FEATURE

AMG: An Asset Manager Whose Stock Is a Value Play

The stock's been hammered, but selling is overdone. Shares are worth 35% more than they currently fetch.

By JACK WILLOUGHBY

September 3, 2016

If you want to make a good contrarian stock pick, consider the shares of a good contrarian stockpicker, Affiliated Managers Group.

Prevailing investment sentiment is bearish on the West Palm Beach, Fla.–based money manager. Affiliated shares are down 22% over the past 12 months, even as the Standard & Poor's 500 has gained 13%. AMG's drop is substantially worse than the typical asset manager's, whose shares are up 3% in that time.

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Affiliated CEO Sean Healey sees "growing demand for alternative strategies" from all sorts of investors.
Photo: Jared Leeds for Barron's

Affiliated (ticker: AMG) is a holding company for about 40 firms that oversee $700 billion of stocks, bonds, and alternative assets. Founded in 1993 by William Nutt, AMG was a pioneer in acquiring controlling stakes in money managers, including well-regarded value-oriented ones, such as Tweedy Browne, Yacktman Asset Management, and Third Avenue Management. It also owns popular alternative asset manager AQR Capital Management, as well as hedge funds, including global stock manager Harding Loevner, credit-specialist BlueMountain Capital Management, emerging markets expert Genesis Asset Managers, bond manager Capula Investment Management, and activist ValueAct Capital.

AMG, the seventh-largest publicly listed asset manager by assets under management, offers the leaders of these boutiques a chance to realize their firms' equity value, while keeping stock available for their successors. In a typical deal, AMG creates a limited partnership in which it owns 60% and the money manager's founders 40%, with each side sharing the revenue. After the investment, the founders retain enough stock to pass onto the next generation of leaders and to keep their autonomy. In return, the boutique can tap into AMG's substantial global marketing, compliance, administrative, and distribution skills.

"Talented managers can't thrive in a bureaucracy. AMG has figured out how to knit them together and keep them strong and vibrant while recycling the equity," says Steven Levitt, co-founder of Park Sutton Advisors, an investment banking firm focused on boutique managers.

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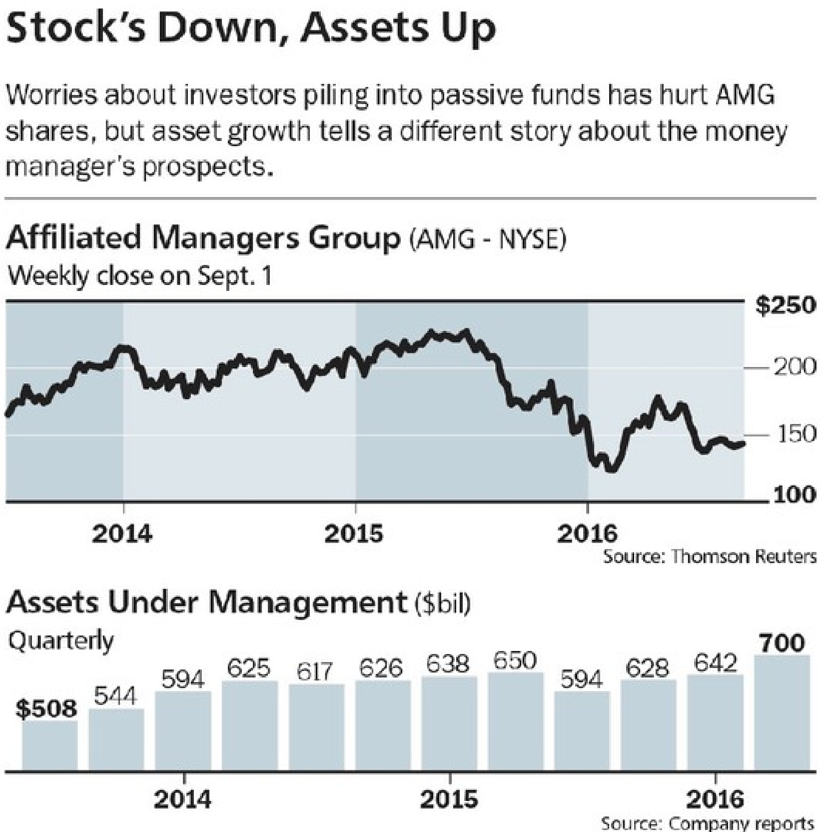
However, AMG is viewed by many as a bellwether for active stock picking and high-priced hedge fund management at a time when both are out of fashion and underperforming. This year through July, a net $131 billion has flowed out of actively managed mutual funds, while $242 billion has gone into passive or index-based funds, whose fees are substantially lower, according to Morningstar. Indexed mutual and exchange-traded funds have grown to $5 trillion in assets as active funds have declined to less than $10 trillion. Hedge funds, too, have begun to suffer net withdrawals in recent months.

Aside from standing–in theory at least–on the wrong side of this trend, AMG has another problem. Third Avenue's high-yield Focused Credit fund imploded last year amid the sharp selloff in energy bonds. The parent firm suspended shareholder redemptions and has seen big withdrawals from several unrelated funds. The wounds, however, don't seem life-threatening. Third Avenue has made two big distributions to investors and plans to liquidate the fund, which, at the time of its closing, represented 13% of Third Avenue's $6 billion in assets. Third Avenue, in turn, amounts to less than 1% of AMG's assets.

STILL, THE PROBLEMS have left AMG's stock dirt cheap. Trading for less than 10 times 2017 earnings estimates, it's priced at an "unwarranted" discount to peers whose stock generally changes hands for 13 to 16 times 2017 earnings estimates, writes Alexander Blostein, a Goldman Sachs analyst who rates AMG a Buy. Even during the financial crisis, AMG traded around 12 times earnings, he notes. Blostein sees the shares soon regaining lost ground, rising from $140 to $190—35% above their current levels—as inflows revive during the second half of this year.

Blostein is among those who think that AMG doesn't fit neatly into the box that investors have assigned it. Matthew Hereford, a portfolio manager at Atlanta Capital, which runs the Eaton Vance Atlanta SMid Cap fund, agrees that the shares "are being penalized as an indirect result of the incorrect perception that the move to indexing would hurt the business. We argue otherwise. AMG's growth prospects are good. They have a large mix of alternative and global mandates less susceptible to the movement toward passive."

3 Has China's Property Boom Run Its Course?



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In fact, 59% of AMG's assets come from institutions and 15% from wealthy individuals, who tend to have longer-term relationships with their money managers than many retail investors. The remainder of AMG's assets are in mutual funds.

Alternative strategies, which can offer returns uncorrelated to stock and bond performance, have gained appeal as investors fret about the course of the S&P 500, now near all-time highs, and interest rates, now at historic lows. Fully 40% of AMG's assets are in these strategies, including everything from infrastructure to private equity to global macro to multistrategy relative value and managed futures. "Contrary to conventional wisdom around challenges in the hedge fund industry, there is significant and growing client demand for alternative strategies across distribution channels," says Sean Healey, the 55-year-old chairman and CEO of AMG. "We believe this is an enduring trend."

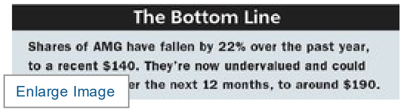
Another strength is AMG's geographical diversification. It has investments in firms with offices in 10 countries and affiliates on four continents. Their holdings literally span the globe, as well as asset categories.

Over the past 10 years, AMG's assets have grown from $241 billion to $700 billion. The only two years they didn't rise were 2008 and 2015—that is, amid the financial crisis and when a couple of big sovereign wealth managers withdrew funds to cope with problems caused by the drop in oil prices. Despite a hiccup caused by Brexit in June, AMG's asset gains should revive this year as AQR, BlueMountain, London-based private-equity specialist Pantheon Ventures, and alternatives manager First Quadrant have posted good numbers. New flows seem to be "back on track," says Craig Siegenthaler, a Credit Suisse analyst who's bullish on the shares.

Helping attract new money are a few popular fund reopenings. Following a year of strong performance, Yacktman again started to accept investments in two flagship funds in the middle of last year. Tweedy Browne recently reopened its Global Value Fund II, which had been closed for two years.

SOLID PERFORMANCE and fund openings should continue AMG's consistent organic growth (not counting market appreciation), which totaled $128 billion over the past 25 quarters. Siegenthaler estimates that the company will generate 2% to 4% in annual organic asset growth over the next three years, compared with an annual loss of 3% of assets at its publicly held peers.

The $128 billion in organic growth coincided with $216 billion in assets from acquisitions. Siegenthaler expects AMG to invest about $5 billion in money managers over the next five years, using spare funds to buy back its own stock. The current environment is ideal for buying good managers at good prices. Among AMG's recent acquisitions are Winton Capital and Baring Asia. Says Healey: "Our investments arise out of relations built up over years. At any given point, there's always a pipeline of active discussions going on."


The Bottom Line

Shares of AMG have fallen by 22% over the past year, to a recent $140. They're now undervalued and could ...er the next 12 months, to around $190.

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Revenue has been affected by the sovereign withdrawals, but should trough this year. After totaling $2.5 billion in 2015, they are expected to fall to $2.3 billion for 2016, before hitting $2.5 billion again in 2017.

Profits, meanwhile, continue to rise. Earnings adjusted for extraordinary items, $691 million, or $12.55 a share, in 2015, could hit $12.86 a share this year and $15.05, by 2017.

AMG's rising assets, revived revenue, and growing profits are occurring in the face of real challenges for active fund managers. "These past few years, we've been in a market that's bad for active managers, a steadily rising market that favors indexers," says Tim Cunningham, portfolio chief of the Thornburg Core Growth fund, which owns AMG shares. "AMG's figured a way around the malaise, assembling a complex that's incredibly diversified. I don't know what's going to change. But at some point, active will be back in favor."

CEO Healey agrees. "People piling into index funds are making one of the classic mistakes of assuming that the current condition will extend into the future indefinitely. The one certainty is markets change. And portfolios should be designed with that in mind." A bet on AMG is a wager that it's ready for the next change.

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