

Investing in the Financial Services Sector

FINANCIAL SERVICES SECTOR REPORT

Companies mentioned in this report:

Followed by Edward Jones

- Aflac (AFL-Buy; \$54.22)
- Allstate (ALL-Buy; \$130.78)
- American Express (AXP-Hold; \$169.45)
- American Tower (AMT-Buy; \$266.54)
- Bank NY Mellon (BK-Hold; \$50.99)
- Bank of America (BAC-Buy; \$41.62)
- Berkshire Hathaway (BRK.A-Buy; \$419,134.00)
- Berkshire Hathaway (BRK.B-Buy; \$278.38)
- Blackrock (BLK-Buy; \$874.03)
- Capital One Financial (COF-Hold; \$159.99)
- Citigroup (C-Hold; \$71.55)
- Equity Residential (EQR-Buy; \$78.57)
- Fifth Third Bancorp (FITB-Hold; \$39.50)
- Invesco (IVZ-Hold; \$27.42)
- JP Morgan Chase (JPM-Buy; \$154.05)
- Manulife Financial (MFC-Buy; \$20.02)
- Moody's (MCO-Buy; \$364.99)
- Morgan Stanley (MS-Hold; \$88.40)
- PNC Financial (PNC-Hold; \$193.36)
- Progressive Corporation (PGR-Buy; \$96.85)
- Realty Income (O-Buy; \$68.13)
- Regions Financial (RF-Buy; \$20.60)
- S&P Global (SPGI-Buy; \$412.36)
- State Street Corporation (STT-Buy; \$83.23)
- Synchrony Financial (SYF-Hold; \$49.80)
- The Travelers Companies (TRV-Hold; \$151.72)
- Truist Financial (TFC-Buy; \$56.13)
- T. Rowe Price (TROW-Hold; \$196.71)
- U.S. Bancorp (USB-Hold; \$57.85)
- Wells Fargo (WFC-Buy; \$46.38)

Source: Reuters. Prices and opinion ratings are as of market close on 6/25/21 and are subject to change.

For more information:

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- Financial services companies are critical in ensuring the economy transacts and functions efficiently by sharing responsibility for the general management and transaction of money. Almost all businesses and consumers are users of financial products and services. We believe that over the long term the sector will be driven by a growing global population, globalization of world economies, and market and technological innovations. That said, reform and economic conditions will also likely influence the sector in the near term.
- We recommend investors hold 14% of their equity holdings in financial services stocks. To manage the risks associated within financial services positions, we recommend diversifying financial services portfolios within the different subsectors such as banks, diversified financials, insurance and REITs.
- The financial services sector has been constantly evolving since the financial crisis, and risks are involved when investing in financial companies. Some of these risks include regulation, litigation, deteriorating economic conditions, and a changing business model.

Why Invest in Financial Services Companies?

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

Long-term Outlook

As a result of the aftermath of the financial crisis, many financial services companies are evolving their business models to meet new regulatory and capital requirements. These requirements are intended to strengthen financial positions and mitigate risks, which together should help rebuild investor confidence. As financial services companies continue to strengthen their businesses, we expect positive long-term trends to benefit the strongest companies over time. As a result, we believe there are many attractive long-term investments within the financial services sector.

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Please see important disclosures and analyst certification on page 5 of the report.

Long-term Trends

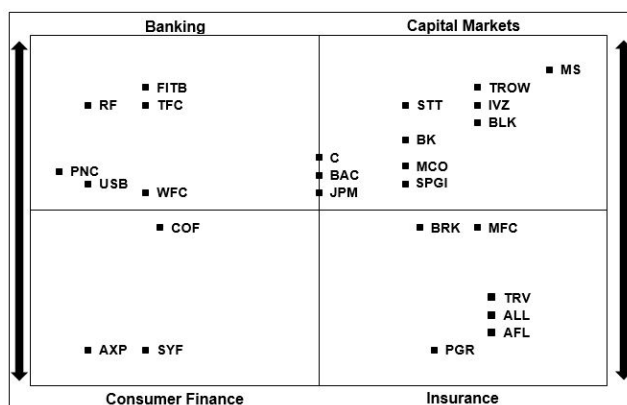
We believe there are three main trends that will positively drive the sector in the long run. These trends are a growing global population, globalization of world economies, and market and technological innovations. As individuals in developed countries live longer, there is an increasing need to save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

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

Understanding the Industry

We break down the financial services industry into four main subsectors: Banks, Diversified Financials, Insurance and REITs. We recommend investors diversify their financial services portfolio by investing in a variety of different companies within the four subsectors. Many financial services companies share similarities with companies in other subsectors. REITs share similarities to asset managers, as both are attempting to maximize finance, and insurance.

Figure 1: Earnings Exposure Matrix of Edward Jones Financial Services Coverage (Excluding REITs)



Source: Edward Jones

Banking

Mega Banks

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

Regional Banks

A scaled down version of large banks, regional banks are locally based institutions that provide a significant portion of the financing required by small businesses, as well as construction and commercial real estate projects within a community. Often times, regional banks are less diversified than the mega banks, deriving a larger portion of revenue from traditional banking activities (borrowing and lending) and a smaller portion of revenue from fee-based business lines (such as investment banking and trading). As a result, regional banks tend to have less exposure to more volatile business segments, making their earnings more predictable relative to larger peers. A long term theme for regional banks is consolidation. Regional banking is often considered a fragmented industry because there are thousands of different community banks across the United States. Industry

consolidation provides an opportunity for these banks to build size and the advantages that come with size. Consequently, we view consolidation as a positive catalyst for future earnings growth and as an opportunity to include regional banks as part of an investment in the financial services sector.

Diversified Financials

Consumer Finance

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

Investment Banks & Brokerage

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

Asset Managers

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

Custody Banks

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

Ratings Agencies

Bond issuers pay ratings agencies to assign a credit rating on their securities, which is an opinion about the ability of the issuer to meet its debt obligations and the likelihood of default. In turn, investors rely on these credit rating to assess and manage risk, typically requiring ratings from two independent ratings agencies per bond. In our view, this process is highly valuable for market participants, making ratings agencies unavoidable gatekeepers to debt capital markets. Collectively, we estimate that S&P

and Moody's account for a dominant portion of all bond ratings in the U.S. and Europe. In addition to issuing credit ratings, ratings agencies offer data and analytics services to asset managers, banks and insurance firms.

Insurance

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

Life Insurers

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

Property and Casualty

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

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

REITs (Real Estate Investment Trusts)

REITs give individuals a way to invest in a diversified portfolio of real estate through the purchase of stock. A REIT typically owns a large pool of properties, manages the properties, and collects rent from tenants. As a general rule, virtually all REITs invest solely in commercial real estate, such as shopping centers and apartment buildings rather than single-family homes. REITs offer many benefits over direct real estate investing, such as diversification by property and geography, liquidity, and flexibility of investment size. REITs provide an investment in real estate that does not require the investor to actively participate in the day-to-day management of the real estate. We believe REITs can be an attractive investment over the long term because the subsector offers diversification benefits within the Financials sector as well as current and rising income.

Valuation

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

Risks

While we believe there are attractive investment opportunities within the financial services sector, it

is important to note, as with all investments, there are some potential risks involved with investing in the sector:

- The potential for high costs related to legal settlements could hurt firm profitability and capitalization, reducing the firms' ability to generate returns and consequently hurting share prices.
- Should financial reform and capital requirements be overly severe and punitive, financial services companies may not be able to grow earnings as they have historically. The result being lower returns on equity and the possibility for negative returns.
- Financial services companies are highly sensitive to changes in interest rates, meaning that greater volatility in interest rates may lead to greater stock-price volatility.
- Financial services companies are highly sensitive to the overall health of the economy. During challenging economic times, the share prices of financial services companies have the potential to be negatively affected.

How to Build a Financial Portfolio

We recommend Edward Jones clients hold 14% of their equity portfolio in financial services stocks. We suggest diversifying across the sector due to the varying opportunities and risk exposures among the companies. As a guideline, investors can look to our Buy-rated financial services stocks on the Edward Jones Stock Focus List and Equity Income Buy List by subsector. Stocks on the Stock Focus List include Bank of America, JP Morgan Chase, Truist Financial, BlackRoc, Aflac, Allstate, Realty Income and American Tower. Stocks on the Equity Income Buy List include JP Morgan Chase, Truist Financial, BlackRock, State Street, Aflac, Equity Residential and Digital Realty Trust. Among the different subsectors within the financial services sector, we recommend investors start with companies in the banking subsector, which tends to be more diversified. After gaining exposure to banking, we recommend employing a balanced approach by adding stocks from the remaining subsectors and price-movement levels.

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

Analyst Certification

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

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Required Research Disclosures

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Other Disclosures

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