

Fixed Interest Update

Listed Investment Trusts (LITs)

- We know that the Net Tangible Asset (NTA) value of a LIT represents the value of the underlying assets. If we accept that the NTA represents the true value of the underlying investments, then there is no logical reason for the ASX unit price not to be at least equal to the NTA price.
- Lower and less certain company dividend payments, along with the recent rally in hybrid prices makes both sectors less attractive for income investors.
- As credit markets continue to improve, we should expect NTAs to move back toward each LIT's issue price. This means that LITs are still cheap and represent excellent value offering attractive yields with potential capital upside in the months ahead.

Attractive entry prices and distribution certainty - LITs look cheap

Credit LITs are relatively new to Australian investors with the first (MXT) only launching in October 2017. So, it's not surprising that when markets sold off during the COVID meltdown, investors panicked and sold LITs without reference to their true value, i.e. worth of the assets in the funds. Simply, no one knew what to expect or how bad things would be.

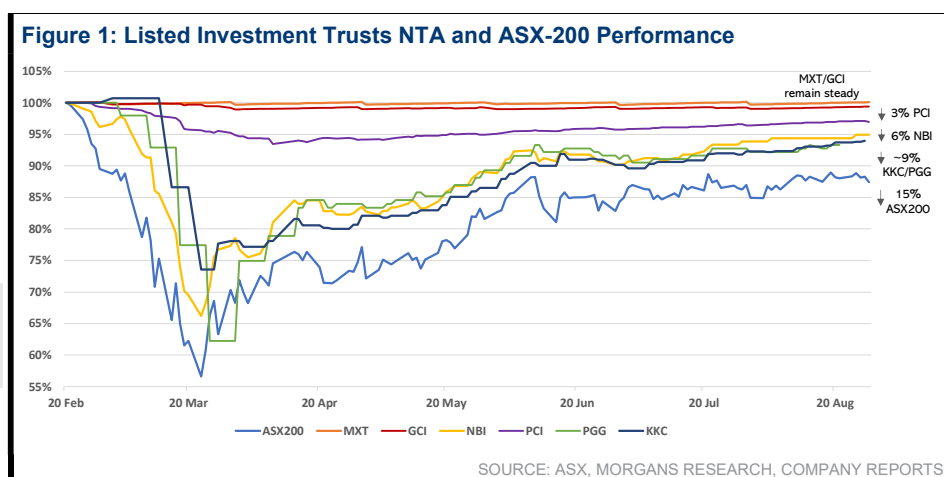
Why wasn't this surprising? Looking back to the GFC we saw similar behaviour in bank issued capital notes (hybrids). Investors sold these securities without considering that in the absence of a bank failure (we didn't know how bad it would be), they would return to the par (face) value over time. Buying hybrids in that sell-off proved to be a sound investment; they continued to pay distributions and prices rose back to face value, enhancing investor returns.

We can look at LITs through a similar lens. We know that the NTA of a LIT represents the value of the underlying assets. Where the underlying assets are traded (e.g. bonds), the NTA will change in line with the traded price of those assets. LITs with few or no traded assets will see little or no change in the NTA (e.g. MXT). Encouragingly, GCI which does hold traded assets has seen virtually no change in its NTA, this is due to the quality and price stability of the underlying securities. Other LITs though, have seen significant changes in their NTA; importantly all have also improved as markets have stabilised.

The progressive recovery in LIT NTAs is a positive sign and confirms to us that the institutional market's assessment of the underlying assets has improved significantly.

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The author (or associated entities) owns units in the LITs mentioned in this report.

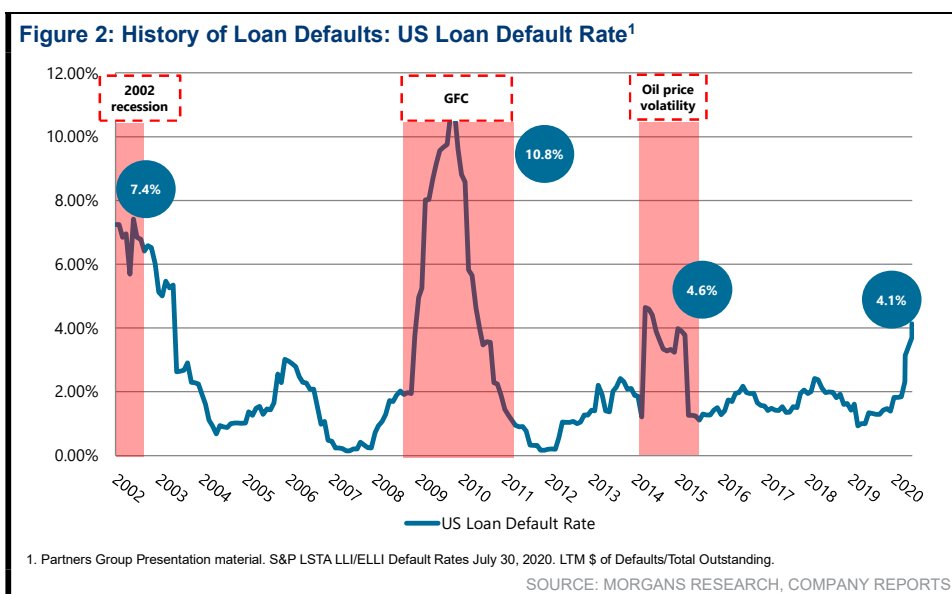


LIT prices remain below their NTAs which cannot be justified

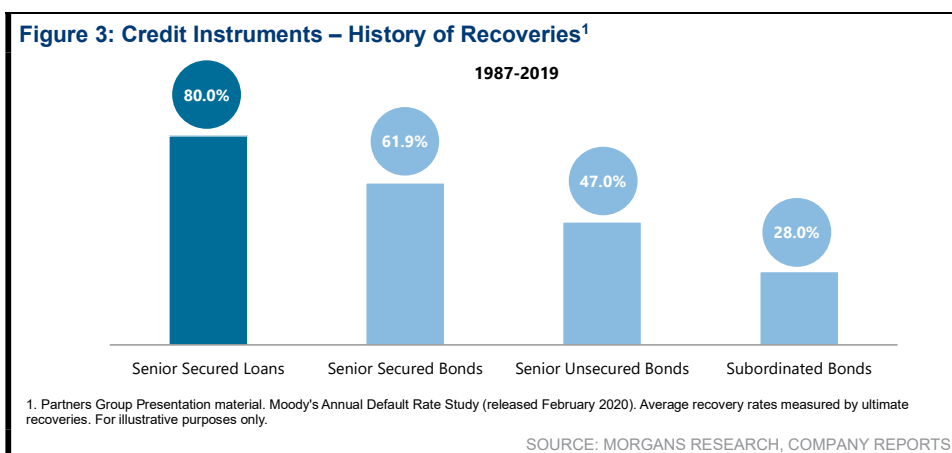
What is perplexing though is that the traded prices of LITs remain below their NTAs. If we accept that the NTA represents the true value of the underlying investments, then there is no logical reason for the ASX unit price not to be at least equal to the NTA price. If investors are concerned that there might be losses to come in a LIT portfolio, then this is already reflected in the published NTA.

Paraphrasing *Independent Investment Research (IIR)* Senior Analyst Rodney Lay from his recent report on LITs; investors who dismiss what the NTA is telling us, are in fact saying they know more about credit markets than the many thousands of investment professionals who trade these markets each and every day.

In the IIR report, Lay goes into considerable detail about loss rates and the math behind the valuation of credit securities. A simpler and certainly more crude approach is to look back to the GFC where default rates reached circa 10%, far worse than we have seen in other modern credit events and what has been experienced this time.



We know though, that in credit (loans & bonds) even where there is a default, there is a recovery value; i.e. debt investors generally see some level of return post a default. The table below shows this historical experience. Applying these historical recovery rates to the portfolio mix of each LIT, we calculate that the traded unit prices continue to overestimate the extent of potential loss.

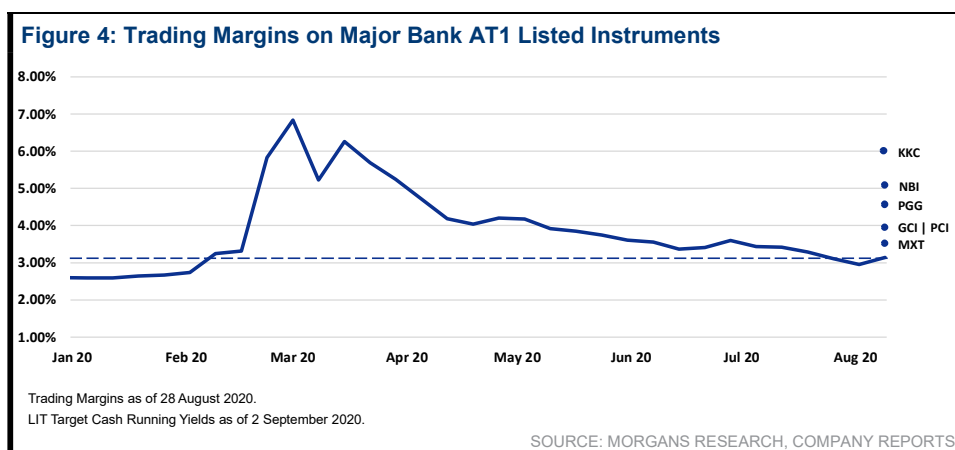


The move up in unit prices we see as a 2 stage process; firstly unit prices should continue to move back towards NTA. Secondly, as credit markets continue to improve, we should expect NTAs to move back toward each LIT's issue price. This means that LITs are still cheap and represent excellent value. Remember, what happened to bank hybrids post the GFC.

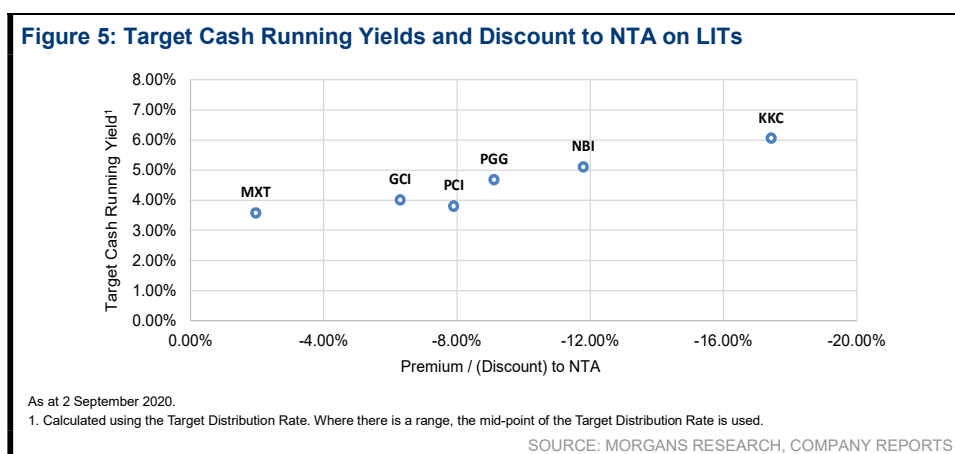
What about the yield?

All LITs continue to meet their distribution targets. This is in stark contrast to ordinary equity dividends where many companies have reduced or even deferred dividend payments. We've always known that dividends are discretionary and indeed this is what we have now seen in practice. Even the bank regulator APRA has directed banks as to how they consider dividend payments. These directions have not applied to bank hybrid distributions though and might explain the substantial rally in hybrid prices. We see this sector as fully priced now with trading margins back to pre-COVID levels.

The chart below shows the move in bank hybrid spreads against the current yield levels available from ASX listed LITs. Again, LITs look very attractive. We also note that most have exceeded their target distribution levels.



LITs are primarily income products and as shown below offer attractive yields and we would expect, further capital upside in the months ahead.



With hybrids moving back to levels we view as fully valued and equity dividends uncertain, investors looking for regular income should refocus on the LIT sector with attractive pricing and yields.

Queensland		New South Wales		Victoria		Western Australia	
Brisbane	+61 7 3334 4888	Sydney	+61 2 9043 7900	Melbourne	+61 3 9947 4111	West Perth	+61 8 6160 8700
Stockbroking, Corporate Advice, Wealth Management		Stockbroking, Corporate Advice, Wealth Management		Stockbroking, Corporate Advice, Wealth Management		Stockbroking, Corporate Advice, Wealth Management	
Brisbane: Edward St	+61 7 3121 5677	Sydney: Grosvenor	+61 2 8215 5000	Brighton	+61 3 9519 3555	Perth	+61 8 6462 1999
Brisbane: Tynan	+61 7 3152 0600	Place		Camberwell	+61 3 9813 2945		
Partners		Sydney: Reynolds	+61 2 9373 4452	Domain	+61 3 9066 3200	South Australia	
Brisbane: North Quay	+61 7 3245 5466	Securities		Geelong	+61 3 5222 5128	Adelaide	+61 8 8464 5000
Bundaberg	+61 7 4153 1050	Sydney: Currency	+61 2 8216 5111	Richmond	+61 3 9916 4000	Exchange Place	+61 8 7325 9200
Cairns	+61 7 4222 0555	House		South Yarra	+61 3 8762 1400	Norwood	+61 8 8461 2800
Caloundra	+61 7 5491 5422	Armidale	+61 2 6770 3300	Southbank	+61 3 9037 9444	Unley	+61 8 8155 4300
Gladstone	+61 7 4972 8000	Ballina	+61 2 6686 4144	Traralgon	+61 3 5176 6055		
Gold Coast	+61 7 5581 5777	Balmain	+61 2 8755 3333	Warmambool	+61 3 5559 1500		
Holland Park	+61 7 3151 8300	Bowral	+61 2 4851 5555				
Ipswich/Springfield	+61 7 3202 3995	Chatswood	+61 2 8116 1700	Australian Capital Territory			
Kedron	+61 7 3350 9000	Coffs Harbour	+61 2 6651 5700	Canberra	+61 2 6232 4999		
Mackay	+61 7 4957 3033	Gosford	+61 2 4325 0884				
Milton	+61 7 3114 8600	Hurstville	+61 2 8215 5079	Northern Territory			
Newstead	+61 7 3151 4151	Merimbula	+61 2 6495 2869	Darwin	+61 8 8981 9555		
Noosa	+61 7 5449 9511	Mona Vale	+61 2 9998 4200				
Redcliffe	+61 7 3897 3999	Neutral Bay	+61 2 8969 7500	Tasmania			
Rockhampton	+61 7 4922 5855	Newcastle	+61 2 4926 4044	Hobart	+61 3 6236 9000		
Spring Hill	+61 7 3833 9333	Orange	+61 2 6361 9166				
Sunshine Coast	+61 7 5479 2757	Port Macquarie	+61 2 6583 1735				
Toowoomba	+61 7 4639 1277	Scone	+61 2 6544 3144				
Townsville	+61 7 4725 5787	Wollongong	+61 2 4227 3022				

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