

LICs Show Their Mettle

By Scott Francis

There is no such thing as the perfect investment. And listed investment companies (LICs), despite their long-standing loyalty from seasoned investors, offer a range of imperfections. In short, they are not quite as good as they would have you believe. Over the course of the five-year bull market they underperformed the market average.

However, when things get tough, the tough get going. It is in a bear market that some market participants suggest that LICs (listed diversified share portfolios managed by professionals) should outperform, and a slender outperformance by some of the bigger LICs in the 12 months to 30 June will hearten many fans of this admirable investment format. What's more, excellent tax transparency among LICs is also a welcome feature when they are set against managed funds.

Compared to their unlisted counterparts, managed funds, LICs are often lower-cost (particularly the older funds like Argo and AFI), tend to pay more reasonable distributions and are more tax transparent. LICs are also a great source of 'instant diversification' for a portfolio, with the underlying assets usually being a well-diversified investment portfolio.

A significant benefit of a LIC compared to a managed fund is the transparency of information that an investor has about the tax situation of the fund. Consider Australian Foundation Investment Company (AFI), the largest LIC in our survey. As at 31 August 2008, it informed the market that its portfolio was valued at \$5.07 per share before tax and \$4.32 after tax — the difference being the provision for unrealised capital gains. As these market statements usually emphasise, AFI is a long-term investor and does not intend to sell all of its holdings.

That said, at least the investors have all the information about the tax position of the fund that they are investing into. In most cases managed fund investors don't even have access to 'after-tax returns' from their funds (an absolute disgrace, in my opinion: this is basic information that every investor deserves to know about their investment), let alone information on the unrealised capital gains tax situation of the fund. If you buy into a managed fund, you do it at the pre-tax net tangible asset level, regardless of what tax liabilities you might also be buying into.

In looking at the performance of LICs, one of the questions is: How should performance be measured? Should it be measured by the performance of the underlying LIC portfolio? Or should it be the return that investors experience; that is, the increase in the share price of the LIC and the value of dividends received? Investment managers may argue for the first performance criterion, as this most accurately reflects their skill. I think the return is a better measure.

As an example of this, consider an LIC in which the fund manager has done a great job and increased the value of the portfolio by 10%, but the actual value of the shares has

slumped by 10% over the course of the year. Is an investor happy with the performance of the LIC? I doubt it, because, regardless of the value of the LIC portfolio, their investment capital has fallen in value by 10%.

It is important to make a quick comment on the sample of LICs that I use in this article. I have tried to focus on LICs that have underlying portfolios of large Australian companies with at least five years of performance data.

So how has this sample of LICs performed? In the 12 months to 30 June 2008 — a particularly difficult time for investment markets, with the All Ordinaries returning negative 12.12% (according to the ASX website) — seven of the 15 LICs in our sample did better than the market average. The average return across the sample (–16.17%) was less than the average market return (–12.12%); however, some smaller LICs with particularly poor returns dragged the average down. If the performance is weighted for size (i.e. more weight is put on the returns from the larger LICs), the average LIC investor has received an above-average market return, 1.9% better than the index return.

Over five years the picture becomes disappointing for investors. Both the average return for an investor in an LIC and the size-weighted return for an LIC investor are more than 4% below the average market return for the five years to the end of June 2008. Both the average LIC investor returns and the weighted return were about 12.6% a year.

How should LICs have performed? There is no perfect benchmark, but one of the local market's exchange traded funds that models the ASX 200 serves as a useful comparison.

The StreetTracks 200 Fund provided a return of 15.65% pa over this same period. Only three of the LICs in the sample beat the average market return (Amcil, Aberdeen and Diversified United Investments), and the first two of these are relatively small LICs at about \$100 million each. In fact, the three funds that provided an above-average market return had a total value at 30 June of \$1.85 billion. The LICs in the sample had a total market value of \$14.2 billion, so on these ASX figures it is fair to say that only 13% of LIC investors beat the average market return over the five years to the end of June 2008.

All data, including the index returns, are taken from the ASX website's 'Listed Managed Investment Update'.

How the LICs performed (to 30 June 2008)			
	Size (\$m)	1 year	5 years (annual avg)
All Ordinaries Accumulation Index		–12.12%	16.77%
Aberdeen (ALR)	96	–9.66%	20.27%
Amcil (AMH)	116	–3.96%	26.67%
ARGO Invest. (ARG)	4041	–8.89%	13.24%
Australian Foundation (AFI)	4867	–7.96%	12.22%
Aust. United Investments (AUI)	732	–10.12%	15.74%
Carlton Investments (CIN)	443	–20.33%	10.78%

Choiseul Investments (CHO)	421	-13.60%	11.06%
Diversified United Investments (DUI)	468	-13.96%	17.78%
Djerriwarrh Investments (DJW)	871	-9.63%	9.82%
Huntley Investment Company (HIC)	126	-16.34%	10.23%
Hyperion Flagship Investments(HIP)	40	-26.81%	12.70%
Milton Corporation (MLT)	1639	-10.34%	12.79%
Sylvastate (SYL)	67	-25.90%	3.57%
WAM Capital (WAM)	117	-33.08%	8.14%
Whitefield (WHF)	219	-31.99%	3.43%
Averages		-16.17%	12.56%
Average out/underperformance		-4.05%	-4.21%
Size weighted out/underperformance		1.90%	-4.11%

LICs marked in yellow are those that have outperformed the average market return.

The simple maths of returns is not always what investing is about. I meet many people who invest in LICs because they are a simple, well diversified, easy to access, low-cost and tax transparent investment that has served them well over many years. They respect the managers running the LICs and appreciate their market commentary over time. However, a difference in returns of 4% a year between both the average and value-weighted average returns from a LIC and the average market is significant, and something investors should be aware of.

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