Discount narrowing - a valuable source of returns

Dominic McCormick | Select Investment Partners | 28 July 2016

As I noted in my recent article "Challenges in building portfolios today (and what to do)", putting together robust investment portfolios in the current environment is hard. With interest rates extremely low and most asset classes offering limited medium- to long-term return potential, there is a drive for more alpha but finding it is not easy. True alpha is about exploiting market inefficiencies but, in today's competitive markets, finding inefficiencies and/or those people who can exploit them is no easy task.

The first step is to look towards those areas that are less well researched and therefore likely to be inefficiently priced and offer more "alpha" opportunity. Small companies, emerging markets and less well known areas of listed property and fixed interest markets are usually seen as likely candidates. These areas certainly can make sense for part of a portfolio, although the alpha in these areas is often swamped by market volatility and risk, at least if considering only long-only funds. Long/short hedge funds in these areas that lessen the market risk issue typically have high fees, poor liquidity and are usually more difficult to analyse. In addition, performance of hedge funds in these areas has been mixed in recent years.

One investment area that I believe offers an inefficiency opportunity, but is often neglected by investors, is listed investment funds and companies (LICs).

This area is regularly priced inefficiently because:

1. it is driven primarily by retail investors who tend to invest on brand and sentiment rather than fundamentals and value;
2. there is limited broker or research house coverage - and much of this is quantitative only and superficial. From brokers in particular there is often a poor understanding of active investment management and strategies employed by these funds; and,
3. the relatively small size of the LIC space and limited liquidity in some cases, as well as the general reputation as a retail-focused area means it does not attract as much professional investor interest.

The key difference with LICs compared to unlisted managed funds is that the share price can differ, often substantially, from the underling Net Tangible Asset value (NTA).

All this means that the appetite for individual funds and the area as a whole waxes and wanes, with the pricing of LICs heavily driven by changing retail investor sentiment and chasing past performance. In addition, these markets are sometimes slow to react to

material news and can be poor at anticipating how the underlying investments are performing (even in cases where there is an equivalent daily-priced, unlisted fund).

LICs are heavily promoted at IPO stage at which point investors effectively buy in at a small premium to NTA because of costs but they are often poorly supported afterwards and dumped at discounts to NTA in the weeks, months and years following the IPO. Often, they are used as the cash source for "new/more exciting ideas" their research department has uncovered. This leads to discounts which can feed on themselves.

Indeed, it is this self-feeding selling that distinguishes listed investment funds from their unlisted counterpart. In an unlisted fund, the performance is all about - and only about - movement in the underlying asset value. However, that is just part of the story with listed funds/LICs. Often a period of poor performance in the NTA leads to investor disappointment and an exaggerated fall in the share price. This then further accentuates the investor disappointment and can lead to more selling, further widening the discount.

This process can also occur in reverse - that is, an improvement in underlying NTA performance of a fund already trading at a discount is enhanced by a narrowing of that discount which leads to an exaggerated perception of good performance and further narrowing of the discount. This is the ideal "double whammy".

It is these pricing dynamics that can provide true alpha opportunities in listed investment vehicles.

Another positive with LICs is they cover the asset class and strategy spectrum, albeit with a heavy equity bias. Nevertheless, there is considerable diversification available across asset classes and equity sectors including private equity, small companies, infrastructure, and resources as well as different strategies including long/short, buy write, market neutral even managed futures. In overseas markets - particularly London and New York - there is even further diversity. This means investors can build some good diversification in the "see through" asset/strategy allocation of a portfolio of listed vehicles and be less exposed to mainstream market movements. Also, some of these asset classes and strategies are obviously more complex and poorly understood by the average investor which can lead to greater pricing inefficiencies.

Of course, the sentiment towards LICs (and therefore their discount to NTA) is also influenced by overall market sentiment - but this sometimes leads to indiscriminate selling of LICs which provides great opportunities when markets get volatile, particularly if the underlying NTAs are little affected. A recent example was Brexit when discounts on global funds priced in pounds and listed on the London market increased significantly even though the underlying NTAs hardly moved because of the currency's weakness.

These dynamics mean that markets regularly provide opportunities to buy well-managed LICs trading at large discounts to NTA and for which you can reasonably expect some narrowing of the discount over time. This discount narrowing may relate to simple mean

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reversion or it may be driven by some specific catalysts. Catalysts could include things as simple as better marketing, recognition of improved underlying performance, portfolio events (such as realisations in the case of private equity-based LICs), dividends, buybacks, tenders or even the occasional fund wind-up (as recently announced by the AMP China Growth Fund).

This discount narrowing can therefore be a valuable source of additional alpha in a low return world.

Figure 1 attempts to show the value of this alpha. Assume a fund's discount narrows from 20% to 10% over a three-year period and assume all other things equal (ignoring tax implications for now).

Figure 1: LIC "alpha" from discount narrowing

Total return from underlying asset %pa	Return after discount narrowing %pa	Increase in return from discount narrowing %
20	24.8	24
15	19.6	31
10	14.4	44
5	9.2	84

The main point from Figure 1 is that in a high-return world, discount narrowing is a useful addition but often not material in terms of contribution to total return. However, in a low return world, discount narrowing can lead to a very significant increase in total return.

For example, if in a 5% return world, you buy a fund that narrows by 10 percentage points (even if it takes three years) you have added around 84% to total annual return. This compares to adding just 24% for the same effect in a 20% return world.

Such a narrowing is by no means an aggressive assumption in many cases and often there are situations where the discount to NTA narrows much faster because of specific catalysts.

Of course, we should not get obsessed about the discount to the exclusion of other key aspects of the fund - such as the outlook for the asset class/strategy and the quality of the manager, as well as structural aspects of the fund. Proper assessment of these issues is what can provide an edge, by judging how the fund may perform in the future and what may happen to the discount to NTA. However, it is clear that the change in the discount can be a significant portion of the fund's return (or loss, as a result of a major widening in the discount).

One issue to consider is whether, in a lower return world, the volatility of discounts will also be smaller and therefore so too the opportunity to add value. In some periods, this concern may be valid but I don't believe that low overall market returns ensure low volatility in markets generally, or in the level of discounts to NTA. Volatility has been tempered lately but often such a period of stability is actually contributing towards and helping to build the inherent instability that creates a period of greater than normal volatility.

What if some funds stay at high discounts to NAV consistently and seem to never narrow? This can happen, but is far from disastrous. In fact, mathematically, you can still do better from a discounted fund that remains at the same discount compared to an unlisted fund into which you invest at NTA. This comes from compounding of dividends – that is, a 4 cent dividend on a $1 NTA is a 4% dividend yield. But on an 80 cent discounted share price, it's a 5% dividend yield and this higher amount compounds over time as it is reinvested – resulting in a higher return.

The bigger danger is that you buy in at a discount that becomes a much larger one, particularly if accentuated by poor underlying NTA performance – for example, buying at a 20% discount to NTA only to see it go to 30%. This is certainly possible and often distressing to a holder, particularly if it is accompanied by poor underlying returns (the "double whammy" in reverse).

However, the following guidelines help:

1. Be patient in waiting for discount opportunities to develop and stagger in over time rather than buying all at once;
2. Consider the quality of the manager and the outlook for the area it invests in and strategy it employs –that is, don't buy in for a large discount alone; and,
3. Try and understand why the discount is large in the first place, and whether it could be temporary (or not) and what specific catalysts may narrow the discount over time.

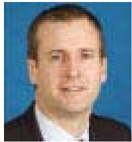
Apart from the lack of easy alternative strategies, why does it make sense to look at such discount capture approaches now?

1. Discounts vary but are relatively high and rising in some areas, especially if able to access the global opportunity set of listed funds;
2. The wave of IPOs in the LIC space locally in recent years is likely to create some attractive opportunities in coming months/years;
3. There has been a growth in the number of "activist" investors in this area in recent years which can help to precipitate catalysts where a large discount persists for an extended period; and,

4. Discount volatility is still reasonable and will increase as overall market volatility increases which is likely at some point given the challenges facing some markets and growing policy and geopolitical risks.

In my experience, many investors and advisers investing in LICs do so from a rather casual/part-time perspective. Too often, they succumb to the heavy promotion of a new LIC at the IPO stage and only begin to properly understand the fund (including the pricing dynamics described above) after it is drifting to a discount and disappointing investors. It is then that it becomes clear how different LICs can be to regular managed funds.

Further, many investors and advisers don't have the time or focus to monitor LICs frequently and take advantage of the added value that good active selection and capturing discount volatility over time can bring. Sometimes, if advisers and investors are on the losing side of those discount volatility swings, they become frustrated and give up on investing in LICs. This is likely a mistake, although more focus and/or guidance is necessary to fully take advantage of the more inefficiently priced areas and opportunities to add alpha in today's low return, highly competitive investment markets.



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