Cuffelinks
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Edition 238, 2 February 2018

This Week's Top Articles

Highlights from Howard Marks on 'Latest Thinking'

Graham Hand

Regular readers of Cuffelinks know we are fans of Howard Marks, Founder and Co-Chair of the $100 billion fund manager, Oaktree Capital. Financial markets are at a fascinating junction where most analysts expect favourable global growth, but a shadow is cast by massive government debts, rising interest rates and growing tensions between US and China (now considered a 'strategic competitor' and 'revisionist power' to the US).

It's valuable to read the latest Marks memo to his clients, especially when he focusses on this strong contrast of market optimism versus fear.

The positives

Marks starts by clarifying he would never tell investors 'it's time' to 'get out'. The market rarely gives such clear signals. To counter the perception that he is overly cautious, he lists a number of positives, including:

- The sustained US recovery from 2009 is now joined by other economies, delivering worldwide growth. There has been no boom and when a recession eventually occurs, there will probably not be a severe bust. The pro-business President Trump is encouraging capital spending, and tax cuts will help company profits.
- US unemployment is down to 4.1%, the lowest in 60 years, which should gradually translate into wages growth and increasing consumer demand.
- At the moment, inflation remains low and any rise in interest rates should be gradual and limited.
- Overall, investors have not been behaving euphorically, reducing the catalysts for a downturn.

The negatives

He warns that this favourable macro environment comes with high prices for most asset classes, plus the threat of rising inflation and interest rates and an uneasy quiet in markets, plus:

- Many valuation measures (such as Buffett's ratio of market capitalisation to GDP, the VIX, bond yields, the Shiller cycle-adjusted P/E ratio) are at or close to all-time highs, which in the past have signalled a downturn.

- Investors are taking risks to compensate for low returns, leaving prudent investors sidelined: *"How healthy can it be when investors think an asset or market is rich but they're holding anyway because they think it might go up some more? Fear of missing out (or "FOMO") is one of the more powerful reasons for investor aggressiveness, and also one of the most dangerous."*

- The easy money has been made, prospective returns are well below normal for almost every asset class and risky investor behaviour prevails. He argues for defensiveness rather than squeezing the last drop of return from the market.

Marks' summary of conditions

Marks does not try to satisfy the demand for a definitive position. Asset prices are worrisome but investor psychology is unpredictable. He will continue to invest on the basis of value relative to price, based on his mantra of "*move forward but with caution*". His summary is:

"For me the key points regarding the general market outlook are as follows:

- *The absence of widespread euphoria certainly is an important flaw in any near-term bearish view.*
- *Thus there's no reason for confidence in the existence of a soon-to-burst bubble.*
- *Investor psychology continues to grow more confident, however.*
- *Asset prices are already unusually high.*
- *Future events remain unpredictable, but today's high prices mean the odds are against a significant long-term upward move from here.*
- *No one can say what's going to happen in the short term."*

And in response to the argument that a more aggressive stance would have produced higher returns, he says that could not have been justified by logical reasoning in the past. He muses:

"Is an incorrect decision one that didn't work out well, or one that was wrong at the time it was made? I insist it's the latter."

We should all recognise this when we have remorse about missing out on a surging tech stock with little revenues, negative bond rates and Bitcoin going above $20,000.

Graham Hand is Managing Editor of Cuffelinks. The article is general information and does not consider the circumstances of any investor.

Howard Marks's latest memo to his clients, which also discusses his reaction to the latest US tax cuts, is linked here: Latest Thinking.

Still, very much, the Lucky Country

Miles Staude

We're so familiar with hearing Australia referred to as the Lucky Country that it often comes as a surprise to learn that Donald Horne, who coined the phrase in his 1964 book of the same name, meant it as a criticism. The opening sentence of his final chapter gives the book its name.

"Australia is a lucky country run mainly by second rate people who share its luck. It lives on other people's ideas, and, although its ordinary people are adaptable, most of its leaders … so lack curiosity about the events that surround them that they are often taken by surprise."

It was meant to be a damning account of the Australian political class, who Horne believed were bereft of original thinking and ideas at a time when, he believed, great economic and technological changes were taking place in other countries. Rather, instead of being innovative, Australians had been lucky, inheriting from the British a system of democracy and rule of law, alongside the wealth an entire continent of natural resources had to offer. He worried that Australia did not deserve its luck and that, unless it lifted its game, its good run would not last.

The start of superannuation

Today the phrase is almost a badge of national pride, used to describe everything from our lifestyle to our prosperity. Its modern meaning underpins a 'she'll be right' positivity that Australians are famous for, a complete contrast to the message Horne was trying to deliver. (That his phrase was so misused was a source of great frustration for him: "I have had to sit through the most appalling rubbish as successive generations misapplied this phrase.").

Horne was a committed republican, well before there was any real republican movement in Australia. Much of his criticism of Australia stemmed from these views, and his belief that Australia still looked to the UK for political ideas and leadership. His follow up book, "*Death of the Lucky Country*", published in 1976, continued this theme.

If Australia was still looking to the UK for leadership in the 1970's, the wry among us might note that the country clearly needed better glasses. In 1976, sinking under unsustainable budget deficits and runaway inflation, the UK needed to be rescued by the International Monetary Fund, in what was the Fund's largest ever bailout.

Far from importing the militant unionism which engulfed British society in the 1970s and led to power rationing and a three-day work week, when the Union (Labor) party returned to power in Australia in 1983, it embarked upon some of the most forward-thinking reforms any developed country had seen. One of these, the Superannuation Guarantee reforms of 1992, addressed the future social-care funding crisis that all western countries were facing with their aging populations.

From humble beginnings to wealth

Today, Australia is a far wealthier county than not just the UK, but also all the other nations Horne had in mind in his writings. That wealth, in the wonderfully Australian egalitarian model, is also far more equally spread than in any of those countries too. According to the annual Credit Suisse Global Wealth Report 2017, wealth per capita in Australia today is second only to that of Switzerland. (Given Switzerland's position as a wealth manager to the world, we can comfortably remove it from our analysis on the basis that much of this wealth does not belong to the Swiss people as much as to Swiss 'tax residents'). Average wealth per capita in Australia in 2017 was US$402,603. This is 97% higher than Germany, 53% higher than France, 45% higher than the UK, and 4% higher than the USA.

Far more impressive than these absolute wealth numbers is how well this wealth has been shared. The most common measure of inequality in economics is called the Gini coefficient. On a scale from 0 to 1, the Gini coefficient measures how unevenly wealth is spread across society. A coefficient of zero equates to all members of society having the same amount of wealth, while a coefficient of one equates to one individual owning all the wealth.

Under this measure, among large wealthy countries, Australia is second only to Japan in its wealth equality, with a Gini coefficient of 0.65 compared to Japan at 0.61. However, while Japan may be marginally more equal, this is considerably overshadowed by the fact that Australian average wealth per person is 79% higher.

Excluding Japan from the analysis the remaining results are striking. European nations like Germany, France, and Sweden, supposed paragons of social equality, have Gini coefficients of 0.79, 0.70, and 0.83 respectively. Whilst more capitalist leaning economic models such as the UK and the USA, have coefficients of 0.74 and 0.86. Australia also comfortably leads the few remaining socialist countries of the world. China, Venezuela, Vietnam and Laos have Gini coefficients of 0.79, 0.94, 0.75, and 0.85 respectively.

And where has all this wealth come from? Undeniably Australia's natural resources laid a tremendous foundation. But too often this simple observation overshadows the bigger picture. The reliance on natural resource industries has been as much a curse as a blessing, tying large parts of the economy to a searing cycle of boom and bust. Australia was also not the only country rich in natural resources that began its life with British institutions. Much of Africa wears that crown, as do Canada, New Zealand, and India (Gini coefficients of 0.74, 0.72, and 0.83 respectively, wealth per person 36%, 16%, and 99% lower respectively).

In fact, the country that invented Wi-Fi, Google Maps and the ultrasound machine can call itself the clever county as much as the lucky country. Today one of Australia's biggest export industries is education. As a percentage of GDP, Australia generates more revenue from exporting education to the world (1.2%) than both the USA (0.2%), and the UK (0.5%), despite these latter two countries' famous universities. Australia attracts the best and brightest from around the world, many of whom, after studying, stay to call Australia home.

Wealth on its own is of little use if you don't hang around to spend it. Here Australia continues to excel: average Australian life expectancy at 83 years is the fourth highest in the world (behind, in order, Japan, Switzerland, and Singapore). Today the Australian health care system is, like so many Australian institutions, the envy of the world. The Washington-based Commonwealth Fund recently ranked health outcomes under the Australian system as the best in the world, despite Australia spending less on healthcare as a % of GDP than all the other countries in its study.

Making your own luck

After 26 years of uninterrupted economic growth, the absolute size of the Australian economy at US$1.3 trillion (population 24 million) is now comparable to that of Russia (population 144 million), a nuclear power which occupies a permanent seat on the United Nations Security Council. Australians have a better quality of life than the *Dolce Vita* Italians (where youth unemployment is 35%, and debt to GDP is 133%) and better social mobility than the famously egalitarian French (a country which hasn't run a balanced budget for 44 years). As a nation, we have created more wealth per person than the cold-hearted capitalist machine of the USA (an economic model which sees 14% of the population living in poverty) yet spread it more evenly than communist China.

A generation on, the fact that Horne's critical tagline of Australia has been co-opted by the nation will be no great surprise to the red-headed among us called Blue. Dry humour runs deep within the 'ordinary people' Horne felt needed a new, more radical, society, as does another defining Australian trait: self-deprecation. There is no doubt that a little over a century ago Australia started its innings on a batting-friendly wicket, but luck isn't what has put all the runs on the board. Whilst it perhaps has not been to Horne's taste, Australia's world-beating prosperity has been built on intelligent incrementalism, not revolution. A modest society that has quietly set about getting the job done.

Miles Staude is Portfolio Manager at the Global Value Fund (ASX:GVF), which he manages from London. This article is the opinion of the writer and does not consider the circumstances of any individual. The title of this piece apes a famous economic article written in 1992 by David Shulman, a senior economist at UCLA.

Does fixed income really diversify portfolio risk?

Gopi Karunakaran

The coordinated global fall in interest rates since the 2008 financial crisis has been one of the greatest tailwinds to asset prices we have seen in modern financial history. Interest rates underpin the valuation of most financial assets as their expected future cash flows are discounted relative to government bond yields. The effect of falling discount rates has been to increase their present capital values (i.e. their prices).

This dynamic has become progressively more extreme as the accumulated effect of extraordinary central bank intervention – abnormally low interest rates, combined with asset purchases – has pushed government bond yields to historically low (or even negative) levels and propelled investors to ever greater heights of risk-seeking behavior.

Is the party finally over?

However, we are now at the point where this tailwind is subsiding. While the stronger global economic growth and declining central bank policy stimulus narrative is becoming more widespread, the missing chapter of the story has been inflation, which has been slow to emerge.

Not only is low inflation pervasive today, it has also become stubbornly entrenched into inflation expectations far into the future as markets assume the party continues along with very gradual policy normalisation.

However, given this policy normalisation is occurring after an unprecedented period of market-distorting stimulus, it is far from clear what the unintended consequences will be for financial markets. But even a little unexpected inflation can easily upset this delicate balance.

There are early indications that inflationary pressures are building. Notably, labour markets globally are tightening, manufacturing costs are rising and even in the land of deflation, the Bank of Japan recently noted that inflation expectations have stopped falling.

For years, central banks have prolonged stimulus without any real knowledge whether inflation transmission is working, thereby risking an overshoot. History shows that when inflation expectations shift, they shift quickly, which could force more aggressive policy normalisation than markets are expecting.

In this scenario, the party may be over.

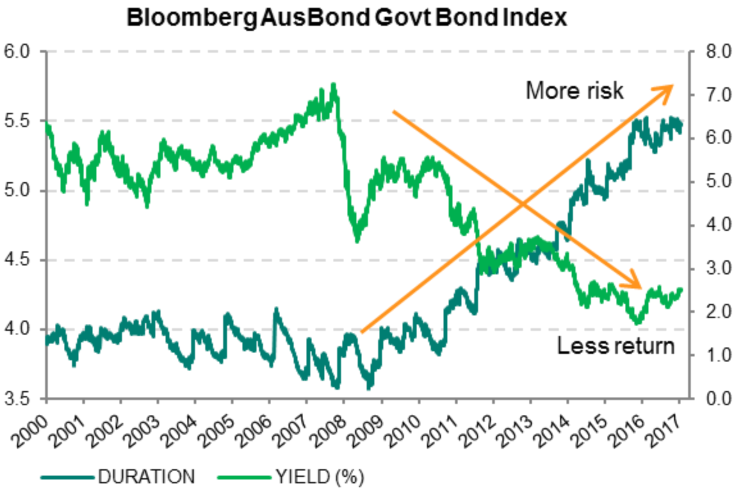
What does this mean for investments?

Assets that shone brightly against the dim light of a low interest rate world would be reassessed under the harsh glare of higher interest rates. Against this backdrop, it's natural to question whether government bond holdings can still play their traditional role as risk diversifiers.

Let's begin with the traditional context, where a conventional 'risk-off' scenario like a recession occurs. Investors can probably expect their government bond holdings to help offset equity losses as capital flees to safety and bond prices rise as interest rates are cut.

Alternatively, if the current consensus view – improving growth, contained inflation and gradually rising rates – does play out, bonds provide stable income but still expose investors to risk of modest capital losses from rising interest rates (duration risk).

The current combination of very low yields and term premia (compensation for holding long maturity bonds over shorter bonds) means bond holders are being poorly compensated for bearing duration risk as a form of risk diversification. The issue is compounded for passive bond investments as benchmark index duration has extended (taking more risk), while average yields have declined (less return) creating an asymmetric risk of capital losses from rising interest rates.



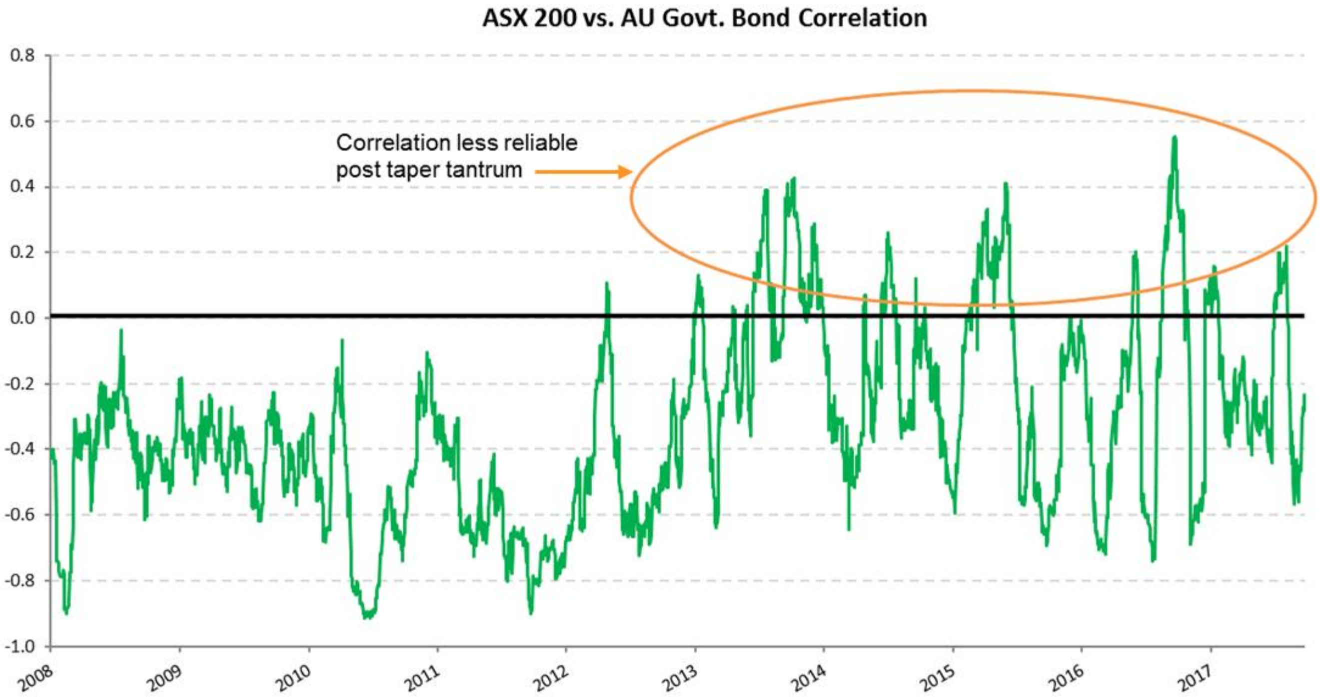
Source: Ardea, Bloomberg

Even in the scenarios where bonds perform as intended, it is expensive to passively hold them at present for risk diversification.

But it could be worse

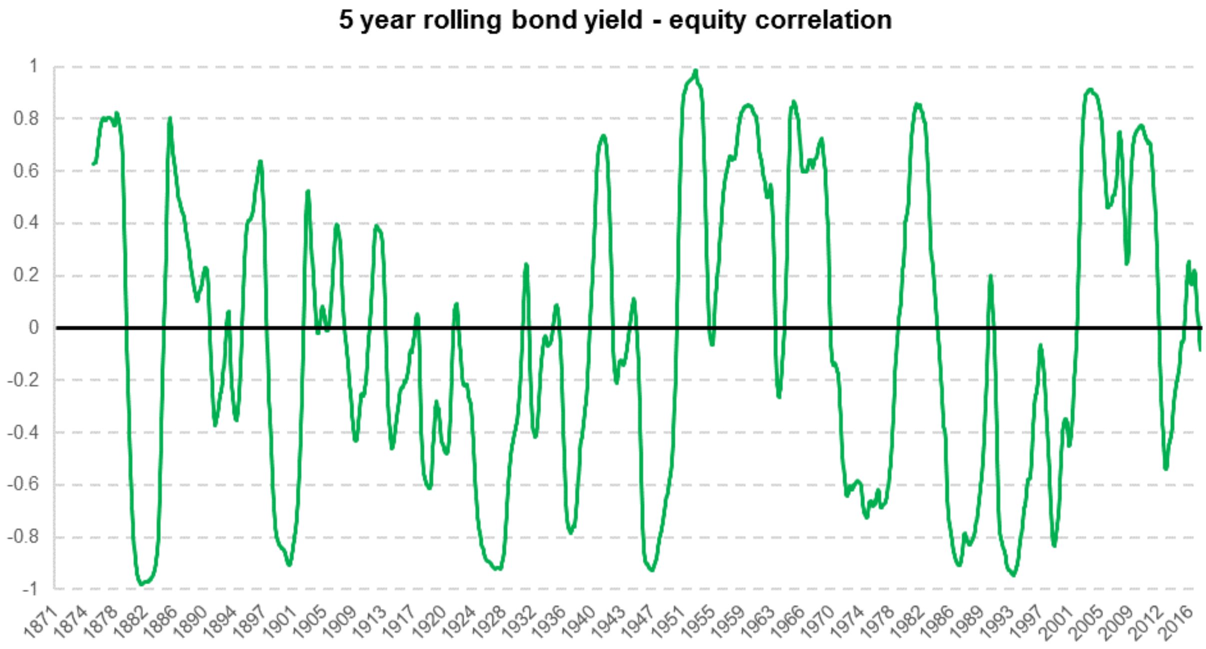
The underestimated scenario – nascent inflationary pressures become more established – would quickly shift focus to fear of inflation overshooting, forcing aggressive, unexpected and disruptive normalisation of monetary policy. Bonds then become the catalyst for a broader asset class sell-off, rather than acting as a defensive risk diversifier.

We got a small taste of what such unanticipated policy tightening can do to markets during the 'taper tantrum' in 2013. Ben Bernanke unexpectedly announced the possibility of reducing the US Federal Reserve's bond buying programme, causing bond prices to drop sharply and triggering a sell-off in equities. The chart below shows how the Australian bond-equity correlation behaved before and after this event – becoming more positive, more often, and thus less reliable as a diversifying relationship.



Source: Ardea, Bloomberg

In fact, this marked change is not unique to Australia or to recent history. Very long-term US data shows that bond-equity correlations are unstable, tending to be impacted by inflation and interest rate paradigm shifts.



Source: Ardea, Shiller, R. [Source data for Irrational Exuberance](), 1871 to present.

Irrespective of whether we are in a paradigm shift in bond-equity correlations or not, the conclusion remains the same. The assumed negative correlation between bonds and equities is not as reliable as hoped for.

The implication for portfolio construction is clear. Investors should evaluate conventional assumption that passively owning government bonds is inherently defensive and risk diversifying.

More to fixed income than buy and hold

There's more to fixed income than just buying and holding bonds. It is an asset class with a wide range of instruments, strategies and return sources that can be exploited to achieve genuine risk diversification. For example, the same factors that distorted bond market valuations have also created relative value pricing anomalies, underpriced volatility, skewed risk premia and offered cheap tail risk opportunities that can all be used for effective risk diversification in a truly defensive fixed income portfolio.

So yes, fixed income can still diversify portfolio risk but only if you choose the right strategy.

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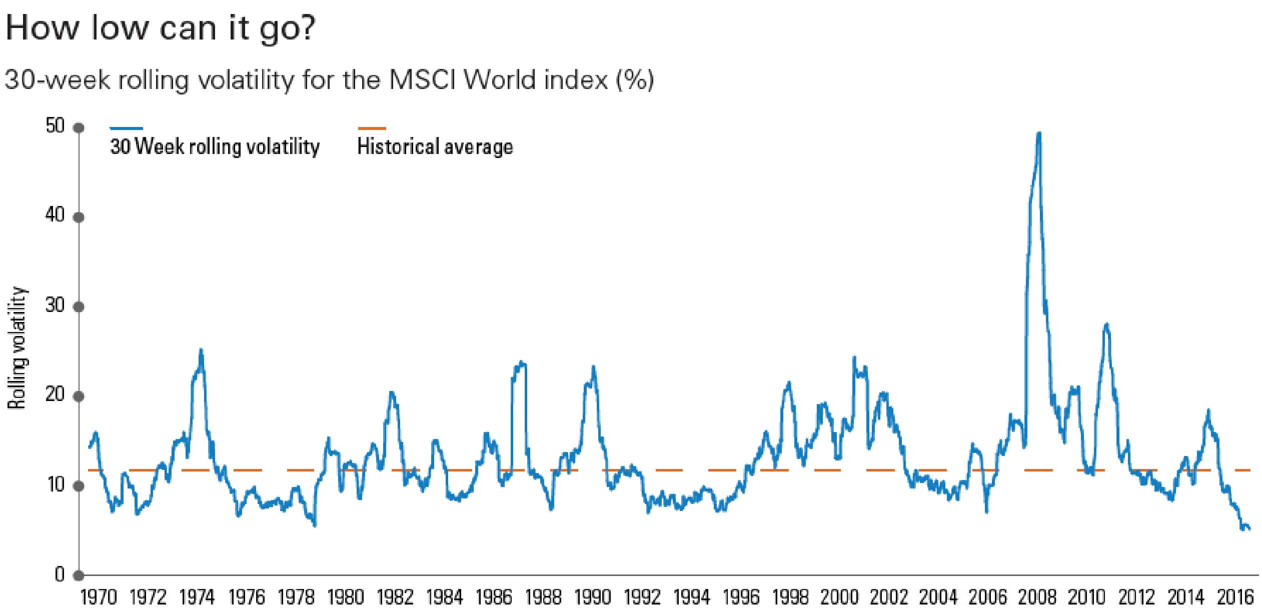
Managing the threat of rising volatility risk

Andy Sowerby

Over the last year, volatility has remained stubbornly subdued, hitting new lows on a regular basis. This trend has been seen across many markets and asset classes, including the often unpredictable emerging markets. US equities led the way, shrugging off public policy uncertainty, the Fed's rate hikes, and natural disasters.



Source: Bloomberg. 1/12/17.

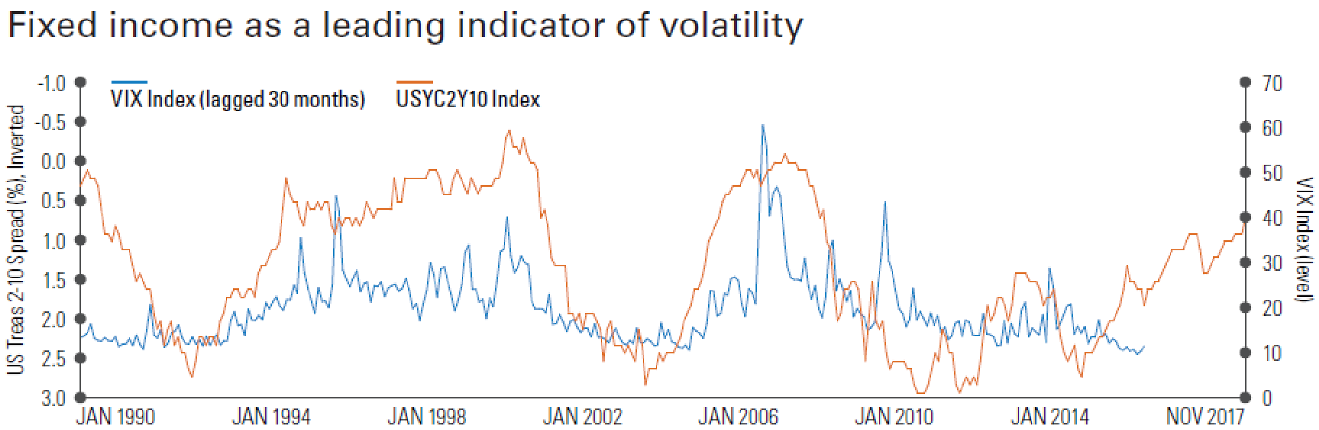
Looking ahead, several key risk factors could come into play. There is considerable uncertainty around key geopolitical relationships and the pace of monetary policy tightening. As global growth takes hold, central banks are beginning to rein in their unprecedented quantitative easing programs. Many countries also have a long way to go in implementing structural reforms. And bond and equity prices looking increasingly expensive, particularly in developed markets.

Can volatility remain this low indefinitely? Will interest rate normalisation put a spanner in the works? And, if volatility does pick up, how can investors not only manage the associated risks, but also take advantage of the opportunities presented?

Ready to revert?

Traditionally, volatility has been mean-reverting, returning to average levels over time. Analysis from Legg Mason's global equity affiliate, Martin Currie, suggests volatility is now at 50+ year lows. Large declines in correlations between stocks, as well as a drop in the individual volatility of stocks themselves, are behind this phenomenon.

If tighter labor markets and higher inflation start to emerge due to sustained global growth, it could initially cause higher volatility in fixed income markets, which may then feed into equity markets. Equity volatility tends to lag changes in the yield curve by around 30 months, according to Legg Mason global equity affiliate ClearBridge Investments. In their view, while quantitative easing acted as a pacifier of volatility, quantitative tightening may act as an accelerant.



Source: Bloomberg, 1/12/17. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

A prolonged period of low volatility can also act to increase the scale of volatility once it returns. Many risk models are built using measures of short-term historical volatility and may now be *"increasingly underestimating the true level of risk in portfolios"*, according to Martin Currie. A pick up in volatility could, therefore, lead to a more rapid market response as risk models adjust from their low base.

Furthermore, investors are expecting markets to continue to perform well as the economic environment remains benign. Hence, the risk of disappointment is skewed to the downside. A deviation from expectations could cause an outsized movement in asset prices.

What investors can do

The implications of higher volatility for portfolios are not always negative. What can investors do?

- **Buy low-volatility stocks:** One approach to the challenge of an uptick in equity volatility is to explicitly seek out stocks with properties that can minimise volatility, both individually and as components of an overall portfolio. A good example is companies with strong dividends that are sustained by the financial and business fundamentals of their underlying businesses. The overall financial characteristics of strong dividend payers can reduce a stock's vulnerability to rapid market changes.

- **Move fixed income away from benchmarks:** A more flexible, unconstrained approach to fixed income may help manage risk, by allowing greater scope to access the full global bond landscape as well as individual security selection. By dynamically shifting allocations in line with market conditions, unconstrained managers can identify the most compelling, potentially undervalued bond markets and currencies — as well as regions, countries, or sectors that offer a better yield or where duration risk should be rewarded — while avoiding or even shorting areas of concern.

- **Consider active management:** As volatility feeds into equity markets, active management may also help to manage risk. For example, strategies designed to invest in stocks with a historical tendency to resist periods of volatility can help protect portfolios from the full scale of any downturns. Lower correlations among stocks and a higher dispersion of returns across the market also creates more winners and losers. As Martin Currie notes:

"We are conscious of increasing dispersion in returns within the asset class, and the consequent need for investors to be selective. This is best achieved through taking an active, fundamentally driven approach to investment, and a focused, stock-picking strategy is very well placed in this regard."

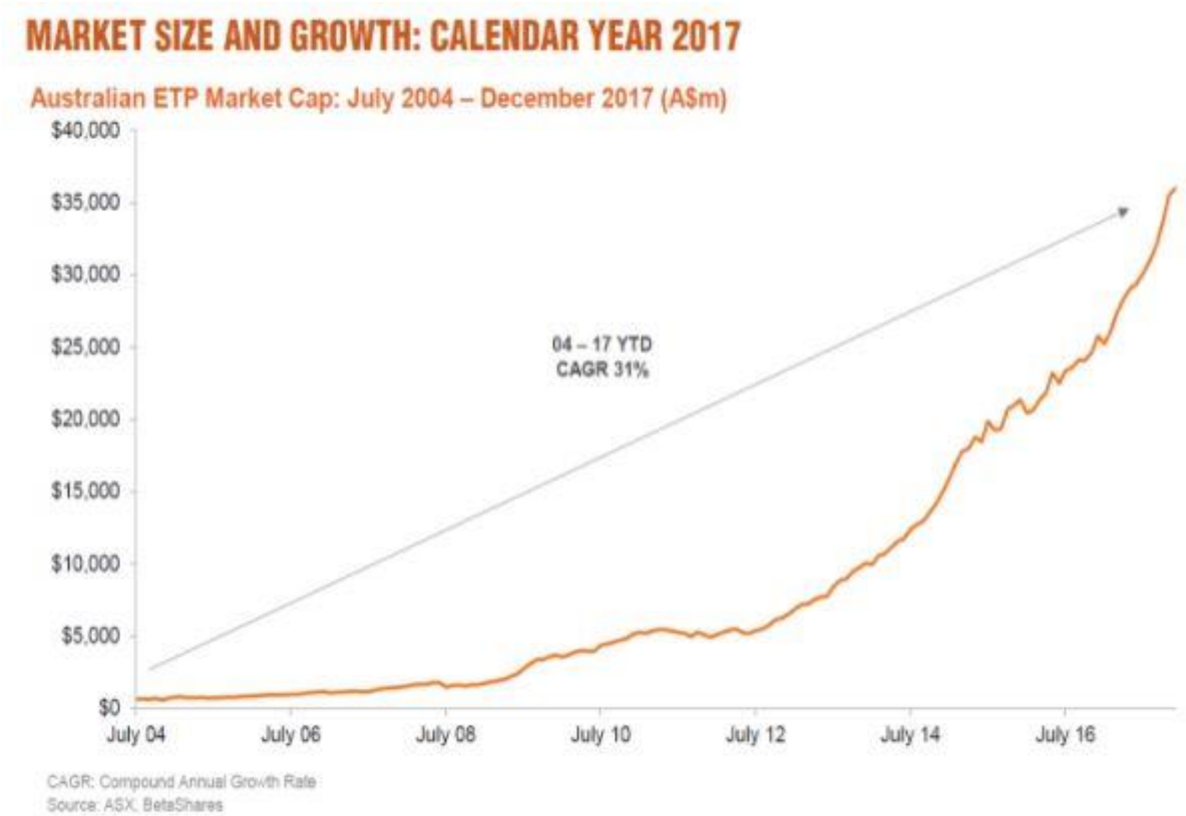
Additional information, particularly around (ESG) environmental, social and governance issues, can increase a manager's conviction in the sustainability of a company's returns, even during periods of market volatility. An active manager with an ESG framework can also be an engaged investor, working with companies to create sustainable long-term returns.

Andy Sowerby is Managing Director at [Legg Mason Australia](), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, guarantee of future results, recommendations or advice.

3 predictions for Australian ETFs in 2018

Ilan Israelstam

The Australian exchange traded product (or Exchange Traded Fund – ETF) industry is set to grow significantly in 2018 based on the momentum of last year. As at end of 2017, Australian ETFs reached an all-time high of $36 billion, up from $25 billion in 2016. Investors increasingly recognise the ease with which ETFs can be used to diversify their portfolios, as well of their cost-effectiveness and transparency benefits.



Before we look at the prospects for 2018, here are some other highlights from 2017:

- Annual new flows (net new money) reached a record $7.8 billion. The three largest issuers (Vanguard, iShares and BetaShares) attracted 72% of industry flows.

- 226 Exchange Traded Products are listed on the ASX, with 31 new products opened and 3 closed or matured in 2017.
- Trading volume increased by 41% over 2016 to reach $32 billion.
- The traditional index-tracking ETFs remained dominant taking 79% of flows, with smart beta (13% of flows) and active (8%) raising the rest. The latter two grew strongly in dollar terms but low-cost tracking still appeals most.

As an indication that direct investors accept they are underexposed to global shares, international equities attracted the most inflows:

Top 5 category inflows (by $) – 2017

Category	Inflow Value
International Equities	$ 3,218,543,150
Australian Equities	$ 2,639,166,266
Fixed Income	$ 1,144,785,846
Cash	$ 388,523,500
Australian Listed Property	$ 230,038,981

Also notable that fixed income did well, while only currency ETFs as a group experienced net outflows for the year.

Here are our predictions:

Prediction one: Millennials will continue to be an important driver of growth

Although investors of all types have embraced ETFs, millennials are attracted by the low cost and ease of use of ETFs, as well as the tailored exposure to investment themes that matter in their lives. In our product suite, for example, ETFs such as the Australian and Global Sustainability Leaders ETFs allow younger people to invest according to their values. Products such as the Nasdaq 100 ETF or the Cybersecurity ETF allow exposure to companies whose products resonate with their daily lives.

Market figures to bear out these trends, and according to CommSec, 25% of all ETF trades are now done by millennials. The diversification benefits of ETFs make them a good way to start investing in the sharemarket.

Prediction two: Greater innovation in bond ETFs

Fixed income has long been acknowledged as a good way to diversify a portfolio, but bond markets have historically been difficult for individual investors to access directly. In the last year in particular, there has been significant innovation in this space, with rapid growth in fixed income ETFs globally. With interest rates at record lows, ETFs give exposure to bonds that go beyond traditional fixed-rate exposure.

The recent launch of floating-rate bond ETFs offer a lower volatility alternative to traditional fixed-rate bond exposures as their interest payments adjust to reflect rises or falls in benchmark interest rates. This is particularly useful in a market where interest rates are rising, and floating rate ETFs appear well-placed to perform well given current interest rate expectations.

Beyond this particular style of fixed income investing, in 2018 more generally, we expect to see further innovation in fixed income ETFs, providing direct investors with much-needed access to lower risk, income-producing assets.

Prediction three: Active ETFs will grow in popularity

Last year saw the continuation of active ETF launches, giving investors more opportunity to diversify their portfolios alongside the passive ETF investments. Indeed, active ETFs offering access to a variety of active management strategies have the potential to match the growth of passive ETFs. For example, BetaShares recently launched the first active ETF with exposure to a professionally managed portfolio of Australian hybrids.

While we remain a strong advocate of passive investing, there are a number of asset classes and managers who can add value via active investing. For example, the complexities of hybrid securities and relative inefficiency of the hybrids market make investing in this asset class via a professionally managed fund vehicle a worthwhile alternative for many investors.

Across all predictions, growth remains the consistent theme

The growth of the ETF industry in Australia will continue on a strong trajectory, and we expect ETFs to reach $47-49 billion by the end of 2018.

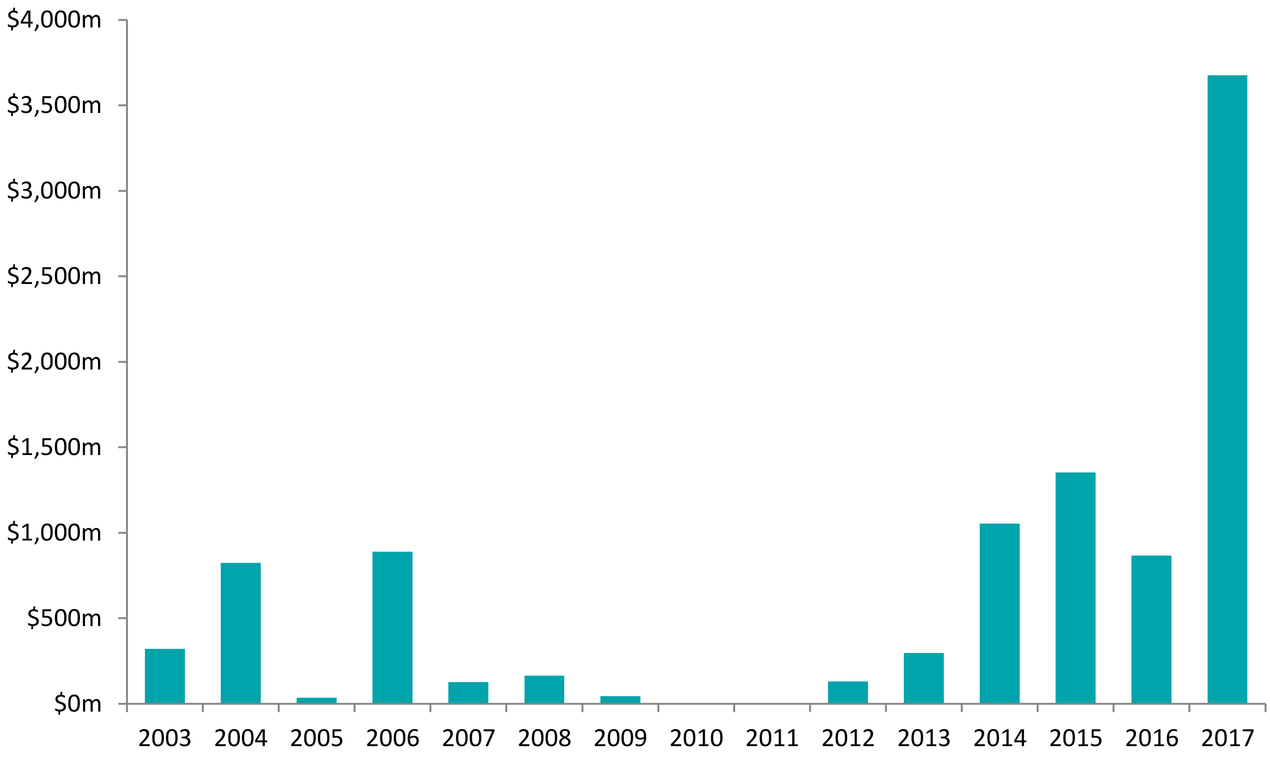
Ilan Israelstam is Head of Strategy & Marketing at BetaShares, a sponsor of Cuffelinks. This article is general information and does not address the needs of any individual. Latest editions of BetaShares' monthly ETF Review can be accessed here.

The reasons LICs have come-of-age

Nathan Umapathy

2017 was another big year for both Listed Investment Companies (LIC) and Listed Investment Trusts (LIT) with a record number of new and innovative entrants into the sector. LICs/LITs dominated capital raisings, bringing in $3.7 billion via Initial Public Offerings (IPOs) – accounting for more than half of the IPOs raisings for the year. And this was further supported by a number of secondary market raisings that saw $1.2 billion raised.

Money raised from LIC/LIT IPOs – 2003 to 2017



The largest 10 IPOs in 2017 of which 6 were LIC/LIT

Name (ASX)	Offer Size
Magellan Global Trust (MGG)	$1515.6m
VGI Partners Global Investments (VG1)	$550.0m
MCP Master Income Trust (MXT)	$516.2m
Bingo Industries (BIN)	$439.6m
Plato Income Maximiser (PL8)	$325.9m
Netwealth Group (NWL)	$264.2m
Wagners Holdings Co (WGN)	$196.8m
WAM Microcap (WMI)	$154.0m
Convenience Retail REIT (CCR)	$133.2m
Spheria Emerging Company (SEC)	$132.7m

Three reason for the growth

The growth rate of LICs was higher than managed funds in 2017, for three main reasons:

- **Future of Financial Advice (FoFA) reforms**: Since July 2013, commissions paid to financials planners by providers of managed fund have been banned. This has removed the incentive for financial planners to use managed funds over LICs or Exchange Traded Funds (ETFs).
- **A competitive dividend yield in comparison to the ASX200**: In July 2010, there was a significant change in the Corporations Act that paved the way for LICs to offer greater consistency in dividends. Previously, LICs could only pay a dividend if they had an accounting profit, which saw a number of LICs being unable to pay dividends through the GFC. However, following the introduction of the solvency test, LICs now have greater flexibility to offer sustainable dividend policies even with the absence of accounting profit. Many LICs offer a grossed-up yield higher than the Australian share market grossed up yield of 6.0%.
- **Stronger demand from the SMSF market**: An increasing number of investors are looking for greater control over their superannuation. The combination of rising property prices and prolonged low interest rate environment has resulted in a level playing field for alternative investment vehicles such as LICs and ETFs. SMSFs are a valuable investor base to cater for, as they now account for 28% of all superannuation assets in Australia and are growing.

We also saw two structural changes which we view as positive developments for LICs:

- **IPO cost absorption**: Historically, the cost of a LIC IPO – generally a fee of 2-3%- was transferred to the shareholder at listing. As a result, for example, a $1.10 IPO would see an opening Net Tangible Asset (NTA) of $1.06-$1.09. In late 2017, some LICs came to market with a proforma Net Tangible Assets (NTA) in line with its issue price. Managers of Magellan Global Trust (ASX:MGG), Spheria Emerging Companies (ASX:SEC) and VGI Partners Global Investments (ASX:VG1) absorbed the issue cost associated with its IPO, while MCP Master Income Trust (ASX:MXT) had its issue cost paid via a loan, which will be amortised by shareholders over the next 10 years. This enabled shareholders of MGG, MXT and VG1 to access these LICs at NTA on day one.
- **Less bonus options**: Bonus options issued at IPOs have generally been offered to investors to compensate for the issue cost reflected in the NTA. Investors who seek to purchase LICs in the secondary market must be cautious of the potential dilutionary impact on the NTA of in-the-money options, as options expiry nears. What is perhaps less understood is that the person who exercises these options is not diluted as they have received the benefit of a lower exercise price. As a result, bonus options were sometimes viewed negatively. With managers choosing to absorb the vast majority of the IPO cost, LICs no longer need to offer options as an IPO sweetener. Many LICs came to market without an option attached, removing the overhang that is cast around LICs close to option expiry.

Table 2: LIC/LIT IPO's – 2017

Name (ASX)	Listed	Issue Price	Proforma NAV	Option Ratio Bonus	IPO Raising
Fat Prophets Global Contrarian Fund (FPC)	Mar-17	$1.10	$1.08	1 option for 1 share	$48,532,405
URB Investments (URB)	Apr-17	$1.10	$1.07	1 option for 1 share	$80,138,665
Plato Income Maximiser (PL8)	May-17	$1.10	$1.08	1 option for 1 share	$325,895,249
Benjamin Hornigold (BHD)	May-17	$1.00	$0.98	1 option for 1 share	$20,001,000
Morphic Ethical Equities Fund (MEC)	May-17	$1.10	$1.07	1 option for 1 share	$48,884,690
WAM Microcap (WMI)	Jun-17	$1.10	$1.09	n/a	$154,000,001
Contango Global Growth (CQG)	Jun-17	$1.10	$1.06	1 option for 1 share	$100,019,057
Evans & Partners Global Disruption Fund (EGD)	Aug-17	$1.60	$1.55	n/a	$167,204,045
MCP Master Income Trust (MXT)	Sep-17	$2.00	$2.00	n/a	$516,180,370
VGI Partners Global Investments (VG1)	Sep-17	$2.00	$2.00	n/a	$550,000,002
Fat Prophets Global Property Fund (FPP)	Oct-17	$1.10	$1.06	1 option for 1 share	$16,682,662
Magellan Global Trust (MGG)	Oct-17	$1.50	$1.50	n/a	$1,515,149,343
Spheria Emerging Companies (SEC)	Dec-17	$2.00	$2.00	n/a	$132,675,092

The focus for 2018

We anticipate these changes will drive further interest and larger capital raisings that are likely to tip through $500 million plus.

We also expect more growth in areas that are still under-represented in investment portfolios. Global equity-focussed products are likely to be a key beneficiary with an increase in both size and different styles of offering. We expect growth in products that offer high and sustainable income, as well as fixed interest products, which is a gap in the LIC sector. Although it has been a strong period of growth for the sector, we believe there are several drivers now in place to see this growth accelerate over the coming years.

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Bitcoin, pricing dislocation and value investing

Carlos Gil

Price and value. Many investors think these two concepts are substitutable, but they refer to two different qualities. As value investors, we believe there can be large divergences between the two, which we call 'pricing dislocations'. These pricing dislocations mean the price of something, in our case, the share price of a company, does not reflect the intrinsic value of that company. By identifying undervalued companies, investors can make superior long-term profits.

Price is what you pay and value is what you get. For example, anyone can know the price of Bitcoin, but do they know its value?

You can buy a flight ticket from Sydney to Melbourne for as low as $120 but think about the value you get from that trip. You get to transport yourself from Sydney CBD to Melbourne CBD in around two hours when by car it would take you a gruelling nine hours and the fuel costs alone would be considerably higher. I would be willing to pay a much higher price to fly instead, because reaching Melbourne in two hours versus nine hours has significant value to me.

Price v value in the equity markets

At any time, there can be varying degrees of pricing dislocation within the stock market. We focus on buying specific companies that might have severe pricing dislocation in favour of value based on a very bankable causality: people. People are a reliable source of pricing errors. Whether they are retail or institutional investors, they make extreme errors of judgement and assess value based on a list of hard-wired factors that trigger an irrational decision framework. Factors such as greed, fear, peer group pressure, loss aversion, short-term bias and anchoring help to create erroneous decisions. Over time, the divergence between market prices and intrinsic values will converge and pricing becomes rational.

Think about the stockmarket crash in 1987 which saw prices fall on average by more than 20%. Now the intrinsic value of companies across the world could not all have fallen by 20% in the space of 24 hours. So, either there was pricing dislocation before the crash or there was pricing dislocation after the crash. Remember the dotcom boom? When the dizzying market prices of that bubble finally corrected back to intrinsic values, the NASDAQ composite index fell by 78% in the 30 months post the then all-time high. Market prices during the bubble phase clearly did not reflect intrinsic values.

Value drivers

Intrinsic value in investing is derived from cashflows. The value of the business is assessed by discounting the free cashflow the business is expected to generate in the future. Returns above a return appropriate for risk may mean that the market value of the business might be undervalued. On the other hand, investors would have avoided a lot of pain during the dotcom boom as many companies were decades away from generating profits and hardly generated any revenues. The intrinsic valuations in those cases were close to negligible.

Is Bitcoin a bubble?

Bitcoin is based on a revolutionary technology called blockchain. Blockchain is based on a decentralised ledger system which uses nodes as opposed to a traditional single-source ledger or single source of truth, to validate and hold ledger entries. It uses these nodes to evaluate and verify a proposed transaction and if the majority of nodes concur, the new entry is added across the network of nodes. This system should improve the integrity and security of data and radically improves the speed and reduces the costs of transactions. The technology will prove to be highly valuable and change the way many large data networks function. It will make a transformative contribution to society and help achieve increased productivity, reliability, and security.

So, Bitcoin is therefore valuable? Not exactly. Bitcoin purports to do two fundamentally important things.

First, it is a digital currency and any currency whether digital or otherwise must do a few things well. It must be widely-accepted as a means of exchange, preferably as legal tender. Bitcoin is not legal tender in any main jurisdiction and some countries have actually made transacting in Bitcoin illegal. You can’t go into a car dealer and buy a car in Bitcoin, you cannot settle a property purchase in Bitcoin, and if you go into Amazon or JB Hi-Fi they will not accept Bitcoin for the purchase of goods.

Furthermore, the price volatility of Bitcoin against major currencies like the US Dollar and the Euro is so wild and erratic that even if it were widely-accepted, why would merchants want to settle business accounts in something that could quite quickly swing their customers transactions from profit to loss in a matter of minutes? There are reasons why banana republic currencies are not in high demand as a medium of exchange – they are volatile currencies. As currency or pseudo currency, Bitcoin is awful.

But the second thing Bitcoin purports to do is be an efficient store of value like gold. It is an interesting assertion. Bitcoin’s proponents claim that unlike gold, Bitcoin has a finite predetermined supply. Many objects have a limited supply and might be very ordinary. What is the intrinsic value of a cryptocurrency? Well it is a wonderfully engineered peer to peer ledger system that is open-sourced with a technology platform that will prove invaluable to society, but its architecture can be widely-replicated, improved, or further developed and it already has been. There are already many Bitcoin-like substitutes: Litecoin, ZCash, Dash etc. The value of Bitcoin in terms of functionality can be replicated by others, and unlike the example of the value I get from flying to Melbourne versus driving to Melbourne (the substitutive alterative), it is likely the value of future iterations of cryptocurrencies will improve upon the technological architecture and security of Bitcoin. Indeed, as blockchain adoption gains increased usage, governments may launch their own cryptocurrencies and legislate them as legal tender, immediately bestowing those currencies with a competitive advantage over Bitcoin and undermining its value.

The price has risen, not the value

Bitcoin has risen in market ***price*** by 2000% over the last 12 months, not value. Market prices and value are two very different qualities, a lesson that for many cryptocurrency investors may prove an expensive one.

Carlos Gil is the Chief Investment Officer of [Microequities Asset Management](). This article does not constitute financial product advice. You should consider obtaining independent advice before making any financial decisions.