

top considerations for Australian

superannuation funds for 2021

welcome to brighter

2020, a year like no other

The 'black summer' bushfires highlighted the need to address climate risk while the COVID-19 global pandemic, which resulted in unprecedented monetary and fiscal stimulus, led to market volatility and record low interest rates.

This has challenged individuals, society and investors. Additionally, we have seen a flurry of regulatory activity, prompted by the changing environment as well as the drive to provide better outcomes for members.

We believe funds should approach 2021 on two fronts – ensuring resilience to address today's unique environment whilst evolving to prepare for a post-COVID world. In other words, your fund and your members should be **ready for anything**.

This paper can be read in conjunction with Mercer's "[Challenge Accepted Executive Summary](#)" - find out how CEOs of super funds are thinking about the future and the lessons learned from 2020.

Here are eight things you should consider as you set priorities for 2021

Regulation, legislation and governance

1. Your Future, Your Super: how do you position your fund for success?

The Your Future, Your Super reforms were announced in the 2020-21 Budget and outlined four important changes, which are due to take effect from 1 July 2021 (however this could be delayed):

- 1. “Stapling” members to their accounts** by ensuring a new account isn’t set up every time an individual starts a new job. The aim is that this will reduce the number of members with multiple accounts.
- 2. Making it easier for Australians** to choose a well performing product by launching an interactive, online “YourSuper” comparison tool.
- 3. Holding funds to account** for underperformance by introducing an investment performance test.
- 4. Increasing transparency and accountability** by strengthening trustees’ obligations to ensure actions are only undertaken if they are in members’ financial interests.

Legislation has been drafted and a consultation period ran from 2 December to 24 December 2020. Mercer is highly supportive of the intentions behind these measures; however, we do believe further development will minimise unintended consequences and ensure improved member outcomes.

In response, you should consider:

- Analysing your portfolio in light of the recommendations to understand and quantify any new risks these measures could introduce. Importantly, Mercer is not recommending strategic asset allocation (SAA) changes based solely on these measures at this point in time.
- Reviewing the impact to the ongoing operation of your fund in light of the proposed Your Future, Your Super changes; including, potential changes to new member acquisition levels, distribution channels and fund sustainability.
- Reviewing the impact on insurance arrangements – this review can be considered alongside compliance with the Insurance in Superannuation Voluntary Code of Practice, and to reflect changed coverage levels following implementation of Putting Members’ Interests First (PMIF) and Protect Your Super (PYS).



2. Design and Distribution Obligations

The Australian Securities and Investments Commission (ASIC) issued its Regulatory Guidance (RG 274) on the Design and Distribution Obligations (DDO) on 11 December 2020. This guidance explains ASIC's interpretation of DDO, its expectations for compliance, and its general approach to administering DDO, which come into force on 5 October 2021.

What do I need to know about DDO?

- It applies to most financial products, but with some exceptions. It applies to superannuation, with the exception of MySuper products, interests in eligible rollover funds, and defined benefit arrangements.
- It places additional responsibility for consumer outcomes on financial product issuers and distributors. It requires issuers to design products that are consistent with the intended consumer's likely objectives, financial situation and needs.
- It requires issuers and distributors to take a consumer-centric approach – placing consumer outcomes front and centre at the product design, distribution and monitoring and review stages of the product life cycle. Effective product governance is central to DDO, with issuers and distributors required to develop and maintain product governance arrangements across the life cycle of financial products.

Trustees will need to review their product governance arrangements and in particular determine the target market for each of its products, specify distribution conditions and monitor and review its products and their distribution. DDO requires these steps to be documented in a Target Market Determination (TMD), which must be made publicly available.

3. The Retirement Income Review: what does this mean for you and your members?

Overall, the Review found that “the Australian retirement income system is effective, sound and its costs are broadly sustainable”. This conclusion is consistent with the 2020 [Mercer CFA Institute Global Pension Index](#), which placed the Australian system fourth overall, out of 39 systems worldwide.

The Review also recommended a system objective “to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way” to provide a framework for future policy development and ongoing assessment.

Other key findings of the Review:

- There is not a single rate of compulsory superannuation that is suitable for all Australians.
- Replacement rates are the most appropriate basis for assessing the success of a retirement income system. The suggested benchmark is 65-75% for most Australians. The Review suggests that an increase in the Superannuation Guarantee (SG) to 12% would mean that this benchmark is exceeded for typical working lives across most income levels. It also suggests that increasing the SG will negatively impact wage growth and hence current living standards. We note that this analysis is based on the assumption that a retiree’s super balance is fully utilised by age 92 and a longevity product begins paying an income at this point. We believe that in reality, this is unlikely.
- The development of carefully designed retirement defaults, together with guidance from super funds, should help members get better outcomes in retirement.
- Home ownership is critical in providing financial security during retirement and is an underutilised asset for the provision of retirement income.

What actions should you consider taking in response to the Review?

Whilst the Report did not make any specific recommendations, it appears supportive of the Retirement Income Covenant, which is set to come into force in July 2022. **We believe you should therefore consider your strategy for your retiring members and ask yourself the following questions:**

- How are your members drawing down their savings in retirement and is this both adequate and sustainable? If not, how can you improve this?
- What are the different cohorts of members at retirement and how do their needs differ?
- Do you have retirement solutions that will meet your retiring members differing needs and are they structured in a tax efficient way?
- Do you have an effective communication and engagement strategy leading up to and into retirement to help guide your members through this challenging process?



4. Insourcing investment management: when does it make sense?

As funds continue their rapid growth, primarily through mergers, many are considering insourcing different operations that have historically been outsourced such as administration and investment management. It is important to note that there are plenty of good reasons to continue to outsource such as access to greater, broader expertise or efficiencies through scale. The question is, which operations to internalise, which to outsource and when is the right time to do it?

The decision to insource or outsource should not be considered as binary – i.e. fully insource or fully outsource. There are a spectrum of ways that elements of administration and investment management can be insourced or outsourced. We believe that funds should consider how they wish to deliver value for members and align internal capabilities with that value proposition. This can allow the fund to focus on its competitive advantages while outsourcing other functions that may be able to be provided at lower cost or higher quality.

Here are some of the key considerations:

- In delivering on your strategic member outcome objectives, have you clearly identified your areas of strength, while also identifying activities that are not aligned with your objectives which may be more efficient to outsource?
- Have you assessed the appropriateness of your internal systems, processes and team for managing these different operations in house?
- Have you considered the relative costs and impact to net returns for your members?
- Does your team have the required skill sets, qualifications and experience to undertake their respective roles?
- Does the governance and organisational structure facilitate effective oversight over your internal investment management activities and promote good member outcomes?
- Have you considered the operational risk management framework in relation to various aspects of the transaction execution process including investment guidelines monitoring on a pre and post trade basis, trade allocation and best execution monitoring?
- Do these operational controls align with your existing risk management practices?
- Is the current approach to measuring and reporting of performance appropriate?

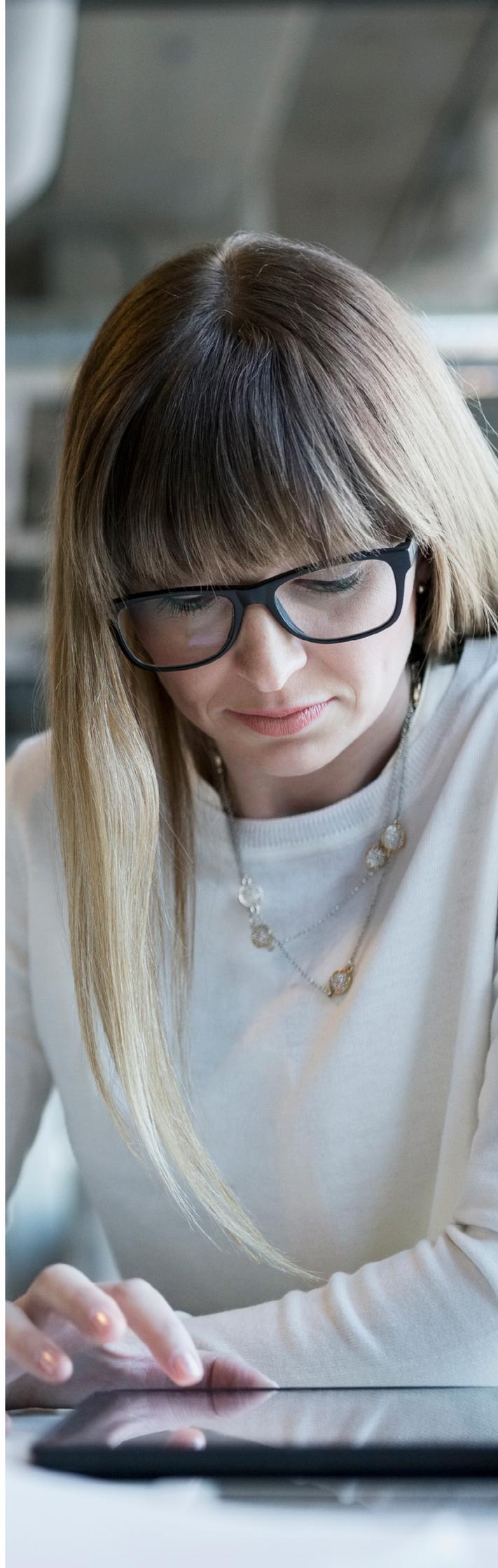
Asset class considerations

5. A future where returns could potentially be lower for longer

In the new world, reliance on traditional modelling and historical asset movements might be misplaced. It is important to consider different scenarios as well as base cases. **Embracing new ideas and capitalising on your ability to invest in less liquid and alternative strategies**, could provide the additional boost in return that your members need given the lower for longer market environment and increasing life expectancies. These ideas are often considered higher risk and complex; however, their correlation to more traditional asset classes is often low. Within the right SAA and governance structure, these asset classes are expected to enhance the risk adjusted return of your portfolio.

We believe remaining nimble and being prepared to be opportunistic could help you boost long-term expected returns for your members. Consider your ability to react to risks and take opportunities during a crisis. **A review of governance processes may allow for faster decision-making and greater opportunism in future.**

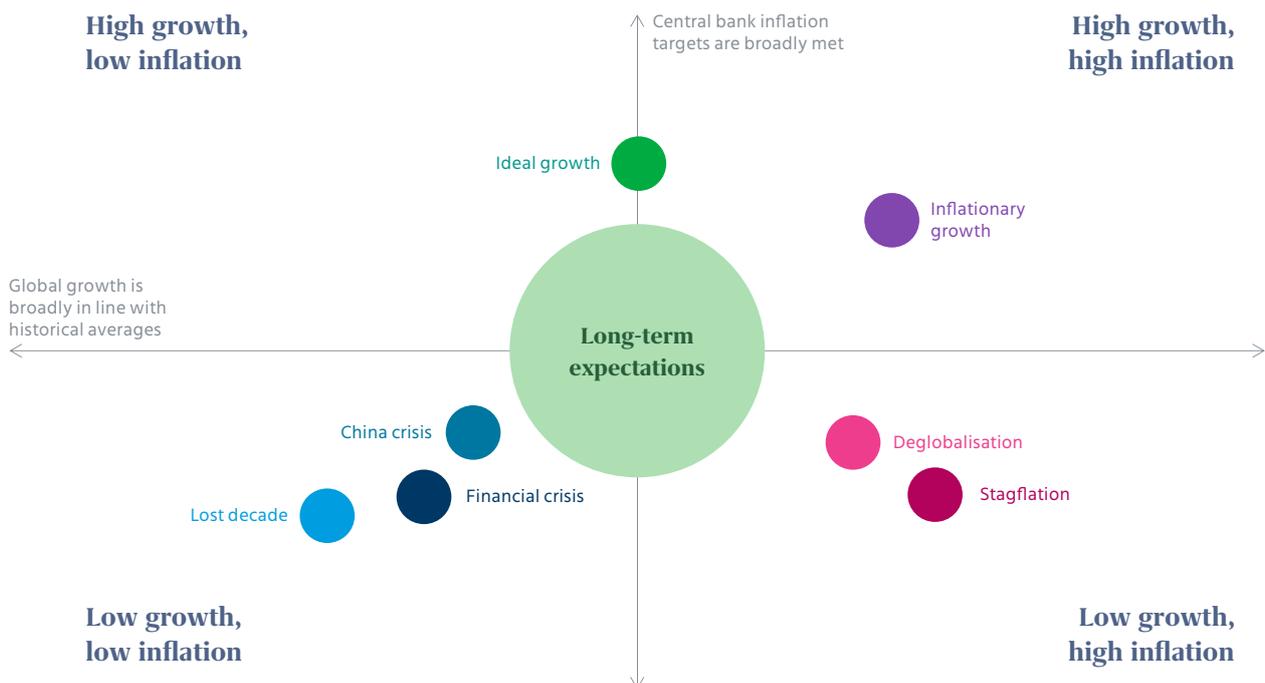
We believe the best strategy is to focus manager selection where it is most rewarded, and simplify investments in asset classes which offer lower potential “added value-to-effort” ratios.



6. Inflation protection: is this necessary?

In the aftermath of the Global Financial Crisis (GFC), Quantitative Easing (QE) activity inflated asset prices. This time, central banks and governments have responded by significantly increasing the money in circulation. The GFC saw credit destruction (disinflationary) whilst the COVID-19 crisis is currently seeing credit creation. We believe that Austerity is therefore unlikely this time; however, the probability of inflation being above target for an extended period within the next decade has increased.

Consequently, we believe funds should avoid biasing portfolios with the assumption that the disinflationary trends of the past three decades will continue or that we will see a repeat of the post-GFC experience. Instead, you should seek to ensure your portfolios will be robust in different inflationary scenarios. Potential scenarios are highlighted in the chart below.



Depending on which scenario materialises, each asset class will perform differently. For this reason, there is no one-size-fits-all approach to protect against inflation.

7. The fixed income dilemma: from fixed income to no income?

With global bond yields at historic lows and central banks indicating that they will aim to keep yields low, the outlook for absolute returns from investment-grade fixed income over the next decade is subdued. We believe an appropriate use of any defensive fixed income allocation should be to generate positive returns in a negative equity market.

This means that you should consider diversifying risk-reducing assets from traditional bonds that rely on duration.

In light of this lower yield environment, we also recommend you test your preparedness for any operational or investment risk as a result of negative interest rates. We note that this is not our base case scenario at this point in time.



Responsible Investing

8. Will the REST case set a new precedence?

In July 2018, Rest was sued by one of its members for failures in relation to action and disclosure on climate change. In November 2020, the case was settled out of court.

Whilst the out of court settlement has meant there hasn't been a formal legal ruling to set precedent, there is a clear cost to funds who are sued and a risk of reputational damage. We believe that funds need to assess all material risks to their portfolios and this includes environmental, social and governance (ESG) risks.

In addition, APRA has indicated it intends to finalise guidance by the end of 2021 to assist entities in developing frameworks for the assessment and monitoring of climate-related financial risks.

You should therefore consider the following questions:

- Do you have a robust climate-related governance framework in place?
- Do you understand the climate risks to which your portfolio is exposed? This can be achieved through climate scenario analysis, carbon footprinting and transition risk assessments.
- Have you engaged with your managers to ensure they have climate governance frameworks in place and they are carrying out appropriate climate risk assessments?



Contact us

Clayton Sills

T: +61 2 8864 6455

E: clayton.sills@mercer.com

Tim Jenkins

T: +61 4 1488 7137

E: timothy.jenkins@mercer.com

Richard Boyfield

T: +61 2 8864 6740

E: richard.boyfield@mercer.com

Dr David Knox

T: +61 3 9623 5464

E: david.knox@mercer.com

Emily Barlow

T: +61 2 8864 6643

E: emily.barlow@mercer.com

Important notices

This document has been prepared by Mercer Investments (Australia) Limited (MIAL) ABN 66 008 612 397, Australian Financial Services Licence #244385.

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© 2021 Mercer LLC. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualised investment advice.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see <http://www.mercer.com/conflictsofinterest>.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary and actual results may differ materially.

Information contained herein may have been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.