Andrew Alcock, managing director, HUB24 Limited

Andrew has over 20 years' experience across wealth management encompassing advice, platforms, industry superannuation, insurance and information technology. He was formerly Chief Operating Officer of Genesys Wealth Advisers where he chaired the investment committee for over $8bn of funds under advice, and Head of the Genesys Equity Program, He was previously the General Manager for Asteron's wealth management business.

INTERNATIONAL MANAGED PORTFOLIOS: A GATEWAY FOR SMSFS TO INVEST OVERSEAS

In Australia, for a variety of reasons, self-managed superannuation funds (SMSFs) have traditionally avoided investing directly in overseas equities. This white paper examines why and how next generation product structures such as international managed portfolios may well change that.

Andrew Alcock

According to the Australian Tax Office's (ATO) latest data, SMSFs have generally had very little exposure to overseas assets. This could be viewed as contradictory to the fundamental principles of diversification and could also be more reflective of the unadvised or 'DIY' segment of the SMSF market. No matter what the drivers are, it's in strong contrast to the investment portfolios of Australia's retail and industry superannuation funds, which have relatively significant allocations to overseas assets.

In recent years, the rise of managed portfolios (or SMAs) has opened up the opportunity for SMSFs, and in fact all investors, to have direct ownership of international assets while enjoying the advantages of professional investment management.

With the arrival of international managed portfolios coinciding with a growing realisation of the need to better diversify investments by asset class, industry and region, a very substantial increase in direct international equity exposure may well be imminent in the SMSF sector.

Why SMSFs need international managed portfolios

Comparing the overall asset allocation to large retail or industry superannuation funds is a powerful way to see just how out of step many SMSFs are with broader industry practice, and prevailing thoughts on asset diversification. In this instance we have examined the allocations of Australia's 10 largest super funds and then compared their average exposures to that of SMSFs in the ATO report.

As the table shows, Australian SMSF asset allocations are very different to those of the country's 10 largest balanced super funds.

Some of the key points to note are:

- All of the super funds have substantial allocations to overseas equities, at 24% on average. Some have allocations as high as 34%.
- Super funds' allocations to 'other' assets, at 15% on average, include significant holdings of private equity, infrastructure and other opportunities outside of Australia.
- Super funds' allocations to cash (7% on average) and Australian equities (24%) are lower than those of SMSFs, at 27% and 31.7% respectively.

Asset allocations – smsfs vs 10 largest super funds

	SMSF	10 largest super funds – Balanced options
Australian equities	31.7%	24.0%
Managed investments (mainly domestic equities)	18.7%	
Overseas equities – direct	0.9%	24.0%
Real estate	17.0%	8.0%
Fixed income	1.8%	22.0%
Other	2.9%	15.0%
Cash	27.0%	7.0%

Sources: ATO and super fund reports.

According to the ATO, at the end of December 2015, the Australian SMSF industry consisted of over 560,000 SMSFs serving over 1 million members, with total assets of $575 billion. Less than 1% of SMSF assets were invested directly in overseas equities. This does seem an almost unreasonably small allocation: for example, SMSF exposure to international assets on the HUB24 platform on average ranges from 17–20% (which in our experience is linked to having a financial adviser). Yet, further analysis revealed that even if we allow for likely additional international exposures via ETFs, LICs, managed funds etc., the total exposure to overseas investments would probably be no more than 4%. We also recognise that some SMSFs may have a more conservative investment profile for good reason, for example if members are approaching or have reached retirement.

This was in contrast to SMSF holdings in direct investments in Australian equities, which accounted for 31.7%. Other notable investment allocations of Australian SMSFs included 17% in real estate (both residential and non-residential) and 27% in cash.

Diversification benefits of offshore investment

The benefits of investing offshore are obvious when you consider the relatively small footprint of the Australian economy in a global context. Australia accounts for only about 1% of world GDP in Purchasing Power Parity terms. Naturally this underscores the point that most of the available investment opportunities are not within Australia.

Regardless of the downward revision to global growth forecasts, there are many overseas economies that are likely to grow faster than Australia. As of late April 2016, the IMF expects that Australia's economy will expand by 2.5% in real (after inflation) terms for the year and by 3.0% in 2017.

For the world as a whole, the corresponding figures are 3.2% and 3.5%. Emerging markets in Asia are expected to grow by 6.4% in 2016 and by 6.3% the following year.

Of course, it is usually possible to find particular industries and companies that are growing faster than the national economies in which they are located. Some of those industries are not well represented on the Australian Securities Exchange (ASX), such as renewable energies and biotechnology. Investing overseas should therefore ideally provide diversification benefits, and potentially higher returns, albeit with sometimes increased levels of risk.

What are the challenges of overseas investment?

Overseas investments carry a number of risks. The more obvious one is currency risk. A rise in the Australian dollar against the currency of the overseas investment may cause a loss or, at least, reduce returns. Many foreign countries carry political or economic risks that are significantly higher than Australia. Additionally, selling overseas investments is a lengthier and costlier process than selling Australian investments. It is often much harder to find information about foreign companies than about those domiciled locally, and it is often difficult to obtain legal remedies if things go wrong.

Traditionally, the logistics of investing in overseas equities have been far more complicated than investing in domestic equities. Overseas investment has involved settlement in foreign currencies, which are normally not capable of being cleared through the ASX's CHESS sub-register.

Managed funds and the development of exchange-traded funds (ETFs) has made it easier for SMSFs to access overseas equities indirectly. For the time being, though, many platforms still offer little direct access to overseas equities.

Growing demand for managed investments

Investment Trends' 2015 Self Managed Super Fund Survey found that the number of SMSFs planning to invest in ETFs in the coming year has increased from 18% in 2014 to 21% in 2015. Similar trends are evident for SMSFs looking to hold listed investment companies (LICs) – with the number rising from 12% to 13% – and SMSFs that are interested in managed funds with the number growing from 11% to 13%. These changes still appear modest, for now.

The Investment Trends report found that many SMSFs are looking for opportunities in international shares. The percentage of SMSFs who plan to invest in this asset class in the coming 12 months is 22%. The SMSFs surveyed by Investment Trends currently held just 4% of their equity portfolios in overseas listed stocks, suggesting further upside potential for this allocation. However some of these investors may seek solutions via managed funds, ETFs and LICs. Investment Trends found that access to investments otherwise out of reach, and diversification-related benefits, particularly for international exposure, are the key drivers of managed funds use.

Furthermore, managed investments increase the focus on the fundamentals of good portfolio construction: we know that professionally managed investments help minimise risks. The implication is that SMSFs (and perhaps to a greater extent the advisers who serve them) should be open to using managed portfolios because

they provide all the benefits SMSFs have seen in direct equities, such as control and transparency. At the same time, SMSFs can benefit from the reduction in risk and ease of administration afforded by professional investment management.

In March/April 2015, within their total share allocation, SMSFs held 31% in Australian banks/financials, 21% in Australian resources/ materials stocks and 43% in other Australian shares. These figures confirm that SMSF asset allocations to shares have been skewed in favour of Australian equities, but that SMSFs, collectively, are aware of this problem and are looking for a solution.

Managed portfolios offer a number of advantages

Managed portfolios offer the benefits to SMSFs of direct asset ownership such as tax efficiency and transparency. There are many additional advantages due in part to the platform technology on which they are implemented.

For example, some platforms allow in specie transfer of assets, which can be managed by an adviser or a professional manager. This can be achieved without capital gains tax and transaction fees through some platforms. There is no reason why the benefits that managed portfolios bring to investment in Australian shares should not apply to overseas shares as well.

Crucially, there are many advantages for the advisers who work with SMSFs. Managed portfolios help advisers reduce their administrative burden and costs.

Depending on the platform, managed portfolios enjoy in-built features that can boost practice efficiency, such as responsive asset allocation and investment decisions for many clients simultaneously without the need for extraneous advice documentation. It is the portfolio manager who can quickly and easily implement changes to their strategy for all investors, potentially minimising the impact on client returns caused by inefficient trading or delays in market timing.

Managed portfolios also help reduce costs for their clients. For example, the ability to net off transactions within investor accounts can drastically reduce transaction fees, over 50% in some cases, when moving between managers with similar holdings. Without managed portfolios, if a direct international stock was purchased, advisers and clients would be responsible for responding to every corporate action announced by overseas companies. Managed portfolios transfer this task to the manager that is running the portfolio. Underpinned by the latest platform technology, managed portfolios can also minimise SMSF tax bills. Tax parcels can be held and managed at an account level and automatically select the most efficient parcel to sell when a portfolio is changed by a manager or adviser. Quick and comprehensive tax modelling also allows SMSFs and their adviser to see potential realised gains/losses before funds are switched to another portfolio or manager.

International managed portfolios set to transform SMSF asset allocation

The increasing development and adoption of international managed portfolios is revolutionising wealth management. This could result in a sizeable increase in SMSF allocations to overseas equities, and from an adviser's perspective, provide an attractive offering to help target the lucrative unadvised DIY segment of the SMSF market.

International managed portfolios remove the challenges which have impeded advisers from including directly owned international equities, particularly on behalf of the SMSFs they are working with. International managed portfolios provide a new route to overseas markets and each of the opportunities they offer.

It remains to be seen just how far SMSFs will go to rebalance their portfolios in favour of overseas equities. All SMSFs are not alike. Asset allocations and risk appetite can vary quite widely between them, which affects the demand for international equities by SMSFs. We also recognise an increasing focus on the retirement outcomes for many investors may restrict future increases in exposure. As such for now, it seems unlikely that the collective weighting of SMSFs to overseas equities will rise above 30% of total assets, the average figure for the large balanced super portfolios over the next five years.

However, it is plausible that the much lower average allocation to international equities, as evidenced by the ATO data, will trend towards 15% in the next five years, as SMSFs gain increasing awareness of greater choice on the direct side via investment structures such as international managed portfolios. **FS**

The quote

It is plausible that the much lower average allocation to international equities, as evidenced by the ATO data, will trend towards 15% in the next five years.

At a glance: the benefits of managed portfolios

- Tax minimisation benefits via the ability to select quick and comprehensive tax modeling options
- A combination of the benefits of direct asset ownership with professional investment management, which offer greater transparency than a managed fund
- In specie transfers, both inwards and outwards where possible
- Dividends from underlying securities flow directly to the SMSF/investor
- Reduced administrative burden and costs for both advisers and clients
- Improved adviser practice efficiency