2/05/2023

Claire McKay
Director, Members Outcomes and Governance Branch
Retirement Advice and Investment Division
The Treasury
Langton Crescent
Parkes ACT 2600

Via email: **yfys@treasury.gov.au**

Dear Claire,

Superannuation Performance Test Regulations 2023

AustralianSuper welcomes the opportunity to provide a written submission regarding the draft Superannuation Performance Test Regulations 2023. We acknowledge and thank the Government for their ongoing commitment to the improvement of fund performance for Australian superannuation members.

AustralianSuper is Australia's leading superannuation fund and is run only to benefit members. Three million Australians are members of AustralianSuper and we invest over $280bn of their retirement savings on their behalf. We act in members' best financial interests by helping members achieve their best financial position in retirement.

Ongoing weaknesses of the performance test

AustralianSuper has long been a supporter of performance testing. We have consistently and unambiguously supported the stated policy to measure fund performance in a consistent and universal manner to assist members to compare fund performance and, by extension, highlight the best and worst performing funds over the long term. Given the compulsory nature of Australia's retirement system and the importance of funds acting in the best financial interests of members, we support measures that ensure only strong long-term performing funds receive Australians' superannuation contributions.

We reiterate our previous position on the performance test, namely that the test:

- only measures how well a fund has implemented its own chosen strategy, not whether the strategy itself is effective in generating strong returns for members over the long term
- is therefore largely an attribution exercise – where each fund compares itself against its own strategic asset allocation (SAA)
- does not adequately capture the value-add that a fund may generate from asset allocation decisions by Trustees
- rewards a poor investment strategy that is implemented well, and
- applies an inconsistent timeline between investment performance (8 years expanding to 10 years) and administration fees (1 year).

Consistent with these concerns, we consider that reforms should be made to the YourSuper Comparison Tool to ensure that the default is that products are sorted from highest net returns to lowest net returns.

We remain of the view that the performance test should be adjusted to reflect relative performance against a universal industry benchmark (tailored to the respective product type). This has the dual benefit of ensuring a more objective test is applied to all industry participants, as well as providing consistency and clarity to members seeking to use the information to make decisions about their retirement savings.

We do not believe that additional benchmarks or more granular benchmarks will improve the effectiveness of the current performance test. We question the value of adding complexity from a member and comparison perspective.

Additionally, all APRA regulated superannuation products should be subject to performance benchmarking, and annual performance assessment, not just MySuper and Trustee Directed Products. This includes Choice products and retirement products. The performance of retirement products is particularly important given a member in retirement does not have an extended period of time to build savings like a member earlier in their working life.

The proposed changes

Under the proposed regulations, the performance test continues to measure how well a fund has implemented its own strategy, not whether the strategy is effective in generating strong returns for members over the long term. By adding more asset classes / sub-asset classes, the performance test will likely become more permissive in measuring how effective the strategy has been in generating returns for members.

The addition of more asset classes and benchmarks is proposed to "neutralise tracking error". Whilst some in the industry have advocated for more asset classes and benchmarks to "neutralise tracking error", this only serves to further eliminate the incorporation of asset allocation and portfolio construction decisions in the test. The test becomes an even more granular attribution exercise – where each fund compares itself against an increasingly granular and self-defined SAA.

We continue to advocate that actual net performance over a long-term period (such as 10 years) against a universal industry benchmark (tailored to the respective product type) would be a far better approach, testing all aspects of an investment strategy – i.e. asset allocation, portfolio construction and security selection. By contrast, under the proposed changes, the test becomes increasingly anchored in just security selection, which is generally the least important of the three aspects for generating net member returns.

We understand the rationale for introducing the additional benchmarks at a more granular level. However, the proposed changes do not address the ongoing risk of funds 'hugging the benchmark' and the test outcomes are still not well-aligned with outcomes for members that incorporate all dimensions of performance a fund can control.

Detailed analysis of the benchmarks can be found in the **Attachment**.

Timeframes and administration fees

We support the staged extension of the testing period from eight to ten years as previously recommended by AustralianSuper. Ten years is a timeframe already required by APRA for product dashboards and the consequential disclosures designed to provide members with decision-making information about superannuation products.

We are still not aware of any compelling rationale for the performance test to apply a one-year timeframe for administration fees. Superannuation is a long-term investment. The investment performance period is eight years (and being extended). Net benefit is what is most important to outcomes in members' best financial interests. We have seen funds adjust their administration fees to change their administration and performance history, in a way that may be short term and not reflective of long-term administration savings. The one-year timeframe for administrative fees represents an inconsistency at the heart of the performance test. It makes the performance test less reflective of strong long-term performance in generating net benefit for members.

Coverage

We welcome the extension of the test to Trustee Directed Products and encourage the Government to extend the test to <u>all</u> APRA regulated superannuation products, including Choice products and retirement products.

We note that in 2021 APRA calculated the value of funds under management in Choice products that will not be Trustee Directed Products as 33% of FUM of all APRA-regulated superannuation products.[1] Consequently, the measures still do not provide Australians with a complete picture of fund and product performance, to enable them to make informed choices regarding the fund which best suits their circumstances.

Retrospective vs prospective

We understand there is a range of views and complexity regarding whether the proposed new benchmarks are applied retrospectively or prospectively. We do not support the new benchmarks being applied retrospectively.

Under the proposed changes to introduce additional benchmarks, funds can potentially choose a 'new' benchmark that improves the outcome for a particular product (and essentially rewrite history).

---

[1] APRA – 13 April 2021 - Senate Economics Legislation Committee - ANSWERS TO QUESTIONS ON NOTICE - Treasury Laws Amendment (Your Future, Your Super) Bill 2021.
https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/TLABYFYS/Additional_Documents

Access to benchmark data

Gaining access to each new benchmark potentially imposes a cost on each fund and by default each member. We agree with the Australian Institute of Superannuation Trustees' (AIST) recommendation that Treasury should initiate a process for commercially provided indices to be made available to super funds on a collective and cost-effective basis.

We would be pleased to provide additional information or to discuss this submission in further detail. If that would be of assistance, please do not hesitate to contact Nick Coates, Acting Head of Government Relations and Public Policy (ncoates@australiansuper.com).

C.N.Cramond

Regards

Mark Comer & Chris Cramond

Joint Acting Chief Strategy & Corporate Affairs Officer

Attachment: Covered asset classes and benchmarks

Attachment – Covered asset classes and benchmarks

Our view remains that fewer benchmarks is better than more: ideally relative performance would be assessed against a universal industry benchmark (tailored to the respective product type). That being said, we understand this may not be feasible in the confines of the Review and therefore make the following comments in regards to some of the proposed benchmark changes or additions (items 3 and 48, Schedule 1 to the draft regulations; proposed sub-regulation 9AB.17(7) Table of covered asset classes).

a. International Equity (developed markets and emerging markets)

We see this change as unnecessary and would question the premise of the problem that it is trying to solve. The existing benchmark for international equities (MSCI All Country World Ex-Australia Equities Index ("ACWI") with Special Tax) includes a look-through exposure to emerging markets, which has ranged from circa 11% - 14% in recent years.

The ability to split out developed markets and emerging markets as part of international equity SAAs is seen as necessary from a number of industry participants. A common refrain is that funds have a tactical, strategic or structural overweight to emerging markets compared to the MSCI ACWI index weight, which creates tracking error versus the test. We would contend that such an overweight is likely initiated in order to achieve outperformance over developed markets. Conversely, funds may have an underweight to emerging markets. Either way, RSEs should be held to account for this decision as a value adding or value detracting decision and the tracking error was known and understood at the time of the decision(s) as one of the most important decisions that an RSE makes in setting an international equities portfolio. Therefore, we see this delineation as unnecessary and the apparent need to "neutralise tracking error" in international equities will only serve to mask poor decisions. When combined with the ability to make changes retrospectively, we are concerned that funds who have made poor decisions in this area will be incentivised to re-categorise poor portfolio construction decisions as SAA decisions.

b. International Unlisted Property

In the time available for consultation and given the cost involved to access new indices, we have not been able to access the time series or the characteristics of the proposed benchmark (MSCI Global (excl. Pan Europe and Pan Asia Funds) Quarterly Property Fund Index (Unfrozen) hedged). However, we have been able to access the Index Methodology and note the following criteria: *"Carry no more than 60% leverage, where leverage is defined as the ratio of total debt to the fund's total Gross Asset Value."* This level of leverage would likely be a great deal larger than most funds' typical core unlisted property exposures and therefore create a risk mismatch (with substantially higher leverage than the Australian unlisted property fund index), or encourage funds to pursue higher risk strategies in unlisted property, which may not be in members' best financial interests. Funds also cannot re-orient their international unlisted property strategy rapidly to account for a new benchmark. We would recommend that this benchmark not be introduced at this time, to allow for further consultation with the industry. Whilst the Australian unlisted property index creates tracking error versus international unlisted property, this tracking error is known and understood by industry participants and the style of investment is likely to be more similar, even if the region is not.

c. Fixed Interest

i. Australian Fixed Interest (Bloomberg Ausbond Master 0+ Index)

The Bloomberg Ausbond Master Index includes Inflation Linked Bonds (ILBs). We understand some funds invest a material SAA in ILBs and therefore it may have seemed prudent to introduce an index with an allocation to ILBs. However, we believe it would be more pragmatic to retain the previous benchmark (Bloomberg Ausbond Composite Index). The Australian ILBs market has not developed to the point where the liquidity allows us as managers to make active decisions around this sector allocation. Likewise, building even an index weight would likely take many months or years, due to the low liquidity in this market. The extended duration of the ILB index reduces its attractiveness for any defensively styled investments. Any portfolio or option that retains a CPI linked benchmark is not properly hedged by these ILBs given the moves in Break Even Inflation (BEIs) / real yields will be the dominant return factor rather than capital accrual from principal indexation.

ii. Australian Credit / International Credit

We see an inconsistency in the way that credit indices are specified between Australian and international credit. For international credit, the Bloomberg Global High Yield Index hedged is used (sub investment grade), whereas for the Australian index, a corporate investment grade index is used. The coverage and risk profiles of these indices are very different. The High Yield Index also has a longer duration than is typically used by funds and where a floating rate sub-investment grade index (such as the Morningstar Leveraged Loans Index) would be more appropriate. However, we would not support the proliferation of credit benchmarks and again stress that less benchmarks are likely better than more.

If limited to one credit index we strongly prefer an international investment grade credit benchmark to better align the respective groupings between Australian and international fixed income. Therefore, for international credit, an index such as the Bloomberg Global Credit Index or the Bloomberg Global Corporate Index would be preferable.

d. Growth Alternatives / Defensive Alternatives

Given the proposed introduction of two additional alternatives sectors, “Defensive Alternatives” and “Growth Alternatives”, with different allocations to the underlying international equities and fixed interest benchmarks, we see the potential for this to be too tolerant with the majority of funds likely to choose defensive alternatives. There is no industry-agreed definition of a “growth alternative” versus a “defensive alternative” and we see the potential for inconsistency and/or misinterpretation, given the self-defined nature of the investments and the permissive nature of the classifications. This is particularly given the disparity in benchmarks between the two (i.e. 75% equities / 25% fixed interest for growth alternatives and 25% equities / 75% fixed interest for defensive alternatives). We therefore see a disincentive for funds to disclose ubiquitous alternative assets as “growth alternatives” even if the characteristics of the investment would suggest as such.

When combined with retrospectivity and given the result for the majority of the nine years to 30 June 2023 will be known, we see the potential for the benchmarks to become highly permissive. The need for surveillance from APRA will be significant and potentially burdensome, particularly in a largely self-defined asset class. Compared to traditional asset classes (for instance, it would be difficult to re-categorise a pool of equity investments as fixed interest), the ability to oversee RSE’s self-classification of alternatives as either growth or defensive alternatives would seem difficult.