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Board Structure, Fee-setting and Performance of Australian Superannuation Funds

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Abstract

The paper will explore the functions and organisation of Australian superannuation funds and attempt to study if there is any relationship between board structure and performance of Australian superannuation funds. The specific objectives of the study are threefold. First, we create a unique database on board composition of Australian superannuation funds with various variables of interest. Second, we examine the relationship between board size, board independence and board compensation on fund performance and fees. Third, we examine the risk management strategies adopted by board members of different superannuation funds and ascertain if there are any cross-sectional differences between different types of superannuation funds. Our study is the first to address these issues. Our study has major implications for the funds management industry.

Background and aims of project:

With over one trillion Australian dollars¹, Australian superannuation industry is the largest investment vehicle in Australia. Given that these are retirement savings of Australian employees, their management is not only of national importance but it will partly determine as to how Australia will address the ageing population problem. There are several studies on the performance of Australian superannuation funds², however, to our knowledge, there is no study that evaluates the role of superannuation funds' board on fund performance and the fees set by the funds. It is surprising that, given the amount of funds involved and various discrepancies reported by Australian Prudential Regulatory Authority (APRA) on board functioning in some of the largest Australian superannuation funds³, no study has investigated how Australian superannuation funds' boards function and what is the relationship between board structure, fund performance and fees.

¹ As per Australian Superannuation Funds Association Statistics, as of July 2007 there are 1.053 trillion AUD under management in the Australian superannuation industry.

² For example, see Bird, Chin and McCrae (1983), Sinclair (1990), Hallahan and Faff (1999), Gallagher (2001), Marisetty and Ariff (2003), Benson and Faff (2003), Sawicki and Ong (2003), Bilson, Frino and Heaney (2004), Holmes and Faff (2004), Bilson, Frino and Heaney (2005), Frino, Heaney and Service (2005) and Langford, Faff and Marisetty (2006).

³ For example, APRA intervened by taking the unusual step of suspending the board of trustees of Host-Plus following a long-running boardroom stalemate. Host-Plus is a \$1.8 billion superannuation fund with 500,000 members from the hospitality and tourism industries.

The primary role of managed fund boards are to review, advise and approve investment policies, asset allocation strategies and sector strategies based upon management recommendation. The board is also involved in engaging expert investment managers following thorough research and due diligence undertaken by management and specialist asset consultants. Hence, attribution of managed funds performance to fund managers alone, as proposed by many researchers and practitioners will not provide a complete picture on how funds are managed.

Managed fund boards are relatively different from the boards of normal corporations mainly in two distinct ways. First, their role is mainly limited to monitoring where as corporations' boards not only monitor but also actively engage in operational aspects of the business strategy. Second, most of the funds are part of a large family and the same director's manage different funds. In the case of many corporations the overlap of directors in different firms is relatively low. These multi-layered compensation structure will have important implications on the expenses on managed funds. Apart from these differences, for superannuation funds the role of board members in implementing an appropriate risk management strategy is quite crucial.

Given the above discussion this proposal aims to explore the functions and organisation of Australian superannuation funds, and attempts to study whether there is any relationship between board structure and performance of Australian superannuation funds in terms of fee efficiency and return generation by the fund managers selected by the board. The specific objectives of the study are threefold.

1. To create a unique database on board composition of Australian superannuation funds with various variables of interest⁴. This is a significant contribution as ready made data is not available on board composition for superannuation funds.
2. To examine the relationship between board size, board independence and board compensation on fund performance and fees.
3. To examine the risk management strategies adopted by board members of different superannuation funds and to ascertain if there are any cross-sectional differences between different types of superannuation funds.

Significance and Innovation:

Our study is both timely and important as superannuation plays a pivotal role in the Australian retirement scheme. In 1992, the Australian Government introduced a compulsory superannuation system to address concerns about Australia's ageing population. This scheme was mandated by law under the Superannuation Industry Act 1993. Since 1993, the government has raised the compulsory superannuation contribution to 9 percent. The superannuation funds industry has grown from A\$120 billion to more than \$750 billion dollars and has become the major component of the Australian managed funds industry. In a recent speech, Kevin Rudd (2006) stated that superannuation is the key factor underlying the success of Australia's funds management industry and it is the main reason why Australia has the largest funds management industry in Asia and the fourth largest in the world. More recently, the government introduced 'super choice legislation', which allows employees to (a) change funds when their current fund is not available with a new employer; (b) consolidate superannuation accounts to cut costs; (c) change to a lower-fee fund; and, (d) change to a better performing fund.⁵

⁴ Some of the variables that have linked performance to board structure in the US (see, for example, Tufano and Sevick (1997), Guercio, Dann, and Partch (2003), Khorana, Tufano and Wedge (2006), Davis and Kim (2007)) are: 1. Fund name; 2. Number of funds that belong to a given trust; 3. Size of the board; 4. Number of independent directors; 5. Number of compensated board members; 6. Whether chairman of the board is independent; 7. Whether there is any retirement plan and a deferred compensation plan for the directors; 8. Qualifications, age and experience of the directors; 9. Outside directorships held by the directors.

⁵ See Fry, Heaney and McKeown (2007) for a detailed analysis of the impact of this important change to the Australian superannuation system.

Given the above discussion it is important to conduct further research on superannuation funds (Gharghori, Sujoto and Veeraraghavan 2007). The proposed project is the first that attempts to understand the board composition of Australian superannuation funds. Our project is important given the value of investment and also the future of Australian retirement savings. More importantly, none of the existing studies have addressed governance issues in the superannuation industry. The main innovation of this project is that existing studies attribute managed funds performance to fund managers alone, however, given the significant role of board members in hiring and firing the fund managers and also monitoring fund performance, we, for the first time, examine the role of boards on fund performance for making more broader conclusions on the attribution of fund performance.

Description of Approach:

There have been no studies on the board composition of Australian superannuation funds due to data constraints. To accomplish the objectives outlined in this study it is crucial that we design a survey instrument (in addition to collecting data from ASIC) to collect comprehensive data from superannuation fund trustee organizations. Fund returns, fees, objectives, type and flows are readily available from the Morningstar database. Our first objective is to merge the proposed governance data with the Morningstar data and the trustee reports from ASIC. We propose to use standard econometric tools to address our aims. We also propose to address the potential endogeneity problem between ownership structure and fund performance (see Demsetz and Lehn (1985)).

To test the relationship between board composition and fund performance we use the following model:

$$R = b_0 + b_1 \ln(TNA) + b_2 \ln(CTNA) + b_3 \ln(AGE) + b_4(risk) + b_5(fee) + b_6 \text{ Fund Type} + b_7 \text{ Fund Manager} + b_8 \text{ Board Size} + b_9 \% \text{ Independent Directors} + b_{10} \text{ Board Compensation} + u_i \quad (1)$$

Equation (1) tests the relationship between fund return (R) and board composition after controlling for other fund characteristics such as fund total net assets (TNA), total net assets of the fund complex ($CTNA$), fund age (AGE), volatility of fund monthly returns ($risk$), fund total fees (fee), and fund type and the fund manager dummy.

We test the relationship between board compensation and fund characteristics using the following models:

$$COMPSEAT = b_0 + b_1 \ln(TNA) + b_2 \ln(CTNA) + b_3 \ln(AGE) + b_4(risk) + b_5(fee) + b_6 \text{ Fund Type} + b_7 \text{ Board Size} + b_8 \% \text{ Independent Directors} + u_i(2)$$

$$COMPPER = b_0 + b_1 \ln(TNA) + b_2 \ln(CTNA) + b_3 \ln(AGE) + b_4(risk) + b_5(fee) + b_6 \text{ Fund Type} + b_7 \text{ Board Size} + b_8 \% \text{ Independent Directors} + u_i(3)$$

$$COMSPONSOR = b_0 + b_1 \ln(TNA) + b_2 \ln(CTNA) + b_3 \ln(AGE) + b_4(risk) + b_5(fee) + b_6 \text{ Fund Type} + b_7 \text{ Board Size} + b_8 \% \text{ Independent Directors} + u_i(4)$$

The dependent variables in equations (2), (3) and (4) represent compensation per seat, compensation per person and compensation for the sponsor respectively. The independent variables are same as specified in equation (1).

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