

SUPERANNUATION CHOICE: THE PIVOTAL ROLE OF THE DEFAULT OPTION

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A controversial global trend in defined contribution pension¹ plans is the introduction and expansion of investment choice to plan members. The international experience with investment choice offers no clear direction on an appropriate choice model. Similarly in Australia, an extensive and long-running policy debate on an appropriate superannuation choice model remains unresolved.² Seeking to increase competitive forces within a rapidly growing superannuation industry, the Federal Coalition government has repeatedly attempted to implement its 1996 pre-election promise to enact legislation allowing superannuation fund members to choose their superannuation fund. Those attempts stalled due to its failure to build consensus with opposition parties and within the superannuation industry. The principle of choice is generally supported but there is considerable disagreement among policy makers about the form of the choice model and implementation issues (see Senate Select Committee on Superannuation (SSCS) 2002).

Meanwhile, a quiet revolution has occurred in the superannuation industry. Increasing numbers of superannuation funds are offering their members within-fund investment choice, with about 80 percent of

1 The term 'pension' is used in the U.S. and other countries to refer to employment-related retirement benefits whereas the term 'superannuation' is generally used in Australia.

2 While the debate continues, superannuation investments in Australia are becoming increasingly important from economic and social perspectives as a result of compulsory superannuation. Assets in superannuation funds total \$534 billion covering 88 per cent of the workforce with over 25 million accounts (APRA, June 2003) held by 9 million fund members – an average of 2.8 accounts per employee.

individuals in defined contribution (accumulation-style) plans reported to now have some choice in how the assets in their accounts are invested (see Bowman 2003; Hely 2004). This expansion of investment choice in the Australian superannuation industry is in step with a world-wide trend of pension plan members in other countries being given greater choice and control over the decision-making in relation to how their pension assets are invested.³

The global move towards choice is founded on the traditional economic assumption that well informed economic agents act rationally to maximise their self-interests. Investment choice enables plan members to select their optimal investment portfolio that matches their risk and return preferences and ultimately, maximises retirement incomes. However, recent behavioural research has challenged the traditional view, arguing a form of 'bounded rationality' is observed in practice. When plan participants face complex decisions required to make investment choice, inertia or procrastination affects their decisions, leading to sub-optimal choices (Choi, Laibson, Madrian & Metrick 2003; Madrian & Shea 2001; Mitchell & Utkus 2003).

These findings have implications for the current and proposed 'choice framework' in Australia. In particular, the findings that many plan participants are unable to make effective choices, even after undertaking education programs, highlights the need to ensure that appropriate default options are provided in superannuation funds. However, to date, the choice debate has focused on expanding education programs, reducing fees and determining the number and types of choices. The role of the default option is considered a second order issue in this debate, merely relegated to the same status as another investment option in a portfolio of investment and fund choices. In this article we address this shortcoming by calling for a renewed focus on default options in superannuation plan design, drawing on the considerable evidence emerging from behavioural research. We first provide an overview of the choice debate in Australia and identify the role the default option has

3 A survey by Mercer Human Resource Consulting shows 81 percent of defined contribution (DC) pension funds in the U.K. and 99 percent of DC funds in the U.S. offer investment choice (Walker 2003).

played in that debate. We then review behavioural research findings and discuss the implications for the default option. The diversity in current medium-term investment performance of best performing Australian default options is then evaluated. We conclude with a discussion of the key issues policy-makers need to consider in addressing the inadequacies in the current default offerings in Australian superannuation plans.

The Superannuation Choice Debate and the Emerging Importance of the Default Option

While investment in superannuation grew rapidly following the introduction of compulsory superannuation in 1992,⁴ most funds offered few investment alternatives to fund members and these alternatives were usually confined to one fund (Brown, Gallery & Gallery 2002). Attempts to regulate investment choice to require funds to offer a wider selection of investments in more than one fund arose in the mid-1990s. In a pre-1996 election promise, the Federal Coalition announced that it would enact legislation requiring all awards and workplace agreements to offer workers a choice of investments in up to five superannuation funds. The Government provided the following justification:

... providing individual employees with choice will increase competition and efficiency in the superannuation industry, leading to improved returns on superannuation savings and placing downward pressure on fund administration charges (SSCS 2002: 2).

Consistent with their pre-election policy statement, the 1997-78 Budget contained proposals for superannuation fund choice. A controversial part of this policy required an employer to nominate a default fund if an employee failed to make an election. Following release of the policy, employers expressed concerns about '... their potential liability if they failed to provide sufficient or accurate information to their employees under the limited choice option, or if the funds they selected to offer to

4 The amount of superannuation fund assets was \$154 billion at June 1992, growing to \$534 billion at June 2003 (APRA 2003).

employees performed badly' (SSCS 2002, p. 5). In response to these concerns, changes to the policy were announced in late 1997, including the addition of an option to offer unlimited employee choice and a reduction in the number of fund choices from five to four under the limited choice option.

Notably, when the Government first attempted to implement its choice of fund policy through the Taxation Laws Amendment Bill (No 7) 1997, it included only the limited choice option. The choice of fund provisions were removed from that Bill in the Senate and re-introduced in the separate Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998; the 1998 Bill made provision for *unlimited* fund choice. Changes to the default fund arrangements were also made in the 1998 Bill. Rather than employers choosing the default fund, the default fund would become the industrial award fund for the employee, or if there was no such award fund, the 'majority fund' in the workplace. If neither of such funds was available, then the employer would be responsible for selecting the default fund. In December 1999 the provisions of the 1998 Bill were debated by superannuation industry representatives and others at a roundtable hosted by the Senate Select Committee on Superannuation and Financial Services (SSCSFS). The Committee's report (SSCSFS, 2000) concluded that the majority of participants favoured unlimited choice and the relevant award fund as the default fund. The Bill was debated in the Senate but was finally defeated in August 2001.⁵

The Government attempted to legislate for superannuation fund choice for a third time in June 2002 with the introduction of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002 to the House of Representatives. The provisions of this iteration of the proposed legislation are essentially the same as in the 1998 Bill in relation to proposing unlimited choice of fund, and nominating the default option as the industry award fund for the employee or, in the absence of such a fund, the majority fund for the workplace, and if

5 The bill ultimately failed on the vote of the Democrats who supported the choice bill but sought a trade-off on another unrelated matter with the Government. The Government rejected the 'deal' and consequently the Democrats voted against the choice bill (Gallery 2002).

neither of these is available, then the default fund would be selected by the employer. In May 2003, the Government announced amendments to the 2002 Bill (see Coonan 2003), which include dropping the three-step approach that employers would have had to follow and instead retaining the *status quo*. That is, the process of selecting a default option under the choice regime would be the same as current practice under superannuation guarantee legislation where employers contribute to a fund determined by the relevant industrial award, and if there is no such fund, the employer selects any complying superannuation fund. The Government reverted to this simpler process in response to objections that the three-step approach would be too costly for business.⁶ The amended Bill was passed by the House of Representatives on 4 December 2003 and the Superannuation Legislation Amendment (Choice of Funds) Bill 2003 was introduced to the Senate on 10 February 2004; debate on the Bill was adjourned that day and has not recommenced at the date of writing.

During the past eight years the Government has three times attempted to enact choice of superannuation fund legislation, but without gaining the necessary support to implement its proposals. Choice of fund was extensively debated within and outside Parliament, including two Senate Committee enquiries (see SSCS 1998 and 2002) and a roundtable discussion (see SSCSFS 2000), all of which involved extensive consultation with superannuation industry leaders and other interested parties. Despite this consultation and wide-ranging debate, consensus has not been achieved. The concept of choice of fund *per se* is not in dispute – it is generally viewed as desirable by non-government political parties, the superannuation industry and consumer groups. One of the major points of contention relates to a perceived absence of adequate consumer protection measures. In their review of the 2002 Bill, the Senate Committee expressed support for the Bill, providing the government appropriately addressed the issues raised in their report (SSCS 2002), which principally relate to strengthening consumer protection. Two major aspects of consumer protection highlighted by the Committee are

6 See the Parliamentary Debate on the Superannuation Legislation Amendment (Choice of Funds) Bill 2002, *House of Representatives Hansard*, 4 December 2003.

consumer education and improved disclosure regulation. In supplementary statements to the majority report, the Democrats and Labor members of the Committee reiterated their demands for better consumer protection measures in return for their support for the proposals (see SSCS 2002: 85-92). Some amendments were made to the 2002 Bill in response to the Senate Committee's report before it was introduced to parliament. However, those changes were viewed as inadequate by the Labor Party and accordingly they opposed passage of the Bill on the basis that it will 'introduce unsafe choice' because *inter alia*, it does not adequately address significant disclosure issues, does not regulate fees and charges, and does not provide for a 'comprehensive and effective consumer education campaign' (see *House of Representatives Hansard*, 4 December 2003: 23914).⁷

Throughout the choice of fund debate, considerable attention has focussed on consumer education and disclosure as essential preconditions of informed choice. Considerably less attention has been given to the default option, with primary consideration given to establishing a process for selecting a default fund that will minimise costs to employers rather than necessarily ensuring the default option is the 'best' alternative for employees who do not exercise choice.

While the choice of fund debate has been raging at the policy-making level, a 'choice by stealth' phenomenon in the superannuation industry is evident. About 80 percent of all superannuation fund members are now offered some choice of how the assets in their accounts are invested (see Bowman 2003; Hely 2004). Hence, even in the absence of choice of fund regulation, the adequacy of the choices presently offered by superannuation funds to their members needs policy-makers' attention. In particular, policy attention to the default option is critically important given that where members are offered investment choice, the vast

7 In November 2003 the Labor Party released Policy Paper 015 *Superannuation: A Simpler System*, stating that Labor will introduce 'safe' choice of fund. Apart from a statement that their safe choice regime will require 'clear disclosure of all fees, charges and commissions' and members switching funds will be required to sign a standard option form which sets out comparisons of fund fees/charges and investment returns (p.13), details are not provided on how safe choice will be achieved; the policy paper states further details will be set out in a future policy document.

majority do not exercise choice and are automatically assigned the default investment option. The Association of Superannuation Funds of Australia (ASFA), the peak superannuation industry body, reports that only about 10 percent of members offered investment choice actually make a choice (see Bowman 2003a).

Important questions that have received little attention are: Is there evidence that fund members exercise informed choice when given the opportunity? and, are the choices and default options offered appropriate in meeting individual members needs? We explore these questions in the next section in the context of the findings of behavioural research.

Implications of Behavioural Research Findings for Default Options

A basic principle of economic theory is that, in the absence of decision-making costs, expanding the choice set cannot make a consumer worse off. So where financial stakes are high and choices are made infrequently, it could be argued that more choices are ‘unambiguously a good thing’ (Benartzi & Thaler 2002: 1593). However, as the number of investment options increases, the associated administration costs increase and the costs associated with sub-optimal investment choices also increase (Benartzi & Thaler 2002). The costs arising from sub-optimal investing have been attributed to various behavioural factors including choice overload, unstable preferences and investment menu design, procrastination and inertia, and limitations of member education programs.

The Problem of Choice Overload

An often-cited experiment used to illustrate the impact of excessive choice (choice overload) is documented by Iyengar and Lepper (2000).⁸ In their experiment they set up two alternative booths in a grocery store

8 For a recent citation in the Australian press see Dunstan (2003).

with one selling six flavours of jam and the other 24 flavours. While sixty percent of shoppers stopped at the booth with 24 jam flavours and forty percent at the other booth, only three percent of shoppers purchased jam from the extensive-choice booth, whereas 30 percent bought jam at the booth where the choice was limited to six options. From this experiment, they conclude that consumers may in fact desire fewer choices. There is some evidence that these findings translate to investment choice in retirement plans. For example, in a study of participation rates in U.S. 401 (k) pension plans, Iyengar, Jiang and Huberman (2003) found that participation rates decline as the number of fund options increases.⁹

In an attempt to more specifically test participants' perceptions of investment choice, Benartzi and Thaler (2002) conducted two related experiments. In the first experiment investors were asked to rate the attractiveness of three unlabeled investment portfolios: one is the portfolio of investments that the investor had selected previously, the second portfolio is the average portfolio for all members of the pension plan, and the third is the median portfolio for the whole group. When asked which investment portfolio they considered the most attractive, participants rated the average portfolio about equal to their own, but surprisingly, indicated a preference for the median portfolio over their own.

While the first experiment involved participants who were forced to make investment choices, Benartzi and Thaler's (2002) second experiment investigates the preferences of plan participants who have the option of allowing an investment manager to choose a portfolio for them. Their sample comprised individuals who had opted to construct their own portfolio rather than the portfolio picked by the investment manager. Participants were asked to rate three portfolios comprising the individual's own portfolio, an average portfolio for all members in the pension plan, and the portfolio selected for them by the investment management firm. The results show that 61 percent of participants

⁹ In the U.S., 401(k) plans are employer-based retirement savings plans to which individuals voluntarily contribute from their pre-tax earnings; members generally have investment choice.

indicated a preference for the portfolio selected by the investment manager while only 21 percent preferred the portfolio they had selected themselves.

What might explain the incongruity between individuals freely selecting an investment portfolio and then indicating a preference for other available portfolios which they did not select? Benartzi and Thaler (2002: 1595) suggest most participants do not have stable, well-defined preferences in that they 'simply do not have the skills and/or information available to pick portfolios that line up with their risk attitudes'. Constructing a well-diversified portfolio that fits personal preferences is a complex task and therefore it is not surprising that pension plan members who elected to choose their own investments seemed to have difficulty with making selections to match their preferences (Benartzi and Thaler 2002).

The Problems of Unstable Preferences and Investment Menu Design

Although retirement plan participants perceive a need to maximise retirement income, they are likely to have difficulty coping with a large number of investment alternatives and the complex decisions involved in investment choice.¹⁰ Even if the range of choices is limited, the problem of 'incoherent' preferences complicates optimal retirement plan design (Benartzi and Thaler 2002). This situation is further exacerbated by the nature of the investment menu offered by plan sponsors.¹¹ For many plan participants, a default heuristic is likely to be viewed as an easy option.

To test how plan participants are influenced by menu choice, Benartzi and Thaler (2001) conducted an experiment in which participants were offered a choice of two investment options (an equity and bond fund, an

10 Benartzi and Thaler (2002) in borrowing from Simon (1955) refer to this problem as 'bounded rationality'.

11 Mitchell and Utkus (2003, p. 15) refer to behavioural problems arising from investment menu design as 'framing effects': 'The investment menu in a retirement plan is an "opaque frame", which most participants cannot see through to understand the underlying risk and return characteristics of the investments being offered.'

equity and balanced fund, or a bond and balanced fund). In all cases, a common participant allocation choice was a 50/50 mix of the two funds. When the choice was increased to five funds, a similar naïve investment strategy was observed. Plan participants tended to allocate equal amounts across the portfolio of choices regardless of the asset type that dominated the plan (i.e. they loaded up on equity funds if the plan was loaded up on equity funds, etc). This behavioural response to portfolio selection is often referred to as the '1/n Rule' (Benartzi & Thaler 2001; Liang & Weisbenner 2002; Elton, Gruber & Blake 2004) and appears to be consistent with the observed behaviour of many participants in U.S. 401(k) plans (Liang & Weisbenner, 2002).

In a follow-up study, Benartzi and Thaler (2002) test 'extremeness aversion' by designing an experiment where the same investment portfolio (C) is placed as either the middle choice or extreme choice in sets of portfolios drawn from four choices (A, B, C and D), with an increasing level of risk moving from A to D. They find that when portfolio C was placed as an extreme choice (in the set A, B and C), 29.2 percent of participants preferred C to B, but when C was the middle choice (in the set B, C and D), 53.8 percent indicated a preference for C over B. Thus when faced with an array of balanced funds with varying risk levels, some plan participants are likely to be attracted to the middle fund simply because of its relative position.

These experimental findings further demonstrate that investor decisions do not necessarily follow the traditional view about rational economic decision-making (Benartzi and Thaler 2002). When faced with difficult investment decisions, many individuals cope by defaulting to a simple rule of thumb, such as avoiding extremes or allocating investments evenly over the range of available funds. The implications are that plan sponsors may be implicitly and detrimentally influencing investment choices through the menu of choices they offer to members (Benartzi and Thaler 2002).

The Problems of Procrastination and Inertia

Much of the prior discussion on investment choice assumes that individuals have the willpower and self-control to exercise choice. However, surveys and empirical research suggest that individuals are not particularly good at dealing with the retirement savings problem. Relatively few people are confident about planning effectively for retirement, many underestimate the amount they need to save for retirement and many delay or avoid the savings decision (Mitchell & Utkus 2003). In combination, these reactions contribute to the observed problems of procrastination and inertia in retirement savings decisions.

Procrastination is evident in the U.S. context of employees' decisions to voluntarily join 401(k) pension plans. Where employers automatically enrol employees in these plans, the number of new members dramatically increases compared to the relatively low rates of participation when employees must actively choose to participate (see Madrian & Shea 2001; Choi, Laibson, Madrian & Metrick 2002a). Although workers who have been automatically enrolled may choose to opt out immediately or later, few choose to do so. Moreover, Choi *et al.* (2002a) find that over two-thirds of new plan participants invest exclusively in the default plan on commencement of employment with this proportion declining to only 45 percent three years later.

Choi *et al.*'s (2002a) findings demonstrate that where individuals are free to choose whether to remain in a pension fund or opt out, few do so, and a relatively large proportion of those who do not opt out do not change from the default investment option which the employer nominated at the time employment commenced. Thus, in this voluntary pension saving environment, 'employers have the power to dramatically change patterns of retirement saving by simply changing the defaults that their employees face' (Choi *et al.* 2002a: 29).

Procrastination has the tendency to produce inertia in the post-enrolment decisions of many pensions plan participants. A common finding is that participants rarely rebalance their investment portfolios after joining plans (Benartzi & Thaler 2002). For example, Ameriks and Zeldes (2001) found that over a 10-year period 47 percent of their sample of TIAA-CREF pension plan participants made no changes to the asset

allocation of new contributions, and 73 percent made no changes to the existing allocation of assets in their accounts. Weber (2003) suggests that such inertia is explained by decision makers wanting to avoid retirement-related decisions which inherently involve contemplating unpleasant factors including the negative aspects of aging and ultimate death.

The Australian evidence is consistent with the U.S. experience. Surveys show that, while 80 percent of superannuation fund members are in funds which allow members to choose the type of assets in which their superannuation is invested or offer members a choice of fund managers (Hely 2004), only about 10 percent exercise that choice (Bowman 2003). Thus a large proportion of superannuation fund members have their accounts automatically allocated to their fund's default investment option.

In contrast to the U.S. and Australian experiences, the majority (67 percent) of Swedish pension plan members choose their investment portfolios (Engström & Westerberg 2003). The Swedish system is more complex and includes a much larger range of investment options than typical 401(k) plans, and the default option is a government provided publicly managed mutual fund. The relatively low proportion of individuals in Sweden not making an active choice runs counter to the theory that as the number of choices increases, the likelihood of the individual making a choice decreases. Engström and Westerberg (2003) propose the high choice participation rates may be explained by the effectiveness of the Swedish government's comprehensive information campaign, marketing efforts by fund companies, and considerable media attention given to the new pension system; they suggest these activities may have reduced the costs of individuals becoming informed.¹² Procrastination and inertia are nevertheless significant problems in Sweden, with one-third of the entire workforce opting out of making an active pension investment choice.

12 An alternative explanation proposed by Orszag (2003) is individuals have informed views on public versus private management through Sweden's long tradition of publicly managed pension funds, and individuals' active choice to invest privately may reflect their greater faith in the private sector rather than the public sector to manage pension savings.

An important implication of procrastination and inertia in retirement plan design is that consideration needs to be given to important psychological and economic issues that arise in the selection of default options. First, a default provision is likely to be interpreted as implicit advice that many plan members will mechanically follow. Second, over-optimism about future income may result in undervaluation of savings. Third, the tendency of plan participants to prefer the *status quo* may require the design of plans that incorporate time-varying default options (Madrian and Shea 2001; Choi, *et al.* 2003; Mitchell and Utkus, 2003).

Limitations of Member Education Programs

Given the behavioural problems associated with choice, an important question is: can member education programs change behaviour sufficiently to avoid sub-optimal choices? Research evidence indicates that due to the behavioural issues associated with investment choice and default options, the benefits of member education programs are limited. For example, Choi *et al.* (2002b) survey workers' attitudes expressed after having attended an employee education seminar on financial investment, with actual behavioural changes recorded on company administrative data systems. Their results reveal a gap between intentions and specific action to join a plan, boost savings, change existing portfolio allocations, or change the mix of future contributions. That is, although many who attend an education program indicate intentions to make changes to their pension plan savings, very few actually do so. Choi *et al.* (2002b: 71) conclude that although education programs may have a positive affect on savings behaviour, the improvement is 'modest at best'.

There is also the issue of the capacity among all workers to acquire and maintain the necessary knowledge and skills to make informed superannuation choices. General literacy problems pose considerable challenges to any financial education campaign. For example, ABS statistics cited in the Senate Committee's report indicate that about 20 percent of Australians aged between 15 and 74 have very poor literacy skills, and up to six million Australians are likely to experience some difficulties with reading and understanding printed material encountered

in daily life (SSCS 2002: 21-22). General literacy and numeracy skills may not be sufficient for making financial decisions in the superannuation context. Even well-educated fund members find superannuation information difficult to understand and are not confident they have the necessary financial skills to choose an investment strategy (Gallery, Gallery & Brown 2000; Brown, Gallery, Gallery & Guest 2004).

While financial literacy problems lead to an inability to make informed choices, another significant barrier is some members' unwillingness to become informed because of the associated costs. These costs include the cost of becoming informed, the cost of maintaining skills and knowledge on an ongoing basis to enable continuing monitoring and revisions of past choices, and the potential costs of making the wrong choice (Brown *et al.* 2002). Such costs can be avoided by opting out of making a choice and accepting the default investment option. This inertia, or member disengagement from the complex decision-making process, cannot be readily solved by 'more' or 'better' education programs.

There is also emerging evidence that, while some superannuation funds have actively pursued strategies to educate their members in superannuation matters, there may be an increasing reluctance to continue to do so. In a Towers Perrin (2003) survey of 12 of Australia's largest superannuation funds, 62 percent indicated the responsibility for member financial education lies with the individuals themselves, with 46 percent indicating it is the responsibility of the fund. When this latter result is contrasted with the 2002 survey results where 88 percent of the respondents indicated the fund should play an active role in educating members about investments, a move away from the fund to the individual seems to be evident (Towers Perrin 2003). However, this decline in funds' willingness to educate members is not surprising in light of 77 percent of respondents citing 'fiduciary or legal concerns about offering information and advice' as a main barrier to providing financial education to members.

Achieving 'informed choice' through education is important but over-emphasised in the current choice debate in Australia. Evidence from surveys and behavioural research shows many people accept the default

option and the reasons for this passive choice need to be linked to a broader question about motivations and decision-making.

Are Default Options Homogeneous?

If the majority of superannuation fund members' assets are invested in the default option, can they expect similar long-term investment return outcomes? Default options may be perceived as homogeneous in their characteristics and performance across different superannuation funds, and accordingly similar outcomes might be expected. However, a closer examination of a cross-section of the best-performing Australian funds shows a wide variation in medium-term performance. Tables 1, 2 and 3 present rankings of superannuation funds based on the five-year performance of their default option to June 2003. Table 1 shows the performance of the overall top ten funds, of which four are government funds and three each of corporate and industry funds. The five-year performance rates of these top ten default options are significantly spread from the lowest at 7.1 percent to the highest almost doubling that rate at 13.2 percent. *Ceteris paribus*, such large differences in investment performance translate into large differences in the superannuation benefits of members in each of those funds.

Further disparities in default option performance are evident when the top ten funds are examined within sectors. Table 2 shows that the five-year performance of default options in industry funds ranges from a rate of 6.2 percent to 7.6 percent. While the spread of 1.4 percentage points is relatively small, it should not be forgotten that these are the *best* performing default options in industry funds; the spread among *all* funds would be considerably larger. When considering the performance of the best default options in master trusts (Table 3), it is clear superannuation fund members in this segment face significantly worse investment performance than their counterparts in industry, corporate or government superannuation funds.¹³

13 Fees charged by master trusts are typically higher than those of industry, corporate or government funds (see Chant and ASFA 2003). Charging higher fees would be justifiable if the fund is generating higher investment income to achieve higher net

Table 1: Best Performing Superannuation Funds in All Segments Based on the Crediting Rate of the Default Investment Option for Five Years to June 2003

<i>Fund Name & Option</i>	<i>Segment</i>	<i>Option Sector</i>	<i>Performance</i>	
			<i>5 yrs</i>	<i>Rank</i>
CTC Staff Superannuation Fund - Accumulation	Corp fund	Balanced	13.2%	1
NSW Bookmakers Superannuation Fund - Accumulation	Corp fund	Balanced	12.3%	2
Local Government Superannuation Scheme (QLD) - Growth Smoothed	Government	Growth	8.1%	3
Unilever Super - Balanced	Corp fund	Balanced	8.1%	4
SA Police - South Aust Police Super Fund - New (Lump Scheme) Scheme Division	Government	Growth	8.0%	5
Australia Post Superannuation Scheme - Defined Benefit	Government	Balanced	7.9%	6
CARE Super - Balanced Option	Industry	Balanced	7.6%	7
The State Superannuation Fund - Long-Term Investment Portfolio	Government	Balanced	7.6%	8
Catholic Superannuation and Retirement Fund - Balanced Portfolio	Industry	Balanced	7.4%	9
REST - Core Strategy	Industry	Balanced	7.1%	10

Source: SelectingSuper accessed at <http://www.selectingsuper.com.au>

Almost all of the default options listed in the three tables are named 'balanced' investment options but, in light of the large differences in performance, the risk characteristics across this group vary considerably. This common terminology illustrates the problem of 'framing effects' in menu design. In their study of investment choices offered by 401(k) pension plans in the U.S., Elton, Gruber and Blake (2004) find that 62 percent of the plans offer inadequate investment choices, and over a 20-

returns for members, but this is clearly not the case with master trust default (major balanced) investment options; their fees are higher and net returns are lower than funds in other sectors.

year period this translates into a difference of over 300 percent in the terminal value of an individual's retirement benefit. Similarly, the diverse performance of the *best-performing* default options indicates a large number of superannuation fund members face significantly different terminal superannuation values just because of differences among their superannuation funds' default investment option. Just as Selnow (2003) suggests that financial fate is often determined from birth, it seems that, if the present wide variation in default option investment performance continues, many Australians' retirement wealth (or otherwise) will be determined by the 'accident' of working for a particular employer or in a particular industry.

Table 2: Best Performing Industry Superannuation Funds Based on the Crediting Rate of the Default Investment Option for Five Years to June 2003

<i>Fund Name & Option</i>	<i>Segment</i>	<i>Option Sector</i>	<i>Performance</i>	
			<i>5 yrs</i>	<i>Rank</i>
CARE Super - Balanced Option	Industry	Balanced	7.6%	1
Catholic Superannuation and Retirement Fund - Balanced Portfolio	Industry	Balanced	7.4%	2
REST - Core Strategy	Industry	Balanced	7.1%	3
ARF - Balanced Investment Plan	Industry	Growth	7.0%	4
HOST-PLUS - Balanced Plan	Industry	Balanced	7.0%	5
Meat Industry Employees' Superannuation Fund - Accumulation	Industry	Balanced	7.0%	6
equisuper - equipselect - Growth	Industry	Balanced	6.9%	7
MTAA - Balanced	Industry	Balanced	6.5%	8
Australian Meat Industry Superannuation Trust - Balanced Option	Industry	Balanced	6.3%	9
HESTA - Core Pool	Industry	Growth	6.2%	10

Source: SelectingSuper accessed at <http://www.selectingsuper.com.au>

Table 3 : Best Performing Master Trust Superannuation Funds Based on the Crediting Rate of the Default Investment Option or Major Balanced Option for Five Years to June 2003

<i>Fund Name & Option</i>	<i>Segment</i>	<i>Option Sector</i>	<i>Performance</i>	
			<i>5 yrs</i>	<i>Rank</i>
AMP SL Secure Portfolio	Master trust	Capital stable	5.3%	1
NAIO BS National Balanced	Master trust	Balanced	4.2%	2
Citi CSMT Citigroup Balanced Trust	Master trust	Balanced	4.2%	3
MAP MSP Balanced Pool	Master trust	Balanced	3.9%	4
Mercer CS Mercer Growth	Master trust	Balanced	3.6%	5
ING CS ING Managed Growth	Master trust	Balanced	3.2%	6
Aon MTC Balanced	Master trust	Balanced	3.1%	7
SMF ES Balanced	Master trust	Balanced	3.0%	8
State Super PRP Balanced	Master trust	Balanced	2.9%	9
AMP CS Balanced Direct	Master trust	Balanced	2.9%	10

Source: SelectingSuper accessed at <http://www.selectingsuper.com.au>

Conclusion

In light of behavioural research findings it is disconcerting so little attention is given to types of choices offered to fund members. Elton, Gruber and Blake (2004: 1) observe:

With all the interest in how investors react given the choices they are offered, it is surprising that there have been no studies of the appropriateness of the decisions that corporations make with respect to which investment choices to offer plan participants.

In the Australian context, fund trustees determine which investment options are offered to fund members, and it is these fund trustees who also set a default option from the range of alternatives on offer. Given the pervasiveness of investment choice in superannuation funds and the low proportion of members making active choices, the role of the default

option has become pivotal in superannuation investment choice. However, virtually no policy-making attention has been paid to default investment options.

Policy makers need to urgently address whether and how default investment options should be regulated. This issue is much broader than the aspects of default options that have been debated in the context of fund choice over the past eight years. Superannuation members across different superannuation funds face significantly different end benefits in retirement simply because the fund to which they belong selected Option A as their default investment, rather than Option B, C, D ... or Z. Leaving the selection of the default investment option to superannuation trustees will inevitably lead to inequities among members of different superannuation funds. Gallery, Gallery and Brown (1996) highlighted the inequities among members of different superannuation funds at a time when few funds offered their members investment choice. Having now moved to a choice environment, those inequities are perpetuated for those members who either passively or actively opt out of making a choice.

Financial education programs may improve workers' knowledge and understanding of their superannuation to the extent where some individuals will commence to make active choices, but education cannot be a panacea. In a choice environment there will always be a core of superannuation fund members who will not make a choice because they are unable or unwilling to do so. Even if the proportion of passive choice members was reduced to the same level as Sweden (i.e., one-third), this proportion still represents a very large number of individuals (totalling some millions) exposed to the vagaries of the default investment selected by the trustee of their superannuation fund.

Some regulation would seem necessary to address the inequities and other problems associated with fund trustees having sole responsibility for selecting default investment options. However, regulating defaults could be seen as a double-edged sword: while laws and regulations can facilitate socially optimum defaults, they may also create avenues for the misuse of governmental power (Choi, Laibson, Madrian Metrick 2002b) or perceptions of unnecessary government interference.

Nevertheless, in the present system where superannuation savings are mandatory but those savings are managed by the private sector, the government has an obligation to provide 'safety net' protection for those savings (Gallery *et al.* 1996), particularly those of members making passive choice (Brown *et al.* 2002). During the fund choice debate, the Senate Committee highlighted the importance of ensuring that default options adequately protect the interests of those members who are unable to protect their own long-term interests (SSCS 1998) and the need for setting minimum standards for default options (SSCSFS 2000). Such protection and standards are even more crucial in the context of investment choice.

Some have argued that setting standards for default options will work against underlying competitive pressures in the industry (see SSCS 1998). Brown *et al.* (2002) suggest a possible solution is the establishment of a government-regulated universal default fund (UDF) to cater for members who are unable or unwilling to make informed choices. While it is recognized this solution is likely to be politically unpalatable for policy-makers and the superannuation industry alike, a UDF nevertheless represents a viable alternative to that of adding more layers of regulation to an already complex system of privately-managed superannuation.

Australian policy-makers can look to the experiences in other countries, such as the Swedish pension system, to evaluate how to best regulate default options that will result in the best possible retirement outcomes for all Australians. Whatever the outcome, the process of determining a suitable default option model needs to commence immediately.

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