Growth / Defensive Asset Categorisation Proposed Solution for Consultation

Introductory Paper

21 July 2020

Background

This document details the proposed approach to growth / defensive (henceforth "G/D") asset categorisation, released for industry consultation.

The G/D exposure measurement is entrenched in industry. It is used to form peer groups by research groups, it is commonly used by financial planners and is used by APRA in their Heatmap reporting.

Yet growth / defensive remains undefined and no standardised approach exists for measurement. This creates concerns around subjectivity and gaming, especially given the huge range of investments that now exist. This undermines confidence in performance assessment.

A diverse working group (a range of super funds alongside research houses, detailed in Table 1) has worked hard on this project for over 12 months. This is a true working group solution and does not represent the recommendation of any individual or their firms. The working group explored well beyond the proposed solution in many directions to enable an informed decision to pull back (where appropriate) to the recommended solution. This enabled a thorough exploration and also the opportunity to better explain our reasoning.

The working group believe a standardised approach to growth/defensive categorisation would benefit industry by increasing confidence in performance assessment. APRA has been kept informed of the progress of the working group.

Name	Affiliation	Nature of involvement
Debbie Alliston	AMP Capital Investors	Working group member
David Bell	The Conexus Institute	Chair of working group
Ian Fryer	Chant West	Working group member
Carol Lee	AustralianSuper	Working group member
Tim Macready	Christian Super	Working group member
Kirby Rappell	SuperRatings	Working group member
Anna Shelley	Equip and Catholic Super	Working group member
Scott Tully	Colonial First State	Working group member

Table 1: Working group members. The working group acknowledges contributions made by Alistair Barker at Australian Super and specifically thanks Mercer for technical expertise and data.

Challenges

A range of challenges were encountered when addressing a better approach to G/D scoring. We narrowed these down to three major problems, summarised in Figure 1.
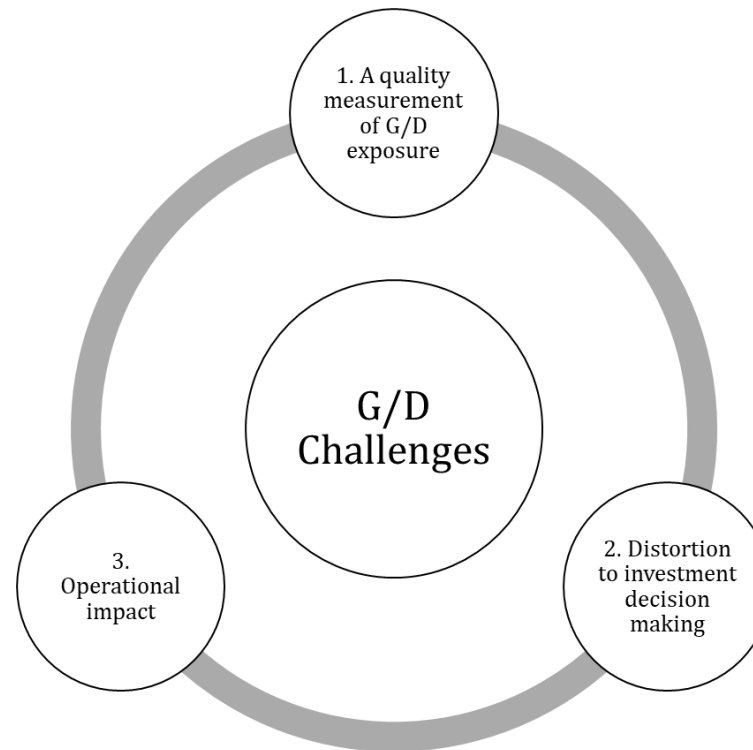

Figure 1: Three major problems faced in developing an approach to G/D scoring.

Expanding on the challenges identified in Figure 1:

1. A quality measurement of G/D exposure: this relates to the desire to produce consistent, comparable fund exposure measurements across a large, diverse range of investment strategies. This area covers many issues including the degree of subjectivity versus prescriptiveness, and the consideration of portfolio diversification benefits.

2. Concern around distorting investment decision-making: if the G/D scoring approach differs significantly from the true risk properties of individual investments and portfolios, then we potentially distort the investment decision-making process (acknowledging that many super funds account for both member outcomes and peer group considerations in their portfolio design).

3. Operational impact: we are cognisant of the operational impact of more detailed approaches.

One way of framing the challenge is to explore different measurements along the dimensions of simplicity and the degree of subjectivity, as per Figure 2. While relevant we note that this framing doesn't consider the quality of the measurement.
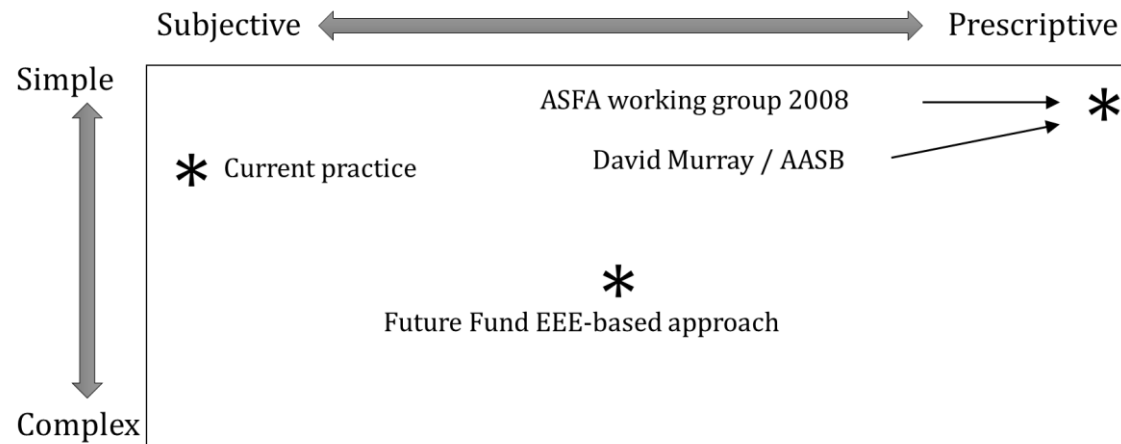
Figure 2: Working group assessment of a range of approaches to growth / defensive categorisation[1].

Proposed Solution

Some important reflections contributed to the proposed solution. Of note:

- G/D is an exposure metric, not a risk metric. It can only be stretched so far before it starts to become more like a risk metric. We are cognisant of preserving its role as an exposure metric.

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[1] *"ASFA working group 2008"* details initial work of a previous industry working group. *"David Murray / ASB"* relates to a standardised approach suggested by David Murray AO, relating to AASB-style standards (see AFR 23 June, 2019). *"Future Fund EEE-based approach"* relates to the equity equivalent exposure measure used by the Future Fund to communicate exposure. *"Current practice"* is self-explanatory.

- To get more nuanced insight into some sectors requires an element of self-assessment. This naturally introduces subjectivity. However, we note that subjectivity can be somewhat controlled by having detailed processes for self-assessment.

- We recognise that a more detailed approach allows better insight, but it also increases operational complexity. We strive to be aware of materiality before mandating complexity.

- The recommendation is based on a foundation of research, rather than opinions. Examples include exploration of performance and fundamental characteristics of investment sectors and the use of test ('meme') portfolios.

The foundations of the proposed solution are detailed in Figure 3. Additionally, we note that the total portfolio G/D score is simply a weighted sum-of-scores (i.e. we do not consider portfolio diversification benefits). A solution is fully detailed in the document *"Detailed Paper: The Growth / Defensive Proposal"*. Models are also provided to assist industry explore the proposal. For further information visit the G/D resources page at www.TheConexusInstitute.org.au .
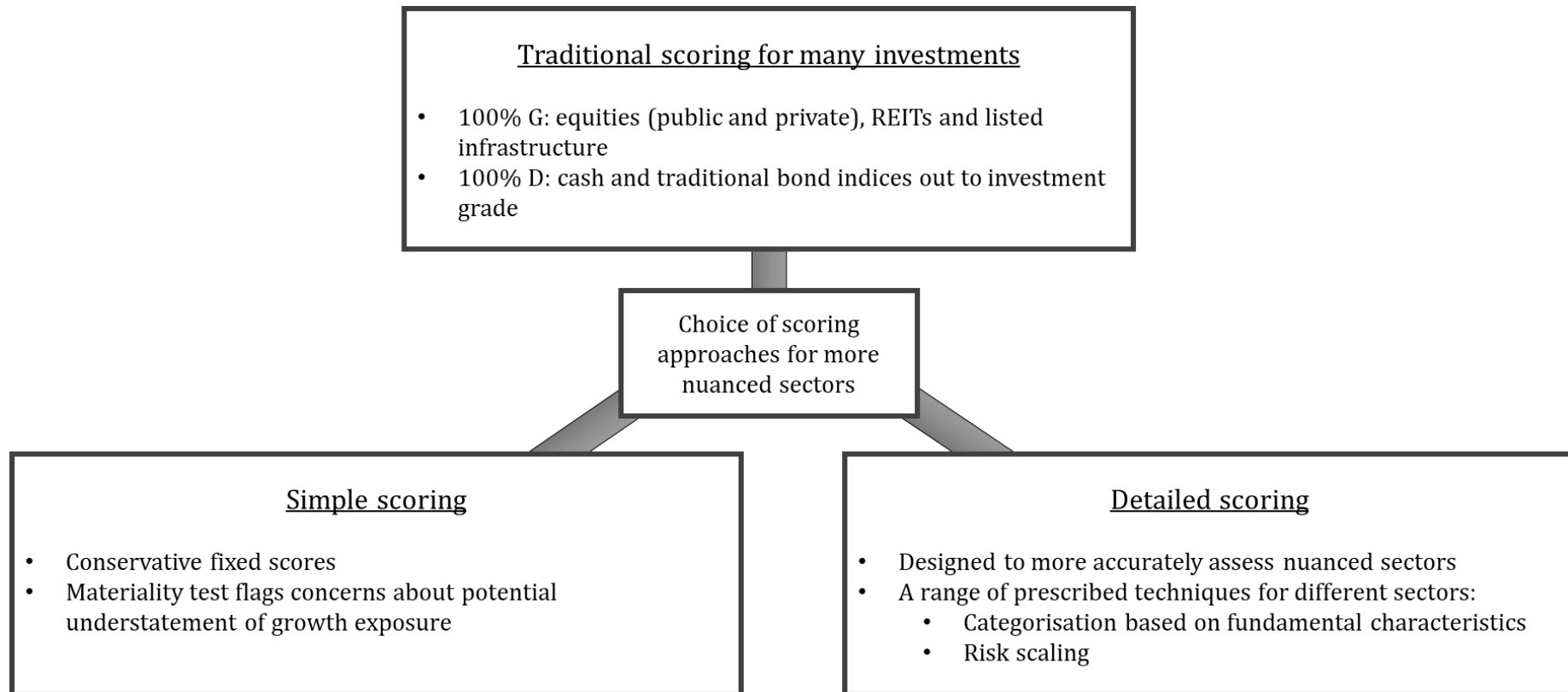
Traditional scoring for many investments

- 100% G: equities (public and private), REITs and listed infrastructure
- 100% D: cash and traditional bond indices out to investment grade

Choice of scoring approaches for more nuanced sectors

Simple scoring

- Conservative fixed scores
- Materiality test flags concerns about potential understatement of growth exposure

Detailed scoring

- Designed to more accurately assess nuanced sectors
- A range of prescribed techniques for different sectors:
  - Categorisation based on fundamental characteristics
  - Risk scaling

Figure 3: Foundations of the proposed G/D solution.

Self-Critique

An important realisation for the working group was that there is no perfect solution and that people and firms will have a different view on how to trade off the three challenges outlined in Figure 1. There will also be different opinions on many of the technical aspects of the proposal. The consultation provides an important opportunity to share your views with the working group.

The working group recognises the importance of a standardised approach to G/D classification and one that captures the nuances of different investments and portfolios in a prescriptive manner. The working group regards the proposed solution as meeting that objective. The working group considers the degree of subjectivity to be relatively small and that the potential for gaming is greatly reduced. By providing a simple scoring option (subject to materiality) the working group has tried to reduce operational impact for the industry. Returning to the spectrum of complexity versus subjectivity detailed in Figure 2, the working group self-assesses the proposed solution in Figure 4.

However, the working group also reflects that complexity is inherent in the proposal. And while self-assessment is accompanied by guidelines, there is room for a degree of subjectivity and ultimately gaming. The working group considers ignoring diversification benefits to be the largest distortion to the investment decision making process – however the working group remains of the view that acknowledging diversification benefits stretches an exposure metric too far and introduces significant complexity and subjectivity.
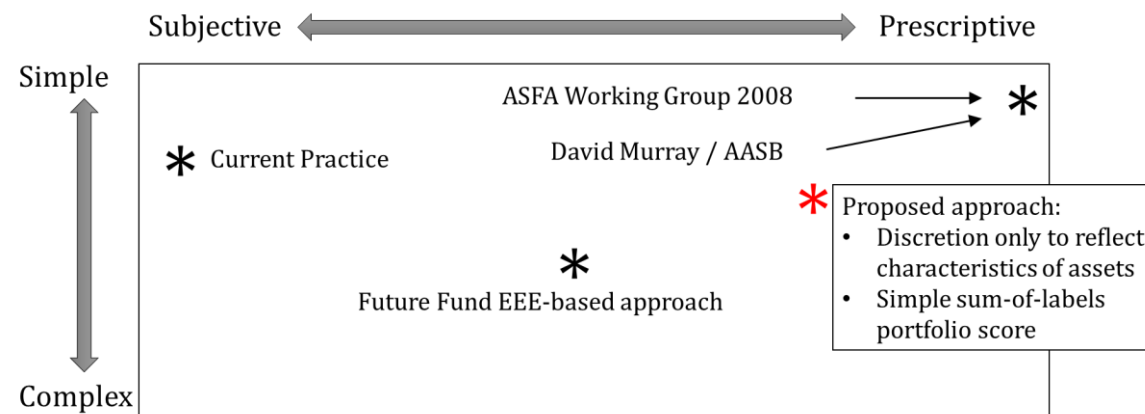

Figure 4: Working group assessment of a range of approaches to growth / defensive categorisation including proposed solution.

Next Steps: Participate in the Consultation

We strongly encourage industry to engage in the consultation process and make this a truly industry-developed solution. Please review the materials and make a submission. All submissions will be read, considered and may significantly impact the design of the final version. Bypassing this submission process will reduce your opportunity to contribute.

Your feedback will inform the working group and impact the final proposal, which will then be shared with APRA.

Submissions are due Monday 28 September.

Formal implementation will likely be 30 June, 2021. However, there are no barriers to early adoption.