

CORPORATE SUPER ASSOCIATION

SUBMISSION TO

APRA and ASIC

ON

CONSULTATION PAPER: UNIT PRICING – GUIDE TO GOOD PRACTICE

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1 BACKGROUND

1.1 The Corporate Super Association

The Corporate Super Association is Australia's representative body for major Not For Profit corporate superannuation funds and their corporate sponsors.

1.2 Abbreviations used in this submission

The Association	The Corporate Super Association
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
The Paper	Consultation Paper: Unit Pricing – Guide to Good Practice
ASFA Paper	Fund valuation and unit pricing: best practice discussion paper, Dec 2004

1.3 Context of submission

APRA and ASIC have invited comments on their joint *Consultation Paper: Unit Pricing – Guide to Best Practice*, issued in December 2004. This submission presents issues raised by members of the Association.

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2 SUMMARY

The Association is supportive of the setting of best practice guidelines for calculation of unit prices for superannuation and managed investments. Certain issues have been raised by our members and we have summarised their comments below.

3 ISSUES RAISED BY CORPORATE SUPERANNUATION FUNDS

Q 8 Transaction costs

We note (page 22) that the Paper appears to advocate the adoption of a buy/sell spread in unit prices. We recognise that the use of differing buy and sell prices can achieve greater equity between investors. However, in light of the inevitable assumptions and compromises involved in setting unit prices, we believe that the adoption of a single price also remains an acceptable compromise. For employer-sponsored superannuation funds, operating in a context where “user pays” is not generally applicable as such funds have a varying degree of mutual sharing of costs (that is, cross subsidization) for services provided by the fund. Individual allocation of transaction costs may not be consistent with the fund’s general approach to allocation of costs.

We also note that the use of buy/sell prices can result in hidden income to investment managers and funds where positive cash flow and/or compensating investor transactions mean that assets do not need to be realised when one or more investors redeem units. This issue has been referred to briefly in the Paper on page 22 but may require greater emphasis in the best practice context. The Fee Disclosure changes to be implemented by 1 July 2005 for superannuation funds and 1 July 2006 for managed investments will make this situation apparent to investors.

Q12 Performance fees

The Paper expresses concern in relation to the complexity resulting from performance fees. Unlike traditional investment manager fees, performance fees are not a function of funds under management, but are based upon different parameters, generally a function of the return above a benchmark return.

As such, additional processes must be set up to track this out-performance and incorporate it into the unit price calculation process. The additional complexity increases the inherent risk of the unit price calculation, such that Best Practice requires independent expert review of the model, its operations and its relationship with the unit price calculation.

The Association would support this approach but would also welcome guidance on best practice. By definition, performance fees can not be known until the end of the performance measurement period. Hence many assumptions/estimates need to be considered when determining an appropriate accrual amount for performance fees because, in effect, an assessment must be made at the start of performance period as to the likely extent of any out-performance. The potential volatility of returns makes this a difficult exercise and there is a risk that an accrual amount will

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be too high or too low. As the number of managers with performance fees increases, so does this risk.

The paper does not discuss this issue. However, the ASFA paper issued around the same time contains some level of analysis of the issue:

ASFA Paper (4.2, page 24)

"Trustees will need to develop and document a policy on the accrual of performance fees, if applicable, that addresses what is an appropriate level of accrual. Factors to be considered include past performance of individual managers as well as the number of investment managers (and proportion of assets) used by the fund who operate under a performance fee contract"

As a consequence, the process of incorporating performance fees into unit prices involves many ongoing stages - estimating an accrual, incorporating this into the unit price calculation, regularly tracking interim and actual performance (which uses different data requirements/calculations), and adjusting the unit price calculation for any differences as appropriate.

ASFA appear to endorse this approach. An accrual of performance fees during the performance period would need to be monitored on the basis of progressive performance information, and be adjusted as appropriate on an ongoing basis.

To be consistent with the APRA/ASIC paper, independent expert review of the processes advocated by ASFA is critical to ensure they work as intended.

In a typical situation in one of our member funds, manager fee rates are set at a product level - due to the pooled nature of the fund - and advised to the custodian for application in the daily unit price calculation. These rates are assessed periodically over a year - taking into account, asset allocation changes, manager changes and at least quarterly when fees deducted from members via pricing are compared to fees paid to managers. At present, this fund does not specifically adjust for performance fees until the performance period is complete. This is because the impact has not been assessed as material enough to require accruals estimates to be developed. In this regard, only two of its managers have such fees, one on a quarterly fee schedule and one on a yearly fee schedule. However, it is recognised that the risk of under or over accrual is greater for performance fee estimates than for manager fees.

In relation to Performance Fees, we would welcome guidance as to the circumstances in which these should be accrued. Materiality considerations will arise.

As a minimum, there is scope to do a monthly review of interim performance and reflect this in the unit price over the next month. Materiality would then determine whether an upfront accrual/interim period adjustment process is needed, and how complex any models used to determine the accrual need to be.

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Q 25 Asset valuations

Periodic valuations: constraints

We support the general thrust of the guidance offered on asset valuations. However, we have difficulty with the statement that in principle, unit prices should only be struck with the same frequency as asset values are determined. We note that this statement is then qualified in relation to various asset classes – the difficulty being that stock exchange listed assets and cash are the only assets in respect of which market daily prices can be obtained. We suggest, in view of the high proportion of portfolio asset value for which daily market value is not available, that the statement should not be made or that it should be modified to acknowledge the practical difficulties of this approach.

Venture capital

We note and accept the points made in the discussion of assets for which there are periodic valuations using recognised methodologies. We suggest that it should be made clear that venture capital falls within this heading. Venture capital is assuming increasing importance in balanced portfolios. These assets, under professional advice, may amount to 15 % (level in Harvard and Yale Endowment Funds) or more of a fund's portfolio, and these percentages will be surpassed in some Australian superannuation funds. The valuation of these investments is subject to regular monitoring, and stability is enhanced through diversification of this class through geographic spread, industry sector spread, vintage year and stage (seed stage, late stage) spread. The stage spread has the effect that investments mature on a rolling basis over time.

The managers of such assets monitor them and provide valuation data on a regular basis and this is subject to independent audit. Australian Venture Capital Association Limited (AVCAL) sets local standards for valuation of private equity investments, and equivalent standards apply in Europe and in North America. Arguably such an expert valuation arrived at on (say) a quarterly basis is as reliable as a basis for a daily unit price as a stock market daily value, which fluctuates subject to various investor whims and sentiments, and which may at times fail to reflect the intrinsic value of the asset.

We would therefore support the specific mention of venture capital investment as an example of an asset class where assets are valued periodically using recognised methodologies (page 43), and acceptance that these values, subject to the caveats on pages 43-44, form as sound a basis for daily unit pricing as do market values for listed securities.

The remarks above will hold good for other categories of assets which we have not discussed in detail.

Illiquid and infrequently valued assets

We are concerned by the proposal in relation to illiquid and infrequently valued assets that “estimates should not be used to strike prices if these investments become more than a small part of the investment portfolio” (page 45). We have the following comments to offer:

- If this proposal were to stand, guidance would need to be offered as to what is considered to be a “small part” of the investment portfolio.

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- If it is being proposed that funds with assets which exceed this threshold should strike unit prices less often, practicality would suggest that unit prices would need to be struck on a regular basis based on the most recent data available rather than market data immediately to hand.
- The expression “alternative” asset types is imprecise and its meaning should be clarified. We presume that the asset classes referred to are not limited to hedge funds and derivatives. We believe that different valuation methodologies apply to different classes of assets and that separate guidance for each class may assist.
- We observe that some illiquid assets may nevertheless be subject to informed independent valuation, and that if these holdings are diversified in terms of expected maturity date and other factors, the risk associated with liquidity reduction is minimised.

Q28, Q29 Imputation Credits and Foreign Tax Credits

We consider the proposed practice regarding imputation credits to be appropriate.

We consider that a similar policy should be adopted regarding foreign tax credits. The level of overseas investment is increasing significantly as funds become conscious of the impact on both risk and return of including a diversified exposure to foreign investments. This trend is likely to increase.

The impact of recognition of foreign tax credits is, as with imputation credits, twofold. The income reported in the accounts and as cash-flow is net of foreign tax credits. Income for tax purposes is gross, and a credit is then allowed against the tax liability on the gross income, subject to certain quarantining restraints.

Hence the tax adjustment proceeds as follows:

Assume US dividends of	\$85
Tax credits	\$15
Taxable dividend income	\$100
Superannuation fund investment income tax on the dividends	\$15
Tax credit allowed (subject to quarantining restraints)	(15)
Net tax effect of US dividend	-

[The effect will be different for regimes or investments where withholding is at a higher or lower rate]

Compare this result with the effect if no foreign tax credit is allowed for:

Dividend income (cash flow amount)	\$85
Tax provided at super fund tax rate (15%)	\$12.75

No credit provided for in unit price until later adjustment.

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The lack of recognition of the tax credit until after the end of each tax year may erode equity between current and future unit holders.

We recognise that the process of estimating the amount of the usable relevant credits is less straightforward than that applicable to imputation credits, and that the impact of foreign tax credits is lower because of the generally lower rate of withholding as compared with the imputation rate. However, we believe that the potential impact on equity between current and future unit holders is significant and will grow as overseas exposure increases as a percentage of fund assets. We believe that the task of recognition is not impossible and that reasonable estimates can be prepared based on past performance combined with current information about changes in exposure. This includes situations (as for domestic dividends) where the foreign income flows through an interposed trust.

We note also that a similar policy should be adopted regarding the recognition of dividends and foreign tax credits for *ex div* foreign stocks to that proposed for dividends and related credits on *ex div* domestic stocks (see discussion on page 48 of the Paper, point 1 under “Treatment of imputation credits”). The point is made that at the *ex div* date, the dividend and the associated tax benefit are removed from market assessment of the asset value. This holds good for overseas stocks as well as for domestic shares.

4 GENERAL COMMENTS

The setting of unit prices has always been an “inexact science” that involves numerous assumptions and estimates. Many of the matters that are being considered in this Best Practice paper are equally valid when setting crediting rates, which is the alternative approach used by some superannuation funds. It is our view that unit prices set on a daily basis are the optimum way to ensure equity amongst investors (members).