Self-Managed Super Funds

Investment Strategy Formation

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WHY CREATE AN INVESTMENT STRATEGY?

For many people, the primary reason for preparing an investment strategy is for compliance with Trustee obligations, and the SMSF legislation regulated by the Australian Tax Office (ATO). However, although it is mandatory, we believe that the investment strategy is significantly more than a compliance document. Primarily, it is your “Master Plan” for how you intend achieving the investment objectives of your SMSF. The strategy is a living document and it should be specific and tailored to meet your needs and you should change it if your assumptions change. It is also important that an investment strategy is broad enough to take into account different market conditions. It should not be changed just because a bull market ends or other market changes occur. Instead, it should be able to generate returns or protect your capital in all market conditions. The ATO says that an investment strategy must be reviewed annually and any changes minuted.

WHAT SHOULD YOU HAVE IN YOUR INVESTMENT STRATEGY?

The ATO has set out some guidelines for preparing an Investment Strategy. It states that:

“Your investment strategy needs to reflect the purpose and circumstances of your fund and consider the following:

- *investing in a way to maximise member returns taking into account the risk associated with the investment*
- *diversification and the benefits of investing across a number of asset classes (for example, shares, property and fixed deposit) in a long-term investment strategy*
- *the ability of your fund to pay benefits as members retire and pay other costs incurred by your fund*
- *the needs of members (for example, age, income level, employment pattern and retirement needs).*

*The investment strategy should set out your **investment objectives** and detail the **investment methods** you’ll adopt to achieve these objectives. You need to make sure all investment decisions are made according to the investment strategy of your fund.”*

INVESTMENT OBJECTIVES:

These can vary from fund to fund, but the broad objective of each SMSF should be to assist in providing for a comfortable retirement, free from a reliance on the government-funded aged pension.

INVESTMENT METHODS:

Once a fund has decided on its objectives, then investment methods can be formulated and employed to achieve these objectives.

The traditional investment method used by most funds is merely to allocate their funds across a few different asset classes. Common asset classes used by SMSFs for investment are cash, fixed interest, property and shares (Australian and International). Asset classes can be further broken down into two categories:

- **Defensive assets** - Cash and fixed interest investments are considered “defensive” assets which are safer but tend to have lower returns.

- **Growth assets** - Property and shares are considered “growth” assets which potentially offer more risk but have the potential of generating higher returns.

Depending on your level of required pension and appetite for risk, you would allocate an appropriate proportion of your fund to defensive and risk assets. Most public super funds offer pre-mixed investment options such as:

- Growth (70% growth and 30% defensive)
- Balanced (60% growth and 40% defensive) and
- Conservative (40% risk and 60% defensive).

For those who are risk averse, 100% defensive asset allocation can all-but ensure that absolute negative returns are eliminated, but at the risk of producing very low returns (returns can be < 3%).

WHAT ARE THE STEPS IN PREPARING AN INVESTMENT STRATEGY?

• DETERMINE YOUR INVESTMENT OBJECTIVES

Covered above.

• DETERMINE THE ASSET CLASSES IN WHICH YOU WISH TO INVEST

Different people bring different life experiences to their SMSF. Some people have had negative experiences with certain asset classes, and wish to avoid them. Although this is understandable, it is better to look at the statistical returns of each asset class over the long term, as super is a long term investment. Shares and property typically offer the highest return, followed by fixed interest and then cash. Therefore it is wise not to avoid an asset class, just because of a negative experience. Diversification is the safest approach, and in the long run should protect against poor investment returns.

• DETERMINE YOUR INVESTMENT METHODS I.E. ACTIVE VS PASSIVE

This will depend on how much time you have to manage your investments and how much you are willing to pay professionals to do this on your behalf. If you are keen to limit costs, then a passive approach may suit. This means that you would 'set and forget' your investments, allowing a long term view to reign over the short term ups and downs that investment markets can throw up. However, many people witnessed just how large these ups and downs can be during the recent global recession, and you may wish to navigate your way through this volatility with a more active approach. As mentioned previously, your strategy needs to be broad enough to be put to work in any market conditions. It is not wise to be changing it continuously, as market conditions change, as trying to second-guess the market can pose significant risks to your investment returns. There would be few in the industry who believe that an active approach would not outperform a passive approach on most occasions, it just comes down to what you feel most comfortable with.

• DETERMINE YOUR RISK MANAGEMENT STRATEGY

In the investment world, it is rare that every single investment works out the way you intend it to. Every investor needs a strategy for dealing with investments that have not turned out as intended. On top of this, there is market risk. Strategies need to be in place to ensure that a fund's asset value can be maximised in all market conditions. There are strategies to limit losses in falling markets, and these are usually best discussed with a professional stock broker.

• DETERMINE YOUR ALLOCATIONS TO THE DIFFERENT ASSET CLASSES

This is determined by two major factors. Your level of required pension, and your risk tolerance. Some people don't like taking risks with money, and this is fine. Excessive risk taking is not the intention of SMSFs (you may actually contravene superannuation regulations if you are too risk tolerant). The different strategies outlined above are a useful place to start, but you can tailor a strategy to suit your own situation.

• DOCUMENT AND SIGN OFF YOUR INVESTMENT STRATEGY

Investment strategies should be clearly documented and signed off by the trustees of the SMSF. The strategy should be clear and unambiguous in nature. They should be reviewed regularly and changed or altered if appropriate or if your circumstances change.

Important: This is not advice. Clients should not act solely on the basis of the material contained in this Document. Details herein are general comments only and do not constitute or convey advice per se. We therefore recommend that our formal advice be sought before acting in any of the areas. The document is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and not be made available to any person without our prior approval.

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