Superannuation Inquiry – two comments

Submission by Ian McAuley, 13 July 2018

To be read in conjunction with workbook

"supermodel2016.xlsx"

Superannuation adequacy – it depends on one's lifetime income profile

People's income, and therefore their superannuation, changes over their lifetimes. Two people, with the same average incomes over their working lives, with the same superannuation fund performance, will experience retirement differently for at least two reasons:

- the absence or presence of early contributions will make a significant difference to the total accumulation and therefore retirement income
- those who have a comparatively flat lifetime income will experience a lower fall in income (perhaps no fall at all) on retirement.

Over my time doing contract and *pro-bono* work for ASIC, industry funds and consumer organizations I developed an Excel model, salaciously named "supermodel.xls" to examine different policy scenarios, the effect of fees, the effect of timing of contributions, and so on. The main working worksheet, with basic outputs, is shown below.

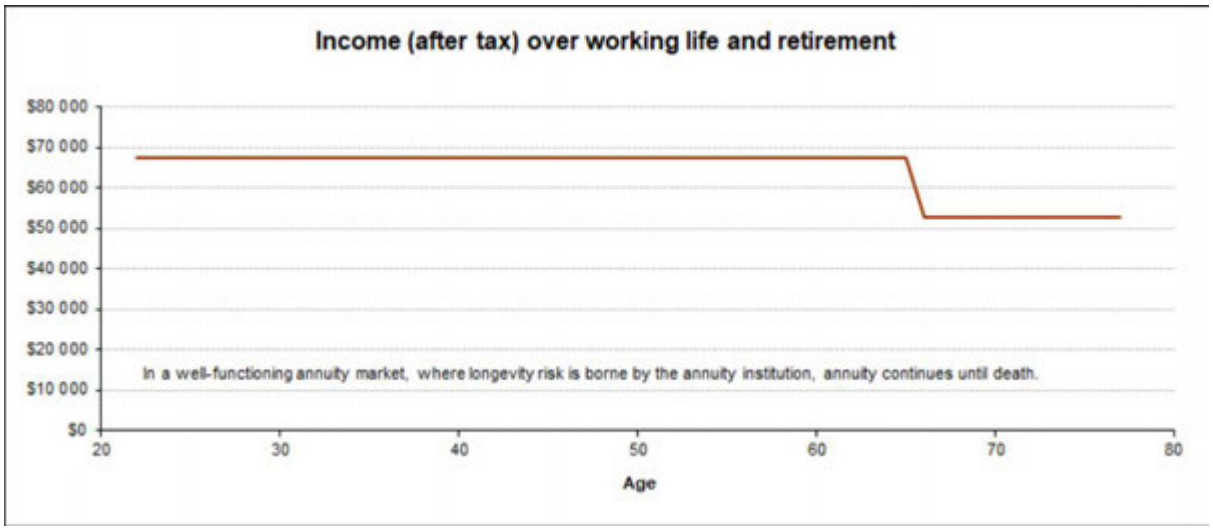
	A	B	C	D	E	F	G	H	I
1	**Superannuation model**								
2									
3		**Contributor inputs**							
4		Commencing age	22						
5		Finishing age (60 to 70)	65						
6		Commencing salary ($'000)	90						
7		Final salary ($'000)	90						
8									
9		Age of break from full time workforce	25		The user can model breaks from workforce for				
10		Years out of full time workforce	0		childcare, study, unemployment etc				
11		Fraction employed in those years	20%						
12									
13		Lump sum contribution at age	22		To accommodate a lump sum -- inheritance, windfall -- if made as tax-paid				
14		Amount $'000	0		contribution generally must be < 180K or $540K over 3 years				
15		Check if contribution is tax deductible (e.g. salary sacrifice)	☐						
16									
17		**Policy inputs**							
18		SGL rate	9.5%		Possibly to be increased to 12%				
19		Contribution tax	15.0%						
20		Earning tax	15.0%						
21		Low income contribution ($500 max)	☐		Up to $500 govt contribution for incomes up to $37 000.				
22		Co-contribution	☐		Assumes max co-contribution of $500 as long as eligible				
23									
24		**Fees and earnings**							
25		Fund earning rate (real)	5.0%		Real return (i.e. nominal return minus inflation) before fees. Returns				
26		Fees as % of accumulation (incl trails)	0.8%		over last 20 years for a balanced portfolio have been around 5.6				
27		Annual fixed fees	$200		percent a year. See the sheet "Returns".				
28		Self managed option	☐		Fees range from around 0.8% up to 2.1% in master trusts.				
29		Self managed threshold $'000	300		Click self-managed box if contribuor changes to a SMSF at a certain accumulation.				
30		Self managed fees	$3 000						
31									
32		**Outputs**							
33		Accumulation at age 65 $'000	706						
34		Years of life expectancy at age 65	20.6		Average of 19.1 years male, 22. years female,				
35		Annuity income over 20 years, $'000	52.7		Assumes annuity fees and earnings same as super				
36									
37		Annuity income as % of lifetime average salary of $90 000	59%		Standard annuity formula used				
38		Annuity income as % of final gross salary of $ 90 000	59%						
39		Annuity income as % of final net salary of $ 67 268	78%		Based on 2015-16 tax tables				
40		Annuity income as % of adult full time earnings	62%		Full time adult total earnings Nov 2017 $'000		85		
41					All employees total earnings Nov 2017 $'000		62		

(The model is submitted along with this document)

Some of the policy details are out of date: I last updated it in 2016 and, because the model is reasonably complex updating it would be a major task. But for the point I am making about lifetime income profiles the model holds.

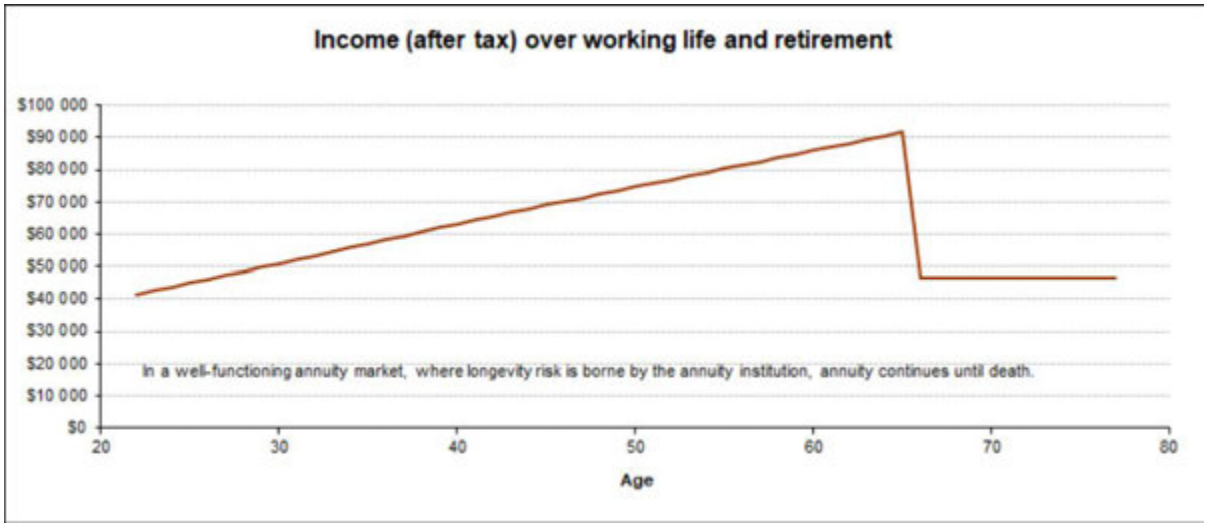
Illustrated above is a basic scenario, a person with 43 of working life, with a flat $90 000 income, with superannuation invested in a low cost fund with a real return of five per cent. (Scenarios such as a break for study or child-bearing, lump sum contributions, conversion to a SMSF aren't selected.)

Part of the output is a graph showing the person's lifetime income, shown below for this individual.



As a variant, I model a person with the same lifetime income, but with a significantly lower starting salary ($50 000) and offsetting finishing salary ($130 000). This is shown below.

Because of lower early contributions this person has a lower income in retirement. But the main different relative fall in income. That drop is 22 per cent for the first person and 49 percent for the second person.



I am not suggesting any policy change to make this drop in income less painful for the second person, but I am suggesting that any discussion about adequacy acknowledge the phenomenon of

loss aversion. People whose lifetime earnings approximate the second scenario are more likely to feel that a 9.5 per cent contribution is inadequate than people in the first scenario.

We don't have good lifetime earnings data, but it is probable that some trades and professions, such as people in building trades and health care have a flatter income than workers in trades and professions with promotion ladders, such as managers, public servants and academics.

Also, in a period of real economic growth when real incomes are rising the retirement cliff is likely to be higher than when economic growth is comparatively stagnant.

Self-managed superannuation funds

I was surprised to find in Section 3.3 such high fees in self-managed superannuation funds.

I have helped people with modest balances and what I'd call an intelligent lay person's financial knowledge and discipline to set up SMSFs. Typically my suggestion has been to go for a "set-and-forget" share portfolio with two to four diversified listed investment companies (e.g. Argo, AFIC), and of course a cash reserve.

Adding up fees – typically 0.15% to 0.20% for LICs, and another small fee for brokerage through an online service (0.12% per transaction) – it's hard to see fees for such a simple SMSF any higher than 0.25%. Assuming accounting and audit fees of $2500 (a reasonable estimate for a simple fund), the fees would be:

- $2500 + $1250 = $3750 or 0.8 per cent for a $500 000 fund
- $2500 + $2500 = $5000 or 0.5 per cent for a $1 million fund

These seem to be significantly lower than the fees indicated by reading off Figures 3.22 and 3.23.

Perhaps the Commission's figures are biassed by funds classified legally as SMSFs, but which are not really "self" managed (but managed by an entity charging fees), or by SMSFs with complex portfolios.

It would be unfortunate if retail or industry funds were to draw on the Commission's report to suggest that *all* SMSFs are expensive. People with balances as low as $300 000 may find an SMSF to be an attractive option. SMSF can serve an important role in keeping the market honest: it would be unfortunate if a body with the authority of the Productivity Commission were to be used to convey the impression that they are invariably expensive.