JANA
DEPTH WITH DIFFERENCE

19 April 2024

Sent to: YFYS@treasury.gov.au

Members Outcomes and Governance Branch
Retirement Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

To whom it may concern,

Annual Superannuation Performance Test – design options

Thank you for the opportunity to provide feedback on JANA's views with respect to the Consultation.

JANA has been closely involved with the 'Your Future, Your Super' (YFYS) policy since it was first announced in October 2020. We have responded to multiple previous consultations and engaged with a range of industry stakeholders to provide thought leadership in this space. As Australia's largest asset consultant, we have also worked with multiple superannuation entities on a variety of YFYS projects. We therefore believe we can bring a unique perspective to the consultation.

JANA commends Treasury on its engagement with the industry to improve the YFYS policy. We see opportunity to improve the test, however, noting industry has employed meaningful resources to understand and manage the performance test, any changes made should be considered through an efficiency and impact lens.

The views and suggested improvements expressed in this paper are the views of JANA and not our clients. Any opinions expressed in this paper do not constitute advice on behalf of JANA.

We would be delighted to discuss any of the points raised in this consultation response further.

Regards,

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JANA Contact Details

Any questions regarding this submission can be directed to the below.

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About JANA Investment Advisers

JANA Investment Advisers was established in 1987 and is Australia's leading and largest investment advisory and research firm. For over 35 years, we have provided considered and responsible advice to our clients, rooted in our depth of talent, global research, deep insight, and innovative thinking.

Today, we have grown to over 140 staff members, with $1.4tn in funds under advice. A management-owned asset consultancy, JANA advises over 80 institutional clients across superannuation funds, universities, foundations, endowments, charitable trusts, insurers, corporate clients, long-service leave funds and family offices. JANA-advised clients have a history of outperforming both their internal benchmarks and peers.

At JANA, we believe that together with our clients, we can make a meaningful positive difference to the lives of millions of everyday people directly or indirectly impacted by the advice we provide. Therefore, we are strongly aligned to increase accountability for financial outcomes in superannuation and improve member outcomes.

Summary

We summarise our consultation response as follows:

- JANA commends Treasury for the broad ranging consultation and welcomes further engagement with industry.
- In responding to this consultation, we note that we are not starting from a 'blank sheet.' We recognise that the current test is well understood. Industry has been required to adapt to continual change over recent years. Material resources have been spent on understanding, monitoring and managing investment strategy to ensure no unintended consequences with regard to the test. In addition to the direct cost associated with this, it has taken up a meaningful proportion of the industry's overall capacity for further change and innovation. The benefit of improving the test and ensuring that it is enduring needs to be weighed against the near-term costs associated with further change.
- Our response is provided through a 'sustainable finance' lens and reflects our view that policy direction and support is imperative in mobilising private sector capital to support our national emissions reduction targets and other sustainability initiatives. A systems-level approach that recognises the interconnectedness of environment, society and economy in enabling a resilient foundation for finance and investments; thus, leading to long term members' best financials interests.
- The current test has limitations, and JANA continues to advocate for a broader approach to the performance test, as we have in prior submissions. We support the addition of further metrics for assessment of success, either through a hierarchical testing framework or through greater regulator discretion in the administration of the test (for example, enabling consideration of a range of metrics and option specific considerations before determining consequences). We consider that this would be effective in minimising the negative unintended consequences of the test and ensure that the performance testing framework was enduring and robust.
- We do not support moving to an alternative single metric test. In our view, none of the alternative single metric tests fulfill all the principles outlined in the consultation paper, nor are they sufficiently superior to the current test to warrant the change.
- We additionally consider that there are incremental improvements that could be made to the existing test and that a framework for ongoing review of asset classes and benchmarks will be required.

Principles for Reform (Question 1)

The paper outlines four principles, to be used to assess potential changes to the testing framework. We support these principles as a sound approach to assessing proposed design changes to the performance test. However, we make the following observations:

- **Improves member outcomes**: Consistent with the objective of superannuation and the productivity commission, the requirement for the test to improve outcomes is appropriate.
- **Effective and efficient**: We support a test that is objective and with clear consequences. However, regulator discretion for the application of consequences may have merit, particularly with a more widely applicable test, applied to products that may have alternative/additional objectives that members actively seek out. We support a goal of not constraining or misidentifying well performing funds, and allowing for regulator discretion over how the application of consequences of failure will further support this goal.
- **Widely applicable and transparent**: We support the goal of a consistent and comparable measure of performance across products. However, we agree this needs to be applied in a manner that does not unfairly punish products offered by trustees to meet member specific needs/preferences.
- **Enduring**: A well-designed test that can endure a changing market/industry and therefore enable less ongoing change should be prioritised. We commend the emphasis on providing certainty to industry to ensure that long term performance is not impacted by changes to the test that reset the rules or baseline.

In addition to these principles, we consider that unintended consequences should be thoroughly considered in the design of the test. This could be incorporated in the first principle, by emphasising that the design of the test should not negatively impact the capacity of the industry to deliver member outcomes. It could alternatively be phrased as a standalone principle.

Design Options

Single Metric Test

2	While we consider the assessment of the implementation of strategy important, assessment of the appropriateness of a strategy is equally, if not more important, particularly in the case of MySuper options where members may not be making an active choice to select the strategy that is being assessed. However, we recognise that other regulatory frameworks exist through APRA and ASIC to ensure trustees are offering appropriate strategies to members.
3 – 5	We do not believe the methodology can be significantly improved through further benchmark proliferation, however, some benchmark recalibration may be appropriate where the benchmarks used are not representative of the opportunity set. We have observed the largest benchmarking 'gaps' are in emerging sectors within asset classes and/or new asset classes that may have once been included withing an 'alternatives' asset class but have drastically different characteristics to the existing defensive or growth alternative benchmarks. Although there could be a case to expand the list of asset classes to better capture these emerging sectors/asset classes, many of these asset classes are in less-liquid and hard to benchmark areas which

<table>
<tr><td></td><td>would likely continue to increase the cost of benchmarking through the use of less-widely adopted indices.

In addition, we believe the underlying issue is the pressure to 'benchmark hug', which we consider arises from the binary nature of a single-metric test that has significant consequences. We believe this issue could be better addressed through broadening the test's assessment and/or in the implementation of consequences by the regulator, such as enabling greater regulatory discretion to make a comprehensive assessment of performance and determine consequences following failure of the performance test, with consideration across a broad range of metrics. This more holistic approach would help to reduce specific concerns about investing in assets that improve overall outcomes for members but that increase tracking error relative to the test.

Notwithstanding, we would highlight:
Currency Hedging: JANA has identified a technical issue with the treatment of currency hedging when reported at the option level. We have provided worked examples for a number of our clients (anonymised), provided at the end of this consultation response.
International Unlisted Property Asset Class: We do not believe the benchmark for the International Unlisted Property Asset Class is representative of the asset class and broad opportunity set, with an allocation to domestic property. We would consider further engagement with industry on whether alternative benchmarks would be beneficial.
New Asset Classes : The current list of covered asset classes does not adequately capture Affordable Housing, Domestic Residential Property, Emerging Climate and Biodiversity related investment opportunities. We consider that any additional asset class would require significant industry consultation before formally establishing the asset classes and an appropriate benchmark, and we note that some of these are still very much 'emerging'.
We continue to strongly support the use of unlisted asset class benchmarks instead of simply reverting to the use of listed benchmarks given the importance of more like-for-like comparisons. Notwithstanding, we are cognisant of the limitations of some benchmarks (including the International Unlisted Property Asset Class) and would support further industry engagement on the matter.</td></tr>
<tr><td>6</td><td>Regular review of the asset classes will be required. Critical to this process will be significant industry consultation on the expected characteristics and appropriate benchmarks for the asset class.</td></tr>
<tr><td>7</td><td>We consider the threshold for failure should be recalibrated for Sustainability-related options. The composition of these options differ from 'standard' options and their performance can vary materially as a result. Members invested in ESG/sustainability labelled options have made an active choice to hold these products and will have done so based on investment objectives disclosed within the Product Disclosure Statement (PDS) that may not reference the composite benchmark metric used in the Performance Test. It is reasonable to assume that such members who invest in sustainable investment options do so because of their investment beliefs and preferences regarding the benefits of this type of investment.

The specific approach to ESG and sustainability varies significantly across funds. The introduction of new or alternative benchmarks (such as ESG/sustainability focused benchmarks) is not considered a solution for this as it will only inflate the challenges</td></tr>
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	currently experienced with indices, and may influence where industry focuses investment opportunity. Rather a widening of threshold for failure that accounts for the greater level of tracking error experienced by these options would be appropriate and should align with Treasury's proposal under the Sustainable Finance Strategy Consultation, to develop a sustainable finance taxonomy and a labelling system for such investment products.
8-14	In our view, there is no alternative single metric test that would fulfill all the principles outlined in the consultation paper, nor sufficiently ameliorate existing concerns with the current single-metric test to merit a change to the performance test. More so, the industry has adapted to existing limitations of the current test, and we believe the hurdle to change to a new approach should be that it materially improves the test and member outcomes. • **Simple Reference Portfolio:** While performance against simple reference portfolio is a valid metric and could be used as part of a multi-metric or hierarchy-based testing framework, we consider it would not be an improvement on the current test if used as the sole metric for assessment. There could be further unintended negative consequences, such as less investment in lower risk unlisted assets. • **Sharpe Ratio**: Assessment of risk-adjusted performance in the form of the Sharpe ratio has merits and would be a welcome addition in a multi-metric or hierarchy testing framework. If used as a sole metric, it could have unintended negative consequences, such favouring private market assets and other issues outlined by Treasury. • **Peer Comparison of Risk-Adjusted Returns**: We believe there is more complexity than value associated with a peer comparison of risk-adjusted performance given the number of required assumptions for appropriate comparison. Additionally, we believe each product should be considered with regards to its own merits given differences in alternative/additional objectives that members actively seek out.

Multi-Metric Test

15	As expressed in prior consultations, JANA considers a multiple metric approach, where a Fund that fails the existing performance test would then be measured against one or more additional metrics before formally failing. This would be more sophisticated and allow for a comprehensive and more effective test with fewer unintended negative consequences than posed by a single metric test. We are supportive of utilising the heatmap metrics as part of the assessment framework. These broaden the measurement of success and have the significant benefit of already being calculated and assessed by the regulator and well understood by industry.
16	JANA is of the view that considering a broader range of metrics would allow for a more comprehensive view of performance and reduce the incentive to benchmark hug.
17	Correlation between metrics is not necessarily an issue. In cases where a product is reading poorly on numerous metrics this is merely reiterating the conclusion that the product is doing poorly. However, in cases where there are mixed signals the benefit of the multi-metric test is that false conclusions are less likely. For example, in a case where a product has failed the YFYS performance test metric but has outperformed peers.

18	The metrics included in the APRA Heatmaps form a solid starting point, but two key additional metrics worth consideration are: 1) performance versus CPI+ objectives and 2) a risk adjusted version of the current Performance Test, such as the Sharpe Ratio (as discussed in our response to questions 8-14 above). To form a final list, consideration to how they are combined would be essential.
19 – 20	While an overall metric for a product might reasonably be determined using a weighted average of the scores of a range of metrics, a traffic light system (majority pass), or mandating a hurdle on a certain proportion of the metrics that must be met, we are not supportive of this approach given that we are not starting with a 'blank sheet.' We consider that an approach that combines metrics in any one of these manners may seem to make test simpler to administer but in practice represents an additional layer of complexity and more significant change than the approaches we would favour (outlined below) without commensurate additional benefits.
21-25	While there are many valid means of implementing a more holistic testing approach that serve to mitigate the unintended negative consequences of the test and ensure we have a robust, enduring test, we consider it prudent to prioritise an approach that leverages the progress made on the current test and the existing regulatory framework with additional metrics limited to those that will make a substantive difference to outcomes. We would favour either: • Retention of the current framework but with regulator review in the instance of failure of the test. The regulator would be expected to assess performance on multiple metrics and consider option-specific circumstances in their assessment of next steps. This would remove the need for formal cohorting and additional assessment metrics for products with different objectives, such as Sustainability/Ethical products. Transparency on the approach and consequences would be required to provide certainty to industry. • A formal hierarchical framework such as is outlined in the consultation paper that utilises the current performance test (subject to modifications mentioned in other sections of this consultation) as the first pass/fail step followed by assessment on a risk adjusted metric, such as performance against CPI+ target, Sharpe Ratio, and heatmap metrics.

Broader Consideration of Reform

Scope of the Test

29-32	We do not support the current test being applied to post retirement products due to the additional goals of post-retirement products beyond investment return, as defined by the Retirement Income Covenant (RIC; refer to JANA's 2024 Superannuation in Retirement Consultation response for further detail). While some retirement products may optically look similar to accumulation options, in that they are invested in multiple asset classes, we expect to see increasing innovation in how these products are managed to meet the unique and specific needs of the retirement phase and this will result in greater tracking error to existing benchmarks. Introducing a single metric test may stifle innovation and could be at odds with the objectives of the RIC. Application of a hierarchical or multi-metric test that sought to capture all aspects of the RIC may also not be appropriate, given that the individual member 'solution' will

	not necessarily be one single product (i.e. RIC requirements may be satisfied by different combinations of products). We would welcome further consultation on this topic.
33	Should different assessment methods be applied to different cohorts of products? As noted in our response to question seven, we consider that Sustainability / ESG / Ethical products should be considered as a different cohort where a greater threshold for failure may be appropriate. We note that there are other specialised TDPs that do not neatly fit the current testing framework. For example, any products that prioritise other objectives, such as income, will have compositional differences that lead to significant tracking error and potential failure of the test even when meeting stated objectives. Cohorting may be appropriate and support innovation in products that meet member's full range of needs. Requiring trustees to highlight in disclosure documents where a product is not subject to the performance test would help members understand the risk of these specialised TDPs.

Fees

How fees are measured has a significant impact on the outcomes of any testing framework. It is also an area where there is potential for negative unintended consequences to arise from the approach taken. JANA considers that the approach best taken will vary substantively depending on the testing framework adopted. Given the breadth of this consultation and the request for brevity in submissions, we have not detailed our views but would welcome further discussions and consultation on this issue.

Consequences

Clear consequences for failing the test are needed, so funds understand the ramifications of failing the test. We would welcome further consultation on this topic once greater clarity on the structure and scope of the future testing framework is known, noting that the appropriate application of consequences will depend on the structure of the test.

Technical Feedback on Current Test

Option-level foreign currency exposure

The YFYS Performance Test undertaken in 2023 was the first to utilise the new asset allocation reporting form, SRS550 Asset Allocation (SRS550). SRS550 allows funds to have the choice to report currency exposure at the investment option-level instead of currency hedging ratios for each asset class.

The August 2023 updated Your Future Your Super regulation provided detail on how option-level foreign currency disclosures are reflected in the Performance Test methodology (Sub regulations 9AB.5(1) to (3A)). An option-level foreign currency exposure is applied across the various international covered asset classes. However, this is problematic because only the International Equity covered asset classes have unhedged benchmarks. This results in a significant difference between the disclosed benchmark foreign currency exposure within a product and the calculated foreign currency exposure contributing to the product's composite benchmark return.

See the following stylised example that details the methodology around how option-level foreign currency exposures are treated under the current Your Future Your Super regulation and illustrates how it can be problematic.

Example Portfolio, by APRA Asset Classes from 550 Disclosure	Australian Equity	20.0%	
	International Equity ACWI	20.0%	
	International Fixed Income	15.0%	
	International Infrastructure	15.0%	
	Australian Defensive Alternatives	10.0%	
	International Growth Alternatives	10.0%	
	Australian Cash	10.0%	
	Product-Level FX Exposure		**20.0%**
JANA Interpretation of Regulation Methodology			
(a) Identify asset classes with international domicile type	Highlighted in blue above		
(b) Sum of SAAs identified in (a)		60.0%	
(c) Divide product-level FX Exposure by (b)	(FX exposure ratio, for Int ACs)	33.3%	
(d) Hedging ratio = 1 - (c)	(Hedging ratio, for Int ACs)	66.7%	
Check if resulting hedging ratio is negative, if so make it 0%		66.7%	
How APRA will allocate to YFYS Asset Classes		Hedged	Unhedged
	International Equites (ACWI)	13.3%	6.7%
	International Fixed Income	15.0%	
	International Infrastructure	15.0%	
	International Equites (ACWI) from Alternatives	5.0%	5.0%
	FX Exposure in Benchmark		**11.7%**

International Equity Unhedged

= 20% Int Equity ACWI

x (1 - 66.7% Hedging Ratio)

= 6.7%

No unhedged benchmarks for <u>any</u> international asset class other than equities or alternatives

The benchmarks for Alternatives incorporate an International Equity Unhedged component

= (37.5% x Growth Alts)

+(12.5% x Defensive Alts)

= 5.0%

This example shows how the current methodology can lead to significant differences, with the currency exposure calculated for an option's YFYS benchmark (11.7%) being significantly different to the disclosed exposure of the option (20%).

To further illustrate the magnitude of the resulting differences, we analysed the disclosed benchmark weights of three impacted funds Balanced Options and observed differences between disclosed and calculated foreign currency exposure levels of ranging between -7 and -9% (see table below).

Fund Balanced Option	Reported Foreign Currency Exposure in Option	Foreign Currency Exposure contributing to Option's Composite Benchmark Return	Difference
Fund A	20.0%	12.5%	-7.6%
Fund B	20.5%	12.8%	-7.7%
Fund C	26.0%	17.5%	-8.5%
Fund D	21.0%	12.3%	-8.7%

We are concerned that this may deter fund's from evolving existing currency management practices towards an approach of setting option level exposure targets, which we view as a positive industry trend that has been underway in recent years.

As an alternative approach, where a fund elects to disclose foreign currency exposure at the option level, we believe it more appropriate that in calculating the composite benchmark return, all International Domiciled covered asset classes are assumed to be 100% hedged, and subsequently, the return contribution of a selected currency basket relative to the AUD (see further detail below) be added to the product's composite benchmark return.

Under this approach, the return contribution from foreign currency exposure could be derived from either one single, or a combination of currency baskets for the following covered unhedged asset classes:

- Covered asset class 5: MSCI All Country World Ex-Australia Equities Index with Special Tax (Unhedged in AUD)
- Covered asset class 6: MSCI Emerging Markets with Special Tax (unhedged in AUD)
- Covered asset class 7: MSCI World ex Australia with Special Tax (unhedged in AUD)