Transcript

The Ideas Exchange
Episode 4: Getting to grips with Listed Investment Companies and Trusts (LICs and LITs)

May 2021

Voiceover [00:00:02] Welcome to the Monthly Ideas Exchange podcast brought to you by ASX, The heart of Australia's financial markets. Each month we'll connect you to a range of leading industry experts who'll give you a look into the finance industry and deliver valuable insights. Hear about important market events, industry research, tips for your own market research, as well as innovative products to help you diversify your investment portfolio. Your host, Martin Dinh, has a passion for all things investing and is a major player in the investment product game, having assisted in the release of over 150 investment products since 2013 with ASX. Join him as he explores investment opportunities beyond just shares from ETFs, REITs, LICs, mFund and much more.

Martin Dinh [00:00:59] Hi everyone and welcome to the Ideas Exchange Podcast by ASX. I'm your host, Martin Dinh, and in today's episode, we'll learn about one of Australia's oldest listed investment structures, namely, listed investment companies and trusts. As of the end of March 2021, listed investment companies and trusts had other 53 billion dollars in assets, covering a wide range of asset classes such as global and domestic equities and fixed income strategies. Today, I'll be joined by Ian Irvine, CEO of the Listed Investment Companies and Trusts Association, as we chat about what they are, some of the benefits and risks to consider and how they can help you meet your investment and financial goals. So sit back and join me and Ian as we explore the world of listed investment companies and trusts.

Martin Dinh [00:01:47] Hi Ian, welcome to the Ideas Exchange Podcast. It's great to have you here today.

Ian Irvine [00:01:51] It's great to be with you, Martin.

Martin Dinh [00:01:53] In the last few episodes, we've talked a lot about exchange traded funds, so I thought this would be a great time to cover another ASX listed investment structure that we've not yet covered, namely, listed investment companies and trusts, short for LITs and LICs. An interesting fact that not many people might know is that listed investment companies and trusts are one of Australia's oldest investment structures that have been helping investors build wealth for many, many decades. I believe they've been almost around for 100 years. Is that right, Ian?

Ian Irvine [00:02:25] Coming up in 2023, Martin, we'll celebrate our centenary. So, just entered the 98th year of continuously delivering this closed end structure for Australian investors to grow and create their wealth, as well as improve the values of their portfolios and derive income from those portfolios.

Martin Dinh [00:02:41] Now, just to give our listeners a bit of context, exchange traded funds have only been around for 20 years. I don't think there are that many listed or investment structures in Australia in general that have been around as long as listed investment companies and trusts. Is that right, Ian?

Ian Irvine [00:02:59] That's definitely correct, Martin. In fact, I would say that listed investment companies were the first to realise the opportunities that an exchange provides on two fronts. Firstly, to raise capital in an efficient way, as well as to distribute product to retail investors in an equally as efficient way. So trading on market between other buyers to sellers and sellers to buyers.

Martin Dinh [00:03:18] So, Ian, for those that are not too familiar with what they are, can you help us understand what they are, but also maybe outline some differences, how they differ from other investment structures, such as exchange traded funds and other types of managed funds?

Ian Irvine [00:03:34] Managed funds in general? Yeah, firstly, we refer to listed investment companies and trusts as a closed end structure, just like any other shares or trusts listed on the exchange. So there's a finite number of shares on issue at any point of time, and a listed investment company or trust will raise capital as and when it needs it. So, for example, establishing a listed investment company or trust through an IPO, so you would go to the market, raise the capital as I mentioned in a most efficient way in a block, as you need it. And then you'd bring it on to market and you'd trade it in the secondary market. So they also realise that retail investors can access that capital and trade with other investors. So firstly, how they are structured and how they raise capital is a primary difference. They're also subject to the ASX and corporation's rules, as is any other share, and you'll hear me say that a number of times as we go through our discussion. But they are just regulated in the same way by ASIC, and the ASX listing rules provides another layer of supervision and regulation for listed investment companies and trusts. Now, boards. So listed investment companies have boards of directors, they hold AGMs, they deliver market information through continuous disclosure obligations under their listing rules, as do LITs. The structure in terms of the governance around an LIT is slightly different. They use what's referred to as a 'responsible entity' to govern the structure and the administration in the day to day goings on of the trust. But they both provide what we refer to as 'active management'. So they're an active style of manager, but they're patient with their capital. Patience with how they use their capital in a wise and considered way through an investment committee in many cases. They seek to do better than the market being an active manager. But you need to understand, when you look at a particular LIC or LIT what benchmark they're measuring themselves against, not everything is measured by an index necessarily. And not everything, in fact, is measured by the ASX 200 index, which we hear a lot about. A lot of ETFs do use that index. So be careful when you start to make comparisons between one structure and another. Effectively, when you invest in an LIC or trust, you obtain proportional ownership of the underlying investments that that structure holds, an LIC or trust holds. You become an owner. Therefore, it's just like buying a bank or a minor in that regard. Now you asked for some of the differences, some of the differences between the Closed-End structure I've just described for an LIC and an LIT. Take ETFs, for example, or managed funds. These are open ended funds, so, there's no specific amount of capital on issue at a point in time, and in fact, funds or capital flows in and out of ETFs and managed funds depending on investor demand. So you make an application to the manager for new unit if you want to invest or you make application back to the manager to redeem an investment and then they cancel units to give you your money back or issue new units to meet your demand and request to grow. The difference there is that as that money flows in and out, the ETF manager or the managed fund manager is required to invest that money according to the strategy or in the case of an ETF, which is the vast majority of ETFs in Australia, if they're following an index to invest in that index, which means there's an obligation to invest in rising markets, as well as sell down falling markets to meet investor demand. New units in a rising market could see value overestimated. Having to sell new units because investors wish to redeem their funds in a falling market means you could be selling out of a longer term opportunity where there could be greater value in the future. So simply put, in the case of an open ended fund, you're dealing with the manager. In the case of a closed in fund such as an LIT and LIC, you're dealing with another investor in the market and you trade in real time on market during ASX trading times.

Martin Dinh [00:07:09] And what about the fees that are typically associated with listed investment companies and trusts? What can investors expect to pay?

Ian Irvine [00:07:18] Well they range, there's a variety. So again, we'll come back to this a little later, I'm sure. But one needs to do their research to determine if this is right for you, and fees and costs is always a consideration. But I stress, its fees and cost after performance. They look at the return first. How much am I paying for this and what's the construct of the fund? Is it a reasonable fee or management expense ratio to pay to the manager? So management expense ratio is a term that's used to describe the monies that a manager will recoup for their work. And this includes the work they do about being an active manager in the case of an LIC, in determining investment decisions, implementing those decisions and making the right judgements on behalf of their owners or investors. They do range. So if it's a large fund that's holding a basket of Australian equities, it can be relatively low in terms of their management expense ratio, what the manager actually charges, as opposed to if I'm investing overseas and there are a number of listed investment companies and trusts that invest in global equities, if you're investing overseas, there's a lot more work to be done. So the fees naturally would be a little higher, even if the returns are not higher than your Aussie equity portfolio, you may have decided that you need global equities in your portfolio. So a well-managed LIC actively making those buy, sell hold decisions is worthwhile. And then the last category is fixed income, just lumping them into three; Aussie, global, fixed income. Where managers actually are more actively involved in choosing a combination of bonds or being involved with corporate debt and making small to medium sized loans to corporate Australian companies. And there's a lot more work to be done there. So you need to understand the work the managers doing, what they're being remunerated for after their performance to make sure that it's right for you both in terms of the net result, as well as where this fits in a balanced portfolio that you're constructing.

Martin Dinh [00:09:01] What about minimum investment amounts? How much does an investor have to put in to get access to a listed investment company or trust?

Ian Irvine [00:09:08] Well, this is pretty much down to the stockbroker you use, be they online or a full service direct broker. I think there's usually a minimum for initial investment of around 500 dollars, the benefit of choosing such a small amount, if that's the way you want to put your foot into the pond, so to speak, with the listed investment company or trust, you're getting exposure to an underlying group of other investments. So for a relatively small amount, I'd suggest 500 is a nice starting point for a very young investor. But a couple of thousand to five thousand dollars may be more appropriate for other investors as they mature and understand a little bit more about what they're investing in. So relatively easy to get in. But the great news is, doesn't matter the amount of money you invest, you're investing in a diversified portfolio in the category in which you're choosing to invest, be that a combination of Aussie equities, global equities, as well as fixed income.

Martin Dinh [00:09:55] And based on all your interactions with retail investors, SMSF trustees and financial advisors, what are the main reasons why they choose to incorporate listed investment companies and trusts into their portfolios?

Ian Irvine [00:10:10] So, you get active management as opposed to passive. Passive is exactly what an ETF does, attracts an index. So you've got an active manager firstly, acting on your behalf in a professional way, usually as part of an investment committee decision on whether to buy, hold or sell to keep in the portfolio. The difference between the two types of structures is an LIC, for example, is a company. So a company making a profit in Australia, pays tax in Australia, can retain those profits on its balance sheet along with the franking where it's paid tax. That's a real benefit for the future because it sits on the balance sheet until the manager decides there's a need for it. With regard to listed investment trusts, like other trusts, including ETFs or managed funds, they distribute all of their income each year so they can't easily retain capital. However, many, if not most of the LITs listed on the ASX, they have what I'd refer to as an underlying cash flow asset base. So these are bonds, corporate debt, where there's a regular flow of income. So the bond is paying a coupon on a regular basis, quite often monthly. The corporate debt is small to medium sized Australian corporate entities, is actually making a loan and receiving an interest payment, that comes in each month. So it makes sense for that to be distributed as received. And with the closed end structure of the listed investment company or trust to continue to make those payments, they don't need to sell down the capital they have or actually call in some of those loans, for example. So that gives both sides of the equation confidence. That's the real nuts and bolts of what makes the difference between open and closed end and the benefits for investors.

Martin Dinh [00:11:40] And what are some of the unique features of the listed investment companies and trusts that investors should be wary about before buying into one?

Ian Irvine [00:11:49] To be wary about? Well, I'm very positive on all their features and benefits. But I think when you say wary to know what they're investing in, and this is when we talk about know your structure. So don't make the same comparison between an open ended fund and a closed end fund. They are different. They serve different purposes and they match up better with different types of investors. So if you're an income investor, I mentioned earlier about the ability to retain income paid out over future period and stream and steady that income as it passes out to investors, I think is a real benefit. To actually be able to invest across a range of asset classes in a closed end structure and deliver the strategy. The strategy itself. So we often talk about, you invest for the medium to long term, held within these closed end structures is a medium to long term strategy. So the manager has time to actually implement those strategies, and sometimes over asset classes that wouldn't be easily available to retail investors such as small or mid or micro-cap stocks, which are available on the ASX, but not too many investors go there in a direct sense. So it's very handy to have a professional manager doing that for you. Private equity and the corporate loans I've mentioned earlier on, are all things that retail investors don't actually get easy access to, and others include infrastructure. It's nice to be able to parcel that up in an active managed closed end structure for all the benefits we've talked about earlier.

Martin Dinh [00:13:10] Am I also right in saying that because the structure is closed ended, i.e. they have a fixed amount of capital, I think investors may need to be wary that when they buy or sell or add a unit or a share, they do need to find another investor who's also willing to buy or sell that share. And, I think sometimes the value of the underlying investments of the listed investment company or trust, i.e. the net tangible asset or the NTA, it can sometimes be higher, i.e. a premium or lower, a discount, than the price of what other investors are offering, just like any other listed company. Is that kind of the right way to look at it, Ian?

Ian Irvine [00:13:49] Well, I think you said the magic words, just like any other listed company or listed trust, they're all closed end and therefore they trade a lot on sentiment and a view that one investor has as opposed to what the other investor has. And the equation is very simple. For every seller, there's a buyer. For every buyer, there's a seller. Now, if someone takes a view that they're investing for the long term and they're willing to pay a little bit more than the value of the underlying, so they'll pay the premium, but they're paying that premium for a reason. The alternative is some investors are willing to sell out at a little less than what the investment is for any range of reasons. And this happens not just on the stock market, but in any market where there's tension between buyers and sellers. People have different reasons for wanting to sell, so they may be selling an investment to take the cash out. They may be selling down part of that investment to reinvest into other asset classes, to rebalance their portfolios. So like any share where there's a lot of work done by brokers to work out what's the true value of mining stock or bank or a retailer, with regard to listed investment companies and trusts, they actually tell the market, at least once a month, what their underlying value is. So investors are quite often more directly and better informed about the underlying values of LICs and LITs than they are with other shares or trusts where sometimes it's a broker's opinion.

Martin Dinh [00:15:06] Now we know that listed investment companies and trusts, they can trade at a discount or premium, due to the fact that they do have a fixed amount of capital, and you mentioned some reasons that they can be temporary mismatches between demand and supplies. But in your opinion, are there any sort of other sort of drivers that might cause listed investment companies or trusts to trade at a persistent discount or premium to its NTA that maybe investors should be aware of?

Ian Irvine [00:15:32] Yeah, look, there's no silver bullet for discounts and premiums. As I mentioned, it's a thing. It's not a good thing. It's not a bad thing. It's a thing. What causes it, I think, is a lot of misunderstanding or lack of knowledge. So congratulations to you today for having this discussion and hopefully this will help. So once people start to understand how this structure works as opposed to others, they can say, okay, I understand what's going on there. But I think the other side of it is, managers that have done well on their communication, that actually treat their investors as they are, owners, or in fact, that they're employers, if you want to look at it that way, so they're employing a manager to make investment decisions on their behalf because they own a stake in that listed investment company or trust. So communicating with your investors and your owners, as is the case with many other listed shares, is very important. So that understanding in the mind of the LIC or LIT manager is really important. It's not like, follow me. It's about, I'm working with you on your behalf and here's what we're doing. So good, clear communication over time, good times, bad times is very, very important and relevant. And what we're seeing, those that do it well, do it often, do it in a concise and measured way throughout or beyond the required ASX listing rules. So as I mentioned at the outset, AGMs are part and parcel of an LIC, more regular newsletters, updates, shareholder meetings, all those sorts of things generally helped people to understand.

Martin Dinh [00:16:55] The media, like what we mentioned before, sometimes the media often reports the negative side of listed investment companies and trusts trading at a discount to its NTA. But do you think it's not always necessarily a bad thing?

Ian Irvine [00:17:08] As I said, it's a thing. It's not necessarily a bad thing. If you come back to the starting point, if I want a quality manager investing with assets that I want to have in my portfolio, I want it actively managed and I want to use this closed end structure. So once you understand that, that's great. A lot of people make the mistake of looking at premiums and discounts as a measure of performance. So the other side of the equation is, what is this fund's performance? And it's not just the performance in general, its performance against the specific benchmark that's stated by that company. This is the benchmark we wish to exceed and do better than average. So in some cases, Aussie equities could be measuring themselves against the 200 or 300 index. But right down the other end in the small cap space it's small ordinaries. So, understand what your investment strategy is and the benchmark used to measure the outcome. Don't confuse an Aussie equity fund with a global index or the other way around a fixed income with the ASX 200.

Martin Dinh [00:18:06] Am I also right in saying that sometimes when listed investment companies and trusts trade at a discount to its NTA, this could be actually an attractive buying opportunity for an investor to buy one at a price less than its NTA and potentially profit from it if it does trade at a premium later down the road. Is that the right way of also seeing it, Ian?

Ian Irvine [00:18:31] It is one way of looking at it, Martin, and there are some investors that do do that. So I might characterise them a little different from investors who are investing for the medium to long term, but that can apply for them as well. So here's an entry point, at a discount, to a fund that I like because all the reasons we mentioned before. So, if I have that view and others had that view as well, then the price of the LIC or trust will rise. So I will benefit from the improvement in the value of the share price as well as the recognition of the true underlying value of the assets that I held. So, yes.

Martin Dinh [00:19:06] So when I look at our data, we do find that there are quite a few listed investment companies and trusts that trade at a discount to its NTA. From your experience in the industry, have you seen some listed investment company and trust managers take action in closing persistent discounts to NTA?

Ian Irvine [00:19:23] Yeah, just a couple of comments on that. At both extremities, at big premiums and at big discounts. Have a look at those funds. You typically find that they may be very small in terms of market cap size. So that's an important consideration. If you come down a little bit on the premiums and up a little bit on the discounts, that middle sector, that's where the real action is, I think, because these are just numbers at the end of a month. But I think back to the point and those managers that are talking with their investors are probably getting themselves a little bit more training around their NTAs as the cycle comes and goes. And we've come out of a cycle where there was a lot of uncertainty, a lot of people decided to invest with market momentum and just follow an index. Now, people that have been income investors have had a not a particularly good experience on the income front, even though the market's come back significantly and running pretty close to where it was pre-COVID, the income has changed. So the opportunity for them to actually invest in LICs that are actually delivering income has shown a good outcome.

Martin Dinh [00:20:21] So, we've spoken or you mentioned earlier in our chat that one appealing feature of listed investment companies is that they are able to pay consistent dividends even during a market sell off. Now, in the context of ultralow interest rates and the recent sell off that we saw during Covid-19, where we saw many listed companies cut their dividends, did you find that some listed investment companies were still able to pay a consistent dividend? Despite all of this happening?

Ian Irvine [00:20:53] Yeah Martin, like the rest of the market, it was mixed. However, it's fair to say and true to say that a number of LICs actually increased their dividend, Some maintained them and some reduced them marginally, and if you look across those three sectors, I keep talking about, Aussie, global and fixed, the Aussie, that's probably where they were able to stream their dividends a little more. So, again, the decision of the investment committee is we're going to pay a dividend that's the same as last year or slightly more than last year, because we have the reserve, and it's prudent to do that now, and we won't exhaust all of our reserves and we'll save some for the future, may have been the discussion. Others took the view of, maybe we should just reduce a little because we're a little bit more conservative on the future. Also, our portfolio is a little different from LIC A to LIC B and the likelihood of being able to replenish the reduced dividends if we pay them out is a little less, however. So that's like a market. It's fair to say that I think the Aussie equity did better than the market generally, where I think dividend payments were down 30 per cent market wise. And I think if you took a holistic view of the Aussie equity, based on LICs, not so much. At the other end where there's fixed income, which is over that cash flow base I spoke of earlier, if that's flowing and their benchmark is probably over the RBA benchmark and the RBA benchmarks come down, as we know, the cash rate's reduced, but they've maintained their margins. So if you looked at the headline, this is the distribution we've paid. It may have been a little less from last year, but in reality, it's the same margin over the RBA rate. It's the RBA rate that's moving closer to zero and these guys are paying that rate, plus. Again, you've got to understand the structure, the benchmark that they're using. That's a really good example of it, to fully understand. Did they pay the same similar or more distribution for an LIT?

Martin Dinh [00:22:34] I think that's really good information. And it's good to know that some listed investment companies, even though it was a mixed result, can consistently pay dividends even during a market sell off, which I think is particularly important in a low interest rate environment. I think this also shows that list investment companies, they can be a useful tool for those investors looking for a reliable source of income, you know, such as those entering into the retirement stage of their lives. Now, one last question before I let you go. For those interested in buying a listed investment company or trust, is there a checklist of items that they should tick off before buying one?

Ian Irvine [00:23:12] Like any other investment, Martin, you start with why am I investing? What's the asset class I want to invest in? What structure do I want? Yes, I want active management, therefore I want to consider an LIC or an LIT. Which would be the managers I'd choose in each of those spaces? So if I wanted to put together a diversified portfolio across three asset classes we're talking about here today, I can do all of that. And I probably can do some infrastructure and private equity as well, just to throw that into the mix. I can do all of that in a closed and actively managed structure. So if I've chosen for active management, willing to pay those fees, I want to construct a portfolio along those lines. That's the starting point. I then go through and choose the most appropriate managers that I think are going to do well into the future. Look at their track record. That's not always a guide to the future, but it's a pretty good indication. Understand what they're saying then look at the communication, the information that they're pushing out. I then decide the manager, look at the fees that I'm going to pay relative to performance and then decide on a particular construct of my portfolio. So asset allocation will be my starting point, understanding structure, choosing the structure that suits you, then putting together your portfolio and the portfolio construction.

Martin Dinh [00:24:14] And if investors want to learn more about listed investment companies and trusts, where can they turn to?

Ian Irvine [00:24:19] Well, they're probably listening to us now on the ASX website, which is always a good spot. But also I represent the Listed Investment Companies and Trusts Association or LICAT, our website LICAT.com.au.

Martin Dinh [00:24:30] Well, Ian, that concludes this month's episode on listed investment companies and trusts. I wanted to thank you for taking time out of your day and sharing your knowledge on one of Australia's oldest investment structures, covering some of the basics, but also importantly, debunking some of the most common myths. We look forward to welcoming you back down the road.

Ian Irvine [00:24:48] Thank you Martin. And thank you very much for this opportunity. Firstly, I think this is a great initiative and I'm very pleased to be able to assist. And hopefully today was useful and helpful for your listeners.

Martin Dinh [00:24:57] Well, that concludes our episode on listed investment companies and trusts. It was great learning about some of the main features of listed investment companies and trusts, but also clarifying some of the most common misconceptions about them. In next month's episode, I'll be joined by Emily O'Neill, ESG and equity analyst at Perennial Value Management, as we talk about making the case for including small caps, environmental, social and governance factors into your portfolio. Until then, thank you for listening. And we look forward to you joining us next month.

Voiceover [00:25:28] Visit the ASX website www.asx.com.au for more articles, online courses and event information or follow us on Twitter and LinkedIn.

ASX grants a non-exclusive license to download the content for private and non-commercial use only. You may not use the content for any other purpose including without limitation distribution to a third party or implying a connection between you (or any third party) and ASX, its officers, employees or contractors. The views, opinions or recommendations of the author or speaker in the content are solely those of the author or speaker and do not in any way reflect the views, opinions, recommendations of ASX. The content is provided for educational purposes only and is not intended to include or constitute financial product advice. You should obtain independent advice from an Australian financial services licensee before making any investment decisions.

ASX does not give any representation or warranty with respect to the accuracy, reliability, completeness or currency of the content. To the extent permitted by law, ASX and its employees, officers and contractors are not liable for any loss or damage arising in any way (including by way of negligence) from or in connection with any information provided or omitted or from any one acting or refraining to act in reliance on this information.