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Overcoming Automation Barriers in Australia's Superannuation Industry

The Impact of Fund of Funds Structures on Investment Operations, contrasting UK and Australian practices

This paper is relevant for: Finance, Investment Operations, Superannuation, Technology and Risk Professionals.
This paper was a keynote address by Cian O'Driscoll at the Investments Operations Challenges Forum in Sydney in September 2024.

Global Investment Operations: Challenges and Complexities

Across the globe, each jurisdiction faces its own distinct challenges in managing investment operations. However, Australia, particularly within its superannuation industry, presents some unique complexities that hinder full automation of investment processes. These challenges largely stem from the Fund of Funds (FoF) structures that are prevalent within superannuation. We will discuss these structures that add layers of intricacy and operational demands.

Example: Typical UK Style Pension Fund

To illustrate these differences, let's first review the investment operations process of a typical UK-style pension fund with a Fund of Funds structure, and compare this to the investment operations process commonly seen in Australian superannuation funds.

Characteristics of Traditional UK Fund Structures

Policyholder Funds

UK pension funds allow members to invest in funds that align with their risk tolerance and profile, similar to the option funds available in the superannuation structure. However, the investment flows and operational processes are often more rigid and streamlined in the UK.

Interfunding Structure

UK pension funds also use a tiered Fund of Funds structure. A higher-level fund (or policyholder fund) invests into a lower-level fund, which in turn invests directly into various asset classes. These asset classes hold the assets directly, making the flow of investments somewhat simpler compared to the multi-layered structures of super funds. UK fund structures, while not as flexible as super funds, can still be complex. In fact, some clients may have up to 10-14 layers of FoF structures.

Multi-level Unitisation

Similar to Super funds, the UK pension funds are unitised across multiple levels. Investments are executed by buying or selling units in these pools, allowing for easier tracking and valuation of assets within the fund structure.

Cash Management

When new money flows into a UK pension fund, it is automatically pushed down through the entire FoF structure, pooling inflows and outflows from other funds. The cash flows all the way down to the base layer—i.e., the asset classes themselves. Pre-defined investment allocation rules for each fund determine how cash is directed through the structure. At the asset class level, rules can specify minimum trade sizes, how residual cash is handled (e.g., investing it in a cash fund), or whether a 'box fund' should automatically absorb residual cash. This entire cash allocation process can be automated, with clients using software to eliminate the need for manual intervention.

Rebalancing

Rebalancing in UK fund structures is also rule-based and automated. The software allows users to create rules that dictate when a rebalance is triggered and how it should be executed. For example, a fund could be set to rebalance on the last business day of the month if it breaches its tolerance limits, or it could rebalance whenever it falls outside those limits on any given day.

To minimise transaction costs, "Passive Rebalancing" is commonly used. This technique strategically allocates new cash flows to underweight assets, helping bring the portfolio back within tolerance limits. Rebalancing may occur at different levels throughout the FoF structure. For example, if a fund at the policyholder level is out of tolerance, a rebalance will also be required at the asset class level. Unlike superannuation funds, there is no concept of a 'banker fund' in UK pension schemes—rebalancing is conducted directly against the market.

Again, this rebalancing process is fully automated via pre-defined rules, allowing for a hands-off, efficient, and low-risk approach for clients. There is full oversight of the rebalancing process.

Benefits of the UK Approach

Although UK FoF structures can be quite complex, the ability to create detailed rules for each fund—including cash inflow/ outflow allocations and rebalancing criteria—allows for full automation of the cash allocation and rebalancing process. This makes the investment operations process both robust and scalable, significantly reducing operational risks and costs.

Compared to superannuation funds, UK pension funds operate with less flexibility but offer a more regimented, automated process with minimal user intervention. This reduces the need for manual adjustments and allows for a more consistent, streamlined approach to fund management.

Super Cash Management and Rebalancing

Let's now explore how the corresponding processes work within Superannuation (Super) funds. At first glance, Super funds may seem less complex due to their flatter investment structures, but they exhibit unique characteristics that differentiate them from other fund structures. Key elements include:

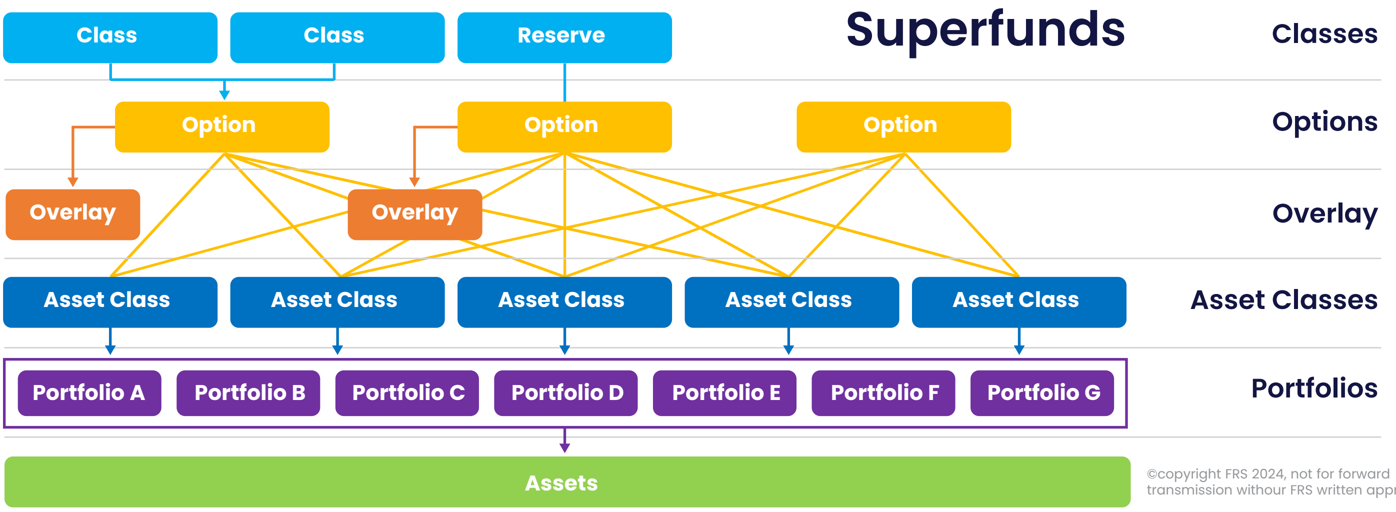
Investment Options

Super funds typically offer members a choice between single asset class/strategy options (e.g., Australian equities or international bonds) and diversified portfolios that spread investments across various asset classes. Members can select options based on their risk appetite and investment goals.

Interfunding Structure

Super funds often follow a tiered Fund of Funds (FoF) structure. This structure involves multiple layers:

- Investment options are made into asset classes,
- These asset classes further invest into sectors or sub-sectors,
- Finally, the investments flow into the underlying portfolios. This multi-tiered structure helps in spreading risk and offers diversification while making the investment chain more manageable.



1 Superfund structures appear not as complex. Often with 2-3 layers depending on the design.

2 Much more active cash management is required to manage and tweak cash flows to underlying asset classes.

3 Internal rebalancing with the banker fund is a common approach to reduce costs.

Overcoming Automation Barriers in Australia's Superannuation Industry

The Impact of Fund of Funds Structures on Investment Operations

Multi-level Unitisation

Superannuation funds typically involve multiple levels of unitisation. This means that at each tier, units are created for the investment pool. Investment is executed by buying or selling units in these pooled vehicles, which allows for easy valuation and management across the structure.

Hedging and Overlay Management

Hedging and overlay strategies are commonly employed in Super funds. These strategies can be implemented at different levels, either at the option level via dedicated hedging portfolios or at the underlying asset level. The overlay accounts play a significant role in adjusting asset or risk exposures without physically buying or selling assets. Synthetic exposures to listed asset classes are created, typically backed by cash from the cash sector that is linked to the investment option. This process allows for dynamic risk management without disrupting physical asset holdings.

Cash Management

When new money flows into an option, Super funds handle cash management differently compared to other regions, like the UK. Rather than automatically pushing cash down the entire FoF structure, the cash may be retained at the option level and hedged through future overlay strategies. Alternatively, the cash can be moved down to the asset level where decisions are made to either trade, hedge or invest in the cash fund. This flexibility allows for more tactical cash management depending on market conditions and investment goals.

Rebalancing Methods

In Australia, Super funds employ three main methods for rebalancing option portfolios:

1 Traditional Rebalancing

This is like UK practices, where trades are created to sell overweight assets and buy underweight ones within the FoF structure. The resultant flows are traded at the asset level in the market.

2 Overlay-based Rebalancing

Rebalancing is managed at the option fund level through hedging, without adjusting the actual holdings within the FoF structure.

3 The 'Banker Fund' Method

Unique to Australia, this method uses a 'banker fund' for rebalancing. The banker fund is typically the largest portfolio within the Super fund and plays a central role in absorbing the imbalances from other portfolios.

The Role of the Banker Fund

In the banker fund rebalancing process, all other portfolios are rebalanced to their target asset allocations. The banker fund buys the overweight assets from other funds and sells to the underweight ones. However, the banker fund itself must adhere to its own investment allocation targets, meaning it cannot breach its set limits during this internal rebalancing process. As a result, full internal rebalancing may not always be achievable if it pushes the banker fund outside its tolerances.

The rationale behind this approach is that the banker fund, being the largest, can better absorb the shifts in asset class weightings without significant impact. By having the largest fund as the banker, the degree of over- or under-exposure for any particular asset class remains relatively small.

Advantages of Banker Fund Rebalancing

1 Minimising Trading Costs

This method helps reduce external trading costs by limiting the need to transact in the market.

2 Handling Illiquid Assets

It avoids trading in illiquid assets, which may be impractical for small volumes and cannot be easily hedged.

Superannuation funds typically conduct internal rebalancing using this method daily, weekly, or monthly, depending on their specific processes.

Potential Equity Concerns

While the banker fund method offers many operational benefits, it also raises potential equity concerns among members in different option funds. For instance, consider a scenario where an option fund decides to reduce its exposure to office property, expecting a long-term decline in demand due to remote work trends. If that decision is sound for the option fund, the question arises: is it equally prudent for the banker fund to increase its exposure to office property in the rebalancing process?

These equity concerns highlight the need for robust management oversight and decision-making processes to ensure that rebalancing decisions are fair to all members and do not unintentionally favour one group of investors over another.

The Need for More Regimented Automation in Super Funds

Although superannuation funds benefit from flexibility and tailored human intervention strategies, this complexity often comes at the cost of operational efficiency and scalability. As a result, many of the processes within superannuation funds remain manual or semi-automated, leading to higher operational risks and costs.

In contrast, the more regimented automation found in the UK pension fund model could serve as a blueprint for addressing some of these challenges. The UK model thrives on rigid rules, pre-defined processes, and automated cash flow and rebalancing operations. By adopting a different approach, superannuation funds could:

Improve Scalability

Automating cash management, allocation, and rebalancing processes based on clearly defined rules, this would allow super funds to scale more efficiently. For example, passive rebalancing could be strategically applied to maintain target asset allocations without manual intervention.

Increase Efficiency

The flexibility in super funds often necessitates ongoing user intervention and oversight. A regimented automation system could eliminate this need, allowing automated decisions and rules to apply overlays and hedges when necessary.

Reduce Operational Risks

Automation significantly reduces the potential for human error. By implementing a rule-based system, Australian super funds could minimise operational risks and ensure greater accuracy in fund management.

Lower Costs

The automated processes for cash allocation and rebalancing not only reduce transaction costs but also lessen the reliance on manual processes, which can be resource-intensive and costly for super funds.

A Case for More Structured Automation in Super Funds

If superannuation funds were to adopt more structured, rules-based automation—like the UK pension model—several operational pain points could be alleviated. By integrating automated workflows for cash management, multi-level unitisation, and rebalancing, super funds could strike a balance between the flexibility of their current operations and the operational efficiencies gained through automation.

Moreover, a more regimented approach would help superannuation funds better manage liquidity and reduce the need for manual adjustments, which are time-consuming and often risky. Ultimately, automating more of these processes, while maintaining some degree of flexibility, would empower super funds to operate with the same efficiency and risk mitigation seen in the UK pensions industry, without compromising the customised investment strategies that are central to the Australian models' success.

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Delivered cloud-hosted or on-premise, Invest|Pro™ securely automates multiple complex fund administration processes including unit-pricing, cash allocation and rebalancing; oversight and validation of operational activity performed by outsourced partners; and in Europe monitoring and reporting for PRIIPs, KID requirements, and Pillar III asset reporting for Solvency II.

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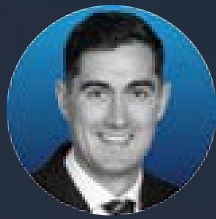

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