Benefits of LICs show in challenging times

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Flexibility, stability, easy access and tax advantages appeal.

Listed investment companies (LICs) offer an array of benefits to self-directed investors seeking diversified exposure to Australian equities. Chief among these is their ability to pay a consistent, tax-effective dividend stream.

Given recent market volatility and current low interest rates, many LICs offer a stable stream of franked dividends, which is particularly appealing to self-managed superannuation fund (SMSF) investors seeking reliable and tax-effective income in retirement.

Fully franked dividend income

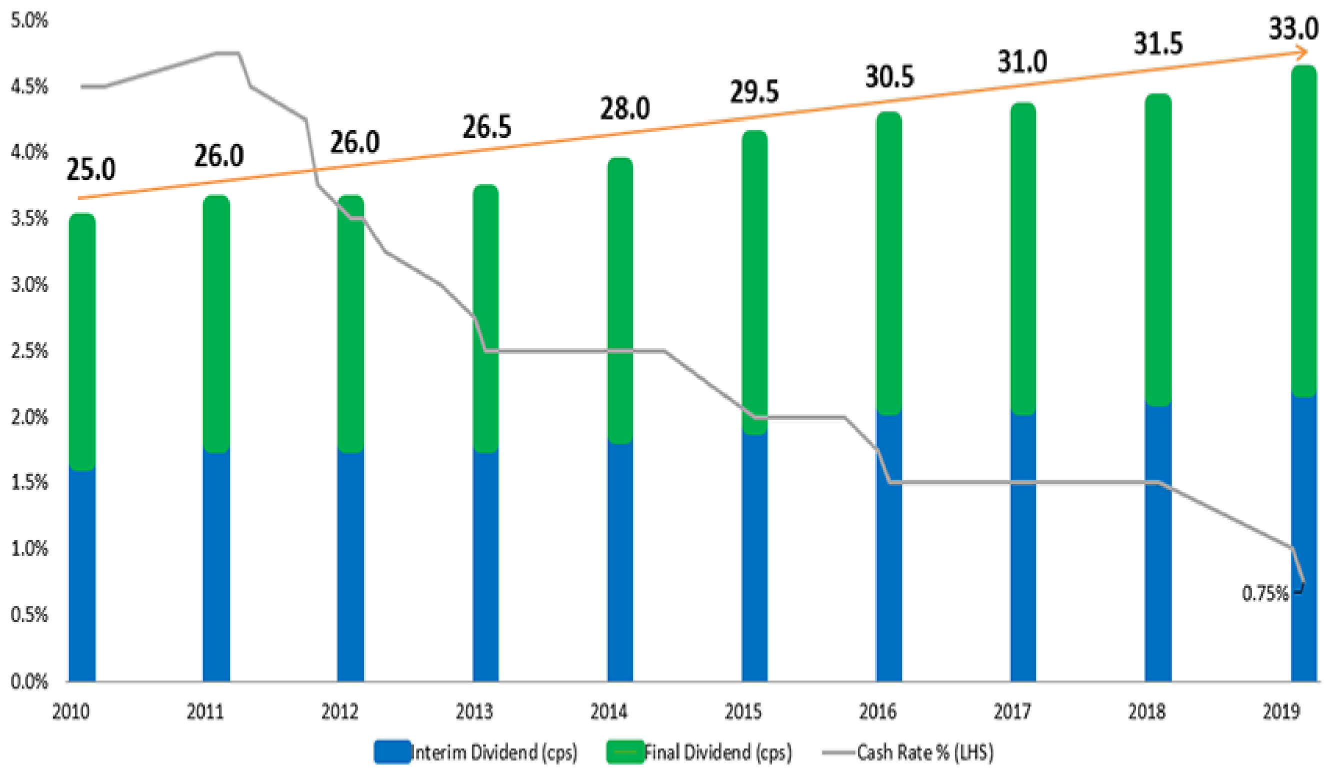
A key advantage of LICs relative to managed investments that use a trust structure is the ability to generate imputation credits from tax paid on corporate profits. These can then be passed on to shareholders to reduce their tax liability and, in the case of many SMSF investors, any excess can be refunded by the Australian Taxation Office (ATO).

Because they pay tax in Australia, even LICs with an international mandate can attach imputation credits to their dividend payments, although often at lower levels.

In contrast, a unit trust can only distribute franking credits from its underlying investee companies. Furthermore, these investment vehicles must pay out all dividends received by the underlying investments every year, which can fluctuate from year to year.

LICs on the other hand have the ability to "smooth" their dividend payments. Because of their corporate structure, LIC dividends are determined at the directors' discretion, allowing the company to pay a more predictable and stable dividend stream that can increase over time. This suits investors seeking consistent income in retirement.

In a falling interest rate environment, the flexibility of the LIC structure has helped Argo Investments maintain steadily growing dividends in recent years (see chart below).



Capital gains tax deduction

In some instances, shareholders can receive a further tax benefit through a capital gains tax (CGT) deduction.

If a LIC is a long-term investor for tax purposes, rather than a trader, it can potentially pay a dividend that includes a capital gain component when it sells an investment for a capital profit. This allows the LIC shareholder to claim the (CGT) discount as though they directly owned and sold the shares in the underlying investee company.

Only a handful of companies, generally the older-style LICs, have been granted this special tax status by the ATO.

Most individual and SMSF shareholders can claim a tax deduction in relation to these capital gains, in addition to the benefit of franking credits.

Administratively simple and cost effective

LICs offer SMSFs straightforward exposure to a managed investment. Because LICs are listed on ASX, investing in a LIC is as simple as buying any other stock. Many LICs are now also available through the various platforms and wraps used by self-directed investors.

Investing in LICs comes without the administrative burden of some other managed investments that require lengthy application and redemption forms to be completed. With a traditional or online broking account, investors can simply buy and sell LIC shares on ASX, providing them with intra-day liquidity.

Unlike many managed investments that require a significant minimum outlay to invest, only a small amount is required to invest in a LIC as determined by the individual broker. Most online trading platforms have $500 minimum trades.
There are no application or redemption fees payable by LIC investors, only brokerage fees that reduce proportionally as the amount invested increases.

Many LICs offer dividend reinvestment plans and share purchase plans that enable existing shareholders to increase their holding without paying any brokerage fees, usually at a discount to the market price.

Highly diversified portfolio of underlying assets

With a minimal investment and for the cost of brokerage, SMSF investors can access a highly diversified, actively managed portfolio of Australian equities in a single ASX trade, and potentially complement other directly held Australian shares.

For example, Argo is invested in 90 Australian companies across all industry sectors, spreading portfolio risk across the economy.

CommSec's latest *SMSF Trading Trends Report* revealed that last financial year self-funded retirees increased their exposure to LICs as they sought diversification to protect themselves from market volatility and secure sustainable long-term income.

Accountability and transparency for shareholders

A further benefit of LICs is their inherent accountability to shareholders because of the corporate structure and ASX listing. Australia's corporate governance regime creates oversight structures that ensure the LIC and its directors are accountable to shareholders, who are the owners of the company. These include the right to vote on resolutions at the annual general meeting and/or extraordinary general meetings.

The various corporate regulations, as well as ASX Listing Rules, also ensure considerable transparency for shareholders, with minimum shareholder communication and disclosure requirements stipulated by law.

For example, a LIC must publish an annual report, monthly investment reports including net tangible asset backing calculations and disclose its entire portfolio of investments at least annually.

Long-term investment approach with no redemptions

With a close-ended capital structure, a LIC has a stable pool of funds to invest, allowing the investment manager to take a long-term investment approach. In contrast, open-ended investment structures, such as unit trusts, are subject to fund inflows or outflows, forcing the manager to buy and sell shares because of fund applications and redemptions.

Also, restrictions can sometimes be imposed on redemptions, such as minimum lock-in periods or even "freezes" on redemptions as occurred during the GFC.

Over time, and particularly during times of extreme market volatility, a LIC's closed-end structure enhances its ability to increase returns to its shareholders, overcome market disruptions and build for the long-term.

Another difference between trusts and LICs is that in good times trusts must distribute all capital gains to shareholders in the year they occur, whereas a LIC can choose to reinvest some or all of those gains for the future after paying any corporate tax due.

Key considerations

As with all investments, SMSF investors should assess the risks of a LIC, as well as their own financial objectives and circumstances. It is important to understand the LIC's investment strategy to ensure it complements the SMSF's existing portfolio and risk profile.

A key consideration for SMSF investors is the LIC's dividend record and ability to pay future dividends and franking.
Fees are another important factor and can vary considerably depending on how they are calculated and whether the LIC is internally or externally managed.

The older-style LICs, such as AFIC, Argo and Milton, are internally managed with a management expense ratio calculated as a percentage of the company's expenses to average assets held. These costs are reflected in the LIC's operating profit and are around 15 basis points or less.

Externally managed LICs generally pay a management fee to an external fund manager and, in many cases, performance fees if performance hurdles are met. In our view, the portfolio performance of these LICs should be assessed net of these fees because of their potential to affect returns to shareholders.

About the author

Jason Beddow is managing director of Argo Investments, a leading listed investment company on ASX.

From ASX
Listed Investment Companies provide a wealth of information on LICs.

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