

February 5th, 2010

Dear clients and colleagues,

In the past month investors' doubt on the economic recovery has been increasing, mainly due to on-going high unemployment and balloon deficits in developed countries plus tightening policies in some fast-growing emerging countries. The stock market turmoil seemed contagious among various asset classes and regions. However, Global Small Cap demonstrated the most resilience against the downturn and the least correlation with others. Here are the Jan 2010 returns of key indexes in CAD\$: TSX -5.35%, TSX Small Cap -2.94%, MSCI World Large Cap -2.24%, MSCI Emerging Market -3.79%, and MSCI World Small Cap -0.49%.

The company we want to profile this week is Federated Investors (FII US). www.federatedinvestors.com

Business Description

Founded in 1955 in Pittsburgh, Federated Investors is a top 6 mutual fund company, the 3rd largest money market fund manager, and the largest institutional money market fund manager in the US. It manages about \$370B in assets, including \$294B in money market and the rest in equity and fixed-income funds. The company has over 200 investment management professionals, offering 145 products to 5,200 clients including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers. FII has been a member of the S&P 500 index since 2003.

Market Data

market cap US\$2.5B, 0 net debt, dividend yield 3.9%, net revenue growth 1996-2009 CAGR 11%, p/e (12/2010e) 12.1x, roe 40.8%, 1-year return 24%.

Target Market

According to Investment Company Institute (ICI), the US has the largest mutual fund market in the world, with \$9.6 trillion in AUM at the end of 2008 vs. \$19 trillion worldwide. Back in 2004, US mutual fund assets were \$8.1 trillion.

The US money market fund is a US\$4 trillion industry, accounting for 40% of US mutual fund. It has been growing rapidly in the past decade, especially in 2007 and 2008, reflecting the flight to safety sentiment of investors during the financial crisis. Money market funds managed 32% of US businesses' short-term assets in 2008.

Competitive Advantages

- Industry leader: According to Strategic Insight ranking by AUM, FII is in the top 2% money market fund managers in the industry, the top 6% fixed-income fund managers and the top 8% equity fund managers. It has been consistently gaining market share, now at over 8.5% vs. 7% in 2007 and 5% in 2000.

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- Solid investment performance: Lipper rankings for 2009 are as follows. For FII's equity funds, 62% of the rated assets are in the first or second quartile over the past three years, 81% five years, and 79% 10 years. For bond assets, the comparable first and second quartile percentages are 68% three years, 76% five years, and 80% 10 years.
- Diversified multi-asset class portfolio: It enables FII to grow consistently through cycles. Net revenue CAGR for 1996-2009 is 11%. AUM CAGR for 2002-2009 is 9.6%.

Competition

The industry is highly competitive. There are over 130 money market fund management firms. The two biggest players are Fidelity Investments and JPMorgan Chase. According to ICI, at the end of 2008 there were over 8,000 open-end mutual funds in the US.

Growth Strategy

Distribution strategy: FII expands multi-asset-class products and multi-channel distribution. It has also been active in M&As.

Management

The founders and their families (Donahue and Fisher Family) are still active in management. All executive officers and current directors collectively own over 14% of the company.

Risks

- Interest rate risk: Fee waiver of investment products yielding zero or negative return reduces the revenue.
- Shifting asset mix: outflow of money market fund tends to increase when the economy recovers.
- Revenue concentration risk: By customer, Edward Jones and the Bank of New York Mellon Corp accounted for a total of roughly 31% of FII's revenue in 2008. By product, approximately 13% of FII's total revenue in 2008 was from services provided to the Federated Kaufmann Fund.
- Potentially more strict regulations: US SEC has tightened money market mutual fund regulations recently. The debate on applying capital requirements on money market funds is on-going.

Investment Theme

- Rising interest rates: The pressure of fee waiver will be relieved as rates increase. FII's revenue is expected to return to the normal growing trend.
- Industry consolidation trend: In the past decade, the percentage of industry assets at larger fund firms has increased partially due to acquisition of small firms. The share of assets managed by the largest 25 firms increased to 75% in 2008 from 68% in 2000. FII has been active in M&As and gaining market share.
- Internal asset shift: In the uncertain economic environment, new clients and new assets move to FII mostly for its high-quality money market products. As the situation improves, equity fund and fixed-income fund are more in favor. We expect some clients retain their assets with FII and switch asset class internally.

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Valuation

Target price = \$34, using DCF model at growth rate of 8.4% for 9 years, 6% at maturity, and risk premium of 7%. Expected rate of return = 41%

Have a nice weekend.

The Global Alpha Team

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