Australian Retirement Trust

GPO Box 2924
Brisbane QLD 4001
P 13 11 84
W australianretirementtrust.com.au

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury

Via Email: YFYS@treasury.gov.au

19 April 2024

Annual Superannuation Performance Test -design options

Thank you for the opportunity to provide a submission in response to the 'Annual Superannuation Performance Test -design options' consultation paper.

Australian Retirement Trust (ART) is one of Australia's largest superannuation funds. Over 2.3 million Australians trust us to take care of more than $295 billion of their retirement savings.

We have been pleased to actively engage with Treasury regarding the development and reviews of the annual superannuation performance test (PT). We have chosen to respond to the consultation questions where we feel we can add the most value.

We submit that:

- The Performance Test has had a positive impact on the industry and will help to deliver better retirement outcomes for more Australians.
- The scope of the Performance Test in its current form is effective for diversified multi-asset accumulation options.
- ART supports testing of all investment options, however the test in its current form is not appropriate for retirement income products or single asset class products.
- The analysis presented by Treasury in the consultation paper demonstrates that alternative designs would have minimal impact on test outcomes. We support this conclusion and favour maintaining stability in the testing framework with a focus on incremental improvement rather than major change.
- It is critically important for the integrity of the test that any future changes should only apply prospectively. Retrospective changes undermine the credibility of the test.
- A regular review process to facilitate the introduction of new asset classes on a prospective basis would be effective in future-proofing the test.
- Values-based investment options, including sustainable investment options, are disadvantaged by the current test given the lack of effective asset class benchmarks. Alternative testing solutions such as a multi-metric test or expanding the assessment window for these specific options could prove to be effective mitigants to this disadvantage.

We trust our submission will be beneficial to Treasury's considerations and we would be pleased to discuss our views further with Treasury.

Chris Ramsay, Senior Manager Policy and Government Relations, is the primary Australian Retirement Trust contact regarding our submission and can be contacted at Christopher.Ramsay@art.com.au.

Yours sincerely,

Ian Patrick
Chief Investment Officer
Australian Retirement Trust

Annual Superannuation Performance Test – design options- Australian Retirement Trust responses

Options for Reform

1. Do you agree with these principles? Are there any other principles that should be considered?

Do you agree with these principles?

ART believes that the principles proposed are reasonable and we agree with them.

Are there any other principles that should be considered?

We propose the following enhancements to the principles be considered:

- A principle of Integrity/Credibility could strengthen future assessment for changes to the test. This principle would focus on adopting industry best practice standards when considering future changes, specifically that benchmarks should only be changed on a prospective (i.e. forward-looking) basis. The dangers of retrospective benchmark changes, which “shift the goalposts”, are well understood within the investment industry. Retrospective changes undermine the credibility of performance reporting as members lose confidence in the integrity of the results.
- Enhancing the principle of transparency to reference ease of understanding. For the test to maintain relevance and achieve its ambition we believe it is important that members understand the outcomes of the test.

Recommendation: Enhancing the principles to reflect a commitment to a) aligning the performance test with industry best practice performance reporting standards, including a commitment to only make changes on a prospective basis; and b) making the test easy to understand for members; would improve the enduring credibility and effectiveness of the test.

Status quo – SAA Benchmark Portfolio

2. Is assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, a strength or weakness of the current framework?

3. Can the existing methodology be materially improved, such as by further calibrating benchmarks, to largely address unintended consequences? How could these improvements overcome the incentive to benchmark hug, and remove barriers to invest in emerging asset classes?

4. What asset classes do you consider require better coverage in the test? What asset classes are covered well by the existing test?

5. Do you consider additional indices covering additional asset classes should be added to the test? If so, please provide the following details for each of your recommendations:

a. Description of asset class
b. Name of recommended index covering the above asset class, including the length of time data is available on the index
c. Details of appropriate fee and tax assumptions for such an asset class
d. Explanation of why you consider this index is appropriate for inclusion

6. How should the test cater for new asset classes in the future?

7. Should the threshold for failure be recalibrated for some products? What evidence supports the need for a different threshold? How could a different threshold deliver better long term returns to members?

8. Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

2. Is assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, a strength or weakness of the current framework?

While this can be framed as both a strength and a weakness of the test, ART believes that this clarity of scope is a strength of the test.

The performance test has been effective in improving implementation outcomes for members across the sector. ART's view is that with a commitment to ongoing incremental improvement, the performance test can continue to play that important role in improving member outcomes.

Assessing both implementation and choice are important to ensure member outcomes that are focused on delivering income for members' dignified retirement, however the efficacy of the performance test risks being diluted if it seeks to achieve both outcomes through a single test. ART's view is that any assessment of choice of strategy would be best designed as a separate test rather than as a change to the current test.

3. Can the existing methodology be materially improved, such as by further calibrating benchmarks, to largely address unintended consequences? How could these improvements overcome the incentive to benchmark hug, and remove barriers to invest in emerging asset classes?

ART believes that there is scope for continuous improvement in the performance test framework. The most meaningful barrier to investment in emerging asset classes under the current framework is the risk associated with benchmarking of emerging and alternative asset classes.

Superannuation funds have proven to be effective and innovative with respect to investment in emerging asset classes over many decades. Investments in emerging asset classes are made as an alternative to some traditional assets in portfolios. The success of those emerging alternative investments is most effectively measured by the return relative to the traditional assets foregone. This is an easy to understand framework and if able to be applied effectively should not limit the appetite for investment in emerging asset classes.

While this framework to investing in emerging assets can be applied under the performance test, there is increased risk that benchmarks are retrospectively applied. Additionally, investments in emerging sectors are typically reactive to opportunities and it is therefore difficult to specifically identify each opportunity in advance, making commitments to investing in “Alternatives”, be they defensive, growth or other challenging to do from an SAA perspective.

Recommendation: Strengthening the protections against retrospective benchmark changes via design principles or other means would facilitate funds to invest more confidently in emerging asset classes.

4. What asset classes do you consider require better coverage in the test? What asset classes are covered well by the existing test?

While most asset classes used in multi-sector portfolio construction are adequately represented, the performance test was constructed after a multi-decade period of benign inflation and falling interest rates. Consequently, most superannuation fund portfolios have had limited exposure to direct inflation hedging assets such as inflation linked bonds and commodities. While there has been limited exposure historically, omitting these asset classes from the Performance Test universe risks constraining funds from investing in them in future.

The treatment of currency exposure within the test introduces some challenges under currently legislated methodology. When reporting currency exposure at the option level, this target is applied to all international asset class benchmarks despite only some asset classes providing hedged and unhedged variants. The implication is that currency exposure is inevitably understated in the Performance Test benchmark relative to that reported.

This could be addressed by using the difference between the unhedged and hedged international equity benchmarks to calculate a currency return and incorporating that in the performance test benchmark return based on the report strategic FX weight.

Recommendation: That option-level currency return be measured as the difference between the MSCI All Country World Ex-Australia Equities Index with Special Tax (100% unhedged to AUD) and the MSCI All Country World Ex-Australia Equities Index with Special Tax (hedged in AUD). This return would apply to the reported strategic currency exposure.

5. Do you consider additional indices covering additional asset classes should be added to the test?

As outlined above, our view is that the current breadth of asset class indices has been impacted by the investment environment over the 20-year period prior to the introduction of the test, and as such, inflation hedging public asset classes are not included.

Additionally, lifecycle strategies focused on retirement adequacy can benefit from allocations to inflation-protected capital preservation closer to retirement. However, applying a nominal bond benchmark implicitly discourages holding AOFM issued Treasury Inflation Linked Bonds, a market that is already relatively illiquid when compared with nominal bonds of equivalent maturity.

We believe that two additional asset classes should be introduced to address this gap with details below.

<u>Inflation-linked bonds</u>

Index: Bloomberg Ausbond Infl Tsy 0+ Yr Index (Bloomberg Ticker: BAIT0 Index, Inception date: 30 June 2014).

This index is designed to measure the market of inflation-linked securities by the Australian Government.

Fee assumption: 0.10% which is consistent with other fixed income assumptions

Tax assumption: 15.00% which is consistent with other fixed income assumptions

<u>Commodities</u>

Index: S&P GSI Index Spot (Bloomberg Ticker: SPGSCI Index, Inception date: January 1970).

This captures a broad exposure to commodity sectors and is recognised as a fair measure of global price movements and inflation.

Fee assumption: 0.10% which is consistent with fixed income assumptions which we believe appropriate given implementation is typically via derivatives

Tax assumption: 15.00% which is consistent with fixed income assumptions which we believe appropriate given implementation is typically via derivatives

6. How should the test cater for new asset classes in the future?

A framework for introducing new asset classes will be important to enable the test to adapt to evolving market conditions.

ART proposes a process for introducing new asset classes is designed collaboratively between Treasury and APRA to ensure enhancements to regulatory data capture are included to enable new asset classes to be introduced on a prospective basis. Limitations of existing data collection need not be a barrier to improving the test provided change is made on a prospective basis in collaboration with APRA to ensure accurate data can be captured to administer the expanded test.

7. Should the threshold for failure be recalibrated for some products? What evidence supports the need for a different threshold? How could a different threshold deliver better long term returns to members?

ART does not propose any changes to the threshold for failure.

8. Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

One limitation of the current test that ART noted in a previous submission is the positive effect that rebalancing of unlisted assets has on performance test benchmark returns and which is unachievable in practice in a multi-asset portfolio. A simpler structure, such as a simple reference portfolio metric would overcome this challenge with the current design. However, the simple reference portfolio metric introduces other challenges, for example accurately and consistently classifying the growth/defensive split of Infrastructure and Property.

<u>Alternative single-metric test</u>

9. Would the Sharpe ratio be a more appropriate testing approach than the current framework? Would this lead to better member outcomes?

10. How should the benchmark for performance be calibrated?

11. What data should be used to estimate the Sharpe ratio, and how frequently?

12. Are either of these approaches better than the existing test methodology (Option 1) or a simple Sharpe ratio (Option 2a)? Are there any other considerations that make this a better or worse option?

13. Are there any other alternative single-metrics that would be superior in addressing the principles set out in this paper? How would they provide a better testing framework? What net benefits do they provide over other proposed metrics?

14. What incentives would these alternative single-metric options provide trustees, and what would be the consequence of this for member outcomes?

9. Would the Sharpe ratio be a more appropriate testing approach than the current framework? Would this lead to better member outcomes?

The analysis that has been prepared by Treasury in framing this consultation is effective at demonstrating that there would be limited incremental benefit of transitioning to a Sharpe ratio single metric test in terms of efficacy of the test. The existing performance test benchmarking approach appropriately accounts for the different risk profiles of different diversified options and the performance test results are unlikely to change substantially under Option 2a versus the current test.

By contrast, and consistent with our proposals with respect to enhancing the design principles, when measured against an enhanced transparency principle, moving to a Sharpe ratio test could detrimentally impact on the ease of understanding which risks undermining the effectiveness of the test.

While in previous submissions ART has suggested Sharpe Ratio as a potential mitigant for challenges in testing specialised products, such as values-based investment options, ART believes that employing the Sharpe Ratio as a single metric test across all products could be detrimental to member outcomes.

12. Are either of these approaches better than the existing test methodology (Option 1) or a simple Sharpe ratio (Option 2a)? Are there any other considerations that make this a better or worse option?

While not our preferred approach, if a Sharpe ratio metric is adopted, we believe that Option 2c where the Sharpe Ratio is compared to the Sharpe ratio of a Simple Reference Portfolio is the superior model.

ART does not support the use of peer comparison measures in the performance test as this is inconsistent with the *Effective and efficient* principle as it would be constraining and would increase the risk of misidentifying well-performing funds.

ART also notes the potential for a number of unintended consequences of change with respect to Option 2a. Measuring the Sharpe ratio via unlisted benchmarks for Property and Infrastructure may disincentivise funds to innovate and improve valuation practices beyond the standards employed in the benchmarks. ART is an advocate for continued improvement in valuation practices across the industry and is opposed to any changes to the performance test that risk undermining this.

13. Are there any other alternative single-metrics that would be superior in addressing the principles set out in this paper? How would they provide a better testing framework? What net benefits do they provide over other proposed metrics?

ART does not propose an alternative single-metric test.

14. What incentives would these alternative single-metric options provide trustees, and what would be the consequence of this for member outcomes?

Sharpe ratio metrics measure both volatility and returns. By incorporating volatility into a single metric test, the incentive to minimise volatility is introduced. Genuine reductions in volatility are beneficial to member outcomes, however artificial reductions in volatility are detrimental to member equity as price discovery is impaired. Artificial reductions in volatility could take many forms and if a metric is introduced that includes price volatility, careful regulatory oversight will be required to protect the integrity of member outcomes.

This risk further supports ART’s position that we do not support a Sharpe ratio single-metric test.

<u>Multi-metric test</u>

15. Would greater alignment to the APRA heatmaps improve the sophistication of the test?

16. Would it reduce incentives to benchmark hug and improve member outcomes?

17. Is correlation between metrics an issue? If so, how should this be addressed?

18. Should the test capture all the metrics in the heatmap? If not, what metrics?

19. How would the benchmark for performance be calibrated for chosen metrics? How would these metrics combine to determine overall pass/failure of the test?

20. What costs would be associated with aligning the test to the heatmap? What would be the benefits?

21. Would this framework improve the sophistication of the test? Would it reduce incentives to hug benchmarks and improve member outcomes?

22. Would this approach be more, or less, favourable than the heatmap approach?

23. What would the costs of implementing this approach be? What would the benefits be?

24. Are these the right measures of performance or are there other more important indicators of performance that should be measured in addition to or instead of those outlined? What metric should be used to assess these indicators?

25. How should the benchmark for performance be calibrated?

15. - 25. Multi-metric Test

Consistent with the principles outlined above, ART favours simplicity in the test framework and on that basis we believe that a single metric test is preferable, noting that the existing single metric test accounts for administration fees in the measure.

If a multi-metric test was to be introduced, ART would favour simplicity with minimal metrics to avoid duplication. A multi-metric test should not extend beyond three metrics and on that basis we would advocate for measures to assess:

a) Investment implementation (achieved via the existing performance test);
b) Member outcomes (measured via performance relative to stated objectives); and
c) Administrative efficiency (measured via administration fees on a representative balance).

The one area where a multi-metric test may be warranted is for values-based options such as sustainable investment options which we discuss in further detail below.

<u>Alternative frameworks</u>

26. How would an alternative framework be constructed according to the elements outlined above? Please provide specific details.

27. How would this framework more effectively advance the principles outlined in this paper?

28. What would be the costs and benefits associated with this framework, compared to the current test and any other alternatives?

26. - 28. Alternative frameworks

ART does not propose an alternative framework.

<u>Broader considerations for reform</u>

Retirement Products

29. What are the most important considerations for performance of retirement products?

30. If the test were to expand to retirement products, would they require a different test to the accumulation phase? Would the test differ for different retirement products?

31. How could longevity products be most appropriately assessed? How could the products be compared?

29. - 31. Retirement Products

ART understands that the measurement of retirement products is being reviewed as part of a separate/different government consultation process.

Retirement products will be designed to meet the obligations of the Retirement Income Covenant. These obligations are defined in terms of 'member outcomes', including stability and sustainability of income, longevity risk, inflation risk and flexible access. The current performance test seeks to measure solely the investment component of 'product outcomes'. As such ART believes the performance test in its current form is not applicable to the measurement of retirement products.

However, ART would be sympathetic to the concept of applying the performance test to the investment performance component (if applicable) of the retirement product, e.g. the investment option available to members in an account-based pension.

This could be considered a pragmatic start to the measurement of retirement products more broadly (since the majority of retirement assets are currently invested in account-based pensions), with improvements and enhancements (e.g. to longevity components) gradually being introduced over time as the retirement phase of the superannuation system matures along with the measurement of retirement products.

Other Products

32. Do you agree that retirement phase, single-sector and externally-managed products are suitable for testing? Why or why not?

33. Should different assessment methods be applied to different cohorts of products?

34. Do you agree that the ‘other products’ outlined above are unsuitable for testing? If you think the ‘other products’ (or a sub-section of these products) are suitable for testing, how could they be appropriately tested?

35. Under each design option, how could the test accommodate cohorts that are suitable for testing? For example, using different metrics or benchmarks for performance for different cohorts.

32. Do you agree that retirement phase, single-sector and externally-managed products are suitable for testing? Why or why not?

ART agrees that all products offered to members are suitable for testing in some form in line with the principle of improving member outcomes to focus on delivering income for members’ dignified retirement. With respect to externally managed products, to the extent these products otherwise meet the definition of trustee-directed and they are only excluded from the performance test on the basis that they are externally managed, ART believes the performance test should be expanded to include these products.

With respect to retirement and single-sector products, both trustee directed and externally managed, the test in its current form has challenges which should be addressed in any test designed for these products.

33. Should different assessment methods be applied to different cohorts of products?

ART believes that the performance test in its current form is unsuitable or could be improved for the following products.

- <u>Retirement income products</u>
  The challenges with retirement income products are described above and demonstrated in the analysis presented by Treasury in the consultation paper.

- <u>Single sector products</u>
  Expanding the existing performance test framework to single sector products unnecessarily restricts member choice to the asset classes defined in the performance test framework, which is designed for multi-sector options. Choice is a fundamental principle of the superannuation system which ART believes should be preserved.

- <u>Values-Based investment options</u>
  The challenges in setting appropriate benchmarks for values-based investment options, such as sustainable investment options, have been well documented with limited solutions available. The consequence is that values-based investment options incur additional tracking error (or active risk) without additional expected return to compensate for the risk which puts these options at a disadvantage.

35. Under each design option, how could the test accommodate cohorts that are suitable for testing? For example, using different metrics or benchmarks for performance for different cohorts.

ART believes that all products are suitable for testing. Suggestions with respect to retirement income products are outlined in the previous section of the submission. With respect to other sub sections of products ART makes the following suggestions:

- Single sector products

  Single sector options should, by their nature, have well defined appropriate benchmarks. These benchmarks are defined and reported through existing regulatory reporting and with appropriate adjustments for taxes and fees these reported benchmark returns could be used to implement a performance test without constraining choice. This would have the added benefit of encouraging accurate benchmarking discipline for single sector products.

- Sustainable investment options (as part of values-based options)

  ART proposes that an alternative performance test measure, specifically Sharpe ratio versus a simple reference portfolio (Option 2c.), is preferred to address the additional active risk inherent in these products. This measure provides the greatest flexibility to account for the diverse range of investment options a fund may offer while still ensuring accountability to member outcomes.

  ART further proposes that a multi-metric test is more appropriate for sustainable investment options. A multi-metric test is more appropriate given the multiple objectives that sustainable investment options are managed to. Consistent with feedback earlier in the submission, we do not believe a multi-metric test should extend beyond three metrics and for sustainable investment options the multi-metric test could include a) a revised Performance Test metric (Option 2c); b) an administration fee measure; and c) a member outcomes measure, such as performance against stated objectives.

  ART recognises that identifying sustainable investment options could be challenging and potentially open to gaming as a performance test avoidance mechanism. ART understands the Government is planning the introduction of sustainable investment product labelling which should address this issue.

Fees

36. How should fees be measured under each design option?

37. Should fees be measured at the current option level, or should they be measured on a different level? How would this be achieved?

38. Are the current assumptions made in comparing fees acceptable? For example, should the $50,000 representative member balance be adjusted based on the median member balance for a product cohort?

39. Is a peer comparison of fees the best way to measure fees? Is there a better approach to benchmarking fees? If so, how should this work?

40. What product cohorts should be considered? How should different cohorts be defined where products could meet multiple cohort definitions, such as single-sector retirement products?

41. How many years of fees data is appropriate to test? Should a greater weighting be given to certain years?

36. - 41. Fees

ART acknowledges that the current test rewards and incentivises administration fee reductions and while this has been highlighted as a potential weakness of the performance test in some submissions, we believe that this incentive is beneficial to members as lower fees improve member outcomes.

There are two areas where we believe the treatment of fees within the performance test could be improved.

1) ART does not support the use of peer benchmarking within the performance test framework including adjustments for administration fees. We believe that market data is an important input when calibrating an appropriate level of benchmark administration fees, however we believe that a benchmark level of administration fees should be defined in the test rather than updated annually based on peer group analysis.
2) The use of a specific single $50,000 representative member balance introduces the potential for administration fee structuring to be optimised for the test as opposed to optimised for equitable member outcomes. This could be addressed by averaging administration fees across multiple representative member balances.

Consequences

42. Should the consequences be adjusted to improve outcomes for members? How would this need to be tailored for the different options for performance testing?

43. How should the consequences be amended to better account for edge cases or different cohorts that fail the test for reasons beyond the trustee's control?

44. How could these provisions be effectively ring-fenced so that it applies only to the edge cases and not failures at large?

45. How could this be achieved without subjecting the regulator to undue challenge and impacting the efficiency of the regime?

46. What other remediation processes could occur?

42. - 46. Consequences

While the consequences of failing the performance test restrict the trustee's ability to communicate to members, serious consequences are important to protect the integrity and efficacy of the test. Identification of special and edge cases risk funds employing strategies to avoid the consequences of failure to the detriment of members.

Consistent with feedback above, ART supports constructive incremental improvements to the performance test where they can improve member outcomes.

ART does not propose any changes in this area. Additionally we believe that any changes to identify and/or differentiate treatment for special or edge cases risks detrimental member outcomes.

Barriers to Consolidation

47. Are there any key barriers to consolidating closed and underperforming products? What quantitative evidence is there of these barriers? How do these weigh against other reasons a person may choose to remain in a product?

48. What evidence do trustees use to demonstrate that remaining in a closed and underperforming product is in the best financial interests of members, compared to moving to a performing product?

49. What is the process or criteria that trustees use when deciding on what product they will transfer members to when consolidating underperforming products?

50. Should APRA receive increased regulatory powers to direct superannuation trustees to consolidate underperforming products?

47. - 50. Barriers to Consolidation

In profit for member funds, the costs of consolidation is borne by members. Trustees need to have some capacity to ensure consolidation can be done in an efficient and cost effective way in the best financial interests of the fund’s membership. Increased regulatory power would need to be tempered with an appreciation for any costs of consolidation and how this would be borne by members.