Why the Equity Bias?

There has been much discussion of whether, and if so why, Australian investors – specifically super funds – are excessively invested in equities and other "growth" assets (such as private equity, infrastructure etc) compared to pension funds overseas.

Recent figures indicate that super funds have around 30 per cent of their assets in Australian equities and another 20-25 per cent in overseas equities.

OECD data for 2009 had Australian pension funds (with 54.4 per cent in equities) a clear leader compared to a list of other countries which included Canada (33.9), Netherlands (32.2) and the USA (45.4). However, pension funds in a few other countries excluded from that list (such as the UK, Ireland and Belgium) have similar equity investment allocations to Australian super funds.

Why might Australian super funds have such a high equity investment allocation? Is it too high?

A number of reasons might be advanced for the high equity allocation (and further study to determine their relative importance is warranted).

Some reasons relate to taxation and consequent features of the Australian capital market.

First, the Australian tax system involving dividend imputation increases the attraction of equity stocks for low-taxed superannuation funds, although this only applies to stocks paying franked dividends. The preferential tax treatment of income from equities relative to fixed income (interest) investments is well recognized.

Second, the dividend imputation tax system also reduces tax-driven corporate incentives to higher leverage. Combined with the dominance of bank borrowings relative to debt capital market issues by companies, as well as the historically strong government fiscal position, this means that there are relatively fewer domestic debt instruments available for investment than in other countries.

A recovery of securitization, covered bond issuance, resurgence in the Kangaroo bond market, and government initiatives to develop the corporate bond market might change that situation.

A third (non-tax) reason could be a form of "hysteresis", where the current situation which has evolved over time becomes the new normal. In this case, very good equity returns for a number of years, combined with lack of commitment to rebalancing of portfolios, led to an upward drift in the equity share of portfolios.

A fourth reason might be found by looking to the overall composition of investor portfolios rather than just their indirect asset holdings via super funds. Many super fund members are home-owners (or home-buyers), and taking those assets into account may make the super bias to equities of less significance. (Whether super funds think this way is debatable).

Further possible reasons reflect the relatively young state of the super industry. Arguably, super fund managers have wanted to make a difference in terms of member retirement outcomes. Because most member balances have been relatively small, there may have been a tendency to invest in more risky portfolios whose higher expected returns could make a noticeable difference to retirement outcomes.

Similarly, given the relatively recent introduction of compulsory superannuation there is a large proportion of the membership in younger age brackets. It is generally accepted that higher risk investments (with higher expected returns) are appropriate for younger investors because their portfolios have more time to recover if bad outcomes occur.

Finally, there are two other speculations worth mentioning. First, with the dominant form of super fund being defined contribution (rather than defined benefit) the optimal form of asset allocation may be one with a higher proportion of risk assets. Second, because the retirement safety net of the old age pension provides a minimum annuity income in retirement, the optimal superannuation portfolio to supplement that may be one of higher risk.

All of the possibilities mentioned above are open to debate and discussion – and that is something which needs to happen. However, an important consideration needs to be remembered. In aggregate, financial risk needs to be borne by someone.

Unless the asset allocations of super funds change the overall level of risk in the system, if they reduce their equity holdings, other investors will replace them. Thus the critical question may be the one of whether it is better that equity risk be borne by super funds rather than by Australian investors wearing other hats. Given the long horizons of super funds they may be the best risk-bearers (although not in the case of members nearing retirement).

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