RESEARCH REPORT

March 26, 2018

Subsector Overview

FIGuring it All Out

Financial institutions are a critical component of any productive economy; they supply capital, provide advisory, and help mitigate risk. However, the all-encompassing term "financial institutions" casts a broad net over a variety of distinct subsectors, each presenting different roles, drivers, and business models. Given the extensive nature of the sector, we have elected to assess each subsector individually, to develop a more comprehensive understanding of what drives outperformance in each area. Though real estate investment trusts are not traditionally incorporated in the financial institutions sector, they do reside within our investable coverage universe; therefore, we have decided to include the subsector in our overview. In all, we conducted a brief analysis of FIG's five main subsectors:

(1) Traditional Banks

(2) Mortgage Companies

(3) Life & Property-Casualty Insurance

(4) Asset Managers

(5) Specialty Finance & REITS

As a result of our findings, we remain confident in the traditional bank's ability to capitalize on rising interest rates. Similarly, mortgage companies and REITs will continue to benefit from increasing demand in the real estate market. In contrast, investment opportunities in asset managers are clouded, as the market is undergoing significant disruption. Finally, we view specialty finance as a way to allocate capital to unique business models in a growing subsector.

Financial Institutions

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FIG Sector Intro Report

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Traditional Banks

Industry Overview

At a high level, commercial banks generate revenue by lending out funds that were deposited by individuals and institutions. Their clients typically include companies that require loans to finance operations or individuals that require personal loans such as mortgages. Banks earn a profit from the difference between the interest rates which they charge on loans, and which they pay on deposits; this difference is known as the net interest margin.

In the past, regulation has prevented commercial banks from performing investment banking and the buying and selling of securities. However, this regulation was lifted in 1999, and during the Great Recession, there was large-scale consolidation of commercial banks and investment banks (e.g. Bank of America and Merrill Lynch).

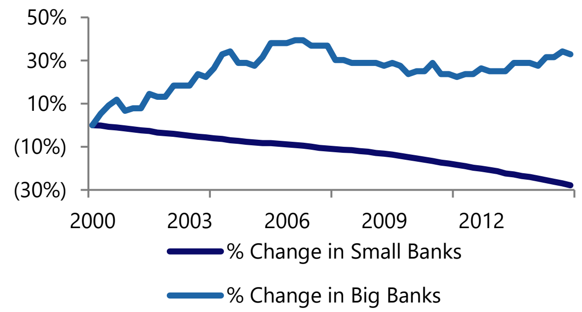
Banks' use and definition of balance sheet items differ from traditional businesses. While mortgages, loans, and other debts are traditionally liabilities, they are considered a raw material input into a bank's profit-making machine. Conversely, deposits and other accounts become liabilities as the bank pays interest on these funds.

Drivers of Performance

Profitability factors for large banks tend to be highly macroeconomic. When the economy is thriving, banks tend to perform well because there is increasing demand for credit. Central bank policy also impacts profitability, as rates affect the net interest margin. When rates rise, banks have the ability to stave off raising the interest paid on deposits, while being able to immediately raise the rate they charge on loans. On the other hand, the three risk areas that banks face are interest rate, credit, and liquidity risk. Interest rate risk arises from the fact that banks tend to hold assets longer than liabilities. Credit risk is the inherent risk that the whomever borrowing from the bank may default. Finally, liquidity risk is the likelihood of the bank being unable to pay depositors their interest.

Exhibit 1

Percent Change in the Number of US Banks



Source(s): George Mason University Research

Canadian Holdings

The three largest banks in Canada are RBC, TD, and Bank of Nova Scotia. In terms of market share, RBC has been seeing a downward trend over the past few decades, while Scotia and TD have steadily grown their percentage of the market. Each of the three banks is known for a unique aspect in which they excel. RBC, being the largest of the three, has the greatest presence in the US. TD is known for being the most customer friendly through focusing on diversity and the community. Finally, Scotia Bank has had the greatest success in international markets.

US Holdings

Compared to the Canadian five-player monopoly, the US market is more saturated and competitive. Structural differences between the Canadian and US bank industries have led to different drivers of performance. For example, Return on Tangible Common Equity (TCE) is an important KPI in the US, but not nearly as much in Canada. TCE is calculated by subtracting intangible assets and preferred equity from book value. This measure became relevant after the 2008 financial crisis, when banks received large amounts of bailout money from the government in exchange for preferred shares.

Mortgage Companies

The traditional system of housing finance is composed of three main sets institutions: mortgage originators, mortgage insurers, and the suppliers of funding. Because these are the three components of the mortgage market, in Canada, the banks dominate the mortgage landscape, holding 75% of outstanding mortgages. In the U.S., the mortgage market is more fragmented with thousands of firms and individuals.

Mortgage Origination

Mortgage origination essentially means the creation of a new mortgage. The originator works with the borrower to complete the transaction including preparing the application documents, processing the mortgage, and the placement of the mortgage on the lender's books. Mortgage originators are part of the primary mortgage market and work with underwriters and loan processors. Underwritings is the process lenders use to asses the risk of lending to a particular borrower. Technology and effective use of data make certain underwriters more competitive.

The primary market is the initial marketplace where the mortgage is created. The secondary market is composed of the servicing rights to the created mortgages. Once a mortgage is originated, the servicing rights to the mortgages can be bought and sold between institutions. This is called the secondary market because the mortgages need to exist before they can be traded this way. Secondary buyers can also package the mortgages into securities and sell them to investment banks. These mortgage-backed securities (MBS) played a role in the financial crisis in 2008 as the packages of mortgages allowed banks to move mortgages off their books to investors. This freed up room for lending capital, which increased the risk of the financial system. However, at their core, MBS are intended to be a way for smaller regional banks to provide mortgages to their clients without having to worry about whether the borrower has the assets to back the loan. The bank becomes a middleman between the borrowers and the investors in the market so that when an investor buys an MBS, they are essentially lending money to a home buyer.

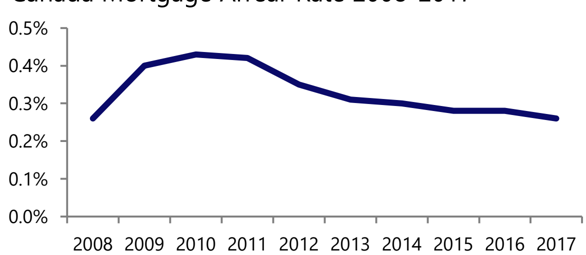
Mortgage Insurers

Mortgage insurers protect lenders against payment default from their clients. There are three Canadian mortgage insurers: Canadian Mortgage Housing Corporation (CMHC), Genworth Financial Mortgage Insurance, and Canada Guarantee Mortgage Insurance. Mortgage insurers not only help lenders mitigate risk, they also allow borrowers greater access to home ownership. The CMHC enables home buyers to finance up to 95% of the purchase price of a home. The higher the percentage of financing, the higher the premium required on the total loan.

As interest rates increase, it will be important to see how variable rate mortgages and the accessibility of capital will affect mortgage originators and lenders.

EXHIBIT II

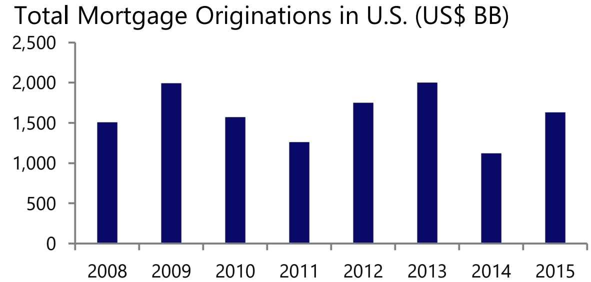
Canada Mortgage Arrear Rate 2008-2017



Source(s): Canadian Bankers Association

EXHIBIT III

Total Mortgage Originations in U.S. (US$ BB)



Source(s): Mortgage Bankers Association

Life & Property-Casualty Insurance

Life Insurance

Life insurance is a contract between a policyholder, an insurer, and a beneficiary. The relationship between these three stakeholders is founded on the concept of a premium, which is paid on a regular basis by a policyholder to an insurer. In exchange, the policyholder is entitled to a lump sum payment, or a benefit, which is received by their beneficiary at the time of the policy holder's death. Insurers are often insurance specific companies (lifecos) or banks. In a sense, insurance premiums represent the level of inherent risk of a policyholder. Institutions create growth by increasing premiums, in addition to investing their liquidity into equity markets; therefore, lifecos are highly dependent on equity market drivers.

Since the start of 2018, lifecos have benefited from rising interest rates, as it has increased their fixed-income investment yields. However, many companies have been burdened with new U.S. Department of Labor fiduciary rulings on retirement-related products. Similarly, the industry is facing a digital transformation to streamline underwriting processes and improve bottom lines.

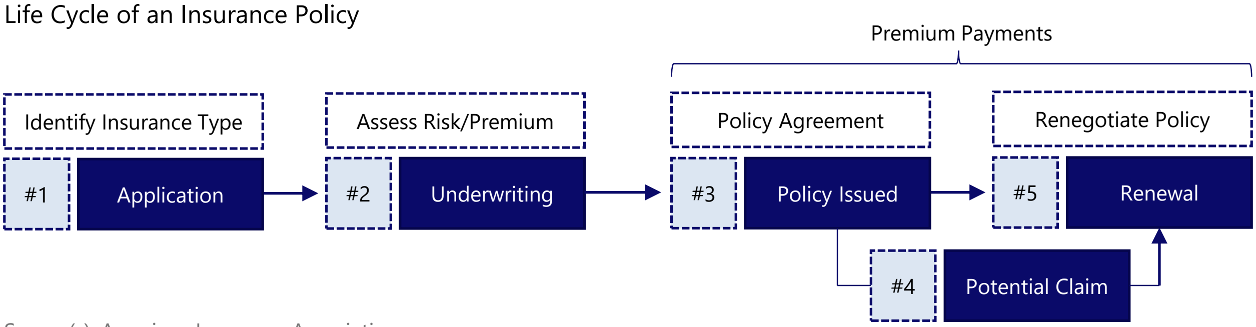
Property-Casualty Insurance

Property-casualty insurance protects two primary areas: physical assets (property), and legal liability (casualty). P&Cs provide more than just insurance, they are active in claim prevention, aligning their interests with societies. This is due to the fact that P&Cs derive their required premiums by assessing real-world risks, such as fires, floods, and storms, in addition to attendant costs, such as healthcare, and judicial verdicts. Therefore, it is in their interest to protect the underlying functions of society that they insure, as it reduces their risk of claims. Unlike lifecos, P&C's services extend beyond the individual, providing coverage for entire communities and ensuring financial stability during times of crisis.

Since P&Cs are so critical to society, they must maintain a higher degree of liquidity to support more significant claims. Consequently, P&Cs strategically limit their risk exposure by allocating capital to a variety of low-risk investment vehicles, such as government bonds. These investments drive the majority of the industry's earnings, as the underwriting process is difficult to predict and often leads to an underwriting loss. Should an insurer become insolvent, policyholders are safeguarded by what is known as a guaranty fund system, whereby all financially healthy insurers must assume the responsibility for the outstanding claims. However, that is not the only unique characteristic of the industry, as profit generated from different insurance lines must remain compartmentalized to its respective state and cannot be used to pay claims elsewhere, making geographic risk a critical component of the P&C industry.

EXHIBIT IV

Life Cycle of an Insurance Policy



Source(s): American Insurance Association

Asset Managers

Overview

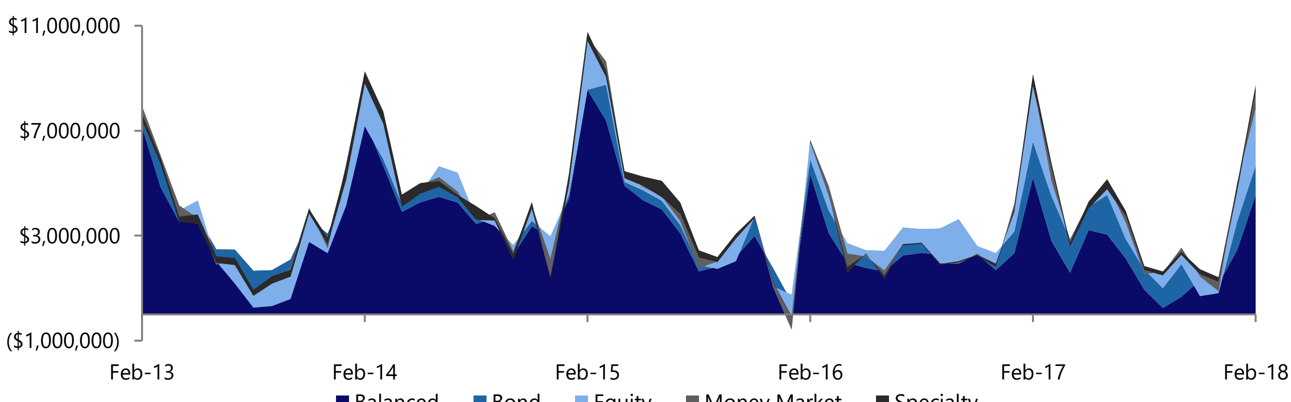
Broadly, asset managers are companies that manage the financial assets of corporate, institutional, and retail clients. These companies use their clients' pooled funds to invest in securities and other assets attempting to achieve superior risk-adjusted returns that match the profile of their clients' investment goals. Asset managers are compensated in two main ways, being management fees and performance fees. Management fees are measured by the management expense ratio (MER), which is the total management fee inclusive of operating expenses and taxes that the client pays per year as a percentage of total assets under management (AUM). The products available to investors can be sorted into four main buckets: mutual funds, managed accounts, institutional assets, and alternative assets. Alternative assets include products such as exchange-traded-funds (ETFs) and hedge funds. ETFs have seen rising prominence over the past decade, as their low MERs and abilities to track certain indices with little deviation risk has caught the attention of investors, especially younger clients. Asset managers generally target high net worth individuals with over $1M in personal investable assets, retail customers, and institutional investors. The goal for customers is to diversify their portfolio of assets in the least expensive way possible while achieving strong investment returns.

QUIC Portfolio

The FIG team currently holds just one asset management name in both Canada and the U.S., being Blackrock; a large-scale ETF provider that operates worldwide, providing customers with low-cost opportunities to invest in a variety of different index and subsector-based funds. Recently, there have been multiple themes that have disrupted the sector. First, as the global economy continues to grow and demographics are shifting towards the expansion of middle classes across Asia, South America, and the Middle East, the number of middle class consumers is expected to grow by 180% by 2040. Next, roboadvisors such as Nest and Wealthsimple have compressed margins for traditional asset managers through market disruption. Lastly, the most impactful disruption in the industry has been the rise of ETFs. Due to the liquidity and low-cost structure of these products, consumers have continued to pour money into the industry (stat here about fund flows). It is important to note that this perceived liquidity and index-tracking ability has yet to be significantly tested by large-scale corrections, which has led some to believe that the market sell-off in early February may have been exacerbated by increased investment in passive funds.

EXHIBIT V

Canadian Managed Fund Flows ($ in 000s)



Source(s): IFIC

Specialty Finance & REITs

Specialty Finance

Specialty finance can be defined as any financing activity that occurs outside of the traditional banking system. Firms in the industry often extend credit to midsize businesses that may not be able to receive credit from a bank. Specialty finance can be divided into many sub-verticals, and as such, we will instead focus on two specialty players in the space to exhibit two interesting business models.

First National

First National is a non-bank lender of mortgages, with over $100B in Mortgages Under Administration (MUA). The company derives the majority of its revenues from the origination, and securitization of mortgages, as well as mortgage servicing and administration. The company raises capital through its $1B credit facility, as well as through public equity markets. First National operates in an industry with high barriers to entry, while also having over 80% of its mortgage portfolio being insured.

TMX Group

TMX group owns and operates the TSX and TSXV, generating revenue through securities listing, trading, and technology. Through its listing segment, TMX generates fees when companies list on its exchanges, as well as a yearly membership fee. TMX also generates revenues through trading of TSX-listed stocks, which ranges from $0.0005 per share to $0.0030 per share, far less than the average NYSE fee. Lastly, the company's technology segment generates revenues through two subsidiaries: TMX Datalinx and TMX Insights. Both of these subsidiaries gather information from a variety of marketplaces, such as dark pool trading activity. TMX has the most control and ability to generate demand within the technology segment and has invested heavily within the space.

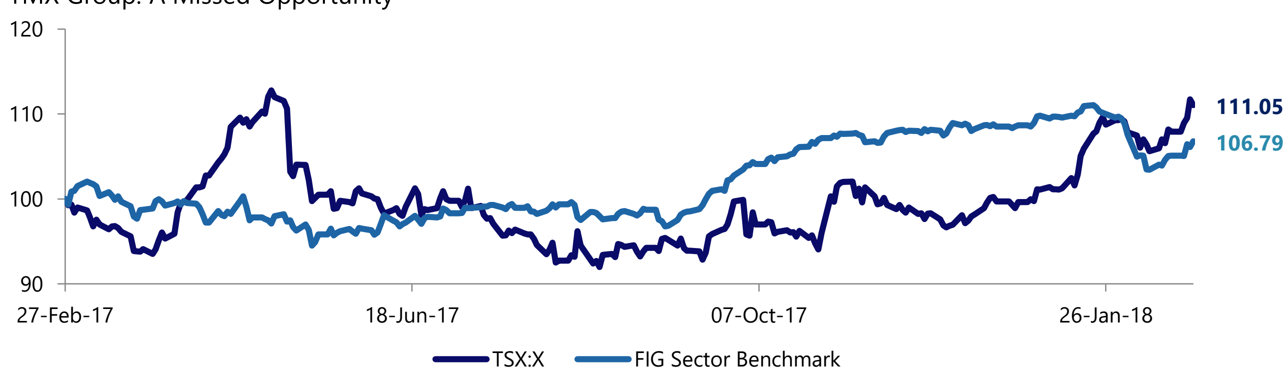
REITs

Real estate investment trusts (REITs) are public investment vehicles that operate as a trust, meaning that shareholders, known as unitholders, must be paid at least 90% of the trust's GAAP net income as a distribution, which is why REITs tend to pay monthly distributions to shareholders yielding 3% to 10% annually. REITs usually operate within one specific subsector investing in office, retail, industrial, multi-residential, and other property types.

REITs are generally seen as a fixed-income substitute for equity portfolios, as REITs pay a high yield to unitholders, while also operating with larger than normal levels of leverage. The Cash Yield (REIT) sector on QUIC was recently absolved and is now operating under the FIG portfolio, currently holding four REITs: Chartwell Retirement Residences, Mainstreet Equity, Killam Apartment REIT, and Summit II REIT. The FIG team will continue to attempt to find value-add names within the space, but a rising rate environment will likely dampen REIT equity returns over the next year.

EXHIBIT VI

TMX Group: A Missed Opportunity



Source(s): Capital IQ

References

1. American Insurance Association
2. Canadian Bankers Association
3. Capital IQ
4. George Mason University Research
5. IFIC
6. Mortgage Bankers Association