Challenger Index Plus

For institutional clients only

How Challenger Index Plus helps super funds to boost returns and reduce costs

The added alpha and lower fee baseline

With the continued government scrutiny and reforms affecting superannuation, Challenger continues to work closely with institutional clients to deliver better performance at a compelling cost.

Finding ways to deliver consistent alpha within strict fee budget guidelines are familiar drivers of the investment management environment – these have always been our goals – but it has become the new base line for us all.

Over $150m in federal super reforms aim to save members $17.9 billion over a 10yr period.

"At $30bn a year, the superannuation fees Australians pay exceed the cost of household gas and electricity bills combined." Federal Treasurer Josh Frydenberg, 2020.

By enhancing industry transparency, the ASFA Heatmap seeks to drive a culture of continuous improvement[1].

Building confidence and alleviating fear are on everyone's to do list

The new Your Future Your Super regime, including new super comparison tools and the existing APRA heat map framework, will result in further pressure on super funds to reduce costs and generate excess returns above set benchmarks.

The mission to achieve compelling and consistent returns, while delivering on the expectation of value for money in a highly competitive and regulated environment are heavy responsibilities, but ones that we can tackle together – head on.

More total realized returns, less management fees

By using Challenger Index Plus **(Index Plus)** as a substitute for traditional passive funds or as a complement to active management options, our Institutional clients have been able to assume higher return assumptions with confidence when building their portfolios. This is because the alpha Index Plus delivers is contractual, and void of any uncertainty.

Index Plus is a solution that helps deliver excess returns above the index in a consistent way. All with zero management fees. Index Plus returns are determined

1 'APRA Insights: MySuper Product Heatmap – 'Fees and costs update and other observations', June 30, 2020.

by three key factors: index selection, underlying eligible assets of the fund and term of investment. The solution offers significant index flexibility across equity markets, fixed income and cash. Available as a daily liquid option or as a fixed term (custom wholly-owned mandate) option, where we can provide even higher yields for longer-term investment commitments.

Index Plus offers:

- Contractual alpha over a selection of indexes.
- Zero management fees.
- A range of investment terms.
- Zero tracking error.

Index Plus solutions are available for the indices in the below table:

Index Ticker	Index Name
RBATCTR	RBA Cash Rate
BAUBIL	AusBond Bank Bill Index
BAGV0	Government 0y+ Index
BATY0	AusBond Inflation 0y+ Index
BAIG0	AusBond Government 0y+ Index
BACM0	AusBond Composite 0y+ Index
AS51T	S&P ASX200 Total Return
AS52T	S&P ASX300 Total Return
ASA6PROP	S&P/ASX 300 A-REIT Total Return
EANREXAN	MSCI World ex Australia Net Total Return (AUD)
MGWD	MSCI ACWI Net Total Return (AUD)
MMEF	MSCI Emerging Markets Net Total Return (AUD)

Challenger is also happy to explore tailored and/or alternative indices beyond those mentioned above should they better suit your requirements.

Index Plus in action

The inclusion of Index Plus as a core building block in diversified portfolios can improve the absolute return and risk-adjusted return outcomes for both active and passive diversified portfolios.

For passive diversified funds, this is due to the guaranteed alpha delivered by Index Plus, combined with the benefit of zero management fees.

For active diversified funds, including Index Plus can increase net returns by replacing the higher fee base of active managers with the zero fee profile of the strategy. Also, Index Plus delivers a stable contractual alpha instead of a cyclical alpha profile that is synonymous with active investment managers.

The two case studies in the table below highlight the benefit of including an allocation to Index Plus in the growth and defensive component of the portfolio. The first case study models the benefit of Index Plus within a **passive** diversified portfolio. The second case study models the benefit of including Index Plus in an **active** diversified portfolio.

In both case studies, we have included Index Plus MSCI ACWI Net total return and the Bloomberg AusBond Composite 0+. This maintains an identical index and asset allocation to ensure a like for like return comparison.

Benefit of including Index Plus within a passive diversified portfolio:

Challenger Index Plus case study[2]	Net Returns			Volatility			Sharpe		
Portfolio	**1yr**	**3yr**	**5yr**	**1yr**	**3yr**	**5yr**	**1yr**	**3yr**	**5yr**
Passive Portfolio	14.6%	7.9%	8.0%	4.9%	5.0%	5.3%	3.0	1.4	1.3
Passive w/Index Plus[3]	15.0%	8.2%	8.3%	4.9%	5.0%	5.3%	3.1	1.4	1.3
Excess	0.4%	0.3%	0.3%	0.0%	0.0%	0.0%	0.1	0.1	0.1

Inclusion of Index Plus within a passive multi asset portfolio improved excess returns and Sharpe ratios across 1, 3 and 5 year time frames, while maintaining a consistent volatility.

2 Using MSCI ACWI and Ausbond Composite Index Plus strategies with rebalancing. All data as at 30 April 2021.

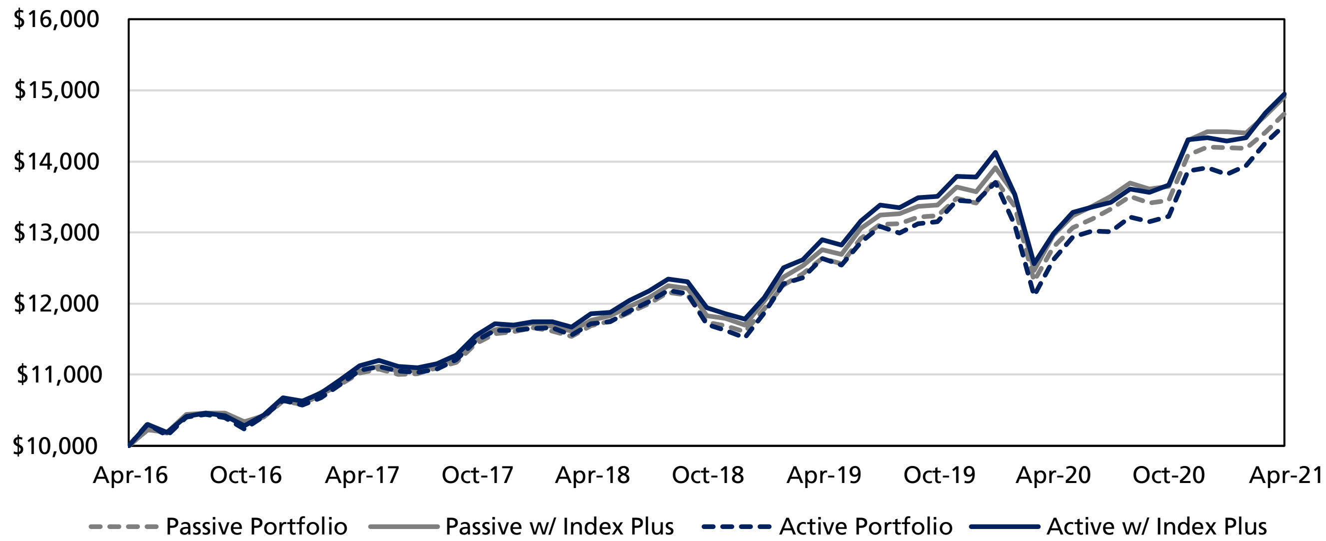
3 Refer to table 1 in the appendix.

Benefit of Including Index Plus within an active diversified portfolio:

Challenger Index Plus case study[4]	Net Returns			Information Ratio			Tracking Error		
Portfolio	**1yr**	**3yr**	**5yr**	**1yr**	**3yr**	**5yr**	**1yr**	**3yr**	**5yr**
Active Portfolio	15.0%	7.4%	7.7%	0.2	-0.3	-0.2	2.0%	1.8%	1.7%
Active w/ Index Plus[5]	15.2%	8.0%	8.4%	0.3	0.1	0.3	1.5%	1.5%	1.4%
Excess	0.1%	0.6%	0.6%	0.1	0.4	0.4	-0.5%	-0.3%	-0.3%

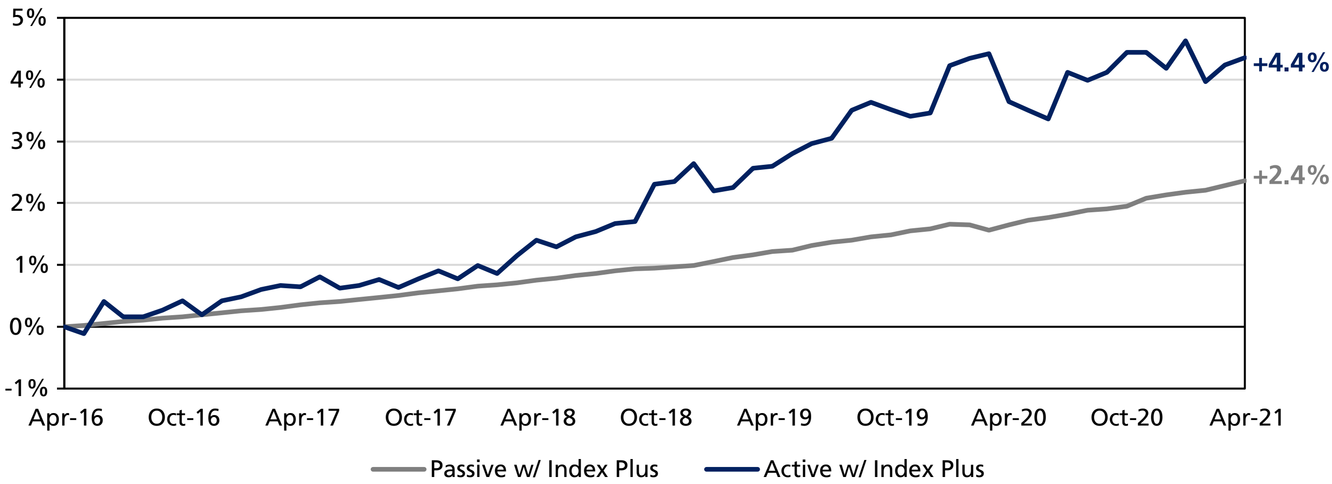
Inclusion of Index Plus within an active multi asset portfolio improves the excess return profile and information ratio over 1, 3 and 5 year time frames, while reducing the overall tracking error.

Growth of $10,000



In the chart above, we compare the growth of $10,000 for a passive diversified portfolio and an active diversified portfolio with and without Index Plus. In the time frame modelled, the passive portfolio with the inclusion of the Index Plus strategy would have outperformed by 35bps per annum over a 5-year period. The active portfolio with the inclusion of the Index Plus strategy outperformed by 64bps per annum over a 5-year period.

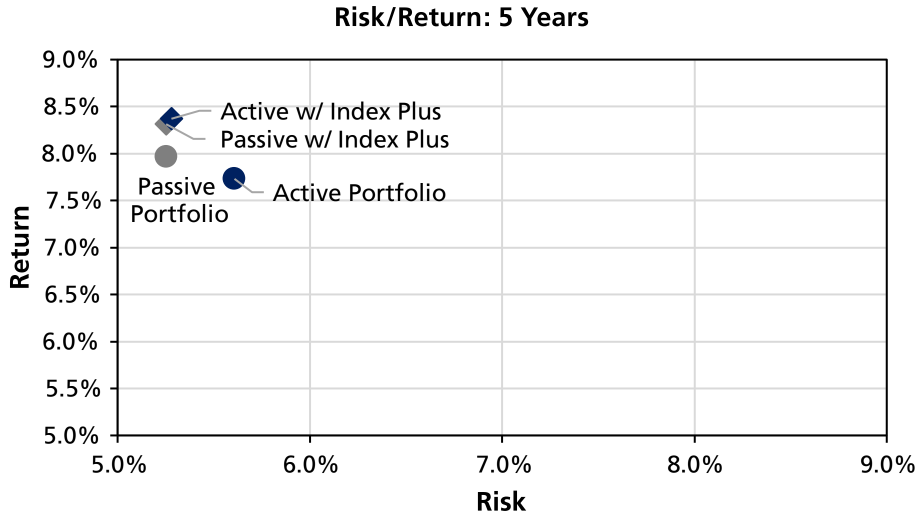
Cumulative Excess Returns on Base Portfolios



4 Using MSCI ACWI and Ausbond Composite Index Plus strategies with rebalancing. Sources: eVestment and Morningstar, all data as at 30 April 2021.

5 Refer to table 1 in the appendix.

Over the five-year time frame modelled, the cumulative excess returns of the portfolios including Index Plus are significant. Somewhat surprising, is that the inclusion of the strategy has had a greater impact on the active diversified portfolio, resulting in a cumulative excess alpha of 4.4%, whereas the cumulative excess alpha of the passive diversified portfolio including Index Plus is 2.4%. The reason for index plus having such a positive impact on the active diversified portfolio is because of the reduction in management fees that index plus provides, and the greater alpha stability that Index Plus provides compared to the cyclical nature of alpha coming from traditional active management.



Inclusion of Index Plus has improved the excess return outcome for the passive diversified portfolio and the active diversified portfolio and has improved the risk/return ratio for the active portfolio while maintaining a consistent risk/return profile for the passive diversified portfolio.

Helping you provide the new way forward

To find out more about Index Plus, contact the Challenger Institutional Partnerships team at challenger.com.au/contact-the-team.

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Appendix

Table 1

Portfolio Asset Allocation and Fees

Passive Product Allocation: From Vanguard Balanced Index Fund	Weight	Fee
Bloomberg Barclays Global Aggregate Float-adjusted and Scaled Index AUD hedged	30.0%	0.03%
S&P/ASX 300 Index	20.0%	0.03%
Bloomberg Ausbond Composite 0+ Yr Index	15.0%	0.03%
MSCI ACWI ND	14.5%	0.05%
MSCI World Ex Aus NR AUD Hedged	9.0%	0.05%
MSCI World Ex Aus Small Cap NR Index	3.5%	0.06%
MSCI Emerging Markets NR Index	3.0%	0.06%
Bloomberg AusBond Bank Bill	5.0%	0.03%

Index Plus Inclusion:
MSCI World and Ausbond Composite

Passive product Allocation	Weight	Fee
Bloomberg Barclays Global Aggregate Float-adjusted and Scaled Index AUD hedged	30.0%	0.03%
S&P/ASX 300 Index	20.0%	0.03%
Index Plus AusBond Composite	15.0%	0.00%
Index Plus MSCI ACWI ND	14.5%	0.00%
MSCI World Ex Aus NR AUD Hedged	9.0%	0.05%
MSCI World Ex Aus Small Cap NR Index	3.5%	0.06%
MSCI Emerging Markets NR Index	3.0%	0.06%
Bloomberg AusBond Bank Bill	5.0%	0.03%

Active Product Allocation: Median Active Manger return for each Morningstar Category	Weight	Fee
Global Fixed Income	27.5%	0.40%
Australian Equity	20.0%	0.30%
Australian Fixed Income	12.5%	0.20%
Global Equity Large Cap	23.5%	0.35%
Global Equity Small Cap	3.5%	0.50%
Emerging markets Equity	3.0%	0.45%
Global Listed Infrastructure	5.0%	0.35%
Cash	5.0%	0.03%

Index Plus Inclusion:
Global Large cap and Australian Fixed Income

Active Product Allocation: Median Active Manger return for each Morningstar Category	Weight	Fee
Global Fixed Income	27.5%	0.40%
Australian Equity	20.0%	0.30%
Index Plus AusBond Composite	12.5%	0.00%
Index Plus MSCI ACWI ND	23.5%	0.00%
Global Equity Small Cap	3.5%	0.50%
Emerging markets Equity	3.0%	0.45%
Global listed Infrastructure	5.0%	0.35%
Cash	5.0%	0.03%

The investment process

For the active portfolio we used the median gross returns[6] for each asset class then deducted active fees from the median return stream.

For the passive portfolio we used index gross returns to simulate institutional passive investments in each asset class, institutional level passive fees were deducted from each index to get net returns.

The return series for the index plus strategies was constructed by adding the contractual 5 year alpha to the monthly time series of the respective index.

6 Source: Morningstar 30 April 2021.