THE OUTLOOK FOR
the self-managed super fund sector

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The self-managed superannuation fund (SMSF) sector has become an important and enduring part of the Australian superannuation system with over 1.1 million Australians choosing to use an SMSF to manage their retirement savings. This paper provides an overview of the current state of the SMSF sector and assesses the challenges that lie ahead for the sector. These include increased compliance complexity, the ageing of SMSF trustees and members, and the need for appropriate asset allocation and high-quality financial advice during the retirement phase. The paper was presented at the 22nd Melbourne Money and Finance Conference, Monash University and Australian Centre for Financial Studies, 10 to 11 July 2017.

SMSF sector overview

The SMSF sector had 590,742 funds with 1,120,117 members and approximately $675 billion in funds under management as at March 2017, representing close to a third of all superannuation assets (ATO 2017). SMSFs had average assets of approximately $1.1 million during the 2015 financial year.

TABLE 1: Average and median SMSF assets

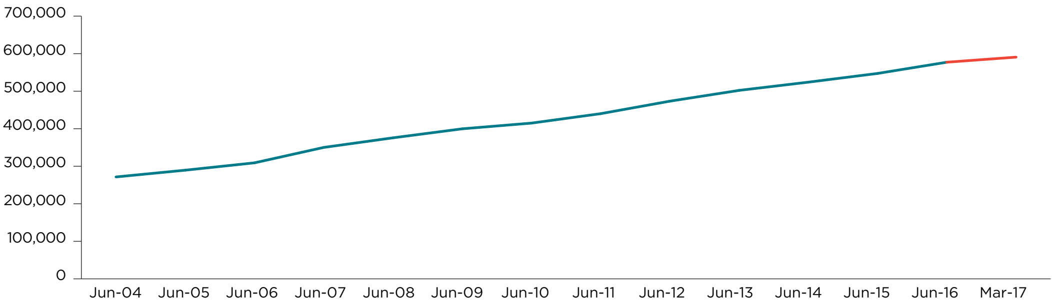
Asset values ($)	2011–12	2012–13	2013–14	2014–15
Average assets per member	475,698	510,136	551,217	589,636
Median assets per member	275,313	299,407	325,542	354,882
Average assets per SMSF	902,917	968,139	1,043,812	1,111,732
Median assets per SMSF	493,348	535,274	581,710	631,077

Source: ATO (2016).

SMSF sector growth

Over the past decade, the SMSF sector has continued to attract new members and achieve strong growth in its asset base to support members' retirement income. Since June 2006 there has been a doubling in the number of individuals who are members of an SMSF and a tripling of the assets held by SMSFs.

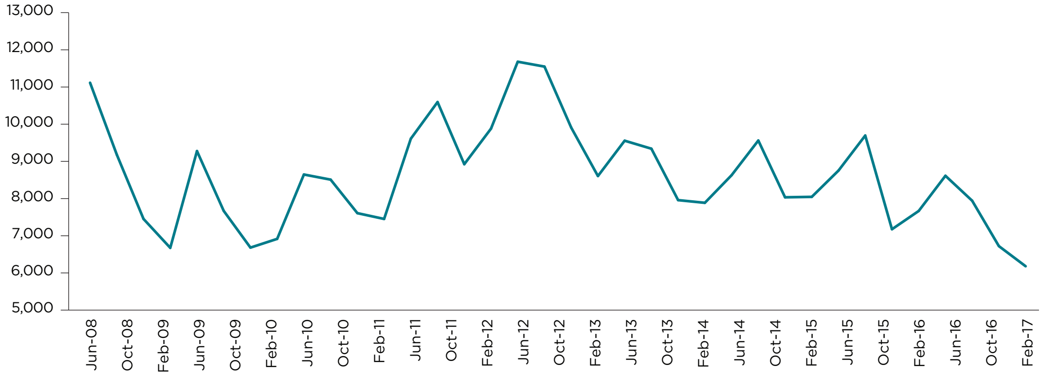
FIGURE 1: Total SMSF member growth since June 2006



Source: ATO (2017).

While SMSF growth has been significant over the past decade, growth has been more modest recently. For much of the past decade the sector has seen quarterly SMSF establishments of 8,000 funds per quarter, although quarterly establishments have fallen since 2015. However, in 2015 and 2016, the growth in the number of SMSFs was still 4.4 per cent and 5.5 per cent, respectively (ATO 2017).

FIGURE 2: SMSF quarterly establishments



Source: ATO (2017).

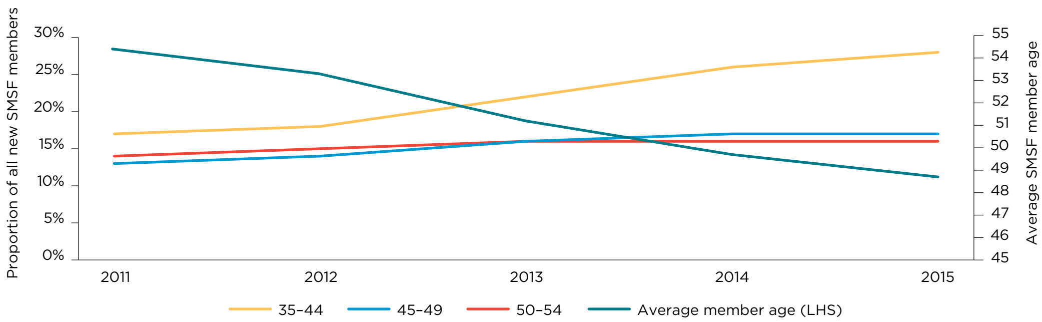
The softening in SMSF growth numbers can be largely attributed to legislative uncertainty over this period, with significant speculation concerning superannuation tax concessions occurring from the time the Abbott government launched its Tax White Paper process. Speculation and debate around superannuation changes continued following the 2016 federal budget and even after the 2016 federal election until legislation was passed by parliament in late November.

With a more stable legislative environment for superannuation in the future, it will be interesting to see whether SMSF establishment numbers will increase again or remain flat.

SMSF sector demographics

One positive factor for the SMSF sector has been the growth in new SMSFs with younger trustees. The past six years has seen a significant increase in the establishment of SMSFs by people aged between 35 and 44. While in 2011, 17 per cent of new SMSFs were established by people in this age bracket, by 2015 this had increased to 28 per cent of SMSFs (ATO 2016). This reflects a shift towards SMSFs being viewed as the chosen vehicle for accumulation and drawdown rather than simply being seen as a savings vehicle prior to retirement (for people making large 'catch-up' contributions to their SMSF).

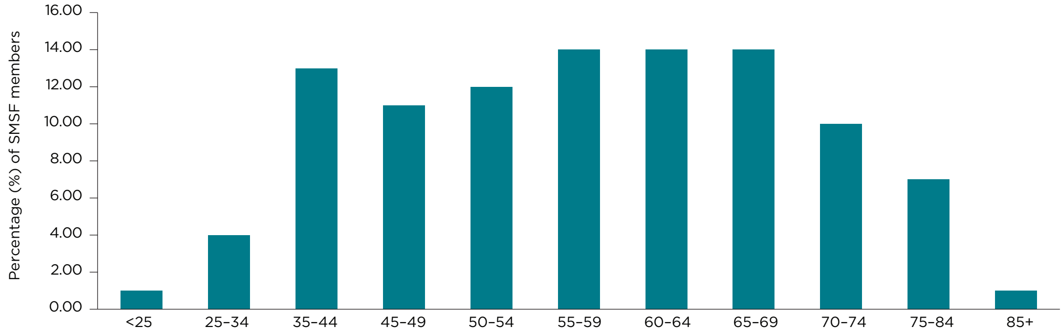
FIGURE 3: SMSF establishments by age



Source: ATO (2016).

While the new member growth from younger trustees is positive, SMSF members are an aging demographic. As of June 2016, 51.4 per cent of SMSF members were aged between 55 and 75. This will present a number of challenges as the SMSF sector shifts towards having a significant percentage of members in the retirement phase drawing down on their assets. New thinking around financial advice in the retirement phase, asset allocations and more sophisticated approaches to managing retirement income will be needed.

FIGURE 4: SMSF members by age



Source: ATO (2016).

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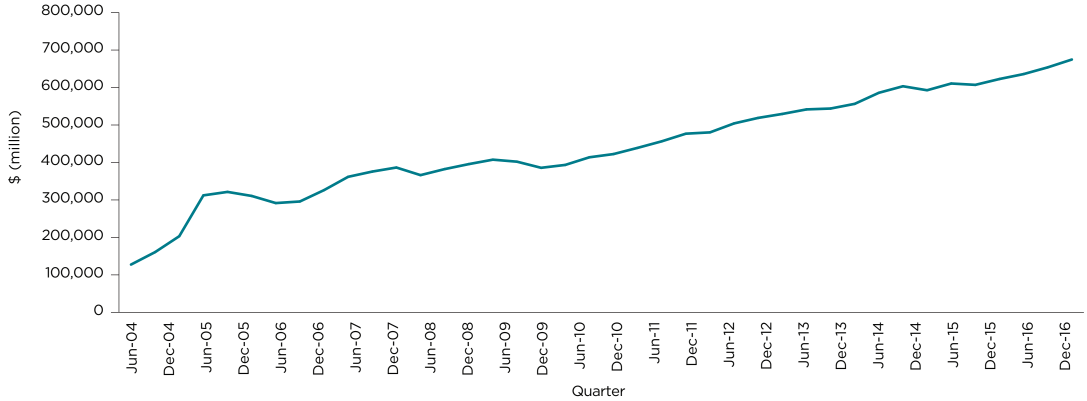
SMSF assets

Strong growth in SMSF assets has continued since the global financial crisis, with average quarterly growth of 2.6 per cent since March 2009. Total SMSF assets reached $674.7 billion as at March 2017 (ATO 2017).

FIGURE 5: Total SMSF assets



Source: ATO (2017).

SMSF asset allocation has remained relatively steady over time, with a significant proportion of assets being invested in listed shares and cash investments. This persistent feature of SMSF asset allocation has been a source of significant commentary and analysis. The key drivers for this asset allocation include:

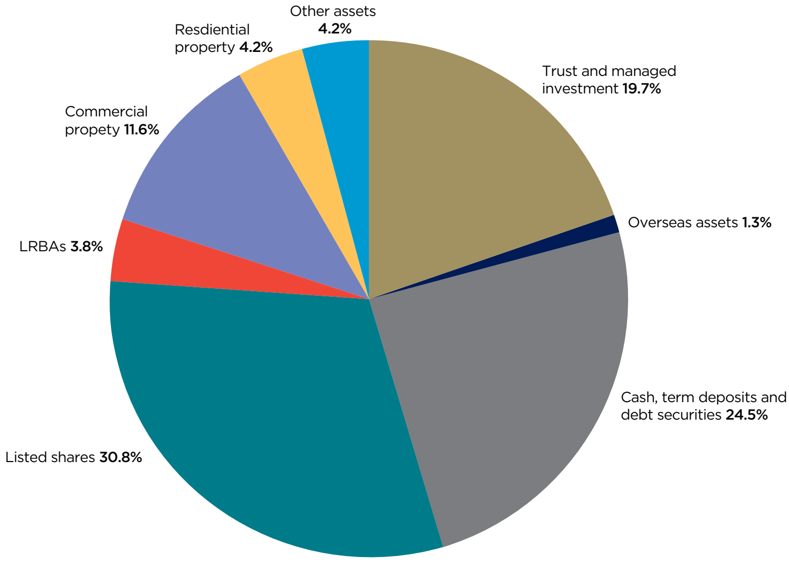
> tax preferences for domestic equities — fully refundable franking credits increase the after-tax return for domestic equities for SMSFs, especially those in the retirement phase

> a desire for liquidity to pay pensions in retirement — this is especially relevant to the SMSF sector where 48 per cent of funds are in the retirement phase (ATO 2016)

> cognitive biases towards assets familiar to trustees, especially blue-chip ASX-listed shares.

It is also important to recognise the limitations of the ATO statistics which underlie these figures, with many internationally focused listed investments such as exchange-traded funds (ETFs) and listed investment companies (LICs) being identified as domestic listed shares, potentially understating the international asset exposure of SMSFs. However, improved diversification of SMSF portfolios is an ongoing challenge that the SMSF sector will need to address.

FIGURE 6: SMSF asset allocation, as at March 2017



Source: ATO (2017).

Property investment and borrowing

One aspect of SMSF asset allocation that has drawn significant attention is investment in unlisted property, especially residential property funded through limited recourse borrowing arrangements (LRBAs).

As at the end of March 2017 quarter, SMSFs had $78.2 billion invested in non-residential domestic property and $28.2 billion in residential domestic property, representing 11.6 per cent and 4.2 per cent of total SMSF assets, respectively (ATO 2017).

The use of LRBAs in SMSFs has been a source of ongoing interest, especially since the Financial System Inquiry investigated LRBA usage and recommended that they be prohibited from further use by superannuation funds in 2014. The then Abbott government rejected the recommendation and this position has been maintained by the current government. The Australian Labor Party has recently announced that it will prohibit new LRBAs if elected.

While the use of LRBAs has grown significantly they represent only a very small proportion of SMSF assets (3.8 per cent), which are held by a small number of SMSFs.

The use of LRBAs to invest in residential property has received criticism for contributing to a potential Australian housing bubble. However, this seems unjustified given that SMSFs hold $28.2 billion of Australia's $6.6 trillion total dwelling stock (ATO 2017), representing only 0.42 per cent of the entire housing market.

Furthermore, ATO data from the 2015 financial year shows that the use of LRBAs is almost evenly split between funding residential and non-residential property, contradicting the theory that all LRBAs are being used to speculate on Australia's red-hot housing market.

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TABLE 2: SMSF limited recourse borrowing arrangement asset allocations, 2015

LRBA investment by asset type	($m)	Proportion of total SMSF assets (%)	Proportion of SMSF population holding those assets (%)	Mean* ($)	Median* ($)
Australian residential real property	9,372	1.55	3.39	507,798	424,500
Australian non-residential real property	9,150	1.52	1.52	1,112,562	650,000
Overseas real property	29	0.00	0.01	451,331	242,205
Australian shares	635	0.11	0.41	283,484	115,247
Overseas shares	428	0.07	0.53	146,334	31,900
Other	751	0.12	0.32	437,856	100,000
Total	**20,364**	**3.40**	**^6.02**	**623,684**	**420,000**

**Mean and median values are only applicable to the funds that held those types of assets.*

Source: ATO (2016).

Challenges ahead

Superannuation legislation

The changes to the superannuation tax settings made in the 2016 Federal Budget, which took effect on 1 July 2017, represent the most significant changes made to superannuation in a decade. The key changes affecting SMSFs are:

> lower concessional and non-concessional contribution caps

> a $1.6 million ‘transfer balance cap’ on assets in retirement phase that benefit from earnings exempt from tax

> removal of the tax exemption for earnings from assets supporting transition to retirement income streams (TRIS).

These changes present two key challenges for the SMSF sector:

> an increase in the complexity of superannuation laws, especially for those with higher balances

> a limit on contributions to superannuation.

Complexity

The changes to the superannuation laws, especially the introduction of the transfer balance cap, have resulted in a significant increase in complexity for individuals affected by the changes, increasing the need for professional advice and assistance with compliance.

The changes which are simplest for individuals to comply with are the reductions in the annual contribution caps. However, even the changes to non-concessional contributions include transitional arrangements for those who have used the ‘bring forward’ provisions and have a superannuation balance of $1.3 million to $1.6 million.

Similarly, changes to TRIS are relatively simple but transitional capital gains tax (CGT) relief for affected assets and broader strategic considerations of maintaining a TRIS create complexity.

The introduction of the transfer balance cap is the most complex change for SMSFs to contend with. The transfer balance cap functions on the basis of credits and debits that limit the amount of assets held in the retirement phase to $1.6 million. While simple in concept, the reality is that the law applies differently to account-based pensions, market-linked and term-allocated pensions, defined benefit pensions, child pensions and death benefit pensions. In addition, transitional CGT relief for assets affected by the new transfer balance cap adds further complexity as will real-time reporting to the ATO of events that give rise to changes in a transfer balance cap.

The estimates of SMSFs affected by the legislation changes vary but some credible estimates are:

> transfer balance cap — 13.8 per cent of SMSFs, 9.9 per cent of SMSF members (Class Limited 2017)

> concessional cap reduction — 23.8 per cent of SMSF members made contributions above $25,000 in the 2015 financial year (Class Limited 2017)

> non-concessional cap reduction — 10.6 per cent of SMSF members aged 49 and over contributed above $100,000 in the 2015 financial year (Class Limited 2017)

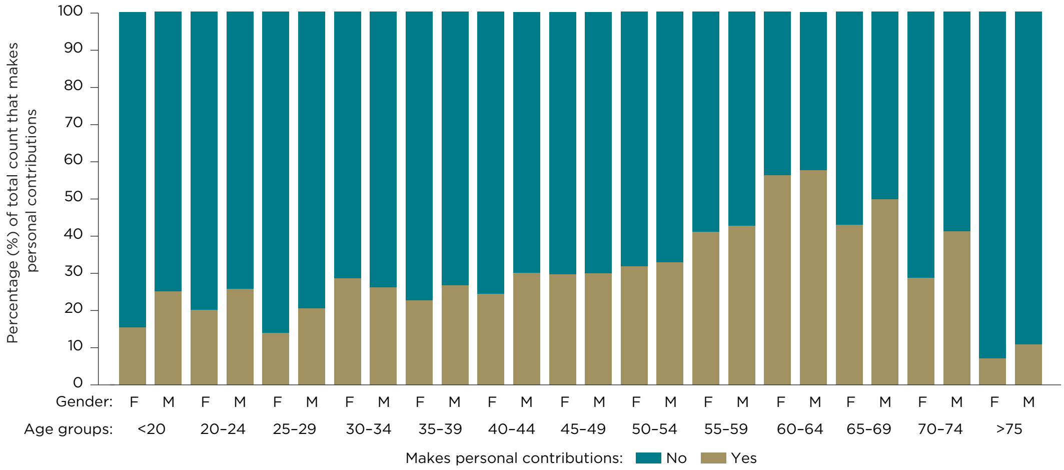
> TRIS changes — ATO statistics indicate that 21 per cent of SMSF members received a TRIS in the 2015 financial year (ATO 2016).

Less contributions to superannuation

The reduction in both concessional and non-concessional contribution caps will have a longer-term impact on the growth of assets in the SMSF sector. The lower caps will constrain contributions to the sector in the future, slowing the growth rate of SMSF assets. (However, the carry forward of unused concessional cap space will allow individuals with under $500,000 in superannuation to make additional contributions.)

For individual SMSF members, lower contribution caps will result in a reduced ability to make top-up contributions to their superannuation, especially later in life. SMSF Association–Rice Warner research illustrated the prevalence of higher personal contributions to SMSFs later in a person's life (SMSF Association 2016).

FIGURE 7: Split of SMSF members making personal contributions by age and gender



Sources: SMSF Association, Rice Warner.

Investment allocation

SMSFs remain heavily weighted to their traditional asset allocation of Australian equities, cash and property as illustrated above in ATO asset allocation statistics. This has stood SMSFs in good stead over the past decade with Rice Warner finding that SMSFs have outperformed their APRA-regulated counterparts in eight out of 12 years between 2005 and 2016 (Rice Warner 2017). However, this asset allocation should be re-examined going forward.

SMSFs need to consider increasing their portfolio diversification by increasing exposure to:

> different markets to reduce home bias

> different market sectors to better harness the benefits of economic growth in new industries (e.g. greater exposure to technology companies not found on the ASX)

> different asset classes, especially fixed interest and bond investments.

SMSFs should also consider and understand the risk they are accepting for their asset allocation's return. Research by Vanguard has shown that the risk of a typical SMSF that aspires to have a 'growth' asset allocation is double that of a diversified growth fund (Bowerman 2014). If this level of risk is unintended (which it most likely is), then SMSF trustees and their advisers should be considering greater diversification away from Australian equities and cash to reduce the risk and volatility of their investments.

Ultimately, this may be a financial advice challenge for advisers servicing SMSFs.

Retirement income

As a significant percentage of the SMSF sector moves towards retirement phase, the ability for SMSFs to deliver stable, long-term retirement income will be put under the microscope.

To date, SMSFs have been successful in providing retirement income to members with 94 per cent of all benefits taken from SMSFs being in the form of an income stream (ATO 2016). This is dominated by account-based pensions. SMSFs have had a very low uptake of retirement income products that can be used to provide stable income and insure against longevity risk.

With the development of comprehensive income products for retirement (CIPRs) the SMSF sector may benefit from a deeper pool of retirement income products and also be challenged to innovate and look at greater sophistication in the drawdown phase. Greater depth of available products and competition for SMSF/retail investors may deliver more attractive product options for SMSFs, which could lead to an increase in the take-up of retirement income products by SMSFs.

As the SMSF demographic shifts, greater attention will need to be paid to asset allocation in retirement, including self-insuring against longevity risk by using a 'pooled' or 'bucket' approach for investing assets to provide current income, flexibility to access capital and manage longevity risk.

Aging SMSF member population

The SMSF sector has a significant number of members who are either beginning retirement or retiring in the next 20 years with 51.4 per cent of members being aged between 55 and 75. In addition to the need to consider changing investment and retirement income strategies, this demographic shift poses additional challenges associated with aging.

The key challenges stemming from aging include:

> the effects of aging and cognitive declines causing individuals to lose capacity to be a trustee of an SMSF

> increased disputes over death benefit payments from SMSFs.

Loss of capacity

This issue of loss of capacity to be a trustee was recently cited as an emerging risk for the SMSF sector in the Australian Law Reform Commission (ALRC) review of elder abuse which culminated in the ALRC's report 'Elder Abuse — A National Legal Response' (Australian Law Reform Commission 2017).

Where an SMSF trustee loses the capacity to be a trustee of an SMSF (or a director of a corporate trustee of an SMSF) the SMSF will become non-compliant unless certain management steps are taken. A common strategy to overcome this issue is for the trustees of the fund (or directors of a corporate trustee) to have an enduring power of attorney (EPOA) in place, and the attorney can step into their role in managing the SMSF.

However, this arrangement can create a number of risks including elder abuse by the attorney and also legal complications with replacing the trustee who has lost capacity with their attorney (this issue is not as common for corporate trustees where a change of directors occurs). These complications can be exacerbated when there has been poor planning for succession of trusteeship. The ALRC Report made a number of recommendations to curb these emerging risks around loss of capacity and trusteeship including:

> introducing new safeguards against the misuse of EPOAs

> introducing 'replaceable rules' for SMSFs into the *Superannuation Industry (Supervisory) Act 1993*, which provide a mechanism for an attorney to become a trustee/director where the EPOA allows for it but the fund's trust deed does not

> introducing an additional operating standard in the *Superannuation Industry (Supervisory) Regulations 1994* for SMSFs requiring them to consider planning for loss of capacity as part of their overall investment strategy

> requiring an attorney who becomes a trustee of an SMSF to notify the ATO that they are doing so as a consequence of an EPOA.

These reforms are sensible adjustments to the existing superannuation laws that mitigate risks of losing capacity and elder abuse without over-regulating SMSFs. In addition to these reforms, SMSF advisers need to be aware of the risks associated with aging SMSF trustees and ensure that their clients are advised and have appropriate strategies in place to meet these challenges later in life.

Death benefit disputes

As the SMSF population ages more death benefits will be paid out by SMSFs. In the 2015 financial year 12.5 per cent of lump sums and 0.8 per cent of income streams paid from SMSFs were death benefits (ATO 2016). These figures have the potential to increase substantially as the SMSF demographic ages and the transfer balance cap forces more superannuation money out of the system. With increased numbers of death benefit payments from SMSFs there is increased potential for disputes and litigation over these benefits.

Already there has been a substantial increase in litigation over SMSF death benefits in recent years. This mirrors the increase in complaints to the Superannuation Complaints Tribunal (SCT) over death benefit payments in recent times. The SCT cites 21.5 per cent of all complaints in the March 2017 quarter related to distribution of death benefits (Superannuation Complaints Tribunal 2017). This trend will continue and grow as more death benefits are paid.

SMSF trustees seeking specialist SMSF and estate planning advice will be a crucial factor in mitigating the risk of death benefit disputes. Trustees need professional assistance in ensuring that binding death benefit nominations are drafted correctly and that SMSF trust deeds are structured properly to allow for appropriate succession of trustees so that death benefits are paid in accordance with the deceased member's wishes.

The ALRC's report also dealt with this issue (albeit from an elder abuse perspective) and has recommended a review of the superannuation death benefit provisions to clarify their application. This review would be welcome given the increase in death benefit disputes arising in SMSFs, and superannuation more broadly.

Advice to SMSF trustees

Financial advice is a key driver of a well-functioning SMSF sector and it is therefore essential to ensure that SMSF trustees are receiving high-quality advice.

This will be supported by the new education and ethical standards for financial advisers, which will be created by the new Financial Adviser Standards and Ethics Authority and backed by legislation and broad industry support. The new regime will mean that new professional standards for all advisers who operate in the SMSF space will be introduced over a period of time.

New financial advisers will need to meet minimum education and exam requirements from 1 January 2019. In addition, a supervision year will commence for new entrants. A new code of ethics is to apply to all financial advisers from 1 January 2020. All financial advisers will be required to pass an exam by 1 January 2021 and have achieved degree qualifications by 1 January 2024. All of these changes will affect all advisers who are providing advice, which requires licensing under the Corporations Act.

Recent SMSF Association–Commonwealth Bank research indicates that key areas in which advisers could assist trustees include retirement advice, pension strategy/management and the provision of clarity around investment research and products (SMSF Association, CommBank 2017).

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