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Consultation on Your Future, Your Super reforms

Thank you for the opportunity to comment on the exposure draft legislation published by Treasury to underpin the Government's proposed Your Future, Your Super package.

IFM Investors was established more than 25 years ago by a group of Australian industry superannuation funds to protect and grow the retirement savings of their members by investing in nation-building infrastructure. Today, we invest across four asset classes – infrastructure, debt, listed equities and private equity – on behalf of nearly 500 like-minded pension funds and other institutional investors worldwide. The $148 billion entrusted to us by these investors incorporates the retirement savings of approximately seven million Australians and more than 30 million working people worldwide.[1]

We are Australia's largest infrastructure manager and second largest listed equities manager. IFM is also one of the largest fixed income managers and non-bank lenders in the market, offering a range of income-based options focusing on corporate, consumer and infrastructure debt, bond and cash strategies. We have a strong track record of delivering long-term performance to our investors through market-leading risk-adjusted returns net of fees. This enables the superannuation funds that invest with us to provide greater financial security and a better retirement to their members than would otherwise be the case.

We fully support the policy intent of the Your Future, Your Super reforms to ensure that superannuation fund members are receiving good value for money from their fund. Unfortunately, there are material issues with the proposed design and implementation of the reforms that mean they do not address substantive issues raised by the Productivity Commission in relation to underperformance and governance nor the findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. As a result, these proposals are likely to have consequences that undermine the interests of super fund members and their retirement security.

[1] As at 30 September 2020.

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We have focused below on key issues relating to addressing underperformance and the best financial interests duty.

Addressing underperformance in superannuation

We support the policy intent of the reforms to provide members with better information about performance and to weed out underperforming funds, which can significantly erode members' retirement savings through lower net returns.

The Productivity Commission recommended an enhanced member outcomes test, which was:

- based on the principle of appropriate benchmarking;
- inclusive of all fees and costs, including administration fees; and
- covered all products, including choice products.

In addition, the Productivity Commission recommended that all fees should be tied to a cost recovery mechanism. It is important that the proposed annual performance test mirrors this approach and covers a broad range of super funds, including products identified by the Productivity Commission and APRA as chronic underperformers. It should also reflect outcomes for members net of all fees, including administration fees. This is what is relevant to fund members because it is what is ultimately available to fund their living standards in retirement.

As IFM is not a superannuation fund, we will not be subject to the annual performance test, although the net returns that our investors receive will be incorporated into the aggregate net returns of superannuation products and compared against a composite benchmark based on each product's portfolio asset allocation.

Our concerns about the proposed performance test are similar to those raised by many other industry participants and stakeholders, and relate to:

- the likelihood that the test will improperly assess performance and provide potentially misleading information to superannuation members;
- its failure to assess the performance of trustees for total portfolio asset allocation strategies, despite the choice of asset allocation strategy being the most important driver of returns for members;
- the incentives it creates for trustees to focus on the management of risk and returns relative to the Your Future, Your Super composite benchmark rather than absolute risk and returns to members; and
- the disincentives it creates for investing superannuation savings into real and unlisted assets which deliver returns for fund members and support productivity growth and job creation in Australia.

We have particular concerns about the proposed treatment of unlisted infrastructure in the benchmarking methodology. Unlisted infrastructure investments are an important contributor to

member returns, with Australian super funds collectively having $111.8 billion allocated to infrastructure. More than three quarters of this allocation is in unlisted infrastructure.[2]

Industry (profit-to-member) super funds typically have a higher allocation to infrastructure than other types of funds. IFM invests on behalf of a number of these funds, as well as other Australian and global investors, through two open-ended, pooled funds in Australian and global infrastructure. Together, they represent $65.7 billion in assets under management, equivalent to more than half of all Australian superannuation funds' allocation to the infrastructure asset class.[3] The continued growth in the number of institutions who choose to invest in our infrastructure funds goes to our track record of strong performance.

The use of a listed index – specifically, the FTSE Core Developed Infrastructure Index hedged to AUD (the "FTSE" index), as set out in the 2020-21 Budget documents – is not an appropriate benchmark for unlisted infrastructure. **It will incentivise funds to build higher risk, less well diversified portfolios, and at the same time disincentivise investing in Australia. Such portfolios will be detrimental to outcomes for members, and indeed the country.**

Generally, listed infrastructure indices demonstrate high correlation with broader listed equities portfolios. This makes them poor benchmarks for unlisted infrastructure exposures, which investors often use to diversify a portfolio away from listed market volatility and provide earnings stability and protection from inflation. Unlisted infrastructure exposures also offer investors a premium for control and influence over the way an asset is managed; this is an opportunity to build and sustain value in a way that is very different to a listed index where the underlying components are typically owned by minority interests.

Additionally, the FTSE index has a highly skewed composition, and is unrepresentative of typical diversified unlisted portfolios. By definition, the FTSE index is constrained to those infrastructure sectors and geographies where infrastructure has been listed on a public exchange.

- The FTSE index is **heavily exposed to North American infrastructure** (two-thirds of the index is US-domiciled) whereas infrastructure funds like IFM's typically invest in core assets across the OECD and selectively in other regions. Australian superannuation funds will also tend to favour Australian infrastructure, given it delivers long-term returns in excess of Australian inflation, which is most relevant to the saving needs of members. **Listed Australian infrastructure contributes just 2.7 per cent to the FTSE index**. The use of the FTSE index will encourage superannuation funds to invest offshore, rather than supporting the local economy.

- The FTSE index is **concentrated in the utilities, railroads and conventional electricity sub-sectors**, as the sectors that have historically been listed. The index has a very low allocation (only 4 per cent) to transport (marine ports, airports, roads), social infrastructure, water infrastructure and other subsectors. Transport comprises the largest sub-sector of IFM's Australian and global infrastructure funds.

These substantial differences between the composition of a concentrated benchmark and the more typical diversified underlying exposures of unlisted portfolios, which have access to a much broader set of opportunities, will in turn generate very different returns between them. If US utilities are performing well relative to Australian ports, the superannuation funds' infrastructure investments

[2] APRA (2020), *Quarterly superannuation performance statistics*, published 24 November 2020.
[3] As at 30 September 2020.

will be deemed to be underperforming, even if the Australian port exposure is delivering solid returns to members. This noise in the performance outcomes, which the industry calls "tracking error", becomes a material risk to the superannuation funds, given it could jeopardise their ongoing existence. This creates a strong incentive to reduce this risk, which can only be done by aiming to track the exposures of the benchmark, and in doing so creating less diversified portfolios with higher risk to members' savings.

With very limited listed infrastructure available in Australia, superannuation funds will likely push allocations to infrastructure offshore and have reduced appetite to invest in assets that support economic growth and deliver critical services to the Australian community. In turn, this may increase the cost of capital for privately financed Australian infrastructure, and increase the reliance on foreign investors to fund our economic growth and productivity.

We recognise the methodological challenges in assessing the performance of infrastructure investments, given Australia has only a few listed infrastructure companies and there is no industry standard for benchmarking the performance of unlisted infrastructure investments. The benchmarking adopted by global institutional investors varies across absolute return, "CPI+", fixed income index and hybrid approaches, as different investors have different goals and risk tolerances for their infrastructure portfolios. These challenges in methodology as well as data availability were noted by the Productivity Commission and have been broadly recognised in discussions we have had in recent weeks with superannuation funds, asset consultants, infrastructure managers and other stakeholders.

In our preliminary analysis of potential alternative benchmarks, all three categories of benchmarks (listed, appraisal based and marked-to-market) have demonstrated significant limitations. We can provide further insights to the pros and cons of the various listed benchmarks available (e.g. the S&P Global Infrastructure Index, the MSCI World Infrastructure Index) although a listed index will always introduce basis risk and is inappropriate for an asset class that typically comprises a majority of unlisted real assets. Alternatively, unlisted indices tend to suffer from the issue that data contributions are voluntary and there is a history of managers coming in and out of these indices at will, which brings into question the integrity of the performance benchmark.

Many key global competitors to Australian funds have used, and continue to use, "CPI+" style benchmarks for their infrastructure portfolios. This generally provides them with greater flexibility to buy the right asset mix to support their overall target objectives for their members, namely significant real growth in members' retirement savings. Common benchmarks, both in Australia and internationally, are CPI+X per cent, where *X* ranges from 3 to 5 per cent. This level of real growth is consistent with the "mid-risk" market position infrastructure asset allocation occupies, which should, over the long term, deliver returns that are significantly in excess of a fixed interest portfolio but more stable than a higher risk broad-based equities portfolio. It is also what investors broadly seek to achieve by making an allocation to unlisted infrastructure as part of portfolio construction considerations and may be the most appropriate to accurately benchmark such a diversified asset class.

We understand that the full benchmarking methodology for the annual performance test will be set out in the regulations for the *Treasury Laws Amendment (Measures for a Later Sitting) Bill 2020: Addressing Underperformance in Superannuation,* due to be released for public consultation in early 2021. We would appreciate further engagement with the Government and regulators as the regulations are developed and will continue to work with industry partners to build consensus on possible solutions.

As part of this consultation process we may also have further comments to make in relation to benchmarking the performance of investments outside of infrastructure equity. The proposed approach for fixed interest, for example, does not account for floating rate based fixed interest investments, a significant and growing part of the fixed interest market and an option that can provide investors with improved capital protection during periods of high interest rate volatility. It will also be important that the performance test does not disincentivise investment in private equity, an increasingly important source of capital and driver of innovation for Australian businesses, with a track record of strong performance for super funds and their members.

As a final comment I would note that, during my 13 years at the Future Fund as Chief Investment Officer and Chief Executive Officer, we consistently made a point of downplaying the role of performance benchmarks in large part because of the types of issues discussed in this submission. The Future Fund has never published a benchmark return beyond the long-term CPI mandate return assigned to it by the Government. Superannuation funds similarly target a long-term CPI+ return. The Government should be very wary of the unanticipated consequences of introducing the performance benchmarks as currently contemplated in the Your Future, Your Super package and supporting legislation.

Best financial interests duty

At IFM, the best financial interests of superannuation and pension fund members are at the heart of our purpose, which is to protect and grow the long-term retirement savings of working people. While we agree that trustees should act in the best financial interests of members, the proposed changes to the *Superannuation Industry (Supervision) Act 1993* are not proportionate nor justified, and are likely to increase costs and legal uncertainty for trustees.

In particular, we have concerns about the provision to allow regulations to be made to specify that certain payments or investments made by trustees of super funds are prohibited, or prohibited unless certain conditions are met. The Explanatory Materials do not set out the rationale for this extraordinary power, and it appears that the regulations could be used to prohibit payments or investments which are subjectively determined to not be in the best financial interests of fund members. Rather than remove ambiguities in relation to trustees' duties, this provision would introduce significant legal uncertainty, only enhanced by the fact that these powers would be embedded in regulation rather than primary legislation, with more limited scope for industry consultation and proper parliamentary debate.

The potential application of this provision to asset managers is unclear, although the Explanatory Materials set out that a prohibition would extend to third party intermediaries used by trustees to "procure" an investment on their behalf. As a global funds manager, IFM makes investment decisions on behalf of not only Australian super funds but all investors who have chosen to invest in our funds and products. Insofar as particular types of investment may be prohibited, we are concerned that this provision could pose a conflict with our duty in relation to protecting the best financial interests of all of our investors. This represents an unacceptable risk to commercial decision-making for external managers offering services to superannuation funds, and could put such managers at a disadvantage in relation to competitors for infrastructure or other assets – ultimately limiting the benefits of scale and reducing returns for superannuation fund members. Furthermore, the provision is not necessary given the power of the regulators to pursue breaches of the best financial interests duty.

Thank you again for the opportunity to comment on the exposure draft legislation for the Government's proposed Your Future, Your Super package. For further information, please contact Anna Engwerda-Smith, Director of Policy and Research, at .

Yours sincerely

David Neal
Chief Executive Officer