A stock that benefits from European QE

by Roger Montgomery

Key points

- *Fund managers can generate for their shareholders a high and an increasing rate of return on virtually no capital.*
- *Favourable conditions for fund managers might persist as the Eurozone joins the bond-buying party.*
- *Henderson Group, listed on the London Stock Exchange and available in Australia via CHESS Depositary Interests, is one such fund manager.*

As global central banks continue their quantitative race to the bottom, investors may be viewing the elevated share market as a difficult place to find attractive prospects.

I consider a high quality company to be one that can deploy large amounts of capital at high rates of return. Another type of high quality company is one that produces high, and increasing, rates of return on virtually no capital. Fund managers fit this latter category.

The fund manager fix

Fund managers are generally remunerated two ways; a fixed margin charged on the total value of assets they manage, and a performance fee charged on returns that exceed an agreed benchmark.

Assets under management (AUM) will grow when capital flows into the fund or prices of the underlying assets increase. Because a fund manager's revenues are linked to the value of the assets managed, the fund manager can enjoy strong revenue growth without requiring a great deal of additional resources.

For instance, if equity markets increase by 10% while flows remains static, then the manager only needs to track the benchmark for revenue to increase by 10%.

Fund management businesses also enjoy a high degree of operational leverage. Once a portfolio is established, it requires very little incremental cost to manage the capital flows. This means that a manager, able to grow revenues by 10% by tracking a benchmark, will experience considerably higher growth at the profit level. What's more, if the manager can outperform the market, then the share of excess returns is directly recognised as gross profit.

But beware; these forces are just as powerful in reverse and when fund flows move in the opposite direction (an issue that PIMCO has been dealing with since the departure of Bill Gross).

The global goal

That aside, it does seem as though favourable conditions for fund managers might persist as the Eurozone joins the bond-buying party. The European Central Bank has announced a bond-buying program that's equivalent to 7% of the Eurozone GDP. The credit market, however, is not large enough to absorb this investment, so capital must be forced into alternative asset classes. Indeed, this is precisely what has transpired – a sharp increase in European equity markets of 15% this calendar year has been experienced amid the flood of cash.

A company that appears to currently be well positioned to take advantage of these forces is Henderson Group (ASX: HGG). This company may not be on many investors' radars because it is listed on the London Stock Exchange, but it trades on the ASX via listed securities called CHESS Depositary Interests.

Henderson manages £81.2 billion of assets across Europe, North America and Asia. It's bigger than BT and similar in size to Colonial. The portfolio is well diversified, with 19% in European equities, 32% in global equities, 24% in global fixed income and 25% in multi-asset and alternative asset classes.

In 2013, Henderson management said they planned to double AUM within five years. Thus far, the plan appears to be on track, if it is not exceeded. The company grew AUM by 11% in the first quarter of 2015 alone. Despite this strong growth, we currently believe the share price implies that AUM will only grow with the market, seemingly underestimating the potential for major capital inflows.

Retail realisation

Another positive realisation following the recent quarterly announcement was the profile of Henderson's inflows and particularly the rising proportion of retail inflows. The retail market refers to investments by individual investors. For reasons unbeknown to us, institutions aren't willing to pay good fund managers appropriately, so Henderson's penetration into the retail market is a positive development. And those strong retail flows may be a reflection of solid performance. Henderson is outperforming the broader market, with 75% of its funds outperforming over one year and 86% outperforming over three years.

The operational leverage from the sizeable capital inflows should start flowing through the company's next financial statements. The majority of Henderson' earnings are denominated in British pounds, and the pound has remained relatively stable against the Australian dollar.

Notwithstanding a stock market correction, Henderson is a company that provides the potential for material upside. Indeed, it is one of those rare companies with fundamentals that actually benefit from an elevated share market. Should robust stock market sentiment in Europe be maintained, fund managers like Henderson are positioned well. And in a stock market where value is rare, a company that isn't being priced as euphorically as some poorer quality business is rarer still.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*