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A Guide to

Listed Investment Companies (LICs)

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This paper explores the benefits and drawbacks of the LIC structure, focusing on how LICs can be an appropriate investment vehicle for shareholders of all sizes, particularly those with a long-term approach.

Contents

Key Points

- LICs are closed-end investment vehicles and thus have a fixed pool of capital. This means they are not subject to applications and redemptions like managed funds, which may force portfolio managers to buy and sell investments at sub-optimal times.

- A number of overseas studies have shown that investment vehicles with a fixed capital base tend to outperform their open-ended equivalents over time on a Net Tangible Asset (NTA) basis, which is a measure of asset valuation[1,2].

- Investors can trade LIC shares on-exchange, avoiding the need for lengthy application and redemption forms, or the requirement to wait for a redemption window to access any funds.

- Given LICs are traded on-exchange and have a fixed amount of capital, the share price may diverge from the NTA at times. When the share price is above NTA, the LIC is trading at a premium. When the share price is below NTA, the LIC is trading at a discount.

- Buying LICs at a discount to NTA can provide investors with the opportunity to benefit from portfolio returns, as well as any closing of the discount that may occur.

- LICs are governed by exchange listing rules and therefore provide comparatively high levels of transparency and accountability.

- LICs can facilitate a progressive dividend policy, giving comfort to those seeking regular income. LICs can also elect to frank their dividends if credits are available. In contrast, managed funds and other trusts are typically required to distribute all taxable earnings each year, and those earnings may or may not have franking credits attached, depending on the underlying assets.

[1] https://citywire.co.uk/investment-trust-insider/news/proof-that-investment-trusts-beat-funds-80-of-the-time/a1076126
[2] https://www.morningstar.co.uk/uk/news/168601/why-do-investment-trusts-outperform.aspx

What are LICs?

Listed Investment Companies (LICs) are corporate entities (companies) established for the purpose of investing in a portfolio of securities. LICs are listed on an exchange, which in Australia is usually the Australian Securities Exchange (ASX).

Because LICs are traded on an exchange, they can be bought and sold through stockbrokers, just like regular shares and other listed investment vehicles, such as Exchange Traded Funds (ETFs).

LICs are accessible to all types of investors, regardless of how much they are investing. LICs can give investors – whether they are investing $100 or $1 million – access to the investment acumen and sophistication of fund managers who might choose to otherwise only manage closed private funds for high-net worth individuals.

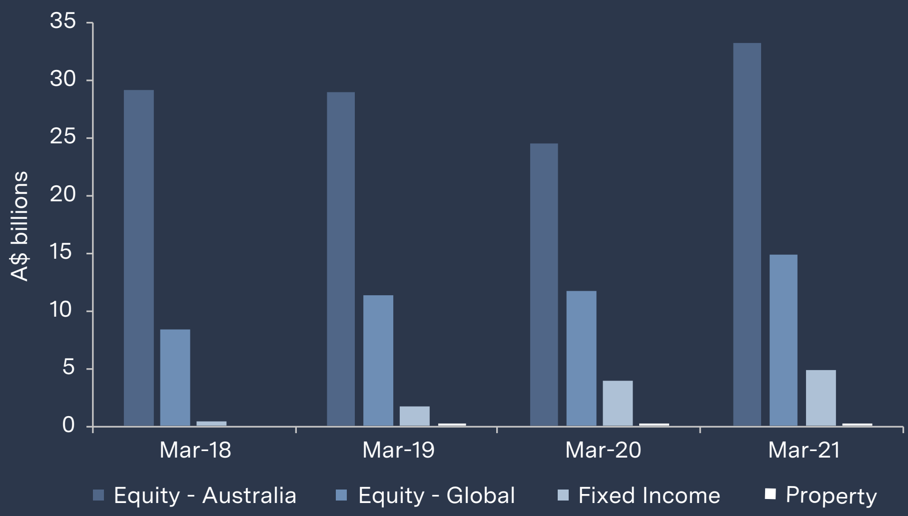
One feature that differentiates LICs from many other investment vehicles is their fixed capital base, otherwise known as a 'closed-end' structure. A fixed capital base means that LICs are not generally subject to periodic cash flows from investor subscriptions or redemptions in the same way that mutual funds or ETFs are.

This fixed capital base has a number of advantages and disadvantages. In this paper, we aim to explore these points and provide assistance to investors who may be considering LICs in their portfolio.

History in Australia

The Australian LIC market has been around for many decades, with the first LIC launched in 1928. Financial practitioners may be aware that LICs predate ETFs, but they may not appreciate they also predate unit trusts (unlisted managed funds). Historically, the Australian LIC market comprised mainly equity funds. However, in recent years, LICs have expanded into other asset classes, such as fixed income and alternatives.

Figure 1: Market Capitalisation of LICs and LITs (Listed Investment Trusts) on the ASX



Source: ASX

Global Perspective

While the main focus of this report is the Australian LIC market, it is relevant to look at trends globally, where LIC-type funds are well established and supported.

For instance, the UK listed investment company market dates back 150 years. The London Stock Exchange is now home to over 450 closed-end listed funds with a combined market capitalisation of over GBP200bn.

The use of investment companies by UK advisers in client portfolios has also increased significantly since the Retail Distribution Review in 2012, which put more onus on advisers to justify investment recommendations made to clients.

Across the Atlantic, the Closed-End Funds (CEF) market in the USA is approximately US$250bn and covers strategies across all major asset classes.

UK Listed Investment Company

GBP£200bn
market cap

USA Closed-End Funds

US$250bn
market cap

How does the LIC structure differ from other investment vehicles?

The following table compares the features of a LIC with a number of other common fund structures.

	Listed Investment Company (LIC)*	Listed Investment Trust (LIT)	Exchange Traded Fund (ETF)	Managed Fund
Exchange-listed	Yes	Yes	Yes	No
Closed or open ended	Closed – fixed size; funds are raised via Initial Public Offering (IPO) and secondary raisings (placement or rights offer)	Closed – fixed size; funds are raised via Initial Public Offering (IPO) and secondary raisings (placement or rights offer)	Open – with daily inflows/outflows	Open – though may have limited redemption windows
Trading	Stock exchange via broker	Stock exchange via broker	Stock Exchange via broker	Application to trustee or responsible entity, either directly, via an intermediary, or through an mFund transaction
Trading cost	Brokerage	Brokerage	Brokerage	Unit trust buy-sell spread
Pricing	May trade at a premium or discount to NTA	May trade at a premium or discount to NTA	Likely to trade at or close to NTA	Trades at NTA – but live pricing is not available
Company or trust structure	Company	Trust	Trust	Trust
Unit of value	Shares	Units	Units	Units
Governance	Board of directors	Responsible entity	Responsible entity	Responsible entity or Trustee
Dividend or distribution	Dividend	Distribution	Distribution	Distribution
Taxation relating to dividends and distributions	The LIC pays tax at the corporate tax rate, which can lead to franking credits, and then pays dividends from earnings. There may also be franking credits from dividends received by the fund from its investments.	The investor pays tax at the marginal tax rate applicable to the ownership type (e.g. for the individual or super fund). There may be franking credits from dividends received by the fund from its investments.	The investor pays tax at the marginal tax rate applicable to the ownership type (e.g. for the individual or super fund). There may be franking credits from dividends received by the fund from its investments.	The investor pays tax at the marginal tax rate applicable to the ownership type (e.g. for the individual or super fund). There may be franking credits from dividends received by the fund from its investments.

* For 'modern' LICs which are classed as 'traders' by the Australian Tax Office

Key Features of LICs

FIXED CAPITAL BASE AND PERFORMANCE

Being closed-ended, LICs are not subject to unexpected inflows or redemptions. This means they have a fixed amount of capital to invest. Unexpected cash flows can force fund managers to buy and sell investments at sub-optimal times.

For example, many open-ended managed funds experience outflows when stock markets are falling and volatility is high, leading to forced selling when prices are low.

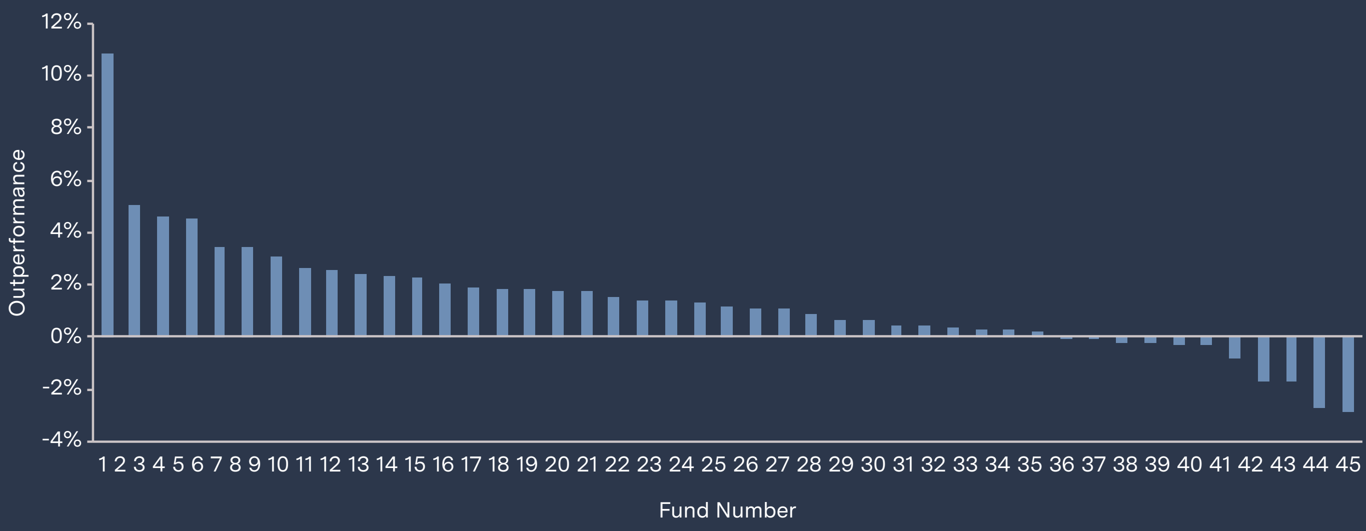
The certainty of capital that the closed-end structure provides means the LIC manager will not be faced with this situation and is therefore able to take a long-term approach to investing. For example, in times of extreme volatility, equity-focused LICs can take advantage of share price falls to make investments in attractive companies with temporarily depressed share prices.

LICs can also choose to be more fully invested when market conditions are appropriate, as there is less need to hold cash in case of redemptions.

Given the reduced need to manage portfolio inflows and outflows, LICs often benefit from lower portfolio turnover which should reduce trading costs and taxes, including potentially lower overall brokerage costs and crystallisation of capital gains along the way.

All of these factors can contribute to closed-end funds or LICs outperforming open-ended funds, such as ETFs and traditional managed funds. In fact, a number of overseas studies[3] have shown that investment vehicles with a fixed capital base tend to outperform their open-ended equivalents over time, as the chart below illustrates:

Figure 2: Annual Net Asset Value (NAV) Outperformance of Closed-End Investment Trusts vs Equivalent Open-Ended Funds Over 5 Years For 45 Funds



Source: Citywire (2017) - Proof that investment trusts beat funds 80% of the time[4]

[3] https://www.morningstar.co.uk/uk/news/168601/why-do-investment-trusts-outperform.aspx
[4] https://citywire.co.uk/investment-trust-insider/news/proof-that-investment-trusts-beat-funds-80-of-the-time/a1076126

Key Features of LICs *cont.*

DIVIDEND POLICY

Given that LICs are companies and not trusts, they have the ability to actively manage their dividend payments. Dividends to investors are paid from earnings, and LICs, like other companies can choose to pay out those earnings as dividends to shareholders or retain them for future use. This can assist the LIC in targeting a steady or 'progressive', or growing, dividend policy.

The ability to pay dividends was a particularly attractive feature of LICs during the recent market volatility associated with the COVID-19 pandemic. During that period, many other investment vehicles and stocks experienced difficulty maintaining stable income payments[5], while many LICs were better able to maintain their dividends.

LICs were also better positioned to sustain a growing dividend than many stocks in 2020, due to the diversified nature of a LIC portfolio, coupled with professional fund management techniques utilised in the LIC sector.

This potential LIC dividend advantage can be attractive to investors nearing or in retirement. In Australia, CommSec reported an increase in LIC usage by Self-Managed Super Funds (SMSFs), even before COVID-19, as the 'hunt for yield' continued in the current low interest rate environment.

One way to assess the sustainability of a LIC's dividend is to check the 'Profits Reserve Dividend Coverage'. This can be done by finding the profits reserve in the financial statements, converting it to a per-share amount and then dividing by the latest dividend to see how many times a similar dividend could be paid in future if there were no further earnings.

It is also worth noting that if a LIC is trading at a discount to NTA, investors will receive a higher dividend yield than if they bought the assets without the discount.

PREMIUMS AND DISCOUNTS

The issue of premiums and discounts between a LIC's share price and the NTA backing is currently a hotly debated topic.

Given that LICs have a fixed capital base, supply and demand for the LIC is reflected in the share price. This can lead to situations where the LIC share price and value of the underlying portfolio diverge. As a result, LICs can sometimes trade at either a premium or discount to NTA.

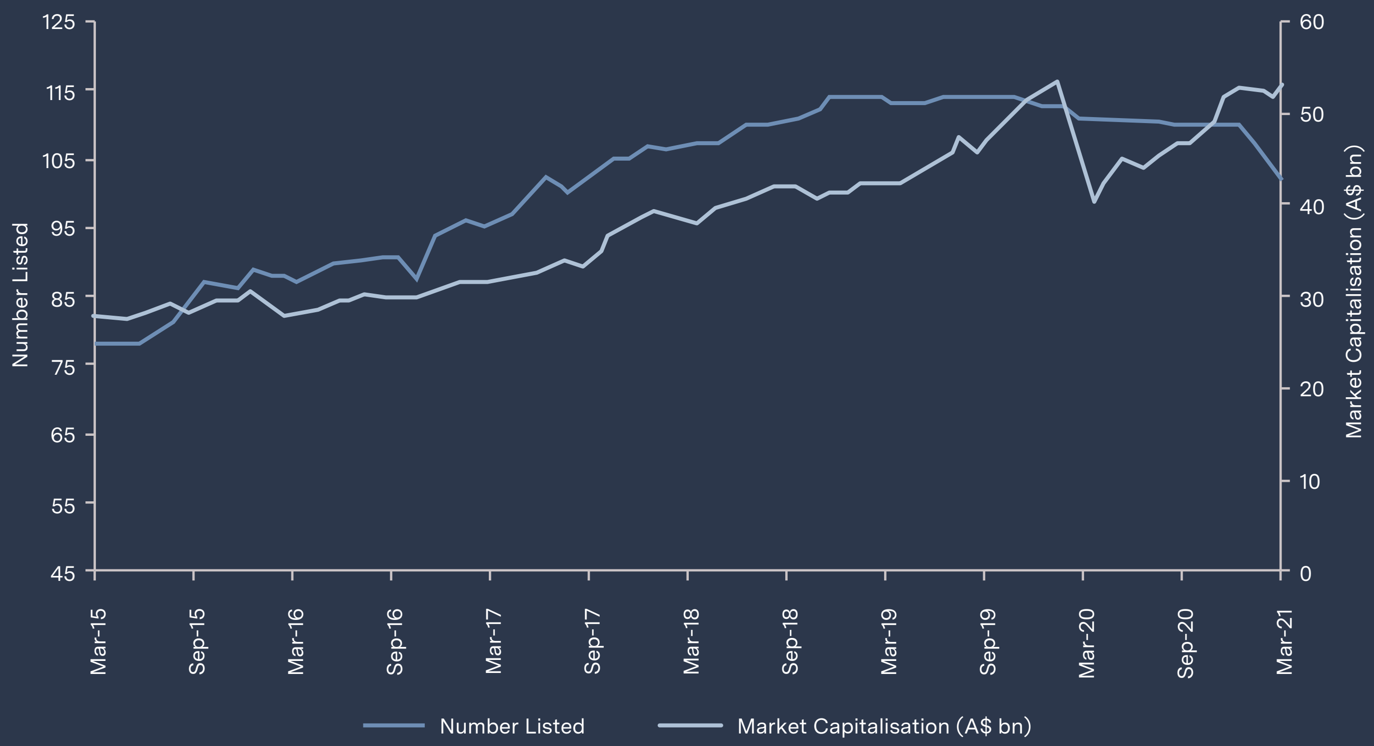
[5] https://www.reuters.com/article/us-health-coronavirus-australia-dividend-idUSKBN22W0LM

There are several reasons why LICs may trade at a premium or discount. These include:

- **Fund size –** small LICs may suffer from low trading volumes, while very large LICs may struggle to maintain demand
- **NTA or fund performance –** including the size and volatility of returns, and the length of track record of the manager
- **Dividend yield –** with many investors looking to LICs to provide stable and growing income over time
- **Cyclical favourability of a strategy** (e.g. value vs growth companies) or asset class (e.g. bonds vs stocks)
- **Accessibility –** if the fund manager is closed to new investment in other channels, then new demand for the investment strategy should funnel into the LIC, and thus help support the LIC's share price.

The number of competing products offered by other providers is also a consideration. For example, the following chart shows that there was a rapid rise in the number of LICs in Australia between 2015 and 2019. This has recently stabilised and even fallen, as some funds have delisted. This may benefit remaining LICs, given there will be a smaller pool of LICs for investors to consider.

Figure 3: LIC Market Growth in Australia



Source: ASX

Importance of investment strategy

When investing, it is important to understand the different investment styles employed by various LICs.

While it is relatively easy to find out whether a LIC is focused on equities or other asset classes, investors may benefit from investigating a little further in order to understand the LIC manager's strategy, its use of leverage - either through gearing or large-scale shorting - and whether it is focused on absolute or relative returns.

These issues were brought to the fore during COVID-19 when, for example, the NTA of LICs with high leverage declined by more than the broader equity market. Their NTA discounts simultaneously widened, creating a 'double whammy'. Many of these LICs rebounded strongly by the end of 2020. However, investors in these types of LICs could be heavily exposed if there is another bout of volatility or a market correction.

Given there is extra risk from investing in fund managers with high leverage, investors are likely to require higher returns from these managers. If these higher returns are not achieved, investors may be less attracted to the LIC, leading to a discount to NTA.

Premiums and discounts through the investment cycle

Individual LICs can oscillate between trading at a premium and discount over time, especially during different parts of an investment cycle.

During the initial stages of COVID-19 in March 2020, when stock market volatility increased dramatically, a number of well-known LICs saw their discounts to NTA expand to more than 25%, before recovering strongly in the following months. For investors with capital available at the time, this proved to be an opportunity. History now shows that investors who took advantage of the COVID-19 related sell-off were rewarded with a significant rebound in the value of assets held within their LIC investments. Furthermore, these investors also benefited from share price gains due to the tightening of discounts between the share price and NTA.

For equity-focused LICs, history has also shown that LIC share prices can underperform in the late stages of bull markets as investors seek individual stocks with strong momentum. It is often not until there is sustained share market weakness that investors 'rediscover' one of the main benefits that LICs provide - access to a professionally managed active fund with the ability to put its fixed capital base to work.

How can LIC managers minimise the impact of premiums and discounts?

The following section summarises some of the key approaches that LIC managers take when trying to reduce a LIC's discount to NTA.

While some of these techniques may not always be as effective or as fast as investors may like, many UK funds have utilised a variety of 'discount control policies' and the UK industry has broadly managed to close its discount over time, as shown in the below chart. Many of these techniques are equally applicable to Australian LICs.

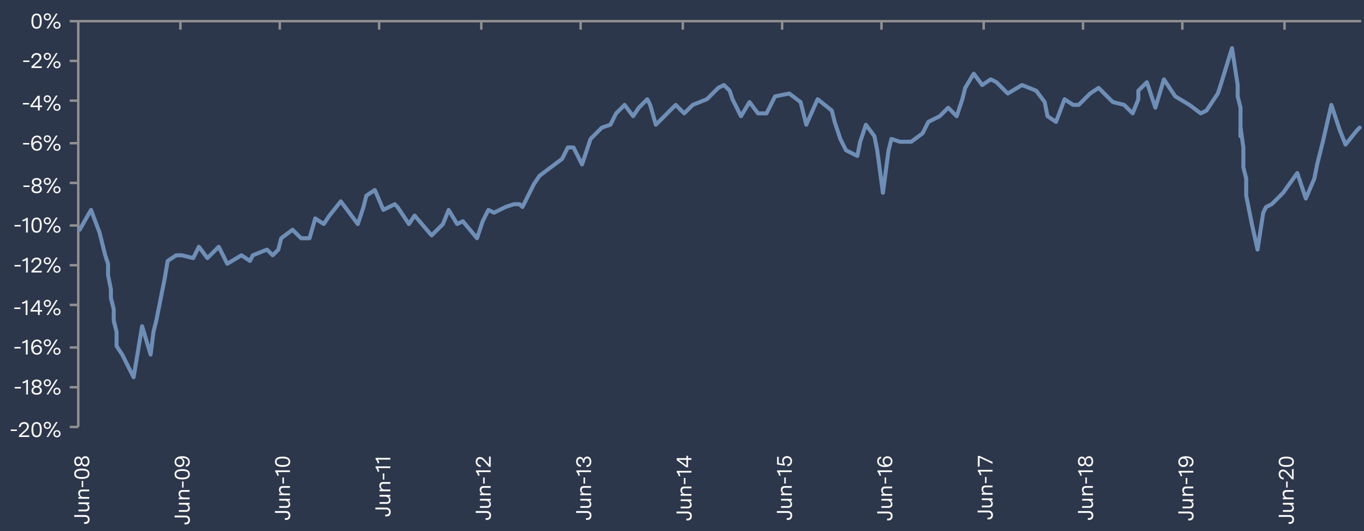
Firstly, it is clearly important that the underlying portfolio of a LIC is performing well and this should always be the core focus of any investment team.

Secondly, good investor relations and marketing can have a positive impact and a number of Australian LICs have closed their discounts through increased transparency and communication. Keeping clients informed, increasing brand awareness and constantly cultivating new investor demand all play key roles in supporting a LIC's share price.

Thirdly, a tool that is commonly used to respond to discounts is a 'share buyback', through which the LIC purchases its own shares on-market. A number of Australian LICs have announced on-market buybacks. Some of these buybacks are relatively active, while others are 'on hold' and will only be utilised selectively. Buybacks provide support to LIC share prices on the days of purchase and this may help improve investor sentiment over the longer term.

Buybacks can also be accretive to the LIC's returns, especially if undertaken at deep NTA discounts.

Figure 4: Average NAV Discount for UK Investment Companies

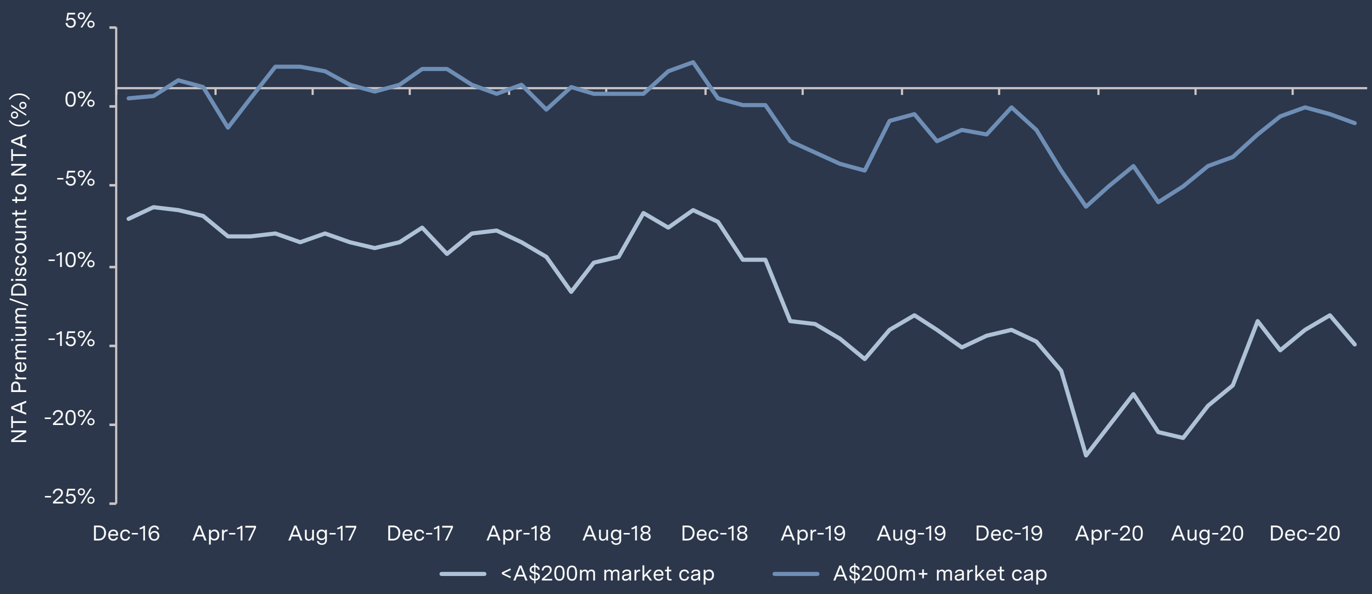


Source: The Association of Investment Companies. (NAV, Net Asset Value, is a similar metric to NTA).

How can LIC managers minimise the impact of premiums and discounts? *cont.*

However, buybacks are not a long-term solution, and the continued buyback of securities also leads to a reduction in fund size which may create additional challenges for LICs that are already subscale. In particular, smaller LICs can have low trading volumes, which often exacerbates the discount. The chart below shows that ASX-listed LICs with less than $200m of FUM have much larger discounts on average than larger LICs.

Figure 5: Historical Premium/Discount Tracker by Market Capitalisation



Source: ASX, Bloomberg, VGI Partners

Other avenues to address the discount to NTA include:

- **Off-market buybacks, though these can have some of the same drawbacks as on-market buybacks.**
- **Targeting a higher dividend yield to attract income-seeking investors. In fact, some LICs with strong dividend yields even trade at substantial NTA premiums.**

For LICs trading at a premium, the share price may be an impediment for new investors. In these situations, a LIC may try to temper demand by reducing the dividend and pausing any buyback in progress.

Investing Using LICs

Which investment strategies make sense in a LIC structure?

For funds that are equities focused, the closed-end nature of LICs is beneficial to high-conviction, long-term strategies. As flagged earlier, the structure reduces the likelihood of the fund manager being a forced seller or buyer at inopportune times.

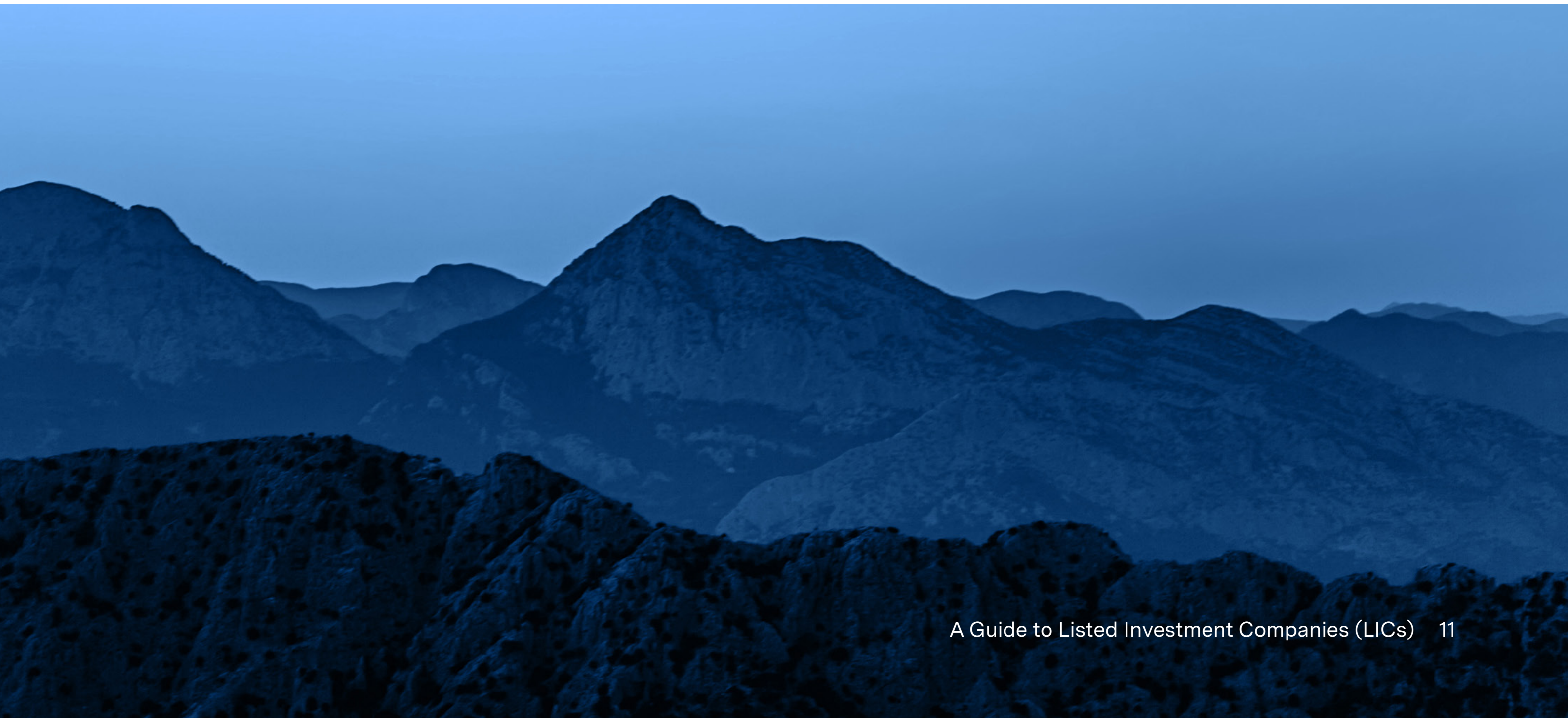
In a similar vein, the LIC structure is also helpful for funds that are invested in illiquid assets, such as property. There have been many examples globally of open-ended funds forced to freeze redemptions when they have been unable to liquidate positions fast enough, or at values that seem reasonable.

Taking advantage of premiums and discounts

As this paper has discussed, while investors should be aware of the risk that a LIC may trade at a discount, the flipside is that discounts can represent a compelling opportunity for new investors, as discounts can allow cheaper entry into a diversified portfolio of underlying companies than if those securities were bought directly.

There are many successful international investment firms that look for well-managed LICs and purchase shares in them when discounts appear. Their thesis is based on discounts being temporary dislocations, so buying LIC shares can provide upside from the discounts narrowing as well as portfolio returns. Retail investors in LICs can utilise exactly the same strategy.

For those investors who are not confident in ‘picking the bottom’ in terms of discount, it may be best to take a long-term view when investing in LICs, say five years or more. This means being aware and comfortable that the share price may oscillate between premium and discount throughout an investment cycle.



The Bottom Line

To conclude:

- LICs can be a shareholder-friendly vehicle that can potentially give investors of all sizes access to the most sophisticated investment acumen.

- Given closed-end funds have a fixed pool of capital, the structure is most suitable for fund managers undertaking active management with a **long-term focus.**

- A number of overseas reviews have shown that investment vehicles with a fixed capital base tend to outperform their open-ended equivalents over time on a NTA basis.

- LICs can trade at a premium or discount to NTA and this can vary throughout an investment cycle.

- Buying LICs when they are at a discount to NTA can provide investors with the opportunity to benefit from portfolio returns, as well as any closing of the discount that may occur.

- LICs can facilitate a progressive dividend policy, giving comfort to those seeking regular income. In contrast, managed funds and other trusts are typically required to distribute all taxable earnings each financial year. LICs can also elect to frank their dividends if credits are available.

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