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Please see an attached submission in respect of the *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Addressing underperformance in superannuation.*

Yours sincerely,

On behalf of the names of the individuals listed below.

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|---|---|
| Rosemary Kelly | Director and Chair of Investment Committee, **Aware Super** |
| Stephen Dunne | Director and Chair of Investment Committee, **CBUS** |
| Mark Burgess | Independent Director and Chair of Investment Committee, **HESTA** |
| Don Luke | Chair, **QSuper** |
| Ken Marshman | Independent Director, Chair, and Chair of Investment Committee, **Rest Super** |
| Michael Traill | Independent Director and Chair of Investment Committee, **SunSuper** |

Any further correspondence should be directed to either of the following:

Michael Traill
[redacted]

Ken Marshman
[redacted]

## A Submission in regard to the *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Addressing underperformance in superannuation.*

### Our Background – Who we are

The signatories to this Submission are all Chairs of Investment Committees and/or Chairs of major superannuation funds in Australia. The total number of members of our associated superannuation funds exceeds 6.5 million Australians. The total quantum of assets under management is approximately $500 billion.

We understand that our respective superannuation funds have provided separate submissions to Treasury. This Submission does not and is not intended to contradict or counter any of the matters that have been raised by each of these superannuation funds individually, even though the emphasis may be different. In that light, this should be seen as an independent submission, read in its own context.

Each of the signatories to this Submission come to this matter from an investment perspective. As Chairs/Chairs of Investment Committees, we are committed to maximizing the investment returns for the superannuation funds for whom we work and for the members of those superannuation funds. We also have a strong vested interest in the success of Australia as a place in which to invest.

Our backgrounds are diverse, but almost exclusively each of us has had multiple decades of experience in the investment industry and in the private sector. Our Submission has been informed by this private sector investment experience in areas such as private industry, commercial banking, investment banking and advisory, investments, investment consulting and in the financial services industry.

Particularly, we understand the nature of investment markets and that they are largely unpredictable and uncontrollable. While it is desirable to have a clearly defined performance test, it is important that the test is sufficiently robust to withstand the vagaries of markets, and not deliver outcomes which were never thought possible in the first place.

### Issues with the proposed legislation

There has been considerable public discussion about some of the practical and technical difficulties of the proposed performance test, and we do not intend to repeat that discussion here. That is not the purpose of this Submission. That said, we believe that many of the points made publicly are valid and should be addressed before the final Bill is brought before Parliament.

The key issues from **an investment perspective** that we see are set out below:

#### 1 Best performance in investments

It is our experience that the strongest long-term investment outcomes come from a combination of a fund having clear long-term investment objectives, discipline in applying a particular set of investment beliefs, a focus on fees and costs, and a willingness to be different at times from the market or other market participants.

The Future Fund is one example of an investment fund which has generated sound returns for Australia by adopting this approach.

The proposed performance test is not consistent with these fundamental tenets of strong investing. In particular, the test encourages an investment approach which is not sufficiently long-term in nature, and which discourages taking positions and views which are fundamentally different from the market in general.

In our view, this will be detrimental for funds' returns and the returns for their members. The potential consequences could be very large, and could also be systemic in nature.

We also point out that the measure of investment returns proposed is net of investment fees, and does not take into account administration fees. This has the potential to mask the impact of high administration fees charged by some funds on members' net returns.[1] We consider that net returns to members, net of ALL fees, including administration fees, should be the measure used in the proposed performance test.

## 2 Nation Building Investments

The proposed Bill disincentivises investment in Nation-building assets and businesses such as agriculture, infrastructure and refinancing of Australian businesses during periods of economic stress (eg COVID-19).

It is hard to see why superannuation funds would risk the differences in timing of returns of these investments when there is less risk (in terms of the test) in simply investing in listed market securities.

## 3 Whole-of-Fund Investing

The principles of the proposed test are based on work done by the Productivity Commission, principles which are based on a "reference portfolio approach" to building investment portfolios. However, there are other approaches to investment than the reference portfolio approach.

Rather than building portfolios by asset classes (as proposed by the Productivity Commission – reference portfolio approach), a Total Portfolio Approach (TPA) is now a widely adopted and strong investment framework. This approach has been adopted by the Future Fund and is now the basis for much investing by the larger superannuation funds in Australia today, as well as by the leading investors globally.

Why is this important? Because today, best practice is to manage risk and return not only through strategic asset allocation, but also through the selection of assets within individual asset classes. For example, a fund may wish to select particularly defensive areas of the equity market at the same time as allocating more risk to the bond sector by investing primarily in credit and non-investment grade rather than government bonds. (Such a strategy would be high risk relative to the proposed performance test.)

None of these complexities is contemplated by the proposed performance test, and would be materially disadvantageous to those funds building portfolios through TPA.

Indeed, the proposed performance test does not take into account the most important determinant of investment outcomes – strategic asset allocation. Rather, it measures just the lesser factors in determining outcomes for members, namely the ability to outperform in particular asset classes as well

[1] The Productivity Commission refers generally to returns net of all fees including investment fees.

as deviations in asset class weightings from the benchmark.  As such, the current test is not really a test of a fund's **overall performance ability** to deliver to promised member outcomes.  It is a test of execution ability, regardless of whether the overall strategy is itself good or poor.

## A SOLUTION FOR CONSIDERATION

We acknowledge the desire of the Government to introduce a performance test that is simple to understand, unambiguous and aligned with the objectives set out by the Productivity Commission.  But the test should not be counter to the fundamental purpose of superannuation, and importantly, should not be counter to the Government's broader goals for the economic development of Australia.

The proposed performance test faces the problem of it being well defined on the one hand, but which is unable to distinguish poorly performing funds (say, because of high fees and bad management on the one hand, or just by the unpredictable nature of markets on the other) from better performing funds.  It also does not distinguish underperformance as a result of risk mitigation versus underperformance as a result of endemic problems within the fund.

It is neither right nor sensible to adversely penalise a fund (and particularly its members) who have underperformed an arbitrary benchmark largely due to the capricious nature of markets, or because of their deliberate risk management strategies.

So how should a performance test properly distinguish between a fund which is inherently sound and has high prospects of being a good long-term performer, and a fund which is by nature very unlikely to deliver strong results?

While it may be possible to build a quantitative model to demonstrate these underlying attributes of what is a good fund and what is not a good fund (say looking at fees, turnover, manager selection, individual asset selection), our view is that such a test would suffer from lack of transparency and from over-complexity.

**This has led us to the strongly presented view that there needs to be a two-stage approach for assessment with a Panel comprised of experienced industry professionals who are collectively impartial but also expert.**

This approach draws on practical precedents drawn from those applied in the Foreign Investment Review Board (FIRB),  TEQSA (Tertiary Education Qualifications Accreditation Agency) and the Takeovers Panel.  These authorities have the common denominator of bringing deep and hard-headed industry experience to the application of policy.

The case for this was well articulated by Justice Kirby as the logic behind the formation of the Takeovers Panel and is referred to on the home page:  "… *it was open to the Federal Parliament to conclude that the nature of takeovers disputes was such that they required, ordinarily, prompt resolution by decision-makers who enjoyed substantial commercial experience and could look not only at the letter of the Corporations Act but also at its spirit, and reach outcomes according to considerations of practicality, policy, economic impact, commercial and market factors and the public interest."*

In the same vein, our view is that a panel comprised of people who have an in depth understanding of the funds management business, the objectives of superannuation and a clear sense of the policy objective of reporting rigorously and independently on performance will be the most effective way of implementing and supporting the objective of implementing the government's policy objectives.

**The proposed two stage process would be as follows:**

> **Stage 1 – Benchmark Test:** We propose that funds be subject to the performance benchmark test along the lines as proposed in the Bill, (amended to account for the matters raised in other public submissions), and that the amended benchmark be used as the **first** hurdle. APRA would have the responsibility for the implementation of this Stage 1 Benchmark Test.
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> **Stage 2 – Independent Assessment:** A **second** hurdle would then apply. Funds that fail the first hurdle would then be required to be assessed by a Panel of industry experts. Its task would be to assess whether the performance identified by the first hurdle could be explained by factors that would be likely to continue to deliver underperformance, and importantly would also make the assessment as to whether performance has met the objectives the fund as communicated to its members. This would be a core consideration of the Panel in assessing a fund.

It seems logical that APRA would be given the responsibility for the selection of the expert Panel and the development of the performance criteria.

The Panel would need to be given clear criteria for assessing funds, with the criteria approved by APRA, and would need to report publicly on the basis of its decisions.

By way of example, criteria for assessing Fund performance could include:

- the appropriateness of the Fund's long-term investment return target and risk profile
- the superannuation fund's expected ability to deliver on the default product's long-term investment return target, given its risk profile
- Strategic and Actual Asset Allocation
- Market conditions impacting returns across asset classes
- The appropriateness of the fees and costs associated with the product, given its stated long-term investment return target and risk profile
- whether the superannuation fund's governance practices are consistent with meeting the best financial interests of members of the fund
- the administrative efficiency of the superannuation fund
- any other matters the Panel considers relevant.

We further suggest it would be appropriate for the Panel, with access to relevant expert input, to advise on the determination of the asset class performance benchmarks, including appropriate unlisted benchmarks, and overall fund performance targets, as part of the first hurdle criteria. These should be clearly articulated and be subject to review to ensure they are fit for purpose.

We wish to make it quite clear that our proposal for a two hurdle approach is not to evade clear accountability. We believe that poor performing funds that do not meet their promise to members should not be entitled to receive funds flow from a government mandated system.

Indeed, the second hurdle will be particularly imposing for those funds that are called before the Panel. No fund would want to get into that position.