

## The Benefits and Uses of ETFs for the SMSF Investor

The unique attributes and benefits of Exchange Traded Funds (ETFs) appeal to both institutional and individual investors. Typically structured like mutual funds, but listed and traded on an exchange like stocks, ETFs are flexible trading and investment vehicles that can be used to help the Self Managed Superannuation Fund (SMSF) investor satisfy a number of critical investment needs. As of 1 January 2011 there were 40 ETFs trading on the Australian Securities Exchange (ASX) representing over \$4.5 billion in funds under management (FUM).<sup>1</sup> The largest provider in terms of ETF market share with 71% of FUM, and the most experienced ETF manager with 10 years in the Australian marketplace, is SPDR<sup>®</sup> ETFs by State Street Global Advisors.<sup>2</sup>

### RISK AND THE SMSF INVESTOR

Managing one's own retirement assets requires thoughtful consideration and careful planning. Planning begins with assessment of one's retirement savings goals – such as how many years until you retire? How much will you need to have saved by then? How much can you save each month to reach your goal and what are some reasonable expectations for returns in the coming years? All these issues are intertwined and the answers will vary widely from investor to investor. We will focus on one important factor that will help our efforts and drive our current discussion on equity ETFs in Australia – and that is risk.

An investment in equities represents fractional ownership in real companies and carries with it all the risks and potential rewards of owning any business. In terms of the risk scale, equities lie on the riskier end of the spectrum when compared with bonds. Generally speaking, the longer an SMSF's time horizon, the greater the risks it can take. In other words, if your SMSF still has many more accumulation years ahead, its portfolio can afford to take on increasingly risky investments. This is simply because potential losses in the short term may be made up in rebound years that will likely follow during recovery years. Whereas if an SMSF has a short time horizon, a bear market lasting several years could seriously damage its member's prospects of retiring on time with sufficient funds saved. A fund with 10 or more years until maturity will usually be considered to have a long time horizon. A fund with less than 10 years until maturity will be said to have a short or medium term time horizon.

In addition to time horizon, as a general rule the greater one's current retirement assets are and the greater one's ability is to save in the coming years is, the greater one's investment risk appetite will be. For similar reasons, if one is closer to reaching one's savings goal and if that person is also able to save more towards retirement, then their ability to brush off potential short term losses can allow them to take on greater investing risks.

A long time horizon and ample savings will generally mean that an investor will be able to invest in higher risk assets, with potentially higher returns, including investments such as stocks and ETFs based on stocks. Whereas investors nearing retirement, perhaps with less than ample assets, will need to reduce risk as well as the returns they can expect to make. SMSF investors who are able to invest in equities must be educated about the different options available to them in the marketplace. Further, they should weigh up the many factors that may determine which investment vehicles are most appropriate for them. These factors can include ease of access, associated fees and expenses, ability to attain proper diversification at a reasonable cost and adequate transparency to make intelligent and timely portfolio decisions.

## THE BENEFITS OF ETFs

ETFs are investment funds that trade just like stocks. They are referenced via a single ticker on an exchange like the ASX, but represent a broad index of assets such as the 200 largest Australian stocks by market cap in the case of the SPDR<sup>®</sup> S&P<sup>®</sup>/ASX 200 Fund (ASX:STW). An ETF will trade at or close to its net asset value (NAV) and is available to be bought or sold whenever the exchange itself is open for business. As they can for stocks, investors may use limit orders to buy or sell ETF shares at desired levels, or stop orders to insure against losses beyond some unacceptable limit. An investment in a managed investment scheme does not offer the benefit of continuous trading. Also unlike managed investment schemes, the holdings of most ETFs are fully

transparent and posted daily. This full disclosure enables investors to make more informed portfolio decisions with greater accuracy. ETFs often have lower costs and fees than comparable managed investment schemes due to their lower overhead and staffing costs. But even beyond straight fees and expenses, ETFs are generally more tax efficient than their managed investment scheme counterparts. Managed investment schemes are subject to unit holder turnover that often results in the selling of fund holdings and in turn the distribution of capital gains. These capital gains will result in taxes that are absorbed by all unit holders. ETF holders can decide when to sell their shares and any associated capital gains taxes are paid at the time of final sale, offering greater control on the timing of tax consequences.

**TABLE 1: COMPARING ETFs TO MANAGED INVESTMENT SCHEMES AND INDIVIDUAL STOCKS**

	ETFs	MANAGED INVESTMENT SCHEMES	INDIVIDUAL STOCKS
PRICING	ETFs trade all day long at their market price, just like stocks. Investors buy and sell shares continuously throughout the day. Captures the precise movement of market at time of purchase/sale.	Managed investment schemes are priced at the end of the trading day. Shareholders purchase and redeem shares at the closing value of the fund. The price or net asset value (NAV) is the value of the fund's assets, less liabilities, divided by the total number of shares outstanding. The closing value of mutual fund shares is calculated at end of trading day.	Market price, capturing the precise movement of market at time of purchase or sale.
TAX CONSEQUENCES	The investor decides when to sell ETF shares, and any associated capital gains tax is paid at the time of final sale, offering greater control on the timing of tax consequences. <sup>1</sup>	In order to meet the redemptions of individual shareholders, the fund may have to sell underlying securities, thus triggering capital gains distributions. Taxes on those gains are absorbed by all shareholders in the fund.	The investor decides when to sell individual shares, and any associated capital gains tax is paid at the time of final sale, offering greater control on the timing of tax consequences.
FEES AND EXPENSES	Due to lower turnover and staffing costs, the average expense ratio for ETFs is significantly lower than that of index managed investment schemes. As of February 2011, STW's expense ratio is running at 29 bps per annum. <sup>2</sup>	Managed investment schemes historically have had a higher average expense ratio due to greater overhead costs. <sup>2</sup>	Fees and expenses for a small retail portfolio can make up a larger proportion of total assets.
MINIMUM INVESTMENT	With ETFs, there is no minimum investment requirement. <sup>3</sup> An investor can purchase as few as one ETF share or as many as is preferred.	Managed investment schemes may require investment minimums.	Individual stocks do not require a minimum investment.
DIVERSIFICATION	ETFs can deliver a portfolio of well-diversified investments.	Managed investment schemes can deliver a portfolio of well-diversified investments.	It is costly and requires significant resources to research, assemble and rebalance a diversified portfolio of equities.
TRANSPARENCY	The securities held within most ETFs are posted daily allowing investors to make informed portfolio decisions real time.	Managed investment schemes only release their holdings quarterly. Leaving investors without the ability to accurately analyze their holdings.	Individual stock holdings will be transparent.

Source: SSgA, 31 January 2010.

<sup>1</sup> However, changes in an ETF's underlying index could trigger the sale of securities which, in addition to transaction costs, may trigger capital gains distributions. In this scenario, any realised gains or losses are passed on to ETF shareholders. To ensure tax efficiency, ETF managers attempt to limit these types of transactions as much as possible.

<sup>2</sup> Morningstar, Bloomberg.

<sup>3</sup> Subject to brokerage rules/costs/ fees.

All of these factors make ETFs one of the cheapest, most simple, most tax efficient and most easily accessible investments in a well-diversified basket of equities for the SMSF investor.

### SUPERANNUATION

Superannuation is a tax-incentivised retirement savings program in Australia where employers are required by law to make contributions to a complying superannuation fund for an employee's benefit. The Australian managed funds landscape is dominated by superannuation funds. According to the Australian Bureau of Statistics, managed funds assets totaled \$1.8 trillion at the close of Q3 2010 with \$1.24 trillion being managed by Superannuation funds. Also at the close of Q3 2010, the Australian Prudential Regulation Authority (APRA) stated there were 434,661 superannuation funds in operation. (See Table 2).

The five main types of superannuation funds:

- **Corporate fund** - These offer membership to employees of a company.
- **Industry fund** – These usually cater to workers from a particular industry or trade group.
- **Public sector fund** – Public funds are only available to public sector employees.
- **Retail fund** - Financial institutions such as banks, financial planning groups and fund managers run retail super funds. These funds are open to all investors.
- **Small funds** – Funds with fewer than five members that fall into two categories.
  - 1) **Small APRA funds** – unlike SMSFs the trustee is an approved trustee firm, not the members of the fund, and these are regulated by APRA.
  - 2) **SMSFs** – generally the trustees of the super fund are the fund members themselves and they are regulated by the Australian Taxation Office (ATO).

During Q3 2010, 422 large APRA superannuation funds accounted for \$830.60 billion in assets. The number of funds was down 7.7% from one year prior in 2009.<sup>3</sup> This decline is just the latest, in a larger, longer term decline of the number of large APRA providers in the superannuation industry. Fee compression and the changing landscape of the superannuation industry brought about by SMSFs have caused widespread consolidation. Most experts agree that this trend will continue.

### SMSFS

SMSFs (or do-it-yourself [DIY] superannuation funds) account for 33% of all superannuation assets in Australia, with over \$400 billion in assets, and are growing at a rapid pace.<sup>3</sup> SMSFs provide its members with control over the range of their investments, the fees being charged, the amount of tax being paid and the ability to include other family members in the fund.

The most recent Cooper Review (Super System Review, published June 2010) of SMSFs advised that the average DIY super fund had \$860,000 in assets, usually only one or two trustees, and an average operating cost of 0.86% per annum in 2008. The average expense ratio of the entire superannuation industry (including SMSFs) was approximately 1.2% in 2008. Although SMSFs tend to have lower operating costs, they lack the heft and resources of their large superannuation fund counterparts. Indeed the Cooper Review went on to point out that the value proposition of lower fees and greater control were central factors for the vast majority of investors who decided to start their own SMSFs. ETFs can add immense value by providing SMSFs with a well diversified, low cost, and easy to understand asset allocation, tax management portfolio rebalancing and transition management tool.

**TABLE 2 - SUPERANNUATION INDUSTRY QUARTERLY ESTIMATES**

	ASSETS (\$ BILLION)					NUMBER OF ENTITIES				
	SEP 2009	DEC 2009	MAR 2010	JUN 2010	SEP 2010	SEP 2009	DEC 2009	MAR 2010	JUN 2010	SEP 2010
BY FUND TYPE										
CORPORATE	59.0	59.9	60.9	56.3	58.0	186	171	171	168	162
INDUSTRY	209.8	218.8	226.6	225.6	237.7	67	65	65	65	65
PUBLIC SECTOR	167.1	172.7	177.4	173.4	181.9	40	39	39	39	39
RETAIL	337.0	345.7	351.2	339.2	352.9	164	154	154	154	156
<b>SUB TOTAL</b>	<b>772.9</b>	<b>797.0</b>	<b>816.0</b>	<b>794.5</b>	<b>830.6</b>	<b>457</b>	<b>429</b>	<b>429</b>	<b>426</b>	<b>422</b>
SMSFS <sup>a</sup>	372.4	387.7	401.1	389.7	408.1	407,563	413,753	420,262	427,491	434,239
<b>TOTAL<sup>b</sup></b>	<b>1,145.3</b>	<b>1,184.7</b>	<b>1,217.1</b>	<b>1,184.2</b>	<b>1,238.7</b>	<b>408,020</b>	<b>414,182</b>	<b>420,691</b>	<b>427,917</b>	<b>434,661</b>

Source: Extracted from Statistics, Quarterly Superannuation Performance, September 2010, Australian Prudential Regulation Authority.

<sup>a</sup> Estimated data on self-managed superannuation funds are provided by the Australian Taxation Office (ATO).

<sup>b</sup> Total assets does not include pooled superannuation trusts and excludes Small APRA Funds, Single-member ADFs and Balance of life statutory funds.

## USES OF ETFs FOR SMSFS

### ASSET ALLOCATION AND THE CORE-SATELLITE APPROACH TO INVESTING

Experienced SMSF investors are discovering what institutional investors have known for some time: asset allocation, not security selection, can help drive long-term investment results. Asset allocation refers to the selection of an appropriate asset mix (e.g. 70% stocks and 30% bonds) that will differ for each investor depending on their ability to take on risk. Asset allocation strategies have historically been difficult for many SMSF investors to implement, given the cost, research efforts and asset size required to achieve an appropriate mix and a proper level of diversification. However, since their launch in 2001, the STW and SFY (SPDR S&P/ASX 50 Fund) ETFs have been good choices for investors wishing to gain broad based Australian stock market exposure through low cost, easily accessible exchange traded products. These ETFs can form the passively managed equity "core" of a SMSF investment portfolio that has the ability to take on equity risk. Allowing a significant share of an SMSF portfolio to be invested in a passive vehicle like an ETF, can help the members avoid costly fees and expenses associated with investing with an external manager. In addition investors can save valuable time and resources necessary to research a plethora of possible investments and come up with a well-diversified portfolio on their own.

Despite investing part of the portfolio passively, core-satellite investors do not totally rule out the possibility of investing in good ideas they are able to uncover on their own. They can then take the remainder of their investable assets and invest in "satellite" positions in the hope of generating "alpha" or excess returns.

As an example, let's say a particular SMSF has set its current asset allocation at 80% equities and 20% fixed income. Within the equity portfolio, the SMSF's members decide that they would like to have passive exposure to the returns of the ASX 200 and invest half of the 80% equity allocation in their passively managed core holding in the STW ETF. The remaining 50% of the equity portfolio will be dedicated to investments in early stage public companies in the renewable energy field. The members of the SMSF currently make their living as engineers in the renewable energy industry and have high levels of technical knowledge and expertise. While the members are very hopeful for the future prospects of renewable energy in our future, they realise that short term volatility in the sector could severely impair the value of the portfolio. For this reason they have chosen a core and satellite approach that can enable the fund to mitigate risk by being invested in a basket of diversified Australian equities, while still attempting to make excess returns in an area where they feel their research and experience may give them an edge.

## TAX MANAGEMENT

Although ETFs are tax efficient vehicles that allow investors to time tax consequences of capital gains, they can also be utilised to help SMSFs in accumulation mode minimise their tax bills in other ways. ETFs are able to do this by passing through franking credits from the dividends it receives from constituent companies.

Investors holding the STW ETF on and around the two distribution dates (June and December) could receive valuable franking credits along with the dividends. Franking credits represent company taxes already paid on corporate profits and can be passed along to shareholders with normal dividends as an "IOU" from the tax office. This credit in essence eliminates the double taxation of profits at both the corporate and personal level. Eligible shareholders are those who can demonstrate they have held the security for a continuous period of 45 days or who have less than \$5,000 in franking credits for the current tax year (the small investor exemption).

Let's illustrate this with an example. An ETF with a franking rate of 25% across its constituent's dividends pays a franked dividend of \$0.75 plus a \$0.25 franking credit. The \$0.25 franking credit represents the taxes corporations have already paid and that do not need to be paid again by eligible investors. This combination of dividend and credit is exactly equivalent to an unfranked dividend of \$1.00. Although an unfranked \$0.75 dividend would normally result in a \$0.11 per share tax bill (at an SMSF's 15% accumulation year tax rate), due to the \$0.25 franking credit the SMSFs will actually receive a \$0.10 rebate making the franking credit act very much like a negative tax. As at 31 December 2010, the STW ETF distributed \$0.78 per share in dividends, 79% of which were franked at a rate of 31.5%. This amounted to a \$0.28 per share franking credit or a \$0.12 per share rebate to an SMSF investor in the 15% tax bracket of an accumulation year.

## REBALANCING

As investors near retirement they may choose to position their investments more conservatively and opt for a higher yielding equity ETF such as the SPDR MSCI® Australia Select High Dividend Yield Fund (ASX:SYI). Or if an investor would like additional diversification in high yield property related stocks they could employ the SPDR S&P/ASX 200 Listed Property Fund (ASX:SLF). Or investors could simply opt to reduce their equity exposure altogether, which ETFs allow at any time. The targeted exposure and deep liquidity of ETFs allows for the simple implementation of periodic portfolio rebalancing. At its most basic level this will involve buying or selling ETFs, individuals stocks and bonds in relatively small amounts to re-establish the fund's predetermined asset allocation and core-satellite positioning. Rebalancing for ETFs

is as easy as buying or selling a few shares of stock however SMSFs that invest with managed investment schemes may find rebalancing more difficult because of restrictions and fees on short-term buying and selling of units.

As an example, a SMSF nearing maturity may want to reduce its holdings of large cap stocks opting for stocks of companies paying high dividends. If the SMSF had used a large cap equity managed investment scheme, the scheme may have a minimum holding period or apply fees for liquidating these positions. The SFY ETF that tracks the S&P/ASX 50 Index on the other hand has no such trading impediments making it an optimal vehicle for rebalancing large cap equity holdings. The institution could freely sell its investment in SFY and use the proceeds to buy SYI, for example.

#### **TRANSITION MANAGEMENT**

ETFs can provide a ready, liquid and low cost investment to help bridge the gap between two other investments. If an SMSF redeems from an external manager or some other investment, and plans to roll the proceeds into a new investment that it has not decided on yet, an ETF could be used as a temporary placeholder for those assets. An example of this transition management process could involve an institution choosing to reduce its large cap equity exposure in order to take advantage of opportunities it is seeing in the commercial real estate sector. After liquidating the fund's equity holdings the fund then has the choice of immediately investing in an ETF such as STW or SFY which will continue to hold its place in large cap equities, or it could opt to invest in SLF to approximate the returns of its new real estate investment until it can be finalised.

#### **CONCLUSION**

SMSFs are at the cutting edge of retirement planning for individual investors in Australia as the government attempts to spur its citizens to become more involved in the process. SMSFs however must be careful to recognise the double-edged nature of this control. With greater control comes greater responsibility. SMSF trustees have proudly accepted this mantle and have shown that with the proper encouragement and training, managing one's own retirement assets can be a cost-effective and financially empowering undertaking. ETF use amongst SMSFs has grown in recent years because investors have realised the immense value proposition of an easy to access, low cost and tax efficient tool to attain equity diversification through a single investment. Through the continued use of ETFs as asset allocation, tax management, rebalancing and transition management tools their usefulness to the SMSF investor should only grow in the years to come.

#### **ABOUT SPDR EXCHANGE TRADED FUNDS**

Offered by State Street Global Advisors, SPDR ETFs are a family of ETFs that provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognised as an industry pioneer, State Street Global Advisors created the first ever ETF in 1993 - the SPDR S&P 500<sup>®</sup>, which is currently the world's largest ETF. In 2001, SSgA introduced ETFs in Australia when it launched the SPDR S&P/ASX 200 Fund and the SPDR S&P/ASX 50 Fund. Currently, State Street Global Advisors manages more than US\$250 billion of ETF assets worldwide.\*

**For more information about our ETFs or how to invest, please call +61 2 9240 7600 or email [info@spdrs.com.au](mailto:info@spdrs.com.au).**

\* This AUM includes the assets of the SPDR Gold Trust (approx. US\$58 billion as of December 31, 2010), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors serves as the marketing agent.



<sup>1</sup> ASX LMI Report 31 December 2010.

<sup>2</sup> Bloomberg; ASX LMI Report 31 December 2010.

<sup>3</sup> Extracted from Statistics, Quarterly Superannuation Performance, September 2010, Australian Prudential Regulation Authority.

All currency is in Australian dollars, unless otherwise stated.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not ensure a profit or guarantee against loss.

Passive management and the creation/redemption process can help minimise capital gains distributions. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.