The rise and rise of compliant SMSF investment strategies: Why it's more important than ever

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Is the "On Just Terms SMSF" on just terms?

Introduction

In putting together this paper, all those famous and oft-used quotes from the movie The Castle (which is in no way associated with the Corrigans in our Case Study) came to mind. Whilst Das, Sal and their respective families may be looked upon by some as being simplistic and unsophisticated, the premise of that movie was "every person's home is their castle".

Who are we to judge others? The Corrigan's were working-class Australians, happy with their modest lifestyle. And in that same vein, is not every person's SMSF their very own "retirement castle"? Who are we to judge the investment decisions of the Corrigans?

Whilst the actual investments of the On Just Terms SMSF and how they were acquired are beyond the ambit of this paper, people's superannuation investment decisions do have an impact on the rest of society in a roundabout way. Poor investment choices may mean superannuants have less money in retirement, which potentially means they will rely on the government-funded Old Age Pension. A tab that is picked up by all of us.

In recent times there has seemingly been a flurry of activity regarding SMSF investment strategies. So, it is worthwhile going through these recent events chronologically, and then looking at the potential implications for each on the On Just Terms SMSF.

Background

To provide a bit of context regarding where we are now, let's wind the clock back to 2019 (ah, 2019!). The ATO announced in August of that year they were going to contact approximately 17,700 SMSF trustees and their auditors regarding funds with at least 90% of their total investments in one asset or a single asset class.

No examples were offered of the types of investments, fund asset size or whether the fund was in accumulation or retirement phase. The ATO letter finished with the flurry "You should be aware that if your auditor identifies you have failed to rectify any non-compliance with the requirements listed above, this could result in the imposition of abovementioned penalties." A tad heavy-handed, but I digress….

At first blush, this appeared to simply be the regulator's concerns that funds with such high concentrations may not have considered asset diversification in developing the fund's investment strategy and may expose the fund to increased risks.

However, it was clear the ATO were targeting the 41 per cent of SMSFs with LBRAs that held 90 per cent of assets in one class (which, coincidently, was the same 17,700 funds).

It is important to note the ATO's letter did not state a fund could not hold over 90% of their total investments in one asset or a single asset class. It simply reminded Trustees in this situation they must be able to demonstrate why they are comfortable this meets their retirement goals and how they are comfortable they have addressed the legal matters required in Superannuation Industry (Supervision) Regulation 4.09. That is - risk and return, liquidity, insurance and inadequate diversification.

And, so it is worthwhile looking at this issue, given On Just Terms SMSF related party borrowing (from Spiro's private company) and asking questions about how funds with lumpy assets such as property (in particular ones with LRBAs) can go about satisfying the elements of – not just diversification – but of liquidity?

In the ATO's own online publication on the matter, it states "When preparing and reviewing your investment strategy, consider the personal circumstances of all the fund members, including their age and risk tolerance. You need to consider:

- diversification (investing in a range of assets and asset classes)
- the liquidity of the fund's assets (how easily they can be converted to cash to meet fund expenses)
- the fund's ability to pay benefits (when members retire) and other costs it incurs
- the members' needs and circumstances (for example, their age and retirement needs)."[1]

Therefore, liquidity considerations, especially meeting the LRBA debt, might be addressed by regular concessional contributions by members of On Just Terms, as lumpy assets, such as the salon and the crash repair premises, are the principal investments of the fund.

Rental income from these assets might also provide liquidity for the repayment of the loan and other property expenses. However, given property may not be readily converted to cash, how else may the members/Trustees ensure there is enough liquidity to pay, say, a death benefit, for example? In some circumstances, policies of insurance may be undertaken to provide the fund with the ability to make a death benefit lump sum payment.

[1] https://www.ato.gov.au/Super/Self-managed-super-funds/Investing/Your-investment-strategy/

And what of retirement benefits for older members, such as Das and Sal? How does having 90% invested in one asset or asset class – namely property with one subject to an LRBA – satisfy Trustee obligations to provide retirement benefits to members? Perhaps the trustees have a plan to achieve diversification by using future contributions to invest in other asset classes over time? We'll come back to this point in a moment.

It is important to remember SMSFs with LRBAs targeted by the ATO could have documented investment strategies that dealt with liquidity in retirement. In fact, the asset allocation of the targeted SMSFs could be part of a legitimate investment decisions, justified by the fund's investment strategy.

Such fund members may well remember the Global Financial Crisis (GFC) and feel an investment in real property via an LRBA is something they are more comfortable with – they can see it, it's tangible, unlike many perceived 'black box' type investments that seem to be offered by many financial institutions and large APRA funds.

As is the case with Das and Sal, it could also be the member's business premises being owned by the fund and leased to a related party; a strategy completely legitimate and contemplated by superannuation legislation.

The investment strategy could be one where the LRBA will be paid off by retirement, at which time the unencumbered property could be sold in pension mode, when the fund is a tax-exempt entity and Exempt Current Pension Income (ECPI) is relatively high, mitigating Capital Gains Tax (CGT).

Let's now come back to the issue of diversification.

SMSF Investment Strategy template – the death of cut and paste?

As we move forward along the SMSF investment strategy chronology, the guidelines provided by the Australian Taxation Office (ATO) in February of 2020 (February, if we only knew then what we know now!), showed they consider the investment strategy to form part of a fund's specific compliance documentation. As such, the investment strategy should be tailored to individual fund circumstances and should not be a document merely repeating standard verbiage, such as generic asset allocation ranges of zero to 100 per cent for each asset class in a table.

As we can see with the Corrigans, each fund member has a unique set of circumstances and given the sole purpose of superannuation being the provision of retirement benefits, the investment strategy should explain how fund assets will meet each member's retirement goals.

Whilst many industry pundits see the ATO guidelines as being beyond their role, under superannuation law, factors must be considered regarding how SMSF trustees are going to achieve member objectives, given the whole circumstances of the fund. Therefore, it is worth remembering, the investment strategy should include (but is not limited to):

- The risk vs return profile of the asset classes
- Diversification
- Liquidity needs (how easily and quickly the assets can be converted to cash)
- Ability to discharge liabilities as they fall due
- Insurance needs of the members.

The ATO make the point in their guideline, formulating the fund's investment strategy is not achieved by specifying investment ranges of 0 to 100% for each class of investment. Whilst most trustees rarely put together such generic asset class ranges (in my experience at least), it appears the strategy of using broad template ranges to ensure the investment strategy covers almost every fund asset allocation without much member input is a thing of the past. The 'set and forget' template is dead.

The guideline states trustees need to articulate how they plan to invest superannuation monies; rather than just use percentage ranges in each asset class, the investment strategy should state reasons why and how investing in those assets will achieve retirement goals.

There is nothing in the legislation that states trustees must use asset allocation ranges, however. The guidelines states in these circumstances, where asset ranges are not used, trustees should list specific assets and include the reasons why investing in those specific assets will achieve retirement goals.

So, what does the ATO suggest a compliant investment strategy should look like?

Unfortunately, they provide no actual examples of what might constitute an ATO 'approved' investment strategy. They do outline a couple of key points trustees must consider.

The first is having regard to diversification, which, as mentioned earlier, is one of the elements of Regulation 4.09 of the SIS Regulations (1994). This seems to be off the back of the previous targeting of funds where more than 90% of the fund's assets were held in property and the fund reported having a Limited Recourse Borrowing Arrangement (LRBA) which we again discussed earlier.

Whilst a fund is not required to be diversified and it may be completely reasonable to have either 100% cash allocations or 90% held in one asset or one asset class, the ATO state trustees must justify how this lack of diversification is going to achieve the fund's investment objectives and cash flow requirements.

What is the rationale behind the lack of diversification? How is the fund going to satisfy its sole purpose for being in existence – that being the provision of retirement benefits for members? Again, many pundits have pilloried the ATO for mentioning diversification or what asset classes a fund should invest in.

Personally, I think the ATO is not taking a stance either way. They are simply saying "Justify your decision." If trustees can justify such a decision, by saying, for example, "We are heavily invested in cash, because we are going to retire soon and a massive drop in capital value in the short term will severely impact the member's ability to survive 25 years of retirement" would, to my mind, placate any scrutiny by the ATO.

In fact, it turns the trustee's mind to other factors, such as longevity risk and the need for capital growth. The trustees may in fact state in the investment strategy they take short-term Tactical Asset Allocation decisions that differ markedly from the longer-term Strategic Asset Allocation position of the fund. The ATO is saying there is nothing wrong with that. What they are saying is what is the rationale behind it.

The ATO also refer to "giving effect" to an investment strategy in the guideline. This is referred to in the operating standard in Regulation 4.09 of the SIS Regulations. Interestingly the ATO decided to interpret this statement in the Regs, saying it means the fund's investments are in accordance with the investment strategy, so the trustees are on track to meet member retirement goals. Again, the ATO emphatically states range of 0 – 100% in a broad range of asset classes does not reflect proper consideration in satisfying the investment strategy requirements.

Once more, the punditry disagreed with the ATO, saying they had no right to dictate what is an appropriate level of diversification on what asset classes funds should invest in. I do not think the guideline is doing that. Having asset ranges of 0 – 100% does not clearly articulate how trustees plan to invest super monies to meet retirement goals.

To clarify the point, the ATO goes on to say they do not consider short-term variations to the fund's investment approach, including to specified asset allocations, constitute a variation of the investment strategy. I could be wrong, but I read this to mean – again – Tactical Asset Allocation ranges, even 90% in one asset class, will not be an issue for the ATO. It always comes back to a requirement to justify the decision. If trustees can do that, the ATO in my view would not be concerned at all.

The point the ATO raise in the guideline is that of regular review; another requirement of Regulation 4.09. Given the COVID-19 hysteria continually sweeping the globe, regular reviews of the investment strategy would be a logical and prudent course of action at this time. Review in this context does not necessarily mean re-writing the whole document. It could be done as part of the annual trustee minutes, which could then be provided to the fund auditor to show the trustees have met the requirement to review regularly and, where necessary, revised the investment strategy.

As with recent case law and ATO initiatives, the role of the fund auditor is brought into sharp focus. Trustees are warned if they do not comply with the investment strategy requirements under superannuation law, the auditor may notify the ATO by lodging an auditor contravention report (ACR).

Given recent announcements by the ATO regarding the imposition of administrative penalties (which can be significant and must be paid by the trustees personally) for breaches of super law, the ramifications are severe. However, failure to address the factors mentioned above (such as the risk of a lack of diversification) can be remedied by attaching a signed and dated addendum to the strategy or a trustee minute which adequately addresses the requirements. This should then be shown to the auditor prior to the finalisation of the audit.

If trustees have not invested in accordance with the investment strategy, they can revise the strategy to ensure it reflects the fund's investments and how those investments will meet retirement objectives.

The investment strategy of On Just Terms SMSF is about the members sitting down and discussing the following - this vehicle's sole purpose is to provide benefits to us members in retirement. We get generous tax concessions to help us achieve that goal.

What assets are going to help us reach that over-arching aim? What if one asset class is heavily impacted by a Black Swan event? What other assets could our fund invest in that may be unaffected (or less affected) by a market downturn? Should the fund have liquidity to buy distressed assets during a market downturn? If our fund borrows to buy an asset, how will it meet that debt obligation? What if some members retire before others? How will the fund meet lump sum, or pension benefit payment obligations?

A quick word on crypto currency and derivatives

The Case Study makes mention of Gazza joining the fund and his desire to have the fund invest in crypto currency and derivatives. This raises a couple of key questions; firstly, can an SMSF invest in such asset classes? Yes, but, the investment must:

- be allowed for under the fund's trust deed
- be in accordance with the fund's investment strategy
- comply with SISA and SISR regulatory requirements concerning investment restrictions.

Before investing in cryptocurrency, the members of On Just Terms SMSF should consider the level of risk of cryptocurrency as an investment. Do they have the experience or knowledge to undertake the high-level decision-making processes required with this investment? Or can they engage professionals that can provide advice on these types of investments?

One of the first discussions should be about upgrading the fund's trust deed to allow for such an investment. Then Con, Gazza and the other trustees deciding if with guidance, their fund can invest in such assets to build its portfolio for the sole purpose of providing retirement benefits to members, taking into account the varying benefit payment dates and requirements of the fund (death benefit pension now, but also growing accumulation benefits for younger members).

It may be a case of members having separate investment strategies, which may be allowed under the fund's governing rules. If the Corrigans think they can build the SMSF nest egg with crypto, the trustees and members may then review and, if necessary, update their fund's investment strategy to ensure the investment being considered is permitted.

It is also important to note the ATO considers cryptocurrencies, such as bitcoin, Capital Gains Tax (CGT) assets and the On Just Terms SMSF will be subject to a tax impost dependent upon the fund's taxation circumstances. When an SMSF engages in these transactions it must comply with the same regulatory requirements that apply to investments in any other assets. That means issues such asset valuations must be considered. The value in Australian dollars will be the fair market value which can be obtained from a reputable digital currency exchange or website that publishes its rates publicly.

The ATO acknowledges the value of cryptocurrency can change constantly. For the purpose of calculating member balances at 30 June, the ATO will accept the 30 June closing value published on the website of a cryptocurrency exchange that reports on historical cryptocurrency values.

Derivatives investing also has several hurdles that must be cleared (other than the fund's governing rules allowing for such an investment). The first being Superannuation Industry (Supervision) (SIS) Regulation 13.14.

Under SIS Reg 13.14, SMSF trustees may not give a charge over the fund assets, which includes a mortgage, lien or other encumbrance. The regulation prohibits trustees from activities such as:

- Participating in margin lending products and
- Creating a mortgage over a property.

One of the exceptions to this prohibition is the LRBA for the Salon, which has its own set of restrictive rules laid out in s67A and s67B of SIS.

Another exception is where the fund creates a charge over fund assets as a result of investing in derivatives, such as options and futures.

Under Regulation 13.15A of SIS, an approved charge on fund assets can be provided for investments with Australian and specified foreign stock exchanges and futures exchanges ("approved body") if:

- The derivatives contract complies with the rules of the approved body (SISR 13.15A), and
- The fund has a Derivatives Risk Statement (DRS) in place.

The DRS must be in place as a separate document to the investment strategy and outlines:

- Policies for using derivatives, including an analysis of the risks associated with using derivatives within the fund's investment strategy
- The restrictions and controls on using derivatives, taking the expertise of the people involved into consideration
- The compliance processes to ensure the controls are effective.

Remember, too, that while the term "derivative" applies to a variety of financial arrangements, not all are eligible obligations that will meet the requirements of SIS.

It is worthwhile mentioning that if Gazza and the trustees decided to take out an option on Bitcoin through a cryptocurrency exchange, these types of unregistered financial hybrid securities would result in the On Just Terms SMSF being qualified by the Auditor (under SIS Reg 13.14). This is because the trustee would have given a charge over fund assets to trade.

Final thoughts

Let's consider the On Just Terms SMSF one final time. Sal's deteriorating health means she decided to receive a pension, but the given assets of the fund – business real property, classic cars, a greyhound and fake jousting sticks – is the request going to be complied with in a timely fashion? Will assets need to be sold at discounted prices (or in a falling market? Since 1 July 2017, pensions can no longer be paid in-specie and must be paid in cash, so assets may need to be liquidated to pay this member benefit.

And given the recent tragic passing of Sal, how is her death benefit going to be paid?

Death benefit lump sums can be paid in-specie, but Das may then have to sell the asset to provide cash he requires in retirement. This may well be achieved by selling, say, one of the classic cars, but could the fund have been structured a better way to ensure he could take a pension and the fund have ready liquidity to do this quickly?

The robustness of SMSF investments and the investment strategy that underpins them are being tested like never before. For funds with older members or those approaching or in retirement, diversification is a way to preserve capital.

Drawing down income streams from cash holdings and not having to liquidate distressed assets, giving them time to recover, is a logical course of action.

For those funds that have younger members, such economic turmoil can be an opportunity. With a diversified mix of asset classes and enough cash holdings to take advantage of the market downturn to purchase undervalued investments, there's a sufficient time horizon to ensure positive returns.

A lack of diversification, on the other hand, with funds largely invested in property via an LRBA, or other lumpy or illiquid assets, could lead to, for example, rent not being received due to the economic impact of lockdowns, closed businesses and market downturns.

Members potentially no longer have a job, which impacts on their ability to make contributions to the fund and have cash to pay back an LRBA. The fund itself may need to ask for a deferral of loan repayments if it does not have the liquidity to pay back the lender. These issues impact on the nest egg of Australians and make those retirement goals that much harder to achieve.