14 October 2022

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

By email: **YFYS@treasury.gov.au**

Re: Consultation Paper on the Review of Your Future, Your Super Measures

MSCI Inc. ("MSCI") submits this letter in response to the Consultation Paper on the Review of Your Future, Your Super measures (the "Consultation Paper") published by the Treasury of the Australian Government (the "Treasury"). As the administrator of three indexes across six asset classes applied by the Australian Prudential Regulation Authority (APRA) to conduct the Your Future, Your Super Performance Test (the "Performance Test")[1], we are pleased to provide our views on the questions raised in the Consultation Paper.[2] We thank the Treasury for inviting engagement from the market.

MSCI has been at the forefront of index construction, calculation, and maintenance for more than 50 years, having launched our first global equity indexes in 1969. We serve as data suppliers to investment advisers and other sophisticated market participants. We do not offer index products and services to retail investors. Our indexes are used by a variety of institutional clients, including asset managers, asset owners, banks, insurance companies and wealth managers. MSCI administers its indexes in an objective manner by applying a rules-based approach.[3] We do not build or manage investment portfolios, but rather calculate the performance of a set of securities such as a country, sector, or style (e.g., value or growth).

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[1] The Performance Test applies three MSCI indexes: (i) MSCI ACWI ex Australia With Special Tax Index (AUD) (*see also* MSCI Global Investable Market Indexes Methodology (August 2021)); (ii) MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) (March 2022); and (iii) MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index (Australia Core Wholesale PFI) (July 2021).

[2] The Consultation Paper seeks feedback on four aspects of the YFYS measures: (i) the performance test; (ii) the YourSuper comparison tool; (iii) stapling; and (iv) the best financial interest duty (BFID).

[3] MSCI methodology documents outline index objectives and detail the rules and guidelines followed by MSCI to create and maintain MSCI indexes in a wide set of possible circumstances, including situations of market stress. MSCI's rules-based index methodologies are designed to ensure that indexes are determined with integrity and that discretion is not used in the production of the indexes except in rare cases not effectively addressed by the methodology. Prior to making any material change to an index methodology, MSCI conducts a broad public consultation with global market participants. Public consultations provide essential feedback, facilitate transparency, fuel innovation and improvement, and ensure the on-going relevance of the indexes. *See* MSCI Index Policies (June 2022).

MSCI calculates more than 266,000 indexes daily across global markets for public and private markets. Many of these indexes are customized to meet client specific objectives,[4] including a number for Australian-based asset owners who have selected MSCI to calculate Australian domestic indexes.

We understand that the purpose of the Consultation Paper is to solicit feedback and assess unintended consequences related to the implementation of the Your Future, Your Super (YFYS) legislation, including the Performance Test. Given the increased tendency of superannuation funds to undertake investment strategies[5] that meaningfully deviate from broad market betas captured in the current set of investment indexes applied by APRA,[6] greater flexibility in terms of index choice may be warranted.

In the attached Appendix, we provide an overview of MSCI and its role as an index provider and set forth our views in response to the specific questions raised in the Consultation Paper. We look forward to continued engagement with Treasury on these topics. We would be pleased to answer any questions about our views, and we would welcome the opportunity to provide more information about indexes and to further discuss the constructive role indexes can play in the YFYS framework going forward.

Sincerely,

s/
Ryan Mensing
Executive Director
Government and Regulatory Affairs
MSCI Inc.

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4 These objectives might include, for example, decarbonisation/risk.

5 These can include, for example, decarbonization and other sustainable finance investments.

6 *See* APRA Investment Indices *available at* https://www.apra.gov.au/investment-indices.

APPENDIX

I. The Role of MSCI Indexes and the Performance Test

The Performance Test applies indexes to assess a product's net investment returns. Indexes measure the performance of representative securities within a particular market, sector, industry strategy or objective. Indexes are calculated, maintained, and administered according to published rules in a formal methodology. It is important to note that the index itself is not an assessment of the value or potential return of index constituents or an analysis or a report concerning the index constituents. An index is not a recommendation to buy, sell or hold index constituents. Index providers have a clearly defined and limited role in the capital markets ecosystem: to design index methodologies, apply the methodology, calculate the associated indexes, and publish and license that information to market participants to use for a variety of purposes including performance benchmarking, research, reporting, and indexed product creation.[7]

Application of MSCI Indexes

The Performance Test applies three indexes administered by MSCI applied across six asset classes: (i) MSCI All Country World ex Australia Equities Index with Special Tax (hedged and unhedged versions);[8] (ii) MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen);[9] and (iii) MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index (Australia Core Wholesale PFI).[10]

- *MSCI All Country World ex Australia Equities Index with Special Tax (hedged and unhedged versions)*

  The MSCI World ex Australia with Special Tax Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding Australia). With 1,454 constituents, the index covers approximately 85% of the global equity opportunity set outside Australia. Its Net Daily Total Return is calculated using the withholding tax rates applicable to Australian superannuation funds.

- *MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen)*
  The objective of the MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) is to accurately measure the performance of unlisted private infrastructure funds and/or separately managed accounts (referred as "funds") domiciled in Australia. The constituents of the index are private infrastructure funds[11] that are held in

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7 See the website of the Index Industry Association; available at https://www.indexindustry.org/advocacy/.

8 MSCI ACWI ex Australia with Special Tax Index (AUD); *see also* MSCI Global Investable Market Indexes Methodology (August 2021).

9 MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) Methodology.

10 MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index (Australia Core Wholesale PFI).

11 Private Infrastructure is a relatively illiquid and heterogeneous asset class. Each investment asset held by a fund could differ from all others in terms of its asset type, location, size, and physical characteristics. The time and cost involved in transactions are significant. The MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) is based on NAV of the underlying funds. The infrastructure asset values used by the funds to

professionally managed portfolios. The Index is produced on a quarterly basis, is value-weighted based on the Net Asset Value ('NAV') of its constituent funds each quarter and is denominated in Australian Dollars (AUD).

- *MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index (Australia Core Wholesale PFI)*
  The objective of the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index is to represent the performance of Australia based open-ended commingled real estate funds for wholesale (institutional) investors. The Index is value-weighted, based on the capital employed starting in July 2021 (until June 2021 it was based on the NAV) of its constituent property funds each month and is denominated in AUD. Wholesale funds are defined as those that are structured for wholesale investors to invest in superannuation and/or corporate funds and where the minimum investment amounts are typically large in value as defined by Australian Securities and Investments Commission (ASIC).

These MSCI indexes have a long history of use across a wide cross-section of Australian institutional investors to benchmark their portfolio allocations to global equities and Australian private assets. They are widely acknowledged as the best representations of the opportunity set available to Australian institutional investors and include unique features tailored for the Australian superannuation community.

II. Response to Consultation Paper Questions on the Performance Test

The Consultation Paper raises four questions regarding how the Performance Test functions and whether it has yielded unintended consequences.

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

A key driver of the Performance Test's construction and index choice is simplicity, but potentially to the detriment of the objectives and interests of members. Superannuation funds spend considerable time and effort on achieving the optimal construction of their portfolios, taking into account the investment climate, the demographic of their member base and the access to available strategies. However, the current construction of the Performance Test does not take all of this into account, but instead could be construed as implicitly disincentivising any deviations from the legislated benchmarks.

While the Performance Test is intended to simply measure how well a fund tracks its chosen asset allocation, more significant deviations from benchmarks may be necessary for members' best financial interest in the long term. For example, hypothetically, a fund that keeps 100% in

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calculate NAV are asset valuations. It is not possible to create representative indexes using only transactions, as unlisted funds' investments are illiquid, and transactions are infrequent. MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) is governed by MSCI Real Estate - Index Policies and MSCI Global Data Standards for Real Estate Investment. *See* MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) Methodology.

cash is very likely to pass the Performance Test, but such a strategy is likely to be suboptimal for members. On the other hand, a fund might have a significant equity allocation, but implement that allocation in a way that deviates from the benchmark (e.g., factor tilts such as low volatility, decarbonisation objectives, or alignment with sustainable development goals). Such deviations could be aligned with members' best financial interests in the long term. However, since this will introduce greater tracking error, it also makes it more likely that the fund would fail the test in certain years. The result is that it may reduce the fund's appetite for making any active decisions.

These unintended consequences can occur in both listed and private assets. For example, a fund may pursue a decarbonisation objective in listed equities, which introduces a tracking error relative to a market cap benchmark. This objective is perceived to align with both member preferences as well as better long run expected returns. However, because the legislated benchmarks do not incorporate any climate objectives, decarbonisation needs to be dialed down significantly to minimise the likelihood of failing the test. Similarly, in private assets, allocators are incentivised to shift capital out of projects that are innovative because the payoff structure is misaligned with the horizon of the test.

We also note that when comparing funds on performance, it is important to make sure there is a 'like with like' comparison. Super funds offer a range of different super products. These products have different levels of risk and thus different levels of expected reward. A high-growth product would be expected to return more over the long run but might experience higher highs and lower lows in the short term than a balanced product. In turn, a balanced product would be expected to return more in the long term, but with increased volatility in the short term than a conservative or cash-based product. As discussed in further detail below, the Performance Test could be adjusted to account for these differences by applying a broader set of indexes.

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?**

The Performance Test could allow for additional secondary benchmark indexes that align with a broader range of investment philosophies and objectives in line with market and client demand, including ESG, climate, and other areas of thematic investing.[12] This could enable the Performance Test to serve its purpose and support the underlying policy objectives of the YFYS measures while also improving the ability of funds to make active decisions.

In addition, we note that the use of domestic benchmarks for global allocations in unlisted equity and infrastructure may also disincentivise offshore investments. However, such investments have historically come with significant diversification benefits and therefore may improve risk-adjusted returns for members. Similarly, the Performance Test does not take into

[12] Thematic investing focuses on opportunities created by macroeconomic, geopolitical, and technological trends. These are not short-term swings, but long term, structural, transformative shifts. These areas may include, for example, technology and healthcare.

account that there may be a significant lag before capital can be deployed in private assets, meaning that it is kept as cash or equitised.

We recognise that the limited availability of indexes in the private markets may be a challenge. However, if an index is chosen as the benchmark for the industry, it is likely to garner more contributors which will expand its survey universe and over time should help the index mature and overcome concerns about its granularity, sector concentrations, volatility, and lack of industry diversity.

3. **Does the calculation of actual RAFE and benchmark RAFE discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?**

MSCI does not have views in response to this question.

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?**

In practice, superannuation funds build portfolios in a variety of ways, for example using a total portfolio approach. While this approach is recognised as having potential to improve risk-adjusted returns, the structure and application of the Performance Test may discourage more funds from adopting it. In fact, a fund with an investment strategy that will deliver poor long-term member outcomes, but is well implemented, could be better placed to pass the Performance Test than a fund with a good long-term investment strategy but poorer short-term implementation. To meet a broader set of objectives and to reduce these unintended consequences, the Performance Test could apply additional benchmarks and parameters that take a more holistic view of investment objectives.