November 2022

ASFA Research note: YFYS and asset exclusion

- APRA's annual *Your Future, Your Super* (YFYS) performance test presents challenges for super funds seeking to minimise their exposure to certain assets, say for social or environmental reasons.
- While funds are free to exclude assets from product portfolios, those same assets will remain constituents of the benchmarks that APRA uses to assess investment performance. Where excluded groups of assets under/over perform benchmarks, this will (all else being equal) alter a product's overall performance vis-à-vis the YFYS test.
- Indeed, the timing of a decision to exclude particular asset groups could make the difference between passing and failing the test. This lends weight to the need to reform the performance test.

Each year APRA assesses the investment performance of all MySuper products relative to a tailored benchmark portfolio over a rolling 8-year (the test also will apply to trustee-directed products from 1 July 2023). For each product, the tailored portfolio comprises a combination of standard asset-class indexes – weighted by the product's asset allocation.

Within any asset-class index, certain types of assets – such as those related to a particular industry – may systemically under- or over-perform relative to the index. An example is the recent performance of fossil-fuel related equities (for Australia, a proxy is the group of ASX 'energy equities', which comprise around 6% of total ASX market capitalisation).

Chart 1 shows that over the 8-year period to 30 June 2022, the group of Australian fossil-fuel equities (blue) under-performed the group of non-fossil-fuel equities (red).[i] The whole-of-market index (black) includes both groups, and is the relevant asset-class index with respect to the performance test. An investment strategy that excluded fossil-fuel equities at the start of the 8-year period would have out-performed a strategy that mirrored the whole market.

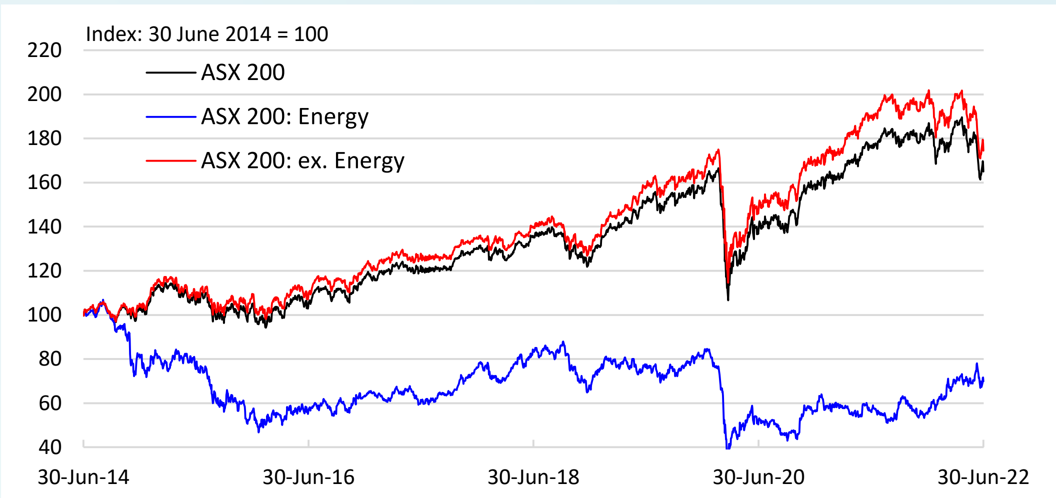
However, the converse is true for the past fiscal year. From the start of 2022, surging global energy prices led to strong price gains for fossil-fuel equities (and contributed to weakness across the broader market). An investment strategy that excluded fossil-fuel equities (for the first time) at the start of FY2021-22 would have under-performed relative to a strategy that continued to mirror the whole market.

Table 1 shows performance outcomes in detail for Australian equities, but also international equities. For the full 8-year period, indexes that exclude fossil-fuel equities out-performed the whole market – by an average of 0.5 per cent per year for Australian equities, and an average of 0.6 per cent per year for international equities.[ii]

For the past fiscal year only (2021-22), the converse is true – that is, the whole market declined by a lesser degree than indexes that exclude fossil-fuel equities. For Australian and international equities, the whole market out-performed indexes that exclude fossil-fuel equities by 2.0 per cent and 1.6 per cent.[iii]

This implies that, for the full 8-year period, an investment strategy that excluded fossil-fuel equities (for the first time) at the start of 2021-22 would have under-performed the whole market by an average of around 0.2 per cent per year.

Chart 1: Australian listed equities*



Source: S&P/ASX200 and ASFA derived (for non-fossil fuels).

These outcomes have implications for performance at the portfolio level.

On average, super funds allocate 22 per cent of their investments to Australian equities and 26 per cent to international equities. The above results, and the average allocations, imply that an investment strategy that excluded fossil-fuel equities at the start of the 8-year period (Scenario 1 in Table 2) would translate into an almost 0.3 per cent per year premium for the whole portfolio relative to its YFYS benchmark.

On the other hand, an investment strategy that excluded fossil-fuel equities at the start of 2021-22 (Scenario 2), would translate into lower returns of 0.1 per cent per year relative to its YFYS benchmark. In this scenario, for a product already close to the YFYS pass-fail threshold (0.5% below a product's benchmark return), the switch out of fossil-fuel equities could make the difference between passing and failing the performance test.

More broadly, for products subject to the performance test – now and in the future – the test will influence fund's investment decisions. While funds may wish to exclude certain types of assets from a product's investment portfolio, doing so would create an additional source of risk in respect of that product – in particular, that excluded constituents may out-perform broader market indexes. This is likely to impact asset allocation, as funds will be less willing to exclude assets even if consistent with an ethical investment strategy.

This lends weight to the need for changes to the performance test. As demonstrated above, the decision to exclude a particular group of assets from a product's portfolio could have a material impact on whether the product passes or fails the performance test. Whether a product is deemed underperforming/performing should not be a matter of degrees, nor the consequence of decisions regarding particular assets in isolation. Where a product fails the test by a small (specified) margin, the trustee should have access to a review process – undertaken by APRA – that considers the facts and circumstances around the product's performance test outcome.[iv]

[i] In Chart 1, the non-fossil-fuel index is ASFA derived.
[ii] International equities indexes used are MSCI World and MSCI World ex. Energy (gross accumulation).
[iii] Ibid.
[iv] ASFA 2022, *Submission to Treasury – Review of Your Future, Your Super Measures: consultation paper*, 14 October. https://www.superannuation.asn.au/ArticleDocuments/1877/202217_Treasury_Review%20of%20Your%20Future%20Your%20Super_final_sans_signature.pdf.aspx?Embed=Y.
* Accumulation indices.

Table 1: Investment performance – listed equities*

8-years to 2021-22: Average annual return	*Whole-of-market index*	*Ex. Fossil Fuel index*	*Relative performance of Ex. Fossil Fuel index*
Australia	6.8	7.3	0.5
World	7.3	7.9	0.6
2021-22 return	*Whole-of-market index*	*Ex. Fossil Fuel index*	*Relative performance of Ex. Fossil Fuel index*
Australia	-6.5	-8.5	-2.0
World	-13.9	-15.5	-1.6

Source: S&P/ASX200, MSCI and ASFA derived.

Table 2: Investment performance – portfolios

Scenario	Whole-of-portfolio performance relative to standard portfolio benchmark
Switch to Ex. Fossil Fuels 8 years ago	0.26
Switch to Ex. Fossil Fuels 1 year ago	-0.10