

GOING HEAD TO HEAD

The costs in running Australian superannuation funds compare well with their US counterparts, according to new research undertaken by **Hubert Lum**.

In 2006, CEM Benchmarking started to benchmark Australian accumulation funds. It has been benchmarking US accumulation funds since 1997. This article examines similarities and differences between Australian and US funds related to cost and performance.

The findings are that performance drivers such as asset mix, investment options offered and default options favour the performance of Australian funds over US funds. On a total fund cost basis, compared with US funds, Australian funds have a significantly higher absolute cost number but asset mix, fund size and average account size explain most of this cost difference.

The analysis is based on data year 2005, which included 100 funds with total assets of A\$749 billion and 12.6 million accounts. This sample represents 12 Australian funds, eight of which were industry funds, with assets of A\$51 billion and 4.3 million accounts and 88 US funds with assets of A\$697 billion and 8.3 million accounts.

Total fund costs

In 2005, total fund costs for the average Australian accumulation fund were more than two and one-half times that of the typical US defined contribution plan. The US defined contribution plan is the US equivalent of the Australian accumulation fund.

On average, Australian funds had a total fund cost of 103 basis points (bp) while US defined contribution plans had a total plan cost of 40 bp. Compared with US funds, Australian funds had higher administrative fees and investment option management fees. The costs are shown in Exhibit 1.

CEM research has shown that the relevant measure to assess whether funds from a region are high or low cost is not the absolute basis point cost number, but the basis point cost number adjusted for asset mix, fund size and account size.

Funds with more high cost assets, such as real estate, hedge funds or private equity, cost more to manage. Economies of scale mean that smaller funds suffer a cost disadvantage. For two similarly sized funds, the fund with more members and smaller average account size will

have higher recordkeeping costs. These three factors account for much of the cost difference between Australian and US funds.

Asset mix

Asset class costs were similar in the two regions. The costs ranged from 27 bp for fixed income to 122 bp for real estate, hedge funds and private equity. Exhibit 2 shows the average costs for major asset classes in 2005.

A key difference in the asset mix between the two regions was the proportion of assets invested in GICs and company stock¹.

These options are low cost or hidden cost investment options so fund costs decrease as the proportion of total assets invested in GICs and company stock increases. While Australian funds had no holdings in these two options, US funds held 30% of their assets in GICs and company stock.

¹ In the US, a corporate fund sponsor may elect to match employee contributions with treasury stock issued by the employee's company. GICs are guaranteed investment contracts. Traditional GICs are loans to insurance companies, generally with fixed maturities and interest rates. The cost of traditional GICs is difficult to quantify since it is usually hidden within the negotiated interest rate.

Exhibit 1: Total costs for Australian and US funds

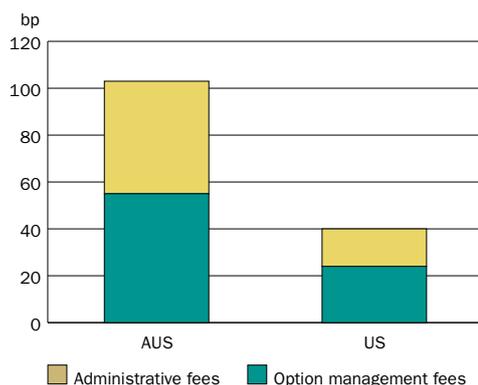


Exhibit 2: Average investment option management fees by asset class

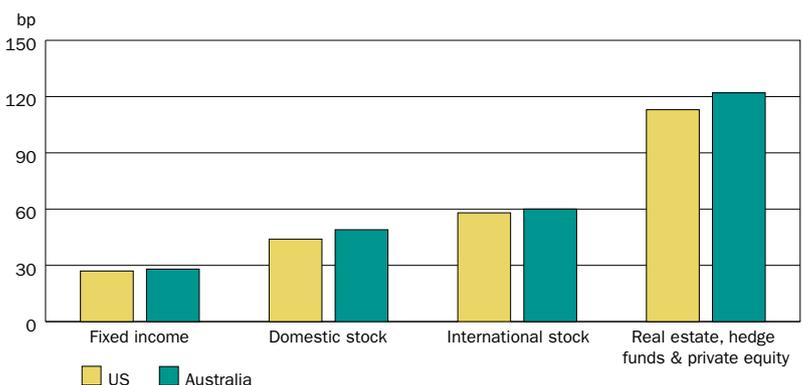


Exhibit 3: Asset mix

	AUS	US
Company stock	0%	11%
Domestic stock	37%	48%
Domestic fixed income	14%	12%
International	30%	7%
GICs	0%	19%
Cash & equivalents	5%	3%
Real estate, hedge funds and private equity	14%	1%
Total	100%	100%

Another important difference in asset mix was the proportion of assets invested in real estate, hedge funds and private equity. These were the highest cost asset classes. Australian funds invested 14% of their assets in these asset classes.

By contrast, US funds invested only 1% of their assets in these asset classes. Exhibit 3 shows the average asset mix for our Australian and US funds.

Member account size

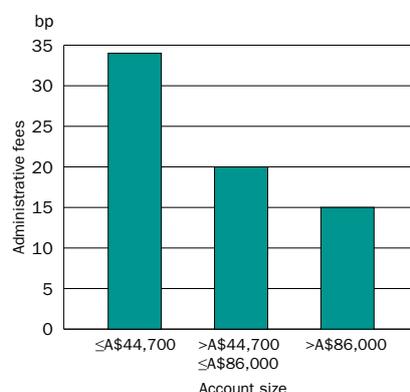
Costs increase as the average member account size decreases. For two similarly sized funds, the fund with more members and smaller average account size will have higher administrative costs such as recordkeeping costs.

Exhibit 4 shows 2005 administrative fees were 34 bp for funds with an average account size of less than A\$44,700 versus 15 bp for funds with an average account size greater than A\$86,000.

The account size impact was significant since the account size of Australian funds was generally much smaller than that of US funds. The median account size for Australian funds was A\$16,000, whereas the median account size for US funds was A\$75,000.

The median account size is the size that divides each of the US and Australian fund groups into two groups of equal number: one-half of the members are above the median and one-half of the members are below the median.

The US funds included in this comparison were US funds with unbundled cost arrangements. In these arrangements, administrative and fiduciary

Exhibit 4: Impact of account size on administrative fees

fees are identified separately or unbundled from investment option management fees.

Fund size

Costs decrease as fund size increases due to economies of scale. In 2005, a ten-fold increase in fund size for US and Australian funds resulted in lower total fund costs by 10 bp. The average US fund at A\$6.8 billion was 60% larger than the average Australian fund at A\$4.3 billion. The US size advantage added to the lower total cost of US funds.

Performance

In 2005, the average total return was 14.2% for Australian funds compared with 6.5% for US funds. The average total return measures the average change in member account balances produced by the net crediting rate earned by investment options weighted by the market value of member holdings.

The average total return reflects differences in asset mix, investment options offered, the default option and value added, vis-à-vis, passively indexed alternatives. The returns are stated in local currency.

The 2005 average total value added was -0.4% for Australian funds and 1.3% for US funds. Average value added measures the return from active management. It measures the degree to which investment options, in aggregate, beat their benchmarks.

The 2005 performance numbers should be treated with caution since it is more meaningful to compare performance over a period longer than one year.

However, we can draw some inferences about long-term performance based on differences between the two regions in asset mix, investment options offered and default options.

When CEM analysed its performance database, it found US defined contribution funds underperformed US defined benefit funds by a wide margin over a long period, on a total return basis, by 1.8% per year over an eight year period ended 31 December 2005.

The main reason for the underperformance was asset mix. Large holdings of underperforming GICs, company stock and cash reduced the return of US defined contribution funds. These assets crowded out better performing asset classes such as non-US stock, real estate, hedge funds and private equity.

Based on asset mix, like US defined benefit funds, Australian accumulation funds have a performance advantage over US defined contribution funds. For example, in 2005 the underperforming assets referred to above – GICs, company stock and cash – totalled 5% for Australian funds and 33% for US defined contribution funds.

In addition, the proportion of better performing assets was higher for Australian funds. Investments in real estate, hedge funds and private equity were 14% for Australian funds and 1% for US defined contribution funds.

The asset mix differences between Australian and US funds are attributable in part to differences in the investment options offered. Australian funds do not offer options in GICs or company stock. In addition, Australian funds offer more options in real estate, hedge funds and private equity. As a percentage of total options offered in 2005, these 'alternative' asset categories represented 6.5% of Australian fund options compared with 0.8% of US fund options.

The proportion of options offered in any one asset class is important since members often divide contributions equally among all available options. Asset classes with a higher number of options can expect to attract a higher proportion of assets. The options offered in 2005 are shown in Exhibit 5.

Asset mix differences also reflect

Exhibit 5: Average number of investment options offered

	AUS	US
Company stock	0	0.7
Domestic stock	1.4	7.3
Fixed income	0.5	1.9
Balanced/Lifestyle	0.1	3.7
International	5.4	2.0
Cash & equivalents	1.0	0.5
GICs	0	0.9
Real estate, hedge funds and private equity	0.6	0.1
Other	0	0.9
Total	9.0	18.0

differences in default options. The effect of the default option in the US is to increase the level of holdings in an investment option since members of these funds tend to leave their contributions in the default option.

The defaults in the US directed contributions to lower performing assets: cash or GICs made up 41% of the defaults offered. By contrast, in Australia, all defaults comprised international balanced funds. This is shown in Exhibit 6.

To summarise, contrary to popular perception, Australian accumulation funds are not high cost funds. On a total fund cost basis, compared with US funds, Australian funds have a significantly higher absolute cost number but asset mix, fund size and average account size explain most of this cost difference.

Exhibit 6: Proportion of funds using different types of default options

Type of default offered	AUS	US
Domestic or international balanced	100%	30%
GICs	-	23%
Cash & equivalents	-	18%
Other	-	4%
No default offered	-	25%
Total	100%	100%

Furthermore, performance drivers such as asset mix, investment options offered and default options favour the long-term performance prospects of Australian funds over US funds. **SF**

Hubert Lum is research director of CEM Benchmarking Inc and is based in Canada.

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and working together is success.*

Henry Ford 1863-1947

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