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Australia vs US

A scorecard on the Australian and US Defined Contribution Systems

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Important information

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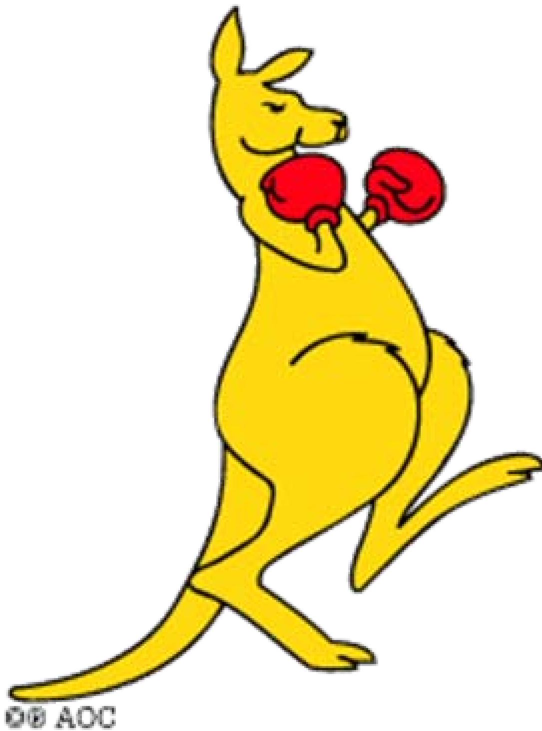
Australia and the US are the contenders for the defined contribution world heavyweight crown



Vs

The Australian retirement savings market is one of the most advanced in the world

- Funded retirement benefits total over $A 1 trillion[1]
- This is 110% of GDP, the fourth highest in the world[2]
- DC benefits represent around 90% of assets[3]
- In 15 years expected to reach $A 3 trillion (in 2008 dollars)[4]
- Three tiered system
  - Means tested, unfunded government safety net
  - Compulsory, funded employer contribution of 9% of pay
  - Voluntary, tax privileged savings

1. Australian Prudential Regulation Authority: Quarterly Superannuation Performance, September 2007
2. OECD – Pension Markets in Focus – November 2007
3. Australian Prudential Regulation Authority: Annual Superannuation Bulletin, June 2006
4. Rice Warner Actuaries: Superannuation Market Projections Report, December 2007

While the US system is larger in absolute terms it is more fragmented

- Funded retirement benefits total over $A10 trillion[1]
- This is about 74% of GDP
- DC benefits currently represent around 35% of assets[1]
  - Forecast to grow to between 100% and 150% of GDP[2]
- Three tiered system
  - Contributory Social Security benefits
  - Voluntary employer-financed pension or DC scheme
  - Voluntary, tax privileged savings

1. OECD – Pension Markets in Focus – November 2007
2. Poterba, Venti and Wise – New estimate of the Future Path of 401(k) Assets.

The US Social Security System is somewhat different to Australia's

- Contributory
  - Contributions currently 6.2% by employer and employee (cap at $102k p.a. earnings)
- Pensions based on:
  - Period of Participation (Max benefit requires 35 years)
  - Retirement Age (discounts for early retirement)
  - "Indexed Career Average" earnings (with progressive scale)
- Typical "full" benefits (plus up to 50% extra for spouse)
  - Low earner ($30k) gets $14,549 p.a. (49%)
  - Mid earner ($60k) gets $22,696 p.a. (38%)
  - High earner (> $102k) gets $28,996 p.a. (28%)

We think our DC system is complex……

401 (k)

403 (b)

NHCE

IRA

Roth 401 (k)

457 (g)

ADP

HCE

PPA

Roth IRA

QDIA

ACP

IRC

We thin[…]plex……

401 (k)

NHCE

STOP

457 (g)

HCE

IRA

ACP

401 (k) – The highlight package

- Voluntary DC savings plan established by employers
  - Initially as a supplement to DB pension, but now often the sole benefit[1]
- Employee contributions from pre-tax income
  - Contribution limits of $15,500 p.a. if < 50 or $20,500 if 50+[2]
  - Tax free roll-up of earnings
  - Benefits fully taxed
  - Preserved to age 59.5 but some early release allowed with 10% tax penalty, and some ability to borrow from account
- Employer contributions not compulsory
  - 50% or 100% “matching” up to 6% is common[3]
  - Total employer & employee contribution limited to lesser of 100% of pay or $46,000

1. Russell Retirement Report - 2008
2. 401K.org
3. Hewitt Associates – 2007 Trends & Experience in 401(k) Plans

Achieving Adequate Retirement Incomes

Adequacy = Participation + Contribution rates + investment returns

To provide adequate retirement outcomes in the DC world you need:

- To participate in the first place
- Contribute at a sufficient level to accumulate a healthy benefit
- Invest wisely

We will look at how the US and Australia DC systems compare in relation to these key measures

Participation

- The Australian system has almost universal coverage
  - But self-employed and very low earners remain a gap
- The US system is still in transition from DB to DC[1]
  - Significant sections of the workforce have no coverage
  - Voluntary system means many employees don't participate
  - Auto-enrolment increasingly used by employers to increase participation
  - But generally only rolling out for new employees

1. Russell Retirement Report - 2008

Contribution Rates

- The Australian system effectively has a minimum contribution rate of 9% of pay
  - Plus incentives (salary sacrifice & co-contribution) for employee contributions
  - But many employees rely on the minimum 9%
  - Some employers have minimum contributions > 9%

- The US system is still in transition from DB to DC[1]
  - Significant sections of the workforce have no coverage
  - Primary source of DC contribution is employees
  - Employer contributions commonly as full or partial “match” of employee contributions, with limit

1. Russell Retirement Report - 2008

Investment - Australia

- Investment choice is a fairly new concept
  - Ten years ago, no choices – one size fits all
  - Now 90% of DC assets involve some choice
- Typically between 10 and 60 choices
- Significant emphasis on multi-manager, active management, diversified options
  - “Conservative” (30/70)
  - “Balanced” (50/50)
  - “Growth” (70/30)
  - “High Growth” (85% + in equities)
- Single sector options available but used less
- Very limited use of direct share investment

In a compulsory system, there is significant emphasis on the default option

- 70% of assets are in the default option for typical Australian employer plan
- From the earliest days of investment choice, default options have had significant equity exposure
  - "Typical" default strategy would be 70/30[1]
  - Average Return over past 10 years has been 8% p.a.[2]
  - Compared with 4.5% p.a. from cash[3]

1. Australian Prudential Regulation Authority: Annual Superannuation Bulletin, June 2006
2. Australian Securities & Investments Commission website: Long term performance figures for typical super fund investment options
3. UBS 90 day bank bill index, reduced to allow for the 15% investment tax paid by Australian superannuation funds

Typical Australian Investment Menus

Large corporate fund:
- 3 Diversified funds
- 5 Single sector funds

Large Industry Fund
- 6 Diversified funds
- 9 Single sector funds
- Single shares option from ASX 200

Large Master Trust
- 18 Diversified funds
- 45 Single sector funds
- 17 options closed to new investors

What about the US?

- The US DC system has historically been associated with[1]:
  - A myriad of mutual fund investment choices
  - Employees responsible for asset allocation decisions
  - Employer matching contributions invested in the employer's own stock
  - "Brokerage window" to allow participants to purchase individual stocks
- Numerous studies on investor behaviour have highlighted that 401 (k) participants have underperformed relative to markets[2]

1. Russell Retirement Report – 2008
2. Eg. Quantitative Analysis of Investor Behaviour – Dalbar Inc. 2006

Typical US Investment Menus

Large mutual fund provider[1]:
- 778 Diversified funds
- Thousands of Single Sector funds including
  - 194 “Mid-cap Value” funds
  - 36 Minnesota Municipal bonds funds

Hewitt 2007 Plan Sponsor Survey – Average result[2]
- 17 Options including
  - 7 Target Maturity funds
  - 3 Target Risk funds

Large Corporate Plan[3]
- 9 Target Maturity funds
- 14 Single Sector funds
- 5 Retail Mutual Funds to be deleted in 2008

1. www.fidelity.com
2. Hewitt Associates
3. Russell US Client

Defaults in the US

- With a voluntary system there has been less emphasis on defaults
  - Typical default has been cash or capital secure
- With auto-enrolment and PPA, there is a new emphasis on Qualified Default Investment Alternatives (QDIAs)[1]:
  - Target Maturity funds
  - Balanced or Target Risk funds
  - Capital preservation products (for first 120 days only)
- Unlike Australia, target maturity funds are rapidly emerging as the most popular default[2]

1. US Department of Labour
2. Hewitt Associates, Russell Retirement Report 2008

What are target maturity funds?

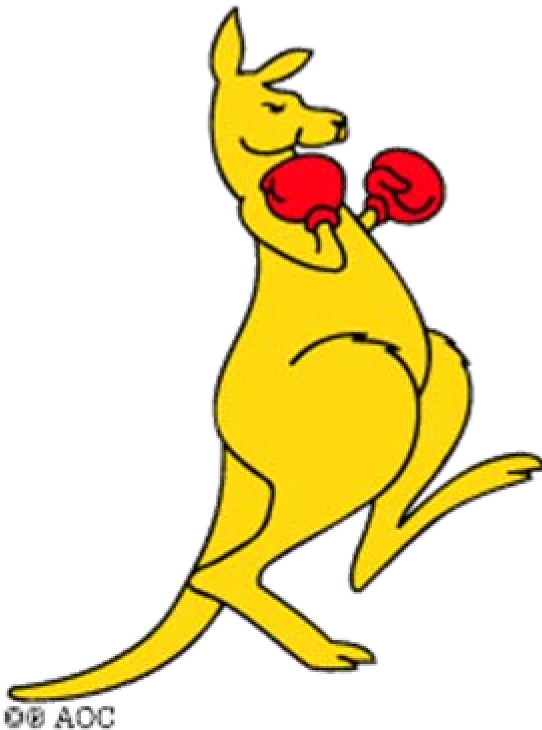
- Participant chooses (or is defaulted to) a fund with a chosen “maturity date”, commonly his or her expected retirement age
- Each fund has a “glide path” which determines how the asset allocation varies over time
- Generally this involves high exposure to equities at younger ages reducing over time
- Avoids the need for individual investors to reset their own asset allocation

Target Date Fund Allocations

Years to retirement

Source: Russell US Client

So who is winning?



Vs

Participation

Near universal coverage

vs

Voluntary Participation supplemented by auto-enrolment

The winner is ….

AUSTRALIA

Contributions

9% minimum plus voluntary incentives

vs

Voluntary contributions supplemented by auto-escalation plus employer matching

The winner is ….

AUSTRALIA

Investments

Balanced target risk defaults plus practical menu range

vs

Wide ranging menu with new target maturity defaults

The winner is ….

AUSTRALIA

For now at least, but the growth of target maturity funds may see this advantage disappear

So, where to from here?

A new look for DC plans in the US

- Transition from "supplementary savings plan" to "primary retirement plan"
- Auto-enrolment, auto-escalation
- Increased focus on value of well-diversified defaults
- Simpler menus with less emphasis on sector funds
- Review of questionable features:
  - Investment in company stock
  - Brokerage windows
  - Early distributions and borrowing
- Increasing focus on decumulation phase

And for Australia?

- Ongoing debate about increasing the 9%
- Auto-escalation
- Super as the primary investment vehicle approaching and after retirement
- Evolution of investment menus:
  - ESG Options?
  - Target maturity?
  - Managing product proliferation
- Increasing focus on decumulation phase

In Summary

- Australia has a defined contribution system which is widely acknowledged as a model for other countries
  - Funded, market-based, nearly universal
- As DC becomes the primary source of retirement benefits in the US we can expect to see rapid evolution and innovation
- Both systems face their greatest challenge as savers become spenders in the post-retirement phase
  - Will benefits be adequate?
  - How should assets be invested?
  - How should assets be decumulated?
  - How can longevity risk be managed?