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Unit Trusts vs Listed Investment Companies

Determining who will manage your portfolio is a complex decision, that understandably takes time. Add the enormous variety of investment structures available, and the complexity rises to a whole new level.

Which investment structure is best for you? The answer to that question will be unique to you and your investing goals. Investors have choices. In our latest Whitepaper, we take an in-depth look at Unit Trusts and Listed Investment Companies. While these two popular investment structures share a common trait – they offer access to active management – there are differences in the income they generate and pay-out to investors and how they are priced.

- By Scott Phillips, Head of Distribution

With so many different investment structures available to accept your investment dollars, how do you know which is best for you? Unlisted Unit Trusts (commonly referred to as managed funds), LICs (Listed Investment Companies) and ETFs (Exchange Traded Funds), provide many options for how to have your wealth managed that the challenge of determining who to manage your money is made more complex.

To provide a little clarity, this Montgomery Whitepaper looks at two of the more popular investment vehicles, being managed funds and LICs and compares them on a variety of key factors.

Structure

Unit Trusts and LICs share a common trait; they offer access to active management by professional investment teams. While the asset class (bonds, equities, property) and the investment strategy might vary, depending on the manager and the investment philosophy, they are generally trying to provide exposure to a particular asset class, out-perform the relevant benchmark and deliver returns via income and or capital growth.

Unit Trusts are generally unlisted, non tax-paying investment trusts. Meaning that all returns of the trust are taxable in the hands of the end investor, be it a Self Managed Super Fund (SMSF), a non-tax paying charity or an individual investor on their respective marginal tax rate.

While a unit trust investor buys units in a trust, LICs are set up as a company listed on a stock exchange and investors buy shares in that company, which is overseen by a Board of Directors.

Distributions/ Dividends

There are two parts that comprise Unit Trust returns; unit price capital growth and distributions. Unit price capital growth, is made up of unrealized capital gains, and distributions are made up of income, dividends, franking credits and realised capital gains, less realised capital losses and fees.

Importantly, Unit Trust managed funds must distribute all interest and dividend income received as well as the net realised capital gains in the financial year they are generated. Generally, this results in more variable distributions to investors year to year, if for example, large capital gains are realised in one financial year compared to another.

LICs on the other hand can pay a dividend regardless of investment earnings (capital gains and income) and can elect what size that is in any year. This allows the LIC structure to maintain a constant dividend should the Board decide. Dividends paid by LICs are usually as a result of investment earnings and as such, the company will pay tax on these earnings. If this is the case franking credits will also be attached to the dividends.

Pricing & Disclosure

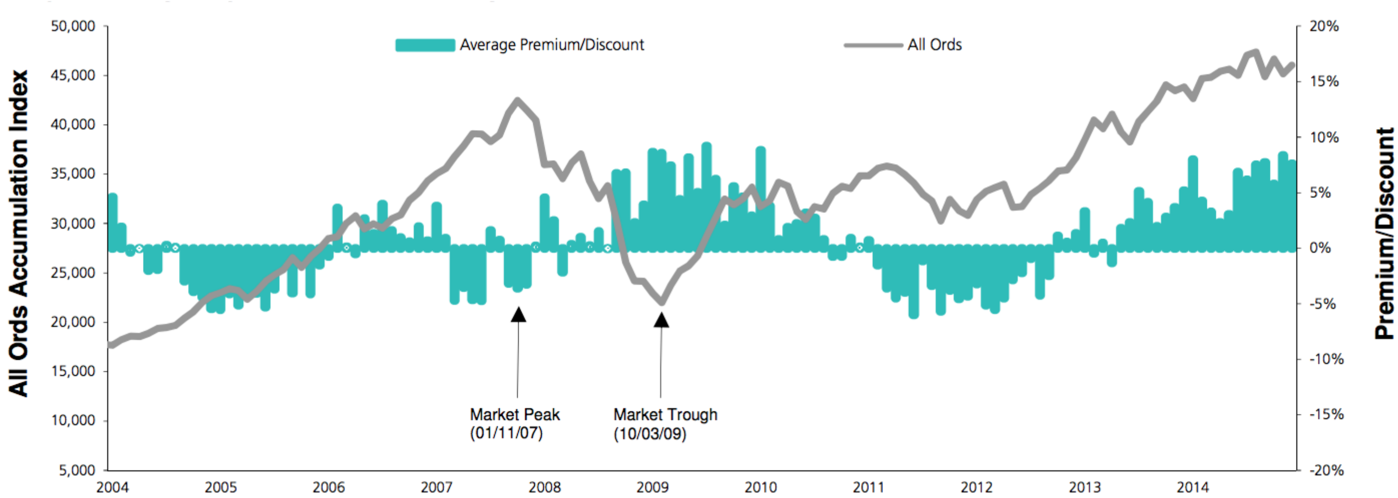
While there are many differences between Unit Trusts and LICs, the most striking is the ability of a LIC to trade at either a discount or a premium to the underlying Net Tangible Assets (NTA). The variation means that an investor may not realize the full return generated by the underlying manager, because stock market investors' buying and selling of the LIC shares can move the share price independently of the value of the LIC assets.

LIC promoters say that because listed structures trade at, above or below the value of their underlying portfolios, investors have the opportunity to buy shares at a discount and sell shares at a premium. It is not the case however that all LIC shares have traded below and above their NTA, so while the opportunity may exist, it has not always been possible to do so.

LICs are obligated to disclose their NTA at the end of each month and have 14 days to disclose this information to the market after month end. This means that an investor is only able to retrospectively know the value of the underlying assets and for the remainder of the month has to guess or estimate the underlying value. As a result, there are usually meaningful periods of time where the NTA of the company is not known. Meanwhile the share market is establishing prices daily. Prices therefore are ultimately set by investor supply and demand for the LIC's shares.

Larger LICs (Market Cap larger than $500m) tend to trade more closely to their NTA over time, but these larger LICs go through cycles of trading at premiums and discounts to their NTA. This is illustrated in Figure 1 below.

Graph 1: Large Cap focused LIC's average share price premium/discount to pre-tax NTA



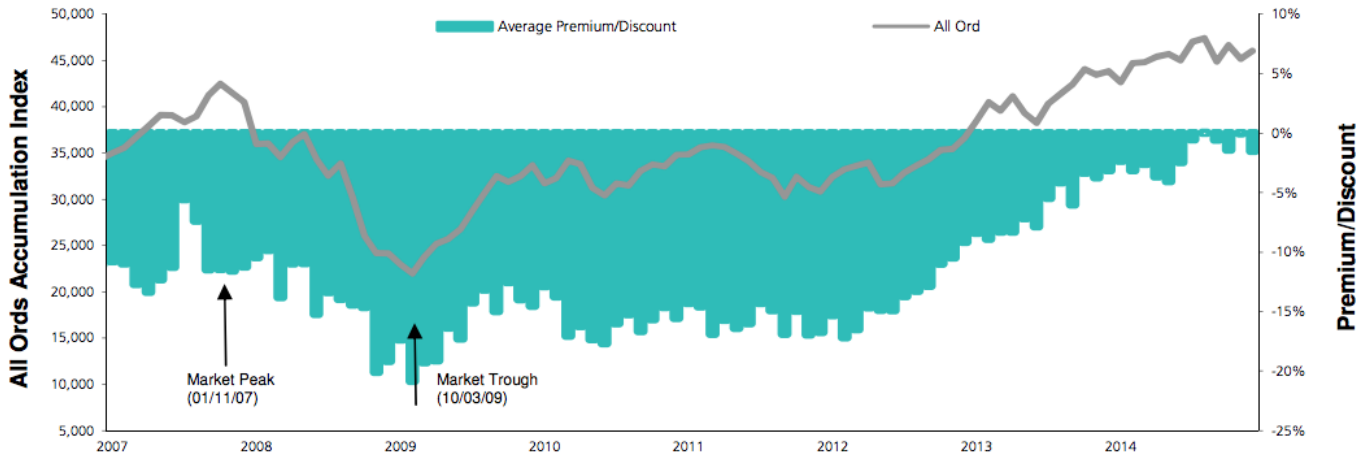
Source: Company data, Iress and Bell Potter

Small LICs (Market Cap less than $500m) can trade, and have traded, at deep discounts to their NTA, averaging a 12 per cent discount over the last seven years. This discount has declined recently as the market has recovered. Over this same period, large LICs have, on average, traded at a one per cent premium.

Investors should also be aware that many of the more recently listed LICs issue attaching options over new shares during the Initial Public Offering (IPO) process and in subsequent capital raisings. If you are buying shares in the secondary market then you need to consider the potentially dilutive effect on the NTA of these options, if they are exercised.

LIC investors must also remember new shares can be issued through activities such as dividend reinvestment plans, share purchase plans, placements, and entitlements as well as exercised options.

Graph 2: Small Cap focused LICs' average share price premium/ discount to pre-tax NTA



Source: Company data, Iress and Bell Potter

Unlisted Unit Trust investors do not have to worry about these influences.

Unlisted Unit Trusts can be marked to market at the end of each day and the value of a single unit always and accurately reflects the underlying portfolio's net asset valuation.

An investor buying and then selling units in an unlisted Unit Trust always receives a value commensurate with the change in the underlying portfolio over the same period.

Demand and supply for new units is managed for the end investor at the Unit Trust's Net Asset Value. With the exception of the bid-offer spread, a unit trust investor never pays a premium nor receives a discount for their investment.

Access & Liquidity

Unlisted Unit Trusts are generally applied for and redeemed directly with the investment manager. Many Unit Trusts have also been made available on wrap accounts and masterfunds offered by the large financial institutions in Australia.

A new service established by the ASX, called mFunds, has also enabled a small number of Unit Trusts to be transacted on the ASX, through approved brokers.

For LIC investors with larger investments, liquidity is a major consideration when exiting. The simple fact is that unless there is a willing buyer in the market for your shares, a large investor may not be able to exit at the price desired or at all.

The open-ended structure of unlisted Unit Trusts means the manager generally redeems units at the closing NTA at the end of each day.

Managing Liquidity

LIC managers can add more capital to the pool they are managing through capital raisings such as dividend reinvestment plans, share purchase plans, placements, and entitlement offers as well as options exercised, but a long term management contract means the fund pool cannot reduce through redemptions – even after poor performance. This lack of outflows however means the manager can maintain positions, liquidate or add new positions regardless of whether investors are buying or selling the underlying shares. That is, the capital is permanent.

The pool of money managed by Unit Trust fund managers rises and falls with inflows and redemptions respectively. That is, the capital is contingent. The manager may be forced to sell stocks in order to fund redemptions. Conversely, a fully invested manager could be forced to buy into positions the manager deems to be expensive, simply because of net inflows. This depends of course on their mandate and whether they are required to be fully invested.

Destabilising

A Listed Investment Company is a publicly listed Australian company. As such regulations including the ASX Listing Rules and the Corporations Act apply. That means the company must hold an Annual General Meeting. However it also means that shareholders representing just five percent of shareholders can call multiple Extraordinary General Meetings (EGM) at any time, and call a vote on such matters including attempting to appoint themselves as directors, removing existing directors or calling for a capital return. While many smaller LIC managers enjoy long term management agreements, even multi-decade agreements, irrespective of performance (and remember funds can flow in but there are no redemptions), between their management company and the LIC, hostile takeover offers can also be mounted.

The incumbent manager of an LIC has a number of defences, such as simply growing the company to a large enough size to dissuade potentially disruptive suitors or owning a sufficient number of shares to be able to block some of the actions of smaller shareholders. And while the Board must act in the best interest of shareholders, anyone with a sufficient amount of investing experience knows that sometimes the debate must be argued through the Courts.

Obviously all of this is potentially destabilising and may distract management from managing the portfolio for their shareholders.

Fees and Performance

Active managers tend to offer either a LIC or managed fund structure for their investment strategy. It is therefore hard to make an inference as to whether one structure produces a better investment result should they have offered the same strategy.

Generally speaking, the larger the investment strategy, be it an unlisted Unit Trust or an LIC structure, the more difficult it is to out-perform the relevant benchmark over time. Some of the largest LIC's in the market have some of the lowest fees, but appear to have delivered index-like returns over the last decade.

Similarly, there are many unlisted managed funds, which have become very large and they too appear to be delivering index-like returns on an after-fee basis.

In saying this, there are many active equity strategies in both LIC and managed fund formats that have neatly out-performed their relevant benchmark over time.

Summary

Like so many aspects of life, investors are faced with a choice. And all choices offer advantages and disadvantages.

So, if you can find a manger that is disciplined, consistent in applying their investment philosophy with a stable, quality investment team that has demonstrated market beating returns on an after fee basis, then they're probably worth a look regardless of the investment structure.

Hopefully, our paper has now equipped you with a better understanding of the differences between LICs and managed funds, allowing you to make a more informed choice based on your investing goals and requirements.

Scott Phillips is the Head of Distribution of Montgomery Investment Management.
All prices and analysis at May 1, 2015.