Investors pushed into risky listed funds

The share price collapse of Dixon Advisory's US property fund and the L1 Long Short Fund have triggered calls for regulators to crack down on advisers selling listed investment companies.

John Kehoe*Senior Writer*

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Financial advisers are warning a regulatory "loophole" is being exploited by other advisers who are being paid lucrative commissions to sell risky listed investment companies to retail investors and self-managed superannuation funds.

The share price collapses of Dixon Advisory's US property fund and Melbourne hedge fund L1 Capital's LIC, both listed on the Australian Securities Exchange, have triggered calls for regulators to crack down on advisers and brokers selling LICs and listed investment trusts (LITs).

The LIC market has rapidly doubled to $45 billion since 2014, when the Coalition government watered down Labor's Future of Financial Advice (FOFA) laws to allow advisers and brokers to resume receiving commissions for selling listed securities.

FOFA was intended to end conflicted remuneration for financial advisers, but some advisers are receiving commissions of up to 3 per cent to sell LICs and LITs to mum and dad investors.

The low-interest rate environment has enticed some investors to chase higher yielding and riskier investments, while they are also seeking to diversify beyond domestic shares.

LICs in recent years have become more exotic beyond traditional listed shares to include hedge funds, private equity, direct loans and junk bonds.

Adding 'petrol on to the fire'

Sydney-based Core Private Wealth director Trevor Geffin said the selling of LICs in return for commissions was "simply not in the spirit of FOFA".

“The conflict of interest is pretty clear and the sheer size of the commissions is adding petrol on to the fire,” he said.

“I’ve actually seen how they are marketed and mums and dads are not going to appreciate the risks in these structures.”

A LIC is an ASX-listed company set up to invest in a portfolio of securities, managed by an investment manager.

Gold Coast-based Cervus Private Wealth adviser Adam Miliszewski said there had been some successful LICs such as the Australian Foundation Investment Company and Argo Investments, but “in the last 12 months there has been a lot more listed investment companies get rolled out with higher ongoing costs and performance fees.”

“You have to wonder why commissions need to be offered to advisers who have a duty to act in their clients best interests,” he said.

“With LICs, there are not only investment risks to consider but structural risks with the price of the LIC able to deviate significantly from the value of the underlying investments.”

Doubling of LIC market

The size of the LIC market on the Australian Securities Exchange has surged to $45 billion, from $24 billion in 2014.

The number of LICs and LITs doubled to 114 over the past five years.

More than half of LICs were trading at a discount of greater than 10 per cent of their pre-tax net tangible asset value as of May 31, according to an *AFR Weekend* analysis of Morningstar data.

A LIC raises a fixed amount of capital and its shares are traded on the ASX.

The L1 Long Short Fund listed in April 2018 and raised $1.35 billion from investors.

Its share price is down almost 30 per cent since inception.

Dixon's beleaguered ASX-listed LIT, US Residential Masters Fund, which invests in New York and New Jersey properties, is trading at about 40 per cent below the value of its net tangible assets.

'Racy' fees

Argo Investments managing director Jason Beddow, who leads the 71-year-old LIC with $5.8 billion in capital, said some newer LICs were charging relatively high fund management fees and that the commissions to sell them were a potential conflict.

"There is a financial incentive or maybe a conflict with an adviser pushing these LICs to their retail clients," Mr Beddow said.

"We think some of the fees are pretty 'racy' in the LICs coming to market."

Listed Investment Companies & Trusts Association chief executive Ian Irvine, who advocates for the sector, said financial advisers were increasingly using LICs and LITs on the ASX for their clients to diversify beyond local equities such as banks and miners.

He rebutted criticisms that commissions were causing advisers to over-allocate their clients into riskier LICs.

"The overriding principle and legal requirement for advisers is to act in the best interests of their customers," Mr Irvine said.

LICs and LITs can trade at a significant discount or premium to the net asset value (NAV) of their underlying investments, in contrast to traditional managed funds and unit trusts where investors can cash out at very close to the NAV of the fund's assets.

Permanent capital

The closed-end funds offer permanent capital to fund managers because they are not subject to redemption risk from investors, who must sell their share holding on the stock market to another investor.

Fund managers can “lock in” the capital, unlike exchange traded funds (ETFs) and traditional managed funds, which are usually open-ended and are subject to the discipline of investor inflows and outflows.

Koda Capital chief executive Paul Heath said advisers were selling LICs and receiving conflicted remuneration due to a FoFA “loophole”.

“The Hayne royal commission report said too often when there is a conflict between duty to the client and self interest, self interest won,” Mr Heath said.

“As long as industry participants seek to exploit these loopholes, ‘restoring trust’ is just words on a page.”

Mr Heath said LICs had several structural problems for mum and dad investors.

First, the capital is permanent so the normal discipline of client inflows and outflows, subject to investment performance, don’t apply.

“Once the money is raised, it’s raised,” Mr Heath said.

Second, there can be a disconnect between the market price of the LIC and the underlying performance of the fund manager. Often LICs trade at a discount to the fund’s net asset value.

“Once you start to go to a negative NTA, a negative spiral is created and it’s almost impossible to stop,” Mr Heath said.

Third, there is a lack of liquidity in the LIC market due to a limited pool of buyers and sellers.

Fourth, there is generally no independent broker research on LIC listings and there is a lack professional investors to ensure accurate “price discovery”, Mr Heath said.

LICs have become a popular vehicle for fund managers and stock brokers, who have come under commercial pressure from the rise of ETFs and tougher financial regulations.

Wilson Asset Management founder Geoff Wilson, who manages six LICs worth $3.2 billion, said LICs did not pay trailing commissions and it would be unfair to ban sales commissions if they were allowed for initial public offerings (IPOs) and capital raisings.

"It would be illogical to single out listed investment companies," he said.

A counter view to that is that IPOs and capital raisings inject new money into real companies to grow. LICs are an investment product or strategy, not really an operating business.

The Abbott government amended FOFA to allow stockbrokers to collect so-called "stamping fees" from companies for selling listed securities.

Mr Wilson said ending sales commissions for LICs would prevent new LIC competitors entering the market, which could help incumbents like Wilson Asset Management.

Geoff Driver, general manager of the biggest and oldest listed investment company, the $7.3 billion Australian Foundation Investment Company which was founded in 1928, said investors liked its sustainable and rising dividends so were prepared to pay a slight premium.

Mr Driver said it was "fairly standard practice" for LICs to pay a commission or stamping fee to advisers and brokers selling the investments to investors.

"Some of the newer LICs have high fees so performance justification is essential," Mr Driver said.

AFIC has an ultra-low fee of just 0.14 per cent a year, with no performance fee.

Will Hamilton, chief executive of Hamilton Wealth Management, said mid-tier brokers were conscious that investors wanted to diversify beyond Australian equities so were putting clients into LICs.

"I'm dubious as to why they're being sold," he said.

"There are some good old-fashioned LICs out there like AFIC and Argo that are stable and run on minimal management expense ratios.

"But people who are being sold LICs should remember it should fit properly in a portfolio according to your risk profile."

FOFA watered down

The FOFA laws were enacted by Labor in 2012 to ban conflicted remuneration such as sales and trailing commissions for financial advisers for selling financial products.

Equities were carved out so brokers would help companies raise capital via IPOs.

LICs and LITs were originally captured by FOFA, because they are not operating businesses but an investment strategy.

But in 2014 the Coalition government exempted LICs and LITs.

In the past, when LICs listed on the ASX, investors paid the fees to list and the LIC would trade at a slight discount when it was floated.

Under FOFA, it is technically not permissible for the customer to pay the commissions.

So as a work around, fund managers began paying commissions to brokers to sell LICs and LITs to retail investors and SMSFs.

A limited number of advisers have rebated the commissions or so-called stamping fees to clients, to avoid conflicted remuneration problems.