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The Your Future, Your Super Performance Test

Overview and summary of research – 8 July 2021

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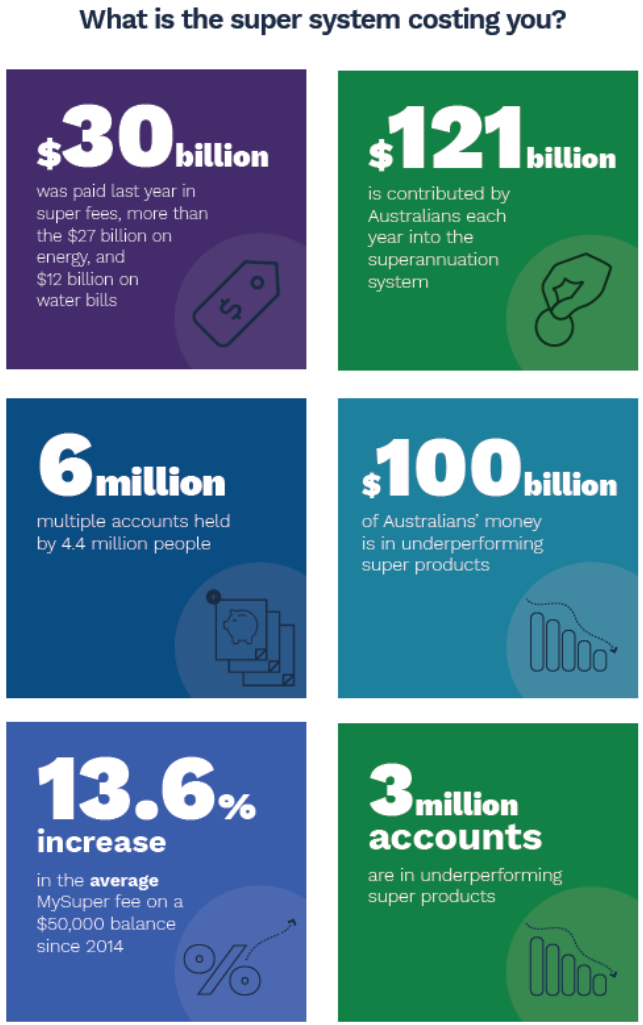
Introduction

- The Your Future, Your Super (YFYS) superannuation reforms were announced as part of last year's Budget
- This presentation provides an up-to-date overview of the YFYS performance test
- All our YFYS research (including submissions and models) has been made open-source and is available here
- This link takes you directly to an aggregated Excel file of all models and calculations developed in our research

Collaboration

- Researchers from five consulting firms joined our working group which explored the YFYS performance test
- To preserve independence, I was lead author. Working group members provided advice and review
- I'd like to acknowledge the contribution of working group members: Emily Barlow, Andrew Boal, Kim Bowater, Nick Callil, David Carruthers, Matthew Griffith, Clayton Sills, and Timothy Unger
- The views shared in this presentation are mine and those of The Conexus Institute

The YFYS Reform Package



The Government paints a picture of a system which is inefficient.

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YFYS performance test – have we missed the forest for the trees?

- The YFYS performance test has been over-analysed in the wrong areas
- Why?
- It is a 'bright-lines' test applied retrospectively (i.e. a past sins test)
  - This means that it places aside lots of information which provides insight into future returns, such as through-time changes made to governance, capability and investment strategy
- The key question is whether the bright-lines test is superior to what APRA would achieve through Heatmaps + frontline
- The secondary question is how to improve the design of a bright-lines test, to
  - Ensure it 'fairly' assesses historical performance
  - Ensure it doesn't distort investment decision-making
- Unfortunately, the secondary question has attracted more focus than the first – (collectively) we all dived into the detail! Although there seemed little preparedness to step away from a bright-lines test

How will the YFYS Performance Test work?

Process

Test	Result	Outcome
Annual performance test (rolling 8yr)	Pass	No change
	Fail (1st time)	Letter to members
	Fail (2nd or more consecutive fail)	Letter to members + no new members allowed

How will the YFYS Performance Test work?

Calculation

Step 1 – Determine tailored performance test benchmark

Strategic asset allocation (SAA) → Map to a set of public market benchmarks → Fund-specific SAA benchmark for the year

Step 2 – Calculate annual relative investment performance

Fund performance minus Performance of fund-specific SAA benchmark equals Annual relative performance for fund

Step 3 – Calculate annual relative administration fees

Fund administration fees minus Industry median administration fee equals Relative administration fee

Step 4 – Calculate annual total relative performance

Investment + administration (relative performance)

Step 5 – Calculate 8yr rolling performance outcome

Compound of 8 individual results

Additional notes:

- Test will be administered by APRA
- Pass mark is >-50bp pa

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How will the YFYS Performance Test work?

Benchmarks

	Index
Public sector benchmarks	Australian shares, global shares (hedged and unhedged), S&P/ASX 300, Australian listed property, international listed property, global listed infrastructure, Australian fixed income (composite), global fixed income (composite), Australian cash, international cash
Non-public sector benchmarks	Australian unlisted property, Australian unlisted infrastructure[1]
Other	25% International Equity (hedged), 25% International Equity (unhedged), 50% International Fixed Interest

(1) Australian unlisted infrastructure index has a sizable look-through exposure to global assets.

- There are ongoing challenges relating to how funds self-determine their SAA to APRA.

Reflections

Important questions

1. How well does long-term backwards-looking performance inform future performance?
2. How well can a single metric assess past performance?

Reflections

Important questions

1. How well does long-term backwards-looking performance inform future performance?

- Many studies show past performance provides only limited insights into future performance
- Doesn't account for:
  - Quality of governance (some evidence that this is an indicator of future performance)
  - Investment approach (e.g. TPA) and capability
  - Investment strategy – implementation model
  - Current portfolio
- APRA can assess all these points through its frontline function

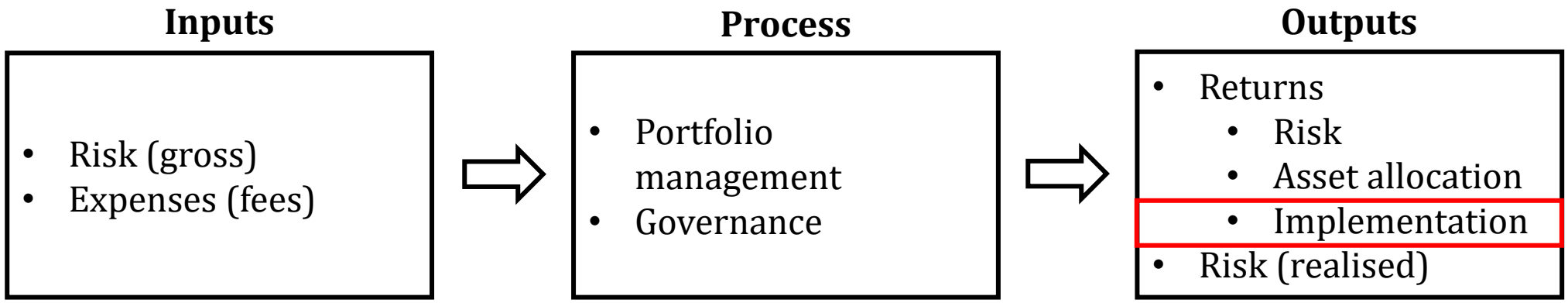
Reflections

Important questions

2. How well can a single metric assess past performance?

- Difficult for a single metric to accurately assess performance
  - Account for all forms of performance
  - Account for risk

The YFYS performance test only assesses the red box in the diagram below.



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Reflections

Which fund did better?

(assuming they took similar degrees of risk exposure)

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

Concerns

Benchmarking process creates distorted concept of tracking error

- Tracking error is a statistical measure of a portfolio's volatility relative to a benchmark
- The test only uses a limited number of benchmarks (even accounting for the additions made)
- This creates a distorted version of tracking error
- Beyond active management and decisions, performance test tracking error is generated by:

Investing in the following public market sectors:

- Australian small cap equities
- International small cap equities
- Emerging market equities
- Corporate bonds
- High yield bonds
- Emerging market debt
- Inflation-linked bonds
- Low or high duration bonds

Investing in the following unlisted sectors:

- Private equity
- Unlisted property *
- Unlisted infrastructure *
- Direct loans

(* despite benchmark improvements)

The following activities:

- Portfolio hedging (e.g. put options)
- Some foreign currency exposure
- Overlay strategies (e.g. volatility targeting)
- Managing ESG risk or any risk which requires active management

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Concerns

Three specific areas of concern

1. How funds will invest
2. Impact on consumers
3. Affect on industry structure

Concerns

1. Concerns relating to how funds will invest

- Dangerous incentive for funds which are well behind on the performance test to ‘swing for home runs’ and take high tracking error relative to benchmark
- Actively managing (in the worst case, gaming) the performance test by taking advantage of benchmark shortcomings
- Poor alignment with portfolio management approaches such as total portfolio approach (TPA)
- Deterrent to strategies which seek to manage risk and provide diversification
- Features of the YFYS performance test do not match up well with future portfolio management challenges

In summary, the YFYS performance test creates a range of conflicts with a trustee’s fiduciary duty.

Concerns

2. Concerns relating to impact on consumers

- Confusion:
  - Contested results
  - Results don't match up with total performance outcomes
- System confidence:
  - Potential for a large cohort of funds to fail the YFYS test concurrently (due to benchmarking noise), reducing system confidence
  - Populist language like "dud funds" (albeit engaging)
- Relies on engagement as the judgement mechanism:
  - Uncertainty about consumer decision making ability
  - Penalises the heavily disengaged who may remain in a fund which becomes further impaired

Concerns

3. Concerns relating to impact on industry structure

- A deterrent to consolidation as funds may be hesitant to merge with other funds which may dilute their portfolio quality, impair their inflow profile, or distract management focus.
- Potential for 'zombie' funds which are impaired (partly due to their performance test result) making them an unattractive merger partner.

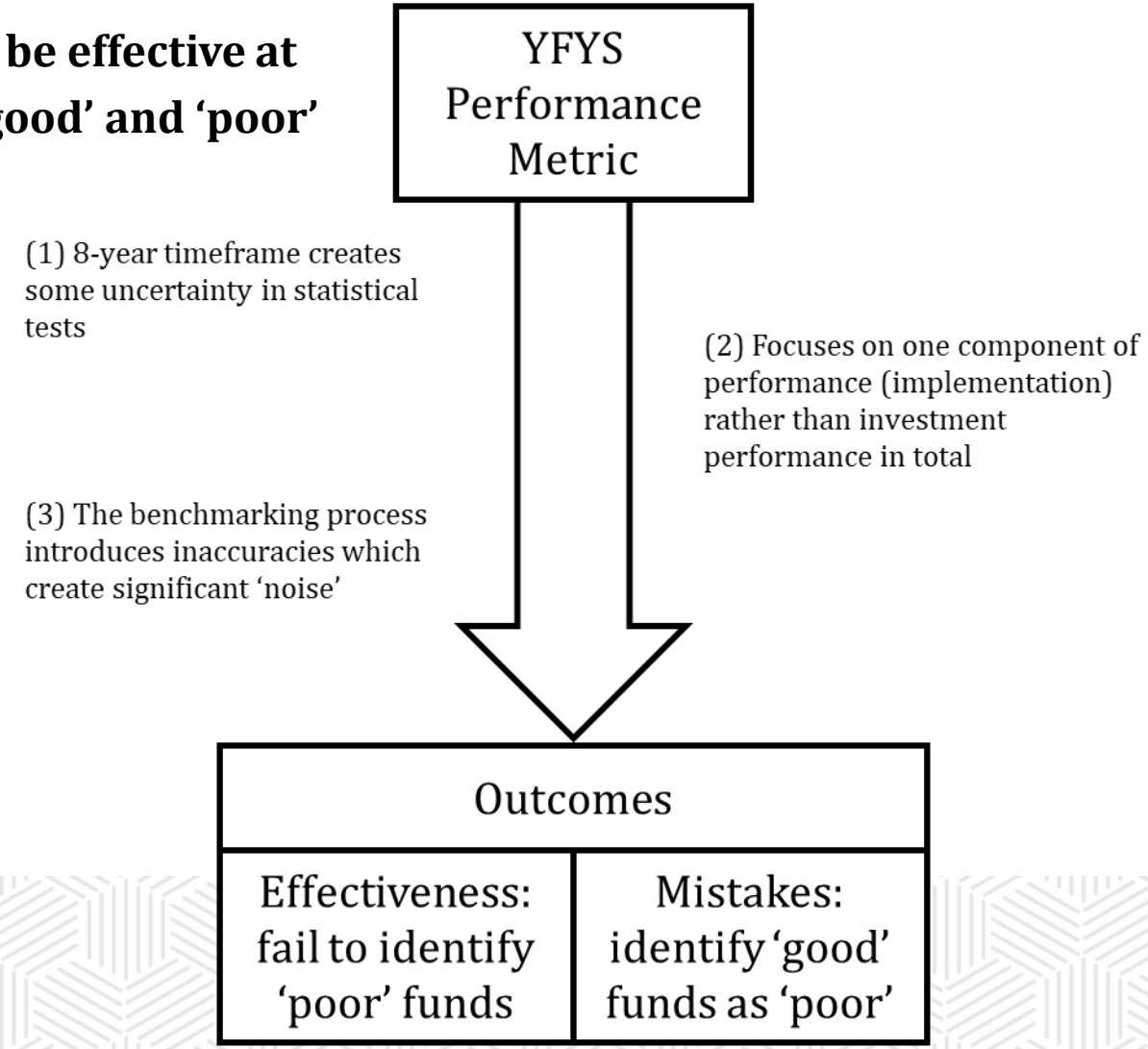
Research undertaken

The Working Group undertook two specific areas of research

1. Will the test be effective at distinguishing between ‘good’ and ‘poor’ funds?
2. Will the test constrain super funds from acting in members’ best interests?

Research undertaken

Research #1: will the test be effective at distinguishing between 'good' and 'poor' funds?



Research undertaken

Research #1: will the test be effective at distinguishing between 'good' and 'poor' funds?

Test	Likelihood
Effectiveness: likelihood of failing to identify a 'poor' fund as 'poor'	31% - 84%
Mistakes: likelihood of identifying a 'good' fund as 'poor'	16%

- The additional benchmarks reduced the likelihood of 'mistakes'
- Further detail of this research available here

Research undertaken

Research # 2: will the test constrain super funds from acting in members' best interests?

We use 1% tracking error as a reasonable estimate of a stable investment strategy

"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 1.3% tracking error

Performance Test

- <2% likely to fail the performance test
- Approx. 25% likely to have to adjust the portfolio over time

"Stable" Super Fund

Portfolio

- 20% total in unlisted property, unlisted infrastructure and high yield
- Active management across and 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

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Research undertaken

Research # 2: will the test constrain super funds from acting in members' best interests?

- Overall, we found that the YFYS Performance Test may constrain funds from implementing the strategy they believe best for their members, but that the degree of constraint is reasonably small and is manageable.
- The additional benchmarks significantly reduced the degree of constraint.
- Further detail of this research available here

Inclusion of administration fees

- Overall, we considered the decision to include administration fees improved the performance test.
- However, on balance, we considered it could have been further improved by focusing on present versus past administration fees.

How to Improve?

- Would a continuation of the APRA model (Heatmap + frontline) deliver greater benefits than the YFYS performance test?
  - Intuitively, yes and it would better inform expected returns
  - But it is clear through proposing a performance test that this is not an option

- There are many ways the design of the YFYS performance test could be improved
  - Accounting for all sources of return and acknowledging risk
  - Our primary recommendation is the simple addition of a second metric:
    - Focuses on risk-adjusted returns
    - Based on realized returns (thereby accounting for all sources of return)
    - Further details are here (go to Appendix 5)

Conclusion

- A bright-lines test applied retrospectively (i.e. a 'past sins' test) provides only limited insights into future performance, and will create 'rough justice' for some funds.
- We believe that APRA's approach (Heatmaps + frontline) would be more effective – we will never know
- Additional benchmarks improved the test and its impacts on portfolio design (by reducing constraints)
- It is difficult to use a single metric to measure performance
    - We recommend an additional risk-adjusted metric as a simple improvement (accounting for all sources of return and acknowledging risk).

Conclusion

Super funds

- Will need to incorporate the YFYS performance test into their investment governance frameworks
  - Even good performing funds will need to reflect as each year creates a new performance series
  - Establishing tolerance for failure and the trade-off between member outcomes and risk of failure are important

Investment managers

- Need to understand the degree of performance test tracking error associated with different strategies
- Strategies which fit in the "Other" category likely to be less desirable
- The test downplays the benefits of diversification and risk management
- Some opportunity for structuring solutions which deliver similar exposure to active management but less performance test tracking error

Welcome your questions and feedback

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