Senate Economics Legislation Committee

Inquiry into the Treasury Laws Amendment (Your Future, Your Super) Bill 2021 [Provisions]

Dr David Bell

Opening statement

Good morning senators and thank you for the opportunity to share our research.

The Conexus Institute is an independent, not-for-profit research institution focused on improving retirement outcomes for Australian consumers. We marry academic research techniques with industry experience. Generally, and in the case of the Your Future, Your Super reforms, all our research has been made open source.

We have undertaken a significant amount of research on the Your Future, Your Super reforms. This has been shared broadly, workshopped informally with Treasury and presented at industry and academic forums. We created a working group of researchers from five leading consultant firms. To preserve independence I was the primary author, while other members served in an advisory and review capacity. All views shared today are mine and those of The Conexus Institute.

I make two initial reflections:

(1) The first is that, overall we consider much of the reform package to be well-intended. But well-intended policy can be detrimental in a complex system unless the design is spot on.

(2) The second reflection is on the flow-on effects of policy. While some initial positive outcomes may be achieved, the reaction of agents to policy and the future effectiveness of the policy are just as, if not more, important.

Much of our focus has been on the Your Future, Your Super performance test. We are pleased to bring some independent, quantitative research to the discussion.

I briefly detail our two most significant research pieces on the performance test:

(1) In our first piece of research we explored the statistical effectiveness of the performance test.

    Will the test be able to successfully distinguish between 'good' and 'poor' funds? We found that the test will be ineffective. It will work ok for the most egregious cases of underperformance but will struggle for more realistic cases. These effectiveness numbers are summarised in Table 1 of our Additional Materials document.

    The performance test is ineffective for two primary reasons. One, the test only focuses on a single component of performance, implementation, and ignores other important sources of performance such as asset allocation. A simple illustration of this issue is provided in Table 2 of our Additional Materials document.

And two, the performance test is implemented in a crude fashion, using a limited number of public market benchmarks. This process distorts the assessment across many assets, most notably unlisted assets, all forms of credit, nearly all fixed income sectors, and the entire universe of alternative assets.

(2) In our second piece of research we assess how the performance test will constrain super funds from managing portfolios in members' best interests.

Because of the severe penalties of failing the performance test, trustees will focus strongly on passing the test. Trustees will also desire a stable investment strategy: they will not want to have to incur costly changes to their investment strategy in response to short-term underperformance.

The term 'tracking error' comes to the fore in this type of analysis. This is the amount of risk relative to the benchmarking process. We find that most funds will need to significantly rein in their tracking error as part of developing a sustainable investment strategy. Diagram 1 of our Additional Materials document outlines the choices and conflicts faced by a trustee.

If trustees are constrained from implementing what they consider to be their best portfolios we expect there will be an opportunity cost: portfolios will be less effectively diversified and there will be less allocated to best investment ideas. We conservatively estimate that the cost of these constraints will exceed $3b pa, more than the benefits of the entire Your Future, Your Super reform package.

Our research on the performance test identifies further undesirable outcomes which impact super funds, industry structure, and ultimately consumers.

In our submission we suggest a modification to the performance test design, which is relatively simple and offsets many of the identified shortcomings.

We have explored other aspects of the Your Future, Your Super suite of reforms. Here, I draw attention to three issues:

1. The first is the stapling model (Your Super Follows You) and how it impacts competition and consumer outcomes. The intent is strong: stapling reduces the creation of multiple accounts. But there are various possible models. Our concerns relate to competition and consumer outcomes:
    a. From a competition perspective this model pre-ordains winners and leaves the primary point of competition to be consumer-based. Is this an effective basis for quality competition given the financial literacy levels of consumers?
    b. From a consumer outcomes perspective, the model may leave consumers in funds which are less appropriate as they change their occupations. This relates to investment strategy, insurance arrangements, and engagement model.

2. The second observation relates to the potential for an upwards spiral in industry marketing expenses. In a stapled fund world, funds may market to win members, but

funds may also decide they need to market to maintain fund membership. I'm not sure that the Member's Best Financial Interest Duties will effectively protect against this risk.

3. The third observation relates to effective consumer decision-making using the ATO information portal. Beyond the difficulties of understanding fund performance, my concern is: how do consumers weigh-up investment performance, administration fees, fund design and insurance arrangements?

That concludes my opening statement. I can expand on any aspect of research we have undertaken. Thank you.

Additional Materials

Test	Likelihood
Effectiveness: likelihood of failing to identify a 'poor' fund as 'poor'	42% - 65%
Mistakes: likelihood of identifying a 'good' fund as 'poor'	35%

Table 1: Assessed statistical effectiveness for realistic cases of the Your Future, Your Super performance metric.

Performance component	Fund A	Fund B
Asset allocation	7.5%	6.5%
Implementation	-0.5% pa	0% pa
Total performance	7.0% pa	6.5% pa

Table 2: Simple case study to highlight different components of performance.

“Common” Super Fund

Portfolio

- 30% total in unlisted property, unlisted infrastructure and high yield
- Active management across many asset classes and management of ESG risks
- This generates 3.6% tracking error

Performance Test

- 22% likely to fail the performance test
- >80% likely to have to adjust the portfolio over time

“Stable” Super Fund

Portfolio

- 10% total in unlisted property, unlisted infrastructure and high yield
- No active management across and no management of ESG risks
- This generates 1% tracking error

Performance Test

- <1% likely to fail the performance test
- 10% likely to have to adjust the portfolio over time

Diagram 1: Simple case study illustrating the conflicts faced by trustees under the Your Future, Your Super performance test.