

Moving forward in a Your Future, Your Super world: Super funds

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1. Introduction

This paper explores how super funds will move forward under the Your Future, Your Super (YFYS) reforms.

All funds will be disrupted, whether it be strategically (their business model and net inflow position), their investment model (to deal with a constrained opportunity set), or operationally (how SAA is reported). Quality of governance, namely the calibre of the board and executive, and their interaction, will be a large determinant of how they emerge.

While a variety of investment models which will be adopted, all funds will find themselves theoretically constrained from maximising member outcomes by the presence of the YFYS performance test. Realistically, there are less investment strategies available to manage market scenarios, and portfolio diversification will be harder to achieve. Funds may find themselves being pushed towards more market timing.

There are some positives. Some strategies will be more accessible if funds apply more sophisticated approaches when determining their SAA. And investment managers will evolve their products and services. The most exciting aspect is that the investment governance of super funds will be sharper than it has ever been. Funds may have never had such detailed investment discussions.

There are question marks over how ESG (and other risks) will be managed, the assessment of retirement products, and how the Member Outcomes Assessment test will evolve.

Overall the challenge of maximising member outcomes is now more difficult because of the constraints created by the YFYS performance test. Hopefully the steps taken by funds during the adjustment period will go some way to minimising the negative impact.

2. Background on YFYS

2.1. Overview

Technically, the YFYS reforms consist of three areas where the laws have been amended (from the Superannuation Guarantee (Administration) Act 1992):

1. Addressing Underperformance in Superannuation: this is discussed further in the next section (and is the primary focus of this paper).
2. Single Default Account: this contains the arrangements for stapling, whereby a “your super fund follows you through life” model will stop the creation of multiple super accounts for consumers. Choice of fund remains in place.
3. Improving Accountability and Member Outcomes: a range of measures designed to increase the amount and quality of information. A significant element is the Best Financial Interests Duties, which requires trustees and directors of corporate trustees to only have regard to financial interests of their members.

Stapling will disrupt the business models of many super funds, especially those which do not access first-time employees. It is expected to create a significant degree of B2C competition. The degree of engagement and active choice is difficult to predict.

In aggregate the reforms will accelerate the rate of industry consolidation.

2.2. The YFYS performance test in further detail

This is a brief explanation. For deeper insights we direct you to The Conexus Institute’s YFYS [resource hub](#)¹.

The performance test is a ‘bright-lines’ test applied retrospectively (i.e. a ‘past sins’ test²). As such it places aside significant information which may inform future returns, such as through-time changes made to governance, capability, and investment strategy. The test process is described in Figure 1 and the calculation methodology is detailed in Figure 2.

The design of the performance test has proven highly controversial, despite its positive intent.

Many views have been expressed on the shortcomings of the performance test. We summarise these in Appendix 1. Our most significant concerns relate to the nature of the test (‘bright lines’ applied retrospectively), what the test measures (implementation performance, which is important but not the whole picture), the backwards-looking nature of the test with no consideration of forward-looking insights, the noise created by the benchmarking process, and the fact the test is risk agnostic.

¹ Much of the work available on Conexus Institute’s Your Future, Your Super resource hub was produced in collaboration with consultants from WillisTowersWatson (Nick Callil and Tim Unger), Mercer (Emily Barlow and Clayton Sills), JANA (Matthew Griffith), Frontier (Kim Bowater and David Carruthers), and Deloitte (Andrew Boal). The views in this paper are the author’s only (David Bell).

² The ‘past sins’ test applies to investment performance but not to administration fees.

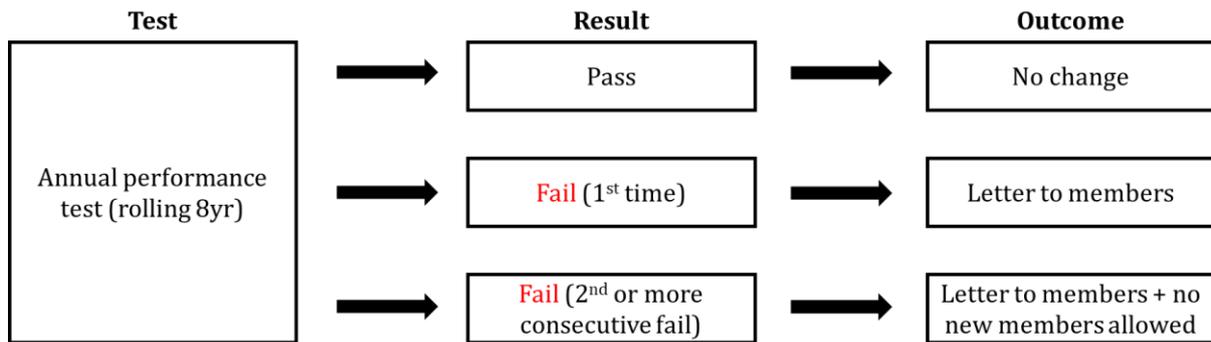
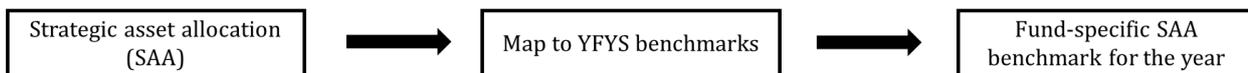


Figure 1: YFYS test process.

Step 1 – Determine tailored performance test benchmark



Step 2 – Calculate annual performance (before admin fees)



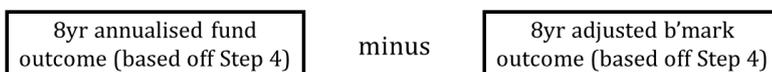
Step 3 – Calculate final year administration fees



Step 4 – Calculate annual total performance



Step 5 – Calculate 8yr annualized performance test result



Additional notes:

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

Figure 2: YFYS calculation methodology. Note that Step 3 is based only on the last year's administration fees. The benchmarks are detailed in Appendix 2.

3. Adjustment period for super funds

Funds will adjust to the YFYS environment. The timeline for adjustment will vary and depend on trustee capability. The key considerations in this adjustment period are detailed in Figure 3. We proceed to explore each item of Figure 3 in further detail.

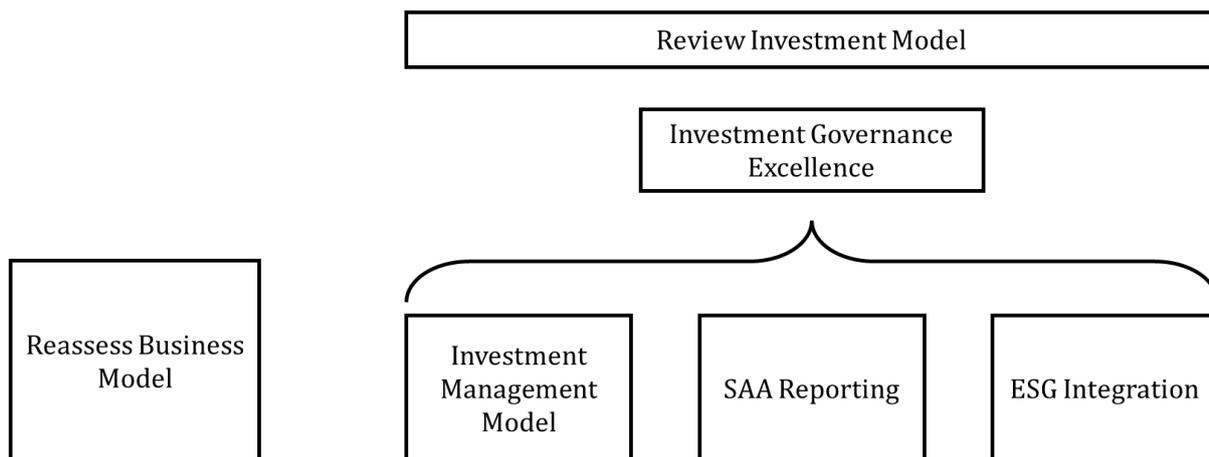


Figure 3: Key considerations for funds during adjustment to the YFYS reforms.

3.1. Reassess business model

Funds will need to consider their present and future scale. In this context size and organic growth profile are both important: size informs scale benefits while net inflow informs future scale and the possible allocation to illiquid assets³.

The YFYS reforms will impact the business model of all super funds, in different ways:

- Stapling impacts all funds, some positively but many negatively. The impact of stapling will take a while to flow through and, whether positive or negative, there is a compounding effect that needs to be modelled.
- With stapling creating a shock to existing business models, some funds will likely develop more substantial business-to-consumer models. This will amplify competition, with associated winners and losers.
- Performance test failure creates the possibility of sizable short-term outflows for those funds, with balances rolling into other funds.
- Some funds may consolidate. Consolidation adds to scale but may not necessarily improve the organic growth profile.

The aggregate impact of the issues listed above is uncertain, so accounting for that uncertainty in the reviewed business plan is important.

3.2. Review investment model

Here we explore the investment-specific areas identified in Figure 3: investment governance excellence, the investment management model, SAA reporting and ESG integration. We then consider the outlook for investment fees along with two present / future challenges impacted by

³ This is a finding from a research project titled “Exploring portfolios with illiquid assets” ([resource hub](#)), undertaken in collaboration with CFA Societies Australia.

the YFYS performance test: APRA’s Member Outcomes Assessment, and the development of retirement solutions.

3.2.1. Investment governance excellence

Best practice super funds will have a common distinguishing feature: excellent investment governance. Underpinning this will be a high-quality investment committee with practical and technical experience. A standout characteristic will be a strong working relationship between CIO and the chair of the investment committee, who is an important communication channel with the broader board⁴. Excellent investment governance will be represented through an agreed tolerance for likelihood of failing the performance test and an agreed framework for trading-off the maximisation of member outcomes against the likelihood of failing the performance test.

Other features of best practice super funds in a YFYS performance test world:

- A strong understanding of where the performance test aligns with managing for best member outcomes and where it conflicts with this objective.
- Implemented modelling of the trade-offs between maximising member outcomes and the risk of failing the performance test. This will be integrated into tools (metrics and dashboards) used to support portfolio decision-making. Figure 4 represents a stylised illustration.
- Processes to ensure that the components of investment management not captured by the YFYS performance test continue to be appropriately assessed and reviewed. This includes the performance of asset allocation decisions (including the overall strategic risk decision) and the performance of risk management activities.

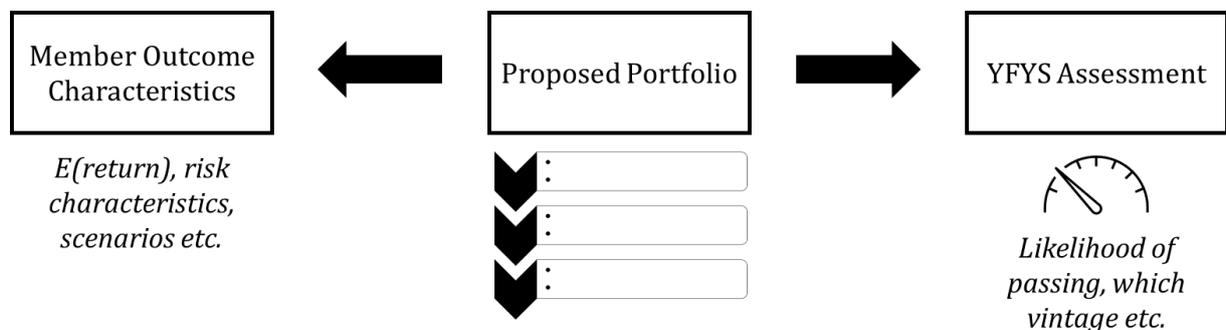


Figure 4: Simple illustration of an integrated portfolio decision-making tool.

⁴ Feedback received on a draft of this paper highlighted that some funds no longer have a separate investment committee: investments are judged to be a crucial strategic board-level issue. This governance model amplifies the need for investment knowledge and experience at the board level.

3.3. Investment management model

We anticipate that three investment models will become common, summarised in Figure 5.

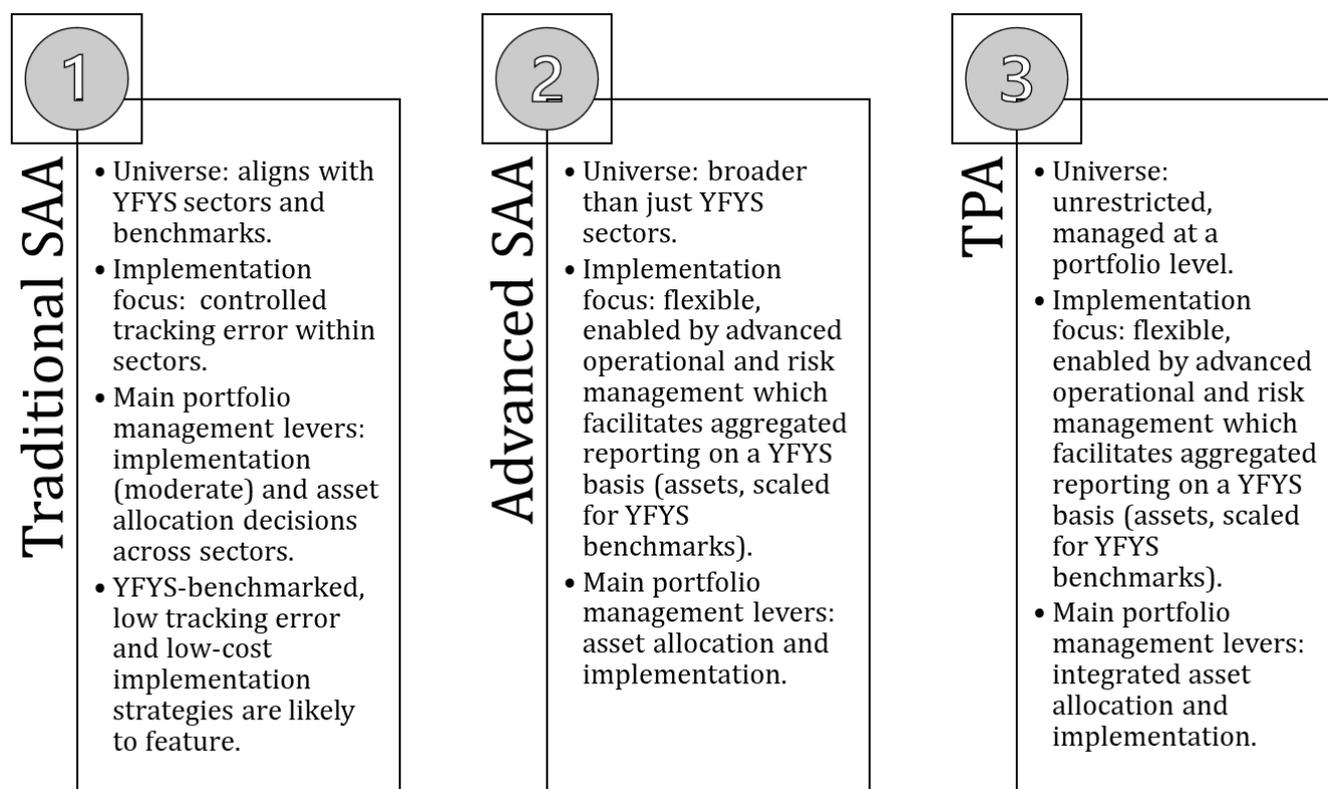


Figure 5: Three anticipated investment management models in a YFYS environment. Definitions: SAA: strategic asset allocation approach: a fund periodically determines a strategic asset allocation which is then implemented. Tactical asset allocation decisions may sit over the top. TPA: the fund constantly reassesses the investment opportunity set and re-allocates the portfolio accordingly across best ideas which reflect bottom-up and top-down considerations⁵.

Under the Traditional SAA model defined in Figure 5, when managed conservatively it is nearly impossible to fail the performance test. However, this may not be the model which provides the best opportunity to maximise member outcomes.

3.4. SAA reporting

⁵ A good reference on TPA is: *“Total Portfolio Approach (TPA) A global asset owner study into current and future asset allocation practices”* by Thinking Ahead Institute – available [here](#).

No standard definition of SAA exists across industry, regulations⁶ or policy. Indeed some investment strategies, such as interpretations of TPA, do not use an SAA at all. In these cases an SAA is generated purely to meet reporting requirements.

In the absence of a formal definition of SAA, we apply the following working definition:

“A fund’s SAA is a best estimate of its expected medium-long term exposure to asset classes, with asset classes and benchmarks defined by the fund.”

There are some important reflections to explore under this working definition. First, there is an aspirational element to an SAA (it may never be achieved). Second, the medium-long term horizon. Third, the focus on assets (including definitions) not products. And finally, the benchmarks are chosen by the fund.

The YFYS performance test appears built on the foundation that a standard interpretation of SAA exists. The observation that an SAA is aspirational in nature ensures a sizable degree of interpretation. The YFYS performance test directly impacts the interpretation of SAA by defining sectors and assigning associated benchmarks.

The YFYS performance test appears to be based on the concept of reference portfolios⁷. The difference is that for the YFYS performance test, sector definitions and benchmarks are defined externally (by policymakers) rather than the funds themselves (the general basis for reference portfolios).

This creates a situation whereby funds will want to evolve their processes to best allow them to maximise member outcomes in the presence of the YFYS performance test. Regulators and policymakers need to monitor the efficacy of the YFYS performance test as these impacts flow through.

When it comes to SAA reporting we identify three specific challenges which we frame in Figure 6, and then proceed to explore in further detail. In the absence of a formal definition of SAA, funds arguably have a large degree of flexibility over how they report their SAA.

⁶ This includes a review of APRA SPG 530 – Investment Governance, APRA SRS 533.0 – Asset Allocation, APRA SRS 550.0 – Asset allocation, and APRA SRS 700.0 – Product Dashboard. We also reviewed ASIC RG 168 – Disclosure: Product Disclosure Statements (and other disclosure obligations), and ASIC CP227 – Disclosure and reporting requirements for superannuation trustees: s29QC.

⁷ A reference portfolio approach is when an asset owner / manager sets themselves an internal market benchmark, typically medium-long term, against which they self-assess performance. NZ Super Fund is a good [example](#).

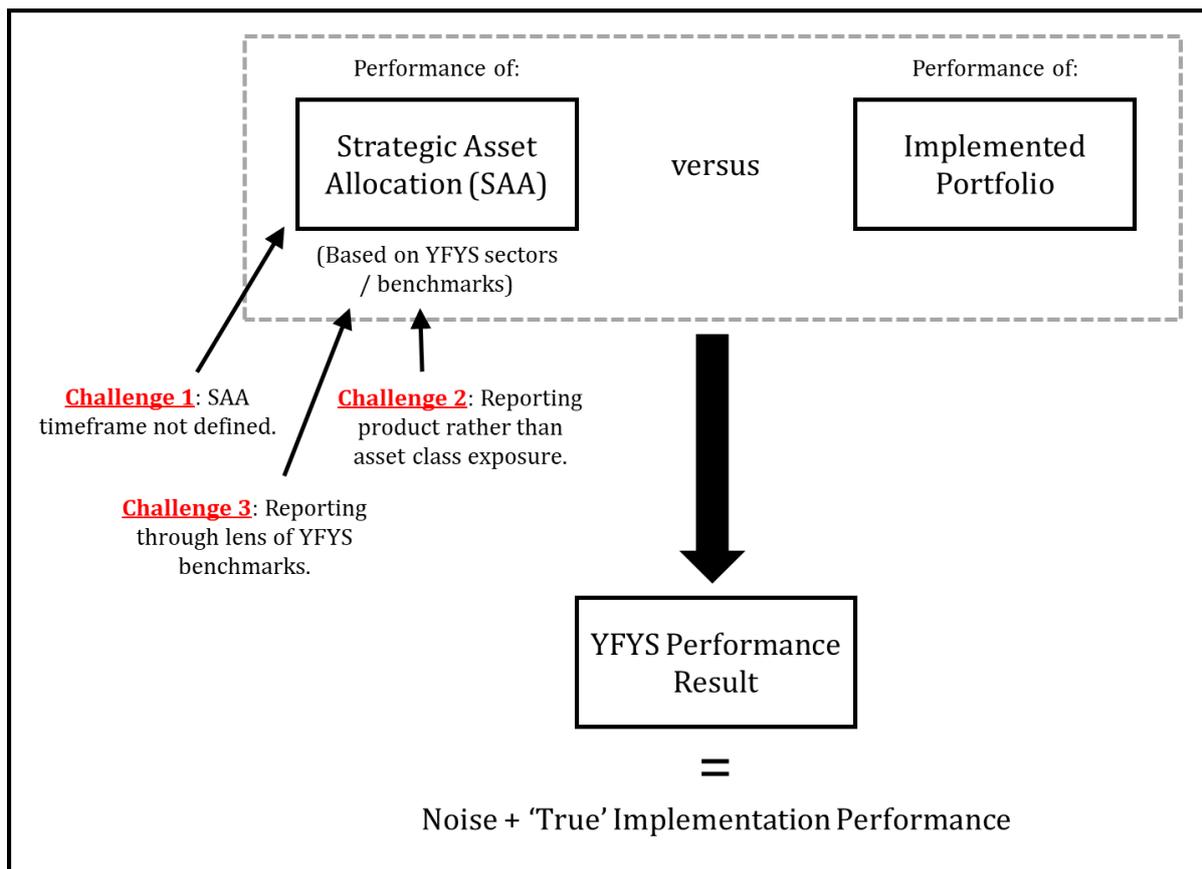


Figure 6: Three primary challenges created by the YFYS performance test structure.

Challenge 1: SAA timeframe not defined

Under the working definition (above) the timeframe for SAA is medium-long term. However, in a performance test environment funds are penalised (in the form of higher tracking error) for reporting an SAA that is far from their current AA. The YFYS-induced incentive is to reduce the timeframe and keep the SAA close to current AA.

Challenge 2: Product not asset exposure

On a look-through basis, all products are combinations of assets, along with a varying degree (zero for passive investments) of active risk. This is also the case for alternative investment strategies like hedge funds⁸. Through this lens, all products perform two roles: (1) they assist in implementing the SAA, and (2) they possibly provide exposure to active returns. This is especially the case for sophisticated investors who have the risk and reporting systems to accommodate look-through insights.

⁸ This has been taught at universities (e.g. [Macquarie University's Hedge Funds](#) elective) and acknowledged in academic research (e.g. seminally [Asness, Krail and Liew \(2001\)](#)).

The YFYS performance test effectively treats alternative investment strategies as an asset and doesn't look through to an asset level. APRA SRS 550.0 requires look-through reporting in some categories but similarly treats alternative investment strategies as assets (i.e. a fund cannot look through to the market exposures within the alternative investment strategy).

Consider the case of a super fund whose SAA is only to traditional asset classes but with an implementation plan that uses some alternative investment strategies (such as hedge funds) which sit in the "Other" category. Let's assume the fund is sophisticated and manages for the look-through exposures to assets that these investments provide. Clearly, in this case the reported SAA exposure does not contain hedge funds. The fund is accountable for implementation performance including management of the look-through process. Of course, actual AA exposure would need to explicitly report alternative investment strategies.

This shouldn't be viewed as controversial (it is not intended to be). Super funds with excellent governance and risk management will be able to demonstrate activities which show how this approach is integrated into the determination and implementation of their investment strategy. Examples include look-through (actual) exposure management, and factor analysis (which is also a requirement under APRA SPG 530). Super funds remain fully accountable for their implementation performance, but it would now be measured more accurately.

Funds which currently, or evolve to, utilise this approach to SAA reporting will experience multiple benefits. The first is that the YFYS performance test will be a more accurate assessment of how well they implement their portfolios. The second is that they can access a larger opportunity set as they can use alternative investments in a manner which won't create unnecessary performance test tracking error.

Look-through exposure to alternative products is explained further in Appendix 3. If funds do not acknowledge look-through exposure reporting in their SAA they may utilise portable alpha strategies. A near identical measurement of YFYS performance would result but there may be higher implementation costs. Portable alpha strategies are explained in Appendix 4.

Challenge 3: Reporting SAA through YFYS benchmarks (via risk scaling)

It is a common risk management technique in financial markets to scale exposures to specified risk units of exposure⁹. The YFYS performance test not only mandates the reported categories, but also the benchmarks to measure those categories.

Funds may run different sector definitions or alternative benchmarks in their respective AA processes. They are then required to transform this into a YFYS-specific SAA. The question is whether this should be undertaken on a crude one-to-one mapping basis or on a risk-adjusted basis, to determine SAA-equivalent 'exposure units' to the YFYS benchmarks. A simple worked example is provided in Appendix 5.

Incorporating risk-scaling techniques improves the accuracy of the implementation performance assessment. It more accurately translates the SAA into the units of measurement prescribed under YFYS, acknowledging that a measurement based on a one-to-one mapping may not be an appropriate representation. If a fund were to run a factor exposure analysis to the YFYS indices,

⁹ A simple example is DV01 exposure in fixed interest markets ([definition](#)).

similar in concept to the factor analysis detailed in APRA SPG 530, the scaled outcome would result.

Funds which do not risk-adjust their exposures to account for YFYS benchmarks will be restricted in their ability to manage their portfolios. They are likely to find themselves constrained in their ability to target specific risk exposures within asset classes.

Possible solutions: Fund SAA reporting

We see two possible pathways in resolving the challenges outlined in this section:

1. A definition of SAA for YFYS reporting purposes is developed. Ideally, this would involve collaboration between regulators and industry, though consensus would likely be difficult to achieve. Table 1 bookends the spectrum of possible outcomes and consequences.

	Simple SAA reporting approach	Reference portfolio SAA approach
Timeframe	See discussion below	
Product look-through	No look-through for hedge funds. Report as per APRA AA standards.	Yes
Risk scaling	No	Yes
Sample description	<i>“A fund’s YFYS SAA is its best estimate of the expected nominal exposure to asset classes and sectors defined by YFYS.”</i>	<i>“A fund’s YFYS SAA is its best estimate of the expected exposure to asset classes defined by YFYS, measured in units of exposure to YFYS benchmarks.”</i>
Performance accountability when used in YFYS performance test	Potentially unreliable unless super funds constrain their activities (sector definitions and benchmarks) to align with YFYS definitions.	More reliable, improving the ability to use active return focused alternatives and a larger spectrum of fixed interest activities. Many activities remain high “tracking error”.
Ability to manage member outcomes	Constrained in the ability to maximise outcomes and manage risk. All activities in Figure 1B (Appendix 1, regardless of colour) generate large tracking error.	Less constrained but substantial constraints remain. Activities in Figure 1B (Appendix 1, coloured black), generate large tracking error.

Table 1: Two major options for defining YFYS SAA reporting.

Note in Table 1 that timeframe is not disclosed. It is likely that funds will shorten the time horizon of their SAA’s (discussed previously – Challenge 1). This is effectively facilitated by APRA allowing funds to report SAA on a quarterly basis. It is increasingly unlikely in the future that YFYS SAA reporting will be based on long-term aspirations.

2. Continue with current state (no SAA definition). Under this scenario there will be varying practices and relative advantages (in the form of portfolio flexibility) gained by some funds based on how they report SAA.

It is likely in both scenarios that super funds will run multiple, at least two, SAA interpretations: one for YFYS reporting (the YFYS SAA), one which drives internal portfolio activity, and potentially a third one (potentially just a re-casting of one of the others) for consumer disclosure.

It should also be acknowledged that a fund's YFYS SAA may be partly designed to minimise performance test 'noise'. This isn't gaming; rather it is the direct outcome of trying to generate the most accurate measurement of implementation performance and reducing the portfolio management constraints created by the YFYS performance test.

3.5. Risk management, scenario analysis, and the push to market timing

The YFYS performance test makes it difficult for funds to manage risks to member outcomes, because many of the techniques create performance test tracking error. This is the point of conflict between managing for member outcomes and managing the risk of performance test failure. Three major risk management activities are constrained:

1. Diversification (beyond the use of the YFYS benchmarks).
2. Manage risk within sectors (e.g. low duration bonds).
3. Dedicated risk management strategies.

This can be illustrated by considering a market scenario (suggested as good practice, but not required, in APRA SPG 530 – Investment Governance). A prominent scenario, persistent inflation, is detailed in Breakout Box 1.

Breakout Box 1 – Persistent inflation

Scenario: higher inflation turns out to be a permanent rather than a transitory event. Bond yields rise, equities are de-rated and there is higher market volatility.

Possible portfolio management activities:

- Diversification: more alternative investment strategies and commodities.
- Manage risk within sectors: select stock sectors expected to outperform in an inflationary scenario, within fixed interest use inflation-linked bonds and low duration bonds.
- Dedicated risk management strategies: put option overlay.
- Asset allocation trades: reduce equities, reduce bonds, increase commodities.

The first three sets of activities in Breakout Box 1 generate performance test tracking error, and trustees will find themselves faced with the conflict of managing the risk of failing the performance test and managing risks to member outcomes. The final activity (placing the commodities piece aside, which does incur significant tracking error) will likely create little impact on performance test outcomes.

Many funds may increase the degree to which they undertake market timing. Indeed they may feel compelled to increase asset allocation activities given the constraints faced by other risk management techniques. Further, given the likely trend in the timeframe of SAA reporting (to be shorter-term, as discussed previously), actively managing asset allocation may incur very little performance test tracking error.

However, we have a range of concerns about market timing. It is a difficult activity, as discussed in Breakout Box 2.

One possible outcome of the YFYS performance test is decreased risk taking via activities which get measured by the implementation-style test (explored above), replaced by increased risk taking in activities not captured by the test. The YFYS performance test would then become less effective at distinguishing between good and bad performers.

Breakout Box 2 – Push to time markets

Market timing is hard. The academic research on the ability to persistently outperform at large scale in the presence of transaction costs is mixed at best. Periods of perceived under and over-valuation can persist for a long time.

There is only moderate evidence of Australian super funds having taken sizable active asset allocation positions in the past. This in turn flags concern around whether the capabilities, culture and governance exist to support this activity.

Just as the YFYS performance test constrains risk management activities, it constrains many other portfolio management activities. These are summarised in Figure 1B in Appendix 1.

3.6. ESG Integration

YFYS creates substantial challenges for ESG integration. There are a variety of integration models. In Figure 7 we assess each model through the YFYS performance test lens.

Impact Investing	Opportunistic Investing	Exclusions	Engagement
<ul style="list-style-type: none"> • Assumed to be in private markets. • Introduces significant tracking error into the portfolio. • Potential for J-curve effect if unlisted. • Likely to be small scale (if at all). 	<ul style="list-style-type: none"> • Assumed to be in liquid markets. • Introduces tracking error, but this can be measured and controlled. • Likely to be small scale. 	<ul style="list-style-type: none"> • Can introduce significant tracking error if applied in a coarse manner. • Quantitative techniques can be applied to limit tracking error impact. • Likely to remain a practice for small components of benchmark. 	<ul style="list-style-type: none"> • Supplement implemented investment strategy with a range of engagement strategies. • Likely to remain commonplace.

Figure 7: Assessed impact of YFYS performance test on different ESG implementation approaches.

Based off Figure 7, we expect the following:

- Engagement by all funds (to different degrees, and potentially difficult to differentiate the degree across funds).
- Exclusions in socially unacceptable areas which are small components of the index. Greater hesitancy to expand exclusion activities. The tracking error introduced by exclusion activities will be quantitatively managed.
- Opportunistic investing, as it is measurable and investment teams will be accountable for outperformance. However, the degree will be constrained by performance test tracking error appetite.
- Little impact investing, when measured as a percentage of portfolio, as it can be a high tracking error activity.

When the YFYS performance test is applied to trustee-directed products (July 2022) we will get some further insight into the impact of the performance test on dedicated ESG / SRI (socially responsible investment) options, as these options place a greater emphasis on exclusions, opportunistic investing, and impact investing.

Note that this analysis, particularly with respect to engagement strategies, does not consider the changes to proxy advice arrangements which have been proposed by Government¹⁰.

3.7. Where to for investment fees?

The YFYS performance test is a net-of-investment fees performance test, so in theory this creates space for active management where the trustee has conviction it will improve net returns. However, we believe there are a range of factors which will likely result in continued fee pressure:

- The ATO Your Super Comparison Tool only considers returns and fees. This creates consumer framing which may feed into product design.
- Government populist language relating to superannuation, such as comparing fees to expenditure on water and electricity.
- APRA communications that fees remain too high.
- Best Financial Interest Duty which, while it may focus on operational expenditure, reinforces a fee reduction mindset.

Overall we see only one direction for fees: lower. However, we think the pace of investment fee reduction may moderate as trustees start to reach the level at which they consider that further fee reductions will impair member outcomes.

3.8. Two important areas facing uncertainty

The construction of post-retirement portfolios and the evolution of Member Outcomes Assessment remain two areas of uncertainty. We briefly explore each.

1. Post-retirement investment portfolios: post-retirement is a far more complex challenge than accumulation, both in terms of design and management, but also assessment. The

¹⁰ The Treasury: "[Greater transparency of proxy advice, Consultation Paper](#)", April 2021.

proposed Retirement Income Covenant¹¹ (RIC) directs trustees to develop a strategy which balances cashflow-for-consumption in retirement against the risks to that cashflow (short and long-term).

Funds may seek to apply investment risk management strategies to manage what is known as sequencing risk in retirement. This could be explicitly (e.g. dedicated risk management overlays) or passively (such as increased diversification) implemented.

The challenge is that if the YFYS performance test is carried across (or even the potential exists that it will be carried across) and applied to post-retirement products, then the application of investment risk management approaches will be constrained.

2. **Member Outcomes Assessment (MOA) Test:** in our opinion MOAs are a regulatory tool which will continue to evolve. This will create the positive outcome of more detailed strategic considerations being undertaken by funds. Presently, much of the focus is on relatively simple measures such as investment performance, peer group relative performance, fees, and projected retirement balances.

At some point we expect MOA analysis to evolve and formally reflect the retirement outcomes of members (given retirement outcomes is the broad purpose of superannuation). Better practice would be for funds to consider the range of possible outcomes, not just expected retirement outcomes. This will lead us to face the constant challenge created by the YFYS performance test: the importance of managing retirement outcome risk in an environment where the binding test is risk-agnostic at best, and at worst penalises funds for managing risk.

3.9. Summary: the post-YFYS super fund

We summarise the key challenges facing super funds in Figure 8, detailing the framework outlined in Figure 3.

¹¹ The Treasury: [“Treasury Laws Amendment \(Measures for a later sitting\) Bill 2021: Retirement income covenant”](#), September 2021.

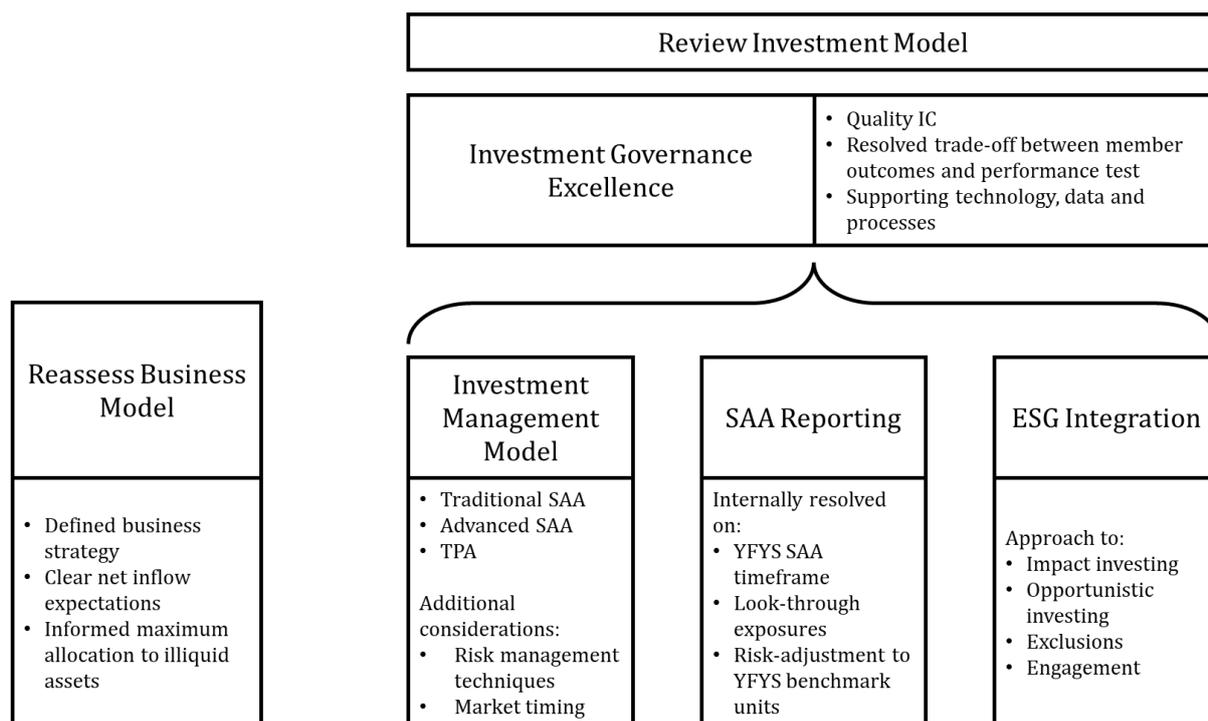


Figure 8: Summarised forecast of adaptation by super funds to YFYS and predicted impact on portfolios.

As detailed throughout this paper the YFYS performance test clearly constrains the ability of funds to maximise member outcomes. The degree of constraint will depend on how funds account for the performance test. If they utilise their sophisticated risk management techniques to report YFYS SAA's which better reflect their performance accountability, then this will reduce the degree of constraint, but only to a degree.

We anticipate the following outcomes:

- Limited exposure to a range of traditional investment opportunities such as emerging market equities, small caps, inflation indexed bonds and EMD.
- Some use of alternative investment strategies such as hedge funds (assuming some funds make adjustments to their YFYS SAA reporting).
- Limited reported exposure to 'Other' bucket.
- Ultimately, less diversified portfolios. Funds will be reliant on existing correlation structures (e.g. negative correlation between equities and bonds) not breaking down.
- More market timing (active asset allocation), but whether this adds value remains to be seen.
- Extremely limited use of explicit risk management strategies.
- Engagement and "controlled exclusions" will be dominant ESG strategies.
- Ongoing focus on fees.
- Potential for increased strategic growth exposure to manage business / peer risk in a B2C environment.

3.10. Will the YFYS performance test become redundant?

Could the YFYS performance test eventually become redundant? The answer to this question is dependent on your interpretation of "redundant".

If redundant is interpreted to mean no performance test failures across the industry, then there is a reasonable possibility that in 5-years' time the test will become redundant. Funds will focus on not failing the test, resulting in adjustments to investment strategy, implementation, and SAA reporting.

However, the definition of redundant should also consider whether the test will be an ever-present consideration of super funds. Under this interpretation the performance test will not disappear. It will be a central consideration in the way that funds design and implement their portfolios.

Whether this is a positive depends on your view of the design and impacts of the performance test. One view is that the test will ensure an ongoing focus on implementation performance (albeit via a test with many known shortcomings). The alternative view is that the test will constrain funds from maximising member outcomes while failing to assess the broader outcomes being delivered to members. We share the latter view.

4. Closing comments

The YFYS reform package will significantly impact the superannuation landscape. All funds will be disrupted, whether it be strategically (their business model and net inflow position), their investment model (to deal with a constrained opportunity set), or operationally (how SAA is reported). Quality of governance, namely the calibre of the board and executive, and their interaction, will be a large determinant of how they emerge.

While a variety of investment models which will be adopted, all funds will find themselves theoretically constrained from maximising member outcomes in the presence of the YFYS performance test. Realistically, there are less investment strategies available to manage market scenarios, and portfolio diversification will be harder to achieve. Funds may find themselves being pushed towards more market timing.

There are some positives. Some strategies will be more accessible if funds apply more sophisticated approaches when determining their SAA. And investment managers will evolve their products and services. The most exciting aspect is that the investment governance of super funds will be sharper than it has ever been. Funds may have never had such detailed investment discussions.

There are question marks over how ESG (and other risks) will be managed, the assessment of retirement products, and how the Member Outcomes Assessment test will evolve.

Overall the challenge of maximising member outcomes is now more difficult because of the constraints created by the YFYS performance test. Hopefully the steps taken by funds during the adjustment period will go some way to minimising the negative impact.

Appendix 1 - Shortcomings of the YFYS performance test

Throughout the passing of the YFYS reforms into legislation many views were expressed on shortcomings of the YFYS performance test.

High level concerns

- Consumers are the action point for decision-making, yet their financial literacy is low.
- 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 present capabilities such as governance structure, investment team, investment strategy and implementation approach. All these provide an insight into future performance.
- The performance test is a risk-agnostic metric which only focuses on one component of investment performance (the red box in Figure 1A below), ignoring other important elements of performance.

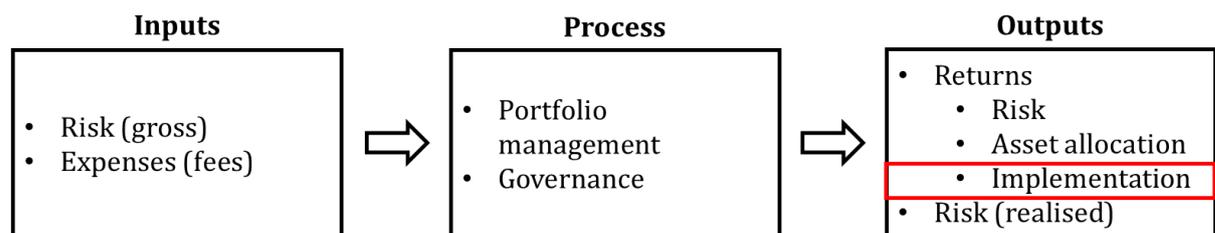


Figure 1A: Investment management process. Red box reflects the component assessed by the YFYS performance test.

- Benchmarking process creates distorted concept of portfolio risk.
 - The test only uses a limited number of benchmarks to assess a large range of investments.
 - This creates a distorted version of performance test tracking error. Figure 1B details some activities which generate tracking error.

<p>Investing in the following public market sectors:</p> <ul style="list-style-type: none"> - Australian small cap equities - International small cap equities - Low volatility equity strategies - Emerging market equities - Geographic-focused equity strategies - Sector-focused equity strategies - Corporate bonds - High yield bonds - Emerging market debt - Inflation-linked bonds - Low or high duration bonds 	<p>Investing in the following unlisted and alternative sectors:</p> <ul style="list-style-type: none"> - Private equity - Unlisted property (non-core) - Unlisted infrastructure (concentrated index) - Impact investments - Direct loans - Hedge funds - Alternative risk premia - Commodities 	<p>The following activities:</p> <ul style="list-style-type: none"> - 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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Figure 1B: Activities (non-exhaustive list) which generate tracking error under the YFYS performance test. Blue categories may create less significant tracking error if look-through and risk scaling SAA reporting techniques are applied (detailed in (3.4)).

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.
- 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 scenarios (e.g. low bond yields, stretched equity valuations, possible high inflation).

Concerns relating to impact on consumers

- Confusion as results may be contested and test results fail to match up with total performance outcomes.
- Populist language like “dud funds” (albeit engaging).
- Relies on engagement as the switching mechanism.
- Penalises the heavily disengaged who may remain in a fund which becomes further impaired.

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.

Appendix 2 - YFYS performance test benchmarks

Asset Class	Benchmark
Australian Equity	S&P/ASX 300 Total Return Index
International Equity (hedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (100% hedged to AUD)
International Equity (unhedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (unhedged in AUD)
Australian Listed Property	S&P/ASX 300 A-REIT Total Return Index
International Listed Property	FTSE EPRA Nareit Developed ex Aus Rental 100% Hedged to AUD Net Tax (Super) Index
Australian Listed Infrastructure	FTSE Developed Core Infrastructure 100% Hedged to AUD Net Tax (Super) Index
International Listed Infrastructure	FTSE Developed Core Infrastructure 100% Hedged to AUD Net Tax (Super) Index
Australian Unlisted Property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index – NAV-Weighted Post-Fee Total Return (All Funds)
International Unlisted Property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index – NAV-Weighted Post-Fee Total Return (All Funds)
Australian Unlisted Infrastructure	MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) – NAV-Weighted Post-Fee Total Return (All Funds)
International Unlisted Infrastructure	MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) – Nav-Weighted Post-Fee Total Return (All Funds)
Australian Fixed Interest	Bloomberg Ausbond Composite 0+ Yr Index
International Fixed Interest	Bloomberg Barclays Global Aggregate Index (hedged to AUD)
Australian Cash	Bloomberg Ausbond Bank Bill Index
International Cash	Bloomberg Ausbond Bank Bill Index
Other/Commodities	25% International Equity (hedged), 25% International Equity (unhedged), 50% International Fixed Interest

Appendix 3 - Look-through exposure in alternative investment strategies

We use the case study of a market neutral equity fund to illustrate the concept of look-through exposure. This is detailed in Figure 3A. Note that it is an accounting principle that the net exposures to the different asset classes must sum to 100% (you can neither create nor destroy market exposure).

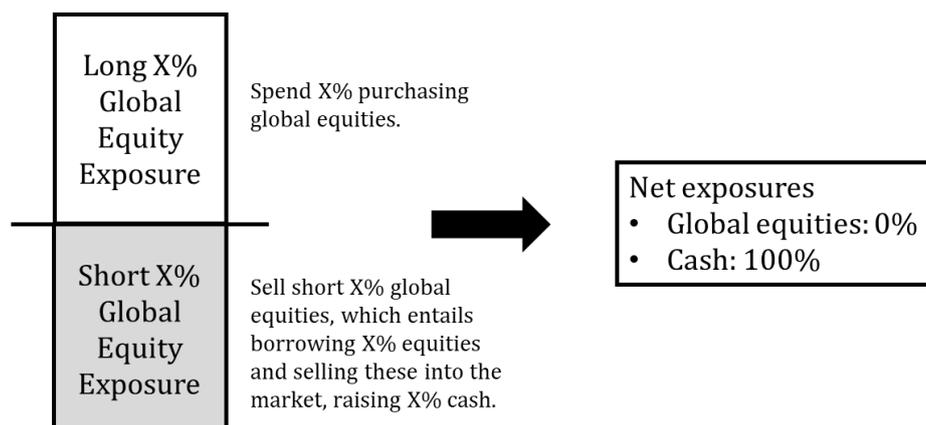


Figure 3A: The mechanics of how a market neutral fund results in a 100% net market exposure to cash. Note that this result is agnostic to leverage. Consider the case where $X = 200$: The fund spends 100% of its own cash and borrows another 100% of cash to purchase equities. It then borrows 200% of equities and sells these into the market, raising 200%. The net cash position is 100% ($-100\% + 200\%$).

In Table 3A we explain the market exposures for a range of alternative investment strategies.

Alternative Investment Strategy	Net Market Exposure
Long short equity	Equities: the investor needs to determine an expected bias of the fund (the most common bias is to be long). Cash: complementary exposure so that the sum of net exposures is 100% (the most common bias is to be long).
Market neutral equity	Cash: 100%. As explained in Figure 3A.
Merger arbitrage	Cash: 100%. These strategies commonly take offsetting equity positions in stock-for-stock acquisitions or take long positions in the target stock in cash acquisitions.
Fixed income arbitrage / relative value	Cash: 100%. Similar to the market neutral equity example except implemented through fixed income exposures.
Long short credit	Credit: the investor needs to determine an expected bias of the fund (the most common bias is to be long). Cash: complementary exposure so that the sum of net exposures is 100% (the most common bias is to be long).

Macro strategies	Cash: 100%. This is the effective benchmark for the strategy. The strategy will only take a position (long or short) if it believes it will help the portfolio outperform the opportunity cost of cash.
CTA's	Cash: 100%. This is the effective benchmark for the strategy. The strategy will only take a position (long or short) if it believes it will help the portfolio outperform the opportunity cost of cash.
Multi-strategy hedge funds	A collection of market exposures based on the investor's forecast mix of underlying strategies and associated benchmark assessments.
Alternative risk premia	Cash: 100%. Similar to market neutral equity and fixed income relative value.

Table 3A: Look-through net market exposures for different alternative investment strategies.

Note that there is a degree of self-assessment required. Funds are incentivised to make an accurate assessment: they bear performance test tracking error for any mis-identification of look-through exposures.

Appendix 4 - Portable alpha strategies

We continue with the market neutral equity case study detailed in Appendix 3. A portable alpha strategy 'ports' alpha from one strategy into a product along with derivatives to achieve a desired market exposure profile. This is detailed in Figure 4A.

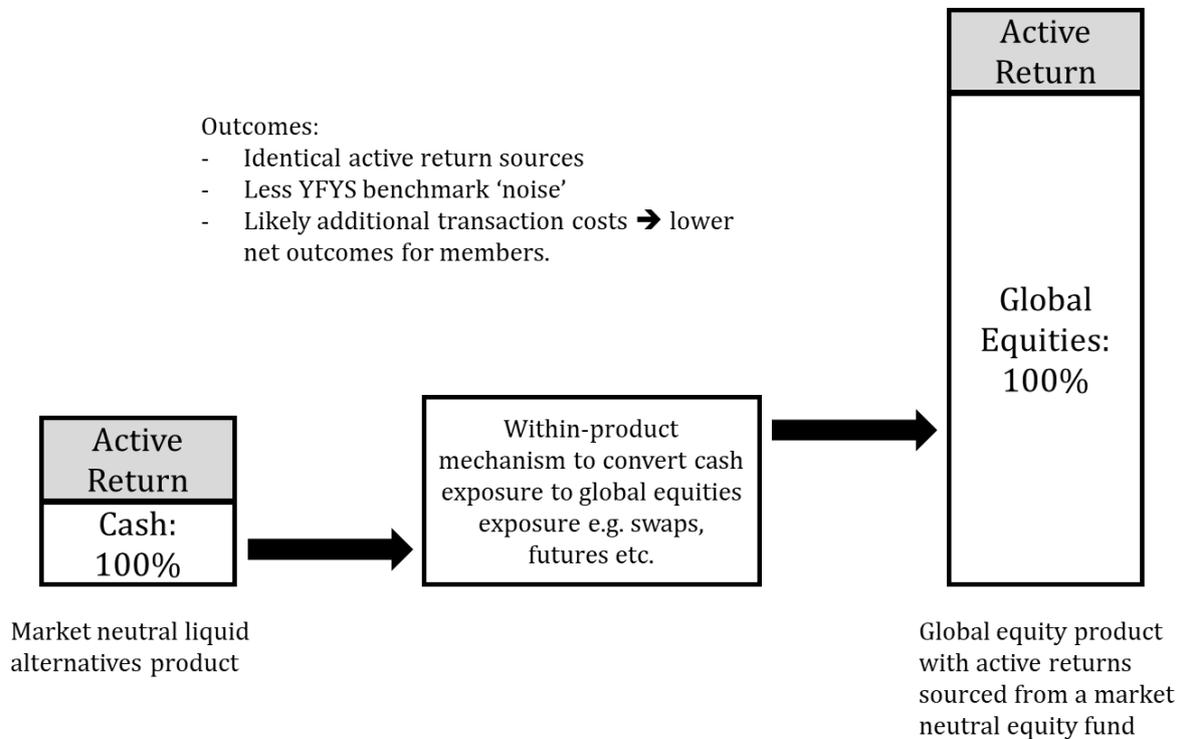


Figure 4A: The mechanics of a portable alpha strategy. The active return profile (source and degree of risk) of the global equities product is the same as the market neutral equity fund. It is only the underlying market exposure which has changed.

Appendix 5 - Risk-adjusting exposures

Figure 5A provides a worked example to illustrate how a fund may risk-adjust their SAA to be in the sectors and units defined in the YFYS performance test.

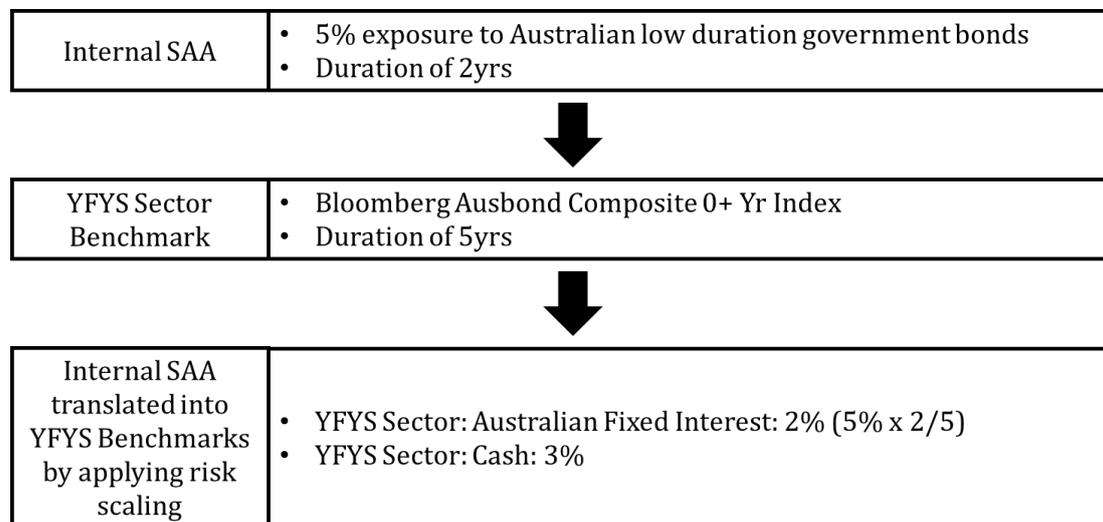


Figure 5A: An example illustrating the process of risk-adjusting an SAA into YFYS sector definitions and benchmark units.

In Figure 5A the duration of the Internal SAA and the Internal SAA translated into YFYS Benchmarks is now identical (0.1yrs¹²). If risk-scaling was not undertaken, then the duration of the SAA would be overstated (0.25yrs¹³). If risk scaling were not undertaken the fund would incur benchmark noise linked to 0.15yrs of duration.

¹² Internal SAA duration: 5% x 2yrs = 0.1yrs. Internal SAA translated into YFYS Benchmarks: 2% x 5yrs = 0.1yrs.

¹³ Internal SAA (YFYS Benchmarks, no risk scaling) duration: 5% x 5yrs = 0.25yrs.