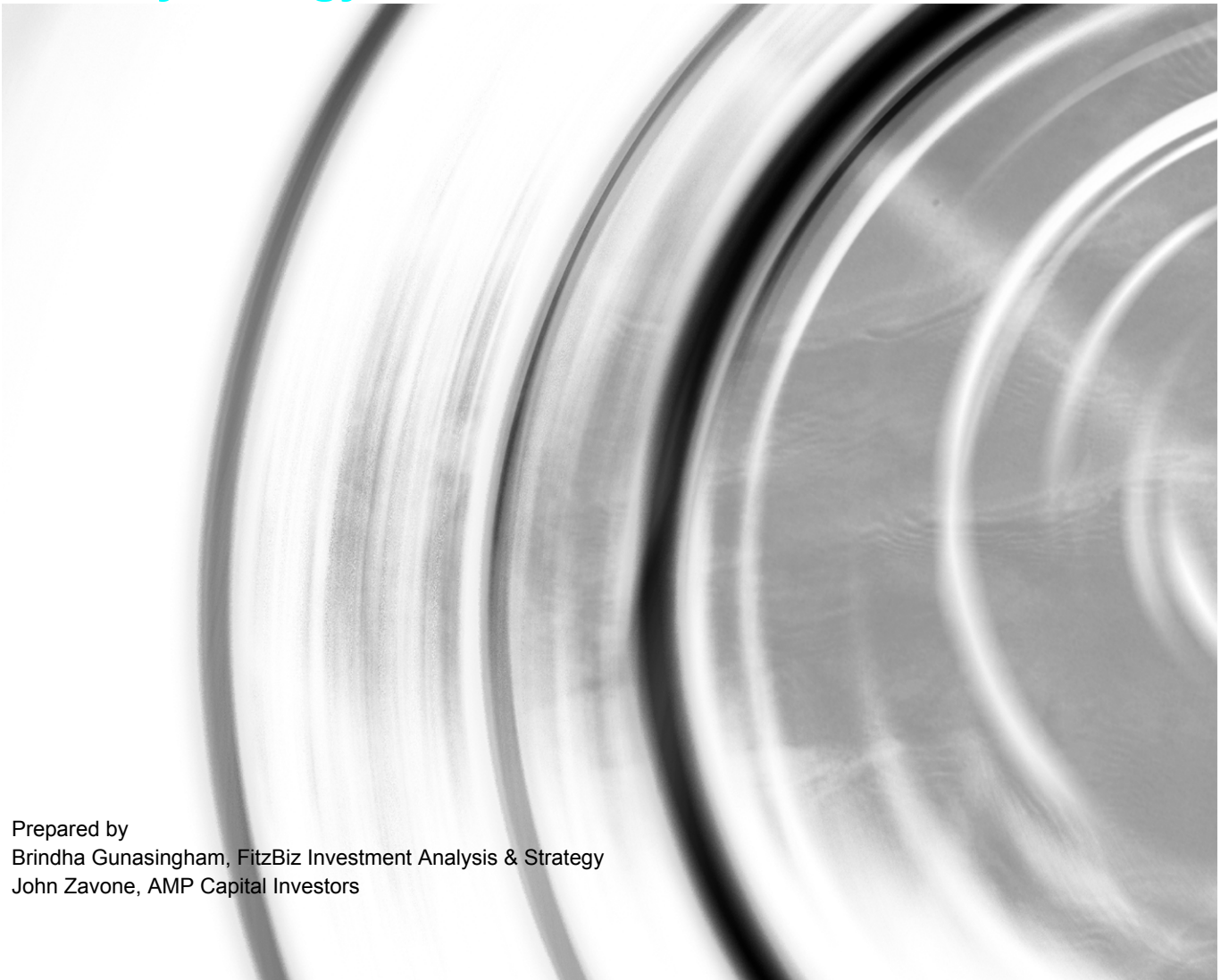




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Discussion Paper for the CMSF Conference 2005: 'The Challenges of Choice'

## The Psychology of Investor Choice



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## Abstract

Investment choices for superannuation fund members are on the rise. But there may be some obstacles to meeting the promised vision of investment choice. Firstly there is a paradox - why do the bulk of members prefer investment choice if asked, and then fail to use it? Secondly, even if members actively use investment choice, do they use it wisely? These are important questions for those interested in the success of investment choice in the long run.

In this paper, we consider the psychology of investor choice. We explore the insights gained from behavioural finance, to shed light on these two key questions, and examine various issues surrounding the introduction of consumer choice of fund into the Australian superannuation industry.

To do this, we first discuss different theoretical aspects of behavioural finance and consumer choice. We then examine the impact of reforms in three other industries, the Australian electricity sector, Australian telecommunication sector and the UK pension sector, particularly in the context of consumer choice. Specifically, we examine the impact of the introduction of:

- Full Retail Contestability (FRC) into the Australian electricity sector, enabling consumers to choose their retail supplier
- Contestability across the Australian telecommunications sector, enabling customers to choose their service providers for local calls, long distance and international calls, mobile calls and Internet services
- Choice in the UK pension sector, enabling investors in employer funds to opt out into their own personal pensions

We compare various aspects of these three industries to those of the Australian superannuation sector in order to highlight issues that may become important with the introduction of choice of superannuation fund. We conclude by discussing potential industry challenges and how trustees can prepare for the impending changes.

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## Setting the Scene

Member investment choice is moving forward at a rapid pace. In the two years from 1998/99 to 2000/01, the number of Australian industry funds offering investment choice grew from 59% to 71%.<sup>1</sup> The latest May 2003 Super Review survey of Australia's top 300 superannuation funds shows that, of those that offer choice, the average number of choices grew from 3.8 in 2002 to 5.0 in 2003, and range as high as 29.<sup>2</sup> Public sector funds now offer an average of 6.3 options, while industry funds offer 5.1 options on average. These moves are being led by the larger funds, though smaller funds are quickly catching up.

At the same time, members themselves are voicing a desire to have more choice. A study by the Financial Planning Association shows 85% of interviewed members from around Australia wanted investment choice. Over half expressed a further preference for choice of fund.

Ultimately the vision is one where fund members are able to select from a wide menu of choices, allowing them to tailor asset allocation to their unique goals and shifting financial circumstances. This is an individual optimisation problem that Trustees are inherently unable to undertake.

The Commonwealth choice of fund legislation will be implemented on 1<sup>st</sup> July 2005. The Government has estimated that the new law will affect 4.82 million employees and 654,000 employers. The Association of Superannuation Funds of Australia (ASFA) has estimated that 30% of employees already have fund choice and an extra 40% could get choice under the new law.<sup>3</sup> In addition, they claim that between 5.2 and 5.7 million employees will potentially have a right to choose their superannuation fund.<sup>4</sup>

The introduction of greater choice is expected to have the following beneficial effects:

- Consumers will win sovereignty over their superannuation
- Increased competition will lead to downward pressure on fees and charges.<sup>5</sup>
- Competition will drive innovation

## Behavioural Finance and Consumer Choice

### Why is investment choice so appealing?

Given the choice between having control or having no control over a situation, people exhibit a clear preference for control. This is true even when their control is not relevant to the outcome. For instance, in experimental lotteries, gamblers are willing to pay more for tickets on which they choose the numbers themselves, compared to an automatic selection. Here control is obviously irrelevant to the outcome, and this is often called the 'illusion of control'<sup>6</sup>. One might expect that in a more uncertain setting where control could affect the outcome, the preference for control is even greater.

It seems likely that investors would find member choice attractive for this reason alone. Member choice offers more control over the allocation and ongoing re-balancing of one's own investments.

This raises the issue of how much confidence is improved, and how willing people are to pay for that control. Interestingly, more recent research highlights the fact that in the case of the lottery, people are not willing to pay much money in order to obtain that control<sup>7</sup>. That is, once there are other trade-offs to consider, the stated preference for control may actually be weak.

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<sup>1</sup> ASFA Research Centre, (2002), July 2002.

<sup>2</sup> Super Review, (2003), May 2003.

<sup>3</sup> Smith, P., (2004), "Spoilt for choice: now you can pick your own fund", The Sun-Herald, 5 July 2004.

<sup>4</sup> Clare, R. (2005), "Implications of Choice of Superannuation Fund Legislations for Members, Employers and Funds", The Association of Superannuation Funds of Australia Limited (ASFA), February 2005.

<sup>5</sup> SCS (Senate Select Committee on Superannuation), (1998), Choice of Fund, 28th Report, Parliament of the Commonwealth of Australia, Canberra.

<sup>6</sup> Summarised in Charness and Gneezy, (2003), "Portfolio Choice and Risk Attitudes: An Experiment", University of Chicago website, [www.uchicago.edu](http://www.uchicago.edu), but credited back to Langer (1975), "The Illusion of Control".

<sup>7</sup> Charness, G. and Gneezy, U., (2003), "Portfolio Choice and Risk Attitudes: An Experiment", University of Chicago website, [www.uchicago.edu](http://www.uchicago.edu)

## Can too much choice be bad?

Perhaps it is not an issue of the cost of choice, but the fact that having too much choice can cause indecision and can eventually result in inaction? Most people agree with the principle of fund choice. The ASSIRT Investor Market Trends survey found that 83% of respondents considered choice-of-fund legislation to be a 'good' or 'great' idea.<sup>8</sup> However, when choice is actually offered — for example, when funds offer their members investment choice — on average, fewer than 10% of members actively exercise that choice.<sup>9</sup>

Sheena Iyengar and Mark Lepper, two psychologists from Columbia and Stanford universities, investigated this issue using different experiments, and found that when they were given too much choice, consumers did not take up any of the choices. Iyengar and Lepper believe humans get uneasy after the number of choices climb above seven. However, according to them, an exception comes into play for US superannuation plans (which only involve voluntary contributions), in which case the number appears to be only two. They found that the contribution rate towards superannuation in the US was the highest among employees of firms that restricted the choice of funds to two. For every extra 10 funds added, the contribution rate dropped by one to two percent.<sup>10</sup>

### The Jam Study by Sheena Iyengar and Mark Lepper

In 2000, Iyengar and Lepper set up a jam-tasting booth in a Californian gourmet grocery store. Shoppers approaching the booth were offered the opportunity to try as many flavours as they wanted and then allowed to buy one of the jams for a discounted price.

At times, the booth offered a choice of six flavours, at other times it offered 24. When only six flavours were on offer, 30% of the shoppers who tried the jams at the tasting booth bought jam at the checkout. When all of the flavours were on offer, only three percent of the taste testers bought jam.

Too much choice appeared to have left shoppers paralysed with indecision. Odder still was the fact that the booth was at its most popular when it had all of its flavours on display. More people stopped to try jams when the biggest variety was on offer, but most didn't buy them.

Iyengar and Lepper concluded that people enjoy being offered a choice and, if asked, will opt for more choice rather than less. Nevertheless, having more choice does not necessarily aid decision-making.

## Why do consumers fail to exercise their choice appropriately?

There are a number of aspects of behavioural finance and consumer choice that could explain why consumers do not exercise their right to choose, or if they do, exercise this in a sub-optimal manner. We discuss these in detail below.

### 1. Omission bias

This is a tendency toward inaction, and there are a number of aspects to this:

- **Decision cost** – there is a cost attached to taking action. It takes time, knowledge and effort. If the perceived need to act does not outweigh the cost, there will be no action. Since superannuation is complex, decision costs are high.
- **Naive optimism** – people are usually naively optimistic about their state of financial affairs. Optimists underestimate the likelihood of bad outcomes over which they have no control.<sup>11</sup>
- **Mental accounts** – people often keep separate accounts in their minds for different aspects of their finances. On average, people give little weight to 'future consumption' as long as they are meeting 'current consumption' out of 'current income'.<sup>12</sup> Since retirement savings are likely to sit in the 'future consumption' box, they may only gain consideration close to retirement.
- **Myopia** – given our short-sighted tendencies, retirement for most people is too far away to consider.

<sup>8</sup> Superfunds, (2000), "Investors endorse choice of fund", June 2000, p.5.

<sup>9</sup> SSSFS (Senate Select Committee on Superannuation and Financial Services), (2000), Roundtable on Choice of Superannuation Funds, Commonwealth of Australia, Canberra, March 2000.

<sup>10</sup> Martin, P., (2004), "Anything but simple is a tax within itself", The Sydney Morning Herald, 8 September 2004.

<sup>11</sup> Kahneman, D. and Riepe, M., (1998), "Aspects of Investor Psychology", Journal of Portfolio Management, Summer 1998, Vol 24, No.4, p52-65.

<sup>12</sup> Kivetz, R., (1999), "Advances in Research on Mental Accounting and Reason-Based Choice", Marketing Letters, 10(3), 249-266.

## 2. Status quo bias:

Even when people do make an active decision they tend to measure changes relative to their current position. Thus, they are more likely to maintain their current position even where it is no more attractive than available alternatives.<sup>13</sup>

US studies have shown that only 2.5% of retirement plan members change asset allocations in a year and three-quarters of members have never changed allocation.<sup>14</sup> The large number of members that sit in the default investment options in retirement plans is also linked to status quo bias. Choi et al (2002)<sup>15</sup> found that in U.S. 401(k) plans, default choices have high persistence, with the bulk of members continuing to contribute exclusively to the default option three years after entry to the plan.

## 3. Ambiguity Aversion or Familiarity bias:

People tend to stick with what they know. There are a number of aspects to this:

- **Ambiguity aversion** is a tendency to avoid options where probabilities are uncertain. Given the ambiguities surrounding superannuation itself, such as political influence and ongoing rule changes, members may be less willing to embrace it. At an investment choice level, investment options that are lacking in information that can be readily compared to other options (such as a limited track record) will be down-weighted.
- **Familiarity bias** – people are drawn to options with which they have past familiarity. For example, despite their potential sub-optimality, Australian investors have a strong bias for domestic rather than international assets.<sup>16</sup>
- **Availability bias** – attention also acts as a filter. People draw on the most available information and recent memories.<sup>17</sup>
- **Herd mentality** – people pay attention to where others pay attention.<sup>18</sup>
- **Decision fatigue** – attention, as easily influenced as it is, also wanes. Fox and Weber (2002) found that if a person needs to face several consecutive decisions regarding uncertainty, they become much more ambiguity averse with each new question.

## 4. “The Path of Maximum Ego”

People try to avoid feeling like a loser, and would generally prefer to lose out through inaction than as a result of their active decisions. This factor can manifest itself in a number of ways:

- **Regret avoidance** – a key motivator behind many investment decisions may be to avoid embarrassment for having tried something and failed.
- **Loss aversion** – potential future losses often weigh more heavily on investors than potential future gains.<sup>19</sup> As a result, the more frequently investors evaluate the performance of their portfolios, the more frequently their losses discourage investment in risky assets.<sup>20</sup>
- **Overconfidence** – most people are overconfident of their abilities, knowledge or future prospects. Overconfidence happens to be greatest for difficult tasks with low predictability, such as investing.<sup>21</sup>

<sup>13</sup> Karlsson, N., Romanus, J., and Garling, T., (1996), “The Status-Quo Bias and Integration of Prior Outcomes in Risky Decisions”, Goteborg Psychological Reports, Goteborg University, 1996, 26, No.4.

<sup>14</sup> Quoted in Poterba, J., (2001), “Comments on “For Better or Worse: Default Effects and 401(k) Savings Behavior” by James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick”, National Bureau of Economic Research website, [www.nber.com](http://www.nber.com), but credited back to Samuelson and Zeckhauser (1988).

<sup>15</sup> Choi, J., Laibson, D., Madrian, B. and Metrick, A., (2002), “For Better or For Worse: Default Effects and 401(k) Savings Behavior”, National Bureau of Economic Research, Working Paper 8651, December 2002.

<sup>16</sup> Baxter, M. and Jermann, U., (1997), “The International Diversification Puzzle is Worse Than You Think”, American Economic Review, March 1997, p 170-80.

<sup>17</sup> Barberis, N. and Thaler, R., (2002), “A Survey of Behavioral Finance”, forthcoming in the Handbook of the Economics of Finance.

<sup>18</sup> Shiller, R., (2001), “Bubbles, Human Judgement and Expert Opinion”, Yale Cowles Foundation Discussion Paper No 1303, Yale International Center for Finance.

<sup>19</sup> Barberis and Thaler (2002).

<sup>20</sup> Charness and Gneezy (2003).

<sup>21</sup> Barber, B. and Odean, T., (2001), “Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment”, The Quarterly Journal of Economics, February 2001.

## 5. “The Path of Least Resistance”

People try to simplify the decision-making process as much as possible, trading off optimality for speed and ease. Investors do this in many ways:

- **Narrow framing** – investors like to narrow the scope of the problem.
- **Decision rules** – investors like to find simple reasons and rules to justify their choices, although these can result in sub-optimal choices.
- **Endorsement effect** – there is a tendency for people to follow the opinions/advice of others, since this makes decision making easier and allows a deflection of responsibility if negative outcomes eventuate. Choi et al (2002) looked at asset allocations in 401(k) pension plans in the United States. They found that default options have a huge influence, particularly when participation in the plan is automatic, as opposed to being selected by the member. In this case they viewed the default option as an endorsement by the Trustee.
- **Representativeness heuristic** – this is a thought process whereby people look for observed similarities to familiar patterns, while ignoring the impact of chance in the pattern.<sup>22</sup> This representativeness bias is likely to lead to members overweighting recent past returns of the investment options presented. If fund managers are not differentiated on skill, or skill is not persistent, then this could lead to costly and inappropriate switching.

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<sup>22</sup> Shiller (2001) - originally Kahneman & Tversky 1974.

## Case Study One: Australian Electricity Deregulation

### Background

Across Australia, both state and federal governments progressively embarked on reforming the electricity sector in the early 1990s. These moves were motivated by the belief that competition promotes choice, innovation and greater price competition.

The aims of the reforms were:

- Full Retail Contestability (FRC) – providing customers with the choice of retail supplier
- Non-discriminatory access to the interconnected transmission and distribution network
- Non-discriminatory legislative or regulatory barriers to entry for new participants in generation or retail supply

Prior to deregulation, electricity provision was exclusively the domain of vertically integrated state owned monopolies. The sector had been fragmented; each State and Territory operated vertically integrated utilities with little interconnection between electricity grids. This led to inefficient use of resources and high prices for some users.

The centrepiece of the electricity reform was the creation of a national electricity market in South-East Australia, featuring a single wholesale market for electricity and an interconnected national electricity grid. The market now allows retailers, aggregators and end users to bid for electricity sold into the wholesale pool by competing generators, while retailers, aggregators and other producers compete for customers.

The reforms have opened up electricity generation and retailing to competition, while addressing bottlenecks in the transmission and distribution grid by allowing third parties access under the National Electricity Access Code. The reforms also include structural reforms aimed at breaking down barriers to interstate and intrastate competition, including the dismantling of State owned monopolies.

FRC has been implemented gradually. It was officially launched in Victoria and NSW in January 2002 and commenced in South Australia in January 2003, and ACT in July 2003. This allowed retail consumers to choose their electricity supplier for the first time. Western Australia and Tasmania are progressing towards FRC, but Queensland has decided against it.

### Results of reforms

#### Market structure

A major impact of deregulation was disaggregation. The situation prior to reform was one where electricity generation, transmission, distribution and retail were controlled by the one entity. This is no longer the case, with individual companies specialising in each stage of production.

However, competition in the industry initially decreased, with the exit of Citipower and Pulse. Barriers to entry increased, with service providers now being required to invest heavily in new systems to track customer programmes. In addition, administrative and bureaucratic barriers are high. Energy retailers have to satisfy the requirements of 13 government agencies and obtain separate licenses for each state and each product that they want to market. Each license can take up to four months to obtain, and cost up to \$50,000. According to the Institute of Public Affairs, these regulations have cost the energy sector \$88 million per annum.

#### Lessons learned – implications for the Australian superannuation industry

##### Low churn rates

Consumer choice was slow to gain momentum. This was partly due to:

- moderate complexity of the product
- relatively low price elasticity of demand
- lack of price competition.

Bearing in mind the similarities between products in both industries, we expect that low churn rates could be a problem in the superannuation industry.

##### Lack of price competition

Despite reductions in barriers to entry and regulation, the electricity industry did not experience significant gains in price competition.

Since we do not expect reductions in either barriers to entry or regulation in the superannuation industry, it will probably take a long time before we see significant improvements in price competition.

## Price

Reforms to the electricity industries resulted in price changes. The real average prices of electricity for commercial and industrial users fell by 22% between 1991 and 1998, due to major falls in the wholesale price of electricity – a result of disaggregation. However, by the time FRC was introduced, wholesale prices had started to rise, fuelled by increased capex costs due to insufficient investment in the preceding years. As a result, most retail customers (households and small businesses) actually experienced price rises, although large businesses, which were heavy consumers of energy, were able to make savings of up to 30%. In Victoria, small energy users (those using less than 160MWh pa) suffered an average price increase of approximately 9% immediately after FRC was introduced.<sup>23</sup>

## Product

Since electricity is a highly homogenous product with few substitutes, there is little room, or motivation, for product innovation. Similarly, there are few ways for suppliers to differentiate their product, except with respect to price. However, there has been some anecdotal evidence of improvements in both service quality and retail efficiency. In recent months, some suppliers are trying to differentiate their products by offering benefits like “green” energy (e.g., Jackgreen who are offering green power to NSW customers).

## Impact of reform on consumer behaviour

As a result of deregulation, consumers now have two choices:

1. Entering into an electricity/gas supply contract with a licensed energy supplier (e.g. Energy Australia)
2. Doing nothing and continuing to receive electricity at (higher) regulated prices

However, due to the moderate complexity of the product, lack of competition and the low relative price savings, consumers have been slow to exercise their choice. Some explanations for this (status quo bias, familiarity bias, path of least resistance) are detailed in the behavioural finance section of this paper.

## Churn rates

There are no precise variables that can be used to measure the rate of take up of consumer choice. This is because consumers may exercise their choice, and by doing so, decide that they are happy with their existing choice. In this case, they may not take any externally perceivable action. However, if consumers do exercise their choice, and as a direct consequence decide to switch service providers or products, these events can be measured externally as switching or churn rates. Thus, in the context of consumer choice, higher churn rates can be used as an indication of an increase in the exercise of choice, although they may not necessarily be beneficial to the industry or consumers. (For example, consumers may switch to less appropriate products or service providers).

Using churn rates as a proxy for the exercise of consumer choice, Figure 1 shows that consumers have been slow to take advantage of the introduction of choice.

In the first five months after FRC was introduced, less than one percent of customers across NSW and Victoria switched retailers,<sup>24</sup> and only about three percent of customers switched retailers by December 2002. By mid 2003, there had been a slight improvement in Victoria. According to a study by Andrea Sharam at the Institute for Social Research at Swinburne University, 87% of Victorian households stuck with their pre-market supplier of electricity (AGL, TXU or Origin). This was the case despite the fact they were priced according to “deemed contract” - which for most customers was at least four percent higher than the price they could get if they shopped around among the six licensed retailers.

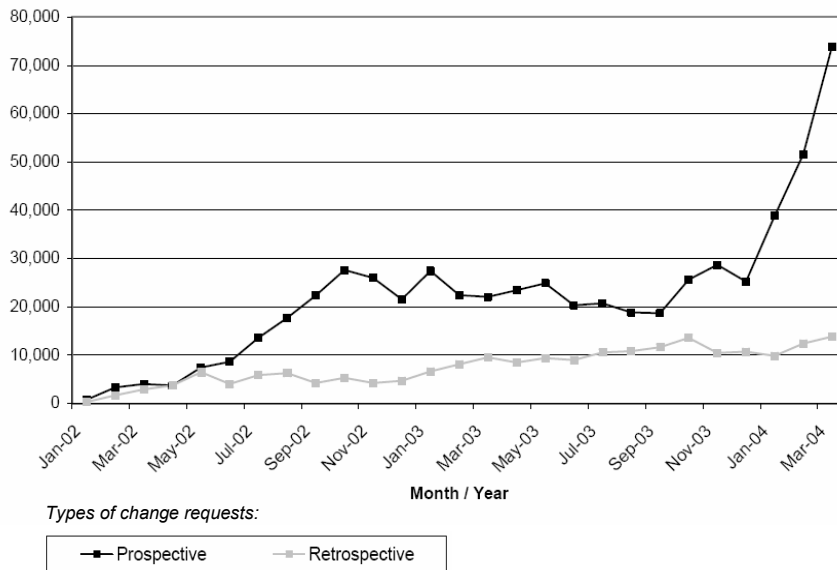
One potential reason for this initial consumer apathy could, in fact, have been a lack of real choice in the market. The immediate impact of the reforms was actually a reduction of players in the market, with the exit of Citipower and Pulse.

In fact, as Figure 1 shows, the introduction of choice did not really seem to have much of an impact until January 2004, probably as a result of increased marketing and competition in the industry. At least four new energy retailers are trying to enter the market, offering incentives and offers like rebates, discounts and even AFL club memberships, to lure customers away from industry incumbents. After these new entrants began actively competing in the market for energy, 20% of Victorian households switched retailers.

<sup>23</sup> Independent Competition and Regulatory Commission, (2002), “Full Retail Contestability in Electricity in the ACT”, July 2002.

<sup>24</sup> Independent Competition and Regulatory Commission, (2002), “Full Retail Contestability in Electricity in the ACT”, July 2002, Table 5.1.

**Figure 1: Number of requests by consumers to change electricity retailer (Change Requests)**



Source: National Electricity Market Management Company Limited (NEMCO), 2004, 'Metering and Retail Market Development 2004 Annual Report' Version 001, Pg. 30

A widely held view across the industry is that these churn rates could rise even higher, up to about 35%, but will eventually settle at 20% on an ongoing basis.

Electricity is a homogenous, but necessary product, with few substitutes and fairly inelastic demand, as shown by the following discussion of price elasticity of demand. Thus, given that consumers had to purchase electricity any way, perhaps they were reluctant to switch providers without any real incentives (in terms of price or quality of product) to do so.

**Price elasticity of demand**

Price elasticity of demand is a measure of the sensitivity of demand for a product to changes in price. A price elasticity of demand of  $-x\%$  implies that if the price of that good rises by 1%, the demand for the good will fall by  $x\%$ . Essential goods, or goods with inelastic demand, have price elasticities close to zero. Non-essential goods, or those with elastic demand, have price elasticities close to -1.

In the context of consumer choice, price elasticity of demand is of interest because it gives us an idea of how much consumers may care about (and therefore act on) price changes that could be a consequence of the introduction of choice.

Electricity is generally considered to be an essential good, with demand that has a low sensitivity to price changes, at least in the short run. However, this sensitivity to price changes, or price elasticity of demand, is quite difficult to estimate. In general, price elasticity for electricity should be negative, since we would expect demand to fall marginally, if prices rise.

In a report published by the National Electricity Market Management Company Limited (NEMCO) in June 2004, the National Institute of Economic and Industry Research recommended the estimates shown in Table 1. Using these, they estimated that the mean price elasticity of demand for the National Electricity Market (NEM) was -0.35. However, since these elasticities were calculated using data from the pre-FRC period, they may not be entirely applicable to current conditions.

**Table 1: Recommended long run own price elasticity of electricity demand by sector (Based on data from 1980 to 1995)**

Sector	Recommended Price of Elasticity Demand
Residential	-0.25
Commercial	-0.35
Industrial	-0.38

Source: National Institute of Economic and Industry Research, trading as National Economics, (2004), "The Price Elasticity of Demand for Electricity in NEM regions", a Report for National Electricity Market Management Company Limited (NEMCO), June 2004, Pg. 7.

These estimates imply that long run demand for electricity is quite inelastic, and are in line with the general consensus across the industry, which is that both short run and long run demand are inelastic, with short run demand being more inelastic. However, estimates of price elasticity of demand vary significantly. For example, a study conducted by Akmal and Stern<sup>25</sup>, using ABS data from 1969 to 1999, found that the long run price elasticity of demand for electricity in Australia (across all sectors) was -0.95, which implies that demand is actually extremely elastic and sensitive to price changes. They also cited a number of other Australian research studies that found elasticities between -0.55 and -0.86.

### **Complexity of product**

Despite its homogeneity and relative price inelasticity of demand, electricity has taken on some post reform aspects that have increased its complexity. With the exception of potential price competition, consumers can find it difficult to comprehend how they are actually benefiting from choice. This is because electricity is almost intangible, and although they may switch providers, the product is still delivered through exactly the same mechanism. Similarly, even if they switch to providers that claim to provide 'green power', consumers have no way of monitoring whether or not this is true.

This increase in complexity of product may have furthered served to decrease consumers' inclination to switch their service provider.

### **Comparisons to the Australian superannuation industry**

Both the electricity and superannuation markets are large, with many players, although we expect competition in the superannuation industry to be slightly lower than in the electricity industry, post-reform, due to reductions in regulation and barriers to entry that have occurred in the electricity industry.

With respect to product, there are greater differences, but we believe there are a number of factors that will make the experiences of the electricity sector quite relevant for the superannuation sector.

Firstly, although homogeneity of product across the superannuation sector is low, it has the appearance of being a homogenous product. This is in part due to the fact that the bulk of employees are forced to invest in superannuation, under the compulsory superannuation regulations, which makes superannuation seem like a single essential good. However, ironically, the problem is probably further compounded by the extreme complexity of the products on offer, which makes consumers reluctant to think about superannuation as a range of products. It is probably a classic case of [omission bias due to decision cost](#).

Similarly, due to the compulsory superannuation regulations, involuntary contributions to superannuation schemes are probably price inelastic, like the demand for electricity, although the demand for superannuation products with respect to voluntary contributions is probably highly price elastic.

With respect to customers and users of the product, the two industries are quite different. Although both include retail customers as part of their client base, the electricity industry includes wholesale clients as a key component. These clients are not really relevant to the superannuation industry, in the context of consumer choice. However, the superannuation industry involves third party intermediaries (financial planners) who play a key role in influencing investment decisions.

Appendix 1 compares the key characteristics of these two industries.

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<sup>25</sup> Summarised in , Langmore, M., and Dufty , G., (2004), "Domestic electricity demand elasticities, issues for the Victorian energy market", June 2004, but credited back to Akmal, M. and Stern, D., (2001), "The Structure of Australian Residential Energy Demand", ANU Working Papers in Ecological Economics, March 2001, Number 0101, Pg. 20

## Case Study Two: Australian Telecommunications Deregulation

### Background

Gradual deregulation of the Australian telecommunications industry has occurred over the past 13 years. Critical events in this progression were the introduction of open competition and the partial privatisation of Telstra in 1997 and 1999 respectively. Telstra is now 49% privately owned. Prior to reform, Telstra supplied all of Australia's telecommunications services as a public monopoly.

The industry is extremely diverse in all aspects and has avenues for further diversification as more cable and radio spectrum capacity become available to the industry. It is continuously undergoing very rapid changes in the range and complexity of its products, its means of production and delivery, and its demand patterns. The associated products are only partially substitutable by hard copy communications media such as post, courier and document exchanges.

There are now few direct regulatory restrictions on entry (there are now 100 plus carriers). It is strategically crucial to the rest of the economy and also socially very significant, but there are still monopoly elements, particularly in the local telephone loop.

### Results of reforms

#### Market structure

More than 100 new carriers have been licensed, but Telstra is still dominant. Telstra still gains three out of every four dollars spent on telecommunications in Australia. It has 85% of market share in local calls, 75% of market share in long distance calls, and takes about 95% of industry profits. Competitors have tended to 'cherry-pick' and compete in the higher margin business such as interstate and international calls.

#### Price

Price competition is variable across different market sectors. Price competition is quite aggressive in the interstate and long distance call market. There have also been price reductions for Internet services and anecdotal evidence points to increased competition in the mobile market.

However, there is a significant degree of price rigidity in local calls. There has only been marginal price reduction in local calls, due to the inherent economics of local call provision (i.e. it is a low margin business with high fixed costs).

Between 57% and 69% of consumers reported dissatisfaction about price competition in the fixed phone market between 2001 and 2004, whilst between 48% and 61% reported dissatisfaction about price competition in the mobile market.<sup>26</sup>

#### Product

There has been a high level of product innovation and differentiation with respect to products, delivery mechanisms, discounts, special offers, pricing plans and bundling.

Mobile service providers are becoming more aggressive. In mid-2002, Vodafone's Graham Maher was quoted as saying that mobile players are acting like utilities which are "specialists in designing pricing that means you're just not quite sure

### Lessons Learned – Implications for the Australian superannuation industry

#### Mixed churn rates

Consumer choice was slow to gain momentum overall, but occurred at different rates across different sectors (e.g., churn rates were lower in the fixed phone local calls arena than in the Internet sector)

This was probably largely due to:

- high complexity of the products and services
- low homogeneity of the products and services.

We expect that low churn rates could be a problem in the superannuation industry, but they could vary by sector. (e.g., they could be much higher for voluntary contributions).

#### Varied motivations for change

Different consumers appear to have different propensities to switch telecommunication service providers. Their motivations appear to vary according to:

- their location
- their resultant awareness of issues associated with the industry.

This could be an issue for the superannuation industry.

#### Distrust and dissatisfaction

Deceptive conduct by some service providers has fostered consumers' distrust and dissatisfaction.

This has had a detrimental impact on their desire to switch telecommunication service providers.

There is potential for this to be a problem in the superannuation industry.

<sup>26</sup> Australian Communications Authority (ACA), (2004), "Consumer Satisfaction Survey 2004", Figure 10.

when you are being ripped off, but you know you are". The latest tactic is for mobile networks to steal customers away from fixed line service providers by making mobile usage a much more cost effective alternative. They are offering customers *bucket plans* which allow customers unlimited mobile phone usage for a fixed fee.

All this change has made the complexity of products extremely high.

### Impact of deregulation on consumer behaviour

Consumers have been less willing to change providers in the local call market as the price savings are not as great as is the case in the interstate and international call markets.

Consumers have shown a great deal of willingness to change with respect to new forms of telecommunications, such as mobile and Internet, where Telstra has less of an entrenched brand dominance and where there is greater product innovation and discounting. However, even in these areas, results have been mixed. For example, research commissioned by the Australian Telecommunications User Group in mid 2002 showed that corporate users had not gained any significant benefits from competition.

### Churn rates

The rate of take up of choice across the telecommunications industry appears to have been slow to build, and has occurred at different rates in different sectors.

Specific churn rates for the industry are very difficult to obtain. However, the ACA Consumer Survey of 2004 provides some, limited, information on how many households and small business have never considered switching service providers, and therefore never compared phone companies.<sup>27</sup> About 32% of retail respondents to the survey had never compared fixed phone companies, whilst 30% had never compared mobile phone companies. Figures for small business were slightly lower, with 27% saying they had never compared fixed phone companies, and only 22% saying that they had never compared mobile phone companies. These numbers were slightly lower than the previous year, implying that churn rates may have increased.

### Price elasticity of demand

As with churn rates, reliable price elasticity of demand estimates for the industry are also difficult to obtain. However, the bulk of evidence shows that price elasticity for fixed phone line services is extremely inelastic, surprisingly even more so than electricity.

Madden et. al. (1993)<sup>28</sup> estimated (and tested the statistical significance of ) price elasticities for fixed phone usage, for both local and long distance calls, using data taken from the period prior to the introduction of competition in the telecommunications sector. They found that elasticities were very close to zero. Based on surveys of previous studies, Albon et. al. (1997)<sup>29</sup> estimated similarly inelastic results, concluding that households and businesses had price elasticities of -0.06 for local calls.

As one would expect, price elasticity of demand for mobile services is much more elastic. Madden and Coble-Neal (2004)<sup>30</sup> used panel data from 56 countries to estimate price elasticity of demand for mobile services at -0.54.

### Complexity of product

The rapid growth of technology, products and services on offer across the telecommunications industry has resulted in substantial levels of product complexity. This in turn has dampened consumer confidence and promoted lower levels of awareness and greater confusion among consumers, particularly in the residential and small business sectors. This was one of the key findings of the Australian Communications Authority's (ACA) Consumer Awareness Survey of 2002. The survey also found that not many customers had high levels of awareness about the industry, as shown in Table 2.

<sup>27</sup> Australian Communications Authority (ACA), (2004), "Consumer Satisfaction Survey 2004", Table 23.

<sup>28</sup> Summarised in Madden, G., Coble-Neal, G., Schipp, M. and Dalzell, B., (2004), "Australian Household Use Patterns of Telecommunications Services", Curtin University, Pg. 2-6, but credited back to Madden, G., Bloch, H. and Hensher, D., (1993), "A Model of Australian Telephone Network Subscription and calling Demands: Evidence from a Stated-preference Experiment", Information Economics and Policy, Vol. 5, Pg. 207-30.

<sup>29</sup> Summarised in Productivity Commission, (1999), "International Benchmarking of Australian Telecommunications Services", March 1999 but credited back to Albon, Hardin and Dee, 1997.

<sup>30</sup> Madden, G. and Coble-Neal, G., (2004), "Economic Determinants of Global Mobile Telephony Growth", Information Economics and Policy, Vol. 16.

**Table 2: Percentage of consumers with high awareness/knowledge**

Section of State (ABS classification)	% of residential population with high awareness/knowledge	% of small business population with high awareness/knowledge
Major urban (urban areas with a population of 100,000 and over)	27	30
Other urban (urban areas with a population of 1,000 to 99,999)	23	17
Bounded locality (rural areas with a population of 200 to 999)	7	23
Rural balance (rural areas with a population of less than 200)	29	13

Source: Australian Communications Authority, (2002), "Consumer Awareness and Information Needs Survey 2002 Special Report No.11-October 2002", Table 7 Page 9.

### Motivation for change

Another key finding of the ACA's survey was that levels of awareness about the industry varied according to the location of respondents. This may have implications for the motivation behind switching providers.

As can be seen from Table 2, consumer comprehension of the telecommunication industry varies widely across regions of different population size. For example, only seven percent of consumers in bounded localities had a high awareness about the industry, as compared to 29% of consumers in other rural areas.

This implies that perhaps, due to perceptions of complexity of product, consumers in these different areas would have a different propensity to switch suppliers.

### Distrust and dissatisfaction

As discussed previously, the ACA reported high levels of consumer dissatisfaction about price competition in the industry. Unfortunately, the industry has also suffered from high levels of consumer distrust, due to poor selling practices and hostile contracts with unfair lock-in terms and conditions.

*Slamming* was a particular problem in the early days of competition. This occurred when phone companies took advantage of customers to implement unauthorised customer transfers. In some instances they even obtained customers' signatures without explaining what the customers were signing. The Australian Competition and Consumer Commission (ACCC) took court action against One.Tel and Primus with regards to this, and won.

The negative impact of these issues on the industry's reputation could have had an influence on consumers' decisions about whether or not to exercise their choice.

### Comparisons to the Australian superannuation industry

Both the telecommunications and superannuation markets are large, with many players, and high growth rates. However, we expect competition in the superannuation industry to be slightly lower than in the telecommunications industry, post-reform, since we expect regulation and barriers to entry to remain high in the superannuation industry. (For example, as a result of new APRA licensing requirements).

The analysis of products shows that both industries have products that are very similar in character. Both industries involve products with low homogeneity (although superannuation products can appear to be highly homogenous, as discussed in the case study about the electricity industry), high complexity, and few substitutes. They are even very similar with respect to elasticity of demand. Fixed phone lines display extremely inelastic properties, as we would expect to be the case for involuntary superannuation contributions, whilst mobile phones have high price elasticity of demand properties, as we would expect to be the case for voluntary superannuation contributions.

With respect to customers and users of the product, the two industries are quite different. Although both include retail customers as part of their client base, the telecommunications industry includes wholesale clients as a key component, and the superannuation industry includes financial planners.

Appendix 1 compares the key characteristics of these two industries.

## Case Study Three: UK Pension Reform

### Background

In 1986, with the passing of the Social Security Act (1986) in the UK parliament, a system of personal pensions was created. Personal pensions are tax privileged savings vehicles that were introduced as a way of making provision for retirement independently of an employer. People were given the choice of switching out of occupational (i.e. employer provided) pension schemes into pension products offered by private sector providers.

At the time, the Government claimed that the reforms would result in bigger pension benefits (through better investment practices), lower government pension costs, greater individual control, investment flexibility and use of supposedly more "efficient" private companies. However, the reality has turned out to be quite different.

Prior to the reforms, workers were generally required to join and contribute to employer run occupational pension schemes as a condition of their employment. The idea behind the reform was to give workers greater control over the investment of their retirement contributions.

A unique aspect of the UK pension industry is the importance of intermediaries (i.e. financial planners), who facilitate any switching between products and providers.

### Costs and Benefits of Personal Pensions

Although personal pensions subsequently caused so much controversy, as a result of the *mis-selling scandal*, they did have a number of beneficial aspects for some, though not all, consumers. Their advantages included:

- Tax relief on the premiums
- Capital gains tax advantages
- Lump sums paid to dependants that would usually be free of inheritance tax
- Job mobility
- Flexibility to take the benefits at any time between the age of 50 and age 75, regardless of employment status
- Ability to phase the payment of benefits over the period from the age of 50 to 75, either through a single plan or through a number of different plans

### Lessons learned – implications for the Australian superannuation industry

#### Churn rates

Uptake of choice was much greater than expected, which could imply that choice may be popular in the Australian superannuation sector.

However:

- this contradicts the implications of the previous case studies
- the UK experience may be less relevant because the numbers were probably artificially boosted by mis-selling (at an expected cost of £11.25 billion).

#### Varied motivations for change

Different consumers appear to have different propensities to take up personal plans. This varies according to their:

- gender
- age
- employment status
- wealth.

This could be an issue for the Australian superannuation industry, meaning that trustees may need to target different consumers in different ways.

#### Distrust and dissatisfaction

Distrust and dissatisfaction, particularly due to the mis-selling scandal, have had a massive, detrimental impact on the UK pension industry. There is potential for this to be a problem in the Australian superannuation industry.

However, ASFA claims that the likelihood of the same type of mis-selling occurring in Australia is low. This is because:

- the number of consumers with substantial defined benefit superannuation assets in Australia is quite low
- in general, these consumers will be exempt from choice anyway
- the market share figures for Australia are quite different, with over 55% of assets already residing in retail funds or Self Managed Superannuation Funds (SMSFs).
- in contrast to the conditions in the UK that occurred immediately after reform, the Australian regulatory regime is very strong.

The *mis-selling scandal* occurred mainly because the disadvantages associated with personal pensions outweighed the advantages for many consumers who were sold these plans, making them significantly worse off. The disadvantages included:

- Their employer would be highly unlikely to contribute to personal pension plans if there was a company scheme in operation
- Consumers switching out of company schemes could lose ancillary benefits associated with membership of the company scheme, the value of which could wipe out any benefits of switching
- Defined benefit occupational pension schemes guarantee an employee's income in retirement. In contrast, personal pension plans tend to be defined contribution schemes
- Personal pension plan holders bear the additional cost of any life insurance and disability insurance
- Initial charges, ongoing management fees, and penalties for early encashment tend to be much higher

### Results of reform

#### The mis-selling scandal (April 1988 to June 1994):

A direct result of the reforms was the *mis-selling scandal*, which occurred between April 1988 and June 1994. This has had serious implications and repercussions with respect to the reputation of the industry with consumers. It has increased consumer mis-trust, and is expected to cost the Government, and the pension product providers involved, £11.25 billion in compensation for over 1.25 million consumers that were made worse off as a result of switching out of occupational pension schemes into private pension products.

During this period, some financial institutions used deceptive and unethical procedures to encourage workers to opt out of occupational plans into personal pensions. By performing inadequate analyses of clients' situations and providing biased information, many salespeople virtually guaranteed that buyers would not receive the information and advice needed to make informed decisions.

50,000 members of occupational pension schemes transferred their assets to private pension schemes (PPS) following high-pressure sales tactics by agents of PPS providers. Many of these people remained working for the same employer but transferred out of good occupational pension schemes, which provided index-linked pensions, into privately run schemes, where the employer did not contribute and which took 25% of the transfer value in commissions and administrative charges. High fees and charges and poor investment returns combined to decimate retirement savings. Many people ended up locked into these products, unable to switch to more appropriate products without paying very high exit fees. As many as 90% of the people who transferred their pensions had been given inappropriate advice.

The primary force driving people to switch pension products was advice from Independent Financial Advisers (IFAs). IFAs went after the high value end of the market and transferred them into products that paid high up-front commissions.

In the wake of the scandal, regulations covering IFAs were tightened and are now more strictly enforced. The Government has also made it more difficult for people to switch to private pension products (e.g., they must be able to show that they will be made better off by switching).

Causes of the mis-selling scandal:

- Fundamental mis-alignment of incentives between IFAs and clients
- Lack of customer education about the pension system or industry
- Complexity of the pension products
- Lack of training & regulation of IFAs (e.g., there were 6 different regulators operating within the pension area)

### Impact of reform on consumer behaviour

Consumers did change providers, but third party intermediaries (financial planners) were the agents behind this change. Mis-alignment of incentives of the financial planners from those of consumers resulted in the mis-selling scandal.

### Churn rates

Consumer uptake of personal plans was much higher than anticipated, with the number of optants being under-predicted by a factor of eight.<sup>31</sup> However, this number is obviously artificially inflated, due to the mis-selling that occurred, and contributions are not high relative to GDP. According to the Inland Revenue, for the year 1999-2000, personal pension plan contributions (including both employee and employer contributions) only accounted for 0.6% of GDP.

Table 3 shows how the proportion of consumers with personal pension plans varied between 1992 and 1998. It shows that by 1992, 12.0% of survey respondents were only members of personal plans, and 6.0% were members of both occupational and personal plans. The proportion of respondents contributing solely to personal pension plans tailed off over the period, to 9.1% in 1998. However, the persistence of these contributions increased from 46.7% in 1993 to 56.8% in 1998.

An important aspect of this issue is the extremely high costs of switching pension plans, which could have dampened churn rates. By moving out of an occupational defined benefit plan, consumers lose out on a host of non-pension benefits, like life and disability insurance. In addition, there are severe pecuniary disadvantages. For example, commission fees are extremely high. They account for about 2.5% of contributions and 1.5% of assets in typical personal pension funds, but since they are frontloaded, can be equivalent to about 10 to 20% of contributions. Switching between personal pension plans is even more expensive, with transfer fees and new upfront fees costing up to 25-33% of contributions.<sup>32</sup>

**Table 3: Type of pension coverage, contributions to personal pensions, and persistence (by year)**

	Year						
Number of Observations	1992	1993	1994	1995	1996	1997	1998
Number of Observations	3,827	3,827	3,827	3,827	3,827	3,827	3,827
Percentage with:							
an occupational pension	34.2	33.4	33.3	37.9	40.0	41.1	42.1
a personal pension (PP)	12.0	12.8	12.5	11.4	10.2	9.6	9.1
both	6.0	6.6	6.1	6.1	5.9	6.7	6.5
Percentage making contribution to PP	7.6	8.2	8.2	9.0	8.1	8.7	8.2
Average own contribution £/month	51.3	59.9	62.9	72.7	69.6	84.4	85.9
Average own contribution % earnings	4.6	4.9	4.9	5.4	5.2	5.7	5.4
Percentage whose contribution persists	-	46.7	46.3	54.6	48.7	54.5	56.8

Source: Disney, R., Emmerson, C. and Wakefield, M., (2001), "Pension Reform and Savings in Britain", January 2001, using British Household Panel Survey (BHPS) data.

### Price elasticity of demand

We have not been able to obtain price elasticity of demand data for the industry. However, given that only about 60% of the respondents to the survey detailed in Table 3 appear to be members of either occupational or personal pension plans, we surmise that price elasticity of demand for these products is probably high.

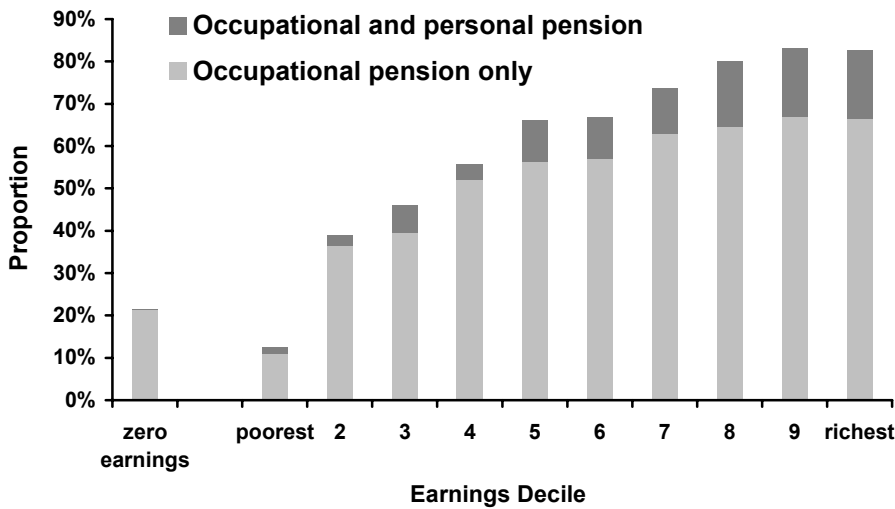
### Complexity of product

UK pension products are extremely complex, and this complexity may have had a slightly detrimental impact on consumer decisions to switch to personal plans.

<sup>31</sup> Wakefield, M., (2004), "Pensions and Savings in the UK", The Institute for Fiscal Studies, Presentation made in January 2004, credited back to Disney, R. and Whitehouse, E., (1992).

<sup>32</sup> Philip Davis, E., (2004), "Is there a Pension Crises in the UK?", The Geneva Papers on Risk and Insurance, July 2004, Vol. 29, Pg. 357.

**Figure 2: Take up of personal pensions among different income deciles in the UK**

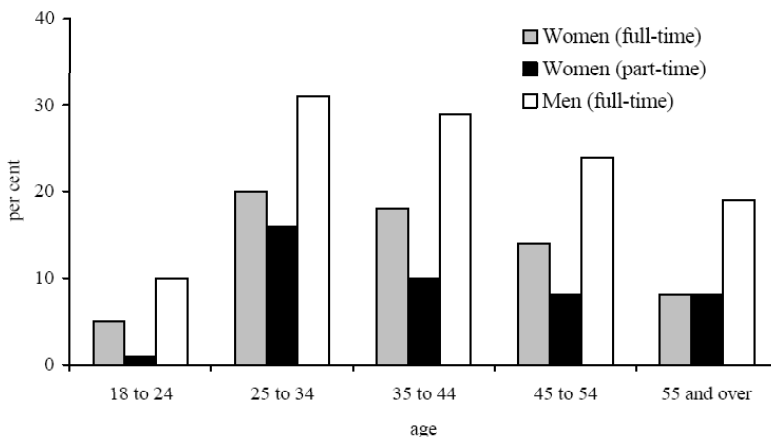


Source: Wakefield, M., (2004), "Pensions and Savings in the UK", The Institute of Fiscal Studies, January 2004, but credited back to Disney, Emmerson and Wakefield (2001)<sup>33</sup> using British Household Panel Survey (BHPS) data.

**Motivation for change**

The motivation for taking up personal plans appears to have been a key issue in the industry. For example, a much higher proportion of wealthy consumers invested in personal pension plans, than was the case for less wealthy consumers. This can be seen from Figure 2. In addition, the uptake of personal plans seems to have varied significantly by age, gender and job status, as shown in Figure 3.

**Figure 3: Personal pension coverage by gender, age and job status (1998)**



Note: Employees in Great Britain aged 18 and over, excluding those in youth training and employment training. Part-time male employees not shown due to small sample sizes.

Source: Disney, R., Emmerson, C. and Smith, S., (2003), "Pension Reform and Economic Performance in Britain in the 1980s and 1990s", The National Bureau of Economic Research (NBER), March 2003, Figure 2.2 using data from the Office of National Statistics (2000).

<sup>33</sup> Disney, R., Emmerson, C. and Wakefield, M., (2001), January 2001, "Pension Reform and Savings in Britain".

## **Distrust**

Due to the mis-selling scandal, consumer distrust of the sector increased, and this has probably had a large impact on consumers' behaviour, probably promoting their disincentives to switch pension plans.

## **Comparisons to the Australian superannuation industry**

As one would expect, and as can be seen from Appendix 1, the UK pension industry and Australian superannuation industry are very similar. However, two key differences and reasons why Australia may not be so susceptible to the *mis-selling* phenomenon are:

1. Post reform regulation and barriers to entry were low in the UK, but are expected to be high in Australia.
2. The Australian market is quite different (there are few consumers with substantial defined benefit superannuation assets, and over 55% of assets already reside in retail funds or SMSFs).

# Challenges for the Australian Superannuation Industry

## Expected Outcomes

Based on our analysis of the superannuation industry and the post reform performance of the three sectors that we have examined in the case studies, we believe that there are a number of outcomes that may occur as a result of the introduction of choice into the superannuation industry. We describe these below.

In 2004, ASFA commissioned ANOP Research Services to conduct a national survey of 514 full-time and part-time employees, between the ages of 25 and 64 years, about choice of fund. Based on this, ASFA estimated that about 8% of fund members will exercise their choice of fund.<sup>34</sup> As a consequence of this, ASFA estimated that there will be flows between funds. However, some of these flows will be between funds in the same sector (e.g., from one industry fund to another, or from one retail fund to another). Overall, ASFA expects gross flows between different fund sectors (corporate, industry, public sector, retail or SMSFs) of about 6% of fund members. They estimate that the gross flow of total superannuation assets between different fund sectors will be higher, at 7.5%, since they feel that members with larger asset balances are more likely to exercise their choice. They expect these flows to take a number of years to occur. Based on the survey results, ASFA also expects SMSFs to enjoy the greatest growth, with net inflows of up to 4%, whilst retail funds could be the net losers.

## Reasons why members may not actively participate in choice

Members prefer choice because, given no other trade-offs, choice increases their confidence that future outcomes are likely to be favourable, whether that confidence is justified or not (illusion of choice). However, members generally do not participate actively in investment choice for the following reasons, some bearing greater weight than others:

- Members are naively optimistic about their future financial welfare (optimism)
- Members are unconcerned with retirement savings as long as they expect to continue earning income (mental accounts)
- Investment complexity makes investment choice decisions difficult (decision cost)
- Superannuation ambiguities such as complexity, political influences and rule changes reduce the attractiveness of superannuation versus other investment vehicles (ambiguity aversion)
- Members are short-sighted (myopia)
- Members are complacent about needing to make changes (status quo bias)
- Members are concerned about making investment changes that may not work out (regret)
- Members are generally happy with the default option, and assume that the Trustees are recommending it (endorsement effect)

## Potential sub-optimal investment behaviour

To the extent that members do take an active role in investment choice, we can expect the following sub-optimal investing behaviours, to varying degrees:

- Concentration in the default option (status quo bias, endorsement effect)
- Concentration in domestic assets and familiar asset classes (familiarity bias)
- Aversion to new options (ambiguity aversion)
- Aversion to unique options (ambiguity aversion, decision rules)
- Tendency to naively spread investments elsewhere (naïve diversification)
- Inadequate regard to optimal risk level (decision rules)
- Sensitivity to presentation of options (decision rules)
- Responsiveness to return comparisons (decision rules)
- Trend following (representativeness heuristic)
- Herd following (representativeness, availability bias, regret aversion)
- Too much switching for no gain (overconfidence)

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<sup>34</sup> Clare, R., (2005), "Implications of Choice of Superannuation Fund Legislations for Members, Employers and Funds", The Association of Superannuation Funds of Australia Limited (ASFA), February 2005.

Through the plan design and marketing, Trustees may have a strong influence on the comparison criteria used by members, the degree of overall defensiveness or aggressiveness, and the model allocation of assets (i.e. default).

## Issues to Consider

### Communicating with members

In December 2000 The Association of Superannuation Funds of Australia (ASFA) published research into how well individuals were able to understand superannuation products, and compare between products<sup>35</sup>. They found that consumers have great difficulty in understanding superannuation products, and prefer to choose less complex options. Those that have difficulty with content use other props to help them decide, regardless of whether those props (e.g., pictures on the front cover) are relevant or in fact misleading. Thus, the format in which information is presented is extremely important. In addition, some consumers will always need verbal explanations of fund features and options to supplement written information. The use of percentages in fee information is a barrier to understanding, and despite prominent warnings to the contrary, consumers will often use historical fund returns to predict future returns where these are provided.

*Perhaps industry participants need to pay more attention to how they communicate with members?*

### Ethics

Changes in any industry have the potential to increase opportunities for unethical behaviour, particularly with respect to the way consumers are treated.

*Should industry participants consider measures to protect consumers?*

### Education

Lack of understanding and fear of complexity appear to be persistent problems amongst consumers in the industry. As it is, most Australians ignore or take minimal interest in their superannuation affairs because they do not understand them. The introduction of choice is likely to add a further layer of complexity to the issue, further exacerbating the situation. There will be members who are unable or are unwilling to exercise choice. Up to 50% of workers are unsure which fund their superannuation contributions have been directed to.<sup>36</sup> Around 64% of fund members have little or no knowledge of their funds; only a quarter of fund members read some or all of the annual fund report; and only 43% of those were able to recall some information detailed in the report.<sup>37</sup> Education is therefore a key issue to consider.

*Perhaps Trustees should educate members about the benefits of investment choice, consider more than one default mix, provide simple-to-use portfolio diagnostic tools, promote understanding of unfamiliar options, focus on potential areas of ambiguity, and consider how members are likely to compare options in the way they are presented?*

### Rate of change

As can be seen from the three case studies, many of these reforms with respect to consumer choice took a number of years to gain momentum. This assumption fits in with findings published by ASFA<sup>38</sup> and is a key issue to bear in mind.

*If they wish to maximise the benefits of change, perhaps Trustees need to begin their awareness campaigns as soon as possible, rather than waiting until after the 1<sup>st</sup> of July 2005?*

### Potential risks to industry participants

Industry superannuation funds should expect an advertising campaign from some participants in the retail superannuation sector. Financial institutions are expected to be actively involved, given the broader options available to consumers through choice. We expect there to be increased attention paid to consumers who are dissatisfied with the under performance, or the expense, of their current superannuation funds.

### Issues to Consider

- Communicating with members
- Ethics
- Education
- Rate of change
- Potential risks to industry participants
- Motivations for change
- Costs

<sup>35</sup> Ageing Agendas, (2000), "Summary of the Outcomes of Consumer Testing of the ASFA Super Choice Key Features Statements", prepared for The Association of Superannuation Funds of Australia Limited, December 2000.

<sup>36</sup> Lampe, A., (2001), "Super a Mystery for Most Workers", The Sydney Morning Herald, 16 May 2001, p. 3.

<sup>37</sup> Kavanagh, J., (1998), "Start Delay Won't Spoil Super Choice", The Weekend Australian, 11–12 April 1998, p. 3.

<sup>38</sup> Clare, R., (2005), "Implications of Choice of Superannuation Fund Legislations for Members, Employers and Funds", The Association of Superannuation Funds of Australia Limited (ASFA), February 2005.

ASIC is concerned that the increased focus on investor choice may lead to high-pressure sales tactics from sectors of the finance industry. ASIC says it will act against anyone who coerces investors into switching funds for the sake of a commission. Such controversies could give the industry a bad reputation.

*Should industry participants be taking steps to prevent any negative sway in public opinion?*

### Focusing on motivation

Understanding the motivation for change could be a key issue when targeting consumers. As can be seen from the case studies, gender, age, socio-economic status, and even location appear to have had different levels of impact on motivating consumers' decisions to exercise their choice. Research provided by ASFA seems to reinforce this, since the likelihood of respondents to their survey switching funds varied according to gender, age, income and their current type of fund.<sup>39</sup>

*Do Trustees need to focus more on these varied motivations for change?*

### Costs

The costs associated with choice need to be considered in terms of the payback to the individual. These include administration costs, compliance/legal, systems, advertising/education, increased employer costs and resourcing.

*What is the real financial benefit given the inverse relationship between number of choices versus number exercising choice?*

### Timing mismatch

Consumers make decisions about their superannuation based on current and historical price and performance information. However, these decisions can have long term consequences, since they usually cannot access their superannuation assets until retirement. This often results in a timing mismatch, since they are unable to predict future investment performance.

*Could this timing mismatch have a detrimental impact on investment decisions? Is there any way of mitigating this?*

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<sup>39</sup> Clare, R., (2005), "Implications of Choice of Superannuation Fund Legislations for Members, Employers and Funds", The Association of Superannuation Funds of Australia Limited (ASFA), February 2005, Pg. 32.

# Appendix 1

Characteristic	Australian Electricity Industry	Australian Telecommunication Industry	UK Pension Sector	Australian Superannuation Industry
	Industry	Industry		
<b>Market</b>				
Size	Large	Large (4% of GDP)	Large	Large
Growth	Moderate (4% p.a.)	High (10% p.a.)	Moderate	High
Number of players prior/after reform	Few/Many	1/Over 100	Many	Many
Regulation prior/after reform	High/Moderate	High/Moderate	High/Low	High/High
Barriers to entry prior/after reform	High/Moderate	High/Low	Low	High/High
<b>Product</b>				
Homogeneity	High	Low	Low	Low, but appearance of being high
Complexity	Moderate	High	Very high	High
Substitutes	None	Few	Few	Few
Elasticity of demand	Fairly inelastic	Inelastic for fixed phones Very elastic for mobiles	Quite elastic	Inelastic for involuntary contributions Very elastic for voluntary contributions
% of total income	Moderate	Moderate	Moderate	High
Room for innovation	Low	High	High	High
Perceived risks of switching products	Low	Moderate	High	High
Perceived benefits of switching products	Moderate	Moderate	Low	Low
Ease of switching products	Easy	Moderate	Moderate	Moderate
<b>Customers</b>				
Type	Wholesale and Retail	Wholesale and Retail	Retail and Planner	Retail and Planner
Frequency of finding providers	Infrequent	Moderate	Infrequent	Infrequent
Other				
Role of 3 <sup>rd</sup> party intermediaries	None	None	Strong (i.e. Financial planners)	Strong (i.e. Financial planners)

## Authors Note

### **Brindha Gunasingham**

**CFA, MA Cantab, MSc (Econ) Lon, BA Hons Cantab**

Brindha is the founder and Principal of FitzBiz Investment Analysis & Strategy. She has a wealth of global expertise and intellectual capabilities obtained from over 10 years experience in the investment and finance industry. She has significant experience in economic and financial research. She was formerly the Global Head of Research of Private Capital at AMP Henderson Global Investors and prior to that was the Australasian Head of Research at PricewaterhouseCoopers Financial Advisory Services. She is currently a Director of the Sydney Society of Financial Analysts, and a Committee Member of the Economics Society of Australia, NSW Branch. Brindha is a Chartered Financial Analyst (CFA) charterholder. She holds a Master of Arts Degree and a Bachelor of Arts Honours Degree in Economics from the University of Cambridge, and a Master of Science Degree in Economics (with special reference to the Asia Pacific Region) from the University of London. She is currently undertaking her doctoral studies in econometrics and finance at the Australian Graduate School of Management.

### **John Zavone**

**BEC (Actuarial), FIAA**

John Zavone is a Senior Portfolio Manager at AMP Capital Investors. John has over 10 years experience in the finance industry, with a background in derivatives, equity fund management, market research and actuarial analysis. He has been a portfolio manager at AMP Capital Investors for over seven years. Currently, he is a senior portfolio manager on the Structured Products Team, which provides tailored investment solutions to institutional and retail investors. Previously, he was a key member of the Active Quant Team, a style of active equities management that exploits market inefficiencies arising through the behavioural biases of investors. Qualified as a Fellow of The Institute of Actuaries of Australia, John's roles prior to AMP Capital Investors were in AMP's consulting services to large superannuation funds.

## FitzBiz Investment Analysis & Strategy

FitzBiz Investment Analysis & Strategy is a consulting business for the investment and finance industry. We are committed to working with our clients to invigorate their investment performance and increase their operating efficiency through our use of innovative research and financial engineering. We apply the latest techniques in research and quantitative methods so clients benefit from well researched, innovative and original investment analysis. As independent consultants, we work closely with clients to provide creative and objective strategic solutions that are suited to their specific needs.

Further details are available from our website, [www.fitzbiz.com.au](http://www.fitzbiz.com.au), or by contacting us using the following details:

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