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Superannuation
Productivity Commission
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Dear Commissioners,

Thank you for the opportunity to provide feedback on the Productivity Commission's (the Commission's) Supplementary Paper (the paper) titled 'Investment Performance: Supplementary Analysis'. QSuper is pleased to provide this submission as part of our ongoing, constructive engagement with the Commission during its assessment of the efficiency and competitiveness of Australia's superannuation system.

This submission presents a methodology to compare risk and return outcomes between similar products from different funds. Risk is materially different between products that are commonly considered to be similar (for example Balanced options), such that comparisons that fail to consider risk provide members with a poor method of assessing the relative benefits of a fund.

Members experience absolute returns

According to the paper "The Commission's analysis is focused on performance relative to indexes, not the absolute level of returns."

This approach can be useful, for example to better understand the reasonability of fees charged that tend to vary across asset classes. The Commission's paper provides some interesting insights in this regard.

However, the primary concern of members has to be the absolute return stream, both the trend level of returns and the volatility of this return stream.

Assessing the performance of a fund considering both risk and return poses a number of challenges. Industry reporting does not fully rise to this challenge. Risk is often only nominally considered via fund offerings being grouped into broad buckets, such as Growth buckets, and with returns primarily considered risk is effectively ignored from that point.

This bucketing tends to be decided considering the weights held of so called 'growth' and 'defensive' assets. However, these splits tend to be self-nominated and there is concern that products with very different levels of risk end up being compared purely on returns. Due to differences in the properties of bespoke direct holdings it is hard to devise a split methodology that avoids self-nomination and the other difficulties that this brings. Therefore, risk is generally dismissed as being similar between products with similar titles when data clearly shows this not to be the case.

QSuper contends that for the following reasons risk needs to be better considered in the comparisons of funds:

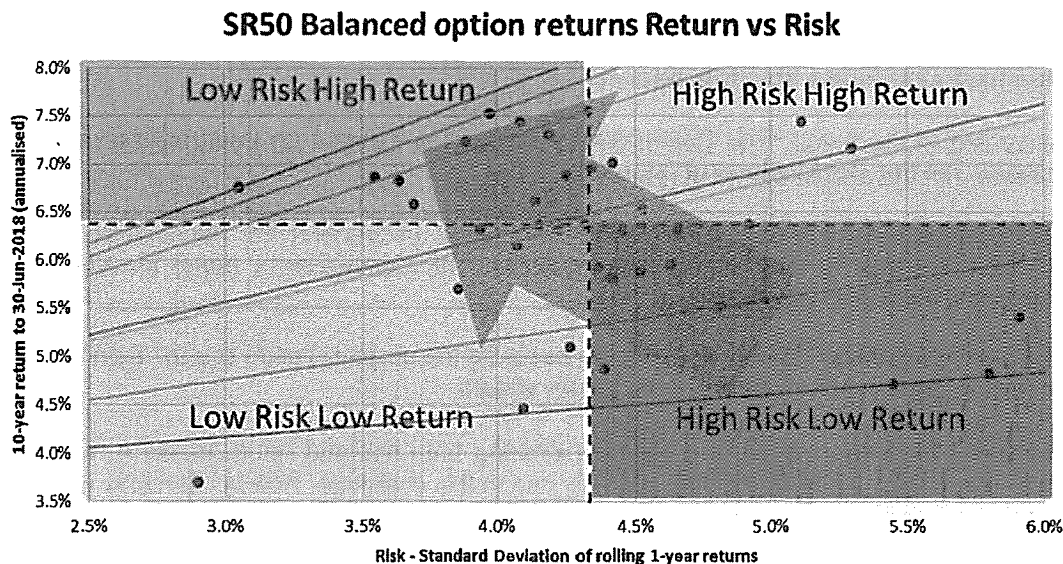
- there is a consensus among the professional investor community that risk is important in constructing a portfolio. If the same returns with less risk (or same risk for greater returns) can be achieved than such a portfolio should be preferred; and
- complexity is a considerable challenge for members in assessing funds and therefore members should have access to effective tools to compare fund performance that consider factors that professionals agree are important.

Further, the Commission has indicated a preference for ranking funds in part considering Investment Performance. This should not be attempted without due consideration of risk.

Only comparing returns is fine if risk is the same – which it is not

The chart below shows risk and return outcomes from a number for funds in the SuperRatings SR50 universe. Different metrics can be used for risk and return and QSuper would be prepared to engage further with the Commission on the relative strength of potential approaches.

A key takeaway considering the dots on the page is that there is not a clear relationship between risk and reward. There are a range of combinations of risk and reward that we have bluntly colour coded in the chart with the dotted lines showing the median risk and return of the funds.



A mistakenly held view among members is that more risk typically means more return. If this was true, we would expect all of the dots to lie on a relatively straight line diagonally across the page. Indeed, the lines shown on the chart are lines of constant risk efficiency for a number of the larger funds. All of these lines pass through a common point representing the cash return (considered to have zero risk for this purpose), before passing through the specific risk and return dot for each fund. These are essentially lines of constant Sharpe Ratios, showing the

returns that funds would achieve if they took a little more or less risk, presuming the fund maintained the same risk efficiency (i.e. maintained the same Sharpe Ratio). Therefore, we see very different levels of risk, returns and risk efficiency from this universe of funds.

The arrow across the page shows the desired direction to rank risk efficiency. This moves up from right to left i.e. an investor should prefer a fund that has less risk and more return. QSuper believes such a comparison provides a means to rank funds that have slightly different risk and return outcomes.

For example, if notional Fund A has slightly more return than notional Fund B, but where fund B has taken much less risk than Fund A to get these returns, then Fund B would have the higher risk efficiency. Its risk efficiency line would be closer to the top left corner than for the inferior fund.

Where risk and return are in the same ball park then such an approach would help identify the superior fund. Likewise, this approach should also assist with identifying funds with high risk and low returns (the red quadrant on the graph).

QSuper respectfully submits the approach above, utilising standard theory to compare fund outcomes, is an appropriate approach to consider risk along with returns.

A second objective of this submission is to highlight the importance of considering the historical return environment when comparing funds.

Ten years may not be indicative of long-term returns

Care needs to be taken when considering historical outcomes that the period of returns and risk considered may not be indicative of long-term returns. For example, the predominant driver of risk in most multi-asset class portfolios is equities, and while ten years sounds like a long period to assess fund performance, we know that equities regularly experience decades where returns are much higher or much lower than most professionals would consider normal/average.

Let us consider two funds, where over the long run Fund A happened to have less equities than Fund B, which most might consider very undiversified and risky. If equities happen to have a decade of well above average returns, as has been the case since the GFC, then Fund B may look superior based on an analysis of the historical returns. This outcome does not reflect investment expertise but rather a poor strategy that happened to be in place at the right time. Noting of course that the predominant driver of most product outcomes is the broad asset allocation that tends not to change materially over time.

QSuper has been working on ways to correct for these anomalies in market conditions, that we would be happy to share.

Conclusion

QSuper believes that risk is important to member outcomes and significantly reviewed its investment strategy post the GFC with the aim of delivering similar returns to the standard equity heavy portfolios but with much less risk. Since commencing this revised strategy QSuper has successfully delivered similar trend returns with less risk (in the order of 25% less by some metrics). QSuper believes there is an opportunity for the industry to deliver superior outcomes for members by similarly increasing their focus on risk.

I trust this feedback will be beneficial to your considerations and would welcome the opportunity to discuss our submission in further detail.

Mr Chris Ramsay, Senior Manager External Affairs and Policy is the primary QSuper contact regarding our submission and can be contacted .

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