

EUREKA *report*



Investment Road Test: Quantum Instalment Warrants

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PORTFOLIO POINT: Quantum Warrants offers SMSF investors a way to conservatively gear their portfolios into the coming market growth.

One of the most pleasing and valid signs of “green shoots” in the Australian financial markets is the reopening of many traditionally available products and services to retail investors. It was the bursting of the credit bubble that pre-empted the GFC, so it’s been no wonder that most forms of investment gearing have been in limbo for much of the past year.

Margin lenders have wound back the range of investments they can lend on and have increased both the rates and levels of capital required to be contributed. Protected lenders offering put option-backed, 100% finance loans are struggling with exorbitant rates (as the cost of protection stays high). Many traditional instalment warrant providers have closed their offerings or have moved to a new, riskier (to investors) product line. The remaining few providers that continue to provide traditional-style, ASX-listed instalments (see **last week’s column**) offer significant benefits to investors looking to gear their SMSF portfolio.

A new player, **Quantum Warrants**, has recently emerged with an unlisted instalment warrant offering that is even simpler to understand and price than traditional ASX listed instalments.

At the height of the last bull market, tax and regulatory authorities got very excited about the emergence of gearing facilities being targeted at SMSFs with real estate assets. Some of these were promoted as ways of getting SMSF tax rates down (potentially to 0% tax) using the interest expenses on the loans to generate tax deductions.

That led to the Australian Prudential Regulation Authority and the tax office review that prompted the “Dutton Reforms” in 2007, which legislated explicitly to allow “limited recourse” gearing by SMSFs. The reforms are enshrined in section 67 4A (d) of the Superannuation Industry Supervision Act (“SIS Act”), which carves out from the general prohibition on super funds borrowing, a borrowing where:

67 4A (d) the rights of the lender against the (Regulated Superannuation Fund) trustee for default on the borrowing or on the sum of the borrowing and charges

related to the borrowing, are limited to rights relating to the original asset ...

So it's the design of the security structure that allows SMSFs to use gearing products. The logic is that, so long as the gearing is linked to the specifically secured investment, any losses under that geared investment can't flow through to the rest of the SMSF fund. This is entirely consistent with the design of the SIS Act, which primarily restricts the "charging" of the general assets of the fund. (The government doesn't want funds to blow up after enjoying potentially years of concessional tax rates, dropping the investor back into the welfare net).

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The Quantum Warrant approach relies on the SIS Act to allow it to take security over the investor's geared asset/s, but with a limited recourse loan that complies with the SIS Act requirements. The magic in the Quantum product is that it does not involve the cost of the usual type of lender protection used in instalment warrants, where the issuer/lender buys a put option to cover itself in case the investor/borrower defaults.

Even though 50%-geared instalments don't create the same risk as higher gearing levels, the cost of a 50% or so put option can still be relatively high after the GFC, translating into total costs for traditional instalments that can be diseconomic.

Instead, Quantum Warrants involve a form of margining whereby a preset "stop loss" level is imposed, such that if the share price falls below that level, the investor will be required to either make a top up cash injection, or Quantum will sell down stocks to refresh the loan to value ratio. So the lessons of overly high margin gearing levels need to be heeded: use low gearing levels and make sure you have the surplus cash to cover these margin calls in down markets!!

Like traditional instalments, Quantum Warrants use a security trustee to hold the investment prior to the loan being repaid, such that the investor retains full beneficial ownership of the investment and the trustee acts simply as custodian. This means that all dividends and franking credits flow through to the investor. The Quantum security trustee is an in-house entity and is specifically prohibited by the transaction documents from dealing with the investments without the investor's written consent (unless there has been a default).

To ensure there can be no repeats of the Lift Capital or Opes Prime debacle, the security trustee is specifically prohibited from engaging in securities lending. With current interest rates of 8.6% and a huge menu of managed funds and listed shares to choose from, the Quantum Warrants approach will be very attractive to SMSF investors looking to conservatively gear into coming market growth.

The score: 3.5 stars**0.5 Ease of understanding/transparency****0.5 Fees****0.5 Performance/durability/volatility/relevance of underlying asset****1 Regulatory profile/risks****1 Innovation**

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