A pathway forward for super funds and investment managers under the Your Future, Your Super performance test

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David Bell
Introduction

• A performance test included as part of the Your Future, Your Super (YFYS) reforms has proven controversial and disruptive
• This presentation considers the pathway forward for super funds and investment managers

• Full papers available:
  1. Moving forward with YFYS: Super funds
  2. Moving forward with YFYS: Investment managers
The YFYS reform package:
1. Addressing Underperformance in Superannuation: performance test
2. Single Default Account: “your super fund follows you through life”
3. Improving Accountability and Member Outcomes: range of measures
Background on YFYS Performance Test

<table>
<thead>
<tr>
<th>Test</th>
<th>Result</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual performance test (rolling 8yr)</td>
<td>Pass</td>
<td>No change</td>
</tr>
<tr>
<td></td>
<td>Fail (1st time)</td>
<td>Letter to members</td>
</tr>
<tr>
<td></td>
<td>Fail (2nd or more consecutive fail)</td>
<td>Letter to members + no new members allowed</td>
</tr>
</tbody>
</table>
Background on YFYS

Step 1 – Determine tailored performance test benchmark

- Strategic asset allocation (SAA)
  - Map to YFYS benchmarks
  - Fund-specific SAA benchmark for the year

Step 2 – Calculate annual performance (before admin fees)

- Fund performance
  - Performance of fund-specific SAA benchmark

Step 3 – Calculate final year administration fees

- Fund administration fees
  - Industry median administration fee

Step 4 – Calculate annual total performance

- Investment minus administration fees
  - Fund SAA b’mark perf. – industry median admin fee

Step 5 – Calculate 8yr annualized performance test result

- 8yr annualised fund outcome (based off Step 4)
  - 8yr adjusted b’mark outcome (based off Step 4)

Additional notes:
- Test will be administered by APRA
- Pass mark is >-50bp pa
Adjustment period

- Reassess Business Model
- Investment Governance Excellence
  - Review Investment Model
  - Investment Management Model
  - SAA Reporting
  - ESG Integration
Investment governance excellence

Standout characteristics:
• High-quality investment committee / board with practical and technical experience
• Strong working relationship between CIO and the governance structure
• Agreed tolerance for likelihood of failing the performance test
• Agreed framework for trading-off the maximisation of member outcomes against the likelihood of failing the performance test
• Ensure that activities not captured by YFYS performance test continue to be assessed and reviewed
Investment management model

1. Traditional SAA
   - Universe: aligns with YFYS sectors and benchmarks.
   - Implementation focus: controlled tracking error within sectors.
   - Main portfolio management levers: implementation (moderate) and asset allocation decisions across sectors.
   - YFYS-benchmarked, low tracking error and low-cost implementation strategies are likely to feature.

2. Advanced SAA
   - Universe: broader than just YFYS sectors.
   - Implementation focus: flexible, enabled by advanced operational and risk management which facilitates aggregated reporting on a YFYS basis (assets, scaled for YFYS benchmarks).
   - Main portfolio management levers: asset allocation and implementation.

3. TPA
   - Universe: unrestricted, managed at a portfolio level.
   - Implementation focus: flexible, enabled by advanced operational and risk management which facilitates aggregated reporting on a YFYS basis (assets, scaled for YFYS benchmarks).
   - Main portfolio management levers: integrated asset allocation and implementation.
SAA reporting

Performance of:

Strategic Asset Allocation (SAA)
(Based on YFYS sectors / benchmarks)

versus

Performance of:

Implemented Portfolio

Challenge 1: SAA timeframe not defined.

Challenge 2: Reporting product rather than asset class exposure.

Challenge 3: Reporting through lens of YFYS benchmarks.

YFYS Performance Result

= Noise + ‘True’ Implementation Performance
SAA reporting

Addressing the challenges:

- Challenge 1: shorter timeframe SAA, updated regularly, maybe other AA definitions
- Challenge 2: look-through SAA reporting (account for strategies such as alternatives)
- Challenge 3: risk-scaled SAA reporting (in ‘units’ of stated index exposures)
Managing portfolio risk

• Challenges:
  • Less diversification opportunities
  • Penalised for managing risk within sectors
  • Dedicated risk management strategies heavily penalized

• Solutions:
  • Potentially greater market timing
## ESG / Sustainability / Climate Risk

<table>
<thead>
<tr>
<th>Impact Investing</th>
<th>Opportunistic Investing</th>
<th>Exclusions</th>
<th>Engagement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumed to be in private markets.</td>
<td>Assumed to be in liquid markets.</td>
<td>Can introduce significant tracking error if applied in a coarse manner.</td>
<td>Supplement implemented investment strategy with a range of engagement strategies.</td>
</tr>
<tr>
<td>Introduces significant tracking error into the portfolio.</td>
<td>Introduces tracking error, but this can be measured and controlled.</td>
<td>Quantitative techniques can be applied to limit tracking error impact.</td>
<td>Likely to remain commonplace.</td>
</tr>
<tr>
<td>Potential for J-curve effect if unlisted.</td>
<td>Likely to be small scale.</td>
<td>Likely to remain a practice for small components of benchmark.</td>
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The post-YFYS super fund

Review Investment Model
- Quality IC
- Resolved trade-off between member outcomes and performance test
- Supporting technology, data and processes

Investment Governance Excellence

Reassess Business Model
- Defined business strategy
- Clear net inflow expectations
- Informed maximum allocation to illiquid assets

Investment Management Model
- Traditional SAA
- Advanced SAA
- TPA
- Additional considerations:
  - Risk management techniques
  - Market timing

SAA Reporting
- Internally resolved on:
  - YFYS SAA timeframe
  - Look-through exposures
  - Risk-adjustment to YFYS benchmark units

ESG Integration
- Approach to:
  - Impact investing
  - Opportunistic investing
  - Exclusions
  - Engagement
Impact on investment managers

Reassess business model
- Does your business model need to be revised given the impact of YFYS on super funds?

Active management
- The case for active management needs to be re-framed and stated strongly.

Understand your clients
- Understand your super fund clients through a YFYS performance test lens.

Opportunities
- There will be a range of opportunities for investment managers.
Considerations

From a business model perspective:
- Super funds: consolidation, internalization and fee pressure
- Super funds: reduced allocations to sectors which incur high tracking error against YFYS benchmarks

<table>
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<tr>
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<th>Active Risk to Stated Benchmark</th>
<th>YFYS Benchmark Risk</th>
<th>Total Gross Risk (YFYS Benchmark)</th>
<th>Total Net Risk (YFYS Benchmark)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active Large Caps</td>
<td>3%</td>
<td>0%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Active Small Caps</td>
<td>3%</td>
<td>6%</td>
<td>9%</td>
<td>6.7%</td>
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</tbody>
</table>
Summary

Super funds
• Significant challenges ahead and another 12 months for the “dust to settle”
• Consolidation a certainty
• Investment practices less clear

Investment managers
• Further challenges ahead and not all will survive
Welcome your questions and feedback

David Bell
Executive Director
The Conexus Institute
https://theconexusinstitute.org.au/
P: +61 417 431 624
E: david.bell@theconexusinstitute.org.au
Level 16, 333 George St, Sydney