

INVESTMENT INSIGHTS
NOVEMBER 2020

QIC

Your Future, Your Super Comparative Benchmarks

Eroding Our Retirement Resilience and
Economic Rebuild



CONTENTS

1	Our position: Identifying the adverse consequences of YourSuper	3
2	Your Future, Your Super: An overview	5
3	Performance: Comparative benchmarking	5
4	At a glance: A summary of unintended consequences	6
5	Flawed passive index benchmarks	7
6	Our solution	7
7	Appendix:	8
7.1	Detailed SAA benchmark approach	8
7.2	Passive indices are being asked to represent a broad church of risk	9
7.3	Key insights from asset class index compositions	10
7.3.1	Listed property index composition	10
7.3.2	Listed infrastructure index composition	11
7.3.3	Region exposure	11

Your Future, Your Super Comparative Benchmarks: Eroding Our Retirement Resilience and Economic Rebuild

During the October 2020 Federal Budget, Treasurer Josh Frydenberg unveiled [Your Future, Your Super](#), a raft of new provisions aimed at improving the accountability, transparency and performance of superannuation funds. These provisions are an extension of previous My Super regulations and now impact all “trustee-directed products”.¹ In essence, they will rank the relevant products by fees and investment returns with underperforming products publicly marked as “underperforming” and barred from new members.

QIC supports the drive for performance in the superannuation industry and believes members’ financial interests must be paramount to all decision making. However, we also believe there are unintended consequences from some of the drafted frameworks which will adversely impact Australian super fund members and the broader community.

That is why QIC is signalling its willingness to work with industry partners, regulators and government to ensure members get the surety and security they deserve from Australia’s super funds, and all communities continue to benefit from long-term sustainable investments into their social and physical infrastructure.

QIC’s main cause of concern focuses on the proposed performance test which will compare superannuation trustees’ non risk-adjusted returns to passive listed indices via an annual performance test.

In short, we see the proposed changes as an erroneous treatment of the key principle of investing – the balance of risk and return – with the real consequence of an erosion of the ability of our nation’s super funds to meet the retirement needs of all Australians, as well as investing into Australia’s vital economic rebuild following COVID.

1. OUR POSITION: IDENTIFYING THE ADVERSE CONSEQUENCES OF YOURSUPER

We strongly agree super fund accountability and member transparency is a vital right for super fund members. However, while the ability for Australians to compare like-for-like across superannuation funds is important, we are concerned about an end result which will erode the security and surety of all Australians’ retirement resilience.

We note the provisions do not force superannuation trustees to invest into the passive indices referenced, but it is a high risk that this is the direction they will follow. This is because the stringent penalties super funds face when underperforming against the indices far outweighs the perceived value of outperforming the indices [See: Performance- comparative benchmarking]. It is this asymmetric imbalance to favour passive indices which will result in the following adverse consequences:

- 1. Contrarian approach to finance theory:** There is a broad church of risk under which asset class definitions such as “real estate”, “infrastructure” or “fixed income” exist. The proposed provisions disregard this, by simplifying asset classes down to a broad definition and a single asset class return number. This in turn, disregards leverage, volatility, drawdown risk and capital gain versus income return. We believe risk and return are fundamental tenets of financial management and need to always be addressed simultaneously. We view a comparison on the basis of asset class and return only as contrary to finance theory.
- 2. Members’ interests will be oversimplified and disregarded:** The provisions direct trustees to take more equity risk than they are currently taking. They assume that a “one size fits all” approach can apply to all members, regardless of their age or time to retirement. This is contrary to the very function of super funds where trustees strategically align portfolios with sequencing risk for members. For example, super funds typically move ageing members away from equity beta as they approach their drawdown phase to provide them surety for their retirement. The drafted provisions do not allow for this orientation.

¹ Those products that are regulated by APRA where trustee has control over the design and implementation of the investment strategy and where the investment strategy covers more than one asset class.

The provisions also simply compare an asset class title (e.g. “infrastructure”) to the benchmark return for that asset class and then weigh this up for all asset classes to the portfolio level. This totally ignores the value of the asset allocation decision or any portfolio management techniques for the whole of the offering to the member. This potentially allows a naïve asset allocation framework to effectively “outperform” a superior one which incorporates long term real assets – even if the latter actually produces more risk-adjusted return for the member.²

3. **Disincentivises nation building:** While using passive indices as a benchmark might be the simple route, we question the use of listed indices. The indices referenced, particularly in real estate and infrastructure, do not encourage superannuation funds to invest in real assets in Australia.
 - a. Real estate covers a broad spectrum of risk/return which can provide investors with reliable defensive income at one end and significant capital gains at the other. The Australian real estate benchmark is a list of REITs, of which the top eight are corporates with accompanying, significant development risk. Investment in well tenanted healthcare real estate for example, would suffer under this construct.
 - b. Australia has no listed infrastructure benchmark, thus to benchmark domestic infrastructure the provisions reference a global benchmark. The global benchmark has a 2.8% weighting towards Australia and a 66% weighting to the United States. This will encourage capital allocation to infrastructure to move offshore, away from the large volume of infrastructure projects signalled as vital for our economic recovery. This is contrary to other government directives requiring domestic partnership and investment in Australia. It also comes at a time when there is a tightening of FIRB regulation, disincentivising foreign investment. This is a disappointing outcome particularly when stimulus is required for post-COVID economic recovery. This lack of capital supply will increase the cost of capital for Australian infrastructure projects.
4. **Encourages capital into short termism:** By pushing capital into the equity market, the framework is removing the incentive to invest long term. Superannuation funds have long been known for their ability to provide long term, patient capital. The guidelines essentially suck duration from the capital market.
5. **Does not reduce total member fees:** As currently drafted, the proposal seeks to maximise net investment returns relative to benchmarks. No reference is made to administration fees. This is an implicit incentive to move management fees into an administration classification – or even not seek those efficiencies which may be possible from managing administration fees more closely as mergers in the superannuation industry begin to occur.
6. **Steps away from sustainability:** The proposed benchmarks ignore any sustainability focus. We believe integrating sustainability results in better risk-adjusted returns for members over the long run. In particular, superannuation trustees and their members are interested in investing to promote Australia’s carbon emissions reductions as per our Paris Agreement targets. The new approach also can present challenges for investors to explicitly address systemic ESG risks like climate change.

² For example a naïve 60/40 portfolio could earn CPI+3% and perform in line with its benchmark. A portfolio with real assets could return CPI+6% but underperform its benchmark by more than 50bps for two years. It would be deemed to be underperforming, despite potentially having given members more return for less risk.

2. YOUR FUTURE, YOUR SUPER: AN OVERVIEW

The *Your Future, Your Super* reforms aim to improve areas failing superannuation members, including multiple unwanted accounts and underperforming funds.

The reforms will work under these main channels³:

1. Superfund stapling

Under the new plan, the superannuation fund chosen by Australians when they start work will now follow them through life unless they switch to another via the ATO-run Your Super portal.

2. Transparency: YourSuper comparison tool

The portal provides members information on high-performing and/or low cost products via an online comparison tool. From 1 July 2021 the tool will, on a quarterly basis, rank MySuper products by fees and investment returns. Underperforming products will be clearly marked as “underperforming”. The tool will be based on information that superannuation funds report to APRA and will be developed in consultation with the Treasury. It will be administered by the ATO.

3. Performance: Comparative benchmarking

APRA will start net performance benchmarking super funds with those deemed as “underperformers” barred from accepting new members until performance improves.

4. Accountability: Alignment of interests

Increasing trustee accountability to ensure superannuation fund actions are only taken in the *financial interest* of members.

As indicated above: QIC supports the endeavours aimed at enhancing the transparency and accountability of super funds towards their members. We also believe it is right to encourage strong fund performance. Our concerns are focused on the performance proposals.

3. PERFORMANCE: COMPARATIVE BENCHMARKING

APRA’s new benchmarking performance framework will be the primary method of measuring underperformance in Australia’s super fund sector. It will be effective from 1 July 2021 for MySuper products and then extend to all “trustee-directed” accumulation products outside of MySuper from 1 July 2022.

The framework stipulates the following:

- Performance will be calculated over an eight-year period to account for longer-term returns, use after-fees and after-tax performance and take asset allocation as given (i.e. asset allocation decisions are not assessed as a driver of performance)
- Asset class performance will be assessed relative to a listed index for the respective asset class
- Products that underperform their annual net investment return benchmark by 0.5 percentage points over an eight-year rolling period will be classified as underperforming

This framework gives rise to a number of unintended consequences which are covered below.

3 <https://treasury.gov.au/publication/p2020-super>

4. AT A GLANCE: A SUMMARY OF UNINTENDED CONSEQUENCES

Theme	Framework direct impact	Potential consequence
Fees	The framework only takes management fees into account and does not measure administration fees.	Administration fees may not be managed efficiently, and trustees may be incentivised to redefine some fees as administration fees rather than management fees.
Performance	Implicitly moves members to 100% equity beta for all equity and real asset allocations.	Increases portfolio volatility, drawdown risk.
	Implicitly moves all fixed income (non-cash) exposures to being long interest rate duration.	Increases asymmetry risk for fixed income returns – with rates so low, the risk of further rate falls (capital gains) is lower than the risk of rates rising (capital losses).
	Implicitly moves members to passive product.	Forgoes the benefits of active management, particularly in times of stress.
All members are treated the same	No alignment with member age demographic in performance measurement.	Pushes ageing members into the riskier proposition of having more equity beta (volatility) as they approach retirement.
Sustainability	By benchmarking to non ESG-aligned passive indices, the pursuit of long-term sustainability goals is foregone.	Diminishes Australia's ability to achieve carbon emission targets.
		Diminishes Australia's ability to invest in new technologies that can provide long term benefits to members.
Nation building	The infrastructure benchmark is global.	<p>Pushes Australian superannuation allocations to infrastructure offshore.</p> <p>Increases cost of capital for Australian infrastructure- especially given new FIRB rules are designed to protect Australia's national interest, resulting in the limiting of foreign investment in Australia.</p>
Diversification	Listed infrastructure and real estate exposures have higher correlation to equity markets than the non-listed equivalents.	Increases drawdown risk for entire portfolio.
	Ignore superior asset allocation frameworks.	Potentially reduces investment in real assets and pushes privately owned assets into public markets.

5. FLAWED PASSIVE INDEX BENCHMARKS

Benchmarking to passive indices means real estate and infrastructure exposures takes on more equity beta, undercutting superannuation funds' ability to deliver the best returns to members.

The below highlights our concerns with the proposed benchmarks. A list of the indices is attached in the appendix.

Index selection: Infrastructure

- The index – FTSE Developed Core Infrastructure Index hedged to AUD – is weighted towards the US (66% exposure) while Australia only carries 3%
- Heavily focused on conventional energy (34%)
- Does not align to the private investment in infrastructure that has been signalled as necessary for Australia's economic recovery
- Also conflicts with FIRB rules aiming to align managers with nation building

Index selection: Real estate

- The S&P/ASX 300 A-REIT Index is dominated by eight corporate exposures which are heavily into development and as such, present a completely different risk profile to actively-managed property assets
- The gearing for listed property is also very different to actively management property assets which are not adjusted for in the index
- Listed property assets also attract much higher volatility
- Core (and even core plus) real estate is traditionally considered a defensive exposure relative to equities

Index selection: Fixed Income

- There are only two choices: cash and long-duration benchmarks
- Not everything can be classified relative to cash
- The long-duration benchmark is a more traditional measure of fixed income holding
- Given low returns and negative yields in today's market – and the potential lower ability of these indices to rally when equity markets sell off – many have been moving to fixed income allocations that don't have interest rate duration such as credit only, total return or absolute return funds.

6. SOLUTION

QIC is eager to work with the Federal Government and propose solutions that meet Government's goals but minimise the unintended consequences this paper has outlined.

Initial thoughts for discussion with industry partners, asset owners, consultants and Government include:

1. **Capping all fees** based on an upper standard deviation limit around the mean of the current fee distribution (\$ fees/member balance). As it is peer aware, it will keep a focus on fee minimisation while competition remains between trustees. This standard deviation can be reassessed annually. It will address both administration and investment fees. It will allow funds to choose the asset classes that they want to have actively managed versus those that they may be happy having passively managed.
2. **Incorporate a risk measure in the net return assessment** so products would be assessed on the basis of net return/unit risk. We are happy to discuss the pros and cons of different risk measures (e.g. volatility, drawdown risk etc).
3. **Redefine benchmarks.** If benchmarks are to be used, we recommend investigating unlisted equivalents and incorporating more granular risk levels (e.g. core, core plus, value-add or in fixed income, total return based on bands of risk taken). This will promote more investment in Australian assets and better align risk and return.
4. **Revisit the strategic asset allocation assessment** from the APRA Heatmap or agree other measures of growth/defensive allocation. Academic theory argues that approximately 90% of portfolio performance rests on the asset allocation decision and we believe that ignoring this in the framework could cost members dearly.

7. APPENDIX:

7.1 DETAILED SAA BENCHMARK APPROACH

n will now be equal to 8 years⁵

Performance relative to listed SAA benchmark portfolio
 = *n year NIR p.a. – n year Listed SAA benchmark portfolio return p.a.*

where

n year Listed SAA benchmark portfolio return p.a.

$$= \left[\prod_{t=1}^{4n} \left(1 + \sum_{l=1}^A (SAA_{l,t-1} \times R_{l,t}) \right) \right]^{\frac{1}{n}} - 1$$

$SAA_{l,t-1}$ is the strategic asset allocation to asset class l at end of quarter t -1 (or start of quarter t);

$R_{l,t}$ is the return on the index chosen to reflect asset class l for quarter t after adjustments for the impact of fees and taxes;

n is either 3 years or 5 years;

A is equal to the total number of asset classes

$$R_{l,t} = (Index_{l,t} - Fee_l) \times (1 - ETR_l)$$

$Index_{l,t}$ is the quarterly return on the index chosen to reflect asset class l for quarter t,

Fee_l is the fee assumed for asset class l,

ETR_l is the assumed effective tax rate for asset class l

Asset Class	Index	Fee Assumption	Assumed effective tax rate
Australian Equity	S&P/ASX 300	0.05%	0.00%
International Equity (hedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (100% hedged to AUD)	0.11%	14.00%
International Equity (unhedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (unhedged in AUD)	0.09%	14.00%
Australian Property	S&P/ASX 300 A-REIT Index	0.12%	14.00%
International Property	FTSE EPRA/NAREIT developed ex Australia rental hedged to AUD	0.22%	14.00%
Australian Infrastructure	FTSE Developed Core Infrastructure Index hedged to AUD	0.26%	14.00%
International Infrastructure	FTSE Developed Core Infrastructure Index hedged to AUD	0.26%	14.00%
Australian Fixed Interest	Bloomberg Ausbond Composite 0+ Index	0.10%	15.00%
International Fixed Interest	Bloomberg Barclays Global Aggregate Index (hedged in AUD)	0.10%	15.00%
Australian Cash	Bloomberg Ausbond Bank Bill Index	0.04%	15.00%
International Cash	Bloomberg Ausbond Bank Bill Index	0.04%	15.00%
Other (assets categorised as Other / Commodities)	25% International Equity (hedged), 25% International Equity (unhedged), 50% International Fixed Interest	As per the underlying asset classes	

⁵ Information Paper – Heatmap MySuper Products, APRA , Nov 2019, retrieved from <https://www.apra.gov.au/sites/default/files/Information%20paper%20-%20Heatmap%20-%20MySuper%20products.pdf>

7.2 PASSIVE INDICES ARE BEING ASKED TO REPRESENT A BROAD CHURCH OF RISK

Benchmarking to passive indices mean private equity, real estate and infrastructure exposures takes on more equity beta, undercutting super funds abilities to deliver the best returns to members.

Asset Class	8-year CAGR (Net of fees)	Index	Comments on Index
Aus Equity	7.82%	S&P/ASX 300	
International Equity (hedged)	10.62%	MSCI All Country World Ex-Australia Equities Index with Special Tax (100% hedged to AUD)	
International Equity (unhedged)	10.08%	MSCI All Country World Ex-Australia Equities Index with Special Tax (unhedged in AUD)	
Australian Property	3.92%	S&P/ASX 300 A-REIT Index	Heavily focused on eight large corporates with significant development risk
International Property	5.92%	FTSE EPRA/NAREIT developed ex Australia rental hedged to AUD	
Australian Infra	9.33%	FTSE Developed Core Infrastructure Index hedged to AUD	Global index with Australia representing 2.8%
International Infra	9.33%	FTSE Developed Core Infrastructure Index hedged to AUD	Heavily focused on the US – exposure of 66% Focused on conventional energy (34%)
Aus Fixed Interest	4.25%	Bloomberg Ausbond Composite 0+ Index	Very duration focused with risks being long with asymmetrical payoff risk Not a good benchmark for absolute return funds
International Fixed Interest	4.52%	Bloomberg Barclays Global Aggregate Index (hedged in AUD)	Very duration focused with risks being long with asymmetrical payoff risk Not a good benchmark for absolute return funds
Aus Cash	1.88%	Bloomberg Ausbond Bank Bill Index	
International Cash	1.88%	Bloomberg Ausbond Bank Bill Index	
Other	7.30%	25% International Equity (hedged), 25% International Equity (unhedged), 50% International Fixed Interest	

7.3 KEY INSIGHTS FROM ASSET CLASS INDEX COMPOSITIONS

7.3.1 Listed property index composition

- The S&P/ASX 300 A-REIT Index is dominated by eight corporate exposures which are heavily into development and as such, present a completely different risk profile to actively-managed property assets
- The gearing for listed property is also very different to actively management property assets which are not adjusted for
- Listed property assets also attract much higher volatility

Corporate	Benchmark Allocation
Goodman Group	26.26%
Scentre Group	10.22%
Dexus	8.43%
Stockland	8.15%
Mirvac Group	7.58%
GPT Group	6.78%
Charter Hall Group	5.28%
Vicinity Centres	4.66%
Shopping Centres Australasia Property Group RE Ltd.	2.05%
Charter Hall Long WALE REIT	1.89%
Waypoint REIT Ltd.	1.80%
BWP Trust	1.69%
Charter Hall Retail REIT	1.56%
National Storage REIT	1.48%
Cromwell Property Group	1.40%
Centuria Industrial REIT	1.15%
Ingenia Communities Group	1.14%
Growthpoint Properties Australia	0.87%
Centuria Capital Group	0.83%
Abacus Property Group	0.81%
Charter Hall Social Infrastructure REIT	0.79%
Arena REIT	0.77%
Aventus Group	0.74%
Rural Funds Group	0.67%
Centuria Office REIT	0.67%
Investec Australia Property Fund	0.60%
Unibail-Rodamco-Westfield SE Stapled Security Chess Depository Interests Repr 0.05 Sh	0.54%
GDI Property Group	0.46%
Hotel Property Investments Ltd.	0.42%
APN Industria REIT	0.30%

7.3.2 Listed infrastructure index composition⁶

Sector Allocation

Sector	Benchmark Allocation
Conventional Electricity	34.2%
Railroads	18.8%
Pipelines	11.5%
Specialty REITs	10.3%
Multiutilities	9.8%
Gas Distribution	3.9%
Transportation Services	3.4%
Travel & Tourism	3.3%
Water	2.8%
Mobile Telecommunications	1.4%
Telecommunications equipment	0.2%
Broadcasting & Entertainment	0.1%
Fixed Line Telecommunications	0.1%

Market Allocation

Market Allocation	Benchmark Allocation
United States	66.4%
Canada	13.6%
Japan	5.8%
United Kingdom	2.8%
Australia	2.8%
Spain	2.6%
Hong Kong	2.4%
Italy	1.8%
France	0.7%
Korea	0.2%
New Zealand	0.3%
Belgium	0.2%
Germany	0.1%
Portugal	0.1%
Singapore	0.1%
Switzerland	0.1%

7.3.3 Region Exposure

Region	Benchmark Allocation
North America	80.0%
Europe	8.4%
Pacific	11.6%

IMPORTANT INFORMATION

QIC Limited ACN 130 539 123 ("QIC") is a wholesale funds manager and its products and services are not directly available to, and this document may not be provided to any, retail clients. QIC is a company government owned corporation constituted under the Queensland Investment Corporation Act 1991 (QLD). QIC is regulated by State Government legislation pertaining to government owned corporations in addition to the Corporations Act 2001 (Cth) ("Corporations Act"). QIC does not hold an Australian financial services ("AFS") licence and certain provisions (including the financial product disclosure provisions) of the Corporations Act do not apply to QIC. QIC Private Capital Pty Ltd ("QPC"), a wholly owned subsidiary of QIC, has been issued with an AFS licence and certain other wholly owned subsidiaries of QIC are authorised representatives of QPC. QIC's subsidiaries are required to comply with the Corporations Act. QIC also has wholly owned subsidiaries authorised, registered or licensed by the United Kingdom Financial Conduct Authority ("FCA"), the United States Securities and Exchange Commission ("SEC") and the Korean Financial Services Commission. For more information about QIC, our approach, clients and regulatory framework, please refer to our website www.qic.com or contact us directly.

To the extent permitted by law, QIC, its subsidiaries, associated entities, their directors, officers, employees and representatives (the "QIC Parties") disclaim all responsibility and liability for any loss or damage of any nature whatsoever which may be suffered by any person directly or indirectly through relying on the information contained in this document (the "Information"), whether that loss or damage is caused by any fault or negligence of the QIC Parties or otherwise. This Information does not constitute financial product advice and you should seek advice before relying on it. In preparing this Information, no QIC Party has taken into account any investor's objectives, financial situations or needs. Investors should be aware that an investment in any financial product involves a degree of risk and no QIC Party, nor the State of Queensland guarantees the performance of any QIC fund or managed account, the repayment of capital or any particular amount of return. No investment with QIC is a deposit with or other liability of any QIC Party. This Information may be based on information and research published by others. No QIC Party has confirmed, and QIC does not warrant, the accuracy or completeness of such statements. Where the Information relates to a fund or services that have not yet been launched, all Information is preliminary information only and is subject to completion and/or amendment in any manner, which may be material, without notice. It should not be relied upon by potential investors. The Information may include statements and estimates in relation to future matters, many of which will be based on subjective judgements or proprietary internal modelling. No representation is made that such statements or estimates will prove correct. The reader should be aware that such Information is predictive in character and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results may differ materially from results or returns ultimately achieved. **Past performance is not a reliable indicator of future performance.**

This Information is being given solely for general information purposes. It does not constitute, and should not be construed as, an offer to sell, or solicitation of an offer to buy, securities or any other investment, investment management or advisory services, including in any jurisdiction where such offer or solicitation would be illegal. This Information does not constitute an information memorandum, prospectus, offer document or similar document in respect of securities or any other investment proposal. This Information is private and confidential and it has not been deposited with, or reviewed or authorised by any regulatory authority in, and no action has been or will be taken that would allow an offering of securities in, any jurisdiction. Neither this Information nor any presentation in connection with it will form the basis of any contract or any obligation of any kind whatsoever. No such contract or obligation will be formed until all relevant parties execute a written contract. QIC is not making any representation with respect to the eligibility of any recipients of this Information to acquire securities or any other investment under the laws of any jurisdiction. Neither this Information nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations.

Investors or prospective investors should consult their own independent legal adviser and financial, accounting, regulatory and tax advisors regarding this Information and any decision to proceed with any investment or purchase contemplated by the Information.

Copyright QIC Limited, Australia. All rights are reserved. Do not copy, disseminate or use, except in accordance with the prior written consent of QIC.