

The Australian

Money for free is just the start

- by: James Brooks
- From: The Australian
- December 14, 2011 12:00AM



Illustration: Igor Saktor

Source: The Australian

OLD-FASHIONED ideas can still win out sometimes over newfangled ones, and when it involves free money in the form of discounted listed investment companies, local investors should be doing their homework.

Every day the Australian stockmarket allows investors to buy a dollar's worth of shares at discounts of up to 30 per cent or more via LICs. That's potentially 70c or less for a dollar's worth of shares.

But this free money component is not the only reason these listed vehicles may be considered more attractive than their more hyped, upstart relative, exchange-traded funds.

LICs function in a similar way to retail managed funds except, instead of buying units, the investor buys shares that trade on the stock exchange. As such, investors have to buy and sell shares through a stockbroker, although the cost of this can be reduced by using an online broker.

Furthermore, they are different from unit trust products in that they are taxed at source and distribute a dividend (usually fully franked) rather than a unit trust distribution.

Operating as closed-end vehicles, the fund managers of LICs can concentrate on investment selection without having to factor in the possibility of money coming into or leaving the fund. This capital stability assists managers who prefer to take a long-term approach to investing.

Typically, LICs provide exposure to a diversified portfolio of investments on behalf of their investors. These investments may include Australian shares, international shares, private equity and specialist sectors such as wine and resources.

The value of the underlying investment portfolio held in an LIC on a per-share basis is referred to as net tangible assets.

However, while the on-market price of an investment company relates to its NTA, its share price is ultimately determined by supply and demand, and as a result an LIC may trade at a discount, premium or at par to its NTA.

There are 63 LICs listed on the Australian Securities Exchange with a value of \$15.8 billion, compared with 57 ETFs with assets worth about \$5bn. Of these LICs, about 48 are trading at less than the value of the shares they own, and some are offering discounts to their post-tax NTA of 30 per cent or more. And while ETFs are low-fee index funds that trade on the stock exchange, just like the shares they own, LICs are actively managed funds. Consequently, LICs' fees can be higher because the investor is paying for professional managers, as opposed to a passive index copycat in the form of ETFs. Nonetheless, the larger LICs remain very competitive in this regard, says Geoff Wilson, chief executive of WAM Capital, one of the star performers in the sector.

"AFIC, Argo, Milton and Brickworks have management expense ratios of around 0.12 per cent," he says.

"Why are people buying ETFs? Because they want to get exposure to the stockmarket as effectively as possible.

"If you buy companies like these LICs, you're getting exposure to the stockmarket more cheaply than via an ETF and you're getting a management team that is actually managing your money, participating in placements and making decisions to buy and sell, giving you a better overall return than an ETF.

"A listed investment company is a closed-end pool of capital, so a manager is never forced to buy or sell anything based on market conditions.

"We made a lot of money buying positions from managed funds that were forced to liquidate parts of their portfolio.

"LICs give the power back to the people because, on an annual or more regular basis, the board is accountable to shareholders, whereas an ETF is a trust with no accountability and no active management. Additionally, LICs provide a higher fully franked dividend yield than ETFs do."

Significantly, Wilson considers LICs to be a superior product for having a board of directors accountable to shareholders.

Tom Millner, chief executive of Brickworks, the winner of this year's inaugural Australian Fund Manager Award for the best listed investment company, agrees: "ETFs don't offer the depth of management at board level.

"LICs have some very noteworthy board members, guys who've been in the markets for 40-plus years, such as the likes of Don Argus, Ross Barker, Charles Goode and Rob Patterson. Shareholders can take comfort from their presence, especially in today's market environment."

Additionally, a key selling point for LICs is the stable income stream they provide investors, irrespective of market conditions, says Geoff Driver, general manager of Australian Foundation Investment Company.

"Even during the GFC, the company structure allowed us to maintain a consistent fully franked dividend income flow to shareholders, which was very reassuring for a lot of investors. Clearly you can't do that in a trust," he says.

"Another advantage LICs have over ETFs is that shareholders are sometimes offered another instrument to invest in and further reinforces the point that closed-end LICs control the timing of their investments."

A case in point is AFIC's recent \$200 million unsecured convertible note offering to its shareholders who want the security and return of a term deposit or bond with upside potential.

Within the sector, a structural change that many insiders believe will increase interest in LICs is the flagged abolition of trailing commissions for financial planners as part of the governments Future of Financial Advice legislation.

This will result in a more level playing field between managed funds and LICs, leading to a narrowing of the discounts seen today, says Wilson.

As such, WAM is putting its money where its mouth is and actively investing in other LICs to take advantage of these discounts.

"We try to find LICs that are trading at big discounts which we think will reduce over time," Wilson says.

"In the early days when Contango Microcap floated, we had about a 5 per cent stake in it when it was trading at around a 30 per cent discount, then when it later went to NTA we sold out."

As irrational as it may appear, LICs can trade at discounts for long periods, thereby offering value opportunities for investors.

"A lot of discounts have narrowed significantly over the last two years, especially among the smaller LICs, many of which were oversold during the GFC despite performing well during that period," Wilson says.

"For me, it's a cyclical thing. If I was a retail investor, I would be buying AFIC, Argo, Brickworks and Milton at the moment because six months ago they were trading at a 5 per cent premium and you can pick them up for around a 7 per cent discount.

"This means you are buying a dollar's worth of assets and exposure to the market for 93c a share which is a better deal than you'd get with an ETF."

"The fact that LICs trade at a premium or a discount confuses people and that creates a phenomenal investment opportunity."
