Your Future, Your Super submission

December 2020

Introduction

Frontier is pleased to provide this submission to Treasury's consultation on the Your Future, Your Super (YFYS) package of reforms.

Frontier is one of Australia's leading institutional investment advisors. We have been advising Australian institutional investors as a trusted adviser for over twenty-five years. We provide advice on more than $400 billion of assets across the superannuation, charity, public sector, insurance and higher education sectors. The fact our advice is free of any product, manager or broker conflicts, means we can provide truly unconflicted advice aligned with our client's best interests.

Frontier agrees with the Retirement Income Review that the Australian retirement income system is effective, sound and its costs are broadly sustainable. We further agree the system is complex and there is a need to improve understanding of the system.

The Government's policy aims are laudable:

- members' contributions should be invested in their best financial interests
- consumers should have access to trusted and reliable information regarding their superannuation to help them make a better choice
- great member engagement is beneficial, although we query whether it alone will produce better long-term returns for members
- unintended multiple accounts should be prevented.

The YFYS package is aimed at implementing a number of key recommendations from the Productivity Review into superannuation and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

In this submission, we provide commentary on where we believe the YFYS reform package can be enhanced to better achieve the Government's policy aims.

As an asset consultant, our submission concentrates on the underperformance test and the comparison portal. We acknowledge the Government believes that these two areas will result in the largest financial benefits to members.

Policy goals

The Government's Your Future, Your Super package aims to make the superannuation system better for members in four key ways.

Goal	Frontier comment
Your superannuation follows you – prevent the creation of unintended multiple accounts.	Important to ensure members' first (default) fund is a quality fund, not an underperformer.
Empowering members – making it easier for members to choose a well-performing product that meets your needs.	Relies on past performance being a guide to the future.
Holding funds to account for underperformance – protecting you from poor outcomes and encouraging funds to lower costs and fees.	Allows funds to underperform for 7-8 years before action. Allows funds to gouge members on administration fees. Performance test not directly related to members' outcomes. Detrimental to disengaged members.
Increasing transparency and accountability – for how superannuation funds use members' savings.	Trustees should be already operating in members' best long-term financial interests.

There is interaction between the goals, particularly the first three. It is important the measures are complementary:

- Members could be better off having multiple quality funds than a single poor fund. The government's figures showed the greatest benefit to members arises from the underperformance test. This policy goal should be prioritised, so members are not stapled to poor funds.
- It appears the *YourSuper* comparison tool will show information which is significantly different from the annual performance test. A fund identified as failing the performance test may be ranked highly on performance in the comparison test (and vice versa). This would be confusing for members.

Current legislative requirements

Since the introduction of superannuation under trust law, funds have had a requirement to act in the best interests of their members.

The introduction of MySuper resulted in a specific 'scale test'. At the time APRA announced it would be concerned if a small fund had long-term poor performance and poor performance was caused by high costs.

Furthermore, funds needed to provide members with a product dashboard, highlighting their investment performance and fees. This requirement was first introduced for MySuper funds, with the intention (but continually delayed) to expand to Choice funds.

In addition, the performance of superannuation funds is compared via peer surveys. These surveys are produced by several commercial organisations but are not typically available to individual members. Consumer comparator websites have to date not produced such detailed information, despite the information being readily available.

Regulatory focus following the Productivity Commission report has resulted in the introduction of the APRA heatmap and SPS 515 member outcomes test. The YFYS proposals overlap with these requirements and blend some element of both the PC recommendation and the Heatmap.

The various measures span relatively simple measures to complex:

- objectives – performance compared to long risk and return objectives
- peer surveys – ranking of actual return relative to peers
- product dashboard – annual and 10 year average return compared to objective
- Productivity Commission – returns compared to passive listed and blend benchmarks
- APRA heatmap – growth return, simple reference portfolio, listed SAA benchmark
- SPS515 Member Outcomes – return and risk
- Your Super comparison tool – ranking of actual performance and fees
- YFYS performance test – returns compared to listed SAA benchmark

Each of these measures is different in its coverage, calculation, and the outcome if the test is not met. We provide details in Appendix A

YFYS performance test

The listed SAA benchmark test assesses the value generated through the implementation of the investment strategy, capturing the value of active management and sub-asset class risk allocation:

- The test assesses how well a fund has implemented its chosen strategy, not whether it is a good strategy.
- It ignores actual returns and the CPI+ objectives of funds that reflect long-term member outcomes.
- It does not incorporate most risk adjusted improvements from more diversified exposures.
- It is not a peer relative assessment of underperformance (unlike some heatmap measures).
- It excludes administration fees, which have a meaningful impact on members' outcomes.

Frontier, as a participant in the Conexus Institute YFYS working group, echoes the concerns the performance test will be ineffective at identifying poor performing funds while introducing a range of undesirable outcomes. The issues are set out in the working group's summary paper.

The test is a new framing of what constitutes underperformance with real consequences for underperformers. It is a notable departure from the current primary focus on long term member return outcomes that link to CPI+ objectives.

Funds will need to work out how to consider this test alongside existing investment objectives and in the context of their investment philosophy.

As the test represents a new regulatory risk, a key step is understanding how portfolios are positioned relative to this new benchmark.

As the test only captures part of the investment strategy, is assessed over a shorter timeframe than existing objectives, and the listed benchmark selection for some asset classes embeds a higher risk into the benchmark, there is a likelihood portfolios well positioned to meet their long-term objectives and member needs could underperform the test from time to time.

Frontier suggestions

We believe developing an effective performance test is a great opportunity to improve superannuation outcomes for consumers. Consumers should have confidence they are invested in a quality fund. However, determining whether a superannuation fund is a "quality" fund (likely to perform well in the future) is complex.

We believe the performance test and the comparison tool can better meet the Government's policy aims with some minor enhancements:

1. Ensuring the performance test and the comparison tool are aligned, so consumers do not receive conflicting information.
2. As the test with the greatest consequence of failure, we believe the performance test should be the most comprehensive assessment. A single test made up of a well-designed collection of multiple metrics is likely to be more effective and reliable than a single metric based on a narrow assessment of quality.
3. As MySuper products are meant to be simple and low-cost, we believe both investment and administration all fees should be included. This is in line with the Productivity Commission (PC) analysis.
4. In line with the PC recommendation, we believe APRA should play a key role in working with funds which failure the performance test to improve or exit. This should provide more timely protection for consumers rather than relying on member engagement.
5. Many funds invest in unlisted assets for diversification and risk-reduction, rather than additional returns. Better recognise these risk-reducing benefits by using blended benchmarks (similar to the PC BP2 which used unlisted benchmarks for private equity, unlisted property and infrastructure).
6. In line with the PC recommendation, we believe the performance test and comparison tool should apply to all investment options, rather than just MySuper options.

We provide a suggested approach which builds on the Government's outlined performance test and comparison tool. We believe an explicit two-tier solution which integrates the goals of empowering members and holding funds to account for underperformance should be adopted.

Test 1: Empower members – funds' investment performance and total fees are ranked quarterly compared to relevant peers. This will be available to members via the YFYS comparison tool. Funds which rank poorly (lower quartile) on either measure are then subject the second detailed test.

Test 2: Holding funds to account for underperformance – this annual test assesses investment performance and total fees using multiple metrics, and the regulator's prudential investigations, to better assess whether a fund has the "right to remain". If the fund fails this assessment, it would be subject to a 12-month period of remediation, or if remediation is not possible, the regulator would ensure an orderly exit for that fund. Other funds would receive a single overall assessment, communicated to members on the YFYS comparison tool.

We provide further details in Appendix B.

We believe these changes will better meet the Government's policy aims of improving consumer outcomes.

Appendix A – Performance comparisons

	Fund objectives	Peer surveys	Product dashboard	Productivity Commission	APRA Heatmap	SPS 515 Member Outcomes	YourSuper comparison tool	YFYS annual test
Measure	Return and risk objectives	Ranking of actual performance relative to peers	Annual and 10 year average return compared to objective	Passive listed and blended SAA benchmarks	Growth return, Simple Reference Portfolio, Listed SAA benchmark	Return, risk	Ranking of actual performance and fees	Listed SAA benchmark
Fees	Net of administration and investment fees	Net of investment fees and asset-based admin fees	Net of administration and investment fees for $50,000	Net of administration and investment fees	Net of investment fees	Net of administration and investment fees	Net of administration and investment fees	Net of investment fees
Period	Option dependent	Multiple	10 years	8 years	3 and 5 years		Unclear	7/8 years
Frequency	At least annual	Monthly	Annual	Annual	Annual	Annual	Quarterly	Annual
Coverage	MySuper and choice	MySuper and choice	MySuper	MySuper and choice	MySuper	MySuper and choice	MySuper	MySuper & TDF
Calculation	Funds	Funds	Funds	Funds + audit	APRA	Funds	APRA	APRA
Failure	-	-	-	APRA ‘right to remain’	APRA	APRA	Members	Members

Appendix B – Frontier proposal

Complexity

Determining whether a superannuation fund is a "quality" fund (likely to perform well in the future) is complex. Establishing whether a fund has performed well in the past is not straightforward, particularly as investment risk will drive returns. One of the easiest ways to outperform peer funds is to take more risk. Working out whether a fund will perform well in the future is even harder, as past performance is not necessarily a guide to the future.

However, members need to be empowered to make their own decision about who manages their retirement savings with simple, clear and trusted information. Driving member engagement can promote competition and lower fees.

Providing members with a simple comparison of a complex issue is vexing. The following options are possible:

1. Elect for a simple solution, ignoring the complexity.
2. Elect for a complex solution and attempt to present it simply.
3. Elect for a two-tier solution – provide a simple solution to members and complex solution for regulators.

The danger with option 1 is poor funds may slip through the test, and members receive poor outcomes in the future. Conversely, a good fund may fail the test and members miss good future outcomes. In addition, a simple test may introduce unintended consequences – funds may consider actively managing to the performance test rather than concentrating on long-term member outcomes.

Option 2, a complex solution, has the benefit that it is more likely to identify poor funds. It is also less likely to unduly influence fund behaviour , as it is more difficult for them to manage to a multi-faceted test. However, it faces the danger members do not engage with the complexity. As seen with the APRA heatmap, it is difficult to present multiple metrics in an easy-to-understand format.

The YFYS proposal is a variation of the first and third options – it has a simple comparison tool for members and a slightly more complex test. However, the implementation of these two initiatives could be enhanced by making them operate more coherently. As it stands, the comparison tool could show a fund ranking highly based on its actual returns but fail the annual performance test (based on performance relative to a benchmark). The reverse could also occur – poor performance but meets the performance test. This would lead to consumer confusion and disengagement – the opposite of the desired outcome.

Frontier proposal

The Government is trying to achieve two goals with the performance test:

- Empower members – providing simple and clear information to help them choose a high-performing and/or low-cost fund.
- Holding funds to account for underperformance – poor funds have no place in a compulsory system and members should be protected from persistently underperforming products.

We believe an explicit two-tier solution which separately addresses these goals should be adopted:

Test 1: Empower members – funds' investment performance and total fees are ranked quarterly compared to relevant peers. This will be available to members via the YFYS comparison tool. Funds which rank poorly (lower quartile) on either measure are then subject the second detailed test.

Test 2: Holding funds to account for underperformance – this annual test assesses investment performance and fees using multiple metrics, and the regulator's prudential investigations, to better assess whether a fund has the “right to remain”. If the fund fails this assessment, it would be subject to a 12-month period of remediation, or if remediation is not possible, the regulator would ensure an orderly exit for that fund. Other funds would receive a single overall assessment, communicated to members on the YFYS comparison tool.

This is very similar to the proposed Government approach. However, there are some slight differences:

- There is an explicit link between the YourSuper comparison tool and the performance test. When a member finds their fund near the bottom of the comparison tool, they will be confident the regulator is investigating. Those funds will need to justify their continued operation.
- The second test is more complex. No longer needing to drive member engagement, this test can reflect the complexity of making an assessment. Based on this assessment, the regulator can then make a judgment as to whether the fund remains “on-watch” until their ranking improves or instigates the fund’s orderly exit. This is the “right to remain” process the Productivity Commission recommended

	Test 1	Test 2
Goal	Empower members – increasing competition and improving outcomes	Holding funds to account for underperformance
Focus	Members	Regulator
Test	Quarterly peer ranking of investment performance and fees	Annual multiple metrics of investment performance, fees, and sustainability
Failure	Member engagement + Test 2	Orderly exit

FAQs

Test 1 – Empowering members

How are peers determined? In line with current industry practice, funds will be grouped into categories based on their exposure to growth assets (as defined by the regulator).

Will funds increase risk to achieve better outcomes? Potentially, but given these surveys already exist, this is a pre-existing issue rather than a new one.

Will this test identify poor funds which have achieved good performance through luck? No, however those members will have received good outcomes to date.

Around a quarter of funds will always fail this test. Is that fair, especially in the future when the poor funds have exited? This test aims to improve competition. Quality funds should still pass the second test.

Test 2 – Holding funds to account for underperformance

What metrics would be used? Like the Heatmap, investment performance, fees and sustainability would be assessed on a variety of metrics. Performance would be assessed on three tests – net investment return, listed SAA (both from the Heatmap) and a new risk-adjusted metric. Administration and total fees would be compared for five representative balances. Details are provided in Appendix C.

How would an overall assessment be determined? APRA will undertake the test and will raise its prudential assessment of these funds. If the fund passes most of the metrics (~80%) and no substantive prudential issues, the fund will receive a "pass". If the funds don't pass most of the metrics, but APRA is satisfied with the remediation action, the fund would receive an "on watch" assessment. Otherwise, the fund would receive an "on review" assessment, and APRA would instigate an orderly exit of this fund. These assessments would be shown on the comparison tool.

Will funds make modifications with the aim of passing this test? In respect of fees, hopefully. In respect of investment, the use of multiple metrics makes this harder for funds to achieve. The metrics have been chosen to limit the ability of funds to adopt a simple approach to 'game' the test at the expense of long-term member outcomes.

Overall

Will this assessment process slow down action on underperforming funds? On the contrary, this should see members transferred out of poor funds quicker. During the year, the regulator will track the quarterly comparison tool results and initiate assessment of poorly performing funds. Engaged members can act based on the comparison tool. The regulator will then act to protect the less engaged members.

Will this process result in fewer funds failing the test? Potentially yes initially. It will highlight the most significant underperformers and take more immediate action. Funds whose performance is less bad will have more opportunity to improve outcomes. If not, the tests will pick them up in the subsequent year.

Appendix C – Investment metrics

Assessing investment performance

When evaluating investment performance, each fund option has its own unique membership, return objectives and risk profile, which will influence its investment strategy and, ultimately, the investment returns that are achieved for members. The comparison of performance across products should consider the investment objectives and level of risk for each product to enable a like-for-like assessment of performance. There are a few ways to account for these differences.

Investment objectives

Measuring a fund against the objective is requirement for all Trustees and is an obvious metric for assessing whether a fund has performed well.

APRA's SPS 530 Investment Governance requires funds to formulate specific and measurable investment objectives for each investment option. Trustees need to monitor and assess regularly whether the investment objectives are being met. The MySuper product dashboard provides members with a comparison between the return target and the actual return achieved.

However, performance against objective has less efficacy in differentiating between 'good' and 'bad' funds. In the short term, whether a fund meets its objective will largely be determined by the investment markets rather than the skill of the fund. For example, most funds missed their return objective for the 2019-20 financial year, but almost all will have achieved it in the previous year.

Over long periods, the return versus objective provides more information. However, over the ten years to June 2020 it is likely all balanced options will have met their CPI-related objective.

Actual returns

The actual returns achieved are what determines member outcomes. A higher return is better than a lower return. As such, a 'good' fund will have achieved a higher return than a 'bad' fund. Most funds track their performance against their peers via surveys provided by the likes of SuperRatings and ChantWest.

It is important when comparing the performance of funds that the comparison is like-for-like. A balanced fund is expected to provide higher returns (in the long term) than a capital stable fund, as it will invest in higher risk assets. For this reason, the survey providers categorise funds into 'universes' based on each fund's exposure to growth assets. Even within these universes, funds which have a higher growth exposure are likely to outperform as they are taking more risk. This can lead funds to take higher risk than their peers to climb the league table.

The other issue with these surveys is there is no standard definition of growth and defensive assets. An industry agreed definition would largely ameliorate this issue.

Notwithstanding these issues, comparisons of actual returns in peer universes is used extensively by the industry and would be useful for consumers.

Risk-adjusted measures

Both the Productivity Commission report and the APRA heatmap recognised the importance of taking account of investment risk. However, risk is not easily defined nor calculated.

- The PC constructed two benchmark portfolios to allow performance assessment across funds – BP1, a listed benchmark portfolio and BP2, using both listed and unlisted indices.
- The APRA heatmap includes three different measures. The first is a peer comparison based on the growth asset allocation of each fund. The simple reference portfolio is used to measure the value a fund has generated through its strategic asset allocation decisions – this is also based on

each fund's growth/defensive allocation. The listed SAA benchmark is a reference portfolio approach like the PC's BP1.

The addition of risk adjustment into these assessments is positive as a principle, but we believe it 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. The reference portfolio specification takes no account of the benefits of more robust portfolios by focusing attention on short-term returns, listed market relative risk and peer-oriented framing of risk.

There are a number of other measures of investment risk. The Standard Risk Measure is shown in each fund's MySuper dashboard. It measures the expected number of negative years over a 20-year period. However, there are some inconsistencies in the calculation of the SRM by funds. The return and risk assumptions used in the SRM calculation will explain part of the differences between funds, rather than any actual difference in risk level.

The traditional measure of investment risk is volatility, calculated as the standard deviation of returns. Investment theory posits that investors require a higher return to compensate for the volatility of assets. The ratio of the actual return to the volatility of those returns (such as the Sharpe Ratio) then provides a measure of risk-adjusted performance. The benefit of volatility as a risk measure is investors can't a priori manipulate the risk measure. One criticism of this metric is it can underestimate the volatility of unlisted assets.

A well-designed collection of metrics, all else equal, is superior to an individual metric. Any individual metric will have shortcomings, and these can be reduced through the judicious use of additional metrics which recognize different measures of risk.