Diary of a Private Investor   Phoenix   Colm Fagan 20 March 2016

In today's climate of extremely low interest rates, which forces savers to become investors, an investment that gives an income close to 6% per annum looks like a treasure, but is it fool's gold? That's the question posed by one of my largest investments, Phoenix Group Holdings ("Phoenix"), which accounted for over 15% of my portfolio at the end of 2015 and delivered a total currency-adjusted return (dividends and capital gains) of almost 23% in the year.

Phoenix is a life assurance holding company with an unusual business model. It doesn't actively sell insurance policies. Instead, it buys life assurance companies that are closed to new business and administers them until the final policies are claimed, which could be 50 years from now or even longer. Its Irish customers include long-standing policyholders of Scottish Provident.

Phoenix's main attraction is the dividend of 53.4p (€0.68) a share, which equates to an annual yield of 5.9% at the current £9.10 (€11.65) share price. A dividend of close to 6% is very attractive, but only if it can be maintained. My first job therefore is to check if the dividend is safe.

The main source of cash for dividends to shareholders is money that Phoenix receives from the underlying insurance businesses. Cash emerges from those businesses as policies go off the books; this allows safety margins in reserves to be released. The business has been a cash cow in recent years: dividends increased by over 25% between 2011 and 2014, and debt fell from 63% of gross book value in 2009 to 34% in 2014. In 2014, "normal" business generated net cash of three times the cost of the dividend and the sale of the non-core asset management business generated almost as much again. Results for 2015 will be published on Wednesday next.

Looking at projected cash flows for the next few years, I estimate that receipts from the underlying businesses, net of expenses and interest on borrowings, will be more than twice the cost of the dividend each year from 2016 to 2019, and will remain strong thereafter. Assuming everything goes to plan, cash flows over the next five years at least will be more than sufficient to cover scheduled debt repayments as well as dividends at the current level. A large chunk of debt is due for repayment in 2019. There should be enough cash on the balance sheet to meet the repayment; alternatively the money could be borrowed in the market, given the strong balance sheet. Therefore, the conclusion is that the dividend is safe for the foreseeable future.

Maintaining a high dividend is no good if it erodes book value. That hasn't happened in the past: despite the high dividend, book value per share increased from £10.58 at end 2013 to £11.43 by mid-2015, but the run-off nature of the underlying businesses means that Phoenix cannot defy gravity forever. Barring further acquisitions, book value must eventually fall as policies go off.

But acquisitions are very much on the agenda, thanks to the strong balance sheet. Acquisitions –at the right price - would boost book value. Phoenix missed out on a major acquisition opportunity towards the end of 2015. That particular company went for well in excess of book value, much more than Phoenix was prepared to pay. As a shareholder, I admire the directors' discipline in not overpaying, but they may not exercise the same discipline in future.

Phoenix's current share price is just 80% of book value. The fact that a company operating in a similar space was sold recently for well in excess of 100% of book value means that Phoenix itself could be a takeover target – and at a price well north of the current share price. Any thoughts I may entertain of getting a windfall profit from a takeover must be tempered however by the knowledge that book value is an arcane concept in life assurance - we are dealing with stocks of insurance policies that could stay on the shelves for decades, not bars of soap or packets of cornflakes that are easily valued and will be sold for cash within days or weeks - so it doesn't necessarily follow that Phoenix is a possible takeover target for a larger competitor. Nevertheless, the fact that the share price is at a discount to book value provides some upside potential.

As always, there are risks. Recent market volatility will have affected the values of Phoenix's insurance businesses, but thankfully not by much. I estimate that a 10% fall in equity and property values would cause only a 4% fall in book value. Other factors, for example an unanticipated increase in longevity or a widening of credit spreads, could have a bigger impact. Another risk is that regulators could ask insurers to do more to compensate customers for past failings. That is a live issue in the UK at present. Sterling could also fall further against the Euro, but I have hedged that risk.

Despite the risks, I believe that Phoenix is still a good long-term investment. Nevertheless, I recognise the risks associated with a high level of exposure to a single stock, so I have decided to reduce my holding to closer to 10% of my total portfolio.