Cuffelinks
Connecting investors with ideas

Edition 229, 1 December 2017

This Week's Top Articles

Ignore the rise of short selling at your peril

Julian Beaumont

Short selling (shorting) has become increasingly prevalent in our stock market, with its potential impact best seen in the fate of targets such as Slater & Gordon and Dick Smith. Even those investors unlikely to consider shorting themselves ignore it at their own peril.

Short selling is aimed at profiting from a decline in the share price. It involves borrowing and selling shares first and then buying them back sometime later, hopefully (for the short seller) at a lower price.

A risky game

Short selling is a risky game, and best left in the 'don't try this at home' basket. Indeed, we at BAEP doubt we would be good at it, given our focus on good-quality stocks to invest in rather than inferior ones to short.

On any trade, short sellers are up against the odds. They must pay the ongoing costs of borrowing stock for the duration of the trade, which includes interest costs and payment in lieu of any dividends (sometimes including the value of any franking credits). Depending on the target company, these costs can add up to 8% annually or even more, which represents the amount by which the shorted stock must drop to break even.

Short sellers are then up against the clock, having to deal with the tendency for stocks to rise higher over time. The most they can return from a short position is 100%, assuming the share price falls to zero, while their potential losses are unlimited, because in theory the increase in a share price has no upper limit.

In addition, the short seller's hand can be forced. As in the case of margin lending, if the share price rises then the short seller will need to post additional collateral, or buy back the stock. Sometimes this can lead to what is known as a 'short squeeze', where the buying pushes the shares higher, causing additional losses and requiring even more buying.

Unlike a long position, an unsuccessful short position gets larger in one's portfolio as the share price rises, and disciplined risk management becomes necessary. For example, many hedge funds will set stop losses around a price rise of 15%. This adds more complexity to the portfolio, and, in the end, more distraction.

Contrary to the popular view, short sellers don't usually benefit from the price decline that can sometimes result from the short selling itself – even if the selling is aggressive. Ultimately, short sellers must buy back the shares they shorted.

Only shareholders have shares to sell, and these same shareholders hold onto their shares at the higher prices at which the short seller originally went short. Unless these shareholders have changed their view of the company, they are unlikely to want to sell them at a lower price at which the short seller can book a profit. Therefore, to profit from a short requires a deterioration in the market's view of the stock's value, which in turn requires a change in investor perception, or new adverse information that comes to bear.

Why go short?

At its crudest, investors go short because they believe the share price is going down, a trade that amounts to an outright bet against the company. Short sellers typically look for looming problems in a company that have been ignored or dismissed by the market. The red flags that short sellers look for and of which all investors should therefore be wary are:

- negative or poor cash flows
- unconventional or aggressive accounting, where real earnings fall far short of reported numbers
- frequent or outsized acquisitions
- indefensible business models
- a reliance on regulatory funding or licensing
- overly promotional management
- poor corporate governance
- insider selling by executive and directors
- a need for capital, requiring ongoing support from equity and other investors, and
- excessive debt.

Shorting commonly forms part of a broader portfolio approach in which shorts sit alongside long positions. The aim of the shorts is to provide some downside protection by making money when the market falls, and thereby offsetting losses incurred elsewhere in the portfolio.

Here, shorts are often as much about the benefits of hedging than an outright bet that particular shares will fall. Indeed, the shorting decision is often a relative one, specifically aimed at finding stocks that will underperform the market rather than necessarily fail.

For example, a 'pairs trade' of buying Ramsay Health Care and shorting Healthscope, another private hospital operator, is likely to be based on a view that Ramsay's shares will perform better than Healthscope regardless of whether both shares go up or down. The position may achieve positive returns in both bull and bear markets. Like all investors, short sellers will have varying degrees of conviction in their positions, from what they think is a 'zero' – their share price target – to merely below average.

A good indication of short seller conviction can be seen from the percentage of a company's shares shorted (available on ASIC's website). Investors should pay attention to high or fast-rising levels of short interest in stocks.

Aggressive tactics

Investors should be aware that short sellers might target a corporation already in their portfolio or under consideration.

In recent years, we have observed short sellers being increasingly more determined, coordinated, aggressive and effective in their efforts. This mostly involves publicising negative views – for example, reverse-broking to sell-side analysts, distributing their own research reports, and feeding the media. Indeed, the media appears willing nowadays to sensationalise the short sellers' negatively-biased stories.

Understandably, this can cause anxiety among targeted companies and their shareholders. Investors, and sometimes even the regulator, may demand answers to the questions raised by short sellers. Companies are forced to defend themselves, which means a step-up in disclosure on potentially difficult issues.

What is the track record of short selling?

Recent high-profile scalps include Slater & Gordon, Estia Health, and Quintis.

Short sellers haven't, however, always been right. They have been consistently wrong in shorting the banks. Against their expectations, the housing market hasn't crashed, nor have bad debts risen meaningfully. This so-called 'widow-maker' trade has been costly.

Our own analysis has found wavering correlations between the short interest of a stock and subsequent returns. Stocks can go up and down a lot, regardless of whether they are heavily shorted or not. Indeed, ASIC's historical data shows that some of the most heavily shorted stocks of one or two years ago have actually turned out to be very strong outperformers. Short sellers operate with the same uncertainty as all investors. If their calls don't work out, they are a forced buyer of the stock as they'll eventually need to close out their short position.

Therein lies the opportunity. Heavily shorted stocks in which investors have conviction may work out better and quicker than would otherwise be the case. Shorting may cast a shadow over a stock and depress the share price. This can potentially provide an opportunity to make outsized returns that benefit from the shadow passing.

Flight Centre: a case in point

A good example is Flight Centre, which since 2012 has consistently been one of the most heavily-shorted stocks on the ASX. The short interest has been premised on a view that its predominantly 'bricks and mortar' travel agency business is structurally under threat from online competition.

In reality, the company is much more diversified and its customer offering better positioned than the shorts give it credit for. Notwithstanding that genuine online competition has been around for more than a decade, Flight Centre has managed to grow its market share of travel bookings, which now tops $20 billion.

This year the company has refocused on costs, culminating in the announcement of a five-year transformation programme. This transformation should see continued growth in travel bookings leverage into strong earnings growth, especially if its aggressive financial targets are achieved.

The shorts' negative view pushed the share price down to around $28, from which the shares have risen to around $48.

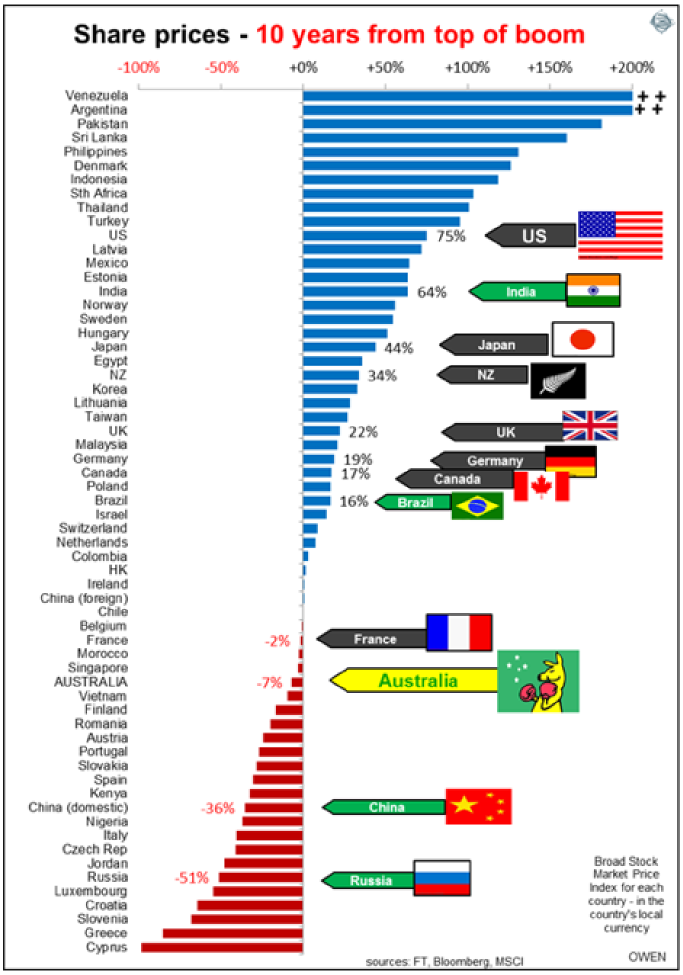
The lesson for investors is to be aware of, but not to fear, short selling. Investors should always be conscious of what short sellers are up to. At BAEP, we seek to understand their views, test them against ours, and investigate the possibility that they might be right, and we might be wrong. Ultimately, research is an investor's best defence, and knowing you are holding robust and high-quality companies gives the conviction to deal with or even take advantage of any short interest.

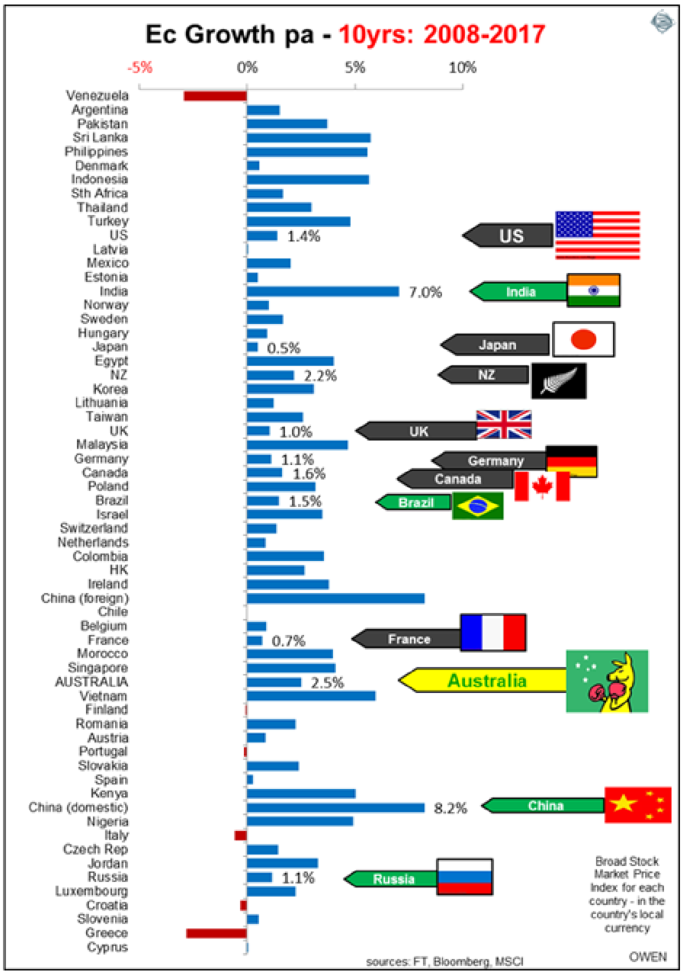
Julian Beaumont is Investment Director at [Bennelong Australian Equity Partners](#) *(BAEP). This article contains general information that does not consider the circumstances of any individual.*

Stock market winners 10 years on

Ashley Owen

It has been 10 years since the end of the 2003-2007 global China/credit boom, and it is time to check in on how stock markets have fared since then. The left chart ranks countries by their broad share price index growth over the past decade. Only 36 of the 62 main stock markets are ahead of their pre-GFC highs. The right chart shows average economic growth rates per country over the same period, *in the same country order as the market performance*, to demonstrate if economic growth relates to share price growth.





Among the 'developed' markets, Denmark won the gold medal in January 2013 for being the first stock market to surpass its pre-GFC peak, and it is now 126% ahead (i.e. more than double its pre-GFC peak). The silver medal went to the US in March 2013 and bronze went to the UK in May 2013. [See previous articles, Stock market Olympics, and the winners are and Australia can learn from gold medal winner, Denmark].

As usual there has been no statistical relationship between economic growth and share prices when measured across countries. Australia has been the so-called 'miracle economy' with the strongest long-term economic growth rate in the 'developed' world, and it did not even suffer an economic recession in the GFC, thanks to a deficit spending spree our grandchildren will be paying off. Yet the local stock market index (in price terms, not accumulation including dividends) is still behind its November 2007 high.

In contrast, the US, UK, Western Europe, Canada and even New Zealand suffered far lower economic growth rates in the GFC and over the past 10 years, but they have generated much stronger share prices than Australia. Denmark, the stand-out gold medallist stock market in the developed world, has had virtually no economic growth over the past 10 years. At the other end of the scale, China had the fastest economic growth rate over the past decade (and the largest aggregate growth in human history) but has had one of the worst stock markets.

Another common feature is that countries with the strongest stock markets often suffer political, economic or social turmoil and this was the case again – e.g. Argentina, Venezuela, Pakistan, Philippines, Turkey and Mexico.

There are many reasons for differences in share prices in different countries of course, but this quick snapshot is a useful reminder of the folly of focusing on economic growth as a pointer to share prices.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

Cuffelinks
Connecting investors with ideas

Four common technical questions on SMSFs and super reform

Melanie Dunn

We continue to field questions daily regarding the superannuation reforms and in particular the transfer balance cap and segregation when claiming exempt current pension income (ECPI). Here is a summary of some more frequent issues.

Q1. What is the ATO view in relation to segregation applied where the fund has a member with a balance that has grown above the $1.6 million cap?

Where an SMSF has a member who, at the preceding 30 June, had a total superannuation balance (across all their superannuation funds) of over $1.6 million, the fund's assets cannot be segregated for tax purposes. To claim ECPI, this fund will need to use the unsegregated method and obtain an actuarial certificate. This is true even if the fund's only member interests are account based pensions meaning that the resulting actuarial certificate will provide a 100% exemption for income.

This test is done each year to determine whether an SMSF is eligible to use the segregated method to claim ECPI. The $1.6 million limit is not indexed or linked to the transfer balance cap so it is likely that more funds will be impacted over time.

Q2. If a fund receives a contribution and immediately starts a new income stream with that contribution, do the trustees need to complete a new set of accounts for the new income stream? Can the fund remain 100% tax exempt if at all other times of the year the fund had only retirement phase income streams?

If a member is commencing a new income stream this will require the trustee to prepare appropriate pension commencement documentation that sets out the terms of the new pension such as calculating and recording the tax-free and taxable components, identifying the type of income stream, the reversionary status, etc.

Assuming the fund is solely supporting retirement phase income streams for the rest of the year, the question here is whether income earned on the day the contribution is received should be treated as segregated or unsegregated. Income earned on all other days of the year must be claimed as ECPI using the segregated method. Whether income earned on the day of the contribution should be claimed under the segregated or unsegregated methods will depend on the documentation and how the fund is administered.

For example, if the documentation identifies that the pension is to commence immediately upon receipt of the contribution with the total value of that contribution, then this may provide sufficient evidence that there was no period where the fund was unsegregated. In this case the fund may be able use the segregated method to claim ECPI for this and all income earned during the year. If income is earned between the time the contribution is received and the time the pension commences and there is no clear segregation strategy documented, then the fund would need to use the unsegregated method to claim ECPI and would require an actuarial certificate for this period.

Note that for the 2017-16 and prior income years it is possible to use the unsegregated method to claim ECPI for all income in this scenario. The required actuarial certificate is likely to provide a tax exemption at or close to 100%. This may prove to be a simpler approach where documentation is not clear.

Q3. It has been said that "segregation for investment purposes is NOT the same as for tax purposes". Could you elaborate on this and provide some examples?

In order to segregate assets for tax purposes a fund must meet the conditions set out in the relevant legislation (s295-385 or s295-395 of ITAA 1997). Income earned on assets that trustees elect to segregate, or that are deemed to be segregated by virtue of a fund solely supporting account-based type pensions, is exempt from tax and capital gains and losses disregarded. The new rules around disregarded small fund assets means some funds will not be able to use the segregated method from 1 July 2017 onwards.

Despite this, it is still possible for these (and other) funds to notionally allocate certain assets to support specific member interests. While the fund's overall income tax liability would need to be calculated using the unsegregated method, post-tax income can still be allocated to member interests according to the notional allocation of assets.

For example, consider an SMSF with three members. Bill and Jenny are the parents of Alfred who is an adult child. Bill and Jenny have both pension and accumulation interests, and Alfred is in accumulation. If the trustee assigned a pool of assets to support Bill and Jenny's interests in the fund, and a separate pool of assets to support Alfred's interest, then this would typically be segregation for investment purposes but not tax purposes. This could perhaps occur where the parent's wanted to invest differently to Alfred, but they did not want separate SMSFs.

To have segregation for tax purposes the fund would need to document that specific assets are set aside solely to support retirement phase income stream liabilities in the fund. Any income from those assets is then ECPI claimed using the segregated method. If the trustee was to specify a property as belonging solely to Bill and Jenny's pension interests, then there would be grounds for that asset to be treated as a segregated pension asset when claiming ECPI. All other assets would remain unsegregated for tax purposes.

Q4. In relation to a commutation made to comply with the transfer balance cap, does this need to happen on 30 June 2017 or can it happen on 1 July 2017? As long as there was a minute in place at 30 June 2017 to ensure that there was no excess transfer balance cap could the commutation could happen on 1 July 2017?

In order to avoid an excess transfer balance at 1 July 2017, commutations to comply with the $1.6 million pension cap must be done prior to 1 July 2017 which is the date at which members will begin to have a transfer balance account. If a commutation is completed on 30 June to bring a member's balance in pension phase to $1.6 million then no excess will occur when the pension interest is assessed for the first time on 1 July 2017. If the commutation is done on 1 July 2017, the member will have an excess transfer balance on that day.

The commutation documents were therefore generally completed at 30 June 2017 or prior in order to facilitate commutations prior to 1 July 2017. In line with the ATO's PCG 2017/5 these did not need to specify the actual commutation value as it is understood the amount of the commutation required may not be known until post 1 July 2017 when the fund accounts have been finalised.

It is also worth noting that to be eligible for the CGT relief the member should have taken an action to comply with the transfer balance cap prior to 1 July 2017. Effecting the commutation on 1 July 2017 may not meet this requirement.

Melanie Dunn is the SMSF Technical Services Manager at [Accurium Pty Limited](). This is general information only and is not intended to be financial product advice. It is based on Accurium's understanding of the current superannuation and taxation laws. Examples are illustrative only. No warranty is given on the information provided and Accurium is not liable for any loss arising from reliance on or use of the information.

Global platforms face regulatory threats

Michael Collins

The year 1995 was three years before Google was founded, nine years ahead of Facebook, a decade before YouTube and 11 years earlier than Twitter. US lawmakers, concerned a recent court ruling would stifle innovation, introduced an amendment to the Communications Decency Act to ensure "providers of an interactive computer service" were not liable for what people might say and do on their websites. The amendment contrasted with how publishers and broadcasters are legally accountable in the US and elsewhere for the content they make public in traditional or online form.

The amendment, which became Section 230 in the Telecommunications Act of 1996 (known as CDA 230), enabled companies such as Facebook, Google, LinkedIn (Microsoft owned since 2016), Reddit, Snapchat, Tumblr, Twitter and YouTube (Google owned since 2006) to emerge as human ingenuity allowed.

Will future restrictions stifle profit growth?

The growth of these companies seems to have outpaced their ability to police misuse of their products without them incurring any legal penalty. Across these platforms the world over, examples of compromised quality include:

- fake news and cheapened facts
- manipulation of algorithms to promote articles to 'trending' status
- troll armies
- bogus 'likes'
- web-based smear campaigns
- viral conspiracy theories with hyped partisanship

They have amplified the role that emotion has played in discourse on these for-profit 'public squares' such that social media is accused of being a 'threat to democracy'.

The controversies have roused policymakers, egged on by traditional media that has lost advertising income to these newcomers. Moves are underway in the US to extend to the internet the same regulations that govern political advertising in traditional media. Some people even question the rationale behind CDA 230.

US lawmakers are restrained when taking on the tech giants on content for two main reasons.

First, the products of these companies are beloved by their billions of users so anything that would disrupt these services would prove unpopular.

Second, digital platforms are difficult to regulate, no matter their size, because they are different from traditional publishers and broadcasters.

The content-heavy business models of the platforms are likely safe for now.

That said, the tech companies (as distinct from their products) have shed much goodwill in recent years as these and other controversies have swirled. With so many controversies raging, the platforms are under pressure to limit abuses on their inventions that have a more sinister side than their creators perhaps expected.

Platforms must take more control or regulators will force them to

It's already happening. US Republican and Democratic senators are pushing (via the Honest Ads Act) to end the exception from laws governing advertising that online has enjoyed since 2006. While legislation on political ads stands a fair chance of being passed, the challenge for lawmakers on content remains that the internet is unique. Digital platforms refute suggestions they are publishers or broadcasters even though many people go to them for their news.

The tech industry overall says that CDA 230 is a needed protection for online services that provide third-party content and for bloggers who host comments from readers. Without the exception, sites would either forgo hosting content or be forced to ensure content didn't breach laws – a claim that would apply differently across the platforms.

The solution for US politicians would seem to be to impose content rules on the digital platforms that are forceful but less stringent than those governing traditional media. Germany's new Network Enforcement Law is a portent of regulation to come – it is regarded as the toughest of laws passed recently to regulate internet content in more than 50 countries. Under the German law effective from October 1, digital platforms face fines for hosting for more than 24 hours any content that "manifestly" violates the country's Criminal Code, which bars incitement to hatred or crime.

In the US, a workable compromise on regulating content could take time, even years, to work out. With the public still enamoured with their favourite platforms, the tech companies will enjoy the protections that flow from CDA 230 for a while yet.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Cuffelinks. This material is general informational and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.

Value beyond the hype in US infrastructure

Dylan Foo

Following the election of Donald Trump, global infrastructure investors turned their attention to the US in expectation of a transformative plan for infrastructure investment, which is yet to materialise.

The past 10 to 15 years in the US infrastructure market have been disappointing despite the scale of the market and its well-recognised need for investment. Given the current model of using municipal or state funding for most infrastructure, the opportunities available to institutional investors have been limited and the market has remained stagnant. Therefore, it isn't a surprise that one of Donald Trump's proposed changes – the business-friendly infrastructure projects fuelling the equity rally – haven't yet come to fruition. In fact, it feels familiar: Barack Obama also came to office with an infrastructure expansion plan, and it was swiftly sidelined.

Nevertheless, it feels like US infrastructure's moment has arrived. Trump's appointment came quite late into our own US infrastructure ambitions. AMP Capital has a strong infrastructure presence in the UK, Europe, and Australasia (in countries that largely have a successful tradition of public investment in infrastructure). We felt that the US was the last bastion for us. Our recent acquisition of ITS ConGlobal, the railroad services and logistics provider, is a product of our decision to buy and actively manage mid-market infrastructure assets in the US. We seek resilient assets that can be bought and managed regardless of the political climate.

Structural change in US infrastructure

Whatever happens on the policy front, there is a gradual structural change underway. US infrastructure is severely underinvested and many assets are in noticeably poor condition. The G20's Global Infrastructure Hub forecasts that $12 trillion needs to be invested in US infrastructure by 2040 and there is currently an estimated $3.8 trillion 'funding gap' for the maintenance and development required. Institutional investors are likely to be a source of this required capital.

While federal policy is tricky to predict, we have more confidence in the macroeconomic picture. We are bullish on US GDP over the next five to seven years, and a great way for allocators to gain exposure to this trend is to invest in infrastructure assets with a strong correlation to US GDP. From a portfolio construction perspective, we have been looking to add US GDP exposure.

Avoid core, but embrace core-plus

Given the investor focus on the US infrastructure market and the lack of opportunities available, the market is competitive. So-called 'core' infrastructure assets are the traditional investment route: tollways, roads, gas utilities, ports. Large public assets traded mostly between asset owners such as pension funds and sovereign wealth funds, coveted for their predictable earnings over decade-long periods, are rare and highly competitive. This is especially so in the US due to its less-established public private partnerships model. Aside from buying well, there's usually not a great deal an owner can do to improve the modest inflation-linked investment returns. They can be worth their high valuations for certain institutional investors seeking liability-matching returns.

Avoiding the high competition for core assets and their restricted return profile, we prefer assets that meet our definition of 'core plus' infrastructure. They have many of the same attributes as core infrastructure – high barriers to entry and a stable cash flow profile, within the sector of essential services – but they are not actually a core asset such as a port or railroad. ITS ConGlobal is an example. It's a service-based business that handles container lifting between various modes of transport like rail, truck, and ship. It is outside the definition of core infrastructure, but shares many of its advantages.

While we are cautiously optimistic about the opportunities in US infrastructure, discipline is essential. We identified the investment opportunity in ITS ConGlobal more than two years before we acquired it last month. We expect to add exposure to US GDP given our read of future economic trends, with more value in the mid-markets than in higher profile assets.

Dylan Foo is Head of Americas, Infrastructure Equity at AMP Capital, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

The impact of the trend to ethical investing

Tarren Summers

The tide has turned for Responsible Investment (RI). Every day I see RI in action, and quantifiable evidence is crucial to ensuring that the products and services of investment managers are meeting the needs of investors.

The Responsible Investment Association Australia (RIAA) recently issued a Report exploring the effect of social issues on how Australians invest. The Report found that 92% of Australians expect their superannuation and other investments to be invested responsibly and ethically. There is a clear expectation that fund managers should take into account environmental, social, and governance (ESG) factors when reviewing companies.

Super funds such as HESTA, AustralianSuper and REST have been nudging their investment managers to adopt their respective ESG policies. Now we are observing a similar push from individuals. A key finding of the Report is that seven in ten Australians would rather invest in a responsible super fund. Millennials would consider switching their investments to another provider if their current fund engaged in activities inconsistent with their values.

RI is now mainstream

There is evidence everywhere of the push to consider RI alongside financial outcomes. I exit at Wynyard train station in Sydney every weekday. At the station, the Commonwealth Bank cops a serve from Greenpeace in the form of an anti-coal funding poster.

The Dutch fund PFZW is set to divest from high-carbon companies, representing about 1.7 billion euros of assets. Citing the need to invest in a way that protects the environment, the fund reported it would divest completely from coal-related companies by 2020, while investments in fossil-fuel companies will be reduced by 30%. PFZW said:

"This will take place in four annual steps and result in investments being withdrawn from approximately 250 companies focused in the energy, utilities, and materials sectors."

More importantly, PFZW believe the investment change will be "neutral to slightly positive" for medium-term investment returns. Do I hear anyone thinking stranded assets yet?

If that is not enough to scare a miner, closer to home, the Commonwealth Bank chair Catherine Livingstone told shareholders at the recent AGM that Australia's largest bank is winding down its funding of coal projects:

"We expect that trend to continue over time as we help finance the transition to a low carbon economy."

We are now seeing internationally-recognised economic and financial organisations debate 'stranded asset' exposures and asset divestitures and warn of the significant economic consequences of climate change in the financial press. We are also witnessing a surge in political and regulatory interventions in response to climate change, reflecting community concerns.

Many of these risks derive from evolving societal, governmental, and market perceptions rather than directly from the potential physical impacts of climate change. However, irrespective of their source, they have the potential to quickly and significantly affect the value of investments, and therefore, represent both material financial risks and opportunities.

These issues cannot be ignored by those entrusted with investment governance, notwithstanding their personal, moral or ideological views on the reality of climate change.

For those that don't consider RI ESG as a key theme for investing, check Section 52 of the Superannuation Industry (Supervision) Act 1993. A key requirement contained in the Act is that trustees perform their duties and exercise their power in the best interests of beneficiaries. Considering the weight Australians (especially millennials) put on RI, fund managers must recognise investment desires that conform with client values.

Tarren Summers is the Co-Portfolio Manager of the Glennon Capital RI Future Leaders Fund and has completed the PRI Academy training in environmental, social, and corporate governance (ESG) issues for the investment and finance community.

Cuffelinks
Connecting investors with ideas

LIC update: benefits of international exposure

Peter Rae

Australian equities rose marginally during the September quarter with the S&P/ASX 200 Accumulation Index up 0.7%. The performance for the 12 months to 30 September 2017 was a solid 9.2% driven by a good performance from large caps and strong gains in the resources sector with the S&P/ASX 200 Materials Index up 17.3% for the 12 months.

PRICING & PERFORMANCE UPDATE*

Best 5-year portfolio returns - % p.a.[#]

Australian Large Cap Focus					Small/Mid Cap Focus & Others				
Company	3M	1Yr	3Yr	5Yr	Company	3M	1Yr	3Yr	5Yr
WHF	-1.4	5.3	7.5	12.9	GFL	5.1	18.6	9.3	17.7
AUF	2.4	9.8	9.7	11.4	FOR	4.1	12.8	16.9	15.0
DUI	0.8	13.5	7.2	11.2	WAX	0.2	-3.4	10.2	13.8
AMH	-1.5	-0.5	5.3	10.2	MIR	0.7	0.5	8.4	12.3
MLT	0.9	8.9	6.7	10.0	HHV	2.6	-14.0	3.8	11.5

Discounts & Premiums to pre-tax NTA - %#

Largest discounts		Largest premiums	
Company	Discount	Company	Premium
BTI	-21.7	WAX	31.5
WIC	-14.8	WAM	27.8
BST	-13.6	FOR	13.4
GC1	-12.8	DJW	13.1
FSI	-7.6	CDM	12.3

*Data to 30 September 2017. Only includes LICs covered by IIR
#Portfolio return = pre-tax NTA + dividends per share. Pre-tax NTA includes tax paid on realised gains.

International LICs performing best

However, the best performing LICs for the 12 months to 30 September 2017 were those with an international focus reflecting the strong performance of international equity markets, with the MSCI World Index (Local) up 17.9% for this period. The top four performing LICs were PM Capital Global Opportunities Fund (ASX:PFG) up 30.4%, MFF Capital Investments (ASX:MFF) up 22.5%, PM Capital Asian Opportunities Fund (ASX:PAF) up 22.2% and Platinum Capital (ASX:PMC) up 20.7%. (IIR does not cover these four LICs and we make no recommendations in relation to these LICs.) The strong performance of these LICs over the past year, which significantly beat the returns of the Australian market, highlights the benefits to investors of a diversified portfolio with a proportion in international equities.

The best performing LIC in our coverage universe was also an international focused LIC, Global Masters Fund (ASX:GFL). GFL invests in quality international shares, but its largest exposure is to Berkshire Hathaway, at 73.8% of its portfolio. Berkshire Hathaway shares rose around 30% for the 12 months to 30 September 2017 helping drive GFL's 18.6% growth in pre-tax NTA. The reason the pre-tax NTA growth did not match the growth in the Berkshire Hathaway share price was that GFL's investment in Flagship Investments (ASX:FSI) achieved limited share price growth and the Australian dollar rose over the same period. GFL was also the best performing LIC in our universe over a five-year period delivering a pre-tax NTA return of 17.7% p.a., again, reflecting the strong performance of Berkshire Hathaway shares over the period. GFL has also delivered strong share price returns of 52.9% over 12 months and 28.7% p.a. over five years reflecting elimination in the discount to pre-tax NTA. Our rating for GFL is Recommended Plus, however, the shares now look expensive trading at roughly a 10% premium to pre-tax NTA.

Cuffelinks
Connecting investors with ideas

Emerging Markets Masters Fund (ASX:EMF) also delivered a strong 12-month performance with a portfolio return (pre-tax NTA plus distributions) of 13.2%, although this was below the MSCI Emerging Markets Index, AUD return of 17.5%. This reflects EMF's bias to sectors leveraged to what it believes are growth sectors such as consumer staples and healthcare. These sectors have not performed as well as "value" sectors of the market over the past year. Over the past three years this LIT has outperformed the benchmark with a return of 8.6% p.a. compared to the benchmark return of 8.1% p.a. EMF provides domestic investors with exposure to a professionally managed portfolio of emerging market funds, a unique proposition on the ASX. From a country perspective, the largest allocations are to China (26.9%) and India (16.9%). A significant portion (18.5%) is also invested in what the company refers to as Frontier Markets. The portfolio is significantly overweight India and the Frontier Markets relative to the benchmark. At 30 September 2017 EMF securities were trading at a 1% premium to pre-tax NTA, a reasonable entry point for long-term investors looking for emerging markets exposure. Our rating for EMF is Recommended Plus.

Cadence Capital (ASX:CDM) and Perpetual Investment Company (ASX:PIC) which both have blended portfolios of Australian and international equities also delivered returns above the domestic market return. CDM delivered a portfolio return of 10.3% and PIC delivered a portfolio return of 10.2%. Our rating for CDM is Recommended Plus and PIC is Recommended. At 30 September 2017 CDM was trading at a 12.3% premium to pre-tax NTA while PIC looked reasonable value at a 4.7% discount.

Australian large cap LICs underperform over 12 months

The five largest Australian large-cap focused LICs delivered an average portfolio return of 8.0% for the 12 months to 30 September, below the S&P/ASX 200 Accumulation Index return of 9.2%. This largely reflects underweight positions in resources, a sector which has performed well over the last 12 months. Over a five-year period, these same LICs have delivered an average portfolio return of 9.1% p.a. versus the market benchmark return of 10.1% p.a.

Over the longer-term we would expect these LICs to perform broadly in line with the market. At 30 September 2017 Australian Foundation Investment Company (ASX:AFI) and Milton Corporation were trading at slight premiums to pre-tax NTA and Australian United Investment Company (ASX:AUI) was at a slight discount. All look reasonable value for long-term investors looking for exposure to a diversified portfolio of Australian large-cap shares. Our rating for AFI and MLT is Highly Recommended and our rating for AUI is Recommended Plus. Diversified United Investment (ASX:DUI) was the best performing large-cap focused LIC over the 12 months to 30 September 2017 beating the market with a portfolio return of 13.5%. Its five-year return of 11.2% p.a. also beat the market benchmark return of 10.1% p.a. At 30 September DUI was trading at a 3.3% discount to pre-tax NTA, a good entry point for investors looking for exposure to a diversified portfolio of Australian large-caps shares. We note that DUI also has a small exposure to international shares and also Australian small caps. Our rating for DUI is Recommended.

Whitefield (ASX:WHF) was the best performing Australian large cap focused LIC on a five-year basis. Whitefield primarily invests in Australian industrial shares meaning that it does not have exposure to the volatile resources sector. Whilst WHF underperformed the industrials benchmark over the past 12 months, its five-year return of 12.9% p.a. was slightly better than the 12.7% p.a. return from the S&P/ASX 200 Industrials Accumulation Index. At a 6.8% discount to pre-tax NTA at 30 September, WHF's shares represent good value for investors looking for exposure to Australian industrial shares. Our rating for WHF is Recommended Plus.

Peter Rae is Supervisory Analyst at [Independent Investment Research](). This article is general information and does not consider the circumstances of any individual.