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Sent by email

Re: Consultation for Review of Your Future, Your Super Measures

Palisade Investment Partners Limited (**Palisade**) is pleased to provide this submission in response to the Consultation Paper released on 7 September 2022 regarding a review of the Your Future, Your Super (**YFYS**) measures. Palisade welcomes the consultative approach that Treasury has taken with respect to the YFYS reforms, particularly given the importance of Australia's superannuation system to not only the millions of Australians who rely on superannuation providers to manage their life savings, but also the broader role that the superannuation industry plays in the economy and financial markets.

Palisade is a leading independent Australian infrastructure and real assets manager providing dedicated professional investment management services to the wholesale superannuation market and other institutional investors. Palisade currently has $3.5 billion in funds under management and commitments, with $1.6 billion managed through direct investment mandates (predominantly Australian superannuation funds) and a further $1.9 billion managed through pooled funds. Palisade has taken an active approach in engaging with Treasury regarding the YFYS reforms, and previously responded to the two prior YFYS consultations in December 2020 and May 2021. Naturally, as an infrastructure fund manager, the nature of our prior submissions focused specifically on the use of a listed index as a benchmark for the infrastructure asset class (in the case of the December 2020 submission) and a subsequent change of the benchmark to the MSCI Australia Quarterly Private Infrastructure Index (in the case of the May 2021 submission). To reiterate, Palisade fully supports the benchmarking of superannuation products and monitoring of ongoing investment performance to ensure the best outcome possible for superannuation funds and their members.

We note that the current consultation covers all four elements of the YFYS measures, with the overall objective to seek feedback on any *unintended consequences* and implementation issues from the YFYS measures. In particular, this submission seeks to provide feedback in respect of Question 2 in the Consultation Paper, namely:

> *"Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?"*

As noted in the May 2021 submission, whilst Palisade was supportive of the decision to not utilise the listed benchmark for the infrastructure asset class, a number of concerns were raised by Palisade and others in the market with the use of the MSCI unlisted benchmark. These concerns primarily centred around the composition of the index (including the relatively small number of constituents and weighting of some of those constituents in the calculation of the index), as well as the timeliness and availability of the index. Palisade is not intending on commenting on those concerns again in this submission, other than to say that we strongly believe they remain relevant and warrant further consideration.

In response to the above question, Palisade's observations are based most importantly on our own dealings as a key player in the Australian infrastructure market, but also on anecdotal discussions held with industry participants, including superannuation funds. Our observations address the question of how the MSCI

benchmark is informing the investment decisions of Australian superannuation funds as it relates to investing in unlisted infrastructure.

In our December 2020 submission, we noted that based on our discussions with market participants, *"many investors have indicated it may materially alter their view with respect to ongoing funding and support for unlisted infrastructure projects"*. Whilst this comment was made in reference to a misalignment in performance outcomes of an unlisted infrastructure portfolio and a listed infrastructure index, the same can certainly be said in the case of a misalignment in performance outcomes of an unlisted infrastructure portfolio and an unlisted infrastructure index, particularly when a given portfolio and an index have differing risk profiles. Infrastructure is an asset class which has varying degrees of risk and return profiles. Accordingly, the vast majority of long-term, open-ended infrastructure portfolios, including those we construct and manage on behalf of our superannuation clients, incorporate a balanced approach to portfolio construction, such that they include both assets on the "core" (providing greater levels of yield and downside protection) and "core-plus" (providing greater levels of capital growth) ends of the spectrum. This is relevant in an index that (a) has a limited number of constituents and (b) is heavily weighted towards one particular constituent – observations which have been raised previously.

Palisade's assessment of the MSCI index, which has been echoed by other market participants including superannuation funds, is that it is more reflective of a "core-plus" (higher returning) portfolio given the relative weighting towards one particular manager's strategy. Palisade's observations are that this has driven many Australian superannuation funds to commence the process of repositioning their infrastructure portfolios to generate returns commensurate with a core-plus portfolio. Palisade has witnessed both superannuation funds avoiding investing in core assets, as well as actively introducing risk to their portfolios – both through the pursuit of assets with greater levels of operational risk, as well as the introduction of greater levels of financial leverage – as a means of bolstering returns.

The role of infrastructure investment in the financial markets and economy is two-fold. Firstly, given the investment characteristics of infrastructure assets (i.e. long-term, stable assets that generate sustainable cashflows), infrastructure plays a crucial role as part of a larger diversified investment portfolio. Secondly, institutional funding of infrastructure, including by superannuation funds, has long benefitted Australian governments with respect to funding their infrastructure needs. In discussing the consequences of superannuation funds repositioning their portfolios to have greater exposure to "core-plus" assets, it is worth considering each of these separately.

Role of infrastructure in investment portfolios

Australian institutional investors have long been adopters of the use of unlisted infrastructure within investment portfolios. The characteristics of infrastructure has meant that as an investment proposition, it has typically been viewed by investors as a defensive asset class, whilst providing moderate levels of capital growth. Again, this risk return profile has typically been a function of a balanced portfolio of core and core-plus assets. To date, the use of unlisted infrastructure within portfolios as a diversifier to traditional asset classes has been a great success for Australian superannuation funds – an approach which has been validated by the many pension funds globally seeking to replicate a balanced infrastructure portfolio which Australian superannuation funds have been the beneficiaries of for many years. This diversification was critical during the Covid-induced market downturn. By way of example, in March 2020 the value of Palisade's infrastructure portfolio fell by only 2%, compared with a fall in Australian equity markets of close to 30%. This relatively limited decline in the value of the Palisade portfolio was due principally to the 60% weighting the portfolio has to core assets such as Public Private Partnerships (**PPPs**) and renewable energy. As noted above, the pursuit of higher returns by tilting away from these assets, in addition to the use of greater levels of financial leverage, will invariably introduce greater levels of volatility to superannuation infrastructure portfolios. This cannot be in the best interests of superannuation members, particularly when this is a significant deviation from the way infrastructure has been successfully utilised in portfolios for decades.

Role of institutional capital in funding infrastructure

Investment into infrastructure by superannuation funds is first and foremost an investment decision trustees make with the interests of their members at heart. A convenient by-product of this however is the role that superannuation funding plays in the development and construction of new infrastructure. Australia in particular has had many successes of utilising private sector capital to fund new infrastructure. A key part of this success has been Australia's PPP model, whereby private capital has funded new infrastructure build with the support of state and federal government availability payments. Whilst some superannuation funds have been cautious of funding greenfield infrastructure (even under a PPP model), the ability for superannuation funds to provide liquidity to project developers (which can then be recycled into further projects) once these projects have been successfully delivered is paramount to these developers continuing to fund these projects.

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Again, Palisade has observed a number of high quality brownfield PPP opportunities either being passed on by superannuation funds because their expected returns are considered too low relative to the MSCI benchmark, or worse yet, superannuation funds seeking to dispose of high quality PPP opportunities which have provided downside protection for their portfolios for many years. This ultimate lack of funding and liquidity for these projects will not only impact the required return for project sponsors in developing projects (which will ultimately impact the cost of capital for governments), but the ability for sponsors to develop and fund projects in the first place. Alternatively, the lack of appetite from Australian superannuation funds for core infrastructure assets could also lead to greater ownership of Australian core infrastructure by offshore investors. Whilst observations to date have been with respect to PPP projects specifically (which are generally considered the lowest risk investment within the infrastructure landscape), it is not unreasonable to conclude that this ongoing pursuit of absolute returns at the expense of risk will permeate into other core infrastructure sectors such as renewable energy and utilities.

Both of the outcomes noted above are undesirable and clearly not what was intended when assigning a benchmark for unlisted infrastructure.

Palisade recognises the importance of an observable and investible index, noting that a benchmark return should represent a passive investment portfolio. The nature of the infrastructure asset class however has meant that an index representative of a passive unlisted infrastructure portfolio has been difficult to produce. As recommended in our May 2021 submission, we believe it would be appropriate for Treasury to consider whether a benchmark for unlisted infrastructure equal to the Consumer Price Index plus a fixed margin is more appropriate – particularly given the strong inflation linkages inherent within the asset class. In order to ensure that the integrity of the YFYS performance test is preserved, we believe it would be appropriate for Treasury to implement this for a period of three years, with a review following that time period. Whilst we appreciate that this is not an "investible" benchmark, we believe the downside from superannuation funds repositioning long-term portfolios higher up the risk curve and exposing members to greater volatility, is far greater than the impacts of having an imperfect benchmark.

Palisade would welcome the opportunity to discuss further.

Yours faithfully,

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