Swot up to get your SMSF right

This year it pays to know the threats and opportunities

JAMES KIRBY
WEALTH EDITOR

There has always been a suspicion that the nation's million-plus SMSF members might live longer than everyone else ... and it turns out it's true.

Actuary Melanie Dunn, head of technical services at Accurium, has run the numbers and found that you should live at least three years longer if you have an SMSF.

Now that's playing with the numbers, of course. SMSF members have bigger balances than average and can pay for better healthcare on that basis.

Nonetheless, as Dunn points out: "We wanted to examine whether SMSF trustees belong to a subset of the population that has a different life expectancy to average ... our analysis found this cohort (the 55-75s) were only 32 per cent of the number of deaths we would have expected based on population mortality rates."

Any SMSF operator might quickly add that you may live longer but you'll be more stressed between trying to allocate funds correctly and navigating the choppy waters of government policy where regulators never cease in trying to make life difficult.

Realistically, if you want to run a successful SMSF — and keep grim reaper at bay for three whole years — you need to know what's going on in the space. Let's do a Strength, Weakness, Opportunity, Threat (SWOT) analysis of the key items that loom this year.

Strength: caps may rise

You can put up to $25,000 into super each year on a pre-tax (concession) basis. Until recently it was possible to put up to $35,000. The key campaign from the sector this year is to get the government to restore the cap to the $35,000 and with Jane Hume, a new minister for financial services, in the hot seat, the campaign aimed for the May budget has a fighting chance.

Also under limited circumstances — based on "irregular work patterns" — you can from this financial year add five years' worth of annual $25,000 (concessional) pre-tax contributions into your SMSF inside a single year.

Weakness: default super can trap you

In a rare example of SMSFs actually being penalised for trying to run their own pension affairs, there has been consistent reports of SMSF members who return to work being forced into "default" institutional super funds. The situation occurs when an older SMSF member get a part-time job that comes under an enterprise agreement that includes compulsory contributions to a nominated industry fund. The issue is another argument in favour of full superannuation choice, which is currently denied workers of all ages.

Opportunity: more members in your fund

Legislation to increase the number of members in a self-managed super fund from four to six very nearly made it through parliament last year. It was only held up on a technicality. It is very likely to get through early this year. For many families this may mean the fund can become multi-generational, which can offer distinct advantages to families capable of investing together.

Opportunity: indexation is ahead

The maximum you can have funding a tax-free pension at present is $1.6m. There is provision to increase this through "indexing" bands of $100,000 depending on the Consumer Price Inflation numbers. This week the CPI rose at its fastest pace in eight years — but it was just below the level required to put through the indexing. However, it does mean the move up to $1.7m will happen in 2021 and that means you can start planning now.

Opportunity: SMSFs cost less than you think

One of the controversies in the sector in recent times has been an alarming attempt by the Australian Securities & Investments Commission to estimate the costs of running an SMSF at $14,000 a year. The number was never convincing. More recently, the SMSF Association has analysed the numbers and estimated the cost is $5000 a year. CEO John Maroney also accused the regulator of frightening off potential SMSF members. Maroney says "the average expense figure represented a questionable use of ATO statistics". Many would put the estimate lower, at $2000-$4000 depending on how much work you do yourself.

In other words, a lot more people could be running SMSFs than the recent "fact sheet" from ASIC would indicate.

Threat: diversification demands

For better or worse the regulator of the SMSF sector is the tax office and it never ceases to be vigilant on every aspect of running a DIY fund. The latest threat has been that if members are not sufficiently diversified they will face fines. The ATO went as far as writing directly to 90,000 SMSFs about their over-dependence on single assets. But it's worth keeping in mind there are half a million SMSFs with more than one million members, and the vast majority of the funds are diversified, and this threat from the ATO is most unlikely to be relevant to you.

Threat: ATO targeting

Late lodgement of SMSF funds had suddenly become an issue due to a severe move by the ATO in recent months that means you will be affected even if you file on time but your accountant does not move as fast. Under the new plan, if lodgements are late the ATO immediately removes your fund's details from the Super Fund Lookup (SFLU) — the online list that a fund or institution checks when you use super money to make any investment. As Graeme Colley at SuperConcepts recently pointed out, all new investing by your SMSF may effectively be frozen until the lodgement is received. Again this is draconian behaviour from the ATO and another argument why it should not be the regulator in this area. It is not a regulator of anything else. The role should move to ASIC.

Low rates change the maths: why quality stocks could still go higher

ROGER MONTGOMERY

I've dealt recently with the reality that as interest rates fall so does their gravitational pull on assets and values ... that is, they go up.

I also reminded investors that while low interest rates are generally supportive for assets, those assets aren't immune to setbacks. I also offered a rule for investing that should never be forgotten; the higher the price you pay, the lower your return.

With Professor Robert Shiller's Cyclically Adjusted Price Earnings ratio at a near record high, the implied return, for the next decade, from investing in the S&P 500 index right now is very low. But a reasonable question might be what should that rate of return (also used as the "required return" or "discount rate" for valuation purposes) be at this stage?

To help answer that question and decide whether it is appropriate — or even sustainable — we can adopt the work of NYU's Stern School of Business professor Aswath Damodaran (whose books on valuation are required reading for the serious investor).

In conventional investment theory the required return is a function of the risk-free rate and the equity market risk premium ERP. The ERP is a factor above the risk free rate — such as the cash rate in Australia of 0.75 per cent — that compensates the investor for the added risk of not being in a risk-free investment.

As I wrote in my last column, as interest rates decline, asset values and prices rise. So, it follows that as risk-free interest rates and ERPs decline, so do required returns and therefore equity valuations rise.

Many of the domestic investors who have captured the recent ASX 200 rally have done so by willingly reducing their required returns. In turn this raises the "valuation" of the equities they are examining and makes the current price look cheap compared to that valuation.

Warren Buffett knows how to get people's attention on risk premiums
BLOOMBERG

Many investors believe the risk-free rate should be the interest rate on long-term government bonds. But if current extremely low yields are unsustainable, and the resultant required returns plainly too low, should investors be chasing those yields down when adopting a required return for their valuation analysis?

When it comes to establishing the equity market risk premium, there is an equal amount of uncertainty about the right approach.

It all led Warren Buffett many years ago to simply declare; "when a business manager approaches me for funds for a project, I simply charge them 15 per cent — that usually gets their attention".

Instead of attempting to determine the correct discount rate, Damodaran suggests inverting the problem by determining what required return is being implied by the current market price of equities. He has done that each year since 1961, producing an estimate of the market-implied expected return of the US equity market.

Using the 10-year US government bond yield as a proxy for the risk-free rate, the market-implied ERP can be solved.

Since the turn of the century, expected returns have averaged about 8 per cent. But because interest rates have declined considerably in that time, the equity market risk premium must have risen — remembering that the expected return is a function of the risk-free rate and the ERP. Indeed, the ERP appears to have risen from 2-3 per cent to 6 per cent more recently. And when compared to corporate bonds, the spread is wider today than it has been since the 1970s.

How is this helpful? In simple terms, the ERP appears to be unusually and possibly unsustainably high. If the risk-free rate, as measured by bonds, stays low, then over time we could see the ERP come down. If that were to happen, equities that appear expensive today might actually be cheap.

The conclusion from all of this is that one should remain absolutely focused on quality. If you don't own high-quality businesses, very little is going to save you when bad things happen to that business. Even a declining ERP is not going to help.

Conversely, owning a high-quality domestic business, such as a Reece Plumbing, or an ARB or Cochlear or CSL, is going to reward you over the very long run regardless of interest rate ructions. The same might be said for high-quality global companies such as Vivendi or Microsoft. But if the ERP does fall and investors are willing to adopt lower required returns, these high-quality stocks could rally even further, and today's extended prices might not seem that extended at all.

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My wife and I need to update our Wills, but we don't see the need to legally or formally grant each other the ability to act as each other's Powers of Attorney. Our parents never did it and they successfully overcame any barrier. Should I be concerned about this?

Many people work on the assumption that their spouse can make legal decisions on their behalf such as entering into transactions such as selling the family home, or even completing financial transactions like withdrawing money from a bank account. If this assumption was correct, then there would be no need for a power of attorney.

A power of attorney is a legal document appointing a person or trustee organisation of your choice, to manage your financial and legal affairs while you are alive. This person or organisation is then known as your attorney. For example, it is quite easy to appoint an attorney to act for you in a variety of circumstances such as if you are taking an extended interstate or overseas trip.

It important to be clear that a power of attorney cannot make decisions for you in areas such as accommodation, health and services.

Your attorney can act immediately or for a time when you are no longer able to manage your own affairs. Your power of attorney can be enduring, which means it continues even if you have lost your legal capacity. An enduring power of attorney gives someone authority to make decisions on your behalf once you are no longer capable to do so.

What happens if I don't have an Enduring Power of Attorney in place?

Should you no longer be able to manage your financial affairs and you don't have an enduring power of attorney, you may need to apply to your state's Guardianship Tribunal for assistance. The powers available and the process of attaining orders will from state to state. For example in NSW, the Civil & Administrative Tribunal (formerly the Guardianship Tribunal) may have to appoint a financial manager to make these decisions for you. This involves a formal hearing where evidence will be heard to assess whether you have lost legal capacity and whether you need to have someone appointed to make decisions on your behalf.

If NSW Civil & Administrative Tribunal decides that you need someone to make decisions about your finances and legal affairs, they will appoint a financial manager. While they have an obligation to take your views into account, the ultimate decision rests with the tribunal.

The person or organisation appointed as your financial manager will not necessarily be the individual you would have chosen. This may be stressful for those involved and can cause considerable conflict and anguish among family and friends. By making an enduring power of attorney, you are ensuring the person or organisation you nominate to manage your financial affairs is the person you want and trust, and most importantly that your family and friends understand that it was your decision.

For many investors, having a financial manager who is not a spouse, adult child, close family member or friend may be disconcerting. You might even make the assumption that if you are seeking to become the financial manager for your spouse, then you will secure this role outright. This is not always the case, and I am aware of cases where individuals have found themselves in the situation where they are making legal decisions about their spouse's financial affairs in conjunction with the NSW Civil & Administrative Tribunal.

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