COMPLIANCE

Charting the course

The SMSF investment strategy has been under increased scrutiny in recent times. Rob Lavery takes a look at the items to be considered when formulating an SMSF's investment plan.

ROB LAVERY
is senior technical manager with the knowIT Group.

In a 2018 report, the Australian Securities and Investments Commission (ASIC) found, having surveyed more than 450 SMSF members, almost one-third did not realise their fund was required to have an investment strategy. What's more, 28 per cent of those surveyed admitted to giving no consideration to members' insurance needs through the fund.

The new year is a good time to revisit the investment strategy requirements of SMSFs and to take the time to review those that are in place to make sure they comply with the law.

The legislation

The obligation for all SMSFs to have an investment strategy is captured in section 52B of the *Superannuation Industry (Supervision) Act 1993*. It states each trustee of the fund must formulate, review and give effect to an investment strategy that considers the whole of the fund's circumstances. Furthermore, this section outlines the sorts of issues an investment strategy should include, being:

- the risk of the investments and the likely return from those investments given the fund's cash-flow requirements,
- the diversification of the fund's investments,
- the liquidity of the fund's investments, given cash-flow requirements, and
- the ability of the fund to pay its liabilities.

The accompanying regulations add the investment strategy should also consider whether the fund should hold insurance policies over the lives of one or more members.

It is worth examining the role investment strategies play through the lens of these three obligations:

1. formulating the strategy,
2. reviewing the strategy, and
3. effecting the strategy.

Now is the time for SMSF trustees to ensure their investment strategy is well-documented, up to date and reflective of the investments held by the fund.

Formulating the investment strategy

All SMSFs are required to have an investment strategy that considers the factors noted above and to ensure the strategy is properly documented. Failure to do so can result in fines of up to 20 penalty units, currently $4200. So how is an investment strategy formulated?

There are a number of online document services that offer templated SMSF investment strategies. That said, a template alone won't ensure the fund's strategy document is compliant.

Outline the members' situations

A good starting point is to outline the situation of the fund's members. By identifying, at a minimum, the name, age and superannuation stage (that is, either accumulation or retirement) of each member, the fund's trustees can ensure the strategy links directly back to these individuals' needs.

Information on the overall make-up of the fund is also recommended. The total investable assets of the SMSF, as well as the fund's regular liabilities, are worth noting to ensure the fund's cash-flow and debt requirements are clear. The SMSF's liabilities do not need to be noted in great detail, however, acknowledging regular outgoings, such as tax, administration fees and potential member payments, will help inform the fund's liquidity requirements.

State the fund's investment objectives

It is common to state the investment objectives of the fund in the strategy document and this may start with a stated return benchmark as compared to an index or inflation rate. It is also good practice to outline the classes of investment the fund is allowed to hold and the platforms that can be used to hold them. Often these are quite broad statements to ensure the fund does not have to regularly redraft this section of the strategy when considering new investments.

A target asset allocation table by class is a feature of most investment strategies. One approach had been to provide target ranges that stretch from 0 to 100 per cent for each asset class to ensure maximum flexibility, however, the ATO has confirmed it does not view such an approach as compliant with the law. As such it is incumbent on trustees and their advisers to put more thought into target asset allocations.

The driving factors when considering such target allocations include:

- the need for cash flow from investments to meet liabilities,
- the risk profiles of members,
- the need for capital growth to meet members' goals and objectives, and
- the need for liquidity for members.

Commentary around the asset allocation table should link the target ranges to these factors.

Single-asset funds

In late 2019, the ATO commenced a review of all SMSFs that have more than 90 per cent of their investments in a single asset or class of assets. The ATO sent letters out to 17,700 SMSFs in this situation.

It is important to note such concentration of investments does not, of itself, contravene any obligation trustees have under superannuation law. That said, the fund's investment strategy must reflect this situation, must identify the risks to which the fund is exposed as a result of a lack of diversification and must outline steps the fund is taking to mitigate these risks.

Particular problems can arise where an SMSF has a property as the fund's sole asset. It is hard to identify strategies to protect against such lack of diversification and the property's cash flow will need to be sufficient to meet all the fund's needs. These issues are exacerbated when the property is geared and loan repayments are added to the fund's liabilities.

Exit strategies

In Information Sheet 205, ASIC provides guidance on the issues that must be considered by financial advisers when recommending a client commence an SMSF. One area that must be considered by advisers is a potential exit strategy should the SMSF no longer be appropriate for its members.

When reviewing the quality of SMSF-related financial advice in 2018, ASIC found the absence of information on the importance of an exit strategy to be the primary failing of advice when it came to risk disclosure.

Information on a potential exit strategy is not explicitly required to be included in a fund's investment strategy, however, it should be acknowledged. This is particularly the case where the fund has large, illiquid assets that will prevent members from leaving the fund or closing it down in an expedient manner.

Insurance needs

An SMSF's investment strategy must consider the insurance needs of its members. It must also explore the fund's role in meeting these needs.

Implicitly, this requires the investment strategy document to consider the insurance held by each member outside of the fund, as well as inside. Commentary on the adequacy of the policies held by each member need not be extensive in the strategy document, however, it must be present.

Review process

It is good practice to include the investment strategy's review process in the strategy

Continued on next page ▶

▸ ***Continued from previous page***

itself. This should consider the time interval between regular reviews, as well as the circumstances that would give rise to additional reviews outside of these regular intervals.

Reviewing the investment strategy

The trustees of every SMSF should review their investment strategy document at regular intervals – annually should be considered a minimum. That said, there are a wide range of events that should trigger an automatic review of the strategy on top of these regular reviews, including:

- the death or exit of a member,
- the addition of a member,
- the marriage or separation of a member,
- a major alteration to a member's assets or liabilities,
- the shift of a member from accumulation phase to retirement phase (or vice versa), and
- a significant change in the assets of the fund.

The requirement that every SMSF's investment strategy consider the insurance needs of each member has added a number of situations to the list of those that demand a review of the strategy. Each client's insurance needs will be dictated by a number of factors, some of which would seem to be otherwise irrelevant to the operations of their SMSF, such as the member's liabilities outside of super.

Operating as the trustee of an SMSF is a significant legal obligation and any major change in life situation should trigger a member to consider whether the SMSF is the right superannuation vehicle for them.

Review your investment strategy now

For those trustees of funds that have not reviewed or updated their investment strategy in the past 12 months, now is the time to act. The ATO has indicated the relevance and quality of investment strategies is a major compliance issue it is targeting. Trustees need to make sure their documented strategies are up to date and meet the requirements of the law.

Effecting the investment strategy

Given the thought and effort that needs to go into each SMSF investment strategy, it is important to ensure the final leg of each trustee's obligation is met – that of effecting the investment strategy.

To ensure this is the case really only requires trustees to ask one simple question about their fund: Is the fund doing what it says it will in the investment strategy?

There are a wide range of reasons why SMSF trustees may find that their fund is not, in fact, doing what its investment strategy requires. A common issue will be that the strategy has not been reviewed for some time and, consequently, the fund's members' situations have changed. This is not the only potential reason however.

Blown off course

Where an SMSF has a range of well-diversified assets, it is common to find the proportions of these assets move over time. Capital value of a higher-risk investment, such as a share portfolio, will typically fluctuate, whereas the capital value of many income-based investments will not. Such fluctuations may cause the fund's investments to slip outside of the target asset allocation ranges outlined in the investment strategy.

This issue will be exacerbated in times of high volatility. During the global financial crisis, even an indexed Australian share fund could drop by over 50 per cent in value in a matter of weeks. Likewise, market recoveries can be rapid as well, causing SMSF portfolios to slip outside their target asset allocation ranges.

A new investment

The investment industry is nothing if not inventive and the introduction of new investment structures and investing platforms is a constant part of the industry. Established SMSFs may well find their investment strategies were written at a time when the latest trend in investing was not yet invented – consequently they do not permit the use of

Particular problems can arise where an SMSF has a property as the fund's sole asset. It is hard to identify strategies to protect against such lack of diversification.

such investments.

Even something as ubiquitous as a managed account product may not have been considered by an investment strategy drafted as recently as five years ago. As such, it is important to ensure the SMSF's investment strategy is updated before any major change in its portfolio is enacted.

Getting your ducks in a row

Now is the time for SMSF trustees to ensure their investment strategy is well-documented, up to date and reflective of the investments held by the fund. The regulator has shown the age of broad or vague investment strategies has come to an end and it is looking to these documents as a way to govern trustees' sound investment practices. ▼