16 January 2013

Navigating Australian capital flows
Superannuation, SMSF's and the housing market

- **Last September, the RBA outlined the growing importance of Self Managed Superannuation Funds (SMSFs). As for retail funds, ATO data points to SMSFs having a pro-cyclical aggregate structure.**
- **SMSFs have instead invested a greater portion of their portfolio in cash, 'other' managed investments and property. The latter exposure is a key topic of interest.**
- **Historically, SMSF property exposure was focused in commercial and industrial property. But the flow of new investment looks to be skewed to residential property – arguably supported by the decision to allow SMSFs to borrow (2007) and limited other investment alternatives.**
- **ATO data relies on tax records and is released more than a year after transactions occur. But the ABS' housing finance release provides an interim data source.**
- **Overall, available data points to a material increase in the scale of SMSF residential property purchases. But the aggregate market impact of SMSF investors on their own is marginal, with the flow of housing finance to SMSFs around 4% of total (ex-refinance) lending.**
- **The more important trend to focus on is total investor demand. This demand impulse has been key for momentum, particularly in NSW and VIC. Its longevity and broader economic impact remain an open question.**

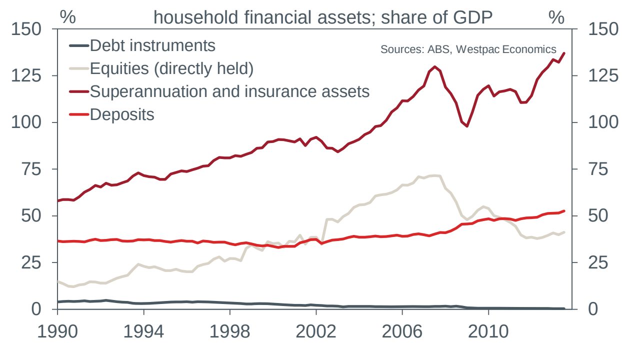
Superannuation is the principal form of savings for Australian households outside of the family home. As at September 2013, household superannuation assets stood at just over of $2trn – $1.7trn in super funds and a further $0.4trn in unfunded super obligations of the Federal and state governments. That equates to around 56% of household's total financial assets; it is over two and a half times the size of household deposits and three times the total value of directly held shares.

Partly due to our ageing population, superannuation shows no sign of losing its appeal. Around 18% of total worker compensation currently flows into super annually, with superannuation seen as being an integral part of households' total portfolio of real and financial assets.

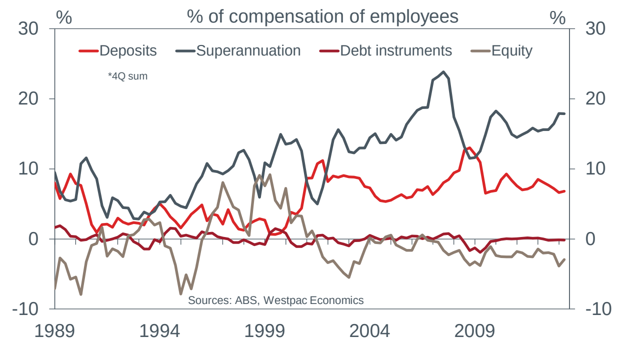
But what has changed over the past five to ten years has been the way in which households choose to manage their super. As highlighted by the RBA recently, there has been a marked shift away from industry and retail funds towards self-managed superannuation (SMSFs). Of the $1.7trn invested in super funds as at September 2013, more than $0.5trn was self managed. Further, whereas SMSFs had previously been the domain of older, well-off workers, increasingly they are attracting the attention of younger workers from a larger subset of the income spectrum.

Given the broadening interest amongst the population, now seems an opportune time to consider the implications of SMSFs for households' welfare. We do not intend to judge the

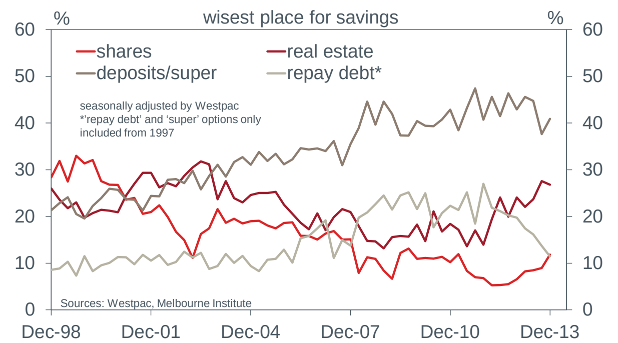
Household financial assets: super key to wealth



Aus HH's financial investment decisions



Consistent with Westpac–MI trend



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appropriateness of the system; rather our focus is on highlighting the divergence in exposures between SMSFs and other super funds as well as the associated implications for the economy. There is also a burgeoning topic to be considered: the rising importance of residential property investment for SMSFs.

Diverging exposures

Historically, the default option for Australian superannuation funds has been a heavily diversified growth mandate. Specifically, institutional super funds (retail; industry; corporate; and public) have held between 20% and 30% of their total assets in Australian equities and a further 20% to 30% in foreign equities. Debt holdings have totalled between 10% and 20% of total assets, with cash limited to less than 15%.

The net effect has been a portfolio which has a significant cyclical exposure, not only to Australia but the globe. Data is hard to come by, but it is likely these exposures are skewed more towards developed markets than emerging, the former having significant advantages vis a vis scale, diversity and liquidity.

SMSFs also have a high proportion of their funds invested in Australian equities, circa 30%. However, direct holdings of foreign equity are non existent. Note it is possible that there is a residual exposure to foreign interests via managed investments which SMSFs have invested around 20% of their assets in – incorporated as part of the 'other' category in the top chart and includes all types of foreign and domestic assets. The balance of SMSFs exposures are focused in cash (around 30%) and property (around 15%). As for direct foreign equities, SMSFs exposure to debt instruments (domestic and foreign) is negligible.

The net effect of these divergent exposures is that SMSFs are much more exposed to cyclical developments in the Australian economy than institutional super funds. The flip side is that they also carry less foreign exchange risk, arguably a positive given the trustees of these funds likely have a lot less experience assessing, pricing and hedging risk in such markets.

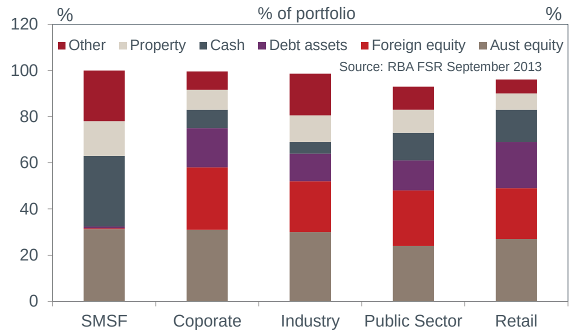
That being said, the absence of direct exposures to foreign equities and debt instruments highlight that SMSFs presently lack the ability to fully diversify their holdings across a broad spectrum of assets. The strong demand for hybrid issuance over the 20 months to June 2013 amongst SMSFs (as referred to by the RBA in September) also indicates that the absence of exposures to debt-like instruments (and one suspects foreign equities) is more a function of limited access than a lack of demand.

Going further, it is possible that the absence of a diversified supply of investment instruments to SMSFs has been one of the key factors behind this sector's recent demand for investment housing. Housing is an asset which has both debt-like (rental yield) and equity-like (potential capital gain) attributes. For investors short of options, such an asset class holds great appeal. This is all the more true considering Australian investors past experience with housing, with its strong historic gross investment returns relative to equities which are still below pre-GFC highs.

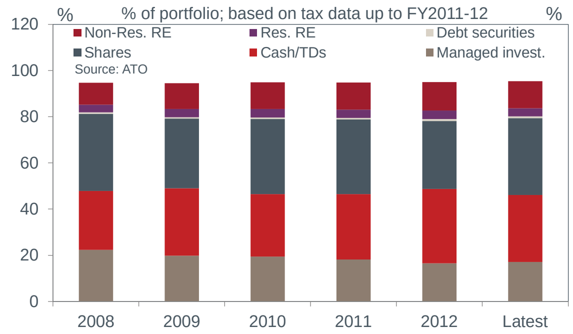
A burgeoning issue: SMSF residential property investment

Historically, SMSF direct property holdings have been heavily skewed towards commercial property, with around 77% of direct property holdings in commercial assets. As highlighted by the RBA, this is a function of the tax benefits on offer to small business owners – a capital gains tax exemption of $500,000 and the ability to consider the subsequent rent paid to the SMSF as a business cost, reducing the taxable profit of the business.

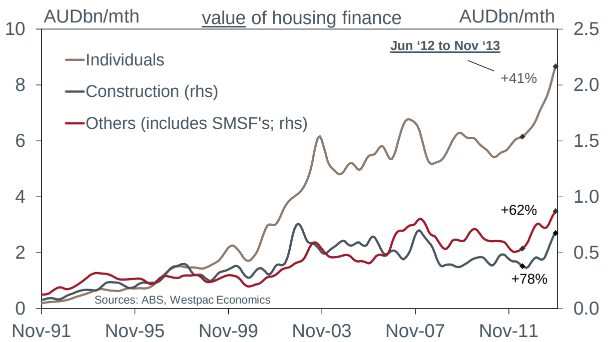
Super funds have differently skewed portfolios



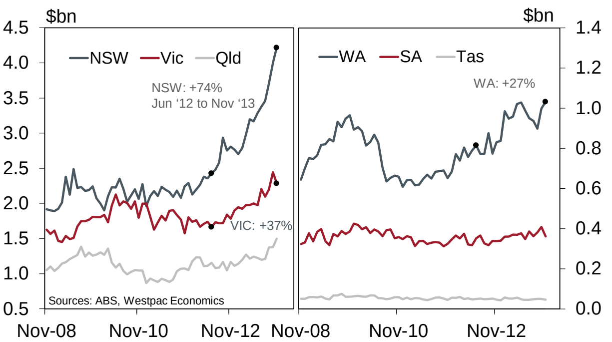
SMSF portfolio biased to cash and Aust equity



Value of finance approvals to investors



Housing finance by state: investors



However, what is perhaps not as clearly understood is that the data collated by the ATO only takes transactions completed before June 2012 (at the latest) into consideration. This is because the ATO data can only be updated as tax returns for a given financial year become available, well after its end.

There is a real dearth of timely data in this area, in part because of its fledgling status as an investment option, and also because of the complexities of recording all the necessary details for each transaction. That being said, the ABS housing finance release provides a way to quantify this demand flow post June 2012.

According to the ABS, lending to SMSFs is accounted for in the 'other' investor category. The total finance offered to this group has increased by around 62% since June 2012, albeit in a volatile fashion. Taken at face value, this growth points to an increase in residential property's share of SMSF total assets, from around 4% to over 6%. The true scale of the increase depends on the proportion of total 'others' lending taken up by SMSFs, the LVR for each mortgage, and the value of cash purchases, none of which is directly observable.

It is worth noting that there are two key factors which may have led to these lending figures underestimating the shift in SMSF portfolios. First, because the benefits of negative gearing are not available within SMSFs, there is an incentive to restrict leverage in these transactions. An (arbitrary) example highlights the value bias potentially created by reduced loan-to-value ratios (LVRs) for SMSF lending: a LVR of 70% versus 100% would see SMSF borrowing 30% lower in value terms for any given portfolio of loans. This implies that SMSF-driven market transaction volume could be higher than the 62% value increase the ABS reported.

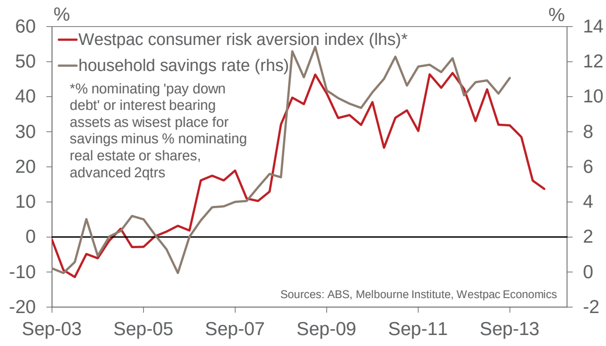
Of more significance is that the housing finance data only includes committed finance agreements. As a result, cash purchases and 'off the plan' purchases without a finance pre-commitment are not counted. There is no real way to assess the scale of these purchases as a proportion of total transactions. However, given the many press reports of strong demand for off-the-plan purchases and the 78% growth seen in the construction investment loan series (which captures pre-commitments for dwellings under construction purchased by all investors), it is plausible that SMSFs have had an additional (statistically unreported) impact on the property market, particularly in Sydney and Melbourne.

All told, we have seen an abrupt change in the size of the flow of new residential investment by SMSFs (some of which may not have been reported to date), but their share of total SMSF assets is still relatively limited at around 6%, if the housing finance trend proves accurate. Further strong activity flows would be necessary if this share is to rise to the level of commercial holdings (12%).

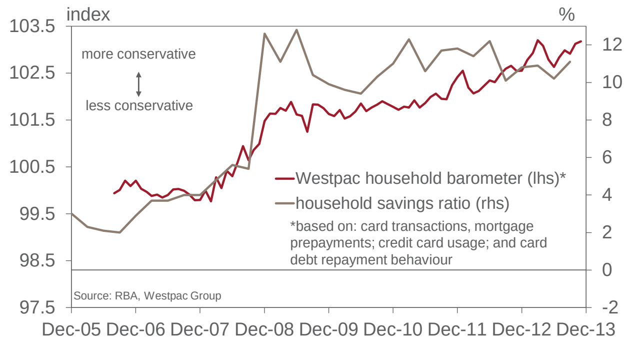
From the perspective of the aggregate housing market, it is then apparent that SMSFs have been (and likely will remain) a marginal demand impulse. At November, lending to 'other' investors totalled about 4% of ex-refinance lending compared to 40% for individual investors and 53% for owner occupiers.

The more important trend apparent in this data then is the role total investor activity is playing, not just SMSFs. Investors' share of total (ex-refinance) lending has only been higher during one period in its history (late 2003/early 2004). Further, this activity has largely been concentrated in NSW (+74%, Jun '12 to Nov '13) and VIC (+37%). Only time will tell if this historically-high and geographically-narrow investor demand will prove to be a temporary or enduring support for housing, and to what extent it will impact the broader economy.

Consumer risk aversion easing



But yet to be seen in spending behaviour



A concluding remark on confidence and its effects

In the previous edition of Financial(s) Matter, we highlighted that (at that point in time) households remained very risk averse.

Some seven months on, we have seen a material reversal in that indicator, with households taking on a more risk-seeking posture. Clearly this new-found appetite for risk has shone through in the residential property market, but it is yet to really be seen anywhere else. Indeed, households' direct equity holdings are little changed over the nine months to September 2013, even as the market rallied. This optimism has also not translated into a surge in discretionary consumption.

The narrow focus of this confidence amongst households gives room to question its effectiveness in developing a persistent improvement in the macro economy – what we need to offset the decline in mining investment in coming years.

It is also important to remember that households' interest in the housing market will only be maintained as long as macro conditions allow. Specifically, how events unfold going forward will depend both on the perceived profitability of these investments as well as the ability of households to accrue the necessary cornerstone equity for further investment. Overlaying these structural forces, confidence and associated changes in risk appetite will remain key.

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