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## **Equitable Distribution of Investment Earnings in Collective Investments**

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## **1. Introduction**

### **1.1. Our Brief**

Rice Walker Actuaries has been sponsored by Investment and Financial Services Association Limited (“IFSA”) to prepare this report. We have been requested to consider the equity of current practices that are followed in determining the investment earnings that are added to the accounts of superannuation and non-superannuation investors under collective (pooled) arrangements.

We comment on the range and equity of the different practices in operation and give examples to show where members can be disadvantaged.

### **1.2. Regulatory Issues**

APRA and ASIC are concerned at the quality of allocation of investment earnings. Several reputable financial institutions have been penalised for incorrect allocation of earnings to member accounts.

The key matters of concern rest around:

- Using historic values for assets (which may be incorrect);
- Valuing illiquid assets;
- Application of buy/sell spreads;
- “hard” and “soft” unit pricing; and
- frequency of calculation of earning rates.

There are also problems with allocation of earnings when transactions have to be back-dated due to administrative errors.

## 2. Executive summary

Investment earnings have been added to members' superannuation accounts and non-superannuation investments for over fifty years. However, changes in the capabilities of systems and investors and the transfer of control of superannuation from employers to employees have meant equity between members of superannuation funds and investors has now become very important.

We have reviewed the past and current practices and noted the diverging approaches that have been used. Some practices are not equitable in their administration. We have set out examples to show how members can be disadvantaged in some circumstances. In the simplified example in Appendix A, 30% of the total actual investment earnings of members is allocated to the wrong member of the fund. In Appendix B, although a lower percentage of the total actual investment earnings is misallocated, 37.5% of the actual investment earnings of one member is allocated to other members of the fund.

The potential inequities have been identified by the industry and therefore we have seen the move away from smoothed interest rates to the allocation of actual investment earnings earned during a year. We have also seen the move to setting Crediting Rates on a monthly or weekly basis to minimise the potential misallocation that can occur. However, with the introduction of Choice of Fund and the extensive availability of Choice of Investment within funds, inequities between members and investors will still occur.

Our review of the issues relating to the different approaches that can be used to allocate investment earnings indicates that the approach that minimises the inequities occurring is to determine the value of assets daily and express all investment balances in terms of units based on these daily valuations.

Having regard to this conclusion we make the following recommendations:

- As there are a number of financial and business issues involved with unit pricing, industry standards should be established to ensure good practice. All organisations which base the allocation of investment earnings on unit pricing should be required to disclose whether or not they comply with these industry standards. We note that IFSA has commenced this process by establishing standards with respect to Scheme Pricing (IFSA Standard No.8.00) and the valuation of Scheme assets and liabilities (IFSA Standard No. 9.00). We also note that IFSA has established guidance on what guidelines fund managers should follow if investors are disadvantaged by incorrect calculations relating to unit pricing (IFSA Guidance Note No. 4.00).
- All public offer superannuation funds and all superannuation funds that act as default funds should be required to allocate investment earnings to accumulation accounts using the daily unit pricing approach or an approach that produces comparable results if they wish to accept new members. This requirement should be subject to a transitional period for any existing fund to enable the appropriate changes in administration systems to be made. We believe that it would be reasonable to require this change to be implemented on or before 1 July 2007.
- All superannuation funds should be required to set out in detail the way that investment earnings are allocated to accumulation accounts. This information should include information on the method used to allocate investment earnings to amounts being transferred in and out of the fund. The information should be sufficient to enable a person to understand any differences between the investment earnings generated by their contributions and the investment earnings allocated to their accounts. The information should also be sufficient to enable a person considering transferring from one fund to another to assess the impact of changing the method of allocating investment earnings.
- All advisers who provide advice to individuals on transferring members' entitlements from one superannuation fund to another should be required to consider the impact of the method used to

allocate investment earnings in the existing fund and the new fund and the impact (if any) of changing the method. It is important that this aspect of the advice be highlighted as it may affect the individual's expectations of the investment earnings obtained in the new fund. It may also impact on the comparison of the investment earnings that will be obtained from the existing fund and new fund in the future.

- All organisations (including government bodies such as APRA and ASIC) that provide general information on the analysis and selection of investment and superannuation vehicles should ensure that the material highlights the need to consider the approach used to allocate investment earnings as part of this process.
- Given the possibility that errors will occur when daily unit pricing is used to allocate investment earnings, all organisations using daily unit pricing be required to have a minimum capital requirement or minimum reserve to ensure that the costs of making good can be met without a one-off impact on the current year's investment return.

### **3. History of Collective Investments**

Most of the money held in collective investments resides in superannuation. This segment benefits from compulsory employer contributions and favourable tax treatment.

#### **3.1. Superannuation Pre-1985**

Superannuation for employees of private and public sector employers has existed under pooled arrangements for many years. However, the composition of the funds has changed markedly in recent times. Generally, a separate Trust arrangement with separate investments was established (and this structure is now mandatory, though employers can still “top-up” benefits directly on termination of employment).

Since the introduction of the first superannuation fund, it has been necessary to allocate investment earnings generated by these investments to some, or all, of the benefits accruing for members of these funds. However, the method used to determine the amount of investment earnings allocated to relevant members’ benefits has changed over time, reflecting the changing nature of superannuation, the impact of technology and the improved availability of data within Australia and from around the world.

Early superannuation funds were typically defined benefit funds provided by paternalistic employers which wanted to ensure that their white collar, long service employees could maintain a reasonable standard of living in retirement. These funds provided low benefits on resignation and required a contribution from the employee. The trustees of these funds were usually senior management of the employer. Importantly, companies were not required by law to set up these funds, so they had total control over the rules. They also decided which employees were eligible to participate, and on what terms.

The employer took the investment risk and therefore controlled the investment strategy. It was also not uncommon for the fund to invest in the shares of the sponsoring employer as this gave the employer control over a significant block of company shares through the Trustees.

Resignation benefits often comprised the member’s own contributions with “interest”, which had to be calculated. In this environment, there was little concern about the equitable allocation of investment earnings and member contribution accounts were credited with fixed, low rates of interest. In fact, during this era, it was not uncommon for a superannuation fund to provide no interest at all in the first few years of service.

This approach did improve as the interest added to members’ contributions was changed to reflect the actual investment earnings of the fund. However, as the trustees normally followed a growth orientated investment strategy which created volatile investment returns from year to year, it was common practice to smooth the interest rate added to member contributions. This approach was more equitable as it meant that interest allocated to members’ contributions reflected the actual investment earnings of the fund over the longer term. However, the interest added did not reflect investment earnings for short service employees, particularly during periods when there were significant fluctuations in the investment earnings each year.

Although superannuation was usually only provided for longer service, white collar employees during this period, some employers did provide accumulation style funds for blue collar employees. These funds still required member contributions and only vested employer contributions on retirement or after long periods of service. Again, paternalistic employers controlled the trustees and typically used investment reserves to smooth out fluctuating investment returns.

### 3.2. Compulsory Superannuation

With the introduction of award and then Superannuation Guarantee superannuation obligations over the last twenty years, the superannuation landscape changed. Superannuation is now provided for almost all employees, employer contributions are fully vested immediately and superannuation has moved from being an employee benefit provided by a benevolent employer to deferred pay provided in accordance with legally binding industrial requirements.

Initially, under this new environment, Trustee Boards still took a paternalistic view of their obligations and the investment returns allocated to member and employer contributions in accumulation funds were still smoothed using investment fluctuation reserves. Trustee Boards believed that members of their funds were best served by having growth orientated investment strategies. Equity between different groups of members was seen to be of secondary importance to the ability to provide good, long term investment returns. This view was particularly relevant for industry based award funds where members would remain in the same industry fund even though they may move from one employer to another.

However, over the last decade, far greater control of the operation of superannuation funds has been imposed by Federal governments through legislation. This legislation has changed the way Trustee Boards approach the allocation of investment returns to member accounts. Three of the changes introduced by this legislation had a fundamental impact on the relationship between members and their superannuation fund:

- Investment earnings allocated to members' accounts have to be based on the investment earnings of the assets supporting those accounts;
- Members have half of the directors of Trustee Boards (either through elections or, in the case of industry funds, through representation by union appointments); and
- There are minimum standards relating the material that had to be communicated to members.

These changes meant that members have become much more involved and aware of the investment strategies of their fund, the investment returns achieved by their fund and the investment returns allocated to members' accounts.

The gradual increase of Superannuation Guarantee contributions to 9% by 2002 and the introduction of member investment choice over the last decade also significantly changed the attitude of employers and Trustee Boards. Increasingly, employers limited their contributions to 9% thereby reinforcing employees' expectations that superannuation was now purely deferred pay and they should have complete control over how their superannuation accounts should be invested. Trustee Boards responded to this change by giving members a range of different investment choices, each with different risk/return characteristics.

Where members could move their accounts between different investment options, Trustee Boards became much more concerned about equity between different members, particularly in respect of the allocation of investment returns. Where a fund offered members a choice of investment strategy, Trustee Boards eliminated investment fluctuation reserves and allocated the actual investment earnings generated in each year to members in that year.

During this period many employers also reconsidered the relevance of defined benefit funds and closed them to new entrants or converted them to accumulation funds.

With continuing defined benefit funds (open or closed to new entrants) the importance of investment returns varies and is dependent on the way that the Superannuation Guarantee minimum benefit

obligations are met. However, regardless of whether this obligation is met by minimum defined benefits or accumulation benefits, the continued emphasis on the defined benefit has meant that there has been little change in approach to the allocation of investment earnings for these funds.

Recent changes to the regulatory environment have also reinforced the importance of investment aspects of superannuation and the equity amongst members. Parts of a Trustee Board's obligations have been transferred from SIS to the Corporations Act. We are therefore now in an environment where ASIC, and not APRA, is responsible for controlling the content and quality of the material provided to members. This has also reinforced the change of superannuation from benefit provided by employers to an investment available to employees and, as such, subject to the same disclosure and protection as other investments available to employees.

The final change that has impacted on the Trustee Board's attitude to equity between members in relation to the allocation of investment earnings is the introduction of Choice of Fund from 1 July 2005. Under this new regime, most employees will take responsibility for not only the investment strategy used but which fund is used to implement this strategy. Although there will be some limitations on the frequency with which a member can transfer their balances, it will mean that members of superannuation funds will be able to move their account balances on a regular basis. Equity between members in relation to the allocation of investment returns has now become very important. It will be vital that the investment earnings that are allocated to members' accounts properly reflect the actual investment earnings of the investments that support those accounts.

### **3.3. Choice of Superannuation Fund**

Many employees will have the right to choose the fund to which their employer will contribute their Superannuation Guarantee superannuation contributions from 1 July 2005. These employees will also have the right to transfer their entitlements in their existing fund to a fund of their choice in the following year. In this new environment, the extent to which monies are transferred from one superannuation fund to another can be expected to increase significantly.

The introduction of Choice of Fund is the culmination of a long journey over the last twenty years for members of superannuation funds. Before the introduction of Choice of Fund if an employee was a member of a superannuation fund, he (or sometimes, she) would have little, if any, involvement in, or control over, the investments supporting their benefits. Many members of superannuation funds can now be expected to take control of the investment strategy they employ for their superannuation balances and change their strategy when they believe it is appropriate.

The transfer of control from employers to members has meant that the equitable distribution of investment earnings between continuing members, new members and terminating members is now extremely important.

Also, we have seen significant improvements in the technology available to investors over the last five years. It is instructive to consider that the first electronic calculators were only introduced into commerce in the early seventies and the first elementary computers in the eighties. The exponential increase in computational power, coupled with the significant increase in the amount of information available, has meant that investors have become much more sophisticated. Therefore, investors are able, and willing, to take any advantage of situations where the investment earnings allocated to an investment vehicle become disconnected from the actual investment earnings achieved on the investments underlying that investment vehicle. This development has also meant that the equitable distribution of investment earnings between continuing investors, new investors and terminating investors in the non-superannuation environment is also critical.

### 3.4. Non-superannuation Investments

Until the 1970's, non-superannuation investments largely comprised of whole of life and endowment life insurance policies. Under these products, the "investment earnings" were allocated by allocating reversionary bonuses which were only payable when the policy matured. Policy holders had virtually no information on the investments backing their policy or the investment earnings on those investments.

Bonus rates were determined by the Life Company's Actuary who actively smoothed out the impact of fluctuations in the investment earnings across policy holders, both current and future. Policy holders, who terminated their policy prior to maturity, particularly after short periods, were paid surrender values that imposed significant termination penalties. On maturity, policies received terminal bonuses to reflect capital gains over the term of the policy.

Merchant banks entered into the investment market from the late 1960's and offered investment products offered through "unit trusts". The unit values reflected the actual value of the investments in the trust. Although this provided a significant improvement in transparency and equity, unit prices tended to be determined monthly and some inequity remained.

A development from the 1980's was the establishment of master trusts, and from the late 1990's, Wrap Accounts. These vehicles allow investors to purchase multiple investments through a common administration platform. A change in investments requires a "switch" rather than a sale and purchase. Due to the high volume of transactions and the potential for arbitrage, these products all utilise daily unit pricing.

Sophisticated investors with access to powerful computing power and immediate access to information are able to take advantage of anomalies between investment earnings allocated to investors and the actual investment earnings obtained on their underlying investments. Therefore, non-superannuation investment vehicles have moved to daily unit pricing to ensure that these anomalies no longer exist.

### 3.5. Current position

Although there are many sources of information on the size of the superannuation and non-superannuation investment market in Australia, this information does not generally provide information for only unitized funds. However, the table below taken from a report by the Australian Bureau of Statistics (ABS Managed Funds, Australia, December 2004 -5655.0) shows that substantial assets are held in superannuation funds. Recent estimates indicate that although most of the non-superannuation fund assets are unitized, approximately 50% of the assets in superannuation funds are not unitized.

#### DECEMBER KEY FIGURES

Consolidated Assets	Dec Qtr 2003 \$m	Sep Qtr 2004 \$m	Dec Qtr 2004 \$m
Superannuation funds	342,903	389,576	412,998
Life insurance offices(a)	167,211	176,616	184,106
Other managed funds	192,388	205,991	216,805
<b>Total</b>	<b>702,502</b>	<b>772,183</b>	<b>813,910</b>

(a) Investments by superannuation funds which are held and administered by life insurance offices are included under life insurance offices.

The table does not provide any insight into whether the superannuation funds are open to new members or what type of crediting rate approach is used. However, it is clear that the investment earnings allocated to a significant proportion of the superannuation fund assets may be affected by the issues considered in this report.

## **4. Allocation Practices**

### **4.1. Smoothed Credit Rates**

With defined benefit funds, it is still the common practice to smooth the investment earnings allocated to members' contributions (and SG minimum benefits, if appropriate) over a period of years, typically 3 years. As employers still underwrite the investment risk with respect to the defined benefits, these funds normally have a growth orientated investment strategy with associated fluctuating investment returns. Smoothed crediting rates are considered to be acceptable, notwithstanding the inequities between members, as the emphasis is on the final defined retirement benefit.

Accumulation funds, or accumulation sections of defined benefit funds, without member investment choice will still also retain investment fluctuation reserves and smooth investment returns over a period of years.

Interest is added to the accounts of members who are in force at the end of each fund year by applying the smoothed interest rate to the members' average account balance during the year. Interest is added to the accounts of members who terminate during the year at an interim interest rate that is a conservative estimate of the smoothed rate that is expected to be declared for the current year.

### **4.2. Annual Crediting Rate**

A common approach used in the past, particularly in stand-alone superannuation funds, was for a rate of interest to be declared at the end of each financial year for the fund that would apply to all members who were in force at the end of the financial year. This "Crediting Rate" would be applied to the opening account balance and contributions during year, either based on the assumption that the contributions occurred uniformly over the year (or since entry), or monthly contributions occurred at some point each month.

Members who terminated during a year would have interest added to their accounts at an "Interim Crediting Rate" which would be a conservative estimate of the expected Crediting Rate for the financial year.

### **4.3. Monthly Crediting Rates**

As the number of funds offering members a choice of the investment strategy has increased, equity between members has become more and more important. Accordingly, the period for which the Crediting Rate applied has been progressively reduced until the Crediting Rate would be calculated for a month or even a week. Interest is added to members' accounts in a similar way to Annual Crediting Rate approach, but using the monthly or weekly period.

### **4.4. Daily Crediting Rates**

As the need for equity between members in relation to the allocation of investment returns has increased, we have seen the reduction in the period for which interest rates are declared. The ultimate result of this reduction in period is the allocation of interest on a daily basis. Under this approach, the investments are unitised and the value of the unit determined each day. An important difference with this approach is that a daily interest rate is not declared. Rather, contributions made by a member are used to purchase units in the fund based on the value of the unit at the time that the contribution is received. Therefore, the value of a member's interest in the fund is the value of these units each day.

## 5. Weaknesses of the Crediting Rate Approach

The Crediting Rate approach has the advantage that it is simple to calculate and administer. However, the approach can lead to significant inequities between members where members can choose their investment strategy and move from one strategy to another and from one fund to another. These inequities can best be demonstrated by considering the hypothetical examples described in Appendices A and B.

### 5.1. The Impact of Misallocation

Under the Crediting Rate approach the interest rate for the relevant period is normally calculated by determining the asset weighted investment return for the period based on the value of assets at the end and beginning of the period, the cash flow and investment earnings during the period.

Where the underlying assets have values that fluctuate significantly on a daily basis (e.g. shares), any Crediting Rate based on average returns over a longer period than one day can cause the misallocation of investment returns amongst members.

It can be seen from the hypothetical examples in Appendices A and B that Crediting Rates that are based on average returns over twelve month periods will lead to significant misallocation.

In Appendix A, four superannuation fund members are considered during the 2000 calendar year.

Member A has \$40,000 invested at the beginning of the year and has contributions (net of fees and taxes) of \$300 per month contributed to the fund.

Member B joins the fund at the beginning of the year, has contributions (net of fees and taxes) of \$300 per month contributed to the fund and transfers \$40,000 to the fund at the end of February.

Member C joins the fund at 1 July, has contributions (net of fees and taxes) of \$300 per month contributed to the fund during the last six months of the year and transfers \$40,000 to the fund at the end of August.

Member D joins the fund at the beginning of the year, transfers \$40,000 to the fund at the end of February and has contributions (net of fees and taxes) of \$300 per month contributed to the fund for the first six months.

The fund is assumed to achieve returns that are based on an investment in Australian shares during this period. The asset weighted annual rate of return for the year is 3.1% pa and we have assumed that this rate is added to all cash flows during the year.

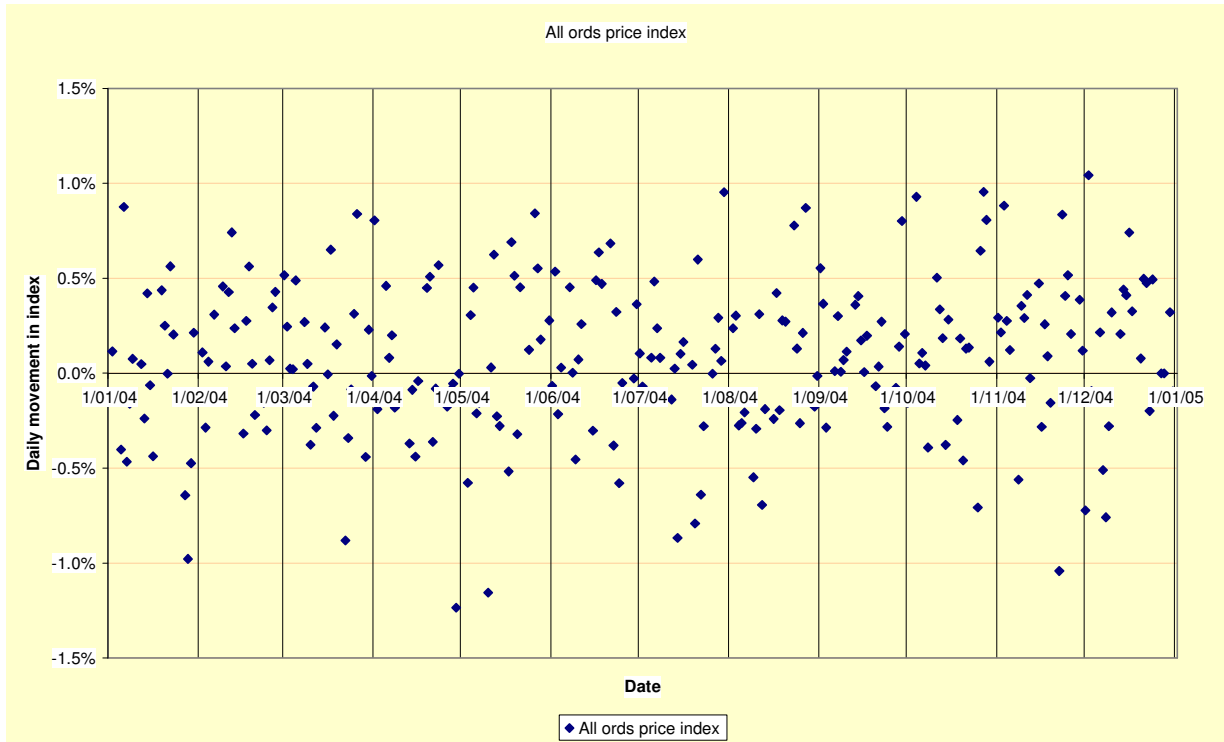
In this example, \$1,154 of total investment earnings of \$3,898 is taken from Members A, B and D and allocated to Member C. In other words, 30% of the total investment earnings are allocated to the wrong member.

In Appendix B we consider the same members, but for the 2004 calendar year.

In this example, \$2,362 of total investment earnings of \$38,502 is taken from Member C and allocated to Members A, B and D. In this example, only 6% of total earnings are misallocated. However, in this case, this misallocation represents 37.5% of the actual investment earnings generated by the assets supporting that member's accounts.

The hypothetical examples demonstrate the potential inequities that will arise if annual Crediting Rates are used. To overcome this problem, funds have reduced the period that the Crediting Rate applies for to shorter periods such as one month. Even with short periods such as this, inequities will occur for investment strategies with wide daily fluctuations in value.

The graph below shows the % change in the All Ordinaries Price Index each day during 2004.



It can be seen from the graph that the daily price movements in the Australian share market can be substantial. Also these movements vary significantly during each month. Even if Crediting Rates only apply for short periods such as one month, the timing of cash flows, particularly cash flows relating to rollovers, will have a significant impact on whether actual investment earnings are allocated amongst members equitably. The variability in daily price movements indicated by the graph would indicate that with investments in Australian shares, the misallocation can still be severe.

These misallocation problems with monthly Crediting Rates can be overcome by investing all cash flow that occurs during any month at the end of each month. This will force the interest credited to a member's account to equal the investment income generated by the assets supporting that account.

However, this approach introduces other issues relating to the interest that any cash flow will need to be credited with from the date of payment until the end of the month. Clearly, if no interest at all is added to the cash flow the member is disadvantaged. Even if the cash flow is invested in a cash investment and interest at the cash rate added to the amount invested at the end of the month, the member is disadvantaged as they have not benefited from being exposed to the investment strategy of their choice from the date the money is received by the fund. As indicated by the size of the monthly investment returns used in the hypothetical examples in Appendices A and B, this could mean that a member is significantly disadvantaged.

The approach also does not overcome the issues for members who transfer their balances during the month.

## 5.2. The Impact of Interim Crediting Rates

One aspect of using Crediting Rates that are calculated in arrears and apply for a specified previous period is that an Interim Crediting Rate will have to be applied to members who transfer their balances before a Crediting Rate has been declared.

The previous approach to this issue was to declare an Interim Crediting Rate that was a very conservative estimate of the Crediting Rate that was expected for the period. This approach may have been acceptable when members were not expected to transfer their balances and therefore it could be argued that terminating members could be treated inequitably as long as continuing members were not disadvantaged.

However, in the new era of Choice of Fund, this position can no longer be taken as it may severely disadvantage members in a Choice of Fund era.

A solution is for the Interim Crediting Rate to be as close as possible to the expected Crediting Rate for the entire period. This approach will itself lead to inequities.

As can be seen from the examples in Appendices A and B, although there is a misallocation of investment earnings amongst members, if all members remain in the fund at the end of the year, the total interest allocated to members' accounts is equal to the total investment earnings of the fund.

The difficulty relating to setting Interim Crediting Rates as best estimates of the expected Crediting Rate for the period is that, particularly with volatile investment strategies, there is a significant risk that the actual investment return from the time the Interim Crediting Rate is declared to the end of the period could result in the actual Crediting Rate for the year to be lower than the Interim Crediting Rate. If this did occur then it would mean that a member who transferred their balances during the year would have interest credited to their account at a higher rate for the period that they were in the fund than if they had retained their balance in the fund until the end of the period. This would be particularly inequitable as part of the investment earnings of continuing members would be paid to a member who had left the fund.

An alternative approach is to set the Interim Crediting Rate at the actual return on the transferring member's accounts from the start of the year to the date of transfer. If this practice is followed, then equity between transferring members and continuing members is guaranteed. However, the practice would be difficult to implement administratively as each transferring member would effectively require a separate calculation for the Interim Crediting Rate. Further, the value of assets would have to be determined daily to enable the actual investment return to be calculated up to the date of transfer. Approximations could be introduced to reduce the administrative burden. For example, the Interim Crediting Rate could be recalculated monthly based on the value of assets at the end of each month. This approach would help to reduce the impact of declaring an Interim Crediting Rate. It does not however eliminate the issue as an Interim Rate will still need to be declared for the current month. This approach is, in fact, basically the same as declaring the actual Crediting Rate each month.

The practice of using Crediting Rates may create inequities between different members. The related practice of using an Interim Crediting Rate creates other inequities. The only way that these inequities can be overcome is to base all transactions on units which are priced daily.

### 5.3. Impact of Smoothing

Trustee Boards declared Smoothed Crediting Rates in the past to minimise the impact of fluctuations in the market values of their fund's assets on members' account balances. Typical smoothing formulae would ensure that, over the long term, members were not significantly disadvantaged by this approach. This approach may have been justifiable where employees were expected to remain with the same employer for most of their working life time. However, today employees expect to have several employers during their career. Therefore, short service employees can be expected to obtain a significant advantage or disadvantage if the actual investment annual returns used in determining the smoothed Crediting Rate fluctuate widely.

Consider, for example, a fund which is invested in the Australian share market and achieves returns (after fees and taxes) equal to the All Ordinaries Accumulation Index. Assume that the Smoothed Crediting Rate is the geometric mean of the actual investment returns of the fund over three years.

If we take the six year period ending 31 December 2004, the actual investment earning rate of the fund would be:

<b>Year ending 31 December</b>	<b>Rate of return %</b>	<b>Smoothed Crediting Rate %</b>
<b>2004</b>	28.0	10.2
<b>2003</b>	14.6	4.9
<b>2002</b>	-8.8	1.9
<b>2001</b>	10.4	
<b>2000</b>	5.2	
<b>1999</b>	16.1	

If a member transferred \$1,000 to the fund on 1 January 2002, this would have increased in value at 31 December 2004 to \$1,338 with the actual investment earnings. However, if the Smoothed Crediting Rate was added to this amount and the member left on 31 December 2004, the gross benefit paid would be \$1,178 - \$160 less than the value of the actual investment supporting this account. The member is paid 53% of the actual investment earnings relating to the \$1,000 transferred to the fund. The \$160 is distributed to the remaining members of the fund.

## 6. Issues with Daily Unit Pricing

We have discussed in Section 4 the misallocation of investment earnings that will occur with the use of a Crediting Rate approach in an environment where investors can choose to move their investments between investment options and investment vehicles.

**We therefore conclude that the only “fair” approach is to value the underlying assets supporting investors’ accounts on a daily basis, determine a unit value at the end of each day and make all account balance transactions in terms of the equivalent number of units.**

However, although this is simple in principle, the implementation of the approach has a number of difficulties. A number of these issues are discussed below.

### 6.1. Administration issues

These issues have been recently addressed in a Joint ASIC and APRA Draft Consultation Paper on “Unit Pricing – A Guide to good practice”. It is not the aim of this Report to consider these issues. However, we note that the Consultation Paper does outline a number of technical issues relating to the calculation of unit prices including the valuation of asset values, determining the impact of tax, the use of reserves and the application of Accounting Standards.

It should, however, be noted that two of these issues have an impact on the equity of daily unit prices.

Firstly, a number of asset classes are not subject to independent daily valuations. For example, direct property investments might only be revalued in accordance with yearly or longer cycles. Infrastructure and private equity funds will often be valued on a subjective basis by the operator of these funds. With daily unit pricing, however, a value has to be placed on these assets. Therefore, the daily unit price may include values that do not represent the true realisable value of some assets. Clearly, the change in unit price needs to be made in line with the underlying growth (or decline) in the value of the investment. If this is not done, investors can enter (or exit) the asset class just before a formal valuation is made.

Secondly, fund-of-fund style investment vehicles have become an important part of the investment options available to investors. With this style of investment vehicle, the daily unit price of the vehicle will depend on receiving the unit prices of the underlying funds. In practice, there may be delays in the provision of the daily unit prices for the underlying funds. Where this occurs, the daily unit price of the principal fund may be based on the unit prices of the underlying funds for earlier dates.

### 6.2. Prudential issues

Our report has considered in detail the need for the investment earnings that are allocated to the accounts of investors to be aligned with the investment earnings realised by the investments backing those accounts. This requirement means that the precision of daily unit pricing is necessary.

It is also important to note that introducing daily unit pricing does not overcome all the difficulties related to ensuring that investors are treated equitably. Investors should reasonably expect the investment earnings that are allocated to their investments be directly related to when they made the investment. However, there are a number of ways in which a delay can occur between when the investor makes an investment and when the investor is allocated units. With superannuation contributions one reason for a delay is the allocation can be delayed while the contributions are reconciled with the total membership. With superannuation rollovers and non superannuation one-off investments, delays can occur between the receipt of the monies and the allocation of units to the investor as the result of inefficient systems or mistakes. It is beyond the scope of this report to consider how these issues should be addressed. However, we suggest that there should be appropriate prudential supervision of all steps in the investment chain to ensure that investors are treated equitably.

### **6.2.1. Computer Systems**

The volume of information and the speed with which this information needs to be processed means that daily unit pricing across all investment vehicles within any organisation requires comprehensive computer systems and processes. These systems need to be fully documented and audited for accuracy and reliability. Independent review of the system would be seen as being desirable and best practice.

Investment markets are continually changing and therefore investment vehicles will invest in new types of securities from time to time. It is vital that the organisation calculating the daily unit prices is committed to updating the system whenever new securities are introduced and has the capital necessary to make and test these changes.

### **6.2.2. Disaster recovery**

Appropriate disaster recovery programs are always essential for any organisation. With daily unit pricing the disaster recovery needs to be comprehensive and virtually instantaneous. One of the advantages of daily unit pricing is that investors can change their investments to reflect their view of future investment markets. This means that where an investor requests a transfer to another investment vehicle with a different risk/return profile it is important that the transfer takes place in accordance with the protocols that were specified in the original contract with the investor. Any delay in making this transfer (and in making the transfer in the underlying assets) may lead to a loss to the investor.

The need for minimal downtime in the case of a disaster means that the organisation calculating the unit pricing should have a disaster recovery program that involves access to a duplicate site in the case of disaster.

### **6.2.3. Oversight and Compliance**

Daily unit pricing is used to ensure equity between investors. It is therefore important that any mistakes that do occur are identified quickly and rectified. This will ensure that extent of any inequity between investors that occurs because of errors is minimised.

Regardless of how sophisticated and comprehensive a computer system is, any daily unit pricing system will still require the involvement of the staff of the organisation calculating the unit prices. This involvement will usually relate to the gathering and inputting of data and the processing of this data according to established procedures. Past experience has clearly demonstrated that human involvement will lead to mistakes being made.

Further, computer systems are designed to handle certain given scenarios. From time to time we can expect that a scenario will occur that the computer system will not handle correctly.

It is important that the organisation's daily unit pricing procedures include oversight during and at the end of the process to maximise the chance that any unit price that has been calculated incorrectly will be identified before it is used in the processing of investors' instructions.

It is also imperative that the organisation calculating the unit prices has a comprehensive and documented compliance program. It is important that the personnel involved in the program are independent of the staff involved in the day to day calculation of the unit prices.

#### **6.2.4. Ability to "make good"**

Notwithstanding the establishment of good systems, oversight and compliance programs, mistakes that lead to some investors receiving more than their fair share of investment earnings will occur. These overpayments will be funded by the underpayment of investment earnings to other investors.

As it is highly unlikely that the overpayments that have been made will be recovered, it is important that there is a process in place to compensate the investors who have been underpaid.

Where the organisation calculating the unit prices has shareholders and generates a profit for these shareholders, then the profit and shareholder capital can be used to finance any compensation. Typically, it will be important to the future of the organisation that the market has confidence in its unit pricing capabilities (and the backing when mistakes are made) so it will be in the shareholders' best interests to finance the compensation.

Where the organisation calculating the unit prices does not have shareholders (or the shareholders do not finance the compensation) the position is much more difficult.

The options exist include:

- To not compensate the investors for the underpayment of investment earnings.
- To make a charge on other investors to make good the under payment. In some circumstances this will not be legal and, even where it was; one would question the equity of charging investors who were not involved in the error.
- If possible, to purchase insurance that would compensate the investor when these errors occurred.
- To have the compensation provided by the Federal Government through an industry financed scheme.

None of these options are very attractive as there will be a cost to some, if not all, investors.

Further, even if insurance could be arranged, it may not be prudent to establish a fund that relies on this protection as experience with other insurance areas has demonstrated that specialised insurance arrangements may become excessively costly or cease to be available.

It may therefore be desirable to consider imposing additional prudential standards on any "not-for-profit" organisation. For example, if these organisations cannot make appropriate arrangements to protect their investors against losses from errors, they could be required to outsource the calculation of unit prices to a third party that does have the ability to pay compensation for any loss that results from errors in the calculation of unit prices. Alternatively, the organisation could be required to establish a reserve funded from retained investment earnings to finance the cost of making good any losses that arise from errors relating to unit pricing mistakes.

## 7. Choice of Fund

### 7.1. The issues

Many members of superannuation funds will be faced with new choices from 1 July 2005 when they are given the freedom to choose where their employer contributes their Superannuation Guarantee contributions. A major consideration for the employees making this choice will be the likely investment return that they will receive from their existing superannuation fund and any new superannuation funds. It is therefore vital that an employee understands the full implications of the policy that the existing and new funds have relating to the transfer of funds and the allocation of investment earnings. The issues that the employee may have to take into account when making their choice are considered below.

#### **7.1.1. *If a Crediting Rate approach is used in the existing fund, what, if any, is the impact of smoothing?***

It is unusual for superannuation funds providing accumulation style benefits to smooth investment earnings across fund years. However, smoothed interest rates may still apply for some members who are provided with defined benefits. Where investment earnings are smoothed across fund years, an employee must consider whether the smoothing approach has effectively held back investment earnings that would normally be released as higher investment earnings in future years. Any potential loss of additional investment earnings should be taken into account when comparing the likely future investment returns that can be expected from existing and future superannuation funds.

Employees will also need to consider whether or not a smoothing formula has allocated higher returns than has actually been earned. This is unlikely for funds providing accumulation style benefits where negative reserves are not permitted. However, with defined benefit funds it is possible for a smoothing formula to result in the allocated investment earnings exceeding the actual investment earnings. Where this occurs one can expect that the future allocated investment earnings will be lower than the actual investment earnings. Again an employee will need to take this into account when considering the expected future investment earnings that will be allocated to their accounts.

#### **7.1.2. *If a Crediting Rate approach is used in the existing fund, does the Interim rate credited up to the date of transfer reflect the actual investment earnings?***

As discussed in Section 5.2 an Interim Crediting Rate will be required to determine the investment earning to be allocated up to the date of transfer. If this Interim Rate is a conservative estimate of the actual investment earnings, a member will need to take into account the loss of investment earnings that will occur if the transfer takes place before the actual Crediting Rate has been declared.

#### **7.1.3. *If a Crediting Rate approach is used in the new fund, will the investment earnings added to the monies transferred to the new fund reflect the actual investment earnings?***

As shown in Section 5.1 the Crediting Rate approach can result in misallocation of investment returns amongst members; particularly for lump sums transfers. A member will need to consider whether the Crediting Rate that will be applied to their initial transfer will properly reflect the actual investment earnings. In this context, the member will also need to consider the date on which their transfer is deemed to commence earning investment earnings. For example, if the transfer is deemed to earn interest from the start of the next month, the member could have lost up to one month's investment earnings.

#### **7.1.4. Opportunity for arbitrage**

As has been highlighted in this report the use of Crediting Rates can mean that investors transferring monies between investment vehicles can be allocated too much or too little investment earnings.

With unsophisticated investors this is unsatisfactory as this gives rise to inequities between investors. The impact of this misallocation is greatest in the year that the money is transferred with the impact on the total investment return reducing if the investor remains with the same investment vehicle for the long term.

However, any disconnection between the investment earnings allocated to an investor and the investment earnings actually earned by that investor may allow the sophisticated investor the opportunity to manipulate their switches between investment vehicles to take advantage of these anomalies. If the investor follows this practice then this can artificially inflate the investor's long term investment return – this extra return being financed by a reduction in return for other investors.

### **7.2. Disclosure**

It can be seen from the issues discussed in Section 7.1 that the method of allocating investment earnings in the existing fund and any new fund may have a significant impact on the effective rate of investment return that a member achieves on their investments. It is therefore very important that there is full and detailed disclosure of the approach that is used. It is also imperative that any person advising a member on the implications of transferring to a new superannuation fund takes into account the impact of these issues as, potentially, a member may be significantly disadvantaged.

## A. Hypothetical Example for the Year Ending 31/12/2000

### A.1. The Model

Consider four individuals (Members A, B, C and D) who were members of a superannuation fund at 31 December 2000.

Member A had \$40,000 in the fund at 31/12/1999 and had contributions (net of tax and fees) of \$300 credited to the fund at the end of each month.

Member B joined the fund on 1/1/2000, had contributions (net of tax and fees) of \$300 credited to the fund at the end of each month and rolled \$40,000 into the fund on 29/2/2000.

Member C joined the fund on 1/7/2000, had contributions (net of tax and fees) of \$300 credited to the fund at the end of each month thereafter and rolled \$40,000 into the fund on 31/8/2000.

Member D joined the fund on 1/1/2000, had contributions (net of tax and fees) of \$300 credited to the fund at the end of each month for the first six months of the year and rolled \$40,000 into the fund on 29/2/2000.

Also assume that the fund is invested in the Australian share market and, for simplicity, the monthly returns (after tax and fees) is equal to the increase in the All Ordinaries Accumulation Index for the month.

The month by month accumulation of the investments in respect of all four members is set out below.

The fund will have accumulated in value to \$174,698 at 31/12/2000.

At the end of the year the Trustee declares a Crediting Rate equal to the asset weighted rate of return achieved by the fund for the year.

The internal rate of monthly return is 0.26% per month which is equivalent to 3.1% per annum and therefore a Crediting Rate of 3.1% per annum is declared by the Trustee.

Monthly investment performance		All Members		
Month ending	Return (%)			
31/12/1999		\$40,000	\$ 40,000	\$ 40,000
31/01/2000	-1.76	\$ 900	\$ 40,197	\$ 900
29/02/2000	1.60	\$80,900	\$ 121,741	\$ 80,900
31/03/2000	0.53	\$ 900	\$ 123,281	\$ 900
30/04/2000	-1.49	\$ 900	\$ 122,347	\$ 900
31/05/2000	-1.29	\$ 900	\$ 121,667	\$ 900
30/06/2000	7.70	\$ 900	\$ 131,933	\$ 900
31/07/2000	-1.34	\$ 900	\$ 131,072	\$ 900
31/08/2000	1.72	\$40,900	\$ 174,232	\$ 40,900
30/09/2000	0.21	\$ 900	\$ 175,490	\$ 900
31/10/2000	-1.13	\$ 900	\$ 174,406	\$ 900
30/11/2000	1.12	\$ 900	\$ 177,267	\$ 900
31/12/2000	-1.96	\$ 900	\$ 174,698	-\$173,798
		Internal monthly return		0.26%
		Equivalent annual rate of return		3.1%

## A.2. Actual individual investment earnings

The table below shows the actual accumulation of the investments that support each individual member.

Month ending	Member A			Member B			Member C			Member D		
31/12/1999	\$ 40,000	\$ 40,000	\$ 40,000									
31/01/2000	\$ 300	\$ 39,597	\$ 300	\$ 300	\$ 300	\$ 300		\$ -		\$ 300	\$ 300	\$ 300
29/02/2000	\$ 300	\$ 40,531	\$ 300	\$ 40,300	\$ 40,605	\$ 40,300		\$ -		\$ 40,300	\$ 40,605	\$ 40,300
31/03/2000	\$ 300	\$ 41,044	\$ 300	\$ 300	\$ 41,118	\$ 300		\$ -		\$ 300	\$ 41,118	\$ 300
30/04/2000	\$ 300	\$ 40,734	\$ 300	\$ 300	\$ 40,807	\$ 300		\$ -		\$ 300	\$ 40,807	\$ 300
31/05/2000	\$ 300	\$ 40,507	\$ 300	\$ 300	\$ 40,580	\$ 300		\$ -		\$ 300	\$ 40,580	\$ 300
30/06/2000	\$ 300	\$ 43,926	\$ 300	\$ 300	\$ 44,004	\$ 300		\$ -		\$ 300	\$ 44,004	\$ 300
31/07/2000	\$ 300	\$ 43,639	\$ 300	\$ 300	\$ 43,716	\$ 300	\$ 300	\$ 300	\$ 300		\$ 43,416	\$ -
31/08/2000	\$ 300	\$ 44,692	\$ 300	\$ 300	\$ 44,770	\$ 300	\$ 40,300	\$ 40,605	\$ 40,300		\$ 44,165	\$ -
30/09/2000	\$ 300	\$ 45,084	\$ 300	\$ 300	\$ 45,162	\$ 300	\$ 300	\$ 40,989	\$ 300		\$ 44,256	\$ -
31/10/2000	\$ 300	\$ 44,874	\$ 300	\$ 300	\$ 44,952	\$ 300	\$ 300	\$ 40,825	\$ 300		\$ 43,755	\$ -
30/11/2000	\$ 300	\$ 45,679	\$ 300	\$ 300	\$ 45,757	\$ 300	\$ 300	\$ 41,584	\$ 300		\$ 44,247	\$ -
31/12/2000	\$ 300	\$ 45,085	-\$ 44,785	\$ 300	\$ 45,161	-\$ 44,861	\$ 300	\$ 41,070	-\$ 40,770		\$ 43,381	-\$ 43,381
	Internal monthly return		0.29%	Internal monthly return		0.37%	Internal monthly return		-0.45%	Internal monthly return		0.37%
	Equivalent annual rate of return		3.6%	Equivalent annual rate of return		4.5%	Equivalent annual rate of return		-5.2%	Equivalent annual rate of return		4.6%

It is important to note that due to the volatility in the monthly returns that have been earned by the fund, the actual equivalent annual rate of return achieved by the assets supporting each member's benefits depends on the actual cash flow in respect of each member.

### A.3. The Impact of Misallocation

The actual earnings and interest allocation for each member are set out in the table below.

	Member A	Member B	Member C	Member D	Total
Actual investment earnings	\$1,485	\$1,561	-\$730	\$1,581	\$3,898
Interest allocated	\$1,302	\$1,091	\$424	\$1,080	\$3,898
Misallocation (\$)	-\$182	-\$470	\$1,154	-\$502	\$0
Misallocation (% of actual)	-12.3%	-30.1%	n/a	-31.7%	0.0%

The points to note are:

- Overall, the total actual investment earnings equals the total interest allocated to members' accounts;
- The investment return for the last four months of the year was negative. Therefore, the investment earnings on the rollover of Member C was negative resulting in a total negative investment return of -\$730 for Member C. However, interest of \$424 was added to Member C's account because the interest was added at the Crediting Rate. Effectively, \$1,154 of the investment earnings of other members allocated to Member C's account; and
- The misallocation of investment earnings allocated to the other members depends on the actual cash flows for each member. However, the misallocation for all members is significant.

## B. Hypothetical Example for the Year Ending 31/12/2004

### B.1. The Results

Using the same approach as outlined in Appendix A but using investment returns for the twelve months to 31/12/2004, the results are set out in the tables below:

#### *Actual investment earnings*

Monthly investment performance		All Members		
Month ending	Return (%)			
31/12/2003	3.68	\$40,000	\$ 40,000	\$ 40,000
31/01/2004	-0.66	\$ 900	\$ 40,634	\$ 900
29/02/2004	3.11	\$80,900	\$ 122,798	\$ 80,900
31/03/2004	1.99	\$ 900	\$ 126,143	\$ 900
30/04/2004	-0.13	\$ 900	\$ 126,882	\$ 900
31/05/2004	1.62	\$ 900	\$ 129,835	\$ 900
30/06/2004	2.65	\$ 900	\$ 134,170	\$ 900
31/07/2004	0.57	\$ 900	\$ 135,835	\$ 900
31/08/2004	1.05	\$40,900	\$ 178,161	\$ 40,900
30/09/2004	3.77	\$ 900	\$ 185,784	\$ 900
31/10/2004	3.14	\$ 900	\$ 192,520	\$ 900
30/11/2004	4.63	\$ 900	\$ 202,329	\$ 900
31/12/2004	3.00	\$ 900	\$ 209,302	-\$208,402
		Internal monthly return		2.31%
		Equivalent annual rate of return		31.6%

Month ending	Member A			Member B			Member C			Member D															
31/12/2003	\$ 40,000	\$ 40,000	\$ 40,000																						
31/01/2004	\$ 300	\$ 40,034	\$ 300	\$ 300	\$ 300	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 300	\$ 300													
29/02/2004	\$ 300	\$ 41,580	\$ 300	\$ 40,300	\$ 40,609	\$ 40,300	\$ -	\$ -	\$ -	\$40,300	\$ 40,609	\$ 40,300													
31/03/2004	\$ 300	\$ 42,707	\$ 300	\$ 300	\$ 41,718	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 41,718	\$ 300													
30/04/2004	\$ 300	\$ 42,953	\$ 300	\$ 300	\$ 41,965	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 41,965	\$ 300													
31/05/2004	\$ 300	\$ 43,948	\$ 300	\$ 300	\$ 42,943	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 42,943	\$ 300													
30/06/2004	\$ 300	\$ 45,410	\$ 300	\$ 300	\$ 44,380	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 44,380	\$ 300													
31/07/2004	\$ 300	\$ 45,970	\$ 300	\$ 300	\$ 44,933	\$ 300	\$ 300	\$ 300	\$ 300		\$ 44,633	\$ -													
31/08/2004	\$ 300	\$ 46,752	\$ 300	\$ 300	\$ 45,704	\$ 300	\$40,300	\$ 40,603	\$40,300		\$ 45,101	\$ -													
30/09/2004	\$ 300	\$ 48,816	\$ 300	\$ 300	\$ 47,729	\$ 300	\$ 300	\$ 42,435	\$ 300		\$ 46,803	\$ -													
31/10/2004	\$ 300	\$ 50,650	\$ 300	\$ 300	\$ 49,528	\$ 300	\$ 300	\$ 44,068	\$ 300		\$ 48,273	\$ -													
30/11/2004	\$ 300	\$ 53,294	\$ 300	\$ 300	\$ 52,120	\$ 300	\$ 300	\$ 46,408	\$ 300		\$ 50,507	\$ -													
31/12/2004	\$ 300	\$ 55,193	-\$ 54,893	\$ 300	\$ 53,985	-\$ 53,685	\$ 300	\$ 48,101	-\$47,801		\$ 52,023	-\$ 52,023													
		Internal monthly return			2.07%			Internal monthly return			2.24%			Internal monthly return			3.63%			Internal monthly return			2.23%		
		Equivalent annual rate of return			27.9%			Equivalent annual rate of return			30.4%			Equivalent annual rate of return			53.4%			Equivalent annual rate of return			30.2%		

### Crediting Rate allocation

Month ending	Member A			Member B			Member C			Member D		
31/12/2003	\$ 40,000	\$ 40,000	\$ 40,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
31/01/2004	\$ 300	\$ 41,225	\$ 300	\$ 300	\$ 300	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 300	\$ 300
29/02/2004	\$ 300	\$ 42,479	\$ 300	\$ 40,300	\$ 40,607	\$ 40,300	\$ -	\$ -	\$ -	\$ 40,300	\$ 40,607	\$ 40,300
31/03/2004	\$ 300	\$ 43,761	\$ 300	\$ 300	\$ 41,846	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 41,846	\$ 300
30/04/2004	\$ 300	\$ 45,074	\$ 300	\$ 300	\$ 43,114	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 43,114	\$ 300
31/05/2004	\$ 300	\$ 46,416	\$ 300	\$ 300	\$ 44,411	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 44,411	\$ 300
30/06/2004	\$ 300	\$ 47,790	\$ 300	\$ 300	\$ 45,739	\$ 300	\$ -	\$ -	\$ -	\$ 300	\$ 45,739	\$ 300
31/07/2004	\$ 300	\$ 49,195	\$ 300	\$ 300	\$ 47,097	\$ 300	\$ 300	\$ 300	\$ 300	\$ -	\$ 46,797	\$ -
31/08/2004	\$ 300	\$ 50,633	\$ 300	\$ 300	\$ 48,486	\$ 300	\$ 40,300	\$ 40,607	\$ 40,300	\$ -	\$ 47,879	\$ -
30/09/2004	\$ 300	\$ 52,105	\$ 300	\$ 300	\$ 49,908	\$ 300	\$ 300	\$ 41,846	\$ 300	\$ -	\$ 48,987	\$ -
31/10/2004	\$ 300	\$ 53,610	\$ 300	\$ 300	\$ 51,362	\$ 300	\$ 300	\$ 43,114	\$ 300	\$ -	\$ 50,120	\$ -
30/11/2004	\$ 300	\$ 55,150	\$ 300	\$ 300	\$ 52,850	\$ 300	\$ 300	\$ 44,411	\$ 300	\$ -	\$ 51,279	\$ -
31/12/2004	\$ 300	\$ 56,726	-\$ 56,426	\$ 300	\$ 54,373	-\$ 54,073	\$ 300	\$ 45,739	-\$ 45,439	\$ -	\$ 52,465	-\$ 52,465
	Internal monthly return		2.31%	Internal monthly return		2.31%	Internal monthly return		2.31%	Internal monthly return		2.31%
	Equivalent annual rate of return		31.6%	Equivalent annual rate of return		31.6%	Equivalent annual rate of return		31.6%	Equivalent annual rate of return		31.6%

### Misallocation

	Member A	Member B	Member C	Member D	Total
Actual investment earnings	\$11,593	\$10,385	\$6,301	\$10,223	\$38,502
Interest allocated	\$13,126	\$10,773	\$3,939	\$10,665	\$38,502
Misallocation (\$)	\$1,532	\$388	-\$2,362	\$442	\$0
Misallocation (% of actual)	13.2%	3.7%	-37.5%	4.3%	0.0%

In this example it can be seen that Member C is worse off and has \$2,362 of the actual investment earnings allocated to other members.

## **C. Financial Services Guide**

This document is a Financial Services Guide (“FSG”) issued by Rice Walker Actuaries Pty Ltd (ABN 35 003 186 883).

We hold an Australian Financial Services Licence (AFSL 239 191) and this requires us to inform prospective clients of certain matters relating to our relationship with them and the services we provide, prior to us providing them with a financial service.

### **C.1. Who are we?**

Rice Walker is an Australian firm of consulting actuaries completely controlled by its executive directors and staff. Our offices are in Melbourne and Sydney.

Our professional body is the Institute of Actuaries of Australia and we abide by its professional Code of Conduct.

We are experts in many aspects of financial services, particularly superannuation.

### **C.2. What advice do we provide?**

We provide formal actuarial advice in a range of areas as well as advice on a range of matters in the fields of superannuation, funds management, collective investments, life insurance and financial services. This varies from general and strategic advice about a range of issues to product advice whereby we provide recommendations about selecting a particular product or service or range of products/services.

### **C.3. Who provides the advice?**

Our Authorised Representatives, are Principals and Senior Consultants of the firm. Most are qualified actuaries. We appoint a Principal to be responsible for each assignment. All work is peer reviewed before it is finalised.

Each Principal will:

Give advice only in areas where they authorised to do so;  
Follow our processes for delivery of advice; and  
Ensure that our other staff do not provide unauthorised advice to clients.

Our Authorised Representatives each have their own area of expertise and we ensure that they limit their advice to these areas.

Full details of the person(s) responsible for providing the advice, their qualifications and experience and the advice they will provide are included in any specific proposal we provide to a client.

### **C.4. Delivery of our Advice**

We deliver our advice in many forms, including delivery of formal reports, presentations to clients, and by discussions in person and by phone or email. Whenever we provide you with advice, we will document this clearly for you in a Statement of Advice which sets out the specific factors reflected in that advice such as your objectives, financial situation and specific needs.

We will normally provide a formal report or letter during the assignment which will fully document our advice, the basis on which it is given and any information about fees in relation to products or investments reviewed.

In the event that we make a recommendation to consider using a particular financial product or service, we provide our clients with the original proposals received from product manufacturers or suppliers so that they are aware of the basis on which we have made our decision.

## **C.5. Remuneration**

### ***Rice Walker***

We would normally agree to receive a fee or regular retainer expressed as dollar amounts in advance of commencing an assignment. The level of these fees is generally based on an estimate of the time that will be taken, the importance and value of the work undertaken, and the extent that we will draw on the resources and research undertaken by Rice Walker.

The details of specific fee arrangements are provided as part of all proposals for clients.

We then submit an invoice setting out our fee and fully describing the work that was done.

Rice Walker does not accept commission. There are some rare circumstances where we are forced to accept commission on a product and we then rebate it to the client or offset it against our fee.

### ***Our Employees***

All employees and Authorised Representatives are solely remunerated by Rice Walker.

All work is undertaken on a fee for service or retainer basis.

### ***Reimbursement of Expenses***

In the course of an assignment, we may incur incidental expenses such as travel. Our policy is to recover these at cost. We do not normally charge for minor expenses such as local courier deliveries or office functions such as photocopying or sending faxes.

### ***Receipt of "Soft Dollars"***

We do not receive any form of indirect payment from product suppliers. We will allow our professional staff to attend seminars, training sessions or other functions where they have an educational content. We also allow our staff to accept reasonable invitations to functions as part of our normal business networking.

## **C.6. Potential Conflicts of Interest**

We do not have any financial association with any financial institution or other product provider. From time to time, we are appointed to provide advice to financial institutions and/or product providers on a fee for service basis. Where such an organisation submits a proposal in a tender held by us, we would disclose the business relationship to our client.

Our work processes include a structured approach based on our research and market knowledge. We also have compulsory peer review of all advice we provide. This ensures that all our advice is provided entirely on merit.

## **C.7. Information Required to Provide Advice**

We take into account the circumstances of a client prior to providing advice and making recommendations. In order to undertake our work, we may require confidential information from our clients. We hold this material securely and confidentially.

## **C.8. Complaints Handling Procedure**

Rice Walker is a member of the Finance Industry Complaints Service. If a client were to have any complaint about a service provided to it, they should take the following steps:

1. Write to the Authorised Representative if the dispute is minor and can be resolved at this level.
2. Contact Michael Rice of Rice Walker on (02) 9268 0750 or put your complaint in writing and send it to:

M J Rice  
Responsible Officer  
Rice Walker Actuaries Pty Ltd  
PO Box Q1523  
QVB NSW 1230

We will seek to resolve your complaint quickly and fairly.

3. If the complaint cannot be resolved to your satisfaction you have the right to complain to the Financial Industry Complaints Service (FICS). They can be contacted on 1800 335 405, or on [www.fics.asn.au](http://www.fics.asn.au). This service is provided to you free of charge.

The postal address for FICS is:

Financial Industry Complaints Service  
31 Queen Street  
MELBOURNE VIC 3000

This document was produced in March 2004. Future changes to the document will appear on our website [www.ricewalker.com.au](http://www.ricewalker.com.au).