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Weekly Review

WEALTH

3 THE DANGER OF CHASING RETURNS | 4 BILLIONAIRE BUFFETT TAKES AN ACTIVE SWIPE | 6 ETFS ROADTEST: IOZ VS STW | 8 PROFITS BONANZA HAS A CAPEX WARNING

– Issue –
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The US President has reiterated his economic plan for America, but the plan still remains very abstract.

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • ?? MONTH 2017

Trump stays mum on tax cut details

Whether we like him or hate him US President Donald Trump is in the process of changing the investment world as we have known it for the last decade. All *Eureka Report* readers need to be aware of this. What is less certain is the timing of the change.

Key Point

- ***The failure to offer specifics on tax means that the timing of the changes is up in the air, and that could create market volatility.***

The failure of the US President to make specific, detailed pledges on the key issues affecting markets – such as tax – indicates it may take longer than the markets anticipated. So don't be surprised if we have volatility.

But the President made it very clear that he is looking for an America where companies pay a lot less tax; the middle class pays a lot less tax; more people enter the middle class; middle class incomes rise; and there is a substantial increase in expenditure on defence. In addition, a big chunk of this will be paid via tariffs on imports or tax structures that stops deductibility on expenditure of imports. But the deficit will rise sharply.

The bottom line of all these things is higher inflation and higher interest rates, and those higher rates will spread around the world including Australia. Investment strategies based on very low rates will be put in jeopardy. It will take time to happen but eventually it may affect our housing market.

America is going to spend $US1 trillion on infrastructure, but it will take time to develop the projects. It is going to need a lot of iron ore pellets and gas and oil.

China will have to change its direction and to the extent that Australia relies on the old China strategy, we too will need to change.

But there is a good chance that the looming American boom will actually infect the world and, if that happens, our commodities will improve in price. If I had to guess I believe that oil will do better than iron ore.

OPEC delivering

While President Trump was preparing to deliver his address there were some fascinating statistics in the oil market.

For months now old-time oil observers have been very doubtful as to whether the proposed OPEC production cuts would be realised. They did not appreciate that last year's production agreements were co-ordinated by none other than Saudi Arabia and Russian President Vladimir Putin. As a result, those production cuts are really starting to work and in the next few months it looks like the oil price will firm. In simple terms, 2017 is expected to see oil demand growth of around 1.5 million barrels per day.

It could be higher, particularly if the United States' economy gathers momentum on the back of President Trump's policies.

Continued on page 2 ...

CONTENTS

ARTICLES PAGE

Trump stays mum on tax cut details	1
The danger of chasing returns	3
Billionaire Buffett takes an active swipe	4
ETFs Roadtest: IOZ vs STW	6
Profits bonanza has a capex warning	8
Why gold's rise may be short-lived	11
Strong start for listed debt market	13
Super confusion: Understand your contribution limits	15
Oil eyes a half-decent equilibrium	17

Continued from page 1 …

The OPEC production cuts take off about a further 1 million barrels per day – a total shortfall of, say, 2.5 million barrels per day. In addition non-OPEC countries outside the US will push the shortfall even higher – perhaps to 3 million barrels a day.

Offsetting that shortfall will be the Trump-inspired US oil production increases. Even the most optimistic of forward predictions of US oil output mean that they will struggle to fill half the gap. In 2018-19 production may be a lot higher – but that is down the track.

we are starting to see the end of the enormous Islamic State turmoil in the Middle East and, out of that turmoil, Russia looks to be one of the most powerful countries in the region. They are desperate for higher prices.

If the oil price does start to edge up it is great news for Australia's liquid natural gas exporters because their production prices are closely tied to the oil price.

Unfortunately, in Australia we have a shortage of gas which is being created by government policies in Victoria and NSW and the fact that, among the Gladstone LNG producers, the Origin and Santos consortiums have sold gas they do not have in Queensland. They therefore suck gas from the Cooper Basin and Bass Strait by paying whatever price is required. Accordingly, the higher oil price means that those businesses in Sydney and Melbourne who are big users of gas will have much higher costs – so in your portfolio keep an eye on stocks that are vulnerable to this situation.

Packer back

And on a somewhat lighter note, when you are investing in a company where the ownership is dominated by a particular family, be watchful if that family suddenly appears in the social page headlines.

Crown Resorts is a good example of such a phenomena. James Packer and the family own just under 50 per cent of Crown. We watched James sell a small slab of his equity in Crown to fund a family settlement. On its own that was fine, but James found himself in the social page headlines with all sorts of affairs and controversies.

Much of the material was inaccurate but it meant that James took his eye off the ball. Furthermore, Crown itself was a very profitable business and, like all profitable businesses, often costs rise in the good times. In particular Crown did not spend enough time studying the government regulation changes in its base consumer market – high roller Chinese gamblers.

As a result a number of its executives are now in custody for allegedly planning to entice Chinese gamblers to high roll in Australia. I am not going into the rights and wrongs of what Crown did but it needed to be very, very attuned to what was happening in mainland China to avoid that sort of risk.

But James has now sorted out his social affairs and, in particular, brought into Crown management the man who has been his strategic advisor for a long time – John Alexander. John Alexander helped James Packer get clear of the media business before the industry hit hard times. It was a brilliant sale. He also has a fantastic eye for costs that can be eliminated, and that is what he is doing at Crown.

Not surprisingly the Crown chief executive thought it better to step aside. Crown is heavily involved in a major development in Sydney to attract Chinese high rollers. It will be hoping that the Chinese relax the rules. It is also looking at a massive new development in Melbourne, although that appears to be based on middle-class Chinese visiting Australia and where gambling is merely a side issue. That is a lot safer market.

Crown has a lot of issues to tack le but the good news is that Packer and Alexander are back.

The hard questions all investors should be asking.

BY MITCHELL SNEDDON • EUREKA REPORT • 1 MARCH 2017

The danger of chasing returns

Past performance is not an indicator of future performance. We read and hear this on every financial product, but do we heed the words? I would suggest not. Go to a rating website for managed funds or a fund manager's website on its own and what is the first thing we do when judging a fund? Look at the performance.

Ranking funds by five-year performance is the accepted norm but a report just released by S&P Dow Jones Indices, presenting research in the age-old debate of passive vs actively managed portfolios (also read ***Billionaire Buffett takes an active swipe***), suggests that maybe we are looking at this the wrong way.

The Persistence of Australian Ac tive Funds report found that of the 74 Australian Equity General funds in the top quartile in 2012, only 1.35 per cent remained in there after five years. In the Mid and Small-Cap space the report found 4.17 per cent of funds in the top quartile remained after the same period. Over a three-year period 6.67 per cent of Australian Equity General funds remained in the top quartile, and 12.50 per cent of Mid and Small-Cap funds. Interestingly, none of the International General Equity top quartile remained on top in the five-year period.

Across Australian Equity General and International the report found more funds in the top quartile at the start of the five-year period did not just drop out of the highest quartile but dropped all the way down to the bottom quartile. It's tough at the top.

Thinking about the asset classes the funds are investing in, the larger the market capitalisation of the stocks the more coverage they receive. This would indicate there is little edge a manager can gain to consistently beat their opposition.

The report shows in the Mid and Small-Cap space far more top-performing funds remained in the top quartile. This would make sense as there is less analyst coverage of smaller stocks, giving an investment team with a sound process a greater edge over the rest of the competition.

It is interesting to note of the Australian Equity General funds surveyed over a five-year period which started in the bottom quartile; 20 per cent made it into the top quartile by the end of period compared to 21.74 per cent for the Mid and Small-Cap funds.

The strategic approach to investing

What does this mean for investors? Don't chase returns. The highest-performing funds are in the top quartile for a reason.

The investment process historically identified good opportunities, but that process may not work across different economic environments. Do not head to the bottom of the table either. Picking underperforming funds can be as dangerous as picking stocks that have halved or more. Sometimes they are cheap for a reason.

Greater importance needs to be placed on the investment process and understanding how a fund manager selects stocks and manages a portfolio. Investors who are looking for a managed product need to ask more questions to get past the jargon. Don't settle for the same trotted out lines, "we're top down, bottom up stock pickers".

Reports like the one quoted in the article help fuel the broad statement that most investors are better off in an index fund.

For those prepared to not understand and monitor their investments, that may be the case. But if you are looking at a managed product you need to place responsibility on yourself and not just blame the manager if you underperform.

For my approach on how to pick active and passive investments, you can see me present at the upcoming Australian Shareholders' Association national conference in May and at our InvestSMART Investor Sessions.

**ASA National 2017 Conference, May 15-16, Grand Hyatt Melbourne*

A pointed message from one of the world's best investors.

BY TONY KAYE • EUREKA REPORT • 1 FEBRUA MARCH RY 2017

Billionaire Buffett takes an active swipe

When multi-billionaire investor Warren Buffett talks, people tend to listen.

So when Buffett, also known as the "Oracle of Omaha", used his annual letter to Berkshire Hathaway shareholders this week to comment on the fees being collected by fund managers, you can bet his words were taken seriously.

Key Point

- ***With the exodus of investment capital into low-cost index products such as exchange-traded funds showing no signs of slowing down, many active fund managers are repositioning their products to be more price competitive.***

"When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients," Buffett exclaimed.

He's correct, to a point. Most active fund managers have underperformed the markets they have invested in over recent times. But as a consequence, rather than making "outsized profits", many investment groups have actually reported lower profits.

Chronic underperformance

In their quest to outperform, analysing reams of complex data and economic signals to build portfolios of premium stocks, most active investment managers have been falling short of the mark.

Why? In some cases, fund managers have simply invested into areas that haven't paid off as well as others. Other fund managers have been investing the right way, but their fees have negated the returns.

The latest analysis of active fund managers just released by S&P Dow Jones Indices, which tracks the performance of more than 1100 actively managed equity and bond funds in Australia, found the majority of managers have consistently underperformed against their respective benchmarks.

For example, around eight out of 10 active managers of funds trying to beat the S&P/ASX 200 Index in the trading year ending on December 30, 2016 underperformed, achieving an average return of 9.2 per cent against an 11.8 per cent gain by the index.

Last year was characterised by a series of unexpected events that confounded global markets and fund managers alike, including Brexit, two yuan devaluations, and the US election result upset. There was also a constant overhang around the future of the European Union, which also caused weak returns across the Continent.

Large locally listed funds management groups with globally focused products, such as Magellan Financial Group and Platinum Asset Management, have both suffered at the hands of fickle financial markets.

Table 1: Percentage of Funds Outperformed by the Index

FUND CATEGORY	COMPARISON INDEX	1 YR (%)	3 YR (%)	5 YR (%)	10 YR (%)
AUSTRALIAN EQUITY GENERAL	S&P/ASX 200	76.38	67.76	69.88	74.27
AUSTRALIAN EQUITY MIDAND SMALL-CAP	S&P/ASX Mid-Small	81.73	61.86	48.00	32.53
INTERNATIONAL EQUITY GENERAL	S&P Devel'd ExAustralia LargeMidCap	86.04	94.15	93.15	89.16
AUSTRALIAN BONDS	S&P/ASX Aus. Fixed Interest 0+ Index	62.96	90.20	77.36	87.50
AUSTRALIAN EQUITY A-REIT	S&P/ASX 200 A-REIT	77.14	92.86	83.33	77.38

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2016. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

For them, and others, that has translated into lower performance fees, revenues and ultimately profits, and that in turn has eroded their share prices. Other unlisted active managers have also been feeling the performance fees pinch, because they too haven't been performing.

But this trend has been going on for years. The same research shows most active fund managers have been underperforming over three, five and 10 years.

And that's one of the driving reasons why more and more investors are questioning the fees being charged by active managers consistently underperforming the market, and for

> **“Even the best active managers will underperform the market at times. The key is to have the patience and discipline to stay with their investment strategy.**

the growing wave of retail and institutional capital being shifted out of managed funds into exchange-traded funds.

The surge to ETFs

Head of ANZ ETFS, Kris Walesby, says the broad range of opportunities available through index-tracking ETFs on the Australian market, their low costs, and the ability for investors to trade in and out of them at will, is proving a big attraction.

He also notes that more investors are using ETFs tactically, to take short-term positions in overseas markets and different asset classes – something that's much harder to do through a standard managed fund structure.

Olivia Engel, deputy chief investment officer of State Street Global Advisor's active quantitative equities team, doesn't dispute the fact that ETFs are giving active managers a run for their money.

“Often investors want to shoot for the rafters and pay up for a really high-quality active manager to deliver them a really differentiated return outcome from what they could get by buying an ETF or from buying an index fund,” Engel says.

“The hurdle and the onus on us as the active management team is to differentiate ourselves from an index outcome and prove that it's worth paying for. So we think that traditional benchmark-hugging active management which has high management fees is probably a bit of an endangered species.”

The new battleground for product providers is unquestionably fees, and fund managers are working to cut them down.

The drive to lower fees

Vanguard's Asia-Pacific Head of Investments, Rodney Comegys, agrees that in what has been, and will continue to be a lower return environment, investors are paying much more attention to cost.

“At a macro global level there's been absolutely no question that there is a preference for global investors to use and move into specifically lower-cost index fund products, and often the vehicle of choice has been the exchange-traded fund.

“The trend has already been going on for a while, but has accelerated in recent times. There are a number of things causing that but one of the biggest is cost and fees, meaning now is a very challenging time for active managers.”

While some active managers actually do outperform the market, high management and performance fees often destroy whatever alpha (excess return to the market) that can be generated.

It's also hard for active managers to consistently outperform an index, so they might have a year or two when they outperform and then a year of poor performance where they give back the alpha they've generated.

“At any given point a specific, more niche, strategy can do very well on the performance tables,” Comsyg adds. “I would say to investors, be very careful and thoughtful as to whether that investment performance can continue.”

Actively managed, high-conviction funds often can deliver very polarising outcomes. These are funds that take a concentrated bet, or position, in terms of a particular market direction, a specific sector, or even in single stocks.

“When we looked at the 2015 high-conviction managers and then contrasted that with the 2016 high-conviction managers we found that the best and worst performers were at opposite ends of the spectrum. Lots of them outperformed in 2015, but most of them underperformed in 2016,” Engel says.

“The consequences of being wrong in these concentrated high-conviction funds is much larger than if you have a wider strategy. I think you can still have a high-conviction investment portfolio without having concentration in it. It can be a very large number of small high-conviction bets rather than a very small number of large high-conviction bets.”

For investors, it's worth noting that even the best active managers will underperform the market at times. The key is to have the patience and discipline to stay with their investment strategy and the belief that they will outperform over the longer term.

If you can tap into a low-cost investment fund strategy that better manages the risks associated with equity investing, then that is definitely something worth paying for.

When two ETFs track the same index, how do you choose between them?

BY PHILIP BISH • EUREKA REPORT • 3 MARCH 2017

ETFs Roadtest: IOZ vs STW

With more than 200 exchange-traded funds (ETFs) listed on the Australian equity market, it's inevitable that some will be similar. So how do you choose when there are two ETFs that are almost identical?

Key Point

- ***What we like about both ETFs is that they are broad based and managed by top quality global managers. Each ETF offers diversity in Australian equities, and can be used as a core holding in an investment portfolio.***

This scenario plays out with two Australian ETFs: the iShares Core S&P/ASX 200 ETF (ASX: IOZ) and the SPDR S&P/ASX 200 (ASX:STW), which both track the S&P/ASX 200 index.

Blackrock versus State Street

The two ETFs are managed by rivals Blackrock and State Street Global Advisors, two of the heavyweights in the industry.

Table 1: Side-by-side comparison

ETF NAME	ISHARES CORE S&P/ASX 200 ETF	SPDR S&P/ASX 200 FUND ETF
ASX CODE	IOZ	STW
CATEGORY	Australian Equities	Australian Equities
INDEX	S&P/ASX 200	S&P/ASX 200
FUND SPONSOR GLOBAL ADVISORS	**Blackrock**	**State Street**
EXPENSE RATIO	0.15%	0.19%
DISTRIBUTIONS	Quarterly	Quarterly
FUND DOMICILE	Australia	Australia
SHARE PRICE *	$23.81	$54.34
UNITS ON ISSUE	23,258,614	54,805,361
MARKET CAP	$553,787,599	$2,978,123,316
EPS – 2017E	$1.46	$3.33
DIVIDEND – 2017E	$1.04	$2.38
P/E RATIO – 2017E	16.3	16.3
DIVIDEND YIELD – 2017E	4.4%	4.4%

Source: AltaVista Research. * Share prices at March 2, 2017

New York-based Blackrock is the world's largest asset manager with $5.1 trillion of assets under management, and Boston-based State Street Global Advisors has $2.45 trillion of assets under management.

The iShares Core S&P/ASX 200 ETF was launched by Blackrock in 2010 and is a low-cost, broad-based fund that invests in the 200 largest companies in Australia. Its benchmark is the S&P/ASX 200 index, which covers approximately 80 per cent of the market capitalisation of the Australian equity market.

The SPDR S&P/ASX 200 Fund was launched by State Street Global Advisors in August 2001, and was one of the first two ETFs listed on the ASX. It also tracks that S&P/ASX 200.

So, which ETF is best?

The similarities

As can be seen from Table 1, there are many similarities between the two ETFs. Both ETFs track the same index, and are weighted in the same proportions to that of the S&P/ASX200. This means that if the Commonwealth Bank is 9.5 per cent of the S&P/ASX 200, it will also be 9.5 per cent of the ETF.

In Table 2, the top 10 holdings of each ETF are listed, which shows that the composition of each ETF is almost identical.

Table 2: Top 10 holdings as at January 31, 2017

COMPANY	IOZ	STW
COMMONWEALTH BANK OF AUSTRALIA	9.5%	9.5%
WESTPAC	7.2%	7.1%
ANZ BANKING GROUP	5.8%	5.8%
BHP BILLITON	5.8%	5.8%
NATIONAL AUSTRALIA BANK	5.4%	5.4%
TELSTRA	4.0%	4.1%
CSL	3.4%	3.5%
WESFARMERS	3.1%	3.1%
WOOLWORTHS	2.1%	2.1%
MACQUARIE GROUP	2.0%	1.9%
TOTAL	48.3%	48.3%

Due to the ETF weightings, the big four banks make up around 28 per cent of each ETF, with the top 10 holdings comprising around 48 per cent, which is almost half the fund. Due to the high concentration of stocks in the top 10, any large movements in these stocks will have a similar effect on the price of each ETF.

> **The way to think about ETF valuation is whether the index itself is overvalued or undervalued. As with anything, it's always best to buy an ETF as cheap as possible.**

The 2017 expected earnings per share (EPS) for each unit of the ETF is calculated by adding up the expected earnings from all the holdings in the ETF. Given both ETFs hold the same shares in the same proportions, they also have the same price earnings multiple of 16.3.

The ETFs will continually collect the dividends from the underlying stocks and pass them periodically through to the ETF shareholder. As expected, both ETFs also have the same dividend yield of 4.4 per cent.

Dividends on both ETFs are paid quarterly, which will suit those who like a regular flow of dividends. The move to pay a quarterly distribution is a recent change for the STW ETF, as it previously paid dividends bi-annually.

The differences

The most noticeable difference between the two ETFs is the expense ratio. The iShares Core S&P/ASX 200 ETF has an expense ratio of 0.15 per cent, whereby the SPDR S&P/ASX 200 fund has an expense ratio of 0.19 per cent. Though a difference of 0.04 per cent is not a huge differentiator, a lower fee will mean the ETF will track closer to the index and ultimately provide better performance.

Blackrock has aggressively been slashing its ETF fees, both here and globally, as it aims to be the market leader in low-cost ETFs. In the US, a price war on ETF fees continues among major providers.

One of the big areas of difference between the two ETFs is the market capitalisation. This is where the SPDR S&P/ASX 200 Fund has an advantage. It is more than five times larger, which gives it more liquidity and has its bid/ask spreads (difference between buy and sell price) closer together.

The difference is not huge, but if you are buying or selling units in the ETF, a closer spread may mean you get a slightly better price. As the iShares Core S&P/ASX 200 ETF increases in size, this issue will diminish over time.

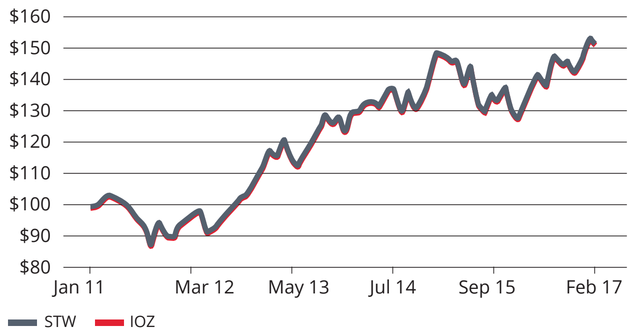
Performance

Chart 1 shows the performance over six years of each ETF. The graph looks like it has just the one line, but it is actually two lines that follow the same path. This highlights the similarity of the performance.

Valuation

Valuing an ETF is quite different to valuing a stock, as the price of an ETF will closely follow the value of its underlying stocks.

Chart 1: Performance comparison



Source: AltaVista Research

The way to think about ETF valuation is whether the index itself is overvalued or undervalued. As with anything, it's always best to buy an ETF as cheap as possible, but determining the best time to do this is often the challenge.

The aim of an ETF is not to outperform the index, but to follow it. So when an index rises or falls, the ETF will simply follow it.

Conclusion

When comparing the ETFs side by side, there is not a lot of material differences. The iShares Core S&P/ASX 200 ETF has the lower management fee, but the SPDR S&P/ASX 200 fund has the better liquidity and closer buy and sell spreads. If we had to choose one, it would be iShares Core S&P/ASX 200 ETF, due to its slightly lower fees.

What we like about both ETFs is that they are broad based and are managed by top quality global investment managers.

Each ETF offers diversity in Australian equities, and can be used as a core holding in an investment portfolio.

Disclosure: InvestSMART holds the iShares Core S&P/ASX 200 ETF in several of its portfolios.

Australia's biggest companies have swept the floor in earnings, but investment remains weak.

BY CALLAM PICKERING • EUREKA REPORT • 28 FEBRUARY 2017

Profits bonanza has a capex warning

Reporting season isn't yet over but the Australian Bureau of Statistics (ABS) has already declared it a huge success. Company operating profits posted their biggest quarterly gain in 15 years during the December quarter, with both profits and income earned rising to their highest level in history.

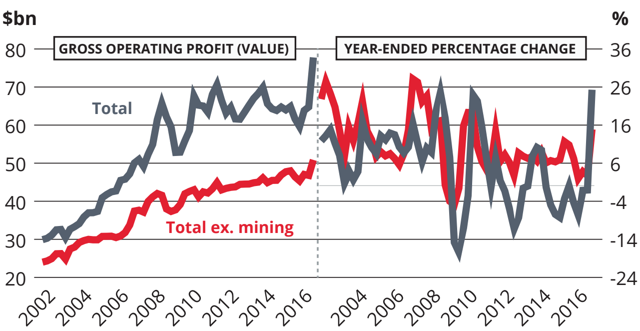
Key Point

- ***Current estimates indicate that dividend payouts among ASX200 companies will be north of $70 billion in both 2016-17 and 2017-18.***

It represents a rapid change in the fortunes of Australia's biggest companies, particularly those in the mining sector, compared with what we have become accustomed to. Just 12 months ago operating profits among Australian corporates sat at its lowest level since early 2010.

Since then operating profits have surged 30 per cent higher, including a 20 per cent rise in the December quarter alone, to establish a new record high.

Chart 1: Australian company operating profits (Quarterly; seasonally-adjusted)



Source: ABS; via CP Economics

The mining sector led the charge. Operating profits across the resource sector rose by 50 per cent in the December quarter, reaching a new record high, offsetting the weakness than has persisted over the past five years.

But the good news is that the rise in operating profits isn't simply a product of higher commodity prices. Operating profits excluding the mining sector rose by 8.7 per cent in the December quarter and that was enough to push non-mining profits to their highest level in history.

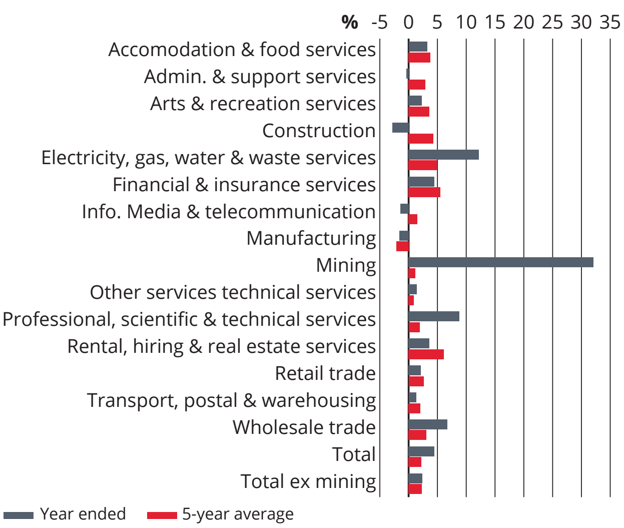
The mining sector accounts for around one-third of operating profits and so tends to dominate movements in the headline figure. But strong results were also posted by some of our most important sectors.

Operating profits among financial services doubled in the December quarter, while profits in the construction sector rose by 32 per cent. The most disappointing results were retail (down 2.9 per cent in the quarter) and 'accommodation and food services' (down 14.4 per cent), though the overall performance of these sectors over the past 12 months has been adequate.

Profitability though can be quite volatile so I often focus on income earned to gauge how specific sectors are travelling. Corporate income earned rose by 2.5 per cent in the December quarter, the strongest quarterly result since the beginning of the global financial crisis, to be 4.5 per cent higher over the year.

Chart 2 compares income from the sale of goods and services across industries. It shows growth over the past 12 months compared with average growth over the past five years. It compares recent performance with sustained performance.

Chart 2: Company income from goods & services (Seasonally-adjusted)



Source: ABS; via CP Economics

The outstanding result for the mining sector speaks for itself but there has also been significant improvement in the income generated across utilities such as electricity and gas, as well as professional services and wholesale trade.

> **Just 12 months ago operating profits among Australian corporates sat at its lowest level since early 2010. Since then operating profits have surged 30 per cent higher.**

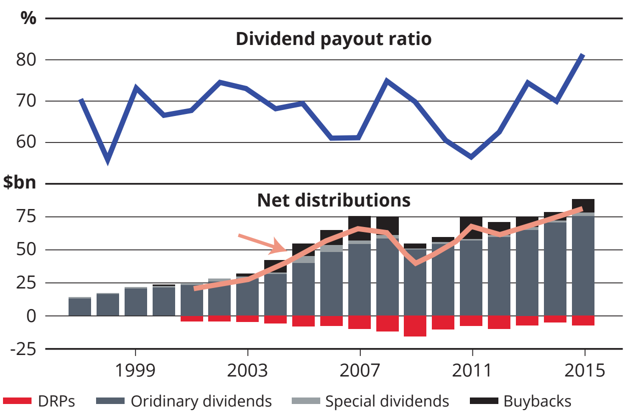
Corporate valuations are designed to reflect all available information, thus it would be difficult to trade profitable on existing data, but the data contained in the graph below does provide some insight into the sectors that have performed well during a difficult economic environment.

These are the type of results that should leave investors grinning from ear-to-ear. The news gets better when you remember that dividend payout ratios remain at elevated levels across most sectors. Higher profits are likely to be paid out in the form of dividends rather than be retained as capital or invested in new technology or capacity.

Current estimates indicate that dividend payouts among ASX200 companies will be north of $70 billion in both 2016–17 and 2017–18.

According to research by the Reserve Bank of Australia, the local market's dividend payout ratio averaged 67 per cent from 2005–2015 – peaking at over 80 per cent in 2015. By comparison, the payout ratio averaged 60 per cent in the United Kingdom; 55 per cent in Europe and 48 per cent in the United States.

Chart 3: Shareholder distributions (All listed companies, financial years)



Source: ASX: Morningstar; RBA

As an economist I'd prefer to see corporates directing more of their profits towards business investment, which drives employment and productivity growth, but as an investor I certainly don't mind higher profits finding their way into my pocket.

A capex catch

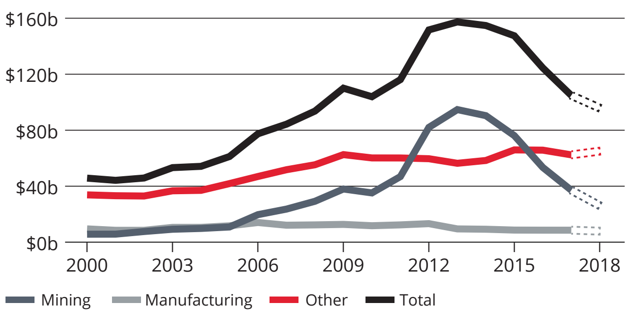
Nevertheless, the great news on profits and income must be tempered against the ongoing weakness in business investment.

On a quarterly basis, the ABS releases a survey that estimates capital expenditure expectations across Australian corporates. This release provides some insight into how investment will develop over the next 12 to 18 months.

According to the ABS and my own calculations, capital expenditure is set to fall by 15 per cent in 2016-17 and a further 8 per cent in 2017-18. This will push business investment to its lowest level since 2008 and isn't expected to stabilise until 2018-19 at the earliest.

Chart 4 shows capital expenditure in the mining, manufacturing and 'other' sectors. The 'other' sector includes most sectors that sit outside mining and manufacturing but it isn't comprehensive and can underestimate total business investment.

Chart 4: Australian capital expenditure (Annual investment; nominal)



* Dotted lines reflect expectations for 2016–17
Source: ABS; via CP Economics

It is no surprise that mining investment continues to fall – expected to decline by 30 per cent in 2016-17 and a further 30 per cent in 2017-18 – but the ongoing weakness in 'other' investment remains a concern. Investment in 'other' sectors is expected to fall by 5 per cent in 2016-17 before rebounding modestly by around 4 per cent in 2017-18.

The reality is that low levels of investment will continue to weigh on employment and productivity growth over the years to come. That's far from ideal for company valuations since investment is often necessary for expansion.

> **“Profitability though can be quite volatile so I often focus on income earned to gauge how specific sectors are travelling.**

The jump in profitability and income is welcome but a key question is whether it is sustainable. There remains a great deal of uncertainty surrounding the outlook for the resources sector and this will dominate changes in profitability over the remainder of the year.

Most analysts believe that commodity prices, in particular iron ore and coal, will fall from their present level during 2017. If that occurs mining profitability and income will decline towards the low levels of 2014 and 2015.

If higher commodity prices persist, however, then this may provide the impetus for greater investment and higher employment. Corporates are still cautious after a lean couple of years and are somewhat reluctant to spend on discretionary items. The longer the commodity price boom lasts the more likely that corporates relax the purse strings and begin to spend on equipment, technology and their employees.

Cautiousness is probably the best play for corporates right now but it isn’t without risk. The trend towards high dividend payouts, cost-cutting and buyback schemes may maximise short-term valuations but it isn’t the path towards long-term success. Firms that don’t invest or continue to push-back profitable investments are unlikely to be the firms that drive economic growth in the years to come.

The stock market's relentless rise, and expectations of more US rate rises, are pressure points for gold.

BY TIM TREADGOLD • EUREKA REPORT • 2 MARCH 2017

Why gold's rise may be short-lived

Gold has hit a speed bump, and without a political or economic crisis the precious metal risks spending the rest of 2017 going backwards, as it did last year.

Key Point

- ***The next test for gold is a speech on US interest rates on Friday (US time) by the chairman of the Federal Reserve Bank, Janet Yellen.***

Since dropping to a 12-month low of $US1125 on December 20 gold has risen 11 per cent to its current level of $US1250 an ounce. But it's now facing the near certainty of rising US interest rates, which lessens the appeal of holding gold.

Important indicators have, until now, been positive for the gold price. These include strong inflows of cash into exchange-traded gold funds, especially in Europe where the winds of political change are blowing.

More than $US1 billion a month has been invested into gold-linked ETFs since the start of 2017, largely because of uncertainty in both Europe and the US under its new president, Donald Trump.

But after a more conciliatory speech to Congress on Wednesday (Australian time) the Trump factor has lessened as a support for gold. After the speech, investors rushed back into the US stockmarket, which surged to another record high, with the Dow Jones index adding 303 points to close above 21000 for the first time.

Trump's focus on the US economy in his speech, with less emphasis on controversial topics, added to investor confidence and speculation that the US central bank will raise interest rates later this month, which is as another sign that the US economy is likely to grow faster than at any time since the 2008 global financial crisis.

Gold pressure point

Good news as this is for the wider economy it is not good news for gold, which relies more on fear than greed to attract interest as an alternative form of investment.

The next test for gold is a speech on Friday (US time) by the chairman of the US central bank, Janet Yellen, where she could expand on comments by other officials about an interest rate increase, perhaps as soon as March 15.

As the US enters a cycle of rising interest rates it is likely that the value of the US dollar will follow, bringing more downward pressure on gold which is generally traded in US dollars.

For investors in gold, including goldmining companies, the outlook is mixed with a negative bias.

There are factors at work which support the gold price, and could push it higher, such as the ongoing problems in Europe, where Greece remains in a never-ending financial crisis. And elections in France, Germany and the Netherlands could pile pressure on the solidarity of the European Union.

Other issues which aid the gold price include problems in dealing with an expansionist Russia and rogue states such as North Korea and Iran.

But on balance, the gold-price pendulum is swinging back into negative territory or, at best, to a period of stability around its current level.

Attempts to analyse gold are always tricky because there are so many moving parts in an equation that involves considering the merits (or not) of a metal which doubles as a commodity and a currency.

Macquarie Bank, in its latest exploration of gold and its outlook, noted the similarities with last year, when the price was almost exactly the same as today ($US1250, March 3, 2016) after an early rally.

The difference this year, according to Macquarie, is that this year's rise in the gold price has "not been as impressive as last year".

Flows into gold ETFs

Major factors at work, this year and last year, include the strength of the US dollar, the level of US interest rates, government bond yields, the inflow of funds into ETFs, and trading in gold futures.

ETF inflows weakened at the end of 2015 and 2016, according to Macquarie, and strengthened in the New Year.

"But whereas in 2015 the fall was relatively modest and the rebound very strong (in 2016), this time the fall was pretty strong, but the rebound has been quite modest," the bank noted.

> **“Risk averse investors will undoubtedly retain exposure to gold as an insurance policy against a political or financial crisis.**

“Notably the level of ETF holdings is substantially higher than it was a year ago, perhaps explaining investors’ reluctance to add new positions.”

Macquarie’s view is that gold “is actually doing well” considering the forces at work in the market.

While the overall economic situation is similar to last year the rally in the gold price has been smaller than last year.

“One reason for this is surely that things didn’t get so bad at year end, and so there was less possibility of a bounce back,” Macquarie said.

“But our analysis suggests another (factor) is that unlike early-2016, investors continue to be confident about the wider economic outlook; equity prices haven’t collapsed and inflation expectations are higher.”

The gold outlook

For gold, the good economic news and promise of stronger global growth is a problem, as are rising US interest rates.

Risk averse investors will undoubtedly retain exposure to gold as an insurance policy against a political or financial crisis, while investors with greater confidence in the future will be less attracted to gold.

It’s for those complex and interconnected reasons that the gold price could be under pressure for the rest of 2017.

Investors are showing a strong appetite for fixed interest securities issues.

BY PHILIP BAYLEY • EUREKA REPORT • 2 MARCH 2017

Strong start for listed debt market

The ASX-listed debt securities market has got off to a stronger start in 2017 than it did last year. That said, 2016 followed a poor 2015 that saw a significant correction in risk appetite.

Key Point

- ***On Tuesday, CBA announced that the bookbuild completed the day before had resulted in the size of the issue being increased to $1.45bn. Challenger's Capital Notes 2 issues was increased to $450m.***

As a result, this time last year only one new issue had been announced, the Commonwealth Bank's PERLS VIII hybrid note issue. The bank went on to sell $1.45 billion of the securities, paying a spread of 520 basis points over 90-day bank bills.

That was the high point for credit spreads. Credit spreads on subsequent issues were set at progressively lower levels.

And in the secondary market, securities that had been trading below par for the most part saw their prices move back to par and beyond over the course of the year.

Now only a handful of notes are trading below par, most are trading above par, and some are trading well over $105 against a face value of $100. These conditions ensured strong support for new issues at the start of 2017.

National Australia Bank got the year underway with its new $800 million, Subordinated Notes 2 issue, which **we wrote about** two weeks ago. Last week, Commonwealth Bank launched its well flagged $750 million PERLS IX note issue, and this week Challenger launched a $350 million, Capital Notes 2 issue.

Moreover, these last two issues have already been upsized with the credit margins to be paid on each set at the bottom of the indicated range.

On Tuesday, CBA announced that the bookbuild completed the day before had resulted in the size of the PERLS IX issue being increased to $1.45 billion. The announcement was consistent with the rumour that by the close of business on the previous Monday (the day the issue was announced), the sponsoring brokers had already taken orders for more than twice the $750 million minimum set by the bank.

Not surprisingly, the bookbuild saw the credit margin set a 3.9 per cent per annum, against the indicated range of 3.9 per cent to 4.10 per cent.

Holders of the $1 billion of soon-to-be-called Colonial subordinated notes (CNGHA) will be given priority if they wish to roll over into the PERLS IX notes. And CBA shareholders and other security holders can participate in the PERLS IX issue if they wish to do so, but as with NAB's Subordinated Notes 2, there will be no public offer.

The PERLS IX notes will be callable in March 2022 and mandatory conversion into ordinary equity will take place in March 2024. The offer is now open tomorrow and will close on March 24.

Deferred settlement trading will begin on the ASX on April 3, under the ticker CBAPF.

It was also on Tuesday, that Challenger announced its $350 million Capital Notes 2 issue, with an indicated credit margin range of 4.4 per cent to 4.6 per cent per annum. This is a new issue and not a replacement for an existing security issue.

The proceeds from the issue will be used to subscribe for Additional Tier 1 capital issued by Challenger's wholly-owned life insurance subsidiary. As such the notes come with all the features or detractions of Additional Tier 1 capital, as issued by banks.

The notes are perpetual but can be called in May 2023, APRA permitting, and mandatory conversion into ordinary shares in Challenger will occur in May 2025, if the notes have not been called. Distributions will be paid quarterly and should be fully franked, but distributions are discretionary and non-cumulative.

The only significant difference in this case is that there is no Capital Event trigger for mandatory conversion into ordinary equity. Being Additional Tier 1 capital raised by an insurance company, there is only a non-viability trigger.

Should APRA determine at any point while the notes are outstanding that the life company has become non-viable, the notes will immediately convert into ordinary equity to recapitalise the company.

> **“CBA shareholders and other security holders can participate in the PERLS IX issue if they wish to do so, but as with NAB’s Subordinated Notes 2, there will be no public offer.**

Of course, all of this is now quite standard and in no way curbed investor appetite for the Capital Notes 2. The very next day (Wednesday) Challenger advised the ASX that the bookbuild for the issue had already been completed with the issue size being increased to $450 million with the credit margin set at 4.4 per cent per annum.

Challenger expects to allocate a further $20 million to existing Challenger security holders. Again, there is no public offer.

The offer closes on March 31 and deferred settlement trading will begin on the ASX on April 10 under the ticker code CGFPB.

Allowing for some oversubscriptions to the three issues discussed here, $3.5 billion or more of new securities could be sold into the ASX-listed debt securities market by the end of the first quarter (or shortly thereafter). At the end of the first half of 2016, only the $1.45 billion, PERLS VIII issue had been completed.

However, the secondary market is already showing some signs of softness with the price of many securities moving off recent highs, especially among bank hybrid notes.

Dr Philip Bayley is a former director of Standard & Poor’s and now works as an independent consultant to debt capital market participants. He is associated with Australia Ratings.

Some of the finer points of getting money into super via NCCs, under the new, post-July, rules.

BY BRUCE BRAMMALL • EUREKA REPORT • 1 MARCH 2017

Super confusion: Understand your contribution limits

It's time to delve a little further into the nitty gritty of getting money into super post July 1 this year.

We've spoken broadly about the new contributions limits. There are limits around putting money into super when you've got $1.6 million in super already. And you can only make catch-up concessional contributions (CCs) it you've got less than $500,000 in super.

Key Point

- ***If you have just less than $1.6m in super on July 1, can you use the pull-forward provisions to get $300,000 into super now? The answer is no.***

But how are these things measured? And how do they interact with the other rules around contributions?

Judging by the volume of questions I'm fielding, there is a lot of confusion, in areas that have already been covered, to a degree.

Let's start with the three-year pull-forward rules, which allow you to add in three years of non-concessional contributions in one financial year. Once used up, you have to wait another three financial years to repeat the exercise.

Non-concessional contributions (NCCs)

As it stands, for the current financial year, the NCCs limit is $180,000 a year. And, if you're eligible, you could potentially get in $540,000 (3 x $180,000) into super this year, using the pull-forward provisions.

From July 1, the annual NCCs limit drops to $100,000 a year. And therefore, the most that can be put in during a single financial year will be $300,000 (3 x the new NCCs limit of $100,000), if you're eligible to make the contribution.

One of the most regular questions I'm receiving goes something like this: "If I have just less than $1.6m in super on July 1, 2017, can I use the pull-forward provisions to get $300,000 into super?"

No.

What has been announced is that you will only be able to use pull-forward provisions to the extent that it will allow you to go just a little bit (that is, less than $100,000) over the $1.6m limit.

If you have between $1.3m and $1.4m in super on July 1, then you could potentially make $300,000 worth of NCCs. Taking the mid-point of $1.35m, you would be able to contribute $300,000, which would take you to $1.65m in total superannuation balance (TSB), which I'll come back to).

If you have between $1.4m and $1.5m, you will be able to use two years of NCCs. That is, the $100,000 for the current financial year and $100,000 for a future financial year. Again, taking the mid-point, if you had $1.45m in super you would be able to get to $1.65m.

But if you have between $1.5m and $1.6m in super, then you will only be able to make NCCs of $100,000. No actual pull-forward is allowed for you.

Total Superannuation Balance

How much do you have in super, in regards to the caps?

It pretty much encompasses everything you have in super. Your accumulation benefit, your pension benefit and any money that is in the middle of being rolled over from somewhere else (they must have thought some people would try to abuse the system while some money was 'in-between' funds).

It is reduced only by any amount that relates to a 'structured settlement' contribution – which largely relate to compensation payments.

Transitional rules for NCCs pull-forwards

There are transitional rules for those who triggered the pull forward rule – by contributing more than $180,000 in either of FY16 or FY17.

You trigger the pull-forward rules by contributing more than the annual limit ($180,000) in this financial year, or more than $100,000 in FY18 or onwards.

In essence, if you triggered it in FY16 or FY17, you will receive a limit of $180,000 for the years up to and including FY17 and $100,000 for the years after.

> **When it comes to making contributions to your super, it's going to pay to know the finer details.**

For example, if you put in $250,000 in FY16, you will have a limit for FY16, FY17 and FY18 of $460,000 ($180,000 for FY16, $180,000 for FY17 and $100,000 for FY18). Following that $250,000 contribution, you will be able to contribute a further $210,000 during the FY17 and FY18 years.

If you trigger the pull forward with a $250,000 contribution in FY17, then you will have a total NCCs limit of $380,000 for FY17, FY18 and FY19.

But obviously, in order to make those contributions, you still need to meet eligibility criteria to contribute, which might include the work test and being under $1.6m in total super benefits.

Final thought

When it comes to making contributions to your super, it's going to pay to know the finer details. Particularly for those close to the new limits.

And judging by the emails I'm receiving, there is plenty of confusion. Superannuation has changed. And it will pay to have the right answers, to know what you're doing … or you simply must see someone who does know the rules so that you don't get it wrong.

The information contained in this column should be treated as general advice only. It has not taken anyone's specific circumstances into account. If you are considering a strategy such as those mentioned here, you are strongly advised to consult your advisor/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.

Bruce Brammall is a licensed financial advisor, a mortgage broker and an expert on self-managed super funds. He is a regular contributor to Eureka Report. To contact Bruce, please ***click here****.*

No one is tipping a return to $US100, but oil prices are moving closer to rebalance and growth.

BY TIM TREADGOLD • EUREKA REPORT • 28 FEBRUARY 2017

Oil eyes a half-decent equilibrium

Oil remains a finely-balanced commodity, with positive and negative forces counteracting the other. But away from the daily market moves are indications that growth is back on the agenda as confidence develops that the worst of a three-year crisis is over.

Key Point

- ***The fact Morgan Stanley looked at Beach as a cash-rich business rather than a struggler trying to survive amid low oil prices is a pointer to how investor sentiment in the sector stands.***

For the first time since the oil price plunged from $US115 a barrel at this time in 2014 to less than $US40 in January last year, all of Australia's leading oil and gas producers are talking more about expansion than cost-cutting and contraction:

- Woodside Petroleum is keen to expand its flagship Pluto LNG;
- Oil Search wants to push ahead with additional LNG-processing plants at its project in Papua New Guinea;
- Santos is confident it can resume paying dividends soon;
- Origin has made an exciting gas discovery in the Northern Territory, and;
- Beach Energy is being questioned about what it will do with a surprise cash surplus.

Investment bank Morgan Stanley was responsible for the Beach part of a research report last week which was headlined: 'How to spend the cash?'

There was no clear-cut answer from the bank to its question, just a debate about expanding exploration at Beach's Western Flank oil business in South Australia's Cooper Basin, and uncertainty over whether the company can grow through merger and acquisition (M&A).

But the fact that Morgan Stanley looked at Beach as a cash-rich business rather than a company struggling to survive in a period of low oil prices is a pointer to how investor sentiment in the oil and gas sector is improving.

Whether the improvement can continue is the great unknown, with oil traders waiting for evidence that production cuts by members of the Organisation of Petroleum Exporting Countries oil cartel are delivering a promised circuit breaker which will allow a flooded market to rebalance, and that US oil production is not filling the OPEC gap to maintain glut conditions and a return to lower prices.

Speculation about which way the market will move over the rest of 2017 is why the oil price, since the start of the year, has been trading between the tramlines of $US53 and $US57, rarely breaking above or below (it was at $US54.05 in New York on Monday).

Vitally important as the price of oil is, there are other aspects to all commodities which are almost as important such as the cost of production and the lack of investment in exploration and project development to meet future demand.

Macquarie Bank noted the increasingly "bullish" tone in the oil market late last week in a report headed: 'View is rebalancing is on the way.'

What Macquarie sees in the oil market is:

- evidence that OPEC production cuts will become increasingly visible over the next few weeks;
- demand for oil is strong, and;
- production cuts by countries which are not members of OPEC will accelerate.

On the OPEC cuts, Macquarie said there was recognition now that better data on how they were working should not have been expected until mid-March "to allow the cuts to make their way through the supply chain".

On demand, Macquarie said there was the potential for a demand surprise: "On the back of improving and globally synchronised economic momentum."

The effect of this increasingly optimistic tone in the oil market can be seen in the latest announcements by Australian oil and gas producers.

Woodside chief executive Peter Coleman has been talking up expansion potential at the Pluto project and development opportunities off the coast of Senegal and in Myanmar. He is particularly pleased with acquisitions made when the oil price was close to its low point.

"We think we have a two-year break on our peers to take advantage in terms of developing new properties and we

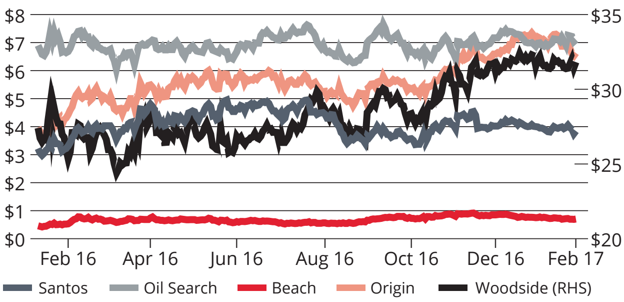
> **Oil Search could be in an even better position to grow thanks to a significant new gas discovery at Muruk in the PNG highlands.**

think we need to get after this next phase of growth," he said after releasing the company's 2016 profit result last week.

How Woodside goes about delivering growth will be keenly watched, especially its plans for Pluto which could become a hub for processing uncommitted gas off the WA coast, or be used to process gas from the remote Browse and/or Scarborough gasfields.

Oil Search could be in an even better position to grow thanks to a significant new gas discovery at Muruk in the PNG highlands, a reserve upgrade and a strong operating performance from the PNG/LNG project – a situation which managing director Peter Botten described as "the stars aligning".

Chart 1: Aussie oil stocks, past 12 months



Source: Bloomberg, Eureka Report

Another factor encouraging Oil Search to start planning additional LNG processing trains is that it has been able to slash operating costs by 30 per cent over the past three years, making the PNG/LNG project one of the most profitable in the world.

No one is tipping a sudden rise in the oil price, and certainly not a rapid return to a price above $US100.

But there is growing speculation that the worst of the price crash is over. That the price of oil and gas will creep higher thanks to a combination of supply constraint and a lack of investment in new projects for the best part of three years, and strong global demand for oil – and even more so for gas.

It's that outlook which explains why the share price of Woodside has been on an upward slope since April last year when it was sitting around $24 and is now $31.50. Oil Search has risen from $6.05 to $7.11, Origin is up from $4.50 to $6.60 and Beach is from 54c last September to 69c. Santos is the laggard, a weak share price thanks to a legacy of high-cost production and poor investment decisions.

Key points for investors to watch over the next month are:

- confirmation that OPEC cuts are working;
- confirmation that US production is not filling the gap, and;
- confirmation that global oil and gas demand remains strong.

If those factors are all positive then the stars really will have aligned for a return to a period of sustainable and profitable growth in the Australian oil and gas industry.