised credit card debt. She also met investors in these strategies.

She learned how these risks generated returns and the ways in which the strategies can potentially be implemented in portfolios. "Timberland grows irrespective of the S&P 500 going up and down and earthquakes happen no matter what the market is doing," she says. These strategies are far more likely to tap into a distinct, idiosyncratic source of risk as opposed to the majority of hedge funds which draw on risks within financial markets, she concludes.

But they often sap liquidity from institutional investors' portfolios. This makes liquidity a trade-off for accessing risks that are largely unaffected by market movements, Blessing says. Some of these unconventional strategies also incur reputational or "headline" risk, she says, and may not comply with regulations or investment policies. This can spur investors to reconsider their investment policies, she says.

The culmination of Blessing's research is *Alternatives: Risk, Returns and Investment Strategy*, a book that examines the work of investment managers running these strategies and discusses how they can be part of diversified portfolios.

"All of my research is based on the real world. From people who manage and use these strategies," she says. "I worked backwards and asked how this could work theoretically."

Depending on their risk appetites and investment policies, some institutional investors Blessing knows have allocated between 5 and 20 per cent to the strategies.

Even though the performance histories of the strategies are largely uncorrelated to those of listed markets, investors should not assume this will always be the case.



Sona Blessing

Investing is a craft. It's not art. It's not science. It's the ability to interpret the models, the numbers, the data and the factors that you work with

"Correlations are based on what has happened in the past. But you invest for the future. This is important. Caution needs to be exercised in interpreting the data.

"Markets are changing all the time. Even if you did well in the past you need to keep changing what you do to fit how the markets change. Some managers do this very well; some fail to exploit the new opportunities in changing markets.

"Investing is a craft. It's not art. It's not science. It's the ability to interpret the models, the numbers, the data and the factors that you work with."

Many such opportunities arise when investor sentiment changes suddenly.

"There are certain behavioural patterns that repeat themselves crisis after crisis," Blessing says.

As institutional investors allocate more capital to strategies such as hedge funds and private equity, aggregate returns have fallen. Some funds have not been able to move quickly to respond to investment opportunities because they are laden with capital.

"A lot of money has flowed into mainstream hedge fund strategies and they have become more and more efficient."

Many hedge fund strategies employ listed assets such as equities and bonds. This resulted in deteriorating performance when public markets crashed in 2008. They may use derivatives to hedge against a falling market – and they may be successful – but these instruments are still based on equities and bonds and are therefore not isolated from listed markets.

In contrast, 'alternatives alternatives' are not based on publicly traded securities and are less likely to become so "efficient".

Timberland, ILS, loan-based lending, collectables and volatility strategies have found places in institutional investors' portfolios. ■

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The New Alternatives

SEPTEMBER 19-20, 2011. THE PARK HYATT, MELBOURNE

This fifth annual conference – the largest of its kind in the Australasian region – aims to focus on the new way investors are approaching their allocations to ‘alternative’ investments.

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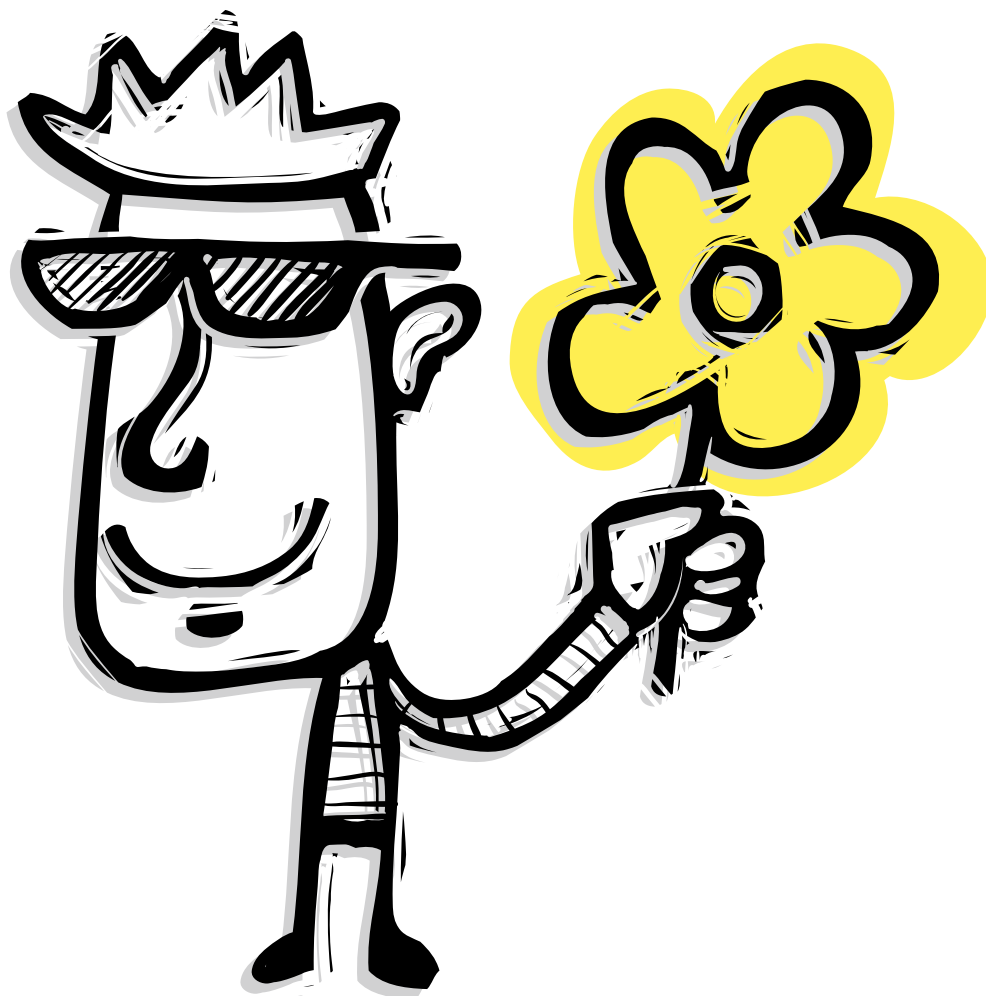
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HOW TO get lucky ON A SUPER DATE PART 2



Funds managers may know the needs of a superannuation fund and possess the skills to satisfy them. But a poorly executed pitch can ruin everything. **MATT MILGROM** and **DANIEL GRIOLI*** explain how communication can make or break deals.

So, the superannuation fund is interested.

You've shown that you understand their goals and have the ability to help achieve them. You know all about them and they want to know more about you.

Don't blow it now.

BE MADMEN

Advertising is not as sophisticated as business pitching but it teaches powerful lessons.

You should make your pitch, or overture, with the same purpose as an advertiser on primetime television. After all, you have only a few brief minutes to capture your audience's attention and convince them that your offer is worth paying for.

Advertising works because it appeals to the self-interests of audiences: the heart-breaking truth is these stakeholders really don't care about you. The only

reason they listen is the possibility that you have something they want. Having millions of dollars on the table gives them that right.

As you review your finished draft, pretend you're the client. Ask yourself *so what?* and in response, highlight benefits that a superannuation fund will care about. Be prepared to resort to supporting information in case a fund finds any of these strengths unconvincing.

Successful sales pitchers leave their egos at the door and remember that:

- benefits win *hearts*
- facts win *minds*
- pitches linking these win *business*

If your pitch is in written form, consider using "word cloud" software to analyse your finished draft. This will visually convey the themes of your writing. A well-written pitch refers to the prospect frequently, and word clouding will make your use of language obvious - sometimes painfully (see figure 1).

This cloud is generated from a real, slide-based pitch. The manager's identity has been hidden to save crimson faces. "Acme" mentioned themselves 86 times, used "us/our" six times, and referred to the client once, *on the first slide*. (It is somewhere in the cloud, but too small to see). "University" is prominent because the first six-to-seven slides were devoted entirely to staff credentials, in which their various degrees were listed.



Figure 1. Word clouds don't lie

Naturally, making the super fund the focal point of a pitch demands some extra effort. In fact, doing it properly may require a subtle tweaking of your entire pitch process: adjusting the focus

of covering letters or the contents of a presentation.

But that effort is the reason you're more likely to succeed: most of your competitors simply won't bother.

REMEMBER TO KISS

The early stages of a relationship are delicate. First-date nerves can hijack the conversation. They can make people waffle and offload their life story warts-and-all, or fall quiet. Neither strategy works in pitches, but striking a balance is tricky. Your key messages must stand out and be remembered, but providing detailed data establishes credibility. Getting the mix right is about remembering to KISS: keep it short and simple.

MAKE IT MINTO

Back in 1987, business educator Barbara Minto identified a valuable principle: ideas are communicated best when presented in a pyramid structure. To demonstrate, let's compare novels with newspapers.

Most novels use an upside-down pyramid configuration (see figure 2). Background, people, locations and plotlines are established over many pages. As they move towards their conclusions, plotlines weave these elements together before reaching grand finales. This delights us, because the whole point of the novel is the journey to the conclusion.

Newspaper articles are structured differently. They convey major points in headlines and readers find detailed information in the bodies of stories. Skilled journalists are trained to write so that a story can be edited from the bottom up without destroying its essence.

Sadly, many business communications read like novels. Perhaps you've endured presentations that start with a funds manager's history, assets under management, client base, office locations and key staff. Five slides in and the prospect has barely been acknowledged. Thirty slides later, they are woken up with the conclusion: *invest with us!*

In part I of this story, it was argued that successful pitches begin by focusing on the prospect. The best use the newspaper-style pyramid (see figure 3). Instead of headlines, they provide "win themes" - simple and powerful arguments that meet prospects' needs - whose benefits support the offer. Their key points are reinforced with images, captions and short bullet-point lists. And details, evidence and data are available for those who want them.



Figure 2. Structure of a successful pitch

Many sell-side brokers have worked this out. Their research starts with conclusions and follows with information supporting their recommendations. Details are provided at the back.

Following this pattern in a pitch will ensure that key messages stick. A set of great examples of how to master this technique is found in the book, *Best Practices for Equity Research Analysts*, by James Valentine.

SUMMARY EXECUTION

Summaries are an excellent way to present a complex offer in a simple and convincing way. In written form, the most obvious are executive summaries. Experienced pitch writers develop this at the start of the process, in skeleton form. By the time the pitch is finished, "win themes" and other essential elements of the offer percolate up into a pithy, headline-led summary.

A good executive summary should always highlight the four Ps: people,

philosophy, process and performance.

Some decision-makers will read only the executive summaries of several pitches when forming a shortlist. Those that are simple, client-focused and benefit-led have high survival rates.

A similar concept can shape the rest of your content. Each logical section can be summarised powerfully by using "key points" boxes at the start of the chapters, list the main ideas covered. Details can be laid out in a mini-pyramid.

Finally, an excellent way to communicate simply and powerfully is through "pull-quotes". These pithy, benefit-focused snippets can be used to break up lengthy sections of text. Usually set in white space in large, bold type, they communicate key messages in an arresting and memorable way.

DON'T RUIN IT NOW

You've gone to the trouble of understanding a super fund. Your focus is on delightful benefits backed by evidence. Drowning them in an ocean of words, pages or slides is the last thing you should do now. Adding surplus material will dilute your position rather than strengthen it.

Use the pyramid principle, executive summaries and diagrams and keep your pitch "as simple as it can be, but no simpler", as Albert Einstein said.

The reasons to buy your services will be dominant and memorable. And your convinced audience will know exactly where to look if they need more data to justify their decision. ■

**Matt Milgrom is a key principal at Tender Success, a boutique consultancy for helping Australian organisations win more pitches, proposals and tender responses.*

Daniel Grioli is an investment analyst at FuturePlus, providing investment management expertise to industry superannuation funds.

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Perhaps you've endured presentations that start with a funds manager's history, assets under management, client base, office locations and key staff. Five slides in and the prospect has barely been acknowledged. Thirty slides later, they are woken up with the conclusion: invest with us!



Super

Superannuation funds are beginning to shed light on the inflated costs of poor foreign exchange execution. PHILIPPA YELLAND reports.

Unsexy. It's the word of choice for many investors when they describe trading foreign exchange (FX) efficiently.

FX is a back-office beta that has long gone unwatched. But transaction fees are being dragged into the spotlight as public lawsuits unfold in the US. In 2009, two of the world's largest public pension funds, CalPERS and CalSTRS, sued custodian State Street. They allege it over-charged them by US\$56 million for currency trading services over eight years. The case is still running.

In Australia, FX inefficiencies and leakages hit the financial media after Qantas Super announced it had become the first superannuation fund to outsource FX services to a specialist manager, Russell Implementation Services (RIS). The fund expects to save more than \$1 million each year through the program.

If monitored and measured, FX trading adds at least 8 basis points to portfolio returns, according to Ian Battye, managing director of RIS. He says the specialist FX manager has saved its clients, which include Russell's multi-manager funds, about \$68 million in trading commissions since 2003. It has done this by transacting through a panel of FX traders instead of leaving it to funds managers' custodians to liaise with a single FX desk.

But it's not the only way to prevent unnecessary FX losses. The \$42 billion Australian Super has used the online database run by Global Trading Analytics, a trading costs analysis provider, for the past three years. UniSuper, which manages \$25.4 billion, reviews FX costs every six-to-12 months.

funds eye special FX

This periodic monitoring began more than six years ago.

THREE SINS

And Queensland Investment Corporation (QIC), the \$60 billion institutional funds manager, has managed FX service since 1997. Troy Rieck, managing director capital markets at QIC, says savings are made by reducing the impact of trading, rather than taking a price at any time, and using instruments that enhance performance, such as cross-currency swaps.

Don't trade when FX markets are notoriously expensive, disorderly and illiquid, Rieck says. This rules out trading at daily market closing times, the end of the month and popular index-fixing times.

FX fees are not fodder for the financial lift-outs of Sunday newspapers. Jeremy Cooper, who led the influential Cooper Review of the superannuation system, recognised that FX fees insidiously eroded superannuation balances. He put superannuation trustees on notice.

In his recommendations, he said the Superannuation Industry Supervision Act, the guiding law for fund trustees, should be amended to include "the expected costs of the (foreign exchange) strategy, including those at different levels of any interposed legal structures and under a variety of market conditions", as one of the factors which fund trustees must "have regard".

He suggested "the availability of valuation information that is both timely and independent of the fund manager, product provider or security issuer", as one of the factors to which APRA fund trustees must also "have regard".

Brett Elvish, who runs consultancy Financial Viewpoint, says implementation efficiencies exist to reduce and control costs. But its

complexity is a barrier.

"To be frank, a lot of people don't understand it," he says. "Not many executives or trustees understand FX efficiencies, and therefore there's not enough focus. FX is a subsidiary activity."

The major problem, he says, is that funds managers' custodians are not acting as fiduciaries. They act on behalf of superannuation fund members when they commit to transactions with the FX desks of investment banks.

"There's an enormous amount of convenience in using custodians to provide the services, but not sufficient monitoring," Elvish says.

Rieck says QIC is not affiliated with any counterparty and does not receive commissions or compensation from FX banks. "QIC operates only as agent for our clients and is never a principal in any transaction," he says, which provides greater transparency and results for investors.

Battye says the common FX model in superannuation is adversarial. The market trades US\$4 trillion each day. Its major players are the banks. They determine currency contract prices and "their interest is to make as much money as possible," he says, and custodians can also exploit the disengagement of principals.

Most FX trading increases costs and diminishes returns in four ways, Battye says. They are:

1. *Specialist competency:* FX trading is not a core competency of many investment managers. They view it as an administrative process and say its costs are too small to matter. They delegate FX trades to custodians through default instructions and it is common for costs to go unchecked.

2. *Bundled service mix:* investors may direct all FX trading to custodians or their affiliates, along with typical back-office tasks. This bundling of additional



Ian Battye



Peter Curtis

There is an enormous amount of convenience in using custodians to provide the services but not enough monitoring

Pick your pairs

Trading in more liquid markets cuts transaction costs, says Troy Rieck, managing director of capital markets at QIC.

It's often cheaper, he says, to trade a hedge from euro to \$A via the \$US than to directly trade euro and the \$A. This is because there is competitive quoting and trading for the euro/\$US and separately for the \$US/\$A, but not directly for the euro/\$A trade on the inter-bank market.

"Some managers like to trade via the cross-rates," Rieck says. "For example, [they] directly trade AUD/EUR instead of AUD/USD and EUR/USD, and their counterparties love them for it because on the cross-rate it is easier to 'hide' a little bit of extra margin for the bank.

"When the price is directly quoted and traded in the marketplace, then that is a harder thing for the bank to do. Everyone loves a little bit more margin - just like these custodians that are getting the pants sued off them by US pension funds over misleading execution of FX trades." This becomes especially important when markets decline and liquidity becomes concentrated in the world's most widely traded instruments. Despite the fact that the \$A is one of the most-traded currencies in the world, there is no directly quoted and traded cross-rate market - but there is a directly quoted and traded market in the Australian and US currencies. "The market liquidity in any of these markets does tend to be lower during times of crisis, but at least the markets are there," he says.

In QIC's experience, the most widely traded exchange rate pairs around the world are the following: EUR/USD, USD/JPY, GBP/USD, USD/CHF and AUD/USD.

There are also markets in a limited range of cross-rate pairs, particularly in Europe, such as the EUR/CHF and EUR/GBP.

services may cut visible custody fees but result in poor and costly FX execution.

3. *Lack of market structure:* Most FX trades are executed away from public exchanges. There are no official trading hours and few reliable trading statistics, Battye says, and no global FX regulator monitors this activity. Given the dominance of a small number of proprietary trading desks, this is problematic. Finally, there is no standard way of reporting FX trades or any obligation to disclose the times at which they are executed.

4. *Potential conflict of interest:* FX trade executors, such as custodians, can stand on both sides of the transactions. Here, a conflict of interest emerges, because they can trade at unnecessarily high prices. This can go unnoticed because there is no obligation to reveal the timing of these transactions.

Elvish says superannuation funds place more emphasis on investment performance at the expense of the more certain gains made through implementation efficiency.

"The betting is skewed to the long-shot, and members are unnecessarily wearing the cost," he says.

Behavioural and psychological factors cause this. It is more enjoyable to talk about investments than the practicalities of FX and investors are typically too confident.

"Individuals over-rate their ability and skill - most of us are above average!" Elvish says.

"We spend a huge amount of time and energy in pursuing alpha, which is a zero-sum game, or a negative-sum game after fees."

Little attention to FX leads to insufficient resources allocated to managing these exposures because "people don't know what they don't know," he says.

"The only time that some super fund execs buy foreign exchange is when they go on holiday."

Elvish says the prudential regulator should ask questions and audit funds the implementation costs of costs.????????

FAT FEES

Battye says "inflated" FX fees can erode up to 2 per cent of the value of institutional investment portfolios over 40 years.

This finding is based on Russell's analysis of 40,000 FX trades executed by investment managers with custodians and other foreign exchange counterparties between January 2008 and December 2009, on about \$23 billion in institutional assets.

The research shows the average cost of each FX transaction - defined as the difference from the mid-point between bid and offer prices - came to about 9 basis points. This is considerably higher than average costs in the FX market for the most-traded developed-market currencies, which is between 1 and 3 basis points. The findings are almost identical to similar research Russell did in 2004, on about 36,000 trades.

Russell's establishment of its FX agency arose from an internal audit of the custody arrangements with its multi-manager business in 2001-02. Senior managers looked at FX costs and accountability and decided to establish an in-house FX team in 2003, led by Battye, who worked for State Street and had worked closely with Russell.

What began as an educational role for external clients - one of which was the \$6 billion Qantas Super - began to morph into an FX service. Andrew Spence, CIO at Qantas Super, was concerned about implementation efficiencies and initiated the fund's two-year analysis of trading costs. It was completed in September 2010. The fund then outsourced FX management for its global equities and alternatives portfolios to RIS, which provides comprehensive records of transactions, including the precise time and date of trades.

AustralianSuper has saved about \$1.5 million by monitoring trading execution costs across its portfolios, Peter Curtis, senior investments manager, says. It "has discussions with managers which have fallen outside the range," he says.

"Tiers were put in place to review the



Dharmendra Dayabhai

**\$56
MILLION**

the amount State Street is being sued for by CalPERS and CalSTRS for excessive foreign exchange charges



Troy Rieck

**\$68
MILLION**

the amount Russell estimates it has saved its third-party foreign exchange clients

Three steps to FX efficiency

For Gary Klopfenstein, senior managing director and head of currency management at Chicago-based Mesirow Financial, efficient foreign exchange (FX) implementation is one of three tasks funds must do to achieve implementation efficiency. Funds should maintain an efficient currency-hedging program. For example, if a superannuation fund has a \$500 million exposure to global currencies and adopts a 40 per cent hedging ratio, what happens if the underlying assets rise in value by 1 per cent, or fall 5 per cent? The hedging ratio is no longer 40 per cent.

This raises a series of questions. When should the hedge be adjusted: daily, weekly or monthly? How do you structure settlements? Which currencies should be hedged against?

Next is FX execution. The best prices and liquidity should be sought and made transparent to clients.

"It starts with independence and a lack of conflict of interest by not being affiliated with a bank," Klopfenstein says.

Risk management - spanning counterparty, settlement and operational risks - also requires vigilant monitoring.

spreads the custodian was charging," he says. "So many people have their fingers in the pie, and this shows that there needs to be continual monitoring."

At UniSuper, Dharmendra Dayabhai, head of portfolio analysis and implementation, says costs are benchmarked against the volumes executed at 4 pm in London, when most global FX transactions usually occur. "We look at all managers and dissect currency trades, their volumes and their timing," he says.

"Some managers get lazy on the execution side. The constant message is that managers are subject to review. That in itself is a policing exercise. Prevention is better than cure." ■

Looking for a smarter approach to currency management?

QIC Capital Markets' strategic currency overlays have been delivering superior performance and significant savings to our clients for over ten years. By continuously monitoring exposures and using intelligent execution strategies that avoid times when markets are illiquid, we offer a smarter and more cost-effective solution to managing currency risks.

With over \$19 billion* in foreign currency exposures under management,

QIC Capital Markets has the scale and experience to offer competitive pricing from up to 20 independent counterparties. We act solely as an agent for our clients, and our fiduciary focus means we work closely with clients to manage the residual risks associated with a currency overlay, such as liquidity and cashflow requirements.

So, if you're looking for a smarter way to manage your currency exposures, contact QIC Capital Markets.

Contact Clayton Sills
Director, Capital Markets
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Don't wait for the future

Superannuation funds should not wait for the SuperStream reform to be written into law before changing their antiquated administration systems. SIMON MUMME reports.

Philip Hind, national program manager of SuperStream, shared an optimistic view of the future of superannuation administration last month.

"In the future we'll see more standard rollover and contributions processing across the industry, more straight-through processing and data quality," Hind said. "Electronic funds transfers will become the norm for submitting contributions.

Hind, who is also chief knowledge officer at the Australian Tax Office, spoke at the AIST Superannuation Administration Symposium in Melbourne last month. He also foresaw more tax file numbers being linked to accounts. "We'll also see more interaction with members online," he said.

Standard methods for processing contributions and data integrity checks, which are key initiatives under the SuperStream reform, would eventually see administrators receive clean member data from employers.

This could be achieved if administrators agreed or were forced to use common processing standards and

Start scenario planning. Ask tough questions. At the moment we can ask these tough questions without the risk of not having an answer. The worst scenario is to do nothing

not maintain different processes in order to keep their market share, Hind said.

Administrators should also aim to become "partners" with employers. Funds should provide a single administrative interface "to make it as simple as possible" for employers to submit member data and contributions.

He flagged likely starting dates for the various initiatives. Data standards could be introduced as soon as December and legislation next year. Account rollovers could become mandatory in 2013 and large- and medium-sized employers begin using new contributions processing methods in mid-2014. They will be followed by small businesses.

"None of this will happen without you being involved in driving some of these initiatives," he told the administrators in the room.

Through an audience poll, delegates were asked how much mandatory data and e-commerce standards would impact funds. The majority – 48 per cent – said it was a big change; 40 per cent said it was ambitious but manageable; 10 per cent said the impact would be negligible; and 2 per cent were undecided.

Hans van Daatselaar, manager of strategy and policy at Superpartners remarked that efforts to introduce the swimEC data standards to superannuation in recent years had failed.

Jason Gracanin, manager of product

development at Pillar Administration, said the momentum to enforce standards now was stronger because it would be part of an overhaul funds' administration processes.

"This is a package. This time we have strong leadership and a lot of people are prepared to kill sacred cows," Gracanin said.

The counsel from Matthew Halpin, chief officer of member administration at QSuper, was not to wait for legislation to be signed before adapting to the proposed reform.

"Draft standards on contributions and rollovers are there. We're looking at them to see how they impact our systems and processes," Halpin said.

QSuper was also considering how to initiate auto-consolidation of the accounts held by inactive members, he said.

Josef Pilger, executive director of financial services at Ernst & Young, said a groundswell of support from administrators was essential. "Putting data standards out there is one thing. Making sure that people understand them and see the advantage is another," he said.

He advised administrators to start scenario planning. "Identify which major areas you will be able to cope with and those you won't. Ask tough questions. At the moment we can ask these tough

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questions without the risk of not having an answer. The worst scenario is to do nothing.”

Through another poll, delegates were asked for their estimates of how much it would cost to implement SuperStream at their funds. The majority, 39 per cent, said between \$500,000 and \$2 million; 21 per cent said more than \$2 million; 17 per cent more than \$5000; 1 per cent said zero; and 22 per cent were unsure, indicating that many funds had not seriously considered what they need to do to adapt to the reform.

There are two types of cost involved in SuperStream, Gracanic said. Implementing new technology but also change management. Business development managers will need to be sent to stakeholders to explain the changes and gain support for them and client services teams will need training, he said.

POLICY FORECAST

David Haynes, project director at AIST, forecasted the impact of the Stronger Super reforms on superannuation administration.

He said the industry regulator, the Australian Prudential Regulation Authority, will probably be empowered to set standards in the future. It will interact more with superannuation funds than banking or insurance companies and will be “a little less avuncular” than it has been in the past.

The SuperStream reform would bring a long overdue modernisation to super fund administration systems.

“Many of us still realise it is the Achilles Heel of the industry and we need to do a lot to bring it in line with world’s best practice,” Haynes said.

During the reform consultations there was a “universal view” that operational reserves should not be mandated on a one-size-fits-all basis but



Matthew Halpin

take into consideration the particular conditions each fund operates in.

“A fund with unit pricing will have greater risks than one with a crediting rate methodology.”

This countered the view, supported by some industry professionals, that a reserve equivalent to 50 basis points of a fund’s capital be set aside. “We don’t think this makes a lot of sense given the risks that different funds face,” Haynes said.

In an audience poll conducted electronically at the outset of the conference, 73 per cent of attendees said they expected the Stronger Super reforms to result in better outcomes for super fund members, while 23 per cent disagreed and the remainder were undecided. ■



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FUNDS CHOOSE THE BLUEDOOR

Early adopters of online administration platform Bluedoor expected the product to streamline and automate administrative tasks. Has the web-based system delivered? MIRANDA WARD reports.

The first super funds and wealth managers to adopt the Bluedoor administration and registry platform wanted the product to tick every box on their admin software wish list. To win them over, it had to be an integrated product, web-based, able to be customised, and easy to implement.

Coming up to three years since the acquisition of Bluedoor Technologies by DST Global Solutions, the early adopters of the Bluedoor system - all self-administering funds - have worked through the initial stages of implementation and are beginning to examine the more customisable aspects of the system.

AXA's North product went live with the Bluedoor system in late 2007, after AXA worked closely with the company to design the North product and a wrap platform on top of Bluedoor's existing core superannuation system.

Steve Burgess, AXA's general manager of platforms, says Bluedoor is delivering on its promise to be more efficient and deliver better customer service when compared to the rest of the industry.

"It's enabled us to deliver a solution to the market that is a genuine positive shift in operational efficiency by being genuinely straight through and operating an online experience which is second to none," Burgess says.

When North, which has funds under management of \$1.8 billion, first went live with Bluedoor, it was focused on providing capital guarantees, says Burgess. The product had to be "capable of carrying that kind of requirement". It had to be a real-time system with straight-through processing.

"Bluedoor represented the kind of technical solution we were looking for," Burgess says.

AXA invested around \$40 million in the platform by the end of 2010.

"That's a total cost," Burgess says. "That would include not just the investment in the Bluedoor system itself, [but] also the cost of project management, change management and



Steve Grant

\$40 MILLION

AXA's
investment in
Bluedoor

design."

Burgess says it's a commitment that anyone would have to make if they were to "configure the core system to suit their requirements."

AXA has continued to work with the Bluedoor team to "enhance and develop its functionality," Burgess says.

This culminated in a release in April when AXA launched enhancements to North, including model portfolios, direct share trading and term deposits.

Such ongoing development is normal, says Nathan MacPhee, CEO of SuperRatings. Bluedoor has not been installed as a complete system, and funds have had to roll out enhancements as they go.

"A lot of the web technology, [such as] the web-based transactional services only came in the last six-to-12 months," MacPhee says.

Bluedoor aims to limit manual processing in administration centres. Achieving this is a step-by-step process, says Mark Cassar, executive director of product development at Bluedoor.

"In any client implementation you'd see a series of steps," he says.

"The first step might be to get it live,



get data converted [and] get people administering products. Really [it's a] system replacement and then they'll gradually introduce broader web capabilities [and] more detailed workflow."

Bluedoor clients, such as AXA, have funded these gradual developments, says MacPhee.

"If a fund wants something from [Bluedoor] they have to pay for it themselves, and they don't know if it's going to be shared with other potential users," he says.

But for some, such as AUSCOAL Super, this is welcome.

"One of the main reasons we chose Bluedoor was to be a partner," Steve Grant, general managers of AUSCOAL Services, says.

"Being a new product and having a small number of users, we saw ourselves very much in a partnership where we can work closely together to make a good product."

The fund has started working with Bluedoor as it prepares for the implementation of Cooper Review recommendations, particularly SuperStream, which aims to overhaul and modernise superannuation administration.

Bluedoor hosted a meeting among users last year at which clients shared experiences and explored further use of the system. Another is planned in the near future.

AUSCOAL has never benefited from this before, Grant says. User groups are usually focused on technical matters, not operational strategy.

"I think that's why existing products in super haven't moved to being anything other than administration systems," Grant says.

AUSCOAL began using Bluedoor in July 2010. It wanted a modern administration platform that integrates workflow processes and provides intelligent character recognition, which translates hand-

40%

AXA's expected saving in operational costs from migrating existing products to Bluedoor

written text into characters that machines can read.

For SuperRatings, it is difficult to make a well-informed judgment about Bluedoor due to its limited history and small number of clients.

"We still think there is [some] development to do for some of the functionalities," MacPhee says.

Burgess says Bluedoor needs to ensure it is scalable and can accommodate

the volume of transactions that AXA and other clients make.

So far, the system has been adopted primarily by self-administered funds. It aims to gain third-party administrators as clients but there have been few opportunities to do so in the past five years, Cassar says. ■

FEAL

Fund Executive of the Year Award

10th 2011 Anniversary

Fund Executives Association Ltd (FEAL) and AMP Capital Investors are pleased to announce that the 2011 FEAL Fund Executive of the Year Award has been presented to Terry McCredden, Chief Executive Officer, UniSuper.

Now in its 10th consecutive year, the award is presented in recognition of outstanding achievement, innovation and leadership. Demonstrating FEAL and AMP Capital Investors' commitment to supporting the ongoing professional development of superannuation fund executives, Terry will receive a \$20,000 business education grant.

Terry McCredden, UniSuper



Presented in partnership with





The Leader of the Opposition, Tony Abbott

Tony Abbott, Leader of the Federal Opposition, discussed the Coalition's financial services policy with influential superannuation executives at an exclusive function on Friday July 22. The event was proudly hosted by Conexus Financial

The Coalition supports Australia's three-pillar retirement system comprising:

1. An aged pension;
 2. A compulsory system of retirement saving through superannuation; and
 3. Incentives for voluntary saving.
- A Coalition government would focus on improving transparency, efficiency, competitiveness and corporate governance in superannuation and work with the industry to achieve greater consumer engagement about retirement planning.

Key elements of Coalition superannuation policy include:

- An open, transparent and competitive process for the selection of default funds under modern industrial awards.
- Improved superannuation governance, including:
 1. Mandatory disclosure of conflicts of interest;
 2. Disclosure of directors' remuneration in line with standards for publicly listed companies;
 3. Providing for independent directors of super fund boards; and
 4. Requiring directors who sit on more than one fund board to demonstrate they have no foreseeable conflicts of interest.
- Appropriate transparency of all processes related to superannuation fund mergers to ensure the interests of fund members are protected at all times.
- Standard definitions in the reporting of fees, gross and net investment returns on individual investment options and asset classes.
- Abolishing the superannuation guarantee age limit.
- Removing barriers to relevant and appropriate income stream products.
- Subject to Budget conditions, restoring incentives to encourage more voluntary super contributions (such as revisiting the concessional contribution caps).



Tony Abbott keeps track of the Coalition's media profile.



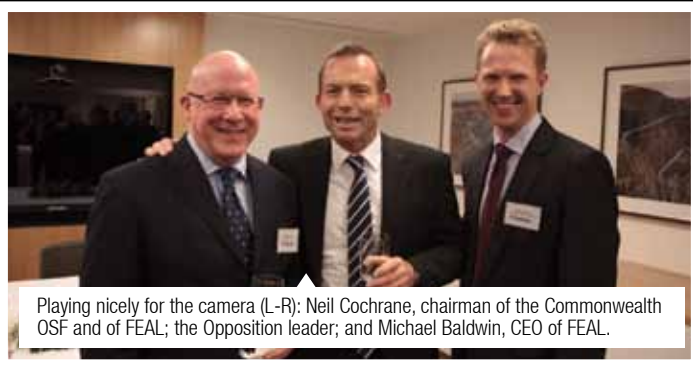
Tony Abbott and Fidelity's director of intermediary sales, Andrew Keay



Fidelity chief executive Gerard Doherty and Tony Abbott.

Photos by : Matthew Fatches, www.mattfatches.com.au

To put better investments together, we constantly pull them apart.



Playing nicely for the camera (L-R): Neil Cochrane, chairman of the Commonwealth OSF and of FEAL; the Opposition leader; and Michael Baldwin, CEO of FEAL.



Gary Bailey, head of institutional sales for Fidelity; Gerard Doherty, CEO of Fidelity; and Laurence Jarvis, associate publisher of *Investment Magazine*.



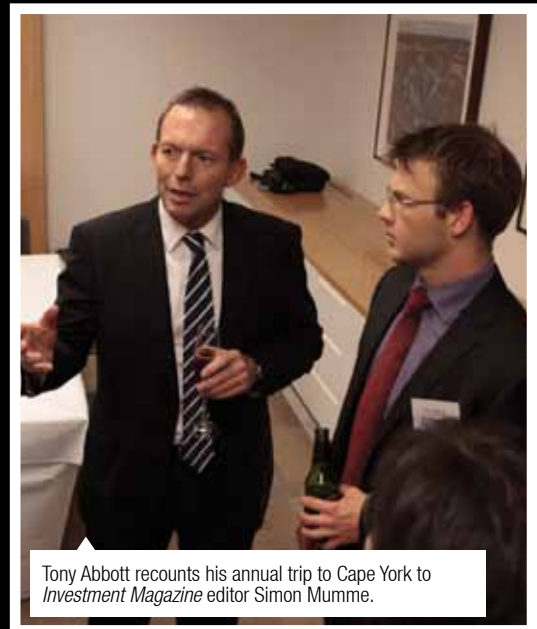
Tony Abbott with shed enterprises principal Sheridan Lee and Conexus Financial group publisher and chief executive Colin Tate.



Holding court. Hanging on Tony Abbott's every word are (L-R): Andrew Keay; Andrew Gale; I&T News editor Brett Cole (back to camera); and *Investment Magazine* editor Simon Mumme.



Enthralled (L-R): Gary Bailey, head of institutional sales for Fidelity; Gerard Noonan, chairman of Media Super and AIST president; and Tony Abbott.



Tony Abbott recounts his annual trip to Cape York to *Investment Magazine* editor Simon Mumme.

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The more you know

Falling prey to survival instincts

Problems in the reform of financial market regulation are compounding systemic risks, writes RICHARD BRANDWEINER, board member of the CFA Society of Sydney.

At the recent CFA Australia Investment Conference in Sydney, Matt Moran, vice president of the Chicago Board Options Exchange, highlighted the use of their volatility index, the VIX, in providing negatively correlated returns to risk assets in very weak markets.

Then, right on cue in the first two weeks of August, the VIX index hit 48, its highest level since the collapse of Lehmann in late 2008 when it broke through 80. To put this into context, the VIX has averaged about 20 with a standard deviation of about 8 since 1990.

The volatility was a reminder of the challenges of late 2008 and of the regulatory reform being enacted around the world to deal with the problems the GFC had highlighted in our financial system.

In February 2009, the CFA Institute Centre for Financial Market Integrity, together with the Council of Institutional Investors in the US, formed the Investors' Working Group (IWG). This was an independent, non-partisan panel formed to provide an investor perspective on ways to specifically improve the regulation of US financial markets. Up until this point, US regulatory talk of reform largely ignored investor considerations.

The working group's report, with recommendations for US financial regulatory reform, was published in July 2009 and is available from the CFA Institute website.

In July 2010, however, the Dodd-Frank Wall Street Reform and Consumer Protection Act became law. Deloitte notes that, "the Act arguably is the most sweeping change to financial regulation in the United States since



Richard Brandweiner

The same regulators who oversaw the industry's problems now sit in judgment of their own decisions

the changes that followed the Great Depression". While there is a raft of reforms, three stand out:

- The creation of the Financial Stability and Oversight Council (FSOC), which has a mandate for identifying risks and responding to emerging threats to financial stability.
- The "Volcker Rule", which aims to prohibit banks from proprietary trading.
- The development of centralised clearing and exchange trading for standard OTC derivatives, as part of a new regulatory regime which is intended to increase transparency, liquidity and efficiency in derivatives, and to mitigate systemic risk which was cited repeatedly in the fallout from the GFC.

The FSOC recently released its first annual report. Jim Allen, head of capital markets policy for CFA Institute, and a contributor to the Investors' Working Group report, believes the report is not so much a forum for uncovering emerging systemic problems as a means of shifting blame for regulatory failure. One of the main reasons for this is the make-up of the FSOC. The Investors' Working Group advocated heavily for the creation of an oversight entity that would be separate from the banking and market regulators.

However, the FSOC is anything but independent. Other than only one independent member, it's made up of all the main regulators in the US - Tim Geithner is the Chair and he is joined by the Fed, SEC and FDIC.

The problem IWG members saw with this type of arrangement was that the same regulators who oversaw the industry's problems would then sit in judgment of their own decisions. Allen sees this problem already playing out in the first annual report, particularly in terms of how little serious discussion was dedicated to the US debt problem, which clearly represents one of the major current systemic risks in the world.

Even so, the new regulatory regime

of derivative supervision is, in part, a response to commitments made by the G20 concerning the standardisation, central clearing, and methods of trading OTC derivatives. Australia is, of course, a member of the G20 and bound by the same commitments.

The Australian Council of Financial Regulators - consisting of APRA, ASIC, RBA and Treasury - is also assessing the derivatives markets and is currently in the consultation phase with interested stakeholders concerning local reform.

The initial consensus is that Australia is a less active OTC market relative to major offshore markets and trades are relatively simple vanilla products. However, the council recognises that market practices can be improved. The consultation paper suggests central clearing for interest rate derivatives as a first step to ensure ongoing confidence in these critical transactions.

It will be interesting to see how these reforms, here and overseas, progress. ■

Fallout over FoFA, Stronger Super

The uncertainties about the Future of Financial Advice (FoFA) and Stronger Super reforms are hurting consumer and industry confidence, says

JAMES BOND, chief economist of the Financial Services Council.

The past three years have seen unprecedented uncertainty in the financial services industry and this was apparent in many of the discussions and presentations at the Financial Services Council (FSC) annual conference at the beginning of August.

While much of this uncertainty has been an understandable reaction to ongoing economic and political conditions in Europe, the US and the Middle East, the regulatory uncertainty associated with the Future of Financial Advice (FOFA) and Stronger Super reforms are having an impact on consumer and industry confidence.

Australians have responded to economic uncertainty by saving more. Australia's savings rate has grown from 3 per cent of GDP in 2007 (excluding superannuation) to 11.5 per cent in March 2011 - returning to levels not seen since the mid-1980s.

Yet at the same time, discretionary member contributions to superannuation funds in the year to December 2010 were \$440 million lower in real terms than in 2009.

It is not surprising that economic conditions have encouraged Australians to save more. The global financial crisis, the sluggish recovery in the US and the rolling sovereign debt crisis on both sides of the Atlantic are affecting consumer and investor confidence.

What we need to understand is why Australians are saving more but not putting these savings into superannuation and investments.

Our industry is strong and critical to Australia; however, ongoing uncertainty regarding the Government's reform agenda is affecting confidence

in superannuation, investments and financial advice.

The announcement by Minister Shorten at the Financial Services Council annual conference that we will see draft FoFA legislation in September is therefore welcome.

Now we have this timetable, the Government needs to stick to it. There is no room for more delays. There is enough uncertainty in the economy without the Government adding to it.

Draft legislation for the Stronger Super package, which was due in June or July, has been delayed until October. It now appears very unlikely the Government will be able to introduce the Bill by February next year.

Between February and July, Paul Costello chaired an inclusive consultation process into the Government's Stronger Super proposals. Difficult issues were discussed between representatives across the industry.

It is a positive development that all segments of the industry came together through the Costello process to discuss common ground and differences.

Most issues were resolved and Costello's recommendations have been handed to the Government.

However, some issues remain unresolved due to the potential for unintended consequences. Principal among these is the one-price, one-product structure for MySuper. The proposed structure for MySuper requires funds to provide only one MySuper product at the same price for all members.

This means that each superannuation fund can have only one MySuper product and can take no account of the size of the employer or the demographics of the workplace.

One product. One Price. One investment strategy.

However, tailored multiple products were always envisaged by the Cooper Review. It states:



James Bond

One product, one price, one investment strategy is a retrograde step that will hurt working Australians

"The Panel also recognises that there might be situations where a master trust could have multiple MySuper sub-funds to reflect the fact that it is serving a range of different employers."

Currently, benefits of scale allow large employers to negotiate low costs for their employees, with some corporate superannuation funds providing superannuation for as low as 50 basis points.

In a world where there is a single price for MySuper, funds will be forced to provide the one product at the same price to all workplaces - whether they have 30,000, 3,000, or 300 staff.

As research from Chant West shows, 750,000 Australians will pay more for their super.

It is absurd that the Government's superannuation reforms could result in people paying more for their superannuation.

And the proposal for a single investment strategy in MySuper means default super cannot by law be tailored to meet the demographic needs or demands of individual workplaces.

This too is an absurdity.

Presently, a younger workplace, such as a supermarket, would typically have a default superannuation investment with a higher exposure to growth assets, whereas an older workplace might have a higher exposure to defensive assets.

The current proposal completely ignores the fact that 25 per cent of corporate superannuation plans today use a non-standard investment strategy that reflects workplace demographics.

One product, one price, one investment strategy is a retrograde step that will hurt working Australians.

Once the Stronger Super and FoFA reforms are implemented, the Government must rule a line under reviewing the financial services sector to provide businesses and consumers with certainty. ■



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Where there's fire, there's smoke and mirrors

The loud cries from for-profit funds to open up awards are self-serving and neglect members' interests, writes FIONA REYNOLDS, CEO of AIST.

As the rollout of the first of the Stronger Super reforms begins, it appears that the next battleground in superannuation is emerging. There has been much clamour in recent weeks about default funds, superannuation in industry awards, and other workplace agreements.

It's obvious that some sectors of the industry and the Opposition are revving up their campaign to "open up awards". This is despite the fact that the Government has already committed to the Productivity Commission reviewing how superannuation funds are selected as default funds in modern awards.

Given this commitment, recent demands to bring forward the scheduled review and the urgent attempts to elevate this matter to the top of the action pile seem out of all proportion. There is no shortage of issues facing the industry, let alone the challenge of successful implementation of the current reform program.

In any case, where's the fire? Is there some kind of systemic market failure occurring in the workplace, with fund members year after year unknowingly being funnelled into high-cost, high-fee, underperforming funds? Is there

something so fundamentally wrong with the current default system that we must drop everything and deal with this question right now?

In my view there isn't. There can be no debate that for the best of two decades, our award-based default system has protected millions of Australian workers from having their retirement savings eroded through unnecessary fees and charges.

No one should be surprised, or indeed suspicious, that the employee and employer representatives involved in nominating default funds in awards and collective agreements have tended to favour not-for-profit funds.

This is in employees' best interests. It's an indisputable fact that the members of not-for-profit default funds are many, many thousands of dollars better off than if their money had instead been invested in for-profit super funds.

This is why the default system is so important. We know that many people do not actively choose their super fund and we know that there are many individual employers who may not want that responsibility either.

But they do want their employees being in the lowest-cost, best-performing funds.

The current default system provides a highly effective and efficient mechanism to achieve that result. It is good public policy in action.



Fiona Reynolds

Our award-based default system has protected millions of Australian workers from having their retirement savings eroded through unnecessary fees and charges

Critics of the existing system are fond of talking about the benefits of competition and free markets. They conveniently ignore the fact that Choice of Fund legislation introduced in 2005 means most employees can choose to be a member of any super fund they like.

What the critics don't like is that, in their view, not enough employees are choosing for-profit funds. Despite the advantages of their household brand names, wide branch networks and cross-selling from planning groups and accountants, competition isn't working to their benefit so they are now seeking to change the rules.

Superannuation is more than just a wealth management system: It's a key part of our nation's retirement incomes policy. It is built on mandated contributions. It follows that both employers and employees (or their representatives) have the ultimate say in determining the default fund or funds for their industries or workplace.

From a public policy perspective, our super system must offer the highest level of consumer protection, particularly for the disengaged. Indeed, this is the thinking behind the proposed "MySuper" default funds, as part of the Government's Stronger Super reforms. Eventually, only MySuper funds will qualify as default funds. ■

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AIST is proud to present informative and interactive workshops covering a range of topics on Stronger Super.

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Learning the ABC of social investing

The nearly ruined ABC Learning childcare empire was saved by a philanthropic consortium, The Good Start. But it wasn't charity. MIRANDA WARD reports.

A consortium of charities, bankers, commercial lawyers, tax experts came together with Social Ventures Australia (SVA) to raise a total \$170 million to acquire the bankrupt ABC Learning childcare centres from competing private equity firms. Goodstart, the biggest social enterprise in Australia, now runs more than 600 of the failed ABC Learning childcare centres.

This wasn't charity but it wasn't the normal run-of-the-mill investment either. It was the grey area in between: an investment with a social benefit. Of the grand total of \$170 million, SVA raised \$45 million for the project. Ian Learmonth, Director SVA Social Financial, says the capital structure of the transaction resembled that of a private equity transaction and the mix and sources of capital was pioneering for the non-profit sector in Australia.

"The capital structure included a medium-term loan from the Australian Government, debt financing from National Australia Bank and additional support from a range of private investors and philanthropists," Learmonth says.

The money wasn't a grant or donation but rather an investment in a subordinated debt instrument, offering a coupon of 12 per cent each year. The minimum investment was \$100,000 with notes issued over an 8-year term, with repayment at the end, and was fully subscribed.

It is this area between donating and investing that SVA's Social Finance Team is trying to capitalise on. This combination of charity and investing means philanthropists or foundations are able to recycle capital, Learmonth says.

"There is a development of non-grant, non-donation money going into



Ian Learmonth

This combination of charity and investing means philanthropists or foundations are able to recycle capital



enterprises so be it debt or equity or some sort of combination of the two going into social enterprises, you see a lot of it in the US and the UK," Learmonth says.

The Finance Team was an initiative created when Learmonth moved to SVA from Macquarie in May. It is building on the example of The Good Start through trying to "unlock additional sources of funding for enterprises" to add to existing pools of funds.

Learmonth believes "there are a vast number of enterprises around Australia that would seek out that kind of support".

SVA provides funding and strategic support to seven venture partners who help to improve education outcomes and increase employment participation in disadvantaged communities across Australia.

"Some of them [are] indigenous related, some are in the aged-care sector, some are generating employment opportunities," Learmonth says.

Current venture partners include:

- The Australian Indigenous Mentoring Experience (AIME): a non-profit charity that aims to increase year 10, year 12 and university rates for all indigenous Australian students who participate in the program;
- Beacon Foundation: aims to influence the attitudes and culture of Australians so that each young person can develop an independent desire to achieve personal success for themselves

and their community;

- Big Picture Education Australia (BPEA): it aims to stimulate vital changes in Australian education by generating and sustaining innovative, personalised schools that work in partnership with their greater communities;

- Fair Business: provides jobs with real pay for the long-term unemployed or those experiencing significant barriers to employment;

- Ganbina: aims to improve the economic and social well-being of indigenous people in the Goulburn Valley (and across Australia via Partnership with Indigenous communities) through programs and partnerships focused on developing individuals to reach their full potential;

- STREAT: a social enterprise providing a supported pathway to employment for homeless and disadvantaged youth; and

- Stronger Smarter Institute: focuses on changing the tide of low expectations for indigenous and disadvantaged children across Australia.

The Social Finance team is supported by the Social Finance Advisory Council. The council of eight provides the Social Finance Team with contacts, ideas and guidance as to how they should develop initiatives, Learmonth says, and the team consists of industry leaders in the finance sector. ■



The dismal science hardens up

It's official. Size does matter. To be precise, 13.5cm is the optimal length.

Tatu Westling, a PhD student at the Helsinki Center of Economic Research, is hypothesising that the GDP-maximising length of the erect male organ is 13.5 cm. He is testing whether countries' GDP growth rates collapses if the male organ exceeds 16 cm or is less than 12 cm.

Westling describes his paper, *Male Organ and Economic Growth: Does Size Matter?*, as "sardonic economics". He criticises other researchers who have focused on economic, social and political factors that contribute to GDP while abstaining from biological and sexual considerations.

"The aim of this paper," he says, "is to fill this scholarly gap with the male organ" by using a statistical method known as cross-country growth regression.

Economic growth – or flaccidity – between 1960 and 1985 correlates to an inverted U curve, Westling says. The low ends of the U curve correspond to very small (<10cm) and very large (>18) male organs, with peak GDP growth occurring in the sweet spot of 13.5 cm.

Westling is so confident of his findings that he asserts that, "taken at face value, the findings suggest that the 'male organ hypothesis' put forward here is quite a penetrating argument".

Citing his statistics, Westling is on shakier ground when he admits that the figures are from health authorities and from self-reported sources, so he concedes that "due to the sensitive nature of the subject matter, self-reported data might be biased, supposedly upwards".

When theorising about the causes of the increased size – of the organ, that is, not GDP – Westling ventures that better nutrition leads to taller males and members. But he also notes that larger extremes are found in Africa, a region not noted for high-protein First World diets.

In conclusion, Westling argues that "the 'private sector' deserves more credit for economic development than is typically acknowledged". He says of his work that, "scientifically, this paper is probably as worthless as much of contemporary economics".

Ain't no mountain high enough...

Erik Metanomski describes himself as a "slugger". The co-founder of Lanyon Asset Management gathers stock ideas through long hours of research rather than moments of insight.

This work ethic seems to apply to his exercise habits as well. In May, he was one of 2000 runners scaling and descending 5164 steps in the Great Wall Marathon. That's right. The race follows a 42-kilometre length of the famous wall traversing the northern mountain ranges of China.

Metanomski, racer 491, completed the notoriously gruelling race in a time of 6:33.57. Most runners taking on the course record times that are double their usual, he says, due to the steps. He ran the race with fellow marathon enthusiasts in his home-town of Adelaide. Before running in China, the group raced in the New York and Gold Coast marathons. Rio de Janeiro might be next.



...or river wide enough

David O'Sullivan was in commando mode.

The CEO of BUSS(Q) was at home after floodwaters streamed through the fund's office in the central Brisbane suburb of Milton, near the bank of the swollen river dividing the city. Like all BUSS(Q) staff, he believed the office was underwater. However a colleague called to tell him otherwise: news footage from a chopper flying above inner city Brisbane apparently showed that the road in front of the office was no longer inundated.

O'Sullivan needed to see this for himself. "I went in on a commando expedition," he says. He parked his car about two kilometres from the office – the closest he could get – and with a backpack and a torch he began to wade through the brown water. Cars were washed up on higher ground.

"But when I got to the office I couldn't believe it. The doors were unlocked and open," O'Sullivan says.

The doors, which are usually locked electronically, were left free to swing open as floodwaters shorted the building's power supply. Fortunately nothing had been stolen. O'Sullivan inspected the deserted and eerily quiet premises.

Surely the thought of staying and vigilantly guarding the building crossed his mind.

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