AUSTRALIAN INVESTMENT COUNCIL

ANNUAL SUPERANNUATION PERFORMANCE TEST

Submission - design options consultation paper

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Investmentcouncil.com.au

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Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600
By email: yfys@treasury.gov.au

Dear Assistant Secretary

The Australian Investment Council welcomes the opportunity to provide this submission to Treasury on the Annual Superannuation Performance Test.

The Australian Investment Council (the **Council**) is the peak body for private capital, representing the leading domestic and international private capital firms operating in Australia. Private capital spans private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds.

Private equity and venture capital (PEVC) are long-term investment classes and, over the long term, have delivered superior returns for superannuation fund members. Over 10 years, Australian PEVC post-fee returns have been 18.2 per cent annually, around 6.7 percentage points greater than the 11.5 per cent return for global listed equity.

The Council agrees with the principle that superannuation fund members should be able to trust that their fund is acting in their best interests both in terms of returns and costs. However, Australia's current superannuation performance testing and transparency framework is overly focused on tangential issues such as implementation efficiency and investment fees, at the expense of risk-adjusted net returns.

The Council's view is that the current performance test disincentivises superannuation funds from investing in higher-return asset classes because superior returns are generally not realised until well after two successive years of 12-month performance testing. This, in effect, creates a misalignment with fund members.

Moreover, the superannuation performance test is inherently linked to the superannuation transparency framework (which comprises the ASIC RG97 regulation, APRA heatmaps and ATO YourSuper comparison tool). This framework should also be reformed in parallel to remove the excessive focus on investment fees. This would reduce member confusion and allow greater focus on net investment returns.

If you have any questions about specific points made in this submission, please do not hesitate to contact me or our policy team via email at policy@investmentcouncil.com.au.

Yours sincerely

Navleen

Navleen Prasad
Chief Executive Officer

About the Australian Investment Council

The Australian Investment Council (the Council) is the peak body for private capital in Australia. Comprising leading private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds, our members collectively manage over $65 billion for investment into the establishment and growth of Australian businesses.[1]

Private capital funds serve an important purpose by pooling capital from a variety of sources to finance economic activity and jobs in Australia. Capital is invested by individuals, Australian superannuation funds, sovereign wealth funds (including the Future Fund), foreign persons, as well as life insurance companies, endowments, and charities.

Private capital invests into a wide range of businesses across every sector of the Australian economy from early-stage to fast growth, turnaround and those requiring expansion capital. These are businesses that provide services such as healthcare, education and hospitality, and are at the forefront of new industries such as aerospace, agriculture, manufacturing, decarbonisation and climate change, financial services and consumer goods.

The Council's members support more than 850 businesses of varying sizes across every sector of the economy, and directly or indirectly employ close to 600,000 people in Australia.[2] Over time, fund managers have invested capital from a wide variety of domestic and offshore institutional investors to support the growth of thousands of high-potential Australian businesses. In addition to providing equity capital, private capital fund managers provide those businesses with a mix of strategic support, mentoring and networking to help them unlock growth opportunities in domestic and international markets, which underpins the creation of new jobs across all sectors of the economy and boosts economic growth.

Private capital makes a significant contribution to the Australian economy and accounts for three per cent of Australia's GDP. Economic analysis confirms that one in nine new Australian jobs are created by private capital-backed Australian businesses, which reinforces the important job-creating role that private capital investment play.[3]

[1] Preqin and Australian Investment Council Private Capital Markets Overview, Feb 2024.
[2] Funding the Future, EY, May 2022.
[3] Private equity: Growth and Innovation, Deloitte Access Economics, April 2018.

Executive summary

This review into the superannuation performance test is an opportunity to rebalance the regulatory framework towards focusing on the risk-adjusted net returns that will enable Australians to fund their retirement. The current framework does not deliver for superannuation fund members because of an over-emphasis on tangential issues such as implementation efficiency and investment fees.

Consequently, the performance test should be changed to compare funds' abilities to generate strong risk-adjusted net returns. This will provide fund members with greater access to asset classes that deliver superior net returns, such as private equity and venture capital.

The performance test is inherently linked to the transparency framework (RG97, APRA heatmaps and YourSuper comparison tool). This framework should also be reformed to recalibrate the focus on investment fees so that it is considered in the context of the risk-adjusted returns generated.

There is alignment between fund member outcomes and Australia's broader economic objectives. Reforms to the performance test and transparency framework would better enable investment into higher-return asset classes, many of which are actively managed. Investment in these asset classes span the economy, and into areas of unmet community need such as energy transition and the care economy, as well as backing industries that will futureproof Australia's economy.

This submission and the recommendations within it respond to the options presented in the consultation paper. However, there may be other appropriate options that would warrant further design and consultation.

Recommendations:

1. The Australian Government's performance testing and transparency framework should focus on improving member outcomes by measuring them against their ability to enhance risk-adjusted net returns over the long term.
2. Out of the options presented in the consultation paper, the performance test should transition from the status quo to Option 2b, which assesses risk-adjusted returns. This shift improves outcomes for members by creating a competitive dynamic around net investment returns, a key driver of long-term member retirement outcomes.
3. Investment fees should be incorporated as part of net investment returns within the performance test, such as in Option 2b. Including investment fees as a standalone metric within a performance test is expected to exacerbate an over-focus on fee minimisation. Administration fees should continue to be included as part of a performance test.
4. The transparency framework should be revised to deprioritise investment fees and focus on net returns, which are the more comprehensive measure of fund performance for member outcomes. This would encourage members and superannuation funds to concentrate more on the net returns that significantly impact their long-term savings and retirement outcomes, rather than on minimising fees in isolation.
5. The performance test should have broad coverage, be practical to apply, and strong consequences for failure. A performance test which measures long-term, risk-adjusted returns, such as Option 2b, enables broad practical application and strong consequences for failure, without the need for excessive tailoring or amendments. However, an inadequate test such as a multi-metric framework which has strong consequences for failure would create detrimental member outcomes.

The need for reform to focus on net returns

Since 2010 there has been a significant effort by successive governments to improve member outcomes in superannuation, leading to an integrated performance testing and transparency framework (presented in
Figure 1).

Figure 1: Superannuation performance testing and transparency framework

Superannuation performance testing and transparency framework

Mechanism	Description	Focus	Issues
YFYS Performance test	• Annual test that assesses product fund performance, excluding pension products and products with less than five years offering • Consequences for underperformance include notifying members and potentially restricting new memberships for consecutive failures	• Remove products with poorly implemented investment strategies	• Assesses the effective implementation of a product's strategic asset allocation, rather than the overall effectiveness of the strategy
Heatmap	• Interactive tool that displays product's data using a colour scheme to reflect performance across various areas, including total fees • While it does not directly impose consequences, it places undue emphasis on funds "heated" in red, influencing stakeholder perceptions and decisions	• Improve transparency and accountability	• Provides insights into superannuation products in terms of investment returns, fees and costs, and sustainability of member outcomes • Includes results from YFYS Performance test
RG 97	• Outlines the standards for fee and cost disclosures in member communications, such as Product Disclosure Statements (PDS) and fund websites • Requires funds to explicitly detail all incurred investment fees (base and performance) with no consideration of the returns created	• Improve transparency and standardisation of product fee and cost disclosure	• Provides fee information outside the context of their impact on net returns
YourSuper Comparison Tool	• A tool provided by the ATO to facilitate comparison of products on various factors, including fees and performance • Allows members to sort products by fees charged, which encourages a focus on cost over other value aspects	• Facilitate member comparison of superannuation products based on total fees and net returns	• Provides fee information outside the context of their impact on net returns • Includes product cost (based on RG 97), results from YFYS performance test, and net returns

While this framework has led to some improvements, such as helping to reduce the number of underperforming funds, it inadvertently compromises the quality of member outcomes. The framework is at odds with the government's proposed superannuation objectives, as well as trustees' obligations to deliver the best financial outcomes for members with the aim of maximising retirement income. This stems from three primary issues:

- **Restricted investment strategies:** The reliance on prescribed benchmarks deters superannuation funds from investing in innovative or unconventional strategies due to the risk of tracking error. This discourages diversification and limits funds' ability to explore potentially higher-return investment opportunities that do not align neatly with established indices.
- **Short-term optimisation:** Current metrics, including the APRA heatmap's three- and five-year horizons for performance against SAA benchmarks, encourage a focus on short-term gains, often at the expense of strategies that provide higher long-term returns.
- **Fee minimisation obsession:** There is an overemphasis on minimising fees as a higher priority than other crucial factors such as the overall net returns. While fee minimisation is important, this singular focus leads trustees to choose cost over value, potentially sacrificing investment quality and returns that could benefit members in the long run.

The primary driver of superannuation member outcomes is risk-adjusted net returns. High net returns, after accounting for all fees and costs, are essential as they ultimately determine the savings accumulated by members over their working lives.

Case Study 1
The MySuper product offered by Hostplus has delivered robust net returns over a 10-year period at 8.77 per cent, as of June 2023. Hostplus has higher investment fees due to its emphasis on active rather than passive investment, but it outperforms other funds with lower fees. For instance, BUSSQ delivers a significantly lower net return of 7.33 per cent despite charging lower fees than Hostplus and taking a similar level of risk with its allocation to growth assets.

Hostplus demonstrates that members ultimately benefit from the net outcomes after fees. It remains essential to evaluate whether fees are justified by their returns, ensuring members receive the best possible retirement outcomes.

Australian superannuation members would be better served by a more direct focus on generating the strongest possible net returns, regardless of the level of investment fees required to generate these returns. This will align the performance testing and transparency framework with the objective of superannuation and trustees' obligations to members.

Recommendation 1
The Australian government's performance testing and transparency framework should focus on improving member outcomes by measuring them against their ability to enhance risk-adjusted net returns over the long term.

1. Private equity and venture capital's role in generating strong risk-adjusted net returns

Investment in private equity and venture capital (PEVC) can help superannuation funds maximise net returns for members and effectively manage risk. These long-term asset classes have demonstrated their capacity to deliver higher risk-adjusted net returns compared with traditional investments in the following ways:

- PEVC delivers higher annualised net returns than traditional asset classes, consistently outperforming listed equities over multiple horizons after fees. As can be seen in **Error! Reference source not found.**, over 10 years, Australian PEVC post-fee returns have been 18.2 per cent annually, around 6.7 percentage points greater than the 11.5 per cent return for global listed equity. Over 20 years, Australian PEVC returns have been 13.6 per cent, greater than Australian listed equity, global listed equity, global bonds, and cash.
- PEVC has maintained historical outperformance through active long-term involvement with growth assets. Governance control and greater information enables PEVC to contribute to firm value creation, with carefully timed investments. In addition, many of the investment opportunities available to PEVC are difficult to access through listed public equity markets.
- PEVC is not closely correlated with traditional asset classes such as listed equity and bonds, making PEVC a valuable tool for diversification in investment portfolios. The average correlation of PEVC, when compared to cash, Australian bonds, global bonds, Australian listed equity and global listed equity is 0.08. PEVC's investment profile can aid in portfolio diversification, leading to superior long-term returns. By spreading risk and balancing volatility with PEVC's stability, overall portfolio volatility is reduced. Including PEVC improves a portfolio's efficiency by optimising for the best possible return at any given risk level, thereby enhancing long-term investment outcomes.

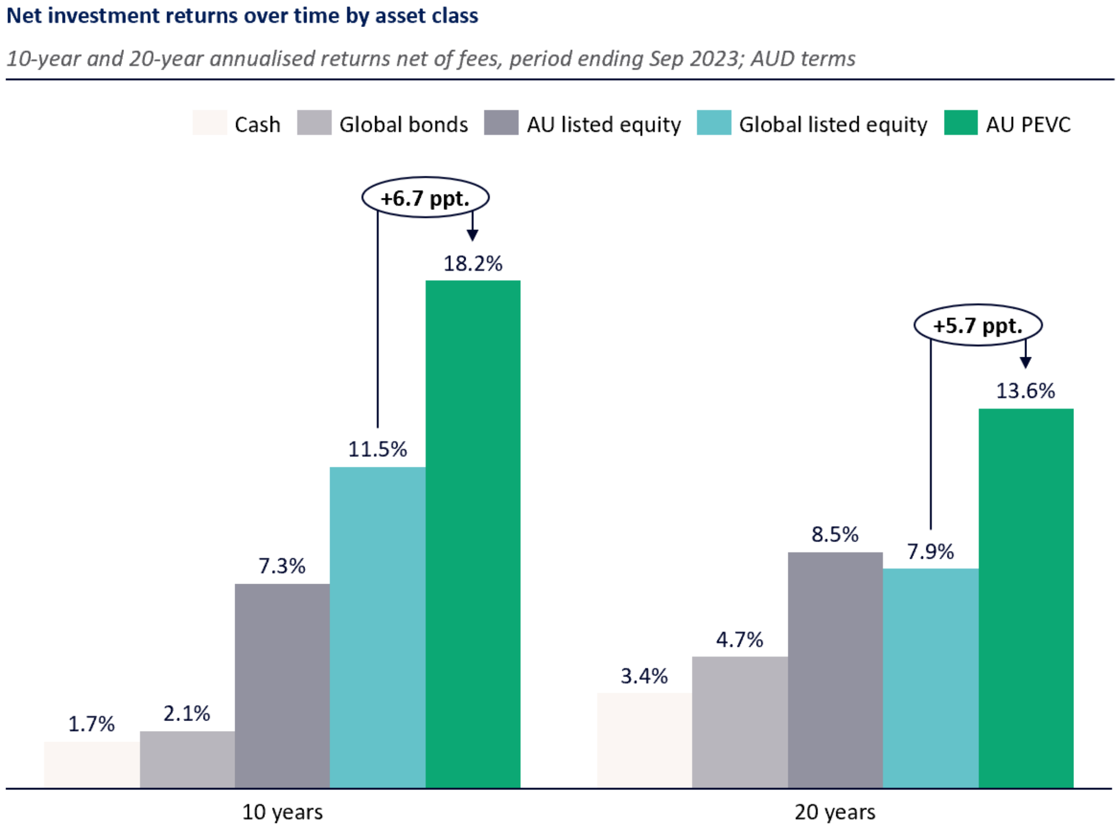
However, the issues with Australian superannuation's testing and transparency framework outlined in the previous section collectively foster a restrictive investment environment that particularly affects the private equity and venture capital sectors.

The framework's limitations create significant barriers for superannuation funds to invest in these asset classes, which are known for their potential to deliver high risk-adjusted returns through long-term capital growth and strategic asset management.

By constraining superannuation funds from fully harnessing the strengths of PEVC, the current testing and transparency measures not only limit the diversification of investment portfolios but also restrict the overall economic contributions these investments can make towards fostering innovative businesses and creating jobs across Australia.

Ensuring that there are no unnecessary impediments to investing in high-performing asset classes such as PEVC will ensure that member outcomes are maximised. It is also important that the performance testing regime does not discourage trustee strategies which allocate towards high-performing asset classes such as PEVC.

Figure 2: Net investment returns over time by asset class



Notes: Cash returns from the Bloomberg AusBond Bank Bill Index, global bonds returns from the Bloomberg Global Aggregate Total Return Index (hedged), Australian listed equity returns from the S&P/ASX 300 Total Return Index, and global listed equity returns from the MSCI ACWI Net Total Return (unhedged). Fee assumptions for publicly traded assets from the YFYS benchmark. PEVC returns proxied with pooled horizon returns, net of fees, expenses, and carried interest, from Cambridge Associates.
Sources: Bloomberg; MSCI; S&P; Cambridge Associates; Australian Government (2023); JP Morgan (2020); Mandala analysis.

2. Private equity and venture capital's role in economic growth and dynamism

There is alignment between superannuation member interests and Australia's broader economic objectives. PEVC is a strong example of an asset class that delivers superior returns for members and makes a meaningful contribution to the Australian economy.

The Australian private capital industry, largely comprised of PEVC is a significant economic contributor, supporting around 600,000 full-time equivalent jobs and adding close to three per cent to the GDP.[4] Projected growth in this industry could increase its GDP contribution to four per cent by 2030, potentially doubling the number of supported jobs. Aligning the performance test with the objectives of superannuation by directing funds towards PEVC is expected to generate approximately one-quarter of these additional jobs.[5]

Based on PEVC's track record and characteristics, nationally significant sectors such as decarbonisation, intergenerational care and manufacturing would be the beneficiaries of increased PEVC investment. PEVC investing is suited to sectors that require innovation and entrepreneurship. It can invest early, often without collateral, taking on risk to provide long-term investment for companies that may not receive support through other funding mechanisms.

This type of investment enables the innovation that will be required in areas such as clean energy technologies, renewable integration, manufacturing technology, consumer-driven research, product commercialisation for care, and new kinds of care service delivery.

Superannuation should be a major source of capital for this type of investment (assuming satisfaction of risk-adjusted return requirements), with members and communities being the beneficiaries. However, the performance test and associated frameworks are a major barrier.

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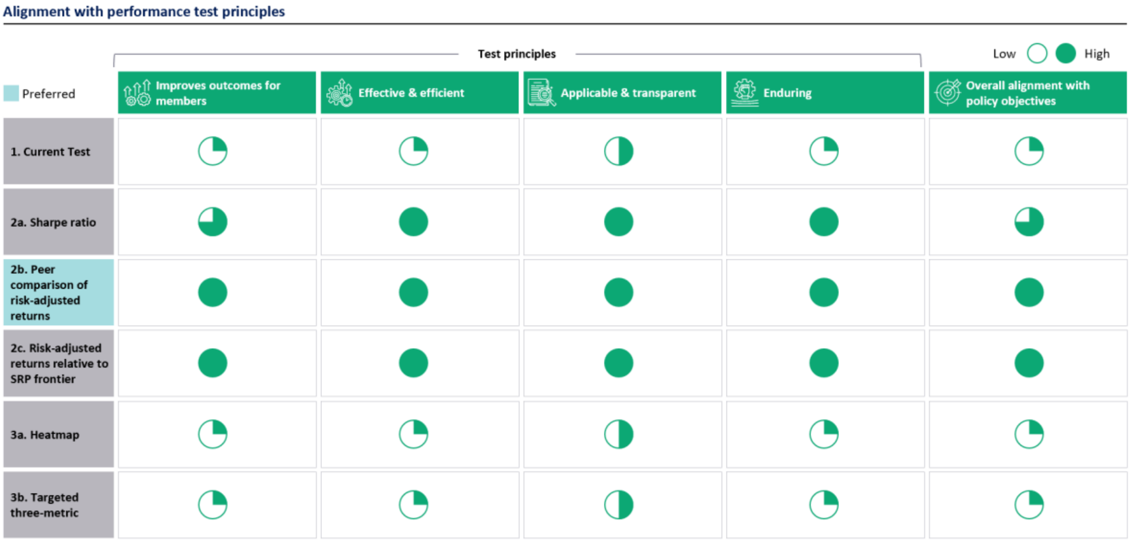
[4] Funding the Future, EY, May 2022.
[5] Forthcoming Mandala analysis.

3. Annual superannuation performance test options

The Treasury consultation outlines four principles for the performance test options, which the Council agrees with. However, we emphasise that primacy of member outcomes should be the overarching principle, prioritised above all others. We have evaluated the options based on these principles, as shown in Figure 3, and accordingly recommend Option 2b.

Figure 3: Assessment of performance test options



Status quo: Option 1
Keeping the current test under Option 1 perpetuates existing issues with the performance test. Maintaining the current test would continue to incentivise benchmark hugging, reducing funds' appetite for higher-return investment strategies if they raise the risk of failing the performance test. This does not serve superannuation members who, within their individual risk appetite, are seeking to maximise savings for retirement.

In addition, the current test only measures the implementation of the investment strategy, without assessing the merit of the strategy or incorporating a measure for risk. While the current test has been effective at reducing the harms of members being placed in a product that has a poorly implemented strategy, it has not created incentives towards improving member outcomes as the strategy of the trustee is not in scope of the test.

Alternative single metric: Option 2a, 2b, and 2c
Alternative single metric options better align with the performance test principles than the status quo or a multi-metric framework. Option 2b is the preferred option out of the alternative single metrics as it promotes competitive dynamics among superannuation funds.

- Option 2a, the Sharpe ratio, is a simple calculation requiring limited data, making it highly practical. However, its emphasis on volatility and equal treatment of upside and downside volatility could distort asset selections.
- Option 2b, a peer comparison of risk-adjusted returns, is the most preferable performance test option as it would encourage competition by motivating improvements and innovation, avoiding incentives for funds to "hug" benchmarks. Option 2b would also utilise the already-accepted concepts of growth and defensive assets, although the

definition of growth and defensive assets for the purposes of the performance test would need to be agreed upon.

- Option 2c, risk-adjusted returns relative to bespoke benchmark, would provide a clear benchmark with simple asset classes of bonds and equities, making it easy to understand and apply. However, it does add some additional complexity around the concepts of volatility and the proposed benchmark —a risk and return investment frontier.

Multi-metric framework: Option 3a and 3b

The multi-metric framework is less favourable as a performance test given its potential to continue the APRA Heatmap's undue focus on investment fees and extend the current performance test's limitations, particularly if the SAA benchmark —the status quo— continues to be included as one of the metrics.

- Option 3a, the APRA Heatmap, has the potential to worsen the existing over-focus on fee reduction as a higher priority than member outcomes. In addition, it would create additional complexity for both funds and members. There is also a risk of correlation between metrics, which could dilute the effectiveness of the assessments.
- Option 3b, the targeted three-metric framework, also risks exacerbating the focus on fees. It will be difficult to select the three most representative metrics for all funds, and this selection could also oversimplify the performance assessment and potentially overlook important nuances.

Other options

Should the Government consider other options for performance testing, the Council argues that the same principle of maximising risk-adjusted net returns be the focus.

Recommendation 2

Of the options presented in the consultation paper, the performance test should transition from the status quo to Option 2b, which assesses risk-adjusted returns. This shift improves outcomes for members by creating a competitive dynamic around net investment returns, a key driver of long-term member retirement outcomes.

4. Treatment of fees in the performance test

Net investment returns already capture the cost incurred when creating value for members. It is misleading to consider these fees outside the context of the returns they generate and has the potential to lead to worse member outcomes if trustees and members are overly influenced by a singular focus on minimising investment fees.

Investment fees should be considered in conjunction with investment returns, which is captured in net investment returns. Utilising net investment returns is the best way of measuring the value for money from investment fees, thereby encouraging trustees to achieve the best retirement outcomes for members. Separating investment fees from investment returns misleads members and distorts trustee behaviour, leading to minimisation of investment fees regardless of the associated returns.

The approach to administration fees should be different to the treatment of investment fees. Administration fees are not directly necessary to derive investment return, instead reflecting a fund's ability to manage its resources effectively over the long term by measuring operational efficiency and sustainability. In addition, administration fees impact members differently from investment fees, as administration fees are directly deducted from a members account and investment fees deducted from returns. It is appropriate that administration fees continue to be included as part of the performance testing and transparency framework.
The recommended Option 2b allows for the inclusion of administration fees within performance testing by subtracting the most recent annual administration fee from the long-term net investment returns.

Recommendation 3
Investment fees should be incorporated as part of net investment returns within the performance test, such as in Option 2b. Including investment fees as a standalone metric within a performance test is expected to exacerbate an over-focus on fee minimisation. Administration fees should continue to be included as part of a performance test.

5. Refocusing fee disclosure practices

The Council emphasises the necessity to realign the superannuation performance testing and transparency framework to reflect the long-term financial interests of members. The current emphasis on fees, contributed to by RG97 and tools like the APRA Heatmap and the ATO YourSuper comparison tool, has led to unintended consequences. The prominence of investment fees can mislead consumers by suggesting poor performance without considering the associated returns. In effect, the perverse outcomes in the performance test that have been identified in the consultation paper are exacerbated by RG97 and the APRA Heatmap.

RG97 requires superannuation fees to be disclosed separately from returns, which has inadvertently disincentivised investments in higher-return asset classes, such as PEVC. These investments tend to have higher fees due to active management, but they yield higher returns compared to many other asset classes. Separating the reporting of fees from returns misrepresents these fees as detrimental, despite the potential long-term value they can generate. The Council's research suggests that superannuation funds focus on fee minimisation, driven by RG97, has skewed allocation strategies towards lower fee investments at the expense of potentially higher net returns.

To rectify this, the Council proposes a revision of the framework to deprioritise investment fees and focus on net returns, a more important measure of fund performance for member outcomes. Investment fees should be de-prioritised, but they must continue to be disclosed within the 'fees and cost' metrics of the APRA heatmap, along with PDSs and periodic statements, to ensure continued transparency.

This recalibration will encourage members and superannuation funds to focus more on the net returns that significantly impact their long-term savings and retirement outcomes, rather than on minimising fees in isolation.

Recommendation 4

To best achieve the policy intent in reforming the performance test, the transparency framework should also be revised to deprioritise investment fees and focus on net returns, which are the more comprehensive measure of fund performance for member outcomes. Addressing deficiencies in the interrelated regulatory instruments would encourage members and superannuation funds to focus more on the net returns that significantly impact their long-term savings and retirement outcomes, rather than on minimising fees in isolation.

6. Breadth of test coverage and failure consequences

In principle. the performance test should have broad coverage, practical application, and strong consequences for failure. The current consequences regime appears to have led to significant consequences for funds that have failed the test and led to a strong focus on avoiding failure. Any strengthening of the consequences would require strong justification. It is also important that these consequences be tied to an appropriately designed test to avoid adverse effects.

Broad coverage with a practical application is essential considering the diverse range of products and the need for a test that does not require excessive tailoring or amendments for different cohorts. Option 2b, which focuses on risk-adjusted returns, provides a holistic measure that can be applied broadly and efficiently across various products.

Recommendation 5

The performance test should have broad coverage, be practical to apply, and strong consequences for failure. A performance test which measures long-term, risk-adjusted returns, such as Option 2b, enables broad practical application and strong consequences for failure without the need for excessive tailoring or amendments. However, an inadequate test such as a multi-metric framework which has strong consequences for failure would create detrimental member outcomes.

7. Conclusion

The Council strongly supports a superannuation performance testing and transparency framework that truly reflects the long-term interests of superannuation members. Our recommendations are aimed at ensuring that the superannuation system not only prioritises risk-adjusted net returns but also fosters a diverse and strategic investment approach, recognising the critical role of PEVC within the financial ecosystem.

We advocate for Option 2b as the preferred performance testing method. This option aligns with our belief that an extended lookback period will more effectively meet the ultimate goal of superannuation —securing a dignified retirement for all Australians. We also call for modifications to the APRA Heatmap to prevent short-term optimisations and provide a more comprehensive overview of performance relevant to retirement outcomes.

As the representative body for private capital in Australia, the Council is committed to collaborating with regulators and policymakers to refine the superannuation framework. By reducing barriers to investment in high-performing asset classes and focusing on holistic financial strategies, we can ensure that the superannuation system remains robust, equitable, and capable of delivering optimal outcomes for all members.