

LIC/LIT Conflict of Interest Debate

14 January 2020, Christopher Joye, Coolabah Capital Investments

Mis-selling plagues the asset class as issuers paying commissions to advisers and brokers continue to cause friction within the industry...

Dominick McCormick wrote a solid piece on the 14th January, defending the LIC/LIT sector from recent criticisms. Dom discloses that he has been retained by the industry lobby group, the Listed Investment Company & Trusts Association, to provide commentary on the subject, which is a smart move on their part.

While I have been on the other side of this debate, and Dom mentions my writings at one juncture, I agree with a number of his technical arguments. I strongly disagree, however, with Dom's suggestion that fund managers paying financial advisers large conflicted sales commissions, which were outlawed in 2012 and, against ASIC's repeated advice, permitted again by the Coalition in 2014, are not creating potential mis-selling crises.

In its confidential August 2019 advice to government, ASIC once again reaffirmed its 2013 advice that allowing fund managers to pay advisers hefty sales commissions to push their products to retail clients is a recipe for disaster.

The crazy thing is that nobody seriously disagrees with ASIC. I come across advisers almost every day, and I would say 90% are opposed to fund manager kick-backs. Those that are relying on these payments are a tiny proportion of the adviser population. Even some of the largest LIC/LIT issuers publicly and privately agree that permitting conflicted sales commissions will inevitably propagate mis-selling crises, if they have not done so already.

In my response to Dom, I made a number of key points. While you can read my full comments at the end of his piece, I would highlight a few here.

Dom quoted me as saying that "managers regard LICs and LITs as especially attractive because they have very high fees and provide permanent capital that cannot be redeemed, which is why they often trade at a substantial discount to their Net Tangible Asset value (NTA)". He questions whether this capital is really permanent, and there are certainly situations where managers face the risk of losing it (eg, if activists seek to have them removed or the responsible entity replaces them).

But nobody is genuinely refuting my proposition that fund managers love LICs/LITs because they are perceived to provide permanent capital, which is absolutely a key motivation for issuers across the industry (numerous LIC/LIT managers have stated that to me personally).

There is nothing wrong with seeking permanent capital. But the closed-end (as opposed to open-end) structure clearly contributes to the prevalence of LICs/LITs trading at a discount to NTA with almost 80% of all LICs/LITs ending 2019 at a discount (the average discount was more than 9%).

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While that is cold comfort for the retail punters that bought the LIC/LIT at issue, as Dom notes, it is a feature of the industry that creates both risks and opportunities. There is also nuance here that Dom cites, such as some LICs/LITs offering differentiated benefits.

I am certainly not questioning the notion that LICs/LITs have a valuable role to play as an alternative. The likes of Magellan and VGI have shown that there are many unique solutions fund managers can provide investors using an LIC/LIT structure. (In fact, I told my mum to subscribe for VGI's VG8 because I liked the idea of her getting exposure to Rob Luciano's management company!)

LITs also offer some possibly powerful solutions to the illiquid assets problem, although that does come with the risk that LITs that hold illiquid assets end up trading at enormous discounts to NTA as we have seen historically with the likes of Allco Max, the Adelaide Yield Trust, the Dixon URF drama, and others. The problem with illiquidity is it creates tremendous uncertainty about what the true NTA is, which is very different to an equities LIC/LIT where there are publicly traded prices for all the shares in the portfolio (in contrast to say illiquid junk bonds or US residential homes where the true value may be difficult to determine).

One interesting question here is why there are virtually no institutional investors buying LICs/LITs? And why do most advisers avoid them? There are probably a few answers. First, the fees tend not to be negotiated, and are too high for most insto's and many advisers. Second, the ability of the LIC/LIT to trade at a large discount to NTA is not a risk that most investors want to have to contend with. And, finally, many are put off by the conflicted sales commissions and the droves of retail punters being pushed into these products, who may not fully understand their risks (and may in turn all seek to exit at the same time).

I don't think that anyone, again, really rejects the idea that the performance of the LIC/LIT sector has been poor: in 2019 alone, Aussie equity and global equity LICs/LITs massively underperformed the Aussie shares and global shares benchmarks with or without franking credits (and this analysis notably post-dates ASIC's independent research). But as Dom says, this point could be made of active managers generally, although the discount to NTA issue is very much idiosyncratic to LICs/LITs, and has exacerbated the poor performance.

The real concern here is that these products are raising capital primarily because they are being actively sold by third-parties motivated by the conflicted sales commissions, which the Future of Financial Advice (FOFA) laws were legislated to ban in 2012. There is nothing ultimately stopping all fund managers shifting their capital raising on to the ASX, and everyone using these conflicted sales commissions to effectively kill FOFA.

Asking ASIC to pick-up the pieces after these mis-selling risks have manifest by prosecuting advisers for failing their best interest duties to clients ex post facto is demonstrably not the solution. As the Royal Commission recommended very clearly, the solution is getting rid of the conflict in the first place, as FOFA intended in 2012, especially when it comes to financial advice!

It is absurd having adviser sales commissions outlawed for unlisted funds and ETFs, but permitted for LICs/LITs. It is even more ridiculous that the government has repeatedly ignored ASIC's advice on this subject, which it emphatically rendered in 2013 (apparently on several occasions and again in 2019). The political risks for Treasurer Joshua Frydenberg, who will now be saddled by Labor with every single LIC/LIT failure, are huge.

The impact of these sales commissions on fund raising is precisely why there are 20-30 local and global fund managers chomping at the bit to pull money from Aussie retail investors on the ASX. Some of these managers will be outstanding, but many are there purely because the conflicted sales commissions make it much easier to raise money from punters.

Anyone involved in this industry knows that the commissions are having a striking impact, and driving substantial sales. Suggesting they are not is silly. Managers that have never been able to raise volume from Aussie retail are suddenly sourcing almost \$1 billion in a few weeks.

Time and time again I have heard those involved in the LIC/LIT industry that if the government removes the ability of fund managers to pay advisers kick-backs, it will stop most coming to market. And that's simply because it would be very hard to raise capital without these payments. But it can be done, as Magellan has proven.

Yes, there are some advisers who rebate commissions to clients. But many do not. And if there is one lesson from both the Royal Commission and the history of Australian financial services, it is that fund managers paying chunky 1% to 3% sales commissions to financial advisers inevitably leads to mis-selling crises. I will leave you with the response of Koda's head of fund manager research, Jason Coggins, to Dom's defence:

"Are we still debating the merits of conflict-free advice? 10 years after Storm Financial? 6 years after Banking Bad? Let's be clear. This is not an anti-LIC crusade. It is calling out ALL conflicts. Conflicts can't be "managed". That's an oxymoron. Yes, most try and do the right thing. But create the option to do the wrong thing and a minority will prioritise their self-interest ahead of others. The industry does not need lobbyists to tell us what is right or wrong. It's simple. Work actively (and only) for the client."

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