Financial Services Observer

June 2018

A Ban on Embedded Trailer Fees in Canada Would Further Widen the Gap Between the Banks and Purer-Play Asset Managers

Contents

The balance of power in the Canadian market continues to shift more and more toward the Big Six banks (Royal Bank of Canada, Toronto-Dominion Bank, Scotiabank, Bank of Montreal, Canadian Imperial Bank of Commerce, and National Bank of Canada) at the expense of the nonbank-affiliated asset managers we cover (IGM Financial, CI Financial, and AGF Management) because of a combination of regulatory changes and increased competition for fund sales. The Big Six banks have used their position as the largest distributors of mutual funds in the Canadian market, as well as an expansion of their fund manufacturing operations, to compete more heavily on price, taking share from nonbank-aligned firms.

We see the potential for regulation to once again disrupt the relationship between the Big Six banks and the purer-play asset managers, as Canadian regulators mull banning embedded trailer commissions in the fund market. With more than 80% of fund assets in Canada held in commission-based accounts, a ban on trailer fees would not only push advisors into fee-based account structures that charge investors directly for advice, as opposed to having their annual fee deducted directly from fund assets, but also put a much greater focus on fund management fees and investment performance. We believe this will open the door much wider for low-cost index-based products, which have traditionally not offered trailer fees, to take hold in the Canadian market, taking share from higher-cost active fund managers.

With fund management fees expected to be under a more powerful microscope, we view the Big Six banks as being more insulated than the purer-play asset managers, given that they already have lower fees than nonbank-aligned asset managers and should be able to continue leveraging their distribution strength to their advantage. We view wide-moat Royal Bank of Canada, Toronto-Dominion, and narrow-moat Bank of Montreal as the best positioned among the Big Six banks on the asset-management front. As for the purer-play asset managers, we believe that there will always be room on third-party platforms for active fund managers that have a track record of good repeatable investment performance and reasonable fees, and view narrow-moat CI Financial as being best suited to fit this role.

Financial Services Observer

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Companies Mentioned

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Mkt Cap (bil)
Royal Bank of Canada RY	Wide	Stable	USD	84.00	75.59	Medium	★★★	109.59
Royal Bank of Canada RY-TOR	Wide	Stable	CAD	107.00	98.00	Medium	★★★	141.32
Toronto-Dominion TD	Wide	Stable	USD	62.00	58.39	Medium	★★★	108.29
Toronto-Dominion TD-TOR	Wide	Stable	CAD	79.00	75.70	Medium	★★★	139.64
Bank of Montreal BMO	Narrow	Stable	USD	82.00	77.40	Medium	★★★	49.90
Bank of Montreal BMO-TOR	Narrow	Stable	CAD	105.00	100.44	Medium	★★★	64.35
Bank of Nova Scotia (Scotiabank) BNS	Narrow	Stable	USD	62.00	60.33	Medium	★★★	73.41
Bank of Nova Scotia (Scotiabank) BNS-TOR	Narrow	Stable	CAD	80.00	78.24	Medium	★★★	94.66
Canadian Imperial Bank of Commerce CM	Narrow	Stable	USD	103.00	87.31	Medium	★★★★	39.03
Canadian Imperial Bank of Commerce CM-TOR	Narrow	Stable	CAD	131.00	113.20	Medium	★★★★	50.33
National Bank of Canada NA-TOR	Narrow	Stable	CAD	70.00	62.02	Medium	★★★	21.05
CI Financial CIX-TOR	Narrow	Negative	CAD	30.00	25.14	High	★★★★	6.67
IGM Financial IGM-TOR	Narrow	Negative	CAD	42.00	38.32	High	★★★	9.23
AGF Management AGF.B-TOR	None	Negative	CAD	7.50	6.78	High	★★★	0.54

Stock Prices, Market Capitalizations and Morningstar Rating data as of May 30, 2018.

Key Takeaways

- Regulatory changes and increased competition are altering the fund landscape in Canada. The balance of power continues to shift more and more toward the Big Six banks at the expense of the nonbank-affiliated asset managers we cover, as ongoing regulatory changes and increased competition for fund sales (with price already becoming a more discerning factor) have an impact on the industry.
- A ban on embedded commissions (trailer fees) would further widen the gap. With more than 80% of fund assets in Canada held in commission-based accounts, a ban on trailer fees would push investors into fee-based account structures and put a much greater focus on management fees and investment performance, with the banks far better suited to compete on price than nonbank-affiliated firms.
- A trailer fee ban would alter advisor relationships with investors. Advisors would need to focus more on investment performance and fund fees, as they would have to justify their advisory fees—which would be billed directly to investors—and place clients in better-performing investment vehicles with reasonable fees, as ongoing compensation will be linked more directly to client portfolio performance.
- Removal of embedded commissions would be a boon for passive products. A ban on trailer fees (which most passive-product providers have been unwilling to pay) would open the door much wider for low-cost index-based products—both index funds and ETFs—given that they provide investors with market-like returns at more reasonable price points than most active managers charge.
- The Big Six banks should be more insulated than purer-play asset managers. The banks already have lower fees than the purer-play asset managers and should be able to leverage their distribution strength to their advantage. We view wide-moat firms Royal Bank of Canada and Toronto-Dominion and narrow-moat Bank of Montreal as the best positioned among the Big Six banks on the asset-management front.
- Active managers with good performance and reasonable fees will also see less of an impact. There will always be room on third-party platforms for active fund managers that have a track record of good, repeatable investment performance and reasonable fees, and among the purer-play asset managers we cover we view CI Financial as being best suited to fit this role.

A Ban on Embedded Trailer Fees Will Have Different Impacts on the Canadian Asset Managers

Regulation can be a double-edged sword. Rules that serve as a barrier to entry—making it difficult (or in some cases impossible) for competitors to enter a market—can be valuable intangible assets that lead to sustainable competitive advantages for industry participants. Patents and government licenses that explicitly keep competitors at bay are the best examples of these types of intangible assets. In most cases, the barriers to entry will benefit the established players in the industry, protecting their revenue and operating profits from being eaten away by new competitors for an extended period. That said, regulation that chips away at existing barriers to entry (derived from past government intervention and/or through the normal course of business for an industry), or rules that diminish some other source of competitive advantage a firm or industry previously enjoyed, can do the exact opposite, as increased competition leads to lower returns for all market participants.

As we've pointed out in past assessments of the purer-play Canadian asset managers—"Moats for the Canadian Asset Managers Are Narrowing," published March 5, 2014, and "Pricing Already Under Pressure in the Canadian Fund Market," published April 5, 2015—the mutual fund industry in Canada has already been affected during much of the past decade by regulatory changes and a more competitive environment for fund sales. As we see it, the balance of power in the Canadian market has been shifting more and more toward the Big Six banks—Royal Bank of Canada, Toronto-Dominion Bank, Scotiabank, Bank of Montreal, Canadian Imperial Bank of Commerce, and National Bank of Canada—at the expense of the purer-play asset managers we cover—IGM Financial, CI Financial, and AGF Management. The banks continue to not only be among the largest distributors of mutual funds in the Canadian market, but also have become some of the largest fund manufacturers and have shown a greater willingness to compete more heavily on price to take share from nonbank-aligned firms.

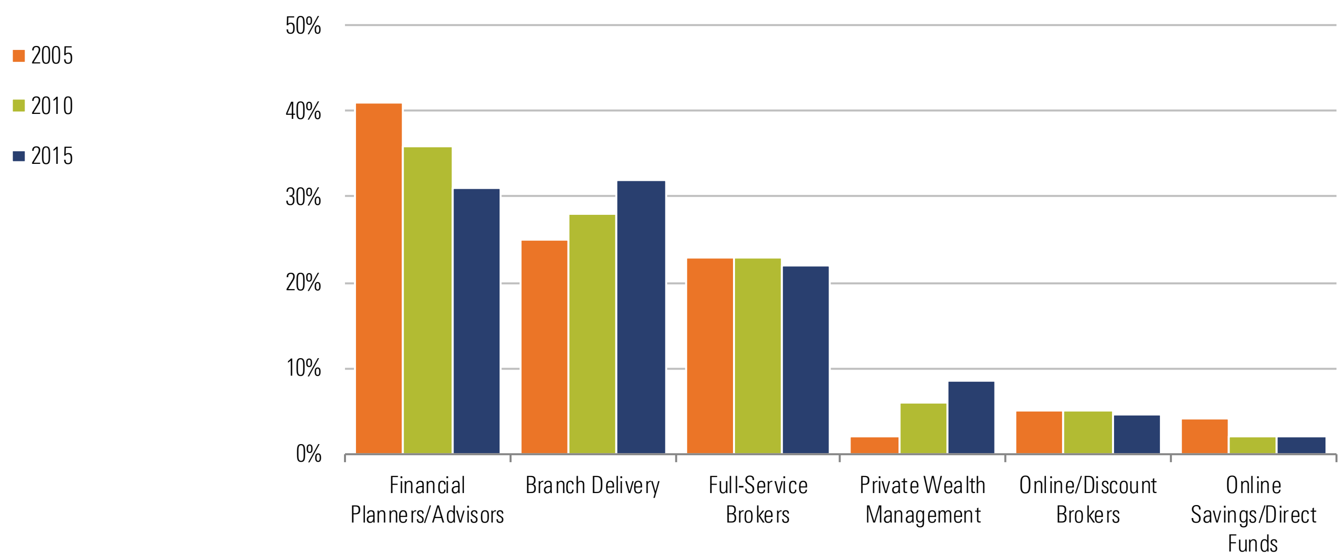
As we look out, we see the potential for regulation to once again disrupt the relationship between the Big Six banks and the asset managers, as the Canadian regulators mull a banning of embedded trailer commissions in the fund market. With more than 80% of mutual fund assets in Canada held in commission-based account structures, we expect this ban, which will force advisors to charge investors directly for advice as opposed to having their annual fee deducted directly from fund assets, to lead to more direct (and uncomfortable) conversations about the costs of advice, as well as the overall cost of investing. A banning of trailer fees (which are embedded with management fees and are pulled directly out of a fund annually to pay for advice) will also put a much greater focus on fund management fees and investment performance in the Canadian market. On top of that, we believe that banning embedded commissions will open the door much wider for low-cost index-based products (which have traditionally not offered trailer fee structures) to pick up share from higher-cost actively managed offerings, especially in instances where fund performance does not justify the fees being charged.

With fund management fees expected to be under a more powerful microscope as we move forward, we expect the Big Six banks to be more insulated than the purer-play asset managers, given that they a) already have fees that are lower than those being charged by the nonbank-aligned asset managers and b) should be able to continue leveraging their distribution strength to their advantage. We view wide-moat Royal Bank of Canada (with its better active performance reputation and lower fees structures), Toronto-Dominion (which has a solid performance track record and reasonable fees, as well as an emerging passive product platform) and Bank of Montreal (which has made a strong showing with its ETF platform) as being the best positioned among the Big Six banks on the asset-management front. As for the purer-play asset managers, we believe there will always be room on third-party platforms for active managers with good investment performance, and view CI Financial as being best suited to fit this role. With a superior long-term investment performance track record, and more reasonable fees relative to peers, the company is the best positioned purer-play asset manager we cover for long-term investors.

Structure of the Canadian Asset-Management Industry Is Somewhat Unique

To understand the impact that a ban on embedded trailer fees (should it come to pass) would have on financial advisors and fund manufacturers in Canada, it is important to look at how the industry is set up, as well as who is best positioned to benefit from a decoupling of management fees from advisor commissions. In Canada, the key channels for fund distribution are financial planners/advisors, bank branches, and full-service brokers. According to the 2016 Investor Economics Household Balance Sheet, these three distribution channels accounted for 85% of fund assets held by retail investors.

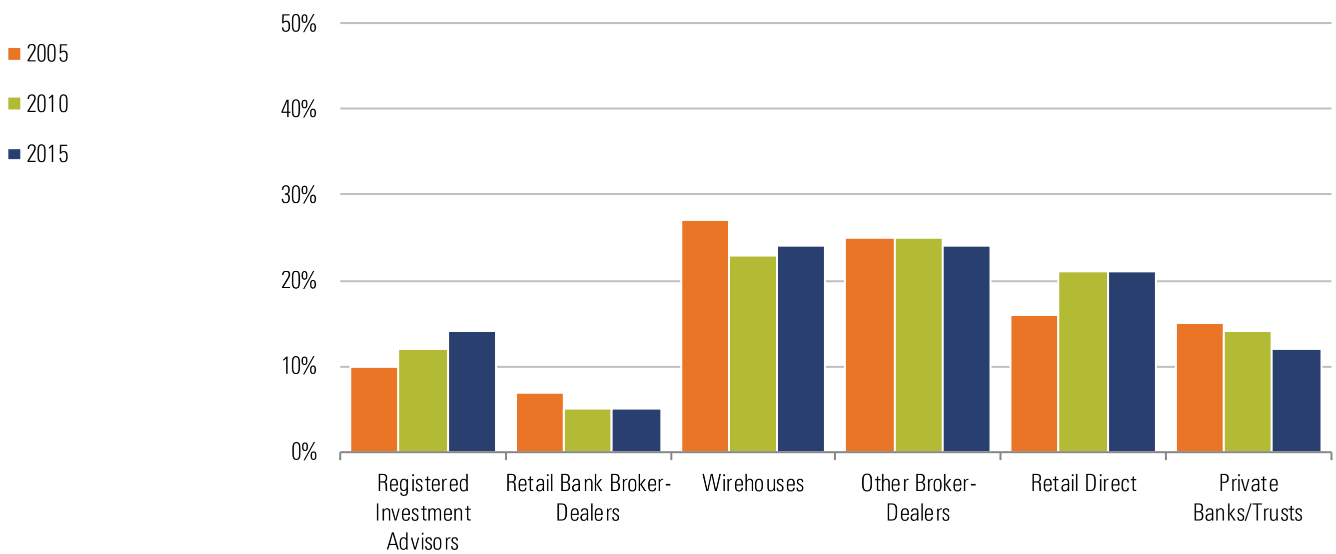
Exhibit 1 Market Share for Fund Assets by Distribution Channel (2005, 2010, 2015), Canadian Market



Source: 2016 Investor Economics Household Balance Sheet. Investment Funds include stand-alone mutual funds, Canadian-listed ETFs, fund wraps, and funds held in fee-based programs.

While this is not too dissimilar from the channel breakdown in the U.S.—that is, in that most retail fund assets are held in relationship-based accounts (with financial advisors across a broad spectrum of platforms accounting for an overwhelming amount of client assets in both markets)—three things do stand out. First, while financial planners/advisors have been losing share in the Canadian market because of heavier competition from the bank branch networks and from private wealth managers, they've been gaining share in the U.S. (much of which we believe is tied to the movement of baby boomer retirement capital from defined-contribution accounts into retail-advised individual retirement accounts). Second, the retail bank branch delivery network in Canada has been taking share for much of the past decade, while its U.S. counterpart, denoted as retail bank broker/dealers, has seen its share of the market decline. And finally, there has been very little growth in the online and discount brokerage channels in the Canadian market, while in the U.S. there has been greater growth in the retail direct channel (which currently accounts for around one fifth of retail assets).

Exhibit 2 Market Share for Fund Assets by Distribution Channel (2005, 2010, 2015), U.S. Market



Source: The Cerulli Report–U.S. Broker/Dealer Marketplace 2016.

Despite both markets being more heavily weighted toward relationship-based account structures, the Canadian market continues to have a greater portion of client assets in commission-based accounts, with more than 80% of the country's retail assets in these structures relative to less than 50% in the U.S. In a 2015 article focused on what Canadians paid for mutual funds, Morningstar's fund manager research group highlighted how prevalent commission-based structures were in that country's retail market. Their research separated fund share classes by the following three distinct distribution channels, as well as by asset classes, and then calculated average fees for each group:

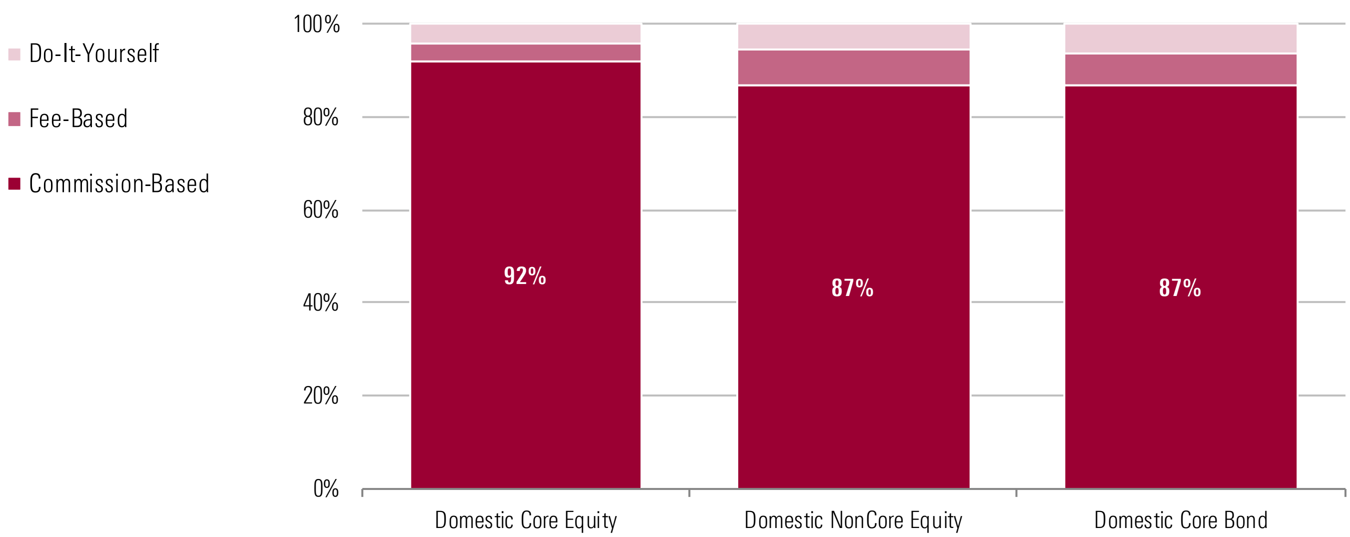
- Commission-Based Advice
  In this channel, investors purchase funds with the help of an advisor. The management expense ratio, or MER, for each share class includes the trailer fee that is collected by the fund company to cover the distribution of the fund. The dealer network employing the advisor receives the whole trailer fee, and the advisor receives a portion of this fee as compensation.
- Fee-Based Advice
  These share classes are also bought through an advisor, but the fund's fees do not include an embedded trailer. Instead, investors negotiate compensation as a percentage of assets directly with their advisors (as well as when investors redeem their holdings).

- Do-It-Yourselfers

  These investors purchase funds through a discount broker or an investment counselor, who provides some of the services of a financial advisor but not enough to warrant a full trailer fee. A small group of do-it-yourselfers use fee-only advisors, which are paid an hourly or flat rate to build a comprehensive financial plan (not to be confused with fee-based advisors).

This was done to better align the report with the distribution channel categories the Canadian Investment Funds Standards Committee, a collection of Canada's major mutual fund database providers and research firms, rolled out in early 2014. While the CIFSC offered up a fourth distribution channel category—Institutional Investors (which include large investors like pension plans, trusts, and estates that tend not to use advisors and negotiate fees directly with fund companies)—the authors of the article chose to focus primarily on the channels that average investors in mutual funds would be navigating to both get advice and invest their capital.[1]

Exhibit 3 Canadian Mutual Fund Assets by Asset Class and Distribution Channel



Source: Morningstar.

If we step back to the channel breakdown reflected in the 2016 Investor Economics Household Balance Sheet (highlighted in Exhibit 1), we see that 85% of fund assets held by retail investors are serviced by financial planners/advisors (31%), retail bank branch networks (32%), and full-service brokers (22%). Unfortunately, we do not get a sense from those graphics of how the different channels are paid, specifically how much of client assets are tied to fee-based accounts versus commission-based structures. This is important because it has an influence on the types of products that make their way

1 Salman Ahmed, Achilleas Taxildaris and Paul D. Kaplan, "A Closer Look at What Canadians Pay for Mutual Funds," Morningstar Magazine, February/March 2015, p. 47.

into client portfolios over time and explains to a great degree why we've seen very little penetration of index funds and ETFs, which tend not to pay trailer fees, in the Canadian market.

Looking at fund distribution through the CIFSC designations (highlighted in Exhibit 3) a full 92% of the assets held in Domestic Core Equity funds, 87% of the assets in Domestic Noncore Equity funds, and 87% of the assets in Domestic Core Bond funds were in commission-based account structures at the end of 2014. Meanwhile, the fee-based channel in each of the three asset-class fund groups held less than 10% of overall assets, despite having a similar number of funds available to investors. Compare this with the U.S. market, where more than 40% of retail-advised relationships utilized fee-based accounts structures in 2015 (a percentage that has likely grown the past couple of years as a result of the U.S. Department of Labor's Fiduciary Rule, which was designed to impose a fiduciary standard on individual retirement accounts serviced by advisors and brokers in the retail channel), and where the retail direct channel (which is nascent in the Canadian market) accounted for another one fifth of assets.

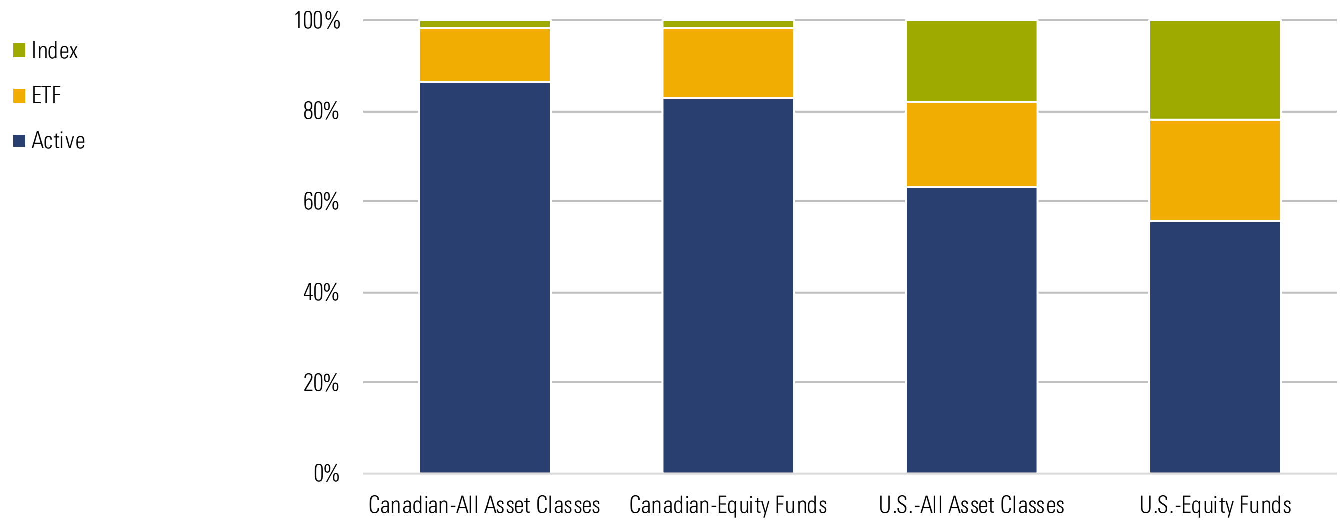
Exhibit 4 Growth of Fee-Based Assets in the Canadian Retail Market

	6-Month Annualized Growth Rate	**3-Year CAGR**
Stand-Alone Investment Funds	6.2%	3.5%
Managed Assets	19.2%	17.2%
Fund Wraps	14.6%	17.9%
Mutual Fund of Funds	12.2%	16.9%
High-End Fund Wraps	21.0%	23.7%
Fee-Based Brokerage	25.4%	17.2%
Discretionary Management	21.8%	17.9%

Source: Strategic Insight, Fee-Based Report–Canada, winter 2017.

A shift to more fee-based structures, which accounted for just 4% of the assets held in Canadian Domestic Core Equity funds, 8% of assets in Domestic Noncore Equity funds, and 7% of the assets in Domestic Core Bond funds at the end of 2014, has been under way, though, with fee-based accounts growing faster on an annualized basis during 2014–16 than they ever have before. Growth was even stronger during the back half of 2016, which coincided with the full implementation of Client Relationship Model Phase 2, or CRM2, a regulatory initiative rolled out between July 2014 and July 2016 aimed at providing investors with transparency around the cost and value of advice from financial advisors in the Canadian market (and expected to spur a movement into more fee-based structures). With more than 80% of the Canadian retail market continuing to be serviced via commission-based account structures, though, the issue of embedded trailer fees remains. The use of embedded trailer fees has historically been very attractive to advisors, who generate around two thirds of their annual commission-based compensation from them, since they have been part of the MER the mutual fund manufacturer charges, rather than being a separate fee charged to the mutual fund investor by the advisor. In the Canadian market, the MER, which is levied annually and is expressed as a percentage of a fund's total assets, includes a management fee—which is a combination of a fund's actual management fee and the trailer fee that gets paid out to advisors—administrative expenses, and taxes. We think the attractiveness of this fee structure to financial advisors, and the fact that advisors generate most of the mutual fund sales in the Canadian market, has given them significant leverage over fund manufacturers, which have taken the brunt of the criticism over high fees and expenses as part of their accommodation of this pricing structure. It also explains why we've seen far less penetration of index funds and (to a lesser extent) ETFs, which tend not to pay trailer fees, in the Canadian market.

Exhibit 5 Active/Passive (Index Funds and ETFs) Breakdown of Canadian and U.S. Retail Markets Based on Total Assets Under Management (2017)



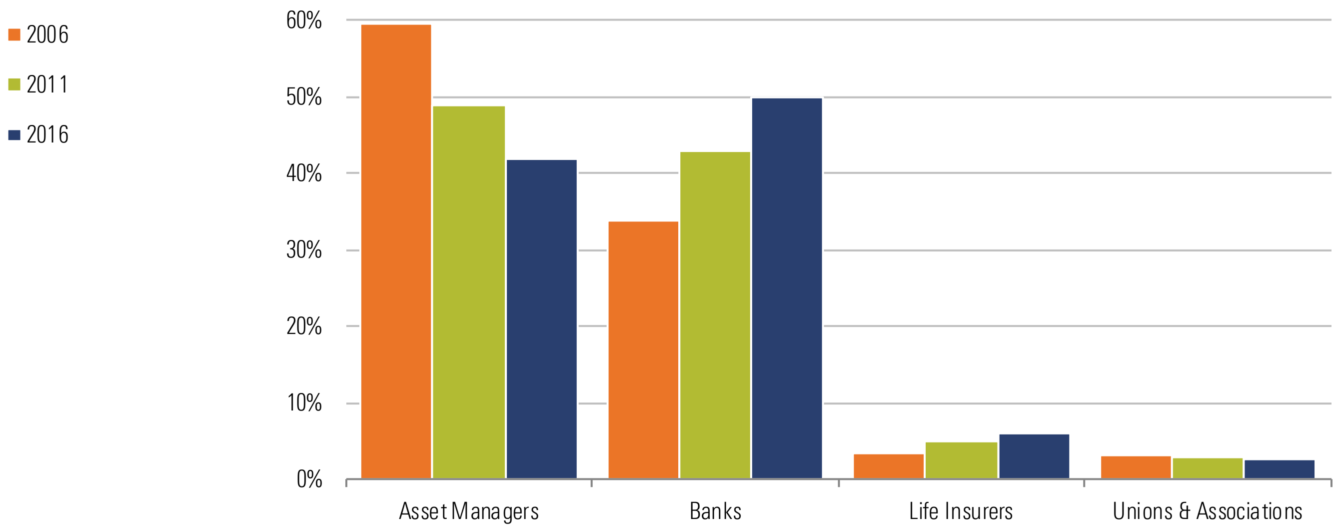
Source: Morningstar Direct–Canadian and U.S. Open-End & ETF (excluding Money Market and Fund of Funds). Data as of Dec. 31, 2017.

Looking at the Canadian market from a fund manufacturing perspective, increased competition from the Big Six banks (Royal Bank of Canada, Toronto-Dominion Bank, Scotiabank, Bank of Montreal, Canadian Imperial Bank of Commerce, and National Bank of Canada) and the major insurance companies during the past decade has eaten away at the market share of the purer-play asset managers—like IGM Financial, CI Financial, and AGF Management. Unlike the U.S. market, where most of the major banks and brokerage firms have shuttered proprietary mutual fund operations—primarily to eliminate the appearance of a potential conflict of interest—the Canadian banks (along with a few insurance companies) have been bulking up their own fund manufacturing operations.

The banks continue to be among the largest distributors of mutual funds in the Canadian market and are some of the largest manufacturers of fund products as well. They've also shown a much greater willingness to compete more heavily on price to take market share. As a result, the Big Six banks saw their share of the mutual fund market increase from 34% at the end of 2006 to 50% at the end of 2016, while the purer-plays have seen their share decline from 60% to 42%. While some of the banks' growth has been achieved via the acquisition of purer-play asset managers, like Scotiabank's 2010 purchase of

DundeeWealth, the bulk of the increase in market share has come from organic growth, which a leveraging of the Canadian banks extensive branch networks to sell product has driven.

Exhibit 6 Canadian Mutual Fund Assets (Excluding ETFs) by Mutual Fund Manufacturing Category (2006, 2011, 2016)

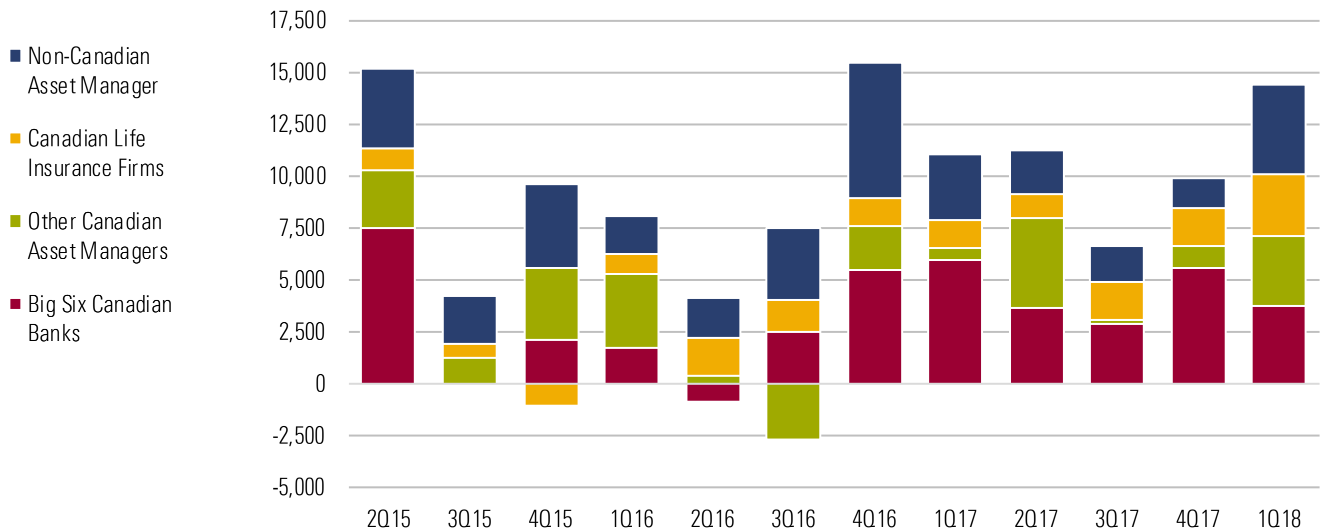


Source: Morningstar estimates, CSA and Investor Economics (Canada)

Looking at retail fund flows over the past 12 calendar quarters (highlighted in Exhibit 7), the Big Six banks in Canada have taken in more capital (on average) than other Canadian asset managers (which includes a mixture of purer-play asset managers and firms with both fund manufacturing and advisory operations) and the Canadian life insurance firms. Over that time frame the banks have garnered 36% of the flows into mutual funds, compared with 18% and 14%, respectively, for the other Canadian asset managers and the Canadian life insurance firms.

It has also been interesting to see the progress that non-Canadian asset managers have made in the Canadian market, picking up a third of inflows the past three years. That said, most of the organic growth was generated by Fidelity, PIMCO, and Dimensional Fund Advisors, which accounted for 52%, 26%, and 19%, respectively, of the positive flows that were generated by the group of primarily U.S.-based asset managers during the past 12 calendar quarters. We'd also be remiss if we didn't note that both wide-moat Franklin Resources and narrow-moat Invesco remained in net outflow mode over the same period that Fidelity, PIMCO, and DFA, as well as a few other U.S.-based firms, were generating positive flows in the Canadian market.

Exhibit 7 Canadian Open-End Fund Flows by Bank and Nonbank Categories (Second-Quarter 2015–First-Quarter 2018)



Source: Morningstar Direct.

With the Big Six banks continuing to invest heavily in their asset-management and financial advisory operations, which they expected to buffer slowing housing market growth as well as the volatility inherent in their investment banking and corporate operations (which are closely aligned with the energy and mining sectors), they continue to have the edge in the Canadian market relative to the purer-play asset managers. Because the banks do so many other types of business with clients, such as mortgage loans, savings accounts, credit cards, and others, adding fund manufacturing and wealth management products and services to their portfolios has incurred proportionally fewer manufacturing and distribution costs than it would for a purer-play asset manager or advisor.

Regulatory Environment in Canada Expected to Be More Favorable to the Big Six Banks

As we noted early on in this report, regulatory actions that chip away at existing barriers to entry (that are derived from past government intervention and/or through the normal course of business) for an industry, or rules that diminish some other source of competitive advantage a firm or industry previously enjoyed, can lead to lower returns for market participants. In the Canadian mutual fund market, we believe that ongoing and proposed future regulatory reforms such as the CRM2 initiatives (the Canadian Securities Administrators' push to ban embedded commissions) and conversations around the implementation of a mandatory best-interest standard (to replace the existing suitability standard) that would require a registered dealer or registered adviser to act in a client's best interests could end up further altering the relationship between the Big Six banks and the purer-play asset managers in the near to medium term.

CRM2 Unlikely to Dramatically Alter the Canadian Asset-Management Business

Since the turn of the new century, the Canadian Securities Administrators, or CSA, the Investment Industry Regulatory Organization of Canada, or IIROC, and the Ontario Securities Commission, or OSC, have been focused on enhancing industry practices. While the Big Six banks and other investment dealers were for a while able to keep regulations from getting too onerous, the 2008–09 global financial crisis brought a renewed focus on curbing inappropriate activities. Since then the regulators and industry participants have agreed to pursue reforms that would not only safeguard the financial services industry but also their clients. The Client Relationship Model Phase 1, or CRM1, initiatives, introduced in September 2009, were an extension of earlier work done by the OSC's Fair Dealing Model Committee, with one of the primary goals being the creation of a standard Relationship Disclosure Document that would clearly set out the key issues in advisor/client relationships, including things like the types of products used, how suitability was determined, and the responsibilities of the dealer and the investor.

Exhibit 8 Three Major Reform Initiatives Associated With Canadian Investment Products and Services

	Status of Reforms	Our Take
CRM2	Reforms have been gradually implemented over several years, culminating in full implementation in mid-2016.	While most clients have seen the new embedded commission disclosures in their statements, we don't expect this to be an industry game changer with regards to fund management and advisory fees.
Banning of Embedded Commissions	The comment period for the CSA's proposal to ban embedded trailer fees closed on June 9, 2017, with a final ruling expected some time in late Spring 2018.	We expect the CSA to clarify and most likely move forward with the banning of embedded commissions in late Spring 2018, with implementation phased in over a multi-year period, potentially ending before 2021.
Best Interest Standard	After multiple published papers and discussions, a majority of the provincial regulators have stopped work on these reforms, which could potentially impose a fiduciary standard on financial planners/advisors.	While this would have been the biggest game changer of the three reform proposals, the odds of it happening in the near-to-medium term have diminished greatly with more recent announcements from the regulators.

Sources: Morningstar, Canadian Securities Administrators, Ontario Securities Commission.

One of the key objectives of the CRM2 initiatives, which were finalized in July 2013, was to increase the number, and expand the contents, of the disclosures that broker/dealers and advisors were required to give to their clients, thereby providing investors with clearer and more complete disclosure of all charges associated with the products and services they were receiving. One of the key changes required by CRM2 was the mandate that broker/dealers and advisors disclose, in dollar terms, exactly what clients paid them for servicing their accounts, including administrative charges, loads, and trailing commissions. CRM2 also called for more meaningful reporting on how investor accounts were actually performing. These changes were intended to further enhance the advisor/client relationship, and were phased in over a three-year period and included the following client reporting requirements:

- Beginning July 1, 2014, investment brokers and dealers were required to provide pretrade disclosures of all fees and charges associated with client instruction to purchase or sell a security, and report compensation derived from debt securities transactions in trade confirmations;
- Beginning July 15, 2015, investment brokers and dealers needed to provide greater disclosures related to current market values and book values of account holdings, as well as around dealer obligations when no market price was available; and,

- Beginning July 15, 2016, investment brokers and dealers had to provide an annual report on charges and other compensation that showed, in Canadian dollars, what the dealer or advisor was paid for the products and services it provided (from embedded trailer-fee commissions to redemption fees, point-of-sale commissions, switching fees, and RRSP administration fees).[2] Broker/dealers and advisors were also required to provide an annual investment performance report summarizing how investors did over various measurement periods, including the calculation of money-weighted rates of return, customized according to when new money was deposited or withdrawn.[3]

While the new disclosures have provided added clarity, there are several nuances investors need to be aware of. Most notably, the new disclosures only relate to the compensation paid to broker/dealers and advisors, leaving out the amounts paid to the asset managers. As the fund manufacturers capture around half of the total amount extracted annually from a fund via its MER, the new CRM2 disclosures fall short of providing investors with a complete picture of all their investment-related expenses. While fund management fees are disclosed in prospectus documents when investors initially purchase a fund, the ongoing costs associated with fund ownership are not generally reported to investors, and it should also be noted that there is no obvious standard for comparing fees among different funds.

On top of that, it may not be intuitive for clients to know how much they "should" be paying for advice, whether those charges are competitive, and/or how the funds they invest in contribute to the overall MER they are paying each year. With the average Canadian investor unlikely to have the contextual knowledge to not only fully digest this new level of disclosure, but also use it to form opinions and then act on them, we're doubtful that CRM2 will have a big impact on investor behavior. Based on the many different discussions we've had with industry participants the past several years this seems to be the case, with CRM2 being viewed largely as a nonevent for the industry. While this may change over time, we do not expect the reforms to have too dramatic of an impact, with both fund distributors (bank-housed and independent) and fund manufacturers (bank-housed and purer-play asset managers) gaining no discernable advantage from the increased disclosure. That said, we do expect two other CSA proposals to potentially have a more significant impact on the competitive structure of the industry.

An Outright Ban of Embedded Commissions Would Fundamentally Change the Industry

The banning of embedded commissions (also referred to as embedded trailers, trailing commissions and trailer fees), is currently under consideration by the CSA. Multiple papers, including CSA Consultation Paper 81-408 (published in January 2017), have been submitted on the topic over the years, with the comment period for the CSA's latest paper closing in June of last year. As part of the proposal process, regulators specifically asked for input on whether banning embedded commissions would impede investor access to financial advice. While no decision has yet been made by the CSA about whether to ban trailer fees, the regulators have announced that they plan to present policy options, including their recommendations on embedded commissions, to the industry in late spring 2018.

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2 "Report on Charges and Compensation" https://www.ific.ca/wp-content/uploads/2015/04/Model-Report-on-Charges-and-Compensation.pdf/10338/

3 "Report on Investment Performance" https://www.ific.ca/wp-content/uploads/2015/04/Model-Report-on-Investment-Performance.pdf/10331/

The use of trailer fees has been the topic of much controversy for some time in the Canadian market. These commissions, which are intended to compensate dealer firms for the ongoing services that their advisors provide to investors (including investment advice) after a mutual fund is purchased, are embedded in the MER rather than being a separate fee, which has historically allowed dealer firms and their advisors get paid without their clients ever seeing the bill for their services. Trailer fees are paid out for the length of time that an investor holds a fund and depending on the type of fund, the distributor selling the fund, and the type of client account it is held in can range from 0 basis points to 150 basis points annually. This has made their use attractive to advisors, who have been able to generate around two thirds of their annual commission-based compensation from trailer fees. Compare this with the mid-1990s when sales commissions accounted for the bulk of their annual commission-based compensation.

Exhibit 9 Average Trailer Fees by Fund Type in the Canadian Mutual Fund Market

Fund Type	Asset-Weighted Average Trailer %	"Rule of Thumb" Trailer Fee %
Domestic Core Balanced - Aggressive	0.83	0.75
Domestic Core Balanced - Moderate	0.88	0.75
Domestic Core Balanced - Conservative	0.91	0.75
Domestic Core Bonds	0.55	0.50
Domestic Core Equity	0.99	1.00
Domestic Money Market	0.27	0.25
Domestic Non-Core Bonds	0.59	0.50
Domestic Non-Core Equity	1.04	1.00
Foreign Core Equity	0.93	1.00
Foreign Money Market	0.24	0.25
Foreign Non-Core Equity	1.01	1.00
Global Core Balanced - Aggressive	1.03	1.00
Global Core Balanced - Moderate	0.96	1.00
Global Core Balanced - Conservative	0.93	1.00
Global Core Bonds	0.63	0.50
Global Core Equity	1.00	1.00
Global Non-Core Balanced	1.01	1.00
Global Non-Core Bonds	0.61	0.50
Global Non-Core Equity	1.01	1.00
Sector Equity	1.04	1.00

Source: Morningstar Global Fund Investor Experience Study—June 2015.

According to Morningstar data, 96% of mutual funds in the Canadian market do not charge a load—either a front-end load (sales commissions paid at the time a fund is purchased) or a deferred load (which is paid when an investor exits a fund)—but the vast majority of funds pay a trailing commission out of the annual MER to compensate advice providers.[4] The MER includes a management fee—which is a combination of a fund's actual management fee and the trailer fee paid to advisors—administrative expenses, and taxes. While actual trailer fee levels will vary, the general rule of thumb is that Canadian investors typically pay 100 basis points for equity funds, 75 basis points for balanced funds (and closer to

4 Benjamin N. Alpert, Paul Justice, Anthony Serhan and Christina West, "Morningstar Global Fund Investor Experience Study," June 2015, p. 76.

100 basis points for a global balanced fund), 50 basis points for fixed-income funds, and 25 basis points for money market funds. As we show in Exhibit 9, trailer fees on an asset-weighted basis will vary slightly from our "rule of thumb" assessment, but in most cases have not been too far off the mark.

We continue to believe that a ban of embedded commissions is inevitable. The language in the CSA's consultation paper was quite strong, with the regulators arguing that embedded trailers create conflicts of interest that misalign the interests of investment fund managers, dealers, and their representatives with those of investors. As long as dealer compensation remains embedded in mutual funds, the CSA believes that when gathering and preserving AUM investment managers are likely to continue to place a greater emphasis on payments to dealers than on the investment performance of their clients' assets. [5] We've long believed that embedded commissions have an influence on the types of products that eventually work their way into client portfolios (whether in Canada or other markets using this kind of advisor compensation structure), and that to a great degree explains why we've seen very little penetration of index funds and ETFs, which tend not to pay trailer fees, in the Canadian market.

Based on the CSA's stated stance on embedded commissions, the lack of obvious arguments against the proposal to ban them (other than concerns about the creation of an "advice gap" for investors who cannot afford to pay out of pocket for financial advice), and the path that other countries in the Commonwealth have taken—notably the United Kingdom and Australia, both of which banned embedded commissions starting in 2013—we would not be surprised to see the CSA come out with an official announcement banning the use of trailer fees when it presents policy options to the industry this year. This would likely include a multiyear implementation period, potentially ending before 2021, at which point Canadian broker/dealer and advisory firms, as well as the fund manufacturers serving them, would have to be in full compliance with the new regulations.

For some perspective, the United Kingdom's Retail Distribution Review, or RDR, went into effect in January 2013 and had a three-pronged goal: ending commissions, embedded or otherwise, with charges for advice paid up front by investors to ensure that they are aware of what they're paying; establishing the two distinct categories of independent financial advisor (who can advise on any product or service that could meet investor needs and objectives but have to give unbiased and unrestricted advice) and restricted advisor (who have a limited list of products and providers that they can advise on); and raising the minimum level of qualification for all advisors.[6] As for the Australian market, the regulators passed a suite of financial reforms in the Future of Financial Advice, or FoFA, act of 2012, which went into effect at the beginning of July 2013 and required that advisors act in the "best interest" of their clients. It also banned commissions (including embedded trailers) on products directly related to advice.

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5 Canadian Securities Administrators. 2017. CSA CONSULTATION PAPER 81-408 – CONSULTATION ON THE OPTION OF DISCONTINUING EMBEDDED COMMISSIONS. January 10, 2017. http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20170110_81-408_consultation-discontinuing-embedded-commissions.html.

6 Susan Yellin, "Banning embedded commissions: What Canada can learn from the Australian and U.K. experience," The Insurance & Investment Journal, Nov. 1, 2013. https://insurance-journal.ca/article/banning-embedded-commissions-what-canada-can-learn-from-the-australian-and-uk-experience/

What Would Be the Key Impacts of a Ban on Embedded Commissions?

We believe the adoption of a ban on embedded commissions would alter the Canadian fund industry in several ways. First, it would force advisors to focus more heavily on investment performance and fund management fees, as they would have to not only justify their advisory fee (which would be completely transparent and billed directly to investors), but also focus on putting their clients in better-performing investment vehicles with reasonable fees, as the ongoing compensation they would earn would now be more directly linked to client investment performance. A ban on embedded trailers would also open the door much wider for low-cost index-based products—both index funds and ETFs—given that they provide investors with market-like returns at more reasonable price points than most active managers charge. That said, we continue to believe there will be plenty of room for active managers with good investment performance, especially if advisors are looking to augment beta-stacked portfolios with alpha (much as we've seen in the U.S., the U.K., and Australia the past several years). We would also expect to see an expansion of the number DIY investors should trailer fees get banned. Much of the shift we see occurring in the Canadian market will benefit the Big Six banks. The Big Six serve as a primary distribution channel for mutual funds and are already at the lower end of the price spectrum with their fund manufacturing operations and have greater ability to alter their asset-management and advisory operations to accommodate a new regulatory regime.

Increased Focus on Management Fees and Relative Pricing

The first and most direct impact of a ban on embedded commissions would be a decoupling of management and other fees from advisor commissions. The most obvious way for the industry to carry this out would be to switch over to fee-based accounts from commission-based structures. A decoupling of management and other fees from advisor commissions would allow clients to make more explicit decisions about what they pay for advice and what they pay for fund performance. It would also put advisors in the position of having to focus more on investment performance and fund management fees, as opposed to the commissions they'll earn, when recommending funds for client portfolios. This is likely to place even greater pressure on management fees for funds held in fee-based accounts.

In Morningstar Canada's official response to CSA Consultation Paper 81-408 (sent in early June 2017), it was noted that during 2011–16 the average fee-based MER for Canadian Equity funds fell 7 basis points (to 1.10%) versus only a 3-basis-point decline (to 2.18%) for the average commission-based fund in the category.[7] We saw a similar change in the fees for Canadian Fixed-Income funds, with the average fee-based MER falling 7 basis points (to 0.87%) compared with no real discernable change in the average commission-based MER (of 1.53%) for funds in the same category. In fact, in 10 of the 14 categories that were looked at by Morningstar the average fee-based MER declined more than the commission-based MER during 2011–16 (shown in Exhibit 10). We view this as an indication that more pricing pressure exists among funds in fee-based accounts than commission-based accounts in the Canadian market. This trend has continued in the data we've seen so far from 2017, further cementing our belief that there is only one direction for fees in the Canadian market as we move forward: down.

7 Davis, Christopher., Szapiro, Aron. "Morningstar Supports Ending Embedded Sales Commissions in Canada." June 7, 2017. Morningstar. https://direct.morningstar.com/research/doc/Jun%2007%202017_Morningstar_Supports_Ending_Embedded_Sales_Commissions_in_810316.

Exhibit 10 Historical Management Expense Ratios in the Canadian Market, 2011–16

Category	Distribution Channel	2011	2012	2013	2014	2015	2016	Change 2011-16
Canadian Equity	Commission-Based	2.21	2.20	2.30	2.24	2.22	2.18	-0.03
	Fee-Based	1.17	1.20	1.26	1.17	1.15	1.10	-0.07
Canadian Focused Equity	Commission-Based	2.46	2.44	2.45	2.43	2.44	2.41	-0.06
	Fee-Based	1.27	1.29	1.30	1.30	1.29	1.28	0.01
Global Equity	Commission-Based	2.59	2.54	2.55	2.53	2.54	2.52	-0.07
	Fee-Based	1.43	1.37	1.38	1.35	1.33	1.32	-0.11
International Equity	Commission-Based	2.43	2.41	2.42	2.38	2.36	2.37	-0.06
	Fee-Based	1.28	1.27	1.29	1.28	1.24	1.24	-0.04
U.S. Equity	Commission-Based	2.29	2.23	2.31	2.28	2.27	2.23	-0.06
	Fee-Based	1.28	1.21	1.27	1.22	1.19	1.17	-0.11
Canadian Dividend & Income Equity	Commission-Based	2.29	2.29	2.30	2.29	2.29	2.26	-0.04
	Fee-Based	1.22	1.22	1.22	1.22	1.20	1.16	-0.06
Canadian Equity Balanced	Commission-Based	2.32	2.32	2.34	2.31	2.30	2.29	-0.02
	Fee-Based	1.26	1.29	1.27	1.24	1.21	1.21	-0.05
Global Equity Balanced	Commission-Based	2.50	2.50	2.48	2.46	2.45	2.43	-0.07
	Fee-Based	1.34	1.31	1.32	1.30	1.27	1.24	-0.09
Canadian Neutral Balanced	Commission-Based	2.23	2.20	2.20	2.17	2.17	2.15	-0.08
	Fee-Based	1.18	1.16	1.13	1.10	1.09	1.07	-0.11
Global Neutral Balanced	Commission-Based	2.38	2.35	2.32	2.31	2.29	2.29	-0.09
	Fee-Based	1.24	1.25	1.24	1.20	1.18	1.17	-0.07
Canadian Fixed Income	Commission-Based	1.53	1.56	1.55	1.55	1.54	1.53	0.00
	Fee-Based	0.94	0.94	0.92	0.91	0.89	0.87	-0.07
Canadian Fixed Income Balanced	Commission-Based	1.95	1.94	1.93	1.94	1.93	1.92	-0.03
	Fee-Based	1.03	1.04	1.03	1.02	1.01	0.99	-0.04
Global Fixed Income	Commission-Based	1.91	1.89	1.91	1.91	1.82	1.80	-0.11
	Fee-Based	1.10	1.08	1.13	1.08	1.01	1.02	-0.08
Global Fixed Income Balanced	Commission-Based	2.21	2.16	2.14	2.12	2.08	2.07	-0.14
	Fee-Based	1.24	1.14	1.19	1.13	1.10	1.08	-0.16

Source: Morningstar.

While there are undoubtedly advisors out there that have already been focused on fees, we think that moving the entire industry to a fee-based structure (much as what happened in the U.K. and Australia when those countries banned embedded commissions) will only increase the level of attention paid to fund management and other fees, especially when the performance being generated by a fund does not justify the management fees being charged and/or the fees themselves could detract from future investment portfolio growth. It is also highly likely that a ban on trailer fees and an increased use of fee-based accounts, will create situations where it no longer makes economic sense for advisory firms to retain accounts with low balances, which would be a boon for the Big Six banks, given that their retail branch networks are much better suited to take on these smaller accounts.

That said, we also think that a decoupling of fees could be slightly problematic for the Big Six Canadian banks, as they more often than not directly employ the advisors that serve investors through their branch networks and private wealth management operations, while manufacturing many of the funds that these advisors end up recommending. With the banks squarely focused on being the low-cost providers in the Canadian market, we expect that they'll look to balance their advisory and fund management fees, keeping both competitive without giving up too much in fees on either front. By virtue of their more diversified operations—that is, by not being a pure-play fund manufacturer or advisory network and offering up a collection of banking and investment services to their clients—the Big Six banks should be in the best position, though, to absorb the fee and margin compression that we envision taking place in the Canadian asset-management industry longer term.

Increased Focus on Fund Investment Performance

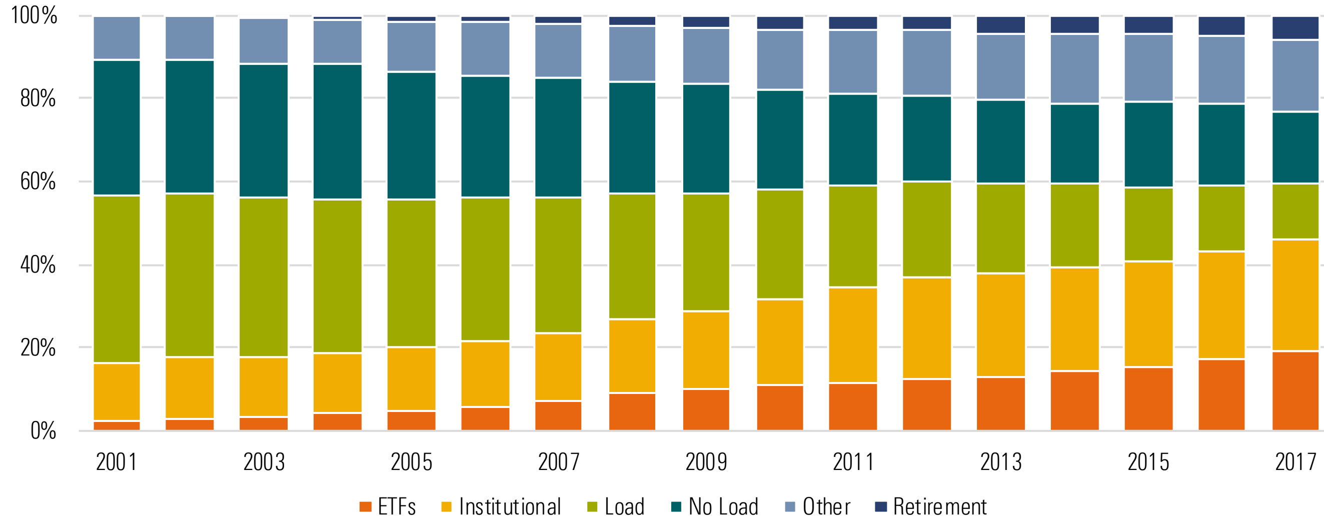
Much as we expect Canadian advisors to increase the level of attention they pay to fund management fees in a world without embedded commissions, we also see them heightening the focus they place on the performance of mutual funds held in each of their client portfolios. With advisors charging clients more directly for their services via fee-based accounts they will have to take greater ownership of how well a client's portfolio performs over time. This will require them to focus on both management fees and investment performance. In our view, there are several different paths advisors are likely to take as they look to maximize client assets, with the first being a focus on low-cost options that generate market-like or better investment performance. The second path would be to find products with better performance track records with fees that don't detract too heavily from the alpha being generated, while a third path forward would be some combination of the first two paths. For the Big Six Canadian banks, these paths could be a bit trickier to follow, especially if they act as both fund manufacturer and advisor without a fully open architecture on their fund platform to provide clients with solidly performing low-cost options.

We also believe that should embedded commissions get banned, there will be a greater impetus for advisory platforms to simplify their product platforms, with share structures that supported commission-based accounts being removed and products overall being re-evaluated with an eye to where they fit in an environment where management fees and investment performance are under greater scrutiny. As advisors become more selective about what products they place in client portfolios, with two of the key differentiators for many products being fees and performance, we expect to see a fair number of mutual funds culled from existing fund platforms at broker/dealers and advisory firms, even as products that may not have made the cut in previous periods—namely, index funds and ETFs—get added.

Expansion of the Use of Low-Cost Products

Our experience in the U.S. since the start of the new century has shown us that as advisors have moved into more fee-based account structures that there has been a greater focus on low-cost options, including but not limited to index funds, exchange-traded funds and institutional share classes. With many investors paying financial advisors to not only allocate their assets, but to reallocate them when market conditions warrant a change, advisors have been incentivized to seek out the cheapest and most efficient way to achieve this end, which has only added to the more rapid growth of low-cost options.

Exhibit 11 Estimated U.S. Market Share Percentage by Fund Share Class Type (2001–17)

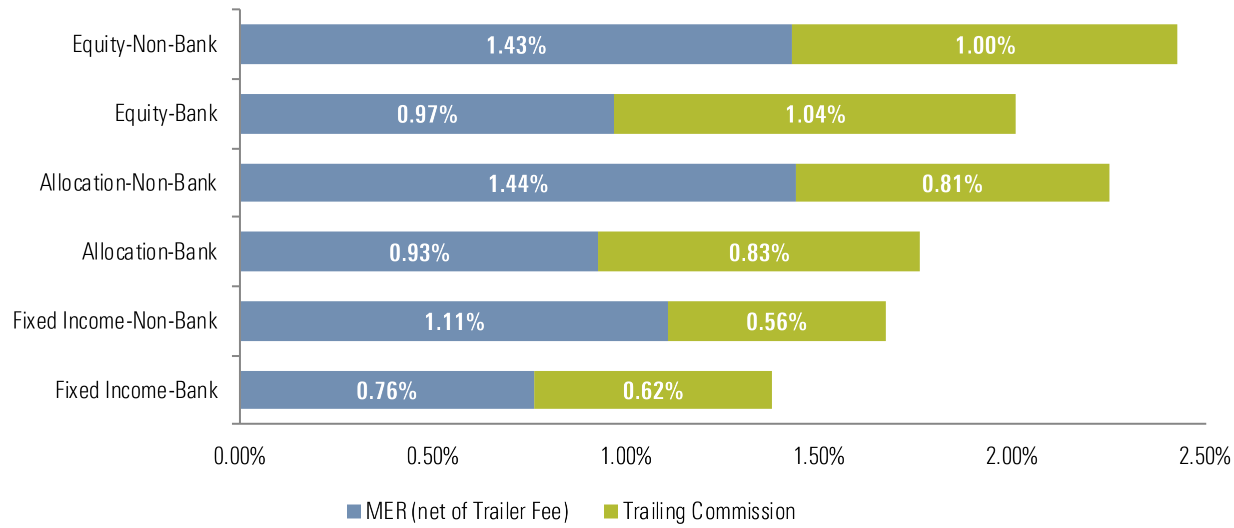


Source: Morningstar Direct. Based on U.S. Open-End and ETF AUM tracked by Morningstar; does not include money market and fund-of-funds AUM.

The Canadian experience has been quite different, as the clear majority of fund investors have relied on commission-based advisors (who get compensated through embedded trailer fees) to invest in mutual funds. As such, there has been no real incentive for advisors to pursue low-cost offerings. Unlike the U.S., where fund management fees tend to decline as the size of funds reach certain benchmark levels, Canadian mutual funds generally do not have repricing mechanisms built into their structures. This means that the only fee compression we've seen in Canada has been when industry participants lower their management fees—which is what has happened the past several years as purer-play asset managers like CI Financial, IGM Financial and AGF Management have reduced fees on certain products to remain cost competitive with lower-priced bank-manufactured offerings.

During the past decade the Big Six Canadian banks have made a more concerted effort to be the price leaders in the industry from a management fee perspective. The banks have invested heavily in their asset-management and financial-advice operations, looking to offset the volatility inherent in their investment banking and other high-end corporate businesses (which are exposed to the energy and mining sectors), as well as in preparation for an eventual slowdown in the Canadian housing market (as home mortgages account for a significant percentage of total loans). From a competitive perspective, the banks have used their ability to scale up their asset-management arms to price their funds lower than those offered by nonbank fund manufacturers. This has given them an edge, especially with more cost-conscious investors, over other third-party channels where bank proprietary funds are not available. About the only concern we have with the banks is that their proprietary funds have tended to charge higher trailer fees than nonbank funds, and as such would be affected more if embedded commissions are banned and bank-housed advisors are forced to make their fees more competitive.

Exhibit 12 Asset Weighted MERs and Trailing Commissions for Canadian Bank and Nonbank Mutual Funds (2011)

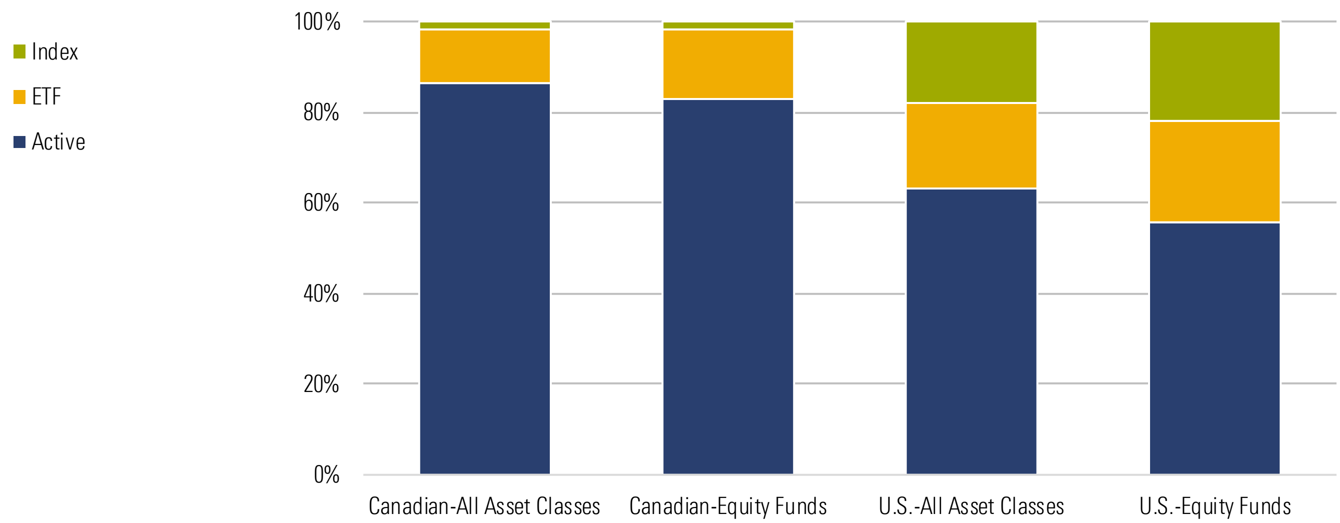


Source: CSA and Investor Economics (Canada).

More Pronounced Growth of Passive Options

With most index-fund and ETF providers historically refusing to pay embedded trailer fees to get on advisory platforms, passive products have gained very little traction in the Canadian market. Once embedded commissions are banned, we believe this key structural impediment to the growth of passive products will finally be removed. Advisors will no longer be financially disincentivized from selling these products, and the ability of these products to offer market-like performance at lower price points than most active funds should make them attractive options for advisors looking to enhance client investment portfolio performance. Much as we saw in the U.K. and Australia, we expect to see more pronounced growth of passive options once embedded commissions are banned in Canada. That said, the passive investment options that have existed in the Canadian market should really be divided up between index mutual funds and ETFs. With little demand historically for index-based products, and Vanguard (which is the largest provider of index mutual funds in the world) refusing to pay trailer fees to gain (and retain) access to (on) advisory platforms, there continues to be no real index fund presence in the Canadian retail fund market. Even though ETFs do not pay trailer fees, the industry had a little over CAD 150 billion in AUM at the end of April (equivalent to about 12% of the retail open-end and ETF assets that Morningstar tracks in the Canadian market). While this is paltry compared with the $3.5 trillion (equivalent to CAD 4.4 trillion) that the U.S. ETF market had under management at the end of 2017, the Canadian ETF industry has increased from CAD 18.3 billion at the end of 2007 to CAD 146.6 billion at the end of last year, equivalent to a 23.2% CAGR during ——17.

Exhibit 13 Active/Passive (Index Funds and ETFs) Breakdown of Canadian and U.S. Retail Markets Based on Total AUM (2017)



Source: Morningstar Direct - Canadian and U.S. Open-End & ETF (excluding Money Market and Fund of Funds). Data as of Dec. 31, 2017.

A lack of meaningful scale in the Canadian market (relative to the U.S. market, that is, which is some 29 times larger) means that Canadian ETF products tend to be priced higher than U.S.-based products.

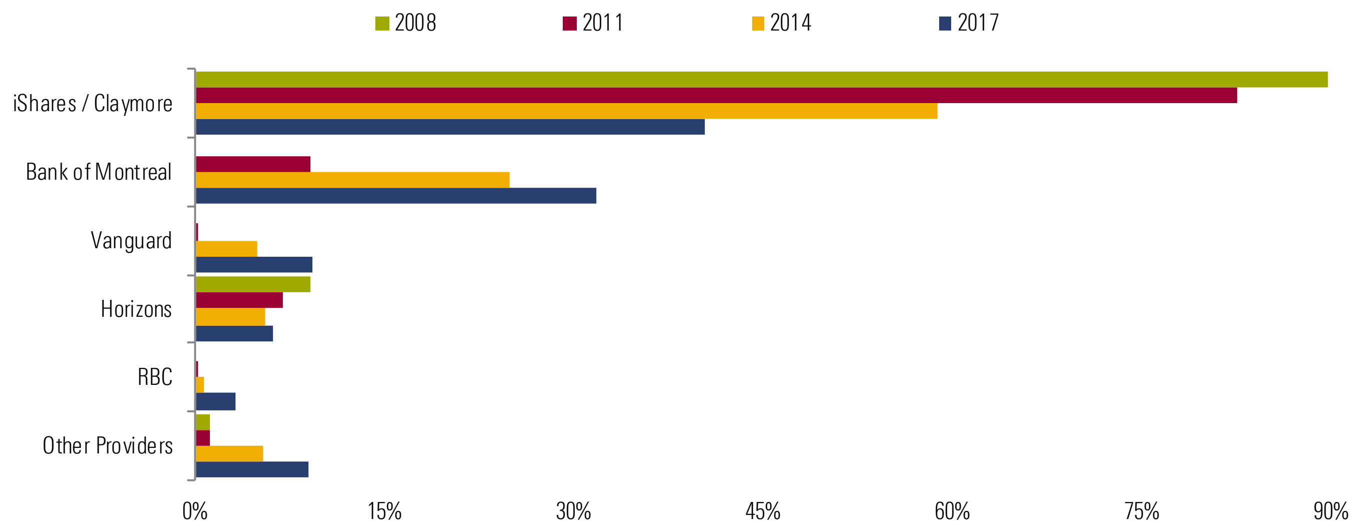
Exhibit 14 U.S. Asset-Weighted ETF Net Expense Ratios Versus Canadian ETF Asset-Weighted MERs

	Canada	**U.S.**
Allocation	0.83	0.36
Alternative	1.23	0.81
Commodities	0.66	0.45
Equity	0.34	0.40
Fixed Income	0.34	0.21
Miscellaneous	0.60	0.22

Source: Morningstar Direct.

While Morningstar tracks some 29 different providers of ETFs in the Canadian market, the five largest providers—BlackRock/iShares (which includes the old Claymore ETF operations that BlackRock acquired in 2012), Bank of Montreal, Vanguard, Horizons, and Royal Bank of Canada—control about 91% of the total market, with BlackRock (at 40% market share) and BMO (32%) being the dominant providers.

Exhibit 15 Market Share of the Five Largest Providers of ETFs in Canada (2008, 2011, 2014, 2017)



Source: Morningstar Direct.

Much like in the U.S. market, Vanguard has attempted to use price to gather assets in the Canadian ETF market, but it looks like both BMO and RBC have been able to use the strength of their distribution networks to drive higher levels of ETF growth during the past decade despite charging more than double the price that Vanguard has been charging for their ETF offerings. That said, we expect that Vanguard will be willing to leverage the scale of its global index fund and ETF operations to push prices much lower in the Canadian market should embedded commissions get banned. This would likely allow the firm to capture a much larger piece of the pie, much as it has done in the U.S. over the past decade. At the end of 2017, there were more than 125 ETF providers operating in the U.S. market and the five largest providers—BlackRock/iShares (39%), Vanguard (25%), State Street/SSgA (18%), Invesco/PowerShares (4%) and Schwab (3%)—controlled 89% of the total market.

Vanguard has basically gone from about an 8% share a decade ago in the U.S. (similar to its current 9% share of the Canadian market) to a quarter of the market by being very aggressive with pricing on its ETF offerings. While we do expect the firm to follow the same game plan in Canada if embedded commissions get banned, Vanguard will still be running up against distribution hurdles. Unlike the U.S. market, which has a more robust DIY environment and where Vanguard has strong brand recognition, both of which are not the case in the Canadian market, the firm will need to be more proactive about working with the Big Six banks to get more meaningful traction with its ETF (and index-fund) offerings.

Looking more closely at the pricing gap between passive products in the U.S. and Canadian markets, we expect that as the scale of the index fund and ETF markets expands in the Canadian market that we'll start to see more comparable fee rates emerge. Much of this will be driven by the largest players in the market, including the Big Six banks that have passive products in their fund manufacturing operations, as well as U.S.-based firms like Vanguard that already have meaningful scale with their index fund and ETF operations that they can leverage to offer lower-priced offerings to Canadian investors.

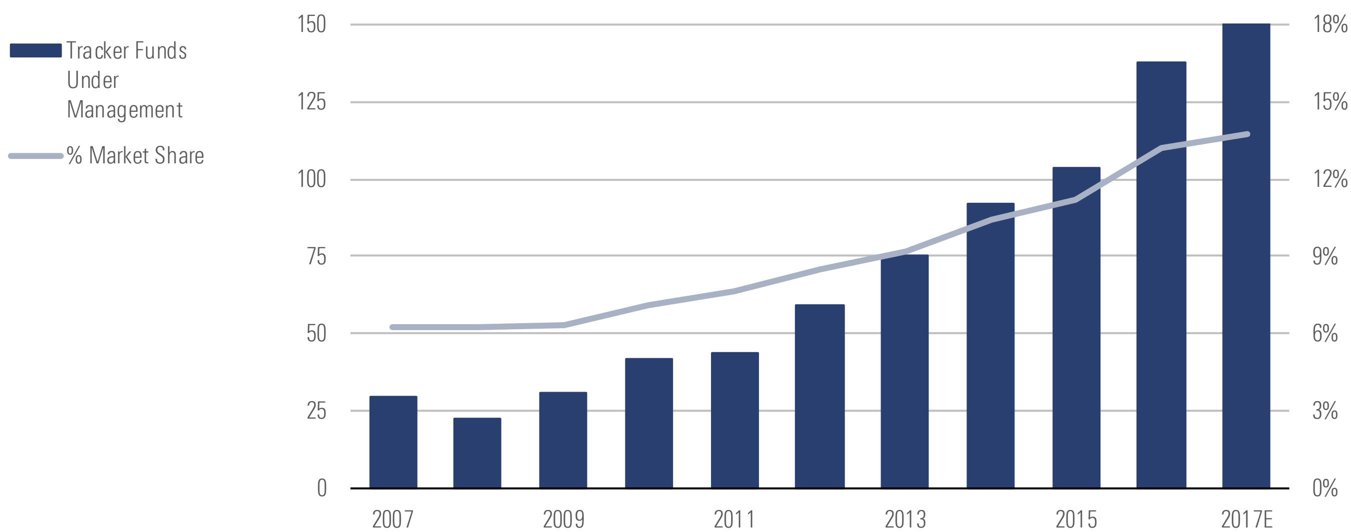
Exhibit 16 U.S. Asset-Weighted ETF Net Expense Ratios versus Canadian ETF Asset-Weighted MERs by Brand

	Canada	U.S.
First Trust	1.06	0.62
First Asset Investment Management	0.80	
Horizons	0.63	0.65
Mackenzie	0.49	
Royal Bank of Canada	0.44	
Invesco/PowerShares	0.39	0.37
BlackRock/iShares	0.35	0.25
Bank of Montreal	0.33	
State Street/SSgA		0.18
Vanguard	0.15	0.08
Toronto-Dominion	0.12	

Source: Morningstar Direct.

Much as we saw in the United Kingdom and Australia, we expect to see more pronounced growth of passive options once embedded commissions are banned in Canada. In the United Kingdom the market share of index funds increased more than 50% to 14% of the total market at the end of 2017 from less than 9% at the end of 2012.

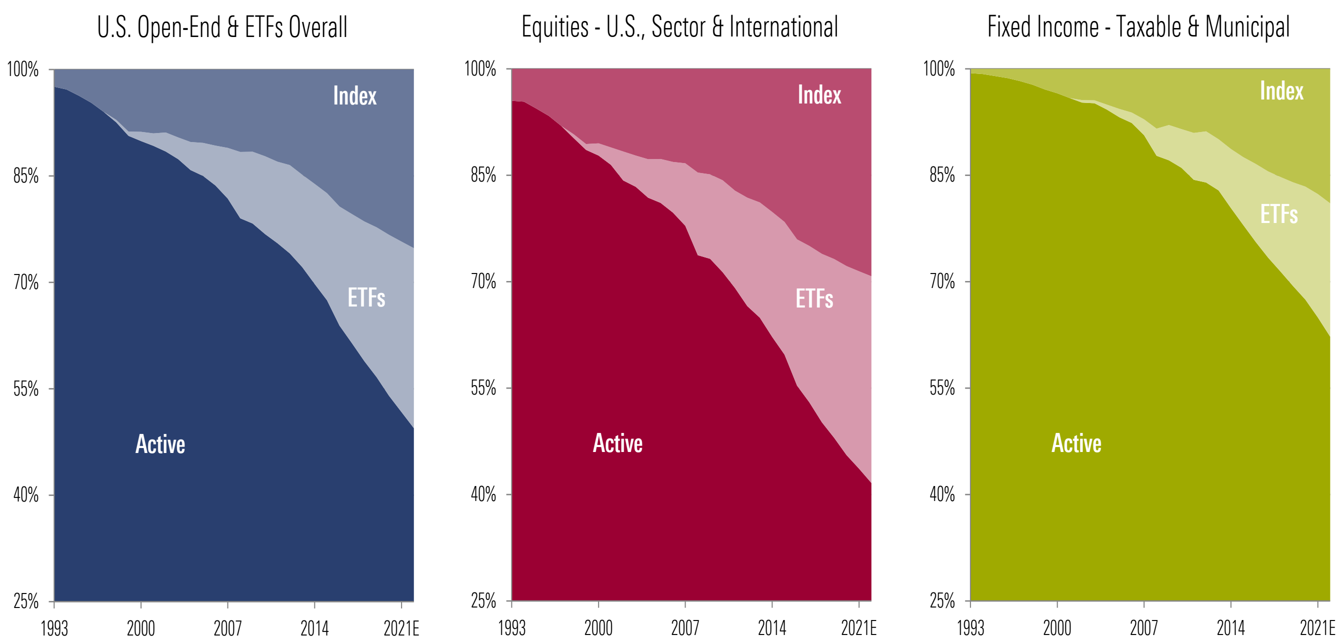
Exhibit 17 Tracker Funds Under Management (in GBP Billions) and Market Share (2007–17E)



Source: The Investment Association; Morningstar estimates.

If we go back three years prior to the January 2013 implementation of RDR, when the reforms were first known in the United Kingdom, then the share of index funds has more than doubled. Given the nascent index fund market in Canada, we would not be too surprised to see a similar level of expansion in the country following a ban of embedded commissions.

Exhibit 18 Percentage of Active and Passive AUM for U.S. Open-End Mutual Funds and ETFs (1993–2021E)

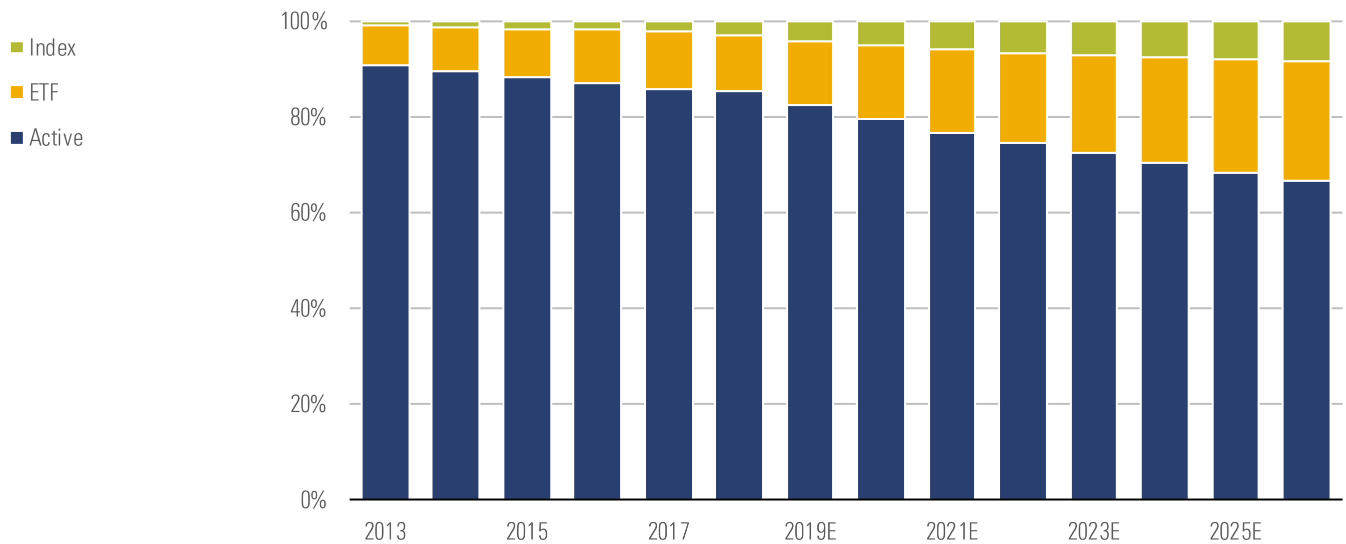


Source: Morningstar Direct—U.S. Open-End & ETF (excluding Money Market and Fund of Funds) historical data.

Passively managed AUM has grown even more dramatically in the U.S., and we expect overall share of passive products to reach close to 50% by 2021. Canada has tended to be about 20 years behind the U.S. when comparing the percentage of mutual fund and ETF assets that are invested in passively managed strategies in each country at any given time. While we do not expect Canada to suddenly make up the entire 20-year gap once embedded commissions are banned, we do believe that the gap will start to close once passively managed products are able to compete on a much more level playing field in the Canadian market.

At this point, we expect the passive market in Canada to be only about 10 years behind the U.S. by 2026—that is, we think it will have a similar passive market share as the U.S. had in 2016 (when just over a third of the market was passive). For some perspective, at the end of 2017 around 15% of retail AUM in the Canadian market was in passive products. If the experience of the United Kingdom is any indication, we would expect the growth of passive products in Canada to accelerate in 2018, the point at which the rules surrounding the banning of embedded commissions will be known, and then continue to grow at a fairly high rate over the next several years.

Exhibit 19 Active/Passive (Index Funds and ETFs) Breakdown of Canadian Market Based on Total AUM (2013–26E)



Source: Morningstar Direct—Canadian Open-End & ETF (excluding Money Market and Fund of Funds) data; Morningstar estimates.

Increased Prevalence and Attractiveness of Robo-Advisors and DIY Options

The decoupling of trailing commissions and management fees will also force Canadian investors to make more explicit decisions about if, and how much, they want to pay for investment advice. We expect that many will decide that advice is worth the cost and migrate toward advisors that charge a rate they find acceptable. Advisors may also decide that clients who are too small from an AUM perspective are not worth the cost of their time and resources, which is the reason why a lot of advisors prefer focus on the high-net-worth segment, where account minimums can range from CAD 100,000 to CAD 500,000. This combination of forces should create a collection of investors that are likely to migrate over to cheaper options, including automated investment strategies (primarily robo-advisors) and DIY platforms. The market opportunity for firms that can figure out how to best service this group of investors will likely see a tremendous amount of growth in the first few years following a ban on embedded commissions.

We also believe that a banning of trailer fees will cause more share classes to be created that are free of commissions and other fees, which will expand the options for nonadvised accounts. Canadians DIY investors currently pay reduced versions of the same advisory fees that investors using an advisor do. With a greater prevalence of clean shares—which are similar to ETFs in that they lack trailer fees and other advisor commission payments—likely to come into existence, the financial attractiveness of DIY options would increase. That said, Morningstar currently estimates that the subset of the Canadian population that already uses DIY platforms to invest only has around 17% of their assets, on average, in fund products—and tend to favor ETFs when investing in funds. As such, while the pricing of mutual funds for DIYers is likely to improve, and the prevalence and accessibility of platforms is likely to increase once embedded commissions are banned, we don't expect an increase in the use or number of DIY platforms and/or robo-advisers to be a boon for mutual fund manufacturers in the near to medium term.

Impact of a Ban on Embedded Commissions Will Be Moderated by Strength of the Banks

While these trends—an increased focus on management fees and relative pricing, an increased focus on fund investment performance, an expansion of the use of low-lost products, a more pronounced growth of passive options and an increased prevalence and attractiveness of robo-advisors and DIY Options—are likely to emerge over time once embedded trailers are banned, we also believe they will be moderated to some degree by the power of the Big Six Canadian banks. These institutions are a bedrock of the Canadian economy, and have been involved with regulators, politicians, businesses and communities for decades. They effectively maintain an oligopoly over the Canadian banking system, with the blessing of the regulators and politicians, and we don't see this changing any time soon. In addition to being institutional mainstays, the banks also have the strongest distribution networks in the Canadian market. Expecting the balance of power in the Canadian mutual fund market to increasingly shift to those with distributional power and to those who own the client relationships, we believe the banks, more than any other Canadian institution, are positioned to excel. The Big Six banks have branches across Canada, allowing them to become one-stop shops for many Canadians to take care of their banking and investment needs. And even if clients have a portion of their savings invested outside of the banks, chances are that they still have a relationship with one or more of the Big Six banks.

The banks are also structurally advantaged to offer lower-priced investment products. Because they engage in many different types of business with their clients—such as, mortgage loans, savings accounts, and credit cards—adding wealth management products incurs proportionally fewer distributional costs than it would for an independent distribution network. Because many of the customers who purchase their investment products are already clients of a bank, the acquisition costs for any given customer are lower too. Because of these structural cost advantages, the banks can offer lower-cost products while still being immensely profitable. They can also pay their salespeople less than the average independent advisor, providing them with another form of cost advantage. While there are tradeoffs, such as the likelihood that the most successful advisors with the biggest books of business will be more inclined to run their own businesses independent of the banks (primarily because it would be more profitable for them to do so), the banks do offer the advisors who are employed by them more job security, steadier salaries, and a system where clients simply are more likely to walk through the door.

The Big Six banks are also focused on gaining as much share of their clients' overall "wallet" as possible. The banks are generally more concerned about attracting client assets, and cross-selling multiple products across the full client relationship, than they are about any one product or service, which allows them to be less profitable on any single product (or products) if the relationship overall leads to acceptable returns. This is not to imply that the banks purposefully sell unprofitable products, but rather that they can glean more value from a client relationship than an independent wealth manager or distribution network generally can. As such, we believe the Big Six banks will continue to be cost and market leaders with wealth management products in the Canadian market, which will allow them to exercise their power in different ways. For example, the banks will not be required to offer Vanguard products on their platforms, even if they end up being the cheapest index fund and/or ETF product available, unless their clients change their behavior and demand the lowest-cost products available and/or the banks decide to offer Vanguard products. The Big Six banks could also restructure their advisor compensation packages to favor proprietary funds, or higher priced fund-of-funds offerings, over potentially cheaper options with similar exposures, as embedded commissions are phased out. As such, while we believe the amount of AUM in passive products, and the entrance of new low-cost producers, will increase in Canada once embedded commissions are banned, the influence of the Big Six banks could moderate the overall impact. There is no "natural law" that dictates that the Canadian market must look exactly like the U.S. market, and we are not naive enough to think that the Big Six banks will sit back and let profits dissipate unabated should a ban of embedded commissions take them down that path.

A Best-Interest Standard Seems Less Likely for Now

The implementation of a "best-interest" standard in Canada has been under consideration for years, with the CSA first publishing a paper on the topic in 2012, and following up with a second report, CSA Consultation Paper 33-404, in April 2016. A best-interest, or fiduciary, standard requires that any investment recommendation at a financial planner/advisor makes to a client be both suitable and in the client's best interest. This is a higher standard of care than most Canadian broker/dealers and advisors are held to, with a "suitability" standard, which requires any recommended investment be suitable given the client's circumstances, being the industry norm. While progress on a best-interest standard appeared to be moving forward, the CSA stated in May 2017 that most of the provincial regulators had decided to no longer consider implementing such a standard.[8] While this does not mean that a best-interest standard will never occur in Canada, it does decrease the odds of new regulation anytime soon.

If CRM1 and CRM2 were the first steps in the Canadian regulators push for industry reform, and a banning of embedded commissions is the next likely step, then the implementation of a best-interest standard should be viewed as one step further toward aligning Canadian industry standards with the paths that other developed markets have taken (or are looking to take). In the United Kingdom, for example, there has been a qualified best-interest standard in place since 2007, and as part of the RDR implemented in January 2013, regulators required more robust proficiency requirements for advisors and made clearer the kinds of advice investors could receive from independent and restricted advisors. As for Australia, the regulators introduced a statutory best-interest standard for advisors as part of its FoFA reforms, which went into effect at the beginning of July 2013. And while efforts to impose a fiduciary standard for broker/dealers and financial advisors handling individual retirement accounts in the U.S. have hit a wall, the Securities and Exchange Commission (as well as several states) has begun looking at imposing some form of a best-interest standard for both taxable and tax-exempt accounts.

Although the path to a best-interest standard in Canada originally looked promising, the CSA announced last year that the AMF (financial regulator in Quebec), ASC (financial regulator in Alberta), MSC (financial regulator in Manitoba), and BCSC (financial regulator in British Columbia) all decided to cease work on the proposed regulatory best-interest standard. This meant the regulator only had the support

8 Canadian Securities Administrators. 2017. CSA Staff Notice 33-319 – STATUS REPORT ON CSA CONSULTATION PAPER 33-404. May 11, 2017. http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20170511_33-319_proposals-enhance-obligations-advisers.pdf

of the OSC (financial regulator in Ontario) and the FCNB (financial regulator in New Brunswick) to move forward. The NSSC (responsible for financial regulation in Nova Scotia) and the FCAA (responsible for financial regulation in Saskatchewan) have not officially stopped working toward a best-interest standard but have stated publicly that they have concerns about the latest proposal and would only consider a best-interest standard if substantial revisions were made.

While this means that sweeping reform across all of Canada is unlikely, we wouldn't consider all reform dead on arrival. The OSC remains the most influential provincial regulator in Canada and if the organization decides to move forward with its own best-interest standard it could create operational and political pressure on other provinces to follow suit. And although the other provinces are not pushing for a best-interest standard, they are instituting other "targeted reforms," which could have some effect on the industry. A final wrinkle in the future of Canadian financial regulation will be the creation of the Capital Markets Regulatory System, or CMRA, aimed at streamlining financial regulation across Canada, by end of June.[9] This new regulatory body would swallow up Ontario and five other provinces, and could push for a best-interest standard on its own. While a best-interest standard would be more problematic for the banks than the purer-play asset managers, it looks to be a longer-term issue for now.

Understanding the Competitive Dynamics of the Canadian Asset-Management Industry

In one of our previous research pieces on the Canadian Asset Managers—"Moats for the Canadian Asset Managers Are Narrowing," published in March 2014—we examined the sources of economic moats for the three purer-play Canadian asset managers we cover—IGM Financial, CI Financial, and AGF Management. At the time, we noted that there can be differences in the competitive dynamics of retail fund markets around the globe (even between ones as close as the United States and Canada) due to the manner that investors are served. We also went through the process of cross-checking our own economic moat methodology assessment of the Canadian asset-management industry against Porter's Five Forces framework. Given the regulatory and competitive changes that have occurred over the past four years, as well as our own expectations about the impacts that a ban on embedded trailer fees could have on the positioning of fund manufacturers and distributors in the Canadian market, we decided to revisit our past assessments, while including a broader discussion of the Big Six banks, which have shown a greater willingness to compete more heavily on price to take share in the overall market.

Asset Managers Tend to Have Economic Moats

In our view, the asset-management business is conducive to economic moats, with switching costs and intangible assets being the most durable sources of competitive advantage for firms operating in the industry. Asset managers benefit from a business that is highly scalable and requires little in the way of capital investment, allowing them to produce higher-than-average levels of profitability, with returns on invested capital tending to fall well above their cost of capital. That said, the financial performance of

9 Cooperative Capital Markets Regulatory System. 2016. Capital Markets Regulatory Authority Initial Board of Directors and New Implementation Timelines Announced. July 22, 2016. http://ccmr-ocrmc.ca/capital-markets-regulatory-authority-initial-board-directors-new-implementation-timelines-announced/

the industry is heavily correlated to the direction of both local and global equity markets, with the past two decades demonstrating just how volatile revenue and profitability can be for the asset managers.

The switching costs in the industry might not be explicitly large, but the benefits of switching from one asset manager to another are at times so uncertain that many investors take the path of least resistance and stay put once they've made an investment choice. As a result, money that flows into asset-management firms tends to stay there—borne out by an average annual redemption rate for long-term mutual funds of less than 20% historically in the Canadian market (and 30% in the U.S. market). We believe asset managers can improve on the switching cost advantage inherent in their business with organizational attributes (product mix, competitive fee rates, distribution channel strength and geographic reach) and intangible assets (strong brands and reputation built on solid investment performance and consistent stewardship and culture), especially if they provide a firm with a discernable level of differentiation from their peers.

Although the barriers to entry are not all that significant, it does take time and skill to gather the level of assets necessary to build scale, which tends to provide the larger, more established asset managers with an advantage, especially when it comes to gaining access to (and maintaining placement on) distribution platforms. Companies that have shown an ability to gather and retain investor assets during different market cycles have tended to produce more stable levels of profitability, with returns exceeding their cost of capital for longer periods. While the more broadly diversified asset managers are set up to hold on to assets regardless of market conditions, it has been firms with both solid product sets across asset classes and singular corporate cultures dedicated to a common purpose that have tended to thrive. Asset managers offering niche products with significantly higher switching costs—such as retirement accounts, funds with lockup periods, and tax-managed strategies—tend to have much sticker assets than managers that are focused on products with relatively fewer switching costs.

Strong brands and reputations, in our view, have also been important attributes for the asset managers, as they tend to not only allow firms to attract investors to their funds, but also have allowed them to limit outflows during periods when performance is below benchmarks and category averages. Brand value is influenced more by consistently positive performance and stable asset flows, though, than by heavier bouts of marketing and advertising. Once a brand has been tarnished, it becomes extremely difficult to revive, even with a manager returning to good performance. The same is true of manager reputation, which once lost tends to be cemented in the minds of investors, making it all that more difficult for an asset manager to regain the trust that had once allowed them to attract and retain assets with ease.

In almost all cases, when looking at an asset manager we start out with the notion that it has the potential for an economic moat, built on the switching cost advantage inherent in the industry. How well a firm builds on, or at the very least maintains, that advantage determines whether we award it a wide economic moat or a narrow one (or in some cases a no-moat rating). As we noted above, this requires looking at both organizational attributes and intangible assets, and then determining if they provide a firm with a discernable level of differentiation from its peers.

Exhibit 20 Economic Moat Map for Select U.S.-Based and Canadian Asset Managers

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
U.S.-Based Asset Managers:			USD									
BlackRock	BLK	Wide	6354.4	Positive	Positive	Positive	Positive	Neutral	Positive	Neutral	Positive	Positive
T. Rowe Price	TROW	Wide	1020.0	Positive	Positive	Positive	Neutral	Neutral	Neutral	Positive	Positive	Positive
Invesco	IVZ	Narrow	972.8	Negative	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral
Eaton Vance	EV	Wide	440.1	Neutral	Positive	Neutral	Neutral	Neutral	Positive	Neutral	Positive	Positive
Waddell & Reed	WDR	Narrow	79.2	Negative	Neutral	Negative	Neutral	Negative	Negative	Negative	Positive	Neutral
Canadian Banks:			CAD									
Royal Bank of Canada	RY/RY-TOR	Wide	660.9	Positive	Positive	Neutral	Positive	Positive	Positive	Positive	Positive	Positive
Bank of Montreal	BMO/BMO-TOR	Narrow	439.2	Neutral	Positive	Positive	Neutral	Neutral	Positive	Positive	Neutral	Neutral
Toronto-Dominion	TD/TD-TOR	Wide	348.0	Positive	Positive	Positive	Neutral	Positive	Positive	Neutral	Positive	Positive
CIBC	CM/CM-TOR	Narrow	225.0	Positive	Neutral	Positive	Neutral	Positive	Positive	Neutral	Negative	Neutral
Scotiabank	BNS/BNS-TOR	Narrow	213.1	Negative	Neutral	Negative	Neutral	Positive	Neutral	Negative	Neutral	Neutral
National Bank of Canada	NA-TOR	Narrow	68.0	Negative	Negative	Negative	Neutral	Negative	Negative	Negative	Neutral	Negative
Canadian Asset Managers:			CAD									
IGM Financial	IGM-TOR	Narrow	156.3	Neutral	Positive	Negative	Negative	Negative	Neutral	Negative	Negative	Neutral
CI Financial	CIX-TOR	Narrow	138.8	Neutral	Negative	Neutral	Positive	Negative	Positive	Positive	Positive	Neutral
AGF Management	AGF.B-TOR	None	37.1	Negative	Negative	Negative	Negative	Negative	Positive	Negative	Negative	Negative

Positive Neutral Negative

Source: Company reports and Morningstar estimates.

Whenever we assess the competitive strengths and weaknesses of an asset manager (whether it is a purer-play fund manufacturer or a bank-housed asset-management arm) we tend to focus on the following eight characteristics:

AUM Scale Efficiency

Because of the scalable nature of the asset-management business—where it typically does not cost twice as much in resources to manage twice as much capital—firms with greater levels of AUM tend to have scale advantages. That said, having more (or less) scale is not always a guarantee of higher (lower) levels of profitability. And scale advantages can be quite different among two companies with similar levels of AUM because of differences in not only product mix and fee rates but the expense structures that have been built up to support the level of assets a firm is running. Stepping away from the Canadian market for a moment, primarily because this can be better explained by looking at our U.S.-based asset manager coverage, we see that there is a definitive difference from a profitability perspective between wide-moat T. Rowe Price and narrow-moat Invesco, even though both firms were running close to $1 trillion in AUM at the end of 2017.

T. Rowe Price, which had $991.1 billion in AUM at the end of last year, generated operating margins (EBIT) or around 45% on average during 2013–17—with the average being 45.1% and the median being 45.2%—which was much better than the U.S. group average of 31% the past five years. That said, the firm's operating margins did drop to 43.0% during 2017 because of a 1.5% drop in the company's effective fee rate, as well as increased selling, general, and administrative costs. Now compare this with

Invesco, which had $937.6 billion in AUM at the end of 2017 and has tended to generate operating margins in a 25%–27% range. While both firms came into 2018 with an effective fee rate of 0.472%, there couldn't be a wider divergence in operating results between them.

Exhibit 21 Scale, Operating Profitability (EBIT), and Operating Leverage of Morningstar's U.S.-Based Asset Manager Coverage

Source: Company reports and Morningstar estimates. BlackRock (which had $6.3 trillion in AUM at the end of 2017) was excluded to ensure more visible comparability among firms.

Invesco is far more diversified, with 46% of AUM dedicated to equities, 24% in fixed-income products, 22% in multiasset offerings (including alternatives) and the remainder in money market funds (which is why the ring around its bubble in Exhibit 20 is green). Meanwhile, T. Rowe Price had 66% of its AUM tied to equity funds, 22% in fixed-income and money market funds, and 12% in multiasset offerings at the end of last year (with its heavier equity exposure leading to a red ring around its bubble). Invesco also has a lot more passive AUM (accounting for 21% of managed assets at the end of last year), with T. Rowe Price having no real passive product offerings to speak of.

When looking at organic growth, Invesco generated 1.8% organic growth annually on average during 2013–17 (with a standard deviation of 1.6%), while T. Rowe Price reported annual average organic growth of 0.0% (1.4%). That said, T. Rowe Price's better investment performance profile proved to be a bigger differentiator, with the firm posting an 11.4% CAGR for its total AUM, compared with 7.0% at Invesco, during 2013–17. This (along with a lesser amount of fee compression the past five years) allowed T. Rowe Price to generate 9.7% annual growth on average during 2013–17, compared with Invesco's CAGR of 5.0% during that same time frame.

Exhibit 22 Comparison of T. Rowe Price and Invesco on AUM, Revenue, and Profitability Measures

	T. Rowe Price (TROW)	Invesco (IVZ)
Assets Under Management (12/31/17)	USD 991.1	USD 937.6
Equities (as % of Total AUM)	66.0%	46.0%
Fixed Income/Money Market	22.0%	32.0%
Multi-Asset/Other	12.0%	22.0%
AUM Growth (5-Year CAGR)	11.4%	7.0%
Organic Growth (5-Year CAGR)	0.0%	1.8%
Standard Deviation	1.4%	1.6%
Effective Fee Rate	0.472%	0.472%
Revenue Growth (5-Year CAGR)	9.8%	5.0%
Operating Margin (2017)	43.0%	24.7%

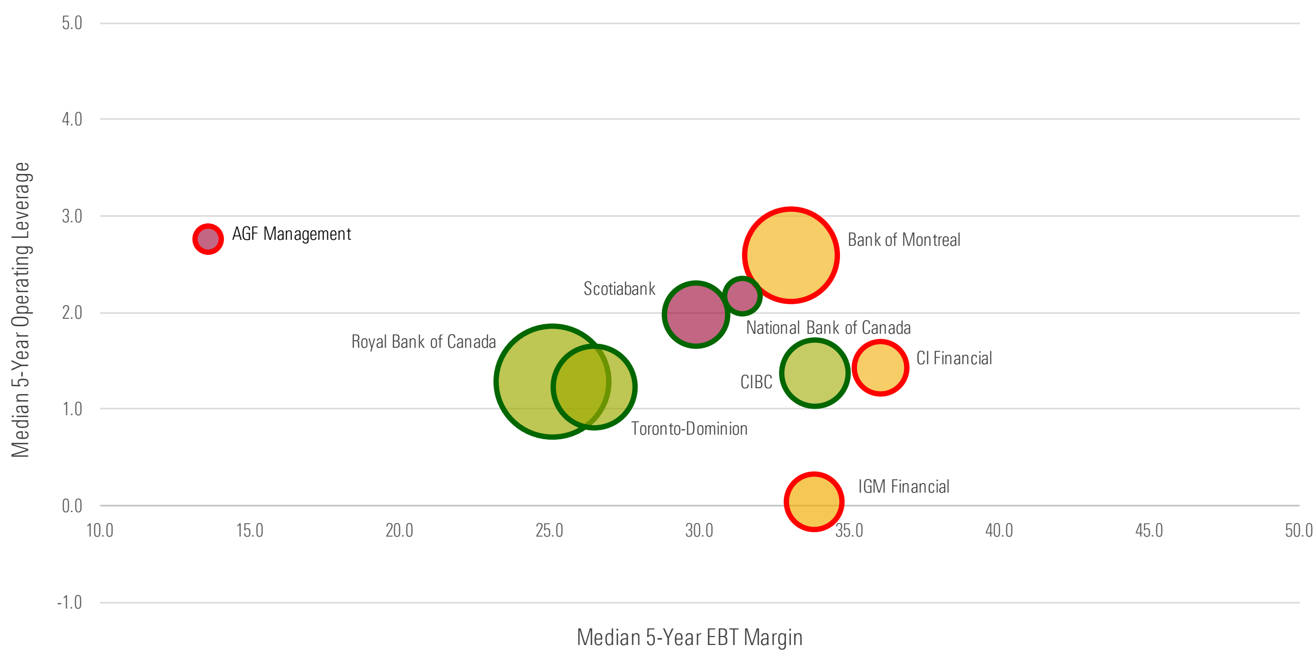
Source: Company reports and Morningstar estimates.

Where we start to see even greater separation between the two firms is in the operating expenses associated with running their operations. Invesco has a lost more retail exposure (with 68% of its AUM sold and maintained via third-party distributors) than T. Rowe Price does, with around 30% of revenue on average each year during the past five years dedicated to distribution and servicing costs (compared with around 3.5% on average at T. Rowe Price). That said, Invesco's compensation costs (at around 28.5% on average during 2013–17) have tended to be lower than T. Rowe Price's (at around 34% on average annually the past five years), which we would argue has been reflected in the quality and consistency of performance at the two firms. But T. Rowe Price is a bit of an anomaly in the industry, generating close to two thirds of its managed assets from retirement accounts and variable-annuity investment portfolios, which tend to be far stickier than retail assets, allowing the company's managers to focus more on long-term performance. This hearkens back to our point that two firms running a similar level of AUM can have different profitability profiles because of differences in product mix, fee rates, and distribution channel strength, as well as the level of compensation required to produce the investment performance needed to gather and retain assets. In most cases, firms with a greater focus on active management will have higher cost structures than those running a greater number of passive portfolios, primarily because of the higher cost associated with the human capital required to run active funds.

While the assessment of the U.S.-based asset managers we cover is straightforward, owing to the fact that they are all independently operated firms, our assessment of the Canadian asset managers we cover has to be a bit more nuanced, given that more than half of them are housed in the Big Six banks. Lacking a fair amount of granularity into the overall product mix, fee rates, distribution channel strength and operating costs of these bank-run operations makes comparability with the three nonbank-affiliated asset managers we cover—IGM Financial, CI Financial, and AGF Management—more difficult. Being housed within the bank also raises the prospect of having some costs borne either by the bank that the asset manager might normally cover, or vice versa, which can throw off comparability even more.

There's also a bit more directionality in our assessment of a firm's AUM scale efficiency, with a worsening track record (like we've seen at AGF Management) getting punished more, especially if we believe it is likely to continue, while an improving trend would be ranked higher.

Exhibit 23 Scale, Operating Profitability (EBT), and Operating Leverage of Morningstar's Canadian Asset Manager Coverage



Source: Morningstar estimates, company reports

Given the limitations of the Canadian asset-management industry, we tend to rely more heavily on our analysts' assessments in determining which firm is more efficient with the scale afforded by its AUM, even as we pay some deference to the bubble chart, which is focused on pretax earnings and operating leverage. This explains why Royal Bank of Canada, Toronto-Dominion, and CIBC rank highly, despite lagging firms like CI Financial, IGM Financial, and Bank of Montreal on a pretax profitability basis. At the end of the day, we're assessing how effective these firms (or in the case of the Big Six banks, their asset-management operations) have been—and will continue to be—at generating appropriate and consistent levels of profitability with the scale afforded by their operations.

Distribution Channel Strength

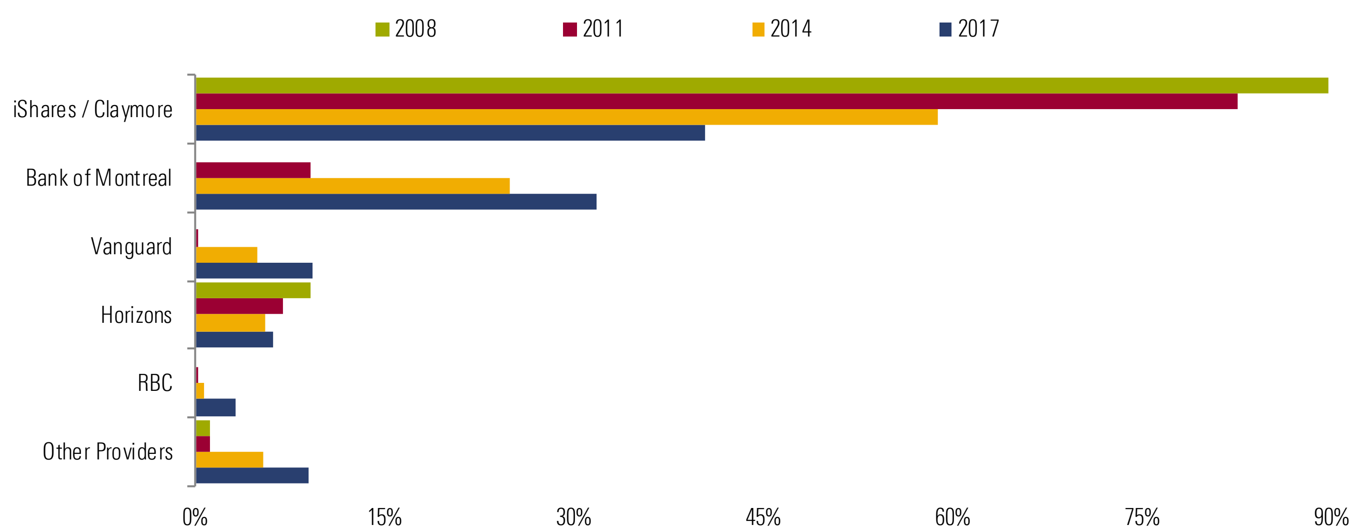
Having a large and effective advisor or branch network and/or strong relationships with brokerage platforms will be a key differentiator in the future, as the balance of power shifts more and more to the distributors in the Canadian market. Unlike the U.S. market, where very few asset-management firms have in-house distribution arms, most of the banks and several of the larger asset managers in Canada have their own captive sales forces. The ability to leverage the strength of their own distribution networks has allowed the Big Six banks to take share from the purer-play asset managers during much of the past decade. As such, we tend to give the Canadian banks higher ratings in this category, with

Royal Bank of Canada, Bank of Montreal and Toronto-Dominion having a stronger position relative to CIBC, Scotiabank and National Bank of Canada. Among the nonbank-affiliated asset managers, only IGM Financial gets a positive rating, due to the contribution provided by its Investors Group distribution arm. While CI Financial does have an in-house distribution network, Assante Wealth Management, it is quite small when compared with some of the larger advisory networks that dominate the Canadian retail market. As part of this assessment, we also factor in the number of client touch points (branches, offices, and number of advisors), what percentage of business comes from in-house distribution versus third-party relationships, and historical and projected organic growth rates.

Passive/Active Capabilities

In both the U.S. and Canadian markets, we believe financial planners and advisors (whether they work for banks or nonbank advisory networks) will focus their future buying activity (assuming embedded commissions get banned) with established providers of passive products and active asset managers that have greater scale, established brands, solid long-term performance, and reasonable fees. Unlike the U.S. market, where passively managed index funds and ETFs each account for one fifth of retail assets, the index fund market in Canada is nascent (with even Vanguard having a very limited presence in the Canadian market) and the ETF market accounts for only 12% of open-end and ETF assets. For firms to succeed on the passive side of the business, they need to not only have a track-record of index investing (which has always been Vanguard's key selling point) but the scale necessary to offer products at attractive price points (at least attractive enough to lure investors away from active funds). More importantly, they'll need access to distribution platforms to get their products into investors' portfolios. As index funds have tended to not offer trailer fee structures in the Canadian market, they've not made much headway historically. But that could change if the regulators ban embedded trailers this year.

Exhibit 24 Market Share of the Five Largest Providers of ETFs in Canada (2008, 2011, 2014, 2017)



Source: Morningstar.

Things have been far different for the Canadian ETF market, which has grown from CAD 18.3 billion in AUM at the end of 2007 to close to CAD 146.6 billion at the end of last year, equivalent to a 23.2% CAGR during 2008–17. What has been even more impressive is the fact that BMO and RBC, both of which had next to nothing in ETF assets at the end of 2007, are now the second- and third-largest providers, respectively, in the market. Wide-moat rated BlackRock/iShares continues to hold the largest share of the ETF business in Canada (having bought its way to the top spot with its purchase of Claymore in early 2012), but BMO has been closing the gap, accounting for 32% of ETF AUM at the end of 2017, compared with BlackRock at 40% (down from 85% after it bought Claymore in 2012). Based on what we're seeing here, as well as what we've seen in the U.S. market over the past decade or so, it looks like BlackRock is having a harder time holding off the bank-housed ETF platforms than it is Vanguard and Invesco/PowerShares (which actually fell out of the top 5 spot this year as RBC zoomed past it) in the Canadian market, much of which we expect is due to the strength of the banks' distribution platforms.

When assessing firms (and bank-housed asset-management operations) in this category, we looked at existing active and passive platforms—including index funds and ETFs—as well as fee competitiveness. As we noted above, BlackRock and BMO dominate the ETF space in Canada (controlling 72% of the market collectively), while Toronto-Dominion and CIBC have established index fund operations that should do well if we see a major push toward low-cost passive investing in the Canadian market (but much of that also depends on how much traction Vanguard, which is the largest provider of index mutual funds in the world, makes in that part of the business). On the active side of the business, we believe that there will always be room for active managers with good investment performance, and view CI Financial as being best suited among the purer-play asset managers we cover to occupy this role. That said, both pricing and performance will play critical roles in any future investment decisions, with the advantage going to firms that can offer solid performing funds at reasonable prices and have the access to distribution required to get products into investors' portfolios.

Product Breadth/Reach

Being able to offer investors a wider array of investment opportunities in more diverse asset classes has tended to not only allow firms to hold on to assets in varying market conditions but provide them with a means of differentiating themselves from their peers. For these rankings, we looked at product category exposures by total AUM, penalizing asset managers with greater amounts of exposure to domestic equities and rewarding firms with higher exposures to more unique asset classes, strategies, and geographies (which should be able to carry higher fee levels for longer periods of time). We also compared exposures to large-cap strategies versus mid-/small-cap strategies, favoring firms with more exposure in the mid-small cap space. While this process was overwhelmingly focused on active strategies (especially those focused on large-cap domestic equity categories), which in our opinion are the most difficult to differentiate, we did weigh in on passive offerings for firms like BlackRock, Invesco, BMO and RBC. We also gave credit to asset managers operating in less crowded and more volatile asset classes, including areas like illiquid debt offerings and emerging markets, where the opportunities exist to outperform (and charge higher fees for said outperformance).

Fund Fee Levels/Disparity

Given the greater level of scrutiny on investment performance and fund management fees we expect to see in the future in the Canadian (and U.S.) market(s), we believe that fund manufacturers with the highest fees (and a lack of performance to justify those fees) will have the most to lose, as lower-cost fund offerings take share, forcing them to lower their fees to remain price competitive. While reduced fees are one of the easiest levers to pull for firms looking to differentiate their products, it comes with both positive and negatives. On the positive side, 10-, 15-, 20- or 25-basis-point reductions in fees would likely lead to a 10-, 15-, 20- or 25-basis-point improvement in annual performance when compared with what performance would have been had there been no fee reduction. On the negative side, fee compression tends to lead to revenue and operating margin compression—that is, absent a large uptick in AUM via increased sales and/or market gains.

For our rankings, we primarily looked at asset-weighted MER percentiles for the Canadian asset managers. We also looked at asset-weighted versus equal-weighted MERs, which in theory could point to a firm benefiting from putting clients in more expensive products (on average), while cheaper products exist in their lineup. There are flaws in this oversimplification, though, so we put a much smaller weighting on this factor; (noting that while in the final tally this extra factor had no effect on overall rankings, National Bank of Canada and BMO did score the worst among the Canadian fund manufacturers). It should be remembered, though, that the Big Six banks in Canada are structurally advantaged in that they can offer lower priced products to investors relative to the purer-play asset managers. In most cases, a higher rating in this category means that a firm has a greater ability to be flexible with pricing, given the positioning of their products, expected organic growth rates and margins.

Fund Fee Diversity/Exposure

For this category, we looked at existing AUM for commission- based, fee-based, DIY, and institutional share classes, and where available estimated the total amount of business an asset manager derived from institutional clients. We gave higher ratings to firms with a greater percentage of their AUM in noncommission-based accounts, which will be the least impacted by a ban on embedded commissions. The pace at which the industry shifts to fee-based accounts will ultimately be determined by the policy recommendations from the CSA should trailer fees get banned, but we believe that fund manufacturers (and advisors) that are much further down that path are going to be better positioned in the near to medium term. We also believe that the use of DIY platforms will likely increase post a ban on embedded commissions. Meanwhile, firms with a greater level of exposure to the institutional channel will also be advantaged, as there are no concerns about embedded commissions and fees tend to be negotiated relative to the size of accounts being managed.

Fund Performance and Reputation

The level of investment performance and the reputation associated with a firm and/or fund will remain extremely important for active managers going forward. A history of outperformance and solid processes can persuade investors to pay higher than average fees. As we noted above, we believe there will always be room for active managers with good investment performance and expect both pricing and performance to play critical roles in investment decisions as we move forward, with the advantage going to asset managers that can not only offer solid performing funds at reasonable prices but have the access to the distribution outlets necessary to get and maintain products in investor portfolios. For this category, we looked at firm rankings based on the Morningstar fund rating (which is a risk adjusted return rating), as well as other rankings of fund performance measurement, to arrive at our final ratings for the Canadian asset managers.

Fund Stewardship and Culture

Better cultures and internal investment processes tend to lead to better and more consistent investment performance, organic growth, and relatively little employee turnover. For this category, we rated firms based on two different Morningstar fund analyst scores—the Culture Grade and the Overall Stewardship Grade—utilized in our North American fund manager research efforts. We then combined the scores from these Morningstar ratings into a final score. Morningstar has studied the relationship between the Overall Stewardship Grade and subsequent returns, showing that there is a positive relationship—largely because of lower fees and better corporate culture grades (while management-incentives tended to show little correlation)—and supporting the notion that stewardship and culture do ultimately matter for returns.[10]

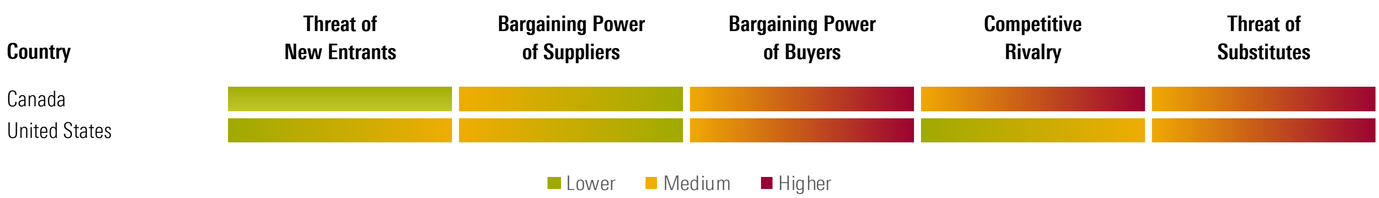
We then assign an overall ranking, which tended to correspond with our moat ratings, for each of the firms we covered in this report. That said, our assessment of an asset manager's moat rating is derived from both qualitative and quantitative metrics, and we tend to fold in an assessment of a firm's historical and future ROICs (which is an easier task with the purer-play asset managers), focusing on both the stability of returns as well as the consistency of a firm's ability to outearn its cost of capital when making our final determination about economic moats. As the bank-housed asset managers are part of a broader organization, not to mention the fact that we have very little return data to measure let alone assess, our evaluation of their asset manager arms tends to be enveloped in our moat rating for the bank that they are part of. We touch on that in more detail in the individual firm breakouts later in this report.

10 Davis, Christopher. 2014. "Stewardship Grades for Canadian Mutual Firms." Morningstar. September 29, 2014. https://direct.morningstar.com/research/doc/29%20Jun%202015_Stewardship_Grades_for_Canadian_Mutual_Fund_702131

Porter's Five Forces Assessment of the Canadian Asset-Management Industry

In considering the competitive positioning of the Canadian asset managers, Morningstar's moat rating methodology focuses on identifying at least one sustainable source of competitive advantage for these firms from five possibilities: cost advantage, customer switching costs, efficient scale, intangible assets (like brands or patents), and network effect. Although we have identified switching costs and intangible assets as the two primary sources of competitive advantage for the Canadian asset managers (much as we do with the U.S.-based firms), we think there is value in looking at the industry from other angles. We think that using Porter's Five Forces framework to asset the competitive environment for companies and their industries is highly complementary to our own methodology, allowing us to add color to our assessment of the Canadian asset-management industry.

Exhibit 25 Porter's Five Forces Map for the Canadian and U.S.-Based Asset Managers



Source: Morningstar.

When looked at through the lens of Porter's Five Forces framework, we note that the balance of power in the Canadian asset-management industry, which continues to be concentrated around the top 10 fund manufacturers, has shifted during the past decade or so, with some of the largest mutual fund distributors morphing into some of the largest manufacturers and, as such, the largest competitors for shelf space. While the market has remained lucrative for most participants, we believe that the banning of trailer fees could shift the balance of power in the Canadian mutual fund industry even more toward the banks and other major fund distributors at the expense of the purer-play asset managers.

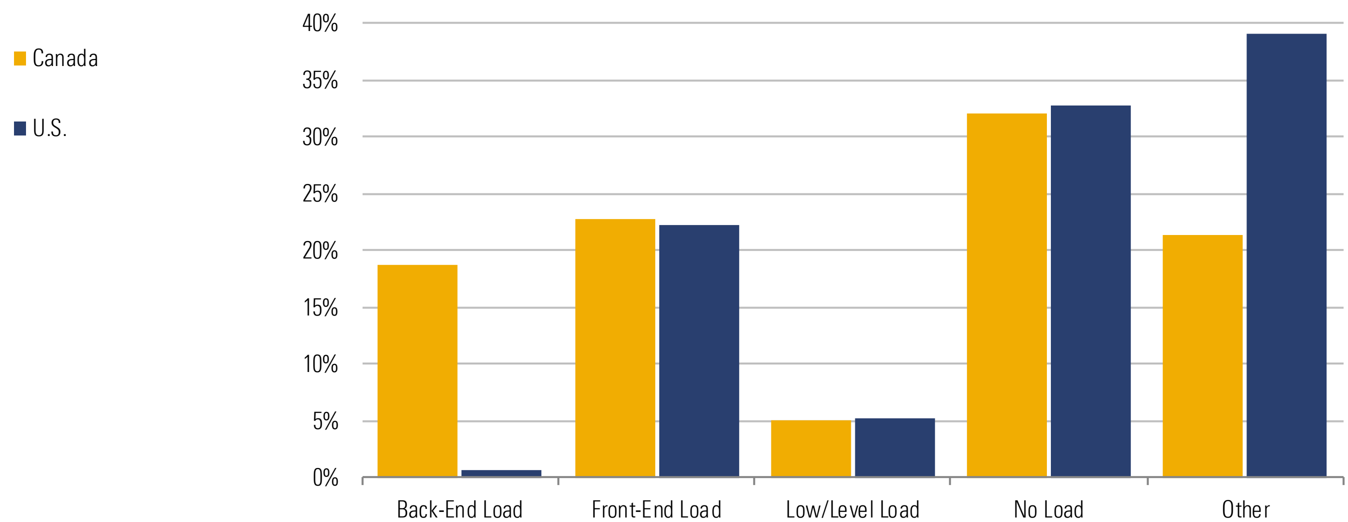
The Threat Posed by New Entrants is Low to Medium

The asset-management industry is highly profitable, requiring little capital investment and generating high returns on invested capital, making it attractive to new competitors. That said, it does takes time and skill to gather the level of assets necessary to build economies of scale, which is required to get consistent and cost-efficient access to distribution. In Canada, third-party distributors—bank branches, full-service brokers, and financial advisors—control most of the distribution and prefer to work with established firms that have solid performing funds and have been willing to maintain traditional fee arrangements between fund manufacturers and advisors. Brand strength, which tends to be influenced by consistently positive performance and stable asset flows, can also play a role in deterring new entrants, especially with Canadian consumers historically being extremely loyal to Canadian brands.

The asset managers have also benefitted from the switching cost advantages inherent in their business, with the average annual redemption rate for long-term mutual funds being less than 20% historically in the Canadian market (compared with 30% on average for the U.S. market). This helps to limit the amount of business that new competitors can take away in any given year. Some of the difference between the long-term redemption rate in the United States and Canada can be explained by the higher preponderance of funds in Canada with deferred sales charges, or DSCs, which impose a declining redemption fee on mutual fund sales made during the first seven years that a fund is held. However, most of it is just plain inertia, which tends to be the biggest driver of switching costs for the industry.

A December 2012 discussion paper the CSA issued, entitled "Canadian Securities Administrators Discussion Paper and Request for Comment 81-407: Mutual Fund Fees," noted that just under 19% of Canadian mutual fund assets were held in a deferred load structure at the end of 2011. This is compared with just over 27% at the end of 2006 and well over 50% in the 1990s. In the U.S., on the other hand, less than 1% of mutual fund assets were held in deferred load structures at the end of 2011 (compared with close to 4% in 2006), based on estimates provided by Morningstar Direct. The decline in the use of deferred load funds in the U.S. started at the beginning of the century but accelerated in 2004–05 after regulators brought enforcement action against brokers who were selling large amounts of Class B shares (which carry deferred sales charges) to investors who would have been better off with Class A shares (with a front-end load that is discounted if investors make a higher minimum initial purchase).

Exhibit 26 Percentage of Industry Mutual Fund Assets Held by Purchase Option (2011) – Canada and United States



Source: Morningstar Direct (U.S.); CSA and Investor Economics (Canada).

As the sale of funds with deferred sales charges waned in Canada, there was a rise in the use of embedded commissions to compensate advisors. Also known as trailer fees, these commissions were intended to compensate dealer firms for the ongoing services that their advisors provide to investors (including investment advice) after a mutual fund is purchased. As trailing commissions in Canada are embedded in the MER, which the mutual fund manufacturer charges rather than being a separate fee to the mutual fund investor, dealer firms and their advisors have been getting paid without their clients ever seeing the bill for their services. This has made their use very attractive to advisors, who generate around two thirds of their annual commission-based compensation from trailer fees (compared with the mid-1990s when sales commissions accounted for the bulk of their annual commission-based compensation). We think this arrangement gave the larger fund manufacturers in Canada an edge, as they were able to use trailer fees to garner shelf space and get advisors to recommend their funds even in cases where a smaller firm that might have better products and/or a stronger performance track record but was offering a smaller (or no) trailer fee.

Another barrier for new entrants has been the tendency of the Canadian market to stifle competition (especially from the outside), with government regulation (such as restrictions on foreign ownership) helping to protect the interests of domestic firms—especially in areas that are big job providers like financial services. With securities regulation handled by both federal and provincial/territorial authorities, manufacturers and distributors of fund products also need to register with multiple regulators in order to establish a true national footprint, leaving them with meaningfully higher setup and maintenance costs. Even with these impediments, U.S.-based mutual fund firms like Fidelity, Invesco, PIMCO and Franklin Templeton have all made inroads north of the border, ranking among the top 25 firms in Canada (based on mutual fund AUM at the end of 2017). On top of that, U.S.-based firms control close to 45% of the Canadian market for exchange-traded funds, with BlackRock's iShares platform continuing to be the largest provider of ETFs in Canada (with a 40% share at the end of 2017).

The relatively stable and lucrative nature of the Canadian mutual fund market has, however, served as a disincentive for the purer-play asset managers to look outside of their home market for growth. The Canadian mutual fund market has grown substantially in the past two decades, increasing in size from less than CAD 100 billion in the early 1990s to more than CAD 1 trillion at the end of 2017, with most market participants benefiting from the growth. Although a few of the purer-play asset managers have made some effort to expand outside of Canada, it pales in comparison with the efforts undertaken by the Big Six Canadian banks and the insurance companies. With most of the larger U.S.- and European-based banks and asset managers pursuing growth in the Asia-Pacific region, as well as the Middle East, where an influx in the number of sovereign wealth funds and wealthy individuals is expected to fuel longer-term growth, we think most of the purer-play Canadian asset managers are going to be in the same boat as smaller U.S.-centric asset managers—left fighting for share in a more mature market.

The Bargaining Power of Suppliers is Low to Medium

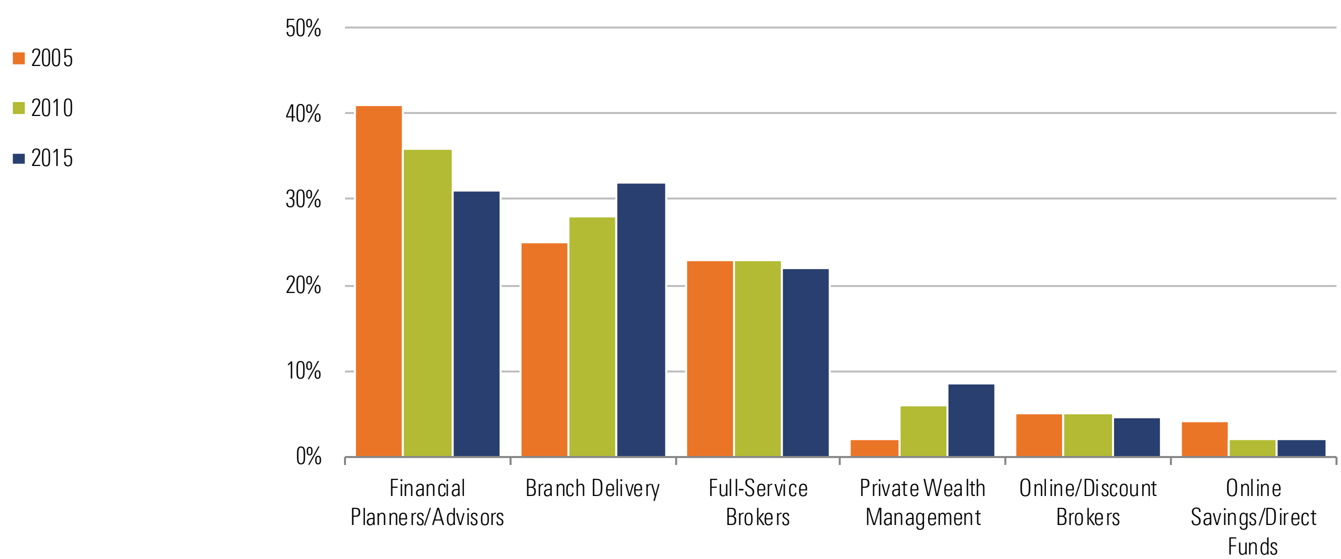
While compensation of investment professionals being the single-largest operating expense for the asset managers, supplier power has not been too onerous. Base and total compensation in Canada remains below U.S. levels, with base compensation accounting for about half of total compensation and the remainder composed of performance bonuses, profit sharing, commissions, and stock awards. Competition for talent can be fierce at times, though. The loss of entire portfolio management teams will potentially have an impact on a firm's ability to hold on to assets—especially in the institutional channel where investors are just as likely to leave in response to management changes as they are when a manager produces consistently poor performance. A good example of this was the disruption created at AGF Management following the 2012 departure of their emerging-markets portfolio management team that included star manager Patricia Perez-Coutts; poached by a U.S.-based asset manager looking to set up shop in Canada. Not only did the team manage close to 10% of the firm's AUM, they were also its biggest driver of gross sales and net inflows, both of which fell off dramatically after their departure.

If there is a positive for the asset managers in relation to supplier power, it is the fact that the asset-management industry is highly scalable. As it typically does not take twice as much staff to run twice as much money, most asset managers experience increases in revenue, and declines in compensation and other expense ratios, as AUM levels rise—that is, as long as fees are stable (or, if they are declining, doing so at a moderate rate). Much of any improvement in an asset manager's profitability depends, though, on the mix of fixed compensation to variable pay (which typically includes compensation tied to changes in AUM levels and/or investment performance). It should also be noted that the operating leverage enjoyed by the asset managers can be a double-edged sword in declining markets, especially if a firm pays out significantly more fixed compensation than variable.

The Bargaining Power of Buyers is Medium to High

In the Canadian market, the key channels for fund distribution are the financial planners/advisors, bank branches, and full-service brokers. In each of these channels, mutual funds may be sold by advisors licensed by the Mutual Fund Dealers Association, or MFDA, while only those that are registered with the Investment Industry Regulatory Organization of Canada, or IIROC, can sell stocks, bonds, ETFs, mutual funds, and options/futures. Financial planners/advisors, which accounted for 31% of retail AUM at the end of 2015, continue to control one of the largest swath of fund assets in the Canadian market, and include a wide range of dealer firms with different degrees of independence and product offerings.

Exhibit 27 Market Share for Fund Assets by Distribution Channel (2005, 2010, 2015)—Canadian Market



Source: 2016 Investor Economics Household Balance Sheet. Investment Funds include stand-alone mutual funds, Canadian-listed ETFs, fund wraps and funds held in fee-based programs.

That said, the branch offices of the Canadian banks, through their front-line advisors (that handle walk-in clients) and dedicated bank branch advisors, have been incredibly busy the past decade, and now control more retail AUM than the financial planners/advisors. The Big Six Canadian banks, especially Royal Bank of Canada and Toronto-Dominion, have some of the most powerful and wide-reaching distribution networks in Canada, which we believe should continue to give them a huge leg up in gathering assets going forward. Full-service brokers meanwhile are the third-largest sellers of mutual funds in Canada (accounting for just over one fifth retail assets) and are structured to serve investors looking for a fuller range of investment services (to include transactions involving equity and fixed income securities, ETFs, options/futures, mutual funds, and segregated funds).

With more than 80% of Canadian mutual funds purchased through financial advisors—whether working as part of or independent of a bank or brokerage firm—we think these buyers (acting as agents for investors) have a significant amount of power over fund manufacturers. We expect the largest networks with the strongest relationships to be able to continue to demand better pricing and performance from the fund manufacturers to stay on their platforms, even as the industry converts to more fee-based account structures once embedded commission are banned. If anything, a ban on trailer commissions will end up giving the distributors, who have the relationships with the clients and, as such, can influence and choose whose products end up in their clients' portfolios, even more power. With advisors expected to seek out active asset managers that have greater scale, established brands, solid long-term performance and reasonable fees—asking for pricing concessions from firms that fall short of these characteristics and using the threat of lower-cost passive products to keep the fund manufacturers in line—we expect the distributors to be firmly in the driver's seat going forward.

That said, the banning of embedded commissions ought to encourage the growth of DIY and/or automated platforms (robo-advisors). Many of the investment options in the Canadian market that do not come with explicit advice (such as those offered on DIY platforms) can still charge similar, albeit often reduced versions of, advisor commissions, limiting the pricing advantage of these products. Once embedded commissions are banned, we expect the pricing advantage, and therefore the attractiveness, of these advisor free products to increase. An increase in the number of clients looking for this type of cheaper "advisory-lite" service should also increase the market opportunity for servicing this segment, which could shift some power over to the suppliers of low-cost functional online platforms. With regards to robo-advisors, we think that these automated platforms are more likely than not to be adopted by the primary distributors of funds in the Canadian market as a way of servicing lower AUM balance accounts in a cost-effective manner (much as they've been in the U.S. the past several years). While the prevalence and accessibility of DIY and automated platforms should increase once trailer fees are banned, we do not believe an increase in the use or number of DIY platforms and/or robo-advisers will necessarily be a boon for mutual funds in the near to medium term, as they are far more suited to deliver market exposure to investors via low-cost passive options—namely, index funds and ETFs.

Competitive Rivalry Is Medium to High

Competition among the manufacturers of mutual funds can be stiff and has traditionally centered on investment performance rather than price as a means of differentiation. That said, with most fund products in Canada sold through financial advisors, the structure of the distribution system has traditionally provided the largest fund manufacturers with a bit of an edge, as they've been able to rely on embedded commissions to garner shelf space and get advisors to recommend their funds even in cases where smaller firms might have better products with a strong performance track record but paying less attractive trailer fees. We believe that the banning of embedded commissions will end up putting a much greater focus on fund management fees and investment performance in the Canadian market and open the door for low-cost index-based products (which have traditionally not offered trailer fee structures) to take greater share from higher-cost offerings, especially in instances where active fund performance does not justify the fees being charged.

As the focus on fees increases, and lower-cost suppliers—like Vanguard and BlackRock/iShares—become more aggressive, competition will heat up for the asset managers in Canada. To some degree, though, we expect this to be somewhat controlled, as no one in the Canadian market (except perhaps Vanguard, which operates under a mutual structure) is incentivized to be the lowest-cost provider. This dynamic, especially in an industry that is so heavily dominated by a banking oligopoly, should help prevent a race to zero in the asset-management industry. That said, we do envision an environment where run of the mill nonbank asset managers resort to 5%–10% annual reductions in active fund management fees in the first few years after embedded commissions are banned, looking to tighten up the gap between their product offerings and passive products (as well as bank offerings).

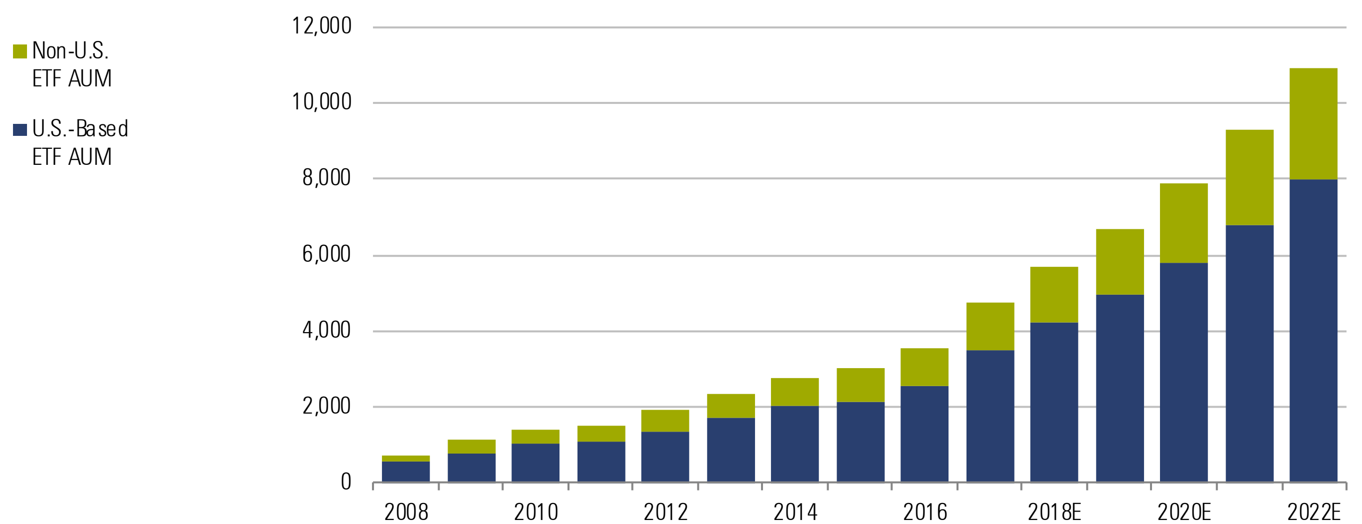
Looking more closely at market share, increased competition from the Big Six banks over the past decade has eaten away at the share of the purer-play asset managers in the Canadian market. Unlike the U.S. market, where most banks and brokerage firms have shuttered proprietary mutual fund operations—primarily to eliminate the appearance of potential conflicts of interest—the Canadian banks (along with a few brokerage firms and insurance companies) have been bulking up their own ability to manufacture funds. As a result, the Big Six banks have seen their share of the mutual fund manufacturing market more than double during the past decade. While some of this has been achieved via the acquisition of purer-play asset managers, like Scotiabank's 2010 purchase of DundeeWealth, the bulk of the increase has come from organic growth driven by their extensive branch networks.

With the Big Six banks continuing to invest heavily in their own asset-management and financial advisory operations, which they hope will serve as a buffer for slowing housing market growth, as well as the volatility inherent in their investment banking and corporate operations (which are closely aligned with the energy and mining sectors), we see a few troubling trends that could have an impact on the purer-play asset managers longer-term. First, the increased size and scale of the banks' fund manufacturing operations have made them bigger competitors for talent, with many purer-plays getting cut out of the market for investment professionals. Second, we think the banks are in a much better position to compete on price over the long run. They're not only some of the largest manufacturers of mutual funds in Canada but are the largest distributors in the market. And while more than two thirds of Canadian funds are sold through distributors with open-architecture, this does not always extend down to the bank branch level, giving proprietary funds a leg up over purer-play products in this channel.

Threat of Substitute Products Is Medium to High

In Porter's view, the existence of products outside the realm of common product boundaries, where the relative price of the substitute products can increase the propensity of buyers to switch, will impact the competitive positioning of existing firms. For the asset managers, this product is ETFs, which have grown dramatically since their introduction, accelerating a trend toward passive investing that started more than two decades ago. While the growth of ETFs is still astounding, with the global market expanding at an 18.8% CAGR during 2008–17E, much of this growth has taken place in the United States, which continues to account for close to three quarters of the AUM invested in ETFs worldwide. At the end of 2017, there was an estimated $3.5 trillion invested in U.S.-based ETFs, accounting for 73.7% of the global market. While Canada's ETF market is significantly smaller, with its end of 2017 AUM of CAD 146.6 billion accounting for just 3.2% of the global market, it has grown (and should continue to grow) at a faster rate than both the U.S. and non-U.S. markets. During 2008–17, Canadian ETF AUM expanded at a 23.2% CAGR, better than both the U.S. and non-U.S. markets at 18.8% and 18.6%, respectively.

Exhibit 28 Actual and Projected Worldwide ETF Asset Levels in U.S. Dollars (2008–22E)

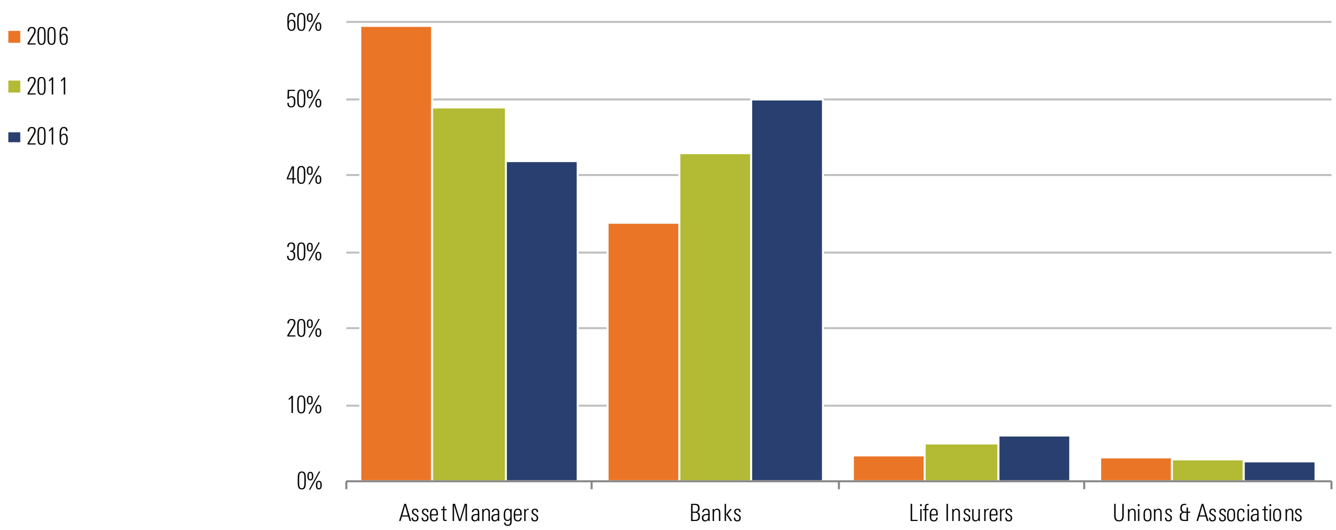


Source: Morningstar Direct; Forward growth projections represent Morningstar's own internal estimates.

Going forward, we expect the Canadian ETF market at a base level to expand at a 20.2% CAGR (during 2018–22), better than both the U.S. and non-U.S. markets at 18.0% and 18.3%, respectively, due to its smaller size and continued growth of ETF offerings from the Big Six banks. That said, a ban on embedded commissions could drive this growth significantly higher in the near to medium term, as a structural impediment to passive products in the Canadian market is finally removed. With investors also likely to call for more open platforms, the threat of substitute products will increase meaningfully in the Canadian market. As some studies have shown, most active market exposures can be recreated through managing factor exposures via low-cost passive products, which tends to be meaningfully cheaper than paying for active management, making a move toward ETFs all that more likely in a market with nothing but fee-based account structures.[11] While Vanguard, Dimensional Fund Advisors, BlackRock/iShares and other passive service providers have not garnered the share of Canadian AUM they have in the U.S., we believe this will change once trailer fees are banned.

Mitigating this to some degree will be the power of the Big Six banks, which we believe will continue to take share from financial planners/advisors in fund distribution and will be responsible for more than 50% of the AUM controlled by the fund manufacturers in the Canadian market. While the banks could shut out these lower cost products, we view this result as less likely as the banks tend to be far more focused on asset gathering and retention than they are on squeezing as much profitability as they can out of their asset-management operations. Besides, in their desire to remain industry price leaders the banks will already need to adjust their own fund management fees downward as nonbank asset managers adjust their own pricing to compete more effectively with low-cost index-based products.

Exhibit 29 Canadian Mutual Fund Assets (Excluding ETFs) by Mutual Fund Manufacturing Category (2006–2011–2016)



Source: Morningstar estimates, CSA and Investor Economics (Canada).

Ultimately, we believe a combination of banks offering these lower cost products explicitly, or offering up their own similarly priced products, will gradually increase the share of passive products in the Canadian market and decrease aggregate fees across the industry. And unlike the purer-play asset managers, the Big Six banks should be more insulated from this shift in the marketplace, as they (a) already have fees that are lower than those charged by the purer-play asset managers and (b) should be able to continue to leverage their distribution strength to their advantage.

11 Pappas, S. & Dickson, J. 2015. Vanguard Research: Factor-based investing. April 2015. https://personal.vanguard.com/pdf/ISGFBI_042015_Online.pdf

Identifying Winners and Losers in a More Competitive Canadian Market

In our past reports on the Canadian asset-management industry, we made several different projections about the industry's near- to medium-term prospects. First, we believed that the balance of power in the industry would continue to shift toward the distributors, many of whom were also fund manufacturers, at the expense of nondistribution aligned fund providers. Second, we expected the Canadian banks, which at the end of 2011 held around 43% of Canada's mutual fund AUM in their own funds, to continue to take share from the purer-play asset managers, due not only to their positioning as core fund distributors but because of their ability to undercut the nonbank fund manufacturers on price. And, lastly, we noted that industry participants would likely see greater fee and margin compression as investors (via CRM2) became far more aware of the true costs associated with fund management and portfolio advice, with fund performance also being put under a much brighter spotlight than ever before.

During our initial run through of the purer-play Canadian asset managers we cover—IGM Financial, CI Financial and AGF Management—in March 2014, we downgraded the economic moat ratings for both IGM Financial and CI Financial to narrow from wide (while keeping AGF Management at narrow). We also downgraded the moat trends for IGM Financial and AGF Management to negative from stable (while leaving CI Financial at stable). These downgrades were based on our belief that the balance of power would continue shifting in the direction of the Canadian distributors that have their own in-house mutual fund manufacturing arms, mainly at the expense of the purer-play asset managers like IGM Financial, CI Financial and AGF Management. This, in our view, would leave all three firms facing various (and at times steep) hurdles in their efforts to attract and retain assets in the Canadian market.

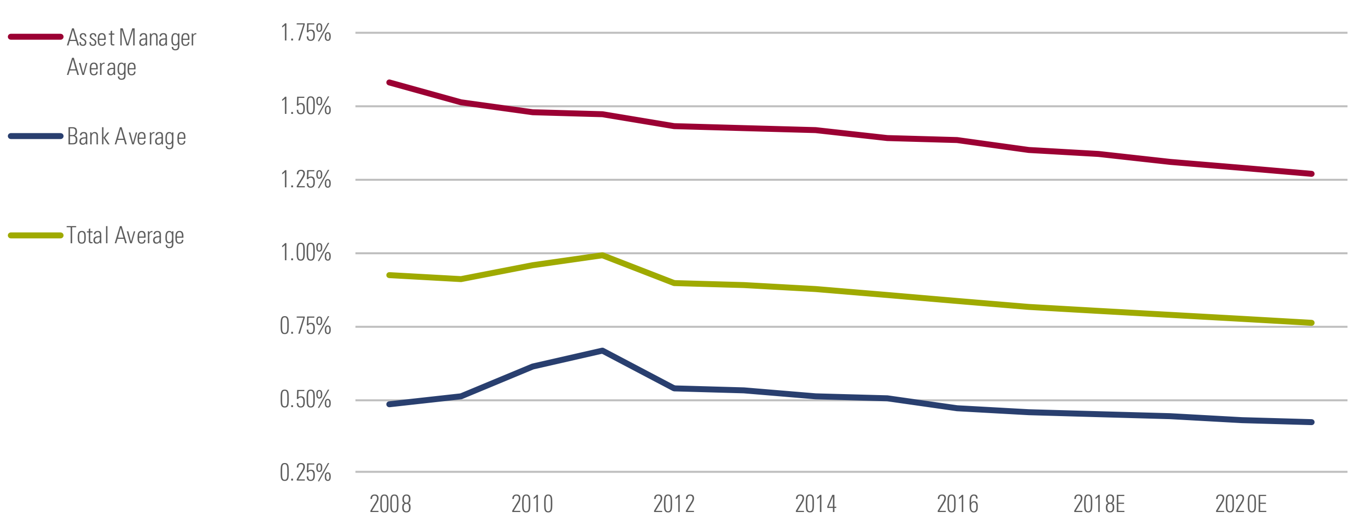
Since that time, we've seen the Big Six banks aggressively take share from the nonbank-aligned fund manufacturers, using their positioning as the price leaders in the Canadian fund market to garner a greater than 50% share. This has pushed the purer-play asset managers to lower management fees to remain competitive on third-party distribution platforms, pressuring both revenues and margins. In hindsight, we were probably not as aggressive as we should have been with our downgrades, as margins at AGF Management declined much more than we anticipated, with sustained bouts of investment underperformance and increased competition weakening the firm's competitive positioning. We should have been much bolder a few years back and taken AGF Management to a no-moat rating, which we ended up doing earlier last year, taking CI Financial's moat trend to negative at the same time.

While we never fully addressed the Big Six banks' economic moats in past reports on the Canadian asset-management industry, these firms are integral to the competitive environment. The banks have positioned themselves as the price leaders in the industry, routinely cutting management (and trailer) fees the past several years to maintain the attractive positioning of their proprietary fund offerings relative to those put forth by the purer-play asset managers in the market. As we noted above, this effort has been rewarded handsomely, with the banks share of the fund manufacturing business increasing from 34% in 2006 to 50% in 2016 (and pushing past 50% in 2017), while the nonbank-affiliated asset managers have seen their share of the market decline from 60% in 2006 to 42% in 2016. We expect fund management fees to continue to decline over the next five years, especially with a ban on embedded commissions putting a greater focus on fund manufacturer investment performance and management fees and envision the Big Six banks maintaining their position as the low-cost leaders in the market.

Another nuance to the pricing picture is that the banks tend not to use deferred sale commission share structures to the degree that the purer-plays asset managers do. This type of share structure involves an up-front commission paid to the advisor out of the manager's pocket, as well as charges to the investor if they withdraw their funds too soon (typically within 7 years). The main advantages of this type of product is that it provides greater incentives for advisors to sell a fund (because of the higher up-front commissions) and it discourages clients from withdrawing their investments (increasing the switching costs advantage for the fund manufacturers). Because these share class structures have tended to encourage sales and reduce overall redemption rates, a banning of embedded commissions would likely depress sales and lead to an overall increase in redemption rates.

Of the purer-play asset managers we cover, we believe that AGF Management has the most financial exposure to these types of products (with 40% of annual cash from operating activities before the payment of deferred sales commissions being paid out as deferred selling commissions on average during 2014–16), followed by IGM Financial (at 26%) and CI Financial (at 17%). While IGM Financial announced in September 2016 that it would discontinue the deferred sales charge purchase option for its Investors Group fund offerings, and reduce fees on its no-load series, at the start of 2017, the firm still paid out 29% of cash from operating activities before the payment of deferred sales commissions as deferred selling commissions last year (compared with AGF Management at 36% and CI Financial at 5%).

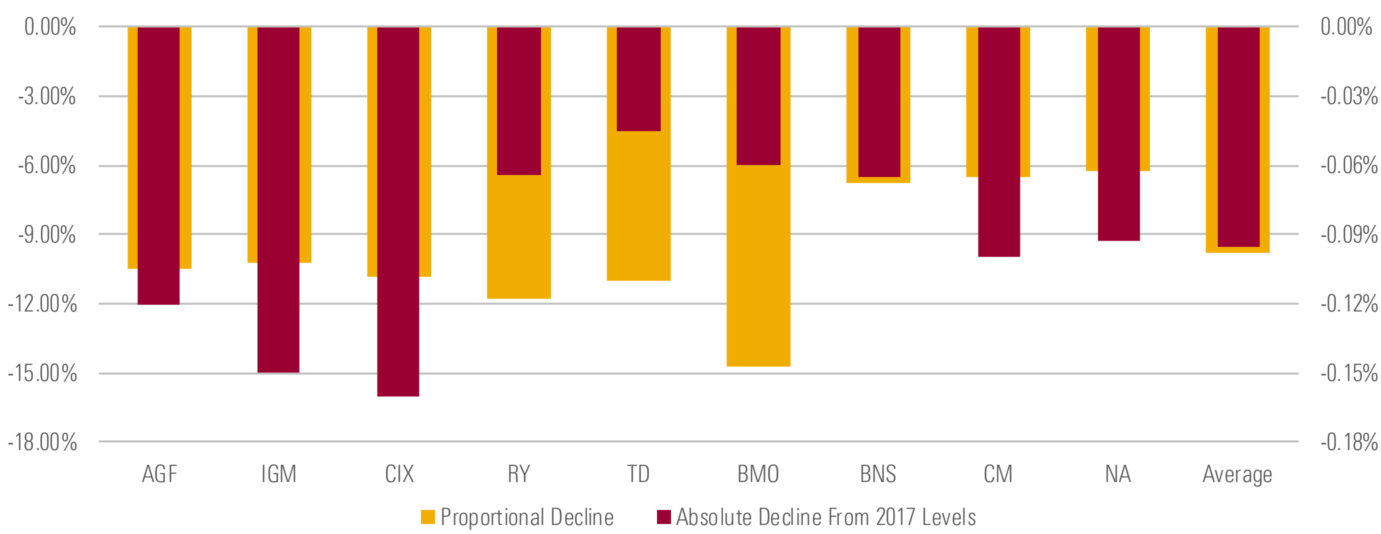
Exhibit 30 Fund Management Fees as a Percent of Average AUM (2008–21E)



Source: Morningstar estimates, company filings.

Overall, we expect industry-level fees to decline anywhere from 10 basis points to 40 basis points over the next five to 10 years, depending on a company's asset mix and the speed and severity of fee declines in response to a ban on embedded commissions. For the nine Canadian fund manufacturers we cover—AGF Management, IGM Financial, CI Financial, Royal Bank of Canada, Toronto-Dominion, Bank of Montreal, Bank of Nova Scotia, CIBC and National Bank of Canada—we are projecting declines in management fee yields of between 6 and 16 basis points during 2018–22. We mapped this out (in Exhibit 30) below, highlighting both the absolute and proportional fee declines we expect to see during our five-year forecast period. The absolute decline (highlighted on the right axis) represents the total basis-decline we expect to see in each fund manufacturers' management fees. The proportional decline (highlighted on the left axis) represents the total basis-point decline of fund management fees divided by the existing fee yield in 2017. On that basis, a 15-basis-point decline would represent a much larger proportional decline for a firm starting at 30-basis-point yield versus one starting out with a 100-basis-point yield. We also note that direct comparisons between the banks and purer-play asset managers on this metric is problematic as firm-level disclosures are not completely comparable.

Exhibit 31 Projected Fee Margin Declines for Canadian Fund Manufacturers Through 2022



Source: Morningstar estimates.

With fees under pressure, distribution will remain key. It is also important to note that advisors do add value for clients, with Morningstar estimating that advisors can add value that is equivalent to a 23% increase in lifetime income for retired clients.[12] While it uncertain how many clients will be better served with automated (and therefore cheaper) advice platforms, we don't believe the answer involves having no in-person advice available. It also remains to be seen if automated advice can keep investors from selling at precisely the wrong time during a downturn or form piling into markets at the peak. We

12 Blanchett, D. Kaplan, P. 2013. Morningstar Investment Management: Alpha, Beta, and Now . . . Gamma. August 28, 2013. https://corporate1.morningstar.com/uploadedFiles/US/AlphaBetaandNowGamma.pdf

believe firms with strong advisor networks, where clients recognize the value being offered and trust and relationships have been developed, will have a significant edge as the ability to be differentiated and price competitive once the manufacturing side of the business becomes increasingly more difficult.

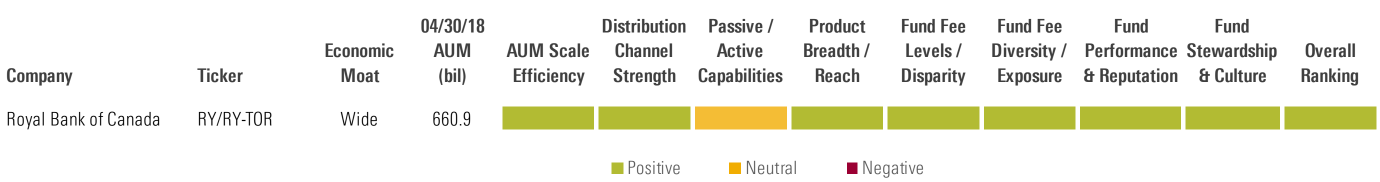
The Banning of Embedded Trailer Fees Will Benefit the Canadian Banks the Most

We view the Big Six banks as being more insulated from the focus that will be put on management fees and investment performance once embedded commissions get banned in the Canadian market as they a) already have fees that are lower than those charged by purer-play asset managers and b) should be able to continue to leverage their distribution capabilities to their advantage. We view wide-moat rated Royal Bank of Canada (with its better active performance reputation and lower fee structures), Toronto-Dominion (which has a solid performance track record, reasonable fees, and an emerging passive product platform), and Bank of Montreal (which has made a strong showing with its ETF platform) as being the best positioned among the Big Six banks on the asset-management front.

Royal Bank of Canada—Wide Economic Moat/Stable Moat Trend

We view RBC's asset-management operations as the best positioned among the nine Canadian firms covered in this report. While the bank will likely see competition from lower-cost passive product providers like Vanguard and BlackRock/iShares, we believe RBC's better active fund performance, ability to offer lower management fees than almost anyone else in Canada, and strong distribution network leaves it well positioned to succeed over the next five to 10 years in the Canadian market.

Exhibit 32 Royal Bank of Canada Ratings Map



Source: Morningstar estimates, company reports.

We believe RBC has many strengths. The bank has the largest amount of AUM among the various fund manufacturers in the Canadian market, has the largest number of financial advisors, has industry leading fee levels (relative to the other Big Six Canadian banks and the purer-play asset managers), has some of the best aggregate fund performance in Canada, and is leading the way with the largest percentage of mutual funds held in fee-based share classes (with more than 15% of open end funds in fee-based structures as of the end of 2017). RBC has consistently been a price leader in Canada, and the bank does not intend to let that status change. Overall, it is difficult to find anything we don't like about RBC's asset-management business, believing that many of the advantages the firm enjoys—especially those resulting from the bank's distributional, scale, and pricing advantages—are sustainable.

RBC has established a strong track record of acquiring and retaining talented investment professionals and asset-management firms. These qualities, combined with industry leading levels of co-investment to align the interests of their managers with investors', as well as management fees that consistently rank among the cheapest in the industry, should allow the firm to deliver an overall positive experience for its fund investors. RBC's investment culture has earned high marks from Morningstar in the past, with RBC Global Asset Management garnering the Morningstar Canada Steward of the Year award in 2016, and PH&N, RBC's fixed-income manager, picking up the fixed-income manager of the year that same year.

The only real issues we can find to note about RBC is that the bank has had only modest success in the passive side of the business, and the firm's management fees do not always compare favorably with some of the low-cost options offered by U.S.-based firms (especially in the ETF market). While RBC has gained some market share within passive, holding 3.2% of the Canadian ETF market at the end of 2017 (making it the fifth-largest domestic provider of ETFs) it has made relatively little headway with index funds (which has been the case for the industry overall due the hurdles imposed by embedded trailer fees). Compare this with Bank of Montreal, which is the second-largest provider of ETFs in Canada (with a 31.8% share) and has a much larger presence in index funds in the country than RBC does.

While the pricing of RBC's index funds and ETFs compares favorably against most Canadian competitors, similar products from U.S.-based firms like BlackRock/iShares and Vanguard have tended to carry lower fees. Given that RBC has been dominant in gathering assets, it doesn't make much sense at this point for the firm to lower fees to Vanguard-like levels. Investors should be aware, though, that there is a sizable gap between RBC's fees on its index funds and ETFs and where the lowest-cost providers are. We believe that as long as RBC can control its distribution and continues to capture a similar or growing percentage of the average Canadian's wallet it should be able to control and adapt to fee pressures as they arise. We currently project that RBC will cut fees by as much as 13 basis points over the next decade, factoring in a 6-basis-point fee decline by 2022. That said, we do expect RBC to increase its AUM at a 5.2% CAGR over the course of our five-year forecast period.

Exhibit 33 Projected AUM Growth and Fee Declines for Canadian Asset Managers

	AUM CAGR 2018-22E	**Fee Declines by 2022**	**Fee Declines by 2027**
Royal Bank of Canada	5.20%	-0.06%	-0.13%
Toronto-Dominion	4.80%	-0.05%	-0.13%
Bank of Montreal	5.60%	-0.06%	-0.15%
CIBC	5.30%	-0.10%	-0.15%
Bank of Nova Scotia	4.00%	-0.07%	-0.15%
National Bank of Canada	4.90%	-0.09%	-0.17%
CI Financial	7.00%	-0.16%	-0.25%
IGM Financial	4.20%	-0.15%	-0.25%
AGF Management	3.90%	-0.12%	-0.20%

Source: Morningstar estimates.

On an overall basis, wide-moat RBC is the second-largest bank in Canada by assets (just behind Toronto-Dominion), and derives two thirds of its revenue from Canada, with the rest spread primarily across the

United States and the Caribbean. We believe the firm has done an admirable job of expanding its nonbank lines of business, running efficient banking operations, and generating some of the best returns for shareholders in the industry. With CAD 5.7 trillion of assets under administration and CAD 660.9 billion in AUM at the end of April, strong global capital markets operations, and a leading share of the domestic banking market, it should remain one of the dominant Canadian banks for years to come. Going forward, we expect RBC to be a steady player in retail and commercial banking, while also generating growth from its global capital markets operations. And, as noted above, we envision the firm continuing to see positive momentum from its asset-management segment, even with the pricing pressures that are likely to be created by the banning of embedded commissions.

Our fair value estimate of CAD 107 ($84) per share assumes that RBC's net interest margin gradually improves over our forecast period, as rates increase in the U.S. and Canada. While we envision average loan and deposit growth of roughly 3% each, our five-year forecast includes an increase in provisioning and charge-offs, as we expect to see some deterioration in the Canadian housing market. That said, our forecast calls for a soft-landing—one that should be much milder than what the U.S. experienced during the 2008–09 global financial crisis. We believe further moves to increase efficiency at RBC, largely through digital initiatives, should translate to improved efficiency ratios, which we expect to improve by around 200 basis points over the next five years. With noninterest income growing at a 4% CAGR during 2018–22, our forecast leads to a 5% (6%) CAGR for operating income (EPS) during our five-year forecast. This should allow RBC to produce an average return on equity of 16%, and an average return on tangible equity of 20%, over this time frame. We expect that much of this is already built into the company's shares, which at current prices are only slightly undervalued.

Toronto-Dominion—Wide Economic Moat/Stable Moat Trend

While Toronto-Dominion's funds haven't generated quite the same level of long-term performance as RBC's funds have, and the firm does have higher exposure to large-cap equity strategies (which we think are more exposed longer term to the growth of index-based products), there is still a lot to like about what Toronto-Dominion has been doing from an asset-management perspective.

Exhibit 34 Toronto-Dominion Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
Toronto-Dominion	TD/TD-TOR	Wide	348.0	Positive	Positive	Positive	Neutral	Positive	Positive	Neutral	Positive	Positive

Positive Neutral Negative

Source: Morningstar estimates and company reports.

If RBC has industry leading fee levels relative to the other Canadian banks and purer-play asset managers, Toronto-Dominion is a close number two, coming in at roughly the 25th percentile for asset-weighted fee levels. Toronto-Dominion also has the largest bank branch network in Canada, and one of the strongest (if not the strongest) domestic retail banking operations in the country, making for solid distributional strength. The bank has gained decent market share in the passive side of the business as well, with its TD Emerald Series offering low prices and a compact product lineup. We also like that the bank does a fair amount of business with institutional clients, limiting some of the impact from the disruption we expect to see in the retail market once embedded commissions are banned. While Toronto-Dominion has only recently begun to enter the ETF space (ranking as the seventeenth largest provider in Canada with just one tenth of 1% of the market from a share perspective), the bank's distributional strength may help them gain some share over time. Combine this with the third largest amount of AUM among the Big Six banks and purer-play asset manager we cover, and we believe that Toronto-Dominion is well positioned for the future.

From a fund performance perspective, Toronto-Dominion has done well, and is only one of two Canadian asset-management firms we cover that has historically had funds that have earned a Gold rating from our North American fund manager research group (with the other firm being RBC). Morningstar's analyst ratings provide a forward-looking assessment of a fund’s ability to outperform its peer group or a relevant benchmark on a risk-adjusted basis over the long run—with Gold-, Silver-, or Bronze-rated funds expected to perform better over time when compared with similar investments. A lower percentage of funds receiving 4- or 5-star overall ratings, though, keeps us from awarding Toronto-Dominion top performance marks. From a cultural standpoint, we like that the bank emphasizes a collaborative environment and encourages long careers for its investment professionals. The company has had above average manager incentives practices as well, requiring managers to invest at least 100% of one year's salary in Toronto-Dominion funds.

If we could find one thing to criticize, it would be the firm's lack of history closing retail mutual funds to new investments due to size constraints, even though Toronto-Dominion does claim to monitor these constraints internally. One of the better U.S.-based managers we cover, T. Rowe Price, regularly closes funds with surging asset bases (especially those where there is limited capacity or liquidity constraints), which aids portfolio managers in their pursuit of consistent above-average investment performance, something we wish a lot more asset managers would do. That said, this is not enough to tarnish Toronto-Dominion, which we believe is well positioned to continue growing its AUM, all while managing fee competition, due to the strength of its domestic distribution network. Taking these factors into account, we expect fee cuts for Toronto-Dominion's asset-management operations to be as much as 13 basis points over the next decade, factoring in a 5-basis-point decline in fees by the end of 2022. We also expect the firm to grow its AUM at a 4.8% CAGR over the course of our five-year forecast period.

On an overall basis, wide-moat Toronto-Dominion is the largest bank in Canada by assets, deriving around 60% of its annual revenue from Canada and another third from the U.S., with the remainder coming from operations in other countries. We think Toronto-Dominion has done a good job of focusing on its Canadian retail operations, capturing a number-one or number-two market share for most key product segments. The bank also has number-two share in business banking in Canada. On top of that, Toronto-Dominion has established a significant presence in the U.S., having the most branches in the U.S. among the Canadian banks via its 42% ownership stake in TD Ameritrade. While we do like the exposure to the U.S. market, the growth it generates will still come with much lower returns on equity for the bank, partially because Toronto-Dominion paid up for its acquisitions in that market. As a major discount-brokerage player, the bank is, however, also positioned to generate additional growth in both markets as investors seek out lower-cost alternatives. We expect the bank to leverage its knowledge of the discount-brokerage industry in Canada, where do-it-yourself investors have had a much harder time finding competitively priced platforms. With CAD 348 billion in AUM at the end of April and maintaining a top-three dealer status in Canada, as well as being the number-one card issuer in Canada, we expect Toronto-Dominion to remain one of the dominant Canadian banks for years to come.

Our fair value estimate of CAD 79 ($62) per share, assumes the bank's net interest margin increases only a few basis points over our five-year forecast period, as rates slowly increase in the U.S. and Canada. We envision average loan growth of 3%–5% annually during 2018–22, as the bank still has room to grow its U.S. wholesale banking presence and nonsecured retail lending in Canada. Our forecast does, however, include increases in provisioning and charge-offs as we expect to see some deterioration in the housing market—noting as we did with RBC that our base forecast is for a soft-landing scenario. We believe further moves to increase efficiency, largely through digital initiatives, should translate to improved efficiency ratios, which we have declining by roughly 150 basis points over the next five years, as noninterest income grows at a 3% CAGR. In sum, our forecasts lead to an EPS CAGR of just over 5%, an average return on equity of 14% and an average return on tangible equity of around 18%. Higher provisioning in the middle years of our forecast, compressing asset-management fees pressure overall wealth management margins, and the fact that extra growth would likely have to come outside of Canada and therefore in lower-return environments, all keep returns on equity from expanding too much over the medium term. While the shares only slightly undervalued at current prices, we would get more interested if they dropped down to a point where we were ensured of a wider margin of safety.

Bank of Montreal—Narrow Economic Moat/Stable Moat Trend

Bank of Montreal has done a good job historically gathering assets and establishing an international asset-management presence. The firm's strength within the Canadian ETF space, with number-two market share (behind BlackRock/iShares), and its ability to gather the second-most AUM among the Canadian banks and asset managers we cover (with CAD 439.2 billion in AUM at the end of April), leads us to believe that these operations will position the Bank of Montreal positively for years to come.

Exhibit 35 Bank of Montreal Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
Bank of Montreal	BMO/BMO-TOR	Narrow	439.2	Neutral	Positive	Positive	Neutral	Neutral	Positive	Positive	Neutral	Neutral

Positive Neutral Negative

Source: Morningstar estimates, company reports.

BMO Global Asset Management has leveraged Bank of Montreal's vast bank branch system to distribute its products and grow into a major player in the mutual fund and ETF markets. Bank of Montreal has the highest amount of its AUM (approximately 10%) coming from ETFs among the firms we cover and accounted for 31.8% of the Canadian ETF market at the end of 2017. The firm's strong market share among passive products (exclusive of strategic beta ETFs) led us to award Bank of Montreal a positive rating for passive capabilities. Bank of Montreal has also done well marketing mutual funds which are fund of funds, investing in their own funds and ETFs. This adds AUM for their own products while also allowing them to charge fees for the fund of fund product.

Although Bank of Montreal is more concentrated in products such as ETFs, which tend to have lower fees than actively managed mutual funds, we have awarded the firm a neutral fee level rating. While Bank of Montreal's ETF products are competitively priced (with only Vanguard and Toronto-Dominion offering lower average price points), the company's mutual funds are hardly a bargain, with the prevalence of fund of fund products pushes prices up even further. Our manager research group has not been a big fan of this business model (which many of the Canadian banks pursue), especially when the fund of funds invests primarily in proprietary funds. The belief is that these products create no value, can add extra fee layers, and make it even less likely for investors to outperform the market, and we don't think the profits generated from this type of business model will be sustainable over the long term.[13]

While rated Bank of Montreal positively on fund performance, we would put RBC and CI Financial (the only two other Canadian firms to receive a positive rating for Fund Performance & Reputation) ahead of Bank of Montreal. Although the bank does have an above average amount of its rated AUM (about 40%) in 4- and 5-star rated funds, it has historically had just Bronze-rated funds (compared with multiple Silver and/or Gold rated funds for several other firms we cover). Taking these factors into account, we expect that the bank's asset-management division could reduce its fees by as much as 15 basis points over the next decade, factoring in a decline of 8 basis points by the end of 2022. We also expect the firm to grow its AUM at a steady pace, generating a 5.6% CAGR for its managed assets during 2018–22.

On an overall basis, narrow-moat Bank of Montreal is the fourth-largest bank in Canada, and derives roughly 70% of its revenue from Canada and nearly 25% from the U.S. The company has a well-established Canadian banking presence, an established U.S. retail operation in the Midwest, and growing commercial and capital markets capabilities. Bank of Montreal is not one of the largest or dominant retail banks in Canada but boasts good share of the domestic commercial lending market and has the lowest relative exposure to residential mortgage loans among its peers, helping to mitigate some of the risks within its loan book. We also like the bank's presence in the U.S., where it has built up respectable deposit market share while avoiding some of the mistakes other Canadian banks have made in their attempts to expand south of the border. As we noted above, Bank of Montreal also has the second-largest amount of AUM among the Canadian banks and purer-play asset managers we cover, with the largest proportion of its revenue coming from wealth-management fees among peers. The firm is also the second-largest ETF provider in Canada (behind BlackRock/iShares).

13 Richard A. Ferri and Alex C. Benke, "A Case for Index Fund Portfolios: Investors holding only index funds have a better chance for success," June 2013.

Our fair value estimate of CAD 105 ($82) per share assumes that Bank of Montreal's net interest margin expands at a slow but steady pace, as rates rise in both the U.S. and Canada. We envision average loan and deposit growth of 4%–5% annually over the next five years. While our forecast includes increases in provisioning and charge-offs, viewing some deterioration in the Canadian housing market as likely over the near to medium term, we are projecting a soft-landing (noting that Bank of Montreal is less exposed to the Canadian mortgage market than its peers). We believe further moves to increase efficiency, largely through digital initiatives, should translate to improved efficiency ratios, which we have declining by 230 basis points over the next five years, as noninterest income grows at a 3% CAGR. Our forecasts lead to around a 6% (6%) CAGR for operating income (EPS), and an average return on tangible equity of 15% during 2018–22. We believe increasing competition in the asset-management industry, slowing growth in Canada, and the fact that additional growth would likely have to come from outside of the Canadian market, will keep returns from expanding too rapidly. At current prices the bank's shares are only slightly undervalued.

Canadian Imperial Bank of Commerce—Narrow Economic Moat/Stable Moat Trend

With competitive fees and some of the highest reported wealth management segment margins, CIBC has grown rapidly into one of the more prominent asset managers in the Canada market. With a smaller advisory network than the largest banks, though, and a history of leveraging embedded commission to gain share, we think the bank will remain in an average position relative to peers going forward.

Exhibit 36 Canadian Imperial Bank of Commerce Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
CIBC	CM/CM-TOR	Narrow	225.0	Positive	Neutral	Positive	Neutral	Positive	Positive	Neutral	Negative	Neutral

Positive Neutral Negative

Source: Morningstar estimates, company reports.

CIBC has managed to translate its smaller scale in the asset-management business into some of the best reported segment level margins, leading to a positive AUM scale efficiency score. That said, the bank's smaller advisory network earns it a neutral rating for distribution channel strength. While CIBC had a history of offering trailer fees that were higher than the industry standard of 100 basis points (to encourage advisors to favor their funds), the practice ended with a round of fee cuts in 2016. By the end of last year, the bank ranked in the 38th percentile for fees on an asset-weighted basis, low enough that it should be able to gather AUM (even without the lure of higher than average embedded commissions).

Performance across CIBC's domestic-equity funds has long been mediocre. While results have looked somewhat better the past few years, the firm still trails the stronger performers in the group—namely, RBC and CI Financial. CIBC does, however, have around a third of its rated AUM in 4- or 5-star funds, above the average for the group, and has historically had a handful of Bronze rated funds, which was enough for us to award it a neutral rating on a Fund Performance & Reputation scale. The bank's positive rating for passive/active capabilities is due to its expanding (and leading) share in the passive mutual fund space (relative to its peers). Taking these factors into account, we currently expect to see CIBC's management fees decline by 15 basis points or more over the next decade, factoring in a 10-basis-point decline during 2018–22. We are also projecting solid AUM growth levels for CIBC, as we believe their index fund gains should help support a 5.3% CAGR for managed assets over the next five years.

On an overall basis, narrow-moat CIBC is the fifth-largest bank in Canada and derives more than 80% of its revenue from Canada. Despite having one of the larger domestic branch networks, CIBC's products haven't typically had top share in Canada, though the bank has made significant strides in multiple categories the past five years. The bank has significantly improved consumer satisfaction ratings, focused on reoptimizing branches and improving internal processes, and has had decent success expanding its wealth operations. As a result, over the past five years, returns on equity have generally been near 18%, often leaving CIBC with a top two ranking within the Canadian market.

Despite these improvements, a couple of items give us reason to pause. First, CIBC has some of the highest concentration in retail loan exposures (particularly uninsured Canadian mortgages) among the Big Six banks. While we don't think the Canadian housing market is at the same place the U.S. market was in 2007 (prior to the collapse of the housing and banking markets in 2008–09), should unemployment levels in Canada increase from here, it would deal a blow to an already highly indebted Canadian consumer, with CIBC being affected far more than of the other Big Six banks. We should also note that the bank remains focused on expanding in the U.S.—aiming to get as much as 25% of its total business from the market over the long run—which would bring some much-needed core banking capabilities to its cross-border clients but keep returns on equity flat to down over the medium term.

Our fair value estimate of CAD 131 ($103) per share assumes that CIBC's net interest margin stays roughly flat initially, with marginal improvements in the later years of our forecast period. We see loan and deposit growth averaging 3% annually. While our forecast includes increases in provisioning and charge-offs, viewing some deterioration in the housing market as likely (with our base case forecasting a soft-landing), CIBC is far more exposed to uninsured Canadian mortgages than its peers. We believe further moves to increase efficiency, such as through digital initiatives, should translate to improved efficiency ratios, although we think management's goal of reaching an efficiency ratio of 55% by 2019 will not come to pass if the housing market deflates. We also have noninterest income growing at a 4% CAGR during 2018–22. In sum, our forecast leads to around a 2% CAGR for EPS, an average return on equity of 14%, and an average return on tangible equity of around 18% over the next five years. At current prices, and assuming our forecast for a soft landing comes to pass, the company's shares currently look moderately undervalued, trading at around 85% of our fair value estimate.

Bank of Nova Scotia—Narrow Economic Moat/Stable Moat Trend

Scotiabank, in our view, has a mix of strengths and weakness that place it in basically an average position for the future. The firm has many of the advantages that come with being a bank, with its fees and distribution strength comparing more favorably with the purer-play asset managers, but relatively average to low strength in other areas lead to a neutral score overall in its asset-management business.

Exhibit 37 Bank of Nova Scotia (Scotiabank) Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
Scotiabank	BNS/BNS-TOR	Narrow	213.1	Negative	Neutral	Negative	Neutral	Positive	Neutral	Negative	Neutral	Neutral

Positive Neutral Negative

Source: Morningstar estimates, company reports.

Scotia Asset Management is a subsidiary of Scotiabank, and most of the funds it offers are products that put an emphasis on the predictability of risk and returns. The funds typically sell through the bank's branch network, where clients tend to be more conservative, investing more in balanced and core funds. Scotiabank's asset managers don't aim for category-topping returns, but rather for solid risk-adjusted results. That said, the bank's risk-adjusted performance has been average to below average. Of the AUM Scotiabank has in Morningstar-rated funds, less than 10% of assets were in 4- or 5-star rated funds. And consistent with the firm's more benchmark like returns, Scotiabank had the second-highest proportion of AUM in 3-star rated funds among the banks and purer-play asset managers we cover. We also note that the bank has not established itself as a key player within passive, leading to a low rating there.

While performance has been less than impressive, Scotia Asset Management's fees are generally within the second-cheapest quintile, which we view as the firm's main strength relative to peers. Given the lower margins and ROE's for Scotiabank's wealth management operations (based on segment level disclosures), though, and having just CAD 213.1 billion in AUM, we've given the bank a negative rating for AUM sale efficiency. Despite being the third largest Canadian bank, roughly half of Scotiabank's operations are overseas, leaving it with far less distributional strength than its domestic peers. While its geographically diverse operations can open up opportunities to sell wealth products to a larger and more diversified client base, potentially leading to more revenue growth longer term, Scotiabank lacks distributional strength overseas as well. Taking these factors into account, we expect the firm to lower fees by as much as 15 basis points over the next decade, factoring in a 7-basis-point decline during 2018–22. We also projecting slightly lower average annual AUM growth of 4% for Scotiabank.

On an overall basis, narrow-moat Scotiabank is the third-largest bank in Canada by assets. The bank is known as Canada's most international bank as it derives 53% of its business line earnings from its international operations—which are comprised of its international banking (32%) and global banking and markets (21%) segments. While the international exposure (which is primarily concentrated in Latin America) provides the bank with higher growth and return opportunities than operations that are focused on more mature markets outside of Canada, it does opens the bank up to more risks. That said, Scotiabank has consistently been one of the most efficient bank-wide operators, and its higher relative level of spending on technology should allow this pattern to continue, giving us confidence that returns on equity near 14%–15% are likely sustainable over the medium term.

Our fair value estimate of CAD 80 ($62) per share assumes that Scotiabank's net interest margin increases at a slow but steady pace, as rates rise in Canada and the U.S., with higher volatility of net interest margins prevailing internationally. We anticipate average loan and deposit growth of 4%–5% most years during our forecast period. While our forecast includes increases in provisioning and charge-offs, viewing some deterioration in the housing market as likely, our base-case forecast is for a soft landing for the Canadian housing market, with the bank having only average exposure to the uninsured domestic real estate market. We believe further moves to increase efficiency, both through digital initiatives and further consolidation abroad, should translate to improved efficiency ratios. Scotiabank has tended to be one of the most cost-focused banks in Canada, and we believe management can meet its goal of a 50% efficiency ratio or better by 2021. We also project noninterest income to grow at a 4.4% CAGR during 2018–22. In sum, our forecast leads to a 6% CAGR for operating income, an average return on equity of 14%, and an average return on tangible equity of 16% over the next five years. At current prices the company's shares are trading at only a slight discount to our fair value estimate.

National Bank of Canada—Narrow Economic Moat/Stable Moat Trend

We view National Bank of Canada as the worst positioned among the Big Six banks. With the second lowest level of AUM among the Canadian banks and purer-play asset managers we cover, and the lowest levels of assets among the Big Six banks, with a less extensive bank branch network than its peers, below average performance and above average fees, we do not envision National Bank of Canada becoming a dominant player in the asset-management industry in Canada anytime soon.

Exhibit 38 National Bank of Canada Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
National Bank of Canada	NA-TOR	Narrow	68.0	Negative	Negative	Negative	Neutral	Negative	Negative	Negative	Neutral	Negative

Positive Neutral Negative

Source: Morningstar estimates, company reports.

National Bank of Canada has carved out a nice banking niche for itself, primarily within Montreal, Quebec City, and Toronto. This smaller footprint, though, means that the distribution power of its bank branch operations is less robust than its larger peers. As a result, the bank has taken a slightly different tack than most of the other Canadian banks, electing to take an equity stake (of 21%) in an existing purer-play asset manager (Fiera Capital, which had CAD 131.4 billion in AUM at the end of March) and operating as an open distribution platform for purer-play asset managers. It has also decided to have much of its fund platform subadvised (primarily by Fiera Capital) rather than employ their own fund managers. As a result, National Bank of Canada's results are primarily determined by their ability to gain advisory relationships within the bank, and then by being able to select and monitor strong subadvisors.

Unfortunately, Fiera Capital has delivered below-average long-term performance for many of the bank's largest strategies. Given the company's investment stake in Fiera Capital, and original agreements to maintain at least 40% of its AUM with the asset manager through 2019, there's not much National Bank of Canada can do for the time being to improve the exposure. Among the more solid stand-alone investment options available to the bank's clients are Westwood Emerging Markets Equity and funds managed by the Cambridge Canadian Equity team. The firm has also retained reputable managers for its fund-of-funds solution (delivered via Meritage Portfolios), including Beutel Goodman, Capital Group, EdgePoint, and CI Black Creek. That said, National Bank of Canada does not compare favorably on fees, being above median levels on average, adding another negative rating to its overall score. While the bank has the potential to be an "open platform hub" for independents looking for better distribution, we expect the distribution strength of the other five large Canadian banks to be maintained. Taking these factors into account, we expect to see fee reductions of at least 17 basis points over the next decade, factoring in a 9-basis-point decline during 2018–22. We're also projecting slightly lower average annual AUM growth for the firm of 4.9% on average per year over the next five years.

Our fair value estimate of CAD 70 per share assumes that National Bank of Canada's net interest margin increase gradually, as rates slowly rise in Canada. We anticipate average loan and deposit growth of 4%–5% most years during our forecast period. While our projection includes increases in provisioning and charge-offs, viewing some deterioration in the housing market as likely, our base-case forecast is for a soft-landing scenario, with National Bank of Canada having much lower exposure to the Canadian markets with the highest housing prices (which should limit the overall impact of a housing market decline). We believe the bank has some room to improve on its current operating efficiency and expect digital initiatives to lead to improved efficiency ratios of over the next several years. We also have noninterest income growing at a 2.4% CAGR during 2018–22. In sum, we believe National Bank of Canada will level out to a sustainable average return on tangible equity of 17% by the end of our five-year forecast period, all while achieving a 5.0% CAGR for EPS during 2018–22. Given the bank's lower exposure to Canadian housing and consistently high returns on equity, the National Bank of Canada's shares look moderately undervalued today compared to our fair value estimate.

A Ban on Embedded Trailer Fees Is More Problematic for the Purer-Play Asset Managers

As for the purer-play asset managers we cover, we believe there will always be room on third-party platforms for active managers with good investment performance, and view CI Financial as being well suited to occupy this role. With a superior long-term investment performance track record relative to both IGM Financial and AGF Management, and more reasonable fees than either of its closest peers, the firm is, in our view, the better positioned purer-play asset manager for longer term investors.

CI Financial—Narrow Economic Moat/Negative Moat Trend

CI Financial is the second-largest nonbank-affiliated asset manager in the Canadian market, with a diverse product mix and proven track record of consistently generating solid investment performance and organic growth. The company had CAD 138.8 billion in AUM at the end of April, and another CAD 42.7 billion in assets under administration, providing it with enough scale to be competitive in the Canadian market. With around 60% of its managed assets by our estimates invested in equity and balanced funds, another 30% invested in fixed-income funds, and the remainder held in alternatives and money market funds, CI Financial also has a fair amount of diversity in its AUM. Adding to that diversification, the company has above average exposure to non-North American investment strategies (which differ from purer large-cap equity and fixed-income funds), and above average exposure to small- and mid-cap strategies, contributing to a more positive product breadth/reach rating.

Exhibit 39 CI Financial Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
CI Financial	CIX-TOR	Narrow	138.8	Neutral	Negative	Neutral	Positive	Negative	Positive	Positive	Positive	Neutral

Positive Neutral Negative

Source: Morningstar estimates, company reports.

CI Financial's key strength over the years has been its ability to generate solid investment performance and organic growth. During the past decade, the company has generally led the entire Canadian mutual fund industry with the most AUM garnering 4- and 5-star ratings from Morningstar. And at the end of 2017, around 60% of CI Financial’s long-term AUM, and 80% of its managed solutions products, were in the top two quartiles on a 10-year basis. This performance track record has tended to provide the firm with top-shelf placement on third-party platforms, leading to a positive average annual organic growth rate of 1.2% during 2013–17. This compares favorably with IGM Financial's Mackenzie unit, which also caters primarily to third-party platforms and produced a 0.74% CAGR for organic growth the past five calendar years. Investors Group, which is IGM Financial's main operating unit, has historically distributed its own proprietary funds through a network of more than 4,000 consultants and reported a 1.0% CAGR for organic growth during 2013–17. Meanwhile, AGF Management, which has been the real laggard in the group, posted average annual retail fund organic growth of negative 7.7% during 2013–17.

CI Financial has come down to earth a bit the past couple of years, though, with a negative 5.0% rate of organic growth in 2016 followed by a negative 1.2% result during 2017, much of which was tied to a period of uncharacteristic underperformance for the company's retail funds. Prior to that period, the firm had generated a 5-year organic growth CAGR of 2.9% on its retail offerings, which was much stronger than Mackenzie's negative 2.6% and AGF Management's negative 10.8% average annual organic growth rates during 2011–15. We should also note that CI Financial's post financial crisis track record of generating organic growth has been weaker than we would have expected given the top-tier positioning of the firm's funds when compared with U.S.-based firms with comparable performance profiles. This exemplifies to us the headwinds that an evolving fund manufacturing and distribution system in Canada has created the past decade, even for firms as well positioned as CI Financial has been.

From an asset-management perspective, CI Financial relies on relatively autonomous in-house management teams and third-party investment advisors. The teams, both external and internal, enjoy wide latitude to manage money as they see fit. CI Financial's relatively light touch frees each manager to maintain distinctive investment cultures with little interference. For their subadvised funds (which includes CI Financial's Black Creek funds), the group gravitates to independent, employee-owned firms with a single, well-defined investment style. The ability to select, hire, and retain top talent, and give these managers the freedom to manage money in their own ways has served CI Financial and its investors well with peer-beating performance. If there was any one weakness to the model, it would be the reliance on these key personnel for their investment expertise. If a key manager were to leave, it could be difficult to replicate the style and process of that previous manager.

While CI Financial has looked to gain a foothold in passive, the firm does not want to compete in the more plain-vanilla index-based parts of this market, where competition can be stiff, and the fees are meaningfully lower. Instead, the firm has looked more to actively managed and factor-based ETF capabilities through its 2015 acquisition of First Asset. The company has also begun building up its own robo-advisor services, which can tap into both its passive and active platforms. While we like the strategic direction of these moves, CI Financial is basically starting from ground zero when compared to others in the field. And while it is possible to be differentiated via active ETF offerings, especially if investment performance is exceptional, there are plenty of other managers coming to market with their own factor-based strategic beta offerings, which could lead to a more crowded niche passive ETF space in the near to medium term, making it harder to differentiate one product offering from another.

On the downside, CI Financial has average to above average fee levels and a lack of distribution strength. For the time being, the company is not aiming to compete on fees, being comfortable with average to slightly above average fee levels. This, in our view, puts more pressure on their ability to generate consistent investment performance. As long as CI Financial can maintain upper echelon levels of performance, there will always be a place at the table. While CI Financial does have its own in-house distribution network, via Assante Wealth Management, the division is quite small when compared with some of the larger advisory networks that dominate the Canadian retail market. IGM Financial's Investors Group, for example, has more than 4,000 advisors, compared with just over 800 at Assante. And the Big Six banks tend to be on the scale of Investors Group as well, with the added advantage of having a branch network in place that can offer additional, and often necessary, services.

Given the generally solid performance of its funds, we expect CI Financial to continue to have a bit of a leg up over its purer-play asset-management peers in the Canadian market. That said, we see several factors pressuring fees in the near to medium term: increased fee transparency following the full implementation of CRM2 in July 2016 (as investors are made more aware of what they are paying for funds), a migration to fee-based accounts (which would be accelerated dramatically if embedded trailer fees get banned), an increased focus on high net worth clients, and a shift toward lower fee products such as index funds and ETFs. Taking all these factors into account, we project that CI Financial's fund management fees could be cut as much as 30 basis points over the next decade, factoring in a 21-basis-point decline during 2018–22. That said, we are forecasting higher AUM growth levels for CI Financial than we are for either IGM Financial and AGF Management (which have higher performance hurdles to overcome), with the company's managed assets expanding at a 7.0% CAGR during 2018–22.

With fee pressures limiting top-line growth to a positive low- to mid-single-digit range on average over the next five years, we expect CI Financial to increase its top line at a 3.2% CAGR during 2018–22. As for profitability, the company been able to fight margin compression better than its peers so far, but pretax margins have generally been down since 2014, and we see this trend continuing as we move forward (driven by both fee compression and a need to spend more money to enhance and maintain distribution and investment performance). Given the operating leverage inherent in CI Financial's business, barring significant outflows or market declines, as long as revenues increase over time the company should be able to keep its margin compression to a minimum (even as the firm commits additional resources portfolio management and to sales and distribution efforts). Taken all of this into consideration, our fair value estimate for CI Financial is CAD 30 per share. With the company's shares currently trading at the lowest price to fair value estimate ratio among the Canadian purer-play asset managers we cover, we'd consider stepping into the shares now (especially at prices below CAD 25.50 per share).

IGM Financial—Narrow Economic Moat/Negative Moat Trend

IGM Financial is the largest nonbank-affiliated asset manager in the Canadian market, with a diverse product mix and both fund manufacturing (Mackenzie Financial) and distribution (Investors Group) arms. The company had CAD 156.3 billion in total AUM at the end of April, providing it with enough scale to be competitive in the Canadian market. Even though the firm has historically generated solid operating margins and maintains a leading share, we've been less than impressed by its investment performance track record and lack of organic growth. This is disappointing, as IGM Financial is structured in a manner that should provide the firm with a sticky set of assets. Armed with a captive salesforce of more than 4,000 advisors, the long-term redemption rate for the Investors Group's segment (which accounts for more than half of IGM Financial's AUM and over two thirds of operating earnings) has averaged less than 9% the past decade. This was much better that the 16% average annual redemption rate at the company's other main segment, Mackenzie Investments (40% of AUM and a fifth of operating earnings), as well as the industry as a whole, which averaged a little over 16%.

Exhibit 40 IGM Financial Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
IGM Financial	IGM-TOR	Narrow	156.3	Neutral	Positive	Negative	Negative	Negative	Neutral	Negative	Negative	Neutral

Positive Neutral Negative

Source: Morningstar estimates, company reports.

These industry leading redemption rates at Investors Group exist despite the group's fund platform having some of the highest fees in the industry (ranking in the bottom third), and the advisory network itself operating within a closed-distribution structure (meaning that the group's advisors have traditionally sold funds managed by Investors Group Investment Management). The main rationale for the higher fees has been that the group's focus on comprehensive financial advice provides extra value for clients. While we agree that most of Investor Group's clients must see value in these services, otherwise the firm's redemption rates would be much higher, we also believe that over time it will be increasingly difficult to justify these higher fees, particularly without good fund performance.

On that front, Investors Group has not fared so well historically. Morningstar ratings for the unit's fund have generally been poor and, while the group's redemption rates are industry leading, investors have not been breaking down the doors to invest with Investors Group, with organic growth averaging just 1% annually since 2012, when the subsidiary decided to cut fees on two-thirds of its funds to drive sales. Since then, Investors Group has lowered fees on several more of its funds and eliminated the back-end load share class from its lineup. While we view these as steps in the right direction, Investors Group remains on the wrong side of the management fee and investment performance equation, and we believe this will eventually put pressure on the firm, despite the strength of its distribution network.

Even so, we continue to view the firm's Investors Group distribution arm as a powerful asset, believing it to be the greatest contributor to IGM Financial's narrow moat, as it increases switching costs and helps increase intangible asset value through the development of long-term retail-advised client relationships. Having control over this valuable distribution network has allowed IGM Financial to participate in another part of the value chain (by way of all the services offered by financial advisors) rather than being a fund manufacturer alone. In essence, the firm has benefited from the strength of its advisor relationships as opposed to relying solely on the strength and consistency of fund performance. Good advisors are able to keep clients from constantly switching products or strategies, as well as from panicking during market upheavals, helping limit redemptions over the long run. This also explains why Investors Group has been able to maintain some of the highest management expense ratios in the industry. What the group needs the most at this point is to improve investment performance, and we believe that IGM Financial's October 2017 decision to combine its Mackenzie and Investors Group fund operations into a single operating unit may help them in that regard (as well as allow the firm to absorb expected fee compression longer term by eliminating duplicate fund offerings and personnel).

While Mackenzie has fared a bit better than Investors Group on the performance front, it has done a far worse job of holding on to assets during the past decade (due in a large part to its lack of distributional power). On the performance front, Mackenzie has struggled to keep up with CI Financial, another key fund manufacturer supplying products for third-party distributors (which has had one of the better investment performance track records in the industry), when it comes to the percentage of funds rated at 4 or 5 stars by Morningstar in any given year. Despite showing some signs of progress on the performance front and cutting fees several times during the past 10 years, Mackenzie is still not competitive with the lowest cost providers in the industry, sitting right in the middle of the pack on an asset weighted MER basis. The lack of distributional strength (being overly reliant on third-party distributors to sell its funds), middling fee levels, and mediocre fund performance (which oscillates between slightly above average to below average depending on the time period) lead us to believe that Mackenzie will also face fee and AUM growth pressures as the industry develops over the next decade.

Overall, we expect future developments in the industry—namely, a move to more fee-based accounts and an increased focus on management fees and investment performance (areas where both Investors Group and Mackenzie have not scored all that well)—to erode some of the switching cost advantages that IGM Financial has historically enjoyed, primarily through its Investors Group advisor network. The company scores poorly on active/passive capabilities (where the firm's CAD 2.2 billion in ETF AUM at the end of April garnered it a market share of 1.5%), product breadth (with Investors Group having some of the highest levels of AUM dedicated to domestic equity strategies among the firm's we cover), and stewardship and culture. While Investors Group has made some positive changes of late, with its management incentive structure having received high marks, it still has a long way to go to fully catch up with some of its peers. Mackenzie has also pursued many different enhancements (such as slimming down product lines, reducing fees, and even offering low-trailer fee options for DIY investors), but without improved performance on a sustained basis they've been less fruitful efforts.

Despite the coming pressures, we note that the balance of power is increasingly shifting toward the distributors, and IGM Financial (via its Investors Group Subsidiary) has one of the few distribution networks that can maintain some level of competition with the banks, which influenced our overall neutral rating for the firm. That said, we still see fees being pressured by several factors in the near to medium term: increased fee transparency following full implementation of CRM2 in July 2016 (as investors are made more aware of what they are paying for funds), a migration to fee-based accounts (which would be dramatically accelerated if embedded trailer fees were banned), an increased focus on high net worth clients, and a shift toward lower fee products such as index funds and ETFs. Taking all these factors into account, we project that IGM Financial's fund management fees could be cut as much as 25 basis points over the next decade, factoring in a 15-basis-point decline during 2018–22. We are also projecting average annual AUM growth of just over 4% during our five-year forecast period.

With fee pressures limiting top-line growth to a positive low- to mid-single-digit range on average over the next several years, we expect IGM Financial to increase its top line at a 2.4% CAGR during our five-year forecast period (with most of this being front-end loaded in 2017). With both commission and noncommission expenses increasing at a greater rate than revenue the past several years, IGM Financial's pretax margins have remained under pressure. We expect this pattern to continue as we move forward, with pretax margins staying range-bound between 30% and 32% of revenue over the course of our projection period. This is down from the 35%–40% during 2004–13, but a reflection of the impact that increased competition and a changing regulatory landscape are having on the firm. Taking all of this into consideration, we arrive at a fair value estimate of CAD 42 per share for IGM Financial's company stock, which at current prices leaves the firm only slightly undervalued.

AGF Management—No Economic Moat/Negative Moat Trend

AGF Management is only about one fourth the size of IGM Financial and CI Financial, the two largest nonbank-affiliated asset managers in the Canadian market, with just CAD 37.1 billion in AUM at the end of April. Sustained bouts of investment underperformance and increased competition have weakened AGF Management's competitive positioning, and the company also relies more heavily on third-party distributors than its peers, putting it more at risk in the current business and regulatory environment.

We believe AGF Management is the weakest positioned of the purer-play asset managers we cover, having the most to lose in a more competitive Canadian market for mutual funds (which is about to be impacted even further by a ban on embedded commissions), and leaving it with the steepest hill to climb to begin reclaiming any sort of competitive positioning.

Exhibit 41 AGF Management Ratings Map

Company	Ticker	Economic Moat	04/30/18 AUM (bil)	AUM Scale Efficiency	Distribution Channel Strength	Passive / Active Capabilities	Product Breadth / Reach	Fund Fee Levels / Disparity	Fund Fee Diversity / Exposure	Fund Performance & Reputation	Fund Stewardship & Culture	Overall Ranking
AGF Management	AGF.B-TOR	None	37.1									

Positive Neutral Negative

Source: Morningstar estimates, company reports.

AGF Management is in a difficult spot. The firm relies on third-party distributors to sell its retail funds, which are below average on pricing and performance perspective, with asset-weighted MERs above the industry median and a higher proportion of its funds on average being rated 1 or 2 stars. As such, the company has had a problem holding on to assets in all channels, as evidenced by the negative 7.9% average annual organic growth rate for its total AUM—which includes retail (negative 7.7%), institutional and subadvisory (negative 11.6%), and high-net-worth accounts (positive 3.2%)—during fiscal 2013–17. The one bright spot has been the firm's high-net-worth operations, which tend to generate positive organic growth in most years, but with the channel accounting for just 15% of AGF Management's total fee-earning assets it hasn't been enough to move the needle.

The company's biggest, and probably more fixable, problem area has been its retail operations, which account for just over half of total AUM and have suffered from poor fund performance much of the past 10 years. While the firm surpassed management's goal of having more than half of its AUM outperforming on a one-year basis, and 60% outperforming on a three-year basis, at the end of fiscal 2017, which has driven outflows to their lowest levels in years, AGF Management will have to demonstrate that it can consistently generate (and improve on) this kind of investment performance to see a sustained improvement in retail flows. With the company's institutional and subadvisory channels running similar portfolios, it was not too surprising to see average annual organic growth of negative 11.6% during fiscal 2013–17, especially given the lumpiness inherent in the institutional channel, not to mention the fact that when consultants turn on asset managers, the outflows can come in buckets.

We continue to believe it will take a sustained bout of investment outperformance for AGF Management to turn organic growth positive on a more consistent basis. History has shown us that it generally takes a firm upward of seven years to recover from a sustained bout of underperformance and outflows, with asset managers needing to demonstrate at a bare minimum that they can generate solid three-year results on a consistent basis before retail-advised and institutional investors are willing to once again commit capital to their funds. With the second-highest exposure to domestic equity strategies, and almost no market share for passive or factor-based strategies (with just CAD 348 million in ETF AUM at the end of April), AGF Management racks up poor scores across the spectrum. While the firm has launched several ETFs featuring strategic beta strategies, we envision the space becoming crowded quickly, making it increasingly difficult to differentiate one product offering from another. These strategies also carry lower fees than more traditional actively managed funds, and as such even if AGF can stop negative flows using such products, the mix shift will result in additional fee compression.

Aside from weaker investment performance and net outflows, AGF Management has also had to contend with investment personnel turnover. During 2014–16, eight portfolio managers and seven analysts left the firm. While the firm has replaced these members of its investment team, hiring some individuals from the outside with either sell-side research experience or international asset-management experience, time will tell if this has an impact on the company's overall culture. With the firm increasing its commitment to existing talent, hiring new talent, merging several funds, streamlining product lineups, adopting more competitive pricing structures, and investing in alternatives and ETF platforms the past several years we would have hoped to have seen better results in the near to medium term. While the company's retail fund operations have started to show better performance of late, they'll have to continue to generate outperformance to see a sustained improvement in flows. Given the weaker competitive positioning of its funds, though, we expect it to take several years before these efforts start to make a meaningful contribution to AGF Management's top and bottom lines.

Taking these factors into account, we project fee cuts of 25 basis points or higher over the next decade, and factor in 15 basis points of declines by 2022. With fee pressures limiting top-line growth to a positive low- to mid-single-digit range on average over the next five years, we expect AGF Management to increase its top line at a 1.3% CAGR during 2018–22. We also envision adjusted EBITDA margins remaining range bound between 22% and 24% of revenue over the course of our forecast period as the competitive environment in Canada pressures fees and profitability for all the nonbank-affiliated asset managers. Taking all of this into consideration, we arrive at a fair value estimate of CAD 7.50 per share for AGF Management, which at current prices leaves it undervalued, but not undervalued enough to get us interested as we hold out for prices below CAD 6.35 per share.

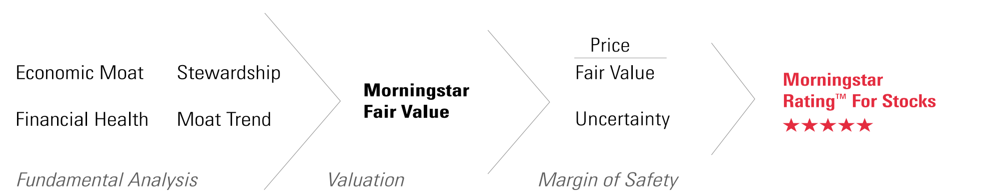
Research Methodology for Valuing Companies

Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Morningstar Research Methodology



Source: Morningstar.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate, and (4) the current market price. This process ultimately culminates in our single-point star rating.

Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward their cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger, stable where we don't anticipate changes to competitive advantages over the next several years, or negative where we see signs of deterioration.

Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value. Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last 5 to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested (RONIC)—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market value weights.

Uncertainty Around That Fair Value Estimate

Morningstar's uncertainty rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The uncertainty rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

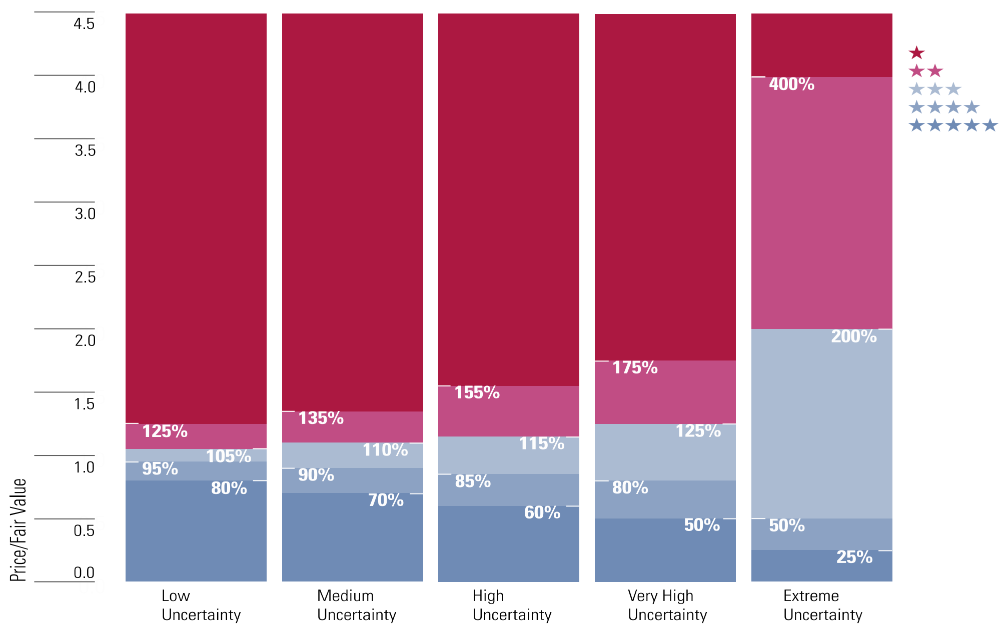
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty regarding the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- Low: Margin of safety for 5-star rating is a 20% discount and for 1-star rating is a 25% premium.
- Medium: Margin of safety for 5-star rating is a 30% discount and for 1-star rating is a 35% premium.
- High: Margin of safety for 5-star rating is a 40% discount and for 1-star rating is a 55% premium.
- Very high: Margin of safety for 5-star rating is a 50% discount and for 1-star rating is a 75% premium.
- Extreme: Margin of safety for 5-star rating is a 75% discount and for 1-star rating is a 300% premium.

Morningstar Equity Research Star Rating Methodology



Market Price

The market prices used in this analysis and noted in the report come from the exchange on which the stock is listed, which we believe is a reliable source. For more details about our methodology, please go to https://shareholders.morningstar.com.

Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically recalculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true, the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience, and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to capital loss.

Risk Warning

Please note that investments in securities are subject to market and other risks, and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in the future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's uncertainty rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

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