Listed Investment Companies: fact, fiction and future

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Understanding the features, benefits and risks of LICs.

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There has been much recent debate about Listed Investment Companies (LICs).

The LIC and Listed Investment Trusts (LIT) sector contains some of the largest, lowest-cost, reliable, trusted, long-lasting investment vehicles that can be accessed by retail and sophisticated investors.

However, LIC myths need to be dispelled, and facts highlighted to illustrate why the sector continues to present opportunities for long-term investors.

Fact: Benefits of long-term investing

When a LIC or LIT raises a block of capital it takes on a responsibility. Management must think deeply, plan carefully and implement its process steadily to generate outcomes for investors over not just one or three years but over five, 10, and 20 years.

Secondarily, the fixed capital of a "'closed-end"' listed investment company or trust creates the financial stability necessary to invest, sustain and enhance investment teams and processes over time. Good investment teams and good investment processes do not suddenly appear.

This commitment to the long term aligns the responsibilities of closed-end fund management with the best interests of investors. The opposite - chasing short-term investment returns and chopping and changing management and strategy - is almost certainly a way to lose money.

The oldest LIC in Australia, Whitefield (ASX: WHF) is 98 years old. Others include:

- Argo Investments (ASX: ARG) 75 years
- Australian Foundation Investment Company (ASX: AFI) 93 years
- Australian United (ASX: AUI) 68 years
- Milton Corporation (ASX: MLT) 71 years
- WAM Capital (ASX: WAM) 24 years

The tenure of key personnel in these companies is typically between 20 and 40 years.

On an after-company tax and costs basis (but before franking credits) these companies, spread across different investment strategies and market segments, have delivered returns ranging from 8.9% to 17.6% yearly since 2000 according to LICAT. *[Editor's note: past performance is not a reliable indicator of future performance].*

Those outcomes represent underlying returns that either equal or exceed their respective benchmarks over long periods across or within those time frames.

Have these long-term investment structures provided investors with a well-managed exposure to the Australian equities asset class over an extended period? It would appear so.

Fact: Long-term approach creates cost savings for investors

Investors in closed-end funds make a commitment. They agree to contribute capital in a single, coordinated capital raising and agree to commit it for the long term. Two potential cost benefits stem from this.

The first is the potential cost efficiency of the coordinated capital raising. A second and potentially far more material benefit is the ability of a closed-end fund to build on a permanent and substantial scale. Scale and commitment allow fixed costs to be spread over a steadily larger pool of assets and for variable costs to be negotiated lower.

An open-end fund (such as an ETF or unlisted managed fund) in contrast, requires no commitment from investors. You may enter one day and leave the next. That lack of commitment comes at a cost.

The continuous inflows and outflows of investor funds result in higher administration and distribution costs, while the repeated buying and selling of investments necessitated by those flows incur greater transactional (and ultimately tax) costs for investors.

Investors in LICs have long recognised and valued this cost differential. The largest and most long-lasting listed investment companies are some of the most cost-efficient investment vehicles accessible by retail investors in Australia.

Argo, Australian Foundation Investment Company, Milton Corporation, Whitefield, BKI Investment Company, and Australian United Investment Company offer total operating costs of between 0.13% and 0.42% per annum. These costs are materially lower than most open-end actively managed Australian equity funds, and in many cases are lower than many open-end index funds.

Has the long-term structure delivered material efficiencies in cost for investors? In many cases yes.

Fiction: The myth about premiums/discounts

A common myth promoted by supporters of open-end funds is that all LICs/LITs trade at discounts, which is always bad. Investors are trapped and can’t get out of LICs/LITs.

What is wrong with this?

For a start, it ignores the inherent benefits that accrue to an investor because a fund is closed-end. A closed-end fund creates benefits for investors through cost savings, longevity of management, and the steady building of scale.

Secondly, LIC/LITs are no different to BHP Group, Commonwealth Bank, or any other share on ASX. Investors may buy and sell their shares on market at any time.

The price at which the shares trade will periodically be cheap and at other times expensive relative to underlying intrinsic value. This is the way buyers are matched with sellers without underlying assets having to be sold.

As with shares generally, among the range of LICs/LITs, there will be frequently expensive market darlings and deep-value shares that trade cheaply more often than not.

Thirdly, the buying and selling of a LIC/LIT at a discount or premium is a zero net sum game between the buyer and seller. It has no impact on the return generated on the underlying assets for all other ongoing investors.

Fourthly, LIC/LIT investors will typically take the dynamics of open-market pricing into account in how they invest. Astute investors may choose to invest steadily over time so that short-term fluctuations in premiums/discounts average out.

Astute investors may seek to time their purchases to when the LIC or LIT trades cheaply. Others may simply invest over very long periods, so any premium/discount at a point of entry or exit becomes inconsequential relative to their investment.

In general, so long as the average premium/discount an investor buys in at is similar to the premium/discount they sell out at, they will have not been disadvantaged.

Indeed, financially, investors who buy at a discount and later sell at the same discount will still have achieved a net benefit over the course of their investment due to receiving investment income generated on the higher asset value.

Lastly, there is the failure to recognise that even for a persistently and heavily discounted LIC/LIT, market forces will ensure a resolution for investors.

Opportunities

If a LIC/LIT is trading persistently cheaply, investors have four main opportunities:

1. They can buy additional discounted stock, on which they will be generating a significant uplift in return from the much higher asset backing relative to the share price paid.

2. If the underlying company management and returns are good, the fact that the closed-end fund has retained its capital provides the financial stability to allow the investment manager to continue delivering that good outcome for investors. The consistent strength of return may also result in the discount reducing over time. In an open-end fund, the outflow of capital from short-term investors may well see the investment manager collapse or the fund wound up – to the detriment of all investors.

3. If the discount is the result of a structural flaw, management could seek to resolve the flaw, and see the discount eliminated as a result (for example, if the operating costs were too high, the company may be able to lower them).

4. If the company can neither attract investors nor remediate a flaw, there are further valuable solutions. The company can return capital, and investors would receive the full asset backing. Or the company can be merged into or taken over by a better manager.

Future: Closed-end funds are an important, valuable part of financial markets

New closed-end funds will periodically come to market, just as others will move through periods of corporate change. Good performers will deliver strength of outcome for investors. Underperformers will be under pressure to improve, return capital, merge, or be taken over.

This is a little different to the open-end ETF and managed-fund environment. New funds come, unsuccessful funds are subject to fund outflows and over time are wound up. However, because managed funds are not listed on ASX, these actions occur out of public sight.

But don't expect closed-end funds such as LICs and LITs to suit everyone – they won't.

They won't suit investors with a short-term mindset who want to move in and out of a fund at exactly net asset backing. They probably won't suit unstable investment strategies or unstable investment teams because this volatility may see dramatic shifts in investor buying and selling, or very niche investment strategies that only appeal to a small number of investors.

However, they may suit investors who by committing to a long-term investment, appreciate the benefits of stable, far-sighted management and the lower operating cost that may come from that commitment; investors who wish to invest in long-term assets but require liquidity of investment; investors who recognise that by investing over the long term they can control the impact of short-term price fluctuations; or those who appreciate the opportunity to occasionally acquire shares cheaply.

Sensible investing always requires long-term commitment – something the closed-end structure encourages and embraces. As Warren Buffet said: "If you aren't thinking about owning a stock for 10 years, don't even think about owning it for 10 minutes".

Many hundreds of thousands of LIC and LIT investors understand the truth in this statement and have benefited through the compounding of sound returns over many decades.

It is important for most investors that Australia's financial markets look to encourage long-term investment thinking over the risks and added costs of short-termism.

ABOUT THE AUTHOR

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ABOUT LICAT

The Listed Investment Companies and Trusts Association (LICAT) represents the interests of Listed Investment Companies (LICs), Listed Investment Trusts (LITs) and investors holding over 700,000 interests in one or more LIC or LIT. LICAT represents the LICs and LITs accounting for approximately 75% of the current Australian capital invested in the sector.

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