Barrenjoey

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To whom it may concern

Your Future, Your Super Review Consultation Paper

Barrenjoey Capital Partners (Barrenjoey) welcomes this opportunity to respond to the Your Future, Your Super (YFYS) Review Consultation Paper.

Barrenjoey is an Australian financial services firm that aims to deliver outstanding outcomes for clients through our Corporate Finance advisory, Equity and Debt Capital Markets, Research, Equities trading, Fixed Income and Private Capital businesses.

This submission addresses consultation questions 1, 2 and 4 of the Consultation Paper.

1. Overview – The unintended impact of Your Future, Your Super on AUD inflation-linked bonds

As an active inflation-linked bond market-maker, we have observed that the Your Future, Your Super legislation has reduced demand for inflation-linked bonds due to the use of the Bloomberg Ausbond Composite 0+ Index as the performance benchmark for all Australian Dollar fixed income bonds. This index does not include inflation-linked bonds, which results in inflation-linked bonds holding contributing to the tracking error of fixed income allocations for the purpose of the YFYS Performance Test.

While the 'Retirement Income Covenant' specifically cites inflation as one of the key risks to retirement incomes, the YFYS benchmarking hinders the ability of super funds to use inflation-linked bonds as a hedge. Providers of MySuper products must balance the benefit to their members of hedging future inflation risk against the requirement to track performance of a benchmark index which does not include these products. This trade-off directly harms Australians who use MySuper products, as it reduces the extent to which their retirement income is hedged against high inflation environments.

The unintended consequences of the Performance Tests extend beyond the effects on retirement savings. This distortion of allocations to inflation-linked bonds are reflected in their prices, which hinders the ability of financial markets and the insurance industry to appropriately value liabilities and impedes the ability of official institutions (such as Treasury and the Reserve Bank of Australia) to estimate inflation expectations.

We recommend that the benchmark AUD CPI bond index, namely the Bloomberg AusBond Inflation Gov 0+ Index (BAIG0), be introduced as the Your Future, Your Super performance benchmark for allocations to Australian Dollar inflation-linked bonds ('inflation-linked bonds').

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Question 2: Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members?

We believe that the use of the Bloomberg Ausbond Composite 0+ Index as the benchmark for measuring returns of all fixed income products in Australia has the following unintended impacts:

i. *MySuper members*

We believe the legislation has resulted in reduced investment in inflation-linked bonds.

For the $98 billion of MySuper assets under management which are allocated to Australian Dollar fixed income, the passive allocation to inflation-linked bonds is nil due to their exclusion from the composite index, notwithstanding that inflation-linked bonds account for 3.4% of the Australian Dollar fixed income universe. It is difficult to know the extent to which the legislation is distorting allocations, but it is likely large. Note that:

- an alternative index that weights bonds in proportion to their outstanding value would result in a $3.1 billion passive allocation to inflation-linked bonds.
- the passive allocation is most likely an underestimate of the optimal allocation, as these bonds have unique risk properties in a superannuation portfolio. They offer the highest certainty in hedging long-dated real consumption risk for Australian investors.

ii. *Inflation-linked bond market more broadly*

We have also observed the following market impact of lower allocations to inflation-linked bonds following the introduction of the YFYS measures:

- a reduction in demand for the inflation-linked bond asset class, and commensurately poorer performance than expected. The current breakeven on 10-year inflation-linked bonds is 2.25%, which is below the median level over the last 20 years, in spite of the fact that the RBA's forecast of inflation is at its highest in 20 years. This discordance between pricing and underlying fundamentals suggests constrained demand is contributing to market prices.
- higher volatility of real yields stemming from the reduced number of active participants in the inflation market.

iii. *Reserve Bank of Australia*

The break-even inflation rate is the main market-based measure for term inflation, followed internationally including by the Reserve Bank of Australia. Lower than otherwise demand for inflation-linked bonds can result in a lower breakeven inflation rate, which is one of the metrics considered by the Reserve Bank of Australia.

iv. *Funding of Australian Government Debt*

The Australian Government (through the Australian Office of Financial Management, 'AOFM') uses inflation-linked bonds ('Treasury Inflation Bonds', or 'TIBs') as part of its funding mix. They offer AOFM an important diversification of its investor base. Inflation-linked bonds are widely used globally as a component of sovereigns' funding mix.

If so, is there a way to adjust the benchmark indices while maintaining a clear and objective Performance Test?

Yes, we recommend the benchmark AUD CPI bond index, namely the **Bloomberg AusBond Inflation Gov 0+ Index** (BAIG0), be introduced as the Your Future, Your Super performance benchmark for allocations to inflation-linked bonds. This would be commensurate with the desire to maintain a clear and objective Performance Test without discouraging the use of AUD CPI-linked bonds.

Question 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?

i. *Longer term member outcomes*

Without the change of benchmark recommended above, we believe super funds will be discouraged from including inflation-linked bonds in investment portfolios, as the design of the legislation makes their inclusion in a portfolio add to the financial risk of the portfolio. This creates a perverse outcome for members, as inflation-linked bonds is the asset class that best hedges long term real consumption risk. A lower allocation to inflation-linked bonds will mean that members bear a larger risk of long-term changes in the price level, increasing the risk to real incomes in retirement.

ii. *Long term impacts on market dynamics and composition*

A lower default allocation to inflation-linked bonds from superannuation funds will lead to an inefficiently low price for inflation-linked bonds, and a higher degree of price volatility. Moreover, demand begets liquidity and liquidity begets demand in turn. A lack of regular inflows into inflation-linked bonds in Australia may lead to a reduction in the size of the market through reduced issuance, which then leads to lower liquidity and higher transaction costs for participants.

Conclusion

We would be happy to expand on any of the points above and/or provide further information to either the consultation process or the technical working committee on the Your Future, Your Super Performance Test.

Yours sincerely,

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