ACCURIUM Education

SMSF Association Accredited Educator

Investment Strategies and managing investment risk in SMSFs

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… the tale of Jeanne Calment

Deciding to retire is a big life decision…

We help it be an exciting one

- Retirement is a trigger to seek advice about finances
- Need to think about own investment strategy for retirement, and how that impacts the SMSF's strategy
- SMSF has new responsibilities and considerations when a member retires
  - Transfer balance account reporting (TBAR)
  - Paying member benefits from a pension or/and accumulation
  - Exempt current pension income and expense deductibility
  - Estate planning/exit plan
- Important to review that investment strategy and trust deed allows for desired retirement strategy

SMSF investment strategy requirements

SIS Act Investment covenants

Trustee must formulate, review regularly and give effect to an investment strategy having regard to:

- the risk involved in fund investments, having regard to the objectives and expected cash flow requirements
- the diversification of fund investments
- the liquidity of the investments, having regard to expected cash flow requirements
- the ability to discharge existing and prospective liabilities

Fit for purpose and compliant – SMSF Audit SIS Reg 4.09

Creating a retirement investment strategy

- Auditor reviews investment strategy for evidence that:
  - has regard to the whole of the fund's circumstances
  - considers investment risk and returns, diversity, liquidity and the ability to discharge liabilities as they fall due
  - considers the insurance needs of members
  - is regularly reviewed
- Auditor checks the investments of the fund to understand if invested in accordance with its requirements
- Material contravention = qualified auditor's report + lodgment of an ACR
  - can notify trustees in the management letter of any further concerns about the investment strategy and its investments

Evidence for auditor:

- A written investment strategy
- A new strategy or notations on current strategy
- Information in minutes of trustee meetings

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Creating a retirement investment strategy

Strategic decisions for an SMSF

ECPI & capital gain strategies

Assessing a retirement strategy

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ECPI and capital gain strategies

Commencing pensions and selling assets

Commencing to pay a pension in the SMSF

Eligible to commence a pension?

- Condition of release met
- Trust deed allows
- Space in TBC

Cashflow requirements?

- Minimum pension standards
- Desired spending from SMSF
- Tax consideration of pension payment vs lump sum
- Liquidity of fund assets to pay the pension

Restructuring investments?

- Pension payments must be ‘cashed’
- Sale of assets / liquidity
- Claiming ECPI and deductibility of expenses
- Investments re-structured towards achieving retirement objectives

Pension documents?

- Tax components
- Reversionary?
- TBAR

Restructuring investments to avoid the $3m cap

ECPI considerations of $3m cap

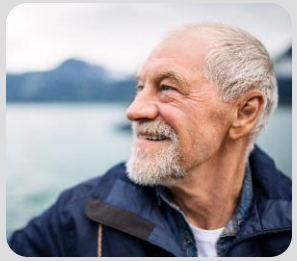
- $3m cap applies from 2025-26 income year
  - first test 30 June 2026
  - a ‘personal’ tax which an individual could choose to pay from SMSF, no change to tax calcs for the SMSF
- If have met a nil cashing restriction condition of release could choose to withdraw savings
  - CGT event when assets are sold or withdrawn in-specie + amounts will be withdrawn from the SMSF
- If member with large balance is in retirement, SMSF is likely to have disregarded small fund assets
  - member in retirement phase with > $1.6m total superannuation balance

SMSF has DSFA
- Proportionate method for ECPI
- Timing of CGT events no impact
- Timing of withdrawals does impact

SMSF does not have DSFA
- Eligible to use segregated method
- Timing of CGT events and withdrawals can impact ECPI if have deemed segregated periods

Mega Super Fund Case Study

$4.8m in super = TSB over the $3m cap



Matt: working aged 68
Accumulation= $2,100,000
ABP = $2,700,000

Mary: working aged 63
Accumulation = $1,800,000

SMSF Investments - 1 July
$6,600,000

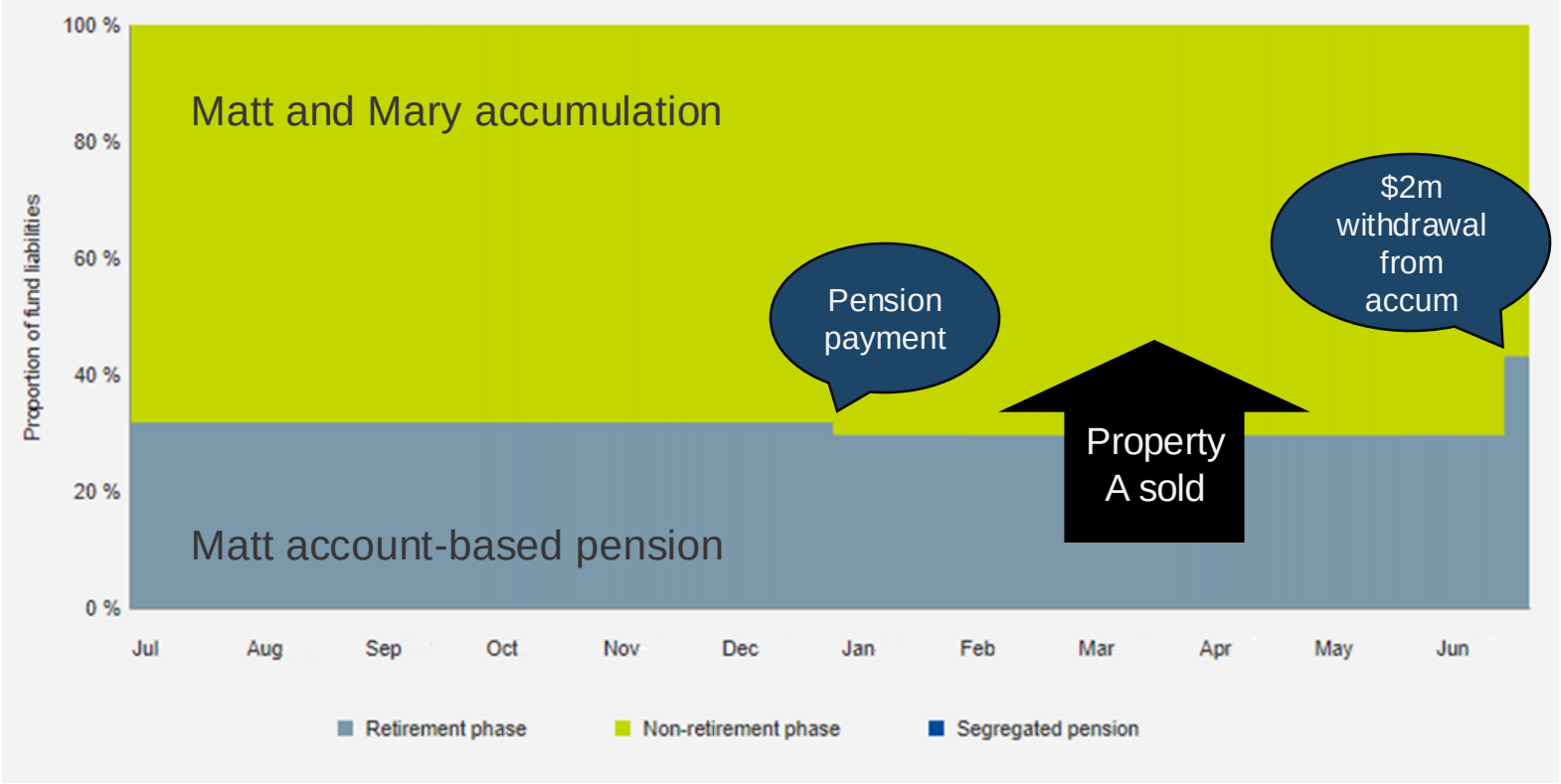
Asset	Market value	Capital gain/ loss if sold
Property A	$3,000,000	+$950,000
Property B	$2,000,000	-$200,000
Share portfolio	$1,100,000	+$220,000
Term deposits	$300,000	n/a
Cash	$200,000	n/a

Impact on ECPI of restructuring balance under $3m

Mega Super Fund case study

- Fund has DSFA
  - Maximising ECPI = maximising actuarial %
- Decide want to withdraw $2m at end of year
- Proportionate method for ECPI 30.778%
- Applies to all income and gains in the year

$950,000 net capital gain
30.778% exempt

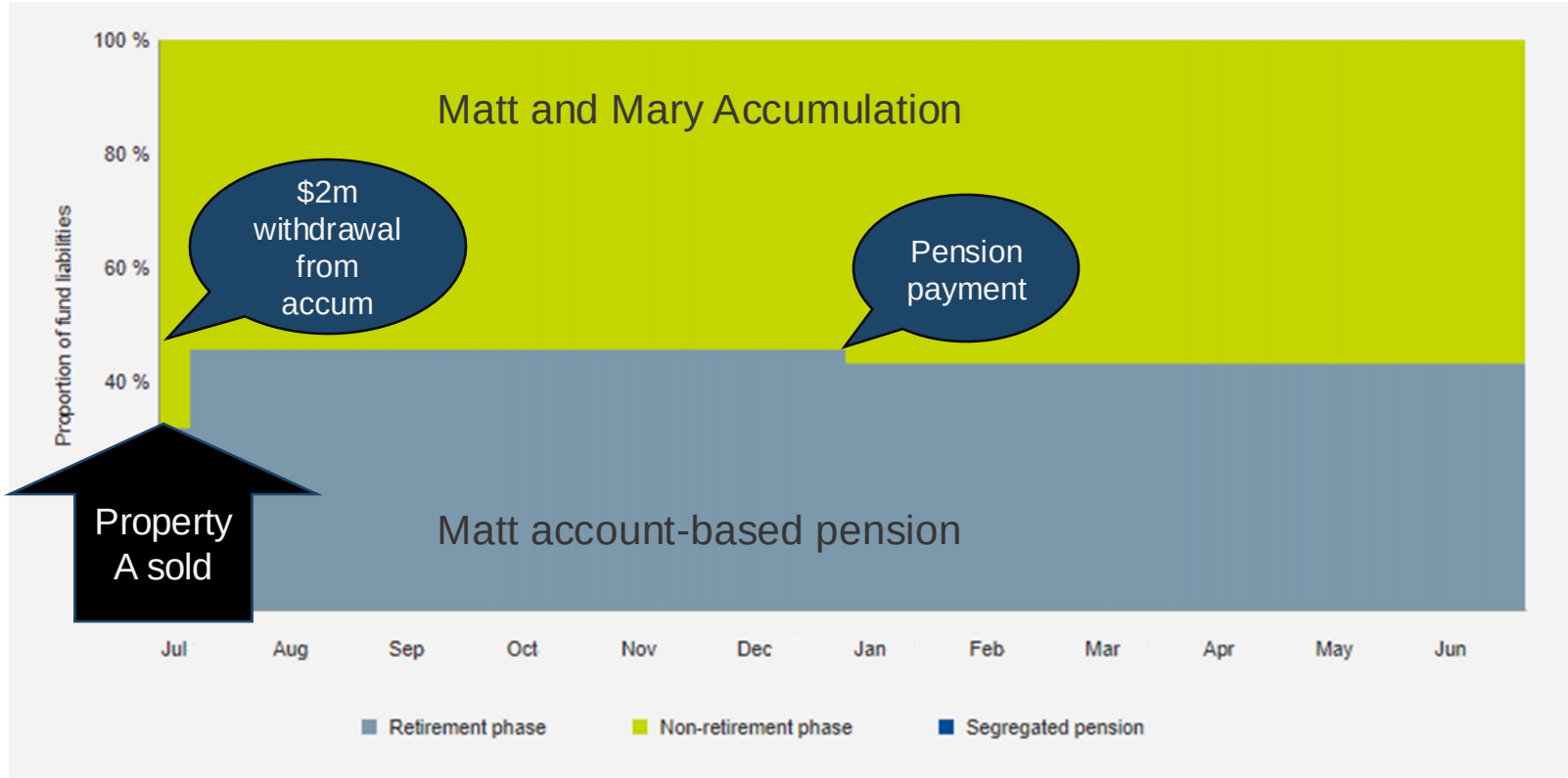


Impact on ECPI of restructuring balance under $3m

Mega Super Fund case study

- Fund has DSFA
- Decide want to withdraw $2m at START of year
- Proportionate method for ECPI ~~30.778%~~ 43.973%
  - For every $100k income an extra $13k tax free ECPI
- Applies to all income and gains in the year

$950,000 net capital gain
43.973% exempt



Timing is everything

…when using proportionate method for ECPI

$$\text{Exempt income proportion} = \frac{\text{average value of retirement phase liabilities}}{\text{average value of superannuation liabilities}}$$

This uses a daily weighted average so *when* a transaction occurs is important to maximise ECPI

- More in retirement phase on average and less in non-retirement phase on average

Timing Important

- Retirement phase pensions commence as early as possible
- commute as late as possible if will remain in accumulation phase

- Contributions and rollovers
  - if will remain in accumulation phase, as late as possible
  - if to be used to start a retirement phase income stream, as early in year as possible

- Withdrawals
  - if from accumulation, as early as possible
  - if from pension, as late as possible

Capital gains or losses

- Net capital gain = exempt income proportion applies
- Net capital loss = can be carried forward

Impact on ECPI of restructuring balance under $3m

Restructuring investments ⟶ capital gains tax event

A capital gain or loss is likely to be realised prior to or at time of withdrawal if selling assets to provide liquidity or paying out in-specie.

…is there any way to use the segregated method?

- Why? Might be able to improve ECPI outcome if realising material capital gains
  - Capital gains on segregated pension assets = tax free
  - Need a scenario where SMSF won't have DSFA = does not have a member at prior 30 June with TSB greater than $1.6m and a superannuation interest in retirement phase OR fund solely in retirement phase

- Can think of multiple theoretical ways to create the situation where the SMSF did not have DSFA HOWEVER most would likely constitute a scheme to avoid tax

Impact on ECPI of restructuring balance under $3m

Types of 'strategies' which will likely catch the eye of the ATO:

- Move accumulation balances to a new SMSF, keeping assets would like to realise gains on in pension SMSF, in year fund A solely in retirement phase sell assets tax free, move assets over to other SMSF, fund unsegregated, withdraw amounts from accumulation
- For fund moving into pension phase for first time (no DSFA), move entire fund into pension, creates deemed segregated period, sell assets tax free, resolve excess by commuting back to accumulation, withdraw amounts from accumulation, pay excess TBA tax and do TBAR
- Roll back pensions to accumulation 29 June, 30 June no retirement phase balance, no DSFA for next year, restart pensions and segregate assets wish to sell to the pensions (note cannot segregate part of an asset), sell assets tax free, unsegregated cash, make withdrawal from accumulation

Mega Super Fund Case Study

Chris: working aged 65
Accumulation= $4,800,000

$4.8m in super = TSB over the $3m cap

Cathy: working aged 63
Accumulation = $1,800,000

Cathy is considering ceasing an employment arrangement to meet the 'retirement' condition of release

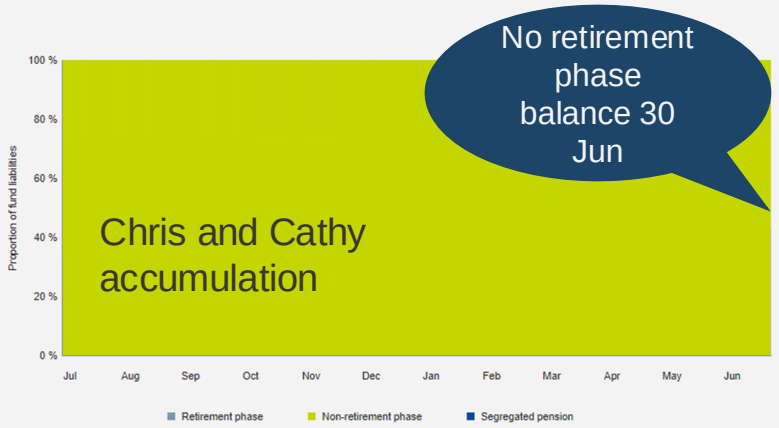
SMSF does NOT have DSFA

SMSF Investments - 1 July
$6,600,000

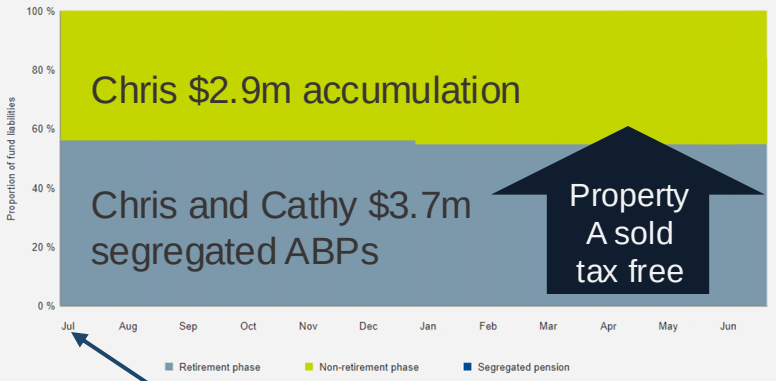
Asset	Market value	Capital gain/ loss if sold
Property A	$3,000,000	+$950,000
Property B	$2,000,000	-$200,000
Share portfolio	$1,100,000	+$220,000
Term deposits	$300,000	n/a
Cash	$200,000	n/a

Example: Impact on ECPI of restructuring balance < $3m

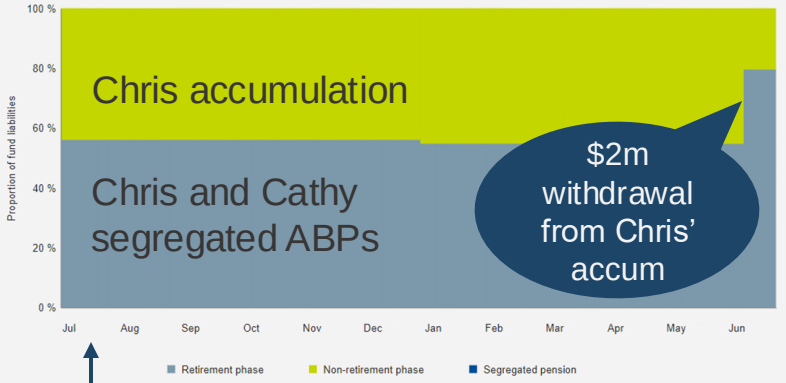
- Setup a segregated investment strategy
- Maintain the segregated strategy beyond first year for investment purposes



No DSFA
Segregated method for ECPI



DSFA
Proportionate method for ECPI



Asset	Market value	Segregated to ABPs?	Capital gain/loss if sold
Property A	$3,000,000	$3,000,000	+$950,000
Property B	$2,000,000	No	-$200,000
Share portfolio	$1,100,000	$550,000 of shares	+$220,000
Term deposits	$300,000	No	n/a
Cash	$200,000	$150,000	n/a

Commence pensions 1 July

SMSF sets up segregated investment strategy for $3.7m in account-based pensions

Investment strategy review

Due to sale of property now have large amount sitting in cash segregated to ABPs.

Chris wants to withdraw $2m from accumulation. Need liquidity in accumulation to facilitate this and would prefer growth assets segregated to ABPs over cash.

Decide to adjust fund assets so Property B is segregated and $2,050,000 in cash unsegregated to support accumulation.

Assessing a retirement strategy

Balancing cashflow objectives and risks

Creating a retirement investment strategy

Accumulation	Retirement
Regular contributions, compound returns	Regular benefit payments + possible lump sums
Investing for growth, long term	Investing for growth… but
Don’t need liquidity	Liquidity required to make payments
No sequencing risk (no withdrawals)	Manage sequencing risk

Holistic retirement strategy for an individual/couple

- Cashflow planning, what do you spend
- Investments to manage growth vs sequencing risk vs liquidity needs
- Age Pension, superannuation savings, non-superannuation savings

SMSF retirement investment strategy

- Commonly a single investment strategy for all fund members
- What cashflows are required from the SMSF
- Issue with multigenerational funds where members have different objectives

Understanding cashflow requirements

Many people don't know what they spend their money on!

- Understand what benefits your retiree may be eligible for which could help reduce costs:
  - Age Pension / Pensioner Concession Card
  - Commonwealth Seniors Healthcare Card (nearly all retirees should be eligible!)
  - Seniors Card
- Do a budget for their retirement spending:
  - Non-negotiables: power and water bills, rent/mortgage, medicines, groceries
  - Lifestyle expenses: dining out, private insurance, holidays, memberships
- Don't forget inflation risk
  - Generally, might desire spending to increase over time to maintain purchasing power

Understanding risks to the retirement strategy

Risk = uncertainty

- SMSF investment strategy focuses on market risk having regard to the cashflow objectives:
  - Risk involved in making, holding, and realising, and the likely return from the investments
  - Composition of the investments, including the extent to which the investments are diverse
- To assess whether investments will achieve objectives must also consider longevity risk
  - Accurium research[1] showed SMSF retirees expected to live longer than population averages
- Future outcomes are not 'risky' if we know about them and can plan with certainty, even if are bad
  - What will future returns be? How long will you live? How much will cost of living rise?

1 - Accurium SMSF Retirement Insights 'SMSF Trustees – healthier, wealthier, and living longer, Vol 2 April 2015, Volume-2-SMSF-Trustees-healthier-wealthier-and-living-longer-April-2015.pdf (accurium.com.au)

Longevity risk in retirement investment strategies

- SMSF investment strategy requirements to discharge pension liabilities
  - Risk lies in the **uncertainty** of lifespans
  - A forecast of retirement is *highly dependent* on the timeframe assumed
- Interesting
  - Since the 2010-12 tables mortality rates have fallen at almost all ages
  - Female mortality continues to be less than male mortality at all but the oldest ages
  - In the 3 years 2015 to 2017 the life tables identified 5,509 people in Australia died aged 100 or over. Around 80% of these were female

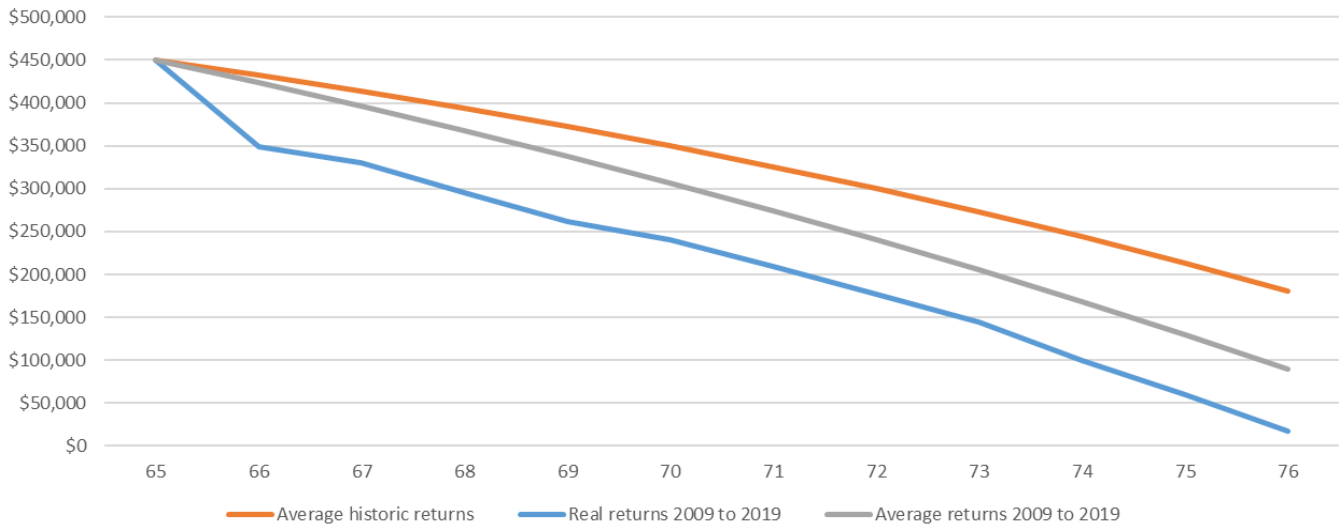
“Any realistic measure of longevity needs to consider the possible improvements in mortality that may occur in the future.”

Market and inflation risk in retirement

Sequence of returns experienced have a big impact on the outcome

- Consider a person retiring aged 65 in 2009 with $450,000 invested in a balanced asset mix[1] and they desired a retirement income of $45,000 p.a. that will increase annually with price inflation

Year	Real return
Average historic 20yrs (1989-2008)	6.4%
2009	-13.3%
2010	8.1%
2011	3.5%
2012	4.0%
2013	10.1%
2014	6.2%
2015	6.9%
2016	7.9%
2017	0.3%
2018	5.7%
2019	8.7%
Average (2009-2019)	4.4%



- Illustrate retirement using actual returns and inflation[2]
- Poor returns at start of retirement bigger impact than later-on
- Cost of sequencing risk hidden using fixed assumptions

1 – Balanced asset mix 25% Aus shares, 25% Aus bonds, 25% Aus property and 25% Cash
2 - Vanguard Index Chart 2019 returns and RBA historic annual inflation rates, years ended 30 June

Evidence of achieving SMSF investment strategy requirements

Assessing retirement strategies

Given the fund investments and risks involved, what is the chance the SMSF investment strategy will help achieve the cashflow objectives?

- Utilise actuarial techniques – stochastic modelling
  - Real world is not static; future outcomes are unknown
  - Considers correlations and interactions over time, allows for realistic variation in returns
  - Can be tailored to an individual's retirement investments and objectives
  - Can use thousands of simulations to stress test likelihood of achieving objectives

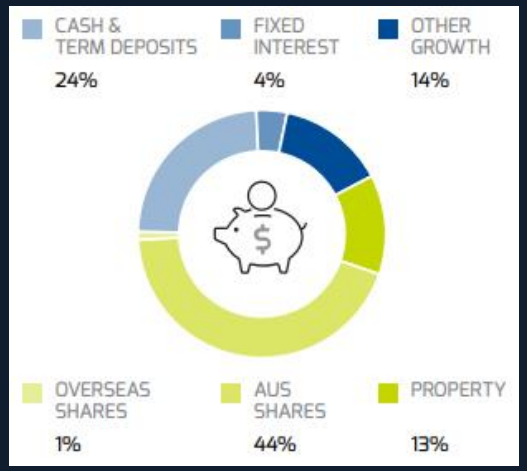
Asset Class A	Yr1	Yr2	Yr3	Yr4	Yr5	…
Sim1	19.94%	10.84%	16.35%	-12.43%	-1.99%	0.93%
Sim2	-24.12%	11.80%	8.23%	-14.84%	9.90%	8.53%
Sim3	4.76%	17.70%	5.57%	-0.86%	-15.06%	6.15%
Sim4	4.63%	-8.86%	3.63%	4.30%	13.73%	13.38%
Sim5	13.88%	9.17%	3.52%	17.56%	-0.96%	-9.46%
Sim6	16.67%	4.32%	-4.38%	17.86%	1.05%	-16.96%
						10.84%

Asset Class B	Yr1	Yr2	Yr3	Yr4	Yr5	…
Sim1	2.04%	3.39%	0.67%	2.61%	3.56%	1.26%
Sim2	2.37%	6.97%	1.92%	3.67%	5.74%	8.84%
Sim3	3.05%	-0.59%	2.12%	6.39%	2.58%	3.58%
Sim4	4.71%	0.77%	1.13%	1.03%	0.47%	3.62%
Sim5	4.79%	3.25%	5.81%	1.00%	0.86%	1.55%
Sim6	2.89%	0.29%	3.57%	0.19%	2.61%	1.08%
….	4.18%	7.17%	1.83%	3.80%	0.59%	0.20%

Case study: P&K SMSF 1 July 2024

SMSF accounts

Peter (69) $1,563,000 Kim (67) $399,000



Non-super assets

Investment portfolio $55,000 (60% growth) Cash $20,000

Peter

Kim

- Currently spending around $90k p.a. increasing each year with inflation
- Allow for spending to reduce 25% when first person passes away
- Is there high confidence spending will last for life?
- Can we afford to go on a big $50k holiday next year?
- Is there high confidence of having $500k when Kim aged 80 for aged care planning?

Case Study: P&K SMSF

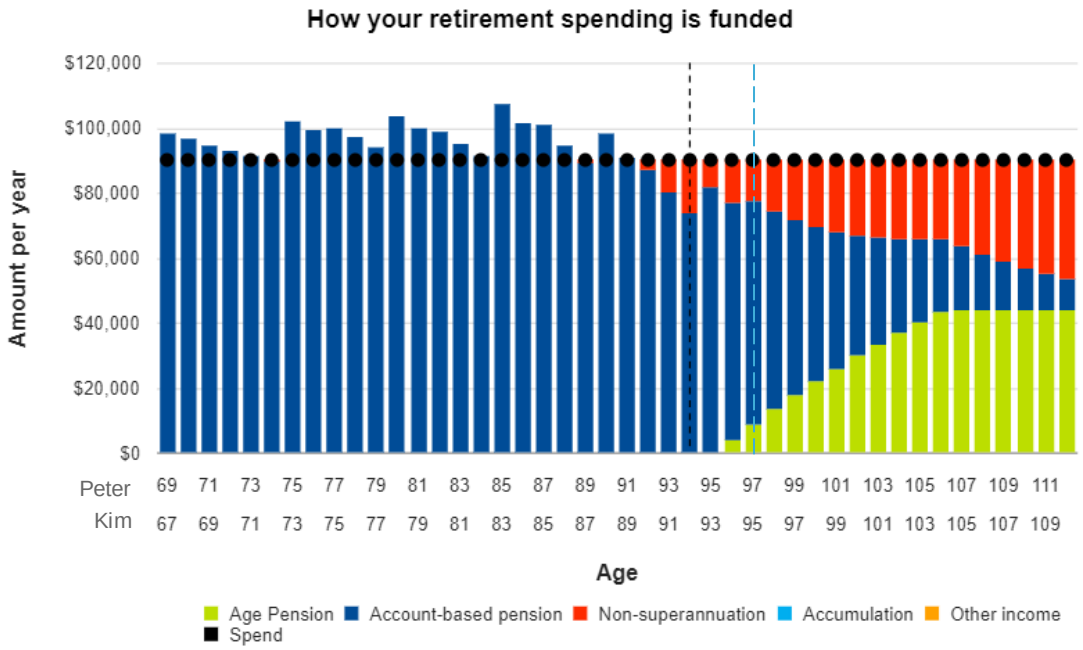
Given the fund investments and risks involved, what is the chance the SMSF investment strategy will help achieve the cashflow objectives?

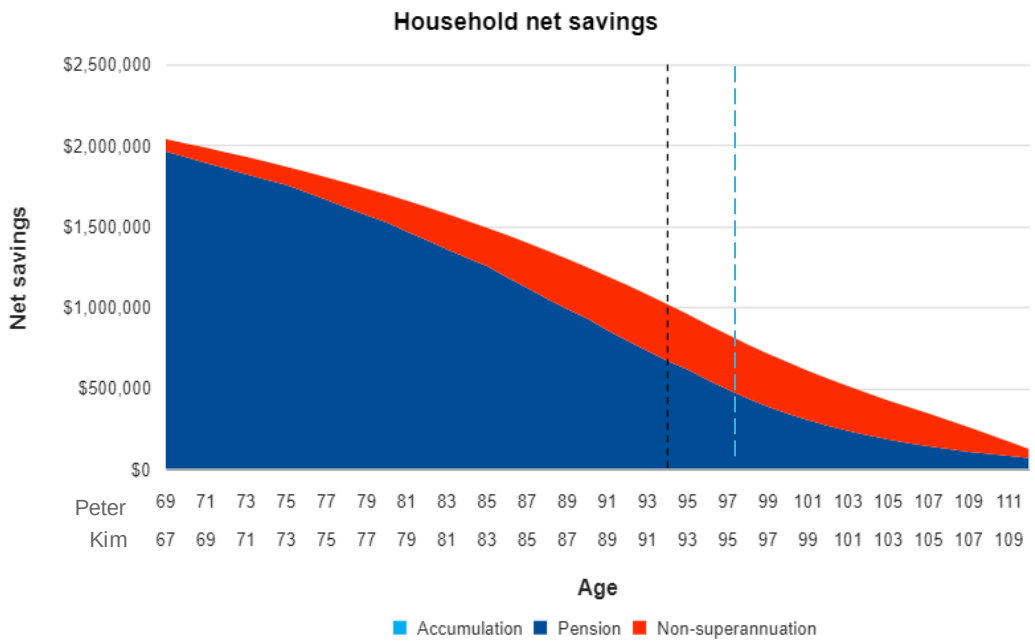
- Methodology:
  - Test retirement strategy by analysing across 2,000 simulations of retirement using returns and inflation from the stochastic asset model[1]
- Success measure:
  - At least 3 in 4 chance can afford target $90,000 annual spending for life if take extra $50k spend next year
  - A 9 in 10 chance have at least $500,000 at age 80 (Kim)

1. Assumptions: Life expectancy based on ALT 2015-17 with 25yr improvement factors, rounded up to nearest whole age. Return assumptions utilising 2,000 simulations over 40 years of 10E24 asset class data, also assume $100,000 personal assets. Investment mix, spending, and assets as stated on slide 35. Other fees, assumptions, and methodology per Accurium's default assumptions in methodology guide for the Retirement HealthCheck on the Accurium website dated Feb 2024.

Case study: P&K SMSF – spending $90k p.a.

Retirement spending





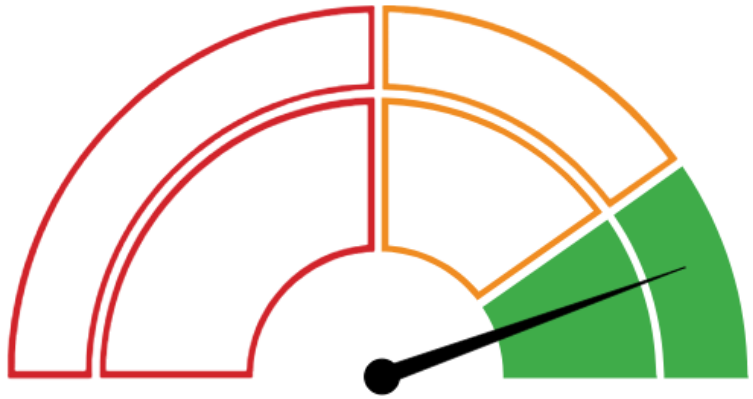
There is a 50% chance that one of Peter and Kim will still be alive in 25 years time. The black dotted line.

There is a 25% chance that one of Peter and Kim will still be alive in 28 years time. The blue dotted line.

Case study: P&K SMSF – spending $90k p.a.

Is the spending sustainable?

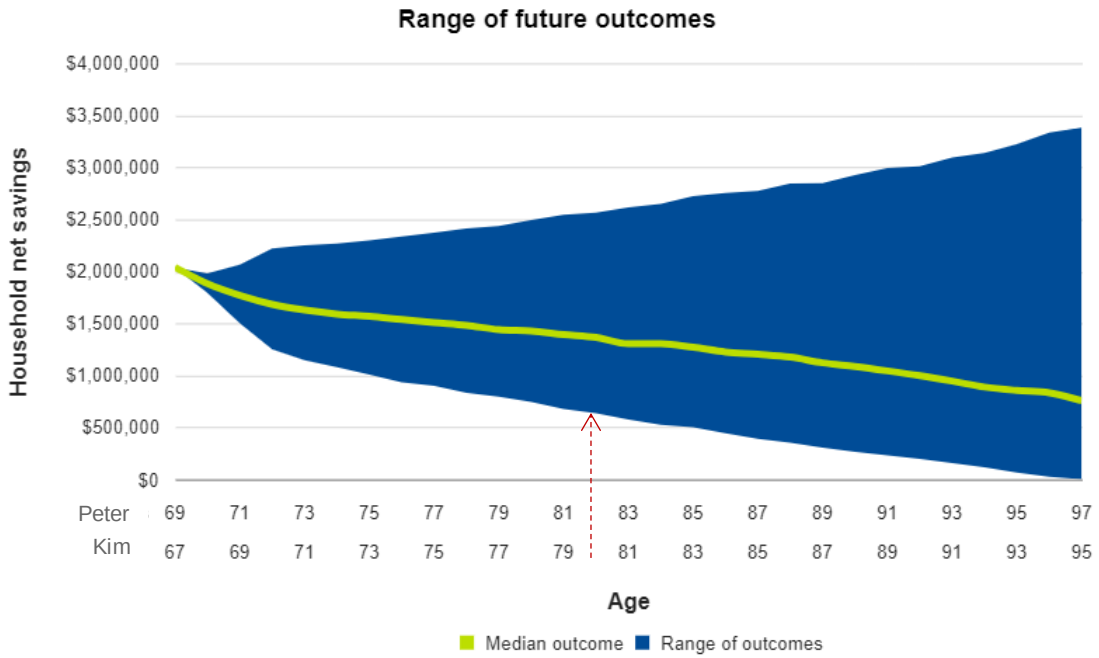
The range of outcomes from the 2,000 ‘real world’ simulations that were stress tested are shown below. In 80% of scenarios considered, future household savings falls in the blue shaded area.



HIGH

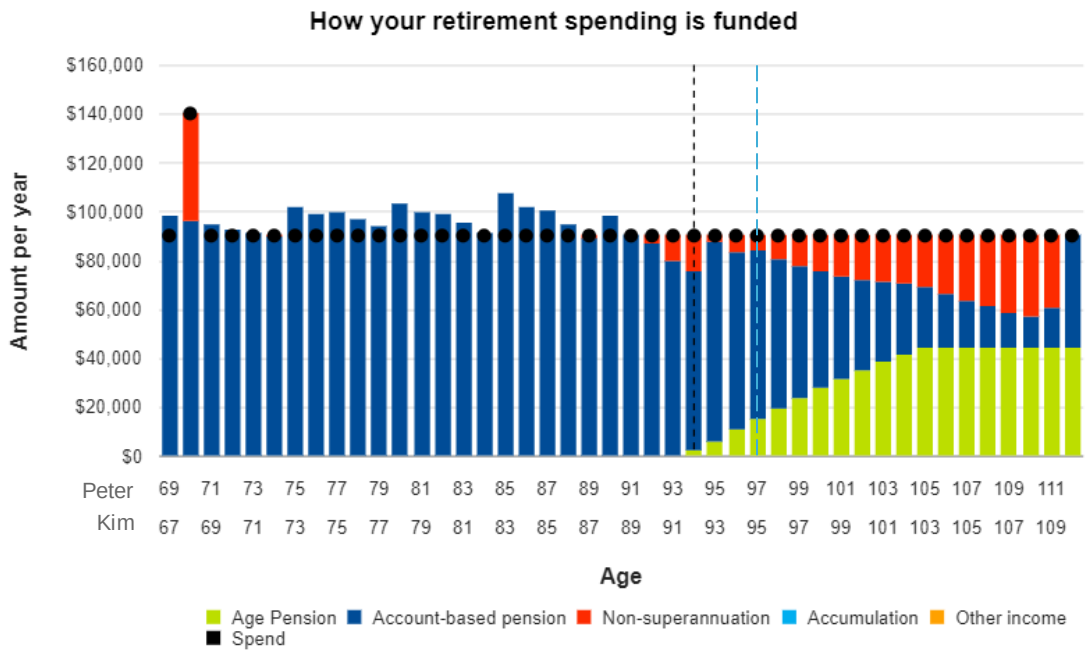
✓ In 91% of the 2,000 scenarios tested the cashflow objective was sustainable for the life of Peter and Kim.

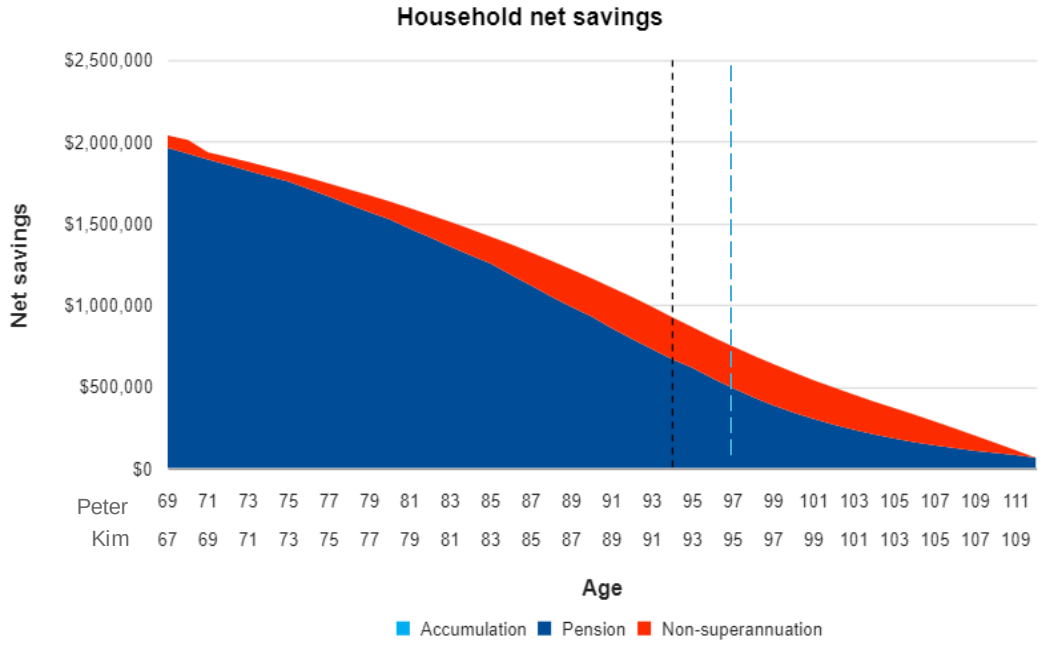
✓ At age 80 median outcome is $1,293,000
In worst 10% of outcomes will have > $500,000



Case study: P&K SMSF – spending $90k p.a.

Retirement spending incl one off $50k





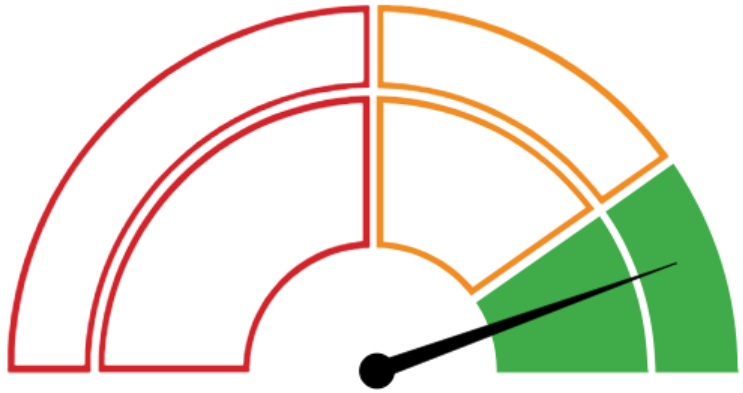
There is a 50% chance that one of Peter and Kim will still be alive in 25 years time. The black dotted line.

There is a 25% chance that one of Peter and Kim will still be alive in 28 years time. The blue dotted line.

Case study: P&K SMSF – spending $90k p.a.

Can they afford the big holiday?

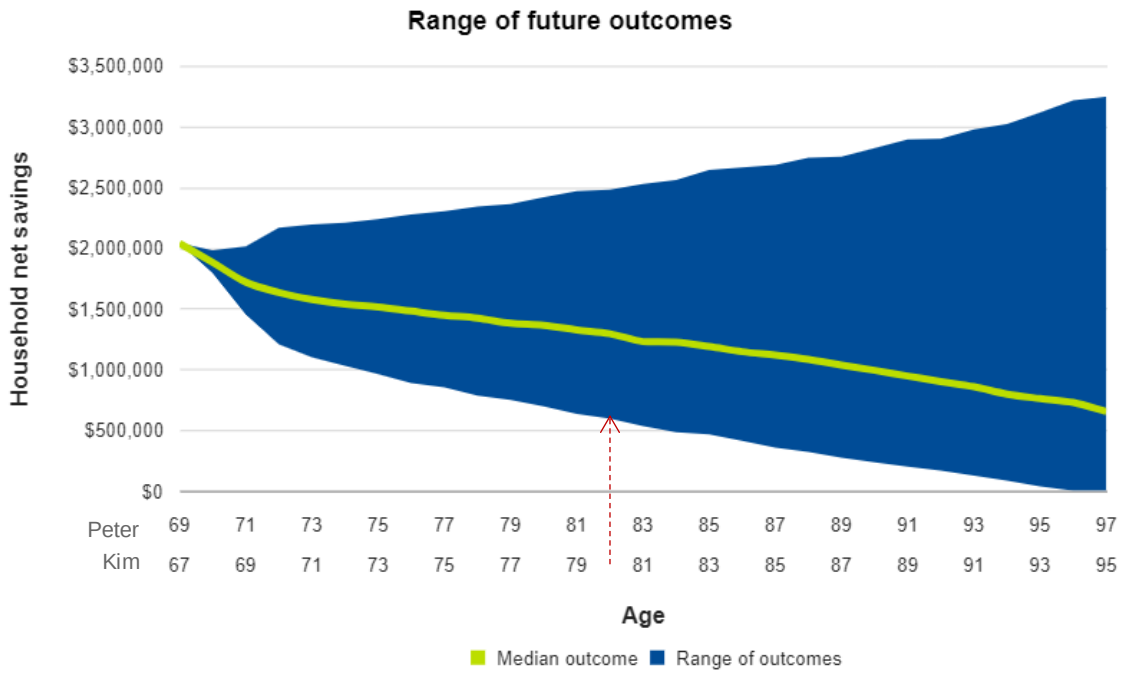
The range of outcomes from the 2,000 ‘real world’ simulations that were stress tested are shown below. In 80% of scenarios considered, future household savings falls in the blue shaded area.



HIGH

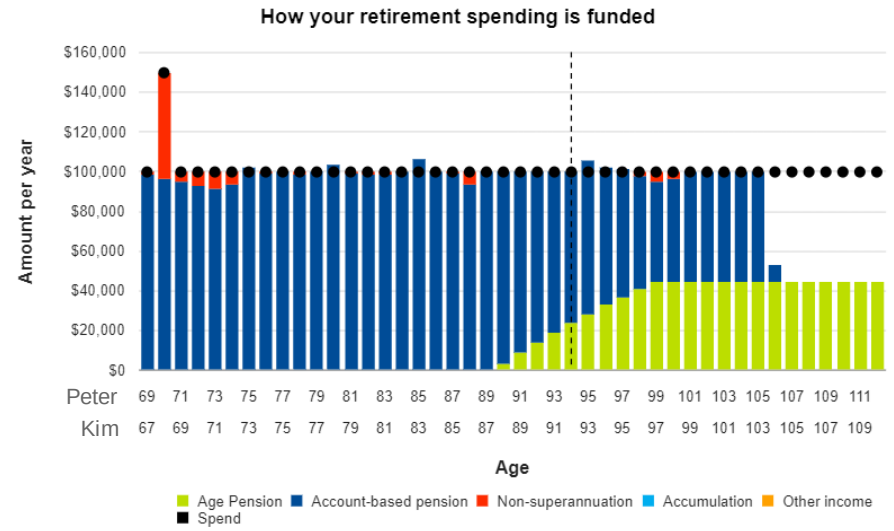
- In 89% of the 2,000 scenarios tested the cashflow objective sustainable for the life of Peter and Kim.

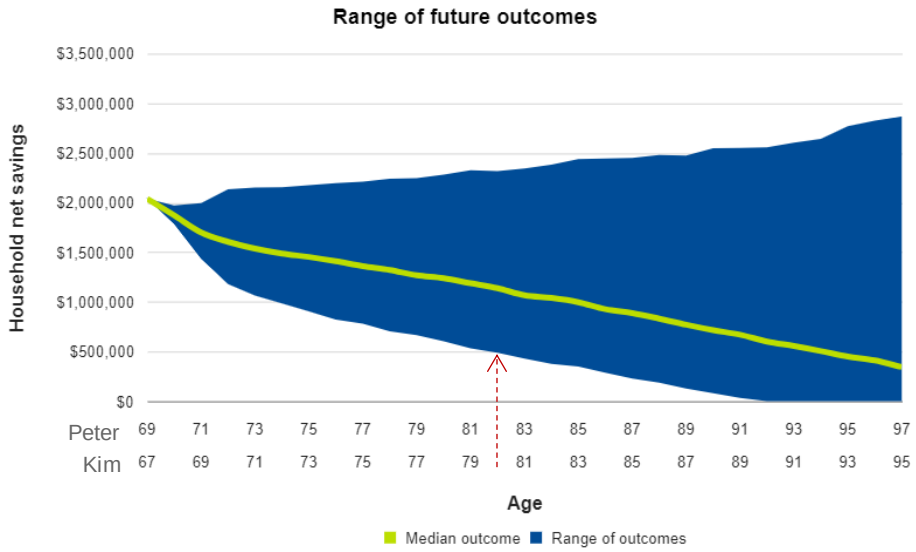
- At age 80 median outcome is $1,293,000
  In worst 10% of outcomes will have > $500,000

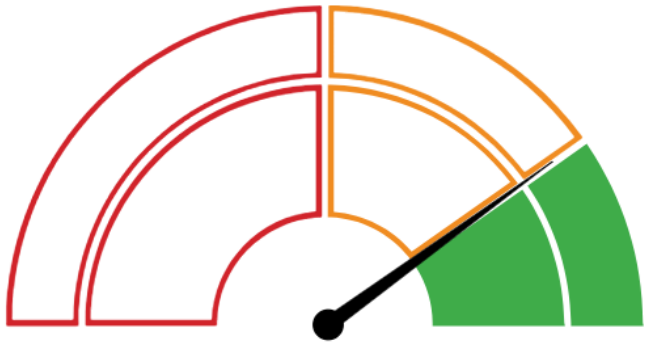


Case study: P&K SMSF

What could they afford to spend and still have ‘high’ confidence?







HIGH

In 80% chance the cashflow objective sustainable for the life of Peter and Kim if spending **$99,500 per annum**.

At age 80 median outcome is $1,137,000.
In worst 10% of outcomes will have around $500,000.

Case study: P&K SMSF

- Showed can have very high (89%) confidence of spend lasting for life if take a big holiday in a year's time, and
  in worst 10% of scenarios will still have more than $500k when Kim is aged 80.
- Spending $99,500 p.a. increasing annually with inflation + $50k spend after 1 year is expected to last for life with 80% confidence
  - An extra $9,500 p.a. vs current $90,000 spend
  - Around $500k in assets in all but worst 10% of future scenarios tested when Kim is 80

Having stress tested the SMSF investment strategy this provides evidence that the strategy supports the client's in achieving their cashflow objectives.

- Could this type of risk-based analysis provide your clients with confidence they can afford that big holiday?
- Or the confidence to not worry about spending a little more each year if that helps to enjoy retirement?

Helping achieve confidence in the investment strategy

Experts can help retirees achieve their retirement objective

- Think about ECPI implications of selling assets and commencing pensions as prepare for retirement
- Evidence that the SMSF investment strategy will achieve the cashflow objectives having regard to the risk of investments can be obtained from a retirement model

Demonstrate the compliance of the SMSF's retirement investment strategy for the fund auditor

- A written investment strategy, notations on current strategy
- Documentation of decisions in minutes of trustee meetings

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Questions?

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