

Self Managed Super Funds

Plain Talk® Library



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Introducing Self Managed Superannuation Funds (SMSFs)

In December 2009, there were over 416,000^{*} self managed super funds in Australia with assets of more than \$384 billion^{*}. This makes them the second largest category of superannuation, according to the Australian Prudential Regulation Authority (APRA). In fact, self managed super funds (sometimes called DIY Super Funds) represent the fastest growing segment of superannuation assets outside industry funds.

SMSFs tend to have larger individual account balances than other superannuation funds, with average assets per fund of around \$858,000^{*}. SMSFs are often used by families to consolidate their superannuation into one fund.

So, why have SMSFs become so popular with many Australians? Many people like the control of managing their financial destiny themselves and enjoy the increased flexibility of a SMSF, but it is not for everybody. SMSFs can be costly to establish and administer and you also need the skills and time to manage your own fund.

For those that are committed and informed, a SMSF can be a powerful way to save for retirement. This Plain Talk[®] guide explains the pros and cons of SMSFs and how to go about setting up your own fund. It also examines types of investments and potential traps.

^{*}Source: ATO Self Managed Super Fund Statistical Report – December 2009

What is a self managed super fund?

Like other superannuation funds, SMSFs are primarily used to build wealth for retirement. SMSFs are different from other superannuation funds as all members are also trustees (or trustee directors, if the SMSF has a corporate trustee). Members are responsible for running the fund including investing the fund's assets, paying benefits and meeting the administrative and compliance requirements of the fund.



SMSFs must have four or less members and must meet a number of other requirements, including:

- a trust deed which meets the requirements of the Superannuation Industry (Superannuation) Act 1993 (SIS Act);
- members cannot be employees of other members of the fund unless they are related;
- trustees cannot receive any remuneration for their services;
- all members must be trustees or, if the trustee is a company, all fund members must be directors of the trustee company; and
- no person, other than a member, can be a trustee or a director of the trustee company.

SMSFs with only one member have slightly different rules:

- They must have two individual trustees or, if a trustee company is used, the member must either be the sole director or one of only two directors of the trustee company.
- The second individual trustee (or second director of the trustee company) must be a relative or any other person who is not an employee of that person.

What are the requirements of self managed super fund trustees?

Superannuation law imposes certain minimum requirements on trustees who must:

- act honestly in all matters concerning the fund and the fund's trust deed;
- exercise the same degree of care, skill and diligence as an ordinary prudent person;
- act in the best interest of fund members;
- retain control over the fund;
- keep money and assets of the fund separate from other monies or assets (for example the trustees personal assets);
- develop and implement an investment strategy;
- allow members to access certain information, such as the financial situation of the fund;
- not enter into contracts or behave in a way that hinders the trustee(s) from performing or exercising functions or powers; and
- not access or allow others to access funds early (unless a condition of release of benefits has been satisfied).

The Australian Taxation Office (ATO) regulates SMSFs to ensure they comply with the SIS Act and regulations.

SMSF tip 1

Choose an investment strategy that meets your investment objectives and timeframe.
Make sure the investments you choose suit your risk profile.

Who can use self managed super funds?

With superannuation choice, most Australians can now set up their own SMSF for their superannuation guarantee and personal contributions.

Employees who are not eligible for choice may only be able to use SMSFs for their personal contributions.

You cannot be a trustee of a SMSF if you:

- are under 18 years old (although people under 18 can be members of an established fund);
- have criminal convictions relating to dishonest behaviour;
- are an undischarged bankrupt; or
- have committed a serious breach of the SIS Act.

Why use a self managed super fund?

SMSFs provide control and flexibility for people who have the time and inclination to build their own wealth for retirement. Managing your own SMSF is not a decision to be taken lightly as it carries responsibilities and risks. After all, you are dealing with your potential standard of living in retirement.

According to a recent study conducted for the Investment and Financial Services Association (IFSA), the three most common reasons people set up their own SMSF are:

- to exercise more control over their superannuation;
- dissatisfaction with current superannuation performance and charges; and
- at the suggestion of their accountant or financial planner.

SMSF tip 2

Draw on the experts when you need them. Whether it's for administration or you need help setting or reviewing your investment strategy, there are professional superannuation and financial advisers who can help. Remember, quality investment advice can make a huge difference to your superannuation balance.

Advantages of self managed super funds

Control

As a trustee, you are responsible for setting the investment strategy of the fund and determining the asset mix. You are also responsible for monitoring and reviewing your investment strategy on an ongoing basis. So, in effect, you are in control of your retirement nest egg.

Flexibility

SMSFs give you greater flexibility when it comes to investing your assets. You are responsible for deciding the investment strategy of the fund and investing the assets accordingly. You also have more options when you retire. You can pay yourself certain types of pensions out of the fund, and enjoy a tax-free income stream.

Estate planning wishes can be enacted quickly and smoothly providing you have made some type of death nomination. This means your dependants or legal representative can receive payment much sooner, relieving any financial burden in the event of your death.

Fees

You have greater control over the fees you pay. By choosing your investments carefully and keeping transactions to a minimum, you can reduce the ongoing fees of the fund. Administrative fees can be high so make sure you compare the potential fees against what you are paying now.

Tax

Investment income is taxed at the concessional superannuation rate, which is a maximum of 15 per cent (higher tax rates may apply if the fund is considered by the regulator to be non-compliant with certain provisions of superannuation law). This compares to investments held in your own name, which can be taxed as high as 46.5 per cent depending on the amount of tax assessable income you receive.

Funds with Australian shares exposure can take advantage of the dividend imputation system. Given the tax concessions applying to SMSFs, excess franking credits can offset other fund tax, such as contributions and investment tax, and reduce the total tax you pay. In some circumstances these excess franking credits can be refunded from the ATO to the fund.

Superannuation tax is a complex area so it is worth seeking advice from a professional tax adviser to ensure your fund is taking advantage of tax-smart strategies.

Disadvantages of self managed super funds

Responsibility

Trustees are legally responsible for all decisions concerning the fund. Part of your responsibility as trustee is to ensure you understand the rules governing your fund and to keep abreast of any legislative changes. Although an adviser such as an accountant or lawyer can assist, the ultimate responsibility rests with you.

Penalties for mismanaging a fund or a compliance breach are high. If the fund is found to be non-complying, a tax rate of 46.5 per cent is potentially payable on all income or other gains, and on the assets of the fund in the first year of non-compliance.

Administration

Meeting all the statutory obligations, such as filing tax returns, keeping minutes of meetings and lodging annual tax returns, takes time.

Fees

The costs associated with establishing a SMSF vary but according to IFSA, the average cost of setting up a SMSF is \$3,500. Start-up fees are typically higher than other types of superannuation funds. Normally an accountant is engaged to help establish the fund and trust deed.

Complaints

Members of SMSFs do not have access to the Superannuation Complaints Tribunal if problems arise. As many of these funds are structured around families, there is the potential for disagreements about how the fund is managed. Such disagreements must either be resolved by the members or through legal action, which can be time consuming and costly.

Is a self managed super fund right for you?

Whether a SMSF is the right option for you depends on a number of factors including your time, money and commitment.

Superannuation assets

If you are considering setting up a fund, you will need a sufficient superannuation balance to make it worthwhile. The larger your superannuation portfolio the more economically viable a SMSF becomes. Annual accounting fees can cost around \$2,000, which is two per cent of a \$100,000 fund.

Commitment

SMSFs require 'hands-on' management. SMSF members are responsible for the overall running of their fund while other superannuation fund members leave this responsibility to professional fund managers.

By deciding to manage your own SMSF you are ultimately responsible for managing the fund and all the responsibilities that come with being a trustee. Ultimately, the decisions you make about your superannuation will have a direct impact on your final retirement benefit.

Skill

The more financially literate you are, the better your chances of investment success. Lack of knowledge can lead to poor or rash investment decisions that can have serious consequences on your returns.

If you believe you don't have sufficient financial knowledge, you can seek advice. A professional financial adviser can help you set your fund's investment strategy based on your objectives and circumstances. Advisers may charge you a fee for their services, or a commission from any investments they recommend, or both. It's important to take these fees into consideration when weighing up your superannuation options.

Time

Running a SMSF takes time and effort. As a trustee you are responsible for keeping records, meeting reporting requirements and investing assets according to your investment strategy. Again, you don't need to do all the paperwork yourself. A superannuation administration service can take care of it for you, at an additional cost. You should weigh up the fees against the time you will save and compare them to what you are paying in your current superannuation fund.

Starting a self managed super fund

Seek advice

A good first step is to talk to a professional adviser about whether a SMSF is right for your individual circumstances. Accountants, financial advisers and superannuation specialists have packages and kits to help simplify the process.

Prepare a trust deed

Once you have decided to go ahead with a SMSF, you must prepare a trust deed that sets out how the fund will operate. Professional advice is needed to prepare the deed. An accountant, solicitor or legal service company can prepare the deed. The deed will detail:

- the fund's objectives;
- who the trustees are;
- who can be a trustee;
- how trustees are appointed and removed;
- trustee powers;
- fund membership eligibility;
- how contributions are accepted;
- how benefits are paid;
- how to appoint professional advisers (such as an auditor); and
- how the fund will be wound up.

Appoint trustees

Trustees must be appointed to properly manage the fund and ensure it meets its legal and tax obligations. There are two options in this regard:

- appoint a corporation as a trustee, which will then also be subject to the provisions of the Corporations Act, or
- appoint individuals as trustees.

To become a regulated fund and qualify for tax concessions, the trustee must ensure the trust deed either appoints a corporate trustee, or states that the sole or primary purpose of the fund is to invest in assets for the purpose of saving for retirement.

After the fund has been set up, trustees have 60 days to notify the tax office via a 'notice of election to be a regulated superannuation fund' and request a Tax File Number (TFN) and Australian Business Number (ABN).

Open a bank account

A separate bank account must be opened for the fund. It is important to separate the fund's assets from personal and/or business assets.

Keep your paperwork in order

The administrative requirements of running your own SMSF include:

- keeping accurate and accessible accounts for the fund. Accounts must detail the financial position of the fund and its transactions and must be kept for at least five years;
- preparing an annual operating statement and annual statement of the fund's financial position, which must also be kept for at least five years;
- maintaining minutes of all trustee meetings and recording any changes to the trustees along with each member's agreement to act as a trustee. Each of these documents must be kept for 10 years;
- retaining copies of all annual returns lodged for a period of 10 years;
- retaining copies of all reports given to members for 10 years; and
- reporting all contributions made to the ATO by specified dates each year.

Appoint an auditor

Your SMSF must appoint an eligible auditor to conduct an annual audit of the fund's financial accounts and statements.

If the auditor detects a breach of the SIS Act which is likely to affect the members of the fund, the auditor of the trustee must advise the ATO.

SMSF tip 3

It is your retirement benefit, so make sure you take care of it.

The ATO has strict guidelines on SMSF investments.



Better super

Since the Government's Better Super system was introduced in July 2007 some further amendments have been made to the rules governing superannuation.

Some of the rules governing superannuation correct as at 1 July 2010 are as follows:

Super benefits	Paid from a taxed fund as either a lump sum or pension benefits are tax free for people aged 60 or over, having satisfied a condition of release
Self-employed contributions	Are fully tax deductible up to age 75 provided certain conditions are met.
Concessional (pre tax) contribution limits	A limit of \$25,000 per person, per financial year apply to super contributions you can make at the concessional tax rate of 15 per cent. Transitional contributions are capped at \$50,000 per person, per financial year, for those aged between 50 and 74 (until 2012). It is proposed that from 1 July 2012 individuals aged 50 or over will be able to make catch-up concessional contributions of up to \$50,000 a year if their superannuation balance is less than \$500,000. The concessional contributions cap is indexed in line with average weekly ordinary time earnings (AWOTE), in increments of \$5,000.
Non-concessional (after tax) contribution limits	The non-concessional cap is currently \$150,000 per annum per person. If you are under 65 years old at any time during the financial year, you may bring forward the next two years of contributions subject to certain conditions. This allows you to contribute up to three times the cap at once, or at any time during the three financial years.
Accessing your super	You can leave your money in your superannuation fund indefinitely after you retire. Investment earnings on your super will be taxed at 15 per cent. Currently the tax can be avoided by rolling your super benefits to a pension fund, enabling retirees to access a minimum amount of income each year.
Contribution age limits	You can contribute to your super up to age 75, provided you meet certain work test requirements.

Choosing your investment strategy

All SMSF trustees must prepare an investment objective for their fund and implement an investment strategy to achieve it. The investment strategy must reflect the fund's purpose and circumstances and detail how it will:

- maximise member returns within an acceptable level of risk;
- diversify across a range of assets (for example, shares, property, fixed interest); and
- pay benefits and fees as required.

There are a number of factors you should consider before setting your fund's investment strategy.

Objectives and time horizon

Before you start building your investment portfolio, you need to determine your investment objectives and timeframe.

Superannuation is a long-term investment strategy, so it's important to take a long-term view when setting your investment strategy.

With current life expectancies and medical advances we can now look forward to a longer retirement. This means you may spend more than one third of your working life in retirement. So, even if you are close to retirement you should take this into consideration. It's important that you plan for your retirement income to outlive you – not the other way around.

According to Westpac Association of Superannuation Funds Australia Limited (ASFA) retirement standard figures, a single man retiring at 60 would need more than \$809,000 to live a comfortable retirement lifestyle. Of course, if you want a more expansive lifestyle you will need to save more.

Risk tolerance

All investments carry some form of risk. Usually, the higher the risk the higher the potential return and vice-versa. It is important to understand your attitude to risk before you invest.

Risk is measured in terms of volatility, that is, the amount that returns fluctuate from year

SMSF tip 4

Make sure you or your adviser monitors your investment portfolio regularly. It is important to review your investment strategy when your circumstances or objectives change.

to year. Growth assets, like shares and property tend to be more volatile over shorter time frames, but offer greater growth potential over the longer term. Generally, the longer your investment timeframe the higher the level of growth assets you can include in your portfolio.

If the thought of your investments going up and down is going to keep you awake at night, you may feel more comfortable choosing a more conservative or balanced investment approach. Although taking no risk can be one of the biggest risks of all, if you invest all your money in cash, inflation and costs can erode your investment returns over time. It's important to keep your money invested to grow in real (i.e. in line with inflation) terms to maintain your purchasing power.

According to the ATO, SMSFs have more than 30 per cent of their assets invested in cash: more than double the amount of other superannuation funds and therefore more likely to be eroded by inflation and costs. If in doubt, speak to a professional investment adviser about the best options for your investment time horizon and risk profile.

Diversification – the key to reducing risk

Spreading your money across a range of investments is one of the best ways to reduce your exposure to market risk. This way you are not relying on the returns of a single investment. Investment markets move up and down at different times. With a diversified portfolio of investments, returns from better performing investments can help offset those that underperform.

Investment restrictions

As mentioned earlier, SMSFs must only invest in assets that meet the sole purpose test. This means they invest in assets for the purpose of saving for retirement. There are a number of investment restrictions imposed on SMSFs.

Except in limited circumstances SMSFs can't perform any of the following:

- acquire assets from a related party (subject to a limited exception);
- borrow money; or
- allow in-house assets (such as a loan, investment or lease of a fund asset to a related party) to exceed 5 per cent of total assets.

It is possible that the list of investment restrictions imposed on SMSFs could be expanded in the future.

SMSF tip 5

Keep your money invested. Holding your money in cash means you may be missing out on potential growth opportunities.

It all starts with the right asset allocation

Once you have established your SMSF, one of the most important decisions you will make is how to invest your funds.

SMSFs can invest in traditional assets such as shares, property, bonds and cash as well as more complex financial instruments such as options and certain kinds of warrants. You should seek advice if you are considering investing in more complex or non-traditional investments.

Research confirms the key to long-term performance is asset allocation – that is, the amount you allocate to shares, property, bonds and cash. Your lifestyle in retirement will depend on you setting an asset allocation that is appropriate for you and other members of the fund.

The major asset classes

Cash

- for short-term investors;
- usually includes higher interest paying securities than bank accounts or term deposits; and
- lowest risk of all asset classes.

Fixed interest

- for short to medium-term investors (around three to five years);
- low to medium risk;
- can provide a steady and reliable income stream and potential for capital growth;
- usually offers a higher interest rate, or yield, than cash; and
- provides access to Commonwealth Government, state governments, semi-government authorities and company debt from Australia or overseas.

Property

- for long-term investors (five years plus);
- lower risk growth asset than shares;
- returns include income and capital growth; and
- diversification benefits with access to properties in retail, office, industrial, tourism and infrastructure sectors both in Australia and overseas.



Australian shares

- for long-term investors (seven years plus);
- potential for higher returns with higher risk;
- potential for income through payment of dividends and tax benefits in the form of dividend imputation; and
- access a diversified range of companies listed on the Australian Stock Exchange.

International shares

- for long-term investors (seven years plus);
- potential for higher returns with higher risk;
- access industries and investment opportunities not available in Australia; and
- diversification benefits when investing in a range of countries, industries and companies.

Self managed super funds and indexing

Indexing is a way of gaining exposure to an investment market. Most investment markets have indices that measure their value over time. For example, a share index measures the change in the value of the shares of those companies included in the index. Indices cover almost every industry sector and asset class, including Australian and international shares, property, bonds and cash.

Unlike active fund managers, an index fund manager does not attempt to analyse which shares, bonds, or other securities are likely to go up and down in value. Instead, they invest in all or a representative sample of the securities in an index and let markets do their work over the long term. Historically, few active managers have been able to sustain above benchmark returns, after costs, over the long term.

A recent report by ratings agency, Standard & Poors, reported that over a five year period to December 2009, benchmarks (or indices) have outperformed a majority of actively managed funds across equity and bond fund categories.

SMSF tip 6**Invest tax effectively.**

The tax concessions available in superannuation can make a big difference to your retirement nest egg. Choosing your investments carefully can minimise your tax so you can keep more of your investment returns.

The results act as another reminder to investors about the perils of ‘performance-chasing’ when investing in managed funds. Over a five year period to December 2009, between 10 and 30 per cent of funds no longer exist showing that picking long-term winners can be challenging. Investors, particularly those saving for retirement, have long investment time horizons – but neither good performance nor investor loyalty can guarantee a fund’s longevity.

Indexing offers an attractive range of benefits for SMSFs. By adopting a ‘buy-and-hold’ approach, the cost of investing can be significantly reduced over time leading to better returns for investors in the long run, especially on an after-tax basis.*

Because index funds invest in all or most of the securities in an index, they provide diversification, which means lower risk. Add to this the potential for after-tax benefits, and index funds become even more compelling for SMSFs. As SMSFs pay a maximum tax rate of 15 per cent on income in the accumulation phase and are tax exempt in the pension phase, using a tax-effective investment strategy like indexing can translate into even better returns.

Take capital gains tax for example. Once capital gains are realised they are distributed as income and subject to tax. Generally, index managers use a buy and hold strategy to take advantage of capital gains discounts and the deferral of capital gains liabilities. This approach can minimise your fund’s tax liability in the accumulation phase and enhance your performance potential.

Indexing can maximise the level of franking credits distributed rather than diluting it like higher turnover, actively managed funds.

Assets held for the provision of a pension are currently tax exempt. As such, any imputation credits received may be refunded by the ATO, increasing the returns achieved by the superannuation fund and the assets available to pay the pension.

SMSF tip 7

Diversify your investments.

Investing in a range of asset sectors, industries and securities reduces market risk and can improve your performance potential.

* Note that past performance is not an indicator of future performance. Our products are designed to closely track market returns before fees, expenses and taxes. Investments are also not guaranteed and may rise or fall in value.

The indexing pioneers

Vanguard pioneered the concept of indexing , introducing the first retail index fund in the US in 1976. Since then, The Vanguard Group, Inc. has grown into one of the world's largest and most respected investment management companies. Vanguard now has global presence with offices in the US, Melbourne, Sydney, Brussels, Tokyo and Singapore. In Australia, Vanguard has been helping investors meet their long-term financial goals with low-cost indexing solutions for more than 12 years.

Vanguard's range of managed funds and ETFs

Vanguard offers a complete range of index funds across all asset classes that can be used as a diversified standalone portfolio solution, or in conjunction with active funds as part of a core-satellite approach.

Sector Funds

- Cash
- Fixed Interest
- Australian Shares
- Property
- International Shares

Diversified Funds

- Conservative
- Balanced
- Growth
- High Growth

Exchange Traded Funds

- Australian Shares
- Australian Property
- US Shares
- International Shares

Vanguard's range of Plain Talk guides

At Vanguard, we believe it is just as important to know about the potential risks of your investments as well as the rewards. That's why we publish our Plain Talk guides on a range of popular investment topics. After all, better informed investors make better investment decisions.

Our Plain Talk range includes:

- Understanding indexing;
- Realistic sharemarket expectations;
- Building your investment portfolio;
- Investing for income;
- Self Managed Super Funds;
- Superannuation;
- Managed funds; and
- Exchange traded funds

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Note: All currency is in Australian dollars unless otherwise stated. Unless otherwise stated data sources are Vanguard, using market data. Performance data is up to date as of 31 December 2009. To view current performance data, visit our website www.vanguard.com.au

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