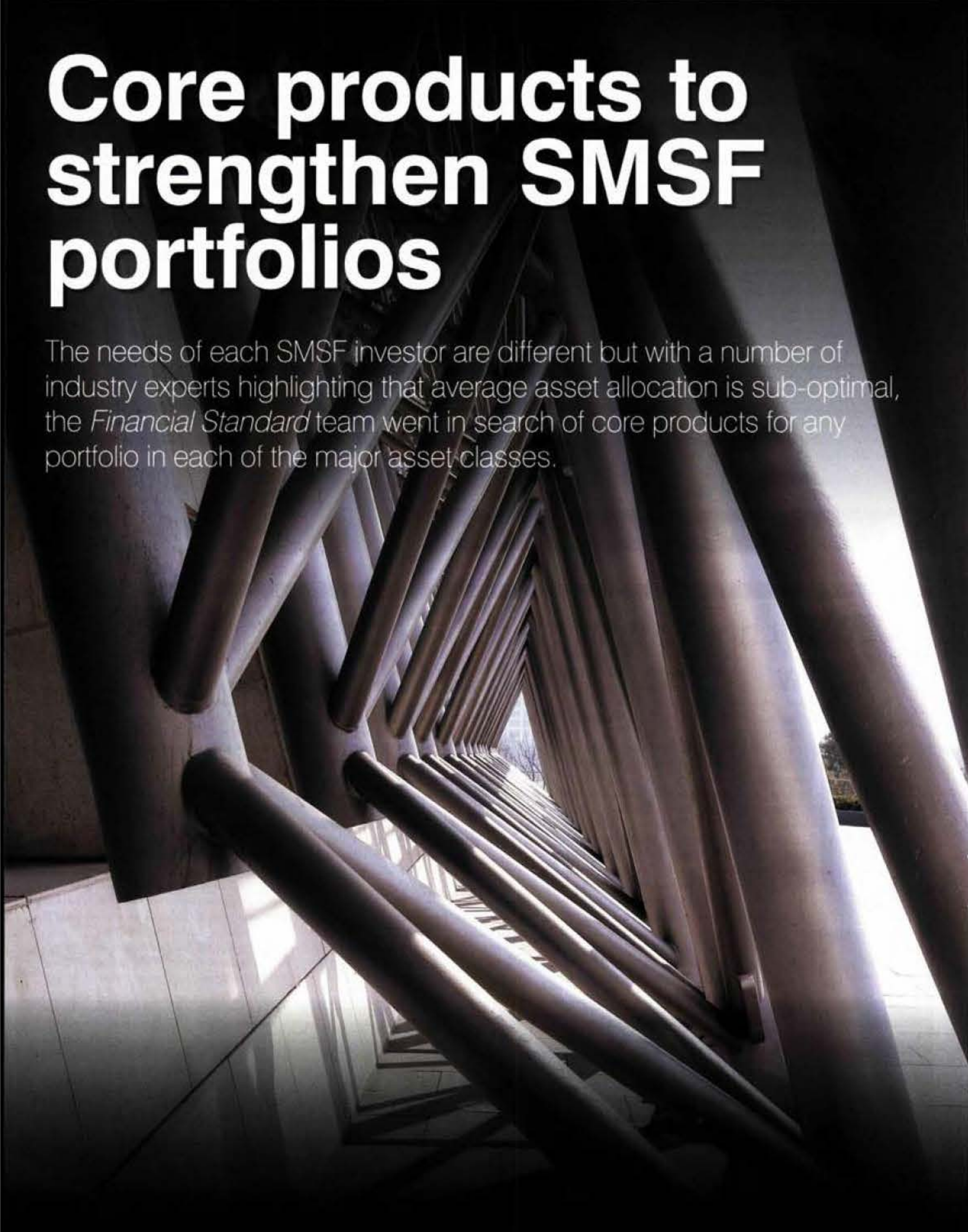
Core products to strengthen SMSF portfolios

The needs of each SMSF investor are different but with a number of industry experts highlighting that average asset allocation is sub-optimal, the *Financial Standard* team went in search of core products for any portfolio in each of the major asset classes.



The self-managed super fund sector provides arguably the most exciting growth opportunity for businesses spanning the entire financial services industry.

The number of SMSFs being set-up continues to grow and contributions are mandated by government policy to increase to 12% by 2025. Total net assets within the segment stood at $543 billion at end of June 2014, up from $127 billion in mid-2004. This represents a compound growth rate of 15.6% per annum over the decade.

The total number of SMSFs has swelled to 531,059 as at 30 June 2014 up from 271,515 in 2004. The effect of this growth has been to increase the average amount per fund to $1,022,490 in 2014, up from $467,750 in 2004.

But it's not just the sheer weight of numbers that poses a huge opportunity. SMSF portfolio are indisputably overweight in Australian shares and cash and lacking exposure to potential growth areas such as infrastructure, global shares, private equity and hedge funds as well as crucial defensive holdings like fixed income and absolute return funds.

Getting the most out of clients' superannuation savings pool is both an opportunity and a challenge as most investors, understandably, want to invest in what they know and many will be looking at their international counterparts and think their portfolio return stack up alright.

The truth is that the strong performance of SMSF portfolios is more by luck than by judgement and with the domestic economy expected soften over the coming years, it might be time to rethink not just asset allocation, but the types of investment products in the portfolio.

We've broken down the major asset classes and product segments to take a closer look at the types of products that should be at the core of most SMSFs.

Beyond Telstra and the big banks

It is not a secret that SMSF trustees love Telstra, the big four banks, Wesfarmers and maybe one or two resources companies. Add some cash and property to the mix and you'll have an average SMSF portfolio.

Over the last years, Australia's well-performing stocks, strong currency and buoyant real estate market have proven that the average, yet simple, SMSF asset allocation has matched and even outgrown returns of funds regulated by the Australian Prudential Regulation Authority (APRA).

The Australian Taxation Office (ATO) SMSF statistical report from June 2014 shows that listed shares are still the individual investors' preferred asset, with a total of $177 billion allocated to Australian stocks. Cash, term deposits and debt securities rank next, with over $162 billion. SMSFs also hold almost $65 billion in non-residential property and $19.5 billion in residential property. Overseas shares account for only $2.2 billion. While these figures are ATO estimates extrapolated from 2012 to 2013 data, they are a good indicator of the average SMSF asset allocation today.

However, changing economic conditions might mean that SMSFs will have to start looking beyond Australian equities, cash and property to match past results.

Verante Financial Planning director and SMSF adviser Liam Shorte[01] explains that at the moment "most of our own SMSF clients have been benefiting from the increased exposure to international stocks we took three years ago and we still believe there are some good opportunities overseas." But the falling Australian dollar means that Verante advisers are "setting targets for drip feeding from unhedged to hedged currency exposure."

Despite the growing focus on global equities, Shorte does not leave Aussie stocks aside and uses high yield exchange traded funds (ETFs) to give investors exposure to their favourite stocks. Some favourites are the Russell High Dividend Australian Shares ETF (RDV), the Vanguard Australian Shares High Yield ETF (VHY), the iShares S&P/ASX Dividend Opportunities ETF (IHD) and the SPDR MSCI Australia Select High Dividend Yield Fund (SYI). With other options looking fully priced, Shorte recommends trustees to use individual research and good managers to access ex-top 20 stocks.

The advice, as well as asset allocation, tends to be different for SMSF trustees already in the retirement phase. To Shorte, dividend harvesters like the Plato Equity Income Fund are more suited to retirees' needs because "it buys into stocks for dividend payments, sells well after the 45 day minimum holding period for franking credits and targets the next stocks to pay dividends."

Low dividend paying and out of favour stocks are also a good option for pension clients because "we don't mind if the returns come from income or growth as long as it is sustainable."

An ETF love story

SMSF trustees' constant search for more transparency, more efficiency and lower costs has made them the first adopters of ETFs in Australia. State Street Global Advisors (SSgA) chief operating officer in Australia James MacNevin says: "The ETF market in Australia has seen a 50% growth over the last 12 months, with $12 billion already in ETFs."

MacNevin explains that most investors use ETFs to get low cost exposure to the top stocks on the Australian Securities Exchange (ASX). But ETFs are also a good choice when it comes to diversification within the asset class: "Most SMSFs hold between 10 and 15 Australian equities stocks, so Aussie equities ETFs can help them broaden the exposure," he says.

Global equities ETFs are seen by investors as assets that can provide growth and high yield: "In 2014, about 40% of the investment flows into ETFs went to international equities," MacNevin says. The trend shows that "SMSF investors were very quick to understand the effectiveness of ETFs to get international exposure."

The fact that trustees are better informed, as well as increasingly aware of the importance of diversification means that they are likely to keep choosing ETFs as a preferred investment instrument.

When talking about the way forward for ETFs in Australia, MacNevin mentions two possible scenarios: in the United States there are currently $2 trillion in ETF assets and a total of 1,600 ETFs. In Europe, there are $450 billion in ETF assets and a total of 2,500 ETFs.

"I would prefer to see less fragmentation in the market, I would like to see larger funds with exposure to the assets that people need," he says.

Even if the popularity of ETFs is growing, managed investments for SMSFs have not gone out of fashion. Some SMSFs use managed funds as a vehicle to invest in different companies, while more sophisticated investors combine them with ETFs to get the extra knowledge – and alpha returns – from active managers.

According to Plan For Life figures, managed funds by retail fund managers represent 9.7% of overall SMSF total funds. Of the leading companies, AMP managed funds enjoyed the highest growth (46%), while BT and Commonwealth grew 11% each over 2014.

An insurance against deflation

Historically low yields are driving investors away from bonds and into higher risk property assets and high dividend securities. Nikko Asset Management global rates and currencies strategist Roger Bridges admits that this is a difficult time to recommend fixed income. However, when investing in this asset class investors should not be worried about yield, but think about it as an insurance policy against deflation.

"Like sometimes with insurance policies, you might not want to pay the cost, but you still need to have it," Bridges says. He notes that "people always see fixed income as too difficult or they think that the yields are too low when they look forward. But when they look at the past, they realise that they've missed on rallies.

"Australians have been very underweight in fixed income and now, with the low yields, cash and term deposits have come off trend."

Ultimately, it depends on each individual investor and on their risk appetite. But Bridges fears that "when there is low fixed income yield, people are attracted by risk and start going into higher risk assets such as hybrids. That's a real danger."

Shorte tries to educate his clients on the importance of fixed income for SMSFs. "It is now almost essential for a SMSF to have access to a Term Deposit Facility like Money Market, FIIG or the new entrant Cashwerx so that SMSF can move funds from one provider to another easily and get the best rates available," he says.

"More and more clients are looking to credit funds for a better return but we do caution that this incurs significant additional risk," he adds. His clients have some exposure to hybrids: "The ANZ at a minimum 6.3% distribution return for SMSF pension clients is certainly more attractive than CBA's last PERLS issue."

However, exposure to bank hybrids can clash to the overexposure to the financial sector inherent on most SMSF portfolios, Shorte notes. "Diversification and research is the key and capping exposure to any one sector or product so there are no big surprises," he adds.

Property under inspection

Despite its rising cost, property remains at the core of most SMSF portfolios. According to the ATO's June 2014 SMSF statistical report, property is in the top three asset classes - collectively representing 75% of all SMSF investments - alongside direct shares and cash. Of those three, it has grown the most over the past decade, from 12% in 2004 to 15.9% in 2014.

One of the primary reasons for this is the establishment of limited recourse borrowing arrangements, or LRBAs, in 2007. These allowed SMSF trustees to borrow funds where the loan is used to purchase a "single acquirable asset" - in a property context, this means an asset held on a single legal title, such as a unit in a block of apartments. Under an LRBA, the lender only has recourse to the asset being purchased should the SMSF trustee default on their repayments.

Because they opened the doors to SMSFs with lower balances, LRBAs afforded the SMSF sector a greater level of property exposure, and the average proportion of asset allocation to property grew concomitantly.

At the same time, the reduction of legal barriers to SMSF borrowing gave rise to LRBA "property spruikers" who took advantage of ASIC's lack of regulatory oversight in the direct property market to scam unwary SMSF trustees. Partly as a response to this, the government's Financial System Inquiry, which concluded in December last year, recommended that LRBAs be scrapped entirely.

SMSF Professionals' Association of Australia (SPAA) chief executive Andrea Slattery[02] feels this decision would have a harmful effect on SMSF investors. "If we remove direct borrowing for super," she says, "you're only affecting SMSFs, and that's an inequitable situation for the investor.

"Borrowing directly into property represents an asset opportunity, and if we look at direct borrowing through SMSFS, at market value property carries about 1.2% or 1.4% of all assets held in an SMSF, and that's after six-and-a-half years of being eligible to do this. So, from our perspective, this has been happening for a long time, it's been quite public, and there is no indication of direct borrowing for property growing too much."

Of course, Slattery does believe more should be done to combat property scams. "ASIC's jurisdiction only comes into being when you're talking about people spruiking to set up a licensed product," she continues, "which means spruiking to set up an SMSF.

"SPAA's position on this has been for a long time that we need to change the legislation to make sure that people providing advice on a borrowing arrangement are licensed. If you have people who are licensed and competent and under the ASIC regime providing advice, that brings integrity into the space. And when you have that, this is simply a way to hold assets that should be considered and should form part of an investment program."

Whether the FSI recommendation will be implemented remains uncertain, but the news is causing justifiable concern in the SMSF sector.

Real estate collective schemes

Outside of direct property or purchases through LRBAs, one of the only other options for lower-balance SMSFs to gain access to property is buying units in unlisted property trusts. These have several limitations, including a lack of transparency (the investment manager uses trustees' funds to purchase property according to its own investment philosophy) and fairly limited potential for diversification (trusts generally only buy commercial property, eschewing residential entirely).

According to DomaCom general manager, sales and marketing Warren Gibson[03], though, there is a better way: fractional direct property investment funds. In this model, lower-balance SMSF investors can purchase units in property of their own choosing up to their recommended asset allocation. "Traditionally with property," Gibson says, "it's an all-or-nothing proposition, right? You either buy the whole thing or you don't.

"What we've done is taken a managed investment scheme [MIS] product and interposed that product in the process of purchasing a property from a group of people. We use a book build process, and all of this occurs online where people commit different amounts towards the purchase of a property."

Once the investment manager has sufficient funds and after a due diligence process – which includes conveyancing, property inspection, formal valuation and pest inspection – a buyer's agent is appointed for the "pseudo-syndicate" and the property is bought, and sits in a sub-fund of the MIS. Investors are then issued units in the sub-fund, and the property title sits with the custodian – which, in DomaCom's case, is Perpetual.

"They can diversify, too," Gibson continues. "They don't have to put it all into one sub-fund. If you've got $50,000, for example, which is say 10% of your SMSF, and you want to have exposure to property you could put $10,000 into each of five different properties. This also allows for greater diversification because whole direct property purchases generally lead to SMSFs that are heavily overweighted in property, given rising property costs."

Under DomaCom's model, investors also have guaranteed and near-immediate liquidity, which isn't something traditionally associated with property purchases. This is achieved via a "secondary market" where unit-holders can sell off some or all of their units in a particular chosen property to fellow investors.

"It's a little like going onto E*Trade or CommSec and selling your shares," he says. "You can sell it all, or just a bit. There are two further liquidity triggers, too: either the fund expires after five years and the proceeds are returned to the investors in proportion to their fractional holding, or 75% of unit-holders vote to sell off the property."

"We're also hoping to launch a complementary product in the coming months which would allow property owners to release some of the equity in their property incrementally, selling it to the same investors who are currently buying it incrementally through this scheme."

The result of this, ideally, is an investment method where lower-balance SMSFs have a chance at reaching their recommended property exposure while retaining control over where their money goes, and without having to go through the process of setting up an LRBA in an unsteady regulatory environment.

"People are missing out on a very valuable asset class," Gibson says. "Property is now such an expensive commodity that it's very difficult to get in, so this enables younger people to get their foot on the property ladder. You may not have enough money to buy a house, but why should you not be able to get into the property market at all? You only need \$20,000 to open an account through an adviser in our fund and then you can invest as little as \$2,000 into each property."

As far as Gibson is aware, DomaCom's fund remains unique – in Australia, at least. And the unorthodox nature of the product means certain AFSLs are, in his words, "waiting in the wings" to see how it performs over time. But in a climate where the doors to direct property may once again be closing on lower-balance SMSFs, unconventional ideas like these may be just what the sector needs.

Better ways to hold cash

Risk free and comparatively simple, it's all too easy to overlook the cash element of client portfolios. But with many SMSFs continuing to hold upwards of 30% of their portfolios in the asset class and the outlook for interest rates remaining very uncertain, it's never been more important to make sure this portion of portfolios is running as efficiently as possible.

"Most retiree clients will have 20-35% exposure to cash and fixed interest," explains Shorte. Returns on longer-dated term deposits are still higher than five- or 10-year government bonds and as such the allocation to credit and bonds is artificially low."

The main hindrance to SMSF trustees moving term deposits in the traditional way is the additional paperwork involved arising from the trust entity structure. Luckily for advisers there are platforms which can make the process easier.

"We use Australian Money Market which has about 20 term deposit providers and two high interest cash accounts on offer," says Shorte. "We link this facility to clients' main SMSF bank account. With one application at the outset we can then access any of those 20 providers for terms of one month to five years without any further documentation. It means the client can switch the funds from, say, BOQ to ING Direct without any further paperwork."

Shorte says one of the main hurdles has been getting older clients used to using newer providers like INGDirect, RaboDirect and UBank as many people are hesitant to use anything but the big four after the GFC.

"With rates lower than ever most realise they have to look for the better offers and with the ease of using the Money Market facility we have many more clients taking up that option."

For platformed funds Shorte sometimes makes use of the BetaShares Australian High Interest Cash ETF [ASX code: AAA]. This can be bought and sold on the Australian Securities Exchange like any share, with settlement taking place within three days of the trade.

Addressing underinsurance

While insurance is typically bundled in to all but the most basic options provided by APRA-regulated super funds, that's not the case with SMSFs. TAL general manager distribution Niall McConville says that few SMSF trustees bother to add any insurance when they set up their funds.

"Only 13% of SMSF members have life insurance. That sounds bad but it's important to note that the average age of members is quite old and those without debt and who or transitioning to retirement will not need as much insurance," he says.

"But the reality is that more and more younger people in their thirties and forties are taking out SMSFs and they probably do need the insurance. There is an opportunity for insurers to address the problem and benefit from the growth from this type of member."

Recent analysis of ATO data by Plan For Life suggests the extent of underinsurance could be even worse than feared. The researcher's most recent report shows that 84% of SMSF members aged 18-64 years old do not have insurance. That's more than 630,000 people.

McConville says part of the under-insurance problem could be explained by the number of people who set up the fund with someone who is not an insurance expert.

"Financial advisers, particularly those who specialise in risk insurance, would be very focused on getting the appropriate insurance for all their clients both in and outside the fund, whereas there are fewer accountants where that is the case," he says."

Life insurance, total and permanent disability insurance and income protection are the key products that can be bought through an SMSF and there are tax advantages for doing so. Policies or claims that are not covered within super can be bought outside and some providers offer a discount for doing so.

Average first year premiums are about $2,500 and in-force premiums tend to be about $3,500, McConville says. Insurance held through super tends to be about the same.

Part of the government's response to the under-insurance problem was to legally oblige SMSF trustees to consider the need for insurance within their fund. TAL provides a template for SMSF trustees to be able to illustrate that they've considered all the options.

Shorte says the cover needed within an SMSF varies greatly from one fund to the next but members' needs can be broadly segmented by age.

"For my existing established client base the bias is towards members over 55 and as such only about 20% of them have a need for insurance as most are debt free and have saved a considerable amount towards retirement and feel they do not need insurance," he says, adding that those who still carry some debt will find use for insurance policies within their SMSF.

Shorte says more than 75% of his clients in the 45-55 age range would have insurances in place either via the SMSF or personally or would be advised to retain the cover they had via their Employer or Industry fund.

"Another tranche is those who come to us and have already set up their SMSF and now want advice. Most of those (70%+) have no insurance in place and rolled over from their initial funds without considering insurance as an important aspect," Shorte explains.

"So while the usual figure quoted of 13% of SMSF members having cover may be right for now, I find it is changing very fast as we see newer, younger SMSF members and people still carrying debt in to their late 50s considering insurance as part of their strategy." **FS**

The quote

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Liam Shorte, director, Verante Financial Planning

The quote

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Andrea Slattery, chief executive, SPAA

The quote

More and more younger people in their thirties and forties are taking out SMSFs and they probably do need the insurance.

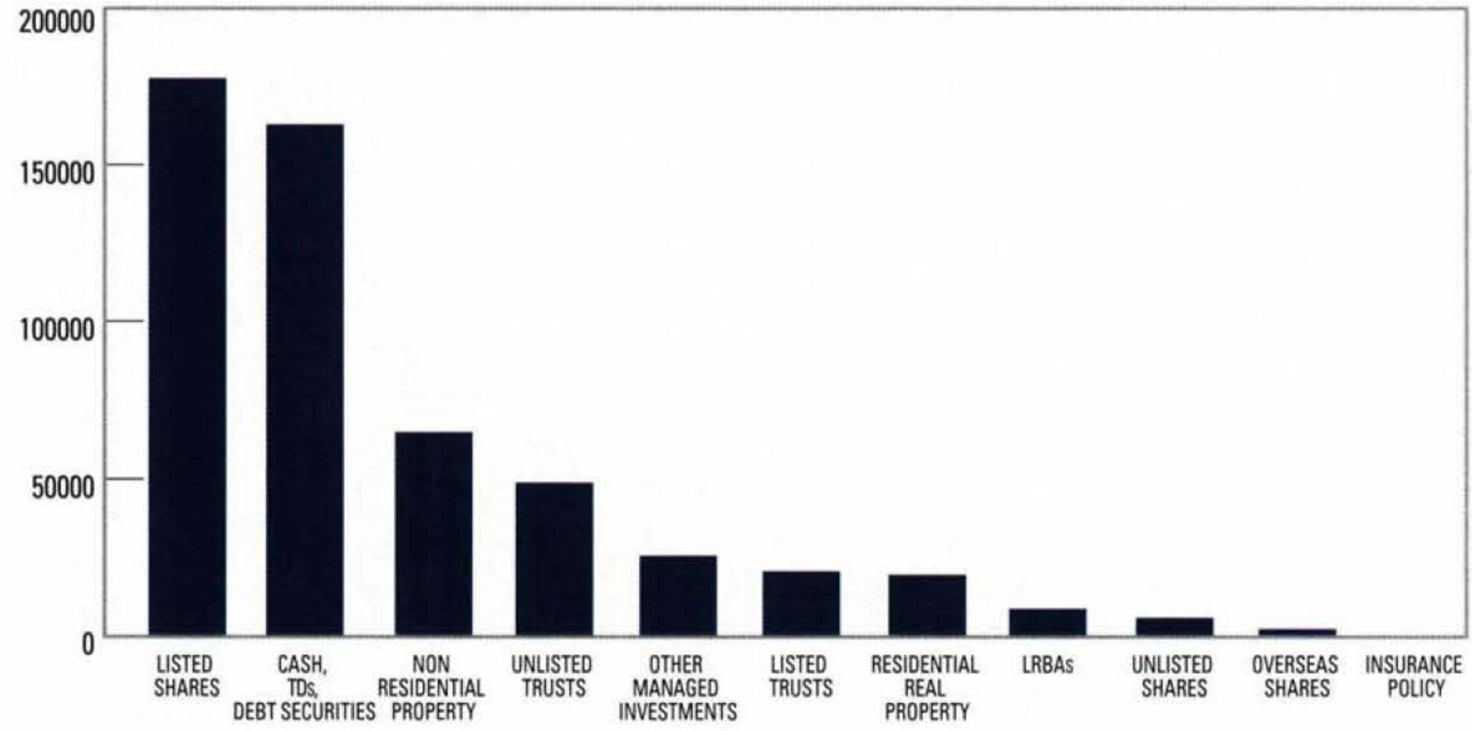
Niall McConville, general manager distribution, TAL

The numbers

$1,022,490

Average SMSF size

Figure 1. SMSF asset allocation ($M) – June 2014

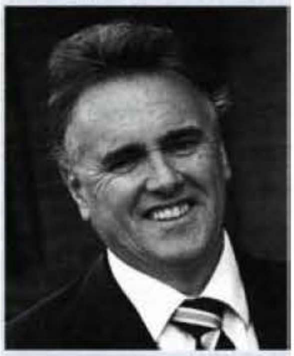


Source: ATO June 2014 Quarterly statistical report

Note: Figures for June 2014 are ATO estimates extrapolated from 2012-2013 return form data

01:
Liam Shorte
director, Verante Financial Planning

02:
Andrea Slattery
chief executive, SPAA



03:
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