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SUPER STRATEGY FOR WEALTH CREATION using self funding instalments

Now that summer is coming to a close and the children are back to school many of you will turn your attention to your investment portfolios. For many that cashed out of the market in the desperate early days of 2009, now is the time to plan and execute a successful and risk appropriate investment strategy for 2010 and beyond. Whilst it appears that the worst of the global financial crisis (GFC) is behind us the effect of reductions in stimulus spending remains a risk for the market. Nonetheless, many analysts are still predicting low double digit returns for the share market this calendar year which certainly beats highly taxed cash returns.

The reputation of leveraged and gearing strategies was battered during the GFC and many investors have shied away from any strategy considered risky. However, leverage can be a very useful tool to enhance your returns when used properly and judiciously. Investors with self managed super funds are eligible to gear using instalment warrants.

A warrant is a structured financial instrument issued by a bank or other financial institution, traded on ASX. Warrants provide investors an alternative way to gain exposure to a variety of underlying assets, such as shares.

FEATURES OF TRADING INSTALMENT WARRANTS

Generally, the purchase of an instalment warrant gives the investor the right to buy the underlying asset with an initial part payment and an optional final payment. Key features of instalments are:

- The holder is entitled to all dividends, distributions and franking credits similar to share ownership.
- Generally issued between one to 15 years by a financial institution.
- Tradeable on-market (ASX) through a broker.
- Offered over 'blue chip/Top 100' ASX listed securities including shares, listed investment companies and exchange traded funds.
- Eligible form of gearing in self managed super funds (SMSFs).

In the 2009 Budget, the Federal government halved the amount of concessional contributions that high income earners could put into superannuation which affected the plans of many Australian investors. This coupled with the effects of the GFC has left many investors looking at ways of enhancing their retirement portfolios' return.

Years ago the only way to leverage your superannuation investments was to invest in an internally geared managed fund or to buy instalment warrants. Though gearing in super for property investment is now possible the costs of creating the required Trust structure and related documents can be quite expensive. The new generation of instalments warrants seem to be an ideal vehicle to enhance returns and achieve an effective superannuation gearing strategy.

These new SFI's offers the same benefits as the traditional SFI. However, some structural changes have expanded its applicability to virtually all equity investors, making warrants more simple, cost effective and transparent. The loan associated with these SFI's is non-recourse allowing safer leverage and suitability in SMSF's, with an interest rate which is often below those offered by margin lenders.

BENEFITS OF INSTALMENTS

Instalments offer investors many benefits and strategies including:

- Leverage and diversification
- Enhanced dividend yield (compared to shares)
- Unlocking wealth from existing shareholdings
- Application within self-managed super funds (SMSFs)
- Smaller initial outlays through partial payment upfront
- Known and limited downside risk through the use of stop loss orders
- Excess franking credits can be refundable for SMSFs
- Potential taxation benefits - Investing in SFI's rather than shares ➤

investment insight

can accelerate the number of excess franking credits that can be used to offset the tax liability in earnings and contributions tax for a SMSF

- Interest expenses are tax deductible
- Tradeable on ASX

SUPER STRATEGY – THE POWER OF INSTALMENTS IN SMSF'S

Instalment warrants are one of the few products that allow investors to obtain the benefits of gearing within a self managed superannuation fund (SMSF).

Apart from the benefits associated with gearing, interest deductions and enhanced franking credits generated, instalments can be used to reduce earnings and contributions tax liabilities payable by a SMSF.

Due to the low tax environment and with the excess franking credit benefits, SMSFs can receive enhanced returns using self funding instalment warrants. The following is an example where an investor purchases \$20,000 of CBASZV (LVR 51%) in their SMSF while in the 'accumulation phase' with earnings taxed at 15%. We compare against investing the \$20,000 into a direct shareholding of Commonwealth Bank.

TABLE 1. THE ACCUMULATION PHASE EXAMPLE

Comparison of Investments		\$20,000.00
	CBA Investment	CBASZV Investment
ASX Code	CBA	CBASZV
Instalment Price	\$51.75	\$25.59
Number of Instalments	386	782
Cash Dividends#	\$881.16	\$1,781.95
Franking Credits#	\$378.02	\$764.45
Total income	\$1,259.18	\$2,546.40
Deductible Funding Costs++	\$0.00	\$1,364.77
Taxable income	\$1,259.18	\$1,181.63
Tax Payable at 15%	\$188.88	\$177.24
Franking Credits to apply	\$378.02	\$764.45
Excess Franking Credits	\$189.14	\$587.21
CONTRIBUTIONS TAX BENEFIT	\$1,260.94	\$3,914.73

Source – RBS Instalments

as at 1 Oct 2009 for 12 months and based on RBS forecast dividends.

++ Interest Rate is variable. For illustration we assume a Interest Rate of 7.51% with 5.85% deductible based on current RBA Indicator Rate as at 31/10/09.

As demonstrated, if a SMSF invests in \$20,000 of CBASZV in preference to CBA, they can achieve an additional \$2,653.79 in contributions tax benefit. This can be used to offset tax payable against other contributions in the fund. Any excess franking credits that cannot be used within the current financial year are refundable by the ATO. These tax benefits effectively increase your returns.

THE ALLOCATED PENSION PHASE EXAMPLE

If the SMSF is now in the 'Allocated Pension Phase', there would not be any tax liability and the interest expense will not be allowable as a deduction. However, since the Fund does not have a tax liability the enhanced franking credit stream is redeemable from the ATO in cash.

TABLE 2. THE ALLOCATED PENSION PHASE EXAMPLE

Income	
Dividend income from CBASZV	\$1,781.95
Franking income from CBASZV	\$764.45
Subtotal	\$2,546.40
Expenses	
Interest costs for 12 months	(\$1,753.01)
Net Income	\$793.39

In Table 2 we can see that the fund in the allocated pension phase, will receive \$764.45 (the franking credits shown in line B) back from the ATO. As a result, the cash flows associated with the Instalment strategy can be illustrated as 'expenses' and 'income' as shown in Table 2.

The CBASZV Self Funding Instalments strategy is positively geared, with more money coming in the form of cash and franking income than is going out in the form of expenses. Income is still being derived in the form of franking credits and the investor is gaining greater exposure to any potential capital growth.

RISKS OF INSTALMENTS

Instalments are issued by a number of different investment banks. Each Instalment is unique. Therefore, it is important that you read each instalment product disclosure statement to ensure you have a proper understanding of gearing, dividends and the relationship to the underlying asset.

Hopefully, this article has provided some insight into a conservative gearing strategy that might help you to enhance your superannuation investment returns.

The warrants example used in this article are issued by RBS Group (Australia) Pty Limited. The Product Disclosure Statements relating to these warrants are available upon request from 2020 DIRECTINVEST website – latest offers section.

At 2020 we are looking forward to continuing to serve the investment needs of ADA members in 2010 and we look forward to providing you with low cost access and educational materials for a range of innovative investment products.

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