Spotting conflicts of interest in DIY funds

TONY NEGLINE

When you run your own superannuation fund there are a number of decisions that might involve a conflict of interest. As an investor operating in isolation it can be easy to cross the line on this issue.

I want to look at two occasions when conflict of interest regularly arises. One involves investments, the other involves getting money out of the super system.

Let's look at the investment side first. Many of the million or so small business owners in Australia also run a self-managed super fund, and it's quite common for the fund to invest in assets that can be used by the business.

For example, the SMSF might own commercial premises the business uses.

From a structuring perspective, a SMSF can be a good place to hold business assets. There are the super tax concessions, and sometimes assets held in a super fund can be harder to access in the event of personal bankruptcy or business insolvency.

In addition, the SMSF will often hold a reasonable sum of money, and from a structuring perspective it's better to access that money rather than use other business capital to own premises.

When a super fund owns commercial property two problems can arise.

• The business might be slow in, or stop, making lease payments. When this happens often the super fund does nothing to protect its rights under the written lease agreement — assuming such a document exists. That is, the trustee does nothing to demand payment and force the "squatter" out.

• It's not always clear the commercial property is the best investment for the fund itself. It is logical to assume no one invests in real estate without wanting to make a capital gain. But does real estate really suit the SMSF members' best interests?

The tax office as SMSF regulator does not prudentially supervise these funds, so it never expresses an opinion about the suitability of various investments owned by a SMSF.

Now let's look at the issue of getting money out of super.

If you stop working before you're 60 and you want access to a lump-sum payment from your super fund between your preservation age and 65, then a trustee has to be satisfied you never intend to work again. Your preservation age is 55 if born before July 1960.

Large APRA-regulated super funds solve this problem by getting you to sign a declaration. What should SMSFs do?

The potential conflict of interest here is obvious, especially for people who want quick access to their money.

SMSF auditors each year have to check these super funds have accurate financial records and have complied with various super laws and the fund's trust deed. The government's Auditing and Assurance Standard Board has published a document to assist SMSF auditors appropriately complete their task.

Auditors are told they need to confirm a lump-sum benefit payment is bona fide, which they can do by "sighting a signed letter to the trustees requesting the benefit be paid and that retirement is evidenced by a statutory declaration or similar document stating that the individual has retired and will not be seeking paid employment in the future".

Clearly this is a similar approach to that often used by large APRA funds.

The next area is "permanent incapacity". Under this rule, a trustee has to decide if a super fund member, because of physical or mental illness or injury, is unlikely to work again in anything requiring their education, training and experience.

As it's the trustee who must reach conclusions about a member's permanently incapacity, the potential for conflict of interest is again obvious for SMSF trustees.

When this type of benefit is paid from a super fund it will receive substantial tax concessions if two appropriately qualified medical practitioners certify the person is permanently disabled and unlikely to work again.

If a SMSF has total and permanent disability insurance, then an insurer will also have assessed a claim based on the wording of the contract.

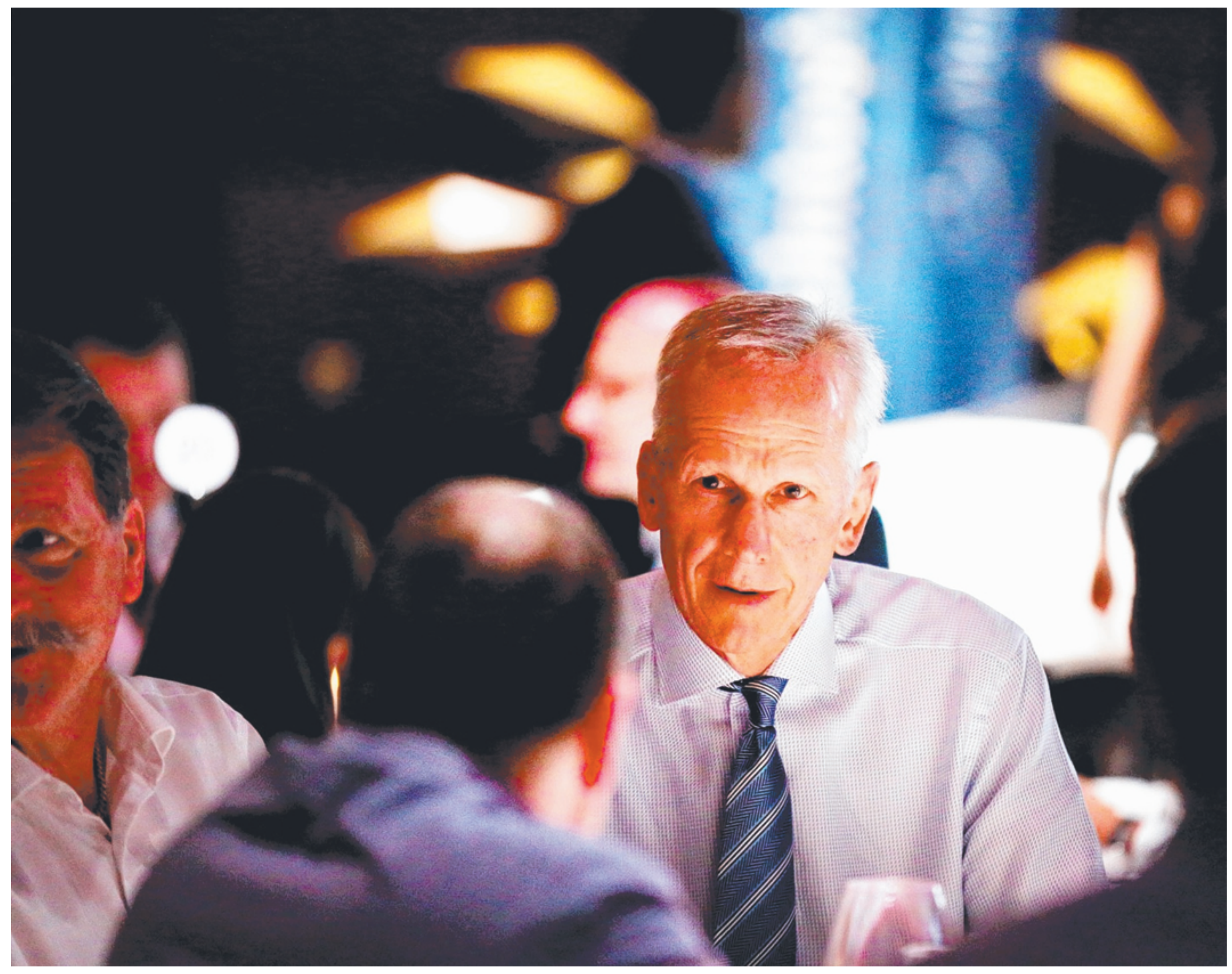
The SMSF data published by the tax office doesn't specifically spell out how many funds breaches these particular rules, but it appears there are surprisingly few, which hopefully means trustees are taking their duties seriously.

Tony Negline is author of The Essential SMSF Guide 2014-15.

Pulling up short: the true story of SMSF diversification

Offshore exposure is vastly understated, says Graham Hand

ANDREW MAIN



NIKKI SHORT

Cuffelinks editor Graham Hand. 'SMSFs are not as badly diversified as most claim'

A common belief in the self-managed super fund world is that investors don't have anything like enough overseas exposure, but recovering banker Graham Hand has investigated the issue and found that the supposed 0.5 per cent offshore weighting of Australian SMSFs is a dramatic understatement.

Hand, who works with funds management legend Chris Cuffe as editor of the free-subscription Cuffelinks newsletter (cuffelinks.com.au) says that the real offshore exposure in DIY funds is closer to 15 per cent, or 30 times as big as conventional wisdom believes.

So, how on earth did that massive discrepancy occur? Hand is a mild-mannered sort of character but he jokingly blames the ATO.

He says that when the ATO publishes its Superannuation Bulletin figures covering the asset allocation statistics for SMSFs (for which it is the regulator), it has a specific category of "overseas shares", which is where the 0.5 per cent number comes from.

In the latest SMSF numbers from the ATO, there is only $2.7 billion in that category, for instance, and yet we know there is almost $600bn socked away in SMSFs.

There are a raft of other overseas exposures not counted in the overseas shares numbers, Hand says, such as managed investments, listed investment companies and exchange-traded funds.

Just on the first category, he notes that just two global equity managers Platinum and Magellan have $29bn and $37bn under management respectively, although much of this is on behalf of large institutions. Nonetheless, Hand says: "Both these fund managers attract significant support from SMSF trustees".

"The global funds of Schroders, Lazard, Fidelity, Vanguard, BT, Colonial First State, and dozens of other popular managers have large SMSF support, not only in broad markets but also in sectors like infrastructure and resources," he suggests.

> 'The ATO needs to run up a few red flags about using the data'
>
> GRAHAM HAND
> CUFFELINKS

He notes a similar situation in LICs, many of which have an increasingly global focus such as Hunter Hall, Perpetual, Templeton, Platinum, AMP Capital China, Global Masters and Magellan.

What's more as Hand points out: "The new global fund from Wilson, Future Generation Global Company, is targeting $550 million and Geoff Wilson says 65 per cent of his clients are SMSFs."

In supporting Hand's contention perhaps the clearest numbers emerge from exchange-traded funds, ETFs, where managers keep good records of how much money is going where.

Exposure of SMSFs to international equities

As at March 2015

%	Mar 31 2013	Jun 30 2014	Sep 30 2014	Dec 31 2014	Mar 31 2015
DIRECT SHARES	1.7	1.8	1.8	1.9	1.7
ETFs	1.8	1.9	1.9	2.1	2.8
MANAGED FUNDS	7.2	7.8	8.0	8.5	9.9
TOTAL	**10.7**	**11.5**	**11.7**	**12.5**	**14.4**

Source: Multiport Pty Ltd

"In May 2015 there were 129 ETFs trading on the ASX with a market capitalisation of $18.6bn. Flows into global equities are among the top few categories and in 2014, net inflows into developed market global equities ranked first at $1.4bn," he says.

And before you worry that those numbers are a bit out of date, he notes that the ATO numbers for March 2015 are in fact estimates, because they are extrapolated from data collected from 2012-3 returns. As SMSF trustees know, SMSFs are allowed to lodge their returns up to a year, or even longer, after the end of the financial year. So there is every chance those inflows to global funds have accelerated.

Hand has taken the trouble to quiz SMSF administrators for their view on how much of SMSFs should actually be categorised as overseas holdings, and again, their numbers are infinitely higher than the ATO's 0.52 per cent. He says online SMSF services group Multiport calculated that about 14.4 per cent of SMSF assets it handles are effectively offshore holdings, based on the 2500 funds it administers.

Of those the majority at 9.9 per cent is held via managed funds, with 2.8 per cent held in offshore ETFs and a skinny 1.7 per cent held in direct overseas shares.

Hand notes that aside from actual totals, the trend is very much on the rise. As he says: "Given the importance of SMSFs in holding one third of all superannuation and the retirement savings of more than one million Australians, and the design of superannuation policy, the knowledge about what they invest in needs significant improvement. This applies to much of the official data produced on SMSFs.

"The ATO needs to run up a few red flags about using the data. SMSFs are not as badly diversified as most claim."

FLOAT WATCH

Offering of fresh food for thought

Costa Group Holdings
ASX CODE: CGC
SHARES ON OFFER: 236.1 million-245.9 million
LISTING PRICE: $2.20-$2.70
MARKET CAPITALISATION: $703.9m-$839.4m
LISTING DATE: July 24

TIM MORRIS

How strong is our national obsession with fresh food? The Bureau of Statistics suggests 94.5 per cent of the adult population is not meeting recommended dietary intake levels for fruit and/or vegetables. But that hasn't stopped sales in the fresh fruit and vegetable industry growing at twice the rate of the population since 2008.

Our favourite fruit is the apple, with a 15 per cent share of sales, while potatoes are the highest grossing vegetable, with 18 per cent of sales. The berry segment — including raspberries, blackberries, blueberries, and strawberries — is one of the industry's fastest growing, generally witnessing double-digit demand growth during recent years.

Berry demand has been a boon for the forthcoming listing of Costa Group, the nation's largest horticultural enterprise. Costa Group's operations traverse the fresh food supply chain, from farming to logistics, wholesaling and marketing. On behalf of proprietary and third-party farmed produce, the company represents 9.5 per cent of Australia's fresh fruit and vegetable industry. Within its core segments Costa Group's market share is more significant, supplying 91 per cent of raspberries, 77 per cent of blueberries, and 42 per cent of mushrooms in Australia.

Its listing on the Australian Securities Exchange represents a sell down by existing shareholders including ex Geelong Football Club president Frank Costa and the Costa family, along with private equity group Paine + Partners. While they are set to retain a collective interest of about 23 per cent, incentive for new shareholders is provided by the company's capacity to expand its dominant market positions.

It is on course to generate its third consecutive period of increasing revenue and operating profit. Planted hectares within its domestic tomato and berry operations are scheduled to rise 50 per cent and a third respectively. Increasing contribution from high-growth international operations also have potential to generate returns.

The company generates 75 per cent of income from "protected cropping", but weather and yield events create earnings volatility risks. Other considerations for investors would be the company's capital deployment strategy.

Tim Morris is an analyst at wise-owl.com.

Beg, borrow or steal: LRBAs offer another way for SMSFs to acquire property

MONICA RULE

As the debate heats up over the tax breaks allowed on residential property investment, it's worth understanding that self-managed superannuation fund trustees don't necessarily need to borrow money to acquire properties. There are other ways to get properties into SMSFs.

The borrowing rules under the superannuation law referred to as the "limited recourse borrowing arrangement" is complicated. Having the incorrect wording on documents can be costly, particularly if you or your SMSF are penalised by the Tax Office for getting these documents wrong.

Let's assume you have $100,000 in your personal bank account and your SMSF has $300,000. You want your SMSF to purchase a run-down residential property listed at $400,000. Although the place is run down you can see its potential as it is in an excellent location. It does need a lot of repairs to bring it up to a state where you can ask for a good rent.

While you would like to get your $100,000 of personal savings into your SMSF, you have already contributed concessional and non-concessional contributions up to the maximum contributions caps for the financial year and therefore cannot make any further contributions.

While you could enter into a LRBA between you and your SMSF so your SMSF can borrow $100,000 from you to purchase the property, it would mean that, once the property is acquired by your SMSF, you cannot use the borrowed money to make any improvements to it. Also, if you decide later that the best thing to do is to demolish the residence, rezone the land and build units, you will not be able to do so — not even with any further accumulated money in your SMSF. This is because, under the LRBA law, although improvements can be made using the SMSF's own money, it cannot change the character of the property that has been purchased with the borrowings. That means you cannot change a residential property into multiple units.

Another less restrictive option available to you is to establish a private company or a unit trust where you and your SMSF can purchase shares or units in this entity. You can then pool your money together and purchase the property through this entity. Once the entity has acquired the property, it can do anything to the property. You can even demolish the residence to build a new structure, or rezone the land and build a different structure. As long as the income received from the property is distributed proportionately between you and your SMSF, it complies with the law.

The related entity needs to comply with other legal provisions such as not conducting a business; not having any loans; not investing in other entities; leasing business premises only to related parties; and, conducting all transactions at arm's length. If you think you can abide by these legal requirements, investing in property via a related entity might be a viable alternative to a LRBA. Limited recourse borrowing arrangements are not the only option for acquiring large assets. LRBAs can be restrictive particularly if you want to improve your acquisition. By using your own money and your SMSF's through a related company or a related unit trust, you can avoid legal restrictions.

Monica Rule is an SMSF Specialist and author of SMSFs and Properties

www.monicarule.com.au