Cuffelinks
Connecting investors with ideas

Edition 195, 24 March 2017

This Week's Top Articles

Four things retirees must know about shares

Dr Don Hamson

Aussie retirees have a love affair with shares, but not all share portfolios are created equal when it comes to providing sustainable income. This article focusses on the four things that pension-phase investors need to consider when investing in equities: tax, income, growth and regulations.

1. Tax matters – but not in the way you think

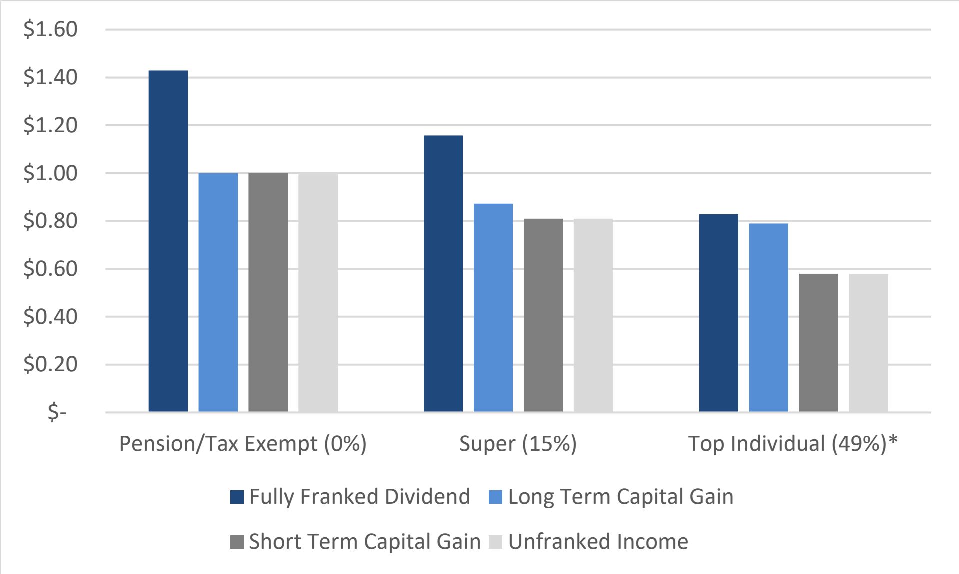
Retirees have different needs to accumulation phase investors, and tax is one of the big differences. In particular, the role of franking credits is crucial, while capital gains tax is not an issue at all.

One failure of the Australian investment industry is that franking is largely invisible, with investment returns conventionally reported pre-tax, excluding franking. For a pension-phase investor, the difference is significant.

Chart 1 highlights the tax differences between pension, super and the highest individual tax rate. For the pension investor, $1 of pre-tax capital gain (short or long term) or unfranked income (interest, rental, overseas dividend, unfranked dividend) is worth $1. However, $1 of fully franked dividend is worth $1.43 since the pension investor gets a $0.43 franking credit refund. Franked dividends are also worth the most for super investors at $1.21, with long-term capital gains worth $0.90 whilst the other two returns are worth $0.85.

This clearly highlights why taxed investors would prefer low turnover strategies to reduce the time value of capital gains tax (CGT). However, for pension investors there is no cost to realising or delaying realising a capital gain, as they pay no CGT. So the common perception that low turnover strategies are tax efficient is not correct for pension investors.

Chart 1. The after-tax value of $1 of pre-tax return



Source: Plato, ATO using current tax rates, including Medicare and Federal Deficit Levies

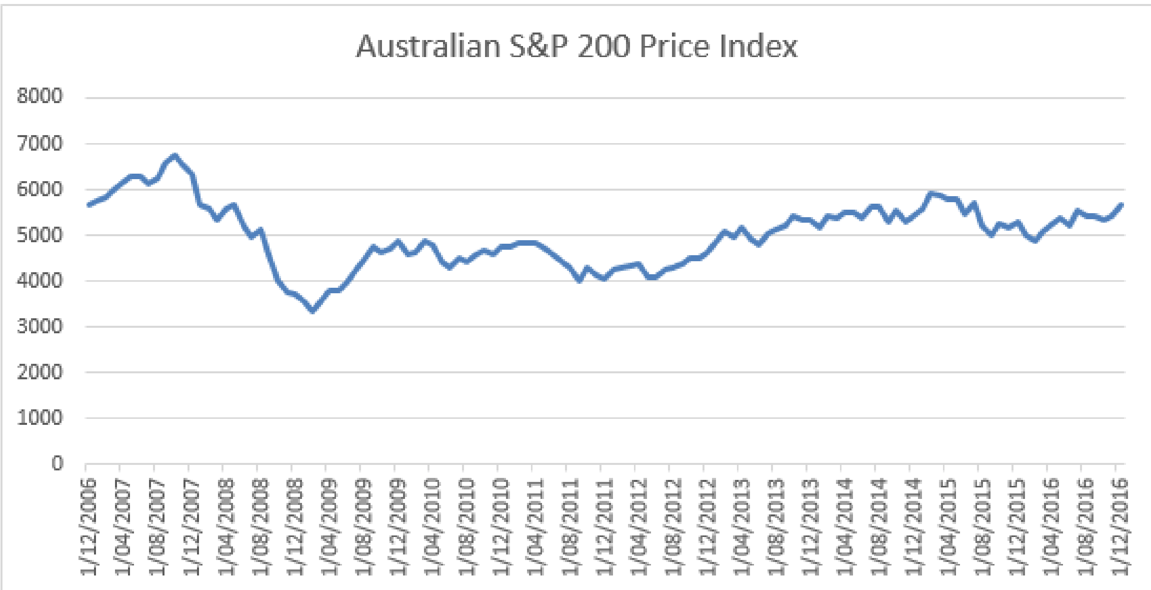
2. Income matters – and so do franking credits

Retirees have different needs to accumulation phase investors. They need income to live off, are likely to be less risk tolerant than working investors, and their pension income is tax free.

This should be reflected in both the design of retirement-phase products, and in the way they're measured. Generally, income returns are calculated without regard to tax or franking credits, while observations that Australian shares have suffered from a 'lost decade' of poor returns don't give sufficient credence to the income generated.

On its own, price growth of Australian shares is underwhelming. Over the 10 years to the end of 2016, the ASX/S&P200 price index has tracked predominantly sideways, as highlighted in Chart 2. In price terms, it still hasn't returned to its pre-GFC highs recorded on 1 November 2007.

Chart 2. Australian shares over the past 10 years to 31 December 2016



Source: S&P

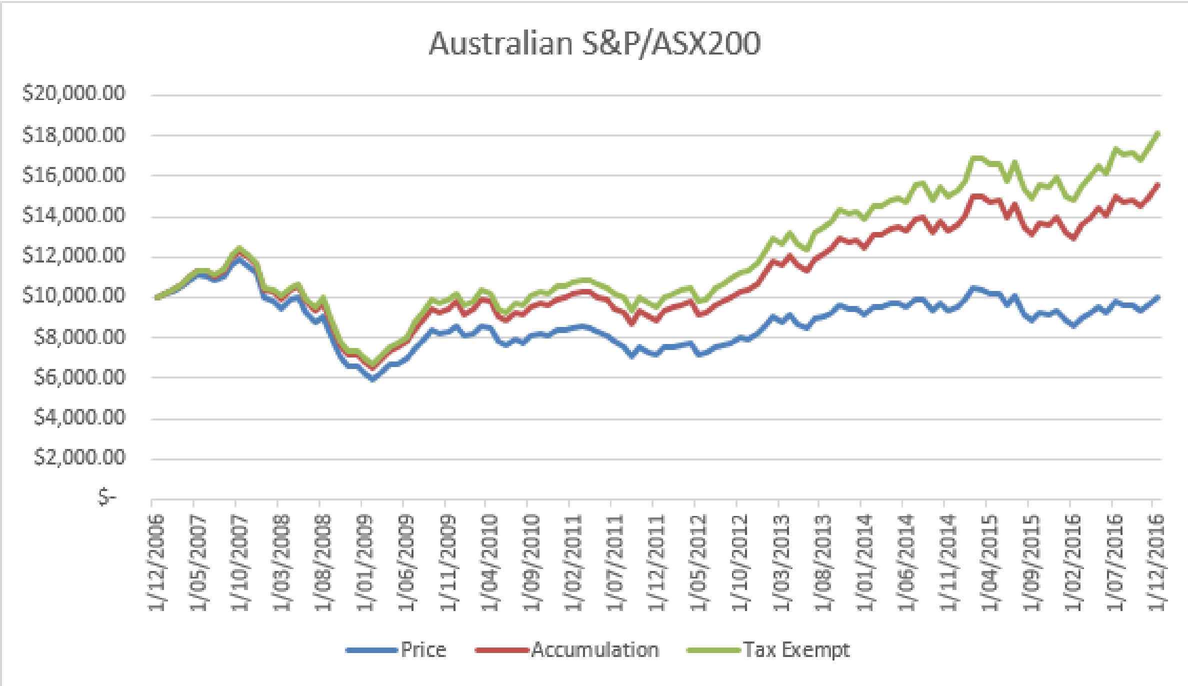
But equity investing is not all about capital growth. When dividend income is added, the Australian ASX/S&P200 has actually returned 4.5% p.a. over the 10 years to 31 December 2016. Not a great return, in our opinion, but certainly better than the capital growth suggests. The official overnight cash rate averaged 3.8% p.a., whilst the average 1 year term deposit interest rate averaged the same 4.5% p.a. as the dividend yield over the same 10-year period.

However, the 4.5% p.a. term deposit income didn't include franking credits, which the dividend income stream did. Australian pension phase superannuation investors get a full refund of franking credits, so franking credits represent extra income.

Using the S&P/ASX 200 Franking Credit Adjusted Annual Total Return Index (Tax-Exempt), the total return for tax-exempt investors like pension-phase super, charities and low income Australian investors increased by 1.6% p.a., giving a tax exempt total return of 6.1% p.a., over the 10 years.

Chart 3 highlights the differences in index returns including franking for tax exempt investors.

Chart 3: Australian S&P/ASX200 cumulative returns with and without dividends and franking credits – 10 years to 31 Dec 2016 based on investment of AUD$10,000.



Source: S&P. Price = return on Australian S&P/ASX200 Index; Accumulation – return on S&P/ASX200 Accumulation Index; Tax Exempt = return on S&P/ASX200 Franking Credit Adjusted Annual Total Return Index (Tax Exempt).

Dividend income and franking credits are an important part of the total return for share investments. For the 10 years to 31 December 2016, income has represented all the return from Australian S&P/ASX200 Index.

Many investment products aren't structured to distribute regular income, and in the current low interest rate environment we believe many traditional cash, bond or annuity based products are unlikely to be able to deliver the minimum 5% p.a. income stream that a 65-74 year-old retiree requires.

3. Growth matters – even in retirement

Ultimately income has to be generated from underlying capital, so most pension-phase investors need to protect - and even grow - their nest egg. This total return focus is key to managing longevity risk and when done well, it's why shares play an important role in retirement portfolios.

Even as an income-focused investor, we believe in building portfolios that generate capital growth over longer time periods despite the subdued capital growth of the Australian market over the past decade. For instance since the start of 1980 to the end of December 2016 Australian shares have risen approximately 10 fold in capital value, with dividend income growth generally keeping pace with that capital growth. Shares enable both income and capital potential to be captured over the longer term.

4. Regulation matters – pension asset tests have moved the goalposts

The last 12 months have presented a number of challenges for self-funded retirees. The government's asset test changes have crimped part-pensions for many people in addition to the raft of new superannuation rules set to take effect on 1 July 2017.

We estimate that a home-owning couple with $800,000 in other assets had (until 2017) received $567.15 per fortnight in part pension and we expect this will fall to just $47.70 per fortnight, a reduction of over $500 per fortnight or $13,500 per annum. Similarly a single home-owner part pensioner with $550,000 in assets will miss out completely on a part pension, losing some $365 per fortnight or nearly $10,000 per annum.

What can pensioners do to offset the pension changes? The government suggested that part pensioners can make up for the loss of income by drawing down on their assets. For instance in the $800,000 couple example, the pension reduction can be offset by drawing down 1.7% of that $800,000 in assets each year.

Alternatively, if the $800,000 in assets earns 7.8% p.a., then based on our calculation the pensioner can offset the loss in part pension without drawing down. We think this is a better option, and is more consistent with the way pensioners behave.

Can a 7.8% p.a. return be achieved in the current low yield environment with Australian official cash rates currently at 1.5% and 10-year Australian Government Bonds currently yielding less than 3%?

It will certainly be difficult, particularly for conservative strategies with large weightings to cash and bonds.

Thankfully Australian equities provide some of the strongest income opportunities available in the world today. For an Australian pension-phase investor who gets a full refund of franking credits, we've shown that the S&P/ASX200 yielded approximately 6% p.a. in income in the decade to end 2016, with about a quarter of this due to franking credits.

But high yield Australian equities have potential to earn even higher rates of income. For instance, Australian banks currently yield around 8-10% p.a. on a grossed-up basis for franking.

However, pension investors need to balance risk and return, and so putting all their eggs in the Australian banking sector may not be a wise strategy. Pensioners investing at least part of their assets in well-diversified equity products (both Australian and global) that produce the required returns should help preserve their capital base over a long-term investment horizon.

Dr Don Hamson is Managing Director at Plato Investment Management Limited*. This article is for general information only and does not take account of any person's objectives, financial situation or needs. On 9 March 2017, Plato opened its first LIC to investors, providing the opportunity to invest in an actively managed, diversified portfolio of Australian shares with an income focus.*

You get what you don't pay for

Robin Bowerman

"You only find out who is swimming naked when the tide goes out" is one of the great lines Warren Buffett has passed on to investors many times.

It appears a lot of people in the fund management industry have been swimming naked for the past 10 years. The S&P Dow Jones SPIVA (the Standard & Poor's Index Versus Active) scorecard for 2016 does not paint a pretty picture for the performance of Australian active managers for the past decade.

More than 80% of international equity and bond funds underperformed their respective benchmarks for the 10 years to December 2016. For Australian equity and REIT funds, the result was slightly more respectable — only 70% underperformed the index.

In his most recent Chairman's letter to shareholders, Buffett sent a clear message to investors around the world about how hard it is to find someone who could outperform the market over the long-term.

"There are some skilled individuals who are highly likely to out-perform the S&P 500 over long stretches. In my lifetime though I've identified, early on, only ten or so professionals that I expected would accomplish this feat".

Strong growth in indexing but active still dominates

It should not surprise that there is a global shift by investors to index and index-style investment approaches. Back in 1997, indexing crossed the threshold of having more than USD 1 billion in assets under management. Today, that figure is more than USD 5 trillion.

Yes, growth has been strong, but given recent commentary from some corners of the investment community you could also be forgiven for thinking that the index approach is swamping the active management market. Indeed, some claim the growth of indexing may compromise price discovery, increase market volatility and even lead to outcomes "worse than Marxism".

In reality, indexing remains a relatively small portion of the market. Even in the US where the indexing take-up by investors has been stronger for longer, indexing represents only about 35% of the mutual fund market. On a global level, indexing represents around 15% of share market value and 5% of global bond market value.

In Australia, investors and advisers have been slower in adopting indexing although growth has been strong in recent years, in part due to the development of ETFs. The market share of indexing according to Rainmaker figures is around 17%. In other words, 83% of funds in Australia are actively managed, so reports of the demise of active management seem altogether premature.

Active and index can be complementary

There is no shortage of cheerleaders for the active cause, many of whom contribute regularly to *Cuffelinks*, and being a competitive industry, it is not surprising that active managers are fighting back.

Vanguard strongly believes there is a role for active management within investor portfolios, demonstrated by the fact about 30% of our global assets are managed in active funds and in Australia we have recently begun introducing active strategies to give Australian investors and financial advisers new choices when building their portfolios.

While the active versus index debate has been anchored around performance, for which the S&P Dow Jones SPIVA report provides the scorecard, what is perhaps missing is a broader discussion about costs.

Warren Buffett's recent shareholder letter was as much about the impact of high fees on investor returns as it was the challenge of successfully picking active managers.

The impact of fees and other expenses

In an Australian context, this goes a lot further than simple fund manager fees. What is critical for the investor is the total amount of fees deducted from their investment, including by the fund manager, platform, advice and fund administration.

Rice Warner was commissioned by Vanguard to study the impact of fees during an average super fund member's contribution life.

Looking at a 20-year-old female in 2016, the Rice Warner modelling examined the impact on their super balance at retirement, assuming this occurs at 65 years-of-age, if the 1.10% per annum cost (the historical average superannuation fund fee) to their super was lowered.

In the base case, if the 20-year-old continued to pay 1.10% per annum on their super balance throughout their working life, they would have around $1.08 million super balance at retirement. However, a decrease in fees of just 20 basis points (0.20%) to 0.90% per annum would mean an additional $44,585 in their account. If fees fell a further 20 basis points it would mean an additional $91,428 at retirement.

And if we lowered expenses to 0.60% per annum, our 20-year-old case study would have $140,654 extra to support their retirement.

Regardless of investment style, low costs are a critical determinant of manager success. In fact, Morningstar has found that cost can be a more consistent indicator of fund success than its own star-rating system.

Inevitably, some may argue that higher costs are needed to support more labour-intensive active management, but investors and their advisers shouldn't let this kind of argument blind them to a simple fact: paying more to chase outperformance will likely be a self-defeating exercise.

Robin Bowerman is Head of Market Strategy and Communications at Vanguard Australia, a sponsor of Cuffelinks. This article is general in nature and readers should seek their own professional advice before making any financial decisions.

10 grey swans to watch out for

Lorne Johnson

As the first quarter 2017 comes to a close, many pressure points we saw in 2016 are still in play, and the Trump administration presents a plethora of new opportunities and risks for markets.

We have identified 10 tail risks that could roil the financial markets this year. We call them grey swans, rather than black, because they may be unlikely scenarios, but they are not implausible, exceptionally rare or unknown. Some of the grey swans we identified last year did swim by, most notably Brexit. While these scenarios are not our base case expectations, thinking about them might help inform the choice of investment strategies.

1. China loses its grip on markets and economic growth

Playing a central role, particularly in the global economy and emerging markets, China again tops our list as the leading grey swan, this time for the risk of failing to control its currency and financial markets or to manage an orderly slowdown of its economy.

Currency, financial and economic pressures continue to swirl around China. Given the shift to a more reflationary environment and greater uncertainties around Sino-US political and economic relations, we see a bigger risk to China's ability to steer a smooth path, with potentially dire implications for other emerging markets. The People's Bank of China (PBOC) may try to limit RMB depreciation. However, against a weaker growth backdrop and a stronger US dollar, China's willingness to play by the current set of rules could quickly come undone if, in retaliation, the PBOC stops defending the RMB, effectively allowing it to depreciate much faster.

2. Election surprises push the European Union closer to break up

With a packed electoral calendar this year, including general, presidential and federal elections in Europe (especially France and Germany), the risk of another shock to European integration from the ballot box is real.

The question before European voters is not limited to a choice among the traditional centrist, left- or right-leaning establishment parties but between globalisation and nationalism. Look no further than the Brexit vote in the UK and the US presidential election upset to see that a platform challenging the status quo can succeed even in a large affluent democracy.

3. The Fed falls behind the curve

Realised growth or inflation that is higher than expected in 2017 could prompt the Fed to move faster to tighten financial conditions in a way that could trip up markets, slow down consumer spending and cause a further surge in the US dollar.

We believe the markets would be able to manage and perhaps even welcome a faster pace of rate normalisation attributable to more robust growth. But an inflation-heavy mix could be toxic, forcing the Fed to tighten financial conditions as consumer purchasing power is declining.

4. Oil prices uncertain again

Oil-producing nations may have reached an agreement to reduce supply, but any one country's non-compliance with the voluntary cuts could lead to a swift collapse of solidarity and a ramping up in global oil inventories, renewing the downward pressure on crude prices.

In the past, such quotas among oil producers have been difficult to enforce. Even if the lower target holds, new sources from countries exempt from the agreement could more than make up for it. Add to that a potential revival of US shale extraction and the deregulation of some US fields under the Trump administration.

5. Emerging markets get squeezed

The protectionist rhetoric of the Trump campaign translates to new restrictions on global trade, dramatically limiting accessibility to US markets just as emerging markets (EM) are struggling with the stronger US dollar and higher US interest rates.

In the four trading days after the US election, the MSCI EM Index plunged 7% and EM debt fared no better as spreads widened sharply and EM currencies sold off. Such a negative reaction reflected the policies expected from a Trump administration: pro-growth fiscal stimulus, which would likely accelerate the pace of Fed tightening, along with a contraction in global trade flows and EM export opportunities. That details of these policies have not been forthcoming creates even more uncertainty for EM assets.

6. Productivity surges to the upside

The economy experiences an improvement in productivity growth, something lacking so far in this expansion, for no other reason than a simple reversion to the long-term trend that typically prevails over the business cycle.

Advances in technology can take years to translate into productivity gains, with current innovation in the nascent peer-to-peer economy perhaps taking longer to manifest. Capital deepening through investment spending is another means for improving output per worker, and that could pick up under the more favourable tax treatment anticipated from the Trump administration. Not all grey swans bode ill.

7. Trade wars break out

Trump's actions to force changes in trade relationships could be seen as a foreign threat that other nations need to address aggressively, imposing their own restrictions on the imports of US goods, with China in particular having little to lose and much to gain by retaliating.

Significant protectionist trade policies employed by Trump could potentially exacerbate existing economic challenges and cause exactly the kind of volatility that China's leadership wants to avoid. Aggressive, pro-growth policies could inflate asset bubbles or supercharge inflation, while overly restrictive capital controls could rile the markets.

8. Cyber-terrorism escalates into cyber-war

Beyond criminal operatives stealing personal data or sovereign states attempting to influence foreign elections, cyber attacks orchestrated by rogue nations remain a key risk, possibly taking the form of terrorism to weaken local infrastructure or confidence in global markets.

Recent experience suggests that many institutions are ill prepared for such an environment, lacking well-defined policies to deal with these incursions.

9. Health care becomes a policy battlefield in the US

After the hasty repealing of Obamacare before a viable replacement has been legislated, the US President and Congress are considering changes to health care while doctors, drug companies and other providers of medical equipment and services are left in the dark. In the interim, the uncertainty is likely to weigh on the health care sector and consumers.

10. New alliances form

Long-standing geopolitical and economic alliances have come under pressure in recent years, and if the US cedes ground by scrapping current agreements, this year may see new coalitions come together to replace the existing global order, with China stepping in to fill the void.

With the US pulling out of the Trans-Pacific Partnership, China is promoting its own regional trade agreement — excluding the US, of course — that some Asian nations are expected to take up.

How can you prepare for the unexpected?

These scenarios do not cover all the surprises we might see over the coming months. We suggest that investors thoroughly review whether their portfolios have adequate downside protection against tail risks and seek a partner that can help them assemble the appropriate defenses for their portfolio. Investors may consider using strategies that can help minimise volatility, while at the same time capturing return opportunities in an unpredictable market.

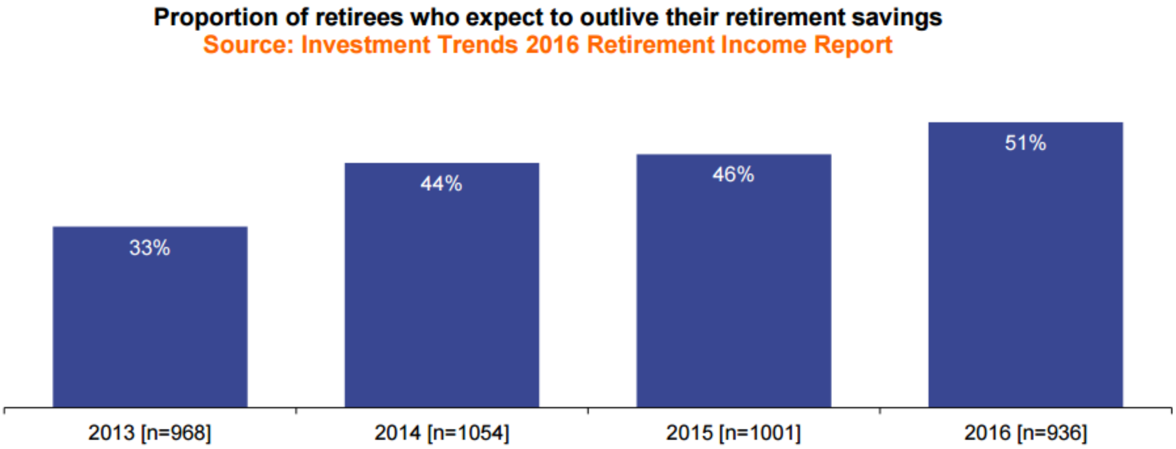
Lorne Johnson is Senior Portfolio Manager, Investment Solutions Group at State Street Global Advisors. This article is general information that does not consider the circumstances of any individual. Read SSGA's Grey Swans for 2017 in full.

Big increase in retirees expecting to outlive their savings

Graham Hand

One of Australia's leading research firms, Investment Trends, has revealed fewer people feel prepared for retirement than at any time since their survey began in 2012. The survey of almost 7,000 Australians over the age of 40 revealed only 44% feel prepared for retirement, but worryingly, this is down from 49% in 2015.

In addition, the 2016 Retirement Income Report shows a remarkable increase in the proportion of retirees who expect to outlive their retirement savings, reaching 51% from only 33% in 2013, as shown below. At a time when Australians have access to more education and advice on retirement than ever, and after 25 years of compulsory superannuation, the worsening of expectations is disappointing.



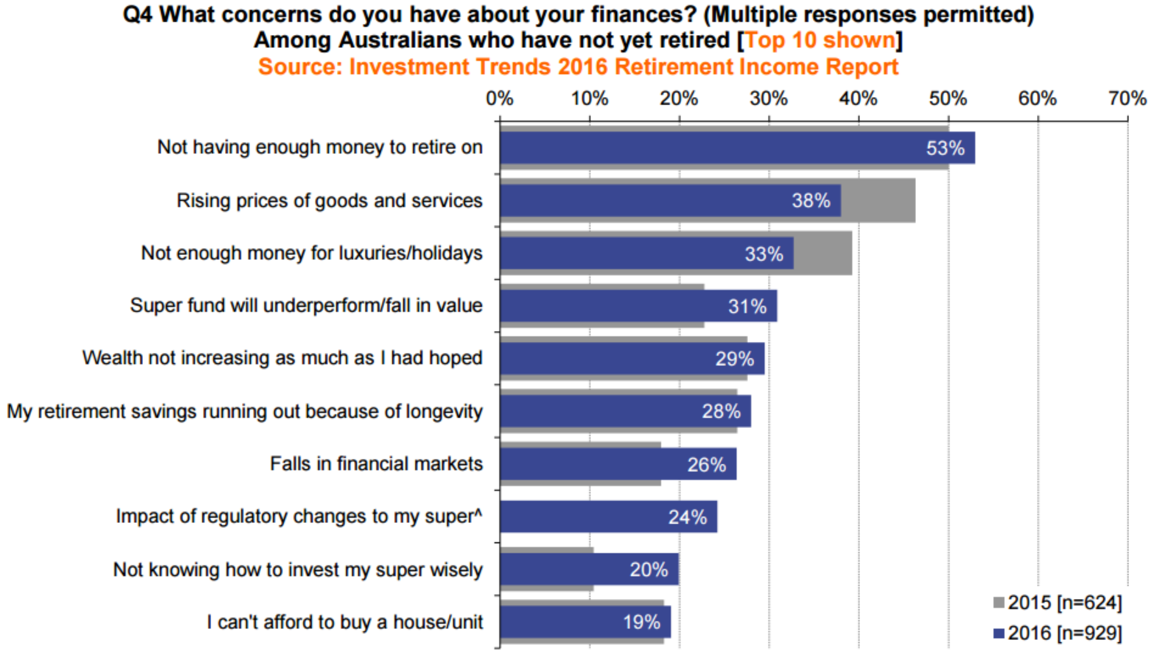
Reasons for the loss of confidence

The researchers identified many reasons for the lack of confidence about future finances from Australians who have not yet retired, as shown in the table below, including:

1. Inability to accumulate sufficient wealth and then not having enough to retire on
2. The rising prices of goods and services (although less of a concern than last year)
3. Worries about potential falls in the share market affecting the value of superannuation
4. Adverse regulatory changes to superannuation.

This poor result is despite share markets performing reasonably well in the last two years (many global markets are trading at an all-time high), superannuation funds delivering solid results and a strong property market supported by low unemployment.

The same concerns translate in income worries, with half those surveyed saying they need at least $3,000 a month in retirement, but only one-third of respondents expecting to achieve this level.



The role of financial advice and planning for aged care

Most Australians do not have a good understanding of retirement products such as annuities or allocated pensions, with only 11% describing the retirement product range as "appealing". The traditional focus on the accumulation stage for superannuation and the media attention on contribution rules and advantages of super have left innovation in the retirement phase in the shadows.

The planning for aged care is even worse. Less than one in five people not yet retired have considered how much it might cost to cover aged care needs. Most people expect to simply turn to government services or the medical profession to cover aged care needs, without considering the future ability of government budgets to pay for such a service.

"As an industry, we must address Australians' lack of engagement on the topic of aged care and better prepare them for potential aged care needs," said Investment Trends' Senior Analyst, King Loong Choi. "This will require further action from super funds, financial advisers and product providers. The government and medical professionals also have a role to play in growing Australians' awareness of the financial aspect of aged care, particularly in light of our aging population."

Only about 20% of Australians have a financial adviser, but the research shows those people allocate about twice as much to retirement savings as those without a planner, who tend to spend more on lifestyle choices such as holidays, renovations, new vehicles or boats.

With interest rates on savings low, and share markets considered expensive, there are a few ways to address the potential shortage of money in retirement. These include the unpalatable choices of saving more, spending less or working for longer. Those sacrifices might be necessary to avoid a retirement worrying about money. It also helps to understand the superannuation rules and with the assistance of a financial planner, take advantage of the tax-efficiency of saving in super.

Graham Hand is Managing Editor of Cuffelinks, a free financial newsletter.

Should we exclude companies purely on ethical grounds?

Adam Tindall

Fund managers used to be discouraged, or even prohibited, from taking ethical issues into account when making investment decisions on behalf of their clients. It was widely agreed that investment managers should not let consideration of ethical criteria distract them from choosing investments that maximise financial returns for their clients unless, of course, the client had specifically mandated ethical investment. Asset owners, so people said, were best placed to take action on ethical grounds.

But times have changed and society has changed with them. Fund managers have also had to keep up because we increasingly felt we didn't want to deliver investment returns to customers irrespective of the cost to society.

How do trustees, managers and investors discharge their duties?

At the heart of this issue lies questions about how investors best discharge their duties. What actions are acceptable in the pursuit of returns? Can investors, or indeed should they, dismiss 'immoral' activities relying instead on governments to intervene via regulation? Is it sufficient for investors to say they tried to engage with a company to improve the nature of a product offering or on their corporate risk management strategy?

As recent campaigns on a range of issues have demonstrated, investors are increasingly being asked to justify their actions. This has raised questions about the role of ethics in investing and whether it is defensible for investors to support an activity that, while commercially convenient, viable and legal, is inherently wrong (i.e. something that is bound to have an adverse impact on stakeholders).

Ethical dilemmas by their very nature are not straight forward. The question of 'whose ethics' is sometimes used as a reason not to articulate and implement an ethical position. Certainly, criticism by others of a particular ethical position may make it tempting to choose the path of least resistance and avoid any explicit consideration of ethics.

Integrating environmental, social and governance (ESG) issues into our investment decisions and in the discussions we have with the entities in which we invest is entirely consistent with the objective of delivering appropriate risk-adjusted returns over the long term. This approach was formalised when AMP Capital became a signatory to the UN Principles for Responsible Investment (UNPRI) in 2007 and further reinforced in 2012 with the public statement of our ESG and Responsible Investment Philosophy.

Deciding to exclude certain companies

In 2012, we did not seek to exclude specific companies, asset types or industry sectors from our investable universe on wholly moral or ethical grounds, but this position was recently revisited. We concluded that we had a responsibility, as an investment manager, for what we choose to do, or not do, and how we invest. And that, under rare or extreme circumstances, it may be appropriate to exclude investments in a particular company or sector for purely ethical reasons. The decision was also reflective of the changing attitudes of our clients, who increasingly do not want to be invested in harmful products.

Subsequently, we added an ethical framework and decision-making process that, under exceptional circumstances, would lead to the exclusion of certain investments from a portfolio based on ethical grounds. Working with ethicist Dr Simon Longstaff of The Ethics Centre, we developed a principles-based framework that provided a consistent basis for considering a range of potential ethical issues, not only now but well into the future.

The three concepts that underpin the ethical framework are:

1. The degree of harm caused
2. The denial of humanity
3. The principle of double effect.

[Editor's note: the principle or rule of double effect concerns the ability to act when a legitimate aim (in this case, removing a company based on ESG guidelines) may cause an effect one would normally be obliged to avoid (eg, reducing the size of the investible universe)].

The result is that we will no longer invest in manufacturers of tobacco and companies involved in manufacture of cluster munitions, land mines, and chemical and biological weapons. We have now started the process to divest of these companies from across our entire portfolio. The divestment of tobacco manufacturers will be the largest to date in Australia.

It's important to note we are only excluding certain companies or sectors by exception. We still firmly believe in company engagement in order to effect meaningful change. In the case of tobacco, cluster munitions, landmines, biological and chemical weapons manufacturers, however, no engagement can override the inherent dangers involved with their products.

Crucially for investors, this decision still means we can meet our fiduciary obligations to them and our obligations to be a responsible fund manager, delivering strong investment returns that continue to meet their objectives. Our analysis has found that our funds can continue to be managed effectively under this new framework without compromising investment objectives.

In looking after our clients' funds, we consider it prudent that we articulate the principles by which we discharge this responsibility. Introducing a new ethical framework is the right thing to do by our investors and it is consistent with our long-term focus on responsible investing, which provides greater insights into the potential risks and opportunities that may impact the value, performance and reputation of companies we invest in.

Adam Tindall is Chief Executive Officer at AMP Capital, a sponsor of Cuffelinks.

Watch premiums and discounts in LICs

Leisa Bell

Independent Investment Research (IIR) has released its December Quarter 2016 review of the LIC sector, sometimes called Listed Managed Investments (LMI). A summary of the performance of the 34 LICs included in the Report is presented below. The full paper with more detailed coverage is available here.

Overall equities performance

For the December 2016 quarter, the S&P/ASX200 was up by 5.2% following the US market rally after Trump's election. Large cap equities, and especially resources stocks, contributed most to this performance. Small caps, down 2.5% for the quarter, still managed an overall gain for the year of 13.2%. For the 12 months to December 2016, the S&P/ASX200 was up 11.8%.

LIC performance

IIR's analysis uses two different measures. The first is total returns (share price gain or loss plus dividends) which represents the actual return received by shareholders from their investment. The second is pre-tax NTA plus dividends, which is better for evaluating manager performance.

Using this second metric, the best performing fund for the December quarter was Global Master Fund (ASX:GFL) with a 15.5% increase in portfolio value due to a strong share price performance of its core holding, Berkshire Hathaway. As the overall market performed well, so too did the majority of LICs included in the Review. However, some small cap LICs had negative returns.

If using the first metric, Westoz (ASX:WIC) was the best performer for the quarter with an 8.1% increase in share price (including dividends) due to its resources focus. This reduced the discount to pre-tax NTA from 16.8% at 30 September 2016 to 9.4% at 31 December.

Premiums and discounts

As at 31 December 2016, 12 of the 34 LICs covered were trading at a premium to pre-tax NTA. The largest of these was Mirrabooka Investments (ASX:MIR) at 25.8%, followed by WAM Capital (ASX:WAM) and WAM Research (ASX:WAX), each at 20.7%.

At the other end of the scale, Global Master Fund (ASX:GFL) was trading at the largest discount to pre-tax NTA at 22.3%, widening from 15.8% as at 30 September 2016. Over the past three years, GFL's discount has averaged 14.4%.

The table below shows the quarterly performance for each of the 34 funds as measured by both metrics mentioned above, along with their premium/discount to pre-tax NTA:

Name	ASX Code	% Return Dec Qtr (Share price incl div)	% Return Dec Qtr (Pre-tax NTA incl div)	Prem / disc to pre-tax NTA at 31 Dec
AFIC Limited	AFI	1.10%	4.10%	-1.20%
Aberdeen Leaders Fund	ALR	3.70%	3.30%	-9.60%
Amcil Limited	AMH	-6.00%	-1.10%	1.10%
Argo Limited	ARG	3.20%	4.50%	-2.20%
Asian Masters Fund Limited	AUF	-6.20%	-4.10%	-0.70%
Australian United Investment Company Limited	AUI	6.70%	6.00%	-7.90%
Barrack St Investments Limited	BST	-5.60%	-7.10%	-11.60%
Bailador Technology Investments Limited	BTI	0.90%	0.90%	-9.70%
CBG Capital Limited	CBC	-2.90%	-1.00%	-11.30%
Cadence Capital Limited	CDM	1.70%	2.90%	6.40%
Contango Income Generator Limited	CIE	0.00%	1.20%	-6.80%
Contango MicroCap Limited	CTN	-0.40%	-10.20%	-4.60%
Djerriwarrh Investments Limited	DJW	6.20%	5.40%	14.90%
Diversified United Investment Limited	DUI	6.70%	5.80%	-8.10%
Emerging Markets Masters Fund	EMF	0.00%	0.60%	1.70%
Future Generation Global Investment Company Limited	FGG	2.40%	4.30%	-3.50%
Future Generation Fund Limited	FGX	3.50%	-1.10%	2.40%
Flagship Investments Limited	FSI	3.80%	-0.40%	-10.70%
Glennon Small Companies Limited	GC1	-1.50%	-7.50%	-3.20%
Global Master Fund Limited	GFL	6.50%	15.50%	-22.30%
Hunter Hall Global Value Limited	HHV	-12.50%	-13.50%	-3.20%
K2 Global Equities Fund (Hedge Fund)	KII	0.40%	0.40%	-0.80%
K2 Australian Small Cap Fund (Hedge Fund)	KSM	-7.00%	-5.60%	-0.40%
Mirrabooka Investments Limited	MIR	0.70%	-2.90%	25.80%
Milton Corporation Limited	MLT	4.10%	5.10%	-2.50%
US Select Private Opportunities Fund	USF	2.30%	5.30%	1.40%
US Select Private Opportunities Fund II	USG	3.30%	7.20%	-1.30%
US Select Private Opportunities Fund III	USP	1.00%	6.00%	1.30%
WAM Active Limited	WAA	-2.20%	0.50%	6.20%
WAM Capital Limited	WAM	6.30%	-0.80%	20.70%
WAM Research Limited	WAX	1.30%	-2.70%	20.70%
Whitefield Limited	WHF	2.00%	3.50%	-11.20%
Westoz Investment Company	WIC	8.30%	-0.60%	-9.40%
WAM Leaders Limited	WLE	0.40%	2.70%	0.40%

Leisa Bell is Assistant Editor at Cuffelinks.

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Future oil prices, where it takes two to contango

Andrew Kaleel and Matthew Kaleel

The recovery in oil prices during the past year, as measured by the price of Brent Crude Oil, has provided a welcome respite for investors exposed to direct commodities, energy-related stocks and high-yield debt, particularly for North American shale oil producers.

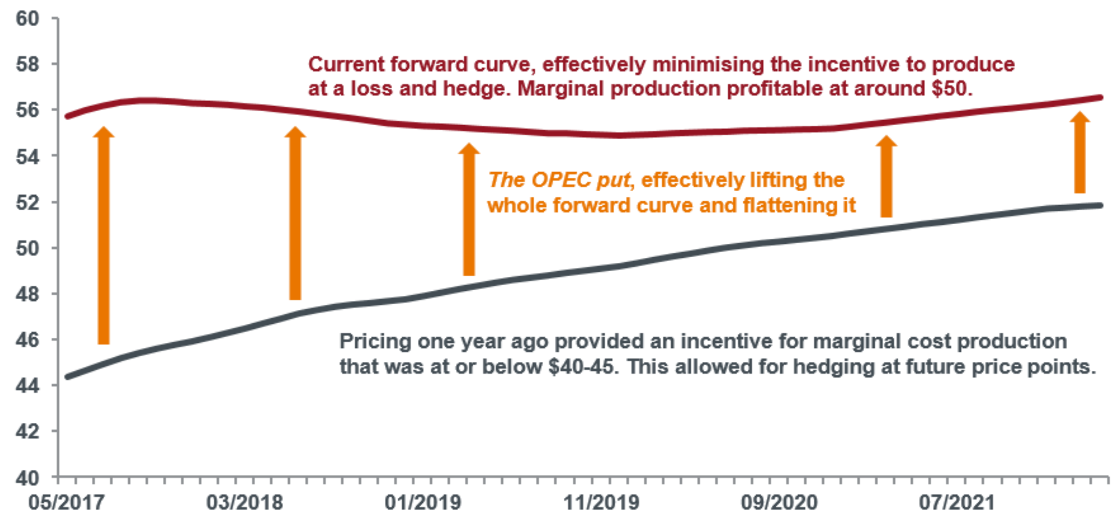
While short-term predictions are fraught with danger, futures markets provide context as to where market participants believe oil prices should be over the medium term. This article provides a deeper understanding of oil pricing dynamics and the prospects for crude oil prices.

Forward curve dynamics

Futures markets provide an insight into the incentive pricing for producers, hedgers, and speculators to act. The spot price is typically quoted on news and business channels, but futures markets provide price points for multiple tenors in the future which can be used by market participants to either hedge production, hedge-pricing risk for buyers, or take a position, as is the case for speculators.

Further 'along the curve' (looking at prices that are at least six to 12 months in the future), there tends to be less noise and more signals which are reflective of market fundamentals. If this were not the case, there would be an opportunity to arbitrage for those investors able to participate in both the physical (spot) market and hedge using futures.

Brent Crude Oil forward curve fair value per barrel in US Dollars



Source: Bloomberg. As at 7 March 2017.

The chart shows forward pricing for Brent Crude Oil as of 7 March 2017 (the 'forward curve', shown in red) and compares this to the forward curve one year ago (shown in grey).

The chart provides a number of insights:

1. Oil markets are back in balance

Since the announcement by OPEC in late 2016 of production limits, oil markets have been rebalancing. While this doesn't negate the effect of currently high levels of global inventories, the forward curves illustrate how the forward curve has effectively shifted up and flattened. This is historically associated with positive performance for the immediate future as there is less incentive to produce today and forward hedge (prices are flat for the immediate future).

2. Shale picks up market share, '*ROPEC*' picks up revenue

The wild card in the oil market deck is now North American shale oil production. A combination of recent increases in rig counts and falling marginal costs for certain oil basins mean that OPEC shares swing production with US shale producers.

Current pricing provides an incentive for more marginal production to come on line in the US, so this will likely translate into higher market share for shale as a percentage of global oil production, while OPEC and Russia (AKA '*ROPEC*') benefit via increased revenues, albeit at lower production levels.

3. Aramco IPO in the balance

It is in the interests of the Saudi Arabians to maintain prices around these levels. With the proposed IPO of Aramco in the next two years, its oil assets would be priced at the average price of the past 12 months. A major objective of Saudi oil production would be to maintain pricing at these levels to keep them low enough not to encourage a major increase in shale production, but high enough to provide a reasonable valuation on oil reserves. The Aramco IPO could potentially make it the largest listed oil company in the world, above Exxon Mobil Corporation.

Conclusion on the oil market

Current oil market pricing in the mid-US$50 range is a 'sweet spot' for all major oil market participants, including OPEC, Russia and the more productive and cost efficient North American shale producers. Barring unexpected events, oil prices will likely remain range-bound for the medium term, with an effective floor of around US$50 as the base case. The abyss oil markets experienced in early 2016 provided an insight into the instability created by an oversupply in energy markets, and this will be front and centre to '*ROPEC*' in encouraging strict compliance with production quotas.

Andrew Kaleel and Matthew Kaleel are Co-heads of Global Commodities & Managed Futures at Henderson Global Investors*. This information is general only and does not take into account the personal circumstances or financial objectives of any reader.*