JANA

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SUBJECT:

APRA Heatmaps – Are Super Funds Left Sweating Unfairly?

1 Heatmaps – are funds left sweating unfairly?

What do hotel rooms, car insurance and groceries have in common? For one they are reasonably homogeneous goods or services which is one driver behind the recent proliferation of price comparison tools that consumers can use to help them find the best deal. Homogeneous is not a word frequently used to describe superannuation products, which are in reality an aggregation of multiple underlying financial services (encompassing administration, custody, insurance, advice/education and investment products) with differing memberships, employers and investment approaches. Making a "like for like" comparison is therefore a challenging endeavour. APRA's recently released heatmaps, whilst a credible attempt to provide a comparison of (initially) MySuper products, is unlikely to be able to please all stakeholders.

In this article we provide a brief summary of the genesis behind, as well as a summary of, the construction of the heatmaps. An accessible overview along with detailed calculation methodology for the heatmaps is provided in an APRA summary paper and therefore we have focused this piece more on our views, implications for different stakeholders and also potential improvements we would like to be considered by APRA for future heatmap editions. We have focused on investment performance metrics given this is the area that has received the bulk of the attention in the first couple of days since the public release of the heatmaps.

From the outset, we support APRA's intentions behind the release of the heatmaps and on the whole we believe they are a credible first attempt given the scale of the task, particularly regarding the sensible metrics chosen to display. Additionally, the decision to calculate some of the metrics for different account balances in order to assess outcomes across the cross-section of a fund's membership rather than for the average member only is a positive. As we cover later, we do think some funds will be feeling unfairly bruised by their results and we

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emphasise the importance of maintaining conviction for investment positioning when this is well founded. We also think improvements can be made in terms of the introduction of metrics that matter more for members, as well as an assessment scale that better rewards (and therefore incentivises) strong performance.

2 Heatmap background – turning up the temperature for member outcomes best practice

Improving member outcomes has been a central tenet of APRA's work in the superannuation industry over recent years with this culminating in the impending (1 January 2020) inception of a new Prudential Standard, SPS515 – Strategic Planning and Member Outcomes. SPS515 will place the promotion of member financial interests as a central tenet of any superfund's strategic objective setting and business planning exercise and will mandate a rigorous annual self-evaluation of how well outcomes have been met across different membership cohorts, with recently introduced legislation providing further support. APRA have had no qualms in articulating that one of the implications of their aim to drive up standards will be the removal of persistently underperforming funds from the industry. The heatmap is a publicly disclosed snapshot of how funds have tracked based on a sub-sect of some of the key metrics used to assess whether high quality outcomes have been achieved.

The inaugural heatmap will focus on MySuper only, although the inclusion of Choice products is intended to follow. There are 21 metrics in total covering 3- and 5-year investment performance, fees and sustainability, with further metrics for insurance also planned. The metrics focus on downside outcomes only, with worse scores earning a deeper shade of crimson, whereas above benchmark scores receive a white rating only, with APRA keen to emphasise this is by no means a perfect score with no room for improvement.

3 Investment Metrics – 50 shades of red?

A look through the press coverage accompanying Tuesday's public release of the heatmaps shows a significant focus on the performance metrics, largely because of the challenging results experienced by large portions of the industry. This is partly driven by the methodology underlying the metrics, as well as the time periods chosen for the assessment. We cover the three-performance metrics used below but have first detailed APRA's methodology for determining the growth and defensive split for a MySuper product as this calculation is a key driver of some of the results (and a lot of the criticism).

APRA take fund reported strategic asset allocation (SAA) information disclosed as part of SRS533 reporting requirements and apply the following growth and defensive classifications to determine an overall growth and defensive breakdown for a MySuper product (which can clearly differ to the weighting calculated and disclosed by the RSE given the high-level classifications).

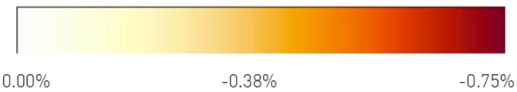
SAA Asset Class	Growth / Defensive classification
Equity, Listed Property, Listed Infrastructure	100% Growth
Unlisted Property, Unlisted Infrastructure	75% Growth, 25% Defensive
Commodities, Other	50% Growth, 50% Defensive
Fixed Interest, Cash	100% Defensive

Source: APRA November 2019 Information Paper (Heatmap – MySuper Products)

APRA have selected the following three metrics calculated over 3- and 5-year periods (to coincide with the 2014 inception of MySuper):

1) Net return versus a trendline that plots average allocation to growth assets (using the above methodology) versus net returns for the MySuper universe where an individual fund's MySuper returns are plotted on the trendline against other MySuper products with the same derived growth asset exposure.
2) Net returns versus a simple reference portfolio (SRP). The SRP is calculated by taking the growth and defensive split (using the above methodology), and assuming the growth exposure is invested passively in listed equities and the defensive exposure is invested passively in listed fixed interest and cash. This SRP is intended to be a comparator against which the benefits of active management, dynamic asset allocation and more complex asset classes can be assessed.
3) Net returns versus a listed SAA benchmark portfolio. This comparator is calculated by assuming a fund's reported SAA is invested passively, i.e. similar to the second metric but with a wider range of asset classes used in the comparator.

A colour-based rating between white and crimson is provided for each metric based on relative performance. Any magnitude of positive performance compared to the trendline or comparator portfolios receives the same white outcome.



Source: APRA November 2019 Information Paper (Heatmap – MySuper Products)

Our view of some of the key implications of the performance metrics are as follows:

- **Emphasis on past returns as an indicator of forward-looking success:** There is a risk that a heatmap type approach, that focuses on historic 3 year and 5 year performance, by implication is suggesting that members rely on past performance as an indicator of future returns. This, of course, flies in the face of one of the fundamental principles of investment; that past returns should not be relied on as an indication of future performance. While funds, together with their advisers, seek to implement strategies that will result in outperformance of benchmarks on a consistent basis, investment returns – both absolute and relative – are inherently cyclical processes. These cyclical processes can take longer than 3 and 5 years to play out (consider the periods leading up to the Tech Bubble and GFC); and we would argue that we are currently in such a period. What is ultimately important is that the past returns are explainable by reference to stated investment approach/philosophy, the prospects for outstanding prospective returns are plausible on a forward-looking basis, and current positioning is explainable / reasonable and consistent with the manager's investment approach. We therefore welcome APRA's intention to extend the timeframes for measurement over time.

- **Active strategies under the spotlight but rigorously determined conviction should be maintained** – an extension of the above is that performance metrics for MySuper products that utilise active fund managers employing valuation-based investment processes have generally received largely crimson scores given the passively constructed comparators used in metrics two and three. The recent trials of valuation disciplined active equity strategies is well documented amidst a market backdrop where the strongest performance has resulted from the typically already more expensive (and therefore underweighted) high growth or high-quality stock names as investors have valued the inherent certainty characteristics in an uncertain world. The story is similar for active fixed interest strategies given the recent tendency for short duration benchmark relative positioning amidst an unprecedented period of monetary easing. Tactical asset allocation programs which have tended to adopt defensive positioning given the combination of historical cross asset class valuations, coupled with the current cocktail of geopolitical risks will also likely have detracted. There will be the inevitable temptation to reconsider the merits of maintaining this positioning and perhaps migrating towards stances with reduced career / peer risk, particularly given the public exposure provided by the heatmaps. JANA is acutely aware of the famous Keynesian adage regarding how long these challenging periods can persist for active strategies but advise that that conviction should be maintained provided this is subject to regular and rigorous scrutiny.

  A clearly sub-optimal outcome for members is an investment approach that significantly references a peer group even when the Trustee may hold a counter view to portfolio positioning. Outstanding return generation requires considerable skill, but also courage, and we fear that the industry is migrating to a peer average which almost certainly will produce a focus on "being average" or marginally good relative to the average (with the risk of being marginally wrong relative to the peer group).

  One of the great successes of the Australian superannuation industry has been the diverse approaches to objective attainment, including funds "bucking the trend" by early adoption to unlisted infrastructure and property, internalisation, backing start-up managers etc. We take many of these innovations as industry norms today, but at the time when these were adopted, they were innovative and required courage of the adviser, the executive and Trustee to a take a carefully calculated risk. Many of these approaches have been enormously beneficial to members. We fear that the drive to peer relativity will result in an "averageness" mindset that might blunt enthusiasm for adopting points of difference which may be truly beneficial to members over the longer term.

- **A high hurdle for defensively focused alternatives** – the methodology APRA use to calculate a growth and defensive breakdown for a fund in our view unfairly penalises defensively focused alternatives. As an example, a high-quality core unlisted property or infrastructure portfolio would be classed as 75% growth and therefore would be judged primarily against equities which we feel is harsh given the differences in underlying risk and return characteristics. As per the previous bullet point, the public disclosure of heatmaps will no doubt make some think twice about the use of alternatives. JANA, however, believe they continue to have a crucial role to play in the current market environment, particularly if they have low correlations and downside protection compared to more traditional asset classes. The potential for renewed bouts of volatility, the divergence in valuations in a number of sectors and regions, and greater idiosyncratic risks including differential impacts from changes in trade policy and currency movements, should be a more conducive setting for the more active investment strategies employed within the alternatives universe, hedge funds in particular. We are encouraged that this challenge has been made by a number of industry participants in the last couple of days and hope remedies will be considered for future heatmaps.

- **Greater scrutiny on APRA submitted data in the future –** we understand that some funds have unsuccessfully attempted to replicate APRA's methodology for the performance metrics. We believe this could be at least partially driven by the historical data submitted to APRA. We understand that APRA have used information submitted as part of their reporting requirements but in some cases this information may have been submitted by third parties such as custodians and/or administrators based on rules-based approaches, and submitted at a time when application of the data to a heatmap would not have been envisaged. In addition, the APRA asset class classifications are generally considered by JANA to be limited in comparison to the breadth and complexity of asset classes and compositions used by many funds today.

  One result of this is potential misclassification of less traditional asset classes that do not fit neatly into the list of options provided by APRA with a common example being the decision to class less traditional areas of the fixed interest space, such as a junior direct lending mandate, as "fixed income" (and therefore assessed versus fixed interest indices for some of the metrics) or "other" (and therefore partially assessed relative to equities). We envisage that future information disclosed will likely require some improvement to the APRA asset class classifications, including more granularity to the asset classes and guidance as to how assets should be reported.

- **No linkage between the reported investment fees and the stated investment approach**. An additional area of caution lies with respect to the potential interpretation of the level of fees as being "inherently good or bad". Some investment approaches include the use of unlisted and more complex capacity constrained strategies which provide valuable expected portfolio benefits by reducing equity risk, without significant sacrifice to expected investment returns. These investments are also amongst the most expensive investment approaches. JANA is cautious about the level of investment fees being interpreted simply by reference to the level of fees themselves.

4 JANA suggested improvements for judging "investment" success

As we have noted above we believe the heatmaps can be an effective gauge for how the industry is performing relative to APRA's member outcomes expectations. We believe there are further improvements APRA could consider for future releases. In addition, there are many other matters that we consider would be worthy of consideration or debate as the public debate to date has focused mainly on a few simplistic (and naïve) metrics such as cost and/or returns in isolation. We are concerned that some of this discussion has been unhelpful and potentially promotes the industry to head in a direction that focuses more on fees and peer relativities as the primary judge of success on the basis that these ex-post measures are the primary indicator for future success. These have the potential to cause the industry to “race to the bottom” on fees, and also promotes an “averageness” peer-conscious mindset that ultimately creates an undifferentiated “average” industry that is potentially detrimental to members outcomes.

Some of the matters we would like to see the industry aspire to consider are as follows:

- **Measures that reflects outcomes relative to the objectives being targeted.** Whilst performance relative to reference portfolios and peers is a useful way of rooting out persistent underperformers, these metrics have no reference to retirement income objectives nor the risks to members of differing cohorts. In many cases, the member and employer constituencies across differing funds and cohorts are not directly comparable, and investment strategies will understandably be different. The peer relative performance may well be a blunt instrument and in some regards, conflicts with elements of SPS515. For example, SPS515 requires trustees to give explicit consideration to documenting and measuring the outcomes being targeted for members. In some cases, this will be expressed as a targeted level of retirement income. Critical to this will be an assessment of the relationship between the membership demographics, the intended retirement outcome and the tailoring of products and services to meet targeted member outcomes. E.g. a member imminently close to retirement in a higher risk / higher return option potentially exposes the member to a higher drawdown in negative equity markets. Conversely, a lower return/risk product might not be appropriate for members with long term horizons and higher tolerance for risk.

  We would encourage APRA to consider other metrics that help stakeholders understand more about the level of return and risk being targeted / achieved to help provide further colour as to how and why the product has been designed. E.g. Inclusion of a net return versus CPI+ objective metric, volatilities, outcomes relative to standard risk measures, worst yearly drawdown and Sharpe ratios are other metrics that might improve transparency around the level risk being taken to achieve targeted returns.

- **Better metrics that attempt to show “value for money”. E.g. metrics which examine the level of fees relative to returns, diversification/risk benefits, the level of services, etc** – SPS515 notes a range of factors that should be assessed to determine whether high quality outcomes have been met, with a subset only incorporated in the inaugural heatmap. JANA sees merit in more of the factors detailed in SPS515 being incorporated into the heatmaps, in particular metrics that attempt to show value for money achieved. This could be a quantitative metric such as fees as a proportion of risk-adjusted performance or qualitative metrics such as member satisfaction scores.

- **More APRA asset classes categories and better guidance to assist Trustees with the classification of assets submitted in APRA reporting** – this will also improve comparability of results across different MySuper products.

- **Consider the time scales under which the assessment is made** – we understand that the 3- and 5-year assessment periods were chosen given MySuper continues to be in its relative infancy. As we noted earlier, we do believe that this reasonably short time period could be argued as inadequate given some (typically more aggressive) options have as much as a 10-year time horizon. This is particularly prevalent given the last five years in no way represents a full market cycle under which many fund managers expect to be judged. We note that APRA plan to extend the timescales for the performance metrics over time, but we believe a more immediate remedy would be to widen the scale e.g. from 0% to -1.5% as opposed to -0.75%.

- **Provide incentive for outperformance –** We discussed the unintended consequence of the heatmaps to incentivise peer or benchmark hugging to reduce career risk. Currently, there is no linkage between heatmaps relating to fees and returns. An obvious example is funds with significant inflows and therefore an ability to invest in higher cost investments that seek to capture the potential benefits of illiquidity/complexity. One remedy would be to include a positive range and colour coding to the scale. This would also better aid interpretation of other metrics, for example, a red metric for fees would be justified if it results in a series of “green” performance metric.

- **Greater transparency for lifecycle metrics –** Around a third of superannuation balances are invested in lifecycle products. Metrics are provided for each of the underlying lifecycle stages. A metric for the overall lifecycle is also provided based on the proportion each stage makes up of the overall lifecycle (a time weighted approach). One of the fundamental arguments behind the use of lifecycle products is the managing of sequencing risk toward the end of the accumulation phase (i.e. a money weighted approach). We therefore believe there is merit in greater weight being placed on metrics toward the end of the accumulation phase or when the pot balance is larger (i.e. analogous to the use of a money weighted rather than time weighted return calculation). APRA’s summary of the methodology used for lifecycle products is unclear on whether any such weighting factor is included in their calculations. JANA sees merit in this being considered and/or clarified for future years.

5 Key takeaways

JANA welcome APRA’s focus to driving up standards in the superannuation industry. We also believe the holistic approach to assessing outcomes provided for members contained within the upcoming SPS515 will assist with this aim, particularly given the range of factors considered as well as the focus on different underlying cohorts that make up a fund’s membership. Whilst we believe that the transparency that comes with public disclosure can help to drive change, we feel that the modifications and additional metrics we have discussed above will give a fairer reflection of where improvement is required and to avoid incentivising adverse changes to behaviour going forward.

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