LIC / LIT Income – A Comparative Analysis

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Overview

It is well known that LICs, as a company structure in contrast to a trust structure (LITs, ETFs, Unlisted Unit Trusts), have a structural advantage in the ability to manage / smooth income as well as attach a higher and more consistent level of franking to that income.

In short, as the analysis in this article illustrates, on a relative basis LICs:

1. Pay higher and more consistent income;
2. That income is less corelated to market cycles, both in up-markets but more importantly in down-markets;
3. On a market cap weighted basis and which represents the volume weighted dollar of investor experience (versus a median calculation - the average across all LICs), the average level of income in the LIC sector increases, whereas it actually marginally declines in comparable ETF sectors;
4. Due to dividend and franking reserves, past is actually precedent to a degree with LIC income (predictability of income) whereas past provides very little guide to future trust income; and,
5. Not forgetting Debt LITs, all eight ASX-listed debt LITs have materially outperformed their ETF cousins on an income basis.

Taking all the above into consideration, it is little wonder that particular LICs are popular amongst investors in the retirement stage in their investment lifecycle. The importance of stability of income in down-markets should not be under-estimated. It reduces the need to realise capital to make up any income shortfall, and realising capital in a significant down market creates significant sequencing risk, as any issuer of retirement products knows very well.

While the S&P/ASX 200 just had a bumper dividend reporting period, the question is how sustainable that is? Some analysts believe not very, believing it was driven by a confluence of events: slashed Capex (20-year low); record iron ore prices (since materially retraced), and; 3) catch-up from slashed FY20 dividends.

Whatever the case may be, the key point: uncertainty in future dividends. Which gets us back to the stability of LIC income.

But what about the discount to NTA risk? Well, again on a market cap weighted basis (exactly how all major global market indices are calculated) and representing the volume weighted of investor dollar experience, the key LIC sector have generally and continue to trade at a premium to NTA (see analysis on page 3). It appears an investor can have both the income and capital cake.

LIC Dividends are More Stable, Particularly in Down-markets.

Which should be of little surprise but it is important to illustrate the definitive evidence. The two charts below illustrate the trailing 12-month yield of the Australian equities - Large Cap LIC sector (top chart) and ASX-listed ETFs with S&P/ASX 200 index mandates (i.e., like-for-like strategies).

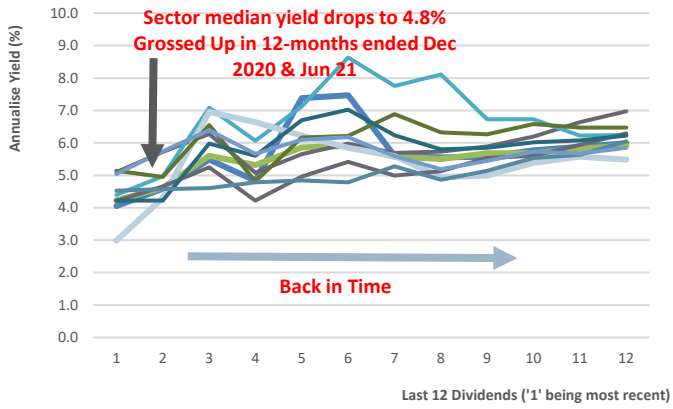
In both charts, number '1' on the Y-axis indicates the trailing 12-month yield based on the most recent dividend / distribution paid (so, effectively June 2020 to June 2021). The number '2' illustratrates the trailing 12-month yield based on the second last dividend / distribution paid, and so on. So the chart extends back in time as the time series moves away from the X-axis.

Each line item is a seperate investment vehicle in the LIC and ETF sector categories.

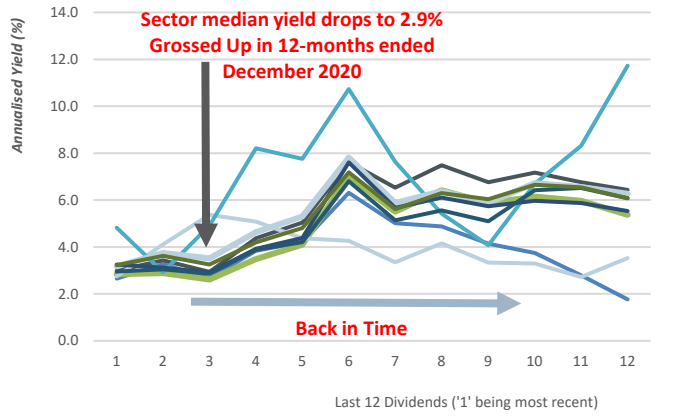
The key area of interest is roughly the payments from '1' though to '4', as these periods encompass 'peak' Covid periods in 2020. What is evident is 1) the relative stability of the Australian equities Large Cap LIC sector and 2) the ETF sector 'dropping off a cliff'.

Both charts are based on net yield, not grossed-up yields. If the analysis was on a grossed up basis you would see even greater relatively variability in the ETF sector. Over the last twelve period, the median level of franking in the ETF sector of interest has varied from 50% (most recent period) to 80%.

Yield Stability - LIC Australian Equities Large Cap



Yield Variability - ETF Australian Equities Large Cap

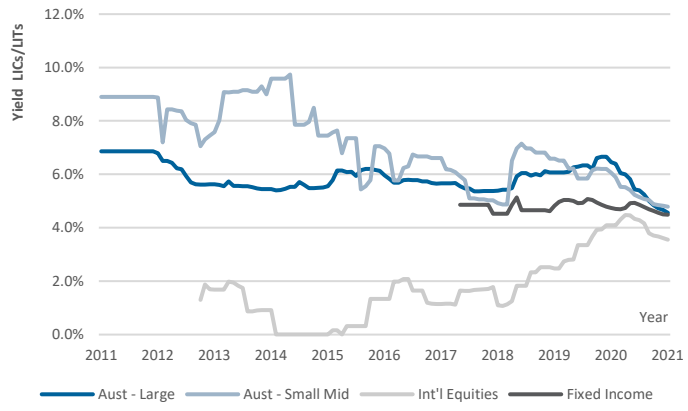


LIC Dividends and Debt LIT Income is Consistently Higher.

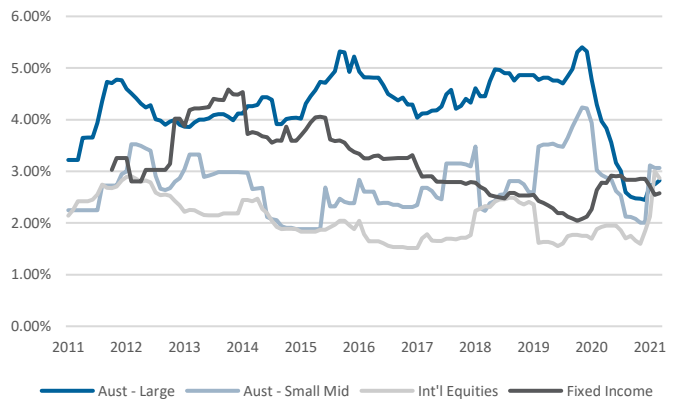
The charts below illustrate yields by the common / key asset classes for the ASX-listed LIC/LIT and ETF sectors. The analysis is based on the rolling trailing 12-month yield, with LIC/LIT yield being a function of NTA (as opposed to current share price, which is a measure of the 'running yield'). The charts illustrate the absolute amounts as well as the differential between LICs/LITs versus ETFs in comparable sectors.

The analysis is conducted on a median basis (not a market cap weighted basis), which includes for the grossed up analysis the median level of franking across all relevant LICs and ETFs.

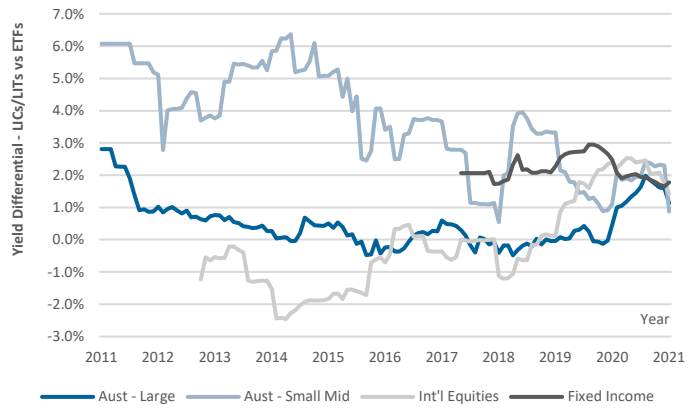
LIC/LIT Yield by Sector (Grossed Up)



ETF Yield by Sector (Grossed Up)



Yield Differential by Sector - LIC/LT vs ETFs (Grossed Up)



The analysis illustrates:

1. On a median basis, LICs/LITs generally pay higher and more consistent income. The differential by sector has varied materially, being highest in the Australian Equities – Small Mid Cap category but has been consistently higher in the Fixed Income sector category.
2. It should be no surprise that ETFs (and LITs) exhibit greater positive correlation to market cycles, both up and down. The sharp decline in median ETF income in 2020 illustrates this correlation well. For investors in or approaching the retirement stage in their investment lifecycle, the ability not to sell an investment to generate required income is particularly important in not incurring sequencing risk.
4. International Equities LICs/LITs had an initial period of underperformance relative to comparable sector ETFs, but this has reversed. This is due to the fact that a LIC will go through a 'ramp-up' period with respect to income. The vehicles will spend the first several years building up its dividend and franking reserves before issuing higher, more sustainable and partly / fully franked income.

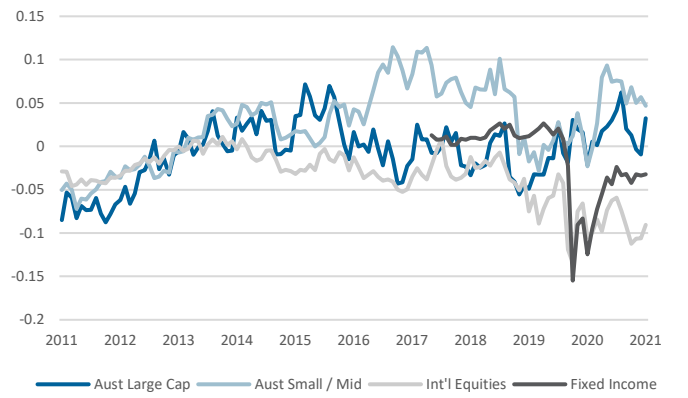
What About Discount to NTA Risk?

The chart below illustrates the Premium / Discount to NTA by market cap weight. As is clear, the key LIC/LIT sectors have actually traded at a premium on the basis of a volume weighted dollar of investor experience (the same methodological basis of all major equities indices). So, it would appear that an LIC/LIT investor can have their income cake and eat it.

The difference between a market cap weighted and a median basis is important. Just like all global indices (which are market cap weighted), a market cap weighted methodology illustrates the broad overall investor experience by dollars invested. A median methodology illustrates the simple average experience across all vehicles. It is like saying the experience of 135,000 AFI shareholders is the same as 500 shareholders in a small LIC!!

Larger LIC/LIT managers are generally 1) longer established (greater dividend and franking reserves) and, 2) relatively superior investment managers. For passive ETFs, two ETFs of markedly different market cap size tracking the same index will largely generate the same performance outcome.

Premium / Discount to NTA (Market Cap Weighted)



For an in-depth analysis of this chart and the underlying drivers, please refer to Page 7 of the RRM August 2021 LIC/LIT Monthly previously published on Livewire (https://www.livewiremarkets.com/wires/the-chart-the-media-doesn-t-show-you-about-lics-and-lits).

Fixed Income LITs – Consistency and Elevated Income.

Not a single debt LIT has missed a beat with respect to target income (with the exception of ASX: MOT and which has missed slightly). The key difference is fixed income debt LITs are active investment strategies (read: through cycle investment strategies), have materially less duration risk and are predominantly either private debt or high yield strategies (high yield is positively correlated to rising inflation / interest rate risk, investment grade (the majority of fixed income ETFs) is negatively correlated). Only a close-ended vehicle can accommodate a private debt strategy (and offer the potential for private debt premia.

Is Past Precedent? Well, to a degree with a LIC (but not with a LIT or ETF, or only to the extent of income from underlying portfolio holdings). By way of its dividend and franking reserve cover (as a function of last 12-months income), LICs can provide a greater degree of certainty of income and franking over the foreseeable future.

Profit Reserves equals X years of future Dividends?? Actually, Not Quite...

It is not uncommon to see comments or analysis that go to this effect: a particular LIC's retained profit reserves are of $XXm amount, the equivalent of X.X years dividend coverage of the latest financial year dividend paid by a LIC.

A LIC profit reserve includes both realised and unrealised gains and losses from current investments. For example, LSF recently booked a massive circa $500m to its profit reserve, but the majority of that amount constitutes unrealised investments.

When a LIC receives cash inflows, it can hold it as cash or reinvest it. Retained Earnings and Profit Reserve do not say anything about how the cash was utilised after it was received. The retained earnings figure and capital profit reserve figure do not actually indicate that they have funds readily available to draw on for dividend smoothing. Anything required beyond what it may have sitting in cash at the time would need to be made up from liquidating assets.

When you read that an LIC has X years of dividend cover that is somewhat misleading. What it actually means is that if the LIC did not book a single dollar of realised gains moving forward (profit reserve dollar) it has the equivalent of X years of the last dividend amount before it exhausts its profit reserve. By law, dividends can only be paid when there is a positive profit reserve. So, a loss making company with no reserves cannot pay a dividend.

Many LICs differentiate dividend reserves from profit reserves. The dividend reserve provides a more accurate measure of the reverses being held for the future distribution of dividends. A dividend reserve is established to set aside amounts for the payment of future dividends. While again, a dividend reserve amount is not actually sitting in cash, but what it does show investors is the board is dedicated to paying out a certain amount in the future.

With respect to the franking reserve, when a LIC receives franking credits from underlying investments and when it pays income tax, franking credits are gained, and when distributing franked dividends, they are reduced. Cumulative excess franking credits are booked to the franking reserve.

If a LIC has a franking reserve, for example, of $0.50/share it has the ability to pay out a fully franked dividend of $1.17/share (subject to having a profit reserve that exceeds this amount – an eligibility requirement). Of course, an Australian equities LIC will also receiving franking credits from underlying ASX-listed companies (the ASX 200 has circa 80% franking levels), so the LIC will typically have future years of fully franked runway that far exceeds simply the franking reserve amount.

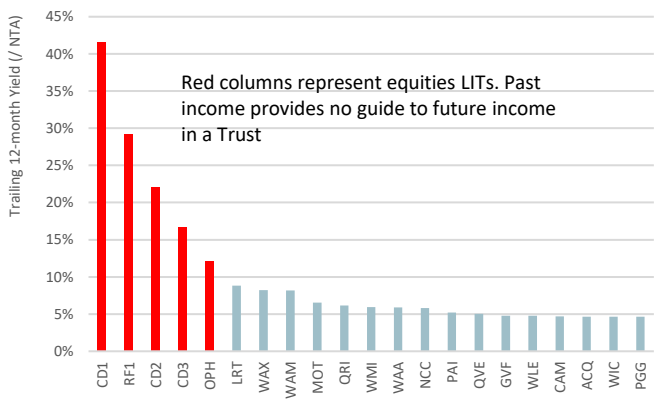
The franking account balance is more indicative of the amount of dividends that a LIC could realistically pay out because all LICs would be highly reticient to go from a 100% fully franked dividend to a less than 100%.

LIC / LIT Yield Rankings by Sector

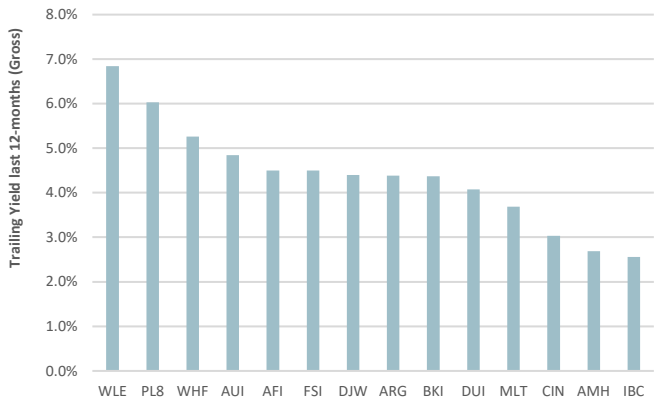
The charts below ranking the key sectors based on the last 12-month trailing yield. The analysis is based on grossed up yield according to the level of franking of each particularly LIC.

We have made the caveat that past income levels of LITs provides little guide to future income, given LITs must distribute all income in the year earned - pass through income from underlying investments + realised gains / losses. For example, Regal would be the first to say that the monster FY21 distribution is in no way indicative of future levels (nor potential would Regal want it to be - it had a circa 60% DRP take-up level, equaling a decent slab of capital to pay away).

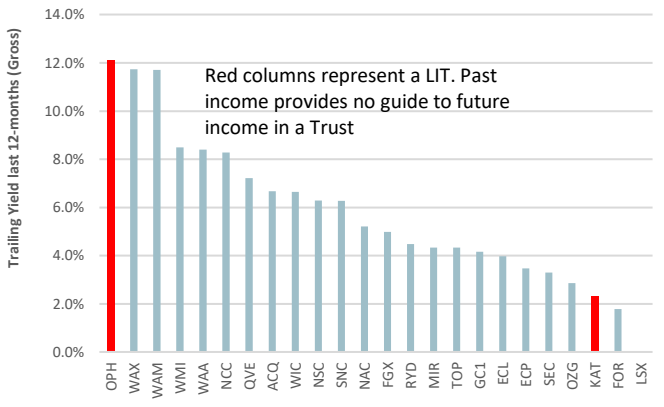
Trailing 12-mth Yield - All LICs/LITs



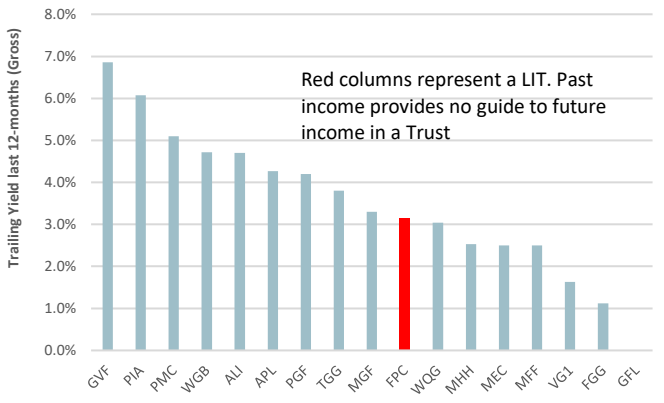
Trailing 12-mth Yield - Aust Large Cap



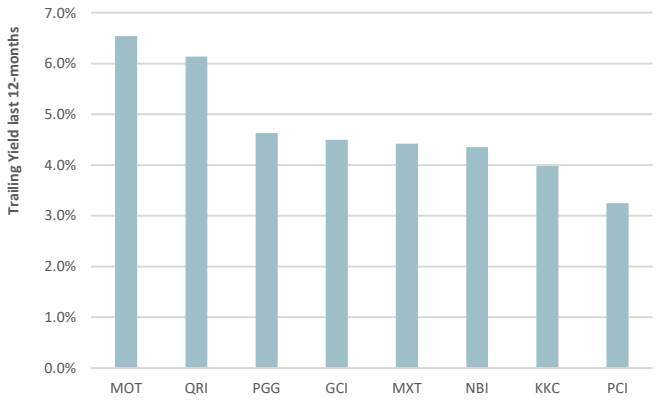
Trailing 12-mth Yield - Aust Small Mid Cap



Trailing 12-mth Yield - Int'l Equities



Trailing 12-mth Yield - Debt LITs



That was Then. What about the Outlook?

The below comments are essentially based on an historic assessment of risk and return of income in order to provide a guide as to where RRM approximates yield levels maybe over the short to medium term. Usual disclaimers apply. A review of reserves has also been undertaken.

By 'risk' we mean the historic variability to the downside of absolute dividend amounts. I.e., has, by what degree, and how frequently have there been dividend declines (a downside deviation measure).

With the exception of debt LITs, LITs are excluded from the below just to points note previously in the article.

In the **Australian Equities - Large Cap sector** RRM's simple advice is to focus on the five or so highest yielding LICs in the sector chart above. Wilson Asset Management (**WLE**) have a superlative track-record and relatively high portfolio turnover facilitates high yield. **PL8** is specifically an elevated and consistent monthly income strategic and specifically designed for retirees. Dom Hansom is highly regarded in terms of an enhanced yield strategy. **WHF** has an impressive history of high, consistent and growing dividends.

In the **Australian Equities - Small Mid Cap sector** no LICs approach the three Wilson Asset Management LICs (**WAM, WAX**, and **WMI**) in terms of elevated yield and consistent and material growth over time. It is the absence of past downside risk and the level of income growth, combined with general manager skill, that provides RRM with conviction that these three LICs will continue to be the standouts. **ACQ** is another standout, having generated some of the highest growth rates in absolute amounts in the sub-sector. While NCC and WIC have had remarkably stable income levels over the years, those absolute amounts have not grown materially.

In the **debt LIT sector**, RRM has a high regard for all seven managers and all eight products. And no strategy has missed a beat with respect to income levels. It is partly a case of picking the appropriated risk-return profile and debt sub-asset class as all strategies differ to each other.

Private debt has the potential to be highly attractive (**MOT, MXT, QRI, KKC (partly)** and, in effect, **PGG**). It is all about extracting the private debt premia. And in contrast to the common conception, the private debt premia is more about the complexity (the ability to structure collateral protections to mitigate risk) and supply / demand (to lend where less players lend) premia than it is about the illiquidity premium. Personally, i like MOT for a little more bang for buck.

GCI is as safe as houses. A specialist RMBS investment manager in a sub-asset class dominated by generalist fixed income investors. You can read this as Gryphon having an information advantage, and the teams early repositioning of the portfolio during peak Covid to capitalise on a dislocation event (after having initially bedded down risk) is a prime example of its abilities. There is a reason GCI's recent placement was materially oversubscribed. And we would expect GCI to come back to the market in the not too distant future.

However, if RRM was a betting entity, we would put our money on **KKC** to lead the pack over the next year in terms of total returns. And bonus, given it currently trades at a discount to NTA, the running yield will be even better.

With respect to the **International Equities** sector, again we would simply point to the rankings chart above. While yields may not be as high as Australian equities sectors, the structural advantage of a LIC are just as evident when you bear in mind that broadly speaking international equities mandates typically do not generate income too much over the 2 - 2.5% level (with zero franking). In contrast, you are seeing almost half the LICs (actually, more than half if you strip out the three LITs in the sector) deliver 4%+ yields.

Additionally, all but one notable LIC in this sector is 100% fully franked, that notable exception being APL, and APL was progressively getting there. Alas, Pinnacle and Antipodes have pulled the pin and are proposing a conversion to an ETMF (subject to share holder approval)

About Risk Return Metrics

Risk Return Metrics Pty Ltd (ABN 98 642 969 819, AFSR no. 001286457) was established by the company's principal Rodney Lay in June 2020 with the express intention to provide institutional grade absolute and relative performance analysis and ratings for retail and wholesale investors, IFAs and investment managers. The primary focus is on the managed investment sectors, both LICs/LITs and Active and Passive ETFs listed on the Australian market. A secondary focus is on the provision of select quantitative based profiles on select Australian domiciled unlisted managed funds. In total, RRM is expected to provide monthly updates on approximately 550 Australian domiciled investment strategies across the full asset class spectrum.

The investment product reports produced by RRM contain a number of differentiating factors to which have and are currently available in the Australian market, with the most notable being 1) HTML-based sub-reports for each strategy and 2) the emphasis on peer group benchmarking for comparative analysis as opposed to the industry standard of utilising industry benchmarks.

The former function enables the provision of detailed metrics regarding returns, risk/capital preservation, performance path, and efficiency, but does so by way of the sub-report feature without comprising the conciseness and readability of the primary report. Less is More, and More is More. The latter is viewed as a superior comparative basis in terms of facilitating investor choice regarding competing investment strategies in a particular (sub-)asset class.

In March 2021, RRM successfully obtained both a retail and wholesale research rating license (Risk Return Metrics Pty Ltd is an authorised representative of Alpha Securities Pty Ltd (ACN: 124 327 064, AFSL: 330757). The retail license is essential to enabling the broad distribution of rated research reports, and is deemed essential for both the LIC/LIT and, in particular, the fast growing ETF segment in Australia, from the perspective of maximising value of ratings research dollar spent by investment managers.

Rodney Lay has 25 years' experience in investment analysis, first starting as an equities analyst at BZW / ABN Amro. Subsequently, he specialised in structured products in the lead up to the GFC and then moved to a dedicated focus on listed and unlisted managed investments. Rodney has had a long involvement in the listed space of the market, both LICs/LITs and ETFs.

Asset class experience is broad, including equities (long-only, long/short, market neutral, enhanced income), global listed infrastructure and property, alternative strategies (hedge funds, global macro, quantitative strategies), retirement solution products, private assets, and public and private debt. Public and private debt strategies have been a particular focus over the last three years, reflecting growing retail and wholesale client demand.

Rodney has a strong understanding of the nuances of different investment structures, including LICs/LITs, Active ETFs, SMAs/ IMAs and the recently launched dual listed/unlisted structure. Rodney has undertaken investment analysis on behalf of some of the most recognised global and domestic fund managers in both the listed and unlisted investment strategy sectors.

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