SMSF Owners' Alliance
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A nugget of good sense sifted from FSI submissions

We have not read all the submissions to the Interim Report of the Financial System Inquiry, though given there were over 6,500 we should hardly need to apologise!

However, we did read with considerable interest the one lodged by Rice Warner and believe this objective analysis should be on top of the FSI Panel's reading list and indeed be "required reading" for commentators and anyone interested in investment and superannuation.

We congratulate Rice Warner for bringing some sensible fundamental analysis to some of the issues canvassed by the Interim Report. For example:

1. Rice Warner points out that there is too much emphasis by APRA funds on avoiding negative returns on annual statements (short-termism). This emphasis can only be implemented by diluting the main goal of maximising long-term returns.
2. Lifetime annuities may provide longevity protection but only from a low starting point (providing a low return to retirees!)
3. The long term investment horizon in retirement needs growth assets to provide inflation protection and make funds last a long time. Growth can be maximised by harnessing the equity risk premiums and franking credits, rather than by holding cash or bonds as is often recommended as "defensive asset allocations" for retirees.
4. The amount of cash held by many APRA-regulated funds for liquidity purposes due to the portability of benefits reduces long-term returns for members.
5. "Conservative" asset allocations produce inferior outcomes because volatility de-risking is insufficient when faced with a significant market fall and the reduction in earnings capacity by moving a significant proportion into defensive assets results in significant long-term underperformance.
6. Lifetime annuities also under-perform over long periods because they are invested conservatively and the guarantees built into the products are costly.
7. The volatility of capital movements (share prices) is largely irrelevant to an investor provided they are not being forced to sell shares. APRA-regulated funds worry too much about short-term market price volatility leading to sub-optimal investment results.
8. Franking credits are sound as a means of avoiding double taxation of company dividends. Removing franking credits and once again putting equity investments at a disadvantage to debt investments would encourage investment in lower yielding

portfolios which would lead to lower retirement incomes for the population and a greater call on the Age Pension.

9. Such action could also tilt capital structures towards a higher proportion of debt capital potentially increasing the rate of failure of business, especially in times of financial crisis, impacting investment returns.
10. SMSFs operate under the same tax superannuation rules as APRA-regulated funds but they are more flexible so can manage tax more easily and tailor investments to match an individual's circumstances.
11. There is not one Australian superannuation fund provider that has in place the right default retirement incomes package. The circumstances of retirees vary greatly so no product can be a magic bullet to solve all situations.
12. Existing products can be easily tailored to meet the needs of retirees but the problem is that superannuation funds do not provide optimal long-term solutions which by definition lead to reduced living standards in retirement and add to social security costs.

Thank you Rice Warner for presenting sound and sensible views on investment fundamentals. We hope this may stimulate more informed discussion amongst commentators.

We also like most of your proposed solutions regarding taxation of superannuation. We have several times suggested that it would be most efficient if the tax rate applying in accumulation phase is the same as the one applying in pension phase.

Where we differ is that we believe it may be best for such rate to be zero and for pension benefits to then be included in a retiree's income tax return. (the so-called EET system)

Another place we may differ is your suggestion that moving to such a system would be equitable in that "wealthy retirees will contribute towards reducing the Budget deficit".

This approach appears to ignore the fact that current retirees have been paying 15% tax on their earnings and contributions in the accumulation phase (and full tax on non-concessional contributions). Any move to introduce tax in the pension phase must recognise this and "grandfather" existing retirees who have accumulated their assets under the existing tax system. It also ignores the fact that "wealthy retirees" have, through the course of their working lives, paid much more in income tax than those who have not saved enough to support themselves financially in retirement.

How grandfathering can be achieved requires more discussion but the equitable way would be for the value of superannuation balances as at the date of change to be recorded and, when people retire, a proportion of their pension (equal to this value as a percentage of their superannuation balance at retirement) be untaxed as per the current system with the balance taxed as suggested by either Rice Warner or preferably in an EET system

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