

Smart Investor

It pays to keep something in reserve

DIY super

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Do-it-yourself funds are well known for their investment flexibility. But there is another, lower-profile feature that is potentially just as exciting: funds have the flexibility to distribute annual investments returns to members or to an investment reserve if they wish to smooth returns out over a number of years.

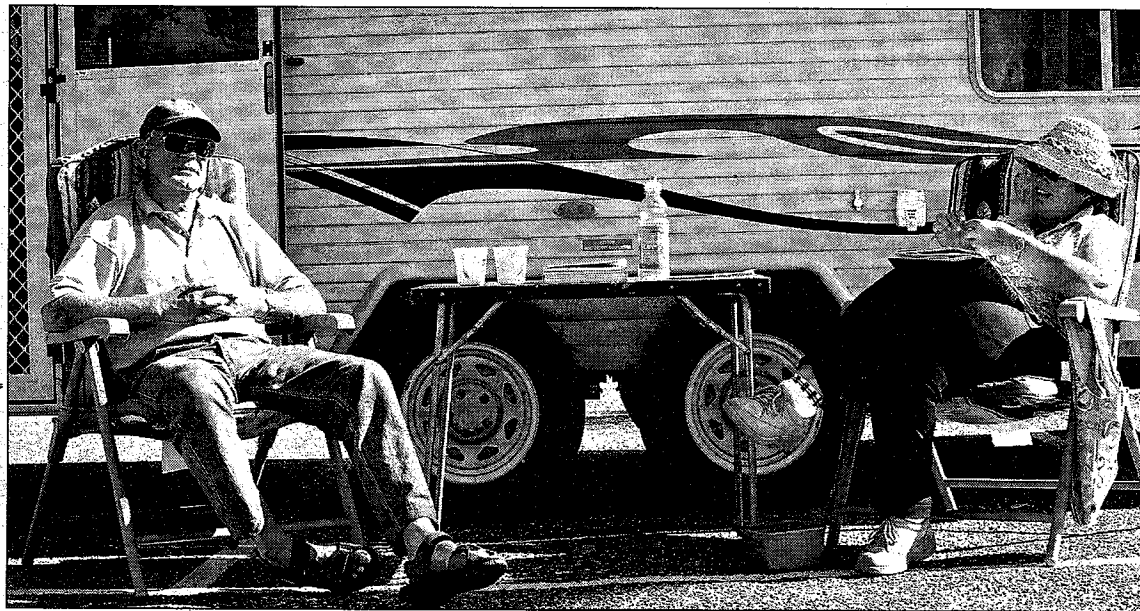
This option is a particularly attractive proposition for funds that are paying pensions to their members, including the new market-linked or term allocated pensions, according to self-managed super fund pension specialist Peter Crump, of Adelaide-based financial planner Portfolio Planning Solutions.

"Market-linked or term allocated pensions are a natural for a smoothing strategy," he says.

The opportunity to direct money to a fund reserve will have increasing relevance as more people retire and begin to spend their super, particularly if they take one of the new market-linked pensions, where the annual value of the pension is the member's balance as of July 1 divided by a government-determined pension factor.

Crump says one aspect of a market-linked pension being highlighted is that if the fund investments do well in a particular year, then members face the prospect of having to take a higher pension than they might wish to take — just because their balance will be higher.

However, if trustees establish a policy that directs how investment



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returns are allocated, they can smooth them out over time in terms of allocating them to member accounts. Crump says this is a way to ensure investment returns are not as volatile, especially during the pension years.

Crump says not all trustees or advisers are aware you can allocate investment returns and use an investment reserve during the good years.

Trustees do not need to allocate full investment returns to member accounts on a year-by-year basis. They may choose to maintain an investment reserve for investment returns in excess of a particular return.

For instance, if a fund earns an investment return above 7 or 10 per

cent a year, then some could go into a fund reserve. Equally, where an investment is below a particular amount the reserves can be used to top up the member account.

Fund trustees can decide that allocating all the investment returns is not an appropriate way to handle them, Crump says. They can implement a policy that includes the use of an investment reserve.

The important issue with such a policy is that it stacks up and is part of the fund's formal investment strategy. It must be appropriately spelled out and explained in the investment strategy.

It could be part of the trust deed, although it need not be. The import-

ant thing is that it is properly documented and is capable of being reviewed by an external party.

Crump says a reserving strategy could be implemented with a market-linked or term allocated pension and a straight allocated pension. It has less relevance for a lifetime or life expectancy pension because a reserve may already be part of the structure.

Crump says there are no formal superannuation rules that state that DIY funds cannot distribute investment returns between member accounts and a fund reserve to iron out volatility.

The Superannuation Industry (Supervision) Act does say it is quite

acceptable for a fund to have reserves for a variety of reasons.

Investment smoothing is one of these reasons. These SIS rules are broad permissions.

The more specific fund rules for reserving should not only state how investment returns are allocated to a reserve during the good years but also how they are credited to member accounts when the money will increase the available pension during years of lower or negative investment returns.

DIY funds have the flexibility to run a fund reserve because member investment returns tend to accumulate during the year and are credited at the end of the year, Crump says.

The actual crediting is a book process and so long as the fund maintains equity between the members in a fair and reasonable manner, having a reserve should be fine.

One trade-off for having a reserve, says Crump, is that fund reserves are taxable whereas member accounts from which a pension is being paid are not taxed.

"A consequence of having a reserve is that those monies are in a tax-exposed reserve," he says.

One reserving strategy could be to direct that the reserves are made up of a cash component of the fund, which limits the capital gains exposure.

The only issue as far as a reserving strategy is concerned is whether the strategy smacks of tax avoidance.

It would not be appropriate if an allocation of investment returns to a reserve was a way to avoid an excess benefits tax on a pension or to maintain a pension rebate entitlement that wouldn't be available if the money went to the member account.