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## LICs let loose

By Scott Francis  
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**PORTFOLIO POINT: Easier new rules, and an improving dividend cycle should renew the attractions to investors of listed investment companies.**

As investors wake to the reality of highly volatile markets, the venerable listed investment company, or LIC, is back in the spotlight for income-hungry investors.

The legislation covering LICs has been changed, to remove the requirement that they could only pay dividends directly out of profits. The old rules had meant that in times of crisis – during the GFC, for example – some LICs could not deliver the distributions many investors had bought them for.

Under the new regulations, LIC dividends are now linked to solvency; in other words, they can operate under conventional dividend regulations.

Geoff Wilson, the chairman of Wilson Asset Management, says the change is a breakthrough for the sector. "It creates a level playing field," he says. "We have never had that before; it's going to make a difference."

Wilson says all LICs are now free to unleash sustainable and progressive dividend payment programs regardless of seasonal factors.

Moreover, he estimates there is a massive \$100 billion in franked dividends stored up in the local LIC sector, which will be progressively passed on to investors in the near future.

It's also worth mentioning that earlier this week, Ross Barker, head of Djerriwarrah Investments (an AFIC offshoot), offered further encouragement to LIC investors by suggesting the dividend cycle may have turned.

After some blue-chips cut dividends by about 25% last year, Barker suggested dividend payout levels should start to improve again in the coming months.

While these positive factors around dividend payout programs play out, the ongoing collapse of the commission-based financial planning system should also widen the spectrum of investment products offered by financial advisers.

"We can now be on the menu with everything else," says Wilson of WAM.

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Listed investment companies occupy a significant place in the hearts of self-directed investors. Long-

established LICs, such as AFIC (long associated with Bruce Teele) Argo (formerly run by Rob Patterson and now by Jason Beddow) and Milton (from Robert Millner's stable of investment companies) are an iconic part of the investment landscape.

The well established LICs such as those mentioned above are known in the market for the integrity of their management, low fees and reliable returns to investors over time.

Then in the early part of this decade a new breed of LIC hit the market – with some of the most successful contemporary fund managers managing their portfolios.

This included Clime (CAM) with Roger Montgomery (Roger has since left and now writes regularly for Eureka Report), Geoff Wilson with the Wilson Funds (WIL and WAM) and Peter Hall from Hunter Hall (HHV).

In some cases, these LICs had higher fees than the previous generation but they were generally still cheaper than the retail managed funds on offer.

This article looks at some of the aspects of LICs that investors should weigh up as they consider investing in this sector. To do this we will look at the biggest LIC on the Australian market, the Australian Foundation Investment Company, AFIC (AFI), and compare it with one of the newer LICs of Wilson Investment Limited (WIL).

But before we start, it would make sense to define what an LIC is.

Listed investment companies are simply "managed funds" tradeable on the ASX. Investors buy shares directly, which gives them exposure to the portfolio of the LIC. The shares might trade at a price higher or lower than the value of the underlying investment portfolio, and income received from the underlying portfolio can be distributed to investors through dividends.

#### -Australian LICs Company

Company	Size (\$mil)	Div yield	Grossed up	One year	Three year	Five year
Aberdeen Leaders	87.6	6.16	8.81	33.99	-0.75	10.29
AMCIL	133.5	2.92	4.17	44.3	5.99	12.66
Argo Investments	3755	3.91	5.59	24.11	-1.59	7.92
Australian Foundation Investment Company	4985.3	4.17	5.95	24.88	2.33	11.45
Australian Leaders Fund	82.3	3.98	5.69	92.8	7.27	11.87
Australian United Investment Company	744.5	3.33	4.76	52.95	0.51	10.73
BKI Investment Company	537.9	4.67	6.67	38.99	2.03	8.17
Carlton Investments	458.9	3.87	5.53	42.86	-1.02	6.54
Century Australia Investments	148.8	9.76	13.94	28.19	-5.95	3.9
Choiseul Investments	486.3	4.18	5.98	34.47	-1.62	4.49
Clime Capital	38.7	2.93	4.18	54.5	-3.83	3.94
Clime Investment Management	22.2	4.55	6.49	119.86	-17.69	-3.84
Contango Microcap	132.8	2.26	3.23	32.88	-12.83	6.11
Diversified United Investment	517.2	3.87	5.53	59.11	1.84	13.67
Djerriwarrh Investments	936.8	5.9	8.42	34.55	5.07	10.53
Fat Prophets Australia Fund	26.2	3.35	4.79	50.41	-0.05	NA
Hyperion Flagship Investments	39.3	8.67	12.39	48.43	-4.59	8.15
Ironbark Capital	62.5	8.41	12.01	19.36	-4.55	2.42
Milton Corporation	1742.5	3.9	5.57	35.84	-2.54	6.66
Mirrabooka Investments	226.9	5.54	7.91	43.51	0.64	8.71
Van Eyk Three Pillars	100.4	2.73	3.9	25.49	-4.89	5.39
WAM Active	15.9	4.8	6.86	55.7	NA	NA
WAM Capital	131.5	6.32	9.03	43.32	-7.11	3.1
Whitefield	226.8	5.07	7.25	52.33	-6.12	4.95
Wilson Investment Fund	85.6	6.34	9.06	49.55	-7.9	0.75

**Fees.** One of the differences between the older and newer LICs has already been alluded to, and that is fees. WIL (according to its prospectus) charges a fee of 1% plus 20% of any outperformance of the portfolio compared to the sharemarket index in a 12-month period, provided the portfolio return is positive.

Let's assume that the portfolio outperforms the sharemarket index by 1% in a year, the total fee charged will be 1.2%. Compared to many retail managed funds that charge 1.8–2.2% a year, this is attractive. AFIC's fees, on the other hand, were 0.19% for 2008–09. This makes it one of the cheapest investments available in terms of fees, even among ultra low-cost index funds.

**Size.** The size of a managed investment portfolio may be of concern to an investor. The bigger they are, the more difficult it is to successfully pursue strategies. And bigger funds are forced to buy more of the bigger companies in the market, and restricts their ability to buy smaller companies. This tends to push larger funds towards holding large amounts of big companies, in much the same way an index fund is formed.

AFIC's market capitalisation is about \$4.7 billion – a fairly large fund by most measures; while WIL's is \$79 million. It is not unreasonable to think that investors who are looking for a portfolio that is able to take active positions that diverge from matching the index might find WIL more attractive; and an investor who is happy with a portfolio that is similar to the index – with some active management – might be attracted to AFIC.

**Tax transparency.** Tax transparency is an issue where traditional managed funds badly lag LICs – and may be part of the reason why LICs have a reputation as being the vehicle of choice for more sophisticated investors. Most managed funds don't report after-tax returns – an appalling situation, in my opinion, given that investors should only be concerned with net returns! The tax-inefficiency of managed funds comes from the way capital gains have to be distributed to their investors, and can lead to high levels of taxable income being distributed to investors.

It is far easier to understand the tax history of an LIC. For example, both AFIC and WIL have only paid fully franked distributions to investors, so people can understand the tax consequences of receiving fully franked income.

Further, LICs tend to report the tax position of their underlying portfolios, so you understand exactly what you are investing in. For example, as of June 30, AFIC had a portfolio that had a value of \$4.49 a share before tax, and \$3.95 after tax (assuming that the portfolio was sold and tax paid on the unrealised capital gains).

Managed funds also have amounts of unrealised capital gains in their portfolios that investors should know about prior to investing – however, I am only aware of one fund that provides that information to investors. The figures on the WIL portfolio show that there are non-realised capital gains on their portfolio – useful information for an investor.

A key advantage of an LIC over a traditional managed fund is that a set number of shares trade – whereas a managed fund has a different number of units on issue as investors join or leave the fund. This leads to trading in the assets of the fund as investors join or leave – and this causes both trading costs and capital gains tax for investors in the managed fund.

**Discount/premium to net tangible assets (NTA).** An important aspect of the decision to invest in LICs or not is the ability of LICs to trade at a discount or premium to the value of the underlying portfolio. For example, as of June 30, WIL had a portfolio valued at 83.4¢ per share, and was trading around 63¢ per share. Effectively this provides an investor the opportunity to buy a portfolio valued at 83¢ per share for only 63¢, an option they might find attractive.

WIL also has the relatively higher fee of 1% plus a performance fee. That 1% would equate to 0.83¢ per share on a portfolio value of 83¢ a share. If we try to do a very simple "net present value" calculation of that fee (0.83¢ per share every year), using a discount rate of 10%, it comes to 8.3¢. This means that even after allowing for a rough calculation of the net present value of future fees, you can buy a 75¢ portfolio for 63¢ per share.

One question might be: If an investment is trading at a discount to the value of its portfolio now, is there a risk that it could trade at a further discount? The answer is yes, however there would be a point in time where, if a portfolio is trading at too big a discount for too long, a decision might be made to simply wind up the LIC and distribute the proceeds to investors, thereby removing the discount.

Further, the manager of the LICs can choose to buy back their shares when they are trading at a discount to the value of their portfolios, something that increases the per-share value of the portfolio for remaining investors. This is something the management of WIL has already done this year.

The price of AFIC provides a different question for investors: With a portfolio valued at \$4.49 per share (NTA as of June 30) and a share price of \$4.72, is it an investment that makes sense?

Confidence in the management of AFIC, and its ongoing low fees, might attract investors to pay \$4.72 a share for a \$4.49 portfolio, although clearly the preference would be to buy a portfolio for less than its value.

**The portfolios.** The table below shows the top 15 holdings of the two LICs, and the biggest 15 holdings in the ASX 200 index. The key observation is the similarity between AFIC and the index, and the extent to which WIL takes more active positions away from the index.

**-Their 15 biggest holdings**

ASX200 Index	WIL	AFIC
BHP	NAB	BHP
Commonwealth Bank	Westpac	Commonwealth Bank
Westpac	ASX	Westpac
ANZ	Bendigo Bank	Rio Tinto
NAB	AP Eagers	Wesfarmers
Woolworths	Wide Bay Australia LTD	NAB
Telstra	McMillan Shakespeare	Woolworths
Wesfarmers	Commonwealth Bank	Telstra
Rio Tinto	Metcash	ANZ Bank
Westfield Group	ARB Corporation	Woodside Petroleum
Woodside Petroleum	ANZ Bank	Computershare
CSL	Primary Healthcare	Santos
QBE	SAI Global	QBE
Newcrest Mining	Credit Corp	Amcor
Origin Energy	Graincorp	Origin Energy

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