Standard Risk Measures

An Overview of Standard Risk Measures in Practice

June 2013

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Comparability between investment options has long been an issue for superannuation fund members looking to assess which option is the most appropriate for their circumstances. Between 2002 and 2007, when members enjoyed strong double digit returns, risk was a secondary consideration as members chased ever higher returns. However, the market turmoil experienced since 2007 provided a salutary message to funds and their members about the importance of focusing on risk-adjusted returns.

Unfortunately, the lack of consistency in investment labelling has made finding the right investment option a source of confusion for those members worried about the security of their retirement nest egg. This issue has been consistently highlighted in the area of investment objectives for many years, but highlighting this from a risk management perspective has proved a greater challenge.

Understanding the objectives and risk of options has been extremely challenging for members and funds, as:

i) For funds, the issue of disengagement amongst members and lack of financial literacy is a constant headwind.

ii) For members, even those who are engaged and financially literate, vague and ill-defined investment objectives can make meaningful comparisons almost impossible.

Since 2008 SuperRatings' has been advocating the need for clear and measurable disclosure of three key figures as part of each investment option's stated objective. These are:

1. A "CPI Plus" return objective (for example, 'to achieve a return that exceeds CPI by 3.5% pa');
2. A clear timeframe, disclosed in years, over which the return objective is to be achieved (for example, 'over a 5 year period'); and
3. The risk of a negative return (for example, 'a likelihood of 1 year of negative returns in any 10 year period').

Despite the ongoing, albeit slow, development of clearer return objectives, a material proportion of funds continue to disclose multiple conflicting objectives that do little to provide clarity. In response, it is pleasing to see APRA's move to partially address the issue of comparability by requiring standard disclosure of the risk of a negative return to fund members in all Product Disclosure Statements (PDS) issued on or after 22 June 2012. This has helped prompt some funds to review their objectives at the same time.

The introduction of the Standard Risk Measure, jointly developed by the FSC and ASFA, which aims "to provide members with a descriptor to assist in comparing investment options (both within and across superannuation funds) utilising a simplified risk measure"[1] has also had a positive effect. In this instance, risk is defined simply as the estimated number of negative annual returns over any 20 year period.

Risk Band	Risk Label	Estimated number of negative annual returns over any 20 year period
1	Very Low	Less than 0.5
2	Low	0.5 to less than 1
3	Low to Medium	1 to less than 2
4	Medium	2 to less than 3
5	Medium to High	3 to less than 4
6	High	4 to less than 6
7	Very High	6 or Greater

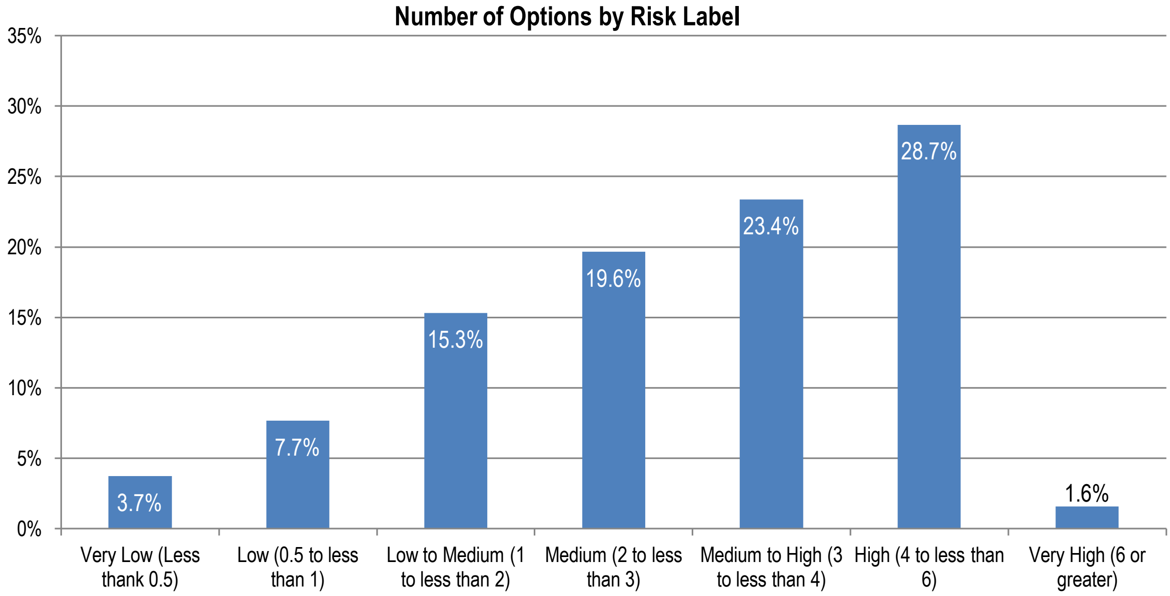
[1] FSC/ASFA Standard Risk Measure Guidance Paper For Trustees, July 2011

Application of Standard Risk Measures

With APRA's disclosure requirement in place for almost a year, the vast majority of funds have now introduced the FSC/AFSA Standard Risk Measure into their publically disclosed investment objectives. We would note that the clarity of the disclosure ranges from the easy to find, to the downright difficult.

To help provide clarity on this issue, SuperRatings' has undertaken an analysis of how the standard disclosure framework has translated into real-world outcomes. Our sample set for this analysis includes the 509 Diversified accumulation investment options within the SuperRatings Fund Crediting Rate Survey, and covers the Not for Profit, Retail Master Trust, Corporate and Government sectors.

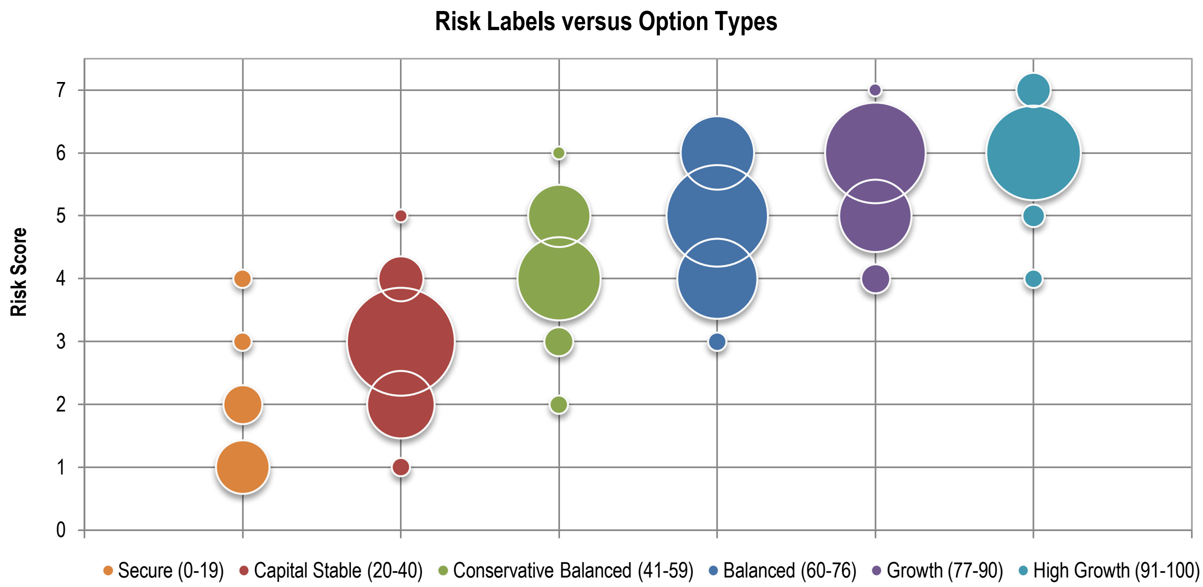
Disregarding the underlying style of the option, the following chart shows the number of diversified options categorised under each Risk Label:



Given the relatively large exposure to Australian and International Listed Equities across superannuation funds, it is not surprising that the most common risk label is 'High' (representing between 4 and 6 years of negative returns in any 20 year period), with approximately 29% of options in our analysis using this categorisation. 'Medium to High' and 'Medium' risk labels are the next most common, representing 24% and 20% of options respectively. At either end of the risk spectrum, less than 4% of diversified options are categorised as the least risky 'Very Low' label, while less than 2% are labelled with the riskiest 'Very High'.

Despite the requirements for standard disclosure, the methodology used to calculate the Standard Risk Measure has been left to individual funds. Trustees are required to develop their own set of capital market assumptions encompassing return, volatility and correlations for each asset class. Whilst the FSC/ASFA guidance states Trustees should use a conservative approach in establishing these assumptions, this does open up the possibility of funds 'gaming' their models to achieve a more desirable label. There has also been a trend for funds to disclose risk scores over short, medium and longer timeframes. While we commend funds for transparency, we would also caution that disclosures should help members to make decisions and not overwhelm members with information.

The following chart compares each option's Standard Risk Measure relative to its option type, defined by SuperRatings' as the percentage of each option invested in Growth assets. The size of each circle reflects the relative number of options in each category.



Whilst risk labels generally rise as the proportion of growth assets increases, the chart above illustrates the problem with traditional labelling. This is especially true for Balanced (60-76) options, which are commonly used as fund's default options, and hold the majority of superannuation member's savings. This analysis found that:

- 24% of Balanced (60-76) options are categorised as 'High' risk.
- 46% of Balanced (60-76) options are categorised as 'Medium to High' risk
- 29% of Balanced (60-76) options are categorised as 'Medium' risk
- 1% of Balanced (60-76) options are categorised as 'Low to Medium' risk

This means that a member in a "Balanced" option could potentially expect to receive negative returns in between 1 and 6 years over any 20 year period, despite the relatively narrower range in actual Growth assets of between 60%-76%.

While the aim of this initiative is to provide members with greater clarity, our analysis suggest that the range of outcomes remains extremely broad. Accordingly, members could interpret these differences in one of two ways:

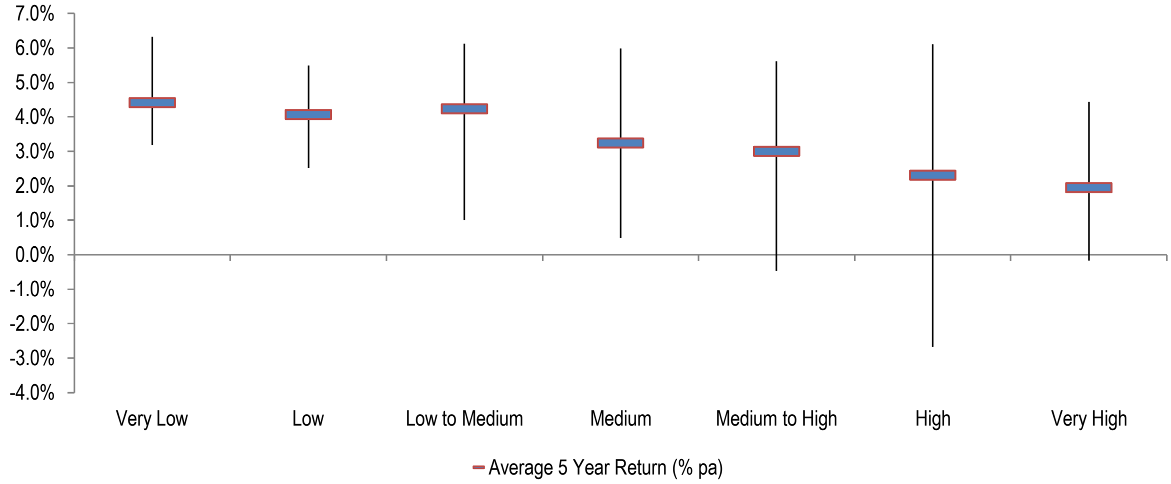
1) That there are legitimate differences in portfolio construction and manager selection between funds, in which case the new Standard Risk Measure provides a useful addition to disclosures.
2) The difference in labels does not reflect any true differences between each portfolio; rather, the label is largely a function of the assumptions used as inputs into each fund's model.

In the second case, rather than assisting members in comparing option between funds, the Standard Risk Measure simply provides a false sense of security that could be damaging in the long run. As with many risk measures, these issues are compounded by the fact that the Standard Risk Measure put in place does not have any regard for the size of potential negative returns.

Standard Risk Measures – Risk and Return Characteristics

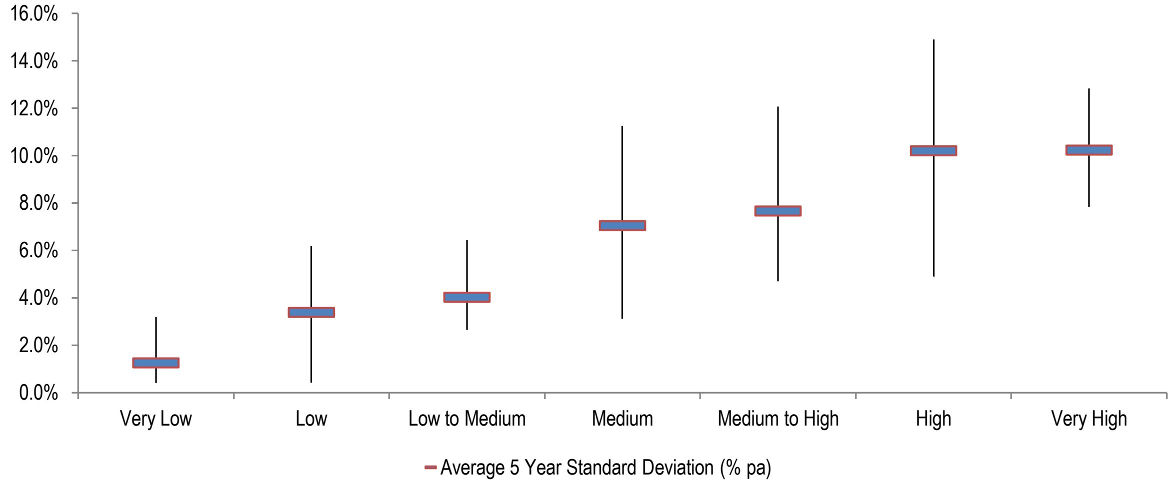
Another worthwhile way in which risk labels can be examined relates to their classification relative to returns and volatility. To examine the real world outcomes from risk labels, classifications relative to returns and volatility have been compared over 5 and 10 year periods.

Range of 5 Year Rolling Returns (% pa)
As at 31 March 2013



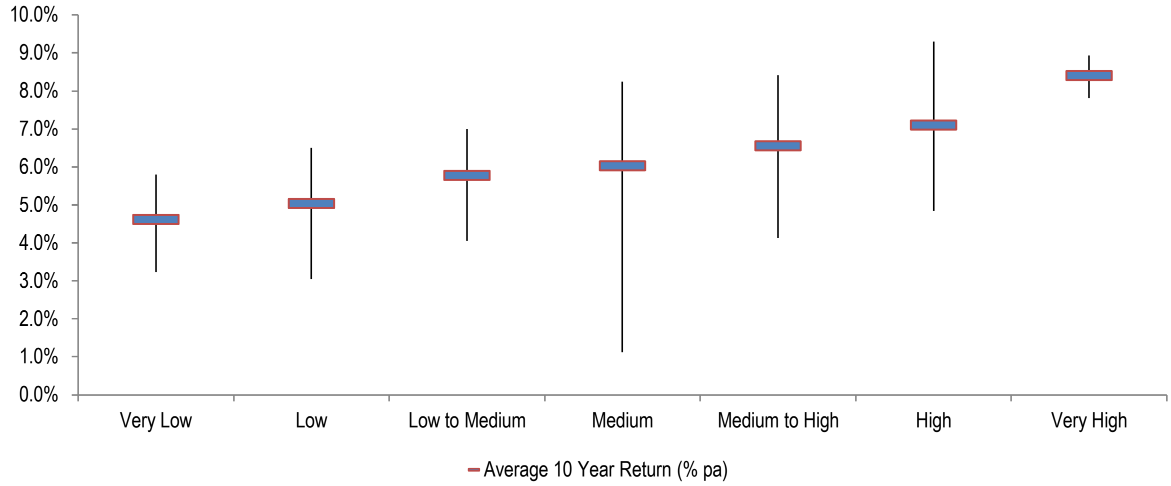
Continued uncertainty in listed markets across the world over the medium term has meant that returns from Defensive assets have generally been higher than those from more volatile Growth assets over the past 5 years. As current 5 year returns include returns from 1 April 2008, which is prior to the greatest losses of the GFC, the higher average returns are for those options categorised as less risky under Standard Risk Measures. It is also clear that higher risk options have displayed a wider range of returns over this period.

Range of 5 Year Standard Deviation (% pa)
As at 31 March 2013



Using standard deviation as a proxy for risk, it is also clear that the volatility of returns also increases as the risk label increases. An analysis of the standard deviation of returns over a 5 year period show a gradual increase in average risk with higher risk labels, together with a general larger spread in volatility.

Range of 10 Year Rolling Returns (% pa)
As at 31 March 2013



Over the longer term 10 year period, which covers a wider portion of the economic cycle, performance figures, relative to risk labels paint a picture of returns more in-line with theory. Here, the average 10 year returns display a gradual increase in return as the level of expected risk increases.

SuperRatings Fund Crediting Rate Survey

From April 30, SuperRatings will begin releasing **SuperRatings' Standard Risk Measure Survey** to all FCRS subscribers. This complements our existing Option Type Survey, which compares funds against peers based on asset allocation, and our Objectives Survey, which compares funds based on their performance against clearly stated objectives. This will be emailed to subscribers as soon as the survey becomes available and will be able to be accessed online. For any queries about subscriptions and access to the suite of Monthly Performance Surveys, please contact Phillip Hunt on 02 9247 4711 or phillip@superratings.com.au