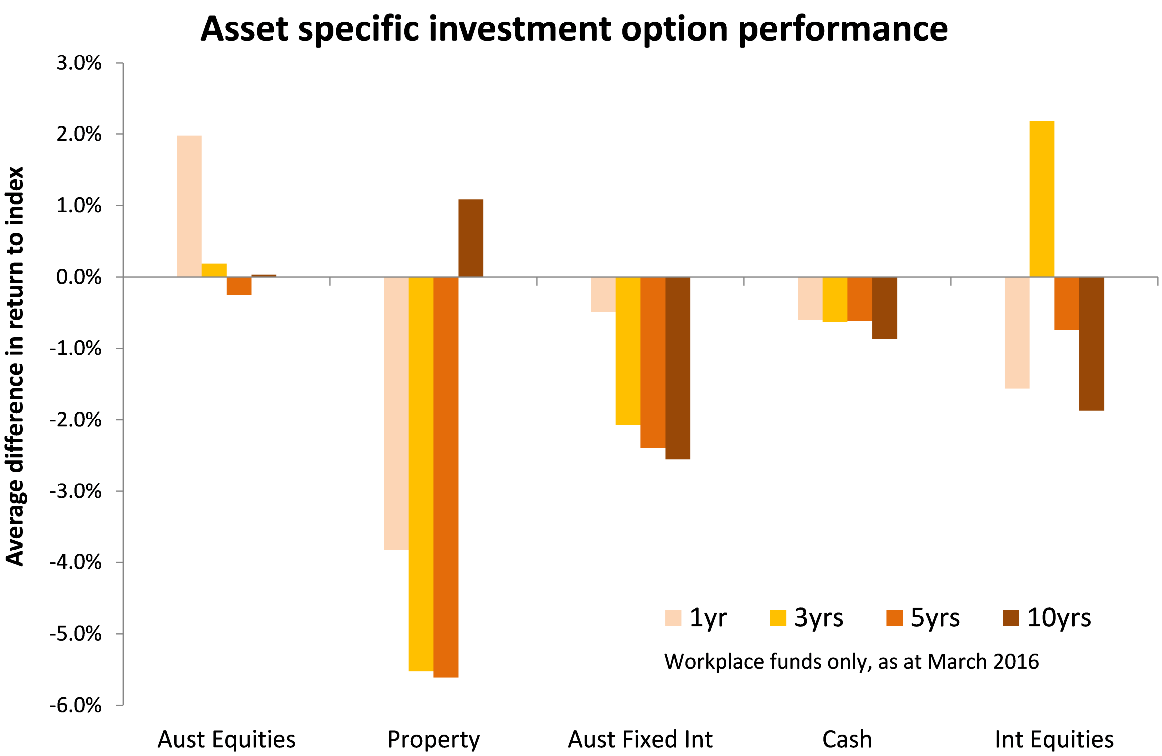
Scale anomaly – cash and fixed income performance by large superannuation funds

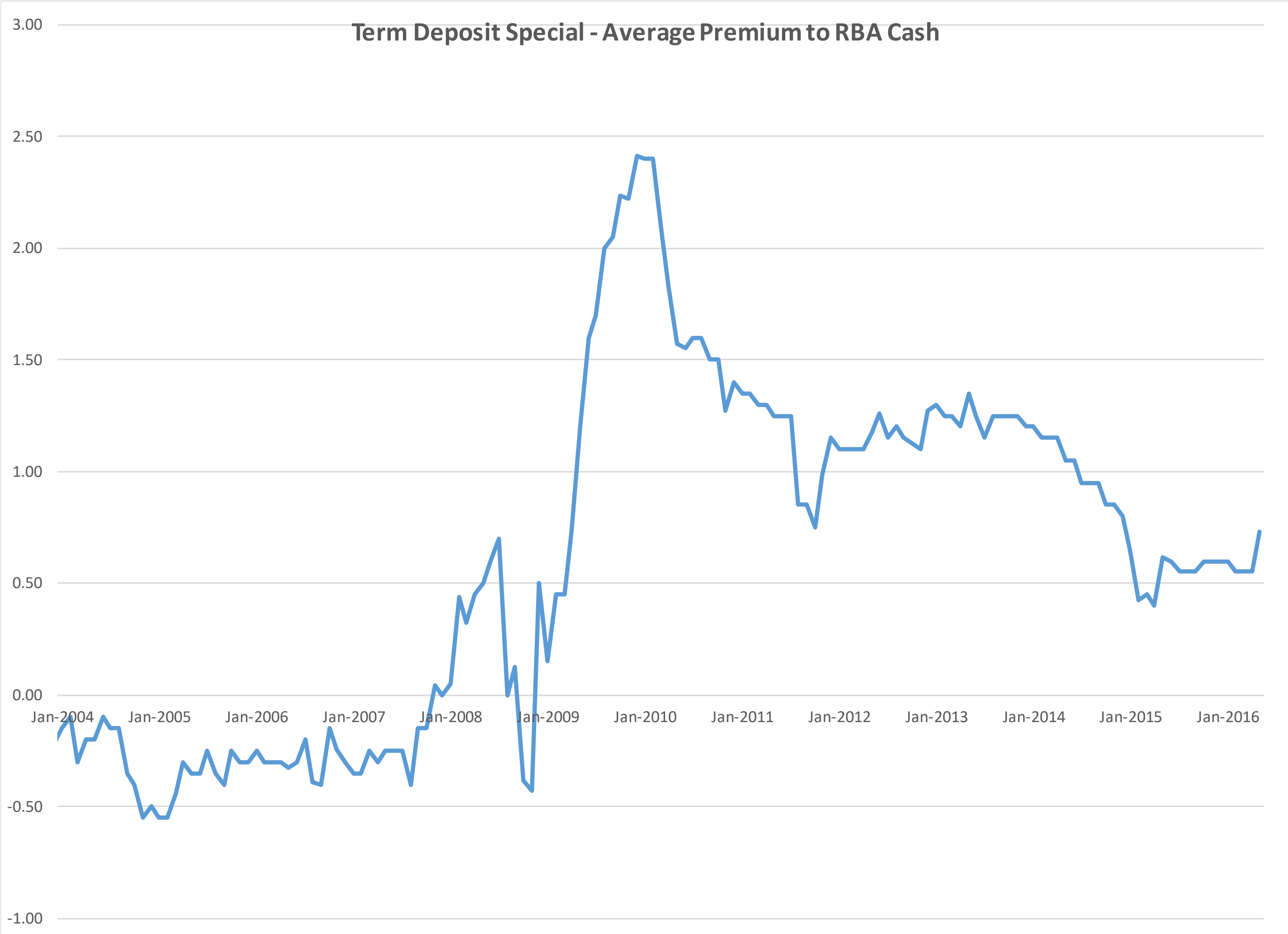
One of the axioms of the superannuation industry is that bigger is better – that larger investors will be able to drive higher returns through scale, internalisation and lower costs. While there is some evidence of this at a whole of fund level – this doesn't seem to flow through to performance for cash and fixed income for large funds.

The chart below compares the performance of single asset class options for workplace funds in the Rainmaker database to benchmarks for each asset class. This gives a crude measure of outperformance. While choice of benchmark and currency hedging are likely to be significant factors in the apparent underperformance for the property and international equities sectors – the interesting asset classes in our view are cash and Australian fixed income. In both these asset classes, where the Bloomberg Bank Bill Index and the Bloomberg Composite Bond Index are the almost universally accepted benchmarks, large superannuation funds have consistently and persistently underperformed the benchmark on a net of fees basis.



Source: http://www.financialstandard.com.au/news/view/82968660?related=83882375

Against this, at the opposite end of the fund-size spectrum, self managed superannuation funds largely rely on term deposits for their cash and fixed income portfolios. The chart below shows the average premium – over official cash rates – for term deposit 'specials' from the five largest Australian banks. This shows that a SMSF – by careful selection of term deposits – could have outperformed cash by a percentage point on average over the last five years. For those willing to deal with smaller banks and credit unions – the outperformance would be even larger.



How is this possible? If term deposit rates are so good – why aren't large superannuation funds investing in them as well.

The answer to this is that large superannuation funds are investing in term deposits – but the rates they are offered are lower than those available for small investors. That is, large investors get worse rates.

This arises because bank capital adequacy rules have been changed post-GFC to include a concept called "net stable funding". This rewards banks that source more of their funding from 'sticky' funding sources such as retail term deposits and penalise banks that are reliant on wholesale funding or large term deposits. Under this construct, banks are willing to pay a premium for retail term deposits that attract this more favourable regulatory treatment.

This is a premium that only small investors can tap into.

Does this mean there is something fundamentally different about cash and fixed income investments and that there aren't advantages from being large.

No not at all.

There are substantial advantages in returns, costs and risk of being a large player in Australia's cash and fixed income markets – just look at the profitability of the big 4 banks – but for large superannuation funds to tap into these benefits they will need to start thinking more like a bank and get directly involved.