Submission to ‘Retirement phase of superannuation’ consultation

Australian Government Treasury

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First Sentier Investors

About First Sentier Investors (FSI)

First Sentier Investors is a global asset management group focused on providing high quality, long-term investment capabilities to clients. It brings together teams of active, specialist investment managers who share its common commitment to responsible investment principles. All investment teams operate with discrete investment autonomy, according to their investment philosophies.

First Sentier Investors has been managing money with a long-term outlook for more than 30 years and today manages more than AU$213.5b[1] of assets on behalf of institutional investors, pension funds, wholesale distributors and platforms, financial advisers and their clients. The firm was acquired by Mitsubishi UFJ Trust and Banking Corporation, a wholly-owned subsidiary of Mitsubishi UFJ Financial Group, Inc in August 2019, and operates as a standalone global investment management business with offices across Europe, the Americas, and Asia Pacific.

This response, and opinions provided in this submission, have been prepared by experienced investment managers within the Equity Income team at First Sentier Investors. This team manages a range of objectives-based equity and multi-asset strategies that target a mix of risk-adjusted returns, income and volatility requirements.

A 'well-rounded' retirement product

The discussion paper defined 'well-rounded' to be a product that address the three core objectives set out in the Retirement Income Covenant, being

1) Maximise retirement income
2) Manage risks to the sustainability and stability of that income, and
3) Maintain flexible access to capital.

While these objectives are broadly accepted by almost all industry participants, we believe some nuanced issues need to be carefully considered.

Multiple objectives across multiple timeframes

The paper states that *planning for retirement income requires retirees to solve a "risky, long-horizon, multi-dimensional problem."* We consider this statement to be one of the most accurate descriptions of the challenge faced by retirement investors.

One challenge for the industry is that the reference to 'maximise retirement income' is subject to different interpretation by industry participants and end members. By definition, 'income' is typically considered as a near-term issue. Income refers to 'cashflows' as much as it relates to 'returns'. Income becomes the focus of end members when that income is required to fund near-term living expenses. Maximising income can be readily achieved on a year-by-year basis by shifting investments to those asset classes that distribute a higher proportion of their total return as income.

In contrast, First Sentier Investors argues that any well-rounded retirement product must retain a long-term perspective when considering the maximisation of income. A number of the investment objectives in retirement are short-term in nature (e.g. Income), but it is critical that a long term investment focus is maintained.

[1] *Source: First Sentier Investors as of 31 September 2023*

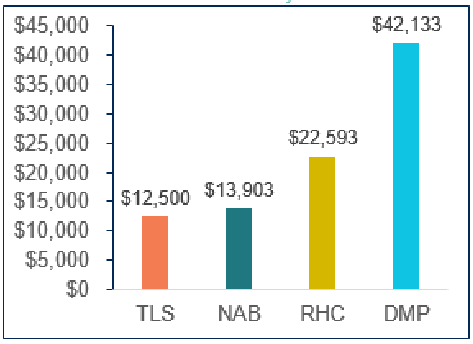
To emphasise this point using an example[2] from our area of expertise in generating income from Australian shares, the timeframes over which we consider 'income' can significantly change how we define 'maximising retirement income'.

Which of these stocks are expected to provide the most income?

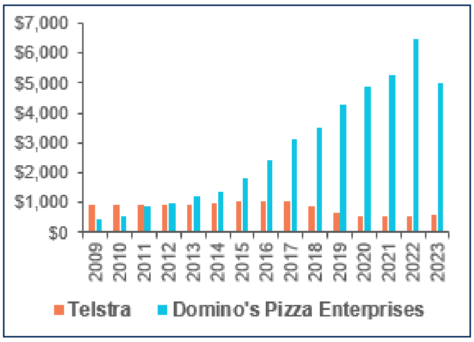
Grossed-up yields (including franking)	June 2008	Average	June 2023
Telstra Corporation (TLS)	9.4%	9.0%	6.3%
National Australia Bank (NAB)	9.2%	9.1%	8.4%
Ramsay Health Care (RHC)	5.6%	3.4%	1.9%
Domino's Pizza (DMP)	4.5%	3.7%	2.6%

Outcome for $10,000 invested in June 2008:

Dividends and franking income received over the 15 years



Annual income per year



High dividend yields ≠ high dividend income

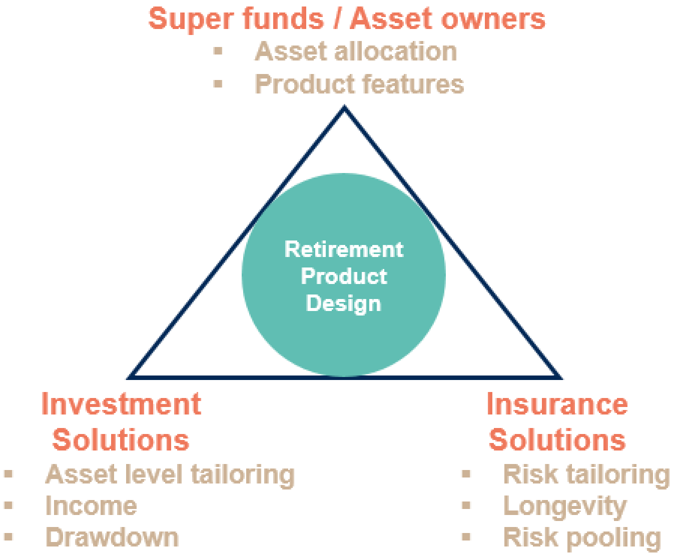
Interrelatedness of investment objectives needs to be understood

Seeking to address multiple investment objectives simultaneously is challenging; the inter-relatedness between the different objectives adds to that complexity and needs to be understood. The design of any retirement product requires a solution that addresses the short-term objectives without compromising long-term objectives.

Innovation needs to be encouraged across the entire value-chain

To date we have observed that the sole focus on retirement product design has been solely directed towards the asset owners. However, the reality is that multiple layers of decisions contribute to the design of a retirement product and involve different specialists. We believe better end member outcomes will be achieved if the regulatory structure encourages innovation more broadly across the entire value-chain.

[2] Sources: First Sentier Investors, Factset, IRESS. Total income and capital over 15 years calculated assuming AUD$10,000 is invested in June 2008. Any fund or stock mentioned does not constitute any offer or inducement to enter into any investment activity.



While the attention of the retirement regulation has been duly focused on Super Funds as the primary fiduciaries of retirees, these asset owners ultimately rely on external solution providers both for their investment allocations as well as for insurance overlays. The regulations and requirements imposed on Super Funds would likely greatly impact the type of products the Super Funds demand from investment and insurance solution providers. The right incentives are required to ensure Super Funds continue demanding products that are aligned with the needs and objectives of retirees. Given the general risk conservatism across the Super Fund industry, external solution providers are relatively well placed to be able to iterate and innovate products that can succeed and fail according to market forces, and draw upon shared experiences across other retirement market segments such as the Wholesale and SMSF segments.

Related to this, our concern regarding the design of performance testing is that the impact may be counter-productive to the outcomes being sought. In short, the introduction of a retirement segment 'performance test' would direct industry resources towards ways to meet/satisfy the test requirements rather than focus on developing strategies and product design features that contribute to a 'well-rounded' retirement product.

Unintended consequences of 'performance test' measures

These issues regarding how to create a 'well-rounded' retirement product become critical when the retirement product framework is extended to consideration of an appropriate 'performance test' or 'benchmark'. In relation to any potential performance test, First Sentier Investors is most concerned about creating incentives that result in the over-simplification of how objectives are defined and measured. In our experience, we have observed numerous examples were we believe investment products simply target the achievement of a singular metric rather than considering all the requirements of retirees holistically and across the multiple timeframes required. Some examples of this have included simply targeting higher dividend yield stocks or fully franked stocks to generate a high level of income and/or franking credits over a short-term period. Employing simplistic investment strategies can often result in satisfying one objective whilst ignoring others and introducing additional issues. Simplifications often result in portfolios that do not achieve what they have been designed to do.

The conflicting role of asset allocation

In a perfect world, asset allocation decisions should be driven by risk requirements – the asset allocation for individual investors should reflect their level of risk appetite and risk tolerance. However, there are risks that the existing 'performance test' framework effectively treats asset allocation as an alpha source, thereby requiring asset allocators to appropriately market time. This creates a challenge for asset owners who manage different pools of capital with different risk profiles, whereby they may be penalised for otherwise appropriate asset allocation decisions taken in response to changes in market conditions.

The majority of innovation in asset allocation over recent years has been focused on alternative asset classes and shifts towards 'illiquid' assets. This may not be as appropriate for the retirement cohort given that 'flexible access to capital' is a core component of RIC. The needs for the retirement investor cohort will likely require more nuanced changes in asset allocation, for example, changing how exposure to an asset class is obtained to improve the income and/or volatility characteristics. This requirement for greater 'intra-asset risk management' must be accommodated into any performance test that is considered for the retirement phase of superannuation.

Measuring 'risk-adjusted returns' are even more critical for retirement products

First Sentier Investors believes that current YFYS Performance Test could be materially improved by migrating the methodology to capturing risk-adjusted returns. For retirement products, we believe this requirement is even more critical. The second objective of the RIC references 'managing the stability of income', which implicitly references risk/volatility considerations.

Which risk measure?

Extending the consideration of the above issue, First Sentier Investors believes greater consideration needs to be given to how risk will be measured as part of any retirement product assessment process. We believe, by itself, volatility may be insufficient as an appropriate risk measure.

Most risk assessment frameworks used by investment practitioners are variations of risk-return optimisation/blending where risk is defined in terms of volatility and correlation parameters. How well do these approaches align to how conservative investors think about risk? Shortcomings include:

- They focus primarily on the potential deviation from an expected return (volatility) rather than the extent of losses that may arise during the investment period
- Forcing the volatility measure to be applied to asset classes where it is clearly evident that the 'normal distribution' assumption fails
- Mostly communicates the frequency of negative returns and ignores the potential magnitude of the negative returns if/when they occur
- Being reliant on prevailing conditions for key inputs and hoping that historic relationships repeat themselves – if recent conditions have been benign, this can result in excessive risk taking beyond an investor's risk tolerance.

'How much could I lose when things go wrong?' - These words are at the heart of how 'conservative/income-oriented investors' think about risk. The question of 'how much could I lose?' implies a focus on absolute loss, while the phrase 'when things go wrong' tells us that risk concerns relate to the maximum potential loss from an investment rather than some potential deviation from an expected return over time (volatility). Therefore, First Sentier Investors believes that a more relevant risk measure should focus on the downside tail risk/drawdowns for retirement products. We believe this is even more critical for retirement products because many of the asset classes allocated to by income-seeking investors have risk profiles that are asymmetric and therefore *volatility* is a poor measure of risk for these asset classes. The shortcomings of the use of *volatility* as a risk measure have been acknowledged by industry participants for many years, but there has been limited progress on a suitable alternative.

Adapting the APRA Capital Risk Charge concept to public-offer investment products

First Sentier Investors believes that additional risk measures that provide richer insights on tail risk outcomes, which are more relevant to income-oriented/retirees more concerned about drawdowns, could be useful for the industry. We certainly acknowledge that there can never be one universal measure of risk that covers all requirements, but believe these kinds of additional measures are preferable to any 'scorecard' type of approach that are likely to be too simplistic and one-dimensional.

In our opinion, APRA already has in place a strong risk framework supporting the regulation of insurers that could be considered for broader application related to retirement products.

The Capital Risk Charge concept is the risk framework used by APRA to manage the risk for life and general insurance companies under its regulatory authority. APRA requires insurers to hold a minimum amount of capital to absorb any losses from identified risks and mandates a specific calculation methodology for each asset class. The framework intends to maintain solvency with a 1 in 200 year failure level, meaning that APRA expects the Capital Risk Charge to be able to cover losses arising from the insurers invested assets in 199 years out of 200.

This risk framework can readily be adapted to a multi-asset investment context to provide an additional valuable measure of risk. The framework prescribes a calculation methodology to each individual asset type, as well as a methodology to aggregate this into a portfolio-level risk measure. By setting a desired level of maximum expected potential loss, this framework establishes the risk limit/budget constraints on a multi-asset portfolio. This provides a powerful and absolute risk control parameter that ensures the multi-asset portfolio does not migrate away from the desired risk profile in the pursuit of higher returns. A key advantage of this risk framework is that risk and stress market scenarios can be assessed in a way that is relevant for each asset class.

Many of APRA's risk management principles to ensure the prudent, long-term solvency and viability of the insurance industry are very similar to the risk considerations required for a well-rounded retirement product. Some reasons that the Capital Risk Charge could be used as the risk framework for retirement products are because it:

- Provides a tail risk measure of 'risk' – The most relevant risk concern for conservative investors is 'what is the most I should expect to lose during weak markets?'
- Seeks to avoid excessive risk taking in the pursuit of higher returns –To ensure alignment with retirement client needs, it is important that any product maintains a risk profile that remains aligned to the conservative risk profile of the retiree investor, regardless of the asset allocation at any point in the market cycle.
- Overcomes the limitations with standard risk metrics – Similar to APRA, retiree investors are more concerned about the potential absolute maximum loss when 'things go wrong' rather than the month to month variability in return. Yet, industry standard risk metrics such as volatility, tracking error and the Standard Risk Measure are far more focused on variability of returns over time rather than the magnitude of potential downside returns. As an example, the FSC Standard Risk Measure framework used in Australian retail managed funds only considers the frequency of negative returns, rather than the potential magnitude of negative returns.
- Provides an independent, arm's length measure of stress market scenarios, defined in a way that is relevant for each asset type – In multi-asset strategies, the suitability of using a measure of volatility differs by asset class. For example, whilst it can be prudent to use a volatility metric for measuring equity risk, its suitability is poor for asset classes such as bonds and credit with asymmetric upside vs downside returns. A key benefit of the Capital Risk Charge is that the risk test applied is tailored to the characteristics of each asset class.
- Removes risk management being dependent on prevailing conditions – The risk approach remains the same regardless of the present state of the markets. This framework avoids excessive risk taking that can arise from using risk metrics (e.g. volatility) that have been calibrated using recent market conditions as the key input.
- Removes risk management being dependent on historic relationships repeating themselves – The risk approach uses a set of conservative assumptions that are intentionally static based on extreme market outcomes (including assumed correlations based on stress market conditions rather than simply recent experience).
- Provides a risk description that can be communicated to investors - The rules and formulas are intuitive to understand and provide prescribed stress tests for the various asset classes. This allows the risk measure to be understandable, which in practice is much more useful than other 'black box' tail risk measures such as VaR, most of which are largely model dependent.

We believe that each of these risk framework principles are important to balance the generation of attractive income from investment ideas across a broad opportunity set whilst delivering a stable and conservative risk profile for retirement investors at all times regardless of the allocation mix at the time.

First Sentier Investors has been managing a retirement investment strategy that applies that approach for many years and would be happy to share our insights on this approach further if required.

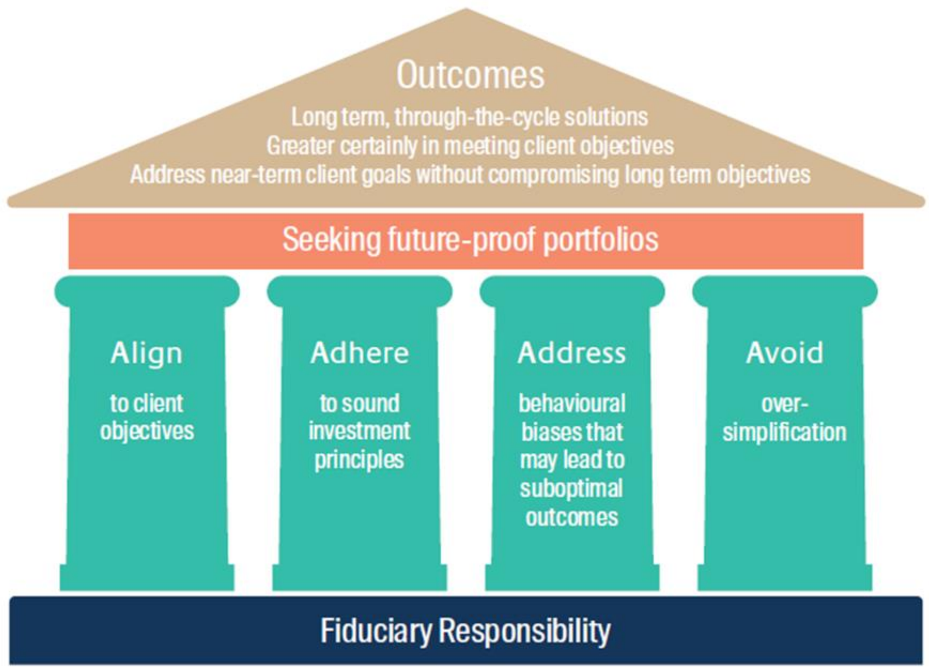
Summary

The challenge during the near-retirement and drawdown phases arises from the fact that the investment objectives and their timeframes may well be conflicting. The problem faced by investors is not one of mere maximisation of a single objective, but rather managing the balance and trade-offs between multiple objectives so they can simultaneously be met.

One impact of this challenge is that investment strategies often promote near-term requirements such as income/yield requirements ahead of other long-term investment objectives.

The diversity of potential products poses another challenge for investors. First Sentier Investors has developed a framework by which different retirement investment strategies can be assessed for their long-term sustainability and effectiveness in contributing to a client's retirement investment objectives being met.

Future-proof framework



Source: First Sentier Investors

This framework sets out the essential features or characteristics that potential investment strategies should exhibit in order to be considered in the construction of a future-proof client investment portfolio. This 'future proof' framework seeks to make the distinction between investment strategies that can be considered as contributing to an effective client solution over the long term and through a range of possible market cycles, and investment strategies whose effectiveness may be more limited to certain market conditions.

Applying this framework to the assessment of member retirement investment strategies will result in:

- Identification of long-term strategies that are effective through-the-cycle solutions
- A mechanism to address near-term client goals (e.g. income) without compromising on long term objectives
- Greater certainty in meeting member objectives by reducing the potential variation between target/desired outcomes and actual outcomes.

A research paper that explains this framework in detail, *Future-proof Portfolios* (August 2018), can be provided on request.

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Disclaimer

This submission has been prepared by Rudi Minbatiwala and Marlon Chan in response to a Discussion Paper ‘Retirement phase of superannuation’ issued by the Department of Treasury in December 2023. This submission contains general information only and is not intended to provide financial product advice.