STOCK STRATEGIST INDUSTRY REPORTS

4 Traits Asset Managers Need for Success

Here's what we believe is required for these companies to thrive over the next decade.

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Mentioned: T. Rowe Price Group Inc (TROW), BlackRock Inc (BLK), Waddell & Reed Financial Inc (WDR), Charles Schwab Corp (SCHW), Affiliated Managers Group Inc (AMG), Cohen & Steers Inc (CNS), State Street Corporation (STT), TD Ameritrade Holding Corp (AMTD), Invesco Ltd (IVZ)

Although most of the traditional U.S.-based asset managers we cover continue to hit record levels of assets under management, driven by the bull market in U.S. equities, the past decade has been difficult for the industry. Between the 2008-09 financial crisis and the increased scrutiny of investment management conflicts of interest, the balance of power in the retail channel has shifted more heavily toward the distributors.

This has led to not only increased fee compression, with investors (put off by the poor relative performance of actively managed funds) increasingly seeking lower-cost index-based options, but also product rationalization on the major retail distribution platforms, with broker/dealer and advisory networks culling funds with poor performance records, high expense ratios and/or low inclusion rates. The recently announced merger of Charles Schwab (SCHW) and TD Ameritrade (AMTD), two of the largest U.S. discount brokers, will only add to the woes of the U.S.-based asset managers.

Much of this has already been baked into our economic moat and moat trend ratings for the publicly traded U.S.-based asset managers we cover, but it is

instructive, in our view, to look at the traits that we think are more likely to lead to above-average levels of organic growth, as well as lower amounts of fee and margin compression, than we forecast for the industry overall. We continue to believe that asset managers will be better served in the long run if they are capable of differentiating themselves from the competition, through offering cost-competitive funds with repeatable investment strategies, and by having enough diversification and/or specialization in their product mix to cater to a wider array of investors, so they can adapt their cultures and processes to a more competitive landscape.

As the industry works to narrow the spread between the fees being charged for actively managed funds and those attached to index-based products, while also improving active investment performance and enhancing product capabilities and distribution, we expect the largest passive managers--with Vanguard, BlackRock (BLK), and Schwab standing out from the pack--and active managers that have scale, established brands, solid long-term performance, and reasonable fees--with Dodge & Cox, American Funds, and T. Rowe Price (TROW) standing out--will be likely to face fewer hard decisions.

Morningstar's list of high-quality stocks at a good price

Four Traits for Long-Term Success

Asset managers need four traits to thrive longer term, in our view. We believe that asset managers with a level of differentiation in their operations, a stable of cost-competitive funds, repeatable investment processes that generate

consistent returns, and adaptable business models are more likely to survive the disruption that has affected the industry the past several years as well as thrive over the next decade.

Differentiation can be achieved four ways. With products expected to face a greater degree of scrutiny, active managers can differentiate their approach through: (1) diversification by product, asset class, channel, or geography; (2) specialized expertise in a product, asset class, channel, or geography; (3) scaled-up business or product offerings; and (4) vertical integration.

Active funds need to be more cost-competitive. We believe that by gradually lowering management fees and expense ratios, active asset managers can give their products a leg up over higher-cost offerings in the same category, as well as eventually make themselves more cost-competitive with passive products (as long as investors believe they are receiving value for the fees they are being asked to pay).

Investment performance must be more consistent and repeatable. With investors having become far less willing to pay up for products or solutions when they believe that the performance and investment outcomes do not justify the fees that managers are charging, the impetus is on active managers to improve the disparity that exists between their performance and their benchmarks.

Asset managers need to have adaptable business models. We tend to look more positively on companies with cultures and strategies designed to protect their economic moats and with a willingness and ability to adapt to competitive changes. We look skeptically on companies that are working to repair serious deficiencies in their operations or that have struggled to adjust to changing conditions.

New Era for Asset Management

The past decade has been difficult for the industry, and the next decade looks to be much harder, especially for active large-cap equity managers. The balance of power in the retail channel has shifted more heavily toward the fund distributors the past 10 years, leading not only to increased fee compression, with investors increasingly seeking out lower-cost index-based

options, but also product rationalization on the major retail distribution platforms, with broker/dealer and advisory networks culling funds with poor performance records, high expense ratios and/or low inclusion rates.

This has played to the advantage of the major providers of passive products, index funds, and exchange-traded funds, which have garnered most of the industry's flows the past decade and remain on pace to grow organically at a high-single-digit rate annually during the next decade (compared with our expectations for flat to slightly negative organic growth for active funds). We believe that the performance disparity that exists between active and passive strategies in most categories continues to serve as a major impediment for a return to positive flows for many active funds.

With many broker/dealer and advisory networks having culled their platforms of funds with poor performance records, high expense ratios, and/or low inclusion rates, much of the damage has already been done, but the hurdles that have been raised for asset managers to gain and retain access to these distribution platforms have made the operating environment more difficult. We expect the announced merger between Schwab and TD Ameritrade, two of the largest discount brokers in the U.S. market, to only add to the woes of the traditional U.S.-based asset managers.

Throw in a focus on the part of regulators on increased accountability and transparency to investors, an increase in the amount and intensity of competition for investor capital (not just in the United States but globally), and the likelihood that the decadelong-plus bull market in U.S. equities will end in the near to medium term, and the future for the asset managers looks to be full of far more headwinds than tailwinds. While much of this has already been baked into our moat ratings for our coverage, it is instructive, in our view, to look at the traits that are more likely than not going to lead to positive organic growth, as well as help to stem the levels of fee and margin compression we anticipate for the industry overall.

Identifying Winners and Losers in a More Competitive Market

Our long-standing belief has been that the asset-management business is conducive to economic moats, with switching costs and intangible assets being the most durable sources of competitive advantage. While the switching

costs might not be explicitly large, inertia and the uncertainty of achieving better results by moving from one asset manager to another tends to keep many investors invested with a fund for extended periods. As a result, money that flows into asset-management companies tends to stay there.

We've also believed that the traditional asset managers can improve upon these inherent switching costs with organizational attributes (such as product mix, distribution channel concentration, and geographic reach) and intangible assets (such as strong and respected brands and manager reputations derived from successful, sustainable records of investment performance), ultimately providing them with a degree of differentiation from their peers.

Although the barriers to entry are not all that significant for the industry, the barriers to success have tended to be extremely high. It takes time and skill to put together a long enough record of investment performance to start gathering assets, but even more time to build the scale necessary to remain competitive in the industry. This has generally provided the larger, more established asset managers with an advantage over the smaller players, especially when it comes to gaining cost-effective access to distribution platforms.

Competition for investor inflows can be stiff and has traditionally centered on investment performance, especially in the retail channel. While institutional investors have always exerted pressure on pricing, with the institutionalization of the retail channel only adding to the pressure on fees, competition based on price has generally been rare, aside from what we've seen in the U.S. market for exchange-traded funds. While compensation remains the single-largest expense for most asset managers, supplier power has been manageable as many companies have reduced their reliance on star managers and have tied manager and analyst pay to portfolio and overall company performance.

Asset stickiness (the degree to which assets remain with a manager over time) tends to be a bigger differentiator between wide- and narrow-moat companies, as asset managers that have demonstrated an ability to gather and retain investor assets during different market cycles have tended to produce more stable levels of profitability, with returns exceeding their cost of capital for longer periods. While the more broadly diversified asset managers

are structurally set up to hold on to assets regardless of market conditions, it has been companies with solid product sets across asset classes (built on repeatable investment processes), charging reasonable fees, and with singular corporate cultures dedicated to a common purpose that have done a better job of gathering and retaining assets. Companies offering niche products with significantly higher switching costs--such as retirement accounts, funds with lockup periods, and tax-managed strategies--have also tended to hold on to assets longer.

Based on this viewpoint, we on the equity research side have traditionally focused on the following six questions when assessing the competitive positioning of the U.S.-based asset managers:

- Does the company have a more broadly diversified product set across asset classes, distribution channels, and geographies that would allow it to hold on to investor assets across market cycles?

- Does the company offer a niche product set that has significantly higher switching costs than the industry overall, providing it with the ability to hold on to investor assets for longer periods?

- Does the company’s size and scale and breadth of product offerings provide it with access to distribution platforms without having to give up too much in order to garner and retain shelf space?

- Are the company’s brands and overall reputation solid enough to allow the company to hold on to assets during periods of poor investment performance within its product lines?

- Does the company have a single corporate culture dedicated to a common purpose, which is ultimately reflected in the level and consistency of investment performance, rate of organic growth, focus and importance placed on risk management, and amount of employee turnover?

- Are the benefits of competitive advantage passed along to the holding company and its shareholders, or do they accrue to employees or other stakeholders?

Asset Managers Living the Four Traits

With the traditional U.S.-based asset managers being challenged by changing customer demands (primarily for lower-cost offerings), mounting competition for retail shelf space (driven by the institutionalization of the retail channel), and increased costs associated with investment performance generation and product distribution, as well as adherence to regulatory changes, the industry is ripe for a period of prolonged fee and margin compression. There has already been an increase in the level of fee compression, as some managers found themselves (in the wake of the introduction of the U.S. Labor Department's fiduciary rule and the product rationalization that followed) needing to adjust their fees closer to median price points, with an eye to overall expense ratios. However, the market has reacted as though management fees were going to be cut dramatically, which starting in early 2018 produced a widening chasm between the haves and the have-nots in the group from a trading multiple perspective.

Although we believe a lot of this has been overblown, with fees likely to continue to come down at a more moderate pace, we have a difficult time getting in front of the cheapest names on our list--including narrow-moat Affiliated Managers Group (AMG) and Invesco (IVZ)--given that they are likely to trade down heavily in the next market correction and we don't have much faith that they can generate the positive catalysts that we believe will be necessary to get their valuations back to where we think they should be.

The market tends to reward two things with the U.S.-based asset managers: above-average organic growth and above-average operating profitability. While there might be some disparity among the have-nots in the group (with Waddell & Reed (WDR) actually trading at a better multiple than either AMG or Invesco despite having poorer organic growth and profitability prospects), there is little disagreement over the haves in the group: wide-moat BlackRock and T. Rowe Price and narrow-moat Cohen & Steers (CNS). For an industry that is heavily tied to the vagaries of the equity and credit markets, companies

that have generated consistent levels of organic growth and profitability over various market cycles have generally been rewarded with premium valuations, with BlackRock and T. Rowe Price having exemplified this both in the past and more recently.

Cohen & Steers possesses many attractive attributes, like a well-respected brand, well-forged distribution ties, and a profitable niche strategy that has historically produced outsize returns (and which would generally lead us in the direction of a wide moat rating. However, our experience has shown us that asset managers that are heavily skewed toward one particular asset class or product set, as Cohen & Steers is, have generally had a more difficult time generating consistent returns. The shares are also a bit rich for our tastes, at least relative to the amount of organic growth and profitability they are expected to generate over the next five years.

We suspect that some of the premium relative to BlackRock and T. Rowe Price is due to the potential for Cohen & Steers, which is the only legitimate takeout target among the small to midsize companies we cover, to be acquired in the near to medium term. The company has carved out a niche for itself as a successful investor in real estate investment trusts, which accounted for 63% of its $71 billion in assets under management (with U.S. real estate strategies accounting for 44% of total managed assets and global/international real estate funds at 19%) at the end of September 2019. It also has meaningful exposure to preferred securities (24% of AUM) and global listed infrastructure funds (11%), making it an attractive addition to just about any portfolio. Chairman Martin Cohen and CEO Robert Steers co-founded the company in 1986, took it public in 2004, and continue to collectively own just under 50% of the common stock. With both men hitting their 70s in the next five years, we could see them starting to look for ways to monetize their stakes, which could involve selling to one of the midtier asset managers. While most of the potential buyers in our coverage already have real estate offerings, Cohen & Steers would be a coveted asset, given its product exposure and the fact that the company garners 44% of its AUM from institutional relationships and another 14% from closed-end funds.

BlackRock Has Used Its Size and Operational Savvy to Clients' Benefit

BlackRock is at its core a passive investor. Through its iShares ETF platform and institutional index fund offerings, this wide-moat company sources close to two thirds of its managed assets from passive products. In an environment where investors are expected to seek out providers of passive products, as well as active asset managers that have greater scale, established brands, solid long-term performance, and reasonable fees, we like how BlackRock is positioned. The biggest differentiators for the company are its scale, ability to offer both passive and active products, greater focus on institutional investors, strong brands, and reasonable fees. The company's iShares ETF platform maintains a leading market share both domestically (39%) and globally (37%), despite intense pressure from Vanguard and Schwab, which have pursued a strategy of offering products with extremely low fees to generate sales.

Some of this is due to the market itself being bifurcated, with Vanguard and Schwab fighting for retail share and BlackRock staying more focused on institutional investors (which tend to put more weight on liquidity relative to cost). Since 2014, BlackRock has also generated the most in absolute annual inflows domestically, despite trailing Vanguard and Schwab from an organic growth rate perspective. In fact, during the past years BlackRock's total ETF flows have been on par with those generated by its four largest domestic competitors--Vanguard, State Street/SSGA (STT), Invesco, and Schwab--combined.

We believe BlackRock's iShares ETF franchise, augmented by a technology platform that offers risk management and product/portfolio construction tools directly to end users, making them stickier in the long run, should allow the company to generate higher and more stable levels of organic growth than its publicly traded peers the next five years. With $6.964 trillion in total assets under management at the end of September 2019, BlackRock is the largest asset manager in the world. Unlike many of its competitors, the company is currently generating solid organic growth with its operations, with its iShares platform riding a secular trend toward passively managed products that began more than two decades ago. This helped the company maintain above-average levels of annual organic growth despite the increased size and scale of its operations. Although we expect the secular and cyclical headwinds to make

AUM growth difficult for the U.S.-based asset managers over the next 5-10 years, we still see BlackRock generating 3%-5% average annual organic AUM growth, with slightly lower revenue growth but steadily improving margins (albeit range-bound between 39% and 41%) during 2019-23. With the company producing better and less volatile AUM, revenue, and profitability growth, as well as having less execution risk than a lot of its peers, BlackRock should continue to garner a premium valuation relative to the group.

T. Rowe Price's Sensible and Investor-Focused Culture Has Been Key to Its Success

T. Rowe Price has never really tried to be, nor has it needed to be, anything other than an active manager. In an environment where active management is under assault for poor investment performance and high fees, this wide-moat company is the best positioned among the traditional active asset managers we cover. The biggest differentiators for T. Rowe Price are its scale, stickiness of its asset base, strong brand identity, consistently solid long-term investment performance, and reasonable fees.

While T. Rowe Price's product mix is not overly diverse, with 87% of its $1.126 trillion in AUM at the end of September 2019 dedicated to equity (57%) and balanced (30%) strategies, the company derives approximately two thirds of its managed assets from retirement accounts (41%) and variable-annuity portfolios (26%). With the switching costs for these tax-deferred products being significantly higher than those for most other accounts (the majority of which are non-tax-deferred), T. Rowe Price has traditionally had a much stickier set of assets than its peers. Benefiting from a steady stream in investor inflows into defined contribution and other retirement plans, the company has recorded net long-term outflows in only 14 calendar quarters the past two decades.

Furthermore, the company's cost-conscious culture and stable AUM and revenue levels have allowed it to consistently generate operating margins in excess of 40%, the highest among the U.S.-based asset managers we cover. T. Rowe Price's ability to generate more stable revenue, profitability, and cash flows than its peers has, in our view, provided the company with more than enough excess capital to continue building on the competitive advantages

that it already possesses. The company has effectively managed its scale, with adjusted operating margins of 44.3% on average during 2014-18, allowing it to generate around $1.5 billion in annual free cash flow on average, with adjusted returns on invested capital exceeding 55% (and ROICs with goodwill exceeding 44%).

Although the company will face headwinds in the near to medium term as the baby boomer rollover phenomenon affect the organic growth it derives from the defined-contribution channel, we think that T. Rowe Price and defined-contribution plans in general have a compelling cost and service argument to make to pending retirees, which should mitigate some of the impact. We also believe the company is uniquely positioned to pick up business in the retail-advised channel, an area of the market that T. Rowe Price has not focused too heavily on in the past, given the solid long-term performance of its funds and reasonableness of its fees.

T. Rowe Price’s biggest advantage over peers has been the level and consistency of its investment performance. The company currently has 45% of its fund assets under management rated 5 stars and another 34% rated 4 stars on a five-year basis. With most broker/dealer and advisory platforms tending to give deferential treatment to 4- and 5-star funds, T. Rowe Price is well positioned. And with 68%, 75%, and 81% of the company’s sponsored U.S. mutual funds beating their peers on a 3-, 5-, and 10-year basis, respectively, at the end of September, we expect T. Rowe Price to generate better organic growth from its active fund platform than the industry as a whole.

With the company likely to generate low- to mid-single-digit AUM growth on average (driven by 1%-3% annual organic growth), we see top-line growth expanding at a positive 1.8% compound annual growth rate (due primarily to mix shift on ongoing industry fee pressures), with operating margins at 42%-44% on average. With the company likely to produce better and less volatile AUM, revenue, and profitability growth, with less execution risk than a lot of its peers, T. Rowe Price should continue to garner a premium valuation relative to the group.

Schwab Puts Investors First With Solid Investment Products and Low Fees
Our manager research group has long praised Charles Schwab Investment

Management for putting investors first by strengthening its investment management team, focusing on low-cost portfolio building blocks, and making its low fees available to all investors by offering a single share class for all of its funds with no minimum investment requirements. This disciplined focus on low-cost core strategies has fueled considerable growth the past few years, particularly among CSIM's index-based strategies, which account for the bulk of its assets.

As its stable of proprietary products has grown (our own internal estimates are that around 25% of client assets are invested in either proprietary or Schwab-controlled products), the company has expanded its investment team and passed along economies of scale through fee reductions. It has also resisted the temptation to launch trendy strategies and has shown a willingness to shutter some of its older, higher-cost funds--all of which is kind of anathema to the rest of the industry.

Although CSIM's product mix is not overly diverse, with 86% of the $241 billion in long-term open-end fund and ETF AUM Morningstar Direct was tracking at the end of September 2019 dedicated to equity strategies, these are predominantly low-cost passive products (which actually accounted for 97% of the company's long-term AUM we were tracking at the end of the third quarter). The asset-management unit had 80% (13%) of its analyst (quantitatively) rated funds designated as Gold, Silver, or Bronze in the most recent semiannual "Fund Family 150: Data and Research to Compare the 150 Largest Fund Families" published by Morningstar Research Services. Schwab also garnered a positive parent rating, with the analyst covering the company's funds noting that while CSIM is part of a larger brokerage operation, it has not been pressured to maximize profitability as a stand-alone asset-management business, allowing it to focus on developing funds that serve as low-cost portfolio building blocks for investors. CSIM had more than 80% of its offerings in low to below-average fee arrangements relative to comparable funds, with fees (currently sitting at an adjusted expense ratio of 12 basis points) likely to continue to fall as many of Schwab's index-based products scale up further. Fund scores relative to category peers are also solid, with 92% of funds in the high range and just 1% in the low category.

While one of the rationales for the merger between Schwab and TD Ameritrade was that the deal would allow the combined companies to better absorb the shift to zero-commission trades (a net positive for most investors), Schwab was already better positioned to hedge against the race to zero in brokerage fees, which account for only 7% of its net revenue. It relies on interest-bearing assets and fees on mutual funds and ETFs to offset the move to zero-commission trades, and notes that brokerage fees as a percentage of net revenue would likely be cut in half as a result of the move. While TD Ameritrade is far more exposed (with brokerage fees accounting for around 30% of net revenue and the shift to zero trading commissions cutting the contribution of those fees to net revenue in half), some of this will be offset by merger synergies, the transfer of TD Ameritrade client cash away from Toronto Dominion Bank to Schwab's own bank subsidiaries over time, and a ramp up in the use of Schwab's proprietary financial products throughout TD Ameritrade's customer base. M

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