Exchanged traded management funds offer a solution to the net tangible asset discount

By Perpetual Corporate Trust
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There are several managed investment structures accessible via the Australian Securities Exchange (ASX) and Chi-X trading platforms, including Listed Investment Companies (LICs),

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Listed Investment Trusts (LITs), mFunds, exchange traded managed funds (ETMFs) and exchange traded funds (ETFs). These structures offer various features and benefits that have evolved in response to different market conditions

Traditionally LICs have been used to hold equity strategies, while LITs are more prominent in fixed income and real estate strategies. A LIC's closed-ended structure (and therefore the limited supply of shares or units available for investors to trade) as well as the nature of assets they invest in, may result in a mismatch between their on-market traded price and their Net Tangible Assets (NTA). These variances are commonly referred to as premiums or discounts.

This article looks at different approaches that managers take to resolve prolonged discounts to NTA within their exchange traded products.

LICs - the current state of play

There are currently 101 closed-ended exchange products made up of LICs and LITs with a market value of $54.5 billion. As at April 2021, 81% of these were trading at a discount to NTA, and for 47 of these products the discount to NTA was greater than 10%.[1]

Premiums and discounts are common with LICs. Historically LICs have traded in a range between a discount of up to 50% and a premium of 18% to NTA, with multiple cycles in between.[2] Some analysts believe when a share price trades outside of about 5% either side of the LIC's NTA, it is trading irrationally.[3]

On average, LICs in Australia are trading at wider discounts in recent years. There are several reasons why, including the proposal to amend the laws around franking credits as well as investors' views on the future performance of the manager and the value of the underlying investments.

These discounts have, arguably, led to a steady rise in popularity of ETFs and ETMFs which, as a result of their structure and composition, trade at market value. This makes ETFs and ETMFs more popular with retail investors who represent a high proportion of LIC investors.

If a LIC trades at a discount, over time this may attract activist investors to the share register who may take short-term positions in the LIC with a view to cashing out when the LIC trades closer to the NTA.

Strategies to overcome the NTA discount challenge

Some of the strategies managers are using to narrow their discounts include:

- More effective marketing and communication to engage with investors and improve the reputation of the LIC and its manager e.g. investor presentations, regular market updates and media appearances;

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- A share buyback, including a conditional tender offer (CTO), where the company offers to acquire a significant percentage of its shares via an off-market buyback at various intervals;
- Adopting a timetable where investors are given an exit facility at NTA, perhaps annually or every three years; and
- Delisting into an equivalent unlisted fund, which can often require a lot of time and paperwork for investors to manage.

In Australia, Monash Investors took a different approach.

Monash Absolute Investment Company becomes Absolute Active Trust

Over the last two years, Monash Absolute Investment Company (MAIC) shares have traded at a significant discount to its NTA. To address this challenge, on 10 May 2021 MAIC received approval from its shareholders to restructure into an ETMF – the Monash Absolute Active Trust (Hedge Fund) (MAAT). The MAIC Board believes the ETMF investment structure has many advantages over the previous listed structure and this transaction will increase shareholder value.

> "ETMFs now combine the best features of LICs and unlisted trusts", says Simon Shields, Principal, Monash Investors.

> They allow us to provide our clients with an exchange traded investment priced at NAV that has no liquidity issues. With its dual registry, applications and redemptions can also be made via the traditional end of day unit price method.

> It's been great to partner with Perpetual to be the first to convert our LIC into an ETMF."

This restructure from a LIC to an ETMF is Australia's first transaction of its kind and can provide a pathway for other LICs trading at a discount to their NTA, provided the assets of the LIC are suitable under the ASX rules governing ETMFs (ASX Operating Rules, or AQU)"

The appeal of Exchange Traded Products

Exchange Traded Products (ETPs) – comprised of ETFs and ETMFs – in Australia continue to grow rapidly, holding $102.8 billion in assets at the end of March 2021 according to ASX and Chi-X data. This represents an 80% increase in flows on the previous year which, according to BetaShares, was the "most rapid growth over a 12-month period in the industry's history".

ETPs are bought and sold through an investor's broker account and allow investors to allocate capital towards active (ETMF) or passive (ETF) managed strategies without the hassle of filling

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out additional paperwork or the need to produce certified documentation for each transaction. Investors also have the benefit of knowing the exact price at which they will be buying or selling units at the time of transaction.

Although investors of all types have embraced the ETP market in recent years, millennials continue to gravitate to the sector. Millennials are attracted by the low cost, simplicity, and ease of use of ETFs, as well as their ability to provide tailored exposure to investment themes that matter in their lives.

Further, fund managers themselves benefit from an open-ended structure, reduced paperwork and the ability for investors to hold the fund alongside their advised products within a platform or in their broker account.

Why an ETMF can solve the NTA challenge?

An ETMF is an open-ended managed investment scheme where units are created and cancelled to meet demand, providing greater transparency.

A LIC, on the other hand, is a close-ended investment structure. Managers have a fixed pool of funds to invest and are not concerned with new monies coming in from applications or monies going out from redemptions or withdrawals.

The ETF and ETMF structure both utilise a market maker or market making agent to support liquidity which allows for the fund to trade on an exchange at a price close to its underlying NTA. This is often supported through intraday pricing generally every 1-15 seconds.

Although LICs are also traded on an exchange, the price – and therefore the differential to NTA – is influenced by the supply and demand of the shares on issue. Other factors that can influence the unit price in relation to the NTA are investment performance, dividend history, the level of marketing and communication with investors, and the track record of management.

Income and tax – LICs vs ETPs

A LIC is a company, giving the Directors the power to decide when to declare and pay a dividend. They can smooth the dividend from one period to the next, frank it directly if the company has paid sufficient tax, and in some cases pay it out of reserves and boost the income return that shareholders receive. Dividend re-investment plans and regular share purchase plans are other common features.

In contrast, traditional managed funds, ETMFs or index tracking ETFs are all trust structures. The advantage of these structures is that it offers a capital gain and income tax to be passed onto the end investor. The dividend distribution is also generally not franked (however, if franking is flowing from the underlying investments, it can be passed through). Trusts are required to distribute all income received.

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Income distributed for an ETP may be paid in cash or reinvested, similar to LICs. Certain brokers may offer their investors an ability to top up their ETP holdings periodically, similar to a regular investment plan.

ASX Governance and Disclosure – LICs vs ETPs

LICs follow the ASX Listing Rule framework while ETFs and ETMFs fall under ASX Operating Rules ("AQUA Rules") framework. While LICs and ETPs are both governed by ASX frameworks, issuers should be mindful of the different compliance and reporting obligations.

LICs are governed by the Board and Company Secretariat and follow the continuous disclosure framework. There's a level of transparency being on the ASX, as they have to hold an Annual General Meeting and publish audited half-year accounts. If investors aren't happy, they can vote out the Board of Directors.

ETFs and ETMF's don't have a Board or Secretariat but require comparable oversight by the Board of the Responsible Entity.

The role of the Responsible Entity

In Australia, ETFs are managed investment schemes and may be either wholesale or retail. The Responsible Entity (RE) has a dual role of trustee and manager of an investment scheme and must be appointed if an investment scheme needs to be registered with the Australian Securities and Investments Commission. Under the Corporations Act 2001, an RE must be an Australian public company with certain levels of net tangible assets, depending on the value of the scheme's assets. The RE must also hold an Australian Financial Services Licence (AFSL).

The RE holds scheme property on trust for investors and has the power to appoint an agent to do anything that it is authorised to do in connection with a scheme on its behalf. This may include the appointment of a custodian to hold scheme property.

An RE can either be owned by the same group as the Fund Manager (an internal RE), or alternatively be run separate to the Fund Manager (an external RE). Where the RE is external they act on behalf of the investment scheme, typically enter into a management agreement with the fund manager.

Generally, it's more cost-effective to engage an external RE or build internal capability compared to running a Secretariat and The Board for a listed company.

Fund managers often opt to engage an external RE provider to leverage their AFSL (if they're introducing a fund to Australia), their industry expertise, speed to market and to achieve economies of scale so they can focus on what they do best – manage the funds.

Perpetual Corporate Trust worked closely with Monash Investors in the conversion of Monash Absolute Investment Company to Monash Absolute Active Trust and we are delighted to be

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appointed as the Responsible Entity for this trust. Depending on your business and distribution strategy, we can help you set up a vehicle that can help you achieve your business objectives.

Perpetual Corporate Trust facilitates a wide range of asset management structures for our clients – including ETMFs, LICs, LITs and mFunds. We currently manage 112 retail Managed Investment Schemes with more than $285bn in Funds Under Management across Responsible Entity, Trustee and Custody appointments as at December 2020. For more information, contact us at pctsales@perpetual.com.au

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1. Source: ASX Spotlights; Listed Investment Entities, April 2021
2. https://www.nabtrade.com.au/investor/insights/latest-news/news/2019/11/are_lics_dead
3. https://www.morningstar.com.au/funds/article/closing-the-gap-can-lics-narrow-the-valuation/208016

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