

Edition 32, 20 September 2013

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Why academics like life annuities

David Bell

It remains a mystery in academic circles why people do not purchase life annuities. Financial models suggest life annuities are beneficial to rational decision-making individuals, yet in Australia the number of life policies purchased remains small (albeit with some nascent signs of growth). This is a global phenomenon – whether in the US, Canada, the UK, Switzerland, Israel, Chile or Singapore (all countries with developed defined contribution accumulation systems like Australia's), there is little take up of life annuities.

In this paper I explain the primary reasons why some researchers believe it makes sense for people to annuitise their wealth at retirement. In my next article I will discuss reasons why people do not annuitise.

In 1965 [Menahem Yaari](#)'s seminal paper on annuitisation was published. Titled "*Uncertain Lifetime, Life Insurance, and the Theory of the Consumer*", this paper came at a time when optimal asset allocation was the talk of the day. Research by people such as Harry Markowitz and Bill Sharpe into the CAPM (capital asset pricing model) and mean-variance optimisation was attracting much research attention. However all this work on asset allocation didn't consider uncertain lifetimes. Yaari not only introduced the concept, but he went on to model how a rational person would draw down their wealth in proportion to their self-assessed survival expectations (the amounts drawn down will decrease as one lives longer and experiences a lower balance). He introduced life annuities into the model and demonstrated that for rational people with no bequest motives, life

annuities have great attraction because retirement income does not have to reduce as a person ages – income is guaranteed for life. Finally he noted that people who buy annuities will experience a valuable ‘*mortality premium*’ which will actually increase their retirement payout (I’ll explain this shortly). Yaari’s work creates the idea of product allocation as opposed to asset allocation and it could be argued that it has greater application to financial planning; in some circles Yaari is known as the ‘Markowitz of annuities’.

For academic researchers, there are three important benefits of life annuities (this article assumes zero default risk by the annuity provider).

1. Annuities eliminate longevity risk

Rational models suggest that the purchase of life annuities increases individual welfare by eliminating the financial risks associated with uncertain lifetimes (ie longevity risk). Specifically life annuities eliminate the possibility of exhausting the savings of those who live longer than expected.

2. Constant income for life enables consumption smoothing

Life annuities provide a constant income stream for life. This effectively guarantees consumption smoothing through a person’s retirement lifetime. There are many proponents of lifetime consumption smoothing – as far back as famous economists Franco Modigliani and Milton Friedman. It is held that a smoothed consumption profile yields more utility than the utility derived from any other spending pattern across time. A life annuity is the only financial instrument which can provide a constant payment for the duration of an uncertain lifetime.

3. Mortality premium delivers higher income

In theory, life annuities provide investors with a higher level of consumption, generated by what is known as the ‘mortality premium’. This important concept is a direct benefit of individuals pooling together, enabling the life company to pay a higher rate based on the expectation that not all policyholders will survive to subsequent periods.

Consider the example of an individual who has \$1,000 to invest for a year. If they invest in an asset with 6% return, they will have \$1,060 at the end of the year. Compare this with a one year life policy where the payment is dependent on the survival of the policyholder. Assume that based on life tables the policyholder has a 3% chance of not surviving the year. Then, assuming the life company has access to the same asset, it can afford to pay \$1,093 (= \$1,060 / (100% - 3%)) at the end of the year. If we expand this process to a second year and then a third and so on we can grasp the concept that because expected survival rates from one period to the next are less than 100%, a lifetime annuity provider can commit to paying higher rates compared to a direct investment in the same underlying asset. Each individual yearly calculation aggregates up into the pricing of a lifetime annuity contract.

How well educated are advisers on the benefits that life annuities provide? In the Australian marketplace, Challenger is the clear market leader in annuity sales and it has unofficially taken on the leadership role in terms of championing the benefits of annuities. This entails both retail and financial adviser education but also lobbying and education of policymakers and regulators. Looking through Challenger’s marketing and education materials, I find mention is clearly made of the first two benefits, namely a lifetime income that is consistent. But I could not find a single mention of the mortality premium. It may be a difficult concept for retail investors to understand but surely it is important that advisers have an appreciation of this concept.

In my next article I will explore some of the reasons for the low take-up of life annuities.

David Bell’s independent advisory business is St Davids Rd Advisory. David is working towards a PhD at University of NSW.

Testing Ben Graham's voting and weighing machines

Roger Montgomery

[Last week](#), I explained three enduring principles laid out by Ben Graham, the father of security analysis and mentor of Warren Buffett:

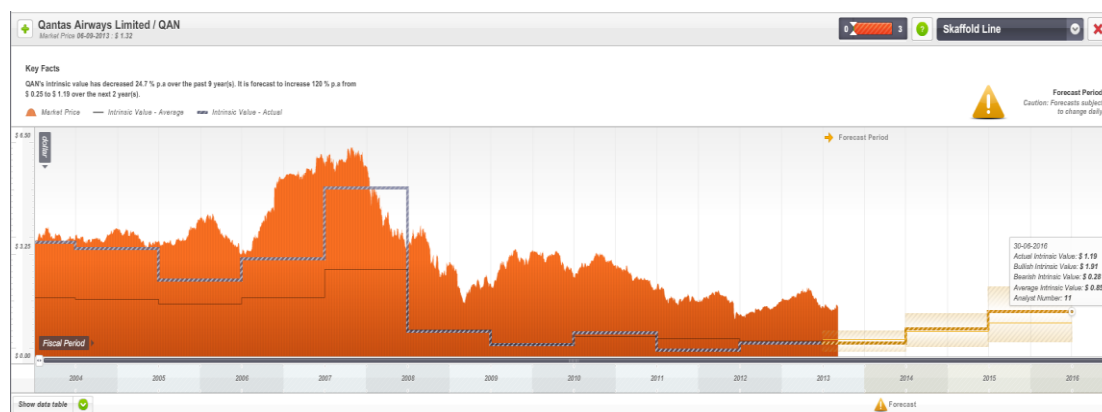
- the 'Mr Market' allegory
- the 'margin of safety'
- the market is a short term voting machine and a long term weighing machine.

What Graham described is something that, as both a private and professional investor, I have observed myself. Prices often diverge significantly from that which is justified by the economic performance of the business, but in the long term, prices eventually converge with intrinsic values. My definition of intrinsic value is the estimated actual value of a company determined through fundamental analysis without reference to its market value. The basic formula is the return on equity divided by the required return multiplied by equity per share.

This week, we compare estimated intrinsic value and share prices for some major Australian stocks to illustrate Ben Graham's enduring principles, using data and graphics from skaffold.com.

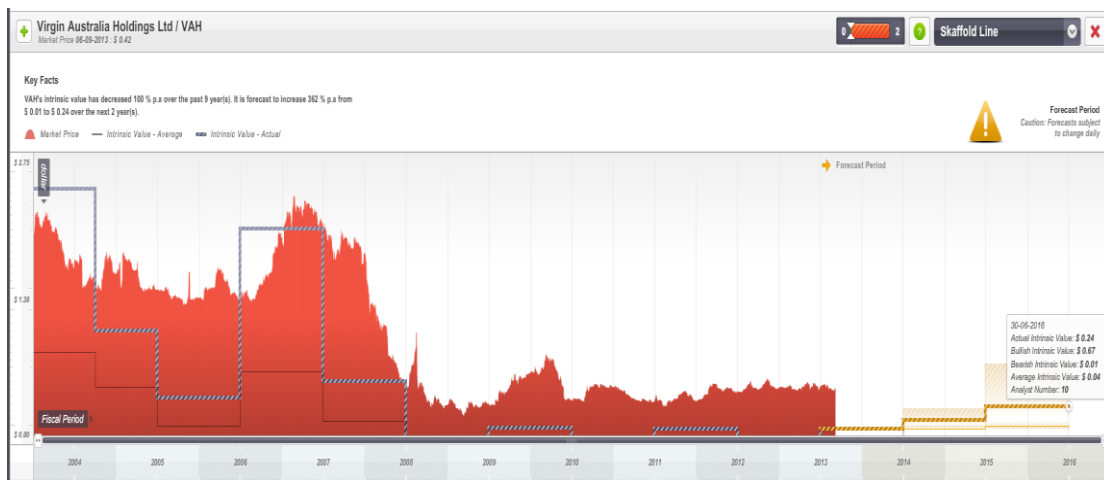
Figure 1 displays ten years of price and intrinsic value history for Qantas. You will notice is that Qantas' intrinsic value (the stepped grey line), based on its economic performance has, at best, not changed for many years. In fact, the intrinsic value of Qantas today is lower than it was a decade ago. And as Ben Graham predicted, the long term weighing machine has also correctly appraised its worth. The price (the orange shaded area) today is also lower than a decade ago.

Figure 1. Ten years historic and three years forecast intrinsic values for Qantas (QAN)



Airlines are a business with particularly challenging economics and whether run well or poorly have a long-term tendency to destroy wealth. Take a look at the Figure 2 for Virgin Australia.

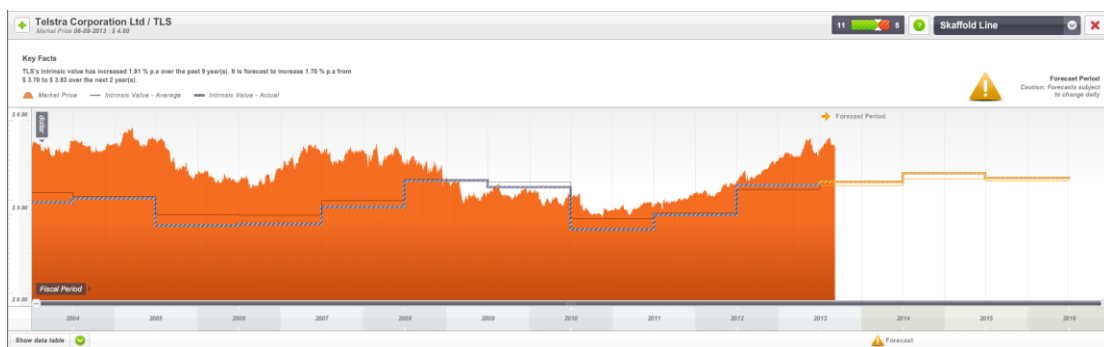
Figure 2. Ten years historic and three years forecast intrinsic values Virgin Australia (VAH)



Unless you can see a reason for a permanent change in the prospects of these companies, the long-term trend in intrinsic value gives you all the information you need to steer well clear. Irrespective of how hard the oarsmen of these business boats row, and no matter how qualified they are for the task, their rowing will always be distracted by the need to perpetually fix leaks in the boats' sides.

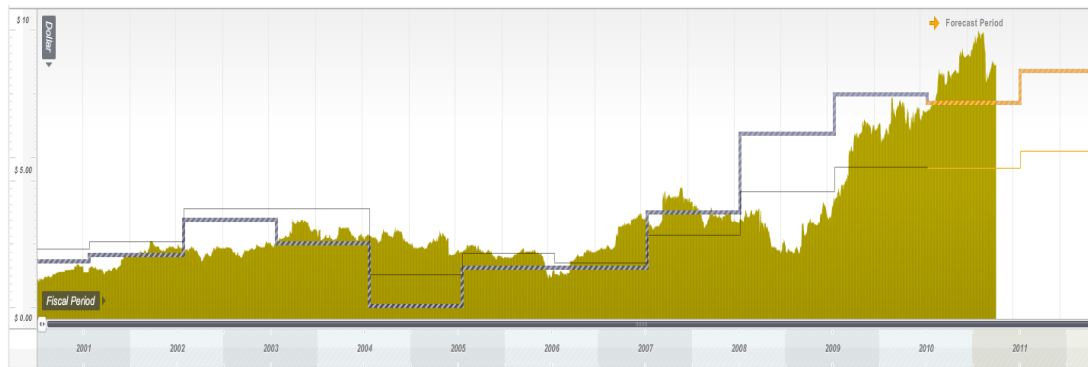
Take a look at Figure 3. This time it's a ten-year history of price and intrinsic value for Telstra. Sure, there have been short-term episodes of price buoyancy (such as the present affliction due to a bout of faddish infatuation with yield), but over the long run, the weighing machine has done and will continue to do its work. The intrinsic value of Telstra has barely changed in a decade, and neither has its price, and over time the share price will generally reflect the company's worth.

Figure 3. Ten years historic and three years forecast intrinsic values for Telstra (TLS)



Finally, take a look at the change in intrinsic value of Oronot prior to and after Sally Macdonald joined the company as CEO in 2005/06 (she recently announced her resignation). Once again price and value show a strong correlation over longer periods of time. Prior to Sally's arrival the price of Oronot tracked the somewhat benign performance of estimated intrinsic value. Then, from 2006 onwards, Sally's effort at improving the value of the company, which continued to rise up until 2012, was also reflected in an expanding share price.

Figure 4. Ten years historic and three years forecast intrinsic values for Oroton (ORL)



I acknowledge that there are critics of the approach to intrinsic value that we follow. Indeed, I am delighted there are as critics are necessary for commercial reasons; not only do they help refine one's ideas, but how else would we be able to find bargains in the market. If it was universal agreement I was after I would simply tell jokes to children.

Figures 1 through 4 (just four examples of those we have for every listed company) confirms what Ben Graham had discovered without the power of modern computing; that in the short run, the market is indeed a voting machine, and will always reflect what is popular, but in the long run, the market is a weighing machine, and price will reflect intrinsic value.

If you concentrate on long-term **intrinsic values** rather than allow yourself to be seduced by short-term **prices**, I cannot see how, over a long period of time, you cannot help but improve your investing. Ben Graham outperformed the market materially over an extended period of time. By abiding by his most popular edicts, you too are more likely to do likewise.

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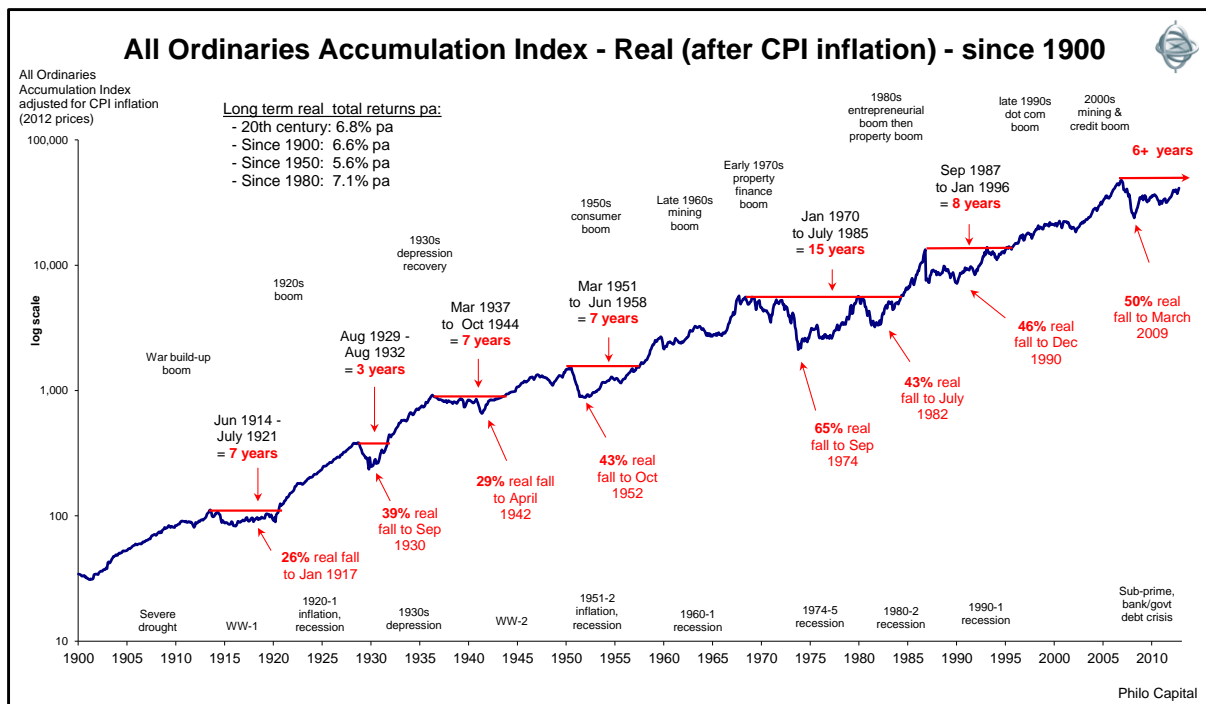
Hold the champagne, that's not a recovery yet

Ashley Owen

A milestone of sorts was passed by the Australian stock market this month. The total return index for the broad market (the All Ordinaries Accumulation Index, which includes re-invested dividends) finally clawed its way back to its November 2007 peak after nearly 6 years 'underwater'.

Six years may seem a long time to wait for a recovery, but in fact the real situation is worse than that. In terms of the real value of wealth after CPI inflation, the real (ie after inflation) total return index is still some 14% below its peak.

Our first chart shows the accumulation index (and its predecessors) since 1900, adjusted for CPI inflation.



The global financial crisis of 2008-9 was not a 'once in a century' or 'black swan' event as it was made out to be. There have been plenty of crashes of similar size (or worse) in the Australian market. In fact major collapses like these have occurred every decade or so. And it has almost always taken longer than 6 years to recover from these frequent major crashes.

Why is it relevant to look at this peak-to-recovery performance? Is it fair to look at performance starting from the boom-time peaks?

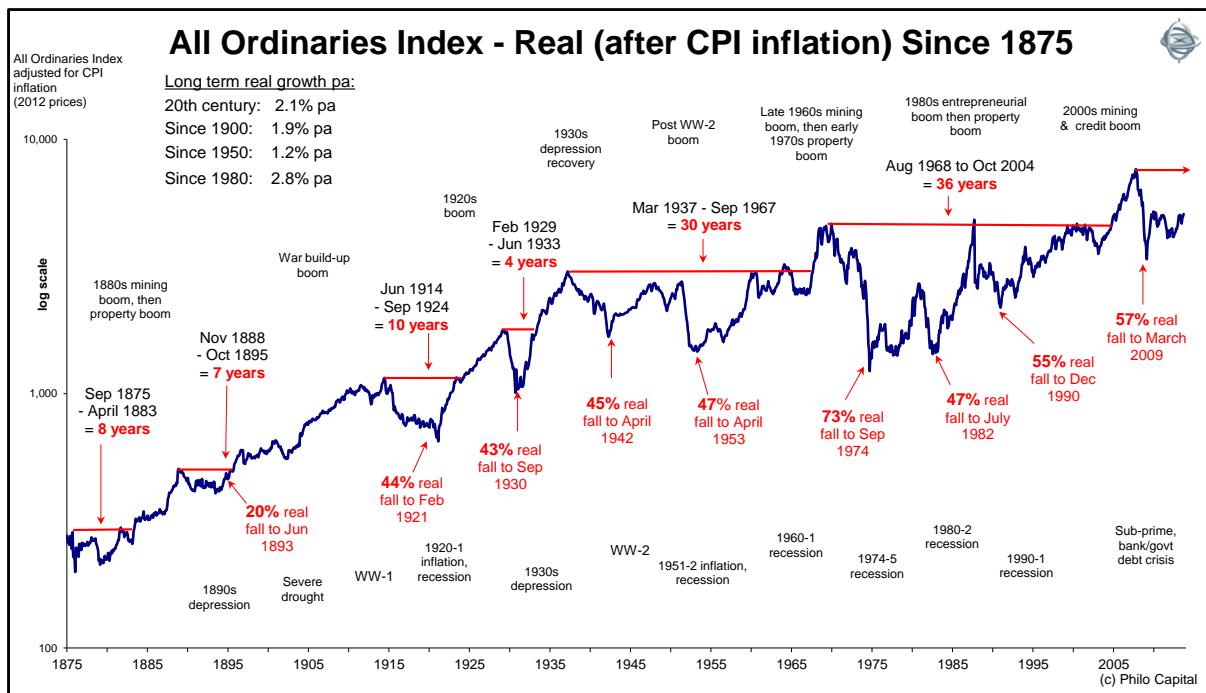
It is important because, sadly, many thousands of investors were enticed into the market right near the top by the media frenzy in the height of the boom. Adding to the flurry of share buying was the government's \$1 million window for lump superannuation contributions that closed in June 2007. The impact of this government measure was very similar to the introduction of franking credits in July 1987. In both cases, large numbers of investors were caught up in the frenzy, sold other assets (incurring tax liabilities in many or most cases) and bought shares or contributed to super funds that in turn bought shares at the height of the boom, only to see their values halve in the crash that followed shortly after.

In both cases the flood of extra money from new investors pushed share prices even higher in the boom, meaning they had further to fall in the bust that followed.

Price index

Looking at total returns like this is academic for many investors because the total return index assumes religious reinvestment of all dividends over the whole period. Retirees who live of the dividend income are more interested in share prices and not total returns, since they spend the dividends.

If we look at the real price index (adjusted for CPI inflation) we see a slightly different story:



Here we see two separate periods in which it took 30 years or more for the broad diversified share price index to recover. That's a whole generation at a time waiting for the market to recover from crashes after booms, which is when many people buy into the market.

Readers with a keen eye will notice that the All Ordinaries index today is barely above its August 1968 peak in real terms after inflation some 45 years later. Actually it's up just 0.5% pa. That's 45 long lean years of virtually zero price growth for people who bought into the large index stocks at the height of the boom.

What were those stocks that dominated the index 45 years ago? It's mainly the same old companies that dominate it today (with some exceptions, notably CBA which was floated in 1991). Of the big cap stocks in 1968, the share prices of Bank of NSW (Westpac), BHP, AGL, Woodside and QBE are all less than 3% pa ahead after inflation (and after adjusting for capital structure changes). However the share prices of ANZ, NAB, CRA (RIO), Santos and Lend Lease are all still below their 1968 boom time highs - after 45 years!

That's 45 years to wait just to get back to square after inflation, let alone make any real capital growth, for those who bought in the boom.

These are broad index returns that are largely driven by the largest stocks. Many investors don't just stick to the boring big stocks at the height of booms. Many are lured into speculative hot stocks, and most of these inevitably disappear altogether in the crashes that follow the speculative booms.

How long to recover the 2007 peak?

Even for those investors who did avoid the hot stocks and stuck to the big boring companies that drive the index, it will probably be many, many years before the All Ordinaries index recovers to its 2007 boom-time high in real terms after inflation. Today the index is around 5,200 and the November peak level was 6,853 so the market index will need to rise by a further 32% from current levels to get back to the peak level.

However, the inflation-adjusted November 2007 peak target is now 7,900 and climbing steadily with inflation. It would require the market to rise by another 50% from current levels to get back to the inflation-adjusted peak. If that takes another say three years to achieve, then that's three more years of inflation of say 2.5% each year. That raises the target by another 8%, which means it would require a rise of 64% from today's level to achieve over three years. That's a big ask.

Inflation is a silent destroyer of wealth, and it is a major reason why it takes such a long time to recover from busts.

It will be a long, long wait for those who bought in the boom, but that is the way it has always been. Investors who bought the 'time-in-the-market' and 'buy & hold' myths and the efficient markets hocus pocus will have a very long wait indeed.

This story refers to the returns from the broad diversified index. Let's not forget that most fund managers fail to beat even the broad market index after taxes and fees. In future instalments I will cover the return histories of individual companies to see who fared better or worse than the broad diversified index over time.

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers and a director and adviser to Third Link Growth Fund.

What's so smart about smart beta?

Adam Randall

The term 'smart beta' has only been around since perhaps 2007, although it seems that we have been hearing about these strategies for much longer. Smart beta sits between passive and active investing and aims to leverage the benefits of both while avoiding the pitfalls. Smart beta strategies have several common characteristics: they are rules-based and transparent at a high level; they claim to outperform the market over the long term; and they have varying levels of quantitative influence. But why should investors consider them, and are they really that smart?

What is beta?

The beta of a portfolio is its exposure to the market capitalisation weighted portfolio (cap weight). This is usually the benchmark like the S&P/ASX200 or MSCI World. Why the cap-weighted benchmark? Well, it is the net position of everyone in the market. Beta is measured by regressing the portfolio returns against the market return. If the market is up 2% then down 3%, and your portfolio is up 1% then down 1.5%, then your portfolio has a beta of 0.5. That is, it moves half as much as the market. If you hold stocks in your portfolio in equal proportion to the cap-weighted benchmark, then you will have a beta of 1. For more information I suggest reading Markowitz (1959) and then Sharpe (1964).

So, really, what's wrong with cap weight?

The market's returns are the average of all investors, importantly, *before fees and taxes*. Fund managers will manage a cap weighted portfolio for very low fees; it has massive liquidity and capacity, so why doesn't everyone just invest in it? If cap weight is the average portfolio of all investors, and investors can have very different reasons for buying, selling, holding, or not holding a stock, then to invest in cap weight means you are *receiving* the same investment objectives, both long and short term, as the average investor.

Supporters of smart beta alternatives argue that cap weight will always overweight overpriced securities and underweight under-priced securities, and the effect of this is largest just when you don't want it. The tech boom and bust is an example where the market can massively misprice entire sectors over long periods of time. Investing in a cap weighted index has you underweight the wrong sectors before the boom, but more importantly, overweight the wrong sectors at the bust. Furthermore, the market can be irrational for long periods of time.

We want more beta

Theory tells us that the risk premium rewards you for taking on more risk, so for decades portfolio managers overweighted stocks with a beta of 1.5 or 2. Simple, hey? Not quite. In his 1972 working paper Robert Haugen first showed that stocks with high volatility (prices jump around a lot) generally had lower subsequent returns. High beta stocks have high volatility. As Haugen's findings didn't fit in with the accepted theories, they were ignored for 30 years by many academics and some fund managers.

The beta described above is market beta. We can also measure exposure to other factors such as high dividend yield stocks or high growth stocks. This is the basis of what is known as Arbitrage Pricing Theory, which says that the returns on your portfolio are dependent upon its exposure to many different factors. In the same way that we can increase or decrease our portfolio's exposure to the market, we can increase its exposure to other factors like energy, gold or changes in interest rates. Thus, you can build a strategy that has your desired exposure to any type of beta.

Some standard smart beta strategies

Historical testing of all commercial smart beta strategies shows that they outperform the cap weighted market over the long term. In the US or Global, this will be in the order of 2-3% per annum over 40-50 years (see Table 1). In Emerging Markets and Developed Small Caps the outperformance is generally 4-5%. All strategies attempt to break the link between a stock's price and its weight in the portfolio, deliver a diversified portfolio, and give a higher Sharpe Ratio (a measure of the excess return for the risk taken) than the market. Portfolios that have stable target weights through time, such as equal weighted and fundamentals weighted, have low turnover and benefit from a rebalancing bonus.

Equal Weight is the simplest alternative beta strategy; just invest the same amount in each stock, let the weights drift and then rebalance back to equal weight each quarter or year. It sounds simplistic and naïve, but over the long term this outperforms, and in fact it is difficult to build a strategy that outperforms equal weight over the long term. The nice thing about Equal Weight is that it makes no assumptions about expected return or expected risk. The S&P500 Equal Weight Index, launched in January 2003, now has nearly US\$4.5 billion invested in related ETFs.

Fundamentals strategies weight companies according to accounting metrics such as total sales and dividends paid, see, for example, Arnott et al (2005). Like equal weight it has slow moving weights to rebalance toward, claiming the rebalancing bonus. However, it also has a moderate tilt toward value and has higher capacity and liquidity. As of December 2012, Research Affiliates had US\$74 billion under management in their Fundamental Index strategies.

Equal Risk Weight and Risk Parity make no assumptions about expected returns, but weight stocks according to their historical volatility. Other risk controlling strategies include Low Volatility and Low Semi-Deviation, which have evolved from the work of Haugen. Moving further toward the quantitative end of smart beta are strategies like Minimum Variance, Maximum Diversification and Risk Efficient Index, which build upon the work of Markowitz in the early 1950's.

Table 1: Long term returns of popular smart beta strategies

1964 to 2012 using 1,000 largest stocks in the United States

Strategy	Return	Standard Deviation	Sharpe Ratio
US Cap Weighted	9.7%	15.3%	0.29
Equal Weight	11.3%	18.3%	0.33
Minimum Variance	11.8%	11.7%	0.56
Maximum Diversification	12.0%	14.0%	0.48
Risk-Efficient	12.5%	16.8%	0.43
Risk Cluster Equal Weight	11.2%	14.6%	0.41
Fundamentals Weighted	11.6%	15.4%	0.41

Source: Research Affiliates

Table 1 highlights that all strategies outperform cap weighted over the long term, and that cap weighted is the outlier. Factor analysis shows the strategies outperform for similar reasons: they all have a significant tilt toward value and/or smaller companies (alternatively, cap weight underperforms because it tilts away from value and/or smaller companies). Smart beta is sometimes criticised for simply capturing well known factors. In an industry which has at times valued complexity as superior intellectual thought, simply capturing well known factors in a transparent manner has been undervalued.

So what's wrong with smart beta?

You will have noticed the phrase 'outperform over the long term.' Smart beta strategies will perform differently in different markets environments, sometimes significantly. If there is a flight from risk, then low volatility will outperform, while equal weight might underperform if the flight is toward large cap.

The trap that investors can fall into is ignoring or selling out of a smart beta strategy that has underperformed for a year or two and investing in something else. This locks in your losses, and you might just time it completely wrong so that the next strategy is just starting its own period of underperformance. Recalling that the tech boom lasted years, most strategies that weren't heavily invested in tech stocks would have underperformed for years. The tech bust, however, would have more than redeemed these losses, assuming that you had fortitude enough to stick to your strategy when others were riding high.

Fund managers will charge more for smart beta than for passive market cap indexing. They would argue that over the long term, after fees and taxes, smart beta outperforms by 1.5% - 2.5% per annum. They would also argue that active managers are in general less transparent and are more focused upon the short term.

Smart beta investing is about understanding the limitations and the timeframe of practical alternative beta strategies, and accepting that outperforming by 2% per annum over 10 years really is world class investing.

Choosing a smart beta strategy

Many large institutional investors have moved away from the core/satellite approach where most of the equity portfolio sits in market cap and the remainder in medium to high conviction active managers. They have allocated less to market cap and active managers and made an allocation in one or two smart beta strategies. When one of the managers or smart beta strategies has exceptional returns the investor rebalances to a strategy that has had market or economic

headwinds. But this is done looking over a period of years, where the investor is not concerned whether the profits are moved in a month or in a year.

Smart beta strategies are rules-based and generally transparent, but they all have a quantitative element, with some strategies becoming a little opaque. A fund manager should be able to easily attribute returns, describe why they are increasing weight to a sector, or have sold out of a country. Costs due to trading are important: some smart beta strategies have large capacity, low turnover and are very liquid. The after-tax returns of the strategy also need to be considered, with some strategies having far lower turnover than others.

Smart beta strategies can and will underperform the market cap for periods of time. You need to understand this pattern of performance and have a long term mindset. Measure the performance against similar factors, such as a value benchmark, and check that the claims of the smart beta strategy are holding. The reward is the potential for higher longer term returns in a cost effective manner. Smart beta is a term you will hear more of, and more strategies will come to the market over time.

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Cost of life insurance in super will rise significantly

Stuart Turner and Maree Pallisco

Recent prudential reforms for superannuation trustees include significantly enhanced responsibilities relating to the management of the life insurance benefits provided to members. This comes at a time of considerable profit pressure within the life insurance industry, pushing premiums up and putting pressure on benefits. In this environment, what can superannuation trustees do to maximise the value of insurance for their members?

The life insurance industry is now enduring a perfect storm. After many years of intense competition in the group insurance market, and high acquisition costs in the retail market, the pressures of increasing claims and higher lapse rates are taking their toll on profits.

In light of this, superannuation trustees need to take a more active role in assessing their existing insurance cover against their members' needs to ensure it is still delivering the right balance of benefits versus cost. A clear understanding of insurance market conditions, and a focus on process and data quality, will help trustees create an attractive value proposition for their members.

[Recent APRA statistics](#) show that, over the past 12 months, the Australian life insurance industry recorded a loss of over \$100 million on group insurance policies (death, TPD and disability). Reinsurers have also been heavily impacted in Australia, with reserve increases significant enough to be the headline item in global profit announcements. Long delays in group insurance claim reporting, mental health claims and disability products have all been cited as problem areas, with reinsurers becoming increasingly cautious in the group life market.

In the short term, superannuation members have been getting a great deal – the insurance premiums paid by members are less than the cost of providing insurance. But this is clearly not sustainable, and many superannuation funds are finding their insurance premiums rising significantly.

At the same time, APRA has introduced new responsibilities for superannuation trustees in the form of *Superannuation Prudential Standard 250 – Insurance in Superannuation (SPS 250)*. Among other things, the new standard requires trustees to maintain insurance data for a minimum five year period – a measure directly aimed at helping insurers to price more accurately and therefore driving a more sustainable industry.

Data quality is a constant challenge for group life insurers. Often, insurers deal with complications from missing data fields, poor records of benefit changes over time, incomplete or unreconciled premiums, and uncertain run-off periods for claims. In the current profit-strapped environment, such data failings will increasingly be met with price hikes to cover the risks associated with incorrect or incomplete information.

Improving data quality is not just an issue for insurers. The new SPS 250 rules clearly outline that superannuation trustees have ultimate responsibility for maintaining data quality, and this goes beyond simply requiring a third-party insurer or administrator to hold accurate information. APRA expects trustees to:

- conduct testing of premium calculation, underwriting, and claims management processes
- hold more than five years of data if the typical claims run-off is over a longer period
- maintain a history of insurance benefit design
- have established processes for accessing data when required, if their records are held by a third party

For superannuation funds, these new obligations should not be viewed as just another compliance burden. They will not only improve insurance data quality but ultimately drive fairer insurance pricing that is better aligned to fund members.

So what should a prudent trustee be doing to make sure they not only meet the requirements of SPS 250, but also gain improved outcomes when it's time to reprice insurance premiums?

- **Have a clear strategy for insurance data records.** If retaining data internally, establish clear extract processes that allow that data to be easily collated and provided to insurance companies for pricing purposes. If relying on an administrator or insurer for the data, define the data extracts now and periodically request them to ensure that they are readily accessible. Also consider how you will access data if your insurer or administrator changes.
- **Understand the performance of insurance portfolios.** Regular analysis of insurance profitability will assist in understanding any potential impacts on insurance premiums when it comes time to re-rate portfolios. It may also help to refine the insurance offering to members, if particular types of cover are too costly for a fund's membership profile. If profitability varies significantly in different segments of the fund's membership, perhaps separate divisions for insurance would better align insurance costs with the member risk profiles.
- **Review insurance benefits to ensure relevance to fund members.** For many years, life insurance has experienced 'feature creep', as small additional benefits were added into policies in an effort to gain an edge over other products on the market. Automatic acceptance limits for insurance have also been increasingly steadily. While the cost of each marginal change may be small, ultimately they add up, putting additional pressure on claims and premiums. By revisiting the benefit design of existing insurance coverage, and removing any features of limited value to members, trustees may be able to better align cover to their members' needs while also reducing pressure on premiums.
- **Clean insurance data periodically.** Establish regular processes to review insurance data for completeness and, where gaps are identified, make required corrections to member or claims records. Such issues are easier to correct when identified close to the time of claim, through

the implementation of regular and structured data monitoring. The improved data quality should also have the added benefit of increasing the confidence of group insurers.

- **Test insurance processes regularly.** Periodically test insurance premium calculations against administration systems, application of underwriting rules by administrators, and alignment of claims management processes to product design. Process errors that go unidentified for long periods are very expensive to investigate and rectify – identifying issues early, can significantly reduce the cost to members.

By focusing on these five key areas, trustees have an opportunity to go beyond mere compliance and derive real organisational and member value from APRA's increased insurance obligations. At a time when premiums are rising, minimising insurance costs while maximising relevant benefits should be a priority for all superannuation funds.

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