16 August 2022

Director, Member Outcomes and Governance Branch
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600 AUSTRALIA

Attention: Luke Spear

By email: superannuation@treasury.gov.au

Dear Mr Spear,

Superannuation Performance Test Treatment of Faith-based Products

Thankyou for the opportunity to provide comments on the Exposure Draft legislation and Explanatory Materials for *Taxation Laws Amendment (Measures For A Later Sitting) Bill 2022: Faith-based products* ('ED' and 'EM' respectively). Broadly, these measures seek to provide regulated superannuation fund trustees subject to the Your Future, Your Super ('YFYS') investment performance benchmark with an alternative test for investment strategies that incorporate beliefs based on religious faith.

About Jefferson and Shea Group

The Jefferson and Shea Group ('J and S') is a boutique consulting hub formed in 2022 and based in Sydney. J and S Principals are former superannuation, investment management and custody executives who work with clients across a number of key sectors, including Superannuation, Impact Investing, Education and Aged Care. J and S specialises in Impact Strategy – the development of good business strategy and its effective implementation in a way that has a genuine impact in the client's field and furthers the client's mission. Some J and S clients are (or operate) regulated superannuation funds subject to the YFYS performance test as currently formulated.

Please refer to the J and S website for further information: www.jandsgroup.com.au .

ED and EM general comments

The ED and EM helpfully recognise the distinct nature and principles of superannuation funds and products which offer investment strategies reflecting the religious faith and values of their member base. These funds and products - a small but important part of the superannuation landscape - have a clear mandate from members to express these values in the way the fund invests. Faith expressions are specifically customised across funds and products, but generally follow one or more of the following investment forms:

1. *Portfolio construction* – diverging from a market-cap benchmark weighting of portfolio assets to favour (upweight) assets neutral or more aligned with faith principles and exclude ('screen out') or downweight other assets less aligned with faith principles.
2. *Active ownership* – holding assets in order to exercise voting rights and seek to engage with a company to improve performance on issues relevant to faith values.
3. *Impact investing* – investing (sometimes in partnership) in organisations which have specific social benefit or otherwise non-financial goals, along with financial goals. Financial goals in this context may be given a longer timeframe to be achieved and/or be held to a lower priority. Considerable due diligence is performed by funds in order to support specific impact investment initiatives.

J and S agrees with the apparent motivation for the ED and EM – a concern that the application of the current YFYS performance test to faith-based strategies is inappropriate and unfair – in that:

- the performance of faith-based strategies may be markedly different from peer strategies and market benchmarks which are 'agnostic'
- the difference is by design; and should, through time, be primarily attributable to the expression of faith values (consistent with members' expectations), and
- this faith expression could cause a single or multiple failure of the agnostic YFYS performance benchmark.

This possibility can be demonstrated with some simple (generally conservative) equity portfolio examples. As at 30 June 2022, our analysis shows:[1]

- a large cap US equity portfolio applying a Catholic Values screen had materially different weightings to the top 3 sectors relative to the S&P 500 Index – Information Technology (44 bps overweight), Health Care (92 bps underweight) and Financials (62 bps overweight)
- a large cap Europe, Australasia and Far East (EAFE) equity portfolio applying a Catholic Values screen had materially different weightings to the top 3 sectors relative to the MSCI EAFE Index – Financials (51 bps overweight), Industrials (65 bps underweight) and Health Care (190 bps underweight)
- the MSCI World ESG Leaders Index had several materially different sector weights to the MSCI World Index, including a 113 bps overweight to Communications Services and a 130 bps underweight to Utilities.

Collectively, these intentional faith- and values-driven portfolio biases create annual return differences to their respective agnostic benchmarks of 84-104 bps over the short term and 11-45 bps over longer term horizons, *in one asset class alone*.

[1] Source: Parametric, FactSet; calculated in USD over 1 year and 5-7 year time periods without considering fees and taxes. 'Bps' refers to basis points. S&P 500 and MSCI EAFE examples are conservative because the notional faith-based strategies use very risk-contrained quantitative construction techniques to tightly control for tracking error at portfolio, sector and style factor bias level.

J and S believes there is no compelling policy reason for penalising a faith-based investment strategy for underperforming an agnostic performance benchmark. This is especially the case for ‘choice’ funds and products where the member has made an explicit decision to align his/her values by moving retirement savings away from an agnostic superannuation solution (as implied by the YFYS performance benchmark) to a faith-based strategy.

As a final general comment, superannuation fund trustees and members see faith-based investing as consistent with pursuing members’ best financial interests, and the overall financial goal of providing for members in retirement. Faith-based investing tends to naturally accommodate a long-horizon perspective (for impact strategies to play out), care for the environment (with responsible stewardship a tenet of most faiths) and concern for stakeholders impacted by the fund’s investment choices, particularly the vulnerable and voiceless. That these are healthy attributes of superannuation investing is suggested by wider industry developments such as APRA’s roll-out of climate change reporting, the (then) Federal Government’s encouragement for funds to divest from Russia (in light of the invasion of Ukraine), Government-industry dialogue on ‘nation-building’ and the momentum of ESG investing that can be seen generally across the industry.

ED and EM comments – specific feedback
Alternative faith-based benchmark indices
The proposed process for gaining APRA’s approval to treat an investment strategy as a faith-based strategy requires a fund trustee to suggest alternative performance indices against which a faith-based strategy could be measured. For the purposes of the alternative faith-based performance test, these indices could substitute for the existing YFYS asset class index benchmarks tabled in Part 6A of the *Superannuation Industry (Supervision) Regulations 1994*.

J and S believes this raises difficulty or unfairness in application across the 3 main forms of faith-based investing, as discussed below.

Portfolio construction
Faith-based strategies often use custom screens to exclude or downweight particular holdings of equities (e.g. alcohol, gambling, adult education) or fixed interest (e.g. interest-bearing securities), and/or favour particular faith-aligned assets (e.g. emerging markets equities and debt, green bonds). To use a comparable screened performance benchmark, the data providers and methodology applying the screens for the superannuation fund and the nominated benchmark must be the same. Similarly labelled indices, strategies and screens (e.g. ‘carbon neutral’) can, underneath, be somewhat different and are therefore not suitable for this purpose and could continue to lead to unintended outcomes if used in this way.

This is because definitions and classifications of assets, activities and sectors and exclusion or reweighting methodologies can vary between data providers. For example, some apply an absolute exclusion for companies engaging in the offending activity, while others exclude only when the activity is ‘material’. Weighting methodologies can also vary, with some (for example) excluding an industry in full, and others ranking companies from ‘worst’ to ‘best’ in the offending activity to reweight only to the best-in-category.

Active ownership
Benchmarks are generally not suited to reflecting the risks and time horizon required for funds to pursue certain shareholder activism causes on the basis of faith. These are individualised activities, opportunities and responses not directly reducable to quantitative performance measurement. For example, within the Australian Listed Equities asset class, a faith-based strategy may choose to hold Australia’s two listed aged care providers, regardless of their weighting in the market index, in order to exert influence over how well the providers implement the new protection mechanisms legislated after the Royal Commission into the Aged Care sector. Similarly, in light of Australia’s current energy crisis, a fund may tactically choose to hold utilities at a particular weight (different to the market index weight) in order to vote and otherwise encourage benevolence towards those in the community impacted by the crisis.

Impact investing
Impact investing uses ‘triple bottom line’, ‘dashboard’ success measures or other approaches which can only be partly captured in any nominated performance benchmark. For example, some faith-based strategies support affordable or inclusive housing impact initiatives within the Australian Listed Property asset class. Outcomes are assessed using numerous agreed measures such as target Internal Rate of Return, number of subsidised rent places produced and proportion of green spaces.

Overall, it may not be realistic to apply a strict financial performance benchmark to many of the faith-based strategies due to their custom, sometimes opportunistic nature and the (partly) qualitative nature of the outcomes sought.

J and S believes faith-based investors tend to be more engaged with their investing than the norm across the industry and, where a person has consciously chosen a fund or product designed to align with their faith, that these members are doing so deliberately and based on their personal assessment of the holistic value proposition of that product, only one element of which is financial performance. As such, J and S’s view is that it is inappropriately paternalistic to impose an ill-fitting approach to performance benchmarking on all faith-based funds and products.

We suggest a more holistic comparative tool such as the APRA heatmap would be more appropriate to highlight any areas of concern APRA may wish to investigate further. This information is also publicly available and can be used by individuals to guide their choice of superannuation provider and product.

The continuing obligation of each trustee to act in members’ best interests is also persuasive in allowing these products to be maintained with a separate reporting regime.

Timing of notification of approved status

The ED (proposed new section 60L of the *Superannuation Industry (Supervision) Act 1993*) provides for funds to apply for 'faith-based strategy' status for a financial year from 1 February of the preceding year up to 31 January of the financial year. APRA is required to advise of status by 31 March of the financial year. This means technically a fund lodging an application on 1 February may have to wait 14 months for a determination in relation to the strategy. Given the importance of this classification, a more reasonable time period should be imposed. For example, section 60L could require a determination and advice to the fund trustee (provided all relevant material has been provided) "within 3 months of the application or 31 March of the financial year to which the application relates, whichever is the earlier".

Notification of new information

Proposed new section 60Q of the *Superannuation Industry (Supervision) Act 1993* requires a fund to notify APRA of any new information which, in broad terms, may impact a product's faith-based strategy status. The section as currently drafted has a very significant scope in operation and could trigger a notification obligation when certain standard internal-to-fund processes occur; for example, roll of offer documents, performance reporting, manager due diligence. This is presumably not the legislative intent and, so, requires section 60Q to be narrower and more specific about the information of interest.

J and S also believes funds would find it helpful to have, at a minimum, guidance on the kinds of concerns this section is addressing and, ideally, a 'safe harbour' on certain kinds of information which may become available. For example, the following are realistic scenarios which section 60Q should not seek to capture:

- a compliance breach by an investment manager (accidental, unauthorised investment into an asset not aligned with faith values)
- a fund member (or member group) querying or objecting to particular investments on faith grounds
- an incident or controversy which exposes a previously approved asset, sector or activity to be non-aligned with faith principles
- a difference between ESG data/ratings providers as to the treatment of a particular asset, sector or activity under particular faith principles
- an incident or controversy at the fund, an investment manager or other outsourced service provider which is non-aligned with faith principles.

In principle, the legislation should ensure this notification requirement, triggered by the receipt of certain 'information', does not create a disincentive for a superannuation fund trustee to receive timely, accurate reporting and transparency about its faith-based investment strategies, consistent with good governance practice and the requirements of SPS and SPG 530.

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We appreciate the opportunity to comment on this proposal and trust our comments assist. For further information, please contact Raewyn Williams, Principal at raewynw@jandsgroup.com.au or on 0434 372 210.

Yours faithfully,

Peter Murphy	Raewyn Williams
Principal	Principal
Jefferson and Shea Group	Jefferson and Shea Group