INDEPENDENT INVESTMENT RESEARCH

IIR Treasury Consultation

LIT/LIC Stamping Fees

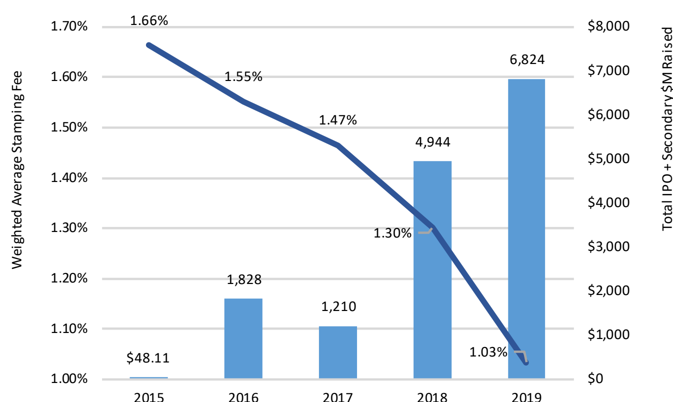
LIC Stamping Fees Review

The Treasurer Josh Frydenberg has announced that the government will undertake a four week targeted public consultation program concerning the issue of LIT / LIC (collectively LMIs)) stamping fees. The Treasurer said that based on the feedback received, he will look at what changes, if any, need to be made to existing regulations around the payment of stamping fees during LMI IPO's.

The purpose of this submission from Independent Investment Research (IIR) is not to put forward a position one way or the other on stamping fees. As an independent research house IIR is removed from those interactions and, secondly, IIR is agnostic with respect to investment vehicle type. What IIR is not agnostic about is a motivation to see the highest quality and appropriately diverse range of investment strategies being made available to Australian retail investors. This focus on quality is reflected in our ratings methodology. As such, this submission will focus on whether any possible disruption to the quality and diversity of LIT/LIC offerings is in the best interests of the Australian retail investor market.

On the topic of stamping fees, IIR notes that the weighted average stamping fees has declined from 1.66% in 2015 to 1.03% in 2019. Meanwhile, speaking to certain broker groups prominent in LIC/LIT IPOs, the proportion of LIC/LIT chess holdings of their client base relative to all other holdings has not significantly changed over this period (both holdings have grown, but the proportions are relatively unchanged). This suggests to IIR that these groups have not engaged in a deliberate push of these products beyond seeking diversification for their client base.

Weighted Average Stamping Fees (by IPO raise amt) 2015-2019



Source: IIR based on underlying ASIC data

IIR would encourage those considering the matter of stamping fees to consider potential second degree impacts on the retail investor base. In our view these potentially include:

1) some of the highest quality public and private debt managers will likely not offer such solution to the Australian retail market if not confident of getting sufficient FUM scale to justify the considerable time and resources required to launch and manage these products;

2) there will be a slow down in fixed income LITs, and which are addressing a strong demand and prudent portfolio construction requirements for investors in the latter stage on their investment lifecycle;

3) retail investors may cease to benefit to the same degree from the illiquidity (and often) complexity premium inherent in certain public and, particularly, private debt instruments which closed-ended vehicles are uniquely placed to capitalise on;

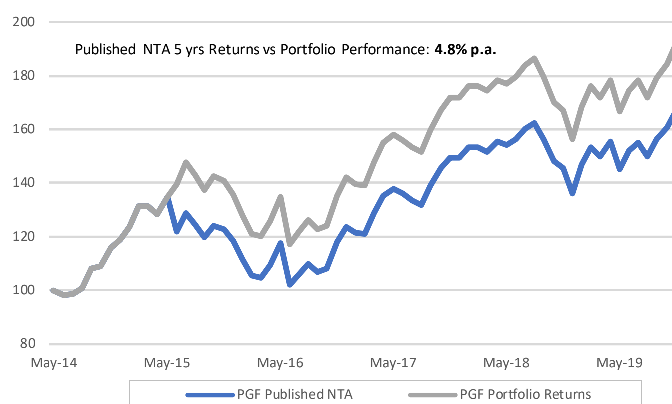
4) retail investors will be largely precluded from private debt and private equity as an asset class without a closed-ended investment vehicle (and private debt can be a particularly suitable asset class for retirees' yield and low volatility preferences);

5) 'push' retail investors into open-ended fixed income mandates, potentially exposing them to the repercussions of the liquidity mismatch risk that has emerged in public debt markets over recent years (as discussed in the submission).

The LMI stamping fee issue is multi-faceted and nuanced in many aspects and needs as much input as possible from all stakeholders to avoid a knee jerk reaction to the situation. We would hope that whatever measures, if any, that are announced by the Treasurer would build on the work done by the ASX in terms of LMI listing rules last year, some of which the ASX resolved to consult further on with LMI sector stakeholders during 2020.

The issue of stamping fees paid to brokers and advisors as part of the ASX capital raising process has caused a fair amount of debate on the topic both for and against the merit or not of their use. The ASIC performance analysis understated returns for any LIC that had loyalty options exercised. The chart below, in this case specific to PGF, illustrates how significant the understatement of actual portfolio performance to be (returns earned by IPO investors and illustrating true 'manager skill').

Loyalty Options - Portfolio Performance vs Published NTA



Source: IIR

Additionally, there was no consideration given to the notion of after-tax performance at the investor level, given the vast majority of LICs pay 100% franked dividends (vs the S&P/ASX 200 at circa 70% franking). Nor, on a comparative basis, has any consideration been given to the potential taxation inefficiencies of unit trusts.

Interesting to note that the Magellan IPO for the Magellan High Conviction Trust in late 2019 (ASX: MHH) went one step forward and didn't pay any fees, stamping fees or otherwise to brokers and advisors rather opting to reimburse investors though additional loyalty and/or foundation units [1]. However, one could even crystal ball into the future and see how the Magellan scheme could also become distorted. Let us say for example a fund manager is raising directly from investors similar to the Magellan model, but offering ever higher allocations of foundation and loyalty units as inducements to potential retail investors. What happens though if this LIC/LIT then suffers chronic under performance and trades at wide discount for the next 5 years? One has to wonder what the ASIC response to this would be.?

[1] Under the MHH IPO, Priority Applicants were eligible to receive valuable Loyalty Units up to 7.5% of the number of Units allotted to them under the Priority Offer. Other investors were eligible to receive IPO Foundation Units up to 2.5% of the number of Units allotted to them under the offer.

There is also the issue of how any rule changes are applied to, or effect other similar investment holding structures for example A-REIT's and ETF's when they initially list. To give one example, a recent A-REIT IPO had offer costs estimated per its offering documents to be circa 6.5% of the total capital raised but didn't pay stamping fees. In other words the NAV of the A-REIT will be impacted by circa 6.5% on day 1. LIC's could remove stamping fees for the sake of optics but up the fees paid to all the investment banks etc which would drive incentives for them to get the IPO away, no doubt through increased marketing to retail investors.

The above should convey that there is a lot of nuance and context that needs to be considered by the all stakeholders including ASIC, the ASX, The Treasurer and the financial services industry as a whole before any knee jerk reactions to ASIC's analysis is implemented. Indeed we voiced our support for some of the ASX listing rules changes brought in at the end 2019 which we think will improve the deal for LIC retail investors and we are encouraged by the ASX's commitment to conduct further work on some other listing rules based on feedback it received during its consultations on LIC ASX listing rules in 2019. One such suggestion is a mandatory LIC Continuation Vote clause, which IIR has previously written about.

Recent IPO Trends

Over the last 24 month period, the most notable trend in the LMI market has been IPOs of LITs based on public or private debt strategies (collectively referred to 'fixed income' in this submission). Over the last two years, 47% of the approximate $8.4bn in primary and secondary capital raises relate to fixed income mandates. Where equity raises have been undertaken, they have largely been undertaken by large, successful and well supported investment managers (Magellan, VGI Partners, Regal Funds Management).

LIT/LIC Capital Raisings over Last Two Years

Asset Class	Amount ($m)	Percentage
Fixed Income	4,006.2	47.7%
Equities	2,416.3	28.8%
Absolute Return	1,611.5	19.2%
Other	366.1	4.4%

This flow of fixed income mandates has been in response to a range of factors including:

- The ongoing search for yield as TDs hit historic lows and cease to be a viable option for retirees from an income adequacy perspective;
- The need to diversify with Australian retail investors historically being very overweight Australian equities and very underweight fixed income as an asset class;
- The increasing number of investors moving in the latter stage of their investment lifecycle, including retirement stage, and during which it is important from a portfolio perspective to mitigate drawdown risk;
- The increasing number of advisers moving off traditional platforms and increasingly investing in ASX-listed investment vehicles.

Investment Manager Quality

The fixed income LITs have generally been issued by very high calibre investment managers. The nature of the LIT/LIC IPO process over the last few years almost demands this be the case. The only way meaningful amounts of capital can be raised is through a large broking syndicate. And the only way a large broking syndicate can be formed is if they believe 1) the investment manager is exceptionally good, and 2) the proposed investment strategy satisfies a genuine investor need and, in many cases, is a new, differentiated product offering.

IIR also notes, that as part of the IPO process, there a multiple levels of vetting and due diligence conducted by multiple parties, independent research houses being only one. While unlisted managed funds also get reviewed by research houses, they are not subject to the multiple layers of due diligence. At a time when the breadth of financial advice is declining, this level of due diligence scrutiny is probably more valuable than ever.

Furthermore, investment managers, cognisant of the time, resources and costs involved in an LIT/LIC IPO are well minded to present very well thought out investment strategies tailored to a particular investor need in the Australian retail landscape. In this regard, there is an incentive to not only offer a very strong offering, but a strategy that is unique to a degree. This facilitates the further diversification of the Australian listed investment strategy landscape. From a product development quality perspective, an argument could equally be made that the stamping fee costs incurred by investment managers actually serve as a quality control device, with Australian retail investors being the ultimate beneficiaries.

One of the more unsubstantiated claims through the one-sided information campaign to remove stamping fees is that the fixed income LITs encompass both highly risky debt instruments and investment strategies. For example, high yield bonds being referred to as 'junk bonds'. At what point was sub-investment grade debt not a legitimate asset class that generally provides a specific and historically known risk-return profile? At what point was unrated private debt (private debt is unrated by its very nature) similarly not a legitimate asset class? And why should Australian retail investors not have access to the latter, as many institutional pension/ superannuation funds do?

Of the four public debt LITs that have listed (or, in the case of PIMCO, planning to list), all have excellent track records in downside risk mitigation, and all have outperformed the applicable benchmarks during down markets. The managers have generated superior risk-adjusted returns, lower drawdowns, shorter times to recovery, lower volatility and, hence superior downside risk metrics. Furthermore, they have historically provided a regular and reliable income stream, preserved initial capital, and provided the potential for broader portfolio diversification benefits, especially for investors overweight equities. They have achieved this through a strong focus on avoiding credit deterioration, timely sector / asset class rotation and rigorous relative value analysis. In short, these managers have track records that have delivered on the stated objectives of the LITs they have issued in the domestic market.

The table below provides a performance summary of the public debt investment managers that have listed on the ASX based on either these managers' most comparable existing strategies or the strategies directly utilised in the ASX-listed LIT.

IIR notes the KKR Opportunistic Credit Strategy (OCS) is an outlier in terms of volatility. This is due to a track record that encompasses the GFC tied with intentionally a high degree of credit risk (largely B and CCC). Excluding the GFC period, historic volatility is 5.7%. Additionally, OCS is only one half of the long-term portfolio allocation, with a European private debt strategy expected to significantly dampen overall volatility and downside risk. Neuberger Berman (manager of NBI) has generated alpha over the long term in the sub-strategies that together represent the NBI strategy.

Public Debt ASX-listed LIT Historic Performance

ASX	Reference Fund	Incept.	Returns	Alpha	Vol
KKR	Opportunistic Credit Strategy	2008	10.2%	4.5%	10.0%
NBI	Global High Yield	2016	5.3%	-0.6%	3.7%
PCI	PPT Pure Credit Alpha Fund	2012	6.6%	4.4%	1.4%

For ASX-listed LITs engaged in private debt strategies, the majority engage in first-lien senior secured debt only. First-lien senior secured debt ranks ahead of any other type of debt in the capital structure in terms of priority of payment and security on assets and cash flows, and reflects a strategic emphasis by these managers on lower credit risk, rather than stretching for yield. Where second-lien is included in a mandate, those managers are investing on a highly selective basis.

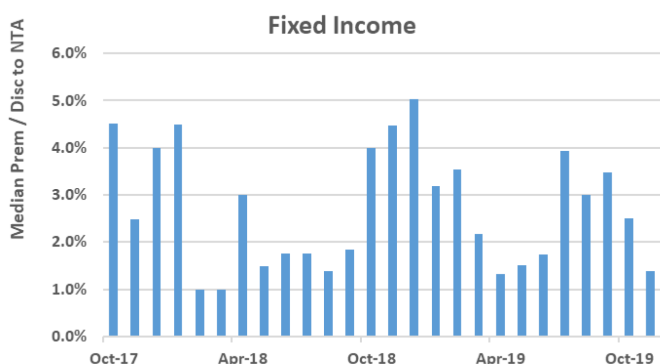
These investment managers generally have a very proactive approach to structuring and managing credits with respect to covenants, controls, security, LVRs, and other protections. The managers generally facilitate this by being either the sole-lender or, in the case of syndicated corporate loans, being the lead or co-lead lender. This provides for greater transparency and deal control, with the potential

to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation.

To date, LIT debt managers have, almost without exception, delivered on income targets, with some also delivering material capital upside. This, tied with the search for yield in the context of low term deposit rates, has underpinned both capital raise and secondary market demand. IIR notes that a number of managers have undertaken secondary capital raises and in which there has been significant demand. Overall, the sector has traded at a healthy premium to NAV. Both reflect well on manager performance in the sector. Mis-sold products? IIR would beg to differ.

However, we note that it is clear to IIR that many of the debt LITs that have listed on the ASX over the last 24-month period would not have incurred the considerable time and internal costs if they did not have confidence in gaining a certain threshold of FUM scale.

ASX-listed Debt LITs Disc / Prem to NAV



Source: IIR

Managing Secondary Market Latent Demand

Investment managers undertaking an IPO are now more mindful of supporting strong secondary market demand post IPO to mitigate the risk of trading at a discount to NTA. They are doing this by scaling back issuance relative to demand. In doing so, scarcity brings more bids than offers in aftermarket.

IPO Structuring Improvements

Dilutive loyalty options and Day 1 NTA being less than the issue price for investors (with investors effectively picking up the costs of the IPO) are both long gone. The last significant option issues were Plato Income Maximiser in May 2017 and Contango Global Growth in June 2017, the latter being the final LIC that issued 'loyalty options'. There is a wide lack of understanding of the dilutive impact on published NTA post the exercise of loyalty options and the actual returns of the underlying portfolio (and those accrued by investors), the latter being the important measure of investment manager skill. Additionally, it is not only IPO investors that benefit from exercising in-the-money options. LICs with outstanding loyalty options have invariably traded at a discount to published NTA. This discount is a rationale pricing in of the potentially dilutive impact of loyalty options. New investors, at purchasing at a share price reflecting the potential dilutive impact of loyalty options are not being subsequently penalised if and when such options are exercised. They can in fact benefit if no such options end up being exercised or a lesser degree are exercised than potential priced in by the market.

Closed-ended Vehicles Matter in Debt Markets

In IIR's view, a key issue in relation to second degree adverse consequences relates to the advantages a closed-ended investment vehicle can have to open-ended vehicles, and this is no more so than in the fixed income asset class, both public and private debt.

To understand the advantageous nature of closed-ended vehicles in the public credit markets requires an understanding of key secular changes that have emerged over the last ten year period, or so, following the GFC. These changes are a combination of the regulation of the marketplace after the GFC and significant growth in open-ended, daily liquid ETFs and mutual funds (reflecting investors' persistent thirst for yield). Given the rapid growth in the public credit market, IIR believes there is urgency in understanding these current market dynamics and identifying possible hidden risks therein.

Pertinent to this discuss are the key secular changes of: 1. lack of market-making and other regulatory changes that will impede price discovery in the next downturn; and 2. the explosion in Asset-Liability mismatched structures.

Fixed-income markets, unlike their counterparts, the more liquid stock markets, are characterized by having the majority of their trades executed OTC. Similar to stocks, once a bond or bank loan is issued in the primary market, investors can, in theory, trade the bonds in the secondary market.

However, while secondary market trading for stocks occurs on popular lit exchanges such as the NYSE, LSE, ASX, etc, there are currently no significant lit exchanges for fixed-income securities, meaning more fixed-income securities are packaged into ETFs. Fixed income ETFs and open-ended mutual / managed funds have been created to appease the demand from retail investors for access and exposure to corporate bonds and loans and a range of asset-backed securities.

These products are attractive to retail investors (and those that have sold products to them) because they believe that ETFs and mutual funds have daily liquidity. What retail investors may not have considered, however, is that this perception of daily liquidity is not entirely accurate: these products are based on OTC securities, which have hidden risks in down-market cycles. Wrapping fixed-income securities into daily liquid open ended mutual / managed funds and ETFs does not solve the problem of the lack of exchange-traded markets for fixed-income securities. It only hides the lack of liquidity of the underlying constituents.

Asset / Liability Liquidity Mismatch

Market liquidity in the global bond and bank loans markets today is a fraction of what it was pre GFC, as broker-dealer inventories of such securities (the traditional liquidity providers during a dislocation event) have reduced substantially subsequent to the introduction of the Volcker Rule in 2014[2] tied with the significant inflow into daily liquid ETFs and mutual funds in both markets [3]. Taken together, the net result is substantially less liquidity on the asset side, but substantially more liquidity on the liability side. This has led to an inherently more volatile and technically dominated public debt markets.

[2] It is estimated that overall broker-dealer inventories have reduced by approximately 75% since the GFC, an™d more so in the sub-IG segment.

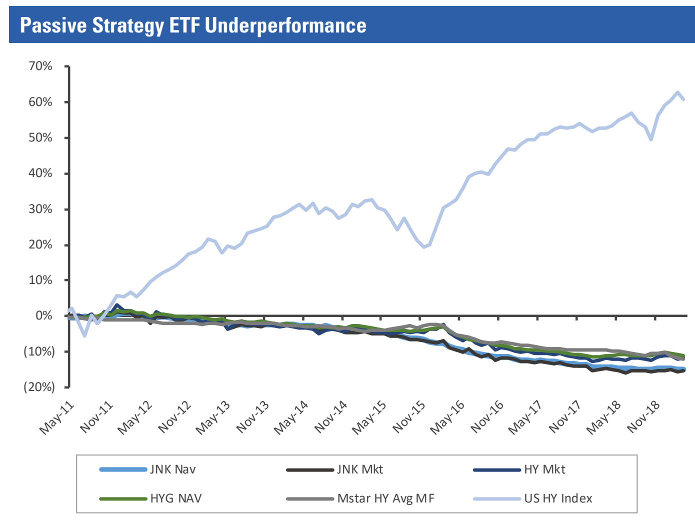
[3] For example, in the sub-IG segment, an approximate 40% of the market segment now comprises daily liquid (and predominantly index-tracking) investment vehicles. With an absence of significant exchanges for credit securities, more securities have been packaged into ETFs or daily liquid mutual funds (effectively hiding the lack of liquidity of the underlying constituents for some retail investors).

For open-ended investment vehicles, which are subject to the vagaries of investor net flows and the consequent necessity to buy and sell in response to both material net inflows and outflows, this evolving market dynamic has led to a situation of more forced selling during market dislocation events and more forced buying in recovering market as investor confidence recovers. In short, an increasing risk of being whipsawed with consequent detrimental impacts on performance.

The increasing bouts of volatility has created a market environment that is increasingly difficult for index aware and index-tracking mandates to perform well. The chart below illustrates the historic performance of a number of the largest sub-IG ETFs as well as the Morningstar high yield average for mutual funds (the majority being active mandates). As evident, there has been marked underperformance. It is IIR's understanding that given the considerable size of the index tracking / aware mandates (tied with a mandate incentive to largely simply replicate the index) combined with limited liquidity during bouts of volatility the mismatch is creating supply-demand related price distortions.

These supply-demand related price distortions became evident in 4Q2018, representing the last material dislocation event. As the US based asset manager Guggenheim has pointed out, during this period, demand for floating-rate bank loans waned when market expectations for Fed rate hikes in 2019 fell from two to zero, resulting in record fund outflows. This repositioning caused mutual fund managers and ETFs (i.e. open ended vehicles) to shed their more liquid holdings to cover redemptions, which led to larger loans underperforming smaller, less liquid loans on a price and total return basis. The limited liquidity in the bank loan market, combined with heavy outflows, exacerbated the negative pressure on loan prices, and resulted in performance that appeared to be more driven by liquidity concerns than credit. For example, as the sell off intensified in December 2018, the gap between first- and second-lien discount margins perversely tightened by 34 basis points for the quarter. The painful lesson learned: liquidity is not a given, and the exits tend to shrink on the way out. IIR views it as a cautionary tale for investors in index tracking mandates in particular but more broadly a risk that applies to all open-ended fixed income investment vehicles.

Passive Strategy ETF Underperformance



In contrast to an open-ended vehicle, a closed-ended structure, by way of 'captive capital', provides an investment manager the ability to opportunistically take advantage of market dislocation events in public traded debt. These investment managers have the ability to represent the 'liquidity provider' to daily liquid mutual / managed funds and ETFs on forced sales of what become discounted debt instruments. In doing so, it can enable an adept manager to generate a higher yield without necessarily having to dial up the credit risk of the portfolio.

So, closed-ended vehicles are not only subject to the detrimental impact of whipsaw risk but they can actually capitalise on the rising structural risks in the public fixed income markets. In the ASX-LIT segment, IIR notes that both KKR and PIMCO very actively seek this dislocation opportunities through their proven ability to identify and select mispriced risk.

The unintended consequences of hampering the growth of closed-ended fixed income LITs in Australia is it effectively pushes investors into open-ended fixed income vehicles. IIR is by no means saying open-ended fixed income vehicles are inherently incompatible with the asset class. Far from it. What we are saying, is open-ended fixed income vehicles are inherently risky when there is a liquidity mismatch, and that risk increases as the degree of relatively illiquid debt instruments in the underlying portfolio increases. In relation to that liquidity mismatch and some open-ended funds having a material portfolio weight to relatively illiquid underlying debt instruments, IIR notes past comments from Bank of England governor Mark Carney:-

"These funds are built on a lie, which is you can have daily liquidity," Mr Carney told MPs at a parliamentary hearing. For assets that "fundamentally aren't liquid" or might become illiquid in a market downturn, the damage of that "lie" for financial stability is that it "leads to an expectation for individuals that it's not that different from having money in a bank". Mr Carney said investors should expect terms that were in line with the liquidity of the assets, with no assumption of instant access if they wanted to redeem their investments. If nothing is done, Mr Carney added, the mismatch between the liquidity of the underlying assets and the liquidity of the funds risked becoming a systemic problem." Bank of England governor Mark Carney warning after high-profile problems at Neil Woodford's flagship fund, which froze withdrawals this month and at another asset manager H2O, which lost close to €2.4bn in a single day after investors took fright over illiquid bonds. Source: Financial Times, June 27, 2019.

Illiquidity & Complexity Premium

In contrast, an investment manager of a closed-ended investment vehicle can very intentionally take advantage of permanent capital by opening up a greater degree of the portfolio to less liquid investments to capitalise on the illiquidity premium. For example, mortgage backed securities and securitised credit are generally deemed to fall in the middle of the liquidity spectrum, between the generally daily liquid investments of open-ended traditional funds and the generally very illiquid investments of private debt funds. Fewer investment mandates target this segment of the liquidity spectrum, and as such it has provided an attractive compensation for risk. It has also provided some investment managers the benefit of not having to increase credit risk (to maintain yield in a declining rates environment) during what is arguably the late stage of the credit cycle.

While open-ended vehicles can and certainly do gain exposure to such asset classes, they can only prudently do so to a lesser degree in terms of portfolio weight due to the inherent liquidity mismatch such investments generate for open-ended investment vehicles.

IIR is aware of ASX-listed active fixed income ETFs that have significant portfolio weights (circa 30%) in Australian RMBS. Asset class returns have been attractive in this segment. However, the Australian RMBS market has limited secondary market liquidity, with investment managers generally holding such investments to each securities maturity. Many may remember that during the GFC the Australian RMBS market ceased up entirely, with the RBA eventually having to step in to provide liquidity.

Here's a not inconceivable scenario for an open-ended ETF with a very material holding in Australian RMBS: A significant market dislocation event occurs. There are broad outflows in the fixed income asset class. The manager of the open-ended vehicle with the 30% portfolio holding in Australian RMBS is required to fund redemptions by selling the more liquid holdings. In doing so, the Australian RMBS weight increases from 30% to 50% of the portfolio, for example. The marked-to-market value of the Australian RMBS is marked down to reflect rising spreads in the market. Reflecting this, monthly performance of the ETF deteriorates, fuelling further redemptions, further selling of more liquid underlying securities, and a further reweighting of the portfolio to Australian RMBS. In a worst case scenario, ETF redemptions are frozen, possibly due to the ETF portfolio exceeded maximum asset class limits or possibly due to the inability to fund further redemptions through asset sales.

While these risks are no different to an unlisted managed fund, a freeze in redemptions in an ETF vehicle would likely come as a complete and unexpected shock to ETF investors. This would run the risk of significantly undermining confidence in the ETF market more broadly, potentially leading to something of a contagion effect.

Private debt and private equity are both asset classes that can deliver a substantial premia to investors by way of the illiquidity and complexity premium. Neither can be delivered to retail investors by way of an open-ended investment vehicle. IIR would argue that private debt in particular can be a useful addition to an overall portfolio for those in the latter stage of their investment lifecycle.

Private Debt offers several advantages over the traded sub-investment grade markets of high yield bonds and bank loans (public debt). Private debt investors receive more detailed due diligence information, senior investments benefit from security over assets, there is a lower degree of interest rate sensitivity as private debt investments are more often floating rate notes, and there is lower marked to market volatility. Further, private debt investors benefit from stronger covenants, better information / monitoring rights

and closer borrower relationships with private equity sponsors / borrowers. This is reflected historically in lower default rates and higher recovery rates, equating to lower capital loss. However, this comes at the price of lower liquidity and the need for more resource-intensive implementation and monitoring processes.

IIR views the addition of private debt closed-ended mandates as a welcome addition to the Australian retail investment landscape. The asset class can serve as an ideal addition to an overall portfolio for an investor in the latter stage of their investment lifecycle. There is a reason the asset class has proved so popular with institutional pension and superannuation funds. To date, there has been six private debt strategies that have been issued as ASX-listed LITs.

One such LIT is the KKR Credit Income Fund (KKC) which will have a 40-50% allocation to KKR European Direct Lending deals. Exposure to the latter strategy will be gained through KLPE II. Like many institutional private debt vehicles, KLPE II itself is a closed-ended vehicle with no liquidity during its term. There is an open period for investments, then the vehicle is locked up for its term. By its very nature, retail investment into such vehicles must be by way of a closed-ended vehicle with an IPO (with all funds invested prior to the final close date of, in this case, KLPE II), and where the investment manager is confident a sufficient scale of FUM will be raised. Without confidence in the latter, the better private debt investment managers will simply not bother to offer the asset class to Australian investors.

In short, closed-ended vehicles provide Australian retail investors; 1) the opportunity to access asset classes they could not otherwise access (and asset classes that may be ideally suited to their investment needs); and, 2) enable Australian retail investors the ability to benefit from a greater degree of the illiquidity and complexity premium than would otherwise be prudently possible through an open-ended vehicle. In relation to this latter point, this has the double benefit of potentially not having an investment manager moving up the credit risk spectrum to maintain yield during a period of declining interest rates.

Finally, closed-ended vehicles also enable the prudent use of leverage. With risk-free rates having declined materially in recent years, there may be a temptation for investment managers to maintain yield by moving up the risk spectrum, generally by taking on a greater degree of credit risk by way of a lower average credit quality or moving down the capital structure in securities. Alternatively, a manager can retain a higher degree of credit quality and/or remain higher in the capital structure through securities that inherently have lower leverage and then apply external leverage to the overall portfolio to increase the overall yield. IIR notes that both the proposed PIMCO LIT and Partners Group prudently apply leverage to augment yield (rather than doing so through higher credit risk).

In an open ended structure, the use of external leverage heightens redemption risk, adding to the degree of forced selling during a market dislocation event (selling in a declining market) and, conversely, the need to repurchase in a recovering market, should net inflows into the investment vehicle return.

As a final point, fixed income closed-ended vehicles in the US account for 57% of the total US$238b market cap. In contrast, in Australia, fixed income closed-ended vehicles account for only 10% of the total A$52b market cap. To a degree, IIR believes the significant weighting to fixed income mandates reflects a better awareness in the US of the structural advantages of closed-ended vehicles in particular the fixed income asset class.

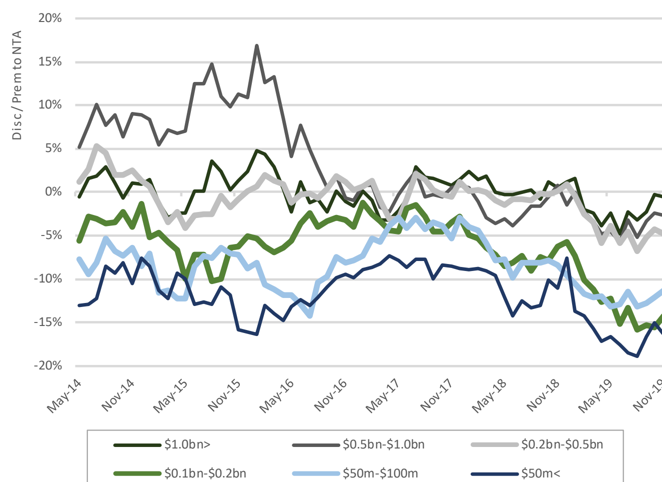
Discounts and Premiums - Scale Matters

The fact that LMIs can trade at deep discounts and premiums is one that divides investors. There is no doubt that it adds a layer of complexity, but it does also offer an additional source of potential returns. Selling a LIT / LIC at a discount is not a good outcome for an investor. However, there are many of investors that buy at a discount and ride out the discount or the degree of it. Such investors pick up on both sides of the trade: the NTA growth and the discount erosion.

The size of a given LIC or LIT is a key determinant of whether the vehicle trades at a discount or premium. Broadly speaking, vehicles under $200 million tend to trade at a discount and those that are at $500 million and above tend to trade at a premium. It is difficult for small scale LICs to generate the same level of interest as larger LICs and they are likely to have poor market liquidity. Consistency of income payments also plays a significant role in keeping a listed vehicle trading at or close to NTA.

The charts below and on the right hand side highlight this tendency where there is a clear correlation between FUM scale and the premium / discount to NTA. The irony is probably not lost upon those participating in the stamping fee consultation and review process. The most vocal critics have pointed to a number of LICs trading at sustained and material discounts to NTA as evidence of mis-selling. But on the basis of the below, it would appear that those LICs that had the lowest degree of "mis-selling" (i.e. those LICs at the lower of FUM) are most susceptible to trade at a material discount.

Simple Avg Premium by Mkt Capitalisation



Source: IIR

Conclusion

Irrespective of what one thinks about the stamping fee issue and the outcome, IIR is quite certain that some of the best global fixed income managers that have, and are planning to enter the Australian LIT market simply would not or will not do so if they were not confident is gaining sufficient FUM scale to justify the time and resources involved in IPO-ing and then managing their respective products. In IIR's view, this would be a highly detrimental outcome for the Australian retail market. Closed-ended fixed income vehicles offer distinct advantages that not only mitigate exposure to some of the broader risks in the public and private debt markets, but actually allow adept managers to capitalise on those dynamics and risks. Captive capital facilitates the ability to prudently extract both the illiquidity and complexity premium to a degree not prudently possible in an open-ended structure. In doing so, there is less a temptation to maintain yield in a declining rates environment by moving up the credit risk spectrum (an issue every central banker in the Western world is rightly cautioning against). Given debt markets are generally viewed as being in a late cycle stage and where lending standards have generally deteriorated, the flexibility accorded by patient, captive capital has probably never been more important. So too is investment manager quality. To mention just two, IIR would argue there are few investment managers globally that have capitalised on the advantages of a closed-ended vehicle more than PIMCO to deliver strong risk-adjusted returns, and through a flexible multi-sector approach, do so through the full economic and credit cycle. Similarly, in private debt, KKR for example is particularly well pedigreed, having extensive resources to work through the full life-cycle of a private debt lend, including strong workout and restructuring experience in the event of a payment default / bankruptcy. IIR is happy to liaise with Treasury and ASIC to whatever degree to assist in delivering the best overall outcome for Australian retail investors.

WHO IS IIR?

Independent Investment Research, "IIR", is an independent investment research house based in Australia and the United States. IIR specialises in the analysis of high quality commissioned research for Brokers, Family Offices and Fund Managers. IIR distributes its research in Asia, United States and the Americas. IIR does not participate in any corporate or capital raising activity and therefore it does not have any inherent bias that may result from research that is linked to any corporate/ capital raising activity.

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.

IIR takes great pride in the quality and independence of our analysis, underpinned by high caliber staff and a transparent, proven and rigorous research methodology.

INDEPENDENCE OF RESEARCH ANALYSTS

Researchanalysts are not directly supervised by personnel from other areas of the Firm whose interests or functions may conflict with those of the research analysts. The evaluation and appraisal of research analysts for purposes of career advancement, remuneration and promotion is structured so that non-research personnel do not exert inappropriate influence over analysts.

Supervision and reporting lines: Analysts who publish research reports are supervised by, and report to, Research Management. Research analysts do not report to, and are not supervised by, any sales personnel nor do they have dealings with Sales personnel

Evaluation and remuneration: The remuneration of research analysts is determined on the basis of a number of factors, including quality, accuracy and value of research, productivity, experience, individual reputation, and evaluations by investor clients.

INDEPENDENCE – ACTIVITIES OF ANALYSTS

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Pitches: Research analysts are not permitted to participate in sales pitches for corporate mandates on behalf of a Broker and are not permitted to prepare or review materials for those pitches. Pitch materials by investor clients may not contain the promise of research coverage by IIR.

No promotion of issuers' transactions: Research analysts may not be involved in promotional or marketing activities of an issuer of a relevant investment that would reasonably be construed as representing the issuer. For this reason, analysts are not permitted to attend "road show" presentations by issuers that are corporate clients of the Firm relating to offerings of securities or any other investment banking transaction from that our clients may undertake from time to time. Analysts may, however, observe road shows remotely, without asking questions, by video link or telephone in order to help ensure that they have access to the same information as their investor clients.

Widely-attended conferences: Analysts are permitted to attend and speak at widely-attended conferences at which our firm has been invited to present our views. These widely-attended conferences may include investor presentations by corporate clients of the Firm.

Other permitted activities: Analysts may be consulted by Firm sales personnel on matters such as market and industry trends, conditions and developments and the structuring, pricing and expected market reception of securities offerings or other market operations. Analysts may also carry out preliminary due diligence and vetting of issuers that may be prospective research clients of ours.

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