MERCER CAPITAL

VALUE FOCUS
Asset Management Industry

SEGMENT FOCUS
Mutual Funds

2016

Q1: Mutual Funds
Q2: Traditional Asset Managers
Q3: Alternative Asset Managers
Q4: Trust Banks

Segment Focus
Mutual Funds

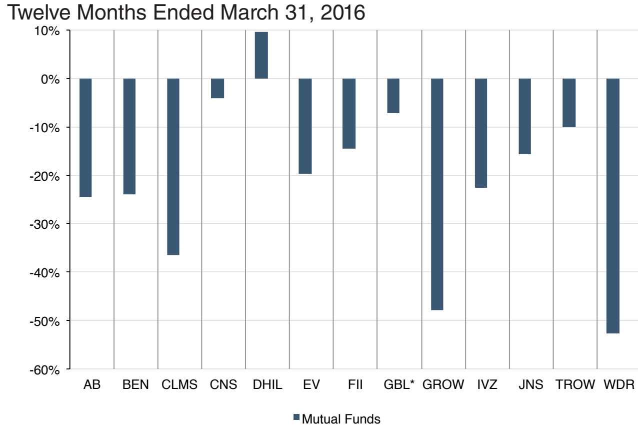
The trend towards ETFs and other passive strategies has been especially challenging for active managers and mutual fund providers. According to **Morningstar**, active funds endured $268 billion in net outflows over the last year while their passive counterparts gained $382 billion in client assets. These dynamics are problematic for many mutual fund companies that rely on active equity strategies with higher fee schedules and profit margins. As a result, most publicly exchanged mutual fund companies are trading in bear market territory while the market has flat lined over the last year.

Active fund outflows are not only attributable to the rise in popularity of low-cost ETF strategies, but also sector-wide underperformance against their applicable benchmarks. Through the first two months of 2016, just 28% of large cap mutual fund managers are beating their benchmarks (27% for all of 2015) and only 1% posted positive returns, according to a **Goldman Sachs** study. Both individual and institutional investors are now more inclined to shun active managers for cheaper, more readily available products, particularly when performance suffers. Many active managers and mutual funds have responded by cutting fees or offering their own passive products to stem the outflows, but this has adversely affected their revenue yields and profitability.

Russel Kinnel of Morningstar elaborates on this trend in **his recent article**, "It's Flowmegeddon! Outflows add to the challenges facing active stock fund managers" saying, "The simple answer to this riddle is competition from exchange-traded funds. ETFs have gained the upper hand in the active/passive debate, even over open-end index funds, which generally offer comparable cost benefits. More advisors are switching to ETF-focused strategies, and, when they get a new client, they quickly sell the weakest performing active funds—possibly all the actively managed funds—in the client's current portfolio. Self-guided investors are moving to ETFs, too." As Mr. Kinnel notes, these redemptions from active funds wouldn't be so alarming in a bear market, but we've come a long way since the Financial Crisis. This current trend is about investor preferences not investor paranoia.

Stock Price Performance

Twelve Months Ended March 31, 2016



Source: S&P Global Market Intelligence
* GBL performance excluding impact of Associated Capital Group divestiture

On balance, passive funds appear primed to continue their dominance over active management, but we still question the sustainability of this trend over the long run. While fees are likely to continue their descent over time, it is hard to imagine that passive investing will completely replace active management. Such a scenario could lead to significant mispricing in the securities markets, which would be fertile ground for enterprising investors and mutual funds.

What We're Reading

It's Flowmageddon!
Morningstar: Russel Kinnel
http://mer.cr/21umWWC

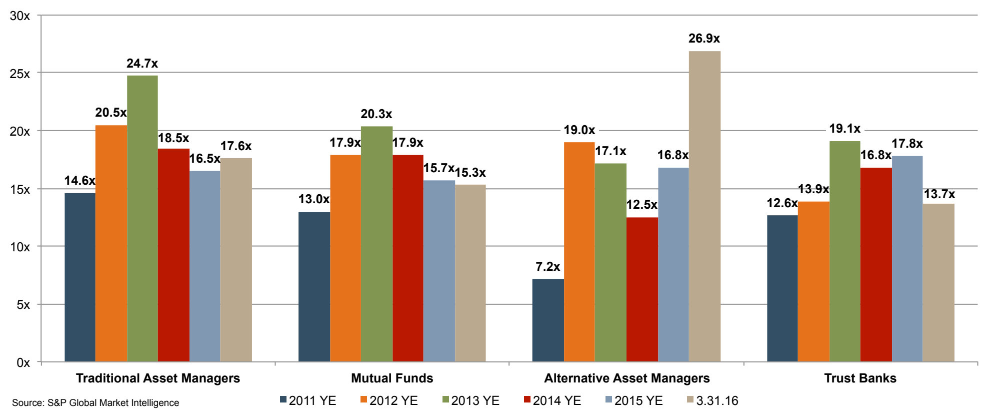
2016 Wealth Management Trends
Deloitte
http://mer.cr/1rtLnal

Top 10 Hedge Fund Industry Trends for 2016
Winston & Strawn LLP:
Don Steinbrugge of Agecroft Partners
http://mer.cr/1UwRoOQ

Asset Manager Pricing & Analysis

From a valuation perspective, it appears that alternative asset managers fared the best in Q1. The group's median multiple rose 60% in the first three months of the year, besting all other classes of asset managers over the same period.

Historical Median Price to LTM EPS by Sector



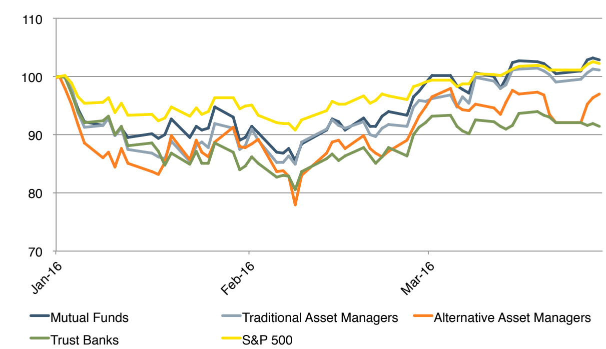
Source: S&P Global Market Intelligence

Closer inspection reveals a much bleaker quarter for the publicly traded hedge funds and private equity firms in our alternative asset manager index. Despite significant gains in the back half of the quarter, the group lost roughly 5% of its market cap during the first three months of the year. In other words, the E is falling faster than the P/E is rising for most of these businesses. With many names trading at a 40%+ discount to their 52 week high, the market seems to be questioning the long-term viability of many hedge funds and PE firms whose high fees and subpar performance have come under scrutiny in recent years.

On the other end of the spectrum, more traditional, longonly managers appear to have taken some market share from their alternative counterparts over the same period. Investors continue to grow wary of higher fees, especially when performance suffers, so this is no surprise to those who follow the sector. Still, hedge funds are typically better poised to profit from market volatility, which might explain the group's advancement since its mid-February bottom.

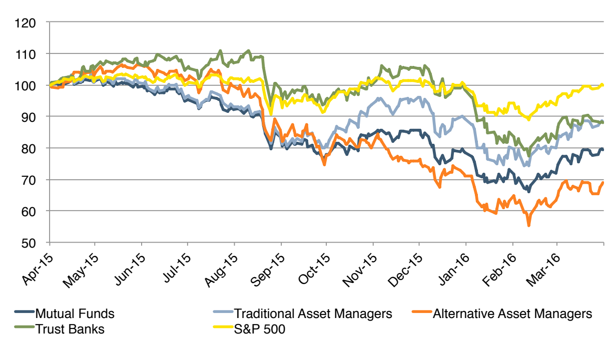
Moving forward, this disparity is unlikely to persist if many of these publicly traded alt managers are to remain a going concern. The past few weeks have been promising, but the index as a whole lost roughly half of its market cap from July of last year to February of 2016. An opportunistic investor with a high risk tolerance might see this as a buying opportunity. Others will look skeptically at the sector's prospects in the era of passive investing.

Asset Manager Pricing in Q1



Source: S&P Global Market Intelligence

Asset Manager Trailing Twelve Month Performance by Sector



Source: S&P Global Market Intelligence

M&A Review

Mutual fund outflows and multiple contraction may actually have positive implications for RIA deal-making in 2016 and beyond. The maturation of the mutual fund industry and active fund managers will likely spur consolidation and buying opportunities for those looking to add scale. With valuations and market caps down over the last eighteen months or so, the affordability index has gotten a lot better for many of these businesses.

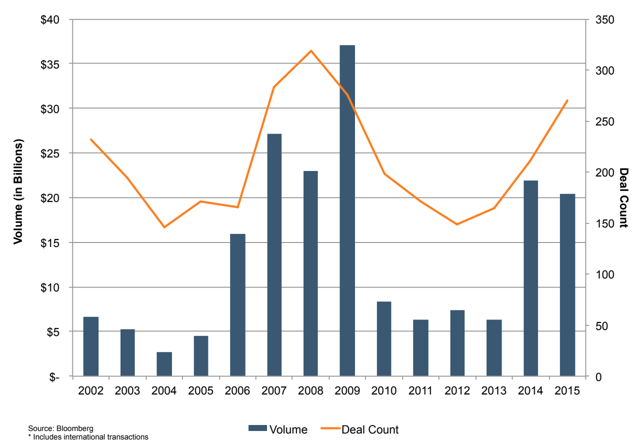
Expectations for slower growth (reflected in lower multiples) could be another driver of M&A activity, as RIAs look to other asset managers to build or replace AUM depleted by outflows and market movements. If organic growth opportunities are truly stalling, acquisitions are a viable means to offset falling management fees and collect market share for those that can afford to do so. Rising cap rates should also help, as the embedded return on investment improves with lower multiples.

The recent gains in volatility should have a more nuanced effect on the pace of acquisitions. Prospective buyers might be spooked by the sector's vulnerability to investor sentiment as a high-beta business. Alternatively, the relatively low levels of leverage and balance sheet risk might make it more resilient to credit crunches or changes in capital requirements.

For whatever the reason, the past few weeks have witnessed a few major transactions in the space, including State Street's $485 million purchase of GE Asset Management and Bank of Singapore's $320 million acquisition of Barclays wealth management operations in the Far East. These deals, coupled with the Kanaly Trust / Mercer Advisors (no relation) merger indicate a growing appetite for larger deals in the last month or so.

On balance, 2016 could be a record year for sector deal-making both in terms of deal count and collective volume. While this may be a stretch given the number of distressed sales during the financial crisis, a continuation of the recent uptick is certainly achievable.

Asset Manager M&A Since 2002*



We believe the backlog of available deals remains fairly robust given the four year pause in transactions from 2009 to 2013 and the aging demographics of many investment management firms. Still, we acknowledge that the decline in transaction activity following the financial crisis of 2008 and 2009 could be indicative of what another bear market could do to M&A trends when the dust settles and AUM has cratered.

RIA Valuation Insights Blog

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Asset Manager Multiples by Sector

				Pricing as of March 31, 2016			
	Ticker	3/31/16 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Total Capital / AUM	Total Capital / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	$162.40	70.42%	17.57	11.05	1.75%	8.09
BlackRock, Inc.	BLK	340.57	89.91%	17.25	15.46	1.32%	12.16
Legg Mason, Inc.	LM	34.68	62.06%	41.23	14.37	0.72%	23.99
Pzena Investment Management, Inc.	PZN	7.55	61.63%	15.02	17.63	1.94%	9.55
Westwood Holdings Group, Inc.	WHG	58.65	91.51%	17.65	nm	2.44%	11.32
Group Median			**70.42%**	**17.57**	**14.91**	**1.75%**	**11.32**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	$23.43	71.56%	11.87	11.59	nm	10.56
Calamos Asset Management, Inc.	CLMS	8.49	62.38%	48.39	21.24	0.88%	6.26
Cohen & Steers, Inc.	CNS	38.92	93.07%	27.58	18.97	3.36%	14.86
GAMCO Investors, Inc.	GBL	37.06	42.04%	10.98	15.68	3.69%	9.63
INVESCO Ltd.	IVZ	30.77	73.17%	13.83	10.98	2.65%	11.91
Franklin Resources, Inc.	BEN	39.05	74.01%	12.50	13.54	3.33%	8.43
Diamond Hill Investment Group, Inc.	DHIL	177.36	76.50%	15.99	nm	3.58%	10.27
Eaton Vance Corp.	EV	33.52	76.72%	15.28	14.20	1.59%	9.83
Hennessy Advisors, Inc,	HNNA	26.70	80.91%	11.85	nm	2.70%	7.57
Manning & Napier, Inc.	MN	8.07	88.00%	nm	10.98	0.34%	0.96
T. Rowe Price Group, Inc.	TROW	73.46	87.95%	15.96	15.08	2.43%	8.70
U.S. Global Investors, Inc.	GROW	1.73	50.88%	nm	nm	3.81%	nm
Waddell & Reed Financial, Inc.	WDR	23.54	45.95%	8.04	11.42	2.06%	5.04
Federated Investors, Inc.	FII	28.85	80.70%	17.87	14.26	0.89%	11.19
Virtus Investment Partners, Inc.	VRTS	14.63	77.10%	nm	nm	3.81%	9.90
Janus Capital Group Inc.	JNS	17.12	73.38%	18.36	13.60	1.62%	nm
Group Median			**75.26%**	**15.28**	**13.90**	**2.65%**	**9.73**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	$17.12	73.38%	27.93	9.32	2.89%	10.87
Brookfield Asset Management, Inc.	BAM.A	34.79	89.21%	19.99	21.94	nm	11.24
Blackstone Group L.P.	BX	28.05	63.13%	26.87	8.78	5.19%	nm
Carlye Group, L.P,	CG	16.88	52.95%	nm	7.14	0.74%	10.54
Fortress Investment Group LLC	FIG	4.78	55.26%	17.04	5.07	2.04%	5.93
Kohlberg Kravis Roberts & Co.	KKR	14.69	59.26%	14.36	6.28	21.22%	nm
Oaktree Capital Group, LLC	OAK	49.33	87.25%	34.01	13.48	17.73%	nm
Och-Ziff Capital Mgmt Group LLC	OZM	4.35	32.25%	29.14	3.55	21.25%	29.10
Group Median			**61.20%**	**26.87**	**7.96**	**5.19%**	**10.87**
TRUST BANKS							
Northern Trust Corporation	NTRS	$65.17	82.23%	16.41	14.39	nm	nm
Bank of New York Mellon Corporation	BK	36.83	81.03%	13.70	10.99	nm	nm
State Street Corporation	STT	58.52	72.02%	13.09	10.82	nm	nm
Group Median			**81.03%**	**13.70**	**10.99**	**nm**	**nm**
OVERALL MEDIAN			**73.38%**	**16.72**	**13.48**	**2.44%**	**10.09**

Data Source: S&P Global Market Intelligence

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In This Issue

About Value Focus Asset Management Industry

Mercer Capital's Value Focus is a quarterly publication providing perspective on valuation issues pertinent to asset managers, trust companies, and investment consultants. Each issue highlights a market segment: 1st quarter: Mutual Fund Companies, 2nd quarter: Traditional Asset Managers, 3rd quarter: Alternative Asset Managers, and 4th quarter: Trust Banks. View past issues at www.mercercapital.com.

About Mercer Capital

As one of the largest valuation firms in the United States, Mercer Capital provides asset managers, trust companies, and investment consultants with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services.

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