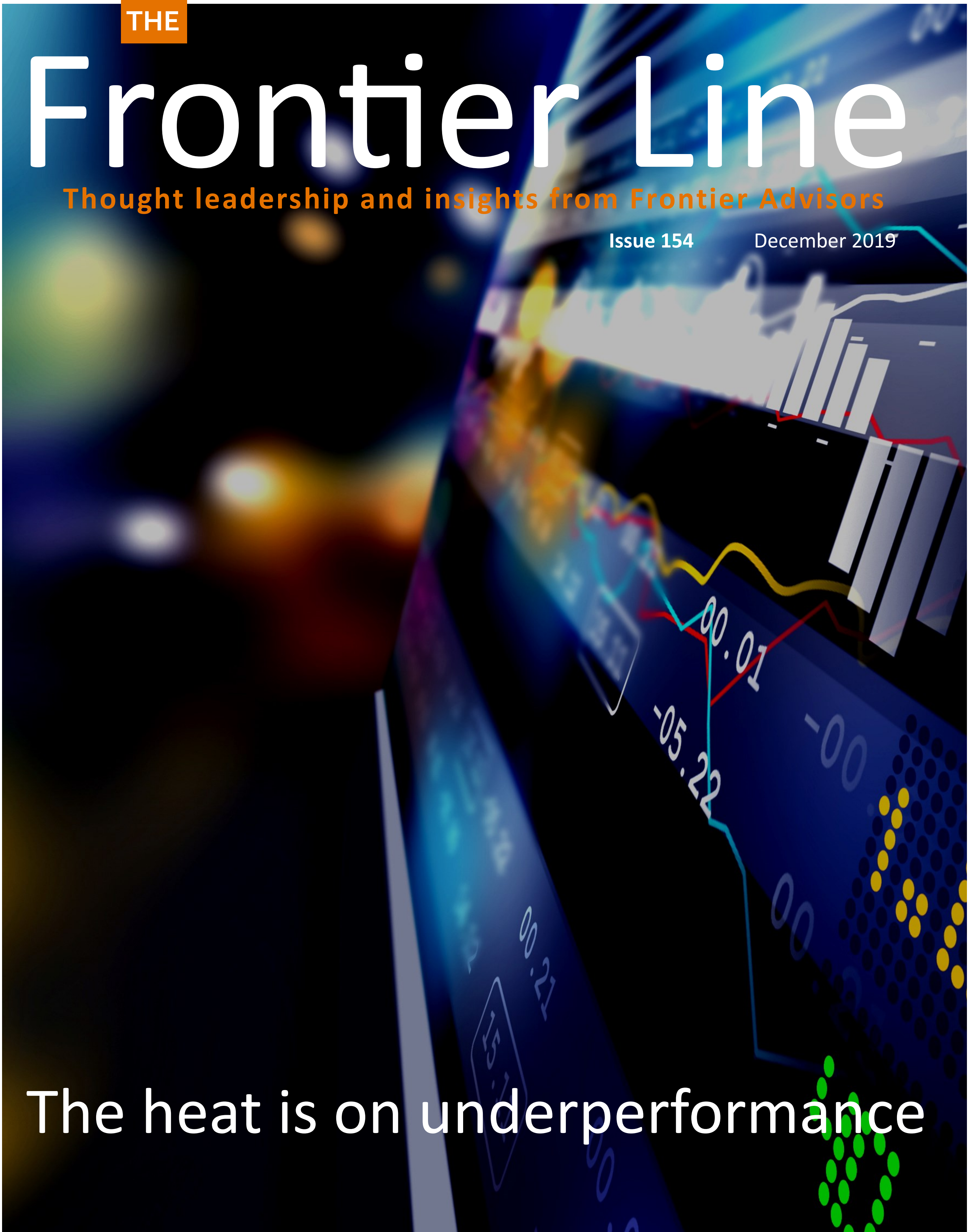

THE Frontier Line

Thought leadership and insights from Frontier Advisors

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The heat is on underperformance

FRONTIER ADVISORS

The heat is on underperformance

The stated objective of recent superannuation industry and regulator focus has been on improving member outcomes and the overall sustainability of the industry, with the spotlight increasingly on underperforming funds. APRA's recently released *Information Paper: Heatmap – MySuper products* details how it intends to identify and highlight underperforming funds.

In this note, we examine the elements of the approach outlined by APRA and provide some preliminary analysis on the key aspects. In undertaking this analysis, we have used the data APRA makes publicly available and have made several assumptions required to achieve APRA's outlined methodology. We think our aggregate findings provide a good indication of how the MySuper cohort will look under these new metrics.

We also provide our views on the Heatmap itself including specific investment metrics selected by APRA, its implications for the industry, as well as areas that we think could be enhanced. While APRA notes the Information Paper is not a consultation paper, it has indicated that it welcomes feedback from all stakeholders and will evolve the Heatmap over time. The heatmap is now locked down and will be published and publicly available in early December 2019.

Introduction

APRA has been clear that one of its key priorities will be improving member outcomes in superannuation as well as maintaining its focus on cleaning up unsustainable and underperforming superannuation funds.

APRA has identified that one of its key priorities will be improving member outcomes in superannuation as well as maintaining its focus on cleaning up unsustainable and underperforming superannuation funds.

For APRA to achieve this objective, it is focusing its attention on improving the standards of practice across the industry – requiring Trustees to assess the outcomes they are delivering for members and fix any identified weaknesses. To support this, the government has released the member outcomes reforms package.

The new MySuper Heatmap has been announced as part this package. The Heatmap will use a graduating colour scheme to indicate how a fund's MySuper Option fares across investment performance, fees and costs and sustainability. Over time, this will be expanded to cover Choice Options and an assessment of insurance-related member outcomes.

While APRA recognises that the Heatmap does not provide information on all the relevant factors for assessing the performance or appropriateness of a particular MySuper product, it will be used as a tool to identify and highlight underperforming and unsustainable funds. Key aspects of the Heatmap approach are outlined in Figure 1.

APRA's attention is on the potentially significant gap between the net returns achieved by members of the top performing MySuper products versus those at the bottom. It is also focused on the fees that are paid by members in different MySuper products. Effectively, APRA is seeking to "weed out the industry's underperforming tail".

We note that APRA's previous language was about "persistent" underperformers—that language is not mentioned in their information paper.

A key (and uncharted) part of APRA's approach is to improve industry transparency – backed by a "new willingness to publicly call out underperformers".

Figure 1: APRA Heatmap at a Glance

Rationale	• Improve transparency • Provide stakeholders with insights about the outcomes delivered - in a way that is comparable across all MySuper products
Intended audience	• Wide range of stakeholders; including policymakers, advisors and employers. Results will be released publicly
Measurement	• Outcomes delivered on a relative basis, compared to peers and benchmarks, across three key areas; investment performance, fees and sustainability
Potential implications	• Increasing peer focus • Benchmark herding risk • Short-term focus for investment strategy

The Heatmap

APRA's primary purpose for the Heatmap is to provide credible, clear and simple insights into the outcomes provided by MySuper products across the superannuation industry. APRA intends to use the Heatmap to hold Trustees publicly accountable for their superannuation funds' performance.

APRA is also focusing on other performance assessment factors which contribute to the outcomes members receive, such as fees, expenses, insurance and sustainability. The metrics are based on data reported to APRA from RSE licensees.

The Heatmap will initially concentrate on three key areas which include:

1. Investment performance (over a three-and five-year period);
2. Fees; and
3. Sustainability.

The Heatmap will be released (at a minimum) on an annual basis. It will have a concise view (showing eight key metrics) and an expanded view (showing 21 metrics).

The Heatmap is designed to emphasise underperformance without giving a "pat on the back to better performing funds".

Products that are performing below the outlined benchmark will be presented on a continuous coloured gradient from pale yellow to dark red. Any product that is performing above the outlined benchmark will be coloured white. APRA has highlighted that receiving the colour white does not mean the product/fund is "blemish-free", or that there is no room for improvement for the MySuper product.

We discuss the metrics and methodology of each area of focus in the next sections, with a particular focus on the investment performance metrics.

Investment performance

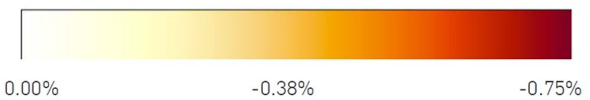
Investment metrics

Calculation

APRA has identified the need to assess investment performance on a risk adjusted basis to ensure that differences across superannuation fund strategies are appropriately considered. It has three primary metrics to assess investment performance:

- the Net Investment Return (NIR) compared to a peer growth allocation trend line;
- the NIR versus a Simple Reference Portfolio (SRP); and
- the NIR relative to a Listed Strategic Asset Allocation (SAA) benchmark.

The Heatmap will display a colour for each metric measured. Colours are applied based on the level of relative performance and in line with the scale below:



Source: APRA Information Paper November 2019

The highest colour concentration is applied to products that are experiencing returns with greater than -0.75% p.a. below the corresponding reference point, indicating significant underperformance.

Frontier comment

The range of investment risk targeted (and taken) in MySuper products is varied. We think it is positive that the assessment incorporates a risk adjustment. This aims to resolve a key flaw in simple, return-based peer rankings and a resulting risk that funds may feel compelled to "move up the risk curve" to compete fairly on peer related metrics.

The measure used for the risk adjustment is the growth/ defensive classification. A reliance on one measure to represent the risk of an investment strategy is a limitation of the Heatmap in our view given investment risk is multi-faceted. Growth/defensive in particular is not a good selection for a single portfolio risk measure as it is a simplistic perspective of risk used primarily for reporting. We encourage the inclusion of additional measures of investment risk in the Heatmap metrics and see this as a key area for future Heatmap enhancements.

While we understand the metrics are focused on the identification of underperformers rather than the full spectrum of performance, we expected at least one metric involving absolute returns and/or returns versus CPI+ objectives, given this represents the eventual member outcome and reflects the primary MySuper objective required by APRA in SPS 530. This is also what has been communicated to members via product disclosure statements and product dashboards.

The degree of risk taken is in part an active investment choice and should not be totally excluded from the assessment. While it is positive to incorporate risk-adjustment, we think it would be appropriate to include return only measures in the suite of metrics.

All three investment performance metrics utilise fund SAAs to set the risk level or as the benchmark. We may see an increased focus on the SAA settings in the context of how it is used in these metrics. For example, funds may choose to reduce any large long-term deviations between the SAA and the actual asset allocation.

Timeframe

Calculation

The concise Heatmap only uses five-year returns. The expanded Heatmap includes both three- and five-year periods. The timeframe selection is restricted by the inception of MySuper in 2014.

Frontier comment

Relative to the three-year timeframe used in prior member outcome measures, the use of five years for measurement is a positive development. However, it is shorter than the timeframe considered in setting investment objectives and strategies, and does not cover a full economic cycle. This limits the metrics' efficacy as an assessment of fund strategies.

We believe investment performance should be measured over the long-term, defined as a ten-year (plus) time horizon. Shorter periods make it difficult to differentiate between persistent underperformers and cyclical investment markets. We support APRA's intention to extend the timeframe as data becomes available.

Relative performance over any five-year period will be influenced by the interaction of investment strategy and market returns. As a result, the metric will likely identify funds with robust investment strategies for the long term as “underperformers” because their strategy has not “paid off” relative to other strategies within the period assessed. The risk of “false positives” will be even more impactful over the three-year measurement period.

Too short timeframes may also lead to an increase in shorter term and peer aware investment strategies.

Once underperforming funds are identified by the set metrics, there are multiple areas of further investigation we think that APRA should undertake to ensure its assessment is robust. This should include longer term performance which is readily available for many funds that converted their existing defaults to MySuper products.

Risk-adjusted approach

Calculation

The risk-adjustment approach used in the NIR and NIR vs. SRP metrics is based on growth/defensive allocations as a proxy for risk. The growth/defensive classification has been outlined by APRA as a standardised approach and will use data provided by RSE licenses. All investment metrics reference the funds’ SAA rather than their actual allocations to establish the risk adjustment.

The growth/defensive split is not applied for the Listed SAA benchmark metric as this is already risk matched via the use of individual fund SAAs.

Table 1: Growth/Defensive classification

SAA Asset Class	Growth / Defensive classification
Equity, Listed Property, Listed Infrastructure	100% Growth
Unlisted Property, Unlisted Infrastructure	75% Growth, 25% Defensive
Commodities, other	50% Growth, 50% Defensive
Fixed Interest, Cash	100% Defensive

Source: APRA Information Paper November 2019

Frontier comment

The inconsistency in growth/defensive classifications between market participants has long been contentious in the superannuation industry as they are self-reported to peer surveys. The introduction of an APRA classification system is intended to resolve this issue and we see this as positive in principle, although it is likely to introduce other classification mismatches (eg. low risk core property and speculative development property are not differentiated).

Variation will remain as the asset classes are broadly defined by APRA (fixed interest and “other” in particular) and SAA allocations are self-reported to APRA. As highlighted in **table 1,** Growth/Defensive classification most funds will see some degree of change in their growth/defensive split as a result of APRA’s methodology.

We note that the APRA methodology is somewhat different to how Frontier has approached growth/defensive definitions. Frontier considers many investments to sit in the spectrum of risk between 100% growth (generally defined as listed equities) and 100% defensive (generally defined as cash and government bonds) and we consider a range of risk characteristics in determining the best split for any investment.

Table 2: Growth/Defensive allocations

Difference in Growth/Defensive allocations	Proportion of fund options
Increase relative to self-reported	43%
No change	16%
Decrease relative to self-reported	41%

Source: APRA/SuperRatings September 2019 data, Frontier calculations

With a preference to not over-specify what is already a limited metric, we have tended to allocate 50% growth/50% defensive to mid-risk assets such as unlisted real assets, non-investment grade credit and mid-risk alternatives, unless the underlying exposures clearly suggest a more nuanced allocation is required. We have also been cognisant of individual investment risk and conservatively allocated higher volatility alternatives as 100% growth, even though some may have some useful diversification characteristics.

Relative to Frontier’s approach, APRA puts a growth premium on unlisted real assets, but defines higher risk alternatives and non-investment grade credit more leniently. This does not fully reflect our view of the aggregate and relative balance of risks for the types of investments being made in these areas, and particularly places a higher hurdle on unlisted real assets that have a strong track record of outperforming in challenging market and economic conditions. We recognise this is an area where there are a variety of views and perspectives.

We expect that the industry will move to this common definition for reporting purposes now that it is available and there may be some strategy changes for the purpose of product alignment.

Net investment return (NIR)

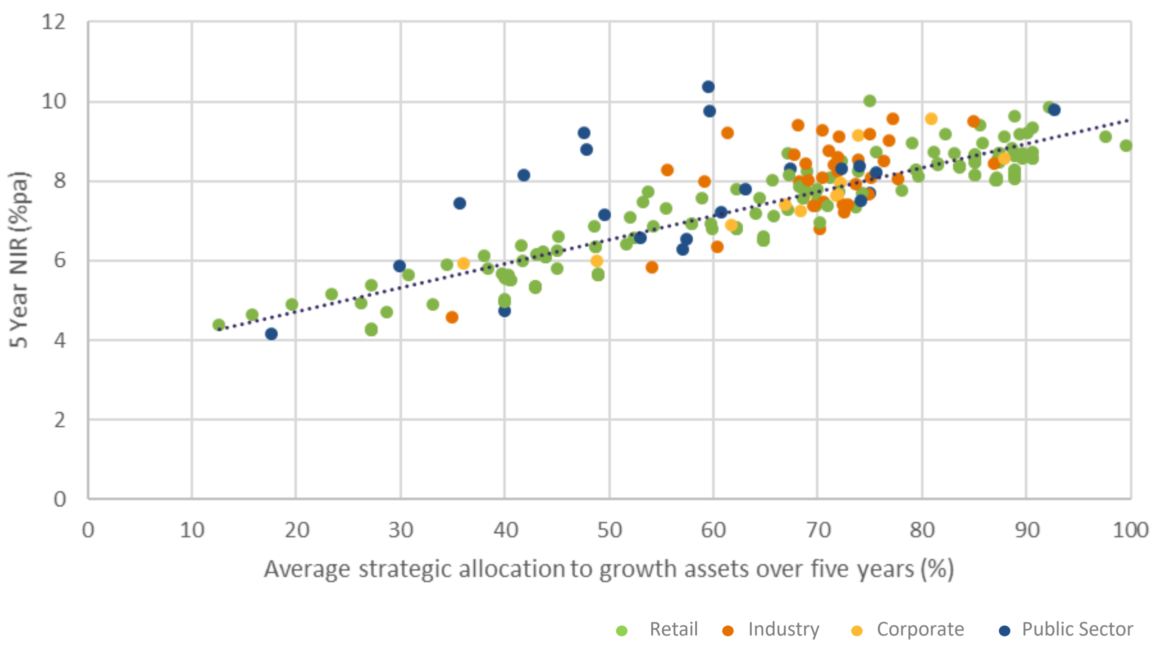
APRA notes that the comparison of absolute performance across MySuper products should take into account the investment objectives and level of risk to enable a like-for-like assessment.

To reflect the various risk profiles across different MySuper products, performance will be measured relative to the performance of peers based on the growth allocation of each product.

To determine a peer-derived trend line, APRA will take the performance of each product (after investment fees but before administration fees) and plot it against its average allocation to growth assets over the specific time horizon. An example is presented in the chart below. If a product falls below the trendline, it will be classified as an underperforming product.

Under this peer-relative approach, a similar number of funds will be deemed to have outperformed as those who have underperformed. This is highlighted in the Table 3.

Chart 1: NIR peer comparison to September 2019



Source: APRA September 2019 data, Frontier calculations using a line of best fit

Table 3: Reference Portfolio Asset Class Breakdown

Performance relative to Peer trend line	Proportion of Fund Options	
	Five Years	Three Years
Exceeds	38%	48%
Trails < 0.38%	34%	21%
Trails > 0.38% but <0.75%	15%	19%
Trails > 0.75%	13%	12%

Source: APRA September 2019 data, Frontier calculations

Simple Reference Portfolio (SRP)

Calculation

The SRP is a notional portfolio of passive, low cost, liquid investments and consists of a growth portfolio using listed equities and a defensive portfolio using bonds and cash. The weight allocated to each portfolio matches each fund's APRA calculated growth/defensive split to enable a "risk-adjusted" analysis.

The purpose of the SRP is to measure the value an RSE licensee has generated for its members through, for example, its asset allocation decisions.

A return is calculated for the growth portfolio and the defensive portfolio by applying APRA nominated index returns to each asset class and the weightings assigned to that asset class, with fee and tax assumptions also applied. The tables below show the asset class breakdown.

The NIR for each product will be compared to the return of the SRP to determine if the product has underperformed or outperformed.

Frontier Comment

Reference portfolios are utilised by some institutional investors as part of their portfolio construction and/or monitoring processes. It generally refers to a risk-matched low cost, passive, liquid portfolio which can philosophically be considered as a starting point from which to build a more sophisticated and diversified portfolio via the inclusion of active management, illiquid assets and alternative strategies, etc.

The use of a reference portfolio for comparative industry performance purposes has some merit as one of several lenses from which to identify underperformers. As the assessment is effectively what value a fund has added above the reference portfolio, outcomes will be the result of both structural portfolio differences from the reference portfolio settings, as well as underperformance from a portfolio strategy execution.

We expect deviations from APRA's specific reference portfolio settings to be likely to result in performance deviations over three- and five-year periods as highlighted in the table below.

Table 4: Reference Portfolio Asset Class Breakdown

Growth portfolio	%	Defensive Portfolio	%
Australian equity	50	Australian fixed interest	40
International equity (hedged)	25	International fixed interest	40
International equity (unhedged)	25	Australian cash	20

Table 5: Simple Reference Portfolio

Performance relative to SRP	Proportion of Fund Options	
	Five Years	Three Years
Exceeds SRP	55%	29%
Trails SRP < 0.38%	22%	11%
Trails SRP > 0.38% but <0.75%	17%	15%
Trails SRP > 0.75%	6%	45%

Source: APRA September 2019 data, Frontier calculations. Balanced options only.

We expect that differences will arise due to allocations to Australian versus international equities and currency hedging settings where the reference portfolio effectively sets a new benchmark position, as well as structural positions away from the reference portfolio such as illiquid exposures and tilts to areas like emerging market equities.

From an attribution standpoint, it is likely that these intentional positions may make up a meaningful part of the attribution for many underperformers over three and five year periods (and for overperformers as well). We encourage consideration of this issue as a particular area of focus for further investigation of Heatmap identified underperformers.

Listed SAA Benchmark Portfolio

Calculation

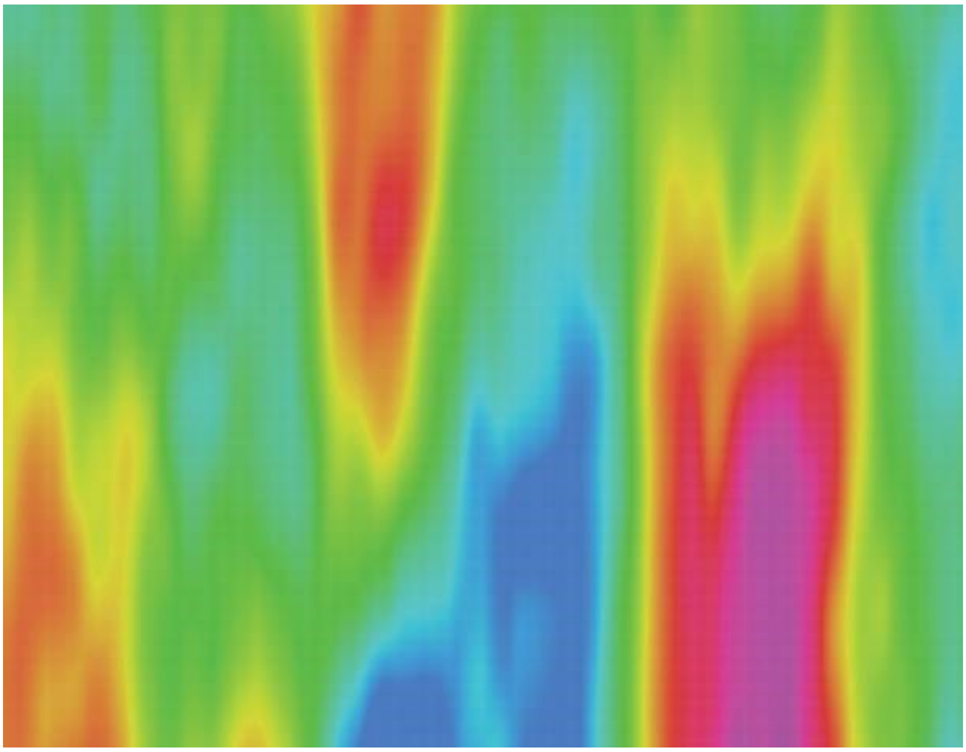
The purpose of the listed SAA benchmark portfolio is to assess the value add through the implementation of each product's investment strategy. The benchmark portfolio assumes investment in listed passive benchmarks for each major asset class. APRA has defined indices to be used in calculating the SAA Benchmark return, together with fee and tax assumptions.

APRA has assumed a 50% domestic and 50% international allocation for asset classes where no domicile has been reported as well as fully hedged benchmarks for international property, infrastructure and fixed interest.

Frontier Comment

MySuper portfolios will typically be more diversified than the Listed SAA benchmark. As a result, they will be lower risk on risk measures such as drawdown magnitude, risk of a negative return and volatility. We think that many MySuper strategies will be biased to underperforming the benchmark portfolio outcome in strong market environments, but more likely to outperform in difficult periods and over the longer term.

This is clearly as issue as it could encourage more risk taking in order to beat the benchmark portfolio, which is a distraction from focusing on member outcomes.



Other metrics

Fees and Costs

Calculation

The Heatmap (concise view) will include metrics for administration fees and total fees for $10,000 and $50,000 account balances. The expanded view includes metrics for administration fees and total fees for a range of account balance levels, including $10,000; $25,000; $50,000; $100,000; and $250,000.

Investment fees are not an explicit metric of the Heatmap, although they are incorporated in the total fee analysis. It appears evident that APRA has assumed that 0.80% p.a. is a reasonable baseline for investment related fees.

The Heatmap will use a graduated colour scale showing the relative positioning of a product's fees based on median absolute deviations, detailed in the Information Paper.

Frontier Comment

While we have not explored the fee methodology in detail, we note that the principle of true comparability is critical, and this has been a weakness in other fee comparison methodologies (noting that further revised RG97 requirements have just been released). There needs to be consistency across funds regarding capturing all fees to members in "total fees".

The Heatmap methodology is not explicit on investment fee expectations as they are incorporated into the net performance measures. A net of fees performance assessment has merit, as some investment strategies with higher fees can produce superior net of fee performance.

As the fee metrics embed an investment fee assumption of 0.80% p.a., this creates an effective benchmark whereby lower fees are beneficial for both the investment performance and total fee metrics.

Based on our calculations, a significant proportion of funds currently fail the administration fee test. A smaller proportion of funds fail the overall test, indicating that the high administration fee funds typically have lower investment fees.

Table 6: Administration fee for $50,000 account

Fee	Proportion of fund options
Less than 0.35%	33%
Between 0.35% and 0.48%	16%
Between 0.48% and 0.60%	14%
More than 0.60%	37%

Source: APRA September 2019 data, Frontier calculations

Table 7: Total fee for $50,000 account

Fee	Proportion of fund options
Less than 1.15%	62%
Between 1.15% and 1.28%	19%
Between 1.28% and 1.40%	7%
More than 1.40%	12%

Source: APRA September 2019 data, Frontier calculations

Sustainability

Calculation

The sustainability metrics are an indicator of an RSE licensee's likely ability to continue to deliver quality member outcomes into the future. APRA uses two representative scale measures:

- The net assets available for members' benefits – includes the defined contribution member balances in Accumulation and Pension Options, defined benefit entitlements and reserves; and
- The total number of member accounts.

The Heatmap will outline three metrics which APRA believes are likely to impact sustainability of member outcomes over a three year rolling average basis and includes:

- **Total Accounts Growth Rate:** measure of the member growth rate of an RSE over the preceding three years;
- **Net Cash Flow Ratio:** a measure of an RSE's overall growth in member benefits such as Superannuation Guarantee contributions; and
- **Net Rollover Ratio:** amounts transferred between different RSE's. It is a measure of the ability of the RSE to attract and retain members.

A solid binary 'heat' colour (orange) is shown on the Heatmap for each of the sustainability trend metrics when an RSE licensee meets any of the combined threshold levels detailed in the Information Paper.

Frontier Comment

The approach taken by APRA for these measures is clearly focused on sub-$5 billion funds. Notwithstanding the clear benefits of reduced fixed costs, positive net cash flows and other benefits which can come with scale, we also believe there are benefits that only small-mid-sized funds can provide to members. These include engagement with members, an ability to target the offering to the membership and from an investment perspective, and an ability to access certain niche asset classes and capacity constrained strategies

The final word…

Frontier supports improved efficiencies in the superannuation sector and the identification of persistently underperforming funds is a key component of that improvement. We think increased transparency and accountability are generally positive for the industry.

APRA has indicated that it is choosing to "call out underperformers" via the public reporting of the Heatmap results. This could risk instability for individual funds and a further erosion of trust in the system, at least in the short term. As a result, it is important to consider some of the potential implications of APRA's chosen Heatmap approach, particular as it relates to its ability to identify real underperformers.

The Heatmap approach is predicated on the idea that funds which will underperform **in the future** can be identified based on past performance. In contrast, ASIC warns product providers, advisers and consumers alike of the risks of relying on past performance as an indicator of future performance. In their guidance they state that "it may be misleading to imply that reliance on simple past performance figures would be a good way to select a financial product or service."

As we have explored previously (see *Best in Show or Worst to Go?*), identifying persistently underperforming funds accurately is a challenging task. Our view has been that a robust assessment across a wide variety of factors is needed. In relation to investment performance, we believe this requires measurement across multiple time periods and consideration of the level and nature of investment risk.

The Heatmap measurement period is impacted by when MySuper was incepted. The inclusion of five years is a positive development relative to the prior three-years based outcomes test. However, it is shorter than preferred for the assessment of long-term investment strategies. This limits the ability of the Heatmap to identify real, long-term persistent underperformers. It may also lead to an increase in the use of short term and peer aware strategies.

We see significant merit in the inclusion of at least one metric involving absolute returns and/or versus CPI+ objectives given these most closely match actual member outcomes and are ultimately one of the most important guides.

While we view the addition of risk adjustment into peer assessments positively as a principle, the Heatmap does not sufficiently address the multi-faceted nature of investment risk. There is a reliance on a simple growth/defensive classification to proxy investment risk and on SAA settings across multiple metrics. These reduce the collective robustness of the investment performance Heatmap component. The reference portfolio specification also adds an additional dimension t o risk management that funds may seek to manage.

The Heatmap risks downplaying the benefits of more robust portfolios by focusing attention on short-term returns, listed market relative risk and peer-oriented framing of risk. We would not like to see these issues reduce the willingness or ability of funds to implement differentiated long-term investment strategies that leverage their specific competitive advantages for the benefit of members.

Careful assessment of the nature of the Heatmap-identified underperformers is therefore critical, as most successful long -term strategies will have times when they are out of favour. These limitations also provide several fruitful areas for Heatmap enhancements in the future.

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