

Submission:
Your Future
Your Super (YFYS)
Exposure Draft

The Director
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25 May 2021

Dear Sir/Madam,

Re: Submission to Your Future, Your Super (YFYS) regulations & associated measures Exposure Draft

The document serves as a submission to the Your Future, Your Super (YFYS) Regulations and Associated Measures Exposure Draft (Issue Date: 28 April 2021) by the Griffith Centre for Personal Finance and Superannuation (GCPFS), Griffith University, Queensland. The Centre is a source of expertise and excellence in four distinct streams: Personal finance and superannuation; Investment; Professionalisation of financial services; and, Financial education. This submission was co-authored by the following researchers:

- Dr Robert Bianchi, Professor of Finance, Griffith Business School, Griffith University;
- Dr Michael Drew, Professor of Finance, Griffith Business School, Griffith University; and,
- Dr Tim Whittaker, Research Director, EDHEC Infrastructure.

The co-authors of this submission support the Government's policy aim as detailed in the explanatory statement, that is:

“Holding funds to account for underperformance, protecting you from poor outcomes and encouraging funds to lower costs and fees to boost Australians’ retirement incomes.” Source: (Commonwealth Treasury, 2020)

We believe the benchmarking proposal to implement the legislative objective is an attempt to implement and enhance standard industry practice. This means the process involves trying to identify the value add (or subtracted) by asset allocation as well as the value added within asset classes themselves. We note that this process requires the use of properly constructed benchmarks to assist in the assessment of performance. However, we believe that there are issues with the benchmarks selected for the assessment of performance. This submission emphasises the issues relating to the benchmark associated with unlisted assets, specifically, **unlisted infrastructure**.

Principles for benchmark selection

There are a set of guiding principles that need to be considered when defining and implementing benchmarks. This is a debate that generates a lot of heat, but, not a lot of light. It is important for the defensibility and robustness of the process that a clear set of principles informs decision making. The need for clear principles comes into sharper focus when selecting benchmarks for unlisted assets (as opposed to listed asset benchmarks). A benchmark is the selection of an investment portfolio that is used to compare the performance of an investment strategy. The process of deciding the benchmark portfolio is important and Sharpe (1992) states that a correctly selected benchmark portfolio comprises of four key attributes.

These are:

- The benchmark portfolio is a viable alternative to the investment portfolio;
- The returns of the benchmark portfolio are not easily beaten;
- The benchmark portfolio is low in cost; and,
- The benchmark portfolio is identifiable **before** the fact.

If the benchmark possesses the abovementioned characteristics, then identifying skill or added value as a result of asset allocation and security selection is possible.

We note that where no actively traded market exists, for instance in private asset classes (i.e., unlisted infrastructure, unlisted real estate, private equity, IP funds, and others), a set of new methodologies need to be designed to construct the returns for these asset classes. Recent research suggests that benchmark indices with no underlying actively traded markets possess severe biases in the valuation of these unlisted assets through time (Crosby, Lizieri & McAllister, 2010; Hartigan, Prasad and De Francesco, 2011; Devaney and Martinez Diaz, 2011). The following section details the analysis of our published journal article which highlights some of the inherent biases in indices that adopt appraisal-based valuation methodologies in index construction. Specifically, the paper to which we refer is:

Bianchi, R. J., Drew, M. E. & Whittaker, T. J., 2017. Unlisted Infrastructure: Biases in Appraisal-Based Valuations?. *Bankers, Markets & Investors*, 148(1), pp. 33-48.

Unlisted Infrastructure Index Returns

Our research in Bianchi, Drew and Whittaker (2017) examined investment returns (as proxied by a major benchmark) for a range of asset classes for the period September 2001 through June 2016. Whilst the unlisted infrastructure index was the best performing asset class in our study during this sample period, our research identified a number of possible biases in the construction of the index's quarterly returns. The biases and issues of these biases are listed below:

Voluntary disclosure of information: The index was constructed by collating the voluntary contributions of information of unlisted infrastructure investment managers. Hence, the returns and the asset composition of the index is dependent on the willingness of unlisted infrastructure investment managers to engage with the index provider and disclose their returns. The design of this index means that the number of contributors, number of assets in the index, and asset composition can vary significantly from quarter to quarter. As a result, the design of the index is a very idiosyncratic process and there is a risk that it does not capture the true systematic return of unlisted infrastructure assets. The absolute high return of the index suggests there is a level of survivorship bias inherent in the returns.

Limited transparency: As at June 2016, there were three (3) investment managers in the index who did not publicly disclose the funds they were managing, despite their inclusion in the unlisted infrastructure Index. In other words, there is a concern regarding the see-through transparency of the underlying funds and assets in the index.

Appraisal-based returns: There are very few observable transactions in unlisted infrastructure, therefore, an appraisal-based valuation approach is employed in a large proportion of the assets in the index. Unlisted infrastructure fund managers appoint a qualified valuer to appraise and determine the value of the unlisted infrastructure assets in their respective fund. Sometimes, this valuation occurs on a quarterly basis while some assets are revalued as infrequently as semi-annually. Geltner (1991) and Clayton *et al.* (2001) demonstrate that the infrequency of the quarterly/ half-yearly valuation process introduces a number of biases and masks investment risk.

Seasonality/ Calendar Biases in the Index: Our regression analysis reveals there is a statistically significant appraisal induced seasonality in unlisted infrastructure returns with a significant uplift in the June financial quarter and a subsequent re-calibration in the September quarter. This finding is consistent with an upward bias in unlisted infrastructure returns in June which coincides with the end-of-financial year for most superannuation funds and companies in Australia.

Appraisal Smoothing of Asset Returns: Return smoothing is when the appraisal index does not incorporate all the pricing information from the current period. Smoothed returns, according to Getmansky, *et al.*, (2004) result in lower volatilities, boosting the Sharpe ratio and reducing the correlation between the smoothed index and contemporaneous market returns. As a result, the asset class with the smoothed index will indicate that it provides diversification benefits, which turn out to be not there in reality. Furthermore, as the index is smoothed, any major changes in market conditions such as the impact of the COVID-19 market dislocation is only recognised in subsequent periods.

Our regression analysis further reveals statistically significant appraisal smoothing between the most recent index return and the return of four financial quarters prior. This unusual time-series characteristic is evidence that appraisers of unlisted infrastructure assets calibrate the most recent quarterly returns with the valuation of one (1) year prior. This finding is evidence of another appraisal-based bias in the valuations of unlisted infrastructure assets.

Concluding Remarks:

We have raised some specific issues regarding the selection of benchmarks for unlisted assets, particularly unlisted infrastructure. It is critical that policy makers (and all stakeholders, including Trustees) are deliberate in the selection of benchmarks to ensure that the investment process can be independently verified and evaluated. Finally, it is critical that selected benchmarks, particularly for unlisted assets, are principle-based and reflect the opportunity set available to investors.

References

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About the Authors

Professor Robert Bianchi

Dr Robert Bianchi is Professor of Finance at Griffith University and Director of the Griffith Centre for Personal Finance and Superannuation (GCPFS). Robert's research expertise is in the areas of asset allocation, superannuation/retirement and alternative investments. Robert has co-authored more than 35 peer reviewed research articles in publications including the *Journal of Banking and Finance*, *Journal of Portfolio Management*, *Accounting and Finance*, *Journal of Applied Corporate Finance* and the *International Review of Financial Analysis*. Robert has more than 25 years of experience in the investment management industry, including directorships at H3 Global Advisors (alternative investments manager), Venitia Pty Ltd (Member of the Sydney Futures Exchange) and he was a bond portfolio manager at Queensland Treasury Corporation (QTC). Robert holds a Bachelor of Commerce from Griffith University, Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia, Master of Business (Research) and a PhD in Financial Economics from Queensland University of Technology.

Professor Michael Drew

Michael E. Drew is a financial economist specialising in the areas of investment governance, asset allocation, and outcome-oriented investing. He has held previous academic appointments at the Australian National University and QUT, and senior industry appointments with JB Were & Son, Myer Family Company, Ord Minnett, QSuper, QIC, and Wilson HTM. Michael's research has appeared in leading practitioner journals, including the *Journal of Portfolio Management*. He has been invited to testify before numerous committees, including the *U.S. Department of Labor and Securities Exchange Commission joint hearing on Target Date Funds*, and the *Productivity Commission hearing on Superannuation: Assessing Efficiency and Competitiveness*. Michael is a regular media commentator and consultant on investment-related matters and has authored over 85 scholarly papers. Michael's work has been cited by numerous agencies (incl. *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, and the *U.S. Senate Hearing before the Special Committee on Aging*). Michael's research agenda has been supported by leading granting agencies and he is a former member of the ARC College of Experts. Concurrently, Michael serves as a Trustee Director of QSuper, a member of the Investment Advisory Board of the Petroleum Fund of Timor Leste, and a Trustee of Mary Aikenhead Ministries. Michael received his PhD in the field of economics from the University of Queensland, is an Accredited Investment Fiduciary Analyst™, a Fellow of the Australian Institute of Company Directors, and Life Member of FINSIA.

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Dr Timothy Whittaker is Research Director and Head of Data at EDHECinfra, a venture of the renowned international EDHEC Business School. His research interests are infrastructure finance, public private partnerships, asset pricing and portfolio allocation. Timothy's research expertise is in the areas of asset pricing, infrastructure investment and portfolio allocation. Timothy was awarded his PhD in Finance from Griffith University in 2013. Prior to completing his PhD he worked for five years as a corporate finance analyst in Australia. In addition, Timothy holds a Master of Business (Financial Management) from Queensland University of Technology and a Bachelor of Economics and Commerce from the University of Queensland.

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