Colin Nicholson: Free Newsletter 145

8 April 2015

This newsletter is a little out of the ordinary – I have not written an article for it. The good news though is that in place of an article from me, is an article by my good friend Dr Alexander Elder. As some of you will know, he has for years talked about the “peak oil” threat. However, I was interested to hear how he now saw the situation and asked if he would write an article on the oil market for us. I hope you like it and find it useful in your investing and trading thinking.

A Turn in Crude Oil

By Dr Alexander Elder

In 2008 oil prices reached $200 per barrel. After coming down from those highs, for years oil stayed in a trading range between $110 and $85 per barrel. This year oil traded at below $50 per barrel. Why?

The latest changes are driven by a revolution in the methods of extracting oil, which are hugely increasing its supply.

Organic fuels (coal, oil, gas) are produced by “cooking” organic remains deep underground for millions of years. The closer to the center of the Earth, the hotter it gets: temperatures increase by 25 degrees Celsius for every kilometer of drilling down. Organic remains cooked at lower temperatures produce coal, at medium temperatures oil, and at very high levels gas.

Because of that, oil is produced in a relatively narrow subterranean level (which is occasionally moved by seismic shifts). That level has been so extensively explored in recent decades that the number of new discoveries has diminished – while the demand of oil kept going up. The resulting discrepancy between supply and demand trends gave rise to the “Peak Oil Theory” which stated that as demand grew faster than supply oil prices could go only way – up. A decade ago, I referred to Peak Oil Theory in some of my presentations. What has changed?

It used to be that to pump up oil from the ground you had to find huge underground lakes of oil, which could form only in specific geological structures: essentially huge rock caves. No cave – no lake – nothing to pump.

Most oil exists not in caves but in soft structures, permeating them like a sponge. A new technology called hydraulic fracturing (fracking) allows companies to squeeze those sponges and pump oil out of them. This vastly increases the available supplies. Peak Oil theory is out the window. With fracking, the US is on its way to become the world’s largest oil producer, outstripping Saudi Arabia.

In the 2nd half of 2014, as the world demand for oil slightly softened, Saudis decided to drive frackers out of business by continuing to pump oil at a steady rate despite lower demand. Saudis’ production costs are around $12-14/bbl, while for frackers those costs are $40-50/bbl. That’s what drove oil from above $100/bbl to below $50/bbl.

What’s next?

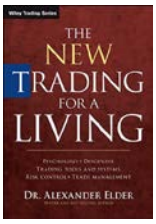
I think that American businessmen and inventors, in the environment of free enterprise, will find how to reduce costs and continue to pump at a profit. This reminds me of a quote from J.P. Morgan, a great late American financier: "A bear on America will die broke."

In a geopolitical sense, cheaper oil is good for democracy. It amounts to a huge tax cut. Low oil prices hurt countries that rely on oil for the bulk of their income, such as Venezuela, Russia, and some Gulf states. Remember, the Soviet Union fell apart when oil dropped to $5/bbl.

Looking at a monthly chart of crude, covering 9 years, we see that oil is trading at levels not seen in a decade. While the media is full of forecasts of $40, $30 and even $15 per barrel of oil, bullish technical signals are emerging near the right edge of this long-term chart. The color of the Impulse system* has changed from red to blue this month, permitting buying. The Force Index* (in the lowest pane) began to rise towards its lower channel line. You can see that earlier such returns into the channel gave good buy signals.

Monthly charts are not for precision timing – for that we have weekly and daily charts - but it does suggest that a rally towards the previous support line in the upper 70s is more likely than another decline.

I hope this helps you in planning oil-related trades.



*The Impulse system and the Force Index are explained in Dr Elder's book *The New Trading for a Living.* My review of the book is now on the Book Reviews page on the Free Resources menu on the free website www.bwts.com.au I do not sell the book, but it may be purchased directly from Dr Elder at www.elder.com. Ask him to sign the book for you.

Listed Investment Companies and Exchange Traded Funds

By Michael Kemp

Have you ever been chatting to someone when they've lowered their voice to a whisper, flicked their gaze nervously to the left and right like those undercover spies in old black-and-white movies, and then asked the question: “Do you know any shares I should be buying at the moment”? In plain old-fashioned lingo they’re on the hunt for a “stock tip”.

It occasionally happens to me but it’s a question I find easy to answer. I tell them to take a look at the larger Listed Investment Companies (LICs) like AFIC, Argo and Milton. Alternatively they could look to invest in one of the growing number of Exchange Traded Funds (ETFs) being offered on the ASX.

The answer satisfies most people, but not all. This article addresses the questions that sometimes follow.

What are LICs and EFTs and how do they differ from each other?

Listed Investment Companies are created by an initial public offering (IPO). A fixed amount of money is raised from the issue of a fixed number of shares. The money is then used to buy shares in lots of other listed companies (like Woolworths, Telstra and BHP, for example). Once created the LIC trades on the stock exchange just like any other listed company. LICs are effectively managed funds, but investors don’t buy units in the fund, rather they buy shares in the fund. And because LICs are listed on a stock exchange investors are able to buy and sell shares in the fund any time the market is open.

Exchange Traded Funds, or ETFs as they are commonly referred to, are also investment funds that are bought and sold on a stock exchange. But they aren’t the same as LICs, and sometimes the differences are significant.

1. LICs (like AFIC and Argo) don’t aim to track specific indices, rather to outperform them. ETFs are different in that they usually do track indices. For example they might track a broad based market index like our own ASX200 or the S&P 500 in the United States or they might track a narrow and specific index like Healthcare or Real Estate Investment Trusts. Some overseas ETFs do, however, undertake active management in an attempt to outperform benchmark indices.
2. ETFs cover a broader range of asset classes than LICs. For example there are ETFs which invest specifically in domestic shares, international shares, fixed income products, foreign currencies, precious metals, commodities and agricultural products.
3. ETFs are open-ended, which means that the number of shares on issue isn’t fixed but can increase or decrease in response to demand from investors. LICs are closed end, so the number of shares on issue isn’t impacted by investor demand.
4. LIC portfolios are constructed using physical stocks (actual shares). So too are ETFs, but not always. Some ETFs (referred to as synthetic ETFs) use derivatives in their portfolios. These simulate the returns that would have been achieved by a portfolio constructed purely from physical securities. The use of derivatives introduces an additional layer of risk which is discussed below.

What are the benefits from investing in LICs and ETFs?

The following benefits are common to both:

1. Diversification. LICs and ETFs allow investors to achieve broad diversification of their equity holdings even from the purchase of a single LIC or equity based ETF. Diversification across different asset classes can also be achieved by the purchase of non-equity based ETFs. For example (and to name just two) a single investment in Australia’s largest LIC, Australian Foundation Investment Company (AFIC), means that your investment covers nearly 90 listed companies operating across a wide range of industry sectors. And an investment in the Vanguard Australian Fixed Interest Index ETF means

you are investing in around 360 fixed interest securities (bonds) issued by state and federal government and investment-grade companies.

2. Low management fees. The management fees charged by LICs and ETFs are typically much lower than those charged by traditional non-listed managed funds (and an investment in traditional managed funds doesn't guarantee higher returns to compensate for their higher fees). The management fees charged by ETFs are low - in the order of 0.15% to 0.3%. For the larger LICs (like AFIC, Argo, BKI and Milton) they are around 0.15%. That might not sound like a big deal but lower management fees, even in the order of 1 percent lower, can provide a significant boost to long-term investment returns. There are, however, a couple of extra costs that need to be considered.

    Firstly there is the (usually) small penalty of the bid/ask spread. That's the difference in the market price between what buyers pay and what sellers receive when shares change hands. The bid/ask spread is highly dependent on the market liquidity of the ETF or LIC but for the large and deeply traded ones, the spread is tight, hence the cost isn't much.

    Secondly there are broker's commissions. To reduce their impact on overall investment returns use a low fee broker, trade in sizeable parcels (preferably $10,000 or more), and purchase these securities as part of a long-term investment plan (rather than trading in and out).

3. Transparency – since both ETFs and LICs are traded on the ASX there is clear price visibility. Also their managers are required to regularly disclose to the market what securities they hold.
4. Liquidity and Access - Trading on the ASX provides the ability to buy and sell your holdings whenever the market is open.
5. Broad range of asset classes - ETFs (more so than LICs) provide Mum and Dad investors access to asset classes they wouldn't otherwise be able to tap into; for example emerging markets, government and semi-government bonds, corporate bonds, currencies and commodities.

What are their main Risks?

1. Systematic Risk (or non-diversifiable risk) – While investing in an LIC or an equity-based ETF delivers company diversification, there's one type of risk that this diversification doesn't avoid. Referred to as systematic risk, it's the risk of the entire stock market suffering a significant downward correction. Ironically ETFs also help in reducing the impact of systematic risk. By using non-equity based ETFs (like those based on precious metals, property and government & corporate bonds) broader diversification is provided across different asset classes.
2. Exchange Rate Fluctuations - ETFs based on an overseas market index or benchmark, and traded and settled on the ASX in Australian dollars, potentially carry exchange rate risk. If the ETF is not hedged against currency risk fluctuations in the exchange rate can affect the value of the portfolio.
3. Counterparty risk – is the risk that the other party to a contract into which you have entered fails to fulfil its financial obligation. It's a risk that synthetic ETFs are exposed to. Synthetic ETFs employ the use of derivatives in order to simulate the returns that would have been delivered had the portfolio been constructed purely from physical securities. Derivatives rely upon the counterparty to that derivative agreement delivering upon their contractual obligation. And since that isn't always certain their failure to do so would cause the synthetic ETF to incur losses. This risk is further enhanced for those ETFs which use over the counter (OTC) derivatives, since they are not subject to central counterparty clearing arrangements. The ASX acknowledges this risk and requires that synthetic ETFs

limit OTC derivative exposure to no more than 10 percent of their net asset value. In addition the ASX has mandated that all derivative counterparties for synthetic ETFs on the ASX must meet certain eligibility requirements.

How do you assess them?

Listed Investment Companies and Exchange Traded Funds provide plenty of useful information on their respective websites. So access these sites and make sure you understand how your money will be invested. Read their respective Product Disclosure Statements, and if you have any questions seek professional advice.

Before you invest you need to understand their structure, investment objectives, principal investment strategies, risks, and costs.

Michael Kemp's articles

Michael Kemp has written a number of articles for my free newsletter. While they are already accessible from the Free Newsletter Archive, they can take some time to find. I have now also provided links to all of Michael's articles for the convenience of readers who would like to sample more of Michael's writing on the Buy Books/Creating Real Wealth page on the free website.