Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: YFYS@treasury.gov.au

19th April 2024

Annual superannuation performance test – design options

IFM Investors (IFM) appreciates the opportunity to provide feedback on design options for the annual superannuation performance test.

IFM is an industry superannuation-owned global asset manager and our purpose is to invest, protect and grow the retirement savings of working people. We manage $220 billion across four asset classes – infrastructure, debt, listed equities and private equity – on behalf of more than 650 like-minded pension funds and other institutional investors.[1] Through our aim to deliver strong, long-term and sustainable investment returns for our owners and clients we are contributing to a more secure retirement for about seven million Australians and more than 120 million people around the world.

IFM supports a well-designed performance test to inform member engagement and promote excellence and value for money in managing Australians' retirement savings. This submission follows our submission to the Government's first review in October 2022[2] and earlier consultations under the prior Government.

We appreciate the openness to reform and the range of performance test design options canvassed in Treasury's options paper. We also support the principles outlined in the paper, proposing that changes to the test be assessed against whether they improve member outcomes, are effective and efficient; are widely applicable and transparent; and can be applied consistently over time.

Our recommendations are for the Government to:

1. Replace the existing performance test with a test based on risk-adjusted returns relative to a simple reference portfolio (SRP) frontier.
2. Consider options to address the increasing costs of index licensing fees for superannuation funds and other market participants. In addition to adopting a test based on an SRP frontier, which would reduce the number of benchmarks needed, these options could include:
    - Review of the existing licensing regime for financial benchmark administrators, which is supposed to ensure "that the price that may be charged for access to a licensed benchmark is non-discriminatory and not manifestly unreasonable"[3], as well as consideration of additional licensing conditions to prevent the use of contract terms that limit price transparency, limit cost-effective

[1] As at 31 March 2024.
[2] Available at https://treasury.gov.au/sites/default/files/2023-02/c2022-313936-ifm_investors.pdf.
[3] RG268, Reasonable and non-discriminatory access RG 268.85 – 87.

access to multiple users via sub-licensing arrangements or make it difficult for licensees to switch providers.

- Establishing a process, potentially administered by APRA, to identify and add lower cost indices for use in the test. This could enable competition among index providers and the development of low-cost indices that meet governance, accountability and regulatory requirements and achieve significant savings for superannuation fund members.

We would be happy to engage further with the Government and Treasury as you consider feedback from stakeholders. Further analysis and information sharing, such as through a technical committee of superannuation industry and academic experts, is needed to build confidence and understanding of how a redesigned test would work with respect to different products and market conditions.

A simple reference portfolio (SRP) approach

IFM prefers a single metric test based on risk-adjusted returns relative to an SRP frontier, as outlined in option 2c of the consultation paper, for the following reasons.

- **It would focus the test on what matters most – value created for members through both investment strategy and execution.** Consistent with our previous submissions, and as noted in the options paper, the current test doesn't take investment strategy into account. This is despite it being the most significant driver of pension funds' portfolio performance, accounting for more than 90% of the variation in the performance of investment portfolios.[4]

- **It would encourage innovation.** The current test incentivises trustees to minimise tracking error relative to benchmarks ("benchmark hugging"). By removing or reducing this incentive, an SRP frontier approach would encourage trustees to focus on generating risk-adjusted returns across their total portfolio. This increased flexibility would empower trustees to consider more investments in emerging asset classes and thematics like social and affordable housing and the energy transition. Investments like these can improve the long-term risk-adjusted returns of a portfolio through diversification benefits, as they tend to have different risk-return characteristics and potentially lower correlation to conventional asset class benchmarks.

  A simple reference portfolio could also encourage trustees to focus on underlying drivers of risk and return across their portfolio, including growth, inflation, liquidity, climate change and geopolitics. Allocating capital in this way can improve diversification and long-term risk-adjusted returns for superannuation fund members.

- **It is an established and credible way to assess the value created by internal investment teams and external managers.** New Zealand's sovereign wealth fund, the NZ Super Fund, and US pension giant CalSTRS both use an SRP as a baseline against which they assess their returns. The SRPs they use are low-cost, investible and diversified, comprised of broad listed equity and debt indices which represent their target risk exposures.

  For the NZ Super Fund, using an SRP has been a longstanding framework for performance assessment. It has used the reference portfolio since 2010 with the composition of the reference portfolio reviewed every five years by its Board.[5] CalSTRS adopted an SRP in 2023 to simplify and improve the transparency of its performance. Following a review of peers and potential benchmarks, a two-index SRP composed of global public stocks and bonds/fixed income was

---

[4] See, Krishan Chandrasekhar (2011), 'The Investment Policy Process: A Perspective from the World Bank', at 170 in Sudhir Rajkumar and Mark C. Dorfman, eds., *Governance and Investments of Public Pension Assets: Practitioners' Perspectives*, The World Bank, citing Brinson, Hood, and Beebower 1991.
See also, Gary Brinson, Brian Singer and Gilbert Beebower (1991), 'Determinants of Portfolio Performance II: An Update', *Financial Analysts Journal*.
[5] NZ Super Fund 2021, *The 2020 Reference Portfolio Review, pg. 2 https://nzsuperfund.nz/assets/Uploads/The-2020-Reference-Portfolio-Review-v2.pdf.*

chosen on the basis it would "give members and the public benchmarks they could compare to the CalSTRS portfolio".[6]

Closer to home, APRA uses an SRP as part of its MySuper Heatmap, as it considers it to be "an appropriate basis on which to benchmark returns and the ability of an RSE licensee to develop and implement an effective investment strategy… [The SRP] provides a benchmark to assess returns that is suitable for the long time horizon of superannuation and is based on the product's target risk-return expectations."[7] The Productivity Commission, in its 2018 assessment of superannuation efficiency and competitiveness, also elected to use an SRP to assess the performance of products across the system.

- **A well-constructed single metric test is the most efficient and effective way to assess the performance of superannuation products.** An SRP frontier approach should remain applicable over time as markets change and as superannuation investors and asset managers continue to innovate in product and portfolio design. By adjusting for risk, it would also allow for comparable and consistent performance assessment of products across the superannuation system including lifecycle, choice and retirement products. While the concepts of volatility and the SRP frontier might be complex to explain to superannuation fund members, as noted in the options paper, we do not expect that it would be more complex than explaining the outcomes of the existing test or a multi-metric test.

Implementation of this approach

Key considerations for the implementation of a test based on an SRP frontier would include:

- **Construction of the SRP and appropriate indices.** SRPs are typically constructed using a limited number of low-cost, liquid indices. Leading global institutional investors typically use just two as a proxy for equity risk appetite, while the SRP used by APRA as part of the MySuper Heatmap consists of six indices. Focused consultation is needed to determine the appropriate construction of the SRP.
- **Best proxy for a product's risk appetite.** We agree with the use of volatility for matching risk appetite, despite its limitations, which are recognised in the options paper.
- **Intervals for calculations of volatility and returns.** Superannuation products include thousands of assets that may be valued daily, such as listed equities, or unlisted infrastructure and private equity assets, which are typically valued quarterly. Further analysis is needed to determine the best way to objectively reflect the volatility of different investments.
- **Incorporation of administration fees and expenses.** Representative administration fees and expenses (RAFE) should be taken into account in addition to investment fees and expenses in assessing performance. In our view, the RAFE and benchmark RAFE should be calculated using the data available since the commencement of performance testing (2021) and be extended for every year until the lookback period for administration fees and expenses matches that for net investment returns. This approach would mitigate against the risk of cost shifting while ensuring that only reliable data is used to calculate the RAFE and benchmark RAFE. Considering the potential for fees and costs to be hidden using other categories of fees or forms of extraction, such as bid-ask spreads, providers should be required to furnish to APRA the actual net returns of a representative member over a one-year period. This figure should be substantially similar to the reported returns after investment and administration fees and costs, as a robustness check.

[6] CalSTRS Investment Committee meeting, September 13, 2023, https://www.calstrs.com/files/ba5e7a960/INV+092023+Item+06.00+-+ExSum+-+Investment+Policy+Revision+%20–+Reference+Portfolio+Benchmark+–+First+Reading.pdf and Meketa Investment Group Memorandum to CalSTRS Board of Trustees: https://www.calstrs.com/files/4a318a532/TRB+012023+Item+05.01+%28Attachment%29+-+Meketa+Opinion+Letter.pdf.
[7] APRA, https://www.apra.gov.au/sites/default/files/2021-12/Methodology%20Paper%20-%20MySuper%20Heatmap_0.pdf.

- **Threshold for failure and consequences of the test.** Suitability of a 50bps failure threshold should be determined based on the outcomes of SRP scenario modelling. This could support confidence in the fairness of the test.

Alternative design options – a multi-metric test

Although our preference is a single metric test based on a risk-adjusted SRP frontier, we are also open to a two-step multi-metric approach that includes a risk-adjusted SRP metric. The additional metric should:

- **Complement the risk-adjusted SRP and address any identified shortcomings.** Identifying a suitable additional metric would be subject to further technical analysis of the risk-adjusted SRP, and consideration of whether additional metrics would support a better-rounded assessment of superannuation product performance.
- **Focus on assessing value added by trustees**. We believe that only metrics focused on value created by a trustee should be used to assess a product's right to remain. Assessing factors peripheral to optimising member outcomes would add complexity to the test without improving member outcomes.

As outlined in the consultation paper, the metrics in the Australian Prudential Regulation Authority (APRA) Heatmaps are highly correlated and in some instances assess short-term or peripheral metrics. This would add unnecessary complexity without providing additional insights, so a more detailed analysis should be undertaken to identify suitable metrics and model their impact.

A metric based on costs to members is not appropriate. It is important that superannuation product fees and administration costs deliver value for money for members, but the most appropriate metric for performance is net returns. Members seeking information about the costs and fees for different products can already access this through the Australian Tax Office (ATO)'s comparison tool.

Indices

Commercial benchmarks are widely used in financial markets, including to evaluate investment performance. With respect to Australia's superannuation performance test, superannuation funds and other market participants need access to specific benchmark data to track the performance of products and portfolios and manage tracking error.

Since the introduction of the performance test, we have seen index licensing fees increase significantly under conditions in which there are no substitutes and little competition regarding price or quality. These higher fees are ultimately being passed onto superannuation fund members, reducing the net returns on the investment of their retirement savings. However, licensing terms are typically complex and opaque, meaning it is difficult to negotiate with providers and compare prices. Some datasets also require access to proprietary terminals or platforms that also have material costs.

The increasing costs of index licensing is a global problem. A recent review by the UK Financial Conduct Authority found that markets for indices are highly concentrated, with a few key providers holding significant market share and maintaining high profitability. There were high barriers to entry for challenger firms, making it difficult for them to enter or expand in these markets and resulting in limited competition for key providers.[8] The FCA found that poor competition was likely to affect consumers through its impact on the costs, quality, access and choice of investment products and that the potential harm was "considerable".[9] Similarly, a US study into index providers estimated that approximately 60% of index licensing fees are markups and that these market conditions are enabled by a lack of competition.[10]

[8] Market Study MS23/1.5, Financial Conduct Authority, Wholesale Data Market Study – Report, February 2024 https://www.fca.org.uk/publication/market-studies/ms23-1-5.pdf

[9] Ibid.

[10] See, Yu An, Matteo Benetton and Yang Song, (2023) "Index Providers: Whales Behind the Scenes of ETFs", posted by the Harvard Law School Forum on Corporate Governance, at https://corpgov.law.harvard.edu/2023/08/08/index-providers-whales-behind-the-scenes-of-etfs/

We see action on benchmark licencing costs as important irrespective of the test design the Government chooses going forward, but especially in the case that it decides to retain the test in its current form (which includes 20 specified commercial benchmarks) or add additional benchmarks.

****

Thank you again for the opportunity to comment. For further information, please contact Mohammed Khelil (Mohammed.Khelil@ifminvestors.com).

Yours sincerely,

David Whiteley

David Whiteley
Global Head of External Relations
IFM Investors Pty Ltd

IFM-19APRIL2024-3518163