

## **Alternative Investment Management Association – Aust Chapter**

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### **AIMA AUSTRALIA SUBMISSION**

#### **Annual Superannuation Performance Test – design options**

##### **A. EXECUTIVE SUMMARY**

###### **A1. Introduction**

This paper is a submission by the Alternative Investment Management Association Australia (AIMA or we) in response to the Australian Treasury's recent consultation paper relating to potential reform options for the Annual Superannuation Performance Test (Test), released in March 2024. Noting the submission closing date of 19 April 2024, AIMA appreciates this opportunity to provide feedback through this late submission. AIMA members consider the determination of an appropriate methodology to calculate and assess performance of Superannuation funds to be critical in achieving the underlying objectives of the Australian Superannuation retirement income system.

We understand that the Treasury's consultation paper requests industry submissions covering two broad areas:

1. Design options
2. Broader considerations for reform.

AIMA's submission primarily addresses the Design options element of the consultation and have elected not to make any comments relating to other areas of reform.

###### **A2. About AIMA**

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,200 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$3 trillion in hedge fund and private credit assets including for Australian superannuation funds.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage \$400 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

### **A3. Summary of key positions**

#### **1. AIMA agree with the key four principles proposed within the consultation paper. However, consideration of risk-adjusted returns should be key tenet of improving member outcomes.**

AIMA are in broad agreement with the key four design principles proposed by the Treasury. Importantly, it is AIMA's view that any Test designed to uphold the principle of improving member outcomes must incorporate an assessment of risk-adjusted investment performance. In general, achieving the same level of net investment return for less investment risk is more beneficial for superannuation members. A reformed Test design must include the consideration of investment risk as a key design principle.

#### **2. Despite some initial success, the current test has some well-articulated drawbacks in assessing the investment performance of Superannuation products.**

AIMA has observed that the Test has experienced some success in identifying historically underperforming funds and has created a sound basis for further reform and enhancement. However, the Test in its current form (the Status Quo) suffers from many drawbacks which fail to fully uphold the key principles. The Status Quo relies heavily on the availability of suitable benchmarks for key investments and does not include a comparison of risk adjusted returns. We see these as major weaknesses that are at odds with the principle of improving member returns.

A key outcome under the Status Quo is that the Test may inadvertently affect trustee investment choices by predisposing certain asset classes over better performing ones (i.e. those assets which are expected to provide the same level of investment returns for lower level of risk). Limiting potentially favourable investment strategies is not in accordance with the principle of improving member outcomes. Importantly, simply tweaking or broadening the scope of the Test's existing benchmarks is not expected to materially enhance this situation, especially for alternative assets which do not have easily identifiable, representative benchmarks. AIMA believes that building on the current framework by incorporating a risk adjusted measure is likely to best address the stated weaknesses of the Status Quo.

#### **3. Replacing the existing Test with an alternative single metric test may resolve some existing challenges but may, on the other hand, present new ones.**

Measuring investment performance in the context of Australian superannuation is inherently complex, particularly if being used to assess the likelihood of suitable future investment performance for members. It is our view that any Test that involves an alternative single metric is not likely to provide a 'catch-all' design that is widely applicable to all without significant weaknesses. That is, there is unlikely to be a perfect metric that will provide an accurate assessment of funds' overall performance.

Replacing the Status Quo with an alternative single metric, especially one that is also retrospectively applied, is likely to create a new set of 'winners and losers'. Having already

observed the impacts of implementing a retrospective test, AIMA believes that introducing radical changes at this point may have further unintended behavioural consequences. In particular, trustees' investment strategies may inadvertently evolve to one that is uniform with other players in the market so as to achieve similar Test metrics and hence pass the Test. Therefore, investment strategies may not be selected to improve returns but rather to stay in alignment with the performance of other funds, which we see as being in conflict with the key design principle of improving member outcomes.

Notwithstanding this, the three alternative single metric design options (2a, 2b and 2c) proposed in the consultation paper are all reasonable options to address the key weaknesses of the Status Quo. These metrics all consider the tension between investment risk and return in assessing the performance of a particular fund. AIMA considers this to be the appropriate area for reform and that Treasury should further explore risk-adjusted returns as a supplement to, rather than a replacement for, the Status Quo.

**4. Some form of a dual-metric test is likely to be most feasible, incorporating a risk adjusted return measure to supplement the existing design.**

Given the challenges and unintended outcomes of replacing the Status Quo with any single metric Test design, AIMA considers a variation of a multi-metric Test to most optimally address the key guiding design principles. Supplementing the current metric with a risk-adjusted return metric would represent a substantial improvement to the Status Quo. AIMA envisages these metrics being of equivalent importance, at least initially, and a 'Pass' achieved if at least one metric was exceeded. AIMA considers Option 2c, or a similar variation to this option (comparison against a simple reference portfolio or SRP), to be significantly beneficial as part of a dual-metric Test. Employing an SRP approach enables a wide range of complex investment strategies to be distilled down to a comparison against a blend of fixed interest and equity assets which can be more easily digested.

An added benefit of adopting an SRP metric is its close alignment with the ways investment performance expectations are communicated to superannuation members (i.e. absolute return targets often in the form of CPI/Cash + X% over a particular investment horizon). Any linkage between the target and actual investment performance is absent in the Status Quo.

AIMA are cognisant of the implementation challenges that are associated with a risk adjusted investment metric. Indeed, the whole of the Australian superannuation system may not currently be sufficiently mature in investment risk management and data collection for a metric such as Option 2c to be easily implemented. Notwithstanding this, AIMA's position is that proactive consideration and management of all elements of investment risk within the superannuation system should be a priority agenda item that should be advocated and encouraged.

**A4. Contact points**

We would be happy to discuss any aspects of our submission or provide further information.

AIMA contact points for this submission are:

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**Yours faithfully**

**Michael Gallagher**

## B. APPENDIX – detailed response

### B1. Consultation Questions – Principles

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

#### B1. AIMA response – Principles

**AIMA agrees with the key four principles proposed within the consultation paper. Importantly, consideration of risk-adjusted returns within the Test would be a key tenet of improving member outcomes.**

We understand that the four guiding principles proposed by the Treasury are:

1. Improves (Superannuation) member outcomes.
2. Effective and efficient.
3. Widely applicable and transparent.
4. Enduring.

In general, AIMA are in broad agreement with the key four design principles proposed by the Treasury. Funds management as a subject matter is inherently complex. Funds management in a Superannuation context is particularly complex, due to its need to serve the needs and interests of Superannuation members' demographic profile and their varying risk appetites. Designing an optimal performance test is therefore likely to be challenging and may require revision and iteration while in its early stages. Notwithstanding these challenges, maximising member outcomes remains one of the primary objectives of the Australia's superannuation system. Maximising member outcomes is achieved, in part, by maximising member balances at retirement and safeguarding these members from underperforming investment options. **AIMA continues to support the Treasury's objectives to design a test that aims to address underperforming funds via an annual performance test.**

In relation to the four principles, AIMA would like to note:

- One additional element that we consider to be highly important in designing a test that improves member outcomes is appropriately allowing for the concept of risk adjusted returns. Generally speaking, achieving the same level of net investment return for less risk is more beneficial for superannuation members. **Therefore, it is our view that any assessment of members' investment outcomes must have regard to the level of investment risk taken to achieve the particular level of investment returns.**
- An effective test, which is widely applicable and transparent, should not predispose trustees' investment decisions to specific asset classes. Any reforms to the current test should provide a transparent and fair comparison of historical returns, with a view to assessing likely future investment performance. It should do so whilst not imposing unnecessary costs to the system, which are ultimately borne by members through lower net investment returns.
- In accordance with the principle of the Test being an enduring one, AIMA also considers any reforms to the existing test should provide certainty to trustees around the measurement of long-term performance and, in doing so, discourage some of the shorter-term investment behaviours observed in response to the Test's initial implementation. Whilst investment performance should be measured over a long-term historical horizon, balance must be achieved to ensure that the historical performance outcomes of the Test does not unduly affect current investment decisions of trustees. For two particular funds, faced with an equivalent investment opportunity, the funds' historical position in the Test should not be a key determinant in their respective prospective investment decision making.

## B2. Consultation Questions – Design options: Status Quo

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:*
  - *Description of asset class*
  - *Name of recommended index covering the above asset class, including the length of time data is available on the index*
  - *Details of appropriate fee and tax assumptions for such an asset class*
  - *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?*

## B2. AIMA response – Design options: Status Quo

**Despite some initial success, the current test has some well-articulated drawbacks in assessing the investment performance of Superannuation products.**

Since its introduction, the Test has demonstrated some success at identifying underperforming funds. The outcomes for products that have failed the test to date have included exit from the market or subsequent improved performance which, at least in our view, partially address the aforementioned design principles. The current Test provides weight to both the investment return of a particular product as well as any deductions relating to fees or taxes, meaning the Test provides a measure of net investment return to members, of which AIMA is supportive. The Test as a concept and framework is beneficial for Superannuation members and should be retained moving forward.

Despite some initial success, we observed that the Test in its current form and design suffers from some well-articulated drawbacks, a number which are conveyed within Treasury's consultation paper itself. **A primary concern relating to the Status Quo is that the metric currently does not allow for a comparison of risk adjusted returns between products.** As mentioned previously, underlying the key principle of improving member outcomes is a consideration and comparison of investment risk taken to achieve a particular level of net investment performance. While the Test under the Status Quo has arguably performed its role in weeding out underperforming funds, it fails to provide a comparison of investment performance between products.

Furthermore, at the focal point of the Status Quo approach is a comparison against industry benchmarks. While benchmarks have a place in analysing investment performance, this approach is less effective for specific asset classes where a reasonable benchmark may not be

available. **This has had, and will likely continue to have, an inadvertent effect on trustee investment choices by predisposing certain asset classes over better performing ones, especially if an easily identifiable and reliable benchmark is unavailable.**

This is considered to be an area of the Status Quo requiring reform and remedy for the Test to be in accordance with key guiding principles of the Test to be both widely applicable and improve member outcomes.

We have observed that a key outcome of the Test is that it narrows the types of investments that trustees are willing to consider. In doing so, it inadvertently disincentivises trustees from investing in strategically important asset classes which may provide more attractive risk-adjusted long term investment returns. For example, take a hypothetical Australian superannuation trustee that is faced with an investment decision between two asset allocations:

- **Allocation A:** A strategic asset allocation composed of largely conventional asset classes, well represented in existing benchmarks. This close alignment to the benchmarks is expected to provide a relative net return that will pass the current Test.
- **Allocation B:** A strategic asset allocation that includes other asset classes, or sub-asset classes, which do not readily align to the existing benchmarks but, on a risk adjusted basis, is expected to perform better than Allocation A.

In the example above, the current design of the test inadvertently incentivises trustees to select Allocation A as the favoured strategic asset allocation over Allocation B. Specifically, while there are higher

risk-adjusted returns expected under Allocation B, there may be a stronger preference for the close alignment of the investment assets in Allocation A to the existing benchmarks using in the Test. This results in a situation whereby a trustee may forego a strategy that is expected to provide superior investment outcomes for members. This is at odds with the principle of improving member outcomes.

One potential enhancement to the current test design, contemplated within the consultation paper, is to broaden the scope of benchmarks used in the current metric. **While this may broaden the investments trustees are more readily willing to consider, AIMA's view is that this is unlikely to have a material impact on the effectiveness of the test.** This is because:

- This does not alter the inherent nature of the Test being an assessment of the implementation of the trustees' particular investment strategies, rather than an assessment of risk adjusted investment performance.
- Maintaining a larger number of investment benchmarks will likely result in significant cost impost to the system. Obtaining and subsequently updating representative benchmarks for certain alternative asset classes can be extremely challenging. Expanding on the scope of representative benchmarks under the Status Quo is likely to give rise to an inefficient test due to the increasing cost impost associated with supervision and monitoring.

AIMA strongly supports the continuation of a Test that includes revisions intended to address the aforementioned weaknesses present in the Status Quo. The current framework represents a reasonable basis for enhancement, particularly one that could be complemented with a risk adjusted metric (for example those that are discussed in later sections of the consultation paper) and would not be in the interests of superannuation fund members for the Test to be entirely removed or replaced.

### **B3. Consultation Questions – Design options: Alternative single metric test**

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*

### **B3. AIMA response – Design options: Alternative single metric test**

**Replacing the existing Test with an alternative single metric test may resolve some existing challenges but may, on the other hand, present new ones.**

Echoing our sentiment from Section B1, superannuation and funds management are inherently complex. Replacement of the current metric with any alternative single metric (including those beyond the three mentioned in the consultation paper) is unlikely to result in a test design that optimally satisfies the guiding design principles. The discussion of the various drawbacks of each of the design options (2a, 2b and 2c) within the consultation paper points to the reality that no particular single measure is likely to provide a catch-all design that is widely applicable without significant weaknesses. That is, there is unlikely to be a perfect single metric that will guarantee an accurate assessment of funds' overall performance.

**Replacing the Status Quo with an alternative single metric, especially one that is also retrospectively applied is likely to create a new set of 'winners and losers'.** Specifically, a particular fund that has been tracking favourably under the Status Quo may well underperform against an alternative single metric.

Trustees have invested resources to embed the Test as a key performance indicator as part of the ongoing management of the funds' investment operations. Radical changes to the Test, may indeed be perceived to be at odds with the principle for the Test to be enduring, especially considering the consensus view that the Test did identify materially poor performers upon its introduction.

The consultation paper suggests three alternative metrics that could replace the current metric, namely the Sharpe ratio, a peer comparison of risk-adjusted returns, and a comparison of risk adjusted returns against simple-reference portfolio frontier. As discussed in the consultation paper, these metrics all consider the tension between investment risk and return in assessing the performance of a particular fund.

AIMA considers this to be the appropriate area for reform that the Treasury should explore further to supplement the Status Quo. As further discussed below, a multi-metric test design which builds on the Status Quo by incorporating the benefits of a risk-adjusted measure is likely to best address the key guiding principles.

### **B4. Consultation Questions – Design options: Multi-metric test**

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?*

#### **B4. AIMA response – Design options: Multi-metric test**

**Some form of a dual-metric test is likely to be most feasible, incorporating a risk adjusted return measure to supplement the existing design.**

##### **AIMA Commentary on Risk Adjusted Metrics**

Given the challenges and unintended outcomes of replacing the Status Quo with any single metric Test design, **AIMA considers a variation of a multi-metric Test to most optimally address the key guiding design principles.** In particular, supplementing the current metric with a risk-adjusted return metric would represent a substantial improvement to the Status Quo.

Options 2a, 2b and 2c are all reasonable candidates to supplement the existing metric as a measurement of risk adjusted returns and AIMA would encourage a more thorough examination of these options as an additional metric to the Test. These options all reasonably address a primary weakness of the current approach, namely, the absence of a risk adjusted measure and the reliance on a reliable benchmark. Indeed, these options would allow trustees to consider more diverse and innovative investment decisions that can improve members' investment outcomes, safe in the knowledge that they will not be unduly penalised by the inherent weaknesses contemplated when solely using the current single metric.

**AIMA proposes a design that incorporates a risk adjusted returns metric such that products would pass the Test as long as they are able to pass on at least one of the two metrics (Status Quo / Risk Adjusted Return measure).** We note that a hierarchical pass-fail design is discussed in the consultation paper, whereby a fund's performance is tested against a secondary metric if they fail to pass on the primary metric. This design is unlikely to be ideal, as it may inadvertently signal to trustees that one particular metric is more important than the other. As a matter of fact, delivering investment returns on a risk adjusted basis should be just as important in improving member outcomes as historic overperformance against a set of representative benchmarks.

Assessed under a risk adjusted metric, trustees should be able to pursue more innovative and aspirational investment strategies with the aim of returning better investment returns on a risk adjusted basis.

Given the establishment of the existing metric under the Status Quo, AIMA acknowledges that continuing to incorporate this metric as part of the Test has the benefit of providing certainty to trustees of a minimum threshold for products to remain in operation in the market.



**In particular, we consider Option 2c or a similar variation of this option (comparison against a simple reference portfolio or SRP) to have a significant benefit as an additional metric.** Employing an SRP approach enables a wide range of complex investment strategies to be boiled down to a comparison against a blend of fixed interest assets and equity which can be more easily digested. An additional metric covering investment returns on a risk adjusted basis should measure net return of the fund to Superannuation members, that is, net of all fees deducted from member accounts. An additional metric design should aim to include both administration and investment fees, so as to mitigate a situation whereby trustees tweak the classification of various fees in order to avoid failing the Test. A Test design which includes the current metric alongside some variation of Option 2c is widely encompassing, capturing an assessment of risk adjusted returns, implementation of investment strategy as well as a fee/cost element that is necessary to reduce.

An added benefit of adopting a metric under the SRP approach is its close alignment with the ways investment performance expectations are communicated to superannuation members. Product disclosure statements often promote their expected returns based on an absolute return measure (often in the form of CPI/Cash + X% over a particular investment horizon) which is comparatively easily communicated and understood, as it can be approximated to a mix of equity and fixed income assets that make up the SRP. The SRP approach provides a simple reference point against which a fund's risk adjusted returns can be measured. In this context, this approach directly relates a fund's actual performance against the disclosed expected returns, which is absent in the Status Quo. Relying solely on the benchmarks under the Status Quo is not likely to be particularly meaningful to superannuation members. Simply widening the scope of representative benchmarks in the Test is unlikely to resolve this matter.

AIMA are cognisant of the various challenges associated with the implementation of a risk adjusted measure, in addition to the Status Quo. In particular, the whole of the Australian superannuation system may not currently be sufficiently mature in investment risk management and data collection for a metric such as Option 2c to be easily implemented. **Notwithstanding this, AIMA's position is that proactive consideration and management of investment risk within the Australian Superannuation system should be a priority agenda item that should be advocated and encouraged.** An examination of global institutional investors perceived to be world-class or in line with best practice would suggest that active management of investment risk should be a key consideration for trustees in making long term planning decisions to maximise member outcomes.

#### **AIMA commentary on APRA Heatmaps**

The consultation seeks feedback on whether an alignment to the APRA heatmaps is suitable as a multi-metric design option. AIMA believes this option is likely to be too complex and ultimately superfluous. While assessment based on a large number of metrics may appear to provide a measure of all-round performance, it is also likely to make it challenging for individuals to understand underlying drivers of underperformance in their decision to stay with a particular fund, or to switch. Superannuation members perceive the outcomes of the Test, and therefore performance of a particular product to be binary (pass or fail), despite the extensive scope that the APRA heatmaps incorporates. The various elements of performance under this design may not be well understood by Superannuation members and can be uninformative to their decision making. Therefore, the APRA heatmaps are unlikely to be a viable ongoing solution. A two metric test will better capture a more holistic view of the product's value and its performance over time, while limiting the level of complexity introduced in the regime.

#### **B5. Broader considerations for reform**

We understand that the Treasury's consultation paper requests industry submissions covering two broad areas:

1. Design options
2. Broader considerations for reform

AIMA's submission primarily addresses the Design options element of the consultation (addressed in sections above) and have elected not to make any comments relating to other areas of reform (i.e. Question 26 onwards).