Investing in the Financial Services Sector

FINANCIAL SERVICES SECTOR REPORT

Companies mentioned in this report:

- **Allstate** (ALL-Buy; $159.13)
- **American Express** (AXP-Buy; $214.56)
- **Bank of America** (BAC-Buy; $33.92)
- **BlackRock** (BLK-Buy; $813.59)
- **Fiserv** (FI-Buy; $150.76)
- **Goldman Sachs** (GS-Buy; $391.05)
- **JP Morgan Chase** (JPM-Buy; $183.99)
- **MasterCard** (MA-Buy; $473.42)
- **Moody's** (MCO-Buy; $385.51)
- **S&P Global** (SPGI-Buy; $438.27)
- **Truist Financial** (TFC-Buy; $35.24)
- **Visa** (V-Buy; $283.60)
- **Wells Fargo** (WFC-Buy; $53.86)

Source: Reuters. Prices and opinion ratings are as of market close on 02/23/2024 and are subject to change.

For more information:

Individuals can obtain the full research report with full disclosures on any of the companies mentioned in this report by contacting a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131. Information about research distribution is available through the Investment Services link on www.edwardjones.com.

- Financial services companies are critical in ensuring the economy transacts and functions efficiently by sharing responsibility for the general management and transaction of money. Almost all businesses and consumers are users of financial products and services. We believe that over the long term the sector will be driven by a growing global population, globalization of world economies, and market and technological innovations. That said, reform and economic conditions will also likely influence the sector in the near term. We believe that our Buy-rated recommendations will be able to navigate the changing landscape.
- When building out the financial services part of your portfolio, we recommend starting with the banking subsector, which tends to be more diversified. After gaining exposure to banks, we recommend employing a balanced approach by adding stocks from the remaining two subsectors: insurance and diversified financials.
- The financial services sector has been constantly evolving since the financial crisis, and risks are involved when investing in financial companies. Some of these risks include regulation, litigation, deteriorating economic conditions, and a changing business model.

Why Invest in Financial Services Companies?

We believe the financial services sector is an important component of a well-diversified portfolio. The sector encompasses a large group of companies including mega banks, regional banks, asset managers, custody banks, consumer finance companies, transaction and payment processors, securities and brokerage firms, and insurers. Financials make up a significant portion of overall GDP and are extremely important in ensuring the economy functions efficiently. Playing such an integral role in the lives of consumers, businesses and institutions, we believe financial services companies should be a key component to an investor's portfolio.

Analyst: James Shanahan, CFA
Analyst: Kyle Sanders, CFA

Recent News

Pressure on Financial Services Stocks

Following the failure of three large regional banks in early 2023, financial services stock prices were under significant pressure. Regional banks, in particular, underperformed larger banks as well as other financial services peers. The bank failures sparked concerns over liquidity, as the failed banks held a relatively large percentage of commercial deposits that exceeded FDIC insurance limits. We believe that liquidity concerns for the larger regional banks are overblown. All the regional banks that we follow tend to be much more retail-oriented, with a comparatively small percentage of uninsured deposits, reducing the risk of massive deposit outflows experienced at the failed banks. JP Morgan Chase (JPM) was a substantial beneficiary of deposit inflows, while the rest of the U.S. banks in our coverage experienced stable or modest outflows in deposits. We believe that most deposit outflows are largely being driven by higher competition from products such as high-yield savings accounts and money-market funds and has less to do with investor concerns over any of our coverage banks' financial health.

Increased Regulation Likely Coming

While we believe that banks in our coverage are already very well capitalized and prepared for a potential recession, the aforementioned bank failures have put banking stocks into focus for regulators. The Federal Reserve provided its view of the events and circumstances that led to the bank failures and suggested that revisions to bank capital requirements are likely. While new regulations may be targeted to all banking institutions, we expect regional banks to be the most impacted given the relatively lower requirements smaller banks are currently held to compared with larger banks. That being said, banks have historically been given several years to fully comply with new regulations, and we expect that banks will likely have until 2026 to 2027 to comply. We believe the regional banks in our coverage are well-capitalized and, if needed, will be able to build additional capital through internally generated cash flow to comply with potential new regulations.

Long-term Growth Trends

We believe there are three main trends that will positively drive the sector in the long run. These trends are a growing global population, globalization of world economies, and market and technological innovations. As individuals in developed countries live longer, there is an increasing need to save and plan for retirement. In addition, as developing economies grow and wealth accumulates within those regions, there is an increasing need for individuals and businesses to have access to a wide variety of financial products in order to manage, hedge and compound their new-found wealth. This new wealth will likely cause globalization to become prominent, meaning there will be a greater desire to easily transfer money across borders. As technology continues to improve, it will become more efficient for companies to offer financial products globally. In addition, technology has the potential to alter the landscape of the financial services industry, leading to reduced costs, new revenue streams and industry consolidation.

For more specific guidance on short-term factors driving the industry, please see our topical Sector Reports, which are regularly written and updated in response to current industry events.

Understanding the Industry

We break down the financial services industry into three main subsectors: Banks, Diversified Financials and Insurance. We recommend investors diversify their financial services portfolio by investing in a variety of different companies within the three subsectors.

Banking

Mega Banks - Mega banks are often the most diversified companies within the financial services sector, given they tend to operate in many business lines. Typically, the focus of a mega bank is on traditional retail and business banking, corporate banking and consumer banking. In order to diversify and increase revenues, these banks also often operate in other financial areas such as wealth management, insurance, custody banking, investment banking and trading. While the economy plays a large role in the performance of these stocks, mega banks' multitude of business lines helps them navigate through challenging environments. Due to the diverse nature of the mega banks, we believe these companies offer a good entry point for investing within the financial services sector. **JP Morgan Chase (JPM)** and **Bank of America (BAC)** are on the Edward Jones U.S. Stock Focus List.

Regional Banks - A scaled down version of large banks, regional banks are locally based institutions that provide a significant portion of the financing required by small businesses, as well as construction and commercial real estate projects within a community. Oftentimes, regional banks are less diversified than the mega banks, deriving a larger portion of revenue from traditional banking activities (borrowing and lending) and a smaller portion of revenue from fee-based business lines (such as investment banking and trading). As a result, regional banks tend to have less exposure to more volatile business segments, making their earnings more predictable relative to larger peers. A long-term theme for regional banks is consolidation. Regional banking is often considered a fragmented industry because there are thousands of different community banks across the United States. Industry consolidation provides an opportunity for these banks to build size and the advantages that come with size. Consequently, we view consolidation as a positive catalyst for future earnings growth and as an opportunity to include regional banks as part of an investment in the financial services sector.

Diversified Financials

Consumer Finance - Similar to banks, consumer finance companies lend to consumers and businesses. However, consumer finance companies focus their lending on credit cards, mortgages, auto loans, student loans and personal loans. As the name would imply, consumer finance companies are closely tied to the health of the consumer, often performing well when consumer spending is up and consumers' financial positions are strong. These companies succeed based on their ability to grow lending at attractive rates while keeping borrower credit standards high. Buy-rated **American Express (AXP)** is our preferred consumer finance stock. With few companies that solely focus on consumer finance, exposure to this space can be included in a portfolio by investing in a mega bank that has a strong consumer finance arm as part of its business model.

Transaction and Payment Processing Services - The rapidly changing world of payments presents one of the more attractive areas for growth within the financial services industry. While growing consumer spending certainly matters, how consumers make payments is becoming increasingly important. Consumers continue to gradually shift from cash payments to card payments. Despite heavy adoption in the U.S., cash payments still represent a majority of total payments globally. This presents an attractive growth opportunity as more payments move to cards. As the dominant payment networks like **Visa (V)** and **MasterCard (MA)** expand into new markets and sign on new merchants, it creates a powerful network effect. This makes it extremely difficult for new companies to compete with the established payment networks. As consumer spending continues to gradually increase and the adoption of cards grows globally, we expect the payment processors to benefit from this growth.

A second area of growth within payments is the growing adoption of digital payments. Many consumers are choosing to complete purchases digitally, using a computer or a smartphone. The growing adoption of digital payments drives greater purchasing volume and the demand for what are known as digital wallets. Digital wallets will store a consumer's information securely online, simplifying digital payments. Digital wallets can usually send all relevant information to a retailer with the click of a button, making the experience nearly frictionless and comparable to swiping a card at a physical location. As consumer preference for digital purchasing grows, this should drive transaction-volume growth across payment networks. **Fiserv (FI)** and **Visa (V)** are on the Edward Jones U.S. Stock Focus List.

Investment Banks & Brokerage - An investment bank is responsible for raising capital and managing the capital needs for large businesses and governments. Meanwhile, a brokerage firm acts as an intermediary between buyers and sellers of financial securities as well as often providing wealth management and financial planning services for their clients. Investment banks and brokerage firms are among the most cyclical companies within the financial services sector because they are very exposed to the trajectory of the financial markets, often performing well when stock and bond markets rise and performing poorly when those markets fall. Few standalone investment banks and brokerage firms remain today after the financial crisis caused a wave of industry consolidation and regulatory reform. Today, investment banks and brokerage firms have higher capital requirements, relatively lower leveraged business models, greater transparency, and stricter laws guiding operations. As a result, we believe investment banks and brokerage firms will not likely go back to historic growth rates and returns. However, because of the evolving industry landscape and the depressed market returns since the financial crisis, we believe there are opportunities to include investment

banks and brokerage firms in a diversified financial services portfolio. **Goldman Sachs (GS)** is on the Edward Jones U.S. Stock Focus List.

Asset Managers - Through various product offerings, asset managers help retail (individuals and families) and institutional (pensions, endowments, 401(k)) clients manage their investments in order to meet specific goals. Some of these products include mutual funds, exchange-traded funds (ETFs), hedge funds and private equity, all of which can be tailored to a client's specific need. Asset managers generate revenue by charging a fee rate against the total assets under management (AUM) that the firm manages for a client. Generally, the greater the number of assets managed on behalf of a client, the lower rate that client pays. Economies of scale are a major factor in the profitability of asset managers. Larger firms can leverage their size in order to charge lower prices and offer newer and more unique products and services. The profitability of an asset manager is highly correlated to the overall market, meaning firms can experience periods of volatility in earnings when markets fluctuate. We believe assets managers are a good source of portfolio diversification for investors whose risk profile can tolerate the volatility. **BlackRock (BLK)** is on the Edward Jones U.S. Stock Focus List.

Custody Banks - Although custody banks include the word "bank" in their name, their core business is very different from traditional banks. Rather than take deposits and make loans, custody banks hold assets (such as securities) on behalf of their customers (such as mutual funds), earning fees derived from the value of those assets. As a result, custody banks' revenues are positively correlated with the rise in asset values and in turn are heavily reliant upon asset-based custody fees. In addition, custody banks are less sensitive to domestic loan demand and not as dependent on interest rates as a source of profits relative to traditional banks. Similar to asset managers, custody banks are highly correlated to the overall market, meaning firms can experience periods of volatility in earnings when markets fluctuate.

Ratings Agencies - Bond issuers pay ratings agencies to assign a credit rating on their securities, which is an opinion about the ability of the issuer to meet its debt obligations and the likelihood of default. In turn, investors rely on these credit rating to assess and manage risk, typically requiring ratings from two independent ratings agencies per bond. In our view, this process is highly valuable for market participants, making ratings agencies unavoidable gatekeepers to debt capital markets. Collectively, we estimate that **S&P Global (SPGI)** and **Moody's (MCO)** account for a dominant portion of all bond ratings in the U.S. and Europe. In addition to issuing credit ratings, ratings agencies offer data and analytics services to asset managers, banks and insurance firms. **S&P Global SPGI** is on the Edward Jones U.S. Stock Focus List.

<u>Insurance</u>

Insurance firms help people protect themselves against the risk of unfortunate or catastrophic events. These companies generate revenue by collecting premiums from customers and earning income on investing the collected premiums. Their primary expense stems from paying insurance claims when the protected event occurs. An insurance firm's profitability is driven by the firm's ability to forecast the frequency and amount of future claims accurately and invest premiums at attractive rates. Insurance companies do their best to ensure that they have sufficient loss reserves and that they can easily access their investments for when they might have to play claims. The insurance subsector can be broken down into two parts: life insurers and property and casualty (P&C) insurers. **Allstate (ALL)** is on the Edward Jones U.S. Stock Focus List.

Life Insurers - Life insurers' offer a wide array of financial services including life insurance, annuities and retirement products. Life insurance policies generally have longer time horizons (such as the entire lifespan of an individual) than policies written by property and casualty insurers. Because of this difference, life insurance companies tend to take more risk within their investment portfolios (such as investments in equities) and derive a greater portion of overall revenue from investment income. While these differences enhance the growth and profitability potential of life insurers, we believe they also increase investment risk and share price volatility. Consequently, Edward Jones provides limited guidance on life insurers.

Property and Casualty - A majority of the P&C insurance business is driven by the sale of automobile and homeowners insurance. P&C insurers write policies (such as auto insurance policies) that provide loss protection on an asset in exchange for premiums (cash paid by the customer). When a loss event occurs (such as a car accident or a storm), the P&C insurer pays claims. Because P&C insurers have policy and loss cycles that are short (six to 12 months), these companies generally invest premiums in lower-risk, shorter-maturity investments. A P&C insurer's

profitability is driven by the company's ability to grow and retain policy holders, underwrite profitable policies, and generate investment income. Because P&C insurers focus their business on relatively nondiscretionary products (there is little choice to purchase insurance regardless of the economic environment), we view these companies as a more defensive option within the financial services sector.

Valuation

When valuing financial services companies, we use various methods, including, but not limited to, price-to-earnings ratios (P/E), price-to-book ratios (P/B), and return-on-equity calculations (ROE). During times of depressed earnings, we feel it is most appropriate to rely more heavily on price-to-book ratios and normalized earnings estimates. During times of more normalized earnings, we focus on both the price-to-earnings ratio and price-to-book ratio. The P/B measurement analyzes the value of equity (or book value) a financial company has on its balance sheet. Most financial companies are in the business of borrowing and lending, so the value of the assets, liabilities and equity on a company's balance sheet are paramount to determining what the shares are worth. Lastly, return on equity is another useful measure to gauge what an appropriate price is for a company based on what it can earn on its capital.

Risks

While we believe there are attractive investment opportunities within the financial services sector, it is important to note, as with all investments, there are some potential risks involved with investing in the sector:

- The potential for high costs related to legal settlements could hurt firm profitability and capitalization, reducing the firms' ability to generate returns and consequently hurting share prices.

- Should financial reform and capital requirements be overly severe and punitive, financial services companies may not be able to grow earnings as they have historically. The result being lower returns on equity and the possibility for negative returns.

- Financial services companies are highly sensitive to changes in interest rates, meaning that greater volatility in interest rates may lead to greater stock-price volatility.

- Financial services companies are highly sensitive to the overall health of the economy. During challenging economic times, the share prices of financial services companies have the potential to be negatively affected.

Environmental, Social and Governance (ESG) Considerations

ESG concerns in the financial services sector often revolve around two issues. One is the environmental impact of providing financing to companies is sectors such as manufacturing, oil & gas and forestry that increase greenhouse gasses. The banks we recommend are making progress to reduce carbon emissions associated with their loan portfolios and have set targets to increase funding for future climate-change initiatives. Recently, **JP Morgan (JPM)** set a goal to finance $2.5 trillion of initiatives that combat climate change, such as clean energy alternatives. Consumer protection is a second key consideration. Banks, asset managers and insurers provide important services entrusted by millions of clients to provide fair products, follow regulations, and prevent unethical business practices. Most of the companies we recommend do a good job of upholding business ethics and regulation related to selling products that are appropriate for clients, protecting confidential client data, ensuring that debt underwriting and collection practices are fair, and handling complaints. Lapses in consumer-protection practices can result in significant reputational, regulatory and legal issues for firms like **Wells Fargo (WFC)**. Our Buy-rating for Wells Fargo is based largely on our view that the company will make significant improvements to address past consumer protection miscues and resolve regulatory violations.

How to Invest in the Financial Services Sector

We suggest diversifying across the sector due to the varying opportunities and risk exposures among the companies. As a guideline, investors can look to our Buy-rated financial services stocks on the Edward Jones Stock Focus List by subsector. Among the different subsectors within the financial services sector, we recommend investors start with companies in the banking subsector, which tends to be more diversified. After gaining exposure to banking, we recommend employing a balanced approach by adding stocks from the remaining subsectors: insurance and diversified financials.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

James Shanahan, CFA; Kyle Sanders, CFA

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