14 October 2022

Australian Government
Consultation Paper

Your Future, Your Super review

Submission from
Prime Super

Prime Super

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1. Introduction

The Federal Government is undertaking a review of the Your Future, Your Super (YFYS) measures, which came into effect in mid-2021. As part of the review, Treasury released a consultation paper on 7 September 2022 seeking feedback on the measures. According to the paper, the purpose of the review is to assess any unintended consequences and implementation issues of the legislation, covering the four key elements of the YFYS measures: (i) the performance test, (ii) the YourSuper comparison tool, (iii) stapling and (iv) the best financial-interests duty of trustees.

Prime Super supports the review of the YFYS measures and embraces the opportunity to present a broad view of the potential impacts it has identified which fail to support—and potentially disadvantage—people saving for their retirement throughout their working life.

This submission responds to two specific elements within the consultation paper: the performance test and the YourSuper comparison tool, and discusses the potential consequences for many funds, their members and the broader Australian economy as a result of the design and implementation of the current YFYS measures.

About Prime Super

Prime Super is a high-performing, independent, profit-to-members super fund with a history of delivering strong, long-term returns that consistently outperform industry medians.

We manage over $6 billion in retirement savings for more than 130,000 members in industry sectors including agriculture, healthcare, aged care, education and recruitment. We welcome members from all industry sectors.

The fund has a strong connection with regional Australia; it was formed in 1996 through the amalgamation of four regional super funds.

Recent awards include a five-star rating from Canstar for Prime Super's pension product, and the gold medal in Money magazine's Best of the Best awards for 2022's Best Property Super Product.

2. Key messages

Prime Super supports initiatives which are designed to increase transparency within super, encourage members to be active and informed participants in their retirement financial well-being, and hold trustees accountable for their performance.

In their current form, the performance test and YourSuper comparison tool measures may not lead to improvements in the superannuation system in Australia. The measures are in effect blunt tools, producing outcomes for members which may be inconsistent with achieving best financial outcomes while potentially obstructing trustees from acting in the best financial interests of members.

In their present form, the YFYS measures have the potential to:

- Substantially decrease competition in super, which will eventually impact the genuine choice of a best-fit fund for superannuants and diminish diversity within the Australian economy as a whole;

- Drive short-termism in investment strategies and their implementation, which is inconsistent with super investments held over a working lifetime and has the potential to negatively impact investment performance and thereby outcomes for workers;

- Discourage and prevent investment in a large range of Australian assets, restricting access to capital and preventing local innovation while again adversely impacting investors and the strength of the economy; and

- Lead to a complete focus on reducing administration costs within super, with a 'race to the bottom' approach that ignores other crucial factors affecting member outcomes and member satisfaction. This, again discourages innovation and ultimately results in a one-size-fits-all, passive investment approach that cannot meet the best interests of members.

3. YFYS measures

The following pages address two of the four measures outlined in the consultation paper: (i) the performance test and the (ii) YourSuper comparison tool.

(i) Performance test

Prime Super considers the performance test and its current methodology to be inconsistent with the promotion of super as a long-term investment.

Test methodology and short termism

By its very nature, super is a long-term investment; it is the second most-valuable asset for most Australians, accumulating over a person's entire working lifetime.

Investment markets fluctuate. A long-term investment such as super cannot be correctly understood in isolation on a year-by-year basis.

Short-term returns reflect current issues and concerns. Long-term returns reflect trends over time and most often involve a smoothing out; an aggregation of short-term market activity and events.

If short-term investment returns are to be relevant at all, they must be contextualized. For example, the current volatility of domestic and international equities markets stems from issues such as the war in Ukraine and the ongoing challenges resulting from the implementation of COVID-19 policies. To judge the performance of a super fund or returns during such a time in isolation would be erroneous.

Markets can move quickly in both directions and as the real direction of market prices emerges, performance initially over-corrects, yielding exaggerated returns in terms of short-term pessimism or short-term optimism. As these are moderated with time, exaggerations are smoothed.

In effect, long-term returns are the best measure of overall investment performance and should be the key consideration in super.

The impact of benchmarks

The use of fixed benchmarks (that is, indices) in the performance test may not lead to the desired result. This approach ignores many important factors inherent in the design and implementation of appropriate investment strategies that focus on long-term financial outcomes.

The benchmarking approach may place trustees in the untenable position in which their duty to act in the best interests of members and to maximise long-term returns will be in conflict with their desire to avoid short-term 'underperformance' and its consequences under the YFYS regime.

Some of the key issues and implications in relation to the performance test methodology (some of which may also result from the comparison tool methodology discussed in subsequent pages) are:

- Funds largely become generic, passive and too similar in their strategies and investments, due to the ongoing need to constantly mimic the relevant passive indices which will be an adverse outcome for Australians;

- Trustees are prevented from making strategic, active investments of capital into unlisted assets or asset classes which the trustee believes may deliver superior returns over the medium to long-term, but are not short-term investments (again, largely due to the make-up of applicable benchmarks, which are more often than not weighted to listed assets and sometimes offshore markets);

  A good example of this is Australian agriculture assets. The performance measures are a disincentive for trustees to invest in Australian agriculture, right now, while perversely foreign investors actively seek out and benefit from this asset class. This outcome adversely affects Australian investors, Australian funds and the Australian economy;

  Another example is investment in housing development—this is a category of unlisted investment, the performance of which is unlikely to be captured or properly measurable in the short-term, but which may deliver suitable returns in the medium and long-term while also benefitting the country's social fabric and economy;

- The ultimate aims of delivering strong investment returns and the best outcomes for members are undeniably obscured and given secondary consideration as a result of the 'peer pressure' created by a forced short-term focus; and

- The test does not consider any measure of risk in relation to return— and therefore is does not take into account the usual concepts of long-term risk-adjusted performance, and investor choice and preference.

Performance measured against objectives

Investment objectives are set by super funds, with the investment portfolio designed to outperform these objectives. The investment objective is a methodology used to help construct an investment portfolio that will in theory deliver a return that exceeds the objective over the determined period of time, given certain assumptions about the behaviour of markets.

The objective is a tool used to help construct a portfolio; it is not an explicit statement as to what the investment portfolio will return.

This concept is demonstrated by the returns of most super funds to 30 June 2019 (prior to the disruptions of COVID-19). SuperRatings reported a median return of 8.52% over 10 years for 'balanced' options (those comprising 60-76% growth assets), while inflation was around 2.20% for the period. Measured against an objective of CPI + 3.0%, the median super fund outperformed the objective by 3.32% per annum.

This result cannot be used to measure the success of a super fund; it is simply a reflection of the investment environment of the time. In the current world where inflation is high and proving to be persistent, it is virtually impossible for any fund to outperform a CPI + 3.0% measure without taking unreasonable risks.

To reiterate, the performance of a fund — as measured against its investment objective — does not reflect the success of the fund in delivering outcomes to members. Rather, it reflects the investment environment in which it operates.

Investment strategy

The law requires that an investment strategy be constructed based on the membership and demographics of the fund. Therefore, a fund that has a higher number of older members may potentially adopt a more conservative asset allocation to help manage the risk of negative returns as superannuants near retirement.

The performance test includes a measure by which peer performance is relevant. Peer performance is also a key metric used by fund members to compare super funds. The performance test, where performance across the market is compared, ignores the requirements of individual funds to employ different investment strategies.

The performance test comparison against a fund's strategic asset allocation results in a significant risk to an asset strategy, and as such, strategies are being changed to remove this risk.

A topical example: investment markets have been strong for a while, and property returns have also been strong, with listed property trusts performing well (until very recently). It is reasonable for a trustee to make a determination that the property market is nearing its peak and therefore take a position that it should be underweight to property.

The performance test compares the return of the fund with an assumed return for the portfolio, based on the strategic asset allocation. As a result, an underweight position leads to a performance shortfall against an assumed performance for the overall portfolio. The outcome is that a fund must either purchase more assets (at what it knows to be an over-priced valuation) or risk underperformance.

The measure of performance against a strategic asset allocation therefore drives the behaviour of purchasing assets at the peak of the market, rather than acting to manage the portfolio in members' best financial interests long-term.

Standardisation of investment strategies a risk

Underperformance as measured against peers creates the risk of a fund being wound up. As a result, investment strategies must, over time, converge to minimise this risk. In effect, the performance test measures encourage super funds to conform to a standard investment strategy, to minimise the risk of underperformance. This creates a larger risk to the economy than an otherwise diverse range of super fund asset allocations.

A measure that assists in weeding out underperformance is positive. However, a diverse range of investment strategies, and views of the investment outlook, result in the total pool of superannuation monies performing better over time. Fully informed members over time will drive improved investment performance through withdrawals from underperforming funds

The recent economic cycle has been unusual and driven by continued economic-easing strategies in developed economies. While the typical economic cycle has historically been between 8 and 10 years, the current cycle has been closer to 13 years—the period following the global financial crisis. Therefore, performance measures over a period of 7 to 10 years have been introduced during a period in which markets are operating outside of their normal long-term patterns.

In summary, the performance test introduces two problems. Firstly, a fund that takes a position that is more conservative than its peers, risks failing the performance test even though in the long term, the strategy may be correct. Secondly, where all funds converge on a similar strategy, the periods of downturn will affect more Australians and the effects will be more significant. While the consequences will increase the need for government-funded age-pension payments, a broad range of asset allocations across super funds would help ameliorate this risk due to the number of underperforming super funds at any point in the economic cycle being fewer.

Consequences of failure

It is Prime Super's strongly held view that it is essential that the government, and therefore its policy settings, actively support a super industry that offers people the choice between large and smaller funds. Large funds cannot provide the services or investment opportunities that smaller funds are able to provide.

However, as noted by Treasury in the consultation paper, products that fail the performance test two years in a row will be closed to new members until they pass a future test. The paper states that:

> *"As part of APRA's supervision, trustees of these products will need to justify how they are meeting their obligations to existing members if they do not merge or improve their performance."*

Treasury also states in the consultation paper that one of the purposes of the performance test is to:

> *"[improve outcomes for members by] encouraging underperforming products to improve their performance, including through potential mergers with higher performing funds."*

There are compelling reasons to retain large and smaller super funds in the Australian superannuation system, some of which are discussed below.

Investment returns are not linked to fund size

There is a perception that only larger funds can be high performing funds.

With over $6 billion in funds under management and more than 130,000 members, Prime Super exemplifies the fact that super funds do not have to be big to deliver strong, medium and long-term investment returns.

Prime Super has out-performed super funds with larger memberships and more funds under management. We achieve strong returns because of our robust, considered, long-term investment strategy. Our small size gives us the ability to act with agility and efficiency. While our investment decisions are made within a stringent hierarchical framework, we are not hampered by layers of bureaucracy in order to seize opportunities and act quickly.

We actively manage our investment portfolio, prioritising long-term returns for our members to provide them with the best possible retirement outcomes. We are also able to offer highly personalised services to our members which in turn enables strong relationships to be built and a thorough knowledge of our members to develop over time.

Research into super funds by Rainmaker (September 2021) found that five Prime Super investment options were placed in the top-five for risk-adjusted returns, including our MySuper investment option. The medium and long-term returns of the MySuper investment option are consistently strong. The three and 10-year returns are 4.20% p.a. and 8.28% p.a., above the industry median of 4.07% p.a. and 7.95% p.a. respectively[1].

We are concerned that regardless of our excellent performance record, consistently above-average returns and exceptional customer service offering, our style and approach may be jeopardised by the short-term, 'one investment strategy fits all' focus of the performance test and comparison tool; we believe this would undoubtedly go against the best financial interests of our members.

Development of the industry and benefits to the economy

As touched on earlier, the strength of an open market is demonstrated through both large and smaller players successfully operating in that market. Competition generated by a broad range of super industry participants will deliver the best returns for members, high levels of service and lower costs.

Competition drives better long-term outcomes for members and buoys the economy more broadly.

The superannuation market is already relatively small in the number of players and is currently reducing in size, while the pool of funds is growing and will continue to grow more quickly as a result of the larger super guarantee payments being made.

There are approximately 65 MySuper offerings provided across the industry. If the industry were constricted to a few, large super funds, a herd mentality could develop with the few funds pursuing similar investment strategies, investments and returns to avoid underperformance.

The Deloitte report *Dynamics of the Australian Superannuation System—the next 20 years to 2014* notes that by 2041 the value of the superannuation system will triple to around $9.5 trillion.

It is conceivable that in this period the major superannuation funds will be approaching $1 trillion in size. This scale will be beneficial but will also present a risk to the Australian economy. The ability of these funds to invest in Australia will be limited to their investment in very large infrastructure projects or takeovers of major listed companies.

[1] SuperRatings Fund Crediting Rate Survey June 2022 – Balanced (60-76).

The Australian economy benefits from, and needs, superannuation investments at different tiers of the economy. It is essential that a place in the financial system be retained for smaller superannuation funds that have a smaller investment cheque to invest in the smaller capital needs (including debt, equity and infrastructure) of Australia.

A mix of smaller and larger funds will allow for differentiated investment strategies, which will spread investment capital more broadly across the economy. It is very important, if the best financial interests of Australians is the priority, to avoid the creation of oligopolistic environments.

Outperformance in a consolidated market

There has been significant consolidation in the superannuation marketplace, and the ability to outperform is therefore limited. Logically, half of all superannuation funds will underperform in any one year when compared against peers.

The performance-test measure creates systemic risks as the number of superannuation funds reduces. At a fund level the risk of underperformance increases with time which drives the need to be the same as other funds.

Even though performance measures are currently based on seven years of performance, any one year of underperformance increases the risk of longer-term underperformance, with two years of underperformance being difficult to recover from. Actions are therefore taken immediately to standardise investment strategies and remove any peer-comparison risk.

Long-term standardisation of the industry creates more significant long-term risks to the Australian economy, such as:

- A reduction in innovation in both products and investment strategies, to remove the risk of under performance against peers;
- An overall increase in risk to the Australian economy as all superannuation funds end up with generally the same allocations to equities, debt, cash etc. A broad range of asset allocations ensures that when economies turn, there will always be a fund that is well positioned, driving a higher level of competition around asset allocations;
- The risk of 'too big to fail' increases with reduced consolidation; and
- The concentration of ownership and ideologies can result in a constriction in shareholder behaviour.

Concentration of listed company ownership

The ultimate result of the market shrinking to a few very large funds will result in a concentration of ownership across the Australian equities markets, with a resulting concentration of power (for example, voting power), influence and monopolisation. The volume of money flowing into these large funds and the need to deploy that money (as well as the make-up of the current YFYS performance benchmarks) will make this result inevitable. This is not supportive of the interests of Australians or the Australian economy more broadly.

Suggestions

Prime Super's point of view is that it is inappropriate for the performance test to remain as a single-measure test that places all funds and strategies 'in the same bucket' and compares them against inflexible benchmarks.

The test needs to comprise a blend of different measures of fund 'performance', including:

- Actual and expected long-term risk-adjusted returns, which take into account the trustee's investment strategy, the fund's investment portfolio and its investment options in relation to that strategy;

- An analysis of the fund's administration fees against the number of members in the fund and in relation to particular investment strategies and actual returns (further discussed in subsequent pages); and

- A more relevant and meaningful set of metrics that give members the genuine ability to compare—in more detail and with greater accuracy—relevant features according to their own priorities. For example, the real costs, net returns and the types of services provided by their fund compared with those offered by other funds.

(ii) YourSuper comparison tool

Many of the issues raised in the context of the performance test are also applicable to the YourSuper comparison tool measure. Further discussion of the comparison tool is included below.

Inappropriate comparisons: lifecycle and single diversified products

The YourSuper comparison tool provides details of fees and returns for super funds and an opportunity for members to compare these across different funds. The simplicity of the comparison tool prevents it from taking into account the differences and nuances between two fundamentally different products.

The comparison tool includes MySuper investment options that are both lifecycle products (where an investment approach changes with each defined age group) and single diversified products (where the investment approach stays the same over time).

The fees and returns of lifecycle products change as members move through different age-based investment categories in the product. These products present their returns and annual fees as a range in the YourSuper tool, reflecting the different fees and costs of the product as a member moves through the age-based categories. Single diversified products display a fee amount and a single return figure. Furthermore, aged-based default options usually comprise one component that outperforms a default strategy (even though it has limited applicability). For example for the year ended 30 June 2022 a cash option was one of the few options that would have had a positive return, the result being that where a cash option is included within a lifecycle product that product would be ranked near the top of the table, even though other elements of that product may not have had reasonable performance compared to the total industry.

This is confusing to members of the public. Age-based investment strategies cannot be compared against single, diversified strategies.

Suggestion

To enable true comparisons to be made, information about the two types of products needs to be calculated and presented distinctly. Lifecycle products need to be separated from single diversified products and the tool needs to be refined to deliver accurate product comparisons.

Separation of investment and administrative costs

When considering super fund fees and costs, investment costs must be separated from administration fees. Investment costs pertain to the cost of investing and different investment strategies will incur different costs. The presentation of a mixture of unrelated costs such as investment costs and administration fees in the YFYS measures serves to cloud the true costs of the services being provided and skews fund comparison results.

Investment costs

Investment costs are relevant for net investment returns comparisons; they enable comparisons and choices to be made between the returns of various styles of investing and the costs of those investment strategies.

It is the net investment returns that are relevant when considering investment costs - a higher-cost investment strategy can deliver a superior after-cost return. Similarly, lower investment costs do not automatically result in superior after-cost returns. Therefore, without the net investment return being presented for consideration, members have no way of making accurate comparisons. They are in effect, being forced to make comparisons without real data; comparing 'apples with oranges' as it were.

This misleads investors and also denies them the opportunity to make an informed investment decision which may in turn truncate their potential to receive greater investment returns. Over time, this type of obfuscation could result in people unknowingly retiring with significantly lower account balances.

Administration fees

A true administration costs comparison comprises the costs of administration measured against the number of members in a fund. This logical formula provides a more meaningful insight for members into how efficiently a fund provides its superannuation services.

Furthermore, if the administration costs of a super fund are expressed as a percentage of overall funds under management (as in APRA's heatmap) the funds with a higher average member account balance (a fund with more white collar workers, or older members) are placed at an advantage over smaller funds

The administration fees of a super fund should relate to managing transactions and engaging with members. If a member has a balance $1 or $1 million, the fund must still process contributions, generate statements and provide member services such as a call centre. Administration costs should therefore be more correctly measured and disclosed on a costs-per-member basis.

A second measure of performance is to calculate the administration costs based on a standardised account balance. As the total administration costs of a superannuation fund in general do not scale as a result of members having a higher average account balance, it would be logical to standardise the average account balance for a Fund and compare the total operating and administration costs as a percentage of adjusted FUM.

For example, two Funds with the same headline figures:

Total operating and administration costs	$40,000,000
Total Fund value	$10,000,000,000
Operating cost ratio	0.40%

The above picture changes when differing member numbers are considered:

Fund 1

Membership of 100,000

Average account balance of $100,000

Adjusted operating cost ratio – based on $50,000 a/c 0.80%
[calculated as $40 mill / adjusted to FUM of $5 billion (i.e. 100,000 members * $50,000)}

Fund 2

Membership of 500,000

Average account balance of $20,000

Adjusted operating cost ratio – based on $50,000 a/c 0.16%
[calculated as $40 mill / adjusted to FUM of $25 billion (i.e. 500,000 members * $50,000)}

Adjusting to compare like with like there is a significant difference in the cost efficiencies of the two Funds, despite the headline cost to FUM ratio being the same.

4. Conclusion

We thank the Federal Government for considering the points raised in this submission.

We urge the government to take this opportunity to redesign the performance test, taking into consideration the abovementioned factors that affect members' financial outcomes. We encourage the government to ensure that the YourSuper comparison tool does not lead to inaccurate understandings and thereby create undesirable outcomes for people.

As discussed, we are concerned that a lack of diversity in the superannuation system will not benefit Australian people. We support people being able to make meaningful choices from distinct service providers. In everything we do at Prime Super, we work to empower people so they can make educated choices in super, and their retirement savings can grow over the long term. This is the way we envisage dignity in retirement being realised for each and every person.

Lachlan Baird

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