Do super funds need to reconsider their investment strategies?

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The industry has been heavily reviewed

- Ripoll, Henry and Cooper have reported
- Chris Bowen outlined a response
- Fees & costs have been centre stage; but what about managing the money?
- Cooper accepts that trustees should formulate investment strategy
- But what governance arrangements encourage good investment outcomes ?
- This has received little attention

This is perhaps puzzling

- Efficiency and managing conflicts of interest are important ; but that can’t be the end of the story
- The survival of compulsory superannuation will depend on how successfully the industry delivers an investment return
- Performance has not been good

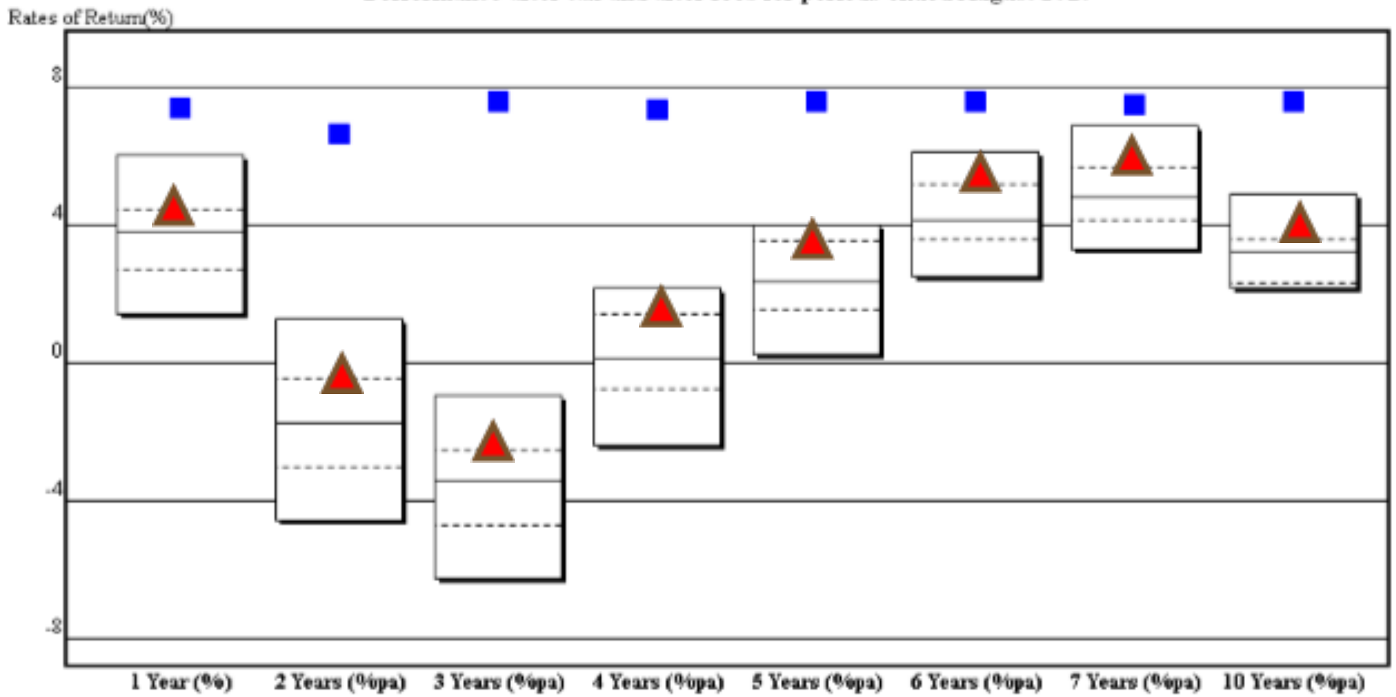
It has been hard going for even the best funds

- Over time, people expect a return well in excess of the CPI

Top Quartile Fund Performance Vs CPI+4.5% p.a.

Comparison with the Mercer Employer Super Balanced Growth (60-80) Universe

Performance after tax and after fees for periods ended August 2010



	1 Year (%)	2 Years (%pa)	3 Years (%pa)	4 Years (%pa)	5 Years (%pa)	6 Years (%pa)	7 Years (%pa)	10 Years (%pa)
CPI+4.5%	7.4	6.6	7.6	7.3	7.6	7.6	7.5	7.6
95th Percentile	6.0	1.2	-1.0	2.1	4.0	6.1	6.8	4.9
Upper Quartile	4.4	-0.5	-2.6	1.4	3.5	5.2	5.6	3.6
Median	3.8	-1.7	-3.5	0.1	2.3	4.1	4.8	3.2
Lower Quartile	2.7	-3.0	-4.7	-0.8	1.5	3.6	4.1	2.3
5th Percentile	1.4	-4.6	-6.3	-2.5	0.2	2.4	3.2	2.1
Number of Funds	52	51	50	44	43	37	33	18

Data Source: Mercer and Lipper, A Thomson Reuters Company

MERCER

Have we put too much faith in equities?

- Most Australian funds have a heavy exposure to the equity risk premium
- They expect to be compensated

Equity Performance: % pa, as of 31 August 2010				
	1Yr	**3 Yr**	**5Yr**	**10 Yr**
Developed Markets				
MSCI(W) Local	**0.3**	**-11.9**	**-2.9**	**-3.7**
Germany Local	4.4	-12.8	-0.1	-4.3
UK Local	6.0	-6.4	-0.5	-2.2
Australia Local	*-1.9*	*-10.5*	*0.3*	*3.3*
Japan Local	-16.2	-21.2	-8.2	-6.1
US Local	2.9	-10.5	-2.8	-3.7
Emerging Markets				
MSCI(EM) USD	**15.6**	**-3.7**	**9.9**	**8.6**
China USD	6.9	-6.4	16.8	6.9
India USD	20.2	0.5	16.3	13.6
Brazil USD	18.2	5.1	20.4	14.2
Russia USD	20.7	-14.5	2.6	10.5
Frontier Markets				
MSCI(FM) USD	**-4.7**	**-18.0**	**-8.8**	**na**

Source: MSCI

What are the alternatives?

- To generate a return a portfolio needs to incorporate risk
- Equity risk, credit risk, illiquidity risk, term risk and manager skill risk should boost returns over time
- But some risks are not compensated
    - Diversifiable risks like stock specific risk are unlikely to add value
    - Unlikely to be compensated for currency risk
    - Only expected inflation will be reflected in bond prices
    - Manager skill is rare
- Funds need the right combination of market risks, manager skill and efficient implementation. Unwanted risks need to be minimised; damaging rare events managed.

The current environment is not easy

- The world has returned to growth but this is no normal cyclical rebound

- Global banking has been saved but imbalances remain
  - Deleveraging continues
  - Sovereign debt and public sector deficits are a growing problem
  - Policy options in the US, Europe and Japan are narrowing

- Investment returns will be hard to generate
  - Volatility will be high
  - It is accepted that few returns are normally distributed; the nasty surprises in the left tail have to be understood and managed
  - Attention will have to be given to fees, tax and implementation

- What is needed is logical thinking and wise judgement

Economists want to believe in recovery

- There are legitimate doubts about US, Europe and China

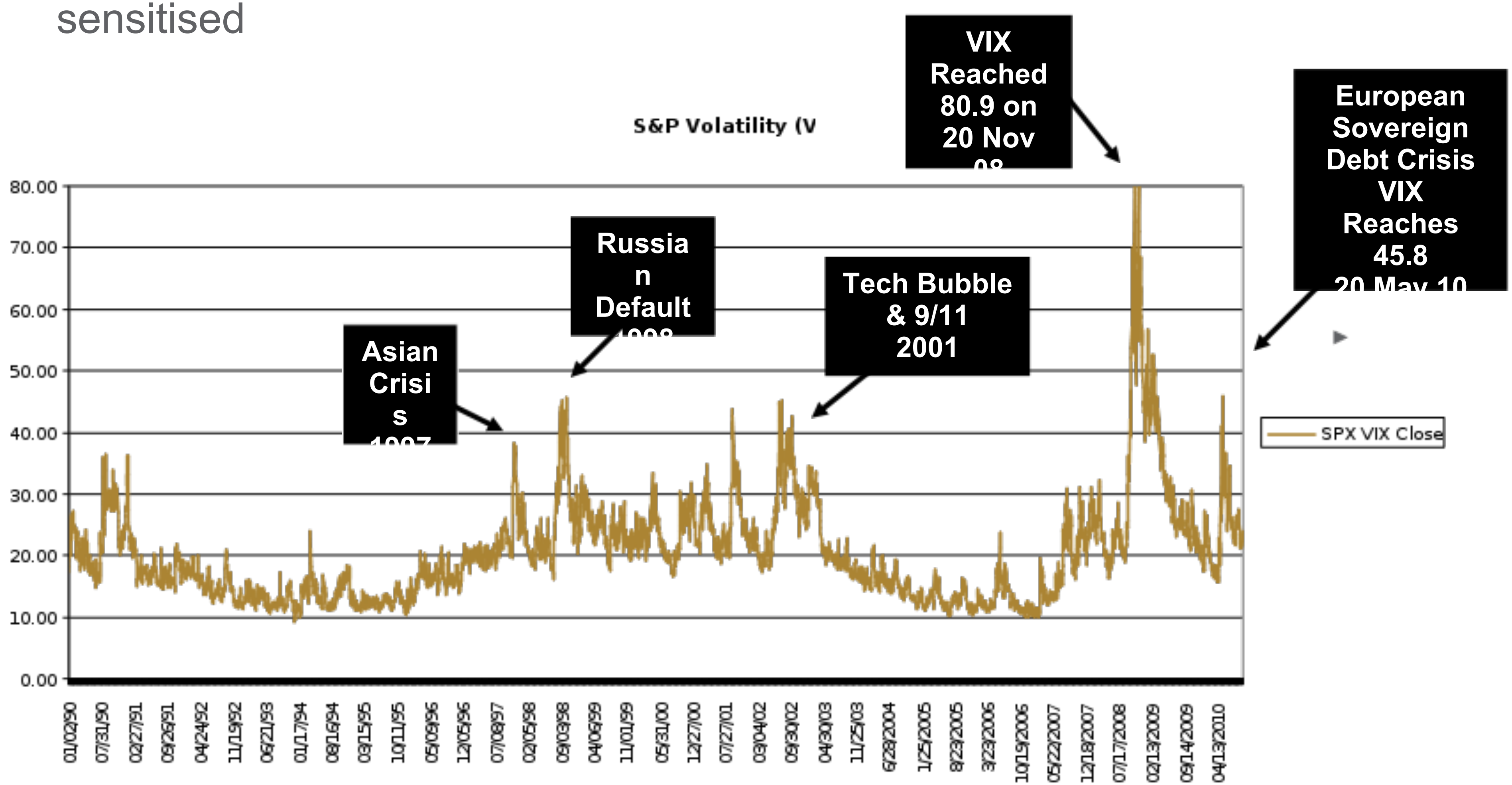
Region	2005	2006	2007	2008	2009	2010	2011	Consensus 2011
US	3.1	2.7	1.9	0.0	-2.6	2.7	2.7	2.8
Japan	1.9	2.0	2.4	-1.2	-5.2	3.2	1.7	0.0
Western Europe	1.9	3.1	2.8	0.3	-4.0	1.8	2.0	1.9
Australia	3.2	2.6	4.8	2.2	1.2	3.4	3.8	3.4
Asia**	8.5	9.3	10.1	6.5	5.5	8.5	6.8	6.8
Latin America	4.7	5.5	5.8	4.2	-2.1	5.8	4.5	4.5
Eastern Europe	6.0	7.1	6.7	4.0	-5.5	4.8	4.6	5.0
Advanced economies	2.6	2.9	2.6	0.2	-3.3	2.5	2.4	2.4
Developing world	7.3	8.0	8.3	5.3	1.8	6.1	5.5	
World	**4.6**	**5.1**	**5.0**	**2.4**	**-1.1**	**4.1**	**3.7**	**3.8**

Source: UBS Forecast Data Base September 20, 2010, GDP % YOY

*** Excluding Japan, including Australia and New Zealand*

But uncertainty is high

- Markets are volatile and highly sensitised

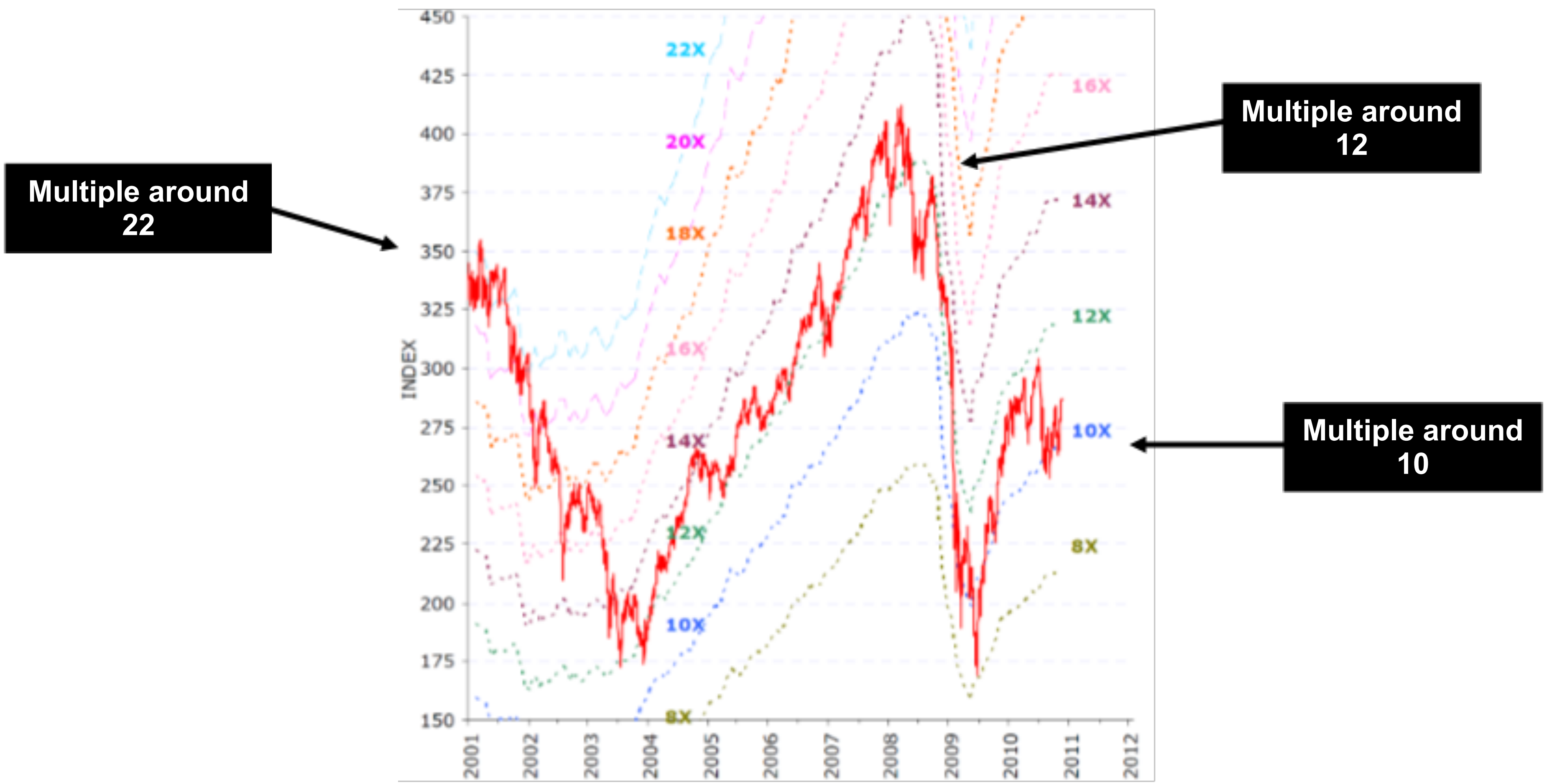


Source: CBOE Volatility Index – VIX Close as of September 23, 2010

With equities the growth in earnings is the key

- Multiples are not overblown; equities have a role but more needs to be done

MSCI World with 2 year forward PE bands



Source: IBES/DataStream, Bloomberg, Morgan Stanley Research; September 22, 2010

Risk management can add value

- Mean variance analysis has taken a hit but it is easy to forget

- The distribution of negative outcomes needs constant attention
    - Credit, options, merger arbitrage, insurance have fat left tails
    - Leverage, crowded trades, illiquidity are problems
    - Correlations are unstable; optimising portfolios gives false comfort
    - Macro shocks & exaggerated swings in risk tolerance undermine many traditional quant models

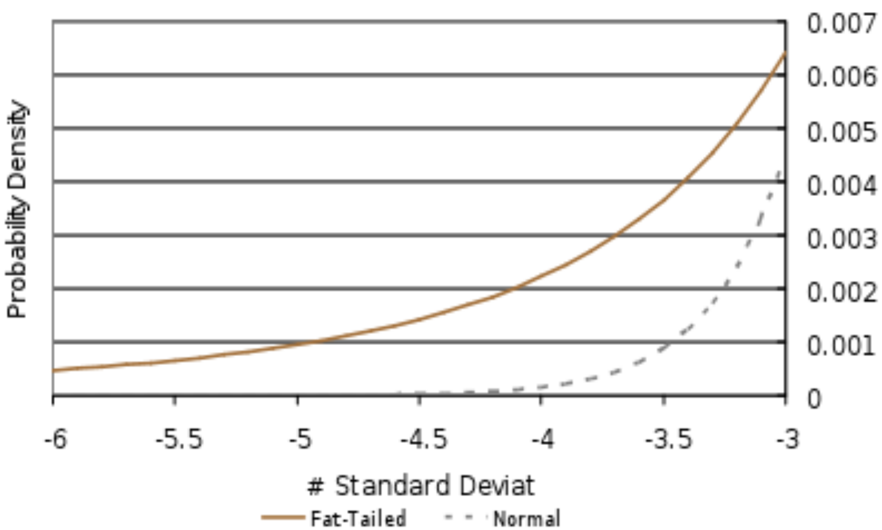
- Good risk management widens the investable universe
    - Private equity, real estate, infrastructure, hedge funds are options
    - Complexity brings problems; avoid managers with high left tail risk

- Consistently avoiding problem investments adds value

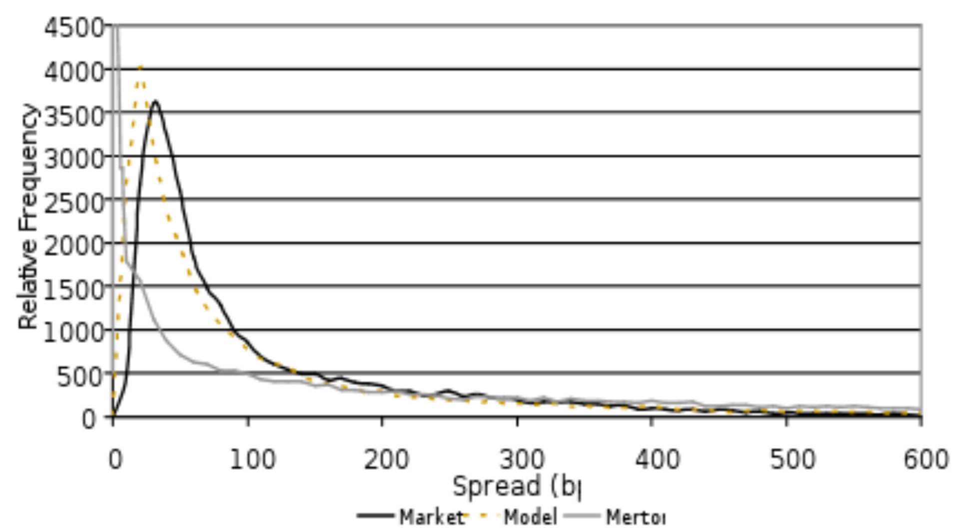
Fat tails – an example

- Merton (1974) extended derivatives pricing theory to credit
- Merton, like Black–Scholes, assumes a lognormal diffusion process
- Merton produces too many low spreads; credit is not normally distributed
- Assuming risk is normal means taking too much risk for too little gain

Fat Tailed vs Normal Distributions



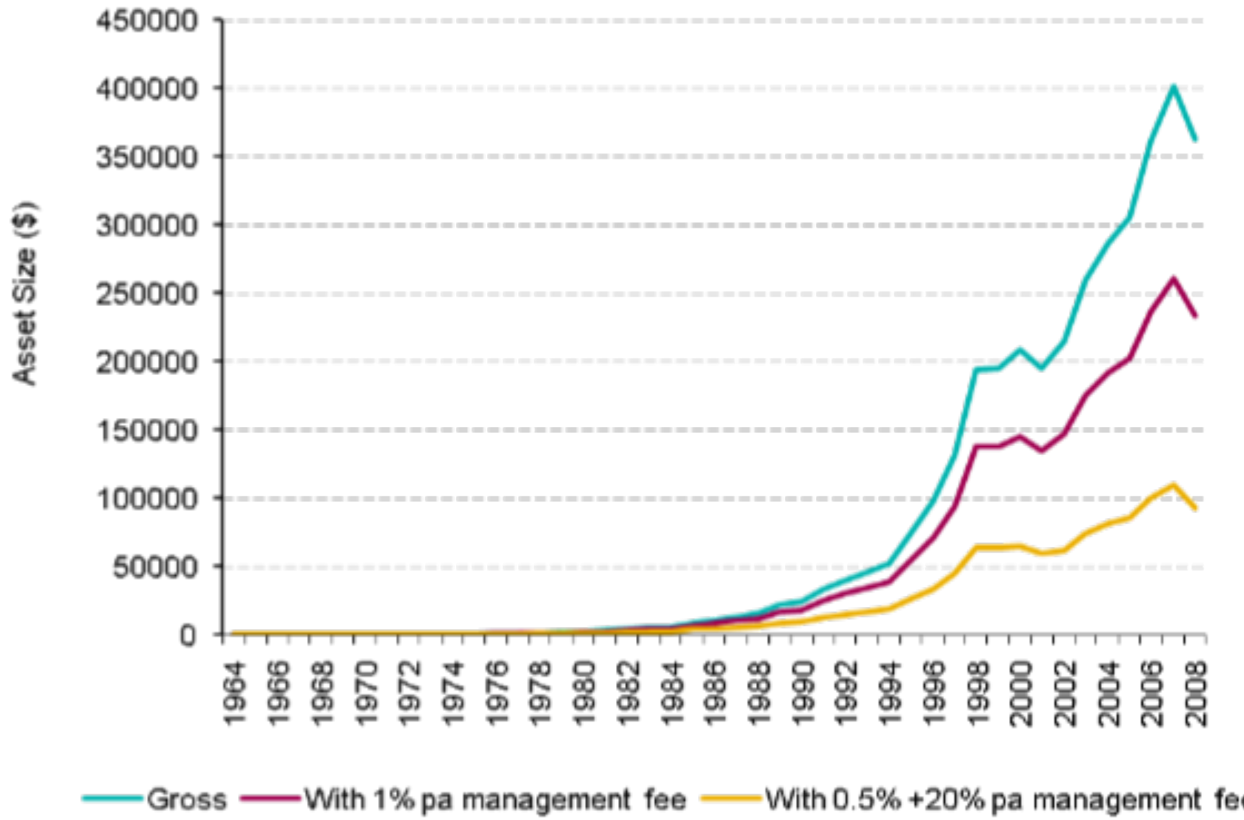
CDS Spread Distributions



Source: Mellon Capital Management, Quantitative Credit Modelling: The Next Generation 2008
Merton (1974) Merton, Robert C., "On the Pricing of Corporate Debt: The Risk Structure of Interest Rates", Journal of Finance, Vol. 29, No. 2, (May 1974), pp. 449-470.

Fees matter

- US$100 invested with Warren Buffett in 1965 would be worth US$360,000 at end 2008
- With a fee of 1%pa it would be US$235,000
- With a fee of 0.5% plus 20% of outperformance over the S&P it would only be US$95,000



Source: Berkshire Hathaway; Towers Watson, Portfolio Construction , September 2010

Implementation and tax are important

- Implementing an investment strategy can be done more cleverly
  - Holding managers to tight style labels is not always wise
  - Multi-manager portfolios can be run more efficiently
  - Custodial, broking and transition costs warrant close attention

- With the right framework, managers can add extra value by paying attention to franking credits and CGT consequences
  - Managers need tax aware benchmarks

What should funds do?

- Good investment outcomes rest on good investment processes

- Funds need proper resourcing with in house staff and outsourced advice
    - The fund needs an investment friendly culture that encourages innovation and challenges group think

- Trustee Boards are very influential
    - They have final responsibility for a fund’s culture
    - They decide the resources available to the investment process
    - They determine how those resources are used

- In the current environment, Trustee Boards should be working to strengthen their investment processes both in terms of resourcing and culture

Conclusion

- We live in troubling times
- There is great pressure on the funds to deliver better investment returns over the next 10 years than were achieved over the past 10 years
- Notwithstanding the last 10 years, equities have been the traditional driver of return; they are likely to be positive in the future but funds should not build their investment strategies exclusively around equities
- Funds need to broaden and strengthen their investment processes to squeeze extra return from better implementation and more imaginative portfolio construction
- It can be done

Speaker background

Don Russell, PhD, CFA

Chair State Super

Don Russell was appointed Independent Chairperson of State Super from 1 January 2008. State Super is a $32 billion fund that manages public service defined benefit schemes for the NSW State Government.

He was appointed Chair of the Investment Committee of LUCRF a Melbourne based superannuation fund from 1 September 2010.

Until March 2010 Don was the Global Investment Strategist at BNY Mellon Asset Management Australia. Prior to joining BNY Mellon in 2007, Don was Executive Director with WestLB Mellon Asset Management (Australia). Don joined WestLB in 2001.

Between 1997 and 2000 Don worked for Sanford C. Bernstein in New York.

Between 1985 and 1993 and again in 1996 he was Principal Adviser to the Hon Paul Keating both during his time as Treasurer and Prime Minister. Between 1993 and 1995 he served as Australia’s Ambassador to the US in Washington. Don also worked for the Commonwealth Treasury joining as a cadet; when he joined Paul Keating’s Office in 1983 he was Assistant Secretary, Economic Branch where he was responsible for economic forecasts and assessments of the Australian economy.

Don Russell was at various times a consultant to the World Bank, Bankers Trust, Westpac Bank and Counsellor in the Australian delegation to the OECD in Paris.

He has a PhD from the London School of Economics, a MEc from ANU and a BEc (Hons) from Flinders University. Don also holds the Chartered Financial Analyst designation (CFA) 2007.

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