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17 December 2020

Dear Sir/Madam

Your Future, Your Super package – Exposure Draft – Underperformance

Telstra Super Pty Ltd as trustee for the Telstra Superannuation Scheme is pleased to provide this submission in response to the exposure draft legislation, specifically the 'Underperformance' suite, released on 26 November 2020 following announcements from the Federal Government's Your Future, Your Super proposed changes in the October 2020 Budget.

If you have any queries or comments in relation to the content of our submission, please contact us by phone on [redacted]

Yours sincerely

Chris Davies
Chief Executive Officer
TelstraSuper

Graeme Miller
Chief Investment Officer
TelstraSuper

17 December 2020

Response to "Your Future, Your Super package" – Underperformance

1. This response is submitted by Telstra Super Pty Ltd, as trustee of the Telstra Superannuation Scheme (TelstraSuper). TelstraSuper is Australia's largest corporate superannuation fund, with approximately $23 billion in funds under management and more than 84,000 members.

2. This submission relates exclusively to the proposed "underperformance" measures.

3. We note that the draft legislation (Part 6A—Annual performance assessments) provides a framework for annual performance assessments of superannuation funds to be made, but provides that the detail of these performance assessments will be specified in Regulations that are yet to be published. The absence of Regulations makes it difficult to provide a fully-informed submission. Nonetheless there are a number of critically important issues we wish to bring to your attention.

4. We are supportive of the principle that superannuation funds should be held to account for the performance they deliver to members, and that where appropriate, the regulator should be empowered to take action to protect the interests of superannuation members.

5. To avoid adverse or unintended consequences, we believe that the yet-to-be-published Regulations require very careful thought and analysis, and that Treasury and APRA should consult widely with the industry prior to proposing or publishing those Regulations.

6. We believe that the proposals as announced in the October 2020 Federal Budget are highly problematic, and if the Regulations reflect these proposals, this will give rise to numerous adverse (and most likely unintended) consequences, including:

   (i) *Superannuation funds will be forced to change their investment objectives, to the detriment of member outcomes.*

   We believe that the overarching objective of all superannuation funds should be to provide members with financial security in retirement, at an appropriate level of risk. Typically, funds aim to achieve this outcome by articulating return objectives relative to CPI – i.e. aiming to outperform inflation and provide members with real growth in their financial wealth, without taking excessive risk.

   In contrast, the proposed measures for a product's performance makes no reference to financial security, to achieving real growth of financial wealth, or to risk. Instead, the proposed measures simply focus on performance relative to a group of arbitrary listed market benchmarks over a single arbitrary time period.

We are concerned that the proposals will force funds to divert their focus from what really matters (i.e. financial security of members in retirement) to managing investments only relative to these benchmarks.

(ii) *The proposals are likely to result in well-run superannuation funds being erroneously classified as underperforming and forced to close down. Perhaps of more concern, the proposed assessment process will not necessarily identify poorly-run superannuation funds and these funds will be permitted to continue operating.*

Given the inherent and natural volatility of investment markets, comparing a single eight year period's performance to a set of listed benchmarks is not a statistically reliable method to judge investment skill.

Our modelling shows that, simply as a result of the natural variability in investment markets and the differences between the composition of a typical superannuation fund's assets[1] and the assets held in the proposed benchmarks, there is:

- approximately a 36% chance of a well-run, skilful superannuation fund failing the proposed assessment in any given 8 year period;
- about an 80% chance of a well-run, skilful superannuation fund failing the proposed 8 year assessment test at least once in a 20 year period; and
- about a 50% chance of a very poorly run fund not failing the proposed assessment in any given 8 year period.

Similar modelling, with consistent results, has been carried out by respected industry groups and consultants.

We would be deeply concerned if Treasury or the Federal Government thought this to be an acceptable outcome.

(iii) *Superannuation funds are likely to make changes to their investment strategies that will reduce diversification and increase risk.*

The proposed performance assessment test will introduce material asymmetry in the risk/return considerations for funds when deciding on whether to actively invest in a manner that is different to the proposed benchmarks. Given that the consequences of underperformance for funds and their members will be catastrophic (i.e. will effectively result in the fund ceasing to exist), we believe that the proposal:

[1] It is assumed that the fund invests actively and has exposure to illiquid assets broadly in-line with the industry fund average

- creates inappropriate disincentives against active management; and
- creates inappropriate disincentives against investing in unlisted assets such a property, infrastructure, private equity, venture capital, agriculture and timberland.

We believe this will lead to materially more passive management and less (or no) investment in unlisted assets. This will reduce diversification and increase risk for members. It will also result in members missing out on the potentially superior returns (and/or lower risks) that unlisted assets and active management have to offer.

(iv) *Certain superannuation funds may substantially increase risk in their portfolios as they attempt to recoup prior years' underperformance.*

For the minority of funds that are already in danger of being declared underperforming (on the basis of their performance to 30 June 2020) the asymmetry embedded in the proposals provides incentives to take inappropriately large amounts of risk in the next year or two, in a desperate attempt to try to recover from their past underperformance.

This excessive risk-taking would clearly not be in the best interest of members.

(v) *Innovation in superannuation product design will be stifled, and funds will be constrained in their ability to tailor product features to meet the financial needs and preferences of specific cohorts of members.*

We are concerned that fear of being declared "underperforming" will drive most funds to adopt investment strategies that look very similar to one-another and the benchmarks that have been proposed. Innovation and differentiation will be stifled.

As an example, a product that is designed for risk-averse members, that deliberately seeks to deliver less volatile returns by targeting lower risk investments within an asset class, will be at material risk of being declared underperforming, even if it delivers exactly what it is intended to do.

(vi) *Vital projects for Australia's future prosperity will be starved of capital – for example in infrastructure, venture capital, private equity, agriculture and timber.*

As noted above, the proposed listed market benchmarks will discourage and penalise investment by superannuation funds in major unlisted projects and opportunities. Instead, this capital can be expected to be reallocated to the primarily offshore listed vehicles that dominate the proposed benchmarks.

As an example, two-thirds of the proposed benchmark for the infrastructure asset class is comprised of US-based assets, with less than 3% allocated to Australia. We find it hard to believe that the Federal Government would want to actively encourage offshore investment in preference to supporting Australia's infrastructure sector.

7. To address these major issues. we believe that the Regulations should include the following features:

   (i) The performance assessment should be based on multiple metrics over multiple periods, rather than being based on a single crude metric of performance over a single period of time. Treasury and APRA should consult widely with the industry on these metrics.

   (ii) The performance assessment should be made, wholly or substantially, relative to the stated objectives of the fund, as articulated to members.

   (iii) If the Government or APRA wishes to introduce metrics for assessing performance that differ from a fund's stated objectives, this should not be done retrospectively and funds should be given time to adjust their strategies to reflect these new assessment criteria.

   (iv) If the Government wishes to compare performance to benchmarks, it is essential that these benchmarks are reflective of the assets, strategies, risk profiles and objectives of the fund. For example, listed benchmarks should not be used to judge the performance of unlisted assets. Levered benchmarks should not be used for unlevered assets. Global benchmarks should not be used for Australian assets.

   (v) There should be provision for APRA to recognise that historical performance is not necessarily reflective of future performance, particularly in circumstances where funds have made major changes to their resources and processes. We therefore believe that Regulations should give APRA discretion to consider all relevant facts prior to deeming a fund's product to be underperforming, rather than this assessment being based on a single binary test. Furthermore, funds should have a fair and transparent process to appeal any such determination.