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"

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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 responsible for recommending Alternative (including Private) Investments to Investment Committees over many years as an independent consultant, Head of Alternative Investments and Chief Investment Officer.

I would categorise myself as a Sophisticated Institutional Investor.

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

Executive Summary

1) A fundamental deficiency in the Discussion Paper is that it purports to discuss investment strategies that only exist with the application of active management (or Manager Skill), without recognising the existence, or application, of those Skills.

2) The current regulatory approach is not fit for purpose as it actively discourages investors from accessing Manager Skill based investment strategies.

3) Existing regulatory settings are currently costing Australian Superannuation investors many billions of dollars per year in lost earnings.

4) No attempts have been made to assess or measure the impact of regulations on investment decisions.

5) Investment management fees are a price that is paid to access higher returns, and not a 'cost' that should be reduced or eliminated.

6) It is not the case that all Alternative or Private products invest in Private Assets, or are Illiquid, or are Leveraged, or charge High Fees.

7) Definitions used in the Discussion paper are confusing. 'Private Capital Funds' is not a product or investment style description used in the investment industry.

8) Investment Risks are those risks that investors reasonably expect to be rewarded for taking by earning a return greater than the cash rate over time.

9) The Future Fund is the best benchmark against which to for assess regulatory proposals. As an unregulated entity it has consistently earned higher returns than equivalent 'Balanced/Growth' style Superannuation Funds by investing in Manager Skill based strategies.

10) 100% of MySuper products passed the Performance Test in the 10 years to June 2024. This demonstrates significant and consistent value added by Superannuation Funds' active management of investments.

11) The fact that all MySuper products passed the Performance Test in the 10 years to June 2024 indicates that there is a fundamental error in applying Vanguard's arguments and conclusions to Sophisticated and Institutional Investors.

12) Superannuation Funds and other Sophisticated Investors have the requisite skills and processes to investigate, assess, and mitigate the risks associated with Private Investments.

13) A key failure of the Australian Regulatory System is that it effectively treats Sophisticated and Institutional Investors as equivalent to retail investors.

14) Scientific method has been lacking in the regulation of investment strategies based on Manager Skill in the Australian Investment system.

15) The combined effect of regulatory policies has been to significantly increase the likelihood of a 'run' occurring on a Super Fund.

16) Public markets are not 'efficient' pricing systems with perfect foresight. Public market values are always incorrect to some degree.

17) For equity investments, Private Equity is expected to have higher returns than Private Companies, which in turn will return more than Listed Equity. For this reason, Institutional Investors will prefer direct ownership of businesses.

18) We have now largely returned to the stasis situation of the 1970's with a small number of banks and a small number of mutual funds (i.e., Industry Funds) dominating the superannuation sector.

19) There is a major risk that ASIC's position with respect to seeking to collect additional statistical data on Private Investments, could lead to repetition of the APRA Heatmap and Performance Test debacle.

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Forward

I have divided this submission into two sections:

1. Feedback and comments related to statements made in, and assumptions underlying, the ASIC Discussion Paper (Discussion Paper or Paper) that are incorrect, questionable, or not supported by evidence.

   Such erroneous beliefs could contribute to regulators making fundamental errors when formulation regulations and policy.

2. Feedback and comments related to specific issues raised in the Discussion Paper and the questions posed regarding Private Investments.

Purpose

In the Forward to the Discussion Paper the ASIC Chair notes that:

> "It is vital ASIC continues to develop its understanding of how investors are driving capital flows and what is motivating them" and, "The focus is on whether existing regulatory settings need to be re-examined and debated".

The purpose of this submission is to provide feedback that deepens and sharpens Regulator's' understanding of how Australia's capital markets actually operate.

Section 1 – Assumptions underlying the Discussion Paper

The following assumptions and statements expressed in the Discussion Paper potentially run counter to ASIC's stated, "objective of facilitating, maintaining and improving the performance of the financial system and entities within it – and supporting confident and informed investor and consumer participation"

a) Manager Skill

A common characteristic of Private Market Investments, and all Alternatives, is the application of Manager Skill. Manager Skills (or investor skills) are the wide range of knowledge, capabilities and experience that underly all investment decisions, including active investment management.

The Discussion Paper is primarily focussed on the associated 'risks', and not the conditions that would encourage the effective use of, these investments.

b) Price of Manager Skill

Manager Skill is one of the key sources of investment returns. Investors who employ Manager Skill expect that net returns to investors will be positive.

Investment management fees therefore are a price that is paid to access higher returns, and not a 'cost' that should be reduced or eliminated.

In the Forward the ASIC Chair notes that:

> "we need to understand whether regulatory considerations are having an undue impact on driving investors' and companies' decisions."

The clear answer is that 'yes', existing regulations are having an undue impact on driving investors' decisions. The combined effects of MySuper, RG97, the APRA Heatmap and the APRA Performance Test is creating a significant bias against the use of Manager Skill based investments, including Private Investments, in Superannuation Funds' portfolios.

c) Definitions

The Discussion Paper exhibits confusion in differentiating between investments and products that are; Public vs Private, Liquid vs Illiquid, Alternative vs Mainstream, Leveraged vs Unleveraged, Domestic vs Offshore, and have High vs Low Fee levels.

It is not the case that all Private Investment products invest in Private Assets, or are Illiquid, or are Leveraged, or charge High Fees. As a result, a number of the assertions made in the Discussion Paper are unsupported by evidence and could potentially lead to misleading conclusions.

Private

The term 'Private' is used throughout the Discussion Paper in multiple ways.

- Private Markets are defined as: "A market that is not a public market" (p.57); while
- Public Markets are defined as: "A financial market in which companies, managed funds and trusts raise capital by issuing equity or debt securities,

debt instruments or hybrid instruments that are listed or traded on a public exchange or public debt over-the-counter market. Includes public equity markets and public debt markets." (Underlining added)

Further 'Private Capital Funds' (which is not a definition used in the financial industry) are defined as, "A managed fund that raises and commingles money from investors (which may be supplemented with debt capital) to invest in private market assets that are not traded on public markets."

(To be consistent with the definitions of Public and Private Markets, the definition of a Public Capital Fund would be a fund that is not a Private Capital Fund.)

If these definitions are strictly applied, then there are multiple investments, that do not qualify as Public Investments, but which are neither private equity funds, private credit funds, private infrastructure funds nor private property funds.

It is not made clear how other private assets and investments, such as hedge funds are to be treated.

It is also not clear what makes a product 'Private' for the purposes of the Discussion Paper. For many assets this definition is uncertain.

Transactions for some **fixed interest securities** such as government bonds, do take place on a formalised exchange. However, as debt securities become less standardized, they are more likely to be exchanged in less-regulated Private Markets.

As there are numerous investment funds that can hold debt securities with a range of different types of issuers, maturities and liquidities, it is unclear how such vehicles are being treated by ASIC in the Discussion Paper.

It is also not explained how the other factors mentioned in the Discussion Paper (Liquid vs Illiquid, Alternative vs Mainstream, Leveraged vs Unleveraged, Domestic vs Offshore, and High vs Low Fee levels) feed into the differentiation between Public and Private Capital Funds?

Hedge Funds, which frequently only invest in 'public / traded' securities, are generally recognised as 'Private Investments' due to the nature of the funds themselves - limited partnerships, commitment-drawdown arrangements, and restricted liquidity.

To provide clarity to the discussion ASIC needs to more exactly specify which characteristic(s) of an investment classify it as 'Private'. Ideally, only definitions that describe actual investment styles and products should be used.

d) Alternative Assets and Investments

One of the key differentiators of investment types has traditionally been between Mainstream/Conventional and Alternative investments. In the Discussion Paper, there is also some confusion around this characterisation.

Alternatives are referred to in variously parts of the Paper. From the perspective of Sophisticated Australian investors or Institutions, these references exhibit a substantial degree of misunderstanding.

Specifically:

- Are Private Equity, Private Debt, and Real Estate, Private Investments or Alternatives? Why not simply refer to Alternatives rather than Private Capital Funds?
- Real Estate is not an Alternative investment in Australia. Real estate, both listed and direct, has been a mainstream investment in Australian Superannuation funds for many decades.

  However, from a US perspective, property is typically included in Alternative Investments. Has ASIC adopted definitions that are applicable to the US rather than Australian investors?
- Superannuation Funds have increased their allocation in dollar terms to all markets as a result of overall growth in assets.

  It is particularly notable however that, while the amount allocated to Australian Shares has increased, the percentage allocation has remained relatively constant at around 20-25%.

  Other changes, such as increased allocations to international equities or particular Alternative strategies, principally reflect allocation changes driven by changing expectations about relative risk and returns.

  There is no evidence to support the assertion that, "The size of superannuation funds' AUM relative to the size of the Australian public equity market, and their drive for diversity, have necessitated that they seek alternative investments".

It is not clear what ASIC means by Alternative Assets and Investments in the context of the Discussion Paper.

Are Private Investments and Alternatives interchangeable?

For Equity investments an index fund has virtually all of its return determined by equity risk, while the returns of a long/short hedge fund (invested in listed securities), or a Private Equity fund, are primarily determined by Manager Skill.

Long/Short Hedge Funds and Private Equity funds are clearly accepted as being Alternatives, but where does ASIC draw the line between Mainstream and Alternative for equity investments with increasing proportions of Manager Skill. i.e., Index Enhanced equity, actively managed equity, index unaware long-only equity, concentrated long-only equity, Convertible Arbitrage Hedge Funds, Event Hedge Funds, and Merger Arbitrage Hedge Funds.

All of these investment strategies invest almost exclusively in exchange traded shares. By ASIC's definition they are all invested in securities traded in Public Markets and would therefore be Public Investment Funds. However, some usually have extended redemption terms or employ hedging strategies, and are generally classified as Alternatives. It would appear to be more logical to classify them as Private Capital Funds.

The same situation applies to Fixed Interest investments (Government, through to Distressed investments), and Property (Established through to Development), with increasing proportions of their returns determined by Manager Skill.

In fact, **all 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 applicable definition of Alternatives:

> *'Alternatives investments (assets and asset classes) have a relatively higher proportion of their total Investment Risk contributed by Manager Skill than do Mainstream / Conventional investments.'*

e) Manager Skill as an Investment Factor

The above discussion raises the issue of the treatment, or lack thereof, of 'Manager Skill' in the Discussion Paper.

Investment Risks

All economics texts define the factors of production as: land, labour, capital and entrepreneurship.

If we reject the highly unrealistic assumptions of Modern Portfolio Theory (MPT) then these factors of production convert into six Investment Risks – Equity (earnings Risk), Fixed Interest Risk, Credit Risk, Property Risk, Commodity Risk and Manager Skill (entrepreneurship).

In investment markets, **Investment Risks** are those risks that investors reasonably expect to be **rewarded for taking by earning a return greater than the cash rate over time**. To these Investment Risks we would add the return that comes from taking the risk of committing capital for an extended period (i.e., Illiquidity Risk). Illiquidity Risk manifests most obviously in the upward slope of the yield curve.

Note: Currency exposures, and market volatility (and hence a security's Beta) are not Investment Risks as they are not rewarded. (i.e., The expected return from currency volatility and market volatility is zero.)

All 'Investments' have greater or lesser exposures to some or all of these seven Investment Risks and thereby are expected to generate returns above the cash rate for investors.

Manager Skill

Manager Skill (or investment skill) is, outside academic circles, widely recognised as a source of investment return (or alpha).

The Future Fund for example, which has consistently earned higher returns than equivalent 'Balanced/Growth' style Superannuation Funds, has consistently allocated significant amounts to Investment Fees in order to generate higher net returns. Investment Fees are the price of accessing Manager Skill.

Over the 10 years to June 2023, the SuperRatings SR50 Balanced (60-76) Index, which includes most MySuper products, returned 7.32% p.a. (SuperRatings 2023), while the Future Fund had an annualised return of 8.8% p.a. (Future Fund, 2023). This 1.5% p.a. outperformance is consistent with the expected 1.5% p.a. of value added from the Future Fund's greater use of Manager Skill, as predicted by the author in 2013 (Peterson 2013).

The investment approach being followed by the Future Fund has been set out in 2 Position Papers published in December 2022 and June 2024.

In the December 2022 Position Paper titled "The death of Traditional Portfolio Construction?" the Future Fund considered the implications for its portfolio from the structural forces that "are challenging many of the assumptions underpinning the way investors have generated returns over the last three decades".

The first conclusion drawn by the Future Fund from its analysis was that:

> *"**Alpha is more important than ever.***
>
> *Taking more traditional market risk will only have a limited impact on achieving higher real returns. In fact, it could increase the risk of large negative returns in the short-to-medium-term, with history suggesting such periods can extend across a decade.*
>
> *Generating excess returns through alpha becomes ever more important but this presents challenges in the ability to identify and access those opportunities." (Emphasis added)*

Consistent with this, the Future Fund identified the following implications for its investment portfolios.

Portfolio implications	**Levers activated**
More alpha	More Private Equity
More volatility	Focus on liquidity and dynamic asset allocation
More domestic exposures	Added to Infrastructure
More defensive levers, inflation protection	Added Gold, Commodities, Tangibles, Alternatives

Each of these Levers involved increasing allocations to investment strategies with higher proportions of Manager Skill (Private Equity, Dynamic Asset Allocation, Infrastructure, and Alternatives).

The June 2024 Position Paper titled, "Geopolitics: The Bedrock of the New Investment Order", detailed the actions that the Future Fund had implemented in its portfolios, including:

- Build exposure to technology (private equity)
- Re-think alternatives exposure to gain greater diversifying characteristics
- Improve portfolio flexibility
    - Currency hedging
    - Better liquidity management
- Improve portfolio agility
    - Dynamic asset allocation
- Richer opportunity set for active management

Again, each of these actions have involved greater allocations to, or the harnessing of, investment strategies with a higher dependence on Manager Skill.

It is a key omission that the Discussion Paper does not consider the role of Manager Skill in Private Investments.

Existing regulatory Approach

The key issue with the existing regulatory approach to Private / Alternative / Active Investments, is that it fails to recognise the existence of Manager Skill as a viable source of investment returns. Instead, **the current regulatory approach, actively discourages investors from accessing Manager Skill based investment strategies.**

The Australian Regulatory Approach to Manager Skill based Investment Strategies is based on the following two premises:

1) Manager Skill based investment strategies cannot, or do not, add value – i.e., do not generate alpha.

   As a result, Investment fees are treated as an expense which reduces returns to investors, rather than a price that is paid to increase returns net of fees. This is most clearly reflected in the 'Consumer Advisory Warning' in RG 97 that ASIC requires in all superannuation products Product Disclosure Statements, which states that:

   Small differences in both investment performance and fees and costs can have a substantial impact on your long-term returns.

   For example, total annual fees and costs of 2% of your account balance rather than 1% could reduce your final return by up to 20% over a 30-year period (for example, reduce it from $100,000 to $80,000).

   As 'Total Annual Fees and Costs' in RG 97 includes Investment Fees, this wording creates a significant regulatory and competitive disincentive for Superannuation Funds to invest in strategies employing Manager Skill – including Private Capital Investments.

For Australian Superannuation Funds, actual fund performance has demonstrated that for every 10 Basis Points spent on Manager Skill (i.e., Investment Fees), the net benefit after fees to investors is between +10 and +34 basis points per annum. (Peterson 2024, pp11-12)

The paragraph in the 'Consumer Advisory Warning' is therefore highly misleading and creates a significant bias against active Manager Skill based investment strategies.

A more accurate, and less distorting/misleading, wording would be:

DID YOU KNOW?

Small differences in both investment performance and fees and costs can have a substantial impact on your long-term returns.

For example, <u>total annual administration fees and costs</u> of 1% of your account balance rather than 0.5% could <u>reduce</u> your final return by up to 10% over a 30-year period (for example, reduce it from $100,000 to $90,000).

On the other hand, <u>total annual investment fees</u> of 1% of your account balance rather than 0.5% could <u>increase</u> your final return by up to 30% over a 30-year period (for example, increase it from $100,000 to $130,000).

Contrary to the Future Fund, and the Revealed Preference of Superannuation Fund Trustees, the view that, 'Manager Skill based investment strategies do not add value', is promoted by some in the investment industry.

These promoters include index providers such as Standard & Poor's, and index fund managers, including Vanguard Investments Australia which is referred to in the in the Discussion Paper (Page 20, Vanguard 2023).

Vanguard argues that:

"The other big advantage of index funds is their long-term track record.

Global index provider Standard & Poor's regularly measures the performance of active funds against passive benchmarks. The results paint a strong case for index funds, because a high percentage of active managers underperform passive index benchmarks most of the time.

For example, the latest S&P Indices Versus Active scorecard, or SPIVA as it's known, showed 57.6% of actively managed large-cap Australian equity funds – that is, funds that invest in a selection of the largest Australian companies chosen by an investment team – underperformed the S&P/ASX 200 Index in 2022.

The SPIVA report found that underperformance rates over the longer term were even higher, with 81.2%, 78.2% and 83.6% of actively managed large-cap Australian equity funds underperforming the S&P/ASX 200 Index over the 5-, 10- and 15-year horizons, respectively."

This result is completely at odds with the most recent results of the APRA Performance Test, in which **100% of the 57 MySuper Funds** outperformed the index-based Performance Test threshold over the 10 years to June 2024.

More significantly, **all 397** of the non-platform Trustee Directed Products offered by Australian Superannuation Funds also passed the Performance Test.

If the Vanguard / S&P Indices (or SPIVA) results actually applied to Australian Superannuation Funds, then **virtually all superannuation fund products would have failed the APRA Performance Test over the 10 years to June 2024**. The fact that 100% passed the Test indicates that **there is a fundamental error in applying the Vanguard argument and conclusions to Sophisticated / Institutional Investors** such as Australian Superannuation Funds, Insurers and High Net Worth investors.

How do we reconcile these apparently contradictory outcomes?

A starting point is to take into account the funds, and therefore the investors, in the Vanguard / S&P analysis. The funds in the analysis are retail investment vehicles, with retail fees. They are also selected naively. There is no process for fund selection, so effectively the funds and managers are chosen randomly, with investors assumed to invest with the 'average' manager. Finally, the analysis assumes equal weighting of investments, which fails to take into account the scale and resources that a particular manager brings to the investment process.

These factors are diametrically opposed to the manager selection processes employed by Sophisticated and Institutional Investors. Institutional Investment management fees start out much lower than for retail clients, and are typically open to negotiation. Also, Institutional Investors employ considerable resources in manager selection (both internal and external), which takes into account both performance and tight compliance and eligibility criteria. Essentially, **Institutional Investors do not invest with the 'average' manager** or fund in any asset class.

It is therefore unsurprising that Institutions' actively managed portfolios outperform indexed portfolios, and that Institutional Funds outperform passive benchmarks.

The only conclusion that reconciles these apparently contradictory outcomes is to recognise that:

> If you are an unsophisticated (i.e., retail) investor, who pays retail investment fees to investment managers, and has no skill in selecting investment managers, then your investments are likely to underperform index investments over the long-term;

> However:
>
> If you are a Sophisticated / Institutional Investor, who pays institutional fees to investment managers, and employs skill in selecting investment managers, then your investments are likely to outperform index investments over the long-term.

These statements are consistent with the actual performance demonstrated by all Australian Superannuation Funds in the Performance Test and by Australian Super and Hostplus Super specifically in the comparison of their actively managed and indexed products. (Peterson 2024, pp11-13)

A key failure of the Australian Regulatory System is that it effectively treats Sophisticated / Institutional Investors as equivalent to retail investors.

2) The second premise in the Australian Regulatory approach to Manager Skill based Investment Strategies is that Manager Skill does not exist. The premise that Manager Skill does not exist stems from Modern Portfolio Theory (MPT), and appears to underly regulators beliefs. In MPT, the conditions necessary for Manager Skill to exist, are assumed not to exist, and therefore this has become a premise on which the regulatory structure is based.

   It is good scientific method to regularly review and measure the scale of errors arising from the deviations of assumptions from reality. Such scientific method has been lacking by regulators in the case of the regulation of investment strategies based on Manager Skill in the Australian Investment system.

   Index Benchmarks

   Given the assumption that Manager Skill cannot exist, then an appropriate reference point for assessing manager and fund performance is a zero-Manager Skill, indexed portfolio.

   The effect of this approach in the APRA Heatmap and Performance Tests has been to create an artificial existential risk for Superannuation Funds that deviate from the benchmark. As a result, Superannuation Funds are discouraged from deviating materially from index-based benchmarks, thereby creating a bias against investment strategies such as Private Investments that incorporate Manager Skill.

Appropriate Benchmark

A fundamental question for Australian Regulators therefore should be, “If indexed based benchmarks create a bias against Manager Skill based strategies, then what would be a more appropriate ‘benchmark’ for comparison”.

The answer thankfully is obvious, as we are in the fortunate position in Australia of having the Future Fund, a well-resourced investment management organisation, with a long-term investment horizon, whose investment decisions are unconstrained by artificial restrictions imposed by Regulators.

The 'Gold Standard' reference point for regulators wishing to, "focus is on whether existing regulatory settings need to be re-examined and debated", would be to ask whether existing or proposed regulations restrict Sophisticated and Institutional Investors from following the investment strategies adopted by the Future Fund?

The simple answer to that question today is that "yes", existing regulatory setting do restrict investors from adopting the Future Fund's investment strategies, and therefore those regulations will be costing investors opportunities for higher risk adjusted returns and do need to be re-examined.

f) Definitions of Risk

Similar to the term 'Private', the Discussion Paper refers to the concept of 'Risk' in multiple dimensions. In particular, the Discussion Paper's references to 'Risk' as it relates to investment decision making and returns, do not align with how investments are actually made.

As noted above, Sophisticated and Institutional Investors do not invest with the average manager. Well-structured and resourced processes are employed, using both internal and external sources.

In the same way that this selection process allows for the identification and selection of investment managers who will add value after fees over time, it also addresses the 'key risks' that ASIC has identified as applying to Private Investments, including opacity, conflicts, valuation processes, illiquidity and the use of leverage.

The use of Manager Skill by Sophisticated and Institutional Investors in the manager selection process provides the basis for operational and malfeasance risks to be identified, evaluated, and managed through the acceptance of that risk or the introduction of risk mitigations.

This appears to be the view expressed by professionally managed Superannuation Funds (Investor Daily, 2025, 8 April)

g) Regulatory Framework – Liquidity Risk

The regulatory framework, particularly that applying to Superannuation Funds, has evolved significantly over the last decade. The most obvious changes have included:

i. The active encouragement of increased concentration in Funds;

ii. Portability regulations (requiring 3-day Fund transfers); and

iii. Increased encouragement for members (and financial advisers) to switch Funds as a result of; Increased Fee focus (YourSuper), Performance Tests (with letters to fund members), and the ATO's YourSuper Comparison Tool.

The combined effect of these, and other policy changes, has been to significantly <u>increase the likelihood of a 'run' occurring on a Super Fund</u>. If this occurs with a large Fund (as occurred in 1979 with St George Building Society) then the resulting disturbance would be likely to have systemic implications as the liquidity mis-match between Funds' investments and member liquidity comes into play.

This however, is an artificial risk that has been created by regulation. Given the long-duration of Superannuation Funds' obligations, there is no inherent mis-match at an industry level between Funds' obligations and illiquid investments (including illiquid Private Investments).

As this risk has been created by regulation, then the most efficient and least distorting method of addressing it (the first best solution) would be via regulatory mitigation. That is, it should be the regulators' duty to provide a solution – such as through making a substantial line of credit available to the industry.

I would expect however that it would be much more likely that having created the problem, regulators will shift the responsibility for managing it by imposing additional liquidity restrictions on superannuation funds' investments, and requiring the creation of substantial capital reserves by RSE licensees.

If introduced, such requirements will further constrain the investment processes of Australian Superannuation Funds, with likely adverse effects on members' returns (i.e., a second (or third, or fourth) best solution).

h) Regulatory Framework – Investment Distortions

As has been widely discussed, the inclusion of investment fees in the fees reported under Regulatory Guide 97 has had, and continues to have, significant distorting effects on Superannuation Funds' investment decisions. This effect has been explained previously (Peterson 2022 p. 16-17).

If we make the very conservative assumption that the investment distortions arising from MySuper, RG 97, the Heatmap and the Performance Test, are reducing investment returns to members by only 0.25% p.a. across the $2.7 Trillion of APRA regulated superannuation funds, then this equates to more than $6 Billion of lost returns to superannuation fund members <u>each year</u>.

The simple reality is that there is no 'magical creation' of returns in investing. To earn returns greater than the cash rate it is necessary to take Investment Risks. These can be either Market Risks, or Manager Skill risks. Market risks are close to free, while investors have to pay a <u>price</u> to access Manager Skills.

Implicit in MySuper, and RG97, is the counterintuitive idea that returns from Manager Skills appear as if by magic and therefore manager fees reduce returns to members. Thus, manager fees are treated as a 'cost', with a negative expected contribution to returns.

This is contradictory to the position expressed in the Cooper Review (2010), which supposedly provided the justification for the current regulatory structure.

Overall:

> "there was no evidence to support the Disclosure Regime's treatment of the Price of Investment Management as a Cost that reduces investment returns by 100% of the expenditure". (Peterson, 2019, p9)

Section 2 – Assertions and Questions

The assumptions identified in Section 1 contribute to the appearance of a number of issues in the Discussion Paper. In addition, there are a number of assertions made that do not correspond to actual market conditions. I will comment on these assertions first and then address the specific questions posed.

a) Assertions made in the Discussion Paper

Fees

> "Private capital funds typically charge management fees of 1.5% to 2.5% of committed capital, and a 20% performance fee with a hurdle rate of 8%" (Page 38)

This statement is inaccurate when applied to Private Credit and Private Infrastructure, where fees are much lower. Some Private Equity Funds and Hedge Funds may ask these fees of smaller investors, but these would not be acceptable for most Institutional Investors.

> "Service fees to portfolio companies. These fees are typically opaque and the cost is ultimately borne by investors" (Page 39)

Service fees are typically declared to Sophisticated and Institutional Investors and capped or rebated at appropriate levels. (Note: A large part of the trend to move from explicit to more opaque 'service fees' is a direct response to ASIC's and APRA's current regulatory stance with respect to Superannuation Fund investment fees.)

Performance

> "The performance of private capital funds is more challenging to assess than that of managed funds that invest in public market assets, as it relies on information provided by fund managers." (Page 39*)*

This assertion is not generally accurate. Many private investments are subject to regular valuations by independent third-party valuers, and in most cases, they are reviewed by an Investor Valuation Review Committee or equivalent.

Valuations

> "As discussed in Report 807, the complexity and opacity of some private market fund structures, especially those with multi-layered fund arrangements, can create substantial valuation risks for the end investors." (Page 39)

I could not find any reference to 'Complexity' or 'Opacity' in the Report 807, so I am unable to comment specifically on this assertion.

> "Fees and leakage of economic value: Private market funds charge substantially higher fees than public market funds. This represents a potentially substantial leakage in economic value from investors." (Report 807: Executive Summary)

This statement reflects the classic academic position that Manager Skill does not add value, and therefore ignores the fact that Private Market funds have more Manager Skill than Public Market funds, and therefore, while having higher fees, also have higher expected returns net of fees.

> "Some market practitioners have expressed concerns about the quality of private asset valuations and whether they are sufficiently responsive to changes in market conditions evidenced by downward movements in the public market." (Page 39)
>
> "Confidence in valuations is particularly acute when private assets experience distress." (Page 40)

This is a potentially valid area of concern - however it applies equally to both public and private market investments.

Public markets are not 'efficient' pricing systems with perfect foresight and no 'Animal Spirits' (Keynes 1936). Therefore, public market values are always incorrect to some degree, with these deviations from true/fair value potentially being very large at times.

It could be argued that independent valuation processes based around strategic valuation parameters may be more representative of true 'value' than 'market' prices for some long-term assets for investors with long investment horizons.

In general, we tend to see assets in Private Equity funds realised for significantly more than their carry values. This suggests that the greater 'risk' to investors is undervaluation of Private Investments.

Leverage

> "Company directors have highlighted to us that private companies have a substantially bigger appetite for leverage than public companies." (Page 40)

Care needs to be taken to avoid generalizing the characteristics of some Private Investment strategies to all. While it is true that some Private / Alternative investments strategies, such as Leveraged Buy-Out Equities and Global Macro Hedge Funds, do frequently employ significant leverage, this is not generally the case in other Private Capital Fund strategies.

Public vs Private Companies

> "The trade-offs that companies face in deciding to go public appear to have altered as private capital has become more readily available." (ASIC Report 807: Page 54)
>
> "Companies' ability to stay private for longer due to the increased availability of equity and debt capital through private channels, including international investment" (Page 27)

These reasons appear to be consistent with market realities. In the past it was necessary for companies to access capital through mechanisms that aggregated many smaller investments into the scale of capital that they required. With larger domestic and international sources of capital available companies have more options to access capital while remaining private.

> "A common reason cited for staying or taking a company private was the flexibility to focus on the medium- to longer-term operation of the business and shareholder returns" (Page 28)

This reason is consistent with the views expressed above that private companies have a greater exposure to Illiquidity Risk, and therefore would be expected to generate higher returns for investors with appropriate longer-term investment horizons.

> "It is important for investors to understand the different risk profiles associated with private companies and investment structures when comparing the performance of public and private companies. With interest rates no longer at the historically low levels that previously fuelled the rapid growth of private markets, high leverage could negatively affect private market investments." (Page 40)

I am not convinced by this reasoning. Lower interest rates also facilitated an expansion of price / earnings ratios in publicly traded equities. It is unclear whether public or private securities will feel the greater impact of higher rates over time.

Equity Returns

An important issue that appears to be misunderstood by ASIC in the Discussion Paper are the Returns to be expected from investing in Public (Listed) Companies, Private (Unlisted) Companies and companies owned in Private Equity (PE) structures.

In MPT, with associated versions of the Capital Asset Pricing Model, the primary determinant of investment returns from equities is assumed to derive from the company's share price volatility relative to that of a 'Market Index'. That is, the expected return of an equity is determined by its Beta (β) relative to the 'Market'.

Unfortunately, the concept of Beta is meaningless, except under the extremely restrictive assumptions which underly MPT.

If we consider the Private (Unlisted) Company as a starting point, then there are two main variations around the investment risk/return profile:

1) An increase in the amount of Manager Skill in companies in a PE structure, with the additional Manager Skill contributed by the PE Manager; or
2) A decrease in Illiquidity Risk through the listing of the company on the Stock Exchange.

   Listing makes the holding of equities more liquid, and therefore reduces Illiquidity Risk. As Illiquidity risk is an Investment Risk that earns a return, then the act of listing a company will reduce Investment Risk, and therefore lead to lower returns.

   Note: Price volatility, which comes from listing a company's shares, is not an Investment Risk and therefore is not rewarded with additional returns.

   Therefore, the expected return profile for equity investments over time is:

   1) Highest return: Private Equity
   2) Middle return: Unlisted Equity
   3) Lowest return: Listed Equity

This ranging is consistent with, and explains, the expected return profile widely held by Sophisticated and Institutional Investors and consultants.

Therefore, we would expect to see very large investors, such as the consolidated Superannuation Funds encouraged by regulators, to prefer 100%, or partner, ownership of companies, as they are then able to manage the business to a longer time horizon – which is more consistent with funds' liabilities – and which will generate higher returns over time.

Superannuation Funds and Private Assets

> "The size of superannuation funds' AUM relative to the size of the Australian public equity market, and their drive for diversity, have necessitated that they seek alternative investments." (Page 22)

This statement does not appear to be supported by evidence.

The proportion of superannuation fund assets invested in Australian equities appears to have remained relatively steady at around 20-25% of AUM. This has occurred while superannuation fund assets have increased their proportion of investments in listed Australian Equity Markets. This does not indicate that Superannuation Funds have been 'squeezed out' of the market in response to their increased AUM.

The increase in international equity holdings would be more likely to be attributable to improved risk / return prospects from international equities relative to fixed interest investments (which became less attractive as interest rates declined), and the reduced attractiveness of higher fee Private investments following regulatory changes over the last decade.

Superannuation Funds: Regulatory Settings

The Discussion Paper asserts that:

> "Consolidation of superannuation funds has had clear benefits for the superannuation savings of Australians, with a number of poor-performing funds exiting and improvements in long-term sustainable outcomes for superannuation members." (Page 22.)

This assertion paints the results of regulators actions in an overly positive light.

As explained below, there is strong evidence to suggest that increased regulation (including consolidation) of superannuation funds has negatively impacted superannuation returns, with no evidence to support the assertion that there have been "clear benefits for the superannuation savings of Australians".

b) Responses to Discussion Paper Questions

Developments in global capital markets and their significance for Australia

1. *What key impacts have global market developments had on Australian capital markets? What key impacts do you anticipate in the future? Please provide examples from your experience.*

   Over the last 46 years I have observed many developments in Australian capital markets, the vast majority of which have arisen from domestic sources.

   Australia is a small open economy, and as a result has developed a financial system that is in many ways more sophisticated than larger economies that are more insular in their dealings. Thus, Australian Institutions were early adopters of sophisticated currency management and financing methods, derivatives and Private Investments.

   Historically, by the 1970's, the Australian financial system was in stasis, dominated by a small number of major banks and mutual life insurance / superannuation funds (e.g., AMP and National Mutual).

Following the release of the Report of the Campbell Committee of Inquiry into the Financial System in 1981, there was an extensive deregulation phase which saw the 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.

Over the last 25 years, and particularly following the Global Financial Crisis, we have been in a reregulation phase. This has seen the imposition of risk weighted capital requirements on banks, and the introduction of MySuper, RG97, the APRA Heatmap and The Performance Test, among many other regulations, on Superannuation Funds.

We have now largely returned to the stasis situation of the 1970's with a small number of banks and a small number of mutual funds (i.e., Industry Funds) dominating the superannuation sector.

The effective restrictions placed on superannuation funds' investments by the incorrect treatment of investment fees, and the high level of organisational risks that come from deviating from 'SAA' index structures, are now at least as great, and therefore as distorting, as those imposed on superannuation fund investments in the 1970s.

It is also notable that many large superannuation funds are now replicating the investment processes of the AMP and National Mutual by moving to internal investment management structures, with a significant driver being a reduction in investment fees. Historically this approach did not produce superior outcomes for investors.

Given that the Cooper Review of Superannuation did not recommend any of these investment controls and restrictions, and as the superannuation industry has been performing well in the areas of investment returns, I am at a loss to understand the motivation for the reregulation of the last 15 years. Australian superannuation investors have been clear losers, and the only winners that I can identify have been index providers, index fund managers, and the regulators themselves.

It is notable that no attempt has been made by ASIC, APRA, the Treasury or the ACCC to measure the combined impacts on superannuation funds' investment returns from MySuper, RG97, the APRA Heatmap and the Performance Test.

Given the current scale of the superannuation sector I would expect that regulators will, in the relatively near future, begin to require mutual superannuation funds to acquire significant capital reserves, which will lead to demutualisation, as occurred with the dominant mutual organizations of the 1970's.

2. *Do you have any additional insights into the attraction of private markets as an issuer or an investor?*

   As explained above, we would expect to see very large investors, such as the consolidated Superannuation Funds encouraged by regulators, to prefer 100%, or partner, ownership of companies, as they are then able to manage the business to a longer time horizon – which is more consistent with funds' liabilities – and which will generate higher returns over time.

3. *In what ways are public and private markets likely to converge?*

   As noted above, the investments traded in Public and Private markets are structurally different (i.e., have different combinations of the 7 investment risks). They are therefore not intrinsically likely to converge.

   It is for this reason that the assertion made in the Discussion paper questioning the outperformance of Private Investments over Public Investment is misleading:

   > "One of the drivers of growth in private markets is the perception that private market assets tend to outperform those in public markets. However, it can be challenging to make like-for-like comparisons due to the lack of public reporting by private capital funds."

   Public and Private investments are different. It is therefore not meaningful to attempt to make "like-for-like comparisons". What is relevant is that well informed Superannuation Fund Trustees make decisions to invest in Private Investments and are prepared to pay a price (investment fee) to access those characteristics and returns.

   What is apparent from the Discussion paper is that ASIC has little understanding of the actual reasons underlying Superannuation Fund Trustees investment decisions.

4. *What developments in public or private markets require regulatory focus in Australia in the future?*

   Distortions in optimal allocations, and resultant costs to investors, between Public and Private Investments created by existing regulations should be addressed first. These are almost certain to have a much greater impact on Australian Superannuation Investors than any probable future development in public or private markets.

Healthy public equity markets

5. *What would make public markets in Australia more attractive to entities seeking to raise capital or access liquidity for investors while maintaining appropriate investor protections?*

   I do not profess to have sufficient experience to provide a definitive opinion.

6. *Do you agree that a sustained decline in the number, size or sectorial spread of listings would negatively impact the Australian economy? If so, can you suggest ways to mitigate any adverse effects that may arise from such changes?*

   As a small open economy, it is to be expected that Australia will become specialized in production in a relatively small number of areas. The domestic economy supports

a number of domestic focussed sectors, with mineral extraction, agricultural products and some advanced manufacturing able to compete internationally. History has demonstrated that it is generally difficult, if not impossible, to oppose market forces for extended periods.

A sector where Australia should be capable of being internationally competitive is in financial products based on the application of Manager Skill to investments. Australia has a relatively long history of, and remains a leader in, applying Manager Skill in infrastructure investing.

It is difficult however to see these comparative advantages being successfully developed in other areas when domestic regulation is actively stifling the industry.

7. *To what extent are any greater expectations of public companies, compared to private companies, the result of Australian regulatory settings or the product of public scrutiny and community expectations of these companies?*

   It is not clear that this is the case. Expectations for all enterprises operating in Australia are high.

Private market risks and market efficiency and confidence

8. *Are Australian regulatory settings and oversight fit for purpose to support efficient capital raising and confidence in private markets? If not, what could be improved?*

   From a regulatory perspective, a fundamental issue concerning Private Markets is the extent to which regulation or investor negotiation should be relied on to promote the efficient operation of the market and investor interests.

   Having been responsible for recommending Alternative (including Private) Investments to Investment Committees over many years as an independent consultant, Head of Alternative Investments and Chief Investment Officer, my experience has been that Institutional Investors are more than capable of assessing Private Investments and protecting the interests of their investors.

   Given this, current Australian regulatory settings and oversight are not fit for purpose.

9. *Have we identified the key risks for investors from private markets? Which issues and risks should ASIC focus on as a priority? Please explain your views.*

   Most of the risks identified by ASIC are manageable by Sophisticated and Institutional Investors through appropriate analysis, due diligence and mitigation.

   The position stated in the Discussion Paper is that:

   > "Like investment risks in all markets, an investor's capability in identifying, managing and mitigating the risks is important for investing success." (Page 38)
   >
   > "Our regulatory framework assumes that wholesale investors are in a better position to look after their own interests than retail investors." (Page 36)

   This view appears to be well founded given my extensive experience in Private Investments in the Institutional market.

10. *What role do incentives play in risks, how are these managed in practice by private market participants and are regulatory settings and current practices appropriate?*

    In the Discussion Paper ASIC asserts that:

    > "Incentives in the private fund business model gave rise to conflicts of interest, such as private fund advisers not disclosing economic relationships with certain investors or third-party providers, or instructing the portfolio companies they controlled to hire the adviser, an affiliate or a preferred third party to provide certain services." (Page 37)
    >
    > "Furthermore, to address information opacity, investors in private market assets often rely on advisers or service providers to assist them with their investment decisions. These third parties may have incentives that do not align with investors' interests, which could be exploited and result in investor detriment." (Page 41)

    Evidence is that the assessment and due diligence processes employed by Sophisticated and Institutional Investors are adequate to manage these areas of concern.

Retail investor participation in private markets

11. *What is the size of current and likely future exposures of retail investors to private markets?*

12. *What additional benefits and risks arise from retail investor participation in private markets?*

13. *Do current financial services laws provide sufficient protections for retail investors investing in private assets (for example, general licensee obligations, design and distribution obligations, disclosure obligations, prohibitions against misleading or deceptive conduct, and superannuation trustee obligations)?*

    Superannuation funds provide retail investors with exposure to private assets. Importantly, these investments occur within a structured framework matching portfolio risk to investors' long-term investment requirements.

    As noted above, Superannuation Funds and other Sophisticated Investors have the requisite skills and processes to investigate, assess, and mitigate the risks associated with Private Investments. These include determining an optimal allocation between Private / Alternative and Public / Mainstream asset classes.

    ASIC's focus in the Discussion Paper does not appear to explicitly consider the role of Private Investments in a diversified portfolio. Instead, the Discussion Paper appears to primarily focus on Private Funds as stand-alone investments. This is not consistent with the way that Sophisticated and Institutional Investors construct their portfolios.

    As explained above, I am comfortable that Sophisticated and Institutional Investors have processes and access to the skills necessary to effectively manage Private Investments in their portfolios. In respect of the specifics around retail investors investing in Private assets, I do not profess to have sufficient knowledge and experience to form a definitive opinion.

Of much greater concern would be the risk that regulators implement policies and regulations that treat Institutional Investors as only having the capabilities of retail investors in making Private Investments and impose unnecessary regulatory restrictions on these investments.

Transparency and monitoring of the financial system

14. *What additional transparency measures relating to any aspect of public or private markets would be desirable to support market integrity and better inform investors and/or regulators?*

The Discussion Paper states that:

> "The opacity of private markets means regulators need to take different approaches. Without the tools and information needed to target our regulatory activity, the likelihood of regulatory interventions effectively responding to market conduct problems is diminished. For this reason, we emphasise the need for greater transparency and monitoring of our capital markets to keep pace with market developments." (Page 33)

> "Data transparency helps regulators supervise conduct to support market integrity and confidence. Data also helps regulators monitor the broader financial system to identify ways to improve efficiency and address potential systemic risks." (Page 44: 3.4 Transparency and monitoring of the financial system)

As a general comment, my observation has been that Australian regulators (with the possible exception of the RBA) have tended to be over-reliant on, and place too much faith in, data collected through regulatory surveys.

This was particularly illustrated with the Superannuation Funds SRS 533.0 Asset Allocation data that APRA relied on for the first few years of the Heatmap and Performance Test. The fact that the data collected was not fit for purpose was pointed out to APRA on many occasions, but this did not alter the regulator's decision to base its actions - to close products and require fund mergers - on this data.

Data collection on Private Investments

The statements made on pages 44 and 45 of the Discussion Paper indicate that ASIC has already come to a view on the desirability and benefits of increasing data gathering and reporting and publicising this information, as is further indicated later on page 45 of the Discussion Paper:

> *"These enhancements to our evidence base would support policymakers and regulators in improving the financial system's performance, supervising regulated entities and monitoring financial stability risks. Making this data publicly available would also improve consumer and industry outcomes and competition by providing clear, current and accurate information for making investment and commercial decisions."* (Page 45)

Unfortunately, these statements, as far as they relate to Private Investments, are better characterised as 'motherhood statements' rather than soundly, research based, policy positions. Similar arguments were made to justify increased fee disclosure under RG 97, with no evidence of any net benefit being created.

I have only **one specific investment concern** related to ASIC seeking more information on Private Markets. This concern is that ASIC may restrict access to those investments or investment vehicles that, for their particular reasons (such as commercial confidentiality) are unable or unwilling to provide the requested information.

Institutional Investors are more than capable of assessing Private Investments and protecting the interests of their investors. To impose on institutions the types of restrictions that may reasonably be applied to unsophisticated retail investors would further limit the ability of Superannuation Funds, and similar organizations, to create value for their members. This would be to the ultimate detriment of individuals and the economy.

Use of collected data

While, as noted above, I have only one particular investment concern with ASIC seeking to collect additional statistical data on Private Investments, I do have **a major concern** as to how that data may be used in the future. These concerns stem from the APRA Heatmap and APRA Performance Test debacle.

APRA and ASIC are happy to trumpet the benefits of the Heatmap and the Performance Test, as reflected in the Discussion Paper's assertion that:

> "Consolidation of superannuation funds [which was significantly driven by APRA's policy with respect to the Heatmap and Performance Test] has had clear benefits for the superannuation savings of Australians, with a number of poor-performing funds exiting and improvements in long-term sustainable outcomes for superannuation members." (Page 22)

This assertion mirrors APRA's claim that:

> "This year's results demonstrate the progress being made to address underperformance. At the end of June, all 15.7 million MySuper member accounts, with combined assets of nearly $1.1 trillion, were invested in performing products." (APRA media Release 30 August 2024.)

There is nothing to support the claim that these actions have, "had clear benefits for the superannuation savings of Australians". The reality is that these claims are not supported by evidence, and fail to reflect that the Heatmap and Performance Test results prior to 2024 were badly distorted by data issues.

As result, APRA's actions to close 'underperforming' products and encourage fund mergers caused significant costs to superannuation fund members with no evidence to suggest that this was associated with improved outcomes.

The source of this debacle, which I am concerned may be repeated by ASIC, was the use of data collected under SRS 533.0 Asset Allocation (and related forms), in the Heatmaps and Performance Tests. The difficulty arose from the fact that when established in 2015, the information collected under SRS 533.0 was not compatible with its subsequent use in the Heatmap and Performance Test.

For example, a number of Superannuation Funds had asset classes that were named to reflect the expected performance and outcome of the investments. In particular this included 'absolute return' investments (asset classes) that, consistent with their naming, sought to deliver absolute positive returns to members through investing primarily in cash and low risk credit investments. Data about these asset classes were provided in SRS 533.0 returns under an 'Absolute Return' definition.

In APRA's subsequent use of the data in the Heatmap and Performance Test, 'Absolute Return' investments were deemed to be 'absolute return hedge funds', and benchmarked against indices with a significant exposure to equities. This meant that, in the performance assessments, superannuation products with allocations to 'Absolute Return' asset classes (that actually produced cash like returns) had returns well below the equity-based returns assumed in APRA's modelling.

As a result, a number of superannuation funds' products 'failed' the Heatmap and Performance Test measures, and were forced to send letters to members and to close products, even though they were performing in line with their objectives and meeting members requirements.

APRA proclaimed, and continues to proclaim, these closures as 'successes', even though they removed effective products from the market. In several cases, superannuation products that 'failed' the performance measures, leading to members redeeming from them, performed very strongly in subsequent years, with significant opportunity costs to those members that had redeemed their investments.

APRA now proclaims that, as a result of its actions, all MySuper assets, "were invested in performing products". This statement is misleading.

The real reason for all funds outperforming the Performance Test thresholds for periods to June 2024, was that a new reporting regime was introduced (SRS 550.0 Asset Allocation and related forms) as of 30 September 2023, and Superannuation Funds were, knowing how the data would be used, able to correctly record their asset allocations under the investment categories specified in SRS 550.0. This therefore eliminated the major distortions resulting from the use of SRS 533.0 data.

With these distortions removed, 100% of MySuper and non-platform Trustee Directed Products 'passed' the Performance Test.

It is in fact likely that the products and funds removed as a result of the inaccurate measures underlying the Heatmap and Performance Test prior to 2024, were also 'performing' products.

There is no evidence to indicate that Superannuation Funds have improved their performance, which would lead to “improvements in long-term sustainable outcomes for superannuation members”, or that APRA’s actions have been beneficial.

It is a major concern that ASIC has adopted a similar approach to APRA with its use of the broad, and ill defined, term ‘Private Market Funds’ in the Discussion Paper. It would be much better going forward to limit discussions to well defined investment strategies that are already used and understood by the investment industry.

Superannuation Fund Performance

Importantly, the 2024 Heatmap and Performance Test results show that **every Australian Superannuation Fund is adding value over and above static asset allocation benchmarks**. They are achieving this through the active management of their investment portfolios (i.e., employing Manager Skills). It is critical that ASIC’s regulations related to actively managed Private Investments do not further hinder this process.

15. *In the absence of greater transparency, what other tools are available to support market integrity and the fair treatment of investors in private markets?*

As noted initially, my knowledge and experiences relate primarily to Institutional investments. In respect of the specifics around retail investors investing in Private assets, I do not profess to have sufficient knowledge and experience to form a definitive opinion.

John Peterson

28 April 2025

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