Research Note: Sophisticated Investor Projections

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Executive Summary

This research note seeks to quantify the historical and future change in the potential share of Australians who could be classified as 'sophisticated investors' in accordance with the definition legislated by the Corporations Act.

These changes arise as a result of the failure of the legislation to index the $250,000 gross income and $2.5 million net wealth tests in the Corporations Act's sophisticated investor definition, which were legislated in 2002, to the increase in both income and wealth over the 20 years since the definition was introduced.

Clearly the share of Australians earning $250,000 in gross income over two consecutive years, or those with more than $2.5 million in net assets, has changed dramatically over the last two decades because of income and asset price inflation.

In reality, meeting the requirements of the sophisticated investor definition is unlikely to guarantee that an investor is immune to poor investment choices or being misled by shady deals. The Corporations Act and the Future of Financial Advice Laws (FOFA) have evolved to provide greater protections for retail investors but much less so sophisticated investors.

The absence of income and asset price inflation indexation in the Corporations Act has driven a shift of more and more Australians out of the FOFA's retail protections and into the much more unrestricted sophisticated investor world.

Consideration of unscrupulous behaviour uncovered in the Hayne Royal Commission or sub-prime lending that led to the 2008-09 global financial crisis or the collapse of Storm Financial Limited should give pause for thought to the potential for all types of investors to be deceived.

This research considers the definition of sophisticated investor and tracks the share of the population who meet this definition through time. Projections are also provided under reasonable economic assumptions of potential income and wealth projections.

We find that the share of persons who could be defined as sophisticated investors has grown very substantially since the legislation was first introduced in 2002. The potential sophisticated investor share has increased from just 1.4 per cent of all Australian households (104,000) in 2002 to 9 per cent (853,000) by 2018 as a result of income growth and asset price inflation.

By the end of the 2020-21 financial year, we project that the sophisticated investor share had increased to 11.3 per cent (1.09 million) of all households. Applying RBA and Treasury income growth and asset price inflation assumptions and projecting forward, we arrive at a median estimate of 34 per cent (4.24 million) of all households that could be classified as sophisticated investors by 2041. Moderately stronger growth in wages and wealth could see this share rise to around 49 per cent of households by 2041. Moderately lower growth would still see the share increase to around 21 per cent by 2041.

If we consider individuals rather than households, we find that the per cent of adults who satisfied the sophisticated investor test in 2002 was 1.9 per cent (285,000) of adults. By 2018, this share increased to 12.1 per cent (2.37 million) of adults. By 2021 the share increases to 16.2 per cent (3.25 million) and by 2031 the share increases to 29.1 per cent (6.78 million) of adults and by 2041 that share is projected to increase to 43.6 per cent or 11.5 million.

Regardless of the appropriateness of the definition of sophisticated investors, it is clear that the circa 11.9 per cent of Australians that could be defined as such today is dramatically different to the 1.9 per cent that parliament had in mind when it created the definition in 2002. And this problem will only grow over time: by 2041 it is entirely possible that half of all households could lose the benefit of retail investor protections.

Quite clearly, the lack of indexation of the original definition's income and wealth assumptions mean that ordinary, or 'retail' investors are shifting into the sophisticated class. This continued creep has considerable implications for these investors and their livelihoods, for the way that advisers and institutions potentially organise themselves to exploit these changes, and, more broadly, for the integrity of the Australia's financial system.

We have not identified any prior research efforts to empirically quantify the proportion of the community that has shifted out of the retail and into the sophisticated investor definitions over time, nor attempts to forecast future changes in the number of individuals and/or households that fall into these two cohorts.

Introduction

Under the Corporations Act, an individual can be classified as a 'sophisticated investor' by obtaining a certificate from a qualified accountant stating that their income is greater than $250,000 per year for the last two consecutive financial years or that they have more than $2.5 million dollars in net assets. This requirement has been unchanged since 2002.

With wages and wealth increasing significantly since 2002, the number of people who potentially meet the definition of sophisticated investor has increased significantly. It would also be reasonable to expect that situation to continue and that the pool of potential sophisticated investors, while small initially in 2002, is now considerably larger today than in 2002 and will become considerably larger again in the decades to come if the tests established in 2002 remain unchanged.

In this paper, we estimate the growth in potential sophisticated investors between 2002 and 2018 using the Household Income and Labor Dynamics Survey in Australia (HILDA) and project these estimates using the ANU microsimulation model PolicyMod to 2041.

Methodology

The interest in the paper is the potential pool of investors as opposed to the actual number of sophisticated investors. The potential pool of sophisticated investors will be considerably higher than the actual number since many people either are not investors and don't require a certificate, or, even where someone is an investor, they may choose not to become a sophisticated investor. The value of this report is estimating the size of the potential pool to demonstrate whether or not the definition of sophisticated investor is still in keeping with the expectation that one would have considerable income and wealth and therefore be in less need of the protections that a 'retail investor' definition provides.

The analysis undertaken focusses on estimates of the pool of sophisticated investors between 2002 and 2018 and then projections beyond 2018.

The only data set that is publicly available that provides the required two consecutive years of income data and wealth data for individuals and households is the HILDA longitudinal data set. HILDA is a nationally representative data set that tracks households and individuals between 2001 and 2018. HILDA enables analysis at both the individual and household level. As such, our analysis provides both individual and household estimates.

While the sophisticated investor definition is for individuals, the implications of this rule also impacts households. Since households often share wealth or have complex arrangements with asset allocation between partners it does make sense to include both an individual and household-based approach.

Under both approaches we consider incomes as individual based but combine the wealth of all members of a household. This may cause some issues for multiple family or share house households, however we would expect the share of these households that are very high income or wealth to be quite limited and to not greatly impact the results. Our HILDA estimates are for every 4 years between 2002 and 2018.

Beyond 2018 we rely upon projections from the ANU PolicyMod model of the Australian tax and transfer system. PolicyMod is a microsimulation model based on the ABS Survey of Income and Housing (SIH 2017-18). The model simulates tax and transfer (welfare) payments on top of the very detailed income and wealth data already included in the SIH. To enable accurate modelling of tax and transfer policy for today and into the future, PolicyMod is projected using detailed demographic and economic projections based on ABS demographic data and projections and the latest projections from the Treasury and the RBA.

PolicyMod (and the SIH) only have income for the current financial year and are not able to provide an estimate that matches up to the exact rule for sophisticated investors. However, we do use the growth rate, or movement estimate between years in PolicyMod, and apply these rates to the 2018 HILDA estimate. We would expect that the movement estimate is unlikely to differ greatly whether or not the income is measured in terms of a single year (SIH) or two consecutive years (HILDA).

The analysis that we undertake does indicate that in the years between 2002 and 2018 the potential pool of sophisticated investors is dominated by the wealth component. With strong house price and superannuation fund growth there is an increasingly large share of households and individuals with a stock of net wealth greater than $2.5 million. Incomes, even today, are very rarely beyond $250,000 for even one given year.

The PolicyMod model updates the underlying survey data’s income and wealth data using the latest available income and wealth data from the ABS. This means that PolicyMod should project with a high level of confidence our pool of sophisticated investors by taking into account the recent weak income growth but very strong growth in asset markets, in particular the housing and equities market.

Projecting beyond today is subject to a larger degree of uncertainty and we base our projections on the latest wage projections by the RBA and Treasury (modest growth) up to 2024-25 and then assume the growth rate in the IGR (Intergeneration Report) of 4 per cent beyond 2024-25. For wealth, we assume growth of 5 per cent per year beyond today.

We accept there is considerable uncertainty around such projections and also provide a ‘hi’ and ‘lo’ scenario. The hi scenario includes wages growth of one percentage point higher and wealth growth two percentage points higher than our standard or median projection. Our lo estimate is for wages growth of one percentage point lower and wealth two percentage points lower than our median projection. The scenarios provide some perspective on potential variability and they should not be viewed as upper or lower limits. We don’t provide any ‘confidence’ estimates on these estimates.

Results

Figure 1 and Figure 2 show that when the rules for a sophisticated investor were first legislated in 2002, they genuinely represented only a small share of the Australia population at just 1.4 per cent (104,000) of households. This share increased dramatically as incomes and wealth increased, and by 2018 we estimate that 9 per cent (853,000) of households had at least one person who qualified.

Following strong growth in wealth between 2018 and 2020-21, by financial year 2020-21 the share of households who qualified increased to 11.3 per cent (1.09 million). PolicyMod projects continued strong growth through this decade to 22 per cent (2.44 million) of households qualifying by 2031 and 34 per cent (4.24 million) households qualifying by 2041.

We have called this projection our ‘median’ projection and it is based on longer term wage growth of 4 per cent per annum and wealth growth of 5 per cent (all in nominal terms). To better understand the impact different economic assumptions could have on projections, we also include a high (hi) and low (lo) projection. These projections assume wage growth that is 1 percentage point higher and lower and wealth growth that is 2 percentage points higher and lower. We don’t offer any guidance on how likely any of these scenarios may be beyond an expectation that are all plausible and offer some perspective on how projections vary with respect to different economic circumstances.

The high projection (with higher wages and wealth growth) is that by 2031 the per cent of households with at least one person qualifying as a sophisticated investor is 28.4 per cent (3.15 million) and by 2041 it grows to 48.9 per cent (6.08 million) of households.

The low projection (with lower wages and wealth growth) is that by 2031 the per cent of households with at least one person qualifying as a sophisticated investor is 16.5 per cent (1.83 million) and by 2041 it is 21.1 per cent (2.62 million) of households.

The results clearly show that the share of households with a potential sophisticated investor has increased substantially between 2002 and 2018 and that it should be expected that where wages and wealth continue to increase that growth will continue in the decades ahead. Our median projection is for around 34 per cent of households (4.24 million) to qualify as sophisticated investors where current tests remain unchanged. There is considerable variation possible around this median estimate depending upon the future trajectory of wages and wealth.

Figure 1 Sophisticated Investor Households population (%)

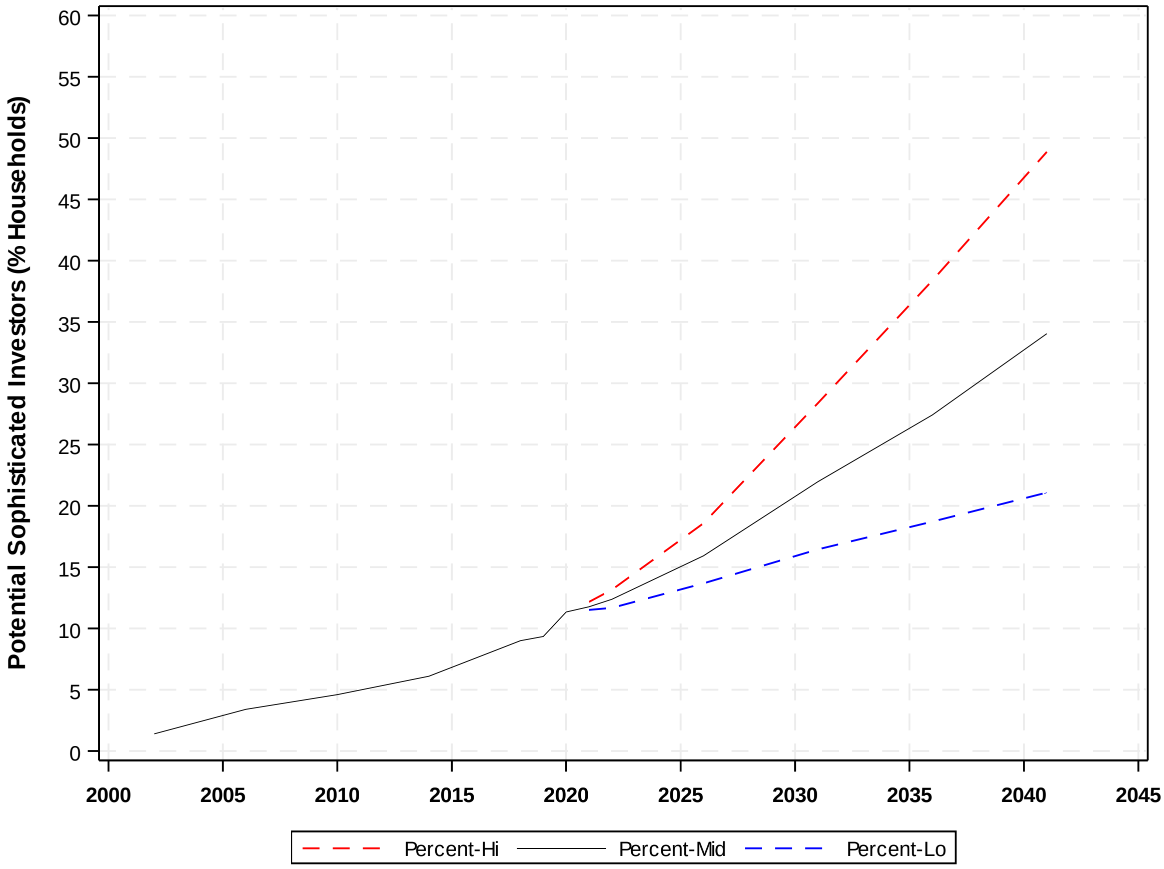

Figure 2 Sophisticated Investor Households potential population (Number)

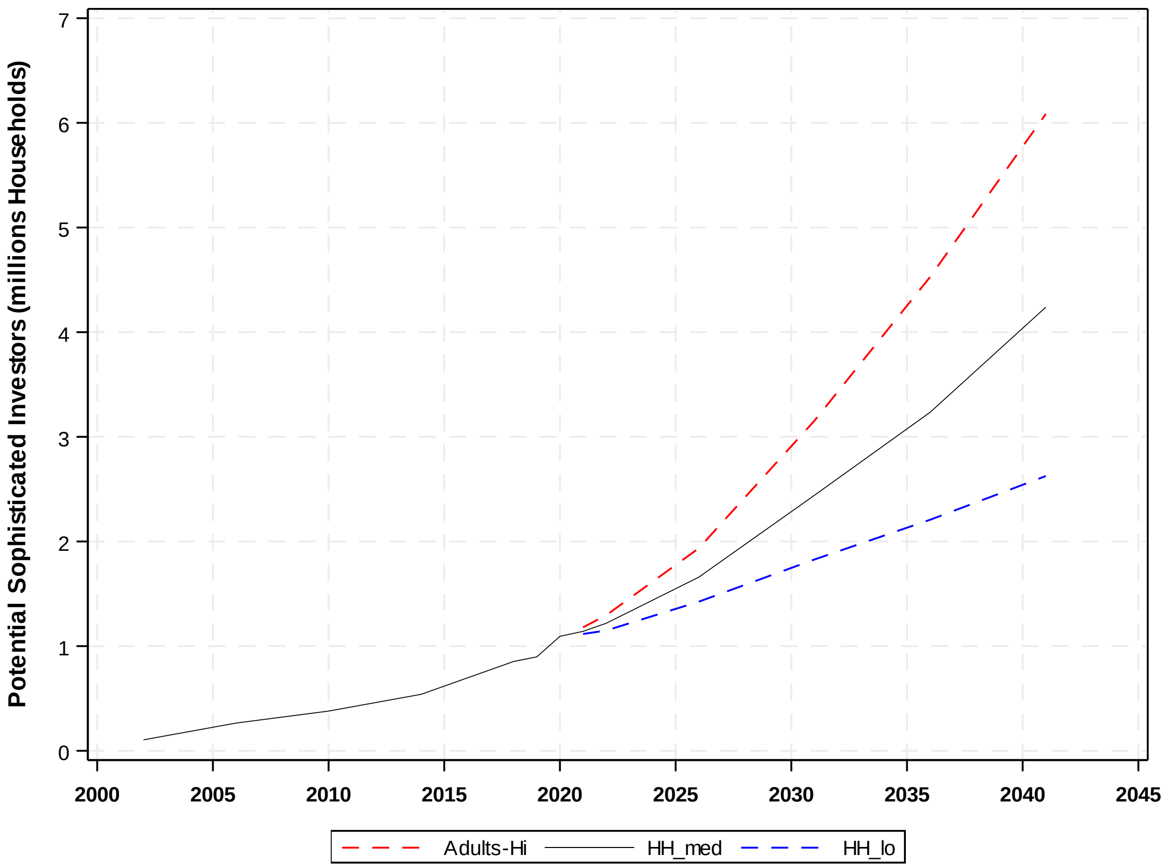

Figure 3 and 4 provide similar information as above except for the total number of adults rather than households. Based on the HILDA data, the per cent of adults who satisfied the sophisticated investor criteria in 2002 was 1.9 per cent (285,000) of adults. By 2018, this share increased to 12.1 per cent (2.37 million) of all adults. PolicyMod projects the numbers who potentially qualify as sophisticated investors rises sharply through the next two decades. By 2021 the share increases to 16.2 per cent (3.25 million) of all adults and by 2031 the share increases to 29.1 per cent (6.78 million) of all adults and by 2041 that share is projected to increase to 43.6 per cent or 11.5 million.

Figure 3 Sophisticated Investor Adults potential population (%)

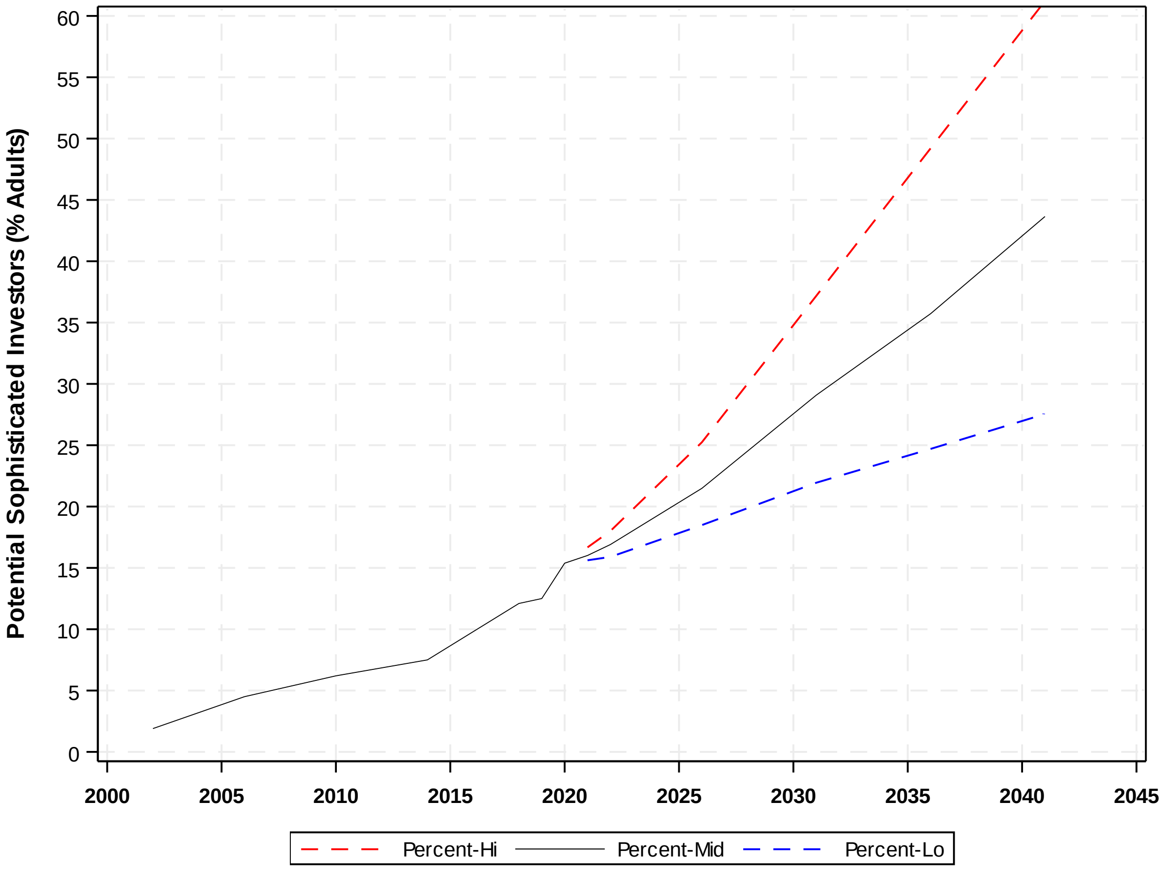

Figure 4 Sophisticated Investor Adults potential population (Number)