Why we should be wary of listed investment companies

WILL HAMILTON

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Listed investment companies (LICs) and listed investment trusts (LITs) have attracted considerable criticism over the last few months — much of it justified.

In their May 2019 review of the sector, Zenith Investment Partners emphasised that $4.7 billion was raised through these structures in 2018. This has continued into 2019 with $945 million raised during the first four months of this year.

I last wrote on LIC and LIT products back in October 2016, noting their attractiveness to fund managers, but expressing concern around their product structuring.

My issue with these structures is that they have essentially become vehicles for raising funds by fund managers rather than being considered as a correct fit for an investor's asset allocation.

Moreover, new listings in this area keep on coming.

As closed-end structures, LICs and LITs are attractive to fund managers. Managers can take a medium-term view when overseeing a portfolio without redemptions and subscriptions included.

In other words, the portfolio size is stable due to the closed end structure, hence their popularity.

In fact, it is fair to say that the demand for these products has come predominantly from stockbrokers. It has occurred as clients try to diversify away from purely Australian equities and cash. Of course since 2017, LICs may also be used to offer global shares and there has been growth in international equities and fixed income through these structures.

One of the important disciplines in constructing a portfolio is about achieving both balance and diversification within and among asset classes. This is set according to an investor’s objectives and their appetite for risk.

Diversification should enhance returns over the long term and help to manage though not eliminate the risks that are inherent in investing.

And so, it is not about buying a product simply because it is offered. Every product must fit a portfolio and be allocated within its asset class appropriately.

Zenith’s review highlights some points not discussed before One of the key points is that LIC products at times trade at a material discount to their underlying asset value. This raises the question about what will happen in periods of market turmoil, a serious issue for management particularly if discounts become deep and persistent.

Among the points the Zenith May 2019 report highlights as relevant to assessing LIC/LIT risk include:

● LICs and LITs need to quote portfolio performance net of fees as managers don’t operate at zero cost

● Managers need to provide clearer investment objectives and greater transparency with regards to return expectations and the risk in the underlying products

● Inconsistent reporting of franking credits between managers, and

● More detailed monthly performance, not simply an NTA within 14 days as per the minimum requirement.

As the points above illustrate, LICs/LITs in their current form lack overall transparency for you the investor.

One of the key selling points for these structures is their liquidity.

Stockmarket sentiment can move an LIC/LIT share price independently of its net tangible assert backing (NTA) which is how an investment can trade at a premium but lately at a discount.

Open-ended structures, for instance, have redemptions and subscriptions at NTA less a minor buy — sell spread — as a result they more accurately reflect the underlying value of your investment.

I find it surprising that liquidity is often used as a benefit to sell LICs/LITs, as liquidity in stockmarkets is a function of whether there is a buyer and what he/she is prepared to pay.

Open-ended structures are liquid except in the cases of extreme stress when a product could become “locked up”.

Note that with all listed products liquidity is only to the point of where a buyer exists.

Fees are always an important issue and as an LIC or LIT investor you are beholden to the fees that are built into a product. These are not negotiable.

In a recent note, Paul Heath the chief executive officer of Koda Capital, pointed out that his concern with LICs was that in investing in them, those responsible for protecting their clients’ interests are advisers who are (because they are an approved capital raising being paid for by the product issuer) therefore conflicted.

Heath goes on to suggest that any payments of sales commissions to promote a product that “contaminates clear-eyed and independent advice should be seen as just that”.

I agree when he says: “This sort of advice is completely compromised and utterly incompatible with the intent of FOFA.”

To make my position clear, I do not blame fund managers for looking at issuing LICs and LITs as they do create fee-generating funds for these managers.

However, investors must take a caveat emptor approach and consider the pros and cons. They need to make a judgment as to whether these products are in their best interest.

Will Hamilton is the managing partner of Hamilton Wealth Management, a Melbourne-based wealth manager.

will.hamilton@hamiltonwealth.com.au