Understanding self-managed super fund performance

Research Report Summary

February 2022

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Purpose

1. To compare, for the reporting period, the investment performance of SMSFs with APRA regulated funds.
2. To identify the minimum amount of capital required for an SMSF to achieve comparable investment returns with much larger funds.

Methodology

Investment performance comparisons between SMSFs and APRA funds have historically been difficult to make. APRA relies on information from financial statements to generate a Rate of Return (ROR) for APRA regulated funds, whereas self-managed super funds (SMSFs) are regulated by the Australian Taxation Office (ATO), which produces a Return on Assets (ROA) measure for SMSFs based on data collated from SMSF annual returns.

When compared to the corresponding ROR of APRA funds, SMSF ROA contains two key inconsistencies. The first is that ROA relies on a net assets denominator which is aggregated over each reporting period. The second is the ROA methodology uses a net earnings figure which is net of contributions tax and insurance flows, whereas the ROR measure is gross of contributions tax and insurance flows.

The overall impact of these differences is to suppress ROA relative to ROR, generating lower performance estimates all else equal.

In recent times, the ATO has adjusted their ROA calculations for SMSFs to align with ROR more closely. Specifically, the ATO has made the following changes to their ROA calculations for SMSFs:

- Fund assets at the beginning of the period have been used instead of average assets over the period.

- The calculation is based on contributions gross of tax rather than net of tax[1].

While these adjustments close the gap between ROA and ROR, it is estimated they would only account for between 25% and 50% of the ROA-ROR gap[2]. Given the way the data is collated and the different data inputs, relative to ROR, the ATO's adjusted ROA is still likely to generate lower performance estimates, all else equal.

Resolving this was the first objective of the research and a necessary first step in any investment performance analysis which looks to position SMSFs within the broader context of the Australian superannuation industry.

To achieve this, the research took anonymised financial statement data received from BGL Corporate Solutions and Class Limited for over 318,000 SMSFs for the three-year period from financial years ending 2017 to 2019 and calculated an annual ROR for each fund in the data sample. A median ROR for the SMSF sector was then derived from the individual fund RORs. To compare against SMSF median ROR, a similar approach was used for the APRA fund sector with a median APRA fund ROR derived from APRA's annual fund-level superannuation statistics back series. The use of median RORs overcomes a shortcoming with using pooled industry data to derive a sector level rate of return. Pooled returns are in effect value-weighted rather than being unweighted like median returns. This means, unlike median returns, pooled returns are disproportionally influenced by the financial performance of the larger funds in the data sample and are therefore an unreliable indicator of individual fund level performance.

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1   These adjustments are in line with recommendations made from independent research conducted by the University of Adelaide International Centre for Financial Services into the investment performance methodology used by the ATO.
2   Independent research conducted by the University of Adelaide International Centre for Financial Services into the investment performance methodology used by the ATO.

Key findings

Research Result

1

SMSF ROA consistently underestimates actual SMSF performance, with evidence suggesting this gap is widening over time.

The table below compares the differences between the ATO's published ROA returns for the SMSF sector and the ROR calculated for each individual SMSF in the data sample for the period 2017 to 2019.

	2017	2018	2019
Median ROR	6.9%	6.0%	6.2%
Median ROA	5.0%	4.0%	4.3%

Source: Understanding SMSF performance, table 3.

Given the differences in the way the data is collated, and the data inputs, it is not surprising the ATO's ROA measure shows a lower rate of return compared to the ROR measure. However, what is surprising is the ROA/ROR differences seem to be becoming more severe over time. The research found the ATO's median ROA calculation underestimates the SMSF median ROR on average by more than 1.9% over the 3-year period from 2017 to 2019. This is over 50% larger than what was presented to the Productivity Commission for the period 2006 to 2016.

Comments

There are fundamental and irreconcilable differences between SMSF annual return data and SMSF financial statement data. While in recent times the ATO has made adjustments to align their ROA calculation measure more closely with ROR, given the differences in the way the data is collated and the data inputs, ultimately it is not possible for the ATO to fully replicate ARPA's ROR calculation.

This research study addresses this issue by using fund financial statement data to calculate an annual ROR for each SMSF in the data sample.

While it may be appropriate to use the ATO's SMSF median ROA and average investment return figures to compare the performance of the SMSF sector with other years, these figures should not be used to compare the performance of the SMSF sector with other sectors.

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Key findings continued

Research Result

2

SMSFs with net assets of more than $200,000, that are not concentrated in cash and term deposits, outperformed APRA regulated funds in two out of three years between 2017 and 2019.

When comparing the headline performance of ARPA funds with SMSFs, at the median APRA funds outperformed SMSFs in two out of three years between 2017 and 2019.

However, when small cash-heavy SMSFs are excluded, the opposite result is observed – SMSFs outperformed APRA funds in two out of three years between 2017 and 2019.

	2017	2018	2019
All SMSFs	6.9%	6.0%	6.2%
APRA funds	7.8%	7.6%	6.2%
SMSFs with more than $200,000 and with less than 80% cash or term deposits	8.0%	6.6%	6.5%

Note: All returns in the above table are median RORs.
Source: Understanding SMSF performance, table 6.

Comments

Of particular interest in this research study is the investment performance of SMSFs which actively invest. Excluding SMSFs which, either by default or choice, abstain from making investment decisions, provides a more useful indicator of performance.

Similarly, SMSFs with balances below $200,000 are more likely to lack the critical mass required to keep pace with larger funds (see research result 5).

Excluding SMSFs which meet either of these conditions (i.e. SMSFs with balances below $200,000 or with more than 80% of the fund balance invested in cash and term deposits) provides a more meaningful comparison of performance relative to APRA funds.

The research found SMSFs with significant cash holdings were associated with significant performance impairment for the three years between 2017 and 2019. The research also found a strong positive relationship between fund size and fund performance for balances up to $200,000. These results indicate the overall performance of the SMSF sector could be improved by identifying and assisting investors with small, cash heavy SMSFs.

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Key findings continued

Research Result

Comments

3

SMSFs generate greater variation in fund-level performance relative to APRA funds.

SMSFs have a higher propensity to outperform and a higher propensity to underperform relative to APRA funds.

While this is a feature of the broader range of investment options available to SMSF investors, it is also a feature of the significant difference in population sizes between the two cohorts.

The greater variation in fund-level performance, and a higher propensity to outperform relative to APRA funds, presents opportunities for advisers to add value, and deliver higher rates of return for suitable superannuation investors.

It also presents opportunities for advisers to assist SMSF investors who have a higher propensity to underperform.

4

In aggregate, SMSFs with more diversified asset allocations achieve higher returns.

The performance benefits of adding a second, third or fourth asset class are strong and consistent across the 2017–19 period. Each incremental increase in asset classes (up to 4) is associated with an improvement in median ROR of between 1% to 3%. Diversification beyond 4 asset classes (up to 7) also improves aggregate SMSF performance, but at reduced marginal rates.

The results are consistent with standard finance theory. Higher levels of diversification are correlated with improved levels of investment performance.

The research results provide tangible evidence of the benefits of diversification. The results provide a useful reference point and education tool for SMSF professionals and investors.

The research results underline the benefits of a properly formulated investment strategy and supports the regulatory focus on SMSFs with inadequate levels of investment diversification.

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Key findings continued

Research Result

5

SMSFs achieve critical mass at balances of $200,000 or more.

The performance of a typical SMSF improves as the balance of the fund approaches $200,000. Once this threshold is reached, the performance of the fund is comparable with SMSFs with much larger balances as illustrated by the flat line in the shaded zone in the figure below.
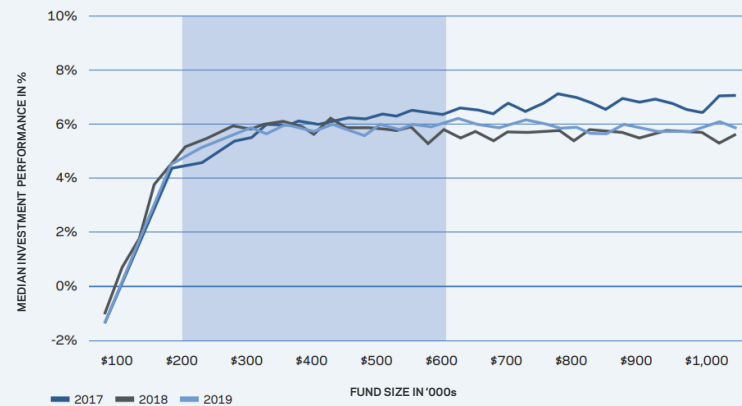
Source: Understanding SMSF performance, figure D2.

The research supports the regulatory focus on fund size, but it also suggests that current guidelines around minimum SMSF balances are poorly calibrated. The research data revealed no material differences in performance patterns for SMSFs between $200,000 and $500,000, so the notion that smaller SMSFs in this range deliver materially lower returns, on average, than larger SMSFs in this range, is not supported by the research results.

Comments

Fund size is important, but mainly for explaining the performance of SMSFs with balances up to $200,000. Beyond this threshold, fund size does little to explain fund performance – at least for the period 2017-2019.

This result complements research released by Rice Warner in 2020 on the cost of operating an SMSF which found SMSFs with balances of $200,000 or more, are cost competitive with both Industry and Retail funds.

In relation to fund size, prospective and existing SMSF investors (and their advisers), should have confidence in the performance prospects if they have $200,000 or more in net assets.

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