<u>Perennial's Submission to the Department of Treasury – Annual Superannuation Performance Test – Design Options.</u>

We write to you with respect to recent changes that APRA have implemented via the MySuper Heatmap, a result of the Government's Your Future, Your Super (YFYS) reform. We have set out below a recommendation for both domestic and international equities benchmarking, we invite your consideration of that proposed.

About Perennial

Perennial Partners is multi boutique investment management firm managing some $8.0bn of assets on behalf of retail, wholesale and institutional investors. Our organisation offers a number of differentiated investment capabilities from some seven boutiques that partner with our firm namely Perennial Value Management Ltd, Perennial Better Future Pty Ltd, Perennial Solutions Group Pty Ltd, Perennial Smaller Companies Pty Ltd, Daintree Capital Management Limited, Fairlight Asset Management Pty Ltd, Perennial Private Investments Pty Limited and Perennial Private Ventures GP LP Pty Ltd.

Our boutiques manage equities both in private and public markets locally and globally, we also manage absolute return credit funds. The Perennial business has considerable experience and an organisational bias in supporting smaller businesses from late-stage growth venture in private companies, pre-IPO through to listed micro-cap and small cap investing. We also offer the more traditional mid and larger cap domestic equity products.

Our submission

Our Submission focusses on requesting that consideration be given to the inclusion of two additional benchmarks to help facilitate investment by superannuation funds in smaller company's locally and globally. We ask that the S&P ASX Emerging Companies index and the MSCI World Small Cap Index be included as benchmarks.

Australian Domestic Equities Benchmarking

It has been a number of years since the updated superannuation performance benchmarking was implemented, we encourage Treasury to consider certain unintended consequences on smaller, innovative listed and privately owned Australian companies which in turn can impact the broader Australian economy and Australian retail investors. It is our view that certain benchmarking of returns in the MySuper Heatmap methodology paper impacts the shareholding performance of the Australian retail investors which the reform is looking to protect.

<u>Our suggestion for the MySuper Heatmap is to introduce an additional Australian Equity asset class by adding the S&P ASX Emerging Companies index as a separate benchmark for superannuation funds' allocations to Australian small cap and micro-cap companies.</u>

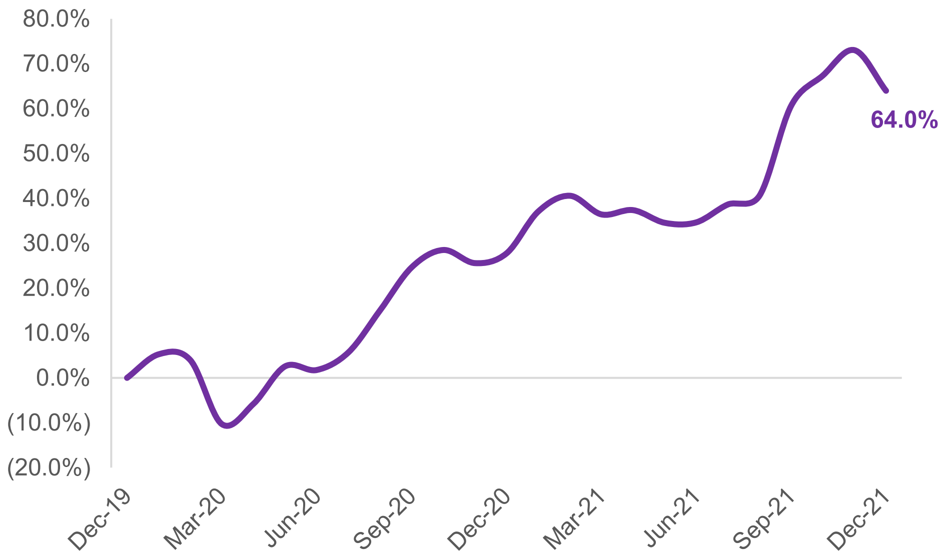
In our view, the MySuper Heatmap encourages Australian superannuation funds to divest their shareholdings in Australian companies that sit outside of the S&P/ASX 300. The reason for this is because the superannuation funds' performance is assessed against the S&P/ASX 300 index. Therefore, if superannuation funds hold shares in listed companies which sit outside this index, the performance of that share is at risk of diverging in share price performance from S&P/ASX 300 constituents. Superannuation funds will not want to risk variances in performance to the benchmark and therefore, they have divested from companies sitting outside the S&P/ASX 300.

This divestment is evidenced by the following:

- The S&P/ASX Emerging Companies Index experienced 24 months of strong performance leading up to the MySuper Heatmap methodology paper in December 2021. However, in the

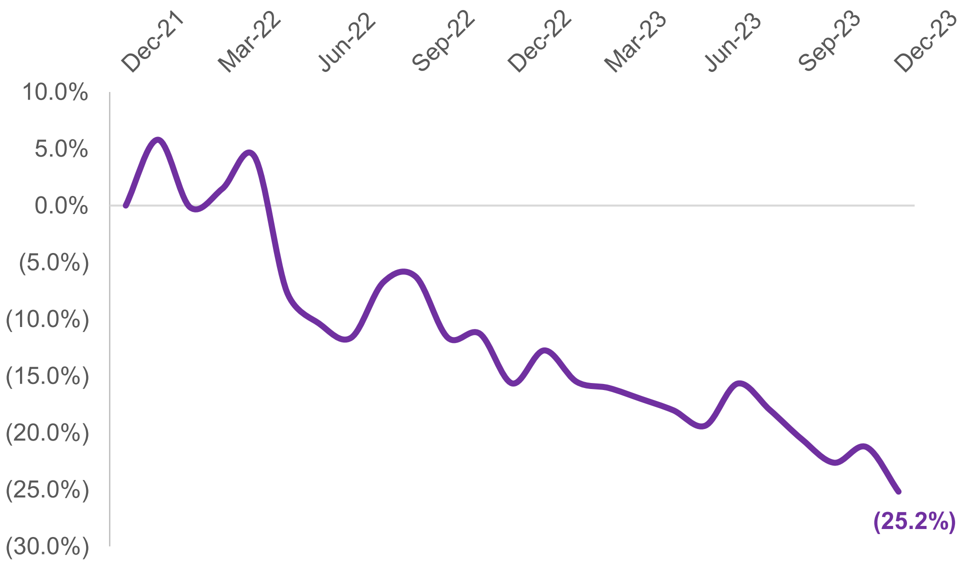
24 months following the paper, the S&P/ASX Emerging Companies Index (excludes the largest 300 companies on the ASX) experienced weaker performance.

Relative <u>overperformance</u> of S&P/ASX Emerging Companies Index v S&P/ASX 300 in the 24 months <u>leading up to</u> APRA publishing the MySuper Heatmap Methodology Paper (Dec-21)



Source: Investing.com

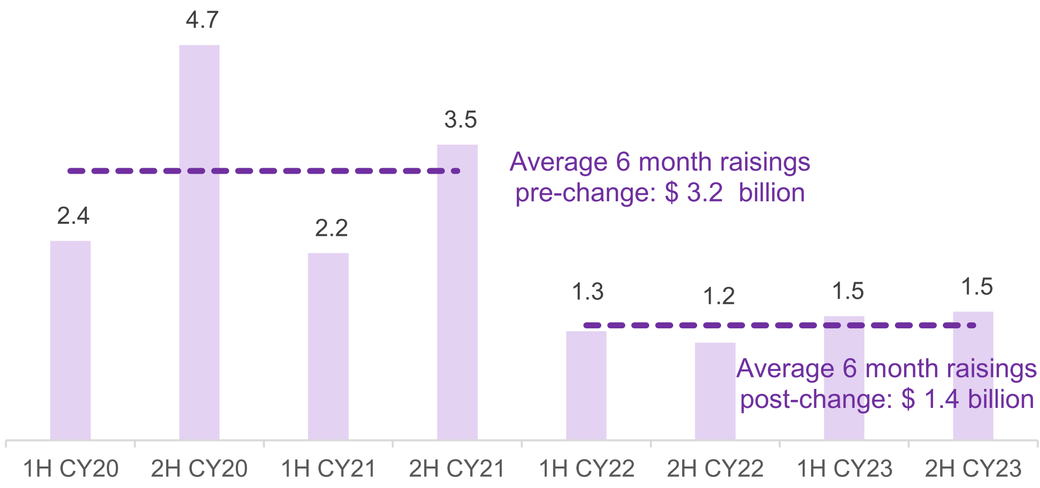
Relative <u>underperformance</u> of S&P/ASX Emerging Companies Index v S&P/ASX 300 in the 24 months <u>following</u> APRA publishing the MySuper Heatmap Methodology Paper (Dec-21)



Source: Investing.com

- The recent inability for ASX small cap companies to raise capital efficiently via follow-on raisings (placements and/or entitlement offers) and IPOs. This is demonstrated below:

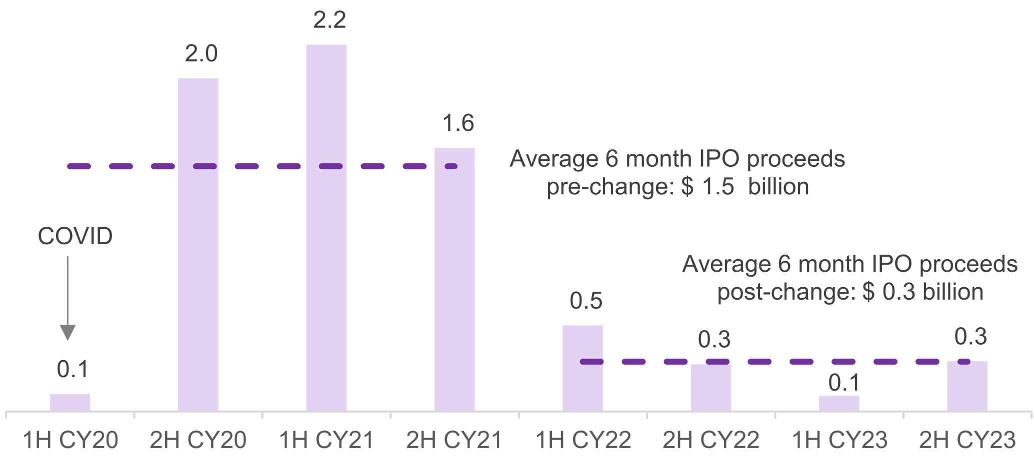
Placement and Entitlement Offer Proceeds for ASX companies (excl. Metals and Mining) with a Market Capitalisation of A$500m or less ($ billion)



Source: FactSet

Follow-on capital (placements and entitlement offers) raised by ASX companies with a market capitalisation of A$500m or less has reduced ~57% from the 2 years leading up to APRA publishing the MySuper Heatmap Methodology Paper (Dec-21) v the 2 years following.

IPO proceeds for ASX companies with a Market Capitalisation of A$500m or less ($ billion)



Source: FactSet

IPO proceeds raised by ASX companies with a market capitalisation of A$500m or less has reduced ~80% from the 2 years leading up to APRA publishing the MySuper Heatmap Methodology Paper (Dec-21) v the 2 years following.

In our view, this divestment out of Australian listed small / micro cap and privately owned companies, which has taken place by Australian superannuation funds, has several negative consequences which should be considered going forward.

- The divestment by superannuation funds from these smaller companies has resulted in these companies' share registers de-institutionalising i.e. institutions are selling their shares in companies to retail shareholders. This means that these smaller ASX companies have less guidance from institutional shareholders, who can often provide timely insights to management, which can assist with operational, financial and share price performance. In turn, this benefits other shareholders (such as retail shareholders) too.
- The de-institutionalisation of these registers is a function of institutional investors, such as superannuation funds, selling shares to retail investors. When this happens, the institutional investors are often selling a large parcel of shares to several smaller shareholders. Naturally, such a significant amount of shares (relative to the company's market capitalisation and liquidity) being sold on market, can lead to poor share price performance for the company. This impacts the share price of companies which, once de-institutionalised, can often be solely owned by retail shareholders.
- Once the significant selling pressure from these institutional investors subsides, a lot of these companies have been left with small market capitalisations, and solely a base of retail shareholders. This has a negative impact for the company as they can no longer quickly raise capital, which typically requires an institutional shareholder/s (via a placement or institutional entitlement offer). This also impacts the ASX, as a key attraction of the ASX for companies is its efficient capital raising structures.
- Reduced investment by Australian Superannuation funds into Australian private companies as these companies share price performance does not track S&P/ASX 300 performance. This has meant that Australian private companies not only have less support from institutional investors at IPO (if they wish to go down this route), but also face reduced institutional demand when they look to fund themselves in private markets for longer, leading to a more difficult funding environment.
- Less access to capital (as discussed in the above two bullet points) restricts the ability for these innovative and growing companies to fund further jobs, which has a broader impact on the Australian economy.
- Due to the poor experience these smaller companies have had on the ASX, the IPO market has been impacted, as quality, smaller companies who have witnessed their peers suffer a negative experience on the ASX, may no longer view the ASX as a viable option, depriving Australian institutional and retail investors of quality investment opportunities on listed markets.
- Many of these smaller ASX companies are being acquired in control stake transactions. Although it is common for these companies to be acquired at a premium to recent share price performance, these share prices have often been off a low base due to the recent selling pressure on these companies' shares (as discussed above). This evidences the undervaluation of these companies on the ASX. After they are acquired, the acquirer (typically being larger companies within that industry or private equity investment funds) will benefit from the company's performance over the coming years, rather than ASX listed investors.
- There are currently 2,307 companies listed on the ASX, there is no relevant index to encourage or facilitate investment in the 2,000 odd companies that sit below the ASX 300.

With the benefit of the above data points, and the assisting commentary, we encourage Treasury to give further consideration of the impact of Australians largest pools of capital, our superannuation funds, not being encouraged to support and invest in smaller Australian businesses. We therefore recommend the inclusion S&P ASX Emerging Companies index as a separate benchmark for allocations to Australian small cap and micro-cap companies, to provide further support to Australian listed small / micro-cap and private companies.

International Equities Benchmarking

Australian investors understand the case for including domestic small and mid-cap (SMID) companies in their portfolios and have typically benefited from these allocations. This is however, at odds with their more sparing allocations to global SMID, leaving them underweight this non-trivial US$13 trillion asset class (approximately 40x the size of the Australian SMID market).

Whilst it is understandable from a behavioural perspective that investors naturally gravitate toward large and well-known foreign companies when investing offshore, Fairlight (Perennial's global small and mid-cap equities manager) believes that there is a compelling case for also including an allocation to Global SMID for several key reasons:

Global small caps typically outperform global large caps

Long-term studies provide a wealth of evidence to support the claim that globally, smaller companies outperform their larger counterparts. From 1927 through 2015 in the U.S., the return premium earnt by investing in small cap companies relative to large cap companies was 3.3% (Andrew Berkin, 2016). Similarly, an analysis of fifteen European markets found an average return premium of 2.4% to small companies over the period 1982-2014 (Stanley Black, 2015).

The small company return premium is intuitive as smaller companies are able to grow faster and have a longer runway to compound growth. Less sell-side coverage means that smaller companies exhibit greater mispricing offering further opportunities to outperform. The return premium may also compensative for lower liquidity and less diversified business models.

The probability of small company outperformance increases steadily with investor time horizon. Figure 1 shows that for long-term investors, the probability of small company outperformance has historically approached 100%.

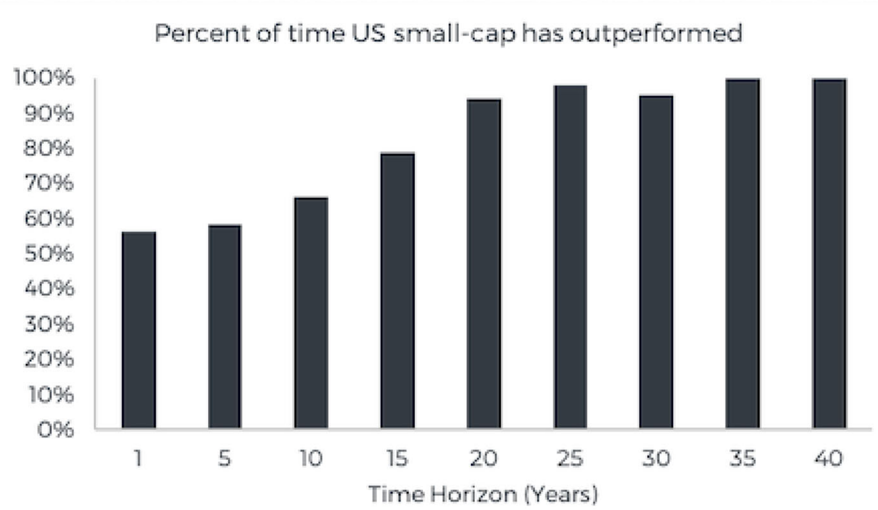


Figure 1. Source: Hanna & Peng, "Small Stocks vs Large: It's How Long You Hold That Counts", 1999

An allocation to SMID improves the risk/return characteristics of global equities.

Diversification is famously the one free lunch in finance and investors can benefit from the imperfect correlation of small and large caps. The reason for this imperfect correlation is because returns generated by large cap stocks are substantially driven by common global factors, while in contrast, returns from small cap stocks are primarily driven by local and idiosyncratic factors.

Whilst small companies are modestly more volatile than large ones in isolation, a blend of global large and global small companies does not necessarily have to be more volatile than a portfolio of global large companies because of the benefits of diversification (Figure 2 uses a large/SMID ratio of 75/25%). This allows investors to earn some of the historic return premium associated with smaller companies, without necessarily taking on additional risk. Restated in finance theory terms - the addition of global SMID moves the efficient frontier of the portfolio upwards.

	Global Large	Global SMID	Global Blend (75/25)
Annual Return	6.7%	8.7%	7.2%
Standard Deviation	11.4%	12.5%	11.5%
Sharpe Ratio	0.28	0.42	0.33

Figure 2. Source: MSCI & Fairlight (MSCI data series begins Feb 2002)

The absolute risk characteristics of global SMID are attractive relative to Australian equities.

The ultimate barometer of the risk characteristics of an asset class was the realised performance during the 2008 financial crisis. During this difficult period, global SMID exhibited better risk control for unhedged Australian investors than both Australian large cap and Australian small cap equities (see Figure 3). This relative defensiveness comes from the tendency of the Australian dollar to depreciate relative to other developed world currencies in periods of economic stress, providing a buffer to unhedged AUD returns.

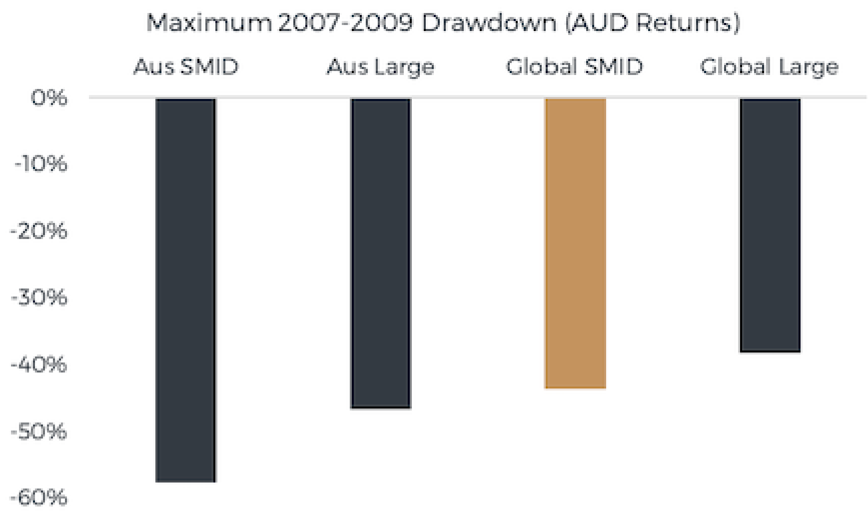


Figure 3. Source: MSCI

For Australian investors adding a portfolio allocation to global SMID can increase portfolio expected returns without a commensurate increase in risk.

We encourage Treasury to consider adding a separate benchmark for allocations to global SMIDs in the MySuper Heatmap, with the relevant benchmark index being the MSCI World Small Cap Index.