

# dimensions

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Wealth management strategy and product specialists

From insight to implementation

3<sup>rd</sup> March 2010

## Cooper's Super: shining a light on the SMSF world

While the preliminary recommendations of the Super System Review are still a month or two away, a very useful output to emerge has been the release of statistical data on self managed super funds (SMSFs).

SMSFs, along with industry funds, are one of the main sources of growth for the industry. There are over 400,000 SMSFs accounting for more than \$300bn of assets – a third of the entire system. Yet relatively little is known about the segment, and what has been available is the result of relatively small private samples or qualitative / perceptual studies subject to response bias, rather than hard data. The Cooper release, based on broad ATO data, is an important addition to our understanding.

So what's actually going on?

### Members want control

There are some confirmations of what was already suspected. For example, the top reasons for establishing a SMSF are:

Control of investments	86%
Greater flexibility of investments	64%
Will perform better than previous fund	53%
Better tax planning	36%
Save money on fees	31%

Source: 2008 ATO new trustee questionnaire

SMSFs are about investing. Actually, it's a vote of no-confidence in the managed funds industry - a rejection of investment strategies on offer from the industry, the results achieved, and the cost of investment products.

And indeed, SMSFs do look very different, if we compare them to a typical super default option.

The largest SMSF allocations are:

Direct equities	32%
Cash & term deposits	26%
Non-residential real estate	9%
Unlisted trusts	9%
Listed trusts	8%
Other managed investments	6%
Other assets	19%

Source: A Statistical Summary of Self-Managed Superannuation Funds

This confirms the bad news for the managed funds industry, with the best interpretation being just 23% of assets being collectively managed. It's impossible to tell what types of "unlisted trusts", "listed trusts", and "other managed investments" are used, but it's a fair bet that global equity funds, property funds, and private structures in the unlisted space; and REITs and listed investment companies in the listed space, figure prominently.

Broadly though, SMSFs have limited engagement with managed funds. The modicum of good news is that engagement improves with fund size; ie the larger the SMSF, the more likely it is to be better diversified, to have lower allocations to cash / term deposits, and higher allocations to unlisted trusts and other managed investments.

### Going it alone

The statistics also confirm SMSFs as substantially self-directed in their investment decisions.

An accountant or tax agent is the most important source of assistance in SMSF establishment, although financial planners are consulted half the time – somewhat higher than we expected.

However planners appear to have less influence in the ongoing management of investments, with only 32-35% of trustees stating that they take advice regarding investment strategy and fund investments. Roughly two thirds of funds claim they are making their own investment decisions.

### Does control deliver results?

More often than not, the answer appears to be no.

In saying this, there are challenges in comparing the returns of SMSFs with alternatives such as industry and retail funds. The latter publish returns based on market valuations of all assets, accrual of tax on realised and unrealised income, and separation of accumulation and pension divisions.

None of these necessarily apply to SMSFs. Some assets are held at cost until realisation. Tax, especially on unrealised gains, is often calculated on a cash basis. SMSFs have more pension assets, and thus a lower average tax burden.

This means that the ATO's calculation the return on assets of SMSFs is only roughly comparable with the published returns of the managed super industry. But

it's still illuminating, and for example, it's possible to compare the performance of categories of SMSFs.

This is where opinions start to diverge. Cooper stated to the recent SPAA conference that the SMSF sector is "in pretty good shape". Notwithstanding that he might have been lynched had he said anything else, and that it may be true of the largest SMSFs, we just can't agree. In particular, the average performance of small to mid size funds is simply terrible:

SMSF size	Average return on assets 2006-8	Average operating expense as % of assets
Up to 50k	-6.5%	5.89%
50k-100k	-0.6%	3.79%
100k-200	2.0%	2.37%
200k-500k	4.6%	1.40%
500k-1m	6.3%	0.89%
\$1-2m	7.9%	0.64%
\$2m+	10.3%	0.42%

Source: A Statistical Summary of Self-Managed Superannuation Funds

This is sobering stuff. Forget financial planner commissions, if you really wanted to improve the efficiency and cost structure of the super industry, the first thing you would do is close down every SMSF below \$500,000.

There is clearly a major scale issue for SMSFs.

Part of the problem is costs – as the average operating expense column shows, expenses as a % of assets jumps dramatically once assets fall below the \$500k-\$1m range. And as for small SMSFs... anyone for a 5% MER?

The cost estimates are also likely to be understated as they exclude non-deductible costs, costs paid outside the fund, and costs incurred within investment structures.

In fact, below \$500k SMSF costs rise above those of many retail super funds which trustees were fleeing in the first place.

But the problem is not just costs, because at each level the average return on assets falls by much more than the increase in the average operating expense. In other words investment efficiency deteriorates as well as cost efficiency.

Part of this is due to SMSFs below \$500k often having a third or more of their assets in cash, but in general it appears that small to medium size SMSFs are simply struggling to deliver returns. While no doubt there are many exceptions, it seems for SMSFs below \$500k, hopes of out-performing existing products are unrealistic.

If we take industry funds as the simple scale alternative, APRA records show the average industry fund return for 2006-8 was 7.7%. Even allowing for issues in performance comparison, in all likelihood the typical SMSF isn't beating the typical industry fund until it is well over \$500K.

### Opportunities and challenges for fund managers

The opportunity for the industry is clear – despite the hype, many SMSFs are not delivering – in absolute terms and relative to simple alternatives. Costs are too high and investment efficiency is low.

In our view, there are two needs, with opportunities for both platforms and asset managers.

**Platforms** are ultimately about efficiency, and there is a screaming need for improved investment efficiency within SMSFs. SMSFs have shied away from expensive platforms and commissions, but the coming unbundling of pricing and commissions creates an opportunity for new business models with more appeal. The data strongly suggests that many SMSFs would be better off using an unbundled wholesale investment platform than their current piecemeal approach.

For **asset managers**, the lack of investment diversification within SMSFs demonstrates the limited range of investments which trustees feel competent

dealing with – cash deposits, blue chip (mainly) Australian shares, and real estate (small scale by definition). That leaves big holes for the industry to fill – if it can get the right solutions to SMSFs in products they will find attractive.

Happily, SMSFs have revealed some key buying preferences in their warm embrace of ETFs. ETFs have not been actively marketed to SMSFs until recently, but Tria's analysis of ETF registers shows that they are full of SMSFs. In other words, SMSFs have found ETFs, and they like them.

A key distribution channel to SMSFs is therefore the ASX. ETFs also demonstrate that SMSFs are not completely adverse to managed investments. There are however clear preferences for:

- Listed exposures which are much more easily accessed, bought, and sold.
- Inexpensive products in terms of entry, exit, and ongoing costs.
- Transparent products which do what they say on the tin.
- No or low commissions.
- Limited scope for disappointment relative to the promise.

It's a stark contrast to the industry's traditional model based on unlisted, actively managed funds with generally much higher costs and too often disappointing performance.

### SMSFs after Cooper

Cooper has surprised more than a few during the Review by making generally favourable comments about the state of the SMSF industry. The general observation from the statistics appears to be that SMSF practices and results are not as bad as feared - not exactly much of an endorsement and certainly a rose tinted glasses view of the situation.

This has resulted in rising hopes that SMSFs will escape new regulation. These hopes should be

dashed, given the massive disparities revealed in SMSF performance and costs, and the problems of sub-scale funds.

There are some SMSFs (especially larger funds) which are competitive with or even superior to collective super arrangements. However trustees are subject to the same behavioural biases as investors in general. A large majority of investors believe they are above average, but by definition many are going to be wrong.

From time to time we've been asked whether we see the growth of SMSFs as a good or bad thing.

You can take diametrically opposite views. One view is that it's simply the market at work, reacting to a consolidated collective industry which is not addressing the changing needs of significant market segments. On this view, SMSFs must be a good thing.

An alternate view is that SMSFs represent the diversion of a large percentage of system assets into arrangements which are often substantially more costly

and less efficient than collective arrangements. As a result the entire system and therefore Australia is less well off. On this reading, SMSFs are a source of inefficiency, or at least the extent to which they have mushroomed in a cost conscious environment.

In general, we strongly prefer the operation of market forces to government fiat, which almost always has significant negative unintended consequences. However the existence of tax concessions for superannuation does create legitimate interests in achieving efficient outcomes.

While trying to predict the recommendations of any regulatory review is a fool's errand, it's clear that super system efficiency demands some limits on SMSFs, and that requiring minimum scale is one of the easier ways to quantify this. In our view, the statistics support a view that minimum scale for SMSFs is \$500,000, if not more. Below that figure, they are generally a wealth hazard to their trustees and a significant loss of efficiency to the industry.

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