CORPORATE ACTION & LICS

After two years of virtual corporate inaction, the past six months have seen a return to energetic (perhaps even rabid) activity. We have seen some large IPO's for all manner of businesses including Virgin Blue, Multiplex, Repco, JB Hi Fi, InvoCare (funeral directors), Tassal (breeders of salmon) and Village Life (retirement villages). Pacific Brands which encompasses a swag of Aussie icons that wasted away under the stewardship of Pacific Dunlop such as Bonds, Holeproof, Dunlop, King Gee, Malvern Star and Clarks, has been revitalised with a bit of help from Pat Rafter and is due to be re-floated in the first half of 2004.

To put this level of action in context it is worth looking back at the dot com boom of the late 1990s. In the December 99 half year (the peak of that boom) there were 86 IPOs raising $3.8 billion. In the December 03 half year there were 85 IPOs raising $6.6 billion! This in itself should be a sobering thought.

LICs have a long and proud history in Australia. Indeed two of them - AFIC and Argo - are local institutions. They allow small shareholders access to a broader market than if they invested directly in the underlying investments. Wilson Leaders, Clime Asset Management and Granite Three Pillars are just three examples of the current crop on offer.

This current spate of offerings should not be surprising given the current buoyancy of the equity markets and the shifting sentiment towards residential property as a store of wealth. However there are some points to keep in mind before joining the headlong rush to invest in the latest new LIC.

The common structure of the offers around at the moment is a $1.00 share with a "free" option exercisable for $1.00 up to a year or 18 months from the listing. After the cost of the capital raising has been deducted the fund will have net assets of around 98 cents a share. There is likely to be limited support in the secondary market post listing since the option reduces the potential gain for an investor. (Suppose I purchased a share in one of these LICs at $1 on the market and it has an asset backing of 98 cents. If the fund returns 15% over the next year all of the options are likely to be exercised for $1, there will be twice as many shares on issue and the asset backing per share will now be $1.06. The fund has had a respectable performance but my reward is paltry in comparison.)

In addition to an annual management fee of around 1% these new generation LICs are charging a performance fee of around 15 or 20% of any out-performance of a benchmark (such as the All Ordinaries Accumulation Index.) In the example I gave earlier, if the relevant benchmark rose by 10% over that same year, the asset backing of my share would fall to less than $1.04 after fees. I'd get better returns from a cash account. Even an index fund should return close to 10%.

We therefore believe that these vehicles are likely to trade below their issue price unless they demonstrate immediate exceptional performance. The most useful way of valuing a well managed LIC (and we would not invest in one at all if we had doubts about the management) is to compare its market price to its asset backing (subject to contingencies such as the exercise of options). If we can buy $1 worth of investments for 90 cents then the equation makes sense. Paying $1 for 98 cents worth of investments does not make sense - even if you do get a "free" option. In the case of these LICs a little bit of patience could well be rewarded.