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[ISA Supplementary Submission - Performance test methodology PDF \(submitted\).pdf](#)  
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Hi s 22 as discussed. This submission argues for a simple (naïve) reference portfolio to assess performance which will give trustees more latitude to construct portfolios and invest in emerging asset classes whilst meeting a minimum performance standard.

You would also be aware the last review adjusted the unlisted infrastructure benchmark index to accommodate clean energy infrastructure, so the problem has started to be addressed in the context of the current test.

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# Your Future, Your Super Review – Performance test methodology supplementary submission

## Overview

The introduction of an annual performance assessment has brought important accountability to funds' trustees to ensure minimum performance outcomes are being met in respect to MySuper products.

The performance test regime represents a significant improvement over the self-assessed Member Outcomes regime that preceded it (even though it continues to operate in parallel).

Since its inception the test has identified 14 MySuper products that have failed which collectively managed \$60 billion in assets for 1.1 million members.<sup>1</sup> This represents around 7% of total member savings and 8% of member accounts. Without the test these members would be none the wiser.

However, as detailed in ISA's initial submission, it is not obvious whether the outcomes of members in these products have materially improved given only 6% of members in underperforming products have left them and more than half of members remained in a product that failed twice – with the balance either merging into products that passed or trustees made changes to narrowly avoid a second fail.

ISA's initial submission estimated members of underperforming products lost \$1.6 billion collectively in the year to June 2022 – even after accounting for fee reductions – relative to members in top performing products. In considering the operation of the performance test and impact on trustee behavior and, ultimately, member outcomes, ISA argues in this submission several shortcomings need to be addressed. These include:

- ▶ The transparent publication of data to ensure test outcomes can be properly evaluated and validated;
- ▶ The failure of the test to assess the trustee's strategy in addition to implementation;
- ▶ The failure of the test to appropriately assess the risk members actually experience in exchange for the net returns achieved over the duration of the test;

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<sup>1</sup> [APRA MySuper Performance Test 2021](#), [APRA MySuper Performance Test 2022](#), APRA Quarterly MySuper Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).

- ▶ The failure of the test to operate over a sufficiently long duration to properly assess member outcomes over multiple market cycles and not discourage investments in asset classes that have longer investment horizons;
- ▶ An inappropriate bias to the calibration of ex-ante administrative fees to avoid technical test failure rather than making trustees accountable for what they have actually delivered to members' accounts in after-fee after-tax net returns;
- ▶ A continued lack of neutrality in fee and cost disclosures required under ASIC Regulatory Guide 97 (RG 97), which results in different fee disclosures on similar underlying investments depending on how they are held and offered to members;
- ▶ Redesigning the test to eliminate gaming and re-orientating the test towards materially improving member outcomes, and presenting test outcomes in a way that is likely to lead to consumers making better decisions.

ISA makes seven specific recommendations to the performance test methodology to improve the integrity and robustness of the test. While ISA suggests material changes to the performance benchmark methodology are warranted, minor changes could be implemented as an initial step to improve outcomes before effecting more significant changes.

### Summary of recommendations

1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA) for all products and numerical performance test results.
2. All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.
3. The basis for RG 97 and related data collections utilised for performance testing should be reviewed to ensure fees and costs borne by members are treated consistently regardless of how products are offered to members (whether directly by a fund or via a platform) and how funds access underlying investments (directly or indirectly).
4. The performance test should be based on the product's RAFF for the duration of the test, and the BRAFF should be member-weighted rather than product-weighted.
5. Consideration should be given to replacing the existing product specific SAA benchmark with a simple naïve benchmark for all MySuper products comprising a simple low-cost diversified portfolio to assess whether trustees are adding value to members savings.
6. Coupled with a simplified transparent test any products that fail be subject to 'a show cause' and more granular assessment of the risk return trade-off for members.
7. APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

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## Performance test methodology

### Key design features of the existing test

Before considering the methodology of the test in detail, it is important to outline its basic structure and operation. The existing test has the following core features:

- ▶ Each product is assessed against a benchmark particular to itself with reference to the historical Strategic Asset Allocation (SAA) of the product as determined by the trustee;
- ▶ SAA Benchmark portfolio returns for each product are calculated with reference to asset class matched market indices net of tax and efficient investment fees;
- ▶ Lifecycle products are assessed at the product level by aggregating the life stages weighted by investments in each life stage;
- ▶ Product and benchmark net investment returns are calculated over a duration of eight years and a minimum of five years;
- ▶ Reference administrative fees for the product are assessed independently of net returns over the previous 12 months rather than the full duration of the product;
- ▶ The benchmark reference administrative fee is the median of all products (not the median paid by members);
- ▶ A failure of the test is triggered when the product's 8 year net investment return falls more than 0.5% below the product's benchmark net investment return inclusive of an adjustment reflecting whether the product's most recent 12 months administrative fee is higher or lower than the product median.

Some of the important consequences of these design features are:

- ▶ The product tailored benchmarks net out the effect of differences in portfolio construction (portfolio strategy) between products – an important contributor to ultimate returns;
- ▶ The trustee sets and can manipulate the construction of the benchmark which their product is assessed against – potentially making the performance hurdle easier to achieve;
- ▶ The net returns obtained by members over the duration of the test are not measured or trustees held accountable for;
- ▶ The use of a 12 month administrative fee adjustment to net investment returns ascribes a higher weight to admin fee reductions than the rolling average impact of investment fee reductions and the effect of any trustee improvement to investment implementation, let alone strategy (which carries zero weight);
- ▶ The use of a median product administrative fee rather than median member fee results in a higher fee assumption for the benchmark than most members pay, resulting in an easier test;
- ▶ The duration of the test might be inadequate to assess trustees' actions over the course of more than one market or economic cycle;

- ▶ There is no explicit consideration of the *actual* risk taken by members in exchange for the returns they receive.

As we consider the test in detail it is important to understand what factors are captured or not by the test and their relative influence on ultimate member outcomes.

Conceptually this is very important because if the test overlooks important factors that contribute to member outcomes, then it won't discipline or incentivise trustees to address those factors.

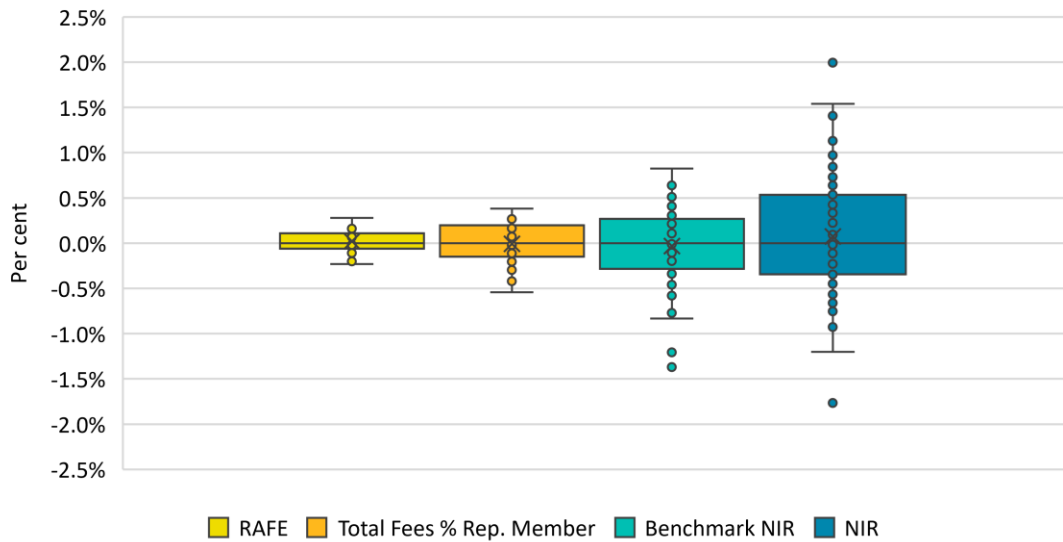
#### Factors contributing to net return differences

ISA has empirically assessed the potential scale and sources of performance improvement including fees, investment execution, strategy, and how they might contribute to realised net returns. Figure 1 below provides a representation of the relative size of these potential factors to the distribution or spread of net returns experienced by members.

As can be seen moving from left to right in figure 1, differences in administrative fees RAFE vary net returns by less than 0.5%, total fees vary net returns by 1.0%, the actual benchmark investment portfolio by around 2.0%, and observed net investment returns by more than 3.0%.

The spread between the best and worst observed net 8 year returns is almost 4.0% and the spread between the median net return is around 2.0% to the best and almost 2.0% to the worst net return.

**Figure 1: Spread of factors affecting net return**  
Year to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test - 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

Given admin fee differences alone have only a modest bearing on net returns of MySuper products, the relative importance the test ascribes to the reference admin fee is curious. Moving a product from the highest to lowest fee could theoretically improve their test outcome by 0.5%, which is just a fraction of the 3.0% difference in the observed net investment returns.

A change in total fees could be more meaningful but at most could improve the test outcome by one third if sustained. Evidently more than two thirds of observed performance differences are due to factors other than fees, including the strategy (underlying asset allocation) and its execution – yet the existing performance test doesn't reward trustees for the portfolio asset allocation – which has the potential to have more than twice the impact of fee reductions.

### Is the test improving member outcomes?

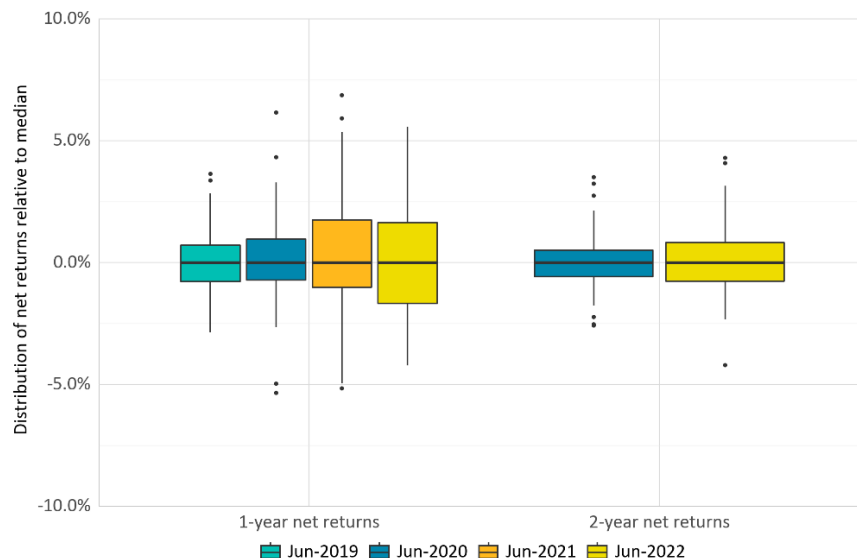
Before considering in detail the test methodology it is useful to assess after two rounds of the test whether the objective of the test is being achieved empirically.

Decomposing improved outcomes and attributing the drivers is a difficult task. However, the starting point is whether the operation of the test has caused poor performing products to 'lift their game'.

If this were the case, we would expect to see fee reductions and a greater focus on investment strategy and implementation result in a narrowing in the distribution or spread of net returns among products. Specifically, we might expect to see products in the bottom two quartiles begin to close the gap to median returns and observe a tighter distribution of below median returns. Figure 2 below shows the distribution of returns for the last four years – two years immediately preceding the inaugural Your Future Your Super (YFYS) performance test, and two years after.

Remarkably we see the return spread increase after the commencement of the test in each of the two years after the test compared to the two years before. This is the case for both below and above median returns. So rather than closing the gap in return outcomes we have at this early stage seen a widening in the performance gap between the poorest products, median products and top performing products.

**Figure 2: Distribution of product level net returns, 2019-2022**

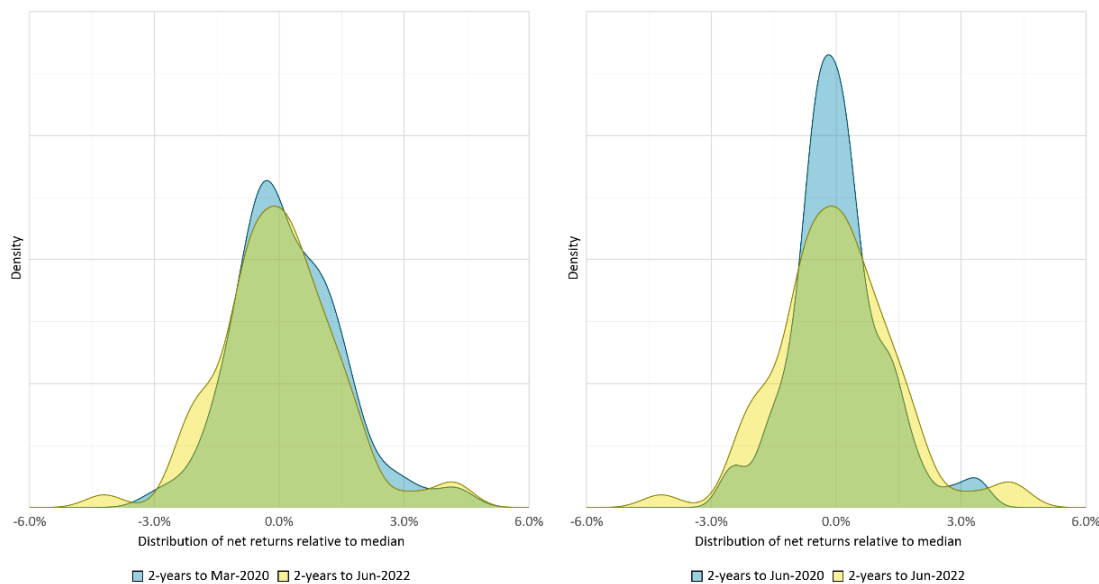


Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

It is possible this outcome is unrelated to the commencement of the performance test. For example, we might expect during abnormally good or poor investment return periods magnification of portfolio

return differences. To assess this possibility, we examined rolling two-year returns at quarterly intervals and calculated average returns and product volatility. We then matched two periods before and after the test with similar average return outcomes and volatility. A density plot of similar periods before and after the test relative to the median is shown below (figure 3). As can be seen, the distribution and range of product returns has not narrowed since the introduction of the tests,<sup>2</sup> with a number of poor performing products achieving significantly lower returns relative to top performing products.

**Figure 3: Density plot (distribution) of MySuper product two-year net returns Before and after the introduction of the YFYS performance test**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

Importantly these outcomes incorporate trustee responses to the performance test including fee reductions among products failing or close to failing the test. The nature of these fee reductions is discussed further later in this submission however it would appear they didn't materially close the net return gap.

### The relationship between performance test outcomes and net returns

In considering whether the test is leading to an improvement in member outcomes (measured by net returns) it is worthwhile examining the strength of the relationship that exists between the performance test and net returns.

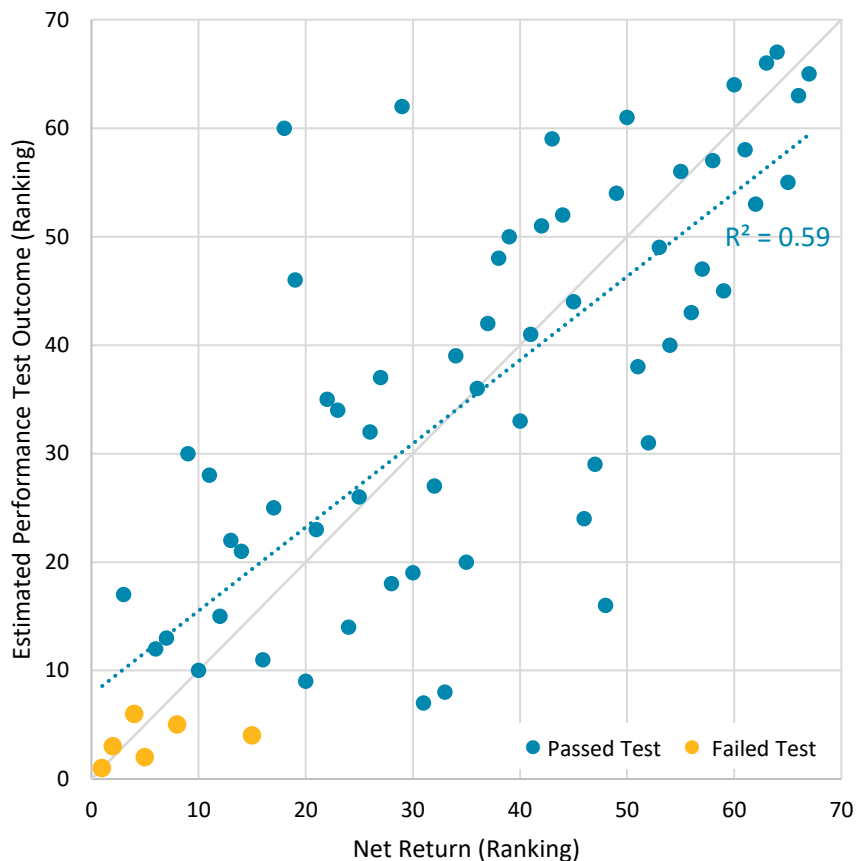
It is evident the test is identifying underperforming products. Figure 4 below shows the relationship between the test ranking and net returns. The products which failed the test (identified by red dots) also had poor net return rankings and so are clustered in the bottom left corner.

<sup>2</sup> In fact, we find evidence at the 5 per cent level of significance that variation in MySuper product net returns in the 2 years to June 2020 is lower than in the 2-year to June 2022.



However, the relationship between performance test outcomes and net returns is not directly linear. There are many outliers where either the product's performance test ranking is apparently adequate (despite the product ranking as poor or failing on a net return ranking), or the product has a relatively solid net return but poor performance test results.

**Figure 4: Relationship between performance test rank and net return rank**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

While on face value there appears to be a relationship between net returns delivered to members and performance test outcomes, it is much weaker than might be expected. A regression between the net return ranking and the performance test rank suggests only 59% of the performance test outcome can be explained by the actual returns delivered to members ( $R^2 = 0.59$ ).

While the role of risk is discussed below, it is likely this relationship is not a causal one. Recalling that the performance test assesses the trustee's implementation of their strategy, it is plausible that trustees capable of implementing a strategy well are also likely to devise a quality strategy in the first place.

However, the absence of a more robust statistical relationship does raise issues around the design of the performance test and its potential failure to predict net return performance delivered to members, which is the key metric that will determine their final retirement savings.

## Transparency and integrity

Empirical evaluation of the performance test to contribute constructively to this review was not a simple task due to a lack of transparency around performance test inputs and outcomes.

Since the inaugural test, APRA, has undertaken the performance assessments using product level data that is not contained in its statistical publications or otherwise publicly available.

Information on selected product-level strategic asset allocation domicile and hedging, while reported by funds to APRA, is not published, making it very difficult to validate the test results and assess its sensitivity to changes.

For ISA to evaluate the second round of the performance assessment we have sought this data directly from ISA member funds or have otherwise used sector level domicile and hedging information with a correction factor based on last year's performance test outcomes.

Seeking to replicate the latest test has been necessary as the regulator won't publish the 2022 numerical performance test outcomes other than a pass or fail until it releases its heatmaps later this year. As a consequence, this review is being conducted with only one out of two years performance test results in the public domain – which by any measure is unsatisfactory.

Other important data that would be useful for evaluating the integrity of the test is also not published, such as product-level actual asset allocations (AAA). The basis for doing so is discussed in the next section.

Until this information is transparently reported, ISA has concerns about the integrity of the performance test including the ways in which Strategic Asset Allocations (SAAs) might be manipulated by funds to pass the test.

**Recommendation:** APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA) for all products and numerical performance test results.

## Gaming of the SAA benchmark

As noted above, products are assessed against a product-tailored benchmark which references the SAA of the product and not the actual asset allocation of the product. Because the SAA is determined by the trustee and there is no specific obligation for it to reflect the actual asset allocation, there is the opportunity for the benchmark to be gamed.

In effect trustees can manipulate the SAA such that it could be reasonably expected to deliver a lower portfolio return than the AAA – in other words, the trustee can lower the hurdle return which they must clear.

It is not possible to independently determine the extent of such manipulation since APRA does not publish the AAA of products to assess how they might deviate from the SAA.

Nevertheless, there was a potential insight into such activity at the commencement of the performance test where a subset of MySuper products significantly revised their historical SAA (thus changing the benchmark portfolio they were assessed against).

#### Evidence of gaming

In the lead up to the first round of performance tests, 35 MySuper products revised their historical SAA benchmarks with most reducing exposure to 'Other' investments and increasing exposure to Cash and Fixed income (see figure 5).

The Other investments benchmark index has averaged 5.1% per annum over the 8 years to June 2022, compared to 1.8% per annum for Fixed income and 1.2% per annum for Cash, so this behaviour increased performance test outcomes by shifting the SAA to categories with lower returning benchmark indices.

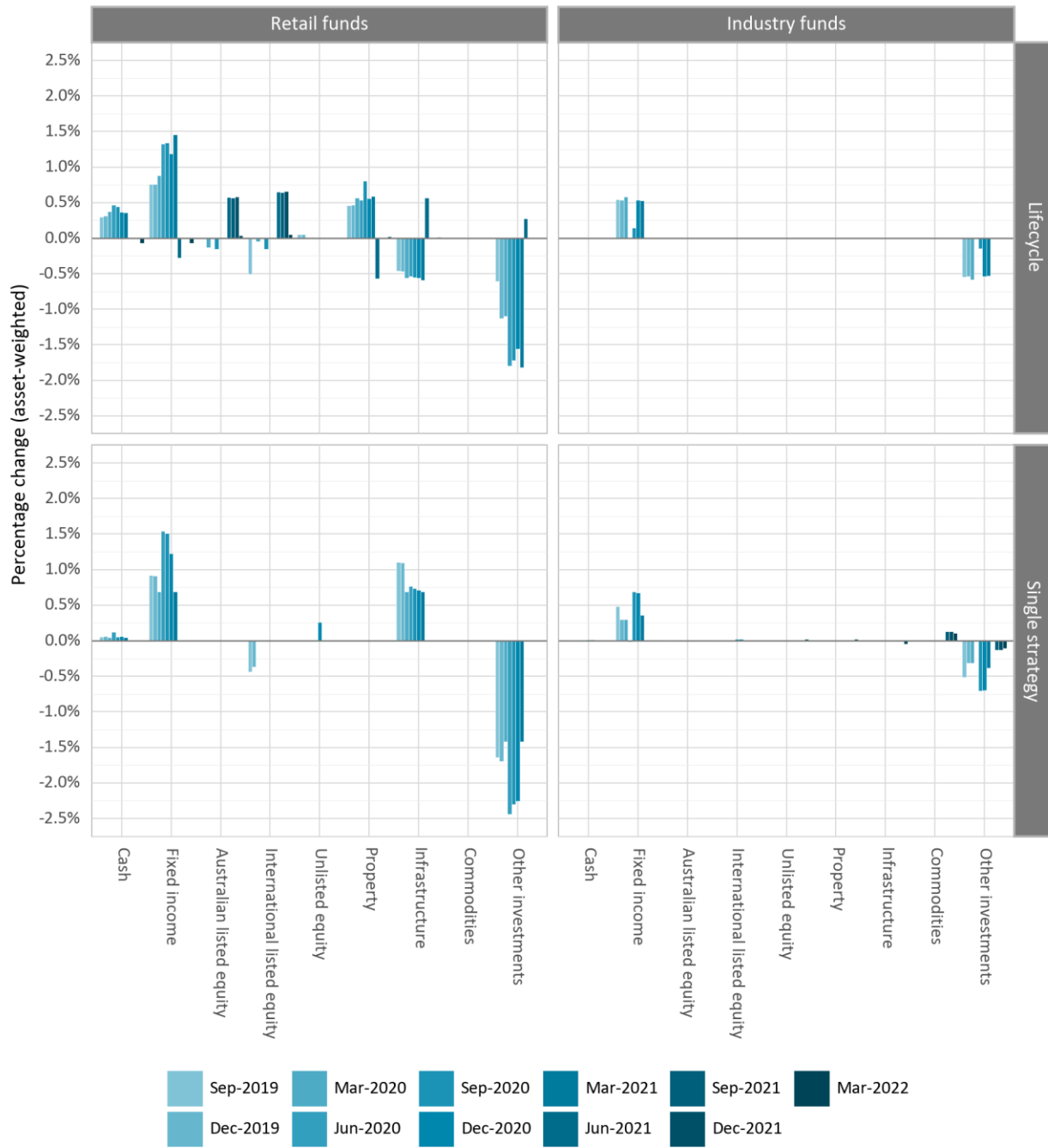
While there was in some instances a legitimate case for trustees to reallocate assets in the 'other' category to better reflect the underlying assets, there were surprising differences in the extent of this re-allocation across sectors.

The behaviour was particularly prevalent in the retail sector which accounted for 20 of the 35 product revisions. Revisions were more likely among lifecycle products and among these 84% of SAA revisions were from retail MySuper products. Furthermore, across both lifecycle and single strategy products the extent of reallocation (as a share of assets) was around three times greater magnitude among retail MySuper products than industry MySuper products.

The ability of funds to influence their product's benchmark returns via changes to their SAA opens the prospect of gaming within the system. In effect trustees can improve their performance test outcome not by increasing the performance of the product, but by lowering the bar to which the product is assessed against.

This reduces the efficacy of the performance tests and weakens their ability to improve member outcomes.

**Figure 5: Revisions to SAA in the lead-up to performance tests**  
 Weighted average assets of all funds by sector



Source: ISA Analysis, APRA Quarterly MySuper Statistics (March 2021, June 2021, March 2022 & June 2022).

## The duration of the test is too short

In general, products should be assessed over the longest time period possible to account for risk and market cycles, and to reflect that superannuation is a long-term investment.

### Market and economic cycles and other regulatory guidance

ISA's analysis of the economic and financial market cycles in Australia shows that over the last few decades, financial market cycles have slightly shortened (to a median of 2.9 years over the period from 1984 and 2020) while economic cycles have substantially lengthened (to a median of 18.6 years from 1984 to 2020). Assessing performance over multiple market and ideally economic cycles allows for a better assessment of the resilience of investment portfolios, along with trustees' responses.

Additionally, the Conexus Institute found that using an 8-year period to assess returns will mean that for every six poor funds, the test will likely misidentify one as a good performer.<sup>3</sup> This reflects that over 8-year intervals, a poor fund may experience annualised performance above the threshold level. This is an unacceptably high risk of false positives.

Support for 10-year timeframe for assessing returns is also found on the Government's own Moneysmart website. The explanation given about how to choose investments uses a 10-year timeframe to show average returns.<sup>4</sup> Similarly, under the MySuper product dashboards legislation, funds are required to work out a return target for a period of ten years and the return for the previous ten financial years, or the period the product was offered.<sup>5</sup>

### Discouraging investment in Venture Capital and early-stage Private Equity

The look-back period has important implications for portfolio construction and the inclusion of asset classes that are illiquid and have inherently long investment horizons. This is especially the case for Venture Capital (VC) and early-stage Private Equity investments. They commit capital in the very early stages of an enterprise many years before relevant products or services are ready for market with the expectation of valuations surging once positive cashflows and profits are attained. This lag (known as the 'j-curve') means the commitment period can be as long as 8-10 years for the specialist funds established for such investments. As a consequence, the existing lookback period may deter new allocations to VC thus distorting investment decisions and reducing the universe of assets that members are exposed to, reducing diversification and risk-adjusted returns.

**Recommendation:** All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.

## Test fails to capture poor risk-return outcomes for members

A common criticism of the YFYS performance test is that it doesn't explicitly assess the risk members are exposed to in exchange for the returns they receive. Whether this is relevant for a relatively

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<sup>3</sup> [The Conexus Institute, Working Version: Review of the Your Future Your Super Performance Test \(20 November 2020\)](#).

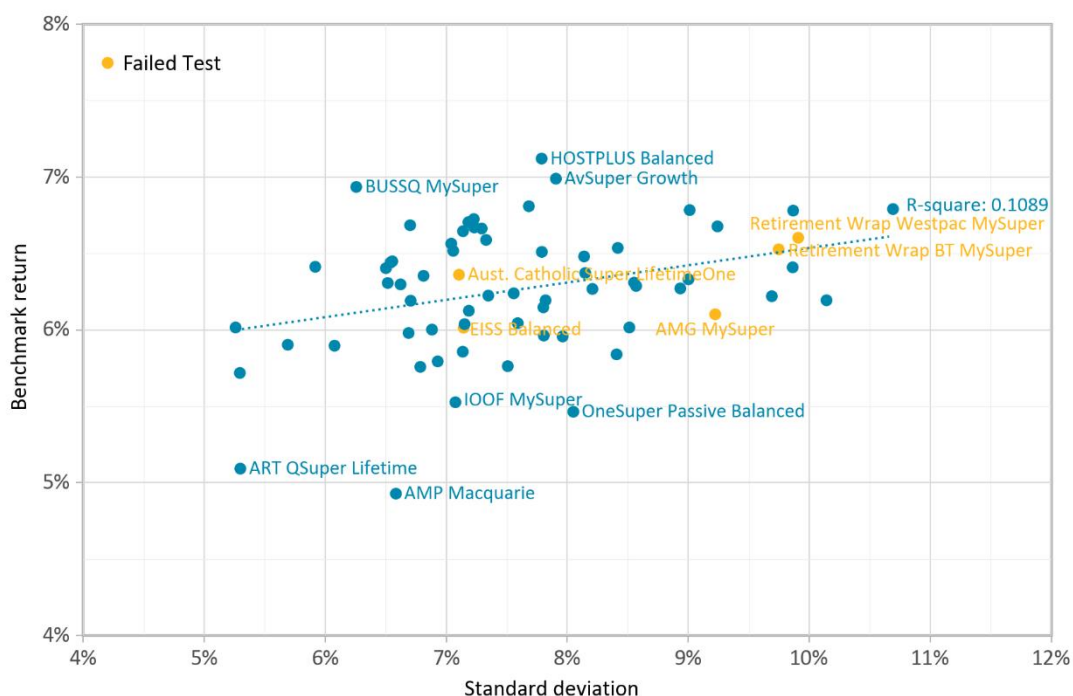
<sup>4</sup> [Moneysmart, Choose your investments \(accessed 14 October 2022\)](#).

<sup>5</sup> Division 2E of Part 7.9 of the *Corporations Regulations 2001*.

standardised product like MySuper is open to debate, but it is useful to examine in the context of the review and the efficacy of the test.

To some degree the performance test does attempt to take risk into account by constructing product-specific benchmarks that are matched to the supposed asset allocation of products. In theory, a product with a riskier asset allocation will have this reflected in the benchmark, thus attempting to control for risk in the performance assessment. In theory this makes some sense as figure 6 below shows. It reveals an expected (but not directly linear) relationship between the MySuper products benchmark returns and risk (measured by the volatility or standard deviation of returns).

**Figure 6: Risk return of MySuper product benchmarks**  
Eight years to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

There are two possible ways to interpret such results when comparing two products:

- ▶ Firstly, you can identify products with a similar return (y axis) and then assess which has delivered that return with the lowest risk horizontally (x-axis);
- ▶ Alternatively, you can identify products with similar risk (x-axis) and then assess which has delivered better returns in exchange for that risk vertically (y-axis).

However, what is more revealing is examining the actual (or realised) risk return of MySuper products, which is shown in figure 7 below.

**Figure 7 – Observed risk return of MySuper Products 8 years to June 2022**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

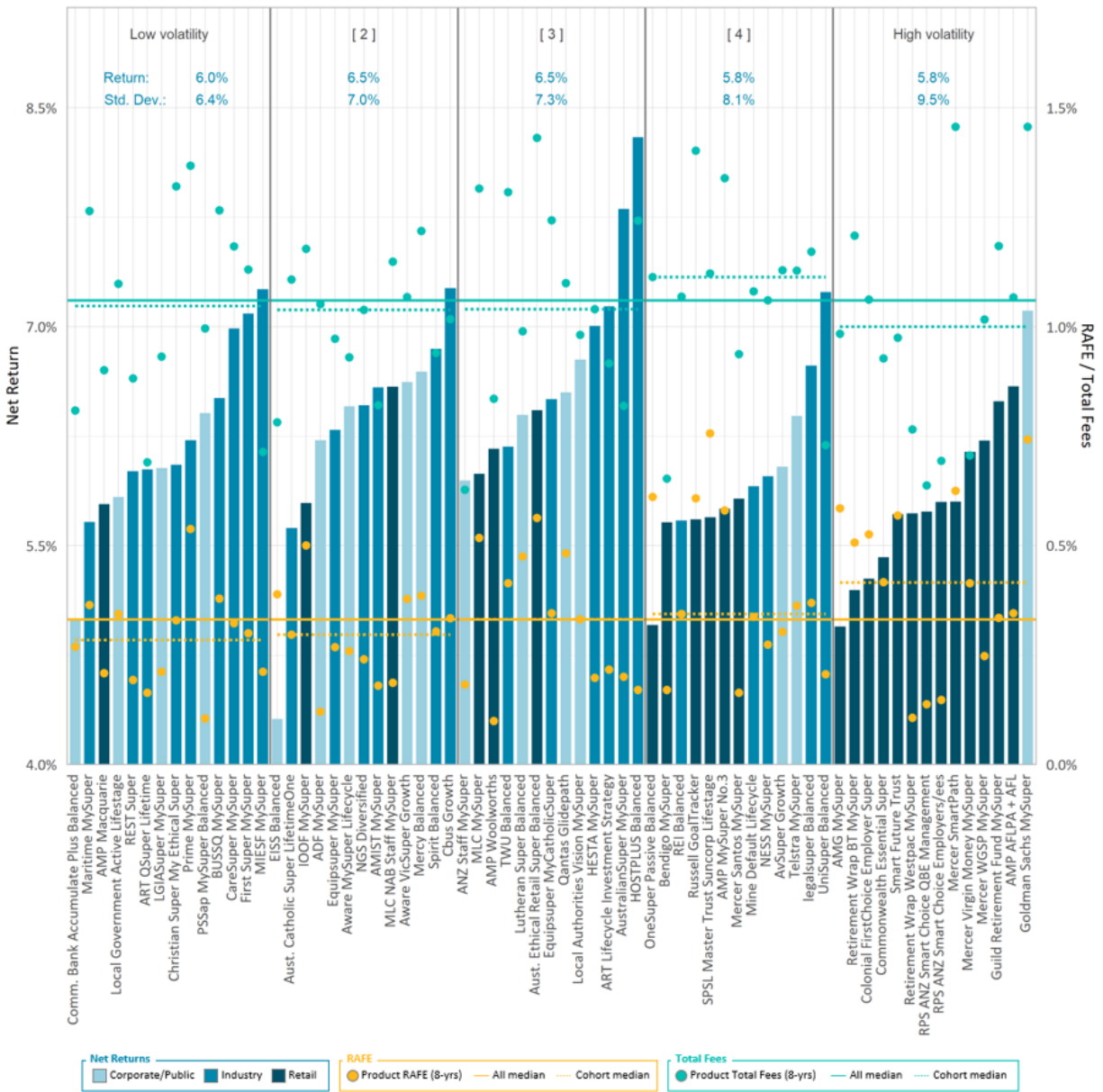
Evidently there are significant differences between the benchmark risk return outcome and the observed risk return outcome.

Specifically, the relationship for observed risk return outcomes is slightly negative because some of the poorest performing products are also the most volatile. This is very unusual and could be explained by three things.

- ▶ Firstly, the benchmark SAA for some of the products might not reflect riskiness of the investment portfolios employed.
- ▶ Secondly, it is possible asset selection decisions within the asset allocations are riskier and lower returning than the benchmarks.
- ▶ Thirdly, is that the fees for the products are significantly higher than the benchmarks resulting in returns being substantially lower despite exhibiting similar volatility to the benchmark.

To shed further light on the issue, figure 8 below quantiles the MySuper products by their observed volatility (least volatile to most volatile) whilst comparing their returns and fee levels.

**Figure 8: MySuper product net returns and fees, ranked by volatility**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

There are a number of observations that can be made from this analysis:

- ▶ The highest average net returns (and best risk return trade-off) can be found among mid volatility MySuper products;
- ▶ There are not marked differences between either administrative or total fees across the cohorts;
- ▶ Although the highest volatility / lowest return cohort have higher than average administrative fees, the median total fee of the cohort is lower than average;



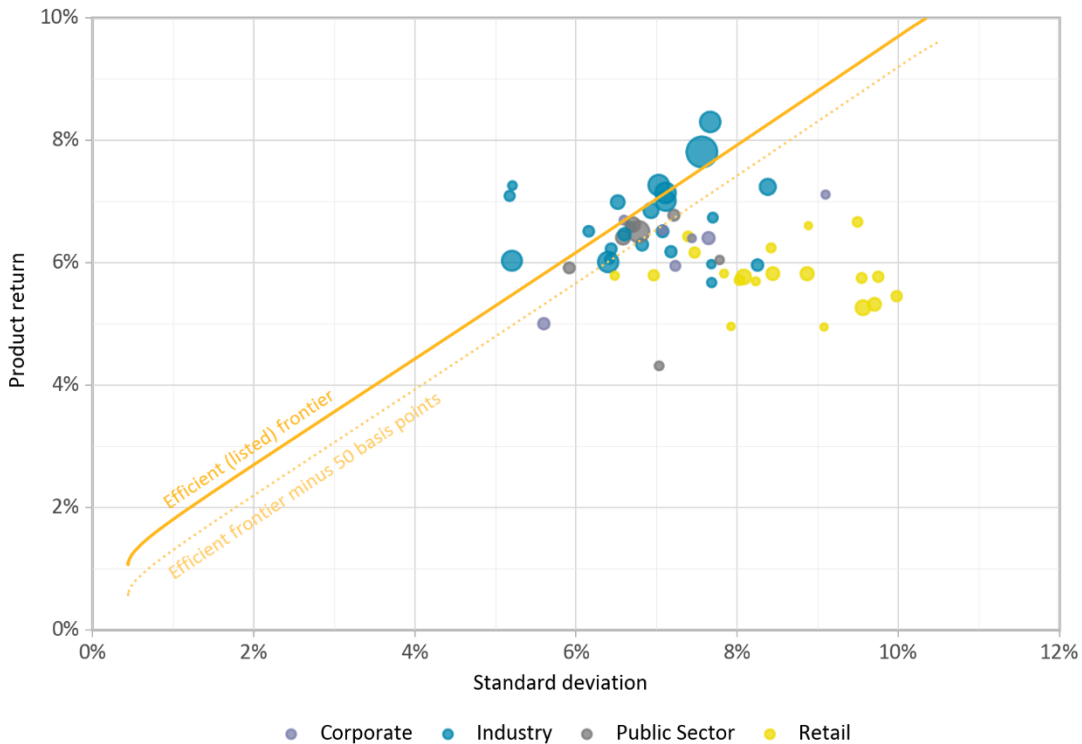
- ▶ For this cohort it is possible the current year RAFE and total fees don't accord with long term fees of the products or the RAFE and total fees are an underestimate;
- ▶ Almost all (13 of 14) products among the high volatility low return cohort are retail MySuper products.

This analysis suggests further examination of the way fees are measured in the performance test is needed as well as a more detailed consideration of risk return efficiency, particularly if a simplified benchmark is pursued.

### Measuring risk return efficiency

An alternative way of assessing the risk return efficacy of MySuper products is to benchmark them on their returns and observed volatility compared to an efficient investment frontier – see figure 9 below. This type of analysis effectively standardises returns based on risk quotas, and based on thousands of portfolio simulations constructed from low risk to high risk.

**Figure 9: MySuper product returns and volatility vs efficient frontier**  
Eight years to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA performance test benchmark indices (see page 22 of Treasury Laws Amendment (Your Future, Your Super—Addressing Underperformance in Superannuation) Regulations 2021 for details).

While the volatility (standard deviation) of returns is only one measure of risk, it is one which members are most likely to notice. A key finding of this analysis is that most retail MySuper products are risk return inefficient – exposing members to up to twice the risk than their returns justify or around 2% per annum lower returns than other MySuper products with similar or lower risk.

These systemic differences in the observed risk return efficiency of MySuper products warrants closer examination by the review.

## Performance test treatment of fees

In its 2018 report into superannuation efficiency and competitiveness, the Productivity Commission found a relatively clear relationship between observed fees and net return outcomes consistent with published academic literature. Using option level data, the Commission found a strong negative relationship between net returns and total fees.<sup>6</sup> In its cameo analysis, the Commission found that a 0.5% difference in fees can cost a full-time worker about 12% of their balance (or \$100,000) by the time they reach retirement.<sup>7</sup>

It is therefore appropriate that the performance test seeks to capture fees, although it does so in a most unconventional way. As noted, the performance test backs out the effect of administrative fees from historical net returns by using a net investment return metric for the benchmark with an ex-ante administrative fee adjustment reflecting the fee a trustee sets in the year a performance test is conducted.

This approach was not consulted on when the exposure draft regulations were originally released<sup>8</sup> – on the contrary, the draft regulations envisaged the use of the full lookback period for administrative fees – in effect treating them in the same way as investment fees and costs.

The changes which were made public only when the final regulations were made were largely the result of lobbying by the retail sector which has historically attempted to obscure or remove entirely the effect of administrative fees and commissions on net returns.<sup>9</sup>

The consistent attempts to obscure the effect of such fees on net returns had previously led the Cooper Review to conclude:

It is illogical and misleading for investment returns to be reported to members on anything other than an after tax-basis and after all costs have been deducted.<sup>10</sup>

As it stands the treatment of fees and how they are measured in the test results in an unexpected relationship between net returns and total fees, and a seemingly incomprehensible relationship

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<sup>6</sup> Productivity Commission, Superannuation: Assessing Efficiency and Competitiveness, Report 91, December 2018, box 3.4 p. 186 and figure 3.2 p. 187.

<sup>7</sup> Ibid – Cameo 3, p. 14.

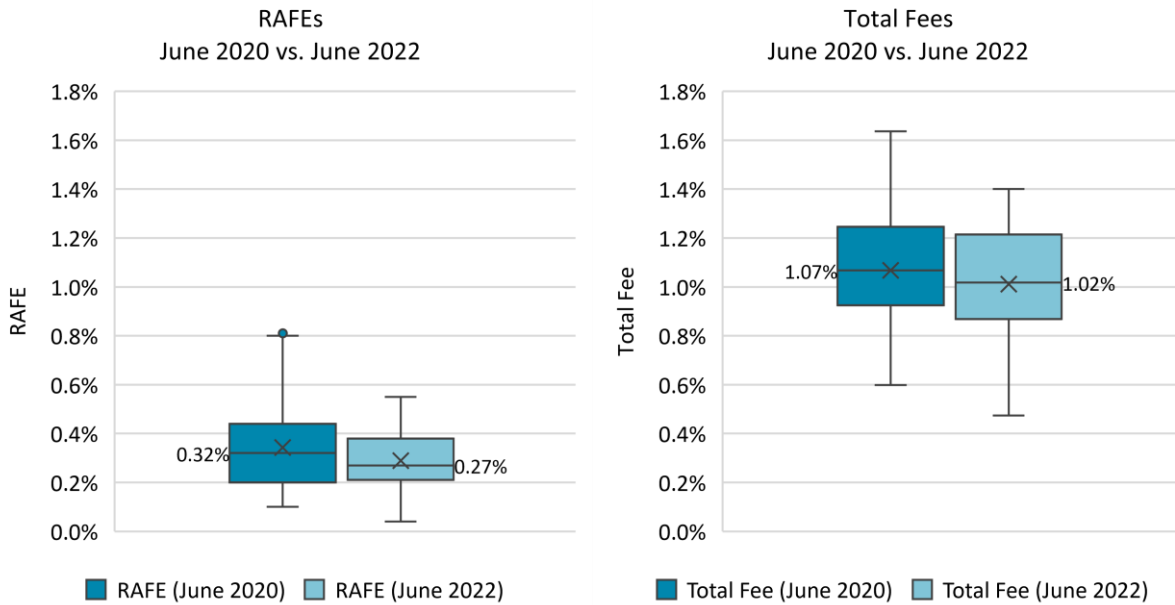
<sup>8</sup> Treasury consultation – Your Future Your Super Regulations and Associated measures, 28 April 2021-25 May 2021, <https://treasury.gov.au/consultation/c2021-162375>.

<sup>9</sup> For example, the Financial Service Council in 2010 proposed to make a new reporting standard for its members (Standard 6B) which would have required its super fund members to report returns net of tax and investment costs but gross of administrative and adviser fees paid by members.

<sup>10</sup> Super System Review Final Report – Part 2 page 111



**Figure 11: Change in the distribution of product RAFE's and total fees, 2020-2022**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

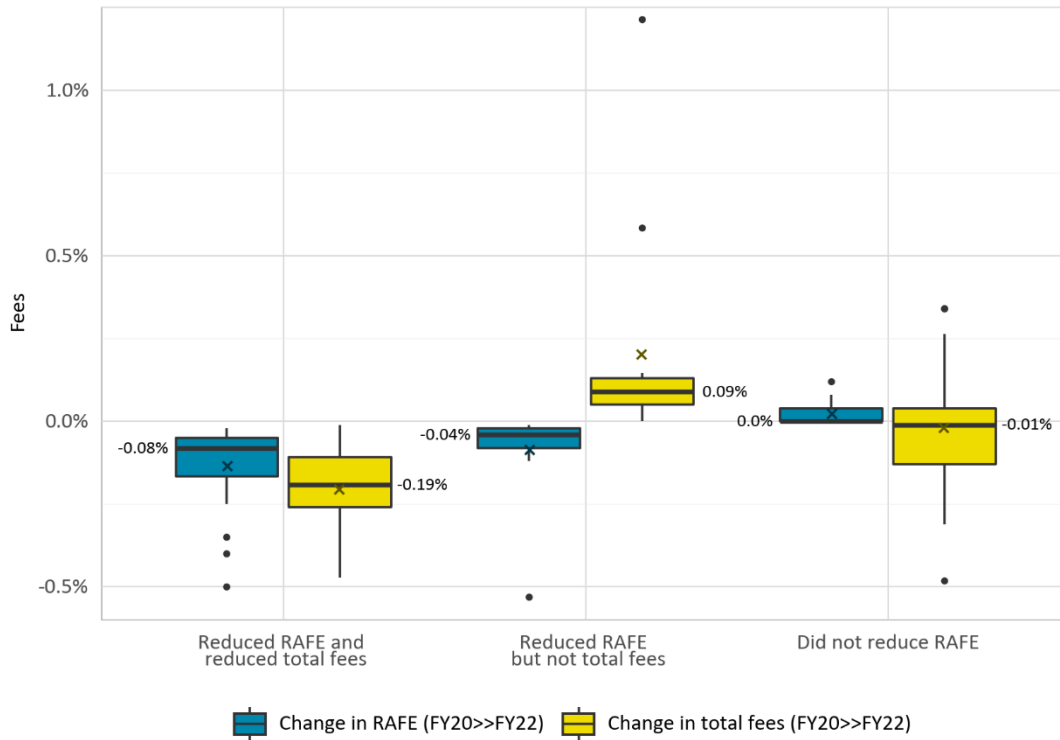
Note: Analysis for total fees exclude products with no Total fee data for June 2020.

On face value this is positive but further examination is warranted particularly since administrative fees and investment fees can move independently of one another. In terms of fee adjustments for the 67 products subject to the 2022 performance assessment:

- ▶ 36 reduced RAFE (around half of total products) and 31 did not reduce RAFE;
- ▶ But of the 36 that reduced RAFE, 23 had a reduction in total fees and 13 did not – either no change or increase;
- ▶ 40 products had a reduction in total fees (the median reduction was 0.15%).

The administrative and total fee changes for these three cohorts is shown below in Figure 12.

**Figure 12: Change in fees 2020-2022, by fee change cohort**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

When these representative member fee changes are applied to each product’s funds under management, there was a total of \$410 million in fee savings for products that reduced their fees but after accounting for products that reported increases in fees the net change was an increase of \$558 million.

#### How fees are measured – the effect of RG 97

This does not seem like an intuitive or expected outcome from the performance test, but it likely reflects ongoing issues with fee disclosure under RG 97 which has seen some notional fee increases of many high performing products (including for instance defining taxes such as stamp duty which are levied on the acquisition of real assets purchased directly by funds as fees). As figures 2 and 3 above show, it is not apparent that the way fees have been redefined by RG 97 is having any impact on net return outcomes for members.

Changes in product level fee disclosures that bear little relationship to after-fee and after-tax return outcomes experienced by members suggest ongoing problems with fee disclosures related to RG 97. In many instances trustees have been required to disclose arbitrary changes associated with how fees and costs have been defined by RG 97 rather than any change in underlying fees or costs borne by members.

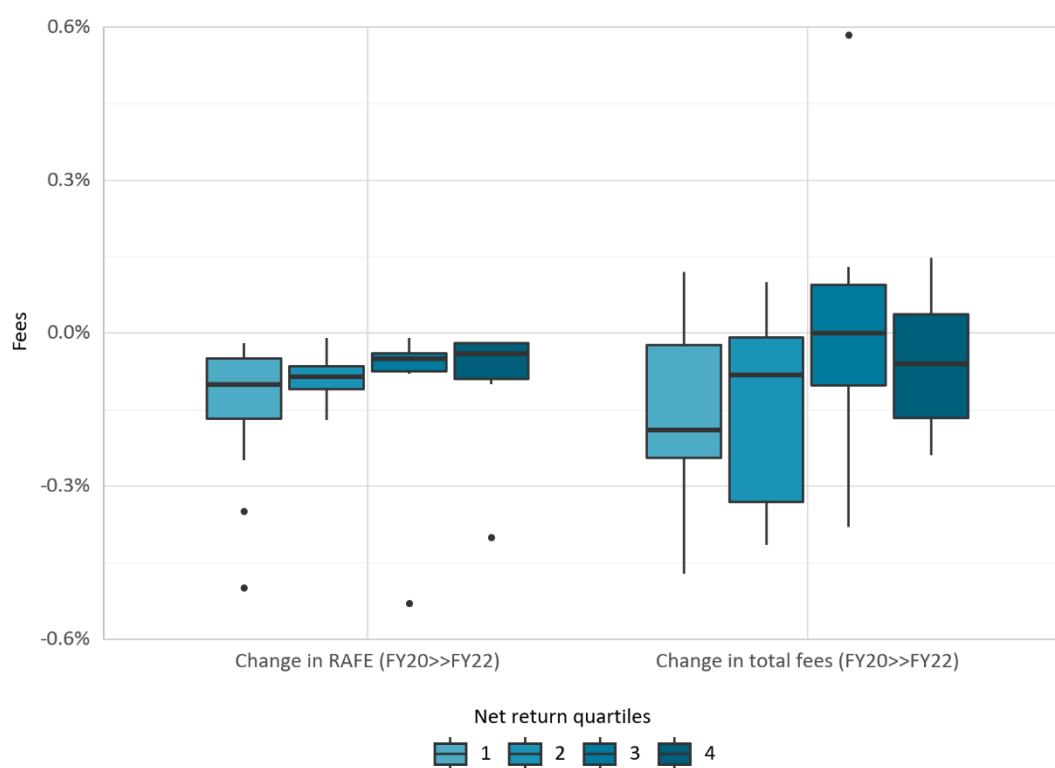
Additionally, concerns remain about the neutrality of the disclosures linked to the way in which funds offer investment options to members (whether directly by the trustee or via platforms) and the way in which funds acquire and hold assets.

**Recommendation:** The basis for RG 97 and related data collections utilised for performance testing should be reviewed to ensure fees and costs borne by members are treated consistently regardless of how products are offered to members (whether directly by a fund or via a platform) and how funds access underlying investments (directly or indirectly).

### Fee changes by performance rank

It's useful to consider the distribution of fee changes by net return cohort to assess where fee changes are occurring. Figure 13 below shows the distribution of fee changes from 2020-2022 by 8-year net return quartile.

**Figure 13: Fee change distribution by net return quartile**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

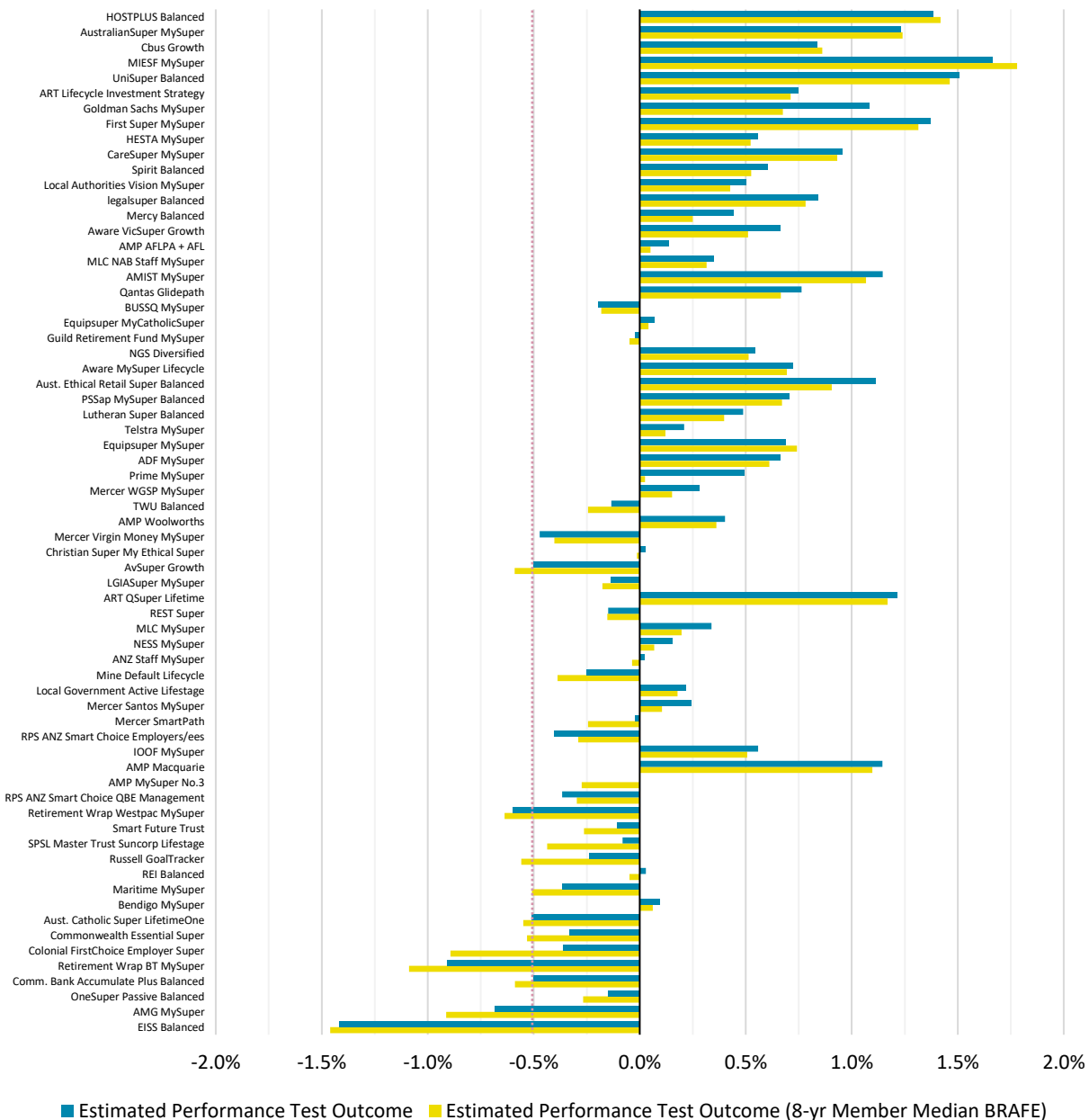
At the median level, fee reductions are evident among funds in the bottom two quartiles by performance rank although the median change in total fees is between 0.1% to 0.2%. While this is clearly welcome it is not sufficient to materially improve member outcomes for members in these poorer performing products and as previously shown it is not apparent it is helping to close the net return gap to better performing products.

### Overall impact of the 12-month RAFE on performance test outcomes.

The use of a 12 month RAFE in the performance assessment has had a significant impact on the performance test results.

Figure 14 below shows estimated performance test outcomes had the final regulations reflected those originally consulted on in May last year, with the exception of using a median member rather than median product fee.

**Figure 14: Estimated performance test outcome vs 8 year BRAFE/ RAFE, June 2022**



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test - 2022, APRA Quarterly Superannuation Performance Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).

Overall, the decision to use a 12-month administrative fee rather than an 8-year administrative fee fully reflected in the net returns of each product coupled with the use of an 8-year member median

benchmark administrative fee has a significant impact on the overall outcomes. Specifically, the final regulations reflected in the current test:

- ▶ More than halved the number of products failing from 11 to 5 in the 2022 test.
- ▶ Improved the test outcomes by an average of 0.06% overall but 0.10% for corporate MySuper products and 0.20% for retail MySuper products.

An important outcome from the emphasis placed on the 12-month administrative fee is that it has permitted trustees who have been running otherwise failing or near failing products to reduce administrative fees modestly to pass the test but have only marginal overall improvement to net return outcomes to members relative to superior products.

Objectively assessed, rather than improve member outcomes it has, in all likelihood, had the opposite effect – it has allowed poor performers to evade the consequences of test failure including informing their members they are in a poor performing product and to find better alternatives.

#### Impact of using a median product RAFE rather than member account RAFE

The more appropriate benchmark is the median member *account* RAFE across all APRA super regulated MySuper products, because superannuation member accounts and funds are not evenly distributed across products.

The largest MySuper products have more than 200 times more members than the smallest products. The number of products is also unstable and subject to change.

Using the median member fee would better reflect the representative typical fees paid by members reflecting the benefits of scale achieved by funds which have higher membership bases.

ISA analysis of the median product fee in 2021-22 reveals it is set at a level that is higher than what two-thirds of MySuper members pay, equal for 8 percent of members, and is lower for just 27 percent of members.<sup>11</sup>

The selection of the median product fee is not representative of what members pay and makes it easier for high admin fee products to meet the performance test.

Additionally, there is no basis for a separate administrative fee benchmark for different product types.

Using a separate administrative fee benchmark for trustee-directed and other choice products may inappropriately entrench high fees with significant profit margins.

The performance tests should be based on administration fees for the full duration of the test so that they both: accurately reflect the outcomes received by members; and incentivise funds to not only reduce administration fees but to keep them low. Further, the benchmark administration fees (BRAFE) should be based on a member-weighted administration fee rather than a product-weighted fee.

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<sup>11</sup> Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).



**Recommendation:** The performance test should be based on the product's RAFE for the duration of the test, and the BRAFE should be member-weighted rather than product-weighted.

## Alternative benchmarking approaches – a Simple Reference Portfolio

Allowing funds discretion to select their own benchmarks and account for fees from the previous year only has created a gulf between passing the performance test and achieving better member outcomes.

Evidence showing funds have gamed the test by selecting easier benchmarks and selectively reducing fees supports the need for a different approach.

A better approach is likely to be found in using a simple reference portfolio, or naïve benchmark, to assess the performance of products and answer the question – is value being created for members?

That is – are sophisticated investment managers adding value for members, over and above what members could achieve if they invested in a 'simple', low-cost portfolio of potential investments?

### New Zealand's Sovereign Wealth Fund uses a Simple Reference Portfolio

New Zealand's Sovereign Wealth Fund, the New Zealand Super Fund, has used a Reference Portfolio as its benchmark since 2010.

The Reference Portfolio serves as a representative alternative portfolio to the actual portfolio that the Fund invests in. It is a notional low-cost, passively managed, and well-diversified portfolio of listed asset classes that are consistent with the Fund achieving its return objectives without undue risk.

The Fund exercises judgement in constructing its actual portfolio, based on its assessment of current asset pricing from long-term fair value. These decisions can then be compared with the alternative of simply holding the Reference Portfolio. In this way, the Reference Portfolio is a device used to hold management to account for its actual portfolio decisions.

The Reference Portfolio differs from the SAA approach in that:

- ▶ It is a benchmark, not a guideline for the actual portfolio's composition,
- ▶ It contains traditional asset classes only, and
- ▶ It is not affected by short-term market conditions.

Compared to the use of an SAA, it encourages a greater separation between governance and management. It allows the Fund to focus on long-term strategic decisions and how they can add value over and above what can be achieved by simply implementing the Reference Portfolio.

The Reference Portfolio is subject to five-yearly reviews to ensure it remains appropriate, with the last occurring in 2020.<sup>12</sup> Key considerations for the review included composition of the portfolio, expected return and risk, interest rate and inflation risk hedging, currency hedge ratios and benchmark indices. It

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<sup>12</sup> Hyde, Carly Falconer, Christopher Worthington and Matthieu Raoux, "How We Invest" White Paper, The 2020 Reference Portfolio Review, January 2021, at <https://www.nzsuperfund.nz/publications/papers-reports-reviews/how-we-invest-white-paper/>.

was decided to retain the asset allocation of 80 per cent to growth assets and 20 per cent to income assets. The main change from the 2015 review was the decision to combine developed and emerging market equities into a single building block, global equities.

A naïve reference portfolio, or variations on it could be readily implemented to assess MySuper products which are designed for relatively disengaged members. The use of a simplified test should be complemented by a follow up assessment of products which fail, allowing any claims related to the underlying risk of the products to be considered carefully.

**Recommendation:** Consideration should be given to replacing the existing product specific SAA benchmark with a simple naïve benchmark for all MySuper products comprising a simple low-cost diversified portfolio to assess whether trustees are adding value to members savings.

**Recommendation:** Coupled with a simplified transparent test any products that fail be subject to ‘a show cause’ and more granular assessment of the risk return trade-off for members.

#### Measuring value added

Using the Reference Portfolio as a benchmark means the Fund can quantify the value it creates over and above what the Reference Portfolio would achieve (table 1).

For example, over the past 10 years, the New Zealand Super Fund has exceeded the Reference Portfolio return by 1.93% per annum, or NZ\$9.26 billion (after costs, before tax).<sup>13</sup> In recent years, the composition of the Fund has become increasingly different to the Reference Portfolio, and the Fund has moved visibly ahead of the Reference Portfolio's returns.

**Table 1:** *Measuring value added by the New Zealand Super Fund  
Fund performance (after costs, before tax), 30 June 2021*

	Ten years per cent pa	Five years per cent pa	One year per cent
Actual fund returns	13.01	13.87	29.63
Reference portfolio return	11.08	12.64	27.90
Value added (actual return less reference portfolio return)	1.93	1.23	1.73
<b>Estimated \$ earned relative to reference portfolio</b>	<b>\$9.26 b</b>	<b>\$2.92 b</b>	<b>\$0.76 b</b>

Source: New Zealand Super Fund, Returns compared with the reference portfolio:

<https://www.nzsuperfund.nz/performance/investment/returns-compared-to-the-reference-portfolio/>

<sup>13</sup> See <https://www.nzsuperfund.nz/performance/investment/returns-compared-to-the-reference-portfolio/>.

The ability to measure the value added by adopting a particular strategy, not just implementing a given strategy, is a critical feature that should be measured by a performance test. Yet it is a key feature missing from the current YFYS test.

Such value-add calculations can be made at the fund level but also at the representative member level, showing a member how much they have gained (or lost) relative to the benchmark, as well as to better assess the differences across products.

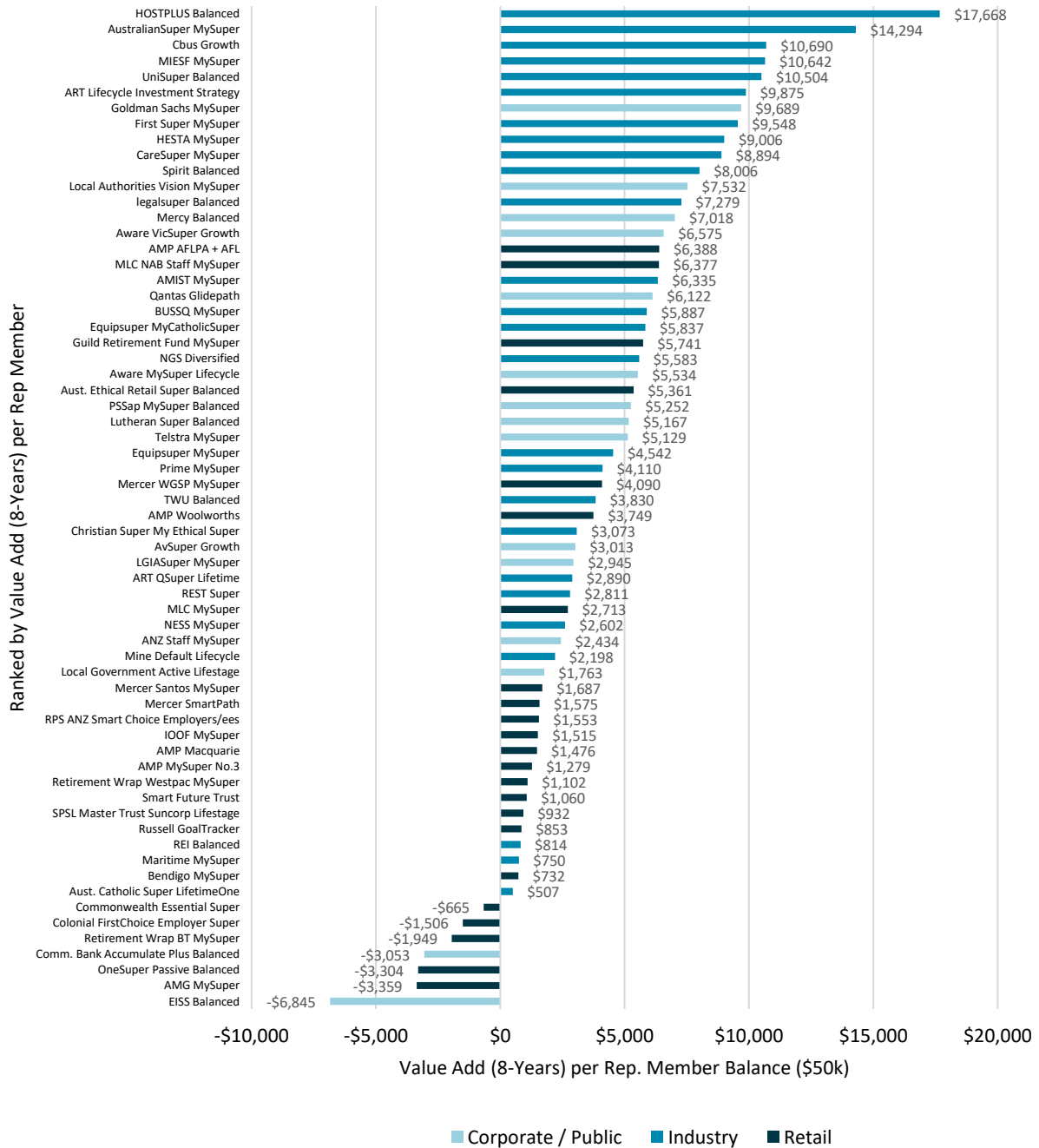
To illustrate a member-focused presentation, ISA has constructed a naïve 70/30 reference portfolio to assess MySuper products against. Using similar fee assumptions to the APRA performance test, seven products underperformed the 70/30 portfolio. Figure 15 below shows the outcomes of an 8-year net return comparison to a naïve portfolio consisting of 70 percent listed equities (equally split between domestic and international) and 30 percent fixed interest (domestic and international) and cash.

As figure 15 below demonstrates, outcomes at a member-level vary significantly from a loss of almost \$7,000 over 8 years from the worst product to a gain of \$17,600 for the top performing product – a difference of almost \$25,000. The publication of member-level value-add could significantly improve member engagement around performance and lead to the selection of better products and enhanced member outcomes.

**Recommendation:** APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

**Figure 15: MySuper member value-add compared to 70/30 naïve portfolio**

**Eight years to June 2022**





FOI 3499 Document 1b

# Performance Benchmarks

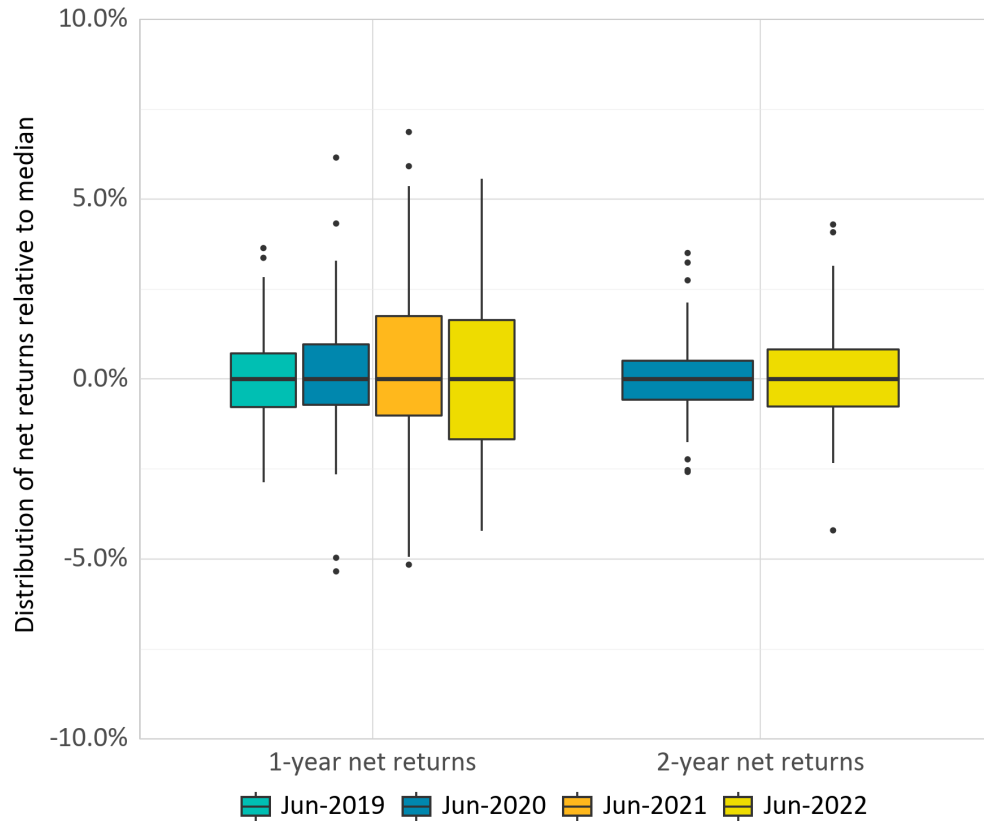
Treasury YFYS Briefing

# Key consequences of existing test design

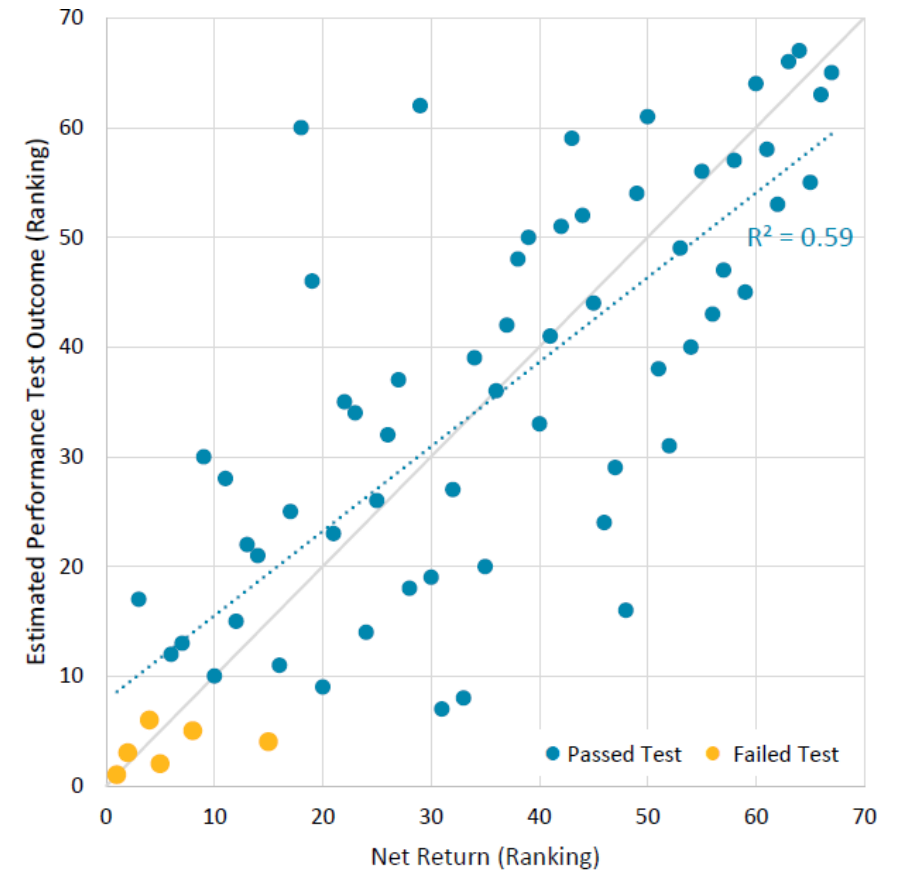
1. The product tailored benchmarks net out the effect of differences in portfolio construction (portfolio strategy) between products – an important contributor to ultimate returns;
2. The trustee sets and can manipulate the construction of the benchmark which their product is assessed against – potentially making the performance hurdle easier to achieve;
3. The net returns obtained by members over the duration of the test are not measured or trustees held accountable for;
4. The use of a 12-month administrative fee adjustment to net investment returns ascribes a higher weight to admin fee reductions than the rolling average impact of investment fee reductions and the effect of any trustee improvement to investment implementation, let alone strategy (which carries zero weight);
5. The use of a median product administrative fee rather than median member fee results in a higher fee assumption for the benchmark than most members pay, resulting in an easier test;
6. The duration of the test might be inadequate to assess trustees' actions over the course of more than one market or economic cycle;
7. There is no explicit consideration of the *actual* risk taken by members in exchange for the returns they receive.

# Is the test improving member outcomes?

## Distribution of product level net returns, 2019-2022



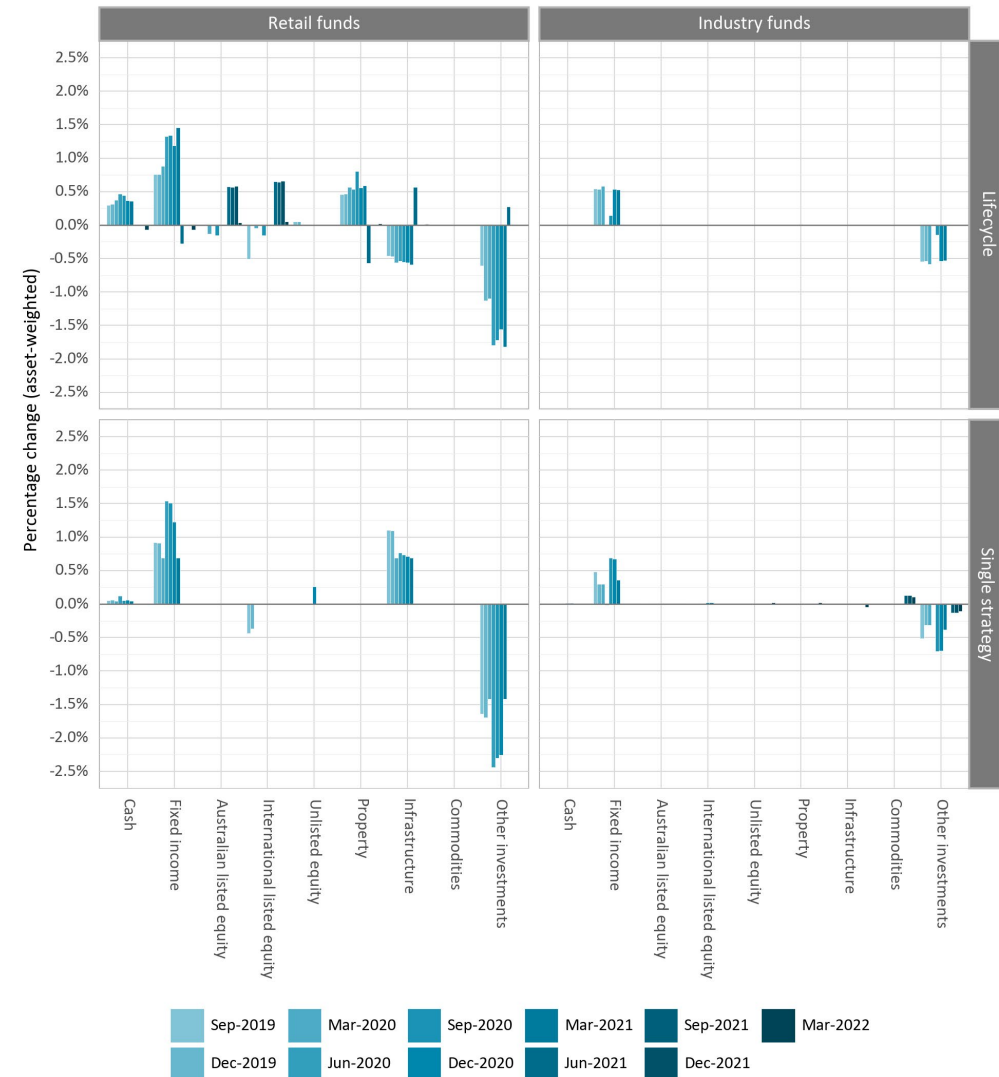
## Relationship between performance test rank and net return rank



# Transparency and integrity

- Performance tests are based on the SAA of the product and not the actual asset allocation.
- Because the SAA is determined by the trustee and there is no specific obligation for it to reflect the actual asset allocation, there is the opportunity for the benchmark to be gamed. In effect, trustees can manipulate the SAA.
- In the lead up to the first round of performance tests, 35 MySuper products revised their historical SAA, with most reducing exposure to 'Other' investments and increasing exposure to Cash and Fixed income.
  - There were clear differences across sectors. 20 of these products were Retail products.
- The ability of funds to influence their product's benchmark returns via changes to their SAA opens the prospect of gaming within the system.
- This reduces the efficacy of the performance tests.

Revisions to SAA in the lead-up to performance tests





# Recommendations

1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA).

# The duration of the test is too short

- Superannuation is a long-term investment, and as such, products should be assessed over the longest time period possible to account for risk and market cycles.
- It is important to assess performance over multiple market and ideally economic cycles allows for a better assessment of the resilience of investment portfolios, along with trustees' responses.
  - Our analysis indicates the financial market cycles have slightly shortened to a median of 2.9 years over the period from 1984 and 2020, while economic cycles have substantially lengthened to a median of 18.6 years from 1984 to 2020.
  - Conexus Institute found that using an 8-year period to assess returns will mean that for every six poor funds, the test will likely misidentify one as a good performer. This is an unacceptably high risk of false positives.
- The Government's own Moneysmart website supports using a 10-year timeframe for assessing average returns.
- Too short an assessment period can discourage investment in Venture Capital and early-stage Private Equity.

# Recommendations

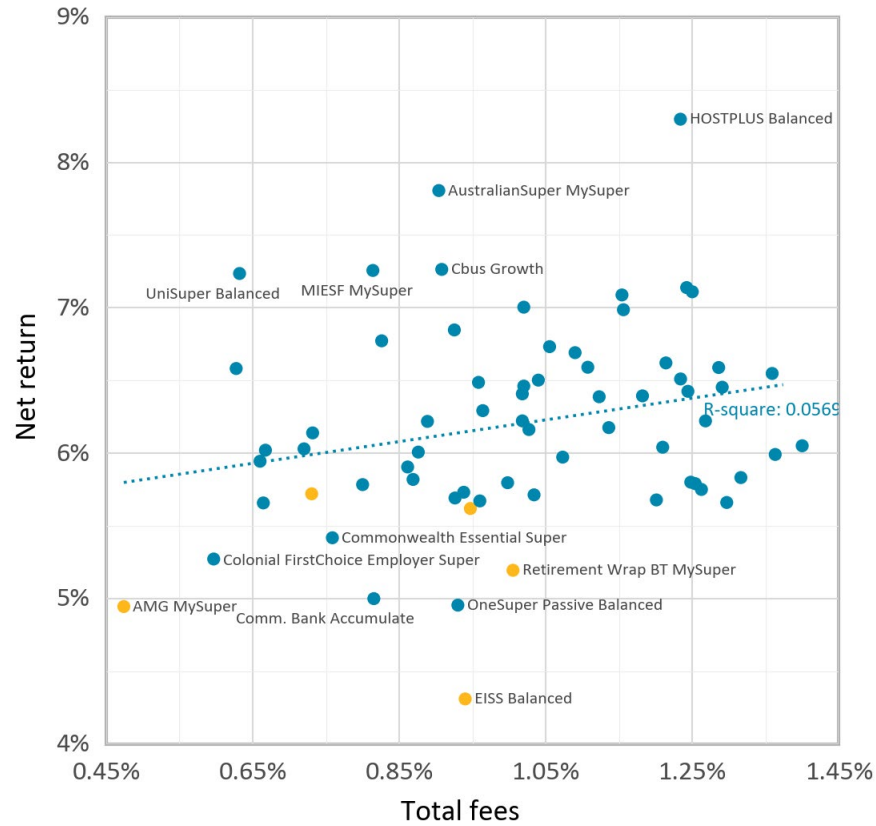
1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA).
2. All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.

# Performance test treatment of fees

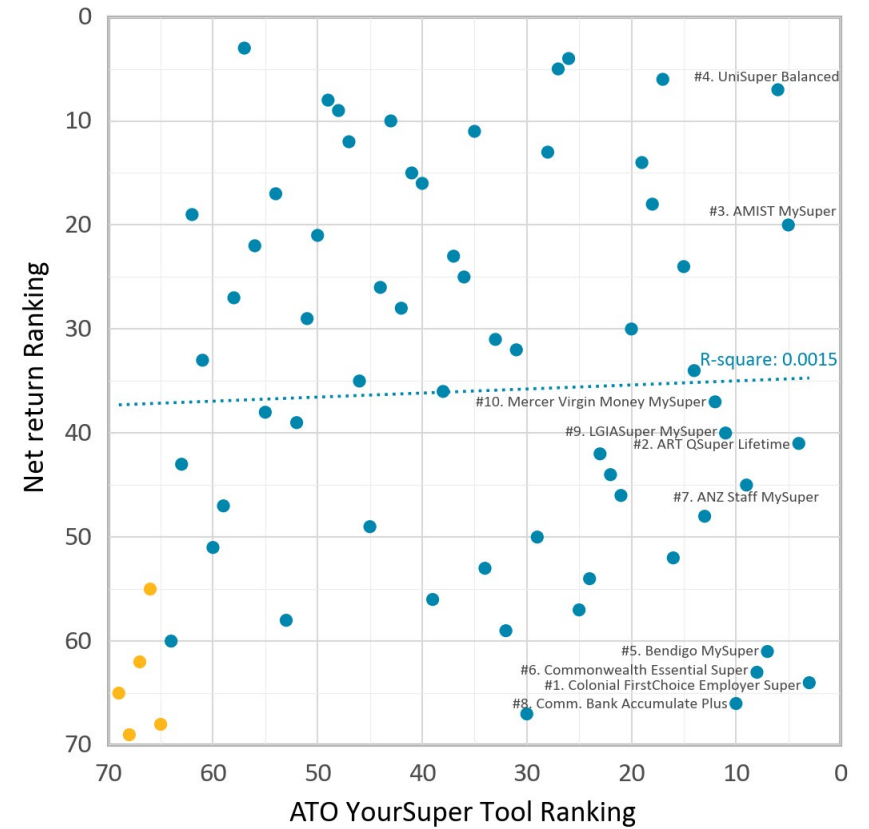
- There is a clear relationship between observed fees and net return outcomes. It is therefore appropriate that the performance test seeks to capture fees. However, they do so in a most unconventional way.
  - The performance test backs out the effect of administrative fees from historical net returns by using a net investment return metric for the benchmark with an ex-ante administrative fee adjustment reflecting the fee a trustee sets in the year a performance test is conducted.
  - As it stands the treatment of fees and how they are measured in the test results in an unexpected relationship between net returns and total fees, and a seemingly incomprehensible relationship

# Performance test treatment of fees

**Net returns and total fees (8 years to June 2022)**



**Net return and ATO YourSuper tool rank**



# How fees are measures – the effect of RG 97

- Since the inception of the test there is no doubt RAFEs have declined with a diminished spread between the lowest and highest RAFEs.
- On face value this is positive. However, total fees (as measured by multiplying each product's funds under management by total representative member fees) increased by \$558 million.
- This seems counterintuitive, but likely reflects ongoing issues with fee disclosure under RG 97 which has seen some notional fee increases of many high performing products.
- Changes in product level fee disclosures that bear little relationship to after-fee and after-tax return outcomes experienced by members suggest ongoing problems with fee disclosures related to RG 97.
- Concerns also remain about the neutrality of the disclosures linked to the way in which funds offer investment options to members and the way in which funds acquire and hold assets.

# Recommendations

1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA).
2. All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.
3. The basis for RG 97 and related data collections utilised for performance testing should be reviewed to ensure fees and costs borne by members are treated consistently regardless of how products are offered to members.

# Impact of the 12-month RAFE on performance

- The use of a 12-month product-median RAFE rather than a member-median RAFE based on the full 8 years has had a significant impact on performance test outcomes. Specifically:
  - More than halving the number of products failing from 11 to 5 in the 2022 test
  - Improved test outcomes by an average of 0.06% overall, but by 0.10% for corporate MySuper products and 0.20% for retail MySuper products.
- An important outcome from the emphasis placed on the 12-month RAFE is that it has permitted trustees who have been running otherwise failing or near failing products to reduce admin fees modestly to pass the test but have only marginal overall improvement to net return outcomes to members relative to superior products.
- Objectively assessed, rather than improve member outcomes it has, in all likelihood, had the opposite effect – it has allowed poor performers to evade the consequences of test failure including informing their members they are in a poor performing product and to find better alternatives.



# Median member rather than median product

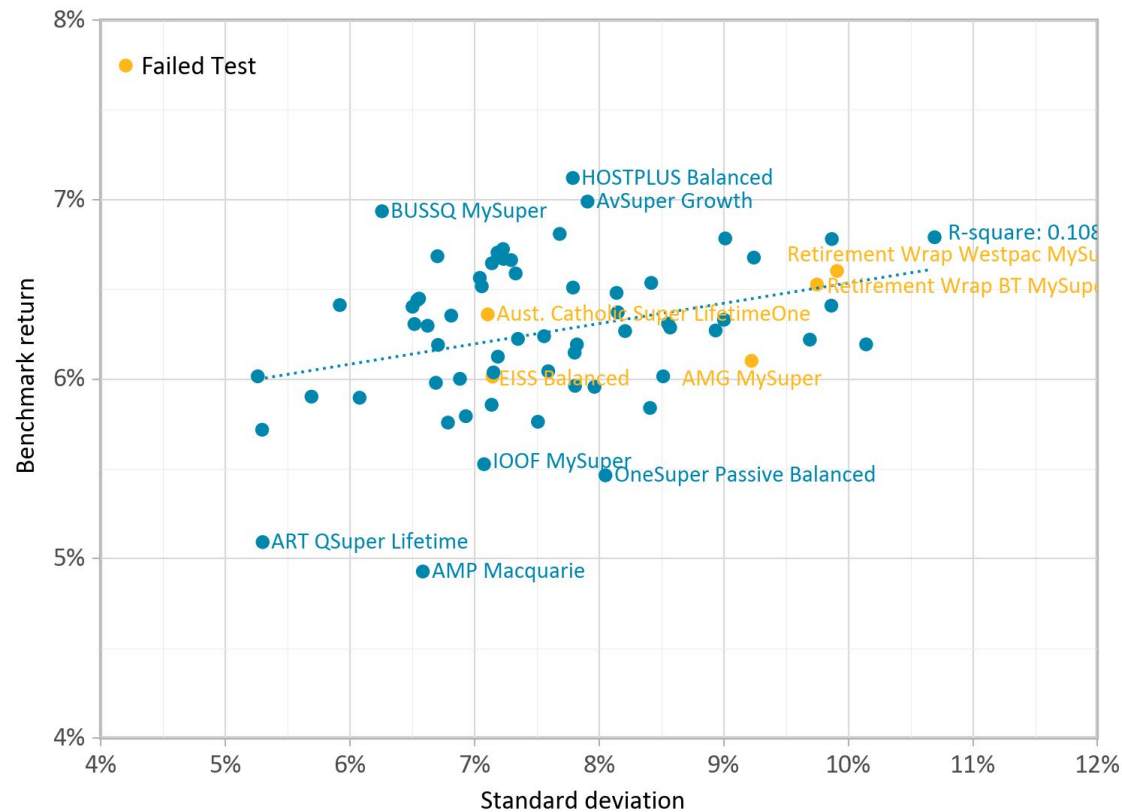
- The performance tests should be based on a member-median RAFE rather than a product-median RAFE.
  - The largest MySuper products have more than 200 times more members than the smallest products. The number of products is also unstable and subject to change.
- Using the median member fee would better reflect the representative typical fees paid by members reflecting the benefits of scale achieved by funds which have higher membership bases.
  - The median product fee in 2021-22 is set at a level that is higher than what two-thirds of MySuper members pay, equal for 8 percent of members, and is lower for just 27 percent of members
- Additionally, there is no basis for a separate administrative fee benchmark for different product types.
  - Using a separate administrative fee benchmark for trustee-directed and other choice products may inappropriately entrench high fees with significant profit margins.
- The performance tests should be based on administration fees for the full duration of the test so that they both: accurately reflect the outcomes received by members; and incentivise funds to not only reduce administration fees but to keep them low.

# Recommendations

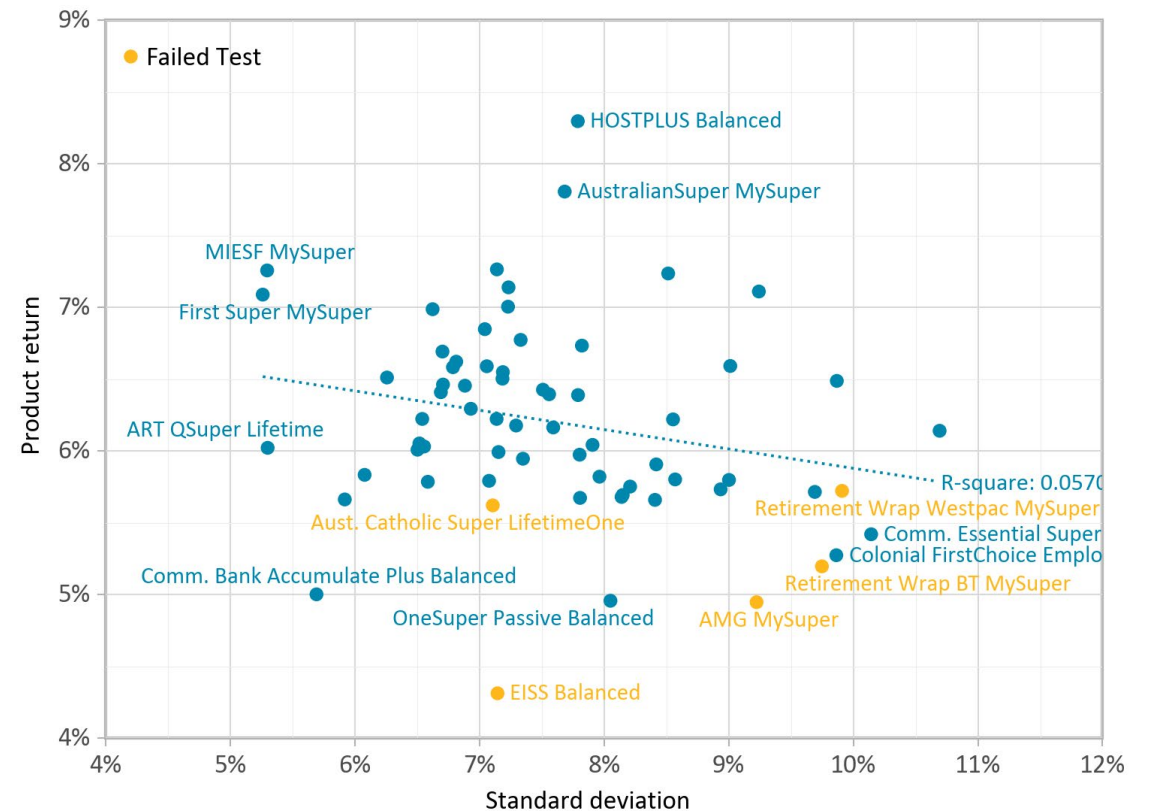
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4. The performance test should be based on the product's RAFF for the duration of the test, and the BRAFF should be member-weighted rather than product-weighted.

# Test fails to capture poor risk-return outcomes for members

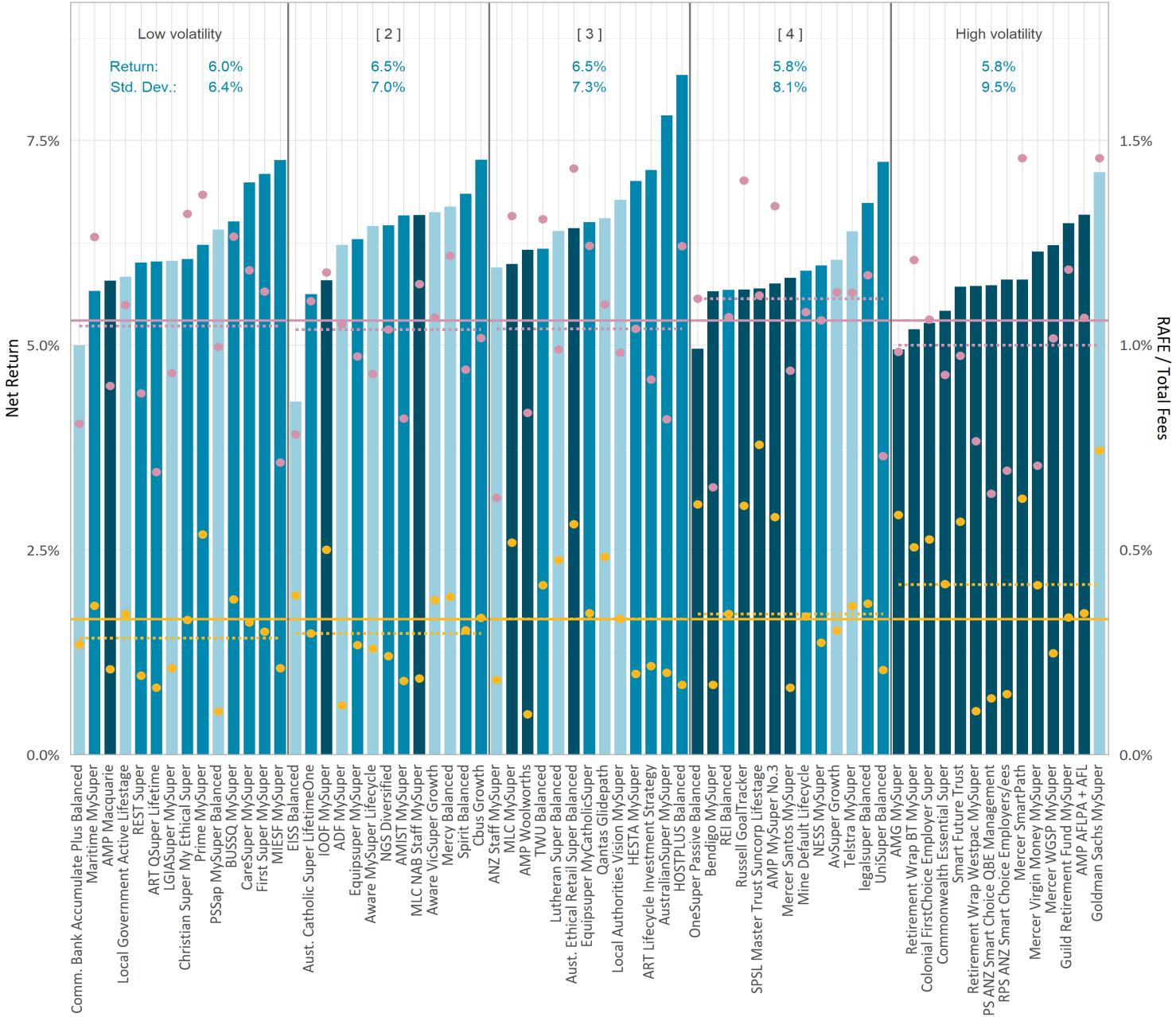
**Risk-return of MySuper product benchmarks (8 years to June 2022)**



**Observed risk-return of MySuper products (8 years to June 2022)**



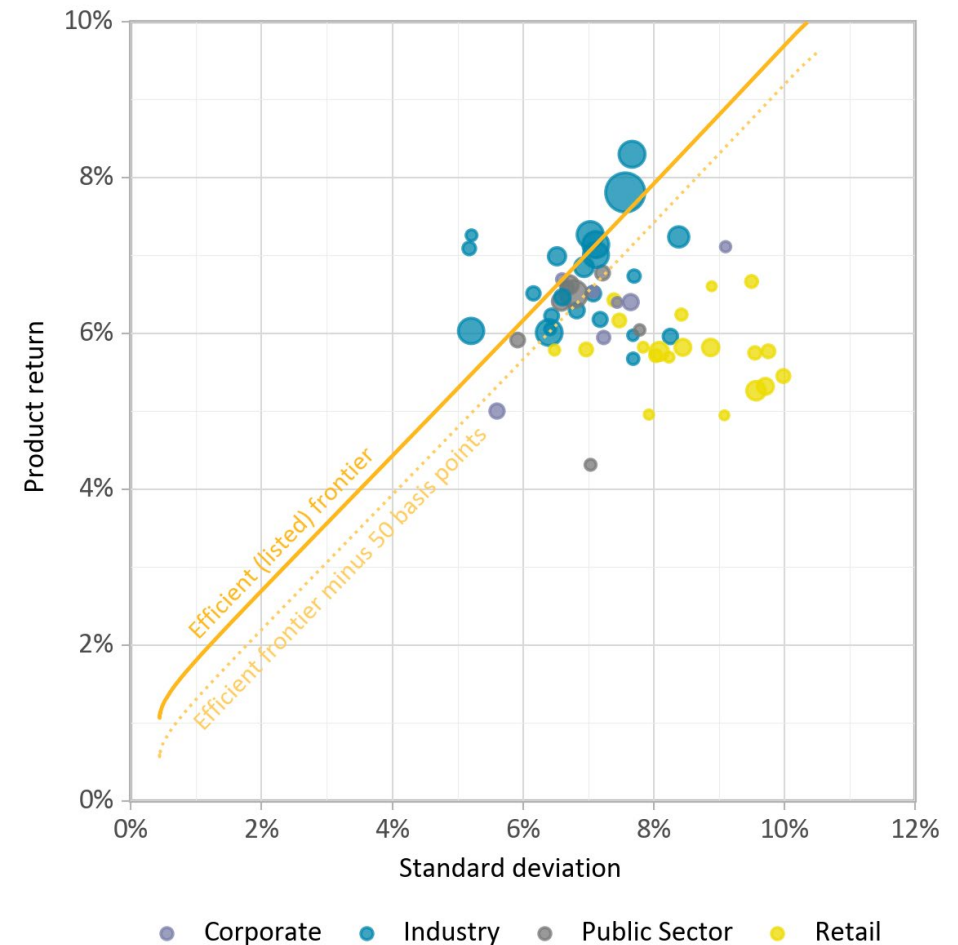
# MySuper product net reruns and fees, volatility quintiles



# Measuring risk-return efficiency

- An alternative way of assessing the risk-return efficacy of MySuper products is to benchmark their returns and observed volatility to an efficient investment frontier.
  - A key finding of this analysis is that most retail MySuper products are risk return inefficient – exposing members to up to twice the risk than their returns justify or around 2% per annum lower returns than other MySuper products with similar or lower risk.
  - These systemic differences in the observed risk return efficiency of MySuper products warrants closer examination by the review.

**MySuper product returns and volatility vs efficient frontier**



# A Simple Reference Portfolio

- New Zealand's Sovereign Wealth Fund, the New Zealand Super Fund, has used a Reference Portfolio as its benchmark since 2010.
  - The Reference Portfolio serves as a representative alternative portfolio to the actual portfolio that the Fund invests in. It is a notional low-cost, passively managed, and well-diversified portfolio of listed asset classes that are consistent with the Fund achieving its return objectives without undue risk.
  - The Reference Portfolio differs from the SAA approach in that: (1)
    - It is a benchmark, not a guideline for the actual portfolio's composition
    - It contains traditional asset classes only, and
    - It is not affected by short-term market conditions
  - Compared to the use of an SAA, it encourages a greater separation between governance and management. It allows the Fund to focus on long-term strategic decisions and how they can add value over and above what can be achieved by simply implementing the Reference Portfolio.
- A naïve reference portfolio could be readily implemented to assess MySuper products which are designed for relatively disengaged members. The use of a simplified test should be complemented by a follow up assessment of products which fail, allowing any claims related to the underlying risk of the products to be considered carefully.

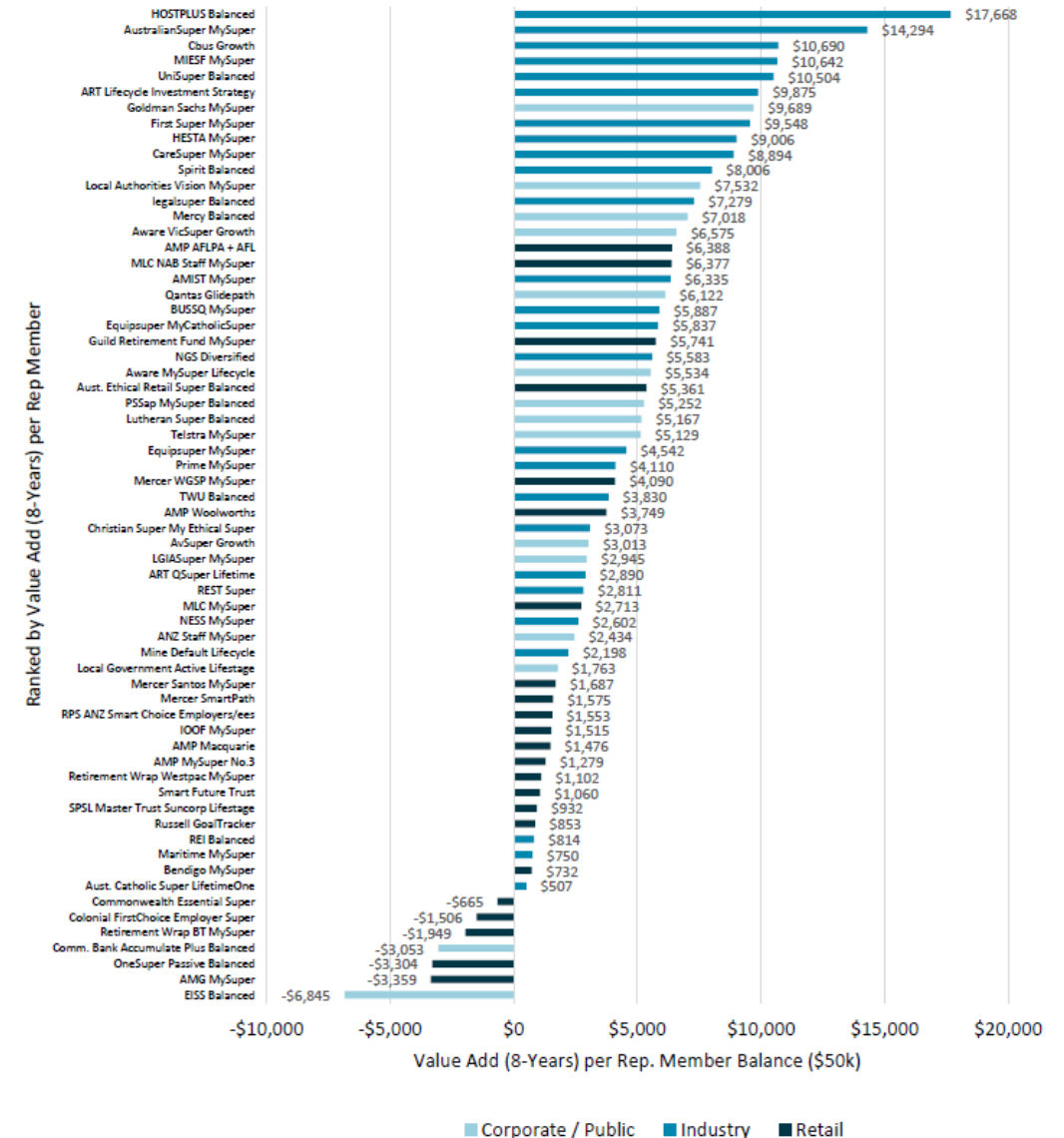
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5. Consideration should be given to replacing the existing product specific SAA benchmark with a simple naïve benchmark for all MySuper products to assess whether trustees are adding value to members savings
6. Coupled with a simplified transparent test any products that fail be subject to 'a show cause' and more granular assessment of the risk return trade-off for members.

# Measuring value add

- Using the Reference Portfolio as a benchmark means the Fund can quantify the value it creates over and above what the Reference Portfolio would achieve.
- The ability to measure the value added by adopting a particular strategy, not just implementing a given strategy, is a critical feature that should be measured by a performance test. Yet it is a key feature missing from the current YFYS test.
- Such value-add calculations can be made at the fund level but also at the representative member level.
  - To illustrate, we have constructed a naïve 70/30 reference portfolio, using similar fee assumptions to the APRA tests, and compared product value add. 7 products underperformed the 70/30 portfolio.
- The publication of member-level value-add could significantly improve member engagement around performance

MySuper member value-add compared to a 70/30 naïve portfolio





# Recommendations

1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA).
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7. APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

# Recommendations

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7. APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

**From:** s 47F (External - Unclassified)  
**To:** s 22  
**Subject:** Performance test consultation  
**Date:** Wednesday, 6 December 2023 6:46:25 AM  
**Attachments:** [image001.png](#)

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Hi s 22 following the announcement at the roundtable are you able to provide any details (even indicative) on the timeline for the consultation including when a discussion paper or options might be available for comment?

This is quite important for us to begin engaging with the investment teams of the funds about a process to respond in a co-ordinated and thoughtful way.

Please call if it would be easier or if I should engage with Luke Spear directly.

s 47F

s 47F

s 47F [@smcaustralia.com](#)

**SUPER MEMBERS**  
COUNCIL OF AUSTRALIA

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