A submission in response to Treasury's request for feedback on its "**Strengthening the Superannuation Performance Test: Consultation Paper"**

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John Peterson
Peterson Research
e: john_peterson@me.com

About the Author

I worked in the Australian financial system for over 40 years, with a primary focus on investment strategy, superannuation investments, alternative investments and risk management.

My experience includes being a member of Investment Committees, Chief Investment Officer, independent asset consultant, and Head of Alternative Investments, for superannuation funds and investment managers. I also have experience as a regulator, having worked for the RBA for 5 years.

My comments primarily relate to my areas of expertise around Superannuation Fund investment strategy, Performance Measurement, and Alternative and Private investments.



John Peterson
Peterson Research

Strengthening the Superannuation Performance Test

Response to Consultation Paper

John Peterson

In 2022, I noted that:

> "*The combined structure of regulation, incorporating Stronger Super / MySuper, RG97, and the APRA Heatmap is deeply flawed. The YFYS Performance Test is merely the putrefied cherry on top of this rotting regulatory cake*." (Peterson, 2022)

There is nothing to suggest that the situation has materially changed in the last 4 years.

Fundamental Problem

While Treasury is now appearing to belatedly recognise the existence of some of the issues with the regulatory structure, there is nothing in the Consultation Paper to suggest any recognition of the fundamental problem, which is based on the incorrect beliefs underlying the regulations imposed on Superannuation Funds.

Put simply, the regulatory structure is not based on an accurate, objective understanding about how investment markets actually operate. Nor do regulators have regard for actual investment processes and outcomes in the real world. It is not surprising therefore that unintended, and less than optimal, outcomes are the result.

Past Results and Outcomes of the Performance Test

Australia's regulators routinely claim positive results from the implementation of the Performance Test. These claims are largely false.

The Discussion Paper repeats the usual regulatory claims that:

> *"The number of products failing the test has declined significantly since its introduction in 2021. This has contributed to a substantial reduction in the number of members in underperforming products, from around 1 million members in 2021 to around 8,500 members in 2025.7 Over this period, APRA data indicates that 108 of the 123 products that failed the test have exited the industry."* (Discussion Paper p.7)

As explained in Peterson (2025; pp 24-27) this ignored the fact that the initial versions of the Performance Test were based on data collected under SRS 533.0 which was not fit for purpose.

When data that was more fit for purpose – collected under SRS 550.0 - was used for the 2024 and 2025 Performance Tests, 100% of MySuper products passed the Test. It is likely

that this would have also been the case if accurate data was used for the initial tests, which would have meant that no funds would have failed the Performance Test in those years.

In short, there is nothing to support regulators claims that the significant expenses incurred as a result of the Performance Test, including fund mergers, has produced any benefits for members.

What is clear is that the distortions to investment decisions resulting from the Performance Test have almost certainly been to members detriment.

APRA's assessment of the Performance Test measure.

In the 2019 Heatmap Information Paper, APRA observed that:

> "*The Heatmap has two views, a concise view and an expanded view. The concise view of the Heatmap shows eight key metrics that APRA* ***considers particularly important*** *for assessing member outcomes based on underlying analysis of the data."* (Emphasis added)

The Concise View excluded the 'Net Investment Return relative to Listed SAA Benchmark Portfolio' measure, indicating that it was not considered to be 'particularly important for assessing member outcomes'. Note however, that the Performance Test is the Net Investment Return Relative to the Strategic Asset Allocation Benchmark Portfolio measure used in the in the Heatmap, with the addition of a minor adjustment for relative Administration Fees (the RAFE).

While APRA has been almost uniformly incorrect in its assessment and implementation of regulations regarding superannuation fund performance - all of which Treasury has accepted - on this particular occasion APRA's assessment was correct, and it was subsequently ignored by Treasury in its implementation of the Performance Test.

Distorting Investment Decisions and Asset Allocations

The primary issue raised in the Consultation Paper is whether the Performance Test creates unintended barriers to investments. Specific concerns are raised in relation to investment in strategies or assets that are not well represented in the benchmarks, even where those investments may support members' best financial interests.

The operative position remains that 'indexed benchmarks' correspond in some way to being 'good'. There is unfortunately nothing that supports this belief. It is not surprising therefore that actual outcomes are not as desired.

It is clear, and is becoming more widely appreciated, that the Performance Test, in conjunction with the associated Comprehensive Product Performance Package, Your Future Your Super, RG97, the SRS 700 Product Dashboard and the ATO Your-Super-Comparison-Tool, has contributed to significant distortions in superannuation funds' investment allocations.

As noted in my submission to the Your Future, Your Super Review 2022:

> "*the unintended consequences on superannuation funds' investment decisions are both large, and significantly adverse for members' outcomes*". (Peterson 2022)

The creation of these distortions, and the negative impact on members' returns, has been communicated to, and ignored by, Australian financial regulators on numerous occasions over the last decade:

- A submission by Peterson Research Institute to the Productivity Commission in respect of the Draft Report on 'How to Assess the Competitiveness and Efficiency of the Superannuation System'. (Peterson 2016; pp 2-6, 30-33)
- Investor Strategy News. An open letter to APRA: State your case on fees. https://ioandc.com/an-open-letter-to-apra-state-your-case-on-fees/ (Peterson 2018a)
- An Open Letter to APRA – Response to ASIC. (Peterson 2018b)
- Submission to the Productivity Commission's Assessment of the Efficiency and Competitiveness of the Australian Superannuation System. Comments on the Draft Report. (Peterson 2018c; pp 9 and 11)
- Submission in Response to ASIC Consultation Paper 308, Review of RG 97: Disclosing fees and costs in PDSs and Periodic Statements. (Peterson 2019; pp 2, 29-33)
- Your Future, Your Super Review. (Peterson 2022; pp 9, 13, and 15-17)
- Annual Superannuation Performance Test - design options. Consultation Submission. (Peterson 2024; pp 30-33)
- A submission in response to ASIC's request for feedback on "Australia's evolving capital markets: A discussion paper on the dynamics between public and private markets". (Peterson 2025; pp 10-14, 15, 20)

Structural Problem

This submission will focus on the specific issues raised in the Consultation Paper, however, as noted previously:

> *"It is not possible to consider the implications of the Performance Test in isolation, as many of its effect will be either amplified or dampened through its interactions with other components of Superannuation Legislation and Regulation."* (Peterson 2024)

Characteristics of Investments

A major issue is that regulators have an immature understanding of the investment process.

All investments made by superannuation funds contain a mixture of investment factors. With the possible exception of Government Bonds, all investments contain a mix of the fundamental sources of return defined in any Economics 101 course:

1. Land (Rent);
2. Labour (Wages);
3. Capital – Physical and human (Interest); and
4. Entrepreneurship - Enterprise / Manager Skill (Profit).

(To more closely align the discussion with common investment understanding, I will refer to the Entrepreneurship / Enterprise factor with the more general term Manager Skill.)

From the point of view of investors there are two additional factors which are sources of investment returns:

5. The return from taking Credit Risk – which is related to profitability and hence equity returns, but is sufficiently different to justify a separate categorisation; and
6. Illiquidity.

For example, the vast majority of equity investments are based on some combination of Land (on which factories, retail locations, offices, and mines are based), Labour (employees and staff), Capital (financing through debt, equity, etc.) and Manager Skill (management, founders, consultants / advisors, etc.) and Credit Risk. Furthermore, some equities have more or less of the Illiquidity factor (ranging from Venture Capital and Private Equity, to Private and Listed Companies).

The mix of these sources of investment returns varies between investments. Importantly, from an investment perspective, **there is no investment that is 'pure' Land, Labour, Capital, Manager Skill, Credit, or Illiquidity**.

For example, some equities such as mining or machinery manufacturers have higher exposure to land and raw materials, but still employ significant amounts of labour and / or capital, with innovations and strategic directions (M&A, etc.) driven by Manager Skill. Other equities – such as service industries, have a higher exposure to Labour and Manager Skill, but still require Capital.

The same applies across all Investment Asset Classes. For example, there is a point at which a property business (or trust) crosses from being in the Property Asset Class, to Alternatives as the Manager Skill and Illiquidity factors increase as a proportion of Total Investment Risk.

Similarly, there will be a point where an interest bearing security transitions from being a Fixed Interest Asset (primarily Illiquidity Risk), to Hi-Yield, an Alternative, Distressed Credit, or an Equity asset, as the proportion of Manager Skill and Illiquidity risk factors increase.

Therefore, it is more reasonable to consider investments as being composed of six (6) investment factors, or types of Investment Risk. These risks are:

1. Equity Risk;
2. Fixed Interest Risk;
3. Credit Risk;
4. Property Risk;
5. Illiquidity Risk; and
6. Manager Skill.

The implication of considering investments from this perspective is that an assessment of Fund Performance must be based on an explicit assessment of the role of Manager Skill in the investments that make up the portfolio.

(It follows therefore that a competent treatment of investment management fees, which is the price paid to access manager skill rather than a cost to be minimised, is also required.)

Discussion Paper: Key issues to address

Benchmark hugging and Investment constraints

The impact of the performance test in forcing superannuation funds to 'index hug' and eschew investments that are not represented in listed indexes, is well documented.

The existential threat to funds' existence that motivates these behaviours is also well documented.

1. *To what extent does the test constrain decisions to invest in certain asset types? Which asset types are most affected, and why? Provide evidence or examples to support your views.*

The Consultation Paper notes that:

> "*Stakeholders have also argued that the test discourages investment in emerging or alternative asset classes that are not well represented in existing benchmarks*." (Consultation Paper; p 10)

The paper then identifies specific emerging or alternative assets, and asset classes, that these concerns relate to.

This approach, and conclusion, reflect an underlying issue with the Performance Test. This issue is that Australia's Regulatory Authorities have an immature understanding of what constitutes an 'alternative investment'. As a result, a major source of distortion relates to what is categorised as alternative investments.

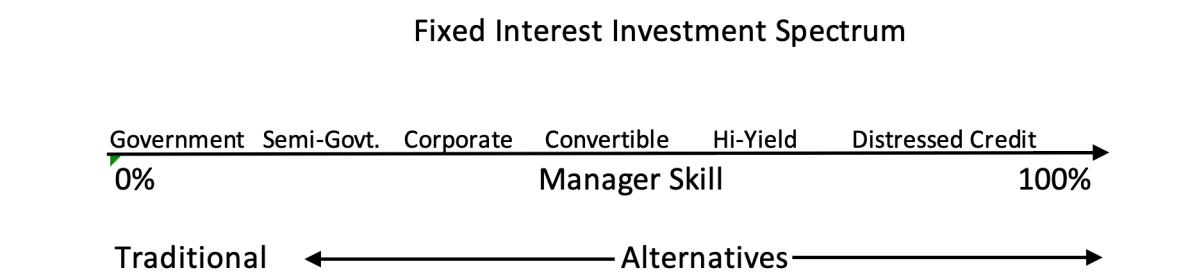
Specifically, in relation to the class of alternative investments defined as 'Private Investments', as noted in Peterson (2025):

> "a*ll of the investment strategies and products identified as Private Capital Funds in the Discussion Paper only exist when Manager Skill is applied. It therefore reflects a major omission, and indicates a significant blind spot in Regulators' understanding, that the Discussion Paper does not explicitly consider the role of Manager Skill in these investments.*
>
> *I would offer the following as a more general and applicable definition of Alternatives:*
>
> *Alternative investments (assets and asset classes) have a relatively higher proportion of their total Investment Risk contributed by Manager Skill than do Mainstream / Conventional investments."* (Peterson 2025: p.8)

The simple reality is that virtually all investments (and hence asset classes) contain a combination of the six investment factors, including Manager Skill. This implies that all asset classes are made up of a spectrum of traditional through to alternative investments, reflecting the differing proportions of Manager Skill incorporated in the investment.

For example, an investment spectrum for fixed interest investments is shown in Figure 1.

Figure 1



Similar spectrums exist across other asset types. For example, Equities range from Listed to Private Equity, and Property from Commercial through to Development.

In each case the proportion of Manager Skill risk in determining investment outcomes increases. This may also be accompanied by an increase in Illiquidity risk.

Notably, Manager Skill has been eliminated from economic and financial theory by the assumptions underlying General Equilibrium Economics and Modern Portfolio Theory. However, there is ample evidence in superannuation fund performance that Manager Skill does exist and is an investment factor that is rewarded. (See Peterson 2026)

It is therefore to be expected that a model that does not allow for the existence of Manager Skill, will poorly represent actual investments, asset classes and portfolios where manager skill is a central component.

It appears that Treasury, APRA and ASIC may finally be coming to some realisation that the model is flawed. Unfortunately, regulators' understanding remains at an elementary level, as represented by their attempts to tweak the implementation of the Performance Test, rather than recognise more fundamental flaws.

The "Whack-a-Mole" Approach to Regulation

The Consultation Paper suggests a number of minor tweaks to the Performance Test aimed at addressing some specific issues that have gained political, and hence regulatory, attention. This approach is flawed and will not produce outcomes which will meet regulatory objectives.

There is a fundamental weakness in the approaches proposed in the Consultation Paper. This weakness stems from confusion between structural flaws in the regulatory regime and specific areas of concern that have current focus. This leads to proposing specific tweaks that do not address the underlying flaws in the regulatory structure.

In short, the proposed approach is inevitably leading to a "Whack-a-Mole" situation of suggesting specific changes to the regulatory structure – on this occasion tweaking the indexes used in the Performance Test – which will further complicate the regulatory issues faced by Trustees, and do little, if anything, to address the distorting effects of the regulatory regime.

As the current approach does not address the underlying flaws in the regulatory structure, distortions to Superannuation Funds' investments and investing behaviour will continue, leading inevitably to further ad-hoc 'fixes' to the Test being proposed – a perpetuation of the 'Wack-a-Mole' regulatory approach.

Overspecification

A further key problem is that the Performance Test is attempting to fully describe (specify) the range of potential, and valid, superannuation fund investments in terms of a limited number (currently 26) of specific index measures.

This approach is basically equivalent to the situation that applied with superannuation fund investments prior to the introduction of the Superannuation Industry Supervision (SIS) legislation in 1993. Prior to SIS being introduced, superannuation funds' investments were constrained to a list of allowed investments – typically defined in Trust Deeds – that was based on the premise that all appropriate investments could be identified and defined in advance.

The reality then was that 'new', but appropriate investments, such as derivative and private investments, were continuously being created. As a result, many funds' investments were either constrained, or were made under a catch-all asset class of 'Other investments approved by the Trustees".

The same basic situation applies with the Performance Test. New appropriate investments are continuously being developed – including infrastructure, housing and 'nation building' investments – which cannot be properly 'captured' in the Performance Test as no suitable market index exists today, or is likely to ever exist in the future.

Regulators are increasingly turning to specific 'fixes' to address the most onerous investment distortions. These include the proposals in the Discussion Paper.

Such an approach is also seen in the suggestions considered over the last 18 months to alter how Stamp Duty on property purchases is treated under the RG 97. This example resulted in changes to Stamp Duty Disclosure Requirements announced on 1 May 2026. I would observe that while this change may ameliorate one particular problem, it will not resolve the broader distortions created by treating a price of investing (in this case stamp duty – in other cases investment fees) as a fee (cost) that regulations penalise investors for incurring.

As with the problems arising from attempts to define specific allowable investments prior to the introduction of the whole-of-portfolio approach specified in the SIS Act, the problems associated with the Performance Test attempting to identify and measure all individual superannuation fund investments will remain intractable. **The only solution will be to shift performance assessment back to the whole of portfolio level**.

Reducing unintended barriers to investment

The tweaks proposed in the Discussion Paper may reduce some specific distortions, but will not reduce unintended barriers to investments by superannuation funds as the present regime only considers results that can be easily measured, while being oblivious to the much greater level of opportunity costs generated by the distortions created.

The distortions will remain and therefore new impacts will come to the notice of politicians, which will stimulate regulators to launch another round of reviews and minor tweaks – which will not address the major underlying flaws and distortions created by the Performance Test and the remainder of the regulatory structure.

I predict that resolving the existing regulatory distortions will require something akin to the Campbell Committee of Enquiry into the Financial System in the early 1980's which recommended removal of regulations such as the 30/20 Rule, the replacement of the Reserve Ratio with the Cash Rate System for implementing Monetary Policy, and the floating of the Australian Dollar. These changes were designed to promote efficiency in the financial system and remove constraints on the investment actions of industry participants.

The combination of Your Future Your Super, RG 97, and the Performance Test has, whether intended or not, reintroduced prescriptive controls and constraints on superannuation fund investments that are at least as restrictive, and distorting, as those addressed by the Campbell Committee.

Adjust for emerging and alternative asset classes (Option 1)

2. *To what extent would a new covered asset class with a CPI + X benchmark address investment constraints the test may impose? Provide evidence or examples to support your views.*

   It is unlikely that the addition of a new asset class with a CPI + X benchmark would address the investment constraints currently imposed by the performance test.

   This is because adding a new asset class would perpetuate the premise that it is possible to fully define, and hence prescribe, the range of valid assets that a superannuation fund might invest in. This will ultimately fail as new investments evolve, or funds run up against constraints – such as allocation limits – that are arbitrarily applied when the asset class is established, but which may prove inappropriate in future.

3. *How could this new covered asset class be designed? In particular:*

   3.1. *How should eligible asset types be determined? What criteria could apply?*

   This assumes that all future appropriate asset types can be specified in advance. Unfortunately, this is impossible.

   If it is not possible to identify new asset types in advance then the same problem that we have today of restricting investments in emerging and new or alternative asset classes will arise.

   3.2. How should the CPI + X target be set?

   3.3. Should different targets apply to growth and defensive assets?

   Attempting to apply a CPI + X target to any single asset, or asset class is fraught. This is because in the real world the returns from single assets or asset classes do not converge to a 'trend' level within the investment horizon of the Performance Test.

For example, the 'Value' factor identified by Fama & French (1993), and extended by Carhart (1997), as represented by the MSCI World Value Index, outperformed the Global Market Index and Growth Index during the period 1995-2007, but then subsequently underperformed both indexes over the following 18 years (2008-2025).

Therefore, as the structural risks associated with the Performance Test will not be diminished, the same restrictions and distortions on investment decisions will remain.

3.4. What allocation cap should apply, and why?

3.5. What other safeguards should apply, and why?

Vacuous, as no one has the perfect foresight assumed by Modern Portfolio Theory, and therefore no one can reasonably attempt to answer these questions.

4. What are the key implementation and transition considerations for this option?

No opinion.

Improve the existing Alternatives covered asset class

As noted above, a core feature of all asset classes, including Alternative Assets, is that they have exposures to each of the 6 sources of investment return – Equity, Fixed Interest, Credit, Capital, Manager Skill, Credit and Illiquidity.

Alternative Assets generally have a greater exposure to Manager Skill than Traditional Assets, therefore attempting to assess the performance of any Alternatives against a benchmark that does not explicitly include Manager Skill is deeply flawed, and will not meet regulatory objectives.

As the proposal to, 'Improve the existing Alternatives covered asset class', does not involve the recognition of the role of Manager Skill in any way, then the proposal is almost certain to fail.

5. To what extent would improving the Alternatives covered asset class address investment constraints the test may impose? Provide evidence or examples to support your views.

6. How could the Alternatives covered asset classes be improved? In particular:

6.1. What asset types should be eligible, and why?

6.2. What changes should be made to the benchmarks, and why?

7. What are the key implementation and transition considerations for this option?

Introduce an assessment of risk-adjusted returns (Option 2) – Simple Reference Portfolio

Investment Risk

Practitioners have demonstrated a much better understanding of the concept of Investment Risk than have Australian Regulators.

Put simply, the purpose of investing is to take on Investment Risk in order to generate a return greater than the cash rate. Or in other words, Investment Risk is the risk that provides a return that is greater than the cash rate.

There are 6 Investment Risks – Equity, Fixed Interest, Credit, Property, Manager Skill and Illiquidity. Any real-world investment has exposure to some, or all, of these Investment Risks, and Investors expect to be rewarded for taking them.

(Note that a currency position applied without Manager Skill does not have exposure to any Investment Risks, and therefore does not have an expected return greater than zero. Similarly, taking on variability in returns (a.k.a. Volatility of Returns) does not provide exposure to Investment Risks, and thus also has a zero expected return.)

For any investment, or sector, or portfolio of assets, the Total Investment Risk is the determinant of the returns achieved. Total Investment Risk is the weighted sum of the Investment Risks of each asset.

For example, if we adopt a risk measure based on exposure to Investment Risk then, assuming a 4% cash rate, some typical asset and portfolio level risks might be:

Table 1

Investment	Equity Risk	Fixed Interest Risk	Credit risk	Property Risk	Illiquidity Risk	Manager Skill	Total Investment Risk	Long-Term Expected Return (p.a.)
Cash	0%	0%	0%	0%	0%	0%	0%	4%
Equities Index	16%	0%	0%	0%	0%	0%	16%	8%
Active Equities	16%	0%	0%	0%	0%	3%	19%	9%
Private Companies	16%	0%	0%	0%	3%	1%	20%	9.5%
Private Equity	14%	0%	2%	0%	5%	5%	26%	12.5%
Venture Capital	10%	0%	5%	0%	7%	7%	29%	13.5%
Development Property	2%	2%	3%	12%	3%	3%	22%	11%
Active Bonds	0%	6%	0%	0%	0%	1%	8%	6.5%
High Yield Bonds	2%	6%	3%	0%	3%	3%	17%	9%
Distressed Debt	3%	2%	6%	1%	6%	7%	24%	12%
Multi-Strat. Hedge Fund	8%	3%	4%	1%	3%	5%	23%	11.5%
Balanced / Growth Super. Fund	7%	1%	1%	2%	2%	4%	17%	8.5%

Note, that Investment Risk is a risk measure that is related to Investment Returns. As it is not related to volatility of returns it can be used to adjust for Investment Risk without the problems associated with attempting to use Volatility.

For example, while Private Equity actually has higher levels of Investment Risk than Listed Equities – as reflected in the table above - the volatility of Private Equity Returns is significantly less than that of Listed Equities.

There should, over time, be a positive relationship between Investment Risk and Investment Returns. This is the commonly talked about 'risk-return' relationship.

Importantly, this relationship only applies between Investment Risk and Investment Returns. As Volatility of Returns is not an Investment Risk, there is therefore no relationship between Volatility and Investment Returns. Therefore, Volatility cannot be used as a risk measure.

This statement may strike as counterintuitive those trained in, or who naively accept, the academic orthodoxy which assumes that higher levels of volatility will be related to higher levels of investment returns – as depicted in the Capital Asset Pricing Model (β Theory), and the upward sloping 'efficient frontier' between investment returns and volatility.

Unfortunately, these relationships can only exist in the extremely narrow situation where the assumptions of General Equilibrium economic theory and Modern Portfolio Theory apply. In reality, those assumptions do not apply in the real investment world, which is more accurately described as a complex system.

As a result, the orthodox beliefs and theories about investment do not apply to actual investments decisions made by superannuation funds, and therefore cannot be used in assessing their performance.

As a result, attempting to use a measure such as the proposed Simple Reference Portfolio, which uses the volatility of the returns of assets as a risk measure, will fail, because there is no relationship between volatility and return level.

Investment Risk based Performance Assessment

Using Investment Risk as a risk measure is a far more appropriate proxy for the risk in investment portfolios. It is also a general measure, in that it incorporates both Market and Manager Skill based Investment Risks. Therefore, it can be relatively easily implemented across all types of investment portfolios.

It also has the advantage of being far more flexible than attempting to assign a 'benchmark portfolio' to each asset class, thereby eliminating the 'Whack-a-Mole' problem. Further, if the Investment Risk levels assigned to each investment type is determined by an independent panel of experts, then the opportunity to 'game' the performance test would be largely eliminated.

Using Investment Risk as a risk measure is also consistent with the Total Portfolio Approach, in that the contribution of each investment to Portfolio Investment Risk can be relatively easily determined. The Portfolio Investment Risk is simply the weighted sum of the Investment Risks of all assets in the portfolio.

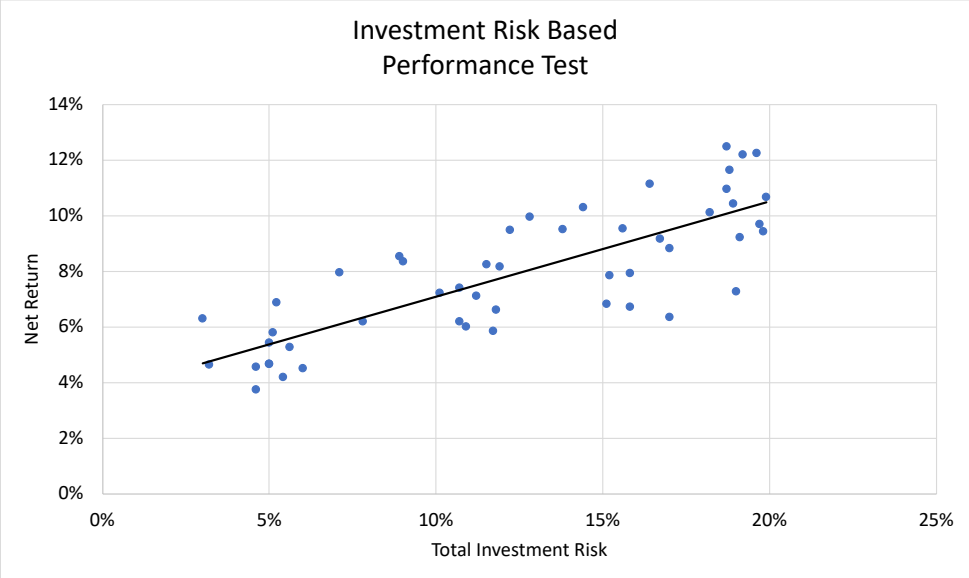
(It can reasonably be expected that an investor - Super Fund Investment Committee, Board, etc. - would already have a good understanding of the types of Investment Risk that all assets in their portfolio contain. If not, then looking at those assets from the perspective of

their Investment Risks would be likely to increase their understanding of the risks in their portfolio.)

A version of the Performance Test based in Investment Risk would look like Figure 2.

Lower risk portfolios (Stable, etc.) would be found on the left of graph, while higher risk portfolios (High Growth) would be at the right end. A regression line would be fitted to the Portfolio Return vs Investment Risk scatterplot, and those portfolios with relatively lower levels of performance vs peers would be candidates for further assessment by the regulator, or preferably an independent panel.

Figure 2



Liquidity Risk

As Volatility of Returns is not related to the level of returns – and hence is unrelated to Performance – it cannot be used as the basis for a performance measure. On the other hand, the liquidity risk of superannuation fund investment portfolios is related to Volatility.

Under current regulatory arrangements managing liquidity risk does impose valid constraints on portfolio construction decisions. This does not have to be the case however.

To a significant degree liquidity risk is a self-inflicted concern, as overall superannuation liabilities, at least in the accumulation phase are, due to preservation, relatively illiquid in aggregate. A mismatch between the liquidity of assets and liabilities only arises as a result of allowing short-term switching between:

i. Different products within a superannuation fund; and
ii. Different superannuation funds.

If this switching was managed by, for example delaying the transfer of illiquid investments for a reasonable period of time, or until they were liquidated, then the investment distortions necessarily introduced by liquidity management, would be largely eliminated.

Simple Reference Portfolio and the Outcome Region

Another major weakness with the concept of an SRP is that it assumes that a suitable portfolio can be identified. The simple weight of numbers of potentially valid portfolios makes this impossible.

As described in the Discussion Paper:

> *"To benchmark performance, a range of reference portfolios would be constructed by varying the weights applied to the underlying asset class indices in the reference portfolio. This would generate a continuous spectrum of portfolios, referred to as the simple reference portfolio frontier, each with a different combination of return and volatility."*

This description illustrates a complete lack of understanding of portfolio construction and portfolio weights.

It also refers to the concept of a 'frontier', which alludes dangerously closely to the concept of an 'efficient frontier'. An efficient frontier in this context would be formed by selecting those portfolios that have achieved the highest return for any given level of volatility, on an ex-post basis. This would involve comparing actual fund returns generated under conditions of uncertainty, to an SRP formed with the benefit of hindsight – i.e. with the benefit of perfect foresight – a situation in which there is no uncertainty.

Such a comparison would be unreasonable and invalid on many different levels.

There are many deficiencies in the approach described under Option 2, one of the most significant being that, unlike as assumed in MPT, not all investments, or asset classes, have the same expected return-to-volatility trade-off. As described in Markowitz's seminal 1952 paper 'Portfolio Selection', there are a large number of possible portfolios, and thus a large number of 'Attainable Expected Return / Variance Combinations' (Markowitz, p.82).

Markowitz then described the process of selecting the expected optimal portfolios – the Efficient Frontier - given the set of assumed returns, variances and correlations of each asset.

What Markowitz was unable to explain was how to have the perfect foresight required to predict the ex-post optimal portfolios in advance. Unfortunately, no-one else has been able to do so in the subsequent 74 years.

Given this real-world limitation, for any set of portfolios with 3 or more asset classes, there are many thousands of valid asset allocations – constituting the Outcome Region of portfolios - and there is no way of determining in advance that any one is, or will be, better than another.

The following table lists the number of possible 100% invested asset allocations that meet the given investment ranges. (It is assumed that asset allocations must vary in 2% steps, and that there are no aggregation limits.) Without perfect foresight, all Distinct Portfolios are equally valid for inclusion in the 'simple reference portfolio frontier'.

Table 2

Number of Assets in Portfolio	Assets	Allocation Ranges (%)	Distinct Portfolios
5	2 3	10 – 40 0 - 20	8,341
10	5 5	10 – 40 0 - 10	22,539,006 (Approx. 22.5 Million)
26	6 10 10	10 – 40 0 - 20 0 - 10	3,019,126,203,600 (Approx. 3 Trillion)

Note: The Performance Test currently has 26 Benchmarks, which would correspond to 26 allowed assets in superannuation funds' portfolios. This would suggest that the possible number of Distinct Portfolios which could be selected as the Simple Reference Portfolio, if there were no aggregate restrictions, would be more than 3 Trillion. In reality the number of valid SRP's is probably in the tens or hundreds of millions.

It is therefore not possible to talk of using a 'frontier' of portfolios as the SRP, as this would imply using an historically (ex-post) estimated 'efficient frontier', whereas, any given portfolio selected at the beginning of the assessment period would have an equal probability of lying on the 'inefficient frontier' as on the 'efficient frontier'.

Introduce a routine review of the benchmarks (Option 3)

As the concept of using market index 'benchmarks' is deeply flawed for the reasons set out above, introducing a routine review of them would be of little use.

Given the past regulatory failures in this area, and the damage caused, if a review is carried out it should be conducted by a panel that is completely independent of Treasury, APRA, ASIC or the Productivity Commission.

Expanding the performance test

Test externally directed accumulation products (Option 4)

Given the many structural problems with the Performance Test it does not seem sensible to consider expanding it to a broader range of products until these issues are addressed.



John Peterson
Peterson Research
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