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# From hurdler to hero

## Using super fund mergers to deliver key investment wins

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Mass consolidation is a much-studied phenomenon of the corporate sector, riding the economic boom/bust cycle—but it is a first for Australia's $3 trillion superannuation industry (see Australian Prudential Regulation Authority (APRA) *Quarterly superannuation performance statistics highlights: September 2020*). The merger, or 'horizontal integration', of APRA-regulated superannuation funds en masse will define the future for an industry approaching its 30th birthday.

If this is *done well*, surviving funds will deliver investment solutions that better match the needs and preferences of fund members, at a lower cost; and fill the void banks have left in becoming a trusted financial wellbeing partner to members. But *done poorly*, 'scale dividends' will be meagre, members will face more limited, ill-fitting options that simply pass on market returns, and culture dilution and 'mission drift' will substitute superannuation funds as the neo-bank conglomerates of the future.

Further, all this is subject to the federal government's (government) overarching policy success measure. That is, whether the superannuation system will, in time, lower the bill for supporting Australians in retirement (versus a government-funded Age Pension). These are high stakes indeed.

The 'story within a story' here is one of *investment consolidation*—how to deal with multiple, overlapping investment strategies as two superannuation funds become one. Not just consolidation, this will be a process of *investment rationalisation* as funds make crucial decisions about which strategies will 'make the cut'.

The classic transition management playbook would require merging funds to analyse their combined 'legacy portfolio' and define the 'target (destination) portfolio' in the merged entity, before implementing through careful transition management. But right from the start, most funds will face a crucial stumbling block. That is, a lack of transparency about what each fund's aggregated holdings look like separately and combined, as they come together. *How can merging funds rationalise investments wisely without transparency over their start or end points?*

This paper describes this challenge through the eyes of two hypothetical merging funds, walking through the three key investment rationalisation steps in a fund merger, and shows how the funds can solve this seemingly intractable problem for their equity holdings using a centralised portfolio management (CPM) equity portfolio structure. This set-up empowers the hypothetical funds to look beyond the risk aspects (hurdles) of investment rationalisation and adopt a more opportunity-attuned mindset. In this fictitious merger journey, the fund 'heroes' who emerge are able to identify clear merger-related investment wins and deliver them in a smoother, more agile and less costly fashion.

## Investment rationalisation in a fund merger—a high-stakes exercise

To illustrate our ideas, we introduce two hypothetical superannuation funds, 'Ice-cream Super' and 'Syrup Super', each with four equity managers, which will be merging into a single fund, 'Sundae Super'.

The practical merger scenarios funds face may be different (for instance, a small fund being absorbed into a bigger fund; or separate front-end identities retained with a shared service back-end). Nonetheless, these ideas can be adapted to these different merger scenarios. We focus only on the listed equity holdings of these funds for the remainder of this paper. Moreover, we use a classic transition management framework and language, applied to a fund merger context.

We depict the investment challenge that awaits the two merging superannuation funds—moving from a notional eight-manager legacy portfolio to a new rationalised target portfolio—in Figure 1.

Before tackling the complexity of this challenge, it is important for both funds to appreciate just what is at stake; why it is so important for the funds to design the target portfolio cleverly, and execute the transition well. The key reasons are summarised in the following discussion.

**The funds' investment portfolios are mission-critical**

This is akin to the production assembly line in a large manufacturing plant. Investment returns are the figurative 'widgets' in the horizontal integration (merger) of our two funds here; the functional outputs which deposit retirement dollars into the accounts of Ice-cream Super and Syrup Super fund members. Delivering on investment objectives is inherently a demanding exercise, even without the short-term organisational disruptions of the merger process.

**How the two funds' investment portfolios come together may directly link to the objectives of the merger**

In the short history of fund mergers to date, some funds have articulated investment objectives like reduced investment fees, increased diversification, and broader capabilities of the investment team. Investment teams must be made aware of the wider organisational goals of the merger and understand how investment rationalisation outcomes can contribute to overall merger 'success'.

**Investment rationalisation can involve all the funds' portfolios at once**

The many moving parts and portfolio values involved makes this scenario quite different from a typical investment transition from just one strategy or manager to another within an (unchanged) broader portfolio.

**The forced investment change environment is a 'window of opportunity' for Ice-cream Super and Syrup Super to enhance or even revolutionise the way the funds invest as the new entity, Sundae Super**

Most funds' investment teams can speak of good portfolio ideas intended to be delivered 'one day'. For portfolios already being reshaped and transitioned, it may be easier (and cost less) to land a number of new ideas in the rationalised target portfolio.

Dramatic industry developments are also forcing a rethink of how superannuation funds invest, such as:

- mandatory comprehensive income products for retirement (CIPRs) retirement solutions (due July 2022)
- The Australian Securities and Investment Commission's Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* (RG 97)
- the rise of 'responsible investing'
- the proposed APRA performance benchmarking rules.

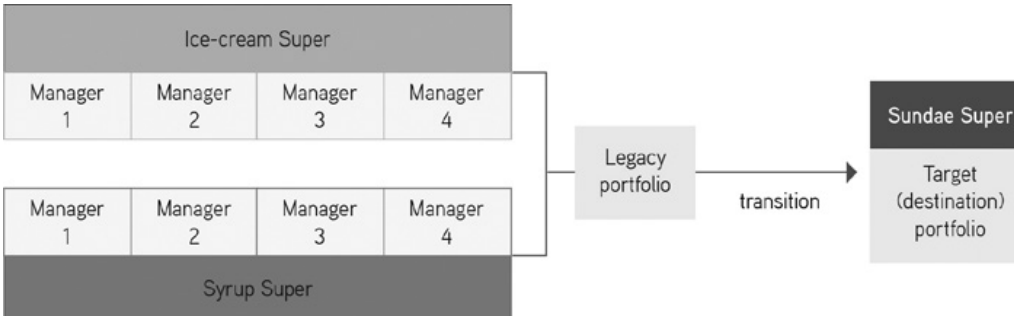
As the hypothetical funds, Ice-cream Super and Syrup Super, think about the strategic investment pivots they need to make to deal with such changes, it makes sense to weave these into the design of the Sundae Super rationalised investment portfolio.

These observations underscore the need to bring a best-practice approach to the rationalisation of superannuation investment portfolios in a fund merger. Managing risks (the hurdles) is, of course, critical, but investment rationalism also provides the opportunity for heroics, if funds are prepared to be curious and eager to find ways to deliver investment wins through the merger process.

**The quote**

*Delivering on investment objectives is inherently a demanding exercise, even without the short-term organisational disruptions of the merger process.*

**Figure 1. Fund mergers: the investment rationalisation challenge (multi-manager equities)**




*Source: Parametric, 2021. We leave the details of the transition portfolio unspecified as an array of structures, manager combinations, etc. are possible.*

**The quote**

*We may never see more dramatic, sweeping investment portfolio changes than in the context of the fund mergers that will more than halve the number of APRA-regulated superannuation funds over the next decade.*

## Defining the merged legacy portfolio

As Figure 1 shows, the design of the Sundae Super target equity portfolio and effective transition hinge on how well the merging funds understand the true starting point in their investment rationalisation journey. First, each fund needs a whole-of-portfolio view of their own equity holdings across the four managers.

Our merging funds, Ice-cream Super and Syrup Super, face a challenge if they use a typical multi-manager structure which parses out the equities allocation among numerous independent managers with different style attributes—each fund must piece together the 'jigsaw' of manager sleeves to create a holistic view. The challenge, in fact, is twofold: to obtain the data from across these sources, and to find the resources and skills to synthesise and analyse the data to create a coherent, insightful whole-of-portfolio view.

A further step, which adds to the degree of difficulty, is needed to reflect the merger context: to combine the whole-of-portfolio views of Ice-cream Super and Syrup Super into a single holistic view of the true legacy portfolio. This merged view of the true legacy portfolio spanning both funds will put the funds in a powerful position to not only manage the risks, but capitalise on the opportunities, of the investment rationalism workstream of the merger. However, combining the eight individual manager equity portfolios to achieve this will be a confronting, arduous task for the merging funds, and may be practically impossible in the traditional multi-manager equity structure described earlier.

We solve this problem by imagining, instead, that the equity positions of Ice-cream Super and Syrup Super are implemented using a CPM structure as depicted in Figure 2.

(For a short research note summarising the mechanics of CPM, see Williams & McKenzie, 'Retirement investing, responsible investing: searching for scaleable implementation', Parametric ResearchBite, January 2021.)

Here, the first, crucial step in compiling the whole-of-portfolio view for each fund has already been achieved as the CPM manager naturally aggregates and optimises the positions of the underlying four managers for each fund, prior to implementation as a single live portfolio (Ice-cream CPM and Syrup CPM respectively).

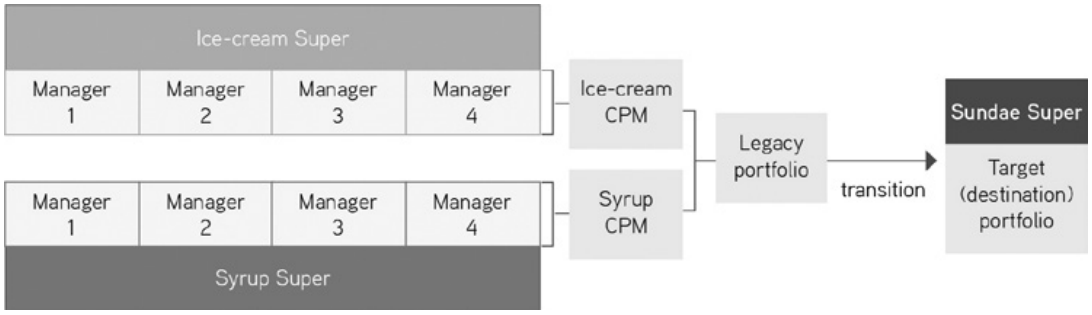
The true legacy portfolio view, then, for Ice-cream Super and Syrup Super together can be generated by the CPM manager creating a report showing the combined positions of these two CPM portfolios. Responding to the twofold challenge, we have now delivered two solutions in one to our merging funds: the CPM manager, with line-of-sight across all portfolios involved and specialist research and implementation skills, offers Ice-cream Super and Syrup Super both access to the data to provide a holistic starting point for the investment rationalisation project, and a trusted partner to perform the aggregation and analysis.

## Designing the merged target portfolio

Identifying a holistic investment rationalisation starting point for Ice-cream Super and Syrup Super is quite a breakthrough, though purely analytical—a matter of solving the data challenge and finding a party to capture the key investment attributes of the shared legacy portfolio. Defining the end point in the rationalisation process—the Sundae Super target portfolio—is different, drawing on strategic thinking, decision-making and exercise of judgment. The hypothetical funds have crucial decisions to make about which equity strategies will 'make the cut' and, further, which new portfolio ideas should be delivered as part of the new Sundae Super portfolio.

A report which captures the combined legacy portfolio can help our hypothetical merging funds answer these vital questions. It is key to elevating the roles of decision-makers in the investment rationalisation process from (mere) hurdlers to potential heroes. Continuing with our proposed CPM structure (solution), Ice-cream Super and Syrup Super could ask their CPM manager to provide the following kinds of insights in the way they summarise the legacy portfolio (see Table 1 on the next page).

**Figure 2. Transparency over the merging funds' legacy portfolio using CPM**




*Source: Parametric, 2021*

**Table 1. Data and analysis for target portfolio decision-making**

| Legacy portfolio insight | Helps funds to identify … | Potential decision for target portfolio |
|---|---|---|
| *Strategy pairing (strategies with similar risk characteristics)* | Which strategies will be direct 'double-ups' in Sundae Super | Absorb assets of redundant strategies based on Sundae Super's preferred decision criteria (e.g. better performance, better risk-adjusted performance, lower fees, better transparency) |
| *Strategies driven by systematic vs idiosyncratic risks* | Which strategies could be absorbed into or replaced by lower-cost rules-based strategies | Absorb strategies high in systematic risk (e.g. 'factor-huggers') into new low-cost smart beta sleeves |
| *Total portfolio tracking error to market cap benchmark* | How different the combined Ice-cream Super plus Syrup Super portfolio is from a simple index portfolio | Redesign Sundae Super target portfolio around a core, low-cost index holding and convert active sleeves into higher-tracking error complements |
| *Strategy rankings by fee, or fee per unit of return* | Higher cost (vs value) strategies | Absorb higher fee strategy assets into lower fee strategies to hit Sundae Super's fee target |
| *Total portfolio redundancy* | How many of a manager's positions overlap with other managers' positions | Redesign Sundae Super target portfolio around a core, low-cost holding of high-overlap stocks and convert active sleeves into ex-core active complements |
| *Embedded capital gains, by strategy* | Which strategies can be changed or divested without triggering a large tax bill | Absorb assets of low-embedded tax strategies into higher-embedded tax strategies and/or specify after-tax return focus of target portfolio |
| *Carbon (or other environmental, social and governance (ESG)) characteristics of total portfolio* | How the combined Ice-cream Super plus Syrup Super portfolio compares to a carbon/ESG benchmark or specific fund ESG target | Absorb assets of ESG-naïve strategies into ESG strategies or add a whole-of-portfolio carbon/ESG screen or overlay to Sundae Super target portfolio |
| *Strategy rankings by RG 97 costs* | Which strategies may reduce competitiveness of Sundae Super in product disclosure documents and web comparison tools | Absorb higher RG 97 cost strategy assets into lower cost strategies to hit Sundae Super's competitive positioning target |
| *Strategy rankings by concentration/diversification* | Which strategies can be changed or divested quickly, with lower transition costs | Accelerate transition planning for concentrated portfolios and/or specify trading and implementation efficiency focus of target portfolio |

*Source: Parametric, 2021*

See how this transparency empowers the hypothetical merging funds. They are now well positioned to think about how portfolio inefficiencies can be addressed in the course of investment rationalisation, and what can be delivered as a merger 'win' in the way the target portfolio is designed. The beneficiaries of these wins are fund members; but there is also, arguably, a more commercial win—a competitive advantage these funds will enjoy as the merger is executed over other funds who do not use a CPM equity structure.

We envisage Ice-cream Super and Syrup Super engaging collaboratively with the CPM manager to gradually refine their target portfolio ideas, until they settle on the final design of the Sundae Super target portfolio. The funds can now move to the implementation phase of the investment rationalisation project with a detailed understanding of the expected portfolio holdings, risks, fees, tax positions, ESG and other sensitive attributes of the newly designed, rationalised Sundae Super portfolio.

## Managing the investment rationalisation transitions

A third area of investment rationalisation can elevate the roles of Ice-cream Super and Syrup Super from hurdlers to heroes: the actual transition path they will forge in moving from their shared legacy positions to the Sundae Super target portfolio. What does best practice look like in this high-stakes exercise? We believe it is a matter of optimising between three objectives, held in tension, depicted in Figure 3.

**Figure 3. Transition management objectives for a superannuation fund**


*Source: Parametric, 2020—reproduced from prior published research.* Transaction costs include explicit costs like brokerage, fees and transaction taxes and implicit costs like bid-ask spreads and price-impact ('market move') costs.*
**See Williams & McKenzie, 'The sting in the transition tail', Parametric Research, May 2020. In this paper, we analysed a hypothetical superannuation fund equity transition scenario and identified tax costs (typically ignored) which were more than six times larger than transaction costs.*

This three-way lens is at odds with the usual framing of superannuation investment transition management as a two-way speed versus transaction cost trade-off. This ignores the taxable nature of superannuation fund investing. The merger context is, surely, the worst time for our funds, Ice-cream Super and Syrup Super, to adopt 'tax blinkers' in relation to the investment rationalisation task, given the intuitive rule of thumb that the larger the transition, the larger the potential tax bill.

(This should not be confused with the tax rollover relief provided to merging superannuation funds in Subdivision 310 of Part 3-30 of the *Income Tax Assessment Act 1997*. This shields funds from tax liabilities (or loss of accrued tax loss shelters) which can otherwise arise through the change of legal ownership of investments in fund mergers. The tax relief does not extend to the investment rationalisation that, inevitably, needs to occur during the process of consolidating the assets within the merged fund.)

Again, we note the difficulties a typical equity structure (see Figure 1) would present to the hypothetical superannuation funds to balance the competing pressures of time, transaction costs and tax costs across the eight transitioning manager portfolios and, indeed, find a transition manager skilled at optimising between these three. And, again, we see how the qualities of our proposed solution cut to the heart of this challenge: in the reimagined hypothetical, Ice- cream Super and Syrup Super use a CPM structure with both in-built transition management and a specific focus on managing 'real-life' portfolio implementation frictions, including taxes and transaction costs.

With the final design of the Sundae Super target portfolio settled, we envisage Ice-cream Super and Syrup Super commissioning from the CPM manager a pre-transition report covering estimates of time, transaction costs and tax costs to move from the merged legacy to target portfolio.

Subject to a clear, prevailing preference (such as 'move as fast as possible'), the report can cover multiple scenarios to give the funds a feel for the different options and trade-offs involved, before agreeing and implementing the transition plan. This is the embodiment of the three-way framework set out in Figure 3 and, in our view, brings best-practice implementation to the investment rationalisation workstream of the fund merger.

## Conclusion

The hypothetical funds, in the course of effecting a broader fund merger, have now navigated a challenging, high-stakes investment rationalisation process and delivered a new, cleverly designed Sundae Super equity portfolio. Using a specialist change management and implementation structure (CPM) has made possible what might be impossible (at best, unwieldy) in a traditional equity structure. In fact, it has brought surprising ease and agility to this critical process. Ice-cream Super and Syrup Super can confidently communicate to stakeholders that they have made the best of their opportunity to deliver a new set of equity holdings which have:

- been stripped of redundancy, uncompensated risk and other inefficiencies that would otherwise have resulted from the merger
- been pivoted to meet key strategic objectives (e.g. to reflect lower fees, better ESG characteristics or a lower (or higher) risk appetite)
- preserved portfolio value through the investment rationalisation process, through intentional management of taxes and transaction costs
- implemented the investment-related deliverables of the fund merger in a timely fashion, consistent with the broader fund merger timetable
- been able to target the investment-related 'wins' from the merger as a contribution to the merger's broader success.

The key takeaway for the real-life peers of Ice-cream Super and Syrup Super is this: the greater the potential investment changes, the more the value of a CPM structure and best-of-breed implementation come to the fore. We may never see more dramatic, sweeping investment portfolio changes than in the context of the fund mergers that will more than halve the number of APRA-regulated superannuation funds over the next decade (prediction published in KPMG's *Super Insights Report 2018*).

Funds can—must—position themselves far in advance to execute well on merger activity when it happens. This becomes compelling for larger funds who expect to be a party to fund mergers over and over again. Part of this preparatory work is to think ahead about the critical process of designing and delivering the production centre of investment 'widgets' (retirement dollars) into a new merged 'factory' setting.

Funds that take the lead from the fictitious funds in this paper will be excited by the opportunity their merger plans present. That is, to tackle the investment rationalisation required with a heroism that delivers key investment wins to the newly merged entity and its members, and helps to underscore the merger's success. **FS**