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Current Your Future Your Super Performance Test

The over-arching objective of the Your Future Your Super Performance Test (the Performance Test) is to improve retirement outcomes over the medium to long term. The current Performance Test approach has the following issues, which are likely to materially impede its effectiveness.

- Failure of the Test can have dramatic implications for the members of a superannuation fund. Reflecting this, the determination of failure should ideally be based on a holistic assessment of the product and provider. That is currently not the case. Pass or fail is determined by a single metric that is a very partial measure of suitability.
    - The Test excludes the return related to the product's Strategic Asset Allocation (SAA). It is not clear why this should be excluded as it is often a large part of the return and the SAA is a very important part of portfolio design.
        - For example, a MySuper product could target a similar level of overall portfolio risk to other products through a higher SAA weighting to equities but with lower beta equity exposure. The Test would result in a structural component of underperformance for such a product because it does not take a holistic approach (i.e. it captures the impact of the lower beta equity exposure versus the respective YFYS benchmarks but not the SAA design).
        - Excluding the SAA return also creates an incentive for superannuation funds to "game" their SAA through selecting a low returning set of asset class exposures (e.g. including a high cash weighting) to the potential detriment of investment outcomes.
    - The Test is backward looking and does not consider the "quality" of the organisation providing the product. Ironically, members are generally told that past performance may not be a good indicator of future performance, but not in this instance where the Performance Test framework is based on past performance being a good indicator of future performance.
    - The Test does not recognise whether a product is achieving its objectives.
- The probability of a product failing the test, even if it is well designed, is not immaterial. High-level modelling suggests that the probability for a well-designed product over a given eight-year period could be in the 5% to 20% range, with this probability rising with successive eight-year periods.
    - Over time, there are likely to be increasing numbers of higher quality products that fail the test, just due to the vagaries of markets. This would be to the detriment of the depth and quality of the industry.
    - As the implications of failure of the Test may be profound for a superannuation fund's members, there is an incentive for a superannuation fund to take less active risk (versus the YFYS benchmarks) to reduce the chance of failure, potentially to the detriment of long-term performance.
- The Test discourages investment innovation. Application of the Performance Test requires a wide range of benchmarks to measure performance. For traditional asset classes such as Australian Equites, reasonable benchmarks are available. However, for some unlisted asset classes and niche strategies, well-aligned benchmarks are unavailable resulting in higher basis risk or the basis risk is high for some unlisted strategies that have reasonable benchmarks (e.g. infrastructure). This leads to less incentive to invest in these alternative strategies, potentially to the detriment of investment outcomes. For example, this could be the case for affordable housing.

Proposed Alternative Approach

We believe that an alternative approach would provide better retirement outcomes. Our proposed approach involves:

- Displaying the 8-year <u>total</u> annualised net return of a product and its ranking (within its product cohort) on the ATO website. The bottom 10% would be highlighted.

- Each year, the bottom 10% of the products would be reviewed by APRA, which would also include a detailed review of the product provider to determine if its quality is sufficiently high. Some aspects of the current heatmap may be useful for this purpose. If quality is not sufficiently high, APRA would indicate the areas that need to be addressed and review the organisation again in a year's time. If unsuccessful, APRA would consider a range of solutions including close the fund to contributions and requiring merger but not limited to these. A qualitative assessment is vital as no prescriptive test will appropriately cover all circumstances.

    - Governance is a key focus of APRA in this alternative model. In that context, it would be critical that the regulator has the appropriate culture and resourcing.

- The cohort for each product would be determined by APRA and would be based on the key attributes of the product (particularly risk). For example, the MySuper products would form one cohort.

The main advantages of the proposed approach would be better retirement outcomes as:

- The quality of the suite of products available to consumers should be higher as a result of:

    - Better basis for determining product suitability through the total return of the product being captured in the performance test.

    - Enhanced quality of superannuation funds reflecting:

        - Competitive pressures as a result of transparency of relative long-term returns;
        - APRA assessments of underperforming funds encouraging funds to improve quality; and
        - Pressure on low quality superannuation funds to merge.

    - More optimal appetite for building strong portfolios for members including active risk taking by high quality super funds because the implications of poor performance are lessened through the APRA quality assessment.

    - Greater incentive for investment innovation.

    - Less complexity allowing greater focus on achieving investment objectives and performing better than peers.

Yours faithfully

Michael Wyrsch
Chief Investment Officer