

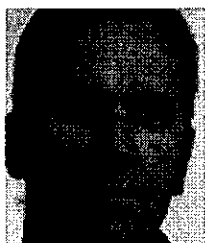


Home > Top LICs

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Top LICs

ASX Investor Update's Tony Featherstone asked Geoff Wilson (pictured) of Wilson Asset Management why he favours the listed investment company structure.



Investors who want diversified share exposure, and prefer to pay professionals to manage their money, usually buy units in an unlisted retail managed fund. This strategy can be effective if the fund consistently outperforms the average market return, after fees, over a long period. Leaving buy and sell decisions to investment professionals, and taking a diversified approach through a managed fund, can also create more peace of mind.

But managed funds/unit trusts have some issues to consider. The main one is when you buy units in a managed fund, you are giving money to the fund to invest on your behalf. If more people buy units, the fund has more to invest, and vice versa. Hence, the fund's size rises or falls depending on money flows in and out of the fund.

The main one is their 'open-ended' structure. When you buy units in a managed fund, you are giving money to the fund to invest on your behalf. If more people buy units, the fund has more to invest, and vice versa. Hence, the fund's size rises or falls depending on whether people are buying or selling units.

Consider how this works in practice. During a bull market a managed fund may produce strong returns, which encourages investors to buy more units in it. As new money flows into the fund, its manager inevitably has to buy more shares to maintain or improve returns. The manager may park some of that inflow in cash, but too much cash for too long could dent performance, so the manager buys more shares even though they may be pricey in a bull market.

"This type of momentum investing can cause a serious destruction of capital when the bull market ends and is replaced by a bear market," says Geoff Wilson, chairman of the well-performed Wilson Asset Management, and one of the market's prominent investment managers. "Most money pours into the market and open-ended funds when share prices are soaring in a bull market. The manager may then be forced to buy companies at inflated prices."

Problems on the way down

Now consider an investor who became nervous about equities during the global financial crisis and sold their units in a managed fund that invests in Australian shares. If other investors in the fund did the same, the manager may have been forced to sell shares to pay out investors who left.

"This places pressure on the manager, who has to put fundamental investing to the side while he or she manages the cash flows (in the fund)," Wilson says. "Invariably, most investors depart a fund when stocks have fallen significantly, which historically has proven to be the best time to buy - the manager may have to sell companies they believe represent good value."

Even worse, the manager may sell shares that have produced good profits but have less attractive valuations than others in the fund. Selling triggers a capital gains tax liability for unit holders, even though the managed

fund could have an overall negative return that year. New entrants in the fund can also incur embedded tax liabilities from previous fund investment decisions. The upshot is, unlisted managed funds sometimes have less-predictable tax outcomes.

Understanding close-ended funds

A close-ended fund, such as a listed investment company (LIC), has a different structure. If an LIC investor wants to sell, they must sell their shares in the LIC to another investor - just like a share. No money is withdrawn from the fund; only the shareholding changes. The amount an LIC has to invest is reasonably static (it can grow if the LIC has a dividend reinvestment or options plan, or issues other shares to raise capital). Therefore, LIC managers do not have to worry as much about managing cash flows within the fund.

"A close-ended fund is a superior structure to a managed fund/unit trust structure," Wilson says. His firm has three LICs: WAM Capital (small and medium-size industrials), the Wilson Investment Fund (long-term investing with a yield focus) and WAM Active (an absolute-return fund that trades shares). "With close-ended funds, the manager does not have to sell stocks in the portfolio to raise cash for a departing investor. Investment decisions are based on company fundamentals rather than money flow via redemptions."

Wilson adds: "I believe LICs are the best vehicle. I chose this structure many years ago after reviewing United States research showing close-ended funds outperformed open-ended funds on average by 1.5 per cent each year over a very long period. The performance difference was mostly due to close-ended funds having more scope to buy or sell companies when they want to, not because they have to."

Risks of LICs

Unlike managed funds, an LIC can trade at a discount or premium to its assets. Always compare an LIC's net tangible assets (NTA) per share, to its share price (**ASX Managed Funds** lists premiums and discounts for all LICs). For example, an LIC may trade at a 20 per cent discount to its NTA. The LIC's shares cost 80 cents, but its assets are worth \$1 per share.

At face value, the LIC looks a bargain - why buy shares it owns when you can get them at a 20 per cent discount by buying the LIC itself? There could be good reasons for the discount. As Wilson notes, the LIC may have poor or limited performance history; it may have suspended its dividend during a bear market; or it could be small and have illiquid shares.

Conversely, an LIC may trade at a premium if investors are willing to pay more than the assets are worth because they believe in the manager and like its performance history. The largest LICs, such as Argo Investments, Australian Foundation Investment Company and Milton Corporation, traded at slight discounts to their NTAs at the end of March. Many smaller LICs with less history traded at double-digit discounts. The average discount to NTA was almost 17 per cent.

Market sentiment also influences LIC discounts or premiums. During bull markets, investors often prefer to invest in fewer shares directly rather than buy into a fund, to get more leverage to a rising market. Bull markets also have a nasty habit of giving investors false confidence; they see less need to pay professionals to manage their money. However, bear markets remind investors about diversification, and the value of paying professional investors to manage your funds if you do not have time or skills.

Wilson says: "When investors want to take their money out of LICs, selling may result in the LIC share price falling below the value of its assets. [But] trading at a discount to NTA can provide a great buying opportunity. On the other hand, when investors are buying shares in LICs, the share price may trade higher than the value of the assets it owns. This is referred to as trading at a premium to NTA. This can provide a selling opportunity."

Choosing LICs

Never buy or sell an LIC solely on the basis of NTA discounts or premiums. Always review the LIC's investment performance. Check its dividend history. Understand what the LIC invests in; the bull market saw many new LICs with more aggressive trading mandates and higher performance fees. Compare the LIC's premium or discount to NTA to its long-term average. A well-run LIC trading at a larger-than-average discount to NTA may be an excellent buying opportunity. A higher premium to NTA could be a sell signal.

Most of all, think about LICs in the context of other investment choices. If you are happy with the average market return, buy a low-cost exchange traded fund (ETF) that tries to match returns from an index, such as S&P/ASX 200. If you want more than the market average, and prefer to pay lower management costs, consider larger, conservative LICs.

Investors who want more specific exposure - for example, investing in small-cap shares - should compare an LIC, such as WAM Capital, against a managed fund that invests in small-caps. Some newer LICs have more competitive base-fee structures than retail managed funds, although often charge a significant performance fee if the fund outperforms its benchmark index.

From ASX

- [Listed Investment Companies](#) provides a wealth of information on LICs.
- Use [ASX market update information](#) to reviews LIC premium and discounts to NTA since 2004.
- View the [monthly sector update](#) to see overall LIC performance.
- Examine [quarterly performance returns](#) to gauge an LIC's investment performance against others.

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