STRUCTURED INVESTMENTS & ADVISORY

STRATEGY NOTE

ISSUE 018

FEBRUARY 2020

HIGHLIGHTS

- Multiple trends are shaping the future of the asset management industry. Some are related to long-term changes in the fundamentals of the global economy which have been, at least partially, a consequence of the financial crisis of 2008, while others are related to technological advancements that are disrupting and redefining the dynamics of entire industries.
- The expansionary monetary policies following the financial crisis of 2008 have resulted in what seems to be a prolonged low interest rate environment. This, in addition to a low inflation, low growth environment amid a tighter regulatory framework, is causing a significant change in the dynamics of the asset management industry on a global level.
- The hunt for yield is pushing investors towards riskier asset classes amplifying the overall risk in the system while passive investing as a low-cost means of gaining market exposure is gaining significant ground against active investing.
- Technology is playing a key role in accelerating the change. The traditional model of commercial banking is being challenged by more flexible, consumer-centric digital banking models, while Artificial Intelligence is threatening the long-standing aspect of human relations in the wealth management industry.
- Environmental concerns and sustainability issues have been gaining significant importance over the past few years. These issues are being integrated into the core of the investment management industry after having been considered long-term qualitative factors with no material effect on the investment outcome.

TRENDS SHAPING THE ASSET MANAGEMENT INDUSTRY

Multiple trends are shaping the future of the asset management industry. Some are related to long-term changes in the fundamentals of the global economy which have been, at least partially, a consequence of the financial crisis of 2008, while others are related to technological advancements that are disrupting and redefining the dynamics of entire industries. There are also longer-term global megatrends that are currently in play such as demographic shifts, that are altering consumption and spending patterns, and climate change.

The first set of trends that will be discussed is that related to economic developments; Global central banks' expansionary monetary policies that were aimed at countering the effects of the financial crisis and prop economic growth caused what seems to be a prolonged low interest rate environment. This, coupled with persistently low inflation and a generally moderate level of economic growth, is causing a paradigm shift in asset management. The search for yield, low interest rates, and the distortion in asset prices, would have consequences for both investors and asset managers and could be pushing investors into taking an excessive level of investment risk.

The other set of trends is mostly related to advances in technology, including artificial intelligence, data science and automation. Technology is radically reshaping and redefining the investment management industry, and the disruptive impact of innovation could be seen all along its value chain.

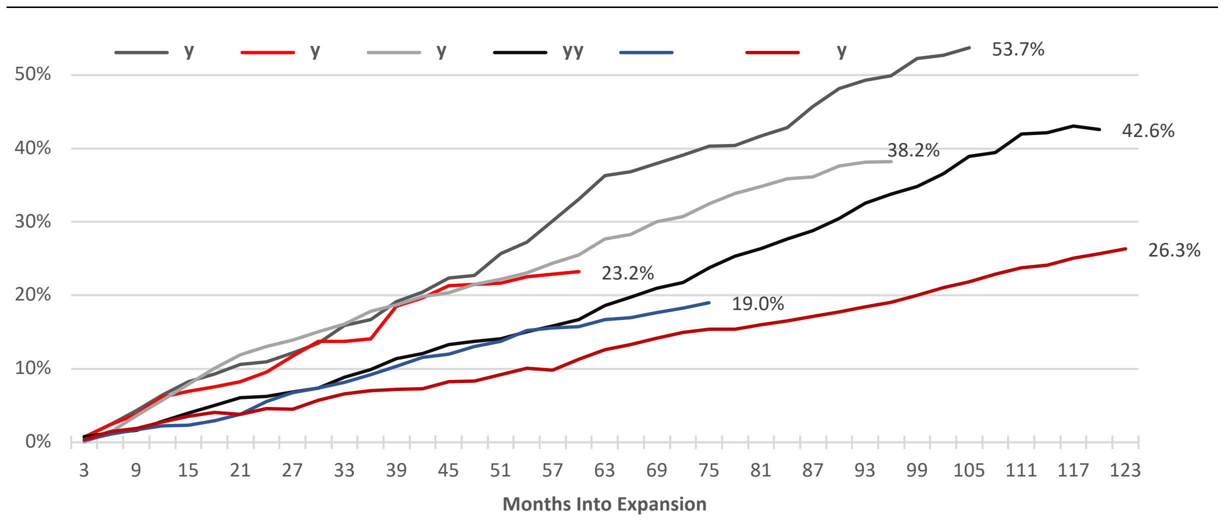
THE BIG PICTURE: LOWER FOR LONGER

In July of last year, the economic expansion in the US officially became the longest in history when it broke the record of 120 months of consecutive growth set by the expansion from March 1991 to March 2001. By the end of 2019, the economy had grown for 126 months and it is expected to continue its growth trajectory for at least two to three more years albeit at more moderate rates of 1.8-2.0%.

It could be the longest running expansion in US history, but it is also one of the most moderate in terms of growth momentum. The US economy has grown by around 26% since the current cycle began in June 2009. The two most comparable previous growth cycles in terms of length were the one that started in 1961, which lasted for 105 months, and that of 1991, which lasted for 120 months. During those two expansions the US economy grew by a cumulative 53.7% and 42.6% respectively.

Job growth also followed the same pattern as the percentage growth in employment since the start of the cycle was around 12.0% compared to 19.7% and 17.0% for the cycles of 1961 and 1991.

Chart . US GDP Cumulative Growth – (Label marks the start of the expansion)



Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis;

The unemployment rate has dropped from a peak of 10% during the financial crisis to 3.5% as of December 2019, the lowest rate since 1969. The participation rate, however, remains below its pre-crisis level and hovered around the 63% level for the past 5 years. In fact, it has been trending down since it peaked in early 2000 at 67.3%, but the downward trajectory accelerated after the financial crisis.

The period around the financial crisis coincided with a structural change in the US job market; many of the baby boomers were at or within a few years of their retirement age and the crisis acted as a catalyst for driving many of them into early retirement. This caused an acceleration in the decline of the labor participation rate.

Chart . US Real GDP Quarterly Growth ( ) p

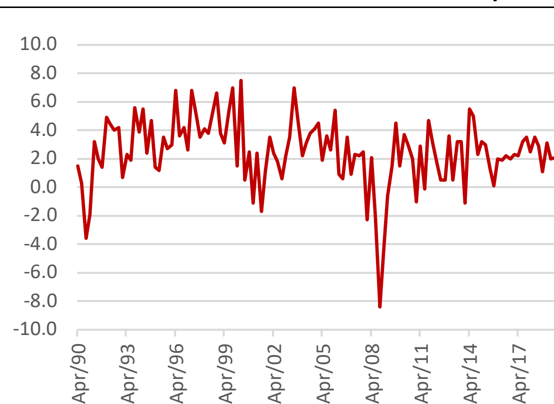
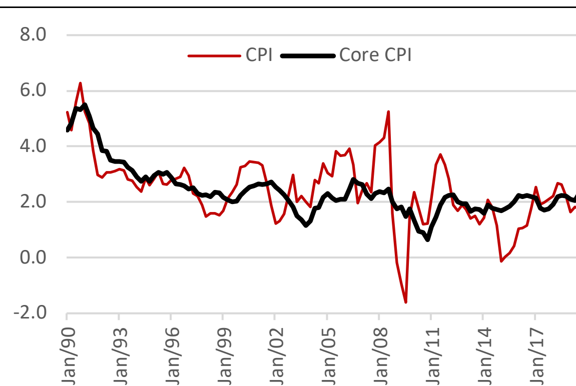


Chart . Core and headline CPI inflation

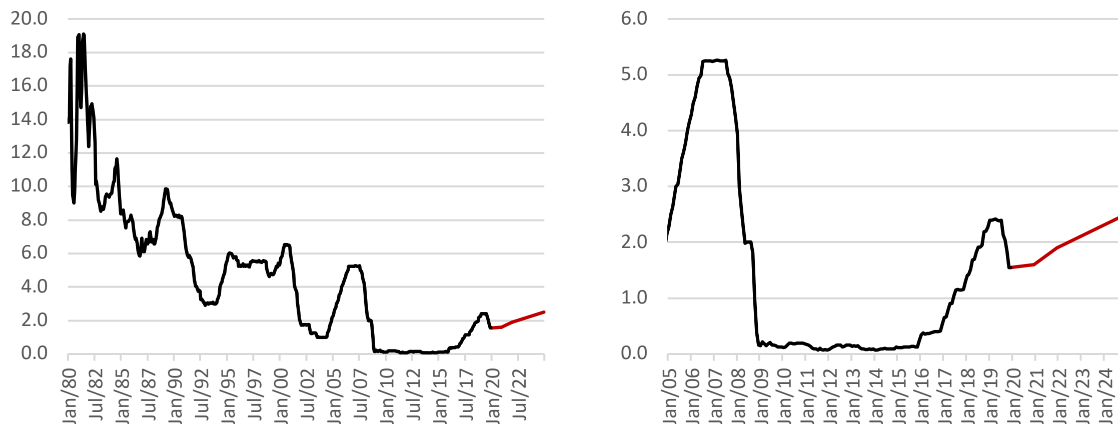


Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Loui, Bloomberg, NBK Capital

The moderate and steady growth in the US GDP has been particularly visible in the past few years as shown in chart 2 above, especially when compared to the previous quarterly

movements. This is coupled with a low rate environment and a moderate inflation that has been hovering around the 2% mark for the past 8 years (chart 3). The Fed, on the other hand, is still maintaining an accommodative policy that would keep rates low, by historical standards, for a considerable period. Against the current rate target of 1.50-1.75%, the latest fed projections call for an average rate of 1.6% during 2020, 1.9% and 2.1% for 2021 and 2022, and 2.5% over the long term.

Chart . Federal Funds Rate ( ) Historical & Projections – Long Term (LHS) and -Current (RHS)



Note: Projected Fed Rate path in Red

Source: Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; NBK Capital

A major consequence of this low growth, low rates, and low inflation environment is a low yield on risk free assets which is leading investors to look for yield elsewhere. Ten-year government bonds in the US are currently yielding around 1.6-1.8%, in the UK the yield is around 0.65%, while yields for German, Japanese, and French are in negative territory. In fact, the total universe of negative yielding global debt reached around USD 17 trillion during 2019.

IMPLICATIONS FOR ASSET MANAGEMENT

Riskier Environment

The expansionary monetary policies of central banks that are based on rate cuts and balance sheet expansions and other unconventional monetary tools, have succeeded in keeping developed economies afloat but came at a cost. Yields have collapsed around the world and risk-free assets are no longer delivering the desired profitability. Moreover, increasingly higher amounts of emerging markets wealth that is seeking high grade developed markets debt are significantly contributing to the demand on such instruments and consequently increasing the pressure on yields. This has intensified the search for yield and pushed investors to seek it elsewhere. Add to this mix the distorted asset prices caused, at least partly, by central bank policies, and a bull market that is still going strong entering its 11th year, and you get a significantly distorted view of investment risk.

Investors are looking into riskier assets to generate yield. Dividend-yielding stocks are now viewed by many as an alternative to high grade fixed income regardless of the fact that investing in equities, whether dividend-yielding or not, still has a very different risk profile from risk-free government bonds or high-grade corporates. Another venue that is becoming increasingly popular among yield-seekers is the area of private equity and private debt and other related complex structures such as corporate leveraged loans. Although this is an area that has been typically accessible only by institutional and high net worth investors, the use of ETFs, structured notes, and other forms of investment vehicles is opening the doors to smaller investors, often at the expense of lower liquidity and potentially higher risk in adverse market conditions.

Passive Investment Taking Over

The low growth, low yield environment has also accelerated an already undergoing “money migration” phenomenon from actively to passively managed funds. In August 2019 the fund management industry in the United States reached a major milestone when investments in passive equity funds topped those in active funds. According to Bloomberg and Morningstar, funds invested in passive US equity funds reached USD 4.271 trillion, compared to USD 4.246 trillion managed by active funds. Total assets in US passive equity funds grew from a little over 11% of total fund investments in US equities to 50% over the past 11 years.

Chart . Assets in US Active Equity Funds

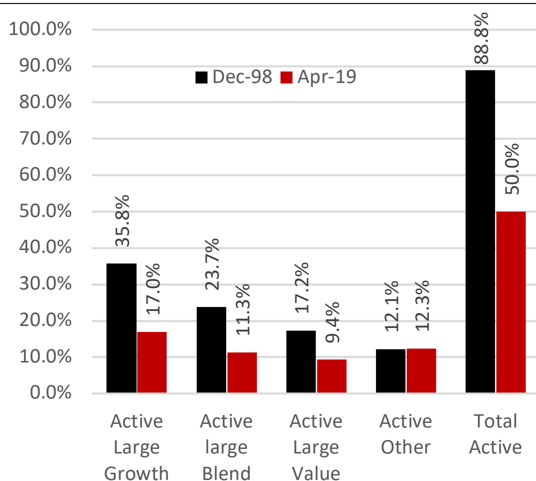
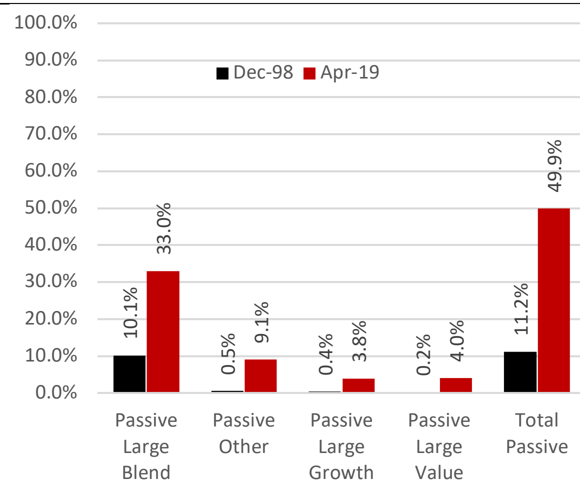


Chart . Assets in US Passive Equity Funds



Source: Morningstar, NBK Capital

The popularity of index funds, ETFs, and other passive investment instruments has been growing since Jack Bogle, the founder of Vanguard Group, invented index funds in 1976. Many factors, however, have been driving the demand of such instruments and have helped in tipping the scale in their favor against traditional active funds.

After the 2008 financial crisis, investors suffering significant losses in active funds started piling money into low-cost passive instruments. This happened at a time when the margins of active managers had already been under pressure due to the cost of increased compliance

and regulatory requirements, technology upgrades, in addition to fee compression due to increased competition and unwillingness of clients to pay higher management fees.

This trend will have consequences for both asset managers and investors. For asset managers, this is not good news; competition will increase in active and passive spaces alike and pressure on margins will intensify. Managers on both sides are trying to improve their value proposition by cutting fees and complementing their services with investment advice, which in turn will eat from their bottom lines.

Passive instruments have become so popular that they are no longer confined to index funds that mimic the performance of major market indices. They could cover multiple strategies and criteria including industry and sector concentration, company size and life cycle stage, commodities, consistency and history of dividend payouts…etc. These funds are being increasingly used to build actively managed portfolios using passive instruments rather than directly trading in the underlying securities.

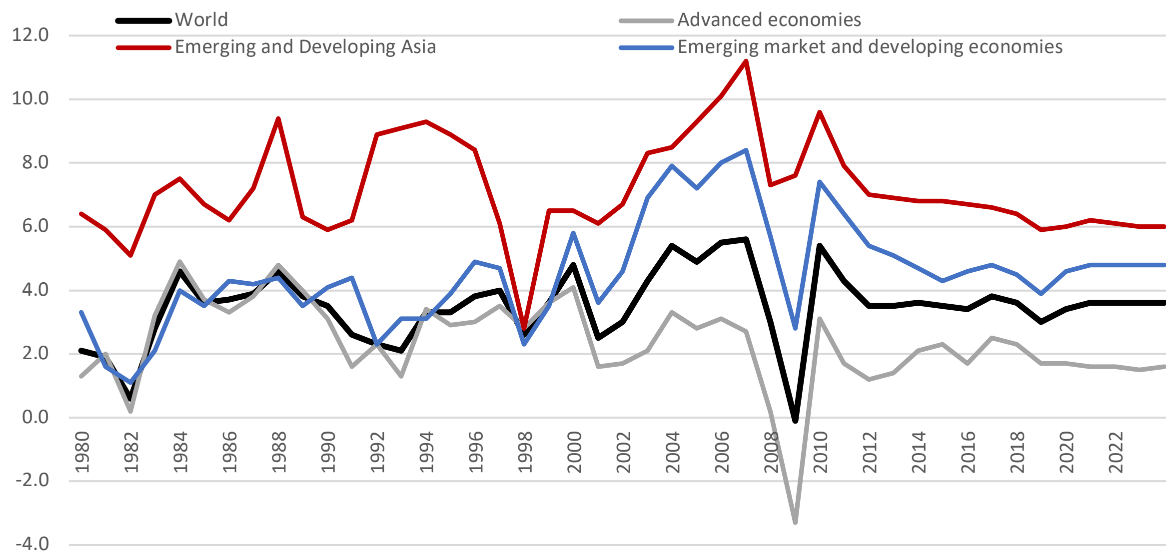
For investors, consequences are mixed; on the positive side, it is a direct and low-cost medium to access a vast array of strategies that could be used to construct portfolios tailored to an investor's specific needs. This comes with the benefit of being able to rebalance a diversified portfolio quickly and easily. On the negative side, the popularity of passive instruments as building blocks for diversified portfolios could magnify a potentially significant tail risk. More than half of the investments in US stocks are now controlled by passive stock ETFs. Some argue that in the event of a market sell-off and because investments in the stock market are being increasingly channeled through ETFs (which have different market-making dynamics) rather than direct equity securities, some funds could become illiquid or face significant losses in the event of unorderly liquidation.

Growth will be coming from the East

The low growth environment which has been prevailing after the financial crisis was mainly driven by anemic growth in developed markets.

Advanced economies as a group have been growing at an average of 1.9% since 2010, mainly due to lower growth in the Eurozone and to a lesser extent in the US. Emerging and developing economies, on the other hand, averaged 4.9% annually since 2009, while emerging and developing Asia averaged 6.8% over the same period. According to the International Monetary Fund (IMF), this trend is expected to continue over the coming few years; global growth will be mainly derived from emerging and developing markets, especially in Asia, as the growth in advanced economies slows further to an average of 1.6% over the next 4-5 years, while world growth stabilizes at around 3.6%.

Chart . Historical and Forecasted Global GDP Growth by Economic Group



Source: International Monetary Fund (IMF DataMapper), NBK Capital

In the face of low growth projections in advanced economies and the richness of their equity markets that is fueled by loose central bank policies, yield hunters eager to boost their portfolio performance would be increasingly looking towards emerging markets. Over the last decade, emerging markets have become more mature and diversified in terms of sector coverage, depth, and regulation. They are no longer dominated by materials and commodities as other sectors have become more developed especially in the area of financials, technology, and industry.

TECHNOLOGY IS ACCELERATING THE CHANGE

The changing economic and market landscape after the financial crisis contributed to the acceleration of technological disruption that has been reshaping the new economy including the investment industry. Digital banking and distributed ledger technology (blockchain) initiatives are redefining the traditional commercial banking model and robo advisors are playing an increasingly important role in the wealth management industry. On the employment side, the massive layoffs that followed the financial crisis forced workers to perform several part-time jobs to make ends meet. The subsequent rise of the digital platforms and mobile apps helped those looking for jobs to be matched with their clients giving rise to the gig economy.

Robo-Advisors

Financial institutions pressured by squeezed margins and rising costs resorted to automation to improve their cost structure. Automation started with streamlining back-office function and progressed through the value chain. Technology has quickly become an essential part of

the toolkit used by investment and portfolio managers; it is now used in security selection and screening, investment research and portfolio construction, all the way to performance evaluation and reporting. Recent development in Artificial Intelligence (AI) and machine learning made it possible for automation to be even extended to front office functions by creating interfaces that would interact directly with the client.

Despite the personal nature of traditional wealth management, automated wealth management systems known as robo-advisors and other similar platforms have had some success in democratizing the investment management process and shifting decision-making to the client's side. This has been helping asset managers reduce management fees and cover more client segments than it was possible before. Smaller investors hold a significant portion of the investable asset pool but are uneconomical to pursue using traditional wealth management channels, thereby creating a significant gap in the industry. Robo-advisors were initially employed as a means of closing this gap but have since evolved to cover a much wider investor base.

Increasing levels of investor education and awareness, in addition to the fast developments in AI and machine learning, are bound to further reduce the role of humans in investment advisory services. Two major forces are acting in favor of robo-advisors; one is the need for investment management firms to streamline costs and increase the efficiency of their business so they can expand their client base, the other is the rapid advances in AI and machine learning which are enabling automated models to be smarter and able to deal with increasingly complex investment products. This, in effect, is changing the traditional role of the human investment advisor from someone who is responsible for managing a clients' portfolio to someone who is responsible for managing the behavioral biases of his clients and keeping them focused on their long-term objectives especially in times of market turmoil.

Digital Banking

Technology is also redefining the traditional commercial banking model. Commercial banks have always been on the forefront of digital innovation by continuously upgrading their IT infrastructure and developing smart banking channels such as online banking and mobile apps. This kind of automation has often been motivated by a need to optimize the use of resources, both financial and human, and looked at as a cost saving exercise. True digitization of the banking industry, however, is much more than an upgrade to the customer interface. It requires a significant overhaul of the traditional culture of banking and embracing new agile ways of conducting business and viewing the customer.

The needs of today's banking clients are completely different from those of earlier generations. Those needs are driven by predominately young customers that are becoming increasingly reliant on smartphones to run their lives. They value a digital offering that would satisfy their needs with the least amount of friction and would complement other digital

solutions they use. Therefore, gaining, or even preserving market share in the future banking industry requires being sensitive to the needs of an emerging client base that is looking for a personalized banking service which mimics that of today's digital giants.

Advances in AI and machine learning and the ability to handle and analyze huge amounts of data is enabling mass customization. Commercial banks now have the ability to use the vast amount of customer data to create customized offerings that would fit each client's needs. This data would include traditional hard data such demographics, wealth and income levels, and credit history, as well as behavioral data such as shopping habits, personal attributes, and other behavioral tendencies.

The consequences of this trend on commercial banks are significant. Given the head start digital giants have had over the banking industry in the requirements of success in a digital world, namely handling and understanding customer data and mass customization, it appears that the most serious competition for commercial banks will not be coming from within the industry. New laws and regulations aimed at protecting consumers and increasing transparency in the system, in addition to the significant role technology is playing in democratizing the financial services industry, are paving the way for new competitive forces to enter the game. Open banking initiatives would allow clients to securely share their banking data and transactions with third parties including other financial institutions and Fintechs. It would also make it easier for clients to switch financial service providers, including banks, as the "pain of switching" would no longer be a factor in their decision-making process when they decide to transfer part or all of their business to a different financial institution. It would significantly reduce the captivity of clients to banks and make it much easier for them to leave one bank for another.

Digital giants and emerging tech companies represent what could prove to be the greatest threat to the traditional commercial banking model in recent history. Banks need to digitize and evolve their operating models and philosophy before it is too late. Today it is much easier for apple to offer financial services than it is for a long-established commercial bank, with decades of layering IT systems on top of each other, to become fully digital. If banks didn't digitize fast enough, their most profitable business segments will slowly be lost to a new kind of competition.

ENVIRONMENTAL ISSUES AND SUSTAINABILITY

Environmental concerns and sustainability issues have been gaining significant importance over the past decade. Factors such as increased social awareness and pressure groups, in addition to regulatory changes that are aimed at encouraging greener and more sustainable economic development are major factors driving the change. Technology has also been a major catalyst by making energy cleaner, smarter and more affordable. Environmental issues

and sustainable investing are quickly becoming pivotal factors in shaping the future of the investment management industry.

Renewables

The same way the transition from coal to hydrocarbons shaped the twentieth century, the current transition away from oil and into renewables has the potential to shape the twenty first century. This would lead to structural changes in energy markets and a multitude of economic sectors, including investment management, in addition to affecting the global geopolitical landscape.

BP expects that the current energy transition from fossil fuel to renewables could be the fastest in the history of energy transitions. It took oil 45 years to go from 1% to 10% of global energy, while natural gas made the same progress in a little over 50 years in early 1900s. Renewables, in contrast are expected to go from 1% to 10% in just 25 years in BP's base-case scenario, with the possibility of that period going down to just 15 years in the event of a faster switch to a low-carbon economy.

Having said that, there are a number of factors that are accelerating the transition to clean energy. They include regulatory directives issued by governments such as global commitments related to carbon emissions and climate targets and the deadlines on the use of internal combustion engines and the subsidies offered to buyers of new electric vehicles (EVs). There are also economically driven catalysts that are related to significant declines in costs, growing electrification of energy, and technological advancements that are making energy smarter, cheaper, and are disrupting the traditional model of central production and distribution of electricity.

The effects of a relatively fast energy transition would be considerable on multiple levels. It would cause structural changes in the global economy and have profound effects on international relations and geopolitics. Countries whose economies depend on oil sales would have to adapt and prepare for alternative sources of revenues to finance their budgets. For investors, new industries would evolve, and the structure of the whole energy sector would change. This would entail changes in the dynamics of multiple sectors including valuation parameters and economic factors determining future growth.

ESG Factors

Increased awareness about sustainability issues and climate change, in addition to social and corporate responsibility, are starting to filter into the investment management industry. More specifically, Environmental, Social and Governance (ESG) factors are slowly becoming an integral part of the investment management process. ESG factors are being integrated into investment analysis and valuation in an attempt to quantify their risk potential on the future revenues of the investment.

While the consideration of environmental social and governance issues is not new to financial analysis, the systematic consideration of such issues is. Financial analysts have always considered factors such as reputational risks, potential for regulatory framework changes and megatrends like demographic changes as part of the overall financial evaluation of investments. What's meant by a complete ESG factor analysis today, however, is the systematic integration of all relevant and material issues into the larger framework of a traditional financial analysis.

ESG factors are being gradually adopted by large investors and are becoming a strategic imperative for many global asset managers. Asset owners and large investors have become global and too big to be able to afford ignoring risks derived from ESG issues on a global scale. The size of the asset management industry has increased so much that investment portfolios are becoming more and more spread across continents and have therefore become increasingly exposed to risks that were previously too far to matter. This adoption would ultimately increase the pressure on both fund managers and individual companies to adopt socially responsible business and investment policies.

Other drivers of a comprehensive ESG adoption include evolving client demand. Millennials are emerging as a new client base and according to a research report by MSCI, they could contribute between $15 and $20 trillion into US domiciled ESG investments over the next 20 to 30 years. Another addition to this client base is the one resulting from an estimated wealth transfer of around $30 trillion from baby boomers to the next generation. This new younger generation of investors has a significantly different set of return requirements; in addition to positive returns, they are a more socially conscious group and want their investments to make a social and environmental impact.

FINAL THOUGHTS

The asset management industry has always been defined by constant change and progress. The nature of change, however, that it is currently undergoing is unique in many ways. It is unique because it is happening along multiple axis concurrently. The technological revolution we are currently living, and its disruptive power, is touching every aspect of our daily lives. This includes the way we commute, we bank, we work, we energize our economy and, of course, the way we invest. Underlying this change in the asset management industry is a unique economic background that has been largely shaped by the financial crisis of 2008 and its repercussions that are still driving the global economy after more than a decade.

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