Moving forward in a Your Future, Your Super world: Investment managers

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1. Introduction

This paper explores the future of the investment management industry under the Your Future, Your Super (YFYS) reforms. It extends on a detailed analysis undertaken on super funds (available here, henceforth the "super fund paper").

The aggregate impact of the YFYS reforms on the investment management industry will be negative, as super funds focus on managing YFYS performance test tracking error and look to further reduce fees. However, there will be winners and losers amongst investment managers.

In such an environment it is prudent for investment managers to review their own business models.

Beyond that we think there are three important considerations.

First, we think the case for active management needs to be re-visited by the investment management community. It needs to focus strongly on outperformance relative to YFYS benchmarks, acknowledging that benefits such as risk reduction and diversification are downplayed in a YFYS environment.

Second, we believe that the investment managers who best understand their clients will be better placed to succeed. This is hardly ground-breaking! But YFYS creates a new, highly prioritised lens through which funds will view investments. Better prepared investment managers will have a good understanding of the impact of the test on the products they offer. Indeed, those investment managers with a better understanding may be able to tailor their products to be a better fit.

Finally, we see a range of opportunities, be it product (specific offerings and structured solutions) or services (such as strategic partnerships and knowledge transfer).

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' test[2]). 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.

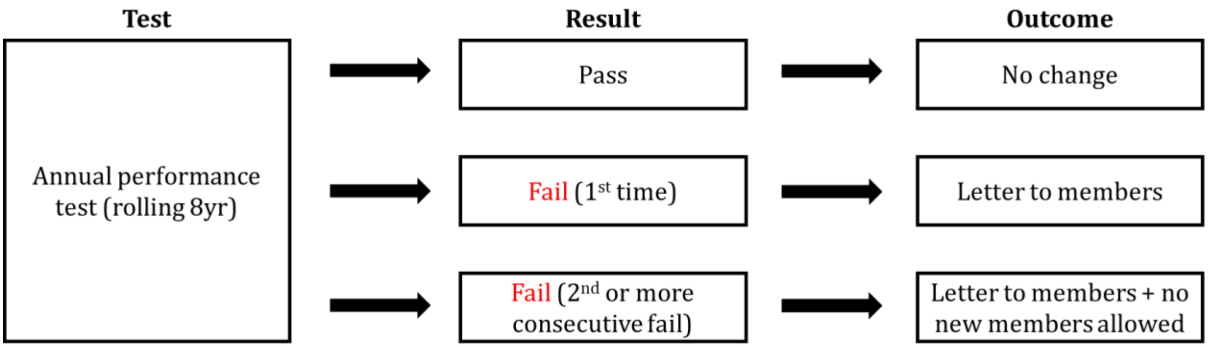

Figure 1: YFYS test process.

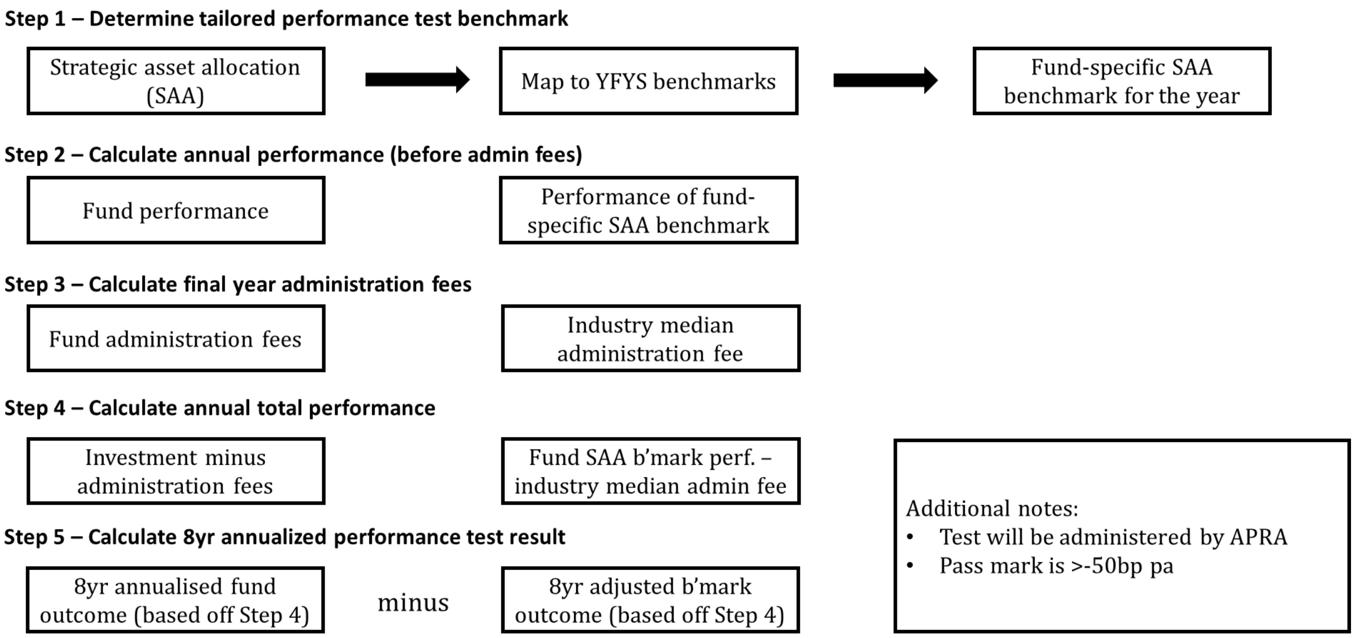

Figure 2: YFYS calculation methodology. Note that Step 3 is based only on the last year's administration fees. The benchmarks are detailed in Appendix 2.

3. How will YFYS impact super funds?

All super 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 they report their SAA (strategic asset allocation)). 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 will be adopted, all funds will find themselves theoretically constrained from maximising member outcomes by the presence of the YFYS performance test. The challenge confronting boards, investment committees and investment teams will be supported by integrated decision-making tools, like the stylised illustration in Figure 3. 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.

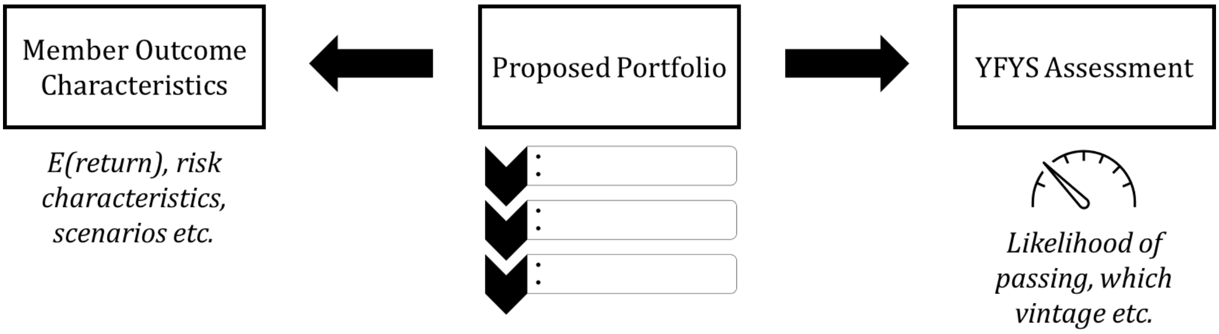

Figure 3: Simple illustration of an integrated portfolio decision-making tool.

There are some positives. Some strategies (including alternative investment strategies like hedge funds and alternative risk premia products) will be more accessible if funds apply more sophisticated approaches when determining their SAA (explored in detail in the super fund paper). 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. Figure 4 captures the majority of challenges facing super funds.

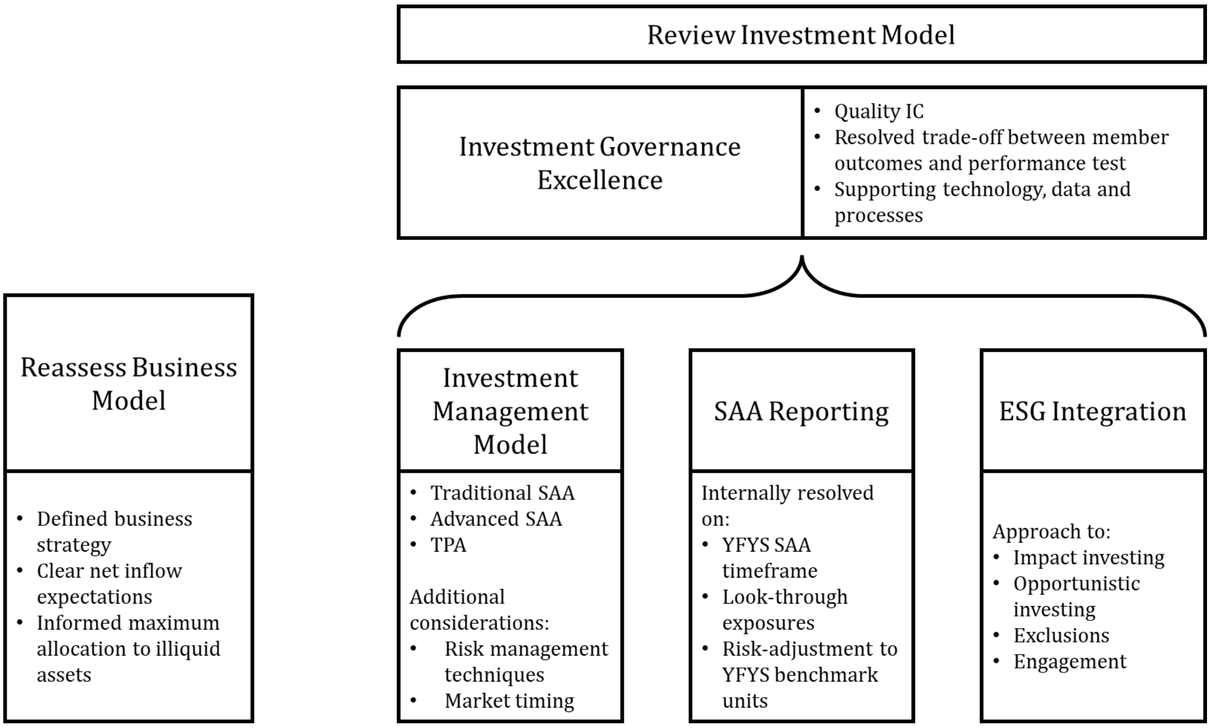

Figure 4: Summarised forecast of adaptation by super funds to YFYS and predicted impact on portfolios.

4. Investment managers – challenges, but opportunities

YFYS adds to existing challenges faced by investment managers (such as fee pressure and internalisation). However we believe opportunities for excellent investment managers will continue to persist. There are a range of important considerations for investment managers, which we summarise in Figure 5. We then explore each of these issues further.

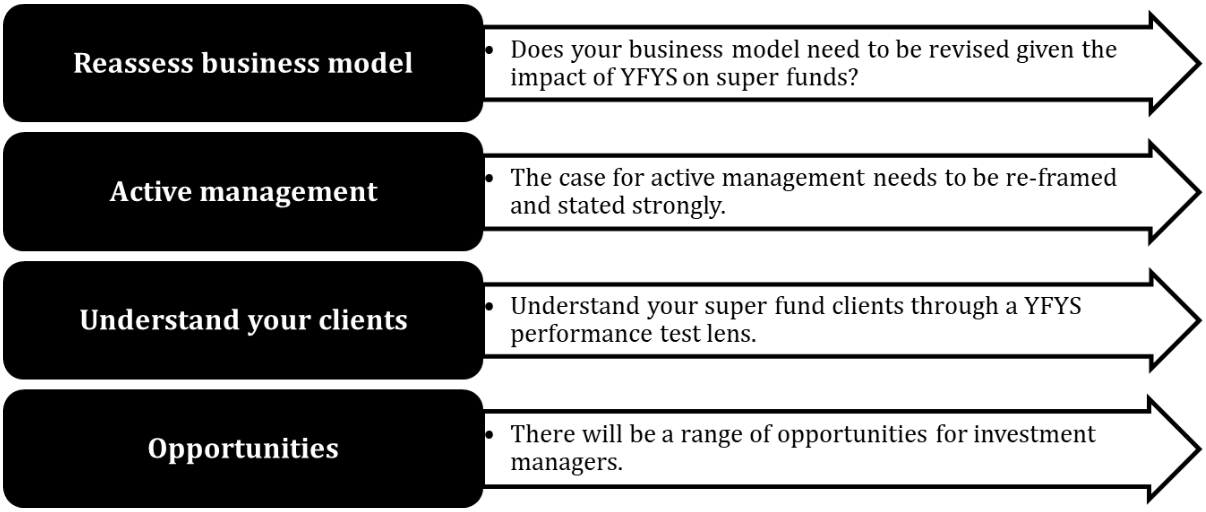

Figure 5: Summary of important issues facing investment managers in a YFYS world.

4.1. Reassessing the investment management business model in Australia

YFYS changes the landscape for investment managers in Australia. The impact will vary depending on the capability and service offering, and the target market (Australian super funds may not be the only target market).

The YFYS performance test will create trends, in some cases adding momentum to existing trends. The two most important are:

1. Ongoing consolidation in the superannuation sector and continued focus on fee reduction. Super funds can provide investment managers scale and moderate margins. Is this an attractive basis for operating in Australia?

2. Reduced allocations to sectors which don't match up well to the YFYS performance test benchmarks (see Appendix 2). The YFYS performance test will create a tracking error budget which will constrain the demand for many investment strategies less attractive (summarised in Table 1B).

For some investment managers, for example those offering higher margin, low-capacity niche strategies, Australia may not be an attractive marketplace.

4.2. The case for active management needs to be re-stated

Passing the YFYS performance test will rank near the very top of priorities of all super fund trustees. The test is a crude measure of implementation performance, and it is risk-agnostic, meaning it places no value on risk reduction or diversification.

Accordingly, trustees are being directed to view active management through a narrow lens:

"Will active management generate higher net returns against the YFYS benchmarks?"

The case for active management needs to be re-visited by the investment management community. It needs to focus more strongly on this narrow lens. This could be established at an industry level (through industry bodies) and/or by individual investment managers.

The investment management industry can argue the outperformance opportunities available through market structure, inefficiencies, specialisation, data etc. Individual managers can argue how they do it better. Other arguments for active management, such as risk reduction and diversification, are likely to be down-weighted by trustees.

Historically there has been more scrutiny on outperformance in public markets relative to private markets. YFYS increases the scrutiny on private market outperformance.

4.3. Understanding clients through a YFYS performance test lens

Investment managers who understand the challenges faced by their clients in a YFYS world will be better placed to offer products and solutions which can help clients achieve their goals. Three areas are important:

1. Understand the YFYS tracking error of offered products. This exercise should be undertaken for each offered product. It provides a proxy for the gross risk (i.e. pre-diversification benefits) a product brings to the portfolio, and insight into the degree of conviction a trustee will need to have in the offering. Table 1 provides a simple example of three Australian equity products.

	Active Risk to Stated Benchmark	YFYS Benchmark Risk	Total Gross Risk (YFYS Benchmark)	Total Net Risk (YFYS Benchmark)
Active Large Caps	3%	0%	3%	3%
Active Low Vol Shares	3%	6%	9%	6.7%
Active Small Caps	3%	6%	9%	6.7%

Table 1: Simplified example of the risk of three Australian equity products relative to YFYS benchmarks. Product-specific benchmarks for Low Vol Shares is a low-vol equity index and for Small Caps is a small cap index. To estimate net risk we assume zero correlation between active risk and YFYS benchmark risk.

In Table 1 we can see that gross risk of the two non-benchmark products is far higher than for the product which aligns with a YFYS benchmark. We also see that net risk will be lower than gross risk (yet gross risk is the rule-of-thumb which may be used by many funds). Further, in this example the YFYS benchmark risk dominates the total net risk.

Having a good understanding of these issues may help investment managers to understand how funds view different product offerings.

2. The performance test is risk agnostic. This means that benefits of low volatility and diversification are not valued in a YFYS testing framework.

3. Data provision, look-through exposure, and benchmark / mandate consultation. Funds may seek greater portfolio transparency so they can better tailor their reported SAA (this is discussed in detail in the super fund paper). To do this, funds may require greater data and transparency from their investment managers.

   Some funds may wish to consult further on appropriate benchmarks for specific products. Consider a product currently classified as a macro fund (hence sitting in the unattractively benchmarked 'Other' bucket). A small change in mandate could result in the product being re-configured as a high-conviction fixed interest fund, and more appropriately benchmarked.

4.4. Opportunities

New product and service opportunities which will likely arise. The genesis of these innovations will be both investment managers and super funds. We consider a few opportunities:

1. Product opportunities: we believe many product opportunities will emerge which account for the YFYS performance test in clever ways. Here are a few examples:

   i. Fixed interest and credit strategies designed to capture more carry (relative to the composite bond benchmark) in a drawdown-controlled manner.
   ii. Private equity solutions which help a fund implement or expand their private equity program with a minimal J-curve effect.
   iii. Fixed interest strategies which provide a tailored trade-off between inflation protection and performance test tracking error.

2. Structured solutions: we believe structured solutions, such as portable alpha, are likely. This will allow some funds to transfer strategies out of the 'Other' bucket and into sectors with less benchmark noise. However, we also note that structuring brings complexity and sometimes additional costs. This is explored in more detail in the super fund paper.

3. Strategic partnerships and knowledge transfer: though strategic partnerships have experienced mixed fortunes in Australia, we think there is the potential for mutually beneficial opportunities.

   One interesting opportunity is asset allocation: in a YFYS world we think asset allocation will be one of the prominent leavers for driving performance and protecting portfolios. In our view Australia has a modest pedigree in asset allocation and there appears to be greater experience offshore.

   Another related opportunity lies in addressing the market scenarios model and manage for. Consider the higher inflation scenario (detailed in the super fund paper): many of the traditional approaches to manage this scenario incur sizable performance test tracking error. There may be an opportunity for funds and investment managers to collaborate on solutions.

4. Impactful ESG strategies: in our view (see super fund paper) ESG activities will largely be constrained to engagement in the presence of YFYS. Funds will be looking to incorporate other ESG activities like exclusions, impact investing and opportunistic investing, but will need to do so in a way that minimises the tracking error impact of thesis activities.

5. Closing comments

The aggregate impact of the YFYS reforms on the investment management industry will be negative, as super funds focus on managing YFYS performance test tracking error and look to further reduce fees. However, there will be winners and losers amongst investment managers.

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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.

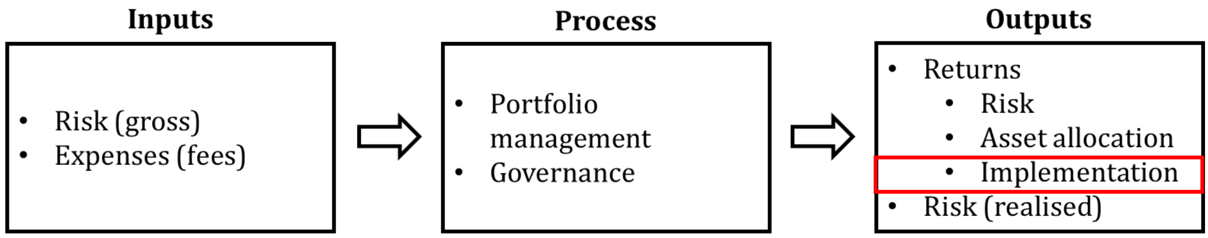

Figure 1A: Investment management process. Red box reflects the component assessed by the YFYS performance test.

- 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.

Investing in the following public market sectors:	Investing in the following unlisted and alternative sectors:	The following activities:
- 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	- Private equity - Unlisted property (non-core) - Unlisted infrastructure (concentrated index) - Impact investments - Direct loans - Hedge funds - Alternative risk premia - Commodities	- 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

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