Weekly Review

WEALTH

– Issue – 25 Nov. 2016

The Australian exchange-traded fund market is evolving rapidly, in terms of both size and diversity.

BY TONY KAYE • EUREKA REPORT • 23 NOVEMBER 2016

ETF inflows show a changing pattern

Australia's exchange-traded funds market is surging towards the 2016 finish line at a blistering pace, with net capital inflows in October topping $600 million and the current month also looking strong.

Key Point

- ***Demand for fixed-interest ETFs indicates yield hunters are looking beyond standard bank income products.***

At this point, total inflows in the current quarter are on track to easily surpass the $1.02 billion of investor funds that flowed into the 150 or so ETFs listed on the Australian Securities Exchange during the three months to the end of September.

So, if all goes according to plan – for the ETF product issuers, that is – the total inflow of funds into Australian-listed ETFs for calendar 2016 should be in the vicinity of $5bn, and potentially more.

Which should push total funds under management across the ETFs space beyond the current $24bn level, further demonstrating the ongoing attraction of these products for investors.

Behind that attraction, of course, is the reality that ETFs are a low-cost entry point for those wanting exposure to whole market indices or asset classes through a single security, and they provide the inbuilt flexibility to buy and sell on-market at will because they're listed, as opposed to unlisted managed funds.

The trading volumes from the ASX show that the 12-month average number of monthly ETF transactions reached 63,843 in September, and the average value of monthly transactions for the 12 months to September reached $1.89bn.

Where the ETFs money is heading

That ETFs are a popular choice for retail investors is undisputed, and the rapid growth in the number of products available in Australia is testament to that.

But what's most interesting around the latest ETF inflows numbers is where investors' money is actually going.

There are two clear patterns in the data flows. The first is that while home-market bias is still evident, with investor inflows into products providing exposure to the broad Australian market remaining strong, the dollar inflows into international equity ETFs are also robust.

In fact, over the year to date, inflows into internationally-focused ETFs have been higher, totalling $870 million compared with around $840m for Australian-focused ETFs.

The bulk of the money continues to be channelled into ETF equities products, covering the ASX200 index, the US S&P500, and the MSCI World Index of the largest developed markets.

Yet, the second clear behavioural investment pattern that has emerged is that the hunt for yield is accelerating – quite likely a reflection of low interest rates and an increased demand

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from those in retirement phase wanting better returns to generate regular income.

Supporting this, the BetaShares Australian Dividend Harvester – which provides investors with exposure to large capitalisation Australian shares and franked dividend income, paid monthly – was the biggest puller in terms of equities funds in the September quarter. According to data from Morningstar, the ETF attracted inflows of $94.2m, compared with $51.5m in the June period.

It was followed by the Vanguard Australian Shares Index ETF and the Magellan Global Equities Fund, with each taking in around $83m in fresh shareholder capital.

Yield hunters target fixed interest ETFs

The fast-growing pool of funds now being directed into fixed interest ETFs reflects a renewed focus by investors on capital protection against their exposure to expensive equity markets, with many recognising the opportunity to chase higher yields in bond ETF products as interest rates begin to rise in the US and other parts of the world.

It is also a clear indication that more investors are recognising the benefits of products that offer higher real returns and greater flexibility than standard bank income products such as term deposits.

Figures from the three months to the end of September show a very strong uplift in inflows into both Australian and international fixed interest products. From a net outflow position of close to $60m in the June quarter, the investor tide into Australian fixed interest ETFs turned completely in the September period to show positive inflows of more than $200m. Likewise, inflows into international fixed interest ETFs tripled from $21m in the June quarter to around $60m in the three months to the end of September.

That trend was well reflected in the Australian ETF numbers, with the biggest fund inflows overall in the September quarter – just under $124m – going into the Vanguard Australian Fixed Interest ETF.

A further $46.7m was directed into the BetaShares Australian High Interest Cash ETF, which aims to generate returns above the 30-day bank bill swap rate and provide monthly income distributions. The fund has achieved this key objective ever since it was launched in 2012.

Over the year to date inflows into fixed income ETFs have been just shy of $500m, compared with $440m in 2015.

"Fixed income products continue to attract considerable investment, with 22 per cent of total ETF flows going into domestic fixed income products and 5.5 per cent into international fixed income products," ANZ noted in its latest ETFs report.

"The inflows into international fixed income ETFs are of particular note, as this was the last key asset class made available to Australian ETF investors. There are only five ETFs in this asset class which have all been open to investors for less than a year (all five were launched in December 2015), pointing to strong demand for international fixed income exposure among ETF investors seeking further diversification."

In the bigger scheme of behavioural investment patterns, the fixed interest uplift is simply part of the ongoing evolution of the ETFs sector, with more products becoming available in the Australian market.

It also reflects the continued diversification of ETF holdings by investors, especially into international products and other asset classes to reduce risk.

Over the long term, low priced 'value' companies tend to outperform higher priced growth companies.

BY DOUG TUREK • EUREKA REPORT • 24 NOVEMBER 2016

How value investing is paying off

American finance Professor Eugena Fama was awarded a Nobel Prize for showing that out of favour, lower priced 'value' companies offer investors above-average long term returns compared with in favour, higher priced 'growth' companies.

Key Point

- ***After several years of underperformance, value strategies have started to deliver and may continue to do so in a Trump world.***

The so-called 'value premium' is one of a few premiums exploited by 'smart beta' strategies and is the house style of several active fund managers.

Value has underperformed in recent years, as investors crowded into defensive, high yield and higher growth stocks. That was until about six months ago, when oversold energy and materials companies rebounded.

Following the surprise election of big-spending Donald Trump, these companies have continued to be favoured. Middle class job-destroying and global trade dependent technology companies, trading on vulnerably high price-to-earnings ratios (P/Es), have since faltered. Here we look more into the value effect and try to answer whether exploiting it could be 'value-able' to you?

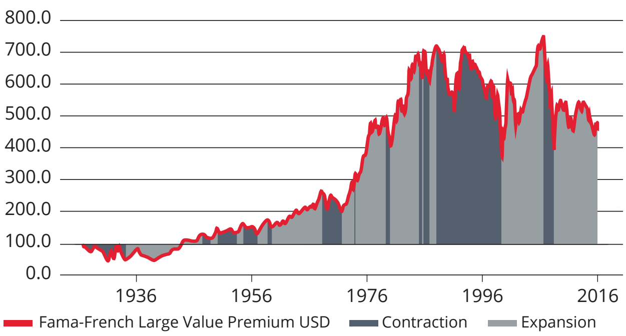
Value premium over the very long term – nearly 90 years

Chart 1 depicts the difference in investment returns from investing in large-value companies instead of growth companies in the US since 1927. The upper part of the chart shows the cumulative difference in return since 1927. The lower part shows this after each time the premium contracts or increases by a threshold 10 per cent.

Key takeaways are:

- Value companies have over the very long term offered better returns, the premium averaging 2.7 per cent annually.
- However a value strategy doesn't reliably deliver. Sometimes growth beats value as shown by the dark bands.
- Since the 1990s the value effect seems less strong among US companies – instead growth and value seem to simply take turns in seasons of outperformance.
- Growth companies which included dotcom stocks outperformed before 2000 until crashing. Value companies outperformed before the GFC, and afterwards were abandoned.
- After the 1929 crash, value companies were out of favour for about six years then outperformed for the next 10 years. Perhaps this is telling us something?
- Not shown, the value effect exists just as strong or stronger among small companies and outside the US.

Chart 1: Fama-French large value premium for US companies since 1927



Source: Morningstar

Value premiums over the shorter term – the last 20 years

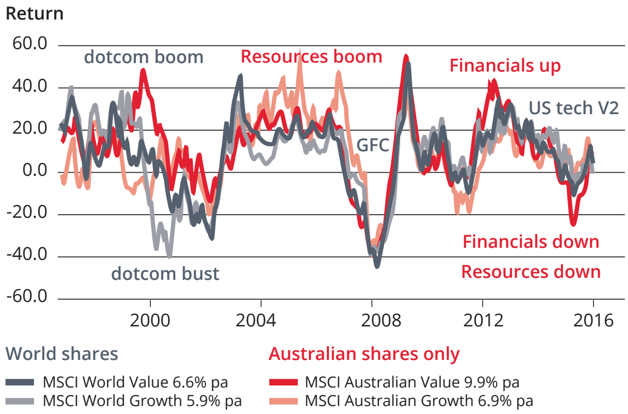
Chart 2 (over the page) depicts rolling annual returns investing in a world and local Australian mix of value and growth companies over the last 20 years. Annual returns investing in value companies are shown in blue and growth companies in red. In these charts whenever the blue line is above the red line, value beats growth and vice versa.

While over the last 20 years value companies beat growth companies, this hasn't been a consistent pattern nor the recent case. Over the last three years value companies have underperformed growth companies – returning 2.4 per cent annually, both locally and across the world coincidentally, versus 6.5 per cent and 4.5 per cent locally and across the world respectively for growth companies.

However, since January this year value companies locally returned 6.7 per cent and 6.5 per cent across the world, compared to 0.4 per cent locally and 1.3 per cent for growth companies. About six months ago it seems value companies started to become more valuable!

> **“Buying BHP cheap when no one thought it sexy and selling it when it was for a premium is how a value strategy can outperform.**

Chart 2: Rolling annual returns investing in value companies (blue) versus growth companies (red) for 20 years to October 31, 2016



Source: Professional Wealth

What actually is a value company?

Value companies can be characterised a number of ways but largely it’s on relative price. Some classify value companies as the bottom third of companies ranked on a price to accounting book value, others by ranking P/Es and others by a combination of like measures.

What industries value companies come from can change. For instance, during the dotcom boom, unloved resource companies like BHP would have been value companies. However, during the subsequent resources boom, the price of BHP would have been bid up to move it out of value and into growth. Buying BHP cheap when no one thought it sexy and selling it when it was for a premium is how a value strategy can outperform. BHP’s share price in 2000 was $7 and in 2007 it breached $40.

Value companies have two, multiplying ways of making money for you:

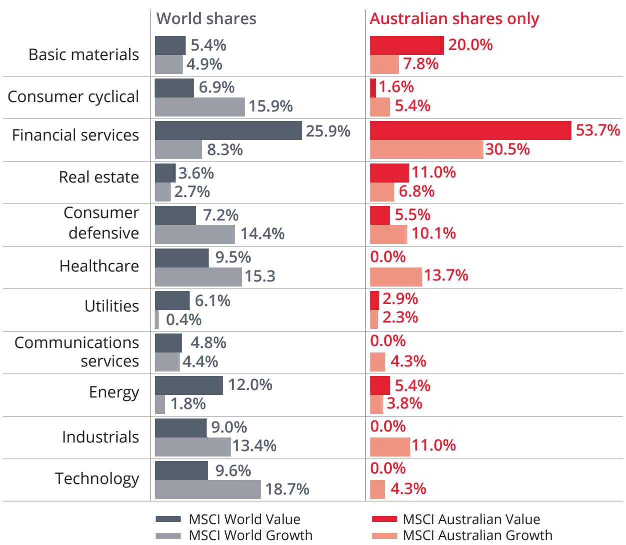
- They can increase their earnings (E), and;
- When everyone notices they have or will, their P/E multiple increases.

Contrast this to a growth company with record earnings growth trading on a high P/E – unless they can keep “beating the fade”, they have two multiplying ways to lose you money: a falling E and P/E multiple.

Chart 3 depicts the industry mix of value and growth companies across the world and in Australia at present. In case you can’t read the chart labels easily, you are more likely to find value stocks in Australia among ‘basic materials’, ‘financials’ and ‘energy’ companies. Outside of Australia add ‘utilities’. Growth companies are more likely ‘consumer’ companies (cyclicals and defensives) and ‘health care’.

At the moment financial stocks, especially banks, are considered good value. In Australia a value strategy generally overweights banks, however, it shouldn’t for all of them. ANZ and NAB were value banks while CBA and Westpac weren’t in some fund manager strategies. The value gap in P/E between these, which was as much as 20 per cent, is largely closed, creating profits for those who saw that value.

Chart 3: Industry sector compositions of companies in the MSCI World and Australia Value and Growth indices



Source: Professional Wealth

High P/E technology stocks generally are growth stocks. It’s hard to consider Facebook trading on a P/E of 45 and Amazon 173 as value companies – they are growth companies. It may be important to your wealth preservation to point out that these two expensive stocks plus Alphabet (Google), Microsoft and Apple now make up five of the top 10 stocks in the US S&P500. Technology is now the largest sector representing

> **If it feels like the dotcom era all over again, then a value strategy is your friend.**

20 per cent of the market. If it feels like the dotcom era all over again, then a value strategy is your friend.

The recent outperformance of value companies locally and offshore is due to a bounce back in oversold resource companies basic materials and energy companies. Since the US election, technology stocks have also contracted in favour of financial stocks and resource companies.

Value style funds*

Given the dynamic nature of what constitutes a value company, a buy and hold strategy is not going to deliver you any value premium.

If you don't want to actively manage a portfolio, you can hire someone else to do this for you. Morningstar counts about 19 Australian equity value-style funds. Note these include 'industrials'-style funds that exclude resource companies. Funds that have been around for, perhaps, 15 years are needed to discern manager value-add from noise/luck. I'm not confident you can do so over a shorter five-year period.

About half of these funds have 40–60 per cent invested in banks, while others have much less. If you are worried about being overweight bank shares look closely before investing.

While most funds are actively managed, a few implement a lower cost, rule based methodology. This includes funds who count Eugene Fama as an advisor and funds adopting US company Research Affiliates' alternative indexing methodology. Some funds offer a value-style ETF, but with up to 64 per cent holdings in the big four banks these fund should be relabelled as bank ETFs rather than diversified value funds.

US-based investment strategy firm Research Affiliates currently believes that after a period of underperformance, value offers an expected premium return of 5 per cent per annum over the next five years. If so, that would be very valuable in a low future returns world.

EDITOR'S NOTE: Eureka Report's stocks analyst team at Intelligent Investor use a value investing approach to locate undervalued businesses that represent strong, long-term prospects for investors. Their recommendations form the basis of the II Growth and II Equity Income funds. Further information on our actively managed stock portfolios can be accessed on the InvestSMART website by **clicking here.*

*Dr Douglas Turek is principal advisor with family wealth advisory and money management firm **Professional Wealth**.*

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The number of shares that a company has outstanding has an important impact on the dividends we receive, and the per share value of the company.

BY SCOTT FRANCIS • EUREKA REPORT • 22 NOVEMBER 2016

Share dilution: Be alert, not alarmed

The core of being a shareholder for most people is simple. As a part owner of a company you hope to benefit from receiving a share of the earnings of a company (dividends) and you hope that, over time, that company's earnings will grow and the shares you own will become more valuable.

Key Point

- ***The decision to issue extra company shares is not a good or bad decision by itself, but can be a clue to management competency.***

Of course, there is a risk that both of these might not happen, something that you need to be comfortable about as a shareholder.

A key input into benefiting from both the share of earnings an investor hopes to receive, and benefiting from the growth of company earnings over time, is the slice of the company that you own. As investors, I think that sometimes we lose track of how important our ownership slice of the company is.

During the financial stress of the Global Financial Crisis, large numbers of discounted shares in companies were issued to raise money as companies struggled to get loans, often with little discussion of how issuing extra shares impacted on the existing shareholders. Overall though, it is important to note that the decision to issue extra company shares is not a good or bad decision by itself. The aim of this article is simply to raise this issue for investors, as something that they should keep their eye on.

Reasons for issuing new shares

It is worth starting this discussion on the issue of share ownership dilution by considering the reasons that companies might issue extra shares. Going to the very start of the decision, there are going to be times that companies will need to raise extra funds.

Those funds might be needed for a variety of reasons, from expanding the business, to purchasing a new business, to paying for a significant asset. There are two core approaches that a listed company might take to raising funds; choosing between borrowing money (possibly through a bond issue or a bank loan), or issuing extra shares.

There are, of course, pros and cons to both approaches. As an owner of a company you will be keen to see that debt levels (for example, the debt-to-equity ratio, or the interest-coverage ratio) remain modest while also not wanting to see so many extra shares issued such that your ownership stake in the company is diluted too much.

It should also be noted that making the decision to borrow money or issue new shares to raise funds is an entirely reasonable decision for a company to make. A key argument for owning shares is the possibility of benefiting from an increasing stream of earnings and dividends. To create growth, funds are needed to invest in new projects and new assets. Further, when the time is right companies might choose to buy back some of their shares. The decision to issue or buy back shares can be part of the decision making that is made to maximise shareholder returns.

At a practical level, key reasons that extra shares are issued include:

- through rights issues to all shareholders to raise more significant sums of money;
- as payments to executives; and
- as part of dividend reinvestment plans, where new shares are sometimes issued in place of cash payments for shareholders who elect to receive dividends in the form of additional shares.

A case study: NAB

National Australia Bank has now, for three years running, kept its dividend steady at $1.98 per year. This is, of course, better than cutting its dividend, but in the short term it does not meet the ambitions of shareholders who hope that dividends will increase over time. It is interesting to think about this flat dividend against the change in shares on issue for NAB over time.

The following table shows the change in shares for NAB over the two most recent financial years.

> **“There are going to be times that companies will need to raise extra funds ... from expanding the business, to purchasing a new business, to paying for a significant asset.**

Table 1: Number of ordinary NAB shares on issue for the last two years at September 30

	2016 NO. ‘000	2015 NO. ‘000
ORDINARY SHRES, FULLY PAID		
BALANCE AT BEGINNING OF YEAR	2,625,764	2,365,791
SHARES ISSUED:		
RIGHTS ISSUE	–	193,912
DIVIDEND REINVESTMENT PLAN (DRP)	21,325	35,057
DRP UNDERWRITTEN ALLOTMENTS	–	24,603
BONUS SHARE PLAN	2,052	2,095
EMPLOYEE SHARE PLANS	7,461	3,540
PERFORMANCE OPTIONS AND PERFORMANCE RIGHTS	359	761
PAYING UP OF PARTLY PAID SHARES	15	5
TOTAL ORDINARY SHARES, FULLY PAID	2,656,976	2,625,764

The first financial year saw a significant increase in the number of shares on issue, a more than 10 per cent increase in the number of shares. Most of those extra shares came about through a rights issue, which set out to raise $5.5 billion in the middle of 2015.

The raising was done to improve the capital position of the business, in anticipation of regulatory change. Importantly for shareholders, the rights issue was structured in such a way that everyone was able to participate in proportion to their holding (it was a two-for-25 *pro rata* rights issue) and those people who did not want to, or who were not able to, buy extra shares still benefited from the rights issue as it was ‘renounceable’ and people could sell their rights on the market, or have them sold on their behalf.

If we have a look at 2016 we can see that there are significantly less shares issued, with most shares issued through the dividend reinvestment program and the employee share plan. The extra shares issued amounted to less than 2 per cent of shares on issue.

Final word

The core of investing in shares remains the fact that we are part owners of a company, and the number of shares that a company has outstanding has an important impact on the dividends we receive, and the per share value of the company.

Being aware of this, and keeping an eye on how companies we invest in are issuing or buying back shares, provides us with a useful source of information about how the company is being run.

Employment across the nation fell on a trend basis in October – the first monthly decline in three years, giving little impetus to monetary tightening.

BY CALLAM PICKERING • EUREKA REPORT • 22 NOVEMBER 2016

How our employment shift is affecting investors

Last week the yield on 10-year federal government bonds rose to its highest level since April – creating speculation that the next rate move for the Reserve Bank may be up rather than down. Yet, the recent run of labour market data provides a sobering reminder of the challenges facing the Australian economy.

Key Point

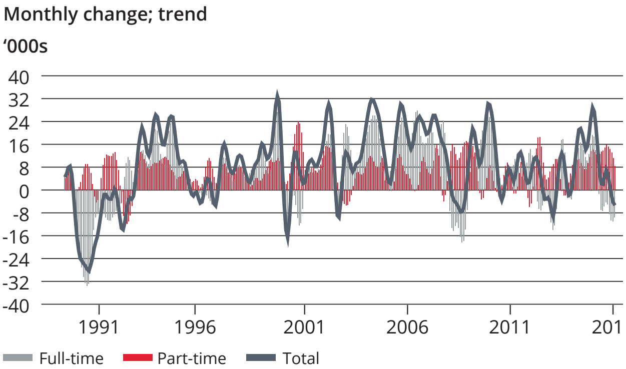
- ***Lower wages should provide a boost to corporates, generally, although retail stocks and rental income are already likely losers.***

The Australian Bureau of Statistics (ABS) released its Labour Force Survey and Wage Price Index last week and it was a disappointing result for investors, with both employment and wages falling well short of market expectations.

Last month I noted that "we currently have an economy that is creating jobs but isn't creating the high-quality or high-wage jobs that we have become accustomed to." The latest employment figures from the ABS indicate that this is no longer true: the Australian economy isn't creating any jobs at all.

Employment across the nation fell by 1000 people on a trend basis in October – the first monthly decline in three years – with employment rising by 108,100 people over the past year. The pace of monthly growth has slowed significantly over the past 12 months, which can be seen clearly in Chart 1.

Chart 1: Australian employment growth



Source: ABS; via CP Economics

The labour force figures are arguably the most important monthly economic indicator for Australia. The state of the labour market provides important insights into the broader health of the Australian economy, as well as the health of specific sectors. It is closely watched by market analysts and investors alike.

A decline in trend employment is obviously undesirable but also relatively unusual. History suggests that such episodes are normally short-lived – with the exception of the early 1990s recession – and the persistence of this current downtrend will be closely watched by market analysts and investors in the months to come. If employment growth remains persistently weak then it might signal that there are underlying problems, particularly across the non-mining sector, which may not be currently priced into equities or bonds.

Chart 2: Australian part-time employment

Source: ABS; via CP Economics

It's also worth noting that the recent weakness may, in part, reflect issues with the ABS's methodology. Recent changes have wreaked havoc with the seasonal factors that help to transform the raw data collected by the ABS into meaningful statistics. This has undermined the reliability of the seasonally-adjusted employment and unemployment statistics.

Throughout the latter half of last year it was speculated, by myself among others, that the ABS had overestimated employment growth. It is quite possible that this recent episode reflects a reversing of that earlier period of over-

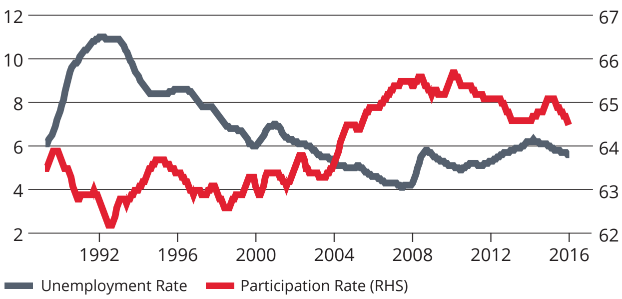
> **"Existing spare capacity ensures that employers will have little trouble finding able and willing employees.**

estimation, which suggests that employment growth may not be as weak as the official estimates suggest.

Unfortunately, it's all but impossible to estimate whether this is correct in real-time, which means that these estimates are the best available information for policymakers and investors.

Full-time employment has been falling for the past 10 months, declining by 9500 people in October, to be down almost 50,000 people over the past year. Part-time employment continues to expand and has now accounted for almost 70 per cent of all employment growth over the past five years.

Chart 3: Australian unemployment and participation rates (%)



Source: ABS; via CP Economics

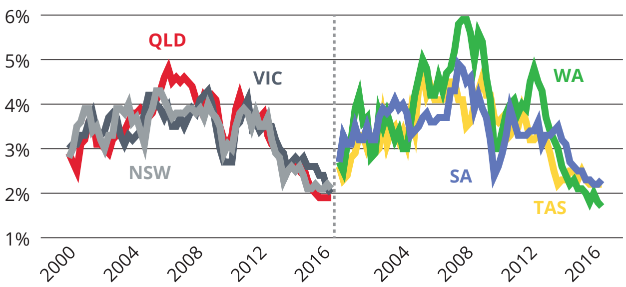
In light of the victory by Donald Trump, the shift away from full-time employment, particularly with regards to young men, bears some watching. It has the potential to be a similar trigger here that the loss of jobs from globalisation was in the United States.

The unemployment rate remained at 5.6 per cent in October, having fallen by 0.4 percentage points over the past year. The participation rate, which measures the share of working age persons in the labour force, has declined to its lowest level since February 2006.

A decline in participation puts downward pressure on the unemployment rate, which – combined with the ongoing shift towards part-time employment – means that the unemployment rate provides an increasingly inaccurate assessment of labour market conditions.

As I noted last month, the under-employment rate currently sits at 8.7 per cent – its highest level on record. The labour market under-utilisation rate (unemployment plus under-employment) stands at 14.3 per cent.

Chart 4: Wage Price Index by State



Source: ABS; via CP Economics

The high level of spare capacity across the economy, reflecting the high number of individuals either searching for work or wanting to work more hours, has put employees in a poor bargaining position. The end result is the weakest wage growth since our last recession a quarter century ago.

According to the ABS, the wage price index rose by 0.4 per cent in the September quarter, missing market expectations, to be 1.9 per cent higher over the year. Weakness is apparent in both the private and public sectors and doesn't appear likely to change anytime soon.

Chart 4 compares annual wage growth across the states. Wage growth is strongest in Tasmania and South Australia but sits well below normal levels in every state. Even the so-called boom states of NSW and Victoria are reporting their weakness wage growth in over two decades.

Soft wage growth will continue to weigh on retail spending and retail stocks in the short term. Existing spare capacity ensures that employers will have little trouble finding able and willing employees.

> **Soft wage growth will continue to weigh on retail spending and retail stocks in the short term.**

In the long term a persistent period of soft wage growth could prove to be a blessing for Australia's corporate sector. Australia is a high-wage economy but productivity has failed to keep-up with wage growth. By international standards, Australians are often overpaid compared with their foreign peers, which has undermined the competitiveness of domestic businesses.

Soft wage growth, combined with a weaker Australian dollar, helps to improve the competitiveness of Australian corporates. This is one of the reasons why key policymakers, such as the Reserve Bank, have argued in favour of a currency devaluation. Stagnant wages basically achieves the same thing, albeit in a less efficient manner.

Of course, this is cold comfort for those who are in the midst of a wage freeze. It certainly doesn't help retailers, and plenty of property investors are struggling under the weight of falling rents.

Current labour market conditions suggest that the Australian economy remains quite weak. Commodity exports continue to drive growth but this sector creates relatively few jobs. The non-mining sector remains reluctant to invest and until that changes I continue to see employment falling short of expectations and interest rates remaining at a low level.

As OPEC's November 30 meeting approaches, analysts are unsure whether the cartel can do much to affect price.

BY TIM TREADGOLD • EUREKA REPORT • 25 NOVEMBER 2016

Will OPEC muster the energy?

Oil is poised to rise above $US50 a barrel, and if you believe the forecasts of some of the world's leading investment banks it could keep rising – for a while.

Key Point

- ***Australian investors are wary with Beach Energy the only obvious beneficiary, so far, from speculation about a higher oil price.***

Goldman Sachs, Merrill Lynch and Citi have all put their names to predictions that the price will get a boost next week when the Organisation of Petroleum Exporting Countries (OPEC) meets to consider a modest cut in production, or a freeze at current levels.

Whether the cut is agreed by a notoriously unreliable group of 14 countries, with Russia a keen observer and likely participant in a cut, is a question that divides opinion given past failures by OPEC members to deliver on their promises.

Australian investors are wary with Beach Energy the only obvious beneficiary, so far, from speculation about a higher oil price. It traded up to a 12-month high on Wednesday of 87.5c. Other oil and gas producers have risen over the past week but not significantly, including Woodside, Santos and Oil Search.

The same trend of 'position taking' ahead of the November 30 meeting of OPEC in Vienna, Austria, can be seen in international markets with global leaders such as Chevron, Royal Dutch Shell and Exxon Mobil all modestly higher.

The challenge for investors with an appetite for the roller-coaster ride that oil and gas investments inevitably deliver is to first believe that OPEC can deliver a production cut, and to then believe that any increase in the oil price is sustainable.

Goldman Sachs sees a short-term boost in the oil price, which early on Thursday was trading at $US48.90/bbl for Brent-quality crude and $US47.94/bbl in the preferred US measure of West Texas Intermediate (WTI).

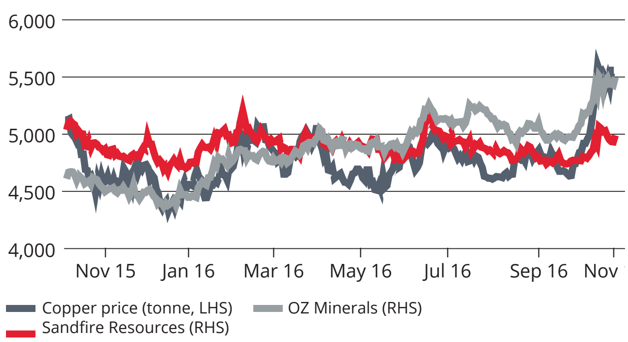
In a note sent to clients on Wednesday Goldman Sachs raised its Brent price forecast for the first half of next year from $US47 to $US56.50 and for WTI from $US45 to $US55.

"According to our commodities research team, an OPEC production cut will be implemented in the first half of 2017," Goldman Sachs said in a note headed: 'Likely OPEC cut to shift the oil price path.'

There is, however, a sting in the tail with the investment bank seeing any cut lasting for just six months with prices for both types of crude oil expected to fall in the second half of 2017, with an earlier tip of $US57 for Brent in the September quarter being cut to $US51.5.

The net result is that over the full 12 months of 2017 Goldman Sachs has actually reduced its Brent crude forecast from $US54.50 to $US54 while the WTI forecast is unchanged at $US52.50.

Chart 1: Copper price versus pure-play copper stocks, past 12 months



Source: Bloomberg, Eureka Report

In a way, the effect of any OPEC cut for the first half of 2017 could be the equivalent of a 'sugar hit' with energy evaporating from the market as the year wears on.

Merrill Lynch reckons that an OPEC supply cut looks "highly probable", a view shared by Citi which told clients this week that: "we believe an OPEC cut is more likely to occur than not".

Significantly, Citi also believes that strength in the oil market over the past 10 days (WTI was at $US44.43 on November 14) is partly the result of short sellers being caught as belief in an OPEC cut grew and they were forced to buy back their position.

"If there is a consistent theme emerging from the oil market it is that supply continues to overwhelm demand with a depressing effect on the price.

"Renewed optimism about the prospects of an OPEC deal is sending the shorts covering and pushing prices back up to the $US50/bbl mark," Citi said.

If there is a consistent theme emerging from the oil market it is that supply continues to overwhelm demand with a depressing effect on the price, a situation unlikely to change for some time even with an OPEC cut.

The big issues in oil are:

- Strong demand being offset by even stronger supply;
- OPEC members desperate for a higher price to replenish depleted budgets and stave off growing social disquiet and potential civil unrest as essential services are reduced or subject to higher prices, and;
- Concern that if OPEC members agree to limit their output to achieve a higher price any shortfall will be quickly made up by oil producers in the US who have already cut production and are poised to restart if the price ticks higher.

The US view, according to Goldman Sachs, is that if the WTI price rises back to $US55 a "substantial" response can be expected from US producers operating in newly developed oilfields based on shale and other tightly-packed rocks once regarded as uneconomic.

That response, according to Goldman Sachs, should keep oil prices withing the $US50 to $US60 range "with downward risks especially without an OPEC cut."

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EUREKA REPORT • 23 NOVEMBER 2016

Claiming back financial trail commissions

Australian investors are collectively paying billions of dollars annually in costly trail commissions to financial advisors, planners and brokers on everyday financial products.

Key Point

- ***On an investment balance of $1 million, the rebates would likely run into the thousands of dollars each year.***

A report on recurring fees in financial services commissioned by InvestSMART and conducted by research firm Rice Warner found that banks, brokers and advisors are collectively being paid more than $3 billion in trail commissions annually.

Trail commissions are paid by investors on an ongoing basis, on a broad range of financial products including managed funds, superannuation and life insurance products, and they can literally add up to thousands of dollars every year.

For some products – such as insurance – commissions can be steep: 10–30 per cent on average and as high as 130 per cent of the first year's premium. Commissions on superannuation and managed funds are not as high but with the large amounts under management, typical of an investor nearing retirement, the fees do add up.

While that may not come as a total surprise, given that full disclosure by financial providers of fees and commissions is mandatory in their financial product disclosure statements, what many investors don't realise is that in many cases they can actually claim them back.

How to get a commissions rebate

InvestSMART's free service **TrailCap** works with many financial products where trailing fees and commissions are paid. Rather than go through a retail financial planner or broker who will receive fees and commissions on products, an independent investor can nominate InvestSMART as their broker, and get a rebate on commissions paid.

Typically, an InvestSMART client will have worked with financial planners in the past. But even those who don't use a financial planner – purchasing units direct from a managed fund, for example – can still get extra rebated dollars through InvestSMART from commissions that otherwise would have been paid to an external party. It's taking advantage of a system that otherwise doesn't benefit the independent investor.

In return for doing so, InvestSMART will rebate 50 per cent of trail commissions beyond a $300 per annum minimum, with rebates then returned as an annual payment.

The overall commission savings quickly add up.

Case study

Here's an example of the potential commission savings that can be achieved, even on relatively low investment balances.

Table 1: Example of potential commission savings

INVESTOR/POLICY HOLDER	INVESTED AMOUNT/ COVER	FUND MANAGER/ INSURANCE COMPANY	ANNUAL TRAILING COMMISSION
DANIEL	$20,000	BT FUNDS MANAGEMENT	$100
	$17,500	COLONIAL FIRST STATE	$87.50
	$35,000	PERPETUAL	$175
KATE	$30,000	MLC	$150
	$25,000	AXA	$125
DANIEL AND KATE'S SUPER FUND	$160,000	AMP	$800
DANIEL'S LIFE INSURANCE POLICY	$580,000	AIA	$580
TOTAL TRAILING COMMISSIONS			$2,017.50
LESS $300 CAP			$1,717.50
ANNUAL SAVINGS			$858.75

This is a hypothetical example based on the experiences of real InvestSMART clients. It does not represent any particular individual.

> **Trail commissions are paid by investors on an ongoing basis, on a broad range of financial products including managed funds, superannuation and life insurance products.**

On an investment balance of $1 million being charged a 0.5 per cent trail commission per annum, or $5000 every year, the rebates available will run into thousands of dollars each year.

Starting the rebates process

It only takes minutes to switch your existing managed funds or life insurance policy to InvestSMART, but you can enjoy the savings year after year:

1. Fill in our fast **online form** (for managed funds)
   OR
   Download our **broker form** (for insurance)
2. Print the form, then sign it and send it by email to admin@investsmart.com.au

Trail commission rebates can be paid, either as a cheque or via electronic fund transfer (EFT).

To receive your TrailCap payments via EFT to an Australian bank account – just complete the EFT section in the **online application form**.

From July 1 next year, those with more than $1.6m in their pension fund are going to have to bring parts of that back into superannuation – putting segregation starkly in play.

BY BRUCE BRAMMALL • EUREKA REPORT • 23 NOVEMBER 2016

Pension cap elevates the segregation option

Tax and access – at its most basic, these are the two things that differentiate investing inside, and outside, superannuation.

Key Point

- ***From July 1 next year, those with more than $1.6m in their pension fund are going to have to bring parts of that back into superannuation – putting segregation starkly in play.***

With super, you have 'restricted access', which means you can't draw on your super until you meet a condition of release. For most, this will be 65. But it can be 60 (or even as young as 55).

But to understand the true power of super, you need to understand superannuation tax. And, for those who do have a good grasp, you need to understand how things will change in relation to tax from July 2017.

Superannuation tax – the basics

When you earn money outside of super, you pay tax at your marginal tax rate. This ranges from zero per cent to an effective rate of 49 per cent, which kicks in once you earn more than $180,000 a year.

Superannuation, however, is taxed 'concessionally'. This means that, in a general sense, it is taxed less than if you had the same investments outside of super. (Note: This is the theory, but this isn't completely true. Low-income earners often pay more tax on their super fund earnings than they would if they held the investment in their personal name.)

Superannuation is taxed at no more than 15 per cent, to encourage people to put money away for their super. Unless you've been very naughty. If you've truly been bad, the Australian Tax Office has the power to tax you at penalty tax rates, which are obscene.

The 15 per cent maximum superannuation tax rate is for income to your super fund. This includes interest, coupons, distributions, contributions, rent and dividends, for example.

When you make a capital gain outside of super, half of the gain is ignored, with half added to your individual income. When a capital gain is made in super, one-third of the gain is ignored, with the remaining two-thirds taxed at 15 per cent (This leads to an effective rate on capital gains for super funds of 10 per cent).

And then there is the tax position of pension funds.

Tax on pension funds

Pension funds are not taxed. Not on income. Not on capital gains.

Pension funds are turned on when members turn a certain age (generally 55, 60 or 65) and request to take an income stream from their superannuation. This turns a superannuation fund into a pension fund.

At that point, the pension fund stops paying tax.

A fund could sell an investment property, or large parcel of shares, for a gain of $200,000. No tax to pay. It could take a massive punt on the overnight movement of a foreign exchange market and make $1 million. No tax to pay.

Or it could slowly, and surely, make the steady returns it has always made. If it is in pension mode, there is no tax to pay on any money earned by assets backing the pension fund.

Franked dividends

If you've every heard that super funds (particularly self-managed super funds, or SMSFs) chase fully franked dividends, but not understood why, here's the explanation.

Let's take a dividend from a major Australian company (say a major bank, or Telstra). The dividend is a fully franked dividend of $700.

A fully franked dividend of $700 really means gross income of $1000. The shareholder receives $700, with a franking credit attached, which accepts that $300 in tax has already been paid.

> "The unsegregated method means that all assets of all members of the fund are treated as one pot.

If you are in the 'accumulation' phase of super, where your tax rate is 15 per cent on income, you will get $150 back. Of a total of $1000, you have received $850 (equal to a tax rate of 15 per cent).

If you are in pension phase for those shares, then you will receive the $700, but you will also receive the whole franking credit of $300 back in a tax refund from the ATO.

It is a different story for those who have earned the dividend outside of super in their personal names. For those earning less than $37,000 a year, they are likely to also get the entire $300 back. However, those who earn more than $37,000 will have to pay some extra tax on top of the $300. The top marginal rate will have to pay another $190 in tax.

What changes after June 30?

Until June 30, 2017, the size of the pension fund hasn't mattered. You could have a pension fund with $5m or $10m in it and whatever that pension fund earned would be tax free.

However, from July 1, 2017, those with more than $1.6m in their pension fund are going to have to bring parts of that back to superannuation/accumulation.

That is, super fund members will be allowed to keep $1.6m in pension – where it will never pay any tax. But if you have more than that, the excess will revert back to superannuation, where it will pay tax at superannuation (rather than pension) rates.

Obviously, for those with larger pension funds, this is going to mean extra tax will be paid on the amount transferred back to accumulation.

The big, approaching choice

SMSFs have always had a choice as to accounting methods – unsegregated or segregated – when it comes to determining the tax position of their SMSF, which is partly in pension and partly in accumulation.

The unsegregated method means that all assets of all members of the fund are treated as one pot (that is being added to and withdrawn from), with an actuary deciding which percentage of all of the assets becomes tax-free as part of the pension (that is, the portion of the fund that is in pension phase, and is therefore *exempt current pension income*).

The segregated method means that the trustees have made a declaration (backed by minutes) as to which specific assets have been segregated into the pension fund. And then those assets backing the pension fund are tax free, while the remaining assets of the super fund will be taxed at super fund tax rates.

Until now, most trustees (or their accountants) have opted to use the unsegregated method, as this is easier from an administration perspective.

But the segregated method is something that more and more trustees are going to want to put some thought into, as the tax savings could be considerable, with the limit on the pension being $1.6m.

If trustees are only going to leave $1.6m in their pension fund, then choosing which assets stay in pension (or which assets are moved to pension, for those who will start them in the future) might lead to considerably better tax outcomes than just using the unsegregated, or proportionate, method.

Here are two examples (though I will deal with this in more detail in the coming months).

1. You have a large capital gain on some shares/property. Say you bought the asset for $50,000 and it/they are now worth $500,000. You may wish to segregate this asset into the pension fund to avoid paying any portion in CGT upon sale. (You would also not pay tax on any income.)
2. High yielding assets. If you put the high-yielding assets into the pension fund, then the income won't be taxed.

Ultimately, this will be a decision that needs to be made by the trustee, potentially at the prompting of the accountant or financial advisor, who is also assessing various aspects of the portfolio.

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The bring-forward rule complicates the transition to the new NCC limits.

BY MAX NEWNHAM • EUREKA REPORT • 23 NOVEMBER 2016

Tax with Max: How the new NCC limits will work

Q. *I am 74 years old and qualify under the 'work test' to make further super contributions. However, I have no capacity to benefit from the non-concessional contributions bring-forward limits of $380,000 as my SMSF balance already exceeds the $1.6 million pension transfer limit.*

However a significant portion of my super fund is taxable and I was, therefore, wondering if it was possible for me to withdraw and re-contribute the $380,000 – or at least the $180,000 – before July 1, 2017 for the tax benefit of my beneficiaries?

Answer: I am glad that you have asked this question as it gives me the opportunity to correct something from my last column. Before dealing with how the new non-concessional contribution (NCC) limits will work, and how they will affect what you are planning on doing, I need to explain when the new super contribution limits will apply and how the current NCC system works.

When the changes to the NCC limits were originally announced in the 2016-2017 federal budget they were to apply from the night of the budget. The Coalition Government, when they dropped the retrospective lifetime NCC limit of $500,000, announced a new two-tiered system that will apply from July 1, 2017.

This means the current NCC limits apply up to June 30, 2017, except when the two-year bring forward rule has been activated. The NCC limit that applies until June 30, 2017 is still $180,000, which is six times the current concessional contribution (CC) limit of $30,000, plus the ability to bring forward two years at the current limit.

Under the first tier of the new system the NCC limit will only be $100,000, being four times the CC limit that will apply from July 1, 2017. The ability to bring forward two years of NCCs will be retained under the new system.

The second tier of the new system imposes a new limit at which point no further NCCs can be made. When the value of a person's superannuation is greater than the new $1.6m pension transfer limit, or will exceed this limit after an NCC is made, no further NCCs can be made.

Under the new legislation, which was passed on Wednesday, the maximum NCC that can be made after July 1, 2017 will be $300,000 using the bring-forward rule. However, if the NCC will result in a superannuation balance of more than $1.6m the contribution is limited to the amount that would bring the superannuation balance up to $1.6m.

Superannuation funds will not have to calculate whether an NCC will result in the $1.6m limit being exceeded continually through a year, instead the $1.6m limit will apply to what a member's superannuation balance was at June 30 of the previous year.

For example, if a member's balance was under $1.3m at June 30, 2017 they will be able to make a maximum NCC of up to $300,000 after July 1, 2017. If that member's balance was $1.45m, they would be limited to a maximum NCC of only $150,000.

Under the current system if the $180,000 limit has not been exceeded in the previous three years a person can contribute up to $540,000 if they have not turned 66. When a person turns 65 during a financial year, and they can use the bring-forward rule, they can contribute up to $540,000 before their 65th birthday without any further tests being passed.

Where someone has turned 65 during a financial year, and makes an NCC after having turned 65, they must pass the 'work test' for the financial year they are making the NCC. Once someone is 66 or older they are unable to use the bring-forward rule and are limited to the annual NCC limit.

In your case, as you are 74 the existing rules will apply for the 2017 year and you will be limited to an NCC of $180,000 for the 2017 financial year.

The important thing for everyone to understand is that the new NCC limits will apply from July 1, 2017, and will only affect superannuation fund members that activate the two-year bring forward rule during the 2017 financial year but did not contribute the full amount.

> **“The new NCC limits will apply from July 1, 2017, and will only affect superannuation fund members that activate the two-year bring forward rule during the 2017 financial year but did not contribute the full amount.**

I had previously thought that the new $100,000 NCC limit would affect anyone making an NCC during the 2017 year, and incorrectly advised *Eureka* subscribers to limit a NCC limit for the 2017 year to $380,000.

If the NCC, using the bring-forward rule, is made before July 1, 2017 the new limits will not apply. If however the bring-forward rule has been activated before July 1, 2017, and the full amount not contributed, the new limits will apply.

It has been announced that transitional arrangements will apply based on when the NCC is made that triggers the bring-forward rule. If someone contributed $190,000 during the 2016 financial year, and nothing in the 2017 year, they will be limited to a maximum NCC of $460,000. This is made up of two $180,000 maximum contributions and one at $100,000.

If the bring-forward rule is activated by a contribution of $190,000 during the 2017 financial year, the maximum NCC will be limited to $380,000. This limit is made up of the $180,000 limit applying for the 2017 financial year and two years of the new $100,000 limit.

In addition if the maximum contribution has not been made by July 1, 2017 the $1.6m limit will also apply to how much can be contributed. This would appear to mean that someone who had triggered the bring-forward rule in the 2016 financial year by making an NCC of $190,000, that has a superannuation balance at June 30, 2017 of $1.65m and did not make an NCC during the 2017 financial year, could not make any further NCCs after July 1, 2017.

The re-contribution strategy that you were hoping to use by withdrawing $380,000 to benefit your beneficiaries cannot be done. If you withdrew $380,000 from your super fund you will be limited to contributing $180,000 as an NCC for the 2017 year.

In fact anyone who is under 66, and has not previously made an NCC of more than the current limits, should seriously consider maximising their NCC limit for the 2017 year, even if their superannuation is currently worth more than $1.6m.

Where an NCC is made during the 2017 year, which results in a person’s superannuation being worth more than $1.6m, they will be forced to either withdraw the excess or roll it to an accumulation account.

So in your case, you can make an NCC of $180,000 before June 30, 2017, as the new $1.6m limit will not apply until July 1, 2017, but you will not be able to make further NCCs from then on as your super balance exceeds the $1.6m limit.

Even with a Trump infrastructure build, many analysts still expect a copper surplus for years to come.

BY TIM TREADGOLD • EUREKA REPORT • 23 NOVEMBER 2016

Hot copper, but for how long?

Copper is hot, but whether investors are buying the sizzle and not the steak is a good question with the evidence pointing towards sizzle without substance.

Key Point

- ***For investors with a taste for copper the message is that the price bounce over the past few weeks is unlikely to last.***

The 19.5 per cent rise in the price of the most widely-used of the base metals from around $US2.10 a pound two months ago to the latest price of $US2.51 has sparked interest in mining companies with copper interests, a wide selection that includes BHP Billiton, Rio Tinto, OZ Minerals and Sandfire Resources.

OZ and Sandfire, the leading pure-play copper stocks on the Australian market, have risen by 23 per cent and 9 per cent respectively since early September, the last time Eureka Report took a close look at the copper and concluded that the market for the metal was over-supplied (***Copper travels down the iron ore road***).

Since then two events have sparked revived interest in copper, though neither has significantly altered the fundamentals.

The first, in late October, was an event known as London Metals Week, a time when commodity traders gather to swap notes with the consensus view being that the outlook for copper wasn't bad thanks to an easing of Chinese bank lending and a fresh burst of infrastructure developments in that country.

The second event was the election of Donald Trump as the next US president and his promise to launch an infrastructure building boom which should mean increased demand for copper and most other metals.

Good for copper as the London conference and Trump's election might be, they cannot alter the fact that there has not been a sudden surge of demand. Much of the recent buying has been the result of speculative trading in a metal which has a long history of being a gambler's darling, thanks to its ready availability and the ease of getting in, and out, quickly.

Questioning copper's stamina

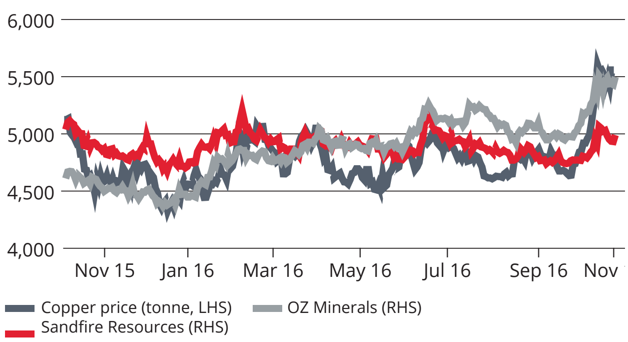
HSBC Bank was one of the first to ring an alarm about the sharp rise in metal prices, questioning last week whether "a significant rally in hard commodities (such as copper) could be an over-reaction".

Of particular interest was the excitement caused by a forecast that under Trump the US could spend up to $US1 trillion on infrastructure such as roads, bridges and airports over the next 10 years.

To put what is undoubtedly a big number into perspective, HSBC explained that: "China has already spent (that much) on infrastructure in just the past nine months".

Barclays Bank, in a comment along similar lines to HSBC, said that although the fundamentals of supply and demand for copper had improved: "[T]he speed of the recent rally leaves it open to the charge that price action has been too much, too fast".

Chart 1: Copper price versus pure-play copper stocks, past 12 months



Source: Bloomberg, Eureka Report

ANZ is another bank wary of what's happening in the copper market, but is also confident that the price will not retreat back to the levels of $US2.10, perhaps settling around $US2.27 (or $US5000 per tonne), a price forecast which implies a 9.5 per cent fall from its current level of $US2.51.

> **For investors with a taste for copper the message is that the price bounce over the past few weeks is unlikely to last, [and] not just because the market remains in surplus.**

BMO, a Canadian investment bank, is forecasting a copper price next year of $US2.25 while Macquarie, an Australian investment bank, is using a copper price of $US2.36 for next year before slipping over the next two years, followed by a recovery to $US2.46 in 2020.

Big copper producers also have their doubts about the sustainability of the recent rally. Two weeks ago the chief executive of Chile's Antofagasta, one of the world's biggest copper miners, said he expected the metal to lag behind other commodities.

Ivan Arriagada told London's *Financial Times* newspaper that he expected global copper output to be in a small surplus "for this and next year, and that won't change until 2019".

The ANZ take echoes the view from Chile, with its analysis of world copper supply/demand showing surplus production for the next two years followed by a deficit of around 250,000 tonnes in 2019.

A short-term surplus

The latest forecast from the copper industry's own organisation, the Lisbon-based International Copper Study Group, is for a copper surplus in 2017 of 160,000 tonnes as production from new mines reaches the market, but the ICSG also makes the point that it is China that really counts in copper, consuming 45 per cent of global output.

The US is a relatively modest consumer of copper, at less than 10 per cent of global production.

For investors with a taste for copper the message is that the price bounce over the past few weeks is unlikely to last, not just because the market remains in surplus but also because a US Government funded infrastructure building program is unlikely to trigger a surge in copper demand.

ANZ, while noting that the fundamentals of copper supply and demand have not suddenly changed also argues that investors have "woken up to the fact that the market outlook isn't as bad as it has been perceived."

"Copper has been stuck in a $US4500/t-to-$5000/t ($US2.05/lb-to-$US2.27/lb) range for most of 2016 on concern of a wave of new supply and weak demand in China," ANZ said in its November 18 commodity report.

"The year-to-date investment in the key power sector remains strong and investment is up 32 per cent year-on-year in the nine months to September. This compares with growth in investment in 2015 of 2.9 per cent."

As for the new supply flooding the copper market ANZ reckons most of that has arrived, led by a 55 per cent increase in Peru's copper production.

"We think at current prices the risks are evenly balanced," ANZ said. "At only 60,000t, our forecast (copper) surplus in 2017 is only 0.4 per cent of global copper consumption (a mere rounding error).

"While the move over the past month looks overdone, we don't expect copper prices to return to levels seen prior to the rally.

"With expectations now reset, we see prices remaining above $US5000/t ($US2.27/lb)."

The investment dynamics

The question investors ought to consider is whether the rally in copper mining stocks will fade as quickly as it arrived.

And there's the wild card, the same wild card in every commodity and equity market: What exactly will Trump do when he gets the keys to the White House?

Trump's infrastructure building plans could see an increase in US copper consumption.

But his rejection of free trade agreements and antipathy towards Chinese imports could be laying the seeds of a future trade war, with Chinese copper demand (45 per cent of the world market) being an early victim.