What's Driving The Dislocation In International Equity Diversified LICs & LITs?

INDEPENDENT INVESTMENT RESEARCH

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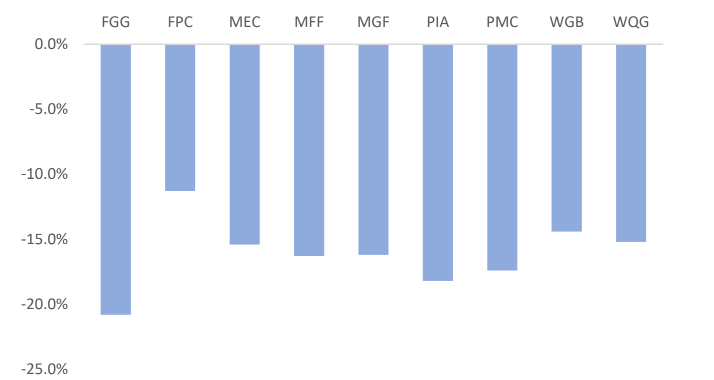
At 31 May 2023, just 7 of the 80 LICs and LITs in the IIR universe of coverage were trading at a premium to pre-tax NTA/NAV, with the remaining 73 LICs and LITs trading at a discount to pre-tax NTA/NAV. Discounts ranged from 0.7% to 40.4% with the average discount being 14.7%. IIR considers there to be a wide range of reasons for the dislocation between portfolio value and share/unit prices ranging from portfolio performance, dividend volatility, liquidity and competition from open-ended structures. Some of the factors contributing to the discounts are market driven and some are self imposed, such as capital raising at significant discounts to NTA/NAV or disruptions within the manager of the portfolio. Dislocation between portfolio value and market prices is becoming an increasing issue for Boards and Responsible Entities with share/unit holders becoming increasingly impatient with closed-ended funds that are trading at discounts for prolonged periods of time. This has resulted in a number of funds restructuring to open-ended structures or delisting and continuing to operate as an unlisted fund.

While discounts are prevalent across the LMI market, in this report we focus on the 9 LICs and LITs classified by IIR as International Equity Diversified. This category of LICs and LITs have a global equity focus with the mandates including both long only and long short strategies. The majority of the LICs and LITs invest directly with one vehicle, FGG, having a fund of fund investment approach.

All LICs and LITs in this category were trading at double digit discounts to pre-tax NTA/NAV at 31 May 2023, with the average discount across the group being 16.1%.

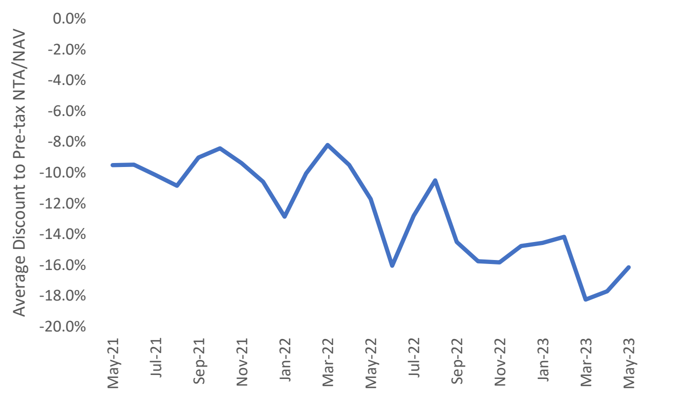
International Equity Diversified Premium/Discounts to Pre-tax NTA*/NAV (as at 31 May 2023)



*Pre-tax NTA includes tax paid on realised gains but is before tax on unrealised gains.

The discounts at which this category of LICs and LITs have traded at has expanded over the last two years. The below chart shows the average discount at which the group of LICs and LITs have traded over the two years to 31 May 2023 (based on month-end data). The average discount for these 9 LICs and LITs has progressively expanded from 9.5% at 31 May 2021 to 16.1% at 31 May 2023, with a peak average discount of 18.2% in March 2023.

Average International Equity Diversified Discount Over Last Two Years



*Based on month-end data.

So what's driving the dislocation between the share/unit prices and portfolio value? Below we take a look at a few factors that IIR believes are contributing to the dislocation between market prices and portfolio values. Note, IIR does not believe there is one single reason for the dislocation for the LICs and LITs in this category. There are often multiple factors that combine to cause discounts. For LICs and LITs in this analysis, some of the discounts are being driven by broader market factors, while other discounts are being driven by internal or company/trust specific factors.

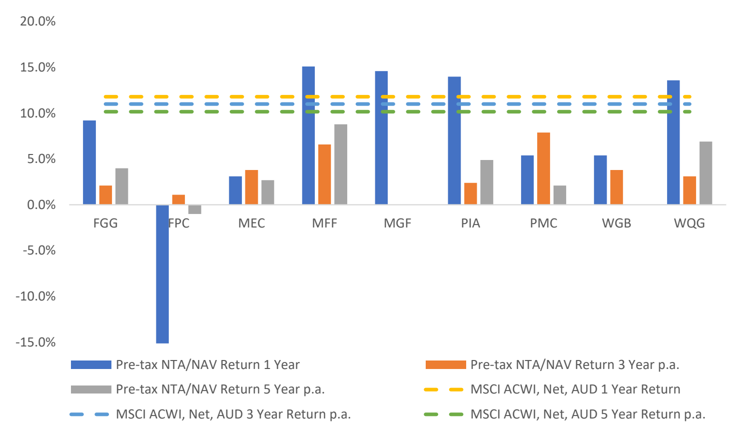
1) Performance

Performance has had an impact on the prices at which the LICs and LITs have traded. The below chart shows the performance of the pre-tax NTA/NAV of the LICs and LITs over the 1, 3 and 5 year periods to 31 May 2023 compared to broader global equities, represented by the MSCI All Country World Net Index, AUD (MSCI ACWI). We acknowledge that for the LICs the pre-tax NTA includes the tax paid on realised capital gains and the MSCI ACWI is pre-tax therefore it is not a direct like-for-like comparison.

The LICs and LITs in this analysis have largely underperformed the broader global market over the short-and-longer term periods. Underperformance of the broader market has no doubt been a contributing factor in the demand for the LICs and LITs.

The performance of some portfolios has improved over the 12-months to 31 May 2023, however some LICs/LITs are rebounding from a low base, which is reflected in the longer-term returns.

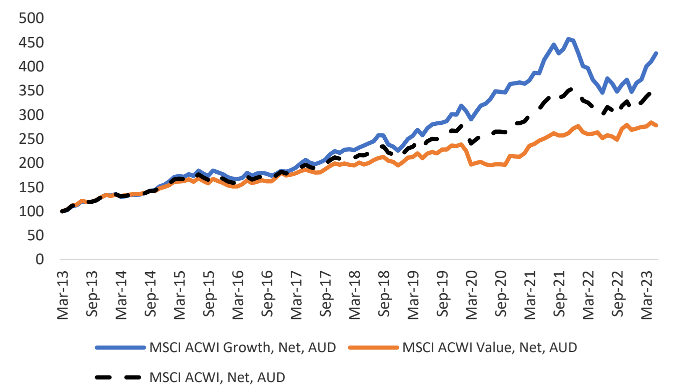
Performance of LICs & LITs Compared to MSCI ACWI (as at 31 May 2023)



The performance of some of the LICs and LITs has been reflective of the performance of some of the style factors within the broader market. For example, for a prolonged period of time value stocks underperformed the broader market, impacting the performance of value focused managers, while more recently growth stocks significantly underperformed the broader market, which impacted the performance of those managers with a growth focused mandate. In addition to broader style factors, there are sectors and sub-sectors of the market that have outperformed that managers may not be exposed to due to investment style factors. Below we provide the indexed cumulative return of the MSCI ACWI, the MSCI All Country World Net Value Index, AUD (MSCI ACWI, Value) and the All Country World Net Growth Index, AUD (MSCI ACWI, Growth) over the ten years to 31 May 2023. We have also provided the calendar year returns if these indices for the last five years to show the deviation in performance of style factors over shorter-term periods.

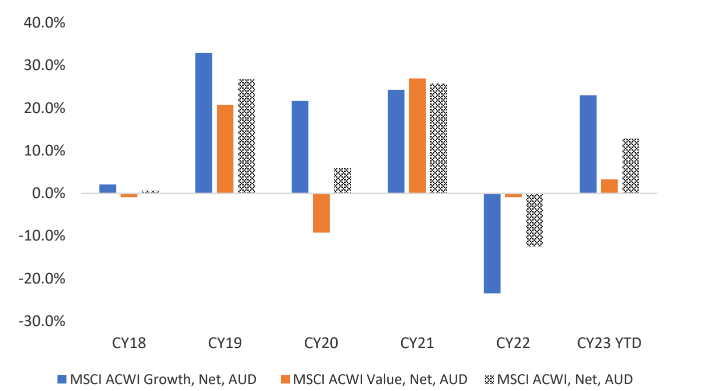
While some of the performance of the portfolios is reflective of broader market drivers, some of the underperformance is also driven by the stock selection of managers.

Indexed Return of Global Market Indices



Source: MSCI, IIR

Calendar Year Performance of Global Market Indices



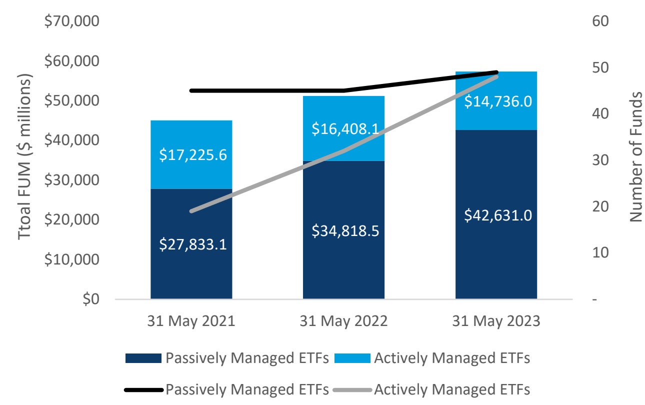
Source: MSCI, IIR

2) Competition

Another factor that is likely contributing to discounts is the high level of competition in the listed managed investment (LMI) market in the global equity category. At 31 May 2023, there were 97 passively and actively managed international equity ETFs, not including regional and thematic focused vehicles, available on the ASX. 48 of these funds are classified as actively managed.

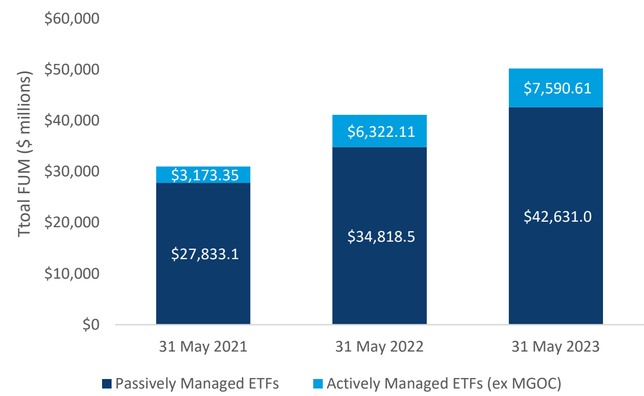
Since 31 May 2021, the number of passively managed ETFs with a global equity focused mandate listed on the ASX has increased by just 4 funds, whereas the number of actively managed ETFs has increased by 29. While the number of passively managed ETFs has only grown slightly, the total FUM for this cohort of funds has grown by 53.2% to $42.6 billion. This compares to actively managed ETFs, the total FUM of which has declined from $17.2 billion to $14.7 billion over the two year period, despite the increased number of funds on offer. The FUM of the actively managed ETFs has historically been heavily driven by a single vehicle, Magellan Global Fund - Open Class Units (Managed Fund) (ASX: MGOC). If you exclude this fund, the total FUM for actively managed ETFs drops to $7.6 billion as at 31 May 2023. However, excluding MGOC, total FUM for actively managed ETFs in this category has increased 139.2% over the two year period.

Diversified Global Equity ETF's



Source: ASX, IIR

Diversified Global Equity ETF FUM Excluding MGOC



Source: ASX, IIR

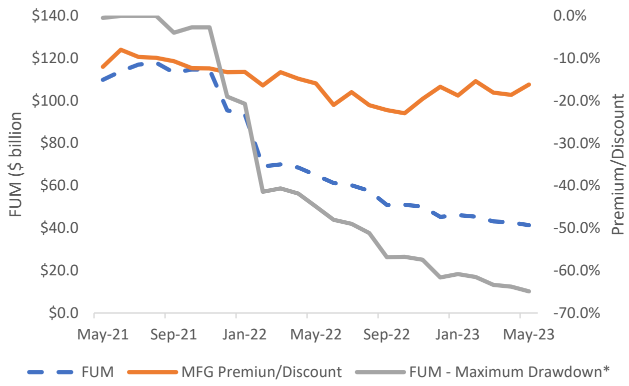
With increasing competition from ETFs, both passively and actively managed, closed-ended funds (LICs and LITs) need to provide a competitive offering to attract investors. If LICs and LITs are not delivering to expectations, investors will look to other vehicles for their diversified global equity exposure.

3) Net Flows

The discounts for some of the LICs and LITs is being influenced by demand for the Manager's funds more broadly. Demand for a manager's funds can be assessed by the net flows of the manager. The widening of discounts for both MGF and PMC have coincided with net outflows from the Manager more broadly.

- **MGF** - is managed by Magellan and is one such LIT whose discount is being influenced by net outflows from the Manager. MGF has traded at a substantial discount since the well publicised disruptions to the investment team. Since the abrupt exit of a number of key figures in the business, the Manager has experienced a continuous stream of net outflows from its funds with FUM falling to $41.4 billion at 31 May 2023, from a high of $118 billion at 31 August 2021. The net outflows are to some extent reflected in the expansion of the discount.

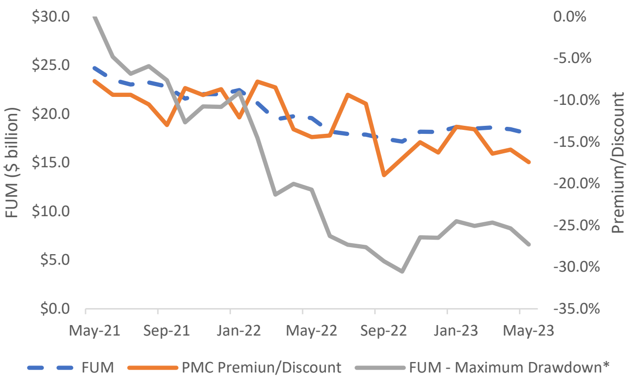
MGF Premium/Discount vs Magellan Financial Group FUM



*Maximum drawdown of FUM from 31 May 2021.

- **PMC** - PMC is managed by Platinum, as ASX-listed asset management company. The Manager has been experiencing net outflows from its funds in recent years with FUM declining 27.3% from 31 May 2021 to 31 May 2023. The expansion of the discount for PMC has followed the decline in FUM of Platinum more broadly.

PMC Premium/Discount vs Platinum Asset Management FUM



*Maximum drawdown of FUM from 31 May 2021.

4) Dividends

A number of LICs/LITs in the category have managed dividends well, maintaining and/or steadily increased ordinary dividends/distributions throughout their history, however there are a few LICs that have experienced volatility in dividends which has contributed to the discounts at which these LICs have traded.

Dividends of LICs that have a global focused mandate are typically driven by portfolio performance given the low payout ratios of internationally listed companies. This means that management of the profits reserve is of particular importance, with LICs needing to ensure they maintain sufficient profit reserves to sustain dividend payments during periods of market and portfolio weakness. If LICs are too aggressive with dividend payments in good times, this will often lead to dividend cuts during periods of market weakness and this often results in an expansion of the discount. The ability to provide a steady dividend during periods of market weakness can be one of the key differentiators for LICs, with trust structures not having the ability to smooth distribution payments in the same way the company structure allows.

Capital Management Initiatives

A number of LICs/LITs have implemented capital management initiatives in an attempt to narrow the discount. We detail some of the recent initiatives in the below table.

We note a number of LICs/LITs have a share/unit buy-back program in place. While these programs provide some liquidity to share/unit holders that are seeking to exit and can limit the downside to some degree, IIR would rather see the capital be put to work and the liquidity in the vehicle retained rather than used for the purposes of a buy-back program, however we understand why LICs and LITs use these programs.

While these initiatives may have some impact on the discount, these initiatives will need to be combined with improved performance and strong stakeholder engagement.

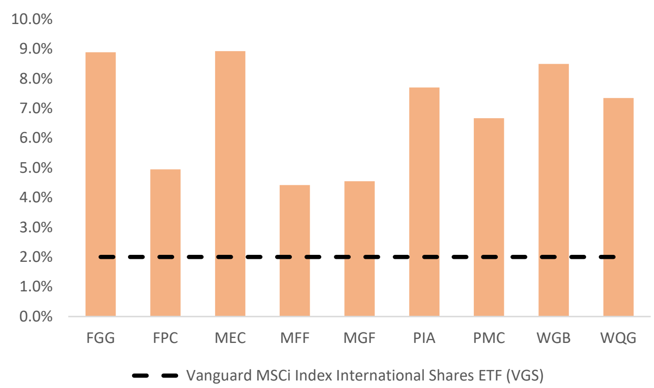
Capital Management Initiatives

LIC/LIT	Initiative	Initiative Detail
PMC	Bonus Option Issue	PMC issued bonus options to shareholders on a 1-for-4 basis in April. The options have an exercise price of $1.37 and can be exercised up until 28 March 2024 with one bonus option providing the ability to acquire one share in PMC. The exercise price represents a 12.5% discount to the pre-tax NTA as at 31 March 2023. In the event the NTA increases over the next 12-months, the bonus options will likely see the discount being maintained until the maturity of the options as shareholders will likely seek to access the portfolio at a discounted price. While this may result in the discount remaining in the short-term, the primary basis for the options is to increase the size of the Company and improve liquidity, which the Company hopes will have a positive impact on where the share price trades compared to the portfolio value over the longer-term. However, we note the key to success for the bonus options is going to be an NTA that remains above the exercise price as well as PMC shares trading in-the-money.
WQG	Increased Dividend Frequency	After the payment of the FY23 interim dividend, WQG increased the frequency of the dividend payment from semi-annual to quarterly and has indicated the fully franked quarterly dividend is intended to increased over the next four quarters. Providing shareholders with some indication and then executing on this has proven a successful strategy to narrow the discount for some close-ended listed funds.
FPC	Equal Access Buy-back	The equal access buy-back will be completed in two tranches and provides FPC shareholders the opportunity to switch from FPC to Fat Prophets High Conviction Hedge Fund (FATP), an ASX-listed exchange traded managed fund. The buy-backs will be completed at a 3% discount to the NAV of FPC. The first tranche was completed in May and saw 3.26 million shares exchanged under the program. A second tranche is scheduled to take place in October 2023.

Discounts Are Providing Attractive Opportunities

IIR believes that the discounts provide some attractive investment opportunities. One of the key differentiators between a LIC and trust structures (both open and closed ended) is LICs pay tax and can pass on franking credits to shareholders through franked dividends. As such, investors can access fully or partially franked dividends through LICs while obtaining exposure to a portfolio of global equities. As shown below, a number of LICs in the International Diversified category have attractive grossed-up yields at current prices.

Trailing Grossed-up 12-month Dividend/Distribution Yields as at 31 May 2023



In addition to the above-mentioned contributors to the expansion of discounts in this category of LICs and LITs, the current market prices are likely baking in some investor expectations of market weakness given the economic headwinds that are forecast, including the increasing risk of recession in the US. We saw this during the COVID market declines, which saw LICs and LITs across the board trade at heavy discounts as the market anticipated drawdowns in portfolios. However, investors oversold LICs and LITs during this period which saw some investors able to take advantage of expanded discounts and generate additional capital gains as discounts narrowed as the expected threats abated.

Substantial discounts, such as those being experienced by International Equity Diversified LICs and LITs, can provide some downside protection to portfolio declines, with portfolio declines already accounted for to some extent in the share/unit price. This does not mean that share/unit prices will not decline further, however the extent of the decline may not be as severe in the event the market weakness eventuates. In the event the market and LIC/LIT portfolios perform better than expected, the discounts provide investors the opportunity to buy portfolios at a discount to par value and potentially reap the benefits of the discount narrowing.

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IIR was established in 2004 under Aegis Equities Research Group of companies to provide investment research to a select group of retail and wholesale clients. Since March 2010, IIR (the Aegis Equities business was sold to Morningstar) has operated independently from Aegis by former Aegis senior executives/shareholders to provide clients with unparalleled research that covers listed and unlisted managed investments, listed companies, structured products, and IPOs.

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