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A conversation about SMSFs

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INTRODUCTION

1. Of all the commentary about this Review so far, the most amusing for me was the magazine (and I can't remember which one) that ran one of those quizzes that went a bit like this. Question 7: What is the Cooper Review?

   - A review into Australia's tax system;
   - A review into Australia superannuation system;
   - A review that will once and for all determine whether Cooper's Sparkling Ale is better than Cooper's Pale Ale.

   I know which review I would rather be working on.

2. SMSFs were always going to be an important part of this Review. With the largest number of funds in the industry and over one-third of its assets, the Panel was conscious that an amount of time needed to be spent on SMSF issues proportionate to the importance of the sector within the industry.

3. To that extent, when the Panel was deciding how to slice and dice the issues to look at, we decided to look at SMSFs separately from the rest of the industry. Not because the sector stood out more than APRA-regulated funds as a sector in particular need of scrutiny, but rather because of its unique issues and regulatory arrangements. The sector is very different from the other parts of super.

4. So let's just quickly recap as to where the Panel is in the process generally, and particularly in relation to SMSFs.

OVERVIEW OF THE REVIEW

5. The terms of reference for the Review are broad - the Panel was asked to look at the governance, efficiency, structure and operation of the superannuation industry. It was a critical part of the brief that we looked at things from the members' perspective. This is what makes the SMSF sector so interesting. The members are on the flight deck making the decisions. It is about them and their retirement savings.

6. To make the task manageable, and to help interested parties respond in a focused way, the Panel broke the Review into three phases, releasing issues papers on governance, operation and efficiency and structure (which included the SMSF issues).

7. The Panel and government were also keen to ensure the Panel's preliminary thoughts in response to the issues raised be communicated throughout the process to encourage transparency and debate.

8. The Panel's phase one preliminary report was released on 14 December last year. In that report, the Panel proposed a member-oriented 'choice architecture' model for the industry.

9. I might chat further about that model with Alan later; but beyond recognising that SMSFs have an important role to play in our system, our preliminary report did not go into SMSFs in any detail. This was because we had only just released our phase three issues paper covering SMSFs. And it was therefore too early to incorporate any thinking on the self-managed sector at the time.

10. However, with submissions for that phase closing tomorrow, we expect to be able to articulate our preliminary views about SMSFs in April/May this year.

SMSF STATISTICAL SUMMARY – WHAT WE HAVE SAID

11. One of the challenges the Panel faced at the outset of this Review was really to understand what was going in the SMSF sector.

12. Stories about investor losses, dangerous investment products, non-compliance, bad advice and general mayhem were often bandied around as 'truths' about SMSFs - yet there was very little hard evidence to go on. It was this that inspired the Panel to develop the SMSF statistical summary, a broad factual overview of the sector derived mainly from published and unpublished ATO data.

13. On the whole, the statistics show that the SMSF sector is in pretty good shape.

14. The average SMSF size has nearly doubled from 2004 to 2008, to $860,000. This has considerably reduced the proportion of small-sized SMSFs ($200,000 and below) within the sector, down to 26 per cent from 42 per cent.

15. On average, SMSFs over recent years have become cheaper to run (as a percentage of assets), possibly as a result of their growing size and their preference for direct investments. This has all been achieved while still maintaining generally good compliance levels and with no signs of widespread failure.

16. SMSFs have also been achieving average net investment returns that, while not being directly comparable to returns in other sectors, appear to be at least as good as (if not better) than the returns in those sectors.

VISION FOR SMSFS

17. So how has this data informed the Panel's thinking about SMSFs?

18. One approach might be to say: "The SMSF sector isn't broken so it doesn't need fixing."

19. Another view is that the sector still has a way to go in improving both its image and its pedigree as an optimal retirement savings vehicle.

20. The ultimate vision for SMSFs should be as a leading superannuation vehicle: compliant and well-managed; able to innovate quickly and efficiently; largely free of the asset-based or percentage fee model for services; and well-placed to achieve net investment returns that are at least as good as other sectors.

21. SMSFs might be able to aspire to this because:

- SMSFs can pursue asset allocations that would be difficult to implement in an APRA-regulated fund;
- SMSFs can have longer-term investment horizons (ie not chasing short-term performance driven by league tables and 'peer risk');
- SMSFs can be run in a tax-efficient manner, particularly in transition to retirement and in managing assets supporting a pension;
- there is a better alignment of interests in a SMSF – members can make well informed decisions in their own interests with minimal agency costs; and
- members are able to bargain directly for reduced prices for the various services they need (eg accounting, administration and broking).

22. What could be improved to achieve even better outcomes for SMSF members?

- Reduced complexity (perhaps SMSFs could be even easier to establish and administer than they are currently).
- There is room for the average SMSF member to have better access to information about high quality investing than is currently the case and they could be able to make better decisions as a result.
- The costs (including opportunity costs) of running an SMSF could be more widely understood and better data could be available enabling comparison with other forms of super.
- SMSFs operating costs could decline through improved efficiency and greater use of technology.

We will see what sort of ideas and feedback comes through in the submissions.

COMPETENCY OF TRUSTEES

23. A perennial question is whether there should be a minimum level of financial and compliance competency required to act as a trustee, given the low barriers to entry. This is a theme echoed in the broader super environment where we stated in our preliminary report to phase one that a higher standard of knowledge and skills for trustee directors would be beneficial to members and industry.

24. The statistics show that, compared to members of other types of superannuation funds, SMSF members are, on average: older, earn higher incomes and have larger super balances. Does older and richer mean more knowledgeable? Do we expect SMSF trustees to be experts on all aspects of super?

25. Realistically, that's simply not feasible. So, potentially, this issue is not so much about trustee education, but about the service providers (accountants, auditors, and advisers) who are engaged by the trustees to help them manage their SMSFs. For example, there is merit to the argument that if you increase the professionalism and competency of the service providers, this has a flow-on effect leading to better informed trustees who are clearer about their obligations and responsibilities.

GATEKEEPERS

26. The SMSF sector is serviced by a large number of service providers, but often those providers will, individually, only service a handful of SMSF clients. For example, of the estimated 11,500 approved auditors, over 50 per cent of them did less than five audits in 2008 and of the 15,500 tax agent/accountants, only 4 per cent of them had more than 100 SMSFs on their books.[1] For those handling only a few SMSFs a year, it is hard to see how it could be economically viable to invest the time and effort to maintain an appropriate level of expertise that would be value-adding to SMSF trustees.

27. In light of the statistics, could the SMSF sector (and thereby its members) benefit from a more consolidated and professional service market? Could consolidation, within the service areas of auditing, accounting/administration and advice, lead to better SMSF expertise? Approved auditors already play an important part in the SMSF regulatory framework, would leveraging off the other service providers be the best way to regulate and improve the SMSF sector?

28. In some ways, the 'scale' issue that has received a lot of airplay in the APRA-regulated sector is at the service provider level in the SMSF sector. Do the service providers have enough scale to do their job properly?

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[1] Super System Review 2009, *A statistical summary of self-managed superannuation funds*, 10 December 2009 – Appendix 1, tables 10 and 11).

SCALE OF SMSFS

29. The right size for an SMSF to make economic sense is an argument that has been going on for years. The statistics show clearly that scale does matter. On average, SMSFs with $200,000 or less had both higher proportional costs than would be charged in a public offer fund and did not perform as well as larger-sized SMSFs.[2] It was also of concern to find out that about half of these funds had 90 per cent of their investments in a single asset class. Not a good overall picture. But there might be an explanation for at least some of these funds: they could be in the latter stages of pension phase. After all, SMSFs are designed to provide income in retirement. Part of that equation involves running down the assets of the fund as retirement progresses. Therefore, the Review has asked the ATO to find out what proportion of the funds under $200,000 fall into that category.

30. Given that small-sized SMSFs still make up a quarter of the SMSF population, it is an issue that the Review has raised. The Panel is thinking about the right solution to this problem and, again, is awaiting ideas from the submissions.

ASSET ALLOCATION

31. If there is one area where there might be room for improvement, it is in asset allocation. There are countless studies showing that this is where the real money comes from; rather than market timing, stock-picking or manager selection in the case of managed investments. We pointed out in our SMSF issues paper that:

- 20 per cent of all SMSFs, that's over 80,000 of them, had all of their investments in a single asset class; and
- 59 per cent of SMSFs, that's approaching 250,000 of them, held only listed Australian shares and cash/term deposits. Is this the best asset allocation for such a large proportion of SMSFs? It might be. This combination can be a very effective strategy, but is it optimal for such a large proportion of the SMSF population?

This data suggest that SMSF investors might not be getting the best advice or information about asset allocation. We might, of course, be wrong about this, but if we are right, what are the possible solutions? If there is a problem here, it does not seem to leap out in the overall net investment return figures of the SMSF sector as compared to APRA-regulated funds. This is all part of the process of finding out more about the SMSF sector for the overall benefit of its members.

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2 Super System Review 2009, *A statistical summary of self-managed superannuation funds*, 10 December 2009 – Appendix 1, tables 17 and 24).

CONCLUSION

32. At the end of the day, this Review is aimed at members. SMSF members, on the whole, appear to be doing well in taking on a higher level of responsibility for their retirement savings and achieving satisfactory net investment returns. With minimum agency issues, generally higher levels of engagement and the benefits of growing assets over fixed costs, SMSFs are an important and valuable part of our super system. The aim of the Review is to see whether there are improvements that can be made which benefit members while not disproportionately increasing regulatory burdens or cost.

33. In doing this, the Review carries the burden of looking out for the unintended consequences of intervention; the curse that haunts all well-intentioned policy ideas. Australia has so far boxed well above its weight in this area. Take the example of the introduction of the cane toad. Cane toads were introduced to Australia from Hawaii in 1935 in an attempt to stop cane beetles from destroying sugar cane crops in North Queensland. They were unsuccessful in controlling the cane beetles and the disastrous consequences of their well-intentioned introduction are well known. The Review is mindful of this story in its work and will do its very best not to release a policy cane toad into the SMSF sector.