

19 April 2024

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

To Whom It May Concern:

Morningstar welcomes the opportunity to comment on the important issues tackled in the Annual Superannuation Performance Test consultation paper of March 2024.

Morningstar is a leading provider of independent investment research and has a long history of advocating for transparency in global markets. Morningstar's mission is to empower investors to reach their financial goals. Our product offering caters to individual investors, professional financial advisers, and institutions, who are all connected to the retirement landscape. This allows us to provide several perspectives to the questions raised and the possible effects of amended Your Future Your Super (YFYS) test rules for investors.

Executive summary

Morningstar is supportive of the key principles outlined in the consultation paper targeting improved member outcomes through wider application, effectiveness, and sustainability of the performance tests. We have noted the key issues relating to the YFYS test frameworks, and align our responses to the following areas:

1. We believe the multi-metric approach is a solid foundation for assessing superannuation products. A multi-metric approach could be designed to consider important details such as excess performance to a benchmark, inflation plus outcomes and risk. The APRA heatmap provides a sound precedent for using such a multi-metric approach.
2. A key tenet of the performance test should continue to be that the focus is on protecting the unengaged members from the products that raise prolonged underperformance risks.
3. The prescriptive nature of indices used in the test imposes constraints on super funds in designing portfolios that achieve more targeted objectives, such as ESG. Further, it impedes competition with index data provision, ultimately increasing costs for funds and investors.

We elaborate on each of these elements here, as well as in answers to some of the questions posed in the consultation paper.

Multi-metric framework

We believe that strategic asset allocation contributes the majority of investment returns over time, followed by portfolio construction and security selection, in that order. The current YFYS testing only captures portfolio construction and security selection. It also fails to incorporate risk and inflation plus outcomes. The need to consider each of the above gives weight to the proposition of a multi-metric framework. The APRA heatmap provides a useful starting point for such an exercise.

The APRA heatmap as a foundation captures some of this dynamic through the products' ability to have bespoke benchmarks based on its own strategic asset allocations (SAAs) and the simple representative portfolios (SRPs). However, it does not specifically address absolute return outcomes or risk. We note that the use of a Sharpe ratio, which was included in the consultation paper as an alternative measure, would capture both. A Sharpe ratio measure would also help capture the value add from strategic asset allocation.

Due to the severity of failing the YFYS test some of the elements of the APRA heatmap should be reconsidered:

- Treatment of unlisted assets
- Peer relative components

Finally we would like to suggest that rolling metrics as opposed to a point in time framework be considered. The issue with point-period measurements is no pattern of under- or out- performance can be determined. The current format of a point measurement is as of a month or quarter end. We find that *rolling-period performance* measures are effective in highlighting consistency and improves the accuracy and fairness of determining pass/fail decisions for products.

We would encourage back testing such a test to assess its efficacy, followed by industry consultation considering the results.

Scope

The focus of any changes to the test should be on enhancements to the primary beneficiaries of unengaged investors who would otherwise be in underperforming options. The current scope of the test, MySuper and Trustee Directed Products (TDPs), covers this member segment.

Advised members who are receiving personalised advice should retain the freedom to invest according to their personal goals and advice businesses should not be put in a position of model portfolio manufacturers having to have each individual underlying manager pass a performance test. This would severely limit model managers from managing portfolios with a 'total portfolio' perspective, damaging end investor outcomes. Excluding advised portfolios also allows for engaged, advised investors to pursue more tailored goals that may not be compatible with the performance test.

Many non-trustee directed Choice products have more specific investment objectives than MySuper funds and TDPs. With this distinct focus, the current test is rendered less suited to products such as sector specific funds, CPI real return funds, and alternative managers. Further, while we understand the desire to build a test

that anticipates future expansions to other products to avoid further redesign, we suggest that, given the differentiated goals of retirement products, extending the scope to retirement products would require a test with specialized focus on liquidity and longevity risks.

Indices

The fixed list of index comparators suffers from several limitations:

- Not all asset classes are adequately represented.
- The list requires ongoing maintenance and development.
- Investment decision-making is influenced with products being indirectly encouraged to hug the relevant indices on the list to minimise the risk of failing the test by virtue of being tested against indices that are not directly comparable with a funds preferred strategy.

By extension, market competition for funds' use of indices from other index providers is impeded, leading to both a lack of diversity among the investment strategies of the tested funds universe and a lack of price competition on the costs of benchmark use, ultimately borne by scheme members.

Allowing super funds a degree of flexibility to elect which indices, from a range of providers, would allow for diversity of opinion, as well as:

- create an environment for more diversity across super funds' investment objectives;
- allow for more targeted insight into the reasons for failures, or partial failures, such as a product excluding certain holdings due to an ESG objective;
- provide an in-built solution to catering for new asset classes in the future, and
- solve for more competition in index provision for benchmarking of funds.

We thank the Treasury for the opportunity to comment on the performance test. We will be happy to engage in further discussion or provide further information.

Yours faithfully,



Peter Bryant

Managing Director, Enterprise
Australia & New Zealand

Morningstar Australasia Pty Ltd