

Puzzle of the Cheap Shares by David Potts

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Amazingly, punters can buy stock in many listed investment companies for less than its worth. David Potts does some snooping to reveal why.

Here's an offer too good to accept. What would you do if you were offered shares in one of Australia's best stocks, BHP Billiton, at 30 per cent off the marked price in the sharemarket?

You'd knock it back.

How do I know? Because there are companies that only invest in blue chip shares, which are trading on the Australian Securities Exchange (ASX) for less than their holdings are worth.

It's the same as buying a house for less than it costs to build.

Yet Clime Capital (ASX code CAM) has shares in BHP Billiton accounting for about 9 per cent of its 20-stock portfolio.

Although the stocks it owns are worth \$1.36 a share, it trades at a smidgin over \$1.

It's not alone.

More than three-quarters of the 40 listed investment companies (LICs) are valued at less than their underlying investments.

Considering they typically beat the All Ords in any given year, LICs should be surging, you'd think. All the more so since they got a windfall last July when the rules for paying dividends were relaxed.

Previously, an LIC had to make a profit before it could pay a dividend.

But the profit was based on the market price of investments.

When the GFC struck, they were still profitable but not on paper. This hit the newer, trading-oriented LICs hardest.

Yet the only Australian sharemarket LICs trading above or at the value of their assets are Australian Foundation Investment Company (AFI) and Argo (ARG), both of which have been around for decades.

Even Milton Corporation (MLT), which has been out-stripping the market for more than 70 years, trades at an 8 per cent discount.

Possibly that's because, after last year's merger with its sister company, Choiseul, a lot of shareholders would have found themselves doubled up in Milton stock.

It must be galling for LICs that they beat the market in their performance, as shown by their rising asset values, yet fall behind it in their share price. It's not as if their holdings of quality stocks, such as BHP Billiton or CBA, are offset by some penny dreadful duds either.

After all, one criticism that the more venerable LICs will wear with pride is that they're too conservative. The newer ones are more gung ho and charge higher fees for the privilege.

But even they can deliver amazing returns.

In a research report on LICs, stockbroker Patersons singles out WAM Capital (WAM) as the best performer "covering the last 10, five, two and one-year periods".

It also has the fastest growing dividend, though it did start from a low base.

Over the past decade, WAM Capital has doubled the annual performance of the ASX, posting 18 per cent a year before fees.

But in the weird world of the market, the same can't be said for its share price.

As we speak, it's trading at a 12 per cent discount to its value.

Patersons says Milton and Diversified United Investment (DUI) are the "best value among the larger, conservative LICs".

Again, both are seemingly undervalued by the market.

How come?

LICs look dowdy next to the forward, flashier exchange traded funds or ETFs.

These are low-fee index funds, which trade on the sharemarket just like shares.

Advisers and DIY super funds love them because they're a one-stop-shop for an entire portfolio. Still, LICs don't see the rapid rise of ETFs as the problem, though they do lay some of the blame with advisers and brokers.

"There's a bit of ETFs raiding our turf," the chief investment officer at Clime, John Abernethy, says. "But LICs haven't been at the top of advisers' minds when speaking to clients because they get trailing commissions from recommending managed funds.

"And there's no broker support, either."

Because a LIC comes with a portfolio, brokers are better off recommending the component stocks and earning brokerage on each one.

Even so, the fact is a few LICs do trade above their underlying asset value and before the GFC hit almost all of them were well over it.

So it can't just be self-interested advisers or brokers who are the problem.

Anyway, from their point of view, LICs don't do enough to sell themselves.

"They could be more pro-active," says one broker. Financial planners Dixon Advisory say the responsibility rests with the boards of LICs

to get their share prices up to the underlying asset value.

After its clients saw their investment going backwards, Dixon Advisory grabbed control of van Eyk's Three Pillars Fund (VTP) about 18 months ago.

It instituted a share buyback and returned 95 per cent of the net asset value per share back to shareholders.

"If the share price moves away from the (net asset backing) it's important for the board to put capital management in place such as a buyback or capital return," Dixon Advisory's managing director (strategy), Chris Brown, says.

But the idea of a buyback to bump up the share price is anathema to most LICs.

"Our fund has grown from \$39 million to \$67 million," Abernethy says.

"If we gave cash back at the bottom of the market our shareholders would have missed out on a 60 per cent capital gain and dividends on the way through."

Milton's managing director, Frank Gooch, points out a LIC needs "size and liquidity". "You'd have to sell better assets to fund a buyback and so you'd finish up with worse stocks," he says. "I'd rather invest in the market and derive a better return."

A bugbear for LICs is that ETFs can cheat when it comes to published returns.

Theirs are pre-tax. LICs' returns are after tax and fees.

LICs are likely to be sitting on huge unrealised capital gains (or losses in the case of the bad ones). Since most are aimed at DIY super funds, they also make a point of paying fully franked dividends, which come with a 30 per cent tax credit.

Trouble is that credit is worth more to some than others, depending on their tax rate.

Ditto for unrealised capital gains or losses.

Another thing. Even though the older LICs beat the All Ordinaries index over time, the margin is still under-stated.

Again, LICs take tax into account but the All Ordinaries accumulation index doesn't, with no accounting for fees or brokerage, either. That said, some of the newer LICs push the envelope when it comes to fees.

"Several newer LICs have a performance fee that is reset every year," Russell Investments' director ETF product development, Amanda Skelly, warns.

"This is effectively a free option for the fund manager and creates potentially risky incentives to manipulate performance."

Often there are an equal number of shares and \$1 options as well.

"If the manager doubles the [net asset backing] of the LIC to \$2, then option holders will choose to exercise the options for \$1," Skelly says.

"This means that for each share that was previously on issue there are now two shares and \$3 worth of assets - or an asset backing of \$1.50 a share."

So the result of the options being exercised is that your shares are worth less.

When all is said and done, it seems LICs come in and out of favour depending on the mood of the market. Speaking of which, the average discount on LICs has been shrinking in the past few months, a bullish sign for the market.

When LICs trade at a premium, the market has moved into speculation mode.

Dixon Advisory runs three share LICs, all trading above their asset backing - Asian Masters Fund (AUF), Global Resource Masters Fund (GRF) and Australian Governance Masters Index Fund (AQF).

Other funds it recommends are Argo, AFIC, DUI and BKI Investment Company (BKI).

Mind you, choosing funds that cost more than the stocks they hold doesn't sound too smart.

But buying at a discount could be a trap.

"A lot of the time the discount will get worse," Skelly says.

"That's an additional risk."

Indeed the discount today, though shrinking, is bigger than it was three years ago.

Even so, there's no doubt the market can get it wrong.

If you can pick up a good LIC such as Milton or WAM Capital for less than its worth, so much the better.

Taking stock

EXCHANGE traded funds (ETFs) are becoming so popular they make listed investment companies (LICs) seem so yesterday.

Pre-digital even.

An ETF is an index fund, only cheaper, and is also listed on the ASX. You get a diversified portfolio of shares off the peg. With a LIC, you get fewer but specially selected stocks. So a LIC uses professional judgment, while an ETF just copies the sharemarket index.

LICs will usually put more store on paying dividends, but ETFs are encroaching on that turf, too. Russell has a blue chip high dividend paying fund (RDV) aimed at DIY super funds.

Still, LICs and ETFs can co-exist.

With a traditional LIC, you're getting the fund manager's expertise and so would hope to beat the overall market. That also makes it riskier. But ETFs have their share of traps for DIY funds.

Their dividends fluctuate, for starters.

Take STW, which tracks the ASX200. Its past four dividends have been 73.8, 65.7, 69.5 and 78.1 cents a share and franking has varied from 65 per cent to 79 per cent.

Nor do ETFs pay dividends quarterly as do some LICs such as Clime. Worse, they're not tax effective. "An ETF is not a company," the managing director of Milton Corporation, Frank Gooch, says. "So you don't know the make-up of your income till it's paid out. It will include capital gains and trading profits, which you pick up regardless of when you go in."

An ETF can never beat the market and, indeed, will always slightly under-perform because of fees, low as they are. Then again, an ETF doesn't have the problem of most LICs, valued at less than the sum of the parts.

It can never get out of whack with the value of the underlying investments because whenever there's a rush of sellers or buyers, more shares can be created or cancelled as need be. Also, a whole market ETF will have far more stocks in it than a LIC, making it more diversified and so less volatile.

But since LICs are starting at a discount they should beat ETFs in a rising market.

David Potts

Code	LIC	Size	Price	Assets	Premium/discount
ALR	Aberdeen Leaders	\$ 78m	\$1.29	1.37	-5.8%
ALF	Australian Leaders	\$ 79m	\$1.21	1.43	-15.4%
AMH	Amcil	\$ 140m	\$0.67	0.78	-14.1%
ARG	Argo Investments	\$ 3,891m	\$6.40	6.33	1.1%
AFI	Australian Foundation	\$ 5,015m	\$4.95	4.90	1.0%
ADD	Aurora Sandringham	\$ 36m	\$0.99	1.00	-0.5%
AOF	Australian Governance	\$ 55m	\$1.70	1.63	4.4%
ALM	Australian United	\$ 733m	\$7.00	7.43	-5.8%
BEL	Bentley Capital	\$ 18m	\$0.26	0.44	-42.0%
BKI	Brickworks Investment	\$ 535m	\$1.27	1.40	-9.3%
CIN	Carlton Investments	\$ 461m	\$17.40	21.71	-19.9%
CYA	Century Australia	\$ 129m	\$0.76	0.81	-7.1%
CAM	Clime Capital	\$ 41m	\$1.02	1.30	-27.5%
CTN	Contango Micro	\$ 181m	\$1.24	1.64	-24.3%
DJW	Djerriwarrh Investments	\$ 891m	\$4.17	3.61	15.5%
DUN	Diversified United	\$ 487m	\$2.96	3.20	-7.5%
ELI	Emerging Leaders	\$ 37m	\$0.95	1.14	-17.1%
MER	Merricks Capital	\$ 25m	\$0.88	1.14	-22.8%
HIP	Hyperion Flagship	\$ 37m	\$1.40	1.47	-4.4%
IBC	Ironbark Capital	\$ 67m	\$0.47	0.57	-17.3%
MLT	Milton Corporation	\$ 1,988m	\$16.12	17.52	-8.0%
MIR	Mirrabooka Investments	\$ 259m	\$1.91	1.90	0.5%
OEO	Orion Equities	\$ 8m	\$0.43	1.18	-63.5%
OZG	Ozgrowth	\$ 67m	\$0.18	0.26	-33.2%
SYL	Sylva state	\$ 53m	\$3.35	3.66	-8.5%
YTP	Van Eyk Three Pillars	\$ 4m	\$0.77	0.90	-14.5%
WAA	WAM Active	\$ 17m	\$1.07	1.19	-10.6%
WAB	Wallace Absolute Return	\$ 6m	\$0.06	0.03	107%
WAM	WAM Capital	\$ 160m	\$1.53	1.76	-13.3%
WIC	Westoz Investment	\$ 143m	\$1.17	1.61	-27.5%
WHF	Whitefield	\$ 177m	\$2.90	3.35	-13.4%
WAX	WAM Research	\$ 91m	\$0.77	0.90	-15.3%