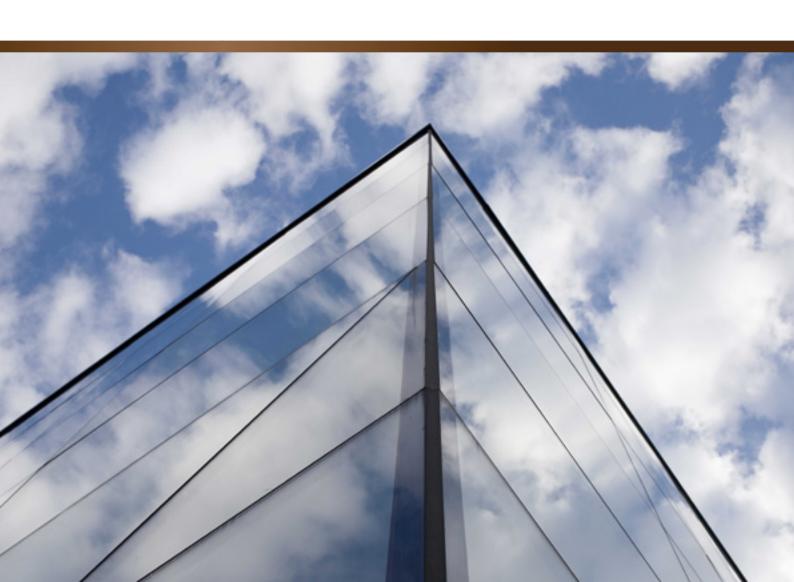
# J.P.Morgan

How super funds are tackling a low return environment



It takes an innovative approach to deliver outsized performance when markets turn, according to Lewis Moreline, Head of Fund Services Product, Securities Services, Australia and New Zealand, J.P. Morgan.

Australia's \$3.3 trillion superannuation industry is facing its biggest investment challenge since the global financial crisis more than a decade ago.

Surging inflation, rising interest rates, and geo-political uncertainty are weighing down the traditional drivers of returns and pressuring portfolios.

Several years of strong returns have suddenly reversed direction with the median balanced super fund losing 3.1 per cent this September and 5.7 per cent over the last year, according to research house SuperRatings.

But funds are finding new ways forward, drawing on the years of experience that have helped them underpin a long-term average return of about 7 per cent a year since 1992, including looking offshore.

Super funds already own about 20 per cent of all ASX listed companies, according to APRA.

There is a rational driver behind this home bias: Australia's dividend imputation system provides a tax-driven return boost that offshore markets can't deliver. But even this benefit has a limit and funds diversify their return exposure through investments into international markets and alternate asset classes.

### Private assets: diversification and potentially bigger returns

Long-term investment mandates make super funds natural owners of infrastructure, direct property, and private equity.

MySuper default funds had 22 per cent of their portfolios allocated to these unlisted asset classes at June 30, 2022 - a four percentage point increase compared to 12 months earlier according to APRA.

Unlisted assets offer more control, less volatility and higher potential returns thanks to their illiquidity premium. Some infrastructure assets, such as airports or toll roads, have consistent consumer demand with charges often linked to inflation.

Funds are not just investing more in private equity funds, they are co-investing alongside managers to increase control and lower fees. They are also forming consortiums that are launching takeover bids for listed companies, such as Sydney Airport earlier this year.

#### **Funds embrace ESG**

Super funds have long led the way in considering environmental, social and governance (ESG) factors in their portfolios, but the fight against climate change is now taking on even more prominence.

APRA's Practice Guide CPG 229, released late last year, underlined the trend by advising that due consideration of the financial risks associated with climate change is a matter of prudent practice for institutions.

This regulatory guidance is crucial given the majority of the world's commitment to achieve net zero emissions by 2050, which raises the risk of holding "stranded assets". For example, coal-powered plants are being replaced by renewable energy sources more quickly than expected, leaving those investors at risk of holding assets no longer able to earn an economic return earlier than anticipated. .

Funds are becoming more active in several ways, including taking a stance against AGL's planned demerger earlier this year because they felt it would not adequately tackle the transition to net zero.

Almost every major super fund has now committed to achieving net zero by 2050. Only 10.7 per cent of respondents our 2022 J.P. Morgan Future of Superannuation report said funds shouldn't adopt a net zero position.

Meanwhile, the proportion of asset owners following responsible investment practices rose to 42 per cent of total industry assets in 2021 from 28 per cent in 2019, according to the Responsible Investment Association of Australasia.

This activist stance is backed up by a recent meta-analysis, that found companies with a higher ESG commitment performed better on financial metrics.

#### How data and greater portfolio transparency is boosting returns

As portfolios grow in size and complexity, funds are demanding more granular data about their investments.

Data can reveal the drivers of investment performance and how that relates to other assets in the portfolio. These richer data sets allow funds to move quickly to protect their portfolios or take advantage of new investment opportunities when markets become volatile. It is not just the volume and quality of data that matters - funds need it faster than ever, particularly in the unlisted sector.

External providers, such as ESG-focused rating houses, are also now adding assessments of greenhouse gas emissions and other analytics.

This creates a huge amount of data for funds to manage, raising the importance of data governance. Funds are combining data from multiple sources into one central repository, creating a single source of truth which helps to manage data quality.

This data can then be analysed by different areas of the fund, including with machine learning, to provide new insights. As funds are bolstering their data analytic capabilities, they are also streamlining and automating many manual processes. This can create new operational efficiencies that may lower costs and incrementally boost net returns.

Returns are also being helped by superannuation funds growing scale amid unprecedented merger activity. Funds that merged between January 2018 and October 2020 cut fees by an average of 13.4 per cent, according to **Super Consumers** Australia.

While investment returns have taken a recent hit from tough market conditions, super funds are quickly adjusting their strategies. They have built up four decades of experience since the introduction of compulsory super contributions, managing retirement savings through multiple market cycles.



J.P. Morgan is pleased to share additional insights on the <u>Future of Superannuation</u> website.

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