

SUBMISSION

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Productivity Commission
— Supplementary Paper,
Investment performance:
Supplementary analysis

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Dear Deputy Chair

Supplementary Paper – Investment performance: Supplementary analysis

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the *Supplementary Paper – Investment performance: Supplementary analysis*

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its \$2.7 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 15.6 million Australians with superannuation.

If you have any queries or comments in relation to the content of our submission, please contact Andrew Craston.

Yours sincerely

Dr Martin Fahy

Chief Executive Officer

Investment performance: Supplementary analysis

Introduction

ASFA appreciates the opportunity to respond to the Productivity Commission's *Supplementary Paper – Investment performance: Supplementary analysis* (the Paper). The Paper provides additional analysis on the performance of Australian superannuation funds that was contained in the Commission's draft report *Superannuation: Assessing Efficiency and Competitiveness* (the draft report).

ASFA acknowledges the Commission's additional work to assess and benchmark the investment returns of Australian superannuation funds, as well as the Commission's revised, more positive view of the performance of the Australian system.

That said, ASFA has some concerns with the Commission's approach. Some of these concerns are similar to the issues that ASFA highlighted in its response to the Commission's draft report.

With respect to the Commission's benchmarking of individual fund/product performance, ASFA considers that numerous caveats/limitations stem from the Commission's data and benchmarking methodology. Together, these caveats/limitations suggest there is a significant margin of error around any threshold for 'underperforming' funds or products. Nonetheless, the Commission defines underperformance as a very small deviation from what is an approximate threshold.

In addition, in terms of forward-looking performance assessment, the Commission's own analysis shows that measures of short-term investment returns are not a reliable predictor of long-term performance.

ASFA considers there would be risks around applying the Commission's current approach to any selection process for funds or products. ASFA is concerned about underperformance and the impact on consumers. However, given the aforementioned issues, ASFA considers that it would be difficult to draw definite conclusions as to whether particular funds/products are 'underperformers'. In this regard, there is a risk that funds/products would be designated as 'underperforming' despite having the potential to deliver high investment returns over the long term.

The Australian system stacks up well, but international comparisons are difficult to interpret

The Commission compares the performance of the Australian superannuation system with pension systems in other countries. ASFA acknowledges that the Australian system stacks up well against its international peers, however the Commission's results are somewhat difficult to interpret.

Firstly, the Commission uses different timeframes for the Australian system and overseas systems – 2008 to 2017 for Australia, and 2007 to 2016 for pension systems in other countries. The use of different timeframes undermines the efficacy of the comparison, particularly given that the average return for Australian funds in 2007 was 15.3 per cent.

Secondly, it is difficult to compare the performance of investments in domestic asset markets across countries. For any jurisdiction, key determinants of the performance of domestic asset markets are the prevailing domestic economic/financial conditions. In contrast, at a system level, the collective decisions of investment managers with respect to domestic assets are unlikely to explain much of the differences in investment outcomes (in respect of domestic assets) across countries.

For Australian funds there is a wide dispersion of returns across asset classes

At a system level, the Commission finds that APRA-regulated superannuation funds (on average), out-perform the vast majority of the Commission's asset-class benchmarks. The only asset classes where the system clearly falls short of a benchmark are unlisted infrastructure and unlisted property. However, as the Commission notes, the benchmarks for these asset classes have significant limitations (discussed later).

Unsurprisingly, the Commission finds a wide dispersion of return outcomes for the various asset classes at the fund level (for the period 2011 to 2017).

With respect to each asset class, the particular assets held by superannuation funds (and in products) differ – simply put, Australian funds do not invest in the same assets within a particular asset class. This is, of course, more desirable than the alternative. In a world where passive investment strategies monopolised capital flows, the prices of securities would cease to reflect underlying value – leading to misallocations of capital and asset bubbles.

Since certain assets will out-perform others in the same asset class over short time periods (such as 2011 to 2017), one would expect a wide dispersion of return outcomes for each asset class at the fund level.

That said, over long time periods performance tends to converge. While particular points within economic/financial cycles favour different sub-classes of assets, over long periods of time these effects tend to dissipate.

The fact that short-term performance is not a reliable indicator of long-term performance is important to understand given that superannuation is concerned with the generation of long-term returns for members.

There are numerous sources of uncertainty in the Commission's analysis and benchmarking

With respect to the Commission's benchmarking of individual fund/product performance, ASFA considers that numerous caveats/limitations stem from the Commission's survey data, its methodology for constructing benchmarks, and its interpretation of benchmarks to identify 'underperforming' funds/products.

Concerns about survey data

Following the draft report, the Commission received additional data from funds in response to the Commission's 'second chance' survey. There are a number of issues with the survey data – which the Commission acknowledges in the Paper. Indeed, the Commission states that "All data reported from the supplementary funds survey should be interpreted cautiously".¹

Firstly, some funds had to make various simplifying assumptions in order to provide the specific data that the Commission requested.

This, in part, reflects some funds' systems for the collection and reporting of data – which are simply not set up to provide the data as requested. Funds are required to produce a range of data to comply with various prudential requirements, and funds have data systems to collect and report data in the required forms. While funds also produce other data for their own purposes (again, requiring specific systems to collect and report), the characteristics of this data may not accord with the Commission's specific requirements.

¹ Productivity Commission 2018, *Supplementary Paper – Investment performance: Supplementary analysis*, Page 5.

In terms of specific simplifying assumptions, an example is that some funds were unable to produce fund-level data for within-asset class performance, and instead provided the Commission with product/option data that was broadly representative of the (unknown) within-asset class performance at the fund-level.

The Commission also notes that there are relatively few observations for some data series, especially for “earlier years”,² although the Commission does not provide information about the affected data series, nor the time periods.

Overall, these factors may reduce the reliability of the Commission’s assessment of asset-class performance, and its benchmarking of individual funds/products.

Concerns about benchmark methodology

ASFA has some concerns with the Commission’s benchmark methodology. In particular, questions remain whether some of the benchmarks are – in and of themselves – appropriate for benchmarking the performance of funds’ investments.

A case in point is the benchmark for unlisted infrastructure. The Commission finds that many funds’ returns to unlisted infrastructure were well below the Commission’s benchmark. However, this result reveals more about the benchmark than the performance of funds’ investments.

For superannuation funds, the overriding investment objective is to maximise returns to members over the long term. Indeed, optimal asset allocation/selection can only be determined *ex post*, after a suitably long time period.

This is not to suggest that benchmarking is not worthwhile or informative, but that benchmarks need to be chosen carefully to ensure they do not lead to biased assessments of performance. In this regard, a benchmark ideally should be representative of the population to which it is being applied. ASFA acknowledges that this can be challenging, particularly for unlisted assets.

The Commission’s benchmark for unlisted infrastructure (the MSCI/IPD Unlisted Infrastructure Index) reflects the performance of infrastructure assets held by a broader set of investors than superannuation funds. The benchmark had an allocation to domestic assets of 54 per cent at June 2018. However, for APRA-regulated funds the allocation to domestic assets (for unlisted infrastructure) averaged 62 per cent in June 2018. Of course, the optimal asset allocation (to domestic assets) may turn out to be significantly different from both of these figures.

With respect to benchmarking investment performance, it is clear that if overseas assets out-perform domestic assets then a fund/product with an ‘average’ allocation to domestic unlisted infrastructure is likely to be marked down (a negative bias). Other problems of bias (positive and negative) arise from the impact of exchange rate changes. In particular, changes in the exchange rate will have no effect on benchmarking outcomes *only* if a funds’ hedging arrangements in respect of its international infrastructure investments mirror those in the benchmark (again, optimal arrangements can only be known *ex post*).

Overall, these issues reduce the reliability of the Commission’s benchmarking of asset-class performance, but also the Commission’s performance benchmarking of individual funds/products. In the absence of a better benchmark, any potential bias in performance assessment should be reflected in a greater margin of error around the threshold for underperformance.

² Productivity Commission 2018, *Supplementary Paper – Investment performance: Supplementary analysis*, Page 5.

Concerns about benchmarking: short timeframe

ASFA has some concerns regarding the Commission's interpretation of benchmarks to identify 'underperforming' funds/products.

Theoretically speaking, where the asset allocation of a fund/product is reflected *exactly* in a benchmark, then a comparison of the investment performance of that fund/product against the benchmark would provide a clear indication of the 'efficiency' of investment – irrespective of the timeframe under consideration (the extreme case would be where a product comprised entirely of allocations to index-tracker funds, and the product was benchmarked against a combination of the relevant indices).

However, where asset selection differs from a benchmark, then comparison of performance against the benchmark becomes more difficult to interpret – particularly over short time periods. The key point is not that benchmarking is not worthwhile or informative, merely that results need to be caveated appropriately.

Consider the benchmarking of investments in domestic listed equities. A typical benchmark is the S&P/ASX 200 or 300 Index, which comprises a weighted average of listed equities. Although the returns of the component equities (of the index) will be affected by common factors, there are numerous sub-factors that affect some equities more than others.

Particular points within economic/financial cycles favour different assets, so it would be expected that over short time periods, certain assets will out-perform others in the same asset class. However, over long periods of time these effects tend to dissipate. With regard to the above example, whether a particular portfolio of equities (that differs from the Index) will generate superior net returns can only be determined *ex post*, after a suitably long time period.

It is certainly the case that the Commission is hamstrung by a lack of data. However, in respect of the Commission's performance benchmarking of individual funds/products, the time frame used is simply not long enough to provide definitive conclusions. Again, this should be reflected in a greater margin of error around the threshold for underperformance.

Short-term performance is not a reliable predictor of long-term performance

In the Paper the Commission analyses trends in investment performance over time, at both the fund and MySuper product level, to determine whether short-term performance is an indicator of longer-term performance.

The implication of this analysis is that short-term performance could be used as a fund/product selection mechanism – either for the selection of the Top-10 "best in show", or as an indicator of underperformance for an elevated MySuper authorisation.

However, the analysis reveals that short-term performance is not a reliable indicator.

The Commission notes that 30 per cent of funds and 40 per cent of MySuper products performed better than the Commission's threshold for underperformance over a relatively long time horizon (11 and 13 years respectively) also underperformed in over half of the rolling five-year periods within those horizons.³

The Commission concludes that while long-term underperformance is often comprised of many periods of short-term underperformance, not all funds that underperform in the short term will be underperformers

³ Productivity Commission 2018, *Supplementary Paper – Investment performance: Supplementary analysis*, Page 33.

over the longer term. The Commission states that “Even funds with relatively good performance can experience runs of short-term underperformance against benchmarks.”⁴

‘Underperformance’ needs to be carefully defined

ASFA considers there would be risks around applying the Commission’s current approach to any selection process for funds or products.

As outlined above, numerous caveats/limitations stem from the Commission’s survey data, its methodology for constructing benchmarks, and its interpretation of benchmarks to identify ‘underperforming’ funds/products. Together, these caveats/limitations suggest there is a significant margin of error around any threshold for ‘underperforming’ funds/products. In addition, in terms of forward-looking performance assessment, the Commission’s own analysis shows that measures of short-term investment returns are not a reliable predictor of long-term performance.

These issues suggest a number of significant risks regarding fund/product selection.

A well-run fund with strong governance arrangements may record relatively low returns during a narrow period. A narrow set of performance criteria, based on shorter-term historical investment returns, could designate such a fund as ‘underperforming’ – notwithstanding that the fund may have high-quality product and service offerings, as well as the potential to deliver higher investment returns than other funds over the long term.

A longer-term risk is that the application of the Commission’s current approach could see funds/products tend towards homogeneity with respect to investment strategy. Specifically, in order to ‘look good’ against a particular benchmark, funds may tend to adopt similar, passive investment strategies for relevant products (using, for example, low-cost index-tracker funds), which might not be in the best long-term interests of members.

This might also increase systematic risk. For instance, where passive investment strategies dominate capital flows in particular markets, price discovery in those markets may become impaired – increasing the risk of misallocations of capital and asset bubbles.

⁴ Productivity Commission 2018, *Supplementary Paper – Investment performance: Supplementary analysis*, Page 33.