Submission to the Financial System Inquiry, March 20, 2014

This submission is prompted by a letter I wrote in September 2013, which was directed to the Treasurer. In the resulting response from Treasury (by Rob Donelly, Chief Advisor, Personal & Retirement Division on March 17, 2014), I was encouraged to make a submission to this Enquiry. What follows is largely extracted from my correspondence.

Specifically, this submission focuses on Point 3 of the Enquiry's Terms of Reference (http://fsi.gov.au/terms-of-reference/), which I reproduce below for completeness:

The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including:

1. *the role and impact of new technologies, market innovations and changing consumer preferences and demography;*
2. *international integration, including international financial regulation;*
3. *changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets;*
4. *changing organisational structures in the financial sector;*
5. *corporate governance structures across the financial system and how they affect stakeholder interests; and*
6. *developments in the payment system.*

The main points in this submission:

- Governance around the SMSF sector is loose. There is considerable focus around the ease of setting up and managing an SMSF. This puts systemic risk into the sector, which many Trustees and Stakeholders do not fully understand. Despite these risks, the funds themselves can be technically fully compliant in all respects
- A proliferation of products and providers has grown around the SMSF industry which makes governance and compliance easy. These (not necessarily explicitly) remove risk and recourse from Trustees (or those who control the relevant Company if a Corporate Trustee is used). With

this, there is also no clear delineation between the interests of product providers and stakeholders

- The system allows investment mandates to be easily set, with a wide range of investments available and compliant. It places few restrictions on the investment process. This is especially dangerous for SMSFs of low notional value
- There is a lack of benchmarking and performance attribution for SMSFs. There is little or no requirement for diversification, and little practical focus on risk. Trustees have no obligation to analyse or modify their performance
- All the above (anecdotally) points towards systemic weakness. This ultimately means that the Government will end up with the financial and social burden if inadequate investment returns (or worse!!) are generated by SMSFs

From these concerns, are suggestions around a governance framework, investment guidelines, benchmarking and ongoing monitoring and management of SMSFs. These are ideas and points for further discussion and investigation, rather than hard recommendations.

All this is detailed further in the extract below (which is largely verbatim from my correspondence). I am happy to provide more information, and to engage with the Panel to further share my thoughts and ideas, and to be involved more actively in the ongoing Financial System Enquiry.

I look forward to the ongoing process.

Roger Cohen

The crux of this letter is my strong belief that there is too little governance around the role Trustees play in self managed superannuation funds (SMSFs). I say this not lightly, as I am basically opposed to increased regulation and process, and applaud the "smaller government" stance the Prime Minister is taking. Australia has a strong and growing superannuation system. SMSFs have been a fantastic addition to this system, however the framework that exists around them currently allows for (in my opinion and experience) very lax governance, with potentially dire consequences. If, however, the deficiencies are addressed now, the result will be a more robust SMSF sector, with fewer burdens on the Government. Please read on for background and more information.

I am a financial services professional who has recently returned with my family to Australia, after living and working in the UK for nine years. Our choice to return home was based on a combination of personal and professional reasons. Personally, we have returned to be with our extended families and long time friends. We see Australia as a wonderful place to live, and to raise our children. On the professional side, our return has provided the opportunity for both my wife, and me to start up our own (separate) business ventures. We see Australia as having a robust and growing economy (compared to most of the rest of the world). Whilst the current environment is tough, we see scope for great opportunity, and look forward to the challenges ahead.

My professional experience is mostly in and around the development and implementation of investment products and solutions (and this is where my Business is focused). Of particular interest are products targeted at, or usable by the pension industry. Part of the process of re-establishing myself professionally, has been to gain exposure to as broad a range of people and products as possible. I have had to learn, or relearn, about the local economy and the financial sector. I am still coming to terms with what has changed and evolved during my absence. I have had to re-establish old contacts and make new ones. Overall, I see many positive outcomes (such as FOFA, the robust superannuation system, the introduction of My Super, the accessibility of self managed or self directed products and more). On the personal side, I have set up a company, a family trust and most relevant, a self managed super fund (SMSF).

It is with respect to this last vehicle that I feel compelled to write. Some time ago, I wrote a blog post on the SMSF sector (http://portablebeta.com.au/2012/09/smsfs-a-reaction-to-past-underperformance/). It highlighted what was then a concern about SMSF investment processes. The fact base was very generic, not tested with any rigour, and anecdotal. It was also in part based on my own experience of setting up and managing an SMSF. The conclusion drawn was that SMSF investors (as a group) are introducing unintended risks into their retirement investment portfolios. This is partly due to a lack of knowledge and understanding about the investment process, and partly as a reaction to poor past performance and the bad experiences they have suffered with traditional managed superannuation schemes. At the time I wrote this (September 2012), I outlined these issues as concerns. Since then, I have seen more and more evidence which validates these concerns, and prompts me to escalate them. I am also passionate to personally and professionally be part of the process to remediate them. Some evidence that leads to my conclusion includes:

- A report from by Steven Ye of Morgan Stanley written in February 2013 (please let me know if you require a reference to it), which shows that the cumulative performance of the SMSF sector as an aggregate lags that of the managed sector. SMSF investors have a different (possibly unintended) appetite and attitude towards risk, which influences their investment behavior
- My own understanding of risk and return emphasises the importance of properly constructing portfolios, understanding investment objectives, setting a strategy, and managing investments. This does not tally with the behavior I observe in many SMSF Trustees. I see SMSF Trustees who (I hypothesise) would not be able to vocalise a clear investment strategy and implementation path, without referring to the documentation around the SMSF they are entrusted to oversee. On paper, this documentation provides a strategy, but too often it is aimed at making the investment process convenient, and ensuring they encounter as few hurdles as possible, without exposing themselves to any personal liability. **It seems more focused on removing the risks around the investment process, rather than around the returns the process should generate**. Investment guidelines are too generic and all encompassing. In theory, this is good. It means that the

universe of investments is wide and far ranging. There is however, little focus on what is chosen from that universe. The behavior I observe is all too often focused on single investments, rather than on the overall investment strategy. What is lacking is an understanding of the benefits of diversification, and a properly annunciated asset allocation strategy. There are few checks and balances (again, the documentation and framework provides an easy route to compliance, with little Trustee overhead)

  - Anecdotally, I see many ad-hoc investment decisions, and (including myself), a very loose approach to strategy and the concerns referred to in the point above
  - It is extremely easy to set up an SMSF. Off the shelf products make setup and maintenance of an SMSF very simple, and relatively inexpensive. Whilst, this provides a great framework for creating and running an SMSF, there is little substance that gives the Trustee guidance on how to manage the investment process (there is much literature, and a myriad of organisations which claim to provide this service, but my observations show that many Trustees bypass these. Also, the quality of the latter varies widely.)

- As a consequence, Trustees do not necessarily have to understand the benefits of portfolio construction, diversification, a clear and implementable investment process and more.
- There is very little one has to do to become an SMSF Trustee. There are no formal requirements, no qualifications, and no requirement for ongoing education.
- It is possible to invest in “dangerous” products (such as leveraged assets, speculative stocks, hybrid securities and more), where the risks are not clearly defined (or definable) and understood. I can outline several ways in which I could potentially “evaporate” the entire net value in my SMSF, without breaking any of the guidelines or constraints in the SMSF mandate. I would be fully compliant in my investment decision, and behavior as Trustee. There would be no recourse to this outcome.
- There is no requirement to benchmark or attribute the performance of SMSFs. While this is not the “be all or end all”, benchmarking and attribution does provide a measure of performance that can be used constructively (and non judgmentally). While benchmarking does introduce an overhead, and the choice of benchmark and methodology can be controversial, it does provide a metric for comparison with actual returns. The absence of proper benchmarking also fosters misinterpretation of performance, which I will illustrate by anecdote
  - I have recently interacted with a number of SMSF Trustees, who are active in the listed equity space. As a generalisation, they all saw themselves generating investment returns in excess of “the industry” (without specifying exactly what “the industry” referred to). They attributed this to sensible choices when investing in listed equities. Over recent times, these equities have indeed generated excellent returns. On further examination, they were also (as a group) holding large amounts of cash. On average, they were holding more cash than most balanced industry schemes, and model portfolios would recommend. When the performance of this cash was factored in to their total investment returns, the result did not look so good. Granted that their portfolios were less volatile than the comparable model portfolios, but most professional investors would interpret this as being underinvested overall. The learning, is that individual Trustees often informally “self

benchmark" on an investment by investment basis. They do not focus on their entire asset base. With a small amount of education, this could be easily remedied

If the SMSF sector, as a whole, continues to underperform the rest of the industry, it is only a matter of time (if not already), before this becomes a systemic risk. Further, within the SMSF universe, there will be a (hopefully small) group of funds with catastrophic returns. In addition to this being a personal tragedy for those affected, the Government will be the ultimate loser, with a segment of SMSF beneficiaries being unable to meet their financial needs in retirement.

As a consequence, there should be a higher degree of onus placed on SMSF Trustees, and perhaps a more stringent governance framework for SMSFs. I do not believe in restricting the opportunity for SMSFs, or for restricting Trustees in their choice of complying investments, however it may be safer to specify a framework, and then provide an opt-out mechanism, rather than the current situation where SMSFs generally start with a very generic and unrestrictive mandate. Such an opt-out mechanism would only be available to suitably qualified Trustees. This would put a "safety catch" on the SMSF, and put much more responsibility on the Trustee to take personal ownership of decisions around the investments under their care. As a default, a Trustee should have to demonstrate a certain level of understanding (which at present is easily outsourced) of the investment process, before being allowed to perform their role.

To implement, the default position for an SMSF, should include a basic (and simple) level of diversification in its investments (I would suggest something very simplistic such as basic concentration limits and exposures to various factors). These need not be compulsory (or a legal requirement), however if a Trustee chooses to operate outside these guidelines, then (as mentioned above), a formal opt-out would be required. To reiterate, the opt-out process could be designed to ensure that Trustees fully understand what they are doing, and the risks they may be introducing. In tandem, Trustees should have the opportunity to be educated so that they understand the basics of managing an SMSF, and their responsibilities in the process (again, current frameworks and documentation technically provide compliance, but more as protection to the Trustee than to the SMSF itself).

I realise that all this introduces complexity into the system, and adds a degree of overhead. Properly executed, these can be kept to a minimum. The outcome overall would be positive for the SMSF sector, its stakeholders and the Government.