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Why your LIC could be a cashbox in disguise

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Cashboxes are back!

What's a cashbox? It is just a company with a whole lot of cash and a "promise" of great things to come.

The newest "fad" is listed investment companies (LICs). QV Equities Limited is the latest to hit the IPO round, following earlier offers from Global Value Fund Limited and PM Capital Asian Opportunities Fund Limited.

To be fair to the LIC sector, there are some very prominent and experienced names involved in these raisings, and if you want to set up a new fund, you have to raise the money somehow. And arguably, the LIC structure is often more favourable to investors than the "for profit" managed funds operated by subsidiaries of the major banks or global fund managers.

What are the issues with a cashbox?

Firstly, there is the premium investors pay for the costs of the IPO – in particular, payments to the distributors or brokers. Most of the LICs will have issue costs of around 2.5% – so if you invest $10,000 – $250 is going to pay for the costs of the offer.

A share you pay $1.00 for initially is really worth $0.975 (described as the Net Asset Value or Net Tangible Asset).

Secondly, you are buying a "promise" – the expertise and skills of the manager hopefully delivering you great returns in the future. Nothing wrong here – this is why we invest.

Thirdly, the gimmick part – with each of these LICs comes an entitlement to "free" options. For every share you purchase for $1.00, you are entitled to one option to buy another share at $1.00. This option can be exercised at any time in the next 18 months – which you would exercise if the NAV was greater than $1.00. If the LIC doesn't perform and the NAV in 18 months was less than $1.00, you wouldn't exercise it.

There is no such thing as a "free" option

Options are never "free" or costless. They have a value, which can be calculated by the application of a complex mathematical formula, such as Black-Scholes. Because this calculation is complex, few individual investors can value the option – so describing it as "free" is both misleading and a gimmick because when it comes to investment, there is no such thing as a "free lunch".

Let's take the recent PM Capital Asian Opportunities Fund LIC to illustrate the issue.

The PM Capital issue was listed on the ASX in late May. For each $1.00 share (ASX Code PAF), participants in the IPO also received 1 "free" option to purchase another PAF share at $1.00. The option is also listed on the ASX and trades under the code PAFO. On Friday, the shares and options closed at the following prices:

Security	Bid	Offer	Last
PAF	92.5c	93.0c	93.0c
PAFO	6.0c	6.6c	6.0c

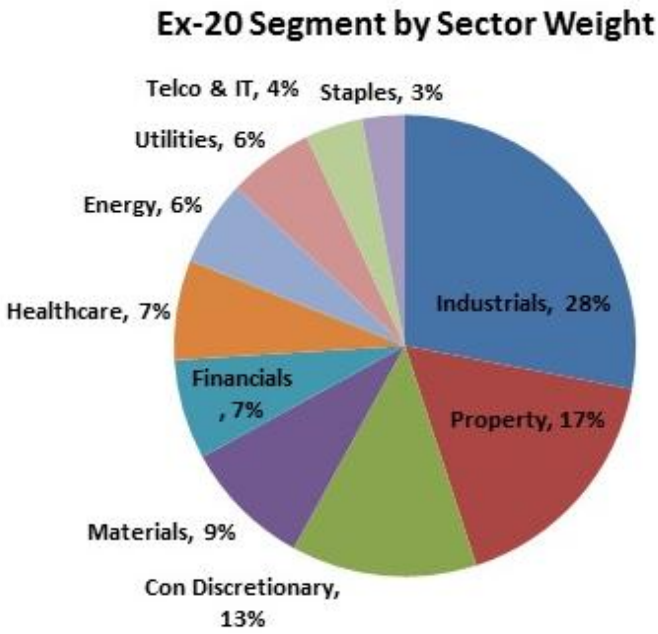
The newly listed option is worth 6.0c. Together, the share and option are worth 99c (compared to the $1.00 participants in the IPO paid). At the bid price (the price you would get if you sold your holding), you would receive just 98.5c before brokerage costs.

QV Equities Limited

QV Equities Limited is a new LIC, which will invest predominately in companies outside the S&P/ASX 20 index, with the aim of providing long-term capital growth and income over a five-year plus investment period.

The Australian share market is highly concentrated, with the top 20 stocks comprising 67% of the market capitalisation of the S&P/ASX 300 index. Further, the financial and resources sectors alone make up 69% of the top 20 index.

By contrast, companies outside the top 20 are more diversified across the sectors (see pie chart below). As the stocks are generally not as well researched, there is arguably an opportunity for a manager to add value through a "bottom up" research and analysis process.



The company will invest primarily in ASX listed entities outside the top 20, with the portfolio typically comprising 20 to 50 stocks. It is also permitted to have up to 5% in unlisted securities, and cash holdings will vary between 0% and 25%.

By way of a formal management agreement, QV Equities has appointed Anton Tagliaferro's Investors Mutual Limited (IML) to manage the company. One of Australia's leading fund managers, IML has won several industry awards and currently manages over $4.9 billion in Australian and NZ equities.

IML will be paid a management fee of 0.99% pa of the net asset value of the portfolio up to $150 million, and then 0.825% pa on the balance above that amount. They will not be paid any performance fees.

QV Equities is seeking to raise between $100 million and $200 million via an Initial Public Offer. Details of the offer are as follows:

Company Name and Code	**QV Equities Ltd (ASX Code QVE)**
Offer	1 fully paid ordinary share at $1.00 1 free option exercisable at $1.00 with 18 month expiry period (ASX Code QVEO)
Minimum Application	2,500 shares
Minimum Offer Size	$100m
Maximum Offer Size	$200m
Proforma NAV (max sub)	$0.977
Offer Opens	14 July
Offer Closes	8 August
Expected Listing Date on ASX	22 August
Brokers	CommSec, Patersons, Lonsec, BBY and others
General Public Offer	Yes

Our view

An investment in an LIC such as QV Equities can be used to compliment a strategy that that is mainly taking exposure in the major companies such as the banks, BHP and Telstra, or is investing in index tracking funds or ETFs.

There is a role for specialist, active managers, particularly in regard to smaller companies where the information in the market is less “efficient” – and in many cases, it is better to do this through an LIC rather than through a normal managed fund. With a managed fund, you are a “customer” of the manager, while as a part owner of an LIC, you are effectively the “employer” of the manager.

That said, if you like this investment opportunity, then it may pay to wait. If your broker will refund the placement/service fee of 1.65% (which brings your purchase cost down to $0.9835 per unit, much closer to the expected NAV of the fund at $0.977), then you might care to participate in the IPO. Otherwise, hang on to your money and wait till it lists on the ASX and buy it on market.