# SMSF Investor Insights

*Discussing key myths surrounding SMSFs*

SMSF Week
19 - 23 November 2018

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# Foreword

## John Maroney, CEO, SMSF Association

The SMSF sector has become a significant and an enduring part of Australia's superannuation system with over 1.1 million Australians choosing an SMSF to manage $750 billion in retirement savings. The SMSF Association is proud to represent and assist the professional advisors and SMSF trustees who make up this thriving part of the superannuation system.

While the SMSF sector is delivering improved retirement outcomes for many Australians, there are still a number of common myths and misunderstanding regarding SMSFs and how they function. That is why the SMSF Association, with the support of OpenInvest, believes it is important to publish research that dispels some of these myths and provides a source of trusted information for those considering an SMSF, as an option to manage their retirement savings, existing SMSF trustees and participants in the superannuation sector more broadly. Better education and understanding of SMSFs should lead to a more secure and dignified retirement for SMSF trustees.

This research, based on Investment Trends' industry leading survey of SMSF investors, highlights the key role that professional advice and assistance should play in running an SMSF. Whether advice is required on setting up an SMSF, how an SMSF achieves appropriate diversification or on ongoing tax and compliance issues, SMSF trustees can access specialist advice to assist them. The SMSF Association accredits specialist SMSF advisors and auditors and encourages SMSF trustees to seek out our accredited advisors and auditors assistance for their SMSF needs.

The SMSF Association believes this research will play an important role in assisting SMSF trustees and their advisors deal with the myths regarding SMSFs and thanks OpenInvest for their support. We look forward to working together to improve outcomes for SMSFs.

## Andrew Varlamos, Co-founder/CEO, OpenInvest

The SMSF sector is large, thriving, and growing all the time, so it's extremely important that we continue to not only monitor the behaviours and trends of existing SMSFs and their trustees, but anticipate and provide for their needs.

We also need to assess and be able to advise and comment on any legislative and broader economic issues that have the potential to impact on the way so many Australians are now preparing for their retirement.

Whatever tools and resources we are able to bring to the table to help SMSF trustees get it right, so that they can enjoy the dignified, fulfilling, and enjoyable retirement they desire and deserve, should be commended.

The SMSF Association does an excellent job of representing the SMSF sector and its one million trustees, and this research report exemplifies the value it provides.

There is little doubt that there are several myths and misconceptions – if not actual confusion – about when setting up an SMSF is the right approach, as well as what SMSF trustees can and should do in order to ensure they are managing a compliant, diversified and successful fund. Consequently, I expect that the findings of this report will be of great interest not only to all SMSF trustees but also to the specialist professionals who assist and advise them.

All of us who have an interest in the continued growth and overall success of the SMSF sector must keep working hard and remain fully informed so that we can assist SMSFs to achieve their goals.

OpenInvest is proud to be a sponsor of this report and the SMSF Association.

# Methodology

This research paper is based on the *Investment Trends 2018 SMSF Investor Report*, based on a survey of 2,315 SMSF trustees.

Other data and findings are referenced as appropriate.

# Executive Summary

The SMSF sector has become an important part of Australia's superannuation system with over 1.1 million Australians choosing an SMSF to manage $750 billion in retirement savings. Over the past decade the sector has had a 58% increase in the number of SMSFs operating and a 133% increase in assets held by SMSFs. Even though the SMSF sector has continued to grow and is a large part of the overall superannuation system, there are still many myths and misunderstandings about SMSFs and how they function.

That is why the SMSF Association, with the support of OpenInvest, has published a report to disprove some of these myths as part of the inaugural SMSF Week. The report, based on Investment Trends' industry leading survey of SMSF investors, provides facts and information to better inform those interested in an SMSF or already engaged with the sector. Publishing this report supports the SMSF Association's belief that education and credible information are key to improving retirement outcomes for Australians.

This research addressed five key issues for SMSFs with the key takeaways being:

**Myth #1: Are SMSFs suitable for everyone?**

- It may come as a surprise, but SMSFs are not for everyone. They demand time, commitment, a strong level of financial literacy and should always be set up with the right expert advice.
- The average time spent on managing the administration and paperwork, and ongoing monitoring is typically four hours per month for SMSF trustees.
- The average ongoing costs of managing an SMSF on a yearly basis in 2018 is $2,500.
- Regulatory uncertainty is now cited as the top challenge in managing an SMSF.

**Myth #2: Do SMSFs need $1 million to be cost effective?**

- SMSFs can start to be cost effective and appropriate with balances far below that figure depending on the individual circumstances of the SMSF's members.
- Costs are one of the strong indicators for individuals choosing an SMSF, especially when compared to asset-based fees in large superannuation funds.
- Control is the key reason for an SMSF, often being stronger then the desire for better returns and lower fees, and, providing the ability to put into action other motivations.

**Myth #3: Will the removal of franking credit refunds significantly impact SMSFs?**

- The proposal to remove refundable franking credits could have a significant effect on the SMSF sector and on those individuals in and approaching retirement.
- The median benefit paid to members by an SMSF in retirement phase is around $50,000 and the corresponding tax refund the median SMSF receives is around $5,500.
- Younger SMSFs typically have a lower allocation to shares (25%) compared to upwards of 40% for individuals aged 55 and over.

**Myth #4: How can I be sure my SMSF is appropriately diversified?**

- Noting the benefits of diversification, 82% of SMSFs believe that diversification is important, however, in practice many do not achieve it.
- Half of the SMSF population cite a barrier to achieving diversification as a problem for their fund.
- Only 36% of SMSFs say they have made a significant (10%) asset allocation change to their SMSF over the last 12 months.
- 50% of SMSFs have half or more of their SMSF invested in a single asset type.

**Myth #5: Does having an SMSF mean I have to go it alone?**

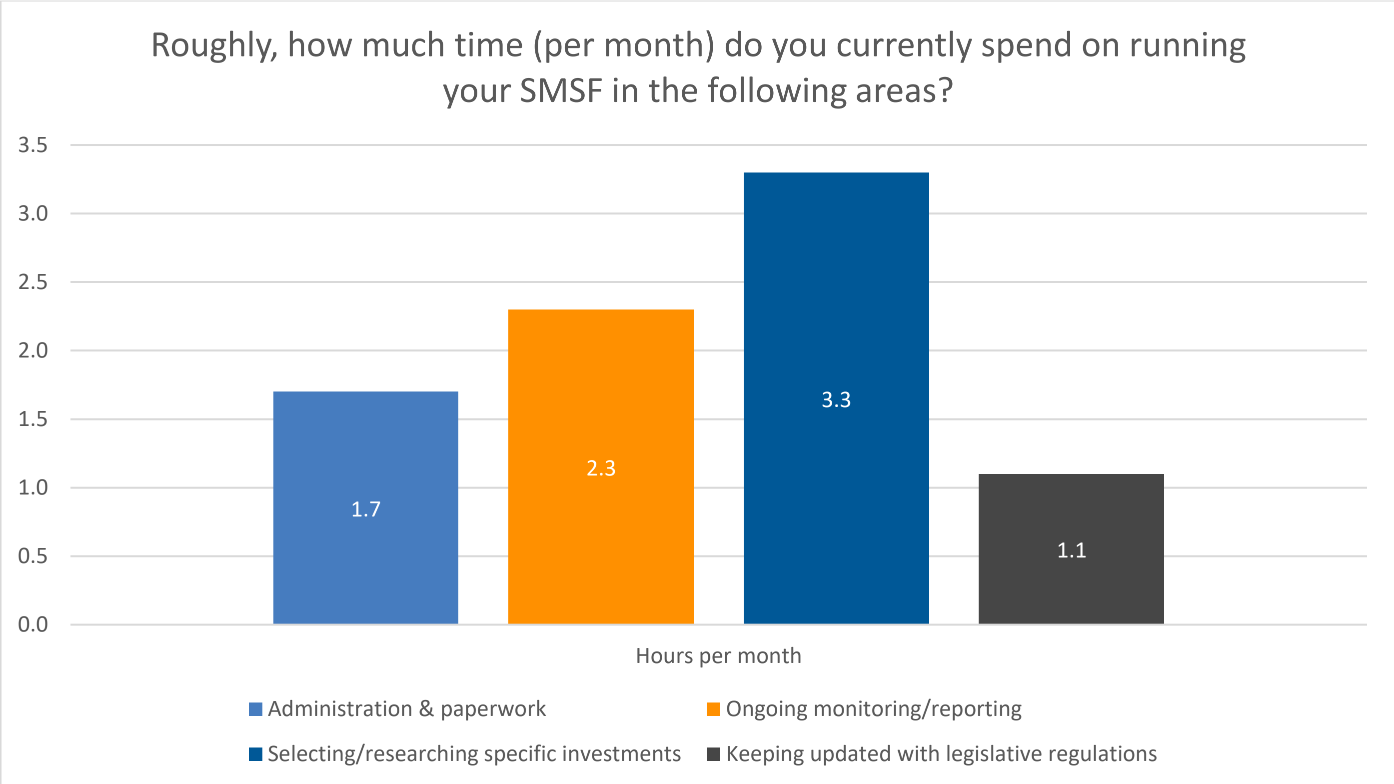
- SMSF trustees are likely to need help from a team of professionals to assist them in their journey of saving for retirement.
- Compliance is the area members require the most help with, closely followed by tax.
- Despite the fact that trustees aim to seek professional assistance which will help them reach a dignified and secure retirement, the number of SMSFs with unmet advice needs remains high.

# Myth #1: Are SMSFs suitable for everyone?

It may come as a surprise, but SMSFs are not for everyone. So, the next time a friend at a barbeque starts talking about their SMSF, remember that the option to take control of your superannuation needs to be right for your circumstances.

SMSFs are appropriate for those individuals who have the time, superannuation balance, and financial knowledge to seek control over their superannuation.

The average time spent on managing the administration and paperwork, and ongoing monitoring is typically four hours per month for SMSF trustees. Researching investments and keeping up with regulatory changes requires an additional four hours per month on average. This highlights that it is not a set and forget type structure and trustees must have the time to devote to their compliance and investment returns.




The SMSF Association believes that SMSFs should be established based on the provision of quality financial advice that ensure that SMSFs are established only when it is in the member's best interests and appropriate for their circumstances, regardless of balance. With this in mind though, we recognise that there are soft thresholds where concerns around fees and returns are mitigated.

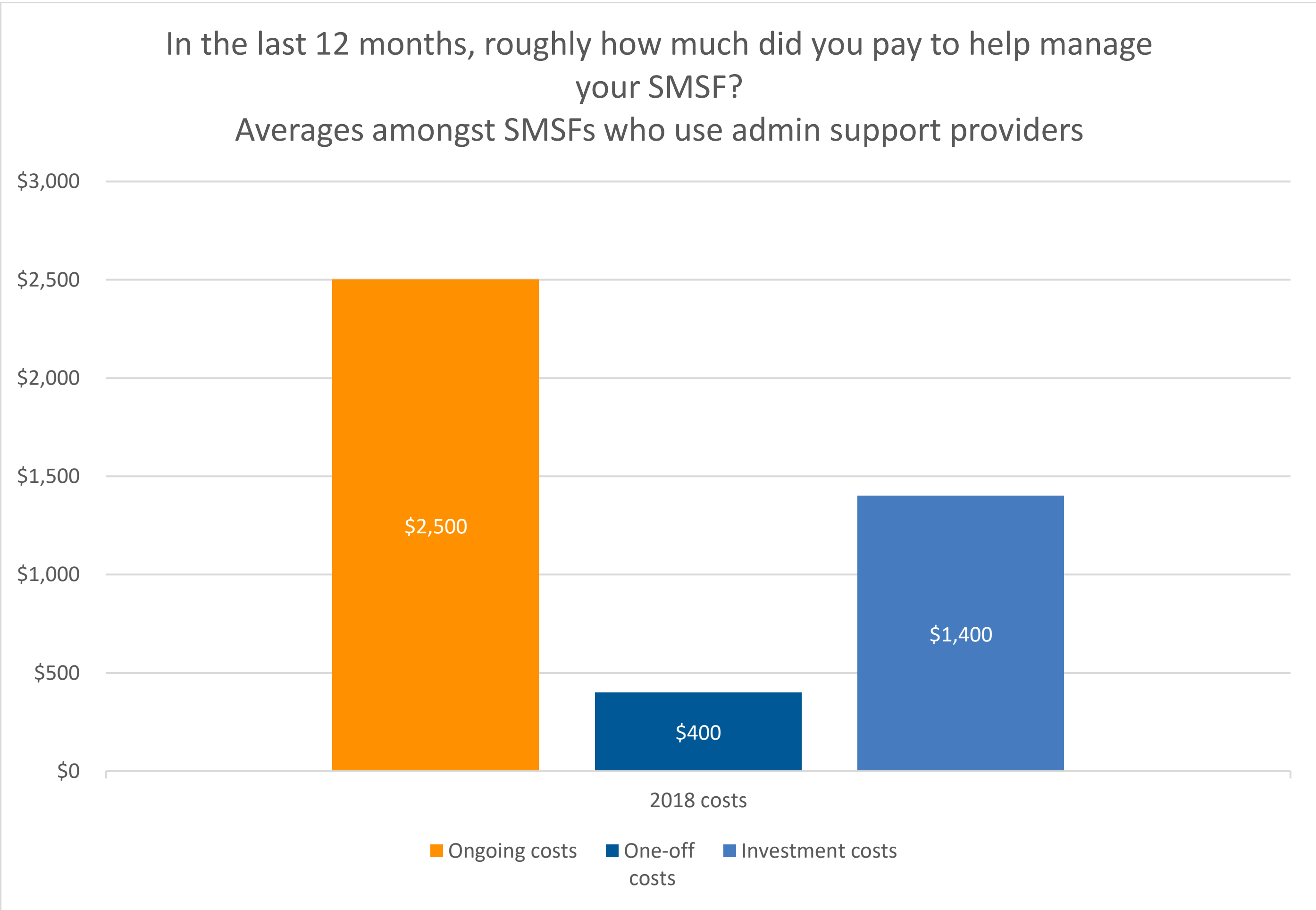
ASIC Information Sheet 206[1] strongly suggests that SMSFs being setup with balances below $200,000 must undergo an important cost-effective analysis, as below this balance, having an SMSF may not be in a member's best interests. This figure was arrived at as a result of the independent research from Rice Warner.

[1] https://asic.gov.au/regulatory-resources/financial-services/giving-financial-product-advice/advice-on-self-managed-superannuation-funds-disclosure-of-costs/

Accountants and financial planners surveyed by Investment Trends believe that the appropriate minimum starting balance for an SMSF is $240,000 and $310,000 on average respectively.

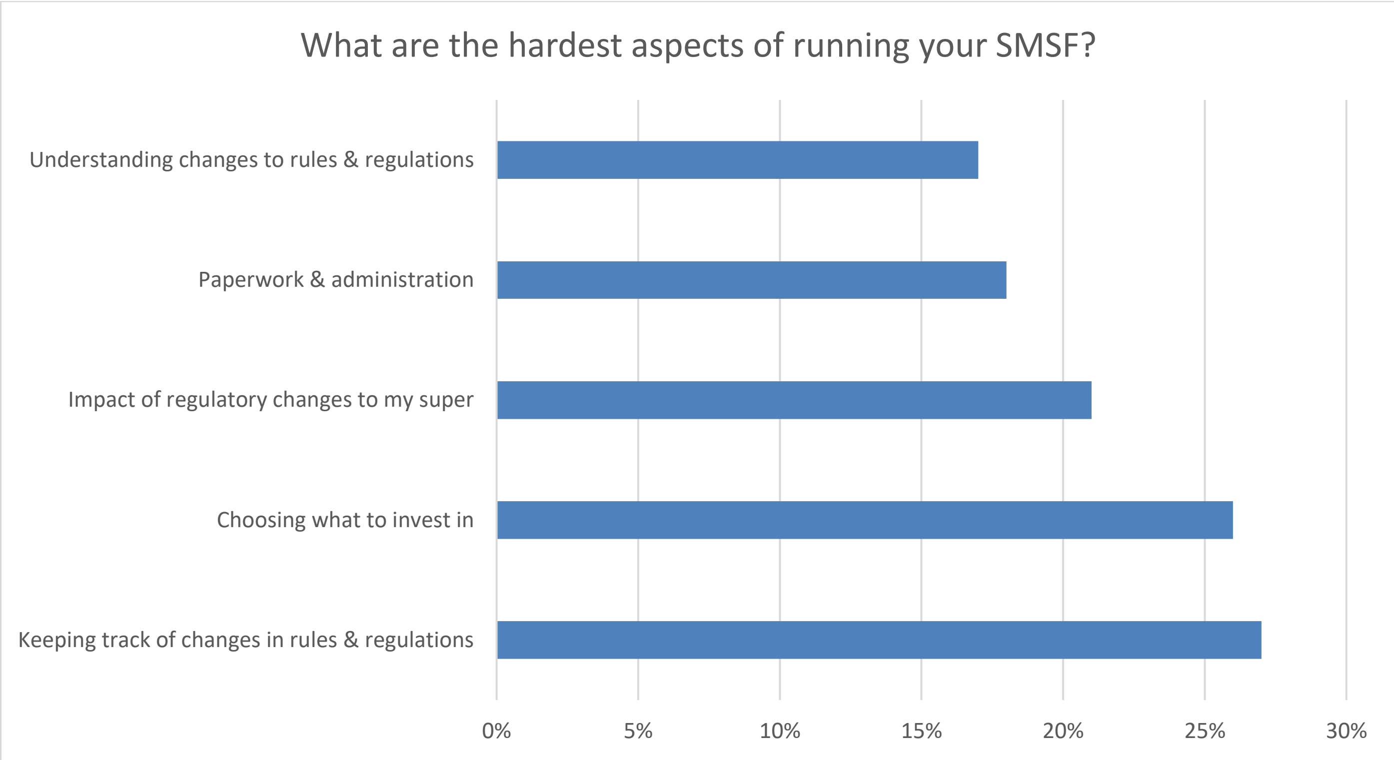
The average starting balances for SMSFs is $430,000. This illustrates that many SMSF trustees have established superannuation balances which are able to reap the rewards of harnessing a lower cost structure than Australian Prudential Regulation Authority (APRA) regulated funds, along with all the other qualitative benefits of owning an SMSF like control, security, choice, flexibility, estate planning and tax efficiency.

On the topic of costs, SMSF trustees must be aware of the typical cost structure of SMSFs to ensure they understand if running an SMSF is suitable for their needs. The average ongoing costs of managing an SMSF on a yearly basis in 2018 is $2,500. Trustees observed a further $400 and $1,400 in one-off and investment costs respectively. Potential SMSF trustees therefore should ensure that their superannuation balance is appropriate for the typical management costs to be cost effective.

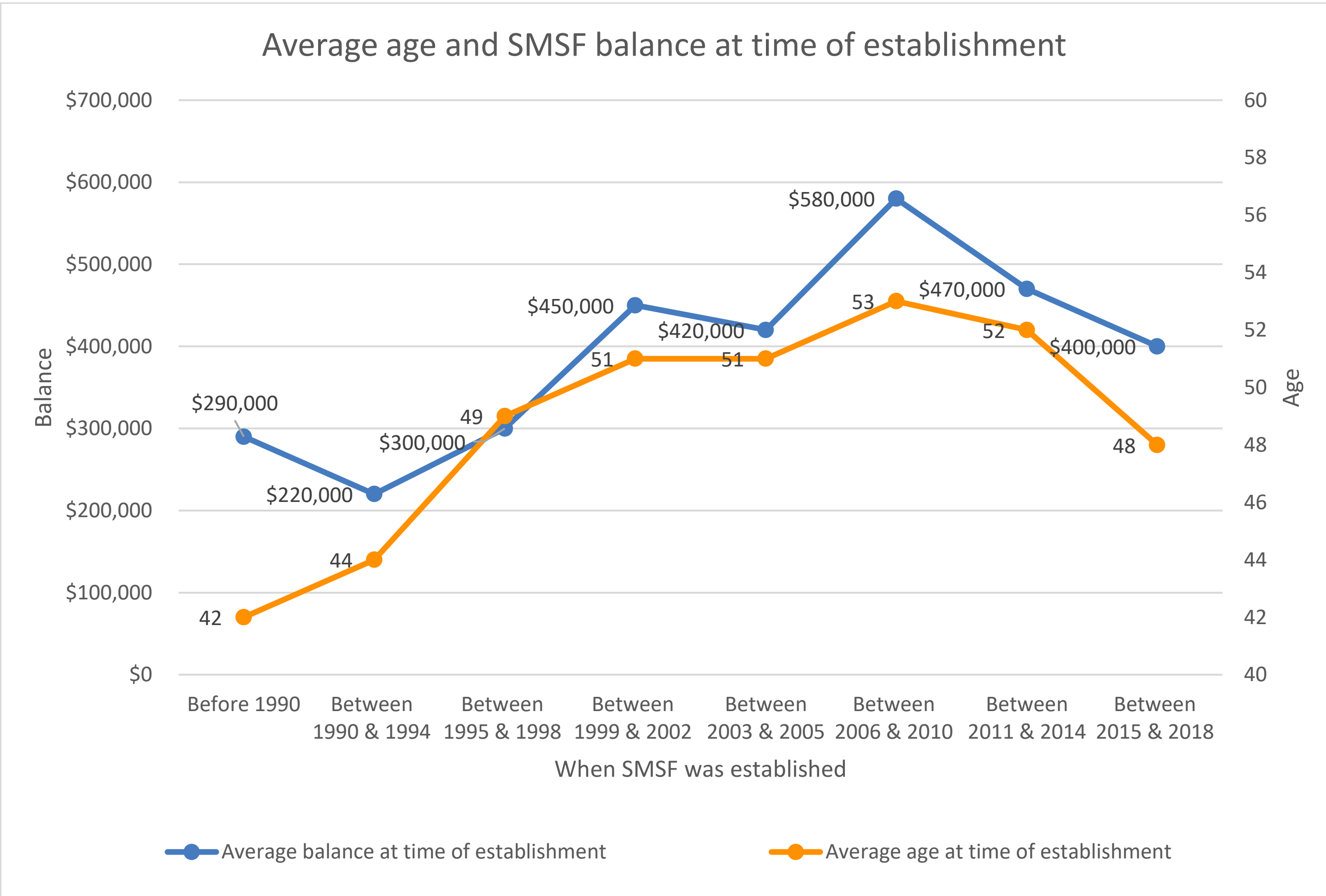



SMSFs can be complex, so most importantly it must be remembered that the ultimate responsibility for compliance with the superannuation rules falls upon the SMSF's trustees. This means SMSF trustees must be up to date with SMSF rules and have the financial knowledge and skill to manage their affairs appropriately.

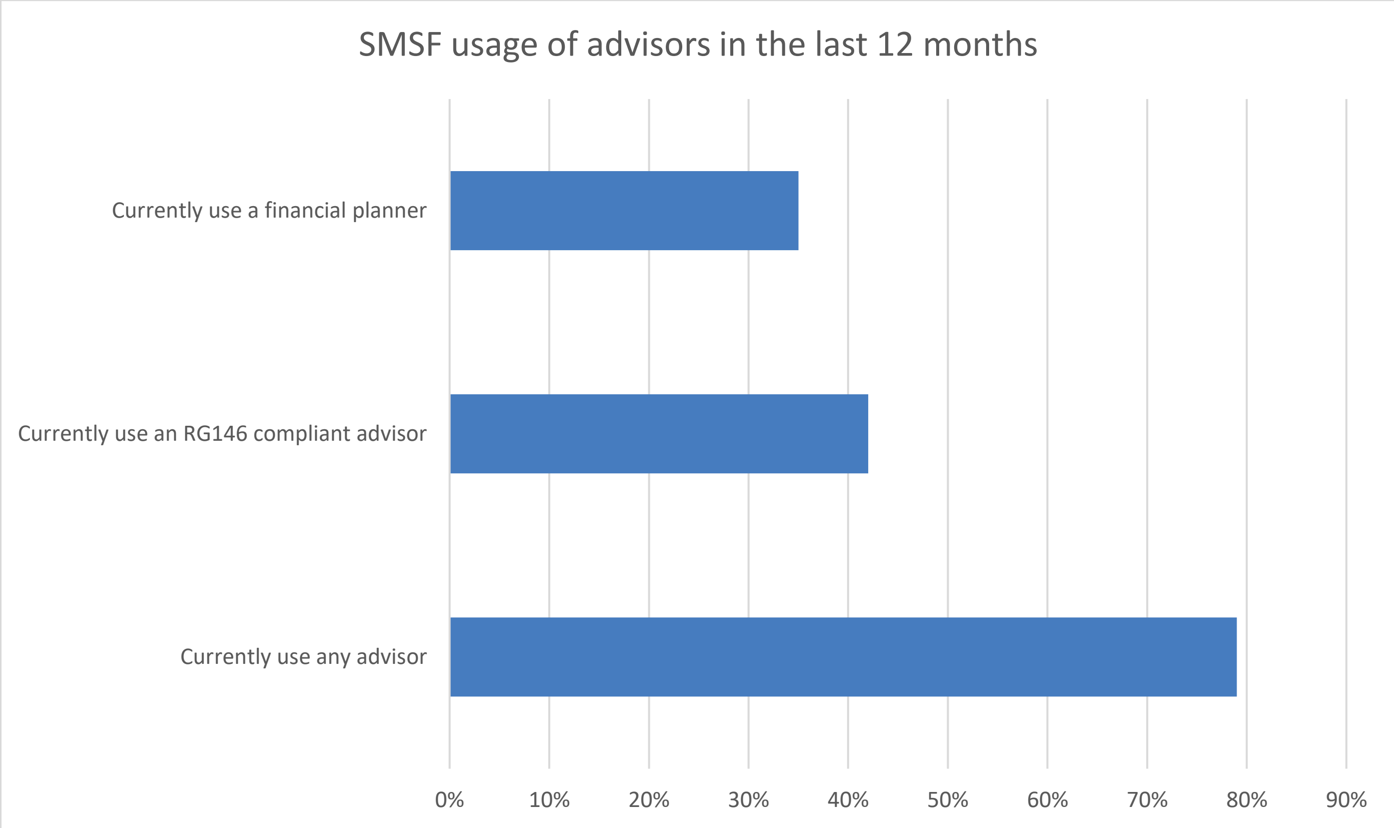
Regulatory uncertainty is now the top cited challenge in managing an SMSF. Over a quarter of SMSFs cite this as a difficulty (27%), just overtaking investment selection (26%).




Reinforced by the research though, SMSFs are not just geared towards older, richer Australians but younger ones as well. The average age at the time of establishment for SMSFs is now 48, with the trend getting younger and younger. Investment Trends data shows that 25% of SMSFs now have a member below the age of 49 in the fund.



Finally, new (and existing) SMSFs should be partnered with a trusted SMSF specialist advisor, whether a licensed accountant or financial advisor. It is very difficult for individuals to 'go it alone' because of all the regulations, legislation and considerations that need to be taken into account. Currently 79% of SMSFs use at least one type of advisor to help manage their SMSF.




It is clear that SMSFs can provide excellent benefits to those who are able to appropriately take control of their superannuation savings to provide a dignified retirement. However, those individuals must have the appropriate time, help, superannuation balance and capability to make the best of their circumstances.

## Myth #2: Do SMSFs need $1 million to be cost effective?

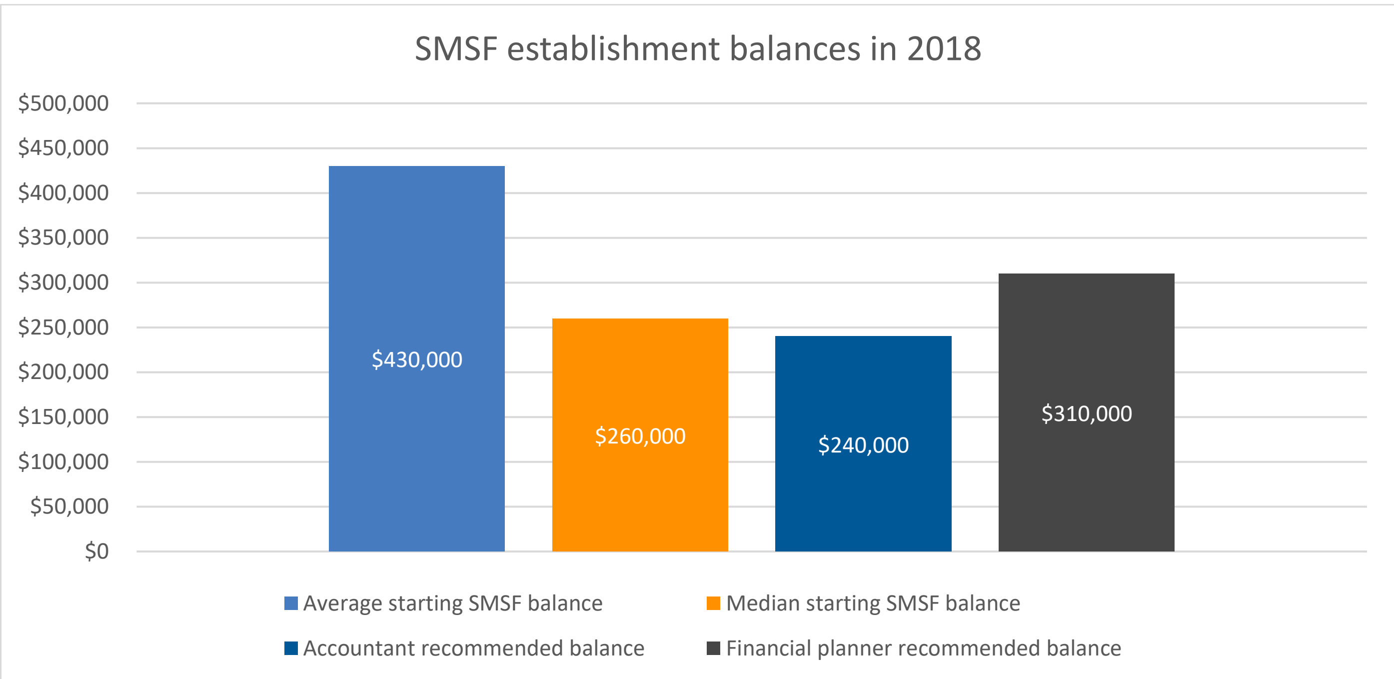
SMSFs do not need $1 million to be cost effective. In fact, far from it, we believe SMSFs can start to be cost effective and appropriate with balances far below that figure depending on the individual circumstances of the SMSF's members. As discussed above, a starting balance of at least $200,000 is often considered to be the appropriate minimum amount an SMSF should be established with.

There have been assertions by the Productivity Commission that SMSFs will only have comparable returns and costs to APRA-regulated superannuation funds where the SMSF has at least $1 million in assets. However, the SMSF Association has argued that this claim has been based on evidence and methodology that is unreliable.

The biggest concern is the use of statistics comparing the costs and returns of SMSFs and APRA-regulated superannuation funds that is much like comparing apples with oranges. This is because the different regulators of each sector use different methodologies to calculate superannuation investment returns. For example, differences in the calculations include how to account for tax paid by superannuation funds and how different costs such as establishment and investment advice fees are measured. This results in incomparable data.

Another significant issue in comparing investment returns, especially between large superannuation funds and SMSFs, is that SMSFs have a significant proportion of members in retirement phase, compared to APRA-regulated funds, which can distort comparisons. The SMSF Association, using Australian Taxation Office data, estimates that approximately 32% of SMSF members are in retirement phase and drawing account-based pensions, with 45.9% of SMSF assets supporting these pensions. Members in retirement phase generally look for more stable income, meaning that they will forgo higher investment returns for reduced volatility and risk. These preferences lead to members in retirement phase having more liquidity and less risky asset allocations and lower investment returns.

The Investment Trends data shows that the average ongoing costs of managing an SMSF on a yearly basis is $2,500. Trustees observed a further $400 and $1,400 in one-off and investment costs respectively. The average starting balances for SMSFs is $430,000.

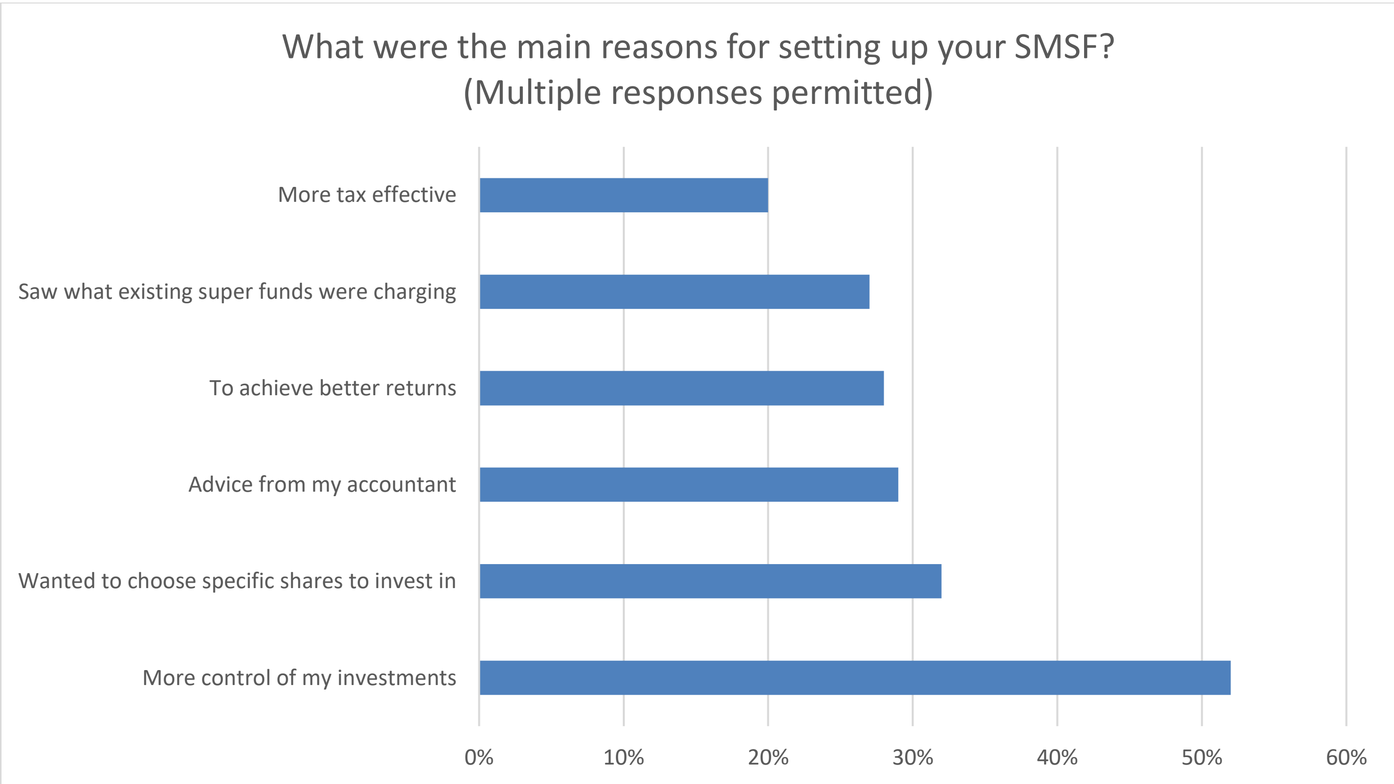


When you compare these costs to the average balance of an SMSF, this typically reflects one per cent or less of an SMSF's balance. This is comparable to APRA-regulated funds which typically range from half a percent to 2 percent. Furthermore, the larger an SMSF balance, the more cost-effective they become because many of the costs associated with running an SMSF are fixed expenses.

Previous Rice Warner research has backed up these claims, finding that the operating costs of SMSFs with balances of $200,000 or more can provide equivalent value to industry and retail funds provided the trustees undertake some of the administration and SMSFs with balances of $500,000 or more can provide equivalent value to industry and retail funds on a full outsourced service basis.

Costs are therefore one of the clear and strong indicators for individuals choosing an SMSF, especially when compared to asset-based fees in large APRA funds. Individuals are willing to incur establishment fees and investment advice fees knowing that they can 'afford' this expense in the aim to reach their retirement goals and achieve economies of scale in their SMSF.

Importantly though, there are broader motivations for an SMSF than just cost, such as control and individual retirement goals. Inherent in the name of a 'self managed superannuation fund', taking control is the overarching motivation which gives individuals the significant responsibility of managing their own retirement savings but also the ability to put into action other motivations which are commonly reflected in SMSF surveys such as this one.
Control is the key reason for an SMSF, overruling the desire for better returns and lower fees.




SMSFs provide the key ability to give ultimate investment choice to its trustees. Trustees are able to create an investment strategy and portfolio which appropriately reflects their financial circumstances and risk profile. This ability to create a diverse, specific portfolio is restricted in institutional superannuation structures and therefore an SMSF provides the ability for more tailored strategies.

SMSFs also provide trustees an increased ability to manage the tax paid by their fund. The flexibility supplied by an SMSF allows individuals to time their contributions, allocate earnings, and time asset sales to an individual's unique situation to give the best retirement savings outcome for members.

With regards to better returns, SMSF trustees believe that they can achieve better net after-tax returns either by their own decision making or investing with professional assistance. Rice Warner analysis indicates that this belief is entirely possible with SMSFs outperforming large APRA superannuation funds in eight out of 12 individual years from 2005 to 2016.[2] However, we also note that SMSF members may just seek a financial retirement goal that is not reflected by a benchmark investment annual return but by a level of income or capital at retirement.

Therefore, blanket findings that SMSFs with assets below $1 million are uncompetitive ignores the intangible benefits to those who are using an SMSF to achieve their retirement goals with their savings.

[2] https://www.ricewarner.com/in-defence-of-the-smsf-investor/

# Myth #3: Could the removal of franking credit refunds significantly impact SMSFs?

The SMSF Association believes the proposal to remove refundable franking credits could have a significant effect on the SMSF sector and on those individuals in and approaching retirement.

Based on the most recent Australian Taxation Office (ATO) statistics for the 2014/15 financial year 311,121 SMSFs utilised franking credits with an average credit of $11,577 per SMSF and a median value of $5,155 per SMSF.[3]
The proposal has the potential to affect all 1.1 million SMSF members and every future potential SMSF member, given that earnings in retirement phase are tax-free (to a limit of $1.6 million of assets per member) and that a concessional 15% tax rate applies in accumulation phase.

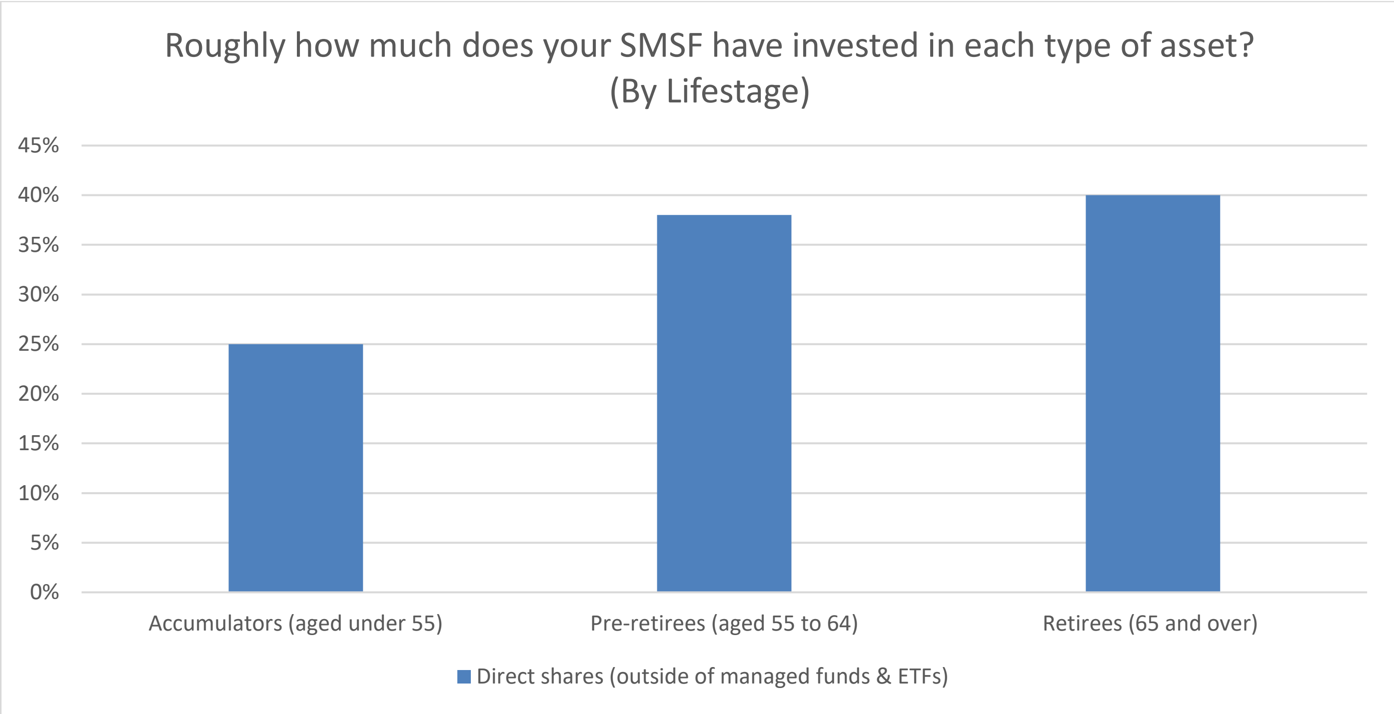
The negative effect of stopping the refunding of franking credits is exacerbated by SMSFs generally not having members generating enough taxable income in the fund (contributions and earnings) to utilise the full value of franking credits against. In contrast, this is generally not an issue for large superannuation funds due to their younger membership base receiving taxable contributions.

More specifically, as of June 2016, 47% of funds are in retirement phase or 267,000 funds. With 60.7% of SMSF members aged over 55, there is approximately 677,000 members either currently affected or will be in the coming 10-15 years as they enter retirement phase. 245,392 members have average income streams less than $58,000 with the overall average income stream for these members is $39,936, highlighting that the refund of franking credits may be a significant portion of their income.[4]

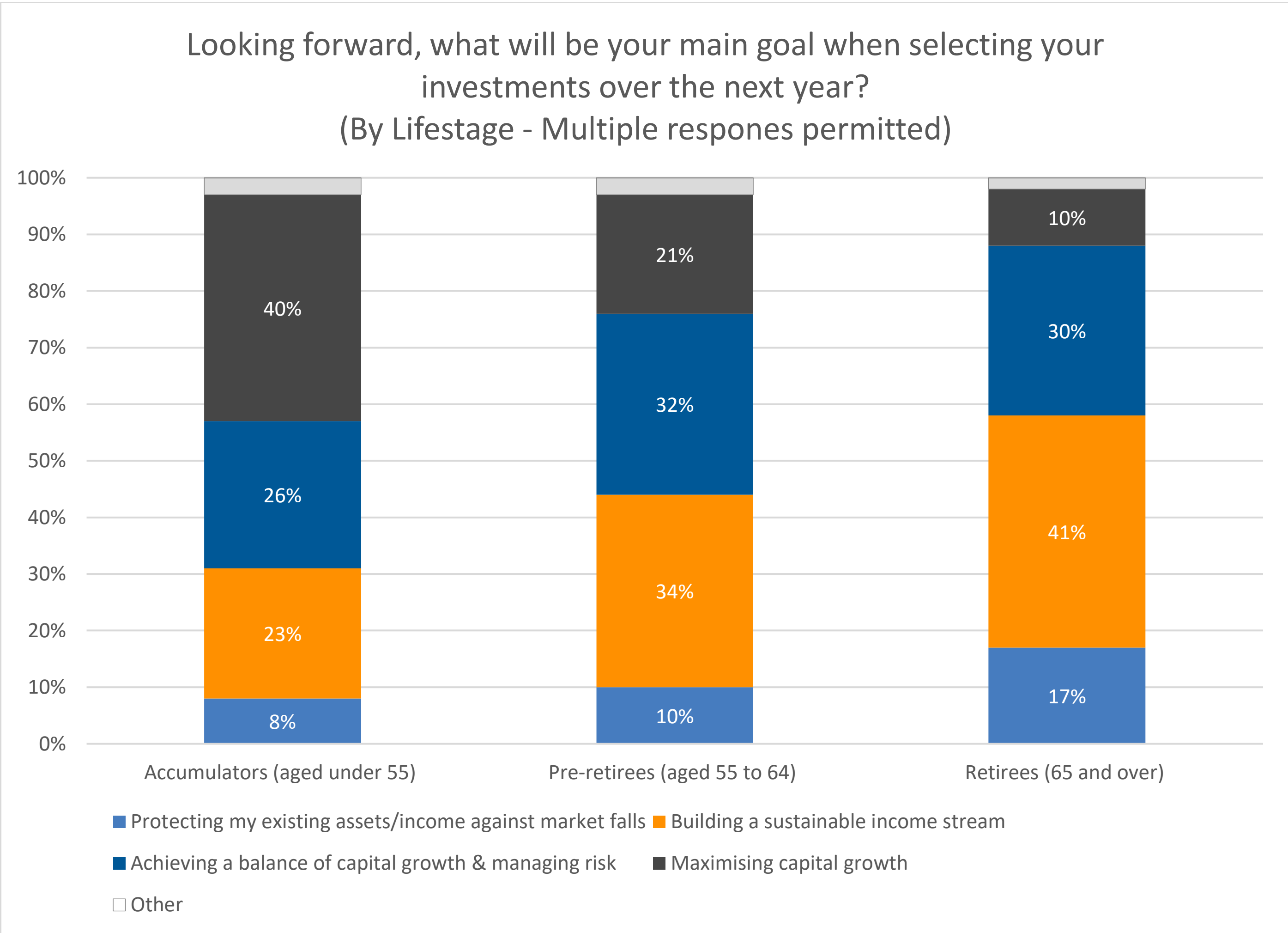
Our analysis of the 2014-15 ATO taxation statistics indicate that the median benefit paid to members by an SMSF in retirement phase is around $50,000 and the corresponding tax refund the median SMSF receives is around $5,500.
Given the average asset allocation to listed shares at 29% of SMSF assets and the fact that 62% of funds are invested in listed shares, this a far-reaching issue.[5]

Younger SMSFs typically have a lower allocation to shares (25%) compared to upwards of 40% for individuals aged 55 and over. This means the impact for older SMSF trustees who are in retirement phase and face lower tax rates because they are in retirement will be even more significant.

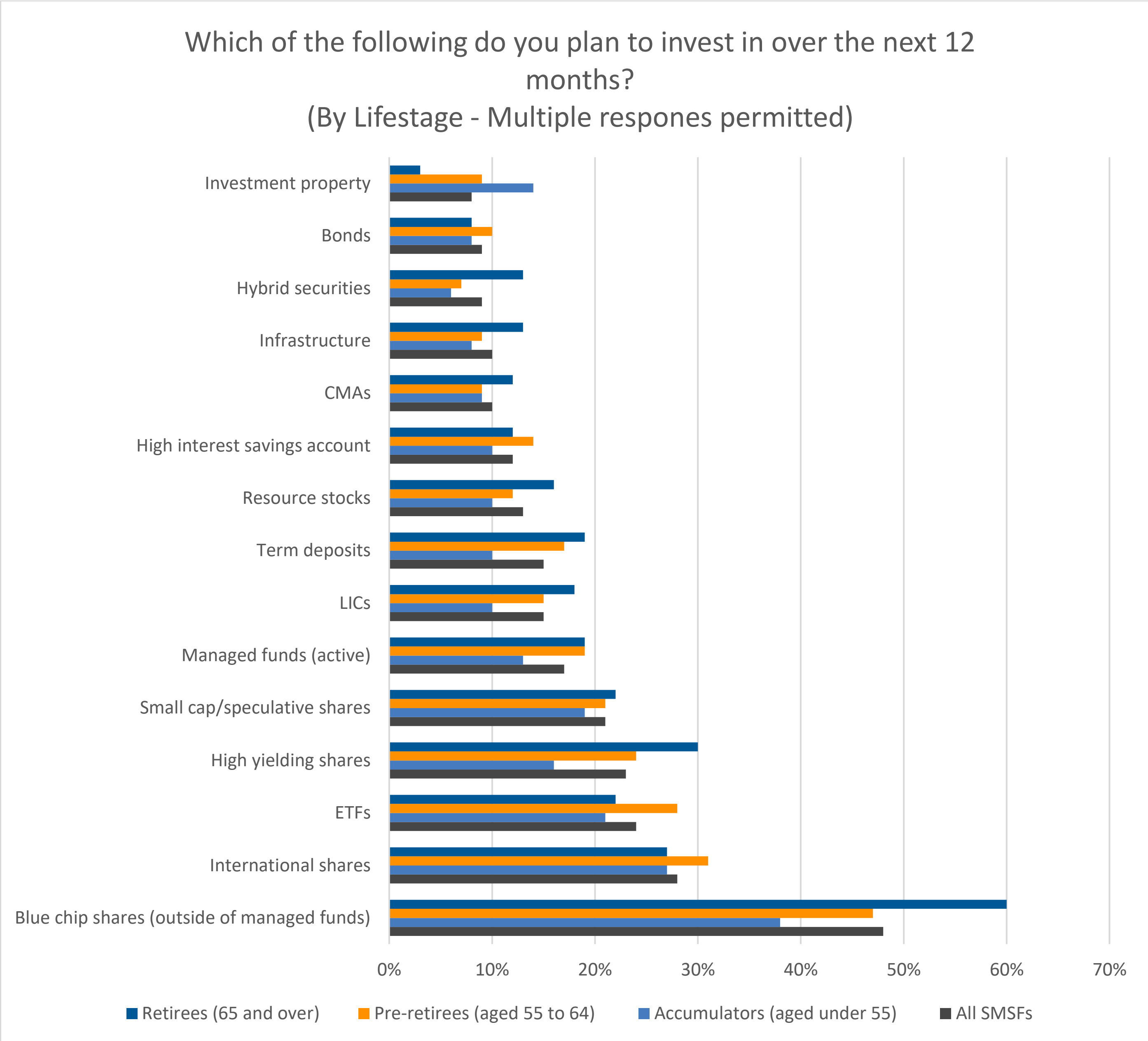
[3] https://data.gov.au/dataset/5c99cfed-254d-40a6-af1c-47412b7de6fe/resource/674f1b70-0a59-4752-9140-84ff713736a2/download/taxstats2015fund02smsfselecteditemsbyyear.xlsx
[4] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2015-2016/
[5] Ibid




This is reinforced by the fact older SMSFs are more likely to cite building a sustainable income stream as their primary investment goal.



SMSFs in the retiree stage are more likely to say they intend to invest in blue chip shares and high yielding shares over the next 12 months, while accumulators tend to show a stronger preference for investment property.




It is these blue chip shares that commonly encompass strong yields and the additional benefit of refundable franking credits. SMSF investors will therefore see a significant reduction in their investment income unless they take action to revise their investment strategy.

SMSFs might seek more assistance in the construction and management of their portfolios in order to address these possible franking credit changes. Licensed financial advisors who specialise in SMSFs can assist. In addition, SMSFs might wish to access online investment platforms that provide diversified managed portfolios.

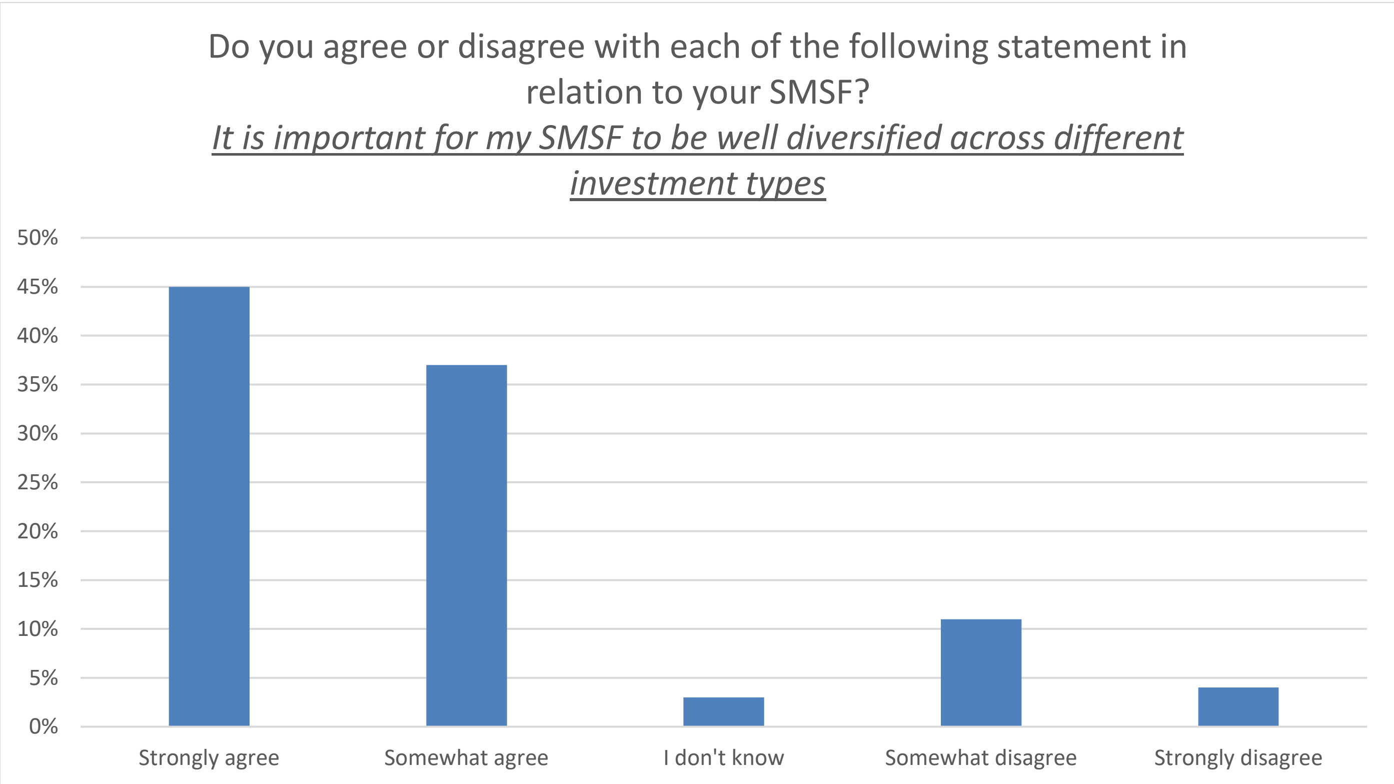
# Myth #4: How can I be sure my SMSF is appropriately diversified?

SMSF trustees need to truly understand diversification and better diversify their portfolios.

The benefits of a well-diversified portfolio are numerous but the key ones that SMSF trustees should focus on are the benefits of mitigating volatility and short-term downside investment risks, preserving capital and the long-run benefits of higher overall returns. By spreading an SMSF's investments across different asset classes and markets offering different risks and returns, SMSFs can better position themselves for a secure retirement.

In addition to these benefits, it is a legal obligation of being an SMSF trustee to consider the diversification of their investments as part of the SMSF's investment strategy. This gives extra weight to the importance of considering diversification for SMSFs while balancing it with the freedom of choice and flexibility that is inherent to SMSFs.

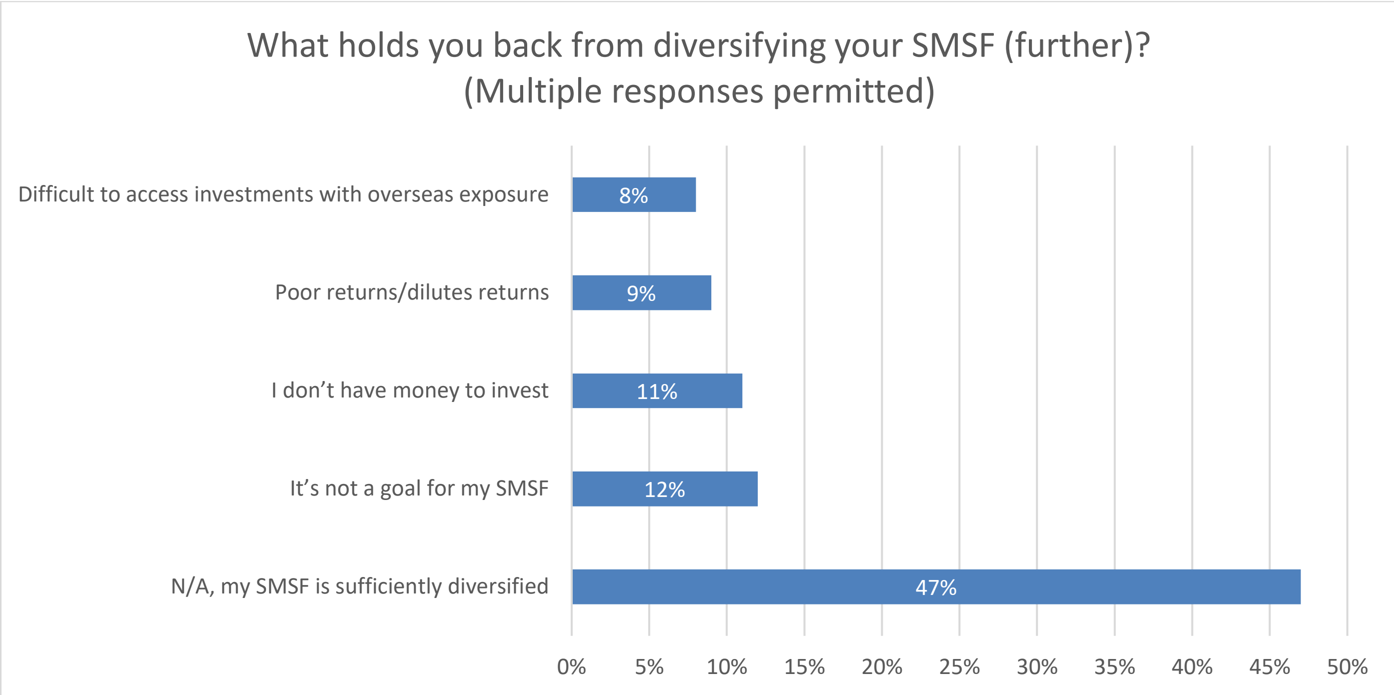
Noting these benefits and trustee obligations, 82% of SMSFs believe that diversification is important, however, in practice many do not achieve it.




Half of the SMSF population cite a barrier to achieving diversification as a problem for their fund. The top two barriers cited are:

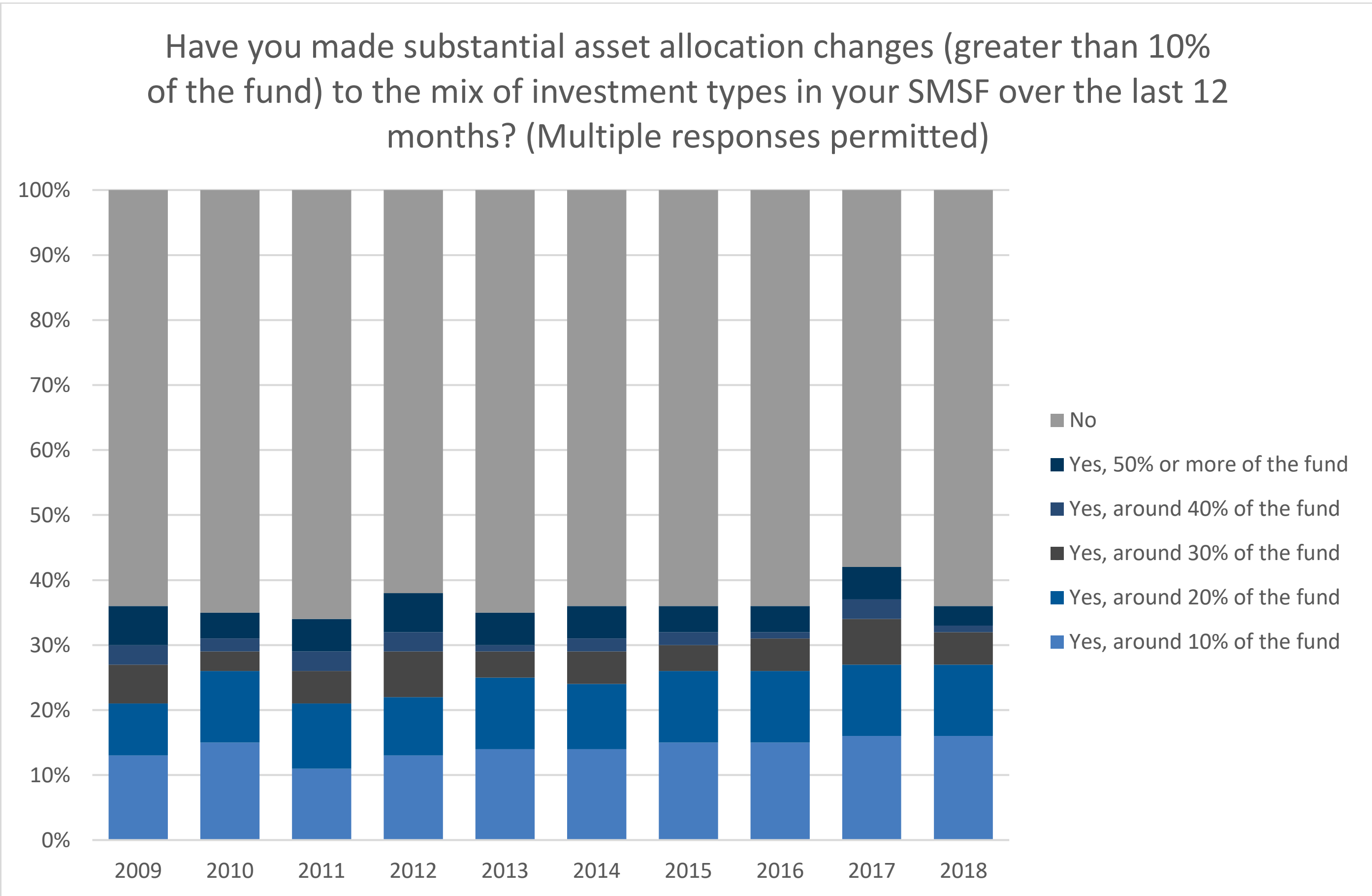
- It is not a goal for SMSF trustees, and
- They believe they have a lack of funds.

There are good reasons to believe that SMSF trustees can be better placed to achieve appropriate diversification for their portfolios. SMSF specialists can assist as can increased education.




Significantly, there may also be a lack of understanding and action taken by SMSF trustees which means trustees are not adequately diversified to minimise market risk.

36% of SMSF trustees say they have made a significant (10%) asset allocation change to their SMSF over the last 12 months. This demonstrates that SMSFs may not be actively restructuring their portfolio on an annual basis to respond to changing market conditions.



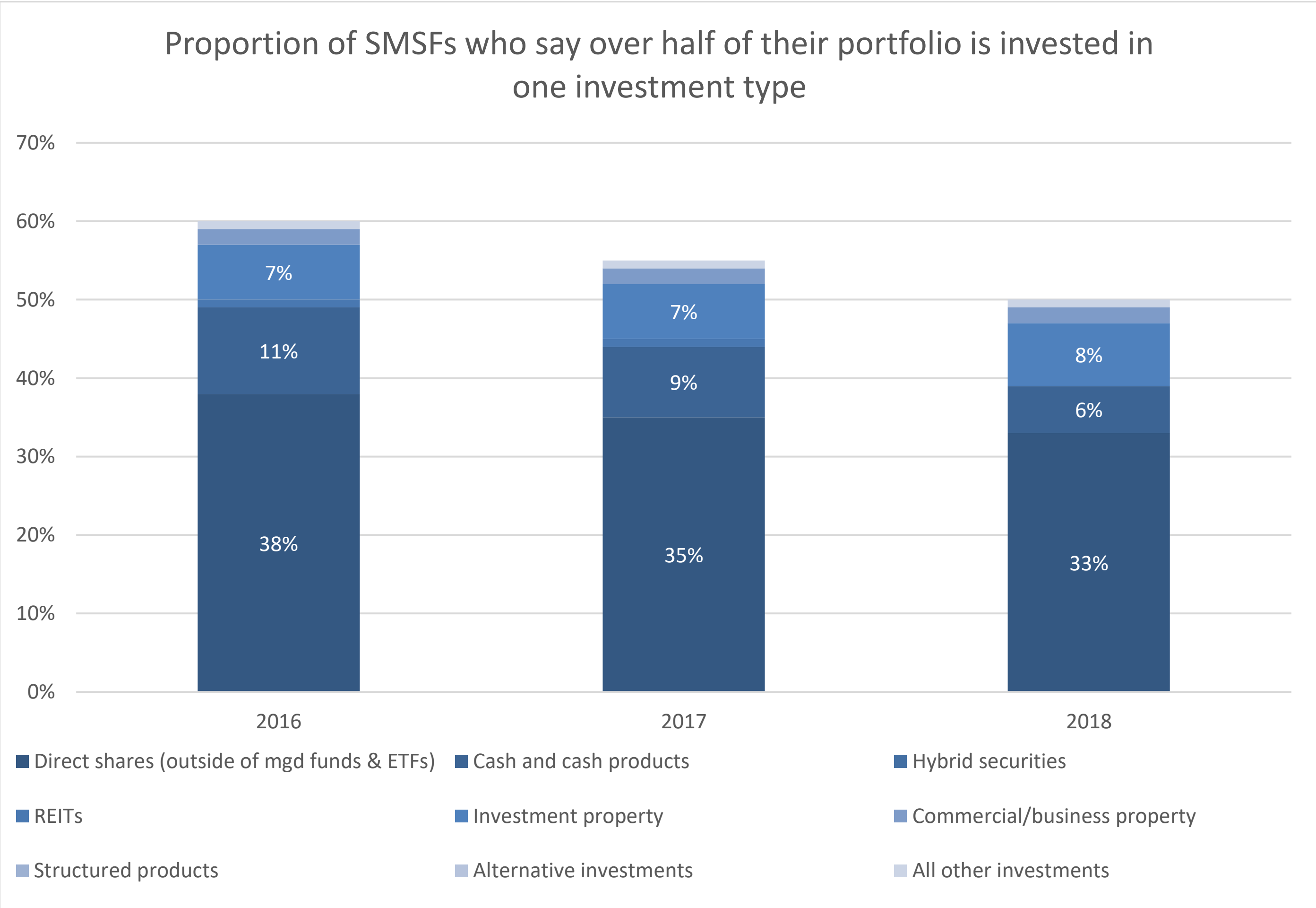
Confusion around what diversification means is still prevalent for SMSF trustees. SMSFs who think they are well diversified are more likely to be invested in managed investments, while those who consider themselves to less diversified focus on shares, cash and investment property.

Furthermore, SMSF trustees say they primarily invest in shares to achieve diversification in their SMSF, while just a quarter say they invest in at least four asset classes to achieve this. When you look at the allocation to shares, the majority of SMSFs believe they can achieve adequate diversification using only a range of shares, with two-thirds of SMSFs considering a portfolio invested in 20 individual shares to be a well-diversified portfolio.

However, the bias and significant allocation to domestic SMSF equities conversely may highlight the fact that SMSFs are not adequately diversified, especially across international markets and other asset classes.

Many investment specialists recognise that even a portfolio containing 30 stocks may not provide sufficient diversification, and there is strong consensus that managed funds help form the building blocks of a diversified portfolio.

Another clear problem regarding diversification is the amount of SMSFs with half or more of their SMSF invested in a single investment. The majority of SMSFs with this type of asset allocation are heavily invested in shares which may mitigate this risk of inadequate diversification because of the ability to achieve some diversification though different shareholdings. However, SMSFs with large overall asset allocations to investment or business properties, or cash are less likely to be appropriately diversified.

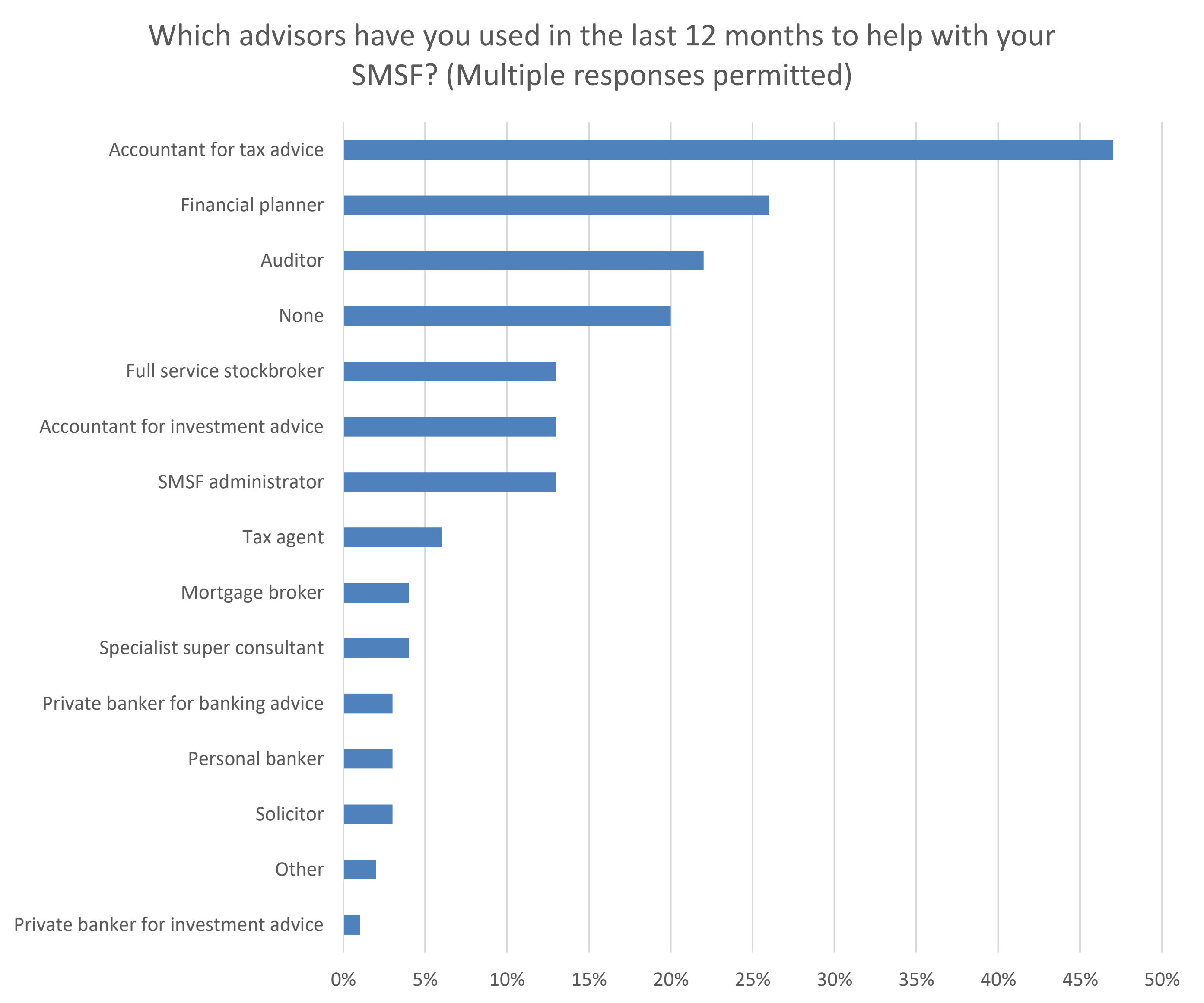


18% of SMSF trustees said they wanted to invest in property as an establishment reason. Property can form part of a diversified portfolio but specialist advice and assistance should be sought. Investing in property should not be the sole reason for the establishment of an SMSF, rather it should form part of the strategy to provide retirement benefits. SMSFs which are undiversified and invest in property, or fall foul of the strict superannuation legislation can cause significant harm to retirement balances.

Given the importance of having an appropriately diversified portfolio, SMSFs ought to consider professional assistance, either from their specialist SMSF advisor, or via accessing investment solutions that deliver diversified managed portfolios.

# Myth #5: Does having an SMSF mean I have to go it alone?

SMSF trustees are likely to need help from a team of professionals to assist them in their journey of saving for retirement. SMSFs usually engage in two different types of advisors each, on average. SMSF advisors work across a broad range of areas of expertise, for example, they include accountants for tax advice, financial planners for investment and strategy advice and SMSF administrators for services to assist trustees run their funds.




SMSF trustees should seek to use the right professionals to get the best outcome for their SMSF.

Compliance is the area members require the most help with, closely followed by tax. If members and trustees do not understand their obligations and the time required to manage an SMSF, this can not only result in severe penalties and sanctions, but a lack of effective engagement and management could cause significant financial detriment.

Tailored taxation and retirement planning can also provide substantial beneficial outcomes to members. This includes control over pension strategies, timing of asset sales, retirement and financial goals and exit strategies, the benefits of which are hard to measure by a simple return calculation.

When focusing on the areas which trustees value the most, it is investment advice which is most valued. This investment advice can be thought of as comprising two quite distinct aspects:

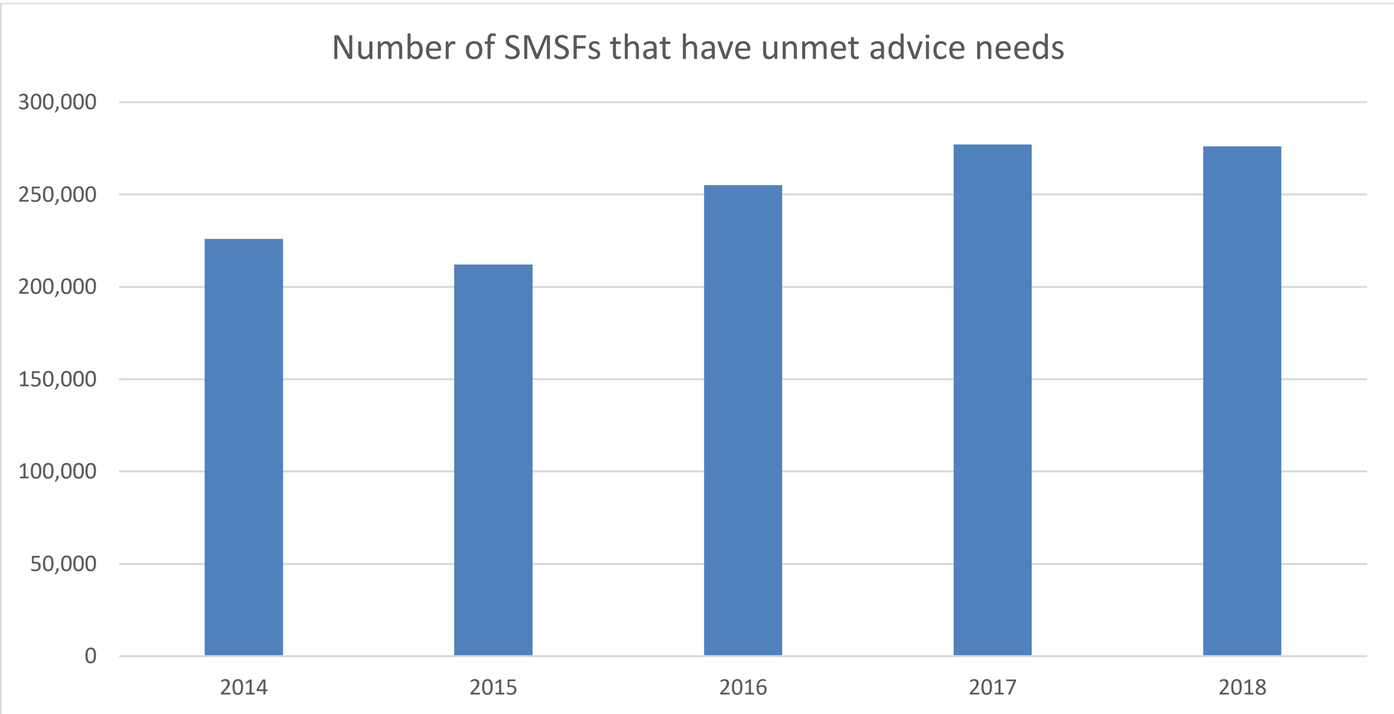
1. The investment strategy for the fund, including ensuring the fund makes an accurate assessment as to the correct risk/return objectives to pursue.
2. Implementing that investment strategy through selecting an appropriate mix of shares, exchange traded funds (ETFs) and/or managed funds, and then managing this portfolio subsequently.

The SMSF Association believes that both elements are extremely important to the outcomes of members in SMSFs. Again, professional assistance from SMSF specialists is vital. Both licensed accountants and financial advisors are able to assist trustees to develop an appropriate investment strategy.

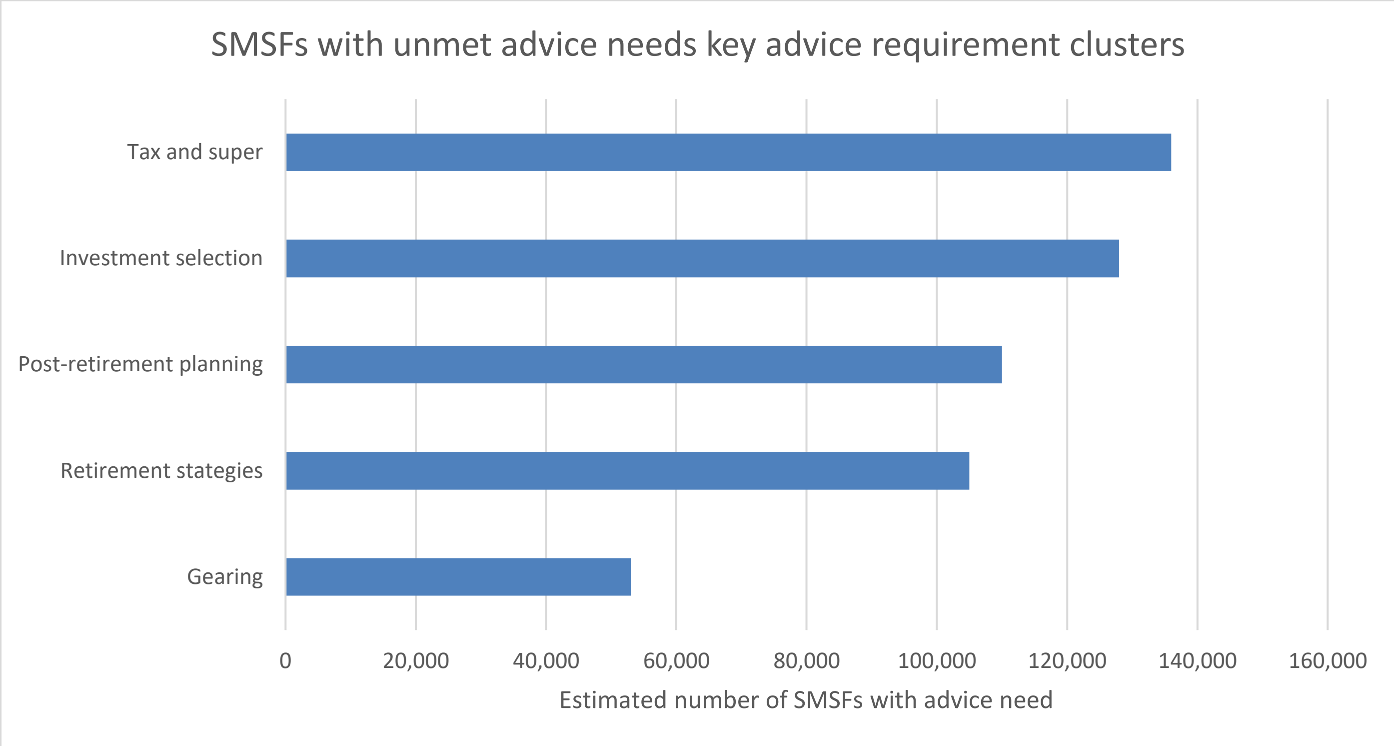
However, when it comes to implementing that strategy by selecting a mix of shares, ETFs and managed funds, an accountant will need to have a financial services licence to be able to assist. SMSFs who are seeking investment selection advice can avail themselves of a licensed financial advisor who specialises in SMSFs, or access investment platforms that provide access to diversified managed investment portfolios.

As described above, it is crucial SMSFs have a portfolio that's appropriately diversified given the circumstances and goals of the trustees.

Despite the fact that trustees aim to seek professional assistance which will help them reach a dignified and adequate retirement, the number of SMSFs with unmet advice remains high.



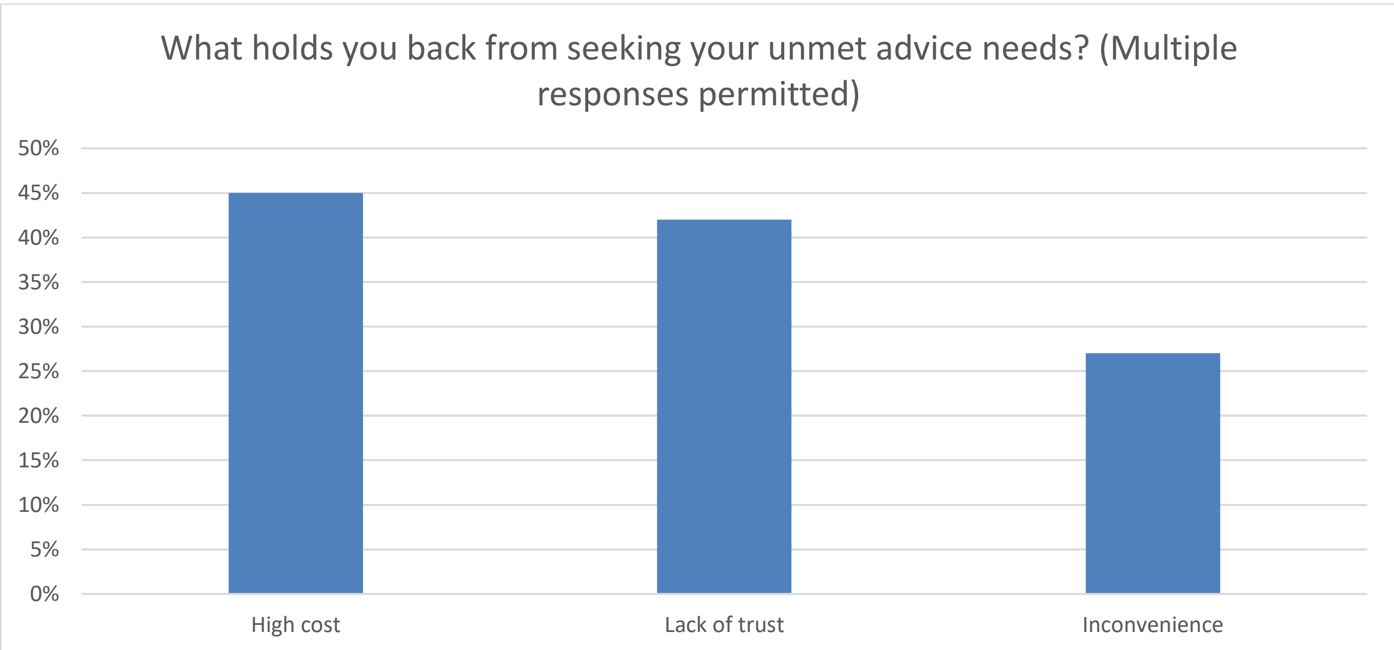

SMSF trustees note the four main areas which they would require more advice being superannuation tax planning, investment selection, post-retirement planning and retirement strategies.




This may be a reflection that SMSF trustees are not seeking the right advisors with the right specialisation which will suit their needs. However, it also exposes an opportunity for SMSF specialist providers to strengthen and showcase their offerings to service the demands that exist. This becomes further highlighted as only one third of SMSFs believe it is important that they receive all of these services from one person.

In contrast to this, despite the use of two different advisors on average, SMSF trustees note significant barriers to seeking professional assistance. Depending on the age of trustees the reasons may vary, however, consistent themes emerge.

The three main groupings of reasons for barriers to entry are high cost, lack of trust and inconvenience.



If SMSF specialists can address these barriers, they will be able to meet the well-articulated and currently unmet needs of more of Australia's 1.1 million SMSF trustees.

For example, investment solutions that provide diversified portfolios might be a more efficient and low-cost way to implement an SMSF's investment strategy than individual selection of shares and other assets. Accountants might find such services to be an excellent way to ensure their SMSF clients have portfolios that are appropriately diversified, increasing the likelihood that the trustees stay on track for a fulfilling and dignified retirement.

Similarly, licensed financial advisors are able to access new technology to bring down the cost of their advice. In addition, the increase in financial education standards and ethics which has been legislated will increase standards amongst financial planners, increasing levels of trust.

SMSF advisors should also provide offerings that can be appropriate for all SMSF trustees depending on their stage of life. Younger trustees are more focused on the cost and time involved in accessing SMSF advice whereas older trustees have a lack of confidence in the quality of the advice and assistance that would be offered to them.