Gearing up for a tricky ride

PUBLISHED: 10 Feb 2011 05:05:18 PRINT EDITION: 10 Feb 2011

Tony Featherstone

The best argument for gearing in a self-managed super fund is a simple figure: 3.3 per cent – the average annual return over 10 years for funds with more than four members. That dreadful return explains the boom in people managing their own super and rapid growth in SMSFs borrowing to buy shares or property to rebuild balances.

Precision tools: SMSFs are too important to risk with inappropriate or excessive gearing.

SMSF gearing has critics. The Cooper review of super says “leverage should not be a core focus of SMSFs”. In response, the federal government in December said it would review gearing within SMSFs in two years to see if “leverage poses a risk to superannuation fund assets ... in SMSFs”.

The government is right to review SMSF gearing. Excessive borrowing to buy growth assets could crystallise and magnify losses within SMSFs if markets tumble. It is one thing to lose personal savings through gearing, quite another to destroy retirement savings using borrowed money. Also, there are grumblings some SMSFs are using gearing, especially in property, to break super rules. SMSFs are too important to risk with inappropriate gearing. About 428,000 SMSFs hold $390.9 billion – almost one-third of the total super pool, the Australian Prudential Regulation Authority’s latest super bulletin shows. It is hard to see the SMSF phenomenon ending soon given an average annual rate of return of less than 4 per cent for funds outside SMSF over 10 years.

Also, there is a deeper question of whether gearing in SMSFs is rational. If one believes sharemarkets revert to the mean over long periods, returning say an average 8 per cent a year, it makes no sense to pay 10 per cent to borrow money. Also, excessive gearing might upset asset allocations and expose SMSFs to too many growth assets, such as shares and property. This theory may have shaped the government’s view on SMSF gearing. But try telling it to a 48-year-old who lost one-third of his super in the GFC and is hell-bent on retiring at 60. A sluggish sharemarket and the halving of the concessional contributions cap for super in 2009-10 means this investor will have to work harder to repair his super balance. SMSF gearing is an option.

“The view that gearing should be banned with SMSFs is extreme,” Tony Rumble, founder of Alpha Structured Investments, a leading structured products provider, says. “My hope is that common sense prevails when the government reviews SMSF gearing. Yes, gearing can magnify losses and should not be used by inexperienced investors. But it is wrong to deny gearing in SMSFs to investors who can achieve a total return in excess of interest costs and accelerate wealth creation.

“The GFC has shown a lot of these abstract textbook theories about diversification and markets reverting to the mean do not work. The reality is there a lot of merit in a do-it-yourself approach that lets people tailor their SMSF asset allocations to growth assets when they see fit.

“The caveat is, investors must use leveraged products that make it easy for them to wind back share exposure if markets experience high volatility and do not have inbuilt mechanisms, such as stop-loss functions, that can force investors to sell their shares as markets bottom and crystallise losses.”

Gearing concerns have not stopped banks and other providers issuing warrants designed for SMSFs, or advisers recommending gearing strategies. Investment Trends found the number of SMSFs using gearing had more than doubled over the past two years and expects a 40 per cent rise this year. Growth is off a low base. Investment Trends’ report found 29,000 SMSFs used geared products in April 2010, up from 18,500 in May 2009 – a small fraction of the total SMSFs. That should rise to 41,400 SMSFs this year, it forecasts.

Having decided to gear, SMSFs must choose the right product. Super rules allow SMSF borrowing through a limited resource loan, where the lender’s only security is the asset purchased. Margin loans are not allowed, making instalment warrants the main option for gearing.

An instalment is a listed security that gives investors exposure to shares by making a part-payment up front and delaying an optional final payment. The advantage is the investor buys the shares for a fraction of the current price while receiving all the capital growth, dividends and franking credits via leveraged exposure. There are no margin calls. Investors pay for these benefits through interest costs. Like any geared product, instalments can magnify losses.

Investors can use instalments in their SMSFs to buy shares or, more recently, exchange-traded funds (ETFs) designed to replicate an underlying index by holding a basket of securities. Another option is self-funding instalments (SFIs), which use dividends from the underlying share to reduce the loan amount, usually over five or 10 years.

Cathy Kovacs, Westpac's head of structured equity investments, believes SMSF trustees should consider using self-funding instalments for gearing. "Self-funding instalments, by definition, are long-term set-and-forget investments that are well suited to SMSFs," Kovacs says.

"Essentially, investors use their own funds to make the first payment, which is about 50 per cent of the current share price, and borrow the rest. Interest is added to the loan each year, and dividends from the shares are used to reduce the loan amount."

Depending on the yield performance of the underlying share, this can create a positively geared investment over time, where the dividends exceed interest costs."

Kovacs says a key benefit of SFIs is no margin calls. "SMSF trustees like self-funding instalments because they are a low-maintenance, simple gearing approach that reduces borrowing levels over time." Interest on Westpac SFIs is about 10 per cent (after adding insurance) – similar to margin loans.

Kovacs also favours instalments over ETFs. "I like the diversification that ETFs offer, which is really important for SMSFs," she says. "ETFs mean investors don't have to choose stocks; they can have geared exposure to the sharemarket in their SMSF through the ETF."

Also, lower ETF fees make a big difference to after-fee returns."

Thomas Bignill, managing director of emerging wealth management firm Mason Stevens, also likes instalments over ETFs. His firm last year launched the Mason Stevens Index Magnifier instalments over several ASX-listed ETFs. "SMSFs should like ETFs for gearing," says Bignill. "When you try to pick stocks you add a layer of risk to portfolios. Borrowing to buy those stocks adds another layer of risk again. We believe we have mitigated some of these risks in our structure."

Mason Stevens' index magnifier instalments have a lock-in feature that traps 50 per cent of the gain as the market rises and can minimise losses through an inbuilt protection trigger. "Because the structure is listed on ASX, investors have liquidity and can select between growth and yield in underlying ETF investments," Bignall says.

"As economies start to show signs of life again, and equity markets grind higher, it could be a powerful strategy to gear into the sharemarket. SMSFs can now use a passive investment such as an ETF that provides diversification and they can have protection for that investment. It can be dangerous to borrow to buy shares without hedging your exposure."

Other instalments, such as those offered by Westpac, use the more traditional approach of put options to hedge downside risk. It sounds technical, but the difference between stop-loss mechanisms and put options in instalment warrants is important. Stop-losses help lower funding costs for instalments (put options cost more when markets volatility rises) but there is a risk they can crystallise losses for SMSFs if the market gaps down sharply and triggers stop-loss price levels.

Alpha's Rumble favours put options over stop-loss levels in instalments and dislikes instalments over ETFs. "I can't see the point in borrowing money to achieve the market return via an ETF" he says. "I like ETFs in the portfolio core to achieve the market return. But investors should use gearing over shares that can beat the market. The equation is simple: if you want to gear, the total return from your investment has to beat the interest cost."

WHICH TYPES OF GEARED INVESTMENT ARE SMSFS USING OR INTENDING TO USE?

Investment type	Current investors (largest outstanding balance in) %	Next wave borrowers (most likely to use)
Loan into property	41	50
Loan into shares	30	27
Loan into managed funds	9	3
Loan into capital guaranteed products	7	8
Warrants	13	13

display full story
BRW

Related News

Topics Personal Investment/Superannuation

Create an alert

Click on the links below to create an alert and receive the latest news as it happens

Topics Personal Investment/Superannuation