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Listed investment Funds

How closed-ended LICs and LITs benefit investors

Angus Gluskie

Closed-ended investment entities such as listed investment companies (LICs) or listed investment trusts (LITs) have a fixed capital. When investors seek to reduce their investment in an LIC or LIT, they sell their shares/units on an exchange like the Australian Securities Exchange (ASX) to a new owner. Importantly, the LIC or LIT itself has not had to sell any investments during this process.

This process contrasts with the actions of open-ended managed funds and exchange-traded funds (ETFs), where investor deposits and withdrawals result in the fund having to repeatedly buy or sell underlying investments to apply or liquidate cash balances.

Because of this structural difference, closed-ended funds provide unique advantages to investors, the broader economy and the financial markets system.

The strategic, cost and tax benefits of a closed-ended structure for investors

Open-ended managed funds and ETFs must repeatedly buy and sell assets to match the continuous ebb and flow of investor deposits and withdrawals. These repeated purchases and sales incur transaction costs and crystallise tax liabilities on gains. In certain circumstances where there have been large withdrawals, ongoing investors in open-ended funds may also be left with an undue proportion of hidden deferred tax liabilities.

In comparison, LICs and LITs, which have a fixed capital, do not face this additional cost and tax burden.

Strategically, an LIC or LIT having a fixed capital has money to invest when other investors are fearful sellers and assets are cheapest. In contrast, open-ended funds and ETFs become forced sellers of assets into cheap and fearful markets to fund net investor withdrawals, and equally, must buy expensive assets when investors deposit funds during periods of exuberance.

LICs/LITs raise capital periodically through block capital raisings. By coordinating with other investors as part of a single block, underlying investors have collective buying power when it comes to the pricing, success or failure of share issues. History shows regular examples of share issues that have been repriced, restructured or cancelled as the result of collective investor feedback.

The provision of long-term investment capital for the economy

In any well-functioning economy, it is vital to have investment structures that can provide long-term investment funding. Property, infrastructure, renewable energy and even general business investment all require long-term capital.

History has shown that using open-ended managed funds or ETFs to fund these investments can be problematic. In times of fear, inves-

tors will withdraw money from open-ended funds, with the adverse consequences that:

- funding for critical infrastructure may be withdrawn
- assets may have to be sold into weak markets, or
- if assets cannot be sold, investors may be prevented from withdrawing their funds.

LICs and LITs as closed-ended funds, however, are one of the few investment vehicle types suitable for providing the economy with patient longer-term capital.

Stability benefit for financial markets

As mentioned, investment markets go through periods of fearfulness and exuberance. Open-ended managed funds and ETFs are by necessity pro-cyclical investors. They must sell investments into cheap markets to fund investor withdrawal demands and buy expensive investments in buoyant times as they apply new investor deposits. This process exacerbates market volatility, contributing to the systemic risk of pricing bubbles, flash-crashes and market collapses.

As fixed-capital entities, however, LICs and LITs can do the opposite. Their fixed capital allows them to be a buyer when markets are weak and assets cheap if they consider it wise to do so. The presence of closed-ended entities such as LICs/LITs can thereby contribute to the stabilisation of investment markets in a way that others may not.

The premium discount dynamic

As mentioned, closed-ended investment entities such as LICs or LITs have a fixed capital. Investors wanting to reduce their investment in an LIC or LIT can sell their shares/units to a new owner, with the price determined in the free and open market.

Importantly, the LIC or LIT itself has not had to sell any investments during this process.

This process contrasts with the actions of open-ended managed funds and ETFs, where investor deposits and withdrawals result in the fund having to repeatedly buy or sell underlying investments to apply or liquidate cash balances.

The closed-end structure provides advantages

Because a closed-ended entity does not have to repeatedly buy or sell investments to handle investor deposits or withdrawals, an LIC/LIT achieves a saving in transaction and taxation costs compared to an open-ended fund.

Importantly, the fixed capital held by an LIC/LIT allows it to be a buyer of assets when markets are most fearful, when open-ended funds and ETFs are forced sellers to fund investor withdrawals and when assets are cheap. This characteristic creates several subsidiary benefits:

- Investors may benefit from the stronger investor return achieved.
- Overall market stability may be improved by having a class of investment entity with stable capital and a willingness to buy assets.
- The economy may benefit by having a source of long-term funding for critical infrastructure such as property, transport infrastructure, energy infrastructure and renewable energy generation.

A free and open market pricing mechanism

By buying and selling shares and units in LICs and LITs on the ASX, investors transact at a price which takes account of all factors those investors consider relevant.

These may include:

- asset backing
- structural risks
- benefits and opportunities
- expectations
- embedded tax liabilities or benefits
- investor opinions on whether the market represents good value or poor value
- general supply and demand on the day of trade.

Accordingly, the price of a LIC or LIT determined in the open market on the ASX may be higher, lower or the same as the underlying net asset backing. This is referred to as trading at a premium or discount to asset backing.

At any point in time, LICs and LITs will trade across a range of premiums and discounts to asset backing. This is a normal and expected part of closed-ended markets and is the mechanism by which the net demand of buyers and net supply by sellers may be matched up.

Naturally, LICs/LITs that are most in demand can be expected to trade at higher levels relative to asset backing, with investors ascribing added value to the attributes that they currently perceive as most favourable. These attributes and the importance investors place on them will change over time.

Some of the factors influencing the ebb and flow of premiums and discounts include the following:

- The changing preference for different asset classes as economic conditions change (e.g. in some conditions, income-producing assets are favoured; at other times growth assets, and at other times again international assets).
- The performance of underlying investment managers changes over time. In some conditions, growth managers do well; at other times value managers may outperform. There are also times when small-cap managers may be in favour.
- Supply and demand of LICs/LITs and other investment vehicles will fluctuate. If there is not enough issuance of LIC/LIT capital, and demand is strong, prices will tend to move towards premiums. When the reverse occurs, prices may soften.

The premium/discount dynamic adds a further dimension

This normal range of LIC/LIT premiums/discounts and their fluctuation over time provides an additional inherent dynamic to investing in closed-ended funds.

The quote

At any point in time, LICs and LITs will trade across a range of premiums and discounts to asset backing.

Investors and their advisers who are active in the LIC/LIT market carefully monitor LIC/LIT premiums and discounts, and seek to invest where they consider the premium/discounts positions and movements may be favourable or attractive.

Conclusion

Closed-ended investment entities such as LICs/LITs provide benefits for both the economy and investors. The premium/discount dynamic of LICs/LITs is a normal part of the successful functioning of closed-ended investment markets, and enables these entities to maintain a fixed capital. Investors who invest in LICs/LITs typically seek to understand this dynamic and utilise it for their benefit where possible. **FS**