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SHOULD SUPERANNUATION FUNDS SEGREGATE THEIR ASSETS?

Raewyn Williams

Last year almost two-thirds of superannuation contributions received by APRA-regulated funds were paid back out to members as benefits. This shift from 'stash' to 'splash' has significant ramifications for how superannuation funds define their mission. Efforts to frame this new 'retirement outcomes' mission in legislation have failed thus far (the objectives were drafted into the Superannuation (Objective) Bill 2016, which at May 2019 still has not been passed by Parliament), but demography is writing its own law: Over 2.8 million accounts will move from the accumulation phase to the pension phase over the next decade (see Rice Warner, *Retirement Won't Wait*). Whether these retirees keep their savings with their super fund, change funds, adopt a self-managed approach or move out of the system entirely will hugely influence the destiny of funds in the industry.

As funds determine their strategic response to the retirement challenge, one important decision is whether to segregate some assets into separate accumulation and pension pools or continue to combine them for scale benefits. This paper explains what asset segregation is, the key motivations for funds to consider it and why segregation is an individual fund choice. We debunk the myth that segregation is merely a question of scale and show how it relates to the broader strategic question of whether a fund sees its enterprise as one of mass production (of investment returns) *or mass customisation*.

Beyond the scale myth, we identify certain ways in which asset segregation decisions can end up being suboptimal, including an over-reliance on the quantitative business case and the temptation to address the important question of how to implement segregation only after the decision is made rather than up front. We also sound the alarm about an aspect of the government's imminent rules around retirement product design: If these end up being too prescriptive, funds may be forced down the asset segregation path rather than being able to determine whether it's truly the right fit for their fund.

A decision about asset segregation closes off, or opens up, particular pathways to delivering good retirement outcomes for members. Funds should use their best thinking, and devote adequate resources, to ensure they get this decision right.

What is asset segregation?

Most APRA-regulated funds have always used an unsegregated structure, meaning that a fund combines the underlying investments of its pension members with those of its accumulation members and man-

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ages them in single pools. The alternative is for funds to segregate their assets by setting a portion aside for the sole purpose of meeting current pension liabilities. Income and capital gains on these assets are exempt from tax.

A fund segregates pension assets by transitioning some investments from existing (unsegregated) asset pools into separate asset pools recognised in the fund's custody and administration records as held solely for members of the fund's pension options. Segregation means what it says: Fluctuations in the value of segregated pension assets affect only pension accounts, income received from these assets are credited only to pension accounts, and the fund's regular pension payments to members are financed only from these assets.

Comprehensive segregation would take place across all asset classes and manager mandates, but the practical option for funds is to adopt partial segregation—in other words, where, across investment portfolios, it makes sense. Figures 1 and 2 compare an unsegregated structure for a multimanager super fund to a segregated structure. Our simple example uses a growth option profile (70% equities, 30% fixed income) for accumulation members and a defensive profile (30% equities, 70% fixed income) for pension members.

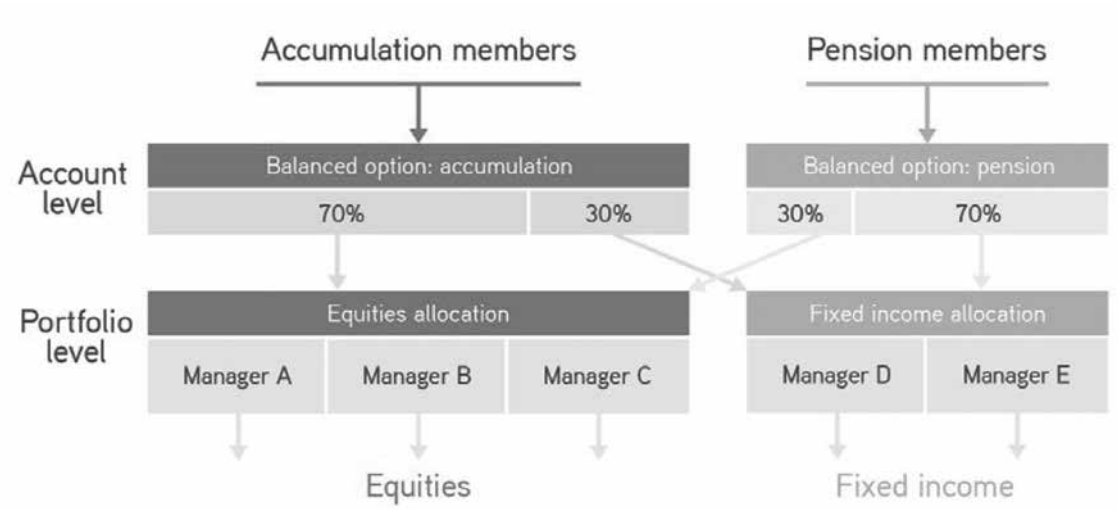
As we can see in Figure 1, the accumulation and pension members' interests are separated at the account level but unsegregated (managed as combined pools) at the portfolio level. The investment mandates of managers A–E are each governed by a single investment management agreement (IMA), and the managers have no knowledge of what percentage of the mandate reflects the interests of accumulation versus pension members. The investments are managed as best-fit portfolios, which in practice means portfolios that reflect the accumulation profile of the majority of underlying members.

The segregated structure in Figure 2 is more complex, proliferating the number of manager mandates. However, each mandate wholly relates to only accumulation or pension members and can be crafted accordingly. While Figure 2 assumes the fund uses the same lineup of managers, this segregated structure caters well to appointing specific managers just for pension members; for example, a manager with low-volatility, high-yield or franking-credit targeting characteristics. Conversely, a manager with a strategy that fits well with accumulation members (for example, low liquidity, long-term payoff, capital gains tax efficiency) may be excluded from the pension lineup.

Figure 1 shows that one crucial kind of investment customisation is achievable without needing to segregate assets—asset allocation. Here, the fund establishes—at option level—a growth risk profile for the accumulation portfolio by choosing a 70% equities and 30% fixed income allocation and a much more conservative risk profile for the pension portfolio by allocating to the unsegregated pools in the reverse proportion. By changing these weights from time to time, the fund can separately manage the risks and expected returns of accumulation and pension accounts. The ability to set a pension-specific asset allocation explains why segregation of the investments themselves is not an imperative for funds— arguably, the most important investment difference between accumulation and pension member preferences is addressed through this risk management tool.

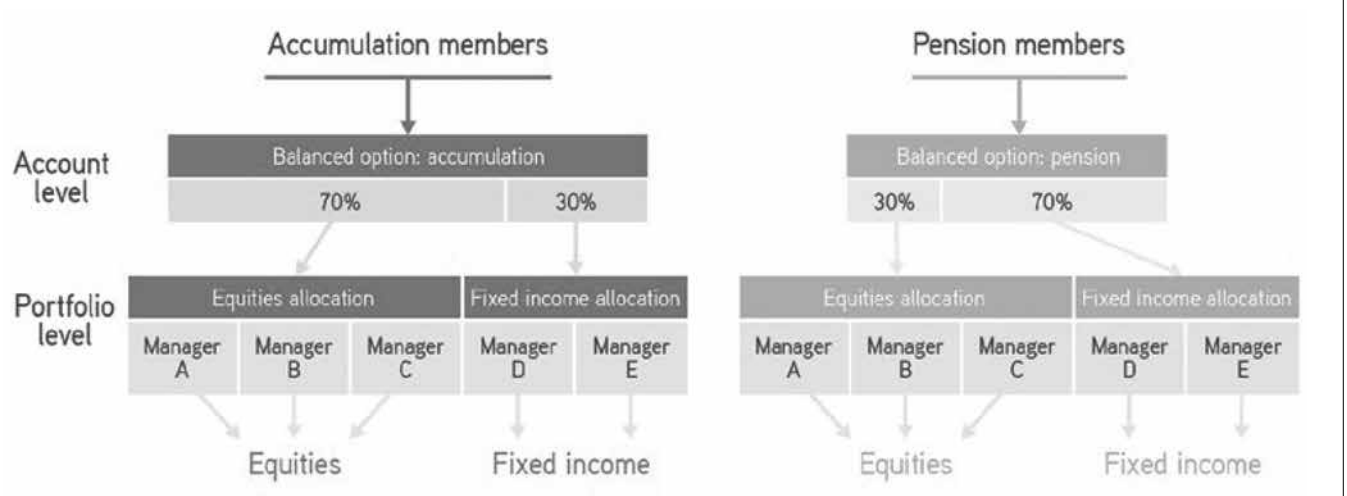
However, asset allocation stops at the shoreline of investment portfolio management; it cannot wade into the portfolios themselves to address the different investment preferences of the underlying accumulation and pension members. The only way to pursue ever finer customisation for these different investor preferences is to con-

Figure 1. Hypothetical multimanager investment portfolio, unsegregated



Source: Parametric, 2019.

Figure 2: Hypothetical multimanager investment portfolio, segregated



Source: Parametric, 2019.

sider segregating some of the underlying portfolio assets themselves.

Segregation at the portfolio level should not be confused with how assets are structured at option level. These will always be separate for accumulation and pension members due to different rules that apply to the way they are valued, regulated and administered. For example, accumulation options will always accrue a tax liability for capital gains tax payable on investment earnings, whereas pension options, being tax exempt, will not; transfers to pension accounts will be capped at $1.6 million (indexed) under the transfer balance cap rules, while accumulation balances will not be capped; and minimum distribution rules apply to pension accounts, whereas members typically cannot access their savings in accumulation accounts.

When should funds consider asset segregation?

A handful of funds (including QSuper and HESTA) have spoken publicly about the benefits of carving out and managing separately some assets specifically for pension members. But is it right for all funds?

At a point in a fund's organisational development, the inherent tension between the economic and efficiency benefits of pooling assets and the need for finer-grade investment levers to deliver customised investment solutions to members will begin to surface. This is not a challenge confined to the superannuation industry—for at least two decades, corporate literature has discussed the holy grail of mass customisation as a way to resolve the tension between these two ways of serving clients and customers.

Using the language of Duke University business professor Paul Zipkin in 'The Limits of Mass Customization', we can characterise the manufacture of investment returns by super funds for their members in an unsegregated structure as an exercise in mass production. Some—but not all—funds may see asset segregation as a step in their transition, like many modern companies, from a mass production to a mass customisation enterprise.

This hints at why it is dangerous for a fund to reduce dialogue about asset segregation to one dimension. For example:

- 'We'll think about segregating when our equity pool reaches $10 billion'.#
- 'Segregation won't make sense for us until at least 30% of our members are in pension phase'.
- 'We customize by having different asset allocation for our accumulation and pension members'.
- 'We have to segregate to become more after-tax focused'.
- 'When segregation becomes industry standard, we'll consider it'.

#Note: The '$10 billion scale test' seems to come from the public pronouncements of QSuper, which segregated $10 billion in pension assets in 2014. In fact, as reasons for segregating the fund, it cited its desire to 'capitalise on the greater tax efficiencies inherent in a segregated asset structure' and 'to optimise outcomes for different member cohorts'.

None of these statements are necessarily wrong, but they lack context and a holistic view. To start with, we counsel funds against consigning the segregation option to simply 'funds of a certain size'. For those taking QSuper's lead, a better question than 'When will we reach $10 billion in pension assets?' would be 'What investment economies of scale exist for our fund at $2, $3 or $5 billion relative to (say) $10 or $20 billion?'.

Adding to these nuances, the fund's own answers must, in light of the new member outcomes test, be evaluated against whether an informed, financially literate member would think the same way. This is the very essence of the fund trustee's fiduciary duty. Larger funds can be forceful advocates for scale efficiencies, but do their own retired members prize growth and scale in their fund of choice in the same way their funds do? Do fee sensitivities drive as many of these retirees' choices as funds might think?

More broadly, as the mass-production versus mass-customisation trends play out, where a fund wants to position itself is a highly strategic matter—one that should drive the question of whether to segre-

gate assets. Figure 3 considers two hypothetical funds with different brands, member profiles, technology platforms, legal positioning and culture and how these attributes would affect their view of the asset segregation decision.

Notably, these attributes have little to do with size. A large fund may as easily fit in the 'reject segregation' camp as the 'consider segregation' camp; similarly, a fund with less scale could sit in either camp. Segregation does, in our view, require a minimum amount of scale, but it need not be anything like the $10 billion pension pool that anchored QSuper's decision.

Why segregate pension assets?

Figure 4 lists the potential investment benefits of segregating—some quantifiable (though not necessarily certain), some not. We make the distinction because funds can often quantify a scale benefit from pooling investments, which creates a powerful bogey for a decision to segregate assets. Business author and historian Jerry Muller describes the way decision makers find safety in hard numbers—what he calls 'the tyranny of metrics'—in the mistaken view that this is the only way to add rigour to the process.

As we look through the list in Figure 4, it seems many of the perceived benefits of asset segregation do not lend themselves easily to quantification. Rather, they require funds to have the courage of their convictions to successfully mount the case for segregation. The degree of difficulty compounds if the business case must pass through multiple layers of governance, which is often the case with super funds.

For funds interested in building the business case for segregation, one quantifiable benefit of asset segregation is the performance drag on international equity pension portfolios from foreign dividend withholding tax. This drag—38 basis points on a passive international equity portfolio over 2018—is a permanent cost to pension (but not accumulation) members and can be addressed if funds can design exposures specifically for pension pools.

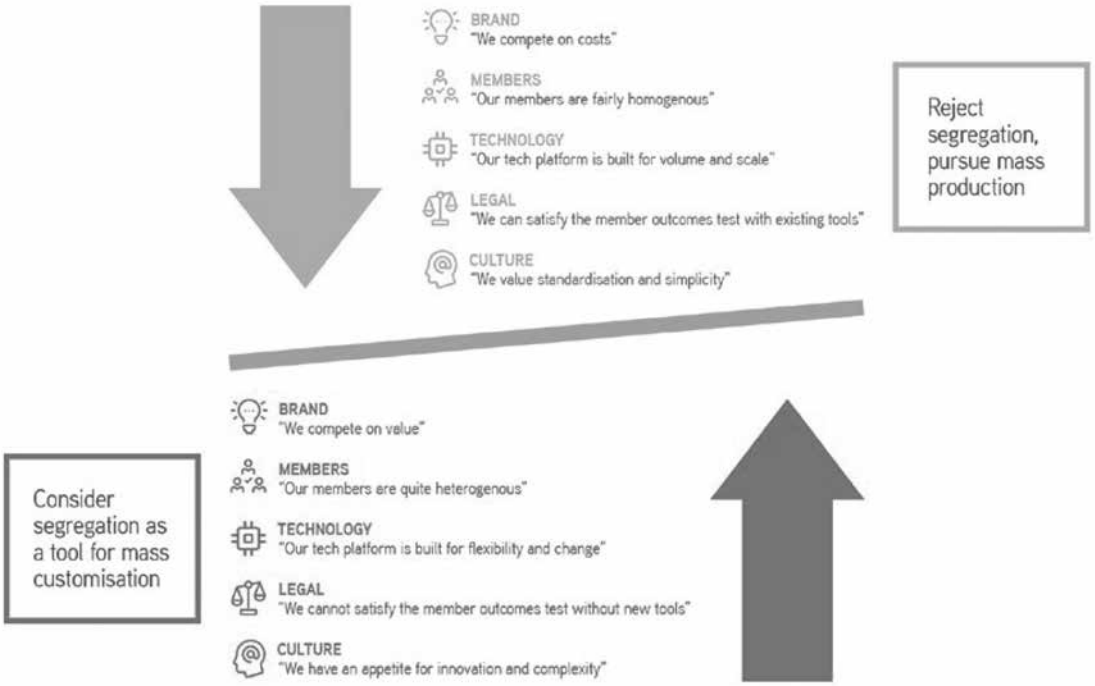
For another example, consider the idea of franking-credit-tilted Australian equities: Our previous research has identified the additional risks introduced into an accumulation portfolio to target this extra source of yield (refer to the Parametric paper 'A Fresh Look at Franking'). But does this evaluation change if a segregated pension

Figure 4: Potential investment benefits of pension asset segregation

Quantifiable	Not quantifiable
Participate in off-market share buybacks for pension members	Choose strategies that better match pension member risk preferences (for example, downside protection, low volatility, inflation linked)
Preserve or tilt toward franking credits; reduce withholding-tax leakage on pension portfolios	Set higher liquidity rules for pension members; harvest illiquidity premium for accumulation members
Target capital gains tax efficiency for accumulation portfolios	Choose yield-focused or income-targeting strategies for pension members
Fund a retirement bonus for members transferring from accumulation to pension	Confine long-horizon payoff strategies to accumulation portfolios (for example, private equity, value factor portfolios)
Increase the current pension income tax exemption available to the fund	Target absolute rather than benchmark-relative returns for pension members
	Match strategies to generational themes (for example, less property exposure if pension members are homeowners; confining ESG strategies to accumulation members given that ESG is more aligned with millennial values)

Source: Parametric, 2019.

Figure 3: Mass production versus mass customisation



Source: Parametric, 2019.

portfolio can double the extra yield for the same amount of risk—or redefine its definition of risk entirely?

Beyond portfolio construction considerations, segregation's siren call to a fund may be just as much about the messages a fund can deliver to what is, after all, its most engaged, sensitive member cohort. A fund can deliver important investment assurances to pension members in an unsegregated structure about returns, cost savings and broad risk management. But segregation, as part of a fund's broader (mass) customisation brand appeal and narrative, can unlock powerful new messages to members about how the fund is addressing specific concerns like salary replacement expectations, tax efficiency, capital protection, fit with homeownership, access to capital and life expectancy. As Figure 3 shows, some funds will value this; others will not.

How should a fund segregate assets?

While it is tempting to tackle the questions sequentially ('We have decided to segregate. Now how should we do it?'), funds should consider the 'how' question as part of the up-front business case.

As we mentioned earlier, it is not necessary (and probably not practical) for a fund to segregate across all assets. Funds should conduct some broad analysis on where in the fund's investment portfolios segregation may make sense. Listed equities are a good place to start because of the dominance of equity risk in most portfolios, the array of equity portfolio management techniques available to target very specific solutions, the yield profile of equities and the tax and franking-credit management opportunities available. Practical discussions with managers and other external partners need to cover questions such as:

- Are management fees charged on a tiered funds-under-management basis? If the manager were to run separate accumulation and pension mandates, would these be grouped for fee-calculation purposes?
- Will the manager agree to run a separate account (discrete mandate) for a small pension pool?
- Does the manager have experience in managing and reporting on specific pension equity mandates? How should the performance benchmark, tracking error and other mandate specifications be different?
- Will there be an increase in custody account-keeping fees for the new segregated pension asset mandates? Will there be an increase in transaction charges as well?

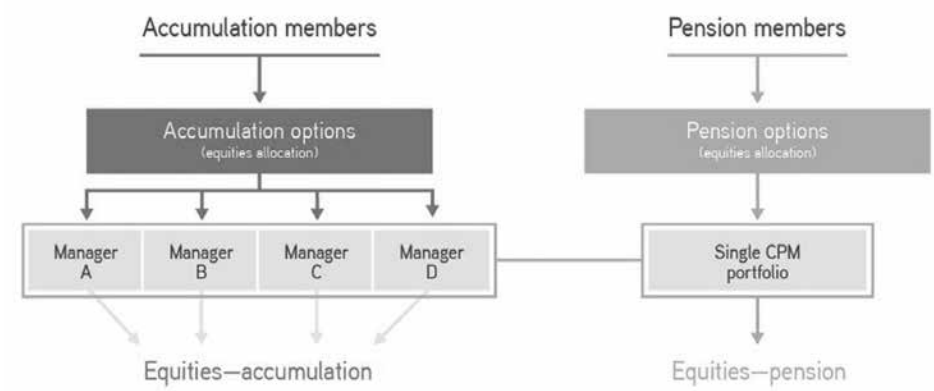
The segregation structure depicted in Figure 2 is the way funds would typically envisage implementing segregation. However, using centralised portfolio management (CPM) may make the fund's task of weighing up the benefits of pooling versus segregating much easier. CPM is a natural asset segregation tool because of its efficient replication capabilities, tax-lot management and record-keeping and ability to customise. Its application as a less complicated way of achieving pension asset segregation in a multimanager equity portfolio is set out in Figure 5.

Compared with Figure 2 (the orthodox segregation route), Figure 5 immediately shows a much less complex segregation structure. Here, the pension assets are transitioned not to multiple new manager mandates but to a new single-manager pension CPM portfolio designed to (initially) replicate the aggregate accumulation investment exposures. The CPM manager takes the daily feeds (portfolio recommendations) from the fund's suite of accumulation managers, making the accumulation portfolio the effective target or benchmark of the pension CPM portfolio.

Initially a fund may choose to simply replicate the accumulation portfolio in the CPM portfolio, which instantly delivers asset segregation. Through time a fund could transition to a more fully customised pension equities strategy without involving the managers in these changes.

A fund using CPM to help deliver mass customisation could change manager feed weightings in the CPM portfolio (say, to give more weight to a defensive manager), add or remove manager feeds or ask the CPM manager to apply a simple overlay across the whole of the pension CPM portfolio. Consider, for example, how easily the pension solution in Figure 5 could adopt an income tilt, downside risk protection, a specific liquidity budget, an off-market share buyback strategy or other idea involving only one moving part—the pension CPM portfolio—rather than the multiple moving parts in Figure 2 (while Figure 5 illustrates the use of CPM to create a single pension portfolio, there is in fact a more advanced application in which multiple different, custom pension portfolios could be created off a single set of manager feeds).

Figure 5: CPM as a pension asset segregation tool (listed equities)



Source: Parametric, 2019.

This demonstrates the wisdom of determining how to segregate as integral to the original decision about whether to segregate assets. Imagine a fund pursuing a mass customisation path based on attributes like those listed in Figure 3 yet baulking at the prospect of proliferating multiple manager equity mandates. Such a fund could defer or rule out asset segregation on the basis of cost, complexity or transparency concerns, missing the opportunity to consider a different way of segregating that avoids many of these issues.

Conclusion

With the demographic shift underway, now is the time for super funds to promote best thinking about an important aspect of retirement solution design—whether to segregate investment assets into separate accumulation and pension pools. A 'yes' to this highly individual decision signals the fund's belief that the member wins out by having the inherent tension between the benefits of pooling and the ability to customise investment strategies resolved in favour of more customisation.

It is easy to characterise segregation as being only for funds of a certain size or along similarly one-dimensional lines, but funds' thinking should be far more nuanced. The influence of scale on this decision is quite limited, and factors like brand strategy, member composition, technological platform, legal positioning and culture are more likely to drive segregation thinking. The decision should nest within the fund's broader strategic thinking about whether a mass production philosophy will drive its enterprise model or whether mass customisation will be key to the fund's future.

How asset segregation would be implemented is also relevant to the decision and shouldn't be parked for an investigation afterward. Innovative ways of segregating assets—such as CPM—could solve some of the problems raised by the more orthodox approach to segregation.

Ultimately, the final form of the government's Retirement Income Covenant could have a huge bearing on whether more funds choose asset segregation. The portfolio levers available in an unsegregated structure may not be nuanced enough to meet the legislative requirements of a comprehensive income product for retirement. This would be a disturbing development, given that we believe segregation is a highly individual decision and should be a question of fund fit, not regulatory impost. Asset segregation will be a good strategy for many funds, as a powerful instrument in their plans to genuinely deliver mass customisation to members, but it will not be the answer for every fund. FS