

Five key themes for LIC investors in 2019

19 June 2016 | Daryl Wilson & Greg Lander, Affluence Funds Management

There are now over 100 LIC's (plus some Listed Investment Trusts, or LITs) on the ASX. The main difference between a LIC and a LIT is tax: LITs help to avoid the great "Labor Franking Credit Grab". We examine this, as well as four other important themes in the Listed Investments sector right now.

We're seeing quite a few opportunities in the LIC sector right now. So, let's look at five key themes for LIC investors in FY19.

Labor might have kicked off a switch to LITs.

Labor's plan to deny franking credit refunds to certain taxpayers is bad policy. It's unfairly targeted and there's options to minimise it. This makes it's inefficient and will result in way less savings than predicted.

In the Listed Investment space, the sudden focus on franking has turned the spotlight on the advantages of the Listed Investment Trust (LIT) structure, as compared to LICs. An LIT is a listed managed fund (similar to an ETF or a REIT). Existing LIT's include Forager Australian Shares Fund (FOR), Magellan Global Trust (MGG) and Metrics Credit Income Trust (MXT). And, there's more on the way. We believe LITs will eventually outnumber LICs.

The main difference between an LIT and LIC is tax. Specifically, an LIT helps to avoid the great "Labor Franking Credit Grab". LIT's pay no tax directly, and therefore have higher cash earnings. So, instead of a franked dividend, an LIT might just pay a higher cash distribution. Importantly, the LIT is still able to pass through franking credits from dividends the LIT receives on its investments. An investor in an LIT receives an annual tax statement detailing the tax treatment of all distributions paid to them. The taxable portions get included in the investors tax return.

As well as new listings, we've also recently seen a couple of existing LICs converting to LITs. We may see this happen a lot more if Labor does get their way. This conversion process does results in a realisation of the portfolio for tax purposes, so it can lead to a big one-off tax payment (and franking credit) as a result.

The flood of listings will continue.

Over the past year we've seen around 10 new entrants to the LIC space. Another (WAM Global) is listing at the end of this week. We expect this trend to continue. The market for LICs is quite discerning. Those that make it to IPO stage tend to be from well-regarded managers, pursuing a strategy that is differentiated and has been successful in the past.

We're selective in the IPOs we participate in, as the post IPO market can quite often result in pressure on share prices. But the quality is high. If you're happy to hold for the long term, you can be well rewarded.

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Recent developments in the market have also led to more shareholder friendly structures. Options have largely been dropped in favour of the manager picking up some or all the initial listing costs. This means the starting NTA is roughly the same as the price investors pay, which is positive.

You can monitor upcoming listings through your broker, or on the ASX website.

What about something different.

While overall returns haven't been stellar in the past 12 months, we've not seen any major market correction either. The longer this goes on, the higher the chance of a decent market fall in the future.

We try not to get caught up in making predictions, but rather to make our portfolio as resilient as possible against a range of different possibilities. We usually hold at least 15% in LICs that can weather the storm of a down market in better shape than most. They're all still pretty good value. There are now quite a few LICs that pursue a long/short or market neutral investment strategy. All of them have the potential to be much more resilient in sustained market corrections.

Be careful of the premium.

It's very rare that we buy any LIC at a premium to NTA. There's very little justification for it. By buying at a premium, you're saying you have so much confidence in the skill of the manager to outperform that you're prepared to pay for some of that future outperformance up front. That's brave, given that both markets and outperformance by a manager tend to be cyclical.

Most LICs trading at a large premium have good long-term performance, an above average dividend yield and a core of loyal investors. A poor short-term performance period or a fall in the dividend makes them very vulnerable. This can then lead to a reduction or elimination of the premium at the same time.

We also expect to see more capital raisings from existing LICs where they trade at a premium to NTA. We usually reduce our holding in an LIC if it moves from a discount to a premium. This leaves us well positioned to top up again if they do raise capital or suffer through a period of poor performance.

Last year's underperformers, next year's winners?

Sometimes the laggards in one year can be outperformers in the next couple of years. This is most likely to be the case where an LIC with a good long-term record has a poor year, leading to the LIC trading at a larger discount than normal. Sometimes this occurs where the sector or market an LIC invests in has performed poorly. For example, in the last 12 months, we've seen large Aussie shares and value stocks underperform. So, it's worth looking at LICs that invest in this area to see if there's any potential bargains.

Potential opportunities right now in LICs that invest in large companies include AFIC (AFI), Amcil (AMH) and BKI Investments (BKI) which has just completed a capital raising. More active investors in this large-cap space include WAM Leaders (WLE) and Century Investments (CYA). Both are managed by the talented team at Wilson Asset management, and both are trading at discounts to NTA.

There are also some smaller LICs which are currently trading at substantial discounts. These often invest in more niche sectors and may not have the liquidity of the large LICs, but some that we think look interesting include Bailador Technology (BTI) which invests in unlisted technology companies, as well as small company LICs Glennon Capital (GCI), NAOS Small Cap Opportunities (NSC) and Barrack Street (BST).

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Change is constant

We expect the ASX Listed Investment sector will continue to grow and evolve in FY19. With this growth will come a wider range of opportunities. Whether you currently have LIC investments or not, we would encourage you to have a look at the market. There's a lot of quality here.

A good starting point for education and ideas might be [ASX's investment products monthly report](#). There are also various LIC research reports available through Livewire Markets and brokers. Also, we've written a guide to LICs which you can find on our website.

Take care and all the best with your investing.

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