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RESHAPING THE LIC LANDSCAPE

Defending against the LIC discount dilemma and captured capital

By Paul Moore, Chief Investment Officer, PM Capital

The perennial issue of investors in Listed Investment Companies (LICs) is that they do not necessarily receive the underlying return delivered by a manager, due to the vagaries of premiums and discounts, listing costs and dilutive capital raisings. A new Listed Investment Company ("LIC") security, known as "PTrackERS", looks to address this issue and tilt the LIC landscape meaningfully in the favour of investors.

THE FORMAT of LICs has not changed in any meaningful way since they first appeared on the ASX. The LIC Whitefield was formed in 1923 and the Australian Foundation Investment Company (AFIC) in 1927. Argo was established in 1946. Many LICs have a long and proud history of providing capital growth and dividends.

In recent years there has been a proliferation of LICs. LICs are closed-ended, meaning that investors cannot apply for new shares (that is grow the size on the fund) or redeem them (that is, shrink the size of the fund) on a daily basis. LICs offer investors the benefit of:

- Gaining exposure to an investment manager via shares in a closed-ended company;
- The simplicity of being able to be trading daily on the ASX;
- The investment manager can focus on investing for the long term without the distraction of daily applications and redemptions, and
- Receiving franked dividends where franking credits are available.

Further, arguably, LIC investment managers have less motivation to hug an index relative to when managing a fund in which investors can redeem daily, as the manager does not need be concerned about redemptions if they are underperforming the index in the short term.

However, the traditional LIC structure poses a number of issues for investors. In very brief terms, they are:

- High establishment costs, in the order of 3%, are paid for up front by the investors and leaving only 97% of the issue price to be put to work (in some cases, this is not immediately apparent due to the creation of soft receivables due from the investment manager equal to the approximate set-up costs being included in reported NTA);
- Even strongly-performing LICs can and do trade away from their underlying net tangible asset (NTA) value, cycling between discounts and premiums. This creates uncertainty for investors as to whether they can obtain the underlying value of their securities;
- Capital markets activity targeted at growing LICs, such as rights offers, placements, share purchase plans, option issuance, can and most often do lead to a dilution of NTA per share for existing holders. This means shareholder NTA plus dividend returns are often very different to that which the investment manager delivers, and
- Many LICs are raised by investment managers seeking to perma-

nently lock up capital which, in the worst-case scenario, can lead to reduced manager accountability to shareholders and dissipation in shareholder engagement, leaving shareholders with the only course of action being to sell – often at a large discount.

Discount/ premiums cycle dilemma

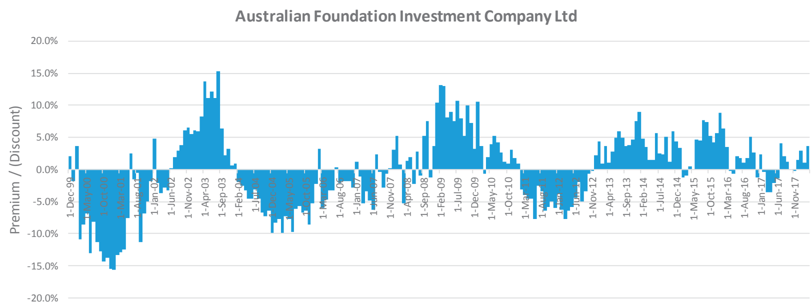
Discounts and premiums are not an isolated case among LICs. It affects the LICs we manage, including the PM Capital Global Opportunities Fund (ASX: PGF), and a wide range of well-known managers investing in different market segments.

History has clearly demonstrated that LIC share prices cycle between premiums and discounts to NTA, with both situations being problematic. For incoming shareholders, it is illogical to pay a premium to the underlying assets, and for selling shareholders, discounts represent the inability to obtain the look-though value of their investment. The charts to the right show what looks similar to a “discount to premium to discount” sine wave pattern of a sample of well-known Australian large cap, small/ mid cap and international LICs since December 1999.

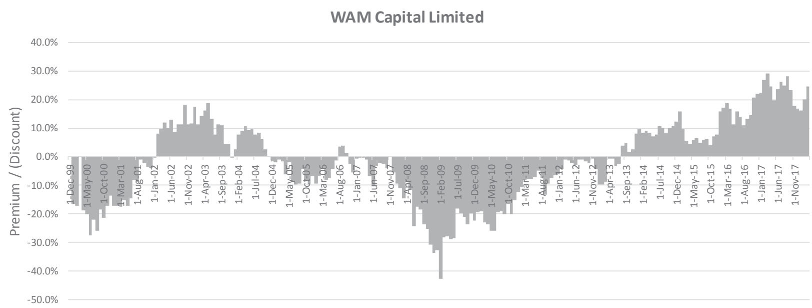
Even when LIC shareholders have invested for the Investment Manager’s recommended investment horizon (seven years, in the case of PGF) shareholders are subject to the vagaries of the market. This can have a significant effect on investor returns, depending on where a traditional LIC’s shares trade relative to its NTA in the future.

The discount/ premium cycle dilemma – an industry wide experience

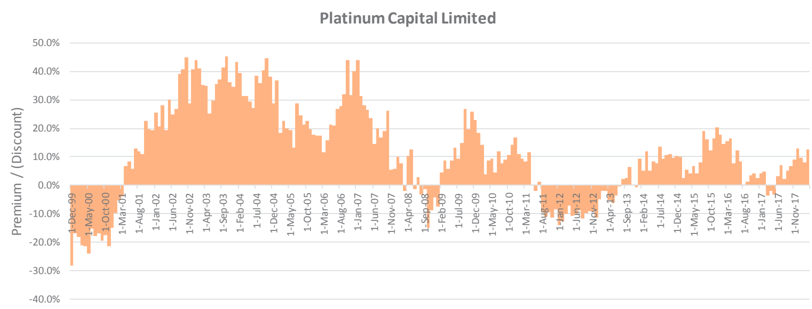
Large-cap Australian Shares



Small-Medium cap Australian Shares



International Shares



PTrackERS Offer a Solution

PTrackERS, are ‘**P**ortfolio **Track**ing **E**xchangeable **R**edeemable **S**ecurities (Converting Security)’. They represent a first of its kind innovation in the LIC space, and have been developed specifically to improve LIC investor outcomes and choice.

PTrackERS are an innovation of PM Capital and the PM Capital Global Companies Funds Limited (ASX: PGF). They are currently the subject of an Offer by PGF and its wholly owned subsidiary, PM Capital GO 2025 Limited (“GO 2025”), which opens Tuesday 10 July 2018 and closes Tuesday 10 August 2018.

At PM Capital we are proud of the difference we’ve been able to make for our investors. We are now in the 20th year of running our Global Companies Fund, which has delivered double the returns of MSCI World Net Total Return Index (AUD) since inception, after all fees and expenses. Our investment performance has been ranked #1 in our Morningstar peer group. To end December 2017 we were ranked #1 out of over 130 funds offering global investments to Australians, over 5, 6, 7, 8, & 9 year returns. Given the high calibre field of finalists, we were pleased to be recognised with the prestigious 2018 Money Management/ Lonsec Fund Manager of the Year Award in the Long/Short category.

PTrackERS are effectively redeemable LIC equity exposure. They have the economic outcome of a LIC but importantly, further enhancements via redemption and exchange options, and have been designed to address investor concerns.

Apart from giving investors access to PM Capital, PTrackERS give investors three options to realise their investments:

1. Convert into fully paid ordinary PGF shares without triggering a CGT event (An ATO Product Ruling has been obtained by GO 2025 and PGF);
2. Sell at any time on the ASX at prevailing market prices, or
3. Redeem in the future based on NTA in June 2025, meaning even if PTrackERS are trading at a discount to NTA, investors can still obtain NTA.

Additional benefits include:

- PM Capital is paying all Offer costs. On day 1, PTrackERS investable assets will equal the Issue Price (NTA will not include any soft intangible receivables from the investment manager. This is extremely rare with LICs);
- The redemption feature should act as a catalyst for PTrackERS to trade closer to NTA due to the arbitrage opportunity in seven years' time. This should also act to facilitate liquidity and exert pressure on both PTrackERS and PGF to trade toward NTA, particularly when approaching June 2025;
- PTrackERS' and PGF's underlying portfolios will be the same, so if the two were to trade at different premium/discount to NTA relative to each other, then an arbitrage would exist between the two securities, again acting to improve stability around NTA;
- PTrackERS are non-dilutive to NTA before tax plus franking credits for both PGF and GO2025, because PTrackERS issued today, convert into PGF shares based on the ratio of NTAs in the future;
- Other LICs lock-up capital, whereas the choice to redeem or stay makes the investment manager truly aligned and accountable for investment performance and communication;
- Increased scale for PGF and thus liquidity and breadth of awareness, and
- A clear dividend policy that intends to target a distribution yield of between 3% and 4% per annum.

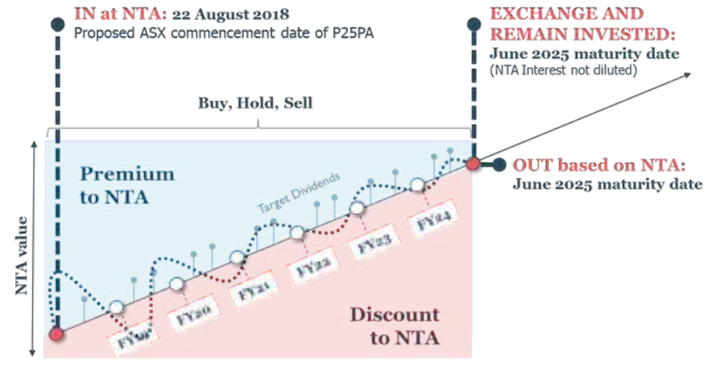
The reason for the timing of the conversion/redemption right being seven years from now, is that this reflects PM Capital's recommended investment time frame across all its global equities strategies. If investors commit to the recommended time frame, they have the right to redeem based on NTA, or continue being invested in the strategy. In this regard market sentiment impacting discounts/premiums at the time of redemption is irrelevant to the ability to obtain NTA.

As such, PTrackERS offer a redemption 'safety net'. This is a significant enhancement to current LIC structures.

PTrackERS further enhance shareholder alignment - of which we believe we are market leaders, noting our 8.9% holding in PGF – because if we do not perform to shareholders' expectations then the shareholders can redeem.

Importantly, PTrackERS are the subject of an ATO product ruling which provides comfort around the equity characteristics of the PTrackERS over their life, and if investors choose to roll-over into PGF shares, CGT relief is available.

In summary, PTrackERS are the fairest and most efficient form of LIC growth.



Buys at NTA, likely to trade closer to NTA as approaches maturity, sells at NTA on the maturity date notwithstanding if a discount exists

The workings of the PTrackERS is depicted below.

A structure such as this provides more transparency than other LICS. Changes in a traditional LIC's capital adds complexity for investors wishing to track and obtain the underlying performance of the manager. For PTrackERS, performance delivered by the manager is relatively simple to determine: changes in NTA plus dividends equals investment manager performance after LIC operating costs.

This is a first of its kind structure for an Australia LIC. It is our hope that it will give more transparency and control to LIC investors, while, as a global equities manager, we encourage people to consider investing outside the concentrated Australian equities market with a long-term view. ■

The Prospectus for PTrackERS is issued jointly by PM Capital GO 2025 Limited and PM Capital Global Opportunities Fund Limited. Investors should consider the Prospectus before deciding whether to acquire the securities. The Prospectus and further information is available at www.pmcapital.com.au. Applications for securities can only be made in the relevant Application Form in or accompanying the Prospectus. The securities are not bank deposits and may go down as well as up due to various market forces.