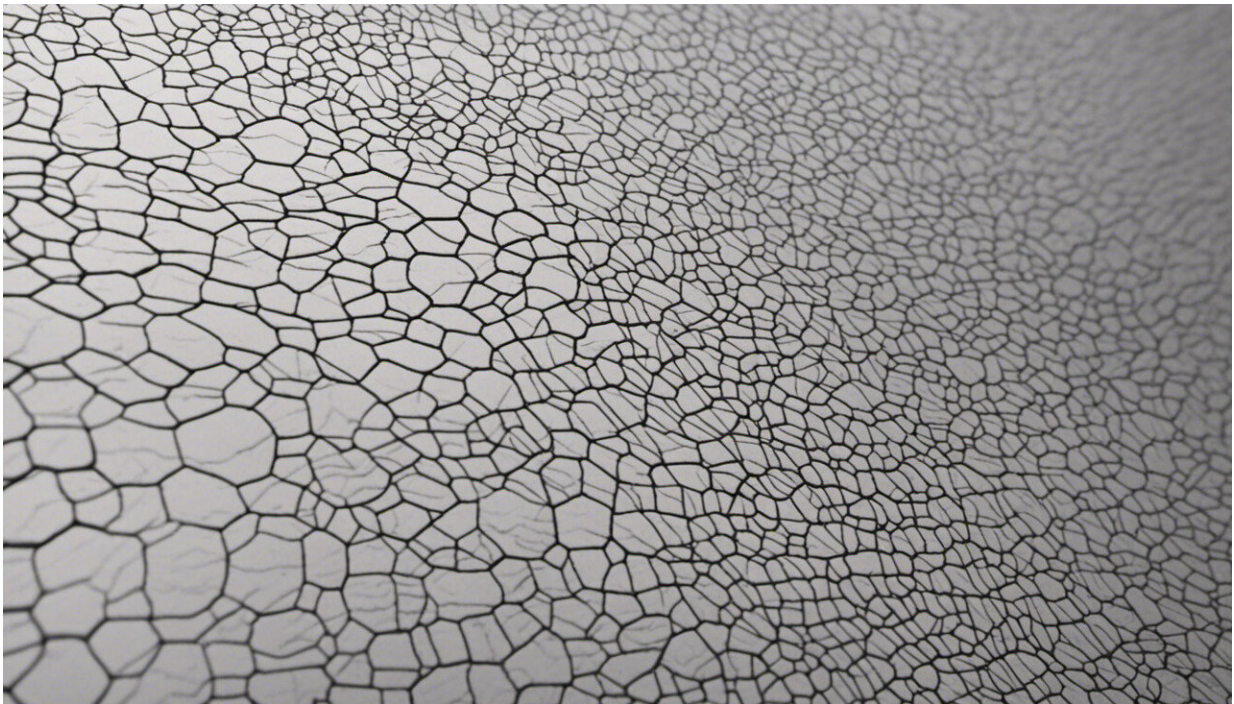


Go ahead, ignore your super, but let's debate default funds

August 14 2014, by Rodney Maddock



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After a lot of un-edifying debate about particular proposals about financial advice we can now stand back and look at the sector with more calm.

The [fundamental problem](#) is that it is very hard to give good financial

advice.

Just think about planning for your own retirement. You first have to form a view about how your income will evolve over the rest of your working life. Are you going to get sacked, are you going to get promoted, and for how many more years do you expect to work? Now think about your spending. How much do you currently spend and is it likely to change? What happens if you have children, get divorced or get sick?

Once you have answered all these questions you have a measure of how much you will save over the rest of your working life, the difference between your income and your expenditure. You then have to think about where to save it. Do you put it all into super, how quickly should you pay down your mortgage, should you have some investments outside super? And then of course, inside super what proportion should you put into Australian shares what about foreign shares, how much should go into defensive assets like cash and bonds?

Having made all those decisions, you then can see how much you will have to retire on. Will you run out of money before you die? How will your savings interact with your access to additional government support through the pension and subsidised health?

If you don't like the outcome you have to decide what to do about it. Can you earn more either in salary or through your investments? Should you take more risk in the hope you will increase your earnings. Can you cut back in your spending somewhere?

Very clearly deciding on a lifetime pattern of saving and consumption is very difficult. It is just simply a really hard problem. Whether you do it for yourself or get someone else to do it, with the benefit of hindsight you will always have regrets.

Because of the difficulty most people either ignore the problem or engage an agent, although an increasing number try to do it for themselves with self- managed super funds.

Default options more critical than ever

The fact that a large number of people just ignore the problem means default options are very important. Compulsory superannuation forces people to save, so they cannot completely ignore the issue. The My Super reforms were designed to make default options less costly, and hence be better long term saving vehicles for the unengaged.

The current policy is however based on the assumption that competition between default funds will force down costs. The Grattan Institute's Jim Minifie [argues](#) this is unlikely. He proposes that instead the government should auction off the right to run default funds, with the lowest cost fund winning. He believes this would force down costs much more effectively and have a big impact on returns.

The second group of people, those who have chosen to do their own [financial planning](#), have had something of a head start in that their costs are lower than people who pay for advice. The evidence suggests however that they do a very bad job. Most self-managed funds invest predominantly in cash (which is excessively conservative) or in Australian shares (which is excessively risky), and little else. They have almost no diversification across domestic asset classes, and none internationally. These appear to be very bad portfolios for long term investing.

The third group of savers, those who use an agent, has been the main focus of attention. Most of the kerfuffle about FOFA has obviously been about advisers. From a regulatory point of view, we could make it very expensive to get advice, by raising educational standards, by limiting

fees, by eliminating any potential conflicts, and by forcing people to renew advice contracts frequently - the cost of preparing such a plan would be between A\$4000 and A\$8000. This is more or less where we were before the recent changes.

Doing it yourself is not the answer

The consequence of that policy would have been to force most people back into doing it themselves or relying on defaults. It is not clear that either is a better outcome than allowing some rent seeking by advisers.

We also required advisers to act in the best interests of clients. Given the complexity of the problem of writing a financial plan, this an almost impossible requirement. With the benefit of hindsight every plan is likely to be inadequate. Some things will have happened which might have been foreseen but were not. The new solution which sets out the concrete steps an adviser must take in producing a plan looks far more workable but has been roundly criticised because it does not completely protect savers.

Rather than continue to squabble about advice, it seems far more fruitful to focus on reducing the cost of the default funds. This would have three benefits. It would protect the people who are least engaged and hence potentially most vulnerable. Having very cheap default funds would also put a lot of pressure on the fees charged by advisers. And, with cheap funds providing better performance on an after-fees basis, fewer people would seek advice at all, thereby bypassing the difficult issues of regulating advice.

The Minifie plan deserves very serious analysis by the Murray inquiry into the financial system.

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