SUPER FUTURE FOR FLUSH FUNDS

THE PROBLEM: HOW TO SPEND $600 BILLION

by JEAN BRUNEL

Changes to Australia's superannuation legislation have focused attention on the huge pool of investment funds that will be available in the year 2000. A speculative view about where the money might go.

Treasury expects assets held by superannuation funds in Australia to grow six-fold to about $600 billion by the year 2000. My purpose here is not to debate that amount, but to place it in a long-term perspective and to assess whether this sum can be accommodated by the capital markets.

In interpreting the possible implications of the recent changes in superannuation legislation which gave rise to that $600 billion estimate, I have been drawn to four possibly surprising, although simple, hypotheses.

- The announced changes will not lead to an acceleration in the growth of superannuation funds over the next 10 years; they will merely allow the industry to sustain the high growth rates experienced in the past decade.
- The changes will lead to only a minor structural change in asset allocation, mainly by reducing holdings in liquid assets and raising commitments to equities.
- There should not be a significant impact on any capital market with the notable exception of the domestic bond market, which would not seem likely to be able to accommodate the needs of the industry in the year 2000.
- Superannuation fund trustees will be playing a more active role in the formulation of investment policy, leading to changes in the way in which investment managers handle the funds in their care.

It is next to impossible to get a proper handle on the current value of assets held by superannuation funds in Australia. The current pool is estimated to amount to about $105 billion. Using asset allocation data provided for the major managers by the leading consultants, we can estimate that the pool would be invested approximately as follows:

Liquids and bonds	$15 billion
Domestic bonds	$25 billion
Domestic shares	$30 billion
Domestic property	$15 billion
Overseas assets	$20 billion

At certain times, investment managers feel somewhat constrained by the size of the capital markets in which they invest. However, it is fair to say that currently, markets can readily accommodate the funds which we need to handle. The following estimates place the industry's holdings in the context of the markets in which they are invested:

Liquids: The Reserve Bank of Australia estimates that broad money amounts to about $240 billion. This is a good proxy for the size of the domestic cash market.

Bonds: Dominguez Barry Samuel Montagu defines the bond market to include all government bonds plus bellwether semi-government stock on issue and estimates that to total about $60 billion. One could argue that the total is in fact closer to $80 billion, as a number of large institutional investors,

Jean Brunel is managing director of J.P. Morgan Investment Management Australia. This is an edited version of his address to an SIA superannuation seminar in September 1989.

principally life offices, are prepared to hold fixed-interest securities beyond this narrow, marketable semi-government universe.

Shares: The total current capitalisation of the Australian sharemarket is about $180 billion.

Property: The total investable property market in Australia probably amounts to about $500 billion. Lend Lease estimates that new annual building commitments average about $20 billion (1988/89 amounted to $37 billion). One can arrive at a market size by assuming that the average building has a life of about 25 years.

Overseas: Morgan Stanley Capital International estimates that the capitalisation of the world's sharemarkets amounts to about $11 trillion). Including international bonds, the total overseas markets exceed A$20 trillion.

Growth prospects

The Treasury forecast of $600 billion in superannuation funds by the year 2000 equates to an annual compound growth rate of about 16 per cent. This increase is little different from that of the past 10 years, when assets held by superannuation funds and life offices grew by a bit more than 17 per cent.

This leads me to my first conclusion.

Let us not overstate the market impact of the policy changes. In fact, they amount to maintaining in the future conditions which have prevailed in the past. At best, they have delayed the onset of industry maturity, and allowed us a still very healthy real growth for the next 10 years.

This should not be surprising. The Treasurer's objective was not to improve superannuation benefits to those who were already getting them; it was to extend superannuation to those who did not already have access to it. This amounts to helping an industry which was rapidly maturing to regain real growth potential.

Will the changes announced by the Treasurer lead to changes in the mix of assets held by superannuation funds in the year 2000? The change most likely to have an impact on investment policy is the move to make pensions more attractive than lump-sum payments. This carries two significant investment implications:

- For as long as bond rates are higher in real terms than nominal growth in the economy, pension liabilities can be effectively "pseudo-immunised", a jargon term which means that they would be most effectively funded, on a risk-adjusted basis, by fixed-income-dominated portfolios.
- If real bond rates are not sufficiently high, then a balanced approach is the only one to make sense in the long term.

In a nutshell, these policy changes should lead to only very marginal investment policy variations.

A number of fund sponsors may still opt to give their managers relatively unstructured investment mandates. However, the fact that pensions create liability streams beyond the employed life of the member will logically lead the average fund to formulate its investment policies in more specific terms. This would very much fit with the trends observed over time around the world.

Both sets of circumstances produce investment scenarios which diverge from current practices, although the divergence will be felt more in the way assets are managed over the long term rather than in the asset classes within which they are deployed.

However, government bonds should increasingly be seen to have structural merits, as they serve a very useful diversification or risk-reduction role in any portfolio. Correspondingly, liquids should have a reduced role, as their purpose is limited to providing funds with the liquidity to service operational requirements.

A greater focus on longer-term objectives may lead to a gradually rising structural commitment to equities, once the current real rate opportunities in fixed income have been exhausted. Domestic shares, property and overseas assets should be expected to generate superior long-term returns, although at the cost of higher short-term risk. The greater focus on the long term should work to reduce the focus on short-term risk.

This leads to my second conclusion. In a nutshell, these policy changes should lead to only very marginal investment policy variations. At first, there could be a gradual move towards higher exposures to domestic fixed-income assets, which would persist for as long as substantial real rates of return are available on long bonds. Beyond that relatively short-term horizon, one might see a gradual increase in equity holdings.

On balance, one would expect the $600 billion in superannuation funds in the year 2000 to be deployed as follows, *assuming no capacity limit in capital markets:*

Liquids	$30 billion
Bonds	$160 billion
Domestic shares	$190 billion
Domestic property	$90 billion
Overseas assets	$130 billion

Investment markets

Having generated a broad estimate of how funds ought to be deployed, the next logical step is to estimate the potential size of the investment universe available to superannuation funds in the year 2000.

It should be said that predicting the sizes of world capital markets in 10 years' time is at best an imprecise effort. The least imprecise way of going about it must be to try to relate the size of each of these markets to some broad measure of economic activity.

Liquids: Over time, broad money rises more-or-less in line with nominal GDP. Over the past 10 years, broad money has averaged 13.7 per cent annual compound growth, while nominal GDP has averaged 12 per cent. J. P. Morgan estimates that real GDP growth should average about 2.5 per cent over the next 10 years or so, with inflation averaging about 7.5 per cent. This should lead to nominal GDP growth of about 10 per cent. This translates into a likely $700 billion cash market by the year 2000, assuming that broad money growth does not exceed that of the economy.

Domestic shares: As first-year Economics tells us, the capitalisation of the sharemarket should grow at least as quickly as nominal GDP. Over the past 10 years, the capitalisation of the Australian sharemarket has grown by a compound average 18.5 per cent per annum, against an average 12 per cent growth in nominal GDP. For the sake of conservatism, let us assume that the capitalisation of the sharemarket does not grow by more than nominal GDP over the next 10 years. In this context, the Australian sharemarket should still be worth more than $500 billion by the year 2000.

Property: Property has tended to grow at least as fast as real GDP as infrastructure is built to serve the needs of the nation. Over the past 10 years, the national accounts suggest that property has grown 15.3 per cent in nominal terms compared with 12 per cent for nominal GDP. Again, assuming for the sake of conservatism that property growth only matches broad economic growth, a property market in excess of $1,400 billion is likely.

Overseas: Assuming that the world's nominal GDP will grow by about 7 per cent a year over the period, and assuming that the Australian dollar will gradually depreciate by about 2 per cent a year against its trade-weighted index (to reflect relative inflation differentials) leads us to estimating that our overseas investment universe will exceed $50,000 billion by the year 2000.

Domestic bonds: I have left bonds for last because they are the one area where we do have a potential problem. While there is no reason to believe that semi-government debt will decline over the next 10 years, there is every reason to believe that, at best, the supply of domestic commonwealth bonds will not expand. This would leave us with a domestic bond market amounting in the year 2000 to, at most, $225 billion, assuming that semi-government offshore debt is brought onshore and that no new issuers of domestic fixed-income paper emerge.

Comparing the typical investment portfolio which we foresee for the superannuation fund industry as a whole in 2000 with the likely individual market sizes leads to some very instructive figures:

	Desired position	Total market size
	($ billion)	
Liquids	30	700
Bonds	160	225
Domestic shares	190	500
Domestic property	90	1,400
Overseas assets	130	50,000

This leads to my third major prediction: with the clear exception of domestic fixed-income assets, the changes announced by the Treasurer should not put undue pressure on any capital market currently included in the investments of the typical superannuation fund. While the industry will become a more substantial proportional holder of domestic shares, the implicit 38 per cent ownership share by the year 2000 is well within the norms observed overseas.

Alternatives for the domestic bond market

While it is beyond the scope of this paper to discuss in depth the likely developments in the bond market, it is instructive to consider the issue at least superficially. Indeed, unless alternative fixed-income investment vehicles develop, the investment strategy outlined earlier would not be feasible. One would have to deploy assets in a different manner, with possibly significant implications.

Three choices can be considered which would lead to the bond market expanding sufficiently to meet the investment needs of superannuation funds:

- fiscal and monetary policy settings are significantly altered over the next 10 years, resulting in renewed deficit spending;
- offshore debt (commonwealth and semi-government) is brought onshore;
- the corporate bond market foreshadowed by the Treasurer develops very rapidly.

While it would be naive to assume that federal budgets will forever be in surplus, it is clear that massive deficit spending is an option which the government would undertake only to counter a cyclical economic slowdown. In that context, it is fair to assume that the total amount of government bonds outstanding will not rise, and thus that the need for fixed-income securities by superannuation funds will not be met by government paper.

While the government is determined to ensure that all of Australia's offshore debt is private, rather than public, it does not seem likely that the government would be able to reduce offshore borrowings by more than the mere $9 billion accounted for by the commonwealth. This would seem to make it unlikely that the gradual redemption of long commonwealth bonds could be offset by repatriation of offshore debt.

The only feasible alternative thus seems to be the corporate bond market which the government is thinking of promoting. This would make eminent sense both in economic terms, because lower interest rates will attract corporate borrowers which have hitherto been "crowded out" by the government, and because the gradual shrinkage of the government bond market will compel the government to create new tools to manage the day-to-day liquidity in the system. The key issue, however, is whether the market will develop sufficiently rapidly to meet the needs of the superannuation industry.

If these needs are not met, one might foresee a number of possible investment avenues, each of which has potential problems:

- Increased equity exposure: higher return volatility.
- Increased short-term fixed-income exposure: lower real return potential.
- Increased offshore exposure: potential currency impact and political interference.
- Offshore bonds hedged into Australian dollars: different diversification characteristics against domestic assets.
- Increased property exposure: need for more efficient securitisation of domestic property. □

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