14 October 2022

Sent to: YFYS@treasury.gov.au

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

To whom it may concern,

Review of Your Future, Your Super Measures

Thank you for the opportunity to provide feedback on JANA's views with respect to the unintended consequences and implementation issues arising from the Your Future, Your Super (YFYS) measures. JANA is supportive of the YFYS policy objectives, but we believe that there are several initiatives that could be considered to improve member outcomes.

JANA has been closely involved with the YFYS policy since it was first announced in October 2020. We have responded to multiple previous consultations and engaged with a range of industry stakeholders to provide thought leadership in this space. As Australia's largest asset consultant, we have also worked with multiple superannuation entities on a variety of YFYS projects. We therefore believe we can bring a unique perspective to the consultation.

JANA notes the preference from Treasury for a focused response. We have therefore provided feedback on the consultation questions where we believe we are most qualified to comment.

Regards,

Kirsten Temple	Georgie Dudley	Duncan Smith
GM, Investment Strategy	CEO-designate and General Manager, Strategy and Innovation	GM, Client Relationships

JANA Contact Details

Any questions regarding this submission can be directed to the below.

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About JANA Investment Advisers

JANA Investment Advisers was established in 1987 and is one of Australia's leading and largest investment advisory and research firms. For 35 years, we have provided unbiased, responsible advice to our clients, rooted in our depth of talent, global research, deep insight and innovative thinking.

Today, we have grown to about 130 staff, with $1.3tn in funds under advice. We are management owned with 55% owned by staff and 45% by Insignia Financial (formerly known as IOOF) through MLC. JANA advises over 80 institutional clients, covering superannuation funds ("super funds"), universities, foundations, endowments, charitable trusts, insurers, corporate clients, long service leave funds and family offices. JANA-advised clients have a history of outperforming both their own internal benchmarks and peers.

At JANA, we believe that together with our clients, we can make a meaningful positive difference to the lives of millions of everyday people who are directly or indirectly impacted by the advice we provide. We are therefore very strongly aligned with the objective of increasing accountability for financial outcomes in superannuation and improving outcomes for members.

Summary Views/Recommendations

A summary of JANA's main recommendations are set out in the tables below. More detail is provided in the body of this submission.

Element	JANA View / Recommendation
Unintended consequences	There is a range of publicly available anecdotal evidence that shows the Performance Test incentivises changes in decision-making, specifically the reduction in active risk. For example, the Conexus Paper 'Assessing the impact of YFYS through interviews with CIOs of funds with performance "buffer"' sets out a range of findings from interviews with CIOs. These findings are entirely consistent with our view on the incentives that the Performance Test potentially creates. E.g. • Given the significant consequences of failure, the Performance Test incentivises managing business risk of failure in preference to member outcomes. • Managing business risk incentivises Trustees to focus on benchmark relative outcomes for each asset class (i.e. the Test result) in preference to overall net of fee, risk adjusted returns. • Where a well-founded, high conviction position is detracting versus a benchmark over a portion of the test period, the consequence of failing the test potentially incentivises Trustees to moderate position sizing, potentially limiting benefits to members by lowering expected return.

Element	JANA View / Recommendation
Retrospective application of Test	Consideration should be given as to whether changes should be made on a retrospective or forward-looking basis only. JANA's preference is that changes are made on a prospective basis to provide more certainty to industry.
Regular review of the Performance Test and its consequences	JANA believes that the Test and related consequences requires a process of regular review (every 2-3 years) to ensure that the Test is accommodating updates to benchmarks, data and the evolving structure of the industry. E.g., As the industry consolidates, at some point the current consequences of failure becomes anomalous if industry structure is already concentrated.
Single Test focused on implementation only	Multiple tests incorporating at least a risk adjusted measure alongside the implementation test, and potentially other metrics to provide a more fulsome appraisal of performance E.g.: • Performance relative to stated CPI + objectives • SAA design (against a simple reference portfolio) • Peer relative performance on a risk adjusted basis (like Heatmaps approach) • Qualitative assessment by independent body/Regulator
Time horizon for Test	Move to a ten-year test on a prospective basis to align with existing industry regulatory disclosure material.
Application of Test to Choice Products	Exclude Choice or at least defer application of the Test on the following basis: • Unlike MySuper members, members have selected products, often as part of a broader financial plan. • The likely range of benchmarks required to develop appropriate YFYS Performance tests for the full range of Choice products is likely to be a significant and complex endeavour, where the unintended consequences experienced in the MySuper segment apply on a larger scale. • Does not rule out the use of existing legislative instruments (e.g. Enforceable Undertaking) where the Regulator targets underperforming products based on APRA's Heatmaps (or a variation thereof) which is also provided to members on an annual basis.

Element	**JANA View / Recommendation**
Definition of Trustee-directed product	If there was appetite to commence application of the Test for TDPs (exclusive of ESG products) next year, the definition of the “asset class” needs to be examined: • Should comprise of at least three “asset classes”. • Broader definition of “asset class” to prevent circumstances where related asset class subcategories (e.g., domestic/global) are each considered a separate asset class.

Benchmarks	• Amend/improve the Unlisted Infrastructure Index to bring it into alignment with industry acceptable principles for index construction (e.g. eliminate unfrozen aspect).
	• Alternatives or “Other” Benchmarks:
	    o General Alternatives: Cash + 3% p.a. (which aligns with current APRA forms SRF533 and 550).
	    o Defensive Alternatives: Cash + 2% p.a. (which aligns with APRA form SRF550 categorisation).
	    o Growth Alternatives: Cash + 4% p.a. (which aligns with APRA form SRF550 categorisation).
	    o Tighten / improve definitions for ‘Alternatives’ in the relevant APRA instruction forms (JANA would be happy to engage Treasury further on this matter). Further detail contained in the body of this submission.

Risk of continuing benchmarking proliferation	• If the Government wishes to retain the current single test which focuses on implementation only, the flow on effect of this might be that the existing YFYS performance test will likely require a lot more benchmarks to combat the weakness of the current test (i.e., which does not account for risk adjusted outcomes). • Consideration would need to be given to whether historic Performance Test metrics are updated to reflect benchmark changes or whether the new benchmarks are included on a forward-looking basis only (we would advocate for changes to the test to be applied on a prospective basis only). • We believe that multiple metrics (including a risk adjusted metric) alongside the current “implementation” test would ameliorate the risk of the current test suffering from ongoing “benchmark proliferation”.
APRA Calculation Test Methodology	• JANA believes that the industry would benefit from more detailed information in relation to the technical aspects of the provision of information as well as the calculation methodology. JANA is happy to engage with APRA and Treasury in relation to this matter.

Element	JANA View / Recommendation
Other	• For both the Comparison Tool and the standard letter to members subsequent to failure, there is a risk that members infer this to be "advice" from the Regulator. • The Comparison Tool is an overly simple and potentially misleading tool which overemphasises low fees and returns in isolation from other more fulsome metrics of performance evaluation (e.g. risk adjusted). There is a risk that members switch to products based on "low cost" or performance chasing which results in members naively selecting products potentially not appropriate for their circumstances. • The standard letter Trustees are required to send to members subsequent to a failure of the Test should be subject to the same standards as other Financial Advice standards (e.g. incorporation of General Advice standard wording, past performance is not indicative of future performance, etc).

1) Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Impact on risk-taking behaviour

The penalties for failing the Performance Test are severe. The severity of the implications of failing means the Performance Test provides an incentive to reduce risk relative to the YFYS performance test. Further, the incentive to reduce risk increases as proximity to failure of the Test increases. This includes active positioning based on:

- Dynamic/tactical asset allocation programs;
- Intra-asset class tilts versus the YFYS benchmarks (for example, small cap equity versus the broad market benchmarks);
- Active management within asset classes (for example, appointing an Australian equity fund manager with an objective to outperform the S&P ASX 300).

There is a range of publicly available anecdotal evidence that highlights the above incentives have led to changes in decision-making, specifically the reduction in active risk. A good recent example is the interviews the Conexus Institute undertook with 10 superfund CIOs[1].

The implications of this are clear: reducing risk can potentially reduce expected returns for members.

JANA has developed a model that stochastically projects the performance for a portfolio and its corresponding YFYS benchmark. Analysis using this model shows that for products with a starting metric reasonably close to the -0.5% p.a. pass/fail hurdle, there is a material probability of failing the Performance Test at least once over the medium term. The exact probability varies with factors such as the years that roll off the metric, the alpha assumptions used to project the portfolio, etc.

[1] *https://theconexusinstitute.org.au/resources/your-future-your-super/*

The probabilities are moderate for a current 8 year p.a. metric of 0.0% and increase significantly the closer the starting metric moves to -0.5%. As an example, our analysis shows that based on a 2% tracking error and a 1/3 information ratio, the probability of failing the Performance Test at least once over 10 years based on a starting metric of -0.4% p.a. is 35% whereas the probability is 15%% for a product with a starting metric of 0.0%.

We note that based on Performance Test scores to 30 June 2021, a significant proportion of the industry (26 products) had a current metric within the 0% to -0.50% range. The meaningful probabilities of failure indicated in our analysis, coupled with the consequences of failure intuitively predict the trends and incentives outlined in the aforementioned CIO interviews undertaken by the Conexus Institute.

We would be happy to share the detailed analysis with Treasury if this would be of interest.

Proposed solutions

JANA has raised in various forums previously (including our initial response to the YFYS policy) that one solution to the above challenges is to apply not one, but a set of metrics that reflect a richer and more fulsome appraisal of performance. Priority should be given to incorporating a risk adjusted metric. There are a range of possible measures and JANA suggests Treasury consult industry on this matter.

Other measures would also be beneficial to capture other elements of overall performance. Examples of additional metrics might include:

- Performance versus CPI+ objectives;
- Performance versus peers (e.g. similar to the metric currently included in the annual Heatmaps produced by APRA);
- Measurement of the quality of the Strategic Asset Allocation relative to a simple reference portfolio (e.g. similar to the metric currently included in the annual Heatmaps produced by APRA).

An overall metric for a product might be determined using a weighted average of the scores of a range of metrics, a traffic light system (majority pass), or mandating a hurdle on a certain proportion of the metrics that must be met.

In addition, JANA considers that a qualitative overlay is also required. E.g. where a product has been unable to pass the majority of tests, APRA (or an Independent Review Panel) would have discretion to determine whether the product should continue (e.g. on the basis of evidence of improving performance) or be deemed to have “failed” based on the multiple metrics. JANA also considers a qualitative review important for assessing more nuanced products such as SRI/ESG/Faith-based products, risk-managed products such as pre/post-retirement products which seek to manage sequencing risk and absolute return products.

2) 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?

Background

If an asset class does not have a relevant YFYS benchmark (or the asset class has high tracking error versus the assigned YFYS benchmark, e.g. due to significant differences in the sector/geographical composition) the hurdle to invest in the asset class increases and allocations to the asset class are likely to be lower than would result without the Performance Test constraint.

Whilst the first thought may be to attempt to ameliorate the problem by adding a plethora of new benchmarks into the Performance Test, JANA cautions against this for two reasons.

Firstly, costs in the industry will increase. As well as the licencing costs of any new index, there are second order costs associated with integrating a new benchmark into the investment process, one example being the requirement to update internal backward and forward-looking YFYS modelling undertaken for a product.

Secondly, JANA believes that the issue around distorting investment decisions or member choice raised in the question would be just as readily solved by the introduction of a risk-adjusted metric or by introducing a suite of metrics per our answer to the previous consultation question.

Notwithstanding the above, we do acknowledge that some benchmark modifications/additions would be helpful. We have detailed these below in order of what we see to be the priorities.

Suggested benchmark changes – unlisted infrastructure

JANA provided detailed analysis of the challenges associated with the MSCI Australia Quarterly Private Infrastructure Index (Unfrozen) - Post-fee Total Return (All funds) ("MSCI Unlisted Infrastructure Index") in our submission to the May 2021 consultation. We have not repeated this analysis here for brevity, the key challenges at that time included:

- Lack of constituent stability given the unfrozen nature of the index;
- Limited breadth of constituents that represents a small fraction of the investable market;
- Bias toward IFM's infrastructure funds given the index is NAV weighted rather than equally weighted.

These issues mean that allocations to unlisted infrastructure will have unavoidably high tracking error which increases the hurdle to investing in the asset class, as well changes to the benchmark having a retrospective effect.

Rather than proposing a new benchmark, JANA suggests that Treasury work with industry on developing recommended changes to improve the design of the current MSCI Unlisted Infrastructure Index to align it closer to the industry accepted standards for index construction.

Suggested benchmark changes – alternatives

Alternative asset classes play an important role in portfolios. However, the categorisation of most alternatives as 'other' in SRF533 and thereby being benchmarked against 50% equities and 50% bonds will likely provide significant hurdles to the use of these asset classes.

The use of defensive alternative asset classes (particularly portfolio hedging / tail risk strategies) in particular is challenging because these likely have a negative expected return versus the 50% equity and 50% bond benchmark as well as significant tracking error.

JANA notes APRA's new asset allocation reporting standard, SRF550 has separate categories for 'growth alternatives', 'defensive alternatives' and 'alternatives.' This contrasts to SRF533 which has only one category for alternatives (i.e. 'other'). JANA believes the hurdles to investing in alternative asset classes would be reduced significantly if separate benchmarks for each category are introduced.

JANA's preference for the benchmarks would be cash + 2%, cash + 3% and cash + 4% for 'defensive alternatives', 'alternatives' and 'growth alternatives' respectively. These benchmarks would reduce the tracking error significantly relative to the current equity/bond composite. They are also the typical benchmark used internally by superfunds to assess the performance of these asset classes.

JANA did consider the suitability of the HFRI indices as a benchmark. These indices however have several key drawbacks including:

- Being constructed using hedge fund performance which only represents one of the sub-components of the alternatives sector;
- The inclusion of a large proportion of products with fee structures that would not be suitable for Australian institutional investors;
- Survivorship bias;
- A concentration (in the flagship index) to the equity long/short hedge fund strategy, which is not representative of the alternative investments held in Superannuation fund portfolios.

Lastly, the definitions of 'growth alternatives', 'defensive alternatives' and 'alternatives' in SRF101 are very vague. If separate benchmarks are included, we recommend tighter definitions/guidance are provided in SRS101, perhaps with examples of alternative asset classes that fit in each category. JANA would be pleased to assist further on possible solutions to the definitions for Alternative asset classes.

Caution when amending/adding benchmarks

It is important for the amendment/addition of benchmarks to be undertaken in a considered manner to ensure there are no unintended consequences. For example, consideration would need to be given to whether historic Performance Test metrics are updated to reflect benchmark changes or whether the new benchmarks are included on a forward-looking basis only. JANA's preference is that changes, where possible, are made on a prospective basis.

We note that when unlisted property and infrastructure benchmarks were added, this was done on a retrospective basis. However, any benchmark changes that result from this consultation will be undertaken after two rounds of Performance Test metrics have been published. It would be problematic if changes were implemented on a retrospective basis and meant a product would receive a different pass/fail result compared that achieved in 2021 and 2022. It is arguably sensible for the changes to be made on a forward-looking basis only despite this increasing the complexity of Performance Test calculations.

4) 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?

Potential for a two-tier system - summary

We noted in our response to the first consultation question that based on our modelling for a representative product, depending on a Trustee's view of "risk appetite", there is a meaningful probability of failure over the next 10 years even if the product enjoys a 0.50% p.a. buffer versus the Performance Test today.

These probabilities vary considerably based on the buffer for the product at the start of the forecast. Using the same analysis we referenced in our response to question 1, the probability of failing the Performance Test based on a starting buffer of 0.10% p.a. (i.e. a metric of -0.40% p.a.) at least once over a 10 year time horizon is almost 35% whereas the probability is c.10% for a product with a starting buffer of 0.90% p.a. (i.e. a metric of +0.40% p.a.).

This modelling demonstrates clearly the stark difference with products with a significant buffer today enjoying a negligible probability of failure and the opposite for products close to the pass/fail hurdle.

We believe this dynamic has the risk of creating a two-tier system where only a small number of very strongly performing products have the ability to access investment opportunities with significant tracking error (particularly private market asset classes) whereas the remaining entities are incentivised to reduce risk (reflected as a lower tracking error relative to the YFYS performance test).

Should the above dynamic come to fruition it would be clearly detrimental to member outcomes.

Potential for a two tier system - solution

It could be argued that products with strong historical performance have earned the right to invest in higher tracking error asset classes. However, we believe this argument is negated by our view that a single, one dimensional Performance Test focused on implementation only is not a robust way to fulsomely assess performance and member outcomes.

Introducing the multiple metrics we have suggested in our response to question 1 will help to remedy the issue discussed above. Some form of two tier structure may develop over time but there are other dynamics that will also contribute to this, for example, whether a fund is cashflow positive or negative.

5) Is there evidence to indicate that the notification and website publication requirements have been effective at encouraging members to consider, and switch to, alternative products? Are there ways this could be improved?

Improvements to fail notifications

Comments from APRA[2] indicate that whilst switches out of failing products have increased, APRA would have preferred for these trends to be stronger.

JANA firstly would like to emphasise that several of the MySuper products that failed the Performance Test in 2021 subsequently passed the Performance Test in 2022 (in some cases comfortably).

[2] *https://www.smh.com.au/money/super-and-retirement/members-fail-to-heed-warning-on-dud-super-funds-20211108-p59717.html*

It is a reasonable line of argument to suggest that higher switching should not be seen as a success because members who switched out of these products over the 12 months to June 2022 will not have benefitted from the performance rebound. Whilst not the main subject of this question, the ability for products to change from failing in one year to passing comfortably the year after shows the importance of selecting an appropriate time horizon for the Performance Test. The time horizon should ideally correspond to a full market cycle given the success of active management is often assessed over a full market cycle and aligned to the timeframes of other regulatory disclosure requirements. We understand the first two iterations of the Performance Test were undertaken over 7 and 8 year time horizons due to data availability but believe the horizon should extend to 9 years in June 2023, 10 years in June 2024 and be conducted over rolling 10 year horizons thereafter. 10 years has a much closer link to a full market cycle and other regulatory reporting requirements, and hence we believe it to be a more suitable horizon to undertake the Performance Test.

JANA believes that the language used in the notification letter the RSE of a failing product must send to members has several deficiencies. Firstly, we believe that advising members to consider moving their "assets into a different superannuation product" based on a metric with no clear link to member outcomes or risk appetite is potentially misleading to members.

In line with comments made elsewhere in this response, the determination should be made based on a suite of metrics rather than a single metric.

In addition, the standard letter Trustees are required to send to members subsequent to a failure of the Test should be subject to the same standards as other Financial Advice measures (e.g. appropriate General Advice standard wording, past performance is not indicative of future performance, etc).

8) Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

This response covers our views to both question 8 and 9 of the consultation.

Exclusion of Choice universe

JANA believes TDPs and the wider Choice product market should be excluded from the Performance Test or deferred until further consultation and consideration has been undertaken. We discuss several of the key reasons below.

Firstly, by definition members make an active decision to invest in a Choice product. Choice members often invest in a range of products to obtain a solution suitable for their overall idiosyncratic objectives. This can be contrasted with defaulted members who are likely to be invested in only one product, have not obtained advice and are possibly unaware of which product they are invested in.

Additionally, it is well recognised that the Performance Test represents a narrow measure of investment success for many types of Choice products. These products often run intentionally high benchmark relative tracking error. Examples include products that adopt some form of sustainable investment, socially responsible investment or ESG type investment strategy. By definition, members that hold products of this nature have made an active choice to hold these products and will have done so based on investment objectives codified within the Product Disclosure Statement (PDS) that may not make any reference to the type of composite benchmark metric used in the Performance Test.

JANA believes that members who hold sustainable investment products do so because of their investment beliefs and/or preferences regarding the benefits (from the perspective of returns and/or the societal good) of this type of investment. In some cases, we can envisage that restricting the ability for new members to invest in these products based on the current format of the Performance Test creates a misalignment between member preferences and the design of the Test.

Another example is products for members nearing the end of the accumulation phase (e.g. lifestages in the latter part of a lifecycle) as well as products for members in the decumulation phase where running a deliberately high tracking error is expected. These products involve investment strategies that consistently run risk levels lower than that of traditional benchmarks (i.e. those used in the Performance Test) for the purpose of managing sequencing risk. By definition, defensive areas of an asset class have a lower expected return and risk versus the broad market and in many cases, there would be the expectation these products would fail the Performance Test based on the current methodology but this failure would have very limited correlation to whether the products have met their stated investment objective.

If there was appetite to commence application of the Test for TDPs , the definition of the "asset class" needs to be examined to prevent capture of single sector products with underlying sub-asset classes. JANA would propose:

- A TDP needs to comprise of at least three "asset classes"
- Broader definition of "asset class" to prevent circumstances where global/domestic, listed/unlisted categorisations are each considered an individual asset class (e.g. Fixed Interest would be an asset class that incorporates sub asset classes for domestic and global, Equities would be an asset class that incorporates domestic and global (hedged/unhedged)).

In addition, given the issues with the application of benchmarks and that members often choose multiple choice products as part of an overarching holistic investment strategy or financial plan, JANA would propose that a better approach would be to implement an enhanced disclosure to members through an annual dashboard which would alert them to the underperformance of the product relative to the test, and the basis of the Test. This is set out further below.

Ensuring quality member outcomes for Choice members

We understand the importance of strengthening member outcomes for Choice members. Our proposal is as follows:

- Exclude or defer all Choice products from the Performance Test (potentially a staggered implementation) to allow sufficient time to appropriately consider the issues arising due to the size and complexity of this segment of the industry;
- Issue members invested in Choice products with a dashboard on an annual basis that provides a summary of key metrics that drive member outcomes. These metrics may be based on the current APRA Heatmaps but also include additional metrics that drive member outcomes that are currently not included in the Heatmaps, e.g. regarding insurance costs. The 30+ metrics in the Heatmaps are likely excessive but we believe the industry could work toward determining 10 key metrics to display. There would be significant overlap between these metrics and the suite of metrics we have referenced in our response to question 1 in terms of assessing MySuper products.
- Further, we consider that enhanced disclosure (be it Heatmaps or a modified version) would enable APRA to focus activities (including use of Enforceable Undertakings) to those products with weakness across a range of metrics.

As previously noted, Choice members (or in consultation with their Financial Adviser) are significantly more engaged and hence are better placed to interpret a dashboard of moderate complexity. This will enable the member to make their own choice (or in consultation with their Financial Adviser) regarding their portfolio rather than having a proportion of the product suite unavailable as a result of closure of the product due to failure.

9) What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

Covered in response to question 8.

Next Steps

Thank you for the opportunity to provide our feedback. As noted above, we would be delighted to discuss any of the points raised in this consultation response further.