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Director

Superannuation Efficiency and Performance Unit  
Retirement, Advice and Investment Division  
Treasury

By email to [yfys@treasury.gov.au](mailto:yfys@treasury.gov.au)

Dear Director

**RE: Annual Superannuation Performance Test – Design Options**

Thank you for the opportunity to provide a submission to the Commonwealth Treasury on the Consultation Paper: Annual Superannuation Performance Test – Design Options.

**Preliminary**

I am an Associate Professor at UNSW Sydney in the School of Risk and Actuarial Studies, UNSW Business School. My research expertise is in superannuation, focussing on the performance, governance and regulation of superannuation funds.

Prior to joining academia in 2011, I served in the Australian Prudential Regulation Authority (APRA) research department. My research impact roles include expert witness, public hearing, and Government advising. I served on two APRA working groups on investment governance and trustee governance in conjunction with the post-Cooper Review (Super System Review) superannuation reforms. I have been a consultant on superannuation governance and performance issues to APRA and Industry Super Australia (ISA) and was a member of the Treasury's Your Future Your Super Review - Technical Working Group in 2022.

The views expressed in this submission stem from my research and experience and represent my personal views, not those of UNSW Sydney.

**Submission: From Universal to Targeted Testing - Introducing Pre-Test Screening to Enhance Testing System Efficiency and Effectiveness**

**Executive Summary**

The Treasury's consultation paper includes four broad options for improving the operation of the performance test. This submission explores the fourth option, proposing an alternative framework for performance testing.

I propose introducing a data-driven pre-test screening mechanism to enhance the existing performance testing framework. It is designed to minimise direct and indirect costs, and mitigate unintended consequences inherent in the current universal application of the performance test. This targeted approach aims to more efficiently identify underperforming

products, which historically only represented a small fraction of the industry, without subjecting the entire sector to the unnecessary compliance burdens and unintended consequences of test imperfections (which will always persist and cannot be eliminated regardless of the performance measures or benchmarks used). The incorporation of pre-test screening as a preliminary filtering step, which uses performance rankings derived from existing APRA performance data, will refine and focus the testing process. It ensures that the subsequent application of the performance test, whether in its current form or a refined version, focuses only on a select subset of products deemed at risk of underperformance based on their performance rankings (e.g. bottom 20% of the cohort).

This approach streamlines the identification process of underperforming products. It directly aligns with the fundamental objective of the performance test: to identify and address the tail end of the industry, now achieved with greater efficiency and cost-effectiveness. By employing a pre-test filter on the pool subjected to performance testing, the number of funds entering the detailed testing phase will be significantly reduced. This targeted strategy ensures regulatory resources, scrutiny, and associated costs are more precisely directed towards areas of genuine concern. As a result, this approach will boost the overall efficiency of the performance testing system, yielding significant cost savings, and mitigating unintended consequences across the industry.

### **Current Universal Testing Framework: Issues and Costs**

The current performance testing framework adopts a universal approach, as illustrated in *Figure 1*. This approach has undeniably played a pivotal role in enhancing member outcomes by successfully identifying and eliminating underperforming products.

However, a closer examination of historical data reveals that these underperforming products constitute only a small fraction of the offerings available within the industry. Moreover, there has been a notable decrease in the number of funds failing the test; for instance, last year, MySuper saw only one single failure. This trend underscores the fact that the challenge of underperformance is not pervasive throughout the industry but is instead confined to its tail end. Given this context, the appropriateness of continuing with a universal testing approach comes under scrutiny. As the primary objective is to address underperforming products at the small tail end of the sector, the justification for imposing the broad-reaching compliance burdens and associated costs of this universal test on the entire industry and its members becomes questionable. For instance, if only the bottom 20% of the sector is likely to fail the test, it raises significant concerns about the efficiency and cost-effectiveness of subjecting the remaining 80%, funds that consistently meet or exceed performance benchmarks, to the same level of scrutiny.

This issue is further compounded by the inherent imperfections of performance measures. Stakeholders have raised many concerns that the current test is a blunt tool leading to unintended consequences that affect the investment decisions of all funds (not just underperformers) and can potentially reduce long-term returns for members. There is also a consensus that no single or multi-metric test can fully encapsulate the complexities of the superannuation industry. Additionally, any changes to the performance measures or benchmarks are likely to incur significant transitional costs and introduce uncertainty that could disrupt the investment strategies of all funds. These imperfections and the subsequent unintended consequences they generate can inadvertently inhibit funds from investing in manners that most benefit their members over the long term.

Considering these factors, a shift towards a more targeted approach in performance testing emerges as a compelling alternative. By focusing regulatory efforts on the tail end of the industry most at risk of underperformance, such an approach maintains the rigorous standards necessary for protecting member outcomes while alleviating the unnecessary burdens placed on the broader industry. This targeted strategy will enhance the overall efficiency and effectiveness of the performance testing system, ensuring that resources are allocated where they are most needed and ultimately serving the best interests of the superannuation fund members.

Figure 1: The Current Universal Performance Testing Framework

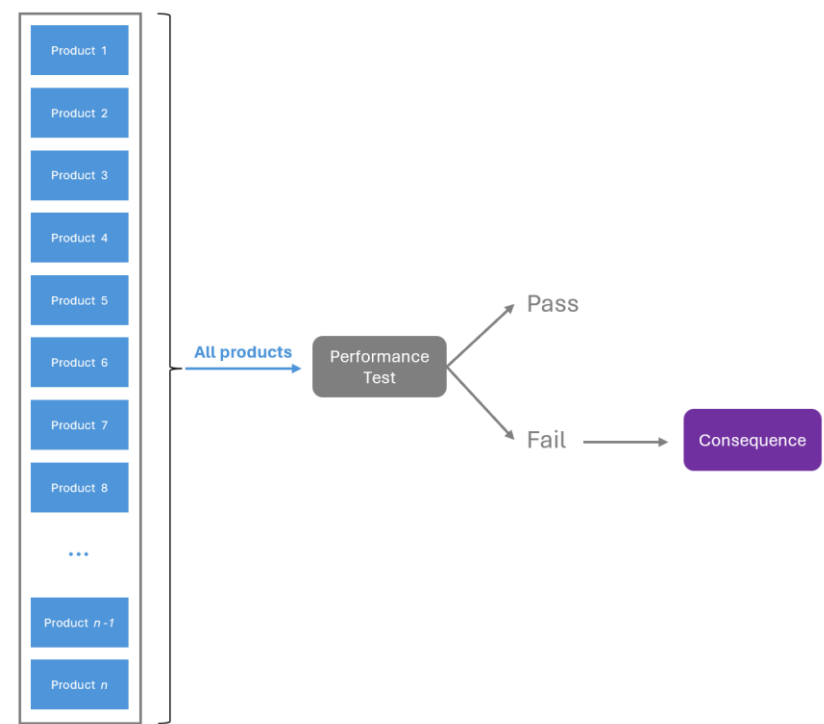
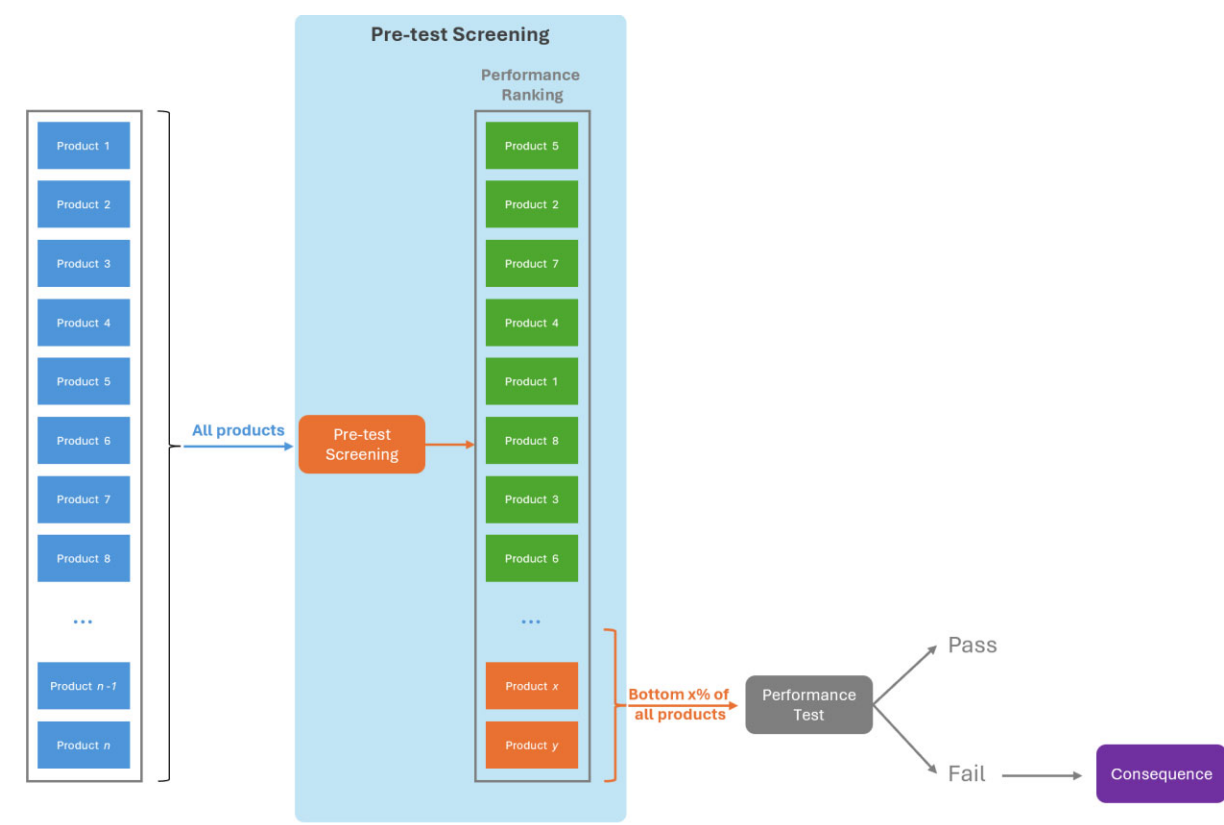


Figure 2: The Proposed Targeted Performance Testing Framework with Pre-Test Screening



## Proposed Targeted Testing Framework: Pre-Test Screening Approach

In response to the limitations and inefficiencies identified within the current universal testing framework, a more targeted approach is proposed to ensure the performance testing system better serves its intended purpose without the broad-reaching consequences currently experienced by the superannuation industry. This proposed approach involves the introduction of a pre-test screening mechanism, which aims at enhancing the precision and effectiveness of identifying underperforming funds.

The cornerstone of this approach is the pre-test screening process, which utilises existing performance data collected by APRA to establish a performance ranking of superannuation products. This preliminary step is designed to filter the vast pool of funds, narrowing down the focus to those at the higher risk of underperformance – essentially, the tail end of the industry that the current system seeks to address but does so at a great cost to all.

By implementing this pre-test screening, only funds that fall within a predetermined lower performance percentile (e.g., the bottom 20%) will proceed to the performance testing phase. This approach aligns with the principle of directing regulatory scrutiny and resources towards where they are most needed, based on empirical evidence rather than a blanket application. *Figure 2* illustrates how this pre-test screening dovetails with the existing framework, illustrating a streamlined pathway from initial screening to potential detailed testing for a select group of funds.

This targeted method addresses several critical issues inherent in the universal testing system:

- **Objective Approach Maintained:** The pre-test screening upholds objectivity by relying on quantitative performance data to form performance rankings, thereby ensuring a transparent and equitable process.
- **Validity Within a Smaller Test Universe:** Targeting funds based on their performance rankings ensures that the testing process remains focused on those most likely to be underperforming. This concentrated approach does not compromise the test's integrity or its capacity to highlight underperforming products (see analysis below).
- **Cost Efficiency for the Industry:** By limiting the number of funds subject to the performance testing phase, the pre-test screening significantly reduces the direct and indirect costs and administrative burdens for the vast majority of the industry, which has historically met or exceeded performance benchmarks. Focusing resources on products that are most likely to benefit from regulatory intervention enhances the economic efficiency of the performance testing system. It ensures that the costs incurred by the industry, and ultimately borne by superannuation members, are justified by the value of the outcomes achieved.
- **Mitigation of Unintended Consequences:** The focused nature of the pre-test screening minimises the broader unintended consequences associated with the current universal testing approach.
- **Filtered Approach:** Acting as a robust filter rather than a determiner of consequences, the pre-test screening identifies which funds should advance to the performance testing phase. This approach reduces the direct pressure on funds, promotes a stable investment environment, and focuses regulatory attention where it is most needed.

## Benefits of Using Performance Ranking in the Pre-Test Screening

Within the proposed pre-test screening framework, the use of performance ranking emerges as a crucial component that offers several distinct advantages:

- **Robust and Consistent Ranking:** The reliability of performance ranking as an approach to determine the tail end of a cohort is evidenced by their consistency across various performance measures. The performance rankings are typically stable despite different performance measures yielding different outcomes. For instance, a product ranked in the bottom 20% using one measure will likely retain a similar rank when evaluated by another.

**Figure 3: Pre-Test Screening – Performance Ranking Example (MySuper Single Strategy Products, 2022)**

RSE name	Single strategy / Lifecycle indicator	Performance Test Pass / Fail indicator	8 year NIR relative to Simple Reference Portfolio p.a.	Performance Ranking : 8 year NIR relative to Simple Reference Portfolio p.a.
First Super	Single strategy	Pass	2.33%	1
Meat Industry Employees Super	Single strategy	Pass	2.33%	2
HOSTPLUS Superannuation Fund	Single strategy	Pass	2.01%	3
AustralianSuper	Single strategy	Pass	1.84%	4
Unisuper	Single strategy	Pass	1.57%	5
CONSTRUCTION AND BUILDING Super	Single strategy	Pass	1.56%	6
Care Super	Single strategy	Pass	1.47%	7
Goldman Sachs & JPMorgan Chase Super	Single strategy	Pass	1.44%	8
Australian Ethical Retail Super	Single strategy	Pass	1.19%	9
legalsuper	Single strategy	Pass	1.18%	10
Mercy Super	Single strategy	Pass	1.18%	11
Spirit Super	Single strategy	Pass	1.12%	12
Local Authorities Superannuation	Single strategy	Pass	1.06%	13
Public Sector Superannuation	Single strategy	Pass	1.03%	14
equipsuper	Single strategy	Pass	1.02%	15
HESTA	Single strategy	Pass	1.00%	16
Australian Meat Industry Super	Single strategy	Pass	0.99%	17
Prime Super	Single strategy	Pass	0.96%	18
AMP Super Fund	Single strategy	Pass	0.93%	19
Aware Super	Single strategy	Pass	0.92%	20
Lutheran Super	Single strategy	Pass	0.89%	21
NGS Super	Single strategy	Pass	0.85%	22
MLC Super Fund	Single strategy	Pass	0.62%	23
IOOF Portfolio Service Superannuation	Single strategy	Pass	0.62%	24
Maritime Super	Single strategy	Pass	0.58%	25
Building Unions Superannuation	Single strategy	Pass	0.56%	26
TWU Superannuation Fund	Single strategy	Pass	0.48%	27
Christian Super	Single strategy	Pass	0.43%	28
AMP Super Fund	Single strategy	Pass	0.42%	29
LGIAsuper	Single strategy	Pass	0.35%	30
Commonwealth Bank Group Super	Single strategy	Pass	0.34%	31
Retail Employees Superannuation	Single strategy	Pass	0.30%	32
OneSuper	Single strategy	Pass	0.22%	33
NESS Super	Single strategy	Pass	0.20%	34
Rei Super	Single strategy	Pass	0.19%	35
ANZ Australian Staff Superannuation	Single strategy	Pass	0.17%	36
AvSuper Fund	Single strategy	Pass	-0.17%	37
AMG Super	Single strategy	Fail - second	-0.38%	38
Energy Industries Superannuation	Single strategy	Fail - second	-0.98%	39
Australian Defence Force Super	Single strategy	Pass		40



Reference: APRA (2023) Heatmap – MySuper Products, December 2022 (Re-issued 24 February 2023).

This consistency holds despite the different aspects of performance that each performance measure might capture, whether it is absolute returns, risk-adjusted returns, or other performance metrics. Prior research has shown that the investment performance ranking remains largely unchanged regardless of the metric used: the work of Bird et al. (1983) supports the view that the choice of performance measure does not significantly impact rankings. Studies by Eling and Schuhmacher (2007) and Eling (2008) corroborate these findings, demonstrating that simpler performance metrics can yield rankings that are in close agreement with those derived from more complex measures. This characteristic of performance rankings gives us confidence that the choice of performance measures, often a considerable issue in the performance testing phase, does not pose as significant a problem when used for ranking purposes in pre-test screening. The pre-test screening process can effectively target the funds most in need of a detailed review without being swayed by the idiosyncrasies of various performance metrics. Hence, we can use a performance measure already collected by APRA for pre-test screening.

- **Efficient Identification of Underperformance with Validity:** The performance ranking system can accurately identify the tail end of a cohort, without compromising the test validity. For illustrative purposes, the "8-year NIR relative to Simple Reference Portfolio" measure from the APRA Heatmap – MySuper Products data is used to rank the single-strategy MySuper products in 2022. As shown in *Figure 3*, employing the bottom 20% as a threshold in performance ranking allows the pre-test screening to successfully identify the subset of products, including the two that failed the performance test. Furthermore, this approach demonstrates consistency when other 8-year investment performance measures available from the APRA Heatmap are utilised as alternative measures to determine performance rankings. The bottom 20% of products remain largely consistent regardless of the specific ranking metric used. Utilising different 8-year investment performance measures yields a similar performance ranking, with the bottom 20% of the cohort consistently including the two failed funds. This finding shows the reliability of using performance ranking as a tool for pre-test screening. It also demonstrates that performance ranking, based on existing APRA data, can maintain the integrity of the performance testing while significantly reducing the breadth of testing required across the industry, thereby decreasing costs and unintended consequences.
- **Utilising Existing APRA Data:** The performance ranking is derived from APRA's existing data, negating the need for additional data collection and thus avoiding extra costs to the industry.
- **Reliable Filter:** The stability inherent in performance rankings is a critical feature that enables the filtering out market-wide noises, allowing a focus on the tail of the sector. By determining the relative position of funds, the rankings are typically stable over time. This implies that temporary anomalies or sector-wide shocks that might unfairly impact a fund's performance do not unduly influence its rank, making the performance ranking a more reliable and harder-to-manipulate screening filter.

### Concluding comments

To summarise, this submission advocates for transitioning from the current universal performance testing to a targeted approach using pre-test screening based on existing APRA data. This method would efficiently pinpoint underperforming products without compromising the test's validity or burdening the industry with unnecessary costs and unintended consequences.

Yours sincerely

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