

LICs get boost from ETF popularity

An overlooked investment vehicle is getting another look-in, as planners begin to reassess the benefits of listed investments. Simon Hoyle reports

The effort put in by the promoters of exchange-traded funds (ETFs) in the past 12 months or so has had some unintended benefits for other players in the listed managed investments (LMI) sector, especially Australia's \$20.2 billion listed investment company (LIC) sector.

At the end of 2009, LICs placed third in size, behind listed property trusts, or Australian real estate investment trusts (A-REITs), at \$78.2 billion, and infrastructure funds, at \$36.2 billion.

ETFs, by comparison, had a combined market value of just \$3 billion, even though in terms of recent publicity and exposure, these investment vehicles have been punching well above their weight.

The marketing push by ETF promoters - in Australia, that's Vanguard, State Street and BlackRock (formerly Barclays Global Investors) - has encouraged a growing number of financial planners to reconsider their approach to LMIs generally.

"There has been a bit of a rub-off effect of the growing popularity of ETFs on LICs," says David Wright, a director of research firm Zenith Investment Partners.

"We'd had very few, if any, of the advisory groups or underlying planners actively using LICs previously. But in the past six to eight months, we've started to have some queries around that.

"Advisers can put together pretty diversified portfolios combining LICs with ETFs, and have a fully-listed exposure, rather than through the unlisted trust environment."

Wright says there's a chicken-and-egg aspect to how deeply LICs are researched for financial planners: there has been little demand from planners for research, and the lack of research means LICs

really haven't figured in planners' minds.

"If there was more research, more comprehensive research, they would be more actively used," Wright says.

"We've canvassed [planners] about covering LICs, but they have been lukewarm."

Wright says a lack of in-depth research on LICs by research firms that also cover unlisted funds means there has not been enough competitive pressure on some LICs to reduce costs for investors.

"If there was more research done, especially by players like ourselves in the unlisted space, you'd be comparing [LICs with] what you see as 'best practice' in unlisted funds," Wright says.

"There is not just a lack of competition between LICs themselves, there's a lack of competition between LICs and unlisted funds."

Wright stresses that not all LICs are equal on the fees issue. Some have their portfolios managed extremely efficiently, and compare well to the best unlisted funds.

Brett Jollie, head of Australia for Aberdeen Asset Management, says LICs offer many of the same benefits as ETFs, and some other benefits as well.

Shares in LICs are traded on the Australian Securities Exchange (ASX) in the same way as units in ETFs. Both are low-cost investment vehicles. And neither LICs nor ETFs pay commissions (up-front or trails), although there are brokerage costs involved in trading on the ASX.

But LICs differ from ETFs and traditional managed funds in at least one critical respect: LICs are closed-end investment vehicles. And they differ in the detail of how they're structured and interact

with investors.

A closed-end investment vehicle initially raises capital from investors, but when investors want to redeem their holdings they must do so on market, by selling to other investors who want to buy in. In other words, they work precisely like any company listed on the ASX: following an IPO (initial public offering) or share issue, the shares in the company are traded on market, and the capital never leaves the issuing company.

In practical terms, this means an LIC manager is never under pressure to sell assets to meet redemption requests - an issue that traditional managed funds potentially face, and often at the worst possible time.

Jollie says LICs "provide an alternative way of accessing what could be quite similar investments" to traditional managed funds.

"They are effectively tax structures," he says. "They are an investment company in their own right. They're predominantly closed, so they [encourage] a fund manager to invest for the long term, or to invest in less liquid assets, because the manager does not have to worry about outflows.

"That can reduce turnover as well - and reduced turnover can help to reduce tax."

Jollie says LICs pay dividends, which can be fully franked, depending on the tax paid by the LIC on its profits. The LIC can determine a dividend policy: it does not have to pay out all its profits as dividends, and can retain profits to reinvest in its investment portfolio.

"In a managed investment scheme, the responsible entity [RE] must distribute its entire taxable income for the year," Jollie says.

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Jollie says LICs do not appear on many planning firms' approved product lists (APLs) "because of their structure".

"For that reason, I think they often get under the radar," he says.

"They are not researched by the standard research houses, and they do not find their way onto APLs, so there's a void in the understanding of what they are and a reluctance to invest in them."

One characteristic of LICs not shared by ETFs is that the share price of an LIC may from time to time trade at a discount or a premium to the LIC's net tangible assets (NTA). ETFs are designed so this can never happen, or so that any discount or premium is minimal.

This particular quirk means it is occasionally possible to buy into an LIC's investment portfolio for less than it's worth (when an LIC is trading at a discount to NTA), and to sell out for more than it's worth (when it's trading at a premium).

LICs regularly publish their NTA values, some as often as weekly, so investors can assess exactly where they stand.

The share price of an LIC is determined by supply and demand; the larger and more popular LICs enjoy stronger demand, and generally trade at a smaller discount, or more often at a premium, than less popular peers.

David Stevens, managing director of Contango Asset Management, says if you "look at the Argos and AFICs [Australian Foundation Investment Company] and so on, the market always loves those and they sell consistently at a premium".

Stevens' business offers LICs and traditional funds to investors, and he says it's horses for courses.

"We wanted to launch a micro-cap fund because we thought it was a terrific investment space," Stevens says.

"After that, we reviewed which was the best [structural] option.

"The closed-end nature [of an LIC] was vital: I would not offer a micro-cap fund in an ETF because it's not closed-end, it's open-ended. The



Brett Jollie

next [financial] crisis is going to shoot a whole lot of bullet holes through the ETF industry. It will be just like the property trusts sector. In the back of the product disclosure statements there's [a clause] that they can freeze these funds ... and that's not in the best interests of investors."

Stevens says the LIC option was also attractive "because micro-cap is a small asset space".

"If I were going to have a \$1 billion fund, I would offer an ETF or [an unlisted] managed fund," he says.

"But in the micro-cap space, you have limited FUM capacity."

Stevens says there's growing interest in LICs from financial planners.

"Some years back it was the private wealth planners from the private banks or broking houses, and individuals, but since then we've seen a number of financial planning groups come on to the register," he says.

Zenith's Wright says there are good reasons why planners may have been wary of some LICs in the past, and it's mainly to do with management costs and agreements.

An LIC generally has an agreement with a management company to manage the LIC's

investment portfolio. Even though the LIC and the management company are, theoretically, separate entities, the agreements can sometimes be quite favourable to the management company: high fees, and long-term management contracts often give the impression that the management company might not work as hard for investors as it should.

On the other hand, because an LIC is owned by shareholders, those shareholders can band together to replace the management company, if enough of them agree to do so.

That's what happened last year, when Dixon Advisory successfully replaced van Eyk as the manager of the Three Pillars LIC.

Dixon is an unusual planning business, in that it not only actively recommends LICs to its clients, but has now itself become the manager of an LIC.

Wright says LICs are an effective way for financial planners to manage their clients' equity exposures.

"One of the things you see time and time again with advisers managing, or attempting to manage, direct equity exposure for clients is that often they are doing it with an arrangement they have with a broker," Wright says.

The broker produces stock recommendations, and the planning firm "cobble that together into a portfolio".

"Each portfolio is different for each client, and it becomes impossible to manage that," he says.

"That's why we've started to see some of the SMA [separately managed account] structures becoming more popular.

"With an LIC, clients' [equity exposures] can be managed in one place in a professional manner, where clients are buying into a portfolio, rather than having individual direct equity portfolios." ■



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