Your Future, Your Super regulations submission

May 2021

Introduction

Frontier is pleased to provide this submission to Treasury's consultation on the Your Future, Your Super (YFYS) Regulations and associated measures.

Frontier is one of Australia's leading institutional investment advisors. We have been advising Australian institutional investors as a trusted adviser for over twenty-five years. We provide advice on more than $400 billion of assets across the superannuation, charity, public sector, insurance and higher education sectors. The fact our advice is free of any product, manager or broker conflicts, means we can provide truly unconflicted advice aligned with our client's best interests.

In our submission to the earlier consultation, we acknowledged the Government's policy aims are laudable:

- Members' contributions should be invested in their best financial interests.
- Consumers should have access to trusted and reliable information regarding their superannuation to help them make a better choice.
- Great member engagement is beneficial, although we query whether it alone will produce better long term returns for members.
- Unintended multiple accounts should be prevented.

In this submission, which builds on our earlier submission, we provide commentary on where we believe the YFYS reform package can be enhanced to better achieve the Government's policy aims.

As an asset consultant, our submission concentrates on the underperformance test and the comparison tool. We acknowledge the Government believes that these two areas will result in the largest financial benefits to members.

Annual performance test

Frontier supports the changes to the annual performance test, namely:

- The inclusion of administration fees.
- The use of more appropriate benchmarks for unlisted property and infrastructure, although we believe an improved infrastructure index should be used (as noted in a separate submission and included in the attachment).

These changes are improvements.

However, our concern remains that the test is a new and back-dated framing of what constitutes underperformance. It is a notable departure from the current primary focus on long term member return outcomes that link to CPI+ objectives.

The performance test only assesses a small part of member outcomes:

- The test assesses how well a fund has implemented its chosen strategy, not whether it is a good strategy.
- It ignores actual returns and the CPI+ objectives of funds that reflect long term member outcomes.
- It does not incorporate most risk adjusted improvements from more diversified exposures.
- It is not a peer relative assessment of underperformance (unlike the comparison website and some heatmap measures).

A fund with an investment strategy which will deliver poor long term member outcomes, but is well implemented, will be judged better than a fund with a good long term investment strategy but been lower risk than its benchmark.

Frontier, as a participant in the Conexus Institute YFYS working group, echoes the concerns that the performance test will be ineffective at identifying poor performing funds while introducing a range of undesirable outcomes. The issues are set out in the working group's summary paper.

As the test represents a new regulatory risk, with real consequences for underperformers, there is a likelihood that funds will adjust their investment portfolios away from well position strategies to meet their long-term objectives. This would be to the detriment of members' long term outcomes.

YourSuper comparison tool

The comparison tool is predicated on the belief that past performance will be a guide to the future.

We note that ASIC warns "it may be **misleading** to imply that reliance on simple past performance figures would be a good way to select a financial product or service.

- Promotions have a higher risk of being misleading if they focus on past performance as a sole or dominant method of selecting a financial product or service.
- The issue here is an implication about the significance of simple past performance figures, without any reference to how the returns were achieved or their relevance to future circumstances.
- If a promotion implies that some aspect of past performance should be the sole or dominant method of selecting a financial product or service, the promoter should have evidence to substantiate the implication."[1]

We believe that ASIC's concerns are valid, noting that the comparison tool will also display fees. We are not aware of any research which substantiates the implication that the past performance of superannuation funds is a guide to the future.

There is a wealth of academic research analysing past performance of investment products generally. ASIC's 2002 report, "A review of the research on the past performance of managed funds" reached a number of relevant conclusions:

- Performance comparisons can be quite misleading if not done properly.
- Returns are only meaningful if adjusted for risk/volatility or comparing "like with like".
- Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the medium to long term. About half the studies found no correlation at all between good past and good future performance.
- Where persistence was found, this was more frequently in the shorter-term, (one to two years) than in the longer term. The longer-term comparison may be more relevant to the typical periods over which consumers hold managed funds.
- More studies seem to find that bad past performance increased the probability of future bad performance.
- Where persistence was found, the "out-performance" margin tended to be small. Where studies found persistence, some specifically reported that frequent swapping to best performing funds would not be an effective strategy, due to the cost of swapping.

We particularly call out the requirement to only compare "like-for-like" products, adjusted for risk. The current superannuation survey providers, like Chant West and SuperRatings, are particular about ensuring comparisons are only made between funds with similar levels of risk (measured by their exposure to growth assets).

Our reading of the regulations is all MySuper products will be compared, without any segregation by risk level. This will lead to inappropriate comparisons, particularly for lifecycle options. Over longer time periods, higher risk options are expected to achieve higher returns, and as a result the higher risk options will appear at the top of the comparison tool and the lower risk options at the bottom.

The chart below highlights this statement by comparing the ranking of the MySuper funds based on 5 year net returns to March 2021. The best performing funds appear in the left of the chart, and the worst are at the right. The risk level for each fund is also shown. The chart illustrates a clear

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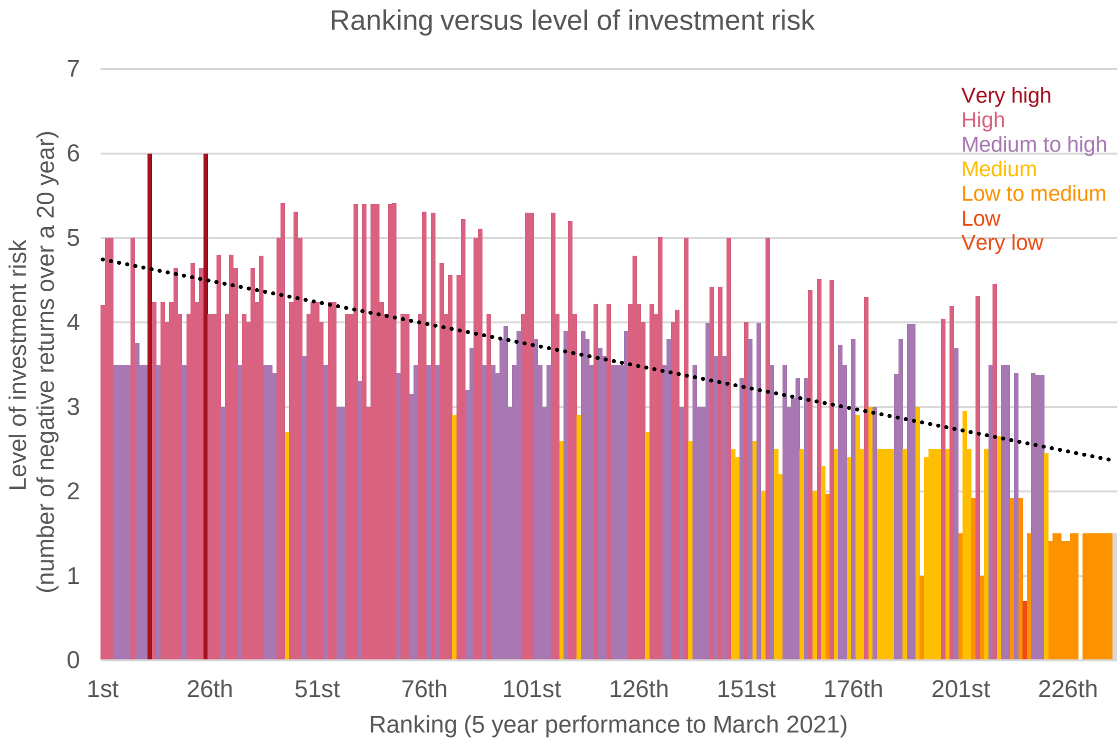
[1] ASIC – Regulatory Guide 53 – The use of past performance in promotional material (July 2003)

relationship between the ranking of funds and the level of risk. Higher risk funds have had higher performance and lower risk funds have had lower performance.



Such an outcome is likely to encourage members to select higher risk funds. It would also be a foreseeable outcome that funds would increase their risk levels to increase their likelihood to appear at the top of the comparison tool.

The current survey providers compare funds in defined universes (based on growth/defensive allocation) which limit the amount of additional risk that funds can take on. We believe the comparison tool should similarly group funds by risk level so that appropriate 'like-for-like' comparisons are possible.

18 May 2021

Director
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To whom it may concern,

Re: Frontier submission – Infrastructure benchmarking under YFYS

Frontier is a leading asset consultant in Australia, consulting to institutions in both superannuation and non-superannuation sectors. As at the end of December 2020, our clients manage assets in excess of $450bn on behalf of superannuants and other stakeholders. Frontier too has been at the forefront of advising asset owners in allocating to the unlisted infrastructure asset class over more than 25 years and has deep experience and credibility in this space. This journey of investing in unlisted infrastructure has demonstrably benefitted the nation, the industry and most importantly, superannuants.

The initial proposals underpinning the Your Super, Your Future ("YFYS") benchmarking outlined in YFYS reforms outlined by the Treasury in October 2020 (Treasury YSYF reforms document) contemplated benchmarking unlisted infrastructure and property investments against listed market benchmarks.

Frontier was at the forefront of public advocacy surrounding the challenges stemming from the originally proposed listed benchmarks. We also undertook a significant amount of analysis on the make-up of client exposures (individually and in aggregate) relative to the original proposed portfolio. We, and many others across the industry, are pleased with the steps the Treasury have taken in amending the originally proposed benchmarks. It clearly acknowledges the challenges of benchmarking unlisted asset classes (both infrastructure and property) and so we welcomed these initial steps in the right direction emanating from the Your Future, Your Super Regulations and associated measures released on 28th April 2021.

The purpose of this submission is to outline several remaining concerns with the newly proposed benchmarks for Australian and for International unlisted infrastructure [the MSCI Australia Quarterly Private Infrastructure Index (Unfrozen) - Post-fee Total Return (All funds)] stemming from the updated regulations above. In addition, Frontier has a proposal which we believe will address the concerns raised, will lift the governance bar pertaining to the measurement of infrastructure performance outcomes and build greater confidence in and transparency in respect of the unlisted infrastructure sector overall.

Frontier can provide an index which will:

- ✓ Deliver greater transparency across the unlisted infrastructure sector;
- ✓ Be more representative across the sector and which will encourage funds to benchmark against a clear core-based infrastructure portfolio (rather than a higher risk, non-core, benchmark);
- ✓ Provide better oversight and collaboration in constructing the unlisted infrastructure index;

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- ✓ Come at a lower cost across the sector (noting ultimately any costs incurred are ultimately borne by members);
- ✓ Provide greater frequency of publication relative to the updated proposed MSCI index

Desired benchmarking traits

For any desired benchmark, in any asset class – financial history and theory specify that the desired traits are ideally that any benchmark is:

- **Transparent** – in that all investors, and asset owners, can understand the make-up of the index, the rules of the index and the constituent traits of the index (this also helps breed clarity and confidence in the market in general in that all participants know what they are being compared to and can, ex-post, attribute differences and the drivers of any under or out performance);
- **Representative** – the index itself does appropriately represent the underlying market that it represents and is inclusive of the broad opportunity set available to investors in this asset class;
- **Objective** – not only should the index represent the asset class in question but is it a fair representation (i.e. one which an independent observer will say here is a fair representation of the appropriate universe) and to the degree that an asset owner or fund manager can outperform this, that is seen, objectively, as a positive reflection and one which can be attributable to good skill versus luck;
- **Investable** – typically, and ideally, benchmarks not only embed the above traits, but investors can normally elect to invest in the benchmark (and hence access the broader market or beta opportunities). Traditionally, investors can do this for a very low fee, the capacity within any benchmark is large and no skill is required to invest in the benchmark – it is more a function of systematised, mechanical, efficient procedures.

Many of the above traits have not been, and remain, unattainable in unlisted asset classes, in particular in infrastructure. This is a critical point.

Ideally, any index also has a reasonable history, and is not dominated by a single or a concentration of constituents. If not, these factors may impair representativeness and objectiveness, which is particularly relevant in an asset class where asset owners, and in this case superannuation funds, may not be able to invest in the underlying components.

Indeed, under the explanatory memorandum from the original 2020 *Treasury Laws Amendment (Measures for a later sitting) Bill 2020: Addressing Underperformance in Superannuation* – it stated "*The amendments seek to ensure that superannuation products have their performance assessed against an **objective, consistently-applied benchmark, giving greater transparency** to beneficiaries and protecting beneficiaries from underperforming products*".

Challenges with the new proposed MSCI benchmark

In addition to the constraints mentioned above, there appear to be a number of significant impediments to adopting the proposed MSCI Australia Quarterly Private Infrastructure Index (Unfrozen) - Post-fee Total Return (All funds), which include:

- Results are only published quarterly (making comparisons harder and alignment with other asset classes less congruous);

- Some of the constituents of the index are, by MSCI's own factsheet on the index, undisclosed. This creates significant challenges for assets owners and concerns regarding underlying influencers (intended or otherwise), and runs counter to a number of the key principles outlined above (transparency in particular);

- The index, we believe (but given the opaqueness of the methodology we find it hard to verify), is heavily dominated by a small number of very large funds. We also further believe that while reasonably well regarded, these funds are more "core plus" infrastructure (i.e. aim for higher returns but, and this is important, operate further up the risk curve). This is significant – as utilising such an index will encourage an ever-increasing spiral of risk taking and will be particularly sensitive to whether any investor has an allocation to funds which significantly drive the index;

- We also understand that the fees for accessing the index are more than AUD $20,000 per subscriber per annum. We obviously cannot comment for and do not represent MSCI – however this is based on pricing provided to some market participants wishing to access the index;

- MSCI also have (for private market indices) a number of sponsors. These are publicly disclosed (See Here) – however it remains unclear whether these entities have a conflicted influence over the index shape, or constituents or rules;

- As unlisted infrastructure specialists and specialists in institutional fund manager research – we value MSCI's overall contribution to the investment industry in public markets – however unlisted markets are complex, and few entities have tracked long term historical data to the same extent that we at Frontier have. Indeed, MSCI were required to make at least one significant adjustment (somewhat outside their control) to this index at a certain point in time as recently as May 2020 (See Here) due to the lack of historical data. The ability of any index to change so substantially based on factors outside the control of the index provider should bring into question the veracity of and stability of the data and at a minimum raise questions on this particular benchmark being the bellwether against which all other funds are assessed.

Collectively therefore, while the move from a listed index for benchmarking Australian and International unlisted infrastructure, is a step in the right direction – it is our view that the choice made does not objectively align with many if not all of the best character traits sought in an index. In addition, it does not appear to align with the traits specifically required, explicitly, by the government (refer to the paragraph at the end of the previous section).

Past consulting precedents

It is well known that challenges have always existed in unlisted asset classes more broadly. There is well established precedent of non-index providers (in Australian and overseas) tracking the broader market universe, which ultimately resulted in the genesis and acceptance of such indices which were then acquired by index providers. For avoidance of doubt, we believe MSCI and indices in public markets serve a vital role for markets, for regulators and for investors in publicly listed markets. For unlisted markets – the precedent was set many years ago when Mercer (a competitor of Frontier) established a property index (from years of working in property) which was then acquired/combined with the IPD in 2009 which was ultimately acquired by MSCI in 2012 (See story).

Fronter infrastructure pedigree

Frontier as a participant in the superannuation market since its earliest inception, has been and continues to be known for our specialist advice in unlisted infrastructure investments. When it comes to unlisted infrastructure, technology, and investments – it should be noted that:

✓ Frontier has an extremely broad universe of unlisted Australian and global infrastructure managers (and mandates) we track and assess on an ongoing basis (with over 100 unlisted products, mandates and direct investments invested in across our broad client base);

- ✓ Frontier has a leading edge (independently assessed by Peter Lee Associates) technology platform, with specific tools focussed on collecting infrastructure data from unlisted infrastructure managers;

- ✓ Frontier currently produces a broad infrastructure index, representative of the data we collect, which covers more managers, is more transparent (and can be split down to its most granular pieces e.g. by sectors and managers) and is driven by virtue of our well established technology platform and methodology (and there is a specific platform driving deep analysis of unlisted assets).

Importantly, the Frontier index and data collection has superior history than the proposed MSCI index, and in addition we believe it will, by its current construct alone, alleviate the other concerns raised in regard to the MSCI index. We also remain open to further refinements outlined in the table below to really assist in providing improved benchmarking for the purpose of YFYS.

As a result of historical challenges in benchmarking unlisted infrastructure more broadly, Frontier as an entity focussed on good governance, appropriate benchmarking and as the provider in Australia with both deep unlisted infrastructure expertise and a well-established and historically enduring database is proposing significant changes which we feel will create even better alignment with Treasury's stated objectives.

Recommendation/Proposal

Given the concerns outlined above, Frontier proposes the following improved approach:

	MSCI proposed index	Frontier Infrastructure Index (historical)	Frontier Infrastructure Index (proposed)
Inception of data	MSCI factsheet states March 2007 (although website suggests 2001)	**Longer history** – 1995 (and note the technology infrastructure to collect data already exists)	
Frequency	Quarterly	Monthly	Monthly
Transparency	Some idea of funds, but totality is opaque and rules undefined	Open-ended funds (no mandates) at least as broad as MSCI	**Greater transparency** - any open-ended institutional fund rated by any of the big 4 asset consultants or with more than $50m invested in aggregate

	MSCI proposed index	Frontier Infrastructure Index (historical)	Frontier Infrastructure Index (proposed)
Cost	We believe in excess of AUD $20,000 per subscriber	Non-disclosed	**Lower cost** - Frontier will provide the index and sectorial breakdown (type and geography) – at no cost for any managers submitting data. For asset owners acquiring the index we anticipate the cost will be $12,000 per annum. This is broadly "at cost" and no to little margin is expected to emerge here.
Weighting	Unclear, says Net Asset Value (NAV) but sum of NAV of component funds is well more than stated aggregate NAV suggested by the Index	NAV weighted	**Improved representativeness** - Frontier remains open to adjusting weighting and working to define a suitable set of rules for such an index.
Consultation	None	None	**Greater consultation and collaboration** - Frontier is open to setting up an advisory committee to set open and communicable rules for weightings (perhaps to limit weights on large funds) and to publish these rules and review them over time.
Additional service options (asset owners only)	No additional insight opportunities	Frontier does have a leading-edge technology platform which provides a significant volume of insights by managers, by geography, by infrastructure type, by revenue sensitivity (which can be aggregated across multiple managers or comparisons made with alternative portfolios) and exploring various metrics within each investor's infrastructure portfolio. These have always been available to asset owners for a fee and will continue to be provided on this basis.	

It is also worth noting that in the wash up after the LIBOR fixing scandal where bankers attempted to and did manipulate reference interest rates in the UK (See Here) the Board of the International Organization of Securities Commissions (IOSCO) and various regulators issued numerous reports pertaining to market benchmarking and the collection/aggregation of a benchmark which itself is sourced from market participants.

The majority of key findings align well with the desirable benchmark traits and principles outlined earlier in this document. One area which also came to the fore in the context of the outcomes in the LIBOR case (and this is a very complex and detailed area) was the need for defining the role for the information vendor (who may collect and distribute benchmark information) and the calculation agent (the entity calculating the index) and ultimately the need to recognise conflicts of interest, which includes having the index universally available as a public service/data point. This aligns with Frontier's proposal outlined in the table above, which is constructed around these principles with singular pricing largely covering costs and noting a broader take would likely lead to a cost reduction.

Frontier is open to working with Treasury and provide access our data and detailed history. We believe the proposal above is a further improvement on every dimension relative to the existing proposed MSCI benchmark – it is published more frequently, has a longer history, is cheaper, more transparent, is open to consultation, with rules and constituents clearly published, with no sponsors and where there already exists buy-in across the broader superannuation industry that the Frontier Infrastructure Index has merit to warrant this proposal.

At a minimum, and should this proposal not proceed, we recommend steps are taken to address the objective shortcomings noted in respect of the MSCI index proposed for unlisted infrastructure assets.

Should you have any queries, please do not hesitate to contact Frontier.

Regards,

Paul Newfield
Director of Sector Research