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Listed investment companies: fact, fiction and future

Angus Gluskie

There has been much debate in the press of late about listed investment companies (LICs). The LIC and trust sector contains some of the largest, lowest-cost, most reliable, trusted and long-lasting investment vehicles that can be accessed by both retail and sophisticated investors.

However, some of the myths about listed investment companies need to be dispelled, and other facts made, highlighting why the sector continues to represent opportunities for long-term investors.

Fact: There is a structural benefit to an investor from long-term thinking

When a LIC or trust raises a block of capital, it takes on a responsibility. Management must think deeply, plan carefully and implement their 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 LIC 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, that is, short-termism—the chasing of short-term investment returns and the chopping and changing of management and strategy—is almost certainly a way to lose money.

The oldest listed investment company in Australia, Whitefield, is 98 years old. Argo is 75 years old, Australian Foundation is 93 years, Australian United is 68 years, Milton is 71 years and WAM Capital is 24 years old. 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 same companies, spread across their different investment strategies and market segments, have delivered returns that range from 8.9% to 17.6% p.a. since 2000. As a further guide to the benefit for an investor of the compounding of consistent returns, an investment of $10,000 in Whitefield in 1970 would today be worth more than $2,700,000 after the payment or provision of all company tax and assuming the reinvestment of dividends.

Those outcomes represent underlying returns which either equal or exceed their respective benchmarks over long periods across or within those timeframes.

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

Fact: A long-term approach results in cost savings for the investor

Investors in closed-end funds make a commitment. They agree to contribute capital in a single, coordinated capital raising, and they agree to commit that capital for the long term. There are two potential cost benefits that 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 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 exchange-traded fund (ETF) or unlisted managed fund, in contrast, requires no commitment from investors. A person 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 incurs 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 to 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% p.a.

These costs are materially lower than the vast majority of open-end actively managed Australian equity funds, and in many cases are lower than a good 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

There is a commonly peddled myth that is promoted by the supporters of ETFs and unlisted funds. The myth goes like this. All LICs and listed investment trusts (LITs) trade at discounts. A LIC/LIT trading at a discount is always bad. Investors are trapped and cannot 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-ended. A closed-end fund creates benefits for investors through cost savings, longevity of management, and the steady building of scale.

Secondly, LICs/LITs are no different to BHP, CBA or any other share on the stock exchange. 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 in which buyers are matched with sellers without underlying assets having to be sold. As with shares generally, amongst the range of LICs/LITs there will be market darlings that are frequently expensive and there will be 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 whatsoever 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. Very astute investors may seek to time their purchases to when their preferred LIC or LIT trades cheaply. Other investors may simply invest over very long periods of time, so that 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 that an investor buys in at, is similar to the premium/discount that they sell out at, they will have not been disadvantaged. Indeed financially, an investor who buys at a discount and later sells at the same discount will still have achieved a net benefit over the course of their investment due to the receipt of 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 there is a resolution for investors. If a LIC/LIT is trading persistently cheaply, there are several opportunities for investors:

1. Investors 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 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 returns 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 (e.g. 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:

a. The company can return capital, and investors would receive the full asset backing.
b. The company can be merged into or taken over by a better manager.

Future: Closed-end funds will not suit everyone, however, they represent an important and valuable part of financial markets

There will periodically be new closed-end funds coming to market, just as there will be other closed-end funds moving through periods of corporate change. Good

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performers will deliver strength of outcome for investors. Underperformers will be under pressure to improve, return capital, merge or be taken over.

This is little different to the open-end ETF and managed fund environment. New funds come, unsuccessful funds are subject to outflows and, over time, are wound up. Because they are not listed on the Australian Securities Exchange, however, these actions are occurring out of public sight.

But do not expect closed-end funds such as LICs and LITs to suit everyone—they will not.

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

However, they may well suit an investor who, by committing to a long-term investment, appreciates the benefits of stable, far-sighted management and the lower operating cost that may come from that commitment. They may suit an investor who wishes to invest in long term assets but requires liquidity of investment. They may well suit an investor who recognises 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 that 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 trust investors understand the truth in this statement and have benefited through the compounding of sound returns over many decades.

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