Superannuation Performance Test Consultation 2024

April 2024

Introduction

Frontier Advisors is pleased to provide this submission to Treasury's consultation on the Your Future, Your Super (YFYS) performance test design options.

Frontier is one of Australia's leading institutional investment advisers. We have been advising Australian institutional investors as a trusted adviser for over almost thirty years. We provide advice on around $660 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.

As we have mentioned in our previous submissions, Frontier supports a well-designed performance test. We view the current consultation with alternative approaches outlined by Treasury as an opportunity to improve the performance test.

Frontier's preferred approach and rationale is outlined in this submission and reflects option 3c in Treasury's consultation paper the targeted three-metric test.

Purpose and principles

Frontier is supportive of the principles outlined in the consultation paper, namely improving member outcomes with a test that is effective and efficient, widely applicable, transparent and enduring. We see improving member outcomes as the primary purpose of the test. In previous submissions we have articulated our views that the current test only partly achieves this primary purpose.

Our view is that the current test is a simple test based on past performance, which is a "weak and unreliable" predictor of future performance. It only assesses a small part of member outcomes, namely how well a fund has implemented its chosen strategy, not whether it is a good strategy. Importantly it does not incorporate a risk-adjustment outside of the SAA, such that funds can underperform the test if they reduce risk.

Additionally, as it is not well aligned with actual member outcomes (a good risk adjusted return) it can result in funds prioritising passing the test in the short term rather than long term returns to members.

As such we view that there are improvements to the test that will help achieve the overarching objectives.

Background

The concerns we (and others) previously outlined, some of which Treasury have summarised in this consultation paper and earlier in their issues paper from 2023, persist from the 2022 industry consultation. We have now been through three rounds of the test from 2021 to 2023 and the impact of these concerns have been experienced by ourselves and our clients.

Our key concerns with the current test include:

- The current test is not well-connected to member outcomes as it only assesses implementation and ignores overall portfolio returns as well as risk.
- The current test discourages innovation and encourages benchmark hugging. When discussing new investments, that may be beneficial to members in the long term, the impact on shorter term

risks and volatility against YFYS test impact in decision making. This impact is heightened for funds that have smaller buffers against the test.

- Risk is not taken into consideration with the test. The current test does not reward funds for implementing a strategy with lower levels of risk which will be beneficial to members during market stress periods.
- Some asset class benchmarks are not truly investable or represent a funds' implementation approach for a sector. This is true for asset classes such as property, infrastructure, private equity and credit along with listed markets for responsible investment overlays. The composition of these benchmarks can affect funds' investment decisions.
- We have seen a number of funds close investment options, reducing member choice.
- While the test has encouraged reduction in administration fees using the last year only does not reflect a member's experience and the reduction in fees has a larger impact on results than actual performance. It also allows funds to subsequently increase fees after passing the test.
- The compliance and administration cost for funds has increased in terms of needing to purchase indices. This is exacerbated having a single index provider for each asset class.

Frontier's preferred approach

One of the challenges in getting a uniformed industry view is that no one test approach is perfect and there are arguments as to why certain tests have both positive and negative attributes.

In previous submissions Frontier has outlined a two-tier solution with a simple first test followed by a second multi-metric test for funds that fail the simple initial test, we still think this approach is the most sustainable for the industry and its regulation. Our understanding is that a "bright line" approach is preferred by APRA and Treasury as this removes any subjectivity or added complexity of a two-stage process.

As such, Frontier view that 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. This is option 3.c. Targeted three-metric test. The three metrics we suggest are:

1. the risk adjusted returns relative to Simple Reference Portfolio (SRP) frontier (option 2c),
2. a peer comparison of risk-adjusted returns (option 2b) and
3. the current test (option 1).

With this type of three metric test a fund would need to pass at least two of the measures to have passed the test. Having three metrics means funds will need to manage the strategy and implementation of the strategy for members rather than solely focussing on a single test (as would be the case if a two metric approach was adopted).

The rationale of having two different risk adjusted measures reflects that there is no one perfect risk measure so by incorporating two different measures of risk (volatility and growth/defensive classification of assets) mitigates this risk to some extent.

This approach improves three key areas which has broad appeal amongst market participants:

- The assessment includes total portfolio performance as it ultimately determines member outcomes.
- Reduces the disincentives to taking actions to improve member outcomes (such as investing in newer asset classes) due to fear of failing an individual test.
- Reduces the opportunity and incentive to manage (i.e. game) the test, leaving funds to focus on member outcomes.

Metrics

Risk-adjusted returns relative to Simple Reference Portfolio (SRP) (option 2c.)

This type of test measures overall portfolio returns and thus links to member outcomes but includes a risk adjustment for standard deviation. The SRP benchmark represents the return that is hypothetically accessible to the member at equivalent risk and low cost, with little or no investment skill.

Peer comparison of risk adjusted returns (option 2b.)

This metric also measures overall portfolio returns and thus links to member outcomes, but benchmarks against the estimated return for peer funds with an equivalent growth/defensive mix. The use of growth/defensive weights amounts to an implicit but imperfect form of risk adjustment.

Current test (option 1)

While Frontier has articulated issues with the current test, for continuity and aiding transition issues, this could be included as one of the three metrics. This would reduce many of the risks around managing closely to the test as the single metric to pass or fail such as benchmark hugging.

We also believe some refinements could also be made including:

- Using a three-year RAFE to better align member experience with test results whilst still encouraging funds to reduce costs to members.
- A way to reduce the costs of purchasing indices either through a collective industry purchase approach or introducing a choice of indices for sector benchmarks (reducing the potential for monopolistic behaviour) and introducing low carbon exposure benchmarks.

Frontier would support, and would happy to be involved in, a technical committee of superannuation industry and academic experts to consider technical and implementation issues of this multi-metric approach.

Conclusions

The aim of this consultation is to design a better overall test that benefits members, while recognising that there is no perfect solution. We believe the outlined three-metric test is the best realistic way forward.

Our understanding is that changes to the current test from this consultation will occur in a couple of years time rather than immediately, which reduces the transition risks with changing the test and allow funds and other market participants to plan for the new test rather than some of the issues with the initial introduction and subsequent changes to the test and the retrospective nature when using historical fund results.

Appendix: Design options

Option	Objective	Measure of Performance
	Option 1 - Status quo	
1. Current Test	Assesses how well a trustee has **implemented their investment strategy**, based on SAA.	**Product Performance** Long-term annual average investment performance *less* most recent administration fees. **Benchmark** Benchmark portfolio of indices based on the product's individual SAA *less* median administration fees of relevant peers.
	Option 2 - Alternative single metric	
2a. Sharpe ratio	Assesses how effectively the trustee delivers **risk-adjusted investment returns above that of the risk-free rate**.	**Product Performance** Long-term average investment performance less the risk-free rate. Result is then divided by volatility of investment. **Benchmark** Multiple options, including a prescribed number (such as 1), peer comparison, or Sharpe ratio of a benchmark portfolio.
2b. Peer comparison of risk-adjusted returns	Assesses whether a product is **providing competitive risk-adjusted returns compared to peers**.	**Product Performance** Long-term average investment performance (net of administration fees) against its exposure to growth assets (as a proxy for risk). **Benchmark** A linear trendline based on results for the relevant product cohort (e.g., MySuper).
2c. Risk-adjusted returns relative to Simple Reference Portfolio (SRP) frontier	Assesses whether a product provides **superior investment returns relative to a simple benchmark portfolio** that bears a similar level of risk.	**Product Performance** Long-term average investment performance (net of administration fees) relative to volatility (standard deviation). **Benchmark** A line that reflects the risk-adjusted returns of a simple reference portfolio, of bonds and equities, for all levels of risk.
	Option 3 - Multi-metric framework	
3a. Heatmap	Assesses the performance of a product against multiple metrics, similar to the APRA heatmaps, to provide a **fulsome performance assessment**.	**Product Performance** Utilises eight metrics contained within the APRA heatmaps (investment performance (3), fees (2), and sustainability of member outcomes (3)). **Benchmark** Varies depending on metric but includes benchmark portfolios and peer comparisons.

3b. Targeted three-metric	Assesses the performance of a product against a smaller set of metrics to provide a more **fulsome assessment of performance** relative to the current test, but is **simpler** than 3a.	**Product Performance** Three independent metrics measuring performance, such as risk-adjusted **returns**, implementation of **promises** to members, and **cost** to members. **Benchmark** Varies depending on metric, but could include peer comparisons, disclosed targets and/or benchmark comparisons.
Option 4 – Alternative Framework		
4. Alternative metrics	This option is an opportunity for stakeholders to put forward an alternative framework that addresses concerns with the current test and the principles outlined in this paper. Options one to three are only examples of test frameworks that could be used and feedback on the detail of these options is welcomed.	