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A key baby boomer exposure
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Key points

- *Challenger has established itself as the main provider of annuities in Australia.*
- *As baby boomers retire, assets in retirement are expected to quadruple over the next decade.*
- *Over the next two decades, Challenger's sales of new annuities could be 30 times higher than they are today.*

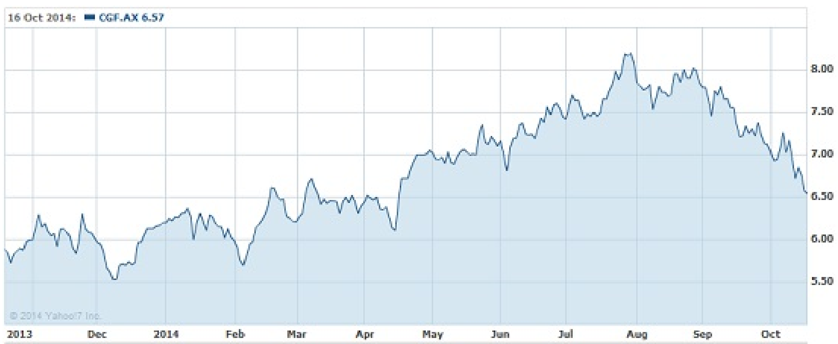
We believe that Challenger Financial Limited (ASX: CGF) is a high quality business as demonstrated by the company's privileged position in a rapidly growing market segment that Challenger itself has largely developed and fostered in Australia.

Whilst many other businesses have, until now, focused solely on the wealth accumulation market, Challenger has built a large high-quality business that has, to a certain degree, ring-fenced a portion of those assets entering their drawn-down or retirement years. A segment that, due to adverse market events such as the GFC, is gaining penetration for those who are risk-adverse and cannot handle the volatility sometimes associated with pure equity-based products.

The business

In terms of business mix, on the one hand, Challenger has its traditional funds management division, which allows the company to participate in the accumulation/wealth-building phase of individuals, companies and trusts. On the other, Challenger is focused to a greater extent on developing the Australian annuities market, in which it presently holds an approximate 70% market share.

Challenger (CGF)



Source: *Yahoo!7 Finance, 20 October 2014*

Whilst Challenger is therefore leveraged to the entire superannuation system lifecycle, it is the businesses ability to develop and manage products, which satisfy retirees' needs for a stable and reliable income stream (annuities) that has seen the business go from strength to strength.

In FY14, the earnings split between funds management and life, or the annuity side of the business, was roughly 10/90. Challenger has positioned itself as the market leader for 'Retiree Services' and this is no accident.

Since mid-last decade, Challenger set out on a path to lead the development of the annuities market in Australia, the only developed economy with mandatory retirement savings (superannuation) to have no formal decumulation structure. This was an opportunity they spotted early and have hence benefited from a first-mover advantage.

The education challenge

But perhaps because annuities in Australia are so poorly understood, Challenger's greatest challenge has been one of education. They have spent years in developing the understanding of retirees, wealth managers, retirement advisors and even the Government on the aspects of longevity risk (people living longer and needing to fund those years with what they have saved) and its management.

Challenger has now built scale advantage in distribution and marketing, presenting to over 5,000 financial advisors alone in 2014. The company has developed and rolled out income guidelines to advisor groups and even assists them with asset allocation models. The business has, and continues to, put a lot of focus into building the annuities market for a reason.

Right now, the industry appears to be at a turning point towards material and sustained growth. Upon delivering his 2014 results conference call, chief executive officer Brian Benari remarked "As a 20-year wave of baby boomer retirement moves into its fourth year, assets in retirement are projected to quadruple in this decade alone."

At the end of June 2014, the total pool of funds flowing from accumulation into retirement was a mind-boggling $66 billion. Of this, annuities captured just 4%, with overseas trends pointing towards a 'natural' level of 10-15%. So here we have two legs of growth coming into the market, which Challenger dominates. We presently estimate that over the next two decades, Challenger's sales of new annuities could be 30 times higher than they are today. That's very exciting from a shareholder's perspective.

Government backup

Further, a catalyst to accelerate the structural growth in the annuities market could soon come in the form of regulatory tailwinds stemming from the Financial Stability Inquiry (FSI) currently underway. David Murray, the Chairman of the FSI, has suggested the government is looking seriously at proactively incentivising retiree investment into private annuities.

This suggests to us that there is a very real chance that supportive regulatory changes are on the table and that there exists a probability that growth in the annuities space will be accelerated by government in the near future.

So here we have a business with three growth legs: firstly, by mandated superannuation contributions; secondly, by Australia's ageing population and a burgeoning of pension phase assets; and thirdly, by possible government regulation. This ensures that in 10-20 years from now, the annuities market in Australia will almost certainly be much bigger than it is today.

The combination of structural growth in superannuation assets and the annuities space is highly positive for both Challenger's Life and Funds Management businesses. This, coupled with our current perception that Challenger's growth in new annuities, Challenger's life book growth and, therefore, Challenger earnings growth, is materially underestimated by the market.

All these positive forces make Challenger one of the few listed business that we believe is worth materially more than the market price today. A reason we, as value investors, hold it in our funds at Montgomery Investment Management and with the recent correction in the businesses share price (not prospects), we think it potentially provides an opportunity for longer-term focused investors.

Challenger has, and will continue to be, in our view, a beneficiary of one of the few subsectors of the Australian market that is in the early stages of structural and sustained growth. At the very least, put this one on your watch list.

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