Buying: Aberdeen Asset Management PLC (ADN)

***Improve the portfolio :** As companies grow (or shrink) and as their share prices go up (or down) the attractiveness of the investment changes. If a company's share price shoots up quickly its shares may no longer represent good value for money, while a company that falls into a long-term decline may no longer be remotely defensive. In both situations selling can be the right course of action.*

Price on 1st February 2016	Index	Sector
246p	FTSE 100	Financial Services
FTSE Market Cap	**Revenue**	**Normalised Post-tax Profit**
£3.2 billion	£1.3 billion	£313 million

"We are a global asset manager with a broad range of investment capabilities. As a pure asset manager, without the distractions of wider financial services activities, we are able to concentrate all of our resources on our core investment management business."(www.aberdeen-asset.com)

Overview

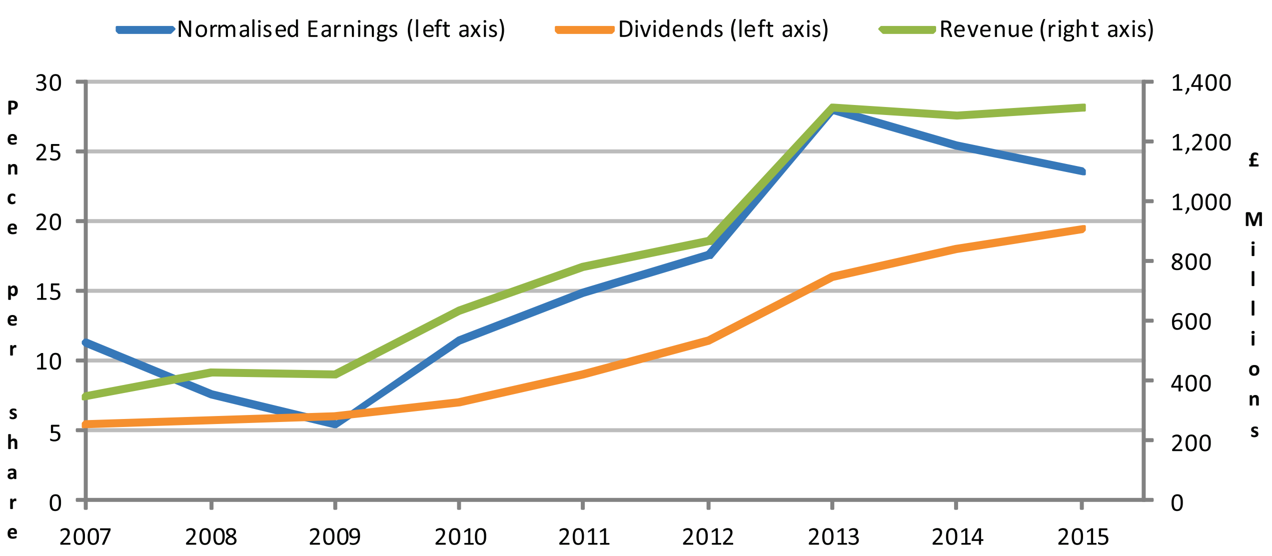
Aberdeen Asset Management has an interesting history in that it started out as an investment trust which was taken over through a management buyout in 1983. In 1991 it listed on the stock exchange as the Aberdeen Trust PLC and since then the company has grown enormously and largely by acquisition (and changed its name).

Over the years it has expanded into various markets including emerging market funds, direct property investment and fixed interest investments. It recently acquired the Scottish Widows Investment Partnership from Lloyds which has given the company a more diverse base of client assets and investment products, moving it away from its historic focus on equity funds. Today the company's assets under management (AUM) are split across: 28% equity; 23% fixed interest; 42% multi-asset and bespoke solutions; 7% property.

The majority of the company's equity funds are invested in Asia Pacific and emerging market companies and both of those regions have recently seen significant price declines and a downward spiral of investor sentiment. This has led to meaningful reductions in AUM, which has a direct impact on revenues and profits.

Growth Rate	Dividend Yield	Profitability	PE10
21.2% (min 2%)	7.9%	12.9% (min 7%)	15.2 (max = 30)
Growth Quality	**Debt Ratio**	**Pension Ratio**	**Rank**
75% (min 50%)	0.0 (max 5)	0.7	5 (out of 235)

***Green** = Better than FTSE 100; **Red** = Worse than FTSE 100 or outside the "rule of thumb" minimum or maximum values*



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality and that its shares are likely to improve the portfolio in the long-run.

Maintaining and increasing portfolio diversification

1. Will this purchase leave the portfolio's average UK revenues at less than 50%?

YES UK revenues currently make up around 41% of the portfolio's total revenues. Aberdeen's UK revenues weighting is 52% and it will push the portfolio's average UK revenues towards but not above 50%.

2. Will this purchase leave the number of holdings from cyclical sectors at 15 or less?

NO The portfolio currently holds 15 cyclical sector stocks so I should be adding a defensive stock. However, at this moment there are no defensive stocks that are suitable for purchase within the top 50 ranked stocks. For example, Jardine Lloyd Thompson and Cobham have too much debt while Rolls-Royce's pension scheme is too big. I would rather not add stocks from outside the top 50, so for now I think the better option is to allow the portfolio to hold 16 cyclical stocks for now and then reduce that back to 15 as soon as possible.

3. Will this purchase leave the number of holdings from this company's sector at 3 or less?

YES The portfolio holds two Financial Services companies (IG Group and Tullett Prebon) and Aberdeen will be the third. No more Financial Services companies will be purchased until one of these is sold.

Avoiding value traps

Good management

1. Is the company focused on a clear and consistent goal and strategy?

YES The company's current goals are described in the latest annual report as:

Our vision: To be a highly trusted partner in delivering investment simply; **Our purpose:** To help clients harness the potential of markets to achieve their chosen goals.

The strategy for achieving these is based around a focus on: high levels of client service; high quality investment research; diversification of expertise, markets, distribution channels and clients; talented and motivated employees; controlled costs, an efficient organisational structure and a strong balance sheet.

On a more tactical level, the company's long-term plans are to:

- Promote our Aberdeen solutions capabilities across a wider investor base - globally.
- Continue to build product specialist resource across all capabilities and also for certain channels (e.g. insurance) - so that our offering is better tailored to specific needs of clients.
- Grow property capabilities in Asia and US to create a global asset class.
- Utilise existing experience to broaden the number of distribution partners who outsource investment expertise to Aberdeen.
- Continue product development to support growing pool of retirement savings.
- Continue penetration across new channels in US with global investment capabilities – plus acquisitions have strengthened our US based investment desks.
- Strengthen use of technology that enhances the information we provide to clients.

Although the details have varied over the years, the company's basic goal of being a global investment management company have not changed, and changes to the strategy have been evolutionary rather than revolutionary.

2. Does the company have an obvious core business that the strategy is focused on?

YES Aberdeen is an investment manager and always has been. It is focused on managing equity and fixed interest funds, alternatives such as private equity, direct property investments as well as multi-asset and bespoke solutions.

Adequate financial control

3. Do the Key Performance Indicators (KPIs) focus on factors beyond revenue and EPS growth such as profitability, leverage, liquidity and investment?

YES KPI's include operating margin, cash flow, fee margin and return on capital employed alongside the usual revenue and earnings per share growth metrics. There are no leverage or liquidity measures, but the company has no debt so this is less of an issue.

Low costs

4. Scale: Is the company in the leading group in terms of market share?

YES Some of the descriptions for Aberdeen include "one of Europe's largest investment houses"; "Europe's largest pure property asset manager by assets under management"; "the largest listed fund manager in Europe". Whether these statements are true at this exact moment in time I do not know, but the company is clearly one of the largest investment managers in Europe.

5. Experience: Has the company had the same core business for many years?

YES The company has been an investment manager since the beginning in 1983, initially as an investment trust.

Caution with big projects

6. Is the company free of "bold" projects which could push it into a major crisis?

YES There do not appear to be any "bet the company" projects underway at the moment.

7. Is the company free of the need for large capital expenditures (capex)?

YES Investment management is not a capital intensive business and as a result Aberdeen has only spent on average 8% of post-tax profits on capex. I define anything below 50% as low, so this is a low capex company.

8. Are revenues generated by the sale of a large number of small-ticket items rather than major one-off contracts?

YES Revenues are generated primarily through fees, which are charged as a percentage of assets under management (AUM). These fees are charged on an ongoing basis per fund which results in a large number of small charges.

Caution with acquisitions and mergers

9. Has the company avoided mergers or large acquisitions in the last few years?

NO Aberdeen has used acquisitions extensively in order to grow and in the last ten years the company spent 31% of total post-tax profits on acquisitions. This is not excessive by my definition (i.e. beyond 100%) but in 2008 the total value of acquisitions breached my definition of "large" for a single year (100% of that year's post-tax profits). The total amount spent was £196m, compared to profits of £50m.

Three companies were purchased: The US equity asset management business of Nationwide Financial Services Inc (for £16m); 100% of the ordinary share capital of German-based property asset manager DEGI (for £88m); Goodman Property Investors (for £98m).

These acquisitions were funded by additional debt and equity. At the time this pushed the debt ratio up above 4, which is quite high, but I don't think it could be considered as a reckless use of debt.

10. Has the company avoided large acquisitions that have little to do with its core business?

YES None of the three acquisitions in 2008 represent a "large" acquisition in their own right, so the problem of integrating a single large business does not applicable. However, even if these were large acquisitions all three are closely related to Aberdeen's core investment management business.

Ability to adapt to changing market demand

11. Does the company operate in defensive markets?

NO Aberdeen is listed in the Financial Services sector, which is defined as cyclical. That definition is appropriate as investment management is a cyclical business because fees (revenues) are typically charged as a percentage of AUM.

If markets go up then fees go up in proportion and the company's investment funds will also probably experience inflows of new investor capital as well, which will also increase AUM. The opposite applies when markets go down, i.e. AUM fall because of market declines and capital outflows. As a result revenues, profits and cash flows can be volatile and highly correlated with the markets in which funds are invested.

12. Does the company operate in markets where the pattern of demand (whether cyclical or defensive) is unlikely to be disrupted in the short or medium-term?

NO The pattern of demand for investment products is undergoing a significant amount of change, which some might already consider large enough to be called disruption.

Aberdeen cites several areas of change, although for me the ones most likely to cause true demand disruption are: the shift towards multi-asset outcome-focused "solutions" rather than market-beating single asset class funds; the increasing importance of individual rather than institutional investors; "robo" financial advisor platforms and the increasing importance of retail investors and direct-to-consumer (i.e. online) communication. These each represent significant changes to the pattern of demand.

13. Does the company operate in markets where demand is expected to grow?

YES The demand for investment products globally is expected to grow in line with populations, disposable incomes and life-spans. Aberdeen also expects the markets in which it primarily invests (Asia Pacific and emerging markets) to continue to grow over the long-term.

Competitive product, service and price

14. Does the company generate most of its profits from products or contracts that do not need to be replaced in the next 10 years?

YES Revenues are generated primarily from fees charged as a percentage of assets under management. Investments funds do not need to be periodically replaced, as long as their performance is acceptable.

15. Does the company sell differentiated products that do not compete purely on price?

YES In the world of active investment management, price is not the primary consideration for most investors. If price is the primary consideration then passive investments offer the market rate of return at almost no cost in many cases (e.g. Vanguard).

For active investment products such as those managed by Aberdeen, performance is likely to be a far more important consideration. Of course fees must be acceptable and not excessive, but there is a considerable range of fee percentages charged, with most falling somewhere between 0.5% and 2% per year.

Indifferent to commodity prices

16. Is the company relatively immune to commodity price movements?

YES Aberdeen may run some commodity funds they are not a significant portion of AUM. There is some correlation between commodity prices and other markets, but I would still describe Aberdeen relatively immune to commodity price movements. For example, if oil prices decline dramatically, this may negatively impact some of the geographic regions and markets that the company's funds are invested in, but it will also benefit others. It would also be relatively easy for Aberdeen to diversify away from commodity price exposure.

Sound financial policy

17. Does the company have a target rate of return on investment of more than 10%?

YES ROCE is used as a pay performance target for directors. The target somewhere around 20%, but the exact figure isn't obvious from the annual report.

18. Is the company's use of leverage is conservative enough given the preceding answers?

YES The company appears to use no debt at all, so in that regard its leverage is fine. However, as an investment manager it also has to carry a certain amount of regulatory capital. This is measured using the Common Equity Tier 1 ratio (CET1), which is the same ratio that I use to measure bank leverage. In Aberdeen's case, the CET1 ratio is currently 16.9%, which is well above my rule of thumb minimum of 12%. However, I'm not sure yet how applicable that rule is to investment management firms rather than banks.

As a somewhat ambiguous alternative, the 2015 annual report repeatedly states that the company has a "healthy level of headroom" above its regulatory capital requirements.

19. Are the chances of this company becoming a value trap acceptably low (and if so, why are the shares attractively priced)?

YES This is an interesting investment case because the current dividend yield is around 8%. Usually a company's dividend yield will only be driven that high if most investors think a dividend cut is very likely.

Having looked at the company's past and present I think the dividend is more likely to be held than cut. If revenues, profits and cash from operations fell substantially then the company could easily use debt to fund the dividend in the short-term. Another important point is that the stock is already priced for a dividend cut, otherwise the yield would not be 8%. If the dividend was cut in half then the yield would drop to 4%, assuming the share price stayed where it is. That is still equal to the FTSE 100's yield and on that basis Aberdeen could still be attractively valued, given its history of above average growth.

If the shares really are cheap, as I think they probably are, why are they cheap? I think the reason is that the company's funds are weighted towards Asia and emerging markets, both of which have seen price declines recently and a reversal of invest sentiment. As a result Aberdeen's AUM have declined in value on a like-for-like basis (i.e. ignoring new assets from acquisitions) as prices have fallen and as clients have withdrawn their capital. Investors are concerned that these trends will continue and that the company's dividend will be cut, and that of course leads to a lower share price. As I don't think a dividend cut is the most likely outcome I think Aberdeen at its current price is an attractive opportunity, albeit one that requires the ability to stomach a possible dividend cut.

Uncovering competitive advantages

1. Does the company have any intangible asset advantages (brand names, patents, regulatory barriers)?

YES A strong brand is important for most financial services companies as clients typically need to trust the company they are dealing with, more so than they would when buying socks. This is likely to be true whether the client is an individual or institutional investor. According to research by Smithfield, Aberdeen's brand does punch above its weight relative to firms of a similar size, and on that basis I'm willing to accept that its brand may be an advantage, especially relative to new and unknown competitors.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to another supplier (e.g. bank accounts or computer software)?

NO While there may be some financial and emotional barriers to switching from one investment manager to another, I don't think these are high enough to be classified as a competitive advantage.

3. Do the company's products or services have a "network effect", i.e. become better as more people use them (e.g. Facebook, eBay)?

NO Investment funds do not function significantly better as more investors invest. While fees may drop as as a fund's size increases that is a scale and cost advantage rather than a network effect.

4. Does the company have any durable cost advantages (e.g. unique location, unique low cost source of raw materials, greater scale)?

NO I don't think the company has any cost meaningful cost advantages over other active investment managers.

Making the trade - Are you happy to own these shares for at least 5 years?

YES Aberdeen is a leading investment manager with a focus on markets which are currently suffering declines (Asia Pacific and emerging market equities). However, its focus on those markets is shrinking due to a deliberate policy of increasing diversification. The company has a strong balance sheet and a competitive history and therefore I do not think it is an obvious value trap. I will be investing approximately 4% of the model portfolio into Aberdeen Asset Management a few days after this issue is published, and a similar percentage from my personal portfolio.

Higher ranked stocks that were not selected	Reason for not selecting
Amec Foster Wheeler	Debt ratio too high
Weir Group	Cyclical company whose growth has been driven by acquisitions funded by debt
Cobham	Debt ratio too high
Jardine Lloyd Thompson (top 50 defensive stock)	Debt ratio too high
Rolls-Royce (top 50 defensive stock)	Pension ratio too high

"When there is a stock-market boom, and everyone is scrambling for common stocks, take all of your common stocks and sell them. Take the proceeds and buy conservative bonds. No doubt the stocks you sold will go higher. Pay no attention to this— just wait for the depression which will come sooner or later. When this depression— or panic— becomes a national catastrophe, sell out the bonds (perhaps at a loss) and buy back the stocks. No doubt the stocks will go still lower. Again pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you'll have the pleasure of dying rich."

— Fred Schwed, Where Are the Customers' Yachts?