SharePad ShareScope

Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

The 50-year view

11 May 2020

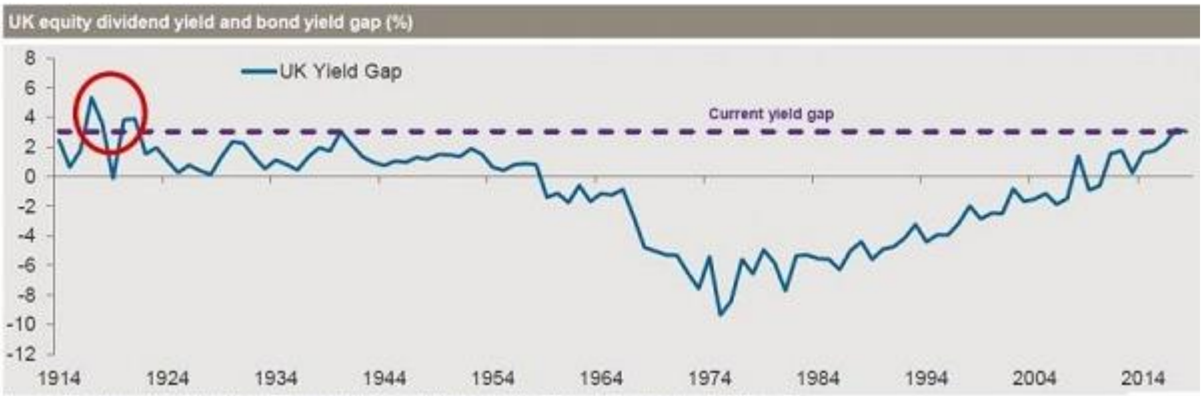
The balance between fear of the virus and anger over the economic damage is fine. Neil Ferguson predicted 65,000 deaths from swine flu in 2009 and recommended school closures and travel restrictions. There were 392 deaths recorded. In 2005 he predicted 200 million deaths from bird flu. The final death toll was 282 worldwide. The track record of those employed by the state is one of over cautiousness.

The risk aversion of state employees is contrasted by the risk-taking, market driven, capitalists. The divisiveness of Brexit may have also been a symptom of this conflict. The last general election suggested that the UK is at heart capitalist as labour's far left policies were firmly rejected. We went into lockdown with 76% of UK adults aged 16-64 in employment, since when around 30% of these have been furloughed, significant salary sacrifices have been made, and livelihoods lost. Dividends have been widely cut while the 421,000 civil servants appear to remain, borrowing increasing amounts of money to feed the spending machine.

These divisions are reflected in markets in the division between valuations of treasury instruments and equity markets. Artificially low interest rates are now fuelling equity market valuations to levels such that expected future returns on risk capital are diminishing. Ultimately, we may reach a point where the risk takers no longer wishes to participate, leaving us with a stagnant economy and worthless capital. At which point we will be applying for jobs as civil servants. We call this financial repression.

How long until repression?

The UK 50-year treasury bond yield today stands at 0.408%, considerably below the 1.5% rate of inflation, while the trailing 12 month yield on the FTSE 100 is 5.05%. That is a whopping 4.6% yield gap, which this graph using data up to 19 February shows is higher than if has been in the last 100 years.



Source: Global Financial Data, Datastream, Citi Research. Data as at 19 February 2019. UK equities in comparison with 10 year gilts.

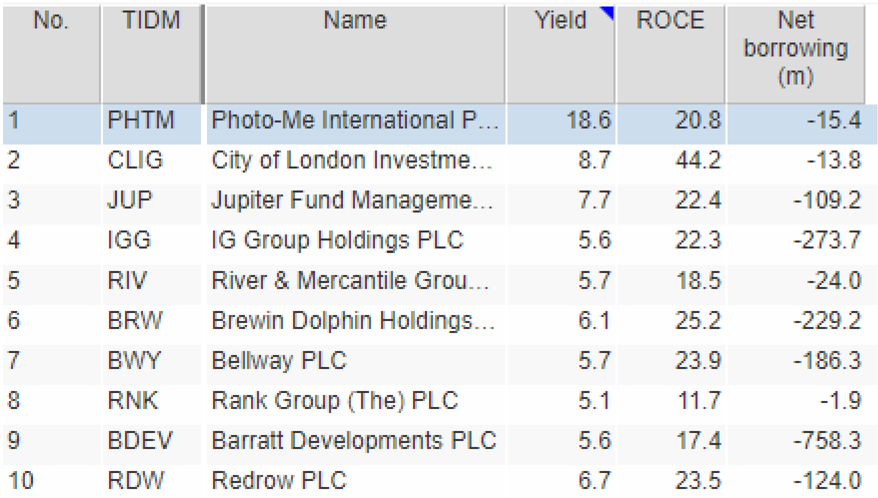
Past performance is not a reliable indicator of current and future results.

There are two ways of closing this gap. FTSE companies are doing their best by cutting dividends, but for those that don't the other solution is a valuation uplift. Relative to bonds therefore the equity market may be cheaper than it has been for the last 100 years. While it seems expensive today - as long as bond yields remain where they are - it can get a lot more expensive yet. This suggests shares that can sustain or even grow a dividend have some way to go.

The companies that will benefit from this valuation uplift will have strong operating models, a genuine and sustainable competitive advantage, and pay good dividends. Classic Buffett stocks like his three longest standing holdings, Coca Cola, Wells Fargo, and American Express. All are strong brands while financial sector companies frequently have high return business models.

SharePad screen

A screen of the 615 companies listed in the FTSE All Share index looking for those that yield more than 5%, have a ROCE above 10%, and have net cash on the balance sheet returns only the 10 companies below (in yield order). Notably 5 of these are in the financial sector and 3 are housebuilders.



No.	TIDM	Name	Yield	ROCE	Net borrowing (m)
1	PHTM	Photo-Me International P...	18.6	20.8	-15.4
2	CLIG	City of London Investme...	8.7	44.2	-13.8
3	JUP	Jupiter Fund Manageme...	7.7	22.4	-109.2
4	IGG	IG Group Holdings PLC	5.6	22.3	-273.7
5	RIV	River & Mercantile Grou...	5.7	18.5	-24.0
6	BRW	Brewin Dolphin Holdings...	6.1	25.2	-229.2
7	BWY	Bellway PLC	5.7	23.9	-186.3
8	RNK	Rank Group (The) PLC	5.1	11.7	-1.9
9	BDEV	Barratt Developments PLC	5.6	17.4	-758.3
10	RDW	Redrow PLC	6.7	23.5	-124.0

Source: Sharepad

The 50-Year view

If we are to take a Buffett view, we may consider which of these is likely to be around in 50 years' time, particularly in the light of the 50-year bond market yield of 0.347%.

- **Photo Me** – I am reasonably certain that vending machines will be extinct in 50 years' time. It is conceivable that Photo Me will have a replacement technology but so also may many other new entrants, making the competitive threat high.

- **City of London Investment Group** – With the F&C investment trust having been in existence since 1868 I suspect that investment trusts will still be in existence in another 50 years and so might this investment trust fund manager, in some shape or form.

- **Jupiter Fund Management** – The experience of New Star which went bust in 2009 reminds me that high profile fund managers can fall victim to bumps in the road, though the strong balance sheet here lends some level of confidence.
- **IG Group** – This is the strongest of the spread betting firms. Likely to be around in 50 years' time though it may be trading intergalactic products by then.
- **River & Mercantile** – This conservatively managed consultant and pension manager is a strong candidate for longevity.
- **Brewin Dolphin** – The wealth management sector faces a growing regulatory burden and consolidation is the likely result. Likely to be very different in 50 years' time.
- **Bellway** – The increase in our debt over the last 50 years has fuelled housebuilders profits which may not be the same in the future. As well as this the company has moved into net debt post COVID 19. Dividend has been postponed.
- **Rank Group** – Gambling as one of the oldest professions is likely to still be going strong in 50 years' time. However, with 90% of staff furloughed and the dividend pulled it fails the test.
- **Barratt Developments** – Interim dividend was cancelled and 85% of staff furloughed while the company relies on debt facilities extensively.
- **Redrow** – 80% of the staff are furloughed and there is some uncertainty over the dividend. While the year end position shows net cash the company has since taken on net debt.

The longevity test whittles the screen down to 4 stocks in yield order

1. City of London Investment Group
2. Jupiter Fund Management
3. IG Group
4. River & Mercantile

Valuation

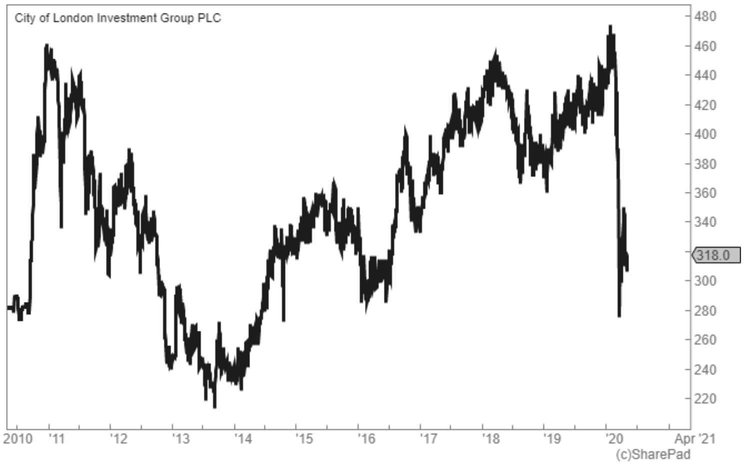
After prioritising the subjective test for business model longevity we may care to screen out stocks that are trading at relative highs. IG Group is currently trading on a PE of 18.2X, above its 10 year cyclically adjusted PE of 17.5X. With spread betting being very popular in lockdown with high volatility I suspect there is a risk of getting into this close to a peak. The shares are up 10% since lockdown started, which may be too little, but as I am confident I will never sell them at the top I intend to ignore this one on the basis that the boat has already sailed. This leaves me with three fund managers, City of London Investment Group, Jupiter and River & Mercantile.

Fund Managers are highly cash generative as fees come in in cash every month but are prone to huge trends in momentum. As fund inflows increase they tend to keep adding to the same stocks in their portfolios, helping fund performance to look good which feeds further inflows as the managers become "stars". The fund management company gets re-rated upwards as the success increases. This can be a very drawn out process and consequently I am using the share price charts over 10 years below to illustrate where each one is in its life cycle. In my personal view this is the single most important facet to understand with fund managers. The cycle operates powerfully in reverse also, which we saw with Woodford.

CITY OF LONDON
Investment Group PLC

Share Price 311p

Mkt Cap £83m



Business lifecycle

This is a very niche fund management company set up by Barry Olliff in 1991 when he identified pricing inefficiencies in emerging market investment trusts so set up City of London Investment Group to capitalise on those inefficiencies. Since then the company has expanded by sector and style but remarkably the company has stuck to its knitting and remains an investor that exploits investment trust discounts and premiums. On occasions they will be activists, buying a trust at a discount to NAV and petitioning to wind up the trust thus recovering a price close to NAV.

The customers are largely institutional which means that in bull markets the company can often experience outflows as institutions take money off the table while in bear markets the company can experience inflows, making the business more stable than many retail fund managers. Barry Olliff stepped down from the company at the end of March this year and has now sold his shares. This is a concern, the company may be at the wrong end of its successful momentum cycle, albeit the company is generally stable and the incoming CEO has been with the company for 20 years.

Recent news

The company reported $6bn of AUM at December 2019, having risen 11% over the previous 6 months. This fell by 27% to 31 March 2020 as the discounts on the investment trusts widened in which their AUM is invested, thus underperforming the market. It is this which makes the downturn potentially an opportunity as those discounts tend to reverse as markets improve, providing some gearing to recovery.

Valuation

The market cap is 2.3% of the AUM and the company has £13m cash in the £83m market cap. The company guides that the revenue on the AUM is 75 basis points giving a run rate of revenue of c. £27m which is a little way below the £32m showing in forecasts. On the basis of current forecasts, the PE is 9.8X and the yield is 9%

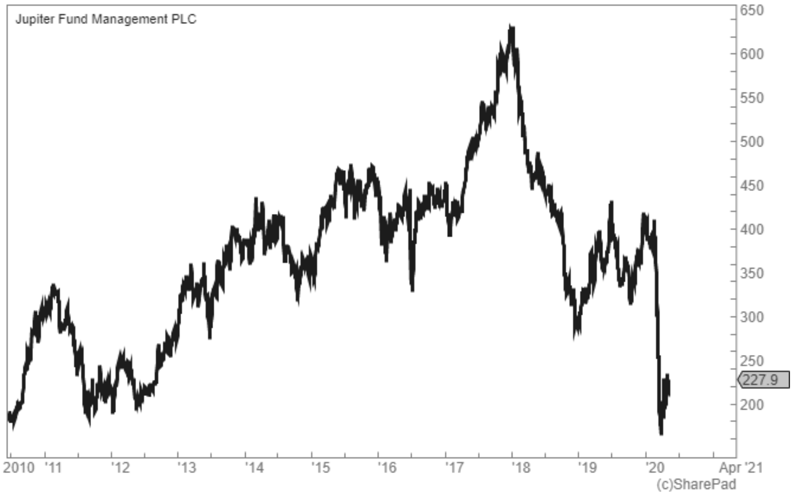
Conclusion

The shares are unusually cheap and with the gearing of investment trust to the market this could be an excellent recovery play on a 6-month view as investment trust discounts tighten. It is just the departure of the founder that keeps me from regarding it as a 50-year holding.

JUPITER

Share Price 226p

Mkt Cap £1,006m



Business Lifecycle

Set up in 1985 as a retail fund manager by John Duffield and sold to Commerzbank in two tranches in 1995 and 2000 John Duffield had a public row with the German owners and left to found New Star in 2001. Jupiter was eventually bought back by the management led by Edward Bonham Carter in 2007 who paid down debt when they floated in 2010. Since IPO the company delivered strong inflows, good fund performance and a growing share price until Edward Bonham Carter stepped down in 2014. Underperformance of funds followed and a number of fund managers, such as Philip Gibbs and Alex Darwall, retired or left. In an effort to re boot momentum the new CEO, Andrew Formica, has recently agreed the acquisition of Merian which will add c 50% to the AUM. Formica was previously CEO of

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Henderson Investors before their merger with Janus. Interestingly Roger Yates, Andrew's predecessor as CEO of Henderson is also a non-executive director at Jupiter giving the feel of trying to re-invent the glory days of Henderson.

Recent news

On 17 February 2020 Jupiter announced the acquisition of Merian Investors adding £22bn to its £43bn AUM for £370m in equity with £20m deferred consideration, valuing Merian at 1.7% of AUM. As markets fell and both companies experienced outflows from funds the AUM of Jupiter fell 19% to £35bn by the end of March while Merian's AUM fell 26% to £15.7bn. While guidance for the combined business operating margins was lowered from 50% to 40% the earnings accretion from the deal actually increases as a function of the number of consideration shares being issued being fixed at 17 February, before the AUM declines. The acquisition is expected to complete in H2 2020.

Valuation

Forecasts are for £317m revenue from Jupiter in 2020. If we add the run rate revenue for Merian of £98m to this we get £415m revenue and the company has guided to 40% operating margins which gives an operating profit of £166m. Today there are 444m shares in issue and this will expand by 95.36m shares. This suggests an underlying EPS potential of c25p which compares to the current year (June 20) forecast of 18.4p so the acquisition looks c 35% enhancing to EPS. On that basis the company may be trading at less than 10X PE.

Conclusion

As part of the acquisition Jupiter has taken issued £50m of debt which has recently priced at 8.875% indicating credit markets believe there is some risk. I also worry that the outflows could continue. A comparison of quarterly flows for the sector is below where Jupiter continues to experience the worse flows of the peer group. I sense it may be better to wait and pay a higher price when flows have turned, given the power of negative momentum for retail fund managers.

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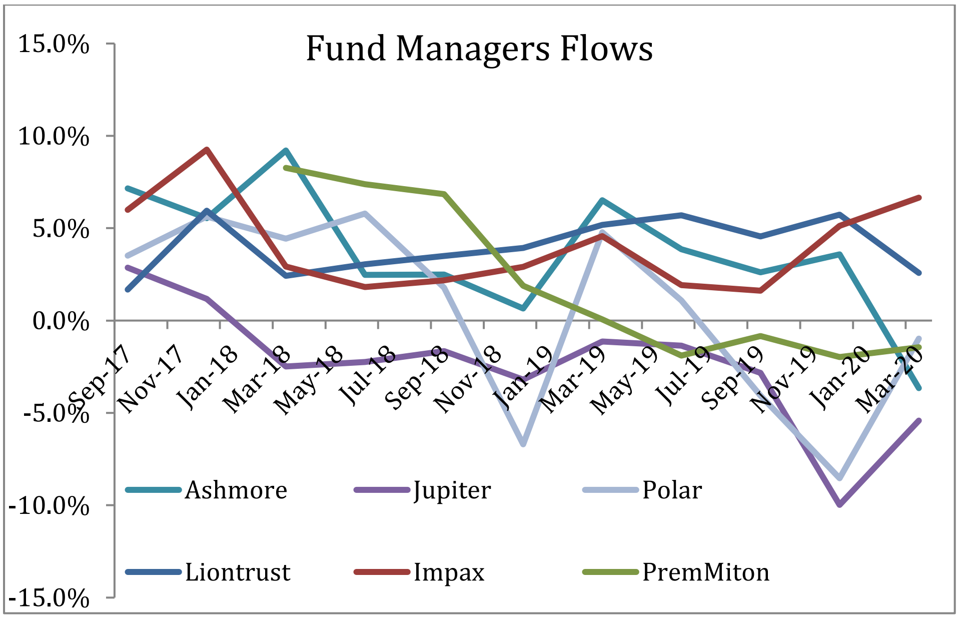
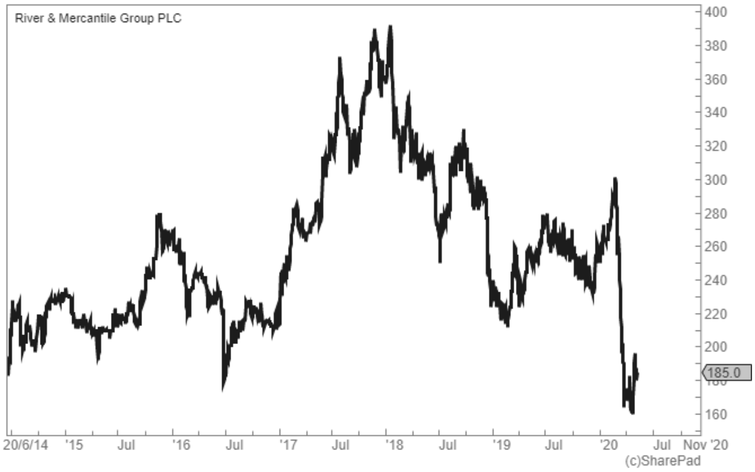


RIVER AND MERCANTILE GROUP

Share Price 185p

Mkt Cap £158m



Business Lifecycle

James Barham founded River and Mercantile Asset Management in 2006 with the backing of Pacific Investments (John Beckwith's family office). In 2014 it merged with the pensions advisory business P-Solve and came to the main market. In 2018 the FCA investigated the pension consultants' sector which introduced some uncertainty over the conflicts between providing advice to pension trustees while also offering pension fund management services ("fiduciary management"). Also, in 2018 the high-profile fund

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manager Philip Rodrigs was sacked for professional misconduct while the company was also fined for essential attempting to price fix the 2015 IPO of On the Beach, in breach of competition law. After a "period of investment" the company returned to growth in 2019, which is evidenced in the share price performance until the bear market arrived in 2020.

Recent News

The company unusually reported net inflows of £215m in the 3 months to the end of March taking AUM down a modest 4.3% to £40.5bn. The company has the potential to earn performance fees on its AUM and following the March bear market the company says it doesn't expect to receive any performance fees. Advisory fees in the 3 months to March were £2.7m, which is in line with the £5.4m received in H1.

Valuation

Current forecasts are for £13.2m PBT in the year to June 20 and the same for June 2021. This is predicated on a 10% revenue decrease in the 2020 year and a 3% increase the following year which looks conservative. This places the shares on a PE of 15X and yield of 5.1%

Conclusion

The shares are not a bargain but with a stable and cash generative business and long-term stable pension clients the company looks to be in a cycle that is its own rather than a hostage to market fortunes. There is a 5.1% yield and having got through some growing pains this could well be one of my long term tuck away stocks.

Summary

As the pain of economic downturn competes with the wall of money forcing valuations upwards there is considerable upside on equity markets for resilient stocks that can maintain dividends. Of the 3 stocks that screen as long term dividend payers Jupiter looks to be risky and City of London Investment Group looks to be a good recovery stock. River & Mercantile looks like the strong long term dividend paying stock which sadly is not a bargain. But the 5.1% yield will satisfy the patient long-term investor.

This is a dangerous time where we can get distracted by the sharp price movements associated with the crisis. It is important to maintain the investment style that works for us. The long-term investor may be happy with River & mercantile, the recovery investor with City of London Group and the high risk investor with Jupiter.

Forthcoming Events

	Date	Event
Jupiter	21-May-20	AGM
Jupiter	29-Jul-20	H1 Results
City of London Investment Group	Sep-20	FY Results
River & Mercantile	Oct-20	FY Results

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