

# thebigpicture

guideposts for the private investor

Week Commencing 25 July 2005

## **Publishing and Subscription Information**

*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## LICS: GET RID OF THEM?

New listed investment companies are struggling to gain acceptance. Reputational problems associated with poor share price performance and sometimes unclear investment intentions are affecting their standing.

A potential investor can generally invest in equities in four ways:

- self-managed direct equities;
- discretionary accounts;
- open-end managed funds; or,
- listed closed-end managed funds.

Self managed direct equities require the highest level of personal commitment. While an investor may have varying degrees of assistance in making investment decisions, the investor himself is ultimately responsible for the investment strategy, stock selection and portfolio administration.

Discretionary accounts offer all the virtues of a professional manager with the added benefit that they can be tailored to the specific circumstances of the individual. Investment decisions can take account of specific taxation circumstances, for example. However, discretionary accounts need to have a minimum size, usually thought to be at least \$100,000, to be financially viable.

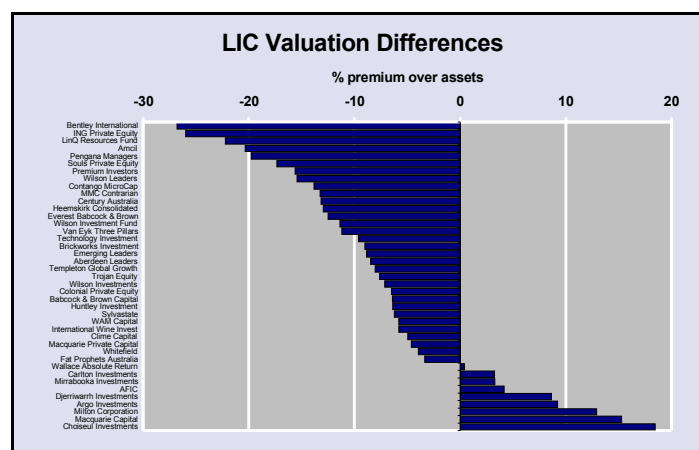
In contrast, managed funds pool capital. This gives them economies of scale and the capacity to cope with small contributions from individuals. However, they are unable to take account of an individual's own taxation circumstances. In some cases, investors may inherit the taxation liabilities of previous investors which, if known, might have led to a different investment decision.

Closed-end listed investment companies can offer some of the economies of scale of managed funds with some limited taxation tailoring. Funds are pooled through a one-off capital raising from individual investors. Individuals can liquidate their investments by

selling their shares in the pool of funds. The pool of funds remains unchanged (subject to any subsequent formal capital raising activities) providing some additional security for the fund manager.

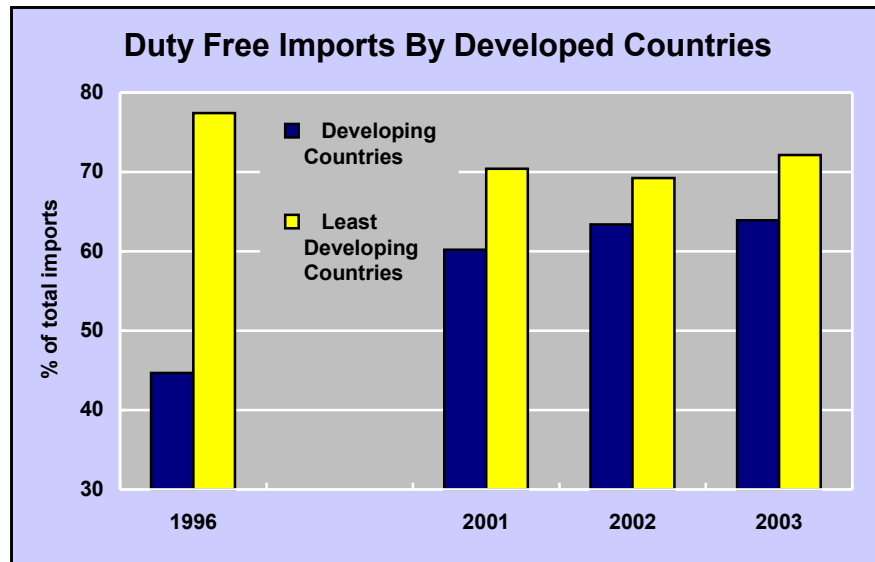
Listed investment companies can attract favourable taxation treatment. Depending on their trading activities,

they may be treated in the same way as a trust or individual for purposes of assessing capital gains tax liabilities.



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## THE WEEKLY CHART SPOT



Source: United Nations

Developing countries have achieved greater market access for their products among the developed nations. Slightly under two-thirds of goods entering developed countries from the developing nations were duty free in 2003 compared with 45% in 1996. However, the least developed nations are still struggling. Less of their goods were getting duty free access in 2003 than in 1996.

## LICs: GET RID OF THEM? CONT'D

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the underlying portfolio rather than be overwhelmed by the analysis about pricing. If, for example, there are grounds for expecting a 15% capital improvement within a reasonable time, a 5% loss in up-front value might be acceptable.

- Worry about post-IPO liquidity only if the purchased security is to be actively traded.
- Look for fund managers with trans-

parent processes which accord with your own investment needs.

- Ensure there are no other better priced products which do the same job.
- Seek assurances from the potential managers that they know how the funds are going to be used. Remember, you can manage your own cash.

*thebigpicture* INVESTMENT RESULTS CONT'D*(Continued from page 4)*

The overall portfolio is limited in size to 25 stocks to provide adequate diversification with discipline. No stocks can be bought for the portfolio until they can be shown to be superior (according to the specified criteria) to something already in the portfolio which can be displaced.

The current weighting of the portfolio is as follows:

Large Cap Core	31.3%
Mid cap core	27.6%
Consistent Value	19.1%
New Momentum	18.4%

The structure of the portfolio allows for the four components to be reweighted to take account of differing risk profiles of individual investors.

As structured above, the portfolio is intended to offer moderate risk within an equity market context. By tilting the portfolio toward higher return lower risk companies, a relatively small number of turnaround situations (i.e. the new momentum group of companies) with potentially stronger than average capital gains can be brought into the portfolio while, at the same time, keeping expected returns above the average for the market and risk no higher than for the market as a whole.

Generally, because of the emphasis on companies exhibiting superior economic performance, the dividend yield should be relatively high. However, there is no specific emphasis on dividends in structuring the portfolio. The 2004/05 dividend yield was 5.4% on the opening value of the portfolio. ■

## LICs: GET RID OF THEM? CONT'D

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### Value Gaps

A listed investment company has a dual character: it represents a portfolio of stocks but is also an equity in its own right to be traded on the stock exchange. Investors can benefit from an increase in the value of the underlying portfolio as well as being able to buy or sell while anticipating movements in the portfolio value.

Listed investment companies are required to report each month on the value of their underlying securities so that investors can make a regular assessment about the extent to which the share price of the company holding the investments is higher or lower than the value of the underlying portfolio.

This has proven a mixed blessing. In theory, the share price of the listed investment company should reflect the underlying value of the securities being held. However, in practice, this does not always occur and the prices of some listed investment companies have traded below the portfolio value for long periods. The frequency of reporting has focused attention on this difference to the detriment of expectations about likely future performance, the normal driver of equity prices.

The Australian Stock Exchange (ASX) itself publishes data in this form. Its latest release on the share prices of its listed investment companies (from which the accompanying chart is drawn) shows the majority trading at a discount to their asset backing. Only a small minority – nine out of 48 – trade at a premium or within 3% of their reported asset backings.

This divergence between value and share price is a disincentive for investors to choose listed investment companies from among the alternative investment forms. However, there are some patterns which suggest a premium or discount to asset value is not random.

### A Pattern Emerges

Larger listed investment companies are less likely to suffer a discount. For example, Argo Investments, AFIC and Milton, with an average market capitalization of \$2.4 billion, were trading at an average premium to asset backing of 8.8% according to the ASX.

At the other end of the scale, three of the smallest, Heemskirk, Pengana and Amcil,

with an average market capitalization of \$26.7 million, were trading at a 17.7% discount to valuation.

Quite reasonably, the market tends to accord cash less than face value when it is held in an investment vehicle despite accounting standards requiring analysts preparing reports to value one dollar of cash at face value. Thus listed companies with large cash holdings such as Clime Capital, Premium Investors, Wilson Investment Fund and LinQ Resources Fund traded at an average discount to stated value of 13.5%.

An observation of a less tangible kind is that the listed entities accorded the highest market ratings are those with the most accomplished investment managers. This is as it should be and often, unsurprisingly, coincides with size since successful managers are likely to attract more funds and grow larger. The demand for their investment management services will also tend to push up the market prices of the portfolios they are managing. In this category are such funds as AFIC, Argo, Choiseul, Djerriwarrh, Milton and Mirrabooka.

There are other forces which also place a drag on performance.

Some managers have highly individualistic styles or are such opportunistic investors that potential shareholders are unable to anticipate adequately the nature of their prospective investment exposure.

In some cases, too, the equivalent to the listed investment company portfolio is also available in the form of other managed fund products sometimes less expensively for the retail investor.

### Leave Them Alone?

The propensity for listed investment companies to trade at a discount to asset backing suggests that potential investors should eschew the opportunity to take up shares in newly listed investment companies. Some investment advisers have gone so far as to put a ban on recommending listed investment companies to their clients no matter what their investment approach, so low has their reputation sunk.

However, rather than throw the baby out with the bath water, a more discriminating approach might involve five guideposts.

- Focus on the post-IPO returns from

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*“This divergence between value and share price is a disincentive for investors to choose listed investment companies from among the alternative investment forms.”*

## *thebigpicture* INVESTMENT RESULTS

*thebigpicture's* intrinsic value Australian equity portfolio increased in value by 27.6% over the year ended June 2005.

*thebigpicture* applies the analytical tools advocated in the weekly review to the construction of an analytical portfolio. The portfolio is used to illustrate the methodology; it is not available as an investment product. Nor is it recommended in any form for any investors. The portfolio is one practical test of how worthwhile the guideposts might be in creating value in an equity market setting.

### Superior Economic Performance

Underpinning the portfolio construction methodology is the choice of companies with 'superior economic performance'. Superior economic performance is defined as having three elements.

- **Profits higher than required rates of return.** All company returns are benchmarked against a cost of capital benchmark, a fundamental measure of business performance and determinant of shareholder value.
- **Improving rates of return.** Rising rates of return ('spread momentum') provide the impetus for better than average share price performance.
- **Achievable growth.** It is critical that growth rates implied by share prices reflect achievable outcomes and investors are not overpaying.

This approach immediately excludes a large number of companies from consideration. For example, loss making companies or even profitable companies with a record of being unable to generate an adequate return on funds employed would not be acceptable investments. Similarly, strongly growing companies might not be attractive if the growth is not adding value for shareholders.

Such companies may perform well for brief periods and may catch a few headlines but are unsuitable investments for longer term, value oriented investors. The portfolio is designed to have a 'buy and hold' bias.

### Portfolio Structuring

The definition of superior economic performance permits identification of a group of focus companies from among the listed universe of Australian stocks. The focus stocks are divided into four groups.

- **Large cap core:** companies with a market capitalization higher than \$1 billion which are adding value with a rate of return higher than their costs of capital, whose rates of return have risen in the last reported period and are expected to rise again in the first forecast period.
- **Mid cap core:** companies with a market capitalization lower than \$1 billion which are adding value with a rate of return higher than their costs of capital, whose rates of return have risen in the last reported period and are expected to rise again in the first forecast period.
- **Consistent value:** companies which do not display a rising trend in their return spreads but which show superior economic performance by consistently delivering a rate of return in excess of their cost of capital
- **New momentum:** companies which might have a history of failing to deliver superior economic performance but which have undergone a significant change in strategic direction

Historical Portfolio Performance		
Year ended June	<i>thebigpicture</i> Portfolio	ASX 200 Accumulation Index
2005	+27.6%	+26.4%
2004	+38.8%	+21.6%
2003	-5.5%	-1.7%
2002	+1.0%	-4.7%
2001	+41.8%	+9.1%

(usually associated with a management change) and which are expected to change from being a value destroyer to adding value within a two year time-frame.

From each of these four groups a limited number of portfolio stocks are chosen.

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