Superannuation investment and the decay of Australian productivity growth

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A recently released report by Towers Watson, "Global Pension Asset Study 2012", confirms that Australian superannuation funds continue to distinguish themselves by having the highest asset allocation to equities of the major pension systems studied and, of that equity allocation, the second highest allocation to domestic equities after the USA.

In an article published in the Australian Financial Review on 9 July 2011, I described how this bias to domestic equities has the characteristics of a Ponzi scheme in which share prices are pushed up by investment inflows until the aging population moves to lower risk strategies and net withdrawals from equities producing a collapse in values, just as they are to be relied upon in retirement.

Such a collapse would have macro-economic consequences for Australia, leaving a generation of baby-boomer retirees less well off than they should have been. This is not the only negative macro-economic impact of superannuation funds' Australian equity investment strategies. There is also a likely significant involvement in the much discussed parlous state of Australian productivity.

The current poor state of Australian productivity growth both in absolute terms and relative to other major economies has been well documented. For example, Dr Martin Parkinson, Secretary to the Treasury, in a speech last year said regarding Multi-factor Productivity (MFP): "..Australia has experienced a much sharper deterioration in MFP than most other OECD countries — that is, more of our actual labour productivity growth has come from capital investment, as opposed to the effects of new technology, managerial skills, and process innovation, than other advanced economies."

As superannuation has become an ever larger part of the Australian financial system, it must be viewed as a possible suspect in Australia's deteriorating productivity performance. Statistics such as the following provide possible circumstantial evidence. Between June 1991 and June 2001 the amount of Australian superannuation invested in listed Australian equities rose from 3.1% to 11.0% of GDP. While a spectacular rise, the impact of this level of equity investment on productivity was probably not dramatic. In that period capital productivity in the Australian economy rose by 0.3%, which is at least positive. In the following period to the end of June 2011, the amount of Australian superannuation invested in listed Australian equities rose to 29% of GDP (and about 28% of the market capitalisation of Australian listed companies), a level at which Australian equity investment is likely to be having a significant impact on the economy. In that same period, Australian capital productivity deteriorated by a dramatic 16.5%.

A possible causal connection between Australian super fund equity investment and declining capital productivity is not difficult to hypothesise. With the large bias to domestic equities and the ongoing flows of new money, Australian super funds need

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to keep investing in new listed equity to maintain their asset allocations. They are thus a natural and, to an extent, captive supplier of capital to Australian listed companies. It is arguable that having such a captive supplier of capital is not conducive to management of listed companies working hard to improve capital productivity.

It might be countered that fund managers will try to provide capital preferentially to companies that are managing capital well and improving productivity. Unfortunately, there is another force at work in Australian superannuation that tends to defeat such efforts; it is passive or indexed management.

Passive equity management involves closely tracking an index, such as the S&P/ASX 200, with a portfolio that closely replicates the composition of the index. With passive management, the manager does not need to think about whether a company's management is doing a good job, rather, if the company is in the index they are likely to have to invest in its capital raisings.

There are arguments for passive management, including that it is cheap to implement compared with active management, in which skilled analysts research companies before deciding to invest in them. With increased competition in the superannuation industry, especially in the area of fees, adoption of passive management is an easy strategy for reducing costs. There are already billions of dollars of superannuation under passive management and the need to develop new low cost MySuper products will likely increase the pressures for its use.

Having a captive supplier of equity capital can be very useful, for example in the midst of the global financial crisis over 2008 and 2009 when Australian companies were able to raise a staggering $168 billion of new capital, a massive 17% of 2008 year end market capitalisation. However, outside of financial crises, this abundance of equity capital combined with significant passive management is possibly more of a bane than a blessing, equally being bestowed on companies with poor management as on existing and start-up companies with high quality management who effectively adopt new productivity improving technologies, who train and motivate their workforce and who efficiently take advantage of new market opportunities.

As for labour productivity, which is being much discussed within the context of the Fair Work Act review, having a captive supplier of equity capital is likely to lead to poor quality management failing to engage their workforce in a way that leads to improved productivity and competitiveness, complacently using equity capital to fund the impact.

Australian superannuation now plays a significant role in the Australian economy. The obligation of Trustees to seek to provide a decent living in retirement for their members is completely compatible with investing member's funds in a way that enhances, or at least does not reduce, Australia's productivity. Taking the familiar path of favouring Australian equities and increasingly adopting the competitively convenient business strategy of passive management will continue to harm both their members and the Australian economy.

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