Aurora Updates
Aurora Dividend Income Trust (Managed Fund) vs. Listed Investment Companies

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Executive Summary

- The Aurora Dividend Income Trust (Managed Fund) is an **efficient** and **low risk** fund that invests in Australian stocks with a **value bias**. Risk management is achieved with both the fully franked value signal and the ability to short stocks to control market risk.

- The Aurora Dividend Income Trust is an alternative to the **Listed Investment Companies** (LICs). A LIC gives investors an exposure to portfolio of actively managed Australian equity investments via a closed end company/trust structure.

- Investing in **fully franked stocks** is a key component of the overall Aurora strategy. The outperformance of the fully franked signal against the S&P/ASX 200 over the last 8 years is stark – +25.3% compared with +8.3% for value strategies and -0.4% for LICs.

- Aurora's strategy produces an investment with **greater and more stable excess returns** compared to both Listed Investment Companies and the conventional common value signal. Aurora's strategy has effectively similar overall risk characteristics to the other forms of active equities, albeit with a diversification from the alpha signal.

- The **Aurora Dividend Income Trust (Managed Fund) should be considered as a risk asset replacement strategy for investors looking to gain access to actively managed Australian equities.**

Disclaimer

Aurora Dividend Income Trust (Managed Fund)

The Aurora Dividend Income Trust (Managed Fund) is a form of actively managed Australian equity investment that employs a variety of complementary strategies to generate returns and income:

- Buying fully franked stocks for stable outperformance due to the franking signal and higher dividends and franking.
- Selling half of the portfolio short in unfranked stocks to capitalise on the underperformance of unfranked stocks.
- A number of value-add strategies to generate ancillary returns.

Recent notes in this series have detailed the strategy[1] and its academic support[2] as well as compared the strategy to other types of investment.[3]

The purposes of this note is to compare the performance against the popular Listed Investment Companies that give investors access to the same active Australian equity asset class.

Listed Investment Companies

Listed Investment Companies (LICs) are incorporated entities that investe in a portfolio of stocks and other assets.[4] LICs are also listed on exchange and so give investors an easy and convenient method of gaining exposure to a portfolio of investments as well as the manager's active management skill. Listed Investment Trusts are a similar closed end investment vehicle with a slightly different legal structure – this note will include both types of vehicles interchangeably as we will concentrate on the investment behaviour rather than legal structure.

As the LICs are closed ended instruments, the market price trade at premium or discounts to the net asset value. Net asset values are generally published by individual LICs on a monthly basis. This analysis will concentrate on the market price, representing realisable prices to enter and exit the investment, rather than net asset values. The variation of LIC market prices around net asset value is an additional risk borne by LIC investors.

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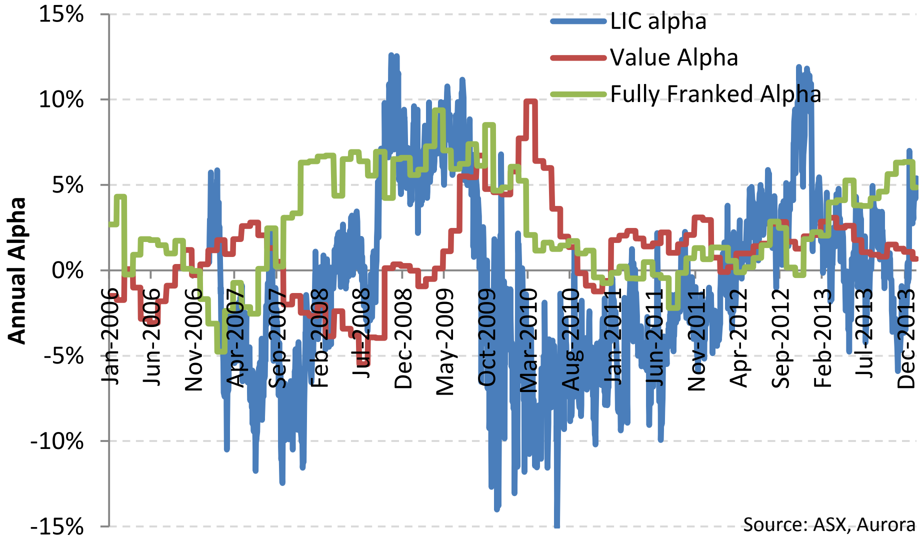
[1] Roe S. & S. Lindsay, (2013a), "Efficient Value Strategy Using the Aurora Dividend Income Trust (Managed Fund)", *Aurora Updates*, 18 September 2013.
[2] Roe S. & T. Gillespie, (2013), "Efficient 'Value' Strategy for Australian Equity", *Aurora Updates*, 29 May 2013.
[3] Roe S. & S. Lindsay, (2013b), "Aurora Dividend Income Trust (Managed Fund) vs Term Deposits", *Aurora Updates*, 2 October 2013.
[4] For additional background and history see http://www.asx.com.au/products/managed-funds/lics-lits.htm and http://www.asx.com.au/education/investor-update-newsletter/201105-lics-now-great-value-investing.htm.

There is a great variety of different assets and management styles employed by LICs. This note will firstly concentrate on Australian equity LICs – the dominant group by market capitalisation. Secondly, we will concentrate on the LICs as a group, rather than singling out individual LICs. To this end, the analysis has been performed using a blend of the Standard & Poor's LIC Domestic Index[5] that was calculated between 2005 and 2012 and the FTSE ASFA Australia Listed Investment Companies Domestic Index[6] calculated since late 2012.[7]

Return Comparison

Figure 1 below shows the annualised alpha (pre tax) to that of a common value strategy alpha[8] as well as the alpha using the fully franked signal that is employed by the Aurora Dividend Income Trust (Managed Fund). This analysis shows stable and leading alpha generated by the fully franked signal compared to the less stable alpha realised by the LIC index and common value signal.

Figure 1: Annualised Alpha of LICs, Common Value Signal, and Fully Franked Signal



The cumulative effect of these differences is shown over in Figure 2. This figure shows the rapid accumulation of alpha from the fully franked signal through the global financial crisis 2007-2009 as well as the stable appreciation after the crisis. This

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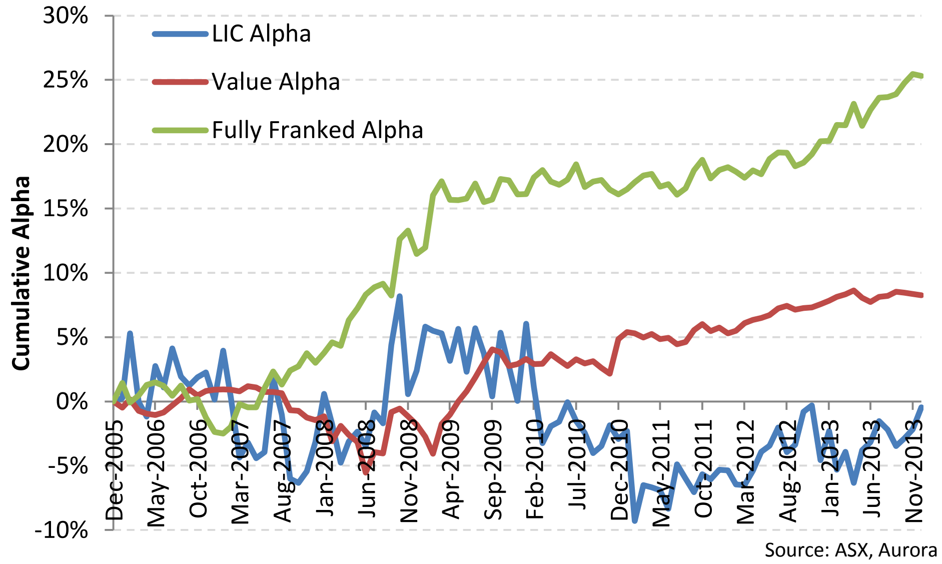
[5] See http://www.asx.com.au/products/managed-funds/lics-index.htm.
[6] See http://www.ftse.com/Indices/FTSE_ASFA_Australia_Listed_Investment_Companies_Index/index.jsp.
[7] The Standard & Poor's index was only computed on a before tax basis while the FTSE index is computed on an after-tax basis making the two indices theoretically inconsistent. The practical impact of this difference is small, and this point is confirmed by statistical tests for the short overlapping period. The blended LIC index is compared against the before tax S&P/ASX 200 Accumulation Index as wells as the before tax MSCI Australia Value Weighted Index.
[8] Common value strategy alpha has been implied by the difference between the returns of the MSCI Australia Value Weighted Index and the MSCI Australia Index.

compares to the less stable and lower levels of alpha generated by LICs and value strategies.

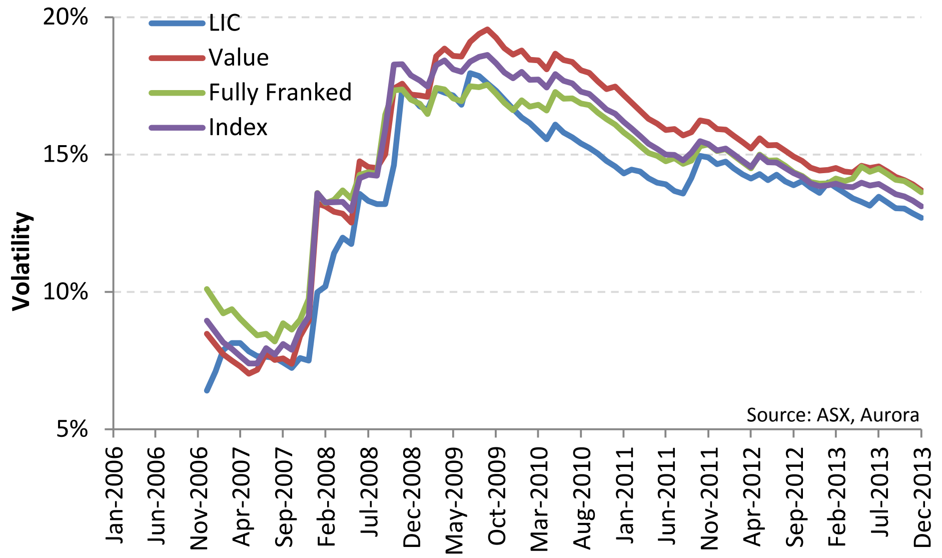
Figure 2: Cumulative Alpha of LICs, Common Value Signal, and Fully Franked Signal



Risk Analysis

Figure 3 below shows a time series of the rolling volatility of the three types of strategy as well as the broad equity index.[9] This analysis shows very similar risk levels between the strategies especial around the time of the volatility spike in 2008. If anything, the LICs as a group exhibited slightly but persistently lower risk in the post crisis time and value strategies a slightly higher level of risk. This analysis represents the total risk of holding these investments.

Figure 3: Rolling Historic Volatility as Measure of Total Investment Risk

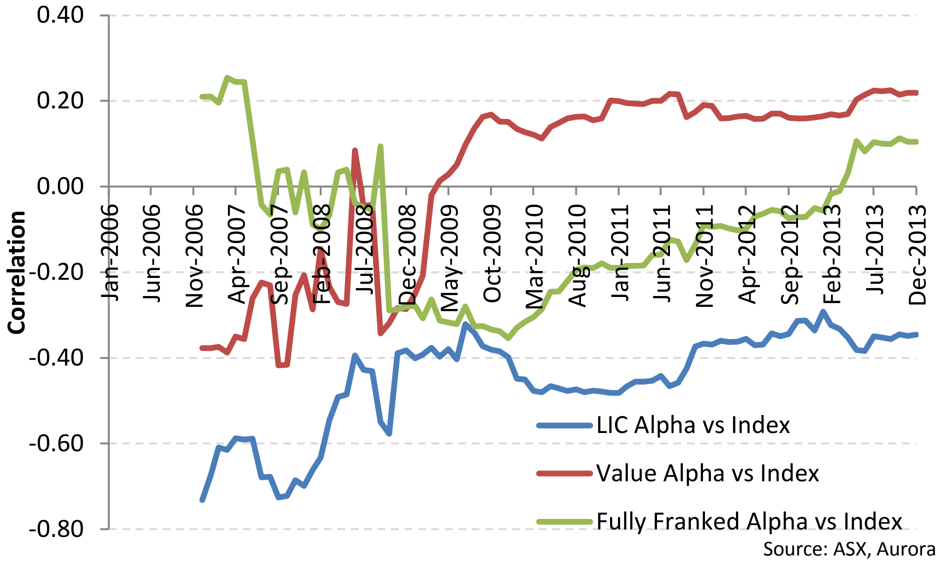


[9] S&P/ASX 200 Accumulation Index.

Additional analysis shows remarkably stable risk levels of the three alpha signals through this period of time with the exception of the value signal rising marginally. This additional analysis also shows significantly higher alpha risk from the LICs (tracking error of 9.8% though sample) compared to the value and fully franked signals (tracking errors of 2.9% and 3.4% through sample).

An additional source of variation contributing to the overall holding risk shown in Figure 3 is the changing correlation of the alpha signals with that of the underlying equity index. In most investors' portfolios the equity risk factor dominates the exposure of the entire portfolio – typically 85-95% for a 'balanced' portfolio. A weak or negative correlation against the equity risk factor highlights the diversification potential of an entire investment or even the active component alone. This analysis shows (Figure 4) the excellent diversification behaviour of the LICs and to a lesser extent that of the fully franked signal. The poor showing of total risk of holding value investments (Figure 3) is explained by the positive correlation between alpha signal and equity index (Figure 4, red line) – essentially this analysis shows outperformance for the value signal is simply a higher beta exposure.

Figure 4: Correlation of Alpha Signals with the Equity Index



Summary

We have compared the risk and return of implementing an active Australian equity investment. This analysis shows that the full franked signal has historically significantly outperformed the other common types of active investment, including listed investment companies over the last eight years. The outperformance of the fully franked signal over this time is stark – +25.3% compared with +8.3% for value strategies and -0.4% for LICs (Figure 2 above). These strategies effectively demonstrate the same overall holding risks over this extended, and at times turbulent, period of time. The full franked signal is a key component of Aurora Dividend Income Trust (Managed Fund).

Note

The Aurora Dividend Income Trust (Managed Fund) (ARSN 151 947 732, APIR Code AFM0010AU) has been issued by Aurora Funds Management Limited.

Disclaimer

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