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Australian Super: Are SMSF's doing it better?

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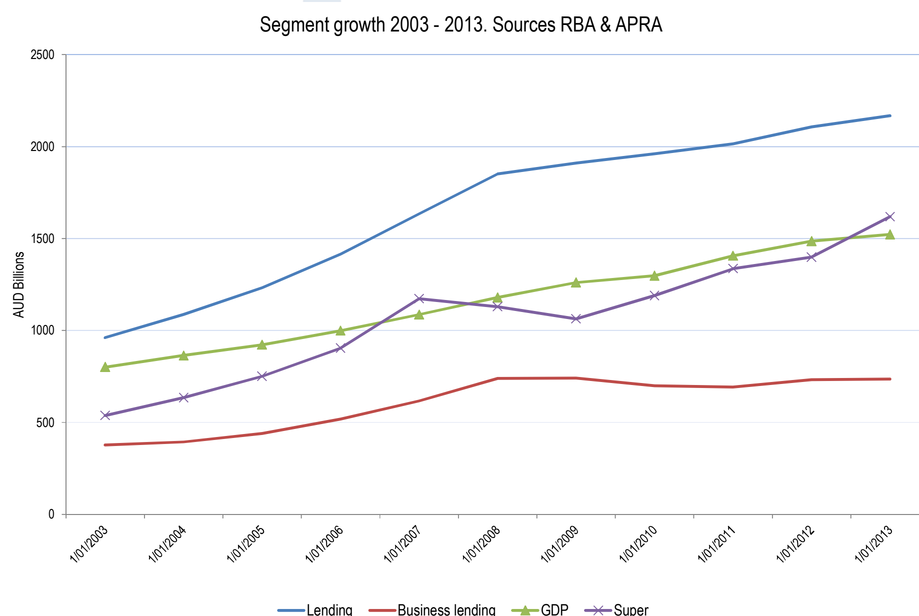
- The tripling of superannuation assets means that superannuation is now larger than GDP and will probably surpass total bank assets within 4 years.
- SMSF has grown more quickly than institutional based super funds, and they have an entirely different approach to investment, both in actual asset allocation and how they change asset allocation.
- SMSF investment performance has been better than institutional performance for 9 out of the last 10 years.
- The big question for investment markets (and banks who hold the deposits) is what SMSFs will do with their $150b of bank deposits over the next few years.

Growth of super an economy changer

It's no surprise that the super funds have seen amazing growth over the past decade, but it's useful to track just how significant the sector is now and will become. The chart below shows total bank lending, bank lending to businesses and GDP as well as total superannuation fund growth. The amount invested in superannuation has grown at a reasonably stable compound rate of 11.1% per annum, well over the c4% p.a. growth of GDP and even the 8% p.a. in total lending (which was driven by enormous housing boom). It's a living proof that compounding is the 7th wonder of the world as superannuation is now larger than GDP compared to around 67% of nominal GDP in 2003. If the current growth rate continues it will surpass total bank lending by about 2017. Those magnitudes of changes result in a different economy and it's all going to occur in a time period of 15 years. Whether the pool of savings is invested prudently or just pushes up asset prices will be a fundamental question for the years to come.



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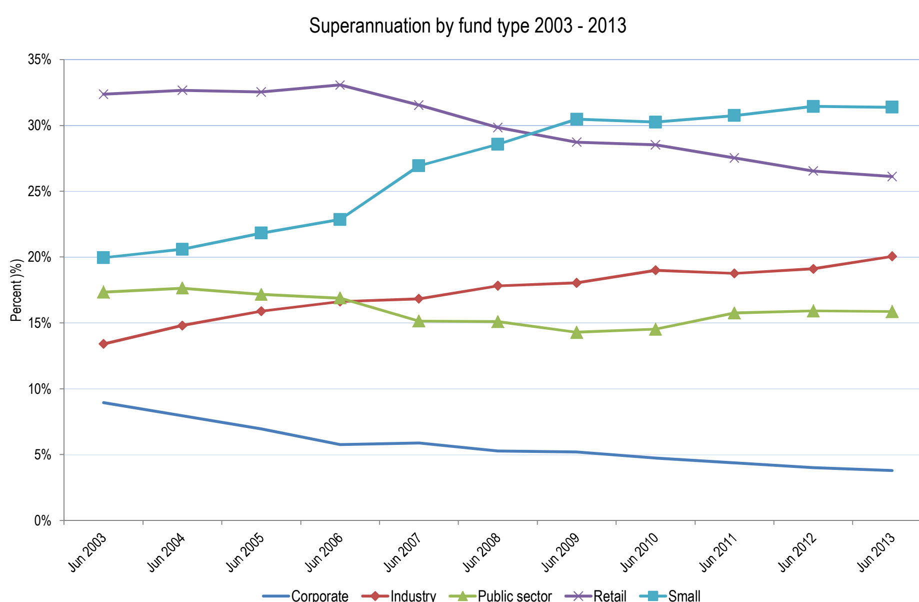
SMSF the real growth engine

Within the growth bubble there have been differences between the various categories of superannuation funds. To a large extent the growth has occurred outside the 2003 incumbents, with industry and SMSF funds growing at around twice the rate of retail super funds. You don't need to feel too sorry for the retail super fund industry; FUM grew by $200 billion which would have increased the fee base by around $3 billion p.a. but retail's share of the total superannuation pool fell from 33% to around 26% and continues to fall. The beneficiaries are the industry funds and SMSF. We suspect that these trends will continue. The chart below shows growth by fund type.



But where is Super invested? The Theory

If you have gone to actuary school, (or even used common sense) you would recognise that Super funds exist to meet the cash flow requirements of retirees and that the asset allocation should attempt to generate enough capital (or cash flows) to meet those pension requirements. The degree of over/underfunding risk tolerance and assumptions about asset returns and the timing of asset returns will also drive asset allocation decisions.

The reality: big guys go exotic

The reality is that institutionally managed Super funds have an entirely different view of asset allocation compared to SMSFs even though they have the same end liabilities and should be using pretty similar inputs. If you were a psychologist it would be called cognitive dissonance and you would be worried. The chart below shows the changes in asset allocation between 2003 and 2013 for the total non SMSF (i.e institutionally advised) sector.

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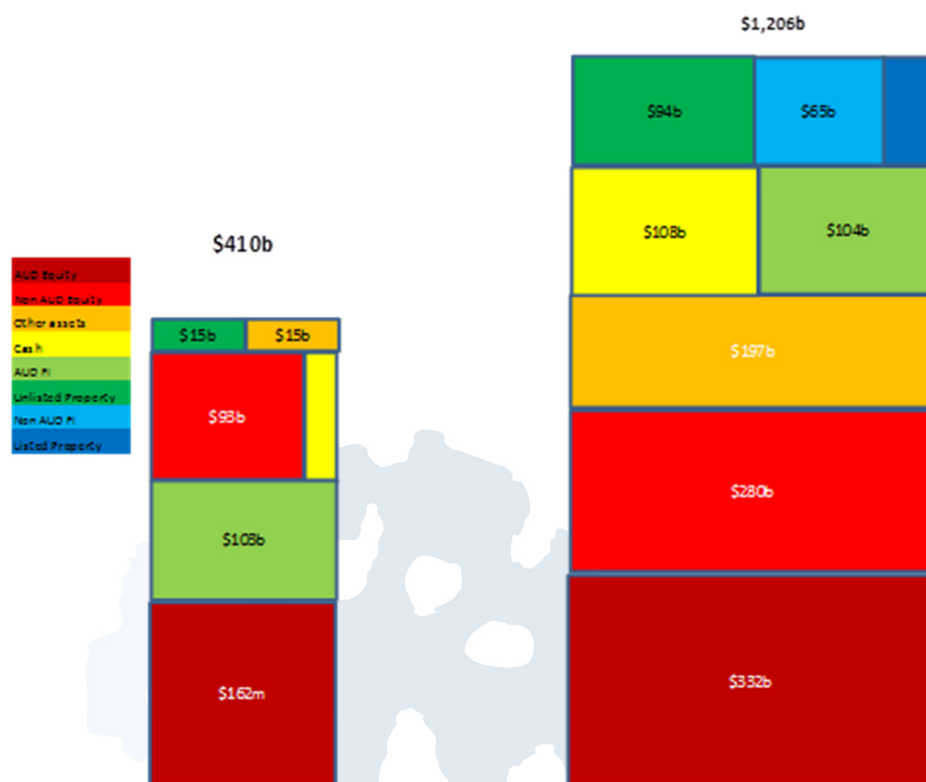

Institutional asset allocation: Buy uncorrelated assets.

While there are some data issues (i.e there is no data on non AUD fixed income in 2003, asset allocation represent only the largest default strategy etc) it does provide an indication of how institutions and their advisers treat asset allocation. In simple terms, the asset allocation decision has been buy anything that is uncorrelated with Australian equities and fixed interest (and also the liabilities) with around $420b of the $800b growth in assets being invested in international equities, international fixed interest and "other assets" such as infrastructure and private equity. You should probably feel sorry for the Australian fixed income managers as the amount invested in domestic fixed income is roughly the same as it was in 2003 despite the market producing an excellent 6% p.a. return over that period.

SMSF sticks to what it knows best.

By contrast, SMSF seem to invest simply in Australian equities, Australian property and cash. Once again there are data issues (APRA/ATO have asset categories such as "unlisted trusts" or "other managed investments" and it's impossible to determine which asset classes these are invested in, so we've made some assumptions). The construction below shows the change in amounts and allocation since 2003. Of the $376b gain, the vast proportion has been left in cash, or invested in equities and property.

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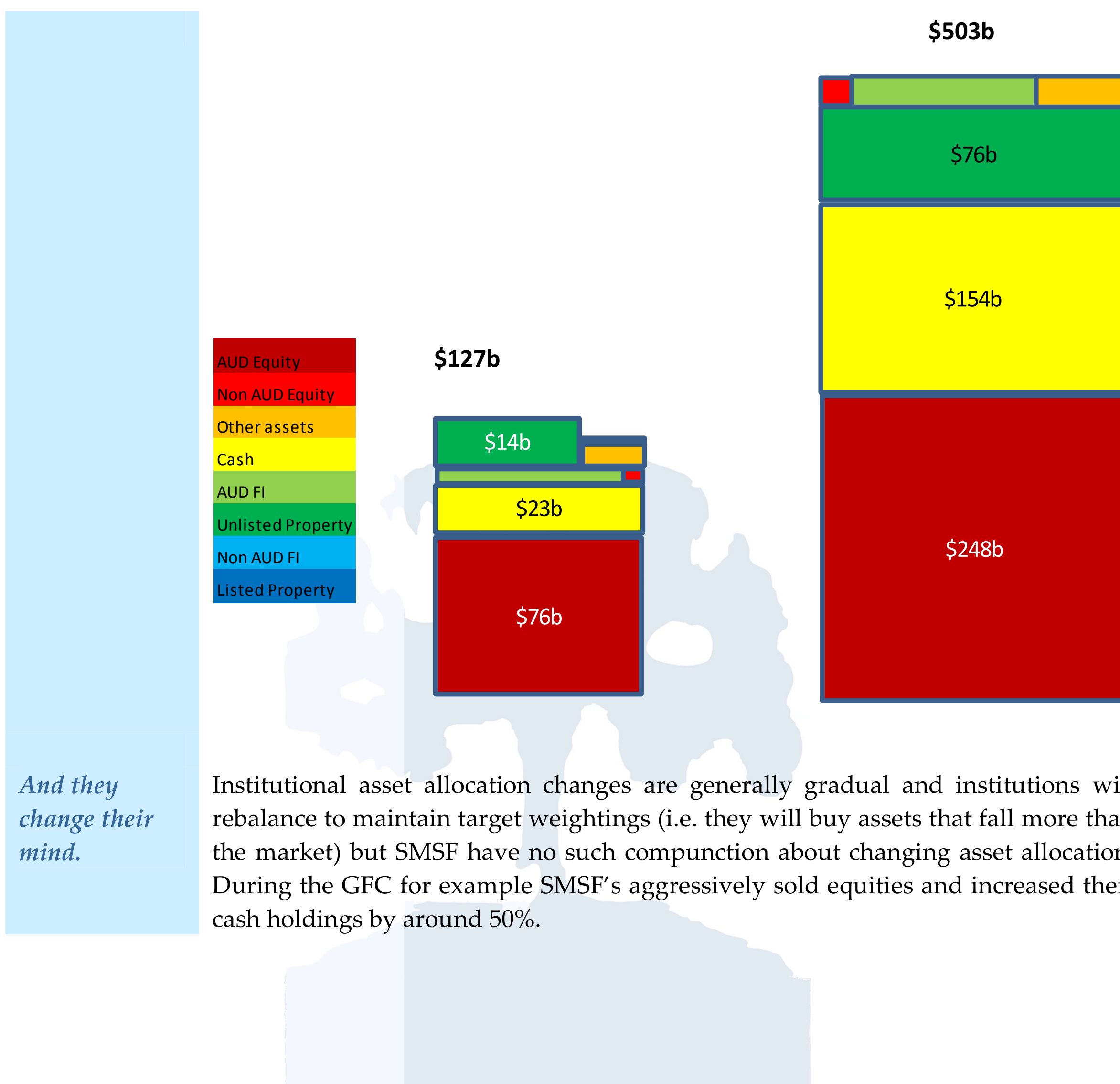

And they change their mind.

Institutional asset allocation changes are generally gradual and institutions will rebalance to maintain target weightings (i.e. they will buy assets that fall more than the market) but SMSF have no such compunction about changing asset allocation. During the GFC for example SMSF's aggressively sold equities and increased their cash holdings by around 50%.

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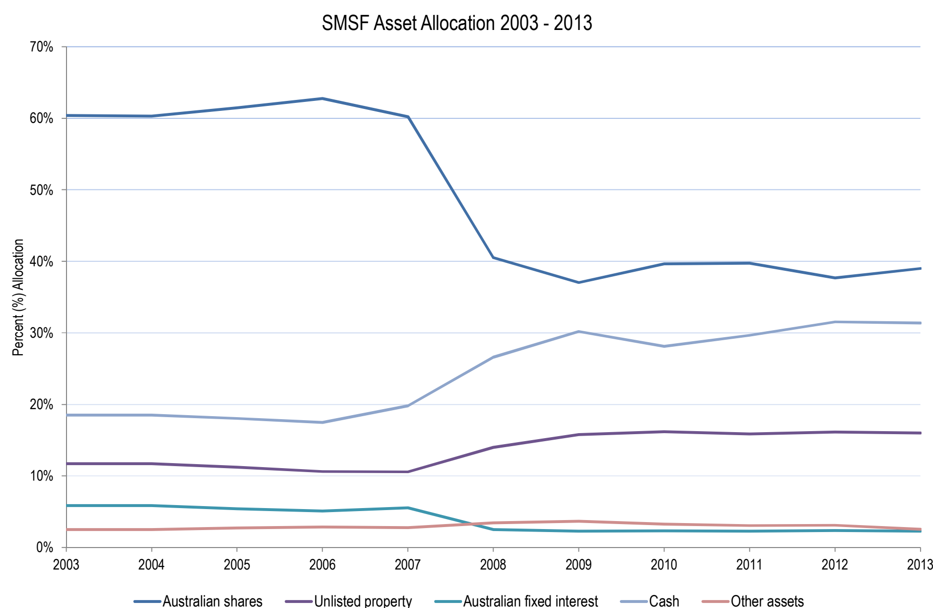

So who gets bragging rights

Because of the vastly different approach to asset allocation between SMSF and institutional superannuation funds (and because with over $1.6 trillion of assets at stake it is becomes systemically relevant) it is interesting to see who performed better and what the implications are for the future (caveat: there are even more data problems than estimating asset allocations; we have to make assumptions about currency and hedging, segment portfolio returns may not look like benchmark index returns, and the timing of asset allocation changes may affect results. We've also calculated pre tax returns which take no account of tax or franking credits). The numbers we calculated are consistent with actual super fund returns (after tax and costs) recently released by APRA, so maybe the assumptions aren't too bad.

Zimbabwe 9: Australia 1

If superannuation was a cricket match a match between Zimbabwe and Australia would be an appropriate analogy; institutionally advised industry funds with loads of talent and full time professionals versus a bunch of amateurs with a Comsec account and some input from a financial advisor. The staggering thing is that SMSF's have outperformed the professionals 9 years out of the last 10 and not by an insignificant margin at the end of the day either: the accumulated return over 10 years is 139% for SMSF's compared to 93% for the professional's.

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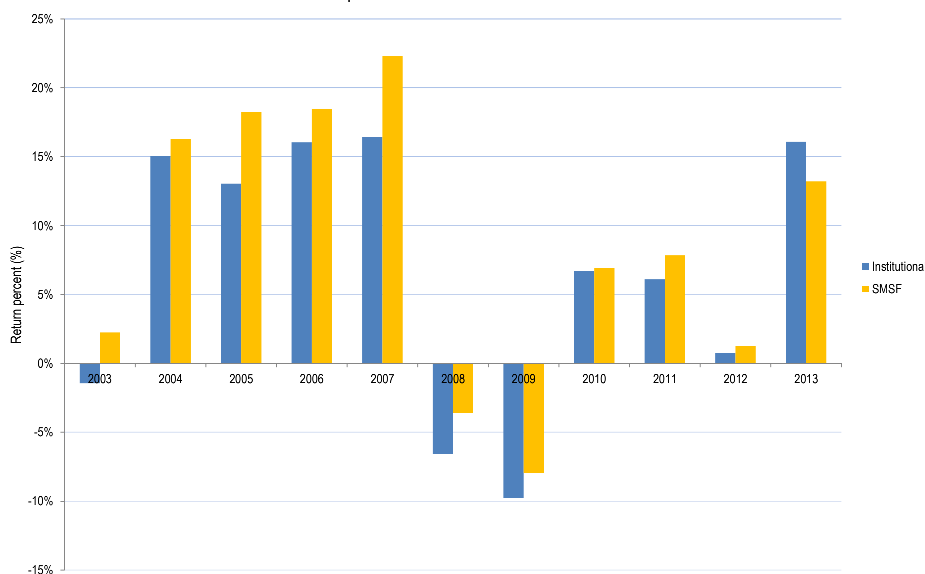
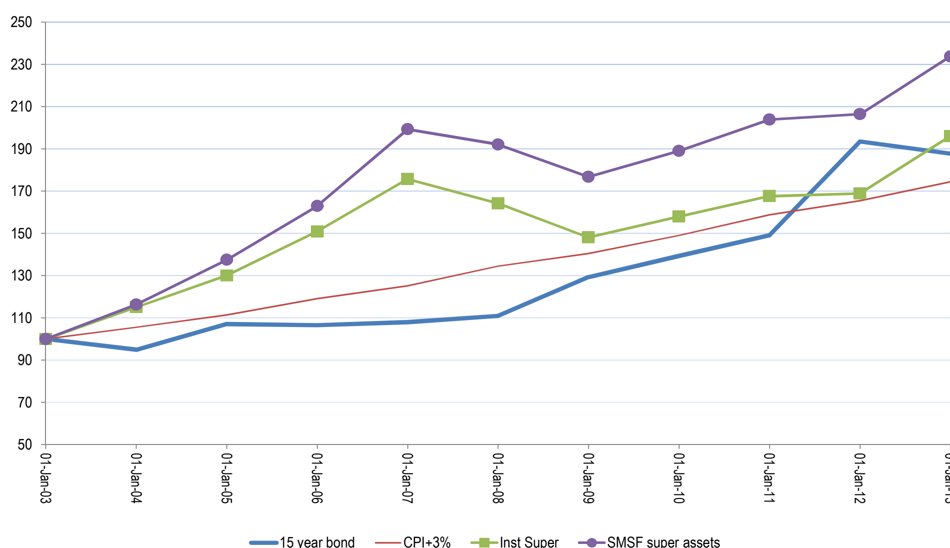


But what about liabilities?

Of course asset performance is only one side of the story. We've also calculated how the liabilities might have performed. Given that we're not actually sure what the end liabilities of the super fund are, we have used returns on a 15 year bond (which covers off on how much is required if you want to pay a straight annuity) and the inflation rate plus 3% which is the actuarial benchmark rate of return. The chart below shows the path of liabilities and assets based to 100 at 30/6/2003.



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And?

The good news is that both asset allocations have done much better than their liabilities, with institutional superuannuation a few percentage points above the long bond rate. SMSF's however, have performed significantly better.

But maybe SMSF's have just taken more risk and markets have been kind

Some of the return differential may be attributable to increased risk of SMSF portfolios and favourable markets. We used an asset optimiser and reasonably standard assumptions to see if this is the case. It looks like the asset allocation of institutional superannuation fund is about 10% less risky than SMSF; not immaterial but not enough to explain the consistently higher returns. The table below shows various risk measures and there aren't material differences. The major risk seems to be that SMSF portfolios are skewed to a non recessionary Australia and would likely perform much worse than institutional portfolios if growth were to slowdown i.e. equity and property values would decline, cash rates would fall and the value of their liabilities would rise. Institutional advised super portfolios have greater exposure to fixed interest and non AUD assets which are the only things you would want to be invested in during an Australian recession.

	Institutionally advised	SMSF
Expected Risk	8.8%	9.5%
Expected Return	5.2%	4.9%
% Defensive	39%	35%
Diversification benefit	1.3%	0.4%

Implications

Interestingly, we doubt that any fund manager who consistently underperformed its competitors over a 10 year period would still be in business; it would have been shut down from fund outflows or it would have changed its investment process. We don't see the same response from the institutional sector in respect of asset allocation. If anything they continue to diversify away from domestic tradeable asset classes. It would be heresy to claim that diversification doesn't matter and that valuation or momentum (or whatever produced the excellent returns from AUD equity and property markets over the past decade) is more important, but the last decade hasn't been kind to orthodox theory.

Hybrid market implications

We think there are a number of implications for hybrids;
-There is a mountain of cash to be deployed; sector cashflows before investment earnings for the SMSF sector are around $17b, investment earnings will be around $50b this year (or around half in a regular year) and we think that some of the $150b of cash in SMSF's will be deployed while term deposit rates remain under 4%.
-Expected supply this year in the hybrid market will be in the order of $10b. We think with prospective yields at c6% the supply will be readily absorbed.

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