

Review of SPG 530 Investment Governance

Submission

March 17, 2023

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About The Conexus Institute

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About ██████████

██████████ is Executive Director of The Conexus Institute. ██████ career has been dedicated to the investment and retirement sector. He has worked with both commercial and profit-for-member firms, and ran his own consulting firm. █████ worked with APRA in the development of the APRA Heatmap. Academically, █████ taught for 12 years at Macquarie University and in 2020 completed his PhD at UNSW which focused on retirement investment problems. Full bio █████.

Thank you to ████████ for input into this submission.

***** The author is willing and able to participate in further consultation. *****

1. Summary and recommendations

We support shifting regulatory frameworks towards a more principles-based approach and suggest that SPG 530 be adjusted to move in this direction. Further, we see room for SPG 530 to be framed to better accommodate some important developments in investment management practice, including continued evolution in philosophy such as total portfolio management, adjustments to investment models (specifically internalisation) and the need for trustees to develop investment strategies for retirement moving forward. We have used this as our lens for suggesting a range of changes to the draft document.

Finally, due to the nature of the draft SPG 530 and our approach to re-framing the document, some parts of our submission may be difficult to understand. Please feel free to call to clarify any issues.

2. Further detail

2.1. Structure and flow of submission

The superannuation industry is continually evolving, creating a range of new challenges for funds to address. We suggest adjusting SPG 530 to accommodate a wider range of investment practices and thus make it more evergreen by addressing these areas:

1. Role of board
2. Statement of investment model
3. Investment governance framework
4. Formulating the strategy
5. Implementing the strategy
6. Risk management framework
7. Governance of investment operations

Generally, we attempt to follow the categories above as section headings, and reference relevant paragraph numbers from the draft SPG 530.

2.1.1. Philosophy, flow of submission and terminology

We support a principles-based approach complemented by examples of best practice. While, in our view, SPG 530 remains reasonably prescriptive, we believe a greater principles-based spirit could be encouraged within SPG 530 before flowing down into some prescriptive observations around what prudent practice entails.

Further clarity on terms such as “investment model” and “investment operating model” would be beneficial. We recommend the following definitions:

- *Investment model* – the overarching (not specific, numeric) objectives, investment philosophy and investment process that results in a process and structure for portfolio formation.
- *Investment operating model* – the operating structures and policies that give effect to the investment model, including portfolio implementation and the monitoring of risk and performance.

2.2. Role of the board

2.2.1. Board responsibility

In paragraph (1) we agree with the statement that the board “supports effective decisions”, which we see as important. However, we also consider that *ensuring an appropriate investment culture and implementation of high quality investment processes* are critical to delivery of long-term member outcomes. We suggest that both these areas are also noted.

2.3. Statement of investment model

We propose a new section, “Statement of investment model”. We envisage that this would capture all high-level aspects of the investment model, including:

- Investment philosophy and beliefs
- Overarching objectives (type (e.g. real returns vs. peer group) rather than specific, numeric objectives)
- Consideration of accumulation and retirement strategies
- Definition of risk and investment horizon
- View on accounting for ESG
- Emphasised and de-emphasised investment activities (e.g. emphasis on active asset allocation, passive versus active market implementation etc.)
- Overview of structural implementation models (internal, external, hybrid, consultant) for each major activity (e.g. asset allocation, public markets, private assets etc.)
- Overarching product philosophy (constant risk, lifecycle etc.)

This section would direct RSE’s to generate a document, which most funds should produce in varying forms already, that provides a foundational reference for the investment governance framework.

2.4. Investment governance framework

We suggest that that overarching paragraphs (i.e. (7) and (8)) should note the importance that the investment governance framework is appropriate to the investment model.

The topics of member equity considerations and investment operating model should be briefly referenced to provide better context for the expanded sub-topics on each.

2.4.1. Member equity considerations

The balance between principles-based and prescription could be improved in (9). A suggested alternative text is provided below:

APRA expects an RSE licensee would ensure that the investment governance framework appropriately considers member equity, with the aim that all members receive fair and appropriate outcomes regardless of fund-level and member-level activities.

Some important areas of member equity for an RSE licensee to consider include:

i) ensuring members are only allowed to transact at fair unit prices across all investment options, thereby treating transacting members and existing members equally;

ii) ensuring member transactions do not impair the portfolio quality of remaining members across all investment options.

2.4.2. Investment operating model

We suggest alternative wording in (10) to reflect that the investment operating model supports both the investment governance framework and the investment model:

APRA expects an RSE licensee would determine the most appropriate investment operating model to support the implementation of its investment governance framework and chosen investment model. The investment operating model should be reviewed to reflect changes in the RSE licensee's business operations and updates to the investment model. APRA expects this decision would be clearly documented, demonstrating how the investment operating model is appropriate with reference to the size of the RSE licensee's operations and complexity of its investment model.

The current emphasis in (11) appears to be investment implementation, whether implemented internally or externally. We believe that (11) should be broadened to cover all dimensions of the investment model.

Our suggested alternative phrasing of (11) is as follows:

When deciding to alter the investment model, an RSE licensee would consider:

- a) whether the reviewed investment model is expected to perform as well as, or better than, the existing model through the lens of risk-adjusted net member outcomes.*
- b) appropriate changes to the investment operating model and investment governance framework, including delegations;*
- c) whether any updates are required to the monitoring and management of performance;*
- d) the ability to resource and maintain the investment model with the required systems and either appropriately skilled staff and/or external service providers, giving consideration to any cultural or agency impacts;*
- e) how the investment model impacts on risk, including investment-related and operational risk, and how these risks will be managed;*
- f) cost-benefit analysis of altering the investment model, on a risk-adjusted basis.*

Note that (a) above would be intended to replace (12).

2.5. Formulating the strategy

We suggest that this section should relate to the aspects of product design and specific details of the investment strategy, such as investment objectives.

2.5.1. Investment objectives

Our proposed investment model statement would outline the overarching objectives including their form. This section is about quantification of objectives which need to be informed by the investment model. A simple example illustrates: an RSE licensee should not build in large expectations of returns from active asset allocation if this activity is not a primary activity in the investment model statement.

We suggest that this section be reorientated to make it more principles-based, and believe some elements of this section can be transferred elsewhere. Specific comments:

- As it stands we find (24) difficult to understand and perhaps could be better clarified.

- If it is necessary to be prescriptive on investment risk we recommend that the discussion on investment risk (25) is separated into two paragraphs on: (a) the need for an appropriate range of risk metrics as part of forming the investment objectives, and (b) the separate issue of communicating risk to members. It is important that internal risk metrics inform the pursuit of investment objectives, are not constrained by the need for member communications.
- ESG, as per (27), belongs in “Statement of investment model”.
- Lifecycle investment strategy (i.e. (28 to (32))). First, we note the overarching philosophy should be captured in “Statement of investment model”. On this topic we are concerned over framing the guidance around one specific strategy (there are multiple approaches). We encourage a principles-based approach which recommends the modelling of lifecycle outcomes as good practice.
- Derivatives should sit in “Implementing the investment strategy”. We note that (34) – (38) include no references to delegated authorities to transact, which should be addressed.
- Currency exposures should sit in “Implementing the investment strategy”. We note that (39) – (43) include no references to delegated authorities to transact, which should be addressed.

2.5.2. Diversification and risk

We suggest that any philosophy regarding risk be captured in “Statement of investment model”, and matters related to the monitoring and management of risk be included in the “Risk management framework”.

- Diversification: this should be addressed under the “Statement of investment model”, including whether it is achieved through diversification of asset classes/investments or management of risk exposures
- Investment risk: definitions should be addressed in the “Statement of investment model”, and the management captured in “Comprehensive risk management framework”.
- ESG risk factors: philosophy should be addressed in the “Statement of investment model”, and the management captured in “Comprehensive risk management framework”

2.5.3. Asset allocation

We find this section ((50) – (57)) concerning as it presumes choosing asset weights within pre-determined ranges across traditional asset classes. It thus gives no guidance for funds using other approaches such as TPA, allocation of cash inflows to the most attractive assets available, liability-driven approaches in the case of defined benefit funds or retirement strategies where longevity protection may be involved, the Age Pension is accounted for, and the investment strategy needs to be formed in the context of a drawdown strategy. It would be beneficial if the document was more approach-neutral. We suggest the following changes:

- The philosophy and approach to asset allocation should be captured in “Statement of investment model”, while some of the other aspects mentioned under “Asset allocation” should sit under “Formulating the strategy” (specifically, setting investment objectives).

This better links asset allocation activities in the context of investment objectives. Specific aspects such as limits should belong under “Risk management framework”.

- “Modelling the asset allocation” places a spotlight on a specific activity within a broad set of investment activities. We suggest that if a principles-based approach was combined with a ‘Statement of investment model’, a natural consequence would be for RSE licensees to allocate governance attention in proportion to the significance of the activity and the approach to implementing that activity.
- ‘Risk budgeting’. We believe that this area should integrate with the formulation of the investment model, noting our understanding that a risk budgeting approach is not in wide use, except to meet APRA requirements.

2.6. Implementing the strategy

Our comments here relate to the section titled “Giving effect to the investment strategy” ((58) to (77)).

Our view is that there is an opportunity for APRA to adopt a principles-based approach, the intended outcome of which would be identification of a range of governance and risk-based activities where the activity will be proportional to its importance in the investment model.

Most of the sub-sections could remain as guidance of what APRA considers to be good practice. The sections on unlisted assets, manager selection and internally managed public assets note important issues. We recommend that matter related to the implementation of asset allocation activities (e.g. due diligence, rebalancing, etc) should be retained in this section, leaving the broad approach to investment strategy be set out under “Formulating the strategy”. While the intended outcome is an important consideration formulating the investment strategy, the resources and processes behind the related activities to achieve those outcomes require oversight.

2.6.1. Rebalancing

It is appropriate for the rebalancing to be considered in this section. Our observation is that rebalancing pairs up well with an SAA-driven investment model but less well with other models such as TPM (whereby concepts of rebalancing and asset allocation are integrated). Adopting a more principles-based approach reduces the risk of addressing a specific rebalancing approach.

As mentioned previously, activities like derivatives and currency management are best placed in this section given that they are implementation activities.

2.6.2. Monitoring investment performance

We suggest that “Monitoring investment performance” should be re-titled “Monitoring portfolios” and should require trustees to implement an appropriate monitoring package which considers performance, exposures, and risk. This could be approached through a principles-based lens.

We note that a rational action in (72) could be to increase flows – if the underperformance has been investigated and there is an opportunity to invest in assets at better valuations. Perhaps just saying “... and taking remedial action as required” may suffice.

2.6.3. Additional ESG impacts

We see considerable room to improve on this section ((73) to (75)). The list of activities discussed seems limited. It would be helpful to distinguish ESG through the lens of (a) meeting the promise to members (e.g. avoiding greenwashing in sustainable options), (b) engagement to bring about

positive change, that could in turn create value, (c) impact activities, where investments are made in whole or part to create social benefit, and (d) risk management, where ESG is pursued to reduce risk exposures, including potentially reputation risk. The philosophy aspects of ESG should be captured in “Statement of investment model”.

We suggest that SPG 530 sets out as good practice that RSE licensees ensure appropriate processes and policies are in place to monitor any of these activities and related implementation activities like voting, and assess performance outcomes.

2.7. Risk management framework

We believe stress testing is over-emphasised and a comprehensive risk management framework should be encouraged. There are many different risk management practices, and each delivers unique insights which can inform the way that portfolios are managed. Stress testing is simply one component of a suite of risk management practices. Other valuable risk management practices include (this list is non-exhaustive):

- Factor exposures – determination of, and exposure to, different portfolio risk or economic factors.
- Sensitivity analysis – sensitivity to different risk factors.
- Scenario analysis – which considers the impact of scenarios (which affect multiple variables) on portfolio performance (technically stress testing considers only one variable).
- Pre-mortems – prospective hindsight analysis for failure to deliver targeted investment outcomes.
- aR analysis including VaR (Value-at-Risk) and CVaR (Conditional Value-at-Risk)
- Drawdown analysis
- Intertemporal considerations (risk manifests differently over differing time frames; for instance cash minimises volatility short-term, but increases shortfall risk in the long run)
- Portfolio event role plays (where a hypothetical event is “walked through” to assess response and outcomes)
- Income risk in retirement settings
- Measures which are specific to ESG and sustainability

We suggest alternative wording:

“An RSE licensee should develop, implement and review a comprehensive investment risk management framework.”

We would then suggest that the following existing areas are treated as sub-sections:

- Investment risk, including stress testing
- Liquidity risk management
 - This could include the encouragement of a comprehensive liquidity management framework which includes stress testing, scenario management, and

consideration of member-equity in the form of stale pricing and distorted portfolio impacts (as explored in [“Exploring portfolios with illiquid assets”](#))¹.

- Climate risk management
- Review of risk management techniques

2.7.1. Stress testing results

We agree that it is good practice to review risk management results, but the emphasis on stress testing fails to maximise the review opportunity and integration of risk management considerations into the formulation of the investment strategy.

2.7.2. Stress testing methodology

It most likely won't surprise that we think this section should focus on the methodology behind a comprehensive risk management framework. As it stands we think over-emphasis on one risk management pathway risks realising the full benefits of incorporating other risk management techniques.

2.7.3. Liquidity management

In our proposed structure (2.1), this section could be placed in “Risk management framework” or “Governance of investment operations”. It crosses over both areas, but at its heart lies a risk management problem and we suggest that it be placed in the former section.

Given the breadth of issues identified in (90) to (94) we believe a more appropriate heading is “Liquidity management framework”.

Finally we note that in (94), inequities arising from transacting at stale prices is a valuation issue more than a liquidity issue. The other two issues raised are appropriate for the liquidity management section.

2.7.4. Model risk

We recommend an additional sub-section be included on “Model risk”, which would address the need to document models, the appropriateness of assumptions, model testing, and data sources.

2.7.5. Risk management processes

We recommend an additional sub-section titled “Risk management processes”, which addresses areas such as risk management structures, processes, approved risk management transactions, delegated authorities, and reporting processes. This should be placed at the start of this section and should be reviewed periodically.

2.8. Governance of investment operations

We consider that a principles-based spirit should be applied to this section. Specifically, it should direct RSE licensees to identify the key operational activities within their investment models and develop frameworks to ensure quality processes, policies, and monitoring are in place.

2.8.1. Valuation governance

¹ In conjunction with CFA Societies Australia, we undertook a project to explore the various governance issues associated with superannuation portfolios investing into illiquid assets.

This is a difficult area. Again we consider a principles-based approach has strong merit, although the working view of The Conexus Institute is that concerns around unlisted asset valuations will continue to increase and explicit industry-level structures or standards may be necessary to ensure confidence in an acceptably controlled range of outcomes. However, such suggestions sit outside the scope of this review on SPG 530.

Accordingly, we don't strongly advocate for the comments made in (95) – (115), but we did review them and we make the following comments:

- There is some guidance (113) on consideration of appropriate strategic frequency of valuations (increasing frequency in periods of heightened volatility could be considered tactical). We suggest good practice is that the frequency could be asset dependent and influenced by each asset's overall potential portfolio impact (which in turn is influenced by position size and asset volatility).
- This section addresses issues as they apply to individual positions but not portfolio-level considerations. This is an important consideration – should an RSE licensee consider a whole of portfolio level valuation adjustment to account for an aggregate stale pricing effect?
- Bringing the stale pricing equity issue down from the previous section (2.7.3) we question whether RSE licensees should have processes in place for estimating and monitoring the aggregate stale pricing effects across each investment option offered to members? A natural extension of this would be to have limits which govern blackout periods.
- (9) mentions the potential for blackout periods, but this topic is not re-visited in this more detailed section.

The points above highlight the breadth of the challenge around valuations. We suggest re-labelling this section "Valuation framework" better reflects the importance of this topic and the broad range of issues.