Growth spurt

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It's no surprise that as do-it-yourself funds have grown to become a phenomenal force in Australian superannuation, so too has an investment industry grown alongside them. It seems every product launch has self-managed super fund investors at least partly in mind.

Many new products are designed around gearing – a strategy that rather divides opinion these days.

Amendments made to the Superannuation Industry (Supervision) Act in 2007 allowed SMSFs to borrow, but with certain restrictions. That's made it the area of greatest product innovation in recent times.

The use of gearing by SMSFs is clearly increasing. Research group Investment Trends found that the number of such funds using geared investments had more than doubled in less than two years, as of April 2010, and it predicted this activity would grow by a further 40 per cent in the next 12 months.

In April 2010 some 29,000 SMSFs were using geared products, up from just 18,500 in May 2009 and 13,500 in July 2008.

The pace of upsurge does reflect the fact that it has only recently become legal to do this – it's a rapid percentage increase off a low base, and those 29,000 funds make up just 7 per cent of all SMSFs.

Even if the number of SMSFs using gearing products nears 41,000 this year, as Investment Trends expects, that's still very much a minority.

"About one in five SMSFs is interested in gearing within the super fund," says Investment Trends principal Mark Johnston. "There's a level of demand for gearing within the super fund, but at the moment the ones who want to borrow are more likely to do so on property rather than shares."

When Russell Investments surveyed planners and trustees about the possibilities of gearing in self-managed super, a very clear division in outlook became apparent. In short, advisers are more excited about it than trustees are.

In the Russell survey, two out of five advisers said they'd provided advice to trustee clients on the new borrowing rules and a further 15.7 per cent intended to do so. But 75.6 per cent of trustees said that they hadn't used the rules to borrow to invest within their self-managed fund and did not intend to do so.

The two positions aren't incompatible: planners can advise on the opportunities without trustees necessarily taking them up. But it's clear that the level of excitement about gearing goes in this order: manufacturer, planner, investor.

Even some planners have their doubts. "One of the best rules surrounding super, in my opinion, was that you generally weren't allowed to gear," says Charles Leyland, found of Leyland Private Asset Management.

"Gearing, while wonderful when the market is going well, can diminish your wealth when things are going poorly. And the last thing a retiree wants to see is wealth disappearing.

"I don't mind gearing – borrowing money to buy an investment property is not a bad thing at all," he says. "But in the self-managed super fund environment I think it's just too dangerous. The purpose of super funds is different to other investments. It's to fund retirement. You don't want to put it at risk."

Warrants are back

Still, there are many ways to achieve gearing, and products take different approaches. At the conservative end is the good old instalment warrant: buying a share in two stages but getting full exposure to the dividends and franking credits from the outset.

Instalment warrants have been around for years but have experienced something of a revival in light of the financial crisis. They are an easy way to make a tentative return to leverage – nothing complex or opaque, nothing too heavily geared, but a way to dip a toe back in the market.

Westpac, for example, has launched a range of instalment warrants, mainly using the self-funding model, for which the second instalment takes the form of a loan that's paid down by dividends from the underlying shares along the way, but on which interest accrues as well.

Cathy Kovacs has been instrumental in launching this range for Westpac, as its head of structured equity investments.

She says there are many reasons for the renewed popularity of warrants – a return to simple structures after the global financial crisis, an easy method of gearing back into the market, but also because they're eligible for use in self-managed super funds.

"The whole opportunity for gearing inside of super is opening up," Kovacs says. "We're just taking the tried-and-tested concept of buying a share in two parts, on the lay-by – half now, half later."

The sort of elaborate structured products that were commonplace before the global financial crisis haven't regained popularity, in superannuation circles or anywhere else for that matter.

"One rule I've followed in 20 years in the sharemarket is not to touch products that are too structured, with too many layers of cost," Leyland says. "I don't buy anything too complicated," he says.

The financial advisory group Implemented Portfolios takes a similar view. "Those types of products are facing an uphill battle," says its investment manager, Jon Reilly.

"With the cost and structure of those products, they're going to struggle a little bit. Our preference is for transparency, so we tend not to go for structured products."

That doesn't mean there's no role for gearing in a portfolio. "We absolutely wouldn't say no, but the key is trustee education – making sure they understand the risks they're taking and the opportunities that may be there. If you have a long enough time frame, go for it, but if it's an uninformed decision, that's where the danger lies," he says.

Why DIYs love ETFs

Outside of gearing, SMSFs have also had a hand in the growing popularity of one of the simplest products available in the market: the exchange-traded fund (ETF).

"We use them to get a low-cost diversified exposure to sectors, countries and regions," Reilly says.

These increasingly versatile instruments can be used for particular themes or ideas, as the range of products available in Australia grows.

"Asset allocation isn't just macro," he says. "There are sectors and tilts within that as well."

Reilly says there are "a few gaps in the ETF space – obviously one being around fixed interest – but within equities there's a lot of choice".

Leyland also likes them as "a low-cost method of getting exposure". They're not going to outperform or underperform the market, he says.

ETF providers themselves have certainly felt a change.

"Planners are embracing ETFs because now they can sit back and look at portfolio construction for the investor, and look at getting the correct asset allocation through these instruments – rather than through higher-cost portfolios or having to go through a lengthy process of determining the right active manager," says Drew Corbett, head of product strategy at ETF provider BetaShares.

"Once you have the sector and asset weights within a portfolio correct, you can devote more time to other needs of clients, like estate planning and tax," Corbett says.

"At a macro level, planners have a strong understanding of what sectors they believe are appropriate in a portfolio and these instruments allow them to reflect that view with a simple investment."

The gearing and ETF growth themes are linked. Corbett has noticed "a little bit of a resurgence in self-funding instalment warrants over ETFs" in light of the rules allowing selective borrowing in self-managed funds.

One of the most popular such warrants is over the S&P/ASX 200.

"One of the reasons for that is the self-funding warrants allow them to gear up and to enhance the dividend and franking outcome around a portfolio," Corbett says. "And in an ETF you get the index as a whole, meaning the volatility is lower than a single stock," he says.

It also remains diversified, by default. "The ETF actively rebalances in line with the index, so it moves towards the better-performing companies on a market-cap basis over time."

Elsewhere, there is also enthusiasm for corporate bond products, agricultural schemes (see page 24, "Going

Agricultural") and, to a limited extent, alternative investments.

But as the other asset allocation articles in this guide demonstrate, SMSF trustees are still drawn towards the familiar in the form of Australian equities and direct property. SMSFs are an outcome of savvy investors wishing to do their own thing – but having done so, they have a tendency to stick to what they know.

Going agricultural

Some more esoteric investment projects are finding their way into self-managed super funds.

Almond Investors, which has launched a tax-effective agricultural product for retail investors over the past eight years, now has a project designed specifically for self-managed funds.

Executive director Wayne Overall said at the launch: "We chose to create our 2011 project mostly for SMSFs because they would have the ability to fund ongoing obligations, avoiding the need for individuals to use their own monies or organise debt finance."

In short, the SMSF becomes its own bank to fund the investment.

Projects like this aren't for everyone – and plenty of schemes within the tax-effective agricultural sector have been attacked for failing to deliver over the years – but there's some logic in pitching such long-term projects (almond trees have a 30- to 35-year productive life) to super funds, which have the time horizon to deal with them.

"Given the longevity of Australians entering retirement, it's not an exceptionally long-time frame," Overall says.

The DIY fund becomes an almond grower, makes payments over a five-year period, receiving tax deductions along the way, and then takes 61 per cent of the harvest sale proceeds from years six to 17 (with the individual investor taking the balance), then all the proceeds up to the 30-year mark.

Overall sees it as "part of a retirement planning strategy, so that [the] investment is cash positive when they retire, therefore giving them the chance to earn annuity income during their retirement years".

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Inside fees

The fee relationship in products is interesting. It's often said, for example, that the boom in the use of exchange-traded funds has to do with the fact that fewer financial planners use a commission model these days.

But a look at SMSF advice shows this sector has moved ahead of the trend away from commissions.

According to the Russell Investments survey of planners and trustees, just 6.6 per cent of SMSF advisers were securing payment through commissions set by the product provider.

It seems SMSF investors are trailblazers in more ways than one – in doing things their own way they're also at the forefront of pay-for-advice fee structures.

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