Three LICs for turbulent times

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At the start of February, markets reminded investors that shares don't always go up in a straight line. The Australian market dropped over 5% from its recent highs, and the US market dropped over 10% from its top. Considering the gains in the market over the past year, these are not big numbers.

But it serves as a reminder that a larger correction could happen anytime. We hold some LICs in our Affluence LIC Fund portfolio that we believe are well placed to navigate turbulent times, three of which we discuss in this wire.

Australian Equity Performance Fund Limited (ASX:AEG)

This LIC is managed by Bennelong Long Short Equity Management and invests primarily in the ASX 100 using a market-neutral pairs strategy. Each pair contains one long and one short position selected from the same market sector. While in an ideal environment, each stock's position will make a positive return; it is the relative performance of the pair that is important. The Portfolio usually comprises 50 to 80 securities with 25 to 40 pair trades and cash on deposit.

The Bennelong management team has a very enviable track record over the last 15 years. The investment strategy for the LIC is very similar to the unlisted Bennelong Long Short Equity Fund, which has delivered 16.5% per annum returns since 2002. Even more impressive, during the GFC in 2008 and 2009, the unlisted fund delivered returns of 12% and 24% respectively.

Currently, AEG is trading at a 4% discount to NTA, which we believe is reasonable. Virtually all market neutral and long-short funds have lagged the market over the past 12 months, as is to be expected during strong market rallies. However, very few have a track record such as Bennelong Long Short Equity in navigating rough waters.

Australian Leaders Fund Limited (ASX:ALF)

The Australian Leaders Fund is managed by Watermark Funds and is a multi-directional equities strategy. This strategy means the portfolio allocation can swing from a net-short position to a net-long position depending on where the manager sees market value. Currently, the ALF portfolio is market neutral (equal long and short positions), indicating the manager is cautious of market valuations.

- The manager invests **long in quality companies** they believe are reasonably valued.
- On the **short side, they sell inferior quality or overvalued companies**.
- They produce a positive return if the long book outperforms the short book.

During a strong rally, these strategies can underperform as poorer quality and cyclical companies often increase faster (or as fast) as the better-quality stocks.

However, during a market correction, usually the better quality and more attractively valued equities will fall less than the others. This resilience is why these strategies can produce positive returns in falling markets. Shorting is difficult, expensive and can result in increased risks due to the greater gross exposure. Watermark is a specialist market neutral manager and is well placed to manage these risks.

From mid-2013 to late 2016 this LIC traded at a large premium to NTA (at times more than 20%), on the back of strong performance and a high dividend. In March 2017, a reduced dividend coincided with a period of lower performance. This poor performance resulted in the share price falling to below NTA.

It is currently trading at a 14% discount, and there still appears to be more sellers than buyers. The ALF portfolio has underperformed the All Ords Index over 1-5 years. It has outperformed over longer periods.

We don't know if the discount to NTA will continue to increase (although at a 14% discount it is already very attractive). The stock is certainly under pressure from the combination of flat performance and reducing dividends. However, we continue to believe that <u>if the market was to experience a large drawdown, this manager and strategy could significantly outperform</u>. We would then expect the discount to reduce on the back of the outperformance.

Future Generation Limited (ASX:FGX)

FGX has consistently been one of the largest holdings in our LIC portfolio. It was established in September 2014 with the dual purpose of an investment vehicle and providing funding to charities supporting children and youth at risk.

It is a fund of funds in Australian equities and currently invests with 19 investment managers who have all agreed to charge no fees. Instead, the LIC makes a 1% annual donation to various charities.

The portfolio is diversified by investment manager, strategy and style. As at 31 January 2018, the portfolio was 45.7% long, 38.4% absolute return, 13.5% market neutral and 2.4% cash.

The underlying managers are in the top echelon of Australian investors, including:

- Paradice Investment,
- Wilson Asset Management,
- L1 Capital, and
- Cooper Investors.

Many of these underlying funds are closed to new investors or have high initial investment limits, putting them out of the reach of most. By investing through this vehicle, you are paying a low total fee, with the dual benefit of knowing all fees are going to charitable causes.

Performance since listing has been reasonable but not spectacular. Given the portfolio includes long-short and market neutral strategies, we would expect performance to lag the market during strong periods.

However, we expect the portfolio to be **far more resilient than the market during severe corrections, and through a whole cycle, we expect it to produce superior risk-adjusted returns**.

FGX is currently trading at a 2-3% discount to NTA, which is we believe is reasonable. The catalyst for a re-rating of that discount may well be a decent market correction, when investors come to understand the value of an all-weather portfolio such as this.