

The Frontier Line

Ongoing developments of Your Future, Your Super

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on \$600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.



AUTHOR

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Greg joined Frontier in 2016 and provides investment advice to a range of clients, as well as undertaking manager and investment research as it relates to client portfolios. Greg is a Principal Consultant, segment head of our large superannuation client group along with being a member of Frontier's Investment Committee and Manager Ratings Committee. Prior to Frontier, Greg was employed by Mercer where he headed the Melbourne based investment consulting team. Prior to joining Mercer in 2008, Greg spent ten years at Standard & Poor's. He was a Director and Head of the Manager Research business and had previously headed research in fixed income and alternatives. Greg had also worked for five years at National Mutual. Greg holds a Bachelor of Science (Hons) from Monash University, a Graduate Diploma in Financial Planning from Finsia and has completed RG146.

Introduction

The second annual Your Future, Your Super (YFYS) performance test showed improved results with fewer funds failing this year, from 13 super funds failing the test in year one down to just five funds in year two, including four receiving a second fail and one new entrant.

In this paper, we will examine the latest developments in the YFYS performance test and explore the three key drivers for better performance in year two, which include:

- The improved ability to understand and manage YFYS risks.
- The negative market environment in the last financial year.
- The impact of administration fee changes.



The YFYS performance test and its impact on member outcomes

Even though the performance test is a two-strike test, super funds that failed in the first year have faced immediate sustainability issues. The 13 failed funds experienced higher than average member outflows and ten of the 13 funds have either now merged or are working through merger discussions.

Other recent developments include the announcement of the Treasury consultation process into YFYS measures, the delay in the first test for trustee-directed options and, somewhat linked, draft legislation for faith-based investment options. This is also consistent with the Labor Party's commentary, before and after the Federal Election, flagging they would tweak certain aspects of the reforms to ensure unintended and negative consequences were addressed rather than make wholesale changes.

Frontier Advisors has always been supportive of measures which improve retirement outcomes for members, although are mindful of any intended or unintended consequences of a new measure. The key to any test is alignment with good member outcomes. While the YFYS performance test covers some aspects of member outcomes, it is more focused on the implementation of a fund's strategy rather than whether the actual strategy has delivered on promised member outcomes.



Chart 1 shows MySuper option performance and volatility over the seven-year test period to June 2021. Due to the supportive market environment, most, if not all, funds exceeded their primary CPI + X% p.a. investment objective (shaded area covers CPI + 3% to CPI + 5% p.a.), including funds that failed the 2021 YFYS performance test.

Chart 1: 30 June 2021 7-year YFYS Results

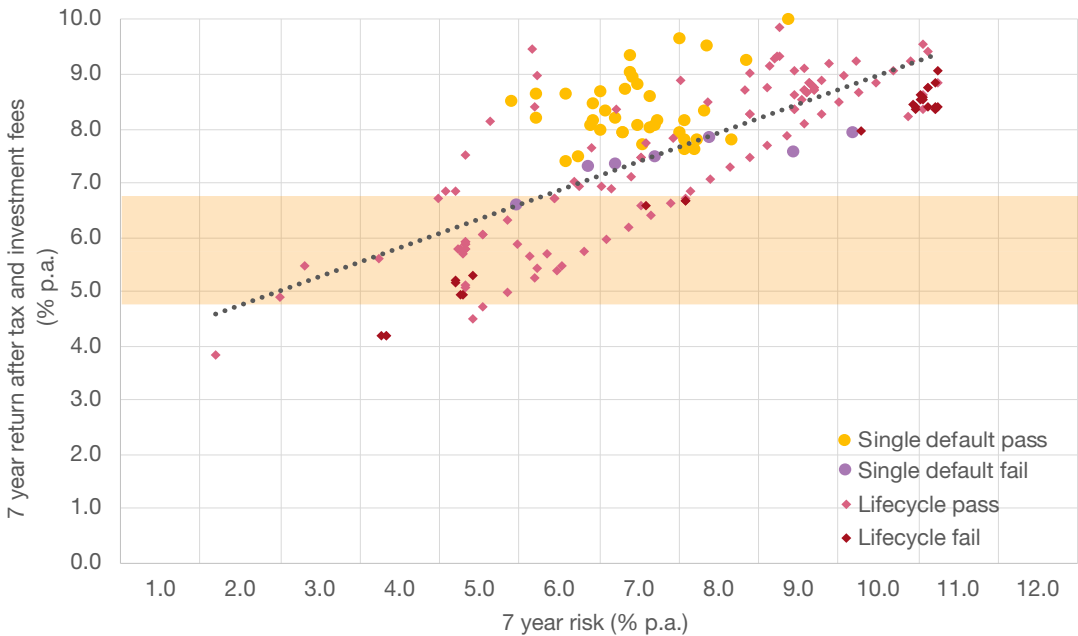
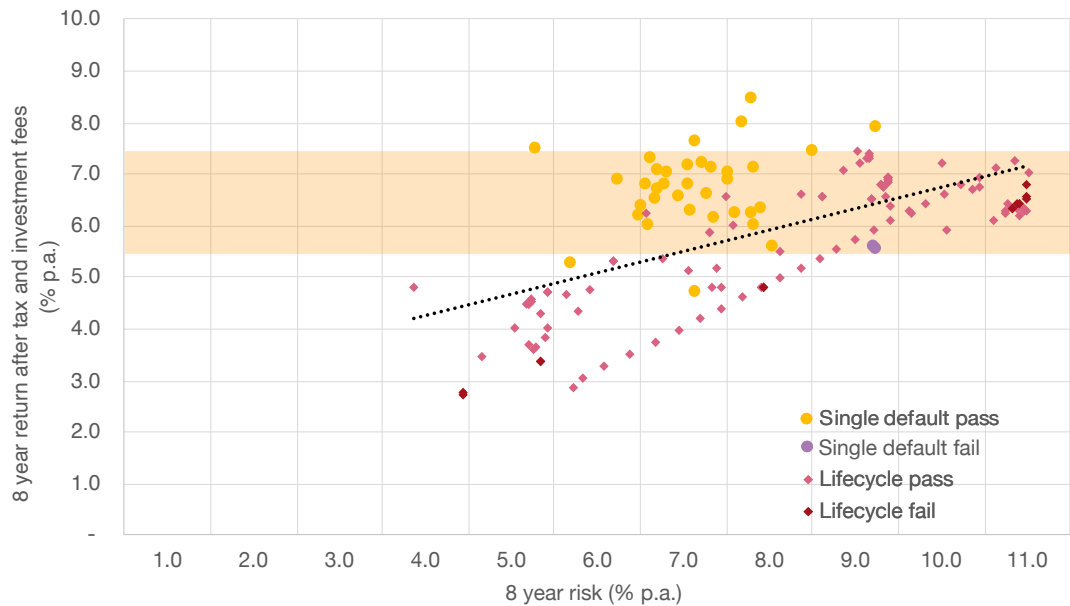


Chart 2 shows for the eight years included in the 2022 test, while fewer funds failed the YFYS test in this period, more funds underperformed against their primary return objective due to market volatility and rising inflation. This indicates that the YFYS performance test is not an effective measure of member outcomes.

Chart 2: 30 June 2022 8-year YFYS Results



Improvements in YFYS test results in financial year 2022

While only 'pass' or 'fail' results are known, Frontier expects improved results for many funds due to several factors, including:

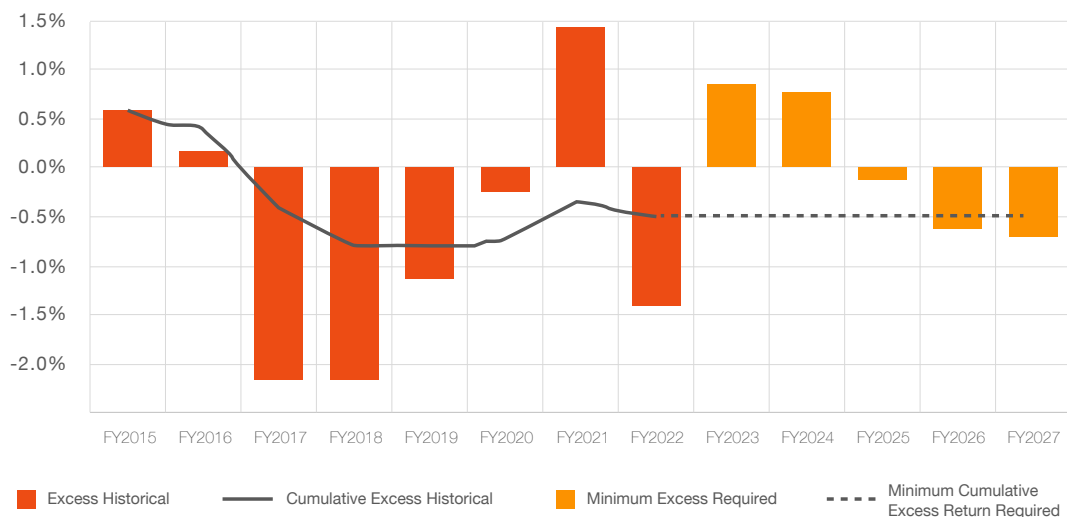
- The fund's ability to understand, manage and plan where their YFYS benchmark risk was taken this year.
- The impact of negative markets perversely making it easier for funds to improve their net performance.
- The reduction in administration fees having a multiplier effect on results.

The backdated nature of the test when first introduced (where significant changes were made between the first announcement and final legislation in August 2021) meant funds inherited a starting seven-year result that was, in essence, not managed. While funds have always tried to maximise long-term returns subject to risk, the importance of how a new benchmark interacted with their strategic asset allocation and actual allocations has led to some negative consequences for funds.

Frontier has been working closely with clients over the last year to understand and manage YFYS risk and has now developed a new related module within our technology platform. The YFYS module will help clients calculate their current position versus the test, forecast net results required in future years, and understand and quantify potential risks within their portfolios.

The platform takes data from APRA and SuperRatings to build historical estimates for the YFYS test and allows clients to more precisely update historical SAA information to ensure calculations are as close to APRA calculations as possible. The data is updated quarterly to help funds keep key stakeholders informed on their progress against the test throughout the year. Importantly, it also advises funds of the minimum net return outcomes needed in future years to keep passing the test.

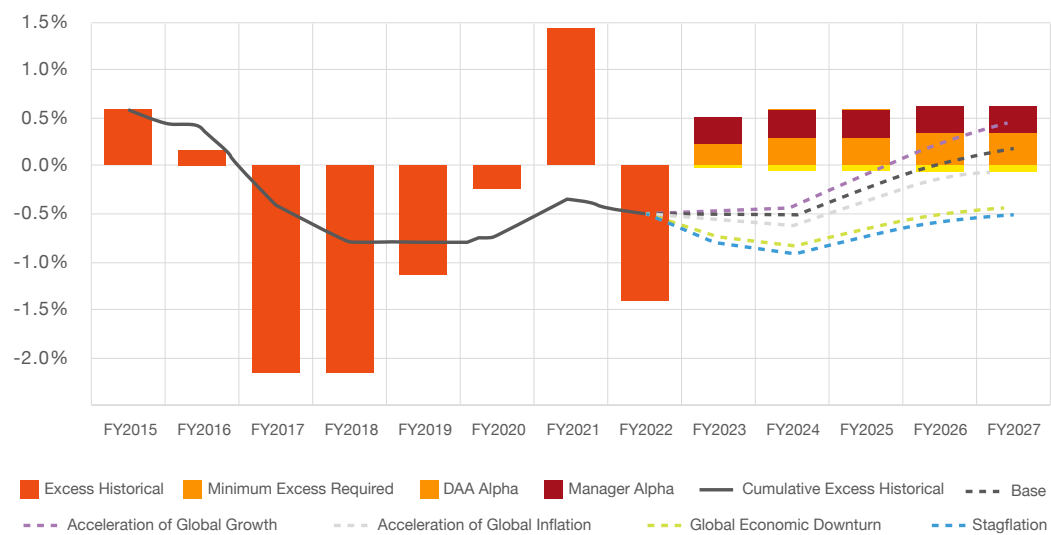
Chart 3: Return requirements - base



Source: Frontier, APRA, SuperRatings

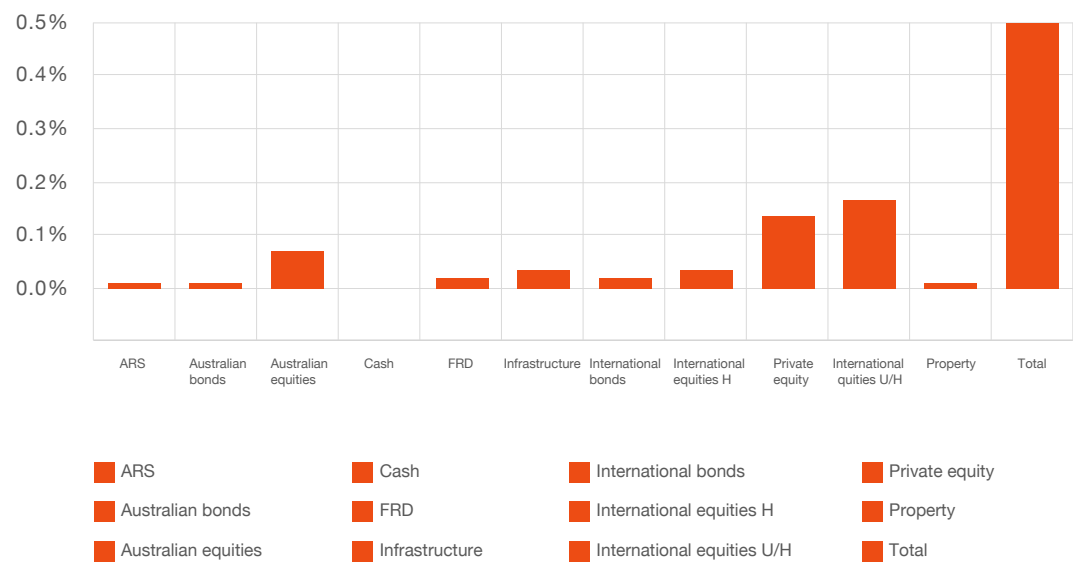
When modelling prospective DAA tilts, the module uses scenario analysis enabling clients to see the potential implications of different market environments on net YFYS results.

Chart 4: DAA + Alpha



The module also enables funds to understand where the sources of risk against the YFYS benchmark reside from an SAA and DAA basis.

Chart 5: Tracking error decomposition - DAA and YFYS



Source: Frontier, APRA, SuperRatings

Negative markets

The negative return environment has been beneficial for funds improving their YFYS position.

After consecutive years of strong equity markets, some funds will be underweight in equities. This would have hindered them in the 2021 year as the test makes no allowance for producing a lower return at lower risk. If these funds didn't change their underweight in response to their 2021 test result, they would have benefited compared to the YFYS test in 2022 as markets declined.

Behavioural finance has historically led many funds to have a philosophy of protecting members capital in down markets whilst seeking to keep up in up markets. The impact of the introduction of the YFYS test on this philosophy has led to some funds debating its relevance, especially after 2021 results were at a time where the seven preceding years had generally been strong for market returns.

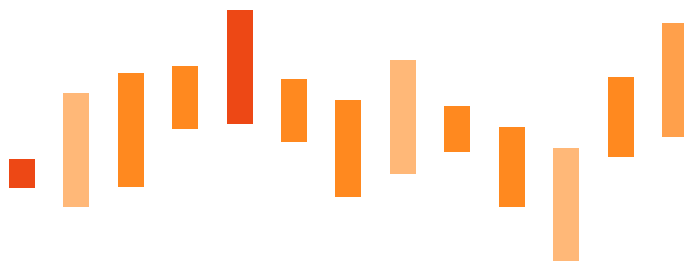
Other aspects of why funds have generally been more successful in negative markets come down to a couple of factors. Firstly, the outperformance of unlisted assets over listed assets (a big benefit for funds in 2022 with their private equity exposures). And secondly, taxation drivers, with funds doing better than APRA's 0% tax assumption for Australian equities because of larger contributions to overall returns from franking credits and buybacks in a year when equities went backwards.

In addition, the quirks of compounding mean those who were failing or lagging the test had a smaller outperformance requirement this financial year than if we had experienced a strong market return. This helped a number of funds who were failing the test to improve to a pass result this year.

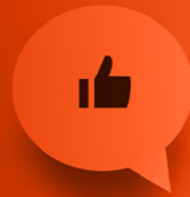
Impact of administration fees

Finally, APRA has stated that one of the successes of the test came in the form of lower administration fees for members. While we still are waiting on the 2022 representative administration fees and expenses (RAFE), Frontier's expectation is the average will be considerably lower than the 2021 0.3826% fee.

The impact of changes in administration fees on test results is proportionally higher than improvements in funds' performance, which once again has a disconnect with actual member outcomes. A ten-basis point reduction in administration fees and a ten-basis point increase in fund performance has an equal impact on member outcomes. However, the administration fee impact improves test results by ten-basis points (as current year administration fees are used for the full eight-year test period) while the performance increase is diluted over the eight years.



The final word

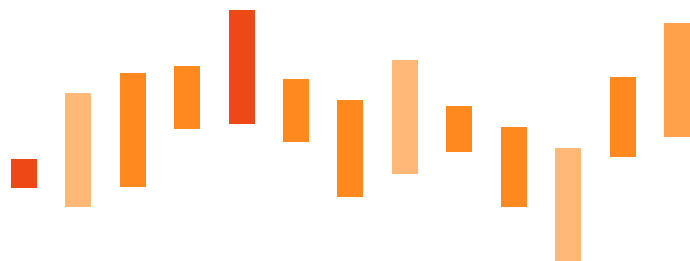


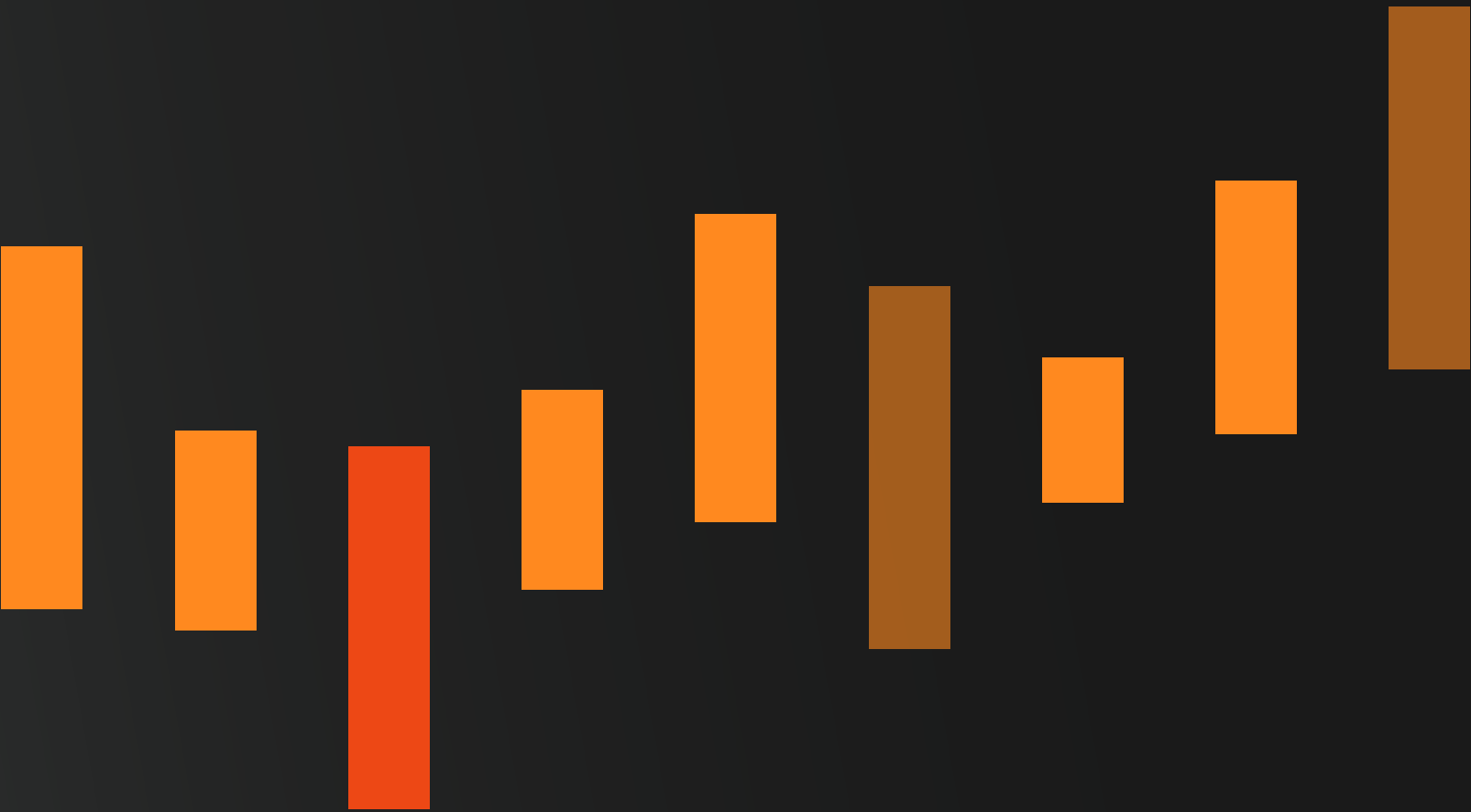
Although 2022 saw an improvement in YFYS test results for MySuper products there is still a lot of uncertainty with the test. Frontier has made a formal submission to Treasury's consultation on the review of the YFYS measures. We hope the ongoing consultation process will help better align the YFYS test with member outcomes and result in a more effective test that can be extended to more or all superannuation options.



Want to learn more?

Please reach out to Frontier if you have any questions or visit frontieradvisors.com.au for more information.





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