YFYS Review

SUPERRATINGS' SUBMISSION

10 | 2022

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01 Executive Summary

SuperRatings and Lonsec would like to thank Treasury for providing us with the opportunity to comment on the Your Future, Your Super (YFYS) Consultation Paper, which was released in September 2022.

SuperRatings, which forms part of the Lonsec Group, is a research and consulting firm that has been assessing and rating superannuation funds and products for 20 years. Given SuperRatings' background in superannuation, benchmarking and analysis, we believe we are well placed to provide input into the YFYS Review. Overall, we support the steps Treasury and APRA are taking to support better member outcomes through improved reporting, transparency and product comparisons of superannuation providers across the industry.

However, we believe there are key areas where the approach to assessing and comparing performance could be improved and also material challenges which should be considered as part of any extension of the performance test.

Through our reviews of the market, it is clear that the test is impacting funds' behaviour. It is increasing the level of analysis and reporting funds are undertaking to monitor their portfolios. While this has clear benefits, it is also increasing the awareness of tracking error relative to the test's benchmark indices, and the need to track and minimise this. Relatedly, there is a reduction in the willingness and ability to engage in Tactical Asset Allocation and Dynamic Asset Allocation to either enhance performance or minimise impacts due to short-term and volatility related market movements, as this may then have a detrimental effect on the fund's outcome relative to the performance test's methodology. This reduction in willingness may be in conflict with members' objectives for monies held in these investment options.

Furthermore, the current set of indices has the potential to distort investment decisions as well as reduce choice for members. We have seen a material slimming of funds' investment menus to date. Overall, this has provided a stronger floor to support the quality of investment options in the market; however, it has also been problematic for a number of ESG, retirement-focused and tailored investment options that fundamentally have a purpose that is valid but not able to be appropriately aligned with the test in its current form.

While the test could be expanded to a broader range of Trustee Directed Products, including single sector options, the fundamental challenge of a single quantitative metric to solve the challenges of member outcomes is fraught. This would likely require an additional overlay, which could be as simple as how well the option performs against an appropriate peer group or its stated investment objective, but then makes it harder to have a bright line test. It would also ignore that superannuation outcomes are more than simply returns and fees. Specifically, high-quality member aligned advice and member engagement add to member outcomes in a way that is not factored into the test.

In relation to retirement/decumulation products SuperRatings does not consider expansion of the existing test to be appropriate. This is due to the differences in the nature and objectives of these products which are based on the unique needs of retirees, as highlighted in the Retirement Income Covenant, such as the need to draw an income from the investment, minimise investment risks and account for longevity concerns.

Accordingly, it is challenging to see how a single quantitative test may apply to all products. It would supply greater transparency for Choice options but would require a broader overlay to provide a workable solution across all investment options in the market.

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Once again, SuperRatings would like to thank Treasury for the opportunity to prepare a submission to the YFYS Review and we would be happy to discuss any aspect of this submission further, as required.

Please feel free to contact any of the following SuperRatings team members should you have any questions or require further information:

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02 About SuperRatings

SuperRatings is part of the Lonsec Group which provides financial advisers, fund managers and superannuation funds with practical, actionable insights that add real value to their investment and advice solutions.

SuperRatings focuses on superannuation research and consulting services providing data analysis, information, bespoke services and product benchmarking to the superannuation industry, corporate sector and the general public. SuperRatings prides itself on providing impartial advice to funds and employers, therefore our ratings methodology includes all superannuation funds and we limit the ratings percentile bands of funds to ensure our assessment remains independent.

We actively promote engagement, education and understanding of superannuation through the provision of:

- Research analysis;
- Ratings;
- Consultancy services;
- Product reviews;
- Benchmarking; and
- Thought leadership.

Since its inception, SuperRatings has comprehensively reviewed hundreds of Australia's superannuation funds and service providers. SuperRatings currently maintains detailed information in respect of almost 530 superannuation products, incorporating 80 MySuper products, 279 choice products and 170 pension products which are all housed within our in-house proprietary database, SMART.

We believe we offer the most extensive industry coverage accounting for over $1.7 trillion in funds under management and over 28 million member accounts. This allows us to understand the various costs, fees, products, services and performance of superannuation funds and benchmark these against the broader market.

03 Responses to Consultation Questions

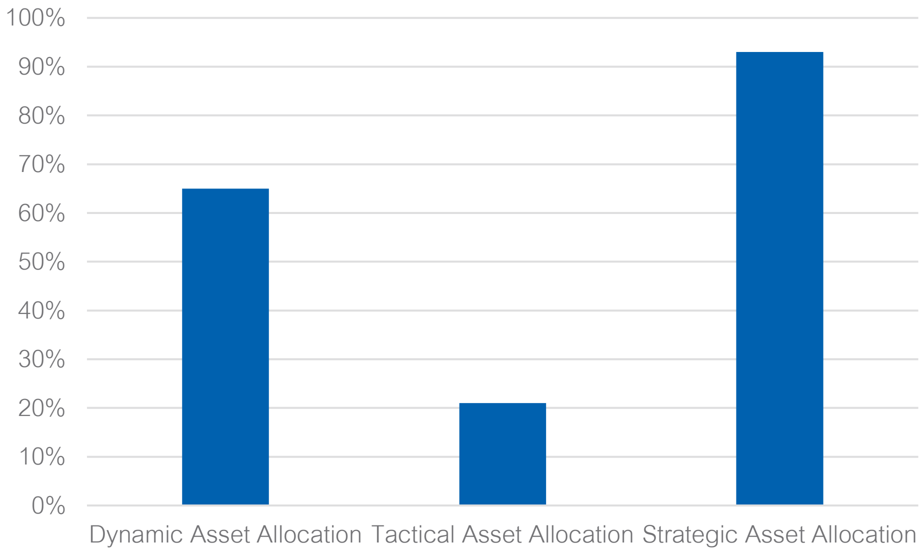
3.1 Test Methodology

Question One

Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Funds set the Strategic Asset Allocation (SAA) as an indication of the long-term asset allocation for a given investment option. However, a significant portion of funds engage in Dynamic Asset Allocation (DAA) and around one fifth of providers use Tactical Asset Allocation (TAA), as shown in the chart below. We note that where superannuation funds do not undertake SAA themselves this is outsourced to an asset consultant.

Asset Allocation Processes Employed by Superannuation Funds – 30 June 2022



Source: SuperRatings' Annual Request for Information from Superannuation Funds 2022

It is currently too early to provide robust industry level insights into this area; however, our discussions with funds suggest that the test has a significant impact on funds' approaches to their portfolio design. Relatedly, there is less impetus to engage in TAA and DAA to either enhance performance or minimise impacts due to short-term and volatility related market movements, as this may then have a detrimental effect on the outcome relative to the performance test's methodology.

While we are yet to see extreme cases emerge, this could potentially result in a worse outcome for members if a fund forgoes a potential lucrative opportunity it identifies through the TAA or DAA processes.

Question Two

Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

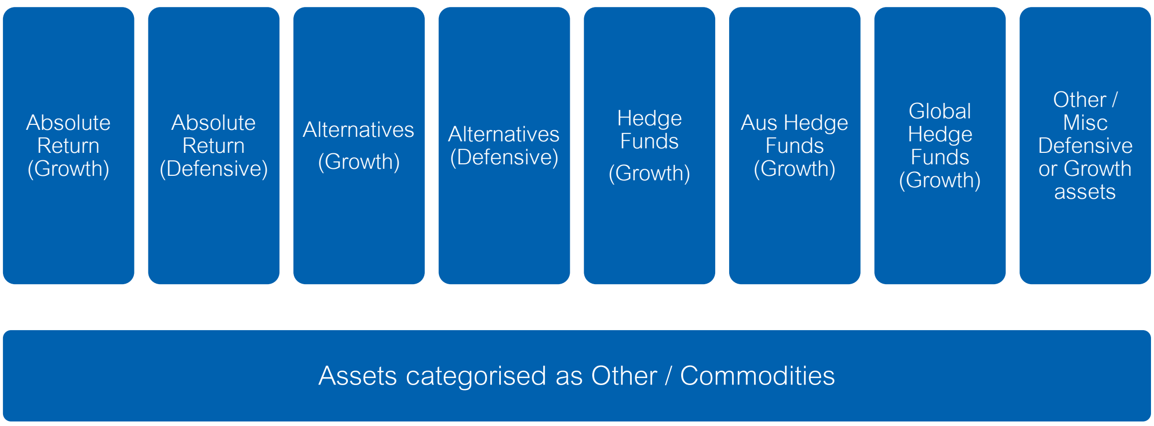
We believe that the current set of indices does have the potential to distort investment decisions and also reduce choice for members. Some key areas where challenges exist are those relating to unlisted infrastructure and unlisted property investments, as well as investment strategies with additional objectives beyond returns such as ESG and sustainable investment strategies.

The current benchmark indices used to represent these asset classes are narrow considering the wide range of unlisted assets super funds invest in and also the varying structures used to execute the arrangements, from co-investment partnership approaches to fund-of-fund structures, which have a considerable impact on the associated fees and net returns derived.

Unlisted investments also vary greatly in terms of the level of funds under management deployed, nature of the associated cash flows, industry, geographic location and perceived riskiness of the investment. Therefore, a fund's unlisted infrastructure portfolio could contain assets which differ materially in terms of one or more of these features relative to the 21 funds in the MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) and/or 17 funds in the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index as at June 2022. Essentially, the current benchmark index classifications for unlisted property and infrastructure may be too narrow to represent funds' portfolios.

Furthermore, the Other category can vary widely in terms of the types of assets that funds are investing in, as shown in the chart below. Moreover, the nature of these strategies, as well as the varying growth/defensive characteristics of these investments further challenges the accuracy of the assesment of this category. Exposures to the Other category range up to a maximum of 15% for MySuper products and 36% for Choice products, therefore the assessment of this category may have a material impact on a fund's test outcome.

Asset Classifications



Source: SuperRatings' SMART Database

In terms of ESG and sustainable investments the current set of benchmark indices does not take into account the nuances of standalone strategies or those which incorporate ethical screens into the investment process across existing investment options. We have already seen the closure of some investment options in this area. As a result, extended application of this test over time without at least a qualitative overlay of the performance test's results would see a reduction in the types of investment options available to members. While in some instances, the closure and rationalisation of options provided a member benefit, we do not believe it is clear that this holds in all cases.

Question Three

Does the calculation of actual RAFE and benchmark RAFE discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?

The current performance test's focus on performance and fees alone is likely to constrain innovation and investment within non-investment performance related product features. The use of a single quantitative metric needs to be considered against the desire to have more Australians engage with their super over time. Greater engagement is likely to result in the exercise of greater choice and this may be constrained by the test. As an example, some funds offer tailored insurance arrangements, particularly where a company has arranged a corporate plan, and changing funds on the basis of performance alone could potentially result in a member losing access to cover they are unable to obtain elsewhere.

Essentially, the concept of how better retirement outcomes is being defined needs to be considered, what is the measurement of success? Again there is unlikely to be one single measure, particularly in retirement as exemplified by retirement income strategies. Higher investment fees can drive better net benefit outcomes through investment in alternative assets and active management, while higher product fees (within reason) that are associated with strong advice offerings can drive better net benefit outcomes for members accessing these services and tailoring their superannuation to suit their needs, particularly in terms of their risk profile. Insurance to support longevity protection or downside protection also provide benefits for some and would need to be considered.

Question Four

What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

While benchmarking is important, if the existing framework were expanded to analysis of all TDPs in its current form, it could lead to significant unintended consequences. There would likely be a lower ability to innovate over time without increasing the risk of failure. Additionally, we expect to see an increased used of passive investment as funds will be limited in their willingness and ability to tolerate tracking error which is key to maximising the probability of meeting the test over time.

3.2 Product Coverage

Question Eight

Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

SuperRatings has replicated the performance test across the full range of products in the market using our Performance Test iQ analytics tool. The table below summarises the proportion of products estimated to pass across investment option types as at 30 June 2022. The estimated results show that Balanced options performed the best out of all option types assessed with 93% of Balanced options estimated to pass the test. As most Australians are invested in Balanced options the strong performance of this category should be reassuring for many fund members.

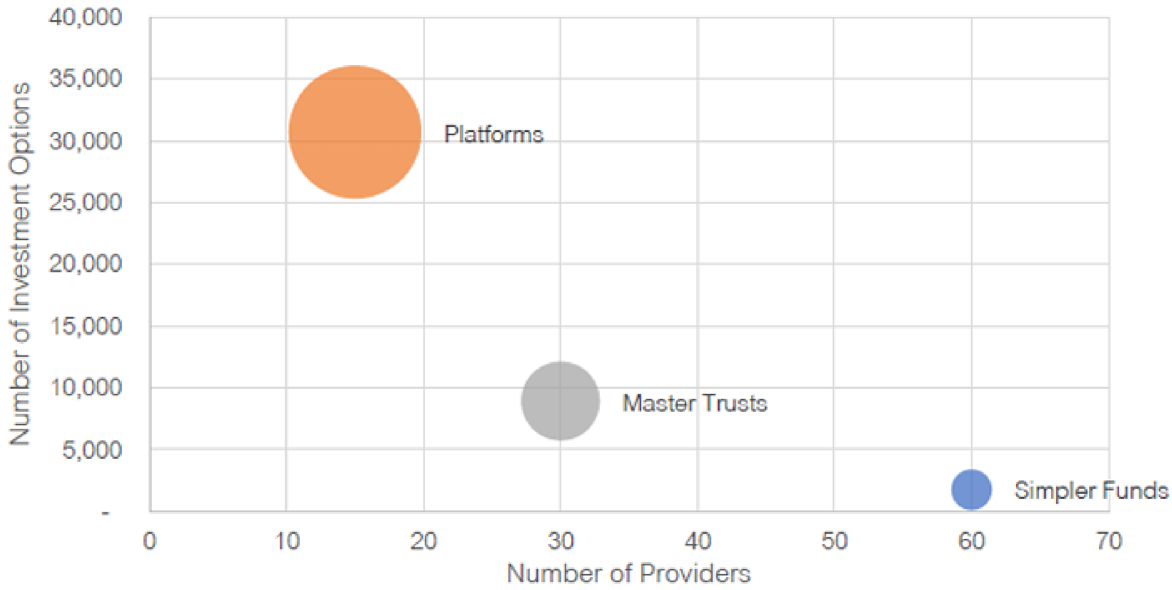
OPTION TYPE	% ESTIMATED TO PASS JUNE 2022
CAPITAL STABLE (20-40)	88%
CONSERVATIVE BALANCED (41-59)	91%
BALANCED (60-76)	93%
GROWTH (77-90)	92%
HIGH GROWTH (91-100)	85%

Source: SuperRatings Performance Test iQ Analytics Tool

Furthermore, in developing the above analysis we identified three key areas of concern:

1. The current definition of a TDP requires clarification. We believe that there is not a clear and consistent definition of a TDP that is understood by, and applied across, the industry. If a common understanding doesn't exist within the industry, it has the potential to amplify confusion amongst members. We believe that the definition should be made as simple and consistent as possible to ensure all investment options intended to be captured as a TDP are. Overall, we believe the intent of the test is to set a minimum quality benchmark, we would wish to see the test applied across accumulation options as appropriate. The chart on the next page highlights the number of investment options available across the market. We believe the potential for options to be excluded from the test via carve outs should be avoided wherever possible to ensure that consumers can have confidence that the quality filter being applied is system wide. Particularly since there is significant variation in the asset allocation and stated objectives of the investment options offered by different superannuation providers.

Number of Investment Options in the Market – 30 June 2021



Source: APRA Annual Fund-Level Superannuation Statistics, 30 June 2021

2. As mentioned in our response to question two, the type and number of asset classes funds invest in through TDPs is broader than in MySuper products. We would recommend consideration of the appropriateness of the current range of asset classes used in the test, with additional asset classes likely to be required to reflect the diversity of investments available in TDPs. This would need to be offset against the complexity and cost of monitoring the test outcomes.
3. There is some evidence that options with objectives that take into consideration aspects of investment other than return, for example ESG/Sustainable options or options focusing on risk reduction, are being removed from the market due to issues aligning their approach to existing benchmarks. The expanded test would most likely need to include some form of additional consideration or overlay to account for these factors.

Question Nine

What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

We would expect that extending the performance test to single sector products would have limited impact in the majority of cases. In relation to retirement products SuperRatings does not consider expansion of the existing test to be appropriate. This is due to the differences in the nature and objectives of retirement products which are based on the unique needs of retirees, as highlighted in the Retirement Income Covenant, such as the need to draw an income from the investment, minimise investment risks and account for longevity concerns. We believe that any test of retirement products would need to account for these factors.

A further challenge may exist here if an adviser meeting their best interests duty deemed a strategy appropriate for their client; however, this could conflict with the investment option's test outcome. Accordingly, there would need to be a pathway for product issuers and these members to be supported towards an appropriate outcome, which may include remaining within the option, should the investment option recommended fail the test. If this option is terminated and the assets removed by the provider, due to the probability that it will fail the test, there could be a secondary set of issues with members then needing to access support to resolve this issue.

3.3 YFYS Comparison Tool

Question Ten

Does the comparison tool adequately inform members and prompt a behavioural response? Is the tool effective at informing new employees of their options when entering the workforce, including those who do not have an existing superannuation account?

We believe the comparison tool is a well-intended start to inform members and new employees of their options. However, the focus on investment performance alone without consideration of the associated risk of the investment options displayed could lead to misinformed behavioural responses.

Furthermore, the tool does not consider insurance or corporate funds' offerings, which often result in discounted fees and tailored insurance for employees. If a member were to switch out of their existing provider due to viewing the YFYS comparison tool and seeing their provider sitting less favourably across the universe they could actually be placing themselves in a worse off position, if they then forego the beneficial arrangements their employer had negotiated with their fund.

Question Eleven

To what extent would altered or additional metrics, or improved functionality, make the tool more effective while ensuring it remains simple and clear? What more can be done to ensure that new employees are able to choose high-performing superannuation product that are appropriate for their needs?

The most glaring omission in terms of a metric we believe is a risk related component, particularly given the future outlook for investment markets which will be lower for longer returns and ongoing volatility.

Other information relating to the products such as the insurance available and whether the fund offers tailored features for certain employers would assist members in deciding whether to act on the information being displayed by the comparison tool.

Question Twelve

As the test is applied to more superannuation products, should the comparison tool also be extended? Considering the volume and complexity of Choice products, how could the tool be extended in a way that is meaningful and digestible to members?

We do not believe an extension of the current tool to Choice products is appropriate as members who use Choice products are more likely to be acting on a wider variety of factors. Due to the variety and complexity of these products, displaying the information without further support and insights could be problematic. Focusing on improving the current tool and ensuring it is appropriate for MySuper offerings would support new employees who do not have other support in this area.