J.P.Morgan

2023 Edition

The Future of Superannuation:

Optimising Outcomes Through Global Investment and Unlisted Assets

Foreword

Australia's superannuation industry is consistently ranked among the best in the world, even as it continues to be reshaped by regulation and market forces.

Our 2022 Future of Superannuation report revealed how the industry's leading executives were navigating this landscape. Many of their predictions about mergers and market conditions came true.

This year's Future of Superannuation report delves into a key part of funds' investment strategies in a new and challenging economic environment - exploring the role of global and unlisted assets.

We are grateful to the executives who took the time to share their views. Their unrelenting focus on delivering better retirement outcomes to their members will continue to drive a brighter future for all Australians.

At J.P. Morgan, we remain committed to supporting the industry and will continue to play an active role in providing innovative solutions and services to help our clients navigate this ever-evolving landscape.

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Executive Summary

Australia's superannuation industry is facing some of the most challenging investment markets of the last two decades. This is coupled with intense regulatory scrutiny and merger activity, prompting funds to invest heavily in their operational capabilities in an effort to bolster portfolio returns.

J.P. Morgan's inaugural Future of Superannuation report in March 2022 captured the industry's views and expectations. This year's report finds how the industry's size is allowing funds to become global investment players who are leading the charge towards unlisted assets.

Merger activity continued strongly through 2022 and early 2023, in line with J.P. Morgan's first survey, which found more than half of executives expected there to be fewer than 75 funds left by 2025.

Those predictions proved largely correct, with 137 funds remaining by the end of March 2023, down from 174 in the September 2021 quarter,[1] and more mergers have since been announced.

Some mergers were prompted by the introduction of APRA's performance test, which initially called out 13 funds in mid-2021. Since then, investment markets have become far more challenging, pushing the median fund's return into negative territory over the full year and for the fifth time in the past 35 years.

While executives we initially surveyed were concerned that the performance test would encourage benchmark-hugging, the funds we spoke to this year remained focused on their existing investment strategies in the face of these challenges.

Unlisted assets have been a significant driver of their long-term outperformance. While funds also see opportunities in listed vehicles – and remain mindful of illiquidity and valuation issues – their appetite for private market assets continues to grow.

Some funds say they are ramping up their internal investment capabilities to make bigger deals, including offshore. It is a strategy closely tied to their increase in size, with several funds now managing more than AUD$100 billion in assets each.

This year's J.P. Morgan Future of Superannuation report demonstrates how funds continue to look at ways to support their members as the industry works to deliver optimal outcomes for all Australians.

Key Highlights:

01

The record pace of super fund mergers has matched the predictions made by fund executives a year ago. More than half of the executives in the Future of Superannuation report predicted there would be fewer than 75 funds left by 2025. There were just 137 funds remaining by end of March 2023, compared to 174 in the September 2021 quarter, and more mergers are in the pipeline.

02

Some of the largest funds with assets above AUD$100 billion are using this scale to increase their offshore investment across a range of asset classes and set up global offices to explore new opportunities. Funds in the AUD$50-$100 billion range have taken a 'wait and see' approach regarding the benefits of offshore offices and continue to assess the strategy.

03

Funds are using their growing scale to continue building internal investment teams to manage certain asset classes or co-invest alongside their fund managers. The strategy is delivering greater investment insights at lower cost.

04

Unlisted assets are set to play an ongoing key role in portfolios, with a particular focus on infrastructure, which has delivered historically strong returns. Funds are maintaining their investment strategies despite a highly uncertain investment and economic outlook.

05

The growing size and complexity of portfolios is placing new importance on gathering quality data to reveal investment insights and manage risk. Funds are investing heavily in their operating infrastructure to drive future performance.

Exploring the global opportunity set

Australia's AUD$3.5 trillion super industry now dominates the local investment and economic landscape.

The industry recorded the fastest growth among 22 major pension markets over the past two decades, rising by an average of 11.3 per cent a year, according to the Thinking Ahead Institute.[2]

The industry's total super assets first matched Australia's GDP in 2010 and now represent around 140 per cent of GDP.[3]

Super funds also dominate the local managed fund industry, accounting for more than three-quarters (77.8 per cent) of all managed fund assets.[4]

The AUD$150 billion Aware Super fund is one of many asset owners increasingly looking offshore as it builds scale to compete on the global stage. The fund expects to reach about AUD$250 billion by 2025-26.

"Australia is a relatively small pool of capital," Aware Super Deputy Chief Investment Officer and Head of International Damien Webb, says. "The superannuation system as a whole totals AUD$3.5 trillion, which is 150% of the Australian stock market. As a result, what we're finding across asset classes is the need for global diversification; with this demand driving our recent strategy to expand our global footprint offshore, starting with the opening of a London office in late 2023."

The Australian sharemarket is dominated by the financial and mining sectors, while overseas markets can offer higher exposure to areas such as healthcare and technology.

"As you get bigger, and because of the positive cash flows, funds are growing faster than the investment opportunities in Australia," Cbus Chief Executive Officer, Kristian Fok, says. "Investing offshore also allows the fund to access investments that you can't easily access in Australia, whether it's biotech or other sectors."

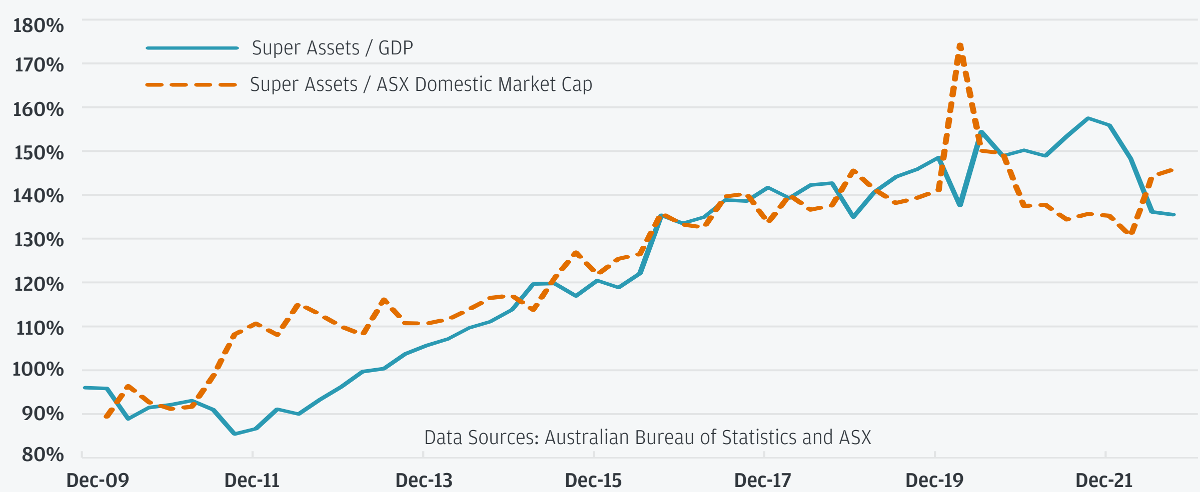
Cbus, with more than AUD$80 billion assets, is a fast-growing large fund. Larger funds heavily invested in the local market can quickly meet their holding limits for single stocks and have difficulty trading without moving the market. Their size effectively limits their ability to generate alpha or outperform. For example, funds above the AUD$100 billion size may have difficulty effectively investing in Australian small caps, according to one analysis.[5]

However, funds' home bias is unlikely to completely disappear thanks to differences in the tax treatment of investments, such as Australia's local franking credits scheme.

"You've got double taxation and have to reclaim withholding taxes," Fok says of offshore investment. "But given the diversification benefits and being able to target areas where we don't have exposure, we tend to try and find solutions for that, although solutions in emerging markets are more complicated."

Large super funds (excluding self-managed super funds) on average now allocate more to international equities (25.5 per cent) than Australian equities (20.8 per cent), according to APRA.[6]

Superannuation Assets Relative to GDP and ASX Market Cap



Source: Do Superannuation Fund Members Benefit from Large Fund Size? Conexus Institute. 24 March 2023. Scott Lawrence and Geoff Warren

The rise of private assets: diversification and alpha benefits

Growing super funds are moving offshore, but they are not limiting themselves to listed markets. Private market assets such as real estate, private equity and infrastructure such as toll roads and airports offer the potential for stable cash flows and higher returns and improved portfolio diversification.

It is a global trend with pension fund allocations to private assets increasing globally from 7 per cent to more than 26 per cent over the past 20 years, according to the Thinking Ahead Institute.[7] It has been a key performance driver for Australian super funds according to asset consultant Frontier.

SR50 Balanced funds correlation of private equity, property and infrastructure allocation versus one year performance to 30 June 2022

Source: Frontier

Note: The dark grey circles on the chart represent all other funds

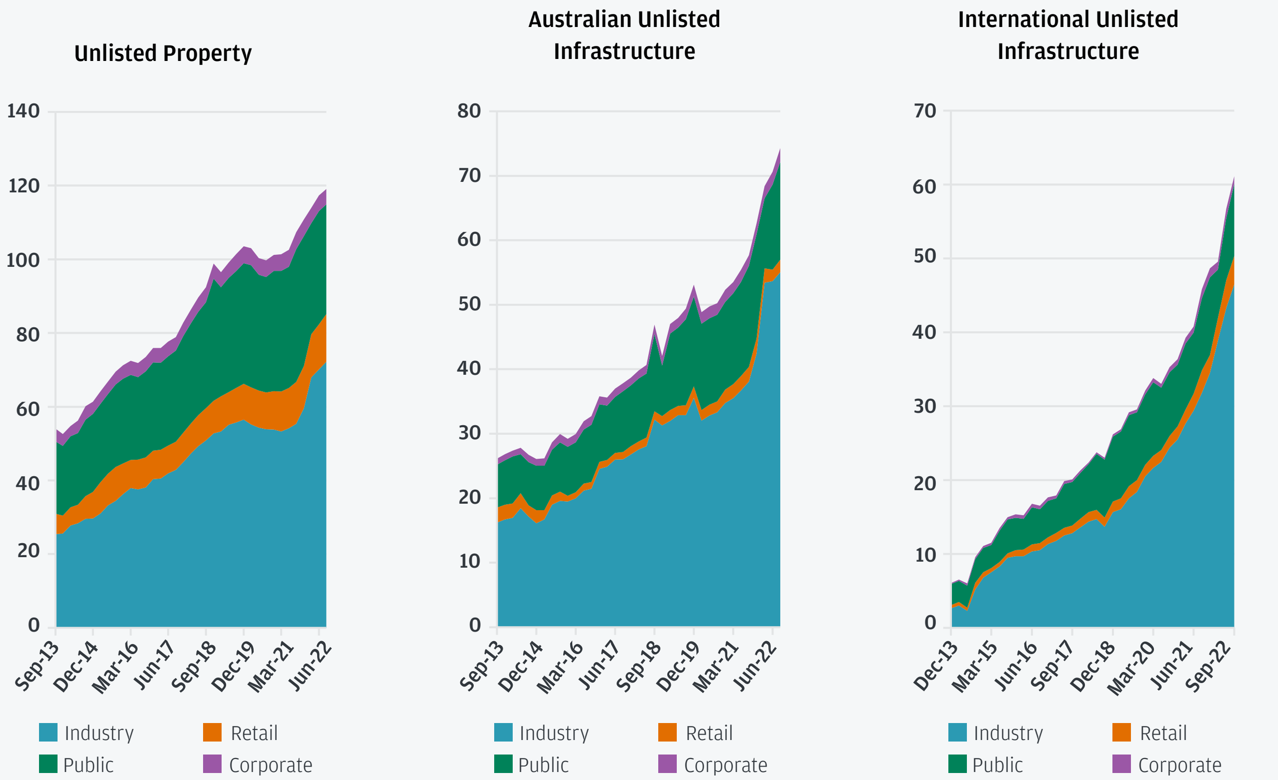
The average Australian super fund has more invested in infrastructure than global peers (which reflects their early mover status), about the same in direct real estate, and less in private equity, according to IndustrySuper data.[8]

While competition for assets has increased over the years, these assets continue to play a key role in their future investment strategies. Industry funds' holdings of unlisted property increased by 31 per cent, holdings of unlisted domestic infrastructure increased by 44 per cent, and unlisted international infrastructure increased by 46 per cent over the year to September 2022.[9]

UniSuper Head of Private Markets, Sandra Lee, says the fund invested in both listed and unlisted assets depending on relative value, but its general appetite for unlisted assets was growing. The fund manages more than AUD$100 billion in total assets.

"UniSuper has historically been a little bit lower in terms of our unlisted infrastructure and private equity exposure relative to our peers," Lee says. "So that's going up a bit more – we've got dry powder, good cash levels, and we can be opportunistic in private market transactions."

Industry funds’ holding of unlisted property and infrastructure assets continue to grow



Source: ISA Analysis, APRA Statistics - Quarterly Superannuation Performance, September 2022

UniSuper is the largest shareholder in listed toll road operator Transurban Group[10] and also took part in a consortium that privatised Sydney Airport in early 2022 (UniSuper already owned a 15 per cent stake in the listed vehicle).[11]

Lee says institutional investors in large private assets such as airports can take a longer-term view than those in listed markets, which tend to focus more on the short-term.

“You can invest a lot more into a major capex program or a new terminal, and you’re not going to get a lot of noise from the market. We can add and create long-term value and not have to worry about mark-to-market daily pricing or volatility.”

However, listed infrastructure and similar assets also offer benefits – market volatility can create investment opportunities during downturns while listed markets are more liquid.

AustralianSuper, which is the largest super fund in the country with about AUD$258 billion in assets, already has about one-quarter of its balanced portfolio invested in private assets and plans to increase that allocation.

“Public and private markets each have their own benefits and constraints, so we like to keep a good mix of both in the portfolio,” AustralianSuper Head of International Investments, Damian Moloney, says.

“Listed markets give us access to a diverse range of return streams at low cost and allow us to move allocations rapidly. On the other hand, private markets give us access to companies and other investments, like infrastructure, that aren’t available through listed markets. They have proven to be a great long-term investment for members.”

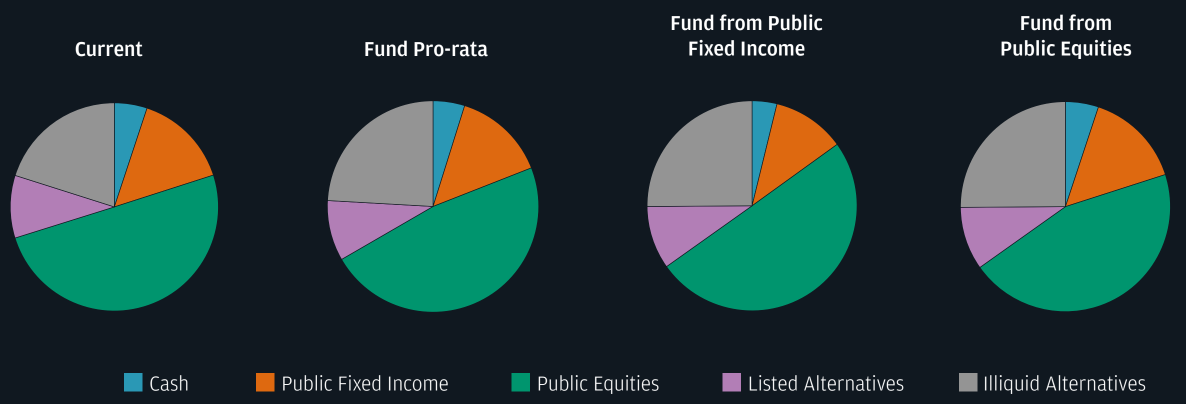
How illiquid and alternative investments can create better investment results in a balanced super portfolio

The J.P. Morgan Asset Management analysis below shows the positive impact of adding core/core+ alternatives such as global core infrastructure, global core transport leasing, core real estate and timberland to an average super fund's portfolio.[12]

Risk-adjusted performance (measured by the Sharpe ratio) is improved whether a 5 per cent allocation to core/core+ alternatives is funded pro-rata from the rest of the portfolio, from public equities, or fixed income.

"This aligns with our recent analysis[13] which also suggest that in light of the 'Your Future, Your Super' regulation, super funds prefer to take active risk through unlisted assets where they view there are more opportunities to add value, compared to the public market," according to J.P. Morgan Asset Management.

Adding 5% core/core+ alternatives allocation to a typical superannuation fund portfolio



Statistics	Current	Fund Pro-rata	Fund from Public Fixed Income	Fund from Public Equities
Expected Nominal Return (%)	7.25	7.24	7.41	7.21
Expected Real Return (%)	4.84	4.83	5.00	4.79
Volatility (%)	7.91	7.73	8.13	7.55
Sharpe Ratio	0.56	0.57	0.57	0.58

Source: 2023 J.P. Morgan Long-Term Capital Market Assumptions (LTCMA). LTCMA represents median manager performance and all statistics are forward looking, net of management fees, and in AUD. Current allocation is based on Australian Prudential Regulatory Authority – Quarterly Superannuation Industry Publication as of October 2022 (roughly 20% public fixed income – Australian cash, Australian government bonds, Australian credit, Global Aggregate bonds; 50% public equities – Australian equity, Global equities; and 30% alternatives – U.S. direct lending, Private equity, APAC REITs, Global REITs, APAC core real estate, U.S. core real estate, Global core infrastructure, Diversified hedge funds, Commodities). Core/core+ alternatives is a composite made up global core infrastructure, U.S. core real estate, European core real estate, global core transport leasing, Asia-Pacific core real estate and Global timberland.

Unlisted assets require greater risk management

While unlisted assets have successfully diversified portfolios and delivered attractive returns, the strategy also comes with heightened regulatory and political risk, as well as increased illiquidity and transaction costs.

The sharp COVID-19 downturn in early 2020 provided a significant test.

Asset valuations plummeted, while member contributions slowed as entire business sectors were shut down and staff were laid off. At the same time, some funds had to meet margin calls against currency hedges, substantial numbers of older members switched out of riskier (and less liquid) investments and into cash, while around AUD$40 billion was withdrawn through an unprecedented early release scheme.[14]

However, an RBA analysis found that funds managed their liquidity well, with aggregate cash balances rising by AUD$51 billion in the March 2020 quarter.[15]

Many large funds also have significant incoming cashflows from members, which also helps manage liquidity.

"AustralianSuper is in the unique position of having strong net cash inflows of over AUD$20 billion per annum and long-time horizon (given the majority of funds are in accumulation phase) and can therefore accept this risk for the return, so long as allocations are of a tolerable size," AustralianSuper's Damian Moloney says.

By way of contrast, Aware Super has a slightly older membership base of public sector workers such as nurses and teachers. "We need to build that into our thinking around cashflow positivity and mergers," Aware Super's Damien Webb says. "We've got a liquidity outcome in mind that needs to be managed and it can be a bit different to some of our superannuation fund peers."

Cbus is a major investor in unlisted property, which forms one of its five sector-specific investment options, but also sees value in listed Real Estate Investment Trusts (REITs).

"We've been very conscious of having quite a large allocation to listed REITs in there, so that covers the liquidity question," Fok says. "It also helps manage the risk of a member trying to time their investment switches just before unlisted properties are revalued."

Unlisted asset valuations have attracted significant attention, including from the regulator, in recent years. APRA has been focused on funds' approaches to liquidity management, stress testing, and that they ensure valuations are up to date. Many funds ran out-of-cycle valuations when asset prices were falling in the initial wake of the COVID-19 pandemic.

Fok says that during the COVID-19 downturn and early super release scheme, the fund was able to step in to revalue assets during an extraordinary time. "You need a pathway to make an adjustment and very clear rationale for why, but then also, over the longer term, it's much better to have an independent entity do the valuation."

AustralianSuper says it has well established policies and procedures to value unlisted assets. "Our governance framework includes a dedicated and independent valuation team and a valuation committee in place to ensure there is proper oversight of the valuation of investments."

> *AustralianSuper is in the unique position of having strong net cash inflows of over AUD$20 billion per annum and long-time horizon (given the majority of funds are in accumulation phase) and can therefore accept this risk for the return, so long as allocations are of a tolerable size.*
>
> **Damian Moloney**
> AustralianSuper
> Head of International Investments

New global offices and stronger internal investment teams

Many of the most promising unlisted asset investment opportunities lie offshore. UniSuper's Sandra Lee points to the renewable energy sector, which is being strongly supported in the U.S., as well as parts of Europe.

The U.S. announced the largest global investment in clean energy last year through the Inflation Reduction Act (IRA),[16] which includes US$369 billion of government incentives to encourage investment in areas such as renewable energy and electrification.[17]

"Australia's obviously got some opportunities, but given our domestic challenges around policy direction, it's been a little bit more challenging to find high-quality renewable deals. I think we will see more opportunity offshore, for example, in the U.S., where renewable projects will be much more supported given the IRA."

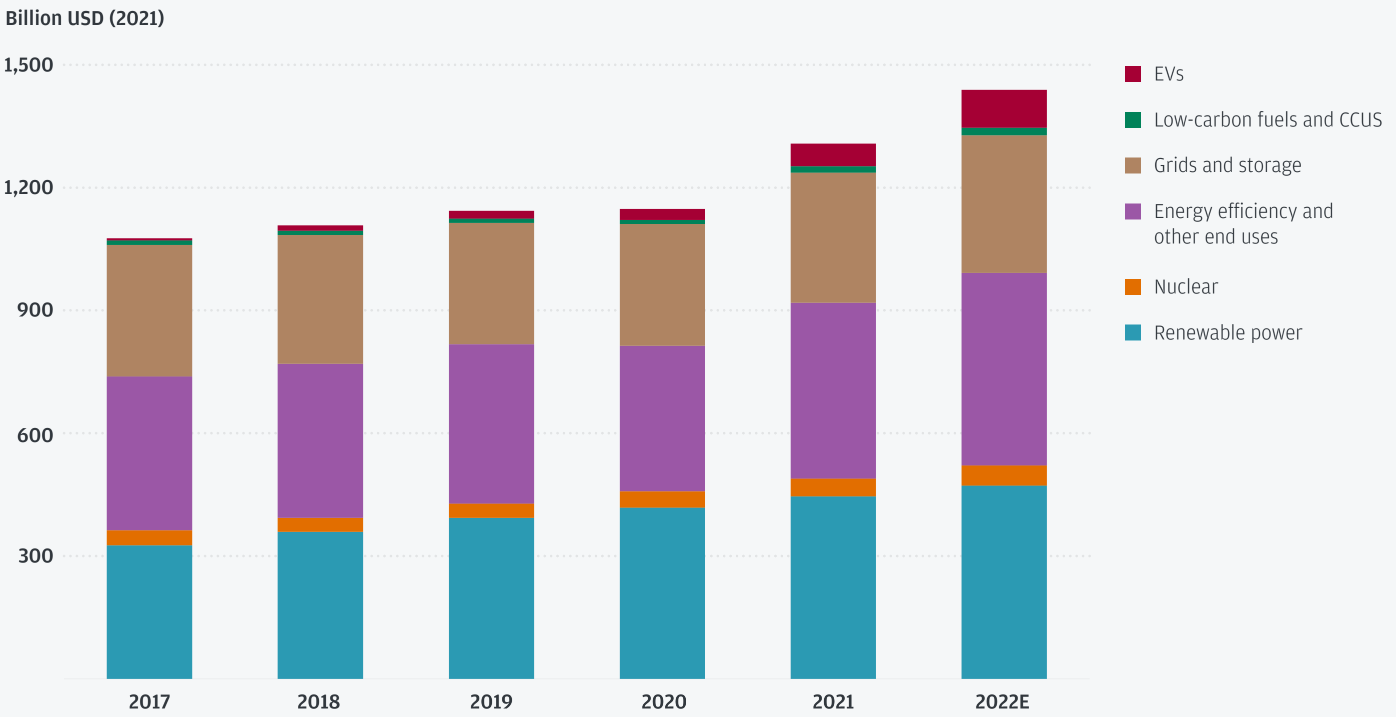
While these unlisted investments have attractive risk-return characteristics, they also tend to come with higher transaction costs and management fees.

A rising number of funds are tackling this issue by building internal investment teams. Many large funds are setting up new offshore offices where they can build new relationships and more closely assess investment opportunities.

AustralianSuper opened a New York-based global office in 2021, which employed over a dozen people as of last year and the fund expects to lift staff numbers to about 100 over the next two to three years.

"The main focus will be mid-market private equity, particularly private equity investments of up to around AUD$500 million, either in partnership with managers or as fund allocations," AustralianSuper's Damian Moloney says. "But we are not rushing to deploy capital today or tomorrow because the markets are still digesting higher interest rates."

Annual clean energy investment



Source: https://www.weforum.org/agenda/2022/07/global-renewable-energy-investment-iea/

The team will also target investment opportunities in private debt and infrastructure.

Aware Super plans to manage about half of its rapidly growing asset base in-house. This serves a dual benefit of lowering fees and expanding its palette of potential investments.

“We’ve been pushing really hard to get our internalised strategies up and running, whether it’s equities, real assets, or cash and credit,” Aware Super’s Damien Webb says. “Thus far that’s contributing meaningfully to boosting net returns by bringing overall fees down and we continue to be on that journey.”

Internal investment teams have a relatively fixed cost base compared to outsourced managers who charge percentage-based fees. They also give the fund potentially greater control and new investment insights. However, internalised teams also create governance challenges around preserving the original culture of the organisation and ensuring that investment performance at least matches external managers.

Aware Super plans to set up its first offshore office by the end of 2023, which will focus on private markets. Webb says successfully investing in private market assets places far greater demands on investors than listed markets.

“In private markets you really do need to have a physical presence there to set up proper origination, business development, sourcing, and then due diligence and asset management activities,” he says.

Aware Super’s private equity team will continue to work with fund managers, but there will be more direct investments in other real assets. In 2021, Aware Super teamed up with Macquarie Asset Management – Private Markets to acquire listed telecommunications company Vocus in a AUD$3.5 billion deal.[18]

“We’ve completed quite a few of those types of investments here in Australia. We would love to take that ability overseas,” Webb says.

Not all funds are internalising or setting up offshore bases. HESTA, which has about AUD$68 billion in assets, is also pursuing global investment opportunities but is taking a wait-and-see approach before opening international offices.

“We’re looking for the best returns and we’re big enough now that we can look wherever they are,” HESTA Chief Operating Officer, Stephen Reilly says. “But living in a ‘Zoom’ world, I think that question of how much you can get done without putting your feet on a plane has a different answer now than what it did three years ago. There are still huge benefits being there, but the benefits are a bit more nuanced than they used to be.”

The success of any offshore expansion ultimately still relies on quality execution.

“Size makes a fund able to consider offshore, but it’s more important to have relationships with experts than the wrong person on the ground anywhere,” Reilly says.

The growing need for data

Fund portfolios are becoming larger and more complex as they increasingly invest offshore and in private market assets. This expansion requires an uplift in quality information and analytics to effectively manage the portfolio.

"Data is everything to us," says UniSuper's Sandra Lee. "We're not just looking for more, but better quality data."

For example, she says UniSuper is collecting more information about what the work-from-home trend means over the long-term for its investments in toll roads and office property.

Aware Super is currently strengthening its operating infrastructure, which will improve its portfolio management, following an internal review that benchmarked it against global peers.

"An area where we thought we had quite a bit of work to do was how we integrated all our various front, middle, and back office systems, as well as our data," Aware Super's Damien Webb says.

"We're going to be a large player and so to deliver those scale benefits we need to have an integrated global capability, as well as best in class technology, insights, data, and trading abilities to support that."

Funds are still grappling with how to manage the overall volume of information attached to securities and move it between systems. HESTA's Stephen Reilly says technology can automate many tasks, allowing investment teams to spend more time looking for better investments.

"The more we set up our systems to flow; to find the right data, put it together, and then present it to the right person at the right time, the more efficient and effective our investment teams are going to be," Reilly says.

Generating insights around the fund's investment holdings allows it to move faster and take advantage of new investment opportunities. But while listed markets have high levels of transparency, extracting the same quality of information across private market assets in a timely fashion is more challenging.

"The issue is if you're a minority investor or you're investing through a trust, when you want to ask for more data on the company, sometimes that can be harder to receive compared to public companies," Cbus' Kristian Fok says.

> *The more we set up our systems to flow; to find the right data, put it together, and then present it to the right person at the right time, the more efficient and effective our investment teams are going to be.*
>
> **Stephen Reilly**
> HESTA
> Chief Operating Officer

Victoria Timlin, the Chief Operating Officer from the U.K.'s Universities Superannuation Scheme (USS), says transparency and access to look-through data from General Partners has been problematic, especially for private credit funds, but the situation is improving.

"Across private markets we are seeing a continued evolution of reporting, standards, and expectations from both General and Limited Partners. Frequent reporting and details on items like portfolio company operating metrics, ESG data, and fund financial information is now the expectation from Limited Partners. This is made available with more consistent reporting across the industry, and we expect this to continue."

Asset owners also have significant control over their unlisted assets, particularly when they invest as part of a small consortium or are the sole owner. It allows them to focus on making positive long-term changes, according to J.P. Morgan Asset Management.

"Private assets are also long-term investments, giving investors longer time horizons to explore new ideas to develop and profit from new environmentally-friendly technologies, rather than focusing on more nearer term markers, such as the next set of quarterly results in the case of public companies."

Environmental, Social and Governance (ESG) data challenges

Environmental, Social and Governance (ESG) factors are now a standard consideration for asset owners, with most major funds committed to net zero emissions across their portfolios by 2050.

Funds regularly engage with their investee companies by actively casting their proxy votes and via direct discussions on ESG factors. That pressure has flowed through to major listed companies, with more than half of ASX200 companies now disclosing detailed information on their ESG risks and plans to manage them.[19]

"We think divestment is really the absolute break glass tool in your toolkit," Aware Super's Damien Webb says. "We use it very sparingly. We really prefer to be on that curve where we're involved with the board."

Funds are also lifting their disclosure of UN Sustainable Development Goals (SDGs). Aware Super for example, provides a mission statement that explains their Impact Measurement Framework, outlining aims to measure the positive impacts of 10 investments representing AUD$1.6 billion of member funds.[20]

However, the wide array of ESG data and standards continues to prove challenging to manage, according to HESTA's Stephen Reilly. There are multiple ESG data providers and each makes their own unique ESG assessments of companies.

"Expectations to have ESG-related metrics available to investors is growing. The challenge is that those ESG metrics still vary widely – you can collect them but are they consistent? There is a huge issue around standardisation," says Reilly.

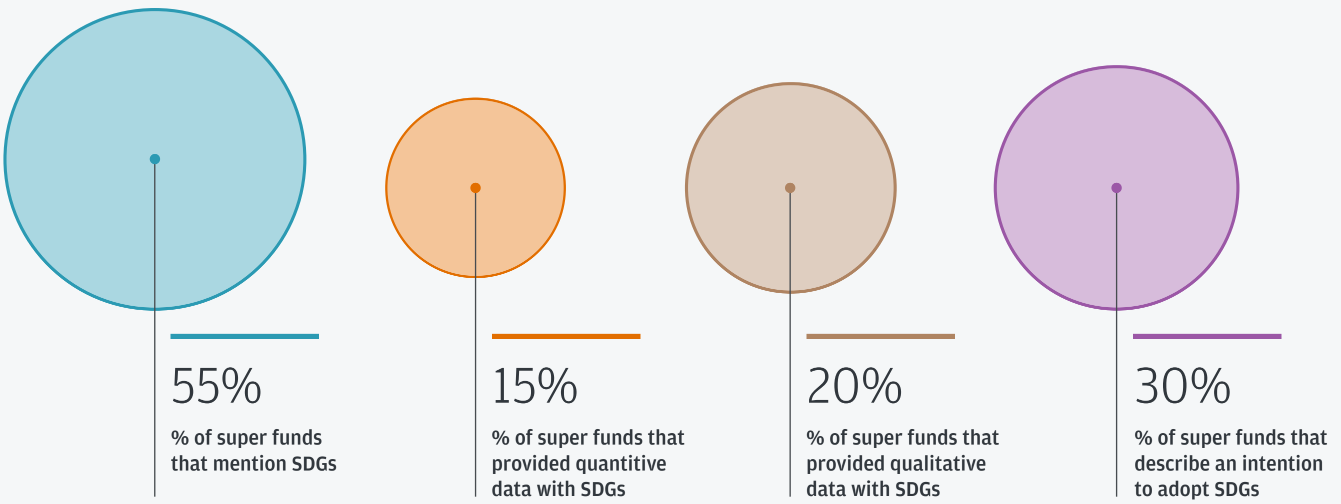
The issue is again compounded with private assets, where there is often less standardised ESG data, Aware Super's Damien Webb says. "It's a multi-year journey. We'll keep fine-tuning it every year as we get more data and then start to craft a plan around how we are going to reduce the carbon footprint of our operating companies."

It is a challenge facing all asset owners around the world. The Universities Superannuation Scheme in the U.K. is also targeting interim carbon emission reductions (a 25 per cent reduction by 2025) on its way to net zero by 2050.

"Achieving net zero is a very difficult undertaking – we need to ultimately change the energy system of the world's economy," the USS' Victoria Timlin says.

It cited poor carbon emission data, with the availability and quality varying widely, resulting in estimated data, as well as government policies not yet aligned with the Paris Agreement.

Disclosures of SDGs by super funds



Source: Sustainable Development Goal Disclosures within Australian Superannuation Funds: An Exploratory Study

An international perspective: the U.K.'s Universities Superannuation Scheme

The Universities Superannuation Scheme is the main pension scheme for universities and other Higher Education institutions in the U.K.

It shares many similar investment views and strategies as its Australian counterparts. However, the majority of its members are in a defined benefit scheme, with those liabilities (a guaranteed pension) linked to U.K. inflation and interest rates.

"With this in mind, we predominately invest in U.K. assets for our liability matching allocations," Victoria Timlin, Chief Operating Officer from Universities Superannuation Scheme says.

It still invests in private market assets including the National Air Traffic Services (NATS), Heathrow Airport, 61 Moto service stations, 201 BP service stations, and 36 Westerleigh (crematoria) locations.

Conclusion

Australia is one of the most advanced and fastest-growing pension markets in the world. It now stands at around AUD$3.5 trillion in size and has become a key driver in the local economy with an ever-increasing impact in listed and unlisted assets and across global markets.

That growth is set to continue even in the face of a challenging global economic outlook.

Australia's mandated superannuation guarantee is set to rise to 12 per cent by 2025 from the current 10.5 per cent – a stark comparison to just 3 per cent when the Superannuation Guarantee was introduced in 1992. Funds are also continuing to increase their investment in further developing their global investment and operational capabilities to pursue innovative investment strategies.

Unlisted assets form a core part of this approach.

Funds are searching the globe for quality private assets such as infrastructure, real estate and private equity. They are managing the unique challenges that come with the asset class such as illiquidity, higher transaction costs, while ensuring that valuations are accurate and equitable. They are building the capability to analyse meaningful data that can provide increased insights in order to undertake timely investment decisions.

The 16 million Australians with a superannuation account can trust that their retirement assets are managed by funds dedicated to navigating the changing industry landscape, focusing on delivering strong financial outcomes for their members.

Footnotes

[1]The ASFA Superannuation Statistics March 2023. Retrieved from here.

[2]Global Pension Assets Study. (2022, November 02). Retrieved from here.

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[10]Transurban corporate report 2022. Retrieved from here.

[11]ASX Release 8 November 2021. Sydney Airport enters into Scheme Implementation Deed with Sydney Aviation Alliance. Retrieved from here.

[12]Industry average asset allocation portfolio is based on Australian Prudential Regulatory Authority – Quarterly Superannuation Industry Publication as of October 2022 (roughly 20% public fixed income – Australian cash, Australian government bonds, Australian credit, Global Aggregate bonds; 50% public equities – Australian equity, Global equities; and 30% alternatives – U.S. direct lending, Private equity, APAC REITs, Global REITs, APAC core real estate, U.S. core real estate, Global core infrastructure, Diversified hedge funds, Commodities).

[13]Source: J.P. Morgan Asset Management, "How YFYS regulation is set to radically reshape the way super funds invest", 2022. Viewable here.

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[18]Macquarie Infrastructure and Real Assets (MIRA) and Aware Super enter binding agreement toacquire Vocus Group at A$5.50 cash per share. Retrieved from here.

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