

## Profiting from volatility

Events have been evolving rapidly since we last put pen to paper to write the monthly Spotlight. The international spread of Covid-19, alongside the breakdown of an agreement between OPEC and Russia regarding oil supply restrictions, has spooked markets into some of the worst days since 1987. One of the longest bull markets in history has abruptly come to an end.

The fall in security prices, despite the announcement of enormous government stimulus packages across the globe, shows the market's lack of confidence in monetary policy tools to solve what is essentially a health crisis. The imposition of quarantining, social distancing and travel restrictions have stoked consumer fear and as a result, we seem destined for an economic crisis – one that cannot be solved by lower interest rates.

As governments struggle to contain the virus, it is difficult to identify companies which we believe will both outperform in the current environment and are ones that we would be comfortable owning over the long-term. However, IG Group is one such company. Ordinarily, if a company had high exposure to the global equity markets, it would not be an obvious candidate for owning during a bear market. However, IG Group presents an opportunity to benefit from the increased volatility which we are currently seeing.

We were originally attracted to IG Group (IG) after a combination of factors caused a substantial sell-off in the stock. IG is a UK-based company which provides online trading in financial derivatives for retail and professional clients. Clients range from retail day traders to institutional hedge funds, but the common thread is that they tend to have a short-term horizon when speculating or hedging and in aggregate, are equally inclined to go long or short. Higher volatility associated with falling markets boosts IG's trading volumes, hence revenues.

Rather than operating a bookmaker model, which requires clients to lose for the company to make money, IG operates an agency model by hedging counterparty exposure to clients, so their interests are aligned.

A period of exceptionally low volatility in markets during recent years had depressed earnings with trading volumes significantly lower. This was exacerbated by the leverage limits imposed by UK and European financial market regulators on contract for difference (CFD) products, which resulted in a substantial drop in revenue.

Prior to the virus outbreak, we believed that the market was discounting the significant opportunities available to IG to re-capture revenue. The company has launched innovative new products which will allow users to access leverage, without exposure to the unlimited losses that the regulators were worried about. In addition, expansion into new markets offered further growth opportunities. We discussed these options more extensively in a recent CredoNews article, Match Winners. These factors remain reasons to own IG Group over the long term.

However, what makes the company particularly attractive in the current market environment is its positive exposure to market volatility. Just as low volatility has depressed earnings in recent years, a period of higher volatility should now buoy IG's revenues. Within the financial sector, IG stands out as one of the few companies that should benefit. In addition, unlike many other companies whose products are in high demand during the outbreak, IG has no supply side constraints to worry about. Indeed, we have already started to see the impact of this, with the company reporting strong results for its most recent quarter and an unprecedented trading value run-rate in the current period.

Volatility is cyclical, and cycles turn. Whilst we could not have anticipated that there would be a global outbreak of a new coronavirus and that it would have this specific effect, buying companies when expectations are low allows for positive earnings surprises.

In an uncertain macro-economic environment, we also look for companies with robust balance sheets, with strong cash generation and high returns on capital. IG fulfils all these criteria.

We are not aiming to buy companies where the only reason to own the stock is due to the current outbreak. We continue to focus on buying companies which we believe are attractive to own over the long-term. IG just happens to provide us with the opportunity to own an attractive long-term growth story, which should also benefit from the current market environment; a rare chance not to be missed.

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