

‘Free money’ in underpriced LIC stocks

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Listed investment companies, or LICs, are an out-of-favour investment vehicle that is now offering virtually “free money”, according to some market experts.

LICs are listed equity funds that manage investments in domestic or global shares – and more often than not are renowned for their dividend yield.

One LIC insider is Wilson Asset Management founder Geoff Wilson, who is also chairman of WAM Capital, WAM Research and WAM Capital, and on the board of three other LICs – Cadence Capital, Clime Capital and Australian Leaders Fund.

Fresh from addressing the Australian Investors’ Association, Wilson is educating investors about the opportunities in the stockmarket that give investors shares worth \$1 for a discount.

By his calculations, there are 59 LICs in Australia, with a value of \$19.1 billion.

“At least 49 [LICs] are trading below the value of the shares they own, creating a lot of great value investing opportunities,” he says.

LICs trade at a discount to their net tangible assets (NTA), Wilson says, because the supply-demand dynamic created by the stockmarket drives the stock more than the movement in its underlying assets.

During a downturn, or an event such as the global financial crisis, investors in a managed fund may redeem units for cash, causing the fund manager to liquidate positions, while an LIC manager can continue to manage a portfolio because of its closed-end nature, since its investment strategy is not dictated by fund flows.

“Research has shown that the closed-end structure enables LICs to invest more efficiently and outperform unit trusts or other managed funds over time,” Wilson says. Further, he believes the outlook for LICs is the brightest it has been in his 31 years in industry, because of major structural changes benefiting the sector that have already caused a narrowing of the discount to NTA of a number of LICs.

This includes the change to the Corporations Act last June which allows companies to pay dividends as long as they are solvent, as well as reform in the financial planning industry whereby commissions on managed funds will be banned from July 1, 2012.

“This will remove a significant impediment for financial planners looking at LICs or other listed investment products,” Wilson says. This means the historical incentive to recommend managed funds over LICs will be removed.

“Finally the playing field will be level [and], we are already seeing an increased level of interest from financial planners in LICs,” he adds.

Wilson believes a large number of LICs could trade at a premium to their asset value.

But JBWere chief investment officer Giselle Roux is conscious that investors can use LICs in the wrong way and must determine the type of portfolio wanted, its size, and the amount of active involvement desired.

“Are LICs there as the core of the portfolio or as a more active surround?” she asks, noting that for those with a small amount of capital to invest, a LIC provides more appropriate equity market exposure than tiny holdings in multiple shares unless investors have a willingness to manage those shares.

“One of the most important things we raise with clients is that LIC selection should be about the performance of the fund over the medium to longer term,” she says.

Roux notes that market capitalisation and liquidity is what separates the larger LICs from their smaller peers.

The smaller operators trade at larger discounts to NTA because of the infrequency of trades, compared with the industry’s largest LICs, such as Australian Foundation Investment Co and Argo Investments.

Milton Corp managing director Frank Gooch agrees, saying his own fund has near 20,000 shareholders and more than 120 million shares on issue.

“[That means] there’s more ability for people to be able to buy into the stock when they want to, and similarly if they want to sell out of the stock, they can,” he says.

Gooch notes that shareholders can become impatient for a narrowing of the discount – as in the case of India Equities Fund.

“You do see a bit of activism to buy back the shares but, really, my personal point of view is that if you start to buy back the stock you’re virtually saying it’s time to wind it up,” he says.

Roux’s colleague, JBVere analyst James Martin, adds that some of the smaller-cap LICs stopped paying dividends through the GFC, to their detriment – given LIC investors often have a dividend preference. Indeed investors tend to reward LICs that pay dividends consistently over time.

Martin cites Djerriwarrh Investments as a consistent payer which as a result is trading at a premium to NTA. He also names Templeton Global Growth Fund as one LIC that resumed paying a dividend before halting it again.

“Communication to their shareholder base was quite poor and its discount to NTA improved by 4 per cent to 5 per cent – but when they stopped, you saw the discount widen again,” says Martin, who adds that the fund has underperformed persistently over time.

LIC investors are relatively conservative and are discouraged by patchy returns, Martin says.

Templeton Global Growth’s portfolio manager Peter Wilmshurst admits the LIC is trading at a discount as a result of its inconsistent dividend track record, largely as a function of an asset class which has not given much in capital gains.

“Through TGG’s close to 25 years of history, the shares have traded close to NTA or at a premium to NTA when we’ve paid a dividend, and they’ve traded at a discount when we haven’t,” he says. “The board is very aware of that but the big issues affecting global equities now are [affecting] TGG now.”

In terms of comparing LICs to Exchange Traded Funds (ETFs) and managed funds, Roux says it would be wrong to say the three are interchangeable.

“People don’t appreciate the management expense ratio (MER) sitting in some of these structures, which can be deceptive,” she says.

Historically, she adds, some funds JBVere recommends are able to outperform the LICs even after fees, so it’s incorrect to assume that you are better off in an LIC because of presumed lower fee structures.

Roux says that because of tax consequences, LIC strategies can inhibit portfolio performance – if managers don’t want to sell equity positions and incur tax.

Gooch says that despite attention being drawn to the fact ETFs have a low cost and low taxing structure, traditional LICs have those benefits “plus more” – given that positions can often be long-term holdings, with more unrecognised capital gains.

He adds that LICs differentiate themselves via their portfolio weightings, with Milton more weighted to financials compared with resources.

“The reason we do that is we’re attracted to the dividend flow we get out of the financial sector,” he says. “If you look at the resource sector, there has been more unrealised capital growth that you can’t really pay on to your shareholders.” Milton has been in a position to grow its dividend for the past four payouts.

Cadence Capital director Karl Siegling, a large investor in the fund, says one of his biggest challenges is to narrow its discount to NTA, though the stock price has risen to its highest level in more than three years after a surge in shares in RHG – the fund’s biggest position.

“It is a frustration of mine that we have one of the best performing funds in the country and we’re trading at such a big discount to NTA,” Siegling says. “But it’s an opportunity for any incoming investor, as they’re still getting same returns off a lower base.”

Siegling believes that over time, as smaller-cap LICs grow in size and age, such opportunistic discounts will disappear.

Nick Fels, the chief operating officer of Bell Asset Management and Global Mining Investments, says the LIC’s board has been trying to raise awareness of the stock, improving demand and liquidity, through ASX and commissioned research from independent third parties.

Global Mining Investments discloses NTA weekly rather than monthly like most peers.

“We think education and information to investors will, over time, narrow the discount,” Fels says. “By being very transparent about positions and having a relatively concentrated portfolio, we’re making a conscious decision to help investors see what the current NTA is.”

Fels says the GMI website has interviews with management, and the LIC hosts an annual roadshow where senior investment team members come to Australia from the UK and meet investors.

"Investors can attend an annual meeting and speak to directors, which provides a mechanism for transparent dealing with people who look after their money," he says.

Alleron Investment Management senior investment manager Steven Robinson says LICs provide a reasonable option for retail investors, providing a reasonably diversified portfolio for low fees. "If you can get them at a significant discount to NTA they're probably good value," he says.

Bell Potter research analyst William Spraggett says LIC investors should consider whether they want exposure to domestic or international equities.

Based on recent research, Spraggett notes that WAM Capital and Magellan Flagship Fund are among LICs trading at a premium to historic norms, while Djerriwarrh Investments and Platinum Capital are among those that are trading in line with historic averages.

LICs trading at reasonable discounts include Australian Foundation Investment Co and Argo Investments.

"On an active return basis, the key standout of the large domestic LICs continues to be AFIC over the medium and long-term," says Spraggett, who notes smaller LICs WAM Capital, Mirrabooka Investments and Contango Microcap have delivered strong NTA performance over all time periods, with each stock price exhibiting strong absolute long-term performance.

He says that from an international perspective, Platinum Capital and Hunter Hall Global Value Fund have delivered good results over the long term, though Platinum is Bell Potter's preferred international LIC as it has a high fully-franked dividend yield, appears inexpensive on a historical basis and has delivered strong relative performance.

The broker's preferred domestic LICs are AFIC, Amcil and Mirrabooka.

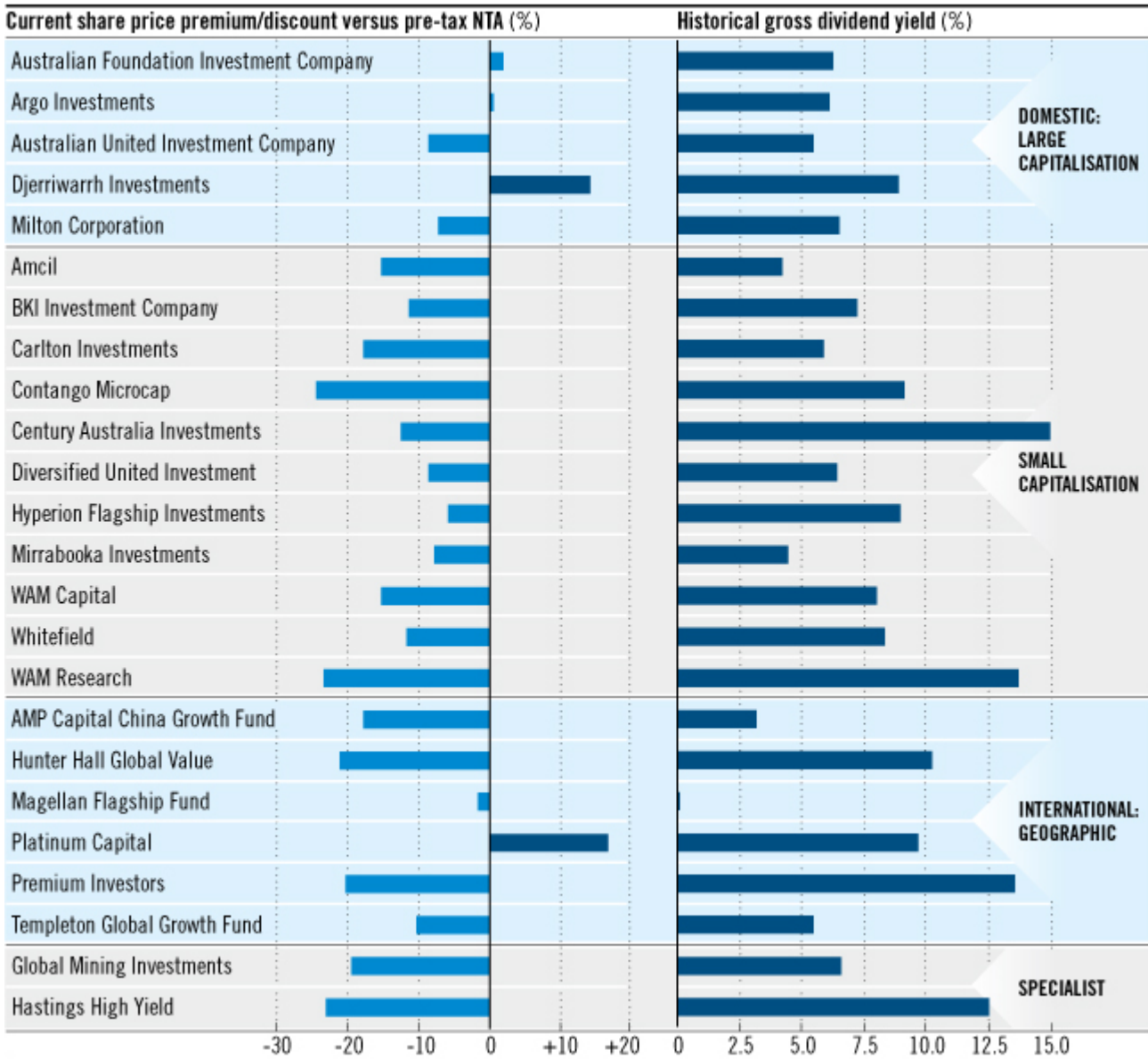
Spraggett also notes that although differences in mandates may seem somewhat innocuous, investors should examine their preference for dividends.

AFIC has yielded 4.4 per cent fully franked (6.3 per cent gross) compared with Djerriwarrh's 6.4 per cent fully franked (9.1 per cent gross) over the past two years, based on historical data.

The LICs within the Bell Potter universe were trading at an average discount to pretax NTA of 13 per cent as at March 31, 2011.

Over the March quarter, the discount of the domestic LICs grew from 2 per cent to 6.2 per cent, with the larger LICs accounting for the majority. Over the same period the discount on the International LICs expanded from 10.7 per cent to 14.3 per cent.

Licked



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