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Take a pass on 'capital repayment LSIFs

Labour Sponsored Investment Funds (LSIFs) offering a repayment of capital at the end of a specified time frame were good sellers last year – raising more than $100 million. Legislative changes tabled in the 2003 Ontario budget were expected to kill this breed of LSIFs. However, the changes were put on the shelf, which means that capital repayment LSIFs live on. But that doesn't mean they're worth of investors' money.

Basic structure

LSIFs have pacing requirements with respect to money they raise from investors. Within a specified time frame, LSIFs must invest 70 percent of funds raised in "eligible businesses". To encourage investment in hospitals and universities looking commercialize research, the Ontario government has given some incentives to draw money to what are known as Community Small Business Investment Funds (CSBIFs).

A CSBIF is a special type of venture capital fund.

It's a fund investing in entities whose assets and employee salaries stay within specified municipal boundaries. While certain LSIFs are restricted to investing in specific provinces, CSBIFs are restricted to specific municipalities. Further, they typically invest in entities (usually hospital or university research facilities) with total assets of less than $1 million.

Suffice it to say that as risky as LSIFs are, CSBIFs are a few notches above it on the risk scale. Otherwise, the government would not offer added incentives to invest in these funds.

CSBIFs qualify as eligible businesses, which is the type of investment in which LSIFs must invest. For every $1 invested in a CSBIF, the Ontario government gives LSIFs credit for investing $2 in an eligible business.

Hence, capital repayment LSIFs are able to meet their pacing requirements and set enough money aside by simply investing a minimum of 35 percent of assets in CSBIFs – which leaves plenty of money to go toward a "zero-coupon" note to cover the capital repayment objective at the end of a ten to twelve year term.

No free lunch

While it makes sense for an investment manager to strive to minimize risk or preserve capital in the context of the overall investment process, I have a problem with capital repayment LSIFs. Making the simple return of original capital the number one priority just doesn't make sense to me. I just don't get the attraction to such funds.

Sure, investors get the up front tax credit. But over a ten or twelve year time frame, simply returning the original capital is not all that attractive. It's not guaranteed, but I suspect it's fairly reliable. The thing is, I simply don't see the potential to deliver much above the targeted capital repayment.

The lesson in all of this is an old one: there is no free lunch. Whether you're talking about straight GICs, index linked GICs, structured notes, or capital repayment LSIFs, there are always tradeoffs. With this breed of LSIFs, it's that such funds are – in my view – investing in CSBIFs merely because it facilitates the capital repayment structure, not necessarily because there is good upside potential.

That's backward thinking in my opinion. I see LSIFs as presenting a good opportunity today for those seeking some diversification and upside potential. (And as a side note, LSIFs offer the best relative value in non-registered accounts – as opposed to RRSPs – in my opinion.) But match the fund with the objective. Investors looking to make sure their capital is returned to them shouldn't bother with capital repayment LSIFs. For this goal, there are more attractive alternatives. Those looking for venture capital exposure – again preferably outside of RRSPs – should look at more traditional LSIFs or venture capital pools.

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