Your Future, Your Super Review: Request for Feedback and Comments

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Introduction:

This feedback is provided in response to the Your Future, Your Super Review (consultation paper) dated 7 September 2022. The authors provide feedback in representation of CEM Benchmarking (CEM). CEM is globally recognized leader in pension benchmarking based in Toronto Canada. With 30 years of experience benchmarking the performance and cost of over 1,100 distinct funds worldwide including Australian superannuation funds, we offer here our advise to the Australian Ministry of Finance where we believe our expertise is of value.

Consultation Question #2.

"Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?"

Response from CEM:

A challenge in benchmarking institutional investor portfolios concerns the use of listed public market equity indices when benchmarking private equity or other unlisted assets. Nearly all private (or unlisted) market asset classes exhibit pronounced lag relative to the reporting date; that is, if a private market annual return is reported for a calendar year December 31 2021 - December 31 2022, this reported return in fact represents the performance achieved over an earlier time period. For private equity the lag is typically 3-4 months (for unlisted real estate the lag can be a year or more), and so the actual return will represent the performance achieved September 30 2021 – September 30 2022 (i.e., three months of lag relative to listed markets). This lag effect is variously described as "stale valuations", "lagged reporting" etc. within the industry and is well known.

The effect of lagged reporting is apparent when benchmarking private market assets with public market returns without incorporating this lag, as done for private equity in the YFYS test. Here, lagged reporting in private markets can appear as excess performance or underperformance as the case may be, and can cause test failure that is unwarranted. In part, the length of the YFYS test (now 8-years) mitigates somewhat against stale valuations, but not entirely.

As we have shown in a recent research piece[1], an increase in value added noise produces an increase in the YFYS test failure rate. As such, difficult-to-benchmark private market assets such as private equity may be excluded from (or have sub-optimal allocations within) MySuper products for solely to reduce YFYS test failure rates.

A practical solution to remove this source of noise is to offer lagged public market benchmarks for unlisted, private market asset classes. To prevent "gaming" the choice of benchmark, it should be required on the part of superannuation funds when choosing a lagged public market benchmark that the correlation between the asset class being benchmarked and the lagged public market benchmark be substantially better the asset class being benchmarked and a raw, unadjusted public market benchmark.

A recent study of ours[2] provides best practices and real world data illustrating the issue of lagged reporting / stale valuations in private equity.

Consultation 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?"

Response from CEM:

We have recently conducted[3] an exhaustive test of the investment portion of the YFYS test by applying the test to the historical data in the CEM database, utilizing over 8,500 individual fund/year Global pension performance observations spanning 1992-2020. Our results are broadly consistent with 2021 and 2022 YFYS test results, predicting an initial failure rate of 14% (7-year test), and a repeat failure rate of 77% (first fail of the 7-year test followed by the a second failure on an 8-year test). However, our results do show that the failure rate is not consistent year-over-year, with increases in failures coinciding with large market downturns.

Our test of the YFYS test allows us to back-test the impacts of the performance test on market composition. In particular, would retirement outcomes improve upon elimination of retirement products that fail back-to-back tests from the market? The answer here is yes; the YFYS test when applied to a Global sample of large pension funds reduces future (independent) failure rates, in some years dramatically. More importantly, we show that YFYS test, were it in operation from 1992, would have improved Global pension returns by 0.08% annually, on average. While this might not seem like a dramatic improvement, given the A$3.4 trillion held in Australian Superannuation accounts at the end of September 2021 would have translated into an additional A$2.7 billion of assets per year to which to help pay pensions.

In addition to quantifying the value of the YFYS test, we looked at the common features among failing plans. Primary features of failing plans were:

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[1] See "What is the value of the Your Future, Your Super test?" with link provided in the appendix to this note.
[2] See "Benchmarking the performance of private equity portfolios of the world's largest institutional investors: A view from CEM Benchmarking" with link provided in the appendix to this note.
[3] See "What is the value of the Your Future, Your Super test?"

1. Small scale – failing funds tend to have lower than average assets under management.
2. Outsourced investment management – failing funds tend to manage assets with more expensive outsourced options.
3. Passive management –failing funds tend to manage a slightly higher proportion of their assets passively.
4. Higher cost – failing funds tend to incur higher investment management costs.

These features are not all equally important and offer competing visions of how to best manage pension assets. Typically, small scale and outsourcing lead to higher costs while passive management leads to lower costs which shows that low cost alone isn't the target, but rather value for money.

Consultation Question #8.

Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

CEM Response:

Our test of the YSYS test was conducted on a large variety of retirement plans in terms of strategic asset allocations, investment implementation styles, membership mixes, and plan maturities. There is nothing in our results to suggest that there should be any issues extending the test to TDPs or any other retirement product provided that the benchmark constructed is fair in the sense that the benchmark displays:

1. High correlation to the investment returns being benchmarked, and
2. Similar risk to the investment portfolio being benchmarked.

Given that TDPs have well defined strategic asset allocations, we believe conditions 1 and 2 above should be achievable and the YFYS test therefore broadly applicable.

Appendix

[1] "What is the value of the Your Future, Your Super test?", published by CEM Benchmarking, June 22 2022. Link: Insights Research | CEM Benchmarking

[2] "Benchmarking the performance of private equity portfolios of the world's largest institutional investors: A view from CEM Benchmarking", published by Journal of Investing, December 2020. Link: Insights Research | CEM Benchmarking