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19 June 2026

Dear Sir/Madam,

Northcape Capital Pty Ltd (Northcape) is pleased to provide this submission in response to the Treasury consultation paper on strengthening the superannuation performance test.

We support the performance test's objectives to protect Australians' retirement savings by holding trustees to account for the investment performance they deliver and the fees they charge. We commend Treasury for its commitment to consulting with all stakeholders to explore opportunities to improve the test.

**About Northcape**

Northcape is an international boutique fund manager fully owned by its staff. We specialise in managing concentrated high-quality equity portfolios for clients. Our experienced investment team is focused solely on delivering strong performance for our clients over the long term.

Our focus on critical thinking in our research process drives an informed assessment of a company's sustainable competitive advantage. We believe that discovering and investing in high quality companies with a meaningful competitive advantage is the cornerstone of repeatable performance.

We believe that protecting capital in down markets is the foundation for superior returns over the long term. We have a strong and practical approach to risk that focuses on avoiding companies that are structurally challenged, highly geared or have poor Environmental, Social and Governance (ESG) standards.

Significant value-added returns since our establishment in 2004 has facilitated growth in funds under management to approximately A$18 billion, which includes approximately A$10 billion of funds invested on behalf of Australian superannuation funds.

We would welcome the opportunity to engage further with Treasury on the design and implementation of the proposed reforms. If you have any queries or comments in relation to the content of our submission, please contact Michael Ryan, Managing Director, on (02) 82343610 or by email michael.ryan@northcape.com.au.

Yours sincerely



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## Key recommendations

1. **Recognise that the test has had unintended consequences on equity markets.**

   The superannuation performance test has been an important consumer protection mechanism. Since its introduction, the test has materially improved transparency and accountability, reduced persistent underperformance, and placed downward pressure on fees. These are outcomes that are clearly in members' interests.

   However, the current design has also created unintended distortions in investment behaviour, particularly in listed equity markets. These distortions are systematic and increasing, and if left unaddressed, risk contributing to the undermining of the long-term member outcomes and of the efficiency of Australian capital markets.

   The superannuation sector is extremely large relative to the local equity market and the Australian economy. This means that any piece of regulation that affects the superannuation sector can have major flow-on impacts on the equity market and the economy. Any unintended behavioural effects are no longer confined to the fund level.

   We urge Treasury to consider the unintended consequences of the performance testing regime in addition to its stated objectives, remembering the maxim that "when a measure becomes a target, it ceases to be a good measure".

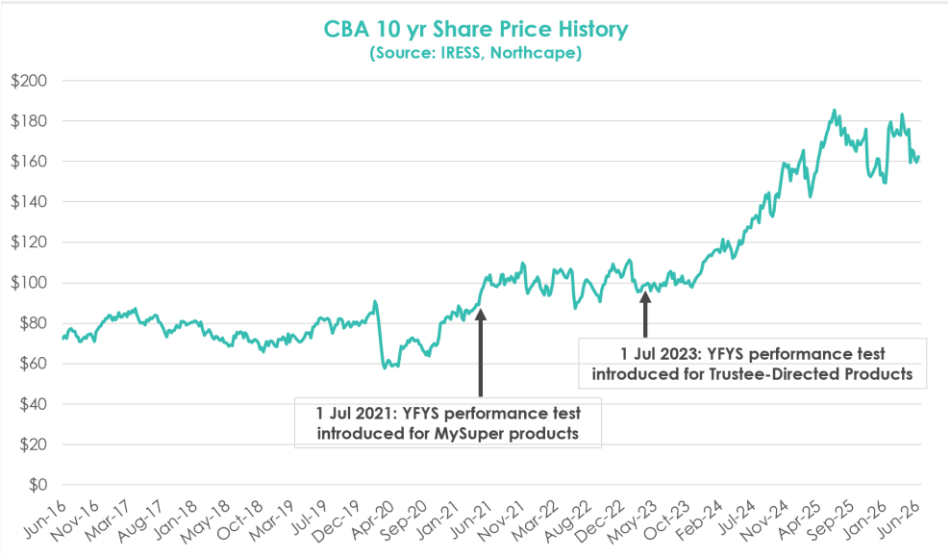
   The central issue is that the combined pressure of benchmark-relative performance and fee minimisation may create incentives for trustees to minimise tracking error to prescribed benchmarks and prioritise fee reduction in a way that is not always aligned with members' best long-term financial interests.

   This pressure on trustees is the consequence of failing the performance test in its current form (public notification, member attrition, and in some cases closure to new members) creating a highly asymmetric risk profile as there is no corresponding benefit for outperforming benchmarks. In listed equity markets, this can discourage active management and long-duration positions that are expected to add value over time but may create short-to-medium-term tracking error to a prescribed benchmark.

   Where large pools of capital have rising passive ownership then they behave in increasingly similar ways and the proper operation of the market is undermined:
   - price discovery deteriorates as fewer investors are willing to take differentiated positions,
   - portfolio adjustments are more likely to occur simultaneously, and market moves are more amplified (see Exhibit 1 which uses the CBA share price history as an example of where passive ownership had led to anomalies even for Australia's largest companies, which can increase absolute risk for members),
   - capital becomes concentrated in benchmark-heavy securities and allocation to emerging, smaller, or non-index opportunities is reduced,
   - equity market's ability to support capital raisings could be limited during the next crisis, as it did in 2009.
   - market pricing becomes more sensitive to flows rather than fundamentals.

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Exhibit 1: CBA share price history




Passive strategies also undermine the ability of trustees to oversee governance at investee companies. ESG and stewardship are long-term risk management and value creation tools which should be assessed as contributors to long-term member outcomes. ESG should be included where it is financially material, and separately recognised where it reflects member preferences. It should not be penalised simply because it creates tracking error.

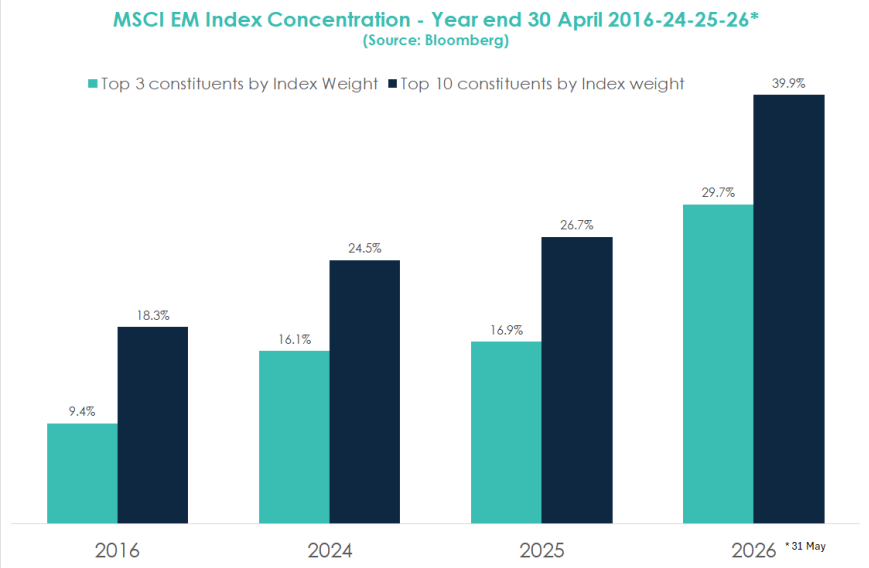
We note that Northcape has an interest in this matter, as an active equity manager. Regardless of our interest, a functional equity market is central to a modern economy. The equity market facilitates efficient capital allocation in the economy and a route to wealth creation for households. Any superannuation regulation imposed on the system has significant influence and should be considered very carefully. The performance testing regime influences capital allocations in ways that warrant ongoing monitoring to ensure alignment with long term member outcomes. For example, proposed adjustments could drive trustees into unlisted assets. We urge Treasury to directly engage with these unintended consequences and their impact on markets and the economy.

A further key issue is that the appropriateness of using benchmark variation as the measure of risk has changed in recent years. Coinciding with the introduction of the performance test in 2021, global equity indices have quickly evolved into very concentrated benchmarks, raising questions about whether benchmark-relative measures remain an effective proxy for diversification and risk management. To outperform the index in this environment requires the investment manager to take extraordinary risks, which may be contrary to members' best interest.

In the example of the Emerging Markets (EM) equity asset class, the MSCI EM index has become so concentrated over the past two years that it does not represent the broad nature of the asset class and no longer provides either a true reflection of the underlying drivers of emerging markets nor adequate diversification for investors (see Exhibit 2).

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Exhibit 2: Increasing MSCI EM Index Concentration 2016 to 2026 (28 May)




The EM index is supposed to represent 24 emerging countries, which together make up more than half of the world's population. Passive inflows into regional funds, Taiwan and South Korea - beneficiaries of the current AI boom have resulted in these two countries making up around half of the MSCI EM benchmark.

Related to the alarming increased concentration of the EM index is overexposure to a single investment theme: artificial intelligence (AI), and more specifically the frenzied global build out of AI data centres. Just three semiconductor stocks currently comprise more than 30% of the index. Crucially, should there be a correction in the index led by the AI-related heavy weight stocks, which totally dominate the index today, capital losses could be incurred by those funds using passive strategies for their EM equity asset class exposure. This capital loss would be reduced or potentially avoided under active EM strategies supported by portfolio constraints.

Many diversified investment strategies construct a portfolio by applying rules (portfolio constraints) designed to manage concentration, sector, country and security-specific risks. The increase in concentration of the benchmark has meant that the migration to more passive management creates more absolute risk for members.

The same increasing concentration effect applies to other global indices including the Australian ASX indices. Although, in Australia's case, this has been driven by different themes, i.e. banks and commodities, the same impacts of benchmark concentration apply.

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**2. Move from punitive closure to informed transparency and accountability**

The asymmetric risk profile created by the performance test has affected trustee incentives and created unintended consequences for markets. The way to address this is to ease the punitive consequences of failing the test, while continuing to provide transparency to members.

Instead of facing an existential risk, failing to meet the performance test should result in a more graduated intervention including forward looking remediation. Forced closure should be reserved for extreme and persistent failure.

Transparency improves accountability because it makes trustees visible, answerable, and comparable on an ongoing basis, not just when they fail. This creates continuous pressure to act in members' best interests without forcing uniform behaviour and allows members to make more informed choices rather than being forced into system-driven closures.

By shifting the trustees' focus from avoiding failure to transparently justify decisions, this allows trustees to take deliberate, explainable risk and to achieve better capital allocation. To achieve informed transparency, trustees must report not just returns, but outcomes, risks, drivers, and decisions in a clear, structured, and forward-looking way. This helps distinguish deliberate strategy from poor execution.

**3. Avoid using volatility as a measure of risk**

We understand the difficulty in establishing a performance test that is simple to apply, easy to understand, caters for a wide range of member objectives and provides trustees with sufficient flexibility without being gameable. We seek to highlight areas that Treasury should consider when refining the test.

If returns were to be benchmarked against return volatility, trustees would have a powerful new incentive to exit listed investments in favour of unlisted assets. Unlisted assets report lower volatility due to a different valuation methodology, not due to a different economic risk profile. This move would reduce volatility in a cosmetic sense only, enabling funds to report lower volatility and pass the test while imposing real costs on members in terms of reduced liquidity, reduced transparency of unit pricing, and higher fees.