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# Weekly Review

WEALTH



– Issue – 9 Sep. 2016

***Low rates are continuing to define the global economy and markets, but the game in both the US and Europe may end sooner than many expect.***

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 7 SEPTEMBER 2016

# The rates game is about to change

When you watch events taking place in the economic community that don't make sense, you know that eventually there is going to be a break.

### *Key Point*

- ***It's when one delves deeper into the economic data that the true growth picture emerges, and that points to limited rate rises.***

The trick is to pick up an early signal, even though you mightn't have the timing right. About the stupidest game I have seen in my life is the current global money market high jinx that sees negative interest rates on European and other country bonds totalling $US13 trillion, and US 10-year bonds selling last night at around 1.54 per cent.

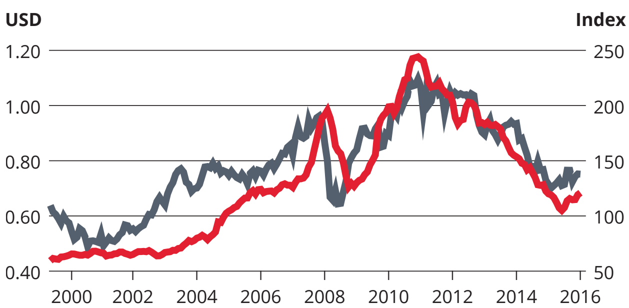
We know that the game has got to end but it now has so much momentum, and global institutions have their strategies wedded to playing the game, that it looks like it is going to go on forever. And then you see something silly happen that makes you realise that our global institutions are not all that bright, and this game may end a lot quicker than we first thought.

The US labour market statistics in August showed a rate of growth that disappointed the market and, of course, in conventional terms that means that interest rates must stay low and the expected rate increase in September is off the agenda. Future rate rises seem unlikely. A classic textbook page in the current game.

### Looking behind the jobs data

But then you look a little deeper and you find that the reason why the US wages growth disappointed in August was that there was an upward blip in the number of highly paid American workers who retired. These highly paid people are often the most productive in the country (as many Eureka readers know, that is rarely recognised in Australia) and so the increase in retirement affected productivity. Once you eliminate the early retirements, wages growth was increasing roughly on track. What is happening is that the institutions are wedded to the game and don't want it to end, and so they don't look too hard at any events that tell them that the end is coming quicker than they thought.

**Chart 1: Australian dollar and commodity prices (monthly)**




* Long-run average = 100
Source: RBA; via CP Economics

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As you all know, I have been a fan of the US growth momentum but it is slower than many expected, so I am reluctant to forecast big rises in American interest rates. I certainly don't get into a quarter-by-quarter lottery prediction game, but I think we are going to see limited rate rises faster than the market expects.

So imagine my joy when I ran across a commentary from Goldman Sachs which points out that, in its view, the normal global industrial recovery cycle of events is on track. Goldman Sachs believes that it won't be long before our banks and other financial institutions begin to accelerate leverage and increase the velocity of money because the destructive global debt deflation cycle is drawing to a close. As part of this upward trend, it says industrial metals appear to have bottomed late last year and have risen significantly.

We have also seen consistent improvement in US consumer demand. China, at the G20, underlined its determination to foster growth. That means that, contrary to the widely held view; we are set to see US rate rises and the continuation of current higher commodity prices.

I certainly don't believe that we are on the brink of any global boom, and I am not in the business of predicting the exact timing, but we all need to be aware that any turnaround along the lines Goldman Sachs is predicting will have important repercussions over a wide area of securities.

A couple of increases in the US Federal Reserve cash rate would send bond prices into a spiral and cause some considerable losses. In Europe where, perhaps surprisingly, there are also signs of a pick-up, it would damage the negative interest rate game being played by so many institutions. Losses would be severe.

The good news for Australia is that resource exporters would increase their revenue, but the bad news is that the Australian dollar would almost certainly rise in these circumstances. I asked *Eureka Report*'s economics commentator Callam Pickering to prepare me a graph of the Australian dollar and commodity index, and you can see they are mirror images. That rise in the dollar would not help our share market.

Moreover, the Australian share market is very much orientated towards yield and any rise in global interest rates would affect those shares unless our Reserve Bank made big cuts, which is not likely under the higher US rate scenario. And we are seeing higher GDP growth, which underlines the likelihood of no immediate rate cuts. We got a whiff of this trend over the last week when Sydney Airport and Transurban shares fell back faster than the market.

Long-term interest bearing portfolios would be affected. Because I don't think the overall rise is going to be spectacular, the damage will be on the margin, but we have been living in this low interest rate environment for a long time and what Goldman Sachs is alerting us to is that the time when it is reversed is coming closer. I should emphasise that Goldman Sachs' view is somewhat different from what the Commonwealth Bank predicted last week. I included the CBA predictions in my coverage last Saturday. The Commonwealth Bank's predictions are very much in line with world thinking, but it is important for all of us to put at the back of our mind that global conditions can change, so make sure your portfolio is not completely wedded to the CBA view of future events.

## Making sense of the oil story

These days' iron ore and LNG dominate the Australian export economy. And LNG is closely linked to the oil price. All the indicators we see show us that there is an increase in the supply of iron ore coming and the Chinese look like cutting back steel demand.

> **"Because Putin has become the major Middle Eastern military power, replacing the US, in time there will be a degree of cooperation, but not until Iran brings it production close to capacity.**

BHP has been warning for some time that it does not believe that the iron ore price is set to catapult into a boom. But the oil price is a different story. Some of you might remember that last year I discussed the role of Vladimir Putin in trying to bring together the Middle Eastern oil producers to get the price up. He concluded that before there could be a coordinated approach in the Middle East, the Islamic State territory problem had to be resolved.

Putin has bought together Iran, Iraq and Syria to help eliminate the Islamic State control over vast areas of the Middle East. But Iran, Iraq and Syria are not good friends with the Saudis because the Saudi leadership is Sunni, so bringing them together on oil production is not easy. Putin arranged one deal with the Saudis at the beginning of 2016 but it fell over. Not discouraged, at the G20 he did another Saudi deal, albeit tentative. Because he has become the major Middle Eastern military power, replacing the US, in time there will be a degree of cooperation, but not until Iran brings it production close to capacity.

The Russians desperately need an oil price rise because their economy is based on the oil price. I think the Russians are going to achieve their goal and, for what it is worth, BHP has a similar view on oil. That is good news for LNG producers like Origin, Santos and Woodside.

***The above threshold deeming rate - a key component of the income assets test – is increasingly higher than the current cash rate.***

BY SCOTT FRANCIS • EUREKA REPORT • 7 SEPTEMBER 2016

# Retirees are getting a raw deeming deal

Deeming rates have always played an important role for people receiving the part age-pension. When working out access to the age pension, either the assets or income test is used to limit a person's age pension, whichever is the most restrictive.

### *Key Point*

- ***Divergent cash rates and deeming rates are forcing retirees to take on more risk to match deemed income.***

Deeming is an important element in the income test. Rather than a thorough calculation of the income that comes from a person's assets, 'deeming' is used as an estimation of the total income earned. That is, a person's financial assets are 'deemed' to earn a certain amount of income under the deeming calculations.

Deeming calculations took on extra importance from January 1 last year, with superannuation income streams included in deeming calculations. This means a higher proportion of retirees' assets are assessed under deeming rules – making those rules and rates more important than ever. However, as we will see, deeming rates have failed to keep pace with interest rate cuts, meaning an investor with cash assets is likely to be 'deemed' to earn more income than they actually do.

## How does deeming work?

As an example of how deeming works, let's consider a couple with $500,000 of financial assets. Currently, the first $81,600 of assets is deemed to earn income at a rate of 1.75 per cent per annum, with the balance earning income at 3.25 per cent per annum. Step by step, the deemed income is:

1. **$81,600 x 1.75% = $1428**
2. **Plus (+)**
3. **(500,000-81,600) x 3.25% = $13,958**
4. **Total Deemed Income = $15,026**

The figure of $15,026 is used to determine the income test figure for the couple, and therefore how much age pension, or part age-pension, the couple is entitled to.

## Deeming rates and the cash rate over time

The following table sets out the historical deeming rates for the past 20 years, compared with the Reserve Bank's target cash rate. The final column is particularly important, comparing the 'above threshold' deeming rate with the RBA's cash rate. It shows that while these have been historically close, that has changed in recent times. Indeed most of the time the deeming rate has been lower than the RBA cash rate, with that reversing recently.

**Table 1: Historical deeming rates for the past 20 years, compared with the Reserve Bank's target cash rate (as at July 1 each year).**

| | BELOW THRESHOLD DEEMING RATE (%) | ABOVE THRESHOLD DEEMING RATE (%) | RBA CASH RATE (%) | DIFFERENCE B/N CASH RATE & 'ABOVE THRESHOLD' DEEMING RATE (%) |
|---|---|---|---|---|
| 1996 | 5 | 7 | 7.5 | 0.5 |
| 1997 | 4 | 6 | 5.5 | 0.5 |
| 1998 | 3 | 5 | 5 | 0 |
| 1999 | 3 | 4.5 | 4.75 | 0.25 |
| 2000 | 3.5 | 5.5 | 6 | –0.5 |
| 2001 | 3 | 4.5 | 5 | 0.5 |
| 2002 | 2.5 | 4 | 4.75 | 0.75 |
| 2003 | 2.5 | 4 | 4.75 | 0.75 |
| 2004 | 3 | 5 | 5.25 | 0.25 |
| 2005 | 3 | 5 | 5.5 | 0.5. |
| 2006 | 3 | 5 | 5.75 | 0.75 |
| 2007 | 3.5 | 5.5 | 6.25 | 0.75 |
| 2008 | 4 | 6 | 7.25 | 1.25 |
| 2009 | 2 | 3 | 3 | 0 |
| 2010 | 3 | 4.5 | 4.5 | 0 |
| 2011 | 3 | 4.5 | 4.75 | 0.25 |
| 2012 | 3 | 4.5 | 3.5 | –1 |
| 2013 | 2.5 | 4 | 2.75 | –1.25 |
| 2014 | 2 | 3.5 | 2.5 | –1 |
| 2015 | 1.75 | 3.25 | 2 | –1.25 |
| 2016 | 1.75 | 3.25 | 1.75 | –1.5 |

> **The key problem is this – for an investor holding investments in cash, the income earned from their investments will be 'deemed' to be higher than the actual income that they receive.**

Looking at the table, the current challenge for retirees is that the above threshold deeming rate is now substantially different (higher) than the current cash rate. The above threshold rate is likely to be more important for investors, as most investors will have assets well above the threshold rate.

The key problem is this – for an investor holding investments in cash, the income earned from their investments will be 'deemed' to be higher than the actual income that they receive. Their age pension will be restricted on the basis of income that is 'deemed' to have been earned, rather than income actually received – which is a tough situation for retirees relying on some part age-pension.

Let's again consider the couple with $500,000 of financial assets, deemed to earn $15,026. National Australia Bank's current advertised term deposit rate for 12 months is 2.4 per cent, providing $12,000 of income for a $500,000 investment. Sure, people can do better if they look around, however it illustrates the point well; while receiving $12,000 worth of income from one of our big four banks, they are 'deemed' for age-pension purposes to have earned $15,026.

There is an argument that retirees can have assets that will provide a higher yield – and certainly Australian shares provide access to income at a level above the deeming rate. The reality is that assets beyond cash and term deposits require people to understand and take on levels of investment risk.

There is a reason that the cash rate is currently at 1.5 per cent (and deeming rates have not been adjusted down from their July 1 level with the most recent rate cut) is because the economic environment is challenging – making it a tough time for retirees to be thinking about additional risk in a portfolio just to try and get their portfolio income to match their deemed income. It seems reasonable that the deeming rate is based on the 'risk free' investment rate in an environment and, certainly, over the last 20 years it seems that deeming rates moved in relationship with the cash rate.

## The solution

The solution seems glaringly obvious – if deeming rates were directly linked to the cash rate, then retirees could feel comfortable that their deemed income would reasonably reflect the earnings on cash investments.

## Final word

There have been, and will continue to be, changes that seem to make the retirement journey more challenging than ever for retirees – a period of low investment earnings following the Global Financial Crisis, historically low interest rates, restrictions in the asset test proposed for the start of next year, later access to both superannuation (winding back to age 60) and the age pension.

Deeming rates are important to calculations for the age pension income test, and making these rates fairer by linking them to the cash rate ensures one small part of the retirement puzzle is fair and reacting to what is happening in the economy.

***The proposed $1.6m transfer-to-pension cap means that anyone with more than that in superannuation is going to have to make some choices.***

BY BRUCE BRAMMALL • EUREKA REPORT • 7 SEPTEMBER 2016

# Busting the $1.6m super cap. Here's what to do

So, you're going to bust the cap. You've got more than $1.6 million in super. And you're wondering what the proposed transfer-to-pension cap is going to mean.

***Key Point***

- ***There are some key dos and do-nots to reposition yourself ahead of the government's still-to-be-legislated change.***

You're going to have some decisions to make. Which of your precious assets stay in, and which stay out?

The new (it's still technically a proposal) $1.6m transfer-to-pension (TTP) cap means that anyone with more than that in superannuation is going to have to make some choices.

We don't know exactly yet what those choices will need to be yet. We'll need to wait to see the draft legislation, hopefully soon, to know those with any great certainty.

But coming from the experts, there are a few things that, even now, SMSF trustees/members should start to consider.

### Refreshing your cost base

If you have a pension fund that currently has more than $1.6m in it, you may wish to consider, *very carefully*, refreshing the cost base of the assets in the pension fund.

Why? To protect yourself from a nasty capital gains tax bill later.

If you are going to be in the position where you have to transfer a substantial amount back to superannuation (from your current pension account, if it's more than $1.6m), then you might also be transferring back from pension to super a big tax problem.

### Here's an example:

Let's say you previous transferred $4m of assets into a pension fund in 2010. The assets you had transferred into the pension fund at that time had a cost base of $2m. They are, by virtue of being great assets that have done well with capital growth, as of today's date, worth $6m.

You are only allowed to keep $1.6m in pension, so you are going to have transfer $4.4m back from pension to super.

With that $4.4m that goes back to pension will be a cost base of $1.467m (I'm just using a proportional amount of the original $2m cost base). If you then had to sell this $4.4m while back in superannuation, you would face a tax bill of $293,333 (assuming 10 per cent tax on the capital gain).

However, if you turned over the $6m in assets currently in the pension fund before June 30 next year, to give yourself a new cost base of approximately $6m, it would dramatically increase the cost base and lower future potential capital gains.

You will incur some trading fees obviously, which will hopefully be far less than the tax you might have to eventually pay. It's something worth considering.

### Wash sale rules – a big, important note

Please be aware of the wash sale rules. The Australian Taxation Office is alert to those who are simply trying to "wash" their cost bases to minimise tax. And they don't like it.

In order to avoid unnecessary attention from the ATO, you will need to be very careful about how you implement a program to refresh your cost base, and preferably seek specific advice for your situation from your financial adviser or accountant, or bone up heavily on what you need to do.

Avoiding a wash sale includes: not selling a similar amount of assets, then simply repurchasing the same amount of assets, such as selling 1000 Commonwealth Bank shares, then repurchasing 1000 CBA shares.

Use it as a time to make some asset allocation changes, or sector changes, or changes to a competitor that you believe is likely to perform better in the future, such as moving from one bank to another bank you think has better prospects. If you're selling 1000 BHP Billiton, then perhaps you'll buy a smaller amount of BHP, but diversify into Woodside Petroleum and/or Rio Tinto or others (please note, they're

> **Which assets should stay in pension and which should go to super? This is going to be a huge question that many will need to answer in the next nine months.**

just examples. I am giving strategic, *not* share advice in this column).

### Even-up your super

I'm seeing example after example where people should start acting immediately to try to even up their super balances between spouses.

A situation you want to avoid is where one member of a couple has a pension fund balance of $2.5m, and the other has a balance of $400,000. After July 1 next year, the spouse with the $2.5m balance will have to transfer back $900,000 from pension to super to fit under the TTP cap and start paying tax (at 10-15 per cent) on income and gains on that $900,000.

You need to do what you can to even-up super funds. That can include some of the strategies **I covered here**. Moving concessional contributions from a high balance spouse to a low-balance spouse, on a yearly basis, will be very important. Sure, it might only be $35,000 (less 15 per cent) and $25,000 (less 15 per cent) but each and every year, it will make a huge difference.

Which assets should stay in pension and which should go to super?

This is going to be a huge question that many will need to answer in the next nine months … but we can't begin to answer it yet.

If you have to transfer a bunch of assets back from pension to super, what assets are you going to leave in pension and which will you push back to super?

The reason it can't be answered is because we haven't seen the draft legislation. And so much is going to depend on what you will and will not be allowed to do, in regards to your $1.6m pension fund.

No one has answers yet. And there are plenty of theories. Max Newnham and I had a good debate on it – both of us were polar opposites on what we though the Tax Office would do – immediately after getting off air from **last week's Advisor Q&A**.

For some, from a risk perspective, it might make sense to transfer higher income assets into super. For others, it will be growth assets. It will be a unique decision to make for yourself.

But first … we need to see the legislation.

**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 adviser/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.**

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***The June update on national accounts won't materially affect the outlook for rates, despite reporting strong improvement from the public sector and a timely boost in tax revenue.***

BY CALLAM PICKERING • EUREKA REPORT • 7 SEPTEMBER 2016

# National accounts paint a positive growth picture

Other economic indicators may be more timely, but few have the capacity to move markets like the release of the national accounts. The quarterly snapshot of the Australian economy provides insight into conditions in the household and business sectors and identifies sources of strength and cause for concern.

### *Key Point*

- ***The national accounts were positive but investors should be wary that commodity prices may drift lower in the coming months.***

The ABS released the national accounts for the June quarter on Wednesday and it was a solid outcome for the Australian economy. While the headline real GDP figure continues to overstate the strength in the Australian economy, the recent pick-up in commodity prices has seen national income growth begin to recover.

The result should be interpreted in a positive manner with regards to Australia's economic outlook. However, investors should be wary that commodity prices may drift lower in the coming months since the end of the year has historically been quite weak for commodities. Furthermore, while the result was a positive, it doesn't materially affect the outlook for interest rates.

## Economic growth and commodity prices

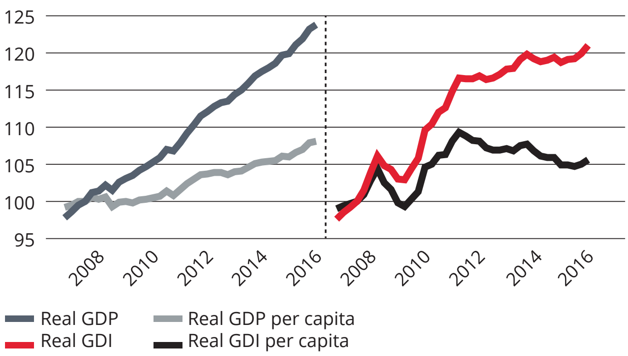
The standard measure of economic growth is real gross domestic product (GDP), which measures the volume of production or income or expenditure that occurs in an economy over a specific period of time. Although there is three ways to measure real GDP they should all be equal since one person's expenditure is another person's income.

The recent decline in commodity prices has called into question whether real GDP is an appropriate measure of economic activity and living standards. Weaker commodity price and our terms of trade has dragged down domestic income growth. We have experienced an 'income recession' for the past two years, which has seen the nation take a pay cut as mining profits plummeted.

In response I have come to prefer a measure of economic activity called real gross domestic income (GDI). This measure is similar to real GDP except that it makes an adjustment for changes in commodity prices and our terms of trade. For a small open economy, such as Australia, it is almost impossible to judge our economic performance without first considering the price of the exports that we sell abroad.

Chart 1 compares the two measures. Real GDP rose by 0.5 per cent in the June quarter, beating market expectations, to be 3.3 per cent higher over the year. By comparison, real GDI has increased by 1.9 per cent over the past 12 months with around half of that growth occurring in the June quarter.

**Chart 1: Australian economic activity, 2007–present, index: Dec 07=100**




Source: ABS, via CP Economics

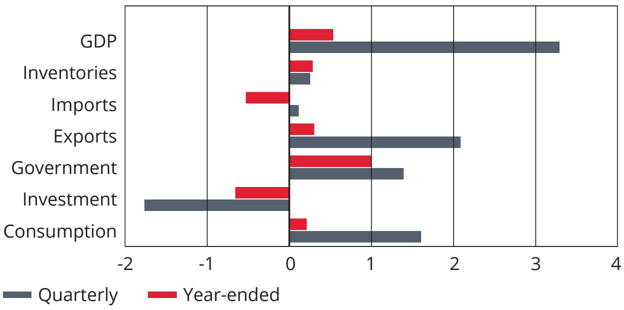
Chart 2 does a good job of highlighting the impact that falling commodity prices have had on our economic performance. Real GDI per capita has fallen 3.4 per cent from its peak almost five years ago, which means that living standards have fallen throughout that period.

Officially the Australian economy is growing at what is considered an above trend rate – with trend considered to be annual growth of around 2¾ per cent – but most of that is due to strong demand for iron ore and coal. Domestic

> **A healthy household sector is a prerequisite for a healthy economy and our household sector is doing better than you might expect.**

demand remains quite weak and that explains why inflation and interest rates currently sit either at or near historically low levels. Nevertheless, the result in the June quarter was a step in the right direction.

**Chart 2: Contributions to GDP growth for the June quarter**




Source: ABS, via CP Economics

## Household sector

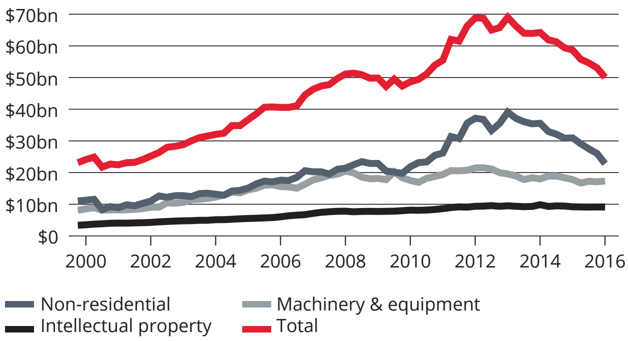
Household spending accounts for around 55 per cent of real GDP. As a component of economic activity it is relatively stable, at least compared with the likes of business investment and residential construction. A healthy household sector is a prerequisite for a healthy economy and our household sector is doing better than you might expect given the ongoing weakness in wage growth.

Household consumption rose by 0.4 per cent in the June quarter, a little slower than earlier in the year, to be 2.9 per cent higher over the year. More timely data suggests that retail conditions have eased a little in recent months as the stimulus arising from higher asset prices, the so-called 'wealth effect', begin to diminish.

Chart 3 shows the contribution made by the major components of economic activity. With the exception of net exports, no sector has been as important to our recent economic performance as household spending.

Residential construction has been another bright spot for the Australian economy but the June quarter suggests that the boom is beginning to stabilise. Residential construction rose by 0.2 per cent in the quarter and now accounts for 3.6 per cent of economic activity. This shift towards stabilisation should continue with building approvals remaining at an elevated level and that activity should be sufficient to contain house price growth over the next few years.

**Chart 3: Australian business investment – volumes, quarterly**




Source: ABS; via CP Economics

## Business sector

Business investment is one of the more volatile components of economic activity and has been a key source of weakness for the Australian economy over the past few years. The end of the mining investment boom is a major reason why the Reserve Bank has cut interest rates. So far lower rates hasn't had the effect on business investment that many analysts predicted.

Business investment fell by 5.7 per cent in the June quarter, consistent with the result from the recent capital expenditure survey, to be 14.7 per cent lower over the year. Non-residential investment fell by a remarkable 12.4 per cent in the June quarter.

> **A quarter such as this is often referred to as an outlier and I wouldn't be surprised if government investment fell next quarter.**

Business investment has now fallen 27.5 per cent from its peak, with another 10 to 15 per cent fall expected during the 2016–17 financial year. The weakness in investment will continue to weigh on full-time employment and if persistent will undermine the performance of domestic equities.

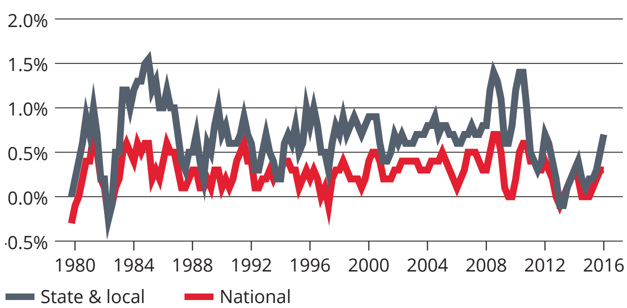
## Government spending

The surprise packet from a market perspective this quarter was the strong result coming from the public sector. Government spending rose by 4.5 per cent in the June quarter, well above market expectations, to be 6.3 per cent higher over the year.

To a large degree this reflected investment by state and local governments, although federal government investment also surged. A quarter such as this is often referred to as an outlier and I wouldn't be surprised if government investment fell next quarter.

Chart 4 shows the contribution to annual growth made by the various levels of government.

**Chart 4: Government spending's contribution to annual GDP growth**




Source: ABS, via CP Economics

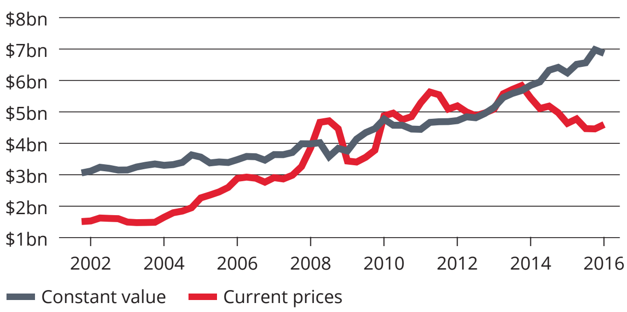
Some readers may be concerned about the budget implications of this result. Obviously spending remains quite high but it is concentrated in investment, which should provide an economic return across a number of years. Furthermore, tax revenue received a timely boost from the combination of higher commodity prices and stronger growth in nominal GDP (up 3.4 per cent over the year).

## External

Net exports remains one of the more difficult components to assess. I noted earlier that net exports has been a major source of real GDP growth – accounting for over two-thirds of growth over the past year – but the income we have earned from those exports has declined.

Net exports have contributed 2.2 percentage points to real GDP growth over the past year but has contributed just 0.9 percentage points to nominal GDP growth. The discrepancy between the two is significant and can perhaps best be illustrated by the Chart 5 which compares the income earned by Australian miners against what their income would be if prices were constant.

**Chart 5: Australian mining income, seasonally– adjusted**




Source: ABS; via CP Economics

Net exports is expected to be a key driver of the Australian economy throughout 2017 and 2018. Commodity prices though will determine whether Australian miners are a good investment or not. LNG exports are expected to be the next boom market and investors should watch closely to see how prices react as new supply comes online.

***Big miners are ramping up their copper production, but too much supply can only have one outcome. The copper price has already fallen.***

BY TIM TREADGOLD • EUREKA REPORT • 6 SEPTEMBER 2016

# Copper travels down the iron ore road

History can have an unpleasant way of repeating, which is why shareholders in BHP Billiton, Rio Tinto and other copper miners should keep their fingers crossed that the economic forces that savaged the iron ore industry do not do the same to copper.

### *Key Point*

- ***Copper producers with low-cost operations would survive and prosper in an oversupplied market but would not produce bonanza profits.***

The issue is as simple as supply and demand, turbo-charged by an inexplicable belief held by some mining-company managers that they are operating in a vacuum, unaffected by what other miners do.

In more simple terms copper has become the "go to" commodity, complete with forecasts of a strongly rising price. But the principal problem is that everything being said today about copper was said about iron ore five years ago, before oversupply crashed the market.

Both BHP and Rio, along with Glencore, Anglo American and China's MMG (formerly known as Minerals and Metals Group) have earmarked copper as their preferred metal for exploration and project development.

In the case of BHP and Rio, that means re-allocating capital away from iron ore to copper projects, such as the expansion of the giant Escondida mine in Chile and the Oyu Tolgoi mine in Mongolia.

## Early warning signs

An early sniff of a potential copper glut came last month when Swiss-based Glencore reversed an earlier decision to cut copper output when it unveiled a 20,000 tonne-a-year increase in its previous forecast for 2016 copper output to 1.41 million tonnes.

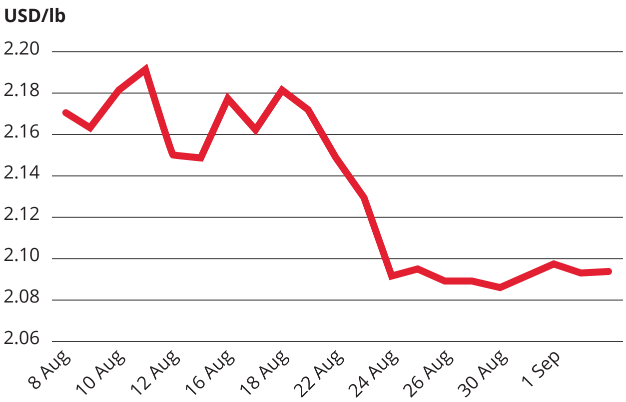
A second warning sign emerged a week later when the copper price nose-dived from around $US2.18 a pound to a 10-week low of $US2.08/lb, appearing to have resumed a plunge which started in 2011 when the price was more than $US4/lb.

Global stockpiles of copper are currently at their highest since October last year amid reports that demand in China, the world's biggest single user of copper, has stalled. This prompted some analysts to revise their predictions that a lack of investment in new mines would lead to a copper shortage next year.

The latest forecast from credit ratings agency S&P Global Ratings is that copper will remain oversupplied this year, with a recovery delayed until 2018.

UBS, an investment bank, sees the copper market shifting from a modest oversupply of 227,000 tonnes this year to a small deficit next year, and for the three years after that, before returning to a substantial surplus of 440,000 tonnes in 2021.

**Chart 1: 30-day copper spot price**




Source: Kitco.com

Who's right in the production and price tipping game is irrelevant in taking a long-term look at copper through the prism of what the same mining companies expanding in that metal said about iron ore in 2011. Back then, forecasts of strong Chinese demand triggered an industry-wide mine development boom.

> **Rio is on the same wavelength as BHP when it comes to copper, with a clue to intent lying in the appointment of Jean-Sebastien Jacques.**

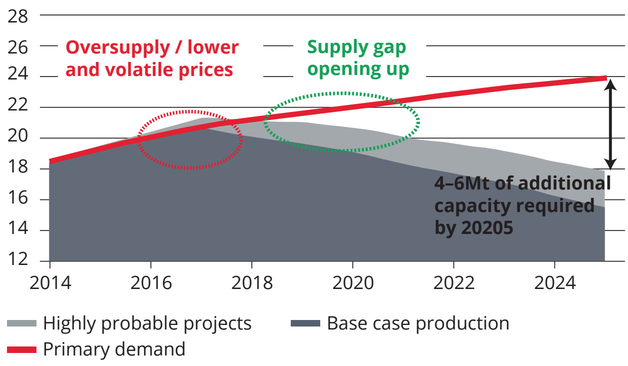
## More copper expansion

In the case of BHP copper sits alongside oil as the preferred target for new investment, with three copper projects named in the company's top five expansion opportunities. These are the expansion of Escondida (jointly with Rio) and Spence mines in Chile, and Olympic Dam in South Australia. The other two highly-ranked opportunities are more iron ore in Western Australia and the Caval Ridge coal project in Queensland.

Exploration targets, which point to where BHP expects to find its next crop of mines, are dominated by copper and oil with additional tenements acquired in Peru and the southwest of the US for copper.

Rio is on the same wavelength as BHP when it comes to copper, with a clue to intent lying in the appointment of Jean-Sebastien Jacques, the former head of the company's copper division, as its new chief executive.

**Chart 2: Rio Tinto's June 2015 forecast for copper supply/demand (million tonnes)**




Source: Rio Tinto copper and coal roadshow presentation, June 2015

In a paper delivered last year while head of copper, Jacques spoke of "creating leading copper and coal businesses" which focused on expanding existing mines (Oyu Tolgoi, Grasberg, Escondida, and Kennecott in the US), plus working towards two new world-class copper mines: Resolution in the US and La Granja in Peru.

But what Jacques said 15 months ago, and the graphs he used to justify his optimism, are looking less attractive today.

Jacques argued that supply disruptions of 6 per cent a year (mine closures and shipping delays) would help boost the copper price as Chinese demand continued to grow.

But since then the copper price has fallen from around $US2.75/lb to its current $US2.09/lb and analysts at the investment bank Morgan Stanley have questioned the assumption that supply disruptions will be as high as Jacques forecast, adding to the oversupply problem.

"Copper mine supply through the first half of 2016 has marginally outperformed our expectations, with disruptions tracking at 1.8 per cent year-to-date," Morgan Stanley said.

"If this low rate of disruption continues through the second half of 2016, mine supply will exceed our initial forecast by around 230,000 tonnes in 2016 (which will be) bearish for the copper price."

## Banking on the next cycle

What the big mining companies are banking on is a shared belief that the copper "cycle" of over-and-under supply runs in seven-year cycles which, in theory, means that copper is close to the end of the current down leg in the cycle.

Deutsche Bank argued in a mid-year study of the copper market that as fundamentals reasserted themselves, an upward price leg would start with the price moving back towards $US2.70/lb in 2019.

Given the widespread uses of copper in a range of industries that include electronics, transport and construction it is hard to dismiss the optimism shown by the mining industry and investment banks towards copper – if it wasn't for the fact that the same people said the same things about iron ore five years ago.

**“Copper is travelling on the same road as iron ore … too many mining companies have decided at the same time to pursue copper expansion programs.**

Back in 2011 BHP, Rio, Fortescue Metals and Anglo American were engaged in a furious race to expand their iron ore mines because they all subscribed to the theory that Chinese demand would underpin a period of growth and high prices. This was simplified into the slogan of “stronger for longer”.

The iron ore stampede produced an inevitable oversupply, which hurt shareholders in all producers of the mineral, and has led to what looks likely to be a decade-long glut. It will be a time when only low-cost mines can produce profitably.

BHP, Rio and Fortescue will successfully ride out a prolonged iron ore downturn, which is expected to see the price settle in a range of between $US40 a tonne and $US50/t.

Copper is travelling on the same road and while companies with low-cost operations will survive and prosper it will not produce bonanza profits for the simple reason that too many mining companies have decided at the same time to pursue copper expansion programs.

The UBS copper “model”, measured in days of total inventory (stockpiled material) is for this year’s inventory of 50 days supply slipping to 44 days by 2018, 41 days in 2020 – but then rising back to 47 days in 2021 as supply from new mines such as those being developed today by BHP and Rio hit the market.

The problem confronting all mining companies is that projects conceived in the boom years have generally satisfied the market and look like doing so for some time.

***With their focus on monthly net tangible assets updates, our LICs presented few surprises during reporting season.***

BY MITCHELL SNEDDON • EUREKA REPORT • 7 SEPTEMBER 2016

# Taking stock of some core LICs

Reporting season doesn't mean too much for LIC investors as you can keep up to date on a monthly basis with the monthly net tangible assets (NTA) updates. For some, you can even keep up daily if you wanted to torture yourself. What reporting season does allow us to do is revisit our managers and take stock. Below are our thoughts on three core holdings in the LIC portfolio and one old favourite.

***Key Point***

- ***Unlisted business investor Bailador is the current best value of our core LIC investments, with the remainder tracking steadily.***

## BKI Investment Company (BKI)

BKI is a true throwback to the LICs of the likes of Argo and AFIC. It's an internally managed portfolio of high quality, dividend paying businesses and carries very little cash. Being internally managed there is a strong focus on keeping costs low. The team has a saying, "the thicker the carpet the thinner the dividend". The lower the fees the more there is for shareholders (which management and the board are).

Coming out of the Brickworks portfolio, the BKI team have the benefit of sitting in the same office as Brickworks and Sol Patt's, which house some of Australia's best long-term investment minds.

The last 12 months have been challenging for BKI, as it has been for the market in general. Total shareholder return for the 12 months to June 30 was negative 0.8 per cent, underperforming the market which returned positive 0.9 per cent. The commentary coming from management was sedate and echoed the team's long-term steady approach. Management also acknowledged the excessively priced traditional income stocks and their cautious take on unsustainable dividends.

You know what you are getting from BKI: a steady stream of dividends from quality businesses at a cheap price. The management expense ratio (think fees) sits at 0.16 per cent per annum. This is cheaper than the majority of exchange traded funds out there.

Last reported post-tax net tangible assets was $1.54 and pre-tax was $1.64. With the share price sitting at $1.58 BKI is a Hold. Given the paper-thin expense ratio we do not require a deep discount to NTA to justify an investment but we would still like to see it below post-tax NTA. **HOLD**.

## Bailador Technology Investments (BTI)

Bailador is the opposite end of the spectrum to BKI and this is an example of what the LIC structure suits. The closed end nature is perfect to give investors the opportunity to invest in illiquid unlisted businesses. Bailador gives retail investors exposure to an asset class generally not accessible.

Bailador specialises in investing in unlisted internet-based businesses. Its largest holding is the highly successful hotel rooms management system SiteMinder. It's a subscription based, software-as-a-service business with high levels of recurring revenue. It has more than 400 distribution partners across 100 countries and equates for 24.6 per cent of Bailador's portfolio.

Due to the lumpy nature of Bailador's returns and the valuation of the underlying businesses a disconnect exists between the share price and value. Over the short term this is going to be even more predominant. Unlike listed equities where the market is constantly changing the price, the valuations in these businesses don't change on a daily, weekly or monthly basis. For some investors the lack of change may prove to be frustrating and cause the LIC to trade at a discount to NTA for long periods of time. But remember the underlying value here needs to be taken with a grain of salt and is at best a measuring stick in which you need to see a substantial discount to value.

The 2016 financial year was a big year for the Bailador team bringing in a large chunk of funds from the exercising of options and putting it to work. Bailador is a small portion of the overall portfolio and something we are more than happy to put in the bottom drawer and watch as it plays out. We definitely look forward to the big sugar hits when profits are taken and dividends are paid.

Currently the Bailador share price is trading at a discount to post-tax NTA of approximately 4.5 per cent. **BUY**.

> “ **Portfolio manager and managing director Chris Mackay is an investor after our own hearts ... this is why Magellan Flagship Fund is our preferred LIC for international exposure.**

### Magellan Flagship Fund (MFF)

Magellan Flagship Fund's fortunes swayed in the wind with the rest of the global managers in FY16. Magellan Flagship Fund finished the year marginally down, in a month that wiped off any previous gains as it finished with the Brexit.

Throughout the year portfolio manager and managing director, Chris Mackay consistently wrote to shareholders in the monthly NTA updates of valuations being stretched in the quality businesses he was targeting for the portfolio. He also remained firm in not compromising the quality of his portfolio by going up the risk curve and investing in smaller and lower-quality businesses to chase returns. Since the pullback at the end of FY16, Mackay has seen opportunities become moderately priced again.

With total sales in the portfolio of approximately 1.5 per cent the Magellan Flagship portfolio is hardly something you would call reactionary. I urge you to read Mackay's **letter to shareholders** in the annual report and to continue to follow his commentary in the LIC's monthly NTA announcements. If you do you will see he is an investor after our own hearts. The updates are constant reminders to investors of his focus on value and quality and an unwavering focus on the long term. This is why Magellan Flagship Fund is our preferred LIC for international exposure, but at the right price of course.

Currently the share price is trading in line with MFF's post-tax NTA of $1.789. But if you were to take into consideration the outstanding options (which are well in the money with a strike price of $0.9964) you need to reduce the NTA by 14.6 cents. Therefore, making it not cheap enough for us. HOLD.

### Australian Foundation Investment Co. (AFI)

Although not in the model portfolio AFIC, as the great grandfather of LICs, is a portfolio we keep a close eye on. As you could imagine, AFIC's fortunes followed the market's.

What caught the attention was an increase in AFIC's weighting in small- and mid-capitalisation stocks, from 15 per cent to 22 per cent, since last year. When you're managing a $6.4 billion portfolio and selling larger holdings is likely to incur tax costs, a 7 per cent shift is significant.

Management noted in its outlook statement that subdued returns were “likely for quite some time” and, to deliver reasonable growth, they clearly feel they need to take a broader approach. Given the outperformance of small and mid-caps over the past year and more, though, they may have missed the boat – or at least the best cabins.

What intrigues us most is not what AFIC is or isn't doing but what the second-largest LIC in the country, Argo, has decided to do. Following on from AFIC's result, Argo made specific mention in its annual report to staying the course with high-quality investments and not changing its investment approach. How the two portfolios fare over the course of the next year will be worth keeping an eye on.

AFIC is currently trading at a slender premium to pre-tax NTA and a larger premium to post tax. **HOLD**.

***We take a look at price guides and how it all fits in with our portfolios.***

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 6 SEPTEMBER 2016

# Price guides and model portfolios

To help provide context for our recommendations (see ***What we mean by Buy, Hold and Sell***), in most cases we'll put a price guide on a stock, to give an indication of where we'll consider changing our recommendation. We'll sometimes leave out the price guide, though, where a stock's value is particularly sensitive to an external factor, or where that value is especially hard to judge, or changing quickly.

An example of the former would be a commodity producer like Santos, whose value depends heavily on the price of the relevant commodity. So the company's value may move up or down by tens of per cent – along with the share price – without anything happening within the company that's worth us reporting on (we assume you don't want us telling you every time the oil price moves by a few per cent). Of course in our reviews we'll try to explain the sensitivity, and we'll provide updates where the gap between price and value changes substantially.

An example of where we've dispensed with a price guide due to a company's value being too hard to judge would be Sirtex Medical. At current prices we don't think there's enough margin of safety to warrant a Buy but, while everything goes well, its price is likely to keep marching upwards with earnings, which is to say relatively rapidly. Rather than chase it higher with our price guide, and risk it becoming quickly out of date, we prefer to express our thoughts about value in words rather than numbers and remind those holding the stock to take profits on the way up.

Even where we do provide a price guide, it's important to note that things change with companies and markets – sometimes faster than our price guides can keep up. We do our best to keep them in line with our thinking, but nevertheless the recommendation is paramount, with the price guide merely playing a supporting role.

### Portfolios

Our **Growth** and **Equity Income** portfolios were originally conceived as a means of demonstrating how you might use our recommendations to manage a portfolio, but they **entered real life** last July and began accepting money for investment (**see here for how to invest**). As a result they are no longer a *demonstration*, but they have perhaps become even more useful as real-life *examples* (and more useful still if you actually want to follow them by investing).

The difference is subtle, but it means for example that we won't hesitate to buy or sell our Hold recommendations, if we think it will help meet the portfolios' objectives (as we did recently by **increasing our Equity Income Portfolio's exposure to banks** – see the comments to that article for a discussion of the subtleties involved). We won't, however, buy our Sell recommendations or sell our Buys, except in limited circumstances to take profits (such as in the example we gave at the beginning).

### Further explanations

All of that is how we try to do it but, as we've already noted today and in *What we mean by Buy, Hold and Sell*, we're limited to some fairly blunt tools – and we don't always swing them with 100 per cent accuracy. Where there are obvious nuances, such as when we think you should manage your weighting to a stock in a certain way (perhaps by increasing your holding gradually as a price falls, or taking profits as a price rises), then we'll try to explain this in our reviews, so pay special attention to the final few paragraphs where this sort of thing is typically covered.

And of course if you don't understand our reasoning, then don't hesitate to ask – either in the comments section of an article or via our **Q&A forum**.

*To read the previous instalment of this series on Intelligent Investor's approach to value investing,* ***click here****.*