Your Future, Your Super regulations submission

May 2021

Introduction

Frontier is pleased to provide this submission to Treasury's consultation on the Your Future, Your Super (YFYS) Regulations and associated measures.

Frontier is one of Australia's leading institutional investment advisors. We have been advising Australian institutional investors as a trusted adviser for over twenty-five years. We provide advice on more than $400 billion of assets across the superannuation, charity, public sector, insurance and higher education sectors. The fact our advice is free of any product, manager or broker conflicts, means we can provide truly unconflicted advice aligned with our client's best interests.

In our submission to the earlier consultation, we acknowledged the Government's policy aims are laudable:

- Members' contributions should be invested in their best financial interests.
- Consumers should have access to trusted and reliable information regarding their superannuation to help them make a better choice.
- Great member engagement is beneficial, although we query whether it alone will produce better long term returns for members.
- Unintended multiple accounts should be prevented.

In this submission, which builds on our earlier submission, we provide commentary on where we believe the YFYS reform package can be enhanced to better achieve the Government's policy aims.

As an asset consultant, our submission concentrates on the underperformance test and the comparison tool. We acknowledge the Government believes that these two areas will result in the largest financial benefits to members.

Annual performance test

Frontier supports the changes to the annual performance test, namely:

- The inclusion of administration fees.
- The use of more appropriate benchmarks for unlisted property and infrastructure, although we believe an improved infrastructure index should be used (as noted in a separate submission and included in the attachment).

These changes are improvements.

However, our concern remains that the test is a new and back-dated framing of what constitutes underperformance. It is a notable departure from the current primary focus on long term member return outcomes that link to CPI+ objectives.

The performance test only assesses a small part of member outcomes:

- The test assesses how well a fund has implemented its chosen strategy, not whether it is a good strategy.
- It ignores actual returns and the CPI+ objectives of funds that reflect long term member outcomes.
- It does not incorporate most risk adjusted improvements from more diversified exposures.
- It is not a peer relative assessment of underperformance (unlike the comparison website and some heatmap measures).

A fund with an investment strategy which will deliver poor long term member outcomes, but is well implemented, will be judged better than a fund with a good long term investment strategy but been lower risk than its benchmark.

Frontier, as a participant in the Conexus Institute YFYS working group, echoes the concerns that the performance test will be ineffective at identifying poor performing funds while introducing a range of undesirable outcomes. The issues are set out in the working group's summary paper.

As the test represents a new regulatory risk, with real consequences for underperformers, there is a likelihood that funds will adjust their investment portfolios away from well position strategies to meet their long-term objectives. This would be to the detriment of members' long term outcomes.

YourSuper comparison tool

The comparison tool is predicated on the belief that past performance will be a guide to the future.

We note that ASIC warns “it may be **misleading** to imply that reliance on simple past performance figures would be a good way to select a financial product or service.

- Promotions have a higher risk of being misleading if they focus on past performance as a sole or dominant method of selecting a financial product or service.
- The issue here is an implication about the significance of simple past performance figures, without any reference to how the returns were achieved or their relevance to future circumstances.
- If a promotion implies that some aspect of past performance should be the sole or dominant method of selecting a financial product or service, the promoter should have evidence to substantiate the implication.”[1]

We believe that ASIC’s concerns are valid, noting that the comparison tool will also display fees. We are not aware of any research which substantiates the implication that the past performance of superannuation funds is a guide to the future.

There is a wealth of academic research analysing past performance of investment products generally. ASIC’s 2002 report, “A review of the research on the past performance of managed funds” reached a number of relevant conclusions:

- Performance comparisons can be quite misleading if not done properly.
- Returns are only meaningful if adjusted for risk/volatility or comparing "like with like".
- Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the medium to long term. About half the studies found no correlation at all between good past and good future performance.
- Where persistence was found, this was more frequently in the shorter-term, (one to two years) than in the longer term. The longer-term comparison may be more relevant to the typical periods over which consumers hold managed funds.
- More studies seem to find that bad past performance increased the probability of future bad performance.
- Where persistence was found, the "out-performance" margin tended to be small. Where studies found persistence, some specifically reported that frequent swapping to best performing funds would not be an effective strategy, due to the cost of swapping.

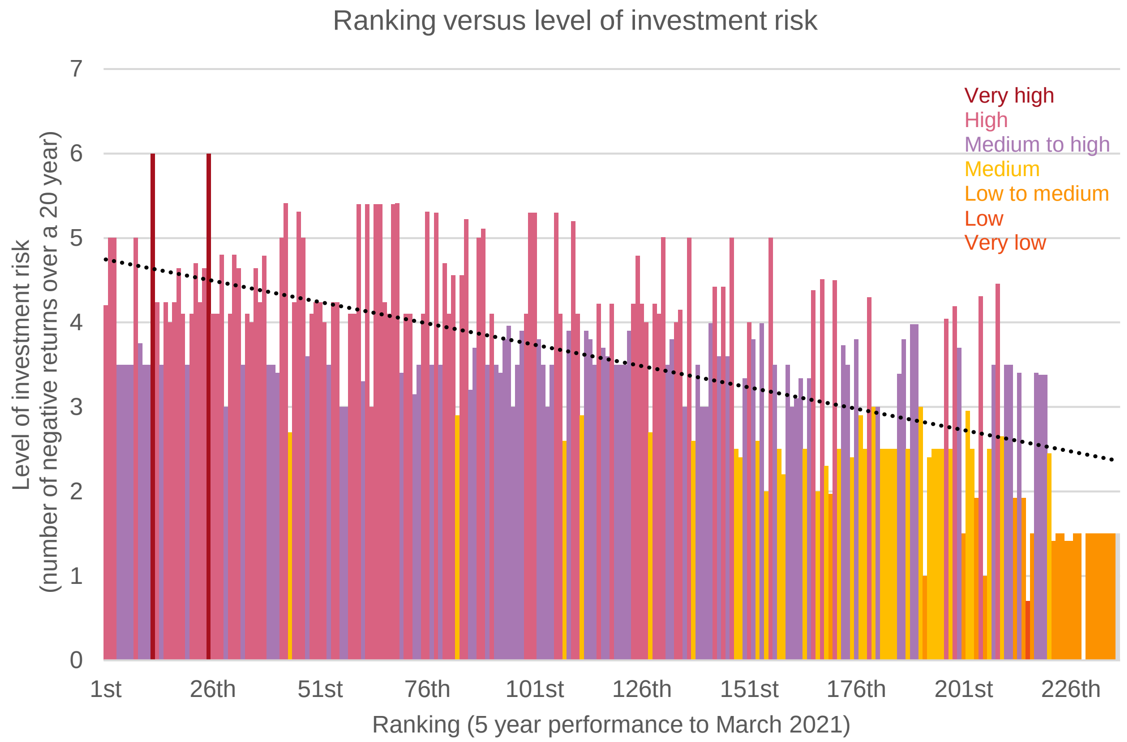
We particularly call out the requirement to only compare “like-for-like” products, adjusted for risk. The current superannuation survey providers, like Chant West and SuperRatings, are particular about ensuring comparisons are only made between funds with similar levels of risk (measured by their exposure to growth assets).

Our reading of the regulations is all MySuper products will be compared, without any segregation by risk level. This will lead to inappropriate comparisons, particularly for lifecycle options. Over longer time periods, higher risk options are expected to achieve higher returns, and as a result the higher risk options will appear at the top of the comparison tool and the lower risk options at the bottom.

The chart below highlights this statement by comparing the ranking of the MySuper funds based on 5 year net returns to March 2021. The best performing funds appear in the left of the chart, and the worst are at the right. The risk level for each fund is also shown. The chart illustrates a clear

[1] ASIC – Regulatory Guide 53 – The use of past performance in promotional material (July 2003)

relationship between the ranking of funds and the level of risk. Higher risk funds have had higher performance and lower risk funds have had lower performance.



Such an outcome is likely to encourage members to select higher risk funds. It would also be a foreseeable outcome that funds would increase their risk levels to increase their likelihood to appear at the top of the comparison tool.

The current survey providers compare funds in defined universes (based on growth/defensive allocation) which limit the amount of additional risk that funds can take on. We believe the comparison tool should similarly group funds by risk level so that appropriate 'like-for-like' comparisons are possible.