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SMSFs under $1m can be perfectly viable

By Patrick Garrett
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The Productivity Commission (PC) recently delivered its draft report: *Superannuation: Assessing Efficiency and Competitiveness (April 2018).*

The draft covered an array of matters related to the superannuation system in Australia, with a focus on needed areas of improvement, both in terms of fees, transparency with members and fund investment performance. This included some findings related to self-managed super funds (SMSFs)

The SMSF sector is the largest sector of the superannuation industry if you break out retail funds, industry funds, etc. SMSFs are not for everyone; trustees need expert advice to manage their fund and the time to oversee their assets and legal obligations.

But SMSFs can provide an effective investment structure for those seeking more control and investment choice with their savings strategy and wealth management. The PC reports highlights many deficiencies and problems in the current retail and industry superfund environment, so it's no wonder that SMSFs are attractive for some investors.

But here's where the report misses the mark. It cites data that compares investment performance of SMSFs larger than $1 million versus SMSFs with less than $50,000 (Draft Finding 2.2). The larger SMSFs have better investment returns. That's a fact. SMSFs have fixed costs (ongoing admin and ATO/ASIC fees), so smaller funds will have larger expense ratios by definition, and this eats into returns.

The report has led to public articles along the lines of one which recently suggested, "If you don't have more than $1 million, don't bother with an SMSF". Blanket statement, no qualifiers for the reader to consider.

I requested the supporting data from the PC on this report and was pleasantly surprised to actually get the information in a timely manner. The data used for the PC's report is the ATO's report *Self-managed super funds: a statistical overview 2015*-2016, which provides key statistics and analysis of the SMSF sector.

In this overview, that data does in fact show poor relative investment returns for smaller funds (see table 21).

This begs the question: Why are low-value SMFS investment returns relatively poor? I believe there are three parts to the answer:

1. Fixed fees and costs: Ongoing administration and regulatory (ATO/ASIC) costs
2. Investment costs: Management of a share portfolio and/or property investment(s)
3. Impact of diversification: Generally speaking, poor diversification leads to poor investment returns

Let's address each of these points:

Fixed costs: Table 23, from the ATO report, shows an average administration expense ratio for SMSFs sized $100-200k of 2.43% or, if you take the midpoint of $150k, $3,645/year. For an SMSF that does not have a bare trust or investment property, but rather a relatively basic portfolio of shares, the presumption of $3,645/year of administration costs appears severely overstated when compared with what is now available in the market due to new and innovative service providers. Trustees starting out with a fairly simple SMSF are able to get ongoing administration for $1,500/year or less, from reputable and experienced providers.

Investment costs: Table 23 also shows an average investment management expense ratio for SMSFs sized $100-200k of 3.97% (this is a very high number). I can only assume that either 1) this is largely influenced by high property-related investment costs and/or 2) the trustees are victims of what the Royal Commission is sadly uncovering, which is exorbitant financial advice fees in the market. If a SMSF trustee is managing a portfolio of shares, they are now able to receive professional investment management advice for as low as 1% (in Six Park's case, it's actually lower).

Impact of diversification: This one is a killer. Small SMSFs are very poorly diversified relative to their larger peers, as shown in Table 18. Smaller SMSFs are much more prone to have asset class concentration in cash, domestic listed shares and/or non-residential property. But is this poor diversification because these trustees ***can't*** get well diversified, or because they don't know how to (or aren't able to) access affordable, professional investment management services that can help them construct well diversified investment portfolios? Robo-advice is not the complete solution to every investment situation, but it's worth noting that services like Six Park enable customers to construct well diversified portfolios using exchange-traded funds for less than 1% (including the indirect ETF fees). About 20% of our customers are SMSF trustees, and they cite two main reasons to use our service: Low fees and diversification.

Context is crucial

I admit that the points above simplify a complex market. The inclusion (or not) of property in an SMSF has a significant impact on underlying costs and returns. Being over-weight to cash may make perfect sense to a conservative, pension-mode trustee. There are lots of permutations.

But here's my beef: Providing data and suggested "findings" with no context, and thus fodder for people to make blanket statements that $1 million is required to have a viable SMSF, is reckless and unfair to consumers who deserve better education about what is and isn't possible.

Six Park cannot provide superannuation advice, but we have many SMSF trustee customers who have made the decision to set up an SMSF, who may add an investment property to the SMSF in the future but use Six Park to invest for most/all of their initial rollover in a diversified portfolio of assets that we manage. For such trustees, it's entirely feasible to have annual administration and operating expenses of $1,500 or less, and rather than pay the "average" investment expense of 3.97% as per the ATO data, their total expenses with Six Park are less than 1%, even if I include the indirect ETF fees, and brokerage is included in our single fee. I would also argue that these trustees stand a good chance of generating strong risk-adjusted returns by having a well-diversified portfolio that is rebalanced on a periodic basis and overseen by a team of experts (at a very low cost).

At the time of writing, Six Park's average SMSF account value is $200k (some accounts are all of the fund assets, some only a portion). If I had to generalize, I would suggest that $150k is probably around the right rule-of-thumb threshold for a viable SMSF (assuming $1,200/year admin fees and 1% investment management fees, along with ATO/ASIC fees), provided their investment configuration is fairly simple (eg. does not involve active trading, illiquid assets, bare trust, property). That's about $3k, or 2% total fees.

Finally, the PC report appears dubious about the ability of SMSFs to generate decent investment returns (aimed mainly at the smaller accounts). But a recent Rice Warner report titled *In Defense of the SMSF Investor* (9 March 2017) has offered the following:

"Perhaps the best indicator of whether SMSFs deliver value is how they perform.

Our analysis of APRA vs. SMSF returns (based on APRA and ATO statistics) shows that SMSF funds collectively have outperformed APRA-regulated funds since 2005, with average compound returns of 8.0% p.a. and 6.2% p.a. respectively. Further, SMSFs outperformed in 8 out of 12 individual years for the period considered. The margin would be greater if fees were deducted from returns!

In our opinion, much of this performance can be attributed to asset allocation, patient long term investing and tax optimisation at the member level. Of course, past investment performance is no guide to the future. However, sensible investment strategies are likely to continue to produce good results over long periods.

Rather than criticise SMSFs, perhaps the rest of the superannuation industry should be challenged to emulate them."

About the author

Pat Garrett is the CEO of Six Park. He co-founded the company in 2014 after a 25-year career in the financial services industry. From 1990 to 2005, Pat worked at JP Morgan in New York, San Francisco, and Melbourne. Since 2005, Pat has worked at Georgica Associates, a private investment management firm based in Melbourne. The views expressed in this article are the views of the author, not Six Park.

About Six Park

Six Park is a leading provider of automated investment guidance (also called "robo-advice") in Australia. Six Park provides investors with simple and streamlined access to cost-effective, globally diversified, professionally managed portfolios tailored to their risk profile.

Table 18: Asset concentration, by fund size (2016)

This table shows, by fund size, the distribution of SMSFs that have 50% or more of their assets by value invested in one particular asset class.

These figures are estimates based on SMSF annual return form data.

Asset concentration, by fund size 2016

Fund size	100%	>=90%	>=80%	>=70%	>=60%	>=50%
$1–$50k	41.7%	64.3%	74.9%	83.6%	90.7%	97.9%
>$50k–$100k	24.5%	51.7%	64.8%	75.3%	85.2%	95.8%
>$100k–$200k	19.9%	44.6%	58.5%	71.0%	82.4%	93.7%
>$200k–$500k	12.1%	36.5%	52.4%	65.2%	77.1%	89.6%
>$500k–$1m	7.6%	27.4%	41.7%	55.4%	69.5%	85.0%
>$1m–$2m	5.3%	20.7%	32.8%	45.7%	60.5%	78.6%
>$2m–$5m	2.9%	15.3%	26.2%	39.3%	54.8%	73.7%
>$5m–$10m	1.5%	13.1%	23.3%	35.3%	50.5%	70.2%
>$10m	1.4%	14.6%	25.9%	38.2%	51.9%	69.1%

Table 21: Average ROA, by fund size

This table shows the average return on assets (ROA) of SMSFs by asset size. The ROA is calculated by determining the net earnings, and comparing this to average assets during the financial year to determine the percentage return on assets.

These figures are estimates based on SMSF annual return form data.

Average ROA by fund size, by year

Fund size	2012	2013	2014	2015	2016
$1–$50k	-18.73%	-17.28%	-12.51%	-17.38%	-16.70%
>$50k–$100k	-9.93%	-5.17%	-2.78%	-6.84%	-7.28%
>$100k–$200k	-5.90%	0.83%	1.55%	-1.02%	-3.28%
>$200–$500k	-2.52%	6.36%	5.88%	2.45%	-0.02%
>$500k–$1m	-0.41%	9.31%	8.33%	4.60%	1.37%
>$1m–$2m	0.67%	10.64%	9.59%	5.70%	2.15%
>$2m	1.49%	11.59%	11.29%	7.52%	4.27%

Table 23: Average expense ratios, by fund size

This table shows average SMSF expense ratios by fund size. The expenses of an SMSF are calculated by summing various deductible and non-deductible expense labels from its income tax return. The total is then compared to its average assets to get a ratio of expenses to assets.

These figures are estimates based on SMSF annual return form data.

Average expense ratios, by fund size 2016

Fund size	Administration and operating expenses	Investment expenses	Total expenses
$1–$50k	8.72%	5.33%	14.05%
>$50k–$100k	3.79%	3.56%	7.35%
>$100k–$200k	2.43%	3.97%	6.41%
>$200k–$500k	1.38%	1.88%	3.26%
>$500k–$1m	0.80%	0.78%	1.58%
>$1m–$2m	0.57%	0.49%	1.06%
>$2m	0.29%	0.40%	0.69%

Table 2. Annual Investment Performance – Rice Warner analysis of APRA and ATO statistics

Year end 30 June	APRA	SMSF
2005	13.3%	17.4%
2006	14.0%	16.0%
2007	15.4%	20.1%
2008	-8.3%	-4.4%
2009	-11.7%	-5.3%
2010	9.5%	7.1%
2011	8.3%	10.4%
2012	0.8%	-0.1%
2013	14.4%	12.3%
2014	12.5%	12.4%
2015	9.2%	10.6%
2016	3.3%	3.4%
Average	**6.4%**	**8.0%**

[1] *Cost of Operating SMSFs, Rice Warner, 2013* http://download.asic.gov.au/media/1336058/cp216-RiceWarner-cost-of-operating-smsfs.pdf