IGM Financial Inc.: The Value Trap Rises

Description

IGM Financial Inc. (TSX:IGM) is a financial services firm whose stock yields an attractive 5% at current levels. At first glance, a beginner income investor may believe that the stock is a great buy, since IGM is a blue chip with over $133 billion worth of total assets under its management as of the end of 2015.

The dividend looks to be safe with a 69% payout ratio, and the company even has a history of hiking its dividend every few years. On the valuation front, the stock appears to be cheap with a 13.7 price-to-earnings multiple, a 2.3 price-to-book multiple, and a 3.5 price-to-sales multiple, all of which are lower than the company's five-year historical average multiples of 14.3, 2.4, and 4.1, respectively.

It has a fairly high yield, dividend safety, and the stock looks to be cheap, so it must be a buy, right?

Not quite.

Upon closer examination of the financials, you'll see some disturbing long-term trends. Margins are trending downward. Revenue and earnings growth are virtually non-existent, and going forward, earnings are likely to go on the downtrend because of the business that IGM is in. IGM-owned subsidiaries, MacKenzie Financial and Investors Group, both sell high-fee mutual funds, which are going the way of the dodo bird with the rise of ETFs, low-cost index funds, and DIY investing services.

You've probably seen the Questrade commercials on television, which take shots at mutual funds: "Why are my mutual fund fees so high, my returns so low, and you guys keep putting up record profits year after year?"

Canadians are starting to realize the true cost of actively managed mutual funds, and with more options available, I believe that's a major long-term headwind for IGM's wealth management businesses. That's more trouble for IGM's earnings trajectory, and that means dividend hikes will be less frequent in the years ahead.

Bottom line

Just because you're familiar with a business behind a stock whose yield is attractive doesn't mean you should invest in it, even if the stock appears cheap based on traditional valuation metrics. You must also examine the fundamentals to determine if a stock suits your long-term goals.

In the case of IGM, I believe it's a value trap, so income investors should steer clear of the siren song of the dividend yield, which may continue to increase as the stock tumbles over the next few years.

The stock has rallied ~20% over the past year, so if you're an IGM shareholder, I'd treat the rally as an opportunity take the profits and run for the hills. When you take the long-term fundamentals into account, IGM is one ridiculously expensive stock that could fall back to the $30 levels over the short to medium term.

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