

Review of Your Future, Your Super Measures

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600
By email: YFYS@treasury.gov.au

About Ardea Investment Management

Founded in 2008, Ardea Investment Management is one of Australia's largest fixed income fund managers. Ardea is entrusted with managing over \$20bn on behalf of superannuation funds, insurance companies, government entities and wholesale and retail investors. As a specialist relative value investor in global government bond and derivative markets, Ardea targets returns beyond the conventional drivers of bond investments.

Scope of comments

Treasury's Your Future, Your Super (YFYS) consultation paper raises issues for discussion across all four key elements of the regulations. In this submission, our comments focus only on the performance test. Within that test, we specifically consider two consultation questions relating to benchmark returns and the impact of the performance test on market dynamics and long-term member outcomes. For both consultation questions, we confine our comments to the Australian fixed income benchmark and market.

Appropriateness of Australian Fixed Income Benchmark for investment decisions

Our first comments relate specifically to Australian fixed income investments and the following performance benchmark consultation question:

“Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?”

The YFYS regulation benchmarks Australian fixed income investments with the Bloomberg AusBond Composite 0+yr Index. In our view, this benchmark unintentionally distorts investment decisions in two ways.

1) Exclusion of inflation-linked bonds

The AusBond Composite index is comprised of nominal bonds only. The choice of a nominal only index discourages allocations to inflation-linked bonds. A nominal bond only index has the following

potential adverse consequences for super funds:

- Reduced real return protection could adversely impact retirement portfolios. Inflation-linked securities have the capacity to outperform nominal fixed income securities in a rising inflation environment.
- Limited capacity to protect portfolios in a stagflation environment (a significant slowdown in growth and rising inflation).
- Less overall diversification in fixed income portfolios.

2) Discourages active fixed income investing and overall portfolio diversification

The AusBond Composite Index is a fixed rate only bond index with around 5.8 years of duration risk. The index composition is skewed towards Commonwealth government bonds, with significant allocations to semi government and Sovereign Supranational and Agency (SSA) issuers and a limited allocation to credit. By benchmarking fixed income portfolios to just this index, the YFYS regulations encourages investments in longer duration fixed income securities, which may cause increased portfolio volatility and potential sizable losses in periods of rising interest rates. For example, returns for the Composite Bond Index in the year to September 2022 was -11%, with performance volatility of 7% (based on monthly returns).

A significant driver of allocations to fixed income is the capacity of the asset class to diversify broader portfolio risk by lowering volatility and exhibiting a return profile uncorrelated with other assets in the portfolio. Longer duration exposures have not always provided this benefit, especially over the last year. A duration-heavy index could discourage active and alternative fixed income investments that may lower overall portfolio risk and serve as a diversifier for broader portfolios.

Potential solutions to these two unintended consequences are:

- Include inflation-linked bonds as an optional benchmark for Australian fixed income.
- Broaden the index to include inflation-linked bonds and a broader range of securities – one such solution is to change the benchmark to the AusBond Master Index.
- Provide optional performance benchmarks with shorter duration.
- Include measures to capture risk and diversification of fixed income allocations.

Implications of Australian Fixed Income Benchmark for market dynamics

Our second set of comments relate to the following performance benchmark consultation question:

What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

We see the following potentially adverse implications from the exclusion of inflation-linked securities for market dynamics and member outcomes:

- Impaired liquidity in Australian inflation-linked securities, adversely impacting the capacity of

investors to access inflation protection, including investors seeking protection against rising costs in retirement and other market participants managing long term inflation liabilities.

- Higher inflation-linked bond risk premia, distorting market inflation expectations, which adversely impacts RBA and other government policy-making decisions, as well as businesses assessing inflation expectations, such as insurance actuaries pricing policies.
- Reduced funding diversification for the AOFM.

This material has been prepared by Ardea Investment Management Pty Limited (Ardea) (ABN 50 132 902 722). Ardea is the holder of an Australian financial services licence AFSL 329 828 and is regulated under the laws of Australia.

This document does not relate to any financial or investment product or service and does not constitute or form part of any offer to sell, or any solicitation of any offer to subscribe or interests and the information provided is intended to be general in nature only. This should not form the basis of, or be relied upon for the purpose of, any investment decision. This document is not available to retail investors as defined under local laws.

This document has been prepared without taking into account any person's objectives, financial situation or needs. Any person receiving the information in this document should consider the appropriateness of the information, in light of their own objectives, financial situation or needs before acting.

This document is provided to you on the basis that it should not be relied upon for any purpose other than information and discussion. The document has not been independently verified. No reliance may be placed for any purpose on the document or its accuracy, fairness, correctness or completeness. Neither Ardea nor any of its related bodies corporates, associates and employees shall have any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of the document or otherwise in connection with the presentation.