Slick LICs

Dominic McCormick | Select Asset Management | 12 September 2014

IPOs of listed investment companies (LICs) have continued to come to market in recent months. There have been at least a dozen since early 2013 with several more in the works, covering an array of underlying asset classes and strategies with some well-known fund managers behind some offerings.

However, as with most cycles of enthusiasm for the LIC structure, there are also reasons for caution regarding some elements of this wave of IPOs. Having said this, we are certainly still far from the zany levels reached pre-GFC where billion dollar cash boxes were launched with little clarity as to where they would invest.

Along with this flood of LICs there seems to be a new narrative being created by the media and promoters that LICs "normally" trade at premiums to Net Tangible Asset Value (NTA). To the casual observer or unsophisticated investor, this seems plausible given some of the larger and more prominent LICs have now traded at premiums for several years. However, it is clearly false to anyone with a sense of history in this area, especially the smaller and mid-sized LICs. Still, this widespread belief makes investors comfortable buying LICs at a premium to NTA in the IPO (because of the impact of IPO costs). This faith in sustained premiums will fade but it's unclear when. Already, a number of recent floats have drifted to modest discounts, although unexpired options complicate the story a little. We explore this further below.

While there is little doubt there is strong current demand for LICs, the problem is that the supply of them can be increased relatively easily. Funds trading at premiums can and do issue more shares in placements and rights issues and new funds are manufactured and sold as IPOs. This is not some unique industrial business that cannot be replicated. Indeed, there is a clear multi-year LIC cycle that benefits from the short memory of many investors, advisers/brokers and the media.

What are the elements of that cycle? The main features are:

1. It starts with a positive equity market environment where investors are keen for listed market opportunities.
2. Most prominent LICs are trading around NTA or at premiums.
3. Brokers are looking for something to sell and LICs are an easy target, generally focused on some increasingly popular themes (e.g. the global story) or gimmicks (e.g. “free” 1 for 1 options at the IPO price).

4. New funds launch – listing at a premium to NTA given the impact of issue costs.
5. Fund NTA growth early on is often slow given the easy market gains may already have passed.
6. Impatient investors become disappointed and begin selling and the fund moves to discount to NTA.
7. "Free options" also contribute to this cycle by constraining secondary demand for the ordinary shares.
8. Brokers accentuate this by using the sale of LICs as a source of funds for other, more exciting, investment ideas.
9. Selling leads to self-reinforcing cycle of weaker share price -> larger discounts -> perception of poor performance -> weaker share price -> larger discount, etc.
10. Arbitragers come in and begin buying up funds at discounts to NTA putting pressure on boards/managers to narrow discounts or wind up/return capital to investors.

Here is another simple way to think about "investing" in an LIC IPO. Suppose you are considering investing in a managed unit trust run by a manager you like and strategy you know. But, you are then told that you have to pay an upfront fee of around 3% to 4% (some going to the sponsoring broker/investment bank, some to individual brokers/planners, and some to cover other costs of the launch, legal, marketing, etc). So you now have invested $1 that is now worth 96 to 97 cents. But then you are told that instead of being able to redeem whenever you want at this 96 to 97 cent NTA or whatever it happens to be on a particular day, the price you receive will vary – it could be higher than or it could be lower – but, over time, it is likely to be lower. (Let's ignore any option impact for now). Therefore, even without the NTA changing from the 96 to 97 cents, there is a possibility your "redemption" or sale price could be 90 cents or even 80 cents or lower. Discounts of 30% to 50% for LICs are not impossible, particularly at times of major market stress. Of course, at any time, it could be worth more than the NTA (as is the case for many now) – but relying on this for the long term does not make sense.

Of course, it is not that simple. It's complicated by the fact that both the underlying NTA and the discount/premium are moving variables. Moreover, LICs are company structures so taxation arrangements and the way return is delivered is different to a unit trust.

And what about the "free" attached option, you might ask? Doesn't that make a LIC IPO much more attractive? Unfortunately, a 1 for 1 option at the IPO issue price (say $1) is not free. Its cost relates directly to the potential for the options to cut the upside on your ordinary shares' NTA in half above the $1strike price up until those options expire or are exercised.

One interesting development in one current offering – Global Wealth Partners – and some other proposed offerings is an arrangement where the options are only issued if the shares are held a certain period (in this case, six months). This is certainly innovative, although I'm surprised the ASX would support this structure which in theory seems to discourage any trading in the ordinary shares for that first six months. Specifically, it does not seem in the interest of any IPO investor to sell their shares and lose the right to the option unless the share price fully compensates the seller for the inherent "value" of that option - in which case, it doesn't make sense for the buyer to buy because they won't receive that option. Of course, the market is often far from rational and it will be interesting to see what level of trading takes place and at what prices.

More generally, an important issue with LICs is the sometimes onerous management contracts that guarantee fees to the manager for five or 10 years, irrespective of NTA or price performance and which, in some cases, pay out the manager part of the fund if they are terminated before that period.

Further, apart from the upfront costs of launching the IPO, there are ongoing costs which in some cases are less clearly disclosed compared to a unit trust structure. Some of these costs are more explicit and additional compared to a unit trust such as the costs of the Board. It is interesting that in the case of Global Wealth Partners, David Koch is being paid $125,000 a year to be Chairman. While not large in the context of larger operating companies, this is a very hefty fee for a mid-sized LIC. Don Stammer's fee for chairing the recently listed QV Equities is a more standard $50,000 per annum. I also find it surprising that this $125,000 chairman is currently doing a US road trip for his Channel 7 morning show "Sunrise" in the midst of the local fund raising. Perhaps he is also visiting the fund's underlying hedge fund managers?

The growth in the number of LICs is a positive development for Australian investors. Along with the growth of ETFs and easier access to managed funds through the ASX mFund platform, the ability to build robust portfolios across all asset classes and strategies using a mix of these vehicles is growing. However, LICs and particularly new LIC IPOs, offer some unique challenges and complexities that many investors seem to be neglecting. Larger and sometimes opaque cost and fee structures, potential option dilution, fluctuating discounts and premiums to NAV, and complex management arrangements make LICs a more complicated investment decision. However, that is certainly not the way they are marketed.

LICs offer an interesting vehicle as a way to access some quality managers and asset classes and strategies - but blindly ploughing money into LIC IPOs without deeper consideration is not the way to maximize the benefits of this fund structure. More patience and discipline is required.

Dominic McCormick is Chief Investment Officer and Executive Director of Select Investment Partners. Dominic has worked in investment management and financial services for 27 years and co-founded Select Asset Management in 2002. He has overall responsibility for investment strategy and research for Select's range of multi-asset, multi-manager portfolios, investing across the spectrum of traditional and alternative investments.