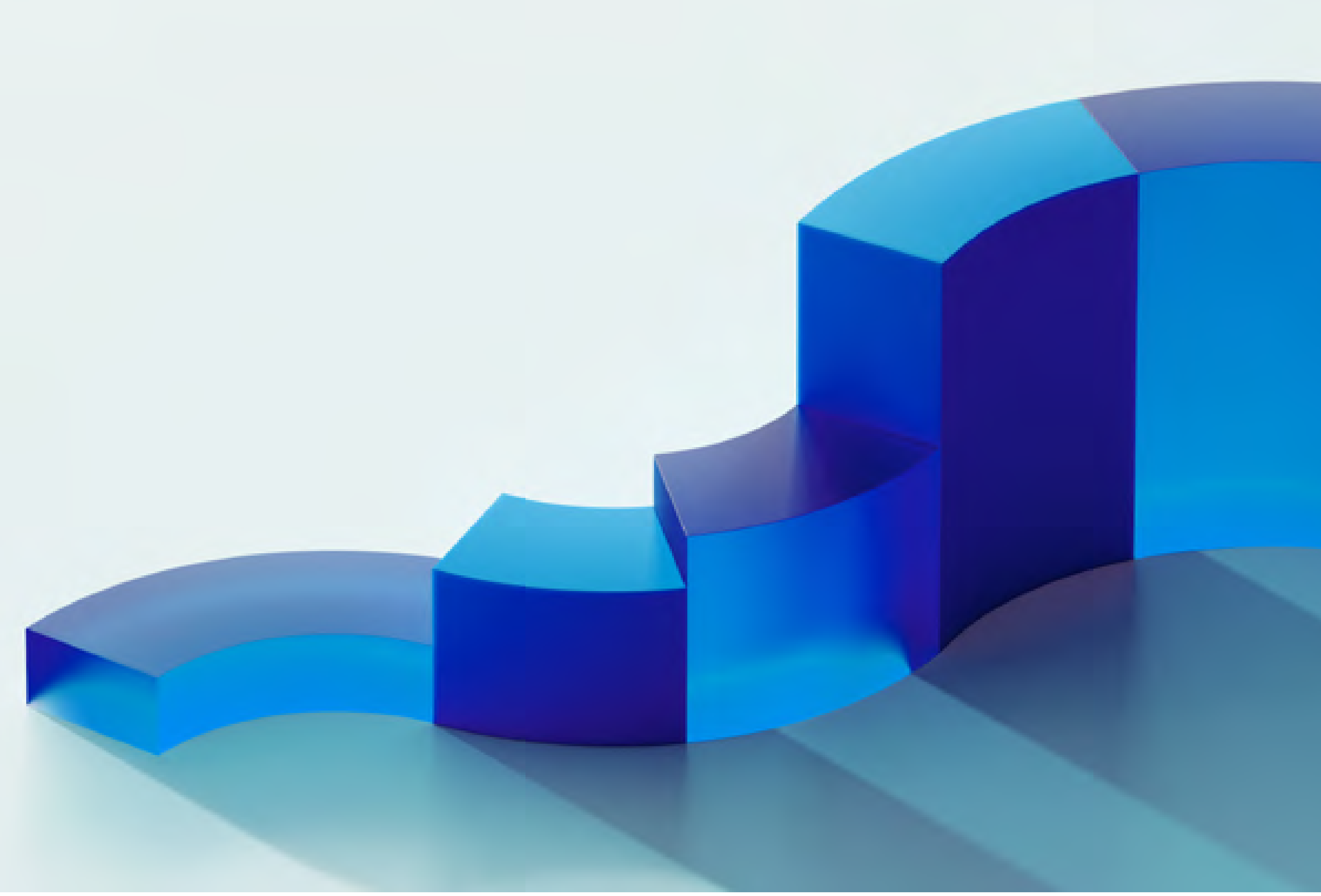


How YFYS regulation is set to radically reshape the way super funds invest

J.P.Morgan
ASSET MANAGEMENT

Introduction

The Australian superannuation system is one of the largest and most advanced pension systems in the world, continually evolving to keep up with demographic, social and market changes.

Yet it is facing its largest overhaul in decades as a result of the introduction of the Your Future, Your Super (YFYS) performance test.

Industry commentary has raised significant concern about its potential impact on the way super funds invest, including:

- Encouraging a shift to low-cost, passive investing and a lower appetite for potentially differentiating and higher-returning investment strategies; and
- A resulting lower long-term investment return for members.

In recognition of these concerns, J.P. Morgan Asset Management (JPMAM) commissioned NMG Consulting to survey super fund CIOs, Heads of Investment Strategy and Asset Consultants about how the YFYS performance test may change investment strategies. The aggregated feedback provides some valuable insights into the implications for the super industry and how CIOs plan to respond to the regulation.

Findings Overview

Super Fund CIOs have one primary objective – to deliver the best risk-adjusted returns they can for their members. This can be broken down into three key portfolio objectives:

1. Achieving target CPI+ outcomes (usually 3-4% above the rate of inflation over the long-term);
2. Investing to meet members' best financial interests; and
3. Outperforming super fund peers.

The survey results found that CIOs remain confident they can continue to achieve those three objectives even as they now have an additional fourth goal to consider: outperforming the YFYS benchmark.

However, this additional objective will have repercussions for superannuation investment strategies.

In particular, where funds are at risk of failing the performance test, there are specific investment alternatives that CIOs are willing to consider to improve their chance of passing the test.

The big changes

The survey results indicated the YFYS performance test may have far-reaching investment implications for super funds, with perhaps some unintended effects. These can be summarised as follows:

1 An additional objective for CIOs

CIOs now have a new investment objective – passing the YFYS performance test.

This may lead to product design changes where fund manager selection becomes more prominent and asset allocation becomes less likely to deviate from a specified strategic asset allocation. There is also expected to be greater fee sensitivity given the "net of fee" nature of the performance test.

Over the long term, this may lead CIOs to be more cautious about their exposure to higher-risk investment strategies.

2 Managing tracking error in public markets

The current 20 YFYS benchmarks act as blunt tools to shape sub-asset class decisions. CIOs are more likely to consider the use of lower tracking error listed equities and fixed income solutions.

Allocations to what are generally regarded as higher alpha opportunities (e.g. small cap equities, emerging market equities, emerging market debts, securitised credit) will be more challenging to justify in the future. While they will be used, there will be a higher hurdle applied, and the allocations will likely be lower to manage tracking error to benchmark.

3 Increased focus on downside protection

Given the focus on lowering tracking error in public markets, products with equity factor risk allocations are likely to require higher conviction due to the risk of underperforming the benchmarks.

While funds still like the idea of investing in high conviction strategies, the focus on downside protection is increasingly important.

4 A higher preference for taking risk in alternatives and unlisted assets, over public assets

CIOs indicated that they are more likely to take higher risk positions in unlisted assets, private credit and alternatives where tracking error is inherent, and there are opportunities to add value over the benchmarks.

There is now a higher hurdle that needs to be met to place any significant bets in public markets.

5 Reduced fixed income tracking error

The universe of sub-asset classes in fixed income is larger than in equity markets, and yet all international fixed income positions will be monitored against a single benchmark according to YFYS.

While CIOs may have previously used unconstrained fixed income managers to access the broadest range of securities across credit ratings, duration, regions and issuer types, the survey indicated CIOs are more likely to find increased value in benchmark-aware bond solutions going forward.

Importantly, it is anticipated that there will be a preference for strategies which offer a core fixed income holding and lower tracking error against the broad benchmark, but can still access a wide spectrum of securities across the fixed income universe.

The big changes

6 Lower propensity to take tactical positions

CIOs indicated that tactical asset allocation is less likely to be used given the tracking error risk that it poses. However, it is an option for funds that are underperforming.

CIOs have expressed an increased willingness to lock-in profits from asset class decisions over long-term uncertainty, despite accepting that it may hurt longer term returns.

This will result in a lower propensity to bet against a fund's strategic asset allocation to take advantage of market falls ("buying the dip"), where long-term investors can add significant value.

Note that the performance test also poses challenges to top-down processes such as currency hedging programs and overlay strategies that are not captured by any benchmarks, potentially creating tracking error while improving the overall risk profile of the product.

7 A challenge to ESG considerations

Despite the increased challenge of super funds adhering to their ESG policies with more allocations to passive-like strategies, the overwhelming feedback in the industry is that ESG is here to stay.

YFYS is more likely to reduce the meaningful use of negative screens. However, 'real' ESG integration will be highly valued, and the demand for more granular ESG information and climate data (e.g. carbon footprint) will only increase.

How funds at risk of failing the performance test are changing

Underperforming funds are under more scrutiny than ever.

The challenges they face will be tougher, their investment strategies are changing and the expectations to merge are higher than ever to satisfy political and regulatory pressures.

The research showed underperforming funds are currently taking larger bets on credit, and are also considering reducing unlisted and alternative investments to lower fees.

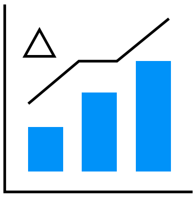
Interestingly, the research showed CIOs of outperforming funds tend to take the opposite strategy.

The CIOs surveyed also suggested underperforming funds will likely take smaller, but higher conviction portfolio positions to pass the test. This may increase the overall risk within the portfolio, creating an unintended incentive for funds that have failed the test once.

Failing funds are also likely to reduce their allocation to high conviction managers where the risk of underperforming is high and increase their allocation to more benchmark-aware investments in public markets. This strategy matches the approach of outperforming funds.

How to address the YFYS challenge

There are several ways investment managers can help super funds navigate YFYS regulation, which now applies to default MySuper options and trustee-directed products from 1 July 2022. Outlined below are some potential solutions based on the survey results.



Equities

The survey revealed that more benchmark-aware strategies will be of increased interest within equities.

Passive management is often thought of as an economical way to achieve market exposure. It maintains the full risk diversification benefits derived from an investor's asset allocation decisions and holds few surprises beyond what the market delivers.

However, indexing also means an inability to deliver any return beyond the benchmark; and stock selection is determined by the index providers, with stock weights determined by the market.

A Potential Solution

JPMAM believes there are ways to potentially outperform the benchmark after fees and to do so with a risk profile highly similar to the benchmark. The JPMAM fundamental research driven enhanced indexation strategy focuses on such opportunities.

This strategy combines the benefits of passive investing with the high-conviction of active management and can be a highly efficient way of building a portfolio.

The JPM Global Research Enhanced Index strategy's objective is to take an acute approach to risk management and yet deliver an opportunity to generate alpha and it has managed to meet this objective for the past 18-plus years*.

The consistency of the strategy is evidenced by an Information Ratio of 1.2 since inception* and a 3 year Information Ratio of 2.11 which further highlights its compatibility with the requirements under the YFYS framework.

The JPM Research Enhanced Index strategies have flexibility to accommodate regional exposures, sustainable tilts and to meet other investor specific objectives.

**Composite inception date September 2003. IR numbers are as at end of Jan 2022.*

How to address the YFYS challenge

Bonds

The survey results suggest a preference for more benchmark-aware fixed income strategies.

The global benchmark for fixed income allocations is the Bloomberg Global Aggregate Index. JPMAM believes maintaining an active approach to investing, yet within the framework of a core fixed income holding, is important for capitalizing on investment opportunities, while also ensuring that ESG considerations are appropriately addressed.

A Potential Solution

The JPM Global Aggregate Bond strategy is an actively managed strategy that is fully ESG integrated and maintains a relatively low tracking error. The strategy combines a disciplined approach to risk with diversified sources of returns, seeking to generate alpha from both security selection and sector allocation. The result has been strong risk-adjusted returns with outperformance in both rising and falling markets.

JPMAM also notes that the listed benchmark for bonds does not include private debt. We believe including a modest exposure to private debt presents opportunities for higher returns. The risk/tracking error levels vary across different private debt strategies.

Alternatives

CIOs indicated a willingness to take positions within niche sectors (deemed as "satellite" relative to the strategy's respective benchmark). This may depend on their overall performance position relative to the YFYS benchmark.

For those that are well positioned we expect funds to explore niche sectors and asset classes in greater detail. Manager selection is critical in alternative and unlisted strategies, and the upside of including more niche strategies can add significant value.

A Potential Solution

Global transportation is one way to add a niche sector within the alternatives mix. Transportation assets such as containerships, aircraft, LNG carriers, railcars and vehicle fleets form the backbone of global trade.

Investments in this sector present unique income-generation opportunities. Transportation assets are largely US dollar denominated, providing investors with access to assets that can help manage inflationary risks, such as real assets, with minimal currency risk and a low correlation with traditional and other real assets, providing significant diversification benefits.

As with private debt, JPMAM believes a modest allocation to private equity investment by superannuation funds presents opportunities to generate superior returns and diversification.

Private equity co-investment funds are a great example that allow institutional investors to invest alongside asset managers where a significant amount of capital has already been committed, with the potential to mitigate the j-curve. Co-investments can offer enhanced returns, lower fees, increased diversification of portfolio companies and sponsors, and a second level of due diligence.

Conclusion

The Government's YFYS reform package introduced a new objective for MySuper portfolios, with the annual performance test forcing super fund CIOs to reassess their current portfolios.

The survey indicates that while CIOs are yet to make significant changes to their investment strategies, changes will happen over the coming months and years.

The feedback suggests that strategies in listed assets will become more benchmark-aware, with high alpha strategies requiring higher degrees of conviction, resulting in smaller allocations.

In the alternatives and unlisted space, CIOs are expected to take advantage of the full range of niche and higher alpha strategies. Within these asset classes, manager selection will be paramount, as higher tracking error means there is a higher probability of failing the annual performance test.

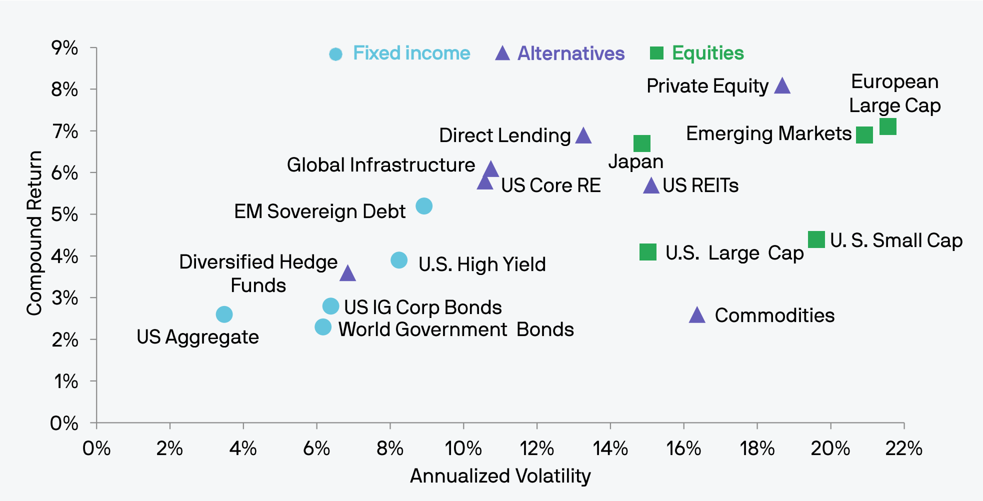
As the regulation extends to all super products later this year, JPMAM will continue to monitor how super funds are managing this transition.

We look forward to working with super funds and welcome the opportunity to explore solutions that will help achieve member objectives.

Appendix

The chart below illustrates JPMAM's expectations for the annualised return of a range of assets in the coming decade. To match historical levels of returns in portfolios in the future, investors will have to increase allocation towards alternative assets where return expectations are higher. This is in line with where we believe CIOs are allocating for alpha. More detail can be found in our 2022 Long Term Capital Markets Assumptions.

2022 Compound return and volatility assumptions (USD)



Source: J.P. Morgan Asset & Wealth Management; estimates as of September 30, 2021.
[1] Refers to a portfolio that is 60% All Country World Equity in USD (unhedged) and 40% U.S. Aggregate bonds. Outlooks and past performance are not reliable indicators of future results. Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee that they will be met.

Overview of the Research Approach

JPMAM commissioned NMG to conduct this research. NMG's approach to the research was "narrow and deep," focussing on a small number of very high value interviews with key decisions makers - CIOs and head of portfolios.

The **Chatham House Rule** applied to these interviews, whilst respecting the confidentiality of the individuals involved in the survey, which created a safe experience for respondents, and produced richer insights.

The study encompassed interviews with 14 super funds across large and medium funds representing more than one-third of public offer super funds' assets under management. Two asset consultants who advise many super funds were also interviewed. NMG considers the findings highly representative of the super fund market.

Given that YFYS implementation is still in its infancy, the approach to the research was highly qualitative in nature. While this offers limited opportunity for comparison and quantitative analysis across the sample, it allowed for a much broader conversation with CIOs to better understand their particular issues and considerations in response to the YFYS performance test.

The main findings of the study will be shared with the respondents. This provides them with a comprehensive overview of what their peers are thinking and doing, and a useful means of benchmarking where their views lie on the spectrum with other super funds.

About NMG

NMG Consulting is a multinational specialist consultancy focused on the insurance, reinsurance, and investment segments. At NMG Consulting, we integrate specialist consulting experience and proprietary insights to help clients shape strategy, implement change and enhance performance.

About J.P. Morgan Asset Management

J.P. Morgan Asset Management, with assets under management of USD$2.7 trillion (as of December 31, 2021), is a global leader in investment management. J.P. Morgan Asset Management's clients include institutions, retail investors and high net worth individuals in every major market throughout the world. J.P. Morgan Asset Management offers global investment management in equities, fixed income, real estate, hedge funds, private equity and liquidity.

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