OUTLOOK RESEARCH

MOODY'S INVESTORS SERVICE

Asset Management – Global

2018 Outlook

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Asset Management Outlook for 2018: Stable

NEGATIVE ← STABLE → POSITIVE

NEGATIVE

What could change outlook to negative

- » Fee compression intensifies across all industry segments
- » Sustained elevated outflows from active management
- » Regulatory disclosures spotlighting fee and performance comparisons reduce demand
- » High valuations and rising rates lead to market correction

STABLE

- » Adapting to industry challenges
  - – New product and technology investments
  - – Distribution models evolving with industry sales trends
  - – Avoidance of fee compression
  - – Cost structure adaptation, margin stabilization
  - – M&A supporting scale & diversification
- » Rising demand supported by global economic expansion

POSITIVE

What could change outlook to positive

- » Improved active performance
- » Moderation of rotation into passive products

The Industry Outlook (positive, stable or negative) indicates our forward-looking assessment of fundamental credit conditions that will affect the creditworthiness of the asset management industry over the next 12-18 months. As such, the outlook provides our view of how the operating environment for the asset management industry, including macroeconomic, competitive and regulatory trends, will affect, among other things, investor demand, product performance, leverage and profitability. Since outlooks represent our forward-looking view on credit conditions that factor into our ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average. However, the outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of the rating outlooks of issuers in the industry, but rather our assessment of the direction of credit fundamentals overall within the industry broadly.

Key drivers of stable outlook for asset managers

Outlook Key: NEGATIVE STABLE POSITIVE

NEGATIVE	STABLE	POSITIVE
Fundamental challenges remain	**Passive (r)evolution**	**Industry in flux**
» Fee sensitivity rising in all sectors	» Active and passive disciplines merging	» Distribution models rebase
» Threat of redundancy in overcrowded field	» Passive uptake spreads beyond investment management disciplines	» Technology uptake is everywhere
» Regulation spotlights conflicts	» Greater opportunity for alternative managers	» Financial flexibility intact
» Rich markets face rising rates		» M&A reshapes competitors

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Fundamental challenges remain

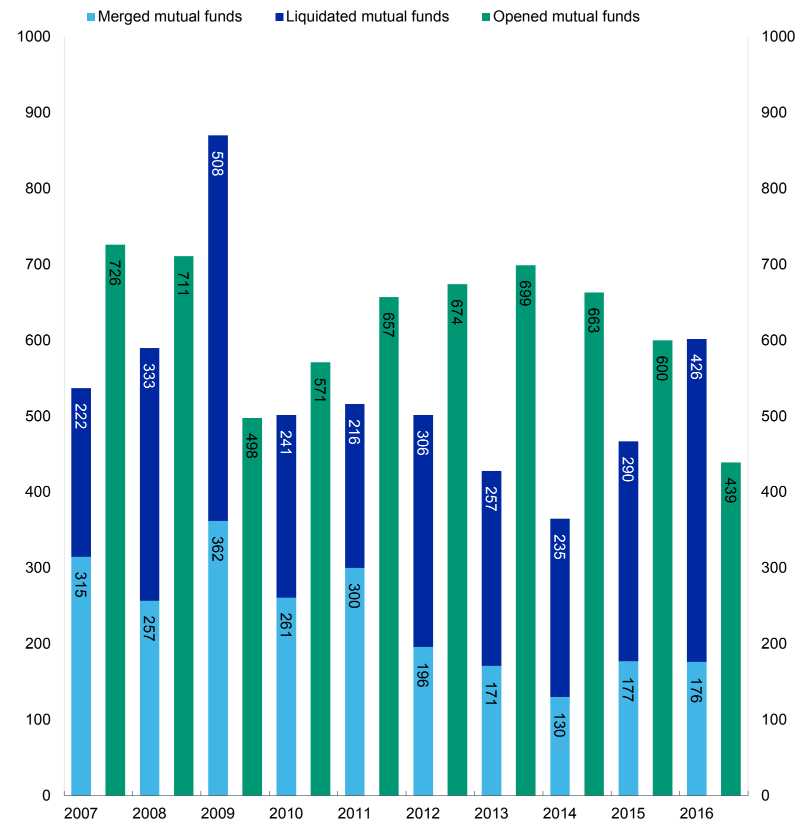
Fundamental challenges remain

Pain points persist for many asset managers

Well publicized challenges include:

- » Greater fee sensitivity
- » Over supply of products in low-active share, benchmarked disciplines
- » Winnowing of products selected for major distribution platforms
- » "Wrapper" diversification - uptake of commingled product structures in favor of mutual funds, including ETFs, separate accounts, collective trusts

US mutual fund population is shrinking



Source: ICI

Fundamental challenges remain

MiFID II to alter competitive dynamics

Regulation supports passive trend and industry consolidation in EU

MiFID II (Markets in Financial Instruments Directive) comes into force in Jan 2018 in the EU. Objective: improve transparency and protect investors

- Involves substantial process changes in trading, execution, product conception, governance, distribution and vast reporting requirements
- Greater transparency in fees and charges will push investors towards low-cost funds such as ETFs
- Introduces execution risks, operational and compliance costs.
- Will also affect non-EU domiciled firms doing business within the EU
- Most managers will absorb research costs historically borne by investors
- Higher operational and compliance costs will lead to consolidation among smaller players

Fundamental challenges remain

Rich markets face rising rates

Potential outcome of Fed tightening?

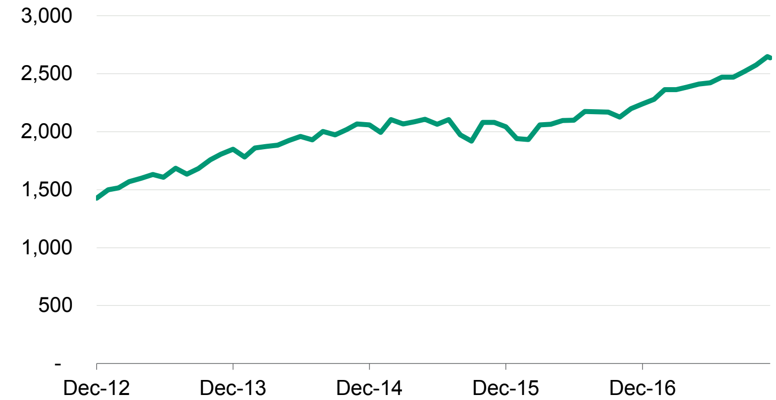
» Revenue lift from ongoing bull market has supported asset managers' revenues and financed business investments

» Global economic growth is expected to remain strong – and inflation low

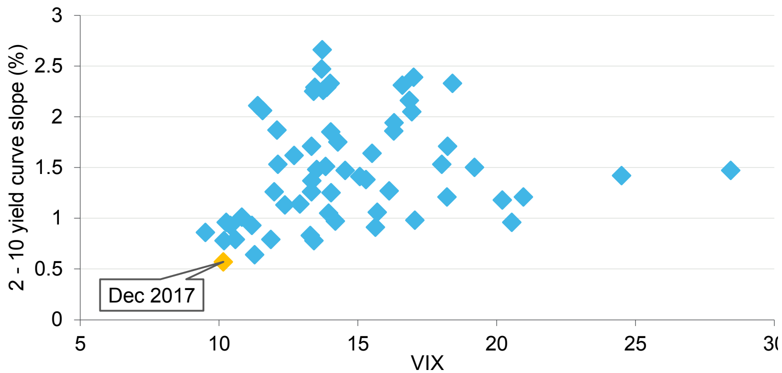
» However, breakdown of "Goldilocks" scenario (declining bond yields and rising stock multiples) is a risk – with both higher inflation and a volatility rebound

Bonds and equities rally with little risk

S&P 500: up 20% in a year



VIX and 2-10 yield curve slope: mixed signals



Source: Federal Reserve, Moody's Investors Service

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Passive (r)evolution

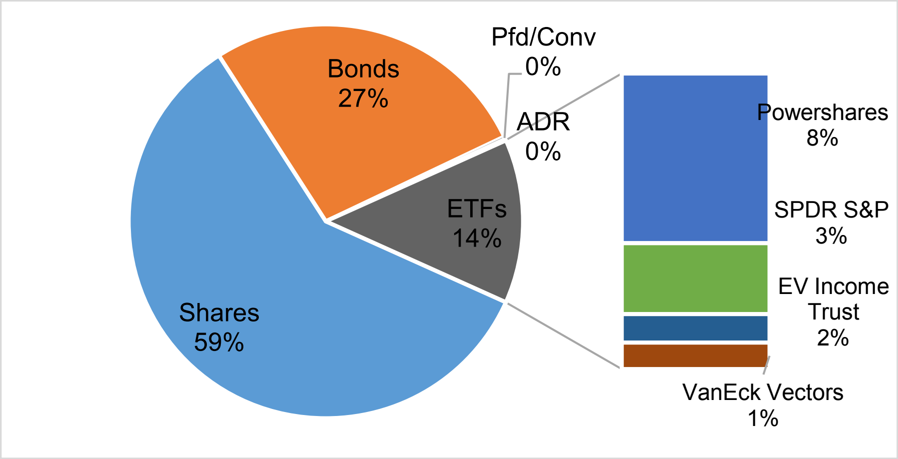
Passive (r)evolution

The “alpha - beta” separation theme is evolving

Active and passive disciplines are more entwined

- Passive products are becoming low cost commodities; their contribution to the value-added chain of investment management is increasingly captured elsewhere
  - McKinsey estimates that despite enormous AUM growth, revenue share remains 3%
  - “Vanilla” ETFs are increasingly used as inputs in active strategies, including multi-factor
- Active products incorporate ETFs for cost and efficiency
- Passive products are assuming active attributes in design and implementation, i.e., smart beta
- Active managers are employing branding skills to carve out niches in smart beta

A symphony: active passive hybrid



Source: Symphony Asset Management 13F-HR, Moody’s Investors Service

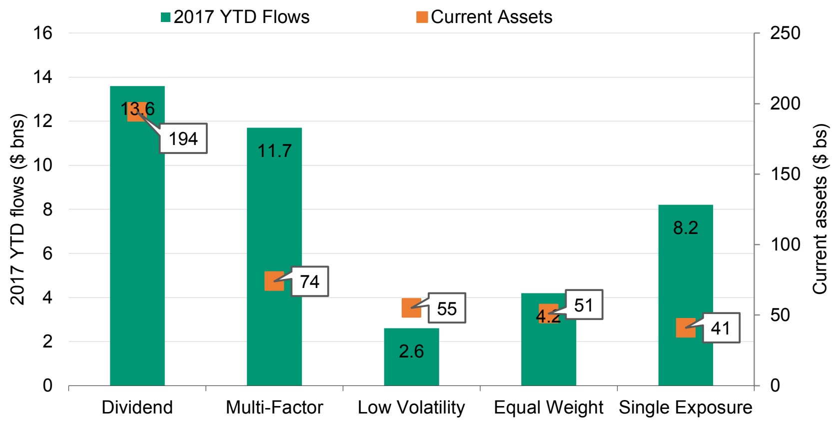
Passive (r)evolution

Passive management is becoming an active discipline

ETF launches tell a story

- Active and multi-factor products have had the highest share
- In addition to ETF leaders (iShares, PowerShares) traditional managers (Franklin, Oppenheimer) are engaged

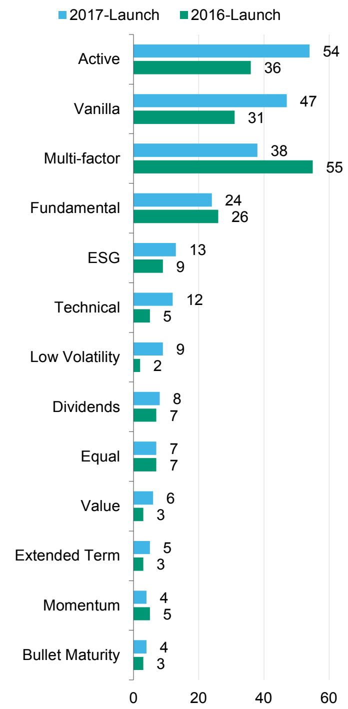
Smart beta: 11% organic growth

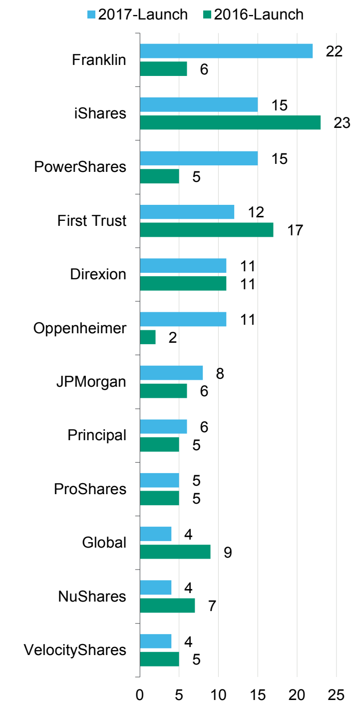


Note: YTD November 2017.
Source: BlackRock, Moody's Investors Service

ETF Launches

Not just vanilla, not just the usual suspects





Note: Top launched funds in category. Source: etf.com, Moody's Investors Service

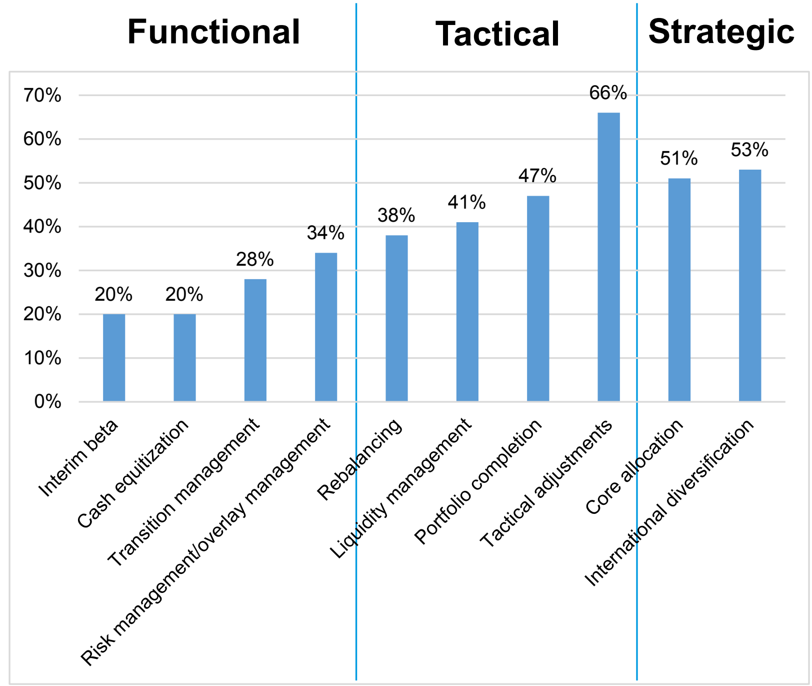
Passive (r)evolution

Institutional use of ETFs – a significant source of flows

Broad applicability of ETFs fuels demand

- Institutional investors find a wide range applications for ETFs
- Functional and tactical applications of ETFs are displacing traditional bank and brokerage services
- Managers are incorporating ETFs into traditional and multi-asset portfolios to build flexible, liquid, cost-efficient solutions
- Passive management is not an end itself, but is employed in larger active schemes

Institutions find many applications for ETFs



Note: 2016 Survey of global institutional ETF investors: % shares of 358 responses.
Source: Greenwich Associates

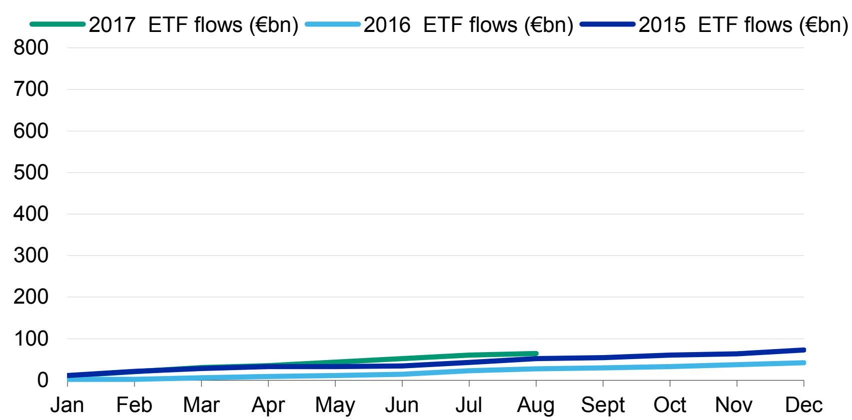
Passive (r)evolution

Europe: passive acceleration likely

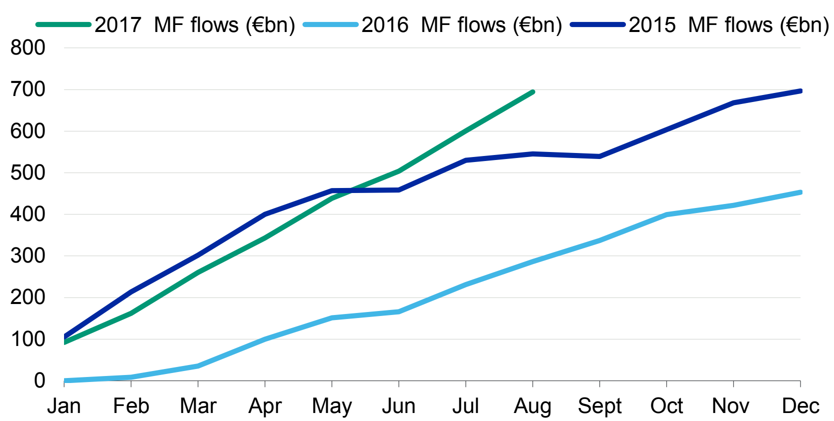
Starting from a low base, passive to grow due to

- Regulations (MIFID II, FCA market study)
- New entrants, (e.g. Vanguard)

Europe: ETF flows in €bn



Europe: Mutual fund flows in €bn



Sources: Deutsche Bank, Moody's Investors Service

Passive (r)evolution

Alternative managers have enormous firepower

Business conditions for private asset managers remain robust

- Capital raising
  - Larger funds are being raised for long-duration, capital intensive asset classes such as infrastructure, real estate, and energy
  - Pools of dry powder are at record levels - $934 billion at September 2017, up almost $100 billion for the year to date[1]
- Capital deployment
  - High market valuations are challenging investors to find suitable entry points
  - Low interest rates allow deals to be financed cheaply
  - Global economic growth cycle has extended opportunity set
- Investment realizations
  - Realizations from post crisis investments have slowed, but profits are being reinvested

[1] Source: Preqin

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Industry in flux

Industry in flux

Distribution architecture changing – new skills required

The move to portfolio-centric client relationships favors larger asset managers

» Advisory channel distributors limit products they will sell, giving access to asset managers with strong performance and scale

» Regulations pressure advisors to act in clients' best interest, and greater product transparency is in demand, affecting choice of product vehicles

  – The mutual fund is increasingly seen as expensive and anachronistic

  – ETFs, separate accounts, and collective trusts are rising in importance

» Advice for fee model means product distribution efforts are more consultative and institutional in character

» To conform, asset managers are upgrading technology and human capital

Industry in flux

Technology's influence on manufacturing

Technology is becoming more engrained in product development and deployment

Active portfolio management

» With greater focus on outcomes, products are designed to manage risks cross multiple asset classes; firms are using same tools to manage enterprise risk

» Statistical analysis of durable drivers of excess return is being used to derive new smart beta products

» Artificial Intelligence tools are being used to augment traditional fundamental analysis

Passive management

» Exchange-traded products rely on significant technology resources to interact in real time with intermediaries and end users

Industry in flux

Technology's influence on operations and distribution

Technology enhances efficiency and distribution reach

Operational efficiencies are an essential response to revenue pressure

- » Investments in database tools and data analytics
- » Cost reduction initiatives in middle and back office

Technology supports changes in distribution practices and product innovation

- » Advisors are increasingly using holistic tools to manage clients' wealth. Managers must sell into "universal account platforms" that optimize portfolios across all client assets
- » Asset managers are acquiring technology to sell into and capture growth of "roboadvice"

Acquired	Robo advisor	Acquirer	Market
Jun-17	Scalable Capital	BlackRock	European robo-adviser; ETF portfolios.
Jul-16	Financial Guard	Legg Mason	Account aggregator; investment allocation, fund selection. Fiduciary.
Jun-16	MyVest	TIAA	Enterprise solution: model portfolios, client management, order management
Mar-16	Honest Dollar	Goldman Sachs	Advice and Management system for IRA owners. ETF portfolios.
Jan-16	Jemstep	Invesco	Practice management solution for RIAs. Advisor branded. Account aggregation, Risk assessment, Personalized analysis.
Aug-15	Future Advisor	BlackRock	Account aggregator and retirement planner. ETF portfolios at Fidelity & TD Ameritrade.

Source: Company reports, SNL, and websites

Industry in flux

Fees are pressured, but margins are resilient

Competitive pressures have not translated to performance pressure

» Rising scale and operating leverage: 2017's bull market positions asset managers for higher profits in 2018

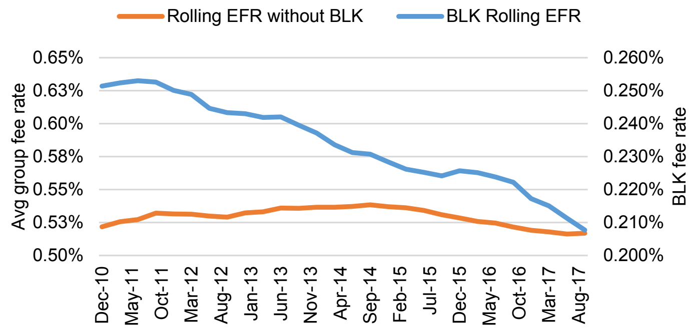
» Asset managers are spending on cost-saving initiatives

» Some asset managers are offering fee concessions in exchange for longer lockups and performance incentives

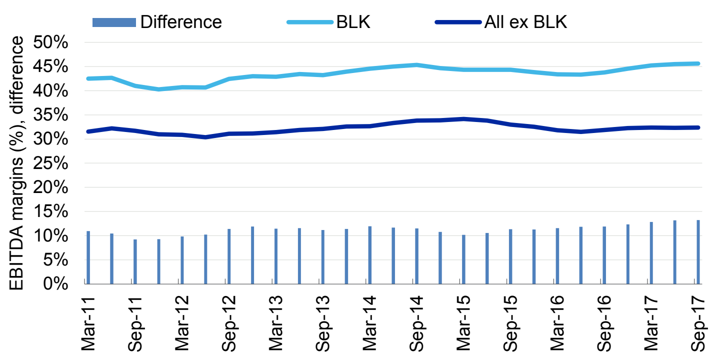
» Blackrock's margin has risen, despite mix shift to lower-fee passives. Other managers experienced modest fee compression, but maintained margin stability

Shock absorbers: scale and efficiency

Fees compress, especially for BlackRock



Margins are more resilient



Note: Other managers: AB, AMG, BEN, CNS, EV, FII, GBL, IVZ, JHG, LM, OMAM, TROW, & WDR. Source: Company reports, Moody's Investors Service

Industry in flux

Mergers and acquisitions

M&A activity reflects an industry in flux

- Mergers to achieve scale, between large, complementary organizations, fortify market position
  - Examples: Standard Life/Aberdeen, Henderson/Janus
- Acquisitions of products in either more defensible or more dynamic industry segments allow acquirers to change incrementally, with potentially less financial risk
  - Examples: Legg Mason's acquisitions of Clarion and Entrust. Invesco's acquisitions of Source and Guggenheim ETFs
- Financial acquirers remain active, including Asian buyers
  - Examples: Softbank's investment in Fortress. HNA's investments in OM Asset Management and Skybridge. Blackstone Strategic Capital's minority interest in Leonard Green Partners.
- Technology and methods are also driving deals, as discussed above