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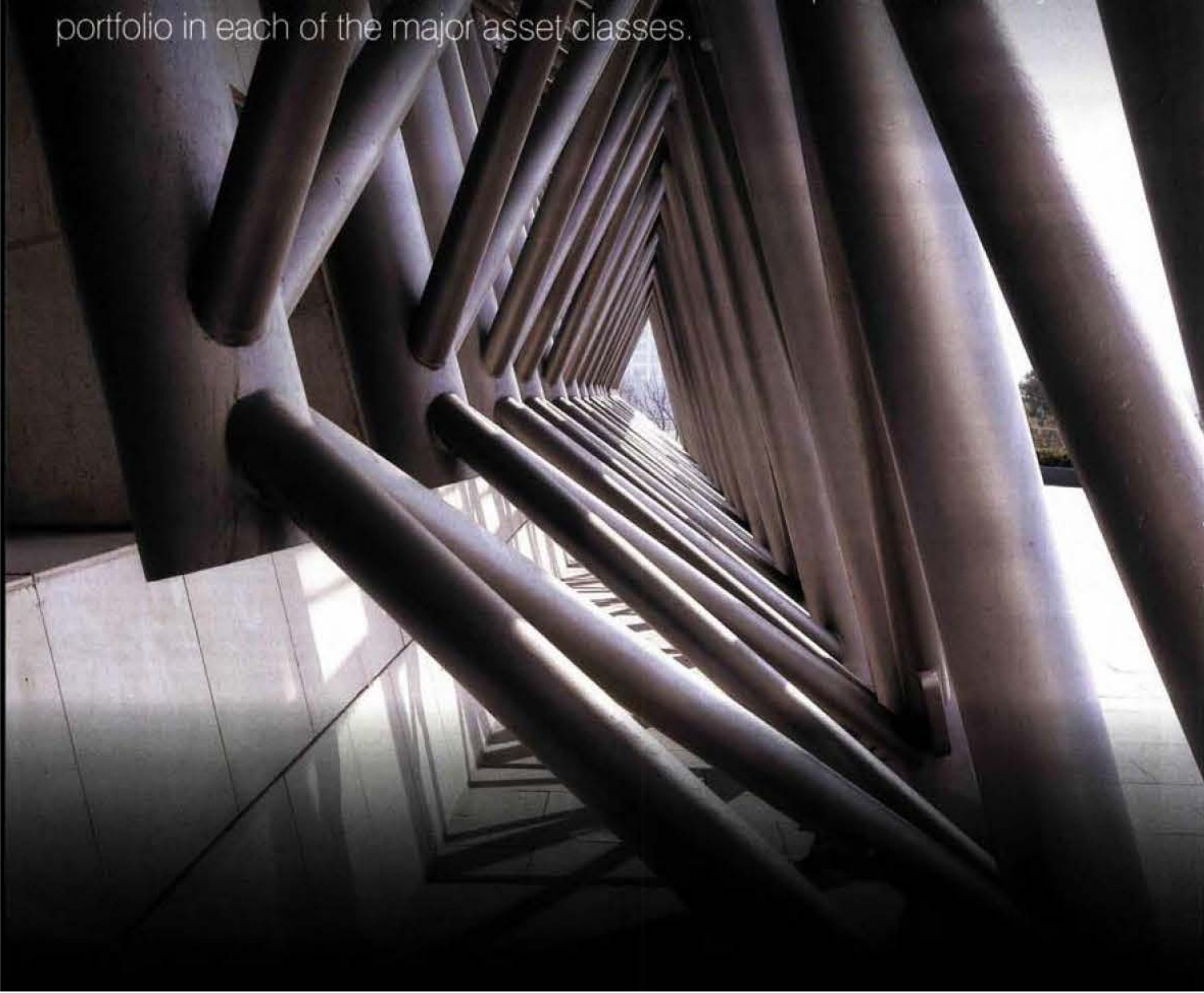
Core products to strengthen SMSF portfolios

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