CHAPTER 9

INVESTMENT BY SUPERANNUATION FUNDS

9.1 There has been much debate recently over the investments made by superannuation funds. The Committee notes that trustees have generally adopted extremely conservative investment strategies as Table 9.1 illustrates. The previous chapter outlined the difficulties which arise when the focus is on short term returns.

Table 9.1

NON-LIFE OFFICE SUPERANNUATION FUNDS' AND ADF's ASSETS

Asset	Value as at June 1991 $ billion	Share of Intermediaries' holdings in this asset class	Share of funds' holdings in this asset class
Public sector securities	10.1	16.7%	13.2%
Deposits, loans and placements	15.4	5.1%	20.3%
Bills and promissory notes	7.1	8.2%	9.3%
Shares	21.6	42.9%	28.3%
Fixed assets	10.3	23.7%	13.5%
Foreign currency assets	10.0	15.1%	13.1%
Other assets	1.7	3.5%	2.2%
TOTAL	76.1	10.1%	100.0%

Source: V W Fitzgerald and I R Harper *Super Preferred or 'Level Playing Field'?* p 38.

9.2 Industry schemes have been particularly conservative in their investment strategies. The typical asset structure of a mature industry scheme is:[1]

Equities	35%
Fixed Interest	25%
Capital Guaranteed	25%
Listed Property Trusts	5%
Cash	10%

Other funds might have greater exposure to property and less in the way of capital guaranteed products. Only one witness suggested to the Committee that superannuation funds have at times been involved in 'speculative' activities.[2]

9.3 Figures provided by the ISC show that in 1987-88, 68 per cent of the $33.247 billion in assets (excluding life insurance policies) of private sector

1 *Development Capital and Potential Claims*, G A Grant, General Manager; Jacques Martin; Paper presented to IIR Conference.

2 Mr Daryl Dixon, SG Evidence, p 79.

superannuation funds was accounted for by the largest 462 funds (assets over $10 million) and 81 per cent by the largest 2 355 funds (assets over $1 million). For public sector funds, of the $33 billion in assets reported to the ABS in 1987-88, 85 per cent was accounted for by the largest 11 funds (assets over $500 million) and 95 per cent by the largest 25 funds (assets over $100 million).[3]

9.4 The ISC concluded that if each life office was treated as one 'fund', 74 per cent of the total assets of superannuation funds and ADFs is accounted for by 490 funds comprising:

- five life offices;
- 12 ADFs;
- 11 public sector funds; and
- 462 private sector funds; or[4]

87 per cent is accounted for by 2 422 funds comprising:

- ten life offices;
- 22 ADFs;
- 25 public sector funds; and
- 2 355 private sector funds.

9.5 Alternatively, if a common threshold of $10 million across all categories is set, the largest 600 funds account for 91 per cent of total assets, that is:

44 life offices;
32 ADFs;
62 public sector funds; and
462 private sector funds.

9.6 This means that there are only 462 private sector funds, or less than one per cent of all superannuation funds, that are significant in a funds management sense.[5] A survey of industry funds in the September 1991 issue of *Superfunds* showed that only five funds undertook the investment management function themselves and all other funds employed life offices or BT or Westpac as their fund managers.

9.7 One of the most strident criticisms of superannuation funds, life offices and fund managers is that they have not invested in 'high risk' or 'patient capital' ventures to any great extent.

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3 Unpublished evidence.

4 *ibid.*

5 There are approximately 100 000 superannuation funds in Australia. See Table 9.2.

9.8 Jacques Martin told the Committee that:

> *... if you can find a fund manager with more than 30 stocks in his Australian equities portfolio, you have someone who is madly diversified. You have fund managers with as few as 20 stocks.*[6]

9.9 The conservatism of trustees and funds managers has led to calls for direction of superannuation funds investments. The main arguments for superannuation fund investments being channelled into particular areas are that:

- superannuation funds receive tax advantages and as a *quid pro quo* should direct investments into particular areas in the national interest;
- compulsory superannuation savings should be used to fund infrastructure or public housing in lieu of public sector financing because government policies will increase the size of superannuation funds at the expense of other financial institutions;
- superannuation funds have shown no interest in voluntarily investing in venture and development capital and should therefore be compelled to do so; and
- Australia is short of capital and therefore superannuation funds should not be allowed to invest overseas rather than in Australian industry.

9.10 IOOF suggested that incentives be offered to superannuation funds which invest in approved areas addressing the needs of new technology, export-oriented industry and public infrastructure. It recommended a new 30/20 rule as a basis for exempting the earnings of superannuation funds from tax.[7]

9.11 In general, however, the superannuation industry is opposed to prescriptive investment guidelines arguing that investment controls for non-prudential reasons will dilute the responsibilities of trustees.[8] In addition, it is argued that prescriptive investment guidelines will reduce returns and increase the riskiness of the investment portfolio.

9.12 A number of reports have recently considered the need for investment controls on superannuation funds.[9] The Government has eschewed non-prudential controls on investments by funds because it is concerned to create a policy environment which

6 Evidence, p 405.

7 Sub No. 59, p 9.

8 See for example, Sub Nos. 89, 95, 102, 106, 114, 119.

9 See for example The Joint Committee on Foreign Affairs, Defence and Trade, *Australia's Current Account Deficit and Overseas Debt*, 1992; the Report of the Task Force on the Commercialisation of Research *Bringing the Market to Bear on Research*, 1991; and the Industry Commission report, *Availability of Capital*, 1991.

maximises superannuation fund earnings and the ultimate benefits available to fund members.[10] The Treasury submission argued that:

> *... it would clearly be inimical to the Government's policy objectives if investment controls resulted in lower overall retirement incomes.*[11]

9.13 The Treasury submission also noted that:

> *Investment guidelines could also:*
>
> - *run the risk of distorting asset markets and resource allocation with adverse consequences for overall economic efficiency;*
> - *conflict with trustees' obligations to invest in the best interests of their members; and*
> - *leave the Government open to claims for compensation if investments in the prescribed areas performed poorly or failed.*[12]

9.14 Treasury argued that superannuation funds are broadening their investment horizons without government intervention. It advised the Committee that:

> *... as the volume of funds available for investment by superannuation funds increases, market pressures will ensure that this trend continues as trustees and managers strive to maintain competitive investment returns. (By definition, if the rapidly increasing supply of superannuation savings continues to be directed solely to those areas where superannuation funds have traditionally invested, the rate of return on those assets will fall.) ... It is therefore unlikely that, given the flexibility of capital markets, investments offering competitive returns will not be able to attract investment support.*[13]

9.15 Tangible evidence of the broadening of the investment horizons of superannuation funds is provided by the Development Australia Fund (DAF) which is a joint venture of the Australian Chamber of Manufactures, the Australian Council of Trade Unions and AMP. It is a national investment fund available to the trustees of large superannuation funds,with a minimum investment of $500 000.

9.16 The Fund is investment driven, which means that return, security, diversification and the need for a balanced portfolio dictate investment selection. The Committee was advised that, subject to these fundamental criteria, investments are selected so as to benefit Australia by providing capital in areas where it is particularly needed. Such

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10 Prudential Statement on Supervision of Superannuation Industry.

11 Sub No. 195, p 25.

12 *ibid*, p 26.

13 *ibid*.

investments include housing, manufacturing with an emphasis on increasing exports and reducing imports, successful businesses whose growth requires further capital development and some special opportunities uniquely available to the Fund.

9.17 Longer term asset allocation of the DAF is likely to be:

- 40% listed shares
- 30% housing
- 10% business development
- 10% fixed interest
- 5% special opportunities
- 5% cash

Development and Venture Capital

9.18 With regard to development and venture capital, Mr G Grant noted that there are three avenues open to trustees to invest in this asset class:

- debt;
- direct investment in a project or company; and
- indirect investment through a Development Capital Fund.

9.19 Mr Grant observed that the debt method is unattractive to trustees and that:

> *... no credible mechanism seems to be in place to facilitate either of the other options.*[14]

However, the MTIA advised the Committee that the Superannuation Trust of Australia is involved in a specialist investor which concentrates on the bottom 20 per cent of the listed share market.[15]

9.20 Mr Block advised the Committee that the actuaries TPF&C had calculated that 1-3 per cent of total assets could be put in high risk assets to achieve a long term real return.[16] However, he went on to argue that development and venture capital requires specialist managers. He said that in the United States there is not only a professional venture capital market, but highly specialised mutual funds or unit trusts which provide capital for small and medium business. He argued that the:

> *... best way forward ... is to encourage major superannuation funds to set up small venture capital subsidiaries.*[17]

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14 G.A. Grant, *op cit.*

15 Evidence, p 987.

16 Evidence, p 1925.

17 Evidence, p 1925.

9.21 Fitzgerald and Harper noted that in both North America and the United Kingdom, pension funds and life offices can become significant suppliers of capital to specialist intermediaries who are in turn important suppliers of equity funds to small and middle business.[18] They went on to note however, that the top 200 US pension funds, controlling over US$15 trillion, have only about 0.3 per cent of their total portfolios in venture capital and similar funds, but nevertheless provide a substantial part of new capital flows to that area. The longer established UK venture capital and related vehicles account for higher proportions of UK pension fund portfolios – up to several per cent.[19]

9.22 The Committee agrees that development and venture capital vehicles require specialist management but was unable to agree on how development capital vehicles could become part of the capital markets framework.

9.23 The IR&D Board, in its evidence to the Committee suggested that:

> *... the problem is that in Australia we have a very underdeveloped capital market by comparison with the rest of the world ... This market is probably at the cowboy end of the spectrum and because of that there is a great need for it to be nurtured and developed.*[20]

9.24 It went on to argue that:

> *... there is no doubt that a trustee is probably capable of being persuaded, rationally, of the benefits of investment for long term economic development. It is in his interest to do that if he or she has members who believe that too. It is rarely in the interests of a professional funds manager to do that because at the end of the day the funds manager is in the business of managing funds to earn fees, and short term performance is the major marketing tool in selling funds management services ... As far as development capital managers specifically are concerned, I think it would be fair to say that most of the people who have operated in that field in Australia, if they were operating in the US or UK markets, would have made quite a good living because those environments are so much more friendly to venture and development capital investment. In Australia it has been diabolically difficult over the last decade ... [Finally] I would have to say that the lack of adequate management to manage high growth potential businesses is a more serious problem than the lack of skilled and experienced intermediaries.*[21]

9.25 It appears to the Committee that with increased involvement of members in the trustee role, better education of trustees, compulsory preservation of benefits and the

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18 Fitzgerald and Harper, *op cit* p 41.

19 *ibid.*

20 Evidence, p 1965.

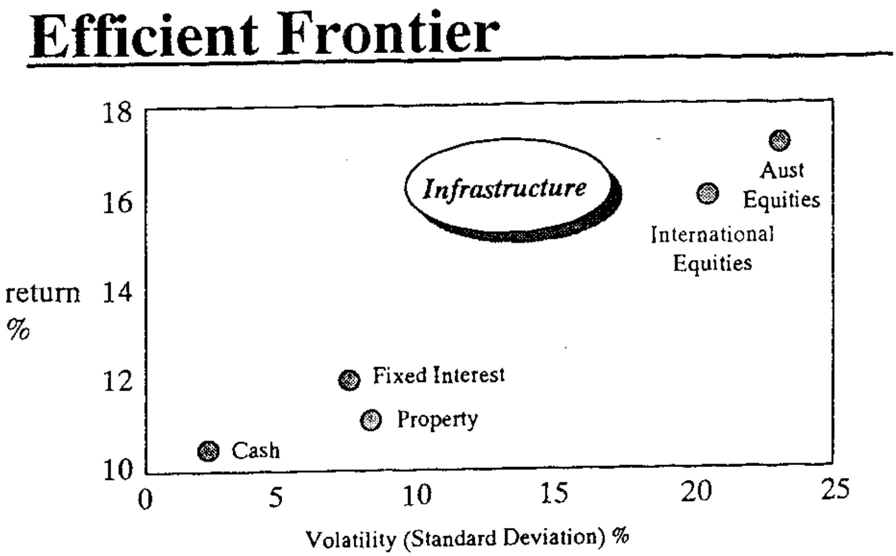
21 Evidence, p 1967.

gradual move towards taking benefits as income streams rather than lump sums, there will be more pressure exerted on the fund management industry to provide vehicles for long-term venture and development capital. In this respect, it is particularly pleasing to note formation of institutional investment in small and medium sized companies with high growth potential such as National Mutual's association with the Advent Group (refer to the Attachment to this chapter).

Infrastructure

9.26 Investment in infrastructure is an another area where calls have been made for compulsory superannuation fund investment. Such investment in infrastructure is necessary for long term economic growth. It is essentially long term and relatively illiquid, and offers trustees the opportunity of matching the funds' liabilities with assets. Figures 9.1 and 9.2 show returns on infrastructure relative to other investment.

Figure 9.1

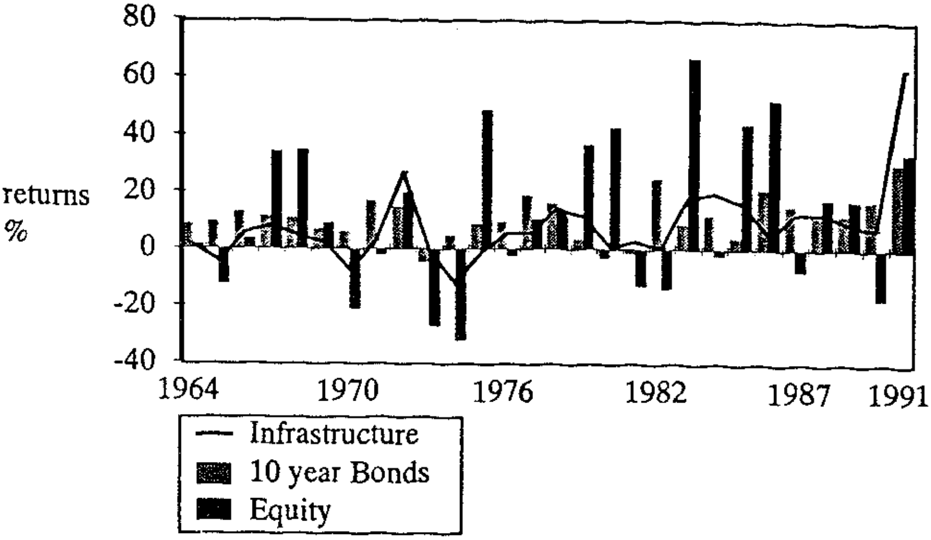


Source: Submission No. 210.

Figure 9.2

Annual Rate of Return

Historic data



Source: Submission No. 210.

9.27 Australian Infrastructure Investment Management (AIIM) advised the Committee that without a specialist fund which could provide management expertise in infrastructure investment, it was unlikely that superannuation funds would invest in infrastructure.[22] However, AIIM also pointed to anomalies in the *Income Tax Assessment Act* (ITAA) which require correction if superannuation funds are to become equity investors in private sector infrastructure projects.[23] AIIM is particularly concerned about application of the public trading trust provisions to the specialist fund which would mean that the income of the fund would be taxed at the corporate rate rather than the concessional superannuation fund rate. Furthermore, it would appear that there are some difficulties with the specialist fund being established as a pooled superannuation trust and that taxation losses accruing to the fund in one project may not be able to be offset against income from other projects.

9.28 Using information provided by AIIM it also appeared to the Committee that infrastructure investment could provide trustees with an asset class that would generate long term rates of return with less volatility than Australian equities. Further details on AIIM are provided in the Attachment to this chapter.

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22 Sub No. 210, p 2.

23 *ibid*, pp 3-4.

> *Recommendation 9.1:*
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> *Given the attractiveness of infrastructure investment for superannuation funds, the Committee recommends that the anomalies in the Income Tax Assessment Act (ITAA) which discourage investment in infrastructure by superannuation funds be removed.*

Conclusions Regarding Development Capital and Infrastructure Investment

9.29 The Committee agrees with ACOSS that the current taxation system has advantaged housing and superannuation at the expense of infrastructure and industry.[24] Whilst ACOSS was not opposed to prescriptive investment guidelines for non-prudential reasons, it was wary of channelling funds. ACOSS advised the Committee that if the Government tried to direct the form of superannuation fund investment, there are:

> *... some quite difficult questions of definition. ... One of the dangers actually is that the purposes will be chosen because they are easy to define; for example, housing – it is easy to define whether something is housing or not, but not necessarily the appropriate purpose that you want to pursue.*[25]

9.30 An alternative approach is to require funds to disclose their investments in specified categories so that consumers can compare the investment profile of funds and strategies for long term growth. The definitional problems alluded to above are reduced if funds are only required to provide information. This measure would be consistent with the recommendations outlined in Chapters 4 and 8 for trustees to maintain a diversified portfolio and to inform members about the investment strategy of the fund.

> *Recommendation 9.2:*
>
> *The Committee recommends that no investment controls be placed on superannuation funds to compel them to invest in particular areas such as development or venture capital or infrastructure.*
>
> *The Committee further recommends that trustees should have to report to members and to the ISC on investments in new asset classes such as development and venture capital and infrastructure investment.*

9.31 As knowledge of investment strategies and funds management becomes more widespread and sophisticated, the Committee believes that trustees will be prepared to consider sectoral specialists or niche marketers to a far greater degree than is currently the case. There is clearly an onus on financial markets to respond to the need for long term investment strategies to pre-empt any community pressure to introduce prescriptive investment guidelines.

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24 Evidence, p 1371.

25 Evidence, p 1382.

Recommendation 9.3:

The Committee recommends that the issue of directing investment of superannuation moneys be re-examined by an appropriate Senate Committee within three years.

Overseas Investment

9.32 Overseas investment by superannuation funds offers opportunities for portfolio diversification and reducing the volatility of investment returns. It can also have a positive impact on the balance of payments by providing dividends and other income from overseas. However, because of currency risks and higher costs, AMP noted that:

> *... international investments must offer the prospect of superannuation returns if they are to be rationally justified.*[26]

9.33 In aggregate, superannuation funds currently have around 13 per cent invested in overseas assets. Life offices have a similar proportion of their assets invested offshore. However, the level of international investments will vary between funds. AMP told the Committee that it was unlikely that the average level of international investments would be above 30 per cent.[27]

9.34 Most submissions to the Committee argued against prohibition on overseas investment. Jacques Martin was:

> *... bemused by the proposition that overseas investment by Australians can lead to economic disaster when the most powerful economies of the world are the most substantial foreign investors.*[28]

Recommendation 9.4:

The Committee recommends that no special restrictions be placed on superannuation funds investing overseas.

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26 Sub 120, p 20.

27 *ibid.*

28 *op cit*, p 9.

Table 9.2

FUNDS WHOSE ASSETS ARE NOT ALL INDIVIDUAL INSURANCE POLICIES : NUMBER OF FUNDS AND TOTAL INVESTMENTS BY TYPE OF ASSET AND TOTAL INVESTMENTS SIZE – 1986-87

Total Investments Size	Funds	Type of Asset						Total Investments
		Public securities	Investments at interest including mortgages	Shares and other equity investments	Real Estate	Insurance policies	All other investments	
$	Number			– $'000 –				
0 to 100 000	78 405	201 433	1 186 701	254 362	45 561	462 128	242 398	2 392 583
100 001 to 200 000	11 828	138 958	781 646	192 308	80 529	283 007	162 294	1 638 742
200 001 to 500 000	6 670	158 870	865 278	222 637	116 574	419 701	207 900	1 990 960
500 001 to 1 000 000	1 838	75 240	370 733	131 360	57 561	452 322	176 461	1 263 677
1 000 001 to 10 000 000	2 043	331 689	773 001	1 212 454	180 008	2 308 572	1 440 677	6 246 401
10 000 001 and over	475	3 461 374	3 157 472	9 956 274	1 756 444	5 102 591	2 589 465	26 023 618
TOTAL	101 259	4 367 564	7 134 831	11 969 395	2 236 677	9 028 321	4 819 195	39 555 982

Note: Funds which did not state total investments at balance date have been treated as having no investments at balance date. They therefore make no contribution to the investment amount totals. Funds which did not provide details of the percentage of investments held in one or more of the investment areas have been treated as having no investments in that area. Where the percentages stated by funds did not total 100 per cent they have been included without modification, except for sampled records which were adjusted.

Source: ISC.

Housing

9.35 The ACTU, the AAPBS and others have suggested that members be able to access their entitlements in superannuation funds for housing. Whilst the details of the schemes vary, the Committee received a number of representations on the broader issue of whether it is desirable for superannuation funds to become involved directly in housing finance.

9.36 The Committee wishes to make it clear that in the following discussion it is distinguishing between individual arrangements between the member and the fund and wholesale arrangements such as the DAF's involvement in low-cost housing in NSW.

9.37 ASFA strode the middle ground on the housing issue noting that:

> *... We have no problem at all with a properly constructed scheme that would enable people to access that for homes. We have a philosophical view that, if you try to use superannuation for too many purposes, you are going to end up dissipating it and it will not achieve the central objective of retirement incomes. But housing is quite clearly different. The Cass report demonstrates very clearly the linkage between home ownership and standard of living in retirement. We do not see that home ownership is inconsistent with the retirement income policy objectives.*[29]

However, ASFA went on to note that whilst it had no in-principle objections:

> *... getting it to work in practice is not easy.*[30]

9.38 LIFA adopted a similar position, noting the administrative complexities of a housing loan arrangement within a superannuation fund, the cost in terms of reduced end benefits and the fact that the time when people will need the money is the time when there is not much money in the fund to borrow against.[31]

9.39 The ACTU told the Committee that there were some administrative and policy issues to be resolved and that:

> *... We do not believe it is necessarily appropriate for members to borrow from the fund as a whole. We have some concern about the proposition that members should be able to borrow from their vested account, because if it is at commercial rates then it is simply providing another form of financing rather than necessarily providing relief, and it is the members borrowing their own money and repaying a rate of interest. It does not relieve the interest payments. There would also be some administrative problems for the funds. They would have to administer a*

29 Evidence, p 1128.

30 *ibid.*

31 Evidence, p 296.

> *mortgage arrangement. But we have said that we are very supportive of a notion which allows fund members to access their vested superannuation entitlement to put towards the purchase of a house.*[32]

9.40 Westpac advised the Committee that it made sense to allow people to access their superannuation savings in order to fulfil the need to own their own home but that most of the collateral for such a loan is in the property itself.[33]

9.41 The AAPBS outlined their proposed Household Savings Plan (HSP) to the Committee. The HSP:

- would be a savings account which operated as a personal superannuation plan and be subject to the tax rules for superannuation and the OSS Regulations; and

- would permit a percentage of the accumulated funds to be invested as a first or second mortgage for the purpose of buying a first home termed the HSP mortgage.[34]

9.42 The attraction of the plan rests on the current taxation deductibility arrangements for personal contributions by self-employed persons and gainfully occupied persons who do not receive an employer financed benefit other than under an award and the preferential treatment of investment income earned by superannuation funds. Compared to normal savings, the HSP would allow a taxpayer with a 39.25 per cent marginal rate to accumulate 60 per cent more savings over a ten year period and 90 per cent more savings over a 20 year period (assuming annual contributions of $3 000 and interest of 10.5 per cent).[35]

9.43 Mr Mansfield supported the principle of allowing superannuation savings to be used for housing but was concerned about possible distortion in the housing market and equity between members.[36]

9.44 The Committee acknowledges that reliance on rental housing is a significant cause of aged poverty but notes that housing is already significantly advantaged through the taxation system because of the non-taxation of capital gains on owner-occupied housing and imputed rental income. In the time available to it, the Committee has not been able to gather sufficient evidence for it to make specific recommendations on whether superannuation savings should be used for housing. In particular, the Committee is concerned about the effect that such arrangements might have on the retirement benefits accrued by members. The Committee received sufficient evidence for it to conclude the compounding effect of investment income was critical in the accumulation of final

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32 Evidence, p 370.

33 Evidence, p 688.

34 Sub No. 148.

35 *ibid.*

36 Evidence, p 1323.

benefits but was not presented with detailed evidence on the effects that a housing loan arrangement might have on final benefits. The Committee intends to report on this issue in its third report.

The Advent Group and National Mutual

The Advent Management Group (AMG) manages development capital funds on behalf of mainly institutional investors. Its expertise is in managing investments in private companies and smaller listed companies. AMG is an autonomous part of the National Mutual Group.

Major shareholders are:

National Mutual Life	53%
Founders and Staff	38%
Colonial Mutual Life	9%

Each company in AMG is the specially established manager of an investment fund:

- Western Pacific Management Company Pty Ltd manages Western Pacific Investment Company Ltd, an unlisted public company, ex-Management Investment Company (MIC), with capital raised of $29.5 million;

- PVM Management Pty Ltd manages Australian Pacific Technology Ltd, a listed ex-MIC which raised $29.5 million;

- Advent Tourism Fund Management Ltd manages Advent Tourism Development Fund, an unlisted non-trading trust which, along with Austin Venture Capital Ltd, provides $10 million for tourism industry investments; and

- Advent Western Pacific Management Pty Ltd manages Advent Western Pacific Ltd, a listed development capital fund which raised $26.5 million.

Australian Infrastructure Fund

Australian Infrastructure Investment Management Limited (AIIM) has been formed as a joint venture between Colonial Mutual Investment Management Limited and Infrastructure Development Corporation Pty Limited. AIIM is in the process of raising approximately $200 million for the Australian Infrastructure Fund (AIF). AIF has been established as Australia's first dedicated infrastructure fund to invest exclusively in Australian infrastructure projects. AIF is structured in the usual form of an investment unit trust.

AIF is seeking funds from a number of major superannuation funds and institutions, which are currently taxed at either 15 per cent or zero per cent tax rates. Current indications are that 55 per cent of unit holders will be superannuation funds and 45 per cent tax exempt institutions. These entities are attracted to the concept of AIF because it provides a vehicle which facilitates diversification of investments in Australian infrastructure and provides access to skilled management expertise in this highly specialised area.

Total funds raised within AMG since its establishment in 1984 are $95.5 million.

AMG is an affiliate of the Advent International Network of development capital companies which covers 18 countries world wide. In this network, AMG maintains direct links with the individual affiliates as well as with the Boston-based central co-ordinating company. The Network manages over $US 1 billion in development capital worldwide.

This Network provides AMG with direct access to experienced people and organisations around the world to:

- help with the due diligence on potential investments, assessing markets and technologies;
- assist Australian companies in which AMG invests to develop their international operations through finding distributors or partners; and
- keeping in touch with relevant international trends/techniques etc. in the management of development capital.