THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS
SPECIAL REPORT

An in-depth look at LICs

A LETTER FROM YOUR RESEARCH TEAM

Dear reader,

Bear markets make tough going for most stocks, but they're especially hard on listed investment companies (LICs). Not only do their portfolios suffer as share prices fall, but the discounts on their own stock tend to widen.

This double whammy has put LICs firmly in the doghouse over the past year, with the stocks reviewed inside these pages, for example, down an average of about 45% from their peaks. But of course it's this same double whammy that has piqued our interest—if now's a good time to be buying stocks (and we think it is—selectively at least), then there must be some sense in buying them through an LIC with a generous discount.

No doubt this is true, but there are a number of problems. First and foremost, you need to have confidence that your LIC can actually pick the right stocks—and let's face it, many of them haven't shown much sign of that so far, which is partly what has led them to their current predicament. If an LIC keeps underperforming the market, then pretty much no discount will be enough. Secondly, LICs are less attractive than their underlying stocks because of the costs they leak, both in fees to their managers and boards, and brokerage commissions for often excessive trading. But if you can find a smart investor, for a reasonable fee, in an LIC priced at a decent discount, then you could be onto a winner—particularly if the underlying stockmarket is offering bargains.

When we last looked at the sector, in our September 2005 special report *An In-Depth Look at LICs*, we were nervous about stockmarket valuations generally, and that's no doubt partly what drew us to the sector—anything to get a bit of a discount. But while it turns out we were right about the problem, we were wrong about the solution and, with the market falling 21% since then, discounts have continued to widen.

This report revisits some of the LICs in that report and also examines some new ones. Most of our positive recommendations are in global LICs, which is a happy coincidence since we believe that the major overseas stockmarkets currently offer better value than our own, yet most people prefer not to invest directly overseas. But there's also a buy among the LICs investing at home, and several more for your watch list.

Hopefully you'll find something that will make a useful addition to your own portfolio. Before we get into the LICs themselves, though, we'll take a look at the sector as a whole and how to go about analysing it.

Many happy returns,
The team at *The Intelligent Investor*

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Solving the LIC riddle

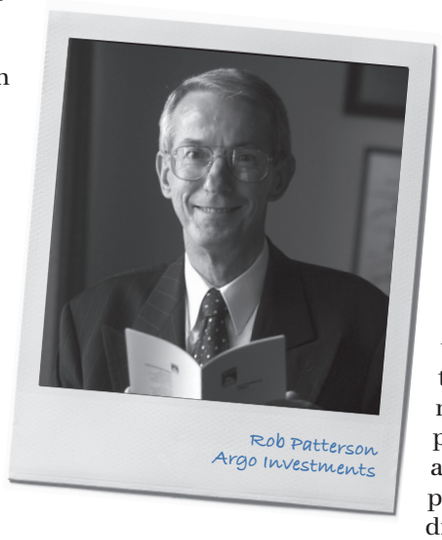
At their core, listed investment companies (LICs) are pretty simple. While other companies will use their money to build a factory or set up a shop, an LIC just goes off and buys a bunch of shares. And since it's easier to put a price on a portfolio of shares than it is a factory or a shop, an LIC is that much easier to analyse.

Or so you'd think—and you'd be right to a point. There are relatively few things that define the value of an LIC—its investing skills, its costs, the current value of its assets and where its share price sits in relation to that value. But as we'll see, on closer examination each of these factors hides considerable complexity and you end up with something like Winston Churchill's famous description of Russia: 'a riddle wrapped in a mystery inside an enigma'.

Valuing the assets

Let's start with the value of the LIC's assets. There are two things we might want to know here and they're not quite the same: the first is what shareholders would get if the company sold its investments, settled any liabilities and distributed the cash; the second is the amount of capital the LIC has to invest on an ongoing basis to generate returns for shareholders.

The main point of difference is tax. If the LIC's investments have been going up, then there will be a portion of its portfolio that would need to be paid in tax if it were liquidated; yet if it doesn't liquidate the portfolio then it will be able to make returns from this 'loan from the tax man'. Long-established LICs such as **Australian Foundation Investment Company** and **Argo Investments** have large slabs of latent capital gains tax, so you might want to deduct this from your valuation of their assets. But, on the other hand, they don't sell much of their portfolios each year and, in the meantime, they're generating returns on the full amount, including the tax.


Rob Patterson
Argo Investments

To further confuse matters, a number of the younger LICs have actually seen their portfolios fall in value, so they may be sitting on potentially valuable tax losses. These are the reverse of the latent capital gains tax—there's a gain to be had when the holdings are sold (if there are gains to set the losses against), but until then the LIC is making returns off the lower amount.

In terms of the terminology, the value of the assets (or at least their current market price) is generally described as net tangible assets, or NTA, and, for the reasons described, it'll generally be given in at least two flavours, pre-tax and post-tax. Which one will be higher will depend on how the portfolio's been travelling.

Taking a conservative approach, and to keep things relatively simple, we have a strong preference for using the lower figure. But we may relax this and at least consider the higher figure in certain circumstances, such as where there are large gains and the portfolio isn't traded much or where an LIC with losses is being taken over by one with gains (such as happened recently with **Brickworks Investments**' takeover of Huntley Investment Company—see page 9).

As if this wasn't enough, there's an even more fundamental problem with valuing an LIC's assets, which is that you don't know the exact contents of the portfolio and they only tell you its value periodically. Typically you get new NTA figures monthly, but even then there's a delay of a few days before the numbers are announced. So you're left looking at the most recent figure and making guesses about how it might have changed given how markets (and the LIC's specific large investments) have fared. Differences of a few per cent can make a meaningful difference to the value calculation, but the stockmarket has been dishing out such movements on a daily basis in recent months.

Investing skills and management

Which gets us to perhaps the most important but enigmatic point of all—the skills of the LIC's investment manager. Ultimately the success of an LIC will depend on how well its investments perform and, along with a not-to-be-ignored dose of luck, this will depend on the manager's stock-picking skills.

The real paradox here is that most people investing in LICs are doing so because they don't feel comfortable picking the shares themselves, yet if you can't pick the shares, why would you suppose you have the skills to pick the right investment manager? Investment managers don't get to manage large sums of money without a confident approach and a decent track record, but my nine-year-old cousin has a confident approach and track records are notoriously fickle.

The answer is that you probably don't have the skills and it's worth approaching the matter from this perspective. Stick to the simple things. What matters in investment management are a focus on value, a long-term perspective, an honesty towards oneself and a humility about the extent of one's ability to predict the future, so look for managers that display these characteristics in their various reports. And, as with any investing, you can make up for a lot with a big margin of safety—in the case of LICs, this means a big discount to NTA (which we'll come to shortly).

As ever, it's also important to see the board of directors of an LIC (as distinct from its investment manager) acting in the interests of shareholders. **Century Australia** (see page 10), for example, recently took its paperwork away from investment manager 452 Capital and outsourced it at half

the cost. And shareholder-friendly LICs will consider buying back shares when they're priced at a wide discount to NTA, even though that will reduce the pool of assets from which the investment manager draws fees.

Management fees

Fees are the other thing that really matter about investment management. Here we have another fundamental paradox, which is that the more you strive (and pay) for higher performance, the worse your performance is likely to be. The problem, of course, is that the fees come straight out of the fund and therefore provide a degree of 'drag'. When you're only aiming to make 10% or so over the long term (a realistic target), 1% of additional fees can represent an almighty hurdle, particularly when performance is so fickle.

Fees come in a variety of ways. First of all there's the simple and straightforward annual management fee—x% of net tangible assets per year (sometimes the fee is expressed as a percentage of gross assets, which is less desirable since it gives the investment manager an incentive to borrow money and increase assets).


Hamish Douglass
Magellan Flagship Fund

On top of this there may be performance fees, whereby the manager takes a certain percentage of gains above a particular benchmark.

As with so many things, the basic idea for this is a good one—to align the investment manager's interests with shareholders—and it would be fine if it was structured correctly (particularly so that past underperformance has to be made up before performance fees are payable) and acted as an alternative to part of the annual fee. But, sadly, managers have found something that can be dismissed so easily with 'you only pay it if you're doing well' too tempting and performance fees have now become a bit of a hidden perk.

They can make a big difference, though, and badly structured fees can provide the wrong incentives. Some are payable purely on the basis of one year's performance, with past underperformance not having to be made up, and this can encourage excessive risk-taking—plodding along 1% ahead of the index each year may produce no performance fees, whereas alternately outperforming by 20% and underperforming by 30% may produce a stream of juicy payments.

On top of all this are the costs of actually trading the shares in the portfolio. On the whole you're looking for managers that trade only a small percentage of the portfolio each year, indicating a long-term perspective and keeping costs low. Brickworks Investments (see page 9) is an extreme example of this with only 3% of its portfolio being traded last financial year, whereas **Platinum Capital** sits at the other end of the spectrum with an astonishing two-thirds of its portfolio being traded over the same period.

The real trouble with fees is that in an uncertain world, and with genuine—as opposed to lucky—outperformance so hard to find, they make up a bigger portion of the value equation than many people imagine. But good managers can undoubtedly make up the difference, as Platinum Capital has shown over the years. On the whole, though, you should require extremely good reasons for expecting this to happen—which are hard to come by—and a decent discount in case it doesn't.

The discount

After all that confusion, the discount has an elegant simplicity—at least once you've decided on an appropriate figure to use for your NTA. The discount is the gap between the share price and the NTA, normally expressed as a percentage—so a share price of 90 cents and NTA of $1 would amount to a discount of 10%. The first point is that you're actually looking for a discount, not a premium. If the share price is above the NTA, it means you're paying more for the assets than they're worth, which removes the possibility of having any kind of margin of safety, especially after fees are taken into account.

So how much discount should you need? Well, as with any margin of safety, it's a case of the more the merrier, but not so much that you miss out on decent opportunities. A good starting point is to look for a discount that's enough to make up for the base fees. If you're expecting a 10% annual return and an LIC has NTA of $1 and charges 1% a year, then you'd want a discount of 10% to make up for the fees—the 10 cents you expect the LIC to earn falls to 9 cents after the 1% fee, and a 90 cent price is needed to give you back your 10% return. With fees of 0.5% you'd want at least a 5% discount, and with fees of 1.5% you'd want 15%.

But this, of course, is just the starting point. From here you need to go upwards or downwards to take account of all the other factors we've discussed—investment skills, management behaviour, performance fees and trading costs.


Peter Hall
Hunter Hall

So while the basics behind analysing LICs are relatively straightforward, the detail certainly is not. But it's the same for everyone of course, and with a sensible approach to investment, reasonable costs and a chunky discount, they can make excellent investments, particularly if you don't have the time or inclination to choose individual stocks yourself for all or part of your portfolio.

Timeless Templeton runs a tight ship

The listed investment company sector has become crowded since 2003. But Templeton will always be the first and, so far, its fee structure is still the best.

SNAPSHOT

TEMPLETON GLOBAL GROWTH (TGG)	$0.74
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$108m
12-MONTH SHARE PRICE RANGE	$0.625–$1.32
BUSINESS RISK 1.5 out of 5	SHARE PRICE RISK 2 out of 5
OUR VIEW	LONG TERM BUY

Most of us can only imagine the fear that engulfed the world when war broke out in Europe in 1939. Many investors would have liquidated their portfolios and retreated to tangible assets such as gold.

But the pioneering global investor Sir John Templeton, determined not to be swayed by the crowd, famously borrowed enough money to buy 100 shares in each of 104 stocks trading below $1, including 34 companies that were in bankruptcy. Only four were eventually rendered worthless; the legend of Sir John Templeton was born.

Templeton died in July this year, aged 95, but his legacy still permeates US fund manager Franklin Templeton Investments, which manages the $157m global portfolio of the Australian-listed Templeton Global Growth Fund. But, despite its name, growth merely forms part of the value assessment and Templeton leaves no rock unturned in its quest to find undervalued stocks.

Templeton is the most diversified LIC that we cover. On 30 June, the portfolio was spread across Europe (34%), North America (29%), the UK (17%) and many other countries, including China and Egypt, for example. The top five holdings account for just 12% of the portfolio, with a further 94 companies contributing the remainder.

Tight ship

Franklin Templeton runs a tight ship. Portfolio managers must only select stocks from a company-wide preapproved list containing the analysts' best potential investment ideas—portfolio manager Peter Wilmshurst explained the process in a podcast interview with our research director, Greg Hoffman, earlier this year.

Templeton's global reach

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
Total (Energy) [France]	2.6	Templeton Small Co. Fund	5.6
France Telecom	2.4	E.ON AG (Energy) [Germany]	1.9
Telenor (Telecom) [Norway]	2.4	Shell Transport (Energy) [UK]	1.9
Royal Dutch Shell [UK]	2.3	Pfizer Inc [US]	1.6
Microsoft [US]	2.2	Deutsche Post (Postage) [Germany]	1.6

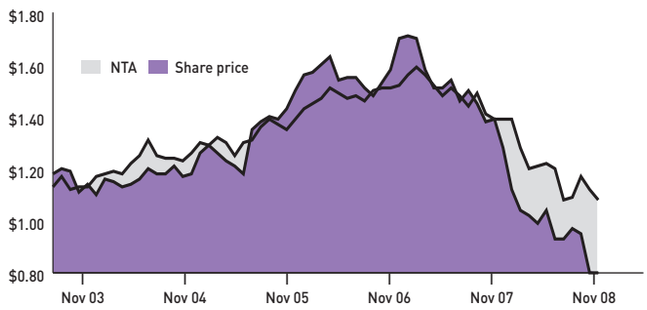
Templeton currently sees value in the world's largest telecommunications companies. We can't vouch for their respective quality, but if Australia's experience is repeated, the 800-pound gorillas of the industry, blessed with established networks and millions of customers, will take the lion's share of profits as demand grows.

Templeton also plans to capitalise on growing energy demand, banking on French oil and gas producer Total and the UK's Royal Dutch Shell, among others. And software developer Microsoft and drug manufacturer Pfizer, both sporting bullet-proof balance sheets flush with cash, appear cheaper than perhaps they ever have.

Performance

Templeton listed in 1987 at $1 per share, only 8 cents below current NTA per share. Fortunately over $1.30 in dividends have been paid since 1996—just don't expect any during the lean years. If the value of the portfolio is falling, there won't be any profits to distribute. However, these have historically been the best times to buy.

Discounting global stocks



As the portfolio is unhedged, the lower Aussie dollar will provide welcome relief. And there's not a skerrick of debt on the balance sheet, so management can concentrate on what it does best: finding undervalued stocks.

Sir John Templeton said the best time to buy was at the point of maximum pessimism. If that's not now, it must surely loom on the horizon. Although global stockmarkets could fall further, current conditions are cherry-ripe for the Templeton team to display its skills unearthing undervalued stocks—outsized returns are borne of decisions made in bear markets.

Low fees and it's cheap

Templeton has the most shareholder friendly fee structure of the LICs we cover, with a relatively low 1% annual management fee and no performance fee. And best of all, it's cheap, with the stock trading at a 28% discount to 30 November's NTA of $1.03. There's also 9.2 cents of deferred tax assets, which could reduce future taxation liabilities.

And although dividends are currently off the menu, we expect management is licking its lips at the valuations on offer as the world enters a downturn. Rarely do stocks trade at such enticing valuations.

The share price has fallen 16% since *28 Jul 08 (Long Term Buy—$0.88)* and we're considering upgrading to an outright Buy recommendation. But, for now at least, we're sticking with our previous view. Templeton Global Growth Fund remains a **LONG TERM BUY**.

Magellan sails smoothly in choppy waters

This fund is managed by a couple of Buffett devotees and invests in high-quality global business franchises.

SNAPSHOT

MAGELLAN FLAGSHIP FUND (MFF)	$0.57
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$215m
12-MONTH SHARE PRICE RANGE	$0.535–$0.82
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	LONG TERM BUY

If there was ever a case of putting your money where your mouth is, then Magellan Flagship Fund, with its holdings in Nestlé, McDonald's Corporation and Yum! Brands (the owner of franchises such as Pizza Hut and KFC), is surely it.

Magellan believes that it pays to invest in the best businesses over the long term, and it therefore invests in high-quality global franchises, with pricing power and customer loyalty. American Express, which is the fund's largest holding and accounts for 17% of its value, is a case in point, but other major holdings follow a similar pattern, including the food companies already mentioned as well as the likes of eBay, Johnson & Johnson, Wal-Mart and PepsiCo.

The portfolio does have a noticeable exposure to the consumer, who seems currently to have their tail between their legs. Still, management has noted that the likes of make-up manufacturer L'Oreal and supermarket chain Tesco have recently announced good results and are predicting increased earnings over the coming year.

Spending spree

Such is management's confidence, in fact, that it has borrowed $49.2m to go on a spending spree, but as stocks continue to decline, the value of the debt worryingly remains the same. The amount the company will borrow is capped at 20% of the portfolio, however, which allows a sizeable buffer.

Flagship investments

2008 TOP 5	WEIGHTING (%)
American Express	17
Nestlé	10.5
Yum! Brands	9.3
eBay	9.3
Wal-Mart Stores	8.4

The company is managed by Magellan Financial Group, whose leading lights are former investment bankers Hamish Douglass and Chris Mackay. The two come with big reputations and are devoted fans of Warren Buffett, and we believe they have the skills to produce good returns for shareholders over the long term. In one instance of good judgment, their decision not to protect international investments from currency risk has worked out very well so far.

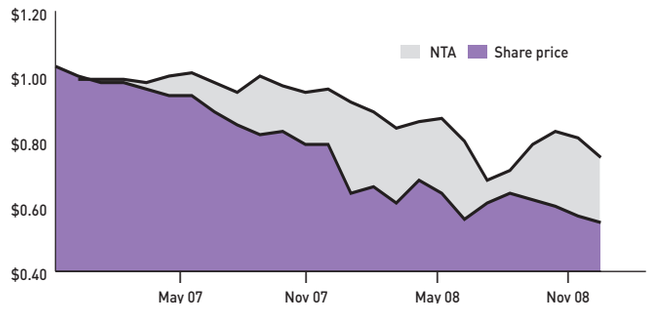
Despite their talents, however, we're not enthusiastic about the generous fee structure. On top of a base fee of 1.25% of the market value of the investments, the manager gets 10% of any outperformance over the fund's benchmark under specific conditions. And that's the problem. Unlike Century Australia, for example, which needs to beat its benchmark by at least 3% before it earns performance fees, Magellan's managers start taking a share the moment the fund outperforms.

Interest on several fronts

Still, the stock trades at a 25% discount to an adjusted post-tax NTA of 76 cents per share, ignoring 8 cents per share in deferred tax assets. The company will be able to use these assets when capital gains are realised. But to err on the side of caution, we're better off leaving them out of the equation.

The discount has received attention on a few fronts. In August, the company announced its intention to buy back up to 10m shares, and so far it has bought back 6.3m, mostly at prices higher than today's. And Chris Mackay has been steadily buying stock himself, increasing his direct shareholding to 18.3m shares, or 4.8% of the company.

No love for brand names



The dark horse is the emergence of LIC activist fund Carrousel Capital, with a 5.5% stake. Carrousel is known for buying big stakes in LICs and shaking up management to demand a favourable deal at the expense of other shareholders, but we're confident that Douglass and Mackay will safeguard the interests of all shareholders.

The stock is down 6% since our last review on *28 Jul 08 (Long Term Buy—$0.605)*, which means we're getting our stable of quality global businesses even cheaper. **LONG TERM BUY**.

Disclosure: Staff members own shares in Magellan Financial Group and Magellan Flagship Fund, but they don't include the author, Alex Chin.

'Our companies will likely be materially less impacted [during the coming downturn] than average companies, as they have very strong financial positions, sell sought-after, good value necessities, are embedded in the fabric of multiple countries (including those that are continuing to grow), have pricing power and are not dependent on a small number of customers.'

Chris Mackay, chief investment officer, 2008 AGM address

Special Report

High fees and deep value at Hunter Hall

Hunter Hall's performance so far hasn't lived up to the hype. But with global valuations dropping by the day, the stage is set for this listed investment company to show what it's made of.

SNAPSHOT

HUNTER HALL GLOBAL VALUE (HHV)	$0.53
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$185m
12-MONTH SHARE PRICE RANGE	$0.455–$1.09
BUSINESS RISK 2 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	LONG TERM BUY

Peter Hall, executive chairman of Hunter Hall Global Value, summarised his investment approach in *Masters of the Market* written by Anthony Hughes et al; 'I am not looking for incremental gains. I am looking for factor gains. I am looking to buy something for one dollar that goes to three or four dollars because the market has got it wrong.'

US investor Richard Pzena, who also practices a deep-value approach, once said that holding such a portfolio should make you want to vomit. The implication is that severely undervalued companies are cheap for a reason; usually that the market believes current issues have permanently impaired the value of the business.

Since the market's assessment is usually correct, it takes a diligent, courageous and fiercely independent investor to disagree and invest people's money accordingly. In fact, Hall's forthright and contrarian views often caused conflict with colleagues and managers early in his career.

Concentrated Portfolio

When a tasty morsel is left behind, though, Hall strikes. The result is a concentrated portfolio of Australian and international companies, as you can see in the accompanying table, where most stocks could potentially have a meaningful impact on overall performance.

Hunter of eclectic stocks

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
NZ Farming Systems Uruguay	3.8	NTL Inc	6.4
Woongjin Coway	3.6	PZ Cussons	6.2
Woongjin Thinkbig	3.2	Krispy Kreme Dougnuts	4.9
Steel Partners	3.2	Elisa Coporation	4.8
Samchully	3.1	Woongjin Thinkbig	4.4

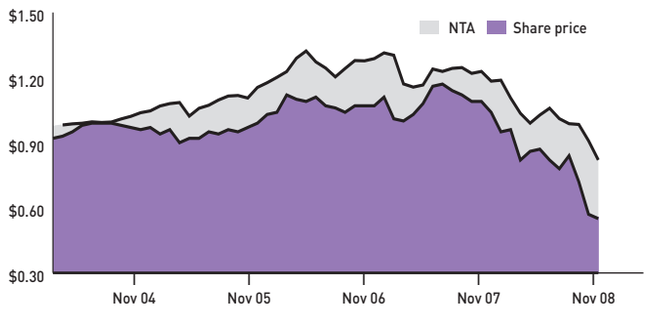
In the three calendar years between 2005 and 2007, Hunter Hall Global Value returned 9.7% per year, including 19.3 cents of fully franked dividends. There were bursts of astounding performance—during the 2006 financial year, French pipe manufacturer Vallourec rose 295%, engineering contractor RCR Tomlinson 201%, LG Telecom 182% and ATM operator Customers 161%, for example. But, judging by the current top five holdings, Hall isn't expecting his next 'factor gains' from household names.

Although it's to be expected from buying into nauseating situations, several selections haven't performed and NTA fell to 68.6 cents on 30 November (excluding 10.3 cents of future tax benefits). If you include dividends, that's still below the 2004 IPO price of $1. So far November hasn't been kind, either, so on a net basis this LIC has lost ground since inception. However, we don't believe the performance so far is a fair representation of the investment team's calibre.

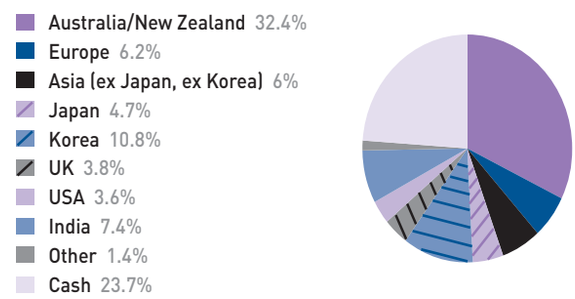
Hefty fees

As an aside, currency exposure is partly hedged since the portfolio is more concentrated than the unhedged Templeton Global Growth Fund, for example. And the company has bought back 60.7m shares at an average price of $0.95 since inception when the shares have traded at a 10% discount to net asset value.

Hunter becomes the hunted



Geographic spread



So does the current discount offer us enough compensation for the hefty fees, comprising a 1.5% annual management fee and a 15% outperformance fee? The current share price offers a 22% discount to NTA excluding future tax benefits. In our view, that's enough to get on board with an investment team that should eventually show a decent long-term track record. The share price has fallen 35% since *28 Jul 08 (Long Term Buy—$0.81)* and it remains a **LONG TERM BUY**.

'I take big positions and have long holding periods because I have made the assessment that this company is worth a multiple of its current valuation.'

HHV's manager Peter Hall taken from Masters Of The Market written by Anthony Hughes et al.

Platinum cuts a long story short

This investment company is known for finding opportunities in the unlikeliest of places, and it's sitting on a pile of cash.

SNAPSHOT

PLATINUM CAPITAL (PMC)	$1.165
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$171m
12-MONTH SHARE PRICE RANGE	$0.915–$1.73
BUSINESS RISK 1.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	HOLD

Platinum Capital is the listed vehicle of renowned international fund manager, **Platinum Asset Management**. Historically, the stock has often traded at a premium to its net asset value, and it has therefore made more sense to access Platinum's expertise via its managed funds. But with the stock now trading at a discount, has this situation reversed?

Platinum has built an enviable track record with its 'top down' style of investing, predicting which industries stand to benefit from structural changes in the economy and then identifying companies best suited to meet those shifts. At its heart, though, the emphasis is on finding and investing in undervalued situations.

Early to the party

Platinum Capital is slightly unusual amongst LICs in that it is prepared to take short positions against sectors and regions it thinks are overvalued. Over the years this flexibility has aided performance, though it doesn't always work out. Last year, management came early to the party by shorting stocks, such as property trusts and financial stocks, in the raging bull market, and the company suffered big losses when it had to exit some of the positions. Despite this setback, property trusts are still being shorted, and steel companies, small companies and emerging markets have been added to the list as the bear market has intensified.

Stocks receiving the Platinum touch

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
Microsoft	3.2	News Corporation	2.2
Mitsubishi Tokyo Financial	3.0	Credit Agricole	2.2
Hutchison Whampoa	2.9	Siemens	2.1
Siemens	2.7	Denso	1.9
Bombardier	2.7	Canon	1.6

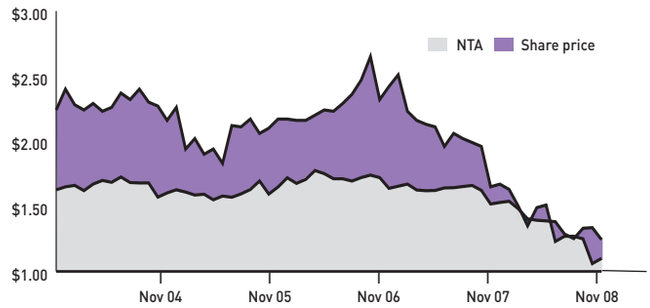
Although Platinum has done well out of shorting over the years, people looking for long-term equities exposure may prefer not to invest in a fund that maintains ongoing short positions. And the high management fees are a drawback for everyone (excepting shareholders of Platinum Asset Management, of course). The annual base fee is a chunky 1.5% of the portfolio and, although the performance fee has a high hurdle rate—5% outperformance over the MSCI World index—the manager gets 10% of any returns above that level.

Muted response

There was a muted response to Platinum's recent one-for-one rights issue, with only 16.3m shares being issued out of a maximum of 127.1m. Even so, that will have raised almost $17.5m, with a further $1.7m coming from the company's dividend reinvestment plan and $2m from a share purchase plan, and this is a great time to have some cash to invest.

Taking the pre-tax NTA at 30 November of $1.207 (which excluded 3.3 cents of future tax benefit), the current discount to NTA is a relatively uninspiring 3.5%.

Brought down to Earth



The stock is down 5% since our last review. But the discount to NTA still isn't sufficient compensation for the high fees, so we'll stay on the sidelines for now and hope for a wider discount. **HOLD**.

'The earnings of many companies are way above trend and so even though valuations now look enticing on price earnings grounds, being say 30% below the historic average of 13 to 14 times, the 'e', earnings, are simply not likely to be sustained.'

'When all the numbers and discernible facts point to a company being abnormally cheap using 20 to 30 year relationships of price to book, enterprise value to sales and understanding of the company's inherent cash generating capacity, the shares have a high probability of making you a handsome return.'

'Markets are likely to remain highly volatile and one should brace for earnings disappointments in the months ahead. Being an economic downturn that was caused by financial crises, it is bound to result in a slower recovery than a standard recession.'

'Politicians and regulators are going to seek vengeance for having been duped by these central agents in our economic system. Future returns in the banking industry are consequently likely to be a lot lower than in the last five years.'

Kerr Neilson, Platinum Quarterly Report, Sep 08

Premium ignores its own discount

Premium Investors has a broad selection of Australia's boutique fund managers at its disposal. But, despite trading at a steep discount, it's tarnished by issuing shares on the cheap to support an unnecessarily high dividend.

SNAPSHOT

PREMIUM INVESTORS (PRV)	$0.555
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$126m
12-MONTH SHARE PRICE RANGE	$0.55–$1.75
BUSINESS RISK 1.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	HOLD

Premium Investors is a 'fund of funds' managed by boutique fund administrator **Treasury Group**, which delegates investment responsibility to the fund managers in which it has ownership stakes.

Typically such arrangements are just an excuse to heap on extra layers of management, with spurious benefits but very real costs. But not so at Premium Investors, where only one layer of fees—albeit with a generous performance component—services the entire arrangement.

The annual base fee is 0.9% and a 20% performance fee is shared equally between Treasury Group and the successful manager when returns exceed 7%. This fixed hurdle for the performance fee focuses attention on absolute returns (making profits even when markets fall) and is crucial to management's aim of paying a 7% fully franked dividend.

Extremely diversified

Only two managers have survived from the early days: Investors Mutual and Orion Asset Management. The former, founded by Anton Tagliaferro, is well-known for a 'value' approach, while the latter has a focus on 'growth' (although we view such terms as somewhat anomalous—all intelligent investment, in our opinion, should be about value, and the calculation of value inevitably involves growth).

Premium for blue chips

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
Telstra	3.0	Westpac Bank	3.3
BHP Billiton	2.7	Telstra	3.1
Commonwealth Bank	2.2	Commonwealth Bank	2.7
Westpac Bank	2.1	National Aust. Bank	2.6
Spark Infras Gp Stpld Sec.	1.5	ANZ Bank	2.2

There are clues to the focus of the other managers in their names—Rare Infrastructure, Global Value Investors, Treasury Asia Asset Management—with the exception of Cannae Capital Partners, which has nothing to do with Hannibal's famous defeat of the Romans and everything to do with equities in Australia and New Zealand.

Probably as a result of this separation of powers, the portfolio is extremely diversified. Telstra is the largest shareholding at 2.9% and roughly half the fund is invested internationally, with a bias towards global infrastructure and Asian assets. If this makes you screw your nose up like a child who's just been offered a piece of Christmas fruitcake, you'll want to give Premium Investors a wide berth.

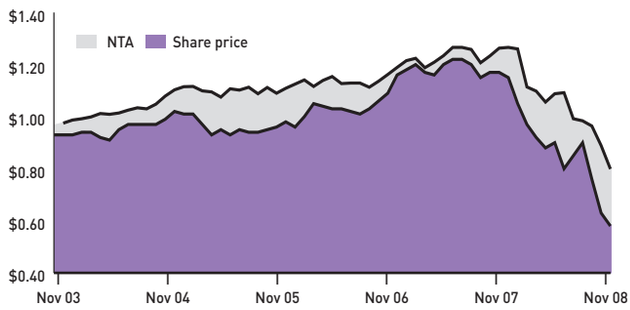
Why aren't we loading up?

So, with a broad selection of supposed investment talent and a steep 22% discount to estimated NTA, why aren't we loading up?

Well our first concern is that management is spurning the opportunity to create significant value by buying back its own shares while they trade at such a wide discount. Indeed, it's actually doing the opposite by issuing heavily discounted shares through its share purchase and dividend reinvestment plans.

We're also frustrated with the unnecessary and unsustainable 7% dividend yield policy, which helps explain why Australia's large banks and Telstra have remained the company's top shareholdings. In its long list of shareholdings, how many do you think pay 7% fully franked dividend yields? No wonder it keeps issuing new shares.

An unattractive discount



And while it won't bother everyone, Premium Investors is using nearly twice as many managers as it did in 2003—several without independent track records—and international exposure has jumped from 13% to roughly 50%. Like Forrest Gump's box of chocolates, with Premium Investors you never know what you're gonna get. Not every fund that Treasury Group brings under its umbrella will be successful, and you might gain exposure to unwanted sectors and styles.

Spoilt for choice

Despite these misgivings, though, there's plenty to like about Premium Investors. But, because we're currently spoilt for choice, we prefer Templeton Global Growth Fund for international exposure where the fees are lower, despite its deserving and having a smaller discount because of its long track record. When investing for the long term we want empathetic business partners, and until management stops frittering away value by issuing new securities and begins taking advantage of the biggest bargain staring it right in the face—its own shares—we're not willing to upgrade. The share price is down 52% since *4 Oct 07 (Hold—$1.16)* and we recommend those already invested **HOLD**.

Brickworks built to last

Lazy, boring and unadventurous—this LIC has some of the qualities we love best in an investment company.

SNAPSHOT

BRICKWORKS INVESTMENTS (BKI)	$0.95
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$335m
12-MONTH SHARE PRICE RANGE	$0.87–$1.465
BUSINESS RISK 2 out of 5	SHARE PRICE RISK 2 out of 5
OUR VIEW	NO VIEW

Brickworks Investments Company (BIC) was spun out of **Brickworks Limited** in 2003, at a time when a host of other LICs were rushing to satisfy an overeager market. But other than its age, BIC has little in common with most of its brethren. While most have fought hard for outperformance (with varying results), trading their portfolios and paying hefty management fees, BIC has been content to plod along quietly in the background. But we'll wager that over the long term the BIC tortoise will prevail over most of the hares.

Its key advantage is low costs, and it takes this to quite an extreme. The annual management fee is just 0.35% of assets per year, with no performance fees. And brokerage is also kept to a minimum, with only 3% of the portfolio being traded last year.

The manager, Souls Funds Management (SFM), is another part of the Soul Pattinson empire. SFM is 73% owned by the quoted **Washington H Soul Pattinson**, which has large cross-shareholdings with the also-quoted Brickworks Limited, which still owns 18% of BIC. The main mover and shaker in all of this is Rob Millner, who chairs each of the quoted companies. There's a podcast interview with him on our website.

Slow and steady

The slow and steady approach has led to a somewhat eclectic mix of investments, from medical research minnow **Clover Corporation** to the big banks and miners. Most of the money is invested in blue chips, but the manager is evidently not averse to smaller bets on relatively speculative companies.

A heavy concentration of stocks

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
New Hope Corporation	14.8	National Aust. Bank	20.4
National Aust. Bank	11.5	Commonwealth Bank	11.9
Commonwealth Bank	8.9	BHP Billiton	7.6
BHP Billiton	8.0	New Hope Corporation	7.0
Woolworths	5.0	St George Bank	5.3

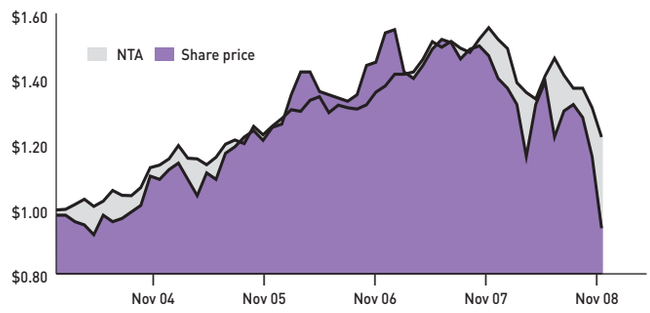
With a broad spread of stocks and very little trading, you're going to get a performance that's pretty close to the index. And, sure enough, NTA grew by 4.2% a year between 12 December 2003 and 31 October 2008, as measured by the change in NTA, compared to the All Ordinaries return of 4.5%. It's no doubt a coincidence as much as anything else, but it's nevertheless interesting to note that the underperformance roughly equates to BIC's costs. Over time we'd expect most other LICs, with higher costs, to average commensurately greater underperformance.

You have to take the rough with the smooth, though. While management displayed exquisite timing by raising cash last year when the market was at its peak, it went ahead and invested most of the money straight away—despite a relatively gloomy prognosis for the economy in the 2007 annual report.

Grist to the Millner

In more recent and fortunate developments, BIC launched a friendly stock takeover for Huntley Investment Company, another LIC. By exchanging six-tenths of one BIC share—at the time worth 53.4 cents—for each Huntley share, the company gained net assets of 64.3 cents per share, including 11.7 cents in cash. So it's a sensible use of capital, despite issuing shares at a discount to NTA, because there will be a bigger increase in NTA for existing BIC shareholders.

Falling like a bag of bricks



As at 30 November, both pre- and post-tax NTA were $1.16 per share. So the current share price translates into a hefty discount to NTA of 18%.

If you want a reasonable entry to a portfolio of mainly blue chip stocks under the stewardship of sensible management, and with very low costs—which are laudable aims—then Brickworks Investments looks like an excellent choice. We're sorely tempted to issue a positive recommendation at the current price. But the NTA has likely fallen a little in December and we'd also like to reconsider the portfolio in the wash-up of the Huntley acquisition. For the moment we're staying with **NO VIEW**.

'Brickworks' investment portfolio was built on a philosophy of long-term investment with a focus on listed Australian entities which it believed to be well managed, have a profitable history and strong dividend growth potential. Our objective is to provide attractive returns to BIC shareholders by way of increasing dividends and capital growth.'

Robert Millner, Brickworks Investments Prospectus, 2003

Century struggles to get runs on the board

This LIC was looking to build a big innings when it listed in 2004, but five years later it's gone backwards.

SNAPSHOT

CENTURY AUSTRALIA (CYA)	$0.665
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$125m
12-MONTH SHARE PRICE RANGE	$0.59–$1.375
BUSINESS RISK 1.5 out of 5	SHARE PRICE RISK 2 out of 5
OUR VIEW	HOLD

Century Australia and its manager, Peter Morgan's 452 Capital, were named with Don Bradman in mind. As cricket lovers will know, Bradman made quite a few centuries, with 452 being his highest first class score. But while the Don used to start at 0 and build up to 100 (and beyond), Century Australia started at 100 and had slipped back into the 60s when we drew stumps for this article.

Its problem has been performance. Since beginning life in April 2004, Century's post-tax NTA had slipped 4% by 31 October 2008. The broader market recorded a gain of 20% over the same period. Most of that underperformance was down to the manager's refusal to be drawn into the resources bubble, and we won't blame it for that—but the market obviously has. We estimate the current discount to NTA to be around 17% (using estimated pre-tax NTA of 80 cents excluding around 9 cents in tax benefits).

But with the bursting of the resources bubble, Century's fortunes may be changing. As the company noted at its recent AGM, between 1 July and 31 October this year the portfolio fell only 9%, compared to a fall of 22% in the All Ordinaries Accumulation Index.

Looking out for shareholders

A cursory glance at the portfolio reveals a varied mix of stocks with an emphasis on media and telecommunications, with **Telstra** the largest holding and **News Corporation** and **Fairfax Media** both featuring in the top ten. **Ten Network** and **APN News & Media** are also in the portfolio. There's a 7.2% weighting in **BHP Billiton**, but with it and **Rio Tinto** making up about 16% of the All Ordinaries Index (when the figures were compiled), this still amounts to a sizeable bet against resources.

Perhaps as a result of the poor returns, management has been keeping a close eye on ways to reduce expenses.

A collection of familiar names

2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
Telstra	8.7	Westpac	6.9
BHP Billiton	7.2	BHP Billiton	6.1
Brambles	6.3	National Aust. Bank	5.9
Westpac	5.1	Insurance Aust. Grp	5.6
National Aust. Bank	4.8	Telstra	4.6

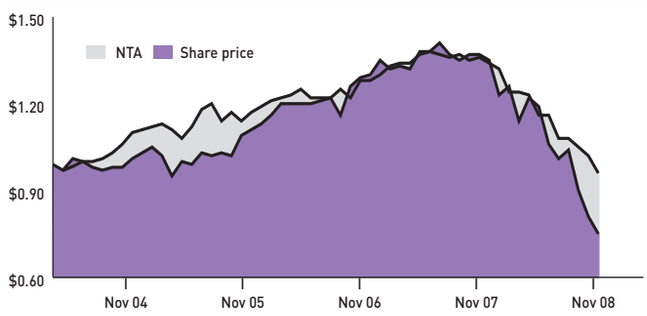
Last year, it took all the company's paperwork away from 452 Capital and outsourced those activities for less than half the original cost. It's always encouraging to see management thinking about shareholders, when it would have been easier to ignore the expenses.

The fees are also pretty reasonable compared to others. The annual management fee is 1% of NTA and there's a performance fee, payable from 1 July 2009 of 10% of any outperformance of the ASX300 index over 3% each year. The plan had been to pay any performance fees in shares, but a recent change made them payable in cash. No doubt the company doesn't want to have to issue shares at such a discount. Indeed, at November's AGM, Century announced a plan to buy back 10% of its shares over the next 12 months. These are further signs of a management that's looking out for shareholders.

Big reputation

So what are we to make of the estimated 17% discount? Well, frankly, it looks quite attractive. It should be enough to compensate for the drag of fees and it implies that the portfolio (before costs) will continue to underperform. It may do, in which case the discount can absorb a fair amount. But we'd suggest that outperformance is just as likely. Peter Morgan comes with a big reputation and, while the markets are littered with big reputations turned sour, we think it's far too early to condemn 452 on the evidence of Century's performance to date.

Discount heads for a ton



The stock is down 32% since our last review, on *30 Jul 08 (Hold—$0.98)*, and the market is again offering Century cheaply. We downgraded to Hold when the discount narrowed to 9%, but it's now almost double that percentage. We're on the verge of upgrading but, for the moment, we're staying put. **HOLD**.

'We remain cautious and focused on our process of investing in companies with conservatively geared balance sheets that are undervalued on a through-the-cycle basis. At the time of writing, the Century portfolio is still very underweight commodity and commodity related companies, we hold no infrastructure companies or property trusts, we continue to hold positions in a number of media companies and the largest position in the portfolio is Brambles.' (Now Telstra.)

Peter Morgan, Annual Report 2008

Should we kick Wilson while it's down?

Wilson Investment Fund is currently trading 49% below its 2003 listing price of $1. Is it time to admit defeat, or is this a golden opportunity to back management while stock prices are cheap?

SNAPSHOT

WILSON INVESTMENT FUND (WIL)	$0.51
INFORMATION CORRECT AT	10 Dec 2008
STOCK CATEGORY	LISTED INVESTMENT COMPANY
MARKET CAPITALISATION	$63m
12-MONTH SHARE PRICE RANGE	$0.475–$1.08
BUSINESS RISK 1.5 out of 5	SHARE PRICE RISK 2 out of 5
OUR VIEW	LONG TERM BUY

Buying an LIC at a discount provides a margin of safety. But if that's eroded by consistent poor performance, onerous management fees and dilutive capital-raisings, like a sitcom that runs too long, your investment will slowly wither and die.

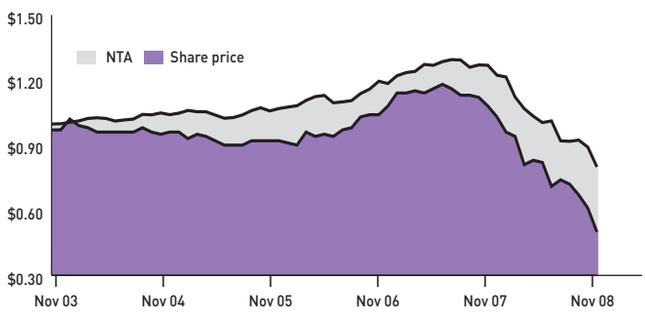
We've been supporters of Wilson Investment Fund (WIF) since it listed in 2003, despite its status as a 'hot' float—it raised $161m in total, $61m more than originally planned. Between then and 31 October 2008, however, WIF's portfolio has returned a paltry 4% (before expenses, fees and taxes), compared to 59% for the All Ordinaries Accumulation Index, well short of management's aim of 15–20% per year.

With the share price languishing 49% below the $1 float price, is it time to declare this recommendation a lemon, or is it a golden opportunity to back management while the chips are down?

Nothing comes for free

Although we've backed management's conservative approach, nothing comes for free. The annual management fee is 1% of 'gross' assets and an onerous 20% performance fee is payable on portfolio returns that beat the All Ordinaries Accumulation Index, or, if the index goes backwards, on any positive returns achieved by the portfolio. Poor past returns don't need to be made up, either; the slate is wiped clean each year.

Market keeps the discount



Management could increase fees simply by borrowing money to expand the portfolio, but that entails risk. Instead, management has twice issued large batches of options that would increase the size of the fund and potentially dilute existing shareholders (almost all of them expired worthless). As my stepfather once told me, you can always back self-interest because at least you know it's trying.

Despite the selfish motives, if WIF's price is low enough we can cope. But what's more important is whether WIF can restore the value lost in the recent market rout. After interviewing portfolio managers Geoff Wilson and Matthew Kidman in a podcast a year ago, we think it can.

Admitting errors

By publishing its portfolio every month, management is commendably admitting its mistakes, which is part and parcel of managing other people's money. But there have been a few horrors, and we can't help thinking they may have been born out of trying too hard to meet such high target returns. Investing in the likes of **Credit Corp** and A.B.C. Learning Centres, for example, doesn't instil confidence (although that's easy to say in hindsight). We'd be happy with low double-digit returns over the journey, preferring capital preservation to the likes of would-be world conquerors like A.B.C..

WIF also has 11% and 8% of its portfolio invested respectively in **ASX** and **Bendigo and Adelaide Bank**. These are aggressive bets. ASX, for example, is threatened by potential new entrants, which could make the current price expensive, despite falling 47% from a record high of $61.00.

Overall, though, a combination of cash, listed debt securities, no corporate debt and stocks bought for the long-term constitutes a relatively conservative portfolio.

Is it cheap?

Management has also bought back nearly 25% of the company's shares at significant discounts to NTA—an efficient use of shareholders' funds—and keeps shareholders up to date with semi-annual face-to-face presentations and monthly performance updates. The fees are off-putting but we're still supporters of management's consistent and transparent approach. But is WIF cheap?

Wilson plays aggressively

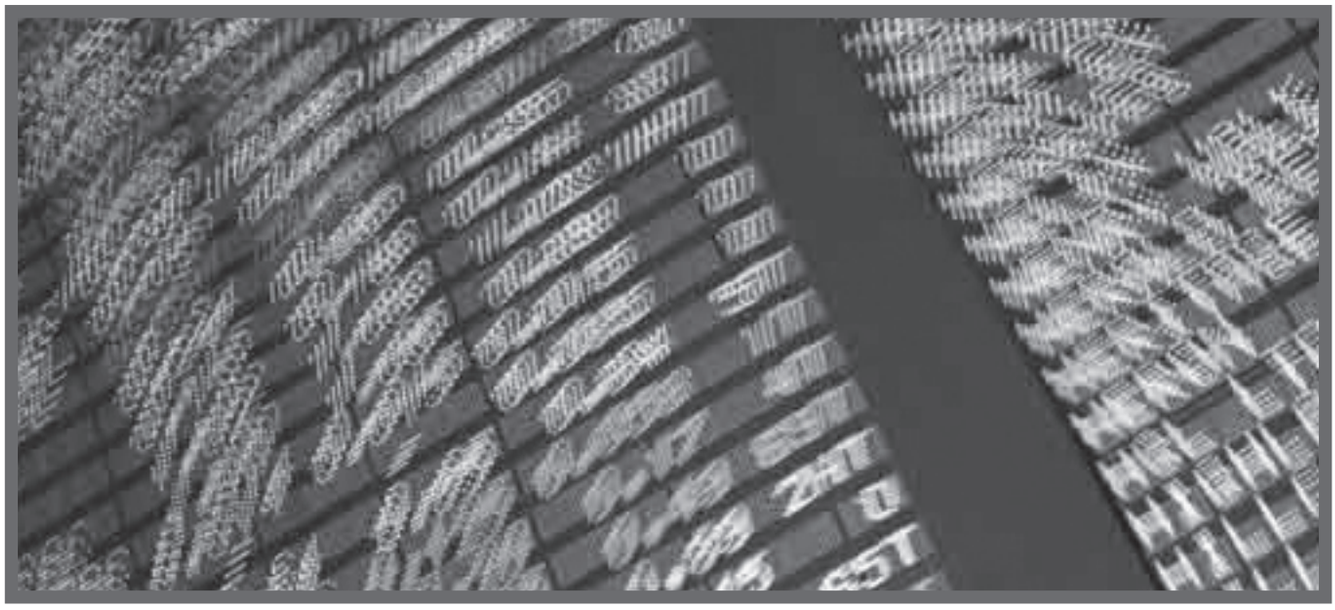
2008 TOP 5	WEIGHTING (%)	2005 TOP 5	WEIGHTING (%)
ASX	11.3	Bank of Queensland Series 1 Reset Prefs	9.3
Bendigo and Adel. Bank	8.2	ASX	6.1
Metcash	4.8	Tower Australia	4.7
Primary Health Care	4.5	MMC Contrarian	4.6
Tower Australia	4.4	Emeco 10% Notes	4.4

Our estimate of NTA as at 30 November is roughly 75 cents (excluding around 8 cents in tax benefits). That would place the stock at a discount to NTA of 32%. That's enough compensation for the fees and, as long as management sticks to its game plan, WIF should prevail long after the financial crisis has receded. The stock remains a meaningful holding in our model Income portfolio and a **LONG TERM BUY** recommendation.

Essential numbers for LICs

COMPANY NAME	ASX CODE	MARKET CAP ($M)	SHARE PRICE ($)	PRE-TAX NTA ($)	PREM/DISC PRE-TAX NTA (%)	POST-TAX NTA ($)	PREM/DISC POST TAX NTA (%)	EXPENSE RATIO (% OF ASSETS)
Aberdeen Leaders	ALR	63	1.10	1.14	–3.5	1.21	–9.1	1.10
AFIC	AFI	4,037	4.14	3.85	7.5	3.48	19.0	0.14
Argo Investments	ARG	3,126	5.41	5.02	7.8	4.78	13.2	0.14
Brickworks Investments	BKI	355	0.95	1.16	–18.1	1.16	–18.1	0.46
Carlton Investments	CIN	382	14.40	15.92	–9.5	14.54	–1.0	0.11
Century Australia*	CYA	125	0.665	0.90	–26.1	0.96	–30.7	1.07
Choiseul Investments	CHO	381	4.10	4.35	–5.7	3.87	5.9	0.13
Djerriwarrh Investments	DJW	735	3.58	3.15	13.7	3.18	12.6	0.29
Hunter Hall Global Value	HHV	185	0.53	0.683	–22.4	0.786	–32.6	1.93
Magellan Flagship Fund	MFF	215	0.57	0.76	–25.0	0.84	–32.1	1.28
Milton Corporation	MLT	1,239	14.50	14.60	–0.7	13.66	6.1	0.19
MMC Contrarian*	MMA	58	0.41	0.68	–46.7	0.754	–45.6	1.30
Platinum Capital	PMC	171	1.165	1.207	–3.5	1.24	–6.0	1.35
Premium Investors*	PRV	126	0.555	0.799	–30.5	0.868	–36.1	1.22
Templeton Global Growth	TGG	107	0.74	1.03	–28.2	1.122	–34.0	0.93
Wilson Investment Fund*	WIL	63	0.51	0.80	–36.3	0.862	–40.8	0.87

*NTA stated as at 31 October



DISCLOSURE As at 10 Dec 2008, in-house staff of The Intelligent Investor held the following listed securities or managed investment schemes: AEA, AHC, ANZ, ARP, AWE, BEPPA, CBA, CDX, CHF, COH, COS, CRS, CXP, DBS, FLT, GFF, GLB, GNC, GTP, HVN, IAS, IDT, IFL, IFM, IMF, IVC, KRS, LMC, LWB, MFF, MFG, MLB, MMA, MOC, MQG, NABHA, NHF, NVT, OEQ, PMV, PTM, REX, RHG, ROC, SDI, SFC, SFH, SGB, SGN, SHV, SIP, SLM, SOF, SRV, STO, TEN, TGR, TIM, TIMG, TLS, TRG, TRS, TTS, VBA, WAN and WDC. This is not a recommendation.

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