

Super System Review Submission

Structure of This Paper

This paper addresses many (but not all) of the points raised in the *Governance – Issues Paper*. Some issues are not addressed – they are outside of my experience. Numbering is included to match the points raised in the *Issues Paper*.

My background covers investment due diligence, risk management and portfolio management, across both traditional and alternative assets. I worked at Colonial First State for twelve years and now I run my own advisory firm, St Davids Rd Advisory. My firm is a signatory to UN PRI (service provider). My experience with superannuation funds has been as an underlying investment manager (and potential manager) for some super funds, as advisory clients (potential clients), and general interest in the sector.

Summary of Key Points

- A review of fund objectives is recommended to resolve the issues of:
 - o Managing against multiple objectives (difficult)
 - o Consideration of a risk targeting framework rather than asset allocation definitions (outlined in the paper)
 - o Consideration of a shift to a post-tax focusClear guidance from APRA is required on objectives of superannuation funds

- Risk management practices need to improve

- Liquidity management issues (including inequitable pricing practices) are poorly understood and need to be better addressed

- Guidance from APRA on whether ESG risks are to be formally managed, and guidance on whether lower returns are acceptable (because lower ESG risks have been taken). UNPRI should not be mandatory, but should rather be viewed as an optional resource (one of high quality)

- It is suggested that APRA should consider sponsoring the funding and creation of a governance group to monitor the governance performance of super funds in much the same way that Regnan, RiskMetrics and ACSI monitor listed companies

- I believe the concept of a government-sponsored long term investment fund (in some form) should be investigated by APRA. Investment may be mandatory or voluntary. Super funds could hold less illiquid assets as a result, improving their potential liquidity / pricing issues
- Many parts of the investment industry, including super funds, are short term focused and choice and performance tables will increase this mindset. It is difficult to break free from this mindset

5.1 General

5.1.1)

The global financial crisis (GFC) highlighted a number of governance problems in the superannuation system. An event of such magnitude coming after a prolonged period of prosperity was always likely to expose problems. The key ones in my view were:

- The objectives of superannuation funds
 - o I think many super funds are managing against multiple objectives (some acknowledge this in their offering document, some do not), being the return objective outlined to investors and their position amongst peers. It is very hard to manage to multiple objectives – which one has priority?
- The decision making processes
 - o In some instances I think the decision making processes are too slow and require too much red tape. In some cases I believe trustee boards may not be best placed to make complex investment decisions. Some funds, particularly larger ones, delegate investment decisions (and a mandate) to an investment committee. I believe in most cases this is a better model
- Investment option labelling
 - o Some funds offer funds which have the word ‘cash’ in them. Even though it is clearly stated that these funds will hold risky assets and the objective is to outperform cash, I believe that many fund members would expect an investment option with the word ‘cash’ in its title to perform similarly to cash returns. In some cases these funds delivered negative returns last year
- Risk management procedures
 - o Unfortunately I see many instances where the resources and attention dedicated to risk management are inversely proportional to past returns (at least that increases the likelihood of greater focus and improved processes in the near term). I think there are a number of shortcomings with the risk management of super funds (as always there are exceptions):
 - Do not have a dedicated risk manager

- Rely on risk management as a consultant provided service
- Rely heavily on historical data analysis
- Do not actively manage liquidity risk
- View risk management as compliance – it is much more

In my view the following areas are important for improving risk management practices:

- Technical risk management skills, via (depending on size) a dedicated risk manager, in-house portfolio and risk management systems, trustee education
 - Strong qualitative input – “What if...”, a forward looking assessment of which risks are most important in the future
 - A risk aware culture: asking questions, answering questions etc, across all levels of the business
- Liquidity risk management
 - I believe liquidity risk management remains one of the most complex and misunderstood risks in the industry, particularly in the areas of liquidity mismatch (and the stability of it) and the potential for price related inequities between investing and redeeming investors. Rather than expand too much further in this paper I refer interested readers to a presentation I wrote on the topic which includes frameworks for assessing the risks (this presentation is attached to this submission): <http://www.stdavidsr.com.au/liquiditypresentation.pdf>
 - Communication
 - The communication of some super funds was weak during the financial crisis. Admittedly it is difficult to explain returns which were far outside communicated expectations. In some cases the communications seemed to have heavy input from legal departments which may have reduced the usefulness for members seeking information during a difficult environment

5.1.2)

The complexity of the superannuation does create governance issues, but they can be overcome. The industry will almost certainly become more complex. For example, consider:

- The greater competition as a result of choice of fund, particularly as more Australians become aware of their ability to choose between funds. Some examples of the complexities this creates:
 - Potential greater issues around managing peer group risk versus the stated objective of the fund
 - Potential increase in demand for capital altering the liquidity profile and liquidity mismatch profile of a fund
 - Potential increased issues around active fund trading / fund mispricing

- Greater emphasis on environmental, social and governance (ESG) issues:
 - o Lack of clarity on whether reduced total returns are an acceptable result if they come attached with less risk, in this case less ESG risk
- The move to provide additional services such as financial planning, insurance and rollover pension products
 - o Each of these areas creates an additional knowledge requirement by the trustee board
- Stronger focus on after-tax returns
 - o Another factor that may make managers, either officially or unofficially, manage against multiple benchmarks, a very difficult thing to do

The key to sound governance is, assuming everyone is ethical and appropriately motivated, ensuring that appropriately skilled people are in charge of key decision making. I believe that more trustee boards will have to consider delegating decision making to other internal groups. Consider the example of a bank. It is impossible for a board to be across every aspect of the business at a micro level. Appropriate delegations of authority are made and, assuming strong control and reporting procedures are in place, the board can oversee the running of the bank.

Applying this example to super funds, I see issues for some:

- Many trustee boards are too involved in investment decision making. In many cases a better model for many funds would be for the investment decision making to be delegated to an investment committee. The role of the trustee board would then be to set the investment mandate and review the performance of the investment committee
- As the complexity of the industry has increased the skillset of some trustees has not kept up, and in some cases I believe that the demands of a trustee may be beyond their capabilities
- I challenge the role of the member elected trustee. If super funds are regulated then this should surely be sufficient protection for members. I believe in the notion of receiving feedback from members around non-investment areas such as member services and communication. This could be done through a separate committee structure which reports up to the trustee board.

5.1.4)

The UNPRI represents an aspirational framework for incorporating ESG considerations into the assessment of investments and the management of portfolios. In essence it recognises that ESG factors are sources of risk to investment returns.

Measuring the return impact, investment risk impact or intangible benefits is extremely difficult, far more difficult in my opinion than other areas of risk such as market risk or even liquidity risk (which

is more complex than market risk). I believe that over any short to medium term period market risk is more important than ESG risks. However there are no regulatory rules around the management of market risk (or any other type of risk).

In essence what I am saying is that if APRA were to be explicit on the management of ESG risks, to be consistent they would have to do likewise for many other risks, some with a more tangible impact on returns (market risk) and systemic risk (liquidity risk). I imagine that APRA would not head down this path as there will always be other risks identified which APRA would subsequently have to incorporate. For instance another example could be tax risk.

In my view ESG risks would be near the bottom of the list in terms of risks to explicitly manage, due to its intangible nature. For instance it is very hard to tangibly explain the ESG risk on any single investment and even more difficult to explain the ESG risk profile of a portfolio as a whole. However it is captured under a broad statement of managing the total risks and returns of the portfolio. Guidance could be extended to say that ESG issues are recognised by APRA as a source of risk to investment returns. This then leaves the trustee board in a position where it is aware it has to manage these risks, but the approach is at their discretion, like many other parts of their investment process, as to how they manage this risk.

As for UNPRI itself I find it a well intentioned, well-managed group that has achieved a lot in a short period of time and for that it is to be commended. However I find it has some challenges to having a sustainable membership:

- It encourages signatories to assist each other (I note this may be via collaboration not necessarily one-to-one assistance), but we are in an environment of competition due to choice of fund. If some super funds have a stated objective to outperform peer funds then it would be difficult for them to collaborate to a significant degree; indeed it may reduce their ability to meet their objectives
- Only asset owners can be on the board of UNPRI and this creates the potential for the group to provide greater services for asset owners as opposed to asset managers; asset managers can arguably make a greater difference to the behaviour and selection of underlying companies / investments. Also this designation can be difficult in Australia where many financial groups perform both roles (asset owner and asset manager).

For me the key issues around ESG risks and superannuation funds are:

- A clear statement from APRA that all forms of risk, including ESG risks, need to be considered and / or managed
- Guidance on whether lower returns are an acceptable result in the short / medium term if the trustee board believes these are being achieved with lower risk (ex-ante)

5.1.6)

In my view existing governance practices are strong across most of the superannuation industry. There is also a substantial amount of resources provided across the industry for trustee education. The areas of greatest concern for me are:

- Trustee members with relationships to asset managers whose products then find their way into the super fund portfolios. I think the process for selection of any product with a conflict should be:
 - o Documented and disclosed, including whether the trustee linked to the product was involved or excluded from the decision making process
 - o Including listing of any benefits which would have flowed to the trustee linked to that product
- Boards where there are too many trustees with linked backgrounds, a potential problem for both industry funds and retail funds. A healthy trustee board has members from a broad range of industry backgrounds so that each can lend their expertise to the board.

There is no simple solution for ensuring best practice governance across the industry. I have a preference for hands-off regulation in a normal market environment (call this a 'self-regulating industry'). However in my view there is a key market participant missing: an independent group that reviews and critiques the governance structure of the industry. By this I mean a group that performs a similar role to that played by Regnan, RiskMetrics and ACSI in the area of listed company governance. Because of the structure of the industry I believe a natural provider of this service may not be forthcoming:

- In the case of listed companies, they are regulated by ASIC and the ASX, but their governance and performance is also actively monitored by fund managers and super funds. This supports the existence of groups like Regnan, RiskMetrics and ACSI
- In the case of fund managers, they are regulated by ASIC, but their governance and performance is also actively monitored by asset consultants and super funds
- Super funds are monitored by APRA and ASIC but there is little natural market mechanism for additional monitoring. This is because the beneficiaries of super funds are a huge number of small investors, rather than a smaller number of larger investors who may be able to fund the expense of a monitoring service. There exists some small groups which monitor the performance of super funds (itself a difficult task) and assign ratings but this level of review does not match the depth and breadth of market-provided monitoring outlined in the other two markets outlined above.

How can this market imbalance be corrected? Because the market structure makes it less likely for an external super fund governance monitoring group to develop of its own accord (no natural source of funding) I propose the idea that APRA should sponsor the development of one. Key features would be:

- An external group to APRA but APRA (or a government body) would fund the development and ongoing financing of the group
- External to APRA, and independent of any regulatory body, to allow the unencumbered delivery of opinion on the governance of super funds

Given what I observe to be fierce competition between industry funds and retail funds I think it is unlikely they will agree a solution (or, all being market participants, may not believe a solution is required). I believe an APRA sponsored boutique super fund governance monitoring group may be the balancing item missing in the industry.

5.2 Trustees

5.2.1)

In general my view is that greater codification of duties can only benefit the industry:

- It provides greater clarification for boards and board members
- It provides clear expectations for what fund members should expect at a minimum

In terms of the areas specified in 5.2.1):

- Explicit provisions setting the priority of shareholder and enabling trustees – yes, I believe greater guidance would be valuable for the industry
- Explicit provisions enabling trustees to override deeds that require the trustee to invest or outsource within the corporate group – I am not sure this is necessary. Provided disclosure of this management structure is appropriate then I view these types of super funds as one option of many for investors. It should be noted that there are potential benefits to this style of fund including:
 - o Greater knowledge of the manufacturing capability
 - o Greater transparency
 - o Greater ability to tailor mandates
 - o Potentially a lower cost structure

5.2.2)

In my view there are varying levels of skill amongst trustees. There is a substantial amount of ongoing education required and this requirement is served quite well by industry bodies as well as asset consultants. However the industry continues to become more complex and, no matter how many education courses are available some trustees will not reach an appropriate skill level.

As mentioned previously, one solution will be the appropriate amount of delegation provided to sub-committees. For instance a board may set an investment mandate and sign off on the risk

management processes and rules, however actual selection of investments and ongoing monitoring could rest with an investment committee. One or two members of the trustee board may be more actively involved with the investment committee. Trustees would still be required to understand all issues around the operation of the funds but their time may be freed up by not having to make day to day investment decisions.

5.2.3)

The objectives of trustee boards will not solely be investment return related. Areas such as efficient operation of the fund, compliance with regulations, communication with members, delivery of features and service are all important. Ultimately though, I believe investment performance is the most important deliverable to members as this will determine the size of the savings pool they live off during their retirement.

A clear issue in the industry is performance benchmarking. Ultimately the performance benchmark for trustees is the stated return and risk objective for each fund option. This has some important implications:

- It is very important that funds explain clearly the risk and return objectives of each option
- Trustees require structures to measure their performance against their own stated objectives
- Trustees also need to ensure they deliver the risk profile stated. This is not as frequently tested, but if a fund takes more risk than outlined in a particular option then members may feel that the fund has not delivered. A key question is whether stating an asset allocation is an adequate description of the risk profile of a fund. This is a problem common to many parts of the investment management industry, not just superannuation funds. My views are:
 - o The risk of asset classes is not (and or may not be) stable over time
 - o Members need to have risk explained to them; there should not be the need for them to be capable of interpreting the risk that comes from a particular asset allocation
 - o Measuring and managing risk is difficult. In my view this is why the industry has got to where it is, namely defined by asset class exposures and reliance on historical data analysis to explain the risk profile

A solution to this problem may be funds targeting risk levels. This is already being done by some funds and investment products across the industry (and has been done in the hedge fund industry for years). So instead of a default balanced fund targeting a certain asset

allocation (eg 70 / 30 growth / defensive) it targets a level of risk over time (eg. 10%). There are many ramifications of this proposal:

- Major changes to documentation, systems and investment processes of super funds
- New frameworks required for measuring performance (would have to be risk and return driven)

The issue of choice of fund and the resulting competition means that trustees may be tempted to measure themselves against peer group indices (some groups state this as an objective). If this comparison affects investment behaviour (in the case where it is not mentioned as an objective) then this represents a potential failure by the trustee board to deliver on its objectives:

- This objective (to beat peer group) may not have been communicated to investors
- Peer group returns may be above or below their own return objectives
- They may take more risk than indicated to try and achieve a particular return objective

This is interesting. I know many trustees who say that their key performance measurement is the league tables. In my view, unless this is the key objective stated in the PDS (often it isn't) then this is a failure of duty by the trustee.

Yet the industry seems to be continuing down the path of performance league tables to assist with performance comparison. Performance comparison works best when all groups involved have:

- Very similar benchmarks (return and risk)
- The benchmarks are clearly defined
- Very similar operating rules (liquidity and asset mix)

Where peer group comparisons work very well for comparing traditional long only equity funds for instance (all have the same benchmark, are generally all 100% invested, and cannot use leverage or short sell), super funds differ in a number of ways to each other, making performance comparison difficult and potentially dangerous:

- They have different performance objectives to each other (in many cases the actual objectives are poorly defined and this is discussed further below)
- They may be targeting different levels of risk (or indeed may not have a stated risk objective)
- They have different asset allocations
- Have different standards about liquidity of the portfolio, accuracy of unit prices etc

I have concerns about the current approach to benchmarking; though profess to not being an expert in this space. If I look at how a benchmark like SuperRatings' SR50 Balanced Index TM works (the median of the 50 largest balanced investment options with exposure to growth style assets of between 60% and 76%), I can see problems with the approach:

- The difference in growth exposure could make a 2% annual return difference in normal market environments and as much as 8% in the extreme environment we have just experienced, even though two funds may have performed their mandates to an equivalent standard
- This benchmarking framework outlined above, defined by exposure to growth assets, encourages a stagnant asset allocation which may not be in the best interests of the investor
- There is no focus on the risk taken to achieve particular returns

I further discuss the issues of an asset allocation definition framework (30 / 70 split for instance) in section 5.5.2.

The consideration of defining funds by risk targets (outlined on the previous page) may produce a better framework for comparing super funds. For instance a useful chart would be a risk / return plot of all super funds targeting particular levels of investment risk.

Delivering on investment objectives is difficult. Delivering on multiple objectives via the additional objective of outperforming peers is extremely difficult. Besides potentially distracting funds from delivering stated objectives, it may lead to herd mentality where no funds change their investments and the whole industry becomes stagnant.

However it is important to be cognisant of the link between peer group risk and investment outcomes. Generally it is easier to manage a portfolio when the portfolio is growing in size. Examples of the potential negative impact redemptions may create include re-balancing issues between liquid and illiquid investments, transaction costs and market impact. I believe there is a feedback loop between future performance and current peer group relative performance:

- A fund outperforms (underperforms) the peer group
- All else being equal that fund will receive greater inflows (less inflows / possible redemptions)
- Portfolio management will be easier (more difficult)
- The fund performance should be positively (negatively) affected

In this respect peer group risk is a risk for the super fund industry. As trustees are responsible for managing risk, this is a risk which needs to be managed, justifying a focus on peer group

performance and asset allocation. However the degree to which peer group risk is an issue will be different for different super funds, depending on how they attract members etc.

There are additional dynamics. For instance:

- Not for profit funds may be less concerned about peer performance compared with commercial funds where management view peer group risk as business risk to corporate profitability
- Groups with more liquid assets may be less concerned about peer performance compared with funds with large exposures to illiquid assets who may be unable to maintain an appropriately balanced portfolio if they experienced large outflows

It appears that the trend to compare fund performance will only grow. I believe, as outlined above, that this creates an additional set of complex risks. The impact of choice of fund is unknown. Many market participants expect that the impact will be minor. It may not be and it may increase over time.

I believe that a possible solution to this problem is risk targeting. The cost and impact of change would be large, but the benefits are significant:

- Reconciles the multiple benchmark problem – super funds have a clear mandate to achieve the maximum return for a given level of risk
- Focuses super fund trustee boards as active risk managers, because they can no longer they cannot let their growth / defensive mandate dictate the risk that results for investors
- Provides a robust framework for comparing results on a risk and return basis

5.2.5)

I don't think there needs to be explicit guidance on the issue of trustee independence as there are arguments both for and against on this topic. A greater ongoing governance review process, as outlined in 5.1.6) would place greater emphasis on boards to acknowledge the risks (conflict, reputation risk etc) versus the benefits (experience etc) of the decision of hiring a trustee who is already on the board of another fund.

5.2.6)

There are many models which can deliver a well-managed super fund. Factors which will impact on the model adopted would include:

- Size of the fund
- Complexity of the investment mandate (eg. level of in-house direct investment activities etc)

This makes it difficult to prescribe a level of appropriate outsourcing.

The only model that would work would be for APRA to review on a case-by-case basis, something that would be difficult.

The other control mechanism is the obligation of the trustee board. Outsourcing obviously does not absolve them of their responsibility to be on top of all investment and operational issues.

I think realistically this would remain an issue that is left for the market to manage itself. An improved governance review process, as proposed in 5.1.6) would ensure that key issues are addressed.

5.2.7)

I feel that the management of potential service provider conflicts is the responsibility of the trustee board. However in my view this sometimes is not enough. The addition of two features would create a stronger structure:

- Declaration of all conflicts of interest in annual reports, including longer reports available at request which detailed how the conflict was noted and dealt with
- Independent governance monitoring group as outlined in 5.1.6)

5.2.8)

I think good quality, balanced boards:

- Firstly have financially skilful and capable people who have the highest ethical standards and are prepared to strongly object to any issues they do not agree with
- Have some degree of trustee rotation to provide fresh insights

Beyond this I think there are pro's and con's of other board features. I think the trustee board should be able to manage itself. I would have greater confidence if there was an independent governance monitoring group as outlined in 5.1.6).

5.2.9)

I don't think stock lending by super funds should be regulated. The trustee board should be responsible for understanding the costs, benefits and risks associated with any decision that affects the fund.

Note that a decision to ban stock lending by super funds would not necessarily stop stock lending. For instance super funds could actively encourage their external fund managers to utilise stock lending as an additional source of income.

5.2.10)

On the issue of consolidation, I think it is the responsibility of the trustee board to have:

- Analysis which confirms why they continue in their current form
- An analysis framework in place that assesses any merger opportunities or opportunities to participate in different models such as pooled operational services

Similarly, super funds looking to be the senior partner in a consolidation need to be able to provide analysis which confirms why the transaction is in the best interests of their members. I understand that this analysis is generally done well with the support of external consultants.

Finally, I think the issue of funds being too big needs to be formally considered. Having been involved in the investment manufacturing industry for many years the focus on that side of the industry tended to be on funds being too large. Are some super funds too large? What is the optimal level of assets for a super fund before their marginal return opportunities diminish? I believe a trustee board should be able to present analysis which confirms what they believe their capacity to be.

5.3 Government and regulatory

5.3.1)

In addressing the questions on government policies I go to 5.3.1.3) first. I believe the key barrier to infrastructure investment is the liquidity risk inherent in some super funds. I feel that liquidity risk is misunderstood and refer the reader to my presentation “Practical Approaches for Stress Testing Liquidity Risk”, attached as a reference or <http://www.stdavidsrd.com.au/liquiditypresentation.pdf>, for further background. In my view some super funds exhibit significant liquidity risk given that the profile of their liabilities (investors) may change as the industry changes; ie. The impact of choice of fund is unknown.

As such, I am concerned about any changes that force a fund to have exposure to illiquid assets. The ability to have a fully liquid exposure has a much reduced systemic risk profile which should be available for all investors.

A solution to this issue would be a single pooled vehicle operated by a government institution, similar in design to the Future Fund. Australian superannuants would have:

- A choice of fund(s)
- An exposure to the pooled Government infrastructure fund. This could be mandatory (every superannuant is forced to have a portion of their savings in illiquid exposures) or encouraged (by marketing or by concessions)

- The Government could influence the return profile (guaranteed, floor, cap) and would need to produce a pricing structure / ongoing application and redemption framework
- The Government could have flexibility in how they design the mandate – eg. may be infrastructure but may also be other areas such as research and commercialisation, agriculture etc
- The balance of issues and likely success of the funds would depend on the interaction of all these variables

A framework like this may encourage super funds to improve their liquidity mismatch profiles as superannuants can source their illiquid exposures from this government source. Perhaps a much lower cap on illiquid investment exposure could be introduced, forcing greater focus on the pricing of the illiquidity premium by super funds.

I imagine there would be significant operational issues associated with a fund like this, particularly in the areas of operations. This could be actively managed by the Government providing a liquidity facility and a floor to returns. There would also be significant investment mandate issues and the structure of the fund would have to be sustainable across multiple governments etc.

Increasing global fiscal debt levels in developed countries will likely increase the need for different sources of capital to sponsor essential projects. If a fund was well managed I would invest in it as I believe that Australia needs a greater amount of capital to support infrastructure and research and I would be prepared to allocate a portion of my retirement savings to support this.

5.3.4)

On this issue I fall back to a similar answer made previously. Full disclosure of related party transactions in annual reports, coupled with the availability of more detailed reports and the oversight of an independent governance groups (outlined in 5.1.6) would reduce the need for rules of this nature. There are instances where related party transactions are beneficial to investors:

- The trustee board may feel more confident in the quality of a service that it is very familiar with (as opposed to viewed a marketing pitch for)

5.3.5)

On the PJC Inquiry, I agree with Recommendation 4. Additionally I believe that trustee boards should have to explain the impact of advertising on fund performance and justify (through a combination of analytics and qualitative reasoning) why the amount spent on advertising is beneficial for members. For instance this may be explained by the expected number of clients reducing ongoing costs for all members by an amount greater than the cost of advertising. It may also reduce systemic risks associated with investors leaving.

5.4 Accountability to members

5.4.2)

I think that the concept of fund members having a say in corporate board room activity is unrealistic operationally. I view corporate governance as an investment activity and all investment activities are the responsibility of the trustee board. I imagine the increased administrative costs could be large and borne by many investors who do not care for the opportunity to have a say. The other issues are that a particular vote may result in lower returns which may be difficult for non-interested investors to accept.

Corporate governance is a complex area which I believe for the majority of investors is best left to professionals. This could be viewed as part of the investment management process. This leaves the responsibility with the trustee board, the group which is ultimately responsible for selecting the investments in the first place.

Transparency of corporate governance process and voting by super funds is important. I do not see why individual corporate governance decisions (eg. proxy voting results) should not be available for review by members (via the member website for instance).

5.4.3)

The first question, what choices to offer members, may have different answers for industry funds versus retail funds. For retail funds the cost of creating an option and maintaining that option are met by the commercial operator of the super fund. For industry funds these costs are borne by all members of the fund. Thus an option that is expensive to administer and manage with low assets, in effect benefits a small number of members at the expense of all. To some extent this has been the case with SRI (Socially Responsible Investment) options.

The trustee board is responsible for any expense of the fund. Thus if they choose to create a new fund option they should be able to clearly justify (through a combination of analytical and qualitative arguments) why the option was created.

The second and third questions about responsibility of the trustee board with regards to the investment choices of their members are difficult ones. This effectively covers the area of disclosure and advice. The disclosure issue (carefully presenting the risk and return profile of the strategy) is clearly a trustee board obligation. The advice issue I am unsure of and the issue probably interacts with other government reviews currently underway. In my view people should have one financial adviser who oversees all their investment strategies.

5.5 Operational

5.5.1)

In my view large parts of the finance industry, including super funds are entrenched in a short term focus and it is difficult to break out of this. Changing investor mindsets is a difficult and slow process. One loop of the cycle (which of course is a generalisation):

- Asset owners such as super funds compare themselves against peer benchmarks which are becoming increasingly prominent as an industry focal point. Super fund trustee boards react to a short term poor performance experience, because if they do not act they fear a failure for which they ignored the potential warning signs. The result is that they may turn over their manager holdings too quickly
- Asset managers are benchmarked over shorter term periods both by external parties but often within their own firms. The results are that they may increase the size of their highest conviction views (due to business risk) and focus more on shorter term trades
- Listed companies are under pressure to deliver short term profit growth and share price performance. This may mean they fail to invest into projects that have longer term outsized performance potential or spend money on projects that reduce business risk but may not meet return hurdles

Factors which may change the behaviour of super funds:

- 5 year performance measurement as the key benchmark
- Encouragement of super funds to award long term contracts to their fund managers, with obvious get out clauses for key staff departure etc

I don't think there is anything which can be done by regulators to change behaviour besides education programs.

5.5.2)

On the issue of exposure to equities I believe it is dangerous to design policy based on a market view (will equities perform well in the future or not), not that I view this as the intention of APRA's question. What can be addressed is the risk. Generally a higher allocation to equities will contribute to a riskier portfolio. What level of risk is appropriate? This itself is a difficult question to answer because volatility (as long as it is associated with higher long term returns) is not a major issue for investors with a long term focus but is very important for investors with a shorter term focus (eg. near retirement). This same question is being asked across the financial planning industry – namely should my client be required to select an asset allocation profile or a risk profile where the investment manager is responsible for managing that risk via model portfolios etc?

It is the responsibility of the trustee board to be able to demonstrate:

- How the return objective requires a certain risk profile to support its attainment
- How the expected return of each investment is expected to contribute to the return and risk of the portfolio

One issue is that the allocation to equities appears quite stagnant; indeed the industry benchmarks are developed around the allocation to growth assets. This means that super funds may become anchored to a particular exposure. At particular points in time I believe there may be more certain paths to achieving the stated mandate with lower risk. A good example was credit spreads were so large that they would have helped super funds easily achieve their general balanced fund objective of cash + 3 – 4%, with more surety and lower risk. Not many super funds substantially followed this opportunity by reducing their exposure to equities. Why not?

- Peer group risk – if other funds are maintaining their exposure to equities then it would be a large peer group risk to switch out of equities
- Not locking in losses – having experienced large falls in the value of their equity investments, there tends to be a behavioural bias to not want to lock in these losses
- There is of course an investment based argument that the forward expected return on equities was so large that it justified a continued high allocation

If APRA were more clear on this area of guidance it may lead to a greater focus on meeting return objectives with as small a risk as possible.

I suggested a risk targeting framework in section 5.2.3) and the issues in this question overlap.

5.5.3)

In my opinion it makes sense that rebalancing processes are explained, though it is likely that most super funds would list the caveat that they reserve the ability to change this policy in extreme markets if they believe it is in the best interests of their investors. I do not think prescribed rules need to be produced by APRA; disclosure is the most important issue. I don't think disclosure necessarily needs to be in the offering document, the web would suffice.

One key benefit of greater disclosure of rebalancing processes would be the greater liability for rebalancing mistakes which would drive improved operational practices.

Interestingly it is worth noting that there would have been a reasonable outperformance impact for super funds that were not actively rebalancing during the GFC versus those that did. This may have been through skill or fortune.

5.5.4)

I believe the use of leverage and also derivatives can enhance returns and improve the risk profile of a fund. This is all under the proviso that the risks are well handled. Risk management culture, processes, systems, people and governance are all paramount. Yet we have seen many instances over the years where banks, specialists in these investment areas, lose substantial amounts of money. For me, despite the investment opportunity I think the current prohibition on any activity that could lead to loss of greater than investment capital should remain.

There are arguments for a stepped expansion of operational capability. There are derivative and leverage based trades which have only moderate risk. I think an approach for managing this would be through an APRA-sponsored institutional accreditation program similar to the RBA's sign-off on bank's market risk (C3) capital measurement processes in 1997 / 98. This would be costly for APRA and may only have small take up. Another model would be for APRA to provide private sign-off's on individual trading strategies where the fund explains the trade and how the risk will be managed. Again this could be administratively expensive for APRA.

5.5.5)

This is one of the biggest issues for APRA and the industry as a whole. A current example is a large super fund, HESTA, announcing that it would *“add tens of millions of dollars to the value of its Australian share portfolio by revolutionising the way its fund managers work. HESTA is the first super fund to measure and remunerate fund managers on their after-tax investment returns, making them accountable for the tax implications of their decisions.”*

The guidance on whether pre or post tax returns are most important is unclear. For instance, if HESTA's decision to move down this path reduced pre-tax performance (but increased post-tax performance) have they failed in their fiduciary duty to their members?

Logically I would argue not, but the guidelines need to be clearer. Intuitively, it is more difficult to manage against multiple objectives (pre and post tax). Peer group benchmarking would also be extremely difficult.

Which are more important, pre or post tax returns?

I would argue post tax returns because logically returns after tax are what is left in the investors hands to live on (admittedly I haven't investigated issues such as rolling over super fund returns and tax benefits to a pension fund or other retirement income streams, and am not an expert on tax).

An after-tax approach will contribute solutions for other industry problems:

- Encourage a longer term investment timeframe for super funds and investment managers
- This would then highlight the importance of ESG issues, which in my view are more relevant to long term investments

- Provide an opportunity to re-set the industry benchmarking process away from a short term total return focus

It would be a major change for the industry and it would provide its own significant challenges:

- A greater amount of complexity across nearly all aspects of portfolio management
- A significant one-off effort to change portfolio management systems, documentation, operational processes, reporting etc
- The potential tendency to hold on to investments for their embedded capital gains rather than their forward looking return / risk prospects
- An additional level of complexity which may prove too hard to understand for some trustees
- Distortion of outcomes between (all else being equal) funds which are growing in size versus funds which are shrinking in size
- Equity issues around investors and the length of time they have been in the fund (issues already faced by investment unit trusts)
- Acknowledgement that different investors may have different marginal tax rates

I think this should be an area of considerable further research by APRA.