30 November 2013

Ai-Lin Lee
Policy Guidance Officer, Financial Advisers
ASIC
GPO Box 9827
Melbourne VIC 3000

Dear Ai-Lin,

Re: ASIC CP216 consultation process

Please find behind a submission from Tria Investment Partners.

Tria is a specialist management consulting firm with a deep understanding of investor, product and business model dynamics. From an external perspective, we are very familiar with macro market trends and related industry dynamics for the wealth management industry and the impact this is having on superannuation funds, their members and suppliers.

Our industry research and data is unrivalled in the form of the *Tria Super Funds Review*; and our analysis is highly regarded both in terms of our weekly note *Trialogue*, and in terms of invitations to present on major strategic issues a to industry forums such as ASFA and the FSC annual conferences.

Given our experience in areas such as cost and pricing analysis, , we believe we are well placed to offer some informed comments on CP216.

Yours faithfully,

Andrew Baker
Managing Partner

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Context

We focus our comments on the cost and pricing methodologies applied in the "Costs of Operating SMSFs" report performed by Rice Warner for ASIC.

We contend that the approach adopted results in an incomplete analysis and therefore a potentially erroneous view of the relativities of costs of SMSFs and APRA-regulated funds; and that certain improvements would result in a more accurate assessment.

Specific responses

C1Q1 (a)

We consider that the way in which SMSF costs have been described in the report are incomplete for the purpose of comparison with APRA-regulated funds.

APRA-regulated funds report pricing which is all-inclusive of investment, administration, and trustee costs. Accordingly, it is important that, to the extent possible, an identical analysis is made of SMSFs costs. Otherwise, you end up with an apples vs oranges comparison.

<u>Currency of prices</u>

An essential point to note is the <u>currency</u> of prices. The SMSF sampling methodology described on page 5 implies that the prices collected are those <u>currently</u> being offered by a range of providers; ie they reflect prices for SMSFs being established now, and not necessarily those prevailing for the existing SMSF base, some of which may have been priced many years ago.

While we agree that this is an appropriate approach, it is not consistent with the paper's approach to the costs of APRA-regulated funds, which is a mix of current and historical prices. This creates a mismatch in the analysis. We return to this issue below.

<u>Investment costs</u>

We raise no objection to the estimates of establishment and ongoing costs outlined on page 5.

We have concerns with the approach to investments costs outlined on page 6. Investment costs often comprise the large cost component of APRA-regulated funds, and therefore differences in this component are likely to be a key driver of price relativities with SMSFs. It is therefore important that the estimation of SMSF investment costs is complete and robust.

The estimation of SMSF investment costs on page 6 is too narrow. It considers only investment costs arising from SMSF use of managed funds, which the paper estimates as 4-12% of SMSF assets.

We agree that SMSF use of managed funds is not especially high, although we point out that the ATO data typically used to evidence this conclusion is both dated (typically 18 months in arrears or longer) and not particularly granular. There is potential for misclassification, which creates some uncertainties about SMSF usage of managed funds.

The analysis makes assumptions about the prices of the managed funds, and then multiples that by the estimated SMSF usage of managed to arrive at an investment cost figure. As far as it goes, this is a reasonable assessment of investment costs arising from the 4-12% of SMSF assets placed in managed funds.

Investment costs arising from assets other than managed funds

But what about the remaining 88-96% of the portfolio?

The paper is silent on investment costs other than those arising from managed fund use, and as a result it effectively assumes that investment costs on the rest of the SMSF portfolio – ie the vast majority – are nil.

We do not consider this to be realistic.

It is of course possible to contemplate situations where other explicit costs are nil or negligible.

For example, where an SMSF is both simple and genuinely self-directed, consisting of cash deposits and a portfolio of shares selected and traded by the trustee, one might argue that investment costs are nil. In fact even this assumption is questionable given that supplier revenue is not nil, for example:

- The "price" of a deposit may be nil, but the institution earns a net interest margin from the SMSF.

- A self-directed share portfolio may have nil management costs, but the SMSF will still pay, at least, brokerage fees on establishment and trading of the portfolio.

But even we accept that such situations represent a "nil" investment cost outcome, it is equally clear that other types of SMSF investment costs are common and material, for example:

- Costs related to the acquisition and management of real estate and real business assets, including the rapidly spreading limited recourse borrowing arrangements (LRBAs).

- Costs related to the acquisition, storage, and safe-keeping of assets such as collectibles, art, bullion, rare coins, wine etc.

- Advice in relation to share and other financial security portfolios. We note that at 3.6 on page 22, it was argued that advice costs in respect to investments should be excluded. We believe this is wrong. Such costs are included in the price of APRA regulated funds. For an apples-with-apples comparison, such costs must also be included for SMSFs.

Some of these costs are ongoing; others are reflected in (sometimes very large) one-off costs. For example, the purchase of art typically involves a buyer's premium of 20%. However whether ongoing or one-off, they are all real costs which should be included.

Preferred approach

Such costs cannot be ignored or defined away.

A more complete approach to investment costs would have been to separately consider each material asset category used by SMSFs (managed funds, deposits, shares, ETFs, real estate, collectibles and so on),generate an indicative cost for each, and produce weighted average. This would be materially higher than the figures appearing in Table 6.

Conclusion

The approach to SMSF investment costs is incomplete and it is likely that total SMSF costs have been materially understated.

C1Q1 (b)

We consider that the scale points at which an SMSF becomes competitive with APRA regulated funds have been significantly understated.

Methodology issues

We content this is the case because the data sample pays insufficient attention to the most current prices of new APRA-regulated products. As new products tend to have significantly lower prices than the installed base of existing products, the averaging of all available prices overstate prices actually available to the member making a decision today.

The methodology described on page 24 indicates that APRA-regulated fund data was drawn from an existing report for the Financial Services Council; ie it was not generated specifically for CP216. The data seeks to encompass the entire current product base for the main segments such as industry funds, retail, and so on. Low, mid, and high prices are derived from this data set.

The methodology refers (also on page 24) to arrival of new low cost personal super products entering the market with significantly lower prices, but then dismisses the use of these products as the relevant price benchmark in favour of the existing data set. This was an error.

It should also be noted that an important new price point appears to have been entirely ignored. This relates to the new SMSF-like products entering primarily the industry fund, such as AustralianSuper's Member Direct and HOSTPLUS ChoicePlus.

Currency of prices mismatch

While the use of the existing data set this is a valid estimation of the entire price set for APRA-regulated funds, it creates a currency of prices issue, particularly in relation to the approach used for SMSFs.

As noted above, the SMSF methodology used the most current prices available.

In comparison, the data set for the APRA-regulated funds, while technically all on-sale and available, is inherently weighted to legacy products and prices. This creates a mismatch of currency of prices. In our view, the dismissed approach of using the most current prices (those relating to new products rapidly spreading through the industry), is the approach which should have been adopted, or at the least used as an alternative benchmark.

Analysis issues

The decision not to use the most current and relevant prices for APRA-regulated funds creates three problems for the comparison:

- The use of an APRA-regulated fund price set weighted to legacy products is like driving via the rear vision mirror. It's like saying you should buy a $500 iPad (ie an SMSF) because your last computer cost you $3,000 (ie an older APRA-regulated product). It's an irrelevant comparison. You need to consider the latest computer price points (ie new APRA-regulated products and price points) to make a correct comparison.

- A member of an APRA-regulated fund, or a member's financial adviser, who is considering shifting from an APRA fund, should not be simply comparing, for example, the stated mid-range SMSF costs with the stated mid-range APRA fund costs. As noted, the SMSF costs are current while the APRA fund prices are not. They should also be considering a benchmark of new APRA-regulated fund products - which tend to be price leaders significantly below the low-range price estimates (and typically half the mid-range estimate).

- This is before considering the omission of the new SMSF-like products. Arguably these are in fact the most relevant APRA-regulated fund comparators to an SMSF offer in terms of features and pricing. To ignore them is to remove an important point comparison. This is particularly problematic because the pricing of these products tends to be fixed dollar (~$258 pa in the case of AustralianSuper's Member Direct and HOSTPLUS ChoicePlus) regardless of balance. These products are especially attractive in terms of pricing, and should have been an important part of the analysis.

Preferred approach

The approach of using the installed base of APRA funds gives a misleadingly high estimate of the price points available to members considering fund switching decisions now.

Rather, a set of prices relating to the new APRA-regulated products now becoming available should have been created as an alternative or additional means of comparison.

Given that the new price points are typically below the low-end estimates calculated, the effect (and the correct interpretation in our view) would have been to make SMSFs uncompetitive until much higher balances than the analysis concludes.

Conclusion

The approach to APRA-regulated fund prices underweights and / or ignores the most recent price points established, price points which will be the go-forward prices for APRA-regulated funds.

Accordingly, we believe that APRA-regulated fund prices have been overstated.

Implications for analysis of cost relativities between SMSFs and APRA-regulated funds

This compounds the issues identified in our response to C1Q1 (a) above. Our contention is that SMSF costs are understated and that APRA-regulated fund prices are overstated.

This has significant implications for estimating scale points at which SMSFs become competitive with APRA-regulated funds.

Our indicative figures suggest the following could have been used as a more appropriate, or at least and additional, price comparison:

Balance	**Industry fund indicative price point***	**New retail product indicative price point***	**New SMSF-like product indicative price point***	**SMSF compliance admin mid-price point****	**SMSF full admin mid-price point****
$50,000	$497	$449	$258	$1,555	$4,250
$100,000	$918	$844	$258	$1,594	$4,289
$250,000	$2,182	$2,026	$258	$1,748	$4,443
$500,000	$4,289	$3,997	$258	$1,999	$4,694

* Tria estimate ** Sourced from Costs of Operating SMSFs

Using the latest APRA-regulated fund prices available – ie equivalent currency of prices - creates a very different view.

On this view:

- Industry fund and new retail prices converge (albeit at somewhat higher figures on our analysis).
- Very low, fixed dollar, prices are available via new SMSF-like products from APRA-regulated funds.
- SMSF full administration costs (which as discussed above we consider to be understated) do not even approach competitiveness with industry fund and new retail pricing until beyond $500,000.
- SMSF costs never approach competitiveness with new SMSF-like APRA-regulated fund prices, even where the SMSF service is for compliance admin only.

C1Q2

We are supportive of the provision of guidance in respect of SMSF costs.

However, and as our response to C1Q1 suggests, we believe that most work needs to be done in respect of (d) the cost / benefit of SMSF structures compared to other super vehicles.

Advisers considering the circumstances of members of APRA-regulated funds and making a recommendation to establish or switch to an SMSF should not be confining their analysis to the member's current APRA-regulated fund, or the APRA-regulated fund price range found by the Costs of Operating SMSFs paper.

There should be an obligation on advisers to consider, as an alternative, new APRA-regulated fund products and their price points in establishing the basis of a recommendation.

C1Q3

Yes, but additional works needs to be performed to present a more complete view of SMSF costs, particularly in relation to investment costs.

C1Q4

As noted above, we believe typical SMSF investment costs have been understated, and should be estimated and disclosed.

C1Q5

A case can be made for the estimation and disclosure of SMSF wind-up costs. This is a set of costs which is likely (albeit not certain in the case of multi-generational family SMSFs) to be incurred at some point, which are not incurred by members of APRA-regulated funds.

C1Q6

The proposals may involve some additional compliance costs for advisers; however given the gravity of the recommendation and the potential impact on member outcomes, it is not unreasonable that advisers be compliant in terms of provision of a complete view of SMSF and APRA-regulated fund costs.

C1Q7

With a more complete analysis of SMSF costs and APRA-regulated fund prices, it is realistic to establish typical benchmarks at which SMSFs are competitive or uncompetitive relative to APRA-regulated funds.

Such scale benchmarks can and should be used by ASIC for review of adviser activities in relation to SMSFs. The challenge for ASIC is how to use such benchmarks in practice, in sorting genuine exceptions from questionable practice.

It may make sense for ASIC to establish typical exceptions from scale benchmarks which provide something of a safe harbour for advisers (assuming that these cannot be gamed). These could include SMSFs which are in the drawdown phase, but which previously met scale benchmarks; or SMSFs which are expected to be built to scale benchmarks in a reasonable period of time.

That said, it remains important to establish benchmarks at which SMSFs are clearly cost-ineffective relatively to easily available APRA-regulated fund alternatives. On our analysis, SMSFs of less than $500,000 are marginal, while SMSFs under $250,000 are twice as costly as low price APRA-regulated fund alternatives, whether industry fund or retail. This should be more than enough of a differential to establish cost effectiveness or ineffectiveness.