

# Guide to: Listed Investment Companies (LICs)



# 01 INTRODUCTION TO LISTED INVESTMENT COMPANIES

There are approximately 90 Listed Investment Companies (or LICs) and Listed Investment Trusts (or LITs) available for investors to choose from on the Australian Stock Exchange (ASX).

At Affluence, one of our core specialties is investing in LICs. In fact, our Affluence LIC Fund only invests in ASX listed LICs. We believe this sector offers investors the opportunity to produce superior risk adjusted returns compared to investing in a passive investment strategy. This guide outlines how LICs work and what to look for.

Through LICs you can now gain exposure to Australian shares, global shares, fixed interest investments, as well as a number of other alternative investment strategies.

Many LICs are run by exceptional managers, using differentiated investment strategies that can help you to diversify your investment portfolio.

The combined value of all LICs listed on the ASX is over \$40 billion. Despite the large size of the LIC sector, there is relatively limited attention from institutional researchers and professional investment managers. This can provide more opportunities for mispricing than in other areas of the stock market. In addition, some quality investment managers can only be accessed through LICs.

While our process is designed to identify the most attractive investments, we have not included a list of the best LICs because our views change over time.

This is based on the performance of the manager, our opinion of the value of the underlying market the LIC invests in, and their trading price relative to NTA. You can access an up to date list of our key investment holdings in our Affluence LIC Fund by registering as an Affluence Member on our website.

Our methodology involves us assessing the quality of each LIC based on various criteria, and then to only buy them at the right price. The key tool we use to identify whether an LIC is expensive or cheap is its trading price on the ASX, relative to the value of the underlying assets it holds (known as the NTA or NAV). This difference between the trading price and NTA is known as the premium or discount to NTA.

Many of the top tier LICs are too expensive some of the time. And so we patiently wait until we can buy them at the right price.

We hope the information in this guide is of value to you in your own investing journey.

As with all our publications, we value feedback, so please let us know if there is anything we can improve upon.

# 1.1

## About Affluence Funds Management

Affluence Funds Management was founded in 2015 to provide investors with a better investment solution. Our focus is on delivering superior long-term investment performance and in providing quality education and investment ideas.

At Affluence, we believe in doing things differently. We are contrarian, value focused, and invest for the long term. We aim to offer our investors only the very best quality investments.

# 1.2

## What is a Listed Investment Company?

A Listed Investment Company, or LIC (pronounced “lick”) is a specialised type of investment fund that pools together investors’ money and invests it under an approved investment strategy.

LICs are listed and traded on the Australian Stock Exchange. Similar vehicles are listed on other security exchanges around the world.

In many ways LICs are similar to managed funds, exchange traded funds and other collective investment vehicles, but there are also some important differences.

We use the term Listed Investment Company because the majority of these listed active investment vehicles are companies. However, there are some which are Listed Investment Trusts (LITs). The main difference between these two structures is in the tax treatment. Companies pay tax on their earnings and pay dividends to their investors (which are usually taxable to them but include franking credits). Trusts pay no tax directly, but instead must distribute their taxable income to investors, who then pay tax on it at their own tax rates.

These distributions usually do not include significant franking or other tax credits. Unless we specifically differentiate between an LIC and LIT, when we refer to LICs in this guide we are referring to both structures.

# 1.3

## Why invest in a LIC?

To achieve better diversification in your investment portfolio.

To access the skills of a professional investment manager.

To get exposure to a particular market, asset class or investment strategy.

To access the benefits of an unlisted managed fund with the ease of trading and liquidity of traded shares.

To receive income from dividends or distributions.

To profit from the change in premium / discount of the NTA compared to the share price.

# 1.4 How do LICs work?

Like other companies, an LIC is overseen by a board of Directors, whereas a LIT is overseen by a responsible entity. Their functions are fairly similar, and in both cases the day-to-day investing activities are carried out by specialist investment managers. These managers are appointed or employed by the Directors of the LIC or the responsible entity of the LIT.

Most LICs are externally managed. This means the investment manager is an external company appointed under a formal contract. The appointment usually lasts for a fixed term of 5 years or more and may be terminated or extended at the end of that period. The investment manager charges a fee to the LIC, usually calculated as a percentage of the net assets of the LIC. There may also be an additional fee payable where performance of the investment portfolio exceeds a certain return benchmark. In most cases where the performance of the investment manager has been acceptable and their fees are reasonable, they will be asked to continue on at the end of the management contract period.

An alternative structure is an internally managed LIC. In this case, investment staff are employed by the LIC directly. Instead of paying an external manager a fee, the company pays the employment and associated costs of the investment staff.

Internal management can be a more attractive proposition for a large LIC because the cost of managing the investments can be more efficient and this can improve returns. However, for most LICs external management makes more sense because the size and scale of activities is not sufficient to make it efficient to manage internally.

LICs have low minimum investments. LICs can be bought and sold daily on the ASX. So long as you have an account with a stockbroker, you can invest in a LIC on the ASX for \$500, or even less. Brokerage costs usually mean it's better to buy a larger parcel than this to average out the transaction costs.

Unlike an unlisted managed fund where units are purchased and sold in accordance with the Fund's unit pricing policy, with an LIC the 'market' determines the security price. This can lead to situations where the share price and value of the underlying portfolio vary dramatically. LICs can issue and buy back shares, but generally this only happens at certain times.

# 1.5 How do LICs Invest?

All LICs have an investment strategy. Generally, the investment strategy will define:

The asset class the LIC invests in (e.g. Australian shares).

The return target the LIC is aiming to achieve and the timeframe for achieving those targets (e.g. to outperform the ASX 200 Index over 3 year periods).

Any investment limits or ranges that will be adhered to (e.g. maximum level of cash holdings, maximum level of investments outside Australia).

All funds within the LIC are pooled together and invested in accordance with the investment strategy.

# 1.6 How do LICs generate returns?

As an investor in a LIC you will receive returns in two ways.



Firstly, most LICs pay regular dividends (or distributions for LITs). These dividends usually include at least partial franking credits and are generally paid from underlying profits generated by the LIC over time. LITs don't pay franked dividends, however they do pass on any franking credits they receive from underlying investments. And because LITs don't pay tax directly, the level of distributions can be higher.

The second source of returns is that the share price of an LIC will increase or decrease over time. The price at which LICs trade on the ASX is set by market forces and is impacted by many factors. Some of these factors may include:

- The reported NTA for the LIC.
- Market conditions and investor confidence.
- The attractiveness of the investment strategy.
- What asset class the LIC invests in.
- The dividend yield (this is never the correct method to price an LIC).
- Performance of the investment manager.
- Cost of running the LIC, including fees to the investment manager.
- How large the LIC is, and how liquid its trading is.
- How well the LIC markets itself and communicates with current and potential investors.
- Whether the directors and investment managers treat their shareholders with respect.

There are many other factors that can impact the price an LIC trades at. In order to have the best chance of achieving above-average returns over time, it's important for you to consider a range of factors and to try to buy at an attractive price. We cover this concept in greater depth later on in this guide.

# 1.7 The LIC Sector

There are approximately 90 LICs and LITs listed on the ASX with a combined market value of over \$50 billion.

They range from small sub-scale vehicles of less than \$5 million to the largest which has a market capitalisation of over \$9 billion.

Many investors have only ever heard of the biggest two LICs; Australian Foundation Investment Company (ASX: AFI) and Argo Investments Limited (ASX: ARG). These two have a combined market capitalisation of approximately \$16 billion, which accounts for approximately 30% of the total sector.

Given their size and concentration, it is understandable that this is where a lot of investors focus in the sector. There are some important similarities between them:

- They are both internally managed and reasonably low cost.
- Their portfolio construction is usually very similar to the major benchmarks.
- Over the longer term, their performance has been similar to the major benchmarks at best (and in many cases they have lagged).

Given their similar portfolios and being very benchmark aware, there are limited diversification benefits available by holding more than one of them. Given they invest, and thus perform, similar to the market index, many investors make the mistake of purchasing these LICs at a premium to underlying NTA. Doing this sets up the investor for a high probability of underperforming the market. On occasions, these LICs can trade at reasonable discounts to NTA. Buying these LICs at a discount can be a good opportunity to improve long term returns.

For those investors who are just looking for market based returns, a low-cost ETF or index fund may be a better alternative.

As an example of the variety that is now available in the LIC sector, we have set out below some LICs which are offering investors something quite different. We are not endorsing the quality or attractiveness of any of these LICs (depending on price it is likely we would buy, hold or sell them at different times), just showing the huge range of asset classes, strategies, discounts and sizes that are available.



## 1.7 The LIC Sector (cont')

LIC	Asset Class	Strategy	Market Cap*	(Discount) / Premium to NTA*
Thorney Opportunities	Australian Shares	Small Cap	\$125 mill	30% discount
Australian Foundation Investment Company	Australian Shares	Benchmark	\$9.0 bill	7% discount
WAM Capital	Australian Shares	Small cap	\$1.6 bill	Par
VGI Partners Global	Global Shares	Long / short	\$550 mill	20% discount
Bailador Technology Investments	Private Equity	Technology companies	\$176 mill	30% discount
MCP Master Income Trust	Private Debt	Investment grade	\$2.2 bill	3% premium

\*Market cap and discount premium to NTA as at 30 April 2024.

## 1.8 How do LICs compare to other investments?

LICs are a listed managed fund. But there are several very important differences between LICs, exchange traded funds and unlisted managed funds that you should be aware of. Below we compare features of these three types of investment products.

Feature	Listed Investment Company	Unlisted Managed Fund	Exchange Traded Fund
Listed on ASX	Yes	No	Yes
Minimum Investment	Set by broker. Can be \$500 or less.	Varies, but usually \$10,000 or more.	Set by broker. Can be \$500 or less.
Eligibility	Anyone with a broker account.	Some are restricted to certain types of investors.	Anyone with a broker account.
Pricing	Set by market forces. Can vary substantially from value of underlying investments.	Usually priced based on the value of their underlying assets (NTA or NAV) +/- transaction costs.	NAV +/- a margin, facilitated by a market maker.
Legal Entity	Normally a company, but can also be a Trust.	Trust	Trust
What does an investor own	Investors own shares in the company.	Investors own units in the trust.	Investors own units in the trust.
Buying and Selling	Investors buy or sell existing shares from another investor on the ASX. The LIC can also issue new units or buy-back units from time to time.	The trust issues units to investors who wish to enter the trust and redeems (buys back) units from investors who wish to exit.	Investors buy or sell existing shares from another investor (or the market maker) on the ASX.

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# 1.8 How do LICs compare to other investments?

Feature	Listed Investment Company	Unlisted Managed Fund	Exchange Traded Fund
Liquidity	Traded on ASX between 10am and 4pm most business days. Smaller LICs can be less liquid, with lower trading volumes.	Liquidity varies. May be priced daily, weekly, monthly or less often depending on the size of the fund and the type of assets it holds.	Fully liquid. Employ a "market-maker" who is required to ensure trading price is close to NAV.
Minimum size of investment entity	ASX sets the minimum size and number of holders for new LICs.	Unrestricted	ASX sets the minimum size and number of holders for new ETFs.
Investment Manager	Can be internal or external, but normally external unless very large.	Can be internal or external, but normally external.	External
Investor Income	LICs pay dividends which are usually taxable to the investor and may have franking credits attached. These credits can be claimed by the investor in their tax return.  LITs pay distributions which are usually taxable to the investor. May include a pass through of franking credits collected by the trust.	Pay distributions. Can be taxable, tax deferred or tax free. Can include some franking and other tax credits that can be claimed by the investor in their tax return.	Pay distributions. Can be taxable, tax deferred or tax free. Can include some franking and other tax credits that can be claimed by the investor in their tax return.
Income Tax	LICs pay tax on income. Attaching franking credits to dividends allows investors to receive some "credit" for tax paid by the LIC.  LITs do not pay tax but distribute taxable income to investors, who pay tax on it. Therefore, distribution returns are pre-tax.	Do not pay tax but distribute taxable income to investors, who pay tax on it. Therefore, distribution returns are pre-tax.	Do not pay tax but distribute taxable income to investors, who pay tax on it. Therefore, distribution returns are pre-tax.
Capital Gains Tax	Pay tax on capital gains. Attaching franking credits to dividends allows investors to receive some "credit" for tax paid by the LIC.  Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold.	Do not pay tax but distribute capital gains to investors who pay tax on it.  Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold. Any tax deferred distributions received may increase this capital gain.	Do not pay tax but distribute capital gains to investors who pay tax on it.  Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold. Any tax deferred distributions received may increase this capital gain.

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# 1.8 How do LICs compare to other investments?

Feature	Listed Investment Company	Unlisted Managed Fund	Exchange Traded Fund
Investment Strategy	Normally active. Tries to beat a market return.	Normally active. Tries to beat a market return.	Can be passive or active.
Management Fees	Normally higher than ETF's but lower than managed funds. Can include performance fees.	Normally higher than LICs and ETFs. Can include performance fees.	Dependent on strategy.
Annual General Meeting	Yes	No	No
Governance	Appoints a Board of Directors, who monitor strategy and the investment manager.	Managed by a Trustee or Responsible Entity. May be the same as the investment manager or independent.	Managed by a Trustee or Responsible Entity. May be the same as the investment manager or independent.
Buy / Sell Spread	Difference between the price sellers offer their shares (sell price) and the price buyers are prepared to pay (bid price). Will be variable and dependent on market conditions and liquidity.	Set by manager. Based on costs of buying and selling underlying investments.	Usually a market maker makes sure that costs of transacting are within preset limits and approximate to underlying asset value.
Transaction Costs	Brokerage costs set by broker.	There is usually a buy / sell spread set by the manager.	Brokerage costs set by broker.
Investor disclosure	Announcements on ASX. May be supplemented by other reporting.	Continuous disclosure rules – normally periodic reports plus ad-hoc disclosure on website or by email.	Announcements on ASX. May be supplemented by other reporting.

# 02 ASSESSING AN LIC

Before confidently investing in an LIC, you need to be able to assess the various aspects that may impact its performance. The following are the main factors we review.

## 2.1 Understanding the strategy

For each LIC, we like to develop a detailed understanding of the investment strategy. This is key to deciding how an LIC might fit into your existing portfolio.

This information can be found in a number of places, but most commonly in the Annual Report, on the LIC website (if it has one) or in regular investor reports.

Some key information you might want to know is:

- What type of assets does the LIC invest in (e.g. shares, fixed interest, diversified)? Does the LIC focus on a small, niche market (e.g. microcap ASX stocks) or does it invest more broadly?
- What geography does the LIC invest in? Is it focused just on Australia, in one or a combination of overseas markets, or both?
- What are the LICs return objectives? Has it managed to achieve those objectives? What should the LICs performance be measured against? (e.g. if the fund invests mostly in large ASX listed stocks, the ASX 200 Index may be the best benchmark).
- How much discretion does the fund manager have within the asset allocation strategy? (e.g. can they hold a large amount of cash if they cannot find compelling investment opportunities?). Some of the best LIC performers historically have tended

to be those which have the most discretion. They also tend to have less volatile performance in down markets.

- Does the manager invest in line with their benchmark, or are they truly benchmark unaware?
- How concentrated are the holdings of the LIC? Some managers hold 50-100 stocks and are very diversified. Others may hold 15 stocks or less. Concentrated portfolios can increase the potential for outperformance, but also the potential for underperformance.
- How does the LIC aim to beat the market? What is the advantage they have that will allow them to do this?
- How will the LIC compliment your investment portfolio? Are they doing something or investing in something that is different to what you currently hold? If so, this can allow you to achieve greater diversification.

If you have time, it may make sense to review the last 3-5 years ASX announcements, particularly those marked as price sensitive. This may assist to provide additional background on the LIC and to understand if the Board or management have deviated from, or changed strategy during that period.

## 2.2 Assessing performance

It is said (and in fact ASIC demands all investment managers make it clear) that historical performance is no guarantee of future performance. While this is true – historical performance can be a great indicator of the potential for future performance.

The right way to assess performance is not by looking at just the historical returns generated, but by comparing those historical returns to a fair benchmark. LIC managers may publish two different types of performance history to assist you, and both are useful.

Firstly, they will almost always publish the performance of the underlying investment portfolio the LIC owns (portfolio performance). Portfolio performance, if possible, should be assessed after all fees and costs but before tax. This result should then be compared to an appropriate benchmark. Assessing performance in this way will assist to understand how the manager has performed relative to the market or asset class they are investing in.

Looking at performance this way allows you to understand the historical performance of the manager of that portfolio. Importantly though, it doesn't take into account changes in the share price of the LIC over time which may be outside the managers control.

For this reason, a second and just as important measure of performance is the returns of the LIC itself (total shareholder return). This is measured for any time period by adding the change in the price of the LIC over a given period (the closing price less the starting price) plus any dividends paid. You may also wish to include franking credits in your calculation. This amount is then divided by the opening price to derive a percentage return. Quite often this data is published by the LIC but if not it is usually available from your broker. This represents the total returns received by shareholders of the LIC for that period. The positive or negative difference in returns between portfolio performance and total shareholder return can be due to a number of factors. This includes the change in discount / premium to NTA over that time period, tax and share issues or buybacks.

Ideally performance should be measured in both ways over a reasonably long period (e.g. 5 years or more). The longer the period you have data for, the better.

In particular, you may find it's important to look at how the LIC performed in down markets, as this will give you some idea as to how aggressive or conservative the strategy is. For example, an LIC which invests in small cap stocks may outperform others over a very long term, but severely underperform in negative markets. That may be acceptable if you are comfortable with that level of volatility, but if not you may be susceptible to selling at the worst possible time.

Watch for, and avoid, these negative signs and influences when assessing performance:

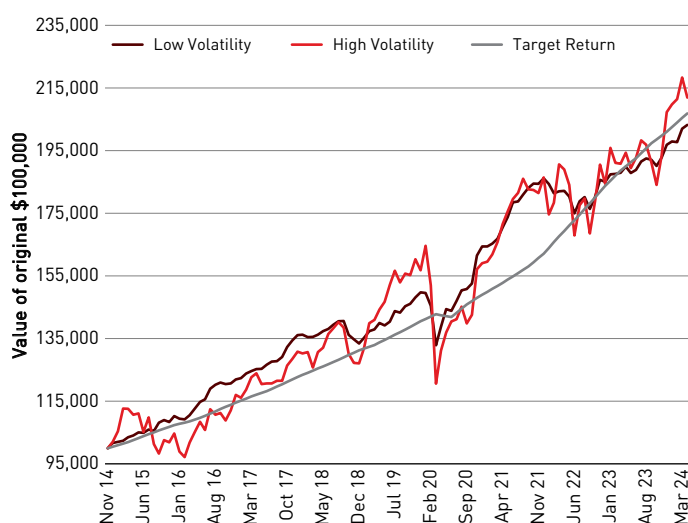
- Performance should be stated after all fees and costs. Performance before fees and costs is irrelevant.
- Performance should be annualised for all periods over 1 year. The financial services industry publishes standards on how to calculate performance and most managers follow them.
- Is there a long enough timeframe to assess performance? Performance data for periods of less than one year is largely irrelevant.
- Is the benchmark fair? A fair benchmark is one which reflects the average return you might expect from the types of assets the LIC invests in. For example, is it an accumulation index (does it include income of the underlying assets). Does it represent the underlying assets of the fund, or a fair long term return? Does it include franking credits, if the performance numbers do? Most managers do a good job of setting a benchmark, but some do not. You would not want to measure performance against an inappropriate yardstick.

Finally, remember that while assessing performance can be useful, it doesn't necessarily reflect the future. Even good managers can go through bad periods. More importantly, asset prices can move in cycles, so you should never assume the last 2-3 years performance will be repeated in the next 2-3 years. Your only aim in measuring performance is to understand how well the manager has performed relative to the asset class / strategy they are investing in.

## 2.3 Volatility and drawdowns

Performance by itself is great, but to get a full understanding of the managers credentials, it is also important to understand volatility, or how returns vary over time. The holy grail for an investor is the delivery of their targeted returns with very low volatility.

High volatility investments are often riskier than lower volatility investments because they can prompt a much wider range of decisions from investors. For example, consider the following two investments:



Many investors would prefer to achieve the reasonable consistent, green line over time. If you held the investment represented by the orange line, it may cause significant angst as values fall and lead to a decision to sell at an inopportune time.

If volatility is an important factor for you, it is important to remember that over time:

- Listed investments tend to be more volatile (but obviously more liquid) than unlisted investments.
- Smaller listed stocks (including LICs) tend to be more volatile than larger stocks.
- Sectors such as resources, IT and biotech tend to be more volatile than sectors such as health, telecommunications and industrials. The first group of industries may include a higher proportion of early stage businesses which may not be profitable or consistently so, whereas the second group are more likely to contain established businesses.

- Assets such as bonds and property (when held directly) tend to have much lower volatility than listed stocks.
- Cash has no, or very low volatility.

Volatility can be measured in number of ways but is generally not well understood by most investors. It can also be difficult to obtain sufficient data to calculate it properly over time. However, there are some things you can do to assess volatility.

Start by looking at a chart of the LICs performance against the index or benchmark. For example, if the LIC invests in stocks, you may look at performance against the ASX 200 Index. Most online brokers will make this information readily available. Study the chart, particularly during a time when the market has corrected. Did the LIC move down more, less or about the same as the market?

Returns from the LIC itself can rise and fall more rapidly or more often than the underlying investment portfolio that the LIC owns. This is particularly the case for small and medium size LICs which tend to trade at higher prices, relative to their NTA in good markets, and at lower prices relative to their NTA in poor market periods. This has the effect of widening the actual range of returns an investor in the LIC can receive.

Some LIC managers publish a historical graph showing the discount or premium to NTA over a number of years. You may find this a very useful tool for understanding how volatile an LIC has been, relative to the market.

Some managers also publish volatility data. Measures such as standard deviation, up vs. down months, and ratios such as the Sharpe and Sortino ratios can be useful tools to assess volatility. They are most useful if they can be obtained for long periods of time and preferably contain at least one period where a significant market correction occurred.

## 2.4 Assessing the people and investment managers

Performance must be evaluated in light of the stability of the team generating it. The people managing the investments for each LIC (not the Directors or the management company) are the most important factor in delivering long term returns.

It is important to know how long an investment management team has been together when assessing the performance of an LIC. If the LIC has existed for longer than the current key investment managers have been in place, it would be wise to discount or even ignore any performance data from earlier periods, since performance is very much influenced by the team running the portfolio and making to day-to-day investment decisions. Likewise, if a key investment manager leaves a team, it is important to understand who will replace them and how that might impact returns going forward.

Stability in the investment team can increase your faith in their ability to deliver above average results. Some key factors you can look for which may indicate a strong alignment of interest include where key investment managers:

- Own part of the investment management company.
- Have a significant personal investment in the LIC, or another fund which is substantially the same and which they manage.
- Have a long history with the management company.

Holdings of non-executive or independent directors are usually less important. It is the investment management staff who ultimately add the value and have the greatest influence on your long term returns.

## 2.5 Size and liquidity

**Size matters. The ideal LIC is not too big and not too small.**

LICs with a relatively small amount of investment assets (say less than \$50 million) are likely to suffer from a high cost load. This will negatively impact returns. This is because many costs of managing an LIC (for example the cost of arranging an AGM) are basically the same regardless of size. When these fixed costs of running the LIC are only able to be spread over a relatively small amount of capital, the cost in percentage terms can be high. It is not uncommon for some smaller LICs to have fixed costs equivalent to 3% per annum or more of the value of their assets. This can represent an unacceptably large drain on returns.

The other issue with smaller LICs can be the limited liquidity, or the value and volume of their shares traded on the ASX. Small individual investors may be able to trade in relatively small parcels, as they can buy and sell lower liquidity LICs much more easily than larger investors. However, the bid / ask spread (the difference between the buy price and sell price on the ASX) can still be quite wide and you may have to be patient to be able to buy or sell at your target price.

Although very large LICs have a cost advantage, they can find it more difficult to outperform substantially over the long term. The large amount of capital they have means they must make quite large investments. This, in turn limits their investment universe (the list of potential opportunities they can hold) to the largest and most liquid investments available.

In general, Affluence prefers to invest in medium size LICs. The flexibility afforded from having a smaller pool of capital and greater investment opportunities for these LICs can outweigh the slight cost advantage that the larger LICs have.

**Size matters.**  
The ideal LIC is not too big and not too small.

## 2.6 Other things to take into account

The above factors are the key attributes we believe you should consider when researching an LIC, however they are not the only ones which can be important. Other features which can be important include:

### Capital management

How and when they have raised capital? Generally, you should be wary of any LIC which has raised equity at a substantial discount to NTA.

### Liquidity

LICs that invest in illiquid assets (e.g. private equity funds) might deserve a larger than normal discount to NTA. Valuations of these assets tend to lag the listed market and to be out of date and less reliable when markets are moving up and down rapidly.

### Internal vs. external management

Internally managed LICs have less of a conflict of interest. This does not necessarily lead to a performance advantage.

### Substantial holders

Details of substantial holders (those investors who own more than 5% of a LIC) are usually found in the annual report or ASX announcements. If the fund manager or another investor you rate highly is a substantial holder, and is holding or increasing their investment, this can be a good indicator. However very large substantial holders can also be a problem, as their interest may not be aligned with yours. They can unduly influence strategy and / or delay / frustrate or even prevent transactions occurring.

### Marketing and communications

Good, consistent communication to shareholders can go a long way to limiting any discount to NTA. How often the manager communicates, how they communicate and how open and honest they are about their performance can be key factors that influence long term price fluctuations.

### Taxation

LICs must pay tax (LIT's do not). Therefore, LICs deliver after tax returns and pay dividends. Those dividends are usually franked, although if they are investing in assets outside Australian shares this may not be the case.

Franking credits are able to be claimed by most investors and offset against other tax liabilities or even refunded in some cases. We believe it is important to factor in franking credits when considering an LIC investment.

## 2.6 Other things to take into account (cont')

### Borrowings

A few LICs borrow directly and some invest in underlying assets that are themselves geared. In general, the higher the borrowing level, the higher the risk and volatility is likely to be. Because of this, you should demand a higher level of return from a geared LIC, compared to an ungeared alternative.

### Types of securities on issue

In addition to ordinary shares, some LICs also have options on issue. These are also generally traded on the ASX. It is important to understand how many options are on issue and their terms (strike price and expiry date), because they can dilute NTA over time if they are exercised. Some LICs also have some form of debt securities on issue, which is effectively a form of gearing.

### Other alternatives from the same manager

Some managers also run unlisted funds which exactly, or very closely mimic what the LIC is doing. This brings into play a very important potential for risk management.

When LICs are trading at, or above their NTA, it may be a better strategy to invest in an unlisted fund and to wait for a more opportune time to "switch" to the LIC or to top up your investment through the LIC when it is trading at a discount.

### The management company

Most LICs are externally managed and have a management contract in place for a fixed period of time. It is unlikely the manager would be terminated or voted out during or even at the end of that period, unless they had severely underperformed and a competitor or other party wanted to aggressively pursue management of the vehicle. Such circumstances are rare.

### Dividends

Be very cautious about buying an LIC based solely on it having a high distribution yield. In fact, a high dividend rate can be a sign that the dividend is not sustainable. In this case the LIC may not be an attractive investment as a reduction in dividend rate usually results in a fall in the share price.


### Earnings

We believe published earnings are basically irrelevant as far as an LIC is concerned. Reported earnings are derived from distributions received from investments, less costs, plus / minus changes in the value of the investment portfolio. Long term performance is a much better measure than short-term accounting earnings.

### Management fees

In our view, management fees are less important than you might think. We obviously don't like high fees if they are not deserved.

However if the manager and strategy are producing alpha (extra performance above the market), then we are prepared to pay for quality. Would you rather pay a 1.5% management fee and 12% per annum returns, or a 0.5% management fee and 8% per annum returns? If you look at performance net of fees and costs (as we do), management fees in isolation become less important



The key attributes and the other factors mentioned above should all be considered when researching an LIC as they all carry importance.

# 03 BUYING AT THE RIGHT PRICE

Having looked at the quality of an LIC, and determined that you would like to own it, the next part of the equation is making sure you buy at the right price.

At Affluence, we do this by applying a four stage process:

**01** Is the underlying market the LIC invests into trading at an attractive price?

**02** What is the current NTA value per share?

**03** How does the current ASX buy price compare to the NTA?

**04** What is the price at which we would like to buy?

## 3.1 Underlying Market Value

Before investing in an LIC, you need to consider whether the asset class the LIC invests in (e.g. Australian shares) is cheap, reasonable value, or expensive. If the underlying investments are very expensive, the LIC is likely to produce a lower investment return over the medium to long term.

This can be a very difficult assessment to make, but one of the questions it may be useful to ask is “would I be happy to own these investments directly?”

If you believe the asset class is expensive, then it may be prudent to be patient and wait until you believe there is more value before considering the LIC, or to make a small investment now, and monitor for signs of greater value in the future.

## 3.2 Net Tangible Asset Value Per Security

ASX requires the NTA per security to be published by all LICs at least monthly, and this must be done by the 14th of the following month. Some LICs will provide NTA data more often (weekly or even daily), but many still only report monthly.

Because the NTA data is usually out of date, it needs to be considered in light of market movements since the last NTA date. For example, if the LIC invests in a diverse portfolio of ASX stocks and the ASX 200 Index has fallen 5% since the end of the last month (when the NTA per security was last reported), it is likely the NTA of the LIC will also have fallen during this period. It is difficult to estimate with certainty the exact NTA between reporting dates, but you can broadly estimate it if you understand what the LIC is investing in.



## 3.2 Net Tangible Asset Value Per Security (cont')

When reporting an NTA, an LIC may provide more than one NTA value. There are up to three NTA calculations that are commonly provided:

- NTA before tax. This calculation does not make any allowance for tax on current years' income and profits and therefore does not reflect the tax that will be paid / payable by the LIC for the current tax year.
- NTA before tax on unrealised gains / losses. This calculation allows for income tax and also for capital gains tax on any investments sold in the current financial year. It does not allow for tax that would be payable if all current investments were sold.
- NTA after tax. This calculation takes into account tax on income and realised capital gains and also allows for tax that would be payable if the entire investment portfolio was sold.

In most cases, we believe the most appropriate value to use is the NTA before tax on unrealised gains / losses.

This reflects the position after allowance for tax payable on current year earnings and capital gains, but before any deferred tax on the remaining investment portfolio.

If the LIC has stated an intention to wind-up or otherwise dispose of all or a substantial portion of its portfolio, it may be more appropriate to use the NTA after tax.

## 3.3 Calculating Discount / Premium to NTA

We believe the price you pay for an LIC relative to the value of its investments (the discount or premium to NTA) is the most crucial thing to get right when buying LICs.

The discount or premium is calculated by the following formula:

$$\frac{\text{Buy price on ASX} - \text{Estimated NTA}}{\text{Estimated NTA}} \%$$

A positive number is a premium. A negative number is a discount. For example, if the buy price is \$0.90 and the NTA is \$1.00, the discount is 10%, calculated as follows:

$$\begin{aligned} &= \frac{\$0.90 - \$1.00}{\$1.00} \\ &= \frac{-\$0.10}{\$1.00} \\ &= -10\% \end{aligned}$$



## 3.4 What is the right price to pay?

It is fair to say we prefer to buy LICs at a discount to their NTA. But in our view, there is no one rule which determines the right price to buy an LIC, relative to its NTA value. There are a whole range of factors to consider.

One of the key factors we take into account is the price and NTA history. If we can, we prefer to study how an LIC has traded historically relative to its NTA. This data is sometimes published by the LIC itself, or may also be available through your broker research.

If you can buy at a price below the average discount / premium, calculated over a reasonably long period, this can be a good indicator of value. Other factors which you might wish to take into account when considering your preferred buy price are:

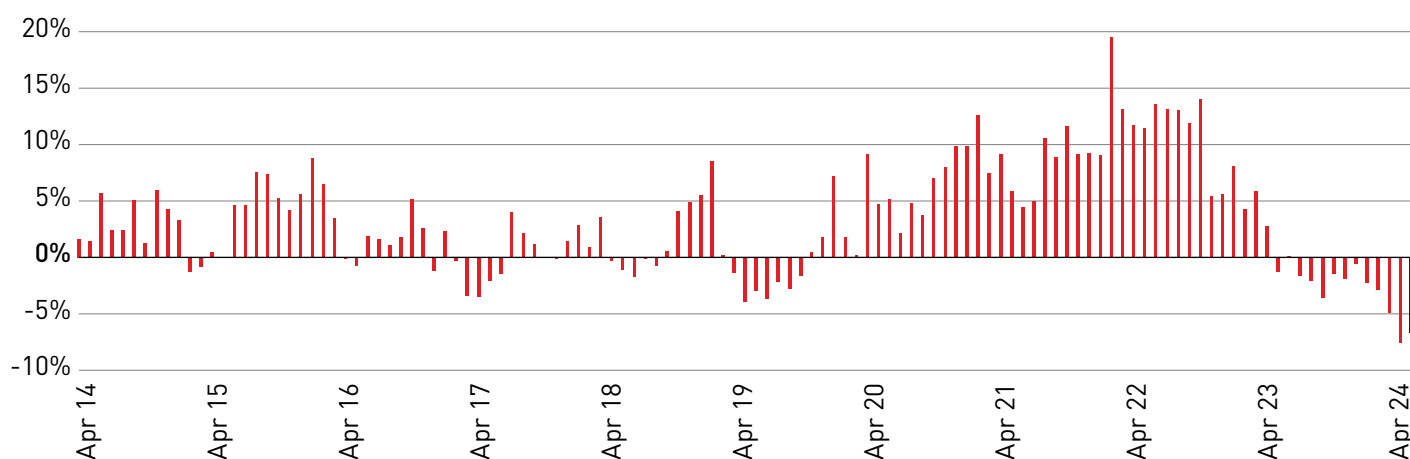
- Historical performance – LICs which have performed very well tend to trade at a premium, or at a lower discount than comparable LICs. In some case it's worth it, but it will depend on the extent of the premium you are paying. By and large, we prefer to be patient and wait for an opportune entry point. Conversely, periods of short-term underperformance by an otherwise excellent manager can provide opportunities to buy in at a good price.
- Size – Larger, more liquid LICs tend to trade at higher prices relative to NTA, whereas smaller LICs are more likely to trade at a discount.
- Underlying assets – LICs that invest in offshore markets or unlisted investments tend to trade at bigger discounts than those who invest in larger, more liquid Australian stocks.

- Portfolio concentration – Some LICs have very concentrated portfolios, where one or a few investments make up a large proportion of the portfolio. These tend to trade at bigger discounts because of the additional concentration risk in the portfolio.
- Investor confidence and market performance – in times when confidence is low, which tends to be during market corrections, LICs can trade at larger discounts. When confidence is high and / or markets are fully valued, LICs tend to trade at higher prices, relative to NTA.

These are just a few of the many variables which can impact the price at which a LIC trades, but we have found over time that they tend to be the most prominent.

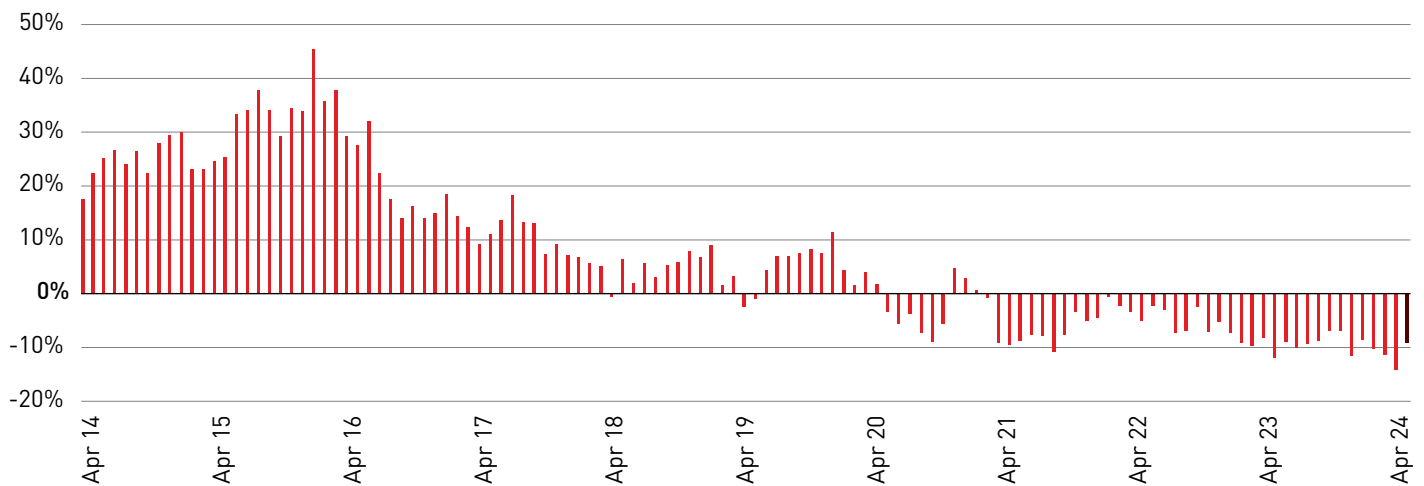
Below are two examples of the change in discounts / premiums to NTA that can occur over a long period. The first is from the largest LIC, AFIC (ASX: AFI). Over the past 10 years AFI has traded in a range of between a 20% premium and a 7% discount to NTA. Given that AFI portfolio performance has been at best similar to the ASX 200 Index, it's easy to see how an individual investors performance could be substantially different depending on the discount / premium when they first invest. Armed with this type of information, it is obvious that one way to potentially improve returns from AFI is to buy it at a discount and sell when trading a premium.

Share price premium / discount to NTA – largest LIC, AFIC (ASX: AFI)



The second example is from AFI stablemate, Djerriwarrh (ASX: DJW). DJW is slightly different in that while it also holds a very benchmark aware portfolio, it also sells options to generate additional income at the expense of potential future capital gains. This leads to portfolio performance that is generally a little behind the ASX 200 Index. However it pays a high dividend yield which historically was chased by yield hungry investors. This chase for yield resulted in investors valuing DJW on a dividend yield basis, which at one point forced it to a more than 40% premium! So, if you bought DJW in 2009 or 2010, by 2016 you would have benefited not only from strong market returns but also from the premium increasing from around 10% to 40%. Since then, reality has finally set in and this stock fell to a discount in 2019, resulting in significant underperformance since 2016.

#### Share price premium / discount to NTA – AFI stablemate, Djerriwarrh (ASX: DJW)



## 04 ISUMMARY

**Like all investments, it's best to do your homework properly before buying any LIC.**

We suggest you consider only quality LICs with proven managers who have performed well in the past.

Ensure those LICs hold assets you like and have an investment strategy you understand, with an appropriate management structure in place.

Understand how an LIC will fit into your portfolio and how you expect it to assist you in achieving your investment goals.

Most importantly, try to buy at the best possible price you can, relative to the value of the underlying assets and the trading history of the LIC.

**We wish you the very best in your investing endeavours.**

# 05 INTRODUCING THE AFFLUENCE LIC FUND

Let us choose an LIC portfolio for you.

The Affluence LIC Fund holds a diversified portfolio of LICs and aims to generate extra returns by buying LICs at unusually large discounts and selling them when the discounts narrow. This discount capture strategy is the greatest source of opportunity.

## Fund Features

Attractive Quartley Distributions

Highly Diversified LIC Portfolio

Unique Discount Capture Strategy

## Investment Strategy

The Fund provides access to a diversified investment portfolio of at least 20-35 ASX Listed Investment Companies as selected by Affluence. We aim to outperform the ASX 200 Accumulation Index over rolling 3 year periods and to deliver these returns with less volatility than the Index.

The Fund aims to invest in LICs that meet one or more of following criteria; Alpha Generators – LICs that can outperform the market, Discount Capture – LICs trading at an attractive discounts to NTA, or Event Driven – special situations such as IPOs, capital raisings and other corporate activities.

## Investment Team



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## Key Statistics

Investment Class	LICs	Applications	Monthly
Minimum Investment	\$20,000	Withdrawals	Monthly
Investment Timeframe	At least 3 years	Management Fees	Nil
Target Returns	ASX200 Accum. Index	Performance Fee	12.5% of positive performance
Distribution Frequency	Quarterly	Buy / Sell Spread	0.10% / 0.10%

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