

14 October 2022

The Treasury
Langton Crescent
Parkes ACT 2600

Submitted via email to: YFYS@treasury.gov.au

RE: Your Future, Your Super Review – Consultation Paper 7 September 2022

To the Treasury

BlackRock Investment Management (Australia) Limited (**BlackRock**) appreciates the opportunity to comment on the *Your Future, Your Super Review – Consultation Paper* (**Consultation Paper**).

BlackRock is an Australian public company and licensed provider of financial services. In Australia we invest AUD \$160-180 bn, predominantly on behalf of Australian retail and wholesale investors. We partner with the Federal Government, 5 state governments, and every large superannuation fund to provide specialist investment management, indexed, factor and active investment portfolios, and our bespoke investment technology, Aladdin. Globally, we are the largest sustainable ETF manager, with US\$473 billion in assets on our sustainable investment platform, across equities, fixed income, multi-asset, liquidity and alternative investments.

Because we work with institutional clients across the superannuation industry, we have some insights into how the Your Future Your Super (**YFYS**) performance test has been applied to MySuper products. In our view, if some aspects of the test are not improved, suboptimal long-term returns may occur for MySuper members, and this outcome could be even more pronounced in the Choice sector. In addition, long-term capital flows may be permanently impacted. This may frustrate Government policy, such as the recently enacted climate change legislation, the Powering Australia Plan, and public commitments to settings that will finance the energy transition, housing, and other impact investing initiatives.

In that context, and in response to specific consultation questions on the YFYS performance test, we make the following recommendations:

- Add an Inflation Linked bond benchmark option to the Fixed Income asset class, given the medium-term outlook for inflation.
- Rename the Fixed Income sector classifications to make them clearer.
- Include generally recognised benchmarks for each of the new Fixed Income sector categories in SRS550.
- Split the Global Equities benchmark into two separate benchmarks for Developing Markets and Emerging Markets, for both hedged and unhedged global equities.
- Change to the FTSE 50/50 listed infrastructure benchmark, which is a more diversified benchmark from a sector perspective.
- Retain the current APRA benchmark for direct infrastructure but change the methodology to be “frozen” so that new constituents do not retrospectively change the historical performance of the benchmark.
- Use HFRI benchmarks for Alternatives that are representative of Listed Growth Alternatives and Listed Defensive Alternatives.
- Allow an equivalent list of sustainable focussed benchmarks for key asset classes where trustees choose to adopt a sustainable approach to that asset class.
- Broaden the components of the test so that it evaluates a product’s total returns, adjusted to the risk in the portfolio, as well as the effectiveness of implementing the asset allocation.
- Given the retrospective nature of the performance test and the fact that trustees were not managing the portfolio with this consideration in mind, we suggest a higher 100 bps underperformance threshold would be more appropriate.

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- Give APRA the discretion to apply a qualitative overlay to gauge the performance of the product in circumstances where it is difficult or inappropriate to apply risk measures in the assessment or to account for material changes to the funds strategy to address under performance (e.g. a change to underlying manager of the fund).

We welcome further discussion on any of the points that we have raised. Any questions in relation to this submission should be directed to Eve Brown at the contact details below.

Yours faithfully,

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Responses to questions

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

The test could potentially impact on risk-taking and risk-aversion behaviour. In our view, the test is flawed because it does not assess the quality of the asset allocation decision, but merely how efficiently the asset allocation is implemented. Asset allocation is the most important decision because it is determinative of members' long-term, total returns. The asset allocation decision should respond to the demographics of the members invested in the product and should adopt a level of risk that is appropriate for them. Instead of evaluating this aspect of investment management, the test merely measures how efficiently the allocation has been implemented, which may not be optimal for some of the investors in the product. Further, in many instances which we will highlight below, the benchmarks available for assessing the efficiency of an asset allocation are mismatched, or even non-existent.

Because the test only assesses how efficiently the trustee has implemented its chosen asset allocation, this could drive undesirable risk-aversion in the asset allocation process. For example, a trustee may choose to invest on behalf of a cohort of young people in a highly defensive asset class that they have a high degree of confidence will pass the test. This may result in lower performance generated for the members, and may see them forego other financial opportunities, such as an illiquidity premium associated with direct assets. Generally speaking, younger people should be in higher growth-oriented portfolios to reflect the long investment time horizon to retirement and earnings potential that lies ahead of them. Conversely, older people that are nearing retirement should be invested in more conservative options that protect the capital that they have spent a career building. The current test does not address whether a product is appropriate for its members, and that is arguably more important than whether it was implemented with less than 50 bps of underperformance.

The retrospective nature of the test might also result in undesirable risk-taking in the asset allocation, at least in the short term, to earn back past negative performance. For example, an oversized allocation to unlisted equities for an older cohort of members might be chosen, as this might sure up performance of the product under the test, despite bringing an increased level of illiquidity risk into the portfolio. Conversely, where a product in a strong pass position due to historical out performance, a choice to lower the use of active risk in the portfolio to prevent future failure, could reduce the opportunity for forward-looking returns for members.

At a minimum, the test could evaluate a product's total returns, adjusted to the risk in the portfolio, as well as the effectiveness of implementing the asset allocation. Total returns could be assessed against three criteria – whether the product's return objective was met (i.e. was the fund "true to label"); whether the strategic asset allocation was suitable for the relevant cohort of members (e.g. do they have 25 year olds in defensive products); and whether the product's risk profile was appropriate in achieving the return (ensure funds are not taking excessive risk in order to achieve a "pass"). Perhaps giving APRA discretion to evaluate these additional points for funds that fail the test would bring additional robustness to the process.

Additionally, given the retrospective nature of the performance test and the fact that trustees were not managing the portfolio with the performance test in mind, we suggest a higher underperformance threshold of 100 bps would be more reasonable. The higher historical threshold would reduce adverse risk taking (either high or low) and would be particularly relevant if the test is rolled out to Choice products next year.

In circumstances where it is difficult or inappropriate to apply risk measures in the assessment, APRA could also be given the discretion to apply a qualitative overlay to gauge the performance of the product. This would be similar to what the Government has proposed in draft legislation governing faith-based superannuation funds and the performance test. The discretion could allow APRA, for example, to consider a fund's broader investment governance arrangements in determining the test outcome and any conditions/future performance requirements.

Broadening the components of the test in this way would likely reduce or eliminate, reactionary risk-aversion and risk-taking behaviour. Further, it would allow APRA to consider alternatives to product closure in circumstances where the product's recent performance is strong and continually improving, or where the trustee has taken all reasonable steps to improve investment performance under the test (such as a material change to the investment strategy or underlying manager). After 13 products failed the test in its first year of operation, barely 10% of the investors in those products responded to the notification and rolled their savings into a better performing product. If this is indicative of industry-wide behaviour, the closure of a product that has sufficient scale, strong recent performance and/or has delivered on its investment objectives, will likely be detrimental to the majority of members. Most members will languish in the closed product, at least for a period of time, and many will suffer last-to-leave disadvantage associated with asset write downs and fire sales.

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 current set of indices could be expanded to provide greater granularity in certain asset classes and ensure investment choice in the portfolio's strategic allocation going forward. The current narrow list of asset classes may unintentionally misrepresent the results of investment decisions that were made before the implementation of the test and drive new decisions that may not deliver the best long-term total returns for some members.

The retrospective nature of the test's implementation means that trustees were not aware of the test 8 years ago, and portfolios may have been managed differently than they are being managed now. Post-implementation of the test, portfolios may be managed so that they more closely track the current benchmarks, with a focus on relative return outcomes rather than long-term total returns.

This may not produce the best long-term returns for members and there is a risk that future outcomes will similarly be affected by benchmark hugging behaviour. In addition, new investment decisions that respond to the immediate imposition of the test could have lasting implications for long-term capital flows. For example, sustainable investments are missing from the set of benchmarks that can be chosen from and as such investing in assets that support the energy transition could cause a product to fail the test.

The test also drives an unhealthy focus on fee minimisation over a short investment horizon, instead of net returns after fees which is what ultimately matter to members. This could cause the avoidance of both active management and investment in direct and sustainable investments. Active management can present significant value to investors, particularly in the areas of direct property and sustainable infrastructure, where the asset manager brings specific expertise to the selection of the assets. With a skewed focus on minimizing cost, and no risk-weighted disincentive for overexposure to other assets, trustees could be encouraged to give up the potential long-term opportunities that active management presents. As a result, superannuation members could miss out on these opportunities and local patient capital from long-term investors may no longer be available to fund these initiatives. In this way, the test does not support the commitments made to transition to Net Zero by 2050 and could contradict the Government's broader energy transition agenda.

We suggest the following changes to the sector descriptions, asset class benchmarks and methodologies underpinning the benchmarks. These changes in conjunction with the recommendations proposed in response to the previous question would improve the operation of the test and would likely result in better long-term returns and choice for members.

Fixed Income

- The Australian Fixed Income benchmark only provides for nominal bond exposure. We suggest the addition of an Inflation Linked fixed income benchmark option, given the medium-term outlook for inflation.

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- The SRS550 sector categories for Fixed Income are unclear. For example, Fixed Income Excluding Credit includes investment grade credit but excludes non-investment grade credit (i.e. high yield). We suggest renaming the sector classifications in line with the first column in red in the table below.
- We suggest the inclusion of generally recognised benchmarks for each of the new Fixed Income sector categories under SRS550 as per the suggested benchmark column in red in the table below.

Global Equities

- The risk and return characteristics of emerging market equities are often quite different to those in developed market equities, and with those different characteristics there are better/worse opportunities for investments. Requiring all global equities to align to a single, combined developed/emerging market benchmark that is determined by market capitalisation weights, misses the opportunity for taking longer-term, strategic positions.

We suggest splitting Developing Markets and Emerging Markets into two separate benchmark categories to provide the flexibility to size emerging market allocations differently to market cap. We suggest this for both hedged and unhedged global equities.

Infrastructure

- Listed – we suggest a change to the FTSE 50/50 infrastructure benchmark as this benchmark is a more balanced/diversified benchmark from a sector perspective (i.e. caps Utilities to 50% and more diversified geographically)
- Direct – we have reviewed alternative direct infrastructure benchmark options and we view the current APRA benchmark as the most representative, however suggest a change to the benchmark methodology. It is currently “unfrozen” which means the historical returns retrospectively change as new constituents are added to the benchmark. We suggest a change in the methodology to be “frozen,” such that new constituents can be added without this retrospectively changing the historical performance of the benchmark.

Alternatives

- We suggest some HFRI benchmarks that are representative of Listed Growth Alternatives and Listed Defensive Alternatives (see table below).

Sustainability

- We suggest an equivalent list of sustainable focussed benchmarks for key asset classes be available where trustees choose to adopt a sustainable approach to that asset class. Given the customised nature of the chosen screens and/or sustainable approach taken by each fund, a one-size-fits-all benchmark would not be appropriate – there are currently in excess of 20 different sustainable benchmarks in global equities (ACWI & World) from one benchmark provider (MSCI) alone, which aim to address different aspects of sustainability (eg. Integration, Values and Screens, Impact). The screening and construction methodology of each index will mean each trustee’s portfolio will be very different in terms of stock, sector and country weights, and it would be appropriate to allow trustees to specify the customised sustainable benchmark to be used for the performance assessment, as part of the SPS550 reporting. A requirement that the benchmark chosen must be formalised in the offer documents for the fund, to avoid cherry picking benchmarks for performance test outcomes, would mitigate against that risk.

Investment Strategic Sector Type	Investment Strategic Sector Listing Type	Australian Domicile	International Domicile	Change to existing Benchmark or new addition	Suggested Benchmark
Fixed Income	Unlisted	Yes	Developed	New addition	Bloomberg Ausbond Composite 0+ Yr Index or Bloomberg AusBond Infl Tsy 0+ Yr Index
Fixed Income	Unlisted	No	Emerging	New addition	Hard Currency: JP Morgan EMBI Global Diversified Index 100% AUD Hedged Local Currency: JP Morgan GBI-EM Global Diversified Index 100% AUD Hedged
Fixed Income (Investment Grade)	Unlisted	Yes	Developed	Suggest change to sector name	Bloomberg Ausbond Composite 0+ Yr Index
Fixed Income (Investment Grade)	Unlisted	No	Developed	Suggest change to sector name	Bloomberg Barclays Global Aggregate Index (hedged to AUD)
Fixed Income (Investment Grade)	Unlisted	No	Emerging	Suggest change to sector name, new benchmark	J.P. Morgan Emerging Markets Bond Index Global Diversified Investment Grade 100% AUD Hedged
Fixed Income (High Yield)	Unlisted	No	Developed	Suggest change to sector name, new benchmark	ICE BofA Developed Markets HY Constrained 100% AUD Hedged Index
Fixed Income (High Yield)	Unlisted	No	Emerging	Suggest change to sector name, new benchmark	J.P. Morgan USD Emerging Markets High Yield Bond Index 100% AUD Hedged Index
Equity (hedged)	Listed	No	Developed/ Emerging	Change to existing Benchmark	MSCI World Ex Australia Net TR 100% AUD Hedged + MSCI Emerging Market Index 100% AUD Hedged
Equity (unhedged)	Listed	No	Developed/ Emerging	Change to existing Benchmark	MSCI World Ex Australia Net TR Index + MSCI Emerging Market Index
Infrastructure	Listed	No	Developed	Change to existing Benchmark	FTSE Developed Core Infrastructure 50/50 Index 100% AUD Hedged
Infrastructure	Unlisted	Yes	Developed/ Emerging	Change to existing Benchmark	MSCI Australia Quarterly Private Infrastructure Fund Index (Frozen) – NAV-Weighted Post-Fee Total Return (All Funds)
Growth Alternatives	Listed	No	Developed/ Emerging	New addition	HFRI EH: Fundamental Growth Index
Defensive Alternatives	Listed	No	Developed/ Emerging	New addition	HFRI FOF: Market Defensive Index

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?

No comment.

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?

We refer to our answers to questions 1 and 2 above.

To reiterate a key point, because the test only assesses implementation efficiency, a trustee could have met its stated total-return objective over the past 8 years and still fail the test. Implementation efficiency is a small component of total returns, which means that in practice a product that has failed the test may well have delivered superior total returns to members than a similar or identical product, issued by a different trustee, which passed the test. Take the example of a trustee whose stated investment objective was inflation + 4% (after fees). The trustee invested in a high percentage of direct assets that provided a strong inflation hedge, delivering significant positive returns above inflation to members, in accordance with the stated objective. Regardless of this, the product failed the test due to benchmark mismatch - the direct asset benchmarks are not investible benchmarks – and higher fees because direct assets cost more to invest in than listed, indexed infrastructure.

Because the test is applied retrospectively, with a small 50 bps tolerance, a product can fail the test despite delivering strong long-term total returns to the members, while a similar product which delivered less strong total returns to members may well pass the test. Given the significant impact on members of failing the test, the outcome described above should be considered and avoided where possible.

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?

No comment.

- 6. Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?**

No comment.

- 7. Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? How can the system best support members in underperforming products?**

No comment.

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

We refer to our answers to questions 1 and 2 above.

- 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?**

No comment.