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Asset Management

April 14, 2018

Financials – Capital Markets

Industry Rating **Market Weight**

Investment Thesis

We recommend a market weight for the asset management industry. The industry faces risks due to elevated asset prices and fee compression. Despite these risks, the industry offers increased growth and profitability to positioned firms through consolidation, rationalization, and international growth.

Drivers of Thesis

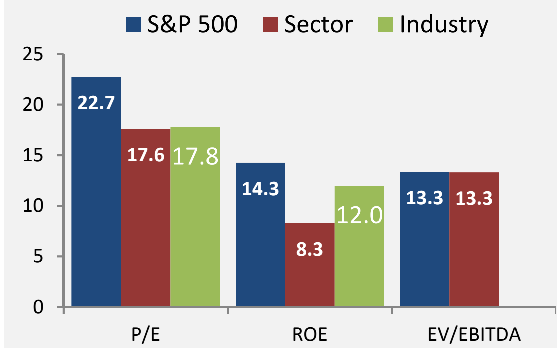
- Accelerating shift from high-cost active to low-cost passive strategies will cause growth in revenues to lag growth in AUM. Passive products received $1.4 trillion in net inflows from 2007 to 2016 while active products lost $1.1 trillion [2].
- Low-cost leader Vanguard's average expense ratio is estimated to be 82% lower than the industry average so we believe fee compression can continue for the foreseeable future [15].
- Strategically positioned incumbent firms such as BlackRock and State Street will realize significant advantages due to scale; establishing elevated barriers to entry and achieving above average growth and profitability

Risks to Thesis

- Accelerating economic expansion and resulting increases in asset prices and disposable income could propel revenues beyond forecasts. Increasing prices and net flows drive growth in AUM. This trend will not be able to completely offset the effects of fee compression, but with benefits of scale, leading firms will be able to improve operating margins.
- Proprietary, or tough to mimic, investment product innovation. Asset managers that are able to structure investment products based on strategic positions such as access, distribution, or scale, will be able to expand fees and generate AUM growth.

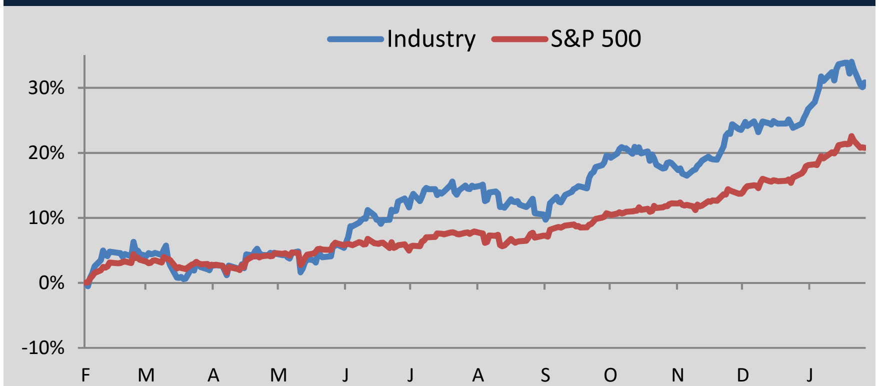
Top Competitors

Market Cap ($ billion)	
BlackRock	$86.2
BNY Mellon	$56.2
State Street	$38.8
T. Rowe Price	$25.9
Ameriprise	$23.8
AUM (2016, $ billion)	
BlackRock	$5,147
Vanguard	$4,700
State Street	$2,400
BNY Mellon	$1,648
T. Rowe Price	$692
Net Flows (2016, $ billion)	
BlackRock	$202
BNY Mellon	$(23)
State Street	$(151)
T. Rowe Price	$3.7
Ameriprise	$(15.8)



Sources: FactSet, [9], [10], [11], [12], [13], [16]

12 Month Performance



Source: FactSet

Industry Description

The asset management industry is composed of companies that manage capital on behalf of companies, governments, and individuals. Clients of the industry are most broadly classified as either institutional or retail investors. Institutional investors represent companies and organizations while retail investors represent personal investment made by individuals and families.

EXECUTIVE SUMMARY

The asset management industry faces slowing developed market AUM growth, forecasted 4.8% CAGR versus 6% globally through 2020 [17]. Emerging markets will offer much stronger growth potential with a forecasted AUM CAGR of 10.6% through 2020 [17]. Managing capital, for institutions or individuals, is as much based on relationships as on performance so growth in foreign markets will strongly favor companies who are able to build strategic networks for distribution.

In addition to slow domestic AUM growth all firms will face slackening revenues that fail to keep pace with AUM growth due to fee compression. Most investment products have become commoditized, yet there is an opportunity for creative firms with strategic distribution platforms that complement their product offerings to achieve above average revenue growth and profitability.

Yet, beyond these headwinds we believe the industry will continue to provide average to slightly above average returns as incumbent firms continue to gain advantages through scale, cost compression, and product innovation.

INDUSTRY DESCRIPTION

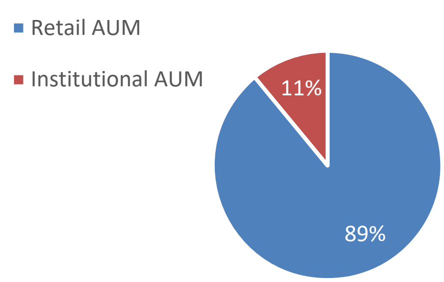
Top 10 Global Asset Managers by AUM

Firm	2017 AUM ($ trillion)
1. BlackRock (U.S.)	5.98
2. Vanguard Group (U.S.)	4.5
3. UBS (Switzerland)	3.1
4. State Street (U.S.)	2.67
5. Fidelity (U.S.)	2.4
6. Allianz Group (Germany)	2.27
7. J.P. Morgan Asset Man. (U.S.)	1.9
8. BNY Mellon (U.S.)	1.8
9. PIMCO (U.S.)	1.69
10. Amundi (France)	1.65

Source: Statista

The asset management industry is composed of companies that manage capital on behalf of companies, governments, and individuals. Clients of the industry are most broadly classified as either institutional or retail investors. Institutional investors represent companies and organizations including for-profit public companies, private companies, non-profit companies as well as governmental agencies and organizations such as state-administered pension funds. Precisely classifying institutional investors can be tricky because some institutional investors are assets managers themselves who actively manage a portfolio of direct investments, while others outsource all investment decisions to asset management companies, while still others execute some blend of both strategies. Retail, or individual, investors represent personal investments made by individuals or families, usually for specific financial goals such as building wealth for retirement or providing current income to live off.

Mutual Fund AUM by Investor Type



Source: ICI Fact Book 2017

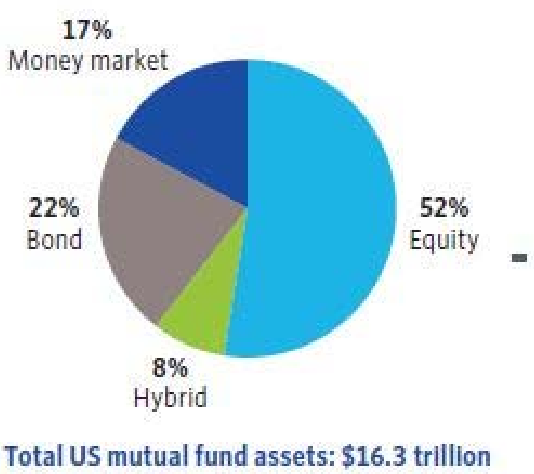
In 2006, the average account balance of institutional mutual funds was over $41 MM while the average retail mutual fund account was just under $27,000. [1] At the same time, there was more than 229 million retail mutual fund accounts while there were approximately 53 thousand institutional accounts. [1] Though the average retail account is much smaller than the average institutional account, retail investors hold the larger share of total AUM. According to the Investment Company Institute (ICI), retail investors held 89% of total U.S. mutual fund AUM in 2017. [2]

The gold standard for the asset management industry is assets under management (AUM). AUM refers to the total amount of capital under management for a given company, fund, investor class, etc. AUM must be distinguished from assets under custody (AUC). AUC refers to capital that is being administered, but not "managed." The difference between AUM and AUC is subtle, but very important. For asset management companies AUM means capital allocated to the firm for which the firm bears some form of decision-making responsibility. A firm holding AUC merely provides a service with respect to the capital such as record-keeping, dividend distribution, and trade settlement and clearing, but bears no decision-making responsibility. Many firms provide both functions (AUM and AUC) for various clients, but leading firms usually specialize and are more-widely known for either their AUM or AUC. The focus of this report will be on firms specializing on AUM.

Asset Classes

The basic units of the asset management industry, assets, come in a variety of classes. The most basic classification scheme roughly divides the industry into four asset classes: equity, debt, real estate, and alternative. Equity represents an ownership stake in some financial asset, usually a publicly-held company. Debt represents a promise to return borrowed capital along with some agreed upon interest. The real estate asset class represents an investment in property. The alternative asset class is diverse and includes investments in less liquid assets such as hedge funds, private equity, and venture capital. Although many of the leading asset managers offer exposure to nearly all asset classes, leading firms in each asset class tend to be specialized on that asset class. Adding one more level of complexity to asset class classification is the fact that asset management companies can offer exposure to these asset classes through a variety of vehicles. The two most common investment vehicles are the mutual fund and the exchange traded fund (ETF). Mutual funds and ETFs can be applied to virtually any asset class.

U.S Mutual Fund Asset Allocation



Source: ICI Fact Book 2017

Strategies

The second key classification is strategy. The Boston Consulting Group identifies five investment strategies that asset managers offer their clients, alternatives, active specialties, solutions, active core, and passive. [3]

Alternative investments could include nearly any asset but are generally characterized by exclusivity, illiquidity, high leverage, and secrecy. These types of investments include hedge funds, private equity, real estate, derivatives, and other conventional asset classes. Since investors in this space or consider more sophisticated, and required by regulation to be wealthier, the rules are far more relaxed and investment managers enjoy wide latitude to apply leverage, take concentrated positions, and restrict redemptions.

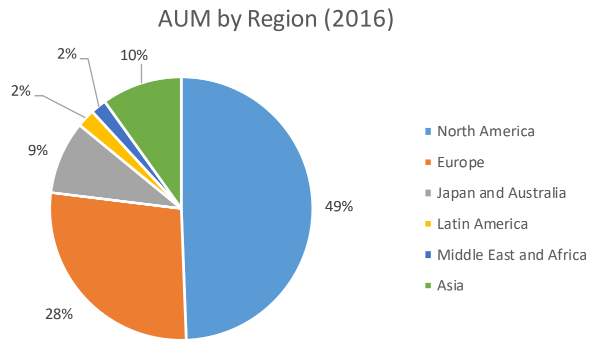
Active specialties and active core refer to investment portfolios that are actively managed and supported by research to try and select the best investment for total return given the investment mandate.

Passive strategies attempt to match returns for a given index by selecting and weighting appropriately the securities contained in that index.

Solutions strategies attempt to select securities and apply asset allocation strategies to achieve some defined goal such as retirement by a certain year. Target-date funds are an example of solutions strategies.

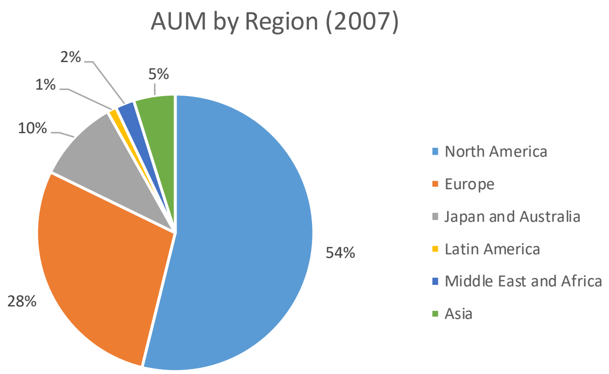
Global AUM Trends

In 2016, global AUM grew to $69.1 trillion, a 7% increase from 2015. North America makes up the largest geographical component with 49% of global AUM. North America is followed Europe with 28% of global AUM. The remainder of the world, the vast majority of the world's population included provide approximately 23% of global AUM. [3]



Source: BCG

These proportions are not fixed. Due to faster growth in Asia, Latin America, and the Middle East, the North American share of global AUM dropped from 54% in 2007.



Source: BCG

The mature asset management industries in the United States and Europe are growing at a modest 6% and 7% respectively, while the younger asset management industries in Asia (ex-Japan) and Latin America are growing faster at 16% and 14% respectively. The faster growth in these regions is even more pronounced in specific countries with China's AUM growing 21% in 2016 and Brazil's AUM growing 17%. [3]

INDUSTRY TRENDS

Shifting Strategies

Investor tastes are shifting significantly as a body of evidence is assembled that throws into question many long-held investor assumptions. Chief among these assumptions is that high-priced active core strategies will reward investors with superior performance because of talented portfolio managers. Challenging this assumption, mounting academic and practical evidence seems to indicate that investors are better served to eliminate costs and pursue returns based on indexed funds that track broad market performance. The result has been a significant shift of AUM from active core strategies to passive strategies. Active core AUM has decreased from 57% of total AUM in 2003 to 35% of total AUM in 2016, while passive AUM has doubled from 9% of total AUM in 2003 to 18% in 2016. This trend is expected to accelerate as BCG forecasts that passive strategies will occupy 20% of global AUM by 2021.

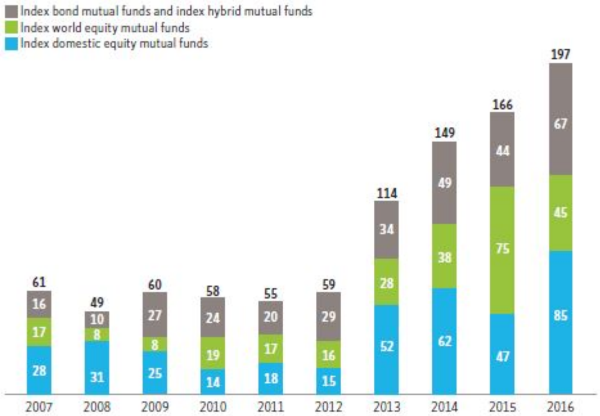
The chart below depicts each strategy's share of global AUM and revenue for the selected years of 2003, 2008, 2015, 2016, and 2021. A significant feature of this chart is the rapid decrease in AUM committed to active core and the rapid increase in AUM committee to passive. The effect of fee compression is on full display as passive investments grew to occupy 18% of global AUM by 2016 but contributed only 6% of global revenues.

Global AUM and Revenue by Product

Source: The Boston Consulting Group (BCG)

This shift to passive strategies is further reinforced by the following chart which shows net new cash to bond and equity index funds from 2007 to 2016. There has been a dramatic and sustained investor preference for index (passive) products across asset classes since at least 2013.

Net New Cash to Index Funds ($, billions)



Source: ICI Fact Book 2017

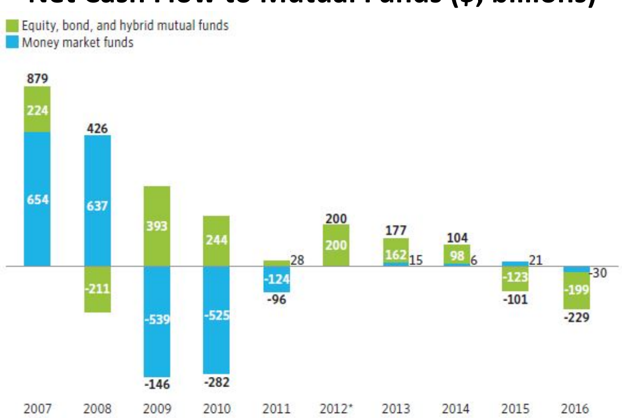
Hand-in-hand with the shift from active to passive strategies is the shift from core to specialty and solutions strategies. Passive strategy products aren't the only products increasing in share of AUM. Solutions strategies have more than doubled from 6% of AUM in 2003 to 13% in 2016 with a forecast to grow to 15% by 2021. Similarly, alternative asset strategies grew from 9% of AUM in 2003 to 15% of AUM in 2016 and are forecasted to reach 16% of AUM by 2021.

Product Innovation

The shift from passive to active has also impacted the product mix that asset management companies offer. Fund flows to ETFs are increasing, while fund flows to mutual funds are declining.

As depicted in the chart below, net cash flows to mutual funds have steadily declined from $879 billion in 2007 to ($229) billion in 2016.

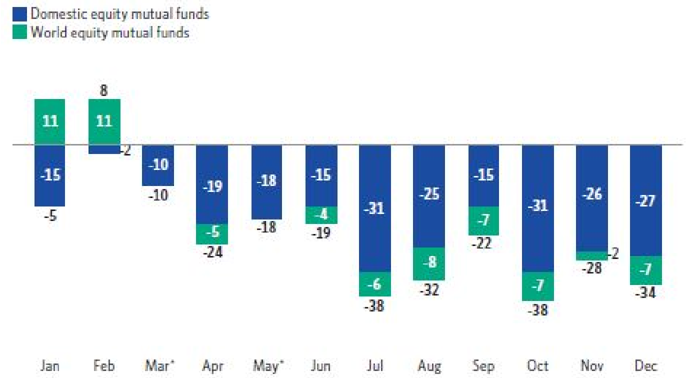
Net Cash Flow to Mutual Funds ($, billions)



Source: ICI Fact Book 2017

This trend is highlighted even further by looking exclusively at equity fund flows in the last year. Net new cash to domestic and global equity mutual funds was negative for 10 out of 12 months in 2016.

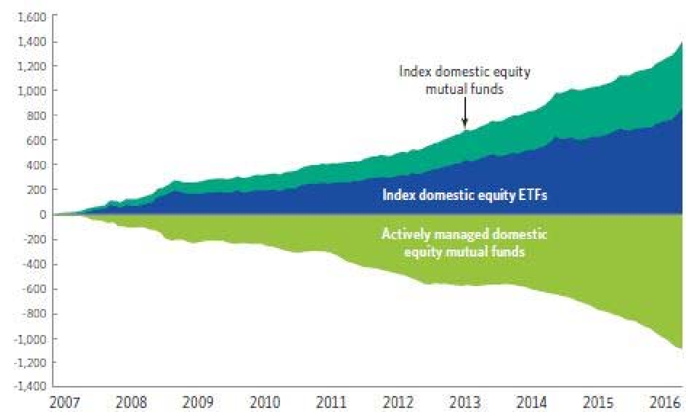
Net New Cash to Equity Mutual Funds ($, billions)



Source: ICI Fact Book 2017

Many of these funds are flowing into ETFs. The chart below shows that a large component of funds leaving active-strategy mutual funds are being captured by ETFs.

Cumulative Flows to Domestic Equity Funds



Source: ICI Fact Book 2017

Regulatory Environment

In 2016, the U.S. Department of Labor (DOL) issued the "fiduciary rule" which would require any individual or organization providing an investment service regarding retirement assets to put the interests of the client above their own. For the asset management industry, the most practical application of this rule affects the way mutual funds are distributed. In the past, mutual funds were distributed with various sales incentives attached. These sales incentives, often called "loads", were seen to introduce a potential conflict of interest for the investment advisor. Investment advisors might recommend specific funds to their clients based on the sales incentives provided by the issuing asset management company and not based on the interests of their client. The Fiduciary Rule seeks to eliminate this potential conflict. In 2017, enforcement of the Fiduciary Rule was delayed until July 1, 2019. Despite the delay, many asset management companies have already responded and adjusted their businesses accordingly. As depicted in the table below, nearly all growth in U.S. mutual fund AUM has occurred in "No-Load" mutual funds.

Mutual Fund Assets by Load Class

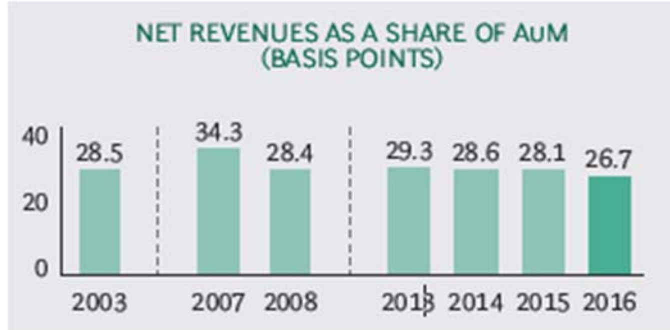
Total Net Assets of Long-Term Mutual Funds Are Concentrated in No-Load Share Classes
Billions of dollars, 2007–2016

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
All long-term mutual funds	$8,914	$5,788	$7,797	$9,030	$8,942	$10,361	$12,331	$13,149	$12,896	$13,616
Load	2,795	1,722	2,185	2,352	2,176	2,362	2,652	2,615	2,440	2,371
Front-end[1]	2,190	1,374	1,750	1,882	1,751	1,893	2,148	2,116	1,989	1,948
Back-end[2]	204	102	98	78	50	39	32	24	15	9
Level[3]	379	237	328	381	367	417	459	468	429	408
Other[4]	10	7	8	8	7	11	10	7	6	6
Unclassified[5]	12	2	2	3	1	2	2	1	(*)	1
No-load[6]	4,587	3,067	4,249	5,090	5,224	6,261	7,598	8,382	8,373	9,093
Retail	3,091	1,951	2,659	3,068	2,991	3,464	4,142	4,639	4,598	4,886
Institutional	1,497	1,116	1,589	2,022	2,233	2,798	3,456	3,743	3,775	4,207
Variable annuities	1,346	854	1,130	1,291	1,251	1,398	1,629	1,671	1,596	1,637
"R" share classes[7]	187	146	233	297	290	340	452	480	487	514

Source: ICI Fact Book 2017

Fee Compression

In 2016 global AUM grew to $69.1 trillion, a 7% increase from 2015. The 5-year compounded annual growth rate from 2008 to 2014 was 5%. Asia and Latin America experienced the most pronounced growth in AUM, while growth rates in North America and Europe were close to average, and growth rates in the Middle East and Africa were below average. Yet, despite world-wide growth in AUM, 2016 was the first time since the Global Financial Crisis in 2008 where total industry revenues fell. This drop in revenues is the result of a longer term trend called fee compression. [3]



Source: BCG

Fee compression is a complicated anomaly that is most influenced by the trends discussed above, increasing AUM allocation to passive strategies and increasing compliance costs due to regulation. Investors have generally preferred lower-cost passive strategies to higher-cost active strategies. Increased regulation and demand for industry transparency have disrupted traditional distribution models that relied on healthy load commissions.

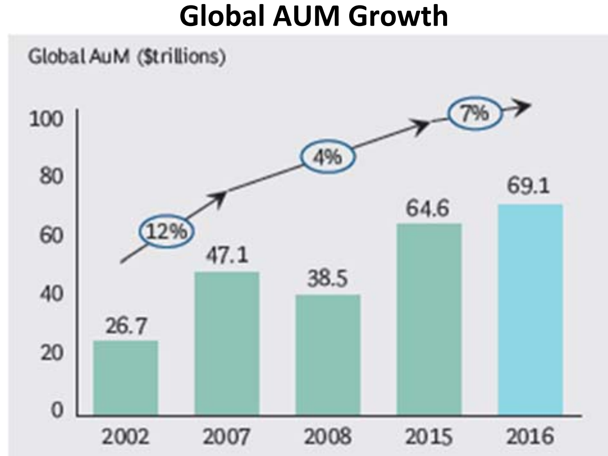
Though fee compression has acted to drag on total revenues among all asset classes and strategies, there are certain asset classes and strategies where fees have actually increased. Multiasset, fixed-income, and private debt strategy products have been able to increase net fees by 2%, 3%, and 2% respectively per year since 2010. [3]

Changing Demographics

Due to the aging global population there will be a tendency for assets to shift into income-generating classes and strategies. Fixed-income assets will reap the benefits of this shift.

MARKETS AND COMPETITION

Global AUM Growth



Source: BCG

The global asset management industry competition will vary by geographical location. The primary drivers of competition within each locality will be asset management company concentration, barriers to entry from international competitors, and growth of AUM.

North America and Europe

The asset management industry in North America and Europe has low concentration, slow growth, and low barriers to international entry. As discussed above, these geographical regions contribute more than 75% of global AUM. As one would expect for mature industries, growth in these regions is relatively slow with AUM growing in the middle single digits each year. Despite the large size and slow growth of these regions, industry concentration is surprisingly low. IBISWorld estimates that there are 928 fund sponsors for 9,784 mutual funds and 1,853 ETFs in the United States alone in 2017 [4]. ICI estimates there are more than 19,000 mutual funds, closed-end funds, ETFs, and UITs in the U.S. [2] Due to the free-market nature of the U.S. and Europe, foreign firms may find it easier to enter these markets than U.S. or European firms will find it to expand internationally. The combination of low concentration, slow grow, and increased threat of international entry make the North American and European asset management industries fiercely competitive. The competitive nature of asset management in these regions will place further downward pressure on industry revenues. It is imperative that U.S. asset managers look globally for growth and profitability.

Asia (ex-Japan) and Latin America

The asset management industries in Asia and Latin America, on the hand, are relatively immature and feature much higher growth in AUM while still maintaining low concentrations of asset managers. Barriers to these regions for foreign entrants, especially in China, are relatively high. In the future it will be increasingly important for asset managers to pursue growth in these regions as AUM growth in domestic economies begin to slow and track general population and GDP trends.

Peer Comparisons

The top 10 global firms by AUM are depicted in the following table:

Firm	2017 AUM ($ trillion)
1. BlackRock (U.S.)	5.98
2. Vanguard Group (U.S.)	4.5
3. UBS (Switzerland)	3.1
4. State Street (U.S.)	2.67
5. Fidelity (U.S.)	2.4
6. Allianz Group (Germany)	2.27
7. J.P. Morgan Asset Man. (U.S.)	1.9
8. BNY Mellon (U.S.)	1.8
9. PIMCO (U.S.)	1.69
10. Amundi (France)	1.65

Source: Statista

As depicted in the table above, the largest asset management companies are global and exist in a variety of structures, both public and private. The peer comparisons that follow are focused on public companies because of they produce a large amount of reliable and accessible information that can be used to understand the asset management landscape. The table below depicts financial data for all investment management companies in the S&P 500. The most noteworthy take away from this table is the fact that industry and company average returns on equity (ROE) lag behind the broader S&P 500 ROE averages for all time horizons listed.

BlackRock

BlackRock is a U.S. based asset management company that has emerged as market leader for ETF investment products. With $1.7 trillion in ETF AUM, BlackRock is the largest ETF provider in the world. [5] 63% of total BlackRock AUM is invested in index and iShares products while 29% is in actively managed products. [6] Bucking the industry trend, BlackRock has been able to expand its operating profit margin to 42.9% in 2016 versus its five year average of 41.7%. In 2016, BLK received net inflows of $202 billion, the most of any investment firm in the S&P 500.

T. Rowe Price

In terms of profitability, T. Rowe Price leads the industry in the S&P 500. Unfortunately, those returns may not be sustainable as much of the firm's growth in AUM has come primarily from increased asset value prices. [7]

Vanguard

At $4.5 trillion, Vanguard is the second largest global asset manager by AUM. The company was a pioneer in the passive investment strategy by being the first to widely distribute index funds. Their distribution of those funds through a direct distribution platform, instead of relying on brokers or advisors, contributed to the firm's ability to keep low-cost funds even cheaper. In the previous three years, Vanguard has received $823 billion in client inflow. According to the New York Times, that is more than the rest of the mutual fund industry combined. [8]

	Mkt Cap (billion)	2016 ROE	2015 ROE	ROE 5 yr
BLK	86.2	11.0%	12.0%	11.6%
BK	56.2	9.1%	8.3%	8.0%
STT	38.7	10.1%	9.3%	9.9%
TROW	25.9	24.3%	23.8%	24.6%
AMP	23.7	19.5%	20.4%	19.8%
NTRS	23	11.0%	11.2%	10.6%
BEN	21.9	14.4%	17.3%	17.9%
IVZ	13.7	10.8%	11.6%	11.2%
AMG	10.6	14.6%	18.9%	17.6%
Industry		11.2%	11.7%	11.2%
S&P 500		14.6%	13.5%	14.9%

Source: FactSet

ECONOMIC OUTLOOK

Historic Asset Value Growth

S&P 500 5-year Price Chart

Source: FRED

As of February 1, 2018, the S&P 500 has returned 22.8% in the past year. This performance was really just the latest lap of what has been a long-term bull market since early 2009 when the index reached a low of $676.53. With the index now north of $2800 there has been a tremendous total return to shareholders. Being this long in such a major market move, valuations are starting to appear stretched. This trend is very important for asset managers because AUM is directly tied to asset values. As the markets, equities in this case, rise so does AUM and concomitantly so do management fees. On the other hand, as asset values fall so does AUM along with management fees.

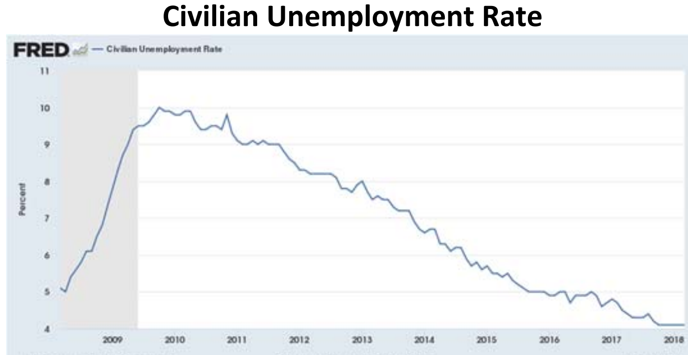
10-Year Treasury Yield to Maturity Rates

Source: FRED

Along with equities, long-term interest rates, which are the basis for long-term fixed-income returns, have steadily been dropping for more than 20 years. The result has been a historic multi-decade bull market for bonds. As rates have steadily decreased, bond fund book values have steadily increased. As with equity valuations which appear stretched, long-term bond prices really only have one direction to go. As with equities, declining bond fund values would mean decreasing AUM for asset managers and concomitantly decreasing fee revenue.

Sustained Decline in Unemployment

Civilian Unemployment Rate



Source: FRED

The U.S. economy in general, and asset managers in particular, have enjoyed a sustained decline in unemployment since 2010. This has been a positive trend for asset managers because an increasing share of first mutual fund purchases occur through employer-sponsored retirement plans. According to ISI, the share of first mutual fund purchases occurring through employer-sponsored retirement plans has increased from 56% prior to 1990 to 71% in 2010 and later [2].

RISKS FOR GROWTH

Our main concerns for the asset management industry are three-fold. First, fee compression appears to be the result of structural changes which will be beyond the ability of any individual asset management firm to control. There are no true proprietary products and winning strategies are often imitated very quickly. The main defense to this threat is to achieve scale. Second, slow growth in developed economies where the vast majority of AUM exists will further exacerbate competition, albeit moderated by consolidation. Third, rapid growth in developing markets, such as China, are likely to be protected by domestic governments from direct access from foreign firms.

INVESTMENT POSITIVES

- Scale – companies that achieve scale will enjoy competitive advantages due to lower unit costs

- Innovation – companies that develop unique investment products based on strategic positions will expand margins and grow AUM

INVESTMENT NEGATIVES

- Fee compression – increased regulation and shifting investor attitudes are placing negative pressure on industry revenues and profits

- The most significant growth is occurring in regions that will be difficult for global asset managers to access directly

- The vast majority of investment products are commoditized and thus asset managers lose pricing power over significant chunks of their AUM

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