Getting the edge with managed funds

LICence to trade

The listed investment company alternative

Many investors have become aware in the past year of a boom in new listed investment companies (LICs) seeking to raise money. Get the edge by understanding what they are and when it makes sense to invest in an LIC.

What is a listed investment company?

An LIC is an investment which is structured as a company and is listed on the Australian Stock Exchange. It has shares which are traded like any other share on the sharemarket.

The company's main activity is to invest in a portfolio of investments - such as shares, infrastructure assets and gold companies - according to its specific purpose.

LICs are not new. The best known are Australian Foundation Investments and Argo Investments, which were founded in 1929 and 1946, invest in blue chip Australian shares, and have a long and distinguished history. At $2.9 billion and $2.0 billion in size respectively, they are two of Australia's largest LICs and have produced strong results for many investors.

Types of LICs

Many listed investment companies invest in a diversified portfolio of Australian shares. However there are also successful LICs specialising in other asset classes.

The recent rush of new LICs has included several different types:

- Diversified Australian share LICs.
- Specialist LICs which invest in small companies, international shares, infrastructure assets, gold companies, or focus on geographical regions

Key differences between an LIC and an unlisted managed investment

The goals of an LIC are generally identical to an unlisted managed investment - maximising the overall return, producing a mix of growth and income, and beating the market in which they are invested.

An LIC is a company, while a managed investment is essentially a conduit through to investors. This creates big differences in areas like tax.

For example, when an LIC makes a profit (perhaps by selling some investments for a capital gain), it pays tax at the company tax rate on that profit. It might then pay a franked dividend to investors from those after tax profits.*

When a managed investment makes the same profit, it passes through the entire profit to investors as a distribution, and investors pay tax at their individual rate.

Below we have detailed other differences for an individual investor who is a resident of Australia. For companies, super funds and non-residents, other tax rules apply.

* An LIC can distribute normal dividends (which can be franked, partially franked or unfranked) and dividends that are attributable to a capital gain, know as the attributable part. An individual who receives an attributable dividend may effectively benefit from the capital gains tax (CGT) discount that would apply if the capital gain were made on investments held in their own name. Investors do not receive the CGT discount on normal dividends.

	LIC	Managed Investment
Structure	Company	Trust
Investors hold	Shares	Units
Traded	Buy or sell on ASX through broker	Buy or sell through fund manager
Price set by	Market supply and demand	Fund manager at net tangible assets[1]
Returns	Dividends and share price growth	Distributions and unit price growth
Income tax	Profits taxed at 30%	Investors receive returns untaxed
Capital gains tax[2]	50% discount may effectively apply if asset held for 12 months or more	50% discount may apply if asset held for 12 months or more

1. Net tangible assets in a managed investment are calculated by dividing the value of the trust by the number of units on issue.
2. Discount available on dividends that are attributable to a capital gain.

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Premiums and discounts

One of the most important concepts to grasp is how the price of LIC shares is set in the market. It's easier to think about this by looking at managed investments first.

The unit price of a managed investment is set by the value of the fund. The fund manager simply divides the value of the portfolio by the number of units on issue, and comes up with the net tangible asset value (NTA) of each unit. That NTA then becomes the price at which the fund manager will issue and redeem units (perhaps with a very small allowance for transaction costs). You always get the underlying value:

Portfolio value	Units on issue	NTA per unit
$10,000,000	5,000,000	$2.00
$11,000,000	5,000,000	$2.20

However, the bottom line for an LIC is that the share price is set like any other company share - by the supply of shares offered by sellers and the demand for shares from buyers. Sellers and buyers make up their mind about what they think the LIC is worth and place their orders accordingly.

The market price will not necessarily be the same as the NTA of the shares. Often it will be similar, but market forces can drive prices well above (ie a premium) - or well below (ie a discount) - NTA for extended periods of time. You cannot always trade at the underlying value of the shares; in fact premiums and discounts of up to 20% are not uncommon. Taking Australian Foundation Investments as an example:

Date	Price	NTA	Premium / (Discount)
30/9/01	$2.60	$2.66	(2%)
29/2/04	$3.26	$2.97	10%

Source: ASX

As a general rule, LICs tend to trade at a discount when markets are poor, and at a premium when markets are rising strongly.

So not only do LICs have the normal volatility of their asset class, they have additional volatility as their share prices fluctuate over time between a premium and a discount to underlying value.

Liquidity

Investors in a managed investment, subject to fund liquidity, are able to redeem some or all of their units back at any time they wish. The LIC investor has to find a willing buyer before they can sell their holdings on the stock exchange. Furthermore they often need to sell a large parcel due to minimum brokerage charges.

Lack of liquidity and underperformance of an LIC manager or the market, conspire to make it difficult for an investor to redeem at fair value from an underperforming LIC.

Fees

Traditionally LICs have had lower fees than managed investments; for example Argo Investments has annual fees and expenses of just 0.2% pa compared to a managed investment which might be 1-2% pa. This is not always true of the newer LICs though; many have performance fees which can result in high fees if performance is good.

Should I invest in an initial offer?

This can be a very difficult decision. The attraction is that an initial offer may allow you to invest with a top manager who is normally hard to access, before the shares trade at a premium.

There are two potential problems:

1. Investors will typically be paying for fund raising expenses; for example shares issued at $1.00 might have a NTA after initial expenses (including upfront commissions) of $0.98 or less.
2. The shares might trade at a discount after they are listed on the stockmarket, suggesting that an investor might have been better off waiting (of course if everyone waits then the initial offer will fail!).

Experience has shown that most of the new LICs have tended to trade at a discount after listing.

LIC or managed investment?

The right answer - LIC, managed investment, or both - will depend on your individual circumstances.

Managed investments are generally a simpler investment to deal with, if only because you always buy and sell at the underlying value.

LICs can appear cheaper, but it's important be able to calculate whether they are trading at a premium or discount, and understand the impact of other securities an LIC might have on issue, such as options.

Your financial planner can help with this decision. At the end of the day, the choice between investment structures is about how best to get exposure to the right investment strategy.

If you need help finding a financial planner, IFSA's *Six Easy Steps* can help.

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