Observations on performance measurement

SUBMISSION TO REVIEW OF YOUR FUTURE, YOUR SUPER MEASURES

About UniSuper

UniSuper is one of Australia's largest super funds with more than 500,000 members and close to $110 billion in funds under management. With a heritage of supporting the higher education and research sector, UniSuper opened its doors to all Australians in July 2021.

UniSuper would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission.

Observations on performance measurement

Treasury is seeking feedback on any unintended consequences or implementation issues from the Your Future, Your Super measures. Our comments focus on the Performance Test and its applicability to products beyond MySuper.

A significant amount has been written by many industry participants on issues with the Performance Test as it is currently designed, much of which is widely accepted and non-controversial. UniSuper agrees with many of these observations that have been made on the Performance Test's design. In this submission, UniSuper suggests changes that could be made to better address the objectives of the YFYS reforms which aimed to increase member engagement, reduce fees, increase investment performance, and hold trustees to account for decisions they make. The views proposed in this submission assume that the core design of the Performance Test cannot be completely replaced or redesigned. Instead, changes to the existing framework are suggested.

Our suggestions include:

- The Performance Test should be retained for MySuper but not extended to other products.
- APRA Heatmaps should be improved to allow "product groupings" (High Growth, Balanced etc) based on a standardised definition of objectives and/or growth defensive splits. This can achieve the goals of identifying underperformance and improving comparability for members
- Should the current Performance Test be expanded beyond MySuper products, there is a key distinction between benchmark aware strategies and benchmark unaware strategies. Therefore, an expanded test should:
    - Include MySuper, Growth, High Growth and Balanced products, as well as single sector options that are benchmark aware; &
    - Exclude any ESG or Conservative products and the retirement-phase
- Regardless of what products are in scope, avoid introducing financial risk measures, such as Sharpe Ratios, which are unhelpful for comparison purposes

Impact to risk taking behaviour from the Performance Test

When it comes to comparing performance between superannuation products, UniSuper fundamentally believes that Strategic Asset Allocation (SAA) is the primary driver of performance. Therefore, performance comparisons should be based on total returns that members receive. "Outperformance" and "underperformance" should be based ideally on a counterfactual question: What investment performance would a member have received in another fund with similar investment objectives and risk profiles?

This is not how the Performance Test is currently designed, being at its core a "relative-to-benchmark" test.

There is a difference between the design of the Performance Test and the outcomes that members receive which creates a tension between the objective of delivering superior investment outcomes for members and the disincentive of failing the Performance Test. The Performance Test incentivises Trustees to become more focussed on taking risk relative to their own SAA instead of taking relative or absolute risk to achieve the most appropriate objective for an option.

In addition, some components of a Trustee's SAA may be either easier to beat or harder to avoid under-performance than others. Trustees are, therefore, incentivised to take different approaches to risk within different components of their SAA or to avoid some investments entirely.

Whether the incentives introduced by the Performance Test start to influence the risk-taking behaviours of Trustees is a question to which UniSuper can only speculate. We would expect any impact on risk taking behaviour to differ between those funds who have a comfortable performance buffer as compared to those who are at risk of failing.

Impact of the indices that are used to calculate the Performance Test

There are some products where no benchmark exists, or relative benchmarking makes little sense. These products are deliberately benchmark-unaware in design and include products such as those with ESG-oriented strategies and those with capital preservation/absolute return focused strategies. ESG-themed products, for example, typically face a constrained investment universe and they do not generally aim to beat general market benchmarks. Retirement products, on the other hand, also face challenges when being benchmarked because they are often focussed on capital preservation strategies. With retirement products, it also has to be recognised that a good retirement strategy is more than the sum of its parts. The Retirement Income Covenant legislation recognises that there are competing objectives for retirement strategies, including investment risk, inflation risk and longevity risk. The RIC is likely to encourage retirement strategy and product innovation. Taking a view that all performance must be benchmark aware undermines this recent and important initiative.

For those products where no benchmark exists or makes sense, we are concerned that extending the Performance Test to these products would incentivise Trustees to fundamentally change their approach to managing the investment strategy to become more benchmark aware. This is likely to be counter to the objectives of the product and therefore to the members who have made the choice to invest in those products.

Over time we expect that Trustees will face continued challenges for any investment products which are in scope of the Performance Test and are benchmark-unaware. This may lead to a rationalisation of existing products and a decline in innovation in these areas. With both ESG products and retirement products in need of further innovation, including products of this nature in the definition of a Trustee Directed Product is undesirable.

We suggest that there are other ways to identify underperforming and expensive retirement products, such as further work undertaken by APRA to identify high fee products.

Consequences from the current implementation of the Performance Test

The Performance Test's focus has been squarely on underperforming funds. After two years, the Performance Test appears to be having a meaningful impact on those Funds who had a MySuper product that was identified as underperforming. This has led to several superannuation funds exiting the market.

UniSuper, as a fund with a strong track-record of performance, has seen increased rollovers from underperforming funds around the performance test cycle. We are confident that we can deliver good long-term returns to these new members.

In future years, should other products become in scope for the Performance Test, we anticipate that the reputation risks associated with having *any* product fail the Performance Test will incentivise Trustees to rationalise the number of investment products which they offer to members to reduce the risk of being identified as a fund with a failing product.

In addition, we anticipate confusion from members between an underperforming product and an underperforming fund. Many members of UniSuper have their superannuation spread across many different products. We expect this to be confusing to members should we find ourselves with one product that has been identified as failing, while the other products remain strong performers. The member's overall outcome may likely still be quite positive and yet they will receive a letter saying they are in an underperforming product.

Products covered by the Performance Test

Given the compulsory nature of superannuation, and the fact that people in MySuper products are overwhelmingly defaulted into those products, we agree with a policy of applying a Performance Test to default, MySuper, products. The current test is based on a “right to remain” proposal of the Productivity Commission further refined by APRA in its Heatmaps.

We accept that the current methodology applied to MySuper products is likely to be an ongoing feature of the super system and the “right to remain” test applied appropriately.

As outlined above when discussing the impact of the benchmarks applied, we consider it to be inappropriate for the Performance Test to be applied to ESG, capital preservation/absolute return or other benchmark-unaware strategies.

The relative-to-benchmark approach adopted by the Performance Test also has merit for those investment products designed to deliver - or outperform - an investable benchmark. The Performance Test is, therefore, suited to also assess single sector investment products such as Australian Shares, International Shares and Listed Property.

We need to be careful, however, before extending the current Performance Test to *all* products.

Given the limited applicability of the Performance Test outside of MySuper products and single sector, benchmark aware strategies, we suggest that the Performance Test remain applicable to MySuper products only, with other measures implemented to achieve the goals of the YFYS reforms.

Achieving the objectives of the YFYS reforms

To achieve the objectives of the YFYS reforms, we consider that performance measures that are “relative to peers” rather than “relative to benchmark” are most appropriate. The Your Super comparison tool provides a suitable mechanism for such comparisons to be made.

Any “relative to peers” based approach will require standardisation before it can be implemented, and with that standardisation also offers significant consumer benefits. Formalising standardised labelling of investment options gives members the information they need to make informed investment decisions. ASIC has recently released an Information Sheet on promoting sustainability-related products, noting that without this information, confidence in the market for sustainability-related products can be jeopardised.

This concept of standardised labelling (“true to label”) applies more broadly to other investment options. In recent years, APRA has worked closely with industry to develop standardised classifications for comparing similar products. The work to standardise definitions of growth/defensive assets provides the simplest and most effective basis for comparing similar products. Making comparisons based on classifications that are more granular than growth and defensive will further complicate disclosures to members and will impede the ability for members to make informed decisions when making comparisons between Funds.

Once developed, the performance of superannuation products should be compared and disclosed against similar products across industry (where they exist) and Trustees must ensure that relevant disclosures are provided to members who elect to invest in these products. Over time, if APRA data reveals that there are repeat underperformers, a rigorous metric, similar to the 50bp pass/fail test for the Performance Test of benchmarkable products, could be considered.

Additional metrics and functionality to the Your Super Comparison Tool

In our above response to Treasury’s question on the effect of the performance test methodology on risk-taking, we highlight that the test already incentivises funds to increasingly shift the focus of risk management in their MySuper products.

We would caution against the introduction of any new metrics which look to standardise risk-profiles across different products as we believe this would create other, potentially significant, distortions to the incentives on risk-taking behaviour.

The challenge of objective peer-relative measurement is what constitutes a fund with a similar risk profile. Risk is inherently difficult to quantify. Volatility is often used as a measure, but predominantly because it is observable. It is due to its observability that volatility is often the basis of most risk metrics. Volatility, however, has many flaws when making comparisons across different investment products. Notably, volatility treats upside and downside performance equally and is unduly influenced by pricing frequency.

This latter challenge of comparing volatility is particularly applicable for diversified investment products which can invest in both listed and unlisted assets. Products that contain unlisted assets will have significantly lower volatility due to their pricing frequency. Therefore, any risk metric for a fund with high unlisted assets would give members the impression that the product contained less risk. Additionally, APRA has recently highlighted concerns with the way in which many funds have valued their holdings of some unlisted assets. Introducing a risk metric creates further incentive for funds to adopt valuation practices that smooth performance but at the cost of member equity.

As we highlight in the section above on achieving the objectives of the YFYS reforms, we believe there is a better solution for Treasury to objectively measure fund's peer-relative returns. It is current practice across the superannuation industry for product groupings to be done based on the growth/defensive split of asset allocation and we hold the opinion that this basis remains the most appropriate. This approach also has its flaws as a risk-grouping approach, but it is far superior to volatility. This approach still achieves the two key objectives of: standardising the risk profile of products within the grouping of alternative products a member could have selected; and clearly identifying products that are the worst in that grouping at growing members' retirement balances.

As before, not all products have a peer-relative performance objective. We would not recommend peer relative measures be applied to ESG products or capital preservation/absolute return strategies. Instead, we believe that funds must ensure that relevant disclosures are provided to members who elect to invest in these products that do not have a peer relative objective and as such not subject to the Your Super comparison tool framework.