WHAT REALLY MATTERS TO MEMBER OUTCOMES

In truth, we have dealt with only one part of the issue of the cost relative to value discussion – and while the fees that service providers charge have received the most attention to date, we need to understand other factors to address where value is destroyed for members.

In 2012, retirees from our universe of funds retired on average with a replacement ratio of 32% (after an average 21.7 years of pensionable service)[2]. And this was over a time frame when markets were generally flourishing. For the last 15 years the average active balanced manager has generated around 10% real return – an impressive result.

If we look at only a subset of retirees, for those who have been in the same fund for 30 years or more (and therefore have reasonable savings periods without interruption), the average realised replacement ratio is actually significantly higher, as would be expected. This shows that reasonable outcomes have at least been achievable from the investments – **inclusive of current costs** – given this favourable environment. So where are things going wrong?

These numbers suggest that we need to examine the issue of cost from a different perspective. Instead of assessing what the service provider provides (and whether they deserve its associated fees), we should turn the analysis on its head by asking: Which decisions have the greatest impact on what ends up in members' pockets when they retire?

A careful analysis of the sources of value erosion, when measured at member level, suggests that even if the investment strategy was capable of delivering a 75% replacement ratio (after reducing it 5.63 points for cost), the combination of inadequate preservation and a lower pensionable pay percentage proved to be significantly greater value destroyers.

Given that the government has not yet made retirement funds compulsory for all employees, nor has it firmed up its position on preservation or pensionable pay allowances, this leaves a significant burden on employers, trustees and consultants to try to manage these shortfalls.

Clearly to stem this value erosion, we need a more effective consulting framework.

WHAT AFFECTS MEMBER OUTCOMES MOST?

1. Whether the member preserves
2. Whether the contributions are a meaningful proportion of their salary (and is not reduced by pensionable pay choice)
3. When contributions start
4. The allocation of contributions between risk benefits vs retirement savings
5. Costs
6. Long-term asset allocation strategy
7. The additional value from fund managers above the long-term asset allocation strategy (alpha)

RANKING THE VALUE-ADD OF SERVICE PROVIDERS

1 LIABILITY MANAGER OR ACTUARY

The most important link in the chain. Understands member structure in the fund and the liabilities it will likely generate. Establishes the right long-term strategy for specifically addressing those liabilities. Get the answer to this problem wrong and it really doesn't matter how well the asset manager might perform, they would still miss the mark.

2 EMPLOYEE BENEFITS CONSULTANT

In many funds, the EB consultant may also be the liability manager. But their other role is to be the critical interface between the trustees, the fund structure and the employer. If the greatest source of value destruction comes from poor linkage with HR policies or member decision making, this is the person responsible for getting that message out.

3 RISK BENEFITS

It's critical to structure these protections efficiently so members only pay for what they need. For some members, the income and family protections rank significantly higher than accumulating savings for retirement. Trustees need to clearly identify and understand these preferences.

4 GOVERNANCE, LEGAL AND RISK MANAGEMENT

This is the command control centre for the fund. Shirking on these costs is not an option.

5 ASSET MANAGER

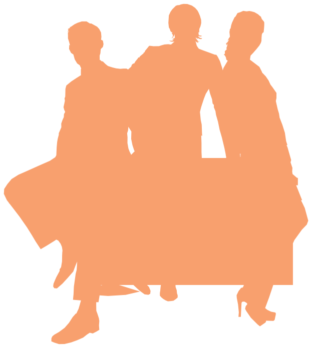
Their AUM pricing model makes this the most expensive part of the value chain. The problem is much of the potential promise of outperformance from the more expensive managers gets diversified away by both time and the use of multiple managers.

6 ADMINISTRATION

Trustees need to clearly understand charging structures in the context of a fund's membership base. Some charging structures are more advantageous to members with low fund credits and others more advantageous to members with high incomes.

7 TRADING COSTS

One of the costs trustees pay least attention to. High turnover strategies and multiple transitions with managers can eat up significant amounts.



- Fixed fees paid annually for services rendered
- Fees paid annually based on assets under management
- Fees paid annually on new cash flows