

# FEDERATED INVESTORS



Federated Investors Incorporated (Ticker: FII), together with its consolidated subsidiaries, is a provider of investment management products and related financial services. The Company sponsors, markets and provides investment-related services to various investment products, including mutual funds and separately managed accounts. Its principal source of revenue is investment advisory fee income earned by various subsidiaries of Federated.

Of the 137 mutual funds sponsored by Federated, its investment advisory subsidiaries managed 52 money market funds (and cash equivalents) totaling \$136.4 billion in assets, 49 fixed-income funds with \$22.2 billion in assets and 36 equity funds with \$16.2 billion in assets as of December 31, 2002. Since its founding in 1955, Federated Investors, Inc. has grown to become one of the nation's largest investment management organizations with assets under management of approximately \$202 billion. The company was recently added to the S&P 500 Index.

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Using Conscious Investor we see that FII has traded as high as \$32.80 on a price-earnings ratio of 23 in year 2001, but has now eased back slightly to \$29/30 per share and trades on a multiple of 17. Over the past ten years, the stock has traded on multiples as low as 9/10 so at present it's selling on a multiple closer to the asset management industry average. But remember, short hand methods of valuation such as the PE Ratio don't tell the full story about a company.

As we said last month, at any one point in time there are only going to be a small number of stocks that meet our price guidelines as well as our investment guidelines. As investors our job is to continually search for companies that fit the bill and often that means we will have to be patient. Hence, the Conscious Investor Watchlist which you can access on our website.

We encourage Conscious Investor® subscribers to follow along on the software and analysis sheets as you work through the report. As well as getting a better understanding of this company, you will also be honing your skills to use Conscious Investor to find and analyze other great companies. The sort of companies that are selling at low prices which you may hold for the rest of your life.

## Part 1: Introduction

With over 135 different domestic and international equity, fixed-income and money market mutual funds, as well as a variety of separate account options, Federated provides a diversified product line through financial intermediaries aiming to meet the needs of a broad range of investors. Product performance, breadth and innovation, combined with one of the largest wholesaling sales forces in the industry, have enabled Federated to achieve substantial asset growth over its 48-year history.

### Time Tested

Mr. John F. Donahue founded the company in 1955 and currently serves as chairman. A timeline of the company's history can be seen on the Federated Investors website at <http://www.federatedinvestors.com/company/history.asp>

### Industry Category

Federated Investors can be located in the highly competitive "Asset Management" sector, along with twenty four other companies such as Eaton Vance, Principal Financial, T Rowe Price, Janus and Franklin Resources. With a market capitalization of \$3.3 billion, Federated is by no means the largest in its sector but far from the smallest. When you choose this sector, Federated Investors is the only company that appears on the radar so we know it meets all the Conscious Investor defaults, which is an encouraging start for our analysis.

## Part 2: Understanding the Company

So what does the company do? Federated manages more than 135 equity, fixed-income and money market mutual funds to suit investors with a variety of goals, time horizons and risk tolerances. Mutual funds own many securities that cross sectors and/or regions and enable investors to diversify.

Federated's investment products are primarily distributed in four markets. These markets and the relative percentage of managed assets at December 31, 2002 attributable to such markets are as follows: trust market (52%), broker/dealer market (23%), institutional market (14%) and international market (1%).

Federated has provided customized separate account management since 1973. Traditionally, institutional clients have been the primary clients, but now Federated offers high-net-worth individuals with investable assets of over \$100,000 the same ability to tailor a portfolio of individual stocks and bonds by working through select financial consultants.

Saving for retirement is one of the most common investment goals. Through financial intermediaries, Federated provides tax-advantaged retirement savings vehicles such as 401k policies, IRAs and variable annuities. Federated offers, in conjunction with Nationwide Financial,

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Retirement Ally<sup>SM</sup> a “back to basics” customizable variable annuity product with diverse fixed and variable investment options.

Federated offers “529 Plans” which are increasingly popular education saving vehicles with estate planning benefits, offering tax-advantaged growth, federal tax-free withdrawals and high contribution limits with income restrictions. Federated and Schoolhouse Capital LLC are jointly offering USACollegeConnect<sup>SM</sup>, a 529 plan product featuring individual investment portfolios, as well as age-based portfolios.

Using Federated’s money market funds, investors can select among nearly a dozen cash management conveniences and achieve diversification and liquidity for their cash investments.

### Scuttlebutt

In recent times, Federated has diversified into equity funds, giving it greater exposure to an eventual sharemarket recovery. Investors seem to have noticed and the stock has recovered from its lows of around \$23. Merrill Lynch & Co. was forecasting early in the year that the stock could jump 41%, to reach \$36, in the next 12 months.

Federated grew total and average managed assets in 2002 and 2001. Period-end managed assets increased 9% in 2002 and 29% in 2001. Average managed assets grew 18% in 2002 and 25% in 2001. Federated benefited from good product performance, the strength of its relationships with intermediaries and institutions, and an increase in cash-management relationships with corporations, government entities and other institutions. These increases in total and average managed assets during 2002 and 2001 reflect strong sales of money market and fixed-income products in each year. Net sales of fixed-income fund assets grew 43% in 2002.

This growth was reflective of a shift toward short-term bond funds during the year as interest rates and yields on money market funds continued to fall. Money market average assets grew 22% in 2002 and ended the year with more than \$150 billion in assets. This strong growth included the addition in the second quarter of 2002 of \$13.2 billion in money market assets for TexPool, Texas’ local government investment pool.

In 2001, money market products led in average asset growth with a 37% increase over the prior year. Average equity assets declined in both 2002 and 2001 primarily as a result of market depreciation, although net equity sales were positive for 2002. Changes in Federated’s average asset mix year over year have a direct impact on Federated’s total revenue due to the difference in the fees per invested dollar earned on each asset type. Equity products generally have a higher management fee rate than fixed-income or money market products. Hence Federated’s keenness to expand its equity fund offerings, although it is regarded as a money market specialist. The most effective way to do this, and the quickest of course, is to simply buy up other funds and that’s what Federated and others have been attempting to do lately.

In this business, companies battle constantly against adverse market movements which eat into the management fees earned based as they are on funds under management/advice. It’s no wonder then, that asset managers are constantly on the lookout for takeover targets, to protect themselves against falls in the value of existing funds under their control.

Unlike Walgreens, last month’s example stock, Federated’s expansion hasn’t come at the cost of margins which have averaged around 28%pa net for the last five years, more than double the

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industry average and even further ahead of the average S&P 500 company. Assets under management are up \$62 billion since 2000.

BusinessWeek earlier in the month (August 4, 2003) was reporting that “buyouts of money managers and mutual-fund companies have kicked into gear”. Lehman Brothers Holdings Inc. made the biggest splash on July 22 with its \$2.6 billion purchase of asset manager Neuberger Berman Inc. But other big players, from American Express to Charles Schwab, are swooping in to buy part or all of companies that manage sizable portfolios. Citigroup, the nation’s largest financial company, says it, too, is in the market. “There’s a lot more stuff that hasn’t hit the radar yet,” says Kerrie MacPherson, head of Ernst & Young’s financial services transactions group.

Why now? The biggest quarterly advance in stock prices since the end of 1998, coupled with an avalanche of new cash from investors, has given money-management firms a big profit lift. The companies generate higher fees as the assets they manage increase. And assets are soaring: Net flows into equity funds in June totaled an estimated \$19.5 billion, according to fund tracker Lipper, the most since March, 2002. “A lot of managers are thinking, hey, there’s some light at the end of this tunnel,” says J. Christopher Donahue, CEO of Federated Investors Inc., which on July 18 bought eight mutual funds with \$470 million in assets from Riggs National (RiGS) Corp.

The buzz ignited the stocks of publicly traded managers. The sector has soared 24.5% this year through July 22, double the increase in the Standard & Poor’s 500-stock index, according to financial-stock specialists Keefe, Bruyette & Woods Inc. (KBW). Many of the stocks -- including Eaton Vance, Affiliated Managers Group, and Janus Capital Group have hit 52 week highs.

But some analysts believe that stock prices and the buyout bids have raced ahead of results. Valuations remain 17% above historical averages, at nearly 19 times expected fourth-quarter earnings, says Glenn Schorr, analyst with UBS Investment Research. “Investors may be overestimating improving fundamentals by underestimating cost pressures in the business,” he says. Negatives include market saturation and regulatory uncertainty regarding disclosure and fees.

The recent deals weren’t cheap. Schwab & Co. paid \$365 million for State Street Corp.’s trust assets. Sanford C. Bernstein & Co. analysts reckon that works out to 3.2% of assets under management, way over the industry’s median 1.9% and higher than the 2.3% Schwab paid for U.S. Trust in 2000. But important elements of the acquisitions being made are retention of the culture and talent of the key people. Asset management groups are aware of the brand strength of the outfits they take over (or at least the smart ones are) and are therefore mindful of the need to retain a good name and the people responsible for premium performance if a good track record exists, so as not to alienate existing investors of the fund being acquired.

Financial services has been the No. 1 sector for dealmaking since 2000. So far this year, there have been \$35 billion in transactions, but Lehman’s is the first megadeal, according to Eric C. Weber, a consultant at Freeman & Co., a New York investment bank specializing in financial services. Most of the activity, he says, will center on boutique firms.

Franklin Resources, T. Rowe Price Group Inc. and others, such as State Street and Eaton Vance Corp., are the more pure asset management companies. They are also among the biggest and like to proclaim their independence. Still, the flurry of activity has observers wondering who’s next. Future deals likely will be struck to broaden product mix or pick up cheap assets at battered firms.

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Even though it lost a raft of key managers, the once white-hot Janus still manages \$150 billion in assets, making it an attractive target.

But for the right price, just about anyone -- even if they're not officially for sale -- could cave. "I haven't been granted the right to just say no," says Federated's Donahue, who sold his company once before to Aetna Inc. in 1982 for \$256 million. (He bought it back 14 years later.) If the market keeps it up, managers like him may see some more hard-to-refuse offers coming their way. The challenge for Federated Investors in the future is to expand funds under management without paying too much for acquisition targets and to keep costs generally under control. The asset managers who can accomplish this will be the ones to flourish in the future.

### **Economic Moat**

We know that Warren Buffett looks for companies with a strong and sustainable competitive advantage due to the services or products of the company. We refer to this as the economic moat around the company. In the next sections we look at the type, strength and sustainability of the Walgreens economic moat.

#### Type

Financials stocks have barriers to entry and manage to enjoy high returns on equity (at least ones like Federated Investors do) because, increasingly, this is a business that depends on scale and cost control. Scale provides public profile and leads to brand awareness -- the better recognized you are the more funds you can attract. Asset management groups vie with each other to increase funds under management and their slice of the growing advice industry and are constantly looking to make acquisitions to increase their presence in both areas.

FII can boast brand recognition as a major strength but also financial strength in its industry, which allows it to spend money on acquiring smaller competitors and build funds under management. The bigger you are the bigger you get. Federated is also regarded as a specialist short term (money market) manager and so exploits this reputation when looking to develop hopefully long term relationships with new clients.

#### Strength

Strength plays a big part in the moat of an asset manager. Federated Investors is a top 10 mutual fund company and recently ranked the largest institutional money market fund manager with approximately \$202 billion in assets under management, up \$62 billion since 2000.

When people invest their hard earned savings they like to know they're with the big names. There's a kind of security I guess, although big doesn't automatically mean safe. Witness Enron and Worldcom for starters. But there is a perception also, among those who aren't investment specialists, that big must also mean better. In the same way that there are people out there who think that a broker's advice can be relied upon or that most actively managed investment funds can actually do what you pay for -- outperform their benchmark indices.

So asset management groups are keen to play this up -- we have the security, we have the research capability, all these highly intelligent professionals working to make you money in good markets and bad, and so on. And it works, people continue to pour money into managed funds year after year so the message they want to deliver must be getting through.

Although it specializes in money market funds, and indeed its strong presence in this area provides protective barriers to entry, it has diversified into equity and fixed interest funds more

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recently so that it is now ranked in the top 5% of all equity fund managers and the top 4% of all fixed interest fund managers, as well as being in the top 1 percent of all money market mutual fund managers.

Having a diversified product mix affords protection against downturns in any one market and the fund outflows that can result, affecting earnings. Fund outflows are one of the greatest risks that fund management groups face on an ongoing basis hence the need to retain key quality personnel and/or maintain investment strategies that provide consistent results. Federated Investors prides itself on maintaining a seasoned investment management team with nearly 150 professionals each boasting 17 years average market experience.

As a member of Conscious Investor, you probably already know that the vast majority of investment professionals will fail to beat the market over time and the bigger they get the harder it becomes to achieve this elusive goal. So I have a tendency to take the claims of organizations such as Federated Investors (claims like investment expertise and market savvy leading to outperformance) with the proverbial grain of salt.

Having said that, perception is everything and we can safely assume, I think, that organizations such as Federated Investors will flourish and continue to meet the needs of the average investor who should be well pleased with the results that managed funds should produce over the long term. For those who (for whatever reason) give little considered thought to investing in general, managed funds are a wonderful product, enabling even investors with limited dollars, to reap the benefits of investing in most of the major asset classes. And the choice available these days is truly staggering. But if investors are going to expect better than average results from investment funds then past performance would suggest that disappointment is likely to be the end result.

### Sustainability

Federated management believe that the investment management industry will remain a growth sector both in the US and around the world and there would be few who would take a contrary position. It's true that market fluctuations will continue to impact earnings from time to time, but growth in the overall industry should continue apace for many years to come.

Retirement planning and provision of funds for the education of future generations seem to be major issues worldwide and should underpin demand for investment products and advice such as those provided by Federated Investors. Longer lifespans are forcing people to fund increased retirement periods and possible regulatory changes that propose increased savings limits into retirement savings vehicle such as 401(k) plans, as well as the privatization of retirement savings could fuel this growth even more strongly.

Managed funds continue to appeal to a growing number of young, old and in between consumers, particularly those who lack the time or the inclination to research their own investments, and because of this, their future would seem assured.

Therefore, the sustainability of Federated Investors competitive advantage will depend on its ability to continue to expand its influence by sensible acquisition of competitors to grow market share, as well as garnering as much as possible of the growth potential of the industry itself.

### Management Ability

Federated shareholders can take comfort from the fact that founder and current Chairman, John F. Donahue, a veteran of the industry, remains a substantial shareholder owning presently, almost

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12% of the company's outstanding stock – a stake worth around \$400 million. His son, President and CEO, J. Christopher Donahue, owns a stake worth roughly half that or around 6% of the outstanding stock. Mr. John W. McGonigle, chief legal officer for Federated as well as fulfilling the roles of secretary and director, joined the firm in 1966 and has been executive vice president of Federated since 1995. He also has a substantial stake, owning 5% or \$173 million worth of the company's stock.

I for one, always prefer to invest in companies where the founders or present management (preferably both) retain substantial percentages of their net worth in the company. I believe it gives a level of focus and dedication that is unlikely to exist when those in charge of the company's future have exposure that extends to nothing more than their annual compensation package.

Judging by the financial results, the Donahue father and sons (J. Christopher's brother, Thomas R., is a director and Chief Financial Officer) no doubt ably supported by the other members of the management team have guided the company to its present position as a leading force in the asset management industry. As long as they stay in place, stockholders can reasonably expect the good results of the past to continue, while remembering the growth prospects for the industry itself remain bright for the long term future.

### **Effect of Inflation**

Warren Buffett believes that all businesses are hurt by inflation but some definitely more than others. The ones that suffer the most he says are those that require large amounts of fixed assets to operate. Businesses that do not require as much in the way of fixed assets are still hurt but to a lesser degree. Buffett says the businesses that are hurt the least are the ones that have a significant amount of economic goodwill.

What is meant by economic goodwill? Buffett says that companies that generate high returns on capital are worth a lot more than the sum total of their recognizable assets, particularly if that return has been achieved without the use of leverage (borrowings). Generally this is achievable because the company has a superior product or service that allows it to charge more than the competition or because it has little or no competition in the first place.

What does this have to do with inflation? Well, Buffett believes that companies that have a lower need for fixed assets are better able to withstand the effects of inflation (because they don't have to wear the resultant increase in cost of replacement assets, raw materials etc when inflation and interest rates start to rise) and that the value of economic goodwill can therefore increase in times of inflation.

This is one of the main reasons why Buffett prefers to invest in companies that do not require heavy periodic reinvestment in plant and equipment or high expenditure in raw materials, energy and labor costs, because when inflation strikes, the cost of all these inputs will rise and the ability of the company to recoup these higher costs by charging higher prices is not guaranteed.

Federated Investors would seem to have the characteristics required to ensure at least some degree of pricing power or economic goodwill. It has above average return on capital and this measure has been consistently above 20%pa for each of the last six years and climbing beyond 50% in each of the last two years. Long term debt has been substantially reduced. And we know there is no shortage of demand for the company's products.

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Net profit margins are very high, having averaged 23.5%pa for the last five years, quite a bit above the industry average of 15.7% which shows some level of competitive advantage and around four times that of the S&P 500. Not all asset managers then, have achieved such healthy margins so Federated management have clearly done well to grow the company profitably and to a position of great strength. If the companies you invest in are to provide at least some level of protection against inflation then they **MUST** possess competitive advantages (moat/s) which allow a degree of control over the price charged for their goods or services and the greater that moat the better.

Remember, Warren Buffett would rather his managers concentrate on expanding the moat each year instead of becoming obsessed with meeting the market's profit expectations year in and year out. It really is as he says, a case of looking after and growing the moat and the profitability will take care of itself.

### Capital Intensive

Federated's most significant operating expenses include compensation and related costs, which represent fixed and variable compensation and related employee benefits, and marketing and promotional costs. Competition for investors funds is intense, and asset managers need to develop new products to take advantage of changing legislative and market conditions as well investor preferences. Obviously then, advertising and related costs such as maintaining a sizeable sales force need to be managed carefully, but Federated Investors management seems to have been able to do this thus far, judging by the healthy profit margins and return on capital.

It's fair to say I think, that any company that can maintain such a high return on capital and well above average profit margins is not a capital intensive business. Management expect to continue to acquire smaller competitors to build funds under advice and may need to borrow funds in the future to accomplish this but their past record is obviously very good and with the founder and two family members still actively involved in the business capital expenditures will surely be undertaken wisely. Stockholders will certainly be hoping for this and that the company can exercise restraint and not overpay when acquiring other fund managers which is becoming an important issue in the present round of deals being struck in the industry.

Federated's management has stated that they will continue to pay regular dividends and repurchase stock (as it did last year) should this prove to be advantageous to stockholders. Despite acquisitions made in the past and the on going costs associated with marketing, promotion and employee compensation, the company maintains well above average return on equity which when coupled with low debt (debt equity ratio is 0.19 as opposed to the S&P 500 average of 1.23) signify a superior business able to be one of the dominant players in its industry and increase market share at the expense of its competitors.

Any business that can generate above average return on equity/capital without high use of leverage has advantages in this area. It's the companies that are best able to afford leverage that usually don't need very much if any and the businesses with high capital needs that often struggle with a debt laden balance sheet to produce average or below average returns. Federated Investors is a good example of this oft-seen fact of business life.

### Other Comments

Go to [http://www.federatedinvestors.com/company/press\\_release.asp](http://www.federatedinvestors.com/company/press_release.asp) to see a very good power point summary of Federated Investors business which will help with developing your understanding of the company.



Click on this URL <http://www.federatedinvestors.com/company/investor/AnnualReport.asp> to access the company's latest annual report.

## Part 3: Conscious Investor Quick Analysis

Now we will look at the six areas of the Conscious Investor Quick Analysis. We have presented this in Viewlet form so click [here](#) to view this part of the Federated Investors analysis. (Or copy and paste the URL [http://www.conscious-investor.com/newsletter/viewlets/fii\\_viewlet.swf.html](http://www.conscious-investor.com/newsletter/viewlets/fii_viewlet.swf.html).) It is recommended that you complete one of the forms as you follow along on Conscious Investor. You can pause the Viewlet and recommence at any time. (You can download these forms from the subscriber-only section of the website.)

## Part 4: Finding the Right Price

Also in the Viewlet you will see an analysis of Federated using the Conscious Investor Scenario Analysis to help determine a profitable price to pay under your margin of safety.

Happy Investing!

### Disclaimer

*The above information does not take into account the particular investment objectives, financial situation and needs of any particular investor. As a result, investors using any of the information contained in this document should assess whether it is appropriate in light of their own individual circumstances before acting on any information provided.*

*The information provided in this document is not intended to give investors specific advice as to whether they should engage in a particular strategy, or buy, sell, or hold any particular security or product specifically mentioned.*

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